Date of Hearing: May 7, 2013

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Roger Dickinson, Chair
SB 318 (Hill, Steinberg, and Correa) – As Amended: June 17, 2013

SENATE VOTE: 36-1

SUBJECT: Consumer loans: Pilot Program for Increased Access to Responsible Small Dollar Loans.

SUMMARY: Establishes, until January 1, 2018 the Pilot Program for Increased Access to Responsible Small dollar Loans (program) under the California Finance Lenders Law (CFLL). Specifically, this bill:

1) Provides that an existing California Finance Lender (CFL) licensee in good standing that wishes to participate in the program shall file an application with the Department of Business Oversight (DBO) in a manner prescribed by the Deputy Commissioner and shall pay a fee. Additionally provides that an entity that is not licensed under the CFLL may file a duel application.

2) Specifies that loans made pursuant to the program shall comply with the following:

   a) Interest on the loan shall accrue on a simple-interest basis;

   b) The licensee shall disclose to the consumer in type face no smaller than 12-point font, at time of application for the loan the following:

      i) Amount borrowed;

      ii) Total dollar cost of the loan to the consumer if loan is paid back on time, including sum of the administrative fee, principal amount borrowed, and interest payments.

      iii) Corresponding annual percentage rate (APR);

      iv) Periodic payment amount;

      v) Delinquency fee schedule;

      vi) A statement of the following, "Repaying you loan early will lower your borrowing costs by reducing the amount of interest you will pay. This loan has no prepayment penalty." And,

      vii) A statement that the borrower may rescind the loan within one business day following the day the loan is consummated and by returning any loan principal advanced.

      viii) This disclosure may be provided via a mobile phone application if the font size can be manually modified by the borrower, and if the borrower is give the option to print the disclosure in a type face of least 12-point size or is provided a hardcopy by the licensee.

c) The loan shall have a minimum principal amount upon origination of $300 and a term of not less than the following:

i) Ninety days for loans whose principal balance upon origination is less than $500

ii) One hundred twenty days for loans whose principal balance upon origination is at least $500, but is less than $1,500.

iii) One hundred eighty days for loans whose principal balance upon origination is at least $1,500.

3) Allows the following interest rates and charges:

a) For a loan made pursuant to this section at an annual simple interest rate not to exceed the lesser of 36.0 percent or the following:

i) 32.75 percent plus the United States prime lending rate, as of the date of loan origination, on that portion of the unpaid principal balance of the loan up to and including, but not in excess of, one thousand dollars ($1,000). The interest rate calculated as of the date of loan origination shall be fixed for the life of the loan.

ii) 28.75 percent plus the United States prime lending rate, as of the date of loan origination, on that portion of the unpaid principal balance of the loan in excess of one thousand dollars ($1,000), but less than two thousand five hundred dollars ($2,500). The interest rate calculated as of the date of loan origination shall be fixed for the life of the loan.

b) The licensee may contract for and receive an administrative fee of the following:

i) Seven percent of the principal amount, exclusive of the administrative fee, or ninety dollars ($90), whichever is less, on the first loan made to a borrower.

ii) Six percent of the principal amount, exclusive of the administrative fee, or eighty dollars ($80), whichever is less, on the second and subsequent loans made to a borrower.

4) Prohibits a licensee from charging the same borrower an administrative fee more than once in any four-month period.

5) Provides that an administrative fee shall not be contracted for or received in connection with the financing of a loan unless at least eight months have elapsed since the receipt of a previous administrative fee paid by the borrower.

6) Allows a licensee to require a borrower to reimburse the licensee from actual insufficient funds fees incurred by that licensee due to actions of the borrower, as well as, receive a delinquency fee in the following amounts:

   a) For a period of delinquency of not less than seven days, an amount not in excess of $14; or,

   b) For a period of delinquency of not less than fourteen days, an amount not in excess of $20.

7) Specifies that no more than one delinquency fee may be imposed per delinquent payment or no more than two delinquency fees may be imposed during any period of 30 consecutive days.

8) Prohibits the imposition of a delinquency fee that is 180 days or more past due if that fee would result in the sum of the borrower's remaining unpaid principal balance, accrued interest, and delinquency fees exceeding 180 percent of the original principle amount of the borrower's loan.

