Equal Access to Small-Dollar Credit

Chris Riendeau

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Executive Summary

Credit scores are an increasingly important part of our lives. Not just used for credit card applications or car loans, they are utilized to determine insurance rates, in background checks for employment, and can alter the terms of payments for basic utilities. Worse than having a bad credit score is not having one at all, and worse than that is not having access to the types of lenders who can help one establish that credit score. This is the situation today in the United States, where geography doesn't only correlate with race, or whether you are rich or poor, but if you even have access to certain types of establishments we often take for granted, like banks and credit unions. According to a study by Pew Charitable Trusts, "45% [of census tracts] do not have a bank branch within one mile of their population center" (Pew Charitable Trusts, 2014).

Neighborhoods which have been historically segregated through redlining (the denial of home loans in non-white neighborhoods), have turned into credit deserts, with the only loan products available being short-term payday lenders who have effective interest rates of up to 400%. Even with these terms, these firms often do not report to credit reporting agencies, and so even the most diligent payday loan borrower doesn't build a credit score. The loan goes unpaid, and into collections, the collection agency will often report that, and so borrowers only have their scores affected punitively, which disallows them an accurate credit score. Without that credit score, their future financial security is put into jeopardy.

Looking at what can be done about this, we examined three criteria. First, what room is available here for revenue balanced against defaults? Is the only reason these areas are served primarily by predatory lenders that it is the only way to profit? Second: what would be a more equitable solution? Currently access to credit, both small and large-dollar, is highly segregated (credit scores in studies have correlated more with race than income), so what alternatives might distribute that access more equally? Thirdly, the political feasibility of the alternative needed to be considered. Would the taxpayers be subsidizing risky loans? Would regulators be stripping consumers of useful credit products, and how would they react? We then applied these criteria to three alternatives:

a) A public small-dollar loan program in Post Offices, with low interest and fees.
b) A regulatory approach which would limit interest and fees to below predatory levels on all small-dollar loans.
c) A laissez-faire approach, allowing current market forces to make corrections on their own timeline.

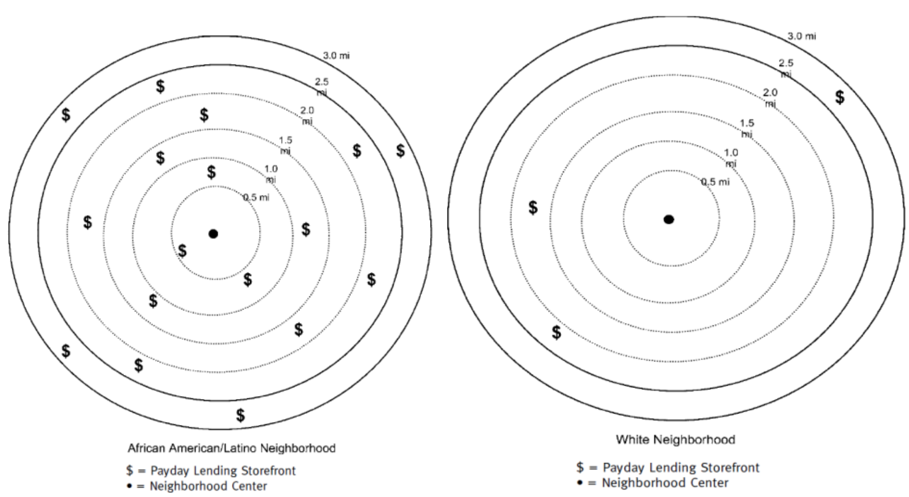
The recommendation we ultimately make is for stricter regulation of the small-dollar loan industry (payday lenders). Allowing for interest rates up to 36% and fees and charges $30 and less provides plenty of room for profit while minimizing the high default rates of predatory lenders, which cause cycles of debt and other negative externalities in these communities, despite their high profitability. Regulation proved popular, as these short-term, high-interest lenders have low favorability ratings. This solution leaves some room for growth in equitable distribution of access, as it relies on the market to transition current predatory lenders currently in underserved neighborhoods into the new regulations or for traditional lenders to move into these communities. Regulation provides a safe middle ground, is popular, and if market forces maintain inequity, additional programs can be considered in the future.

