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August 3, 2018

Gerard Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

RE: Comment on Notice of Proposed Rulemaking on the Payday Alternative Loan Program RIN 3133-AE84

Dear Mr. Poliquin,

We thank the Board for undertaking a review of NCUA's Payday Alternative Loan program, and we are pleased to comment on the Notice of Proposed Rulemaking posted in the Federal Register on June 4, 2018. Based on extensive research conducted over more than seven years, Pew strongly supports efforts to make it easier for borrowers who use payday and similar loans to access safer, lower-cost credit. We have found that with the right regulatory landscape, depository institutions can serve these borrowers and dramatically improve their outcomes.[1]

Pew supports NCUA's efforts to give credit unions more flexibility in providing lower-cost small credit to members coping with a cash shortfall. We commend NCUA for focusing these efforts on loans repaid in substantially equal installments, because both single-payment loans and loans with a balloon payment put consumers at serious financial risk.[2] All the changes NCUA has outlined are positive, but our research indicates they will not be sufficient for credit unions to substantially expand their offerings of lower-cost loans.[3] With modifications to the Board's proposal, we are confident that credit unions can provide affordable credit to Americans who turn to high-cost, non-depository lenders today.[4] Safe and competitive alternatives offered by depository institutions that reach scale could save millions of borrowers billions of dollars per year compared to the high-cost credit in widespread use today.[5]

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[1] The Pew Charitable Trusts, "How CFPB Rules Can Encourage Banks and Credit Unions to Offer Lower-cost Small Loans," (2016), http://www.pewtrusts.org/en/research-and-analysis/articles/2016/04/05/how-cfpb-rules-can-encourage-banks-and-credit-unions-to-offer-lower-cost-small-loans.
[2] The Pew Charitable Trusts, "Payday Lending in America: How Borrowers Choose and Repay Payday Loans" (2013), http://www.pewtrusts.org/~/media/assets/2013/02/20/pew_choosing_borrowing_payday_feb2013-(1).pdf.
[3] The Pew Charitable Trusts, "Standards Needed for Safe Small Installment Loans From Banks, Credit Unions," (2018), http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2018/02/standards-needed-for-safe-small-installment-loans-from-banks-credit-unions.
[4] The Pew Charitable Trusts, "Why Credit Unions Should Watch the Payday Loan Market," (2015), https://www.cutimes.com/2015/12/04/why-credit-unions-should-watch-the-payday-loan-mar/.
[5] Bourke, Nick, "How OCC Can Help Banks Disrupt the Payday Loan Industry," (2017), https://www.americanbanker.com/opinion/how-occ-can-help-banks-disrupt-the-payday-loan-industry.

We respectfully urge the Board to make several important adjustments to the proposed rule as explained below, both to encourage more credit unions to offer small loans and to enable those that already offer these loans on an ad hoc basis to make them more widely available to members who could benefit from lower-cost credit. These changes would be good for members, non-members who might join credit unions to gain access to lower-cost loans, and providers.

About Pew and Pew's Qualifications for Commenting on the Board's Proposal

The Pew Charitable Trusts is a global, non-governmental research and public policy organization dedicated to serving the public. We strive to improve public policy by conducting rigorous analysis, linking diverse interests to pursue common cause, and focusing on tangible results. Consumer finance is an area to which Pew has dedicated significant resources in recent years. Pew's consumer finance project has produced a comprehensive body of research and developed a group of highly qualified experts on this subject. Altogether, the full-time staff on this project collectively has approximately thirty years of experience working together to conduct research and analysis on the market for small-dollar loans. Their prior training and experience includes advanced degrees in law and public policy (including training in statistical research methods), professional public opinion research at the highest levels, product management and consulting work in the consumer finance industry and elsewhere, Wall Street analyst experience, community organizing, and policy analysis and advocacy.

As of this writing, Pew's research and contributions to the literature include the following:

- Unique, nationally representative surveys consisting of in-depth telephone interviews with borrowers of payday and similar loans (as well as the public) conducted according to the highest standards of survey research.

- Conversations with hundreds of borrowers in more than 20 focus groups throughout the country.

- More than one hundred meetings and interviews with lenders of all types. Pew has completed one-on-one interviews with dozens of bank and credit union officials.

- Extensive consultation with community groups in a majority of states, including representatives of consumer advocacy groups, civil rights and faith-based organizations, consumer credit counselors, legal advocates, and others.

- Analysis of academic literature and regulatory data. We have read published academic papers about payday and auto title loans and reviewed publicly available data about this market from state and federal government agencies as well as additional non-publicly available data obtained through special requests to various regulators and private companies. This includes anonymized data about hundreds of thousands of subprime small installment loans.

- Including the five *Payday Lending in America* reports, Pew's consumer finance project has released more than 20 extensively researched and reviewed issue briefs, fact sheets, and multi-media publications.

In recent years, we have provided comment letters, testimony, technical assistance, and informal input to federal regulators and state government officials throughout the country and spoken about this topic at dozens of conferences and other professional gatherings. Our work has been cited or quoted in a wide variety of publications from federal, state, and local government officials, and in more than one thousand media stories on small credit.

Pew is deeply committed to unbiased research and dedicated to improving public policy through pragmatic measures that would accommodate the interests of both borrowers and providers, as well as the public generally. Stakeholder outreach has been a constant feature of our work since it started. In sum, Pew is highly qualified to comment about the proposed rule for Payday Alternative Loans. We look forward to the opportunity to work with NCUA as it modifies and finalizes this important rule.

Section 1: Problems with Payday and Other High-Cost Small Loans

Pew has documented extensively the problems in the high-cost, non-depository small-loan market.[6] Roughly 12 million Americans use payday loans annually.[7] The average borrower takes a $375 loan and keeps it out for five months of the year, paying $520 in fees alone on top of the original principal.[8] Approximately 2.5 million Americans use auto title loans annually, averaging $1,000.[9] Most borrowers pay more in fees than they originally received in credit. This type of small-dollar lending also puts borrowers' vehicles at risk because lenders can repossess them if borrowers do not repay. Annual percentage rates (APRs) on payday loans typically fall between 300 and 500 percent,[10] while on auto title loans they average roughly 300 percent.[11]

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[6] This section provides just a brief summary of problems in these markets. For more detail, please see pewtrusts.org/small-loans.
[7] The Pew Charitable Trusts, "Payday Lending in America: Who Borrows, Where They Borrow, and Why" (2012), http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/pewpaydaylendingreportpdf.pdf.
[8] Ibid.
[9] The Pew Charitable Trusts, "Auto Title Loans: Market Practices and Borrowers' Experiences" (2015), http://www.pewtrusts.org/~/media/assets/2015/03/autotitleloansreport.pdf.
[10] The Pew Charitable Trusts, "How State Rate Limits Affect Payday Loan Prices" (2014), http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs/content-level_pages/fact_sheets/stateratelimitsfactsheetpdf.pdf.
[11] The Pew Charitable Trusts, "Auto Title Loans: Market Practices and Borrowers' Experiences" (2015), http://www.pewtrusts.org/~/media/assets/2015/03/autotitleloansreport.pdf.

The problems with these loans go well beyond pricing. An average payday loan comes due in just two weeks, taking up 36 percent of a typical borrower's next paycheck.[12] Few borrowers can afford to sacrifice such a large share of their income, so they repay the loan and quickly take another to cover their bills. This fact explains why 80 percent of single-payment payday loans are taken within two weeks of a previous loan[13] and why a typical borrower has a loan out for about five months of the year.[14] Auto title loans usually carry a term of about one month, and the loan repayment plus fee consume an average of 50 percent of a borrower's income.[15] As a predictable result, most borrowers quickly take another loan, because they cannot afford to pay their bills without it. Terms that are much too short lead to repeated borrowing, with consumers able to afford fees but not repay principal. Pew has found that 41 percent of payday loan borrowers[16] and 47 percent of auto title loan borrowers eventually retired their debt using a one-time windfall like a tax refund or help from family and friends.[17]

The unaffordable payments on single-payment loans would normally result in borrowers defaulting, but a payday lender has access to a borrower's checking account on payday, which makes them the first creditor to get paid, while auto title lenders can repossess a borrower's vehicle, creating strong ability to collect on very unaffordable loan payments. Even when loans have longer terms, lenders frequently set payments too high because they maintain strong ability to collect. Other lenders have set terms to be too long, such as 18 months for a $500 loan, so borrowers barely make a dent in the principal and most of their payments in early months just go to interest or fees.[18]

Lenders also mostly compete on factors other than price, because consumers seeking payday loans are usually in financial distress and show little sensitivity to price.[19] Instead, payday loan borrowers focus primarily on certainty of approval, ease of application, and speed of obtaining funds.[20] This trio—certainty, ease, and speed—explains why credit union members have turned to payday lenders when credit unions have not checked all three of these boxes. Because consumers do not prioritize cost and affordability when in a bind, lenders price at the rate limits set by states, no matter how high they are. When there are no limits, lenders price at an even

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[12] The Pew Charitable Trusts, "Payday Lending in America: Policy Solutions" (2013), http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf.
[13] Consumer Financial Protection Bureau, "CFPB Data Point: Payday Lending" (2014), https://files.consumerfinance.gov/f/201403_cfpb_report_payday-lending.pdf.
[14] The Pew Charitable Trusts, "Payday Lending in America: Who Borrows, Where They Borrow, and Why" (2012), http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/pewpaydaylendingreportpdf.pdf.
[15] The Pew Charitable Trusts, "Auto Title Loans: Market Practices and Borrowers' Experiences" (2015), http://www.pewtrusts.org/~/media/assets/2015/03/autotitleloansreport.pdf.
[16] The Pew Charitable Trusts, "Payday Lending in America: How Borrowers Choose and Repay Payday Loans" (2013), http://www.pewtrusts.org/~/media/assets/2013/02/20/pew_choosing_borrowing_payday_feb2013-(1).pdf.
[17] The Pew Charitable Trusts, "Auto Title Loans: Market Practices and Borrowers' Experiences" (2015), http://www.pewtrusts.org/~/media/assets/2015/03/autotitleloansreport.pdf.
[18] The Pew Charitable Trusts, "From Payday to Small Installment Loans: Risks, Opportunities, and Policy Proposals for Successful Markets" (2016), http://www.pewtrusts.org/~/media/assets/2016/08/from_payday_to_small_installment_loans.pdf.
[19] The Pew Charitable Trusts, "Standards Needed for Safe Small Installment Loans From Banks, Credit Unions," (2018), http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2018/02/standards-needed-for-safe-small-installment-loans-from-banks-credit-unions.
[20] Ibid.

higher level, with annual percentage rates consistently exceeding 450 percent.[21] This pricing is more than three times higher than is necessary for credit to be widely available from these lenders.[22]

Pricing from other non-depository providers is also very high, with effective APRs from pawn lenders often topping 200 percent, and total costs for items from rent-to-own providers frequently around four times the price of the same goods from mainstream retailers. In total, consumers spend well over $30 billion in interest and fees annually to borrow small amounts from non-depository lenders, with payday lending representing less than 30 percent of this spending.[23]

Section 2: Why the PAL program has not scaled

Credit unions can provide liquidity to many consumers who borrow today from non-depository lenders. Credit unions can also be profitable at prices that are typically about six times lower than those in the payday loan market—but not as low as those in NCUA's PAL program or the FDIC's 2008 Small-Dollar Loan Pilot program. If NCUA improves the existing PAL program sufficiently to enable credit unions to make safe small loans widely available to members profitably, that would not only enhance the safety and soundness of these institutions, but it could save millions of borrowers billions of dollars.

Credit unions and banks are well-positioned to offer small loans. Every single payday loan borrower has a checking account and income, because those are the two requirements to obtain a loan.[24] Three-quarters of auto title loan borrowers are banked.[25] But the volume of bank and credit union small-dollar loans has remained low, and the entire NCUA PAL program has resulted in fewer than 200,000 loans in recent years, compared with roughly 100 million payday loans annually.

The PAL program has not reached scale for three reasons:

1) Lack of automation: It is unsustainable to offer small loans by conducting the same manual underwriting as for conventional loans because that process is time-consuming and expensive. For credit unions to offer a higher volume of small loans, they will need clear and affirmative

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[21] The Pew Charitable Trusts, "How State Rate Limits Affect Payday Loan Prices" (2014), http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs/content-level_pages/fact_sheets/stateratelimitsfactsheetpdf.pdf.
[22] The Pew Charitable Trusts, "Trial, Error, and Success in Colorado's Payday Lending Reforms" (2014), http://www.pewtrusts.org/~/media/assets/2014/12/pew_co_payday_law_comparison_dec2014.pdf.
[23] The Pew Charitable Trusts, "Standards Needed for Safe Small Installment Loans From Banks, Credit Unions" (2018), http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2018/02/standards-needed-for-safe-small-installment-loans-from-banks-credit-unions.
[24] The Pew Charitable Trusts, "Payday Lending in America: Who Borrows, Where They Borrow, and Why" (2012), http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/pewpaydaylendingreportpdf.pdf.
[25] The Pew Charitable Trusts, "Auto Title Loans: Market Practices and Borrowers' Experiences" (2015), http://www.pewtrusts.org/~/media/assets/2015/03/autotitleloansreport.pdf.

regulatory guidance that reduces compliance risk and enables a high degree of automation. Recent technological advances enable members to apply for small credit quickly via online or mobile banking. We anticipate all PAL programs that reach scale will primarily process applications this way to keep the cost of originating a loan low. Credit unions will also be able to quickly deposit loan proceeds into members' checking accounts which will play a large role in serving members who often shop based on how fast they can get access to funds. Building out programs that use a high degree of automation and making financial commitments to their success requires adequate initial revenue and the expectation of sustainability. Therefore, there needs to be sufficient revenue available for this option to be attractive to both credit unions and service providers. If they both commit to and invest in the automation needed to make credit more widely available to members, then the costs of processing applications, underwriting, and originating small loans should decline substantially.

2) Insufficient revenue: While the interest rates permitted by the PAL program are higher than those for larger, mainstream loans like mortgages, auto loans, and credit cards, they are not sufficient for credit unions to scale small-loan programs. Our modeling based on market analysis and interviews with industry representatives has estimated that for a $400, 3-month loan to be sustainable to a depository institution, roughly $60 in revenue needs to be available; for a $500, 5-month loan, roughly $100-125; and for a $800, 6-month loan, roughly $140-170. Under current PAL limits, the maximum revenue available on these loans is $39, $56, and $87, respectively. The existing pricing is not enough to cover the costs of the current program, including manual origination and servicing small loans, let alone investing in the necessary automation and marketing for the program to succeed. Viable pricing would be nowhere near as high as the payday loan market, but it would have to be more than is currently permitted by PAL. It is possible for a PAL program to succeed even if there are certain loan sizes and terms that are unprofitable, but in aggregate, the program will have to have enough revenue to stand on its own. Some credit unions have operated small-loan programs that require a subsidy from the credit union's other activities. While mission-driven credit unions are admirable for offering small loans at a modest loss, subsidized lending will not reach scale, and millions of borrowers will continue to spend billions of dollars on high-cost loans instead. Even at the higher pricing we recommend in this comment letter, credit union small-dollar loans would still cost roughly six times less than average payday loans.

3) Insufficient flexibility: PAL is a worthwhile attempt to spur small-dollar lending, but in its current form is far too rigid to succeed. Limiting the program to closed-end loans at low prices only up to $1,000 and 6 months simply has not allowed the flexibility that either members or providers need. Consumers benefit from a range of loan sizes to cope with shortfalls depending on the type of need they have, sometimes less than $200 and sometimes more than $2,000. Smaller loans may help them avoid missing bill payments, while larger ones may help them cover rent or a mortgage during an income shortfall or replace a household appliance, make a down payment on a vehicle, or cover moving expenses and a security deposit. Some consumers are also likely to fare better with lines of credit than with closed-end loans. And many consumers will need more than six months or even 12 months to repay. Pew's research has found that an average payday loan borrower can afford to spend roughly 5 percent of gross

income on loan payments. For an average borrower earning $30,000 per year, that is $125 per month, including both principal and cost. For such borrowers, 6 months is not long enough to repay $1,000 and 12 months is not long enough to repay $2,000. If rates are limited to 36 percent APR, credit unions also are likely to need revenue from loans larger than $2,000 to subsidize unprofitable smaller loans. Open-end credit is often less costly to provide because credit unions can originate loans just once. Open-end lines can also better serve the needs of members coping with income volatility. Allowing more flexibility on size, term, and structure will make PAL programs more sustainable and enhance safety and soundness for credit unions that begin to offer small loans or expand their current offerings. It is possible to make the PAL program rules more flexible in a way that is consistent with core consumer protection principles.

Section 3: An optimal PAL program

An ideal program that worked well for providers and consumers would be based on the three core elements of successful small-dollar lending: *fair prices, affordable payments, and reasonable time to repay*. In such a program, costs should be spread evenly over the life of the loan, and total price should be reflective of both the amount borrowed and the amount of time credit is outstanding. Small loans that reach the scale needed to compete with payday lenders, meaning they are available to a large share people who would otherwise turn to high-cost credit, will necessarily have all-in APRs over 36 percent.[26] Neither the public[27] nor payday loan borrowers[28] see that as a problem.

One mutually sustainable pricing structure for providers and consumers would be setting an interest rate of 18 percent, plus a monthly service fee of 4 percent of the original loan amount, capped at $20. This would result in high double-digit APRs for the smallest loans, and APRs would decline as loan sizes increase. A sustainable APR for a $400 loan would be much too high for a $2,000 loan, and similarly, an appropriate APR for a $2,000 loan would be much too low for a $400 loan. Using this pricing structure would spread costs evenly over the life of the loan.

