

# REENGINEERING NONBANK SUPERVISION

## Chapter Six: Overview of Nonbank Consumer Finance

FEBRUARY 2020



## About This Paper

This paper, *Reengineering Nonbank Supervision*, serves two primary purposes. First, as a stakeholder awareness document covering state supervision of the nonbank marketplace, and second, as a change document or roadmap to assist state supervisors in identifying the current state of supervision and making informed changes to state supervisory processes. The paper is comprised of several standalone chapters that together will cover the industry supervised by state nonbank financial regulators, the existing system of supervision for nonbanks and the challenges and opportunities for state supervisors in “reengineering” that system.

The chapters provide a broad overview of the industry participants and how they are regulated by state nonbank supervisors. We combine these sometimes unlike participants into a single industry of nonbanks due more to jurisdictional coverage and supervisory constructs than similarities between the participants themselves. The common theme is that all of these participants provide or facilitate consumer products and services and fall under the authorities granted to nonbank supervisors.

State financial regulators are the primary regulators of nonbanks operating within the United States. Together, they have forged a series of initiatives, collectively known as [CSBS Vision 2020](#), to modernize nonbank licensing and supervision. This paper contributes research and engages discussion on possible actions that might be taken.

Chapters to date:

- Chapter 1 – Introduction to the Nonbank Industry
- Chapter 2 – Overview of State Nonbank Supervision
- Chapter 3 – Overview of Nonbank Mortgage
- Chapter 4 – Overview of Money Services Businesses
- Chapter 5 – Overview of Debt Collection and Relief

CSBS has established a webpage – found [here](#) -- containing all published chapters.

## Acknowledgements

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**Comments and questions on the content of this paper can be directed to:** Chuck Cross, CSBS Senior Vice President of Nonbank Supervision and Enforcement, [ccross@csbs.org](mailto:ccross@csbs.org)

**Media contacts:** Jim Kurtzke, CSBS Vice President of Communications, [jkurtzke@csbs.org](mailto:jkurtzke@csbs.org)

## Chapter Six

# Overview of Nonbank Consumer Finance

While the term “consumer finance” can be a very broad reference to any financial transaction involving a consumer, for the purposes of this white paper, consumer finance or consumer lending will be discussed narrowly as a subset of financial services companies that are not mortgage lenders.<sup>1</sup> Even with this narrowed coverage, consumer finance is one of the broader categories of industries within the nonbank marketplace. It includes companies that make consumer loans (secured and unsecured) for personal, family or household purposes, including personal loans, auto loans and student loans; as well as consumer lending companies that provide small dollar credit, which includes payday loans, and vehicle title loans, a class of high-interest credit secured by the borrower’s vehicle title. Consumer finance also includes retail installment sales contracts that may or may not be considered loans depending on state law. The categories of consumer loans can be complex as state law and licensing requirements may include any or all these loans in a master consumer finance law, or in separate laws covering each loan type individually.

### Key Findings

- Outstanding student loan balances are estimated at \$1.6 trillion owed by approximately 45 million consumers.
- Personal loan balances (secured and unsecured credit combined) were at an all-time high of over \$305 billion mid-year 2019, a growth of 46% in the last four years.
- Millennials have the highest level of debt overall (avg. \$134,323), and Baby Boomers carry the second highest level (avg. \$95,095).
- Spurred by fintech online loans, outstanding unsecured personal loan balances increased to \$148 billion in the second quarter of 2019, up 222% from 2012.
- While there are no national reporting standards or requirements for consumer finance companies, CSBS is in the early stages of developing a call report, or periodic filing widely used by financial regulators, that would be deployed through NMLS.

In addition to the company types or products identified above, consumer finance can be marketed and provided to borrowers in a variety of ways: physical retail locations; over the phone; through the mail; online via the Internet; and, mobile device apps. The repayment structure of loans is relevant as well; bifurcated into categories of installment (equal payments over time) and single pay, as well as single pay that become installment loans. In this chapter we briefly address some of the marketing (e.g., lead generators), delivery mechanisms and other products that may be considered a part of Consumer

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<sup>1</sup> This distinction is not necessarily consistent with state law where second mortgage loans are often covered under the state’s consumer lending law. For this paper we cover second mortgages in Chapter Three – Overview of Nonbank Mortgage.

Finance, however, we are primarily concerned with five product types in four categories, plus online and fintech as delivery systems for each of these products:

- Personal loans
- Auto loans
- Student loans
- Small dollar credit
  - Payday loans
  - Vehicle title loans
- Online and Fintech lending

Consumer lending is the practice in which money is lent to an individual (secured and unsecured) for personal, family or household purposes, also known as consumptive debt. Frequently, these loans will be repaid in installments, but popular products like payday loans may be structured with a single large payment due in a very short period of time (e.g., two weeks).

Although nonbank consumer finance products are sometimes referenced as an alternative for “unbanked” consumers, “banked” customers also rely on consumer finance companies to meet their credit needs (note that a requirement of a payday loan and online lending is that the borrower have a checking account). Many consumers may use multiple financial products simultaneously. As stated previously, a consumer must have a bank account, as well as a paying job, in order to take out a payday loan. Often these consumers will also have a credit card issued by a “traditional” financial services provider. So why would a consumer choose to take out a costly payday loan rather than use a lower interest rate credit card? University of Pennsylvania professor Lisa Servon in *The Unbanking of America* explains, “The shrinkage of credit has also caused people to juggle their available credit and use payday loans in ways that would seem counterintuitive without complete knowledge of individuals’ situations. For example, some people who take out payday loans also have credit cards that are not maxed out.” She explains that the credit card may be held as a “safety net” for these consumers and that “... failure to repay a payday loan won’t affect a consumer’s credit score, [but] failure to repay a credit card will.”

Small dollar credit includes payday and vehicle title loans, with loans often less than \$5,000. Small dollar credit may be provided online or through brokers (lead generators) marketing on the internet. Typically, these loans will be repaid in a single payment that

## UNBANKED OR UNDERBANKED

According to the FDIC’s National Survey of Unbanked and Underbanked Households, “unbanked” means that no one in the household has a checking or savings account and a household is categorized as underbanked if it had a checking or savings account and used one of the following products or services from an alternative financial services provider in the past 12 months: money orders, check cashing, international remittances, payday loans, refund anticipation loans, rent-to-own services, pawn shop loans, or auto title loans. (<https://www.fdic.gov/householdsurvey/>)

includes both the borrowed amount and the fee or interest. An estimated 15 million people annually use these products to meet their financial needs (Center for Financial Services Innovation, n.d.).

Vehicle title lending, or title lending, is a short-term, high cost loan that is secured by the title to the borrower's vehicle and payable in single or multiple installments. Vehicle title lending is not auto lending. As discussed below, vehicle title lending is supervised by less than half of the state financial regulators.

Online lending or fintech lending is the delivery mechanism for both single payment and installment products. When consumers conduct online searches for loans, lead generators or brokers send consumers to companies offering loan products in the consumer's state.

## Other Products

The following products are addressed briefly here due to their close association with small dollar or consumer finance credit:

Pawn loans are small loans made against personal property. While rates, fees and recordkeeping for pawnshops are set by state law, licensing and oversight of pawnbrokers in many states is handled at the county or municipal level rather than the state level and therefore are not covered in this white paper.

Check cashing is the cashing of a third-party check for a fee. Like a payday loan, a cashed check makes funds available immediately. However, similarities to a loan end there. There is no interest rate or calculated annual percentage rate (APR); the service is based on a third-party's promise, the transaction is not repaid directly by the consumer, and the transaction is not covered under the Truth in Lending Act, which governs all consumer credit. However, separating check cashing from consumer finance does not have absolute clarity. According to HG Legal Services, "Check cashing is a more traditional form of very short-term loan. Some institutions will allow you to write a check to that entity and receive cash. This is a sort of throwback to a time when more transactions took place at the register via check."<sup>2</sup> In fact, the state of Washington requires payday lenders to first hold a check casher license before receiving an "endorsement" to conduct payday lending (RCW 31.45.073).

However, check cashing is identified as a money services business (MSB) by the federal Financial Crimes Enforcement Network and is reported as an MSB in the Nationwide Multistate Licensing System MSB Call Report. Therefore, we include our coverage of check cashing in Chapter Four – Overview of Money Services Business.

Retail installment sales contracts are treated differently state by state and may or may not be considered loans or credit depending on state law. In a retail installment sale, the consumer enters into an agreement for a good or service (e.g., a refrigerator or a car), where the price of the good or service is repaid in installments. The repaid amount typically exceeds the purchase price of the item; however, the treatment of the difference between the item's price and the amount repaid again depends on state law and in some states is controlled by whether the retail installment sales contract is made by the

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<sup>2</sup> <https://www.hg.org/legal-articles/what-are-the-laws-regarding-check-cashing-and-payday-advances-35466>



retailer (e.g., an appliance store) or a third party provider of credit. Examples of how states handle retail installments sales differently follow.<sup>3</sup>

In states where a retail installment sales contract is not considered a loan, the borrower is paying more for the good or service in exchange for the ability to pay it off over time. Although the difference may appear as fees or interest, in these states the amount is not considered a finance charge, but rather a difference in price for the opportunity to obtain the purchased item now and make payments over time. In these states, the financial regulator may or may not have jurisdiction.<sup>4</sup> Examples of states that fall into this category are Montana (with jurisdiction if the retailer is the one that either keeps the contract or sells it to a holder in due course, but the contract is not a loan); and Washington (without jurisdiction).

Contracts that states consider as loans will typically fall under a consumer finance or consumer credit law, and the financial regulator may have jurisdiction. Here, the difference between the actual cost of the good or service and the amount repaid may be considered interest or finance charge on the contract, and the state would have the ability to review the product as a consumer loan. States that fall into this category include Florida, New Jersey and sometimes Wyoming, if the transaction meets certain tests.

Some states, such as Montana and North Dakota, only consider the contracts to be loans when they are made by a third party that is not the retailer. In these situations, the state financial regulator would typically have jurisdiction.

A final category includes states where retail installment sales are considered loans or credit, but the state financial regulator has no jurisdiction. In these states the attorney general would be the default government authority for consumer protection purposes, however, the industry would not be considered “supervised” and for the most part, a consumer’s recourse would lie primarily through the civil court process. Examples of states in this category are Georgia and Iowa (but the regulator gains jurisdiction when the contract is acquired by a licensee).

Compounding the understanding of retail installment sales are nuances in individual state laws. For example, New Hampshire considers the transaction to be a loan if financing, even at 0%, is offered. This consideration holds even in situations where the seller of the product is making the contract. However, that same retailer, if not offering financing would not be considered to have made a loan, but rather a credit sale. Either way, the financial regulator has jurisdiction to investigate but not examine.

In several states, an interpretation can be made that the transaction fits under the code administered by the state financial regulator, however, the regulator has not historically examined the retailer or the transactions but may investigate consumer complaints. These differences in state law, coverage,

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<sup>3</sup> These examples may not take into consideration all nuances of state law and should not be relied on for any licensing or legal purposes.

<sup>4</sup> Lack of financial regulator jurisdiction does not mean that state law is ignored or unenforced. As discussed in Chapter Two – Overview of State Nonbank Supervision, the state attorney general will typically hold enforcement authority wherever a law does not assign specific coverage.

jurisdiction and interpretation make understanding this area of consumer finance a complicated undertaking.

Retail installment sales contracts are covered by the federal Truth in Lending Act and the Equal Credit Opportunity Act (although not necessarily included under state law), as well as state laws governing the contracts specifically. While they are an important part of the history of consumer finance (see History below), given the myriad of differences and the need for further analysis, an in-depth discussion of retail installment sales contracts is not provided in this chapter.

## Products Claiming Not to Be Credit and/or Claiming Exemption from State Licensing

Finally, there is an increasing category of products that arguably fall into the category of consumer finance but are so new that state law applicability has yet to be determined or state regulatory policy yet to be developed. Frequently, the providers of these products claim that their product or service is not a loan or credit, and therefore is exempt from regulatory requirements. These products include:

Earned income advance mechanisms. Several payment products have emerged in recent years that provide consumers with immediate access to their wages. This burgeoning industry has come to be known generically as the payroll advance industry. While multiple names and descriptions exist across the industry, these products all perform the same function. Earned income advance providers fall under two broad business models: employer integrated or direct to consumer.

