



# REINVESTMENT ALERT

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## **AFFORDABLE ALTERNATIVES TO PAYDAY LOANS Examples from Community Development Credit Unions**

The payday loan industry, which enables borrowers to take out small loans for a term of two weeks or more, has tapped a market opportunity. Virtually unheard of in the early 1990s, the number of payday lenders nationwide is currently estimated at 8,000-10,000.<sup>1</sup> Borrowers can use a payday loan to pay for car repairs, medical expenses or other emergencies and then repay it when they receive their next paycheck.

However, payday loans carry a very high cost. In Illinois, where no usury laws exist, the cost of a payday loan is typically 20 percent of the amount borrowed. The annual percentage rate of these loans can be over 500 percent. As the number of transactions (loans or rollovers) grows, the cost of the loan increases. For instance, if a consumer takes out a \$250 loan and takes six weeks to repay it, the total loan cost is \$150. The cost of borrowing \$250 rises to \$650 for 26 weeks and to \$1,000 for 40 weeks. Despite industry claims to the contrary, a Woodstock Institute analysis of data collected by the State of Illinois determined that the average payday loan is rolled over 13 times. Woodstock Institute analysis also documents that payday loans are often made to lower-income borrowers and may create a greater burden for minority borrowers.<sup>2</sup> Such costs can easily trap lower-income consumers in a downward spiral of debt.

### **Alternative Payday Loan Products**

Part of the reason for the growth of the payday loan industry is that payday lenders operate in a competitive vacuum. In other words, very few regulated financial institutions offer comparable loan products. However, a few innovative community development credit unions (CDCUs) are beginning to fill the vacuum.<sup>3</sup> Faith Community United Credit Union in Cleveland and Louisiana-based ASI Federal Credit Union offer affordable alternatives to payday loans for their members. Their experiences are instructive of how CDCUs, mainstream credit unions, savings and loans, and banks can establish similar consumer loan products.

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<sup>1</sup>For more information, see Woodstock Institute Alert Number 14: "Unregulated Payday Lending Pulls Vulnerable Consumers Into Spiraling Debt."

<sup>2</sup>Ibid.

<sup>3</sup>Credit unions are not-for-profit financial cooperatives owned and controlled by their membership. The mission of CDCUs is to provide access to financial services and credit in low-income communities, many of which have been abandoned by banks and other financial institutions.

## ASI Federal Credit Union's Stretch Plan

ASI Federal Credit Union began operations in 1961 in a small frame building on Avondale Shipyard property and operated out of that building until 1986. Since 1986, ASI has opened 11 other offices in South Louisiana. The Credit Union's primary mission is to serve the financial needs of its members, and this mission continues to be the driving force behind the credit union today. ASI Federal Credit Union's Stretch Plan is a revolving line of credit that members can turn to as an alternative to a payday loan.

**Table I**  
**ASI Federal Credit Union**

<b>Location</b>	Harahan, Louisiana
<b>Year Established</b>	1961
<b>Field of Membership</b>	Persons living or working in Mandeville, Westwego, or Algiers, Louisiana; also, employees or relatives of employees of a number of Select Employee Groups
<b>Members</b>	56,913
<b>Assets</b>	\$136,394,809 (as of 6/00)
<b>Number of All Outstanding Loans</b>	22,217 (as of 6/00)
<b>Amount of All Outstanding Loans</b>	\$104,961,758 (as of 6/00)

### ***Eligibility Requirements***

Members of the Credit Union who utilize direct deposit of a paycheck are eligible to participate in the Stretch Plan. A new member must show proof that she has had direct deposit for the past 6 months, though it could have been at another institution. No credit check is required (see Appendix A for more information).

### ***Interest Rate, Terms, and Fees***

The annual interest rate on the line of credit is 18 percent, and there is a fee of \$3 per week for membership in the plan. (Membership in the plan also gives customers a free 10 minute phone card, free travelers checks, \$.25 money orders, free checking and ATM usage, and overdraft protection for their checking account.) The maximum amount of the line of credit is \$500. There are no in-house collection fees; collection fees will only be charged if the account is turned over to a collection agency, and then whatever fees the agency charges will be assessed. These fees are approximately 33.33 percent of the outstanding debt.

### ***Financial Counseling and Savings***

One-on-one counseling is available for members who would like help managing their finances. The Credit Union also offers seminars on personal finance management.

