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**Low-Cost Payday Loans:
Opportunities and
Obstacles**

The Annie E. Casey Foundation

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Low-Cost Payday Loans: Opportunities and Obstacles

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A Report by the Isenberg School of Management
University of Massachusetts at Amherst
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EXECUTIVE SUMMARY

Background: On October 26, 2004, the University of Massachusetts Isenberg School of Management received a grant from the Annie E. Casey Foundation to conduct research on market and regulatory efforts to

lower the cost of small dollar, short-term credit for low- and middle-income (LMI) workers and their families. Specifically, under the grant, we were to examine whether competition from banks and credit unions had the potential of lowering the cost of payday loans. Payday loans are small, short-term loans that are secured by the borrower's personal check postdated until the borrower's next payday. The cost typically ranges from \$15 to \$22 per \$100 for a two-week loan, which works out to an annualized percentage rate of 391 percent to 572 percent. Payday lending has grown explosively in recent years. In 2004, there were 22,000 payday loan stores extending about \$40 billion in loans.

Over the next six months, we conducted numerous interviews with regulatory staff, consumer advocates, industry officials, academics, and others regarding payday loans and alternatives offered by banks and credit unions (depository institutions). Through that process, we identified two major payday lenders for in-depth case study, as well as several depository institutions offering payday loan alternatives. Based on our interviews and case studies, we have made the following findings:

Case studies indicate that depository institutions have the tools and infrastructure that they could deploy to offer their customers alternatives to payday loans at significantly lower cost. Since 2001, the North Carolina State Employees' Credit Union (NCSECU) has been offering a highly successful and profitable payday loan alternative: a checking account linked revolving line of credit offered at an APR of 12 percent, or 50 cents for a \$100, two-week loan. Depository institutions are able to offer lower-cost alternatives because:

- Their operational costs are minimized given their preexisting infrastructure. They already have the physical facilities, loan staff, collection processes, etc., in place.
- They are in a better position to minimize credit losses through the use of direct deposit and automatic deductions for repayment, tools generally unavailable to payday lenders.
- They have the advantage of offering and deriving revenue from a variety of products and services, allowing them to profitably offer small dollar credit at lower margins.

- Payday loan alternatives offered by banks and credit unions in the form of revolving lines of credit are superior to payday loans in terms of customer convenience, speed and privacy.

Though depository institutions have the means to offer low-cost payday loan alternatives, the proliferation of fee-based bounce protection programs represents a significant impediment to competition. Some depository institutions are already offering high-cost payday loan alternatives in the form of fee-based bounce protection. Under these programs, banks and credit unions offer to cover customers' overdrafts for fees ranging from \$17 to \$35 per overdraft. Though they are not identified and marketed as payday loan alternatives, fee-based bounce protection programs are functionally equivalent to payday loans when used by customers as a form of credit. When used on a recurring basis for small amounts, the annualized percentage rate for fee-based bounce protection far exceeds the APRs associated with payday loans. Banks and credit unions benefiting from overdraft fee income may not want to cannibalize this income by offering their customers lower-cost, small dollar credit options.

To promote competition and help consumers identify the lowest-cost credit product, the report recommends that the Federal Reserve Board impose homogenous disclosure requirements on all functionally equivalent forms of small dollar credit. Specifically, the report recommends imposition of the same APR disclosure requirements on fee-based bounce protection programs that are applicable to payday loans and lower-cost alternatives such as checking account linked lines of credit (LOCs).

Perceptions of regulatory hostility also discourage banks and credit unions from offering low-cost payday loan alternatives. Many depository institutions view regulators as hostile to payday loan alternatives, though our research shows this is a misperception. In fact, our interviews with all five federal banking and credit union regulators revealed widespread consensus that low-cost, properly structured payday loan alternatives would be positive from a consumer standpoint and likely warrant credit under the Community Reinvestment Act (CRA). Though regulatory staff saw public policy benefits in the development of payday loan alternatives, significant outstanding issues remain regarding credit criteria, capital requirements, repayment structures, and safeguards against excessive recurrent use of such products. As a consequence, our report recommends the formation of a task force of senior bank regulators to provide guidance on these issues to depository

institutions interested in offering payday loan alternatives. We also recommend that regulators become more proactive in publicly encouraging payday loan alternatives.

The report describes several payday loan alternative models for institutions interested in offering them. Case studies contained in the report include revolving and fixed loan options, with varied repayment terms, loan limits and support services. A unique feature of the NCSECU program is a requirement that users save 5 percent of any money borrowed. This mandatory savings component—after being in effect for 18 months—has generated savings in excess of \$6 million. NCSECU officials hope the program will help their members accumulate sufficient savings to end their reliance on short-term credit. The mandatory savings feature is extremely popular with NCSECU members, many of whom have never had savings.

Another model identified in the report is the Citibank Checking Plus program. This is also a revolving line of credit linked to a customer’s checking account, offered at a 17 percent APR. Citibank offers this as a low-cost alternative to fee-based bounce protection. However, we believe the product could also be used by LMI families to meet short-term emergency cash needs. Citibank has started making a \$500 line of credit under the program widely available to checking account customers in good standing for six months. This effort could be easily replicated by other institutions to provide additional small dollar credit options to the LMI community.

We conclude that depository institutions are able to profitably offer payday loan alternatives. Whether they have the will to do remains to be seen. Regulators and other government officials will need to publicly encourage payday loan alternatives for such products to be offered more broadly by banks and credit unions.

INTRODUCTION

On October 26, 2004, the University of Massachusetts Isenberg School of Management received a grant from the Annie E. Casey Foundation to support research on market and regulatory efforts to lower the cost of small dollar, short-term credit for low-income workers and their families. Specifically, under the terms of the grant proposal, the research was to:

- Identify payday loan alternatives;
- Develop case studies and list practices to meet short-term credit needs;
- Identify obstacles to competition; and
- Identify potential regulatory options to lower the cost of short-term credit.

Our research included numerous, extensive interviews with regulatory officials; consumer advocates; officials from the banking, credit union, and payday loan industries; academic experts; and others regarding the potential for competition from depository institutions to lower the costs of small dollar, short-term credit for the low- and moderate-income (LMI) population. Through that process, we identified a major multiline and monoline payday lender¹ for in-depth case study, as well as several depository institutions offering payday loan alternatives.

In addition, we examined Citibank's Checking Plus program, which is an overdraft line of credit for checking account customers, because we believe it is typical of overdraft lines of credit (LOC) offered by most banks and credit unions and could be potentially adapted to LMI families' small dollar credit needs. Indeed, Citibank has started to experiment with making Checking Plus more widely available based on flexible credit criteria, an effort that we believe should be encouraged and replicated by other major banks.

The following report is the result of our six-month research effort.

I. Overview of the Payday Loan Market

Payday loans are short-term loans, generally for less than \$500. They are typically secured by a check provided to the lender, postdated to the borrower's next payday.² The application process is highly streamlined, and credit criteria minimal—a key attraction of the product is the immediacy with which the borrower can access needed cash. The cost

of a payday loan typically ranges from \$15 to \$22 for a two-week, \$100 loan. When expressed as an annual percentage rate (APR), these costs range from 391 percent to 572 percent.

If the loan is approved, the customer receives the advance at the time the application is made. In exchange for the advance, the customer writes a check for the amount of the advance, plus the charge.³ For example, where the customer borrows \$300 and the charge is \$15 per \$100, the customer would write out a check for \$345. The payday lender agrees to defer deposit of the check until its due date on the customer's next payday. Customers will make an appointment to return to the payday advance store on that date and will typically repay the loan in cash, retrieving their personal check, or they will take out another loan in a "back-to-back" or "rollover" transaction.⁴ If the customer does not return, the payday lender may attempt additional collection efforts or deposit the check. If the check is deposited and returned, the payday lender will assess a returned check charge, in addition to the interest charge and in some states, where permitted, a late fee.

Payday lenders were virtually unheard of 15 years ago. One research firm estimates that today, there are more than 22,000 store locations extending about \$40 billion in short-term loans.⁵ A total of 37 states have enacted laws permitting this type of credit, albeit under a widely varying range of restrictions. The largest monoline payday lender, Advance America, went "mainstream" this year with an IPO and listing on the venerable New York Stock Exchange. For the end of 2004, Advance America reported annual revenues of \$570.2 million, representing an increase of 16.5 percent over 2003 revenues of \$489.5 million. A total of five payday lenders are publicly traded.

Why the explosive growth in payday lending? Ironically, payday industry officials point to banks themselves. They assert that payday loans look relatively cheap to their cash-strapped customers compared to high NSF fees, which accompany bounced checks, retail service charges for returned checks, and/or late fees associated with missed rent or utility payments. A payday loan can help customers avoid these costs, as well as avoid damage to their credit scores from NSF transactions. They contrast the \$40 billion in payday loans last year with studies showing \$22 billion collected from consumers in NSF fees in 2003, and another \$57 billion in late fees.⁶

Whether viewed as filling legitimate credit needs, or as predatory exploitation of desperate individuals, there is no doubt that payday loans are growing and seem to be popular with customers. Who constitutes this growing band of payday loan users? First, and most obviously, they are bank or credit union customers. Indeed, a checking account is one of the few prerequisites for a payday loan. Industry survey data also suggest that they are middle- and lower-middle-income workers, with 52 percent of households making between \$25,000 and \$50,000. Only 19 percent have household incomes in excess of \$50,000 per year with the remaining 29 percent making less than \$25,000 per year.⁷ Over half have some college education. Forty-one percent own their own homes, compared to a 60 percent national average. Industry data, as well as consumer studies indicate that African Americans are an important part of payday lenders' customer base, as are military families.⁸ Indeed, payday industry leaders have made a concerted effort to reach out to the African-American community through, for instance, financial education initiatives, and partnerships with traditionally black colleges.

Payday industry research and consumer studies also agree that the product is subject to heavy recurrent use. An independent working paper recently released by the FDIC's Center for Financial Research⁹ indicates that more than half of all payday loan customers use the product more than six times a year, and that at "mature stores" 37 percent of all customers use the product more than 12 times a year.¹⁰ According to a survey conducted by the Iowa Banking Department, in 2004, payday loan customers in that state averaged 12 loans a year.¹¹ A recent study by the Center for Responsible Lending finds that 91 percent of all payday loans are made to borrowers with five or more payday loans per year, and that borrowers, on average, receive 8 to 13 payday loans per year. The two companies participating in our research indicate their average payday customer uses the product seven times a year¹² and about half use it more than six times a year.¹³

II. Why Won't Banks Compete?

In recent years, a concerted effort has been made by federal policymakers and regulators to encourage depository institutions to more aggressively compete with alternative service providers in providing financial services to the LMI population. The 1990s saw widespread bank branch closings in economically distressed neighborhoods, with a corresponding rise in payday loan and check cashing outlets. As the century turned, however, banks began to see it as in their business interests to reach out to underserved communities. Federal

officials also began to push banks to do more to compete with so called “fringe providers.” Much of the focus was on banking the “unbanked.” Under the Debt Collection Improvement Act of 1996, the Treasury Department launched its Electronic Funds Transfer (EFT) initiative to increase direct deposit of federal checks through low-cost electronic bank accounts for those beneficiaries using higher-cost check cashing outlets. In 2001, the Bush administration awarded \$8.35 million to fund “First Accounts”—pilot programs designed bring “unbanked” low-income families into banks and credit unions. Though EFT and First Accounts have met with mixed success, the policy thrust has been supported by the industry.

Perhaps the most successful example of bank/credit union competition providing price pressure in the delivery of financial services to the LMI population is the Latin American remittance market. On March 22, 2002, the Partnership for Prosperity, a public/private coalition led by the U.S. Treasury and State Departments to foster economic growth in Mexico, recommended that the government work “to lower the cost to Mexicans working in the United States of sending money home by, in part, encouraging more banks to market aggressively the opening of accounts to Mexican workers and offer remittance features in their accounts.”¹⁴ This report affirmed and accelerated interest among depository institutions to enter the lucrative US–Mexico remittance market, a market which surpassed \$13 billion at the end of 2003.¹⁵ Traditionally dominated by large money transfer organizations (MTOs) such as Western Union and Moneygram, the US–Mexico remittance market saw the emergence of depository institutions as competitors in the late 1990s. Though depository institutions’ market share remains disappointingly low, their entry into the market has coincided with a pronounced decline in remittance costs. Over the past five years, average remittance transaction costs have been reduced by 50 percent.¹⁶

Banks and credit unions were initially inhibited from entering this market out of concern over reputational risk associated with international money transfers and perceived regulatory hostility. However, with the dramatic growth of the Latino population, depository institutions became convinced that remittances were an essential product and marketing tool in tapping this burgeoning customer base. Government officials came to recognize the pro-law enforcement benefits in bringing more international money transfer business into highly regulated bank venues and the important benefits to the economies of developing Latino countries from increased remittance dollars. Finally, government and community advocacy groups saw bank competition as a means of lowering financial services costs to

low-income Latino immigrant families and of helping them establish banking relationships to help move them into the economic mainstream.

Such a “perfect storm” of interests has yet to coalesce in support of bank/credit union entry into the payday loan market. Unlike “unbanked” and remittance initiatives which they have supported, most commercial banks seem indifferent, if not skeptical, of the payday loan market. First, and foremost, they are not convinced that a business case can be made for this product line, though a small, but growing number of credit unions are trying to develop economically viable models. For the most part, however, depository institutions seem to perceive payday loans as not only unprofitable, but also fraught with reputational risk and regulatory animosity. Concerns regarding reputational risk are closely associated with skepticism over profitability: most bank officials we interviewed perceived the product as too high risk to offer profitably except at extremely high interest rates, thus inviting criticism from media, public policy officials, and consumer advocates.

Perceptions of regulatory animosity also stem from the position taken by most federal bank regulators against partnerships between federally regulated banks and payday lenders. This perception appears to be misguided. Indeed, the bank regulators interviewed for this report unanimously agreed that banks and credit unions should be encouraged to develop *low-cost* small dollar credit products *of their own and that this would be positive* from a public policy standpoint and likely warrant credit under the Community Reinvestment Act (CRA).¹⁷ Though this informal view was held by all regulatory officials we contacted, there is no formal uniform guidance on how banks and credit unions might successfully accomplish this. Formation of a task force to develop such guidance is a key recommendation made later in this report.

III. Bounce Protection as an Impediment to Competition

Ironically, payday lenders assert that banks are already offering a competitive product that is higher cost than the traditional payday loan. Specifically, they argue that fee-based bounce protection programs fill the same, small-dollar, short-term credit needs as payday loans, but at a much higher effective interest rate.

Under these programs, banks and credit unions will offer to cover checks that overdraw their customers’ checking accounts up to a certain limit in exchange for a fee that typically ranges from \$17 to \$35 per check. Defenders of these programs argue that they are a

service to bank customers, not a form of credit, designed to cover inadvertent overdrafts and that it is misleading to characterize their costs as an APR.¹⁸ Whatever the intent of these programs, available data indicate that many bank customers are overusing the “service” generating substantial income for some depository institutions. In addition, a minority of institutions allow overdrafts at ATMs or in using an online debit card transaction at point of sale (POS), belying the notion that the service is provided only for checking account mistakes.

One study indicates that as of the end of 2003, approximately 66 percent of depository institutions offered fee-based overdraft protection, with the majority charging between \$20 and \$25 per overdraft.¹⁹ Other research indicates that approximately 2,500 institutions actively market such programs to customers.²⁰ The 2004 Federal Reserve Payments Study showed that returned checks dropped from 240 million in 2000 to 189 million in 2003.²¹ Some analysts suspect that the reason for the drop is the growing ubiquity of overdraft protection.²² Data regarding the use of the product at individual institutions are lacking, but the experience of one California based credit union suggests that it is subject to extreme misuse. After offering its fee-based product, “Privilege Pay” for 90 days, the USA Federal Credit Union in San Diego California conducted an analysis of customer usage. Their findings: a fourth of the product’s users were under the age of 25; 57 percent of the overdrafts were for \$100 or less; a third were incurring the \$22 per overdraft fee more than five times a *month*. “Instead of Privilege Pay being used as we had intended, a number of our members chose to utilize the product more as a no-qualifying line of credit,” according to Mary Cunningham, President and CEO. The credit union has been reworking the program by reducing the fee, limiting its use, providing free financial counseling, and tightening qualification criteria.²³

Marketing materials distributed by one vendor who sells fee-based bounce protection programs to banks state that the “heaviest users of the Privilege will tend to be hard working wage earners with inadequate savings to meet unexpected expenses” and that “[c]redit unions and banks that offer the Overdraft Privilege have discovered that checking account holders will continue to use their privilege again and again, despite the fees. They will truly appreciate the convenience the Overdraft Privilege provides and view the NSF fees as a natural—and reasonable—consequence of overdrawing their account.”²⁴ A study by a small Kentucky bank also found surprisingly high fees among its most frequent users—one customer was using the service 22 times a month at \$25 per overdraft. Bank personnel

emphasized that many of the most avid users were higher-paid professionals.²⁵ An academic survey of consumers' use found no correlation between income and frequency of overdrafts, with the proportion of frequent users among those making less than \$1,500 a month virtually the same as the proportion of those making over \$4,000 a month. The study did find a high correlation between age and overdraft protection usage, with accountholders between the ages of 18 and 35 representing, by far, the heaviest users of the service.²⁶

A recent Bernstein Research Call Report analyzed the top 25 banks with assets over \$2 billion which derive the most income from NSF fees and found that such fees accounted for 11 percent to 41 percent of those institutions gross pretax income in 2004.²⁷ Other research indicates that for all banks, NSF revenue represents about 18 percent of net operating income.²⁸ The Bernstein report also found that “[c]onsumers have already started to understand that payday lending can represent a cost-effective alternative to bounce protection,” a factor responsible for a leveling off of deposit service charges in 2004, despite a 7 percent growth in deposits. The report further found that “[i]mproved disclosure of the costs of bounce protection, and the ability to opt-out is likely to increase price-elasticity so that banks must either face share-loss to payday lenders or reduce costs of bounce protection . . .” In other words, for many customers' small dollar credit needs, payday loans may be less expensive than fee-based bounce protection.

