NCUA Payday Alternative Loan Regulations:

Open Comment Summary

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Executive Summary

According to the April 2017 Pew Charitable Trusts' report, "Americans Want Payday Loan Reform, Support Lower-Cost Bank Loans," 12 million Americans use payday loans each year totaling nine billion in loan fees. It is estimated that credit unions comprise less than two percent of the $38.5 billion payday-lending loan market.

While many credit union industry executives have trepidations about offering small dollar lending at 18, 28 or 36 annual percentage rate (APR), because it seemingly contradicts the industry's "people helping people" motto, predatory lenders are targeting the underbanked across the nation with astronomical APRs. And it's just not predatory lenders going after this submarket. US Bancorp, for example, launched its "Simple Loan" product in September 2018 with APRs as high as 70 percent.

Certain credit union industry executives and policy makers believe the credit union industry can more fairly serve the payday loan population with enhanced Payday Alternative Loans (PALs) tools. In April 2018, the National Credit Union Association (NCUA) proposed amending the NCUA's general lending rule, and for good reason. NCUA's existing PAL program has resulted in fewer than 200,000 loans in recent years, compared with roughly 100 million payday loans annually. Since the proposed amendment was released, the NCUA has received more than 45 letters both supporting and questioning its PALs II proposal, which was designed to level the playing field for credit unions.

The purpose of this white paper is to identify the differences between PALs I and PALs II and to gain insights from representatives of credit union leagues, credit union service organizations, consumer protection groups and credit union executives. The goal is to try to

decipher the following conundrum: If the credit union industry doesn't responsibly enter this arena now, then when will it? And, if the credit union industry doesn't enter in a forward-leaning, meaningful manner, who will protect the underbanked - many of whom are credit union members?

PALs I & II Breakdown

Eight years ago, the NCUA Board amended its general lending rule to enable Federal Credit Unions (FCUs) to offer PALs loans as an alternative to predatory payday loans. In doing so, the Board "intended to provide a regulatory framework so FCUs could be a viable alternative to high-cost payday lenders," the NCUA stated in its report "NCUA Payday Alternative Loans – Proposed Rule," which was released in May 2018. The rule permitted FCUs to charge a higher rate of interest for this type of loan if FCUs met certain conditions.

According to NCUA, PALs I current regulatory framework permits an FCU to charge an interest rate for PALs loans that is 1000 basis points above the general interest rate set by the Board for non-PAL loans, provided the FCU is making a closed-end loan with the following conditions:

- The principal of the loan is not less than $200 or more than $1000.
- The loan has a minimum maturity term of one month and a maximum maturity term of six months.
- The FCU does not make more than three PALs loans in any rolling six-month period to any one borrower and makes no more than one PALs loan at a time to a borrower.

- The FCU must not roll over any PALs loan. The prohibition against roll-overs, however, does not apply to an extension of the loan term within the maximum loan term permitted by the rule, provided the FCU does not charge any additional fees or extend any new credit.
- The FCU fully amortizes the loan.
- The FCU sets a minimum length of membership requirement of at least one month.
- The FCU charges an application fee to all members applying for a new loan that reflects the actual costs associated with processing the application, but in no case may the application fee exceed $20.
- The FCU includes, in its written lending policies, a limit on the aggregate dollar amount of loans made under of a maximum of 20 percent of net worth and implements appropriate underwriting guidelines to minimize risk; for example, requiring a borrower to verify employment by producing at least two recent pay stubs.

While PALs II incorporates much of PALs I requirements, there are unique differences. As noted in the aforementioned report, the Board "believes the different features in PALs II will encourage additional FCUs to offer PALs II loans as an alternative to predatory payday loans. Additionally, the proposed change "will help FCUs meet the specific demands" of certain payday loan borrowers that may not be met by PALs I. PALs II, the report noted, would provide borrowers with a safer, less expensive alternative to traditional payday loans.

As per NCUA, the leading PALs II enhancements are as follows:

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- Loan Amount: The Board is proposing to permit PALs II loans in amounts up to $2,000, which is significantly higher than PALs I loans. Also, PALs II would eliminate the minimum loan amount that is part of the PALs I program.
- Loan Term: Corresponding to the increase in permissible loan amount, the Board is proposing a maximum loan term of 12 months. This differs from the six-month maximum loan term for PALs I, and is directly correlated to the requirement that FCUs amortize PALs loans and the proposed higher PALs II loan limit.
- Membership Requirement: The Board is proposing to impose no minimum length of membership requirement for a PALs II loan. Conversely, under PALs I, an FCU must set a minimum length of membership requirement of at least one month before lending to a borrower.
- Number of Loans: The Board proposes no requirement in PALs II limiting an FCU to making only three PALs loans to a member in a rolling six-month period. This limitation is applicable to PALs I loans and permits FCUs to make one loan at a time to a particular borrower and no more than three in any rolling six-month period to that borrower.

"The Board is proposing to incorporate all other requirements of PALs I into PALs II," a NCUA statement noted. "The Board is also soliciting comments from interested stakeholders on the possibility of creating a third PALs loan program (PALs III), which could include different fee structures, loan features, maturities and loan amounts."

