COMMENTS

of the

CENTER FOR RESPONSIBLE LENDING

on the

Notice of Proposed Rulemaking on Short-term, Small Amount Loans

National Credit Union Administration
12 CFR Part 701
RIN 3133-AD71

July 6, 2010

VIA ELECTRONIC SUBMISSION

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Secretary of the Board
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The Center for Responsible Lending provides the following comments regarding the proposed rule to encourage federal credit unions to offer responsible small-dollar loans as an alternative to payday lending.

I. Introduction

The Center for Responsible Lending (CRL) is a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help, which consists of a state-chartered credit union (Self-Help Credit Union (SHCU)), a federally-chartered credit union (Self-Help Federal Credit Union (SHFCU)), and a non-profit loan fund.

SHCU has operated a North Carolina-chartered credit union since the early 1980s. Beginning in 2004, SHCU began merging with community credit unions that offer a full range of retail products. In 2008, Self-Help founded SHFCU to expand Self-Help's mission. CRL has consulted with Self-Help's credit unions in formulating these comments, and its federal credit union will be subject to these regulations.

We commend NCUA for its efforts to encourage federal credit unions (FCUs) to offer responsible small loan products. However, we encourage NCUA to think of this program in the context of two realities: 1) *short-term* loan products, whether they are called "payday loans" or are offered through a credit union, are likely to trap already vulnerable customers in costly debt; and 2) consumers with the ability to repay responsible loans can be served by *existing* affordable small loan products, and NCUA should actively encourage increased availability of these products.

The destructive nature of payday loans is well documented, with borrowers more likely to become delinquent on their credit cards and file for bankruptcy than similarly-situated people who do not use payday loans.[1] In addition, households with access to payday loans are more likely to pay other bills late, delay medical care and prescription drug

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[1] Using a database on payday borrowers of a large Texas-based payday lender, researchers find those approved for a payday loan were 88 percent more likely to file for Chapter 13 bankruptcy within two years than the rest of the Texas population. They were also 14 percent more likely to file for Chapter 13 bankruptcy than their peers who had applied—and then been denied—a payday loan. See Paige Marta Skiba & Jeremy Tobacman, *Do Payday Loans Cause Bankruptcy?*, Vanderbilt University Law School and University of Pennsylvania (September 8, 2008), available at http://bpp.wharton.upenn.edu/tobacman/papers/rd.pdf. Using this same database of borrowers, the authors of the study find that taking out a payday loan makes a borrower 92 percent more likely to become seriously delinquent on their credit card (ie; 90 days or more late) during the year. See Sumit Agarwal, Paige Marta Skiba, & Jeremy Tobacman, *Payday Loans and Credit Cards: New Liquidity and Credit Scoring Puzzles?*, Federal Reserve Bank of Chicago, Vanderbilt University Law School, and University of Pennsylvania (January 13, 2009), available at http://bpp.wharton.upenn.edu/tobacman/papers/pdlcc.pdf.

purchases, and lose their bank accounts due to excessive overdrafts.[2] These impacts can push families on the fringes of the middle class down into poverty.

Payday lending causes this financial harm for at least two key reasons: first, its repayment structure—a balloon payment with a short repayment term, and second, the lender's disregard for the borrower's other obligations.

Payday loans are structured to be repaid in full, from a single paycheck, within about two weeks. It is extremely unlikely that borrowers who take out a payday loan due to a lack of funds to deal with an unexpected expense will have several hundred dollars available in the next pay period to repay the loan in full while continuing to meet regular obligations. These borrowers may benefit from access to a responsible small loan, but these repayment terms are ultimately harmful, not helpful.

Second, because loans are secured by access to the borrower's checking account (through a check or electronic means), and the due date is the next payday, payday lenders can be reasonably assured of repayment when they access the account on payday.[3] As a result, the lender has no incentive to take a borrower's other obligations into account, and those other obligations often go unpaid. Responsible lenders, on the other hand, consider a borrower's other obligations and lend money only on a repayment schedule that is affordable given that borrower's income and expenses.

