

The Consumer Finance Act: Report and Recommendations to the 2011 General Assembly



February 2011

North Carolina Office of the Commissioner of Banks

Joseph A. Smith, Jr.
Commissioner of Banks



North Carolina Office of the Commissioner of Banks

The N.C. Office of the Commissioner of Banks (NCCOB) regulates state-chartered banks, savings and loans, trust companies, mortgage lenders/brokers/servicers, mortgage loan originators, as well as consumer finance companies, check-cashers, and other financial services. NCCOB is funded by industry fees and assessments and not taxpayer dollars.

North Carolina Office of the Commissioner of Banks

Consumer Finance Division
4309 Mail Service Center
Raleigh, NC 27699-4309
Phone (919) 733-3016
Fax (919) 733-6918
www.nccob.gov

Table of Contents

Executive Summary	1
Introduction.....	2
Background: the Study Group, the CFA and the Annual Report.....	3
The Study Group	3
The CFA	5
The Annual Report	6
Challenges in the Data	7
Revised Data Collection Form	8
Revised Annual Report Format	8
Overview of the Consumer Finance Industry	8
Trends in consumer finance.....	9
Profile of Finance Company Borrowers	16
Options for Serving the Small Dollar Loan Market	20
Credit Cards.....	21
Bank and Credit Union Products	21
Alternative or Informal Loan Products.....	22
The Consumer Finance Business in North Carolina	23
Other Aspects of the Business	25
Non Filing Insurance and Non Filing Fees	25
Credit Insurance	27
The Role of Sales Finance	28
Industry Profitability.....	30
Industry Perspective	30
Segmentation analysis: 2007-2009	32
Drivers of Profitability: Multivariate Analysis	38
Consumer Protection Issues	44
Appendix A: Legislative Study Commission's Recommendations	
Appendix B: Summaries of Study Group Meetings	
Appendix C: Roster of Registered Attendees of Study Group Meetings	
Appendix D: List of Resources Provided or Discussed During Study Group Meetings	
Appendix E: Revised Annual Report Data Instrument	
Appendix F: Outlier Removal Methodology	

Executive Summary

The modern consumer finance installment loan industry is nearly a century old. For 50 years, the industry in North Carolina has been regulated through the North Carolina Consumer Finance Act (G.S.53, the CFA or the Act). The CFA and other similar laws were originally passed when working people had few legal credit options; these laws were effective in driving out illegal loan sharking by providing a safe, accessible lending option. The CFA has evolved but stayed true to the fundamental principle of providing access to affordable, repayable credit. Today, the CFA governs the business of providing direct-to-consumer installment loans in amounts up to \$10,000 for terms of up to seven years in a highly regulated manner.

The consumer finance installment loan industry is a product of public policy. This policy framework warrants occasional review as the world changes. In this spirit, North Carolina lawmakers have reexamined the state of the consumer finance industry and the balance between lender viability and consumer protection. In the process, a legislative study commission, the Joint Legislative Commission on the Modernization of North Carolina Banking Laws and the Consumer Finance Act (the Commission) called on the North Carolina Office of the Commissioner of Banks (NCCOB) to conduct a more in-depth study. This report presents evidence from study group meetings, licensees' annual reports, interviews, presentations, existing research, and reports and recommendations submitted to the NCCOB.

The Commission's overarching requirement was that the law contain appropriate consumer protections but also recognize the potential profitability of the lender. The CFA currently appears to adequately protect consumer interests, and provide a relatively safe source of credit for about 6% of North Carolinians. Most of these North Carolinians have bank accounts and credit cards, but they are more likely to be credit constrained and have relatively fewer affordable options. CFA strictures protect these borrowers from excessive costs associated with many of the alternatives. At the same time, the consumer finance installment loan industry continues to demonstrate potential for profit under the CFA. Lenders recorded an aggregate profit in 2009. Over the past 12 years, the majority of licensees have been profitable, and the aggregate industry net worth more than doubled between 1998 and 2009. The decline among large national chains has dampened aggregate profitability for the industry in this state, but if we remove the national chains from the equation, we see a stable record of positive net income since 2001.

Nevertheless, the industry is not thriving. Lenders report difficulties raising debt and equity to fund growth or start new companies. In fact, industry growth has declined by several measures in relation to volume. Due to structural changes in the market, we see a long-term decline in the share of consumer credit provided by consumer finance companies. The efficient and convenient credit card has come to dominate consumer credit, eclipsing the traditional hands-on, bricks-and-mortar model of the consumer finance lender. In the short-term, retrenching by credit card lenders and banks may open opportunities for consumer finance lenders, but economic weakness may also reduce the number of qualified prospects. Disentangling the short-term effects of the credit crisis from long-term fundamentals is challenging as the net effect of the credit crisis remains to be seen.

Additional findings and conclusions:

- Operating costs have risen over the study period; from 1998 to 2009, the aggregate average cost per loan has increased in line with inflation. Lenders benefitted from the offsetting fact that the aggregate average-interest expense per loan hit a 12-year low in

- 2009. Among the non-national chain lenders, average loan balances have also risen at about the same rate as inflation.
- The appropriate metrics are needed to evaluate industry health for policy decisions. Detailed throughout this report, we cite the limitations of using the annual report data, and describe the analytic techniques we applied to adjust for any distortive data. The right metrics must also be used, including greater detail and segmentation. Enhanced reporting requirements and public report formats will be implemented for 2010 reports. These changes should give policymakers a clearer view of the industry.
- Extensive analysis of the available data indicates that variation between lenders accounts for most of the variation in profitability, which is not surprising given the large number of small operators whose profit margins are prone to being irregular. Next, cost of funds and credit losses are the strongest drivers of profit. Our analysis leads us to caution that permanent changes to the CFA may not be an appropriate response to temporary economic conditions that are not under the control of lenders or legislators.
- We found nothing to suggest that maximum loan amounts to a single individual should be increased. Through the annual report data, we saw that only a small number of loans are being made in the top of the allowed range.
- We also saw no strong evidence that called for increasing consumer protection and disclosure.

Introduction

On April 27, 2010, the Commission presented its report to the Regular Session of the North Carolina General Assembly. The Commission was tasked to specifically study four areas: the rise in operating costs for the industry and what impact it was having on the delivery of the product, the maximum amount that could be extended to any single borrower, the rate and fee structure of the industry, and “strategies for increasing consumer protection and disclosure.”¹

While gathering data for their report, the Commission participated in a series of meetings that included industry representatives and consumer advocates. The Commission noted a divergence of views and lack of adequate data. They charged NCCOB to convene further meetings with “borrowers, economic and market experts, consumer advocates, and the industry” as participants. After conducting these meetings, NCCOB would then make a report to the 2011 General Assembly. This report would include a summary of the meetings and recommendations. NCCOB was also asked to do a series of tasks including: revisiting past data, reviewing the annual report form, gathering new data, and analyzing the new data. Through these tasks, the Commission hoped to get a clearer picture of the consumer finance industry’s financial status. The Commission’s recommendations require that any CFA modifications adhere to certain consumer protection standards (“understandable, transparent, effective and fair credit”), and they balance “all appropriate consumer protections” with “the requirement for the potential profitability of the lender.” (See Appendix A.)

¹ Report to the 2010 Regular Session of the 2009 General Assembly of North Carolina by Joint Legislative Study Commission on the Modernization of the North Carolina Banking Laws and the Consumer Finance Act, 2010.

<http://www.ncga.state.nc.us/documentsites/legislativepublications/Study%20Reports%20to%20the%202010%20NCGA/Modernization%20of%20North%20Carolina%20Banking%20Laws.pdf> (last accessed January 24, 2011)

This document is NCCOB's report and includes a summary report on the four meetings that were held pursuant to the Commission's instructions (see Appendix B). To develop recommendations, NCCOB contracted with researchers at the University of North Carolina at Chapel Hill's Center for Community Capital (the Center). For more than a decade, the Center has studied the provision of financial services to underserved communities in North Carolina and nationally (see www.ccc.unc.edu).² Researchers at the Center performed in-depth analysis of the annual report data furnished by CFA's licensees over the prior 12 years. They also examined existing research on consumer debt, and conducted interviews with industry representatives, industry experts, credit counseling agencies, and consumer advocates. The researcher's analysis and findings are incorporated into this report.

Lobbyists with the North Carolina Credit and Personal Finance Council (NCCPFC) raised concerns about the Center's ability to produce unbiased research.³ NCCOB turned to the Center for its analytical capabilities and experience in studying consumer financial services in the context of business sustainability. NCCOB has assisted and followed the analysis performed by the Center, and remains confident in its reliability. All policy recommendations and industry assessments in this report are those of NCCOB, not those of the Center.

The remainder of this report is divided into four sections. In Section 3, the report provides background on the Study Group, aspects of the CFA, and the annual report. In Section 4, the report gives an overview of trends in consumer credit and in the consumer finance industry, and describes the business model for North Carolina's consumer finance companies. In Sections 5 and 6, the report examines the potential for profitability (section 5) and consumer protection issues (section 6).

Background: the Study Group, the CFA and the Annual Report

The Study Group

In order to encourage broad participation in study group sessions, NCCOB asked industry representatives and consumer advocacy groups to invite other stakeholders to participate in the four scheduled meetings. The mix of attendees included strong representation from the state's consumer finance industry and some out-of-state lenders. Representatives from consumer advocacy groups, consumer credit counselors, credit unions (State Employees and Self-Help) and the North Carolina Bankers Association were also represented. In addition, NCCOB staff and representatives of the North Carolina Departments of Insurance and Justice were in attendance. (See Appendix C.)

² The Center was already under contract with the NCCOB to analyze North Carolina foreclosure patterns and national data provided by loan servicers. The NCCOB has previously engaged the Center to study the impact of the closure of payday lending in the state of North Carolina (see *North Carolina Consumers After Payday Lending*, November 2007), and the savings patterns of lower income working households using volunteer income tax preparation sites (see *Transforming Tax Refunds into Assets*, August 2005).

³ Specifically, the NCCPFC was concerned that many funders of the Center's research projects have, according to the NCCPFC, "adversarial public advocacy relating to the private enterprise, for-profit consumer finance industry" and about affiliations of the Principal Investigator.

In several of the meetings, professionals shared their expertise. These included representatives from the Center for Financial Services Innovation, Equifax, and RSM McGladrey and McGladrey & Pullen. Each meeting was dedicated to a particular subject. (Longer descriptions of each meeting are provided in Appendix B.) At the first meeting in August, participants reviewed the Commission's findings and the goals of the study group meetings. They discussed NCCOB's data collection, reporting on finance companies, and the level of data that would be necessary to meet the study objective. Throughout the meetings, both consumer advocacy groups and industry groups repeatedly stressed how difficult it was to assess the underlying economics of the consumer finance business with the annual report data.

In September, participants focused on the demand side of the industry. The topics included the need for short-term consumer loans, the alternative/substitute products and channels available in the marketplace, and an overview of the consumer finance industry. Through this meeting, participants learned that there is very little information available about consumer usage and attitudes toward consumer installment lending. They found that much of the available research examines credit cards and very high cost "alternative financial services" such as payday lending. A general discussion broke out about long-term trends in the use of revolving debt versus installment debt, recent trends in consumer borrowing behavior, and what options underserved consumers face in the current environment.

In October, the meeting topic focused on industry profitability. The Center presented the industry overview (updated through 2009), and gave a more granular analysis of companies' financial performance over the 2007 to 2009 period. McGladrey & Pullen presented a summary of the findings from their cost study, and a finance company executive provided a profitability example based on three of his company's branches. Much of the discussion and debate revolved around two key themes put forward by industry representatives: first, to what extent have CFA's tiers and rate caps prevented income from growing in step with operating costs, and second, whether return on equity is a better measure of viability of the industry than absolute profitability.

The November meeting explored consumer protection issues. Participants also took some time to discuss shortcomings of the annual report data (collected by NCCOB) and, according to consumer advocates, the danger of using this data to establish new policy direction in such an economically volatile period as 2008 and 2009. Consumer advocates described the financial challenges facing many in the state – using both client anecdotes and macro economic data. Participants also dedicated much of the November meeting discussion to the topic of renewals. Industry representatives explained how renewals are a service of value and that repeat borrowing is a sign of customer satisfaction. Other topics covered were the issue of non-filing insurance, and the low number of consumer complaints. Industry representatives detailed the built-in consumer protections that make their loans a good and sound product, while consumer advocates emphasized the role of the CFA in ensuring those protections. Citing these "two very different perceptions of the good," the Commissioner of Banks closed the final study group meeting with a discussion of the legal and policy context.

A list of resources cited or discussed during the meetings is found in Appendix D.

The CFA

The North Carolina Consumer Finance Act (“CFA”), N.C.G.S § 53-164,⁴ is a carefully crafted and comprehensive exception to North Carolina’s usury laws. The CFA was enacted in 1961 adding North Carolina to the list of states with model small loan laws, the first of which was passed in the early 1900’s.⁵ The result has been the creation of a narrowly bounded lending industry whose existence is predicated on the perceived need for consumer access to small installment loans.

The maximum rate of interest in North Carolina is limited by Chapter 24 of the North Carolina General Statutes. However, the CFA permits an exception for licensees who comply with certain requirements. Most loans are made under the Section-176 regime of 30% for the first \$1000 borrowed, and 18% for amounts over that (176 loans). Provisions explicitly delineate who may lend and the permissible terms of credit and manner in which credit may be extended. The CFA also sets forth specific disclosure requirements as well as enforcement provisions.

Though the CFA includes express prohibitions and restrictions, there are provisions which create a general presumption of exclusion with respect to what may be done under the Act. This is consistent with the CFA’s underlying purpose to create only a narrow carve-out to usury laws. Below is a summary of key provisions:

- Businesses must have a license issued by the NCCOB’s office. Only CFA licensees may lend pursuant to the CFA and all loans must be made pursuant to conditions and requirements of the Act. CFA licensees are generally prohibited from occupying the same office as other businesses except as provided for by the Act or as authorized by the NCCOB.
- The maximum loan amount under the Act is \$10,000.
- N.C.G.S. § 53-166(b) provides a sweeping prohibition against attempts to circumvent the CFA’s requirements and limits.
- Each violation of the Act is a Class 1 Misdemeanor. With limited exceptions, loans in violation of the CFA are void, and licensees may not collect or retain any principal or charges related to the void loan. The NCCOB has the power to revoke licenses for any violation of the CFA, including violation of specific provisions, reporting requirements, or regulations promulgated under the CFA.
- Two categories of licensees and corresponding permissible loan amount, term, and interest rates are shown on page 5 in Chart 1.

⁴ The Consumer Finance Act, Article 15 of Chapter 53 is available at:

http://www.ncleg.net/EnactedLegislation/Statutes/HTML/ByArticle/Chapter_53/Article_15.html.
Regulations Promulgated Under the Consumer Finance Act, North Carolina Administrative Code, Title 4, Chapter 3, Subchapter 3E, available at: <http://reports.oah.state.nc.us/ncac/title%2004%20-%20commerce/chapter%2003%20-%20banking%20commission/subchapter%20e/subchapter%20e%20rules.html>.

Administrative Interpretations Issued by NCCOB under the Consumer Finance Act, available at: <http://www.nccob.gov/public/FinancialInstitutions/CF/CFAdministrativeInterpretations.aspx> (last accessed March 25, 2011)

⁵ F.B. Hubacheck, “Progress and Problems in Regulation of Consumer Credit,” *Law and Contemporary Problems* 19, no.3 (Winter 1954): 4-28. <http://www.jstor.org/stable/1190401>

Chart 1: Consumer Finance Act Summary

Type	N.C.G.S. § 53-173 Licensees	N.C.G.S. § 53-176 Licensees
Maximum Loan Amt	\$3,000	\$10,000
Maximum Rate	Principal < \$600 36% Principal > \$600 15%	Loans < \$7,500 blended rate: Principal < \$1000 30% Principal > \$1000 18% Loans > \$7500 18%
Maximum Term (months)	Loans ≤ \$600 - 25 \$601 - \$1,500 – 37 \$1,501 - \$2500 – 49 Loans > \$2,500 – 61	Between 6 & 84 mo.
Processing/Origination Fees	May not exceed the lesser of 5% or \$25	For loans < \$2,500, may not exceed \$25; For loans > \$2,500 may not exceed the lesser of 1% or \$40.
Other		Due date of first monthly payment must be within 45 days of disbursement of funds

- Interest is calculated as simple interest.
- Processing/Origination fees may only be charged twice in a 12-month period.
- N.C.G.S. § 53-178 provides a general prohibition of all charges and fees not explicitly provided for. The only other permitted fees and charges are:
 - a. Returned check fees limited to \$25.
 - b. Credit insurance (Credit life, credit accident and health, credit unemployment, and credit property insurance) may be sold with loans. Neither the premiums charged nor any benefits to the lender count toward the limit on permitted fees.
 - c. Filing fee / non-filing insurance. The lender may charge a fee for the amount of fees necessary to file / record a security interest, the amount of non-filing or non-recording insurance or the amount of non-filing or non-recording insurance (less one dollar) to be retained by the lender as self-insurance.

There are several other general restrictions applicable to the extension of credit and collection of loans. Loans may not be secured by real property. There is a limit of one loan per customer per CFA Company. After a loan matures, interest and charges may not exceed 8%. Prepayment penalties, attorney fees and assignment of earnings are prohibited.

The Annual Report

NCCOB collects operating information from all licensees annually.⁶ The main goal of this task has been to monitor industry compliance and set assessments, in accordance with General Statute Section 53-122. NCCOB publishes a high-level summary of the data (the Annual Report) once a

⁶ The 2009 Consumer Finance Annual Report. North Carolina Commissioner of Banks.
<http://www.nccob.gov/public/docs/News/Pub%20And%20Research/09%20Consumer%20Finance%20Annual%20Report.pdf>

year. As this process was not designed as a tool for evaluating industry profitability and borrower welfare, the information collected is self-reported and unaudited.

The data do include balance sheet information, a high-level income statement, and details about lending activities. In 2009, NCCOB added some new data fields regarding lending activity, approval rates, delinquency rates, and indirect lending. The statute limits the reporting to activities falling under the CFA (i.e. direct consumer installment lending). Thus, we found the data can be used for some deeper analysis of industry conditions with several caveats. In light of the increased interest in using this data for such purposes, NCCOB has revised the form to address several of these issues.

Challenges in the Data

Study group participants raised a number of issues about the reporting of licensee information. These concerned differences in accounting methods, varying definitional interpretations, and the potential for inaccurate and/or inconsistent cost allocation methodologies. Key caveats include:

- The reporting process allows for divergent approaches to reporting revenue and allocating expenses from sales finance and other non-CFA activities.
- Information is collected in broad categories, making it difficult for researchers to analyze the underlying dynamics or make comparisons. For example, the only expense category itemized is interest paid. Some organizations voluntarily itemize “other” expenses while others do not, making the total pool of data inconsistent. We found it is not possible to determine credit losses, an important consideration to both policy and industry interests.
- The reporting process has different approaches for reporting recoveries, with some organizations including certain recoveries in income and others including them in net loan losses.
- Some licensees chose to apply a tax accounting treatment/definition to the reporting of certain line items, whereas others report using Generally Accepted Accounting Principles (GAAP) treatment/definitions.
- Some licensees amortize loan application fees over the life of the loan, in accordance with the Statement of Financial Accounting Standards No. 91. Other licensees consider such amortization immaterial for application, and merely report loan application fees upon receipt.

We also found significant diversity in the ways licensees operate, with a handful of national operators on the one end of the spectrum and many small, single-branch organizations on the other. These differences impact not only profitability but also the core business decisions that management makes in the operation of its business, such as:

- Licensees vary in organizational structure. Some are sole proprietorships while others are shareholder-owned corporations. These different structures have diverse capitalization structures, which results in varying means by which earnings may be distributed to owners. In a shareholder-owned company, the owner may also be an employee and may, in effect, distribute earnings as salary expense (on the income statement). A sole proprietor or general/limited partner may not pay themselves a

salary but instead receive an equity distribution (reported in the equity portion of the balance sheet instead of the income statement).

- Some licensees are completely self-financed while other licensees depend heavily on the availability of outside capital for their lending activities.
- Several licensees operate sales finance business as well, and some combine income, assets and/or expenses from sales finance activity into their reporting. Some licensees use this reporting technique for some years and not for others.
- Large, chain licensees have home office expense burdens, and access to parent company capital. Most small and independent operators do not have home office expense burdens or access to parent company capital.
- Some licensees report affiliated branches as separate organizations, and in some cases there are intra-company financial transactions.

A third area of concern focused on how the information is presented. Because all line items are reported as an industry aggregate, we found it is difficult to discern underlying conditions and to use the data to make policy decisions. In particular, the results of a small number of very large licensees overshadow the overall industry picture by the sheer virtue of their size.

Revised Data Collection Form

Study group participants made recommendations for better definitions, clearer instructions, a more detailed itemization of expenses and, for licensees engaged in sales finance activity, clear instructions for allocating expenses. NCCOB circulated proposed revisions to both the industry and consumer groups to develop a final revised form. The draft revised form with annotated changes is included in Appendix E. When final, the new form will be used to report 2010 results.

Revised Annual Report Format

Participants gave a number of suggestions on improving the reporting process. Consumer and industry advocates suggested presenting the data by size segment. Industry representatives recommended using a format like the Tennessee car-title-loan industry report, which shows results by categories. These categories are based on how many branches each lender has.⁷ NCCOB is considering how to segment the consumer finance reporting in a similar manner, as this will correct the overwhelming effects of a few large lenders. Moreover, NCCOB is exploring building in more mechanisms to identify outlier data for removal or correction. NCCOB may consider showing additional, calculated metrics that have been found to be important indicators of industry health. They are also considering using lender averages as well as aggregate averages.

Overview of the Consumer Finance Industry

The course of the consumer installment lending industry in North Carolina is best understood through the context of national trends in consumer credit and developments in alternative products. In this section, we review the state of the industry, profile finance company customers, and review their borrowing alternatives.

⁷ *The 2010 Report on the Title Pledge Industry*, Tennessee Department of Financial Institutions, March 2010. <http://www.state.tn.us/tdfi/compliance/tpl/TPLReport2009Final.pdf> (accessed January 24, 2011).

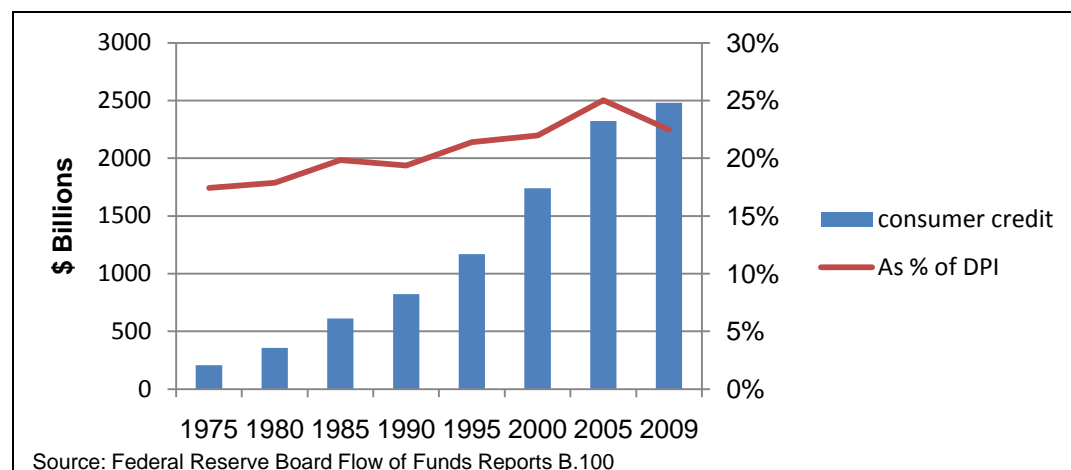
Trends in consumer finance

From 1910 to 1935, the modern era of consumer credit emerged and with it, the birth and growth of installment credit.⁸ In 1914, New Jersey passed the first modern small loan bill with a 3% per month rate cap and no fees. Many states subsequently passed laws to create a framework for small dollar installment lending. These “anti-loan shark” bills were motivated by a reform movement that sought to legitimize and regulate small-loan lending expressly in order to drive out predatory lending. Reformers saw existing usury ceilings as too low to enable viable small-dollar lending to the working class, and thus blamed them for creating pent-up demand and a climate for illegal and exploitative salary lending.⁹

Encouraged by public policy, installment lending quickly caught on and was offered by independent lenders as well as national chains of consumer finance companies. Sales finance companies also began providing installment loans, especially to facilitate the selling of automobiles. Later banks and credit unions joined in the consumer installment lending business and by the 1950’s, outstripped the consumer finance companies.¹⁰

Total consumer credit outstanding¹¹ has grown more than ten-fold since the mid-1970’s, and, as a percent of disposable personal income (DPI), from 17% to over 20% (see Chart 2). Over the 12-year study period (1998 to 2009) alone, consumer credit outstanding nationally grew by 80%.

