Consumer Lending & the California Finance Lender's Law
February 11, 2012
2:00 p.m.
California State Capitol, Room 444

Key Questions & Themes:

As policy makers ponder the issues surrounding the California Finance Lenders Law (CFLL), a few key questions may be able to help shape the debate:

1. How can we increase access to small dollar credit at lower costs, while ensuring more entities can enter the marketplace?

2. Consumer loans under the CFLL above $2,500 have no restriction on the annual percentage rate (APR) that may be charged. This can result in potentially costly borrowing options for consumers. What is the appropriate balance between increased consumer protections and ensuring access to credit? Do these loans have sufficient underwriting criteria to ensure that the borrower can pay the loan back?

3. Car title lending is regulated under the CFLL without specific language in the CFLL to govern all of the practices related to car title lending. Is it necessary to create specified requirements in the CFLL regarding car title loans?

4. The structure of the CFLL provides specific tiers of allowable charges for loans under $2,500, loans from $2,500 to under $5,000, loans from $5,000 to under $10,000 and finally loans above $10,000. Each of these tiers provides for certain allowable interest charges and payment schedules. Does this current framework function for all participants or should consumer lending statutes undergo large scale reform?

5. Currently, the CFLL Pilot Program for Affordable Credit Building Opportunities has three licensees. What can be done to encourage more participants? What has limited participation? Is it the lack of demand? Should the Pilot Program be a starting point for CFLL reform?

6. What impact does unregulated internet lending have on CFLL lending? How can this be qualified?

7. What data should be collected from the small dollar lending industry?

Highlights of this Report:

- The CFLL provides for varying rate structures depending on the amount of money borrowed. The consumer lending structure of the CFLL involves installment loans both secured (car title lending) and unsecured loans. APRs on these consumer loans vary from 36% to over 100%.

- The Federal Deposit Insurance Corporation (FDIC) estimates (National Survey of Unbanked and Under-banked Households) that one third of households nationally, utilize alternative credit products, which would include loans offered under the CFLL.

- While the economic downturn has restricted credit in some cases, credit cards remain the primary source of credit use for consumers seeking to meet short term needs, though it is estimated that almost 1/3rd of consumers do not have a credit card.

- California Finance Lender (CFL) licensees conducted 381,131 unsecured installement loans and 38,148 auto title loans for a total of 419,279. The total dollar amount of these loans was $968,768,000.

- 258,273 CFL loans were made in amounts under $2,500.

- A large percentage of CFL loans (89,989) occurred in the $2,500 to $4,999 range at APRs above 100%.

- Based on staff review of a popular online CFLL lender that offers high costs installment loans at rates exceeding 100% APR, if the borrower took the loan to term, at the advertised 139% APR, for the full 47 months they would have paid back $13,914.62 (interest-principal-origination fee) on a $2,525 loan. This comes out to $11,389 in interest charges.

- In California, 28% of adults do not have a checking or savings account, according to the U.S. Census.

- Payday lending happens at a rate almost 30 times more frequently than CFLL small dollar loans

General Overview:

The CFLL applies to lenders who make consumer or commercial loans, whether unsecured or secured by real or personal property or both, to consumers for use primarily for personal, family, or household purposes. The CFLL is regulated by the Department of Corporations (DOC). The CFLL is in the California Financial Code, Division 9, commencing with Section 22000. The regulations under the CFLL are contained in Chapter 3, Title 10 of the California Code of Regulations, commencing with Section 1404 (10 C.C.R. §1404, et seq.).

The CFLL was enacted by the California legislature effective on July 1, 1995 and consolidated and replaced the Personal Property Brokers Law, the Consumer Finance Lenders Law and the Commercial Finance Lenders Law which were previously applicable to personal property brokers, consumer finance lenders, and commercial finance lenders.

According to the DOC, finance lenders and brokers, by number of licensees and dollars of loans originated, are the largest group of financial service providers regulated by the department. A finance lenders license provides the licensee with an exemption from the usury provision of the California Constitution. Licensed under the law are individuals, partnerships, associations, limited liability companies and corporations. The law requires applicants to have and maintain a minimum net worth of at least $25,000 and to obtain and maintain a $25,000 surety bond. In general, principals of the company may not have a criminal history or a history of non-compliance with regulatory requirements.

In addition to the lending authority provided by the law, the CFLL provides limited brokering authority. A "broker" is defined in the law as "any person engaged in the business of negotiating or performing any act as a broker in connection with loans made by a finance lender." Brokers licensed under this law may only broker loans to lenders that hold a CFL license.

