

Payday Lending: The Credit Union Way

Credit unions once offered short-term, unsecured credit to their members, but “somewhere along the way credit unions decided small loans were unprofitable and walked away from them. So the payday lenders came along, recognized a niche market and need, and learned that small, short-term loans could be made profitably.”

“*Payday Lending: The Credit Union Way*” by the Credit Union National Association Lending Council & National Credit Union Foundation/REAL Solutions®, looks at the history of the payday loan product, customer demographics and offers guidance to credit unions who offer payday loan alternatives.

- *Payday lending customers are capable of making rational decisions*
- *15-25% of credit union members use payday lenders, credit union employees are also likely customers*
- *Payday loans can be cheaper than the alternatives, including credit union “courtesy pay”*
- *Credit unions can exclude application or participation fees in their APR calculations for payday loans. Fees are charged even if credit application is denied.*
- *Consumer groups fail to recognize that banning payday loans does not eliminate the need for short-term credit*
- *Credit unions can use varying strategies to mitigate risk*

Full white paper available:

<http://www.ncuf.coop/media/REAL%20Solutions/NancyPierceCUNALendingCouncilPaydayLendingWhitePaperWithNCUFAndREALSolutions.pdf>.

Noted in the white paper:

➤ **Payday lending customers are capable of making rational decisions**

“The profile of a payday loan borrower suggests an individual who is capable of making rational decisions, yet chooses to do business with a payday lender instead of a credit union, for whatever reason.”

➤ **15-25% of credit union members use payday lenders, credit union employees are also likely customers**

“About 20 percent of checks used as collateral for payday lenders are written on credit union checking accounts...Credit unions that have run their membership data bases through Teletrack to look at PDL “hits” over some period of time, report between 15 to 25 percent of their members have or are using payday loans.”

“Are [credit union] employees using payday lenders? Probably. Look at the profile once again of a payday loan user. It fits the profile of most credit unions’ frontline staff, particularly tellers and MSRs.”

➤ **Payday loans can be cheaper than the alternatives, including credit union “courtesy pay”**

“Let’s consider some alternatives for the working mom who is short \$100 until payday, 14 days from now. She could get a \$100 payday loan, pay \$15, and the APR for that two week loan would be 391 percent. She could also choose to write a bad check and pay an average of \$48 in NSF and merchant fees. That would be a comparable APR of 1,251 percent!”

“Even if she has courtesy pay with her credit union, the average fee is \$25, or an APR of 650 percent. Another option for her might be to not pay the \$100 minimum balance due on her credit card, resulting in a \$26 late fee—678 percent. If she chooses to not pay her \$100 utility bill which may result in a \$50 late or reconnect fee, that’s a comparable APR of 1,304 percent!...The argument can be made that by securing a payday loan to solve her cash flow needs, this woman is taking a proactive approach to her financial dilemma.”

➤ **Credit unions can exclude application or participation fees in their APR calculations for payday loans. Fees are charged even if credit application is denied.**

“A federally chartered credit union cannot charge more than 18 percent APR. State-chartered credit unions should review their statutes to know what can legally be charged in the way of interest rates and fees...Whether fees need to be disclosed as part of the finance charge is another consideration, particularly for federal credit unions banging up against an 18 percent APR limit.”

“Charges that can be *excluded* are application fees, *if charged to all applicants*, whether or not credit is actually extended. Many federally chartered credit unions, as well as state chartered credit unions, use an application fee to cover the application process expenses. These typically range from \$10 to \$25. Because the fee must be assessed whether credit is granted or not, credit unions are advised to make their underwriting criteria available to members ahead of the application process so members can pre-qualify themselves on their own.”

“Fees charged for participation in a credit plan are also excluded from the finance charge calculation. For example, the StretchPay and Freedom models have annual fees attached to them to participate in the loan product. These are not included in the APR. Fees can be charged on a monthly or annual basis.”

➤ **Consumer groups fail to recognize that banning payday loans does not eliminate the need for short-term credit**

“It is the quoted APR that gives these loans a bad rap and causes consumer groups like the Center for Responsible Lending to try to put payday lenders out of business. Yet, studies indicate that 92 percent of borrowers are aware of the finance charge and many recall it being disclosed as an APR...So while the cost of a payday loan may give some consumer groups heartburn, it is not a deterrent to the many borrowers who get these loans.”

“But eliminating local payday lending activity does not eliminate the need for emergency cash loans. People still come up short prior to payday and the center [Center for Responsible Lending] does not address how these consumers managed their cash-flow problems. If they had to use one of the other alternatives, or had to drive to an adjoining state that made payday loans, or used the Internet to get an even higher priced loan, it is possible consumers in these states paid even more to solve their cashflow problems.”

➤ **Credit unions can use varying strategies to mitigate risk**

“Some risks can be minimized through your underwriting criteria; others can be reduced by pooling your risk with other credit unions, limiting the loan dollars you will extend for the product, or setting up a special reserve to cover losses.”

Target only current credit union members; require direct deposit

“These [existing] members already have a relationship with the credit union and, as such, minimize some of the riskiness of the loan...credit unions generally have a minimum membership requirement, such as being a member for at least 30 to 90 days.”

“Requiring direct deposit as an underwriting criterion is one of the best ways to mitigate risk. Credit unions that require direct deposit report minimal losses.”

“Another loss strategy is to require a credit union checking account, and even better, an active checking account where one or two deposits have been received.”

Price product to cover losses; Fund a special loan loss reserve to cover anticipated losses

“The payday lending industry’s losses run between \$2 and \$4 per \$100. Prospera Credit Union’s GoodMoney product, a true payday loan, reports losses of \$4.36 per \$100.”

“So if your credit union is planning to offer a payday loan product to those people currently using the payday lender down the street, expect similar losses and price accordingly.”

“If your credit union’s decision is to offer the product at a loss, there should be discussion regarding how long to subsidize it and at what cost...The last thing a credit union wants is a product that distresses and demoralizes employees because of the extra burdens it puts on them, especially if the product is a money loser.”

“...a guideline might be to anticipate losses from one to three percent of loans made. For the credit union that has set aside \$500,000 for its loan product, that would result in anticipated losses between \$5,000 and \$15,000.”

Establish underwriting criteria

“Most credit unions require some form of income and employment verification. If the member already has direct deposit with the credit union, then this step is easy. Some credit unions, as part of the qualifying criteria for a payday loan product, require direct deposit. If not, then at a minimum, require a current pay stub.”

“Most credit unions choose not to run a credit check for a payday-like loan product, knowing many borrowers will likely have credit challenges, and eliminating this step reduces expenses. Other credit unions run a credit check to see if the borrower may qualify for a better-rate loan, for counseling purposes, for cross-sales opportunities, or to ensure the borrower is not in bankruptcy. Some also use the credit bureau information to track demographic information about their product users, such as credit score. Other credit unions use a subprime credit bureau such as Teletrack to see if the borrower has used payday lenders in the past, has any current loans outstanding, or if the borrower caused a loss to any subprime lender.”