CoreLogic Teletrack

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The future of “convenient cash” for underserved consumers

How online lenders are innovating in a tough regulatory environment

Convenience stores. When you need one, you need one. You're well aware the products cost more, but at that particular moment, it's worth every penny.

Online lending services are a lot like that, at least according to the valued customers of one anonymous business owner within the online lending space. Here's a clip from a recent customer letter he received:

> *You have become a lifeline to us as we went through some hard times. Things are looking up but it was good to know that if we needed to, we could get the necessary funds from you... thanks for being there.*

"I get these [letters] left and right," he says. As a former IT executive who has been operating an online lending call center for the past 11 years, his upbeat, confident demeanor shifts to a proud, almost protective tone when he speaks about his customers and the unique consumer audience he serves.

But if he sounds protective, it's for good reason.

The very products his customers have come to rely on, quick and accessible online loans, are under fire from recent regulatory activity tied to "Operation Choke Point"—the highly publicized federal initiative targeting the banks and third-party payment processors (TPPPs) that service online lenders and other businesses. Many banks, fearing federal scrutiny, investigations and lawsuits for doing business with online lenders, are scaling back or severing ties with TPPPs who process Automated Clearing House (ACH) payments for online lenders, making it increasingly difficult for lenders to service their customers.

While it would seem the current regulatory crackdown will even further limit the financial options available to these consumers, it could prove just the opposite. The issue has put a spotlight on America's underbanked population, and the opportunity they represent, forcing the government, banks and the online lending industry to think about appropriate service alternatives.

We all have the same goal: helping consumers.

The irony of the current controversy is this: both sides—the federal government and online lenders who operate legally and legitimately—want to help consumers.

With initiatives like Operation Choke Point, agencies including the U.S. Departments of Justice and Treasury, and the Consumer Financial Protection Bureau (CFPB) say they're trying to protect consumers against predatory lending practices. More specifically, the initiative targets the ability of online lenders to process online consumer loan payments through the ACH system via banks and TPPPs.

12 million: The number of American consumers who take out payday loans each year. Roughly 3 million of those consumers use online lenders versus storefront lenders.[1]

Online lenders, on the other hand, are trying to provide a convenient and much-needed financial service to a segment of consumers who are locked out of traditional banking options. The ability of lenders to accept online payments is a vital service component that facilitates a smoother process for all parties involved.

The consumer segment in question is a big one. According to industry estimates, roughly 68 million U.S. consumers are underbanked, with little to no access to traditional banking and credit products. Similarly, an [2]FDIC report revealed that more than one in four households fall into this category and conduct "some or all of their financial transactions" without the help of traditional banks.

Some of these consumers are subprime due to below-average credit performance, while others may simply have thin credit files or no files due a variety of circumstances such as being students, newly divorced or new U.S. citizens. Still other consumers do not trust banks and refuse to engage in traditional banking practices.

[1] Wolff, M. (2012, July). Who borrows, where they borrow, and why. Retrieved from http://www.pewstates.org/research/reports/who-borrows-where-they-borrow-and-why-85899405043

[2] Burhouse, S., & Osaki, Y. (2012, September). 2011 FDIC national survey of unbanked and underbanked households. Retrieved from https://www.fdic.gov/householdsurvey/2012_unbankedreport.pdf

Creative ideas are emerging from all sides.

Interesting strategies for moving forward are emerging from all sides. On the legislative front, bi-partisan bill [3]H.R. 1566 aimed at creating a federal charter for Internet consumer credit corporations was introduced in 2013. It would help standardize and better regulate lending practices at the national level versus state-level, drive more fair and equitable consumer loan products and ideally ease industry criticism. Currently with the House Financial Services committee, the bill is supported by the Online Lenders Alliance (OLA), the industry organization for online lenders.

State Payday Loan Regulation and Usage Rates

[4]Click here view state-by-state restrictions

More recently, the Office of Inspector General released a February report suggesting the possibility of [5]allowing local post offices to partner with banks to offer alternative banking services—including small loans—to its customers. Amid clear conflicts with the business models of banks and online lenders, the idea of helping consumers while resuscitating the struggling U.S. Postal Service is gaining interest, even support, most notably from the high-profile Democratic Senator Elizabeth Warren.

Within the online lending space, legitimate lenders and industry leaders are forging ahead by first letting go of the past. Many are acknowledging that payday loans—a longtime product staple for storefront and Internet lenders—should be offered in conjunction with other product options. The concept of repaying a lump-sum payday loan within two weeks is not always possible, particularly for borrowers who are already living paycheck to paycheck.

