

Approved: February 8, 1999  
Date

MINUTES OF THE SENATE COMMITTEE ON FINANCIAL INSTITUTIONS AND INSURANCE .

The meeting was called to order by Chairperson Senator Don Steffes at 9:00 a.m. on February 1, 1999, in Room 529 S of the Capitol.

All members were present except:

Committee staff present:      Dr. Bill Wolff, Research  
   Ken Wilke, Office of Revisor  
   Nikki Feuerborn, Committee Secretary

Conferees appearing before the committee:      Judi Stork, Acting Bank Commissioner  
   Chuck Stones, Kansas Bankers Association  
   David Brant, Securities Commissioner  
   Allan Steppat, Community Bankers Association  
   Roger Walter, General Counsel, Securities Comm.

Others attending:                      See Attached

Chairman Steffes announced the availability of the report stating the requirements that would be necessary to allow participation of USD's in the state Employee Benefit Plan. These reports will be sent to all Committee and staff members. Dr. Wolff said that it may be possible for the adoption of such a plan to come through Rules and Regulations rather than statutorily as it is the Health Care Commission's responsibility to determine eligibility. An appropriation to cover the cost could be requested by Rules and Regulations.

**Hearing on SB 120 - Powers of the Bank Commissioner**

Chairman Steffes thanked the Bank Commissioner and KBA for their cooperation in submitting language for the proposed "wild card" legislation which would delineate who is to receive notice and a time schedule upon issuance of Special Orders.

Judi Stork, Acting Bank Commissioner, walked the Committee through the proposed legislation and reiterated their position of being very willing to share all information on the issuance of Special Orders (Attachment 1). The bill provides for:

- Notice to the Chairman and ranking minority member of House and Senate Banking Committees when Special Orders are issued.
- Written summary of Special Orders issued to Chairmen of Banking Committees within two weeks of start of Legislature.
- Legislative Committees to request information from Division of Budget regarding impact of Special Order.

Commissioner Stork reminded the Committee that in the 31 years Special Orders have been issued, only one has had any measurable fiscal impact on the state. When the Order was issued, they had no idea of the number of banks which would participate in the subsidiary corporation option. They do look at costs and impact as much as they can but she recommended that the Division of the Budget supply this information as they can work with the Department of Revenue.

Chuck Stones, Kansas Bankers Association, presented testimony in agreement with the proposed bill (Attachment 2). He also offered to invite bankers from national and state chartered banks to any future meetings regarding proposed state bank regulations or redefinition of responsibilities of the Bank Board. The Special Order authorization is necessary in order to avoid any delays in allowing state chartered banks to compete with national banks on an equal footing and not be forced to change to national charters.

The Committee acknowledged that this was the only "wild card" ever issued which had such an economic impact. It was suggested that there be a provision that disallows a tax break without first having the agreement of the Tax Committee. National banks had been provided with this option in the early 1980's but

SENATE COMMITTEE ON FINANCIAL INSTITUTIONS AND INSURANCE

CONTINUATION SHEET - FEBRUARY 1, 1999

state banks did not have the option until 1995. It was suggested that the Governor be included in those being notified of any Special Orders issued.

Allan Steppat, Community Bankers Association, supplied testimony supporting the bill (Attachment 3). They agree that there should be notification to the Legislature as quickly as possible when Special Orders are issued by the Bank Commissioner. Mr. Steppat reiterated the importance of the Bank Commissioner retaining this authority.

Chairman Steffes ordered the Hearing closed

**Hearing on SB 122 -Securities; regulation of**

David Brant, Securities Commissioner, first provided the Committee with copies of information on the Pay Day Loan industry published by the Consumer Federation of America and SCOR Reports on the capital formation alternatives for small companies (Attachments 4 and 5). Pay Day Loan legislation has been in the statutes since 1993. It allows the lending agency to lend \$100 for a two-week period and charge \$15 in interest. This is an APR of 340%. In order to raise capital, small businesses attempting to sell stock offerings are finding find this to be very challenging. Most small companies try to avoid bank loans.

Commissioner Brant informed the Committee that **SB 122** would conform the anti-fraud provisions of the Act to also pertain to investment advisors (Attachment 6). Investment advisors would be required to disclose to clients if they personally own any of the stock they are attempting to sell to the client. The states are now the sole regulators of investment advisors managing less than \$25 million in client assets; the SEC manages those federal-covered advisors who manage large portfolios. There are several advisors under investigation at this time. If found guilty, the advisors would not have their licenses canceled but fraud charges could be brought against them.

