Breaking the cycle of payday loan 'trap'

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By Kirk Wagner, The (Appleton, Wis.) Post-Crescent, for USA TODAY

Holly Maurice at GoodMoney credit union shares a laugh while serving a customer in a Goodwill store in Darboy, Wis.

By Sue Kirchhoff, USA TODAY

WASHINGTON — Tellers at the North Carolina State Employees' Credit Union noticed a troubling change several years ago: The first people in line on payday were high-cost lenders, waiting to cash checks from credit union members.

A glance at the records showed thousands of credit union customers were turning to payday outlets for small loans to be repaid with their next paychecks. Such products typically carry annual fees of 300% to 1,000%. Many strapped borrowers repeatedly roll over the loans, sinking deeply into debt.

To wean its members from payday providers, the State Employees' Credit Union (SECU) in 2001 introduced a short-term loan that has a 12% annual interest rate, a maximum limit of $500, requires borrowers to repay via direct deposit of their paychecks and put 5% of loan proceeds in savings accounts. Each month, more than 40,000 people use the product, which has a maximum 31-day term. Overall, members have accumulated $10 million in savings accounts.

"We wanted to find a way to get our members out of this trap," says Jim Blaine, SECU president. "We have a couple of our vice presidents using it, a vice chancellor of a university. ... It's not just a poor person's product."

The SECU is one of a growing number of credit unions now offering products specifically designed to combat payday, or cash advance, lending, which soared in the 1990s even as the nation experienced record economic growth.

Payday lending has become a $40 billion annual business (in loan volume) with more than 22,000 U.S. outlets, according to the Community Financial Services Association of America, the industry's trade group. By comparison, Starbucks has 8,624 U.S. locations and McDonald's about 14,000.

Mainstream lenders were initially slow to react, but more than 1,000 of the 9,000 U.S. credit unions now have products designed as alternatives to payday loans, says Dan Mica, president of the Credit Union National Association. That includes the Prospera Credit Union in Appleton, Wis., which started a program in a Goodwill Industries thrift store last year after Prospera CEO Ken Eiden noticed people going from the store to a payday lender across the way. Eiden says Prospera has already lent $1 million via the product.

Obstacles to alternative loans

Still, there are obstacles to alternative loans. Credit union officials fret about the stigma of being labeled a payday lender, albeit a lower-cost one. The SECU's Blaine says his short-term loans are his most profitable product, but Mica says given the poor credit quality of borrowers, many are break-even or community-service products.

Federal Deposit Insurance Corp. Chairman Sheila Bair, while she was a professor at University of Massachusetts in 2005, wrote a paper suggesting one reason banks and credit unions may have held back from short-term lending was to avoid undercutting highly profitable, bounced-check protection programs that have become de facto payday protection for some customers — with similarly high fees.

And Yolanda McGill of North Carolina's Center for Responsible Lending worries regulators could view credit union competition as a solution in itself, making them less likely to clamp down on payday lenders. She also says the ultimate goal must be to get people out of the short-term loan trap.

In Oregon, regulators say it's not either-or. A state law pushed by consumer advocates that takes effect in mid-2007 puts a 36% annual cap on payday loans. In the meantime, officials are working with such non-profits as Our Oregon and credit unions to promote alternative loans, including putting informational fliers in food bank boxes.

"If all we do as regulators is say, 'We're going to cut back on this, cut back on that,' (high-cost lending) will pop up someplace else," says Cory Streisinger, director of the Oregon Department of Consumer and Business Services. "We want to say, 'Here are some other options.' "

The effort has helped Ruby Stoker, 36, of Junction City, Ore. She and her husband, Ronald, got into trouble after taking out an $800 payday loan that, in a matter of months, morphed into four loans with an overall balance of $2,200. Stoker, who was carrying some loans with annual fees of 800%, now has a 13% credit union loan with a stretched-out repayment plan.

"They don't even do a credit check. They just use your paycheck. ... You're done in 10 or 15 minutes," Stoker says. "We're both graduates from college," adds Stoker. "It's not (that) you wake up in the morning and say, 'Let's go get ourselves into debt and bury ourselves to the point where we have to make a choice between paying the rent and eating.' "

The country has a long history of high-cost lending. There are a variety of theories for the recent growth, from banking deregulation to savvy marketing and consumers' desire for convenience. Mica expects there will soon be more than 40,000 payday outlets.