9) Requires a licensee to attempt to collect a delinquent payment for a period of at least 30 days before selling or assigning that unpaid debt to an independent party for collection.

10) Specifies that prior to disbursement of loan proceeds, the licensee shall either:

   a) Offer a credit education program or seminar to the borrower that has been previously approved by DBO; or

   b) Invite the borrower to a credit education program or seminar offered by an independent third party that has been previously reviewed and approved by DBO.

11) Requires that a licensee must report each borrower's payment performance to at least one consumer reporting agency (CRA) upon acceptance as a data furnisher by the CRA.

12) Provides that a licensee that is accepted as a data furnisher after admittance to the program must report all borrower payment performance since its inception of lending under the program, but no longer than six months after acceptance into the program.

13) Allows the Deputy Commissioner to approve a licensee for the program, prior to that licensee's acceptance as a data furnisher by a CRA if the Deputy Commissioner has a reasonable expectation, based on information supplied by the licensee, that:

   a) The licensee will be accepted once it achieves lending volume required of data furnishers of its type; and

   b) That lending volume will be achieved within the first six months of the licensee commencing lending.

14) Provides the Deputy Commissioner with authority to withdraw participation from the pilot program to a licensee that fails to become a data furnisher within the first six months of program participation.

15) Specifies that a licensee shall provide each borrower with the name of the CRA or agencies to which it will report the borrower’s payment history.

16) Mandates that each loan shall be underwritten to determine a borrower's ability and willingness to repay the loan pursuant to the loan terms, and shall not make a loan if it determines, through its underwriting, that the borrower's total monthly debt service payments, at the time of origination, including the loan for which the borrower is being considered, and across all outstanding forms of credit that can be independently verified by the licensee, exceed 50 percent of the borrower's gross monthly income.

17) Requires the licensee, in conducting underwriting, to seek information and documentation, verified through at least one CRA or other available electronic debt verification service, pertaining to all of a borrower's outstanding debt obligations, including loans that are self-reported by the borrower but not available through independent verification.

18) Requires the licensee to request from the borrower and include all information obtained from the borrower regarding outstanding deferred deposit transactions in the calculation of the borrower's outstanding debt obligations. A licensee shall not be required to consider, for purposes of debt-to-income ratio evaluation, loans from friends or family.

19) Provides that no licensee shall require, as condition of providing the loan, that the borrower waive any right, penalty, remedy, forum, or procedure provided for in any law applicable to the loan.

20) States that the provisions of the program do not apply to any loan with a bonafide principle amount of $2,500.

21) Prohibits:

   a) any person, in connection with the making of a loan, from offering, selling, or requiring "credit insurance";

   b) a licensee from requiring, as a condition of the loan, that the borrower waive any right, penalty, remedy, forum or procedure provided for in any law applicable to the loan, as specified; and

   c) a licensee from refusing to do business with, or discriminating against a borrower or applicant on the basis that the person refuses to waive any right, penalty, remedy, forum, or procedure.

22) Allows a licensee to use the services of one or more finders, as specified. Those finders may perform one or more of the following services for a licensee at the finder's physical location for business:

   a) distributing written materials;

   b) providing written factual information about the loan;

   c) notifying a prospective borrower of the information needed to complete an application;

   d) entering information from a prospective borrower into a database;

   e) assembling credit applications and other materials;

   f) contacting the licensee to determine the status of loan application;

   g) communicating a response regarding underwriting; and

   h) obtaining the borrower's signature on documents.

23) Prohibits a finder from engaging in the following:

   a) providing counseling advice;

   b) providing unapproved loan-related marketing material; and

   c) interpreting or explaining marketing materials.

24) Specifies the activities that qualify a person as a broker rather than a finder, and require a finder to comply with all laws applicable to the licensee that impose requirements on the licensee for information security safeguards.

25) Requires a finder to provide a specified statutory disclosure upon receiving or processing an application for a Program loan and allow a finder to be compensated, as specified, by the licensee pursuant to a written agreement. This bill would prohibit a licensee from directly or indirectly passing on any portion of the finder's fee to a borrower.

