Testimony of Edward H. Jacob, Manager/CEO
North Side Community Federal Credit Union
Before the House Oversight and Government Reform Committee
Subcommittee on Domestic Policy

Chairman Kucinich, Ranking Member Issa, and distinguished members of the Subcommittee, I appreciate the opportunity to testify before you today on the issue of payday lending.

I am Edward Jacob, Manager of North Side Community Federal Credit Union in Chicago. Before coming to North Side since 1999, I worked at Bank One and its predecessor banks, First Chicago and First Chicago NBD in lending and Community Reinvestment positions.

North Side is a 33 year-old community development credit union with assets of $8 million and loans totaling over $3.5 million. We are certified as a Community Development Financial Institution (CDFI) by the U.S. Treasury, and have a low-income service designation from the National Credit Union Administration (NCUA). North Side offers savings and checking accounts and ATM cards to 3,000 members. Loan products include small consumer loans, VISA credit cards, new and used auto loans, and a small number of home equity and mortgage loans.

North Side serves individuals who live or work in the Chicago neighborhoods of Lakeview, Uptown, Edgewater and Rogers Park. These neighborhoods, while undergoing revitalization over the past decade, continue to be economically and ethnically diverse with many individuals who are unable to utilize traditional financial service institutions. For these community residents, North Side serves as an alternative to the many predatory financial institutions operating in the neighborhood.

Throughout our 33-year history, North Side has focused our efforts on helping low- and moderate-income people build wealth through basic financial service products. We focus our products and services on the low-income and unbanked segments of our community, offering savings and checking accounts with no minimum balance, and invest heavily in financial literacy programs for people to better understand how to budget and save. Our loan products target specific unmet needs where we can add value for individuals and the community.

THE PAYDAY LENDING INDUSTRY

If there is one thing the booming payday business in the last 15 years has proven, it is that there is demand for small, short-term loans. The industry has grown from 200 outlets in 1993 to over 25,000 outlets today, and now increasingly, payday loans are also available on-line. They do roughly $48 billion in annual business, with over $8 billion in annual fee income, have over 20 million customers, and process over 160 million transactions annually. According to the Community Financial Services Assoc. of America, 68% of their customers are under 45 years old, 75% have incomes over $25,000 and 25% have incomes over $50,000, and 42% own their own home. All have checking accounts (if accessing a traditional payday loan, the customers typically write a post-dated check or repay the loan from an ACH withdrawal from an existing account).

One of the reasons the industry has enjoyed this rapid growth is that they offer convenience – a borrower can walk in and have their loan 15 minutes later. But of course this convenience comes at a price. When we have members come into the credit union who are in trouble with payday loans, we ask to see a copy of their loan note. We have seen notes with APR’s ranging from 300% to over 900%.

DEVELOPMENT OF THE NORTH SIDE PRODUCT

Prior to the development of our Payday Alternative Loan (PAL), North Side offered a small, $500 credit builder loan for our members, but required membership for one year for the loan. As we worked to develop our Payday Alternative Loan (PAL), we had the assistance of many private and public sector partners. The National Credit Union Administration has been supportive of our work both on the regulatory and examination side, and with their Office of Small Credit Union Initiatives (OSCUI). The CDFI Fund of the

U.S. Department of the Treasury provided initial financial support. We participated in the National Community Investment Fund's Retail Financial Services Initiative, which helped us measure profitability of the loans. Local banks have also provided support – both financial and technical as we developed and studied the product.

We developed our Payday Alternative Loan (PAL) in mid-2002. What prompted us to get involved is what you just saw in the video, when one of our members brought in her sister who was in trouble with payday loans. She'd taken out seven payday loans, owed about $3,000, and was using every paycheck just to pay the rollover fees on her loans.

