

Roundtable 3

Case Study #4

Northside Community Federal Credit Union

Chicago, Illinois

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Program Description

The Northside Community Federal Credit Union (NCFCU), a not-for-profit cooperative financial institution owned and controlled by its members, has created an important loan product, called Hot Funds/Cold Cash, that serves as an alternative to pay day loans for its members. This is an extremely important advancement as the pay day loans are often very detrimental to many of its users and it is critical to develop alternatives.

Program Goals

The credit union seeks to offer an alternative to the currency exchanges (known as check cashing outlets in many other parts of the country) without the high fees. They also seek to offer banking services to people shunned by the commercial banks and the restrictions that they impose. Hot Funds/Cold Cash is a major part of their efforts to help people move away from high cost fringe banking institutions.

Organization Description

Founded in 1974, Northside Community Federal Credit Union (NCFCU) is a not-for-profit cooperative financial institution owned and controlled by its members. It is a Community Development Credit Union, which was created to serve the needs of low income members living or working within a defined geographic area and businesses and community organizations located in the defined geographic area. The credit union has a small branch with four staff and a volunteer board. Operationally, Northside seeks to be self sufficient from its own revenues. It does not want to seek operating grant support for its activities or to fuel its growth.

Types of Financial Services

To join, a household needs to deposit a minimum of \$15 into the savings account, called the Share Savings account, and pay a membership fee of \$1. This account earns dividends with a minimum balance of \$5. The checking account, called No-fee Share Draft account, is available if the savings account is \$200 or more and a reduced version, called the No-fee Economy Share Draft account is available with a savings account of \$100. Northside also offers CDs, Visa credit cards, an ATM with cards, direct deposit and payroll deduction plans with employers. Bill paying through credit union checks, photocopying and faxing are also available.

While the credit union will accept cash and checks for deposits, it does not cash checks at this time because it does not dispense cash. The security issues are too great, so Northside tellers do not have cash to dispense. It has considered cash dispensing, but it would have to incur new costs

to create greater security, such as installing bullet proof glass, using security guards or cameras, etc. The credit union does not have these funds and does not want to change the character of the office. (However, the CU does have an ATM and this vehicle offers a viable means of providing some cash to members.)

The credit union also offers loans for consumer purposes, autos, mortgages and home improvements, education and debt consolidation. Members are eligible for loans if the Share Savings account has a minimum of \$85. A member may borrow up to \$6,000 on a signature; larger loans require security. The credit union also offers a very important loan that serves as an alternative to pay day loans. (See next section.)

Loans for new and used cars comprised almost 50% of Northside's outstanding loan portfolio (12-31-01) and home equity loans comprised an additional 16% followed by debt consolidation at 7.12%. Loans for home purchase and home repair were relatively small because the office is located in a relatively high cost area. Similarly, there were relatively few small business loans. Car and home loans have some security for the loans and therefore can represent slightly lower risk lending.

PayDay Loan Alternative

Northside offers a loan called "Hot Funds, Cold Cash". This is an especially important product. It is providing an alternative to short term pay day loans. The CU offers this short term loan product, but the rate and fee structure is much more reasonable for the borrowers and does not force extremely difficult choices caused by the constant rolling over of fees every two weeks or so if the loan cannot be repaid. The loan program offers up to \$500 and is repaid with equal monthly payments over a one year term. Partial payments are allowed and there is no prepayment penalty for early repayment. In the past, the program had required that the borrower be a member of the credit union for at least one year with an income of at least \$1,000 per month. It also required that the applicant had no current loans or rejections in the last year. Recently, the credit union raised a grant of \$20,000 from Northern Trust Bank to act as a segregated loan loss reserve for this program. As a result, starting January 1, 2002, Northside will be able to make these loans without the 1 year membership requirement. The applicant will need to demonstrate an up-to-date work history if the membership record is not met. The term will be shortened to six months. The rate of 16.5% and the initial loan fee of \$10 will remain the same. The credit union will run credit reports (not for loan approval but to understand the credit background and history of the borrowers) and ask the purpose of the loan under the new program, which it did not do under the old program. With some of the employer groups, Northside will obtain repayment through direct payments from the borrower's paycheck.

