

# REGULATORY ALERT

NATIONAL CREDIT UNION ADMINISTRATION  
1775 DUKE STREET, ALEXANDRIA, VA 22314

**DATE:** October 2010 **NO:** 10-RA-13  
**TO:** Federal Credit Unions  
**SUBJ:** Final Rule - Part 701, Short-term, Small Amount Loans

Dear Boards of Directors,

The NCUA Board has amended its general lending rule to enable FCUs to provide members a viable alternative to predatory payday loans.

Effective October 25, NCUA's new rule on "Short-Term Small Amount Loans" will make it more attractive for FCUs to offer this needed service.

## What does the new rule allow?

- Small loans of \$200-to-\$1,000 to borrowers who have been members for at least 1 month;
- Short terms of 1-to-6 months;
- Application fee up to \$20;
- No rollovers;
- **Interest rate up to 28% APR** if FCUs meet all of the above conditions.

The new rule will allow FCUs to meet the short-term cash needs of members, particularly those of modest means.

## Why offer alternatives to payday loans?

Predatory payday lenders charge triple-digit interest rates and exorbitant fees to borrowers who need short-term cash. Borrowers who cannot afford to repay within 2 weeks are often forced to roll over their loans and pay additional fees.

Many borrowers find themselves in cycles where their loans roll over repeatedly, incurring even higher fees. These borrowers are often unable to break free of this unhealthy dependence on payday loans. This dependence often reflects or exacerbates other financial difficulties payday loan borrowers are experiencing. Thus millions of Americans are trapped in a downward spiral of debt which is difficult to escape. Victims of predatory payday loans include credit union members, potential members, and even credit union employees.

The NCUA Board believes the new short-term small loan rule provides the regulatory framework for FCUs to offer members a reasonable alternative to high-cost payday loans.

**Will this rule prohibit FCUs from participating in other types of short-term, small lending programs?**

No. FCUs may participate in any program that provides loans in accordance with the interest rate ceiling, Regulation Z, and all other applicable laws and regulations.

**Why can FCUs charge up to 28% for short-term small loans?**

NCUA's new rule increases the interest rate ceiling for short-term small loans to account for the higher degree of risk associated with this type of lending. The rule allows FCUs to charge an interest rate that is 1,000 basis points higher than the interest rate ceiling as set by the NCUA Board; currently this would amount to 28%. The NCUA Board believes FCUs would not be able to cost-effectively operate a short-term small loan program pursuant to the interest rate ceiling of 18% which still applies to all other loans.

**Can short-term small loans be extended?**

While the new rule specifically prohibits roll-overs, FCUs are permitted to extend the term of a short-term small loan, provided that the conditions below are met. While FCUs are expected to set the term and amount of each loan in a way that allows borrowers to repay it within the term, the NCUA Board realizes that there may be instances where an unexpected event results in a borrower's inability to repay the loan. In that event, the term of the loan can be extended, within the 6-month limit set by this rule, as long as the FCU does not charge any additional fees (other than interest) or extend any additional funds. For example, if a borrower takes out a \$300 loan for 3 months and, at some point within those 3 months, is unable to continue making payments, the FCU can extend the loan term for another 1-to-3 months, but cannot extend new credit or charge additional fees in connection with this extension.

The prohibition against rollovers prevents borrowers from being charged additional fees for extending a loan or re-borrowing funds to avoid delinquency.

**Will FCUs be able to offer short-term small loans to members of the military?**

Yes, FCUs will be able to offer loans under the terms of NCUA's rule to members of the military. Department of Defense (DOD) regulations impose certain requirements on payday loans as they are defined in the DOD regulation. For purposes of the DOD regulation, a payday loan is a closed-end consumer loan

with a loan amount under \$2,000, a maturity less than 91 days, and accompanied by a post-dated payment instrument or authorization to debit a member's account.

Under the requirements of NCUA's rule, most short-term small loans will not meet the definition of a payday loan for purposes of the DOD regulations. While all loans made under this rule will be for less than \$2,000 and many will have maturities of less than 91 days, FCUs are not required to accept a post-dated payment instrument or obtain authorization to debit a member's account. FCUs wanting to offer short-term small loans to members of the military, therefore, can permissibly structure their short-term small loan programs so as to not have to comply with the DOD regulations.

**Must the loan be amortized, or can the borrower make a balloon payment at the end of the loan term?**

The loan must be amortized in such a way that allows the borrower to repay the loan in the given term. FCUs must structure the payments so that the borrower is paying a portion of the principle and interest in equal or near-equal installments on a periodic basis over the course of the loan. While NCUA is not prescribing specific payment schedules (such as monthly or bi-weekly), FCUs should offer payment schedules that allow borrowers to easily repay the loan within the given term.

**May multiple loans be made to a borrower?**

No. FCUs may make only 1 loan at a time to a member and no more than three loans in any rolling six-month period. The intent is to prevent members from becoming over-extended.

**What can the application fee cover?**

The Federal Reserve Board's Regulation Z defines an application fee as the fee necessary to recoup actual costs incurred by the lender in reviewing an application and is charged to all consumers who apply, regardless of whether credit is actually extended.