The Committee requested they be informed if high profile cases were being investigated. It was suggested that the term "advisory client" be removed from the bill unless the definition section is amended. Suggested language was "soliciting clients to be advised."

Chairman Steffes closed the Hearing on **SB 122**.

Commissioner Brant asked for the conceptual introduction of legislation which would address licensing of lenders, usury, and powers of the Consumer Credit Commissioner. These issues will require two days of hearings.

Senator Praeger moved for this conceptual idea to be placed in proposed legislation. Motion was seconded by Senator Clark. Motion carried.

Senator Becker moved that the minutes of January 26, 27, and 28, 1999, be approved with technical changes. Motion was seconded by Senator Brownlee. Motion carried.

The meeting was adjourned at 10:00 a.m. The next meeting will be held on February 2, 1999.



STATE OF KANSAS  
BILL GRAVES  
GOVERNOR

Judi M. Stork  
*Acting Bank Commissioner*

Kevin C. Glendening  
*Assistant Deputy Commissioner*



Sonya L. Allen  
*General Counsel*

Louise A. Monell  
*Administrative Officer*

OFFICE OF THE  
STATE BANK COMMISSIONER

SENATE COMMITTEE ON FINANCIAL INSTITUTIONS AND INSURANCE

February 1, 1999

Mr. Chairman and Members of the Committee:

I am Judi Stork, Acting Bank Commissioner, and would like to make a few comments today relating to **Senate Bill 120**.

Chairman Steffes asked for my assistance in drafting some language to amend K.S.A. 9-1715, commonly known as the "wildcard" law. The bill you have before you today is a result of that request. The Office of the State Bank Commissioner was glad to assist in this process. There is no desire on our part to be secretive in nature regarding the issuance of Special Orders, and as long as additional disclosure requirements do not become overly burdensome for the office, we support changes to the law. The language of this bill accomplishes the committee's goal of increased sharing of information and does not create an undue burden on the agency.

The bill provides for the following:

- It provides notice to the Chairman and the ranking minority member of the banking committees in the Senate and in the House at the time a Special Order is issued by the Bank Commissioner. This was a concern voiced by this committee during the last legislative session and again during the interim study. The notice will include a copy of the Order and a narrative description of the purpose of the Order.

Senate Financial Institutions & Insurance

Date 2/1/99

Attachment # /



● The bill provides for a written summary to be given to the Chairmen of the banking committees within two weeks of the start of the legislative session. This written summary must contain a copy of all Special Orders issued during the preceding year as well as an explanatory synopsis of each Order. By providing this summary, the Chairman has again been given notice of the issuance of any Special Orders. If the Chairman desires additional discussion of the Special Orders, he can request the Bank Commissioner attend a legislative hearing.

● Lastly, it provides the legislative committees the ability to request information from the Division of Budget as to how any Special Order will impact the state. The budget division analyzes the state's financial picture and should have the best resources available to adequately prepare a statement as to the impact on all state agencies as well as the citizens of Kansas.

It was apparent from the comments of this committee, as well as the interim committee, you would like more disclosure regarding the granting of parity between state and national banks. This bill provides for that disclosure, on two separate occasions, and it allows the committee to obtain economic impact information, if you so desire. The Office of the State Bank Commissioner has no objections to this bill.

# Kansas Bankers Association

800 SW Jackson, Suite 1500

Topeka, KS 66612

785-232-3444 Fax - 785-232-3484 kbacs@ink.org

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2-1-99

TO: Senate Financial Institutions and Insurance Committee

FROM: Chuck Stones, Director fo Research

RE: SB 120

Mr. Chair and Members of the Committee:

Thank you for the opportunity to appear before you regarding SB 120, which deals with the "Wild Card" Authority of the Bank Commissioner. As you are aware, we opposed a similar bill, last year because it had the potential to cause delays in the issuance of Special Orders that would maintain competitive equality between nationally and state chartered banks. The dual banking system, as you know, is the existence of two separate, equivalent chartering and regulatory systems at the state and federal level. The dual banking system provides financial institutions a meaningful choice between state and federal chartering, supervision, and regulation. It is a unique system in the world, and has been the major factor in the dynamism of the American banking system.