Whether this is so will depend on how the customer uses the product. An \$18 charge for a \$100, two-week payday loan will amount to an annual percentage rate (APR) of 468 percent. A \$22 charge on a two-week overdraft will amount to an APR of 572 percent. However, if the customer needs \$300, the payday loan charge will rise to \$54, while the charge on the overdraft will stay at \$22, lowering the APR on the latter to 190 percent. The APR for the bounce protection fee will depend on the size of the overdraft, the amount of the fee, and the length of the grace period. A fee of \$30 on a \$20 overdraft repaid in one week would result in an APR of 7,812 percent. Customers using fee-based overdraft protection multiple times a month in increments of less than \$100 are paying astronomical APRs.²⁹

All federal regulators have moved to provide best practice guidance for bounce protection programs, including advising against permitting access to overdraft funds through ATMs.³⁰ In addition, the Federal Reserve Board (FRB) recently finalized rules under Regulation DD, implementing the Truth in Savings Act (TISA), strengthening disclosure requirements applicable to overdraft protection programs and extending prohibitions on false advertising.³¹

Because overdraft protection is a long-established customer service historically provided to accommodate customers on an ad-hoc basis, it has always been exempted from coverage under Regulation Z, implementing the Truth in Lending Act (TILA). In both its proposed and final rules under TISA, the FRB cautioned that it “is not proposing at this time to cover these services under TILA and Regulation Z, although further consideration of the need for such coverage may be appropriate if concerns about these overdraft programs persist in the future.”³²

The fact that bounce protection plans are not currently subject to TILA may obfuscate their true cost for consumers and inhibit the ability of consumers to shop and compare. Payday loans are subject to TILA disclosures and site visits of the two vendors we examined revealed prominent display of the APR on their product. Ironically, much less expensive forms of small dollar credit also offered by banks—e.g., revolving lines of credit, credit card linked accounts, or small, fixed-term loans—are required to disclose their cost as an APR. The lack of homogeneity in required disclosures impedes the ability of consumers to understand that these other forms of credit may be lower cost.³³

To the extent so many depository institutions are relying on bounce protection for significant fee income, they may view it as against their own interests to cannibalize profits through development of other, lower-cost forms of small dollar credit.

IV. Federal Bank Regulatory Treatment of Payday Lending

Federally insured depository institutions are overseen by five separate regulatory agencies. Nationally chartered banks, and thrifts are regulated, respectively, by the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS). State-chartered banks, which are members of the Federal Reserve System, are regulated by the Federal Reserve Board. State-chartered non-member banks are regulated by the Federal Deposit Insurance Corporation (FDIC). Finally, federally insured credit unions are subject to the jurisdiction of the National Credit Union Administration (NCUA).

Perceptions regarding regulatory hostility toward payday lending derive in large part from the intolerance that most bank regulators have demonstrated toward partnerships between depository institutions and payday lenders. To understand the reasons for this perception, some background on the regulatory treatment of such partnerships is helpful.

A. The Majority Approach to Third-Party Payday Loan Vendor Agreements

In November 2000, the OCC and OTS issued advisories to the CEOs of their regulated institutions “to highlight and discourage any abusive practices associated with payday lending.”³⁴ These advisories promised “close review” of payday lending activities “through direct examination of the bank, examination of any third party participating in the transaction under an arrangement described above, and, where applicable, review of any licensing proposals . . .” The advisories provided detailed guidelines regarding capital, credit concentrations, monitoring, reporting, consumer disclosures, rollovers, waiting periods, etc., specific to payday loans. Issuance of these advisories was followed by a number of aggressive enforcement actions brought by the OCC against nationally chartered banks affiliating with payday loan vendors.³⁵ Numerous safety and soundness violations were cited in these enforcement actions, as well as findings that the affiliations in question were “rent-a-charter” arrangements designed to allow the payday lender to evade state consumer protection laws.³⁶ In announcing one such enforcement action, the OCC stated that the bank “had effectively turned over the management of the bank’s main business to a third party, and then virtually ignored how that business was being conducted . . . The bank essentially rented out its national bank charter to a payday lender to facilitate that nonbank entity’s evasion of the requirements of state law that would otherwise be applicable to it.”³⁷

The Federal Reserve Board has not issued specific payday lending guidance for state-chartered member banks. In January 2, 2001, letter to Congressman Melvin L. Watt, FRB Chairman Alan Greenspan indicated that such guidance was not necessary “[g]iven the very limited number of instances of payday lending that we have seen in the institutions we supervise about this type of lending.” Chairman Greenspan also promised that “[s]ince state member banks could become more involved in payday lending and since activities such as ‘charter renting’ have potential to circumvent state law, the Board will continue to monitor these activities closely.”³⁸ A few years later, a state-chartered member bank, First Bank of Delaware stated in a SEC filing that it was ending its affiliation with a payday lender because of “materially increased regulatory requirements.”³⁹ In a subsequent SEC filing, the bank indicated that instead of giving up its payday loan affiliation, it would give up its membership in the Federal Reserve System and switch to the FDIC as its primary regulator.⁴⁰

There are currently no institutions regulated by the OCC, OTS, NCUA, or FRB that affiliate with payday lenders.⁴¹

B. The FDIC Approach to Third-Party Payday Loan Vendor Agreements

In July 2003, the FDIC issued its own guidelines for payday lending that permitted certain state-chartered banks to maintain affiliations with payday lenders but set forth a number of regulatory requirements.⁴² Among other things, these guidelines required that payday loans “need significantly higher levels of capital, perhaps as high as 100 percent of the loans outstanding” and that payday loan portfolios should be classified as substandard for regulatory reporting, risk management, and loan loss reserving purposes. The guidelines also instructed institutions to limit the number and frequency of extensions, deferrals, renewals, and rewrites; prohibit financing of unpaid interest and fees, and simultaneous loans; and ensure comprehensive risk management, reporting, and internal controls.

Consumer groups criticized these guidelines as insufficient, arguing in particular that dollar for dollar capital requirements were ineffectual since banks sell most of their payday loans back to their payday loan vendor partners. They also charged that consumer protections in the guidance did not significantly add to the federal consumer protection laws such as TILA that are already applicable to payday loans. In March 2005, the FDIC revised its guidance to prohibit banks from making payday loans to customers who had payday loans outstanding from any lender for more than three months in the previous 12 months. Because payday loans are typically of two-week duration, the practical effect of the revised guidance is to prohibit FDIC-regulated banks from making more than six payday loans a year. This change has been characterized as “positive” by consumer advocates, though they continue to call on the FDIC to ban all “rent-a-charter” arrangements.⁴³

The FDIC disputes that it permits “rent-a-charter.” Rather its position is as follows:

Federal law authorizes federal and state-chartered insured depository institutions making loans to out of state borrowers to “export” favorable interest rates in accordance with the laws of the state where the bank is located. That is, a bank is allowed to charge interest on loans to out of state borrowers at rates authorized by the state where the bank is located, regardless of the usury limitations imposed by the state laws of the borrower’s residence.

The FDIC Guidelines for Payday Lending address appropriate actions for managing risks associated with third parties who offer payday loans. The Guidelines make clear that the use of third parties in no way diminishes the responsibility of a bank's board of directors and management to ensure its payday lending program is conducted in a safe and sound manner and in compliance with applicable laws. FDIC-supervised banks have been informed that they will be held accountable for the activities of their payday lender partners, and the FDIC has taken actions against banks based on the activities of their payday lender partners. Banks cannot simply "rent" their charter and leave management of the program to a third party. Such an approach would prompt the FDIC to pursue appropriate corrective action, which may include instructing the bank to discontinue payday lending.⁴⁴

C. Regulatory Attitudes Toward Depository Institutions Offering Their Own Payday Loan Alternatives

Though federal regulators differ in their approach to payday lender partnerships, our interviews with them suggest that they agree, at least informally, on allowing the institutions they regulate to offer low-cost payday loan alternatives on their own. During our interviews, OCC and OTS staff acknowledged that because their 2000 advisories did not differentiate between products offered through a vendor versus those offered from within the institution, there was a perception that they wanted to discourage all payday loan activity. All examination staff we spoke to indicated that a properly structured payday loan alternative program would not only be permissible under current guidelines, but would probably warrant credit under the Community Reinvestment Act.⁴⁵

Though regulators recognize the potential benefits of banks and credit unions offering competitive payday loan products, there are a number of outstanding issues that need to be addressed. Given the potentially high credit risk of payday loans, capital requirements are an obvious concern. The starting point would be 8 percent, as for any other type credit that is repaid in less than one year. Whether examiners might require higher capital requirements would depend on the loss experience of the program. Several examiners suggested that banks interested in entering this market should conduct a pilot program to establish a loss history. Several also indicated that capital reserves would be less of a concern if the size of the payday loan portfolio was a small percentage of all loan activity.

Given the small dollar amount of these loans, they indicated that large banks could probably offer the product without raising significant capital concerns. They also indicated that high loss rates would not pose capital adequacy concerns, as long as the product was profitable and subject to sound risk management.

Consumer issues and reputational risk were also a focus of examination staff. All recognized that for the product to be a successful competitive model, it would need to be offered to those with credit impairments and thus likely warrant a higher interest rate to compensate for enhanced credit risk. (As is discussed later, concerns about high loss rates for payday loans may be exaggerated.) All stated that the bank would need to develop written policies to guard against abuse and specifically, to address the problem of recurrent use. It was also noted that such loans would have to comply with safety and soundness requirements that credit must be based on the borrower's ability to repay and that this might be more of a problem where loan repayment was required in full on the customer's next payday instead of in a series of installments.

Finally, a number of examiners noted that the new Basel II capital standards, as well as those being developed under Basel I "lite"⁴⁶ might help institutions interested in developing payday loan alternatives. Depending on how they were structured, payday loan alternatives could qualify as qualified revolving lines of credit (QRE) and thus receive more favorable treatment than other forms of non-mortgage consumer lending. On the other hand, if such payday loan alternatives were considered subprime, the Interagency *Guidance for Subprime Lending Programs*⁴⁷ could apply, which would result in significantly higher levels of capital.

CASE STUDIES⁴⁸ For purposes of our research, we identified ten institutions for case studies. These institutions were selected for variety in terms of their business model, product structure, customer base, and geographic location.⁴⁹ These include two payday loan vendors, seven depository institutions offering payday loan alternatives, and one major bank offering a low-cost overdraft protection product. Lengthy questionnaires were sent to each of these institutions, which delved into such areas as the structure and cost of their products, the application process, qualification criteria, advertising, customer use, and profitability. We also sought respondents' views on the role of competition in lowering the costs of small dollar credit. Below is an overview of their responses. More detailed case study descriptions are included in Appendix A.

I. The Payday Loan Model

Two payday loan providers agreed to participate in our project. One, Valued Services Acquisition Company (VSAC), is a subsidiary of a multiline provider, CompuCredit, which is a publicly traded, broad-based financial services company focused on short-term credit products. The other, Advance America, is the nation's largest monoline payday loan vendor as measured by the number of advance centers operated.

Valued Services Acquisition Company

The Valued Services Acquisition Company (VSAC) operates 520 stores in 14 states. It uses two different business models depending on whether the state allows or restricts payday loans. In four states where loans are restricted, West Virginia, Florida, North Carolina, and Arkansas, the company uses the bank agency business model and operates as a loan servicer for Community State Bank chartered in South Dakota. In those states, the bank sets the fees, terms, and rates in accordance with South Dakota law and FDIC regulations and charges \$18 per \$100 loaned. In the remaining ten states, it uses its standard business model, and the cost will vary according to state law, ranging from \$15 to \$22 per \$100 advanced. Generally, the loans are made until the next payday, with a minimum repayment period of seven days and a maximum of 32 days.

To apply for a loan, the applicant need only submit a recent bank statement, a contact telephone number, two forms of identification, and proof of income. At a minimum, the

applicant must document a steady source of income, valid identification, a verifiable address, and an open checking account. Important additional qualification criteria include an applicant's work history, references, and whether he/she uses direct deposit. The latter, though important, is not required. In bank agency model states, the bank's underwriting criteria also include length of employment, income level, bank statement balance, number of recent NSF checks, and length of time in current residence. The company has not historically used FICO scores⁵⁰ in qualifying applicants; however, effective April 2005, the company is phasing in a scoring tool that accesses multiple databases, including TeleTrack,⁵¹ CP Bureau, Lyons systems, eFunds, and credit bureau scores. In bank model states, approximately 25 percent of loan applications are denied. In other states, the denial rate is 20 percent.

Applications are accepted in company stores, most of which are located in strip malls. The stores are open from 10 a.m. to 6 p.m., Monday through Friday, and 9 a.m. to 1 p.m. on Saturday. A small but growing number of loans are made over the Internet through the bank agency model. Fraud is a major problem in doing business over the Internet and the company finds that it is safer for applications from customers with whom they have already done business than for new customers.

Loan limits are governed by state law. In most states, the maximum loan amount is \$500. The average payday loan issued to VSAC customers is \$316, which VSAC estimates represents 29 percent of the average customer's take-home pay. The average repayment period is two weeks, while approximately 20 percent of loans are monthly. The average customer uses the product seven times a year. On average, customers use the product three consecutive times, though 40 percent use the product once without another consecutive transaction. Rollovers and consecutive use are limited by many states, as they are in the FDIC's examination guidance. Effective June 2005, VSAC and its bank will begin offering an installment loan product for customers who are ineligible for a payday loan because of these limits.

The 60-day delinquency rate is 2 percent. In bank agency model states, a loan is charged off when it has been outstanding for 60 consecutive days, or earlier as circumstances dictate. In other states, it is charged off after 90 days. For 2004, charge-offs represented 13 percent of fee and interest revenue and 1.7 percent of total loans originated.

Regarding factors that drive profitability, VSAC did not provide cost data in bank model states. In states where VSAC operates under enabling statutes, relative costs break out as follows: rent 16.25 percent; advertising 8.75 percent; payroll 32.5 percent; store G&A 11.25 percent; corporate G&A 15 percent; and bad debt 16.25 percent.

Advance America

As of December 31, 2004, the company operated 2,408 payday cash advance centers in 34 states. As with VSAC, the company uses two different business models depending on whether payday lending is restricted under state law. In 540 of these centers, Advance America acts as servicing agent for several FDIC-regulated banks in five states that restrict payday lending: Pennsylvania, Michigan, North Carolina, Texas, and Arkansas.

The permitted size of payday cash advances offered by Advance America varies by state and ranges from \$50 to \$1,000. The company further limits payday advances to a percentage of monthly income, which range from 15 percent to 35 percent of net pay. The permitted fees and/or interest also vary by state and range from \$10 to \$44 on a \$100 advance. Consistent with the typical payday loan model, customers will make an appointment to repay their loan on the date of their next payday. If the customer does not repay the loan at or before his scheduled appointment, the company may attempt to deposit the check. If it is returned, there may be a returned check fee that, depending on the state, ranges up to \$30. In the three states that allow late fees, such fees might also apply, up to a maximum of \$10 or 5 percent of the unpaid balance.

Customers must apply for the loan in person. Advance America centers are located in high traffic, suburban retail areas. Center hours vary, but most are open Monday to Friday, 10 a.m. to 6 p.m., and 10 a.m. to 3 p.m. on Saturday. To apply for a loan, the customer fills out a short application, and provides proof of identification, evidence of income, and a current bank statement. If the customer qualifies, he/she is immediately given the loan. In standard business model states, Advance America determines qualification criteria for the loans it makes. In bank agency model states, the bank determines qualifications for loans. Advance America does not undertake an evaluation of creditworthiness, other than requiring proof of identification, a bank account, and regular source of income. It uses Teletrack to validate a customer's Social Security number and charge-off information, if any.⁵² The company does not track denial rates. It states that the most common reasons for loan

denials are an invalid Social Security number, a current bankruptcy, the customer already has an outstanding payday loan, incomplete documentation, charge-offs, or insufficient income.

