Pilot Program Update: Rapid Growth of Finders and the Need for Regulation to Keep Pace

Regulators, policymakers, consumer advocates, and lenders continue to struggle to find a balance between profit-driven lending practices, access to fairly priced loans and mission-driven policies. Given recent findings released by the Department of Business Oversight (DBO) relating to finder activity, it is more critical than ever to insure the original intent of the 2013 Pilot Program for Increased Access to Responsible Small Dollar Loans (The Pilot)—*to innovatively offer borrowers greater access to small dollar loans and credit building opportunities*—and preserve that original intent . . . To achieve this requires asking if the pilot, Particularly, its growing use of poorly regulated and incentivized third parties ("finders") benefit borrowers in the most responsible manner? And if not, how will we use this as a guide for future decision-making?

BACKGROUND

It is widely accepted that a person's financial stability is connected to their workforce competitiveness, physical well-being, social relationships, and the strength of the community in which they live. Unfortunately, many low and moderate-income individuals and households lack access to affordable credit, savings, and/or social support systems that can help them overcome financial emergencies. For many, access to responsible small-dollar credit is critical to manage finances, meet basic needs, and achieve financial stability.

Over the past decade, the California State Legislature has grappled with expanding access to capital and credit building products for low to moderate income borrowers. Perhaps the most noteworthy and successful of these efforts was establishing the Pilot. *(See last page for Timeline of Relevant Bills.)* Typically, very few lenders offered installment loans between $300 - $2,500, and even fewer loaned these amounts to individuals with little to no credit history. As a result, in 2010 the legislature enacted SB 1146 (Florez) - the *Affordable Credit Building Opportunities Pilot Program* - to encourage more lenders to offer "affordable" small dollar loans that simultaneously protect borrowers from predatory lending and offer credit building opportunities. This pilot was eventually replaced by SB 318 (Hill) - the *Program for Increased Access to Responsible Small Dollar Loans* due to increase lender participation. California sought to provide borrowers with opportunities to access "affordable" and "responsible" loans as a means to spur economic stability for all, especially the most underserved. Over the years, several ideas were proposed to further modify the Pilot. Unfortunately, some bills sought to expand the roles of additional yet poorly regulated third parties that would be required to be licensed brokers in other contexts referred to as Finders (i.e. SB 235 in 2015 – which was successful-- and the introduced version of AB 784 as well as SB 325 in 2017—which were unsuccessful). SB 235 was promoted under

ideate LABS

the rationale that it would bring more community banks and credit unions. However, it mostly brought high cost lenders and service providers into the Pilot thereby placing at risk the financial interests of the very same consumers the Pilot intended to serve.

HOW THE PILOT WORKS

Lenders must apply to the DBO to participate in the Pilot. Currently, there are 15 approved pilot lenders. Pilot lenders must:

- Abide by basic underwriting standards based on borrower's ability to repay (this requirement does not exist in most if not all of the alternative products that serve families with little or no credit);
- Offer credit education to borrowers before disbursing loans to increase financial literacy;
- Report loans to a major credit reporting agency so that borrowers can build credit;
- Loans must be unsecured installment loans;
- Lenders may not charge balloon payments or prepayment penalties.

In return, lenders are allowed to:

- Charge marginally higher interest rates and fees (administrative and delinquency) compared to those usually permitted by California Finance Lender Laws (CFLL) for these loan sizes;
- Use lightly regulated "Finders[1]". Finders (persons or a company) earn referral and other compensation for consummated loans that they refer.
- Because of the inherent risk of involving compensated third parties in marketing loans, "Finders" activity was limited, and Finders were only authorized to work from their physical location for business; distribute pilot loan information to prospective borrowers; and act as a communications link between prospective borrowers and pilot lenders.

Latest Policy Developments

- Consumer Financial Protection Bureau proposed tighter regulations on loan approvals and abusive payment withdrawals for Payday, Vehicle Title, and High-Cost Installment Loans.
- At the federal level, payday and car-title lenders worked with Republican lawmakers to propose **Sec. 733 of the "Financial Choice Act"** which seeks "Removal of Authority to Regulate Small-Dollar Credit" by declaring federal authorities "may not exercise any rulemaking, enforcement, or other authority with respect to payday loans, vehicle title loans or other similar loans."

PILOT IMPLEMENTATION

Initial 2014 Pilot Findings

In 2015, the California Department of Business Oversight (DBO) released its first report analyzing the pilot from 2011 – 2014. The report mainly covered data on loans made *without the use of Finders* due to limited Finder activity in the period covered by the report. The Finder approach is predominantly used by a single company.

