Are Credit Unions Viable Providers of Short-term Credit?

Victor Stango*
Graduate School of Management
University of California, Davis

February 3, 2010

* Contact: University of California, Davis, CA 95691. Email: vstango@ucdavis.edu. Thanks to Kristen Monahan for research assistance. The views expressed in this paper (and any errors) are the author's.

Abstract

Whether banks and credit unions can offer attractive and lower-priced alternatives to standard payday loans is an important question. This monograph presents several new pieces of evidence addressing the question, focusing on credit unions as potential competitors to payday lenders. National data on payday loan offerings by credit unions show that very few credit unions currently offer a payday loan alternative. Industry reports suggest that those credit unions offering such loans seem unwilling or unable to undercut substantially the prevailing prices set by payday lenders. Industry reports also reveal that, relative to standard payday loans, the short-term loans offered by credit unions generally carry greater restrictions on approval and repayment, meaning that risk-adjusted prices for credit union payday loans may not be lower at all. Evidence from the demand side also suggests that current prices and features for credit union payday loans are not competitive; survey evidence suggests that most current payday borrowers prefer higher-priced but less restrictive standard payday loans to lower-priced but more restrictive alternatives offered by credit unions. The combined demand- and supply-side evidence suggests that credit unions are probably not viable providers of short-term credit for consumers who currently use payday loans.

Introduction

The rapid and widespread growth of the payday loan market has sparked considerable controversy. One active debate in that controversy is about whether prevailing rates/fees charged by payday lenders are "too high."[1] Payday lenders argue that rates/fees for payday loans are set slightly above break-even, after covering the costs of offering loans and adjusting for default risk. A counter-argument frequently voiced by credit unions is that those fees cover more than costs, and that credit unions in particular can effectively serve the same borrowers at lower prices.[2] This paper attempts to answer the question at the heart of the debate: can credit unions effectively serve the market in which payday lenders now operate?

There is little hard evidence on whether credit unions can serve as a source of short-term credit for those who currently use payday loans. Two things must be true in order for credit unions to serve as viable competitors. Credit unions must willingly provide some form of payday loan at a lower price. Equally critical is that current payday borrowers must find the credit union version of a payday loan attractive. Even if credit unions offer lower-priced payday loans, those loans cannot compete with standard payday loans if they have qualitative characteristics that potential borrowers find unattractive (such as a less convenient application process), or that would screen most potential borrowers out of the market (such as tighter credit approval requirements).

This paper presents some new evidence illuminating the debate. We first summarize new data collected by the National Credit Union Administration on the prevalence of payday lending at credit unions. Those data cover the entire population of credit unions in the United States, and allow a

[1] A second debate is about whether access to short-term credit at prevailing interest rates helps or harms borrowers. That debate is not the focus of this monograph. For discussion of that debate see, e.g., Zinman (2010) and the papers referenced in that study.

[2] A recent National Credit Union Federation meeting included a session on "Real Solutions to Members' Payday Loan Needs." The session chair noted that "Providing alternatives to payday loans is a good business decision, a good social decisions, and a good advocacy decision." http://www.ncuf.coop/?sectionpath=1/105/106&pageid=552.

comprehensive assessment of whether credit unions find it attractive to offer payday loans. Those data show that very few credit unions currently offer payday loans. Fewer than six percent of credit unions currently offer payday loans, and credit unions probably comprise less than two percent of the national payday loan market.

We also present survey evidence in which credit unions themselves report the greatest practical obstacles to offering payday loans. Responses are generally variants on a single theme: most credit unions do not offer payday loans because they see little chance to break even on a low-priced payday advance product - either because the rates/fees they would charge are too low, or because payday loans are too risky.

The second section of the paper describes the features of credit union payday loans, among those credit unions that offer such a product. It then compares those features to those of the standard payday-lender loan. The comparison includes obvious features such as rates/fees, loan term/maturity and restrictions on who can borrow. The comparison also includes less obvious features such as convenience (location, business hours, application/approval speed) and privacy.

The data on terms shed further light on the difficulty that credit unions face in competing against the standard payday loan. Despite much lower nominal loan APRs, credit union payday loans often have total fee/interest charges that are quite close to (or even higher than) standard payday loan fees. Further, credit union payday loans have tighter credit requirements, which generate much lower default rates. Together, the combination of only slightly lower total charges and significantly lower default rates raises the possibility that risk-adjusted prices on credit union payday loans are no lower than those on standard payday loans. That also suggests that current payday loan fees may be at break-even levels.

