Credit Union Alternatives to High Cost Payday Loans

Sarah Marshall, North Side Community Federal Credit Union
October 17, 2013

Mission: To promote the financial well being of our diverse community by providing affordable financial services and expanding the availability of alternative financial resources.

Where: Chicago, IL
One location, 3,400 members approximately $10 million in assets.

Why: Affordable alternatives to payday lenders are an important need in low to moderate income communities.
Small Dollar Loans at North Side

★ Payday Alternative Loan
★ -- a $500 loan to borrowers with direct deposit regardless of credit

★ Step Up Loan
★ -- a $1000 loan available to borrowers who have successfully repaid five Payday Alternative Loans

★ Hot Funds/Cold Cash
★ a $500 loan available to members without direct deposit that have had an account for over a year, in July & August and December & January

★ Borrow and Save
★ A small dollar loan of $1000 with a required savings component

The Payday Alternative Loan

➢ Recently renamed Credit Builder loan to help members understand other benefits of the loan besides meeting an emergency need. Also helps to connect with a demographic more interested in credit building than emergency cash.

➢ Loan Terms:
  16.5% interest rate with $30 application fee
  No rollover, only 2 loans per year
  No minimum credit score
  Must show proof of $1000/monthly income
  Must go through credit counseling if credit score is under 600

➢ Over 11,000 loans written to date since 1999 with an average of 850 loans per year.

➢ YTD for 2013: 507 Small Dollar ($1000 + under) Loans
Step Up Loan

- Graduate Loan from the Payday Alternative Loan -- $1000 loan offered to members with 5 Payday Alternative Loans paid in full.
- Allows members to access a larger sum of $. Very popular with many repeat borrowers. Term of six months to a year.
- Approximately 30% of all small dollar loans written in 2012 were Step Up Loans, demonstrating borrowers value the Payday Alternative products.

Hot Funds/Cold Cash: offered to provide a product to members without direct deposit

Borrow & Save Loan

- Pilot in partnership with National Federation of Community Development Credit Unions
- Loan Terms:
  - 16.5% Interest Rate
  - One Loan Per Year per member
  - FICO score not considered but borrowers with scores lower than 600 must go through credit counseling
  - $25 Application Fee
  - $25/monthly savings requirement. If member successfully repaid loan AND savings component, 6.5% of interest was reimbursed + half of application fee.
- 76 Loans Written
- At least 20% of borrowers had taken out a loan with predatory lender in the recent past (not all responded)
Benefits of Small Dollar Loans

★ Credit Counseling required of all borrowers with FICO scores under 600; helps them build a more stable credit history
★ Small Dollar Loans help members build a relationship with the credit union; over 30% of new members are referred by a friend and many mention the small dollar loan.
★ Helps members get out of the cycle of payday lending and provides a safe alternative product.
★ Huge cost savings to members over predatory lenders. Average $900 in fees for the member.

Success Story - David

★ Many members graduate into traditional lending products.
★ In 2011, David came to the credit union by way of attending a credit counseling session. His FICO score was 539.
★ He worked with our credit counselors, and used North Side’s credit building tools, including the Payday Alternative Loan. His score climbed to 650 in six months.

“I became motivated to do more because I could see the results. I learned the value of good credit and financial stability.”

-- David Burton, North Side member

★ He continued to work to build his credit, and is right now in the processing of closing on his first mortgage. This was his initial goal and dream when he came to the credit union for counseling.
Credit Union Alternatives to High-Cost Payday Loans

Nicole Pendleton, Freedom First Credit Union
October, 2013

Mission:
Helping people prosper, helping our communities thrive

- Headquarters: Roanoke, VA
- Year Chartered: 1956
- Charter Type: Community
- Area Population:
  - Roanoke MSA: 308,707
  - Montgomery County & Radford City: 94,392 & 16,408
- Membership: 46,514 (61% LMI)
- Designations:
  - NCUA Low-Income, 2010
  - US Treasury CDFI, 2010
- Assets: $311M
**Strategic Outcomes**