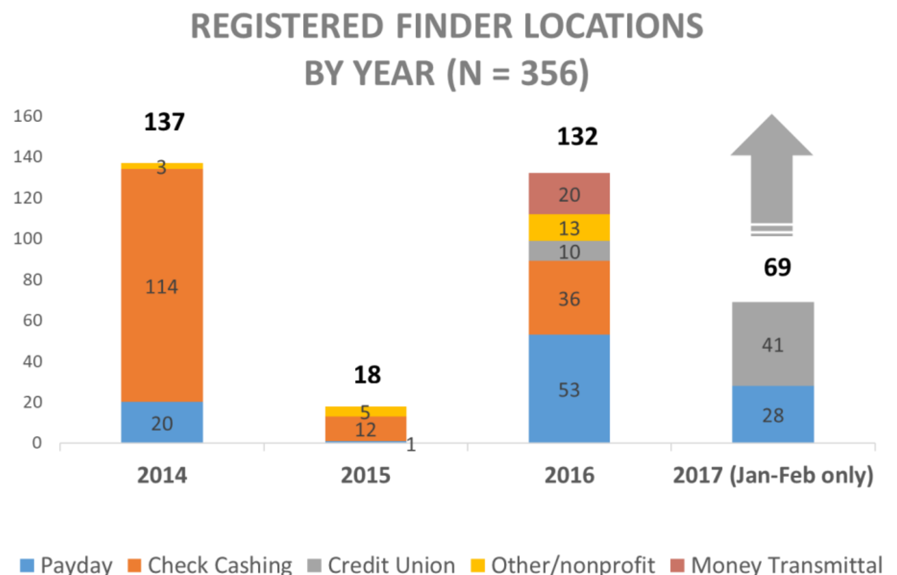
ideate LABS

The report found:

- **Borrower applications** increased by 59%.
- **Loan approval rate** increased from 39% to 50%.
- More than half a billion dollars ($551,576,814) were disbursed.
- 61% of multiple-loan borrowers saw an average **credit score increase *355 points.***
- Of the 164,300 loans made in 2014, borrowers used their loan to: build or repair credit (45%); pay for medical or other emergency (18%); pay bills (13%); consolidate debt (6%); non-vehicle purchase (5%); vehicle purchase or repair (5%).

2017 Pilot Findings

In 2017, the DBO released its second report summarizing loan activity between January 2015 through December 2016. Given its timing, this report provides important insight into the expansion of Finders that occurred after passage of SB 235 (Block). Findings from this report and data collected from Pilot registrants are found below.



In 2015, over the objections and concerns expressed by consumer advocates, the legislature enacted SB 235 (Block) with the intent to expand the use of Finders (which were supposed to be Community Banks and Credit Unions). As a result, the use of finders in the Pilot dramatically increased. The number of storefront locations where finders conducted business grew by a staggering 733% between 2015 and 2016. Only 18 new finder locations were registered in 2015, this jumped to 132 locations in 2016, and 69 were registered between Jan-Feb of 2017 alone. Finders/referral partners are allowed to conduct business in multiple physical locations. A closer analysis of the Finders that registered for the pilot post-SB 235 revealed a troubling trend of rapid growth in certain types of entities acting as Finders who create a potential risk for long-term negative impact if left unregulated and unchecked.

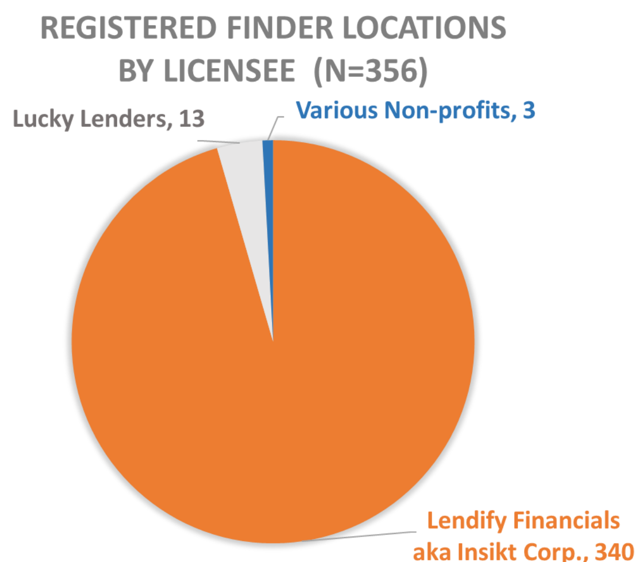
The chart above shows that of the 356 registered Finder "locations" in the Pilot, about 75% are either high cost check cashing (162) or payday lenders (102) which creates a greater likelihood of loan stacking, and other unhealthy lending practices. The purpose of the Pilot was to provide an alternative to these types of lenders, so that low-income borrowers with little or no credit history could separate themselves from these predatory actors and advance into the mainstream financial system.