Instead, lenders are offering payment alternatives that better align with the lifestyles and budgets of consumers. For instance, options such as installment loans allow borrowers to more easily repay the loan over time and still pay their other bills. Likewise the interest rates can vary, based on the estimated time it would take to repay the loan.

Blake Sims, a partner with Hudson Cook, LLP who has been providing legal advice to the consumer finance industry for 15 years, says it's all about giving customers choices—and providing clear and conspicuous disclosures about those choices.

"What we're seeing now is more lenders giving consumers more product offerings and options," says Mr. Sims. "Anytime there are choices and options for the consumer, it's good for the consumer."

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Many of today's borrower options involve convenient payment alternatives that are processed outside the ACH system, allowing lenders to service consumers and work around the prohibitive, "post-Choke Point" practices of banks and TPPPs. Below are a few payment choices, all of which are revocable at will by the consumer, meaning borrowers can revoke or cancel the payment without warning, despite the loan terms.

Debit and pre-paid cards

Possibly the ultimate payment convenience for borrowers, cards can be used a few different ways. Debit card transactions can be processed as a one-time lump payment over the phone or online with consumer consent. In this case, the customer provides the PIN number and the payment is processed as a true "debit" or otherwise known as an "online" debit transaction.

Borrowers can also set up recurring monthly payments using a debit card. Basically, they agree to make payments that will automatically debit their account on agreed-upon dates. These transactions are processed as "credits" without using the PIN number. These are known as "offline" debit transactions.

Pre-paid cards, popular with consumers without traditional bank accounts, allow borrowers to make payments with the same ease as a credit card transaction. Available everywhere from retail stores, banks and even online lenders themselves, consumers simply load cash money onto the card and they can then use the card to pay bills online.

[3] H.R. 1566: consumer credit access, innovation, and modernization act. (n.d.). Retrieved from https://www.govtrack.us/congress/bills/113/hr1566

[4] State payday loan regulation and usage rates. (2012, July). Retrieved from http://www.pewstates.org/uploadedFiles/PCS_Assets/2012/State_Payday_Loan_Regulation_and_Usage_Rates.pdf

[5] Frumin, A., (2014, February). Elizabeth Warren backs plan to save USPS, replace payday lenders. Retrieved from http://www.msnbc.com/msnbc/elizabeth-warrens-plan-save-the-usps

Checks

Not necessarily a new payment option, checks continue to be widely accepted among online lenders and are a reliable payment option in lieu of ACH. Most online lenders require checks to be certified checks or money orders, but some still accept personal checks.

Remotely created checks

Remotely created checks are processed just like a traditional print check, without requiring the borrower to write or mail it. The customer provides their banking information such as account number and routing number over the phone or online, and the lender can remotely create the check, print it out and present it to the bank for payment. It's processed through the check system, instead of the ACH system.

Electronic payment order

Sometimes called "remotely created payment orders" or "echecks," electronic payment orders are a hybrid between an ACH and a remotely created check. Borrowers authorize the lender to create a payment order, which is different than a check since no actual check is printed or presented. The lender sends an electronic notice to the bank stating that the consumer has authorized the payment order. Banks currently process these requests through the check system, not the ACH system.

The future is here, and online lenders are embracing it.

Looking ahead, smart trends are fast emerging within the online lending space as businesses are forced to evolve. In fact, some online lenders are actually thriving in today's market as they test fresh products and platform technologies that connect subprime consumers with more affordable and transparent short-term credit products.

"Members of Online Lending Alliance are innovators," says Lisa McGreevy, OLA President and CEO. "They listen to the needs of their customers and provide them with the flexible credit products they want, when they want them from the convenience of their home or on their smart phone."

Across the industry, Mr. Sims says his firm is seeing exciting developments and greater product diversification that includes more installment loans, an increase in lender underwriting and a rise in open-end "line of credit" products that give consumers greater control over how much they borrow and repay. Other key industry innovations include:

Key Trends in Online Lending

- Expanding product options to include installment loans, open-end line of credit products
- Partnering with large employers to offer low-wage employees affordable access to short-term loans
- Targeting the consumer gap between prime and subprime with more affordable rates, and "step-up" products
- Offering short-term commercial loans to help small business owners with unexpected expenses and financing gaps

Partnering with employers

The original payday loan started when employers began offering employees 'advances' on their paycheck. Today, some large employers, particularly those with a high number of lower wage employees, are realizing the benefit of offering a more formal, short-term loan service to employees. While the employer clearly stands to profit from the service, it's also a valued employee benefit that gives workers direct access to a lower-cost loan product.