In the standard business model, a payday cash advance is charged off if a customer does not pay at least 15 percent of his/her outstanding balance within 60 days. In the bank agency model, an advance is generally charged off once it has been outstanding for 60 days. As of December 31, 2004, 1.9 percent of loan balances had been outstanding for 60 days or more. For all of 2004, charge-offs net of recoveries were 14.2 percent of fees and interest revenue and 1.62 percent of total loans originated. The company feels that the major factors driving profitability are its ability to draw new customers, to control operating costs, and to price the product attractively as compared to NSF fees, other overdraft charges, and late or delinquent fees. In terms of attracting new customers, it feels the most important factors are customer service, the speed of the transaction, price, and convenience.

II. Payday Loan Alternative Models

Several banks and credit unions agreed to participate in our study, though only a few had been offering their payday loan alternative for an extended period of time. The largest and most successful program we identified was that offered by the North Carolina State Employees' Credit Union.

North Carolina State Employees' Credit Union: Salary Advance Loan

Chartered in 1937, the North Carolina State Employees' Credit Union (NCSECU) serves 1.2 million members. In 2001, it began offering its payday loan alternative, the Salary Advance Loan (SALO), after noticing increased use of payday loans by its members. The SALO is a revolving loan, with a maximum outstanding balance of \$500, offered at an APR of 12 percent. Thus, on a \$500, two-week loan, the charge is less than \$2.50. SALOs must be repaid in full on the borrower's next payday through automatic deduction. One of the most innovative features of the product is a forced savings component, which requires that 5 percent of each advance be placed in a special savings account. The account is unrestricted, but if the member withdraws savings, he cannot access a SALO for six months. This feature is designed to provide members with an incentive to let savings accumulate until the funds are sufficient to ease reliance on borrowing.

To qualify for the loan, applicants must have their paycheck direct deposited into their credit union account and must not be in bankruptcy. Applications can be made online, through the call center, or on the NCSECU website.

About 40,000 NCSECU members use the product, and about 70 percent use it once a month. The average SALO is \$367 and the average repayment period is 20 days. (State employees are on a monthly payment cycle.) Since the program's inception, NCSECU has made a total of \$305,405,278 in SALOs, generating \$1,919,097 in interest income, while experiencing \$707,474 in net charge-offs and earning an estimated return of 7.76 percent. In 2004, annualized charge-offs represented .24 percent or .17 percent net of recoveries. Most losses are attributable to customers with FICO scores of 540 or less.

Instituted less than 18 months ago, the mandatory savings component has resulted in over \$6 million in new deposit funds. The mandatory savings feature is popular with NCSECU members, many of whom report that this is the first time in their lives that they have had any significant savings. It has also reduced NCSECU's credit risk by providing increased security for SALO loans.

NCSECU officials acknowledge that profitability is heavily driven through members' recurrent use. They initially sought to impose a mandatory financial education program on chronic users of the SALO, but this requirement proved to be unpopular and was driving many members back to payday lenders. NCSECU officials hope that the mandatory savings component will, over time, reduce members' heavy reliance on SALO. Nonetheless, they believe the low cost of the loans justifies the program as currently structured.

North Side Community Federal Credit Union: Payday Alternative Loan

North Side Community Federal Credit Union (NoSide) is a 30-year-old community development institution based in the north side of Chicago with 4,400 members and assets of \$9 million. It started offering its Payday Alternative Loan (PAL) in 2002. NoSide's PAL is a fixed-term loan with a loan maximum of \$500 offered at an interest rate of 16.5 percent. The loans are repaid in six monthly installments. There is a one-time application fee of \$30.

All applications must be made in person. It is available only to credit union members, though nonmembers can apply for membership and a loan at the same time and receive a loan in as little as 20 minutes. An applicant must present two pay stubs to verify net

pay and have an income of at least \$1,000 per month. NoSide's qualification criteria are among the most flexible of all the institutions we examined. Direct deposit is not required and applicants in bankruptcy can still apply. Credit reports are requested only once a year to minimize adverse impact on an applicant's credit score. A low FICO score will not disqualify a loan applicant, but if the score is less than 580, he/she must attend three financial literacy workshops to qualify. Fifty-three percent of loan recipients have FICO scores between 500 and 599, while 17 percent are below 500 and 14 percent have no score.

Most of the marketing of the product is done through word of mouth. NoSide is exploring partnerships with employers to let employees know about the product. It also advertises in its newsletter, which is mailed to all members with their monthly statement. Though the product is in high demand, to date, it has not proven to be profitable. The 60-day delinquency rate is a high 20 percent. NoSide estimates that the interest received on each loan averages \$25 while transaction costs average \$30 per loan.

ASI Federal Credit Union: Stretch Plan

ASI Federal Credit Union is a 44-year-old, \$200 million asset low-income, community development credit union in an economically distressed area of New Orleans. Its Stretch Plan offers a package of financial services to ASI's low-income members for a flat, \$4 weekly fee. These services include a ten-minute phone card, free travelers checks, a free refund anticipation loan, and 25-cent money orders. Most important, it includes a \$500 line of credit at 12 percent interest, which can increase to \$1,000 after the member has successfully used the program for a period of time.

The line of credit is repaid in two equal installments, beginning with the second payday after the line of credit has been accessed. This repayment schedule is designed to give cash-strapped members some breathing room in repaying the debt. No credit report is required to qualify for the product. The applicant only needs to show that he or she is employed and uses direct deposit. If the member stays with the program and establishes a good repayment history, he/she can graduate to an Asset Builder Loan, with a line of credit up to \$3,000. With the Asset Builder Loan, the \$16 monthly fee goes into an interest bearing savings account so that participants can build savings while participating in the program. Only one participant in ten stays with the Stretch Plan long enough to "graduate" to Asset Builder.

The program has been popular and profitable. In 2004, the credit union made nearly 8,000 Stretch Loans, double the volume of 2002. In 2003, the program generated \$947,000 in fees, and about \$360,000 in charge-offs, generating net profit of about \$80 to \$90 an account, or one-third of ASI's net operating income. In 2004, the program generated \$1,046,000. Current total outstanding balances run about \$500,000 a month, with delinquency rates of .35 percent to .37 percent.

The credit union did not initiate the program to make money and is currently considering ways to curb recurrent use. It is also concerned that many of its members are still using payday lenders, in addition to balances available with the Stretch Loan. The credit union recently received grant funds to help members pay off their payday loans. To qualify, members must agree to intensive financial education classes and commit to a long-term repayment schedule.

"Part of the problem is lack of financial education, but part of the problem is the lack of jobs," says ASI President Audrey Cerise. "It's hard to get people to put something away for a rainy day, when it's always raining."

Pentagon Federal Credit Union: Asset Recovery Kit

The Pentagon Federal Credit Union (PFCU) serves 600,000 members in the United States defense community. Federally chartered in 1935, the credit union has over \$7 billion in assets. At the end of 2004, the PFCU launched its pilot payday loan alternative, the Asset Recovery Kit (ARK), in response to its perception of the rapidly growing use and marketing of payday loans to the military.

The ARK is a short-term, fixed loan with a loan ceiling of \$500 or 80 percent of the applicant's net pay, whichever is lower. Payment in full is due on the member's next payday. The loan does not charge interest, but instead levies a \$6 flat fee. The fee is equivalent to a 31.49 percent APR, assuming a loan amount of \$500 repaid in 14 days.

PFCU uses an abbreviated application, which requires the applicant's name, address, Social Security number, and place of employment. The applicant must also provide a pay stub. PFCU verifies that the member's paycheck is on direct deposit and obtains a credit report to verify that the applicant is not under bankruptcy. The entire process takes around 30 minutes. Applications are not accepted over the Internet or by phone, because the credit union wants "high touch" visibility and accountability with its clients.

Intensive financial counseling is required to qualify for the ARK product. The counseling is provided in a private office in a credit union branch to assure privacy for credit union clients. ARK cannot be used to pay off a payday loan, though PFCU will help such clients develop a workout plan. Rollovers are permitted up to five times in any 12-month period.

As of March 2005, PFCU had issued 87 loans, totaling \$35,039, with an average loan amount of \$403.

Austin Bank of Chicago: Ready Cash Now

Austin Bank of Chicago (ABC) is a \$227 million community bank. In February 2005, it started offering Ready Cash Now, which is a fixed loan that can range from \$300 to \$999.99, with an APR of 11.99 percent. The loan is repaid over a period of 12 months through automatic deductions from the customer's deposit account. Borrowers must have a deposit account and proof of continuous employment for 12 months. The bank obtains a credit score to check the applicant's credit history, but does not use credit scores to qualify an applicant for the loan. Loans are limited by a maximum debt ratio of 55 percent of net monthly income. Direct deposit is encouraged, but not required. ABC has conducted outreach with church leaders and community groups to promote the product as an alternative to payday loans. It is advertised through brochures, posters, and statement stuffers. ABC is hoping that the product will bring in new customers who will transition into other products and services. Because of the recent launch of the product, statistical information is not available.

La Salle Bank, N.A.: Center for Working Families Program Loan (CWFP)

One of the largest banks in the Midwest, LaSalle Bank is also based in Chicago and has \$62.8 billion in assets. It recently formed partnerships with the Local Initiatives Support Corporation's (LISC) Center for Working Families (CWF) and the Center for Economic Progress (CEP) to offer small loans to meet unexpected cash needs of CWF clients. This product is meant to promote long-term individual economic empowerment as opposed to merely an alternative payday loan. As such, the loan can only be taken out to meet certain types of unexpected needs such as a car breaking down or emergency home repairs. A maximum of two loans can be taken out a year and the total amount loaned cannot exceed \$1,000. The APR is 12 percent with a maximum loan term of 12 months.

Qualification requirements are stringent. Applicants must have participated in the CWFPP for three months and must have completed a three-month financial education program. A CEP financial counselor assists the applicant with the application and accompanies him/her to the bank branch. If approved, loans are available the next business day. Applicants must be employed, not in bankruptcy, with a debt to income ratio no higher than 70 percent. The loan loss reserve for the program was provided by LaSalle Bank's community development (CDC) subsidiary.

Windward Credit Union: Personal Signature Loan

Windward Community Federal Credit Union (Windward) was chartered in 1953 to serve the financial needs of the Marine Corps Base Hawaii Personnel. With 9,500 members and \$46 million in assets, it has since expanded its charter to become a community service credit union. It seeks to provide its members with an alternative to payday loans through flexible application of the underwriting standards for its fixed-end Signature Loans. For loan applications of less than \$2,000, its loan officers are authorized to make the loan at the time of application. They obtain a credit report on the customer to help determine ability to repay, but they do not use credit scores in the qualification process. Applicants with a debt/income ratio of more than 55 percent will receive heightened scrutiny. The current interest rate is 10.9 percent but can go up to 12.9 percent for customers with impaired credit. Most of the loans are for \$500 or less. They are installment loans and must be repaid within six months. According to Windward staff, the credit union makes very little money off the loans, but believes the product is justified as a customer service and in helping customers build a credit history that may qualify them for larger loans down the road. Windward staff estimates that customers using the loan do so, on average, four times a year. Usage is cyclical and higher during holiday seasons and tax time.

III. The Overdraft Protection Model

Citibank's Checking Plus overdraft protection product was also included in this study. It is not designed or marketed as a payday loan alternative. However, given the product's low cost and streamlined application procedure, it could be used as a cheaper credit alternative by many payday loan customers. Citibank is experimenting with more flexible credit criteria to make the product more widely available. Checking Plus is similar to checking account linked lines of credit commonly available at most banks on a selective basis. Citibank's

willingness to expand accessibility to more customers will hopefully be replicated by other financial institutions.⁵³

Citibank: Checking Plus

Citibank's Checking Plus is a revolving, unsecured line of credit linked to a customer's checking account that is automatically accessed when a customer overdraws his or her account. The interest rate is a current variable rate of 16.75 percent in New York and 17.00 percent in all other states. There is a \$5 annual membership fee in all states except New York. The credit line can also be accessed at an ATM or by transferring funds online from Checking Plus to another bank account. When using a Citibank ATM, customers must access a separate Checking Plus account to clearly differentiate balances available in the checking account and those available through the line of credit.

Balances are repaid in monthly installments through automatic deductions from customers' checking accounts. Automatic deduction is a condition of maintaining the line of credit. The default repayment schedule is 1/60th of the outstanding balance, with a minimum payment of \$10. Customers can prepay the balances or request a different default repayment schedule.

The product is offered as part of the process of opening a checking account. Credit checks for the account and Checking Plus are run at the same time. Existing customers can also apply by calling the CitiPhone Banking number or applying online. Pre-approved credit lines range from \$500 to \$25,000. To qualify, applicants must demonstrate an ability to repay. Customers must have acceptable credit to qualify for the product, though customers with lower credit scores may qualify for a \$500 line if they have been customers in good standing for six months. Citibank is experimenting with making Checking Plus more widely available to customers with no or limited credit histories.

Checking Plus is the only overdraft protection program now offered by Citibank. Fee-based overdraft protection programs are being phased out at Citi branches. Citibank feels that high NSF and overdraft fees provoke customers to close their accounts. Checking Plus is a lower-cost form of overdraft protection, making it more popular with customers and more acceptable among regulators. It assists in customer retention, avoiding costs associated with customers opening and closing accounts. It is part of Citibank's core offering and when used responsibly, is an effective money management tool for customers.

ANALYSIS **I. Can Depository Institutions Provide a Lower-Cost
Payday Loan Alternative?**

Depository institutions have a number of inherent advantages in providing lower-cost, small dollar credit products.

First, their operational costs are minimized because of their preexisting infrastructure. They already have the physical facilities, loan staff, collection processes, etc., in place. Their customer base is already established, minimizing marketing costs. By definition, all payday loan customers already have checking accounts. “Advertising” can easily be done through preexisting channels for offering new products, for example, through newsletters or inserts in bank statements. Payday lenders, on the other hand, must establish stores, hire staff, and employ mass media to advertise. Data collected in connection with our study, as well as independent research released by the FDIC’s Center for Financial Research, suggest that profitability is predominantly driven by operating costs. The payday loan model relies on extensive personal interaction, geographic convenience, and a significant customer base to be profitable. This translates into high rent, payroll, and advertising costs.

Second, depository institutions may be in a better position to minimize credit losses through the use of direct deposit and automatic deductions for repayment. The most profitable credit union models we identified (NCSECU and ASI) used both, keeping loan losses to slightly more than one-third of revenues. Payday lenders frequently rely on the customer to physically return to the store to repay in cash, while the depository institutions need only automatically deduct the repayment when it is due. Depository institutions can also make priority claim on checking account funds, whereas the payday lender, must “wait in line” where they find it necessary to cash the personal checks they hold as collateral. Some of these advantages will become less important if payday lenders become more reliant on a customer’s consent to electronically access checking account funds for repayment.

Third, at least as compared to monoline payday loan vendors such as Advance America, depository institutions have the advantage of offering—and deriving revenue from—a variety of products and services to their customers. Because they need not rely exclusively on these products for a significant source of revenue, they are in a better position to provide it at lower cost. In addition, payday loan alternatives might serve other important business goals, such as customer retention or, in the case of the North Carolina State

Employees' Credit Union, building deposit funds through the mandatory savings component. The other business functions served by these loans can justify narrower profit margins.

Fourth, payday loan alternatives that take the form of revolving lines of credit (LOC) linked to checking accounts have the added advantages of customer privacy and convenience. Interviews with payday lenders and depository institutions providing payday loan alternatives all emphasized the importance of speed and convenience in providing this form of credit. Once the LOC is established, the customer need only write a check to access it, in contrast to payday loans where personal visits are required each time the customer wishes to use the product. Though the LOC approach has the advantage of customer convenience and privacy, some might argue that it makes use of the product "too easy" thereby fostering chronic repeat use. However, as discussed below, recurrent use is less problematic from a public policy standpoint if the rate charged is comparable to or less than a credit card rate and, particularly, if the product has a mandatory savings component.

II. Does Price Matter?

Our interviews and survey responses indicated mixed views on the price sensitivity of payday loans and alternative products. There appears to be little price competition in the payday loan industry. The vendors we studied charged the maximum allowed in states where the product is permitted. Recent independent research released by the FDIC confirms that this is uniform in the industry.⁵⁴ There is no evidence of price collusion or monopolistic concentrations in the payday loan market. This may suggest that payday loans are efficiently priced as compared to the relatively high operational costs associated with the product. Alternatively, it may suggest that the customers who use the product are sufficiently desperate for cash that the immediacy of the product is more important than the price paid.

Interviews and industry survey data indicate that payday loan customers do make a cost analysis in comparing the price of a payday loan with the alternative costs of bouncing a check and/or incurring late fees. For instance, 73 percent of respondents in the industry's 2004 customer survey⁵⁵ ranked avoiding late charges on bills as a personal benefit of the payday advance; 66 percent ranked avoiding bounced checks as a benefit. Advance America views its ability to price its product attractively as compared to bank NSF charges as key to its future profitability. Price may not be an exclusive, or even dominant, determinant in customers' decisions to use payday loans. However, it is clearly a factor. Less than

half of the respondents to the industry's survey expressed satisfaction with fees charged for the product. This would suggest that if depository institutions can match payday lenders' speed and convenience with a lower-priced product, they should be well positioned to capture significant market share. As discussed below, a more important question may be whether they have the incentive to do so.