Problem Statement

Many majority-minority neighborhoods lack access to traditional loan and credit products and rely upon subprime and predatory lenders who do not reliably report to credit-reporting agencies. This unequal access to credit creates disproportionately low credit scores, lack of credit scores, and ultimately excludes these communities from economic development.

Background

Credit, and credit scores, are a large part of our lives. Utility companies, employers, mortgage underwriters—they all use your credit score to determine some part of your future, some convenience or inconvenience which will be visited upon you. This seems fair, because one assumes a credit score is based on personal responsibility, money management, and paying your bills on time. Studies have shown, however, that credit scores track more along lines of race than anything else, including income (Kabler, 2004). Historically, the inability for minority borrowers to get credit was clear discrimination at the source of the loan. In the case of home loans, "redlined" neighborhoods (those with certain percentages of minorities) were ineligible for FHA-backed loans, and so mortgage lenders would not give loans to minorities in these neighborhoods. The Fair Housing Act and other anti-discrimination laws have made that kind of discrimination illegal, but the banks haven't moved in and set up shop. The geographic distribution of lenders remains a major issue in the establishment of credit, with majority-minority neighborhoods having clusters of sub-prime lenders, such as payday lenders, car-title lenders, check-cashing storefronts and pawn shops, and a lack of traditional banks.



(fig. 1, Center for Responsible Lending)

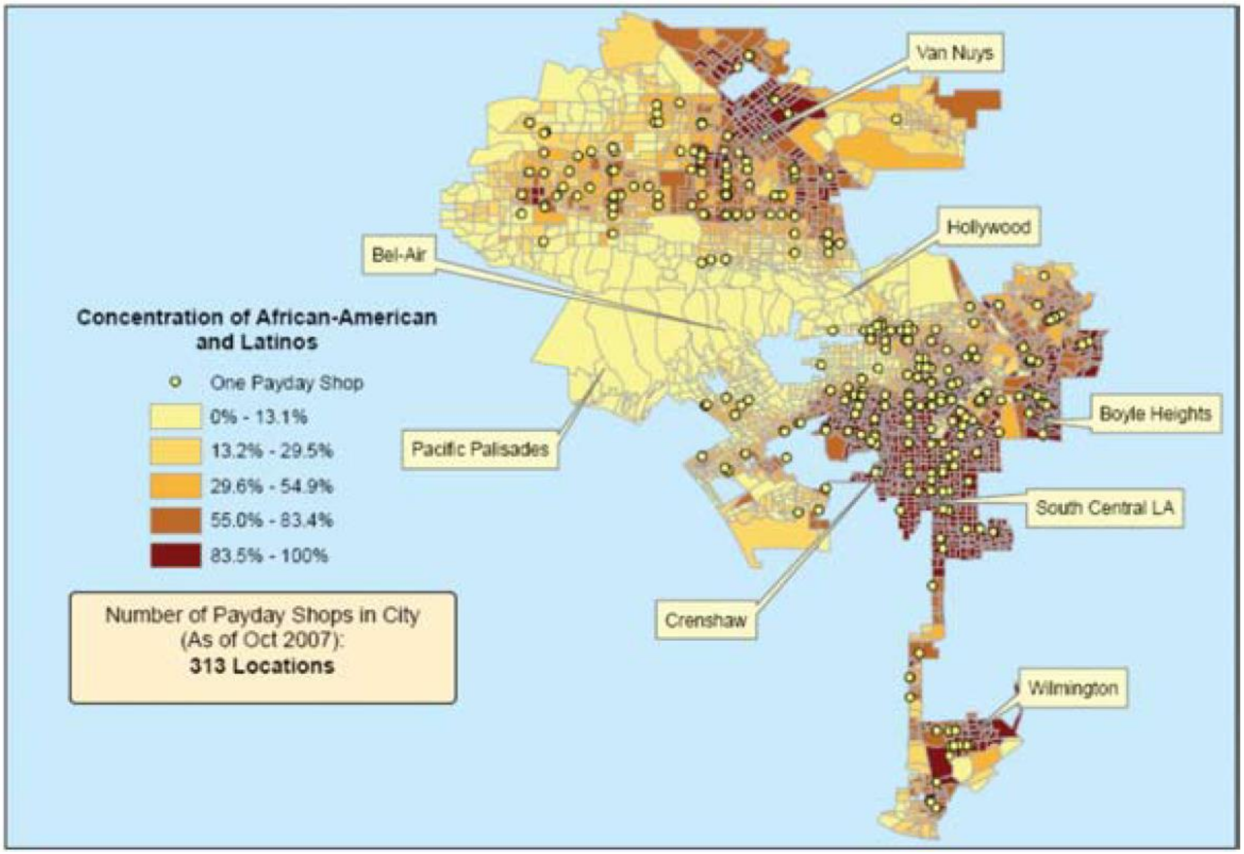
The deeper social ill here is not simply a lack of access to friendly credit terms, but that these types of lenders are not reliable credit reporters to the credit reporting agencies. As such, even on-time payments often do not help consumers of high-interest small-dollar loans, like payday loans or check-cashing advances build their credit scores. A home loan or a car loan isn't typically the first credit one applies for, and borrowers typically build some credit score with smaller loan products (credit cards, department store cards, etc.) before applying for those larger loan products. Home ownership is an important wealth-creator for American families, and is correlated with many positive effects, from the psychological and personal to the economics of a community (Dietz, 2003).