**Employer integrated:** Companies work with the providers and then market the product to their employees. If an employee opts to participate in this program, then the employer shares all necessary information with the earned income advance provider. Next, the provider funds the requested advance and subsequently deducts the amount from the employee's next paycheck. In some cases, the employer administers this last step as well, simply using the product as a platform to transfer the funds.

**Direct to consumer:** This model removes the employer from the process. Thus, any employee seeking earned wages before a scheduled pay period can access these services regardless of their company's participation. Once an employee submits the required information, he or she requests the wage advance directly from the provider. The provider then funds the advance and collects it by debiting the employee's bank account on the next payday (this model is similar to and often appears to be a nuanced variant of payday lending).

Under both models, providers require some sort of payment for consumers to use the product. This payment comes in the form of monthly subscription costs, transaction fees, or voluntary "tips." Some providers even offer multiple expedencies to receive the advance with the quickest option costing the most. Additionally, many providers incorporate an overdraft prevention process into their system that charges a fee upon use.

Property Assessed Clean Energy financing: According to Investopedia, a Property Assessed Clean Energy (PACE) loan is a type of financing that's available for energy-efficient upgrades or the installation of renewable energy sources for commercial, industrial and private residential properties. Launched in 2010, the PACE Program, which is overseen by the U.S. Department of Energy, allows local and state

governments, as well as inter-jurisdictional authorities authorized by state law, to provide funding for the cost of energy improvements on qualifying properties. This money is then repaid over time by the property owner. PACE loans are offered through private contractors but are secured by a property tax lien and are collected through the tax bill. Many localities fund the program by issuing bonds linked to homeowner tax payments. These bonds are then sold to a private company that securitizes them and sells them on Wall Street. The local government often receives a fee for participating (National Consumer Law Center). In terms of size, the residential PACE loan market (R-PACE) is estimated at over \$5 billion and may be the fastest growing segment of the U.S. lending industry. As of December 2019, however, residential PACE financing is available only in California, Florida, Minnesota and Missouri.<sup>5</sup>

Income Sharing Agreements: Income-share agreements (ISAs) are advances to students that use alternative criteria, such as the student's major and GPA, to underwrite the "loans" in exchange for a percentage of the student's earnings for a specified number of years after the student graduates from college (NCLC). Under the agreement, the student promises to make monthly payments following completion of the education program based on a percent of gross income.

Shared Appreciation Home Financing: Shared appreciation home finance products use data and algorithms to offer quick access to home equity by purchasing a fractional share of the home that is repurchased, along with any appreciation (or depreciation), when the term expires, the home is sold, or upon certain other events. (NCLC)

Rent-a-Bank Charter: The payday lending rent-a-bank model is not new and all but disappeared under bank regulator scrutiny more than a decade ago.<sup>6</sup> In recent years, the model has seen a resurgence with payday lenders and marketplace or online lenders using fintech models to reach wider audiences.

According to the *Wall Street Journal*: "The lender-bank partnerships are sometimes known as "rent-a-charter," since the lender pays the bank to take on its status as a national financial institution not subject to state usury laws that cap interest rates. The bank reviews the credit policies submitted by its online partner, then uses its capital to fund each loan until an investor ultimately takes it over. The whole process typically takes a day or two. Some experts argue rent-a-charter arrangements reduce risk. Taxpayers aren't in danger of being on the hook if a loan fails, while borrowers are given wider access to credit even if banks don't want to take risks." (Source: <https://www.wsj.com/articles/greater-scrutiny-looms-for-bank-online-lender-rent-a-charter-deals-1471824803>)

While clearly credit, under this model, the consumer finance company often claims exemption from state licensing and or usury limits through federal preemption of state law. In a rent-a-bank charter arrangement, the consumer finance company typically markets the loan and sources customers, makes underwriting decisions, services and administers the loan, handles all communications, bears default risk and collects most of the profits. For a fee, the bank technically makes the loan and then is contractually obligated to sell it to the consumer finance company or into the market immediately or very shortly

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<sup>5</sup> Note that both CA and MN require R-PACE lenders to be licensed through the NMLS. See: [https://nationwidelicencingsystem.org/slr/PublishedStateDocuments/CA\\_PACE\\_Company\\_New\\_App\\_Checklist.pdf](https://nationwidelicencingsystem.org/slr/PublishedStateDocuments/CA_PACE_Company_New_App_Checklist.pdf) and [https://mortgage.nationwidelicencingsystem.org/slr/PublishedStateDocuments/PACE\\_Company-New\\_App-Checklist.pdf](https://mortgage.nationwidelicencingsystem.org/slr/PublishedStateDocuments/PACE_Company-New_App-Checklist.pdf)

<sup>6</sup> Similar to rent-a-bank is the rent-a-tribe model discussed on page 14.



after origination. The consumer finance company essentially pays the bank to leverage its status as a depository institution not subject to state usury laws that cap rates. These arrangements can frustrate state regulators' ability to protect consumers even when state law prohibits or limits lending practices. However, some bank/nonbank relationships are established for legitimate purposes and are not primarily designed to evade state law.

The debate around rent-a-bank charter arrangements focuses on a bank's ability to legally "export" rates from one state to another, even if the rate is prohibited in the second state, and a legal concept known as the "true lender" doctrine. At its most elementary level, the true lender doctrine considers whether the entity making the loan is truly the lender by examining factors in the making of the loan. It is therefore understandable that a nonbank desiring to charge higher rates than allowed by state law would seek an arrangement with a bank identified as the lender in the transaction.

In an abstract published in the *George Washington Law Review* entitled "Crossing State Lines: The Trojan Horse Invasion of Rent-a-Bank and Rent-a-Tribe Schemes in Modern Usury Law," author Jayne Munger argues: For situations where another lender is using the bank as a front to claim the bank's exportation doctrine, however, the doctrine prevents borrowers from gaining any relief and instead promotes a legal fiction (<https://www.gwlr.org/wp-content/uploads/2019/04/87-Geo.-Wash.-L.-Rev.-468.pdf>).

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### THE TRUE LENDER DOCTRINE: FUNCTION OVER FORM AS A REASONABLE CONSTRAINT ON THE EXPORTATION OF INTEREST RATES JOHN HANNON

For the Duke Law Journal

The true lender test arose in the context of perhaps the most egregious extension of the ability to preempt state usury laws, wherein payday lenders and other nonbank entities have periodically obtained the benefits of the exportation doctrine by utilizing an arrangement commonly referred to as "rent-a-charter." In this model, a nonbank entity solicits borrowers, makes all the credit decisions, and directs a partner bank to originate its loans—only to purchase them from the bank within days. This use of a chartered bank as a conduit to originate loans thereby confers on the loans the full preemptive shield of the exportation doctrine. However, a series of courts have recently begun applying a more exacting level of scrutiny to these arrangements. Courts applying the true lender test disregard the form of the lending configuration in favor of a searching examination of its substance, considering a variety of factors designed to determine which entity is the actual lender. Only after making that determination will the courts decide whether the actual lender is entitled to the broad protections granted to chartered insured depository institutions.

(Source:

<https://scholarship.law.duke.edu/cgi/viewcontent.cgi?referer=&httpsredir=1&article=3934&context=dlj>)

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State regulators are not the only ones frustrated by these arrangements to avoid consumer protection

laws. State Attorneys General have filed actions against companies using the rent-a-bank model<sup>7</sup> and consumer advocacy groups are raising concerns about potentially new arrangements between banks and nonbanks designed to evade state law. On Nov. 18, 2019, the National Consumer Law Center stated, “Advocates reacted with outrage to a new proposal from two federal bank regulators that could make it easier for payday and other high-cost lenders to use banks as a fig leaf so that online lenders can offer predatory loans at interest rates that are prohibited under state law. Online lenders have become increasingly bold in using rent-a-bank schemes to offer loans up to 160% in states where their rates are illegal.” (Source: <https://www.nclc.org/media-center/fdic-occ-proposal-would-encourage-rent-a-bank-high-cost-predatory-lending.html>)

## History

The history of the consumer finance industry is convoluted and spans back to biblical times. The Bible contains many passages about “usury,” which translates to interest and today refers to unusually or illegally high rates of interest. Some theologians believe the Bible warned against charging interest on ANY loan, while others believe it forbids the modern-day practice of loan sharking, which charges borrowers exorbitant interest rates. It is important to understand usury and the beliefs and opinions around it because they form the underpinnings of modern-day prohibition and regulation of financial products.

In ancient times, pawn shops operated as businesses that offered short-term loans, backed by collateral. In 1812, New York City was the first in the United States to regulate pawn shops, curbing the practice of charging excessively high interest rates.

Fast forward 40 years, and sales financing was born.

The Singer Sewing Company offered installment credit so consumers could produce clothing from home. The salesman would come by weekly to collect payment, usually \$1 a week. By 1899, more than a half of furniture dealers in Boston used installment loans (Rhode, 2009). In 1904, Spiegel was the first company to offer credit through the mail for its catalog purchases.

In the late 1800s, small loan finance companies opened, but they were not legal businesses and did not comply with state usury laws. During this time, it was common for people to get short-term loans from these lenders.

Consumer lending became more prevalent in the early 1900s as consumers secured short-term loans from brokers who charged illegally high interest rates. The smaller the loan the higher the interest rate.

<sup>7</sup> <https://www.natlawreview.com/article/marketplace-lending-update-4-litigation-mounts-to-new-highs-colorado-securitizations>

## USURY RATE

Most states have established a usury rate that cannot be exceeded unless an entity is specifically excepted or exempt from the usury statute. State laws establishing legal loan rates vary from 5% to 30%. Consumer loans and legalized payday and vehicle title loans enjoy exemptions from state usury limits provided the entity is licensed to conduct the authorized business. However, a license in one state does not provide a lender the authority to “export” its rates to another state. The lender must be appropriately licensed in each state where its loans exceed the rate of usury.

Financing was based on the consumer's reputation in the community. Because these loans were unsecured, meaning they existed without material collateral, they would leave the lender unprotected if the borrower did not pay. Ironically, borrowers and lenders were simultaneously fighting for protection.

Massachusetts was ahead of its time and passed the first act to regulate consumer finance companies in 1911 as a result of loan sharking. Other laws would follow.

According to the FDIC, the bank share of consumer credit—loans to consumers that are not backed by real estate—fell from the late 1980s to the early 2000s because of securitization. Starting in the late 1980s, asset backed securities (ABS) created from credit card debt, auto loans and private student loans became widely used. The bank share of consumer credit fell from 52% in fourth quarter 1990 to 35% in fourth quarter 2000. Due to accounting changes bank levels returned to 49%; however, in 2010, the federal government stopped subsidizing private lenders to make student loans and instead originates all federally subsidized loans itself. This shift caused another decline in the bank share of consumer credit because only the federal government can make federally subsidized student loans. If student loans continue to grow faster than other forms of consumer credit, the bank share of consumer credit may continue to decline. In 2018, the bank share of non-mortgage consumer credit stood at 42% (<https://www.fdic.gov/bank/analytical/quarterly/2019-vol13-4/fdic-v13n4-3q2019-article1.pdf>).

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### The Pew Charitable Trusts

A hundred years ago, when a mass market for consumer credit did not yet exist, underground purveyors of consumer credit began to emerge, and a variety of problems ensued. "Salary lenders" offered one-week loans at annual percentage rates (APRs) of 120 percent to 500 percent, which are similar to those charged by payday lenders today. To induce repayment, these illegal lenders used wage garnishment, public embarrassment or "bawling out," extortion and, especially, the threat of job loss.

State policy makers undertook an effort to suppress salary lending while also seeking to facilitate the expansion of consumer credit from licensed lenders. One key change was a targeted exception to the traditional usury interest rate cap for small loans (all original colonies and states capped interest rates in the range of 6 percent per year). The 1916 publication of the first Uniform Small Loan Law permitted up to 3.5 percent monthly interest on loans of \$300 or less. Two-thirds of states adopted some version of this law, authorizing annualized interest rates from 18 to 42 percent, depending on the state. Subsequently, a market for installment lenders and personal finance companies developed to serve consumer demand for small-dollar credit. (Pew Trusts, 2012)

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Car loans came onto the scene in 1919 when General Motors created General Motors Acceptance Corporation (GMAC) and pioneered motor vehicle sales financing. In the 1920s, banks entered the consumer lending space; finance companies were operating with licenses in some states, and a free market economy of consumer finance had been established. In 1923, the Uniform Small Loan Law allowed state licensed lenders to charge much higher interest rates than those allowed by most state usury laws. (The University of Chicago Law Review, December 1944, The Future of Small Loan Legislation, George G. Bogert)

The Great Depression hit in 1929, paralyzing consumer spending. As a result, the New Deal introduced several Acts to expand credit and spur the economy. According to Pew, “[B]y the middle of the 20th century, a mass-market consumer financial industry was emerging. Consumers were gaining access to a wide range of credit products, including mortgages to purchase homes and credit cards to purchase goods and smooth household consumption. State laws started to become inadequate to regulate national lenders. A series of federal banking-law developments in the 1970s and 1980s eased regulations on federally insured depositories, mortgage lenders, credit card lenders, and other financial companies, giving them broad rights to disregard state usury interest laws. As this deregulation proceeded, some state legislatures sought to act in kind for state-based lenders by authorizing deferred presentment transactions (loans made against a post-dated check) and triple-digit APRs. These developments set the stage for state-licensed payday lending stores to flourish. From the early 1990s through the first part of the 21st century, the payday lending industry grew exponentially.”