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The Credit Union Perspective

There are approximately 6,557 credit unions with assets exceeding $1 trillion in the United States that serve more than 100 million members, but there are only roughly 600 credit unions offering small dollar lending. According to the aforementioned Pew Charitable Trusts report, the average payday loan borrower is in debt for five months of the year and spends an average of $520 in interest to repeatedly borrow $375.

California Credit Union League President/CEO Diana Dykstra feels credit unions can do better. "Credit unions could provide the same $375 for five months for roughly six times less than what the payday lenders charge," she wrote in a letter to the NCUA. "Clearly credit unions offer a better alternative and we support efforts to make consumer-friendly payday alternative loans available to more consumers."

The California and Nevada Credit Union Leagues is one of the largest state trade associations for credit unions in the nation and represents the interests of more than 250 credit unions and approximately 10.5 million members. While the NCUA proposes to retain the current PALs rule (PALs I) and provide an additional option with different terms and conditions via the PALs II loan option, Dykstra noted that California and Nevada Credit Union Leagues suggest a collaborative alternative: A single PALs program that provides ranges under which FCUs may offer short-term, small-dollar loans.

"This parameters-based approach provides credit unions with flexibility to tailor their loan products to meet the needs of the consumers in their communities," noted Dykstra. "We respectfully hope that we can assist the NCUA in developing a payday lending alternative that

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truly meets the needs of consumers, allows more federal credit unions to offer PALs and meets the NCUA's safety and soundness objectives."

For Pleasanton, Calif. – based Patelco Credit Union, which serves more than 300,000 members, the proposed PALs II platform is encouraging news, but requires further investigation, noted Compliance Manager Jay Hartlove.

"We are in favor of the changes the NCUA is proposing that will make is easier for credit unions to develop PAL programs," noted Hartlove in a letter to the NCUA. "The current restraints on PAL programs, coupled with the Bureau of Consumer Financial Protection's new restrictions on payday lending have kept us from exploring a new PAL program."

Getting more specific on NCUA proposal, Patelco CU endorses removing the limitation of how many PAL loans can be made within a certain period of time (as long as there can only be one loan at a time per member), raising dollar limits and time frames to allow more flexibility to tailor loans as needed, while still "staying inside the safe harbor" from the Bureau of Consumer Financial Protection's rules.

"We would like to see guidance on measuring the ability to repay for low dollar amount, short term loans, so we can establish underwriting rules that reflect our risk tolerance. We would also like to see the maximum interest rate raised into alignment with the MLA maximum of 36 percent APR," noted Hartlove. "Credit unions should also have the option to give a PAL loan to a new member. If underwriting rules capture risk tolerance, then there should not be an artificial waiting period before we can help someone."

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The Consumer Protection Perspective

While many credit union and credit union leagues support NCUA's PALs II proposal, not all organizations share the same perspective. In a letter to NCUA's Secretary of the Board Gerald Poliquin, the Tucson, Ariz. – based Center for Economic Integrity implored board members to not forget the credit union ethos: People helping people.

"Credit unions pride themselves as membership driven organizations exiting primarily to meet the needs of its members. The relationship and trust that credit unions have with its members is developed over time and is not based on extracting huge profits for the lending institution but on building long-term customer and community relationships," wrote Executive Director Kelly Griffith. "These relationships are based on the principles of fairness, transparency and integrity. Arizona credit unions, large and small, state chartered and federally chartered hold themselves to a high ethical standard. The proposed PAL II and PAL II put that standard and the reputation of the entire credit union industry at risk."

The Durham, N.C. – based Center for Responsible Lending shares similar concerns. The organization went on record noting that PALs II as proposed will "increase the likelihood that credit union members end up in cycles of unaffordable high-cost loans" that resemble payday loan debt.

"Federal credit unions already offer a range of products that meet small dollar credit needs that bear no resemblance to payday loans in structure or cost," the organization stated in a letter to the NCUA. "Thus, authorizing additional expensive payday loan-like products is not necessary, yet risks harming the very people it aims to help."

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A central point of contention cited by The Center for Responsible Lending is removing the limit of three application fees per six months. This move could lead to "the high-cost loan flipping PAL has been intended to prevent." Senior Policy Counsel Rebecca Borne, one of four authors of the letter, noted that repeat borrowing at high percentage rate violates the definition of a federal credit union: A cooperative association organized for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes.

"Loan flipping runs directly counter to this purpose. We believe that NCUA's intent, like FCUs, is to help members. Our experience is that repeat borrowing is essentially credit for unproductive purposes, providing little-to-no real benefit to the borrower and often inflicting harm," wrote Borne. "Moreover, the proposal to lift this limit rests on an erroneous reading of the CFPB Payday (loan) Rule, further compelling the Board not to finalize this change as proposed."

A CUSO Weighs In

According to the Credit Union Service Organization, QCash Financial LLC, there are more than 50,000 non-depository locations in the U.S. that provide costly alternative financial services. Consumers and members alike rely on payday loans to meet everyday expenses for food, utilities, rent or daycare, borrowing at annual percentage rates that typically exceed 300 percent. Most of these consumers have low credit scores, but they do have regular income and an active checking account, the two requirements to get a payday loan.