This pricing structure, with an interest charge plus a reasonable fee for each month a loan is outstanding, is also far better for both providers and consumers than attempting to have a low Truth in Lending Act (TILA) APR and making up the additional necessary revenue via front-loaded application fees or annual participation fees that are not part of the TILA APR. Setting an artificially low APR limit and then allowing non-TILA fees means that borrowers who use small amounts for short periods of time pay too much, as do borrowers who use large amounts for

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[26] The concept of "all-in APR" is similar to the "Military APR," or MAPR, in the Military Lending Act, and includes all interest and fees related to the loan. All-in APRs on the current PAL program, inclusive of allowable application fees, can be 80 percent or higher. If protections are provided to ensure affordable payments, reasonable time to repay, and costs that are fairly applied, this is appropriate for very small loans from credit unions. APRs should decline as loan sizes increase.

[27] The Pew Charitable Trusts, "Americans Want Payday Loan Reform, Support Lower-Cost Bank Loans" (2017), http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/04/americans-want-payday-loan-reform-support-lower-cost-bank-loans.

[28] The Pew Charitable Trusts, "Payday Loan Customers Want More Protections, Access to Lower-Cost Credit From Banks" (2017), http://www.pewtrusts.org/~/media/assets/2017/04/payday-loan-customers-want-more-protections.

long periods of time. Similarly, large upfront fees effectively penalize borrowers who repay early and make the first month of a loan much more profitable than all other months, which in non-depository loan markets has led to problems with loan flipping, or lender-driven refinancing. Borrowers who use typical amounts of $300-$600 for roughly half the year would pay too little, meaning that they would require a subsidy from borrowers who pay prices that are unnecessarily high. The reason is that by setting one interest rate for all loans, the rate on a $300 and $2,000 loan would be the same, though larger loans are sustainable for credit unions at lower rates than smaller ones.

Pew supports NCUA's efforts to expand small-loan programs so credit union members can access them, but the apparent focus on showing an artificially low TILA APR means that programs will be structured in a way that overly relies on front-loaded fees and causes some consumers to pay too little to sustain the program and others to pay too much. An interest rate plus monthly service fee model would avoid this problem and result in much greater equity among borrowers while aligning their incentives with those of providers. Our recommended standards for small-dollar loans from credit unions and banks are presented in **Figure 1** (see **Appendix A** for an explanation of these standards).

<u>Figure 1</u>

Safe, Small Installment Loans Should Meet All of These Criteria

Checklist for new, scalable, consumer-friendly small-dollar credit from banks and credit unions

- ☑ Serves customers who would ordinarily use higher-cost small loans by offering installment loans or lines of credit
- ☑ Payments are no more than 5 percent of paycheck or 6 percent of deposits
- ☑ Annual percentage rates do not exceed double digits, inclusive of all fees, with rates declining as loan sizes increase
- ☑ Total cost is no more than half of principal
- ☑ Costs are spread evenly, other than annual or small application fee
- ☑ Loan payments cannot trigger overdraft or nonsufficient funds fees
- ☑ Reports are sent to credit bureaus
- ☑ Borrowers may take only one loan at a time
- ☑ No more than 1 in 10 of each institution's small installment loans is charged off
- ☑ Loans are available quickly through online and mobile banking

Section 4: Recommended Changes to NCUA's Proposal

Given that the Board may not be in a position to change its approach to loan pricing or meet all of Pew's published standards as discussed in the previous section, we offer the following specific recommendations for amending the Board's current proposals:

1) **Program Structure**

For simplicity and facilitating widespread adoption, we recommend combining PALs I, II, and III into one PAL program with three components: closed-end and open-end loans lasting longer than 45 days, and exempt loans that meet original PAL I requirements. The two PAL versions plus an open-end option are similar enough that it would be easier for compliance purposes for credit unions to just have one program. This would also be easier for credit union members to understand. Further, it is possible to maintain existing exemptions from the CFPB's rule for payday and similar high-cost loans even within a single PAL program by setting a minimum term of 46 days for all loans or lines of credit that do not meet all PAL I standards.

For the closed-end and open-end loan components, the concepts outlined in PAL II and expanded on in our recommendations in this letter would address the needs of consumers by potentially allowing them a longer term and higher loan amount to cover larger expenses, as well as faster availability with the removal of the 30-day membership requirement. The "exempt" component would reflect the original PAL I parameters, because this program is exempt from the CFPB's payday loan rule as explained below. The CFPB exemption is the only advantage to PAL I, and it would only be applicable to the small share of loans with terms shorter than 46 days. If NCUA recommends a minimum term of 46 days for all loans that do not meet PAL I criteria, there is no need for multiple closed-end PAL options, because such loans would not be covered by the CFPB's final small-loan rule.[29]

2) **Creating a line of credit option**

Borrowers of high-cost loans, like many low- and moderate-income households, are at risk of fluctuating incomes. Nearly half of households in the U.S. have experienced an income gain or drop of more than 25 percent in any given two-year span.[30] People working on a contract basis in the "gig" or "sharing" economy may be especially susceptible to these fluctuations.[31]

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[29] Consumer Financial Protection Bureau, "Payday, Vehicle Title, and Certain High-Cost Installment Loans" (2017), https://www.federalregister.gov/documents/2017/11/17/2017-21808/payday-vehicle-title-and-certain-high-cost-installment-loans.

[30] The Pew Charitable Trusts, "The Precarious State of Family Balance Sheets" (2015), http://www.pewtrusts.org/en/research-and-analysis/reports/2015/01/the-precarious-state-of-family-balance-sheets.

[31] Justin Fox, "The Rise of the 1099 Economy," *Bloomberg View*, Dec. 11, 2015, https://www.bloomberg.com/view/articles/2015-12-11/the-gig-economy-is-showing-up-in-irs-s-1099-forms. Data show that since 2010, 1099s (the forms that some employers fill out when paying contract workers more than $600) have been gaining ground and even outpacing W-2 forms. As companies drop employees and add contract workers, W-2s decrease and 1099s increase. The Census Bureau's count of non-employment businesses (i.e. independent workers) has also increased.

Together, these data suggest that if there is an increasing shift away from salaried employment, that could exacerbate income volatility since wages fluctuate with varying work schedules.

Swings in income can destabilize a family's finances by making it difficult to budget and meet monthly expenses, including loan payments. Lower-income households observed as part of the U.S. Financial Diaries Project received a larger share of their income from inconsistent sources compared with moderate-income households.[32]

Other research has confirmed that poorer households experience higher rates of income volatility than their middle-income counterparts,[33] and low-income households with children and people with disabilities are among those more likely to experience sharp income declines.[34] Further, research on work schedules for young adults shows that part-time employees experience a higher level of work-hour instability and lower averages of work hours, and that fluctuations in work hours may result in financial insecurity.[35]

Recent research has also found that highly-indebted households' consumption is more sensitive to income shocks.[36] Because these households devote a greater share of their income to fixed monthly debt payments, they have less room to cut non-essential expenses when faced with an income loss. These consumers also experience income spikes periodically, enabling them to retire debt when they have a surplus.

Because income-volatile households may require cash more often than households with more regular income, but also may be able to repay that money more quickly when their incomes spike, lines of credit are likely to better meet their needs than closed-end loans. Whereas a borrower may fare better with a closed-end loan when they need a cash infusion to pay for an unusually large expense or make a purchase and then repay it in steady increments over time, lines of credit could serve as a better option for those who seek credit for consumption-smoothing. Lines of credit are also likely to be less costly for credit unions to administer because they are originated only once, and therefore they can be available at lower cost to borrowers. Whereas a borrower might pay several application fees in a 12-month period, they

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[32] Anthony Hannagan and Jonathan Morduch, "Income Gains and Month-to-Month Income Volatility: Household evidence from the US Financial Diaries," (2015), 1, https://static1.squarespace.com/static/53d008ede4b0833aa2ab2eb9/t/553521dae4b048e6faa46cdb/1429545456581/paper1.pdf#page=1. The authors summarized income volatility by an average coefficient of variation of monthly income, which was 55 percent for those below the poverty line and 34 percent for those from 100-300 percent of the poverty line.

[33] Gregory Mills and Joe Amick, "Can Savings Help Overcome Income Instability?" *The Urban Institute*, 6, http://www.urban.org/sites/default/files/alfresco/publication-pdfs/412290-Can-Savings-Help-Overcome-Income-Instability-.PDF#page=6. Coefficient of variation for monthly household income in lowest quintile was 0.499 and 0.321 for middle quintile.

[34] Gregory Acs, Pamela Loprest, and Austin Nichols, "Risk and Recovery: Understanding the Changing Risks to Family Incomes" (2009), *The Urban Institute*, http://www.urban.org/sites/default/files/alfresco/publication-pdfs/411971-Risk-and-Recovery-Understanding-the-Changing-Risks-to-Family-Incomes.PDF.

[35] Susan J. Lambert, Peter J. Fugiel, and Julia R. Henly, "Precarious Work Schedules among Early-Career Employees in the US: A National Snapshot," *University of Chicago*, 12, https://ssascholars.uchicago.edu/sites/default/files/work-scheduling-study/files/lambert.fugiel.henly_.precarious_work_schedules.august2014_0.pdf#page=14.

[36] Scott R. Baker, "Debt and the Consumption Response to Household Income Shocks" (2014), http://web.stanford.edu/~srbaker/Papers/Baker_DebtConsumption.pdf.

would pay just one annual participation fee to use a line of credit. For these reasons, we strongly recommend NCUA create a PAL line of credit.

3) Loan features

a) **Rate:** We greatly prefer the pricing model outlined in Section 3 (an 18 percent interest rate plus a reasonable service fee each month a loan is outstanding of up to 4 percent of the original loan amount, capped at $20 per month), but if NCUA ultimately decides to set one APR limit for PAL loans, we recommend that rate be 36 percent APR. As suggested in Section 3, this would enable credit unions to offer PALs profitably and expand their offerings to more members than under the 28 percent limit. The 36 percent APR is used in the CFPB's small-loan rule for longer-term loans, in the Military Lending Act, in the FDIC's Small-Dollar Loan Pilot, and by many states for their small-loan statutes. Near-prime installment lenders often self-cap their rates at 36 percent.[37] It is justifiable for NCUA to use this rate as well. Because a 36 percent APR is not enough to sustain a small-loan program, allowing a non-TILA fee for both a closed-end and open-end option is necessary as discussed below.

b) **Application fee:** If NCUA elects to use our preferred pricing of 18 percent interest plus a monthly service fee up to $20, no application fee is needed. But under a 28 percent or 36 percent APR limit, a non-TILA application fee is necessary. Our research indicates a 36 percent interest rate and $20 application fee will be inadequate to support a robust small-loan program in a safe and sound manner. If NCUA does not permit an APR above 36 percent, then an application fee somewhat higher than $20 will be necessary for credit unions to scale up small-loan programs and reach members who most need help. The appropriate ceiling for the application fee depends on many factors, and our research has modeled the overall revenue needed to operate successful programs and has previously explained the risks to consumers of large upfront fees.[38] Without knowing more detail about the other parameters of the program, we cannot recommend a specific application fee. However, an application fee of just $20 would produce inadequate revenue, preventing credit unions from adequately investing in the program and earning enough revenue to make these loans available to members who most need them.

   Additionally, we recommend clarifying that the application fee allowed in the PAL program may be used to cover a wide range of operational costs associated with applications. Under the official interpretation of section 1026.4(c) of Regulation Z, "an

[37] For example, OneMain Financial, the largest installment lender in the United States, limits its annual percentage rates to 36 percent. https://www.onemainfinancial.com/personal-loans.
[38] The Pew Charitable Trusts, "Payday Lending in America: Policy Solutions" (2013), http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf.

application fee that is excluded from the finance charge is a charge to recover the costs associated with processing applications for credit." In the current PAL regulation, the Board notes that application fees should be set at a level that reflects the "actual costs associated with processing the application." We encourage the Board to clarify that "actual costs" may include systematic costs associated with processing applications for credit, including investments in technology and automation, instructing potential applicants about how to apply, and paying third-party providers that can help lower the costs of application-related lending activities such as underwriting and processing. To the extent that the Consumer Financial Protection Bureau may be responsible for supervising certain credit union activities, the Board may wish to coordinate with that agency about the interpretation of application fees under the PAL program.

This interpretation of the allowable application fee within the Board's proposal is important to the overall success of closed-end PAL loans from the standpoint of safety and soundness. For the Payday Alternative Loan program to take root as a viable alternative to high-cost credit at scale, the marginal cost of processing an application and originating a loan will have to be very low, and the time required will have to be no more than a few minutes. These factors are critical both for members and credit unions. Yet neither a 28 percent nor a 36 percent interest rate will provide enough revenue to sustain the entirety of the program. For example, 28 percent interest on a $500, 6-month loan is just $42, while 36 percent interest is just $54—less than half of what is needed for such a loan under a successful program. Additional fee revenue will be important to paying the cost of achieving fast, automated loan origination and maintaining the program in a manner that is consistent with safe and sound credit union operation.

c) **Limit on Usage:** NCUA proposed removing the limit of three loans per six months in PAL II. The possibility of application fees rather than a monthly service fee creates the risk of loan flipping or other harms. But because these loans are repayable in installments, and we anticipate nearly all loans will have terms of at least 46 days, there will be few instances in which borrowers seek a fourth loan within six months. As a result, the limit of three loans per six months is generally unnecessary to protect consumers. But if the Board is uncomfortable with both raising the application fee above $20 and removing the limit of three loans per six months, we would recommend the Board permit somewhat higher application fees and keep the limit of three per six months, because that limit is not likely to impede many borrowers from accessing this lower-cost credit.

d) **Participation fee:** As with closed-end loans, a rate of 36 percent will not be sufficient to enable safe and sound open-end small-dollar lending. Therefore, we recommend the Board permit an annual participation fee up to $50 for line of credit programs in lieu of an application fee. This fee amount will provide enough additional revenue to enable small lines of credit without putting consumers at risk.

e) **Size:** Increasing the maximum loan size to $4,000 makes sense for three reasons. 1) At APRs of just 36 percent, typical loans of $300-$600 that last several months will not be profitable. But loans of $2,000 to $4,000 will be profitable at that APR, so the safety and soundness of the program as a whole will be enhanced by enabling loans of $2,000 to $4,000. 2) If loans of $2,000 to $4,000 are not permitted under the PAL program, then credit unions would not be able to charge interest above the standard 18 percent limit. At that rate, these loans made to members with less-than-prime credit are likely to lose money, so credit unions are not likely to offer them. A lack of lending in that range inside credit unions to members who lack prime credit scores can hurt both members and credit unions. 3) If loans in this range are unavailable, some members will turn to high-cost lenders instead. In California in 2017 alone, non-depository finance companies issued 321,423 consumer loans between $2,500 and $4,999 with APRs of 100 percent or higher. Just that one loan category in just one state had more volume than the entire PAL program among all credit unions combined across the United States.[39]

f) **Term:** For loans of even $2,000, 12 months is not enough for most consumers to repay. In the traditional installment loan market, which uses high-touch underwriting methods, consumers would almost always have more than 12 months to repay a $2,000 loan. If the Board increases maximum loan amounts to $4,000, as we recommend, then giving consumers up to 36 months to repay would be enough time to ensure that payments are generally affordable. Therefore, we recommend increasing the maximum term to 36 months. We support NCUA's recommendation for a minimum term of one month, but we encourage NCUA to recommend a minimum term of 46 days for all loans that do not meet the specifications of the original PAL program. This way, an exemption from the CFPB's small-loan rule is not needed.[40] Further, most borrowers need at least 46 days to repay, so such a minimum term is consumer friendly. Under the standards we published (Appendix A), by setting an affordable installment payment of five percent of each paycheck (or six percent of deposits into an account), no minimum term is necessary, because the affordability mechanism ensures that. We also recommend limiting costs to half of principal, which is more effective than a hard duration limit at making sure loan terms do not last too long. But if those parameters are not part of the final rule, a term

[39] California Department of Business Oversight Annual Report , Operation of Finance Companies Licensed under the California Financing Law (2017), http://www.dbo.ca.gov/Licensees/Finance_Lenders/pdf/2017%20Annual%20Report%20CFL%20Aggregated%20Final.pdf.