How do credit cards fit into the history of consumer finance? Credit cards are an important part of the history of consumer finance, but since credit cards are issued by banks and credit unions, they are not under the supervision of nonbank regulators. But a history of consumer finance is not complete without at least a nod to credit cards.

## SHORT HISTORY OF CREDIT CARDS

- **1800s** merchants would use credit coins and charge plates to extend credit to local farmers and ranchers, allowing them to forgo paying their bills until they harvested their crops or sold their cattle.
- **Early 1900s** department store cards became the precursor to modern-day store cards, acceptable only at that merchant.
- **1946** Brooklyn banker John Biggins launched the Charg-It card. Charg-It purchases were forwarded to Biggins' bank, the middleman that reimbursed the merchant and obtained payment from the customer in what came to be known as the "closed-loop" system. Purchases could only be made locally and only bank customers could obtain a Charg-It card.
- **1950** Diners Club Card debuted, inspired by a forgotten wallet at a business dinner.
- **1959** American Express launched the first plastic credit card. Within 5 years 1 million cards were in use at 85,000 merchants worldwide. Around the same time, major banks issued the first revolving credit cards, where the balance did not have to be paid each month. (CreditCards.com, n.d.)
- **2019** credit-card loans crossed the \$1 trillion mark, reaching \$1.08-trillion in Q3 of 2019. (Debt.org, n.d.)

Other areas of consumer lending were born to serve specific consumer groups. For instance, in 2003, the Tribal Lending model was created for Indian tribes to form tribal lending entities (TLE) that are financed by a third-party. The TLE can loan to tribal and non-tribal members, usually on terms that are unlawful under the internal laws of the states where the borrowers reside. The tribes often profess that they are immune from state lending laws and interest rate caps and cannot be sued. This belief has been challenged several times by state and federal regulators, as well as private litigators challenging tribal lending as a variant of the rent-a-bank model to originate payday and other personal loans across the country at rates above what state law would otherwise permit.<sup>89</sup>

<sup>8</sup> <https://www.consumerfinance.gov/about-us/newsroom/cfpb-sues-cashcall-for-illegal-online-loan-servicing/>

<sup>9</sup> <https://portal.ct.gov/DOB/Enforcement/Consumer-Credit-2017-Orders/Great-Plains-Lending-et-al--Restated-Order-and-Ruling-on-Motion-to-Dismiss>



## IS TRIBAL LENDING IMMUNE FROM STATE LAW?

According to Pew, some state regulators argue that Internet lenders who charge interest rates that exceed a state's usury rate are breaking the law. Authorities have typically targeted such problematic Internet lending through enforcement actions, and the issue of tribal-based lending has found its way into the courts. The case against CashCall (and partner company Western Sky) was important not only for the CFPB, but also for states: It was one of the largest examples of multistate actions against online lending companies, and at least 20 states have brought civil or administrative actions, including Arkansas, Colorado, Connecticut, Florida, Georgia, Illinois, Iowa, Kansas, Maryland, Massachusetts, Michigan, Minnesota, Missouri, New Hampshire, New York, North Carolina, Oregon, Pennsylvania, Washington, and West Virginia. Many courts and regulators have found the lenders violated state law, and that sovereign immunity—in cases involving tribal-based lending—did not apply.

In other tribal lending cases in California and New York, the judges issued differing opinions. In California, the court ruled that sovereign immunity applies to a tribal lender—meaning the tribe is allowed to lend to California residents. In New York, the judge held that sovereign immunity did not apply because the activity took place off of tribal lands, and therefore the loans were considered illegal. Other states have also upheld this view and pursued cases, noting that state law applies if the borrower is a resident of that state, irrespective of where the lender is located or incorporated. (Pew Trusts, 2015)

The Talent-Nelson Military Lending Act (MLA) was passed in 2006 to protect active duty military members, their spouses, and their dependents from certain lending practices, including high cost payday lending. The MLA caps the APR on consumer loans at 36%. The MLA was expanded in 2016 to include almost all forms of credit within the Truth in Lending Act's scope, other than residential mortgages and purchase money loans, so that this wider range of creditors is prohibited from charging more than 36% interest or requiring consumers to submit their disputes to arbitration. Notably, MLA coverage is expanded to include credit cards and other forms of open-end credit to stop creditor attempts to structure credit to evade the prior MLA definition of consumer credit (Source: National Consumer Law Center, July 23, 2015).

## Consumer Lending Process

Over time, consumer information was collected by hundreds of credit bureaus and exchanges across the country. Loans were based on a credit score which rated the consumer's ability to repay, how long they had been in their home and what type of job they held. But lenders were limited in data collection by credit bureau reports, i.e. payment history and amount of debt.

Today, the credit score process is much more analytical, based on a plethora of data. Many companies incorporate their own models, as well. There can be 200 data points used to evaluate a consumer based on a reputation algorithm. Now, social media data is being added to the process.

In the end, predictability of repayment is the basis of consumer lending. This has led the industry to develop risk-based pricing, offering consumers different interest rates or other loan terms, based on the estimated risk that the consumers will fail to pay back their loans. Avoiding loan default is key, especially when you consider the amount of consumer debt, including credit cards, auto loans, student loans and personal loans, [was] on pace to top \$4 trillion in 2019 (Andriotis, 2018).

Compared to home lending, consumer lending is a relatively simple process. Borrowers either visit a retail branch location physically or do so virtually through the internet or an app. The process involves an application requiring current and historical personal information, employment information, bank account information, the borrower's assets and liabilities (debt), and frequently the purpose for the loan. The information is verified, credit is checked and consumers are identified into categories of borrowing possibilities (e.g., prime versus nonprime). Once approved, the consumer has full access to the borrowed funds. Compared to the home purchase or refinance, the consumer loan process from application to funds received is quick and efficient, often occurring within hours or days.

## Personal Loans

Personal loans, also called signature loans, may be secured or unsecured. They are frequently made for amounts ranging from \$1,500 to \$30,000 and for periods of time ranging from two years to five years with payments due monthly. Common interest rates range from an annual percentage rate of around 16% to 36%, with interest calculated based on number of days between payments (daily simple interest using a 365-day year) as opposed to amortizing the principal using monthly simple interest and a 30-day month and 360-day year (the "30/360" method typical in first lien mortgage loans).

There are risks to borrowers in using the daily simple interest method that can result in application of funds primarily to interest with little to none applied to pay down the loan balance when payments are missed. It is not unusual for maturity dates to extend indefinitely on certain daily simple interest loans until the extra payment is made to cover unpaid principal and any accrued but unpaid interest.

Personal loan installment payments are made (usually monthly) over a period of time until the loan and interest are repaid in full. Installment loans can be made as fixed rate (rate and payments do not change) or adjustable rate loans. An example 2-year, 4.5% fixed rate loan for \$2,500 would have 24 monthly payments of \$109.12.

While we do not yet have national level regulatory data on the nonbank personal loan market,<sup>10</sup> analysis by credit bureaus Experian and TransUnion provide useful data on the market.

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<sup>10</sup> State regulatory data relies on call reports through the NMLS. A consumer finance call report is currently in development.

The graph below shows that personal loan balances (secured and unsecured credit combined) was at an all-time high of over \$305 billion mid-year 2019, a growth of 46% in the last four years.

### Total Personal Loan Balances in the U.S.



Source: Experian data from Q2 of each year

According to Experian, personal loans continue to hold their place as the fastest-growing debt category in the U.S. — double the growth of credit card debt, the next-highest category.

#### Demographics

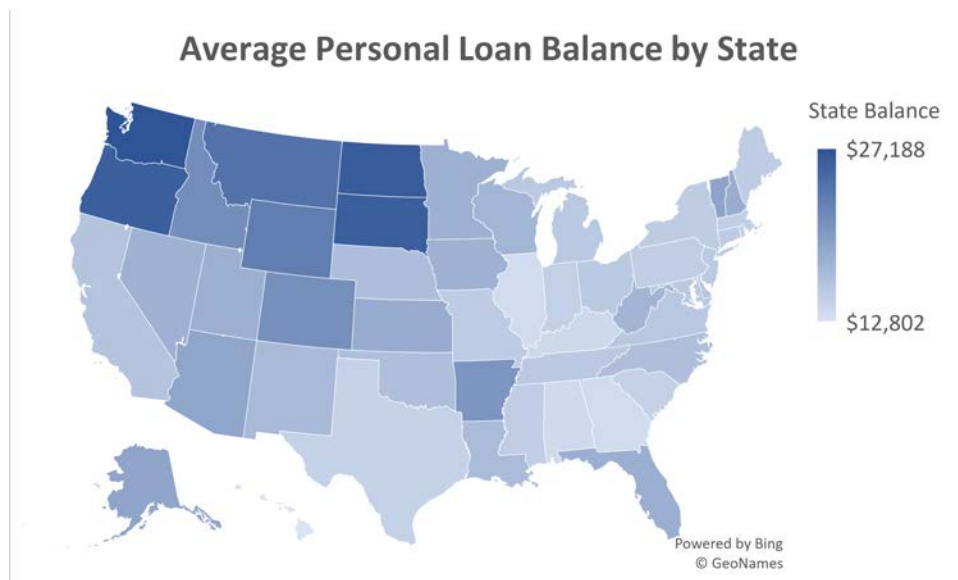
Baby boomers (1946 – 1964) carry the second highest level of debt overall (avg. \$95,095) and have the highest level of personal loan debt (avg. \$19,253). Millennials (1980 – 1994) have the highest level of debt overall (avg. \$134,323), but the second highest level of personal debt (avg. \$17,175). (source: Experian)

Personal Loan Snapshot	
Average Personal Loan Balance	\$16,259
Average Monthly Payment	\$360
Average Annual Percentage Rate (APR)	9.41%
Number of Outstanding Personal Loan Accounts	38.4 million
Number of New Personal Loan Accounts	6.8 million
Percentage of Consumers with a Personal Loan	11%
Existing Personal Loan Debt	\$305 billion

(Source: Experian Oct. 24, 2019 <https://www.experian.com/blogs/ask-experian/research/personal-loan-study/>)

**Geographics**

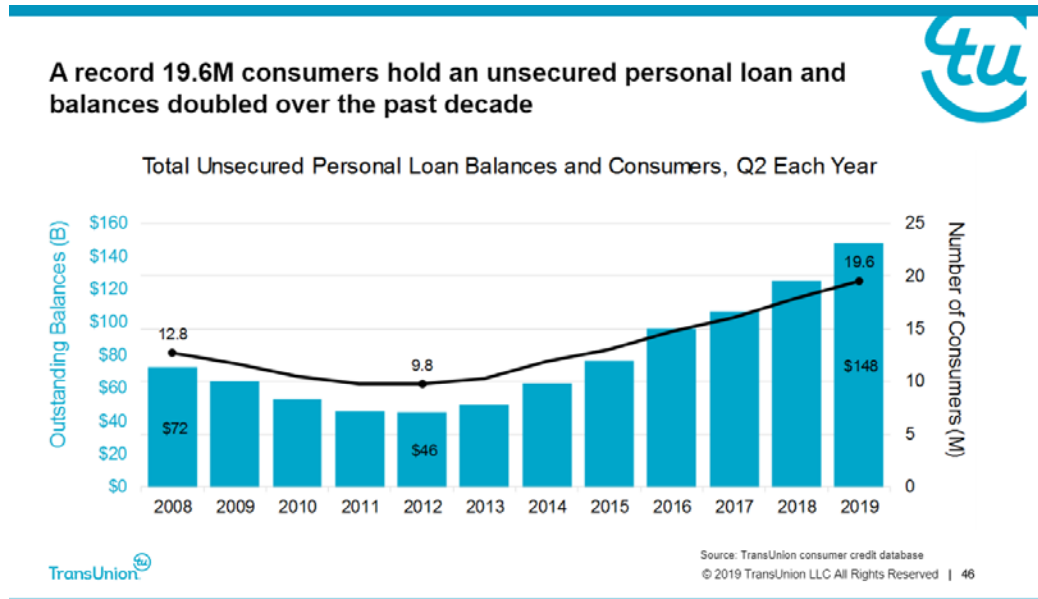
Experian also identifies the market into average balances by state. Washington state has the highest average personal loan balance at \$27,188, with Hawaii at the other end of the spectrum at \$12,802.



