Date of Hearing: April 1, 2019

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Monique Limón, Chair
AB 539 (Limón) – As Amended March 26, 2019

**SUBJECT**: California Financing Law: consumer loans: charges

**SUMMARY**: Prohibits California Financing Law (CFL) licensees from receiving charges on a consumer loan at a rate exceeding 36% per annum plus the Federal Funds Rate for loans with a principal amount from $2,500 to $10,000.

Specifically, **this bill**:

1) Establishes an interest rate cap on consumer loans with principal amounts from $2,500 to $10,000. Licensees may not receive charges exceeding an annual simple interest rate of 36% per annum plus the Federal Funds Rate. As of 3/22/2019, the Federal Funds Rate was 2.4%.

2) Permits a licensee to receive a $75 administrative fee, in addition to the permitted charges as described in #1 above, for loans of $2,500 - $5,000, in accordance with existing law.

3) Prohibits a licensee from charging a penalty for the prepayment of a consumer loan, excluding consumer loans that are secured by real estate.

4) Establishes a minimum loan term of one year for consumer loans with principal amounts in excess of $2,500, but less than $10,000. Excludes consumer loans that are secured by real estate.

5) Establishes a maximum loan term of five years for loans of $5,000 to $10,000.

6) Requires that fees paid to a licensee for the privilege of participating in an open-end credit program are considered "charges" as defined in Sections 22200 and 22201 of the Financial Code.

**EXISTING LAW**:

1) Provides for the CFL, administered by the Department of Business Oversight (DBO), which authorizes the licensure of finance lenders, who may make secured and unsecured consumer and commercial loans (Financial Code Sections 22000 et seq.). The following are the key rules applied to consumer loans made pursuant to the CFL:

   a) Consumer loans under $2,500 are capped at interest rates which range from 12% to 30% per year, depending on the unpaid balance of the loan (Sections 22303 and 22304). In addition to the allowable interest charges, licensees may receive an administrative fee capped at the lesser of 5% of the principal amount of the loan or $50 (Section 22305).

   b) In addition to the requirements in "a" above, CFL licensees who make consumer loans under $5,000 are prohibited from imposing compound interest or charges (Section 22309); are limited in the amount of delinquency fees they may impose (Section 22320.5; delinquency fees are capped at a maximum of $10 on loans 10 days or more delinquent and $15 on loans 15 days or more delinquent); are required to prominently display their schedule of charges to borrowers (Section 22325); are prohibited from splitting loans with other licensees (Section 22327); are prohibited from requiring real property collateral (Section 22330), and are limited to a maximum loan term of 60 months plus 15 days (Section 22334). For loans from $2,500 to $5,000, administrative fees are capped at $75 (Section 22305).

c) In addition to the requirements in "a" and "b" above, CFL licensees who make consumer loans under $10,000 are limited in their ability to conduct other business activities on the premises where they make loans (Section 22154); must require loan payments to be paid in equal, periodic installments (Section 22307); and must meet certain standards before they may sell various types of insurance to the borrower (Sections 22313 and 22314).

d) Generally speaking, the terms of loans of $10,000 or above are not restricted under the CFL.

2) Until January 1, 2023, authorizes the Pilot Program for Increased Access to Responsible Small Dollar Loans (Pilot) within the CFL (Financial Code Sections 22365 et seq.). The following are key rules applied to consumer loans made pursuant to the Pilot:

a) Permits approved licensees to make a loan with a bona fide principal amount of at least $300, but less than $7,500. Interest rates are capped at the lesser of 36% or 32.75% plus the prime rate for the unpaid principal balance up to $1,000, and the lesser of 35% or 28.75% plus the prime rate for the unpaid principal balance in excess of $1,000 (Section 22370(a) and (b)).

b) Provides that a licensee may charge an administrative fee in an amount not to exceed 7% of the principal amount, or $90, whichever is less, on a first loan, and 6% of the principal amount, or $75, whichever is less, on a second or subsequent loan. A licensee may not charge an underwriting fee more than once in any four-month period, and no administrative or underwriting fee may be charged in connection with a loan refinance unless at least eight months have elapsed, as specified (Section 22370(c)).

c) Requires a licensee to underwrite each loan and states that the licensee shall not make the loan if it determines that the borrower's total monthly debt service payments exceed 50% of the borrower's gross monthly income, as specified (Section 22370 (f)), for a loan of $2,500 or less. For a loan of more than $2,500, the borrower's total monthly debt service payments cannot exceed 36% of the borrower's gross monthly income.