Taking the concept a step further, employers are now partnering with quality online lenders to offer reliable short-term loan products to their employees at more affordable rates.

Bridging the gap between prime and subprime

Consumers who fall below prime and above subprime constitute a grey area. Unfortunately, they are usually lumped into the subprime category and must accept subprime rates. Recognizing the opportunity, some online lenders are actively targeting these consumers, offering them more affordable rates—think 60 percent APR versus 300 percent. As borrowers repay their loans on time and improve their credit status, they are steadily graduated to better loans with increasingly lower rates that align with the reduced risk.

Offering subprime small business loans

Behind many small businesses are consumer backers, who are often personally financing their ventures. Sometimes they need help with payroll or juggling unexpected business expenses. Here again, online lenders are rising the occasion to offer a variety of small, short-term commercial credit products to business owners that can't qualify for standard credit products and bank loans.

Get proactive today, for stronger lending performance tomorrow.

Today's online lending industry is changing at a breakneck pace, and businesses that want to survive simply cannot stand still. In addition to the earlier-mentioned ideas, there are smaller, immediate steps all online lenders can take to better align their business with market standards and customer needs, strengthen their industry reputation and optimize their performance now and well into the future.

Audit products and processes against industry best practices

The OLA offers detailed best practice guidance and industry updates via its [6]website, and through organized conferences and summits. Even if you're not a member, take time to understand the latest guidance and create a checklist to ensure all teams within your business—including marketing, credit, risk and compliance, IT and customer support—are operating in accordance with the guidelines.

To further advance and protect your business and the broader industry, consider using the OLA Best Practices Enforcement Form available on their website if you see or know of another online lender violating industry best practices.

Understand and comply with acceptable regulatory standards

Account debit return rates can be red flags, and if they get above 30 percent, something may be up. As Lenders and TPPPs work to comply with standards set forth by federal regulators and NACHA, they should continuously and diligently monitor all return rates.

At a bare minimum, test your portfolio on a monthly basis using the OLA best practices for return testing. In addition to promoting a better relationship with processors and bank partners, it can help facilitate better products for consumers and in some cases can help reduce default and fraud.

Use alternative data sources to better segment consumer risk

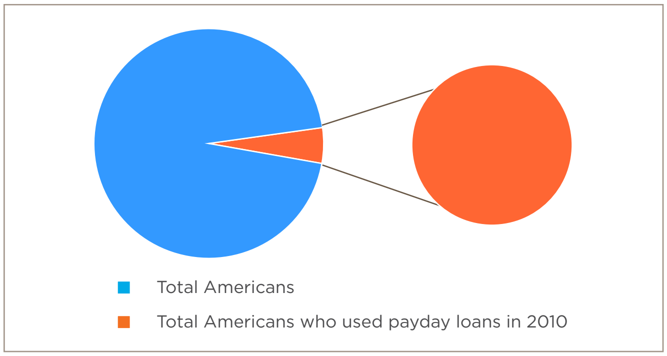
The 2009 recession hit consumers hard and destroyed long-held subprime borrower stereotypes. Those who appear to be high risk based on a low credit score—a static number that captures one aspect of an individual's credit history—could actually be on a steady positive rebound that is not yet reflected in a score or credit report.

Alternative data sources offer a fresh layer of insight that can show if consumers are paying other expenses or short-term loans in full and on time. This allows lenders to more accurately assign risk, better segment prospects and customers and offer more competitive, consumer-friendly terms. Some alternative sources allow users to contribute their data, such as loan payment data, to a shared database system. This gives lenders a unique opportunity to further support consumers by reporting payment information that can help strengthen their credit profiles.

[6] OLA Best Practices. (n.d.). Retrieved from http://www.onlinelendersalliance.org/?page=BestPractices

Pew's survey

[7]Pew's survey found 5.5 percent of adults nationwide have used a payday loan in the past five years, with three-quarters of borrowers using storefront lenders and almost one-quarter borrowing online. State regulatory data show that borrowers take out eight payday loans a year, spending about $520 on interest with an average loan size of $375. Overall, 12 million Americans used a storefront or online payday loan in 2010, the most recent year for which substantial data are available.



[7] Wolff, M. (2012, July). Who borrows, where they borrow, and why. Retrieved from http://www.pewstates.org/research/reports/who-borrows-where-they-borrow-and-why-85899405043

About CoreLogic

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CoreLogic Teletrack processes more than 10 million inquiries, scores, decisions and updates every month to support the risk assessment needs of payday loan providers, installment lenders, rental purchase companies and other consumer finance businesses servicing consumers with less than perfect credit histories.

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