Further evidence on non-price terms reveals that tighter credit requirements are not the only negative feature of the credit union payday loan. Credit unions typically have locations and business hours that consumers find less convenient than those of commercial payday lenders. Application times are longer at credit unions. And, default on a credit union payday loan may harm one's credit score, while default on a standard payday loan does not harm one's credit score.

The final section of the paper presents survey evidence asking current payday borrowers to choose between the two versions of a payday loan one can find in the market: one with fees/features matching a typical credit union payday loan, and one with fees/features matching a standard payday loan. The survey questions ask borrowers whether they prefer lower-priced but more-restrictive/less-convenient payday loans to higher-priced but less-restrictive/more-convenient payday loans. The survey also identifies those restrictions/conveniences that borrowers consider most important in assessing the tradeoff.

The survey evidence paints a negative picture of how consumers view credit union payday loans. Most payday borrowers indicate a strong preference for a less restrictive but higher-priced standard payday loan; very few prefer the credit union version of a payday loan. Borrowers' distaste for the credit union payday loan is driven most strongly by credit unions' shorter hours of operation, a lack of privacy conferred because credit union payday loans do not "keep my payday borrowing separate from my other banking, for personal reasons," and the fact that defaulting on a credit union payday loan harms one's credit score.

In short, it appears unlikely that credit unions could serve this market. At lower rates/fees, credit unions are either deterred outright from offering payday loans, or are only willing to offer a type of loan that potential borrowers find unappealing.

Background

Payday loans are short-term advances against a future paycheck. A payday lender generally advances a customer $100-$500 per loan.[3] In return, the borrower leaves a postdated check with the lender for the loan principal plus fees, and the lender deposits the check after two weeks. The loan fee, which one can view as an interest charge, is typically about $15 per $100 advanced.

Payday loans differ in a few ways from auto loans, mortgages and credit cards. Payday advances are uncollateralized, unlike mortgage and auto loans (but like credit cards). Requirements for approval are minimal; most lenders require the applicant to show only a recent bank account statement, a pay stub, and photo identification. In most cases, the only cause for denial is recent default on a payday loan. Payday lenders monitor payday-specific defaults using databases that are not used by other lenders, meaning that the decision to approve and the downside of default for a payday loan are generally independent of the rest of a borrower's credit report. All of these things generate convenience and flexibility for borrowers, albeit at prices that are higher than those on many other types of debt. And for borrowers without any other source of credit, the looser credit standards are also attractive.

For payday lenders the downside of less restrictive approval requirements is more frequent default. Default rates on payday loans are higher than those on other loans, in part because the loans are uncollateralized and in part because payday lenders lend money to riskier borrowers.

Payday lenders also differ from other lenders. Payday lenders are not banks, and often offer only payday loans. The scale of a payday outlet can be quite small and startup costs are minimal compared to those of a bank, meaning that payday lenders quickly saturate attractive markets. That saturation means that borrowers often find payday lenders to be located quite conveniently. Payday

[3] See Stegman (2007) for an overview and history of the market. See also Barr (2004) and Caskey (1994; 2005).

lenders also keep much longer business hours than do banks; some stores are open around the clock. Again, some borrowers view that as a convenience.

Payday lending has become widespread in the United States during the last twenty years. There are currently more than 24,000 physical payday outlets; that figure is roughly 50% greater than the total number of banks and credit unions in the country. Many more lenders offer payday loans online. Estimates of market penetration vary, but most data suggest that between five and ten percent of the adult population in the United States has used a payday loan at least once.

Public Policy and the Policy Debate

If one treats the standard $15 per $100 loan fee as an interest charge, the annual percentage rate (APR) on a typical payday loan is 391%.[4] It is the APR that critics generally cite as the right metric to use for thinking about whether prices are "too high," both because that APR exceeds the levels on most other consumer loans, and because it exceeds the usury ceiling in most states.[5] Critics argue that high prices justify legislation capping payday loan APRs at lower levels; such legislation has passed in some states.

"Too high" can only be measured relative to a benchmark, of course, and for most economists and policymakers the right benchmark is "breaking even," or earning zero profit in economic terms.[6] That benchmark also helps to frame the debate as articulated by credit unions. To argue that APRs charged by payday lenders are too high is to argue either that payday lenders are charging

[4] The law ("Regulation Z") requires that any fee charged only to approved borrowers be treated as equivalent to an interest charge. Application fees charged independent of approval need not be counted as interest. Here, we treat all charges as "borrowing costs," whether they meet the legal definition of an interest charge or not. The question at hand is an assessment of economic costs, which are independent of how the law treats a particular charge.