26) Mandates that a licensee to notify the Deputy Commissioner within 15 days of entering into a contract with a finder, as specified, pay an annual finder registration fee, and submit an annual report to the Deputy Commissioner regarding the finder, as specified. This bill would require all arrangements between a licensee and a finder to be set forth in a written agreement between the parties.

27) Allows the Deputy Commissioner to examine the operations of each licensee and finder to ensure compliance, and permit the Deputy Commissioner to take specified actions against a finder upon a determination that a finder has acted in violation.

28) Require the Deputy Commissioner to examine each licensee at least once every 24 months and provide that the cost of the examination shall be paid to the Deputy Commissioner by the licensee examined.

29) Requires, on or before January 1, 2016, and again, on or before January 1, 2017, the Deputy Commissioner to post a report on his or her Internet Web site summarizing utilization of the Program, as specified. That report shall include, among other things, the results of a random survey of borrowers who have participated in the Program.

30) Clarifies under the CFLL that an extension of a loan subject to the CFLL by a person that is unlicensed under the CFLL voids the loan contract, and would prohibit any person from collecting or receiving any principal, charges, or other recompense in connection with the loan.

31) Sunsets the program on January 1, 2018.

EXISTING LAW

1) Provides for the CFLL administered by the Department of Corporations (DOC), authorizes the licensure of finance lenders, who may make secured and unsecured consumer and commercial loans (Fin. Code Sec. 22000 et seq.).

2) Specifies that CFLL licensees who make consumer loans under $2,500 are capped at interest rates which range from 12 percent to 30 percent per year, depending on the unpaid balance of the loan. (Fin. Code Secs. 22303, 22304.) Administrative fees are capped at the lesser of 5 percent of the principal amount of the loan or $50. (Fin. Code Sec. 22305.)

3) Authorizes, until January 1, 2015, the Pilot Program for Affordable Credit-Building Opportunities (Pilot) that allow licensees accepted into the program to offer small-dollar consumer loans under the CFLL that are subject to the following:

   a) the loan has a minimum principal amount upon origination of $250 and is not more than $2,500, as specified;

   b) the interest rate does not exceed 30 percent for the unpaid principal balance of the loan up to and including $1,000, and, 26 percent for the unpaid balance of the loan in excess of $1,000;

   c) an administrative fee not in excess of either five percent of the principal amount, or $65, whichever is less;

   d) the loan term is: (1) 90 days for loans whose principal balance upon origination is less than $500; (2) 120 days for loans whose principal balance upon origination is at least $500, but less than $1,500; and (3) 180 days for loans whose principal balance upon origination is at least $1,500;

   e) the licensee must report each borrower's payment performance to at least one of the national credit reporting agencies; and

   f) the licensee must underwrite each loan and shall not make a loan if it determines that the borrower's total monthly debt service payments exceed 50 percent of the borrower's gross monthly income. (Fin. Code Sec. 22348 et seq.)

4) Imposes various other restrictions on participants in the above pilot program, including the use of finders, and requires the Commissioner of the DOC to submit a report summarizing utilization of the pilot program, including recommendations regarding whether the program should be continued after January 1, 2015. (Fin. Code Sec. 22361.)

FISCAL EFFECT: Unknown

COMMENTS:

According to the author:

In 2010, SB 1146 was enacted to authorize a pilot program intended to increase the availability of responsible small dollar loans made in California. Since that legislation was enacted, five lenders have applied to participate in the SB 1146 pilot program. Three of the applicants were accepted, including Progreso (accepted to the pilot program in April 2011; made 118,000 loans under the pilot during 2012), LendUp (accepted to the pilot program in November 2012 and not yet lending under the pilot), and FairLoan Financial (accepted to the pilot program in November 2012; has made under 100 loans under the pilot program since acceptance). Two of the applicants to the pilot program withdrew their applications.

Despite the existence of the SB 1146 pilot, relatively few installment loans are made in California, with principal amounts under $2,500. This represents a challenge to the significant population of people in California, who are unable to access affordable credit through banks and credit unions. Californians who lack credit scores or have very thin credit files currently have very few options when they need to borrow money. Credit cards are often unavailable to this population, or, if available, bear very high interest rates and fees. Californians with subprime credit scores also have few options for affordable credit, and typically access payday lenders or high-interest rate installment lenders that lend in amounts above $2,500, when their incomes fail to match their spending needs.