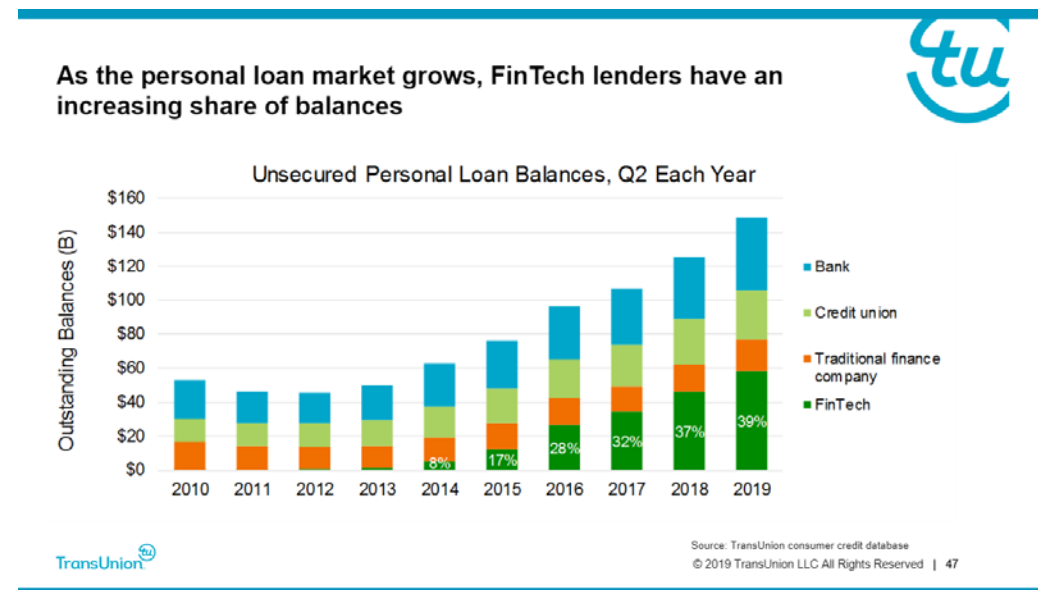
(Data source: Experian)

Unsecured Personal Loans

TransUnion finds that unsecured personal loans (avg. balance \$8,856) comprise a little over half of the average total personal balance identified by Experian. The TransUnion graph below shows origination volume growing dramatically in this sector. Q2 2019 data placed outstanding unsecured personal loan balances at a new high of \$148 billion based on 19.6 million accounts, up 222% from 2012.



Much of this growth in personal loans has driven by online loans originated by fintechs, often referred to as “peer-to-peer,” “marketplace” or “platform” lending, connecting borrowers to investors who are willing to buy or invest in the loan. Borrowers repay the loan in installments which cover the loaned amount plus fees and interest. For more on fintech, see Fintech in the Consumer Finance Space below.

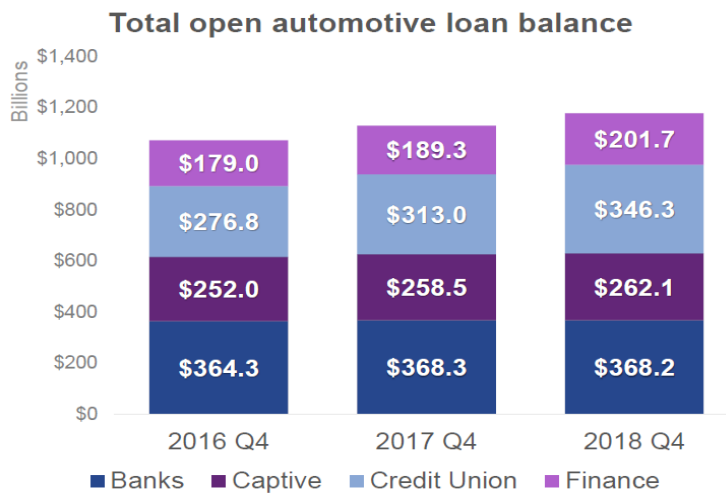




## Auto Loans

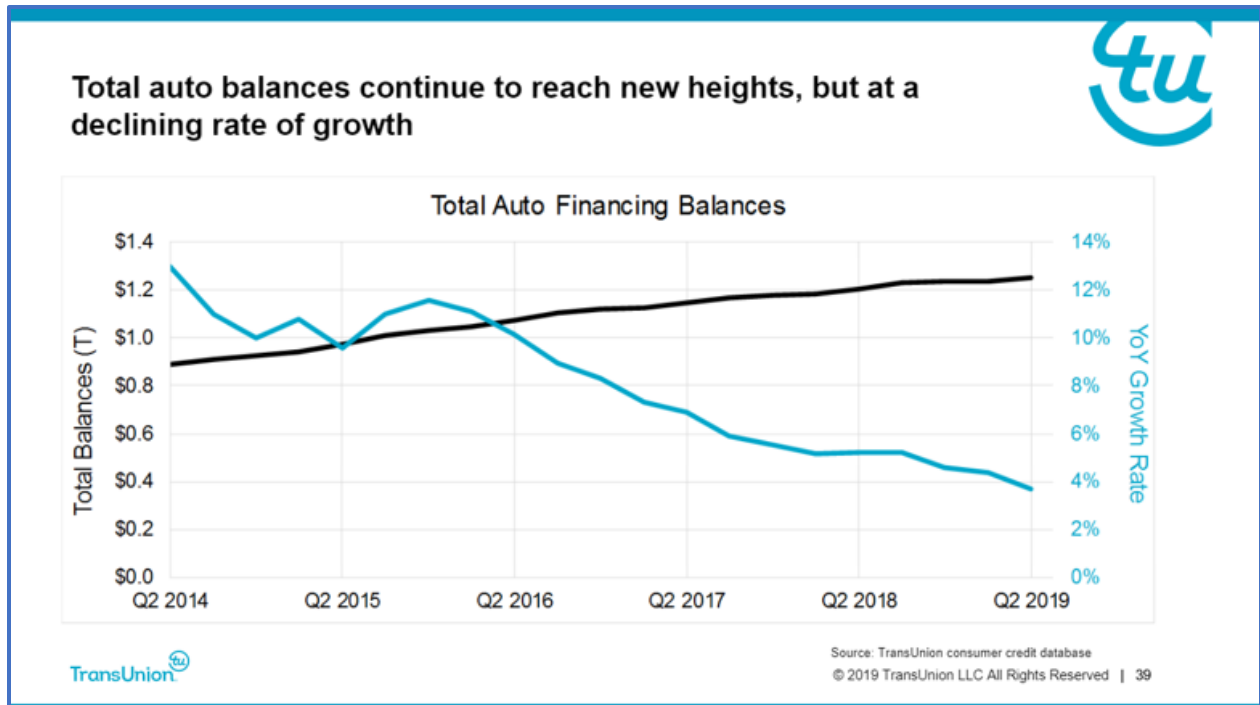
Close to 100 years ago, the Federal Reserve issued a warning to all banks: “Do not offer financing for automobiles used for pleasure.” (Minnesota Historical Society, 1920) But the banks fought back, and auto lending from financial institutions was born.

When a consumer finances a motor vehicle through a bank or nonbank lender, the terms of the loan dictate that the lender is purchasing the car for the borrower with an agreement the borrower will pay back the loan over a predetermined length of time, plus interest.



With Kelley Blue Book identifying the top selling vehicle in America in 2018 as the Ford F Series truck (Price range \$30k to >\$90k using kbb.com price calculator), it is easy to understand an average loan amount for 2018 at over \$22,000. According to Experian, total outstanding auto loan balances in 2018 hit an all-time high of \$1.18 trillion, with volume expected to continue an upward climb in 2019.

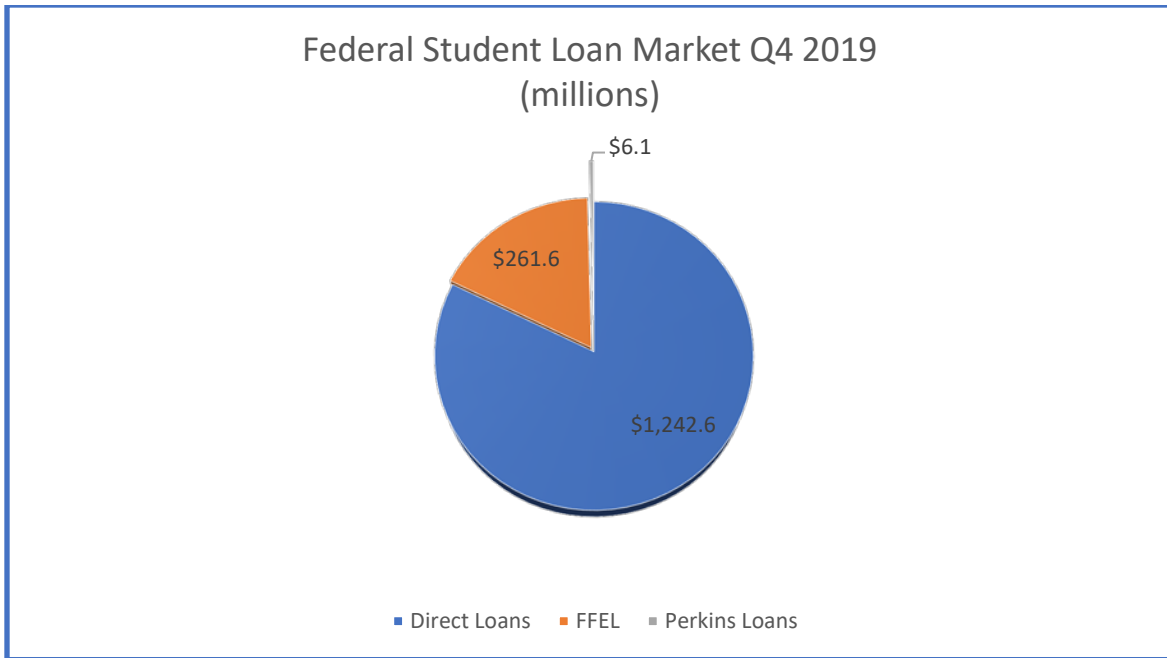
Auto loans are made by banks, credit unions, consumer finance companies and auto dealers (through a bank or other lender). Large auto manufacturers have their own auto lending arm as well (e.g., Toyota Financial Services). According to Experian, loan amounts across all types of auto loans hit record numbers with monthly payments reaching highs driven by interest rate increases in the fourth quarter of 2018. The TransUnion chart below reflects that despite a dramatic slowing in the rate of growth in auto finance, loan amounts continue to climb.