### ***Program Activity***

Since the program's inception in June 1999, ASI has received 2,390 applications and approved all of them. The average size of the line of credit is \$300 and approximately \$700,000 in loans have closed. Even though the program requires direct deposit, delinquencies and defaults can occur if the person's direct deposit stops for some reason, such as the loss of a job or the onset of an illness that requires a leave of absence from work. Currently, there are 43 delinquent lines of credit, amounting to \$8,000. Twenty-seven lines of credit have defaulted, amounting to \$4,000. The total amount that has been charged off is \$4,000, which represents approximately 0.56 percent of the amount of loans closed. The loan loss reserve for this product is not separate from the loan loss reserve for other loan products.

### **Faith Community United Credit Union Payday Loan Program**

Members of Mt. Sinai Baptist Church founded Faith Community United CU in 1952. The membership was committed to providing community services, and changed its charter in 1991 with the community organizing assistance of Working for Empowerment through Community Organizing (WECO), a local community development corporation. Located in a low-income African American neighborhood on the southeast side of Cleveland, Faith Community United CU's services have made a profound difference to its members who live in communities with inadequate access to financial services and credit.<sup>4</sup>

**Table II**  
**Faith Community United Credit Union**

<b>Location</b>	Cleveland, Ohio
<b>Year Established</b>	1952
<b>Field of Membership</b>	Individuals who live, worship, or work in Cuyahoga County, OH
<b>Members</b>	3,802
<b>Assets</b>	\$7,499,733 (as of 9/30/00)
<b>Number of All Outstanding Loans</b>	1,372 (as of 9/30/00)
<b>Amount of All Outstanding Loans</b>	\$4,864,032 (as of 9/30/00)

Faith Community United CU offers affordable short-term loans through its Grace Loan Program. The program was originally funded by a grant from a local foundation.

### ***Eligibility Requirements***

Members are eligible for this loan if they have had a minimum of one year of direct deposits at the credit union and have at least \$50 in their savings account. No credit check is required (see Appendix B for more information).

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<sup>4</sup>For more information, see *Credit to the Community: The Role of CDCUs in Community Development*, 1997, Woodstock Institute.

### ***Interest Rate, Terms, and Fees***

The annual interest rate for the loan is 17 percent. Borrowers also pay a \$15 fee per loan. The maximum amount of the loan is \$500. Loans must be repaid within two pay periods from the day they are processed. Repayment can be made by post-dated check, money order, or automatic debit. A collection fee of \$30 is charged for returned checks or cancellation of direct deposit.

### ***Financial Counseling and Savings***

Borrowers receive credit counseling on a one-on-one level and are required to save \$10 with each repayment.

### ***Program Activity***

Since the program's inception in February 1999, Faith Community United CU has received 400 applications, of which they have approved and closed 354. The total amount of loans closed is \$164,685, and the average size of the loan is \$465. Currently, there are two delinquent loans amounting to \$800. Two loans have defaulted amounting to \$800. The total amount that has been charged off is \$800, which represents 0.49 percent of the amount of loans closed.

## **Summary of Case Studies**

The programs described here not only provide affordable alternatives to payday loans—they also conform to credit union underwriting standards. Table III compares the cost of a six-week \$200 loan from an Illinois payday lender, ASI Federal Credit Union, and Faith Community United CU. The credit union alternatives are considerably cheaper than a loan from a payday lender, where the total charges are \$120. The Stretch Plan is one-fifth of the cost of a payday loan, and the Grace Loan saves consumers more than \$70.

**Table III**  
**Cost Comparison of a Six-Week \$200 Payday Loan from Alternative Sources**

	<b>Illinois Payday Lender</b>	<b>ASI FCU's Stretch Plan</b>	<b>FCU CU's Grace Loan</b>
Initial Fee	\$ 40.00	\$18.00	\$15.00
Fees for 2 Rollovers	80.00	0	30.00
Interest	0	4.15	3.92
<b>Total Interest &amp; Fees</b>	<b>\$120.00</b>	<b>\$22.15</b>	<b>\$48.92</b>

These case studies also demonstrate that it is feasible for credit unions to provide payday loans without harming their safety and soundness. Of the 2,390 loans made by ASI, only 43, or one percent, are delinquent, and one-half of one percent are in default. Faith Community United CU has a similar record. Only four Grace Loans, or one percent of the total number of loans, are delinquent or in

default. Moreover, the delinquency and default rates of payday loans are comparable to overall loan failure rates. In 1999, the loan delinquency rate for all credit unions for all loans was 0.75 percent.

