NCUA LETTER TO FEDERAL CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION

1775 Duke Street, Alexandria, VA 22314

DATE: **July 2009** **LETTER NO: 09-FCU-05**

TO: **All Federal Credit Unions**

SUBJ: **Payday Lending**

Introduction

The National Credit Union Administration (NCUA) encourages federal credit unions (FCUs) to find sound ways to serve their members' small loans needs. This letter alerts FCUs to the risks, compliance issues and responsibilities associated with operating a payday lending program. It also highlights the potential benefits a well-designed, small loan program can provide to members and FCUs alike.[1] NCUA reminds FCUs of the need to comply with statutory and regulatory provisions in operating a lending program and offers suggestions on how FCUs can best serve their members' interests in this context.

Payday Lending Defined and Effects on Borrowers

Although there is no one universally accepted definition of "payday loans," that term generally refers to small-dollar, short-term loans borrowers promise to repay from their next paycheck or salary deposit. Historically, these loans have often been made by lenders who charge high fees and may engage in predatory lending practices. While some payday loan borrowers use these loans sparingly, other borrowers find themselves in cycles where their loans roll over repeatedly, incurring high fees, and are unable to break free of this unhealthy dependence on payday loans. NCUA believes this dependence often reflects or exacerbates other financial difficulties payday loan borrowers are experiencing. It is understandable, therefore, that for many, the term "payday loan" carries a negative connotation.

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[1] This letter supplements previously issued Letter 01-FCU-03 on the same topic.

NCUA is aware that an increasing number of FCUs are interested in establishing short-term loan programs that are more advantageous to their members than programs available from traditional payday lenders and pawn shops. NCUA believes a well-run loan program can be an opportunity for an FCU to improve the lives of its members by providing low cost, small loans. An FCU's program should be designed ultimately to try to help members end their reliance on payday loans and guide members toward the FCU's more mainstream, low cost financial products and services, including financial counseling. An FCU's board of directors is responsible for articulating loan policy, underwriting standards, and the degree of risk an FCU is willing to take in its various loan programs.

Legal Framework

The Federal Credit Union Act (Act) and NCUA's lending regulation impose a ceiling on the interest rate an FCU may charge for credit. 12 U.S.C. §1757(5)(A)(vi); 12 C.F.R. §701.21(c)(7)(i). Currently, the interest rate ceiling is 18% per year on the unpaid balance. It is calculated "inclusive of all finance charges." Id. As a result, even a minimal finance charge can cause a loan to have an annualized interest rate in excess of the ceiling, especially with respect to a payday loan that is typically for a small dollar amount and a short term. For example, a $10 finance charge on a $200 loan with a two-week term and a stated interest rate of 16.5% actually would have an annualized interest rate of nearly 150%, far exceeding the 18% ceiling.[2]

NCUA's long standing policy has been to look to the definition of "finance charge" in Regulation Z (Reg Z) of the Federal Reserve's (Fed) regulations to determine what fees are finance charges.[3] The NCUA Board articulated this policy in the preamble of a final rulemaking and the Office of General Counsel has subsequently reiterated the policy in numerous legal opinions.[4]

Reg Z implements truth-in-lending legislation to promote consistent and informed use of consumer credit. It requires creditors to disclose the terms and costs of consumer credit transactions but does not generally govern charges for consumer credit. Reg Z defines "finance charge" broadly as including "any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or a

[2] NCUA calculates the annualized interest rate in this example as follows. The additional borrowing cost attributable to the $10 fee on the $200 loan for 14 days is $0.71 per day. The daily rate of $0.71 x 365 days is $259.15, the projected borrowing cost for a full year for the $10 fee alone. $259.15 divided by $200 equals 129.58% annualized just for the $10 fee. Adding the stated interest rate of 16.5% to the 129.58% equals 146.08%, which is nearly 150% as stated above.
[3] 12 C.F.R. Part 226.
[4] 45 Fed. Reg. 22888, 22890 (April 4, 1980); OGC Legal Op. 91-0412 (April 30, 1991).

condition of the extension of credit."[5] As a result, most fees charged in connection with an extension of credit are considered finance charges.