The relation of small-dollar credit access to large-dollar credit access is clear, as one needs a credit score of some kind before large-dollar amounts will be lent to them. This issue of access then must look at questions of geographic distribution, quality of loan products, credit reporting, and see what factors allow for the continuation of discriminatory lending, absent the direct discrimination. Loans are available, as lending tends to be profitable, but the terms of many of the small-dollar loans available in majority-minority communities are costly, especially payday loans with effective interest rates around 400% (Howarth, 2017). The term "effective interest rate" to mean inclusive of fees, both for initiation and punitive fees for lateness or underpayment. The typical model for a payday lender is to charge some kind of flat fee, which while seemingly quite small (say $50 or so) when coupled with interest, or late re-payment fees, adds up quite quickly to more than the original amount loaned, as the principal on these loans is typically less than $1000 and the terms are short. When borrowers cannot repay in full, the lenders often allow them to roll over the remaining principal into a new loan, with new fees, and so borrowers may pay back the original principal value and many times before they are actually considered paid-off on the loan. This cyclical debt structure and high effective interest rate is where payday lenders and check-cashing places tend to differ from traditional loan products at banks and credit unions. This is the major reason any examination of credit access has to look not only at the amount of lenders but their terms as well.

Evaluative Criteria

The criteria for **economic** evaluation were two-fold: is the program sustainable in that it produces revenue, and does it avoid excessive defaults? These criteria were chosen for a few different reasons. The cost-revenue issue is obvious, in that any program must sustain itself if it is to be considered viable, and so the profits must be able to account for the overhead of the lender. Looking at only profits, however, can create blindspots around negative externalities. Default rates were important to consider, as the problem is no necessarily that credit access is entirely absent, but that it is segregated in its quality as well. Everyone theoretically has access to high-interest loans, but do those loans serve their purpose in the community, or are they creating cycles of debt, defaults, and lower credit scores. The goal of a loan in this context is threefold: to provide an opportunity to build credit for the borrower, to provide funds for that borrower which they can repay, and to make profit for the lender. The default rate works well as a measure for the first two goals, with the profitability measuring the third.

Looking at **equity** we considered how much the alternative increases access to credit products in the target area, what kind of products are they, and do those products help residents build credit? The equity issue being one of distribution of access, the simplest measure to consider was whether or not the alternative in question will alter the number of non-subprime lenders within targeted area. The tendency of high-interest lenders who do not report reliably to credit agencies to cluster in poorer, majority-minority neighborhoods is really at the heart of the issue (fig 1), and so the alternative either needed to change the terms of current lenders in those areas, or stimulate an influx of new lenders operating on less predatory terms.



(fig. 2, Center for Responsible Lending, 2017)

The other measure of equity considered, given the data available, was whether or not the alternative would elevate credit scores. This substitutes as a metric for turning the credit-invisible (those without scores) into scored consumers, since it stands to reason if a score is raised, those without scores would be establishing credit. There is a difficulty in garnering data related to credit-invisible consumers, and this serves not only as a functional workaround but also an indicator of whether the alternative is beneficial to consumers. Looking at a downgrade in credit scores would mean the alternative was not helping to solve the policy problem at hand. An ideal alternative would be equally distributed geographically with the potential to create or improve credit scores among its users.

