Credit Union Times

Why Credit Unions Should Watch the Payday Loan Market

The CFPB's proposed payday loan rules should enable credit unions to provide better small loan alternatives.

By **Nick Bourke** | December 04, 2015

In the next few months, the CFPB will propose new payday loan rules that build on the bureau's initial framework. Those rules will provide a much-needed response to many of the deficiencies in the payday loan market, which will benefit the consumers who currently use these loans. But the CFPB also should ensure the new rules help credit unions provide better small loan alternatives.

More than 100 million payday loans are issued annually, typically at rates between 300% and 500% APR. This is a large market that credit unions could serve better than payday lenders do, and at far lower cost to borrowers. Today, credit unions do help members facing financial hardship through programs that encourage saving and increase financial literacy. But when these individuals and families are struggling to make ends meet, they often look for immediate financial assistance. So payday lenders step in with an offer that some folks can't refuse: A loan averaging $375 with an appealing fixed fee, usually provided in less time than it takes to have a pizza delivered.

Payday loans often turn into months-long ordeals that cost consumers more in fees than they receive in credit. But on the front end, speed and ready access to credit are major selling points of payday loans. Seven in 10 customers (https://law.utexas.edu/wp-content/uploads/sites/25/hawkins_just_until_payday.pdf) report focusing primarily on speed or convenience, as opposed to cost, when choosing where to borrow. So, to entice members to use lower-cost, more reasonably structured installment options, credit unions will need to issue small loans much more quickly.

Federal regulators have an important role to play in making that possible. First, regulators should continue to support the NCUA's Payday Alternative Loan program. These loans cost six to seven times less than a payday loan. With maximum charges of 28% annualized interest and a $20 application fee, effective APRs range from 35% to 148% depending on a loan's size and duration. While these rates are high, the small principal amount results in low costs for the member. For example, a three-month, $300 loan with an APR of 69% would cost only $35. In a recent survey, 85% of Americans said the terms of such a loan were fair.

The program's efficacy is reflected in a surprisingly low charge-off rate of just 2%, which is partially attributable to the fact that borrowers are already credit union members who make regular deposits to their checking accounts and typically repay via electronic debit. Yet the PAL program has tight revenue constraints, which is one reason that few of these loans are issued. About one in 7 federal credit unions currently participates in the PAL program, and they issued approximately 170,000 loans in 2014 – just a sliver of the overall market with far less than 1% of the volume of payday loans issued that year.

That's why regulators should support new ways for credit unions to make affordable small loans quickly and efficiently, which the CFPB is now considering. Its proposed regulatory framework supports both the NCUA PAL program and a new type of loan that has affordable payments (5% or less of the borrower's monthly income) and reasonable durations (no longer than six months). These are the two safest types of loans outlined in the CFPB's framework given their clear and conservative safeguards.

In our conversations with credit union executives nationwide, they have stressed the need for the kind of alternatives the CFPB is considering in order to minimize regulatory burden and allow origination of better loans at a fair price. Unlike other loans described in the CFPB's proposal, which would require extensive documentation and underwriting, the simplified origination process of the two loan programs would enable credit unions to issue these safe and affordable loans quickly, with far less compliance burden.

Consumers who borrow from regulated depository institutions where they already hold accounts would save significant sums of money and reduce their risk of becoming unbanked. In Pew's study of online borrowers, 22% reported closing or losing a checking account in association with an online payday loan.

If the CFPB formalizes these options, credit unions would be able to greatly expand their small loan offerings.

Nick Bourke directs the Small Dollar Loans project at The Pew Charitable Trusts. He can be reached at 202-552-2000 or nbourke@pewtrusts.org (mailto:nbourke@pewtrusts.org).