[40] The CFPB for Payday, Vehicle Title, and Certain High-Cost Installment Loans (12 CFR 1041) is focused on loans with terms of 45 days or less. Installment loans lasting longer than 45 days are generally exempt, as discussed in the next section.

of 1 to 36 months makes sense, with a 46-day minimum for all loans that do not meet all PAL I specifications. Though regulatory flexibility on term is appropriate, most people borrowing more than $400 will need at least three months to repay.

g) Membership: We support NCUA's proposal to remove the 30-day membership requirement so that consumers considering high-cost loans can instead join a credit union to access a lower-cost option. We believe that this approach would allow credit unions greater flexibility to devise tailored lending products that meet and address the needs of their communities and spur innovation while maintaining safety and soundness. We expect most credit unions will only extend new members small amounts of credit, so if NCUA wished to preserve the membership requirement for loans of $2,000 or more, we do not expect that would impede such lending. To be clear, we do not believe this restriction is necessary, but we also do not see it as harmful.

h) One loan at a time: We support NCUA's proposal to limit credit unions to providing one PAL loan at a time to a member. Allowing multiple closed-end loans at a time incentivizes loan splitting, where providers encourage borrowers to take multiple small loans to earn multiple application fees. Instead, if consumers may seek to borrow again before repaying a first loan, a line of credit is more appropriate and cost-effective for them.

i) **Net worth limit:** We have not studied the impact of the restriction on dollars loaned to 20 percent of net worth, though in interviews with credit union executives, most have said it is not likely to pose a substantial constraint on lending. But low-income designated credit unions (LICUs) and community development financial institutions (CDFIs) are likely to issue a relatively high volume of these loans because their members have a greater need for them. At the same time, their members often carry small balances in their deposit accounts, so we would encourage NCUA to examine whether aggregate small-loan volume over the course of a year could surpass 20 percent of net worth, and whether it makes sense to exempt these two types of credit unions from this limit. LICUs and CDFIs serve members who could benefit from lower-cost small-dollar lending the most. Normal supervision can ensure that this lending is done in a safe and sound manner.

j) **Underwriting:** We encourage NCUA to clarify that simple underwriting based primarily on evidence of deposits is adequate for small-dollar loans. As long as monthly payments are small, streamlined underwriting standards on small, lower-cost loans pose little risk to borrowers because of the general safety of the loans. We also recommend NCUA clarify that a review of recent paystubs is only necessary for new members or members who do not make regular deposits into their accounts. We favor clear approval for loans with installment payments that are no more than 5 percent of each paycheck or 6 percent of deposits into an account. Only if more than 1 in 10 loans charge off should examiners require tightened underwriting standards.[41]

k) **Reporting:** We recommend that borrowers' repayment history be reported to credit bureaus so that borrowers can establish a successful track record of repayment and potentially improve their credit scores, which might result in graduation to lower-cost credit options in the future.

l) **Overdraft:** We strongly recommend that the NCUA prevent PAL program loan payments from triggering overdraft or NSF fees. If lenders can earn enough revenue through loan programs, there is no reason for allowing additional fees. Excessive overdraft or NSF fees can put borrowers' financial well-being at risk, and small-loan programs could be a good alternative for consumers who make regular use of overdraft as a form of small credit.

m) Structure: We strongly recommend all loans be repayable in substantially equal installments and amortize fully to a zero balance. Members should be able to repay loans early at any time without penalty.

Section 5: Relationship between PAL & CFPB payday rule

Few if any small-dollar loans from credit unions will be subject to the rule for Payday, Vehicle Title, and Certain High-Cost Installment Loans that the Consumer Financial Protection Bureau finalized in 2017. This gives the Board flexibility to expand the PAL program going forward. The focus of the CFPB rule is on short-term loans lasting 45 days or less, and there is a conditional exemption for short-term loans that meet the requirements of the original PAL program and for low-volume programs.

Loans lasting longer than 45 days are generally not covered by the CFPB rule. The rule's underwriting requirements do not apply to these longer-term loans, and they are also exempt from the rule's other provisions for payment withdrawal, record-keeping, and disclosure practices except if the loan requires balloon payments or has a cost exceeding 36 percent APR. This is the APR as defined by the Truth in Lending Act, not the Military Lending Act. Loans by

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[41] The Pew Charitable Trusts, Oct.7, 2016, comment letter to Director Richard Cordray regarding "Proposed Rule for Payday, Vehicle Title, and Certain High-Cost Loans, Docket ID: CFPB-2016-0025," 58-60, https://www.regulations.gov/document?D=CFPB-2016-0025-142716.

banks and credit unions to checking account holders are granted additional exemptions from the payment withdrawal requirements if their payments cannot trigger overdraft or non-sufficient funds fees. Therefore, any loans made by credit unions that have a term of at least 46 days would never have to comply with the CFPB rule's underwriting requirements, and in most cases would not have to comply with the CFPB rule at all.

For these reasons, we believe NCUA should recommend that credit unions set minimum terms for these loans of at least 46 days, unless all the provisions of the original PAL program are met. <u>If credit unions set terms of at least 46 days, no exemption from the CFPB rule or other action would be necessary for compliance.</u> NCUA can act unilaterally on this issue and does not need the CFPB to take any steps to permit viable small-dollar loans from credit unions.

Given the more expansive rule the CFPB originally proposed in 2016, it was understandable that NCUA worked diligently to gain an exemption for PAL loans from that proposal. But the rule the CFPB finalized in 2017 was substantially different from the proposed rule, and it provided explicit exemptions for nearly all small-dollar loans that would be issued by credit unions. Therefore, no further exemption is needed for the types of loans envisioned by the Board's proposal if the loans carry terms of at least 46 days.

Section 6: Request for Information

All the items in this request for information are addressed earlier in this comment, but they are also included here for ease.

1) Should the Board propose a third alternative PALs rule and why?

We recommend one PAL program with a closed-end, open-end, and exempt option.[42] We believe this will be simpler for consumers and credit unions than the three separate programs.

2) Should the Board set the permissible interest rate for PALs III loans above that permitted for other PALs loans? If so, why and what legal justification supports a higher interest rate?
3) Should the Board increase in PALs III the maximum amount an FCU can charge for an application fee above that permitted for other PALs loans?

Additional revenue is necessary to make the programs sustainable for credit unions. Ideally, the Board would permit annualized interest of 18 percent plus a monthly service fee of four percent of the original loan amount or $20, whichever is lower.

[42] The exempt option would meet the requirements of the original PAL program and would therefore qualify for the CFPB's conditional exemption to the rule.

Otherwise, if the Board prefers to set an APR limit for the program, we recommend an annual percentage rate of 36 percent plus an application fee for closed-end loans and an annual participation fee for open-end credit. For closed-end loans, an application fee of $20 plus a rate of 36 percent is not enough revenue to operate a small-loan program; therefore, a fee somewhat higher than $20 would help providers be sustainable and would help consumers because they would gain access to loans that cost far less than those available to them today from nonbanks. For line of credit programs, to achieve pricing that puts neither borrowers nor credit unions at risk, a participation fee up to $50 per year would be warranted.

4) Should the Board allow FCUs to make more than one kind of PALs loan at a time to a borrower?

Members should have only one loan at a time. It could be a closed-end loan or it could be a line of credit that allows multiple draws.

5) Should the Board set in PALs III the limit on the aggregate dollar amount of loans made above that permitted for other PALs loans?

We have not conducted research on the limitation of 20 percent of net worth for credit unions, though most executives do not perceive it to be a major constraint. That may be different for credit unions whose members could most benefit from small credit, LICUs and CDFIs. Therefore we recommend NCUA examine whether those two types of credit unions warrant an exemption from this limit.

6) Should the Board eliminate for PALs III the requirement that FCUs implement appropriate underwriting guidelines?

The Board should not eliminate this requirement, but should clarify that evidence of regular deposits can be a major factor in underwriting and paystubs are only needed for new members and those without regular deposits.

7) Should the Board set for PALs III the maximum loan amount above that permitted for other PALs loans?

We recommend a maximum loan size of $4,000 both to help ensure the safety and soundness of the overall program and to enable members to access loans to cover larger expenses, especially as payday lenders and auto title lenders issue loans above $2,000 in states where that is permitted.

8) Should the maturities for PALs III loans be longer than those permitted for other PALs loans?

We recommend a maximum term of 36 months.

9) Should the Board permit PALs III to include an open-end loan product?

We strongly recommend the board create an open-end option under the PAL program.

a. If the Board permits an open-end product, should the Board allow FCUs to charge participation fees, provided the fees are not considered a finance charge under Regulation Z?

Unless the Board intends to allow annual percentage rates above 36 percent, then a participation fee will be necessary for the program's success.

b. If the Board permits participation fees on an open-end PALs product, should the Board set a maximum cap on that fee, and, if so, what should the maximum amount be?

We recommend a maximum annual participation fee of $50 if the rate is 36 percent. A higher participation fee will be needed if the rate is only 28 percent.

10) Should the Board require FCUs to conduct an ability to repay determination in PALs III similar to that required by the CFPB's Payday Loan Rule? 12 12 CFR § 1026.2(a)(20). 13 Id. at § 1026.4.

The CFPB's ability to repay determination makes sense for very high-cost loans, such as those issued by payday lenders. But such a determination is unnecessary for safer, lower-cost loans, such as those that would be permitted under our recommendations for the PAL program. The explicit safeguards and price limitations of the PAL program are strong enough that the Board does not need to impose ability to repay rules similar to those in the CFPB's rule for short-term payday and high-cost loans.

11) Should the Board prohibit FCUs from charging overdraft fees for PALs loan payments drawn against a member's account?

We strongly recommend the Board prohibit FCUs from charging overdraft fees for payments on PAL loans. Because the credit union controls the depository account from which payments will be drawn, there is no justification for an overdraft fee, meaning that any such fee would merely represent a way to circumvent the intended price limits in the program.

To conclude, we view optimal pricing limits as 18 percent interest plus a monthly service fee of 4 percent of the original loan amount, capped at $20 per month. This fee could be described as 4 percent of the first $500 lent, with that $500 figure indexed to inflation, so the monthly service fee would keep pace with inflation. We also recommend an underwriting standard that clearly permits loans with payments limited to 5 percent of each paycheck or 6 percent of incoming deposits. We also favor limiting costs to half of loan proceeds.

If these recommendations are not adopted, then we favor raising the maximum rate to 36 percent APR, plus an application fee somewhat higher than $20, and an annual participation fee for lines of credit (in lieu of an application fee) capped at $50. We would also encourage simple underwriting standards based primarily on evidence of regular deposits into a checking account.

Thank you for your consideration. We are confident with some modifications to the proposed rulemaking that many Americans who today turn to payday and similar loans can gain access to lower-cost credit from credit unions that will substantially improve their financial health.

Sincerely,

Nick Bourke
Director, Consumer Finance
The Pew Charitable Trusts
www.pewtrusts.org/small-loans

Appendix A: Standards publication
Appendix B: Survey of borrowers published in 2017
Appendix C: Survey of public published in 2017
Appendix D: Nick Bourke's op-ed in CU Times

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A brief from THE PEW CHARITABLE TRUSTS | Feb 2018

Standards Needed for Safe Small Installment Loans From Banks, Credit Unions

Millions of borrowers could save billions of dollars annually

Overview

Several recent developments have raised the possibility of banks and credit unions offering small installment loans and lines of credit—which would provide a far better option for Americans, who currently spend more than $30 billion annually to borrow small amounts of money from payday, auto title, pawn, rent-to-own, and other small-dollar lenders outside the banking system. Consumers use these high-cost loans to pay bills; cope with income volatility; and avoid outcomes such as eviction or foreclosure, having utilities disconnected, seeing their cars repossessed, or going without necessities. Many of these loans end up harming consumers because of their unaffordable payments and extremely high prices; in the payday and auto title loan markets, for example, most borrowers pay more in fees than they originally received in credit.

Millions of households could benefit if banks and credit unions were to offer small installment loans and lines of credit with standards strong enough to protect consumers, clear enough to avoid confusion or abuse, and streamlined enough to enable automated low-cost origination.

Many credit unions and community banks already offer some small installment loans and lines of credit. But because regulators have not yet issued guidance for how banks and credit unions should offer small-dollar installment loans, or granted specific regulatory approvals for offering a high volume of such loans, these programs have not achieved a scale to rival the 100 million or so payday loans issued annually—let alone the rest of the nonbank small-dollar loan market. So, with most banks and credit unions either not offering small loans, or only offering them to people with relatively high credit scores, consumers with low or no credit scores looking to borrow small amounts of money often turn to alternative lenders in the nonbank market. Yet three-quarters of all households that use these alternative financial services already have accounts at banks or credit unions, and borrowers who take out payday loans in particular must have both an income and an active checking account to serve as collateral when their payments are due.

Now, the Consumer Financial Protection Bureau's (CFPB's) final small-loan regulation, issued in October 2017, permits providers to offer small installment loans and lines of credit with few restrictions—and adds strong consumer safeguards for loans with terms up to 45 days. Banks and credit unions have stated their interest in offering small installment loans and lines of credit, and some policymakers have expressed support for the idea. But while finalizing this rule was a necessary step for banks and credit unions to be able to offer such loans, it is not sufficient. In order for these loans to reach market, banks and credit unions will need to develop small-loan products, and their primary regulators—the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board of Governors, the Federal Deposit Insurance Corp. (FDIC), and the National Credit Union Administration (NCUA)—will need to approve the products.

The opportunity for more banks and credit unions to enter the small installment loan market is not without its challenges. In order for these traditional lending institutions to seriously compete with the large number of payday and other nonbank small-dollar lenders that market aggressively, many banks and credit unions—especially large ones—would need not only to offer small-dollar loans but to make sure that consumers are aware that they offer such loans. And banks and credit unions would need to compete with nonbank lenders on speed, likelihood of approval, and ease of application, because small-dollar loan borrowers usually seek credit when they are in financial distress.

But banks and credit unions would also enter the market with large comparative advantages over nonbank lenders, with their lower costs of doing business allowing them to offer loans profitably to many of the same borrowers at prices six times lower than those of payday and other similar lenders. The banks and credit unions would be lending in a largely automated fashion to known customers who already make regular deposits, so both their acquisition costs and automated underwriting costs would be lower than those of nonbank lenders. The cost of capital for banks and credit unions is the lowest of any provider, and their overhead costs are spread among the multiple products they sell.

The idea of banks offering small-dollar loans is not entirely new, and experience is instructive. Until regulators largely put a stop to the practice in late 2013, a small number of banks offered costly "deposit advances" that were due back in a lump sum on the borrower's next payday, at a fee most often of 10 percent per pay period—or roughly 260 percent annual percentage rate (APR). Regulators should not permit banks to reintroduce deposit advance loans; for consumers, it is also vital that any small-dollar loans from banks and credit unions not replicate the three key harms that characterized the deposit advance market: excessive pricing, unaffordable payments, and insufficient time to repay.

This brief includes guidelines for banks and credit unions to follow as they develop new small-dollar loan programs. The guidelines are designed to protect consumers and enable sustainability and scale for providers, who should offer small installment loans or lines of credit with the following features:

- Affordable installment payments of no more than 5 percent of each paycheck or 6 percent of deposits into a checking account.
- Double-digit APRs that decline as loan sizes increase.
- Total costs that are no more than half of loan principal.
- Loan payments that cannot trigger overdraft or nonsufficient funds fees.
- Online or mobile application, with automated loan approval, so that loan funds can be quickly deposited into a borrower's checking account.
- Credit bureau reporting of loan terms and repayment.

The status quo

The nonbank options for credit are often poor, with high-cost loans dominating the landscape. Twelve million Americans use payday loans annually, and many others use different forms of high-cost credit.[1] The FDIC has found that 20 percent of all American households are underbanked, meaning that they use alternative financial services in addition to using banks and credit unions.[2]

The bulk of research on payday lending has focused on whether consumers fare better with access to loans with unaffordable payments that carry APRs of around 400 percent, or whether, instead, these loans should be banned and small-dollar credit made mostly unavailable. But such research incorrectly assumes that these are the only two possibilities, especially since other studies have shown that consumers fare better than they do with payday loans when they gain access to alternatives featuring affordable installment payments and lower costs.[3]

Payday lenders' products are so expensive because they operate retail storefronts that serve an average of only 500 unique borrowers a year and cover their overhead selling few financial products to a small number of customers. Two-thirds of revenue goes to handle operating expenses, such as paying employees and rent, while one-sixth of revenue covers losses.[4] They have higher costs of capital than do banks or credit unions, they do not have a depository account relationship with their borrowers, and they often do not have other products to which borrowers can graduate. Their customer acquisition costs are high, and because storefront lending requires human interaction, they make limited use of automation. The online payday loan market, while it avoids the costs that come with maintaining retail storefronts, has higher acquisition costs and losses than do retail payday loan stores.[5]

Banks and credit unions do not face these challenges on the cost side—and, because of customers' regular deposits into their checking accounts and pre-existing relationships with providers, the losses from small-loan programs run by banks and credit unions have been low.

Giving consumers a better option

Many customers use high-cost loans, pay bills late, pay overdraft penalty fees as a way to borrow, or otherwise lack access to affordable credit. Being able to borrow from their bank or credit union could improve these consumers' suite of options and financial health, and keep them in the financial mainstream: The average payday loan customer borrows $375 over five months of the year and pays $520 in fees,[6] while banks and credit unions could profitably offer that same $375 over five months for less than $100.

Yet while 81 percent of payday loan customers would prefer to borrow from their bank or credit union if small-dollar installment loans were available to them there,[7] banks and credit unions do not offer such loans at scale today primarily because regulators have not issued guidance or granted specific regulatory approvals for how banks and credit unions should offer the loans. The CFPB appropriately issued strong final rules in October 2017 for loans lasting 45 days or less, removing some of the regulatory uncertainty that discouraged banks and credit unions from offering installment loans and lines of credit.[8] Because of the investment involved in launching a new product, and concern on the part of banks and credit unions about enforcement actions or negative reports from examiners, these traditional banking institutions will need clear guidance or approvals from their primary regulators—the OCC, the Federal Reserve, the FDIC, and the NCUA—before they develop small-loan products.

Experience with small-dollar loan programs suggests losses will be low. For example, over the past decade, certain banks and credit unions offered small-dollar loans under three regulated programs—the NCUA Payday Alternative Loan program, the FDIC small-dollar loan pilot, and the National Federation of Community Development Credit Unions pilot—and collectively they charged off just 2 to 4 percent of those loans.[9] Several providers, including Rio Grande Valley Multibank, Spring Bank, Kinecta Federal Credit Union, and St. Louis Community Credit Union's nonprofit partner Red Dough, have already adopted Pew's recommendation to set individual payments at no more than 5 percent of each paycheck, and all have found charge-off rates to be manageable.[10]

The following attributes distinguish safe loans from those that put borrowers at risk and should be used to evaluate bank and credit union small-loan offerings.

