Debunking the Four Common Fears of Small-Dollar Lending

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Executive Summary

In the United States there are approximately 6,557 credit unions with assets exceeding $1 trillion. These credit unions serve more than 100 million members. However, there are only roughly 600 credit unions that offer small-dollar lending. It is estimated that credit unions comprise less than two percent of the $38.5 billion payday-lending loan market. As a result,credit union executives are leaving small-dollar lending monies on the table that could otherwise be responsibly lent to deserving members at reasonable rates.

Generally, a small-dollar loan equates to an amount more than $300 dollars and less than $5,000 with varying pay-off terms. According to Pew Charitable Trusts' research, 12 million American adults use payday loans each year. The average borrower takes out eight loans of $375 each per year spending $520 on interest with a payoff time period of 18 days. Pew research also finds that the average payday loan recipients are primarily females between the ages of 25 and 44 years old.

There are also five demographic subsets demonstrating higher odds of applying for a payday loan: those without a four-year college degree; home renters; those earning below $40,000 annually; and those who are separated or divorced.

The underlying hypothesis points to four fears: the financial risk of implementing a new product, the uncertainty of changing CFPB regulations, potential reputation risk and the draining of financial resources.

"Americans support small-dollar loans at fair prices, even if the APRs are somewhat higher than those for credit cards."

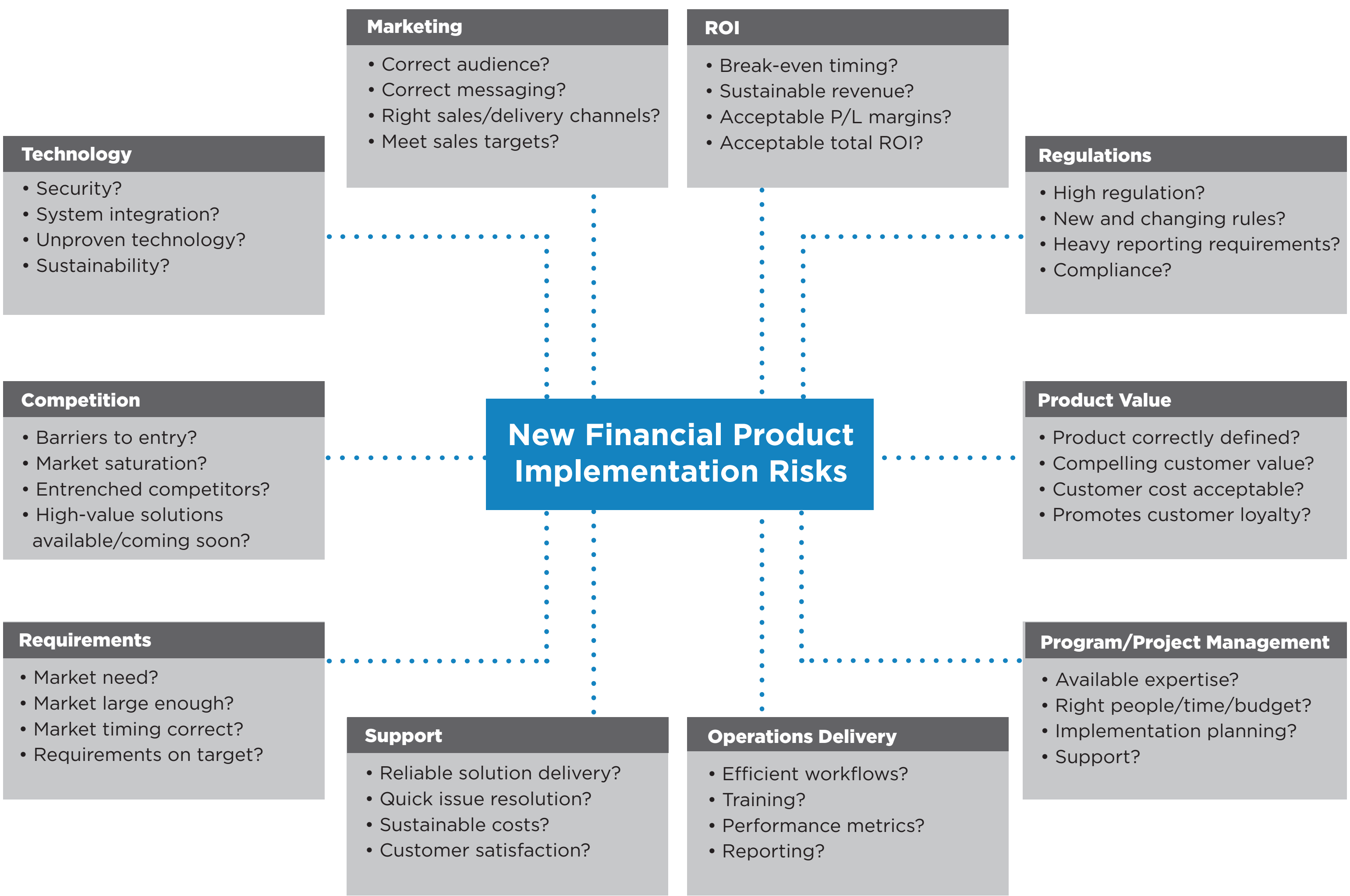
- Alex Horowitz | Senior Research Officer