The existence of two regulatory systems promotes efficiency, as regulators learn from each other and have the incentive to improve their operations to serve their constituencies. The dual banking system also promotes creativity within the banking industry. Innovations that originated at the state level include checking accounts, NOW accounts, ATM's, electronic funds transfers, and bank insurance sales.

We feel the changes made in the bill for this year fully meet the concern expressed last year for information regarding the issuance of Special Orders and our concern of potential delays. It also allows for further information to be obtained by the parties receiving notification if deemed necessary or prudent.

SB 120 represents compromise in its best form and appears to be the best of both worlds. We urge your support.

Senate Financial Institutions & Insurance

Date 2/1/99

Attachment # 2



Date: February 1, 1999  
To: Senate Financial Institution & Insurance Committee  
From: Community Bankers Association of Kansas  
Re: Support of Senate Bill 120

Thank you for the opportunity to offer our comments on Senate Bill 120.

1. We believe to the Bank Commissioner's authority to grant state banks the ability to engage in the same types of activities of national banks is a necessary and important power if the dual banking system is to be preserved and if Kansas state-chartered banks are to remain competitive.
2. Likewise, we believe it is an important step of the process for the Kansas Legislature to be informed when this authority is used to bring about parity for state chartered banks. K.S.A. 9-1715 provides the mechanism for which this goal is accomplished; however, the Committee has suggested that improvements are needed in this process.
3. Senate Bill 120 accomplishes this objective by enlarging the scope of who receives notification of any use of the wild card authority by the Bank Commissioner. Formerly a single notification of special orders by the Commissioner was made to the president and the minority leader of the Senate and the speaker and the minority leader of the House of Representatives. Senate Bill 120 provides for the chairpersons of each standing committee having jurisdiction over financial institutions to also receive notification at the time the special order is issued and again prior to the start of the annual session of the Kansas Legislature. Senate Bill 120 addresses the concerns expressed by Chairman Steffes during the 1998 Legislative Session.
4. The Community Bankers Association of Kansas supports SB 120.

Senate Financial Institutions & Insurance

Date 2/1/99

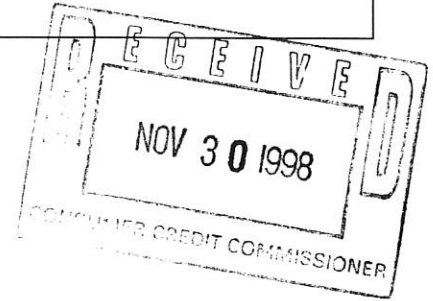
Attachment # 3

*Directed By The Members We Serve*



# Consumer Federation of America

November 23, 1998



Commissioner  
Office of Consumer Credit Commissioner  
Jayhawk Tower  
700 S.W. Jackson, #1001  
Topeka, KS 66603-3758

Dear Commissioner:

Consumer Federation of America recently published a new report on payday lending, titled "The Growth of Legal Loan Sharking: A Report on the Payday Loan Industry." (Copy and press release enclosed.) The report includes a review of the legal status of payday lending, an eight-state survey of payday loan fees, and suggestions for officials and consumers. Please see the press release for a short summary of our findings.

Payday lending is now authorized by laws in nineteen states and the District of Columbia. Another thirteen states set no limits on small loan interest rates or set a minimum fee on loans that accommodates payday lending. In some of these states, payday lending may be discouraged by other provisions of small loan laws while some of these states prohibit check cashers from lending money.

CFA urges officials in the other nineteen states with small loan laws and usury caps to enforce current laws and resist efforts by payday lenders to enter the market. Even with payday loan laws on the books, it is very difficult to prevent abusive lending and collection practices. States with no usury laws or small loan rate caps should impose limits for this form of short-term credit. The maximum typical small loan cap for loans of \$200 at 36% APR is a generous price for small loans.

None of the payday loan laws, most of which were initially drafted by the industry, adequately protect consumers. If repeal is not feasible, CFA recommends amendments to lower the cost of loans and prevent collection abuses. As I mentioned at the October conference of the National Association of Consumer Credit Administrators, CFA and the National Consumer Law Center have prepared a model Deferred Deposit Loan Act. (Copy enclosed.) We hope that you can use this model to improve existing payday loan laws.