III. Best Practices in Offering Payday Loan Alternatives

Our research revealed a variety of different approaches to low-cost payday loan alternatives. Efforts by depository institutions are still in the germination stage and much more experience needs to be obtained before definitive conclusions can be reached. Below are some initial thoughts and recommendations for depository institutions seeking to structure a payday loan alternative.

Interest Rate: Bank and credit union officials interviewed for this report repeatedly raised the issue of reputational risks associated with providing payday loan alternative products. First and foremost was the issue of what kind of interest rate could be charged to make the product sustainable from a business standpoint without incurring public criticism from the media, public officials, and consumer groups.

Perceptions of high credit losses associated with the payday loan product may be exaggerated. The experience of the North Carolina State Employees' Credit Union suggests that small dollar credit can be made widely available to customers, including those with severe credit impairments, at rates lower than or comparable to that applicable to credit cards. The NCSECU enjoys obvious advantages in its tax-exempt status and a membership base that enjoys stable, state government employment. However, a program like SALO could be offered at double, or perhaps even triple, the 12 percent rate offered by NCSECU and still win plaudits from consumer advocates.

"Staying within a credit card rate is a no brainer," says Martin Eakes, who heads Self-Help Credit Union and the Center for Responsible Lending. Rates as high as 36 percent might be justified, adds Eakes, for programs that provide credit to customers with severe credit impairments and also provide support services and strategies to address recurrent use. Jean Ann Fox of the Consumer Federation of America concurs, while cautioning that 36 percent represents the outside limit. She adds that a revolving line of credit should not exceed the cost of a cash advance on a credit card. Both Eakes and Fox laud the mandatory

savings component of the NCSECU program as one way to help break debt cycles. Both note that while a 36 percent APR is high, it is much lower than the APRs typical of payday loans or fee-based bounce protection.

Disclosure of the rate should be in terms of both the APR as well as the dollar cost per \$100. Because payday loan customers are accustomed to receiving both types of disclosures, this will help them understand the comparative cost of the payday loan alternative. Relying exclusively on an APR disclosure might create confusion. For instance, it should be made clear that if the APR for a payday loan alternative is 12 percent, this translates into less than 50 cents for a two-week, \$100 loan (not \$12).

Application Process: To be competitive, depository institutions must use a highly streamlined application process with the loan provided to qualified applicants at the time of application. Most of the successful programs only require valid ID, proof of stable employment, and a checking account. Many also require that the customer use direct deposit and automatic checking account deductions for repayment. If credit checks are conducted, it is for the limited purpose of verifying that the customer is not in bankruptcy and has no outstanding debts with the institution. In addition, credit checks are kept to a minimum (once per year) to avoid multiple inquiries damaging applicants' credit scores. The immediacy of the product and the willingness of the payday loan vendor to extend credit to those with credit impairments are keys to the success of the payday loan industry.

Repayment Schedule: The most successful payday loan alternatives from a business standpoint mirror the repayment schedule applicable to payday loans, i.e., they require repayment in full on the next payday. Payday industry survey data indicate that 77 percent of payday loan customers like this repayment schedule. Interviews with depository institution officials offering payday loan alternatives suggest that many of their customers also like the certainty and finite nature of a near-term, single repayment. These customers have difficulty managing money; thus, a series of monthly payments may be more challenging for them than a single payment. If they are unsuccessful in managing multiple installment payments, they can incur significant late fees.

On the other hand, a single repayment will be larger than individual installments spread out over a period of months. If the customer cannot make the single payment, he/she will be forced to rollover the loan or conduct a back-to-back transaction to avoid default, incurring a new set of finance charges. Indeed, rollovers are common in the payday loan

industry and are the primary cause of consumer groups' complaints that payday loans trap consumers in a cycle of debt. As a consequence, many depository institutions providing payday loan alternatives have opted for installment loans, whereby the customer can repay the loan, usually over a period of 3–6 months. The Citibank Checking Plus product defaults into a 60-month repayment plan, providing maximum flexibility for cash-strapped customers. Citibank also allows its customers to request and obtain a shorter repayment schedule if they like. The Citibank model enables the consumer to tailor payments based on his/her own personal preferences and financial management abilities.

Both the single repayment and the installment approach have advantages and disadvantages for consumers. From the lender's perspective, the installment approach may also involve incrementally higher operational costs and credit losses. This is one area where more experience is needed before firm conclusions can be reached. Regardless of whether a depository institution opts for a single repayment or installments, the required payments should be realistic and there should be limits on the payment amounts as a percentage of the customer's pay.

Recurrent Use: All institutions providing flexible access to small dollar credit products point to some customers' tendencies to use the product excessively. Thus, any effort to offer a payday loan alternative should include policies and procedures for addressing repeat use. Some of the depository institutions we examined placed express limits on the number of loans that could be extended through their payday loan alternative each year. Some also limited the maximum dollar amount per year that could be borrowed. The potential disadvantage to this approach is that it may turn customers back to higher-cost providers once they have reached their limit. Many institutions have also tried mandating financial education for chronic users. However, to effectively deal with those who chronically misuse credit, these financial education programs are intensive and involve a significant time commitment. As a consequence, they are expensive to provide and are also unpopular with many customers who may be unwilling to commit the time and instead turn back to higher-cost providers.

The NCSECU has tried a different approach to help those who chronically rely on credit by mandating that its members save 5 percent of amounts borrowed through its loan program. Unlike other approaches to recurrent use, this strategy is popular with customers and appears to be working quite well, judging by the large amount of deposits NCSECU has already accumulated.

Obviously, a customer's recurrent use of a product that costs 12 percent, or even 16–18 percent per year, is less problematic from a public policy standpoint than recurrent use of a product costing hundreds or thousands of percentage points on an annualized basis. The need for absolute limits on the number of loans that can be made each year should be weighed against the cost of the product and the existence of support services or strategies to help customers build assets and eventually become less reliant on credit.

A related issue concerns whether there should be restrictions on customers' ability to use payday loan alternatives offered by depository institutions if they are also using payday loans. Several individuals we interviewed were concerned that cash-strapped customers would use a depository institutions' payday loan alternative in addition to, not in lieu of, payday loans. Many of the depository institutions participating in our study would not let their products be used to pay off payday loans, though they offered counseling services and a workout plan for those customers with outstanding payday loan balances.

Some customers will certainly use a depository institution's payday loan alternative in addition to payday loans; others will use it as an alternative to those higher-cost products when confronted with short-term cash needs. Denying the product to the latter because it might be abused by the former is not justified. However, institutions can—as part of the application process—ask customers if they have outstanding payday advances. In addition, in a few states, payday loan vendors are required to report loan activity to a centralized database. Regulators in those states could consider allowing depository institutions to check a customer's current and past payday loan activity before determining whether to make the loan.

Financial Education: Providing financial educational brochures or toll-free hotlines for financial counseling are of questionable benefit to those who chronically misuse debt. Intensive programs offered, for instance by the NoSide Credit Union, LaSalle Bank through the CWF, and the ASI Credit Union hold greater promise in having some beneficial impact on customers' misuse of credit. The more intensive programs are too expensive to offer on a wide-scale basis and would likely be rejected by many customers. Intensive financial education targeted at those customers with the most severe credit problems is an important service that depository institutions can provide. For the broader customer base, however, a mandatory savings program along the lines offered by the NCSECU may be the more successful strategy.

**RECOMMENDATIONS FOR
REGULATORY ACTION**

I. Bounce Protection

As previously discussed, the widespread use of fee-based bounce protection and the high revenues being generated by those programs may provide disincentives for some banks and credit unions to provide lower-cost, small dollar credit. Why offer a small dollar line of credit linked to a checking account at an 18 percent APR if a bank can collect many multiples of that by assessing a \$17 to \$35 fee each time a customer overdraws his/her account? Banks and credit unions offering fee-based bounce protection may benefit from the lack of APR disclosure requirements ordinarily applicable to credit extensions under the Truth in Lending Act.

The Federal Reserve Board could encourage competition by requiring APR disclosures among all small dollar credit products, including fee-based bounce protection. This would empower consumers to understand the true costs of small dollar credit alternatives and enhance the ability of institutions offering the lowest-priced alternatives to gain market share.⁵⁶ Ironically, in the short run, APR disclosures of fee-based bounce protection might help payday loan vendors, since for some consumers, their product will be less expensive. But it would also reward depository institutions who are foregoing fee-based bounce protection and providing less expensive LOCs to customers who need help covering occasional cash short-falls.

The APR disclosure applicable to fee-based bounce protection could be conditioned on a customer's repetitive use of the product. For instance, if the consumer overdrew his/her account more than three times in a 12-month period, this would suggest that the consumer is using it as a source of credit, not to cover inadvertent overdrafts. At that point, banks and credit unions could be required to disclose the effective APR the customer has been paying by using the overdraft service, as well as notify the customer of the existence of lower-cost credit options. It is standard for most banks and credit unions to have in place checking accounts linked to a LOC, credit card, and/or savings account. Indeed, the "best practice" guidance recently issued by federal bank and credit union regulators encourages banks and credit unions to disclose the existence of such lower-cost credit options.⁵⁷ The disclosure of lower-cost credit options could be made mandatory for those customers whose checking account activity demonstrates that they are using fee-based overdraft protection as credit.

At this point, the Federal Reserve Board appears content to regulate bounce protection disclosures under Reg DD, implementing the Truth in Savings, while leaving the door open to TILA treatment at some point in the future. Though this paper endorses subjecting recurrent use of fee-based bounce protection to TILA, it must be acknowledged that the TILA disclosure regime is far from perfect and that many of its requirements could be simplified and made more understandable to consumers. In December 2004, the Federal Reserve Board began a comprehensive review of Regulation Z, starting with the publication of an advance notice of proposed rulemaking (ANPR) on the rules for certain kinds of open-end credit.⁵⁸ This effort to simplify and improve TILA disclosures could provide another important opportunity to evaluate the ability of consumers to understand the cost of bounce protection against functionally equivalent forms of credit.

II. Public Endorsement of Low-Cost Payday Loan Alternatives

As of this writing, the one federal financial regulator who has been the most vocal supporter of depository institutions developing their own low-cost payday loan alternatives is Deborah Matz of the National Credit Union Administration. In addition, as previously mentioned, the FDIC's payday loan guidance provides that:

When a customer has used payday loans for more than three months in the past 12 months, institutions should offer the customer, or refer the customer to, an alternative longer-term credit product that more appropriately suits the customer's needs. Whether or not an institution is able to provide a customer alternative credit products, an extension of a payday loan is not appropriate under such circumstances.⁵⁹

Given repeat expressions of concern about reputational risk and regulatory hostility during our interviews with industry officials, more public support from a broad range of regulators would be helpful. Returning to the remittance analogy, public endorsements of banks and credit unions offering remittance services by the U.S. Treasury Department and federal bank regulators were instrumental in making the activity "respectable" for more institutions.

Such public statements would, of course, differentiate between lower-cost products offered by depository institutions on their own versus those offered through servicing agreements with payday vendors. The broader regulatory community will not embrace the latter unless and until such agreements alter the business model to provide a lower-cost option to

consumers, consistent with principles of safety and soundness. If they are undertaken purely for interest rate exportation, they will not be allowed. Consumer advocates argue that current servicing agreements raise costs for consumers because they permit circumvention of state usury laws.

Depository institutions' entry into this market is at a very preliminary stage. An initial first step might be for regulators to simply support greater flexibility in credit criteria for existing product lines, as Citibank has done with Checking Plus and as Windward Credit Union has done with its Signature Loans. North Carolina Banking Commissioner Joe Smith⁶⁰ argues that regulators should publicly encourage and allow banks and credit unions broad latitude to experiment with payday loan alternatives on a pilot basis. Public expressions of regulatory tolerance for such experimentation could embolden banks and credit unions concerned about regulatory hostility or heightened scrutiny of this form of credit.

III. Regulatory Task Force

Our interviews with bank examination staff indicate that regulators are also in the early stages of thinking about the type of regulatory requirements that should apply to payday loan alternatives. Interviews with depository institutions indicate that some of their examiners have been skeptical of payday loan alternatives, and particularly scrutinizing of the amount and sources of capital held against these loans. Federal financial regulators should consider forming a joint task force of senior examination staff to develop preliminary guidance on payday loan alternatives, recognizing the need for institutions to have broad latitude in experimenting with these products. Areas where such guidance could be most helpful are in capital treatment, ability to pay (method of repayment), and repeat use. Given the small dollar amount of payday loan alternatives, high capital requirements are unlikely to be a problem for large institutions. However, stringent capital treatment could be an impediment for small, community-based institutions. The NCSECU experience suggests that the use of direct deposit and automatic account deductions for repayment can keep credit losses to acceptable levels. Thus, high dollar-for-dollar capital may not be warranted. Institutions should also be able to make these small loans without underwriting as they can with bounce protection services.

This task force could also reinforce and clarify that credit under the Community Reinvestment Act is available to institutions offering low-cost payday loan alternatives, as well as institutions providing funding for loan loss reserves for other institutions'

programs.⁶¹ A number of the smaller institutions that we reviewed obtained funds from third-party sources to meet capital requirements. For instance, the Northern Trust Company has provided funding for the NoSide Credit Union's loan loss reserves. Private Bank and Trust has also provided support for this program. The task force working with the FFIEC could prompt publication of the availability of CRA credit for such activities, perhaps prompting other institutions to follow suit.

CONCLUSION Depository institutions have the tools and infrastructure that they could deploy to offer their customers low-cost alternatives to payday loans. Whether they are willing to enter this market remains to be seen. Perceptions of high operational costs and credit losses appear to be exaggerated based on the limited experience of institutions that have successfully offered payday loan alternatives to date. Perceptions of regulatory hostility also appear to be unfounded. Our interviews with regulators indicated unanimous agreement that development by depository institutions of their own low-cost payday loan alternatives would be positive from a public policy standpoint and likely warrant CRA credit.

A more substantial impediment to banks and credit unions entering this market is the proliferation of fee-based bounce protection. In a sense, fee-based bounce protection is a “payday loan alternative” whose costs, if used as credit, can far exceed that of a payday loan. Many banks and credit unions will not view it as in their interests to offer lower-cost, small dollar credit options such as LOCs and closed-end installment loans, if they can reap much higher, per transaction fee income from bounce protection. Competition could be facilitated if regulators required homogenous APR disclosures for all small dollar credit products. This would empower consumers to identify the lower-cost products and enhance the competitive position of institutions that are foregoing the hefty revenues associated with fee-based overdraft protection in favor of those lower-cost options.

From a broader perspective, policymakers should examine whether incentives built into the current financial regulatory structure serve the needs of consumers given trends toward an ownership society. Increasingly, Americans must rely on their own financial abilities and judgment to accumulate and manage financial assets. Regrettably, overuse of credit has achieved epidemic proportions in this country. The rapid growth of payday lenders is a symptom of the problem, not the cause of the disease. A payday loan is what it is: a high-cost form of small dollar, short-term credit that credit-impaired consumers want and need, given the comparatively higher costs of NSF or late fees and the lack of lower-cost credit alternatives. The escalating demand for the product reflects the woeful inability of millions of Americans to effectively manage their finances and accumulate savings.

Perhaps the most important discovery of our months of research is the mandatory savings component of the NCSECU. Taking a lemon and making lemonade, Jim Blaine, the NCSECU’s creative president, has conditioned access to credit on savings, thus creating a healthy savings rate for his most credit-addicted members: the more they borrow, the

more they have to save. Financial institutions throughout the country should look to this program as a model of how to give customers who chronically use debt a chance to see what it is like to finally have something on the plus side of the family's budget ledger. Policymakers should foster market mechanisms that lower credit costs and build savings. Requiring consistent disclosures of the costs of equivalent credit products is one way to do this. Another is to reconsider the dominance of the lending test under the CRA and give at least as much credit to those institutions that help customers save.

BIBLIOGRAPHY, CONTACTS LIST, & COMPANY DOCUMENTS

In addition to the resources noted in the footnotes to the text, compiling this report required using three types of resources that are provided in detail in this section.

The **Bibliography Section** includes documents reviewed and the websites from which those documents were retrieved, if any.

The **Contacts List** includes the names and affiliations of individuals who were interviewed by the author or otherwise provided comment or input in the preparation of this report. The author deeply appreciates the help of all individuals listed, while emphasizing that the views expressed in this report are her own and do not necessarily reflect that of any other individual or institution.

The **Company Documents Section** includes a listing of brochures, forms, pamphlets, and other printed material obtained from the institutions contacted while researching this report.

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Cash Advance Application
CFSA Access Brochure
First American Cash Advance Leaflet
Posters and Desktop APR Disclosures

APPENDIX A — DETAILED CASE STUDIES⁶²

I. Depository Institutions

Austin Bank of Chicago: Ready Cash Now

Background

Founded in 1891, Austin Bank of Chicago is a \$227 million community bank. In February 2005, the bank started to offer its payday alternative product, Ready Cash Now, to its customers.