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 of SB 1146:

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.

SB 1146, 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 February 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.

Since the 2010 legislation was enacted, five lenders have applied to participate in the SB 1146 pilot program. Three of the applicants were accepted, including Progreso (accepted to the pilot program in April 2011; made 118,000 loans under the pilot during 2012), LendUp (accepted to the pilot program in November 2012 and not yet lending under the pilot), and FairLoan Financial (accepted to the pilot program in November 2012; has made under 100 loans under the pilot program since acceptance). Two of the applicants to the pilot program withdrew their applications.

Although aggregated annual data are not yet available for 2012, DOC has indicated that only two CFLL lenders made the vast majority of installment loans with principal amounts below $2,500 during 2012 – Progreso Financiero and Adir Financial, each of which made approximately 118,000 loans during 2012. As noted above, Progreso is a pilot program participant that makes loans of various sizes under the pilot. Its loans are currently available in 65 locations throughout California. Adir Financial is not a pilot program participant. It extends unsecured loans of up to $500 to finance purchases made by customers of the Curacao department store chain in Los Angeles. Its loans are not available elsewhere in California.

On February 11, 2013 the Assembly Banking Committee conducted an oversight hearing to examine the issue of small dollar loans under the CFLL. That hearing was inspired by concerns that low income, low credit consumers face daunting and costly options when seeking short term credit. During committee testimony, Commissioner of DOC offered the following comments relevant to the issue current under consideration:

The Committee has inquired about the barriers of access to small dollar credit at lower costs. The leading barriers to access to affordable small-dollar credit under the California Finance Lenders Law appear to be (1) the lenders' lack of access to affordable funds, resulting in unprofitable lending margins, and (2) the statutory restrictions on charges and rates. Based on discussions with licensee, industry representatives, and anecdotal observations, it appears that barriers exist to increasing access to small-dollar credit while at the same time, keeping the cost of credit affordable for consumers. Lenders indicate that it is cost prohibitive to make small dollar loans under the California Finance Lenders Law because of the law's restriction on charges, the high costs of capital to lender to make these loans and the thin margins on generating loan volume… Many lenders indicate that it is not cost effective to make small-dollar loans even under the interest rates and charges allowed under the pilot program.

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.

Small dollar 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.

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.

Installment Lending vs. Payday Lending.

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 $255. 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:*

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.

Costly Installment Lending:

In addition to payday loans, financial institution overdraft programs, and lending under the pilot, consumers seek out car title loans and installment loans with no interest rate regulation above $2500.

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 borrower's 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. 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.

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.

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. 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.

Small dollar lending and financial institutions?

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, Michael 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.

A recent article highlight the struggles of financial institutions to offer low costs products. In a May 9, 2013 article, *California Thrift's woes Show Challenges competing with Payday Lenders,* American Banker, revealed that PacificCoast Bank in Oakland, California stopped offering its short-term loan program that was modeled on the FDIC pilot. A spokesperson from the bank revealed that the model was economically sustainable, and thus not able to compete with payday lenders. Finally, PacificCoast Bank revealed that they plan to work with LendUp, a San

Francisco based lender, currently operating under the payday lending law and the pilot program, on a revised product.

Differences between existing pilot and SB 318:

Interest rates:

Existing pilot: On loans between $300 and $1000 the interest rate is 30%. On loans between $1001 and $2,499 the interest rate is 26%.

SB 318: On loans between $300 and $1,000 the rate is the lessor of 36% or the Prime rate plus 32.75% (currently equals 36%). On loans of $1,000 to $2,499= the lessor of 36% or the prime rate plus 28.75% (currently equals 32%).

Fees:

Existing pilot: The lessor of 5% of principal amount or $65.

SB 318: The lessor of 7% of principal amount or $90, or 6% percent of the principal amount, exclusive of the administrative fee, or eighty dollars ($80), whichever is less, on the second and subsequent loans made to the same borrower.