Several entities are not required to be licensed under the CFLL, including banks and savings and loan associations, credit unions, mortgage lenders, licensed check cashers, licensed pawn brokers or those licensed under the deferred deposit transaction law (DDTL). "Non-loan" transactions, such as bona fide leases, automobile sales finance contracts and retail installment sales are also not subject to the provisions of the CFLL. Violating the CFLL can result in penalties of $2,500 for each violation, imprisonment (for not more than one year)—or both—and willful violations can also be punished by a fine of $10,000 in addition to imprisonment (for not more than one year) or both.

The CFLL provides for varying rate structures depending on the amount of money borrowed. The consumer lending structure of the CFLL involves installment loans both secured (car title lending) and unsecured loans. APRs on these consumer loans vary from 36% to over 100%. Who makes use of the costly products? The FDIC estimates (National Survey of Unbanked and Under-banked Households) estimate that one third of households nationally, utilize alternative credit products, which would include loans offered under the CFLL. Generally, it is understood that the unmet need for affordable small-dollar loans is very large, and the Center For Economic and Policy Research has concluded via their study, "Small-Dollar Lending: Is There a Responsible Path Forward" that "it is reasonable to infer from the very large size of the current market for ultra-high-cost credit…that the unmet demand for high-quality small-dollar loans is very large. Presumably, all of those who currently obtain ultra-high-cost loans would, other things being equal, prefer to obtain much lower-cost affordable loans." What drives the high cost nature of these products? The answer to this question is the real core of the controversy concerning CFLL installment loans, and to a larger extent, payday loans.

In 2010, the Center for Financial Services Innovation (CFSI) reviewed the subject of small dollar loans, including obstacles to greater access and growing alternative approaches. CFSI states that installment loans are costly to provide due to the operation of physical stores and underwriting expenses. Furthermore, they stated, "One industry representative estimates that achieving breakeven with a $200 loan requires charging borrowers an APR of about 250%. The breakeven APR drops to approximately 145% if the volume of $250 loans reaches 1,000. Larger loans in the amount of $2,500 would require APRs closer to 44%, and the breakeven APR would drop to a projected 35% if 1,000 loans at that amount were made." On the other side of this debate some argue that the high interest rates are not a reflection of actual risk, but an attempt to exploit customers for greater financial gain.

Last year, on January 9, 2012, the Assembly Banking & Finance Committee held a hearing "Update on the California Finance Lenders Law." Witnesses at that hearing represented a broad spectrum of industry participates and consumer organizations. The results of that hearing provided committee members with an overview of the CFLL market and products. While legislation was not a direct result of that hearing it has provided policy makers with an overview of a segment of the lending market that is typically not filled by larger financial institutions. Furthermore, that hearing revealed the pace at which a new CFLL pilot project (discussed later) was getting off the ground in order to effectively fill the void in the small dollar lending market.

Industry representatives at the January hearing described the cost pressures of finding capital to lend as a major driver of costs and the high interest rates. Additionally, the borrowers for these products, due to low credit scores, are deemed high risk. Furthermore, some CFLL lenders offer one product at a location, meaning that the costs of offering that product cannot be absorbed into other operations. The overhead cost of offering one product results in a higher proportion of costs per loan. One industry participant relayed to the committee that marketing costs meet or exceed the costs of capital.

A particularly interesting line of questioning at the January 9th hearing involved default and repossession rates in the car title lending industry. Adequate data on this point is not available. One industry witness speaking on behalf of one company revealed that for their company the default rate was around 12% with a 6-7% repossession rate. All industry participants claimed that repossession was the last option as the costs of repossession are expensive because the automobile must be held in storage for 30 days. After repossession, the auction price is used to cover any outstanding costs with any surpluses going back to the consumer, per California law.

The primary reasons that the committee continues its research in this area are, first, the need for the underbanked or unbanked to access affordable credit has been an ongoing concern for policy makers nationwide. Second, due to the high cost nature of some of these products, it is a priority that policy makers continue to monitor this lending market to ensure that both credit and consumer protection needs are met.