The consumer need is for small loans, not for short-term loans. While NCUA's proposed small loan product is certainly an improvement over a 400% annual percentage rate (APR) loan, some of the features of the proposed rule could create indebtedness problems for borrowers similar to the very payday loans NCUA has recognized as problematic. We caution NCUA to ensure that its design of its small loan product not put unwarranted emphasis on "short-term" structures. In particular, NCUA's product definition should not include any of the harmful features of payday loans such as a balloon payment, a

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[2] An increase in payday lending locations in a particular county is associated with an 11 percent increase in involuntary bank account closures (generally due to the account being excessively overdrawn), even after accounting for county per capita income, poverty rate, educational attainment, and a host of other variables. For more information, see Dennis Campbell, Asis Martinez Jerez, & Peter Tufano, *Bouncing out of the Banking System: An Empirical Analysis of Involuntary Bank Account Closures*, Harvard Business School (December 3, 2008). In addition, another researcher finds that access to payday loans increases the likelihood that a family will face a hardship, have difficulty of paying bills, or have to delay medical care, dental care, and prescription drug purchases. See Brian T. Melzer, *The Real Costs of Credit Access: Evidence from the Payday Lending Market*, Kellogg School of Management, Northwestern University, (January 3, 2009), available at www.kellogg.northwestern.edu/faculty/melzer/realcosts_melzer_01_03_09.pdf.

[3] The payday lending industry reports that over 90% of payday loans are repaid on time. However, CRL research finds that, after repaying their loan, payday borrowers typically must take out a new one almost immediately. For the typical borrower using multiple payday loans in a year, about half take a new loan at their first opportunity, and 87% take a new loan within the same two-week pay period. See Leslie Parrish and Uriah King, *Phantom Demand: Short-term due date generates need for repeat payday loans, accounting for 76% of total volume*, Center for Responsible Lending (July 2009).

short repayment period, or underwriting based on a borrower's income without consideration of other obligations.

As we discuss in greater detail in the following section, we recommend that NCUA:

- Ensure FCUs are not offering products with predatory features similar to payday loans. Unless the NCUA actively enforces its regulations regarding permissible fees, some credit unions may decide to forego NCUA's proposed small loan model with its higher interest rate ceiling and instead offer products that include, for example, high application fees that are excluded from the APR calculation.

- Encourage FCUs to broadly offer existing responsible credit products to all members that can be responsibly served, including overdraft lines of credit, credit cards, installment loans, and other small extensions of credit.

- To the extent NCUA seeks to encourage a separate small loan product to serve specifically as a payday loan alternative, revise the proposed requirements to ensure sustainable loan terms and responsible underwriting standards. These include an installment structure, an adequate repayment period of at least three months, and an assessment of the borrower's other obligations in determining the borrower's ability to repay.

- Encourage FCUs to aid small-dollar borrowers in building savings.

II. Recommendations

A. Ensure FCUs are lending in compliance with interest rate ceilings and not engaging in predatory payday lending practices.

As NCUA notes, some FCUs currently offer payday loan alternative products that carry high fees or otherwise violate NCUA's interest rate ceiling, and, as a result, these products "may be contrary to FCUs providing members with a better alternative to high-cost payday loans."[4] A January 2009 letter from the National Consumer Law Center provides numerous examples of credit unions charging high participation and/or application fees, or collecting finder's fees for referring members to Credit Union Services Organizations (CUSOs) for triple-digit rate payday loans. While we commend the NCUA's July 2009 letter that clarified which types of loans are permissible under the National Credit Union Act, increased enforcement efforts curbing evasive practices is needed.[5]

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[4] 75 Fed Reg 24497.

[5] NCUA Letter to Federal Credit Unions on Payday Lending, 09-FCU-05 (July 2009).