**FISCAL EFFECT**: Unknown

**COMMENTS**:

1) PURPOSE:

The authors state:

> This bill seeks to promote affordable and accessible credit for consumers and give responsible lenders confidence in the regulatory stability in California so they can expand and offer safer loan alternatives to consumers. The lack of guidance from the Legislature on allowable interest rates for loans of $2,500 -

$10,000 has led to a "wild west" where unscrupulous lenders are charging interest rates from 100% to more than 200% on these larger installment loans. Consumers are struggling under these egregious terms, and at least one out of three consumers default on these debts.

These high default rates and unconscionable interest rates have caused turmoil in the regulatory environment. In recent years, the Legislature has considered bills designed to address this problem, but which also would have restricted access to carefully underwritten loans made by responsible lenders. Meanwhile, the ongoing class action lawsuit against high-cost lender, CashCall, led to a unanimous California Supreme Court opinion in August 2018 that decided that these sky-high interest rates may be considered "unconscionable." Additionally, advocacy groups have voiced their intentions to take this issue to the people in the form of the ballot initiative. If the Legislature would like a say in determining how our consumer credit markets should be structured, the time is upon us to act.

As Chair and Member of the Assembly Banking Committee, we have worked over the past year to negotiate a compromise between consumer advocates and responsible lenders in California. The result of those negotiations is AB 539. Some national organizations continue to state that the interest rates allowed by AB 539 are still too high, while high-cost lenders say that they are too low. The bill is supported a large coalition of community and faith-based organizations, cities and counties, and responsible lenders who recognize that 100% interest rates and high default rates are harming more than 100,000 California families each year and that we must act to protect our consumers.

2) BACKGROUND:

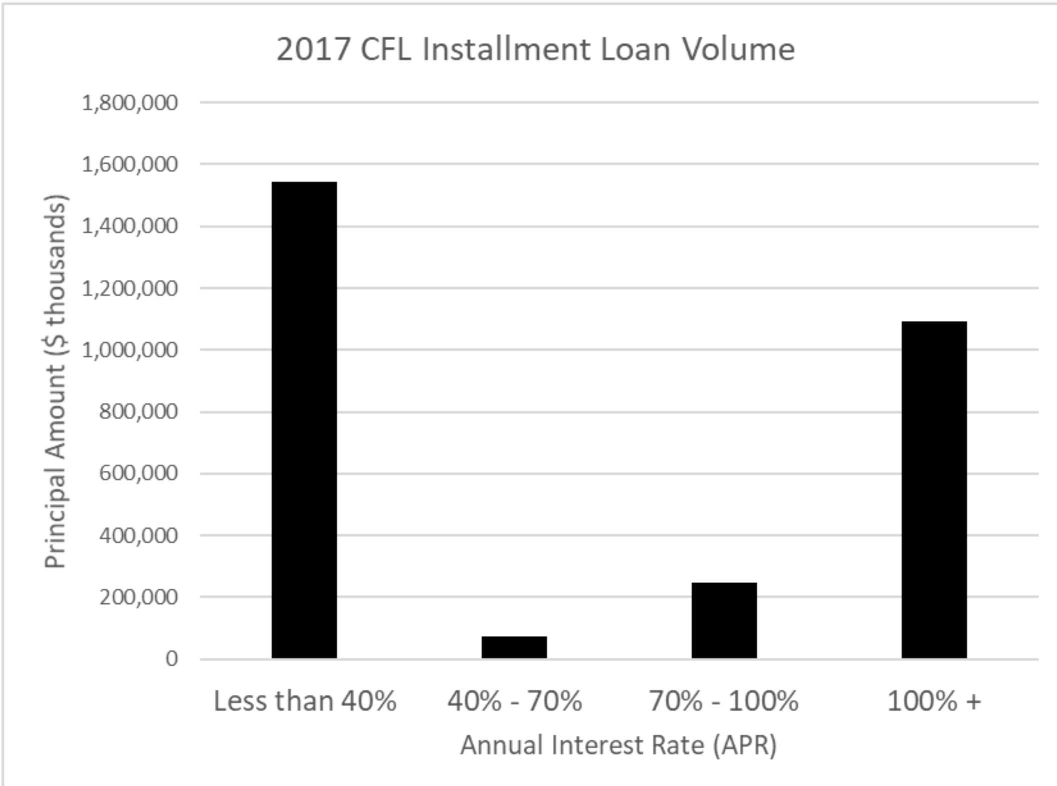
CFL lenders that offer installment loans with principal amounts of $10,000 or less often serve consumers who have limited credit options due to damaged credit history or minimal credit experience. Some of these consumers are not able to qualify for credit from banks and credit unions, so they turn to alternative financial service (AFS) providers (e.g., payday, title, and installment lenders) for their credit needs. Due to the higher credit risk of borrowers and less efficient business models of many AFS providers compared to banks and credit unions, the interest rates and finance charges for AFS products can be significantly higher than typical credit card rates, which are in the range of 10-30% APR.[1]