Payday Alternative Product: Ready Cash Now

Description of product

Ready Cash Now is short-term, fixed loan that can range from \$300 to \$999.99 with an APR of 11.99 percent. The loan is repaid over a period of 12 months. Automatic payments are deducted from the customers' deposit account. If payments are late, a penalty equal to 5 percent of the monthly payment applies.

Application process and requirements

The customer fills out an application by providing his/her name, address, Social Security number, and place of employment. Applications are usually approved by branch managers within 24 hours.

The borrower must have a deposit account at the bank and proof of continuous employment of 12 months. The bank obtains a credit report to check the applicant's credit history, but does not use credit scores to qualify an applicant for the loans. Loans are limited by a maximum debt ratio of 55 percent of net monthly income. The bank will explore the possibility of altering the debt ratio as the volume of applications increases. Direct deposit is not a requirement of the Ready Cash Now product, but the bank encourages applicants to set it up. Applicants must agree to automatic deductions for repayment.

Advertising and marketing of the product

The bank uses several avenues to advertise and market the Ready Cash Now product. It is in the process of conducting outreach through community groups and church leaders.

The bank's outreach is designed to spread the message about the dangers and costs of taking payday loans and to promote more affordable alternatives such as the Ready Cash Now product. The bank has also done interviews with community banking newspapers on payday loan alternatives. It advertises its Ready Cash Now product in its branches using brochures and posters, and also includes information about the product in monthly bank statement stuffers. Finally, the product is also advertised in local newspapers such as the *Austin Weekly News*. The bank hopes that strong word of mouth will help promote the product.

Business Aspects

Before the introduction of Ready Cash Now, Austin Bank of Chicago had begun to offer a Ready Cash Loan product, which was an open-end credit line for individuals and businesses having a demand deposit or money market account with the bank. The credit line for this particular product is \$1,000 to \$10,000. The bank decided to begin a smaller version of this product, Ready Cash Now, in response to the growth of payday lending in the community it serves. With easier qualification requirements, Ready Cash Now is a more competitive alternative to payday loans.

The bank views Ready Cash Now as furthering its mission to provide financial services to its customers. The bank strives to provide affordable financial services to its customers to allow them to improve their social and economic status.

Austin Bank of Chicago sees Ready Cash Now as a business tool to attract more customers and grow the bank. It hopes to transition Ready Cash Now borrowers into other financial products and services.

Due to the recent launch of the product, statistical data on delinquency, default, and charge-off rates are not yet available. The bank applies the same collection procedures to Ready Cash Now loans as with other loan products. Collections are done in-house by well-experienced collectors.

Views on the Competitive Landscape

Obstacles to offering payday lending alternatives

The primary competitive obstacle to banks entering this market is the difficulty of making a profit without charging high rates. Austin Bank of Chicago does not intend to make a profit on this product, but rather is offering it as a service to the community and as a way to attract customers who will eventually use other bank products and services.

Community Reinvestment Act credit to banks that offer low-cost, short-term credit

The bank believes that CRA credit should be given to banks who are offering low-cost alternatives to payday loans. CRA credit could provide an incentive for some banks that are not offering payday loan alternatives to get into the market.

Citibank: Checking Plus

Background

Citibank is a global financial services corporation with bank operations on several continents. Its U.S. banking operation offers an overdraft protection product called Checking Plus to its customers. This is the only overdraft protection program now offered by Citibank. Fee-based overdraft programs are being phased out of Citibank branches. In addition, in connection with its proposed acquisition of First American Bank in Texas, Citibank will be replacing that bank's fee-based program with Checking Plus.

Overdraft Protection Product: Checking Plus

Description of product

Checking Plus is a revolving, unsecured line of credit linked to a customer's checking account that is accessed when a customer overdraws his or her account. The interest rate on the Checking Plus overdraft line is a current variable rate of 16.75 percent in New York and 17 percent in all other states. There is a \$5 annual membership fee in all states with the exception of New York.

Customers can also access Checking Plus if they are in need of a short-term loan. The credit line can be accessed by using an ATM or transferring funds online from Checking Plus to a Citibank checking account, money market account, or savings account. When using a Citibank ATM, customers must access a separate Checking Plus account to clearly differentiate balances available in their checking accounts and funds available through the line of credit.

All Checking Plus balances are repaid in monthly installments through automatic deductions from customers' checking accounts. Automatic deduction is a condition of maintaining the line of credit. The default repayment schedule is 1/60th of the outstanding balance, with a minimum payment of \$10. Customers can prepay the balances or request a different default repayment schedule if they like. Failure to make the minimum payment results in a charge of \$25.

As a revolving line of credit, all Checking Plus interest rate disclosures are in full compliance with the Truth in Lending Act/Regulation Z.

Application and qualification process

The Checking Plus application process can be initiated by calling the CitiPhone Banking toll-free number or by applying online 24 hours a day. It is available to customers without regard to income. Applicants must demonstrate an ability to repay. Pre-approved credit lines range from \$500 to \$25,000. In general, the customer must have acceptable credit to qualify for the product. Customers with lower credit scores may qualify for a \$500 line of credit if they have been customers in good standing for a minimum of six months.

Advertising and marketing of the product

Advertising and marketing of the Checking Plus product is done at the branch level. The product is offered as part of the process of opening a checking account. Credit checks for the account and Checking Plus are run at the same time.

Citibank also screens its current checking customers to see if they qualify for small loans of up to \$500 using Checking Plus. The qualification process is automated at account opening based on credit and ability to pay.

Business Aspects

The denial rate for walk-in applicants for Checking Plus is high—45 percent. However, overall denial rates are very low, because Citigroup regularly solicits its existing checking account customers for pre-approved accounts. Denials usually are the result of a customer's bad credit. Citibank is experimenting with making small LOCs under Checking Plus more widely available for those with no or limited credit.

A Checking Plus loan is delinquent if it is not paid. The customer gets a notice informing them of the delinquency. A phone call is placed after 60 days. After 180 days, the loan is written off and the bank attempts to collect on the loan. Loan losses are small—less than 5 percent, lower than Citibank's losses on its credit card business.

The profitability of Checking Plus is proprietary. In 2004, about 30 percent of Checking Plus accounts were active. Of those active accounts, 38 percent of customers used the service once a year or less; 28 percent used it 2 to 5 times a year; 24 percent used it 6 to 10 times a year; and 20 percent used it over 10 times per year.

The bank sees the Checking Plus product as providing an important customer service and also meeting important business needs. The product provides “error” protection for customers who overdraw their accounts and also helps customers build better credit as all repayments are reported to the credit bureaus. High NSF and overdraft fees can provoke customers to close their accounts. Checking Plus is a lower-cost form of overdraft protection than fee-based programs, making it more popular with customers and more acceptable among regulators. It assists in customer retention, thereby avoiding costs associated with opening and closing accounts. Citibank sees Checking Plus as a good marketing tool and a good source of new customers for their other financial products.

Citibank believes that the market for overdraft protection will continue to grow. Banks offering the lower-cost product will have a competitive advantage.

Parting Comments

Checking Plus is part of the core offering at Citibank. When used responsibly, it is an effective money management tool for customers to manage their accounts.

La Salle Bank, N.A.: Center for Working Families Program (CWFP) Loan

Background

Headquartered in Chicago, LaSalle Bank, N.A. has \$62.8 billion in assets and \$36.4 billion in deposits. One of the largest banks in the Midwest and second largest in Chicago, LaSalle serves individuals, small businesses, middle market companies, and institutions with streamlined solutions to meet the scope of customers’ financial needs. La Salle is owned by the parent company, La Salle Bank Corporation, a subsidiary of ABN Amro based in the Netherlands.

La Salle formed partnerships with the Local Initiatives Support Corporation’s (LISC) Center for Working Families (CWF) and the Center for Economic Progress (CEP) to offer small loans as a tool for economic empowerment. Targeted toward CWF clients, the program provides small loans to those who have limited financial resources to cope with an emergency situation.

Payday Alternative Product: Center for Working Families Program Loan

Description of product

The Center for Working Families Program loan ranges in size from \$300 to \$1,000 and is offered at an interest rate of 12 percent with a maximum loan term of 12 months. Loans are repaid in 12 monthly installments. A maximum of two loans can be taken out per year, so long as the first is paid off before the second is taken out. The total amount loaned cannot exceed \$1,000 per year. The loan can only be taken out to meet certain types of unexpected needs such as a medical emergency; losing child care; a car breaking down; needing a uniform for a job, job tools, and home repair, to name a few. The emergency must be a one-time, nonrecurring situation.

Application process and requirements

There are several requirements that applicants must meet before they can qualify for a loan. Applicants must have participated in the CWFP for three months and must have completed a three-month financial education program. The CWFP counselor must sign the bottom of the loan application to document completion of the financial education course. Applicants must also be employed, not in bankruptcy, and have no fraud-related issues in Chex Systems (bounced checks will not disqualify). In addition, they must not have a debt to income ratio of 70 percent or higher. Credit checks of applicants are not required. Loan applications are taken by consumer loan officers during regular bank hours and, if approved, the cash can be available the next business day. The CWFP counselor accompanies the applicant to the bank.

The bank's Consumer Lending Department provides closing documents to the LaSalle retail branch closest to the appropriate CWF. Accompanied by the CWFP counselor, the applicant comes to that branch to sign documents and receive loan proceeds. A payment book is forwarded from Consumer Lending to the applicant within two weeks of closing. In the event of a delinquency, Consumer Lending will issue a copy of the delinquency notice to the applicant and the CWF financial counselor.

Advertising and marketing of the product

There is no advertising or marketing of the product since it is offered as part of the CWFP program.

Product limitations

The loan ceiling is \$1,000, subject to the 70 percent debt-to-income ratio. There is a maximum of two loans per applicant per year. The first loan must be repaid before the second loan can be issued. A maximum of \$1,000 can be loaned per year.

Business Aspects

The program is relatively new and therefore does not have enough historical information on default, delinquency, and charge-off rates. The program is subject to an internal limitation on loan losses of \$30,000 per year. If this threshold is reached, the program will stop making loans. La Salle's loan loss reserve is being funded by its Community Development Corporation (CDC) subsidiary.

Delinquencies are defined by the bank as loans that are not paid by the due date. Guidelines for dealing with delinquencies and defaults are generally the same as they are for other types of short-term consumer loans offered by the bank.

La Salle Bank has been working with and financially supporting the North Side Community Federal Credit Union's efforts to develop a payday loan alternative. The bank does not view itself as "competing" with payday lenders but rather is seeking to find a cost-effective way to provide short-term credit to families in unexpected need.

Views of the Competitive Landscape

La Salle Bank faced initial regulatory obstacles in offering this product. The OCC was initially reluctant about the CDC subsidiary providing funding to the parent for the loan loss reserve, but acquiesced.

Profitability is a major obstacle for a product of this type to become more widespread. The bank is offering the product as a service to its members. The bank management typically expects a return on assets (ROA) of 15–17 percent to justify the launch of a new product. This loan is not expected to meet that hurdle. However, if the program can break even or generate a small profit, a case can be made to upper management to significantly expand it.

Banks will not start offering payday loan alternatives on a widespread basis unless the business case can be made.

Community Reinvestment Act credit to banks that offer low-cost short-term credit

In order for CRA credit to be a meaningful incentive, these loans need to be built into the lending test. La Salle Bank community development officials doubt that will happen and that mortgage lending will continue to be the focus of the CRA's lending test.

North Carolina State Employees' Credit Union: Salary Advance Loan

Background

Chartered in 1937 to promote the financial well-being of teachers and state employees, the North Carolina State Employees' Credit Union (NCSECU) delivers financial services to 1.2 million members through a network of 175 branches throughout the state. In 2001, the credit union started offering its payday loan alternative product, the Salary Advance Loan (SALO), after noticing that its members were making increasing use of payday loans. The SALO is an integral part of NCSECU's philosophy of trying to improve the social and economic status of its members through an array of low-cost financial products.

Payday Alternative Product: Salary Advance Loan (SALO)

Description of product

The SALO is a revolving loan that allows a maximum outstanding balance of \$500, at an interest rate of 12 percent, with payment in full expected on the member's next payday. (A state employees' typical pay cycle is monthly.) Thus, on a \$500, two-week loan, the charge is less than \$2.50. As an open-end loan, SALO interest rate disclosures are in full compliance with Regulation Z. The loan has a mandatory savings component, which requires that 5 percent of each advance be placed in a special savings account. The savings funds are freely available to the SALO user, but if the member withdraws the savings, he/she cannot access a loan advance for six months. This feature is designed to provide an incentive to members to let savings accumulate until they are sufficient to help the member meet cash flow needs without having to resort to borrowing.

Application process and requirements

The application process is simple. Each member fills out an abbreviated application by providing his or her name, address, Social Security number, and place of employment. The credit union requires that an applicant provide a copy of the member's payroll check stub to verify the amount of their net pay. NCSECU verifies that the member's paycheck is on direct deposit with the credit union and obtains a credit report to verify that the applicant is not under bankruptcy. Direct deposit is the primary focus of the qualification

process. SALO applicants must also agree to the mandatory savings component of the program.

NCSECU members may apply for loans at credit union branches, through the credit union's call center, or at the NCSECU website. Branches are open from 8:30 a.m. to 5:30 p.m., Monday through Friday. The call center is open from 8:00 a.m. to 9:00 p.m., Monday through Saturday, and 1 p.m. to 6 p.m. on Sundays.

The credit union envisions that the Internet will become a more important channel in the distribution of payday loans and alternative products like its own. NCSECU hopes to allow members to access SALO advances over the Internet during the first quarter of 2005. New applications over the Internet are minimal, but approximately 20 percent of requests for subsequent advances are initiated over the Internet.

Advertising and marketing of the product

The credit union uses several avenues to advertise and market the SALO product. It does not advertise in normal media due to the exclusive membership of credit unions but instead uses its monthly newsletter, which is mailed to all members with their monthly statement. Most of the marketing is done by word of mouth by the NCSECU membership. Occasionally, the credit union does some targeted mailings to members known to be using payday loan vendors.

Loan limitations

The loan ceiling is limited to \$500. The loan ceiling may be further limited by the amount of the members' next paycheck. The average SALO loan is about \$367. Extensions of the repayment period are not permitted. As an open-end loan, a member is eligible for another SALO when the previous SALO balance has been repaid. Advances cannot be used to pay a prior advance. The average initial repayment period is about 20 days. Approximately 70 percent of NCSECU members who use the SALO product do so monthly.

Business Aspects

The SALO product has been popular with the members of the credit union. During 2004, the credit union made a total of \$129,374,865 in SALOs. Over 46,000 NCSECU members use the product.

Delinquencies and defaults are defined by the credit union as loans that are not paid by the due date. In 2004, SALOs that were 60 days delinquent represented 2.64 percent of

all SALO loans; those 90 days delinquent represented 1.57 percent. The annualized net charge-off for SALOs in 2004 was approximately .17 percent of loans originated. Charge-offs occur when NCSECU has exhausted all possibility of collection or at the latest, when the loan is 180 days past due.

Branch loan officers handle loans that are delinquent or in default, generally by making phone calls and sending letters. If those efforts fail, the credit union files for a judgment in small claims court.

The SALO product has been profitable. Since the inception of the SALO program in January 2001, NCSECU has generated \$2,052,211 in interest income while experiencing \$757,706 in net charge-offs, or 37 percent of interest income. NCSECU feels that the automation that it has put into place in handling the monthly advances for this program makes the \$1.3 million in net interest income sufficient to cover costs and generate a respectable profit.

Below are the basic economics of the SALO loan program:

Interest Rate (2004)	11.75%
Loan Losses	0.24%
Cost of Funds	1.75%
SECU Operating Costs	2.00%
	<hr/>
To Retained Earnings	7.76%

The mandatory savings component of the SALO has provided an additional business benefit. In less than 18 months, the savings component has generated \$6 million in new deposits. The mandatory savings component is popular with NCSECU members, many of whom report that this is the first time in their lives that they have had any significant savings. It has also reduced NCSECU's credit risk by providing increased security for SALO loans.

SALO Support Services

NCSECU developed the SALO program after observing increased usage of payday lenders by its members. A quick, informal survey at a few NCSECU branches revealed over 4,000 members making use of check cashing companies. Costing a small fraction of the typical payday loan fee, SALO is widely used by NCSECU members. With its reduced costs and

savings component, SECU's management hope that the SALO program will have a long-term, favorable impact on the financial well-being of members and their families.

As an additional service, NCSECU offers financial education to customers who use the SALO product. This "financial fitness" program is provided at no cost through a company named Balance. Offered on a voluntary basis, this program is viewed positively by NCSECU members. NCSECU experimented with requiring financial education for chronic borrowers, but found that "the old adage of leading a horse to water is quite true in this segment of our membership." NCSECU has found the "forced savings" component of the SALO product to be much more effective in helping members regain some control of their finances.

The credit union also reports all positive and negative SALO payment information to Equifax. By reporting positive information, they feel that they are helping members establish a better credit history file. For those who default, reporting negative information occasionally helps the institution collect the charge-off balance.