Finally, we examined the **political feasibility** of each alternative, whether it would be considered worth the risk to stakeholders, especially taxpayers, and if its restrictions would be considered burdensome. For the question of risk, the cost of the program to the public was used as a measure. Taxpayer buy-in is generally correlated negatively to program cost for social programs, and so the less public spending the less political resistance will likely be met. Beyond that, looking at market solutions and regulations we wanted to examine the opportunity costs: will people lose out on options for credit products? How do they feel about that? Here some research and survey data was found that proved useful on public opinions relating to small-dollar lending practices.

Alternatives

The first alternative considered (Alternative A) is the creation of a small-dollar loan program implemented via the U.S. Postal Service in Post Office locations. Although some studies have been conducted regarding the Postal Service providing a more complete package of banking services, for the purposes of this analysis only the provision of small-dollar loans was considered. In order to create some level of competitive advantage in a market with numerous alternatives, we set the interest rate low, at 16%, and fees at $10. There is room for flexibility here, and the Post Office conducted a study looking at 28% interest rates (and full banking services) which predicted greater revenue (USPS, 2014). Without that suite of other services, however, and wishing to remain below the average rates of credit card cash advances which average in the 20-30% range, the low rates and fees were selected to be profitable, but as consumer-friendly as possible. (Kossman, 2015).

The second alternative considered (Alternative B) is a new regulatory regime surrounding small-dollar lending which includes the establishment of a nationwide 36% interest rate cap on small-dollar loans, limits on fees, and would obligate all lenders to report all data to credit agencies. This is a top-down regulatory approach, with numbers based on the Department of Defense's limits on interest rates under the Military Lending Act, passed in 2006 but finalized in 2015 (Dept. of Defense). Differing from the MLA, however, would be a separate limit on fees (MLA uses a 36% rate inclusive of fees and interest). Initiation fees will be capped at $30 and late fees at $25. This provides slightly more flexibility for lenders in taking on risky loans, and adds more room for profitability without creating a loophole in which predatory fees essentially substitute for high interest rates (Howarth 2017)

Lastly, we considered the no-action alternative (Alternative C). This option looks at the state of lending as it is in states without their own stricter regulatory regimes. It looks at the effective interest rates of payday lending (around 400%), the current distribution of loan products, and the public opinions surrounding things as they are (USPS, 2014). We asked whether market forces are making positive changes without intervention, and whether that is happening to the extent which intervention would be considered unnecessary.

