

May 28, 2020

Guidance on Small-Dollar Loans

Federal Reserve, FDIC, NCUA and OCC Issue Interagency Lending Principles for Offering Responsible Small-Dollar Loans

BACKGROUND

On May 20, 2020, the Federal Reserve, FDIC, NCUA and OCC issued Interagency Lending Principles for Offering Responsible Small-Dollar Loans (“*Lending Principles*”).¹

This issuance follows a separate statement by the Agencies, along with the CFPB, encouraging banks, savings associations and credit unions to offer responsible small-dollar loans² to consumers and small businesses in response to COVID-19.³ The press release for the Lending Principles states that the Agencies “recognize the important role that responsibly offered small-dollar loans can play in helping customers meet their ongoing needs for credit . . . including during periods of economic stress, natural disasters, or other extraordinary circumstances such as the public health emergency created by COVID-19.”⁴ However, the release makes clear that the Lending Principles are not just a reaction to the circumstances created by COVID-19, but a culmination of the Agencies’ thinking on “the evolving conditions and products in the small-dollar loan markets over the last several years.”⁵

SUMMARY OF LENDING PRINCIPLES

The Lending Principles are intended to encourage supervised banks, savings associations and credit unions (collectively, “*financial institutions*”) to offer responsible small-dollar loans to customers for both consumer and small business purposes. They do not apply to non-bank lenders, whether affiliated with financial institutions or otherwise, but could apply to U.S. branches and agencies of foreign banks. The Lending Principles cover a variety of small-dollar loan structures that may include open-end lines of credit with applicable minimum payments or closed-end loans with appropriate shorter-term single payment or longer-term installment payment structures. They do not address financial institution overdraft programs or credit cards.⁶

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The Agencies note that responsible small-dollar loan programs generally reflect the following characteristics:

- A high percentage of customers successfully repaying their small-dollar loans in accordance with original loan terms, indicating affordability, eligibility and appropriate underwriting;
- Repayment terms, pricing and safeguards that minimize adverse customer outcomes, including cycles of debt due to rollovers or reborrowing; and
- Repayment outcomes and program structures that enhance a borrower's financial capabilities.⁷

The Agencies encourage financial institutions to refer to certain core lending principles when implementing policies and risk management practices for small-dollar lending activities. These core lending principles include the following:

- Loan products are consistent with safe and sound banking, treat customers fairly and comply with applicable laws and regulations.
- Financial institutions effectively manage the risks associated with products they offer, including credit, operational and compliance.
- Loan products are underwritten based on prudent policies and practices governing the amounts borrowed, frequency of borrowing and repayment requirements so as to facilitate successful repayment of the loans, rather than reborrowing, rollovers and collectability in default.⁸

Further, the Agencies state that reasonable loan policies and sound risk management practices and controls for responsible small-dollar lending, whether offered directly by the financial institution or through third-party relationships, would generally address the following:

- **Loan structures:** Loan amounts and repayment terms that align with eligibility and underwriting criteria and that promote fair treatment and credit access of applicants, and product structures that support borrower affordability and successful repayment of principal and interest/fees in a reasonable time frame.⁹
- **Loan pricing:** Loan pricing that complies with applicable state and federal laws and reflects overall returns reasonably related to the financial institution's product risks and costs.¹⁰
- **Loan underwriting:** Analysis that uses internal and/or external data sources, such as deposit account activity, to assess a customer's creditworthiness and to effectively manage credit risk. Such analysis may facilitate sound underwriting for credit offered to "non-mainstream" customers (*i.e.*, those who may not meet a financial institution's traditional underwriting standards) or customers temporarily impacted by natural disasters, national emergencies or economic downturns. Underwriting can also use effectively managed new processes, technologies and automation to lower the cost of providing responsible small-dollar loans.¹¹
- **Loan marketing and disclosures:** Marketing and customer disclosures that comply with consumer protection laws and regulations and provide information in a clear, conspicuous, accurate and customer-friendly manner.¹²
- **Loan servicing and safeguards:** Processes that assist customers in achieving successful repayment while avoiding continuous cycles of debt and significant credit costs due to rollover or reborrowing. For customers who experience distress or unexpected circumstances affecting their ability to repay small-dollar loans, such processes may include timely and reasonable workout strategies. Such processes could also include restructuring single-payment loans or open-end lines of credit into installment loan structures in appropriate circumstances.¹³