*Market Snapshot*

According to data provided by lenders to DBO, CFL lenders originated 745,012 consumer loans with principal amounts of $2,500 to $10,000 in 2017, totaling to an aggregate principal amount of $3 billion. As reflected in Chart 1, the market is roughly bifurcated – $1.5 billion, or 52%, of loans have interest rates below 40% APR and $1.1 billion, or 37%, of loans have interest rates above 100% APR.

[1] "APR", or annual percentage rate, is an annualized metric for the cost of borrowing that includes fees and interest paid over the life of a loan.

Chart 1




*Market Trends*

The existence of high-cost installment loans[2] is a relatively new phenomenon in California. CashCall, a high-cost lender, is credited with pioneering this product in the mid-2000s. CashCall experimented with various interest rates until settling on 135% in 2009. These high interest rates allowed CashCall to operate a profitable business model even though its model assumed a default rate of 35-40%.[3] As investors and competitors witnessed CashCall's success in spite of such high default rates, copycat business models entered California, and this market has increased drastically since 2010, as reflected in Chart 2. High-cost lenders originate more than 350,000 loans each year with interest rates of 100% or more, for an aggregate principal amount of $1.1 billion.

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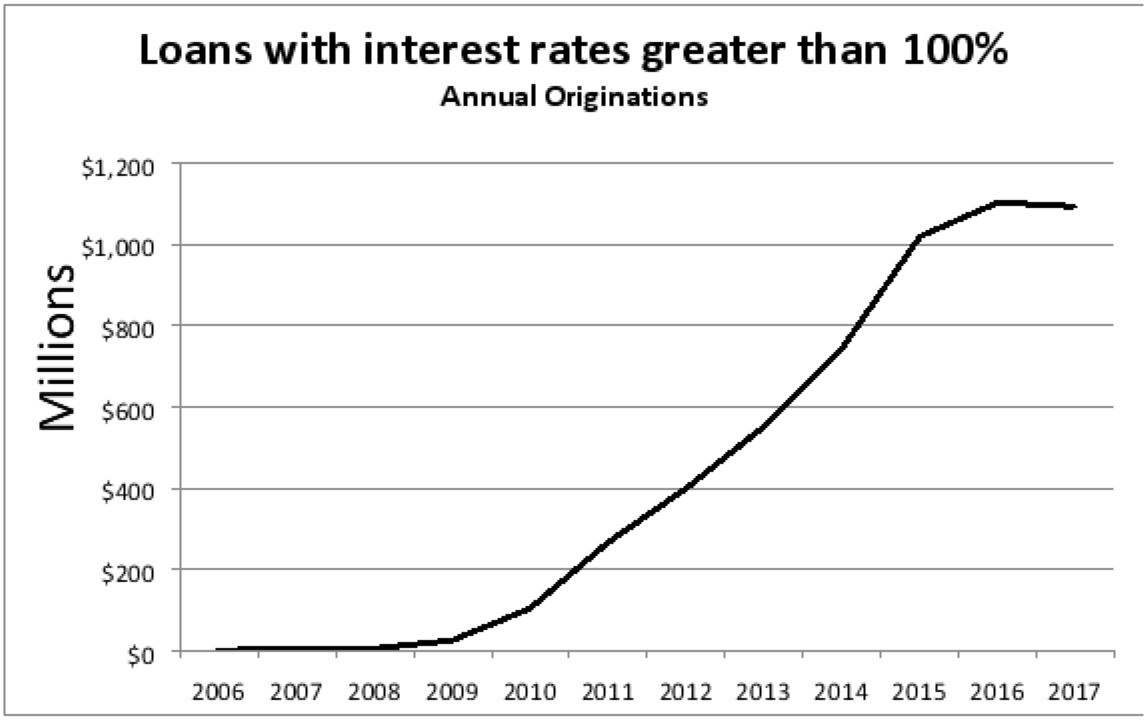
[2] In this analysis, the term "high-cost loan" refers to a loan with an annual interest rate of 70% APR or more. Loans with lower interest rates, however, could still be considered high-cost. The term "high-cost lender" refers to lenders who reported that all or nearly all of the consumer loans that they originated had an annual interest rate of at least 70% APR.

[3] The information about CashCall's business model was provided by CashCall Chief Financial Officer Delbert Meeks in a 2013 court filing as part of a class action lawsuit against the lender (Case No. C 08-03174 MEJ).

Chart 2




*Examples of Loan Terms*

Since CashCall showed that the model could be profitable, more than a dozen large lenders now offer similar products in California. Each lender typically adjusts the interest rate and loan terms over time as they attempt to meet their profitability targets. Table 1 below provides example loan terms that were posted on lenders' websites on 3/24/2019. The websites advertise the "quick," "easy" availability of these products.

