

BALANCING CONVENIENCE AND RISK:

Developing Alternative Payday Loans



Many low- and moderate-income families face chronic shortages in household cash flow. A 2003 study by MetLife found that 87% of families with incomes under \$30,000 per year live paycheck-to-paycheck, as do 65% of households with incomes between \$30,000 and \$49,999. For households with higher incomes and good credit scores, managing household cash flow is a matter of juggling readily available, and moderately priced, consumer credit: credit cards, checking overdraft loans, and lines of credit. But, for lower-income families or those families with poor credit—often one and the same—household liquidity is a constant struggle. For these families, “fast cash” often means the difference between paying rent and buying groceries.

Among the many products that have emerged from the “fringe” financial services industry, a product known as a “payday loan” is among the fastest growing and most profitable. Also known as a “cash advance loan,” a payday loan is a relatively small short-term loan made on a borrower’s post-dated check—minus the lender’s fees. (On an average \$300 loan, a borrower will typically receive \$255 in cash and incur \$45 in fees.) According to the Center for Responsible Lending, the market for payday loans quadrupled in just three years. In 2000, payday lenders generated \$1.4 billion in fees on 41 million transactions. By the end of 2003, the industry made \$6 billion in fees on 100 million transactions. During this period, total loan volume grew from \$10 billion to \$40 billion.

On the surface, payday loans may seem like a reasonable solution to short-term hiccups in cash flow, especially for borrowers unable to get mainstream credit. Indeed, commercial payday lenders counter critics’ charges of usury by pointing out that high fees—\$45, say, for a two-week \$300 loan—are justified to cover their risk. Payday loan customers do have a higher risk profile than prime-rate borrowers, so products should be priced accordingly. Payday lenders require no formal underwriting, requiring only that customers have a job and a checking account.

CHAPTER SUMMARY

PRODUCT/STRATEGY DEFINITION—A traditional payday loan is a short-term loan or cash advance made on a borrower’s post-dated check. Payday loans carry hefty fees and often lead to chronic debt as the loans are rolled over. Payday alternative loans retain the transactional qualities (fast cash, easy underwriting) while dropping the predatory aspects.

CRITICAL SUCCESS FACTORS —

- ❖ **Competitive pricing.** Traditional payday loans are expensive: Fees are high, and loans are often rolled over every two weeks (for another fee). Lower pricing is cheaper, and longer loan terms allow customers to break away from traditional payday loans.
- ❖ **Fast turn-around.** Customers need their cash immediately. If alternative products are to compete with payday lenders, lenders have to issue loans almost immediately.
- ❖ **Customer relationship management and education.** Staff needs time to build relationships with customers and help them develop long-term financial plans. Partnering with a nonprofit or community-based organization that offers these services is another option.
- ❖ **Loss mitigation.** These are high-risk loans, and institutions need a way to minimize losses while keeping product costs down. Grant funding for a loan-loss reserve or loan guarantees are two options to consider. Requiring direct deposit for repayment will lower risk, too.

INSTITUTIONAL FIT—This strategy is appropriate for institutions who are partnering with community-based organizations, or for employers who want to improve the financial well-being of their employees. Payday loans are also a good tool to increase deposits from, and strengthen relationships with, commercial customers by offering an inexpensive way to offer their employees cash advances.

The structure speeds loan approval but also raises the lenders' risk profiles. Moreover, industry defenders argue, the pricing structure of payday loans is analogous to that of other short-term products of convenience like short-term airport parking. Customers pay for convenience, and the loans should be used sparingly.

These economic arguments sound reasonable on the surface, but for people who live paycheck-to-paycheck, payday loans are a carousel of chronic debt. The loans' short terms often make it impossible for borrowers to pay back the entire loan. Those who can't pay back their loans have two choices: either, for another \$30-\$45 fee, they can rollover the loan, retaining the \$300 principal, or they can default on the loan. This opens the floodgates to NSF fees from their bank and a bounced check fee from the lender, legal liabilities, and wage garnishment. (Lenders can repeatedly run a check through a borrower's account, increasing fees with each pass.)