While she paid $3,000 in interest and rollover fees on these loans for a few months, she had not paid a penny of principal on her loans. Not only that, when we ran her credit report, none of the payments showed on her credit report. Not only was there $3,000 gone that she couldn't spend on her kids, or on investing, or on a downpayment for a home, but she wasn't building up a positive credit history. Her story, and similar stories from other community residents pushed us to act.

STRUCTURE AND UNDERWRITING

We structured our Payday Alternative Loan as a $500 loan, at 16½%, for a six-month term. We structured it as a six-month term loan because we felt the structure of a traditional payday loan (with the entire balance due in one month) encouraged rollovers. Realistically, few borrowers have the ability to re-pay the entire loan after two weeks or one month – so they begin to be caught in the trap of an ongoing cycle of debt. Initially, we offered the PAL with no minimum credit score. The goal was to bring new members into the credit union, and then work with them to improve their financial situation.

We made an underwriting changes in December of 2004, when we instituted a minimum credit score of 580 for new PAL borrowers. If the applicant doesn't meet the minimum credit score, we will still make the loan, but we require that they go through our financial training program. We want to work with them, but they also have to show us a commitment that they want to improve their financial knowledge and their financial future.

In some ways, North Side PAL borrowers are similar to those of the payday lending industry noted earlier. Credit scores (which were run initially for statistical purposes only) averaged 532, and only 10% had scores over 600. Many people had previously taken out payday loans, but over 25% were unbanked, and never had a checking or savings account. Of the borrowers, 60% were African-American, 17% Latino, 14% Anglo, 5% Asian. Over 60% of the borrowers were female, and 95% made under $40,000/yr in income. Over 40% of the borrowers identified the use of the funds as "paying bills," although in some cases we made loans to pay off existing payday loans.

We have made over 4,200 of these loans over the last five years, totaling over $2.1 million. To date, we have charged-off about $140,000, roughly 6.7%. As of the end of February, our 60-day delinquencies are 5%. While obviously higher than other loan products, PAL is a sustainable product with this portfolio performance.

OTHER FINANCIAL INSTITUTIONS OFFERING ALTERNATIVE TO PAYDAY LOANS

I am pleased that North Side is not alone in working to develop alternatives to payday loans. Over the past four years, other banks and credit unions have also developed and tested products in this area. In 2004, the National Federation of Community Development Credit Unions (NFCDCU), with the support of JP Morgan Chase, created the Alternative Products to Payday Lending (APPLE) program, through which seven credit unions in six states were selected to create and develop alternatives to high-cost "payday" loans.

The credit unions selected include ASI Federal Credit Union in Harahan, LA, Bethex Federal Credit Union in the Bronx, NY, Faith Community United Credit Union (in Chairman Kucinich's district in Cleveland, OH), Lower East Side People's Federal Credit Union in New York, NY, Northeast Community FCU, Mission Area FCU and Patelco CU in San Francisco, CA, South Side Community Federal Credit Union in Chicago, IL, and West Texas Credit Union in El Paso.

State Employees Credit Union in North Carolina has also been a leader in providing small, short-term loans to it's members. Through it's salary advance program, it provides over $20 million a month in short-term, affordable (12%) loans to it's members, and in 2003, it developed a savings enhancement, whereby 5% of the loan proceeds are deposited into a savings account to help the borrower break the cycle of ongoing debt.

Banks are also working to serve this market. In Chicago, Austin Bank of Chicago offers a payday alternative product, and First Bank of Oak Park has partnered with a community organization in West Garfield Park to offer a product. LaSalle Bank, partnering with the Local Initiatives Support Corporation, also offers small emergency loans in 11 Chicago communities.

LESSONS LEARNED

I believe here are three key lessons we have learned over the past four years with our Payday Alternative Loan product.