Payment size

When making small loans to customers with poor credit scores, lenders typically obtain access to borrowers' checking accounts to help ensure repayment. While this helps lenders make credit available to more consumers by minimizing the risk that they will not get repaid, it also puts consumers at risk that lenders will take such large payments from their accounts that they will be unable to afford other expenses. This has been a pervasive problem in the market for payday, auto title, and deposit advance loans.

Extensive research, both in borrower surveys and in analysis of installment loan markets serving customers with low credit scores, shows that these borrowers can afford payments of around 5 percent of their gross paychecks[11] (or a similar 6 percent of net after-tax income). Using this threshold as a standard for affordable payments would help protect consumers whenever lenders take access to their checking accounts as loan collateral, while also providing a clear and easy-to-follow guideline that works well for lenders. To improve operational efficiency and keep costs down, banks and credit unions can assess customers' income based on deposits into checking accounts and automatically structure loans to have affordable payments that take no more than 5 percent of each gross paycheck or 6 percent of deposits into accounts.[12] This payment size is sufficient for borrowers to pay down their balances—and for lenders to be repaid—in a reasonable amount of time.

Pricing and competitive factors

Small-loan markets serving customers with very low credit scores are competitive on many elements, but generally speaking not on price[13]—because those seeking this credit are in financial distress and focus primarily on speed, likelihood of approval, and ease of application.[14] To succeed in this market, any bank or credit union program must be competitive on these essential features. If banks and credit unions can achieve that, then they could leverage their strong competitive advantage by being able to offer loans profitably at much lower prices.

The payday loan market is typically characterized by 400 percent APRs, but banks and credit unions can be profitable at double-digit APRs as long as applicable rules allow for automated origination.[15] These APRs for small loans borrowed for short periods of time need not be as low as the APRs for credit-card debt to be broadly viewed as fair. For example, 80 percent of Americans think that a $60 charge for a $400, three-month loan is fair, though its APR is 88 percent.[16] (See Figure 1.) That $60 cost is roughly six times lower than average payday loan pricing for the same loan. But bank or credit union loans or lines of credit with three-digit APRs should attract additional regulatory scrutiny—because those rates are unnecessary for profitability, because they may be indicative of inadequate underwriting, and because the public sees them as unfair, meaning that they could create reputational risk for a bank or credit union. And APRs should decline as loan sizes increase, because the relatively high APRs needed for very small loans to be profitable are not justified for larger loans.

Any fees charged, other than a small application or annual fee, should be charged monthly, in order to be spread evenly over the life of the loan. Such a structure does not penalize borrowers who repay early or create an incentive for lenders to refinance loans.

Figure 1

Americans Say Planned Bank Small-Loan Prices Are Fair

Respondents' opinions on proposed 5% payment loans

Notes: Respondents were read the following statement: "Here are some examples of small loans that might be available to people who have low credit scores. For each, please tell me whether you think the terms seem fair or unfair. (Insert item.) Do you think the terms seem fair or unfair? a) $500 for a fee of $100 paid back over 4 months, so a person who borrows $500 will pay back $600; b) $500 for a fee of $600 paid back over 4 months, so a person who borrows $500 will pay back $1,100; c) $400 for a fee of $60 paid back over 3 months, so a person who borrows $400 will pay back $460." Results are based on 1,205 interviews. The order of these statements was randomized in the survey. Numbers shown do not total 100 percent because "don't know" and "refused" responses (indicated in gray) were omitted.

Source: The Pew Charitable Trusts, "Americans Want Payday Loan Reform, Support Lower-Cost Bank Loans" (April 2017), 7, http://www.pewtrusts.org/~/media/assets/2017/04/americans-want-payday-loan-reform.pdf

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Repayment term

Few borrowers can afford to repay small loans in just a few weeks. At the same time, some payday lenders have set unreasonably long terms to earn more revenue, such as 18 months to repay $500.[17] The CFPB's final small-loan rule takes the important step of steering the market toward terms of more than 45 days. To ensure that loan sizes and durations do not become excessive, some regulators and state lawmakers have set maximum terms for various loan programs, such as six months. A more flexible approach would be to ensure that the total cost of a small-dollar bank or credit union loan never exceeds half of the loan principal, which would discourage lenders from setting terms that are too long—because they cannot earn additional revenue from doing so. At the same time, such a limit would allow for terms long enough to accommodate loans larger than $1,000 (the average size of an auto title loan).

Providers should be free to experiment with both installment loans and lines of credit, as long as all of the safeguards described in this brief are included. Some consumers, such as those who need to make a substantial purchase or handle an unusually large expense, may be more likely to repay under the discipline imposed by installment loans. For consumers facing income volatility, the flexibility offered by lines of credit could be a better fit.

Automation

The cost of manually processing applications is too high to offer small loans at scale. So, to keep the cost of origination low—and to compete with nonbank lenders on speed and ease—banks and credit unions will need to largely automate the lending process, including determining eligibility, establishing the maximum loan size, processing applications, and disbursing funds. Some additional time would be required for banks or credit unions to process loan applications from people who are not already their customers, but the financial institutions may find it worthwhile to do so since it would mean acquiring new accountholders.

Underwriting

As highly regulated institutions, banks and credit unions engage in underwriting to ensure that they are lending in a safe and sound manner. The underwriting criteria for small-dollar installment loans must be carefully tailored so that these loans can be competitive with more expensive options such as payday, auto title, or rent-to-own loans. The guidelines must allow for prescreening, high approval rates,[18] and fast origination at very low cost, similar to those employed for overdraft programs and other automated systems; otherwise, the provider would have to charge a high price to be profitable.

Prescreening customers to determine eligibility can improve the likelihood that the loans are advertised only to customers who are likely to be approved. Among customers with damaged credit, traditional metrics such as a credit score are limited in their effectiveness at assessing the likelihood of loan repayment. Therefore, relying primarily on a credit score to determine eligibility is likely to deny access to these customers, many of whom would otherwise use high-cost products. To mitigate this issue, providers should be able to experiment with underwriting criteria. Important elements are likely to include whether the customer is maintaining an account in good standing; the length of the customer's relationship with the bank or credit union; regularity of deposits; and the absence of any warning signs such as recent bankruptcies or major problems with overdrafts (a small installment loan would be better for most customers than paying several overdraft fees, but very heavy and persistent overdrawing could indicate deeper financial troubles that would make further extension of credit unwarranted). At the same time, if criteria are too strict, banks and credit unions may be unable to serve customers who could most benefit from small credit, leaving them with more costly nonbank options.

Providers will necessarily underwrite differently when lending to people who are not current customers but are joining the credit union or bank specifically because of its small-loan offerings. Regulators should leave banks and credit unions the flexibility to adjust their underwriting to ensure that losses remain manageable, while also making loans available to customers who would otherwise turn to high-cost lenders or suffer adverse outcomes because they could not borrow. For loans with terms of just a few months, annualized loss rates may look high compared with conventional credit products, but that should not be cause for concern as long as the absolute share of loans charged off is not excessive.

Credit reporting

Loans should be reported to credit bureaus so that borrowers can build a track record of successful repayment, which in turn could help them qualify for lower-rate financial products. To maximize customer success, borrowers should be automatically placed into electronic payments that coincide with days they are likely to have incoming deposits, which keeps losses lower for providers and increases the odds that customers will succeed. Customers must have a chance to opt out of electronic repayment and pay manually if they prefer.

Convenience

In order to attract customers from payday and other high-cost lenders, banks and credit unions must offer loans that are at least as convenient. With sufficient automation, the loans can be far easier and faster to obtain than those from nonbank lenders. The pre-existing relationship between the bank or credit union and customer means the applications can be started through an online or mobile banking platform, with the funds deposited quickly into checking accounts. Applying for credit and receiving it electronically can be especially helpful to customers who seek credit outside of normal banking hours or who do not live near a branch of their bank or credit union. If, on the other hand, banks and credit unions offer loans that—while at a lower cost than those available through payday and other lenders—are not as fast or convenient, many customers will continue to leave the banking system to borrow money.

Other safeguards

The characteristics described above would make small loans far safer than those available from payday and other nonbank lenders. But three additional protections can benefit consumers further, without discouraging banks and credit unions from lending:

- To ensure that loans are made in a safe and sound manner only to customers who have the ability to repay them, providers should ensure that no more than 1 in 10 loans defaults. There may be valid reasons for high default rates during downturns or after natural disasters, but if more than 1 in 10 loans consistently defaults, lenders should change their loan policies and practices so at least 9 in 10 customers succeed.[19]
- Small-dollar loans from banks and credit unions should not trigger overdraft or nonsufficient funds fees, which today are charged when payday and other nonbank loans overdraw accounts. This protection is feasible for traditional financial institutions because they both operate the checking account and service the loan. If a lender accidentally charges such a fee, the customer should receive a prompt refund.

- Each lender should ensure that it is extending only one small loan at a time to each customer.[20] If customers repay as agreed, they should be able to borrow again.

Figure 2 identifies the features that would make high-volume offerings of small installment loans and lines of credit from banks and credit unions safe. Programs that use automation and seek to achieve scale should meet all of these criteria. Existing, low-cost, ad hoc, or low-volume programs from community banks and credit unions that are not automated tend to have many consumer-friendly features, though they do not meet all of these criteria.

Figure 2

Safe, Small Installment Loans Should Meet All of These Criteria

Checklist for new, scalable, consumer-friendly small-dollar credit from banks and credit unions

- ☑ Serves customers who would ordinarily use higher-cost small loans by offering installment loans or lines of credit
- ☑ Payments are no more than 5 percent of paycheck or 6 percent of deposits
- ☑ Annual percentage rates do not exceed double digits, inclusive of all fees, with rates declining as loan sizes increase
- ☑ Total cost is no more than half of principal
- ☑ Costs are spread evenly, other than annual or small application fee
- ☑ Loan payments cannot trigger overdraft or nonsufficient funds fees
- ☑ Reports are sent to credit bureaus
- ☑ Borrowers may take only one loan at a time
- ☑ No more than 1 in 10 of each institution's small installment loans is charged off
- ☑ Loans are available quickly through online and mobile banking

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Conclusion

For too long, consumers who are struggling financially have had poor options when they seek to borrow small sums of money. These consumers are mostly bank and credit union customers, and it is imperative for their financial health that regulators, banks, credit unions, and other stakeholders find a way for them to gain access to better credit than that offered at high cost by nonbank lenders. Seventy percent of Americans report that they would have a more favorable view of their bank or credit union if it offered a $400, three-month loan for $60, and 80 percent believe that such a loan is fair[21]—as do 86 percent of payday loan borrowers.[22] Around this price point, 90 percent of current payday loan customers would rather borrow from a bank or credit union.[23] Numerous banks and credit unions are interested in offering small loans with the consumer-friendly characteristics laid out in this brief. With clear guidelines from regulators, that credit could reach the market and millions of Americans who are using high-cost loans today could save billions of dollars annually.

Endnotes

1 The Pew Charitable Trusts, "Payday Lending in America: Who Borrows, Where They Borrow, and Why" (July 2012), 4, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/pewpaydaylendingreportpdf.pdf; Center for Financial Services Innovation, "2016 Financially Underserved Market Size Study" (November 2016), http://cfsinnovation.org/wp-content/uploads/2016/11/2016-Financially-Underserved-Market-Size-Study_Center-for-Financial-Services-Innovation.pdf.

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10 The Pew Charitable Trusts, Oct. 7, 2016, comment letter to Director Richard Cordray regarding "Proposed Rule for Payday, Vehicle Title, and Certain High-Cost Loans, Docket ID: CFPB-2016-0025," 28, https://www.regulations.gov/document?D=CFPB-2016-0025-142716.

11 Ibid., Appendix C.

12 To gain a more complete financial picture, providers may wish to ask the applicant to state his or her income on the loan application, especially for joint accounts, but payment size should be determined using verified income or deposits, not stated income.

13 The Pew Charitable Trusts, "How State Rate Limits Affect Payday Loan Prices" (April 2014), http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs/content-level_pages/fact_sheets/stateratelimitsfactsheetpdf.pdf.

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16 The Pew Charitable Trusts, "Americans Want Payday Loan Reform, Support Lower-Cost Bank Loans" (April 2017), 7, http://www.pewtrusts.org/~/media/assets/2017/04/americans-want-payday-loan-reform.pdf.

17 The Pew Charitable Trusts, "From Payday to Small Installment Loans" (August 2016), 10, http://www.pewtrusts.org/~/media/assets/2016/08/from_payday_to_small_installment_loans.pdf.

18 Although providers' underwriting criteria will vary, they should all target loans to customers who are likely to be approved and make those loans available via online or mobile banking so that customers do not become discouraged and turn to high-cost lenders.

19 This recommendation refers to the proportion of loans defaulting, but it intentionally does not use annualized loss rates to measure that share. Annualizing losses on short-term loans, but not outstanding balances, tends to yield a high annualized default rate even when relatively few loans go unpaid.

20 Pew intends this recommendation to ensure that banks or credit unions do not issue more than one loan at a time to each borrower, but that does not mean that, when using third-party vendors, these lenders should be required to check the records of other providers using the same vendor.

21 The Pew Charitable Trusts, "Americans Want Payday Loan Reform," 4, 7.

22 The Pew Charitable Trusts, "Payday Loan Customers Want More Protections," 11.

23 Ibid., 7.

For further information, please visit:

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A chartbook from THE PEW CHARITABLE TRUSTS | April 2017

Payday Loan Customers Want More Protections, Access to Lower-Cost Credit From Banks

Results of a nationally representative survey of U.S. borrowers

The Pew Charitable Trusts

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Overview

Payday loans typically carry annual percentage rates of 300 to 500 percent and are due on the borrower's next payday (roughly two weeks later) in lump-sum payments that consume about a third of the average customer's paycheck, making the loans difficult to repay without borrowing again. They are characterized by unaffordable payments, unreasonable loan terms, and unnecessarily high costs.

In June 2016, the Consumer Financial Protection Bureau (CFPB) proposed a rule to govern payday and auto title loans[1] that would establish a process for determining applicants' ability to repay a loan but would not limit loan size, payment amount, cost, or other terms. The CFPB solicited and is reviewing public comments on whether to include in its final rule alternatives to this process with stronger safeguards, particularly a 5 percent payment option that would limit installment payments to 5 percent of monthly income, enabling banks and credit unions to issue loans at prices six times lower than those of payday lenders, making lower-cost credit available at scale. An analysis by The Pew Charitable Trusts determined that the CFPB's proposal would accelerate a shift from lump-sum to installment lending but, without the 5 percent option, would shut banks and credit unions out of the market, missing an opportunity to save consumers billions of dollars a year.[2]

Previous Pew research found that payday loan borrowers want regulatory action to reform payday lending and expand lower-cost credit options, so in light of the CFPB proposal, Pew conducted a new nationally representative survey of 826 borrowers and found that:

- **70 percent of borrowers believe payday loans should be more regulated.**
- **Support for requiring installment payment structures is strong.** Three in 4 borrowers say having several months to repay and doing so in smaller installments would be major improvements, but most say additional underwriting would not.
- **Borrowers' priorities for reform include lower prices, affordable payments, and being able to obtain small loans from banks and credit unions.**
- **8 in 10 would prefer to borrow from a bank or credit union if they were equally likely to be approved, and 90 percent would do so if the loans cost six times less than those of payday lenders.** The pricing differential is based on payday lender fees for loans and on prices financial institutions would reportedly offer.

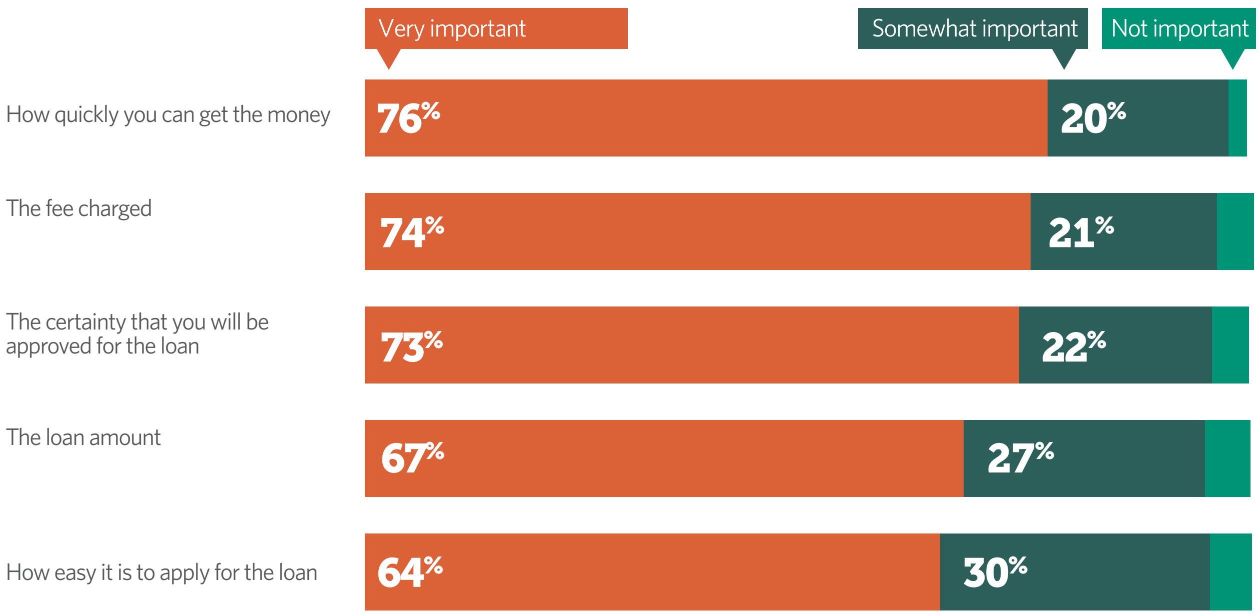
- **Virtually all would choose loans that cost six times less.** Ninety-two percent of borrowers say they would prefer the lower-cost credit that banks and credit unions would likely offer under the 5 percent payment option. Only 5 percent would opt for more expensive payday installment loans that went through the proposed ability-to-repay origination process.