- Created Community Development Department
- VP
- AVP
- Analyst/Grant Writer
- CD Educator
- Loan Officers
- Mortgage Originator

**Community Grant Programs**
- % of prior year net income
- Align with programs & partnerships

**Micro-branch**
- Establish in severely underserved, targeted area
- Partnerships with City and others
- $850,000 grant from CDFI in 2011
- $343,176 HUD CDBG Grant

**Financial Education**
- Regularly scheduled public sessions
- Partnerships with schools, non-profits, municipalities, religious facilities
  - Counselors approved by VHDA
  - VA, VHDA, USDA, FHA approved lender
  - LMI Portfolio Program
  - FHLB Set-Aside Program
  - Down Payment Assistance
  - Weatherization Rehab
  - Accessibility Rehab
  - US Dept. of Mines, Minerals and Energy Grant ($167,000)

**Strategic Outcomes**

- Formed MBL Department
- $9.2M portfolio in 2012
- Initial target market (NPOs)
The Community Development Team

Impact Banking Products

- Borrow & Save
- Credit Builder
- IDAs
- Micro Loans
- PAL (Payday Alternative Loans)
- TGIF (The Goal is Freedom)
- Responsible Rides
- Federal Home Loan Bank of Atlanta Set-aside and DPA Programs
- Affordable Housing Program
Impact Banking Products

- 12 – 36 month repayment period
- $250 - $5,000
- Max 18% APR
- No Application Fee
- 50% of loan amount into locked savings account, released at maturity, for planned savings
Results: 2Q2012 - 2Q2013

★ 219 loans: $390,812  
★ 219 savings accounts: $198,415  
★ DQ ratio: 0.04%  
★ 5 charge-offs: $3,500

★ Weighted average interest rate: 15.91%  
★ Average income: $2,400/month ($28,800/year)  
★ Average credit score: 569 (range from 0, 421, to 721)  
★ 66 had no credit score

Success Stories

★ Linda:  
  – Single mom starting Community College and needed $500 to assist with books. Limited credit; received loan and financial education.

★ Wanda:  
  – Single mom expecting first grandchild. Due to not receiving expected child support for a period of time, bills got behind. Loan paid off delinquent debt and consolidated bills, strengthened credit, now in Responsible Rides.

★ Tamura:  
  – Single mom who had several small, older collections. Qualified for Responsible Rides, referred for Borrow & Save, and is working to repair credit while saving for down payment, also pre-qualified for AHP program.
Key to Success

- Financial Education/Development Services
- Hardship Letter & Alternative Underwriting Guidelines
- High touch exposure
- Keep it simple
- Cross-sell; access to other Impact Banking Products
- Ultimate goal of transitioning to Conventional Products

Next Steps

★ Continue to Offer Borrow & Save
★ Capturing Impact
★ Savings balances after loan closing
★ Credit scores
★ Conventional product take-up
Borrow and Save Building Assets with a Better Loan A Federation Pilot

What is Needed in the Marketplace

A Loan Product That Provides Cost Savings And Builds Savings
Credit Union Alternatives in the Marketplace

Many effective alternative to payday products save borrowers $$millions by offering affordable small dollar loans

State Employees’ Salary Advance Program with rates from 5% to 11% and with monthly volume of $35-40 Million saves borrowers upwards of $3M /Month

Better Choice-A Pennsylvania credit union-wide alternative to payday product 64,000 totaling more than $32M and saving consumers over $23M in fees and interest

What is Also Needed in the Marketplace

✓ A product that allows for the short term need while addressing longer-term financial stability

✓ a fairly priced loan product, that included savings and financial counseling was the place to start
Borrow and Save
Product Design and 18 Month Pilot Launch