This area of lending is typically not fulfilled by mainstream financial institutions like banks and credit unions. Furthermore, the preceding economic downturn has tightened credit for all consumers, specifically low to moderate income families with median credit scores. As traditional forms of credit, such as credit cards have become more restrictive, the use of alternative means has increased. While the economic downturn has restricted credit in some cases, credit cards remain the primary source of credit use for consumers seeking to meet short term needs, though it is estimated that almost 1/3rd of consumers do not have a credit card. According to the Federal Reserve, nationwide credit card debt is $858 billion making it the third largest source of household indebtedness. Given the large percentage of credit card use, small installment loans and payday loans are a drop in the credit ocean, yet that makes them no less important, especially for consumers that cannot access a credit card. Whether it is a credit card, or non-traditional means of credit it is clear that the utilization of credit to make up for diminished income is not sustainable for a borrower.

CFLL licensees constitute a class of “exempt persons” for purposes of California’s constitutional usury limitations (Cal. Fin. Code § 22002). The following are the charges and fees allowed under the CFLL for consumer loans:

Loan Amount	APR restrictions	Other restricts
$225-$2500*	12-30% depending on principal amount of loan	Administrative fees are capped at lessor of 5% of principal amount of loan or $50.
Over $2500	No APR cap	For loans under $5000 licensees are prohibited from imposing compound interest or charges and are limited in the amount of any delinquency fee that may be imposed.

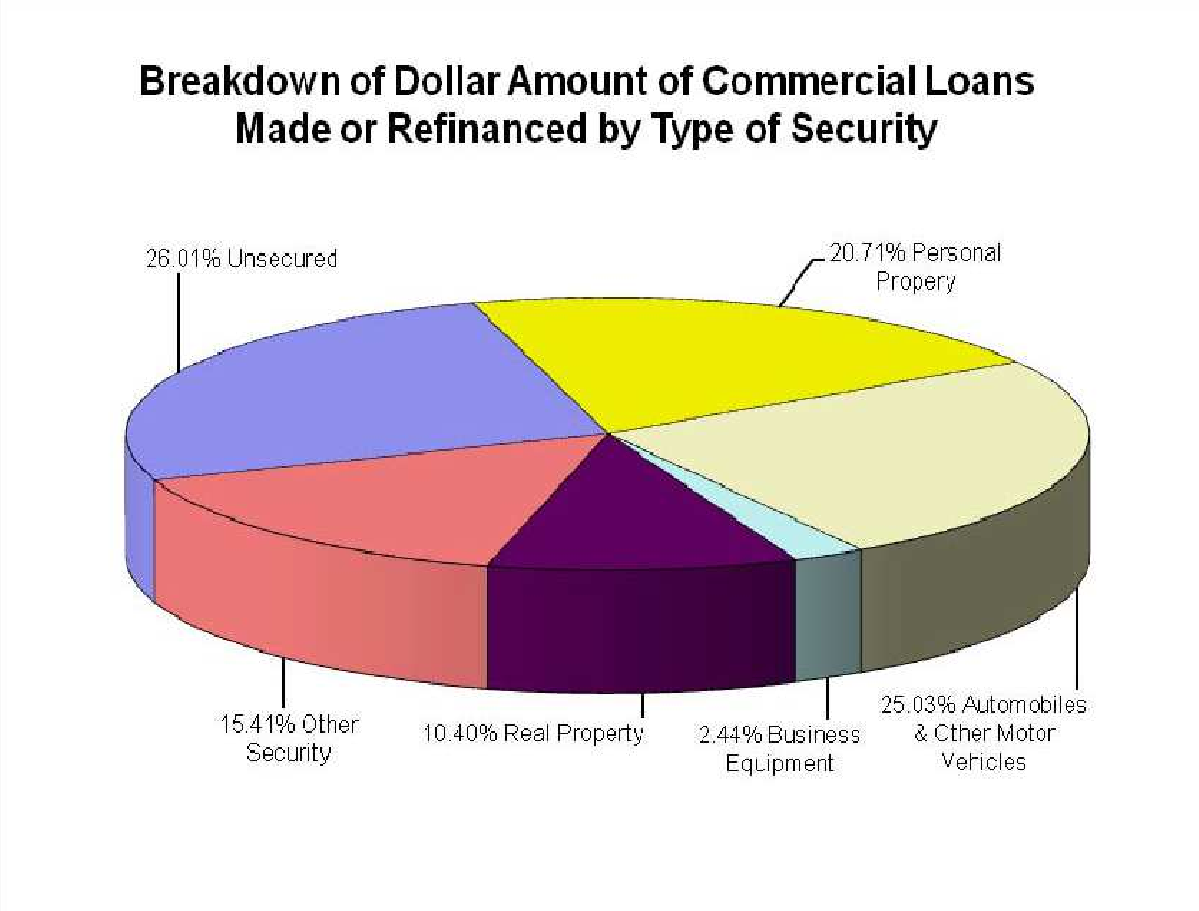
*Exceptions apply under The Affordable Credit-Building Opportunities pilot program beginning at F.C. §22348. Additionally, please see attachments to this document for further details.