[5] States that allow payday lenders to operate have typically passed "enabling" legislation allowing lenders to operate without facing an APR-based usury ceiling, or by establishing a payday loan-specific ceiling that is higher.

[6] To be more precise: breaking even here means covering average total costs.

prices that are above their own break-even levels, or that credit unions could break even at significantly lower rates/fees.[7]

The existing academic research identifies some key issues in thinking about whether payday lenders charge break-even prices. Like all lenders, a payday lender must cover the full set of costs associated with its loans. But for payday lenders the makeup of those costs is quite different from that for costs on auto or credit card loans. All loans generate per-loan processing costs, which include both labor and any costs associated with credit scoring. For auto and credit card loans those costs are quite small relative to the loan principal, meaning that break-even interest rates are driven largely by banks' financing costs, adjusted for default risk. But on a payday loan per-loan processing costs are material – a $5 per loan processing cost is substantial on a $200 loan. Equally substantial on payday loans are the fixed costs (overhead) associated with being in the business. Those include rent, building expenses, utilities, insurance and so on. Again, large banks can spread those costs over many more loan dollars than can a payday lender. A final cost for payday loans is default risk. Default on payday loans is more costly than on collateralized loans like auto loans, because on a payday loan the chances of recovering the loan principal are nearly non-existent. To see how this affects break-even loan charges, suppose that a payday lender incurs per-loan costs of $12.00; with no risk of default, the break-even per-loan charge is $12.00. But if five percent of customers never repay the loan, with an average loan size of $300, the break-even per-loan charge rises to $42.00.

That background helps to understand the general conclusion of academic evidence in this area, which is that current fees/APRs are indeed break-even prices for payday lenders.[8] Most per-loan costs on payday loans are made up by what economists would call fixed costs: rent, utilities, and so on. Nearly all of the remainder are labor costs and default costs. That stands in marked con-

[7] One could make the argument by asserting that credit unions have lower costs than payday lenders, but lower costs are not what credit unions (or banks) cite as the reason for their viability in the market.
[8] See Flannery and Samolyk (2005), and Skiba and Tobacman (2007).

trast to most large-principal loans (such mortgages), for which the cost of funds or financing is the biggest share of per-loan costs. What that means in practical terms is that using the APR as a measure of the “markup” on a payday loan is misguided; the APR is really only a good metric of the loan markup when financing costs are the most important component of costs to the lender.

Beyond the evidence directly comparing payday lenders’ costs, a smaller body of work shows that the imposition of rate/fee caps has been shown to drive payday lenders out of business.[9] That is what one would expect if the caps lie below break-even price levels for payday lenders. Nor do payday lenders appear to earn “excess returns” in the stock market.

The evidence to date leaves two questions open. First, even if prevailing fees are at break-even levels for payday lenders, is it possible that credit unions can offer an identical product at lower prices while breaking even? And second, if credit unions cannot break even by offering an *identical* product, can they do so by offering a product that has lower rates/fees but is similar enough to the standard product that borrowers will find it attractive? These two questions are the focus of this monograph. If credit unions can provide such a product, then those institutions should supplant payday lenders, and in doing so make consumers better off. While that change that should occur even without government intervention, its prospect reduces the downside of regulation that drives payday lenders out of business. If it is on the other hand unreasonable to expect other lenders to fill the void left by payday lenders when they are gone, then the argument for legislation that drives payday lenders out of the market is weaker.

[9] See Zinman (2010) and the studies mentioned in that paper. To be precise, these studies show that the rate/fee levels imposed by the caps are below break-even levels.

How Many Credit Unions Offer Payday Loan Products?

A starting point for any discussion about whether credit unions can substitute for payday lenders is to ask whether credit unions willingly offer payday loans. In principle, credit unions face no legal or regulatory obstacles to offering payday loans.

Recently, the National Credit Union Administration (NCUA) began tracking payday loan product offerings at credit unions. Those data are publicly available, and cover the entire population of federally insured credit unions in the United States.[10] The data describe, for each credit union, whether it offers payday loans as well as other detailed information about its location, size, and characteristics.