Late fees

Existing pilot: 7 day delinquency=$12; 14 day delinquency=$18

SB 318: 7 day delinquency=$14; 14 day delinquency=$20

Time limit on repeat fees:

Existing pilot: Licensee shall not charge the same borrower more than one administrative fee in any six month period. An administrative fee shall not be contracted for or received in a refinancing of a loan unless one year has elapsed since the receipt of the previous fee paid by the borrower.

SB 318: A licensee shall not charge the same borrower more than one administrative fee in any four month period. An administrative fee shall not be received in a refinancing unless at least eight months have passed.

In addition to the differences listed above, the proposed program in SB 318 is different from the existing pilot in several non-controversial ways, while also retaining key elements of the existing pilot such as mandatory underwriting standards.

Arguments in support.

Progreso Financiero writes in support,

> *We are writing in support of SB 318 (Hill). SB 318 would make some targeted, essential*

changes to a currently existing Pilot Program for Affordable Credit Building Opportunities under the California Finance Lenders Law (CFL) which was established by SB 1146 (Florez) in 2010 to address the very serious lack of access to capital for low income borrowers. SB 1146 was a visionary and innovative attempt to remove numerous barriers in California law to the making of socially responsible, small loans at fair terms and rates to the millions of Californians who are underbanked and financially vulnerable.

At the time the Pilot was being considered, there were relatively few unsecured, small dollar, credit-building installment loans available to people of modest means with little or no credit history. This is largely due to the fact that mainstream lenders have struggled to serve these customers. Small dollar lending is high-cost and challenging; lenders incur many of the same expenses and risks with small dollar loans as they would with larger loans but with much less profit. Despite these very real challenges, there is an extraordinary and growing demand for such small loans. This imbalance between supply and demand drives individuals and families, particularly those from low income, minority communities, to rely on expensive, potentially dangerous financial options that can be harmful to their financial well-being.

The Pilot Program took important, pioneering steps toward addressing some of the statutory barriers relating to making small loans. However, more needs to be done. SB 318 takes the experience and lessons learned from the existing Pilot Program and proposes changes necessary to increase the supply of good, small dollar lenders and loans so that low income consumers have real, readily accessible alternatives that will help them achieve positive financial outcomes and build a more secure financial future.

Progreso Financiero is an innovative, mission-driven, California-headquartered company that is dedicated to helping more than 23 million hard working and under-banked Latinos in the U.S. access responsibly priced credit and establish positive credit histories. We lend to lower income Latinos who have little or no credit histories. We are able to do this by using our unique, proprietary, innovative credit scoring system that we combine with in-person, traditional customer relationship building. As part of the Pilot Program, we also offer credit education to our borrowers and help them fully understand what it means to take out a loan and be financially responsible. We have developed a robust, growing micro-lending platform available in nearly 70 locations in California.

The result of our approach is that we have helped hundreds of thousands of Californians move up the economic ladder. We have an unsurpassed track record in this area of lending, and since our founding in 2005 we have originated nearly $600 million dollars in small dollar loans. Approximately half of our customers come to us with no credit score. Our loans help them build a positive credit history and credit scores. Our efforts have been nationally recognized on several occasions. We were certified as a Community Development Financial Institution (CDFI) in 2009 by the U.S. Department of Treasury, a designation that is reserved for organizations who have demonstrated a commitment to increasing economic opportunity and promoting community development in underserved populations or distressed communities in the US. We were the sponsor of the original legislation and worked hard for its passage. Much of the Pilot Program is modeled after our best practices…

Now, after several years of experience in the Pilot it is clear that more needs to be done to increase access to the program for both lenders and borrowers. We need to make the benefits of the Pilot more widespread, viable and useful to Californians. SB 318 does that. SB 318 addresses some of the economic barriers faced by current and potential lenders in this market while preserving the responsible lending practices of the program. We hope that this will attract more program participants and help cultivate a robust responsible small dollar lending industry in California.

The best way to combat predatory and harmful lending is to encourage and allow more socially responsible lending like that enabled by the Pilot Program. SB 318 does this in a measured, thoughtful way. The more lending flourishes under the Pilot Program the better off are those who need better options for small loans.