Every year, DOC releases a report of statistical data regarding the CFLL compiled from data required to be submitted by licensees. The following charts and data come from the *2011 Annual Report: Operation of Finance Companies Licensed Under the California Finance Lenders Law:*

CALIFORNIA FINANCE LENDERS					
Calendar Year	Number of Loans Made	Principal Amount of Loans Made	Average Size of Loans Made		
			Consumer Loans	Commercial Loans	All Loans
2011	3,076,347	139,166,897,599	36,097	47,604	45,238
2010	2,560,497	114,778,811,783	44,920	44,805	44,827
2009	2,207,881	89,287,544,941	42,814	39,932	40,440
2008	2,249,716	110,013,356,592	30,138	54,460	48,901
2007	2,893,697	202,350,867,103	52,331	76,851	69,928
2006	3,940,311	315,492,843,743	106,657	63,574	80,068
2005	3,653,036	285,178,701,531	88,605	70,803	78,066
2004	4,167,772	246,616,649,910	50,861	68,536	59,172
2003	5,140,316	278,153,215,784	28,264	96,559	54,112
2002	3,522,892	179,873,083,672	27,363	78,928	51,058

California Finance Lenders
Loans Made or Refinanced By Size
For Calendar Year 2011

Size of Loan	Number of Loans	% of Total Number	Principal Amount (in thousands)	% of Total Amount
CONSUMER LOANS				
$ 499 or less	126,954	20.07	$ 32,158	0.14
500 to 1,999	136,719	21.61	157,099	0.69
2,000 to 2,499	12,766	2.02	27,391	0.12
2,500 to 4,999	171,291	27.07	508,827	2.23
5,000 to 9,999	55,751	8.81	391,488	1.71
10,000 or more	129,198	20.42	21,721,158	95.11
Total Consumer Loans Made	632,679	100.00	$ 22,838,121	100.00



California Finance Lenders
Loans Made or Refinanced by Interest Rates Charged
for Calendar Year 2011

Rates Charged	Number of Loans	% of Total Number	Principal Amount (in thousands)	% of Total Amount
CONSUMER LOANS				
LOANS UNDER $2,500				
Step Rate:				
2.5, 2, 1.5, 1% per month	119,253	43.14	$ 31,287	14.44
Alternate Rate:				
1.6% per month	31	0.01	38	0.02
Federal Reserve Bank Rate plus 10%	0	0.00	0	0.00
Other Rates:				
Up to 14.999 APR	12,970	4.69	19,740	9.11
15.000 to 19.999 APR	14,624	5.29	13,683	6.32
20.000 to 24.999 APR	5,067	1.83	10,516	4.85
25.000 to 29.999 APR	24,008	8.69	33,848	15.62
30.000 to 34.999 APR	21,977	7.95	31,909	14.73
35.000 to 39.999 APR	51,624	18.68	56,332	26.00
40.000 to 69.999 APR	26,852	9.71	19,234	8.88
70.000 to 99.999 APR	0	0.00	0	0.00
100.000 or More APR	0	0.00	0	0.00
Variable Rates Based on Index	33	0.01	61	0.03
Total Loans Made	276,439	100.00	$ 216,648	100.00
LOANS OF $2,500 TO $4,999				
Up to 14.999 APR	3,067	1.79	$ 9,822	1.93
15.000 to 19.999 APR	4,615	2.69	16,395	3.22
20.000 to 24.999 APR	3,750	2.19	12,658	2.49
25.000 to 29.999 APR	14,803	8.64	52,395	10.30
30.000 to 34.999 APR	13,819	8.07	46,033	9.05
35.000 to 39.999 APR	8,651	5.05	30,954	6.08
40.000 to 69.999 APR	1,555	0.91	4,462	0.88
70.000 to 99.999 APR	30,563	17.84	83,172	16.34
100.000 or More APR	89,989	52.54	249,318	49.00
Variable Rates Based on Index	479	0.28	3,618	0.71
Total Loans Made	171,291	100.00	$ 508,827	100.00