Chart 2: Consumer Credit Outstanding



As other products have become increasingly popular, traditional consumer installment loans have not reaped their share of this growth. Consumer debt classified as “revolving” has grown more rapidly than closed-end consumer debt. In 1970, revolving consumer debt represented less than 1% of DPI in the US, and non-revolving installment debt (including auto loans) stood near 15%. By the end of the millennium both of these debt forms converged as a share of DPI of

⁸ Lendol Calder, “The Evolution of Consumer Credit in the United States,” in *The Impact of Public Policy on Consumer Credit*, ed. Thomas A. Durkin and Michael E. Staten (Norwell: Kluwer Academic Publishers, 2002), Chapter Two, pp.23-35.

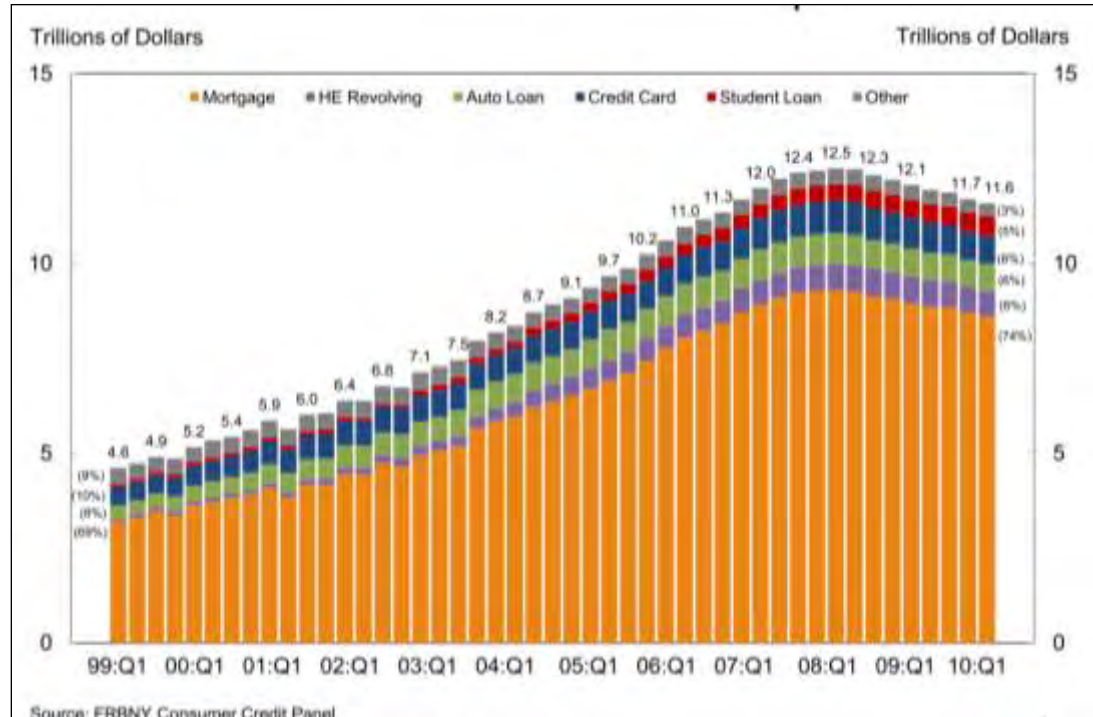
⁹ Irving S. Michelman, *Consumer Finance: A Case History in American Business* (New York: August M. Kelley Publishers, 1970).

¹⁰ Ibid.

¹¹ Excludes home mortgages.

around 10%,¹² a trend which continued through the end of 2009. As shown in the Chart 3 below, the “other” category (which includes direct installment lending by consumer finance companies) represents about 3% of all consumer debt today.

Chart 3¹³: Total Debt Balance and its Composition



Today, the major source of revolving consumer debt is credit cards. The rise of credit cards has been accompanied by advances in credit scoring, technology, and securitization. These developments have introduced significant efficiencies into the credit-card business model: “It is impossible to imagine the current prevalence of credit cards without automated underwriting and, later, automated account management.”¹⁴ From the first financial institution securitization of revolving consumer credit in 1986,¹⁵ credit card securitization grew to a \$120 billion market in 2007.¹⁶

The substitution effect of credit cards on installment credit has been widely noted. Former Federal Reserve Chairman Alan Greenspan remarked, “[T]he rise in credit card debt in the latter half of the 1990’s is mirrored by a fall in unsecured personal loans.” In testimony before the

¹² Dean M. Maki, “The Growth of Consumer Credit and the Household Debt Service Burden” in *The Impact of Public Policy on Consumer Credit*, ed. Thomas A. Durkin and Michael E. Staten (Norwell: Kluwer Academic Publishers, 2002), Chapter 3, pp. 43-63.

¹³ Federal Reserve Bank of New York, *Quarterly Report on Household Debt and Credit*, November 2010.

¹⁴ Peter McCorkell, Fair Isaac Company “The Impact of Credit Scoring and Automated Underwriting on Credit Availability”, in *The Impact of Public Policy on Consumer Credit*, ed. Thomas A. Durkin and Michael E. Staten (Norwell: Kluwer Academic Publishers, 2002), 210.

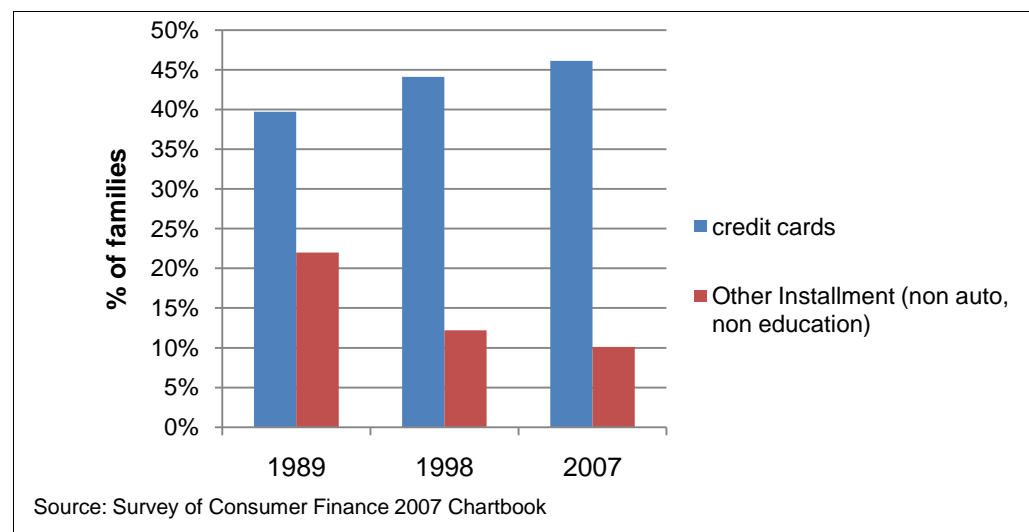
¹⁵ Kathleen Johnson, “Consumer Loan Securitization,” in *The Impact of Public Policy on Consumer Credit*, ed. Thomas A. Durkin and Michael E. Staten (Norwell: Kluwer Academic Publishers, 2002), pp. 287-300.

¹⁶ Dan Freed, “Credit Card Securitization Stalls”, *The Street*, August 8, 2010, <http://www.thestreet.com/story/10834089/credit-card-securitization-stalls.html> (accessed January 18, 2010)

Senate Banking Committee, Todd Zwyicki of George Mason University explained: “When consumers in earlier generations purchased furniture, new appliances or consumer goods, they typically purchased those items “on time” by opening an installment loan...or through a layaway plan. A consumer who needed unrestricted funds to pay for a vacation or finance a car repair would typically get a loan from a personal finance company or pawn shop. Today, many of these purchases and short-term loans would be financed by a credit card.” Zwyicki cites the “time, inconvenience, and more limited usefulness of a personal finance loan [and] the more flexible repayment option of credit cards.”¹⁷

As of 2007, the share of households with credit card balances (46.1%) is roughly comparable to the share of families with installment loans (46.9%).¹⁸ The majority of this installment debt, however, is for vehicles and education. The percent of families with non-auto, non-education installment loans has seen a steady decline to just 10% in 2007.

Chart 4: Credit Cards vs. Consumer Installment Loans



Over the last few decades, the personal credit market has seen other products emerge and take market share from direct installment lending. Once consumer credit lost its tax deductibility in the 1980’s, households increasingly turned to home equity lines of credit.¹⁹ In more recent years, more homeowners used cash-out refinance loans to consolidate and substitute for consumer debt.

Banks have expanded the use of transaction account overdraft services as an alternative small-dollar advance product since 2000. These transaction account overdraft services are for much smaller amounts – and usually much higher effective annual percentage rate (APR) - than

¹⁷ U.S. Senate Committee on Banking, Housing and Urban Affairs, *Modernizing Consumer Protection in the Financial Regulatory System: Strengthening Credit Card Protections*, Thursday February 12, 2009, report prepared by Todd J. Zwyicki.

¹⁸ Federal Reserve, “Survey of Consumer Finance Chartbook 2007,” *Federal Reserve*, <http://www.federalreserve.gov/pubs/oss/oss2/2007/2007%20SCF%20Chartbook.pdf> (last accessed January 19, 2011).

¹⁹ Sangkyun Park, “The Determinants of Consumer Installment Credit,” *Federal Reserve Bank of St. Louis*, http://research.stlouisfed.org/publications/review/93/11/Determinants_Nov_Dec1993.pdf (accessed January 19, 2011)

typical consumer finance loans.²⁰ Another small-dollar loan program, payday lending, has experienced growth for much of the study period. This practice, regulated at the state level, was allowed in North Carolina between 1997 and August 2001, with a final closure of out-of-state chain stores in 2006. A maximum of 7% of North Carolinians used these loans with a median amount of \$244 and APR of 419%.²¹ This industry continues to operate in many states around the country.

Against this dynamic background, the national consumer finance business has been fairly stagnant or even in decline. Between 1998 and 2007, the share of household debt comprised of loans from consumer finance companies fell.²² According to Federal Reserve Board economists, “revolving credit, particularly credit card debt, has substituted for small installment loans because of its ease of use and availability. Similarly, home mortgage debt has substituted for all types of consumer credit through equity extraction done most often through cash-out refinancing or home equity loans. These substitutions are attributable to relative price changes among credit instruments, appreciation in home values (allowing more equity extraction), and economies in offering different credit services.”²³

The fortunes of the large, national chain consumer finance companies reflect a general weakness in the industry. In March 2009, citing difficulties accessing funding and mounting delinquencies, HSBC closed its 800-branch network of stores operating as Beneficial and Household Finance. HSBC had already closed 600 branches over the period of 2007 to 2009.²⁴ In July of 2010, Wells Fargo restructured its consumer finance division, closing its 638 offices nationwide, claiming that the independent network of branches was no longer “viable”.²⁵ Shortly thereafter, America International Group (AIG) announced the sale of 80% of American General, a 20-billion-dollar company originally opened in 1920. AIG blamed frozen debt markets and recent losses.²⁶ CitiFinancial, the consumer finance division of Citibank, has been for sale since early 2009. The company, originally founded in 1912 under the name Commercial Credit will change its name to One Main Financial in preparation for the sale.²⁷

²⁰ FDIC, “FDIC Study of Bank Overdraft Programs”, *FDIC*, http://www.fdic.gov/bank/analytical/overdraft/FDIC138_ExecutiveSummary_v508.pdf (accessed January 19, 2011). The report found that most banks initiated this service since 2001.

²¹ UNC Center for Community Capital, “*NC Consumers After Payday Lending: Attitudes and Experiences with Credit*,” November 2007. Prepared for the North Carolina Commissioner of Banks. http://www.ccc.unc.edu/documents/NC_After_Payday.pdf (accessed January 19, 2011).

²² Brian K. Bucks, Arthur B. Kennickell, Traci Mach and Kevin B. Moore. “Changes in U.S. Family Finances from 2004-2007: Evidence from the Survey of Consumer Finance.” *Federal Reserve Bulletin*, volume 95. February 2009, pp. A1-A55. Table 17.

²³ Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit, Board of Governors of the Federal Reserve System, August 2007. Hereafter referred to as Federal Reserve Credit Scoring Study. <http://www.federalreserve.gov/boarddocs/rptcongress/creditscore/default.htm>. (last accessed January 23, 2011).

²⁴ Mitchell Jaworsky, “HSBC to Exit Consumer Lending in US, Cut Jobs,” *AHN News*, March 2, 2009, <http://www.allheadlinenews.com/articles/7014275200> (accessed January 19, 2011)

²⁵ Wells Fargo, “Wells Fargo and Company to Consolidate its Wells Fargo Consumer Finance Division into the Company’s Newly Expanded Coast to Coast Community Banking Network; 638 Independent Consumer Finance Offices to be Closed,” news release, July 7, 2010.

²⁶ Erik Holm and Serena Ng, “AIG Sells off Sagging Piece of Its Empire,” *Wall Street Journal (Eastern edition)*, August 12, 2010.

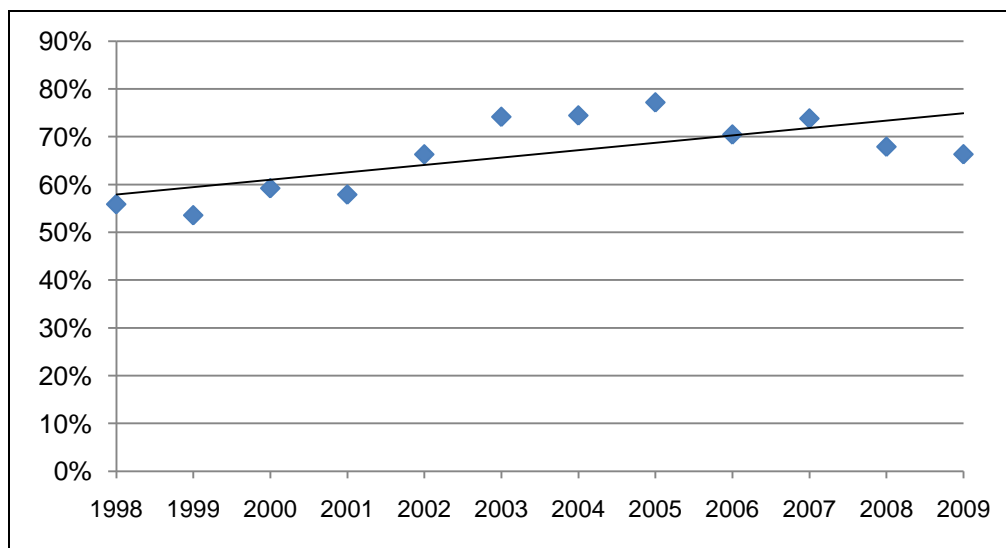
²⁷ Bradley Keoun, “Citigroup Picks One Main as New Name for CitiFinancial,” *Bloomberg News*, December 8, 2010, <http://www.bloomberg.com/news/2010-12-08/citigroup-picks-onemain-as-name-for-consumer-loan-unit-in-step-toward-sale.html> (accessed January 18, 2010).

As noted, the finance companies are not the only North Carolina financial entities to feel profit pressure. In his 2009 annual report on state chartered banks and savings institutions, the Commissioner reported “nominal” asset growth, if not actual shrinkage. He continued to say, “As a result of the deep and persistent recession afflicting the State and the nation, North Carolina banks continue to experience declines in asset quality and overall profitability.”²⁸

Thus we see many forces at work on the finance companies: long-term erosion of market share and demand relative to substitute products and channels, nationwide weakness among large chain finance companies, and a credit crisis that is impacting other financial services companies.

North Carolina’s consumer finance industry reflects these trends. Since 1998, there has been a more than 20% decline in the number of licensees and locations, and a lesser decline in outstanding receivables (12%). Over this period, the peak for receivables and branches was 2000 – driven in part by the entrance of Washington Mutual Finance Group in 2000 with 45 branches. Washington Mutual Finance Group exited shortly thereafter in 2003. The number of loans receivable outstanding at year-end has fallen almost every year since 1998, but, interestingly, rose in 2009 to the highest level in 9 years. Over this period, we can see in Chart 5 below that the share of lenders that are profitable has slightly increased.²⁹

Chart 5: Percent of Profitable Lenders



The peak year for total industry profitability was 2006. That year, income was 15% higher than in 1998, expenses were only 2% higher than 1998, and interest paid was 18.5% lower than in 1998. These results were achieved partially by a drift to higher-loan balances (from \$2300 to \$3100) as the number of loans outstanding (averaged over the year) fell 20%. Thus on a per-loan basis, lenders enjoyed a \$240 rise in revenue with only a \$99 increase in operating costs and interest paid, between the years 1998 and 2006.

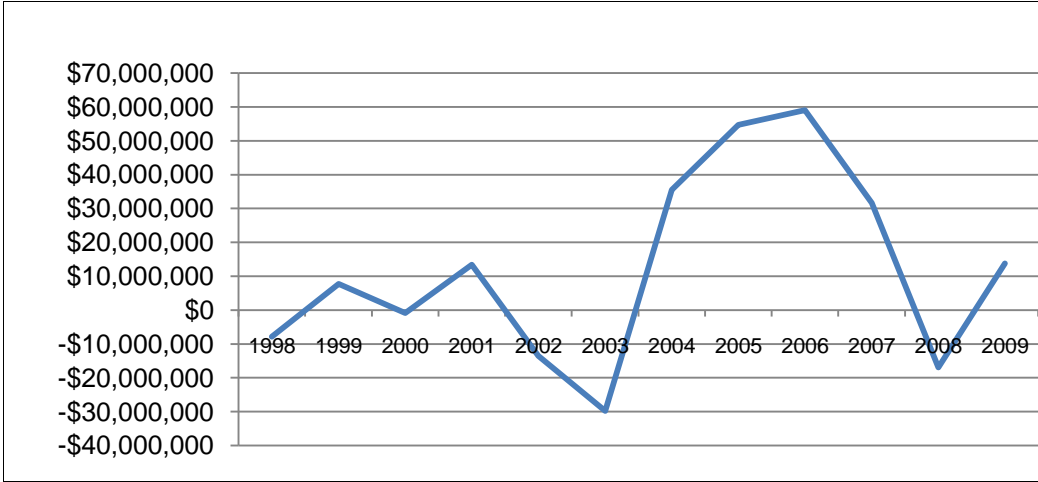
²⁸ Annual Report of the Commissioner of Banks from Joseph A. Smith, Jr., North Carolina Commissioner of Banks, Cover Letter.
<http://www.nccob.gov/public/docs/News/Pub%20And%20Research/2009%20Bank%20Annual%20Report%20-%20Final.pdf> (accessed January 23, 2011.)

²⁹ Throughout the report, when referring to licensee-reported data, profit refers to net income before tax.

Like the rest of the financial industry, licensees' profits fell after 2006. Compared to 2006, the amount of loans receivable in 2009 was down 14% and income was down 23%. Operating expenses were down just 10%, but interest paid was down by 41%. Industry-wide, in 2009, licensees reported income of \$553 per loan, operating costs of \$402 per loan, and interest payments of \$122 per loan, resulting in net income of \$27 per loan.

While the industry operated in the black in 2009, it should be noted that in 2008, the industry reported an aggregate pre-tax loss. Although revenues were higher than in 2009, and interest costs were on the decline, operating expenses were still slightly above 2006 levels and did not adjust downward until 2009.

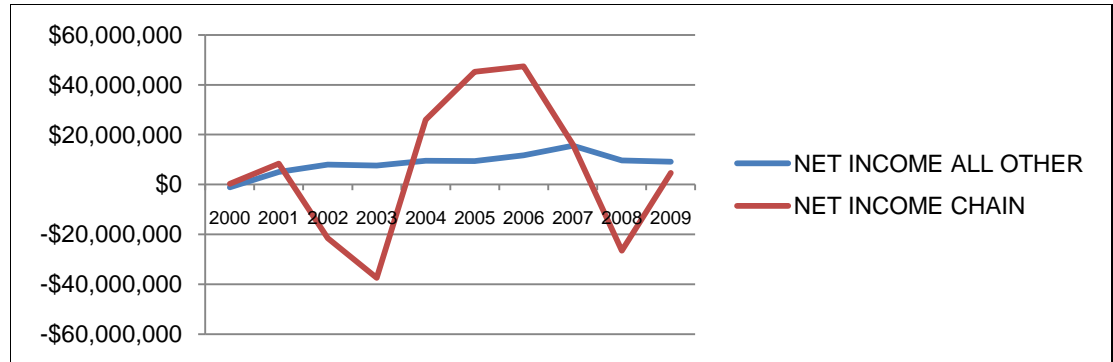
Chart 6: Total Industry Net Income



The recent troubles of large chain companies³⁰ have reduced the ranks of North Carolina branches. Since 2006, the total number of branch locations is down by 108. Over this time period, the large, national chains accounted for 107-branch closings. From just 2008 to 2009, these national chains accounted for 45 closings (out of a net loss of 51 for the industry as a whole). When aggregate net income is split between large chain lenders and others, the "all other" segment has stayed in positive territory since 2001 from a net income perspective.

³⁰ Large chains are: American General, Associates, Beneficial, CitiFinancial, Equity One, Household, Wells Fargo and Washington Mutual.

Chart 7: Industry Net Income, National Chains vs. All Other Lenders



The number of loans made in the \$1000 to \$3000 category has consistently grown. In 2009, this category represents nearly 60% of loans made. Other loan categories have steadily declined and loans from \$3000 to \$7500 are just 20% of the number of loans made. Very large loans, over \$7500, make up 8% of loans (though they account for about a quarter of dollars loaned). The smallest loans, those below \$600 and those from \$600 to \$1000, are 4% and 10% of the loans made and just 1% and 3% of dollars loaned.

Loan size trends also diverge between national chains and others. The vast majority of large loans are made by the national chain lenders. Since 2000, their average loan amounts have been slightly more than double that of the smaller and independent companies. However, their share of the market has been shrinking, and so has the average loan amount within that segment.

Chart 8: Number of Loans Made by Size – National Chains

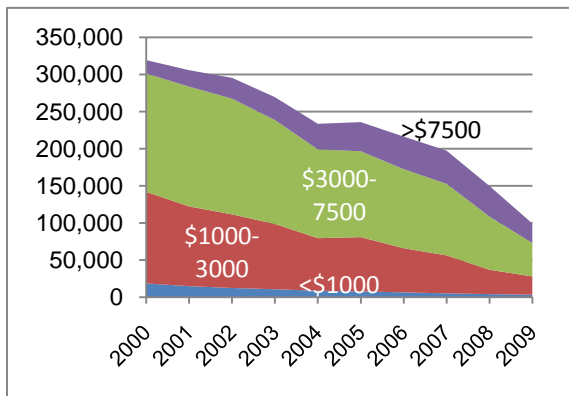
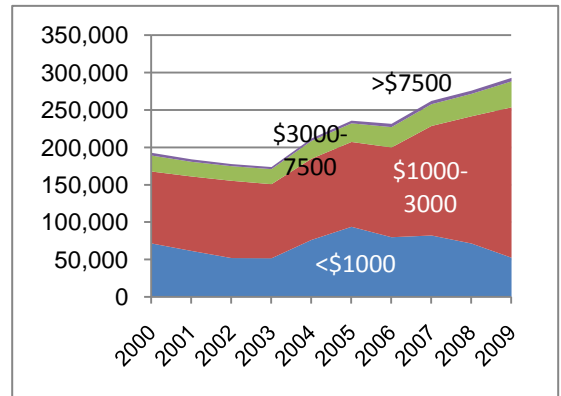


Chart 9: Number of Loans Made by Size – All Other

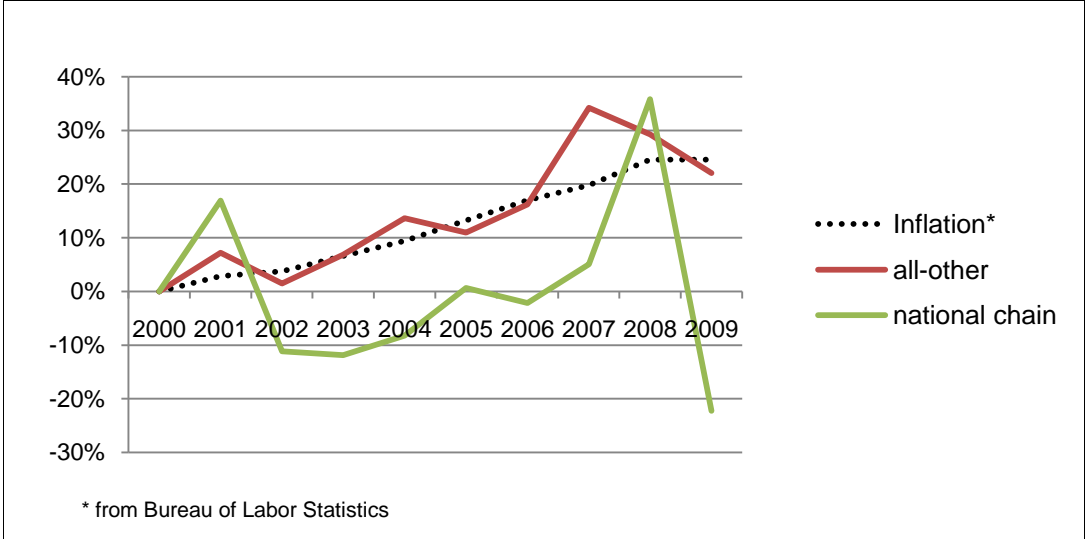


What has this meant for average loan amounts? The 2009 aggregate average across the industry was lower than it was in 2000, dragged down by the trends among large, national chains. Meanwhile, among non-national chain lenders, the average of all licensees' average loan amounts was 22% higher in 2009 than in 2000 (from \$1645 to \$2008).^{31,32} Rising average loan amounts, consistent with inflation, have helped offset rising fixed costs for these operators.