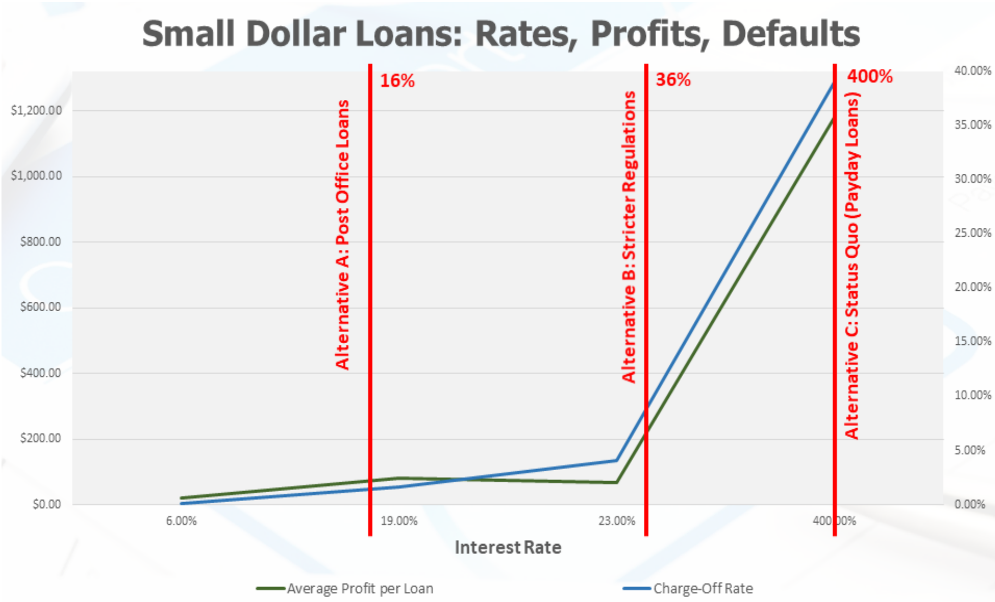
Analysis

Economic Analysis

Setting up a Post Office lending program (Alternative A) would not be cheap, but could be profitable. Given an employee's total compensation at $60,000 annually, it would require a full-time loan employee to originate 1000 loans-per-year to break even at 16% interest—about 1 loan per every 2 working hours, using study data that shows about $60 of profit-per-loan (see appendix). Utilizing current postal employees to originate some loans when possible would increase viability, and although this analysis looked at 16% interest, there is always the possibility of tweaking that upwards. The question to be asked when hammering out the details is what interest does the government have here, and is revenue more important than maintaining low rates? Can a government program remain competitive without lower rates, given its slow speed in innovation, adoption of technologies (phone apps, etc)? The Postal Service may be the best equipped agency to enter in this field, given their current infrastructure, but their ability to compete and generate revenue in the small-dollar lending industry is not a given.

A Center for Financial Services Innovation study demonstrates that the regulatory scheme (Alternative B) still allows private lenders plenty of room for profitability in the 20-36% interest rate range, while minimizing credit-damaging defaults (see appendix). More flexible employment terms and technical innovations allow for a competitive advantage over the public option. These products already exist in regular banks and credit unions, and at small-dollar lenders in more strictly regulated states. Given the unpopularity (see Political Feasibility analysis below) of payday lending products with astronomical interest rates, it only stands to reason that lower rate loans would appeal to a broader market, expanding use to compensate for diminishing profitability. This option also leaves charge-off rates (defaults) below 10%, which not only allows for healthy repeat business (compared to debt cycles where loans just continue to accrue interest and principal is never paid down), but reduces negative economic externalities in the community associated with defaults and lowered credit scores.

Payday lending, when unregulated (Alternative C) is highly profitable, but its high interest rates and punitive fees lead to extreme rates of defaults. Alternative C is certainly viable for lenders, but damaging to consumers, costing them an estimated $2.2 billion annually in states where unregulated (Davis, 2017). That amount of money being removed from communities, along with the degradation in credit scores, makes for hollow profits which do nothing to bolster the economic development of borrowers or their neighborhoods. The profit-motive is obvious however, looking at the chart below, where each alternative is mapped against its interest rate, estimated profitability and charge-off rate (default rate):



(fig. 3)

There is no doubt payday lending is profitable, but that is why economically it was important to look not only at profits, but also charge-offs. For the banks certainly if you are making enough money, the number of defaults is less important, but for a borrower's community which typically does not house the persons and businesses who collect these profits, those defaults lead to lower credit scores, lower rates of home ownership, and divert money out of the area.

Equity Analysis

The Post Office Loans program (Alternative A) allows lower-rate loans to be distributed universally. The distribution of Post Offices is not correlated with race or income in the way that banking institutions and payday lenders are. In fact, according the Postal Service's research, "Fifty-nine percent of internally-managed Post Offices are in ZIP Codes with zero or one bank branch, illustrating that the Postal Service is geographically well-positioned to reach people with little-to-no access to retail banking services" (USPS, 2014). Socioeconomic geography, therefore, won't preclude access, nor will it create a program with a higher-than-normal risk pool. If this program was only rolled out in underserved communities, it would remain equitable in its benefits (well-served communities do not have an issue with access to credit) but the risk would be borne by all taxpayers, while only some would enjoy the benefits. Additionally, having the program in high-income areas as well as low-income reduces the overall default risk versus only lending to people with less means to repay. Looking at low-interest, low-fee, small-dollar loans from a study from the Center for Financial Services Innovation, we can see that the potential for increased credit scores is around 70% of borrowers, with 24% seeing an increase of 50 points or more (Garon, 2016).

The proposed regulatory scheme (Alternative B), however, leaves room for error in regards to equity. Market forces will drive new loan products into underserved populations, but perhaps not all of them, and perhaps not commensurate with demand. We can see the motivating factors for the density of predatory lenders in some of these communities being both a lack of competition from traditional lenders (banks and credit unions) and high profits. Assuming some predatory lenders maintain their physical facilities under this regulatory scheme and simply adjust their loan terms, the transition may be quick and equitable. With the reduced potential in profit-per-loan, however, one must assume some drop off in payday lenders, which may or may not be replaced by more traditional establishments moving into these areas. This could leave a gap in credit availability on any terms. This unintended consequence doesn't necessarily warrant concern. Research in states with 36% interest caps has shown that when these types of loans are not available, payday borrowers largely cut back on their expenses, but also find alternatives with familial loans or pawn shops (Howarth, 2017). Although for some individuals this might cause problems, overall the lack of predatory lending in states is shown to save around $2.2 billion annually in fees (Davis, 2017).