Rates Charged	Number of Loans	% of Total Number	Principal Amount (in thousands)	% of Total Amount
<u>LOANS OF $5,000 TO $9,999</u>				
Up to 14.999 APR	2,899	5.20	$ 22,375	5.72
15.000 to 19.999 APR	1,856	3.33	14,102	3.60
20.000 to 24.999 APR	8,041	14.42	58,963	15.06
25.000 to 29.999 APR	9,075	16.28	60,866	15.55
30.000 to 34.999 APR	5,332	9.56	36,447	9.31
35.000 to 39.999 APR	20,917	37.52	154,176	39.38
40.000 to 69.999 APR	279	0.50	1,698	0.43
70.000 to 99.999 APR	4,025	7.22	25,423	6.49
100.000 or More APR	3,308	5.93	17,293	4.42
Variable Rates Based on Index	19	0.04	145	0.04
Total Loans Made	55,751	100.00	$ 391,488	100.00
<u>LOANS OF $10,000 AND MORE</u>				
Up to 14.999 APR	108,206	83.75	$ 20,556,040	94.64
15.000 to 19.999 APR	5,772	4.47	90,974	0.42
20.000 to 24.999 APR	8,133	6.29	105,381	0.48
25.000 to 29.999 APR	900	0.70	11,004	0.05
30.000 to 34.999 APR	540	0.42	6,253	0.03
35.000 to 39.999 APR	1,957	1.51	21,882	0.10
40.000 to 69.999 APR	64	0.05	1,148	0.01
70.000 to 99.999 APR	751	0.58	9,420	0.04
100.000 or More APR	331	0.26	80,500	0.37
Variable Rates Based on Index	2,544	1.97	838,556	3.86
Total Loans Made	129,198	100.00	$ 21,721,158	100.00
Total Consumer Loans Made	632,679		$ 22,838,121	

California Finance Lenders
Loans Made or Refinanced By Type of Security
for Calendar Year 2011

Type of Security	Number of Loans	% of Total Number	Principal Amount (in thousands)	% of Total Amount
<u>ALL CONSUMER LOANS</u>				
Unsecured	381,131	60.24	$ 834,837	3.65
Personal Property	22,505	3.56	100,439	0.44
Automobiles & Other Motor Vehicles	109,680	17.33	1,959,716	8.58
Auto Title Loans	38,148	6.03	133,931	0.59
Wage Assignments	9	0.00	90	0.00
Real Property	65,663	10.38	19,647,136	86.03
Other Security	15,543	2.46	161,972	0.71
Total Consumer Loans Made	632,679	100.00	$ 22,838,121	100.00

It is difficult to discuss the CFLL without also briefly reviewing the DDTL. The DDTL (Will also be referred to as payday loans) provides that deferred depository lender may accept a post dated check from a borrower, written at a maxium of $300, in exchange for providing the borrower with a loan of $245. The DDTL allows the lender to charge a maxium of 15% of the face amount of the check. The DDTL in combination with the CFLL provides that a consumer in need of a small dollar loan is limited to seeking a payday loan, unsecured installment product, or a car title loan. Data thus far demostrates that consumers are utilizing payday loans far in excess of products offered under the CFLL.

In order to put these options in perspective and in contrast the following is a chart of informaton from the DOC *2011 Annual Report: Operation of Deferred Deposit Originators:*

	2006	**2007**	**2008**	**2009**	**2010**	**2011**
Total Dollar Amount of Deferred Deposit Transactions Made	$2,553,427,572	$2,969,905,917	$3,092,592,282	$3,088,358,316	$3,125,299,157	$3,276,629,497
Total Number of Deferred Deposit Transactions Made	10,048,422	11,152,466	11,841,014	11,784,798	12,092,091	12,427,810
Total Number of Individual Customers Who Obtained Deferred Deposit Transactions (repeat customers counted once)	1,432,844	1,609,680	1,665,019	1,567,188	1,646,700	1,738,219

Based on the 2011 data of CFLL loans and payday loans the following are important highlights.:

- CFL licensees conducted 381,131 unsecured installement loans and 38,148 auto title loans for a total of 419,279. The total dollar amount of these loans was $968,768,000.

- 258,273 CFL loans were made in amounts under $2,500.

- A large percentage of CFL loans (89,989) occurred in the $2,500 to $4,999 range at APRs above 100%.

- DDTL lenders conducted 12,427,810 transactions for a total dollar amount of $3,267,629,497.

- The average dollar amount of DDTLs made was $263 at an average APR of 411% for an average loan term of 17 days.