Please let me know the status of payday loan litigation or legislation in your state. I look forward to working with you. My direct phone is 757-867-7523.

Sincerely,

Jean Ann Fox  
Director of Consumer Protection

Enclosures

1424 16th Street, N.W., Suite 604 • Washington, D.C. 2003

Senate Financial Institutions & Insurance

Date 2/1/99

Attachment # 4





# Consumer Federation of America

For Immediate Release  
Tuesday, November 10, 1998  
10:00 A.M.

Contacts  
Jack Gillis, 202-737-0766  
Jean Ann Fox, 757-867-7523

## **PAYDAY LENDERS CHARGE EXORBITANT INTEREST RATES TO CASH-STRAPPED CONSUMERS**

CFA Calls on States to Curb High-Cost Credit and Protect Consumers

Washington, D.C. – High-cost payday lending is spreading rapidly across America, aided by state adoption of weak laws legalizing triple digit interest rates for short-term loans and fed by cash-strapped consumers seeking quick loans, according to a report released today by Consumer Federation of America.

“Consumers who have maxed out their credit cards are turning to payday loans for quick cash,” stated Jean Ann Fox, Director of Consumer Protection for Consumer Federation of America. “The payday loan industry is the modern day equivalent of ‘loan-sharking.’”

CFA is calling on states to enforce existing small loan rate caps and usury laws. A survey of payday lending practices in eight states found violations of current laws and the use of out-of-state national banks to evade state laws banning payday lending.

In a typical payday loan, a consumer writes a personal check for \$115 to borrow \$100 for up to 14 days. The check casher or payday lender agrees to hold the check until the next payday when the borrower can allow the check to be sent to the bank, redeem it by bringing in the full \$115 in cash, or “roll” it over by paying the fee to extend the loan for another two weeks. The cost of this loan is a \$15 finance charge and 391% Annual Percentage Rate. If a consumer “rolls over” the loan three times, the finance charge is \$60 to borrow \$100.

Payday lenders have won state laws exempting them from usury laws or small loan interest caps in nineteen states and the District of Columbia. Another thirteen states set no limits on small loan interest rates or set a minimum fee that permits payday lending to operate legally. Three of those states prohibit check cashers from making payday loans. The industry is expected to aggressively seek legislation in the remaining nineteen states where these loans are now illegal.



## Survey of Payday Loans in Eight States

CFA and member organizations in eight states surveyed payday lenders, asking for information on the maximum loan amount and term, the fee for loans, whether loans could be extended, and the annual percentage rate for the loans. Of the states surveyed, payday lending is not legal in Pennsylvania and Virginia. In Oregon and Illinois, payday loans are permitted under small loan acts that do not impose interest rate or fee caps. Payday loans are specifically authorized in Tennessee, California, Florida, and South Carolina. As Appendix A in the report shows, the telephone surveys found:

- Payday loans are being marketed in Virginia by a national bank located in Pennsylvania through Dollar Financial Group's 14 check cashing locations in the Tidewater area. Loans cost \$17.50 per \$100 for up to 14 days, for an annual percentage rate (APR) of 456%. Virginia imposes a 36% APR cap for small loans for licensed lenders and prohibits check cashers from making loans. Almost-A-Banc's out-of-state national bank does not comply with Virginia's ban on payday loans.
- Payday loan companies are operating in Pennsylvania without legal authorization. Several lenders in Western Pennsylvania are charging \$15 per \$100 loaned or 391% APR.
- Rates in Illinois and Oregon, where no interest limits are set on small loans, range from \$10 to \$22/\$100 in Illinois and from \$15 to \$20/\$100 in Oregon. The highest APR in Illinois was 573% and in Oregon the highest was 521%.
- Not all lenders complied with the maximum fee for loans in states with payday loan laws. Ten of nineteen lenders surveyed in Florida quoted higher than 10% of the check. Half the Tennessee companies quoted fees of more than \$15 per \$100 allowed by statute.
- Most payday loan personnel, when asked to quote the annual percentage rate for their loans, mistakenly quoted the percentage of the face value of checks, denied the transaction was a loan, or said they did not know the APR.
- Lenders agreed to roll-over or renew payday loans more than half the time. In Tennessee where roll-overs are prohibited by law, lenders stated that consumers could pay off the first loan and immediately take out another one.
- State payday loan laws set maximum terms of 30 to 31 days. Only one California outlet quoted a 30-day loan term. All of the rest quoted shorter terms, with "until your next payday" and 14 days the most common terms. A few lenders give consumers only seven days to repay loans. Consumers unable to pay off the loan and fee on such short notice would likely pay the fee again to roll-over the loan.