### **Model Affordable Payday Loan**

A review of the payday loan industry and payday loan alternatives suggests that a model product must have flexible criteria to be an attractive alternative to payday loans for potential borrowers and must utilize measures to reduce credit risks. Further, credit unions should enable borrowers to develop good financial management skills to reduce their reliance on payday loans.

#### **Program Flexibility**

A model affordable payday loan should offer some flexibility to serve as a viable alternative to a payday loan. Therefore, the following standards are suggested.<sup>5</sup>

- **Credit Union Membership Tenure:** Minimum credit union membership tenure or financial institution patronage (in good standing) should be as little as 1 to 6 months so that relatively new members or customers can access the product.
- **Loan Amount:** Payday loans are emergency loans and should be readily repayable from the borrower's next paycheck. Therefore, the maximum loan amount should be no more than \$400.
- **Interest Rate and Fees:** Payday loans' interest rates should be comparable with the interest charged on other consumer loans. An annual interest rate of 15 to 20 percent is reasonable. To help offset processing costs, a loan fee of \$10 to \$15 can also be assessed. Other fees may include a return check fee or a fee to cancel direct deposit services. Rollovers (see loan terms below) should not carry an additional fee, but should incur additional interest expense.
- **Loan Term:** The repayment period should allow the borrower time to receive a payroll check; however, the loan term should not exceed 6 to 8 weeks, inclusive of rollovers.

#### **Reducing Credit Risks**

It is important to observe due diligence when underwriting all credit union loans. Therefore, the following underwriting and other standards are recommended:

- **Direct Deposit:** Borrowers must utilize direct deposit or payroll deduction and allow the financial institution to debit that account for the payday loan payment. The lender should document that the amount of the direct deposit is large enough to cover the loan payment.
- **Borrower Documentation:** The borrower should provide proof of employment for a period of at least two months immediately prior to the loan request.

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<sup>5</sup>Many of the standards reflected here are reflective of standards developed by the Campaign for Payday Loan Reform. The Coalition is working with the Illinois Department of Financial Institutions to develop stricter regulations of the Illinois payday lending industry.

- **Loan Loss Reserve:** Examiners may require that small community development credit unions establish a special loan loss reserve, particularly if the payday loan activity is relatively large given total loan volume. The reserve may be eligible for funding from foundations and other philanthropic agencies.
- **Credit Reports:** The lender may choose not to mandate the review of a credit report, although procuring a report could help the credit union to work with a borrower to improve their credit.

### **Encouraging Thrift and Improving Financial Literacy**

Offering an alternative to a regular payday loan can be an important service to members. However the final goal of the credit union should be to put that loan product “out of business.” In other words, over the long term, the credit union should work with members to enable them to exercise thrift, improve their financial management skills, and save for emergencies. The following services, offered in conjunction with the payday loan, would further these goals:

**Savings:** A portion of the loan repayment should be directed into the member’s savings account and pledged for use in case of emergency or for use as collateral for a conventional loan.

**Financial Literacy:** Borrowers should be encouraged to work with credit union staff, either on a one-on-one basis or through financial literacy workshops, to learn to manage their financial resources (see Appendix C for more information on financial literacy resources).

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**Appendix A**  
**ASI Federal Credit Union Stretch Loan Program**

<b>Start of Loan Product (Month and Year)</b>	<b>June 1999</b>
<b>Fees</b>	
Interest rate of loan (%)	18%
Amount of loan fees (% and flat fees)	\$3/week
Fee to rollover a loan	\$0
Collection fees	No in-house collection fees; collection fees only apply if credit union has to refer account to a collection agency. Collection agency fees are normally 33.3%.
<b>Underwriting Criteria</b>	
Maximum amount of loan	\$500
Credit check required?	No
Membership tenure to be eligible for loan	New members can take out loan, but they must prove they have had direct deposit at another institution for at least 6 months.
Amount of savings required to be eligible for loan	N/A
Is direct deposit or payroll deduction required?	Direct deposit is required.
<b>Time Period of this Report (Starting and ending month and year)</b>	
	<b>June 1999 – September 2000</b>
Number of loan applications	2,390
Number of loans approved	All that meets direct deposit requirement.
Number of loans closed	2,390
Total amount of loans closed	\$717,000 (approx.)
Average amount of loan	\$300
<b>Delinquencies and Defaults</b>	
Number of loans currently delinquent	43
Amount of delinquent loans	\$8,000
Number of defaulted loans	27
Amount of defaulted loans	\$4,000
Total amount of charge offs	\$4,000
Charge off rate (percent of loan \$ charged off)	0.56% (approx.)
<b>Encouraging Thrift/Savings/Financial Literacy</b>	
Are savings required?	Not required
Credit counseling services related to loan	One-on-one remedial counseling is available.