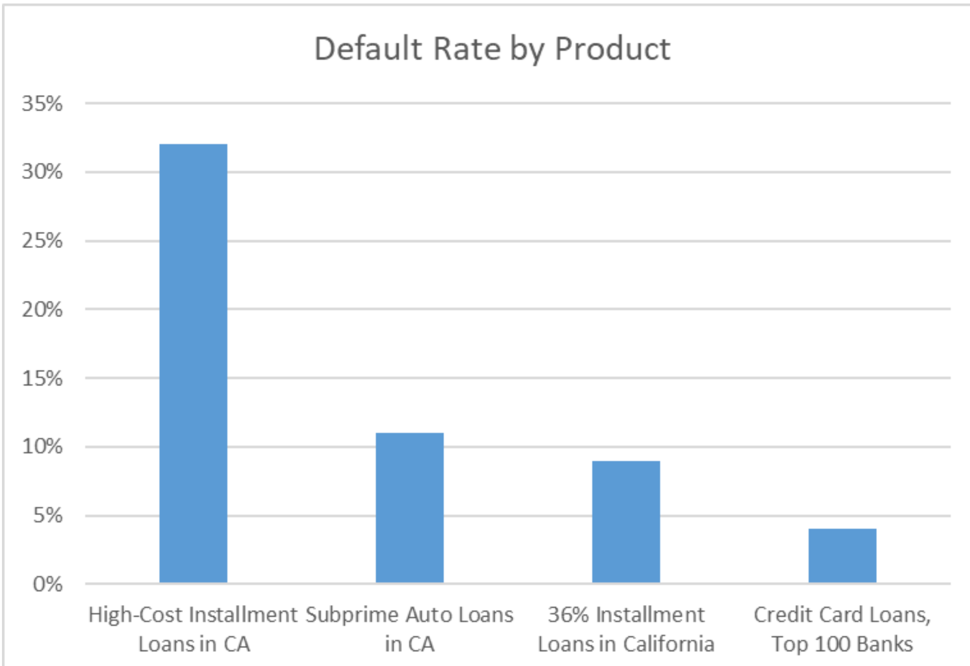
Table 1

| Lender | Loan Amount | Loan Term (months) | Monthly Payment | Total Repayment | APR |
|---|---|---|---|---|---|
| Advance America | $2,550 | 24 | $449 | $10,782 | 206% |
| Check'n Go | $2,600 | 9 | $612 | $5,508 | 218% |
| Elevate | $2,600 | 16 | $483 | $7,726 | 224% |
| LoanMe | $2,600 | 47 | $388 | $18,255 | 184% |
| SpeedyCash (aka CURO) | $2,600 | 42 | $281 | $11,806 | 132% |

3) HOW DO THESE LOANS AFFECT CONSUMERS?

While these high-cost loans may be "quick" and "easy" to obtain, data provided by high-cost lenders suggest that consumers often do not have such an easy time paying back the loans. In fact, high-cost lenders charged-off 32% of their loans in 2017.[4] This metric indicates that at least one out of three borrowers are unable to repay their loans.[5] This high default rate is nearly unprecedented in the financial marketplace, based on analysis of loan performance metrics for other credit market. For comparison, the default rate in the subprime auto loan market in California was 11% in 2017, with "subprime" defined as borrowers with a Vantage Score of 300-600.[6]

Chart 3




What happens when a loan is charged-off? Lenders are able to count this as an expense that can be used to lower the taxes they owe to the state and federal governments. For borrowers, however, charged-off loans do not go away. Lenders assign the amount owed to debt collectors or sell the loan off in the secondary market to a debt buyer. The consumer's credit score is negatively affected, and they are subject to aggressive collections practices, which can ultimately result in their car being repossessed, their paycheck garnished, their bank account closed, and even bankruptcy.

For those consumers who can ultimately repay these loans, they avoid the negative consequences that accompany a default, but their benefits are limited by the high rate of interest and the lack of improvement to their credit score. As indicated by the loan terms