These findings show that payday loan borrowers strongly favor reform and are especially supportive of steps that would encourage lower-cost bank and credit union loans. A separate survey of American adults found that the public shares these sentiments.[3] This chartbook discusses recommended changes to the proposal, including adoption of the 5 percent option, which is supported by Pew as well as many banks, community groups, and credit unions.

Figure 1

When Deciding Where to Get a Loan, Borrowers Say Speed, Cost, and Certainty Are Top Factors

Percentage of respondents by loan characteristic



Notes: Respondents were asked: "In choosing where to get a payday loan, how important is the following to you? The fee charged; How quickly you can get the money; How easy it is to apply for the loan; The certainty that you will be approved for the loan; The loan amount." Then the respondents were asked: "You listed the following as "very important" when choosing to get a payday loan. Which one would you rank as the most important one?" Results are based on 826 interviews. Numbers do not total 100 percent because "refused" responses were omitted.

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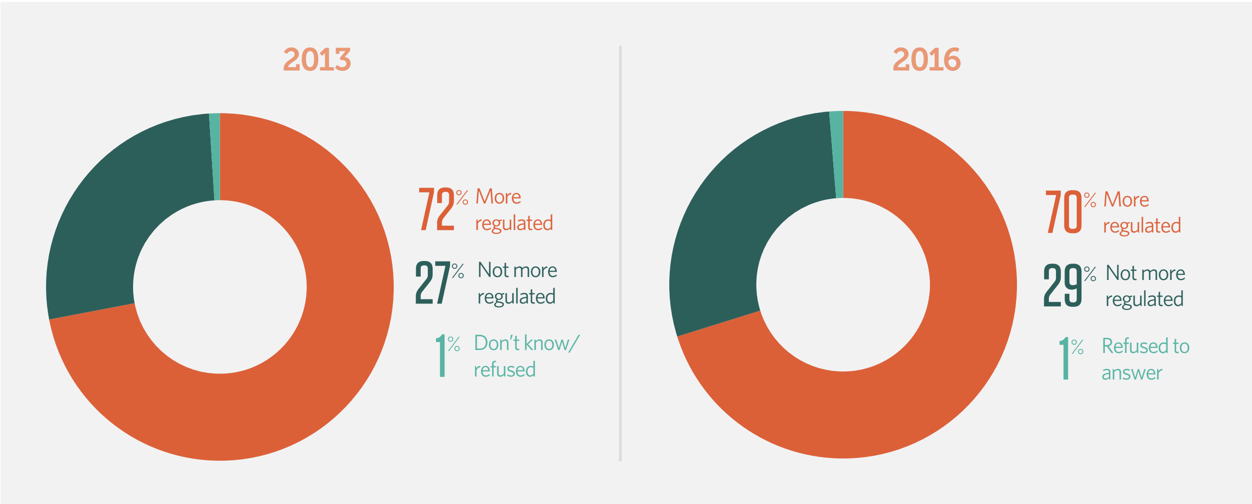
Those who cited multiple factors as "very important" were asked which was the most important. Thirty-nine percent chose "the fee charged"; 24 percent chose "how quickly you can get the money"; 21 percent chose "the certainty that you will be approved for the loan"; 11 percent chose "the loan amount"; and 6 percent chose "how easy it is to apply for the loan."

Figure 2

As They Did Three Years Ago, 7 in 10 Borrowers Still Want Payday Loans to Be More Regulated

Percentage of respondents, 2013 and 2016



Notes: Respondents were asked: "Should payday loans be more regulated or not?" Results are based on 826 interviews.

Source: The Pew Charitable Trusts, "Payday Lending in America: How Borrowers Choose and Repay Payday Loans" (2013), 48, http://www.pewtrusts.org/~/media/Assets/2013/02/20/Pew_Choosing_Borrowing_Payday_Feb2013-(1).pdf#page=48

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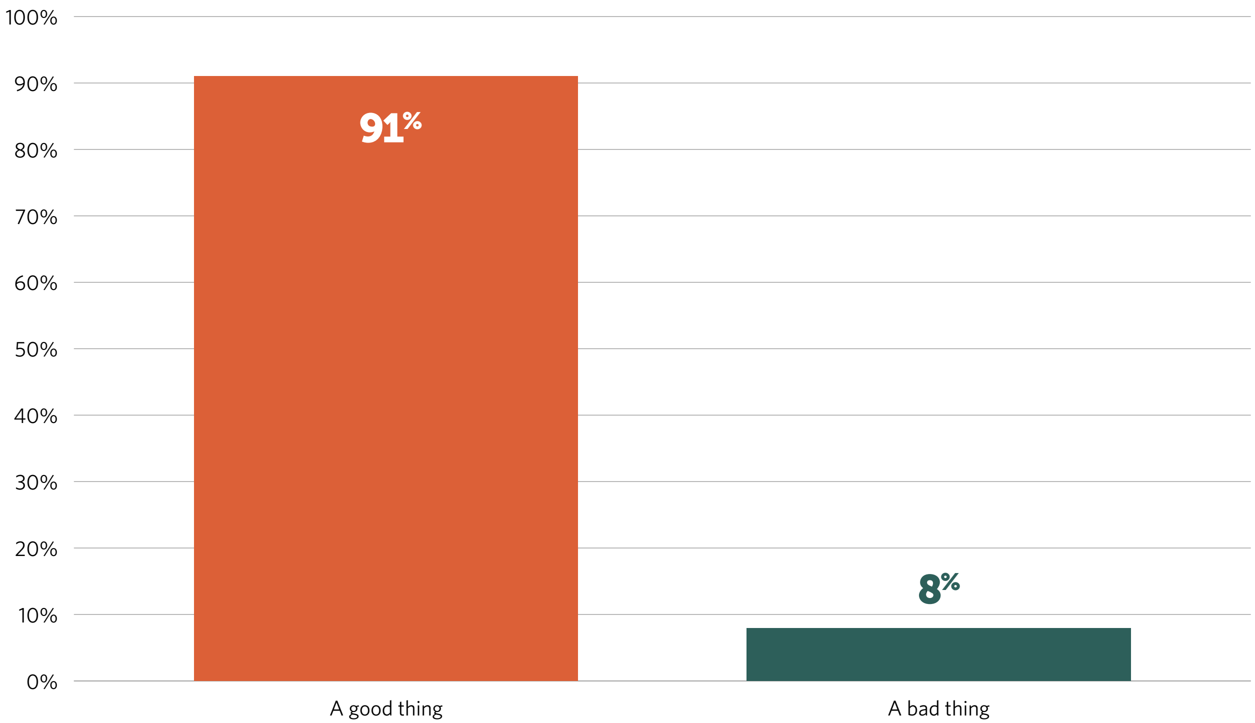
Roughly 12 million Americans use payday loans annually, spending an average of $520 in fees to repeatedly borrow $375.[4]

Figure 3

9 in 10 Borrowers Say Having Fewer Payday Loan Stores and Lower Prices Would Be a Positive Change

Percentage of respondents



Notes: Respondents were asked: "If some of the payday loan stores closed in your area, but the remaining stores charged less for loans, would that be a good thing or a bad thing?" Results are based on 826 interviews. Numbers do not total 100 percent because "refused" responses were omitted.

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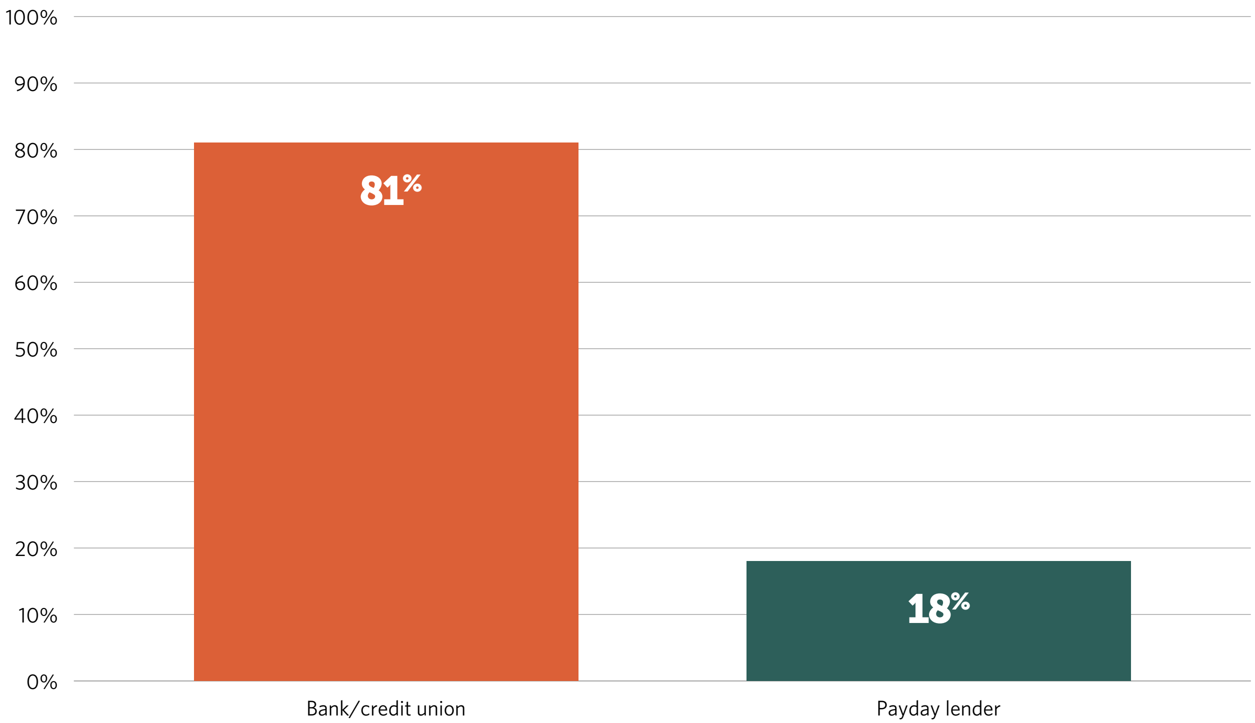
In 2010, Colorado enacted a successful payday lending reform that led to the closure of more than half of payday loan stores over the ensuing five years but also doubled the number of customers served at each remaining store. The state required prices to be roughly three times lower than before the law changed, and lenders responded with improved efficiency. As a result, credit remains widely available, but loan payments now consume an average of 4 percent of a borrower's paycheck instead of the previous 38 percent. The reforms have saved Colorado borrowers more than $40 million annually.[5]

Figure 4

8 in 10 Payday Loan Customers Would Prefer to Borrow From a Bank or a Credit Union

Percentage of respondents by lender type



Notes: Respondents were asked the following: "If you were equally likely to be approved for a small loan, would you prefer to borrow from a payday lender, or from your bank/credit union?" Results are based on 826 interviews. Numbers do not total 100 percent because "refused" responses were omitted.

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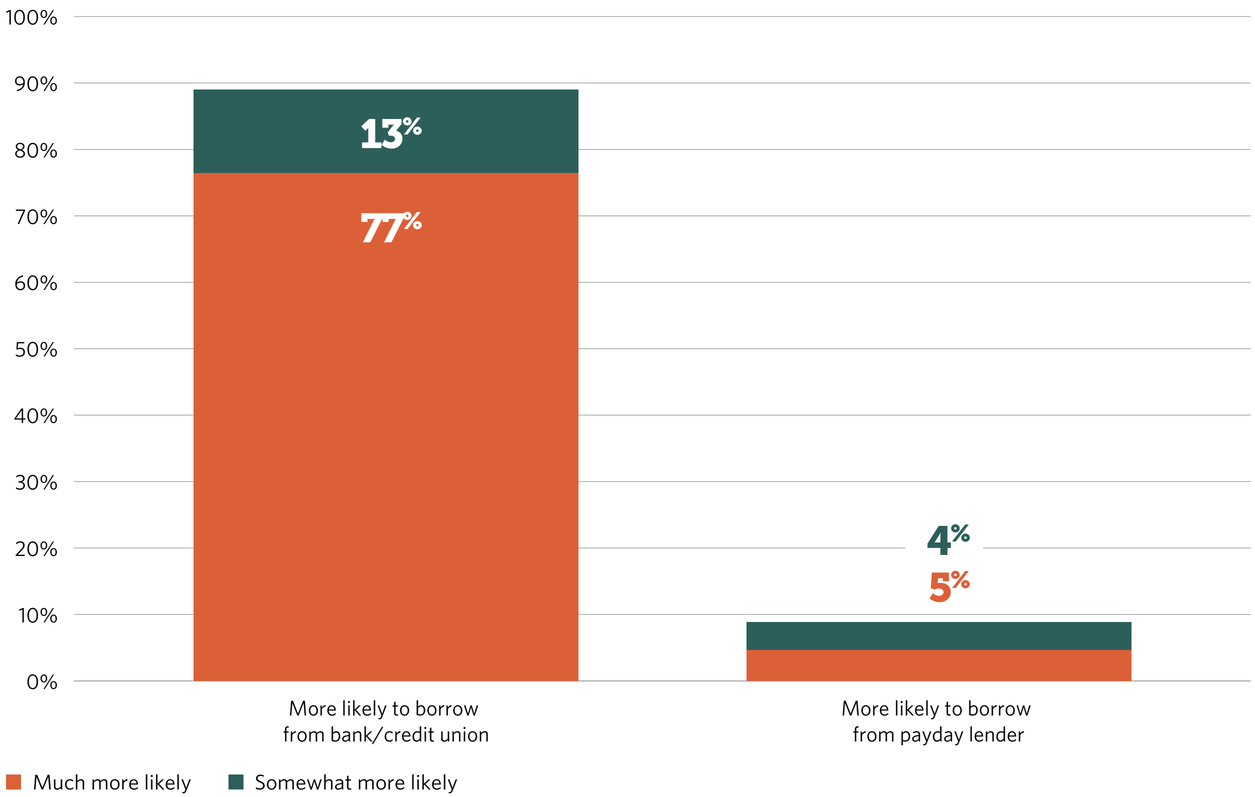
Every payday loan customer has a checking account at a bank or credit union because it is a loan requirement. Most customers would prefer borrowing from their bank or credit union instead of a payday lender as long as they were equally likely to be approved, but they cannot do so because regulatory uncertainty has made it difficult for banks and credit unions to issue small loans. Many financial institutions have expressed an interest in offering lower-cost, small-dollar credit to their customers who use payday loans, but only if they receive clear regulatory guidance that enables them to do so with simple underwriting.

Figure 5

9 in 10 Customers Would Borrow From Their Bank or Credit Union if Prices Were 6 Times Lower Than Payday Lenders'

Percentage of respondents by lender type



Notes: Pricing difference is based on published reports of banks' planned small-dollar loans. Respondents were asked: "Some banks and credit unions are considering offering a $400 three-month loan with a $60 fee. The same loan from a payday lender has a fee of about $350. If you were looking to borrow a small amount of money, would you be more likely to borrow from your bank/credit union or more likely to borrow from a payday lender?" Results are based on 826 interviews. Numbers do not total 100 percent because "refused" responses were omitted.

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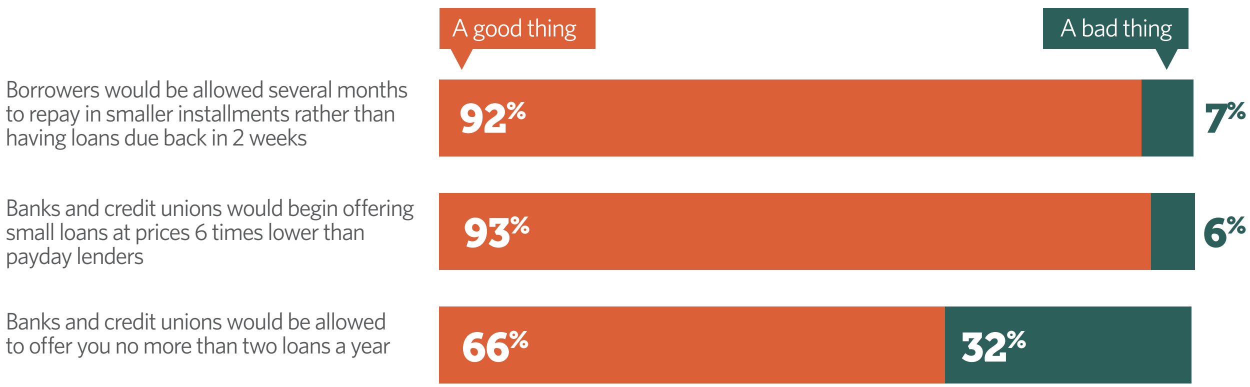
In May 2016, *American Banker* reported that at least three large banks were planning to offer small loans, repayable in affordable installments, at prices that were roughly six times lower than those of average payday loans.[6] Given the choice, most borrowers say they would use these lower-cost bank or credit union loans rather than payday loans. Financial institutions have stated that they would not be able to offer such loans under the CFPB's proposed ability-to-repay (ATR) test but would under the 5 percent payment alternative. Several bank and credit union trade associations have asked the bureau to include the 5 percent payment option in the final rule.[7]

Figure 6

Most Borrowers Say That Lower-Cost Bank Loans With More Time to Repay Would Be Good for Them

Percentage of borrowers by loan feature



Notes: Respondents were asked: "New regulations are being considered for payday loans. The next few screens are some situations that might result because of the new regulations. Please select whether you think it would be a good thing or a bad thing for you: Borrowers would be allowed several months to repay in smaller installments rather than having loans due back in 2 weeks; Banks and credit unions would begin offering small loans at prices 6 times lower than payday lenders; Banks and credit unions would be allowed to offer you no more than two loans a year." Results are based on 826 interviews. The order in which these questions appeared was randomized in the survey. Numbers do not total 100 percent because "refused" responses were omitted.

