Comments submitted to the
National Credit Union Administration
By the National Federation of Community Development Credit Unions

RE: Payday-Alternative Loans
Advance notice of proposed rulemaking (ANPR)

The National Federation of Community Development Credit Unions (the Federation) submits these comments in response to the NCUA Board's advance notice of proposed rule-making (ANPR) regarding its regulation governing payday-alternative loans (PAL or PAL loans), formerly known as short-term, small amount loans. The Board has signaled its intent to encourage more federal credit unions (FCUs) to offer PAL loans and its belief that it may be necessary to amend the regulation.

The Federation appreciates the opportunity to comment on this matter, as a credit union financial intermediary that has supported the development of sound small dollar loan programs at member institutions across the country. We applaud the NCUA's efforts to protect credit union members from payday loans and other harmful debt traps, and to encourage more credit unions to responsibly meet the credit needs of their members.

The Federation believes strongly that credit unions, as not-for-profit and member-owned institutions, have an important role to play in providing not only short-term alternatives, but long-term antidotes, to predatory payday loans in their communities. As a general comment, we urge the NCUA to encourage credit unions to responsibly meet members' credit needs – but also to help members' achieve financial self-sufficiency and independence from debt, through savings programs, budget and credit counseling, and other interventions. Community development credit unions are regularly developing products and services to address these needs and have done so long before the 2010 regulation. While enlisting more credit unions in making PALs may benefit some credit union members, PALs are not a long-term or one-size-fits-all solution; and measuring success by the volume of PALs made, misses the bigger impact that credit unions are having in helping people build savings and to break free from payday lenders and other debt traps. Designing a loan product by regulation, while well-intentioned can stifle opportunities for innovation in the very institutions that would be most able to provide such alternatives.

With regard to the NCUA's PAL regulation, the Federation cautions against permitting credit unions to shorten loan repayment terms to less than one month or to increase interest rates even beyond the 28% currently allowed under PALs. The high cost and short (typically 2-4 week) loan repayment terms of payday loans are two key features that combine to make loans difficult to repay and to push borrowers into long-term indebtedness. Such high-cost, short-term loans could be detrimental to the financial health of credit union members, and ultimately to the institutions themselves.

The Federation encourages the NCUA to permit credit unions to offer longer-term repayment loans, for example, up to one year, and to consider extending the minimum repayment term to 90 days. These changes would help distinguish PALs from typical payday loans and ensure that cash-strapped borrowers are afforded a meaningful amount of time to repay. If the NCUA increases the permissible dollar amount of PALs, it would be prudent to increase the maximum loan repayment term, as well. It should be noted that some of our member

credit unions' most successful anti-payday loan products offered by credit unions are longer-term loans or lines of credit.

To help inform these and other decisions, the Federation urges the NCUA to conduct additional research into current PAL loan practices and performance. The NCUA should, for example, identify loan maturities that credit unions currently offer and that are in most demand by members; and compare the performance of shorter-term (e.g. 30-60 day) PALs to longer-term (e.g. 90-180 day) loans to determine whether long term loans achieve better results. The NCUA must take careful action to ensure that credit unions provide meaningful alternatives to payday loans, and do not lead borrowers into the same cycle of indebtedness that the PAL regulation is intended to prevent. To that end, the Federation further urges the NCUA to preserve its limit of one PAL at a time per borrower, with a limit of three loans over a six month period.

Background on the Federation and its Role in Promoting Responsible Loan Products

Established in 1974 to promote financial inclusion, the Federation is the premier Community Development Financial Institution (CDFI) intermediary that organizes, supports and invests in credit unions serving low- and moderate-income communities across the country. The Federation pioneered alternative capital for low-income credit unions and, with more than $55 million in assets under management, remains the leading investor in community development credit unions (CDCUs). With 250 member credit unions in 46 states serving a combined membership of more than 2.2 million low-income Americans, the Federation designs and supports innovative financial products, services and programs both at a national level and through regional efforts.