The data show that as of March 2009, of the 7,749 credit unions covered in the data, roughly six percent (479) offer payday loans. Unfortunately, these data do not include payday loan volume at these lenders. A back-of-the-envelope calculation is instructive, however. If each of those 479 credit unions matches the loan volume of the typical payday lender, then credit unions represent roughly 2% of the national payday lending market. The figure will be smaller if one includes online payday lending. It will also be smaller in states that allow payday lending, because payday lenders are concentrated there.

While the situation may change over time, the available NCUA evidence suggests two things about entry by credit unions into the payday lending market. First, relatively few credit unions find it worthwhile to enter the market. And second, entry by credit unions to date is small compared to the size of the market now served by payday lenders.

[10] http://www.ncua.gov/DataServices/FOIA/foia.aspx.

Why Don't Credit Unions Willingly Offer Payday Loans?

The fact that so few credit unions offer a payday advance product raises a simple question: what is the practical obstacle to offering payday advances at lower prices? To answer that question, we commissioned an independent survey in May 2009 to ask credit union representatives about the downside of offering payday loans. The surveyor (a graduate student research assistant) contacted 46 credit unions via phone calls, starting from a list of 250 credit unions randomly selected from the NCUA data file of 7,749. All respondents were credit union employees, and many were loan officers or branch managers.

Of the 46 credit unions the surveyor was able to reach, 38 responded "no" to the question "Do you offer a payday loan product?" The surveyor then asked an open-ended question, "Why do you choose not to offer a payday loan product?" Most respondents would not supply a reason. Several (7) respondents noted that the credit union was simply unable to process *any* loans because it is too small.

Ten credit union respondents did supply an open-ended response to the question. Of those responses, the most common reason (with 6 responses) for not wanting to offer a payday loan product was that such loans are "too risky." Some of those respondents reported that as a result of direct experience, e.g., "We used to offer payday loans but stopped because delinquencies were too high." The remaining respondents split their reasons between "insufficient demand" and "interest rates are too high." The latter response is in essence a risk-based explanation, as it indicates that the rates required to break even are either unattractive to customers or above a rate that the credit union is willing to set.

While the sample here is small, a consistent pattern does emerge. The practical obstacle to offering payday loans is profitability. Most credit unions do not offer payday loans because at below-market fees/rates, it is too difficult to offset default risk. While this evidence is not conclusive, it is not encouraging for credit unions: it appears that break-even fees are no lower for credit unions than they are for payday lenders. In some sense, this evidence provides a market test of whether credit unions can be competitive providers of short-term credit, and right now that test suggests a negative answer.

What Are the Terms of the Credit Union Payday Product?

There has been little systematic reporting about what terms credit unions set when they do choose to offer a payday product. Knowing those terms is important for the debate; if credit unions can substantially undercut prevailing payday loan rates, their competitive position will be better. Finding that credit unions cannot substantially undercut prevailing payday loan rates weakens the argument that prevailing rates are "too high."

To better understand those characteristics, we commissioned a graduate research assistant to document terms of payday loans offered by credit unions. The research assistant examined online data (via a series of Google searches), and also conducted a phone survey. Other information about terms comes from a reference published by the National Credit Union Foundation.[11]

Before discussing the survey results, two pieces of background are necessary. First, the biggest constraint faced by credit unions offering payday loans is a requirement that federal credit unions charge no more than an 18% APR, which equals $1.50 per $100 of loan principal per month. Most credit unions comply with that requirement. Some state credit unions charge APRs of up to 36%. To offset lower loan APRs, credit unions do two things: they offset low explicit APRs with per-loan processing fees or annual loan program fees, and they impose restrictions on loan terms and

[11] http://www.realsolutions.coop/assets/2009/3/24/REAL_Solutions_Payday_Loan_Toolkit_v032309.pdf .

access. The former raise prices closer to break-even levels, while the latter are intended to reduce default risk.

A second piece of background information is that many credit unions that offer payday loans do so as part of alliances in which a group of credit unions offers the same product, and in which all credit unions pool default risk. The two largest alliances are Better Choice and StretchPay, located in Pennsylvania and Ohio. Better Choice has roughly 80 credit union members, while StretchPay has over 100 – meaning that together these two alliances make up roughly 40% of the national total of credit unions that offer payday loans. So, the terms set by those alliances are very informative, because they have been adopted by many credit unions. What's more, for a credit union, joining an alliance like these two is the most plausible avenue to offering payday loans. One other point worth noting is that the Better Choice program receives subsidies from the Pennsylvania state treasury. Its prices are therefore likely to be below the break-even fees/rates at which credit unions would willingly offer payday loans if unsubsidized.

