

# California Finance Lender's Law: Consumer Protection and Potential Reforms.

January 9, 2011

2:00 p.m.

California State Capitol, Room 444

Background

## General Overview:

The California Finance Lenders Law (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. Even though the CFLL is a relatively recent statute, it is based upon previous statutes.

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 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. "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.

If a business makes a one-time loan, then the business can rely on the safe harbor of no more than one loan in a 12-month period. However, where the safe harbor and other exemptions under the CFLL do not apply, then the business may need to apply for a license under 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.

CFLI 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 CFLI 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

Every year, DOC releases a report of statistical data regarding the CFLI compiled from data required to be submitted by licensees. The following charts and data come from the *2010 Annual Report: Operation of Finance Companies Licensed Under the California Finance Lenders Law*:

	Number of Licensees	Number of Applications
2010	4,327	1,022
2009	4,964	1,097
2008	5,618	1,188
2007	7,358	2,065
2006	7,577	2,358
2005	6,725	2,480
2004	5,342	1,618
2003	4,608	1,258
2002	4,110	984
2001	3,732	628

**California Finance Lenders  
Loans Made or Refinanced By Size  
For Calendar Year 2010**

Size of Loan	Number of Loans	% of Total Number	Principal Amount (in thousands)	% of Total Amount
<b><u>CONSUMER LOANS</u></b>				
\$ 499 or less	103,543	21.56	\$ 34,822	0.16
500 to 1,999	90,976	18.94	98,474	0.46
2,000 to 2,499	8,517	1.77	18,635	0.09
2,500 to 4,999	105,368	21.93	325,195	1.50
5,000 to 9,999	43,946	9.15	303,647	1.41
10,000 or more	128,034	26.65	20,798,281	96.38
Total Consumer Loans Made	<u>480,384</u>	<u>100.00</u>	<u>\$ 21,579,054</u>	<u>100.00</u>
<b><u>COMMERCIAL LOANS</u></b>				
\$5,000 or more	<u>2,080,113</u>	<u>100.00</u>	<u>\$ 93,199,758</u>	<u>100.00</u>
Total Commercial Loans Made	<u>2,080,113</u>	<u>100.00</u>	<u>\$ 93,199,758</u>	<u>100.00</u>
Total Loans Made, All Categories	<u>2,560,497</u>		<u>\$ 114,778,812</u>	

**California Finance Lenders  
Loans Made or Refinanced By Type of Security  
for Calendar Year 2010**

Type of Security	Number of Loans	% of Total Number	Principal Amount (in thousands)	% of Total Amount
<b><u>ALL CONSUMER LOANS</u></b>				
Unsecured	253,878	52.85	\$ 427,887	1.98
Personal Property	19,048	3.97	62,898	0.29
Automobiles & Other Motor Vehicles	132,128	27.50	2,226,753	10.32
Wage Assignments	38	0.01	127	0.00
Real Property	60,671	12.63	18,659,383	86.47
Other Security	14,621	3.04	202,006	0.94
<b>Total Consumer Loans Made</b>	<b>480,384</b>	<b>100.00</b>	<b>\$ 21,579,054</b>	<b>100.00</b>

**California Finance Lenders  
Loans Made or Refinanced by Rates Charged  
for Calendar Year 2010**

Annualized Rate of Charge	Number of Loans	% of Total Number	Principal Amount (in thousands)	% of Total Amount
<b><u>CONSUMER LOANS</u></b>				
<b><u>LOANS UNDER \$2,500</u></b>				
Step Rate:				
2.5, 2, 1.5, 1% per month	97,028	47.79	\$ 23,081	15.19
Alternate Rate:				
1.6% per month	34	0.02	48	0.03
Federal Reserve Bank Rate plus 10%	0	0.00	0	0.00
Other Rates:				
Up to 14.999 APR	13,190	6.50	32,197	21.19
15.000 to 19.999 APR	12,360	6.09	12,139	7.99
20.000 to 24.999 APR	5,817	2.86	10,309	6.79
25.000 to 29.999 APR	19,356	9.53	25,959	17.09
30.000 to 34.999 APR	12,215	6.02	14,753	9.71
35.000 to 39.999 APR	38,333	18.88	31,122	20.48
40.000 to 99.999 APR	4,486	2.21	2,005	1.32
100.000 or More APR	7	0.00	10	0.01
Variable Rates Based on Index	210	0.10	308	0.20
<b>Total Loans Made</b>	<b>203,036</b>	<b>100.00</b>	<b>\$ 151,931</b>	<b>100.00</b>