Beginning in 1994 and running through 2001, Northside had made 1,779 loans in this program totaling \$889,500. These loans comprised 34% of the number of outstanding loans at the end of 2001 – the largest single loan type; however, the outstanding loan amount for this loan product equaled only 3.23% of the credit union's total outstanding loan portfolio. The loan application process is very simple with a brief application form (account number, date, social security number, name, address, home and work phone, employer, position, work address, gross monthly income,

date hired, residence – own/rent/other, and purpose of the loan). There is no real underwriting of the loan applicant as there would be with a personal signature loan.

The economics of this loan vary dramatically with that of pay day loans. The latter keep rolling over high fees roughly every two weeks if the borrower cannot repay. Pay day lenders do not allow partial repayments; this often forces borrowers to keep rolling over the loans and incurring continuous fees. As a result, the APR can reach well into the high hundred percentages on an annual if the borrower requires a full year or more to repay. In contrast, Northside earns \$45.88 in interest and a \$10 fee for a \$500, one year loan at 16.5% if the loan is repaid at maturity. If the loan is repaid prior to maturity, the earnings are even less. The loans require at least 10 minutes of staff time, even though the process is very simple, and the time increases greatly if there are any collection problems. The credit union hopes to break even on these loans and not create financial damage for its members. But the loan product does not generate profit although it is a major part of the organization's activities (234 of these loans were outstanding at 12-31-01 out of a total of 693 total outstanding loans for the credit union). The default/writeoff rate of around 3% is relatively low, but is nevertheless twice as high as the default rate on the credit union's other loans and can still strain the credit union's resources. If the volume increased, these economic factors would not change – increased scale would still not generate additional profit. However, the program has been beneficial in some other ways for the credit union, as some borrowers have improved their financial condition over time and have moved on to take out car loans at a later time.

Start Up Costs and Funding Sources

New programs are planned and implemented very inexpensively. There is a marketing committee comprised of some board members and the manager. They consider new product and program ideas, review other organizations and their programs and undertake all the planning and any necessary training internally with very little added cost.

Phase In Plan

As noted above, the Hot Funds/Cold Cash program began in 1994 under a particular loan structure. Experience guided the credit union to recently make some changes – e.g. reduced to six months term, prior one year membership no longer required, etc. – that were not part of a planned phase in program. In general, Northside tends to plan and respond to its members' needs through all of its programs and services.

Pricing of Services

The overdraft fee is \$12 (compared to \$29 charged by most large banks). The withdrawal fee for the ATM is \$1 and the deposit fee is \$2. The fees for withdrawal from the low-balance share account are \$1 for accounts less than \$100 and \$5 for accounts less than \$50. The visa account charges an annual fee of \$7.50 with a late payment fee of \$5. The bill paying service charges \$.50 per check. The photocopying charges are \$.20 and \$.25 for letter size and legal size paper, respectively. Faxing costs \$1 for each page received and \$2 for the first page sent and \$1 for each additional page sent.

Car loans varied in rate depending on the loan to value of the loan and the term of the loan (from 24 months to 60 months) and whether the car is new or used. The range in the rates was 7.5% to

12.25% as of February 2002. Rates were also lower if the borrower were a member for over 5 years, repaid the loan through payroll deductions or direct deposit, held a checking account at the credit union or had repaid three loans in full. The late payment fee for loans is \$10, again much lower than many other institutions. Since loans for new and used cars comprised almost 50% of Northside's outstanding loan amount (12-31-01), the rates for these loans were the most important. However, the rates for the other loans also were very competitive. Northside pays interest on its savings accounts; the rate tends to be equal to or higher than many other institutions offer.

