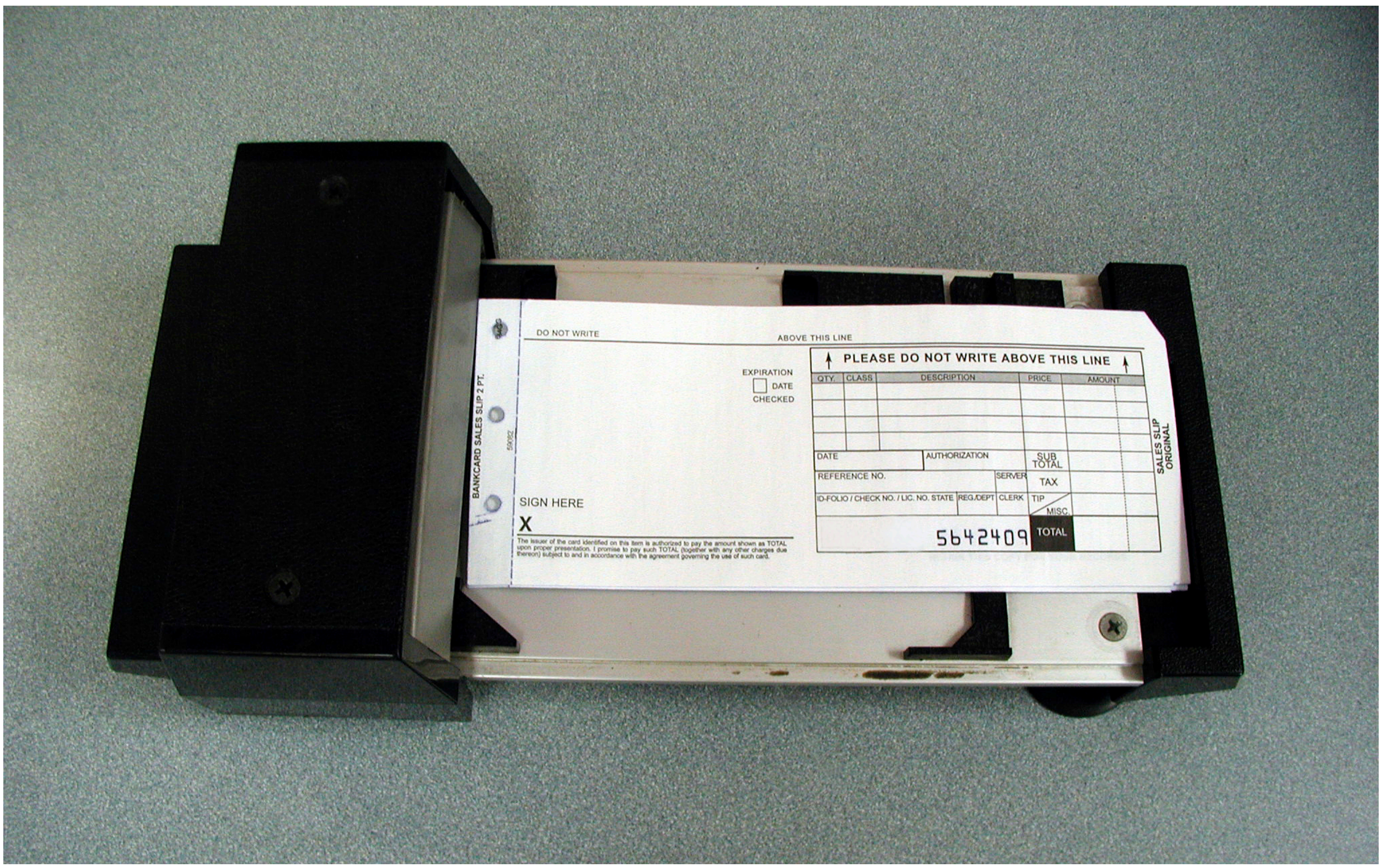
Assembly Banking and Finance Committee

Summary of Legislation

2013–2014

Roger Dickinson, Chair
Travis Allen, Vice Chair



Members:

Katcho Achadjian
Rob Bonta
Ed Chau
Mike Gatto
Diane Harkey
Eric Linder
Henry Perea
Freddie Rodriguez
Shirley Weber
Das Williams

Committee Staff:

Mark Farouk, Chief Consultant
Kathleen O'Malley, Principal Consultant
Tiffany Morrison, Committee Secretary
Peter Renevitz, Minority Consultant

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BUSINESS FILINGS

AB 2289 (Daly) Business filings

This bill amends several laws administered by the Department of Business Oversight (DBO) to clarify the definition of an "electronic record," and increases, from 15 days to 30 days, the amount of time in which the Commissioner of DBO has to review franchise applications and franchise renewals under the Franchise Investment Law.

Status: Chaptered by Secretary of State, Chapter 782, Statutes of 2014

SB 537 (Committee on Banking and Financial Institutions) Business and finance

This bill makes technical and clarifying changes to several sections of the Financial Code administered by the Department of Business Oversight (DBO) and to provisions of the Franchise Investment Law also administered by the DBO.

Status: Chaptered by Secretary of State, Chapter 334, Statutes of 2013

COMMUNITY INVESTMENTS

AB 495 (Campos) Community investment

AB 495 would create the California Community Investment Program within the Governor's Office of Business and Economic Development (GO-Biz). Requires the program to create a database of low-income neighborhoods, compile and maintain an inventory of California public sector funding resources and financing mechanisms, coordinate public sector financial investment and public programs to assist low-income communities to become business, development, and investment ready, develop criteria for triple bottom-line investment funds, establish overall triple bottom-line goals and standardized metrics for economic, social, and environmental outcomes to be accepted by eligible investment funds, establish and convene regular meetings of the California Community Investment Network comprised of organizations and institutions with expertise and resources to advise the California Community Investment Council and eligible investment fund managers, and report biannually to the Legislature and the Governor on the status and progress of the California Community Investment Program and performance on goals and triple bottom-line outcomes, as specified.

Status: Died in Senate Appropriations Committee

CONSUMER LOANS

SB 318 (Hill, Correa, Steinberg) Consumer loans: Pilot Program for Increased Access to Responsible Small Dollar Loans

Until January 1, 2018, establishes the Pilot Program for Increased Access to Responsible Small Dollar Loans for the purpose of allowing greater access for responsible installment loans in principal amounts of at least $200 and less than $2,500; and requires loans made pursuant to the Program to meet specific requirements.

Status: Chaptered by Secretary of State, Chapter 467, Statutes of 2013

SB 896 (Correa) Finance lenders: nonprofit organizations: zero-interest, low-cost loans: exemptions

Exempts nonprofits that facilitate zero interest, low-cost loans under specified circumstance from the California Finance Lenders Law (CFLL).

Status: Chaptered by Secretary of State, Chapter 190, Statutes of 2014

SB 1181 (Correa) Finance lenders

Revises provisions of the California Finance Lenders Law (CFLL) relating to venture capital (VC) companies.

Status: Chaptered by Secretary of State, Chapter 68, Statutes of 2014

CORPORATIONS

AB 367 (Brown) Limited liability companies: filings

This bill would require a limited liability company to annually file the specified informational form and would revise the applicable filing period for limited liability companies.

Status: Died in Assembly Banking and Finance Committee

AB 434 (Hagman) Preferred shares: rights and preferences distributions

This bill provides that a distribution to a corporation's shareholders may be made without regard to the preferential dividends arrears amount or any preferential rights amount, or both. This bill corrects a code section reference that was inadvertently not corrected by AB 571 (Hagman, Chapter 203, Statutes of 2011).

Status: Chaptered by Secretary of State, Chapter 38, Statutes of 2013

AB 457 (Torres) Shareholders

This bill eliminates the 10-day waiting period that currently applies for corporate reorganizations in which shareholders have the right under dissenters' rights to demand payment of cash for their shares.

Status: Chaptered by Secretary of State, Chapter 109, Statutes of 2013

AB 491 (Torres, Bonta) Corporations: bylaws: emergency powers

This bill authorizes a corporation, nonprofit public benefit corporation, nonprofit mutual benefit corporation, or nonprofit religious corporation to take actions in anticipation of or during an emergency, as defined, and to adopt bylaws to manage and conduct ordinary business affairs of the corporation effective only in an emergency.

Status: Chaptered by Secretary of State, Chapter 255, Statutes of 2013

AB 1255 (Pan) Corporations: consumer cooperatives

This bill authorizes a consumer cooperative corporation to (1) provide for preferred memberships and/or non-voting memberships in its articles of incorporation or bylaws; (2) divide a membership class into one or more series; and (3) authorize the board of directors to fix the rights, privileges, preferences, restrictions, and conditions attaching to any wholly unissued class or series of memberships. Also, makes conforming changes to the laws governing consumer cooperative corporations.

Status: Chaptered by Secretary of State, Chapter 538, Statutes of 2013

AB 1355 (Wilk) Limited liability companies: indemnification: agents

This bill would require a limited liability company to indemnify its agent, as defined, in proceedings, as defined, for the successful defense or settlement of claims brought against the agent by reason of his or her agent status.

Status: Died in Assembly Judiciary Committee

AB 1529 (John A. Pérez) Nonprofit corporations: abatement: dissolution: surrender

AB 1529 enacts an administrative dissolution and surrender process for nonprofit entities that Franchise Tax Board (FTB) has suspended for at least 48 continuous months, or that haven't filed a statement of information for at least 48 continuous months. Before dissolving or surrendering the entity, FTB or the Secretary of State must mail a notice to the last known address for the corporation, or if that fails, provide a 60 day warning of the dissolution by posting a notice on their website listing the corporation's name, the Secretary's file number, and the California corporation number, as applicable.

Status: Vetoed by the Governor

AB 1679 (Harkey) Escrow companies: Fidelity Corporation: hearings

AB 1679 required the Commissioner of the Department of Business Oversight (DBO) to abstain from a hearing for an Escrow Agents' Fidelity Corporation (EAFC) if an employee of DBO is the member's successor in interest.

Status: Died in Senate Banking and Financial Institutions Committee

AB 1859 (Maienschein) Professional fiduciaries: professional corporations.

This bill authorizes the creation of licensed professional fiduciary corporations (LPFC).

Status: Died in Senate Judiciary Committee

AB 1934 (Alejo) Nonprofit corporations: corporation sole

AB 1934 would have required the Secretary of State, if he or she determines the articles of incorporation to form a corporation sole did not conform to law, to nonetheless file it if the articles of incorporation are resubmitted with an accompanying written opinion of a member of the State Bar of California that the specific provision of the articles of incorporation objected to by the Secretary of State conform to law and the supporting points and authorities upon which the written opinion is based.

Status: Died in Assembly Banking and Finance Committee

AB 2180 (Brown) Business filings: statement of information

AB 2180 would have changed the filing date for statements of information (SOIs) that various corporate entities file annually or biennially with the Secretary of State (SOS), requiring that filing date to be the same date on which the corporate entities must file tax returns. For nonprofit public benefit corporations that do not file tax returns, the filing date is May 15.

Status: Died in Assembly Appropriations Committee

AB 2525 (Bonta) Limited Liability Worker Cooperative Act

AB 2525 would have established the Limited Liability Worker Cooperative Act, which would provide for the organization and operation of worker cooperative companies. The bill would authorize a worker cooperative company to be formed for any lawful purpose provided that it is organized and conducts its business primarily for the mutual benefit of its members as patrons of the worker cooperative company. The bill would authorize a worker cooperative company to engage in any lawful business activity, except as specified, but would prohibit construing the act to permit a worker cooperative company to render professional services, as defined. The bill would provide for, among other things, information to be included in a worker cooperative company's articles of organization and operating agreement, requirements as to voting rights of members, and time periods for sending notice of meetings at which members are entitled to vote and would require an individual who signs specified records to affirm under penalty of perjury that the information in the record is accurate. The bill would authorize certain classes of membership in the worker cooperative company, including a worker-member class. The bill would provide that members of the worker cooperative company have equal votes, but would authorize the worker-member class to have ultimate decision-making authority. The bill would authorize members of a class to vote separately on any matter. The bill would authorize a worker cooperative company to include in its name the word "cooperative."

Status: Died in Assembly Banking and Finance Committee

AB 2742 (Committee on Banking & Finance) Business: corporations and financial services

AB 2742 updates code sections within the jurisdiction of the Assembly Banking & Finance Committee stemming for changes made from the Federal Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

Status: Chaptered by Secretary of State, Chapter 64, Statutes of 2014

AB 2755 (Bocanegra) Nonprofit corporations: directors

AB 2755 makes changes to the definition of directors under California's Nonprofit Corporation Law. Specifically, this bill: 1) Provides that if a person does not have the authority to vote as a member of the board of directors of a nonprofit corporation, they may not be considered a member of the board. 2) Provides that an individual designated as a member of the board through the corporation's articles or bylaws will not be limited with regard to that person's right to vote as a member of the board.

Status: Chaptered by Secretary of State, Chapter 914, Statutes of 2014

SB 1041 (Jackson) Business: filings

SB 1041 makes various technical, non-substantive, and clarifying changes throughout the Corporations Code in preparation for the Secretary of State (SOS) automated filing system.

Status: Chaptered by Secretary of State, Chapter 834, Statutes of 2014

SB 1301 (DeSaulnier) Corporate Flexibility Act of 2011: Social Purpose Corporations Act

SB 1301 changes all references to a flexible purpose corporation (FPC) to a social purpose corporation (SPC). Authorizes a corporation formed (pursuant to the Corporate Flexibility Act of 2011) before January 1, 2015, to elect to convert its status from a FPC to a SPC by amending its articles of incorporation. Requires that any reference to SPC be deemed a reference to FPC, for any FPC formed prior to January 1, 2015, that has not amended its articles of incorporation to convert its status to a SPC. Changes all references to a flexible purpose corporation to a social purpose corporation.

Status: Chaptered by Secretary of State, Chapter 694, Statutes of 2014

CREDIT AND DEBIT CARDS

AB 1300 (Roger Hernández) Credit cards: oral disclosures

This measure requires a credit card issuer on or near the campus of an institution of higher education or at an event sponsored by or related to an institution of higher education to orally disclose to a first-time cardholder between 18 and 26 years of age certain information.

Status: Died in Assembly Banking and Finance Committee

AB 1927 (Frazier) Student financial aid: debit cards

Requires the Regents of the University of California (UC), the Board of Trustees (BOT) of the California State University (CSU), the Board of Governors (BOG) of the California Community Colleges (CCC), and the governing bodies of accredited private non-profit and for-profit postsecondary educational institutions, as a condition for participation in the Cal Grant Program, to adopt policies that best serve the needs of students when negotiating contracts between their postsecondary educational institutions and banks and other financial institutions to disburse students' financial aid awards and other refunds onto a debit card, prepaid card, or a preloaded card; and, requires the polices to meet specified requirements.

Status: Vetoed by the Governor

CREDIT REPORTS

AB 1220 (Skinner) Consumer credit reporting: adverse action

This bill makes it unlawful for a consumer credit reporting agency to prohibit, or to dissuade or attempt to dissuade, a user of a consumer credit report furnished by the credit reporting agency from providing a copy of the consumer's credit report to the consumer, upon the consumer's request, if the user has taken adverse action against the consumer based upon the report. This bill authorizes the Attorney General, among others, to bring a civil action, for a civil penalty not to exceed $5,000, against any credit reporting agency for a violation of these provisions.

Status: Chaptered by Secretary of State, Chapter433, Statutes of 2013

AB 1658 (Jones-Sawyer, Chau) Foster care: consumer credit reports

Requires county child welfare agencies (CWA) to undertake specific actions regarding a child's consumer credit record when he or she is 16 years of age or older and is in foster care.

Status: Chaptered by Secretary of State, Chapter 762, Statutes of 2014

AB 2564 (Nestande) Commercial credit reporting agencies

Requires a commercial credit reporting agency to furnish a source of information to the subject of a commercial credit report upon the request of a representative of the subject. Requires the printed copy to be provided at no cost to the subject of a report, and prohibits an agency, or a business affiliate of that agency, from assessing a fee upon the subject of a report in connection with ensuring the proper data is contained within the commercial credit report of the subject. Also requires an agency to endeavor to maintain the most accurate data possible regarding the subject of a report.

Status: Died in Assembly Banking and Finance Committee

DIGITAL CURRENCY

AB 129 (Dickinson) Lawful money

This bill would extend the Pilot Program for Affordable Credit Building Opportunities until January 1, 2016, and change the date for the committees to report to the legislative committees to January 1, 2015. This bill would also provide legislative findings demonstrating the need for the limitation on disclosure of the information provided to the commissioner by a licensee for purposes of preparing the report regarding the program.

Status: Chaptered by Secretary of State, Chapter 74, Statutes of 2014

LOCAL AGENCY FUNDS AND INVESTMENTS

AB 279 (Dickinson) Financial affairs

This bill authorizes local agencies, until January 1, 2017, to invest up to 30% of their surplus funds through a private sector deposit placement service.

Status: Chaptered by Secretary of State, Chapter 228, Statutes of 2013

AB 1933 (Levine) Local government: investments

This bill expands the list of financial instrument in which local agencies may invest surplus funds to include United States dollar denominated senior unsecured unsubordinated obligations issued or unconditionally guaranteed by the International Bank for Reconstruction and Development (IBRD), International Finance Corporation (IFC), or Inter-American Development Bank (IADB).

Status: Chaptered by Secretary of State, Chapter 59, Statutes of 2014

AB 2298 (Rodriguez) Local agency funds

Allows state chartered financial institutions that maintain local agency deposits to submit their Local Agency Deposit Weekly Reports via email or other electronic means.

Status: Chaptered by Secretary of State, Chapter 214, Statutes of 2014

MONEY TRANSMISSION

AB 786 (Dickinson) Money transmissions

This bill makes numerous changes to the Money Transmission Act (MTA), including, among others, granting a limited exemption for payroll processing firms, reducing minimum net worth requirements, authorizing the Commissioner of the Department of Business Oversight to grant partial exemptions from the MTA, revising what constitutes an eligible security for purposes of the MTA, and requiring the issuance of specified regulations by the Commissioner.

Status: Chaptered by Secretary of State, Chapter533, Statutes of 2013

AB 2209 (Dickinson) Money Transmission Act

Exempts from the requirements of the Money Transmission Act a transaction in which the recipient of the money or other monetary value is an agent of the payee pursuant to a preexisting written contract and delivery of the money or other monetary value to the agent satisfies the payor's obligation to the payee. The bill would revise and reorganize various provisions of the act relating to, among other things, the definition of relevant terms under the act and the required contents of license applications and customer receipts.

Authorizes the commissioner to exercise any power set forth in the act with respect to a money transmission business, if necessary for the general welfare of the public, regardless of the licensure status of the money transmission business.

Status: Chaptered by Secretary of State, Chapter 499, Statutes of 2014

MORTGAGES

AB 553 (Medina) Reverse mortgages: notifications

This bill would prohibit a lender from taking a reverse mortgage or assessing any fees until seven days from the date of loan counseling, as specified. The bill would make specified changes to the disclosure notice. The bill would delete the requirement that the lender provide a written checklist and would, instead, prohibit a lender from taking a reverse mortgage application unless the applicant has received from the lender a specified reverse mortgage worksheet guide. The bill would require that the worksheet contain certain issues that the borrower is advised to consider and discuss with the counselor. The bill would require the counselor and the prospective borrower to sign the worksheet, as specified.

Status: Died in Assembly Banking and Finance Committee

AB 1072 (Wagner) Mortgage loan modification

Existing law prohibits a person from accepting payment for services in advance of the loan modification approval.

AB 1072 Assesses civil penalties for collecting advance fees and would authorize designated state and local government officials to commence civil actions to recover those penalties.

Authorizes further civil penalties for unlawful or fraudulent mortgage modifications perpetrated against seniors or disabled persons, as defined, and provide criteria for the assessment of these additional penalties.

Status: Died in Assembly Judiciary Committee

AB 1091 (Skinner) Finance and mortgage lenders

This bill authorizes the Commissioner of the Department of Business Oversight to issue citations and levy fines for violations of the California Finance Lenders Law (CFLL) and California Residential Mortgage Lending Act, as specified; prohibits specified acts by CFLL licensees; and revises the de minimis exemption for commercial finance lenders within the CFLL.

Status: Chaptered by Secretary of State, Chapter243, Statutes of 2013

AB 1700 (Medina) Reverse mortgages: notifications

Prohibits a reverse mortgage lender from accepting a reverse mortgage application until seven days have passed from the date of mandatory loan counseling. Specifically, this bill deletes the current requirement that the lender provides the borrower with a specific checklist prior to counseling, and instead provides a reverse mortgage worksheet guide in at least 14-point font.

Status: Chaptered by Secretary of State, Chapter 854, Statutes of 2014

AB 1730 (Wagner) Mortgage loan modification

Enhances potential civil and criminal penalties for violation of existing prohibitions regarding mortgage loan modification fees.

Status: Chaptered by Secretary of State, Chapter 457, Statutes of 2014

AB 1770 (Dababneh) Real property liens: equity lines of credit: suspend and close

Specifies a process for termination of a Home Equity Line of Credit (HELOC)

Status: Chaptered by Secretary of State, Chapter 206, Statutes of 2014

SB 310 (Calderon) Mortgages: foreclosure notices: title companies

This bill exempts title companies from liability for violations of the Homeowners' Bill of Rights in certain circumstances.

Status: Chaptered by Secretary of State, Chapter251, Statutes of 2013

SB 676 (Block) Real estate records: unlawful destruction

This bill authorizes the Bureau of Real Estate (BRE) to suspend or revoke the license of any real estate broker, real estate salesperson, or corporation licensed as a real estate broker, if the real estate broker, real estate salesperson, or any director, officer, employee, or agent of the corporation licensed as a real estate broker knowingly destroys, alters, conceals, mutilates, or falsifies any of the books, papers, writings, documents, or tangible objects that are required to be maintained and provided pursuant to notice, or that have been sought in connection with an investigation, audit, or examination.

Status: Chaptered by Secretary of State, Chapter 349, Statutes of 2013

SB 1051 (Galgiani) Buyer's Choice Act

SB 1051 removes the sunset on, and thus makes permanent, the California Buyer's Choice Act (BCA), which generally prohibits a seller of a foreclosed property from requiring the buyer to use a particular title insurance or escrow company as a condition of the sale.

Status: Chaptered by Secretary of State, Chapter 198, Statutes of 2014

SB 1459 (Committee on Banking and Financial Institutions) Mortgage loan originators: educational requirements

This bill requires an applicant for a mortgage loan originator (MLO) license issued by the Department of Business Oversight (DBO) to complete two hours of approved education related to relevant California law as part of the applicants 20 hours of pre-license education, and requires a licensed MLO to complete one hour of continuing education related to relevant California law as part of that MLO's eight hours of continuing education. The bill also clarifies the test an MLO license applicant must complete may be developed by or deemed acceptable by the Nationwide Mortgage Licensing System and Registry (NMLSR).

Status: Chaptered by Secretary of State, Chapter 123, Statutes of 2014

PRIVACY

AB 844 (Dickinson) Credit and debit cards: transactions: personal information

AB 844 would have updated provisions of the Song-Beverly Credit Card Act of 1971 related to the protection of personal identification information, to reflect the increasing use of debit cards to purchase goods and services and the increasing use of the Internet as a venue for use of both credit cards and debit cards to purchase goods and services.

Status: Died in Senate Banking and Financial Institutions Committee

AB 1710 (Dickinson, Wieckowski) Personal information: privacy

AB 1710 requires, with respect to the information required to be included in the notification of a data security breach, if the person or business providing the notification was the source of the breach, that the person or business offer to provide appropriate identity theft prevention and mitigation services, if any, to the affected person at no cost for not less than 12 months if the breach exposed or may have exposed specified personal information; expands existing security practice and procedure provisions to businesses that own, license, or maintain personal information about a California resident, as specified; and expands on security procedures and practice provisions that apply to businesses that own, license, or maintain personal information about California residents and prohibit the sale, advertisement for sale, or offer to sell of an individual's social security number (SSN), with exceptions.

Status: Chaptered by Secretary of State, Chapter 855, Statutes of 2014

SB 383 (Jackson) Credit cards: personal information

SB 383 expanded the Song-Beverly Credit Card Act to online transactions involving an electronic downloadable product. Permitted a person or entity to require a cardholder, as a condition of accepting a credit card as payment in full or in part in an online transaction involving an electronic downloadable product, to provide personal identification information (PII) if used solely for the detection, investigation, or prevention of fraud, theft, identity theft, or criminal activity, or for enforcement of terms of sale.

Status: Died in Assembly Banking and Finance Committee

PROJECT FINANCE

AB 122 (Rendon) Energy improvements: financing

This bill establishes the Nonresidential Building Energy Retrofit Financing Act of 2012 and requires the California Energy Commission to establish the Nonresidential Building Energy Retrofit Financing Program by July 1, 2013 to provide financial assistance through revenue bonds for owners of eligible buildings to implement energy efficiency improvements and renewable energy generation.

Status: Died in Assembly Appropriations Committee

AB 850 (Nazarian) Public capital facilities: water quality

This bill authorizes joint powers authorities to issue rate reduction bonds to finance publicly owned utility projects until December 31, 2020. The bonds would be secured by utility project property and repaid through a separate utility project charge imposed on the POU customers' bills. This bill also requires the California Pollution Control Financing Authority to review each issue of rate reduction bonds proposed by JPAs.

Status: Chaptered by Secretary of State, Chapter 636, Statutes of 2013

AB 2045 (Rendon) Energy improvements: financing

AB 2045 established the Nonresidential Real Property Energy Retrofit Financing Act of 2014, which creates a financing program administered by the California Energy Commission that uses revenue bonds to facilitate private financial assistance to owners of nonresidential property to implement energy efficient improvements and renewable energy generation.

Status: Died in Assembly Banking and Finance Committee

AB 2729 (Medina) Infrastructure financing

AB 2729 established the California Infrastructure Finance Center within the California Infrastructure and Economic Development (I-Bank) for the purpose of designating one or more private entities as a California Infrastructure Development Corporation (CIDC). A CIDC is entitled to specified participation rights related to the joint development of infrastructure projects within the state.

Status: Died in Assembly Jobs, Economic Development and the Economy Committee

SB 1463 (Committee on Governance and Finance) California Health Facilities Financing Authority

This bill makes several technical changes to the California Health Facilities Financing Authority Act, in particular clarifying that the Authority has the ability to issue private placement debt.

Status: Chaptered by Secretary of State, Chapter 261, Statutes of 2014

RESOLUTIONS

ACR 73 (Roger Hernández) The Glass-Steagall Act

This resolution would urge the President and the Congress of the United States to enact federal legislation to protect the public interest by reviving the separation between commercial banking and speculative activity embodied in the Glass-Steagall Act.

Status: Died in Assembly Banking and Finance Committee

AJR 10 (Grove) State debt

Urges the Federal government to not take any action to redeem, assume, or guarantee state debt.

Status: Died in Assembly Banking and Finance Committee

AJR 11 (Wieckowski) Bankruptcy

This resolution urges the Congress and the President of the United States to support and pass legislation that allows private student loan debt to be dischargeable in a bankruptcy case filed under Chapter 7 or Chapter 13 of the Bankruptcy Code.

Status: Chaptered by Secretary of State, Chapter110, Statutes of 2013

SJR 19 (Correa) High-cost loan limits

Expresses the Legislature's opposition to the reduction of the current national and high-cost conforming loan limits and would urge the Federal Housing Finance Agency (FHFA) to resist implementation of any reductions to those limits.

Status: Chaptered by Secretary of State, Resolution Chapter 116, Statutes of 2014

SECURITIES

AB 713 (Wagner) Broker-dealers

AB 713 provided that any person who meets the definition of a finder, and who satisfies all of the conditions established for finders, is deemed to be a finder and not a broker-dealer. Defined a finder as follows: a natural person who, for direct or indirect compensation, introduces or refers one or more accredited investors, as defined, to an issuer, or an issuer to one or more accredited investors, solely for the purpose of a potential offer or sale of securities of the issuer in an issuer transaction in this state.

Status: Died in Senate Appropriations Committee

AB 783 (Daly) Securities transactions: qualification requirements: exemptions

This bill would exempt from qualification offerings or sales of securities using a general solicitation or general advertising, provided the transaction meets specified requirements, including a requirement that the sales are made to accredited investors and the aggregate offering price of securities, as defined by reference to Regulation D, does not exceed $1,000,000, less the aggregate offering price for all securities sold within 12 months, as specified.

Status: Died in Assembly Banking and Finance Committee

AB 856 (Hagman) Securities: sale or issue: exemptions

This bill would add nonpreferred voting securities, as defined, to the list of securities exempt from qualification requirements under these provisions and would make other conforming changes.

Status: Died in Assembly Banking and Finance Committee

AB 2096 (Muratsuchi) Securities transactions: qualification: notification: small company

AB 2096 created a new way in which a person seeking to offer or sell securities could qualify their offering, by authorizing the "qualification by notification" of offers or sales of securities advertised by means of general solicitation and general advertising, as specified. AB 2096 authorized the "qualification by notification" for security offerings that meet the following criteria: A) The aggregate amount of securities sold to all investors by the issuer within any 12 month period is not more than $1 million. B) The aggregate amount sold to any investor does not exceed $5,000, or a greater amount as the Department of Business Oversight commissioner may provide as specified. C) The offering meets the federal exemption requirement for sales of securities not exceeding $1 million.

Status: Died in Senate Appropriations Committee

SB 538 (Hill) The Corporate Securities Law of 1968

This bill enacts several changes to the Corporate Securities Law of 1968 to augment the securities law enforcement resources of the Department of Business Oversight (DBO) and streamlines the process by which DBO may collect judgments from securities licensees found to have violated the securities laws; authorizes the DBO to charge a renewal fee of up to $35 to licensed broker-dealer agents and investment adviser representatives; and makes a variety of technical changes to other laws administered by DBO.

Status: Chaptered by Secretary of State, Chapter335, Statutes of 2013

STATE FINANCE

AB 1206 (Morrell) State agency funds: security for deposits

This bill, until January 1, 2019, would revise the reference to letters of credit issued by the Federal Home Loan Bank of San Francisco in the provision described above to refer instead to a letter of credit issued by a federal home loan bank.

Status: Died in Assembly Banking and Finance Committee

AB 2274 (Gordon) The California Debt and Investment Advisory Commission

AB 2274 modifies the reporting requirements an issuer of debt is required to make to the California Debt and Investment Advisory Commission before a proposed sale of debt issue.

