NCUA LETTER TO FEDERAL CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA

DATE: **April 2001** **LETTER NO.: 01-FCU-03**

TO: **Federal Credit Union Officials**

SUBJ: **Payday Lending and Title Loans**

The criticisms associated with payday lending and title loans have received significant attention from the media. The National Credit Union Administration urges credit unions to be aware of the risks associated with payday lending and title loan programs.

Payday loans (a.k.a. deferred advance loans, cash advance loans, check advance loans, post-dated check loans, or deferred deposit check loans) are small-dollar, short-term loans borrowers promise to repay from their next paycheck or salary deposit. These loans normally have high fees, are rolled over frequently and can result in offensive lending practices.

For example: A person borrows $100 until the next payday. The lender provides a two-week loan and charges a $15 fee. The lender will require the borrower to provide a postdated check for $115 to be held until the borrower's next payday. When the loan comes due, the borrower may repay the loan by allowing the lender to process the check or by bringing in the full payment of $115 in cash. The borrower may also have the option to "roll over" the loan by taking out another loan and paying an additional $15 for another two weeks. In this example, the annual percentage rate (APR) calculates to 391 percent for the original two-week loan of $100 with a $15 fee.

Because federal credit unions are limited to a maximum lending rate of 18 percent, structuring a loan in this way is impermissible[1]. Generally, credit unions offer a

[1] The Federal Credit Union Act and the NCUA Rules and Regulations set the maximum interest rate federal credit unions can charge on loans and lines of credit at 15 percent per annum inclusive of all finance charges. The Act permits NCUA to increase the interest rate above 15 percent for periods of up to eighteen months. The current maximum interest rate is set at 18 percent. In determining whether a particular charge constitutes a finance charge for purposes of compliance with the interest rate ceiling, we generally follow the Reg Z interpretation of that term. If the credit union charges a fee only to those borrowers who receive the loan, the fee is included as a finance charge and must be included in the APR calculation.

much less costly alternative to their members, granting them a loan with no fee; interest is calculated over the term of the loan according to the APR disclosed. Although obtaining a payday loan from a credit union is less costly to the borrower, the credit union assumes a variety of risks.

Title loans, which are similar to payday loans, have some of the same risks. Title loans are short-term loans secured by clear title to the borrower's vehicle. The original term is normally 30 days, but the typical arrangement allows the borrower to extend the loan several times by paying the interest due for the previous month. Much like the payday loan, the borrower is often unable to pay the previous month's interest, so it is rolled (or added) into the loan, putting the borrower deeper in debt. The increased loan amount raises the loan payments; the increased payment can then cause the borrower to default on the loan, resulting in repossession of the vehicle.

Title companies are urging financial institutions to participate in these ventures. The NCUA wants to caution credit unions that funding arrangements with title loan companies introduce several risks to the financial stability and reputation of the credit union.

Credit unions assume the following risks by participating in payday lending and/or title lending:

Credit Risk

Borrowers obtaining loans to "get them through" frequently have limited financial capacity, blemished credit, or no credit history. The short term of the loan makes it difficult for the borrower to accumulate the needed payoff funds by the due date.

Transaction (fraud) Risk

Given the frequency of renewals and add-ons, these low-dollar loans can pose high levels of transaction risk. Because the transaction amounts are small, they seldom draw attention and are therefore subject to creation of fictitious lenders. These loans are also vulnerable to unauthorized add-ons or renewals which can mask delinquency. Small-dollar loans are often handled at the lowest level of lending authority; therefore, employees could misrepresent loan information or fail to adhere to underwriting policies, and the dollar amount may preclude the loan from being reviewed at a higher level.

Reputation Risk

Because of the high fees and negative characteristics emphasized by the media, members may believe the credit union is participating in inappropriate lending practices.

Compliance Risk

Equal Credit Opportunity Act (Reg B):
The credit union is responsible for ensuring compliance with Reg B requirements concerning nondiscriminatory lending and notification of action on loan applications. Further, if using a credit scoring system to evaluate these borrowers, the credit union must ensure such systems comply with Reg B requirements for system validation, and if overrides are allowed, that they are based on nondiscriminatory factors.

Truth in Lending Act (Reg Z):
Credit unions must ensure accurate Reg Z disclosures are provided to borrowers. Failing to accurately disclose finance charges and APRs can result in having to pay restitution to borrowers. Small dollar loans have a small dollar tolerance for inaccuracies.

Electronic Fund Transfer Act (EFT) and Truth in Savings Regulation (TIS): Some credit unions may be establishing a lending program whereby they open a deposit account for each borrower, deposit the loan proceeds into the account, and issue an electronic access card to debit the funds from their account. The requirements of both EFT and TIS apply to such programs.

Because these loans contain substantial risk for the borrower (who can get trapped in this type of borrowing) as well as the credit union, it is important management consider the following features in establishing guidelines:

- Limits on "rollovers."
- Limits on the number of payday loans or title loans a borrower may have in one year.
- Substantial waiting periods between loans.
- Right to rescind a loan, without charge, within 24 hours after it is made.
- Clear and understandable disclosures concerning the costs and risks associated with these loans.

We encourage credit unions to proactively protect their members. As a credit union, you may want to provide information to your members on these issues. Make certain potential borrowers know the true cost of using short-term credit with up-front fees. Naturally, the preferred alternative is to borrow from the credit union. The person should shop around and compare offers, looking closely at the APRs. The borrower may also want to consider obtaining an advance from their employer, seeking assistance from a local consumer credit counseling service, or inquiring about obtaining overdraft protection on a checking/share draft account.

If your credit union is approached by a payday lender or title loan company seeking to establish a funding agreement, we recommend you consult legal counsel in addition to discussing the opportunities and risks of the venture.

Sincerely,

_____/s/______________________________
Dennis Dollar
Acting Chairman
National Credit Union Administration Board