Both Better Choice and Stretch Pay charge an APR of 18%. Both also charge fees: StretchPay charges an annual fee of $35/$70 for loan amounts of $250/$500, while Better Choice charges a per-loan application fee of $25. Better Choice has a 90-day repayment period, while StretchPay has a 30-day repayment period. Table 1 shows terms of Better Choice and Stretch Pay loans, and shows terms at some other credit unions.[12] Terms of other credit unions' payday loans vary somewhat, but are generally similar in structure: nearly all combine an 18% APR with fees. Some credit union payday loans forgo charging an APR altogether, and simply charge per-$100 fees. One of the more well known of such programs is the Goodmoney program, which has a fee of $9.90 per $100 borrowed, and a two-week loan term. On the high end is the ADVANCPay program operated by Nevada FCU,

[12] For ease of comparison, we list here only "closed-end" payday loans with a fixed repayment term. Some credit unions offer open-end (revolving) lines of credit, but those are less comparable to the standard payday loan (and more comparable to a credit card).

which charges a flat fee of $70 per loan, with loan amounts up to $700. Because these data are not comprehensive, it is possible that other credit unions charge rates/fees that are either higher or lower than those in the sample shown here.

Comparing these terms to those of the standard payday loan involves is not straightforward. One source of complexity is that the total charges for a credit union payday loan may vary based on how quickly the loan is repaid. Another source of complexity is when a credit union imposes an annual fee rather than a per-loan fee, average charges per loan will fall as the number of loans taken rises. Finally, one must account for the fact that some credit unions require a "savings deposit" from the loan principal. Stretch Pay requires a 10% compensating balance, while Better Choice requires 5%. These deposits can only be recovered after the loan is repaid, and effectively reduce the loan amount by either 5% or 10%; for example, a $500 Stretchpay loan above actually leaves the borrower with $450 in short-term cash. The proximate effect of such savings deposits is to increase effective interest rates on credit union payday loans. For example, Veridian Credit Union holds back a full 50% of the loan amount, but charges interest on the entire amount; that effectively doubles the APR paid by the borrower.

Taking all of these terms into account, one can accurately compare loan terms by choosing a representative loan amount and repayment period, and calculating the total cost of borrowing across different products. Table 2 makes that comparison. It compares the total cost of borrowing on a standard payday loan to borrowing costs for the set of programs listed in Table 1. The table compares total borrowing costs for a small ($180) and large ($450) loan with two terms: two weeks and one month. For those loans with two-week terms, the latter scenario represents one "rollover" of each loan.

The table reveals that the standard payday loan compares favorably to some programs and unfavorably to others. There are no columns in which the standard payday loan is more costly in total than any credit union alternative. That stems in large part from the very high fee on the ADVANC--Pay loan. But for loans with smaller amounts and shorter terms, the standard payday loan beats most of the programs in terms of total borrowing cost. In particular, for a smaller ($180) loan over a two-week horizon, the standard payday loan beats three of the other programs, essentially matches one other, and is more costly than two others. Note, however, that Stretch Pay is by far the most common benchmark for other credit unions, and for that term the standard payday loan costs almost exactly as much as a Stretch Pay loan. As loan amounts increase, the loans with lower fees start to win out, and on longer terms the loans with longer terms and/or annual rather than per-loan fees start to win out.

The patterns above suggest one general conclusion and some specific conclusions. The general conclusion is that credit union payday loans are generally less costly than standard payday loans, but often not by much, and that they are sometimes more costly.

The specific conclusions involve how different types of borrower should view the alternatives. All else equal, a borrower needing a small sum for a short period of time may find the standard payday loan to be quite competitive in terms of total borrowing costs. Borrowers who need money for longer periods of time, and who would therefore roll over a series of loans, should find credit union payday loans with longer terms attractive, and among those loans ones with annual fees rather than per-loan fees should be the best choice. Loans with annual fees rather than per-loan fees appear to be rare, however.[13] Borrowers wishing to borrow significant sums should find credit union payday loans with per-loan fees that do not increase at higher loan amounts attractive.

[13] Using Better Choice as an example of a program with only an annual fee may be misguided, because that program is subsidized and may set break-even prices.