Although the majority of payday borrowers eventually repay their debts, the economics of the industry depend on repeat borrowers. For example, the fee for a 14-day, \$300 loan is \$45; but the fees skyrocket to \$225 after four rollovers (*see table*). According to the Center for Responsible Lending, 91% of all payday loans are made to borrowers who take out five or more payday loans per year. On average, borrowers receive between eight and 13 loans per year; only 1% of loans go to one-time borrowers. As a result, roughly five million borrowers are caught in this debt trap.

This churn also has important implications for financial institutions wanting to develop competing loan products. First, chronic rollovers create a monopoly effect since lenders don't necessarily need more customers to make money. They just need existing customers to continue rolling over debt. As a result, it is difficult for alternative providers to compete strictly on the basis of cost: Borrowers caught in a debt cycle return to the same lender again and again, despite fees or APR. And, since chronic borrowers typically live paycheck-to-paycheck, many view their rollovers as separate transactions. For many chronic borrowers, the rollover fee simply becomes the price of credit.

Market Profile for Payday Loan Customers

- Have bank accounts
- Most are employed, with incomes ranging from \$15,000 to \$60,000 per year
- Need "fast cash" loan decision and disbursement
- Most under 40 years old
- Slightly more than half are women
- Have average of nearly 12 loan transactions per year
- Average cash advance is \$245.03 with an average finance charge of \$49.37 (528% APR)

Source: John P. Caskey, "Fringe Banking and the Rise of Payday Lending" (2003).

In the past couple of years, community-based financial institutions have begun developing low-cost alternatives to payday loans. Community partners are interested in this strategy to help their constituents reduce their reliance on predatory loans. Research has shown that employers have a self-interest in payday loan alternatives: Their employees are less productive and less reliable when they are worried about finances. Though these market-based solutions to the credit needs of low-income borrowers are still in their infancy, the pioneering products compete on the basis of cost and convenience—the two main drivers in this market segment. This chapter profiles the Payday Alternative Loan developed by North Side Community Federal Credit Union in Chicago. According to North Side estimates, PAL loans save customers an average of \$950 per year, which means that roughly \$2 million per year goes back into the community. North Side's PAL has also generated significant value for the credit union, helping it to attract new members and deposits, build relationships with employer groups, and strengthen its reputation as a national innovator. With a few modifications to product fees and guidelines, the product could be profitable, though North Side has thus far declined to make all these changes because doing so would limit its ability to serve very-low-income members. Yet institutions that do not share North Side's commitment to mission could well develop a remarkably strong product by building on North Side's innovations.

Product and Strategy: Building a Better Payday Loan

For North Side, the principal challenge of the PAL was balancing risk while meeting customer demand at a price that worked for both the institution and the borrower. North Side's PAL aims to supplant what the credit union views as customers' exploitative relationships with commercial fringe creditors. That means offering a better, lower-cost product; but, it also means linking members to credit counseling, financial education, and access to asset building products to meet their needs.

When North Side rolled out its Payday Alternative Loan (PAL) in 2002, the goal was to help members break the debt cycle while also competing with lenders on the basis of convenience. An equally important motive was attracting business accounts from employers who wanted to offer fairly priced payday loans to their employees. The eligibility requirements were minimal. In the beginning, the only requirement was that customers make at least \$1,000 per month and join the credit union. (As delinquencies crept up, North Side eventually began requiring a three-part financial education course for borrowers with credit scores below 580.) Members can borrow up to \$500 at one time, and they must pay back a minimum of \$87 per month. There is a \$30 application fee—up from \$10 when the loan was launched—and an APR of 16.5%. The loans also have a much longer term—six months for a PAL versus two weeks for a conventional payday loan—which drastically reduces rollovers and fees. From a customer's perspective, the PAL is a bargain: The net cost of a six-month loan of \$500 is about \$55 (\$30 application fee and \$25 in interest), compared with \$540 for a traditional payday loan (\$45 initial fee and 11 rollovers at \$45 each). North Side sweetens the deal, too, offering to make a borrower's last payment (up to \$50), or to put \$50 into a savings account. Through the end of July 2005, North Side has done 3,531 loans. North Side recognized the inherent risk in the payday loan product from the very beginning. It raised a loan loss reserve of \$58,000 from four local banks, the majority from one large bank in the region.