## **Using Checks to Make Loans Causes Problems**

“Making small loans based on personal checks is a gimmick that benefits lenders and harms consumers,” Ms. Fox stated. Since a written agreement is necessary to make payday loan disclosures and the “checks” are often redeemed for cash, the check is superfluous to the transaction. Lenders use the ploy of loans based checks to foster the advantageous cost comparison between bank bounced check charges and the payday loan fee. The CFA report notes that the proper benchmark for payday loan costs are other forms of short-term credit, such as credit card cash advances and small loan rates.

Holding the borrower’s personal check makes collection easier and less expensive for lenders. For larger loans, some payday lenders ask consumers to leave two checks so that at least half the repayment will clear the bank.

A serious consequence of basing loans on personal checks arises when lenders threaten or actually file criminal bad check charges or sue for triple damages for check fraud when consumers default on loans. The Florida Comptroller recently won a cease and desist order against a lender accused to using phony sheriff’s letterhead to collect debts. Lenders who knowingly take a “bad” check are hard put to convincingly claim they are the victims of fraud when the check fails to clear the bank.

## **Payday Lending is Booming Business**

Payday loans are big business at traditional check cashers and at brand-new stand-alone payday loan outlets. CFA estimates that payday lending is at least a \$1 billion per year business that is growing rapidly. A few states keep annual records on the size of the business. In Washington, over half a million loans were written in 1997 worth \$145 million. Lenders collected almost \$22 million in fees and charged off about \$2 million. Colorado reported 188 payday lenders in 1997, making almost 375,000 loans worth almost \$43 million. In Colorado, the average APR was 485%.

The largest check casher making payday loans, Ace Cash Express, brought in \$10 million in small loan revenue in 1997, almost double the prior year’s revenue. Stand-alone companies are exploding in size. Advance America, which expects to have more than 500 outlets by the end of the year, opened its first store in November of 1997. Check Into Cash, Inc., which has filed an S-1 form at the Securities and Exchange Commission to go public, reported \$21.4 million in earnings in 1997 and almost that much in the first half of 1998. Eagle National Bank, which makes ‘Cash ‘Til Payday’ loans for Dollar Financial Group’s nationwide chain of check cashers, made over 200 thousand loans in 1997 worth \$31 million.

## **Recommendations to Policymakers**

“States should enforce usury laws and small loan rate caps to protect borrowers who are prey to predatory lenders,” Ms. Fox stated. “Interest rate caps should be reinstated for small loans in those states that repealed usury limits.”

CFA and the National Consumer Law Center propose model state legislation for those states that elect to permit high-rate micro small loans.

CFA continues to call on the Treasury Department to adopt consumer protection rules for bank accounts that federal check recipients are opening to comply with EFT’99, the requirement that federal checks be electronically deposited. Check cashers and banks are offering accounts that provide access to Social Security and SSI checks through the unregulated fringe banker.

“Check cashers want the ten million unbanked federal check recipients to come to them for their monthly checks,” Ms. Fox explained. “Treasury’s silence on consumer protections for these accounts invites the marketing of abusive payday loans secured by future federal benefit deposits to vulnerable consumers.”

## **Advice to Consumers**

To avoid the steep cost of payday loans, CFA urges consumers to budget carefully and set aside a nest egg of savings to cover emergencies. Consumers should shop for the lowest cost credit available and compare both the dollar finance charge and the annual percentage rate. Consider overdraft protection for checking accounts. Consumers who use payday loans are advised to borrow only as much as they can afford to pay with the next paycheck and still have enough to make it to the next payday.

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The CFA report is available, free to the press, \$10 to others who write to CFA Payday Loan Report, 1424 16<sup>th</sup> Street, NW, Washington, DC 20036.

CFA is a non-profit association of some 260 pro-consumer groups that was founded in 1968 to advance the consumer interest through advocacy and education.