Additionally, data from finders/referral partners that registered for the pilot show:

- 87% of ALL finder locations are connected to a single lender: Insikt, Inc. (parent company to Lendify Financials).
- Less than 1% of all 356 finder *locations* are managed by a nonprofit[2].

ALARMING TRENDS

The DBO's 2017 report on lending activity cites several areas of positive impact by the Pilot. However, given the types of predatory lenders acting as finders, it also found astonishingly high growth in finder activity between 2014 and 2016, and the following trends, some of them alarming:



- **Number of loans approved increased** 23% over 2014 and 3% over 2015.
    - *The number of finder-related loans increased by 38,923%.*
- **Principal of all loans increased:** $242.4 million total (35% more than 2014 and 8% over 2015.)
    - *The finder-related principal amount of loans disbursed grew by 73,949%.*
- **Borrower applications increased** by 17%.
    - *More specifically, finder-related applications grew 8,557%.*
- Regardless of the size of the loan, **borrowers who used finders were consistently given higher APR's** (no less than 30% while the minimum APR for those who did not use finders had a wider spread and their minimum APR began as low as "up to 14.99%".) This is significant because it is contrary to claims made by supporters of finders that the finder model reduces costs and generates savings for the borrower.
- **Credit scores were less likely to improve when borrowers used a finder**. Less than half of borrowers who dealt with a finder had an increase in credit scores (48%) -- 20 percentage points lower than those that dealt directly with a pilot lender (68%).
- **Finder-initiated loans that have a delinquency rarely catch up**. If you deal with a finder and are delinquent 7 days or more, there's a 53% chance that you will never get current again. If you are NOT dealing with a finder and are in a similar situation, you have a 70% chance of getting current. This is significant because it seems to indicate a more mercenary approach to the placement of loans by finders and their lenders.

[2] Due to the small amount of finder locations managed by non-profits, data was combined into the "Other" category.

ideate LABS

History of Compensated Third Party Loan Originations

Consumer advocates have long known that third party origination schemes, which are not particularly innovative or new, incentivize and compensate those third parties for the promotion and marketing of loans pose inherent risks to consumers, particularly those in low-income communities. This is particularly true where there is insufficient regulation and oversight of their activities.

The overall value added by Finders to consumers depends on their role and responsibilities, their expertise as well as their regulation, motivation and monetary compensation.

Examples of how incentivized third parties have acted against the best interests of the borrower include:

- Brokers pushing loans prior to the recession that were unneeded and misleading the borrowers about the loan terms and their obligations under the loan and sometimes simply fabricating the loan to receive a payment.
- Home improvement contractors going door to door to sell inflated priced home improvements and the expensive loans that support the payment for the home improvements. This is a long term problem. The most recent example of this has occurred in the Property Assessed Clean Energy program (PACE) which are being scrutinized and sued for their use of unregulated poorly trained third parties who are taking advantage of consumers.
- "Street Teams" in Telecom marketing where 3rd parties concentrate on a neighborhood to sell contracts for phone service engaging in questionable practices to make the sale.

Since the 1950's, America's health industry has relied on the *Promotora Model*, a promising practice that increases awareness and enrollment in health programs, preventive care services and the improvement of self-efficacy. Similarly, under the 2010 Capitation Fee Project, the California Public Utilities Commission authorized Southern California Edison to pay a capitation fee ($1-$20) to participating organizations for each new customer they help enroll in the CARE or FERA Program. Both examples successfully increased outreach to customer populations by leveraging community organizations acting on behalf of the needs of individuals and families.

Similarly, navigating the use of finders/referral partners throughout the RSDL pilot has been a slippery slope, especially given recent policies that exclusively and gratuitously slide the role of finders/referral partners away from their original intention: a very limited role in connecting potential borrowers with pilot lenders and providing pre-printed materials to borrowers to obviate predatory lending. As the pilot program grew, so did the role of finders/referral partners due to aggressive policy engagement by a single financial institution, the Insikt Corporation, aiming to better utilize finders as an integral part of its business model. Currently, Insikt Corporation accounts for 87% of all finder locations participating in the statewide pilot (See pie chart, page 4).

