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Guidelines for Affordable Small Dollar Loans

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As public awareness of the dangers of payday loans grows, new small dollar loan programs are cropping up that promise to be more affordable. Some payday alternatives live up to that promise. Others, like payday loans, are exorbitantly expensive and have a dangerous structure that ensnares borrowers in a cycle of debt. Here are five keys to an affordable small dollar loan.

1. Ensure ability to pay, not ability to collect, on both the front and back end. The foundation of every responsible loan is the ability to pay. Every lender must take steps to ensure that the borrower can make the expected payments as they come due, while meeting other expenses, without re-borrowing or entering into a cycle of debt. Responsible underwriting also requires monitoring the back end to ensure that default rates (on a per borrower, not per loan, basis), refinancing, and repeat late payments are minimal. Significant default rates should not be tolerated even if they are manageable from a profitability perspective.

2. Set a maximum 36% annual percentage rate (APR), including fees. Pricing is essential to affordability. The 36% APR rate cap for small dollar loans has a long history, going back more than 100 years, and has gained wide acceptance at the state and federal level. A 36% rate is still high, especially for larger loans: for $1,000 borrowed for a year, it results in $360 in interest—over a third of the amount borrowed. But for small loans, 36% strikes a balance between affordability and revenue. Pricing with a reasonable periodic interest rate rather than a flat fee also gives lenders an incentive to offer longer term loans with a more affordable structure and to avoid making loans that borrowers cannot afford to repay. Lenders earning 300% APR can tolerate high defaults. Those earning only 36% cannot.

3. A minimum 90-day term, or longer for larger loans. Short term and balloon payment loans can be unaffordable even without a high fee. Most consumers who do not have $300 today will not have $300 in two weeks without cutting into income needed for other expenses in the next month. A longer term is critical to enabling the consumer to repay the loan while meeting other expenses. A 90-day term spreads the loan out over at least three pay and rent cycles, though more time may be needed for larger loans. One additional month per each $100 over $300 is a good benchmark, but the payments must still be underwritten to fit the consumer's actual income and expenses.

4. Equal, amortizing installment payments instead of balloon payments. Balloon payment loans result in huge payments that consumers typically cannot afford. Even if the balloon is not due for several months, cash-strapped consumers may find it difficult to save and will be caught in a bind when it comes due. Installment payments break up a loan into smaller pieces that the borrower can more likely afford and help ensure regular progress towards repayment. The payments must be fully amortizing—with both principal and interest in each payment on a regular amortization schedule—so that the borrower makes progress in paying down principal.

5. No check holding or required (or coerced) automated repayment. Check holding and other forms of preauthorized payments lessen risk for the lender but often lead to sloppy underwriting and trouble for borrowers. Lenders can make unaffordable loans because they are guaranteed repayment, but the borrower risks bounced checks or insufficient income to pay for necessities. Some lenders claim that preauthorized payments are voluntary, but make it difficult, expensive, or inconvenient to pay in another fashion or delay disbursement of the loan. The payment method should be the consumer's choice, without coercion or steering, and something that the consumer can easily change.

The Guidelines in Practice

Taken together, these five principles result in loans that are far more affordable than payday loans or their bank-issued cousins, the deposit advance loans that several major banks recently discontinued in response to regulatory and public scrutiny. A 90-day $300 installment loan at 36% APR would result in semi-monthly payments of $52.66, nearly the same amount as the rollover fee for a typical $300 two-week payday loan. But the loan would have no balloon payment, the consumer would be making regular progress toward repaying the loan without a huge income gap each month, and the loan would be fully repaid in 90 days.

Type of loan	Terms	Repayment Method	Fees/interest with rollovers		Amount of final payment	APR with fees
			Every 15 days	For 3 months		
Payday loan	$15 per $100 for 15 days	Post-dated check	$45.00	$270.00	$345.00	360%
Bank deposit advance	$10 per $100, repaid upon next deposit	Offset from next deposit	$30.00	$180.00	$330.00	240%
Model loan	36% APR, 90 days, semi-monthly payments	At consumer's choice	$2.66	$15.96	$52.66	36%

Any loan, no matter how fairly structured, can be unaffordable for a financially strapped family. Thus, both front end underwriting and back end monitoring of default, late payment, and refinancing rates are still essential to ensuring responsible, affordable lending. But lenders will have an incentive to ensure ability to pay if they follow the other guidelines. A $300, 90-day, 36% APR loan earns only about $16 in interest, which is not enough to cover significant defaults. If repayment is not automatic, but rather depends on the consumer's ability to make the payments when they come due, a loan program will survive only if the loans are truly affordable. The combination of affordable pricing, a realistic repayment structure, and responsible underwriting will result in genuinely affordable alternatives to payday lending.

For more information about designing affordable alternatives to payday loans and about the history of the 36% rate cap:

NCLC Report: Why 36%? The History, Use, and Purpose of the 36% Interest Rate Cap (2013)
NCLC Report: Stopping the Payday Loan Trap: Alternatives that Work, Ones that Don't (2010)