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California Legislature

May 12, 2022

Martin Gruenberg, Acting Chair
Michael Hsu, Director
Rohit Chopra, Director
Federal Deposit Insurance Corporation
550 17th Street, NW, Room 6000
Washington, D.C. 20429

Dear Board Members:

We, the undersigned members of the California State Legislature, urge the Federal Deposit Insurance Corporation (FDIC) to take action against banks that partner with non-bank lenders to originate high-cost loans in efforts to circumvent state interest rate restrictions. FDIC-supervised depository institutions should not be permitted to originate loans on behalf of third parties who seek to evade state laws that protect consumers from unaffordable interest rates. The State of California has a long-established public policy interest in protecting consumers from harmful, fraudulent, and abusive practices. Efforts by high-cost lenders to evade our state laws seek to undermine the will of Californians as expressed through their democratically elected representatives, and we ask the FDIC to crack down on these schemes.

Brief history of high-cost installment lending in California

High-cost installment lending is a relatively new phenomenon in California. While payday lending was formally permitted in the state in 1996, installment loans with interest rates above 100% APR were not common until 2010, after CashCall pioneered the product and showed other lenders that it could be profitable to make high-cost loans even if 40% of borrowers defaulted along the way.[1]

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[1] For more on the story of CashCall as a pioneer of high-cost lending, see, e.g., https://www.latimes.com/projects/la-fi-reddam-cashcall-loanme/

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In the wake of the Great Financial Crisis, high-cost lenders mimicked CashCall's business model and focused their marketing of triple-digit interest rate loans towards families who experienced damaged credit and uncertain job prospects. By the middle of the decade, more than a dozen large lenders were offering installment loans with rates exceeding 100% APR, and lenders originated more than $1 billion of these loans each year from 2015 through 2019.[2]

High-cost loans harm California families

Lenders market high-cost loans as "quick" and "easy" to obtain, but data reported by high-cost lenders to California regulators suggest that consumers often do not have such an easy time paying back the loans. In fact, high-cost lenders charged-off 92,144 loans in 2017, or 32% of their loans.[3] This high default rate is unprecedented in the financial marketplace, based on analysis of loan performance metrics for other credit markets. As one point of comparison, the default rate in the subprime auto loan market in California was 11% in 2017, with "subprime" defined as borrowers with a Vantage Score of 300-600.[4]

When lenders charge-off a loan, they record an expense that can be used to lower the taxes they owe to the state and federal governments. For borrowers, however, charged-off loans do not go away. Lenders assign the defaulted debt to collectors or sell the loan off to a debt buyer. The consumer's credit score is negatively affected, and they are subject to aggressive collections practices, which can ultimately result in their car being repossessed, their paycheck garnished, their bank account closed, and even bankruptcy.

For those consumers who can ultimately repay these loans, they avoid the negative consequences that accompany a default, but the benefits of accessing credit are offset by the high rate of interest and the lack of improvement to their credit score. Interest and finance charges on high-cost loans typically exceed the original principal amount borrowed – often by a magnitude of 2x or more – over the scheduled loan term. Furthermore, only a few high-cost lenders report the borrower's payments to a credit bureau. This means that even if a borrower repays the loan on time and in full, their credit score does not improve, leaving them trapped outside of the mainstream financial system with little hope of accessing better rates and products offered by banks and credit unions.

State government actions to balance credit access and consumer protection

In response to the explosive growth in high-cost installment lending and the attendant defaults, California state legislators introduced several bills from 2017 to 2019 that proposed to extend interest rate ceilings that applied to loans of $2,500 or less to larger

[2] See annual reports related to the California Financing Law here: https://dfpi.ca.gov/california-financing-law-publications/
[3] Data obtained from annual reports submitted by lenders to the Department of Financial Protection and Innovation. Copies of those reports are available upon request.
[4] This data was collected from credit bureaus by Urban Institute and published here: https://apps.urban.org/features/debt-interactive-map/?type=auto&variable=autoopen_pct&state=6

installment loans. After several bills failed to be approved by the Legislature due to concerns that the proposed rates would too severely restrict access to credit, the Legislature passed Assembly Bill 539 (Limón and Grayson, Chapter 708, Statutes of 2019), which established an interest rate cap of 36% plus the Federal Funds Rate for loans of $2,500 - $10,000.

Assembly Bill 539 represented a thoughtful compromise based on an analysis of borrower outcomes as reflected in annual reports filed by lenders and from conversations with borrowers and lenders alike. As legislators considered their positions on the bill, they heard from a number of large lenders who communicated their ability to serve nonprime consumers at interest rates that complied with the bill. Legislators overwhelmingly agreed with the provisions of Assembly Bill 539 and approved it by a 60 – 4 margin in the State Assembly and a 30 – 5 margin in the State Senate. The bill received bipartisan support with over 40% of Republicans voting "aye" on the bill.