Reg Z, however, expressly excludes certain charges from the definition of finance charge. For example, "[a]pplication fees charged to all applicants for credit, whether or not credit is actually extended" are excluded.[6] The Fed's Official Staff Interpretations to Reg Z further explains:

> An application fee that is excluded from the finance charge is a charge to recover the costs associated with processing applications for credit. The fee may cover the costs of services such as credit reports, credit investigations, and appraisals. The creditor is free to impose the fee in only certain of its loan programs, such as mortgage loans, [h]owever, if the fee is to be excluded from the finance charge under § 226.4(c)(1), it must be charged to all applicants, not just to applicants who are approved or who actually receive credit.[7]

Other fees, such as some participation fees, are also excluded from the definition of finance charges in Reg Z. A participation fee is a payment to access a credit plan, not a fee imposed separately on individual closed-end transactions. Minimum monthly charges and charges based on either account activity or the amount of credit available under a plan are not excluded from the definition of finance charge. For example, a fee charged and then refunded based on the extent to which a borrower uses available credit is a finance charge.[8]

The interplay between the loan interest rate ceiling applicable to FCUs under the Act and NCUA's lending regulation and the provisions of Reg Z can be complex. An FCU must ensure its program complies with applicable law. Including finance charges in the annual percentage rate (APR) presents the greatest compliance challenge for most FCUs with respect to the loan interest rate ceiling. As shown in the below examples, an FCU can structure its program to be cost effective, comply with applicable law, and satisfy member needs.

Examples of Permissible and Impermissible Programs

FCUs can structure a permissible short-term, small loan program in many ways. Examples of permissible programs include the following.

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[5] 12 C.F.R. §226.4(a).
[6] 12 C.F.R. §226.4(c)(1).
[7] 12 C.F.R Part 226, Supp. I, Section 226.4—Finance Charge, 4(c) Charges excluded from the finance charge. Paragraph 4(c)(1).
[8] 12 C.F.R. §226.4(c)(4); 12 C.F.R Part 226, Supp. I, Section 226.4—Finance Charge, 4(c) Charges excluded from the finance charge, Paragraph 4(c)(4).

● An FCU offers a loan of $500 for 120 days at 16.9% APR and no fees. Minimum payments are due on each payday. If a member has received two loans, then the member must complete a budget counseling course made available through the credit union before receiving a third loan.

● An FCU offers 18% APR loans of $100-$600 that are to be repaid in installments of one month for every $100 borrowed. There are no other fees.

● An FCU offers loans up to $1,000 for six months and deposits half of the loan amount in the borrower's savings account. There is a $10 application fee. The APR will vary depending on whether the loan is paid with or without automatic payment, but in no event will it exceed 18%.

All of the above examples permit members to repay their loans over a period of months rather than within two weeks. Although not legally required, this maturity feature may make it easier for members to pay off their loans and minimize roll-overs and keeps the APR within legal limits. FCUs should consider if similar maturity terms would enhance their own loan programs.

The following are examples of programs that are not permissible.

● An FCU offers loans with no application fees or participation fees. There are no finance charges other than an APR of 18.5%. This exceeds the 18% ceiling.

● An FCU offers loans with a stated 0% APR and charges an application fee of 20% based on the loan amount. The FCU has essentially the same processing costs for all payday loans regardless of amount. The 20% fee does not accurately reflect the costs of processing applications so the fee should be considered a finance charge under Reg Z and be included in calculating the APR. This would raise the APR above the 18% ceiling.

● An FCU offers loans with a stated APR of 18%. It charges a variable participation fee depending on the loan amount. This fee is charged multiple times if the borrower: fails to cancel the account after repayment, repays one payday loan and takes out another, or pays something less than full repayment at maturity. The program contemplates multiple participation fees based on individual closed-end transactions or account activity. These participation fees are not based simply on gaining access to a credit plan and, therefore, should be considered finance charges under Reg Z and would cause the APR to exceed the 18% ceiling.

<u>Credit Union Service Organizations (CUSOs)</u>

FCUs should remember that making consumer loans is not a preapproved activity for CUSOs.[9] Consequently, if a CUSO makes payday loans, then an FCU must divest itself of its ownership interest in the CUSO and may no longer invest in or lend to the CUSO. State chartered credit union investment and divestiture requirements in such a CUSO will be governed by applicable state law.