- Required Common Underwriting Guidelines
- A small-dollar loan (Loans not to exceed $1,000)
- Mandatory savings requirement with percentage of savings to be determined by the CDCU
- Loan term between 6 and 36 months
- No more than 3 rollovers per year.
- Not more than one loan out at a time
- Adherence to NCUA guidelines on maximum interest rates and fees
- Tracking of loans including repayment history, the amount of savings and uses

Four credit unions of varying asset size were selected as part of the pilot:

<table>
<thead>
<tr>
<th>Name</th>
<th>Location</th>
<th>Asset Size</th>
<th>Membership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Union Settlement Federal CU</td>
<td>New York, NY</td>
<td>$6,928,160</td>
<td>3,644</td>
</tr>
<tr>
<td>North Side Community FCU</td>
<td>Chicago, IL</td>
<td>$10,762,869</td>
<td>3,347</td>
</tr>
<tr>
<td>Santa Cruz Community CU</td>
<td>Santa Cruz, CA</td>
<td>$103,118,009</td>
<td>11,496</td>
</tr>
<tr>
<td>Freedom First CU</td>
<td>Roanoke, VA</td>
<td>$292,114,693</td>
<td>44,932</td>
</tr>
</tbody>
</table>
## Results

<table>
<thead>
<tr>
<th></th>
<th>Aggregate Portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Union Settlement</td>
</tr>
<tr>
<td><strong>Number of Loans</strong></td>
<td>83</td>
</tr>
<tr>
<td><strong>Total Loans $</strong></td>
<td>$66,550</td>
</tr>
<tr>
<td><strong>Total Savings $</strong></td>
<td>$11,118</td>
</tr>
<tr>
<td><strong>Savings Requirement</strong></td>
<td>15%</td>
</tr>
<tr>
<td><strong>Average Loan Size</strong></td>
<td>$740</td>
</tr>
<tr>
<td><strong>Average Rate</strong></td>
<td>25%</td>
</tr>
<tr>
<td><strong>Average Term</strong></td>
<td>6 months</td>
</tr>
<tr>
<td><strong>Savings per borrower</strong></td>
<td>$176</td>
</tr>
<tr>
<td><strong># of repeat loans</strong></td>
<td>25%</td>
</tr>
<tr>
<td><strong>Delinquencies %</strong></td>
<td>4.00%</td>
</tr>
<tr>
<td><strong>Write-offs %</strong></td>
<td>2.00%</td>
</tr>
</tbody>
</table>

## Savings Impact

<table>
<thead>
<tr>
<th></th>
<th>Aggregate Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Required Savings</td>
</tr>
<tr>
<td>Union Settlement</td>
<td>$11,911</td>
</tr>
<tr>
<td>North Side</td>
<td>$5,700</td>
</tr>
<tr>
<td>Freedom First</td>
<td>$129,395</td>
</tr>
</tbody>
</table>

## Potential Savings to Borrower from Borrow & Save Loan

<table>
<thead>
<tr>
<th></th>
<th>Union Settlement</th>
<th>North Side</th>
<th>Freedom First</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans</td>
<td>$66,550</td>
<td>$74,500</td>
<td>$255,266</td>
<td>$396,316</td>
</tr>
<tr>
<td>Interest per annum</td>
<td>$16,638</td>
<td>$16,900</td>
<td>$50,000</td>
<td>$92,538</td>
</tr>
<tr>
<td>Fees</td>
<td>$1,660</td>
<td>$1,800</td>
<td>$5,000</td>
<td>$8,460</td>
</tr>
<tr>
<td>CU Loan Cost</td>
<td>$84,846</td>
<td>$88,700</td>
<td>$255,266</td>
<td>$255,266</td>
</tr>
<tr>
<td>Payday* Loan Cost</td>
<td>$32,750</td>
<td>$32,750</td>
<td>$129,395</td>
<td>$129,395</td>
</tr>
<tr>
<td>Difference</td>
<td>$52,093</td>
<td>$56,950</td>
<td>$125,871</td>
<td>$125,871</td>
</tr>
<tr>
<td>Accumulated** Savings</td>
<td>$131,188</td>
<td>$160,338</td>
<td>$130,042</td>
<td>$130,042</td>
</tr>
<tr>
<td>Total</td>
<td>$372,500</td>
<td>$372,500</td>
<td>$525,266</td>
<td>$525,266</td>
</tr>
</tbody>
</table>

### Notes:
- *Potential Savings to Borrower from Borrow & Save Loan*
- **Accumulated Savings**
- *Total Savings**
- **Total**
Sustainable for the CU?