Both the tilt toward longer terms and the tilt toward higher loan amounts suggest that credit union payday loans should appeal more strongly to those borrowers in greater financial distress. Borrowers in better financial shape may not be so strongly drawn to the credit union product. That raises a question: is it reasonable to expect credit unions to compete for the more-stressed borrowers currently served by payday lenders? One might expect that credit unions inherently might attract borrowers who are on the high end of the spectrum in terms of financial stability. Such a mismatch between products and borrowers might make it harder for credit unions to make inroads in this market.

As a final observation, the relatively high level of payday loan rates/fees charged by credit unions has proven somewhat controversial. In July 2009, the National Consumer Law Center issued a sharp critique of some credit unions for offering "false payday loan 'alternatives'" that cost nearly as much as standard payday loans.[14] The letter notes that some credit unions "which by law have an 18% usury cap, add fees to manipulate the APRs." In some of their examples, the effective APR on a credit union's payday loan exceeds 400% (that is merely a restatement of the results in Table 2 above, although we prefer to compare borrowing costs rather than APRs). In the same month, the National Credit Union Administration issued detailed guidelines for credit unions considering offering payday loans, with the intent of altering credit unions to the "risks, compliance issues and responsibilities associated with operating a payday lending program." The discussion highlights the difficulty that credit unions face in developing a payday loan product that breaks even at prices below those charged on a standard payday loan.

[14] http://www.consumerlaw.org/issues/payday_loans/content/NCUA-Statement0709.pdf

Qualitative Differences Between Payday Lenders and Credit Unions

Apart from the terms of loans, there are other substantive differences between payday advance products offered by payday lenders and credit unions. Some differences are restrictions imposed by credit unions on approval and repayment. Others are differences inherent in the ways that the two types of institutions do business.

Credit unions generally impose stricter standards for loan approval.[15] Most credit unions require that the borrower be a member of the credit union for 60-90 days before taking a payday loan. Most credit unions deny applications from customers with late payments on other loans, or who have filed for bankruptcy. Some use credit bureau information to screen out bad risks. Some require that borrowers have direct deposit of their paycheck. Many only lend to borrowers above a minimum income threshold.

These restrictions have several effects. By restricting access only to long-term customers with no other delinquent accounts, the credit union uses different, and arguably better, information about creditworthiness than a commercial payday lender would have facing a walk-in borrower. Using credit bureau information represents a greater investment in learning about risk compared to that made by a standard lender. The membership restriction, minimum income requirement and direct deposit requirement change the set of customers who are eligible for loans, generally screening out the more-distressed borrowers and keeping the less-distressed borrowers.

The upshot of all these differences should be lower default rates on credit union payday loans. That is borne out by data from one industry report listing payday loan loss rates at four credit unions with different loan criteria. The first is Prospera Credit Union, which uses the Goodmoney

[15] See http://www.realsolutions.coop/assets/2009/3/24/REAL_Solutions_Payday_Loan_Toolkit_v032309.pdf for specifics. The web sites for Better Choice (http://www.pacreditunions.com/betterchoice.html) and StretchPay (http://www.ohiocreditunions.org/StretchPay/CUInfo.htm) contain details on those programs. The discussion that follows relies on those industry releases for information.

program. That program is quite close to a standard payday loan, has no direct deposit or membership requirements, and only slightly more stringent approval standards; its loan loss rate is 4.6%. Wright-Patt requires 60-day minimum membership and a minimum monthly income of $1,300, but does not require direct deposit; its loan loss rate is 1.7%. Veridian Credit Union uses the same credit scoring database used by standard payday lenders, but requires direct deposit; its loss rate is 1.8%. Four Corners Credit Union requires direct deposit, and has a loss rate of 0.3%. By comparison, the net loss rate for payday lenders is around 4%.

Lower default on credit union payday loans means that a simple comparison of terms or borrowing costs cannot answer the "are standard payday rates too high?" question. Standard payday loan rates are set to cover default risk on standard payday loans. Credit union payday loan rates must also cover default risk, but that risk is lower. Consequently, *default-adjusted* rates/fees at credit unions may be quite comparable to (or even more expensive than) those on standard payday loans.

The qualitative differences between credit unions and payday lenders are subtler but may also matter to consumers. One difference is in application and approval times, which are generally shorter at payday lenders.[16] Store hours at credit unions are limited relative to those at payday lenders, and are sometimes shorter than normal banking hours. While these differences may seem minor, they might matter to payday borrowers.