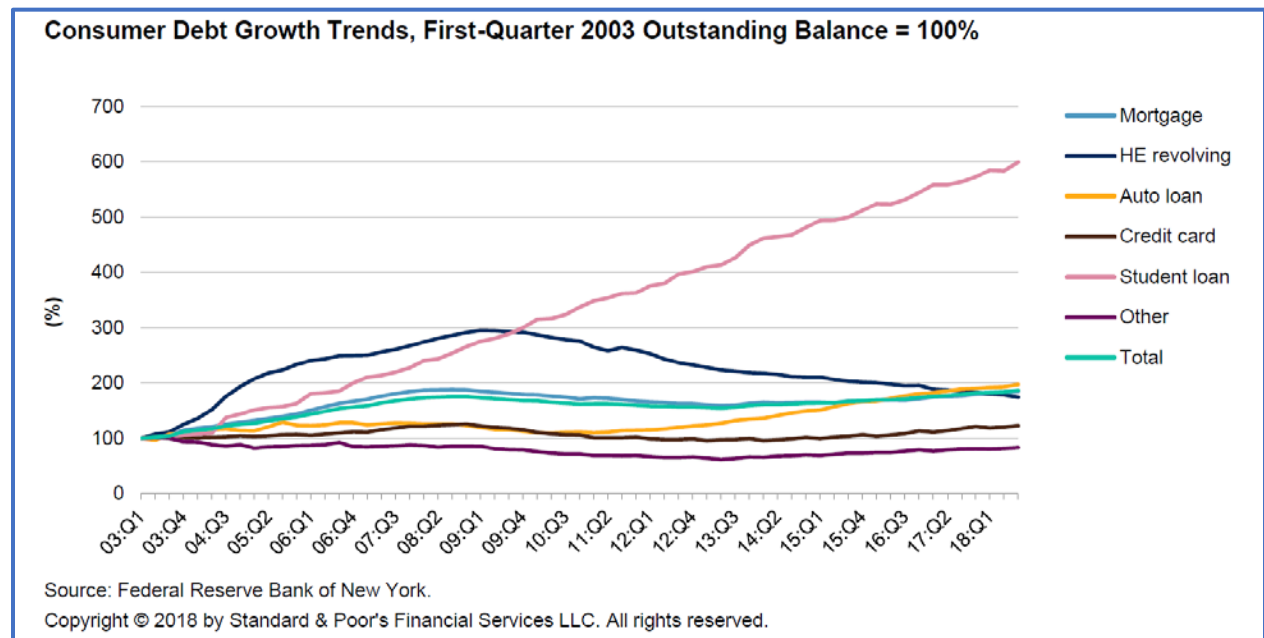
## Student Loans

Outstanding student loan balances are estimated at \$1.6 trillion owed by approximately 45 million consumers. Good data for the private student loan market does not exist, however, Federal Student Aid provides quarterly statistics on Federal Direct Loans, Federal Family Education Loans (FFEL) and Perkins Loans. The total market of federal student lending reflected 42.9 million unique borrowers with total federal student loan balances of \$1.51 trillion as of Q4 2019.<sup>11</sup>

<sup>11</sup> <https://studentaid.ed.gov/sa/about/data-center/student/portfolio>

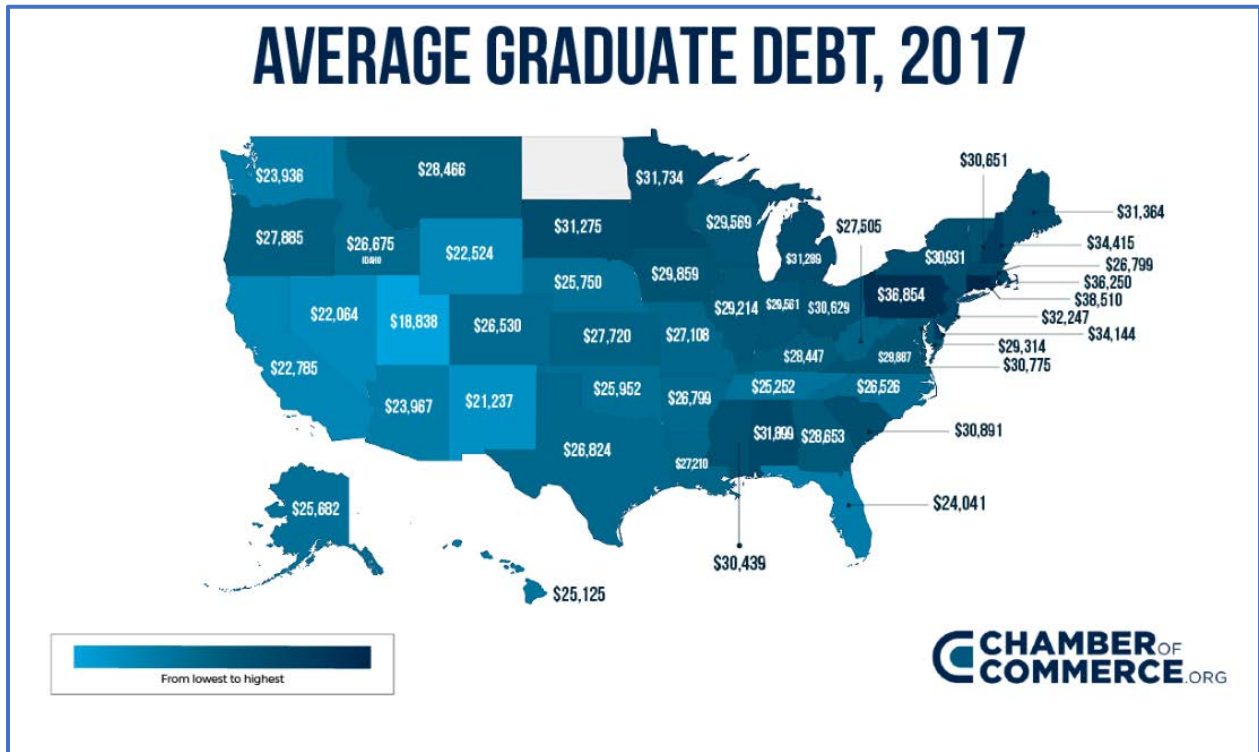


According to Standard & Poor’s Financial Services LLC, “[T]he total balance of student loans is now almost 6 [times] what it was in 2003. No other segment of consumer debt has a balance more than 2 [times] what it was in 2003 as student loans have grown for longer and more consistently than all other forms of consumer debt.”



State jurisdiction of student lending is a complex topic. Some states claim jurisdiction over student loans regardless of the lender or source of funds and some states have jurisdiction over private colleges making loans. Usury limits may or may not apply to student loans. Much of student lending under

government programs is financed by banks outside the jurisdiction of state nonbank regulators. However, several states have jurisdiction over the servicing of student loans, including loans made by banks but serviced by student loan servicers.



## Small Dollar Credit Process and Borrower Profile

### Payday Loans

Payday lending (also known as deferred deposit loans), is accepting personal checks or an authorization to electronically debit payment from that person’s account and giving that person money that is equal to the check/debit minus a transaction fee. The lender agrees not to cash the check or process the debit until an agreed-upon date, by which time the borrower is expected to pay off the loan.

Again, experts consider small dollar credit to be comprised of payday lending, vehicle title lending and online brokering/lending. The process involves the lending of money to borrowers via these products under state specified terms and conditions. It is a demand-driven business backed by the statistic that nearly half of all Americans live paycheck to paycheck and cannot come up with \$2,000 in the event of an emergency (Servon, 2017). According to the Consumer Financial Services Association of America (CFSA), this number could be closer to \$400, and 40% of Americans report that they spend more than they earn.

It appears obvious that consumers are willing to pay significant fees in exchange for liquidity, or funds to cover expenses. The typical fee for a payday advance is \$15 per \$100 borrowed.<sup>12</sup> Before entering into a transaction, the fees and terms must be fully disclosed and included in every contract. The term of the loan is usually two weeks. According to the Community Financial Services Association of America (CFSA), 90% of payday store front borrowers repay in cash.

One reason industry critics take issue with payday lending is the product's finance charge (e.g. \$15 per \$100 borrowed on a two-week loan), which is typically converted to an annual percentage rate (APR) that can be 365% or more. Industry supporters counter that this calculation is misleading and overstates the cost of a two-week contract because it assumes 25 rollovers, or loan renewals, by the borrower when the loan is priced for the short-term duration of the contract.

Recent analysis by the CFPB shows that store front payday lending is declining. The count of storefront locations fell to approximately 13,700 in 2018 from a peak of over 24,000 in 2007. The volume of payday loans fell from over \$50B to \$29.2B during this same period. And revenue fell to \$4.6B in 2018 from over \$9B in 2012.

## Vehicle Title Loans

Vehicle title loans are a type of credit product in which the lender takes a security interest in the borrower's vehicle by holding the title and the loan approval and amount is primarily based on the vehicle's value, rather than a credit check and traditional underwriting. While some vehicle title loans are structured to be repaid with a single payment due in about 30 days, others have longer loan terms and are repayable in installments. Vehicle title installment loans are available in 18 states, some of which allow both single-payment and installment loan structures. In a 2016 study by the CFPB, the median APR on a vehicle title loan was 259%.

([https://files.consumerfinance.gov/f/documents/Supplemental\\_Report\\_060116.pdf](https://files.consumerfinance.gov/f/documents/Supplemental_Report_060116.pdf))

## Online Small Dollar Credit

Online loans are not so much a type of product as a means of marketing and providing small dollar credit. Here we differentiate online loans from the fintech product discussed below by the dollar amount and payment structure: smaller loans (e.g., \$500 to \$2,000) and single payment or installment structure. While online loans may not be marketed as payday loans, they are typically thought of as payday or deferred presentment loans made online.

The process for online loans involves the consumer shopping online, going to a specific site or to a lead generator via a search. After the consumer completes and submits an online application, the lender might approve them instantly or require copies of paystubs or proof of residency, depending on the lender and type of loan.

As mentioned above, online borrowers must have a checking account, as the money loaned via an online lender is deposited into a bank or credit union account and usually repaid by an automatic debit

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<sup>12</sup> For information on fees, amounts and other information state by state, see the [CSBS Chart of State Payday Lending Laws](#).

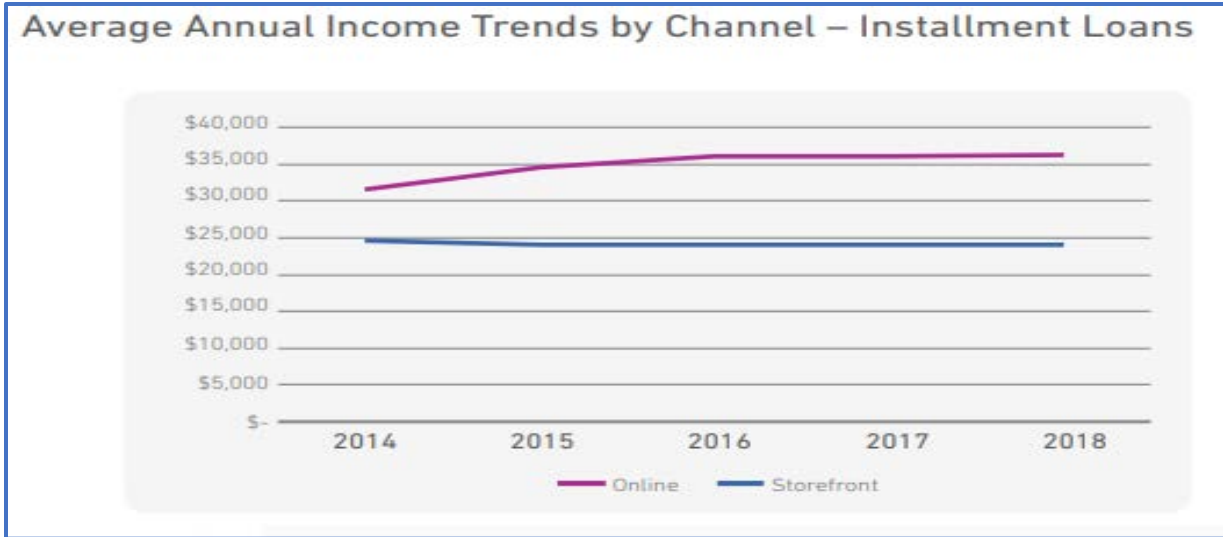


to the same account. According to the Online Lenders Alliance (OLA), lenders require automatic debit or Automatic Clearing House (ACH) for payment of 90% of these loans.

Based on their FICO score, online borrowers are classified into credit types (e.g., prime, non-prime, etc.) by lenders as above-average credit risks, or non-prime, based on their FICO scores. FICO is a person's credit score calculated with software from the Fair Isaac Corporation (FICO), from a consumer's mortgage, auto loan and/or credit card history. If consumers do not pay those bills in a timely manner, their FICO score declines. Near-prime and non-prime consumers are defined as having FICO scores below 700, although the line varies. According to the OLA, online lenders do not lend to consumers with FICO scores below 500. Many Americans do not have a FICO score, so the industry uses other credit scores in place of FICO.