The purpose of this white paper is to better understand why only a small number of credit unions execute small-dollar lending relative to the majority of competing lenders.

Fear One:

The Financial Risk of Implementing a New Product

When credit union executives determine that a new product offering is needed, the normal course of action is to conduct industry research and evaluate selected vendors via exhaustive request for proposals (RFPs) and in-house demonstrations. Despite due diligence processes, inherent risks can be realized when a solution is rolled out to membership. Small-dollar lending, however, can be an exception to this rule.



Numerica Credit Union

NUMERICA CREDIT UNION

BANKING
58% with checking accounts
26% with credit cards

PROFILE
115,000 members in total
52% younger than 49
66% married
47% household > $75,000

LOANS
39% members with auto loans
27.8% members with an average of $414,883 business loans
average 5,000/year,
average $ 525 small-dollar loan amount

The $1.5 billion dollar Numerica Credit Union serves 115,000 members at 19 branches and offers small-dollar loans. Josh Sledge, director at the Chicago, Ill.-based Center for Financial Services Innovation, a national nonprofit advocate agency on consumer financial health, explained there are financial risks associated with implementing small-dollar credit (SDC) products. However, with proper industry and product research, he said these risks don't necessarily need to deter credit unions from offering the service.

"Structuring sustainable SDC products can be challenging due to resource constraints associated with underwriting and servicing," said Sledge. "Though lenders should be cognizant of the costs and risks associated with offering SDC products, there is a critical need among many consumers for these solutions."

According to Pew's Horowitz, both banks and credit unions have expressed trepidations regarding small-dollar lending. He added, however, that not all concerns are intuitive and that the financial risk usually depends on underwriting practices. "Losses are not the primary cost of issuing small loans. Overhead, including staff time, is the primary cost," he said.

"With proper research, analysis and risk assessments, the financial risk associated with implementing a new product greatly diminishes.

The launch of a new product is a careful consideration of the cost of implementation versus potential financial benefits, as well as competitive evaluation and industry analysis of products that are currently available or deficient."

Jana Erny | Numerica Credit Union VP of Retail Lending
Spokane Valley, Washington

State Employees Credit Union

State Employees' Credit Union®

BANKING
1.2 million checking accounts
250,000 credit cards
1.5 million debit cards

PROFILE
2.1 million members in total
Average age: 47
income: $76,000 per household

LOANS
98,000 auto loans
124,000 mortgages
406,000 personal loans
Average balance $1,834
Average SALO loans 190,000
Average balance $400

For the $33 billion Raleigh, North Carolina-based State Employees Credit Union, serving 2.1 million members at 256 branches, the financial risk of a new service depends on the underwriting requirements of the product, explained Senior Vice President of Lending Development Mark Coburn.