Arguments in opposition.

Consumers Union writes in opposition:

Although the lenders participating in the current pilot program claim that SB 318 will better enable them to achieve success and profitability, we still have relatively little data regarding the performance of the outstanding loans in the program. It is difficult to tell whether consumers are benefiting from the existing pilot, since it is only halfway complete. It is even less clear whether SB 318 would achieve a better outcome. Furthermore, we believe it is important that the business needs of individual lenders are balanced with consumers' need to get a fair deal and improve their financial health.

Given this context, we are concerned that the current provisions of SB 318 may impose too many new fees on consumers and result in riskier loans. Still, Consumers Union firmly believes that consumers deserve reasonable access to affordable credit. We appreciate the intent behind SB 318 – to create a fair and viable framework for installment loans under $2500.

We have been in discussion with the author's office to address our concerns in three key areas: (1) interest rates; (2) timing and amount of administrative fees; and (3) refinancing standards. We have indicated to the author that the following changes would remove our opposition:

Interest rates: allow the rates to float with prime, but place an upper cap of 36% on the first $1000 borrowed and an upper cap of 34% on additional principal above $1000.

Administrative fees: permit administrative fees to be charged every four months, capped at the lesser of 7% of principal borrowed or $90, but reduce the amount charged to the same consumer on subsequent loans to the lesser of 5% or $65.

Refinancing: permit administrative fees in connection with a refinancing after 8 months but set minimum standards for who is eligible for a refinance loan, so that borrowers *struggling to repay existing loans are not taking on unsustainable debt burdens. Calculate applicable fees based on the new additional amount borrowed only*.

Arguments of concern.

Center for Responsible Lending, Law Foundation of Silicon Valley, and the California Reinvestment Coalition have provided letters expressing neither support or opposition, but concern with the provisions of SB 318. The concerns generally expressed are that it is too early to create a new pilot when the existing pilot has yet to run its course and that the increase in fees and interest proposed to be charged to consumers in the bill are not appropriately justified. These groups also express concern with the increased interest rates and administrative fee and that the interest rate is tied to the Prime rate could rise. Furthermore, concerns have been raised regarding the frequency at which administrative fees may be charged.

Questions & Discussion.

1) This bill would create a new small dollar pilot program prior the exhaustion of the current pilot program. The reasons and justifications for these changes are mentioned elsewhere in this analysis. However, as a fundamental matter of policy, the question must be asked as to whether it is appropriate to give up on the pilot project before the release of the required report on its impact and potential reforms? Related to this issue, is whether it is appropriate to have two pilot programs operating at the same time. The existing pilot is schedule to sunset on January 1, 2015, meaning that it would continue for one more year in conjunction with the pilot proposed under SB 318. Staff recommends that that the existing pilot should be terminated with language that ensures that existing pilot lenders will transition automatically to the new program proposed under SB 318 should it be signed into law.

2) Two years after its creation, the pilot project has only three licensees. Those three licensees made a combined 118,100 loans in 2012 under the pilot, with 118,000 of those loans being made by Progreso. As noted earlier, during the same period over twelve million payday loans were made in California. From a standpoint of both volume of loans and number of licensees the pilot has not garnered the participation or market saturation that was hoped for when the original legislation was passed in 2010. A major selling point of the existing pilot was its potential to supplant the lure of payday lending by providing a sustainable alternative. Thus far, the numbers do not reflect that the existing pilot has provided the alternative that policy makers hoped for. On the other hand, not every borrower that can get a payday loan would qualify for a loan from a pilot lender. The pilot requires robust underwriting standards that are not required for payday loans. Staff discussion's with pilot lenders reveal that 40% or more of borrowers are rejected for pilot loans for not meeting the underwriting criteria. While these early indications may reveal that the existing pilot needs revisions for success, the issue on how to determine "success" is complicated. Staff is reminded of this by the 2002 statement of then Secretary of State Donald Rumsfeld when he said, "There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things that we know we don't know. But there are also unknown unknowns. There are things we don't know we don't know."