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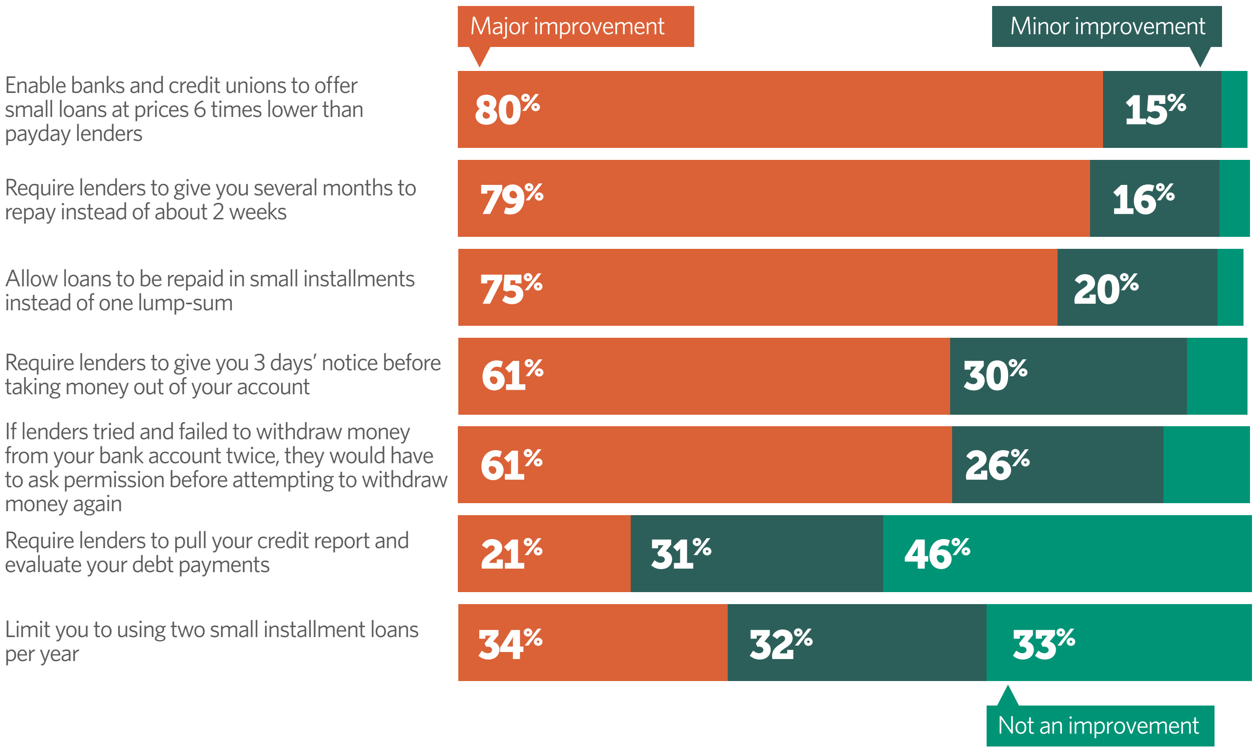
If borrowers of high-cost credit were able to access loans from banks and credit unions that cost six times less than those offered by payday lenders, Pew estimates they would save more than $10 billion annually, more than the United States spends on some major anti-poverty programs such as Temporary Assistance for Needy Families basic assistance and Head Start.[8] Borrowers reacted positively to the idea of banks and credit unions offering lower-cost small loans.

Figure 7

Borrowers Say Lower Prices, More Time to Repay, and Smaller Payments Would Be Major Improvements

Percentage of respondents by potential regulation



Notes: Respondents were asked: "The next few screens are some steps regulators could take to help improve payday and other small loans. For each, please respond by selecting how much of an improvement you think it would be: a major improvement, a minor improvement, or not an improvement. a) Enable banks and credit unions to offer small loans at prices 6 times lower than payday lenders; b) Require lenders to pull your credit report and evaluate your debt payments; c) Require lenders to give you several months to repay instead of about 2 weeks; d) Require lenders to give you 3 days' notice before taking money out of your account; e) Allow loans to be repaid in small installments instead of one lump-sum; f) If lenders tried and failed to withdraw money from your bank account twice, they would have to ask permission before attempting to withdraw money again; g) Limit you to using two small installment loans per year." Results are based on 826 interviews. The order in which these questions appeared was randomized in the survey. Numbers do not total 100 percent because "refused" responses were omitted.

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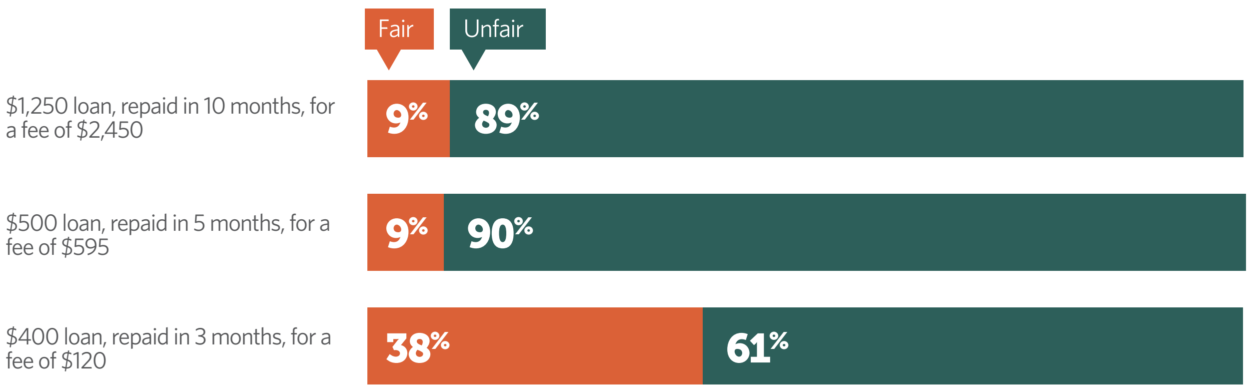
When presented with possible components of the CFPB's final regulation, borrowers said loans with lower prices, more affordable payments, and reasonable installment structures would be a major improvement, but most said a debt evaluation process or a limit on the number of installment loans they could use was "not an improvement" or only a "minor improvement." The outcomes borrowers favored most were those that would probably result from the 5 percent payment option. The proposed rule relies heavily on a specific origination process that would make offering lower-cost installment loans at scale too difficult for banks and credit unions, but these institutions say they would be likely to offer such loans if the CFPB includes the 5 percent payment option in its final rule.

Figure 8

Borrowers Say Current Payday Installment Loan Charges Are Unfair

Share of respondents by loan type and terms



Notes: Respondents were asked: "Here is a loan that payday lenders might offer under the new regulations. Please select if you think the terms are fair or unfair. a) A $1,250 loan, repaid in 10 months, for a fee of $2,450 (meaning you borrow $1,250 and pay back a total of $3,700); b) A $500 loan, repaid in 5 months, for a fee of $595 (meaning you borrow $500 and pay back $1,095); c) A $400 loan, repaid in 3 months, for a fee of $120 (meaning you borrow $400 and pay back $520)." Results are based on 826 interviews. The order in which these questions appeared was randomized in the survey. Loan A has an APR of 206 percent, while Loan B has an APR of 401 percent, and Loan C has an APR of 172 percent. Data do not total 100 percent because "refused" responses were omitted.

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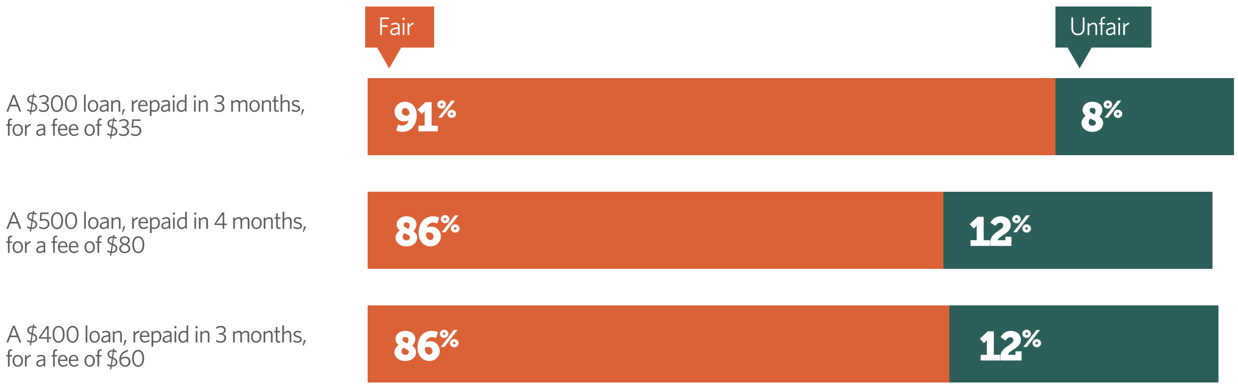
Under the CFPB's proposed ATR provisions in which lenders would pull borrowers' credit reports, use a real-time database, and have an estimate of similar people's expenses, $1,250 and $500 loans, repayable in 10 and five months for $2,450 and $595 in fees, respectively, would probably continue to be offered. The bureau's commentary on the proposed rule stated that most payday installment loan borrowers would pass an ATR test for monthly payments of more than $300, which is larger than the monthly payments for many payday installment loans and more than borrowers say they can afford.[9]

Figure 9

Borrowers Say the Loans That Banks Would Be Likely to Offer Are Fair

Share of respondents by 5% payment option loans



Notes: Respondents were asked: "Here is a loan that banks might offer under the new regulations. Please select if you think the terms are fair or unfair. a) A $300 loan, repaid in 3 months, for a fee of $35; b) A $500 loan, repaid in 4 months, for a fee of $80; c) A $400 loan, repaid in 3 months, for a fee of $60." Results are based on 826 interviews. The order in which these questions appeared was randomized in the survey. Loan A has an annual percentage rate (APR) of 69 percent, while Loan B has an APR of 75 percent, and Loan C has an APR of 88 percent. Numbers do not total 100 percent because "refused" responses were omitted.

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Figure 10

Payday Loan Customers Would Borrow From Their Banks if Loans Cost 6 Times Less

Percentage of borrowers by likely loan products

	Loan A	Loan B
Amount of loan	$500	$500
Cost of loan	$125	$750
Type of lender	Bank	Payday lender
Results	**93%**	**5%**

Notes: Respondents were asked: "The next few screens will show some small loans that last a few months and might be available to people who are looking to borrow money to pay an urgent bill. If you were looking to borrow a small amount of money, please mark whether you would choose Loan A or Loan B." Results are based on 826 interviews. Numbers do not total 100 percent because "refused" responses were omitted.

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Banks and credit unions could offer five-month loans of $500 for a $125 fee under a 5 percent payment option, which borrowers say compare favorably to the $500 loans with $750 fees that payday lenders would be likely to issue under the proposed ATR provision. Unless the proposed regulations are modified, high-cost loans are the only ones likely to be widely available.

Figure 11

Nearly All Borrowers Prefer Loans With Lower Prices and Simple Origination Processes

Percentage of borrowers by likely loan products

	Loan A	Loan B
Amount of loan	$500	$500
Cost of loan	$75	$450
How the lender assesses whether you qualify	Based on your checking account history, income, and history with the bank	Based on your credit report, income, and the lender's estimate of your expenses
Results	**92%**	**5%**

Notes: Respondents were asked: "The next few screens will show some small loans that last a few months and might be available to people who are looking to borrow money to pay an urgent bill. If you were looking to borrow a small amount of money, please mark whether you would choose Loan A or Loan B." Results are based on 826 interviews. Numbers do not total 100 percent because "refused" responses were omitted.

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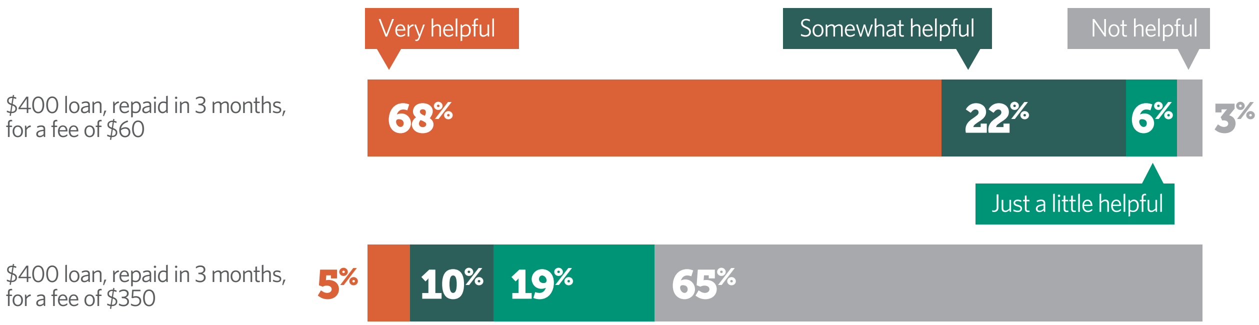
If banks are allowed to issue loans under the 5 percent payment option using the borrower's checking account history and income information for underwriting purposes, they will be likely to offer a three-month loan of $500 for $75 in fees. Most borrowers would choose this loan over a $500 loan with $450 in fees that payday lenders would be likely to issue under the proposed ATR provision.

Figure 12

Borrowers Say Cost Is Crucial to the Helpfulness of Small Loans

Percentage of respondents who say each loan is a benefit



Notes: Respondents were asked: "If you were short on cash, how helpful do you think the following loan would be? a) A $400 loan, repaid in 3 months, for a fee of $60 (meaning you borrow $400 and pay back $460); b) A $400 loan, repaid in 3 months, for a fee of $350 (meaning you borrow $400 and pay back $750)." Results are based on 826 interviews. The order in which these questions appeared was randomized in the survey. Numbers do not total 100 percent because "refused" responses were omitted.

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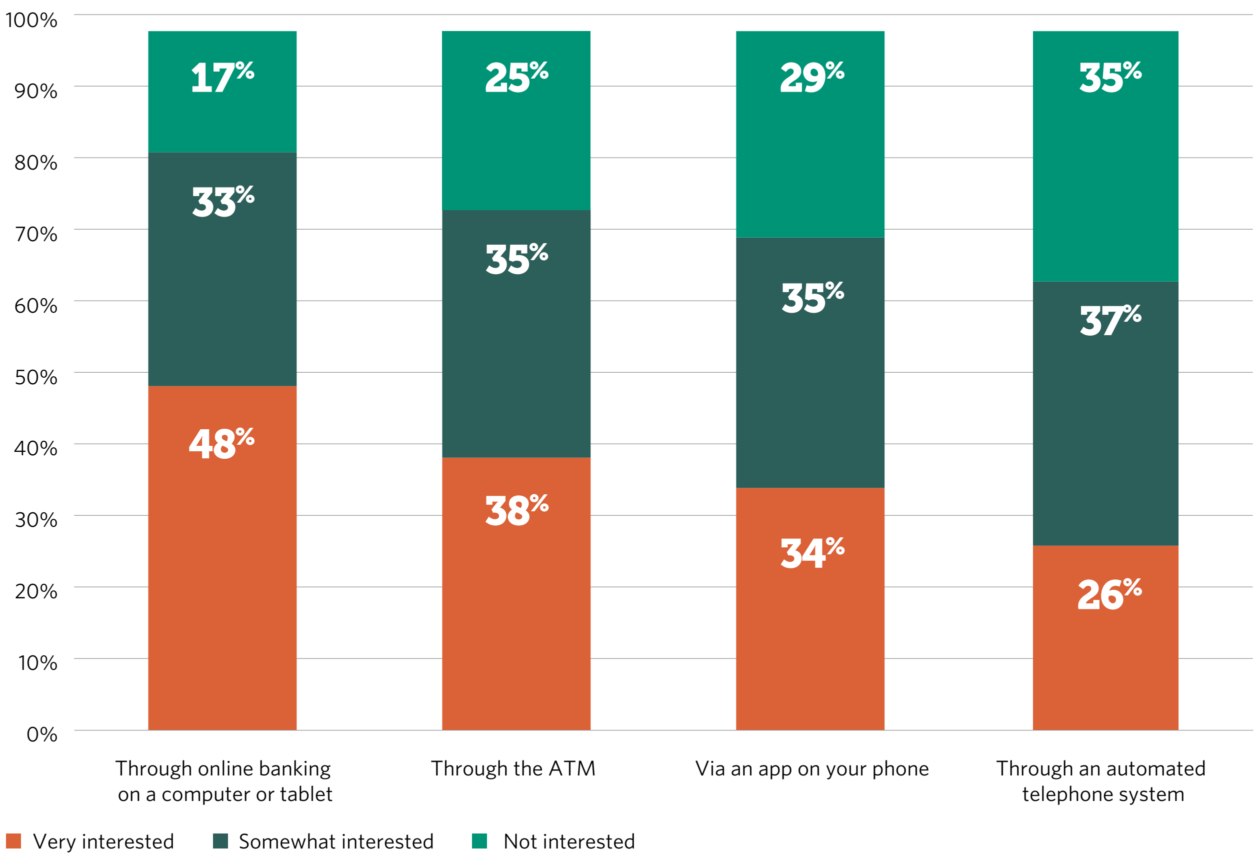
Advocates of payday loans frequently point to the help that readily available, small-dollar credit provides to borrowers when financial difficulties arise. And although borrowers agree that credit can be beneficial, they say cost is a major factor in determining whether loans are helpful. Banks would be likely to offer loans of $400 for a fee of about $60 if the 5 percent payment option is included in the CFPB's final rule, while payday lenders would charge fees of around $350 for the same $400 loan issued under the proposed longer-term ATR provision, meaning borrowers view the potential bank loans as far more helpful than payday installment loans. The bank loan with a $60 fee would have an APR of 88 percent, compared with an APR of 473 percent for the payday loan.