³¹ Excluding a few licensees who did not report number of loans outstanding.

³² Using aggregate averages of each segment results in similar patterns; the aggregate average loan for the non-national chain lenders is 27% higher in 2009 than in 2000 (from \$1,547 to \$1,964).

Chart 10: Change in CPI and Average Loan per Lender – National Chains and All Other Lenders (vs 2000 level)



Events of the very recent past may even signal an opportunity for the traditional installment lender niche. Credit card securitizations and borrowings are sharply off,^{33,34} and as of September 2010, the total revolving debt carried by consumers was less than it had been in 2005.³⁵ With weak home values, loans against home equity are harder to access. New regulations on overdraft programs and a trend of states curbing payday lending may also mean more demand for consumer finance companies. Borrowers may be drawn back to the product’s predictability and relative availability.³⁶ However, the net effects of the financial crisis on demand remain to be seen. We next turn to review what is known about finance company customers.

Profile of Finance Company Borrowers

According to interviews of operators, there is no “typical” customer – borrowers can range from teachers, to principals, and from factory workers to accountants. Many borrowers own homes, have bank accounts, and use credit cards. Interviewees reported a general shift from blue collar customers to those working in the service sector. When asked why customers use finance companies, some of the common reasons cited were strong personal relationships, greater levels of comfort with finance companies than with banks, lack of other options, and the fact that consumer finance companies qualify borrowers on a case by case basis rather than using credit-score-driven approval systems. According to operators, the loans are used for a variety of purposes such as cars (repairs and down payments), life events (holidays, vacations, funerals and weddings), debt consolidation, and general expenditures. The most common sources of new customers cited were word-of-mouth, mail solicitations and referrals, (often from banks).

³³ Dan Freed, “Credit Card Securitization Stalls,” *The Street*, August 8, 2010, <http://www.thestreet.com/story/10834089/credit-card-securitization-stalls.html> (accessed January 18, 2010);

³⁴ Sara Lepro, “Review 2009/Preview 2010: Two Credit Products are Back in Style,” *American Banker*, January 3, 2011. Vol. 176, no 1.

³⁵ Federal Reserve, “Federal Reserve Statistical Release,” January 7, 2011, <http://www.federalreserve.gov/releases/g19/>

³⁶ Sara Lepro, “Pitching Personal Loans to the Post-Crisis Consumer,” *American Banker*, Sept 29, 2010.

As the traditional consumer finance industry is a relatively small niche, research on consumer finance borrowers is rare. Neither the Center for Financial Services Innovation Study on short-term credit needs of low-income consumers (the CFSI Study) nor the FDIC survey of un- and under-banked consumers specifically asked respondents about consumer installment credit.

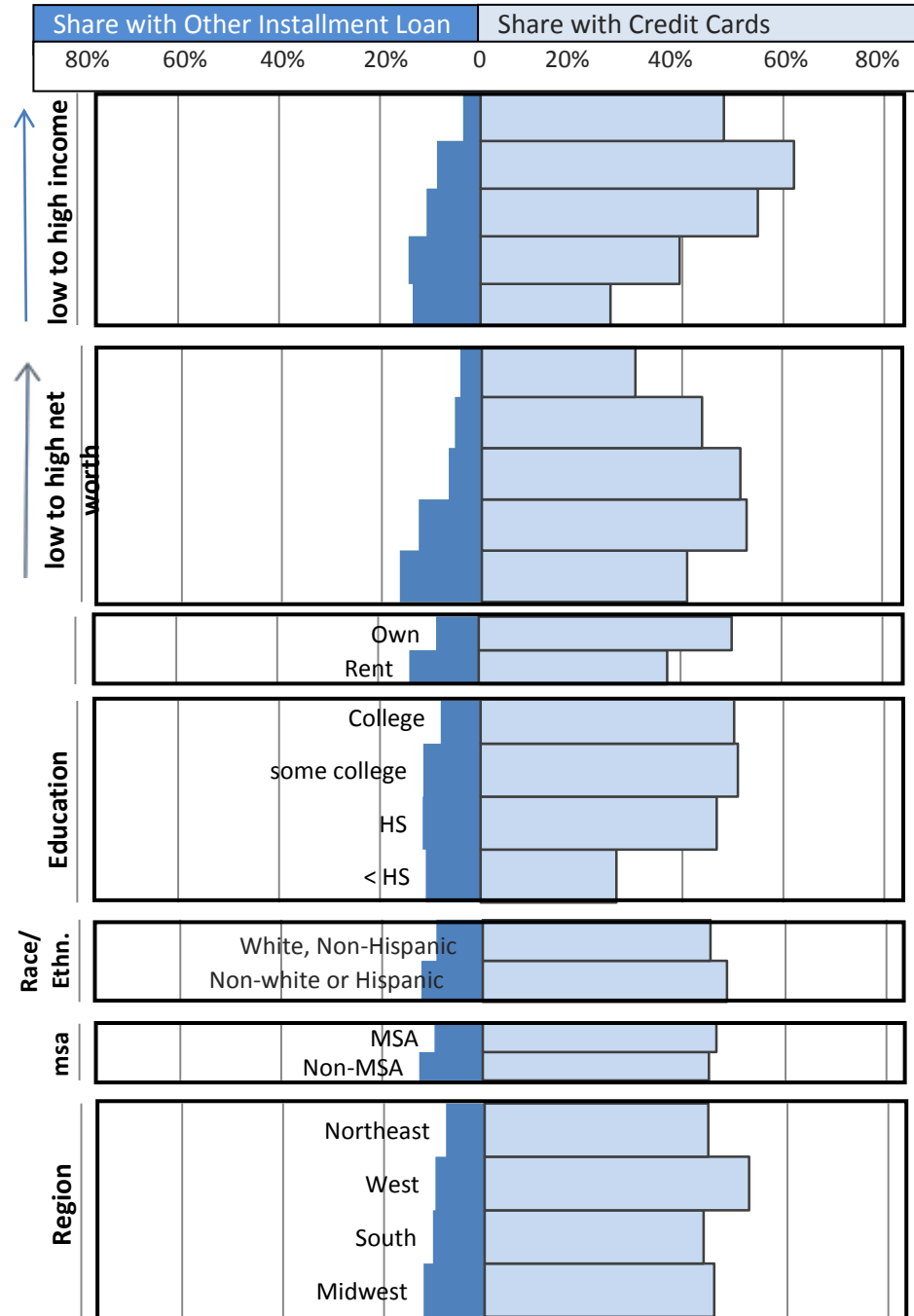
Perhaps the closest proxy in a national survey is found in the Survey of Consumer Finance, a nationally representative survey conducted every three years by the Federal Reserve Board. The 2007 survey, the most recent data available, had 4,422 respondents. This survey included a category named “other installment loans” (for non-real estate-secured loans other than auto and education loans). The “other installment loan” category was used by 10% of respondents in 2007, though it includes other activities besides the direct, consumer finance channel.³⁷

The demographic details from this study are instructive. From 1998 to 2007, this product was least popular among the more affluent, although use of this product declined across all income groups. Renters were more likely than owners to hold these loans, and residents of rural and non-major metro areas (MSAs or metropolitan statistical areas) were more likely than residents of MSAs to have “other installment loans”. Minorities were more likely than White, non-Hispanic households to use these loans. Those with at least a college degree were less likely to use these loans than those without, while families with heads of household aged 44 and younger, and households with children tend to be more likely than older households to use these loans. Many of these preferences contrast with the penetration of credit cards though credit cards are much more prevalent in all categories. (See Chart 11.)³⁸

³⁷ For example, the median loan is \$2,800. This number is generally consistent with North Carolina’s finance company average loan size, but the mean is much higher. Individuals in the highest-net-worth category and self-employed individuals report mean “other installment loan” amounts that are much higher than typical finance company limits, suggesting that other channels serving these sectors are included in the data.

³⁸ Federal Reserve, “Survey of Consumer Finance Chartbook 2007,” *Federal Reserve*, <http://www.federalreserve.gov/pubs/oss/oss2/2007/2007%20SCF%20Chartbook.pdf> (last accessed January 19, 2011).

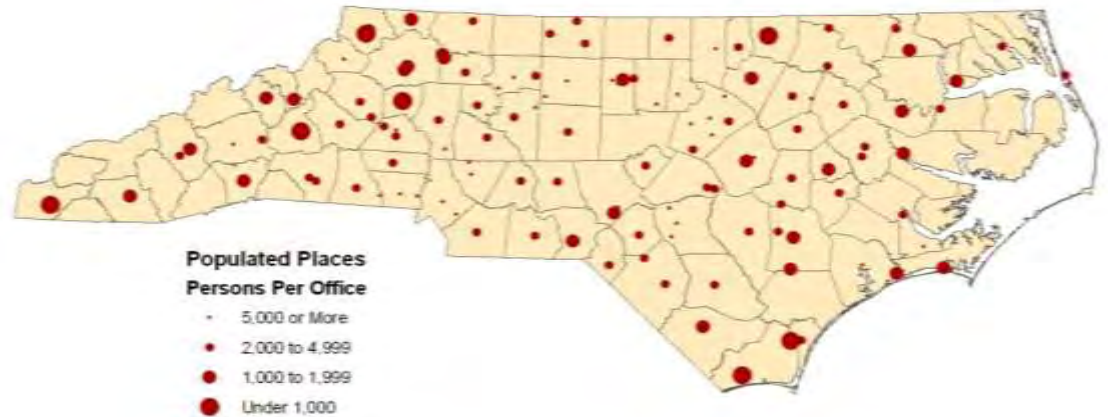
Chart 11: Share of Households Using Other Installment Loans and Credit Cards



Source: Survey of Consumer Finance 2007 Chartbook

The geographic distribution within North Carolina confirms the national statistic that these businesses are less concentrated (on a per capita basis) in non-MSAs. While there are more finance company branches in counties with major population centers, Chart 12 shows the number of finance company offices relative to area population.

Chart 12: Finance Company Locations – Persons Per Office



In April, 2009, Equifax Analytical Services³⁹ compiled a report examining the credit profiles of finance company borrowers in North Carolina. Their analysis covered a seven-year period, and included all customers who had at least one finance company loan in the prior seven years. They found that 476,950 people (5.9% of all records) in North Carolina had a finance company loan – either a direct loan or a sales finance loan - on their credit reports. They further analyzed loans less than or equal to \$3500 – 3.3% of all records – to better isolate direct, CFA loans. The analysis showed:

- 59% of consumer finance customers had one-to-two finance company accounts on their record; 21% had more than four accounts.
- The average credit score of finance company loan customers was 578. This average was well below the North Carolina average credit score of 671. Over half had credit scores below 620.
- Most consumer finance customers had an estimated annual personal income between \$20,000 and \$40,000.

Other loans showing on the credit records of consumer finance customers suggested that this population has had access to other credit options over the previous 7 years.

- 62% of finance company customers had mortgages on their credit file.
- Over half of people with finance company loans had three or more credit card accounts. 15% had no credit card accounts, and 21% had seven or more.
- 88% had at least one auto loan on their credit records.
- The overwhelming majority (83%) had some type of bank relationship, and 37% had a credit union relationship.

³⁹ Equifax Analytical Services. North Carolina Consumer Finance Profile Analysis. April 19, 2009. Submitted to the NCCOB.

These findings are generally supported by a national credit scoring study by Federal Reserve economists (Federal Reserve Credit Scoring Study). This study consisted of more than 300,000 credit bureau records, and sheds light on how credit products are distributed across households by credit profile and other characteristics. Households in the lowest two-credit score quintiles were much more likely to turn to installment loans from consumer finance companies to obtain new credit than were those in the top three-credit score quintiles. Of the new loans obtained over the study period, the share that came from installment loans from consumer finance companies was 22% in the bottom credit score quintile, 10% in the next quintile, and 2% in the top three quintiles. Still, credit card loans were more common across all credit score buckets. Within each credit score bucket, Black and Hispanic households relied more heavily on consumer finance loans than did non-Hispanic white households.⁴⁰

NCCOB conducts a biannual survey of North Carolina residents regarding various financial products.⁴¹ In 2009, the Consumer Banking and Finance Survey interviewed 1,000 state residents age 20 or older who had at least one financial product. Survey findings are as follows:

- Seven percent of respondents had taken a personal loan from a finance company in the prior two years.
- Incidence of finance company loan use has not changed significantly since 2007, while payday loan/auto title loan use has gone from 4% to 11%.
- Finance company loans were highest among North Carolinians with annual income of \$50,000-\$75,000.
- Finance company loans were used more by African American consumers than by whites. Twenty percent of minority respondents had taken a finance company loan but only 6% of whites had taken a finance company loan.

Options for Serving the Small Dollar Loan Market

Currently, there are some alternative products available, though each product differs from the finance company product. As we have seen, the most commonly used product is the credit card, while lesser-used options include products available through banks and credit unions. Also, many rely on informal and largely unregulated arrangements to meet their short-term credit needs.

An issue requiring further definition is loan size. The FDIC, in its pilot study of small dollar loans, distinguished between small dollar loans (SDLs) and nearly small dollar loans (NSDLs). SDLs were defined as having a balance of \$1,000. NSDLs were defined as having a balance between \$1,000 and \$2,500. The CFSI Study finds that unbanked consumers are much more likely to use SDLs while the majority of under-banked consumers (those having a bank account but also using defined alternative financial services), borrow at NSDL levels.⁴²

⁴⁰ Federal Reserve Credit Scoring Study (see footnote 23).

⁴¹ MarketSearch Corporation, *Consumer Banking and Finance Survey*, North Carolina Office of the Commissioner of Banks, April/May 2009. <http://www.nccob.gov/public/docs/news/pub%20and%20Research/2009%20consumer%20banking%20and%20Finance%20Survey.pdf>. (accessed January 19, 2011).

⁴² Schneider, Rachel and Melissa Koide, *How Should we Serve the Short-Term Credit Needs of Low-Income Consumers?* Center for Financial Service Innovation. 2010. http://cfsinnovation.com/system/files/Research_Paper_Credit_Symposium_April62010.pdf. (Last accessed January 24, 2011)

This size segmentation is mirrored in CFA's tiered licensing and pricing system, which recognizes the higher relative fixed cost of making smaller loans. SDLs represent less than 15% of loans made and 4% of dollars loaned, while loans in the \$1000-\$3000 range were most popular.

For the purposes of the study group, NCCOB broadly defined the term "small dollar, short-term credit" or "small loans" to mean loans between \$500 and \$15,000 borrowed for a period of between three- and twenty-four months. This definition was recognized to be broader than CFA approved loans, but was used to ensure the inquiry covered a range of options available.

Credit Cards

Credit cards are the most widely used short-term credit product by a significant margin. According to the NCCOB's 2009 Consumer Banking and Finance Survey, 63% of North Carolinians have used a bank-issued Visa or MasterCard within the prior two years.⁴³ However, several key features differentiate credit cards from finance company loans. First, finance company loans are fully amortizing. With credit cards, consumers can become unclear how much they should pay in order to successfully retire the debt. Second, finance companies are mandated to make loans with simple interest, not compound interest. Over the course of an 18- to 36-month loan, this difference between simple and compound interest can make credit cards significantly more expensive to the consumer.

Interviews with finance company lenders suggested that the majority of finance company borrowers do have credit cards, but prefer to borrow from the finance company for larger expenses. The lenders indicated that their customers liked being able to pick the payment that would fit their budget and know exactly when the debt would be repaid. They reported that some customers have credit problems and would not be able to borrow money or pay an expense through a credit card.

Bank and Credit Union Products

Banks and credit unions make installment loans, though they tend to serve a higher credit profile market and at lower average rates than consumer finance companies.⁴⁴ Some products offered through depository institutions which may substitute for small-dollar finance company loans, though not as widely available, may serve as models for other depositories to follow. In one example, the North Carolina State Employees Credit Union offers a salary advance loan which allows members to borrow up to \$500 at 12% APR. The loan and interest must be repaid on the member's next payday, and 5% of the loan proceeds must be deposited in a limited-access savings account if they roll the loan over.⁴⁵ Borrowers are also provided with financial education and debt management services at no cost. While the salary advance loan has proven popular with credit union members, this type of loan would not meet the needs of the typical finance company customer seeking a larger loan amount and longer repayment terms.

⁴³ MarketSearch, *Consumer Banking and Finance Survey*, 2009 (see footnote 41).

⁴⁴ Analysis of credit reports by credit score quintiles found that that 6% of new loans obtained by people in the lowest credit score group were bank installment loans, with a mean interest rate of 12.2%. This same group obtained 22% of its new loans from installment loans from consumer finance companies at a mean rate of 19.9%. In the second lowest credit score quintile, bank installment loans accounted for 6% of new loans (at 10.8% mean interest rate) – closer to the 10% who used finance company installment loans (at 20.5%). In the top 3 credit score buckets, new loans were more likely to be bank installment loans (4% at 8.4% interest) than consumer finance installment loans (2% at 16.% interest). Federal Reserve Board Credit Scoring Study. August 2007. (see footnote 23)

⁴⁵ State Employee's Credit Union, "Salary Advanced Loans," Information off webpage <https://www.ncsecu.org/Loans/SalaryAdvance.html>. (accessed January 19, 2011)

A loan product similar to a finance company loan is offered by Wells Fargo bank and designed to pay off debt, although the loan can also be used to pay large expenses. The Debt Pay Down Solution® loan allows customers to take out unsecured loans for larger amounts for up to five years with a fixed interest rate and set monthly payment.⁴⁶ Borrowers are also provided with free online financial planning tools. At this writing, however, this product is not available in North Carolina.

In 2008, the FDIC initiated a small-dollar loan demonstration project to evaluate affordable lending by financial institutions and establish a model for banks to follow. According to the FDIC, “The pilot was a case study designed to illustrate how banks can profitably offer affordable small dollar loans as an alternative to high-cost credit products, such as payday loans and fee-based overdraft protection.”⁴⁷ Twenty-eight banks – none headquartered in North Carolina – participated in the pilot and provided information to the FDIC about customers and loan performance. The loans were for a maximum of \$2,500, had a term of at least 90 days, and could carry a maximum interest rate of 35% including fees. The ultimate profitability of these loans varied based on lender characteristics and how profitability was evaluated. While some lenders found short-term profitability on these loans to be challenging, the majority of lenders anticipated long-term profitability as a result of volume lending, repeat customers, and cross-selling other products.⁴⁸

Alternative or Informal Loan Products

Some North Carolina residents rely on less common loan products when faced with a small-dollar credit need. One of these is the employer loan. These loans can be provided by a bank or credit union, but the cost of underwriting such loans is low because the employer provides almost all the needed information and repayment is automated through payroll deductions. One company offering these loans, Workers Choice USA,⁴⁹ advertises no direct costs to employers and allows employees to borrow up to 50% of their monthly income with a fixed repayment schedule.⁵⁰ Once an employer signs up for the service, virtually the entire loan process from underwriting to repayment is automated. While employer-based loans are not common, there is some indication that consumers may find such loans desirable. In a survey in 2007, the Center found that only 6% of North Carolinians had received an employer-based loan in the prior three years. Those customers felt that the loans were fair and reasonable, and they were satisfied with the product.⁵¹

Storefront payday lending has not been available in North Carolina since 2006. However, there is some evidence that a small minority of consumers are still utilizing payday loans to meet their short-term credit needs, either by driving to another state or through the internet. The 2009 Consumer Banking and Finance Survey found that 11% of people surveyed had received a payday

⁴⁶ Wells Fargo, “Personal Loan,” Information off webpage.

https://www.wellsfargo.com/personal_credit/debt_consolidation/index. (last accessed February 5, 2011)

⁴⁷ Federal Deposit Insurance Corporation (FDIC), “Small-Dollar Loan Pilot Program,” *FDIC*,

<http://www.fdic.gov/smalldollarloans/>. (accessed January 19, 2011)

⁴⁸ “A Template for Success, The FDIC’s Small Pilot Program,” *FDIC Quarterly* 4, no. 2 (2010): 28-

41. http://www.fdic.gov/bank/analytical/quarterly/2010_vol4_2/FDIC_Quarterly_Vol4No2_SmallDollar.pdf (accessed January 19, 2011)

⁴⁹ Workers Choice, USA “Program Benefits,” information off webpage,

<http://www.workerschoiceusa.com/benefits.asp> (accessed January 24, 2011)

⁵⁰ The specific loan terms available vary by state and can be customized by the employer within state regulatory requirements.

⁵¹ UNC Center for Community Capital, “NC Consumers After Payday Lending: Attitudes and Experiences with Credit,” (see footnote 21).

or auto title loan within the prior two years, an almost three-fold increase since 2007, and more than reported using a consumer finance installment loan.⁵² In this study, the share of borrowers that reported being “satisfied” or “very satisfied” with their payday or auto title loan (80%), was slightly below that for consumer finance companies (83%). The Center’s prior study found that payday loans had one of the lowest scores of all short-term credit products for both fairness and customer satisfaction.⁵³ Participants in that study preferred the finance company product’s longer repayment term and its installment nature.

Some consumers are able to meet their small-dollar loan needs through informal loans from friends or family members. While these types of loans are unregulated and the terms and conditions likely vary widely, it is worth noting that this is a viable option for many people. The Center’s study cited previously found that 42% of the people surveyed (lower-income, banked households) who had a financial shortfall in the prior three years reported that they borrowed from friends or family members. However, this is not an option for all families and informal lending cannot replace regulated financial products for meeting consumer demand.

The Consumer Finance Business in North Carolina

Despite the options listed above, the CFSI Study reports that “there is a shortage of high quality small-dollar, short-term credit in the marketplace today.”⁵⁴ Still, direct consumer installment loans are a relatively small part of the overall market for consumer credit. How does the consumer installment lending business, particularly as legislated and practiced in North Carolina, fit into the marketplace?

CFSI identifies the following advantages of the installment lending business model: Larger loans; longer terms; fixed rates; equal repayments; loan data reported to major credit bureaus; and direct interaction.⁵⁵ To this list, we would add transparency and stability of lending terms.

The product offered by North Carolina’s consumer finance companies, which is strictly prescribed by the CFA, offers these advantages. Limits on rates and fees make it difficult to pad the loans with ancillary charges. The one-loan-per-customer rule prohibits making multiple, smaller and higher-rate loans to a single borrower. Lenders are restricted to a modest origination fees and a \$25 maximum NSF fee. The only other allowed charges are UCC filing fees or non-filing fees and credit insurance premiums. Lenders may not charge late fees or extension fees.

The CFA dictates that lenders set level payments of principal and interest, using simple interest, to pay the loan off within a specified term between six months and seven years. This closed end, self-amortizing structure gives borrowers the benefit of a fixed monthly payment that, within a reasonable time frame, will extinguish the loan. In practice, and partly due to the one-loan-per-borrower rule, loans are regularly renewed (see section 6 for more discussion). However, the statute limits the lender to collecting origination fees no more than twice per year.

Perhaps the most distinguishing feature of the consumer installment business is its traditional, high touch, high cost business model. Just as they have for decades, NC Consumer finance companies operate using a monoline store-front model. Licensees may not conduct other forms of businesses other than sales finance activities (see section 4.e.), and those pre-authorized by

⁵² MarketSearch, *Consumer Banking and Finance Survey*, 2009 (see footnote 41).

⁵³ UNC Center for Community Capital, “NC Consumers After Payday Lending: Attitudes and Experiences with Credit,” (see footnote 21).

⁵⁴ CFSI, *How Should We Serve the Short-Term Credit Needs of Low-Income Consumers?* p.3 (See footnote 42).

⁵⁵ *Ibid.*

NCCOB. The most common other form of authorized business is tax preparation services. The monoline store-front approach to doing business requires an expensive infrastructure with high fixed costs.

Finance company representatives described a high-touch approach to loan making and management. As described by several industry participants, a classic branch has three people. Interviewees suggested having 200 to 400 accounts per employee. In 2009, the average across the industry in NC was 1,078 loans per location, while the average branch had 4.5 employees (238 loans per employee, industry-wide). Key activities in the branch include taking and processing payments, collections, and making loans. Other branch tasks include preparing mailings, marketing, maintaining relationships with retailers (in the case of sales finance), and managing insurance. Most payments are still made by walk-in. Though one respondent described how remote payment tools have led to efficiency gains in loan management, in general the consumer installment loan is an old-fashioned product, a fact that many in the industry take pride in.