   Loan volume and the number of licensees would indicate a lack of pilot success. However, the lack of data is troubling in that the committee does not have a clear view of other issues that may be affecting the lack of success. SB 318 does require a report to occur in two years after implementation of its provisions that will shed some light on its success. However, at this time the answers to the following questions regarding the existing pilot would be helpful in making further determinations:

a) How many borrowers are repeat borrowers, and of those, what is the frequency?

b) How many borrowers refinance? Generally, what are the reasons for refinance?

c) How many borrowers are rejected for a loan? What are the reasons for rejection?

d) How many borrowers have improved credit scores? Do those borrowers move on to different credit options?

e) How many borrowers had used payday loans, or had outstanding payday loans?

3) Tiered interest rates. SB 318 provides for two interest rates tied to the prime rate (currently 3.25%). For loans $1,000 and below the rate is 32.75%+Prime that currently equals 36%. For loans from $1,000 to $2,499 the rate is 28.75%+Prime that currently equals 32%. Amendments to this bill in Senate Judiciary capped the rates at 36%. Should the Prime rate rise 4% in the next four years the rate for both tiers would be 36% eliminating the slight savings a borrower would receive for those amounts above $1,000. How likely is an increase of this nature in the next four years? The Federal Reserve has indicated that an increase in the federal funds rate is unlikely until mid-2015. The federal funds rate has an impact on prime so it is likely that the Prime rate will remain stable for the next few years. The most important factor to determine the appropriate response to this issue will be the performance of the program itself. If, in a few years' time, program participants are successful under the current rate structure and that structure has moved relatively due to little fluctuation in the Prime rate then policy makers may want to consider locking in rates before making this program permanent.

4) The existing pilot provides that six months must elapse before the same borrower can be charged an administrative fee. SB 318 shortens this to 4 months. The existing pilot provides that an administrative fee may not be received for a refinancing of a loan unless at least one year has elapsed since the previous fee paid by the borrower. SB 318 shortens this to eight months. If the decreased timeframes are justifiable, then it may be worth considering that a limit be placed on the number of times a loan can be refinanced. Repeat refinancing has been a feature of very high cost lending in other states on installment loan products. While this bill has worthy goals, the potential of increasing participants in this market could also increase the potential for abusive refinancing by new entrants.

5) The existing pilot and the program provided for under SB 318 both contain an element of credit education in that a lender must provide access to a borrower to a credit education program. While it was not an issue in the existing pilot, it may be appropriate to specify that any credit education programs must be offered free of charge.

6) As noted earlier, under the current CFLL, loans above $2,500 have no rate restrictions leaving borrowers in need of amounts over $2,500 with expensive options. The current pilot and the program provided for in SB 318 would allow lending between $300 to $2,500. Should this range be increased to $5,000 under the proposed program? This increased range

of loan amounts would not change the existing CFLL but could allow program participants to demonstrate whether loans up these amounts are profitable for the lenders and responsible for the borrowers.

Amendments.

1) Eliminate the Pilot Program for Affordable Credit-Building Opportunities and ensure that existing licensees under that Pilot will automatically migrate to the proposed program in SB 318 should it be signed into law.

2) Clarify that the credit education program shall be at no-costs to the borrower.

3) SB 318 requires licensees to apply to the Deputy Commissioner of DBO and provides the Deputy Commissioner with the authority to regulate these entities. Delete reference to "Deputy" throughout so that the "Commissioner" of DBO is the primary regulator.

4) The June 17th, 2013 amendments contained a drafting error. The following change is recommended:

    a) Page 7, line 6, strike “a” and insert: that

5) A licensee would be allowed to provide certain disclosures about their loan via a "mobile phone application." Given rapid changes in technologies (smart phones, tablets, tablet/phone hybrids) that program participants may want to use to reduce overhead costs, staff recommends the following amendment:

    a) Page 5, line 39: required by paragraph (3) in a mobile ~~phone~~ application, on which

REGISTERED SUPPORT / OPPOSITION:

Support

Silicon Valley Community Foundation
California Hispanic Chambers of Commerce
Progreso Financiero
FairLoan
LendUp
OpenCoin
Vallarta Supermarkets
Silicon Valley Leadership Group

Opposition

Consumers Union

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