"A member's salary must be on direct deposit to qualify for our Salary Advance Loan Program (SALO) product. This requirement has led to reasonably accepted delinquency and charge-off ratios and an acceptable effective rate of return after losses," said Coburn who noted that SALO was introduced in 2001. "We have almost 200,000 active open-end accounts. We have successfully offered this product for over 15 years and believe other institutions can do so as well."

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Mark Coburn | State Employees' Credit Union
Senior Vice President of Lending Development
Franklin, North Carolina

DuPont Community Credit Union

DuPont Community CREDIT UNION

BANKING
56,163 checking accounts (72%)
18,101 credit cards (23%)
44,967 debit cards (58%)

PROFILE
77,664 members in total

LOANS
9,155 auto loans
6,730 mortgages
3,156 (47%) are second and
3,574 (53%) are first

While DuPont Community Credit Union's Senior Vice President and Chief Operations Officer, Steve Elkins hasn't spoken in great length about small-dollar lending with credit union counterparts, he assumes DuPont Community Credit Union's micro-lending practices are similar to other credit unions offering the same service. He added that the loans are generally under $3,000 and are used for a variety of reasons, such as to pay income taxes, for a vacation, for Christmas shopping or car repairs. Like many credit unions entering the payday lending market, DuPont Community Credit Union is continually evaluating how to best serve the underbanked.

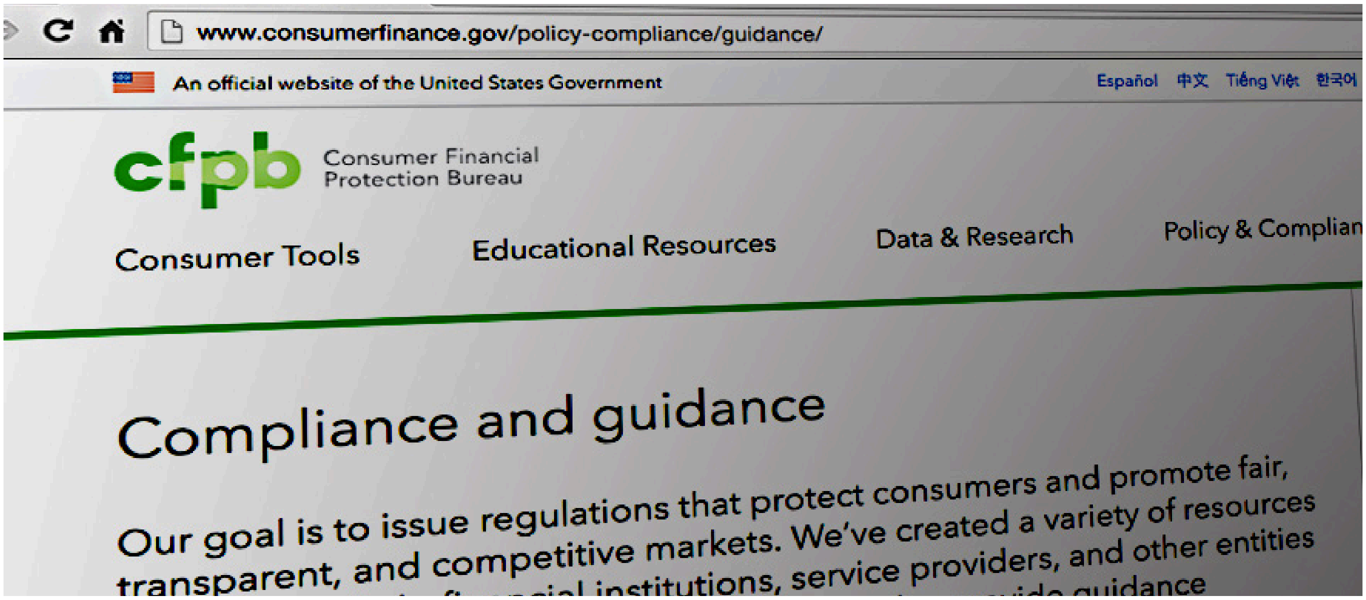
"The community development manager has been tasked to come up with a plan to better serve our community and the underserved market," said Elkins. "We have not yet gotten that granular as this is a very specific product offering." "We have never called it micro-lending or small-dollar lending, this type of lending is just something we have always done," said Elkins.

