



## CDFIs Innovate on Small Consumer Loans\*

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Fair and impartial access to credit is a core component of building household financial stability. It is essential, however, that available credit products meet the needs of consumers and contribute to their overall financial well-being. This article examines the business models of two community development financial institutions (CDFIs) that offer small credit-building products, as well as describes other developments in the field.

### The Need for Small Consumer Loans

Nearly two out of three Americans do not have sufficient savings to cover an unexpected expense of \$500.<sup>1</sup> Further, income uncertainty and volatility cause many families to experience spikes and dips in their monthly budgets, often leaving insufficient capital to cover expenses. With limited access to traditional lines of credit, many consumers turn to small loan products to weather a financial shock or to smooth their income fluctuations. While predatory, expensive products can lead consumers into a cycle of repeated usage and mounting debt, consumer-friendly products can provide the opportunity to build credit and improve financial capability.

Small-dollar lending is a priority for the Consumer Financial Protection Bureau (CFPB). There are currently no comprehensive federal rules regulating nonbank providers in this marketplace, and state laws vary greatly. The CFPB released an outline of its small-dollar lending proposal<sup>2</sup> in March 2015 and expects to release a formal proposal in the first quarter of 2016.<sup>3</sup> One section of the CFPB proposal would require lenders to verify income and expenses of the borrower, but does not limit loan duration or payment size. Since the CFPB lacks authority to limit interest rates, payday loans — one popular type of small consumer loan

product in which borrowers are charged average annual percentage rates of 400 percent<sup>4</sup> — may continue to exist under this section of the proposal. Though verifying consumers' ability to repay is an important step, consumers may also find relief on the price side under the longer-term alternatives section of the proposal. The CFPB proposes to make loans more affordable by requiring less underwriting and documentation if the lender agrees to limit the loan term to six months and to cap monthly payments at 5 percent of the borrower's monthly income.

The goal of making small-dollar lending more responsible and affordable is one way the CFPB aims to protect consumers and promote financial capability. CFPB defines financial capability as feeling in control of one's day-to-day finances, having the capacity to absorb a financial shock, being on track to meet financial goals, and having the financial freedom to make choices and enjoy life.

The Center for Financial Services Innovation (CFSI) is also committed to building financial capability. Its mission is to improve the financial health of Americans, especially the underserved, by shaping an innovative financial services marketplace with increased access to high-quality products and services. To further that mission, CFSI developed its Compass Principles as "aspirational guidelines to assure quality innovation and execution in financial services — services that enable people to transact, borrow, save and plan in ways that are beneficial to the consumer and profitable to the industry."<sup>5</sup> The CFSI Compass Guide describes a high-quality small-dollar loan as one that is made with confidence in the borrower's ability to repay; is structured to support repayment; is priced to be profitable for the provider and

\*The views expressed here do not necessarily represent the views of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.

<sup>1</sup>Kristin Wong, "Most Americans Lack Reserve Cash to Cover \$500 Emergency: Survey," NBC News, January 8, 2016, available at <http://ow.ly/YNTXJ>.

<sup>2</sup>"CFPB Considers Proposal to End Payday Debt Traps," March 26, 2015, available at [www.consumerfinance.gov/newsroom/cfpb-considers-proposal-to-end-payday-debt-traps](http://www.consumerfinance.gov/newsroom/cfpb-considers-proposal-to-end-payday-debt-traps).

<sup>3</sup>Rachel Witkowski, "Nonbanks to Feel Brunt of CFPB Rules in 2016," *American Banker*, January 6, 2016, available at <http://ow.ly/YSRxX>.

<sup>4</sup>Nick Bourke, "Regulators Should Let Banks Get Back to Small-Dollar Loans," Pew Charitable Trusts, January 7, 2016, available at <http://ow.ly/YNWTe>.