Views of the Competitive Landscape

Obstacles to offering payday lending alternatives

NCSECU has faced no regulatory obstacles in offering a competitive payday loan alternative. The product is offered as an open-end loan in full compliance with Regulation Z. NCSECU reports that the biggest regulatory issue in North Carolina is the inability of the state government to address customer protection abuses among traditional payday lenders who have aligned themselves with FDIC-regulated banks.

NCSECU has been able to offer a competitive product because it is pricing it as a service to its members rather than as a way to generate excess income. NCSECU believes its product provides more value for its members than payday loans. NCSECU welcomes any organization that can offer payday alternatives at lower cost and better value.

Community Reinvestment Act credit to banks that offer low-cost, short-term credit

NCSECU believes that credit under CRA for banks should only be allowed if they offer a low-cost alternative to the payday lender programs. Offering CRA credit may impact banks' willingness to offer low-cost, short-term credit to the LMI population, but NCSECU doubts that "for-profit" depository institutions will take the initiative to enter this line of business in a true low-cost manner.

Competitive landscape over the next five years

As long as individual states are impeded in their ability to regulate the activity of payday lenders that are aligned with FDIC-regulated banks, the competitive landscape will remain challenging. NCSECU hopes that the programs offered by credit unions and other responsible institutions can create sufficient competition for payday lenders to force a reduction in the fees that they charge. NCSECU fears, however, that competitive forces will be slow in lowering costs and feels that regulators, the courts, and legislative bodies need to do more to protect consumers now.

NCSECU feels that traditional financial institutions (i.e., banks) will not be involved in providing low-cost alternatives to payday lending in the near future. Their biggest incentive to do so would be providing a meaningful service to their customers. Their biggest disincentive and the one that drives their decision-making process is their belief that they cannot make sufficient profits to warrant the service.

Parting Comments

“Our members using our alternative program are good, honest, hardworking people. They are not unintelligent, just not experts in finance. Perceived as less affluent, they are often stereotyped and end up paying more for goods and services while receiving less in value. They must be served with responsibility, with a broad array of services, if they are to be able to improve their social and economic status.”—Philip Greer, Senior Vice President—Loan Administration, North Carolina State Employees’ Credit Union.

North Side Community Federal Credit Union: Payday Alternative Loan

Background

North Side Community Federal Credit Union (NoSide) is a community development credit union based in the north side of Chicago. In 2002, the credit union started to offer its Payday Alternative Loan to its customers. It is a 30-year-old credit union with 4,400 members and assets of \$9 million.

Payday Alternative Product: Payday Alternative Loan (PAL)

Description of product

The PAL is a fixed-term loan that allows a maximum outstanding balance of \$500, at an interest rate of 16.5 percent APR. The loan is repaid in monthly installments over a period of six months. The first payment is due on the borrower’s next payday. The credit

union recently raised its one-time application fee from \$10 to \$30 in an effort to make the product more financially sustainable by increasing fee income.

Application process and requirements

Loan applicants must call to schedule an appointment. The credit union does not take applications over the Internet. During the appointment, the applicant completes an abbreviated application form, which asks for his/her name, address, Social Security number, and place of employment. An applicant must present two recent pay stubs to verify net pay and have an income of at least \$1,000 per month. An applicant may not have any other outstanding loans with the credit union. Membership in the credit union is a key requirement, but applicants can join and receive the loan on the same day—sometimes in as little as 20 minutes. Direct deposit is not a requirement of the PAL product. Applicants in bankruptcy may still qualify for the product.

NoSide obtains a credit report to check the applicant's credit score. To minimize any impact that running a credit report may have on an applicant, it is obtained only once per calendar year. A low FICO score will not automatically disqualify an applicant for the loan, but if the score is less than 580, the applicant must attend three financial literacy workshops to qualify for the loan. The most recent data available indicate that 53 percent of the credit union's PAL customers have FICOs between 500 and 599, 17 percent are under 500, and 14 percent have no score.

Advertising and marketing of the product

The credit union uses several avenues to advertise and market the PAL product and has found the product to be in extremely high demand. The credit union also advertises PAL in its newsletter, which is mailed to all members with their monthly statement. Most of the marketing is done by word of mouth by the NoSide membership. The credit union believes that partnering with its Select Employers Group (employers who have a partnership with the credit union and promote its services to their employees) is a highly effective means of marketing and delivering the product. Many employers are besieged with requests for salary advances. NoSide can provide value by offering the loans to workers instead.

Through presentations at conferences and through local and national media coverage, the credit union tries to obtain outside support for its product and encourage other financial institutions to make similar efforts to offer low-cost alternatives to payday loans.

Product limitations

The loan ceiling is limited to \$500. Borrowers are only eligible for this loan twice a year. An applicant can only receive a second PAL loan for the difference between the loan ceiling (\$500) and any amount borrowed through a PAL within the preceding 12 months. The repayment period can not exceed six months. There is a late fee of \$10 if the loan is more than ten days past due.

Business Aspects

The PAL product has been popular with the members of the credit union, but it has not yet proven to be profitable. NoSide estimates that the interest received averages \$25 per loan, but the transaction cost per loan is \$30. The credit union sees the PAL as a tool to help grow the credit union by attracting more new members. NoSide hopes to transition PAL borrowers into other, more profitable financial products and services. To date, 59 PAL “graduates” have taken out 84 other types of loans (including 10 auto loans) totaling \$268,000.

Delinquencies and defaults are defined by the credit union as loans that are not paid by the due date. The 60-day delinquency rate for PAL loans is 20 percent. Collections are done in-house. Due to the small volume size of a PAL loan, it is not worth sending to an outside collection agency.

Charge-offs occur when the credit union has exhausted all possibility of collection or at the latest when the loan is 180 days past due. As of 12/31/2004, the credit union had written off 112 of the 3,100 loans written.

Support Services

The credit union tries to help improve the financial well-being of its customers by using several mechanisms. It offers financial education to customers who use the PAL product at no cost through different financial literacy workshops. Financial education is mandatory for an applicant whose FICO score is below 580. The credit union also reports all positive and negative payment information to Trans Union.

NoSide views the PAL product as fitting its mission to provide value to its members. The credit union aims to provide affordable financial services to its membership to allow them to improve their social and economic status. It recently moved its offices to be more community based and is currently located across the street from a payday lender. The

Payday Alternative Loan program is an integral part of its philosophical approach to serving members.

Views on the Competitive Landscape

Regulatory issues

At the start of the PAL program, the National Credit Union Administration (NCUA) required that the credit union set up a segregated loan reserve to cover losses.

NoSide was able to obtain financial support from commercial banks to assist the credit union in offering its payday loan alternative. Banks that have given financial support are Northern Trust, Private Bank, and La Salle Bank. Half the funds received have been used to cover loan reserves and the remaining half have been used to cover operational costs linked to the PAL product.

Community Reinvestment Act credit to banks that offer low-cost, short-term credit

NoSide believes that credit under CRA for banks is allowed if they support programs that offer low-cost alternative payday loans. Offering CRA credit would increase banks willingness to support programs such as the credit union's PAL product. Some banks may be more willing to support other institutions' programs, than to provide the product directly.

Business incentives

NoSide believes that traditional financial institutions (i.e., commercial banks) will find it difficult to provide low-cost alternatives to payday lending in the future. Their biggest incentive would be useful service for their customers. Their biggest disincentive and the one that drives their decision-making process is that they cannot make sufficient profits to warrant the service.

Pentagon Federal Credit Union: Asset Recovery Kit

Background

The Pentagon Federal Credit Union (PFCU) serves 600,000 members in the Army, Air Force, Coast Guard, Pentagon, and Department of Homeland Security. Federally chartered in 1935, the credit union manages over \$7 billion in assets. In 2001, the credit union created the Pentagon Federal Credit Union Foundation to promote money management training and targeted financial assistance to the men and women in America's defense community. The PFCU also began to explore the idea of offering a payday alternative product to its members. It authorized a loan fund of \$500,000 and turned to its

foundation to raise grant funds for a loan loss reserve to cover the high risks associated with such short-term, unsecured loans. After careful planning and raising the needed funds, PFCU launched its pilot payday loan alternative, the Asset Recovery Kit (ARK), at the end of 2004.

Payday Loan Alternative Product: Asset Recovery Kit (ARK)

Description of product

The ARK is a short-term, fixed loan with a maximum loan ceiling of \$500. Payment in full is due on the member's next payday. The loan does not charge interest but instead levies a \$6 flat rate fee. The flat fee is equivalent to an APR of 31.49 percent, assuming a loan amount of \$500 repaid in full in 14 days.

Application process and requirements

There is an abbreviated application that simply requires a member to provide his/her name, address, Social Security number, and place of employment. The credit union also requires that the applicant provide a copy of his/her payroll check stub to verify the amount of net pay. PFCU verifies that the member's paycheck is on direct deposit with the credit union and obtains a credit report to verify that the applicant is not under bankruptcy. The entire application process takes around 30 minutes.

Financial counseling is a requirement of using the ARK product. Loan recipients are required to participate in a Consumer Credit Counseling Services (CCCS) program, which includes money management training and help with debt restructuring. The counseling is provided in a private office in a credit union branch to assure privacy for the client. The program emphasizes self-help and strategies for fiscal responsibility, not "charity." It tries to build on the "can do" spirit and attitude characteristic of the teaching and training received by enlisted men and women.

In determining locations to offer the ARK pilot, PFCU and its foundation targeted locations in which there were large military bases with a high concentration of payday lenders. The location selected as a part of the initial roll out was Fort Hood in Killen, Texas. The program will be expanded to Washington, DC; Fayetteville, NC; and Colorado Springs based upon the success of the pilot and additional funding.

Members can apply for ARK loans at the credit union's branch locations during normal business hours. The branches are open from 9 a.m. to 4 p.m., Monday through Thursday, 9 a.m. to 5 p.m. on Friday, and 9 a.m. to 12 p.m. on Saturday. Members cannot apply

for an ARK over the Internet. The credit union wants “high touch” visibility and accountability with all applicants.

Advertising and marketing of the product

The credit union uses several avenues to advertise and market the ARK product. It advertises in newspapers that cater to military personnel like the *Fort Hood Sentinel and Killen Daily*. It also uses brochures, flyers, and other materials in its branches. The credit union also depends on word of mouth and referrals from the ASYMCA and base officers. PFCU believes that convenience and respectful treatment are the most importance aspects of marketing ARK to members, with price being a less important factor.

Product limitations

The loan ceiling is limited to 80 percent of the applicant’s net pay up to a maximum of \$500. Rollovers of the ARK product are permitted up to five times in any 12-month period, provided the individual continues to receive credit counseling. Each rollover or renewal costs a flat fee of \$6. In addition, ARK cannot be used to pay off a payday loan, though PFCU will help such soldiers develop a workout plan.

ARK Business Aspects

As of March 2005, ARK had issued 87 loans. The average loan size was \$403. The total dollar volume of all loans originated was \$35,039. The program had generated \$522 in revenue (\$6 times 87). There had been no charge-offs. Six of the loans were more than a day past due.

PFCU developed ARK to serve its core constituents, service men and women and their families, providing them with an alternative to high-cost payday lenders. The product is designed to extend lower-cost credit to members who have severe credit impairments and to help them rehabilitate and repair their credit situation. PFCU is trying to fulfill its mandate of “people helping people.” PFCU does not seek to make a profit on this product. The \$6 flat fee is designed to break even in covering the processing costs in making these loans.

PFCU is attempting to improve the social and economic status of all its members through a broad array of low-cost financial products. The ARK program is an integral part of its philosophical approach to serving members.

Views on the Competitive Landscape

Regulatory obstacles to offering payday lending alternatives

PFCU's regulator has encouraged it to develop this product. It has confronted no regulatory obstacles. The program is an open-end loan in full compliance with Regulation Z.

Market obstacles to offering payday lending alternatives

PFCU feels that short-term credit will remain expensive due to several reasons. The loans are high risk. They also have large operational costs relative to the small size of the loans.

The credit union feels that there is very little incentive to depository institutions to offer competitive products to payday loans because of the reputation risk and the cost of processing the loans. It believes that legislative mandates will probably be required to effect change.

A key challenge for credit unions offering payday loan alternatives is funding for loan loss reserves. PFCU suggests that credit unions might partner with community development banks in seeking out funding from the CDFI Fund for loan loss reserves. Charitable foundations and funding from large banks for CRA credit are other potential sources.

II. Payday Loan Vendors

Advance America: Payday Cash Advance Vendor

Background

Advance America is the largest provider of payday cash advance services, as measured by the number of payday cash advance centers operated. As of December 31, 2004, the Company operated 2,408 payday cash advance centers in 34 states. All centers are Company operated. Advance America does not franchise. Advance America focuses exclusively on payday cash advance services and does not provide check cashing, pawn lending, title lending, or wire transfers.

Payday Product

Description of product

Advance America offers payday cash advance products using two different business models. Under the standard business model, payday cash advance terms, interest, and/or fees are governed by the laws of the state where the center is located. Under this business model, the payday cash advances are approved and made by Advance America. The company determines the terms, condition, and features of the loan in accordance with applicable state laws. Advance America is responsible for all risks and losses associated with the payday cash advance. As of December 31, 2004, there were 1,868 company centers in 29 states that were using the standard business model.

Under the bank agency business model, state-chartered, FDIC-regulated banks provide the payday cash advances consistent with the laws of the state where they are chartered. Under the agency business model, Advance America acts as the processing, marketing, and servicing agent through its payday cash advance centers. The lending banks determine approval of all applications and establish all of the underwriting criteria. The terms and conditions of the payday cash advance are determined by the lending bank. As of December 31, 2004, the company was serving as processing, marketing, and servicing agent for the lending banks under the agency business model in 540 company centers in five states.

The permitted size of a payday cash advance varies by state and ranges from \$50 to \$1,000. The permitted fees and/or interest on a payday cash advance also vary by state and range from \$10 to \$44 on a \$100 advance.

Payday cash advances are due on the customer's next payday. In exchange for the payday cash advance, the customer writes a check for the amount of the payday cash advance plus the interest and/or fee that will be due and the company or the lending banks agree to defer deposit of the check. For example, where the interest and/or fee for the payday cash advance is \$15 per \$100, and the customer borrows \$300, the customer would write out a check for \$345, which the company or the lending bank agrees to defer deposit until the payday cash advance's due date. Customers usually repay their payday cash advance by returning to one of the company's centers with cash. Upon repayment in full, Advance America returns the customer's personal check. If a customer does not repay the payday cash advance in full on or before the due date, the company attempts to collect from the customer directly and may deposit the customer's personal check. Most states do not allow late fees. In the three states where late fees are allowed, the company

will impose a late fee for past due payday cash advance. If the company or the lending bank deposits the customer's check and it is returned due to insufficient funds or some other reason, the company or the lending bank will charge a returned check fee.

The returned check fee varies by state and ranges up to \$30. In the three states where late fees are permitted, they are set as a percentage of the outstanding loan amount, up to a maximum of \$10 or 5 percent of unpaid balance, whichever is greater.

Application process and requirements

Customers apply for a payday cash advance in person at one of Advance America's centers. The centers are typically located in high-traffic, suburban retail areas. Most often, the centers are located in strip malls with a large anchor tenant such as Wal-Mart, Blockbuster, or a regional grocery store. Hours vary by location; however, most centers are open Monday–Friday, 10 a.m.–6 p.m., and 10 a.m.–3 p.m. on Saturday. Advance America does not currently accept applications over the Internet, though notes in its prospectus, "We also compete with companies offering payday cash advances and short-term loans over the Internet as well as by phone. Some of these competitors have larger local or regional customer bases, more locations and substantially greater financial, marketing and other resources than we have. As a result of this increasing competition, we could lose market share, possibly resulting in a decline in our future revenues and earnings."

The customer fills out a short application and provides required documentation, which includes proof of identification, a pay stub or other evidence of income, and a bank statement. If approved, the customer signs an agreement to repay the loan in full on or by a specific date. The customer writes a personal check to cover the amount of the payday cash advance plus the applicable fees and/or interest. An appointment is made to return on the due date of the payday cash advance to repay it, plus the applicable fee and/or interest, and to reclaim the check. If the customer qualifies, he/she is immediately given cash or a check drawn on Advance America's or a lending bank's account in the amount of the payday loan.

Qualification process

The qualification process varies according to which business model is used at a particular Advance America center. Under the standard business model, the center determines whether to approve a payday cash advance application. The center does not undertake

an evaluation of the creditworthiness of its customers, other than requiring proof of identification, a bank account, and a regular source of income. TeleTrack is used primarily for Social Security validation and to obtain charge-off information. Advance America considers the customer's level of income in determining the amount of the payday cash advance.

Under the bank agency business model, Advance America provides information to the lending bank, and the bank determines whether to approve a payday cash advance to an applicant, utilizing its own credit criteria.

Under both models, the Advance America center reviews the documents presented by the customer for completeness and accuracy, makes copies for record keeping purposes, and, if the payday cash advance is approved, Advance America or the lending bank, as applicable, executes an agreement with the customer governing the terms of the payday cash advance.