In an effort to better understand "micro lending," which is another phrase used to describe small-dollar credit, the $980 million Waynesboro, VA-based DuPont Community Credit Union, supporting 77,664 members, hired a community development manager this year.

"We are not fearful of small-dollar lending, but from a reputation risk, marketing and branding standpoint, we have discussed how we can best offer this product in the market and ensure that the members that use small-dollar lending are not perceived as inferior to other members."

Steve Elkins | DuPont Community Credit Union
SVP and Chief Operations Officer
Waynesboro, Virginia

Fear Two:
Changing CFPB Regulations



In 2010, the National Credit Union Administration (NCUA) adopted a rule to allow federal credit unions to make short-term/small-amount loans and to extend lines of credit to their members. These Payday Alternative Loans (PALs) provide consumers with an alternative to borrowing from potentially predatory payday lenders.

Many states allow state-chartered credit unions to offer similar small-dollar and short-term loans to members. In March 2015, the Consumer Financial Protection Bureau (CFPB) released an outline of proposals covering short-term and longer-term credit products. In June 2016, the CFPB recently announced updates regarding new legislation on short-term, small-dollar loans. While the Credit Union National Association (CUNA), for example, supports aspects of CFPB's past proposals, which could curtail consumer abuse and provide stronger consumer protections, there are some concerns that the new rules could impact both the NCUA's PAL program and other similar programs offered by state-chartered credit unions.

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According to Pew Charitable Trusts, regulators should continue to support the NCUA's PAL program because loans' costs, on average, are six to eight times less than a payday loan. Currently, there is a $20 application fee and a maximum charge of 28 percent annualized interest. Effective annual percentage rates (APRs) range from 35 to 148 percent (depending on a loan's size and duration). A three-month $300 loan with an APR of 69 percent, for example, would cost roughly $35. In a recent survey, Pew Charitable Trusts cites that 85 percent of Americans said these terms were fair.

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>
> ***- Jana Erny, VP, Retail Lending, Numerica Credit Union***

While the CFPB is expected to align with NCUA programs and guidelines, credit union executives like Coburn are taking a "wait and see" approach. He added that previous commentary from the CFPB proposed changes that "could necessitate modifications to payday alternative products" offered by many credit unions, including State Employees Credit Union. Among related issues Coburn keeps an eye on is the repeat nature of loans or advances and resulting concerns about placing members in repeat borrowing cycles.

"Once we noticed that a high percentage of members were borrowing on a repetitive cycle in the first two years of our SALO product, we initiated a mandatory savings component to the product in 2003," said Coburn. "A percentage of each advance automatically goes into the savings account and eventually builds to a level that provides the member the ability to break their borrowing cycle."

The CFPB estimates that there are 12 million payday or small-dollar customers each year. Annual interest rates on these loans amounts of a few hundred dollars can range between 300 and 500 percent. These predatory lending practices, however, are not found in credit union platforms. As such, "payday" and "small-dollar loans" should be distinguished.

In order for credit unions to effectively and successfully become responsible payday lenders, industry experts recommend that the CFPB use Fair Lending standards, Unfair, Deceptive, or Abusive Acts or Practices (UDAAP) regulations to ensure credit unions are well-regulated. And regulations, such as updates from CFPB, are commonplace within the financial services industry. As such, Numerica Credit Union's Erny said keeping apprised of regulatory changes should be part of any financial institution's best practices.

"Rather than fearing CFPB regulation changes, it is an opportunity to educate staff on short-term loan product specifications and guidelines so they can better assist members," noted Erny. "CFPB regulations are typically not vague, making it clear to interpret and properly implement programs and/or products."