Status: Chaptered by Secretary of State, Chapter 181, Statutes of 2014

SB 898 (Cannella) State government: state funds

SB 898 requires every state agency, department, and entity to provide its employer identification number (EIN) to the California State Treasurer. Allows the Treasurer to use the EINs to monitor state money deposited outside the centralized State Treasury System (STS). Requires a bank or financial institution, upon request from the Treasurer to provide the following information associated with an EIN to assist the Treasurer in monitoring accounts and state money deposited outside of the centralized STS: the account number; account balance; account owner of record; account type; account opening date; account closing date; and, account purpose, if known.

Status: Chaptered by Secretary of State, Chapter 393, Statutes of 2014

UNBANKED AND UNDER BANKED

AB 385 (Dickinson) Bank on California Program

AB 385 would have permanently placed the Bank on California Program within the Department of Business Oversight and established a quarterly reporting system for participating banks. Additionally, the bill requires participating financial institutions to comply with specific administrative obligations.

Status: Died in Senate Appropriations Committee

MISCELLANEOUS

AB 978 (Blumenfield) Financial institutions: Iran sanctions

Requires the Commissioner of the Financial Institutions (CFI) to examine a licensed financial institution that maintains a correspondence account or a payable-through account with a foreign institution for compliance with the federal Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (Iran Sanctions Act) and related federal regulations and presidential executive orders, as specified. In the case of violations, the CFI is authorized to bring state action and is required to forward evidence to the United States (U.S.) Department of the Treasury.

The terms of the bill are inoperative should Iran be removed from the U.S. Department of State's list of countries that support acts of international terrorism or the U.S. President certifies that Iran has ceased its efforts relative to nuclear explosive devices of related technologies, as specified.

Status: Chaptered by Secretary of State, Chapter139, Statutes of 2013

AB 1169 (Daly) Escrow agent rating service: escrow agents

This bill defines the term "escrow" and "escrow agent rating service" and, until January 1, 2017, requires escrow agent rating services to comply with specified portions of the California Consumer Credit Reporting Agencies Act, and establish policies and procedures reasonably intended to safeguard from theft or misuse any personally identifiable information it obtains from an escrow agent.

Status: Chaptered by Secretary of State, Chapter380, Statutes of 2013

AB 1282 (Bonta) Financial institutions: credit unions

This bill modifies the formula used to calculate assessments paid annually by state-chartered credit unions to the Department of Business Oversight.

Status: Chaptered by Secretary of State, Chapter115, Statutes of 2013

AB 1396 (Committee on Banking and Finance) Department of Financial Services

This bill would change the name of the proposed Department of Business Oversight to the Department of Financial Services and transfers duties from the Department of Business Oversight and Department of Corporations to DFS.

Status: Died in Senate Governmental Organization Committee

AB 1856 (Wilk) Deposit in lieu of bond

AB 1856 expands California's Bond and Undertakings Law to include a cashier's check, made payable to a designated officer, issued by a bank, savings association, or credit union authorized to do business in this state, among the assets that may be deposited in lieu of bond.

Status: Chaptered by Secretary of State, Chapter 305, Statutes of 2014

SB 139 (Hill) Exchange facilitators

This bill deletes the January 1, 2014 sunset date on provisions of state law that regulate persons engaging in business as exchange facilitators, as defined, and continues these provisions indefinitely.

Status: Chaptered by Secretary of State, Chapter 45, Statutes of 2013

SB 233 (Leno, Correa) Debt buying

This bill enacts the Fair Debt Buying Practices Act, to further regulate the activities of persons and entities that purchase "charged-off consumer debt," as defined.

Status: Chaptered by Secretary of State, Chapter 64, Statutes of 2013

Consumer Lending & the California Finance Lender's Law

February 11, 2013
2:00 p.m.
California State Capitol, Room 444

I. Opening Remarks:

A. Assemblymember Roger Dickinson, Chair.

B. Assemblymember Mike Morrell, Vice-Chair.

II. Overview of California Finance Lenders Law:

A. Jan Owen-Commissioner, Department of Corporations.

III. Perspectives on current market and potential reforms:

A. Paul Leonard, Center for Responsible Lending.

B. Oscar Rodriguez, Equal Access Auto Lenders of California.

C. Dan Gwaltney, Vice President, California Financial Service Providers.

D. Rosemary Shahan & a consumer witness, Consumers for Auto Reliability & Safety.

E. Joe Lang on behalf of Community Loans of America.

IV. Pilot Program for Affordable Credit-Building Opportunities:

A. Sasha Orloff & Jacob Rosenberg, Co-founders of LendUp

B. James Gutierrez, Chairman, Fair Loan Financial & Founder of Progresso Financiero.

V. Public Comment

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

Key Questions & Themes:

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

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

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

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

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

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

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

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

Highlights of this Report:

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

36% to over 100%.

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

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

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

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

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

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

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

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

General Overview:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

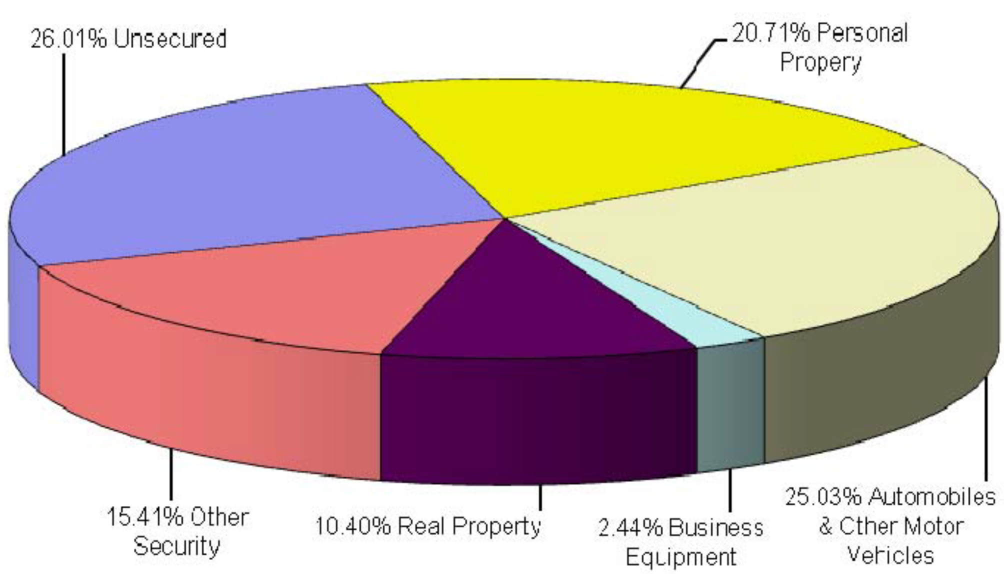
Every year, DOC releases a report of statistical data regarding the CFLL compiled from data required to be submitted by licensees. The following charts and data come from the *2011 Annual Report: Operation of Finance Companies Licensed Under the California Finance Lenders Law:*

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

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

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

Breakdown of Dollar Amount of Commercial Loans Made or Refinanced by Type of Security



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

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

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

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

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

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

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

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

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

- CFL licensees conducted 381,131 unsecured installement loans and 38,148 auto title loans for a total of 419,279. The total dollar amount of these loans was $968,768,000.
- 258,273 CFL loans were made in amounts under $2,500.
- A large percentage of CFL loans (89,989) occurred in the $2,500 to $4,999 range at APRs above 100%.
- DDTL lenders conducted 12,427,810 transactions for a total dollar amount of $3,267,629,497.
- The average dollar amount of DDTLs made was $263 at an average APR of 411% for an average loan term of 17 days.
- Based on information provided by DOC, 90% of the CFLL lending volume under $2,500 comes from two companies, Progreso Financiero and Adir Financial.

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

Costly Consumer Lending:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Online Lending:

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

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

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

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

New Alternatives:

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

According to the author:

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

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

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

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

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

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

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

Where are the banks?

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

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

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

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

Conclusion:

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

Overview of the Deferred Deposit Transaction Law

March 4, 2013
2:00 p.m.
California State Capitol, Room 444

I. Opening Remarks:

- Assemblymember Roger Dickinson, Chair
- Assemblymember Mike Morrell, Vice-Chair

II. Introduction to the Deferred Deposit Transaction Law

- Jan Owen, Commissioner, Department of Corporations

III. Safe Small-Dollar Loans Research Project

- Alex Horowitz, Research Manager, Safe Small-Dollar Loans Research Project, The Pew Charitable Trusts

IV. Perspectives

- Chuck Cole, California Financial Service Providers
- Paul Leonard, Center for Responsible Lending
- Eleanor C. Glass, Chief Giving Officer, Silicon Valley Community Foundation
- Natasha Fooman, Vice President of Government Affairs, Advance America
- Leigh Phillips, Director, San Francisco Office of Financial Empowerment

V. Public Comment

CALIFORNIA DEFERRED DEPOSIT

TRANSACTION LAW

Assembly Committee on Banking & Finance

March 4, 2013

Assemblymember Roger Dickinson, Chair

Mark Farouk-Chief Consultant
Kathleen O'Malley-Senior Consultant
Tiffany Morrison-Committee Secretary

PAYDAY LENDING IN CALIFORNIA: BY THE NUMBERS

The *2011 Annual Report, Operation of Deferred Deposit Originators Under the California Deferred Deposit Transaction Law,* offers some updated statistics on the California payday lending market for 2011.

1) Total dollar amount of transactions: $3,279,629,497

2) Total number of transactions: 12,427,810

3) Individual customers who obtained payday loan: 1,738,219

4) Average annual percentage rate: 411%

5) Average dollar amount of transaction made: $263

6) Total number of returned checks for deferred deposit transactions: 931,387

7) Total dollar amount of returned checks: $246,769,462

8) Total number of returned checks recovered (including partial recoveries): 642,069

9) Total dollar amount of returned checks recovered: $160,480,858

10) Total number of checks charged-off: 280,233

11) Total dollar amount charged-off: $72,367,689

Chart 1
Change in Number of Licensed Locations

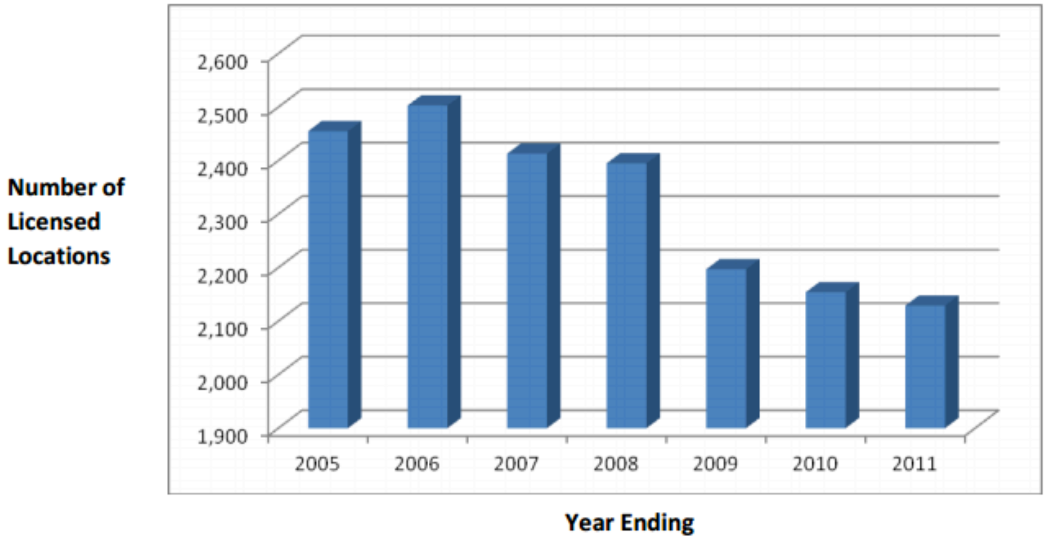


Chart 2
Change in Dollar Amount of Deferred Deposits Made

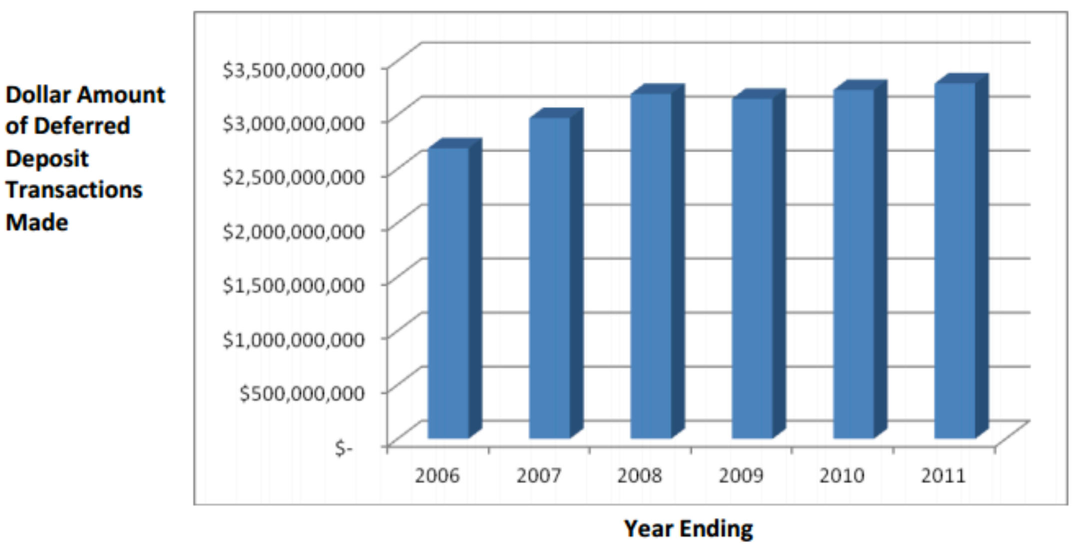


Chart 3
Change in Number of Deferred Deposits Made

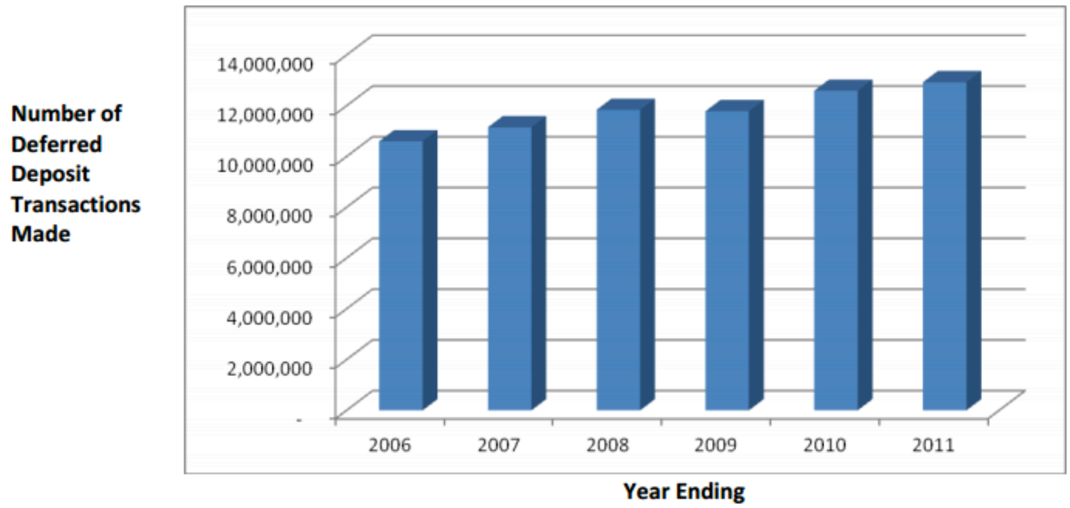
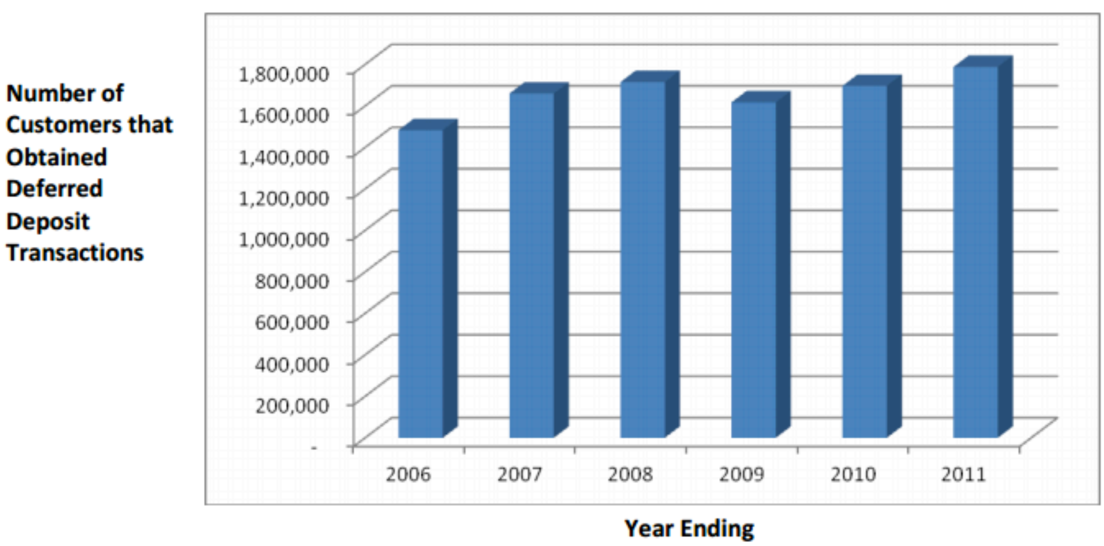


Chart 4
Change in Number of Customers that Obtained Deferred Deposit Transactions



OVERVIEW

A payday loan, known more formally in California as a deferred deposit transaction (DDT), is a short-term loan in which a borrower writes a post-dated, personal check to a lender for a specified amount, which is capped by state law. The payday lender advances the borrower the amount on the check, less the fee, which is also capped by law. The payday lender does not cash the check at the time the loan is made. Both parties are aware that the borrower lacks sufficient funds to cover the check when the check is written. The assumption underlying the loan is that the borrower will repay the loan by the agreed-upon date, either by depositing sufficient funds in his or her checking account to cover the check, or by paying the payday lender in cash on the loan's due date, and having the lender return the original check to the borrower, without cashing it.

Under the California Deferred Deposit Transaction Law (DDTL), any payday lender who makes a payday loan must be licensed. Each licensee may defer the deposit of a customer's personal check for up to 31 days. The face amount of the check presented by a borrower may not exceed $300, and the fee charged by the licensee may not exceed 15% of the face amount of the check ($45 on a $300 check). This statutorily capped fee must be expressed to borrowers in the form of an Annual Percentage Rate (APR). Given the short-term nature of payday loans (average is 17 days) the average APR is 411%. However, while the APR is high on a short-term product, the dollar costs of the fee does not to exceed 15% of the face amount of the check.

Licensees may charge one non-sufficient funds fee, capped at $15, for checks that are returned by a customer's financial institution. In addition, licensees may not directly or indirectly charge any additional fees in conjunction with a payday loan. Licensees may not enter into a payday loan with a customer who already has a payday loan outstanding and may not allow a customer to use one loan to pay off another. Licensees are also forbidden from accepting any collateral for a payday loan or making any payday loan contingent on the purchase of any goods or services. Each payday loan must be made pursuant to a written agreement. Licensees must clearly post their fees and charges at their business locations.

In the early 1990s, check cashers operated in what could only be termed as a legal gray area as they cashed checks from consumers for a fee (ranging from 10-20%) in which the check might be deposited immediately or held for 14 days. The reasoning behind this practice was the belief that sections of the California Commercial Code concerning the use of checks was the governing body of law for these transactions. These transactions did not involve loan agreements or loan disclosures and the fees were generally the same regardless of the length of time the check was held by the check casher. However, subsequent discussions and opinions led to the creation of clear statutory authority for offering payday loans via SB 1959, (Calderon, Chapter 682, Statutes of 1996). SB 1959 permitted check cashers to defer deposit on payday loans made by the check casher. These transactions were originally regulated by the State Department of Justice. SB 898 (Perata, Chapter 777, Statutes of 2002), shifted the responsibility for administering payday lending from the California Department of Justice to the Department of Corporations (DOC).

Payday loan customers are underbanked, but not unbanked because the transaction requires that the borrower have a checking account. The debate over the appropriateness of the payday loan product has been the subject of numerous bills appearing before this legislature since the first statute authorizing the product. Consumer organizations highlight that payday loans are a "debt trap" meaning that the borrower gets stuck in a cycle of debt leading to further deficits in personal income. For example, if the borrower doesn't have $300 today for expenses then will the borrower have the extra money after paying their regular bills, to pay back the loan in two weeks when the loan comes due? In many cases, the borrower simply takes out additional loans, back-to-back, in an attempt to make up the income deficit. As will be discussed later, many payday borrowers take out numerous loans throughout the year. The other side of this debate is that payday loans are a necessary product for consumers to fill short term needs and pay emergency expenses. Additionally, some argue that it is a product is one of last resort for borrowers as they may have exhausted other options, or they may not have had options to begin with. Another factor is that a payday loan is convenient and relatively easy to obtain. This ease may also add to consumer demand for payday loans in that they may be easy to get and simple to understand.

As mentioned previously, much of the criticism of the payday product is that it creates a cycle of debt where a borrower uses the product back-to-back numerous times during the year. In this case a borrower may not be using the product for short term needs but to fill gaps in their actual income. The counter to this argument is that the actual economic conditions of the borrower may be creating the debt trap, or the short term expense was one that was not realized by the borrower in advance and has created an unfilled income deficit. Even if consensus could be achieved on these issues, the next hurdle is attempting to find consensus on potential solutions. The legislative history of this issue demonstrates the vast differences in approaching this problem. Many of these efforts are listed later in this background paper, but overall the themes of previous legislative attempts in this area have consisted of the following approaches:

- Cap the APR on payday loans to 36%.

- Increase the loan limit to $500.

- Create alternative loan programs under other lending laws. Example would be the Affordable Credit Building Opportunities Pilot under the California Finance Lenders Law.

- Create a real time payday lending database.

- Regulate and restrict online payday loan advertisements.

- Provide borrowers with right to request and enter into an extended repayment plan.

- Require further study and reporting of payday lending by DOC.

- Provide enhanced enforcement and penalties.

Over the last decade as states across the nation have expanded or restricted payday lending the availability of research and data has increased. The latest in the series of research offerings are two reports from the Pew Charitable Trust, Safe Small Dollar Loans Research Project. These reports offer the latest findings from Pew's research in this field. The research, as with opinion on this issue, has had a tendency to vary. While certain themes are common (borrowers tend to take out multiple) loans, some researchers have drawn different conclusions, or have acknowledged the dangers of the payday product while realizing that it may be a "necessary evil." In order to sample snippets of the research available, the following are excerpts from various research papers and projects. (Committee staff encourages readers to read the body of research for themselves.)

- Operating costs for payday lenders are high relative to the size of the payday loan and these high costs offset much of the revenue generated from the loan (Elliehausen).

- Less than half of payday customers have savings or other types of liquid credit (Elliehausen).

- Fifty-four percent of payday borrowers have a bank credit card compared to 74.5% of the general population (Elliehausen).

- Most payday borrowers are aware of the finance charge but not the APR (Elliehausen).

- Lack of knowledge concerning payday loan alternatives may assist with a perception that options don't exist (Edmiston).

- Payday borrowers may be option limited due to the constraints of their credit ratings (Edminston).

- In reviewing small dollar credit (payday loans are included in this definition) researchers found that the top three loan attributes that mattered most were: quick access to money, ability to qualify, and clear terms (Levy & Sledge).

- Repeat loan usage has been correlated with the ratio of loan size to income, and that the need for credit came from a consistent shortfall of income relative to expenses (Levy & Sledge).

- Many borrowers report taking out several payday loans (8-14) per year. (The majority of research on the issue reports in the repeated use of the product).

- Research on states that have banned payday lending concludes a range of impacts, from increased use of unregulated online lending to other negative credit effects. Other studies and surveys have found consumer satisfaction that the product is gone, or a belief that the dangers of the product outweigh the benefits. Media reports suggest that online lending has increased in states with a ban, while the Pew research disputes this.

- The Pew research, mentioned earlier, provides the following:

    - Twelve million American adults use payday loans annually. Nationally, on average, a borrower takes out eight loans of $375 each per year and spends $520 on interest.

    - Most borrowers use payday loans to cover ordinary living expenses over the course of months, not unexpected emergencies over the course of weeks. The average borrower is indebted about five months of the year.

- If faced with a cash shortfall and payday loans were unavailable, 81% of borrowers say they would cut back on expenses. Many also would delay paying some bills, rely on friends and family, or sell personal possessions.

- In states that enact strong legal protections, the result is a large net decrease in payday loan usage; borrowers are not driven to seek payday loans online or from other sources. Fifty-eight percent of payday loan borrowers have trouble meeting monthly expenses at least half the time.

- The choice to use payday loans is largely driven by unrealistic expectations and by desperation. A majority of borrowers say payday loans take advantage of them, and a majority also say they provide relief. The appreciation for urgently needed cash and friendly service conflicts with borrowers' feelings of dismay about high costs and frustration with lengthy indebtedness.

- By almost a 3-to-1 margin, borrowers favor more regulation of payday loans. In addition, two out of three borrowers say there should be changes to how payday loans work. Despite these concerns, a majority would use the loans again. In a state where payday storefronts recently stopped operating, former borrowers are relieved that payday loans are gone and have not sought them elsewhere.

- 55% of borrowers surveyed believe that payday loans take advantage of borrowers, while 48% say the loans help more than hurt, with 8% reporting that the loans both help and hurt. Furthermore, 56% say the loans relieve stress and anxiety versus causing it.

- Six reasons people use payday loans:

    - Desperation, as more than a third of borrowers report that situation in which they were so desperate they would accept a loan on any terms offered.

    - Perception that payday loans do not cause ongoing debt.

    - Reliance on accurate information provided by the payday lender that the product is a two week loan.

    - Focus on fee, rather than how a lump sum repayment will affect their budget.

    - Trust that by some bank deposit borrowers that bank payday loans are safer than non-bank payday loans.

- Temptation as some borrowers consider them to easy to obtain.

In 2008, DOC released two reports, "California Deferred Deposit Transaction Law, California Department of Corporations, December 2007" (DOC Report) and "2007 Department of Corporations Payday Loan Study" (AMPG study).

The DOC report was based upon a survey of payday lenders and DOC's annual report for 2005-06. The AMPG study was based on an online survey of payday lenders, a telephone survey of borrowers, and five customer focus groups. AMPG's study was conducted between August and December 2007, for the 18-month period between April 15, 2006 through September 11, 2007.

Both reports highlighted that, while a payday loan is intended to be a short-term, one-time loan to meet emergency financial needs, a large number of Californians use payday loans on a regular, on-going basis and find that establishing a payday loan account "opens the door to a repetitive cycle of borrowing that is difficult if not impossible to end" (AMPG study). The DOC report also found that 2.4% of payday loan borrowers took out more than one loan at the same time from multiple payday lenders.

The key findings from the DOC AMPG reports:

- Eighty four percent of licensees' business is attributable to repeat customers (only sixteen percent comes from customers who take out only one loan). Nineteen percent of licensees' business is attributable to customers who took out more than 15 loans during the 18-month period studied by AMPG.

- Forty one percent of licensees offer some type of bonus (either cash or gifts) to customers who refer new business to the licensees. Cash is much more common than other types of gifts. Of those who offer cash bonuses, nearly one half offer $10 or less, and just under one third offer between $20 and $25 (AMPG).

- Very few licensees accept personal checks for repayment (despite the fact that a post-dated check is required in order to obtain a payday loan). Customers commonly pay off their loans in cash. Nearly all payday lenders who do accept personal checks for repayment charge non-sufficient funds (NSF) fees for returned checks (DOC and AMPG).

- Fifty seven percent of licensees require customers to borrow at least $50. The majority of loans (63%) are between $200 and $255. Twenty payday lenders responded that the minimum amount they would lend was $255 (AMPG).

- Although payday lenders may charge up to $45 in loan fees to lend the maximum amount of $300, 14% of lenders charge less than $45 on $300 loans. The smallest amount charged on a $300 loan was $25, corresponding to a maximum loan amount of $275 (AMPG).

- To prevent the loss of revenue due to defaulted loans, most payday lenders (87%) offer arrangements in which borrowers are allowed to pay back loans at a reduced rate or based on an agreed-upon schedule. Payday lenders reported that about 20% of loans issued during the eighteen-month study period required some type of workout arrangement (AMPG). However, less than 1% of all payday loan customers entered into formal, written payment plan arrangements during 2006 (DOC).

- Customers who take out multiple loans in a year tend to do so in a consecutive fashion (with less than five days elapsing between paying the first one off and obtaining a second one).

- Nearly 450,000 borrowers had back-to-back time-frames of 6 loans or more (DOC).

- Of those borrowers who obtained more than one payday loan in the last eighteen months, 28% used multiple locations of the same payday lender; 72% used multiple payday lenders (AMPG).

- Borrowers were asked whether the amount borrowed was the amount needed or the most the lender would loan. When asked in this way, 63% of borrowers said they borrowed the amount needed; 32% said they would have borrowed more, but the lender wouldn't loan it; and only 3% said that the lender offered more than the borrower needed.

- When borrowers were asked where they obtained the rest of the money they needed if they could not obtain all they needed from the payday lender, 8% said they borrowed the money from family or friends, 8% said they did not get the rest of the money they needed, 5% waited until their next payday, 3% went to another payday lender, and less than 1% borrowed money from a bank.

- Thirty-six percent of borrowers indicated they had used more than one payday lender. When asked why, 73% said they needed more money than one location would loan them at one time, 12% said they needed more money before the loan with the first company could be paid off, and 11% said they used one loan to pay off another.

Report Policy Options for Future Study

1) Clarify and confirm that licensees cannot refer delinquent payday loans to a local prosecutor for collection of returned checks.

2) Enhance the regulation of electronic transactions.

3) Improve consumer disclosures by requiring that the notice provided to borrowers prior to entering into a payday loan agreement be a separate, distinct document from the written agreement; require the licensee to have the borrower initial a copy of the notice to acknowledge receipt; and require the licensee to retain a copy of the notice with the borrower's initials acknowledging receipt in the file.

4) Require applicants for a license and existing licensees to notify DOC of other business that would be or is being conducted at the licensed location.

5) Expand consumer protections for payday lending conducted over the Internet by requiring that notices and disclosures are provided to Internet borrowers, and that borrowers can download the agreement, notices, and disclosures. Alternately, if the borrower cannot download those documents, require the licensee to mail copies to the borrower within 24 hours.

6) Require that payment plans entered into between licensees and borrowers specify the payment dates and amounts of each payment, be in writing, and be signed by the borrower.