In order to incent FCUs to offer a responsible small-dollar product, the NCUA must ensure that evasions of interest rate ceilings and other actions by FCUs that result in members being offered high-cost loans are not tolerated.

1. Actively prohibit manipulation of the APR to evade credit union interest rate ceilings.

Some credit unions charge little or no "interest" on short-term loans but charge large "application fees" or "participation fees" in order to evade the federal interest rate cap. TILA Commentary, however, requires that any application fees charged should be for the purpose of recovering processing costs and that participation fees be recurring and not vary based on the amount of credit available.[6] Some credit unions, however, have small loan products in which the "application fees" far exceed cost recovery levels, and the "participation fees" are one-time costs that do vary based on the amount of credit extended. In short, these costs are substitutes for the cost of credit and may not appropriately be excluded from the APR. NCUA should explicitly prohibit such treatment and ensure adequate enforcement of the prohibition.

2. Actively prohibit indirect payday lending through credit union service organizations.

Many credit unions are engaging in abusive payday lending, either directly or indirectly, through credit union service organizations (CUSOs). Again, in addition to existing or future guidance rules, interpretations and guidance, *active enforcement* is needed to ensure that these practices are curbed.

Additionally, some federal credit unions are investing in CUSOs that engage in payday lending, often in violation of state lending laws. NCUA should prohibit credit unions from owning stakes in service organizations that make loans that violate state laws or exceed the 18% rate cap.

Federal and state credit unions are also contracting with CUSOs, earning a finder's fee when the CUSO makes a payday loan to the credit union's customer. This finder's fee should be prohibited.

(For a thorough discussion of credit union-related payday lending and recommended actions for NCUA, *see* Memo from Lauren Saunders, National Consumer Law Center, (January 27, 2009), *available at* http://www.nclc.org/issues/payday_loans/content/NCUA-payday-letter0109.pdf.)

B. Encourage FCUs to broadly offer existing responsible small loan products in its portfolio to all members.

[6] *See* OSC § 226.4(c)(1)-1; OSC § 226.4(c)(4).

The typical payday customer could instead use a number of affordable small loan products already in the marketplace that could suitably meet unexpected financial needs, including credit cards, overdraft lines of credit, and small installment loans. Instead of creating another small loan product for this segment of consumers, NCUA should encourage credit unions to find ways to extend these mainstream product offerings to members not currently receiving them.

Examples of such product lines already exist. For instance, some financial institutions offer an overdraft line of credit to all customers regardless of their credit score. To limit the institution's risk and the borrower's debt load, these institutions offer a reduced credit line to customers with lower credit scores (perhaps a line of $250 instead of $2,000). Similarly, a "starter" credit card, carrying a lower credit limit than an institution's primary credit card and perhaps secured by modest savings, would provide a borrower affordable credit along with the opportunity to establish positive credit history.

Expanded access to existing credit union products can be achieved through a streamlined underwriting process and an affordable repayment structure without posing high risk to FCUs.[7] Specifically, we encourage NCUA to recommend a small-dollar line of credit option requiring only a single application process, which would ultimately result in cost-savings for both FCUs and their borrowers.

C. Revise the small dollar loan proposal to ensure it features affordable terms and responsible underwriting.

It is important to ensure that the structure of the proposed small dollar product does not render it the functional equivalent of a payday loan. Three loan terms proposed by NCUA are of particular concern: the repayment period, the fees, and the underwriting criteria used to determine ability to repay.

1. Establish longer loan terms, repayable in installments.

NCUA proposes an appropriate loan term ranging from one month to six months for loans ranging from $200-1,000. While these proposed loan terms are longer than the traditional payday maturity of two weeks, they are unlikely to allow adequate time for repayment, particularly for loans closer to the $1,000 limit. We strongly urge NCUA to require loan terms of at least three months.