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[4] CFL licensees are required to report the number of loans that they "charged-off" in their annual report to DBO. Under generally accepted accounting principles, a company is required to write-off (aka, charge-off) a loan that is not collectable, meaning the lender has a reasonable belief that it will not be able to collect the principal and interest on the loan.

[5] In annual reports to DBO, lenders are not required to report the number of loans originated that were used to refinance an existing loan. This means, for example, that a borrower could take out three sequential loans from high-cost lenders, default on the last loan, but the data would show a charge-off rate of 33%. If the metric was focused on the borrower rather than the loan, the charge-off rate in this example would be 100%.

[6] This data was collected from credit bureaus by Urban Institute and published here: https://apps.urban.org/features/debt-interactive-map/?type=auto&variable=autoopen_pct&state=6

summarized in Table 1 above, scheduled interest and finance charges on high-cost loans typically exceed the original principal amount borrowed, often by a magnitude of 2x or more. Furthermore, only a few high-cost lenders report the borrower's payments to a credit bureau. This means that even if a borrower repays the loan on-time and in full, their credit score does not improve, leaving them trapped outside of the mainstream financial system with little hope of accessing better rates and products offered by banks and credit unions.

4) UNDERWRITING: Evaluation of ability to repay is an essential component of healthy credit markets

   Credit markets generate a valuable public benefit by providing consumers with capital to finance investments that improve their financial well-being. Credit markets work best when the interests of borrowers and lenders are beneficially aligned. We observe this mutual interest in a large majority of credit markets (e.g., mortgage finance, credit cards, and bank loans). Lenders who consistently make loans that borrowers cannot repay are unable to sustain a profitable business, providing a strong incentive for lenders to evaluate a borrower's ability to repay and to verify that a loan fits within the borrower's budget.