# Consumer Federation of America

## **The Growth of Legal Loan Sharking: A Report on the Payday Loan Industry**

Jean Ann Fox, Director of Consumer Protection  
Consumer Federation of America  
November 1998

Lending small sums of money at exorbitant interest rates for short periods of time was once considered a social problem requiring the solution of usury and small loan laws.<sup>1</sup> However, payday lenders have persuaded nineteen states to legalize triple digit interest short-term lending and are pressing the remaining states to make payday loans legitimate.

Payday loans have proved very controversial due to the high interest rates charged, collection practices by some lenders, and disputes over compliance with credit laws. These loans sanction the writing of bad checks and entice consumers into relying on very expensive debt to live beyond their means.

In 1997 CFA published a report on check cashing and payday loan practices which found that state consumer protections are inadequate to prevent rate-gouging and to promote informed decisions.<sup>2</sup> This report updates the status of payday lending under state laws and regulations, surveys payday loan terms in 8 states, and offers recommendations to policymakers and advice to consumers.

### Payday Loans Provide Quick Easy Credit At a Steep Price

Check cashers, stand-alone companies, and banks are making small sum, short term, very high rate loans that go by a variety of names: "payday loans," "cash advance loans," "check advance loans," "post-dated check loans" or "delayed deposit check loans." Typically, a borrower writes a personal check payable to the lender for the amount he wishes to borrow plus the fee. Fees for payday loans are typically a percentage of the face value of the check or a fee per \$100 loaned. Under the federal Truth in Lending Act, the cost of loans must be disclosed as both a finance charge (in this case the fee) and as an annual percentage rate (APR), the standard cost of credit to the borrower on an annual basis.

In a payday loan, both the lender and the borrower know that sufficient funds to cover the check are not available when the check is tendered. The check casher agrees to hold the check until the consumer's next payday, usually up to two weeks. At that point, the consumer can either redeem the check with cash or a money order, permit the check to be deposited, or renew

<sup>1</sup> Symposium Combating Loan Sharks, 8 Law and Contemporary Problems, Winter 1941.

<sup>2</sup> "The High Cost of 'Banking' at the Corner Check Cashier: Check Cashing Outlet Fees and Payday Loans," Consumer Federation of America, August 1997.

the loan by paying another fee. Payday lenders charge the same fee to roll-over the loan although the transaction costs for a renewal are not comparable.

Although payday lenders typically do not get a credit report on borrowers, they do ask for evidence of an open bank account and current employment. Payday lenders use data base companies, such as TeleTrack, to screen out risky borrowers.

A cash advance loan secured by a personal check is very high priced credit. The National Consumer Law Center reports effective interest rates for payday loans earlier in the decade of 700 to 2000%.<sup>3</sup> The APR varies depending on the fee and how long the check is held before being deposited or redeemed. For a \$100 loan for a seven-day period under Iowa's law, the annual percentage rate is 780%; for a five-day period, the annual rate is 1,034%. Loans which are renewed over and over because the borrower cannot afford to pay off the principle while keeping up the fees every 7 to 15 days, carry a steep finance charge. A \$100 loan with a \$15 fee every two weeks costs 391% APR. This loan, rolled-over three times, costs \$60 to borrow \$100 for 56 days for the same 391% APR.

### Why Payday Lenders Use Personal Checks to Make Small Loans

When payday loans were first offered in the mid-'90s, most state usury or small loan laws made these transactions illegal. By labeling the transaction as check cashing instead of lending, companies sought to avoid credit laws. Litigation by Attorneys General and private class action lawsuits have produced court decisions and settlements confirming that payday loans are subject to usury, limits small loan caps, and other credit protection laws.

Recently enacted laws in some states to permit payday lending define this transaction as "deferred presentment" with the fee not to be considered interest for purposes of state usury laws. Other states have muddled the distinction between check cashing and payday lending by permitting loans to be made if the fee charged is the same as that for cashing a check. Regulators in Florida permit payday loans if the fee charged is the same as that allowed for check cashing (10%) but consider rollovers to be extensions of credit not permitted under Florida's money transmitter law.

Payday lenders benefit from using personal checks as the loan device although the transactions do not require that a check be written. In many cases, the "check" is never cashed, but is returned to the borrower when cash to pay the loan is exchanged for the "check." Loaning money based on personal checks sets up the advantageous comparison in fees between bank bounced check charges and the payday loan fee. A \$15 per \$100 payday loan fee might look like a bargain compared to a bank's \$25 bounced check charge plus a merchant's fee in addition. However, the proper cost comparison for payday loans is with other sources of small loans. A 14 day payday loan with a \$15 fee costs 391% APR compared to the typical state small loan interest cap of up to 36% APR. A typical rate for a secured credit card is 24%. Overdraft protection on a checking account costs in range of 18 to 24% plus a small one-time fee.