A one-month loan term – particularly when underwritten solely based on recurring income – does not significantly differ from the balloon payment common in the payday lending market. We commend NCUA for recognizing the problematic nature of balloon

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[7] In its small loan pilot program, the FDIC found that borrowers had higher delinquency rates, but ultimately were not a higher default risk than those using similar unsecured loan products. See A Template for Success: The FDIC's Small-Dollar Loan Pilot Program, *FDIC Quarterly*, 2010 Vol. 4 No. 2. Self-Help has observed similar findings with its loan products.

loans, noting that "requiring a member to pay back the entire amount or a substantial portion of an STS loan in one payment may not be feasible for some borrowers and may exacerbate a borrower's weak financial situation".[8] NCUA should expressly prohibit terms requiring balloon payments for small dollar loans, and for the same reason, a one-month loan term should not be permitted. See the Appendix for a detailed illustration of the critical importance of repayment terms in determining loan affordability for borrowers.

Three months to one year provides the borrower time to pay off the debt and manage other necessary expenses. Three months is the minimum loan term that the FDIC concluded was appropriate for small dollar loans, citing that "…bankers reported that a longer loan term is key to program success because it provides more time for consumers to recover from a financial emergency than the single pay cycle for payday loans."[9] *At a minimum*, NCUA should consider an alternative standard proposed by NCLC in its recent report on small dollar lending, which recommends that for every $100 borrowed, the consumer has one month to repay.[10] Under this standard, the minimum loan term for the smallest allowable loan of $200 would be two months.

2. Limit fees on small-dollar loans that are not captured by the interest rate ceiling.

The NCUA proposes two potential interest rate ceilings for its small-dollar product: (1) a 28% APR with an additional application fee of up to $20 or (2) a 36% APR inclusive of all fees. If the former alternative is adopted, NCUA should limit the number of application fees a borrower may be charged.

Under the first alternative, a $200 loan with a 30-day term could reach an effective APR of 150% ($20 application fee + $4.59 in interest for 30 days). This high APR illustrates why a longer minimum loan term is more appropriate: Not only would a longer repayment term lower the APR (a 90-day repayment term would result in an 89% APR), providing clear affordability benefits to the borrower, but it would also reduce the number of application fees the borrower may be subject to.

We also encourage NCUA to consider the impact of application fees on the desirability of the product among payday borrowers, who will not be accustomed to this upfront fee.

3. Require consideration of a borrower's other obligations in determining ability to repay.

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[8] 75 Fed Reg 24500.

[9] A Template for Success: The FDIC's Small-Dollar Loan Pilot Program, *FDIC Quarterly*, 2010 Vol. 4 No. 2.

[10] Lauren Saunders, Leah Plunkett, and Carolyn Carter, *Stopping the Payday Loan Trap: Alternatives that Work, Ones that Don't*, National Consumer Law Center (June 2010).

NCUA proposes using a “borrower’s proof of recurring income (i.e., paychecks or other income stream) as the key criterion in developing standards for maturity lengths and loan amounts.”[11] Additionally, NCUA notes that “FCUs are not expected to run a credit report on a borrower to determine ability to repay.”[12]

Recurring income should be merely one factor considered in the underwriting process. While appreciating the need for streamlined underwriting, we strongly encourage NCUA to require more substantive underwriting to ensure that credit is extended only when a borrower has the ability to repay the loan *while continuing to meet their other obligations*. Failure to consider a borrower’s other obligations is a key contributor to the debt trap caused by payday lending, and it is likely to create the same problems in this context. FCUs, which have access to all of a borrower’s checking account activity, should be able to develop a streamlined manner of measuring other obligations. Even if NCUA does not prescribe the manner, it should require some manner of measuring other obligations.

D. Encourage building savings.

In addition to the recommendations above, we ask NCUA to encourage FCUs to develop ways for its more financially members who face financial shortfalls to build emergency savings that can ultimately be used instead of exclusively relying on credit.