<table>
<thead>
<tr>
<th>Credit Union</th>
<th>Union Settlement</th>
<th>North Side</th>
<th>Freedom First</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Rate Income</td>
<td>25.0%</td>
<td>17.0%</td>
<td>18.0%</td>
</tr>
<tr>
<td>Fees Income as % of loan</td>
<td>4%</td>
<td>4%</td>
<td>0</td>
</tr>
<tr>
<td>Loan Losses on Borrow and Save</td>
<td>2%</td>
<td>4%</td>
<td>1.4%</td>
</tr>
<tr>
<td>Cost of Funds⁺</td>
<td>.13%</td>
<td>-.45%</td>
<td>.8%</td>
</tr>
<tr>
<td>Operating Cost⁺</td>
<td>9.0%</td>
<td>5.2%</td>
<td>4.9%</td>
</tr>
<tr>
<td>To Retained Earnings</td>
<td>18.0%</td>
<td>11.0%</td>
<td>11%</td>
</tr>
</tbody>
</table>

**Additional Costs**
- Financial education
- High-touch underwriting
- Other technical assistance
- Marketing
- Data Collection

Key Findings

- Borrow and Save loans perform well for the credit union
- There is demand for Borrow and Save with multiple purposes and uses among borrowers
- Small dollar loan borrowers build savings and credit and reduce the need for rollovers or repeat loans
- Credit scores and membership tenure are not predictive of repayment
- The Borrow and Save loan is a sustainable product for credit unions
Best Practices

✓ Maximize the amount put into savings; Savings can cushion against losses
✓ Use credit scores for informational and support service purposes only
✓ Requiring long-standing membership to access the product does not significantly impact write-off
✓ Financial Literacy and debt counseling are important components of the program
✓ Consider an open-ended loan program which can minimize paperwork and servicing. ATMs, the phone, and the internet can be used to access and manage funds
✓ Small increases in interest rate to boost profitability will likely not affect uptake. Pricing is key
✓ Build-in to your program design opportunities for borrowers to “graduate” into savings, investment and lower cost loan products. This works both as a low-cost incentive and an income generator for the CU
✓ Factor in all the extraordinary costs associated with the product to determine profitability

Key Marketing Concepts

✓ Market as a positive way to build credit and savings
✓ Distinguish this product from other small dollar loan products in the community and at the credit union
✓ Incentives are a useful marketing tool but not an essential long-term “draw” for this product and can be minimized to save on costs
✓ Partner on the marketing with social service providers, faith leaders and other local organizations
✓ Open the program to new members
Expanding the Program
For Additional Information

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212-809-1850
Payday Lending Research
Opportunity Finance Network
October 17, 2013

www.pewtrusts.org/small-loans

Pew’s Consumer Financial Security Work

Safe Small-Dollar Loans
• pewtrusts.org/small-loans

www.pewtrusts.org/money
• Checking, debit and overdraft
• Prepaid cards
• Credit cards
How Payday Loans Work

- Packaged as “short-term” loan for “temporary needs”
  - Obtained from storefronts, online, some banks
- Little to no underwriting
  - Borrower has an income source and checking account
  - Lender can debit account to collect payment (deferred presentment)
- Short repayment period, tied to borrower pay cycle
  - Balloon or lump-sum repayment
  - If borrower cannot pay that, pays fee to renew, or borrows again
- Avg. loan is $375
  - Fee per pay period: $55 store, $95 online, $35 bank

Payday Loan Business Model

- Nearly all loans go to repeat borrowers
  - 97% of loans go to those using 3+ per year; 63% to those using 12+
  - Average borrower in debt five months during year
- Consecutive usage is the norm
  - More than three quarters of loans originated before next pay period
- Profitability of payday lenders depends on repeat borrowing
  - 4 to 5 loans before customer is profitable (industry estimate)
- High overhead costs
  - 2/3 of revenue covers overhead; 1/6 covers losses
State of Regulation

**How States Regulate Payday Lending**

States have deployed a variety of strategies designed to prohibit, control, or enable this form of small-dollar credit.