Use of a personal check makes collection easier for lenders. Consumers can be frightened into paying up to avoid prosecution for bad check charges or civil litigation for triple damages. Use of the criminal process gives payday lenders a collection advantage that no other

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<sup>3</sup>National Consumer Law Center, The Cost of Credit: Regulation and Legal Challenges, Boston, MA, 1995, p. 59.

creditor enjoys. The Florida Comptroller brought charges against a payday lender who used fake sheriff's office letterhead for collection purposes. Attorneys in Ohio report that lenders use the checks without supplying the contract as if they were the victims of bad checks, not a contract in dispute. Holding a borrower's check eases debt collection even when threats are not involved. There is a cost savings to the lender who can "collect" on the debt by sending the check through the bank clearing process. Some payday lenders get borrowers to sign authorization to permit the lender to electronically withdraw funds from the consumer's bank account, using the Automated Clearinghouse system.

### Payday Loan Industry

Payday loans are made by check cashing outlets, pawn shops, and other entities that fill the vacuum left by the majority of mainstream lenders that have left the small loan market. Traditional small loan companies are more likely today to be offering home equity lines of credit than loans for a few hundred dollars for a short period of time. Although some banks, credit unions, and small loan companies make relatively small loans, payday lenders have targeted that market.

Payday lending has exploded in the last few years. Colorado is one of the few states with an industry-wide annual report available. For 1997, the Attorney General reported that 188 lenders made 374,477 post-dated check loans totaling \$42,823,089. The average annual percentage rate charged on these loans was 485.26%. The average term for loans was 16.58 days. Over 58,000 of these loans, or 15.5%, were refinanced.<sup>4</sup> For the year ended 12/31/97, Washington reported 562,031 loans made by check cashers. These loans were for a total of \$144,923,986. The average size loan was \$255. Lenders collected \$21,541,338 in fees and charged off \$2,054,338.<sup>5</sup> Indiana reports that the number of payday lenders jumped from 11 in 1995 to 59 in 1997, with loan volume increasing from \$12,688,599 in 1995 to \$98 million in 1997.

Missouri licenses about 450 lenders and reports fast growth. Oklahoma estimates that 900 of 1400 licensed small lenders are in the payday loan business. Idaho, which had two payday lenders in 1993, now has 74. In two years, Iowa payday lenders increased from eight to sixty-four. Louisiana licenses 345 lenders. The number of lenders almost tripled in Wyoming in two years with over \$5 million in loans made in 1997, compared to \$2.3 million in 1996. Mississippi officials estimated over 350 locations made payday loans in 1998 before regulation. By late March of 1998, Indiana had 96 licensees with 225 branches for a total of 321 locations in Indiana.

Public data on the profitability of payday lending is sketchy. An Internet posting by Aaffordable Payday Loans claims that company has "\$800,000 'on the street' with an average 30% per month return on our money."<sup>6</sup> A cover story in the trade magazine of the check cashing industry noted that "holding a check for a fee is bringing a bundle of profits to increasing numbers of operators."<sup>7</sup>

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<sup>4</sup>State of Colorado Department of Law, "1997 Post-Dated Check Cashers Supervised Lenders' Annual Report.

<sup>5</sup>Washington State Department of Financial Institutions *1997 Annual Report*, p. 37.

<sup>6</sup><http://www.aaffordable.com/history.html> "The History of Payday Loans Payday Advances"

<sup>7</sup>Storey, Charlene Komar, "Delayed Deposit Business Skyrockets," *Cheklis*, Fall 1997, p. 6.