Small-dollar loans have the potential to help borrowers develop a savings habit. Some of the most successful credit union small loan programs include a compulsory savings component.[13] Studies have shown that a relatively small amount of funds in savings is sufficient to cover most unexpected financial needs, and that families earning $25,000 or less per year with some savings is eight times less likely to take a payday loan than similarly-situated families who lack savings.[14]

III. Conclusion

We commend NCUA for encouraging FCUs to offer responsible small loans that can help its members with financial shortfalls as an alternative to harmful payday loans. However, we caution NCUA to ensure that borrowers have at least 90 days to repay these loans, that these repayments be made in installments, that small loans should not have upfront fees that add to the cost, and that FCUs establish underwriting standards that fully

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[11] 75 Fed Reg 24499.

[12] 75 Fed Reg 24499.

[13] For example, North Carolina State Employees Credit Union offers a salary advance loan that carries a 12% APR and requires borrowers to save some of the loan proceeds. As of 2006, borrowers had saved $8 million through the program. See https://www.ncsecu.org/PDF/Press/022206_SalaryAdvance.pdf.

[14] Testimony of Jean Ann Fox, Director of Consumer Protection, Consumer Federation of America before the Subcommittee on Domestic Policy of the House Committee on Oversight and Domestic Reform (March 21, 2007).

consider the borrower’s income and obligations.

We urge NCUA to also encourage FCUs to more broadly offer existing credit products, such as overdraft lines of credit, credit cards, and installment loans, to all members that can be responsibly served.

Finally, to better incent FCUs to offer these types of products, NCUA must rigorously enforce its regulations regarding permissible fees that can be charged outside of the interest rate ceiling and prohibit indirect payday lending through CUSOs. If credit unions can continue to evade existing NCUA rules, there will be no reason for them to offer more affordable alternatives.

We would be happy to discuss the content of our comments further.

Appendix

Regardless of whether the payday or other short-term loan is offered for free (many initial loans are offered for free or at a substantial discount), or for $15-20 per $100 borrowed, a typical household would struggle to meet their basic obligations and repay their payday loan debt in a two week period. The table below shows the result for a payday borrower earning $35,000 a year. Within one pay period, they have enough money to either repay their payday loan or meet very basic obligations with the proceeds of their paycheck, but do not have adequate funds to do both. Many families will likely have other expenses not captured here, such as a car loan, childcare—the typical borrower is single and has minor children—clothing, and other debt obligations, making the repayment of their payday loan on one paycheck even more insurmountable. Thus, to make ends meet after paying back their first payday loan, they would need to take out a new loan during the same pay period.

The NCUA should ensure that borrowers have a longer loan term to repay small loans through installments.

Income and Expenses for Payday Borrower Earning $35,000 per year	**Cost of Two-Week Payday Loan**		
	$0 per $100 (free loan)	**$15 per $100 (391% APR)**	**$20 per $100 (521% APR)**
Income and Taxes			
Income per half-month pay period	1346.15	1346.15	1346.15
Taxes	16.42	16.42	16.42
Social Security	88.92	88.92	88.92
Income after tax	1240.81	1240.81	1240.81
Payday loan payment due on $350 payday loan	350.00	402.50	420.00
Paycheck remaining after paying back payday loan	890.81	838.31	820.81
Household Expenditures per 2 week period			
Food	178.65	178.65	178.65
Housing	476.50	476.50	476.50
Transportation (insurance, gas, maintenance, etc)	144.38	144.38	144.38
Healthcare	95.88	95.88	95.88
Total Essential Expenditures	895.42	895.42	895.42
Money from paycheck remaining (deficit)	**(4.61)**	**(57.11)**	**(74.61)**

*The median payday loan size in the United States is currently $350.
Source: Two-week estimates for taxes, Social Security, and household expenditures derived from annual estimates from the 2007 Consumer Expenditure Survey, Bureau of Labor Statistics, households earning $30,000-39,999 annually.

This table is excerpted from Leslie Parrish and Uriah King, *Phantom Demand: Short-term due date generates need for repeat payday loans, accounting for 76% of total volume*, Center for Responsible Lending (July 2009).