LOANS OF \$2,500 TO \$4,999

Up to 14.999	APR	2,003	1.90	\$	6,280	1.93
15.000 to 19.999	APR	4,815	4.57		16,064	4.94
20.000 to 24.999	APR	6,082	5.77		20,924	6.43
25.000 to 29.999	APR	13,649	12.95		49,393	15.19
30.000 to 34.999	APR	9,835	9.33		32,608	10.03
35.000 to 39.999	APR	7,699	7.31		24,409	7.50
40.000 to 99.999	APR	25,215	23.93		77,645	23.88
100.000 or More	APR	35,240	33.45		94,793	29.15
Variable Rates Based on Index		830	0.79		3,079	0.95
Total Loans Made		<u>105,368</u>	<u>100.00</u>	\$	<u>325,195</u>	<u>100.00</u>

<u>Annualized Rate of Charge</u>	<u>Number of Loans</u>	<u>% of Total Number</u>	<u>Principal Amount (in thousands)</u>	<u>% of Total Amount</u>
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LOANS OF \$5,000 TO \$9,999

Up to 14.999	APR	4,112	9.36	\$	24,117	7.94
15.000 to 19.999	APR	2,413	5.49		18,385	6.05
20.000 to 24.999	APR	10,119	23.03		73,478	24.20
25.000 to 29.999	APR	9,788	22.27		67,408	22.20
30.000 to 34.999	APR	3,220	7.33		22,129	7.29
35.000 to 39.999	APR	9,729	22.14		69,513	22.89
40.000 to 99.999	APR	3,266	7.43		21,154	6.97
100.000 or More	APR	1,258	2.86		7,198	2.37
Variable Rates Based on Index		41	0.09		265	0.09
Total Loans Made		<u>43,946</u>	<u>100.00</u>	\$	<u>303,647</u>	<u>100.00</u>

LOANS OF \$10,000 AND MORE

Up to 14.999	APR	110,615	86.39	\$	19,475,000	93.64
15.000 to 19.999	APR	5,132	4.01		93,242	0.45
20.000 to 24.999	APR	7,015	5.48		92,859	0.45
25.000 to 29.999	APR	1,488	1.16		18,047	0.09
30.000 to 34.999	APR	431	0.34		5,383	0.02
35.000 to 39.999	APR	816	0.64		9,276	0.04
40.000 to 99.999	APR	469	0.37		8,654	0.04
100.000 or More	APR	579	0.45		187,264	0.90
Variable Rates Based on Index		1,489	1.16		908,556	4.37
Total Loans Made		<u>128,034</u>	<u>100.00</u>	\$	<u>20,798,281</u>	<u>100.00</u>

Total Consumer Loans Made                      480,384                      \$                      21,579,054

### **Costly Consumer Lending:**

Personal loans made by CFL licensees typically go to consumers with low credit scores in need of fast cash. The most costly options under the CFLL are car title lending and unsecured personal loans.

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 costs 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. A rate cap does not exist for any personal loan (Auto, Auto-title, personal) made under the CFLL.

Car title lending has come under recent 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 as 180% APR. 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 service 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 costs of the loan.

In examining CFL licensees who make secured car loans (This includes car title loans and car purchase loans) finds that in 2009 approximately 18,921 auto related loans were made in California with APRs over 40%, for a total volume of \$64,204,118. In 2009, for loans with APRs over 100%, 4,243 loans were made, totaling \$13,948,175. Again, it is important to note that these numbers are approximations because an auto-purchase lender could be in these

categories. Additionally, anecdotal information suggests that most car title loans are made with APRs between 90-120%.

On the unsecured side of the CFLL lending market are unsecured personal loans. The most well-known of entities offering these loans is a company called CashCall. CashCall advertises frequently on television. CashCall offers unsecured loans over \$2,500 that have no interest rate restructures. 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, consumers with low credit scores will pay a higher premium for credit. Additionally, the immediate nature of CFL loans also is a factor in their price structure. Furthermore, with the risk at stake in these types of loans, some parties contend that the high interest rates are necessary to continue to operate in this particular market. 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?

### **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 between payday loans of \$255 and CFL loans of \$2,500 or more. Between those two amounts there is little incentive on the part of potential lenders to offer loans due to stringent restrictions on fees, marketing, and interest rates. For example, in 2008, 98,665 CFL loans under \$2,500 were originated, whereas almost 12 million payday loan transactions occurred. 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 pilot program attempts 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.

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 banking 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.

In summary, the CFLL is a seventeen year old statute, comprised of several other laws that are decades older. The last major change to this law was SB 1146, which with its good intentions it is still too early to gauge its success. Most telling is that thus far only one CFLL licensee has a license to participate in the pilot program created under SB 1146. If a new market of small dollar loans is to be created it is vital that more lenders enter this marketplace with competitive rates for consumers. Finally, in evaluating the necessity of triple digit interest rate loans above \$2,500, the consumers getting these loan products are most likely suffering from a drastic economic situation or event that creates desperation for credit. Is a consumer in dire need of credit able to fully understand the risk associated with these products? Can more changes be made to the CFLL to create a better lending marketplace? Should the pilot program under SB 1146 be altered to create more interest on the part of lenders?