Figure 13

Borrowers Are Interested in Obtaining Bank Loans Electronically

Percentage of respondents by lending channel



Notes: Respondents were asked: "The next few screens are some ways that your bank could offer small loans. Please mark whether you would be very interested in obtaining a loan this way, somewhat interested, or not interested. a) Via an app on your phone; b) Through online banking on a computer or tablet; c) Through an automated telephone system; d) Through the ATM." Results are based on 826 interviews. The order in which these questions appeared was randomized in the survey. Numbers do not total 100 percent because "refused" responses were omitted.

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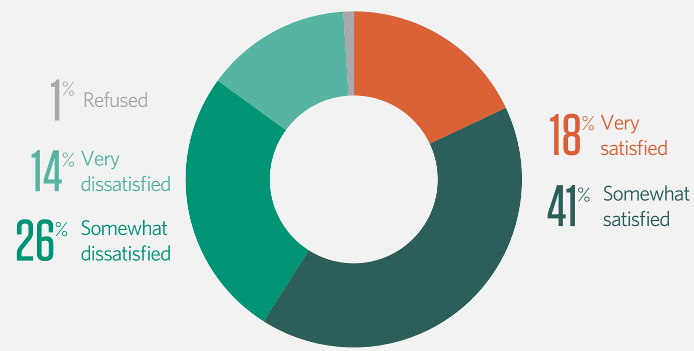
Consumers are interested in obtaining loans through online banking and other channels. To keep costs down, banks would need to be able to issue loans using electronic and other automated methods that do not require staff time to process applications or disburse funds, but banks need clear standards to support such automation for lower-cost small-dollar loans. The ability to prescreen customers for eligibility, automate the origination process, and deposit proceeds immediately into checking accounts are the factors that would enable banks to profitably offer small loans at prices much lower than those of payday lenders.

Figure 14

Borrowers Report Mixed Feelings About Current Loan Options at Their Bank

Percentage of respondents by satisfaction level



Notes: Respondents were asked: "How satisfied are you with your bank's loan options that are available to you today?"/"When you had a bank account, how satisfied were you with the bank's loan options that were available to you?" Results are based on 826 interviews. Numbers do not total 100 percent due to rounding.

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Figure 15

Borrowers Responded Positively When Asked About Banks Offering Small-Dollar Loans

Selected answers to "What would it say to you about your bank if they started offering small loans?"

That the bank cares:

- It would say that my bank cares about me more than a payday lender.
- I would think that they are interested in helping people who are going through hard times.
- That they cared about average people.
- They care about their customers and are reasonable.

That the bank is fair and helpful:

- It says that my bank is interested in being fair.
- They are willing to help people who are experiencing difficulties.
- That the bank is trying to be helpful to middle- or lower-class families.
- That banks were finally trying to help people in need.

That borrowers can stop using payday loans:

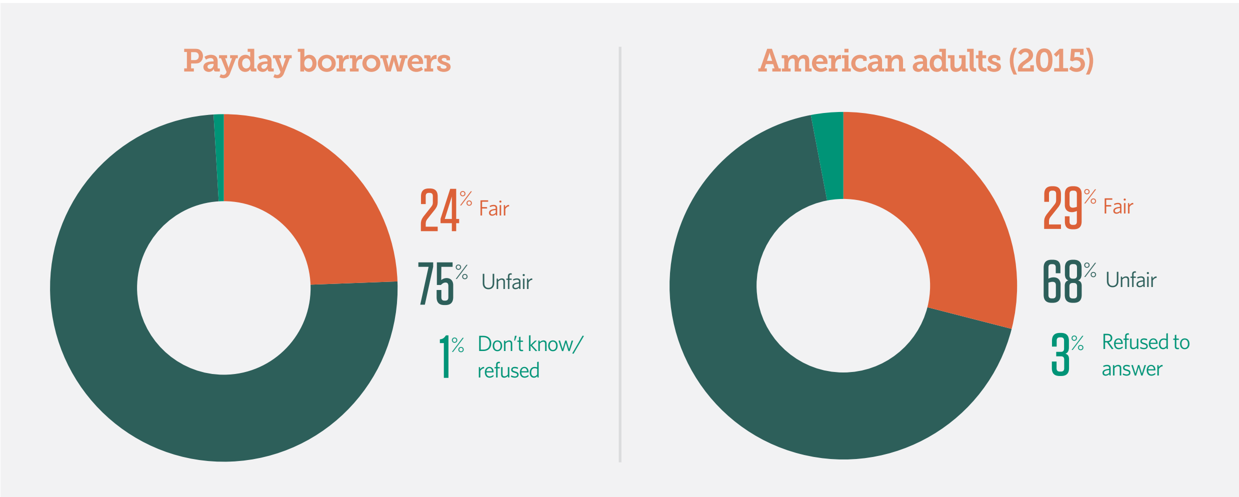
- That would be awesome. I would stop going to payday lenders.
- I would use that option before using an overpriced payday loan.
- It might help me finally get rid of my payday loan.
- That they are helping you get a small loan with a small fee, so the payday loans don't rip you off.

Note: Respondents were asked an open-ended question: "What would it say to you about your bank if they started offering small loans you could qualify for, repaid in a few months at a price six times lower than payday lenders?" Quotes were selected from among 826 interviews.

Figure 16

3 in 4 Borrowers and Most Americans See a $35 Checking Account Overdraft Fee as Unfair

Percentage of borrowers and U.S. population



Notes: Respondents were asked: "Today, banks typically charge a fee of around $35 for each overdraft. Do you think that's fair or unfair?" Results are based on 826 interviews.

Source: The Pew Charitable Trusts, "CFPB Proposal for Payday and Other Small Loans: A Survey of Americans" (2015), 7, http://www.pewtrusts.org/~/media/assets/2015/07/cfpb_chartbook.pdf#page=9

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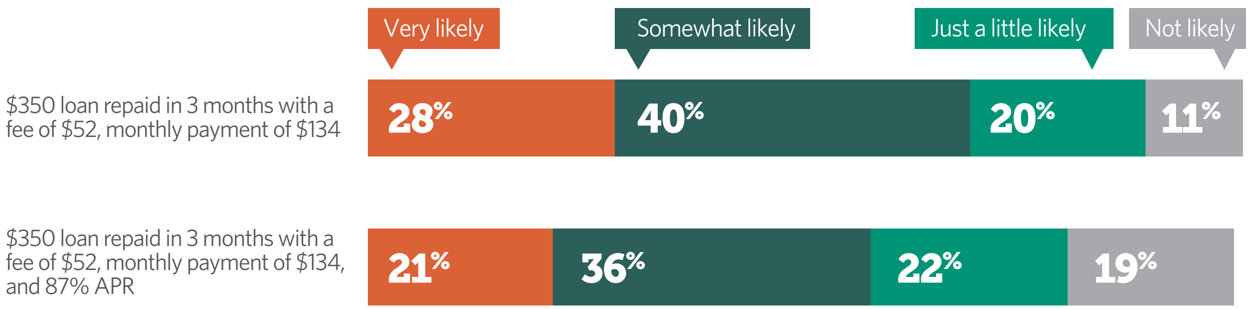
As shown in Figure 9 on Page 11, 9 in 10 borrowers see a $35 fee for a $300, three-month loan as fair, but 3 in 4 believe it is unfair to charge the same amount for a checking account overdraft. Current regulation does not support borrower preferences because it permits such overdraft fees but does not enable banks to offer lower-cost small-dollar loans at scale.

Figure 17

Most Payday Loan Borrowers Would Use Lower-Cost Bank Loans if Short on Cash

Percentage of respondents by loan product



Notes: Half of respondents were asked: "If you found yourself short on cash, how likely would you be to take this loan? $350 loan repaid in 3 months with a fee of $52, monthly payment of $134." The other half were asked: "If you found yourself short on cash, how likely would you be to take this loan? $350 loan repaid in 3 months with a fee of $52, monthly payment of $134, and 87% APR." Results are based on 826 interviews. Numbers do not total 100 percent because "refused" responses were omitted.

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Emphasizing annual percentage rate information does little to dissuade borrowing, deterring only about 1 in 10 respondents: When APRs are featured prominently, 57 percent of payday loan borrowers say they would be likely to use such a loan if short on cash, compared with 68 percent when APR is not highlighted.

Methodology

On behalf of The Pew Charitable Trusts, the GfK Group conducted a national study of 826 payday loan borrowers Aug. 23-28, 2016. The survey was conducted using KnowledgePanel, a probability-based web panel designed to be representative of the United States. The survey consisted of two stages: initial screening for borrowers and the main survey with the study-eligible respondents. To qualify for the main survey, a panel member must have used a payday loan (at a store or online).

The margin of error including the design effect is plus or minus 4 percent at the 95 percent confidence level.
A detailed methodology is available at http://www.gfk.com.

Endnotes

1 Consumer Financial Protection Bureau, "A Proposed Rule for Payday, Vehicle Title, and Certain High-Cost Installment Loans," June 2, 2016, https://www.federalregister.gov/documents/2016/07/22/2016-13490/payday-vehicle-title-and-certain-high-cost-installment-loans. For a summary of the proposed rule, see http://www.pewtrusts.org/en/research-and-analysis/analysis/2016/09/07/how-the-cfpb-proposal-would-regulate-payday-and-other-small-loans.

2 The Pew Charitable Trusts, "How CFPB Rules Can Encourage Banks and Credit Unions to Offer Lower-Cost Small Loans," (2016), http://www.pewtrusts.org/en/research-and-analysis/analysis/2016/04/05/how-cfpb-rules-can-encourage-banks-and-credit-unions-to-offer-lower-cost-small-loans.

3 The Pew Charitable Trusts, "Americans Want Payday Loan Reform, Support Lower-Cost Bank Loans" (2017), www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/04/americans-want-payday-loan-reform-support-lower-cost-bank-loans.

4 The Pew Charitable Trusts, "Who Borrows, Where They Borrow, and Why" (2012), 9, http://www.pewtrusts.org/~/media/legacy/%20uploadedfiles/pcs_assets/2012/pewpaydaylendingreportpdf.pdf.

5 The Pew Charitable Trusts, "Trial, Error, and Success in Colorado's Payday Lending Reforms" (2014), 6, http://www.pewtrusts.org/~/media/assets/2014/12/pew_co_payday_law_comparison_dec2014.pdf.

6 Ian McKendry, "Banks' Secret Plan to Disrupt the Payday Loan Industry," *American Banker*, May 6, 2016, http://consumerbankers.com/cba-media-center/cba-news/banks-secret-plan-disrupt-payday-loan-industry.

7 The Pew Charitable Trusts et al., group comment letter on the CFPB's Notice of Proposed Rulemaking for Payday, Vehicle Title, and Certain High-Cost Installment Loans, Oct. 6, 2016, https://www.regulations.gov/document?D=CFPB-2016-0025-142119. The signatories on this letter include nonprofit leaders, credit counselors, researchers, and representatives of banks that collectively operate 1 in 6 bank branches in the United States.

8 Center on Budget and Policy Priorities, "How States Use Federal and State Funds Under the TANF Block Grant" (2015), http://www.cbpp.org/research/family-income-support/how-states-use-federal-and-state-funds-under-the-tanf-block-grant; U.S. Department of Health and Human Services, "Head Start Program Facts: Fiscal Year 2015," last modified Feb. 8, 2017, https://eclkc.ohs.acf.hhs.gov/hslc/data/factsheets/2015-hs-program-factsheet.html.

9 The Pew Charitable Trusts, "Payday Lending in America: How Borrowers Choose and Repay Payday Loans" (2013), 13, http://www.pewtrusts.org/~/media/assets/2013/02/20/pew_choosing_borrowing_payday_feb2013-(1).pdf; The Pew Charitable Trusts, "From Payday to Small Installment Loans" (2016), 7, http://www.pewtrusts.org/~/media/assets/2016/08/from_payday_to_small_installment_loans.pdf; Consumer Financial Protection Bureau Proposed Rule, 12 CFR 1041 (2016), 48137–38.

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A chartbook from THE PEW CHARITABLE TRUSTS | April 2017

Americans Want Payday Loan Reform, Support Lower-Cost Bank Loans

Results of a nationally representative survey of U.S. adults

The Pew Charitable Trusts

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Overview

Typical payday loans have unaffordable payments, unreasonable durations, and unnecessarily high costs: They carry annual percentage rates (APRs) of 300 to 500 percent and are due on the borrower's next payday (roughly two weeks later) in lump-sum payments that consume about a third of the average customer's paycheck, making them difficult to repay without borrowing again.

In June 2016, the Consumer Financial Protection Bureau (CFPB) proposed a rule to govern payday and auto title loans[1] that would establish a process for determining applicants' ability to repay a loan but would not limit loan size, payment amount, cost, or other terms. The CFPB solicited and is reviewing public comments on whether to include in its final rule alternatives to this process with stronger safeguards, particularly a "5 percent payment option" that would limit installment payments to 5 percent of monthly income, enabling banks and credit unions to issue loans at prices six times lower than those of payday lenders at scale. As such, it would be likely to win over many payday loan customers.[2]

An analysis by The Pew Charitable Trusts determined that the CFPB's proposal would accelerate a shift from lump-sum to installment lending but, without the 5 percent option, would shut banks and credit unions out of the market, missing an opportunity to save consumers billions of dollars a year.[3]

To gauge public opinion on various reforms, including the proposed rule, Pew surveyed 1,205 American adults and found:

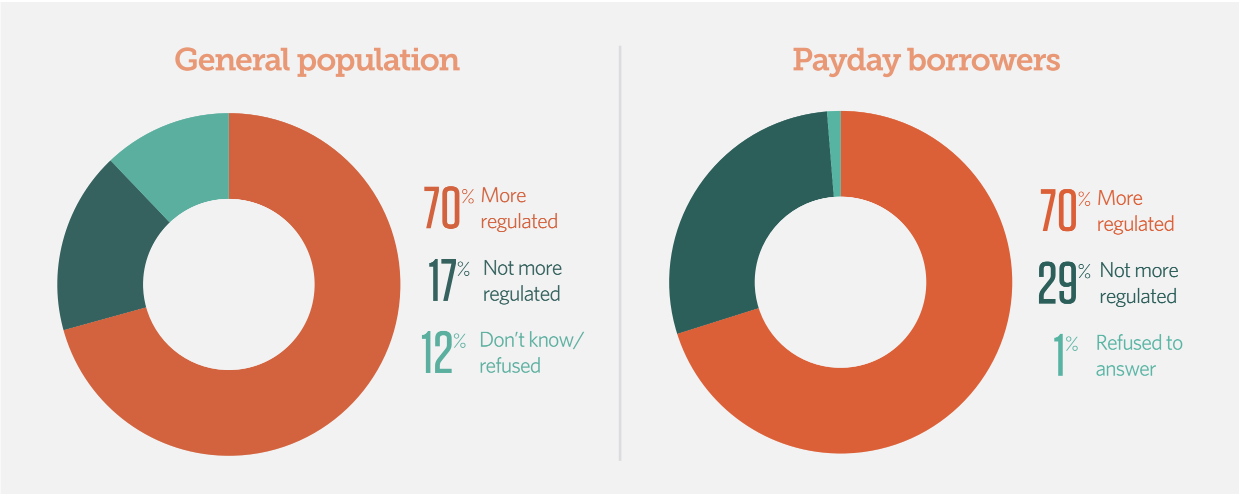
- 70 percent of respondents want more regulation of payday loans.
- 7 in 10 adults want banks to offer small loans to consumers with low credit scores, and the same proportion would view a bank more favorably if it offered a $400, three-month loan for a $60 fee (as reportedly planned).
- When evaluating a loan regulation's effectiveness, Americans focus on pricing rather than origination processes.
- Respondents say typical prices for payday installment loans that would probably be issued under the proposed rule are unfair.
- 80 percent dislike the proposal's likely outcome of 400 percent APR payday installment loans with more time to repay, but 86 percent say enabling banks and credit unions to offer lower-cost loans would be a success.

These results show that the public supports the CFPB's actions but strongly favors allowing banks and credit unions to offer lower-cost loans. A separate Pew survey of payday loan borrowers found similar sentiments.[4] This chartbook delves more deeply into these findings and discusses recommended changes to the proposal, including adoption of the 5 percent payment option, which is supported by Pew as well as many banks, community groups, and credit unions.