In addition to Assembly Bill 539, the State of California has advanced a number of policies intended to balance access to healthy financial products while ensuring that consumers benefit from legal protections when using those products. Examples of those efforts include:

- Establishing the Pilot Program for Increased Access to Responsible Small-Dollar Loans in 2013, which allows approved lenders to charge rates and origination fees higher than statutory caps that apply to loans of $2,500 or less, in exchange for additional consumer protections and reporting requirements.
- Requiring "buy now, pay later" (BNPL) lenders to be licensed under the California Financing Law (CFL), which provides regulatory clarity to BNPL lenders, brings BNPL activity under the oversight authority of the California Department of Financial Protection and Innovation (DFPI) to ensure users of BNPL products are covered by protections provided by the CFL, including disclosure requirements and interest rate and fee ceilings, and allows consumers to benefit from access to lower-cost forms of credit than payday loans, overdraft credit, and high-cost installment loans.
- Establishing the California Consumer Financial Protection Law, modeled after Title X of Dodd-Frank, which provides DFPI with broad supervisory, regulatory, and enforcement authority over any provider of a consumer financial product or service operating in California.
- Pursuant to the CCFPL, DFPI entered into memoranda of understanding with providers of earned wage access products, ensuring that California consumers have access to lower-cost alternatives to payday loans and overdraft credit, while providers agree to certain consumer protections and reporting requirements.

Partnerships between FDIC-supervised banks and high-cost lenders undermine California's public policy

In an effort to evade state interest rate restrictions, at least nine high-cost lenders have partnered with six FDIC-supervised banks to originate consumer loans with triple-digit

interest rates in states where such loans are illegal.[5] To the extent that these arrangements remain in place, state laws designed to protect consumers from unaffordable loans will be less effective in meeting the policy goals intended by the people who enacted the laws – either voters who approved such laws via ballot initiatives or legislators and governors who enacted legislation.

States have tools to pierce these arrangements and hold lenders accountable for breaking state lending laws, but these tools are more costly to employ and less likely to be effective than typical enforcement authorities provided to state financial regulators. These tools must often be used in resource-intensive and time-consuming litigation, rather than through typical administrative actions that are used when state-licensed financial institutions, such as state banks, state credit unions, independent mortgage companies, or payday lenders, violate state law. One of the most common tools to pierce these arrangements is the true lender doctrine where a state shows that the true lender is not the bank whose name is on the loan contract but rather the nonbank lender who has the predominant economic interest in the loan. In order for this tool to be effective, courts must look beyond the formal contract and evaluate the substance of the economic arrangement between the bank and the non-bank lender.

The California DFPI is currently embroiled in the early stages of a legal battle with a high-cost lender that partners with an FDIC-insured bank to originate high-cost installment loans that break California law. In this case, the lender recently sued DFPI, seeking a judgment that the regulator does not have the authority to investigate the lender for potential violations of California law.[6] DFPI filed a counter claim, specifying that the lender, not the bank partner, is the true lender and thus subject to California law.[7] While DFPI makes a strong case, the legal matters will likely take years to resolve, leaving California consumers subject to risks posed by the very kinds of loans that California policymakers overwhelmingly outlawed.

FDIC has the opportunity to support federalism, consumer protections, and access to affordable credit

While states continue to pursue legal action against non-bank high-cost lenders, the FDIC has the opportunity to stop FDIC-supervised banks from engaging in these partnerships. We urge the FDIC to employ all of its tools – supervisory, regulatory, and enforcement – to put a stop to these partnerships.

FDIC action on this matter can support a variety of public policy objectives, including support of the principle of federalism in American democracy, consumer protections, and access to affordable credit. States should retain their ability to exercise the historic police

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[5] https://www.nclc.org/issues/high-cost-small-loans/rent-a-bank-loan-watch-list.html
[6] https://www.consumerfinancemonitor.com/2022/03/15/oppfi-files-complaint-to-block-true-lender-challenge-by-california-department-of-financial-protection-and-innovation/
[7] https://dfpi.ca.gov/wp-content/uploads/sites/337/2022/04/Civil-Action-Opportunity-Financial-LLC-Cross-Complaint.pdf

powers of the states to protect their consumers. Congress has never enacted legislation to preempt states from establishing restrictions on high-cost loans or from applying those laws to non-bank lenders, and the FDIC should not allow its supervised banks to frustrate state enforcement efforts.

California policymakers have determined that reasonable interest rate restrictions solve the twin goals of providing access to affordable credit for consumers who may not qualify for prime credit offerings and preventing lending markets with misaligned incentives to flourish, where lenders can prosper while borrowers fail. Targeted efforts by the FDIC to stop bank partnerships that originate high-cost loans would support the decisions of democratically elected representatives of the people of California, along with many other states that have established similar policies.

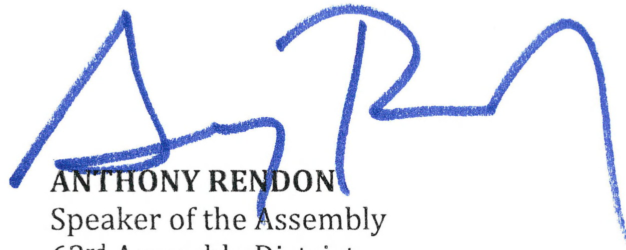
We appreciate your attention to this important matter and look forward to any efforts to address this problem.

Sincerely,

MONIQUE LIMÓN
State Senator, District 19
Chair, Senate Committee on Banking and Financial Institutions

TONI G. ATKINS
Senate President pro Tempore
39th Senate District

TIM GRAYSON
State Assemblymember, District 14
Chair, Assembly Committee on Banking and Finance



ANTHONY RENDON
Speaker of the Assembly
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