LINKING LENDERS AND COMMUNITIES

BRIDGES

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A Closer Look
Included with *Bridges* is *A Closer Look,* a supplement that takes

"Fringe" Lenders

Traditional Institutions Search for Alternatives

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The financial service industry has expanded beyond the traditional financial services of yesteryear. A host of nontraditional or "fringe" financial service providers have grown in popularity, adding more consumer options to the mix.

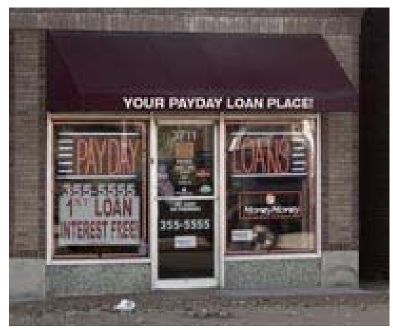
Traditional financial services are typically offered by regulated financial institutions, such as banks and credit unions, and include checking and savings accounts and home mortgage and auto loans. "Fringe" financial service providers offer check cashing and payday and title loans.

This article focuses on check cashers and payday lenders, why consumers turn to these services and how financial institutions can create partnerships to offer lower-cost alternatives.

Check Cashers

Check cashing outlets are the most commonly used fringe financial service. They cash government benefit checks and payroll checks, for a fee. Some check cashing outlets also sell money orders, collect bill payments and offer payday loans.

Check cashing outlets were originally designed to serve consumers who did not have a traditional bank account. However, a growing number of



According to the Center for Responsible Lending, the following is a **profile of the typical payday loan:**

loan amount = $325

14-day Interest = $52

amount of check = $377

average borrower refinances **eight times**

average borrower **pays**

topics from previous and current issues of *Bridges* and examines them from the perspective of a particular area or community. This issue of *A Closer Look* focuses on two programs in Arkansas that help small businesses provide health insurance to their employees.

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Americans are turning to check cashers to access their funds more quickly.

$800 to borrow $325

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99 percent of loans go to **repeat borrowers**

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average annual percentage rate (APR) = 416 percent

Check cashers may be more conveniently located for consumers than banks or may be open for business during more convenient hours. Consumers with low bank balances may be unable to cash checks at their banks without sufficient off-setting balances. The Check Clearing for the 21st Century Act (Check 21) provides for faster clearing of checks. Some consumers find, that while their bill payments are processed faster, they are still required to deposit payroll checks and wait for them to clear before accessing their funds. For consumers living paycheck to paycheck, as a growing number do, this hold period can result in insufficient funds to meet basic needs. Check cashers, on the other hand, provide immediate cash without waiting for the check to clear. However, the fee for providing this service is often high.

Payday Lenders

Some consumers who find themselves short of funds turn to payday lenders. Payday loans are small-dollar, short-term loans secured by a check that the borrower leaves with the lender, who holds the check until the borrower’s next payday. They are known to consumers by various names, such as cash advance loans or deferred presentment transactions.

Payday loans are usually priced at a fixed-dollar fee, which represents the finance charge to the borrower. The loans are short-term, usually 14 days. The cost of borrowing, expressed as an annual percentage rate (APR), can range from 300 percent to 1,000 percent or more, according to the Federal Deposit Insurance Corp. The loan is due on the consumer’s next payday. Those unable to pay the loan in full must pay another transaction fee to postpone payment until the following payday. This is known as a rollover.

Unlike the check cashing outlet patron, payday loan consumers must have a checking account to secure a loan. So why would consumers pursue such a costly option if they have a banking relationship?

There is some indication that consumers turn to payday lenders when an unexpected financial emergency arises, such as auto repairs or medical expenses. A study by the Federal Reserve found that consumers turn to payday loans when there is an increase in dependents in their household. Other sources, including the payday lending industry itself, cite speed and ease of obtaining loans and an expectation by consumers that they will not be turned down.

Perhaps one trend that is particularly disturbing is the use of check cashers and payday lenders as collection points for utility bills. According to the National Consumer Law Center, 21 large utilities use more than 650 licensed payday lenders as payment stations. For those who live paycheck to paycheck or who do not have a relationship with a financial institution, it may be enticing to take out a payday loan to pay utility bills, resulting in increased financial stress on these consumers.

Arkansans Take Action

In 2003, Arkansas Advocates for Children and Families convened a group of consumer, government and business leaders to identify practices that prevent families from sustaining adequate incomes or maximizing the income they do receive. Topping the list were the detrimental effects of payday lending on the working poor.