Figure 1

7 in 10 Americans, Borrowers Want Payday Loans to Be More Regulated

Percentage of respondents, by survey group



Notes: Respondents were read the following statement: "Now I'd like to ask you some questions about payday lending. Payday lenders are companies that generally operate through storefronts or the internet. They make small loans, often at high interest rates that are usually due back on the borrower's next payday." Then they were asked: "Which of these statements comes closer to your point of view? 1) Payday loans should be more regulated; 2) Payday loans should not be more regulated." Results are based on 1,205 interviews. General population numbers do not total 100 percent due to rounding. The payday borrower data are from a separate survey of payday loan borrowers that was conducted online, and "don't know" was not presented as an option, though respondents could decline to answer.

Source: The Pew Charitable Trusts, "Payday Loan Customers Want More Protections, Access to Lower-Cost Credit From Banks" (2017), www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/04/payday-loan-customers-want-more-protections-access-to-lower-cost-credit-from-banks

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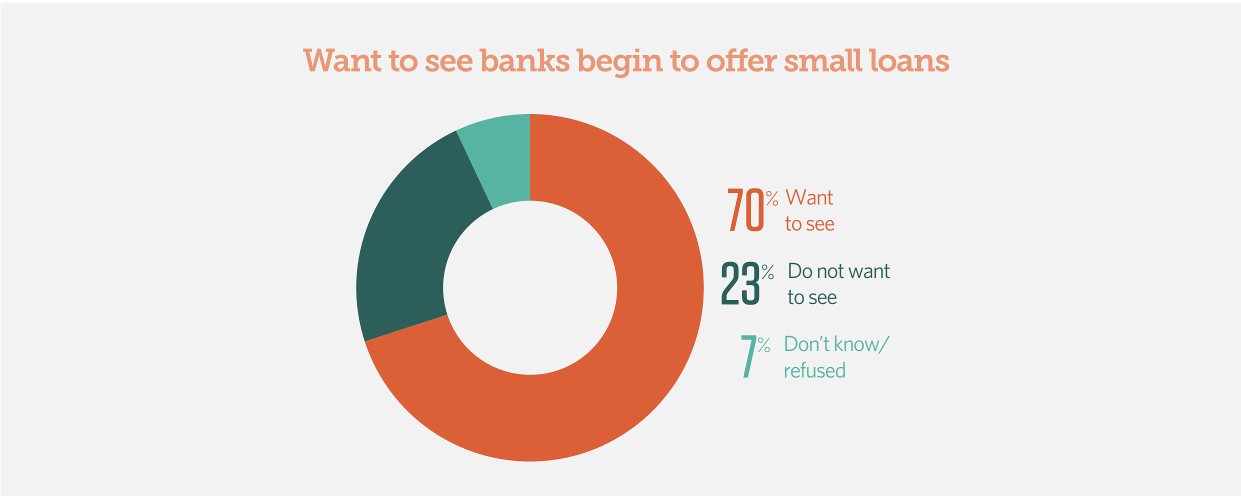
Roughly 12 million Americans use payday loans annually, spending an average of $520 on fees to repeatedly borrow $375.[5] Borrowers and the general population support more regulation of the small-loan industry in equal proportions.

Figure 2

7 in 10 Americans Want Banks to Offer Small Loans to Borrowers With Poor Credit

Percentage of respondents



Notes: Respondents were asked: "Today, banks generally do not make loans to people with low credit scores. Do you want to see banks begin to offer small loans of a few hundred dollars to their customers who have low credit scores, or do you not want to see that?" Results are based on 1,205 interviews.

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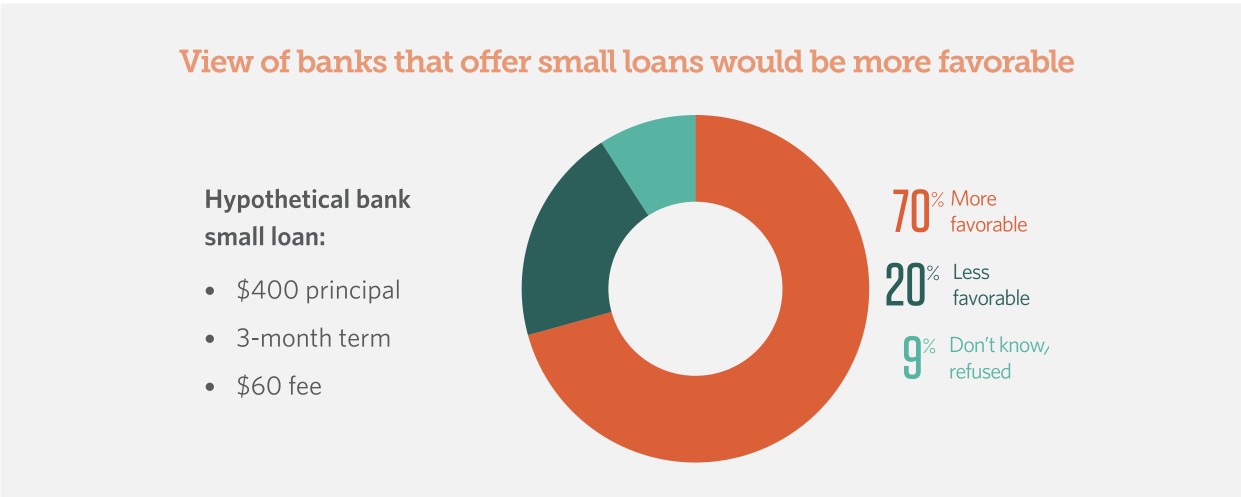
Banks generally cannot profitably make loans to people with low credit scores in the current regulatory environment. In May 2016, *American Banker* reported that at least three large banks were planning to use the 5 percent payment option that the CFPB proposed in its 2015 framework to offer such customers small loans repayable in affordable installments at prices roughly six times lower than average payday loans, such as a $400, three-month loan for a $60 fee.[6] Most Americans would like to see banks begin offering these loans.

Figure 3

70% of Americans Would View a Bank More Favorably if It Offered Lower-Cost Small Loans

Percentage of respondents



Notes: Respondents were asked: "Some banks are considering offering a $400, three-month loan with a $60 fee. Payday lenders charge about $350 for the same loan, while using a credit card would usually cost less than $60. If a bank began offering a $400, three-month loan for a $60 fee, would your view of that bank be more favorable or less favorable?" Results are based on 1,205 interviews. Numbers do not total 100 percent due to rounding.

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Seventy percent of survey respondents said they would have a more favorable view of a bank if it offered a $400, three-month loan for a $60 fee (as some banks are planning to do).[7] Banks report that they would need to use the 5 percent payment option in order to make these loans available.

Figure 4

Americans Say Loans That Have More Time to Repay but Still Carry 400% APRs Would Be a Negative Outcome

Percentage of respondents in favor of each possible result

Notes: Respondents were read the following statement: "The government agency that regulates payday lending has proposed some new regulations. I'd like to get your opinion on some of the possible outcomes of the new regulations. For each, please tell me if you would view it as mostly a good outcome or mostly a bad outcome. a) If most people who use payday loans got more time to repay them, but the annual interest rates continued to be around 400 percent; b) If most people who use payday loans could get loans from their banks and credit unions that cost six times less than payday loans; c) If some payday lenders went out of business, but the remaining lenders charged less for loans." Results are based on 1,205 interviews. The order of these statements was randomized in the survey. Numbers do not total 100 percent because "don't know" and "refused" responses (indicated in gray) were omitted.

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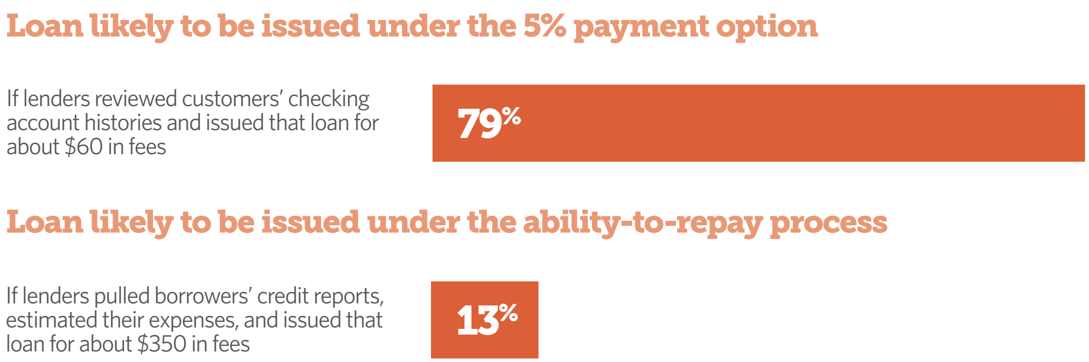
The most likely outcome of the CFPB's June 2016 draft rule would be to shift the market to longer-term payday installment loans. Similar loans today carry interest rates of around 400 percent, and prices would not be likely to decline under the proposal. Most Americans view that as a bad outcome. If the CFPB modified its proposed rule to include the 5 percent payment option it featured in the 2015 framework, banks and credit unions would be likely to offer lower-cost loans, creating a better alternative for borrowers. The public overwhelmingly said that would be a good result.

Figure 5

Americans Care More About Loan Prices Than Origination Processes

Share of respondents that favors each $400, three-month loan



Notes: Respondents were read the following statement: "Here are two possible outcomes of the proposed regulations for payday lending. Please tell me which of the two you would view as a better outcome for a $400, three-month loan: If lenders pulled borrowers' credit reports, estimated their expenses, and issued that loan for about $350 in fees; If lenders reviewed customers' checking account histories and issued that loan for about $60 in fees." Results are based on 1,205 interviews. The order of these statements was randomized in the survey. Numbers shown do not total to 100 percent because "don't know" and "refused" responses were omitted.

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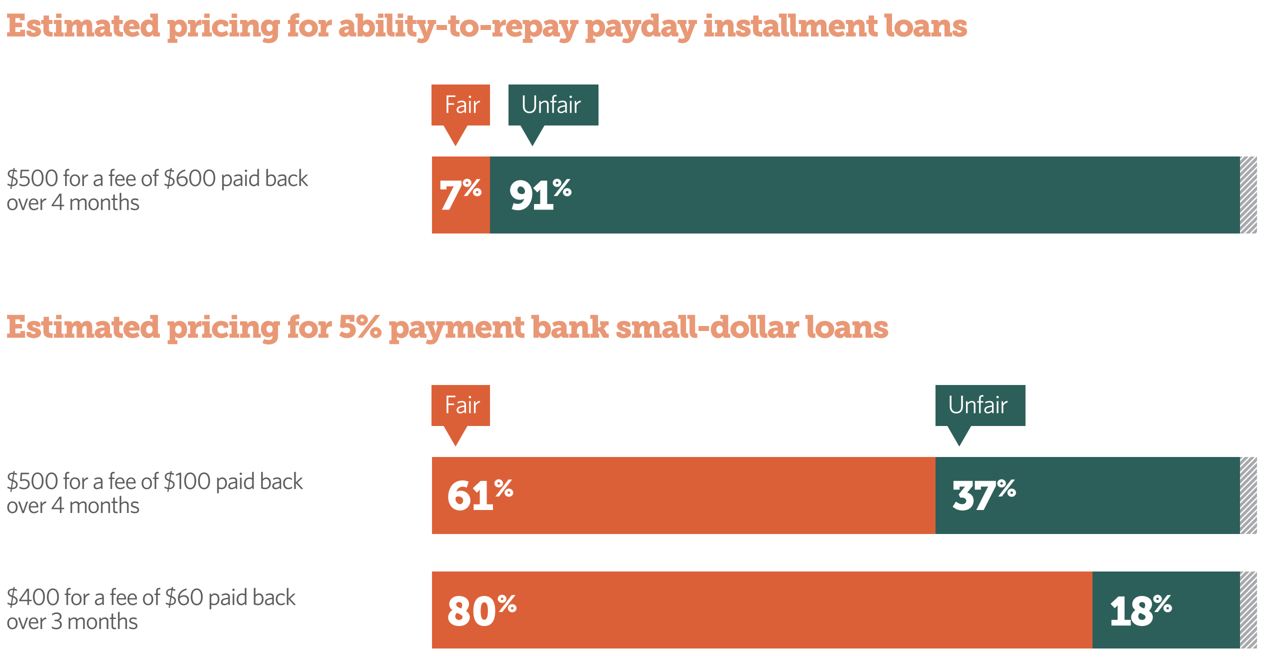
The CFPB's proposed rule focuses on establishing the process that lenders must use to originate loans, allowing those willing to comply with those guidelines to charge high prices and preventing lower-cost providers, such as banks and credit unions, from offering lower-cost loans at scale. If banks are permitted to issue loans using borrowers' checking account histories instead of the bureau's proposed ability-to-repay process, their pricing for small-dollar loans would be roughly six times lower than that of typical payday lenders. By a margin of 6 to 1, Americans prefer the loans that would be available from banks and credit unions under the CFPB's earlier 5 percent payment option to those that payday lenders would issue under the proposed ability-to-repay provision.

Figure 6

Americans Say Payday Installment Loan Charges Are Unfair but That Planned Bank Small-Loan Prices Are Fair

Share of respondents, by loan type and terms



Notes: Respondents were read the following statement: "Here are some examples of small loans that might be available to people who have low credit scores. For each, please tell me whether you think the terms seem fair or unfair. (Insert item.) Do you think the terms seem fair or unfair? a) $500 for a fee of $100 paid back over 4 months, so a person who borrows $500 will pay back $600; b) $500 for a fee of $600 paid back over 4 months, so a person who borrows $500 will pay back $1,100; c) $400 for a fee of $60 paid back over 3 months, so a person who borrows $400 will pay back $460." Results are based on 1,205 interviews. The order of these statements was randomized in the survey. Numbers shown do not total 100 percent because "don't know" and "refused" responses (indicated in gray) were omitted.

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Americans view current payday installment loans and those likely to be issued under the CFPB's proposed ability-to-repay provision as unfair, but they say the loans that banks and credit unions plan to offer under the 5 percent payment option would be fair. Banks and credit unions have said they cannot take on the paperwork, compliance, and regulatory risk of the ability-to-repay process but are interested in offering small credit at lower prices with stronger safeguards under the 5 percent option.

Figure 7

3 in 4 Americans Say It Would Be Good if Banks Offered Small Loans, Even With Higher APRs Than Credit Cards

Percentage of respondents that agree

Notes: Respondents were read the following statement: “Here are two views regarding small loans that banks might begin offering. Please tell me which of the two you agree with more. It would be a good thing if banks started offering small loans to their customers who use payday loans today because the prices would be six times lower than payday loans; It would be a bad thing if banks started offering small loans to their customers who use payday loans today because the interest rates would be higher than credit cards.” Results are based on 1,205 interviews. The order of these statements was randomized in the survey. Numbers shown do not total 100 percent because “don’t know” and “refused” responses were omitted.

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By a margin of almost 5 to 1, respondents said it would be a good thing if banks began offering small loans at prices six times lower than those of payday lenders, even if the rates would be higher than those for credit cards. All payday loan borrowers have a checking account because it is a loan requirement, so if these loans became available, they would be likely to replace a large share of high-cost loans.

Methodology

On behalf of The Pew Charitable Trusts, Social Science Research Solutions conducted a nationally representative random-digit-dialing (RDD) telephone survey of 1,205 adults Aug. 12–21, 2016. The survey included an oversample of approximately 200 African-American and Latino respondents, which was weighted to match the demographic incidence of the RDD sample, producing an overall sample representative of the general population. The margin of error including the design effect is plus or minus 3.37 percent at the 95 percent confidence level. A detailed methodology is available at http://ssrs.com/omnibus.

Endnotes

1 Proposed rule, 81 Fed. Reg. 47864 (July 22, 2016), https://www.federalregister.gov/documents/2016/07/22/2016-13490/payday-vehicle-title-and-certain-high-cost-installment-loans. For a summary of the proposed rule, see The Pew Charitable Trusts, "How the CFPB Proposal Would Regulate Payday and Other Small Loans: A Summary of the Draft Rule" (2016), http://www.pewtrusts.org/en/research-and-analysis/analysis/2016/09/07/how-the-cfpb-proposal-would-regulate-payday-and-other-small-loans.

2 The Pew Charitable Trusts, "An Analysis of the Draft Rule: The CFPB's Proposed Payday Loan Regulations Would Leave Consumers Vulnerable" (2016), http://www.pewtrusts.org/en/research-and-analysis/analysis/2016/09/07/the-cfpbs-proposed-payday-loan-regulations-would-leave-consumers-vulnerable.

3 The Pew Charitable Trusts, "How CFPB Rules Can Encourage Banks and Credit Unions to Offer Lower-Cost Small Loans" (2016), http://www.pewtrusts.org/en/research-and-analysis/analysis/2016/04/05/how-cfpb-rules-can-encourage-banks-and-credit-unions-to-offer-lower-cost-small-loans.

4 The Pew Charitable Trusts, "Payday Loan Customers Want More Protections, Access to Lower-Cost Credit From Banks" (2017), www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/04/payday-loan-customers-want-more-protections-access-to-lower-cost-credit-from-banks.

5 The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (October 2013), 12–16, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf.

6 Ian McKendry, "Banks' Secret Plan to Disrupt the Payday Loan Industry," *American Banker*, May 6, 2016, http://consumerbankers.com/cba-media-center/cba-news/banks-secret-plan-disrupt-payday-loan-industry; Consumer Financial Protection Bureau, *Small Business Advisory Review Panel for Potential Rulemakings for Payday, Vehicle Title, and Similar Loans: Outline of Proposals Under Consideration and Alternatives Considered* (March 26, 2015), http://files.consumerfinance.gov/f/201503_cfpb_outline-of-the-proposals-from-small-business-review-panel.pdf.

7 Ibid.

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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.

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