POTENTIAL IMPACT

According to Federal Reserve research, 37% of U.S. adults in 2019 would borrow, sell something or not be able to pay if faced with a hypothetical \$400 expense. It is not surprising then that one in five U.S. adults reported using alternative financial services, such as payday loans, through providers other than traditional banks and credit unions.¹⁴ As concerns have been raised about payday loans¹⁵ and the CFPB has taken steps in recent years to limit payday lending,¹⁶ small-dollar loans by financial institutions may present an appealing alternative.

Similarly, small businesses, due to their size, “closely resemble consumers in their financing needs and behaviors,” including by seeking small loans.¹⁷ However, historically, banks may be less willing to make such loans due to their typically higher underwriting costs and, as a result, small business often turn to consumer alternative financial services providers, such as payday lenders.¹⁸ As the Agencies encourage financial institutions to offer small-dollar loans to small businesses, and with the issuance of the Lending Principles, this may change.

Further, the Lending Principles note the potential for using new technologies when providing small-dollar loans—possibly a reference to recent interest in bank-fintech partnerships in the small-dollar lending space.¹⁹ Such partnerships would combine the experience of financial institutions with the innovation of fintech firms, and possibly ameliorate shortcomings that have been observed with respect to nonbank online lenders, including lack of transparency in website disclosures.²⁰

To incentivize depository institutions to engage in the small-dollar lending space, the CFPB also recently approved a No-Action Letter (“NAL”) template that insured depository institutions can use to apply for a NAL covering their small-dollar products. The CFPB explains that the issuance of the NAL template is intended to provide a mechanism through which deposit-taking institutions subject to the CFPB’s supervisory and enforcement authority may obtain a NAL that “addresses the application of the prohibition on unfair, deceptive, and abusive acts and practices to described aspects of their particular small-dollar lending products.”²¹ The template includes protections for consumers, such as a prohibition on late payment fees or prepayment penalties.²²

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ENDNOTES

- 1 Agencies, *Interagency Lending Principles for Offering Responsible Small-Dollar Loans* (Mar. 20, 2020), available at <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200520a1.pdf>.
- 2 The Lending Principles do not define “small-dollar loan.” The FDIC’s Small-Dollar Loan Pilot Program, which ran from 2008 through 2009 studied loans made by banks in the amount of \$2,500 or less. FDIC, *A Template for Success: The FDIC’s Small-Dollar Loan Pilot Program* (2010), available at <https://www.fdic.gov/bank/analytical/quarterly/2010-vol4-2/fdic-quarterly-vol4no2-smalldollar.pdf>.
- 3 Agencies and CFPB, *Federal Agencies Encourage Banks, Savings Associations and Credit Unions to Offer Responsible Small-Dollar Loans to Consumers and Small Businesses Affected by COVID-19* (Mar. 26, 2020), available at <https://www.fdic.gov/news/news/press/2020/pr20039.html>.
- 4 Agencies, *Joint Press Release: Federal agencies share principles for offering responsible small-dollar loans* (May 20, 2020), available at <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200520a.htm>.
- 5 See Lending Principles at 1. The Agencies had previously adopted separate and conflicting guidance on small-dollar loans; the Lending Principles are intended to provide uniform principles for all financial institutions. For instance, to address conflicts with previous guidance, the FDIC will rescind two letters, from 2007 and 2013, and make technical corrections to its guidance from 2015. FDIC, *Fact Sheet: Regulators Issue Guidance for Offering Responsible Small-Dollar Loans* (May 20, 2020) (“*Fact Sheet*”), available at <https://www.fdic.gov/news/small-dollar.pdf>.
- 6 Lending Principles at 1.
- 7 Lending Principles at 1–2.
- 8 Lending Principles at 2–3.
- 9 Lending Principles at 3.
- 10 Lending Principles at 3.
- 11 Lending Principles at 3–4. The guidance refers to the guidance released earlier this year relating to the use of alternative credit underwriting information in the Interagency Statement on the Use of Alternative Data in Credit Underwriting (Dec. 3, 2019). FIL-82-2019 (Dec. 13, 2019), available at <https://www.fdic.gov/news/news/financial/2019/fil19082.html>.
- 12 Lending Principles at 4. Applicable laws and regulations may include the Equal Credit Opportunity Act, the Truth in Lending Act, Section 5 of the Federal Trade Commission Act and Section 1036 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. *Id.*
- 13 Lending Principles at 4.
- 14 See Federal Reserve, *Report on the Economic Well Being of U.S. Households in 2019* (May 2020), pp.21, 27, available at <https://www.federalreserve.gov/publications/files/2019-report-economic-well-being-us-households-202005.pdf>.
- 15 In a 2013 white paper, the CFPB concluded that many consumers who turned to payday loans or deposit advances were “unable to repay their loan in full and still meet their other expenses. Thus, they continually re-borrow and incur significant expenses to repeatedly carry this debt from pay period to pay period. For both products, the high cost of the loan or advance may itself contribute to the chronic difficulty such consumers face in retiring the debt.” CFPB, *Payday Loans and Deposit Advance Products: A White Paper of Initial Data Findings* (Apr. 24, 2013), pp. 43–44, available at https://files.consumerfinance.gov/f/201304_cfpb_payday-dap-whitepaper.pdf.