As a result of those meetings, Arkansans Against Abusive Payday Lending (AAAPL) was formed. This informal organization is dedicated to improving the lives of Arkansans, particularly the working poor, by supporting legislation that restricts or abolishes payday lending and by crafting alternatives that may be offered by regulated financial institutions.

The Community Affairs staff at the Little Rock Branch of the Federal Reserve Bank of St. Louis has worked with AAAPL to help it craft a model alternative product. In 2006, the Fed convened a focus group of bankers to discuss barriers to an alternative product, as well as acceptable characteristics of a model product. Armed with this information, AAAPL developed the Payday Alternative Loan (PAL). In February 2007, the Fed held a meeting to highlight the model and to provide the FDIC an opportunity to share their proposed rules for small-dollar loans.

Properties of this model are:

- reasonable interest rates established by the financial institution,
- installment payments that fully amortize the loan in six to 12 months, and
- a savings component that helps the borrower establish a savings account equal to the amount borrowed.

For more information on the Payday Alternative Loan (PAL) product, contact Hank Klein, founder/president of Arkansans Against Abusive Payday Lending at klein@aristotle.net.

Actions to place limits on payday lenders and check cashers also have had an impact on their density in Arkansas. (See map.)

What's Next?

It is undisputable that check cashers and payday lenders provide a service that consumers demand. It is equally true that these services exist because services such as signature loans and personal lines of credit have steadily declined over the past 20 to 30 years, leaving a consumer finance need unfilled.

Automated underwriting and the use of credit scores also have stripped the customer relationship out of the consumer financing decision. These changes are not necessarily bad as they are designed to mitigate risk and help financial institutions compete in the expanded financial services market.

The question for regulated financial institutions is whether an increased level of consumer education and improved access to other forms of short-term credit would effectively reduce the use of more high-cost services. And, can financial institutions provide these small-dollar loans without losing money on them? The answer is unequivocally "yes."

An example is the State Employee's Credit Union (SECU) in North Carolina, which offers a Salary Advance Loan program. Loans are a maximum of $500 repayable in a lump sum at the end of the month.

The program works much like a line of credit, with repayment and future loans fully automated through funds transfer, voice response, SECU's call center or over the Internet. The program has low-cost origination, maintenance and servicing costs. To qualify, members must have a SECU checking account and not be under bankruptcy.

Costs and profitability are shown in the table.

SECU Profitability Analysis for a $10 Million Portfolio (Annualized)

Revenue at 12% APR	$1,200,000
Actual loan losses (1/4 of 1%)	($25,000)
SECU average cost of funds (4%)	($400,000)
SECU average cost of operations (expense-to-asset ratio) (2%)	($200,000)
Net before taxes	$575,000
	ROA of 5.75%

To help financial institutions make informed decisions about these types of programs, the FDIC issued its Final Affordable Small Dollar Loan Guidelines in July 2007. For more information, visit www.fdic.gov/news/news/financial/2007/fil07050a.html

In January 2008, the FDIC will launch the Affordable and Responsible Consumer Credit program. The program is a two-year study designed to assist bankers by identifying replicable business models for affordable small-dollar loans. For more information, visit www.fdic.gov/news/news/press/2007/pr07088.html.

Resources

Arkansans Against Abusive Payday Lending
www.stoppaydaypredators.org

Check 21 FAQ
www.federalreserve.gov/paymentsystems/truncation

Fannie Mae Foundation, Alternative Financial Service Providers
http://urbaninstitute.org/UploadedPDF/410935_AltFinServProviders.pdf

Journal of Economic Perspectives, Payday Lending, Winter 2007
http://stlouisfed.org/news/assets/pdf/StegmanPaydayLendingJan07.pdf

National Consumer Law Center, Utilities and Payday Lenders: Convenient Payments, Killer Loans, June 2007
www.nclc.org/reports/content/payday_utility.pdf

Law Protects Servicemen

Concerned about how high-cost debt obligations were affecting service men and women, and more specifically their preparedness for battle, the Department of Defense asked Congress to address the issue.

Congress responded with the Limitations on Terms of Consumer Credit Extended to Service Members and Dependents Act. This new federal law protects active-duty service members, their spouses and dependents from predatory lending. The law took effect Oct. 1, 2007, and targets payday lenders, auto title pawn lenders and providers of income tax refund anticipation loans.

Among other things, the law:

- limits the APR lenders can charge to the military to no more than 36 percent;
- prohibits rollovers with the proceeds of other credit extended to the borrower by the same creditor;
- prohibits lenders from requiring borrowers to use a check or other method of access to a deposit, savings or other financial account of the borrower as security; and
- prohibits lenders from requiring borrowers to waive their right to legal recourse.