Revenues

Gross revenues have grown steadily over the past six years, from 1996 to 2001, based on the audits for the first five years and internal financials for 2001, from \$323,543 to \$485,665. In the earlier years in this time sequence, investment income was a larger absolute and percentage source; for example, of the credit union's total income of \$323,543 in 1996, \$155,849 was from investment income with only \$99,291 from interest income on loans and \$51,521 from fees/charges. This balance remained for a while, but has shifted, particularly in the last few years. At the end of 2001, income from investments totaled \$87,075, while income from interest and fees from loans was \$267,590 and income from fees was \$98,161. The credit union began doing a better job of lending to its members in the later years and its income position has improved accordingly.

Operating Costs

Unaudited financial statements for 2001 showed \$351,962 in expenses, of which \$171,638 was for salaries and benefits. The next greatest expense was for office operations followed by the loan loss provision of \$22,000. They also spent over \$11,000 on marketing and over \$9,000 on professional and outside services. The credit union is run with very low costs. Like other institutions that compete with check cashers (called currency exchanges in Illinois), they must operate with a different cost structure and overall business model.

Projected Losses

The credit union has an historic rate of charge offs in its portfolio of 1.55% of total funds lent, as of 1-31-02. At the same date, the write offs for the Hot Funds/Cold Cash program were 3.01% (\$26,829.61), or roughly twice the rate of write offs of the total portfolio. The average loan amount written off under this program was \$282.41. The total number of loans written off under the program is 95, or 5.34% of the total number of loans disbursed. Delinquencies have also run at a higher rate historically under this program, roughly 3 times more. The credit union had delinquencies of 2.44% on its total portfolio at 1-31-02. While the performance of the Hot Funds/Cold Cash program is below that of its general lending, the performance record is, nevertheless, very good. A larger organization with greater financial cushion would be able to more easily absorb this risk.

Profit/Cash Flow

Northside does generate some net income. However, credit unions either distribute most of the income or net earnings back to members in the form of dividends or use them to build reserves. Northside tends to distribute most of their earnings back to members. In 2001, the credit union generated a surplus of income over expenses of roughly \$132,700; of that total, \$122,400 was

scheduled to be returned to the members as dividends. The amount of dividends has grown in most years since 1996, jumping from just under \$79,000 in 1999 to over \$148,000 in 2000. The reduction in 2001 is most likely due to lower interest rates and therefore, lower spreads on the loans for a financial institution.

As described above, the income generated by the Hot Funds/Cold Cash program is minimal. Over the course of a year, one of these loans might break even if there were no problems and it is repaid on time. It is difficult to estimate whether the program as a whole achieves break even, however, it is likely that it generates a small operating loss in addition to its actual loan losses.

Rates of Return

The “equity” in a credit union is provided by the members, mostly in the form of regular shares (savings accounts), share drafts (checking accounts) and CDs. The total member equity in 2001 was \$5,411,786. With additional equity in the form of reserves and undivided earnings, the total equity in 2001 was \$5,859,875. There were minimal liabilities – \$23,623, with this type of accounting. The assets, which are almost entirely comprised of equity, took a large jump in 2001 from \$4.8 million to \$5.86 million. The credit union is doing an excellent job of increasing deposits and loans recently. The actual capital, sometimes thought of as equity in other businesses, is comprised of regular reserves and undivided earnings. At the end of 2001, Northside’s capital was \$424,467, creating a capital ratio of 7.2%.

Volume/Scale

Northside has not grown as quickly as some of the other credit unions in the country. One of the reasons is that it does not seek out operating grants, as some of the other credit unions do. Northside has an operational goal of being self sufficient, and this goal has strengthened the organization on the one hand, but helped to create lower growth on the other hand. However, the volume of lending is increasing – both the numbers of loans and the outstanding loan amounts – and this continued performance will continue to improve profitability. This will be very important, as the credit union is probably not yet at a volume, which can generate economies of scale for their activities. One of their goals is growing to a larger scale at which they can provide the services at the same or lower costs and generate greater net income from the earnings. The credit union is also heavily dependent on one depositor (see next section) and this could cause major difficulties at their present scale.