7) Require a written agreement signed by the borrower in order to extend the due date of a loan. Provide the licensee with an option to notify the borrower by mail of the approval to extend the due date of the loan, if the borrower elects not to sign the extension agreement. Like the recommendation above, this recommendation would help avoid misunderstandings between payday lenders and borrowers over repayment plan terms.

8) Require licensees to prominently disclose that borrowers have the right to request a written extension agreement and payment plan.

9) Require that specific language be used in payday loan advertising to disclose one's licensure by DOC, and require that all advertising disclosures be in the same language as the advertising itself.

10) Require (rather than authorize) the use of a specific chart to compare payday loan fees and related cost information. Existing law requires licensees to post a schedule of all charges and fees, as specified, and provides an example of one way in which the information may be presented.

11) Require license applicants to list each person in charge of a payday lending location, and require that person to submit fingerprint information and a historical profile through a Statement of Identify and Questionnaire (SIQ). Require the licensee to notify DOC within ten days of a change in the person responsible for the location, and to submit new fingerprint information and an SIQ for that person. Require each licensee to notify DOC at least 60 days prior to a change of its officers, directors, or any other persons named in the application.

12) Confirm DOC's jurisdictional nexus over payday lending activities by stating that a payday lender is subject to the CDDTL when it conducts deferred deposit transaction business "in this state."

13) Expand the grounds for barring, suspending, or censuring persons managing or controlling payday payday lenders, and for denying, suspending, or revoking licenses.

14) Allow DOC to issue administrative orders to prevent unsafe and injurious practices, and make these orders effective within 30 days, if no hearing is requested by the person(s) accused. Allow DOC to suspend or revoke a license for failing to maintain a surety bond, as required by law, through more expedient administrative orders.

15) Increase the civil penalty for violating the payday loan law from $2,500 to $10,000 per violation. Allow administrative penalties of up to $2,500 per violation to be levied and collected through specified administrative hearing procedures.

16) Require the preparation and retention of accurate records and reports by licensees.

17) Authorize the Commissioner to subpoena all books and records of payday lenders.

18) Allow DOC to seek a court order to enforce any administrative decision awarding restitution, administrative penalties other than citations, and cost recovery, without having to file a civil suit and motion for summary judgment.

19) Provide that a citation is deemed final if the cited licensee fails to request a hearing within 30 days of receiving the citation. Allow DOC to issue a citation to assess an

administrative penalty, not to exceed $2,500 per violation (rather than $2,500 per citation).

20) Streamline DOC's ability to void loans and order fees forfeited. Clarify that DOC has the authority to order the voiding of loans and the forfeiture of fees by administrative order, rather than by pursuing a civil suit.

21) Change the payday loan origination fee from a percentage of the face value of the check to a flat fee.

22) Increase the maximum amount of a payday loan from $300 to another amount, such as $500 or $750.

23) Adjust fees based on the loan amount, with a sliding scale that reduces the fee as the amount borrowed goes up.

24) Prohibit a licensee from entering into a deferred deposit transaction with a customer during the period-of-time that the customer has an outstanding deferred deposit transaction with another licensee.

25) Restrict a customer from having a payday loan outstanding with any payday lender for more than three months during a twelve-month period.

26) Require licensees to offer a payment plan with a minimum of six equal, monthly installment payments to all borrowers who have had continuous (consecutive) loans for three months, and prohibit licensees from charging customers any additional fees or interest in connection with the payment plan.

27) Require all licensees to use a uniform database to record all transactions in real time.

PAYDAY LOAN ALTERNATIVES

Several banks offer short-term type loan products for their customers under a cash advance program. For example, Wells Fargo offers a Direct Deposit Advance Loan that charges a fee of $1.50 for every $20 borrowed. The internet website explaining the product points out that the product is an expensive option and that other options may be available. Other national banks also offer products in this lending space. These products are short term in nature so when the finance charge is calculated as an APR these products have triple digit APRs, and in turn have attracted a fair amount of criticism from community and consumer organizations and federal regulators. On January 2, 2013, United States Senators Blumenthal, Durbin, Schumer, Brown and Udall sent a letter to the chief federal regulators of national banks demanding an end to payday lending by banks. The letter claims that banks offer payday loans via "payday advances" that are structured just like payday loans.

Many credit unions offer payday advance products for their customers. These programs typically have a savings component built into the loan and require longer repayment periods than a payday loan. The committee in previous years has highlighted several programs offered by credit unions, specifically in the Sacramento and San Francisco areas. An additional entrant into this market is 1st Valley Credit Union in San Bernardino that offers an Assist Member Program (AMP). The AMP requires that the borrower have a three month membership, established direct deposit and must be current on all loans. The maximum term of an AMP loan is 90 days with an APR of 28% (plus $10 loan application fee) with 10% of loan proceeds going to a frozen savings account to help build savings.

This kind of innovation is desperately needed in the small dollar lending market. Current short-term offerings by banks and credit unions far exceed those offered just 5 years ago. Does the existence of these programs mitigate the need for non-bank payday loans? It is plausible that many people do not belong to a bank or credit union that offers one of these products. Additionally, consumers may be fearful that going to their bank or credit union to ask about one of these products would adversely affect their account relationship with the institution.

Why don't mainstream financial institutions offer more short-term loan options? 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 Federal Deposit Insurance Corporation (FDIC) parameters for a loan under the program was an amount of $2,500 with a term of 90 days or more at an APR of 36% or less. As the program came to a close, 34,400 small-dollar loans were made with a principal balance of $40.2 million nationwide. Small-dollar lending was often used as a relationship building opportunity in order to building long term opportunities with the customer. The Pilot began with 31 banks participating, one of which was located in California (BBVA Bancomer USA). The Pilot ended with only 28 participants. Delinquency rates for the loans ranged from 9-11%, but loans with longer terms performed better. It does not appear that the Pilot led to widespread adoption of small-dollar lending programs at non-pilot banks.

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

Survey and research data provide that other alternatives may be available, including credit cards or loans from family and friends. A credit card could potentially meet the short term needs of a consumer in financial hardship. However, payday borrowers as a population have a lower rate of credit card equity than the general population. Furthermore, payday borrowers may have incorrect views on the charges and fees associated with the credit cards use versus a payday loan. As for the use of friends and family, the Pew research highlights that many borrowers used loans from friends or family to pay off a payday loan indicating that the friends/family option was available prior to the use of the payday loan. A person in financial trouble may feel stigmatized about that financial hardship, whether perceived or real, and may wish to avoid the embarrassment of asking friends or family.

Technology is trending to find new ways to get consumers the goods and services they want, in ways that are cheaper and quicker. This is also the case for payday lending as new start-ups are entering this realm with an emphasis on online lending. LendUp, a recent entrant into this marketplace is a direct payday lender that created a way to use small-dollar loans as an opportunity for consumers to build credit. Consumers who have poor or no credit can apply for and receive small-dollar, short-term loans (up to $250 for up to 30 days). LendUp uses an underwriting process that uses risk analysis and only approves 15% of applicants. LendUp says that it uses data analytics, a new type of risk model that utilizes non-traditional data sources like social media to make decisions. The loan fee can be lowered and discounted for repaying the loan early, and by taking educational courses on good credit, financial planning and more.

UNREGULATED INTERNET PAYDAY LENDING

Many licensed payday lenders that have storefront operations also offer payday loans via the internet in compliance and conjunction with their state licenses in accordance with state law. However, unregulated online lending has grown in recent years. Pew research predicts that by 2016 internet loans will account for 60% of payday loans almost double from last year. Last year, on August 16, 2012 the LA Times reported, *California Warns of Online Payday Lending Risk,* that DOC had issued a consumer alert concerning the dangers of online lending, as well as sanctioned nine payday lenders for unlicensed activity. On February 23, 2013, the New York Times reported, *Major Banks Aid in Payday Loans Banned* *by States,* that a growing number of payday lenders had setup online operations to avoid rate caps in states that have banned payday lending. The article pointed out that for an online payday loan the borrower gives the lender their account and routing number to set up automatic repayment of the loan via their account. These authorizations can lead to numerous overdraft charges as online payday lenders repeatedly ding the consumer's account for the outstanding loan repayment. In some cases, these transactions have occurred even after the loan was paid off. In one case highlighted in the article, a consumer with six outstanding payday loans attempted to close their bank account to stop any future withdrawals. The account was not closed by the bank and the consumer racked up $1,523 in insufficient funds fees, extended overdraft and service fees. The article further placed responsibility on the banks for allowing automatic withdrawals by illegal payday lenders and for not quickly honoring consumer's requests to end these withdrawals in a timely manner.

Restricting unregulated payday lending is difficult as many payday lenders may operate offshore in other countries or use tribal sovereignty to avoid state enforcement. Furthermore, borrowers may not be aware that an illegal payday loan (loan made by unlicensed lender) is unenforceable. These unregulated payday lenders typically will not follow consumer protection laws, fair debt collection laws, and in some cases may abuse the court process to intimidate borrowers into paying their loans. While storefront payday lenders may be limited by geographic location, internet payday lenders (both legal and illegal) are available by the thousands online and those that are unlicensed are not constrained by fee caps. This lack of regulation may, unfortunately, make them an attractive option for borrowers seeking to borrow beyond the California limit of $300.

Research on the impact of storefront payday lending restrictions and a potential growth in online lending reveal that consumers would not necessarily choose the online lending route if storefront payday lenders were eliminated. However, some media reports have highlighted concerns with the rising use of unregulated online payday. The Portland Business Journal reported on February 11, 2009, *Borrowers Flock to Online Payday Lenders,* that Oregon laws effectively banned 80% of the state's storefront payday lending businesses forced borrowers to turn to unregulated online payday lenders. As with the previously mentioned articles, online borrowers in Oregon faced harassing and illegal debt collection tactics, extremely high fees and interest rates, and deceptive marketing ads. The Portland Business Journal article did not reveal actual data on the amount of online lending before or after Oregon's heavy restrictions on storefront lending. This lack of data is a typical problem in researching this issue.

The Consumer Federation of America, conducted a survey of online payday lending in 2011, *CFA Survey of Online Payday Loan Websites*. This survey of twenty online payday lenders, included a mix of California licensed and unlicensed payday lenders. Key findings include:

- Payday lenders require electronic access to borrowers' bank accounts. Instead of holding a paper check to secure payment of loans made at payday loan stores, Internet payday lenders gain authorization to electronically deposit loan proceeds and withdraw payments directly from borrowers' bank accounts.
- Borrowers complete online applications and provide Social Security numbers, bank account and bank routing numbers in online applications.
- Surveyed loan size ranges from $100 to $1500, with payment/s due on the borrower's next payday with loan terms ranging from five to thirty days.
- Typical cost of a $500 loan is $125 or 652% APR for a two-week loan. Surveyed loan cost ranged from a low of 378% in Kansas to 780% charged by six payday lenders.
- The default payment plan for most sites is to pay the finance charge only, with no reduction in loan principal for several paydays. To initiate payment in full, a borrower has to notify the lender days before the due date to request the lender to withdraw the full amount.
- While some payday lenders purport to be state-licensed and to comply with state rate caps and loan terms, many online payday lenders claim a choice of law from states with no rate caps or from foreign countries. A growing number of online payday lenders claim to be exempt from state law enforcement due to tribal sovereign immunity.
- Online payday lenders pay up to $110 for referrals of qualified loan applications from lead generators or affiliate marketers and some payday lenders encourage borrowing by offering discounts on the initial loan. Online payday lenders that make loans in states where licensed typically also link applicants to lead generators when applications come from states they do not serve.

Finally, online payday lending largely functions through the use of third party online finders or referral services. Many of the online loan portals a consumer may find on the internet may be finders and not actual payday lenders. These finders take the borrower's information and then send it out for bids from payday lenders on what they will pay to the finder to lend to the particular borrower. Once a lender is matched with a borrower, the borrower is forwarded to that specific lender's loan website. This process happens behind the scene in only a few minutes. This system of finders, however, fuels unregulated online lending. If a borrower from California goes through one of these services (often the borrower will not know whether the site they are visiting is a lender or finder) the third party service does not determine whether the payday lenders who bid for the loan are licensed in California, or for that matter, licensed anywhere. Typically the factors that determine whether the loan is funded is the referral fee that the lender is willing to pay to the finder, and if the borrower meets that lender's risk profile.

In conclusion, an illegal loan made in violation of state law is void and unenforceable.

PRIOR STATE LEGISLATION

AB 1158 (Calderon), would have raised face value of the check securing the pay loan to $500. Held in Senate Judiciary.

AB 2511 (Skinner). Would have prohibited the offering of a payday loan to someone receiving unemployment benefits, unless the APR for the loan was 36%. Held in Assembly Banking Committee.

AB 377 (Mendoza). Provided for various changes and reforms to the DDTL. Additionally, would have raised the face value of the check amount to $500. Died in Senate Judiciary.

AB 2845 (Jones, Bass & Feuer). At one point, would have capped the APR on payday loans at 36%. Was amended in Assembly Banking & Finance committee to state the intent of the Legislature to enact changes recommended in the DOC reports. Held in Assembly Rules Committee.

AB 7 (Lieu, Chapter 358, Statutes of 2007): Gave DOC the authority to enforce specified federal protections granted to members of the military and their dependents under the Payday Lending Law.

SB 1551 (Correa): Would enact various changes intended to improve regulatory oversight of the payday lending based on recommendations found in the two reports referred to in this analysis. Failed passage in Senate Judiciary.

SB 1959 (Calderon, Chapter 682, Statutes of 1996): Enacted the earliest version of a payday lending law in California. Gave regulatory authority to the California Department of Justice.

SB 898 (Perata, Chapter 777, Statutes of 2002). Enacted the Deferred Deposit Transaction Law and shifted the responsibility for administering the law to DOC;

ISSUES AND QUESTIONS FOR CONSIDERATION

1) What is the appropriate amount of regulation for payday loans in California? Is more regulation necessary? Are the perceived or real dangers of the product acceptable risk given that consumers may have desperate needs, or is it not worth those risks?

2) Options to payday loans do exist. Loans from friends or family, credit cards, bank and credit union products. However, these options may not be available at all times to all borrowers. Can policy makers assist with creating or expanding alternative small dollar products?

3) As described earlier, Pew research finds that 55% of borrowers surveyed believe that payday loans take advantage of borrowers, while 48% say the loans help more than hurt, with 8% reporting that the loans both help and hurt. Furthermore, 56% say the loans relieve stress and anxiety versus causing it. Three in five borrowers would use the product again if necessary. This information presents a confusing picture of borrowers believing that the product takes advantage, yet seemingly they would continue to use it if needed. How can this contradiction be explained? Does the product itself create this contradiction?

4) The research and data demonstrates a lack of financial literacy on the part of borrowers. Borrowers may perceive they have no other option than a payday loan because they are unaware of other options or have unrealistic concerns about approaching other options. What policies can be promoted to increase financial empowerment and financial literacy?

5) *Hyperbolic discounting* is a concept in economics and human behavior research that describes that a person with the choice between two equal rewards, one occurring now and one occurring later, the person will choose the immediate reward. A simpler way to explain, is that the self today makes choices that the future self would prefer not to make. This behavior may explain why some borrowers use the payday product when saving or other financial options may be available.

6) The academic survey and research data on payday lending studies the issue from a nationwide perspective. Nationwide research is vital and important for any financial policy debate. On the other hand, California is the most diverse state in the nation with a cost of living higher than other states. The only California research on the behavior of

borrowers was conducted via the DOC studies mentioned earlier in this background. Those studies have been the subject of debate and disagreement since they were released in 2007.

7) Between the parties of this debate, very little agreement can be found on the future of enhanced regulation. For a more in depth look at these disagreements, staff recommends a review of the committee analyses of the legislation mentioned under "Prior State Legislation."

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March 11, 2013
2:00p.m
California State Capitol, Room 444

I. **Opening Remarks:**

- Chair, Assemblymember Roger Dickinson
- Vice Chair, Assemblymember Mike Morrell

II. **Regulation of the Money Transmission Act:**

- Teveia Barnes, Commissioner, Department of Financial Institutions

III. **Assessments of Emerging Payment Technology, The Money Transmission Act & Consumer Protection:**

- Thomas Brown, Lecturer, UC Berkeley Law School and Partner, Paul Hastings LLP
- John Muller, Vice President & General Counsel, PayPal Inc.
- Michelle Jun, Senior Attorney, Consumers Union
- Rob Barnett, Vice President-Assistant General Counsel at Automatic Data Processing, Inc.

IV. **Public comment.**

EMERGING TECHNOLOGY AND THE CALIFORNIA MONEY TRANSMISSION ACT

Assembly Committee on Banking & Finance

March 11, 2013

Assemblymember Roger Dickinson, Chair

Mark Farouk-Chief Consultant
Kathleen O'Malley-Senior Consultant
Tiffany Morrison-Committee Secretary

On August 3, 2000, the National Conference of Commissioners on Uniform State Laws (NCCUSL) issued its first draft of a model act to provide a uniform regulation for money services business. One of the main drivers behind the creation of a uniform model act was to address concerns arising from potential money laundering activities and that states had begun to implement differing regulatory frameworks. A final version of the act was ratified by NCCUSL on August 6, 2004. Alaska, Arkansas, Iowa, Vermont, and Washington implemented the model act in its entirety. The creation of the model act did not end the patch work of state regulation. Instead, each state made their own changes and additions to the act.

On September 30, 2010, AB 2789 was signed into law by then Governor Arnold Schwarzenegger. AB 2789 established the California Money Transmission Act (MTA). The MTA combined the regulatory and licensing requirements of the Transmission of Money Abroad Law, the Travelers Check Act and the Payment Instruments Law. In addition to these changes, the MTA includes licensing for domestic money transfer and non-bank issued stored value. The MTA is administered by the California Department of Financial Institutions (DFI). Currently, there are approximately 71 MTA licensees, according to data available on DFIs website.

WHAT IS MONEY TRANSMISSION?

At the most basic level money transmission is the transfer of funds involving three parties, 1) Sender 2) Money transmitter and 3) Recipient. The transfer of funds may be intrastate, interstate, or international. Typically this service is conducted at a physical location where the sender of funds pays a fee to the remittance service and the money is then wired to the recipient. Though, as will be discussed later, emerging technologies are breaking up this old model.

Large money transmitters may have a home office, transaction clearing centers, service center (s), regional offices, and branches. They may also contract with agents. Agents may include established businesses such as grocery stores, truck stops, check cashers, pharmacists, travel agents and supermarket chains. The money transmission home office pays its agents using a fee schedule that provides predetermined charges for money transmission.

This is how the traditional model of money transmission works. A sender enters an agent location and wishes to send $500 to a recipient in another location. The sender provides the agent the funds and instructions for delivery to the recipient. The agent takes the funds and instructions and usually enters the transaction into a computer terminal owned by the money transmitter and that is linked to the money transmitter's processing system. Upon receiving the instructions, the money transmitter will contact its appropriate receiving agent for payout to the recipient. The sender and/or receiving agent will inform the recipient that the transmitted funds are available for pick-up. The availability of funds to the recipient may range from minutes to several days depending upon the location and availability of the receiving agent and money transmitter's delivery policy. While computers are the typical means for the transferring of money, telephone lines and fax machines are still widely used.

According to World Bank estimates, remittances totaled $414 billion in 2009, of which $316 billion went to developing countries that involved 192 million migrant workers. For some individual recipient countries, remittances can be as high as a third of their Gross Domestic Product (GDP). The top recipients in terms of the share of remittances in GDP included many smaller economies such as Tajikistan (45%), Moldova (38%), and Honduras (25%).

Historically, the money transmission involved face-to-face transaction between the consumer and transmitter agent that would accept the consumer's money and transmit those funds to another agent outside of the United States for delivery of those funds to the consumer's family or friends. These transactions were dominated primarily by a few large transmitters such as Western Union and MoneyGram. Subsequent to the issuance of the draft NCCUSL money transmission act, states across the country amended their statutes to provide enhanced regulation to foreign and domestic transmission and non-bank issued stored value. Forty eight states and the District of Columbia have money transmission licensing statutes.

As will be discussed later in this document, the definition of money transmission can be quite broad, both legally and interpretatively. Furthermore, the traditional model of money transmission has changed as emerging technologies are changing the way businesses accept payments and the way that consumers send money or pay for goods and services.

<u>Highlights of the MTA:</u>

The following are some highlights of California's MTA (Financial Code Sections 2000-2172):

1) Defines “payment instrument” as a check, draft, money order, traveler’s check, or other instrument for the transmission or payment of money or monetary value, whether or not negotiable. The term does not include a credit card voucher, letter of credit, or any instrument that is redeemable by the issuer for goods or services provided by the issuer or its affiliate.

2) Defines “receiving money for transmission” or “money received for transmission” as receiving money or monetary value in the United States for transmission within or outside the United States by electronic or other means. The term does not include sale or issuance of payment instruments and stored value.

3) Defines “Stored value” as monetary value representing a claim against the issuer that is stored on an electronic or digital medium and evidenced by an electronic or digital record, and that is intended and accepted for use as a means of redemption for money or monetary value or payment for goods or services. The term does not include a credit card voucher, letter of credit, or any stored value that is only redeemable by the issuer for goods or services provided by the issuer or its affiliate, except to the extent required by applicable law to be redeemable in cash for its cash value.

4) Requires licensing for domestic money transmittal services. Prior to enactment, licensing was only required for international money transfer.

5) Provides for regulation of non-bank issued stored value cards that may be offered by licensees. In order to offer non-bank stored value the seller of stored value must be licensed.

6) Prohibits a person from engaging in the business of money transmission in California or advertising, soliciting, or holding itself out as providing money transmission unless licensed.

7) Requires specified information to be included in an application for a license which shall be in the form proscribed by the commissioner of DFI.

8) Authorizes the commissioner to conduct an examination of an applicant, at the applicant’s expense, and would require the commissioner to approve an application for a license if the commissioner makes specified findings, including that the applicant has adequate net worth and is competent to engage in the business of receiving money for transmission. In order to meet the net worth requirements a licensee that sells or issue payment instruments or stored value must maintain securities on deposit on a surety bond of no less than $500,000 or 50% of the average daily balance of outstanding payment instruments and stored value in CA. A licensee engaged in money transmission must either maintain securities or a surety bond not less than $250,000 no more than $2,000,000.

9) Requires licensees to file audit reports with the commissioner within 90 days after the end of each fiscal year.

10) Imposes various fees and would require the commissioner to levy assessments on licensees for the purposes of administering these provisions regulating money transmission including:

a) A $5,000 application fee;

b) An annual license fee of $2,500;

c) An annual branch office fee of $125 per branch office;

d) An annual $25 fee for each branch employee; and,

e) For licensees that sell or issue payment instruments, an annual assessment based on the volume and aggregate face amounts of payment instruments and stored value issued or sold in California.

11) A licensee must maintain specified eligible securities including and/or a surety bond and maintain $500,000 in net-worth.

12) Requires a licensee to provide specified notices and disclosures to customers, including a notice relative to a customer's right to a refund, disclosures relating to rates of exchange, a notice indicating that payment instruments are not insured, and a notice providing information on making complaints to the commissioner against a licensee.

13) Requires licensees to maintain financial records for a 3-year period.

14) Mandates each licensee to file with the commissioner a certified copy of every receipt form used by it or by its agent for receiving money for transmission prior to its first use.

15) Authorizes the commissioner to suspend or revoke a license if the commissioner finds that a licensee or agent of a licensee has, among other things, violated the provisions of the act or engaged in fraud or unsound practices and would authorize the commissioner to assess specified civil penalties against a person that violates these provisions.

16) Makes it a crime for a person to engage in the business of money transmission without a license or for a person to intentionally make a false statement, misrepresentation, or false certification in a record filed or required to be maintained under these provisions.

17) Exempts from licensing,

a) The United States or a department, agency, or instrumentality thereof, including any federal reserve bank and any federal home loan bank.

b) Money transmission by the United States Postal Service or by a contractor on behalf of the United States Postal Service.

c) A state, county, city, or any other governmental agency or governmental subdivision of a state.

d) A commercial bank or industrial bank, the deposits of which are insured by the Federal Deposit Insurance Corporation or its successor, or any foreign (other nation) bank.

e) Electronic funds transfer of governmental benefits for a federal, state, county, or local governmental agency.

f) A board of trade designated as a contract market under the federal Commodity Exchange Act (7 U.S.C. Secs. 1-25, incl.) or a person that, in the ordinary course of business, provides clearance and settlement services for a board of trade to the extent of its operation as or for such a board.

g) A person that provides clearance or settlement services pursuant to a registration as a clearing agency or an exemption from registration granted under the federal securities laws to the extent of its operation as such a provider.

h) An operator of a payment system to the extent that it provides processing, clearing, or settlement services, between or among persons excluded by this section, in connection with wire transfers, credit card transactions, debit card transactions, stored value transactions, automated clearing house transfers, or similar funds transfers, to the extent of its operation as such a provider.

i) A person registered as a securities broker-dealer under federal or state securities laws to the extent of its operation as such a broker-dealer.

18) If the commissioner finds all of the following with respect to an application for a license, the commissioner shall approve the application:

a) The applicant has adequate tangible shareholders' equity, as specified in Section 2040 to engage in the business of money transmission and the financial condition of the applicant is otherwise such that it will be safe and sound for the applicant to engage in the business of money transmission.

b) The applicant, the directors and officers of the applicant, any person that controls the applicant, and the directors and officers of any person that controls the applicant are of good character and sound financial standing.

c) The applicant is competent to engage in the business of money transmission.

d) The applicant's plan for engaging in the business of money transmission affords reasonable promise of successful operation.

e) It is reasonable to believe that the applicant, if licensed, will engage in the business of money transmission and will comply with all applicable provisions of this chapter and of any regulation or order issued under this chapter.

FEDERAL LAW & REGULATIONS:

Federal Regulation E, the Electronic Funds Transfer Act (EFTA) was amended via the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) to include regulation of international remittances and money transfer. Section 1073 of Dodd-Frank expanded the scope of EFTA to include requirements concerning remittance disclosures to consumers. The Consumer Financial Protection Bureau (CFPB) has been tasked with creating rules to implement these changes. Last year, CFPB released draft rules that were to take effect February of 2013. However, CFPB postponed the final rules until later in the year to work out potential compliance issues.

A brief description of the new requirements:

- Money transmitters will be required to provide customers with written pre-payment disclosures containing information about the specific transfer, such as the exchange rate, applicable fees and taxes, and the amount to be received by the designated recipient.

- Money transmitters will be required to provide a written receipt when payment is made. The receipt must include the information provided on the pre-payment disclosure, as well as additional information, such as the date of availability, the recipient's contact information, and information regarding the customer's error resolution and cancellation rights. As an alternative, the new money transmitter regulation allows money transmitters to give customers a single written disclosure prior to payment containing all of the information required on the receipt, so long as the money transmitter also provides proof of payment such as a stamp on the earlier document.

- The pre-payment disclosures and receipts must be provided in English and in each of the foreign languages principally used by the money transmitter to advertise, solicit, or market money transfer services at a particular office. If you offer customers the ability to make money transfers using text message or a mobile application, the new money transmitter regulation provides additional guidance on how to provide the required disclosures.

- If, (i) due to the laws of a recipient country or (ii) the method by which transactions are made in the recipient country, a money transmitter cannot determine certain amounts that are required to be disclosed, exceptions permit the money transmitter to disclose an estimate of the amount of currency to be received, rather than the actual amount.

- Money transmitters will be required to provide customers with a 30-minute cancellation period that allows a customer the opportunity to review both the prepayment disclosure and the receipt to ensure that the transfer was sent as the customer intended. If a customer requests, a money transmitter must promptly provide the customer a notice describing the customer's "error resolution" and cancellation rights, using specified language or substantially similar language. Even after the cancellation period has passed, customers will have a right to a refund or other remedy if an error occurs in a transaction.

- In the event a customer timely requests the cancellation of a money transfer, the new money transmitter regulation requires money transmitters to provide customers with a refund, at no additional cost to the customer, the total amount of funds provided by the customer, including any fees and, to the extent not prohibited by law, taxes imposed in connection with the money transfer, within three business days of receiving the request to cancel the money transfer.

The United States Department of Treasury under the Financial Crimes Enforcement Network (FinCEN) requires registration of money services businesses (MSB). According to FinCEN an MSB includes any person doing business, whether or not on a regular basis or as an organized business concern, in one or more of the following capacities, and that meets a threshold of $1,000 per day or more transactions:

- Currency dealer or exchanger.
- Check casher.
- Issuer of traveler's checks, money orders or stored value.
- Seller or redeemer of traveler's checks, money orders or stored value;
- Money transmitter.

FinCEN registration does not apply to a bank or a person regulated or registered with the Securities and Exchange Commission. Entities registered with FinCEN must make electronic filings under the Bank Secrecy Act (BSA). As of July 1, 2012, all such filings must be electronic and made through the BSA E-Filing System. Reports that must be filed through this system include, but are not limited to:

- Currency Transaction Report (FinCEN Form 104)
- Designation of Exempt Person (FinCEN Form 110)
- Suspicious Activity Report (Form TD F 90-22.47)
- Suspicious Activity Report by the Securities and Futures Industries (FinCEN Form 101)
- Suspicious Activity Report by Money Services Business (FinCEN Form 109, formerly 90-22.56)
- Suspicious Activity Report by Casinos and Card Clubs (FinCEN Form 102)
- Currency Transaction Report by Casinos (FinCEN Form 103, formerly 8362)
- Registration of Money Services Business (FinCEN Form 107)
- Report of Foreign Bank and Financial Accounts (Form TD F 90-22.1)

EMERGING TECHNOLOGIES:

The last five years have witnessed technological changes that have drastically altered the old business model of remittances, as well as, the ways in which consumers pay for goods and services. Whereas, the traditional model involved visiting the location of a money transmitter agent, new technologies have completely changed the way in which customers send and use money.

Now a consumer wishing to send money to another person for goods, services, or simply as a remittance to family or friends, has various online services to choose from, including applications utilizing smart phones. The way in which consumers pay for goods and services has transcended checks and credit cards and is rapidly evolving with electronic payment systems and new innovative payment networks. Large financial institutions are also getting on the bandwagon as several large financial institutions (BofA, Chase, and even Golden 1 Credit Union) are offering money transfer services using smart phone and web based applications.

In the payments space, typical five channels have been available, 1) Cash 2) Check (Paper or Check 21 substitute check) 3) Automated Clearing House (ACH) transaction 4) Credit/debit/stored value and 5) Wire transfers. Emerging technologies have created new payment methods such as web payments, contactless payments, mobile payments, Bitcoin and other virtual currency.

Between December 2011 and January 2012, the Federal Reserve Board conducted a survey of consumers concerning the use of mobile financial services (http://www.federalreserve.gov/econresdata/mobile-devices/files/mobile-device-report-201203.pdf). The following are brief findings from their report.