Loan underwriting also has a high human element. Several interviewees eschewed automated underwriting and overreliance on credit scores, the approach used by credit card lenders. For that group of borrowers who do not neatly qualify under automated underwriting models, finance companies offer traditional, case-by-case underwriting. They look at credit reports, but often disregard the credit score, instead looking more closely at particular lines. Underwriting places heavy emphasis on analyzing ability to repay, and closely examines income and employment. Interviews also indicated that these lenders are highly attached to the communities in which they lend and have a deep knowledge of local employment conditions. Interviewees said most decisions are made within the hour, often as quickly as 15 minutes. They also reported declining 70% or more of applications from new clients. The industry-wide declination ratio reported in 2009 was 53%; this statistic implies that finance companies are underwriting more than two borrowers for every loan made.⁵⁶

Another challenge for finance companies is funding. Finance companies cannot access low cost deposits to fund loans and instead rely on three primary forms of funding. In 2009, accounts and notes payable represented 79% of assets. Most of these borrowings (82%) were funded by parent companies or affiliates. The lion's share of these parent company/affiliate payables were attributable to six large national or regional chains headquartered outside of the state (who accounted for 79% of the loans receivable in the state). For the rest of the companies, 47% of assets were funded by borrowing from banks or other financial institutions, 26% from parent or affiliate companies, and 17% from other liabilities and payables. Industry-wide, equity constituted 19% of assets, but the North Carolina-based and smaller companies were, as a whole, more highly leveraged with only 10% equity.

While some independent, smaller and North Carolina-based companies are fully self-funded, many use bank financing. Bank financing became the engine of profit growth for consumer finance companies of all sizes, leading to this observation in 1970: "The structure of the consumer finance business would never have reached its present proportions had it not become, along with the sales finance business, a favorite customer of the American banking system."⁵⁷ Over time, changes have come in the form of other consumer credit channels, bank consolidation and, most recently, the credit crunch. Yet licensees describe a relatively standard set of asset-backed borrowing arrangements with banks. Through variable-rate lines of credit, banks advance up to a maximum percentage of eligible receivables or the "borrowing base" (that is, outstanding loans adjusted for delinquency and other factors). In addition to being secured by

⁵⁶ Declination rates of 50% or more were the norm at least as long ago as the 1960's, see Michelman p. 303.

⁵⁷ Michelman, p. 306.

receivables, the lines are usually secured by owners' personal guarantees and other assets of the company. In part because the receivables are not particularly liquid, the lenders are very hands-on, requiring such items as monthly financials and biannual audits paid for by the finance company. In lengthy loan agreements, banks set limits on debt to equity, debt coverage ratios, tangible net worth, subordinated debt, loss reserves, and distributions. As part of the audit, lenders may also want to confirm regulatory compliance, credit quality, and any other aspects of the business practices that might represent a risk. In this regard, banks appear to be a de facto safety and soundness regulator. Personal guarantees help align the interests of the owner/operator with those of the bank toward making loans to borrowers who can afford them.

Despite the hassles, bank borrowing enables companies to realize higher return on equity and fund growth. However, companies cannot grow on debt alone. Equity is hard to raise, and must be committed for longer terms. Retained earnings can be a source of the equity required to leverage debt for growth, but companies and industry representatives maintain that profitability is constrained by regulation. Another factor at work is deleveraging by banks in the wake of the financial crisis, leading to decreases in advance rates and increases in equity requirements. Mergers, such as Wells Fargo-Wachovia, have reduced competition. Smaller banks who financed smaller companies have exited or even failed, leaving their borrowers without a credit facility.

On the positive side, lower interest rates have led to increased interest margins, which boosted profitability in 2009. A looming concern for some interviewees is, if and when rates rise, whether higher rates will eat into profits or trigger credit line reductions.

From a financing standpoint, it appears stronger companies that are not too highly leveraged appear to be weathering the current conditions and benefiting from lower cost of funds. For this segment, growth is limited more by market demand and credit quality than by funding constraints. Companies that are more highly leveraged may find themselves painted in a corner, especially if their existing lenders are pulling back: to grow profits, they must grow receivables, but to grow receivables, they must raise capital, and potential funders want to see growth. Interviewees predicted it would be nearly impossible for small startups to raise new funds in the current environment.

These findings confirm the CFSI Study which reports that "the difficulty of finding adequate capital keeps many [installment] lenders from scaling up which would enable increased profitability and reduced prices...that challenge has intensified amid the general credit constraints of today's economy."⁵⁸

Other Aspects of the Business

The CFA allows licensees to conduct a small number of supplemental activities—Non-filing insurance and fees, credit insurance, and sales finance. We discuss these below.

Non Filing Insurance and Non Filing Fees

The CFA permits licensees to collect fees related to the filing or recording of security interests, limited to the actual cost of doing so.⁵⁹ The licensee must fully disclose to the borrower the use of the fees collected. The licensee is permitted to either: 1) actually pay the recording or filing fee

⁵⁸ CFSI, *How Should We Serve the Short-Term Credit Needs of Low-Income Consumers?* P.13 (See footnote 42).

⁵⁹ Furthermore, N.C. G.S. § 53-77 prohibits the collection of notary fees. Fees for releasing a security interest are only permitted when that fee is actually paid to a public official or agency.

to the public officials or agency, 2) apply the fee to non-filing insurance (NFI), or 3) simply retain the fee as self-insurance. If the fee is used for insurance or self-insurance, it must be no more than the actual cost of filing or recording, minus one dollar. In practice, the Department of Insurance has historically set the cap much lower (for example, for non-auto loans, the lowest fee for filing hard copies is \$38 for two pages. The limit on NFI is currently set at \$30, and loans with NFI would not be subject to a release fee).⁶⁰

According to 2009 data submitted to NCCOB, more than 80% of loans made in 2009 were secured, with personal property serving as security for 58% of all loans. Loans on which non-filing fees were charged represent 54% of all loans secured by personal property. In 2009, licensees reported to NCCOB that they collected \$3,969,675 dollars in non-filing fees on 121,219 loans (an average of \$33 per loan, compared to \$1,800,426 in filing fees they collected at an average of \$28 per loan).

We are assuming that “non-filing fees” represents both fees collected for third-party non-filing insurance and for self-insurance. The NC Department of Insurance and Credit Property Survey report \$1,573,535 of insurance premiums were collected for CFA NFI. We assume if both agencies’ reports accurately reflect all CFA-related third-party and self-insured non-filing insurance, licensees would have retained \$2,396,140 in self-insurance non-filing fees. This amounts to 1% of the amount of reported interest collected in 2009⁶¹ and 19% of net income reported. The product can impact the bottom line in other ways. Potential commissions appear quite small as only \$80,481 was reported paid in commissions and brokerage fees (on the \$1,519,980 in premiums for NFI on security other than auto.)

A more significant impact on licensee profitability arises in the event of a borrower defaulting on a secured, insured loan, triggering an NFI claim. NFI insures the creditor against loss incurred from the lender's decision not to protect his security interest (by filing a financing statement or otherwise perfecting its lien). Licensees have not historically reported loan loss data, making the impact on losses unclear. In 2009, we know licensees reported filing NFI claims on 3,264 loans, 8.5% of the loans charged off that year, but we don't know how much they received. As a rough estimate, applying the 87.78% loss ratio to the \$1.5 Million in NFI premiums suggests about \$1.3 million in NFI claims paid.

⁶⁰ Memo from Jim Long, Commissioner of Insurance to Credit Property Insurance Companies regarding Non-Filing Insurance, October 9, 2008, <http://www.ncdoi.com/lh/Documents/AdvisoryNonfilingInsuranceRates.pdf> (accessed January 24, 2011)

⁶¹ Note this interest includes amounts collected on sales finance activities by some licensees.

Chart 13: NFI Premiums under CFA and RISA

2009 Data from North Carolina Department of Insurance

Non-Filing	CFA-auto	CFA- other	CFA Total	RISA Auto	RISA other
Earned Premium	\$53,555	\$1,519,980	\$1,573,535	0	\$2,875,207
Commission & Brokerage	0	\$80,481		0	\$1,601,189
# of Policy Holders	0	25,474	25,474	0	
Incurred Losses %	73.20%	87.78%		N/A	86.92%
Commissions/Brokerage %	0.00%	5.29%		N/A	55.69%

Chart 14: NFI Premiums and Filing Fees – CFA

CFA Annual Report

Non-filing Fees total	\$3,969,675
<i>Premiums reported by NF Insurers per DOI</i>	<i>\$1,573,535</i>
<i>Remainder = Estimated Self Insurance fees</i>	<i>\$2,396,140</i>
Filing Fees	\$1,396,974

Credit Insurance

Consumer Finance Companies are permitted to sell credit life insurance, credit accident insurance, credit health insurance, credit unemployment insurance, and credit property insurance. Insurance income made up 5% of licensees' reported income in 2009. Income from credit insurance appears to be relatively low cost and provides indirect benefits to consumer finance companies.

Credit insurance premiums are not considered a prepaid finance charge when determining the annual percentage rate. Insurers market the credit insurance products directly to creditors, who then sell the insurance at the time credit is extended to their customers.⁶² Credit insurance may also be sold as a group policy to insure loans already on creditors' books.⁶³ In addition, credit insurance may be sold again at each refinancing.

Consumer finance companies have multiple incentives to sell credit insurance to customers. First, creditors benefit from the fact that credit insurance mitigates losses. Second, consumer finance companies can generate income from direct or contingent commissions.⁶⁴ According to the 2009 annual report, consumer finance company insurance-related income was \$15,375,654. In 2009,

⁶² "A Primer on Consumer Credit Insurance", 54 Consumer Financial Law Quarterly, Report 52 (2000).

⁶³ N.C.G.S.A. § 58-71-10

⁶⁴ Contingent commissions involve the ex post payment of commissions based on the performance of the referred book of business. Cummins, David J. and Neil A. Doherty, *The Economics of insurance Intermediaries*, The Journal Of Risk and Insurance, 2006, Vol. 73, No.3, 359-396.

392,247 consumer finance loans were made, and credit life insurance was sold in conjunction with 281,343 loans. Credit property insurance was sold in conjunction with 223,490 loans, accident & health insurance was sold in conjunction with 187,252 loans, and unemployment insurance was sold in conjunction with 118,246 loans. These numbers imply that some loans carried multiple forms of credit insurance.

The Role of Sales Finance

The CFA restricts the activities that can be conducted by licensees, barring them from conducting “other business” unless previously approved by NCCOB. The CFA does permit companies to hold installment contracts under the Retail Installment Sales Act (RISA), often referred to as “indirect” or “sales finance” lending. This report refers to financing activities conducted under RISA as “sales finance.” NCCOB does not regulate the sales finance business.

In a typical sales finance transaction, a consumer obtains financing through the seller of the product. The seller, who is responsible for “extending or arranging” financing, provides the buyer’s credit information to a finance company. The finance company then buys the installment contract from the seller of the good or service. Once the buyer and seller complete the financed sale, the contract is assigned to the consumer finance company.

Sales finance loans tend to be larger than consumer installment loans (see Chart 15), and there is no limit of the number of sales finance loans that can be made to an individual debtor. Consumer finance companies may use the acquisition of installment sales contracts to generate new direct lending business. The purchase of installment contracts provides the finance company access to potential future customers and credit information about those potential customers without the usual marketing and human resource expense.

The sales finance business is also complementary to the consumer installment business as both businesses can be operated from the same platform and within the same infrastructure. Interviewed licensees who engaged in sales finance activity indicated that sales finance was critical to their bottom lines and their ability to grow. Typically, sales finance will represent fewer but larger loans and may generate more gross income per loan than direct loans. According to 2009 filings, where licensees first reported the share of indirect lending, lenders made 392,247 direct loans for \$1.063 billion⁶⁵ and thirty-seven of the lenders also did indirect loans, in the amount of \$122 million (22,781 loans). For these licensees, indirect loans were 17% of loans made and 23% of dollars loaned. These lenders hold 63% of the direct receivables, and reported generating 47% of the profits. Their average net income at \$175,000 was not markedly different from the average of \$165,000 for the direct only reporters, but they were more likely to be profitable (84% vs. 66% of the direct only reporters). As sales finance can be a source of new borrowers, we compared the average share of loans to new borrowers between these two groups, but found no difference.

The Sales Finance activity records complicated our ability to analyze annual report data. The report form asks companies to specifically identify income from Consumer Installment lending for interest collected, interest earned, and for loan processing fees. The report form also requires reporting of total income. Licensees often included sales finance revenue in the “Other Income” area, but did not always distinguish what is attributable to Sales Finance verses other sources. Licensees are also asked to determine the appropriate allocation of total expenses to the consumer installment loan business alone. The form, however, does not specify rules for

⁶⁵ Assuming that the loans made figure excludes all sales finance loans. Note that four lenders reported exactly as many indirect loans as total loans, both in number and dollar amount, indicating that there is at least some double counting or misreporting.

reporting these expenses. Since it appears that many licensees presented balance sheet items for the business as a whole instead of items allocated to consumer installment activities only, it is impossible to do an accurate assessment of historical return on equity (or return on assets) for just the consumer installment loan business using the aggregate industry data. More generally, because so many licensees also provide sales finance, seeking to evaluate the consumer finance business as an independent venture using the experiences of all North Carolina companies as historically reported, is likely to be misleading.

Chart 15: Retail Installment Sales Act Summary

Loan amounts greater than CFA direct loans

- \$75,000
- No Limit for debt secured by real property or a manufactured homes

As with CFA, RISA contracts may be refinanced or consolidated with other RISA contracts.

Different rate structure and tiers *(There are separate permissible finance charges applicable to residential manufactured homes and revolving credit contracts not included here.)*

RISA General Rate Structure		Optional RISA rate structure for automobiles	
Amount Financed ("A.F.")	Maximum Interest Charge	Age of Vehicle Model	Maximum Interest Charge
< \$1,500	24%	1-2 yrs	18%
\$1,500 to \$2,000	22%	3 yrs	20%
\$2,000 to \$3,000	20%	4 yrs	22%
>\$3,000.	18%	5 or more	29%

RISA Fees (& fee restrictions) – There is no explicit general statutory bar to fees in RISA. RISA segregates fees into those that are included in the finance charge and those that are excluded. RISA provides in § 25A-8 (b) and (c) two categories of fees that are excluded from the finance charge. Otherwise, the finance charge includes “the sum of all charges payable directly or indirectly by the buyer and imposed by the seller as an incident to the extension of credit. . .” (§ 25A-8(a)).

Fees excluded from Finance charge (§ 25A-8 (b) - (c))

Security interest related charges permitted by § 226.4(e) (1)-(3) of Regulation Z.

Transfer of equity fees - Lesser of 10% of unpaid balance of the debt or \$35.00

Substitution of collateral fees-Lesser of 10% or \$15.00

Default Charge: After an installment is past due for 10 days or more , there can be one default charge per default of the lesser 5% of installment past due or \$6.00.

Deferral Charge Can be 1.5% of each installment for each month for the deferred period.

Credit Insurance:

- Credit Property insurance so long as it is clearly disclosed to the buyer
- Voluntary Credit Insurance under either (1) § 226.4(a) of Regulation Z or (2) G.S. 25A-17

Fees explicitly included in “finance charge”

- Mandatory credit insurance
- Loan fee, finder's fee, etc.
- Appraisal, investigation, or credit report fees

Industry Profitability

In Section 4, we examined the economic performance of the consumer finance industry in North Carolina at an aggregate level using annual report data. In this section, we present several further levels of analysis. First, we report on the industry's perspective, based on interviews with operators and information provided at study group meetings. Second, we provide segmented analysis of 53 companies who reported exclusively on direct consumer installment lending in 2007, 2008 and 2009. Last, we present findings from regression analysis allowing us to better identify the drivers of profitability given the available data.

Industry Perspective

In interviews and meetings, industry representatives stated that income has not kept pace with costs. Increased salaries, health insurance, fees and licenses, and collections costs were all cited as rising costs. Industry representatives cited a shrinking market and a decreasing share of qualified borrowers as problems for generating new income. Resoundingly, they agreed that the CFA prevents revenues from keeping up with growing costs. As industry representatives pointed out, the CFA tiers have not been adjusted since 1983, when the loan amount limit for lenders operating under section 176 was raised from \$5,000 to \$10,000 and the amount on which those lenders can charge 30% was set at \$1,000.⁶⁶

Several industry representatives also pointed out that the strict limit on fees does not apply to other consumer lending channels. As one operator explained, consumer finance companies can charge only \$25 for a returned check, less than banks or credit card lenders. Other types of lenders collect late fees and regularly impose fees to take payments by phone. Consumer finance loan origination fees are much lower than banks'. And even though banks and credit unions may charge a lower nominal rate of interest on their loans, they are also paying a lot less for their funds.

Some interviewees pointed to South Carolina, Georgia, and Virginia, as preferred regulatory environments that allow for greater profitability. Some of these states' regulations include: no rate cap, no loan limit, allowing rule of 78's or pre-compute interest instead of simple interest, and higher and more types of fees.

One reason to support these lenders' profitability is to ensure that North Carolinians can have the option of safe, manageable, installment loans. Companies point to the higher fees, opacity of even the mainstream alternatives (banks credit, unions, and credit cards mentioned above), and the tightening of credit as reasons that households need access to the consumer installment loan product. Another concern they expressed is that borrowers might seek very high cost payday loans from the internet or neighboring states, because consumer finance companies cannot offer very small loans at profitable rates. Several industry representatives were adamant that they had no desire to emulate payday lending which they considered a worse option.

⁶⁶ General Assembly Of North Carolina, 1983 Session, Chapter 126, House Bill 336. *An Act To Regain The State's Authority Over Interest Laws, And To Make Appropriate Changes In The State's Interest Laws.* <http://www.ncga.state.nc.us/enactedlegislation/sessionlaws/pdf/1983-1984/sl1983-126.pdf> (accessed January 24, 2011)

The broadly shared view that “installment loans offer the best and safest credit structure for consumers”⁶⁷ led to the creation of the consumer finance industry in the first place, a century ago. This principal is based not on a theoretical dichotomy between regulated versus free markets, but instead on a practical middle ground. This view holds that excessive restrictions harm consumers by discouraging legal lending —giving quarter to abusive illegal practices— and that well-regulated lenders can benefit customers while earning adequate returns.

Finding that balance between consumer and lender welfare requires that one must use the right metrics. According to lenders interviewed, consumers might use APR to understand their comparative costs, but APR is not good for measuring the viability of the product. Instead, operators look at dollars per loan, income per loan (which varies with loan size), and cost per loan (which, except for interest costs and charge-offs, is fixed). Some other important metrics they watch include debt to equity, interest coverage ratio, delinquencies, charge-offs, and return on receivables.

Some industry representatives believe the most important single measure is return on equity (ROE), as it drives their ability to raise capital from investors who use ROE to compare alternative investments. Therefore, industry representatives’ point out that net income (or net income per loan) must be considered in the context of equity invested. Industry representatives provided the below illustration at the third session:

- If the lender holds 30% equity, a \$1,000 loan with \$20 net income per loan results in a 6.67% ROE. If the equity is 50% instead, the result may be greater income per loan (due to \$9 less in borrowing costs assuming a 4.5% interest rate), but the ROE is lower (5.8% ROE at \$29 in income).

Bank lenders require consumer finance companies to carry a higher level of equity relative to other financial service companies. Bank ROE’s, offered as a benchmark by industry representatives, ranged in the mid-teens over most of the study period and fell to near zero in the last two years.⁶⁸

ROE analysis simplifies comparison of alternative investments, but is hard to apply to our current research question. Equity structure varies substantially between licensees, limiting the usefulness of cross-company ROE analysis. Moreover, some licensees co-mingled equity from sales finance activities in presenting their balance sheets, so standalone ROE analysis of CFA activity could not be performed. With better data, ROE benchmarking might be appropriate within certain classes of licensees.

On March 24, 2010, RSM McGladrey and McGladrey & Pullen LLP⁶⁹ prepared a report (the McGladrey survey) on behalf of the NCCPFC for the Resident Lenders of North Carolina Association.⁷⁰ The report, presented at the legislative panel meeting, was based on survey data for the years 2006 to 2008. Thirty-five companies participated. The majority of the responses came from small to mid-sized licensees. The McGladrey survey respondents represented 29% of the consumer finance industry in 2006, 30% of the consumer finance industry in 2007, and 36%

⁶⁷ The Consumer Finance Act: A Value Proposition, presented by Larry Heckner, President of the North Carolina Credit and Personal Finance Council, at November 2010 session, submitted to NCCOB.

⁶⁸ Profitability Benchmarks for Consumer Finance Lending, Presented by Chris McKinley at October session, submitted to NCCOB.

⁶⁹ A leading professional services firm providing accounting, tax and business consulting.

⁷⁰ “The Resident Lenders Of North Carolina Inc. is the industry association who represents the privately held finance companies who operate in North Carolina. The owners of these companies live in communities across North Carolina.” Information off website. <http://www.rlnc.org/> (last accessed January 24, 2011).

of the consumer finance industry in 2008, based on total direct finance loans receivable as reported in the NCCOB Annual Reports. As a percent of “non-chain/national company types,” the respondents represented 68%, 71%, and 74% of receivables for each year, respectively. Participation in the McGladrey survey was voluntary and self-selecting.

Many of the respondents are involved in sales finance as well as direct lending. When reporting to the NCCOB, these companies may use differing approaches to allocating costs to CFA-only activities. The McGladrey survey applied a consistent rule: operating expenses were allocated based on the number of loans outstanding at year end within each category, while interest expense was allocated according to the principal balance of loans outstanding. They then reported results on a per loan basis, based on the overall average of each respondent’s average loans outstanding at the beginning and end of each year.

Among the respondents, from 2006 to 2008, the average expense per loan rose \$71 or 11%. Personnel expenses were the largest single component of costs and this cost increased \$13 per loan (7%) on average. Despite the McGladrey survey’s efforts to itemize expenses by major categories (rent, repairs, utilities, depreciation, interest, credit reports, credit losses and home office expenses), the second biggest category of expense was still “other branch expenses.”⁷¹ This category increased 30% and accounted for more than half the increase in average cost per loan. The second biggest contributor to increased cost per loan between 2006 and 2008 was credit losses. Credit losses were up \$26. Over this period, average interest expense per loan fell slightly, by 6% for respondents.⁷²

When the McGladrey survey results are compared to the population of all licensees using the NCCOB annual reports for the 2007 and 2008, per loan income for all licensees was significantly higher (41% higher in 2007 and 29% in 2008). All licensees had higher costs for interest paid but lower operating expenses than the McGladrey survey sample. The total expense on a per loan basis was only 3 to 4% less than that reported by the McGladrey survey in 2007 and 2008.

One reason for this difference is that the overall population of licensees appears to be less highly leveraged than the subsample of companies who participated in the McGladrey survey. Another difference arises in average interest income per loan, which was much higher for the full population than for the McGladrey survey sample. Different cost allocation methods might also be a factor. These differences illustrate the impact that outlier licensees can have. The difference in results also demonstrates the difficulties stakeholders have had in drawing conclusions from industry-wide composite information. To understand industry conditions better, we performed a segmentation analysis, discussed in the following section.

Segmentation analysis: 2007-2009

We present a more granular analysis using an approach similar to that used by the McGladrey survey, after first removing outlier data. Our analysis uses the most recent three years’ data (2007, 2008, and 2009) for the lenders who remained in business for all three of these years. We exclude all section 173 licensees from our analysis. Like the McGladrey survey, we use averages of averages, giving equal weight to small companies and large.

⁷¹ Consumer protection advocates raised a concern during the October 2010 meeting regarding the potential for double-counting between branch expenses and home office expenses, but these were not clarified.

⁷² RSM McGladrey Inc. and McGladrey & Pullen. *Cost Data – Direct Lending Under the North Carolina Consumer Finance Act, A Study Prepared on behalf of the North Carolina Credit and Personal Finance Council*. March 24, 2010. Submitted to NCCOB.

We remove all licensees deriving more than 10% of their total income from “other income.” These companies are not primarily in the direct finance business and we do not have the information needed to reallocate expenses. Sixteen licensees were thereby excluded, each having “other income” ranging from 13 to 96% of total income. From the remaining dataset, we removed the single, very large remaining licensee (thus, the large, chain companies are excluded from the analysis).

After the above exclusions, our analysis contained fifty-three licensees. The following table represents their average results per loan over the years 2007 and 2008 as compared with information compiled by the McGladrey survey for the overlapping time period. Our study sample had significantly higher income per loan and lower expense per loan than the McGladrey survey sample. Our study sample also recorded average-positive net income per loan. These sample differences are not surprising as the two studies used variant methods for sample selection. The McGladrey survey information is representative of companies who selectively chose to participate in their survey, whereas our information resulted from rules-based exclusion of certain companies. The comparison in Chart 16 illustrates the difference in results that can be achieved by using different selection methods.