   In the market for high cost installment loans addressed by this bill, there is not a strong mutual interest between lenders and borrowers. By charging high interest rates, lenders can generate enough revenue to profit on a loan, even if the borrower eventually defaults. This misalignment of interests creates an incentive for lenders to avoid the costs associated with underwriting which results in borrowers accepting loans that they cannot afford. Data provided by lenders to DBO show that high-cost lenders made more than $100 million in operating profit from California borrowers in 2017, in spite of a 32% charge-off rate. Existing law in California supports an incentive structure that skews heavily in favor of high-cost lenders.

   Capping allowable interest rates as proposed by this bill would better align the interests of borrowers and lenders in the CFL market. At the proposed rates, a lender cannot sustain a profitable business model without evaluating borrowers' ability to repay.

5) ESTIMATED IMPACTS

   If enacted, California will join 38 states and the District of Columbia that have interest rate caps for these types of loans, according to the National Consumer Law Center. The cap proposed by this bill would be at the higher end of caps in other states. All else equal, this should result in a more robust market for state-licensed loans than other states, while still providing protection from unaffordable interest rates.

   The interest rate cap proposed by this bill will reduce the number of consumer installment loans made by CFL licensees in California. Some consumers who were previously served by high-cost lenders will be able to qualify for loans from lenders operating under the proposed caps. Consumers who are unable to demonstrate an ability to repay will have difficulty finding a lender that will offer them a loan under the proposed rate cap. These factors will likely result in a significant decrease in the number of consumers who default on loans and help them to avoid the associated negative consequences to their financial well-being.

6) ARGUMENTS IN SUPPORT

The County of Los Angeles, as sponsor, writes:

> In December 2017, the [Los Angeles County Board of Supervisors] recognized the harmful effects that unregulated, high-cost lending was having on its most vulnerable communities and directed the Los Angeles County Department of Consumer and Business Affairs (DCBA) to identify options to curb the effects of these types of loans in Los Angeles County…In response, DCBA formed a workgroup that researched and analyzed trends and policies affecting high-cost loan products…The overconcentration in low-income and minority communities, the report found, is likely fueling a cycle of debt, adding to income instability and can contribute to conditions of blight, crime and ill health…
>
> The County's commitment to reducing our community's reliance on loans that default at a rate of 40 percent and contribute to a lack of financial security among communities most susceptible to predatory lending is clear and ongoing. AB 539 is an important step toward providing access to fair, affordable credit and promoting a healthier market for economically disadvantaged Californians.

The California Financial Services Association, which is comprised of traditional Consumer Finance Lenders licensed by the Department of Business Oversight, writes:

> CFSA members are frequently approached by consumers trying to find ways to get out of exceedingly high interest rate loans with APRs well in excess of 100%. Some consumers are able to take out lower interest rate loans in order to pay off higher interest rate loans, whereas other consumer who have no practical ability to repay a loan are generally stuck. It is a fallacy to suggest that lending money to consumers who have no practical ability to repay a loan is somehow beneficial…
>
> From a business perspective, AB 539 is also important because it provides certainty in the marketplace. Whether it be a suggested ballot initiative or repercussions from last year's Cash Call ruling, lenders need certainty so they can expand their business in California. AB 539 provides the necessary certainty.

A coalition of consumer advocacy, community, and religious groups under the title of Californians for Economic Justice writes:

> While the state unemployment rate is near record lows, the household incomes of working Californians have not kept up with the rising costs of housing, child care, and health care. As families face financial pressure, California has a responsibility to ensure that available credit products meet the needs of consumers, reflect their ability to repay and do not allow Californians under financial duress to be subjected to predatory practices. Currently, California is failing to meet these responsibilities…
>
> AB 539 will protect borrowers from the predatory practices of triple-digit lenders by enacting a reasonable interest rate cap on installment loans that allow lenders to make a fair return and give borrowers a fair chance to repay the loan.