Consumer Preferences for Payday vs. Credit Union Advance Products

The evidence suggests that standard payday products differ from the typical credit union payday loan on loan terms, borrower/approval restrictions and qualitative features. Many of those differences are

[16] http://www.consumerlaw.org/issues/payday_loans/content/NCUA-Statement0709.pdf

intended to reduce default risk on credit union payday loans, making a comparison of loan terms less than completely informative in the "are rates too high?" debate.

A more fundamental issue is that we have limited evidence regarding how consumers view the differences between standard payday loans and credit union payday loans. The differences in terms and the qualitative differences might be irrelevant to consumers; they could also be highly valued. Learning about borrower preferences therefore sheds substantial light on whether credit unions can be expected to make inroads in the payday lending market.

To answer that question, we commissioned an independent survey research firm to ask forty current payday borrowers a series of questions about standard and credit union payday loans. The main body of the survey began by positing a credit union payday loan with terms slightly better than those offered by the Better Choice program:

> In the next several questions, suppose that your bank or credit union offered a payday advance program that charged an 18% annual interest rate on each loan and a $35 annual fee (paid regardless of the number of loans).

The survey followed up by asking a series of questions comparing that loan to a standard payday loan.[17] Each question also asked the borrower to value one other feature of the credit union product. For example, the question focusing on direct deposit asked:

> If the product had the fees/rates above but *required that the loan be repaid immediately when your paycheck was direct deposited*, and was otherwise just like a standard payday advance, would you use that product to meet short term needs for cash, or would you still prefer to use a payday lender?
>
> a. ____ I would use my bank or credit union
> b. ____ I would prefer to use a payday lender

[17] The store at which the survey was conducted is located in Sacramento, California. Respondents received $25 for participating in the survey.

The survey asked seven such questions, each varying the characteristics of the credit union product. The characteristics were:

- Direct deposit requirement
- Loans only available during normal banking hours
- Default negatively affects credit score
- 5% “savings deposit”
- 30-minute application and loan approval period
- No loan rollovers
- 60 day minimum membership requirement

The characteristics are simply the set of qualitative differences between standard payday loans and those offered by credit unions.

The survey results reveal two pieces of information. First, they indicate the value that borrowers place on lower prices; in the spectrum of prices charged by credit unions, the Better Choice product is quite attractive. Second, by proceeding characteristic by characteristic, the survey elicits information about which non-price characteristics are valued most highly by borrowers.

Table 3 summarizes the survey results. For every characteristic but one, three-quarters (30/40) or more borrowers would prefer a standard payday loan to a credit union payday loan. In some cases, the preference is nearly unanimous. The survey results suggest a ranking of characteristics. The least attractive characteristics are limitations on rollovers and short operating hours. Next are longer application/approval times, and reporting of default to credit bureaus. Minimum membership requirements and savings deposits are also viewed as deterrents to taking out a payday loan. The least unattractive option is payroll direct deposit.

In addition to these questions, the survey also asked two other questions of note, intended to elicit information about the less tangible differences perceived by borrowers across the products. One question asked a direct question about preferred lenders for *identical* products:

> Suppose that your bank or credit union offered a short-term loan product that was *identical* to a standard payday loan. Would you use that product to meet short term needs for cash, or would you still prefer to use a payday lender?
>
> a. ____ I would use my bank or credit union
> b. ____ I would prefer to use a payday lender

This question elicits the borrower's preference for "soft" characteristics associated with each type of lender. It was followed by an attempt to understand what those soft characteristics might be:

> 2. If you answered (b) in the last question and would still prefer to use a payday lender, can you explain why? Please check any reasons that apply.
>
> a. ____ **Location**: my payday lender is closer to my home or work.
> b. ____ **Hours**: Payday lenders let me obtain cash before or after normal bank business hours.
> c. ____ **Speed**: Payday lenders are able to give me cash quickly, without spending a lot of time in the store.
> d. ____ **Privacy**: I prefer to keep my payday borrowing separate from my other banking, for personal reasons.

In the first question, a majority (55%) of current payday borrowers would prefer to borrow from payday lenders even if a bank or credit union offered an identical product. That indicates that for some customers, the qualitative benefits of payday lenders are substantial. Responses to the second question indicate that the most important "soft" features of payday lenders are hours (checked by 77% of respondents), privacy (73%), speed (64%) and location (59%).