<sup>5</sup>Beth Brockland, "Compass Principles: The Compass Guide to Small-Dollar Credit," Center for Financial Services Innovation, 2014, available at [www.cfsinnovation.com/Document-Library/The-Compass-Guide-to-Small-Dollar-Credit](http://www.cfsinnovation.com/Document-Library/The-Compass-Guide-to-Small-Dollar-Credit).



successful for the borrower; creates opportunities for upward mobility and greater financial health; has transparent marketing, communication, and disclosures; is accessible and convenient; and provides support and rights for borrowers.

**Business Model Case Study: Capital Good Fund**

Some companies and nonprofit organizations are beginning to see a market opportunity to provide small consumer loans that embrace the Compass Guide principles. Andy Posner, founder and chief executive officer of Capital Good Fund, a CDFI based in Rhode Island with a mission of providing equitable financial services that create pathways out of poverty, said: “On the one hand, banks seem to have given up on serving the small-dollar loan market. On the other hand, you have the payday lenders, rent-to-own, auto title, subprime auto, etc. — a \$100 billion industry — that is all-too-eager to prey on the economically vulnerable. Unfortunately, there is nothing in the middle in terms of companies whose sole mission is to do small personal loans equitably.” Posner pointed out that there is extremely high demand with no competitors meeting the true needs of the customers.

This demand is reflected in the fact that, although Capital Good Fund has no marketing and advertising budget, the organization needs to raise ongoing operating capital to meet the growing demand for its products. Its recent capitalization effort is an example of innovation within the organization. In 2015, Capital Good Fund launched a Direct Public Offering, which allows the organization to raise capi-

tal in increments of \$1,000 from unaccredited and accredited investors in 15 states.<sup>6,7</sup>

With the capital raised, Capital Good Fund plans to expand into states beyond Rhode Island, including Delaware. The products available in Delaware would be similar to those currently offered by Capital Good Fund, as described in the table at the bottom of the page.<sup>8</sup>

Capital Good Fund has provided more than 1,000 loans totaling more than \$1 million since it was founded in 2009 and has had a repayment rate of 90 percent. Unlike most lenders, who would view a high repayment rate as a sign of success, Posner said that the high repayment rate is a signal that Capital Good Fund has the potential to take on more risk and make credit available to more traditionally underserved customers. Posner explained that Capital Good Fund’s underwriting and risk management policies are based on close relationships with customers and sound underwriting standards, rather than a reliance on big data or what he terms “magic algorithms.” Loan payments made by Capital Good Fund’s borrowers are submitted to the three main credit bureaus, enabling its customers to build credit. The CDFI also offers financial coaching to both customers and noncustomers for a fee of \$180. This fee is broken down into monthly payments of \$15 and is booked as a loan with zero percent interest that is also submitted to credit bureaus, providing yet another opportunity for positive credit building.

Products Offered by Capital Good Fund				
	Emergency Loans	All Other Consumer Loans	Weatherization (Energy Efficiency) Loans	Car Loans
Minimum Loan Amount	\$300	\$700	\$500	\$8,000
Maximum Loan Amount	\$500	\$2,000	\$10,000	\$13,500
Interest Rate	36%	24%	0%	9% to 15%
Closing Fee	None	None	None	\$850 (rolled into loan)
Down Payment	\$0	\$0	\$0	\$500
Repayment Period	12 months	24 months	2–5 years	60 months
Typical Uses	Debt repayment, payment of past due bills, utilities, unforeseen expenses	Immigration costs, security deposits, auto repairs, computer purchase	Insulating walls, replacing light bulbs, sealing ducts	Vehicle purchase

Source: [www.capitalgoodfund.org](http://www.capitalgoodfund.org)

<sup>6</sup>For more information about Capital Good Fund’s direct public offering, see [www.socialcapitalfund.org](http://www.socialcapitalfund.org).  
<sup>7</sup>Rule 501 of the U.S. Securities and Exchange Commission’s Regulation D defines an accredited investor as a person who earns an individual income of more than \$200,000 per year, or a joint income of \$300,000, in each of the last two years and expects to reasonably maintain the same level of income; has a net worth exceeding \$1 million, either individually or jointly with his or her spouse; or is a general partner, executive officer, director, or a related combination thereof for the issuer of a security being offered. See <http://ow.ly/YSSAG>.  
<sup>8</sup>More information on this CDFI’s loan products is available at [www.capitalgoodfund.org](http://www.capitalgoodfund.org).