North Side Manager Ed Jacob also chose to make PALs as widely available as possible. "We don't even require customers to have a bank account," he notes. "That puts us even farther out on the risk continuum than payday

lenders. At least they require you to post a check on your account." In a sense, this extra risk has been a boon to the customers and the community—an important social return for a mission—driven financial institution: more money in the pockets of community members, more money spent at local businesses, and fewer assets stripped away from the community as a whole.

Operations: Lowering Costs, Mitigating Risk

Operationally, the loans are extremely simple. When a customer comes into the bank, the teller confirms proof of income and a valid identification. The customer fills out a loan application, which is then processed by a loan officer. The credit union squeezes transaction costs by minimizing paperwork and limiting the time spent with loan officers. North Side also reduces collection costs by encouraging members to use direct deposit or electronic payment, though less than a third pay automatically. (North Side's examiner prohibited requiring electronic payment as a condition of the loan, though examiners elsewhere in the country have allowed it.) North Side staff spends 10 hours per week making collection calls before delinquencies are sent out to a collection agency. Not only does this save money on collections, but it also helps North Side separate customers who have no intention of repaying the loan from credit union members with genuine hardships.

About two years after launching the PAL, North Side saw its delinquencies edging upwards, and in December 2004, North Side made several changes. First, it raised the application fee from \$10 to \$30, a move that covered more of the product's cost but did little to minimize defaults. To mitigate that risk, North Side required applicants with credit scores below 580 to enroll in a three—part financial education class before they could get the loan. The changes cut the loan volume nearly in half—North Side averaged 130 loans per month in 2004, but made just 169 in the first quarter of 2005—but delinquencies have started edging back down, presumably because many of the potential delinquent borrowers simply walk away.

North Side's ongoing struggles with delinquencies underscore the challenges inherent in creating a payday loan product that balances prudent underwriting while making loans accessible to the broadest possible range of customers.

THE HYPOTHETICAL COST OF A \$300 LOAN: COMMERCIAL PAYDAY LOAN V. NORTH SIDE PAL

Although North Side’s PAL is a six-month term loan, borrowers could repay it within a matter of weeks—making it a much less expensive option than a conventional payday loan. The following chart outlines the relative cost of a hypothetical \$300 loan when compared to the fees associated with rolling over a traditional payday loan.

	Commercial Payday Loan	North Side PAL
Original Loan Amount	\$300	\$300
Restrictions and Limitations	-Must have a bank account -Must present proof of employment -Must present valid ID	-No bank account required -Must show proof of \$1,000 monthly income -Must present valid ID -\$500 limit -No more than two loans per year -Borrowers with low credit scores below 580 must enroll in credit counseling class
Term	14 days	14 Days
Fee Structure	\$45	\$30 (application fee) +16.5% interest
Net Cost	\$45	\$31.90
Term	28 days (14 days, plus one 14-day rollover)	28 days
Fee Structure	\$45 (original fee) + \$45 (rollover)	\$30 (application fee) +16.5% interest
Net Cost	\$90	\$33.80
Term	70 days (14 days, plus four 14-day rollovers)	70 days
Fee Structure	\$45 (original fee) +\$180 (four \$45 rollovers)	\$30 (application fee) +16.5% interest
Net Cost	\$225	\$39.50
Term	6 months(14 days, plus eleven 14-day rollovers)	6 months
Fee Structure	\$45 (original fee) +\$495 (eleven \$45 rollovers)	\$30 (application fee) +16.5% interest
Net Cost	\$540	\$53.81

North Side Manager Ed Jacob considered a number of strategies—raising fees, requiring credit counseling, restricting loans based on credit counseling, requiring repayment through direct deposit (though credit union regulators have given mixed signals on this requirement)—but found that each risk mitigation strategy either made the loans less convenient for the customer, reduced loan volume, or both.