Ongoing Subsidies

The credit union has a very important goal of breaking even. In addition, it wants to break even from its own income and does not want to depend on operating grants. As a result, it does not attempt to obtain subsidies for most of its activities. In some cases, however, it does have some assistance, although this assistance is not sought for operations. Instead, it seeks some assistance for new program development and similar types of support. For example, the credit union won a CDFI Fund award, which will be used for capital (\$150,000) and enhanced technology (\$50,000). It also obtained a \$20,000 grant from a bank to act as a reserve for its Hot Funds/Cold Cash program. It also has an investment (called secondary capital by the credit unions and which functions as a subordinated loan) of \$100,000 from Bank One and the credit union does solicit other lower return deposits from friendly organizations. Moreover, its largest single depositor is

Lakefront SRO, a local nonprofit housing development corporation with \$2.7 million in deposits. The developer could possibly obtain higher rates from another source; and removal of this account, if the nonprofit ran into some problems, for example, could be devastating to the credit union.

Staff Training/Needs

The credit union was staffed by volunteers during its first 10 years of operation. Now, there is a full time staff of four – manager, loan officer/assistant manager, teller and member services officer and a marketing manager. The staff needed little training to implement the Hot Funds/Cold Cash program, which is very straightforward and has a simple application and processing procedure.

Technology

High technology approaches do not play much of a role in the credit union's activities. It uses more of a "low tech, high touch" approach. Nevertheless, a basic level of technology – computers, ATM, etc. – is crucial to the smooth operations of the institution. The credit union decides to use less technology when there are interfaces with members.

Legal Issues

There were no meaningful legal issues in the development and implementation of the Hot Funds/Cold Cash program.

Regulatory Issues

The credit union is a regulated financial institution that must address all the normal regulatory issues faced by any similar regulated institution. The use of a reserve fund under the newer Hot Funds/Cold Cash program was probably helpful in gaining acceptance from the regulators, although the historic loss rate for the program was not out of line.

Market Study

No market study was undertaken. The credit union staff and board understood the conditions facing their members and saw the negative effects of using pay day loans. As a result, they designed and implemented the alternative program, beginning in 1994. This was very insightful since the pay day loans had not become very widespread at that time.

Marketing

The marketing is done mostly through Northsides's relationships with local employer groups using the credit union's services. The employers tend to be nonprofit organizations. The marketing is done formally and informally through flyers, promotions, presentations, etc.

Locations, Hours

Northside has one small location on the north side of Chicago near the lakefront. It is open from 8 to 3 on Tuesday and Wednesday, 12 to 7 on Thursday and Friday, and from 8:30 to 1 on Saturday. On Friday's, staff also travel to the largest employers from 1 to 3 and offer transactions on a laptop that is connected to the main computer in the office. The credit union is closed on Sunday and Monday.

Partnership Issues

Northside has loose partnerships with employers to implement direct deposit and payroll deductions, large depositors and others interested in assisting their community development goals. These partners also result in some of the larger deposits, which form the lifeblood for Northside and also are heavily involved with the financial literacy training, as described below.

Procedures

Special procedures for the program are not really necessary. The application and approval processes are very simple and straightforward.

Financial Literacy Training

Some of the financial education occurs in one-on-one situations with members. There are also more formal course trainings given over periods of several weeks. These courses are usually given with the employer/partners, such as Lakefront SRO, where there have been trainings with the tenants. The Northside staff prepares and presents the trainings.