- Based on information provided by DOC, 90% of the CFLL lending volume under $2,500 comes from two companies, Progreso Financiero and Adir Financial.

What does the above data tell us? First, payday lending happens at a rate almost 30 times more fregently than CFLL small dollar loans. This could be for any number of reasons, such as multiple store locations, marketing or that borrowers do not need amounts above the payday threshold. Second, the CFLL small dollar lending market is dominated by two companies. One of these companies (Progreso) is a licensee under the CFLL Pilot Program for Affordable Credit-Building Opportunities (discussed later in this briefing).

Costly Consumer Lending:

Personal loans made by CFL licensees typically go to consumers with low credit scores in need of credit that cannot be acquired via traditional means (Bank loans, credit card, family loans). The most costly options under the CFLL are car title lending and unsecured personal loans. These loans are most often made without robust underwriting to determine if the borrower can repay the loan, nor to what impact such a loan would have on the borrowers debt to income ratio.

A car title loan is when a consumer borrows money against the title of their car for a specified period of time. During the loan period, the consumer continues to use their vehicle as necessary. If the consumer defaults on the loan then current law allows the lender to repossess the car for the cost of the loan. Car title lending in California is conducted under the CFLL, under which various forms of consumer lending are authorized. The CFLL does not explicitly authorize car title lending, but CFL licensees may offer these types of loans. Car title loans are subject to the provisions of the CFLL, which for loans above $2,500 no interest rate caps exist.

Car title lending recently came under scrutiny due to media coverage, specifically, an LA Times article, "*Title Loans' Interest Rates are Literally Out of Control,*" February 11, 2011, that highlighted the high interest rates on these loans and the consequences if a consumer does not pay off such a loan. The article provided the following details:

- One customer put up his truck as collateral for a $2,500 loan with payments of $200 per month. The customer expected to pay off $5000-$6000 by the time the loan was finished. This particular customer was charged an APR of 108% as a return customer vs. 120% for new customers.

- According to one car title lender interviewed, three quarters of the loans were paid off typically within 8 months.

- The way in which a typical loan would work, is the customer brings in his or her vehicle to the lender for inspection and test drive. The lender then determines what the vehicle might fetch at auction, which could be half of the Kelley Blue Book Value. On a vehicle with a $6,000 Blue Book value the lender might loan $2,600 with interest rates as much at 180% APR. Industry practice is to loan no more than 50% of the whole sale value of the car. Key to this point is typically title lenders do not loan an amount equal to the whole value of the automobile, therefore creating some equity cushion should the loan go into default.

Industry representatives argue that the borrowers who use their services have very low credit scores and are not likely to have access to other means of credit, if at all. Additionally, they point out that while the loan may be securitized, the repossession and disposition of an automobile is a costly endeavor and such costs must be built into the cost of the loan.

In examining CFL licensees who make auto title loans, information from the 2011 DOC report finds that auto title loans made up 38,148 of consumer loans under the CFLL. Information suggests that most car title loans are made with APRs between 90-120%. As for default rates and repossession rates the ability to retrieve that information is difficult.

On the unsecured side of the CFLL lending market are unsecured personal installment loans. The most well-known entity offering these loans is a company called CashCall. CashCall advertises frequently on television and recently has begun to offer real estate refinance loans. CashCall offers unsecured loans over $2,500 that have no interest rate restrictions. A quick perusal of their website reveals the terms and interest rates for typical loan transactions. For example, on a loan of $2,525 the following would apply:

- $75 fee
- 139.22%
- 47 payments
- $294.46 monthly payment.

Under the above scenario, if the borrower took the loan to term for the full 47 months they would have paid back $13,914.62 (interest-principal-origination fee) on a $2,525 loan. This comes out to $11,389 in interest charges.

On August 24, 2009, CashCall settled with the California Attorney General in a suit alleging that CashCall had made false and misleading statements regarding interest rates and other loan terms, and that they violated several provisions of California's debt collection laws. This settlement did not address the actual costs of the loans because extremely high interest rates are not prohibited under California law.

Certainly, low asset consumers with impaired credit scores will pay a higher premium for credit. Industry participants provide that high interest rates are necessary to continue to operate in this particular market due to high capital costs and the overhead costs associated with operating a business. Furthermore, they point out the risk these consumers have for default. However, in weighing risk, one must also consider that car title loans are secured by an asset deemed to have more value than the loan itself.