Since 1999, the Federation has invested PRIDE deposits in credit unions to help to share risk for alternatives to predatory loans, including usurious payday loans, in their communities. These deposits help CUs develop responsible and affordable products for their members. In September 2011 the Federation launched the Borrow and Save program which built on our previous investments and provided seed capital for credit unions to offer small dollar loans linked to savings, to both provide sound alternatives to payday loans, and to help people save their way out of indebtedness altogether. Please see the attached "Guide to Responsible Small Dollar Consumer Loans at Community Development Credit Unions in New York".

The Impact of Predatory Lending on Communities

Long-standing research has conclusively demonstrated that predatory lending and related schemes such as rent-to-own have a deleterious effect on low-income communities. And new research dispels the notion that most payday loans are used to cover the "emergencies" advertised as the primary use by the payday loan industry. A July 2012 study by the Pew Charitable Trusts concludes that "most borrowers use payday loans to cover ordinary living expenses over the course of months, not unexpected emergencies over the course of weeks. The average borrower is indebted about five months of the year."[1]

As the NCUA pointed out in its October 2010 regulation, predatory payday lenders charge exorbitant fees – averaging 400% APR nationally – to borrowers for very short-term loans. Borrowers who cannot afford to repay within two weeks are often forced to roll over their loans and pay additional fees. The very business model of payday lenders is based on repeated borrowing; research has found that this "churning" accounts for up to 75% of payday loan volume.

[1] "*Payday Lending in America: Who Borrows, Where they Borrow and Why,"* Safe Small-Dollar Loans Research Project, Pew Charitable Trusts, July 2012.

Borrowers' repeated use of payday loans often reflects and exacerbates other financial difficulties they are experiencing, as well as structural problems faced by a growing number of Americans: a lack of living wage jobs; rising housing costs; mounting medical debt; and loss of social safety net programs. Thus millions of Americans are trapped in a downward spiral of debt that is difficult to escape.

A CRL report in 2011 studied the impact this cycle of debt has on borrowers over time. Tracking payday borrowers for two years after taking out their initial loan, the study found that borrowers were indebted an average of 212 days their first year, and that they became more heavily indebted—taking out loans more frequently and for larger amounts—over time. And nearly 50 percent of payday borrowers ultimately defaulted on the loans. [2]

Insufficient research has been done on the experience of Payday Alternative Loans in credit unions to justify increasing permissible fees and interest rates, or making other changes that could be detrimental to borrowers and to credit unions, themselves. As stated in the Request for Comment, the NCUA's 2010 rulemaking called for a review of the PAL loan data collected on the 5300 call reports and a reevaluation of the requirements of the rule following a one-year period. As of September 30, 2011, 372 FCUs reported offering PAL loans with an aggregate balance of $13.6 million on 36,768 outstanding loans. The most recent data shows that as of June 30, 2012, 420 FCUs reported offering PAL loans with an aggregate balance of approximately $16.7 million on 41,264 outstanding loans. The Board notes that, during this nine-month period, there was a slight increase in the number of participating FCUs, and it commends those FCUs that offer PAL loans to their members.

This preliminary NCUA analysis leaves open several questions, including:

- How many CUs are making Payday Alternative Loans but not reporting on their 5300 call reports, either because the loan features do not exactly match the NCUA's 2010 regulation, or because they are offering different (and potentially better) small dollar loans?
- What are the underwriting parameters of existing successful PAL loans at credit unions?
- Do PALs with shorter or longer repayment terms perform better?
- Have credit unions providing PALs determined the cost of processing loan applications?
- Does payroll deduction or other authorized electronic payment affect success of PAL loans?
- Do all credit unions understand that PAL loans can and have been made without undue risk and as sustainable products?
- Do NCUA examiners understand the product?

The Federation completed an analysis of PAL/STS lending from NCUA 5300 call report data in January 2012 and found that, notwithstanding volatility in the data on delinquency and charge-offs, PALs are performing on par or better than unsecured credit card loans, the dominant source of rotating short-term consumer credit. In FY 2010, FCUs reported a delinquency rate of 1.54% on all credit card balances, slightly higher than the 1.51% [delinquency] reported on STS loans. FCUs charged off 4.36% of their credit card loans in FY 2010, significantly higher than the 1.06% in STS loan charge-offs during the same period. The strong performance of PALs does not indicate a need to increase permissible interest rates.