Chart 16:
Average Profit per Loan 2007 to 2008 – UNC Sample vs. McGladrey Survey

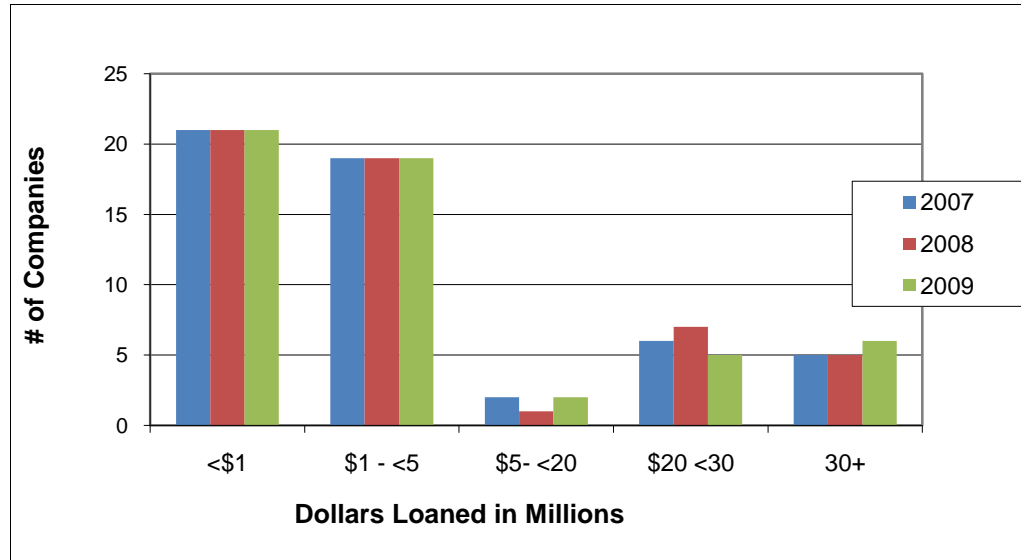
	2007		2008	
	Study sample	McGladrey sample	Study sample	McGladrey sample
Average Income/Loan	\$582	\$489	\$583	\$493
Average operating expense/Loan	\$375	\$522	\$384	\$586
Average interest expense/Loan	\$153	\$121	\$125	\$106
Average pre-tax net income/Loan	\$ 54	-\$154	\$74	-\$199

UNC sample n = 52 (one lender did not report number of loans); McGladrey survey sample n=35

Within the study sample, we can disaggregate the data to provide greater insight into the companies’ operating results, which we present in the next several charts.

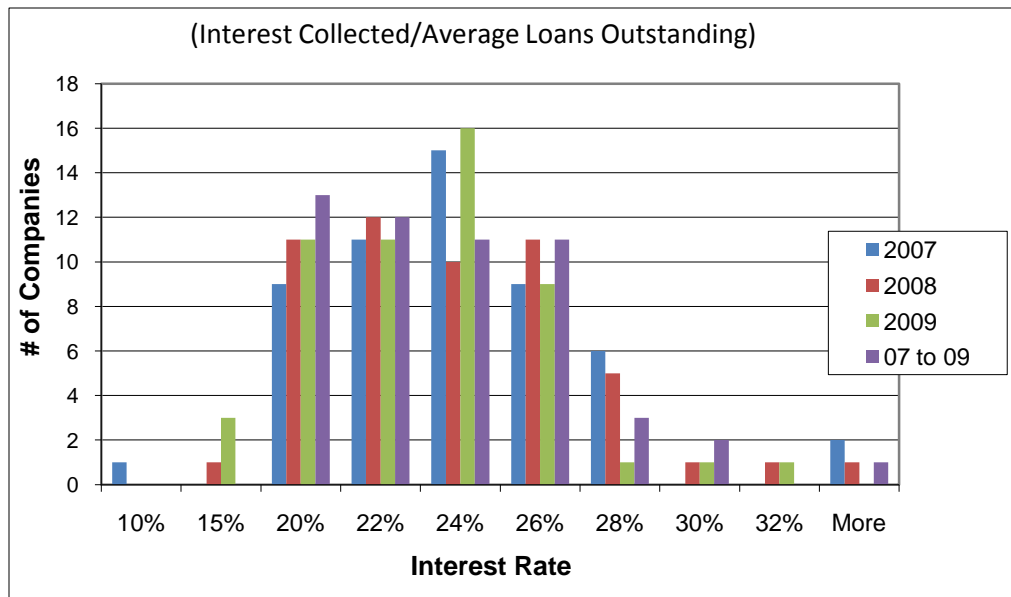
Most of the licensees were small companies having average loans receivable of less than five million dollars. The number of licensees having average loans receivable within a given range was consistent year to year.

Chart 17: Company Size by Loans Outstanding



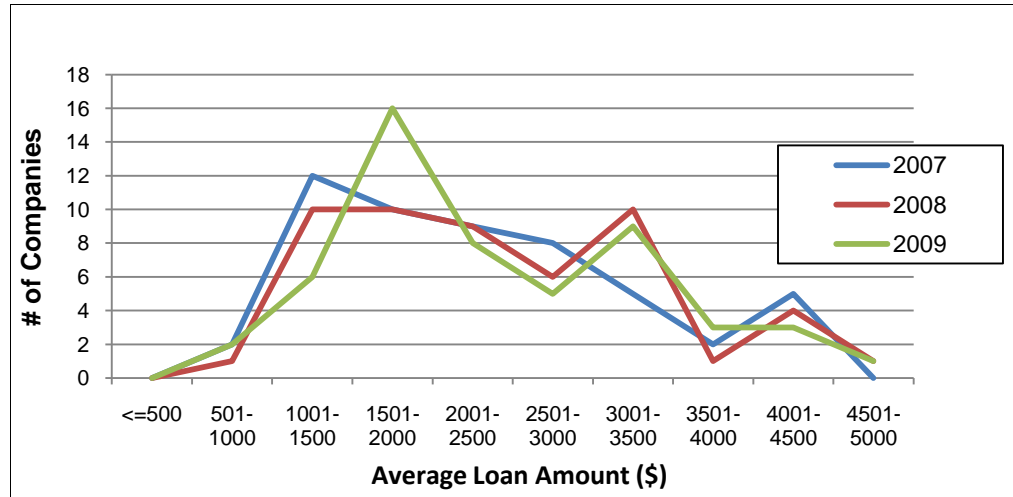
The average interest rate for the licensees is a function of the average loan size. The average rate was around 24% in 2009, whereas in the other years, the average interest rate was spread over a wider percentage range.

Chart 18: Average Interest Rate by Company



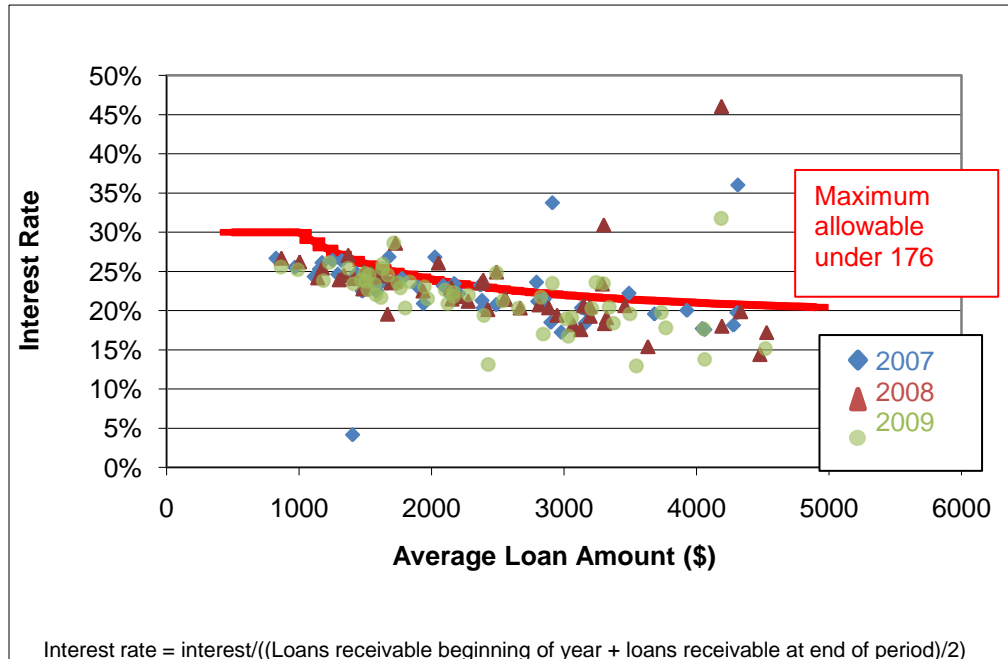
Average loan size remained somewhat consistent between 2007 and 2009. In 2009, we did notice a definite spike in the number of licensees having an average loan size of between \$1501 and \$2000.

Chart 19: Average Loan Size by Company



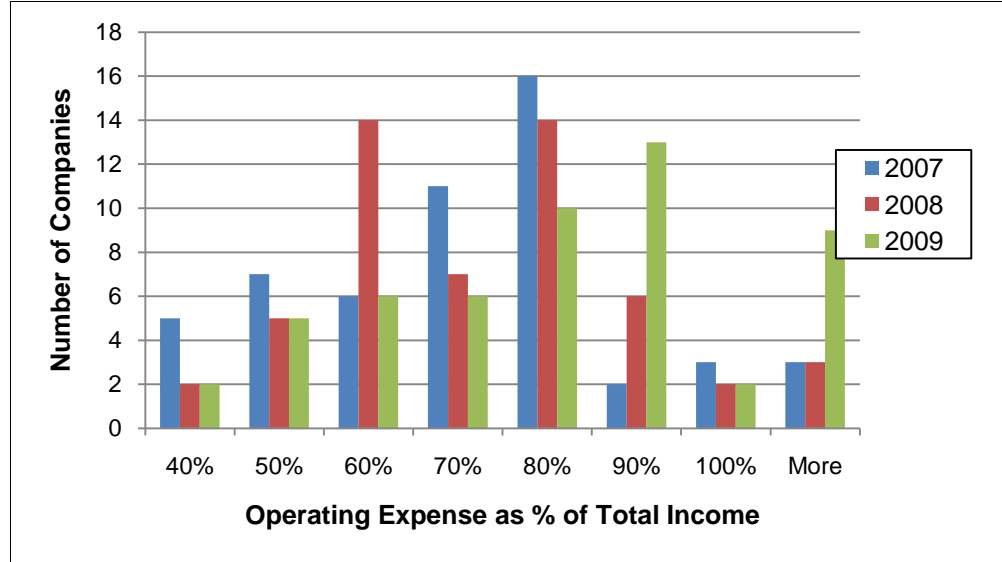
For our review, industry representatives submitted the 2010 Tennessee state report for the title pledge industry. The Tennessee state report reveals that not all title pledge companies were charging the maximum allowable interest rate. Using a similar approach, our results indicated that, in general, the CFA licensees were charging the maximum blended rate allowable (represented by the bold line in Chart 20).

Chart 20: Interest Rate vs. Average Loan Amount by Company



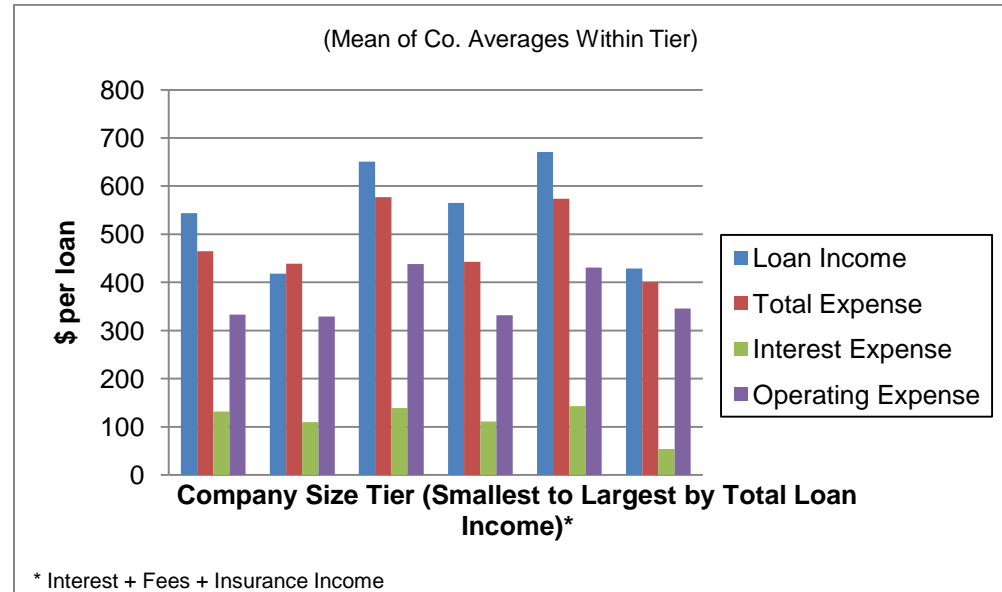
Operating expense, as a percentage of total income, increased substantially for most companies in 2009, as compared with 2007 and 2008. Twenty-four of the 53 licensees had operating expense of 90% or more of total income.

Chart 21: Operating Expense as Percent of Total Income



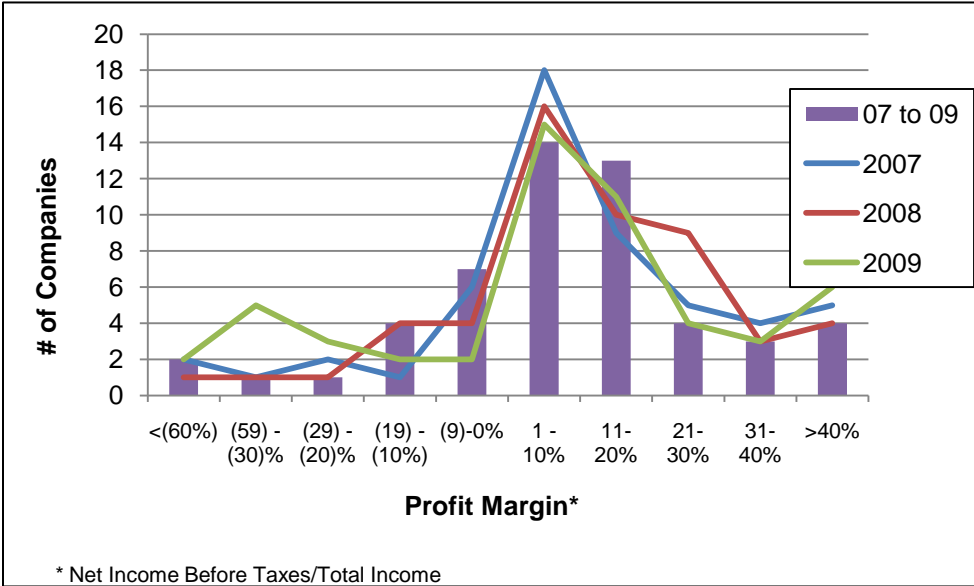
In 2008, size does not appear to be a factor in determining company profitability. Going from left to right on the Chart 22 below, from the very smallest to the largest companies by income, we do not see consistent patterns in income per loan, total expense per loan, interest expense per loan, or profit per loan (the gap between loan income and total expense bars). The exception is that the largest group appears somewhat anomalous, with lower income per loan and much lower interest expense per loan.

Chart 22: Per Loan Income and Expense by Income Tiers – 2008



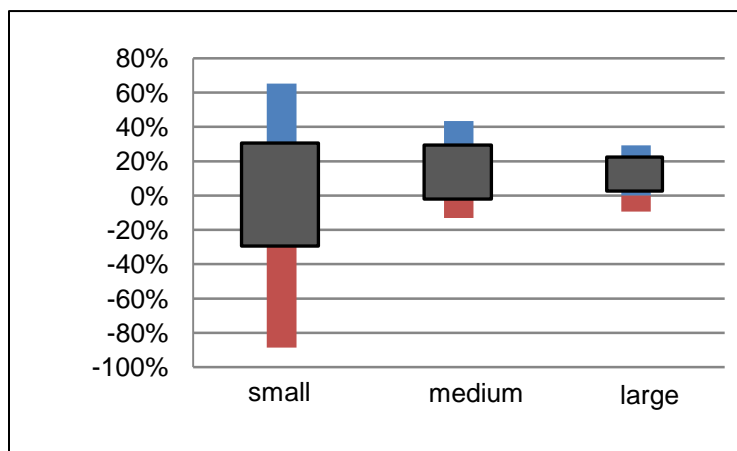
Most licensees had net profit margins clustering around 10% over a three-year average, with 24 licensees having profit margins in excess of 10%, and 11 licensees having profit margins of over 20%. The same general results were seen over each of the three years as shown in Chart 23.

Chart 23: Profit Margin (Pre-Tax)



Profit margins averaged between 9% and 10%, but individual results varied greatly. Using 2008 data, we conducted a detailed profitability analysis. In 2008, the mean profit margin was 9.6 percent, and the median was 9.8%. The greatest variability was attributable to smaller companies. The chart below shows the range of profit margin (and one standard deviation above and below the mean), dividing companies into thirds. The chart is arranged by company size measured by receivables. While all three size groups have a similar average profit margin, the smaller companies have the widest range. The third group, with the largest companies, has a fairly narrow range. We did not find it surprising that small companies exhibit greater volatility in performance, as minor deviations can have greater impact on the smaller bottom lines. This finding suggests that the high number of smaller companies are subject to (and drive much of) the variability we observe as seen in Chart 24.

Chart 24: Profit Margin Range by Size Tier



Overall, we found it difficult to see clear patterns associated with profitability. The strongest correlation we found was that of interest paid as a percentage of interest collected; generally, licensees who paid less than \$.35 in interest expense for every \$1 of interest collected from customers made a profit while those who paid more did not. Other factors did not appear well correlated to profitability, so we next applied a multi-variate regression analysis to statistically identify profit drivers, which we discuss in the following section.

Drivers of Profitability: Multivariate Analysis

For this analysis, we began with 1,034 filings from 139 cases. The data were submitted over the period of 1998 to 2009. In order to analyze the profitability of consumer finance companies, we construct a panel database spanning 1998 to 2009, a second panel covering the same time period without the six largest lenders, and a richer cross-sectional database for 2009 which includes expanded data. As the data exhibited idiosyncrasies, we used the following statistical techniques to remove distortive or bad data. (See Appendix F for a more detailed account of this process):

Step 1: Remove aggregate filings from licensees within the same organization where there were clearly identified intra-company accounting adjustments (one case).

Step 2: Remove licensees operating under N.C.G.S. 53-173 (17 institutions).

Step 3: Remove filings missing critical information (72 filings from 48 different institutions).

Step 4: Remove filings that appear to comeingle sales finance activity (200 filings).

Step 5: Remove licensees which filed in only a single year: (six institutions; five of these had filings in only 1998).

The resulting panel database covers 72-separate institutions and 599 filings, accounting for over 68% of all lending income reported between 1998 and 2009. We then created a second-panel dataset that removed the very largest respondents. Specifically, we restricted the smaller- lender panel to institutions with an average number of loans receivable of less than 20,000. This panel excludes the six-largest companies and reduces the number of filings to 556.

We also created a 2009 cross-sectional database, with 65 institutions, or 84% of all institutions, and over 96% of total lending income for 2009. That year, licensees specifically report sales finance activity so we skipped step 4 above. We also dropped four institutions without any

information on delinquent loans, reducing the sample size to 61. All omissions of individual licensees were based on the above rules. As a result, the end dataset is much more representative of direct installment lending than before removals.

Data

The two key profitability measures we examine are profit per loan⁷³ and profit margin.⁷⁴

We analyzed the effect of several independent variables on the two profitability measures. For categorical variables, the category marked with * serves as the reference category in the statistical model. We divided companies by the number of offices into three categories: those with a single office*, those with two to nine offices, and those with ten or more. We expect that single office companies may be less efficient, but also recognize that home office expenses may lessen the profitability of multi-office licensees. We also used the number of loans (measured as the average number of loans receivable) to capture the effect of economies of scale.

Average loan amount is measured as the total amount of loans receivable divided by the number of loans receivable. Average loan amount is expected to be positively correlated with profitability because, even though interest rates may be slightly lower, total earnings on larger loans should be greater while total costs are expected to be roughly constant, regardless of loan size. We also include a variable for the share of loans secured by personal property* as opposed to motor vehicles, or signature/endorsement, or other.

Two other variables that are expected to drive expenses are loan turnover (the number of loans made during the year as a share of average number of loans receivable), and the share of loans that are renewals of existing loans* as opposed to new loans made to former borrowers, or loans made to new borrowers. Lower turnover implies relatively fewer originations and therefore lower costs. Similarly, a high share of renewals might also lead to lower origination costs by streamlining credit review and loan setup.

Our descriptive analysis indicated that interest costs drive profitability, so we include a variable for net-interest margin per loan (interest collected less interest paid as a share of the amount of loans receivable). We expect a positive correlation between the increase in net-interest margin per loan and profitability measures. Loan performance is measured by charge-off rate (number of loans charged off as a share of average number of loans receivable), and is expected to be negatively correlated with profits.

The cross-sectional 2009 data adds several additional variables (available for the first time that year). As already noted, for the 2009 dataset, we do not exclude companies with indirect lending activity. We can control for the share of indirect loans made, which we hypothesize will correlate with profitability based on the larger expected size and indications from interviews. We include variables for denial rate, which may raise costs but may also increase credit quality, and 60+ day delinquency rate. We also include a factor for number of loans per employee which should be a proxy for personnel costs per loan (which is not specifically reported).

In the 2009 analysis, we also control for local economic conditions, defined as average county employment measures for each institution across all branch offices. The location of branch

⁷³ Referencing lines on the annual report data collection form, this variable is defined as the net income before taxes (Line 22) divided by the average number of loans receivable (arithmetic mean of opening loans receivable (Line 27) and reconciled loans receivable (Line 33)).

⁷⁴ Referencing lines on the annual report data collection form, this variable is defined as the net income before taxes (line 22) divided by total income (Line 16).

offices was determined by the current listing on the NCCOB’s website⁷⁵ cross-referenced with the 2008 and 2009 Annual Reports. The employment measures include the amount of “structural unemployment” defined as average unemployment rate from April 2001 to December 2007, or from peak-to-peak of the past business cycle. In addition, “cyclical unemployment,” or the effect of the recent recession, is captured by the percentage change in total employment from December 2007 to December 2009.

Descriptive statistics on our three samples are shown in Chart 25 below, and are also compared to the full filings of all 176 companies to identify bias introduced by our filters.

Chart 25: Characteristics of Datasets

	All Non-missing 176's N=840	Full Panel (1998-2009) N=599	Smaller lender panel N=556	2009 Only N=61
Profitability measures:				
Profitable	70%	75%	76%	74%
Median Profit Per Loan (Mean)	\$42 (\$3.5)	\$47 (\$38)	\$47 (\$38)	\$43 (\$23)
Median Profit Margin (Mean)	9.1% (-7%)	10.2% (6.6%)	10.5% (6.9%)	8.3% (.9)
Reported				
Number of Offices				
Single-Office	46%	44%	47%	51%
2 to 9	33%	33%	36%	34%
10+	21%	23%	17%	15%
Median number of Loans (Mean)	931 (6861)	1067 (6706)	971 (2618)	992 (7981)
Median Average Loan Amount (Mean)	\$1810 (\$2040)	\$1796 (\$1983)	\$1749 (\$1915)	\$2046 (\$2,193)
Median Loan Turnover*	111%	114%	115%	105%
Median Net Interest Margin*	15.80%	16%	16%	17%
Loan Type				
Personal Property Share*	40%	38%	39%	40%
Signature/Endorsement Share	2% (8%)	.1% (8%)	.1% (5%)	.1% (6%)
Motor Vehicles Share	45% (48%)	45% (47%)	47% (50%)	51% (56%)
Other Considerations Share	0% (5%)	0% (6%)	0% (5%)	0% (2%)
Borrower Type				
Renewed Account Share	60% (57%)	61% (58%)	60% (58%)	67% (63%)
Former Borrowers Share	15% (17%)	15% (17%)	15% (18%)	16% (17%)
New Borrowers Share	20% (26%)	20% (25%)	19% (24%)	15% (19%)
Charge Off Rate	6% (8.6%)	5.4% (7.1%)	5.2% (7%)	6.2% (7.2%)
Indirect Share	0 (33%)			1% (35%)
Loan Denial Rate*	34%			34%
Loan Delinquency Rate	5.2% (11.1%)			5.2% (11.1%)
Loans Per Employee	139 (198)			145 (200)
Local Economic Conditions				
Structural Unemployment Rate*	6.10%			6%
Cyclical Employment Change*	-7.40%			-7.10%

*where mean and median are nearly identical, only median is shown

The panel companies are slightly more likely to be profitable than the full dataset. Though median profit per loan and margin are fairly comparable, the full dataset appears to have some outliers dragging average profitability down, possibly due to partial-year results from companies

⁷⁵ See <https://www.nccob.org/online/CFS/CFSCoCompanyListing.aspx> (accessed November 2010).

exiting the market in a given year. Other than a slightly higher charge-off rate and lower median loans per employee, the full dataset does not differ significantly in other ways from the panel.