1) Mobile phones and mobile Internet access are in widespread use.
    a) 87 percent of the U.S. population has a mobile phone.
    b) 44 percent of mobile phones are smartphones (Internet-enabled).
    c) 84 percent of smartphone users have accessed the Internet on their phone in the past week.
2) The ubiquity of mobile phones is changing the way consumers access financial services.
    a) 21 percent of mobile phone owners have used mobile banking in the past 12 months.
    b) 11 percent of those not currently using mobile banking think that they will probably use it within the next 12 months.

c) The most common use of mobile banking is to check account balances or recent transactions (90 percent of mobile banking users).

d) Transferring money between accounts is the second most common use of mobile banking (42 percent of mobile banking users).

3) Mobile phones are also changing the way consumers make payments.

a) 12 percent of mobile phone owners have made a mobile payment in the past 12 months.

b) The most common use of mobile payments was to make an online bill payment (47 percent of mobile payment users).

c) 21 percent of mobile payment users transferred money directly to another person's bank, credit card, or Paypal account.

4) Perceptions of limited usefulness and concerns about security are holding back the adoption of mobile financial services.

a) The primary reason why mobile phone users had not yet adopted mobile banking was that they felt their banking needs were being met without the use of mobile banking (58 percent).

b) Concerns about the security of the technology were the primary reason given for not using mobile payments (42 percent) and the second most common reason given for not using mobile banking (48 percent).

c) More than a third of mobile phone users who do not use mobile payments either don't see any benefit from using mobile payments or find it easier to pay with another method.

5) The "underbanked" make significant use of mobile financial services.

a) The underbanked make comparatively heavy use of both mobile banking and mobile payments, with 29 percent having used mobile banking and 17 percent having used mobile payments in the past 12 months.

b) 62 percent of the underbanked who use mobile payments have used it to pay bills.

c) 10 percent of the completely unbanked reports using mobile banking in the past 12 months, and 12 percent have made a mobile payment.

Mobile payment devices and systems are turning into new and innovative ways for businesses to accept electronic payments.

In addition to the money transmission licensing acts across 48 states, James Freis, Director of FinCEN testified on June 29, 2012, in front of the U.S. House Committee on Financial Services,

> *FinCEN's regulations also have made it clear that the acceptance and transmission of currency, funds, or other value that substitutes for currency from one person and the transmission of currency, funds, or other value that substitutes for currency to another person or location, by any means, constitutes money transmission, and that any person wherever located doing business wholly or in substantial part within the United States engaging in money transmission, regardless of any other business lines the person is engaged in – such as the provision of telecommunication services – would likely be a money services business under FinCEN's regulations, and as such must register and comply with all the reporting, recordkeeping, and monitoring requirements applicable to a money transmitter.*

<u>Payment networks:</u>

Payment networks are the infrastructure, made up of multiple parties, that provide for the processing of electronic financial transactions, most notably, credit card transactions. A typical credit card transaction has four parties: the customer, the bank that issued the customer's card, the merchant, and the merchant's bank. The merchant typically receives less than the merchant's bank as the transaction is discounted due to the interchange rate (paid to network) and any fees paid to the merchant bank. The largest payment networks are Visa, MasterCard, Discover and American Express. The top issuers of credit cards are American Express, JP Morgan Chase, Bank of America, and Citigroup.

The interchange fee paid by merchants has been the source of great controversy between merchants and payment networks and issuing banks. Interchange fees are set by the payment networks and can vary based on type of card used and transaction volume. The largest criticism of interchange fees have been 1) they are uncompetitive, as fee competition among the established networks is fairly non-existent. 2) Medium and small merchants have no ability to negotiate on the fee schedule, 3) Network rules prohibit passing the fee along to customers.

One of the most contentious fights concerning interchange involved the "Durbin amendments" to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The Durbin amendment specified that financial institutions with assets over $10 billion could only charge interchange fees that are "reasonable and proportional to the actual cost." The Durbin Amendment also gave the Federal Reserve the power to regulate debit card interchange fees, and on December 16, 2010, the Fed proposed a maximum interchange fee of 12 cents per debit card transaction, which CardHub.com estimated would cost large banks $14 billion annually. On June 29, 2011, the Fed issued its final rule, which holds that the maximum interchange fee an issuer can receive from a single debit card transaction is 21 cents plus 5 basis points multiplied by the amount of the transaction.

On July 13, 2012, a settlement between retailers and the payment card industry (Visa, MasterCard, several banks) over interchange fees was reached. The settlement will not be implemented until it receives court approval. The settlement only applies to credit cards not debit cards.

The settlement establishes:

- Cash payment: $6.05 billion
- Credit interchange modification: 10 basis points for eight months. Anticipated value is approximately $1.2 billion
- Ability to charge "checkout fees" at the point of sale for customers paying with a credit or charge card. Fee cannot exceed 4%. This includes American Express and Discover although they were not parties to the settlement.
- Ability to form buying groups to negotiate interchange rates collectively

The settlement allows members of the class to opt-out of the damages portion of the settlement agreement if they prefer to litigate independently for more damages. No retailer can opt-out of the forward looking injunctive portion of the settlement, related to rule changes such as the surcharge. The defendants have the right to terminate the settlement agreement should more than 25% of the merchants opt out of the damages portion. Retailers have until October, 2012, to opt-out.

California enacted Civil Code Section 1748.1 in 2005 which prohibits a retailer in any sales, service, or lease transaction with a consumer may impose a surcharge on a cardholder who elects to use a credit card in lieu of payment by cash, check, or similar means. A retailer may, however, offer discounts for the purpose of inducing payment by cash, check, or other means not involving the use of a credit card, provided that the discount is offered to all prospective buyers.

This law will still prohibit retailers from charging a surcharge in California although there is a settlement.

States do not have the ability to regulate interchange rates between retailers, banks and the card networks. The main area of nexus is how retailers pass along those charges to customers. As mentioned previously, CA prohibits retailers from imposing a surcharge; however this restriction does not apply to non-retailers, such as government agencies. It's foreseeable that we may see legislation prohibiting fees for these non-retail entities.

The emergence of alternative payment networks has arisen in large part from the desire of merchants to mitigate the fees and costs associated with the traditional payment networks.

<u>**ALTERNATIVE PAYMENT NETWORKS**</u>:

Growth in technology has assisted with the rapid development of alternative payment networks. PayPal started in 1998 to allow people to send money without sharing financial information. The bulk of PayPal's business came from its relationship with Ebay (Ebay now owns PayPal) in which buyers paid for goods on Ebay via Paypal's service. PayPal is currently the global leader in processing payments with over $115 billion processed annually.

Square Inc. a payment processing company that began by offering a credit card reader to businesses in order to process credit card transactions including software to facilitate payments. Square is on track to process $10 billion in payments a year. They also offer smart phone app that allows customers to pay for goods and services with participating merchants. Square's main focus has been providing its services to small merchants like food trucks or taxi drivers. Square makes money by charging a 2.75% fee for every transaction.

Alipay reports a registered user base of approximately 600 million, and is accepted for online payment at many retail websites and service providers in China. They process more than 8.5 million transactions a day, and are partnered with more than 65 financial institutions including Visa, MasterCard, and all national banks in China. Alipay also provides payment solutions for more than 500,000 external Chinese merchants for online retail, virtual gaming, digital communications, commercial services, air ticketing, and utility fee payment transactions.

Popmoney lets you send money from your bank account to anyone using their name and email address or mobile number. Popmoney was developed by CashEdge (now part of Fiserve) and is offered through 1,400 US financial institutions (including US Bank and Citi) and processes nearly $50 billion in online fund transfers annually.

The Intuit Payment Network was developed to provide small businesses with an inexpensive way to get paid electronically. The service moves money directly from a sender’s bank account to a receiver’s bank account for one low flat fee of 50 cents. The network also offers several other ways to get paid: through QuickBooks invoice links, by credit card, ecommerce buttons, and through custom web links. Intuit, the maker of QuickBooks, Quicken, and TurboTax has over 240,000 merchants using the Intuit’s credit card processing service.

ClearXchange (CXC) was formed in 2011 as the first network created by financial institutions to let customers send person-to-person payments directly from their checking and savings accounts with only the recipient’s mobile number or email address. CXC is equally owned by Bank of America, JPMorgan Chase, and Wells Fargo. Although their service is just out of pilot mode, the three founding partner banks, when combined, reach over 50% of all U.S. online and mobile banking customers.

Dwolla was created in 2008 as an alternative payment network to help lower interchange fees for merchants. Dwolla allows consumers and organizations to send and receive money for only 25 cents per transaction, no matter how high the transfer amount. The company currently processes over $50 million per month in transactions and have signed up more than 100,000 users. Dwolla is currently not licensed as a money transmitter in California. These developments in payments provide businesses with multiple options for accepting payments for goods and services. Additionally, these innovations are creating an active competitive payment processing marketplace where businesses have the ability to price shop for these services.

The previous list of companies is only a small sample of companies operating in this space. For a list of money transmitters licensed in California, visit http://www.dfi.ca.gov/Directory/money_transmitters.html.

Stored Value:

An additional expanding model in the money transmission business is the use of stored value, typically via a pre-paid card, but new technology is growing the use of stored value across new mediums. The MTA regulates the issuance of non-bank stored value. The exempts stored value offered by a bank, or stored value on what is known as a "closed-loop" system. A closed loop system is typically a gift card or some other item representing monetary value that can only be used within the network of a given retailer or merchant. Money transferred via traditional means using an agent, or via computer can often be loaded onto a stored value device and provided to the receiver.

ISSUES & QUESTIONS FOR DISCUSSION:

- The emerging technologies that bring convenience to the consumer and competition to the market can create regulator confusion. As these technologies avoid storefront locations or traditional banking relationships, regulatory frameworks must keep up in order to remain relevant and clear, not just for consumers, but for those that desire to innovate.
- The road to becoming licensed as a money transmitter in California can create significant compliance costs. These costs can occur before the actual transmission business is off the ground. Licensing fees, net-worth reserves, bonding requirements, audited financial statements, as well as, compliance with Federal money laundering laws are among the costs that payment start-ups must consider.

Many of these costs could be borne multiple times over if a potential licensee wishes to become licensed in more than one state. Policy makers may want to consider establishing a scaled approach to licensing in so far as potential transaction volume dictates net-worth requirements. Furthermore, it may be difficult to mitigate some compliance costs, but what policies and/or regulations may be necessary to avoid uncertainty in regards to these costs?

- The MTA creates a potential chicken and egg scenario. Many start-ups in the payments business rely on venture capital funding. Funding is difficult when one is not licensed to conduct business, yet one cannot acquire a license without sufficient funding. Furthermore, this conundrum creates difficulties in creating pilot projects or limited test runs of products because these market tests could be illegal, yet it is difficult to determine success of an innovation without testing.

- Do we need a clearer definition of "money transmission" to clarify when a business that is sending money from point A to point B is not engaged in transmitting money? Additionally, what clarifications may be needed to ensure that the MTA statute provides for functional regulation with a rapidly changing payment system landscape?

- What can policy makers do to ensure a correct balance between removing barriers to market entry while also providing sufficient state oversight?

- Each state has its own set of money transmission requirements that all differ from each other to varying degrees. As mentioned previously, these differences can potentially create barriers for new companies. Often, the requirements of different states may be slightly different, but functionally the same in wanting to ensure that a licensee is not financially over-leveraged and that consumers are appropriately protected. However, policy makers and regulators may wish to consider efforts to create some uniformity, or even reciprocity in licensing. However, before embarking on creating the potential for reciprocity it is vital that California standards are standards that other states may wish to copy and in turn, offer reciprocity for California licensees. Policy makers may want to consider encouraging California regulators to work with other state regulators to design more uniform regulations and standards.

- An idea circulating among some observers is that the Legislature should repeal the MTA. This idea may reflect frustration with compliance and regulatory difficulties facing existing and potential future licensees, a repeal of the MTA would lead to dangerous consequences. First, the repeal of the MTA would not provide the state with specific enforcement and licensing authority over entities that transmit money, issue payment instruments (money orders, traveler's checks) or non-bank issuers stored value. A complete repeal of the MTA could leave California with little oversight over entities that take consumer money and transfer it to other parties. If an entity offers services as a payment system that has no net-worth or bonding requirements then what protections would consumers have to recover lost funds, or for the state to hold them accountable? The purpose behind financial asset requirements is to ensure that if the consumer's funds are in jeopardy they have some recourse for potential recovery. This is not to say that numerous federal laws and regulations don't also regulate this area of operations. However, just like mortgage lending, the state has a vested interest in maintaining authority over practices that directly impact California consumers and specifically the safety and soundness of these entities.

Legislative Responses:

On February 21, 2013 Assemblymember Dickinson, Chair of Assembly Banking & Finance introduced AB 786. Initially, this legislation includes clarifications on issues relating to net-worth requirements, the use of certain types of accounts to fulfill liquidity requirements, clarifications on what entities are not money transmitters, and enhanced enforcement powers. AB 786 is viewed as a starting point for further discussion involving reform of California's MTA.

Tuesday, October 29, 2013
10 a.m.-12:00 p.m.
Alhambra City Hall
Council Chambers
111 South First Street
Alhambra, CA 91801

I. Welcome and Introduction

- Honorable Ed Chau, Chair

  Assembly Committee on Housing and Community Development

- Honorable Roger Dickinson, Chair

  Assembly Committee on Banking and Finance

II. Overview of Current Real Estate Trends

- Bill Watkins, Ph.D. Executive Director, Center for Economic Research and Forecasting, California Lutheran University

III. Update on the KYHC Program

- Claudia Cappio, Executive Director, California Housing Finance Agency

- Diane Richardson, Legislative Director, California Housing Finance Agency

IV. Housing Counselor Perspective on KYHC Program

- Peter Serbantes, Director, Home Strong USA

- Selena Davis, Homeownership Services Manager, Neighborhood Housing Services of Los Angeles County

V. Servicers Stakeholder Perspective on KYHC Program

- Robert Mansur, Operations Manager, Government and Community Partnerships, JP Morgan Chase

- Shelly DeVries, Special Programs Supervisor, OCWEN Loan Servicing

- Mary Chandler, SVP, HHF & Specialty Program Management, Bank of America

- Marisa Barker, Community Outreach Vice President, Nationstar Mortgage

- Miguel Bustos, Regional Servicing Director, Wells Fargo Home Mortgage

VI. Update on KYHC Innovation Programs

- Dee Sodano, Vice President, Community 2nd Mortgage Principal Reduction Program Community Housing Works

- George Guillen, Housing, Homeownership and Preservation Division, Los Angeles Housing Department

VII. Public Comment

Tuesday, October 29, 2013, 10:00 a.m. - 12:00 p.m.
City Hall, Alhambra, California

In February 2010, President Obama announced $1.5 billion in funding for innovative measures to help families in the states hardest hit by the burst of the housing bubble. Housing Finance Agencies (HFAs) were the designated recipients of the funding and were responsible for developing programs that meet the guidelines provided. In California, the California Housing Finance Agency (CalHFA) is the designated recipient.

As one of five states targeted for assistance, California was initially awarded close to $700 million under the federal Housing Finance Agencies Innovation Fund for the Hardest-Hit Housing Markets program (Hardest Hit Program). On August 11, 2010, the Obama Administration announced that it would be expanding the program from the original five states and giving the existing states more money. California received an additional $799.5 million in Hardest Hit funds. CalHFA also received approval to use $476.3 million in previously allocated foreclosure-prevention assistance for the Hardest Hit Programs, increasing the total available to nearly $2 billion. In total, $7.6 billion was allocated to 18 states plus the District of Columbia. The following states received Federal Hardest Hit Funds: Alabama, Arizona, California, Florida, Georgia, Illinois, Indiana, Kentucky, Michigan, Mississippi, Nevada, New Jersey, North Carolina, Ohio, Oregon, Rhode Island, South Carolina, Tennessee, and Washington D.C.

Hardest Hit Programs were required to follow basic guidelines to assist homeowners who are at risk of foreclosure. In meeting that goal, the funds could be used to do any of the following:

- Mortgage Modifications—Programs that provide modification of loans held by HFAs or other financial institutions or provide incentives for servicers/investors to modify loans.
- Mortgage Modifications with Principal Forbearance—Programs that pay down all or a portion of an overleveraged loan and take back a note from the borrower for that amount in order to facilitate additional modifications.
- Short Sales/Deeds-In-Lieu of Foreclosure—Programs that provide assistance with short sales and deeds-in-lieu of foreclosure in order to prevent avoidable foreclosures.
- Principal Reduction Programs for Borrowers with Severe Negative Equity—Programs that provide incentives to financial institutions to write down a portion of unpaid principal balance for homeowners with severe negative equity.
- Unemployment Programs—Programs that provide assistance to unemployed borrowers to help them avoid preventable foreclosures.
- Second Lien Reductions—Programs that provide incentives to reduce or modify second liens.

Keep Your Home California Program (KYHC)

The Hardest Hit program guidelines required CalHFA to submit its proposal to the U.S. Treasury Department for approval by April 16, 2010. To form the proposal, CalHFA met with loan servicers, loan counseling agencies, Fannie Mae, the general public, and other stakeholders to identify the greatest areas of need among at-risk borrowers. On June 23, 2010, CalHFA received approval from the U.S. Treasury for the KYHC.

The KHYC program includes four separate programs to assist individual homeowners:

1) Unemployment Mortgage Assistance Program (UMA) –UMA provides temporary financial assistance in the form of a mortgage payment subsidy of varying size and term to unemployed homeowners who wish to remain in their homes but are in imminent danger of foreclosure due to short-term financial problems. The Unemployment Mortgage Assistance Program provides mortgage payment assistance to eligible homeowners who have experienced an involuntary job loss and are receiving California EDD unemployment benefits. Benefit assistance through UMA can be up to $3,000 per month or 100% of the PITI (principal, interest, tax, insurance) and any escrowed homeowner's association dues or assessment for up to twelve months. The maximum assistance per household is $36,000.

2) Mortgage Reinstatement Assistance Program (MRAP) – Intended to assist homeowners who have fallen behind on their mortgage payments due to a temporary change in a household circumstance. The Mortgage Reinstatement Assistance Program provides assistance to eligible homeowners who, because of a financial hardship, have fallen behind on their payments and need help to reinstate their past due first mortgage loan. Benefit assistance through MRAP can be a one-time payment of up to $25,000 to cover principal, interest, taxes and insurance, as well as any homeowner's association dues.

3) Principal Reduction Program (PRP) –The Principal Reduction Program provides assistance to eligible homeowners who have experienced an economic hardship coupled with a severe decline in the home's value. Homeowners who qualify for the PRP could be eligible for up to $100,000 in assistance from Keep Your Home California.

4) Transition Assistance Program (TAP) – The Transition Assistance Program provides one-time funds to help eligible homeowners relocate into a new housing situation after executing a short sale or deed-in-lieu of foreclosure program. The TAP can provide up to $5,000 in transition assistance per household.

CalHFA began offering the four programs on a pilot basis to its own portfolio of borrowers in the fall of 2010. On January 10, 2011, CalHFA launched the UMA statewide. On February 7, 2011, CalHFA launched the other three programs (MRAP, PRP and the TAP) statewide.

Below is a chart of the estimated amount of assistance that CalHFA is offering in each of the four programs:

Program	Allocated Program Funds
UMA	$874,995,915.28
MRAP	$159,400,000.00
PRP	$772,197,793.52

TAP	$2,300,000.00

*Funds may be reallocated based on results

Homeowner Eligibility Requirements for KYHC

To qualify for the KYHC program homeowners must meet the following eligibility requirements:

- Own and occupy the home as primary residence;
- Meet program income limits;
- Have documented, eligible hardship;
- Adequate income to sustain modified mortgage payments;
- Mortgage loan is delinquent or in imminent default;
- Unpaid principal balance does not exceed $729,750;
- Property must not be abandoned, vacant or condemned; and
- Property must be located in California.

Servicer Participation

One of the key components of the success of the KYHC program is adequate participation by the servicers and banks that hold the mortgages of homeowners eligible for the programs. As of October 16, 2013, a total of 157 servicers are participating in the KYHC program. Attached is a document containing servicer participation by program. Servicer participation in the KYHC program is strictly on a voluntary basis.

KYHC Funding

As of September 16, 2013, $402,375,292.95 of the $2 billion has been allocated, helping 29,344 homeowners in California.

Programs	Homeowners Assisted	Total Amount Distributed
Unemployment Mortgage Assistance	22,749	$256,449,070.50
Principal Reduction Program	2,149	$94,925,918.63
Mortgage Reinstatement Assistance Program	4,081	$49,677,731.60
Transition Assistance Program	365	$1,322,572.22
Total Program Funds Allocated	**29,344**	**$402,375,292.95**

KYHC Scorecard

In September of 2013, KYHC unveiled an online servicer scorecard. The scorecard is a tool for homeowners to use to determine how mortgage servicers are working with the KYHC program. The scorecard evaluates servicers based on percentage of applications approved and declined, how many days it takes to respond to applications, and the total funding issued per program during that particular month.

Wells Fargo and Bank of America together accounted for almost 44 percent of the fundings issued through the program in August 2013. Wells Fargo customers accounted for 1,870 transactions in August, the most in the program from any single servicer, followed by Bank of America at 1,519. However, Bank of America customers were issued $7.82 million in funding, about $3 million more than second-place Wells Fargo. The difference is due to the fact that in August, Bank of America had many more customers qualify for the Principal Reduction Program, which has the largest benefit amount of the four KYHC programs.

The most recent scorecard is attached to this document.

Local Innovation Fund Programs:

The Local Innovation Fund Program was designed to allow local governments, nonprofits and other entities across California the opportunity to tailor foreclosure prevention solutions to address their particular needs and geographic areas. Through a competitive process, CalHFA Mortgage Assistance Corporation (MAC) selects and funds several innovative local programs meeting the compliance requirements set forth under Emergency Economic Stabilization Act of 2008 (EESA). Program design, eligibility, and the type of assistance vary with each local program.

Community Second Mortgage Principal Reduction Program (C2MPRP)

Offered by Community Housing Works, the Community 2nd Mortgage Principal Reduction Program provides capital on a 35/65 matching basis with participating nonprofit, credit union, and small community lenders. The purpose is to reduce the outstanding principal balances of subordinate second mortgages for borrowers of qualifying properties with negative equity, to achieve affordability on existing mortgage loans, or to be utilized in conjunction with a loan modification.

C2MPRP attempts to reduce the number of avoidable foreclosures in California by providing a niche principal reduction program for troubled borrowers with amortizing, subordinate mortgage debt from Nonprofit Community Lenders, such as Credit Unions, NeighborWorks Organizations, and Community Development Financial Institutions (CDFI). This program is provided under a contract with CalHFA and its KYHC programs, and as provided for by the US Treasury's Hardest Hit Fund.

Los Angeles Housing Department Principal Reduction Program (LAHD-PRP)

LAHD contracted with CalHFA MAC to offer the Los Angeles Mortgage Modification Program to target those neighborhoods most impacted by foreclosures and sub-prime lending in the city of Los Angeles. Working with local community based partners LAHD-PRP intends to enable eligible homeowners in Neighborhood Stabilization Program (NSP) targeted neighborhoods to receive sustainable loan modifications with permanent principal reduction. Program funds will be used to compensate lenders for forgiven principal on proprietary (non-HAMP) loan modifications. For loans over 180 days past due, the payout will be $0.06 for each $1.00 of principal forgiveness.

Short Sale Gateway Program, Neighborworks Sacramento – program discontinued

This program was intended to provide an avenue for homeowners that had exhausted options to modify their loan by providing an option to keep them in their homes through a lease-purchase agreement. The goal was to prevent dislocation of households, prevent the creation of vacant units, and return borrowers to successful homeownership. Neighborworks Sacramento was to purchase properties from the banks and lease them back to the borrower, put the borrower through counseling, and then sell the mortgage back to the original homeowner at the end of the lease period. Neighborworks Sacramento decided to return the funding and discontinue the program.

Recent Federal Action

Freddie Mac and Fannie Mae (GSEs) -Principal Reductions

In early September, 2012, Freddie Mac and Fannie Mae announced they would allow their borrowers to participate in the KYHC program. This change may have been spurred by KYHC dropping a requirement that banks match taxpayer funds when a homeowner receives mortgage reductions through the program.

Freddie Mac issued guidelines explicitly stating, “effective immediately, you (servicers) should participate in state modification assistance programs that permit you to apply funds as a partial principal curtailment for homeowners with Freddie Mac-owned or guaranteed mortgages." Fannie Mae and Freddie Mac own about 62% of outstanding mortgages in California, according to an estimate released by the state attorney general's office earlier this year. Prior to this announcement, neither had elected to participate in principal reduction because of concerns about additional costs to taxpayers.

The servicing guide lender letter from Freddie Mac and Fannie Mae is attached.

Challenges That Impact KYHC

Loan modification programs present many unique challenges. Some of these issues are subject to vigorous debate, while others are identified and acknowledged by all sides. All of the factors that fed the engine of mortgage growth prior to the subprime collapse and made credit easy for consumers to acquire, are now the issues that make loan modifications difficult. Securitization, investor decisions, the nature of servicing, and a host of other unseen dynamics can play a potential role in making otherwise effective programs on paper, fall short in "real-world" application. This is not to say that policy makers, regulators nor industry groups should resign themselves mediocrity. Instead, as these groups become aware of these challenges, proactive problem solving may be able to assist in foreshadowing these problems with KYHC program, and improving its odds of success. With hundreds of reports, media articles, policy committee hearings at the state and federal level the problems associated with loan modifications are documented. In an attempt to forecast, or at the least raise awareness about these potential pitfalls, below is a brief summary of issues that have faced loss mitigation programs, and could impact KYHC.

- *Borrower contact fatigue*: In order to make a program work, borrower outreach and contact is vital. As numerous accounts demonstrate the most difficult step to getting the modification process started, is making contact with a distressed borrower. In some cases, a borrower may not be responsive to a servicer through whom they have already had a bad experience, either through collections activity, or through previous loan modification attempts. Additionally, mailings and phone calls may be confused for unwarranted solicitations regarding other financial services.

- *Transmission and permeation of incorrect information*: Many borrowers in an effort to seek assistance may reach out to loan modification companies that have little to no actual experience, or seek counsel from family and friends that leads to incorrect assumptions about qualification or ability to seek a loan modification. Media has also played a role in this problem, as short snippets regarding the eligibility of various programs can lead borrowers to assume that they qualify without knowing the actual requirements.

- *Loan type*: Early in the subprime crisis, the loans that were doing the most damage were non-traditional loans that included rate and/or payment adjustments that would the leave borrowers unable to afford their mortgage. These loans were easier in some ways to modify because they had more features that could be adjusted to reach an affordable payment. While many of these loans still exist, more and more 30 year fixed rates loans are defaulting. These loans present several challenges as they don’t have as many features to modify.

- *Investors:* For loans sold into the secondary market, investor decision making is a major obstacle in the loan modification process. This obstacle can come from delay in granting a servicer permission to modifying a loan, down to broad prohibitions on modification, or the type of modification that can be offered. This can have a negative impact on borrowers who may learn that their servicer participates in a specific program, but later learn that the investor in their loan does not authorize that program-specific type of modification.

- *Servicing*: Loss mitigation strategies require customer service skills and often one-on-one attention that doesn't benefit from the automation model that servicing has traditionally operated under. The servicing model also confuses borrowers who may not understand that the entity that owns their loan and the servicer are most often not the same entity and have different roles and motivations. Furthermore, consumer groups and academic experts have argued that the servicing model may lead to incentives that make modification difficult.

- *Sustainability*: The characteristics of a loan modification that is sustainable for borrowers is still the subject of vigorous debate. The magic number, at least for HAMP and numerous other programs, seems to be a mortgage payment that is no more than 31% debt to income (DTI) ratio. For HAMP, this ratio is determined based on housing expenses but does not look at other debts such as credit cards, or even car payments. A 31% DTI for a borrower with large credit card debt may not be sustainable or even realistic. In addition, DTI ratios are not the only point of debate. There still exists a debate between industry and consumer organizations regarding the types of modifications that lead to sustainably mortgages. Some may see extending the length of a loan as sufficient to bring down monthly payments, while others may see interest rate reductions as the solution, or even a combination of both. Other advocates believe that principal reduction is the best way to reach affordability. However, even if one can arrive at the conclusion that principal reduction is one tool in the modification tool-box, then disagreements arise as to how such an approach would work as everyone seems to have a different view on how much principal reduction is enough.

- *Second Liens*: Servicers also service second lien mortgage loans, further complicating the loan modification process. Attempted loan modifications where a second lien exists become difficult because the second lien holder must agree to the modification and possible extinguishment of their lien holder rights when they ultimately will not benefit. Junior lien holders have been slow and reluctant to agree to re-subordinate in this episode and have held up refinancing, modifications, and short sales.

<u>Federal Foreclosure Mitigation Programs</u>

Home Affordable Modification Program (HAMP)

The federal "Making Home Affordable Program" was developed by the U.S. Department of the Treasury, at the urging of President Obama, in order to help borrowers avoid foreclosure.

In 2008, the president signed and enacted the Emergency Economic Stabilization Act. This legislation granted Treasury the opportunity to create the Troubled Asset Relief Program (TARP). In 2009, Treasury allocated $50 billion in TARP funds to implement the HAMP.

HAMP relies on financial incentives to servicers to modify mortgages for homeowners as well as beneficiaries of these modifications to stay current on their mortgage payments going forward. Homeowners, who are not unemployed, but still struggling to make mortgage payments, may be eligible for the HAMP. HAMP may lower monthly mortgage payments in order to make them more affordable and sustainable for the long-term.

Borrowers may be eligible for HAMP if:

1) Mortgage was obtained on or before January 1, 2009;
2) Owe up to $729,750 on your primary residence or single unit rental property;
3) Owe up to $934,200 on a 2-unit rental property; $1,129,250 on a 3-unit rental property; or $1,403,400 on a 4-unit rental property;
4) The property has not been condemned;
5) Have a financial hardship and are either delinquent or in danger of falling behind on your mortgage payments *(non-owner occupants must be delinquent in order to qualify);*
6) Have sufficient, documented income to support a modified payment; and
7) Must not have been convicted within the last 10 years of felony larceny, theft, fraud or forgery, money laundering or tax evasion, in connection with a mortgage or real estate transaction.

On June 1, 2012, in an effort to continue to provide meaningful solutions to the housing crisis, the Obama Administration expanded the population of homeowners that may be eligible for HAMP to include:

- Homeowners who are applying for a modification on a home that is not their primary residence, but the property is currently rented or the homeowner intends to rent it;
- Homeowners who previously did not qualify for HAMP because their debt-to-income ratio was 31% or lower;
- Homeowners who previously received a HAMP trial period plan, but defaulted in their payments; and

- Homeowners who previously received a HAMP permanent modification, but defaulted in their payments, therefore losing good standing.