The status quo, or a lack of intervention (Alternative C) has essentially divided the credit market into two categories geographically and economically. The products offered in some areas are not even close to equitable in regards to interest rates, terms, fees, etc. Looking back at Figures 1 and 2 we can see the distribution of predatory lenders is highly correlated to race.

The Postal Service, as well, in their investigation into banking products found that currently over a quarter of American households do not have access to a bank or non-predatory credit products, and Pew Charitable Trusts found that 45% of census tracts lack a bank within a mile of their population centers (USPS, 2014) (Pew Charitable Trusts, 2014). The current market is clearly not equitable, and the numbers bear out why—predatory lending is highly profitable. Lacking any other motivation, it stands to reason this market failure will not sort itself out in any reasonable timeline.

Political Feasibility Analysis

Setting up Post Office lending (Alternative A) is a public risk, and a state intervention in a private market. Surely unpopular with lenders (who would have to compete with the government), its political feasibility hinges on profitability, the predicted probability of which is tenuous. Looking back to the economic analysis, it is certainly possible for a program to be self-supporting. The start-up costs, however, of outfitting 30,000 Post Office locations with personnel and training, would be expensive, assuming profitability came later that's upwards of 30,000 salaries, plus administrative costs, which could be in the ballpark of $1 billion for the first six months or so, before interest payments start trickling in (see appendix). The good news is that research has found 71% of people are very likely or somewhat likely to use postal lending services if they existed (Pew Charitable Trusts, 2014).

Moving on to look at stricter regulations (Alternative B), the politics are simpler. Regulating lenders is extremely popular: payday lenders have favorability rating of 3%, where used car dealers are up at 16%; loss of access in states where loans have been restricted polled well a year after regulations went into effect, with 88% reporting their lives better or unchanged by the new regulations (Howarth, 2017). With numbers like these the question that comes to mind is why don't these regulations already exist? The DoD uses them, as do 15 states, but states like Ohio and South Dakota passed their laws via referenda, due to strong lobbying pressure. The payday loan lobby has averaged around $5 million in annual political contributions over the past decade, and that influence is an obstacle to passing legislation, especially via state legislatures (Center for Responsive Politics, 2018). If this gains saliency, the poll numbers will be too one-sided for politicians to ignore, especially at the federal level where payday lender lobbying money is diluted in a larger pool of interests.

Looking at things now (Alternative C), satisfaction scores are low for users of predatory products, with only 4% of payday loan borrowers reporting they would likely use the product again in the future (fig. 4).

Table 9: Fairness and Satisfaction Scores

	N	Fairness Score	Satisfaction Score	Satisfied-fair gap	Likely to use in the future
Take out a bank loan/line of credit	19	3.79	3.72	-0.07	39%
Borrow from employer	4	3.75	3.50	-0.25	4%
Enter debt negotiation	3	3.67	3.33	-0.34	15%
Borrow from insurance/retirement	14	3.57	3.64	0.07	16%
Bounce checks/use overdrafts	16	3.50	3.37	-0.13	8%
Loan from finance company	5	3.40	3.80	0.40	14%
Seek bankruptcy protection	6	3.17	3.33	0.16	9%
Obtain a pawnshop loan	9	3.14	2.56	-0.58	7%
Receive an early tax refund advance	5	3.00	3.20	0.20	Not asked
Receive a payday loan	6	2.83	3.33	0.50	4%
Use a credit card/cash advance	33	2.82	2.75	-0.07	29%

(fig 4. UNC Center for Community Capital)

The counterpoint is that access and maximum freedom of choice is maintained. No one has to be concerned about losing this option if they need a short-term, small-dollar loan. Coupling that with status quo bias, and the strong lobbying from the industry leaves this fairly politically viable. Ballot initiatives have passed in multiple states, so there is also at least some saliency regarding predatory lenders, but the user base for these products tends to be largely citizens with little political agency. What might be telling is that federal government has chosen to regulate these products for military personnel, who tend to have strong political advocates and connections as a group, but not for the nation as a whole. Changing the narrative from protecting soldiers and their families from exploitative loans to protecting everyone may seem simple, but thus far it has not worked out that way.