![Map of the United States showing the state regulations for payday lending](image)

- **Permissive states**: 28 states
  - 55% of the population
- **Moderate states**: 8 states
  - 16% of the population
- **Restrictive states**: 15 states
  - 29% of the population

[www.pewtrusts.org/small-loans](http://www.pewtrusts.org/small-loans)

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**Bank Deposit Advance Loans (DAP)**

**Bank Deposit Advance Loans Mimic Payday Loan Model**

<table>
<thead>
<tr>
<th>Conventional Payday Loan</th>
<th>Bank Deposit Advance Loan</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Advertised Term</strong></td>
<td>One pay period with lump-sum repayment (about two weeks)</td>
</tr>
<tr>
<td><strong>Amount loaned</strong></td>
<td>Usually up to $500</td>
</tr>
<tr>
<td><strong>Most common advertised price</strong></td>
<td>$15 per pay period</td>
</tr>
<tr>
<td><strong>Annualized interest rate on a 2-week loan (APR)</strong></td>
<td>391 percent</td>
</tr>
<tr>
<td><strong>Security provided to lender</strong></td>
<td>Post-dated check or electronic debit authorization for borrower’s account at third party institution</td>
</tr>
<tr>
<td><strong>Requirements to borrow</strong></td>
<td>Income stream, checking account</td>
</tr>
<tr>
<td><strong>Borrower experience</strong></td>
<td>Average borrower indebted 5 months during year; ½ of loans are quick re-borrows</td>
</tr>
</tbody>
</table>

[www.pewtrusts.org/small-loans](http://www.pewtrusts.org/small-loans)

[Report](http://www.pewtrusts.org/small-loans)
Methodology – Pew Survey Research

- First-of-its-kind survey of American payday loan borrowers
  - Random Digit Dialing, including cell phones, Spanish, minimum of six attempts per phone number

Two-part survey:
- Omnibus (49,684 total screens)
  - Margin of error +/- 0.2 percentage points (usage and demographics)
- Follow-up, in-depth survey with 451 to 703 borrowers
  - Margin of error +/- 4.2 to 4.6 percentage points (opinion research)
- 10 two-hour borrower focus groups in five cities
Most Use Payday Loans for Recurring Expenses

MAJORITY OF PAYDAY BORROWERS HAVE TROUBLE MEETING BILLS AT LEAST HALF THE TIME

FREQUENCY OF TROUBLE MEETING BILLS:

- 14% Never
- 42% Less than half the time
- 23% Every month
- 14% Most months
- 21% About half the time
- 58% Half the time or more

Report: 2/2013  www.pewtrusts.org/small-loans

Renewing is Affordable, But Paying Off is Not

AVERAGE PAYDAY BORROWER CAN AFFORD $100 PER MONTH

- 14% More than $400 per month
- 9% Don’t know
- 37% Less than $100 per month
- 28% $101 to $400 per month
- 12% $100 per month

< $430

$375 principal + $55 fee = $430 due in two weeks

Report 2/2013  www.pewtrusts.org/small-loans

Page 10
Renewing is Affordable, But Paying Off is Not

What Are the Options?

- Payday Loan, Cash Advance
- Bank / CU / Installment Loan
- Credit Card
- Home Equity

www.pewtrusts.org/small-loans
Why People Use Unaffordable Loans

1. Desperation
   More than one-third of borrowers say they have been in such a difficult situation that they would take a payday loan on any terms offered.