**Appendix B**  
**Faith Community United Credit Union Grace Loan Program**

<b>Start of Loan Product (Month and Year)</b>	<b>February 1999</b>
<b>Fees</b>	
Interest rate of loan (%)	17% APR
Amount of loan fees (% and flat fees)	\$15
Fee to rollover a loan	\$15 per draw
Collection fees	\$30
<b>Underwriting Criteria</b>	
Maximum amount of loan	\$500
Credit check required?	No
Membership tenure to be eligible for loan	One year of direct deposits.
Amount of savings required to be eligible for loan	\$50
Is direct deposit or payroll deduction required?	Either
<b>Time Period of this Report (Starting and ending month and year)</b>	
<b>February 1999 – December 1999</b>	
Number of loan applications	400
Number of loans approved	354
Number of loans closed	354
Total amount of loans closed	\$164,685
Average amount of loan	\$465
<b>Delinquencies and Defaults</b>	
Number of loans currently delinquent	2
Amount of delinquent loans	\$800
Number of defaulted loans	2
Amount of defaulted loans	\$800
Total amount of charge offs	\$800
Charge off rate (percent of loan \$ charged off)	.49%
<b>Encouraging Thrift/Savings/Financial Literacy</b>	
Are savings required?	Borrowers are required to save \$10 with each repayment.
Credit counseling services related to loan	Each member is personally counseled and given written material with each draw.

## Appendix C Financial Literacy Resources

A number of national organizations can provide resources to financial institutions developing payday loan alternatives and financial literacy programs. The following is a listing of such organizations.

<p><b>Consumer Action</b> <a href="http://www.consumer-action.org">www.consumer-action.org</a> (415) 777-9648</p>	<p>Consumer Action is a nonprofit, membership-based organization that serves consumers through a 4,000+ network of community groups nationwide. Consumer Action runs the National Consumer Resource Center, operates a free consumer hotline and offers free multilingual publications.</p>
<p><b>Consumer Federation of America (CFA)</b> <a href="http://www.consumerfed.org">www.consumerfed.org</a> (202) 387-6121</p>	<p>CFA publishes pamphlets on consumer issues. This group targets its materials to moderate-income people and partners with other consumer groups as well as private corporations to market its materials.</p>
<p><b>Money2000</b> <a href="http://www.money2000.org">www.money2000.org</a> (217) 333-4901</p>	<p>Money2000 is a program that is run through the Cooperative Extension System (CES). It is designed to help participants increase savings and reduce debts through personalized financial education classes, materials, and other resources.</p>
<p><b>National Center for Financial Education (NCFE)</b> <a href="http://www.ncfe.org">www.ncfe.org</a> (619) 232-8811</p>	<p>NCFE is a nonprofit organization of financial planners founded in 1982 that works to educate, motivate, and empower the public to do a better job of spending, saving, investing, and planning.</p>
<p><b>National Community Reinvestment Coalition (NCRC)</b> <a href="http://www.ncrc.org">www.ncrc.org</a> (202) 628-8866</p>	<p>NCRC is a coalition of 700 organizations working on issues of community reinvestment and economic development across the country. NCRC has developed a financial literacy training series in English and Spanish.</p>
<p><b>National Endowment for Financial Education (NEFE)</b> <a href="http://www.nefe.org">www.nefe.org</a> (303) 741-6333</p>	<p>NEFE helps consumers acquire the information and gain the skills necessary to take control of their finances through youth and adult educational programs. NEFE also maintains the Economic Independence Clearinghouse, a web-based inventory of financial literacy resources.</p>
<p><b>National Federation of Community Development Credit Unions (NFCDCU)</b> <a href="http://www.natfed.org">www.natfed.org</a> (212) 809-1850</p>	<p>A coalition of 150 CDCU's, NFCDCU was formed to provide technical and financial assistance to CDCUs and to advocate on their behalf. It provides training and management and channels investments from banks and foundations.</p>
<p><b>National Foundation for Consumer Credit (NFCC)</b> <a href="http://www.nfcc.org">www.nfcc.org</a> (301) 589-5600</p>	<p>Consumer credit counseling offices conduct credit counseling and assist in debt repair at no or low-cost to consumers already in financial trouble. Consumer Credit services are generally targeted to adults that have debt problems.</p>