### Business Model Case Study: Oportun

Another CDFI that offers small consumer loans is Oportun,<sup>9</sup> a for-profit CDFI based in Redwood City, CA. Oportun offers “starter loans” at a minimum of \$300 and larger loans up to \$6,000 for returning customers. Most of Oportun’s customers are Hispanic, and nearly 90 percent live in low-to moderate-income neighborhoods in California, Illinois, Nevada, Texas, and Utah.

Raul Vazquez,<sup>10</sup> Oportun’s chief executive officer, said: “We estimate that there are approximately 25 million U.S. Hispanics who are outside the financial mainstream because traditional banks don’t have financial products that suit their needs or because they don’t have the necessary credit history to access traditional credit.” Oportun has made 1.3 million loans totaling more than \$2.2 billion to more than 680,000 customers since it started lending in 2006.

Unlike traditional financial institutions, which deem individuals with limited credit history as “unscorable,” Oportun uses a proprietary system that leverages advanced data analytics and nine years of insights gained from serving customers to determine a loan applicant’s ability to repay, approving loans to those applicants Oportun believes are likely to repay on time. Oportun’s underwriting also includes verifying income for all loan applicants. It uses

data analytics to determine loan amounts and terms that fit individual budgets to increase the likelihood of repayment. Oportun aligns loan payments with customers’ pay periods with terms of six to 35 months and avoids balloon payments. Additionally, Oportun does not charge any prepayment fees.

Oportun’s loans are affordable compared with the alternatives typically available to people with little or no credit history in the geographic areas it serves. According to a study conducted for Oportun by CFSI, those alternatives are on average more than three times more expensive than Oportun’s loans but can be up to seven times more expensive. Vazquez said that the CFSI study “estimated that Oportun saved our customers a cumulative total of \$345 million.”

Oportun reports customer accounts to credit bureaus to help borrowers establish a credit history. Vazquez added: “Credit scores are not just used for access to financial services, but they are also used increasingly for being able to rent an apartment and to get a job, so we feel that from a mission perspective, we help to create a very valuable asset for our customers.” Credit reporting is an essential part of promoting financial well-being among Oportun’s customers, as approximately 48 percent of all Oportun customers had no credit score when they first applied.

Oportun also supports customers by educating them on the basics of credit at the time the loan is deployed as well as sending text message reminders about upcoming payment due dates. Vazquez explained that “Our business model is based on our customers successfully paying back their loans, so our interests are aligned with theirs. Their success is our success.”

Vazquez also credits Oportun’s success to its for-profit business model. Though Oportun has a mission similar to that of many nonprofits, its for-profit status has allowed the company to expand and meet the needs of many customers. Oportun has raised equity from social venture capitalists, received loans from large banks, and issued bonds. Oportun seeks to expand to one or two additional states each year through its access to low-cost capital. The other secret to this growth, Vazquez said, is “a large team of more than a hundred engineers, mathematicians, and data scientists on payroll to help develop our risk engine and build web-based workflows that allow us to be efficient by embracing technology.”

### CDFI Industry Potential

Capital Good Fund and Oportun are not the only CDFIs involved in consumer finance. In addition to approximately 25 CDFI loan funds that make consumer loans, CDFI-certified banks and credit unions are also increasingly



Sherlie Martinez received a loan from Capital Good Fund to purchase a car for her and her daughter. Photo: Capital Good Fund

<sup>9</sup>Formerly Progreso Financiero, Oportun changed its name in 2015. Derived from the Spanish word *oportunidad*, which means opportunity, Oportun became the new name of the growing organization. For more information about Oportun’s loan services, see [www.oportun.com](http://www.oportun.com).

