

Designing Better Small Dollar Loans

Behavioral Insights from Community Design Sessions with Borrowers

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In 2022 and 2023, New America Chicago hosted its first CivicSpace community design sessions. Partnering with 32 Chicago area residents who had recent experiences with predatory loans, attendees worked together to answer two critical questions: 1) Where do you go for information you can trust about small dollar loans, and 2) what features make those loans safe and useful? Recruitment focused on communities hit hardest by high interest loans.

Overwhelmingly, participants often do not know where to find affordable, small dollar loans. Long, opaque processes made more reputable lenders less attractive than high-interest lenders. Many did not even think it was worth their time to apply at banks or credit unions, regardless of their ability to pay. Other process and eligibility barriers kept specific communities from loans, including low-risk borrowers.

This Executive Summary highlights a handful of key findings and recommendations for beneficial community lending practices and policy considerations. More detailed findings helpful to lenders and policymakers are in [the full report](#).

Trusted Messengers and Lenders

Lack of trust with financial institutions

A general distrust of banks was an issue with some participants. Others were concerned about the lack of security using web-based applications.

Lack of common trusted messengers

Residents did not identify one common source of trusted information about borrowing, but most trusted family, friends, social media, online resources, credit unions, or nonprofits (detailed in the report).

Differences between generations

Respondents indicated that different generations seemed to trust different types of messengers, with younger people relying on social media and older people relying on traditional media.

No clear winner; family and friends common

For smaller loans there was not one common answer, but asking friends and family was one of the most popular. For larger emergencies, asking family and friends was the first choice for most people, with a strong cultural aversion to taking out loans notable among Latina participants.

Confusion about credit unions

Many people were not sure how credit unions worked and who was qualified to use them.

Desired Loan Features

During our group activities, participants contributed to a list of the best and worst loan features from their experiences searching for small dollar loans. Some highlights follow.

Positive Loan Features

- No hidden fees and fixed, low interest rates under 10 percent
- Clear eligibility and loan amounts
- Clear, simple processes with a 24-hour turn-around
- Use payment history or other proof to assess risk for borrowers who haven't used credit before, people with ITINs, and self-employed workers
- Options that build credit
- Customizable due dates, payment frequency, etc. to manage cash flow and pay on time
- Flexible cash assistance through trusted nonprofits

Negative Loan Features

- Hidden fees and high interest rates
- Complicated, lengthy application processes, without clear eligibility

- Set amounts of loans that do not match what is needed
- Loan terms influenced by zip codes
- Locked-in membership fees
- Charges taken out of account a month ahead
- Hidden liens
- Relentless harassment, including contacting employers or family instead of the borrower

Beneficial Community Lending Practices

Ensuring that there are affordable loan alternatives can open new, underserved markets and help build a virtuous cycle of economic growth across the region. Our findings, combined with research around borrowing behavior, can help lenders and policymakers design better products and public policy around the rules of play in consumer lending.

Clear, simple loan eligibility and quick processes

People will not choose lower-cost alternatives unless it is crystal clear that they compare favorably with the products they are accustomed to using, especially in communities with less trust of banks. Clearly stating who is eligible, providing a simple application process, and creating a one- to two-day turnaround will help replace high-interest loans with better alternatives.

Tech-enabled alternatives to credit checks

Merchant websites have a number of ways of assessing risk for payment plans that do not involve credit checks. Offering alternatives to credit checks can make low-interest loans more accessible to Black and Latino communities where cash is common, credit scores are often lower, and affordable financing can be hard to find.

Just-in-time financial education

Mini financial lessons and coaching at times of decision, such as quick summaries of good versus bad debt, can help people make better financial choices.

Choices shown in real dollars and APR

When thousands of payday borrowers were shown the cost in dollars of their loan over two weeks, one month, two months, and three months compared to the same

costs using a credit card, the amount borrowed and future borrowing decreased.

Default choice architecture used for good

People are likely to take the default option offered to them, even if it is more expensive. Socially conscious lenders can flip this on its head to make the default option the choice that is most optimal for the customer's financial health.

Repayment time improved

Breaking debt down into smaller amounts for specific items leads people to allocate 19 percent more money to repayment, and starting with the smallest debt first can make people more likely to follow through on debt pay down plans. Including this element in lending apps, online account interfaces, or bills could help improve consumer credit usage and repayment.

Temporal framing to increase savings

Pairing small, low-interest loans with an automatic savings or investment program that shows the contribution in daily or weekly payments is more likely to increase uptake. A nonprofit loan program could put a portion of the interest payment in a savings account, for example.

Loans that improve credit with regular repayment

Offering small dollar, credit-builder loans that report on-time payments to credit bureaus can be helpful for underserved communities. Nonprofits or credit unions can also use choice architecture to offer a few repayment options, with the one that is financially best for the consumer selected as the default.

Overdraft fees replaced with small, short-term loans

Creating a regular, low-interest line of credit under \$250 for account holders that is available until payday, and that can be automatically approved based on payment and deposit history, could help customers keep their bank accounts open and help banks keep customers longer.

Policy Considerations

Solve for multiple problems

Any policy solution that eliminates high-interest loans

but doesn't help people make ends meet is a partial solution. Incentivizing financial institutions and nonprofits to provide low-cost help for regular expenses that come before payday and for financial emergencies would help improve financial health in low-income neighborhoods.

Enact federal caps and guidance

Having a patchwork of banking regulations in 50 states makes it difficult to protect consumers and leaves them vulnerable to gouging in the Wild West of internet and nonbank lending. The federal government should enact a cap of 36 percent APR on lending and enforce the cap across the board.

Require honest lending

Federal regulations should require a simple, clear table of actual borrowing costs for all loans across the country. Use lessons learned from the 2009 Credit Card Accountability Responsibility and Disclosure (CARD) Act to improve payment information and the total cost of paying off loans compared to other types of credit, in simple language. Make it clear how costs increase if the borrower borrows more or rolls over a loan.

Expand programs to meet the size of the problem

Not only is additional funding in CDFIs needed, but creative solutions that leverage different sources of capital are sorely needed. Creating new funding sources that allow for collaboration among nonprofits, CDFIs, banks, credit unions, fintech, employers, and state agencies could make a difference.

Create incentives for financial institutions

Using tax policy and the Community Reinvestment Act to incentivize financial institutions to provide affordable, short-term capital in low-income neighborhoods with limited banking options could also increase financial stability.

Regulate and harness fintech

Fintech and online banking have the potential to solve for access problems but they also have great capacity for harm. The federal government must enact clear guidelines and require a federal registry and common data reporting for online financial services, particularly

lending. Online financial services regulations should allow for creative solutions, while protecting consumers.

Make AI a force for good

Generative artificial intelligence (AI) based on curated, accurate information could be a powerful tool for educating consumers at the point of decision, if regulated well. However, there is tremendous potential for inaccurate or misleading information so thoughtful regulation is needed.

Integrate financial health concepts into government programs

The government could change asset rules and integrate just-in-time financial education into current activities to build healthier financial practices. Individuals receiving government benefits like food stamps could receive a small automatic savings deposit, since people are more likely to save when it is automated.

Recognize that lending policy doesn't exist in a vacuum

Policymakers can help reduce reliance on high-interest loans by enacting policies that alleviate financial pressure on individuals and families. For example, expansions in Medicaid have been directly linked to reductions in high-interest loan uptake. Reinstating the expanded monthly Child Tax Credit or policies that improve access to well-paying jobs can reduce the need for loans.