Issues and Concerns

- Northside has a relatively low level of assets. This is a hindrance as there are fewer economies of scale and less capacity to help its members and to achieve wider impact. The management is very aware of this situation and has targeted growth as one of its major goals.
- The profitability needs to be improved along with the need for growth. New members need to be added who can offer more profitable activities and some ways to assist the existing members to increase their own personal wealth would help the profitability of the credit union at the same time. Similarly, the level of capital is relatively low (although meeting regulatory requirements) and this could make it more difficult to meet major emergencies. Management is very clear about these needs as well, and is taking steps to address it.
- The salaries appear to be very low. This may make it difficult to attract and retain high quality employees, although the present staffing appears to be doing an excellent job. It may affect the long term capacity and the ability to grow, as noted above. The low salary levels are somewhat offset by a strong benefits package, including a company match for the first 5% an employee invests in a 401k account and an excellent health insurance program that covers all family members for \$30 per month.
- There is a major dependence on friendly depositors. One in particular has a disproportionate level of deposits that could devastate the credit union if something were to happen to that organization (which has a long history and is in good financial condition at the present time). Here again, the need for growth and lowered depositor concentration can be highlighted.

Lessons Learned

- Northside is working on creating a new business model for providing services to the unbanked and fringe banked. Commercial banks are very dependent on fee income for their retail operations. In fact, Chicago has been the site of the beginnings of this

approach, as First Chicago (now part of Bank One) began charging a \$3 teller fee in 1995. It was among the first large banks to try to make its retail services pay for themselves. However, a community development credit union cannot charge high fees if its clients are mostly low income people. First, they cannot afford it. Second, they will go to the fringe banking institutions, even if they are more expensive. Therefore, the credit union, like other financial institutions trying to serve low income people, is creating a new approach. It is centered on low cost operations, very low fees on its financial services and generating break even or slightly better cash flow from its accounts and its lending.

Another benefit for many commercial banks operating in a middle or upper income market is the capacity for cross selling. Banks want their customers to use as many of their products as possible – checking and savings accounts, loans, credit cards, etc. While they may not make money on some of these products – such as checking accounts, banks use fees and machines (ATMs, online banking) to generate lower costs with some profit and also have the higher margin products to generate additional profit. This cross selling is much more difficult in a low income community. Residents have a lower level of funds to put into various types of accounts or utilize additional products, making cross selling less realistic. They also tend to have worse credit, making lending more risky.

- Therefore, the economics of the business model used by Northside and other institutions working in low income areas are difficult. Most banks tend to be loosely structured on the “80/20” rule, in which the bank makes little money on 80% of its customers while most of its profit is derived from 20% of its customers. For this credit union, there is a much worse ratio – a 90/10 ratio or worse, in which it makes most of its profit from 10% of its members and breaks even or literally loses money on the remaining 90%. This approach can result, overall, in breakeven or low profit operations. For example, about half of the credit union’s accounts have less than \$100 and about 75% have less than \$250. These accounts are expensive because there may be many withdrawals as well as some deposits, which require time to administer while yielding little spread income, especially if the institution is not charging high fees for these transactions for low balance accounts. High numbers of transactions and low balances create a difficult economic proposition for a financial institution. They are balanced by a few accounts with relatively high balances and few transactions; these accounts generate the necessary income.

This model has severe drawbacks, especially when the economy is having difficulties that can result in lower deposit levels, lower spreads on accounts as the interest rate environment falls and greater losses occur from defaults and collection costs. In difficult economic times, the dividends paid to members also decrease as there are more losses, more draws on the loan loss reserves, and potentially, a reduction in the capital supporting the institution. It can also result in reductions in withdrawals and a slowing in adding new members who want to open new accounts.