Lending Risks for FCUs

FCUs must be attuned to and understand the variety of risks associated with small amount, short-term loans. FCUs should also strive to provide financial education and try to help their members understand these types of transactions so members can choose the products best suited for them.

Credit Risk:

Borrowers who need these loans frequently have limited financial capacity, blemished credit, or no credit history. The short-term nature of the loans may make it difficult for borrowers to accumulate the needed payoff funds when due. An FCU should set borrower and program limits to control credit concentration risk.

Transaction/Fraud Risk:

Given the frequency of renewals and add-ons, these loans can pose high levels of transaction risk. Because payday transaction amounts are small, these loans often do not receive the same scrutiny as higher dollar loans and may be vulnerable to unauthorized add-ons or renewals that can mask true delinquency and loan losses.

Reputation Risk:

Because of high fees and the negative connotation often associated with payday loans, current and potential members may believe an FCU making these loans is participating in inappropriate or predatory lending practices. An FCU should clearly disclose the costs and risks associated with loans and never mislead members in advertisements or as part of the application process.

Compliance Risk:

As with any loan an FCU makes, it must comply with applicable consumer protection laws, including the Equal Credit Opportunity Act (ECOA) and Regulation B (Reg B),

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[9] 12 C.F.R. Part 712.

Truth in Lending Act and Reg Z, Electronic Fund Transfer Act (EFTA) and Regulation E (Reg E), and Truth in Savings Act (TISA) and Part 707 of NCUA's regulations.

- ECOA and Reg B: An FCU must comply with requirements concerning nondiscriminatory lending and notification of action on loan applications. Further, if using a credit scoring system to evaluate borrowers, an FCU must ensure the system complies with requirements for system validation, and, if overrides are allowed, that they are based on nondiscriminatory factors.

- Truth in Lending Act and Reg Z: An FCU must provide accurate disclosures to borrowers. Failing to calculate and disclose finance charges and APRs accurately can result in an FCU having to pay restitution to wronged borrowers.

- EFTA and Reg E: An FCU that establishes a loan program where it opens a deposit account for each borrower, deposits loan proceeds into the account, and issues an electronic access card to the borrower to debit the funds may be subject to the terms of EFTA, Reg E, TISA, and Part 707.

An insured credit union may not use any advertising, including print, electronic, or broadcast media, displays and signs, stationery, and other promotional material, or make any representation that is inaccurate or deceptive in any way.[10] This general prohibition applies to how an FCU describes and promotes the terms of any loan program. In this regard, FCUs should perform thorough due diligence before entering into any sort of third-party relationship with a CUSO or other party for the purpose of making payday or similar loans.

An FCU that refers its members to a third party to obtain payday loans for a finder's fee or other purpose incurs risk in doing so. For example, as noted above, an FCU cannot own or invest in a CUSO if the CUSO makes consumer loans. Also, an FCU would be in violation of Part 740 of NCUA's rules if it misrepresents the terms of a payday loan being offered by a third party to whom the FCU refers members. Further, not only would this create significant reputation risk, but it is contrary to the FCU's central mission to serve its members.

Payday Lending Risks for Members

While payday loans can help members on a short-term basis, members should be made aware of the risks associated with this kind of borrowing on a long-term basis including the high cost. For FCUs that offer small amount, short-term loan programs, NCUA suggests the program should include features that try to help members use the FCU's more mainstream financial products and services. For example:

[10] 12 C.F.R. §740.2.

● Limiting the number of roll-overs a member may make or limiting the number of payday loans a member may have in one year;

● Imposing substantial waiting periods between loans;

● Permitting a member to rescind a loan, without charge, within 24 hours after it is made; and

● Providing financial counseling services in conjunction with these loans.

Conclusion

FCUs can enhance their members' economic well-being by offering alternatives to payday loans that provide members with short-term credit at fair rates. These programs should be geared to moving members away from short-term loans and towards more mainstream products and services. FCUs should carefully craft their loan programs to navigate the risks associated with this type of lending and comply with applicable law.

Sincerely,

/s/

Michael E. Fryzel
Chairman
National Credit Union Administration Board