CONSIDERATIONS FOR PILOT IMPROVEMENT

The Pilot was created with the intent of providing a safer market for consumers with little or no credit history to access small loans, and thus, a viable option to end cycles of debt for many fixed income individuals and families. However, several consumer organizations have raised serious concerns that,

while the intent of the pilot was laudable, the uncontrolled and unregulated growth of the finders/referral partners aspect of the pilot deviates from the original purpose of the pilot and may create problems for the consumers it was intended to help. Specific concerns include:

- The **Pilot's loose regulatory standards and lack of regulatory oversight for Finders** (e.g. qualifications, compensation, evaluation and accountability systems) allows and perhaps encourages predatory practices such as debt traps and compensated steering of loan products, loans stacking, upselling to larger unneeded loan amounts, etc.
- Aggressive and increased **engagement of profit-driven stakeholders which checkered records relating to consumers.**
- Disproportionate increase of **Finders connected to payday lenders and other high cost market actors.**
- The **lack of Finders registered by non-profits** is a missed opportunity to strengthen Pilot outcomes since nonprofits are better positioned to impact lasting change through earned community trust and visibility and are a safer option as a compensated third-party loan originator. (See "Promotora Models" in textbox above).

POLICY RECOMMENDATIONS

1) Conduct On-going, Outcomes-based Research before Additional Pilot Expansion Efforts

- More research, evaluation and reporting by finders should be conducted to determine the:
    - *Pilot's impact and outcomes* as reported by lenders, borrowers and especially Finders. Given recent legislative allowances for finders/referral partners that parallel those of lenders/brokers as well as data that shows borrowers are less likely to increase their credit score via a finder as opposed to without a finder, strict reporting obligations and licensure should be required of finders/referral partners with audits managed by the DBO. **Because Finders are in the lending business they should have their activities in that function licensed and regulated with the same level of scrutiny and oversight as licensed lenders and brokers.**
    - *Practice of Pilot and payday loan stacking*. For finders that are also involved in other financial service businesses (like payday and car title loans), it is unclear what the interplay is between those primary businesses and their pilot activities. This information would offer a better understanding of the lending dynamics among Pilot borrowers, Finders and lenders. It can also help guide policies regarding 1) the sequencing of loan payments (i.e. which loan(s) should be paid first based on the balance size, interest rate, or the available balance to lessen the financial burdens of the borrower); and 2) tightening Pilot lending practices wherein Pilot borrowers are prohibited from taking on a second payday loan—currently, borrowers are not allowed to take on two Pilot loans simultaneously.

2) Keep Consumers at the Center of Responsible and Affordable Policy-Making

- *Policies should protect and set borrowers up for success.* Despite claims, increasing the amount a consumer can borrow will not increase the number of loans being made or consumers served. Rather, it allows current Pilot lenders to encourage their borrowers to take out larger loans they may not need, thereby increasing the amount of debt the borrower takes on (and the Finder's compensation) and defeating the objective of helping them to build credit and integrate into the financial mainstream. There are no barriers to lending above $2,500 that require the pilot to expand. **The only thing that increasing the loan limit of the pilot accomplishes is that it would allow a pilot lender to use finders to make bigger loans which finders would have to be licensed as lenders or brokers to perform anywhere outside of the pilot—*essentially de-regulating the use of third parties for larger loan amounts.***

3) Increase Regulatory Oversight and Clarify the Role of Finders/Referral Partners

- *More oversight regulatory attention is needed for the activities of Finders* (e.g. full licensure, minimum qualifications, compensation restrictions, evaluation for fitness and accountabilities). Currently, the role and accountabilities of finders/referral partners are poorly defined and conflicting, especially as they relate to fully licensed lenders. **Finders should be fully licensed with the same examination, compliance, and reporting obligations as pilot lenders.**
- *More clarity and restrictions are needed for Finders who are also payday lenders*. There is a conflict of interest between a Finders obligation to the public good and their private interests (i.e. profits to be made from soliciting Pilot borrowers with payday lending, loan stacking, and other predatory products). More stringent policies should be in place to deter payday lenders from engaging in unscrupulous practices under the guise of Pilot loans, if at all. **It is worth considering whether high cost financial service providers should be allowed to operate as finders at all.**
- More time is needed to fully understand the potential and pitfalls of the program given the tremendous growth in finder/referral partner activity. **This explosive growth does not support the assertion that more flexibility or expansion is necessary to maximize impact.**

4) Increase Purpose-Driven Finders, Not Profit-Driven Ones

- *Limit future pilot F partners to non-profit entities* to balance the current overdevelopment of high cost check cashing and/or payday lenders registered in the pilot.

5) Revisit the Pilot Sunset Provision

Program permanency should be implemented. When it was proposed that the sunset on the Pilot program be removed, more lenders expressed interest in lending under the Pilot. However, when the removal of the sunset was reduced to simply an extension of 5 years much of that interested evaporated. Making the Pilot permanent is the single easiest and direct way to expand and improve the Pilot. It would provide prospective lenders the level of confidence and certainty they need to make the long and short-term investments required to do serve this market.

APPENDIX A