- The issue of scale is reflected in the range of products that the credit union offers. While it does offer the pay day loan alternative, the credit union does not offer check cashing, another important feature in addressing the needs of low income people using fringe banking institutions. Check cashing is not offered because of the issues

- associated with security for the cash that would be needed and the subtle changes that would occur between the CU and its members. In part, this is also an issue of scale. The scale issue is also reflected in the credit union's capacity to withstand losses under the Hot Funds/Cold Cash program. While its loss rate of 3% is excellent in many respects, Northside's capitalization structure and overall size can be strained by this level of losses. A larger, more fully capitalized institution may more easily absorb this level of loss. In order to be a fully effective alternative to fringe bankers, an institution needs to be able to offer the full range of financing products needed by its constituents.
- Viable options to pay day loans must be developed. There is a major effort throughout the country at present to eliminate or restrict these loans. This effort is very appropriate. However, if pay day loans were to end or be rendered ineffective, many borrowers could be forced to find other lenders who could be even worse. Therefore, it is very important to develop viable alternatives. Northside offers one such possibility, although with limitations: it requires credit union membership and a credit union or similar institution willing to offer these loans. It would be important for the credit union trade associations and other interested parties to publicize this option and others more widely and to help interested institutions implement these new approaches. Additionally, other options need to be developed for locations without interested credit unions or other similar institutions. Finally, alternatives for people who do not want to join credit unions or other institutions need to be developed.
 - The related issue for pay day loan alternatives is scale. Pay day loans and other fringe banking institutions and products have spread with remarkable rapidity across the country. Therefore, it is equally important to not only develop pay day loan alternatives but also to find ways to achieve scale in these efforts. Moreover, it is also important to find ways to make them more accessible to a wider range of people. All credit unions, for example, only lend to their members (and cash checks, usually, only for their members). The check cashing outlets accommodate everyone. Similarly, the check cashing stores have many more branches convenient to their customers and they are open for much longer hours and on the weekends as well. To compete on a larger scale and meet these financial needs, the alternative lending institutions will have to find ways to expand their coverage, locations and hours. Northside is moving in this direction with its programmatic change eliminating the one year membership requirement.
 - Viable options for larger loans up to five years for automobiles, furniture and other higher cost items must also be created. Fringe lenders charge excessive rates and fees in these areas also. Northside has a large lending niche in automobiles; other credit unions do as well. Predatory mortgage lending is another large arena for fringe lenders. It is also an area that credit unions have successfully addressed and created major alternatives. These lending products serve as excellent models and demonstrate the effectiveness of profitable lending at reasonable rates with secured loans.
 - Northside is led by a very competent manager, Ed Jacob, with great vision and energy in addition to an exceptional level of experience in the banking world. The staff is similarly dedicated, especially given the relatively low salaries. These conditions exist in almost all successful community development efforts, so it is clear that these people exist. Nevertheless, it is important to try to build these institutions so that more of these

- people are drawn to the field and receive appropriate training and support. There is no replacement for the kind of leadership – managerial, technical and vision – that exists at Northside and other community development institutions.
- There are different types of credit unions. One is founded on a membership base that is connected to one or more employers or industry groups. They typically serve moderate and middle income households. The NCFCU typifies another type of credit union and is called a Community Development Credit Union (CDCU); please see Case Study #1, Bethex Federal Credit Union and Case Study #6, Northeast Community FCU for descriptions of other CDCU programs. They are usually created in low income areas to serve low income people. As a result, their programs, emphases, goals and products are often different than the mainstream credit unions. There are also far fewer CDCUs (over 200 CDCU's compared to a total of over 10,000 credit unions in the country as a whole) and they tend to be small and not well capitalized. However, they tend to know the low income neighborhoods and the needs of low income households well. While the more mainstream credit unions do not know the issues in low income neighborhoods as well as the CDCUs, they have much greater size and there are many more of them. It is therefore important for these credit unions to become more involved in offering financial services in low income neighborhoods. Some CDCUs have created partnerships with the other CUs and these are very important and encouraging. More of these partnerships are needed and deepened assistance from existing partnerships will be essential in the future. Together, both types of CU can increase the effectiveness of programs designed to assist low income neighborhoods.