2. Perception
   Borrowers perceive that payday loans do not create ongoing debt, or are “not another bill,” although the loans do in fact create high-cost, ongoing debt.

3. Reliance
   Borrowers rely on lenders for accurate information. Lenders sell payday loans that are packaged as a two-week product, although the borrower ends up indebted for five months on average.

4. Focus on fee
   Borrowers focus on being able to afford the finance fee, rather than on how the lump-sum repayment will affect their budget.

5. Trust
   Some bank deposit advance borrowers believe that bank payday loans are safer or more regulated than other payday loans.

6. Temptation
   Some borrowers consider the loans “too easy” to obtain, because they are readily available, and borrowers have a consistent cash shortfall.

www.pewtrusts.org/small-loans

Report 2013  www.pewtrusts.org/small-loans See p.20
Payday Loans Do Not Eliminate Overdraft Risk

**Pie Chart:**
- 48% have not overdrafted checking account in the past year.
- 52% overdrafted checking account in the past year.

**Payday Loans Causing Overdrafts:**
- All Borrowers: 27%
- Storefront: 23%
- Online: 46%

www.pewtrusts.org/small-loans
Report 2013
Deposit Advance Loans
Do Not Eliminate Overdraft Risk (CFPB Report)

We found that deposit advance users in our sample of accounts were much more likely to have incurred an overdraft or NSF fee during the 12-month study period than eligible non-users. Notably, we found that while just 14% of eligible non-users incurred an overdraft or NSF fee during the 12 month study period, 63% of those consumers who used deposit advances had overdraft or NSF activity. Deposit advance users who incurred an overdraft or NSF fee typically incurred a greater number of fees than eligible non-users with at least one overdraft or NSF fee.

Paying Off the Loans

TWO IN FIVE PAYDAY BORROWERS REPAY USING HELP, WINDFALL, OTHER LOANS

<table>
<thead>
<tr>
<th>Source of Additional Funds</th>
<th>Repaid Using Help, Windfall, Other Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan from bank/credit union</td>
<td>3%</td>
</tr>
<tr>
<td>Used a credit card</td>
<td>4%</td>
</tr>
<tr>
<td>Pawned/sold items</td>
<td>12%</td>
</tr>
<tr>
<td>Took out another short-term loan</td>
<td>12%</td>
</tr>
<tr>
<td>Used a tax refund</td>
<td>17%</td>
</tr>
<tr>
<td>Family/friends</td>
<td>19%</td>
</tr>
<tr>
<td>Had/saved enough money</td>
<td>71%</td>
</tr>
</tbody>
</table>

41% Used at least one of these options.
Borrowers Have Torn Feelings

**MAJORITY FEEL PAYDAY LOANS TAKE ADVANTAGE OF BORROWERS**

- **ALL PAYDAY BORROWERS**
  - Payday loans do not take advantage: 40%
  - Payday loans take advantage: 55%

- **STOREFRONT**
  - Payday loans do not take advantage: 45%
  - Payday loans do not take advantage: 63%

- **ONLINE**
  - Payday loans do not take advantage: 39%
  - Payday loans do not take advantage: 65%

**SLIGHTLY MORE SAY LOANS HELP THAN HURT**

- **ALL PAYDAY BORROWERS**
  - Payday loans mostly help borrowers: 41%
  - Payday loans mostly hurt borrowers: 48%
  - Payday loans both help and hurt: 8%

- **STOREFRONT**
  - Payday loans mostly help/both: 35%
  - Payday loans mostly hurt: 60%
  - Payday loans both help and hurt: 5%

- **ONLINE**
  - Payday loans mostly help/both: 60%
  - Payday loans mostly hurt: 40%
  - Payday loans both help and hurt: 10%

By Nearly a 3-to-1 Margin: *Borrowers Want More Regulation*

**ALL PAYDAY BORROWERS**

- Loans should be more regulated: 27%
- Loans should not be more regulated: 72%