However, one must ask to what extent do the loans themselves create a self-fulfilling prophecy, in that the rates charged create such a large potential for eventual default that the potential default creates the justification for the high rate, and thus the cycle continues. One must also ask, if the existence of high risk consumer borrowers justifies the triple digit interest rates?

Online Lending:

Online small-dollar lending takes on many forms. In some cases it provides innovative ways to reach customers while reducing overhead costs associated with a physical storefront. The other side of internet lending is the arena of unlicensed and unregulated lenders that bypass California's regulatory structure. In the case of unlicensed lenders it is not always the case that the lender is not regulated. In some cases lenders may have licenses in other states, while in other cases, Tribal governments may sanction online lending utilizing their sovereignty to avoid state regulation.

The major issue of contention between parties to the small-dollar lending debate is to what respect increased regulation of licensed lenders will drive consumers to online lending, specifically unregulated lending? Unfortunately, the best information at this point is anecdotal at best as to the true impact of unregulated online lending. The closest one can get to this information is a very unscientific review of search terms on internet search engines. For example, in Google the following searches appear (The number represents searches per month in the United States.)

- "Payday loan." 1,830,000
- "Payday loan online" 246,000
- "Online Payday loan lenders" 110,000

Again, this is not a scientific approach to analyze the true impact of online lending. The above numbers do not reveal if these searches lead to actual loans. These numbers only demonstrate that enough interest exists in such products that over 2 million searches occur per month across the U.S. via one internet search engine.

New Alternatives:

In 2010, the legislature passed and the Governor signed SB 1146 (Florez), Chapter 640, Statutes of 2010. The bill created the Pilot Program for Affordable Credit-Building Opportunities to increase the availability of affordable short-term credit and to expand credit-building opportunities for individuals. According to the June 18, 2010, Assembly Banking & Finance Committee analysis the author stated the following need for SB 1146

According to the author:

> *Enacted in the 1950's, based on statutes from the 1920's, the CFL is archaic and needs reform. For example, its restrictions on interest rates, fees, and marketing partnerships for loans in the $250 to $2500 range effectively discourages lenders from making loans that would otherwise be a fair alternative to payday loans. As a result, today there are very few fully amortizing, credit building loans in the $250-$2500 range and even fewer providers. Instead, the vast majority [of] CFL licensees only make loans above $2500, precisely because there is no cap on interest rates for loans over $2500. Lenders simply do not believe they can make a profit below $2500, given current CFL law. Thus, if a lender wants to make small loans, they become a pawn broker or payday lender (who as an industry makes over 10*

> *million loans to California residents each year). The result: Californians have only one option—pay-day loans—and no opportunity to build or repair their credit. . . . Californians need access to credit, now more than ever. But, they also need alternatives that are safe and affordable, provide credit education and help borrowers build credit. SB 1146 will hopefully allow consumers who need small loans an alternative to a pay-day loan option, which likely causes more of a financial burden when payments cannot be made.*

This bill, sponsored by Progreso Financiero, established a pilot program under the CFLL to fill the gap in loan products that exist in the small dollar loan market. The pilot program intends to fill this gap by allowing some flexibility on the fees and interest rates associated with the loans, with an enhanced underwriting process to determine borrower's repayment ability, something often lacking for non-bank loans, specifically payday loans. Additionally, the sponsor viewed the pilot program as a way to help the unbanked and underbanked build credit files in order to advance to more traditional lines of credit by the requirement that loan performance be reported to the credit reporting agencies. No other lending law requires reporting of payment performance. The goal of the pilot program is to make small dollar lending a profitable business so that more options will become available, while creating lending standards that will make it a responsible product under certain conditions. A licensee under the pilot must also have a credit education program that the consumer will undergo prior to disbursement of loan proceeds. Furthermore, the debt-to-income ratio of a borrower cannot exceed 50%. Lenders in the small dollar market may attempt to use third parties to find customers. These third parties are known as finders. These finders have a relationship with the lender as they might be business entities such as a grocery store or other retail establishment. The idea behind using finders is that it is a cost effective way to reach customers with needed a physical storefront for the lender. The pilot program contains very specific mandates and restrictions on finders, including caps on the payments that the lender may make to the finder. At the committee's 2012 hearing on this issue, testimony provided by a pilot participant demonstrated that acquisition of cost effective capital is a major obstacle in the small dollar lending environment.

The driving force behind the pilot program is that many people do not have access to mainstream credit options due to minimal credit history. This history is often due to a lack of a relationship with a financial institution through a checking or savings account. Ironically, a consumer without a checking account would not be able to get a payday loan as payday loans are contingent upon the borrower having a checking account so in some cases an unbanked borrower may not have many options at all.