In the end, Jacob’s decision to limit the number of loans per year and require credit counseling for the highest-risk members allowed North Side to minimize risk while also keeping the barriers low. By contrast, ASI Federal Credit Union in New Orleans (*see box on next page*) has managed to make its payday alternative loans product profitable as a stand-alone product by introducing a higher fee structure, instituting separate membership requirements for the program, and requiring direct deposit for repayment as a condition of the loan.

**Marketing and Customer Relations:
Helping Members Move From
Borrowing to Savings**

North Side has never put many resources into marketing their credit products. It has done some direct mailing to existing members and employer groups, but most of its marketing is word-of-mouth. North Side has built a portion of its membership by recruiting employees of area businesses, and Jacob says the PAL has been an attractive product for small- and medium-sized businesses looking to improve their employees’ finances and reduce financial stress among low- and moderate-income workers. On the customer side, Jacob says, “We have more volume than we can handle.” A while back, an employee at the local post office took out a PAL, and the following week 30 postal employees showed up to apply for loans. Other than that, there are no billboards, no signs, no mass marketing. The product essentially sells itself because it is responding to such overwhelming demand for reasonably priced, fast-turnaround credit.

North Side views the PAL primarily as a hook to lure customers away from competing fringe credit and then move them into the financial mainstream. Every PAL customer receives a phone call from a North Side customer education representative, who encourages him/her to enroll in financial education classes. Representatives explain that the PAL offers an opportunity to build credit history and offers a gateway to asset building. The new financial education requirement for PAL customers with poor or no credit will also provide North Side with the opportunity to build relationships, and begin to establish trust, with new members. Given the success of the PAL product, the credit union now finds itself facing an enviable challenge: scaling up beyond its current five-member staff so it can meet the growing demand for high-touch customer relationships.

The PAL has also produced several secondary institutional benefits. Over the past two years, Jacob estimates that the PAL had a hand in helping to attract at least four new employer groups, though it was not the only factor. One employer has put up a \$10,000 certificate of deposit to help secure PAL loans to his employees at \$0.50 on the

dollar. If North Side turns away one of the employees using traditional underwriting, the employee may still be able to get a loan since the employer's capital helps defray some of the risk. If this model is successful, North Side will explore a similar relationship with other employers.

Performance & Outcomes:

The Economics of Gateway Products for the Unbanked

North Side's PAL is not profitable as a stand-alone product, but Jacob doesn't expect it to be. Rather, he views the PAL as an instrument that members can use to break the payday loan debt cycle. Put another way, the loans are the products that will bring members into the credit union, where they will eventually migrate to more profitable products. "Even with our fee structure, these loans won't be profitable on a product basis," Jacob says. Over the long-term, however, Jacob is convinced that PALs are the gateway to member relationships that will be profitable. Of the 3000 loans made by North Side, the credit union has gained 1000 new members. "Most banks are focused quarter to quarter," he notes. "But we're focused on

A Fair-and-Profitable Alternative Payday Loan: ASI Federal Credit Union's "Stretch Loan"

ASI Federal Credit Union, based in and around New Orleans, has developed a profitable payday alternative loan program. Under ASI's "Stretch Plan," credit union members pay \$4 per week for a variety of services that appeal to low-income customers: a 10-minute phone card; free travelers' checks; overdraft protection; a free refund anticipation loan on their federal refunds; and \$0.25 money orders. But the big draw is the "Stretch Loan," a 12% APR line of credit from \$200 to \$1,000.