Models

In the first model using panel data, profitability in time t for institution i is given by π_{it} and predicted using a vector of reported variables (X_{it}).

$$\pi_{it} = \beta_0 + \beta X_{it} + \varepsilon_{it} \quad (1)$$

Profitability across all companies is likely correlated with time and economic conditions. Over the course of 1998 to 2009, the industry has experienced two recessions, or more than a full business-cycle. In addition, each institution exhibits idiosyncrasies in their business operations and accounting mechanisms which may not be fully accounted for by removing outliers or controlling through observed variables. To control for these confounding factors, we alternatively include fixed effects for year (λ_t), or institution (c_i), or both.

$$\pi_{it} = \beta_0 + \beta X_{it} + (\lambda_t) + (c_i) + \varepsilon_{it} \quad (2)$$

We run Model 1 and Model 2 for the full panel database. In addition, we repeat these models with the smaller lender dataset. For the cross-sectional database, we cannot use time- or institution-level fixed effects, but include economic variables for county unemployment (γG).

$$\pi_i = \alpha + \beta X_i + \gamma G_i + \varepsilon_i \quad (3)$$

Results

The output from these regression estimations is available in Chart 26 and Chart 27. Overall, the models exhibit high statistical significance. The variables included in the basic model explain about 15% to 20% of the variability in profitability (R-squared equal to 0.158 to 0.209). When we added a control variable for year (model not shown) there was almost no change in results, and no year had statistically significant effects except in the profit margin model (where 1998 and 2005 were significant at the .05 level).

When we added controls for individual institutions, the explanatory power of the model jumped another 40% to 50% demonstrating the substantial degree of idiosyncrasy in profitability from company to company. In other words, company attributes other than those captured in our model account for much of the difference in profitability.

The 2009 cross-sectional model, which included expanded information on denial rates, delinquency rates, indirect lending, and local economic conditions, explained 41% of the variation in profit per loan and 59% of the variation in profit margin.

Two other variables are consistently significant across all models: net interest margin and charge-off rate. A single percentage point increase in the net interest margin is associated with at least an additional \$9 to \$16 in profit per loan or another 1.9 to 2.9 percentage points in profit margin.

Similarly, a 1 percentage point increase in the charge-off rate is generally associated with a \$2.0 to \$2.5 decrease in profitability per loan or 0.3 to 0.4 percentage points in profit margin. When controls for denial rate and delinquency rate are included in the 2009 cross-sectional model, the effect of the charge-off rate on profitability dramatically increases to nearly \$14 per loan or 3.5 percentage points in profit margin. In the profit margin model, the delinquency rate is a

statistically significant predictor of profit margin in its own right. A percentage point increase in the delinquency rate is associated with a 1.5 percentage point decrease in profit margin.

Together, these results suggest that key factors determining consumer finance company profitability are the cost of debt (because the interest received part of the net interest margin is essentially fixed by law) and credit quality.

The remaining variables are less statistically consistent, and therefore must be interpreted with care. These variables still demonstrate some patterns. Higher average loan amounts are associated with slightly more profitability. A greater share of loans to new borrowers, as opposed to renewing accounts, is associated with greater profitability. A greater share of loans based only on an endorsement, as opposed to personal property, is associated with less profitability.

Summary

Taken together, these analyses paint a consistent picture of the industry. Consumer finance in North Carolina is not a growth industry, but it can and does generate a profit for most licensees. The average profit margin consistently falls between 9% and 10%. Using a very simple summary example, if the average loan of around \$2,000 generates \$480 in interest (at 24%), and if a 10% profit margin is achieved on the interest alone (not including other income forms), the \$48 profit would result in a return on equity before tax of 12% if the company holds 20% equity, confirming the potential for profitability.

Whatever analysis we use, the cost of funds and charge offs have a significant impact on profitability. Economic conditions (at least as proxied for by year) do not appear to effect profitability once interest rate environment and charge-off levels are controlled. Scale does not seem to impact profitability either, suggesting that larger companies operate like a sum total of individual small companies, using a fairly comparable branch model. However, there is enormous variation among lenders, and unobserved factors – those not captured by the available data – account for most of the outcomes for individual companies. Larger companies tend to exhibit greater consistency of financial performance.

It is possible that better future data collection can help isolate for some of the heretofore unobserved factors, particularly those relating to expenses. Nevertheless, it is likely that small companies, which predominate by number of licensees, will continue to have widely varying results, no matter what data is collected and what rules apply.

Chart 26: Profit per Loan

Model:	1. Full Panel (1998-2009)				2. Smaller Lender Panel (1998-2009)				3. 2009 Only	
	Pooled		Institution [†] Fixed Effects		Pooled		Institution [†] Fixed Effects		Cross-Section	
	N:	R-Squared:	β	P> t	β	P> t	β	P> t	β	P> t
	599	0.209			556	0.188			61	0.413
			β	P> t	β	P> t	β	P> t	β	P> t
intercept			-265.046	0.000	na	na	-238.903	0.000	na	na
Number of Offices ¹										
2 to 9			-11.948	0.340	-2.789	0.915	-7.848	0.546	-5.435	0.831
10+			-11.742	0.497	23.864	0.507	2.215	0.935	9.729	0.785
Number of Loans			0.000	0.630	-0.001	0.190	-0.001	0.707	0.006	0.055
Average Loan Amount			0.045	0.000	0.010	0.138	0.039	0.000	0.006	0.371
Loan Turnover			-0.054	0.731	-0.158	0.394	-0.030	0.853	0.312	0.108
Net Interest Margin			12.637	0.000	10.066	<.0001	11.453	0.000	9.345	<.0001
Signature/Endorsement Share ²			-0.793	0.047	-1.141	0.030	-1.078	0.012	-1.095	0.088
Motor Vehicles Share ²			0.055	0.809	-0.393	0.342	0.128	0.591	-0.319	0.502
Other Considerations Share ²			0.134	0.738	-0.400	0.514	0.296	0.501	0.049	0.945
Former Borrowers Share ³			0.672	0.188	0.055	0.935	0.692	0.182	-0.174	0.801
New Borrowers Share ³			1.125	0.003	0.814	0.099	0.975	0.013	0.497	0.343
Charge Off Rate			-2.231	0.000	-2.334141	<.0001	-2.026	0.000	-2.123	0.000
Indirect Share										0.516
Loan Denial Rate										1.119
Loan Delinquency Rate										-3.902
Loans Per Employee										0.001
Structural Unemployment Rate										-44.061
Cyclical Employment Change										-4.215

Chart 27: Profit Margin

Model:	1. Full Panel (1998-2009)				2. Smaller Lender Panel (1998-2009)				3. 2009 Only	
	Pooled		Institution [†] Fixed Effects		Pooled		Institution [†] Fixed Effects		Cross-Section	
	N:	R-Squared:	β	P> t	β	P> t	β	P> t	β	P> t
	599	0.209			556	0.188			61	0.413
			β	P> t	β	P> t	β	P> t	β	P> t
intercept			-56.900	<.0001	na	na	-52.317	<.0001	na	na
Number of Offices ¹										
2 to 9			-2.024	0.484	-2.421	0.649	-1.578	0.606	-3.104	0.562
10+			-1.484	0.710	3.780	0.607	0.103	0.987	1.316	0.861
Number of Loans			0.000	0.598	0.000	0.389	0.000	0.981	0.001	0.198
Average Loan Amount			0.007	<.0001	0.001	0.660	0.006	0.001	0.000	0.854
Loan Turnover			-0.018	0.618	-0.009	0.819	-0.013	0.731	0.014	0.736
Net Interest Margin			2.665	<.0001	1.928	<.0001	2.414	<.0001	1.829	<.0001
Signature/Endorsement Share ²			-0.201	0.029	-0.328	0.002	-0.254	0.012	-0.340	0.012
Motor Vehicles Share ²			0.016	0.761	-0.154	0.068	0.029	0.606	-0.183	0.068
Other Considerations Share ²			0.061	0.506	-0.132	0.289	0.111	0.286	-0.074	0.617
Former Borrowers Share ³			0.300	0.011	0.115	0.408	0.315	0.010	0.101	0.486
New Borrowers Share ³			0.306	0.000	0.214	0.034	0.286	0.002	0.175	0.114
Charge Off Rate			-0.381	0.0031	-0.363229	0.0016	-0.344	0.009	-0.319	0.006
Indirect Share										0.054
Loan Denial Rate										0.295
Loan Delinquency Rate										-1.533
Loans Per Employee										0.002
Structural Unemployment Rate										0.006
Cyclical Employment Change										-14.554
										0.035
										-0.319
										0.913

Reference categories: Single office company, Personal property secured, Renewal. **Bold** indicates significance at .10 level.

Consumer Protection Issues

As hard as it is to measure lender welfare, measuring the effect on consumer welfare from access to various forms of consumer credit is much more challenging. While debates have raged for years, very little research exists that truly proves whether the consumer is better or worse off with certain higher-cost loan products. In one research experiment, four-month, 200% APR consumer installment loans were made to marginal applicants at a South African bank. Researchers found that those marginal applicants exhibited a range of positive economic and psychological outcomes, compared to similar borrowers who had been denied the loan. The study's authors are careful not to generalize their findings, and recognize that their results run counter to prior studies where high-cost credit created negative effects. The research reinforces that it is not an easy task to distinguish harmful loans from beneficial ones.⁷⁶

We did find evidence on consumer satisfaction that was specific to the North Carolina consumer finance industry (though less scientific). NCCOB's Consumer Banking and Finance Survey and UNC's survey of short-term credit needs indicated that consumers were generally satisfied with finance-company-loan products and that these products meet their needs. A survey of consumer finance customers conducted by the North Carolina Credit and Personal Finance Council (NCCPFC) also found widespread consumer satisfaction with the industry and products available. We also report on consumer complaint data reported by the North Carolina Department of Justice.

The Consumer Banking and Finance Survey asked people about what they perceived to be major and minor problems with finance companies and other non-bank lenders. This survey question was not directed solely at customers, and it is likely that the majority of people giving their opinions have never received a finance company loan. The most commonly cited concern was the fairness of rates and fees charged by the lenders; 33% of people said this was "a major problem" and another 33% identified it as "a minor problem." Similar numbers were cited for banks and mortgage lenders as well, suggesting that this may reflect distrust of financial institutions overall.

The study also asked people to rate how satisfied they were with financial products. Of those who had received a finance company loan in the prior two years, 47% of borrowers said they were "somewhat satisfied" and 36% of borrowers said they were "very satisfied." The percentage of people who were "very satisfied" with the finance company loan was lower than borrowers' satisfaction with some other financial products, but the vast majority were "somewhat" or "very satisfied" (83%) — more than for rent-to-own (81%), check-cashers (80%), payday/auto title loans (80%), and pawn shops (71%). We caution that many of these figures are derived from small sample sizes.

The UNC study includes an even smaller number of finance company customers; only 15 people (8%) surveyed reported that they had used a finance company loan to meet a financial shortfall in the prior three years. The responses given by this small sample should be considered suggestive rather than representative. The 15 finance company customers surveyed were very satisfied with the loan products they received, and rated the finance company loan second only to bank loans in terms of perceived fairness, and highest in satisfaction.

⁷⁶ Karlan, Dean and Johathon Zinman, *Expanding Credit Access: Using Randomized Supply Decisions to Estimate the Impacts*, Rev. Financ. Stud. (2010) 23 (1): 433-464. doi: 10.1093/rfs/hhp092 First published online: November 28, 2009. (accessed January 10, 2011).

The North Carolina Credit and Personal Finance Council (NCCPFC) conducted a survey of its customers in December, 2009 and January, 2010.⁷⁷ A total of 2,500 finance company customers were surveyed via customer-feedback cards placed at lender offices. The study did not use a representative sample, so again, the findings should be interpreted as suggestive rather than representative. Study participants indicated that they were using finance company loans for a wide variety of reasons including paying living expenses (27%), purchasing something for a special occasion (18%), and vehicle repair (15%). More than half the consumers surveyed (54%) had compared the costs of a finance company loan with the costs of other types of loan products before receiving a loan.

The NCCPFC found that 99% of consumers felt the company was fair and the product was satisfactory. When asked about the consequences of being unable to obtain a finance company loan, 88% of the customers surveyed said it would have a negative impact on their families. Only 10% of customers said that the finance company is their only option for borrowing money and 40% said they would take a loan from friends or family members if they could not get a finance company loan. This finding is consistent with the UNC study which found that lower-income North Carolinians generally have multiple ways to handle short-term credit needs.

Neither the NCCOB nor the North Carolina Department of Justice Consumer Protection Division received many complaints from consumers about finance companies in North Carolina. According to the Justice Department, consumer finance complaints numbered 78 in 2008, 93 in 2009 and 74 in 2010 – a small fraction of approximately 500,000 loans outstanding. Two-thirds of the complaints were related to vehicle financing, (at least a portion of which are likely covered under Sales Finance activity) and mortgage loans (not covered under the CFA). Consumer finance complaints represent about 5% of all credit related complaints over this period.⁷⁸ This is in-line with the estimated share of the general population who are finance company borrowers.

While the CFA limits the ways in which lenders can practice “term substitution” – where regulation of some terms will cause lenders to adjust other terms⁷⁹ – there are a number of ancillary consumer issues that were raised during the Study Group meetings. Limited evidence was presented as to the pros and cons of these practices from the consumer point of view, but discussions and available information are summarized below:

Credit Insurance

Credit insurance has the potential to be a beneficial product for both consumers and consumer finance companies, but it has also drawn much criticism.⁸⁰ With respect to consumer finance regulation specifically, credit insurance has been seen as a legal way for lenders to skirt rate and fee limits that “violates the cardinal principle of a single, all-inclusive maximum rate of charge.”⁸¹ However, it has also been recognized that the income from credit insurance has been important to maintaining industry profitability within the constraints of the small loan laws. The following

⁷⁷ Survey of Consumer Attitudes, March 9, 2010, Presented by NCCPFC and provided to NCCOB. Also, available via Resident Lenders of North Carolina, Information off webpage. http://www.rlnc.org/images/stories/rlnc%20pdfs/5NCCPFCCEWPresentation_SurveyofCustomerAttitudes_03_24_10.pdf (last accessed January 25, 2011).

⁷⁸ North Carolina Department of Justice Consumer Protection Division, Consumer Finance and Credit Complaint Data. November 17, 2010. Prepared by David Evers. Submitted to NCCOB.

⁷⁹ Zywicki, p. 26.

⁸⁰ Keest, Kathleen E., *Stone Soup: Exploring the Boundaries Between Subprime Lending and Predatory Lending*, Corporate Law and Practice Course Handbook Series, Consumer Financial Services Litigation (2001).

⁸¹ Hubachek (1954) p. 20

is a summary of key consumer issues related to credit insurance. These issues affect the majority of consumer finance borrowers, because most consumer finance loans have one or multiple forms of credit insurance.

Issue 1: Insurance Premium Refunds: This study did not examine how insurance refunds are made with respect to consumer finance lending if a loan is paid off early (as when it is renewed). In general, insurance premium refunds have been criticized for being calculated based on the Rule of 78's. The refund schedule in North Carolina can be based on the Rule of 78's⁸² or on a "short rate" table which features a pro rata refund after a cancellation fee is deducted. (Other more consumer-friendly options are also allowed, or on certain lines, required.) Critics argue that the Rule of 78's, which gives the creditor or insurer a greater return on prepayments made during the first half of the loan term, is "one factor in how loan flipping snowballs the cost of serial refinances."⁸³ Proponents state that the benefit to creditors and insurers, created by the Rule of 78's, serves as compensation for the risk of prepayment or acceleration.

Issue 2: Low Loss Ratio as an indication of low consumer value: This study did not examine the costs and benefits of credit insurance with respect to consumer finance lending. In general, an insurance line's loss ratio is often cited as a measure of pricing efficiency.⁸⁴ Consumer advocates often point to the low loss ratio of some credit insurance products as an argument that these products are overpriced.^{85,86} Proponents point to the benefits credit insurance provides including peace of mind. Proponents also argue that cyclical external circumstances, present in one year but not the other, may significantly impact the loss ratios for a given product. For example, the National Association of Insurance Commissioners (NAIC) said that a 75% loss ratio is a "reasonable benchmark" for unemployment credit insurance.⁸⁷ According to the North Carolina Department of Insurance survey, in 2008 the loss ratio of unemployment insurance was 26.48%, well below the NAIC target. In 2009, the impact of the credit crisis spread and the loss ratio rose sharply to 74.08%. In interviews, several finance company operators mentioned the fact that having been able to offer unemployment insurance has provided a noticeable offset to recent loan losses, and also indicated that customers are showing increased interest in the product.

Issue 3: Pricing Structure and transparency of finance charge: This study did not examine credit insurance pricing structures. Credit insurance is excluded from the finance charge under both North Carolina and Federal Law.⁸⁸ In general, the use of financed single premium insurance, where the premium is paid up front and included in the loan amount, is criticized for adding cost in a manner that is not transparent to consumers,⁸⁹ (even though disclosure law under Regulation Z requires each premium to be clearly stated separately on the Truth in Lending form and the borrower must sign a statement verifying their election to purchase any such policy).

Issue 4: Reverse Competition: The current incentive structure pays the creditor a commission for the sale of credit insurance. This incentive structure is criticized by those who claim that credit

⁸² "§ 4:49. Rebates of unearned interest and costs-Rule of 78's (sum of digits)," 1 Com. Asset-Based Fin. § 4:49.

⁸³ Ibid. And Keest (2001).

⁸⁴ Keest (2001)

⁸⁵ Anthony Rolo, Jeffrey R; Seewald, and Daniel T. Plunkett, *Update on Credit Insurance Issues and Developments: An Industry Under Siege. Consumer Finance Law Quarterly Report (Winter 2004).*

⁸⁶ Recommendations for NC Commissioner of Banks Study on the NC Consumer Finance Act, submitted to NCCOB by Chris Kukla, Center for Responsible Lending, November 22, 2010.

⁸⁷ Keest (2001)

⁸⁸ Reg. Z, § 226.4(d) (voluntary insurance must not be included in finance charge) and N.C.G.S.A. § 53-189.

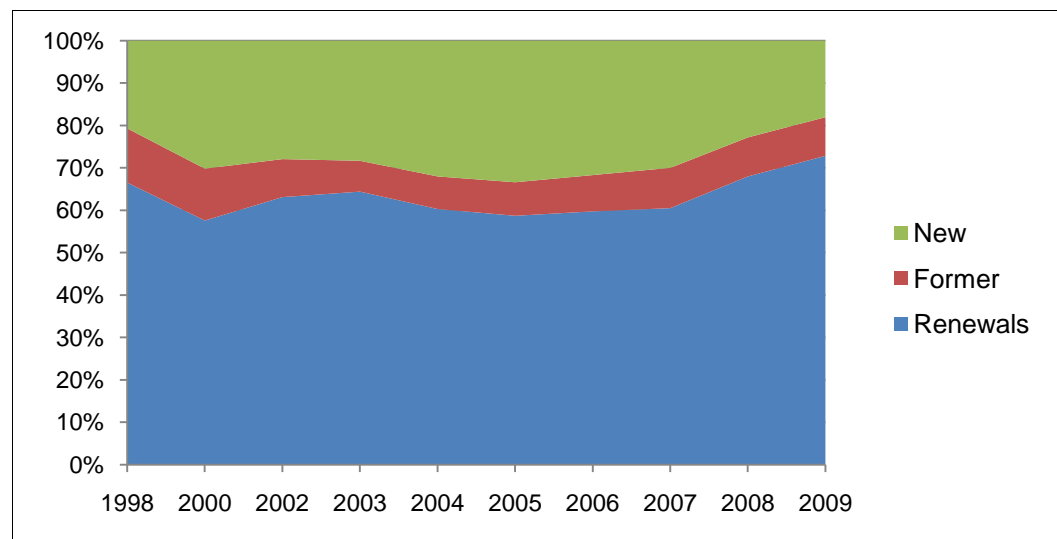
⁸⁹ Ibid. at 1124.

insurance already gives the creditor the benefit of “greater security on the loan.”⁹⁰ Furthermore, opponents have expressed concerns about relationships between consumer finance companies and the credit insurers,⁹¹ and about the potential conflict of interest created by contingent commissions. Opponents believe these relationships may result in “disincentives to help consumers through the claims process” when the finance company’s bonus is contingent on the number of successful claims.⁹²

Renewals

A large share of the customer base of finance companies is existing customers, mostly those renewing a current loan. As shown in the chart below, in recent years, the share of loans made to new customers has been declining while the share of renewals has risen. In interviews, several operators reported a decline in credit quality of new applicants and rising denial rates, citing unemployment problems, as well as applicants who had become over extended on credit. This revelation may partly account for the fact that the number of loans made to new borrowers in a year has fallen 45% since 2005, to just 77,392.

Chart 28:
Percent of Loans Made – Renewals, Former Borrowers or New Customers



One appealing aspect of the installment loan is that, by making regular and manageable payments, the borrower can succeed in extinguishing their debt within a reasonably short period of time. This benefit is articulated by one industry representative: “The installment system of payments gives the customer a ‘road map out of debt.’”⁹³

The renewal frequency of consumer installment loans suggests that many borrowers are not extinguishing their indebtedness under their original schedule. Is this a problem? Interviewees and representatives of the industry reject the label “refinance” and stress that every loan made

⁹⁰ Center for Economic Justice, *Credit Insurance in Texas: Better Rate Regulation Needed to Protect Consumers*, (April 1998).

⁹¹ *Ibid.* at 369.

⁹² Keest, (2001)

⁹³ *Installment Loans Pros and Cons*, submitted to NCCOB via email by Andrew Morrison, October 8, 2010. Morrison is with Brundage Management/Sun Loan Company.

is a new loan, with re-underwriting and new funds advanced. They regard the ability to renew accounts as an important service for customers, and stress that repeat business is a sign of customer satisfaction and loyalty, and that it is a benefit to customers to have a single loan and a single payment. A company is only allowed one loan per borrower. If a client has a new need that arises within the term of the loan, which can easily be two- or three-years, they must have the old loan closed out first.⁹⁴

Moreover, a common alternative to the consumer installment loan is the credit card, which is designed as revolving, and requires only negligible amounts of principal reduction. The regularly renewed installment loan, with more built-in discipline, may be more consumer friendly than a credit card. The credit card could also carry a high rate of interest that may be subject to change, late fees, over-limit fees, and annual fees.

Nevertheless, advocates observed that the fact that more than half of all outstanding consumer finance loans in NC are renewed⁹⁵ and that most loans are to existing and former borrowers, diminishes one of the stated benefits of the loans.

Our analysis does not enable us to evaluate how well the CFA limits the costs of long term indebtedness while allowing for responsible repeat borrowing. Two other CFA elements come into play on this issue in addition to the rules limiting loans per borrower and the limits on processing fees. First, lenders (and borrowers) have the flexibility to set the repayment term on each loan, as long as it is for least 6 months and no more than 7 years⁹⁶; Second, if a loan is still outstanding at its scheduled maturity date, the interest rate falls to 8%.

Non-Filing Insurance

Some study group participants called for the elimination of NFI, citing a number of potential problems.⁹⁷ One possible concern is that the prospect of collecting the small non-filing self-insurance fee leads licensees to require collateral (and thus obtain NFI or self-insurance fees) when they would otherwise make unsecured loans.

Another concern is that non-filing insurance can evolve into default insurance. Generally, a licensee who secures a CFA loan with an interest in personal property may obtain possession of the collateral if the loan defaults. One risk a secured creditor (licensee) faces is that another party will have a competing interest in that same collateral. If the licensee files or records the security agreement properly, they will generally be protected from such competing interests. However, if they fail to file or record then they risk losing the ability to obtain the collateral in the event of a default. Non-filing insurance aims to protect the lender in a situation in which, but for their failure to record or file the security agreement, the licensee would have been able to use the value of the collateral toward satisfaction of a defaulted loan. So if NFI covers the entire loan balance regardless of what the actual value of the collateral may be, NFI begins to approximate default insurance. Moreover, some lenders report no or negligible charge-offs. If the NFI routinely provides 100% coverage, then there is no default risk to the lender, raising a question of the appropriateness of the interest charged.

⁹⁴ Wagner, Erin. Presentation on November 17, 2010 meeting. Providing Loans for Existing Customers: Why and How. Submitted to NCCOB.

⁹⁵ Estimated as loans made during the year which renewed existing accounts divided by the average number of loans outstanding.

⁹⁶ On section 176 loans.

⁹⁷ Recommendations for NC Commissioner of Banks Study on the NC Consumer Finance Act, submitted to NCCOB by Chris Kukla, Center for Responsible Lending, November 22, 2010.