The unbanked or those without an account with a financial institution constitute approximately 22 million, or 20% of Americans. This population spends $10.9 billion on more than 324 million alternative financial service transactions per year. Bearing Point, a global management and technology consulting company, estimates that the unbanked population expands to 28 million when you include those who do not have a credit score. In addition, Bearing Point puts the underbanked population, defined as those with a bank account but a low FICO score that impedes access to incremental credit, at an additional 45 million people. Although estimates find that at least 70% of the population has some type of bank account, these individuals continue to use non-bank services, ranging from the purchase of money orders, use of payday lenders, pawn shops or sending of remittances. The Federal Reserve Board has noted that 50% of current unbanked households claim to have had an account in the past.

In California, 28% of adults do not have a checking or savings account, according to the U.S. Census. In San Francisco, the Brookings Institution estimated that one in five San Francisco adults, and half of its African-Americans and Hispanics, do not have accounts. Recent market research indicates that Fresno and Los Angeles have the second and third highest percentages of unbanked residents in the country.

Nationwide, the unbanked are disproportionately represented among lower-income households, among households headed by African-Americans and Hispanics, among households headed by young adults, and among renters. A Harvard Poll of Hurricane Katrina evacuees in the Superdome found that seven out of ten did not have a checking or savings account.

Where are the banks?

In the discussion of small dollar lending often the number one question is why do financial institutions not provide greater lending opportunities in the small dollar markets? One obvious answer is that underwriting standards at most mainstream financial institutions would prohibit lending to consumers with marginal credit. Another answer is the lending in this market place is not cost effective without lending at interest rates that might bring about reputational risk to the image of the institution.

In order to better grasp the role of banks in small dollar lending, and potentially encourage greater lending in this space, the FDIC in 2007 started a two year Small-Dollar Loan Pilot Program. This program was designed to demonstrate that banks can offer affordable small dollar products that are profitable for the participating banks, while also providing an alternative to high-costs loans and costly overdraft protection programs. The FDIC parameters for a loan under the program was an amount of $2,500 with a term of 90 days or more at an APR of 36% or less. As the program came to a close, 34,400 small-dollar loans were made with a principal balance of $40.2 million nationwide. Small-dollar lending was often used as a relationship building opportunity in order to building long term opportunities with the customer. The Pilot began with 31 banks participating, one of which was located in California (BBVA Bancomer USA). The Pilot ended with only 28 participants. Delinquency rates for the loans ranged from 9-11%, but loans with longer terms performed better. It does not appear that the Pilot led to widespread adoption of small dollar lending programs at non-pilot banks.

In 2005, Sheila Bair, prior to her role as Chairman of the FDIC, wrote a report (Low Cost Payday Loans: Opportunities & Obstacles) that researched the ability of financial institutions to offer affordable payday loan alternatives. She found that banks and credit unions do have the ability to offer low-cost small-dollar loans, however the use of fee-based overdraft protection programs were a significant obstacle to offer alternative programs. In additional research in this area, Micheal Stegman, "Payday Lending", Journal of Economic Perspectives concluded that "bottom lines are better served by levying bounced check and overdraft fees on the payday loan customer base than they would be by undercutting payday lenders with lower cost, short-term unsecured loan products..."

An additional factor is also that many borrowers in the small dollar lending environment have impaired credit that in most cases will not allow them to get a loan from a bank, even if the bank offers a small dollar loan. Mainstream financial institutions have a perceived (or real) fear of regulatory backlash if underwriting standards are lowered to serve these populations.

<u>Conclusion</u>:

Ensuring consumer access to affordable short-term credit will continue to be a challenge faced by policy makers. Attempting to achieve balance between affordability and cost effectiveness, while maintaining the ability of consumers with low credit scores to get a loan, will not involve simple reforms. While reforms can be attained, each reform made to one section of California's lending laws can have an unmitigated impact on another lending law. However, due to the difficulties the legislature faces in this area, developments in technology and the drive of tech-minded entrepreneurs is slowly starting to change the face lending and how people use money. New start-up companies, such as LendUp use new creative methods to offer small dollar loans via the internet that may be able to save credit impaired borrowers money while also building their credit files which will then open up future doors to sources of mainstream financing. Also, data collection on the profile of consumers that take out small-dollar loans could lend important perspectives to the debate.