<sup>10</sup>Raul Vazquez was appointed in 2015 to serve on the newly created Federal Reserve Board of Governors Community Advisory Council. For information, go to [www.federalreserve.gov/newsevents/press/other/20150922a.htm](http://www.federalreserve.gov/newsevents/press/other/20150922a.htm).

meeting the credit needs of low- and moderate-income consumers or those who have been underserved by traditional financial institutions.<sup>11</sup> In early 2016, the National Credit Union Administration and the U.S. Treasury Department's Community Development Financial Institutions Fund signed an agreement that will streamline the application process for low-income credit unions to become certified as CDFIs.<sup>12</sup>

Also in early 2016, Senator Sherrod Brown (D-OH) called for the Obama administration to prioritize funding in fiscal year 2017 for the programs under Title XII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Title XII — Improving Access to Mainstream Financial Institutions<sup>13</sup> was a key economic empowerment provision in the act, but no part of Title XII has been implemented since the law was passed in 2010. Under sections 1205 and 1206 of Title XII, CDFIs may establish partnerships to provide low-cost, small consumer loans with reasonable terms, and the CDFI Fund would help CDFIs defray the costs of operating small consumer loan programs.<sup>14</sup>

The Wells Fargo NEXT Awards for Opportunity Finance in partnership with the Opportunity Finance Network (OFN) recognize innovation by leading CDFIs. The awards were solely dedicated to consumer finance in 2015 and will continue this theme in 2016.<sup>15</sup> Beth Lipson, executive vice president of strategic initiatives at OFN, said: "With 57 percent<sup>16</sup> of Americans struggling with financial health, and a growing number of households turning to high-cost alternative financial products and services, CDFIs are needed

more than ever to expand their role and provide this market with affordable and responsible products." OFN is offering a webinar series for CDFIs in 2016 on consumer financial services.<sup>17</sup>

As CDFIs begin to offer a variety of products and services to meet consumer financial needs, they will be well-suited to deliver small loans that will help consumers improve their overall financial capability.

#### Additional Resources

- Thea Garon and Beth Brockland, "Designing High-Quality, Small-Dollar Credit: Insights from CFSI's Test & Learn Working Group," Center for Financial Services Innovation, 2015, available at [www.cfsinnovation.com/Document-Library/Designing-High-Quality-Small-Dollar-Credit-Insig](http://www.cfsinnovation.com/Document-Library/Designing-High-Quality-Small-Dollar-Credit-Insig).
- Joe Valenti, Sarah Edelman, and Julia Gordon, "Lending for Success," Center for American Progress, July 2015, available at <https://cdn.americanprogress.org/wp-content/uploads/2015/07/LendingForSuccess-report.pdf>.
- "Small Dollar Consumer Loans: Nonprofit Lenders Making a Difference," Credit Builders Alliance, 2013, available at <http://ow.ly/Z5amI>.

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<sup>11</sup> According to Opportunity Finance Network.

<sup>12</sup> Information on the agreement is available at <http://ow.ly/YSWxq>.

<sup>13</sup> See [www.sec.gov/about/laws/wallstreetreform-cpa.pdf](http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf), page 754.

<sup>14</sup> See <http://ow.ly/YSX16>.

<sup>15</sup> More information on the NEXT Awards for Opportunity Finance is available at <http://nextawards.org>.

<sup>16</sup> Aliza Gutman, Thea Garon, Jeanne Hogarth, and Rachel Schneider, "Understanding and Improving Consumer Financial Health in America," Center for Financial Services Innovation, March 24, 2015, available at [www.cfsinnovation.com/Document-Library/Understanding-Consumer-Financial-Health](http://www.cfsinnovation.com/Document-Library/Understanding-Consumer-Financial-Health).

<sup>17</sup> For webinar recordings or to register for upcoming webinars, visit <http://nextawards.org/webinars>.



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