To qualify, borrowers must be members with a six-month history of direct deposits. Borrowers are required to pay back \$101 each pay period, but they can withdraw the money right away. When borrowers have established solid credit and made regular payments over six months, they are eligible for ASI's Enhanced Credit Builder program, which features a \$3,000 line of credit.

Although the fees are relatively high compared with a traditional line of credit, they are necessary to accommodate the customers' higher risk profile. Nevertheless, \$16 a month is still a bargain compared with the rollover fees charged by traditional payday lenders. To maintain a balance of \$1,000, a customer pays \$340 per year in fees and interest—an effective 34% APR, but still far less than the \$520 average on payday loans in Louisiana. What's more, borrowers are able to build their credit scores.

SOURCE: Shirk, Martha, "Paycheck Poverty," AdvoCasey, Winter 2005, Volume Seven, Number One. http://www.aecf.org/publications/advocasey/winter2005/pdf/paycheck_poverty.pdf

building relationships with our members over two to three years.” The measure of the loans’ success is not in whether or not they are profitable as stand-alone products, but rather how they help members migrate, which Jacob admits, yields a blend of social and financial returns. Thus far, Jacob’s gateway theory seems to be holding true. In 2004, North Side had 96 mainstream loans (car loans, small business loans, etc.) outstanding to 66 PAL graduates for a total of \$298,000. Still, he says, “The bigger question is whether or not someone who has been with us from the start will stay with us once their financial condition changes.”

Still, there are ways to mitigate the risk of payday loans while minimizing losses. North Side has already started requiring credit counseling classes for applicants with low credit scores. But, there are trade-offs in reducing loan volume. Consider the following chart:

The experience of other credit unions has demonstrated that with direct deposit, it’s possible to manage delinquencies and reduce the cost of servicing loans. On the other hand, many customers simply don’t make enough money to meet their basic needs. Even with financial education, counseling, and limits on the number of loans, many still borrow chronically. In this case, credit unions must content themselves with the fact that they offer safe harbor—that customers can borrow over and over but not at predatory rates.

¹ “The MetLife Study of Employee Benefits Trends: Findings from the 2003 National Survey of Employers and Employees,” (<http://www.metlife.com/WPSAssets/21038406741080074055V1Employee%20benefit%20trends.pdf>)

BALANCING RISK, PROFITABILITY, AND CUSTOMER CONVENIENCE IN PAYDAY LENDING

Risk Management Strategy	Impact on Risk Profile	Impact on Customer Convenience and Loan Volume
Restrict number of loans a customer can take out per year	- Lowers exposure to bad loans, but may drive borrowers to higher-cost lenders	- Less convenient - Using higher-cost lenders increases default risk
Institute more stringent repayment guidelines; i.e., loans must be paid off in full before taking out another	- Lowers overall exposure - Cuts delinquencies - May drive borrowers to high-cost lenders	- Less convenient for borrowers - Cuts loan volume
Require credit counseling	- May lower risk profile by weeding out people who just want the money	- Less convenient for borrowers - Cuts loan volume
Require payment through direct deposit	- Improves profit and lowers risk by giving lender first shot at paycheck, though not all regulators may allow this	- Limits loans to people with regular jobs - May sideline workers with informal-sector income - Only accessible for workers with payroll departments willing to set up direct deposit
Increase fees (with or without requiring membership or banking relationship)	- Can make payday loans profitable as products - Little impact on default risk	- Less convenient - Cuts loan volume, usually by making a loan program available only to credit union members
Institute “emergency only” provisions	- Lowers risk profile by discouraging chronic borrowing - Cut checks directly to vendors to ensure money goes to emergency purpose	- Very inconvenient: By definition emergency borrowers need cash immediately, and can’t wait 2-3 days for emergency loan approval
Restrict loans based on credit scores	- Lowers risk profile	- Cuts loan volume
Build relationships with employer groups	- Lowers risk by offering point of intervention if loan is in arrears	- May cut loan volume, but also may help improve credit score if employers can assist with repayment through direct deposit or pressure