In Alabama, Florida, and Oklahoma, there is an additional step in the qualification process. Those states require that Advance America use state-approved databases to determine whether or not a customer qualifies for a payday cash advance based on that state's requirements. Advance America uses a database offered by Veritec Solutions, LLC.⁶³

Advance America does not track denial rates. Common reasons for a payday cash advance being denied include an invalid Social Security number, current bankruptcy, the customer already has an outstanding payday cash advance, incomplete documentation, charge-off information on Teletrack, or the customer's income is insufficient for the payday cash advance requested.

Advertising and marketing of the product

Advance America utilizes mass media advertising campaigns (primarily through television, direct mail, and the yellow pages) to increase demand for its payday cash advance services. Advertising expenditures occur primarily during key seasonal periods, such as the back-to-school and holiday seasons in the third and fourth quarters of each year, when consumers are most likely to have short-term liquidity needs. In the year ended December 31, 2003, Advance America's center advertising expense was \$23.9 million.

Advance America utilizes marketing promotions at its centers with high-impact, consumer relevant, point-of-purchase materials. The company also provides their centers with promotional materials such as brochures, pens, key chains, and coupons for use in local marketing. Local marketing also includes attendance at, and sponsorship of, community events such as blood drives, food drives, voter registration programs, and other charitable events.

Drawing on statistical data from its transaction database, Advance America uses direct marketing strategies to advertise to prospective customers who have demographic characteristics similar to its existing customers.

Product limitations

Under the standard business model, payday cash advance limits are set by state enabling statutes, and vary from \$50 to \$1,000. Advance America further limits payday cash advances to a percentage of monthly income. The range of such limitations is 15 percent to 35 percent and varies by state. In the nine months ending September 2004, the average payday cash advance was \$327, and \$321 in the year ended December 31, 2003.

Most states do not allow rollovers. In states where they are allowed, Advance America adheres to CFSA best practices, which limit rollovers to four, or the state limit if it is lower.

Under the agency business model, the bank complies with guidelines established by the FDIC, which pertains to among other things, payday cash advance limits and cooling off periods. In general, a customer must “cool off” after 60 days of consecutive transactions with the lending bank. Under recent FDIC guidance, a lending bank may not make a payday cash advance to any customer who has had payday cash advances outstanding from any lender for more than three months.

Financial education

Advance America promotes financial education to its customers. Through a partnership between its national trade association and the National Urban League, Advance America provides its customers with information on money management. This initiative stems from Advance America’s promotion of the FDIC Money Smart program, also through its partnership with the National Urban League.

The Money Smart financial education program helps individuals learn to open and maintain bank accounts, purchase a home, better save money, protect their credit history, and know their consumer rights. Money Smart is available free of charge in multiple languages and formats. Both of these programs are favorably viewed by Advance America's customers.

The company also offers literature to educate customers about alternative forms of short-term credit such as a loan from another institution, a credit card advance, or an account with overdraft protection.

Advance America provides every customer with a brochure, which provides, among other things, access to the National Foundation for Consumer Credit Counseling and the foundation's toll-free telephone number.

Product usage

Approximately 16.3 percent of customers use the product one time and pay in full without the need for an additional transaction; 32.8 percent of customers use the product two to five times in a year; 22.2 percent of customers use the product six to ten times in a year; and 28.7 percent of customers use the loan over ten times in a year. In 2004, the average repayment period was 15.4 days.

Credit reporting

In states where payday cash advances are offered using the standard business model, the company reports certain information to Teletrack, including charge-offs, recoveries, and bankruptcies.

In Alabama, Florida, and Oklahoma, the company reports the status of the customer's account (active, paid, charge-off, etc.) so that the database can monitor compliance with state law.

Business Aspects

Delinquencies, defaults, and charge-offs

Approximately 5 percent of advances made per payday cycle will not be repaid within the terms of the contract.⁶⁴ Of those, half will ultimately not be collected.

In the standard business model, a payday cash advance is charged off if a customer does not pay at least 15 percent of his/her outstanding balance within 60 days of the due date.

In the agency state model, a payday cash advance is generally charged off 60 days after the due date. As of December 31, 2004, 1.9 percent of outstanding advances were 60 days past due. In 2004, charge-offs net of recoveries were 14.2 percent of fees and/or interest charged to customers and represented 42 percent of average outstanding advances and 1.62 percent of total loans originated.

Collection procedures

As part of the closing process for each payday cash advance, the customer schedules an appointment to come back to the center to repay the payday cash advance on its due date. The day before the due date, the Advance America center calls the customer to confirm the appointment.

If the customer does not return to repay the payday cash advance, the center's manager has the discretion to either (1) commence past-due collection efforts, which typically may proceed for up to 14 days in most states, or (2) deposit the customer's personal check. Past-due collection efforts include:

- contacting the customer by telephone or in person to obtain a payment a promise to pay; and
- attempting to exchange the customer's check for a cashier's check if funds are available.

If at the end of this past-due collection period, the payday cash advance center has been unable to collect the amount due, the customer's check is deposited.

Additional collection efforts are not required if the customer's deposited check clears. If the customer's check is returned because of non-sufficient funds or because of a closed account or a stop-payment order, additional collection efforts begin. These additional collection efforts are carried out by center employees and typically include:

- contacting the customer by telephone or in person to obtain payment or a promise to pay;
- sending a series of collection letters to the customer; and
- attempting to exchange the customer's check for a cashier's check if funds become available.

Major factors affecting profitability

The major factors driving the profitability of the business are: (1) Advance America's ability to attract new customers; (2) its ability to control center operating costs; and (3) its ability to provide an attractively priced alternative to NSF fees, overdraft percentage charges, and other late or delinquent fees.

In terms of attracting and retaining customers, research indicates the most important factors are customer service, the speed of the transaction, price and a convenient location.

Bank Affiliation

Advance America contracts with state-chartered, federally insured financial institutions to offer payday cash advance services in certain states. The company currently contracts with four banks: BankWest, First Fidelity Bank, Republic Bank & Trust, and Venture Bank. As of September 30, 2004, BankWest, a South Dakota bank, was offering its payday cash advance program in 101 Advance America centers in Pennsylvania; First Fidelity Bank, a South Dakota bank, was offering its payday cash advance program in 87 Advance America centers in Michigan; Republic Bank & Trust, a Kentucky bank, was offering its payday cash advance program in 312 Advance America centers in North Carolina and Texas; and Venture Bank, a Washington bank, was offering its payday cash advance program in 30 Advance America centers in Arkansas.

The advantages of such relationships are (1) the ability to offer a payday cash advance service in different markets; and (2) the imposition of discipline and professionalism required by the FDIC's "Guidance to Examiners on Payday Lending." Another advantage is that the company is better able to build a national brand by being in as many states as possible.

The disadvantages of such affiliations are: (1) increased exposure to regulatory change; (2) increased legal, reputation risk; and (3) increased criticism by consumer groups.

Views on the Competitive Landscape

The company sees competition increasing over the next five years. Bounce protection, or overdraft privilege (ODP), poses the greatest potential threat primarily because of the regulatory advantages that banks enjoy relative to payday loan companies. The ODP product is not subject to disclosure requirements, fee caps, or other limitations regarding repeat use.

Advance America believes that the industry will become more competitive as it matures. The primary obstacles to the business are regulatory and legislative. The company believes that, over time, the price of small denomination, short-term lending will commoditize. For example, Wells Fargo offers a competing product at a lower price.

There has been no material change in the regulatory environment since Advance America went public. There are currently 13 states with no laws, so there is still work to be done. Advance America's goal is to work with policymakers and grassroots organizations to facilitate the implementation of a balanced, visible, and predictable regulatory framework that protects the interests of the customers while allowing the company to operate profitably.

Changes in state laws and regulations could have a material adverse effect on Advance America's business, results of operations, and financial condition. By and large, the company believes that increased regulation that is fair and balanced creates a safe harbor and stabilizes the industry and provides a predictable environment for public investors.

Advance America feels that the payday cash advance industry has low barriers to entry. It is highly fragmented and very competitive. Advance America sees significant increases in competition when legislation is favorable, and less when it is restrictive.

Advance America believes that perceptions of payday cash advance providers are mixed. The way it is perceived by regulators is varied. The industry as a whole is positioned negatively in the media, but people who use the service are overwhelmingly favorable. Public perceptions have not impacted competition. The industry is growing rapidly.

Parting Comments

"We believe that it is important to put the payday cash advance product in context with other non-traditional sources of such credit. Only in doing so can policy-makers properly evaluate such issues as prices, APR and patterns of usage."

(Excerpt from the Advance America Response to U-Mass Questionnaire)

Valued Services Acquisition Company (VSAC): Payday Loan Vendor

Background

Valued Services Acquisition Company, LLC is a subsidiary of CompuCredit, a financial services company founded in 1996 to market credit cards to underserved consumers. CompuCredit utilizes proprietary modeling and technology to identify low-risk consumers disqualified for credit using traditional credit scoring methods. CompuCredit is also a leading purchaser and servicer of subprime and underperforming assets, having converted and/or serviced over \$6.4 billion in assets. More recently, it has diversified its product offerings. Today, it is a broad-based financial services company focused on underserved consumers. Its core credit card lending business has broadened to include small consumer loans, auto lending, stored value cards (SVC), debit cards, prepaid telephony, check authorization and guarantee services, bill payment services, as well as portfolio and bad debt purchasing. Its storefront payday loan business is operated through its Valued Services Acquisition Company, LLC (VSAC) under varied store names, including First American Cash Advance and Check Advance.

Payday Product

Description of product

The company operates 520 payday loan, or “deferred presentment product,” stores in 14 states. It uses two different models depending on whether the state allows or restricts payday loans. In four states where payday loans are restricted, West Virginia, Florida, North Carolina, and Arkansas, the company uses the bank agency model and operates as a loan servicer for a state bank chartered in South Dakota. In those states, the bank sets the fees, terms, and rates in accordance with South Dakota and federal law, which is \$18 for a \$100 loan. In the remaining ten states, where the company operates under state enabling statutes, the company uses its standard business model and the cost of the loan will vary according to state law and the term of the loan. In general, on a transaction, the cost will range between \$15 and \$22 per \$100 advanced. In most states, loans are made until the next payday, with a minimum repayment period of seven days and a maximum of 32 days.

The cost of the loan is disclosed on the promissory note or customer agreement as both a dollar amount and as an annual percentage rate (APR) in full compliance with the Truth in Lending Act (TILA).

Application process and requirements

An applicant fills out an application and provides supporting documentation. In general, the supporting documentation consists of a recent bank statement, a contact telephone number, two forms of I.D. (state issued with photo and a second ID with a name and signature), and proof of income (for example a payroll stub or tax record). In those states in which the company services loans for the bank, the application information is input into a computer system and transmitted to the bank for consideration. The bank processes the applicant information and either approves or denies the loan request. If approved, the amount of the loan is determined by the bank and the approval is transmitted to the loan servicer. A proceeds check made payable to the borrower and issued directly from the bank is printed and issued to the borrower. In those states where the company operates under state enabling statutes, the applicant's information is reviewed and the request is either approved or denied based upon company underwriting criteria.

Qualification process

In those states in which the company services loans for the bank, the qualification process and underwriting criteria are determined solely by the bank. At a minimum, an applicant must have a steady source of income, an open checking account with a current bank statement, a valid ID, and proof that he/she lives at the address provided. The bank sets underwriting guidelines, developed in consultation with the software/database operator TeleTrack. The bank's scoring model is based on a number of factors including, but not limited to, the length of employment, income level, bank statement balance, number of NSF checks over the last month, and the length of time in residence. In those states in which the company operates under state enabling statutes, the underwriting criteria are set by the company. At a minimum, an applicant must have an open checking account, a steady source of income, a valid ID, and a verifiable address.

The company's acquired businesses have not historically used FICO scores in qualifying applicants for loans. Effective April 2005, the company is implementing in a phased approach a scoring tool that accesses multiple databases, including TeleTrack, DP Bureau, Lyons systems, eFunds, and credit bureau scores. The company believes that it has as a core competency the ability to build sophisticated empirically based underwriting models that allow it to better identify the risk of individual consumers. The company will not initially report payday loan consumer performance to the credit bureaus, noting that the current credit scoring algorithms used by FICO would penalize customers every time their

FICO score was checked and thus could inadvertently harm their credit. In many instances, the company does use TeleTrack but does not use ChexSystem or TeleCheck.⁶⁵ Important additional qualification criteria are the applicant's work history, his/her contact information and references, and whether he/she uses direct deposit. The latter, though important, is not mandatory.

In those states where loan decisions are made by the bank, 25 percent of loan applications are denied. In those states where the company operates under state enabling statutes, 20 percent of loan applications are denied. The most common reasons for denials are that the applicant does not have an active checking account, has previously been charged off, or has other outstanding payday loans.

Applications are taken at company stores, which are mostly located in strip malls. The stores are open from 10 a.m. to 6 p.m., Monday through Friday, and 9 a.m. to 1 p.m. on Saturday. A small, but growing number of loans are made over the Internet. The company has been able to build underwriting criteria to limit fraud and believes that the low cost of the Internet operating infrastructure relative to the storefronts could make it more profitable than the stores, even at lower prices to the consumer. The company operates through the bank agency model in its Internet, which is more heavily regulated. Overall, however, the Internet remains expensive due to fraud and highly unregulated due to the presence of many unlicensed operators. The company finds that it is safer for applications from customers who have previously done business with the company.

Advertising and marketing of the product

Advertising is done using various channels: television, print ads, flyers, and partnering with vendors, such as MIDAS or local store marketing partners. Direct mail advertising has been found to be the most effective. Available statistics indicate that 50 percent of customers say they "saw the sign" when ask why they chose a particular location.

Loan limitations

In those states in which the company operates under state enabling statutes, loan limits are set by state law and vary from \$300 to \$1,200. In most states the maximum loan amount is \$500. Presently, the maximum loan amount offered by the bank is \$750. Nearly 40 percent of all customers qualify for the maximum payday loan amount.

The company estimates that the average payday loan of \$316, which equates to 28.7 percent of take home pay, assuming that customers' average household income is \$35,000 and average take home pay is \$1,100.

Repayments and rollovers

The average repayment period is two weeks. The minimum repayment period is seven days and the maximum is 32 days. Approximately, 20 percent of loans are monthly. Approximately, 40 percent of customers use the product one time and pay in full without the need for an additional consecutive transaction. Approximately 20 percent of customers use the product two consecutive times and then leave the product for some period of time. The average customer uses the product three consecutive times before leaving the product for a period of time. The company's combined statistical data indicate that nationwide, the average borrower uses the service seven times a year.

In those states in which the company operates under state enabling statutes, state law may specifically limit the number of rollovers and mandate a cooling off period between loans. In bank agency model states, the bank complies with examination guidelines established by the FDIC relating to loan limits and cooling off periods. In general, a customer must "cool off" after 60 consecutive days of consecutive transactions with the bank. The company is currently in the process of developing new product guidelines to respond to recent FDIC guidance requiring that payday loans are not to be provided to customers who had payday loans outstanding from any lender for more than three months.⁶⁶ Effective June 2005, the company and its bank will offer an installment loan to consumers who are not eligible for a payday loan. The company intends to expand on this new product offering over time by introducing risk-based pricing and credit cards and other loan products into the stores.

Customer support services

Community Financial Services Association (CFSA) Financial Literacy brochures are provided in all store locations and are available to all borrowers. Customers view the information positively, while maintaining the privacy of their personal financial affairs. A key part of the company's management program is to encourage managers to "manage" the customer so that they can repay the loan. In some cases this may mean that the manager should suggest a smaller loan amount. Credit counseling is not required under applicable federal or state law.

Credit reporting

Loans are not reported to credit agencies, though the company is in talks with FICO to try to add payday loan repayments to customers' credit scores. The dilemma is that reporting such repayment history could have a negative impact if other creditors view repeated borrowing negatively, despite positive repayment. Furthermore, the credit bureaus face challenges related to the data architecture of their systems that makes the categorization of the payday loan product difficult. All charge-offs are reported to TeleTrack in those states in which TeleTrack is used by the company or bank. TeleTrack is widely used by the microlenders.

Business Aspects

In bank agency model states, a loan is delinquent, as defined by the bank, at midnight on the due date. The loan will be in default if payment is not made by the fourth calendar day following the due date. In those states in which the company operates under state enabling statutes, the loan is delinquent and in default if not paid on or before the due date as set forth in the customer agreement.

In bank agency model states, a loan charges off in accordance with FDIC guidelines, which is generally 60 days after the due date. In those states in which the company operates under state enabling statutes, a loan is charged off 90 days after the due date. The percentage of loans made in 2004 that became more than 60 days overdue was 2 percent. For 2004, charge-offs represented 13 percent of fee and interest revenue and 1.7 percent of total loans originated.

Collections are primarily performed in-house until the loan is charged off. Store personnel comply with all applicable state and federal laws. The company continuously monitors collection efforts and responds to complaints by borrowers.