A typical payday product might be a two-week loan for $200 with a $30 fee, which translates into an effective annual percentage rate of 390%. Lenders provide immediate cash in return for a postdated check for the loan plus the fee, often with no background credit analysis.

Steven Schlein, spokesman for the Community Financial Services Association, says that borrowers often choose payday lenders to avoid high bounced-check or credit-card late fees from mainstream lenders, which can be as pricey as some of their products on an annual basis. He said the industry hasn't felt much impact from the credit union products.

"Only a few credit unions to our knowledge are offering two-week loans at low denominations," Schlein says. "We encourage them to. We're an entrepreneurial business who operates in a free market."

Research cited by Schlein's group and other analysts indicates many payday customers are repeat borrowers. For example, the Washington State Department of Financial Institutions, based on a voluntary survey of 66% of the state's payday lenders, found about half of borrowers took out six or more loans in 2004 and 25% took out a dozen or more.

States are cracking down on payday lenders, imposing fee caps and limits on the number of loans a borrower can have. The Department of Defense wants a 36% annual limit, given huge problems with payday lending near military bases.

Lenders, in response, are finding ways around the tougher rules. In Oregon, some payday firms have applied to switch to a different form of charter to circumvent the new law. State officials may also have to ask the Legislature for action to regulate Internet sales of payday loans.

Credit unions face challenges

The Filene Research Institute is working with credit unions in Ohio, Maryland and Wisconsin to design alternative loans and will expand into 10 more states next year. It is also encouraging credit unions to offer check cashing, international wire transfer and other services now offered by high-cost firms, along with credit counseling.

"Payday lenders stepped in and built a niche very nicely, but very expensively," says Lois Kitsch of the Filene Research Institute. "Credit unions have a very difficult time ... because they have a very real problem lending to get people from paycheck to paycheck."

JoAnn Johnson, chair of the National Credit Union Administration, says regulators support the efforts. Some consumer advocates, while applauding the moves, say credit unions have been slow to meet the needs of their borrowers, especially given their tax-exempt status.

"Their mission for being created was primarily ... to serve people of modest means. The larger ones have gotten off track," says John Taylor of the National Community Reinvestment Coalition, who argues credit unions should be subject to federal rules requiring banks to reach out to underserved areas.

Banks are making some moves into the area. James Ballentine, director of community and economic development at the American Bankers Association, says there may be more movement once several banks get going and build data on "whether you're really going to be chasing people down for $200."

SECU's Blaine dismisses talk that the products are financial losers.

"This is the most profitable loan product that we offer. That's the first myth that you'll hear other lenders offer," Blaine says.

Blaine has a PowerPoint presentation showing that at a 12% interest rate and 4% default rate, the SECU makes a healthy 2% on its cash advances. In reality, he says, the default rate is far less. "We don't put that in there because people don't believe it."

With 40,000 people using the program monthly, the SECU became the largest payday lender in the state. It modified the program in 2003 to require that 5% of loan proceeds go into savings. The idea is that after 18 months, borrowers will set aside enough to pay off the loan.

Ora Houston, 50, of Trotwood, Ohio, was in such bad financial shape several years ago she was even turned down by a payday lender. She tried the Wright-Patt Credit Union, which has a payday alternative, and got the $250 she needed. "I was about to lose everything, totally everything. I went to a lot of financial institutions, and they turned me away," she says.

Doug Fecher, CEO of Wright-Patt, says Houston got a loan requiring little in the way of a credit check and carrying a $35 annual fee. By reporting her payments, Wright-Patt helped Houston build a credit score and secure a $1,000, no-fee line of credit.

Counseling's not 'preachy'

In Appleton, Eiden's Goodwill product charges a $9.90 fee per $100, which translates into a more than 200% annual rate. After the third loan, borrowers get a voucher for free counseling and opportunities to consolidate and pay off previous loans. The program offers check cashing, money wire transfer and other services. Five dollars of the $9.90 fee covers defaults.

"You can't be preachy. After having established a rapport with (borrowers), we try to talk to them about how their financial futures could be different," Eiden says.

About half his borrowers should be able to get on a better footing, Eiden says. Others have chronic problems and may be surviving on Social Security or disability payments. He is working with area social service agencies. For example, some borrowers who were taking out payday loans for prescriptions are going to a free clinic.

Asked whether demand for his product will wane given North Carolina's crackdown on payday outlets, Blaine gives an emphatic "no."

"People are so embarrassed to talk about their finances, they think, 'I'm the only one that ever had a late payment,' " Blaine said. "It's not an exception. The normal thing is living payday to payday."

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