Fear Three:
Reputation Risk

In order to compete regionally and nationally, credit unions must understand their risk-tolerance, the products they offer and impact on brand reputation against serving the wants and needs of their members. Products, like small-dollar lending, must address all demographics, which may change depending on the geographical reach of a credit union. So whether small-dollar lending is considered a risk or a fear, an organization's risk-tolerance model must be clearly defined.

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> ***- Steve Elkins, SVP, Chief Operations Officer, DuPont Community Credit Union***

"We are not fearful of small-dollar lending, but from a reputation risk, marketing and branding standpoint, we have discussed how we can best offer this product in the market and ensure that the members that use small-dollar lending are not perceived as inferior to other members," said DuPont Community Credit Union's Elkins. "We also haven't been comfortable yet with the language like 'low income' as it relates to micro-lending."

For State Employees Credit Union, four questions have to be asked and answered before a platform like small-dollar lending is offered to membership. The four questions are: Are you serving the needs of your membership? Are you charging a fair rate? Can you handle the administrative challenges associated with the recurring nature of the product? What are you doing to either prevent members from getting into a repeat borrowing cycle or assist members in getting out of a repeat borrowing cycle?

"We believe the highest reputation risk to our credit union would be to abandon the members that need access to small-dollar credit, which are served by our SALO product," said Coburn. "We plan to continue serving these members with whatever products and terms that are acceptable based on regulatory requirements."

Numerica Credit Union's stance on small-dollar lending reputational risk includes ensuring the product is compliant with state and federal statutes. "Having staff that are properly educated and can serve as knowledgeable ambassadors, goes a long way to alleviate potential reputation risk," said Erny. "With initial product discovery, assessing reputation risk should be an important question and helps to reduce the likelihood of the product having an adverse impact on reputation."

Industry experts agree that a valid, NCUA regulated small-dollar lending framework can reduce risk when membership needs (i.e., charging fair rates, accommodating administrative challenges and deterring an endless borrowing cycle) are addressed. And while there is always some risk involved in lending, these same experts argue that there could be a higher risk abandoning members in need of small-dollar credit.

Center for Financial Services Innovation Manager Eva Wolkowitz noted that lenders can to high-quality product standards, as outlined in

CFSI's "Compass Guide to Small-Dollar Credit." The report defines high-quality, small-dollar loans as:

- Loans made with high confidence in the borrower's ability to repay
- Loans structured to support repayment
- Loans priced to align profitability for the provider with success for the borrower
- Loans that create opportunities for upward mobility and greater financial health
- Loans that have transparent marketing, communications and disclosures
- Loans that are accessible and convenient
- Loans that provides support and rights for borrowers

"We encourage all lenders to create high-quality offerings that have sufficient consumer protections. Lenders can support consumer financial health by reporting repayment activity to major credit bureaus, reporting repayment activity to major credit bureaus, developing products in partnership with their communities and emphasizing transparent marketing, disclosures and communications," noted Wolkowitz. Loans that feature multiple borrowing and next payday lump-sum payments can produce reputational damage when borrowers can't repay and get deeper in the debt cycle. Presently, 35 states allow lump-sum payday loans. As collateral, the borrower pledges a check dated for the next payday. This model has resulted in multiple borrowing by one individual (those receiving the loans couldn't pay back the full amount without borrowing again). As a result, many organizations' reputations suffered. In 2010, after 20 years operating with this model, Colorado state lawmakers determined that the system was broken.

According to a 2013 Pew Charitable Trusts report entitled, "Payday Lending in America: Policy Solutions," legislation was passed in The Centennial State that changed the terms for payday lending from a single, lump-sum payment to a series of installment payments over a six-month period, with lower maximum allowable interest rates. Today, borrowers in Colorado pay an average of four percent of their paychecks to service the loans, compared with 36 percent under a conventional lump-sum payday loan model.

If credit unions adopt this approach to small-dollar lending, including risk mitigation, streamlined underwriting, automated processes, cost-cutting and cooperative solutions, the reputation-risk model decreases considerably. "Colorado's 2010 payday loan reform was a success," noted Horowitz.