It is important to note that HAMP modifications are not the only option available to borrowers. First, a large number of loans are not eligible for HAMP based on the type of loan or the borrower's characteristics. Even in those cases where a borrower may not qualify for HAMP, many servicers do offer their proprietary modification programs. The nature of proprietary loan modifications offered by servicers varies by servicer and by loan characteristics so proprietary loan modifications are not standardized across the industry, as opposed to the standardization of HAMP. Servicers that participate in HAMP must first determine if a borrower is eligible for HAMP before considering them for a proprietary loan modification. Often lost in the discussion of loan modifications is that the ability to get a modification, or the type of modification offered, may reach beyond simple borrower qualifications. Investors may be required to give approval for certain modification approaches, and some loans by there nature are more apt for specific modification actions. For example, the growth of prime loan defaults has reportedly been problematic to address because prime loans may have less modification flexibility because they lack the features of non-prime loans, such as adjustable payments, that would allow quick changes to monthly payments.

Principal Reduction Alternative (PRA). This program provides principal forgiveness. More than 100 servicers participate in HAMP and can evaluate homeowners for principal reduction. Participating servicers are required to develop written standards for PRA application. The largest servicers include Bank of America, CitiMortgage, JP Morgan Chase, and Wells Fargo.

A homeowner may be eligible for PRA if:

- Mortgage is not owned or guaranteed by Fannie Mae and Freddie Mac.
- Owe more than the home is worth;
- Occupy the house as a primary residence;
- Obtained mortgage on or before January 1, 2009;
- Mortgage payment is more than 31 percent of your gross (pre-tax) monthly income;
- Owe up to $729,750 on your 1st mortgage;
- Have a financial hardship and are either delinquent or in danger of falling behind;
- Have sufficient, documented income to support the modified payment; and
- Must not have been convicted within the last 10 years of felony larceny, theft, fraud or forgery, money laundering or tax evasion, in connection with a mortgage or real estate transaction.

Home Affordable Unemployment Program (UP). This program assists unemployed homeowners. UP may reduce mortgage payments to 31 percent of a homeowner's income or suspend them altogether for 12 months or more.

A homeowner may be eligible for UP if they meet all of the following criteria:

- Are unemployed and eligible for unemployment benefits;
- Occupy the house as a primary residence;
- Have not previously received a HAMP modification;
- Obtained a mortgage on or before January 1, 2009; and
- Owe up to $729,750 on the home.

Home Affordable Refinance Program (HARP) This program assists homeowners whom are not behind on their mortgage payments but have been unable to get traditional refinancing because the value of the home has declined. HARP refinanced loans require a loan application and underwriting process, and refinance fees apply.

A homeowner may be eligible for HARP if they meet all of the following criteria:

- The mortgage is owned or guaranteed by Freddie Mac or Fannie Mae;
- The mortgage has been sold to Fannie Mae or Freddie Mac on or before May 31, 2009;
- The mortgage cannot have been refinanced under HARP previously unless it is a Fannie Mae loan that was refinanced under HARP from March-May, 2009;
- The current loan-to-value (LTV) ratio must be greater than 80%; and
- The borrower must be current on the mortgage at the time of the refinance, with a good payment history in the past 12 months.

Home Affordable Foreclosure Alternatives (HAFA). This program was created to encourage the use of short sales and deeds-in-lieu of foreclosure for HAMP- eligible borrowers unable to qualify for modifications of currently underwater mortgages. Servicers agree to forfeit the ability to seek a deficiency judgment in exchange for borrowers engaging in short sales or issuing deed-in-lieu of foreclosures. All parties receive financial incentives in the form of relocation assistance, one-time completion, and reimbursement to release subordinate liens.

A homeowner may be eligible for HAFA if they meet all of the following criteria:

- Have a documented financial hardship;
- Have not purchased a new house within the last 12 months;
- First mortgage is less than $729,750;
- Obtained a mortgage on or before January 1, 2009; and
- Must not have been convicted within the last 10 years of felony larceny, theft, fraud, forgery, money laundering or tax evasion in connection with a mortgage or real estate transaction.

HAFA is available for mortgages that are owned or guaranteed by Fannie Mae and Freddie Mac or serviced by over 100 HAMP participating mortgage servicers.

Second Lien Modification Program (2MP). If the first mortgage was permanently modified under HAMP and the homeowner has a second mortgage on the same property, a homeowner may be eligible for a modification or principal reduction on their second mortgage as well, through MHA's 2MP. 2MP works in tandem with HAMP to provide comprehensive solutions for homeowners with second mortgages to increase long-term affordability and sustainability. If the servicer of the second mortgage is participating, they can evaluate the homeowner for a second lien modification.

A homeowner may be eligible for 2MP if they meet all of the following criteria:

- First mortgage was modified under HAMP;
- Must not have been convicted within the last 10 years of felony larceny, theft, fraud or forgery, money laundering or tax evasion, in connection with a mortgage or real estate transaction; and
- Have not missed three consecutive monthly payments on a HAMP modification.

California Action: Homeowner Bill of Rights

On April 23, 2012, Senate President Pro Tem Darrell Steinberg and Assembly Speaker John A. Pérez announced the formation of a Conference Committee to address foreclosure issues and homeowner protections.

The creation of the Conference Committee arose from a settlement reached between banks (Citi, Wells Fargo, Bank of America, Chase and Ally), federal agencies, and the state attorneys general from 49 states and the District of Columbia. The investigation began in October of 2010 as media stories highlighted widespread allegations regarding the use of "robo-signed" documents used in foreclosure proceedings around the country. The attorneys general formed working groups to investigate the widespread allegations, however, further investigation led to a larger discussion with the five largest mortgage loan servicers regarding various facets of the foreclosure and loan modification process. While conducting their investigation the attorneys general identified deceptive practices regarding loan modifications, foreclosures occurring due to the servicer's failure to properly process paperwork, and the use of incomplete paperwork to process foreclosures in both judicial and non-judicial foreclosure cases.

The settlement also required major changes in loan servicing required of the five banks party to the settlement. These changes include:

- Information in foreclosure affidavits must be personally reviewed and based on competent evidence.
- Holders of loans and their legal standing to foreclose must be documented and disclosed to borrowers.
- Borrowers must be sent a pre-foreclosure notice that will include a summary of loss mitigation options offered, an account summary, description of facts supporting lender's right to foreclose, and a notice that the borrower may request a copy of the loan note and the identity of the investor holding the loan.
- Borrowers must be thoroughly evaluated for all available loss mitigation options before foreclosure referral, and banks must act on loss mitigation applications before referring loans to foreclosure; i.e., "dual tracking" will be restricted.
- Denials of loss mitigation relief must be automatically reviewed, with a right to appeal for borrowers.
- Banks must implement procedures to ensure accuracy of accounts and default fees, including regular audits, detailed monthly billing statements, and enhanced billing dispute rights for borrowers.
- Banks are required to adopt procedures to oversee foreclosure firms, trustees, and other agents.
- Banks will have specific loss mitigation obligations, including customer outreach and communications, time lines to respond to loss mitigation applications, and e-portals for borrowers to keep informed of loan modification status.

- Banks are required to designate an employee as a continuing single point of contact to assist borrowers seeking loss mitigation assistance.
- Military personnel who are covered by the SCRA will have enhanced protections.
- Banks must maintain adequate trained staff to handle the demand for loss mitigation relief.
- Application and qualification information for proprietary loan modifications must be publicly available.
- Servicers are required to expedite and facilitate short sales of distressed properties.
- Restrictions are imposed on default fees, late fees, third-party fees, and force-placed insurance.

The Conference Committee was tasked with formulating legislation to require that all mortgage loan servicers follow the servicing standards established by the multi-state settlement agreement. The Conference Committee held five hearings totaling over 20 hours of testimony from stakeholders ranging from servicers, community advocates and individual homeowners. Based on the information gathered at those hearings, the Conference Committee issued two conference reports AB 278 (Eng, Feuer, Mitchell & John A. Pérez) and SB 900 (Leno, Evans, Corbett, DeSaulnier, Pavley & Steinberg) known as the Homeowner's Bill of Rights (HOBR).

HOBR provides for the following:

- Ends the process known as "dual track" in which a borrower negotiating in good faith with their bank for a loan modification is shuffled through the foreclosure process.
- Requires servicers to establish a single point of contact so that borrowers have a consistent point to raise questions and receive loan modification responses.
- Provides that paperwork filed relative to foreclosure is accurate and complete.
- Provides borrowers with pre-foreclosure information on their rights in the foreclosure process.
- Provides borrowers with the right to receive information on the entity that actually owns their loan.
- Provides servicers a right to remediate violations.
- The provisions of the HOBR became law January 1, 2013.

The Technology of Consumer Financial Transactions

November 21, 2013
City of Mountain View
City Council Chambers
500 Castro Street
2nd Floor
Mountain View, CA 94041
10:00am-1:00pm

I. Opening Remarks

- Assemblymember Roger Dickinson, Chair

II. The Composition of Credit/Debit Card Transactions & The Future of Card Swipe

- Kim Ford, Vice President of Public Affairs for First Data
- Richard Santoro, Vice President of Government Affairs for MasterCard Worldwide

III. The Growth of Mobile Payments & Money Transmission Technology

- Bill Gajda, Global Head of Strategic Partnerships, Visa
- John Muller, Vice President, Global Payments Policy, PayPal Inc.
- Thomas Brown, Lecturer, UC Berkeley Law School and Partner, Paul Hastings LLP
- Rosemary Gallagher, Senior Regulatory Counsel, Western Union

IV. Consumer Security and Mobile Payment Platforms

- Brennen Byrne, CEO Clef

V. Financial System of the Future

- The Promise of New Financial Technology
    - Mary Dent, Co-founder of dcIQ
- Digital Currency
    - Chris Larson, CEO Ripple Labs

VI. Consumer Protection in Payments Innovation

- Suzanne Martindale, Staff Attorney, Consumers Union

VII. Public Comment

The Technology of Consumer Financial Transactions

Assembly Committee on Banking & Finance

November 21, 2013

Assemblymember Roger Dickinson, Chair

Mark Farouk-Chief Consultant
Kathleen O'Malley-Senior Consultant
Tiffany Morrison-Committee Secretary

On March 11th, 2013 the Committee on Banking and Finance conducted a hearing titled, *Emerging Technology and the California Money Transmission Act.* That hearing focused on the growing use of alternative means to send and receive payments within the United States and around the globe. That hearing led to the introduction of AB 786 (Dickinson) which revised and updated various provisions of the Money Transmission Act (MTA) in order to address changes in technology that required revisions to the MTA. AB 786 was signed by Governor Brown on October 4, 2013. A substantial amount of consumer financial transactions are covered under the MTA. While working on AB 786 committee staff encountered a broad set of questions and issues concerning the growth of mobile payments and alternative payment networks. This growth has brought about numerous developments in regulatory policy making, as well as, potential legislative action. For the most part California and the United States have a financial regulatory system geared toward stagnant technology and business models. The existing structure largely covers insured depository institutions (banks) or non-bank entities that assist with international remittances. These historical models have focused on ensuring the safety and soundness of the institutions and preventing money laundering activity. In addition to these layers, existing legal frameworks establish the rights and responsibilities of each party to a transaction and the appropriate procedures if loss or fraud occurs. The emergence of new technologies has blurred these lines in some ways because new middle parties have been introduced into the payments space. Most developments in mobile applications that send or receive money, or pay for goods and services are still connected to a traditional payment method, such as credit card or checking account. In this environment the traditional payment offerings are still present, but the legality of the roles they play are still part of a larger discussion and debate within the payments industry and among federal and state regulators.

Traditional Methods of Payment:

Today, electronic payments made through payment card networks and the automated clearinghouse system (ACH) make up four out of five noncash payments in the United States according to a 2010 Federal Reserve study on payments. The use of plastic credit or debit cards has become ubiquitous for the majority of consumer payments. Consumers use their cards to pay for goods or services and within seconds a transaction is approved and the sale is complete. This interaction is so frequent that rarely would anyone ask about the behind the scenes aspect of this transaction. What happens in those few seconds? Who are the parties to the transaction? What legal frameworks govern these transactions?

The terminology and process of a credit card transaction:

Acquirer- A bank that processes and settles a merchant's credit card transactions with the help of a card issuer.

Authorization- The first step in processing a credit card. After a merchant swipes the card, the data is submitted to merchant's bank, called an acquirer, to request authorization for the sale. The acquirer then routes the request to the card-issuing bank, where it is authorized or denied, and the merchant is allowed to process the sale.

Batching- The second step in processing a credit card. At the end of a day, the merchant reviews all the day's sales to ensure they were authorized and signed by the cardholder. It then transmits all the sales at once, called a batch, to the acquirer to receive payment.

Cardholder- The owner of a card that is used to make credit card purchases.

Card network- Visa, MasterCard or other networks that act as an intermediary between an acquirer and an issuer to authorize credit card transactions.

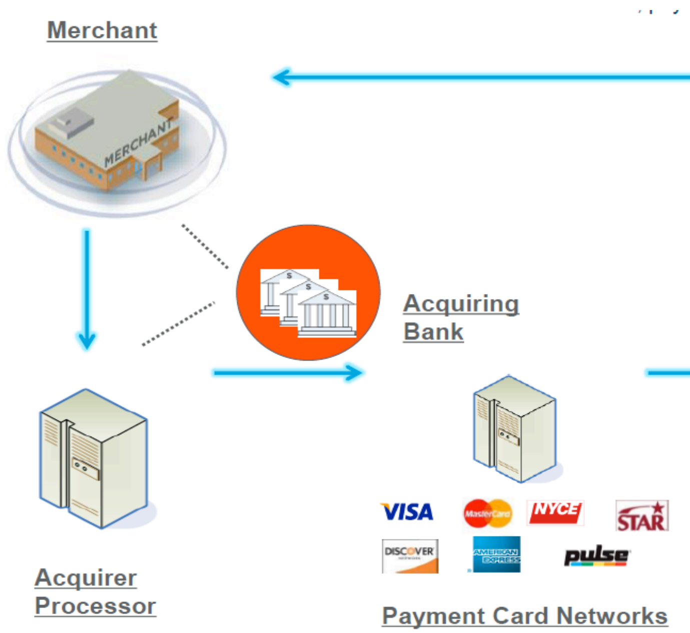
Clearing- The third step in processing a credit card. After the acquirer receives the batch, it sends it through the card network, where each sale is routed to the appropriate issuing bank. The issuing bank then subtracts its interchange fees, which are shared with the card network, and transfers the remaining amount through the network back to the acquirer.

Discount fee- A processing fee paid by merchants to acquirers to cover the cost of processing credit cards.

Funding- The fourth and final step in processing a credit card. After receiving payment from the issuer, minus interchange fees, the acquirer subtracts its discount fee and sends the remainder to the merchant. The merchant is now paid for the transaction, and the cardholder is billed.

Interchange fee- A charge paid by merchants to a credit card issuer and a card network as a fee for accepting credit cards. They generally range from 1 to 3 percent of the transaction value.

Issuer- An financial institution, bank, credit union or company that issues or helps issue cards to cardholders.



Chip & Pin and Chip & Signature:

The U.S. remains the last development country reliant on the magnetic stripe credit cards (mag stripe). The U.S. is currently on pace to be a full decade behind Europe on the implementation of credit card chip & PIN technology. Until the introduction of Chip and PIN, all face-to-face credit or debit card transactions used a magnetic stripe or mechanical imprint to read and record account data, and a signature for verification. Under this system, the customer hands their card to the clerk at the point of sale, who either "swipes" the card through a magnetic reader or makes an imprint from the raised text of the card. In the former case, the account details are verified and a slip for the customer to sign is printed. In the case of a mechanical imprint, the transaction details are filled in and the customer signs the imprinted slip. In either case, the clerk verifies that the signature matches that on the back of the card to authenticate the transaction.

This system has proved reasonably effective, but has a number of security flaws, including the ability to get physical access to the card via the mail or via the use of black market card readers that can read and write the magnetic stripe on the cards, allowing cards to be easily cloned and used without the owner's knowledge.

Credit card chip technology was established in 1994 by Europay International SA. This chip technology is also called EMV, as it was named after its original developers, Europay, MasterCard® and Visa®.

A cardholder's data is more secure on the chip-embedded card than on a mag stripe card. Chip-embedded cards support superior encryption and authentication as opposed to mag stripe card making the data on mag stripe cards easier to obtain via fraudulent means. Chip technology counters the static nature of mag stripe cards by implementing technology that creates dynamic values for each transaction. EMV cards can be used both online and in face-to-face transactions, both supporting signature and PIN verification with PIN being the dominant method used in Europe.

As previously mentioned the U.S. is lagging behind in implementation and acceptance of EMV technology. The first U.S. credit card utilizing EMB was issued by United Nations Federal Credit Union (UNFCU) in October of 2010. The primary reason UNFCU issued the card was that many of its members reside outside the U.S. and were in need of a globally accepted card. Outside of the U.S. mag stripe cards are becoming less accepted. Several large card issuers in the U.S. (Wells Fargo, JPM Chase, and U.S. Bancorp) have begun to migrate some of their portfolios over to EMV cards, but thus far in limited quantities and targeted toward higher income card holders. A factor that is contributing to the limited role out of EMV in the U.S. is that currently no merchant accepts EMV chip-embedded cards. Most EMV chip cards issued board and in the U.S. also contain a mag strip thus allowing acceptance at all U.S. merchants that accept credit cards.

Perhaps both the issuance and acceptance of EMV chip cards (and potentially other chip-enabled devices such as mobile phones) will increase with a recent announcement by Visa. This announcement specified incentives and deadlines to urge U.S. merchants to accept both contact and contactless chip-enabled cards. One merchant incentive includes the elimination of the requirement for annual card network compliance validation if 75 percent of a merchant's transactions originate from chip-enabled terminals effective October 1, 2012. For the largest merchants, savings from an annual compliance validation would average approximately $225,000 a year. Further, Visa set October 1, 2015 as the date when a card-present counterfeit fraud liability shift from issuers to merchant acquirers will be implemented if fraud occurs in a transaction that could have been prevented with a chip-enabled payment terminal. While the announcement lays a path towards EMV chip card migration, it does not necessarily set a path to chip-and-PIN as Visa will continue to support both signature and PIN cardholder verification methods.

Money Transmission & Mobile Money.

At the most basic level money transmission is the transfer of funds involving three parties, 1) Sender 2) Money transmitter and 3) Recipient. The transfer of funds may be intrastate, interstate, or international. Typically this service is conducted at a physical location where the sender of funds pays a fee to the remittance service and the money is then wired to the recipient.

Large money transmitters may have a home office, transaction clearing centers, service center (s), regional offices, and branches. They may also contract with agents. Agents may include established businesses such as grocery stores, truck stops, check cashers, pharmacists, travel agents and supermarket chains. The money transmission home office pays its agents using a fee schedule that provides predetermined charges for money transmission.

This is how the traditional model of money transmission works. A sender enters an agent location and wishes to send $500 to a recipient in another location. The sender provides the agent the funds and instructions for delivery to the recipient. The agent takes the funds and instructions and usually enters the transaction into a computer terminal owned by the money transmitter and that is linked to the money transmitter's processing system. Upon receiving the instructions, the money transmitter will contact its appropriate receiving agent for payout to the recipient. The sender and/or receiving agent will inform the recipient that the transmitted funds are available for pick-up. The availability of funds to the recipient may range from minutes to several days depending upon the location and availability of the receiving agent and money transmitter's delivery policy. While computers are the typical means for the transferring of money, telephone lines and fax machines are still widely used.

According to World Bank estimates, remittances totaled $414 billion in 2009, of which $316 billion went to developing countries that involved 192 million migrant workers. For some individual recipient countries, remittances can be as high as a third of their Gross Domestic Product (GDP). The top recipients in terms of the share of remittances in GDP included many smaller economies such as Tajikistan (45%), Moldova (38%), and Honduras (25%).

Historically, the money transmission involved face-to-face transaction between the consumer and transmitter agent that would accept the consumer's money and transmit those funds to another agent outside of the United States for delivery of those funds to the consumer's family or friends. These transactions were dominated primarily by a few large transmitters such as Western Union and MoneyGram. Subsequent to the issuance of the draft National Conference of Commissioners on Uniform State Laws money transmission act, states across the country amended their statutes to provide enhanced regulation to foreign and domestic transmission and non-bank issued stored value. Forty eight states and the District of Columbia have money transmission licensing statutes.

Money transmission activity is regulated via the California Money Transmission Act (Financial Code Sections 2000-2172). The United States Department of Treasury under the Financial Crimes Enforcement Network (FinCEN) requires registration of money services businesses (MSB). According to FinCEN an MSB includes any person doing business, whether or not on a regular basis or as an organized business concern, in one or more of the following capacities, and that meets a threshold of $1,000 per day or more transactions:

- Currency dealer or exchanger.
- Check casher.
- Issuer of traveler's checks, money orders or stored value.

- Seller or redeemer of traveler's checks, money orders or stored value;
- Money transmitter.

FinCEN registration does not apply to a bank or a person regulated or registered with the Securities and Exchange Commission. Entities registered with FinCEN must make electronic filings under the Bank Secrecy Act (BSA). As of July 1, 2012, all such filings must be electronic and made through the BSA E-Filing System. Reports that must be filed through this system include, but are not limited to:

- Currency Transaction Report (FinCEN Form 104)
- Designation of Exempt Person (FinCEN Form 110)
- Suspicious Activity Report (Form TD F 90-22.47)
- Suspicious Activity Report by the Securities and Futures Industries (FinCEN Form 101)
- Suspicious Activity Report by Money Services Business (FinCEN Form 109, formerly 90-22.56)
- Suspicious Activity Report by Casinos and Card Clubs (FinCEN Form 102)
- Currency Transaction Report by Casinos (FinCEN Form 103, formerly 8362)
- Registration of Money Services Business (FinCEN Form 107)
- Report of Foreign Bank and Financial Accounts (Form TD F 90-22.1)

These activities are also subject to Federal Reserve Regulation E. On July 21, 2010, the Dodd Frank Wall Street Reform and Consumer Protection Act (Dodd Frank Act) was signed into law. Section 1073 of the Dodd Frank Act creates new protections for U.S consumers sending money abroad. Such transfers or remittances as the Act identifies them are now the subject of rulemaking by the Consumer Financial Protection Bureau (CFPB) the agency charged with implementing Section 1073. The CFPB issued a final rule regulating remittance transfers by amending Regulation E (Reg E) that governs electronic transfer of funds. CFPB issued new rules concerning remittance transfer that took effect October 28, 2013.

The new rules require companies to give certain disclosures on fees and other costs prior to payment for the remittance transfer. The rule also gives consumers 30 minutes to cancel a transfer and companies must investigate if a consumer reports a problem with a transfer. For more detail on these rules visit, http://www.consumerfinance.gov/remittances-transfer-rule-amendment-to-regulation-e/.

Mobile technology has opened up a range of possibilities for mobile payments and money transmission services yet other countries are far ahead of the U.S. in usage of these new payment applications.

Mobile money transfer typically refers to services whereby customers can use their mobile devices to send and receive money or to transfer money electronically from one person to another using a mobile phone.   This transfer can be either a domestic transfer or international remittance transaction. The key characteristic of mobile money transfer services is the fact that they relate to private transactions only (i.e. transactions involving transfers of money from one person to another). Mobile money transfer addresses person-to-person (P2P) money transfers and is a subset of mobile payments.

Mobile money transfers using mobile phones require senders to give the money to a remittance center and pay a fee. The remittance center then transfers the money electronically through the phone service provider to the recipient's phone. In the case of international remittances, the person receiving the money gets a text message advising of the transfer. The recipient can go to any licensed outlet, including a retail store or restaurant, to get the money. The recipient may have to pay a fee to collect the money. In the case of domestic remittances, the transfer is handled automatically on the mobile money platform.

The mobile remittance industry is burgeoning due to the increased penetration of mobile phones in remote regions and the mushrooming of various remittance service providers, both national and international, for global money transfers. According to the Migration Development Brief of the World Bank, remittance flows to developing countries were estimated to have reached USD 372 billion in 2011, and are expected to reach USD 467 billion by 2014, and total worldwide remittance flows are expected to reach $615 billion by 2014. India and China rank highest as recipients of migrant remittances, to the tune of $64 billion and $62 billion respectively. Tajikistan and Lesotho receive remittances that are as high as 31 per cent and 29 per cent of GDP respectively. Various money transfers options (phone to phone, cash to phone, phone to cash, mobile-wallets etc.) can be made conveniently using mobile devices through platforms and applications provided by various banking institutions and money transfer operators worldwide. Various money transfer operators provide services either through a network of agents or partnering with banking institutions depending on the regulations of the central bank and other financial bodies of various nations.

In 2007, Safaricom and Vodafone launched a mobile money transfer service called M-PESA. Five years later M-PESA provides services to 15 million Kenyans (more than a third of the country's population) and serves as a conduit for a fifth of the country's GDP. M-PESA now processes more transactions domestically within Kenya than Western Union does globally and provides mobile banking facilities to more than 70% of the country's adult population. However, the service cannot function without the presence of the formal financial sector. Bank branches are a vital part of the cash management operation of an M-PESA agent. Moreover, the early adopters of the service in Kenya were more likely to be banked than non-users. M-PESA has also been implemented in Tanzania, South Africa and Afghanistan. The M-PESA application has also served as a platform for innovations in other areas such as insurance, savings and banking in Kenya.

In Pakistan, 89% of the adult population does not have a bank account. Easypaisa was established in 2009 in Pakistan through a partnership between Telenor Pakistan and Tameer Microfinance Bank. The regulation mandated a bank led model and hence the license for branchless banking rests with Tameer Microfinance Bank, while Telenor Pakistan also acquired 51% ownership in Tameer for better governance of the new business. The partnership has developed a network of over 20,000 agents. The main differentiating factor in Easypaisa is that customers do not require a mobile phone or account with Telenor to pay their bills or to send/receive money. These transactions are done at any of the 20,000 Easypaisa shops around the country by the merchant on his mobile phone. In 2010, Easypaisa mobile accounts (m-wallets) were launched for Telenor SIM subscribers only. Mobile Account subscribers use their own phones for all transactions and only need to go to Easypaisa shops in Pakistan to deposit or withdraw cash from their Easypaisa mobile account. Services offered include bill payments, money transfers, airtime purchase, savings and insurance, retail purchase, corporate solutions, viewing account balances and recent transactions, managing PIN codes, and so on. In 2012, Easypaisa conducted on average over 5 million transactions every month.

GCASH is a mobile money transfer service from Globe Telecom in the Philippines, which transforms a mobile phone into a virtual wallet for secure, fast, and convenient money transfers at the speed and cost of a text message. The recipient in the Philippines can easily receive a sender's remittance direct to his mobile phone. Globe Telecom issues an account which is the GCASH account in which the money is sent by the sender to be withdrawn by the recipient. The recipient is sent an SMS alert indicating the amount sent to his or her GCASH account.

Airtel Mobile Money is a core offering of Airtel which offers more than money transfer services. By July 2012, Airtel Mobile Money had been launched in 14 countries where Airtel operates. This follows successful improvements to the previous product called Zap. Airtel Mobile Money enables customers to send money, pay bills, buy airtime, pay online and also receive batch payments. With over 11 million registered customers representing about 20% of Airtel Customers, Airtel Money is intended to service the unbanked population. Airtel Mobile Money is set up as a separate operation within the Airtel business. It uses an internally developed application which enables both STK and USSD access. It is aiming to introduce new relevant financial products, mainly savings and insurance.

Payment Innovation: Rise of Mobile Payments and Alternative Payment Networks.

Consumers currently can make three types of payments using a smartphone or tablet computer. The first is a person-to-person transfer initiated by a mobile device that could include noncommercial payments from one person to another, or commercial payments to a small scale merchant. Second, is for goods or services purchased over the internet on a mobile device. The third option is at point of sale (POS) device initiated from a mobile device at a physical location. These payments can be made using a variety of technologies such as a wallet system that may utilize a smart phone based app to generate barcodes, or a QR Code that allows the user to pay for something from funding source associated with the mobile wallet. Other options connect a virtual wallet with an email address or username and password.

Mobile payment systems are designed to create a system of disintermediation where the traditional payment networks and financial institutions are removed from the payment system. In *Overview of Mobile Payments in the United States* (Banking & Financial Services Policy Report, Volume 32, #8, August 2013), Erin F. Fonté writes:

> The most famous and successful company to achieve disintermediation from the established credit/debit card networks and processors is Square, a mobile POS startup co-founded by Twitter founder Jack Dorseyand launched in 2009. The initial goal of Square was to use a plug-in device for an iPhone or iPod (called a "dongle," and, not surprisingly, square in shape) that turns the mobile device into a mobile POS terminal. Square has been one of the most successful non-FI entrants into the payments space since PayPal, and as of June 2012, was processing $6 billion in payments annually. After seeing the success of Square, the companies that manufacture POS hardware and software created their own mobile POS devices. Verifone created its mobile POS device called Sail. Intuit, the company that created QuickBooks, launched GoPayment, a mobile POS device and virtual signature service that integrates with QuickBooks. PayPal launched PayPalHere.
>
> Disintermediation at the wallet refers to the current race by several companies to create a virtual wallet in which all of the payment cards in the average person's wallet—debit cards, credit cards, store gift cards, stored value cards—are housed in a virtual wallet app on the purchaser's smart phone. The smart phone is then used as the payment device that will interact with the POS for a proximity payment or to conduct a remote payment.
>
> There is currently a lot of time and money being invested by major credit card networks, mobile network operators (such as AT&T, Verizon, T-Mobile, and Sprint), major banks, major alternative payments providers (such as PayPal), and major technology companies (such as Google) to create and corner the market

on the mobile wallet. Although there are several other mobile wallet startups, the activities of mobile wallet providers Isis, Google Wallet, and PayPal are currently garnering a lot of attention. Isis is a joint venture between AT&T, T-Mobile, and Verizon, but is also partnered with Visa, MasterCard, and American Express. JPMorgan Chase, Capital One, and Barclaycard have agreed to issue cards for the wallet. Google Wallet involves MasterCard and payment processor First Data Corporation, and Sprint Nextel is the designated mobile network operator (but Google Wallet only works on Sprint mobile devices). Google Wallet is also going to include some form of coupon or offer redemption, and may be expanded to include loyalty and rewards components as well. The PayPal wallet just gained major publicity by announcing a partnership with Discover to bring PayPal's digital wallet and payment services to millions of merchants in the Discover network, with services currently scheduled to roll out in 2013. Mobile payments industry pundits are waiting to see what Apple does on the mobile payments/mobile wallet front. Apple's recent announcement of Passbook, along with confirmed rumors that Apple will include NFC technology in the iPhone 5, lead industry observers to speculate as to whether Apple has its own mobile wallet offering in mind given that it manufactures the iPhone. And the recently announced Merchant Customer Exchange (discussed earlier in this article) is a merchant-created mobile wallet initiative.