Financial data related to the profitability of the company's payday lending operations in each individual state are proprietary. However, the company's most recent 10-k filing breaks out its storefront operations.⁶⁷ In states where the company operates under state enabling statutes, the major factors impacting profitability are occupancy costs, loan size, personnel, advertising, and regulatory costs. In these states, relative costs break out as follows: rent 16.25 percent; advertising 8.75 percent; payroll 32.5 percent; store G&A 11.25 percent; corporate G&A 15 percent; and bad debt 16.25 percent.

Views on the Competitive Landscape for Payday Lending

In those states in which the company operates as a loan servicer for a bank, the bank has determined that there exists a demand for the product and the most cost-effective methods of delivering the product is by way of a non-affiliated third-party loan servicer. The major advantage to the bank is a cost-effective method of delivering the product. The advantage to the loan servicer is access to a market that otherwise would not be accessible, albeit as a loan servicer rather than the actual lender. The disadvantage to the company is that the fee received from the bank for provision of loan servicing is considerably less than profits in those states in which the company operates under state enabling statutes.

The company sees several sources of competition over the next five years. The biggest competitive threat comes from other check cashers and retail outlets entering payday lending. Other sources of potential competition come from credit card companies and credit unions. The company feels that credit cards are not a strong threat because they are less convenient than payday loans, with a 7–10 day processing time. Credit unions are not as much of a threat because their credit standards may be too high to serve payday loan customers. Bounce protection is an alternative product but tends to be more costly than a payday loan. Revolving lines of credit are the most competitive product but are generally not accessible to payday loan borrowers because of high credit standards. Short-term, fixed-rate loans are the most competitive with payday lending such as those offered under Georgia's Industrial Loan Act.

The company believes that the industry will continue to grow, but at a slower rate than during the previous five years. There will be more competition in the future. Overly restrictive laws could result in limiting competition and raise the cost to consumers. An increase in competition will decrease costs to consumers. A stable regulatory policy will also encourage more competition.

The company does not view payday loans as highly price sensitive at this time due to the very high costs of alternative outcomes, e.g., late fees, NSF charges, etc. Customer convenience, service, respect, and the speed of the transaction are more important factors to customers than price.

The company feels reasonable regulation of the industry should provide consumer protections while not overly restricting access to the product. This will benefit both

consumers and the industry. Competition will lower the cost to consumers. There is a strong demand for the product and consumers will have to turn to higher-cost alternatives in those states imposing prohibitions and/or unnecessary restrictions. Reasonable regulation encourages entry into the market, which results in competition, which leads to lower prices and better service for customers. Uncertainty in the regulatory arena causes expenses to increase. For example, the company recently acquired three businesses for which it had to fund the majority of its purchase price with equity as opposed to lower-cost debt. The targeting of banks that do business with payday lenders by community groups has reduced the supply of debt financing, which in turn has imposed higher capital costs on businesses that provide these services to consumers. This has resulted in the unintended consequence of consumers paying higher costs to these service providers, and will likely restrict the ability of companies operating in the industry from reducing prices to consumers in an aggressive manner.

Parting Comments

“The majority of state regulators recognizes the need and strong demand for the product, and as a result has supported the passage of reasonable regulations in 37 states and the District of Columbia. As a result of one-sided negative media coverage of the industry, a significant portion of the public views the industry negatively. However, the vast majority of those individuals who actually take the time to learn the facts about the industry understand that the product serves an important need and that it is many times the best alternative for customers. Additionally, the vast majority of payday customers values the product and is glad it is available to them.

We have made a serious commitment to a business model that places great importance on customer retention and being able to offer a variety of financial service products that have value for the customer as that customer moves up the economic ladder. This includes a significant investment in technology that will allow movement to risk-based pricing, multiple product offerings, economic education efforts, etc. If the regulatory or legislative regime changes abruptly, our ability to execute on our strategy will be significantly impaired. Not only will this adversely affect our business model, but, of equal importance, it will adversely affect our customer.”

(Excerpt from the VSAC Response to U-Mass Questionnaire)

¹As used in this paper, the term “monoline” payday lender refers to an entity that provides only payday loans in its retail outlets. The term “multiline” payday lender refers to an entity that provides payday loans as well as other financial products and services.

²Payday lenders operating over the Internet will request electronic access to a customer’s bank account, and use a faxed paper check or the completed online application to obtain the customer’s account routing numbers. See, Fox, JA, and Petrini, A., “Internet Payday Lending: How High-Priced Lenders Use the Internet to Mire Borrowers in Debt and Evade State Consumer Protections,” (November 30, 2004) www.consumerfed.org/Internet_Payday_Lending113004.PDF.

³Some payday lenders also request consent to electronically access a customer’s bank account when the loan is due.

⁴As mentioned later in this report, numerous studies have found a significant level of rollover transactions in the payday loan industry, leading to charges from consumer advocates that payday loan customers are trapped in a “cycle of debt.” As Audrey Cerise, head of ASI credit union told us, “We see many of our customers paying \$80 a month for the same \$300 payday loan.” Not all payday lenders have the same policies and practices regarding rollovers.

⁵Stephens Inc., “Industry Report: Payday Loan Industry,” May 24, 2004.

⁶Stoneman, Bill, “Sizing NSF Related Fees” (Banking Strategies, January/February 2005) (citing studies conducted by Sheshunoff Management Services, Austin, Texas).

⁷May 2004 survey sponsored by the payday lending industry trade group, Community Financial Services Association (CFSA survey) conducted by the Cypress Research Group. Phone interview with Pat Cirillo, Cypress Research Group on May 6, 2005.

⁸The CFSA May 2004 survey estimated that 24 percent of payday loan customers are African American as compared to 21 percent of the population as a whole. High concentrations of payday loan stores in North Carolina neighborhoods are the subject of a recent, highly critical report by the Center for Responsible Lending, “Race Matters: The Concentration of Payday Lenders in African American Neighborhoods in North Carolina” (March 22, 2005). Research conducted by consumer advocacy groups as well as industry-funded analysts indicate that 26 percent of all military families have used payday loans, representing 2 percent of the estimated nine households who used payday loans in 2004. See, e.g., Elliehausen, G., and Lawrence, E. “Payday Advance Credit in America: An Analysis of Customer Demand,” Credit Research Center, Georgetown University, Monograph #35. See also Stephens (2004).

⁹Flannery, M., and Samolyk, K., “Payday Lending: Do the Costs Justify the Price?” April 4, 2005, available at www.chicagofed.org. The paper includes the following disclaimer: “The views stated here are those of the authors and do not reflect those of the FIDC or its Board.”

¹⁰The paper defines a “mature store” as one in operation for more than four years. At “young” stores, i.e., those in operation from 1–4 years, 26 percent of customers used the product more than 12 times a year.

¹¹Data compiled by Rod Reed, Finance Bureau Chief, Iowa Division of Banking.

¹²Compucredit Response to U-Mass Questionnaire on file with author.

¹³Advance America Response to U-Mass Questionnaire on file with author.

¹⁴Partnership for Prosperity, Report to President Vicente Fox and George W. Bush, Monterrey, Mexico, March 22, 2002, p. 3. This recommendation was one of several relating to economic development and growth in Mexico.

- ¹⁵Hernandez-Coss, Raul, "The US-Mexico Remittance Corridor," World Bank Working Paper No. 47 (2005) at p. 5.
- ¹⁶Hernandez-Coss, Raul, 2004 Survey by the Inter-American Development Bank, "Sending Money Home: Remittances to Latin America from the US, 2004" (May 17 Conference), www.iadb.org/mif/v2/remittancesstudies.html.
- ¹⁷See 66 FR 36,620, 36,631 (July 12, 2001). Interagency Q&As published by the Federal Financial Institutions Examination Council (FFIEC) to provide guidance on CRA credit recognize that the scope of the lending test may include "establishing loan programs that provide small, unsecured loans in a safe and sound manner (i.e., based on the borrower's ability to repay) and with reasonable terms."
- ¹⁸Fusaro, Marc, East Carolina University, Department of Economics Working Paper #0505 (2003). This research is based on a survey Fusaro conducted from June 2000 to September 2003. Using modeling techniques, he found that 65 percent of protected overdrafts are "unintentional" and that consumers realize a \$50 surplus in using the programs by avoiding bounced check charges and late fees. His study also found that consumer overdrafts increase by 50 percent when bounce protection is offered by an institution, which seems to suggest that consumers do intentionally use the service.
- ¹⁹Moebs, Michael (2004). Data derived from a summer 2004 presentation made to members of the Federal Financial Institution Examination Council by economist Michael Moebs of Moebs Services.
- ²⁰Stoneman, B., "Sizing NSF-Related Fees" Banking Strategies (January/February 2005) (citing research by John M. Floyd Associates).
- ²¹Ibid., quoting Richard Oliver, senior vice president and retail product manager, Federal Reserve Bank of Atlanta.
- ²²Ibid.
- ²³Cunningham, Mary, "Privilege Pay—Is It Really Such a Privilege?" (USA Federal Credit Union 2005).
- ²⁴Flowers, Robert J. "Impact: Your Bottom Line" (January 2005) a publication of Impact Financial, LLC.
- ²⁵American Banker, "Spare Change: Overdraft Coverage-A Surprising Profile of Frequent Users" (May 5, 2005).
- ²⁶Fusaro (2003).
- ²⁷The report estimated that deposit services charges for selected banks ranged from 23 percent to 82 percent of gross pre-tax income and that NSF fees represented half of deposit service charges (February 2005).
- ²⁸Moebs (2004).
- ²⁹An excellent analysis of the comparative costs of payday loans and other forms of small dollar credit is contained in the Washington State Department of Financial Institution's "Payday Lending Report: Statistics and Trends" (2003).
- ³⁰Department of Treasury, Office of Thrift Supervision, "Guidance on Overdraft Protection Programs" (February 14, 2005). Department of the Treasury, Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, "Joint Guidance on Overdraft Protection Programs (February 18, 2005).
- ³¹Federal Reserve System, Final Rule, Truth in Savings, 12 CFR Part 230, Docket No. R-1197 (May 19, 2005).

- ³²Federal Reserve System, Proposed Rule, Truth in Savings, 12 CFR Part 230, Docket No. R-1107 (May 27, 2004).
- ³³Not all use of bounce protection should be treated as credit. When truly used on rare occasion to cover inadvertent overdraft, the APR could be misleading. However, when used on a recurring basis, the customer is clearly using it as a credit source. Thus, it is difficult to see justification in the TILA exemption.
- ³⁴OCC Advisory Letter 2000-10 (Nov. 27, 2000); OTS Advisory Letter from Richard M. Riccobono to Chief Executive Officers re Payday Lending (November 27, 2000).
- ³⁵Goleta/Ace, NR 2002-85; Peoples/Advance America, NR 2003-6; Brooking/Cash America NR 2003-3; Eagle/Dollar Financial NR 2002-1.
- ³⁶Federally regulated banks and thrifts benefit from federal preemption or so-called interest rate exportation laws that allow their branches and some affiliates to charge nationally uniform interest rates, regardless of usury caps applicable in the state where they are doing business. An excellent discussion of the federal regulatory framework that applies to bank involvement in the payday loan industry can be found in Robert W. Snarr, Jr., "No Cash 'til Payday: The Payday Lending Industry" Supervision, Regulation and Credit, First Quarter 2002, Federal Reserve Bank of Philadelphia, www.phil.frb.org/src/srcinsights/srcinsights/q1cc1.html.
- ³⁷OCC Press Release, "OCC Orders Eagle to Cease Payday Lending Program," NR 2002-01 (January 3, 2002). See also, Fox, J.A., "Unsafe and Unsound: Payday Lenders Hide Behind FDIC Bank Charters to Peddle Usury," Consumer Federation of America (March 30, 2004), which contains a good discussion of federal bank regulatory actions against "rent-a-charter" arrangements.
- ³⁸Letter from FRB Chairman Alan Greenspan to the Honorable Melvin L. Watt (January 2, 2001).
- ³⁹Republic First Bankcorp Inc., Form 8-K, Securities and Exchange Commission (June 27, 2003).
- ⁴⁰Republic First Bankcorp Inc., Form 8-K, Securities and Exchange Commission (October 2, 2003).
- ⁴¹Wells Fargo, a nationally chartered bank subject to the OCC's jurisdiction offers a payday loan product of its own for \$10 per every \$100.
- ⁴²The original guidance was issued in June of 2003, then updates on March 1, 2005. See March 1, 2005 Payday Lending Programs Revised Examination Guidance (FIL-14-2005).
- ⁴³Center for Responsible Lending Press Release, "Analysis of FDIC's Revised Examination Guidance for Payday Lending Programs," (March 14, 2005).
- ⁴⁴See March 1, 2005, Payday Lending Programs Revised Examination Guidance (FIL-14-2005); e-mail communication from Mike Zamorski, Director, Division of Supervision and Consumer Protection to S. Bair (May 17, 2005).
- ⁴⁵FFIEC Interagency Q&A, 66 FR 36,620, 36,631 (July 12, 2001).
- ⁴⁶Federal bank regulators have agreed to revisit Basel I to update capital rules for small and regional banks, in response to concerns that the new Basel II standards will create regulatory advantages for larger banks. See, e.g., American Banker, "Regulators Reverse Stand and Will Revisit Basel I" (June 17, 2004).
- ⁴⁷See, January 31, 2001, Interagency Expanded Guidance for Subprime Lending Programs (FIL 9-2001); March 4, 1999 Interagency Guidelines on Subprime Lending (FIL-20-99), which can be found at www.ffiiec.gov.

⁴⁸All case studies are based on interviews and questionnaire responses on file with the author.

⁴⁹The institutions reviewed for this report by no means represent the universe of depository institutions offering payday loan alternatives. There are many other fine programs being developed, particularly among credit unions. For instance, JP Morgan Chase and the National Federation of Community Development Credit Unions have provided grants totaling \$225,000 to support the efforts of six credit unions to offer payday loan alternatives. These six credit unions are: ASI Federal Credit Union (included in our report); Bethex Federal Credit Union, Bronx, NY; Faith Community United Credit Union, Cleveland, OH; Lower East Side People's Federal Credit Union, New York, NY; Northeast Community FCU, Mission Area FCU and Patelco CU, San Francisco, CA; and South Side Community FCU, Chicago, IL.

⁵⁰FICO scores are credit ratings made pursuant to criteria developed by the FairIsaac Co.

⁵¹TeleTrack is a data provider specializing in subprime consumer credit.

⁵²In Alabama, Florida, and Oklahoma, the company is also required to use a state-approved database, Veritec Solutions, to ensure the customer complies with state restrictions relating to multiple loans.

⁵³Customers who have overdrafts and do not have Checking Plus are charged overdraft fees. Citibank does not agree to pay overdrafts, but as a matter of practice, may let customers overdraw up to \$50 before their checks are returned. Bank employees are encouraged to call customers on the first overdraft to let them know about Checking Plus. The \$50 overdraft limit is not advertised and is designed to address the rare, inadvertent overdraft.

⁵⁴Flannery and Samolyk (2005).

⁵⁵Cirillo (2004).

⁵⁶Regulatory treatment of bounce protection has unfortunately been reported in the press as regulatory endorsement to the potential detriment of those trying to offer lower-cost alternatives. On January 25, 2005, for instance a Forbes.com report stated, "Despite protests by consumer watchdog groups, which claim that these services 'punish the poor' and encourage bad fiscal habits, the Federal Reserve ruled that overdraft plans constitute legitimate fee income, not unfair interest rates," www.forbes.com/2005/01/25/cz_0125findsvp_print.html.

⁵⁷Department of Treasury, et al. Overdraft Guidance (2005).

⁵⁸The FRB's ANPR can be found at www.federalreserve.gov/boarddocs/press/bcreg/2004/20041203/.

⁵⁹FDIC Payday Lending Guidance (2005).

⁶⁰Interview with North Carolina Banking Commissioner Joseph Smith, December 13, 2004.

⁶¹FFIEC Interagency Q&A, 66 FR 36,620, 36,631 (July 12, 2001).

⁶²Institutions subject to these more detailed case studies responded to our questionnaire and provided written documentation. Two other institutions: ASI Credit Union and Windward Credit Union participated through phone interviews on March 30, 2005 (Audrey Cerise, President, ASI) and on April 19, 2005 (Sue Carter, Vice President and Chief of Operations).

⁶³These states seek to limit use of multiple payday loan vendors. For instance, in Florida, a consumer is not legally eligible for a payday cash advance if they have exceeded state imposed rollover limits or if they have had an open

payday cash advance in the last 24 hours. Veritec Solutions is an industry-funded, real-time, centralized database to track payday cash advance activity and assure regulatory compliance.

⁶⁴Assumes 24 cycles per year of 15.2 day duration.

⁶⁵TeleCheck is widely used by retail institutions for check acceptance, verification, and guarantee services. ChexSystems is a network of banks and credit unions that share information about mishandled depository accounts. The information is used to assess risk in opening new customer accounts.

⁶⁶See FDIC Financial Institution Letter, FIL-14-2005, Payday Lending Programs Revised Examination Guidance (March 1, 2005). As previously mentioned, the revised guidelines have the practical effect of limiting the number of payday loans extended to individual customers to six a year.

⁶⁷The company's 10-k can be found on its website at www.compucredit.com.



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