Clarity Services, a part of Experian, studied more than 350 million consumer loan applications and more than 25 million loans from 2014 through 2018. That study reflects the following for online loans (<https://www.clarityservices.com/wp-content/uploads/2019/04/2019-Alternative-Financial-Services-Lending-Trends.pdf>):

- The volume of online payday (single payment) loans roughly doubled from 2014 to 2018, and the volume of online installment loans grew 7.4 times during the same period.
- Online installment loans are growing much faster than online single pay loans. Over the last two years, online installment loans continued to grow at a robust clip, while online single pay loans trended toward negative or flat growth.
- The number of unique borrowers for online installment loans has increased by approximately 30% yearly for the past three years, while unique borrowers declined for online single pay loans over the last two years. Based on the data, it appears that single pay borrowers are more likely to exit the online market or migrate to online installment loans.
- There has been a trend toward higher online loan amounts over the last five years. For example, the percentage of funded loan amounts between \$500 and \$2,000 represented 43% of all loans in 2014 and increased to 60% in 2018.
- A greater percentage (62%) of loans are being repaid over 7 to 12 months in 2018. In general, longer payment terms mean lower monthly payments.
- The average number of single pay loans per borrower in 2018 was 3.2.
- In 2015, default rates for a borrower's first single pay loan was 24%, but in 2018, only 18% of these types of loans defaulted. Overall, first payment default rates for the first online single pay loan continued to decline in 2018.
- Online installment loan borrowers report significantly higher annual incomes than store front installment borrowers.



(Source: Clarity Services, Inc. 2019)

The CFPB’s 2016 report, Supplemental findings on payday, payday installment, and vehicle title loans, and deposit advance products, compares small dollar credit installment loans for vehicle title, storefront payday and online payday.

	Loan amount (average)	Loan amount (median)	APR (average)	APR (median)	Payment frequency
Vehicle title installment loans	\$1,098	\$710	250%	259%	Bi-weekly or monthly
Payday installment loans (all)	\$1,291	\$1,000	268%	249%	Weekly, bi-weekly, semi-monthly, or monthly
<b>Sub-set of payday installment loans by origination channel</b>					
Storefront payday installment loans	\$1,295	\$1,000	237%	248%	Weekly, bi-weekly, semi-monthly, or monthly
Online payday installment loans	\$2,122	\$2,400	279%	221%	Bi-weekly or monthly

(Source: CFPB)

Curious how to calculate the APR on a payday loan? The Federal Reserve Bank of St. Louis provides this simple calculation.

### Calculating the APR of a Payday Loan

1. Add all fees and interest charges to calculate total fees.
2. Divide the total fees by the amount financed (borrowed).
3. Multiply the answer by the number of days in a year—365.
4. Divide the answer by the term of the loan expressed in days.
5. Move the decimal point two places to the right and add a percent sign.

**Example:** If a borrower takes out a two-week payday loan in the amount of \$300 and the lender charges a \$45 fee, the APR will be figured as follows:

$$\$45 / \$300 = 0.15$$

$$0.15 \times 365 = 54.75$$

$$54.75 / 14 \text{ days} = 3.91$$

Move decimal two places to right and add percent sign:  
391% APR on this loan.

SOURCE: Federal Reserve Bank of St. Louis. "It's Your Paycheck! Lesson 8: So How Much Are You Really Paying for That Loan?"

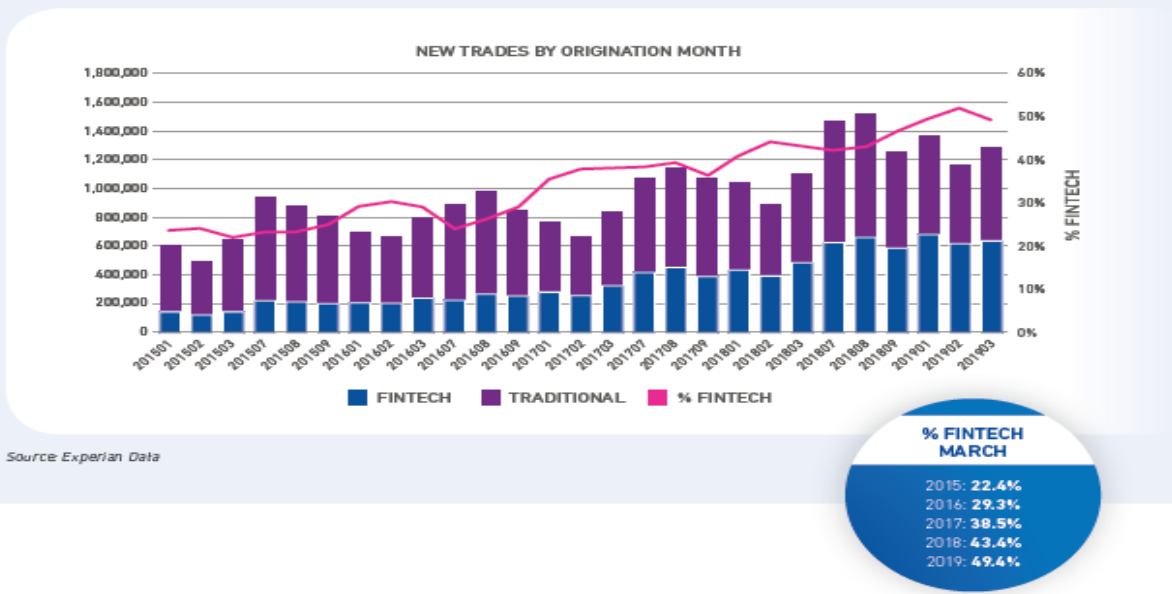
<https://www.stlouisfed.org/~/-/media/education/curriculum/pdf/its-your-paycheck-lesson-8.pdf?la=en>.

## Fintech in the Consumer Finance Space

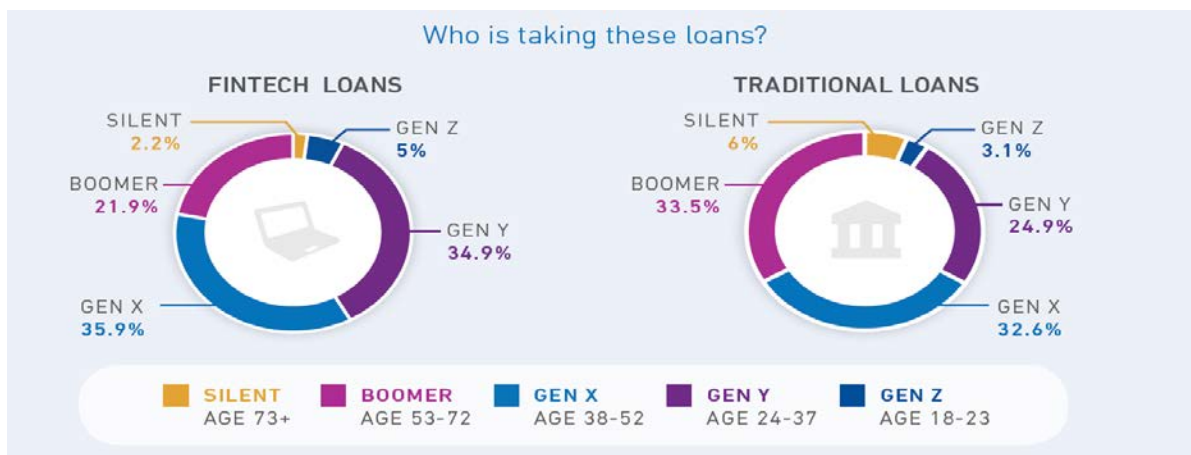
Fintech companies – firms that leverage technology to create new business models, new delivery channels, automated decisions, and partnerships with traditional banks – are today a constant in financial services and are integrated into daily life. Operating within industries such as mortgages, money transmission, debt and consumer finance, fintech firms have piqued the interest of consumers and attracted a wide range of investors.

The substantial growth in fintech lending is helping fuel the overall increase in personal loans. According to Experian, "The contribution of fintech to unsecured lending is increasing. A year over year comparison shows that in March of 2015 fintechs made up only 22% of the market, whereas in March of 2019 fintechs made up nearly half of loans originated." (See Experian Fintech Vs. Traditional FLs September 2019, <https://www.experian.com/innovation/thought-leadership/fintech-trends-unsecured-personal-installment-loans-ebook.jsp>)

Contribution of Fintech to unsecured lending is increasing



Innovation by fintechs allows them to increasingly pierce the consumer finance marketplace. Fintechs excel in three primary areas: marketing, underwriting and the use of data to identify underserved consumers. And fintech’s current market share of unsecured personal loans of \$45.5 billion is projected to grow to \$73.7 billion in 2022.



While fintechs originally targeted substantially higher personal loan amounts than traditional lenders, Experian analysis shows that emergent fintechs have made market inroads by targeting lower loan amounts. In March of 2019, the average fintech loan balance was \$5,548 versus traditional lender averages of \$7,383. For fintechs, this is a dramatic drop from the 2016 average balance of \$12,000.

And contradicting conventional thinking that fintech products are the provenance of younger generations, the combined cohort of 38 to 72-year-old borrowers comprise 58% of the fintech market,

only 9% less than their share of the traditional market. And these older generations are borrowing higher amounts with lower credit risk. Measured by VantageScore<sup>®13</sup> fintech originated loans to Boomers and Gen X have higher credit scores, coupled with higher loan amounts and better performance.

Unsecured Personal Loans	Boomer Fintech	Boomer Traditional	Gen X Fintech	Gen X Traditional
Score	677	668	654	645
Avg Loan	\$ 11,112	\$ 8,489	\$ 10,865	\$ 8,813
90+ days delinquent	2.9%	3.4%	3.7%	5.2%

(Source: Experian)

Beyond personal loans, fintech is providing technologies to existing consumer finance lenders while creating new versions of more traditional products. The handprint of big and small technology can also be seen on payday, auto and student lending, where marketing, lead generation, brokering, underwriting, funding, servicing and collection processes are being facilitated, and in some areas, now controlled by fintechs.

### Cash Flow Underwriting

While rental, utility and telecom data have been used for a decade to determine financing risk, cash flow underwriting is a newer type of nonbank consumer financing. It is an underwriting system that has evolved to take advantage of certain types of data, i.e. bank account information. It enables lenders to assess the credit risk of potential borrowers for different asset purposes.

Cash flow underwriting is the use of transactional data – the deposits into and withdrawals from bank accounts – and monthly balances that indicate residual income. This data is useful for banks and nonbanks alike because lenders say it is predictive in consumer and small business loans. Nonbank lenders are using it more often, especially with millennial consumers who have little credit history.

FICO scores, as mentioned above, are a specific type of data used for middle- and upper-income households, based on the past payments of obligations. But industry experts say those scores may not be as predicable for borrowers who have low or moderate incomes. According to the CFPB, there are 40 to 60 million Americans who do not have enough credit history or no credit history to be assessed actuarially. Since there is no prior history upon which to base those consumers’ scores, lenders are interested in the information in consumers’ bank accounts. There is an ability to conduct a more personal risk assessment by reviewing cash flow data to assess a consumer’s ability to repay. As a result, the ultra FCIO credit score now exists, which is FICO plus cash flow underwriting.

With the consumer’s consent, the lender pays to access bank account information from data aggregators. Experts say these are important intermediators, acting as the conduit between the bank and its data and the lender.

<sup>13</sup> A joint venture of Equifax, Experian and TransUnion.



Cash flow underwriting will expand but there are questions to be answered. For instance, do checking account overdrafts indicate higher credit risk? Does an insufficient checking account balance over several months predict risk? There may be a higher rate of these incidences within certain segments of the population which could generate a disparate impact<sup>14</sup> to lending. Over time, the industry will determine what is predictive and useful.

## Current State of Consumer Finance

Today's consumer finance industry faces several challenges from technology to regulation. Technology brings innovation to consumers, opportunity to lenders and competition to the market. While some companies have embraced technology, providing all their services online, others remain firmly rooted in "brick and mortar" retail locations, while many have become hybrid companies offering products in both physical and virtual places. Feeding the technology challenge is consumer expectation of convenience and almost instant access to services.

Complying with a myriad of state-specific rules, regulations and licensing requirements further challenges the industry. Today, this challenge manifests itself primarily with those lenders embracing technology to reach consumers across multiple jurisdictions. But each state has unique requirements that consumer finance lenders must comply with, making it more challenging for companies seeking expansion through the internet.

State licensing requirements are varied and limitations on loans are applied differently from state to state. In some states, loans are categorized by dollar amount borrowed. Some states have requirements controlled by loan type or loan purpose; most states differ on dollar limits, and allowable rates, fees, costs and add on products. Conducting a consumer finance business requires an understanding of a very technical industry with a patchwork overlay of laws. But to the consumer, any type of credit is just a loan, despite these challenges faced by lenders.