Conclusion and Recommendation

Looking at the analysis in aggregate, we concluded that the best choice at this time is to pursue a regulatory approach to the small-dollar loan industry (Alternative B), as it scored best overall in two criteria, and the lowest in none:

Alternative	Equity of Access	Economic Viability	Political Feasibility
Alternative A: Public small-dollar loan Program operated out of Post Offices.	**High**: Using Post Offices creates equal distribution across geography, both economic and physical.	Medium: Low margins and high personnel costs make this less competitive than private lenders. Significant revenues unlikely	Low: Risky endeavor for an agency already in a tricky financial situation. State intervention will face resistance from stakeholders like banks/payday lenders.
Alternative B: Federal Regulation of Small-dollar Loans: Interest rate cap at 36%, stricter regulations of fees.	Medium: Remedying predatory terms will not necessarily correct geographic inequities., but there will be a market vacuum in underserved areas which will be tempting for new businesses to fill.	**High:** There is a market niche for non-predatory small-dollar loans which the research confirms. Lower defaults creates greater sustainability and local economic development.	**High:** Referenda have passed with similar regulations, the DoD uses similar regulations, and small-dollar lenders are highly unpopular in polling.
Alternative C: The status quo. State regulation of small-dollar lenders, no public lending,	Low: The quality of loan products available to you now correlates far too closely with both race and economic geography of your neighborhood. Inequities abound.	Medium: This market is surviving as is, but high default rates create negative externalities in the long run. High profits but minimal economic development.	Medium: Despite some saliency and low favorability, status quo bias makes this option, itself a lack of action, fairly viable.

(fig. 5)

Setting the interest rate cap at 36%, late fees at $25 and loan initiation fees cap at $30 allows for healthy profits of around $100-300 per loan, with loan values $1000 or less and 12 month terms, without driving up default rates (see figure 3). These rates should be high enough to entice competition and bring better small-dollar loan products into many underserved areas, although there is admittedly the risk that some communities remain underserved or ignored. This isn't necessarily a big problem, however, in that removing the predatory lenders removes many negative consequences which other non-traditional loans (familial, pawn shops) do not create. Borrowing money from a parent or sibling and paying them back late doesn't hurt your credit score, and pawn shops don't create a cycle of debt because they collect your collateral (the pawned item) instead of rolling over the principal into a new loan. States with these regulations have seen benefits, rather than drawbacks, even among regular consumers of these products (Howarth, 2017).

There is also no risk to taxpayer, and despite legislative inaction, regulating the industry is extremely popular. The only opposition will be from lenders and their allies in congress, but the polling data may outweigh the lobbying dollars if the issue gains saliency. While this may not be the most profitable for lenders, or the most equitable for consumers, a regulation-based alternative provides the best balance of profitability, default minimization, distribution of access, and political feasibility, and it is our recommendation at this time.

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Appendix

	Kinecta	Region Savings Secured	Vancity Fair and Fast	All Lenders Combined
Numer of Loans	2483	33281	912	$12,225.33
Average Loan Size	$418.14	$376.00	$955.00	$583.05
Average Interest Rate	23.00%	6.00%	19.00%	16.00%
Average Term Length (Months)	6	12	13.5	$10.50
Application Fee	$31.95	$8.00	$0.00	$13.32
Charge-Off Rate	4.10%	0.13%	1.60%	$0.02
Average Interest Collected	$57.86	$12.33	$99.87	$56.69
Total Collected	$1,218,665.79	$13,174,048.58	$948,108.98	$5,113,607.78
Total Loaned	$1,038,241.62	$12,513,656.00	$870,960.00	$4,807,619.21
Profits	$180,424.17	$660,392.58	$77,148.98	$305,988.57
Average Profit per Loan	$72.66	$19.84	$84.59	$59.03

Data from CFSI study (Garon, 2016) used for figure 3. Profit-per-loan refers to interest and fees collected less the principal loss given the number of loans, their amounts, and the charge-off rate. Personnel and administrative costs were not calculated, but compared against profits later. Post Office program looking at ~$60/loan profit and $60k per FTE employee thusly needing 1000 loans-per-year to compensate employee, assuming loan employees are separate from other staff and wages are not pro-rated between traditional postal services and loans.