With respect to third-party non-filing insurance, regulatory guidance issued by the NCCOB seeks to address these concerns. Two NCCOB newsletters issued in 2009 and 2010 clarify that licensees should “ensure accounts are handled properly according to the insurer/lender contract and applicable law” though “this could mean significant policy changes for some licensees.” They advise licensees that “in no way should non-filing insurance be used as default insurance.” The NCCOB’s communiques emphasize that any NFI claims received by licensees should be applied to the indebtedness of the borrower, that collection efforts should be ceased on those loans paid in full by NFI, that any judgements should be canceled and payments reported to credit bureaus, and that consumer finance companies are prohibited from pursuing recovery on behalf of the insurance companies. In addition, these newsletters indicate that additional guidance is forthcoming.⁹⁸

While the newsletters did not address the issue of self-insured non-filing insurance, guidelines should apply to ensure that self-insured non-filing income is not simply another form of interest. Either way, it is clear that better information is necessary to properly understand the impact of non-filing insurance on profitability and on borrower welfare.

In summary, our research regarding consumer protection issues relied on a limited amount of existing information which showed consumer finance customers to be generally satisfied. It also reported on information shared by study group participants on their view of risks and benefits to consumer finance company borrowers. This study did not involve direct research with borrowers. The existing evidence and items brought forward at study group sessions provided no basis to believe that borrowers are being systematically harmed by consumer finance companies. The limited information instead suggests consumer finance lenders, as regulated by the CFA, are meeting a specialized need on reasonable terms.

⁹⁸ NCCOB, Non-Depository Entities Division, *Non-Depository Newsletters* issued April 19, 2010 and October 31, 2009. Available via <http://www.nccob.org/public/FinancialInstitutions/Mortgage/MortgageNewsArchive.aspx> (accessed January 25, 2011)

Appendix A: Legislative Study Commission's Recommendations

FINDINGS AND RECOMMENDATIONS

The Joint Legislative Study Commission on the Modernization of North Carolina Banking Laws and the Consumer Finance Act makes the following findings and recommendations to the 2010 Session of the 2009 General Assembly:

FINDINGS:

The Committee finds that:

1. The North Carolina Consumer Credit and Personal Finance Council (Council) believes that the current interest rate structure denies consumers access to the loans they need because the rates and maximum amounts of the loans have not changed substantially since 1982. As a result the Council believes that consumer finance companies can no longer afford to make small loans because of the increases in operating costs faced by the consumer finance companies.
2. Consumer advocacy organizations such as the Center for Responsible Lending believe that there is not sufficient data to support an increase in the interest rate or loan limits. The Consumer Action Network at the North Carolina Justice Center believes that higher fees and charges for services and loan products and practices that encourage high cost repeat transactions are harmful to consumers.
3. The annual report from the Commissioner of Banks shows that about 70% of the consumer finance lenders in the State are profitable in any given year but that the data shows that expenses have increased for consumer finance lenders. The annual report concluded that the market for consumer finance loans has expanded and diversified; the industry has shrunk in the State but not necessarily due to the Consumer Finance Act; and there are large variations in business models for consumer finance lenders. The report does not provide clear information regarding the profitability of the consumer finance companies.
4. There are very divergent views on the state of the consumer finance industry in the State and more consistent and clear data is needed regarding the costs and profitability of the industry as well as its impact on consumers and their access to credit.

Appendix B: Summaries of Study Group Meetings

Meeting 1: August 18, 2010

Chief Deputy Commissioner Mark Pearce explained that the North Carolina Office of the Commissioner of Banks (“NCCOB”) has contracted with the UNC Center for Community Capital (UNC) to act as an agent of NCCOB for research and analysis. He added that the agreement between NCCOB and UNC is available for review by participants. The findings and recommendations as reported in the Joint Legislative Study Commission report were reviewed. Pearce clarified that the meetings would be undertaken as an inquiry and that no model legislative language would be developed in the meetings.

The meeting topics, as detailed in Pearce’s advance letter to participants, were discussed in order:

- (1) Does the current NCCOB annual report form collect adequate information to inform policymakers regarding industry performance and operation?

The NCCOB explained that the Annual Report was developed monitor the industry for statutory compliance and collect fees, and that there had been no prior need for information beyond that of a self-reported, unaudited nature. Participants expressed concern that the report is not sufficient to analyze profitability trends, and therefore more data and better segmentation is needed. Internal inconsistencies in prior annual reports led to general concern regarding the accuracy of the data being collected. NCCOB was asked to plan lead time for implementing new reporting requirements. Both industry representatives and consumer protection advocates offered to submit a list of data elements that they would like to see going forward. Pearce clarified that all communication to him from participants would be shared with all participants, along with any attachments.

- (2) Are the annual report data elements adequately defined to enable consistent information reporting among all licensees?

Additional definitions were called for to ensure consistent reporting. An allocation method should be incorporated in the definitions for reporting certain data elements between direct and indirect lending.

- (3) What, if any, data validation should be performed by NCCOB?

A consumer protection advocate said there was a need to validate accuracy, but also to explain variations from data norms and trends, and suggested a supplement to the Annual Report to give more information about what data means. Industry representatives stated that when submitted data seems questionable, NCCOB’s examiners contact their offices for clarification. Industry representatives also noted that some other states also only require attestation under oath.

- (4) What other information sources should be used to supplement NCCOB’s analysis?

Industry representatives agreed to provide a list of key ratios by which they evaluate their businesses. They also suggested a review of FDIC and Federal Reserve studies, including those by Tom Durkin. In terms of other publicly available data on the industry, industry representatives noted that because most of the industry companies are privately held, there isn’t much out there, particularly not on North Carolina only business. Consumer protection advocates suggested a review of studies of credit card and other personal credit usage.

Meeting 2: September 22, 2010

Mark Pearce gave opening remarks, recognizing industry attendees from other states. He explained that the purpose of the meeting was to inform the thinking of NCCOB about the needs of the consumer, and secondarily, on the availability of products in the marketplace.

Rachel Schneider from the Center for Financial Services Innovation (via phone) presented findings from a survey of un- and underbanked households and a report entitled "How Should We Serve the Short-Term Needs of Low-Income Consumers?" She noted that financial products can help consumers achieve an improved financial life, provided they are of high quality, meaning that they are transparent, fairly priced, affordable, repayable, and reported to credit bureaus. She noted that the survey did not specifically capture information about consumer finance loans. She discussed pros and cons of different types of lenders, noting that banks and credit unions have constraints in serving higher risk customers and that installment loans offer several advantages relative to some other forms of credit. She noted a lack of capital is constraining growth in the industry.

An out-of-state industry member cited a study linking rising consumer indebtedness to the availability of revolving credit products that did not have a built-in discipline of repayment. A discussion of demand ensued. An out-of-state industry member then noted that both consumers and lenders have reigned themselves in in the past two years, and that some consumers who want loans can't get them. An industry lobbyist noted that payday lenders are gone, and that credit cards have gotten out of hand. He feels there is strong demand for the installment lenders' product and said that the demographics are different from what one might expect.

Pearce asked about trends in credit profiles. Industry participants said that though the average scores remain around 680 nationwide, the percentage of the population below that score has jumped. An Equifax representative reported, noting that channels for credit have been cut off for individuals who can't get a bank loan or credit card. Industry members reported various observations: that the incidence of returned checks is down; that there has been a change in the profile of the typical customer this past year; that they are seeing customers who have either lost their credit card privileges or reached their limit; that the credit score of their portfolio has gone up; that NSF's and late fees have gone down; and that they are getting more referrals from banks.

Pearce shifted the discussion to the supply side of the equation. A representative from the North Carolina State Employees Credit Union gave an overview of the salary advance loan product they launched ten years ago. The representative explained that the product has a \$500 cap and 12% interest. SECU now has 125,000 accounts. Customers who roll loans over must contribute to savings and have accumulated \$19 million in savings accounts. With only \$4 million in losses to date, the product has been profitable. Pearce then observed that banks are not running to offer loans in this space, and the SECU product, designed as an alternative to a payday loan, is not an installment loan.

An industry member said his local bank ran out of money two years ago, forcing him to fund his business by taking capital out of his retained earnings. He stressed that it is very difficult to stay in business under the current conditions.

Phil Lehman, Assistant Attorney General, said that his office is seeing internet payday loans. One attendee reported seeing prepaid cards that look like payday loans; another predicted that a substitute for Refund Anticipation Loans would emerge, now that regulations have limited that product. An industry member expressed concern for North Carolina residents who go to South Carolina, Tennessee or Virginia because there is no product here to meet their needs, adding that he can't afford to make loans in the small size that these consumers are seeking from out-of-state lenders. A consumer protection advocate suggested that these borrowers may not be desirable customers for the North Carolina lenders, due to high default risk. An out-of-state industry member stated that in another state, he had seen situations where an applicant would have been a good prospect, but for the problems that payday loans had caused them. He stated that his company does offer loans smaller loans and thinks that installment lenders should be filling that space. He indicated that he could not operate profitably in North Carolina. He observed that the consumer is best served by borrowing as little as they can for as short a period of time as they can, and that the installment loans enable them to get out of debt.

A consumer protection advocate observed that this is a difficult and atypical time in which to be performing any trend analysis.

Meeting 3: October 20, 2010

Mark Pearce gave opening remarks and presented the agenda, noting that this meeting will address the financial issues of the study. Pearce acknowledged his new position with the FDIC and introduced Commissioner of Banks, Joe Smith, who will be taking responsibility for the project.

Janneke Ratcliffe from the UNC Center for Community Capital presented slides updating through 2009 the data presented by NCCOB on March 24, 2010 to the Joint Legislative Study Commission. Compared to the 2008 report, 2009 data show a decline in number of branches but no decline in number of licensees, a drop in loans receivable, and a return to profitability. She also presented a methodology for identifying outliers in the annual data under study. Martha Svoboda, also from UNC, then presented a segmentation analysis using data from 53 lenders over the 2007-2009 period. Ratcliffe added that they would use multivariate analysis in the next stage of their research. These analyses are detailed in the research study. Industry representatives then argued why the emphasis should be on return on equity rather than profit per loan or profit margin. The industry reiterated concern about the level of inconsistency in the historical data.

C. Everett Wallace of the North Carolina Consumer Credit and Personal Finance Council introduced information on the state of the industry. Wallace explained that the industry presentation would include a slideshow by Chris McKinley of Green Cap Financial, and a slideshow by RSM McGladrey, summarizing their cost study of the industry in North Carolina. Wallace noted that the last change to the statute was in 1982, and that \$.44 today compares to \$1.00 then. He stated that the relative 100% cost increase has reduced the capacity of the industry licensees to serve their markets.

Chris McKinley explained that return on equity (ROE) and return on assets (ROA) were two critical measurements to assess the business. He said that because the equity invested is at full risk, shareholders expect a reasonable return on their investment. McKinley gave historical ROE figures from other industries. He stated that consumer finance companies are typically required by their primary funding source to maintain higher assets than banks, so this industry needs a 20-25% ratio of equity to assets. He also noted that if the investment is returning less than 15% to investors, the company cannot attract additional capital. McKinley illustrated the positive impact that reduced debt has on profitability while reducing return on equity, thus demonstrating "why we cannot look at just dollars earned as a measurement of the health and sustainability of a finance company." McKinley then illustrated the assumptions and income statement for an average branch with \$1.1 million in receivables, based on three of his company's branches. The assumptions included: an average loan of \$2500, each of which is outstanding for seven months; three full-time employees each handling 200 loans; an 8% annual bad debt charge off; 70% leverage on assets at a borrowing rate of 4.5%; other income of \$22,000; and operating expenses of \$206,100. As a result, this hypothetical branch would generate a loss. McKinley further pointed out that the industry as a whole actually has a leverage ratio of 80%, rather than his 70% assumption, and emphasized that operating expense is the biggest part of the average branch's bottom line.

Next Bob Eash and Morris Marshburn of McGladrey & Pullen, LLP presented a summary of their previous report. McGladrey reported that means were computed by averaging results from each company, and calculated that the average company lost from \$139 to \$199 per loan from 2007 to 2009. One consumer protection advocate observed that the overhead burden seemed unusually high compared to other financial institutions and asked what was in the large "other" expense category.

Mark Pearce then summarized concerns over the quality of the annual report data. Pearce then handed the project over to Commissioner Smith, who clarified that the state legislature delegated to the NCCOB the authority to take the information resulting from the study and come up with recommendations, but that it will be the state legislature that makes any final decisions. Commissioner Smith asked the consumer finance industry groups and the consumer protection advocates each to caucus and come to him with a single representative who would tell him what their group members want. He noted that the legislature has allowed this carve-out of the usury laws

for installment lenders to serve the North Carolina public, but added that it is not the objective of the policy to ensure that the consumer finance industry experience returns comparable to the capital markets. However, he stated that policy should make it possible for owners to earn a return.

Meeting 4: November 17, 2010

Chris Kukla from the Center for Responsible Lending led the presentations by the consumer protection advocates. He stated that the annual report data is difficult to use for the purposes of this issue, citing the following concerns: data are not verified, reporting methodologies are inconsistent, and the data should be better segmented. Kukla suggested that more information is needed about borrowers and borrowing patterns. He requested better information on costs and other income, and a better context and explanation of changes or outliers. He would also like to see the data include more information on the impact of indirect lending and other business lines. Kukla observed that the industry's case for adjusting the Consumer Finance Act is based on 2008 activity, but that drawing conclusions from that year isn't a good idea due to the recession and financial crisis. Kukla stated that the CFA balances profitability and consumer needs and that the industry has not made the case that the industry is imperiled. He contended that the data illustrates that the industry is stable and thus that the current limits are appropriate. He noted that data presented at the October meeting demonstrated that companies charge the maximum allowable rates. Kukla raised a concern that 69% of loans are made to existing borrowers, 11% to prior borrowers, and 20% to new borrowers and added that this perpetual debt needs further investigation. He questioned whether loans fees should be limited to once a year, instead of every six months, and whether borrower counseling should be required under certain circumstances. He expressed concern about non-filing insurance and suggested using the UCC approach instead. Kukla noted that credit insurance is a high cost/high profit product being sold to consumers through this channel, but that the topic is outside the purview of this session.

Victor Moore of OnTrack Financial Education highlighted issues he hears from consumers and based on his experience having worked in the consumer finance industry. Moore stated that many people get upsold. He said that consumers don't understand the deferment process and that company branches don't know how to handle work-outs. He suggested having a debt management standard.

Beth Young of the Financial Protection Law Center presented next. She stated that she has represented borrowers for 30 years, and that a pricing change should not be made based on times like these. Young reported how developments in technology and the internet, online lenders, debt buyers, debt restructurers who 'reduce debt for fees,' and loan modification scams all target her clients, who are the direct finance industry's typical customers as well. She reported her clients are loyal to their finance companies, describing how one client asked that his finance company loan not be included in his debt management plan. Young expressed a concern that indentured debt is not good for society.

Bill Rowe of the NC Justice Center presented economic data showing that the unemployment picture is grim, incomes are down and poverty rates are up. Rowe asserted that, if anything, the state needs to decrease interest rates, and definitely should not increase them at this time.

Chris Kukla then closed the consumer protection advocates' presentations by questioning the industry's request to increase the interest rate from the standpoint of potential impact on the customer base and on demand and defaults. He suggested that focus be placed on those companies that are doing well as models for best practices.

Dr. Ricky Keys of Security Finance gave a definition of consumer protection and presented a chart to show that the consumer protections in the CFA businesses are similar to those of banks and credit unions along a number of dimensions.

Erin Wagner DiNero of Wagner Financial then gave a presentation on renewal of consumer finance loans. She pointed out that loans made to prior and existing customers are really new loans. She noted that the loans amortize and said that customers turn to their trusted lenders when a new need for credit arises. Commissioner Smith reminded the group that each licensee is barred from making more than one loan per customer.

Larry Heckner of the North Carolina Consumer Credit and Personal Finance Council, shared a handout summarizing the benefits of the CFA and the consumer finance product, and reiterated that the NC Consumer Finance Installment loan is a good and sound product.

Upon the conclusion of the presentations, Commissioner Smith reported that consumer complaints under the CFA are relatively low. He addressed the issue of improved data collection, acknowledging work being done by the NCCOB to develop a new report form, and noting the intention to allow for an adequate implementation period. He requested that recommendations for improvement be submitted to his office. NCCOB staff pointed out that they had a statutory requirement to file the Annual Report by March 31.

Commissioner Smith stated that he has received no specific requests for modification to the CFA, and he summarized his observations that expenses have gone up, there has been some increase in the average loan amount, and there has been consolidation. He added that the situation is similar to what banks are experiencing—a change in cost structure, consolidation, an inability to cover costs, and a lack of demand. Commissioner Smith indicated that pricing and fee increases are issues for the General Assembly to decide.

As to renewals, Commissioner Smith inquired whether an intervention was really necessary and if so, what it should be. Consumer advocates suggested requiring counseling and work-outs. Industry advocates responded that lenders have no incentive to make a loan that the customer cannot repay, that repeat customers are there because they have a new need. They pointed out that it is not finance companies that are driving people to credit counselors, and reiterated that the consumer finance loan is a great product – the question is, How they can provide the product under the current statutory scheme? They pointed out that having loyal customers is a positive situation. Consumer protection advocates responded that having customers continuously in high rate loans is inconsistent with the claim that installment loans help customers become more financially stable, and the industry position that the financial viability of customers therefore warrants bigger loans.

Commissioner Smith reminded everyone that the direct financing industry is a small industry but one with a long history. He noted that the state's policy of low rates with only a few exceptions is deeply rooted in NC policy, history, and culture, and thus the burden of proof is on any party desiring to change the law. He concluded the meeting by reiterating that the industry is asking for further exemption, while the consumer protection advocates are calling for additional protections, and that the ultimate decision would be made by the General Assembly.

Appendix C: Roster of Registered Attendees of Study Group Meetings

Others attended who did not register and some who registered did not attend; several attended fewer than four sessions.

FIRST	LAST	Organization	City	State
Vic	Barr	Security Finance North Carolina	Lincolnton	NC
Bob	Barry	Regional Management Corp.	Raleigh	NC
Birny	Birnbaum	Center for Economic Justice	Austin	TX
Fred	Bone	Bone and Associates	Raleigh	NC
Leigh	Brady	NC State Employees' Credit Union	Raleigh	NC
Teresa	Browning	NCCOB	Raleigh	NC
Dick	Carlton	Law Office of Richard H. Carlton	Raleigh	NC
Celeste	Collins	OnTrack Financial Education and Counseling	Asheville	NC
Dave	Darby	Darby and Associates	Advance	NC
Skip	Davis	The Plateau Group	Crossville	TN
Erin Wagner	DiNero	Wagner Financial Services	Winston-Salem	NC
Bob	Eash	RSM McGladrey, Inc.	Raleigh	NC
Royce	Everette, Jr.	Time Financing Services Inc.	Greenville	NC
Charlie	Fields	NCCOB	Raleigh	NC
Harris	Greene	Greene Finance	Mount Airy	NC
Branton	Grimes	NCCOB	Raleigh	NC
Glenn	Hall	National Finance Company		
Larry	Heckner	Clark Lytle & Geduldig	Wilmington	NC
Tami	Hinton	NCCOB	Raleigh	NC
Jeff	Joyner	First Point Resources / Equifax	Raleigh	NC
Christopher	Kukla	Center for Responsible Lending	Durham	NC
Peter	Laroche	Consumer Credit Counseling Service of Forsyth County, Inc.	Winston-Salem	NC
Philip	Lehman	N.C. Department of Justice	Raleigh	NC
William	Lewis	UNC Center for Community Capital	Chapel Hill	NC
Patrick	Lindsey	Dixon Hughes PLLC	Raleigh	NC
Louise	Mack	Prosperity Unlimited	Kannapolis	NC
Hazel	Mack-Hilliard, Esq.	Legal Aid of NC - Winston-Salem Office	Winston-Salem	NC
Morris	Marshburn	RSM McGladrey, Inc.	Raleigh	NC
Chris	McKinley	Green Cap Financial	Burlington	NC
Andrew	Morrison	Brundage Mgmt/Sun Loan Company	San Antonio	TX
Rodney	Oldham	NCCOB	Raleigh	NC
Jim	Overton	Self-Help	Durham	NC
Mark	Pearce	NCCOB	Raleigh	NC
Janneke	Ratcliffe	UNC Center for Community Capital	Chapel Hill	NC
Scott	Reynolds	SCR Group	Chapel Hill	NC
Al	Ripley	North Carolina Justice Center	Raleigh	NC
C. Allen	Roberts	Compass Technologies, LLC	Buford	GA
Bill	Rowe	North Carolina Justice Center	Raleigh	NC
Rachel	Schneider	CFSI	Chicago	IL
Peter	Skillem	Community Reinvestment Association of North Carolina	Durham	NC
Pam	Smith	Century Finance	Rocky Mount	NC
Joseph	Smith, Jr.	NCCOB	Raleigh	NC
Paul	Stock	N.C. Bankers Association	Raleigh	NC
Martha	Svoboda	UNC Center for Community Capital	Chapel Hill	NC
Eric	Trainor	Texas Capital Bank	Baton Rouge	LA
C. Everett	Wallace	NC Credit and Personal Finance Council	Durham	NC
Rose Vaughan	Williams	NC Department of Insurance	Raleigh	NC
Andrea	Young	Financial Protection Law Center	Wilmington	NC

Appendix D: List of Resources Provided or Discussed During Study Group Meetings

2007 Consumer Banking and Finance Survey. Market Search for the North Carolina Office of the Commissioner of Banks <http://www.nccob.org/NR/rdonlyres/3AA6DED2-78ED-4340-B3F9-248ED05B4F7D/0/NCCOBConsumerBankingandFinanceSurvey.pdf>

2009 Consumer Banking and Finance Survey. MarketSearch for the North Carolina Office of the Commissioner of Banks. <http://www.nccob.org/NR/rdonlyres/C43519A8-06B2-4920-A153-3AAB1A0CFD6E/0/2009ConsumerBankingandFinanceSurvey.pdf>

2009 Consumer Finance Annual Report available at <http://www.nccob.gov/public/docs/News/Pub%20And%20Research/09%20Consumer%20Finance%20Annual%20Report.pdf>

The 2010 Report on the Title Pledge Industry, Tennessee Department of Financial Institutions. March 2010. <http://www.state.tn.us/tdfi/compliance/tpl/TPLReport2009Final.pdf>

Comments of Birny Birnbaum, Center for Economic Justice, Regarding North Carolina Consumer Finance Data Collection. November 15, 2010. Submitted to NCCOB.

The Consumer Finance Act: A Value Proposition, presented by Larry Heckner, North Carolina Credit and Personal Finance Council at November 17, 2010 study group meeting, submitted to NCCOB.

The Consumer Finance Act, Article 15 of Chapter 53 available at http://www.ncleg.net/EnactedLegislation/Statutes/HTML/ByArticle/Chapter_53/Article_15.html

Regulations Promulgated Under the Consumer Finance Act, North Carolina Administrative Code, Title 4, Chapter 3, Subchapter 3E, available at <http://reports.oah.state.nc.us/ncac/title%2004%20-%20commerce/chapter%2003%20-%20banking%20commission/subchapter%20e/subchapter%20e%20rules.html>

Administrative Interpretations Issued by NCCOB under the Consumer Finance Act, available at <http://www.nccob.gov/public/FinancialInstitutions/CF/CFAdministrativeInterpretations.aspx>

Consumer Finance Study, N.C. Commissioner of Banks, presented at October 20, 2010 study group meeting, Janneke Ratcliffe & Martha Svoboda, UNC Center for Community Capital.

Cost Data – Direct Lending under the North Carolina Consumer Finance Act, A Study Prepared on behalf of the North Carolina Credit and Personal Finance Council. RSM McGladrey Inc. and McGladrey & Pullen. March 24, 2010. Presented at October 20, 2010 study group session. Submitted to NCCOB.

Credit card statistics, industry facts, debt statistics. At Credit Cards.com.

Definitions, Distinctions and Degrees of Protecting Financial Service Consumers, presented to N.C. Commissioner of Banking on November 17, 2010, Rickie C. Keys, PhD, MPH, President, Renewal Financial Services, LLC. Submitted to NCCOB.

Economic Situation for North Carolina's Consumers, presented at November 17, 2010 study group session, Bill Rowe, NC Justice Center. Submitted to NCCOB.

FDIC National Survey of Unbanked and Underbanked Households, 2009. <http://www.fdic.gov/householdsurvey/> Includes summary and link to full reports including the Addendum on the Use of Alternative Financial Services (2010).

Finance and Credit Complaint Data. North Carolina Department of Justice Consumer Protection Division, Consumer November 17, 2010. Prepared by David Evers. Submitted to NCCOB.

G-19 Consumer Credit, Federal Reserve Statistical Release. <http://www.federalreserve.gov/releases/g19>

G-20 Finance Companies, Federal Reserve Statistical Release. <http://www.federalreserve.gov/releases/g20>

How Should We Serve the Short-Term Credit Needs of Low-Income Consumers? Rachel Schneider and Melissa Koide, Center for Financial Service Innovation. 2010.

http://cfsinnovation.com/system/files/Research_Paper_Credit_Symposium_April62010.pdf

Installment Loans Pros and Cons, submitted to NCCOB via email by Andrew Morrison, October 8, 2010.

NCCOB Current (through 2009) Annual Report Form.

North Carolina Consumers After Payday Lending; Attitudes and Experiences with Credit Options. November 2007.