In order to reach borrowers who need alternatives to payday loans, FCUs are not expected to subject applicants to extensive reviews of their credit-worthiness. The application process typically involves verification of employment, age, and residence. Therefore, an FCU's application fee can only be the amount needed to recoup the actual costs associated with processing an application, with a maximum amount of \$20. If an FCU undertakes a more limited application process with repeat borrowers, there would be no justification for charging the same application fee each time the borrower applied. *The NCUA Board emphasizes that FCUs cannot use the application fee to offset the higher degree of risk associated with this type of lending.*

### **Are FCUs required to charge an application fee?**

No. This new rule does not require FCUs to charge any application fee. If FCUs do choose to charge an application fee, that fee cannot exceed the processing costs or \$20, whichever is lower. FCUs should evaluate member needs and the cost of processing applications in determining whether to impose an application fee and the amount of such fee.

### **Does the provision that allows only application fees prohibit an FCU from charging late fees?**

No. FCUs may charge late fees provided the fees are in accordance with all applicable laws and regulations. The NCUA Board, however, cautions that FCUs should establish the term and amount of a short-term small loan so that a member can pay back the loan without incurring any late fees.

### **Why is there a membership requirement for a short-term small loan?**

If a short-term, small amount loan borrower has no prior relationship with the FCU, there is a greater risk that the borrower may walk off with unsecured cash and never return. However, if the borrower is a member of the FCU for a minimum of 1 month before receiving a short-term small loan, this will reduce the chance of default. FCUs are encouraged to evaluate their risk tolerance and set a membership requirement accordingly.

### **Is there an aggregate lending cap on short-term small loans?**

FCUs offering short-term small loans are required to establish a lending cap in their written lending policies on the aggregate dollar amount of short-term small loans outstanding, not to exceed 20% of the credit union's total net worth.

### **Can payroll deduction be required for the short-term small loan program?**

No. The Federal Reserve Board's Regulation E prohibits financial institutions, including FCUs, from conditioning an extension of credit to a member on the member's repayment by preauthorized electronic fund transfers. However, under Regulation E, FCUs can offer members a lower interest rate or other incentives if they participate in payroll deduction. The NCUA Board believes payroll deduction is an important tool for FCUs to utilize in lowering the risk associated with these loans. The NCUA Board encourages FCUs to incentivize or otherwise encourage members to utilize payroll deduction if it is available through the member's employer.

### **How does the Dodd-Frank Wall Street Reform and Consumer Protection Act support FCUs offering a short-term small loan program?**

The Dodd-Frank Act includes federal assistance to federally insured financial institutions that are providing small loans. Specifically, §1205 of Title XII

authorizes the Secretary of the Treasury to establish multi-year demonstration programs with eligible entities to provide low-cost, small loans to consumers that will provide alternatives to more costly payday loans. Institutions participating in programs under this section are required to promote and provide financial education and literacy to small loan borrowers.

In addition, §1206 amends the Community Development Banking and Financial Institutions Act of 1994 by requiring the Community Development Fund to make grants to community development financial institutions (CDFIs) and to any other federally insured depository institution with a primary mission to serve targeted investment areas to enable such institutions to establish a loan-loss reserve fund to defray the costs of a small loan program established or maintained by such institution.

This section also requires the CDFI Fund to make technical assistance grants to be used for technology, staff support, and other costs associated with establishing a small loan program. To receive a grant or technical assistance grant under this section, a financial institution must have or establish a program with loans under \$2,500 that are paid in installments with no pre-payment penalties, and the institution must report payments of the loan to at least 1 consumer reporting agency and meet any other affordability requirements established by the Administrator of the CDFI Fund.

Title XII also grants the Secretary of the Treasury the authority to issue regulations implementing and administering the grants and programs discussed in Title XII.

The requirements of NCUA's short-term small loans rule will not prohibit an FCU, which is otherwise eligible, from receiving a grant or participating in a program under the Dodd-Frank Act. FCUs will be able to comply with the requirements of NCUA's rule to take advantage of the higher interest rate and still be within the limitations of Title XII.

### **What underwriting standards are required for short-term small loans?**

FCUs are required to establish underwriting standards in their written lending policies for short-term small loans. The NCUA Board believes FCUs are in the best position to evaluate the needs of their members and their risk tolerance and set appropriate underwriting standards. Guidance on how to structure underwriting for short-term small loans is included in the Best Practices section of the NCUA rule.

### **Are the Best Practices required to offer short-term small loans?**

The Best Practices section of NCUA's rule is guidance, not a regulatory requirement. The NCUA Board believes the suggestions in the Best Practices section will be beneficial to FCUs and members, but recognizes that each FCU should have some flexibility to determine the features of its own program.

### **Will NCUA reevaluate the rule?**

Yes, NCUA is adding new items to the 5300 Call Report and Credit Union Profile to collect data over the next 12-to-18 months about the success of short-term small loan programs under this rule. The data will include information about delinquencies, charge-offs, number and dollar amount of loans made, and what features FCUs are offering to members.

After NCUA has sufficient data, the NCUA Board will evaluate the success of the rule and make changes, if necessary, to improve the rule for consumers and FCUs.

### **What will NCUA examiners review during examination of short-term small loan programs?**

Examiners will review the written short-term small amount lending policy as well as the FCU's procedures and processes to determine whether:

- Proper underwriting standards have been established and are being followed;
- Loans are being made in a way that provides the member with the best chance to successfully repay a loan made under this rule;
- Application fees are being used to recoup costs associated with processing an application and not to account for the riskier nature of this type of lending;
- A lending cap has been established to limit the aggregate dollar amount of short-term small loans to a maximum of 20% of net worth.

If you have any questions about this final rule empowering federal credit unions to offer short-term small loans as a viable alternative to predatory payday loans, please contact your district examiner or regional office.

Sincerely,

/s/

Debbie Matz  
Chairman