Like any lending activity, consumer finance is a volume-based business, meaning that significant loan volume is needed to offset fixed costs and generate a profit. Even small changes in requirements or lending limitations can have a large impact on the viability of the business model.

The industry complains that regulators, especially the CFPB, do not fully understand the purpose and benefits of small dollar credit, specifically the payday loan. The CFSA reports that borrowers are not using small dollar credit for emergencies but rather for monthly expenses, further exemplifying the need for this type of credit.

According to the Financial Service Centers of America, 35 states have enacted laws permitting payday loans. Industry analysts estimate there are more than 22,000 physical locations nationwide, extending approximately 150 million payday advance loans with a value of \$50 billion annually in small dollar, short-term credit to between 15 and 20 million American households (Financial Service Centers of America, 2013). In states where payday lending is allowed, but not authorized as an exception to usury, state usury limits control the allowable interest and fees, making payday loans unprofitable and unlikely to be made.

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<sup>14</sup> Disparate impact in United States law refers to practices in employment, housing, and other areas that adversely affect one group of people of a protected characteristic more than another, even though rules applied by employers or landlords are formally neutral.



## Future Predictions for Consumer Lending

Over the next five to ten years, consumer finance experts predict the industry is likely to continue the face-to-face loan model, regardless of the growth of technology. While technology speeds up the process, allowing consumers to apply for and access funds more quickly, the industry will still expect to build relationships that come from personal interactions.

They believe consumers still want to conduct business at branches, but physical branches are expensive to operate. For example, some bank branches today are designed like cafes to enhance the consumer experience and this type of competition for consumer attention is costly. Smaller companies will remain face-based operations, specifically ones that are locally or regionally located. But, for larger companies, branches may exist in a virtual format, allowing the consumer to communicate via telecommunications software. The increased use of technology via virtual branches is expected to decrease operating costs.

Technology will continue to provide more transparency, as well. Customers will become increasingly aware of the types of available products and how credit scoring works. Technology will also help consumers balance and manage their budgets. They will continue to be able to enter information online and come up with a solution that works for them. Electronic education to the consumer will help tremendously, allowing the consumer to make more appropriate choices.

In terms of the law, some consumer lending experts believe states should modernize their laws for the sake of efficiency, i.e. those that still reference “ledger cards” and “certified mail.” And, because the state and federal laws are seldom synchronous, much work is needed to harmonize supervision, especially when it comes to lenders operating in multiple states.

The future of the market is uncertain depending upon several factors, some political and others technology and product-based.

The first is the direction of federal oversight and how policy makers and regulators view products. The consumer finance industry, unlike mortgage, has always been siloed into unique product types and providers. These siloes contribute to legal, jurisdictional and supervisory difficulties. But whether a single product or provider type can work for consumers is debatable. Some experts say that the market is moving towards a nationwide product, allowing technology disrupters the ability to leverage uniformity and diminish smaller and more traditional competition.

A second factor that could be intentionally or unintentionally facilitated by the first is online lending. Industry experts say there is a movement away from retail outlets, fixed stores, and other places consumers go for small dollar credit loans. Because borrowing money can be an uncomfortable situation for many people, experts hope there is more one-to-one direct online lending for customers in the future.

The third factor is the relationship with the banking industry. Some argue that competition may increase if banks are further encouraged to enter the small dollar credit arena.<sup>15</sup> The argument follows a theory that more market participants will likely result in lower consumer prices.

Furthermore, banks of all sizes are exploring fintech partnerships, and state and federal regulators are devoting significant effort to ensuring appropriate and effective oversight of these relationships. Most small and mid-sized banks cannot stay up-to-date on technology because it is expensive. These partnerships could bring more cooperation and product innovation to the industry. Banks have the benefit of lower capital costs, but nonbanks may have greater consumer knowledge in this area, coupled with technology innovations and the ability to experiment. This combination of efforts could result in better consumer products at lower rates.

Regardless of future regulation or market competition, there is one constant: there will always be people that do not have access to traditional credit or are not fond of banks and credit unions. Some experts say current societal trends focusing on spending and not saving, materialism, and the lack of credit discipline will continue unless there is a shift in Americans' financial thought process. Either way, the nonbank consumer finance industry will likely always exist in some form with constant change being the new norm.

## State Supervision of Nonbank Consumer Finance

There are literally hundreds of state laws or rules that govern both the nonbank marketplace and supervision of the many industries that constitute the marketplace. The consumer finance industries that are the subject of this chapter are no exception. Every state has legal requirements covering limitations on lending to consumers and except for Arkansas, every state has laws covering licensing of consumer finance lenders.

While many consumer financing laws and rules are similar from state to state, founded on the same consumer protection concerns regardless of state borders, many are also quite different. And some states have laws or types of laws with limited counterparts in other states. For example, payday lending is legal in 40 states with online lending allowed by 34 of those states, while several states effectively prohibit payday loans through usury limits. Of the 40 states that allow legal payday lending, 39 states have licensing requirements. And among the states requiring licensing, significant differences exist in allowed lending terms and supervisory authority. This type of inconsistency in state law exists across all nonbank industry types and is not unique to consumer finance, however it is more pronounced with consumer finance.

While consumer finance companies may not be able to conduct business in the same manner in every state, they have the opportunity to have influence on the system that governs them, and in many respects, this is the very reason why there are such stark differences. This is especially true for the tens of thousands of smaller companies operating in regionalized pockets of the country, but larger

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<https://www.pewtrusts.org/en/search?q=payday%20lending%20proposal&sortBy=relevance&sortOrder=asc&page=1>

companies as well have the same access and ability to influence local government. While this may be a less convenient system for national level companies, under the state system smaller companies are not foreclosed from having a voice, and the local knowledge of the effect of financial services is one of the great strengths of state supervision.

Below we discuss the fundamentals of supervision for consumer finance companies: licensing, reporting requirements, compliance and consumer protection, examinations, investigations and enforcement actions. When these fundamentals employ standardized approaches for addressing nuances in state law, that standardization creates harmonization and uniformity in the state system of supervision.

As with mortgage and money services businesses, state regulators focus policy on compliance, consumer protection and financial condition or safety and soundness requirements for licensed entities. State supervision falls into functional categories of licensing and reporting requirements, examination responsibilities, complaint handling and enforcement authorities.

## Compliance and Consumer Protection

As discussed in Chapter Two – Overview of State Nonbank Supervision, through laws and rules, the regulators institute expectations or norms of conduct for the industry and then subsequently monitor, examine or investigate the industry for compliance with those expectations. States have very similar, and in many cases the same requirements for disclosures to consumers and treatment of consumers and many of these requirements are rooted in federal regulation.

Compliance with certain federal regulations simultaneously satisfies compliance with certain state regulations. For example, federal regulations under the Truth in Lending and Equal Credit Opportunity Acts will be tested by state regulators for compliance. Such reliance helps establish standards in supervision and consistency for consumers, companies and regulators. However, there are numerous individual state requirements that have been put in place by state legislators and state regulators implementing state law that are specifically designed to protect that state's consumers. These requirements can be identified into broad categories:

- **Licensing and General:** Background requirements, competent management, license renewal, physical location requirements, records retention, data protection, regulatory fees, reporting, etc.
- **Financial Condition and Safety and Soundness:** Bond amounts, capital requirements, solvency, board oversight, accounting requirements, etc.
- **Loan terms and conditions:** Amount of loan, term of loan, structure of payments, interest rate, fees, and penalties.
- **Disclosures:** Federal and state disclosures pertaining to loan terms or other consumer protection requirements.
- **Examination and Investigation:** Record keeping, information requests, physical inspection, complying with subpoenas, testimony, etc.

Consumer protection can be thought of as ensuring no consumer harm through negligence, lack of oversight or intentional acts. Consumer protection in the context of consumer finance is a concept, coupled with a body of laws and rules designed to protect the rights of consumers in financial transactions. Often, consumer protection is confused with compliance. However, compliance is the demonstration of complying with the laws and rules that are in place to protect consumers.

## Financial Condition and Safety and Soundness

Consumer finance companies are responsible for maintaining a sound financial condition, so they are able to carry through with their statutory and regulatory obligations, complying with the laws, rules and directives of its supervisors and ensuring that consumers are treated appropriately and protected from harm.

State regulators have two primary tools to ensure sound financial condition. First, many states have established a minimum net worth requirement as a condition of maintaining a license. This requirement ensures that a prospective licensee has the minimum requisite assets available to operate a consumer finance business. Second, states require consumer finance companies to post bonds with the state to protect consumers from losses borne out of failure or misappropriation. When all goes wrong, bonds provide the cushion needed to make consumers whole.

In addition to net worth and bonding, states have general financial safety and soundness requirements. These requirements are specific to a license type, representing the typical bounds of sound financial practices. For example, a payday lender may have different financial requirements than a personal loan or a vehicle title lender. Much like in banking, these requirements are based on a broad statutory requirement to protect the public interest. In implementation, financial condition is closely related to that of banking: capital, asset quality, earnings, liquidity and sensitivity to market risk. Consumer finance companies should have sufficient capital to absorb losses, assets strong enough to support their business, profits sufficient to ensure ongoing operations, funds liquidity appropriate for the ebb and flow of cash demands and a financial position not subject to substantial swings based on market changes or unexpected events. Among other measurements, states may look to the following ratios to ensure financial safety and soundness:

- Operating margin
- Net margin
- Return on average assets
- Return on average equity
- Current ratio
- Working capital
- Debt to assets
- Equity to Total Assets

Without sound financial condition, a consumer finance company will not have the wherewithal or financial stability to put in place and maintain good compliance management systems; without compliance or adherence to requirements consumers are likely to be harmed. Failures in consumer protection directly impact the consumer finance company's reputation and create real legal risk, both of which can result in negative outcomes for the institution's financial condition.

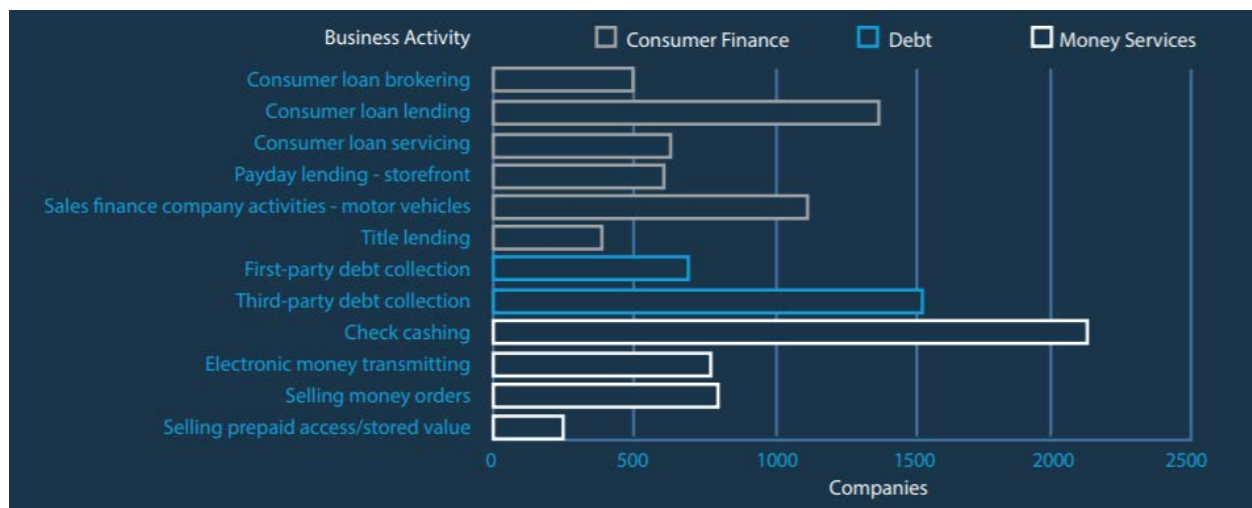
## Licensing and Reporting Requirements

Each state agency maintains a licensing section that is responsible for accepting applications, approving and issuing licenses and monitoring reports of activity (where required). Frequently, consumer finance licensing responsibilities will be combined with the licensing responsibilities for other nonbanks. Since 2012, states have increasingly transferred their licensing process to the Nationwide Multistate Licensing System (NMLS).<sup>16</sup>

Currently, 31 states license company types included in this chapter under at least a half dozen license types through NMLS. While each state may identify license types under unique names (e.g., small loan lender, regulated lender, consumer loan licensee, consumer finance licensee, etc.), the majority of companies providing products discussed in this chapter are captured by some states in NMLS: personal loans, auto loans, payday loans, vehicle title loans, non-federal government student loans, retail installment sales contracts and PACE loans.