7) ARGUMENTS IN OPPOSITION

The California Financial Service Providers, the trade association for small-dollar consumer lenders, writes:

> This bill would have the effect of eliminating most small dollar loan products in California, as this has been the result in other states that imposed unworkable rate caps…A consumer's need for credit does not disappear once a rate cap is in place and industry shuts down. To meet their financial obligations, consumers are forced to choose costlier or unregulated options, such as overdraft programs, unregulated loans or bankruptcy...
>
> Providing credit to non-prime consumers is demanding and requires lenders with sophisticated underwriting, years of experience, new technology enhancements, and ability to secure funds to lend in this space. Our member businesses are in the communities they serve and have significant premise and operating costs. Additionally, labor costs, the cost of underwriting and compliance, the cost of credit reporting, and the cost of defaults, all drive up the price of delivering the product to consumers.

The California Hispanic Chambers of Commerce writes:

> The California Hispanic Chamber of Commerce (CHCC) represents the interests of more than 800,000 Hispanic business owners in California. We are deeply concerned about the impact AB 539 will have on small businesses and consumers. As proposed, AB 539 will limit lenders' ability to provide a variety of short-term credit options to borrowers in need…
>
> Rate caps and other artificial ways of restricting small-dollar lending only serve to push responsible, licensed companies out of the market while doing nothing to address consumers' underlying need for credit. AB 539 would result in more than $1.3 billion in unmet consumer loan demand; without access to safe, reliable credit options, borrowers will be forced to overdraft their bank accounts, declare bankruptcy or seek loans from other non-state-licensed and illegal, offshore lenders to get the money they need.

**REGISTERED SUPPORT / OPPOSITION**:

**Support**

County Of Los Angeles Board Of Supervisors (Sponsor)
African Methodist Episcopal Church
American Federation Of State, County And Municipal Employees (AFSCME), AFL-CIO
Asian Law Alliance
Bay Area Legal Aid
Beneficial State Foundation
California Asset Building Coalition
California Catholic Conference
California Financial Services Association
California Labor Federation, AFL-CIO

California League Of United Latin American Citizens
California Reinvestment Coalition
California Voices For Progress
Californians For Economic Justice
CALPIRG, California Public Interest Research Group
City And County Of San Francisco - Office of Financial Empowerment
City And County Of San Francisco - Treasurer's Office
City of Concord
Coalition For Humane Immigrant Rights
Color Of Change
Community Development Technologies
Community Housing Opportunities Corp
Community Legal Services Of East Palo Alto
Consumer Attorneys Of California
Consumers For Auto Reliability & Safety
County Of Santa Clara
East Bay Community Law Center
Housing And Economic Rights Advocates
League Of United Latin America Citizens
Lendmark Financial Services
Mission Asset Fund
Mission Economic Development Agency
National Association Of Social Workers, California Chapter
National Housing Law Project
NEW Economics For Women
NextGen California
OneMain Financial
Oportun
Opportunity Fund
Public Law Center
Service Employees International Union (SEIU)
Small Business Majority
St. John Church Oceanside
Swords To Plowshares - Vets Helping Vets
The Green Lining Institute
True Connect
UDW/AFSCME Local 3930
UnidosUS
United Way Bay Area
Ward Economic Development Corporation
Western Center On Law And Poverty

**Oppose**

Advance America; Cash Advance Centers Of California, Inc.
Axcess Financial
Bizfed Central Valley
CA State NAACP
California Black Chamber Of Commerce

California Financial Service Providers
California Hispanic Chambers Of Commerce
Cashback Loans
Champion Financial Services
Check Into Cash Inc.
Curo Financial Technologies Corp
Habematolel Pomo Of Upper Lake
La Metro Hispanic Chamber Of Commerce
Latin Business Association
Los Angeles County Business Federation (Bizfed)
Online Lenders Alliance
Orange County Hispanic Chamber Of Commerce
Slavic-American Chamber Of Commerce
Titlemax Of California, Inc. D/B/A Titlemax
Valley Industry And Commerce Association
Wheels Financial Group, Llc D/B/A Loanmart

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