"Those customers are not among the seven percent of households that are unbanked," noted QCash's CEO Ben Morales. "Rather they are among the 20 percent of households that are

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underbanked, meaning they hold an account at a credit union or bank, but they also meet some of their needs by going to alternative financial services providers."

QCash has used Washington State Employees Credit Union (WSECU) as an incubator for its payday loan alternative technology for more than 10 years. During this time frame, WSECU has made over 300,000 of these type short term loans for over $200 million.

"This experience, including years of research and development, technology enhancements, financial modeling and, above all, member service uniquely positions us to identify elements of the rule that merit reconsideration, modification, deletion or reconstruction," noted Morales. QCash, he added, respectfully asks that the NCUA PAL program fall in line with existing regulatory requirements from the Department of Defense and Consumer Financial Protection Bureau (CFPB), while preserving the exemption the PAL program enjoys under the newly issued CFPB Payday loan rule.

As reported in Credit Union Journal, WSECU offers two small dollar lending options: Q-Cash and Q-Cash plus. For the former, members can obtain a low fee loan on amounts between $50 and $700, which doesn't require an application. For the latter, members can obtain loans for $701 to $4,000. While a credit report is not needed for this loan, a $25 application fee applies.

"We have seen, first-hand through our clients, the benefit of a thoughtfully designed and tailored program can bring to consumers and credit unions," said Morales. Currently only 18 percent of FCUs offer payday loans to its membership, which Morales said is due to the inability to make the loans profitable. Instead of limiting FCU to 28 percent APR, Morales is calling on NCUA to raise that figure to 36 percent, a CFPB rule that is allowable for covered borrowers under the Military Lending Act. Additionally, he requests that there is no name change.

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“We recommend the NCUA avoid naming its products separately, (e.g. PALs I, PALs II, and PALs III) and simply maintain one PAL Program that encompasses the available loan options available to federal credit unions,” he said.

WSECU’s President and CEO Kevin Foster-Keddie commended NCUA’s on its PALs II proposal, but agreed with Morales that there is still work to be done. The current application fee doesn’t cover the full cost of origination and he suggests increasing loan terms to 36 months and loan amounts to $4,000.

“We support a number of the changes outlined in the PAL II proposal, such as limiting the number of loans at any given time to one, removing the restriction on the number of loans over a specific period and eliminating the minimum length of membership,” said Foster-Keddie.

Conclusion

Whether it remains PALs I or PALs II or a possible hybrid, PALs III, if the NCUA wants to increase its payday lending adoption rates, changes are required. The Board is currently considering the more than 45 letters that have been received from credit union leagues, credit union serviced organizations, consumer protection groups and credit union executives. It remains unclear if the Board will adopt some or all of these respectful suggestions. It is clear that striking a balance between consumer protection groups and credit union executives will be a challenge.

“The 18 percent annual usury cap for federally-chartered credit unions does not apply to loans made under the PAL program which permits rates of 1000 basis points higher than the federal cap, currently 28 percent, for loans that meet the terms of the PAL program,” noted Center for Economic Integrity’s Griffith. “The Board is proposing that the size of PAL II loans be doubled to $2,000 to qualify for this much higher rate. We are very concerned about

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continued erosion of the important federal usury ceiling for credit unions, especially for larger loans."

Before the California Credit Union League can fully support NCUA's proposal, President and CEO Diana Dykstra said certain changes are necessary. These include a maximum interest rate of 36 percent APR, no minimum loan amount and no maximum loan amount of $2,000 or more, minimum maturity term of one month and a maximum maturity term of 36 months and no limit on the number of PAL loans to a member within a certain amount of time, among others line items.

"The NCUA proposes to retain the current PALs rule (PALs I) and provide an additional option with different terms and conditions, a PALs II loan. The Leagues support a different approach; specifically, a single PALs program that provides ranges under which FCUs may offer short-term, small-dollar loans," noted Dykstra.

While to date the PAL program has had relative low adoption rates, Morales applauds NCUA's attempt to offer additional options to FCUs to enter this space and offer payday alternative loans that can meet the short term liquidity needs of respective members.

"The alternatives contemplated, which if promulgated as proposed will modify loan amounts, terms, frequency and membership requirements, are a good step forward for America's FCUs," noted Morales. "However, the rule construction is unnecessarily complex. Our recommendations shore up what we have observed as problems in the proposed rule and will serve to meet NCUA's stated objectives, while enhancing regulatory certainty and bringing parity to the short-term lending industry at large."

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Along with QCash there are other fintech CUSOs looking to eliminate predatory lending by developing flexible solutions to meet regulatory, member, mission and margin needs, said Morales. Credit unions, he added, should embrace this movement.

“The inability to pass enabling regulation for credit unions to responsibly enter the market says that the industry is ‘okay’ with letting our members use predatory solutions to meet their liquidity needs,” said Morales. “The credit union industry has to combat predatory lenders in their communities, because if we don’t do it now, when will we? We have to put members’ needs first, while securing respective bottom lines.”

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