1. The product is not used for a one-time emergencies.

In a large percentage of instances, people are not taking out these loans for a one-time emergency. If I had a dime for everyone who told me the car broke down, and they needed to fix the car to get to work, I would be a wealthy man. Someone once asked me once what was the solution to payday lending problem in our country. I said it is simple - build better cars. But the reality is that many people face ongoing cash flow problems. They are not just living week-to-week and paycheck-to-paycheck, but living a week **before** paycheck to a week **before** paycheck. That is the reality of many Americans. And that is why the traditional payday loan is so destructive. They are being offered to customers who continually roll them over because they are unable to pay the loan back when it is due. The repeat customer is the payday lenders most profitable customer. The purpose of our PAL is to get our member out of the cycle of debt, and to move on to other wealth-building products.

2. Issues of profitability

I am often asked about the profitability of our PAL product. In late 2002, we were fortunate to be chosen to participate in the Retail Financial Services Initiative (RFSI), sponsored by the National Community Investment Fund. Through RFSI, six banks and six credit unions who were working on products to serve low-income and unbanked markets received assistance in product development, underwriting, and measuring profitability. This was a three-year project to try new products to reach out to the unbanked and to measure profitability of the products.

The goal for our PAL is to have a sustainable product. A $500 loan at 16½% for six months generates only $25 in interest income. As a federally chartered credit union I have an interest rate cap of 18% on my loans. State chartered credit unions and banks can charge a higher APR.

North Side has not structured the product to make money on it on a product basis. As payday lenders have shown, they can be tremendously profitable at 400%, even with high charge-offs. But I believe small consumer loans, appropriately underwritten and done efficiently, can be profitable on a stand-alone basis at between 20% and 30%.

One way to increase profitability is to reduce the transaction costs as much as possible. Use of technology and offering an electronic product can cut the transaction costs significantly, and improve product profitability.

At North Side, we view profitability on a relationship basis. Over time, how many PAL borrowers are staying with us, moving on to better products for themselves and for us as a financial institution. We measure a number of things with our PAL borrowers – the use of other deposit products (and balances), and whether they later take out larger loans (eg. Auto loans) that are profitable.

So far we've made over 150 loans totaling over $600,000 to what we call PAL "graduates", members who started with a payday alternative loan, and were able to move on to larger loans. As members take out auto loans and mortgage loans, those are loan we can make some money on.

3. Moving people out of the cycle of debt is a difficult issue.

I don't want to be the cheapest payday lender. I'm pleased that we are saving our members and the community so much money, and providing an alternative to the payday lenders, but the most important difference between North Side and a payday lender (even more important than the interest rate) is that I want to move people **out** of my payday alternative loan product. This is often the most difficult thing for us. It is not my mission and vision in life to have members come in and take out this loan every six months. And that is where I think the really hard work is, is to take people along a better financial path. Alternatives Credit Union in New York has developed a model called the Credit Path, a model of how to help people build net worth and build assets. All of us, banks and credit unions, have got to do a better job of this.

CONCLUSION

We are pleased with the results of our work over the past few years in this area. It has been a successful product for North Side - we have established it in a sustainable way, and it has helped us grow our membership and provided ancillary marketing benefits. But more importantly, it has been a successful product for the community and our members. Every dollar that is paid in interest and fees to a payday lender represents a drain on the local community. As seen earlier in the video, one of our members who had taken out 7 payday loans paid over $2,900 in interest and rollover fees over a 4-month period. When she refinanced this loan with us, and successfully paid off the loan in 6 months, she paid less than $85 in interest. This left over $2,800 in additional funds to meet the needs of housing expenses, food, clothing or savings, all of which can be recycled in the community to boost the neighborhood economy.

For the 4,200 Payday Alternative Loans we have funded so far, our members have saved over $3 million compared to interest and fees which would have been paid on typical payday loans. These are funds which, instead of being stripped from the neighborhood economy, can be used to build community wealth.

I'm a small, $8 million credit union on the north side of Chicago, and I've saved my members and my community about $3 million compared to traditional payday loans. If I can do that from my 2,500 square foot storefront, think of what other larger financial institutions can do with their expertise, their knowledge, and their technology. We all can do more, and we must.

Thank you very much.