Additionally, in a quick survey of 6 CDCUs that offer payday loan alternatives and are not reporting on the PAL/STS lines, or that reported in 2010 but not in 2011, we found that:

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[2] Uriah King and Leslie Parrish, *Payday Loans, Inc.: Short on Credit, Long on Debt*, Center for Responsible Lending, 3/31/11, available at: http://www.responsiblelending.org/payday-lending/research-analysis/payday-loan-inc.pdf.

- CDCUs are not reporting on the STS lines unless their rates and terms exactly match all of the NCUA rules. Credit unions charging different application fees or offering longer-term loans are not using these 5300 lines.
- CDCUs that reported in the first year but not the second determined that they were more successful with their previous underwriting and fee parameters on small dollar loan alternatives to payday loans.
- Some CDCUs reported that they were concerned that reporting separately on STS loans would bring heightened scrutiny by examiners. The experience of one Borrow and Save grantee suggests that this is not an unfounded concern as there were actual obstacles established by the examiner to the smooth implementation of the product.

The Federation does not believe that permitting higher fees and interest rates on PALs, shortening loan repayment terms, or allowing more than one PAL at a time per borrower, will result in more credit unions offering PALs. The conclusion that the way to expand PALs is to make them mimic more closely payday industry products rather than the responsible lending terms that are found in most credit union products, is premature at best and counterproductive at worst. As the NCUA appears to have done research solely through the compilation of call report data, the case has not been made that lower than expected volume on the PAL/STS line in the call report is a result of product pricing rather than other factors. Instead, we believe this is, in large part, a result of reporting issues, credit unions providing small dollar loans with different features than outlined in the PAL regulation, or factors other than allowed rate and maturities. It is highly likely that the proposed changes will not realize the desired increases in lending or reporting but will certainly have a negative effect on PAL borrowers.

Increased Fees and Interest Rates may Increase Risk

The Federation believes that permitting credit unions to charge higher fees or interest rates on PALs could pose credit, as well as reputational, risks for these institutions and the credit union movement at large. It should be noted that the PAL interest rate cap of 28% is already above some states' usury caps and 1000 basis points above what FCUs are permitted to charge for other forms of credit. Particularly given the low delinquency and charge-off rates on PAL loans made to date, there is little apparent rationale to increase the permissible interest rates on PALs.

Similarly, there is little evidence that credit unions should be allowed to charge higher or repeated application fees, which the Board has noted may only cover a credit union's costs for processing a PAL loan application. According to NCUA's FAQ from 2010, in order to reach borrowers who need alternatives to payday loans, FCUs are not expected to subject applicants to extensive reviews of their credit-worthiness. The application process typically involves verification of employment, age, and residence. Therefore, an FCU's application fee can only be the amount needed to recoup the actual costs associated with processing an application, with a maximum amount of $20. If an FCU undertakes a more limited application process with repeat borrowers, there would be no justification for charging the same application fee each time the borrower applied. *The NCUA Board emphasizes that FCUs cannot use the application fee to offset the higher degree of risk associated with this type of lending.*

It should be noted that many of the Federation's member CDCUs have chosen not to offer PAL loans, believing that their existing personal or emergency loan products better meet their members' needs, or that charging a 28% interest rate to struggling borrowers is unjustifiable for a credit union.

In summary, there is clearly a need for alternatives to predatory financial services in low and moderate income communities. Community development credit unions have a long history in developing products and services to address these needs. There is no set formula that these alternatives to predators must follow. In fact, maintaining flexibility on the part of the credit union and the regulator to recognize the local market needs and to address appropriate products will be the best means with which to combat the predators. We urge the NCUA to join us in a more in-depth review of best practices, training and capacity building for credit unions and examiners to best address the need for small, emergency loans.