UNC Center for Community Capital for the North Carolina Commissioner of Banks.

http://www.ccc.unc.edu/documents/NC_After_Payday.pdf.

North Carolina Consumer Finance Profile Analysis. Equifax Analytical Services. April 19, 2009. Submitted to the NCCOB.

North Carolina Credit and Personal Finance Council cover letter and summary of the Forums on Modernizing the NC Consumer Finance Act. December 2, 2010. Submitted to NCCOB after final study group meeting.

Overview of the Consumer Finance Industry, 1990-2007. Presented by C. Everett Wallace on behalf of the North Carolina Credit and Personal Finance Council. January 2010. Submitted to NCCOB.

Profitability Benchmarks for Consumer Finance Lending, presented by Chris McKinley. Submitted to NCCOB.

Providing Loans for Existing Customers: Why and How. Erin Wagner. Presentation on November 17, 2010 meeting. Submitted to NCCOB.

Quarterly Report on Household Debt and Credit, August 2010. Federal Reserve Bank of New York.

http://www.newyorkfed.org/research/national_economy/householdcredit/DistrictReport_Q22010.pdf

Ratios for Calculations Related to the Consumer Finance Industry, memo from C. Everett Wallace, NCCPFC dated August 25, 2010 and suggestions for annual report (untitled), submitted to NCCOB.

Recommendations for NC Commissioner of Banks Study on the NC Consumer Finance Act, submitted to NCCOB by Chris Kukla, Center for Responsible Lending, November 22, 2010.

Report to the 2010 Regular Session of the 2009 General Assembly of North Carolina by Joint Legislative Study Commission on the Modernization of the North Carolina Banking Laws and the Consumer Finance Act, 2010.

<http://www.ncga.state.nc.us/documentsites/legislativepublications/Study%20Reports%20to%20the%202010%20NCGA/Modernization%20of%20North%20Carolina%20Banking%20Laws.pdf>

Small Dollar Loan Pilot, Federal Deposit Insurance Corporation. Includes summary and links to detailed reports.
<http://www.fdic.gov/small-dollarloans/>

Small Dollar Loan Products – Scorecard (Updated May, 2010), National Consumer Law Center and Consumer Federation of America, available at http://www.nclc.org/images/pdf/high_cost_small_loans/payday_loans/cu-small-dollar-scorecard-2010.pdf and Statutory Backup, August 20, 2008, <http://www.nclc.org/images/pdf/pr-reports/scorecard-small-dollar-backup-2008.pdf>

Summary of Research on Finance Company Borrowers, Dr. Kim Manturuk, Research Associate, Center for Community Capital. Submitted to NCCOB.

Survey of Consumer Attitudes, March 9, 2010, Presented by NCCPFC and provided to NCCOB. The summary report of the survey is available via Resident Lenders of North Carolina, http://www.rlnc.org/images/stories/rlnc%20pdfs/5NCCPFCCEWPresentation_SurveyofCustomerAttitudes_03_24_10.pdf (last accessed January 25, 2011). Additional attachments were included in submission to NCCOB.

Trends in North Carolina Consumer Finance Industry. Mark Pearce, Chief Deputy Commissioner of Banks, Submitted to the Joint Legislative Study Commission on the Modernization of North Carolina Banking Laws and the Consumer Finance Act, March 24, 2010. Available at <http://www.nccob.gov/public/docs/News/Testimony%20And%20Speeches/Trends%20in%20North%20Carolina%20Consumer%20Finance%20Industry%20--%20March%202010.pdf>

Appendix E: Revised Annual Report Data Instrument – DRAFT – JANUARY 31, 2010

Issues addressed by this DRAFT revision noted in red text boxes.

Filing Instructions Page



Consumer Finance Annual Report

Filing Instructions: Please complete the general information requested and Schedules A through I. A company operating more than one licensed office in North Carolina must file a single, consolidated report for all licensed offices. Round all amounts to the nearest dollar. Do not use cents. Additional instructions appear on Schedule H.

Note: Loans Receivable in all schedules are to include only loans made under the North Carolina Consumer Finance Act. Do not include sales finance receivables or any other business in this report. Where business other than the licensed consumer finance business is conducted in any licensed office, the licensee must allocate expenses according to appropriate and reasonable accounting principles.

Definitions: ———— Definitions add clarity. No co-mingling of direct and sales finance reporting.

Application - 'Application' means an oral or written request for an extension of credit that is made in accordance with procedures used by a creditor for the type of credit requested. A completed application means an application in connection with which a creditor has received all the information that the creditor regularly obtains and considers in evaluating applications for the amount and type of credit requested (including, but not limited to, credit reports, any additional information requested from the applicant, and any approvals or reports by governmental agencies or other persons that are necessary to guarantee, insure, or provide security for the credit or collateral). This definition applies to both initial and renewal applications for extension of credit.

Approved Loan Application Withdrawn - An application approved for credit, but the applicant chose not to accept the loan.

Interest expense - Includes all interest expenses on all debt or capital of the company. (Consumer finance and sales finance)

Occupancy expenses - Occupancy expense is the total occupancy expenses, such as rent, utilities, insurance and repairs and maintenance for all operating locations of the licensed company.

Provision for credit losses - Provisions for credit losses on loans under the Consumer Finance Act.

Recoveries - Accounts that have been charged off, but that have been subsequently collected.

Salaries, wages and benefits - Salaries, wages and benefits for all company personnel. Benefits include employer paid health, dental, pension/retirement contributions, employer portion of federal and state payroll taxes, unemployment and other fringe benefits provided to company personnel.

Sales Finance Loans - Installment sales contracts of retail merchants.

DRAFT 2010 ANNUAL CONSUMER FINANCE REPORT QUESTIONNAIRE

This page is the General Information data that needs to be entered before the actual Annual Report information is entered.



Annual Report - General Information

1. Person to contact with any questions about this report:

*Name: *Title: *Phone:

2. *Number of employees in North Carolina offices:

3. List the names of all affiliates licensed under the North Carolina Consumer Finance Act (i.e., same ownership, management or control, whether partial or complete).

To add an affiliate company, select the company from the drop down and click the Add button.

4. Is the licensee, parent company or affiliate engaged in consumer finance business in other states?

Yes No

5. Is the licensee a subsidiary of a bank holding company?

Yes No

If the answer is "yes", give the name and address of the bank holding company

Holding Company:
Address 1:
Address 2:
City:
State:
Zip:

DRAFT 2010 ANNUAL CONSUMER FINANCE REPORT QUESTIONNAIRE

5. SCHEDULE OF ALLOCATION:

The dollar amounts entered in annual report #17 (a,b,c,f) of the Expense section in Schedule B must represent the application of the percentage as calculated below.

A - Total number of consumer finance loans in NC:

January 1, 2010

Number
55

December 21, 2010

5

Average Number for A

30

B - Total number of consumer finance loans and sales finance loans in NC:

January 1, 2010

Number
60

December 21, 2010

6

Average Number for B

33

Allocation Percentage (Avg A divided by Avg B)

0.91

The allocation percentage shown above should be used to allocate the following expenses by multiplying the allocation percentage by the total expenses in each category:

- Salaries, wages and benefits (#17-a)
- Occupancy expense (#17-b)
- Depreciation and amortization (#17-c)
- Other expenses (#17-f)

For licensees doing both direct and sales finance, calculates an operating expense allocation formula based on # of loans made in each category.

Other Expense Reporting:

The provision for credit losses should be reported based on the actual or direct allocation to direct lending under the Consumer Finance Act.

Interest expense should be reported based upon the interest paid on borrowed funds that related to direct lending. If an allocation is necessary, the net principal balance (gross minus unearned interest) of loans outstanding for direct and indirect should be utilized.

Income Tax

Income tax should be reported based upon the net income related to direct lending. If an allocation is necessary, allocate income taxes according to the share of total net income that was related to direct lending activities.

For licensees doing both direct and sales finance lending, specifies allocation instructions for credit losses, interest allocation and income tax.

7. Person attesting this report on behalf of the licensee:

*Name:

*Title:

Cancel

Save

*Denotes a required field

DRAFT 2010 ANNUAL CONSUMER FINANCE REPORT QUESTIONNAIRE

This is the beginning of the actual annual report information.



Annual Report
 Year Ending : 12/31/2010 Ready For Submit : No

All fields are required unless marked with a *. Round all amounts to the nearest dollar. Do not use cents. **Please Save this page at regular intervals.**

On completing data entry, click [Validate Data] to verify that the data entered is correct. Please correct any errors displayed. **You will be able to submit a report only if 'Ready To Submit' displayed above shows a value of 'Yes' on [Validate Data].**

Cancel Done Validate Data

**Schedule A
 Balance Sheet**

North Carolina Office of the Commissioner of Banks
 ASSETS

1.	Cash on hand and in banks	<input type="text" value="0"/>
2.	(a) Loans receivable (unpaid principal balances) [2(a) must agree with Sched. D, line 32]	<input type="text" value="0"/>
	(b) Less reserve for possible loan losses	<input type="text" value="0"/>
	(c) Net loans receivable	<input type="text" value="0"/>
3.	Real estate (net)	<input type="text" value="0"/>
4.	Furniture, fixtures and equipment (net)	<input type="text" value="0"/>
5.	(a) Unamortized Fees	<input type="text" value="0"/>
	(b) Other Assets (identify below)	<input type="text" value="0"/>
	* Identify other assets if any (maximum of 100 characters) <input type="text"/>	
6.	Total assets(sum of items 1, 2(c), 3, 4 & 5)	<input type="text" value="0"/>

Adds common category for "other assets" for those using GAAP accounting (unamortized fees).

LIABILITIES AND NET WORTH OR SHAREHOLDERS EQUITY

7.	Accounts and notes payable	<input type="text" value="0"/>
	(a) Banks and other lending institutions	<input type="text" value="0"/>
	(b) Parent Company or affiliates	<input type="text" value="0"/>
	(c) Other	<input type="text" value="0"/>
8.	Other liabilities	<input type="text" value="0"/>
9.	Total liabilities [item 7 plus item 8]	<input type="text" value="0"/>
10.	Net worth or shareholders equity [Line 10 must agree with Sched C, line 25]	<input type="text" value="0"/>
11.	Total liabilities and net worth or shareholders equity [Item 6 must equal item 11]	<input type="text" value="0"/>

Round all amounts to the nearest dollar on all schedules

Save

DRAFT 2010 ANNUAL CONSUMER FINANCE REPORT QUESTIONNAIRE

Schedule B

Statement of Income and Expenses

North Carolina Office of the Commissioner of Banks
INCOME

12.	Interest collected and earned on loans under G.S.53-173 and 53-176	<input type="text" value="0"/>
13.	Loan processing fees under G.S. 53-173(a1) and G.S. 53-176(b)	<input type="text" value="0"/>
14.	Net insurance income, including origination fees	<input type="text" value="0"/>
15.	(a) NSF income	<input type="text" value="0"/>
	(b) Other income	<input type="text" value="0"/>
	* Identify Other income if any (maximum of 100 characters)	
	<input type="text"/>	
16.	Total income	<input type="text" value="0"/>

Reminds licensee to report income on direct lending ONLY

Clarifies "NET" insurance income

Adds common "other income" line

EXPENSES

17.	(a) Salaries, wages, and benefits	<input type="text" value="0"/>
	(b) Occupancy expense	<input type="text" value="0"/>
	(c) Depreciation and amortization	<input type="text" value="0"/>
	(d) Interest expense	<input type="text" value="0"/>
	(e) Provision for credit losses	<input type="text" value="0"/>
	(f) Other expenses (Specify type and amount - Only list expenses greater than 10% of total expenses.)	<input type="text" value="0"/>
18.	Total expenses, before income taxes	<input type="text" value="0"/>
19.	Net income before income taxes	<input type="text" value="0"/>
20.	Income taxes [ENTER TAX CREDITS AS NEGATIVE]	<input type="text" value="0"/>
21.	Net Income \$ [Line 21 must agree with Sched C, line 25]	<input type="text" value="0"/>

Breaks out operating expense into several major categories

Limits catch all category to 10%; otherwise must specify.

Save

DRAFT 2010 ANNUAL CONSUMER FINANCE REPORT QUESTIONNAIRE

Schedule C

Reconciliation of Net Worth or Shareholders Equity

North Carolina Office of the Commissioner of Banks

22. Net worth or shareholders equity at the beginning of the year	<input type="text" value="0"/>
23. Additions	
(a) Net income [Line 23(a) must agree with Sched B, line 21]	<input type="text" value="0"/>
(b) Other (identify)	<input type="text" value="0"/>
* Identify Other additions if any (maximum of 100 characters)	
<input style="width: 100%; height: 20px;" type="text"/>	
24. Deductions	
(a) Dividends / Drawings	<input type="text" value="0"/>
(b) Other (identify)	<input type="text" value="0"/>
* Identify Other deductions if any (maximum of 250 characters)	
<input style="width: 100%; height: 20px;" type="text"/>	
25. Net worth or shareholders equity at the end of year [Line 25 must agree with Sched A, line 10]	<input type="text" value="0"/>

Schedule D

Reconciliation of Loan Balances

	Number	Amount
26. Loans receivable, beginning of year	<input type="text" value="0"/>	<input type="text" value="0"/>
27. Loans made during the year [Line 27 must agree with 34(e) and 35(d)]	<input type="text" value="0"/>	<input type="text" value="0"/>
28. Loan balances purchased during the year	<input type="text" value="0"/>	<input type="text" value="0"/>
29. Loan balances sold during the year	<input type="text" value=""/>	<input type="text" value="0"/>
30. Loan balances charged off during the year	<input type="text" value="0"/>	<input type="text" value="0"/>
31. Collections of principal during the year	N/A	<input type="text" value="0"/>
32. Loans receivable, end of year [Line 32 must agree with Sched A, line 2(a)]	<input type="text" value="0"/>	<input type="text" value="0"/>

Schedule F
Classification of Loans by Security

34. Loans made during the year based in whole or in larger part on:		Number	Amount
(a)	Personal property		
	(i) \$600.00 or less	0	0
	(ii) \$600.01 to \$1000.00	0	0
	(iii) \$1,000.01 to \$3000.00	0	0
	(iv) \$3,000.01 to \$5,000.00	0	0
	(v) \$5,000.01 to \$7,500.00	0	0
	(vi) \$7,500.01 to \$10,000.00	0	0
	(vii) Total Personal Property Loans	0	0
(b)	Signature or endorsement		
	(i) \$600.00 or less	0	0
	(ii) \$600.01 to \$1000.00	0	0
	(iii) \$1,000.01 to \$3000.00	0	0
	(iv) \$3,000.01 to \$5,000.00	0	0
	(v) \$5,000.01 to \$7,500.00	0	0
	(vi) \$7,500.01 to \$10,000.00	0	0
	(vii) Total Signature or endorsement loans	0	0
(c)	Motor vehicles		
	(i) \$600.00 or less	0	0
	(ii) \$600.01 to \$1000.00	0	0
	(iii) \$1,000.01 to \$3000.00	0	0
	(iv) \$3,000.01 to \$5,000.00	0	0
	(v) \$5,000.01 to \$7,500.00	0	0
	(vi) \$7,500.01 to \$10,000.00	0	0
	(vii) Total Motor Vehicle loans	0	0
(d)	Other considerations		
	(i) \$600.00 or less	0	0
	(ii) \$600.01 to \$1000.00	0	0
	(iii) \$1,000.01 to \$3000.00	0	0
	(iv) \$3,000.01 to \$5,000.00	0	0
	(v) \$5,000.01 to \$7,500.00	0	0
	(vi) \$7,500.01 to \$10,000.00	0	0
	(vii) Total Other Consideration loans	0	0
(e)	Total loans made (calculated automatically)	0	0

Combines prior
schedules E&F into one
table.

DRAFT 2010 ANNUAL CONSUMER FINANCE REPORT QUESTIONNAIRE

Schedule G

Classification of Loans by Type of Borrower

	Number	Amount
35. Loans made during the year:		
(a) to present borrowers	<input type="text" value="0"/>	<input type="text" value="0"/>
(b) to former borrowers	<input type="text" value="0"/>	<input type="text" value="0"/>
(c) to new borrowers	<input type="text" value="0"/>	<input type="text" value="0"/>
(d) Total loans made (calculated automatically)	<input type="text" value="0"/>	<input type="text" value="0"/>

[Lines 34(e) and 35(d) must agree with schedule D, line 27]

Save

Schedule H

Consumer Finance Offices

Use the 'Offices on Record Detail' link below to report the number and amount of loans outstanding for offices operating as of 12/31/2010, and for any offices that were closed during 2010. Only the offices open as of 12/31/2010 will be taken into account for the assessment calculation. If the number of Offices on Record shown below is incorrect, please notify NCCOB of any changes immediately.

Offices to Report:

[Offices on Record Detail](#)

Offices on Record: 2

You must click on the link directly above and report the appropriate information for each branch before you can submit your annual report.

Offices on Record pop-up window will call for list of branches, loan count/amount for each, and indication of closed branches.

DRAFT 2010 ANNUAL CONSUMER FINANCE REPORT QUESTIONNAIRE

Schedule I
Additional Questions

36.	Number of loan applications:		
(a)	Approved loan applications closed (pull from figure 33g)	<input type="text" value="0"/>	
(b)	Approved loan applications withdrawn	<input type="text" value="0"/>	
(c)	Denied loan applications	<input type="text" value="0"/>	
37.	Number and amount of fees as follows:	Number	Amount
(a)	Processing Fee	<input type="text" value="0"/>	<input type="text" value="0"/>
(b)	UCC-1	<input type="text" value="0"/>	<input type="text" value="0"/>
(c)	Returned check fees	<input type="text" value="0"/>	<input type="text" value="0"/>
(d)	Non-Filing fees: Third Party	<input type="text" value="0"/>	<input type="text" value="0"/>
(e)	Non-Filing fees: Self Insurance	<input type="text" value="0"/>	<input type="text" value="0"/>
(f)	Insurance Origination fees	<input type="text" value="0"/>	<input type="text" value="0"/>
38.	Number of loans with credit insurance and net premiums collected:	Number	Net Premiums Collected
(a)	Credit life insurance	<input type="text" value="0"/>	<input type="text" value="0"/>
(b)	Credit accident and health insurance	<input type="text" value="0"/>	<input type="text" value="0"/>
(c)	Credit unemployment insurance	<input type="text" value="0"/>	<input type="text" value="0"/>
(d)	Credit property insurance	<input type="text" value="0"/>	<input type="text" value="0"/>
(e)	Total credit insurance (any type, calculated automatically)	<input type="text" value="0"/>	<input type="text" value="0"/>
39.	As of December 31 of the year, total number and amount of loans:	Number	Amount
(a)	Current or less than 30 days past due	<input type="text" value="0"/>	<input type="text" value="0"/>
(b)	30-59 days past due	<input type="text" value="0"/>	<input type="text" value="0"/>
(c)	60-89 days past due	<input type="text" value="0"/>	<input type="text" value="0"/>
(d)	90 + days past due	<input type="text" value="0"/>	<input type="text" value="0"/>
40.	Number of loans and net amount of:		
(a)	Charged-offs	<input type="text" value="0"/>	<input type="text" value="0"/>
(b)	Recoveries	<input type="text" value="0"/>	<input type="text" value="0"/>
(c)	Where collateral was repossessed	<input type="text" value="0"/>	<input type="text" value="0"/>
(d)	Where claim made against non-filing insurance policy	<input type="text" value="0"/>	<input type="text" value="0"/>

Uses "UCC-1" instead of "filing fees"

Splits third party NFI vs Self-Insurance

Specifies "net" insurance premiums

Captures net amounts charged off or recovered, including from collateral or NFI

Adds recoveries

Date Modified: 1/20/2011

Drops questions on Sales Finance ("indirect") loans, number and amount by security type.

Save

Appendix F: Outlier Removal Methodology

Step 1: Aggregate filings from licensees within the same organization: In one case, related institutions reporting as individual branches reported inter-office transfers in their income and assets, leading to outlier profitability and loss from one branch to the next, but not for the organization as a whole, so we aggregated those filings and treated the separate licenses merely as branch offices.

Step 2: Remove G.S. 53-173 licensees: Regulatory differences result in a divergence in business practices that might muddy outcomes of the statistical analyses. The removal of these institutions was confirmed by the COB. Through this step, we removed a total of 17 institutions and 122 annual filings.

Step 3: Remove filings missing critical information: We exclude filings missing key information necessary for completing statistical analyses such as total assets (Line 6), total income (Line 16), total expenses before taxes (Line 19), or opening loans receivable (Line 27), and reconciled loans receivable (Line 33). We identified and removed 72 filings from 48 different institutions that were missing information on at least one of these variables.

Step 4: Remove filings that include sales finance activity: Licensees are supposed to report only business activities under the CFA. We found lenders sometimes assign sales finance and other business activities to “other assets” and “other income”. In other cases, we found licensees group all lending together. We also could not control for the amount of sales finance (indirect) lending until 2009 when it was added to the report. To isolate reliable filings and examine only those institutions in those years for which we can accurately isolate direct lending, we applied the following three filters:

- *Remove filings with greater than 20% of total income or total assets described as “Other.”* This step eliminates most cases where Sales Finance is reported as other income and other assets, which is necessary because we cannot discern how expenses were allocated. While there are valid reasons to have other income and assets related to consumer finance lending, having such a large portion of total business activity only vaguely accounted for, or sometimes not described at all, is anomalous and suggests business results would not necessarily reflect the direct lending consumer finance business. This filter removes 150 filings from 44 institutions.
- *Remove outliers identified through linear regression.* The other assets and income filter may not completely identify indirect lending operations if lenders comingled their reporting of consumer and sales finance lending. We resolve this issue by also applying a more general approach to identifying outliers by examining the residuals from ordinary least squares (OLS) linear regression. The regression model has the general form,

$$Y_i = (\alpha) + \beta(X_i) + \varepsilon_i$$

where Y_i represents a variable of interest, usually standardized by the average number or amount of loans receivable, for an institution in a specific year. Standardizing adjusts for differences in institution size. The residual, ε_i , captures the extent to which this predicted value differs from the actual value. The absolute range in Y will vary depending on the specific variable of interest, causing variance also in the residual term. Therefore, we standardize the residual using its standard deviation,

$$\varepsilon_i / \sigma_\varepsilon$$

This standardization allows for a general “rule of thumb” to identify outliers, such as any residual greater than three standard deviations away from zero.

We use two models in sequential order. First, we model lending income defined as interest collected (Line 12) and credit investigation charges (Line 13) per loans receivable. The income received per loan should be logically related to the average loan amount through the effective interest rate. We specify a quadratic function form to account for the tiered maximum allowable interest rate laid out in General Statute 53 (i.e. higher loan amounts will yield higher interest collected per loan, but at a diminishing rate due to lower marginal interest rates). In addition, we include a measure of loan “turnover,” defined as

the ratio of total loans originated to average number of loans receivable, to capture the role of origination activity. The equation predicts a normal range of income as a function of loan amounts and lending activity. In those cases where the difference between an institution's actual income and predicted income exceeded three standard deviations from the norm, the filings or institutions were removed (12 filings from 9 institutions).

Subsequently, we model total expenses (Line 19) per average number of loans receivable. To predict expenses, we include the number of offices (Schedule H), average number of loans receivable, turnover ratio, share of loans based on motor vehicles (Line 35c divided by Line 35e), and share of loans to new borrowers (Line 36c divided by Line 35d). This foreshadows the independent variables used in our final analysis. The difference between actual expenses and predicted expenses exceeded three standard deviations for 13 filings from 13 institutions. These filings and institution were removed. All 13 filings reported total expenses equal to at least \$1,200 per loan receivable when the average across all filings is under \$500.

- *Remove licensees that have the majority of filings flagged.* The first two filters remove filings (from specific years) that are flagged as likely involving sales finance or are otherwise outliers. A pattern of such filings is also indicative of mixed accounting and reporting from year to year. Consequently, where the majority of filings from an institution are flagged, we remove all filings from that institution. This process removed 25 institutions and 60 additional filings.

Step 5: Remove licensees which filed in only a single year: The final step is to drop all institutions which have only one filing. We found only six institutions which meet this criterion. Five of those six institutions filed reports in 1998 only.

The resulting panel database covers 72 separate institutions and 599 filings, derived from the original database of 139 institutions and 1034 filings. This panel database accounts for over 68% of all lending income reported between 1998 and 2009, including nearly 76% over the last three years.

Number of Filings

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Total
Panel	43	41	55	57	57	53	50	55	51	47	45	45	599
Raw	98	81	99	91	88	85	86	88	84	80	77	77	1034
Share	44%	51%	56%	63%	65%	62%	58%	63%	61%	59%	58%	58%	58%

Lending Income (Millions)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Total
Panel	\$160	\$107	\$193	\$203	\$225	\$185	\$187	\$212	\$196	\$197	\$190	\$184	\$2,239
Raw	\$272	\$257	\$280	\$276	\$284	\$273	\$267	\$285	\$321	\$262	\$249	\$243	\$3,270
Share	59%	42%	69%	74%	79%	68%	70%	74%	61%	75%	76%	76%	68%