Fear Four:
Draining of Financial Resources

While SDC products are typically viewed as low-margin, it can be difficult to make small-dollar loans sustainable, especially considering the capacity constraints most credit unions face."We recommend that providers continue to develop solutions that meet their customers' small-dollar, short-term credit needs, in a way that's good for the customer, and also profitable," said Sledge. "Providers can consider streamlining underwriting, automating processes, or using white-labeled or cooperative solutions to achieve these mutual goals."

To ensure financial solvency with small-dollar loans, Horowitz points to the PAL program (e.g., regular deposits, auto repayment by electronic debit) and its low charge-off rate of two percent. He explained that this successful low rate 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. To date, one in seven federal credit unions currently participates in the PAL program. In 2014, these credit unions issued approximately 170,000 loans, which represents less than one percent of the total volume of payday loans issued that year.

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Automation is the key driver to avoiding a fiscal sink hole, explained Coburn. Without automation, repetitive loans administered manually will cause a financial imbalance. State Employees Credit Union, for example, has automated a significant portion of its small-dollar lending product offering (over 97 percent of its subsequent advances processed through automated delivery channels initiated by the member).

"We have had many conference calls over the years with other credit unions that are considering payday alternative loans. The cost to implement in regards to administrative resource requirements and the impact on other areas of operations is always a key point of discussion," said Coburn. "These loans can be a productive and beneficial part of your loan portfolio if delivered and administered in an efficient manner." Numerica Credit Union's maximum small-dollar loan amount is $750. Erny explained that approximately 5,000 small-dollar loans are awarded each year at an average loan amount of $525. The average payback time is 14 days with approximately 12 percent default rate defined as non-payment.

"As a business practice, Numerica Credit Union has a diversified line of products and services," said Erny. "New products are kept as a small portion of the overall portfolio in order to minimize potential financial risk and draining of resources." While State Employees Credit Union doesn't have a "concrete" small-dollar lending amount, the term is based on its SALO payday alternative product, which has a maximum of

$500. Members may apply in the branch, at the contact center or online. Each year, roughly 34,000 new SALOs are awarded at an average amount of $407. The average payback period is 20 days. Coburn noted there is a 90 day delinquency rate (.836 percent) and the charge-off percentage is 3.61 percent.

"Members must be on direct deposit to qualify for our SALO product," said Coburn. "All advances must be processed on our website, voice response system or mobile device."

Conclusion

This white paper outlined the four common fears of small-dollar lending, which industry experts and credit union executives addressed, and in large part, dispelled. With less than two percent of the credit union industry tapping into the $38.5 billion payday-lending loan market, credit union executives are therefore encouraged to analyze respective demographics and explore NCUA regulated third party automated small-dollar lending solution providers.

For those credit union executives considering offering small-dollar lending, Numerica Credit Union's Erny said the best was to eliminate fears and risks is to conduct thorough research focusing on: federal regulations, state statutes, peers using similar products and internal litmus tests. "Talk to your organization's regulators to help ensure initial product success," said Erny. "Before embarking on the full discovery of a small-dollar lending product, determine your organization's risk appetite."

Since high volume small-dollar loans require a higher degree of oversight, Coburn suggested executives survey members to determine the specific need for a small-dollar lending solution.

"You should carefully evaluate the manner in which the product will be delivered and the impact the recurring nature of loans will have on other operations," said Coburn. "You should also have a plan for addressing/assisting members that get into a repetitive borrowing cycle."

CFSI's small-dollar lending team members agree with Erny and Coburn recommending that credit unions focus on members' needs for SDC products, while identifying respective goals for offering them small-dollar lending solutions."SDC products can have a significant, positive impact on a credit union's overall membership by helping address financial challenges like misaligned cash flows, unexpected expenses or building credit," said Sohrab Kohli, senior associate at CFSI.

Olympia, Washington-based QCash Financial started as a short-term loan solution for members of WSECU in 2004. QCash Financial is a provider of an automated, cloud-based, omni-channel lending platform that enables financial institutions to provide short-term loans quickly to the people they serve. For more information about QCash, visit its website at QCash.com