According to the Payments Strategies Group at the Federal Reserve Bank of Boston Starbucks is viewed by analyst and industry trade reports as a very successful model of a closed loop mobile payment model. Starbucks enables customers to utilize a mobile app that generates a QR code that can be scanned by the in store POS reader. Mobile phones account for 10% of Starbucks' U.S. transactions. Starbucks couples this mobile app with their customer loyalty rewards system creating additional incentives so consumers will use the app. Based on this success other merchants are also rolling out closed loop mobile payment apps. Other retailers offer customers who use mobile payment apps the opportunity to order in advance of arriving at the physical location of the store so that the consumer does not have to wait in line for their purchase.

Between December 2011 and January 2012, the Federal Reserve Board conducted a survey of consumers concerning the use of mobile financial services (http://www.federalreserve.gov/econresdata/mobile-devices/files/mobile-device-report-201203.pdf). The following are brief findings from their report:

1) Mobile phones and mobile Internet access are in widespread use.

   a) 87 percent of the U.S. population has a mobile phone.

   b) 44 percent of mobile phones are smartphones (Internet-enabled).

   c) 84 percent of smartphone users have accessed the Internet on their phone in the past week.

2) The ubiquity of mobile phones is changing the way consumers access financial services.

   a) 21 percent of mobile phone owners have used mobile banking in the past 12 months.

   b) 11 percent of those not currently using mobile banking think that they will probably use it within the next 12 months.

   c) The most common use of mobile banking is to check account balances or recent transactions (90 percent of mobile banking users).

   d) Transferring money between accounts is the second most common use of mobile banking (42 percent of mobile banking users).

3) Mobile phones are also changing the way consumers make payments.

   a) 12 percent of mobile phone owners have made a mobile payment in the past 12 months.

   b) The most common use of mobile payments was to make an online bill payment (47 percent of mobile payment users).

   c) 21 percent of mobile payment users transferred money directly to another person's bank, credit card, or PayPal account.

4) Perceptions of limited usefulness and concerns about security are holding back the adoption of mobile financial services.

   a) The primary reason why mobile phone users had not yet adopted mobile banking was that they felt their banking needs were being met without the use of mobile banking (58 percent).

   b) Concerns about the security of the technology were the primary reason given for not using mobile payments (42 percent) and the second most common reason given for not using mobile banking (48 percent).

   c) More than a third of mobile phone users who do not use mobile payments either don't see any benefit from using mobile payments or find it easier to pay with another method.

5) The "underbanked" make significant use of mobile financial services.

   a) The underbanked make comparatively heavy use of both mobile banking and mobile payments, with 29 percent having used mobile banking and 17 percent having used mobile payments in the past 12 months.

   b) 62 percent of the underbanked who use mobile payments have used it to pay bills.

   c) 10 percent of the completely unbanked reports using mobile banking in the past 12 months, and 12 percent have made a mobile payment.

An April 2013 report from Business Insider found the following:

- In-store mobile payments nearly quadrupled last year: eMarketer has estimated in-store mobile payments as adding up to $640 million in transaction volume in the U.S., up from $170 million in 2011. However, this figure does not include swipes on mobile credit card readers like Square and PayPal Here, only consumer-side mobile payments.

- Card readers are building up real scale: Square's mobile payments volume rose to $10 billion in 2012, up from $2 billion in 2011. Starbucks is switching its credit and debit card processing to Square, and as of January 2013 accepts the "Square Wallet" app at 7,000 locations.

- Mobile payments as part of mobile commerce are also exploding**:** PayPal processed some $14 billion in mobile payments last year, evidence of mobile catching on as a transactional platform. PayPal hopes to build a merchant-powered network based on the ubiquity of PayPal as a payment and money transfer platform. PayPal users are already able to pay at thousands of traditional stores by keying in their mobile number and a PayPal PIN selected online (or in their PayPal app).

- Credit card companies are getting in on the action: Credit card companies have responded by making aggressive moves to enter the space. Visa (V.me), and American Express (Serve) have each introduced digital wallet-like products, MasterCard's PayPass is an NFC-enabled system that is also integrated with the "Google Wallet" app, and Discover has opted to partner with two of the bigger names in the digital payments space ("Google Wallet, and PayPal).

- In the early stages**:** As of year-end 2012, only 7.9 million U.S. consumers (less than 90 percent of the total) had adopted a consumer-facing NFC-compatible system like "Google Wallet," or apps that use QR codes or other methods to generate a payment.

Table 1: Mobile Payments Technologies	
Near Field Communications	Wireless protocol that allows for encrypted exchange of payment credentials and other data at close range.
Cloud Based	Leverages mobile connection to the Internet to obtain credentials not stored on the mobile device.
Image Based	Coded images similar to barcodes used to initiate payments. Credentials may be encrypted within image or stored in cloud.
Carrier Based	Payments billed directly to mobile phone account. Merchants paid directly by mobile carrier, bypassing traditional payment networks.
Proximity Based	Geolocation used to initiate payments. Merchant will identify active users within range and verify identity. Credential exchange is cloud-based.
Mobile P2P	Payment initiated on mobile device using recipient's email address, mobile phone number, or other identifier. Payment is via ACH, card networks, or intra-account transfer.

*FIDC, Supervisory Insights - Winter 2012, *Mobile Payments: An Evolving Landscape*

Legal & Regulatory Issues.

FIDC, Supervisory Insights - Winter 2012, *Mobile Payments: An Evolving Landscape*

Table 3: Laws and Regulations That Apply to Mobile Payments Transactions		
Law or Regulation / Description: Electronic Fund Transfer Act (EFTA) / Regulation E *Establishes rules for electronic fund transfers (EFTs) involving consumers.*		
Coverage: Generally includes any "transaction initiated through an electronic terminal, telephone, computer, or magnetic tape that instructs a financial institution either to credit or debit a consumer's account." This includes transactions such as debit card transactions, direct deposits and withdrawals, and automated teller machine (ATM) transactions. The regulation generally applies to financial institutions, but certain	**Applicability to Mobile Payments**: Applies when the underlying payment is made from a consumer's account via an EFT.	**Key Obligations / Other Information**: The rule establishes consumer rights to a number of disclosures and error resolution procedures for unauthorized or otherwise erroneous transactions. The disclosures include upfront disclosures regarding, among other things, the terms and conditions of the EFT service and how error resolution procedures will work.

provisions apply to "any person."		
Law or Regulation / Description: Truth in Lending Act (TILA) / Regulation Z *Establishes rules regarding consumer credit; intended to help consumers understand the cost of credit and compare credit options.*		
Coverage: Generally applies to "creditors" that offer or extend credit to consumers and includes both open-end and closed-end credit products, including credit cards.	**Applicability to Mobile Payments:** Applies when the underlying source of payment is a credit card (or other credit account covered by TILA and Regulation Z).	**Key Obligations / Other Information**: Creditors are required to provide disclosures to consumers describing costs; including interest rate, billing rights, and dispute procedures.
Law or Regulation / Description: Truth-in-Billing *Requires wireless carriers to provide certain billing information to customers.*		
Coverage: Applies to wireless carriers.	**Applicability to Mobile Payments**: Applies when mobile payment results in charges to mobile phone bill.	**Key Obligations / Other Information**: Wireless carriers must provide clear, correct, and detailed billing information to customers. This includes a description of services provided and charges made.
Law or Regulation / Description: Unfair, Deceptive, or Abusive Acts or Practices (UDAP) under the Federal Trade Commission (FTC) Act /Unfair, Deceptive or Abusive Acts or Practices (UDAAP) under the Consumer Financial Protection Act of 2010 *Prohibits "unfair or deceptive acts or practices in or affecting commerce."*		
Coverage: Applicable to any person or entity engaged in commerce. Made applicable to banks pursuant to Section 8 of the Federal Deposit Insurance Act.[16]	**Applicability to Mobile Payments**: Applies to all mobile payments regardless of underlying payment source.	**Key Obligations / Other Information**: Prohibits "unfair or deceptive acts or practices in or affecting commerce." The Dodd-Frank Act also added the concept of "abusive" practices to "unfair" or "deceptive" ones, and gave the Consumer Financial Protection Bureau (CFPB) authority to further define abusiveness.
Law or Regulation / Description: Gramm-Leach-Bliley Act (GLBA) Privacy and Data Security Provisions *Establishes rules regarding consumer privacy and customer data security.*		
Coverage: The privacy rules and data security guidelines issued	**Applicability to Mobile Payments**: Applies when a	**Key Obligations / Other Information**: Financial

<table>
<tr><td>under GLBA apply to “financial institutions,” which include depository institutions as well as nonbanks engaged in financial activities.</td><td>financial institution handles information of a “consumer” or “customer.”</td><td>institutions are required to provide consumers with certain notices regarding the privacy of nonpublic personal information and allow them to opt out of certain types of information sharing. The GLBA data security provisions give guidance on the appropriate safeguarding of customer information.</td></tr>
<tr><td colspan="3">Law or Regulation / Description: Federal Deposit Insurance or NCUA Share Insurance
Protects funds of depositors in insured depository institutions and of members of insured credit unions in the event of failure of the institution.</td></tr>
<tr><td>Coverage: Applies to “deposits” and “accounts” as defined in laws and regulations of the FDIC and National Credit Union Administration. These include savings accounts and checking accounts at banks and share accounts and share draft accounts at credit unions.</td><td>Applicability to Mobile Payments: If the funds underlying a mobile payment are deposited in an account covered by deposit insurance or share insurance, the owner of the funds will receive deposit or share insurance coverage for those funds up to the applicable limit.</td><td>Key Obligations / Other Information: Deposit insurance or share insurance does not guarantee that a consumer’s funds will be protected in the event of a bankruptcy or insolvency of a nonbank entity in the mobile payment chain.</td></tr>
<tr><td colspan="3">Note: This table is not exhaustive, and other laws, regulations, and policies may apply.</td></tr>
</table>

In California, most mobile payment systems that rely on the transfer of money from one party to another fall under the regulatory supervision provided in the MTA. Most other states also have statutes regulating domestic and international money transfer. Like California, most, if not all, states require that an operator wishing to do business in that state must also be licensed in that state. This creates a requirement for licensing in all 50 states if a mobile payments provider wants to have full market access across the U.S. California's MTA, like most states is broad in its interpretation of what factors constitute money transmission for sake of licensing. The broadness of the statute has raised a number of questions, some of which were addressed by AB 786, referenced earlier in this document. However, other questions have yet to be resolved. For example, what effect, if any occurs when the mobile payment app is used to pay for a retail goods or services. Traditionally, money transmission activity involved sending money from A to C via B, not sending money in exchange for goods or services. If a consumer shops via an online marketplace that fulfills orders via third parties does acceptance of money from the consumer make the online marketplace a money transmitter under the law?

Another issue and one that may hold back some consumers from the use of mobile payments is how does the use of a mobile payment app or system change how disputes are resolved in the case of fraudulent payments or unauthorized charges. Mobile payment services typically function by linking to one or more payment sources. Many mobile payment platforms allow consumers to choose among several different funding sources for payment, such as a credit card, debit card, bank account, or mobile phone account. For instance, a particular payment application on a smartphone may be linked to a credit card so that the credit card is charged when the consumer pays using that application. Depending on the payment source used to fund the mobile payment (e.g. credit card versus prepaid card versus mobile carrier billing), consumers may or may not have statutory protections regarding unauthorized charges. The Federal Trade Commission convened a mobile payments workshop to look at these issues and found the following:

> Mobile payment users may not recognize that their protections against fraudulent or unauthorized transactions can vary greatly depending on the underlying funding source. Generally, credit cards provide the strongest level of statutory protection, capping liability for unauthorized use at $50. If a mobile payment is linked to a bank debit card, a consumer's liability for unauthorized transfers is limited to $50 if reported within two business days, and up to $500 for charges reported after two business days. However, if consumers do not report unauthorized debit transactions on their bank account within 60 days after their periodic statement is mailed to them, they can face unlimited liability, whether or not the charges result from a lost or stolen card or another electronic transfer. Other types of funding mechanisms, however, do not have the same statutory protections as credit cards and debit cards. For example, there are no federal statutes besides the FTC Act that protect consumers from unauthorized charges if their mobile payment mechanism is linked to a pre-funded account or stored-value card such as a gift card or general purpose reloadable card, also known as a pre-paid debit card. At the workshop, one consumer group advocated for the extension of the additional federal protections afforded to credit and debit cards to these financial products, specifically pointing out the inequitable situation caused when these cards are used as payment vehicles for mobile payments. Certainly, the inconsistency in protections complicates the landscape for consumers who may not understand the differences between these funding sources.

Additionally, the FTC looked at data security and mobile payments and found:

> Another key concern for consumers when making mobile payments is whether or not their sensitive financial information can be stolen or intercepted. As noted

above, a Federal Reserve study reported that 42% of consumers were concerned about data security, and this concern was the most cited reason why consumers have not used mobile payments. Specifically, consumers were concerned about hackers gaining access to their phone remotely, or someone intercepting payment information or other data. Given that a major impediment to consumers' adoption of mobile payment technologies is the perceived lack of security, the incentives for industry to get security right should be strong. Nevertheless, although the technology to provide enhanced security in the mobile payments market is available, it is not clear that all companies in this market are employing it.

Technological advances in the mobile payment marketplace offer the potential for increased data security for financial information. A number of workshop panelists described how, under the traditional payment system, financial data is often transmitted or stored in an unencrypted form at some point during the payment process. By contrast, mobile payment technology allows for encryption throughout the entire payment chain, which is often referred to as "end-to-end encryption." Additionally, under the traditional payment system, financial information on a card's magnetic stripe that is transmitted from a merchant to a bank consists of the same information sent each time a consumer makes a payment. Thus, if this information is intercepted, it can be used repeatedly for subsequent, unauthorized transactions. Mobile payments, however, can utilize dynamic data authentication, whereby a unique set of payment information is generated for each transaction. Accordingly, even if the data is intercepted, it cannot be used for a subsequent transaction. In the mobile context, payment information also can be stored on a secure element that is separate from the rest of a phone's memory, preventing hackers who access a phone operating system from compromising sensitive financial information.

Mobile payment providers should increase data security as sensitive financial information moves through the payment channel, and encourage adoption of strong security measures by all companies in the mobile payments chain. Consumers may be harmed when less responsible companies use insecure methods to collect and store payment information.

Further, the reputation of the industry as a whole may suffer if consumers believe lax security practices are the norm. Many federal and state laws also impose data security requirements on businesses that collect and use financial information and other sensitive data.

While numerous laws overlap and exist that already govern portions of the mobile payments process, many of these laws still operate and respond the same as if the technology behind the business activity has not changed.

How will the source of the funds used to make the mobile payment (e.g., bank account, credit card, prepaid credits, etc.) affect the answers to the questions above?

Mobile Payments Security & Consumer Privacy

While implementation and adoption by merchants remain significant challenges to broader use of mobile payments, consumer concerns regarding security also hold back greater use. In a Federal Reserve study concerning the use of mobile payments by consumers, 42% of consumers cited concerns with security as the primary reason for not using mobile payments. The Federal Trade Commission (FTC) concluded in a staff report, *Paper, Plastic…or Mobile*, that

> Given that a major impediment to consumers' adoption of mobile payment technologies is the perceived lack of security, the incentives for industry to get security right should be strong. Nevertheless, although the technology to provide enhanced security in the mobile payments market is available, it is not clear that all companies in this market are employing it.

Additionally, the FTC Workshop of Mobile Payments gathered stakeholders together to discuss the emerging policy issues relating to mobile payments. Their discussion revealed that in the traditional payments system consumer financial information is at some point in the payments process stored or transmitted unencrypted, but that the rise of mobile payments has the ability to ensure that consumer data is encrypted throughout the process. Further, the information on mag strip cards is static so that once it is captured it could be used repeatedly. On the other hand, as mentioned earlier mobile payments can utilize dynamic authentication where each transaction generates unique data.

In the traditional payments space banks, merchants, and payment card networks have access, or potential access to information about the consumer. In the mobile payments space, in addition to the traditional actors, payments include operating system and software manufactures, hardware manufacturers, mobile phone carriers, application developers and loyalty program administrators. Furthermore, the FTC found:

> For example, when a consumer pays using a credit or debit card during a traditional point of sale purchase, the merchant typically has detailed data about the products the consumer purchased, but does not have the consumer's contact information. Conversely, the financial institution that issued the card has a consumer's contact information and the name of the merchant where the consumer shopped, but generally does not have information about specific purchases. Mobile payments can allow multiple players within the mobile

> payments ecosystem to gather and consolidate personal and purchase data in a way that was not possible under the traditional payments regime. Such consolidation may provide benefits to consumers, such as helping merchants offer products or services that a consumer is more likely to want. This collection of data may also help reduce the incidence of fraud. However, these data practices also raise significant privacy issues.

In a current transaction via the use of a credit card a merchant would get very little information about the consumer as they are restricted in how they collect data through state law, credit card acceptance agreements, and customer loyalty considerations. Mobile payment systems could provide avenues for merchants to discover shopping habits of the consumer that could be used for marketing or analytical purposes. California is very clear on prohibiting the collection of personal information by merchants from consumers when using credit cards, but this is potentially clouded when a mobile payment system is used. Given that traditional payments are still a near universal option, consumers still have the ability to avoid mobile payments completely without hindering their ability to purchase goods and services.

Virtual Currency:

Recent headlines concerning virtual currency have been dominated by Bitcoin with some of this attention resulting from negative publicity. The high profile *Silk Road* case in which federal law enforcement officials arrested the operator of an online illegal drug market place that facilitated the sale of drugs and other illegal goods through acceptance of Bitcoins. Bitcoins were used because it is a decentralized currency allowing users to be pseudonymous to some extent, even though every Bitcoin transaction is logged. Bitcoin is not the first, nor the only virtual currency. Numerous models of virtual currency have sprouted up over the last decade, and this growth has inspired additional questions by government officials and policy makers.

On November 18, 2013 the United States Senate Committee on Homeland Security and Governmental Affairs conducted a hearing "Beyond Silk Road: Potential Risks, Threats and Promises of Virtual Currencies." Some excerpts from testimony at that hearing are reprinted below:

Mythili Raman, Acting Assistant Attorney General, Criminal Division:

> Early centralized models, where the currency is controlled by a single private entity, have expanded and now encompass a wide range of business concepts. Some centralized virtual currencies take the form of digital precious metals, such as e-Gold and Pecunix, where users exchange digital currency units ostensibly backed by gold bullion or other precious metals. Others exist within popular online games or virtual worlds, such as Farmville, Second Life, or World of Warcraft. Still others are online payment systems such as WebMoney and Liberty

> Reserve, which are available generally outside of specific online communities and denominate users' accounts in virtual currency rather than U.S. Dollars, Euros, or some other national currency. Decentralized systems such as Bitcoin, which have no centralized administrating authority and instead operate as peer-to-peer transaction networks, entered the scene relatively recently but are growing rapidly. A network of sites and services, including exchangers who buy and sell virtual currencies in exchange for national currencies or other mediums of value, have developed around virtual currency systems, as well.
>
> Criminals are nearly always early adopters of new technologies and financial systems, and virtual currency is no exception. As virtual currency has grown, it has attracted illicit users along with legitimate ones. Our experience has shown that some criminals have exploited virtual currency systems because of the ability of those systems to conduct transfers quickly, securely, and often with a perceived higher level of anonymity than that afforded by traditional financial services. The irreversibility of many virtual currency transactions additionally appeals to a variety of individuals seeking to engage in illicit activity, as does their ability to send funds cross-border.

Jennifer Shasky Calvery, Director Financial Crimes Enforcement Network United States Department of the Treasury:

> Indeed, the idea that illicit actors might exploit the vulnerabilities of virtual currency to launder money is not merely theoretical. We have seen both centralized and decentralized virtual currencies exploited by illicit actors. Liberty Reserve used its centralized virtual currency as part of an alleged $6 billion money laundering operation purportedly used by criminal organizations engaged in credit card fraud, identity theft, investment fraud, computer hacking, narcotics trafficking, and child pornography. One Liberty Reserve co-founder has already pleaded guilty to money laundering in the scheme. And just recently, the Department of Justice has alleged that customers of Silk Road, the largest narcotic and contraband marketplace on the Internet to date, were required to pay in bitcoins to enable both the operator of Silk Road and its sellers to evade detection and launder hundreds of millions of dollars. With money laundering activity already valued in the billions of dollars, virtual currency is certainly worthy of FinCEN's attention.
>
> That being said, it is also important to put virtual currency in perspective as a payment system. The U.S. government indictment and proposed special measures against Liberty Reserve allege it was involved in laundering more than $6 billion. Administrators of other major centralized virtual currencies report processing similar transaction volumes to what Liberty Reserve did. In the case of Bitcoin, it has been publicly reported that its users processed transactions worth approximately $8 billion over the twelve-month period preceding October

2013; however, this measure may be artificially high due to the extensive use of automated layering in many Bitcoin transactions. By way of comparison, according to information reported publicly, in 2012 Bank of America processed $244.4 trillion in wire transfers, PayPal processed approximately $145 billion in online payments, Western Union made remittances totaling approximately $81 billion, the Automated Clearing House (ACH) Network processed more than 21 billion transactions with a total dollar value of $36.9 trillion, and Fedwire, which handles large-scale wholesale transfers, processed 132 million transactions for a total of $599 trillion. This relative volume of transactions becomes important when you consider that, according to the United Nations Office on Drugs and Crime (UNODC), the best estimate for the amount of all global criminal proceeds available for laundering through the financial system in 2009 was $1.6 trillion. While of growing concern, to date, virtual currencies have yet to overtake more traditional methods to move funds internationally, whether for legitimate or criminal purposes.

Jeremy Allaire, Chairman and CEO, Circle Internet Financial

> All of these risks and opportunities require that governments around the world take a proactive stance with regards to guidance around digital currency. It should be noted that digital currency has expanded globally due to different regulatory standards and attitudes overseas, particularly in the European Union and China. Several foreign firms have also refused to accept U.S. customers due to the lack of clear regulatory guidance. We do not think that it is in anyone's best interest for digital currency to become an offshore industry, or an industry dominated by China. No other country in the world has a startup entrepreneurial culture like the United States. We should protect and embolden this spirit that creates economic growth and provides us with a considerable global advantage. In terms of U.S. regulation, it appears to me that Federal and State regulators generally appear to have ample statutory authority to adopt regulations and take enforcement actions as necessary to protect consumers and ensure responsible conduct in the world of Bitcoin commerce, that their actions to date have been constructive, and that we stand ready to assist them in their ongoing efforts to adapt their regulatory tools to new digital currency.

FinCEN Issues Guidance on Virtual Currencies

FinCEN issued interpretive guidance earlier this year to clarify how the Bank Secrecy Act (BSA) and FinCEN regulations apply to users, administrators and exchangers of virtual currencies. Under the regulatory framework, virtual currency is defined as having some but not all of the attributes of "real currency" and therefore, virtual currency does not have legal tender status in any jurisdiction. Specifically, the FinCEN guidance addresses convertible virtual currency which either has a real currency equivalent value or serves as a substitute for real currency.

The roles of persons (including legal entities) involved in virtual currency transactions are defined by FinCEN as follows:

- User: A person who obtains virtual currency to purchase goods or services
- Exchanger: A person engaged as a business in the exchange of virtual currency for real currency, funds or other virtual currency
- Administrator: A person engaged as a business in issuing into circulation a virtual currency and who has the authority to redeem and withdraw from circulation such virtual currency

A person, or legal entity, may act in more than one of these capacities. Further, it is important to note that "obtaining" virtual currency covers much more than the scenario of a "user" who merely purchases virtual currency. Depending on the model of the particular currency, a party could "obtain" virtual currency through various acts including earning, harvesting, mining, creating, auto-generating, manufacturing or purchasing.

The threshold issue is whether actions will subject a person or legal entity to BSA's registration, reporting and recordkeeping regulations that apply to money services businesses (MSBs). A user who obtains convertible virtual currency and uses it to purchase real or virtual goods or services is not subject to MSB compliance because such activity does not meet the definition of "money transmission services" and the user would not be a "money transmitter."

However, an administrator or exchanger engages in money transmission services and, as a result, is a "money transmitter" under FinCEN definitions by (1) accepting and transmitting convertible virtual currency or (2) buying or selling convertible virtual currency. As a money transmitter, the administrator or exchanger would generally be subject to MSB reporting and recordkeeping.

Further, the FinCEN guidance expressly addresses the category of de-centralized virtual currency – the Bitcoin model – and states that "a person is an exchanger and a money transmitter if the person accepts such de-centralized convertible virtual currency from one person and transmits it to another person as part of the acceptance and transfer of currency, funds, or other value that substitutes for currency."

In the area of foreign exchange, accepting real currency in exchange for virtual currency is not subject to FinCEN regulations applicable to "dealers in foreign exchange" since a forex transaction involves exchanging the currency of two countries and virtual currency does not constitute legal tender as a currency of a country.

For a more detailed overview of digital currency and Bitcoin see testimony of Jerry Brito, Senior Research Fellow, Mercatus Center at George Mason University which can be found at:

http://www.hsgac.senate.gov/download/?id=0dcd748d-035a-4c0f-b695-7680adc2425d.

Policy Questions for Consideration:

As policy makers continue to examine the evolving nature of mobile payments the following questions should be considered:

1. Are the mobile payment services appropriately regulated as mere communication services or as money transfer services (or as a hybrid, or even as some other type of service)?

2. Who is responsible for providing consumer disclosures for products and services requiring such disclosures, and what protocols will apply to proving that these disclosures were given?

3. What privacy rules apply to, and who is responsible for, security of customer data? Should consumers be allowed to select higher or lower levels of identity protection as a matter of their own convenience?

4. To what extent should consumers be responsible for unauthorized or fraudulent mobile payments if they handle their mobile devices carelessly or share their identification information with others?

5. How will theft of mobile devices or hacking of customer authentication data affect responsibility for unauthorized payments?

6. What protocols are essential to ensure accuracy of payment data in transmission?

7. What consequences should follow if the data are compromised in transmission?

8. Should consumer disclosures be focused on the liabilities and risks associated with different funding options (Credit card vs Debit, vs ACH) for mobile payments?

9. Should the MTA be amended to address payments that go for retail transactions vs straight money transmission from A to B?

10. Should those accepting or facilitating mobile payments be allowed to use customer data for marketing or other purposes? Should consumers have a right to opt-in or opt-out of such data sharing?

11. To what extent must mobile payment services be accessible to the disabled, and how might this be achieved?

12. Who will keep records of mobile payment transactions, and how? How may consumers obtain these records?

13. What obligations and liabilities result when mobile payment systems "go down"? Is unavailability of a mobile payment system the equivalent of denying consumers the right to their funds?

14. Given that all new mobile payment options operate using existing payment infrastructure are new rules needed at all?

Assembly Banking and Finance Committee Informational Hearing

"Bank on California"

Thursday, February 6, 2014
2:00 pm- 5:00 pm
State Building Auditorium
455 Golden Gate Avenue
San Francisco, CA

VIII. Welcome and Introduction

- Honorable Roger Dickinson, Chair
  Assembly Committee on Banking and Finance

IX. Bank on California

- Honorable Jan Owen, Commissioner, California Department of Business Oversight

X. The Population of the Unbanked and Underbanked

- Keith S. Ernst, Associate Director for Consumer Research, Division of Depositor and Consumer Protection, Federal Deposit Insurance Corporation

- Nick Bourke, Director, Safe Small-Dollar Loans Research Project, The Pew Charitable Trusts

XI. The Purpose and Goals Behind "Bank On"

- Anne Stuhldreher, Senior Program Officer, Strategic Initiatives, The California Endowment

- Peter Manzo, President and CEO, United Way of California

XII. Bank on Partnerships with Financial Institutions

- Lily Lo, Manager/CEO, Northeast Community Federal Credit Union

- Alex Alanis, Vice President, State Government Relations, California Bankers Association

XIII. Creation and Success of Bank On Programs

- Leigh Phillips, Director, San Francisco Office of Financial Empowerment, Bank on San Francisco

- Thomas Bennett, Vice President, Community Impact, United Way California Capital Region, Bank on Sacramento

- Patrick J Soricone, Vice President, Community Building & Impact, United Way California Silicon Valley, Bank on Silicon Valley

- Olivia Calderon, Director, Financial Empowerment Initiative, City of Los Angeles, Bank on Los Angeles

XIV. **The Future of Bank On California**

- Honorable Jose Cisneros, Treasurer and Tax Collector, City and County of San Francisco

XV. Public Comment

Assembly Banking and Finance Committee

"Bank on California"

Thursday, February 6, 2014
2:00 pm- 5:00 pm
State Building
455 Golden Gate Avenue
San Francisco, CA

Introduction

The Bank On movement started in San Francisco in 2006 with the launch of Bank on San Francisco. In 2008, California launched Bank on California from the office of former Governor Arnold Schwarzenegger. There are currently eleven "Bank On" programs launched in California. Most Bank On programs in California are led by the municipal government or the local United Way.

Former Governor Schwarzenegger stated in 2008, "Through Bank on California we will help working families save money by accessing basic financial servicers others may take for granted- putting them in the financial mainstream. This simple, innovative idea won't cost taxpayers a dime, helps working families get ahead and grows our economy at the same time."

The following are programs in California: Bank on San Francisco, Bank on Los Angeles, Bank on Oakland, Bank on San Jose, Bank on Fresno, Bank on Sacramento, Bank on Orange County, Bank on Stanislaus, Bank on American Canyon, Bank On Napa Valley, and Bank On Central Coast.

Since Bank on California launched in 2008 without statutory oversight, the program has been housed in several state departments including the Governor's Office of Planning and Research, the State and Consumer Services Agency, and currently resides in the Department of Business Oversight (DBO). Due to the program being pushed from department to department in the span of 5 years, it is difficult to determine the success of the program and whether it appropriately serves the needs of the local Bank On Programs. The program has thrived predominantly due to the local level programs and the large-scale recognition of Bank on San Francisco. Bank on California programs at the local level are largely funded by non-profits and coalition organizations.

Bank on California involves a voluntary partnership between financial institutions and cities, is intended to increase the supply of starter account products offered by participating financial institutions, raise awareness among unbanked individuals about the benefits of account ownership, and make quality money management education more easily available to un- and underbanked individuals. Allowing Californians the opportunity to open bank accounts, allows them to gain access to lower-cost sources of credit, begin to save, build a credit history and invest in their future.