Overall, the survey results paint a fairly clear picture. The characteristics of typical credit union payday loans make those loans quite unattractive to most payday borrowers. Most payday borrowers reject a product with even one of those restrictions, and fees/rates substantially lower than those offered by nearly any credit union (the terms of the loan in the survey are less expensive than even the subsidized terms of the Better Choice program). Some of the unattractive features are restrictions on approval or repayment. One interpretation of this result is that borrowers place high value on the option to default, should they be unable to repay the loan. The high value that borrowers place on softer features such as hours of operation and privacy are in some sense more damaging to the credit union business model, as they are inherent in the ways that the two types of institution to business. Even if credit unions decided to mimic the standard payday product as closely as possible, they would be unable to match those features.

Conclusion

It seems unlikely that credit unions can viably serve as providers of short-term credit to the customers currently served by payday lenders. Several pieces of data provide the basis for this conclusion.

First, very few credit unions choose to offer payday loans right now, even though there are few legal or regulatory obstacles to doing so. That evidence is a market test suggesting that the standard payday loan out-competes the credit union version of a payday loan, even given the lower rates on some credit union payday loans.

Second, there is little evidence that credit unions can offer a payday loan with competitive terms at lower prices. Credit union payday loans often have total borrowing costs that are quite close to those on standard payday loans. And, credit union payday loans have lower default risk. There is no compelling evidence to suggest that risk-adjusted prices on standard payday loans are any higher than those on credit union payday loans.

Third and finally, current payday borrowers overwhelmingly prefer a higher-priced but less restrictive loan to a lower-priced but more restrictive loan. Given that standard payday loans are less restrictive than those offered by credit unions, it seems unlikely that even at substantially lower prices a majority of consumers would prefer credit union payday loans.

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Table 1. Terms of Credit Union Payday Loan Alternatives.

	Fee	APR	Term	"Savings" held back
Better Choice (80+ Cus)	$35/$70 per year	18%	90 days	5%
Stretch Pay (100+ Cus)	$25 per loan	18%	30 days	10%
ADVANCPay	$60/$70 per loan	none	2 weeks	none
GoodMoney	$9.90 per $100	none	2 weeks	none
Rivermark	$15 per loan	25%	30 days	none
1st Financial FCU	$50 per loan	10%	30 days	none
Four Corners	$20	18%	120 days	none

Sources: http://www.ohiocreditunions.org/StretchPay/CUInfo.htm,
http://www.pacreditunions.com/betterchoice.html,
http://www.realsolutions.coop/assets/2009/3/24/REAL_Solutions_Payday_Loan_Toolkit_v032309.pdf.

Table 2. A Comparison of Borrowing Costs on Standard Payday Loans and Credit Union Alternatives.

	$180 loan		$450 loan	
	Two weeks (1)	One month (2)	Two weeks (1)	One month (2)
Standard payday loan	$ 27.00	$ 54.00	$ 67.50	$ 135.00
Better Choice	$ 36.41	$ 37.84	$ 73.54	$ 77.09
Stretch pay	$ 26.50	$ 28.00	$ 27.50	$ 30.00
ADVANCPay	$ 70.00	$ 140.00	$ 70.00	$ 140.00
GoodMoney	$ 17.82	$ 35.64	$ 44.55	$ 89.10
Rivermark	$ 16.87	$ 18.75	$ 19.69	$ 24.38
1st Financial FCU	$ 50.75	$ 51.50	$ 51.88	$ 53.75
Four Corners	$ 21.35	$ 22.70	$ 23.88	$ 26.75

Notes: Calculations assume loan amount of $450 for all loans except Stretch Pay and Better Choice. Stretch Pay loans are for $200/$500 before the 10% savings deposit, leaving the borrower with $180/$450 in short-term credit. Better Choice loans are for $189/$472.50 before the 5% deposit, leaving the borrower with $180/$450 in short-term credit. ADVANCEPay uses the non-direct deposit rate to provide comparability to the standard payday loan.

Table 3. Consumer Preferences for Standard and Credit Union Payday Loans, by Credit Union Payday Loan Characteristic

	Consumers preferring:	
Characteristic	Bank/CU	Payday lender
Direct deposit	33%	68%
Normal banking hours only	10%	90%
Default affects credit score	13%	88%
5% savings deposit	25%	75%
30 minute application time	18%	83%
No rollovers	8%	93%
60 day membership	25%	75%

Notes: Results from a survey of 40 current payday loan customers. Survey asks consumers to choose between a standard payday loan and a credit union loan with terms identical to those in the Better Choice program; the credit union loan also has the restriction listed in the "characteristic" column.