ENDNOTES (CONTINUED)

- ¹⁶ In 2017, the CFPB issued a final rule governing “the underwriting of certain personal loans with short term or balloon-payment structures” (*i.e.*, payday loans). CFPB, *Executive Summary of the Payday, Vehicle Title, and Certain High-Cost Installment Loan Rule* (Oct. 5, 2017), available at https://files.consumerfinance.gov/f/documents/201710_cfpb_executive-summary_payday-loans-rule.pdf. The rule requires that, before making such loans, a lender “must reasonably determine that the consumer will be able to make the payments on the loan while also meeting major financial obligations and basic living expenses without needing to re-borrow over the next 30 days” (“*mandatory underwriting provisions*”). *Id.* at 3. The rule also sets out requirements regarding principal step-down options for certain covered short-term loans, payment withdrawals from consumers’ transaction accounts, record retention and compliance programs. *Id.* at 4–7. However, in 2019, the CFPB proposed rescinding the mandatory underwriting provisions and, in the meantime, delayed the compliance date of the mandatory underwriting provisions from August 19, 2019 to November 19, 2020. CFPB, *Payday, Vehicle Title, and Certain High-Cost Installment Loans; Delay of Compliance Date; Correcting Amendments* (June 6, 2019), 84 Fed. Reg. 27907.
- ¹⁷ Claire Kramer Mills, Jessica Battisto and Scott Lieberman, Federal Reserve Bank of New York Outreach & Education Function, *Growing Pains: Examining Small Business Access to Affordable Credit in Low-Income Areas* (Dec. 18, 2019), available at <https://www.federalreserve.gov/publications/2019-november-consumer-community-context.htm>.
- ¹⁸ *Id.*
- ¹⁹ See, e.g., American Banker, *BankThink: There’s a better way to regulate small-dollar lending* (Dec. 4, 2019), available at <https://www.americanbanker.com/opinion/theres-a-better-way-to-regulate-small-dollar-lending>.
- ²⁰ For a discussion of these shortcomings, see Barbara J. Lipman, Federal Reserve Board Division of Consumer and Community Affairs, and Ann Marie Wiersch, Federal Reserve Bank of Cleveland Community Development Department, *Search for Small Business Credit Online: What Prospective Borrowers Encounter on Fintech Lender Websites* (Dec. 18, 2019), available at <https://www.federalreserve.gov/publications/2019-november-consumer-community-context.htm>.
- ²¹ CFPB, *CFPB Takes Action to Help Struggling Homeowners Seeking Mitigation Efforts; Consumers Seeking Small-Dollar Loans* (May 22, 2020), available at <https://www.consumerfinance.gov/about-us/newsroom/cfpb-helps-struggling-homeowners-seeking-mitigation-efforts-consumers-seeking-small-dollar-loans/>; CFPB, *BPI NAL Template* (May 22, 2020), p.2, available at https://files.consumerfinance.gov/f/documents/cfpb_bpi_no-action-letter.pdf.
- ²² BPI NAL Template.

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