For states choosing to license consumer finance companies through NMLS, companies can utilize a single license application form, regardless of license type requested, and submit the form for approval simultaneously to multiple states. Participating states and their license applicants benefit from improved efficiencies and electronic delivery to multiple agencies in a single submission.

Number of Non-Mortgage Companies Licensed in NMLS 2018



(Source: NMLS)

Unlike mortgage and MSB, there are no national reporting standards or requirements for consumer finance companies. However, many if not most states require some reporting from these companies on at least an annual basis. CSBS is currently in the early stages of development of a call report for consumer finance companies that would be deployed through NMLS.

<sup>16</sup> All states use NMLS to license mortgage companies and MLOs and most states use NMLS to license MSBs.

## Examinations, Investigations and Enforcement

Most states with licensing authority conduct regular or routine examinations of consumer finance companies. Many states have adapted examination processes from the bank examination side of the agency, although in the consumer finance space exams are more focused on compliance reviews than financial condition reviews (for a discussion of differences see Chapter Two – Overview of State Nonbank Supervision).

Most consumer finance examinations are conducted as single or independent state exams. This is especially true where companies only operate in a single state or where the state law is so unique that multistate review is not practical. Historically there has been little national level enforcement activity of consumer finance companies. This is likely due to the fact that unlike mortgage, where national level enforcement is relatively common, products are not homogenous or marketed equally across state lines. The exception here may be with national or regional level payday lending and auto finance companies, whose product offerings may be identical or very similar state to state.

State examiners and investigators attend national level training schools with other state regulators where they learn the same examination processes and procedures and investigative techniques that foster uniform approaches to how a company is reviewed. These trainings make it possible for examiners to participate in multistate exams or investigations where they are looking for the same things and sharing their findings with each other. While enforcement must be handled pursuant to each state's independent legal authority, the actual documents are often drafted from standard templates that facilitate national level reports of examination.

Examination authority, granted through state law, is a key component to the states' individual supervision programs. Conducting examinations of licensed consumer finance companies allows state regulators to monitor the financial services and products offered to consumers in their respective states. It also gives regulators the opportunity to determine whether a company is operating in a safe and sound manner. The states commit a large portion of their resources to conducting consumer finance examinations, which generally take place on a continuing basis throughout the year.

From a state regulator's perspective, the examination process typically includes the following components:

- Identify the Scope of the Review
- Prepare and Send Information Request to the Company
- Review of Company Documentation
- Document Analysis and Findings
- Prepare and Issue Final Report to the Company
- Determine the Outcome of the Review (Close or Move to Investigation/Enforcement)

These examination components align with what a traditional audit may look like for a company with one significant exception – the regulator determines the outcome or next steps for the company. The regulator may choose to simply close the examination with no further actions or may choose to take further action based on the findings of the review (i.e., conduct an investigation or pursue enforcement for documented violations).



## Consumer Complaint Handling

State regulators investigate and resolve complaints filed by consumers against consumer finance licensees. Consumer complaints are an important data source that can provide valuable information regarding company operations and treatment of consumers. State regulators leverage this data to determine which companies pose the highest risk, and therefore which companies will be prioritized for examination purposes.

Currently there is no national state data base of complaint activity. Each state maintains its own complaint management system and these systems are not connected. Therefore, we are unable to provide a national level view of complaint volume or severity in the consumer finance space.

The CFPB does maintain a national complaint database of consumer complaints filed with at the national level. The state system is granted full access to this database and state regulators use this data to assist in risk profiling supervision. For 2018, the CFPB complaint database reflects the following consumer finance activity:

Personal loan complaints	4,200
Auto lending complaints	8,100
Student loan complaints	10,400
Payday loan complaints	2,300
Vehicle title loan complaints	<u>600</u>
Total consumer finance	25,600

## Multistate and Coordinated Supervision

Traditionally, nonbank single state examination programs differ from state to state, but within the last 10 years there has been a shift towards uniformity. There are several reasons for this shift, but the primary force behind this change are the nonbank financial service providers who are leveraging technology to scale up operations quickly across state lines.

Today, state nonbank regulators recognize that the operating needs of companies offering services beyond state borders may conflict with individual state focused systems and have acted responsibly and timely to modernize processes and efficiencies wherever possible. Examples of this responsiveness can be seen in expansion of the NMLS, information sharing, multistate and coordinated examinations and direct collaboration with industry through CSBS.

The National Association of Consumer Credit Administrators (NACCA) has developed multistate processes in the consumer finance supervision similar to the multistate processes developed for mortgage and MSB supervision discussed in prior chapters. Through regulator committees established for payday lending and auto finance NACCA provides supervisory and administrative support to the examination process. This includes updating examination procedures, reviewing preliminary

examination results, and approving the final report of examination. Additionally, the committees coordinate any necessary negotiations regarding corrective action and multistate settlements.

NACCA also plays a vital role in coordinated supervision with the CFPB by proposing examination targets, participating in examinee selection, assembling state examination teams, and identifying the Examiner in Charge (EIC) and the Single Point of Contact (SPOC) for the examination. For more on multistate and coordinated supervision see Chapter Two – Overview of State Nonbank Supervision.

For the purposes of coordinated supervision with the CFPB, NACCA has developed examination procedures for payday lending and auto finance. In general, these procedures offer guidance for review of the following: transaction testing (compliance with state statutes, the Truth in Lending Act and other applicable federal regulations), advertising, prior examination results, management (internal audits, policies/procedures, business plans, board minutes), cyber security and employee training. Specifics of examiner review include:

- Confirmation of proper registration and licensing, and review of structure and ownership
- Review of products and lending activity
- Review of employee training programs including coverage of regulatory compliance, underwriting, collection, internal controls and customer service
- Adequacy of cybersecurity and data protection program
- Review of loan documents for compliance with state and federal law and regulation with focus on federal Truth in Lending, electronic funds transfers, the Military Lending Act, and Graham-Leach-Bliley Act
- Review advertising for appropriate disclosures, and evidence of misleading or false advertising
- Records retention

## Information Sharing

Information sharing is a key ingredient in multistate and coordinated supervision. Information sharing improves state supervision by drawing upon the resources of many states. Through information sharing states are able to “see” beyond state boundaries and identify practices taking place at the national level that previously appeared only at the local level. For example, a single state may uncover misleading advertising practices and unlicensed activity not detected by another state. At the same time, another state may detect disclosure issues with the same company. When states share this information, practices or patterns of violation may begin to appear in ways that would not previously have been identified or understood. In this sense, information sharing is not only beneficial to state regulators, but to a greater number of consumers as well.

But information sharing among the states accomplishes more than enhancing supervisory oversight or protecting a broader base of consumers. Information sharing also benefits the industry through reduced burden and cost. Industry members directly bear the cost of supervisory efforts. When state regulators share information, there is less duplication in information requests and less time invested in analyzing and reviewing the same information by the respective states; the cost savings that result from those efficiencies flow directly to the nonbanks being reviewed.

Several mechanisms have been established in the state system to foster supervisory information sharing. These include sharing mechanisms within NMLS, sharing between the state system and the CFPB<sup>17</sup> and coordinated supervision established under NACCA.

## Fintech and the State System

To be more responsive to the needs of fintechs, CSBS convened the CSBS Fintech Industry Advisory Panel (“FIAP”), comprised of 33 industry members. The FIAP is designed to support state regulators’ increased efforts to engage with financial services companies involved in fintech. The FIAP engages with the CSBS Emerging Payments and Innovation Task Force and other state regulators to identify actionable steps for improving state licensing, regulation, and non-depository supervision and for supporting innovation in financial services.

On Feb. 14, 2019, the advisory panel released a list of [recommendations](#) for state regulators to consider when streamlining state nonbank supervision. State regulators support most of the recommendations provided by the advisory panel and are considering several more for future action or implementation.

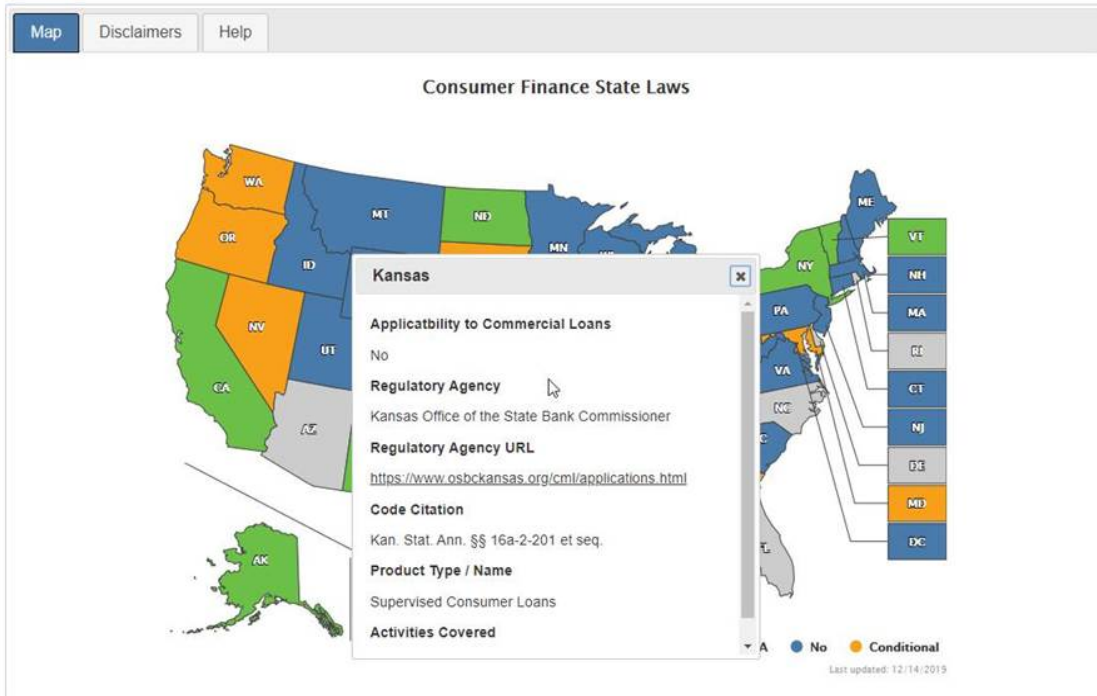
One of the FIAP recommendations was the creation of a 50-state survey of consumer finance licensing laws for reference use by regulators, industry, consumer groups and other stakeholders. This information can serve as a valuable resource and tool for both *states* to see the similarities and differences and for *industry*, particularly new entrants including fintechs, to use as a first step in determining state compliance requirements. The survey identifies state licensing and lending requirements for “consumer loans,” however that may be defined by state statutes (note that payday, title lending, and other more targeted license types are not included in the research). The state law survey includes which business activities trigger a consumer loan license and whether the statute applies to commercial lending as well as noting major license requirements, statutorily mandated loan terms and limits on fees and charges.

All information contained in the survey has been reviewed and verified by the appropriate state agency that is noted as the regulatory authority. Relevant statutes for each state are provided to aid additional research and the state information will be updated on an annual basis.

CSBS has developed a tool to accompany the survey results, both of which can be found [here](#).

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<sup>17</sup> <https://www.csbs.org/sites/default/files/2017-11/CFPB%20CSBS%20MOU.pdf>



## Conclusion

The nonbank consumer finance marketplace and the supervision of nonbank consumer finance are broad and complex areas. The industry’s history, from sewing machine sales and door to door collections in the 1800s to retail locations to fintech today, reflects an industry evolved by technology, but still very rooted in the personal experience. A variety of products, from payday loans to consumer loans to auto loans and student loans may share only a single common denominator: the consumer.

This complex and divergent industry is met with equally complex and divergent regulations and supervision across state lines and even within individual states. Only a little more than half the states supervise payday loans while the remainder ban them or ignore them and similar disparities exist with vehicle title, online lending, retail installment, and other products. And while all states supervise consumer loans, it can be difficult to find commonality across the laws.

Such diversity reflects a supervisory framework that is less mature in uniformity of licensing and multi-state supervision than can be found in other areas of nonbank oversight. But much in the way commissioners have harmonized mortgage and MSB supervision, we can now see them turning their attention to consumer finance through adoption of NMLS, the Fintech Industry Advisory Panel, NACCA’s multi-state supervision processes, and the State Examination System.