Additional facts regarding Bank on California:

- The goal of the Bank on California Program is to financially empower lower income consumers by making it easier and more affordable for them to deposit their paychecks, pay their bills, and start saving.

- The Bank on California Program increases the supply of starter account products that work for the low-income, unbanked Californians by developing baseline product criteria that must be offered by all participating financial institutions.

- The Bank on California Program raises awareness amongst unbanked consumers about the benefits of account ownership and spurs Californians to open accounts.

- The Bank on California Program makes quality money management education more easily available to low-income Californians and raises statewide awareness of the unbanked problem and potential solutions.

- An estimated 7.8 % of Californians are unbanked and an additional 18% are considered underbanked.

- The average unbanked Californian pays one thousand dollars ($1,000) to cash a year's worth of paychecks.

- Californians with bank accounts are more likely to save, have higher credit scores, and get better priced car and home loans.

<u>The Unbanked & Underbanked</u>

Unbanked means a consumer does not have a bank account.

Underbanked means a consumer has a bank account but still uses costly alternative financial services.

The Federal Deposit Insurance Corporation (FDIC) found that a quarter of the U.S. Population relies on alternative financial services such as check cashing, money orders and payday lending. Of these 30 million households, 9 million are unbanked. Twenty-one million are underbanked. Barriers to mainstream banking are most prevalent in low-income and minority communities. Almost 7 million households earning less than $30,000 per year are unbanked people. Moreover, 54 percent of African American households and 43 percent of Hispanic households are either unbanked or underbanked.

Without access to mainstream financial services, families may spend tens of thousands of dollars over a lifetime on the high fees associated with check cashing, money orders, payday lending and other alternative financial services. The average unbanked worker spends an estimated $40,000 throughout his or her life just to cash paychecks. These individuals also fall prey to short-term, high interest loans offered at check cashing outlets becoming trapped in the endless cycle of debt. Overall, alternatives financial services cost Americans about $13 billion per year.

An FDIC survey titled, 2011 National Survey of Unbanked and Underbanked Households, found that unbanked individuals cited convenience as the primary reason that they use alternative financial services, which are typically located in proximity to low-income neighborhoods and are often open during non-traditional hours when typical mainstream financial institutions are closed. Alternative services are also attractive because they provide individuals, who are often living from paycheck to paycheck, with immediate access to their money. A payday loan can be obtained in a matter of minutes, for example, while a bank loan, if even offered, requires an underwriting process and may not be available for several days or weeks. In addition, people who are unbanked are often less likely to have sufficient financial knowledge to navigate through the mainstream checking, saving and loan product options in their communities. Some individuals rely on alternative financial services because they simply have no other options. They may be unable to open a bank account due to prohibitively high minimum balance requirements or monthly service charges. Some do not have access to proper identification, such as a U.S.-issued driver's license, required by banks. Many have made mistakes in previous banking relationship that have landed them in ChexSystems, a national database that financial institutions use to identify people who have had past problems with bank accounts, such as unpaid overdraft charges. California's economic health depends on the financial stability of its residents.

Some of the key overall findings from the FDIC 2011 survey include:

- 8.2 percent of US households are unbanked. This represents 1 in 12 households in the nation, or nearly 10 million in total.

- The proportion of unbanked households increased slightly since the 2009 survey. The estimated 0.6 percentage point increase represents an additional 821,000 unbanked households.

- 20.1 percent of US households are underbanked. This represents one in five households, or 24 million households. The 2011 underbanked rate in 2011 is higher than the 2009 rate of 18.2 percent, although the proportions are not directly comparable because of differences in the two surveys.

- 29.3 percent of households do not have a savings account, while about 10 percent do not have a checking account. About two-thirds of households have both checking and savings accounts.

- One-quarter of households have used at least one alternative financial service (AFS) product in the last year, and almost one in ten households have used two or more AFS. In all, 12 percent of households used an AFS product in the last 30 days, including four in ten unbanked and underbanked households.

In addition, the FDIC found in the 2011 survey in regards to California:

- 7.8% of households in California are unbanked.
- 18% of households are underbanked.
- 70.9% of households are fully banked.
- 70.5% of households have both checking and savings accounts; 1.5% have only a savings account; 18.8% have only a checking account.
- 23.2% of households have used an alternative financial service in the last year, including all underbanked households and 66.2% of unbanked households.

Financial Institutions

Financial Institutions (banks and credit unions) are clearly very important to the success and longevity of Bank On. Banks and credit unions choose whether or not to participate in a Bank On program. The Bank On program requires participating financial institutions to adhere to several stipulations such as:

- Offer a low or no cost account.
- Accept the Mexican and Guatemalan consular identification cards as primary identification.
- Open accounts for those with a ChexSystems history that is more than one year old.
- Open accounts for those with a ChexSystems history that is less than one year old if they receive financial management training.
- Waive one set of non-sufficient funds/overdraft fees per client.
- Require no monthly minimum balance.
- Participate in four financial training sessions in the community each year.
- Actively partner with community groups to promote the product.
- Track account data and report that information on a quarterly basis.

According to a report released by Corporation for Enterprise Development (CFED) in March 2012, financial institutions defined their goals for Bank On participation in three ways:

1) New, sustainable banking relationships- Financial institutions are looking for significant numbers of new, previously un-or underbanked consumer to open account and successfully manage and retain those accounts over time.

2) Improving the financial lives of customers- This is often a primary goal for community relations staff within institutions and dovetails with the goals that policymaker and community groups have for Bank On programs.

3) Relationships with governments and community groups-The coalition or partnership approach to the Bank on model provides significant opportunities for financial institutions to build or strengthen relationships with government and nonprofit entities.

Bank On provides a business opportunity for financial institutions. While basic starter or second chance bank accounts may not be the most profitable products, a new, formerly unbanked customer can represent a good business opportunity if that customer enrolls in direct deposit, uses debit cards, uses online banking and keeps the account over time. According to the CFED, financial institutions participating in local Bank On programs around the country have opened tens of thousands new accounts, anywhere from just over a thousand to almost 80 thousand new accounts per locale. An issue remains that the direct connection between Bank On and the new accounts is hard to conclusively establish.

Participating California Bank On Financial Institutions

According to the Department of Business Oversight, below is a list of participating Bank On financial institutions:

- Amalgamated Bank
- Bank of America
- Bank of the Sierra
- Bank of the West
- BBVA Compass
- Broadway Federal Bank
- First California FCU
- Cathay Bank
- Central Valley Community Bank
- Chase
- Citibank
- City National Bank
- Comunidad Latina Credit Union
- Community Trust Self-Help FCU
- East West Bank
- First Bank
- Golden 1 Credit Union
- Kinecta Federal Credit Union
- Mission SF FCU
- Northeast Community FCU
- NuVision Federal Credit Union
- Oak Valley Community Bank
- Orange County's Credit Union
- One PacificCoast Bank, FSB
- Pacoima Development Federal Credit Union
- Patelco Credit Union
- Pan American Bank
- Rabobank
- Redwood Credit Union
- SAFE Credit Union
- SafeAmerica Credit Union
- San Francisco FCU
- San Mateo Credit Union
- Santa Clara County Federal Credit Union

- School's Financial Credit Union
- Security First Bank
- Spectrum FCU
- Sterling Bank and Trust
- Travis Credit Union
- Union Bank
- United Security Bank
- US Bank
- Wedbush Bank
- Wells Fargo

Challenges Facing Bank On

According to a report released by the U.S. Department of the Treasury, "Banking On Opportunity, A Scan of the Evolving Field of Bank on Initiatives," the Bank On program faces a number of obstacles including:

1) **Tracking data and using it to assess the impact and efficacy of the program**- Financial institutions are often limited in the information that they are able and willing to collect and report and local governments do not have regulatory authority to enforce data collection. In addition, it is not feasible to track consumer outcomes beyond the aggregate number of accounts opened and basic account activity, and many financial institutions do not collect additional demographic data. Confidentiality requirements restrict what kind of data financial institutions are able to share with outside partners. For example, financial institutions would be prohibited from releasing individual account details that Bank On program staff may want to compare with other data collected from residents. Because of this lack of individual-level data, it is difficult to understand how Bank On initiatives affect the communities they aim to serve, influence the financial behaviors and choices of those who open an account, and determine why a customer closes an account.

   Also, because financial institutions are the point of entry for the Bank On initiative, other partners may have little or no opportunity to interact directly with Bank On clients. This lack of access makes it difficult to connect customers with other beneficial services, such as financial education or credit counseling. Bank On coordinators also cannot follow up to verify whether customers were counted and tracked.

   When data is tracked, they are self-reported and not verifiable. There may not be consistent definitions or measures of account activity tracked across all programs. For example, the term “average monthly balance” can mean a different thing to different institutions. Even the definition of “unbanked” can vary across and sometimes within programs. Despite efforts to clarify the process, there is no independent oversight to determine if accounts are accurately tracked. This lack of consistency may lead to both over counting and undercounting.

2) **Financial Institutions**-Financial institutions are a necessary component to the success of Bank On. While their participation is necessary, obstacles exist. First, the support and engagement may vary by financial institutions’ size, mission, and the level of commitment of individual financial institution representatives. Financial institutions are concerned with the amount of staff time dedicated to what is often a six to 12-month negotiation process just to launch the program. They may also balk at having staff participate in numerous meetings, especially as they begin to engage in multiple local Bank On programs that may need to be staffed by the same financial institution representative. Some Bank On programs have found it easier to work with credit unions (both CDFI and non-CDFI) because by mission and design, these institutions are more focused on the needs of low or moderate income

consumers and members.

While some initiatives have sought to develop more innovative products, they have found that financial institutions are hesitant to stray from what their peers have already undertaken in other Bank On programs. The product criteria developed by Bank On San Francisco inadvertently became a ceiling, and most subsequent initiatives have struggled to convince financial institutions, especially some of the larger banks, to offer additional features, such as eliminating overdraft protection charges, providing free money orders, capping monthly fees at $5, or removing opening balance requirements.

Similarly, as more Bank On campaigns emerge, large national banks struggle to respond to multiple requests from different initiatives around the country or a region. It can also be time consuming to engage financial partners. Communities in which a high-level elected official is not engaged can struggle to reach agreement on product criteria.

3) **Maintaining momentum**- The Bank On programs need continuous support and momentum in order to further expand Bank On and reach out to more individuals.

4) **Funding Limitations**- Bank On programs cost relatively little but some funding is necessary for conducting an effective marketing campaign, coordinating large numbers of partners and using creative new strategies to improve financial access outcomes. Bank On initiatives typically rely most heavily on contributions from financial institutions and in-kind resources provided by coalition partners.

5) **Financial Education**- Financial education is a common component of Bank On initiatives but many initiatives struggle with how to successfully deliver financial education so that it is convenient and appropriate for participants and improves their ability to maintain accounts and achieve financial stability.

6) **Leadership Transitions**- Because Bank On initiatives are often driven by local governments, a change in administration can potentially disrupt an initiative. When an elected official leaves office, there is a risk that his or her successor will not continue to support the initiative, particularly if it is an initiative that is closely tied to the preceding administration. Bank On programs that have navigated this transition successfully, including San Francisco, Seattle-King County, and St. Petersburg, have done so because the program has been embedded in the infrastructure of the city and the community and because local leaders have supported maintaining the program. Elected official and staff transitions can be particularly challenging to a program that is still in the planning and has not yet launched the development stages.

7) **Evolving Field of Financial Access**-The economic environment has changed dramatically since the start of the first Bank On initiatives. According to Center for Financial Services Innovation research, regulatory reforms and technological advances are changing the types of financial products offered by financial institutions as well as the costs of products and services. Demographic and technological changes are also creating incentives for new

financial service providers to enter the market. Over the past several years, large retailers such as Wal-Mart and Kmart have begun offering a range of financial products targeted toward the unbanked. In addition, a range of non-bank financial service companies such as Mango Financial and Progreso Financiero have created new products, such as prepaid debit cards and web- and mobile-based applications with advertising strategies that market specifically to low-income populations and communities of color, and which may provide terms and pricing that are better than “fringe” providers in the marketplace. Thus, there may be a new set of reasonable alternatives to both financial institutions and alternative financial service providers. While the goal of the Bank On model is to connect consumers to financial institution accounts, these new products may offer appropriate choices either as “transition” products to mainstream banking, or in some cases, as alternatives.

The Role of Bank on California

According to research conducted by the U.S. Treasury, statewide initiatives have the opportunity to serve two important roles.

1) Bank on California "can help cultivate new local programs by providing technical assistance, leveraging connections with statewide partners and assisting local programs in understanding financial regulations. Additionally, they can help leaders of statewide Bank On programs share best practices and resources. It is important that statewide programs clearly define their role and their relationship with existing local Bank On programs."

2) Bank on California may "also be able to overcome financial access challenges facing rural areas and smaller towns, which often lack the resources and infrastructure necessary to get a Bank On effort off the ground."

Bank on California is a leader, as the first established state-wide program in the nation but the role and purpose of Bank on California is unclear. Bank on California has the ability to organize local programs, provide a clear and focused point of contact for financial institutions participating in multiple local programs, and provide technical assistance and other support to reduce the burden on local programs. It is important that Bank on California streamlines the requirements and procedures of local programs as well as creates efficiencies that can reduce the resource needs of local programs.

Bank On 2.0

In September, 2013, The JPMorgan Chase Foundation and Cities for Financial Empowerment Fund announced the creation of Bank On 2.0. Bank On 2.0 is a new effort to create a unified, national approach to delivering safe, affordable banking products and services to low-income and under-banked people through municipal programs across the country. Bank On 2.0 will build on grassroots success of a wide array of Bank On and related banking access programs. The ultimate goal will be to create a national approach and infrastructure that includes products, services, best practices, resources and other technical assistance that will facilitate local municipal efforts to connect unbanked and under-banked residents to safe and affordable mainstream banking services. By developing comprehensive, proven models, Bank On 2.0 will help individuals successfully navigate the financial system, enhancing their ability to build savings, assets and reach overall financial stability.

Legislative Action

Assemblymember Roger Dickinson introduced Assembly Bill 385 in 2013. Currently, this measure is in the Senate Appropriations Committee. This measure would place Bank on California indefinitely in the Department of Business Oversight. In addition, this measure would place expectations on what is required when a financial institution participates in a Bank On program. AB 385 would also require some reporting to the DBO so the DBO is able to more accurately determine the success of the Bank On programs. This legislation raised a number of questions regarding the program. For instance:

- How can DBO accurately monitor the benefit of the programs if financial institutions have no reporting requirements?
- Can California ensure the longevity and success of the program without statutory oversight?
- Do local Bank Ons prefer to have a set of concrete standards that may sway participation by financial institutions or do they prefer to each negotiate with each financial institution in regards to what products are offered?

Conclusion

The New America Foundation wrote in 2011, "The Bank On Approach demonstrated wide-ranging, bipartisan appeal. It's simple to understand, inexpensive to run, and is built on partnerships that can be replicated"

The Bank On program has become a national model for promoting access to mainstream financial services, supporting working families, and strengthening local economies. A Bank On program involves local partnerships among city officials, financial institutions and community-based organizations working together to better serve unbanked and underbanked residents. Bank

On promotes safe, affordable financial products such as a low or no cost checking account. In addition, Bank On relies on outreach campaigns to inform the public about the program and provides financial education to help targeted residents achieve and maintain financial stability.

As California moves forward with Bank on California, the Legislature has the authority to decide whether Bank on California becomes more. Taking steps to permanently place Bank on California within the Department of Business Oversight could be a beneficial step to ensure stability. In addition, statutory guidelines could benefit a number of local governments who look to the state for guidance.

Is Our Personal Data Really Safe and Secure:
A Review of the Recent Data Attacks

A Joint Informational Hearing of the
Assembly Judiciary and Assembly Banking & Finance Committees
February 18, 2014 / State Capitol Room 4202
1:30 (or Upon Adjournment of Session) – 4:30 pm

Introduction by the Chairs *(5 minutes – 1:30-1:35 pm)*

I. How Does the "Point of Sale" Payment Card System Work, and What Went Wrong In the Recent Breaches Involving Large Retailers?
(*30 minutes – 1:35-2:05 pm*)

Panelists:

- **Alex Alanis**, Vice President, State Government Relations, California Bankers Association
- **Rachel McGreevy,** VP, State Government Affairs and Community Relations, MasterCard
- **Lenny Goldberg,** Privacy Rights Clearinghouse

II. How Could These Mega Data Breaches Have Been Prevented?
(50 minutes – 2:05 – 2:55 pm)

Panelists:

- **Bill Dombrowski**, President & CEO, California Retailers Association
- **Jen Beser,** Sr. Director Global Corporate Initiatives, Visa
- **Jamie Court**, Consumer Watchdog
- **Norma Garcia,** Consumers Union

III. Are These Recent Data Breaches Covered by Existing California Law?
(*30 minutes – 2:55 – 3:25 pm*)

Panelists:

- **Ed Berberian,** Marin County District Attorney
- **Lee Tien,** Electronic Frontier Foundation

IV. How If At All Should California Law In This Area Be Updated? *(50 minutes - 3:25– 4:15 pm)*

<u>Panelists</u>:

- **Diana Dykstra,** CEO, California Credit Union League
- **Norma Garcia**, Consumers Union
- **Lenny Goldberg,** Privacy Rights Clearinghouse

Public Comment *(10 minutes -- 4:15 – 4:25 pm)*

Chairs' Closing Remarks *(5 minutes – 4:25 pm-4:30 pm)*

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Is Our Personal Data Really Safe and Secure: A Review of the Recent Data Attacks.

A Joint Informational Hearing of the Assembly Judiciary and Assembly Banking & Finance Committees

Prepared by staff of Assembly Banking & Finance Committee

Banking & Finance Data Breach Background

Recent Data Breaches:

The recent retailers affected by the mega data breach are not the first nor will they be the last. The recent data breaches once again made all entities aware that the current payment system has flaws and everyone pays the price, literally. Just to name a few, recently, Target, Neiman Marcus, Michael's all fell victim to hackers. The largest of the three is Target. Between November 27 and December 15, 2013, hackers were able to get access to Target's point of sale system (discussed later), which allowed them to duplicate cards and receive customer's important information. This exposed as many as 40 million U.S. customers to credit-and-debit card fraud. Ultimately, Target reported that an additional 70 million customers had their personal information stolen including names, mailing address, phone numbers, and emails, totaling those affected to 110 million. Target on-line shopping was not affected in the breach and to date, social security numbers were not compromised. The data breach included customer names, credit card numbers, and the card's expiration date. Hackers were even able to retrieve customer's encrypted PIN number from Debit or ATM cards. Both Neiman Marcus and Michael's fell victim to the same type of intrusion but on a smaller scale. These data breaches raise a number of questions such as:

1) As a leader in privacy regulations, what can California do to prevent these from occurring?

2) Would EMV technology prevent data breaches?

3) How can consumers protect their personally identifiable information?

4) Are all entities involved taking the correct steps to ensure the safety and soundness of consumers in the future?

Timeline

Feb. 4: Target CFO John Mulligan testifies to Congress that the company would accelerate its investment in advanced credit card technologies. Mulligan says the company first learned of the breach when notified by the Justice Department. Neiman Marcus and law enforcement representatives also testify.

Feb. 2: White Lodging says it is investigating a breach involving bars and restaurants at 14 hotels it manages, including Marriott (MAR, Fortune 500), Radisson, Renaissance, Sheraton, Westin and Holiday Inn locations. The breach occurred between March 20 and Dec.16, 2013. Independent security researcher Brian Krebs first reports this breach on Jan. 31.

Jan. 30: Target says stolen vendor credentials were used in its massive breach.

Jan. 28: Consumer Bankers' Association, which represents nearly 60 of the nation's largest card-issuing banks, says its members have responded to the Target breach by replacing 15.3 million consumer cards at a cost of $153 million.

Jan. 26: Michaels, the country's largest crafts chain, reports "possible fraudulent activity" on some of its customers' payment cards, suggesting there may have been a breach. CEO Chuck Rubin says the company has not confirmed a breach, but wanted to alert customers.

Jan. 23: Neiman Marcus acknowledged cyber-criminals stole card information for 1.1 million customers who shopped at the retailer between July 16 and Oct. 30, 2013. About 2,400 cards were later used fraudulently, it said.

Jan. 16: Federal investigators warn retailers and other companies that accept card payments about an advanced piece of malicious software that potentially affected a large number of stores. It is widely believed this was the malware that infected Target.

Jan. 14: The nation's largest retail bank, J.P. Morgan Chase (JPM, Fortune 500), says it is replacing 2 million customer cards, prompted by the Target hack.

Jan. 11: Neiman Marcus says a cyber-security firm has found a payment card breach. The company said it is too early to tell how many customers have been impacted.

Jan. 10, 2014: Target says hackers also obtained personal information -- including name, address, phone number and email address -- for up to 70 million customers. It says there may be some overlap with the 40 million impacted by the credit and debit card breach, but it couldn't say how many were counted twice.

Dec. 27: Target says cyber-criminals made off with PIN data, adding that information was "strongly encrypted" and likely remains "safe and secure." It had earlier said PIN numbers were not part of the breach.

Dec. 22: Chase Bank implements strict limits on how much customers can withdraw and spend using debit cards, citing an effort to prevent fraud. Within days, it relaxes those limits.

Dec. 21-22: Target offers customers a 10% discount on many items in its stores.

Dec. 19: Target confirms a breach from Nov. 27 to Dec. 15 involving up to 40 million cards.

Dec. 18: The Secret Service acknowledges it is investigating a reported breach that involved credit and debit cards at Target (TGT, Fortune 500). The news was first reported by Brian Krebs, a security researcher and blogger.

How did it happen?

The latest information provides that the hackers gained access to Target's computer network using the stolen credentials of a refrigeration contractor via "a malware-laced email" sent to the contractor's employees.[1]

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[1] *Email Attack on Vendor Set Up Breach at Target*, Krebs on Security. February 14, 2014. Available at http://krebsonsecurity.com/

Hackers used a malware program called Citadel to steal passwords from Fazio Mechanical, a suburban Pittsburgh-based company that installed refrigeration systems for Target stores in Ohio and Maryland. Fazio acknowledged that it is part of the investigation into the Target data breach and said its credentials gave its employees access to Target's network "exclusively for electronic billing, contract submission and project management."[2] This access allowed hackers to break into Target's POS systems in order to install malware that enabled the theft of payment card information. Among data security professionals there remains disagreement as to the exact cause of the Target breach, as some believe the breach was the result of multiple attacks over an extended period of time designed to expose weaknesses that could be exploited.[3]

The use of malware in the Target breach appears to be part of the same attacks that affected several other retailers. According to various data security firms and law enforcement sources these attacks demonstrated a high level of sophistication and coordination that had not been witnessed before.[4]

General Data Breach Statistics

Trustwave, a global information security and compliance services and technology company, each year releases a report based on their investigations into data breaches. The following are brief findings from their 2013 report:[5]

- The retail industry was the top target for data breaches in 2012 making up 45% of our investigations. Food & beverage was the second most targeted industry followed by the broader hospitality industry.

- Cardholder data was the primary data type targeted by attackers.

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[2] http://faziomechanical.com/Target-Breach-Statement.pdf
[3] *Disagreement on Target Breach Cause*. Bank Info Security. February 10, 2014. http://www.bankinfosecurity.com/disagreement-on-target-breach-cause-a-6491
[4] *Target Breach May Be Part of Wider Attack*. The Washington Post, January 17, 2014
[5] Executive Summary of Report Available at http://www2.trustwave.com/rs/trustwave/images/Trustwave_GSR_ExecutiveSummary_4page_Final_Digital.pdf

- Mobile malware increased 400% in 2012. “Malware,” which is short for “malicious software” is used to exploit vulnerabilities in computer systems, gather sensitive information, or gain access to private computer systems for a specific purpose—normally cybercrime.

- Out of more than 450 data breaches we investigated, the United States was the top victim location. 73% of victims were located in the U.S.

- In 2012, almost all Point-Of-Sale (POS) breach investigations involved, what’s known as, “targeted malware.” That’s when malware is designed for a specific computer system, business or computer user. SQL (Structured Query Language) injection and remote access made up 73% of the infiltration methods used by criminals. Other commonly used methods were Blackhole exploit kits, malicious PDF files (61% targeted Adobe Reader users) and “memory scraping.” Criminals planted malware on users’ machines by using all of these infiltration methods.

- It took businesses an average of 210 days to detect a breach. Most victim organizations took more than 90 days to detect the intrusion, while 5% took more than three years to identify criminal activity.

- Only 24% of victim organizations detected the intrusion themselves. Most were informed by law enforcement or another regulatory body.

- Web applications emerged as the most popular attack vector; e-commerce sites being the most targeted asset.

- Users are continuously using weak passwords with “Password1” being the most common password of choice since it meets the bare minimum password requirement typically mandated by policies enforced by IT administrators.

Other Recent Breaches.

Since July 18, 2013, Privacy Rights Clearinghouse has identified over 300 U.S. data breaches in which consumers' personal information was compromised. In addition to the retail breaches previously discussed, several other breaches have been revealed in recent months, including:

- The September 2013 discovery of attacks by an underground criminal identity-theft service, SSNDOB, on major U.S. aggregators of consumer and business data (including LexisNexis, Dun & Bradstreet, and Kroll Background America) as well as on the National White Collar Crime Center;

- The October 2013 discovery of a major hacking attack on computer software company Adobe, in which almost 3 million customers' usernames, encrypted passwords, and encrypted payment information were exposed, with approximately million additional active usernames and encrypted passwords later found to have been compromised as well;

- The October 2013 discovery of the sale of consumers' dates of birth, Social Security numbers, driver's license numbers, and financial information to an underground criminal identity-theft service by Court Ventures, an aggregator of public record information and subsidiary of consumer credit bureau Experian;

- The December 2013 discovery of an attack on JPMorgan Chase that compromised personal information pertaining to prepaid cash cards (Ucards) used for corporate and government payments;

- The December 2013 discovery that 4.6 million Snapchat usernames and phone numbers had been compromised by a group stating its goal was to "raise public awareness on how reckless many internet companies are with user information";

- The January 2014 discovery of two separate breaches involving Yahoo, including one in which malware was served to personal computers via the Yahoo ad network and another in which Yahoo Mail usernames and passwords were found to have been compromised, apparently via a breach on third-party database;

- An apparent breach of guest credit and debit card information held by White Lodging, which owns and manages hotels nationwide under brands including Hilton, Marriott, Sheraton, and Westin.

Existing Payments Ecosystem in the United States:

To properly assess the impact of the latest round of payment system attacks and resulting data breaches it is important to establish some basic information regarding the existing payment structure within the U.S.

The U.S. remains the last developed country reliant on magnetic stripe credit cards (mag stripe), a four-decade old technology. The U.S. is currently on pace to be a full decade behind Europe on the implementation of credit card chip & PIN technology (EMV-Europay, MasterCard, Visa standard). Currently, all face-to-face credit or debit card transactions use a magnetic stripe to read and record account data, and a signature for verification. Under this system, the customer hands their card to the clerk at the point of sale, who "swipes" the card through a magnetic reader. The merchant transmits to the acquiring bank the cardholder's account number and the amount of the transaction. The acquiring bank forwards this information to the card association network requesting authorization for the transaction and the card association forwards the authorization request to the issuing bank. The issuing bank responds with its authorization or denial through the network to the acquiring bank and then to the merchant. Once approved the issuing bank sends the acquiring bank the transaction amount less an interchange fee. This process occurs in a manner of seconds.

This system has proved reasonably effective, but has a number of security flaws, including the ability to get physical access to the card via the mail or via the use of black market card readers that can read and write the magnetic stripe on the cards, allowing cards to be easily cloned and used without the owner's knowledge. The inherit convenience of mag stripe cards is also their inherit weakness.

The data stored on the magnetic stripe is referred to as “Track One” and “Track Two” data. Track One data is personal information associated with the account. Track Two data contains information such as the credit card number and expiration date. In some circumstances, criminals attach a physical device to the POS system to collect card data, which is referred to as “skimming”. In other cases, cyber criminals deliver malware which acquires card data as it passes through a POS system, eventually exfiltrating the desired data back to the criminal. POS systems are connected to computers or devices, and are often enabled to access the Internet and email services. Malicious links or attachments in emails as well as malicious websites can be accessed and malware may subsequently be downloaded by an end user of a POS system

The terminology and process of a credit card transaction:

Acquirer- A bank that processes and settles a merchant's credit card transactions with the help of a card issuer.

Authorization- The first step in processing a credit card. After a merchant swipes the card, the data is submitted to merchant’s bank, called an acquirer, to request authorization for the sale. The acquirer then routes the request to the card-issuing bank, where it is authorized or denied, and the merchant is allowed to process the sale.

Batching- The second step in processing a credit card. At the end of a day, the merchant reviews all the day’s sales to ensure they were authorized and signed by the cardholder. It then transmits all the sales at once, called a batch, to the acquirer to receive payment.

Cardholder- The owner of a card that is used to make credit card purchases.

Card network- Visa, MasterCard or other networks that act as an intermediary between an acquirer and an issuer to authorize credit card transactions.

Clearing- The third step in processing a credit card. After the acquirer receives the batch, it sends it through the card network, where each sale is routed to the appropriate issuing bank. The issuing bank then subtracts its interchange fees, which are shared with the card network, and transfers the remaining amount through the network back to the acquirer.

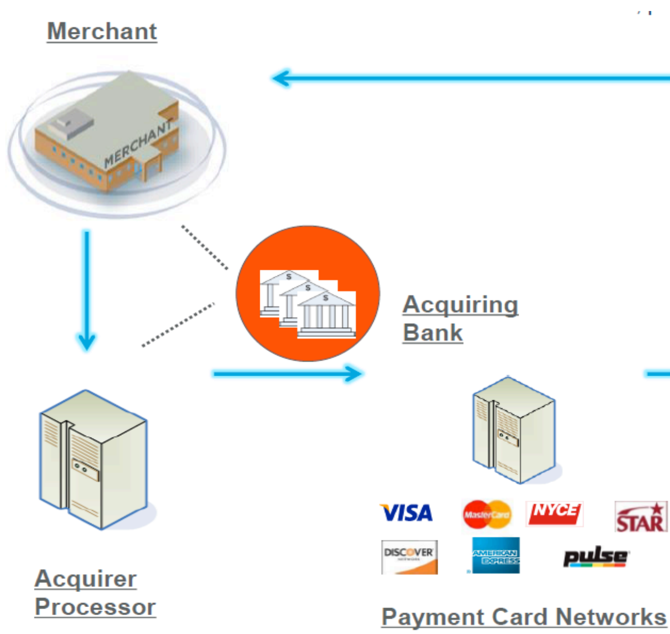
Discount fee- A processing fee paid by merchants to acquirers to cover the cost of processing credit cards.

Funding- The fourth and final step in processing a credit card. After receiving payment from the issuer, minus interchange fees, the acquirer subtracts its discount fee and sends the remainder to the merchant. The merchant is now paid for the transaction, and the cardholder is billed.

Interchange fee- A charge paid by merchants to a credit card issuer and a card network as a fee for accepting credit cards.

Issuer- A financial institution, bank, credit union or company that issues or helps issue cards to cardholders.

Chart: Overview of Typical Credit Card Transaction[6]



The U.S. has over 10 million credit card terminals and 1.2 billion credit cards, with less than 2% of cards having chip technology according the Smart Card Alliance. Annually, credit card fraud equals $11 billion globally, with the U.S. portion amounting to $4.73 billion.[7] The Nilson Report, a credit card industry newsletter, points out that the U.S. accounts for just

[6] Provided by First Data.

[7] Saporito, Bill. "The Little Strip on Your Debit Card is a Massive Achilles's Heel," Time.com. Jan. 23, 2014

over a quarter of the global volume of credit card transactions per year, yet accounts for almost 50% of the fraud worldwide.

Mobile Payments:

The Aite group forecasts that U.S. mobile payments will reach $214 billion in gross dollar volume in 2015, a monumental rise from $16 billion in transactions in 2010.

Consumers currently can make three types of payments using a smartphone or tablet computer. The first is a person-to-person transfer initiated by a mobile device that could include non-commercial payments from one person to another, or commercial payments to a small scale merchant. Second, is for goods or services purchased over the internet on a mobile device. The third option is at point of sale (POS) device initiated from a mobile device at a physical location. These payments can be made using a variety of technologies such as a wallet system that may utilize a smart phone based application to generate barcodes, or a QR Code that allows the user to pay for something from a funding source associated with the mobile wallet. Other options connect a virtual wallet with an email address or username and password. The potential security benefit to a consumer using a mobile payment application is that the consumer's underlying payment data can be shielded from the retailer's payment system. This is one form of the process known as tokenization, which is discussed in detail later in this document.

An April 2013 report from Business Insider, *Why Mobile Payments are Set to Explode*, found the following:

- **In-store mobile payments nearly quadrupled last year:** eMarketer has estimated in-store mobile payments as adding up to $640 million in transaction volume in the U.S., up from $170 million in 2011. However, this figure does not include swipes on mobile credit card readers like Square and PayPal Here, only consumer-side mobile payments.

- **Card readers are building up real scale:** Square's mobile payments volume rose to $10 billion in 2012, up from $2 billion in 2011. Starbucks is switching its credit and debit card processing to Square, and as of January 2013 accepts the "Square Wallet" app at 7,000 locations.

- **Mobile payments as part of mobile commerce are also exploding:** PayPal processed some $14 billion in mobile payments last year, evidence of mobile catching on as a transactional platform. PayPal hopes to build a merchant-powered network based on the ubiquity of PayPal as a payment and money transfer platform. PayPal users are already able to pay at thousands of traditional stores by keying in their mobile number and a PayPal PIN selected online (or in their PayPal app).

- **Credit** card companies **are getting in on the action:** Credit card companies have responded by making aggressive moves to enter the space. Visa (V.me), and American Express (Serve) have each introduced digital wallet-like products, MasterCard's PayPass is an NFC-enabled system that is also integrated with the "Google Wallet" app, and Discover has opted to partner with two of the bigger names in the digital payments space ("Google Wallet, and PayPal).

- **In the early stages:** As of year-end 2012, only 7.9 million U.S. consumers (less than 90 percent of the total) had adopted a consumer-facing NFC-compatible system like "Google Wallet," or apps that use QR codes or other methods to generate a payment.

Payment Card Industry Data Security Standard (PCI DSS):

The Payment Card Industry Data Security Standard (PCI DSS) is a proprietary information security standard for organizations that handle cardholder information.

Defined by the Payment Card Industry Security Standards Council (Council), the standard was created to increase controls around cardholder data to reduce credit card fraud via its exposure through 12 requirements. The 12 specific requirements under PCI-DSS are:

Build and Maintain a Secure Network and Systems.

1) Install and maintain a firewall configuration to protect cardholder data.

2) Do not use vendor-supplied defaults for system passwords and other security parameters.

Protect Cardholder Data

3) Protect stored cardholder data

4) Encrypt transmission of cardholder data across open, public networks

Maintain a Vulnerability Management Program.

5) Protect all systems against malware and regularly update anti-virus software or programs.

6) Develop and maintain secure systems and applications.

Implement Strong Access Control Measures.

7) Restrict access to cardholder data by business need to know.

8) Identify and authenticate access to system components.

9) Restrict physical access to cardholder data.

Regularly Monitor and Test Networks.

10) Track and monitor all access to network resources and cardholder data.

11) Regularly test security systems and processes.

Maintain an Information Security Policy.

12) Maintain a policy that addresses information security for all personnel

Although the PCI DSS must be implemented by all entities that process, store or transmit cardholder data, formal validation of PCI DSS compliance is not mandatory for all entities. Currently both Visa and MasterCard require merchants and service Providers to be validated according to the PCI DSS. Smaller merchants and service providers are not required to explicitly validate compliance with each of the controls prescribed by the PCI DSS although these organizations must still implement all controls in order to maintain safe harbor and avoid potential liability in the event of fraud associated with theft of cardholder data. Issuing banks are not required to go through PCI DSS validation although they still have to secure the sensitive data in a PCI DSS compliant manner. Acquiring banks are required to comply with PCI DSS, as well as, to have their compliance validated by means of an audit. A key component of PCI DSS is that organizations do not store sensitive payment cardholder information that is contained in the magnetic strip of the card. If information from the front side of the card is stored in some form, PCI DSS requires that information be protected via encryption.

PCI DSS is an evolving standard and the most recent version (version 3.0) was released November, 2013 and became active January 1, 2014. The new version has been updated to cover topics such as payment terminal security, malware detection, secure software development, use of third party service providers, and ensuring ongoing security rather than point in time compliance.

A report on PCI compliance, *Verizon 2014 PCI Compliance Report*, reported that 56% of U.S. businesses do not meet minimum compliance with overall PCI standards. Delving further into specific areas only 17% complied with security monitoring requirements that require detection and response when data has been breached. Furthermore, 24% were compliance with security testing requirements and 56% met standards for protecting stored sensitive data. Ironically, Europe while leading the way on EMV implementation had only 31% compliance. Limiting access to personal cardholder information is described in the report as one of the "golden rules" of security, but, 71% of the organizations in Verizon's PCI compliance index failed to adequately control access to cardholder data to the level required to be PCI compliant.

EMV: Chip & Pin and Chip & Signature:

Credit card chip technology was established in 1994 by Europay International SA. This chip technology is also called EMV, as it was named after its original developers, Europay, MasterCard® and Visa®.

EMV technology is used today in more than sixty countries outside of the U.S. with worldwide usage at 40% of the total credit cards and 70% of the total terminals based on the EMV standard.[8]

A cardholder's data is more secure on the chip-embedded card than on a mag stripe card. Chip-embedded cards support superior encryption and

[8] First Data, EMV in the U.S.: Putting It into Perspective for Merchants and Financial Institutions. http://www.firstdata.com/downloads/thought-leadership/EMV_US.pdf

authentication as opposed to mag stripe card making the data on mag stripe cards easier to obtain via fraudulent means. Chip technology counters the static nature of mag stripe cards by implementing technology that creates dynamic values for each transaction in the form of a different verification code for each transaction. EMV cards can be used both online and in face-to-face transactions, both supporting signature and PIN verification with PIN being the dominant method used in Europe. However, while the EMV cards can complete online transactions, those transactions do not have the same level of security as provided by the chip in the face-to-face transaction. In the online scenario the consumer still enters their card data to complete payment with the addition of a PIN. Currently, several European payment technology companies are working to bring the Chip & PIN protection to online transactions.

EMV compatible cards come in three forms. A chip embedded card is inserted into the POS terminal and the consumer enters their PIN or uses a signature to complete the transaction. The other way to pay is via contactless cards in which the transaction occurs when the consumer swipes their card within the appropriate distance of the POS terminal that can read the radio frequency identification device (RFID) on the card. The third type of card is a hybrid chip card that allows for both contact and contactless transactions.

As previously mentioned the U.S. is lagging behind in implementation and acceptance of EMV technology. The first U.S. credit card utilizing EMV was issued by United Nations Federal Credit Union (UNFCU) in October of 2010. The primary reason UNFCU issued the card was that many of its members reside outside the U.S. and were in need of a globally accepted card. Outside of the U.S. mag stripe cards are becoming less accepted. Prior to the recent large scale breaches, most large card issuers in the U.S. (Wells Fargo, JPM Chase, and U.S. Bancorp) have begun to migrate some of their portfolios over to EMV cards, but thus far in limited quantities and targeted toward higher income card holders or those that frequently travel to European countries. Subsequent to the recent breaches, several financial institutions replaced cardholder's magstripe cards with EMV cards if they were amongst the millions that had their payment data compromised.

A factor that has contributed to the limited role out of EMV in the U.S. is that currently few merchants accept EMV chip-embedded cards. Most EMV chip cards issued abroad and in the U.S. also contain a mag strip thus allowing acceptance at all U.S. merchants that accept credit cards. Also, up until the recent headline generating data security lapses, most American consumers were unaware of EMV technology or retailers that had EMV capable POS terminals.

On August 9th, 2011 Visa announced an accelerated implementation to EMV technology and established October 1, 2015 as the date when card-present counterfeit fraud liability will shift from issuers to merchant acquirers if fraud occurs in a transaction that could have been prevented with a chip-enabled payment terminal.[9] While the announcement lays a path towards EMV chip card migration, it does not necessarily set a path to chip-and-PIN as Visa will continue to support both signature and PIN cardholder verification methods. The announcement specified incentives and deadlines to urge U.S. merchants to accept both contact and contactless chip-enabled cards. One merchant incentive includes the elimination of the requirement for annual card network compliance validation if 75 percent of a merchant's transactions originate from chip-enabled terminals. For the largest merchants, savings from an annual compliance validation would average approximately $225,000 a year. Some industry analysts conclude that only 60% of U.S. point-of-sale terminals will meet the target date.

The history of European adoption of EMV also took a different course and was instigated for varying reasons, many of those different than the current debate in the U.S. American payments model has been very efficient through the verification of transactions from POS over land line phone lines. In Europe, the inefficient telephone system used for verification, created pressure for card networks to create a secure and localized payment transaction system.

The impact of EMV in the United Kingdom was a large reduction in payment card fraud of 40% since 2000, however the U.K. Payments Administration claims that the failure of the U.S. market to adopt EMV has impacted the U.K. market as counterfeit fraud increased because criminals would copy data from stolen U.K. cards and would in turn use the stolen cards in countries with chip and PIN.[10]

Would Existence of EMV Technology Have Prevented the Mega Data Breaches?

Even in Europe where EMV is over a decade ahead of implementation in the U.S. EMV does not protect against all threats. EMV does not exist for card not present transactions such as online transactions or over the phone, and is unable to protect payment data downstream in the payment process once it has left the POS terminal. Statistics for the U.K. and other EMV countries

[9] Press Release available at http://corporate.visa.com/newsroom/press-releases/press1142.jsp

[10] First Data, 7

demonstrate that criminals follow the path of least resistance as fraud migrated away from attacking the card present transaction to target transactions such as online banking, online shopping, and mail and phone orders.[11]

EMV is but one step of a multi-layered approach to payment security. Julie Conroy, a senior analysts and fraud expert with Aite Group has stated that the attacker's malware in the Target breach would have penetrated the payment system regardless of what cards were used by consumers.[12]

EMV would have prevented the ability of fraudsters to make duplicate cards via stealing data at the POS terminal, but it is very unclear whether it would have prevented the Target and Neiman Marcus breaches specifically. However, EMV would make it difficult for criminals to use the information acquired from a breach to make fraudulent cards.

Speed Bumps for EMV Implementation:

According to a First Data report on the implementation of EMV the estimated total costs could be around $8 billion.[13] The costs to financial institutions to issue mag-stripe cards can costs as little as 10 cents each, whereas EMV cards can costs up to $1.30 each.[14] Estimates on the costs vary in terms of production and issuance to the customers, but some estimates find that EMV cards could cost, per card, as much as $10-15 more than existing mag-stripe cards.[15] The Aite Group estimates that the implementation of EMV cards could cut fraud losses in half in the U.S. According to the Nilson Report, U.S. Merchants and banks had 2012 losses of $11.5 billion due to credit card fraud or about 5 cents on every $100 spent and will rise to over $12 billion by 2015. The breakdown of how each entity in the payments chain will absorb the costs is unclear due to ongoing issue relating to the Durbin Amendment, which is discussed later in this document. Thus far, U.S. Financial Institutions have spent nearly $172 million reissuing more than 17.2 million debit and credit cards affected by the Target data breach.[16]

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[11] Ibid, 11
[12] *Why Target's CEO Changed His Mind About EMV*. American Banker. January 21, 2014
[13] First Data, 13
[14] *The Economics of Credit Card Security*. Washington Post. January 21, 2014.
[15] *Data Breaches Renew Fight Over Credit Card Chip Technology*. USA Today. January 30, 2014.
[16] *Banks spent $172m on Reissuing Credit Cards Affected by Target breach.* Banking Business Review February 2014

As mentioned previously, some estimates find that only 60% of businesses will meet the 2015 EMV deadline. This means that even during initial phases the marketplace will still have a fair share of mag-stripe cards and EMV capable cards will also still include mag-stripes so that consumers are still able to use their cards at non-EMV compatible merchants. The story of the Netherlands adoption of EMV is telling as they began their transition to EMV in 2007 with a target completion date of 2010. This allowed magnetic stripe cards to stay in the market longer than most other European countries. During the transition, criminals targeted the remaining magnetic-stripe terminals and in 2011 there were 555 successful skimming attacks on payment terminals, up from 176 in 2010.[17] In a telling example of the potential issues that can occur with a transition to EMV, PayPal President David Marcus reported that on a recent trip to the U.K. his EMV enabled card was compromised.[18]

The European experience demonstrates that fraud shifts to the weakest links in the payment system during a transition to EMV. In what may be a controversial statement on EMV, a report from the Federal Reserve Bank of Kansas City finds:

> *Fraud for card-present transactions on lost or stolen cards may stay the same or even potentially increase. Many countries that use EMV payment cards do not allow cardholder authentication with signatures. Issuers in the United States, however, appear likely to continue to allow signature authorization on EMV debit and credit card transactions (Heun; Punch). As a result, fraud on lost or stolen cards may not decline in the United States. Fraud may even rise as fraudsters, unable to commit fraud on counterfeit cards, begin to target payments with relatively weak security, such as transactions that allow signature authorization. Fraudsters may put more effort into stealing computer-chip payment cards, knowing that they may be able to commit a few fraudulent transactions using a forged signature before issuers cut off use of the card...*
>
> *...The experience of countries that have adopted computer-chip payment cards shows that EMV payment cards offer capabilities for*

[17] Sullivan, Ricard. The U.S. Adoption of Computer-Chip Payment Cards: Implications for Payment Fraud.
[18] *PayPal President's Credit Card Hacked for Shopping Spree*. USA Today. February 10, 2014.

strengthening authentication and preventing fraud. The degree of payoff from adopting the cards only emerges over time, however, because authentication methods tend to evolve and improve during a transition period. Still, some fraud will migrate to payments with weak authentication capacities, and card issuers will need countermeasures to improve authentication.

Another factor that will take some time is consumer education. Prior to the recent data breaches most U.S. consumers had not heard of EMV technology as these cards were available to a limited number of consumers that met certain guidelines, such as a frequent traveler. The implementation of EMV will require consumers to become comfortable with a new way to make purchases via inserting the card into the terminal and providing a PIN, or tapping the card against the contactless reader. One card network reported that only 5% of the contactless cards on the market today are ever used for contactless payments.[19] The experience of mobile payments implementation may also be telling for the transition to EMV as one of the often cited reasons for the initially slow adoption of mobile payments by consumers is a lack of viewing mobile payments as convenient as traditional payment methods.

Finally, the form of EMV technology may offer additional points of concern and disagreement amongst industry participants. The form of EMV offered will be up to each issuer so that the credit card market in the U.S. will see a mix of Chip & PIN and chip & signature cards. Chip & signature cards offer less protection than those that require a PIN because should someone (other than the cardholder) get physical access to the card the signature is easily forged.

Additional Payments Security:

EMV technology is a vital piece of a larger puzzle in protecting payment information as it does not alleviate the "need for secure passwords, patching systems, monitoring for intrusions, using firewalls, managing access,

[19] First Data, 16

developing secure software, educating employees and having clear processes for handling of sensitive payment card data."[20]

Point-to-point encryption (P2PE) technology helps merchants and acquirers protect payment card data within their systems by encrypting sensitive cardholder information. Because the card data can only be accessed, or unscrambled, with decryption keys held securely by the acquirer, gateway or card network, cardholder information is protected within the payment processing environment.

Point-to-point encryption (P2PE) ensures sensitive credit and debit card data is protected from first card swipe, while in transit, all the way to the payment processor. This technology is also referred to as end to end encryption, or E2EE.

State of the art encrypting devices scan and encrypt cardholder information prior to performing an electronic payment transaction. These sophisticated devices use Triple DES Encryption and DUKPT key management technology to encrypt and transmit cardholder data securely over any network. The encrypted cardholder data being transmitted is NOT equivalent to the original cardholder data in any way. Even if the data were to be intercepted, it would be useless to data thieves.

An additional security measure gaining some media attention is tokenization. Tokenization has advantages for both merchant and service providers. Tokenization is software-based and replaces the cardholder's primary account number (PAN) with a randomly-generated proxy alphanumeric number ("token") that cannot be mathematically reversed and is used for long-term storage or for use as a transaction identifier. From a service provider's perspective, being a software-only technology, it is fairly easy to institute.

For recurring payments from a merchant's standpoint, tokenization is ideal. For these type of payments, the card number is only on the merchant's network "in flight" during the initial transaction which can now be encrypted and protected using P2PE but beyond that, the merchant uses the token that

[20] Statement of Troy Leach, Chief Technology Officer, Payment Industry Security Standards Council. *Before the Committee on Banking, Housing, and Urban Affairs, Subcommittee on National Security and International Trade and Finance United States Senate*. February 3, 2014.

represents the original card for subsequent payments or to track customer transactions for marketing purposes. A myriad of targeted marketing programs can be developed by the merchant using cardholder purchase history data in a tokenized fashion in the merchant's database to, for instance, project what new products may complement those the consumer previously purchased.

One of the major benefits of the tokenization implementation planning process is that it offers the opportunity for merchants to potentially get a head start in compliance with PCI version 3.0, which requires an annual assessment of the locations and flows of cardholder data. Locating all the cardholder data within a merchant's location and identifying who should have access to it could help merchants get ahead of future PCI compliance by re-engineering the logical controls and restrictions to tokenized data.

Tokenization is also a major part of mobile payments security. In the case of mobile payment applications like Square, the consumer's face is the token as because it is shown to the merchant but the actual payment information is secure and never shared.

Dodd-Frank Act: The Durbin Amendment

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) has also created some unintended difficulties ahead for EMV. The Durbin Amendment, entitled "Reasonable Fees and Rules for Payment Card Transaction," added Section 1075 to Dodd-Frank and dealt with the controversial issue of interchange fees. The interchange fee regulation provision is a major point of vitriol between merchants, financial institutions and the card networks. However, a lesser known portion of the Durbin Amendment concerning Debit network competition may have direct impacts on EMV. The Durbin Amendment includes two sets of provisions intended to permit merchants to choose between competing network processing paths for each electronic debit transaction. Issuers and payment card networks are prohibited from (i) restricting the number of payment card networks on which an electronic debit transaction may be processed (network exclusivity restrictions) and (ii) "inhibiting" a merchant (or ATM operator) from directing the routing of an electronic debit transaction through any network that can process that transaction (merchant routing restrictions). The plain meaning of all of this is that debit cards must be able to allow at least two debit networks to process a transaction when the transaction is made. The current EMV standard may not allow for this two network competition and may pose an obstacle for complete integration as debit cards would still rely on mag stripe technology. The Electronic Transactions Association, a global trade group representing companies that offer electronic transaction services has stated that for successful migration to EMV technology the issue regarding dual debit networks needs to be resolved as the technical features of the current EMV standard do not allow this.[21]

The Durbin Amendment altered interchange transaction fees and rules for debit card transactions. The goal behind Durbin was to transfer wealth from the issuing banks to the merchants with the hope that it would result in lower prices for consumers through lower fees to merchants. The interchange fee is the amount that a merchant has to pay the cardholder's bank (the issuer) through the merchant acquiring bank (acquirer) when a card payment is processed. Currently, only 4 card networks exist: Visa, MasterCard, American Express, and Discover. Visa and MasterCard account for 85% of the U.S. consumer credit card market. In 2011, debit cards were used in 49 billion transactions for a total value of $1.8 trillion, and credit cards were used in 26 billion transactions for a total value of $2.1 trillion**.**

The Federal Reserve Board administered the final rule of the Durbin Amendment which capped the interchange fee at $0.21 cents per transaction to cover the issuers processing costs plus up to an additional 5 basis points of the transaction to cover losses due to fraud and an additional $0.01 for fraud prevention. Additional rules include that the issuers must ensure that each debit card can be processed on at least two unaffiliated networks. Also, the choice of which network a transaction will route to is now decided by the merchant. Merchants can now impose a $10 minimum on credit card transactions (although not in California because state law prohibits merchants from doing this) and are allowed to give discounts to those who pay cash or debit cards.

[21] Electronic Transactions Association Letter to Congressional Leadership, January 27, 2014. Available at http://www.electran.org/wp-content/uploads/ETA-Card-Security-Hill-Letter.pdf

The final rule only applies to banks with over $10 billion in assets. Banks under the $10 billion threshold are still bound by the merchant routing and network exclusivity rules. In August, 2013, U.S. District Court Judge Richard Leon who sits on the District Court for the District of Columbia overturned the Federal Reserve's ruling of the Durbin Amendment.[22] He concluded the Fed had included costs of debit card issuing in its calculation of the cap which Congress did not intend for in the Durbin Amendment. Judge Leon's decision has been stayed pending a higher court deciding an appeal brought by the Federal Reserve which might not be decide before June, 2014. The appeal will be heard by the U.S. Circuit Court of Appeals for the District of Columbia. The plaintiffs in the case are: the National Retail Federation, NACS (a trade group for convenience stores); the Food Marketing Institute; Miller Oil Co.; Boscov's Department Store LLC; and the National Restaurant Association.

The history of the Durbin Amendment reveals significant disagreements between merchants and the card networks, including financial institutions. Merchants have fought to lower the amount of interchange that they pay and have argued is inherently unfair, while financial institutions argue that interchange revenue is a vital source of anti-fraud revenue. Specifically, community banks and credit unions argue that interchange revenue allows for the quick reissue of customer credit and debit cards when fraud occurs and that the fees cover other fraud losses incurred by financial institutions but that have resulted from problems at the merchant's end of the transaction. While this fight is not always clear in regards to the aftermath of the recent mega data breaches, the way in which entities in the payments market attempt to prevent future events will be influenced heavily by the Durbin amendment debate. The sides of this conflict are best demonstrated through a recent exchange between the National Retail Federal (NRF) and the Independent Community Bankers of America (ICBA). On January 21, 2014 the NRF sent a letter[23] to Congressional leaders that, among other things, stated:

> *For years, banks have continued to issue fraud-prone magnetic stripe cards to U.S. customers, putting sensitive financial information at risk*

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[22] NACS v. Board, No. 11-02075, Mem. Op. Jul. 31, 2013

[23] Letter available at http://www.nrf.com/modules.php?name=Documents&op=showlivedoc&sp_id=7794

while simultaneously touting the security benefits of next-generation PIN and Chip card technology for customers in Europe and dozens of other markets.

On January 22, 2014 ICBA responded with a press release[24] that stated:

> *The NRF should focus its attention on responding to the harm that security breaches at several retailers have done to consumers and their financial institutions rather than hurling false allegations blaming the banking industry for these retail breaches," ICBA President and CEO Camden R. Fine said. "Retailers and their processors—not banks—are responsible for the systems in their stores that process payment cards. ICBA hopes that the massive retail security breaches at Target, Neiman Marcus and others will spur retailers to adopt security solutions going forward." Nearly every retailer security breach in recent memory has revealed some violation of industry security agreements. In some cases, retailers haven't even had technology in place to alert them to the breach intrusion, and third parties, like banks, have had to notify the retailers that their information has been compromised.*

Federal Law Relating to Payment Security

Federal Gramm-Leach Bliley Act

The Gramm-Leach-Bliley Act (GLBA) was enacted in 1999. The law requires financial institutions – companies that offer consumers financial products or services like loans, financial or investment advice, or insurance – to explain their information-sharing practices to their customers and to safeguard sensitive data. The law does not apply to information collected in business or commercial activities. Whether a financial institution discloses non-public information or not, they must have a policy in place to protect the information from foreseeable threats in security and data integrity. Three main components of the law are the financial privacy rule, the safeguards rule, and the pretext rule.

The financial privacy rule requires financial institutions to provide each consumer with a privacy notice at the time the consumer relationship is established and annually thereafter. The safeguards rule requires financial institutions to develop a written information security plan that describes how

[24] Press release available at http://www.icba.org/news/newsreleasedetail.cfm?ItemNumber=177385

the company is prepared for, and plans to continue to protect clients' nonpublic personal information. The privacy notice must be clear, conspicuous, and accurate statement of the company's privacy practices. Customers have to right to opt-out from having their information shared with certain third parties. GLBA does not apply standards of care to merchants or non-financial entities that may hold or transmit consumer payment data and other personal information

The Federal Trade Commission Act: Section 5

Section 5 of the Federal Trade Commission Act (FTC Act) (15 USC 45) prohibits ''unfair or deceptive acts or practices in or affecting commerce.'' The prohibition applies to all persons engaged in commerce, including banks.

An act or practice is unfair where it:

- Causes or is likely to cause substantial injury to consumers,
- Cannot be reasonably avoided by consumers; and,
- Is not outweighed by countervailing benefits to consumers or to competition.

An act or practice is deceptive where:

- A representation, omission, or practice misleads or is likely to mislead the consumer;
- A consumer's interpretation of the representation, omission, or practice is considered reasonable under the circumstances; and,
- The misleading representation, omission, or practice is material.

The FTC uses Section 5 as a means to bring action in the world of privacy and data security since the federal government lacks in the area of data security regulation. Although, there is no clear data security regulation, the

FTC can bring action under other various regulations such as the Children's Online Privacy Protection Act, the Fair Credit Reporting Act, including the Disposal rule, the Graham-Leach-Bliley Act, and the Telemarketing and Consumer Fraud and Abuse Act.

In addition, since 2010, the FTC has considered whether to give consumers a "Do Not Track" option that allows them to opt out of websites collecting information about their online activity, similar to the FTC's Do Not Call Registry, which allows consumers to opt out of most telemarketing calls.

Cardholder Liability Protection

The **Truth in Lending Act (TILA)** (15 U.S.C. 1601 et seq.) limits consumer liability to $50 if the credit card is lost, stolen, or used without the cardholders authorization, and it prohibits the unsolicited issuance of credit cards.

The Electronic Fund Transfer Act (EFTA) (15 USC 1693 et seq.) specifies that a debit card holder is not liable for any charges, if the loss or theft of the debit card is reported to the customers bank immediately and the card has not been used. If notification to the bank occurs within two business days, the consumer could be liable for up to $50. On day three, liability jumps to $500. After 60 days if the unauthorized use is not reported the customer is 100% liable.

In the case of both credit and debit cards most financial institutions have zero liability policies when card data has been compromised and it is clear that the cardholder is not at fault. However, these are policies and no force of law.

Federal 2014 Legislative Prospects

- Senator Patrick Leahy reintroduced the Personal Data Privacy and Security Act of 2014. This bill was originally introduced in 2005 because "security breaches are a serious threat to consumer confidence, homeland security, national security, e-commerce, and economic stability" and has been reintroduced in each of the last four sessions of Congress. The bill would establish a national standard for data breach notification, and require businesses to safeguard personal information from cyber threats. Under the legislation covered entities are required to provide notice to the Federal Bureau of Investigation or the United States Secret Service of "major" security breaches of "sensitive personally identifiable information."

- Senators Tim Carper and Roy Blunt introduced the Data Security Act, legislation that would require companies that accept credit cards to have information security plans aimed at protecting data and incident response plans to address what steps must be taken in the event a breach occurs. The legislation also contains a notification provision which would require companies to notify affected customers and federal authorities in the event of a breach and to provide credit monitoring services if over 5,000 customers are affected.

California Law

California enacted a data breach notification law in 2003, the first-in-the nation. (Civil Code sections, 1798.29 and 1798.82.) Since 2003, all but four states have enacted similar security breach notification laws. California's security breach notification statute requires state agencies and businesses to notify residents when the security of their personal information is breached. That notification ensures that residents are aware of the breach and allows them to take appropriate actions to mitigate or prevent potential financial losses due to fraudulent activity, as well as to limit the potential dissemination of personal information.

To be more specific, existing law requires any person or business that conducts business in California, and any state agency, that owns or licenses "computerized data" including personal information to notify any resident of California whose personal information was, or is reasonably believed to have been, acquired by an unauthorized person as the result of a breach of security. The type of personal information that triggers the requirement to notify individuals is unencrypted, computerized information, consisting of an individual's name, plus one of the following: Social Security number; driver's license or California Identification Card number; financial account number, including credit or debit card number (along with any PIN or other access code where required for access to the account); medical information (any information regarding an individual's medical history, condition, or treatment); and health insurance information (policy or subscriber number or other identifier used by a health insurer, information about an individual's application, claims history or appeals), or a user name or email address, in combination with a password or security questions and answer that would permit access to an online account.

Notice must be given to individuals "in the most expedient time possible and without unreasonable delay." Notice to individuals may be delayed if a law enforcement agency determines that notification would impede a criminal investigation or in order to take measures necessary to determine the scope of the breach and restore reasonable integrity to the system. An entity that maintains the data but does not own it must notify the data owner immediately following discovery of a breach.

Privacy as a fundamental right in California

According to section 1, article I of the California Constitution. The Legislature has expressly codified that:

1) The right to privacy is being threatened by the indiscriminate collection, maintenance, and dissemination of personal information *and the lack of effective laws and legal remedies*.

2) The increasing use of computers and other sophisticated information technology has greatly magnified the potential risk to individual privacy that can occur from the maintenance of personal information.

3) In order to protect the privacy of individuals, it is necessary that the maintenance and dissemination of personal information be subject to strict limits.