## Check cashing outlets

A seminar at the National Check Cashers Association 1998 convention drew standing room only crowds for check cashers interested in going into payday lending. As check cashers lose a portion of their traditional business to electronic delivery of state benefits and federal payments, check cashers are searching for profitable financial services to replace check cashing. The National Check Cashers Association has issued a position paper in support of payday lending and is working on a model legislative proposal for states that have not authorized payday lending.<sup>8</sup> Loan & Check, a vendor to the trade, claims that payday loans will grow by 600% over the next ten years.<sup>9</sup>

Ace Cash Express, the largest chain of check cashing outlets is based in Irving, Texas, and operates 725 Company-owned stores and 100 franchise stores in 29 states. Its small-loan product offered in 240 stores provides earnings growth.<sup>10</sup> Ace's 1997 payday loan revenue of \$10.1 million was double the volume of business in 1996. Act is now opening stores inside Wal-Mart Supercenters. An Oregon news report noted that Ace Cash Express charges \$18 to borrow \$100 for 14 days, for an effective interest rate of 469%.<sup>11</sup>

## Stand Alone Payday Lenders

Stand alone payday loan companies have experienced explosive growth in the last five years. Advance America, Cash Advance Centers, a South Carolina company, have 426 branches in 16 states. The company opened its first store in November 1997 and expects to have over 500 outlets by the end of 1998.<sup>12</sup>

Check Into Cash, Inc., based in Cleveland, TN, opened its first store in 1993 and now operates 340 outlets in 15 states. The company reported revenues of \$21.4 million in 1997 and almost exceeded that amount (\$21.2 million) for the first half of 1998. For the first six months of 1998, Check Into Cash completed 652,000 transactions attributable to 120,000 customers. Bad debt expense has ranged from 2.3% to 5.6% since 1993.<sup>13</sup>

Other large stand alone payday lenders include National Cash Advance and Check & Go. The company reported a volume of \$9.9 million in 1996, nearly triple 1995 revenue. National Cash Advance, another Tennessee company, opened 165 stores in less than three years.<sup>14</sup> Another large stand-alone payday lender, Check 'N Go, started with one store in Cincinnati in 1994 and has about 400 outlets nationwide.<sup>15</sup> Check 'N Go charges \$20 for every \$100 loaned.<sup>16</sup>

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<sup>8</sup> National Check Cashers Association, "The Consumer's Choice: The Role of Deferred Deposit Services in Meeting Short Term Financial Needs." June 8, 1998.

<sup>9</sup> "Why Do Some Check Cashing Outlets Double Their Business Within 24 Months? Simply, They Add Payday Loans," Loan & Check flyer distributed at the National Check Cashers Association convention, Nashville, TN, October 17, 1998.

<sup>10</sup> Stephens Inc. p. 27.

<sup>11</sup> Harwood, Joe, "Checking It Out: Fast Loans Cost Consumers A Bundle," The Register-Guard (OR), 11/9/97, C1.

<sup>12</sup> Huntley, Helen. "Short loans, high rates, regulator questions," St. Petersburg Times, October 25, 1998, p. H-1,2.

<sup>13</sup> Form S-1, Securities and Exchange Commission, Check Into Cash, Inc., p. 3-4.

<sup>14</sup> Ho, Rodney, "Fees of Quick-Cash Chains Draw Scrutiny," The Wall Street Journal, 6/10/97, p. B 2.

<sup>15</sup> Sacramento Business Journal, October 26, 1998. [www.amcity.com:80/sacramento/stories/102698/focus2.html](http://www.amcity.com:80/sacramento/stories/102698/focus2.html).

<sup>16</sup> The Business Journal, Milwaukee, September 22, 1997. [www.amcity.com/milwaukee/stories/092297/story3.html](http://www.amcity.com/milwaukee/stories/092297/story3.html)



**16a-2-404. Payday loans; finance charges.** (1) On consumer loan transactions in which cash is advanced:

- (a) With a short term,
- (b) a single payment repayment is anticipated, and
- (c) such cash advance is equal to or less than the

maximum amount of the first tier used in the blended alternative rate in paragraph (a) of subsection (2) of K.S.A. 16a-2-401, and amendments thereto, and adjusted in K.S.A. 16a-2-401a, and amendments thereto, a licensed or supervised lender may charge in lieu of the loan finance charges specified in K.S.A. 16a-2-401, and amendments thereto, the following amounts:

(i) On any amount up to and including \$50, a charge of \$5.50 may be added;

(ii) on amounts in excess of \$50, but not more than \$100, a charge may be added equal to 10% of the loan proceeds plus a \$5 administrative fee;

(iii) on amounts in excess of \$100, but not more than \$250 a charge may be added equal to 7% of the loan proceeds with a minimum of \$10 plus a \$5 administrative fee;

(iv) for amounts in excess of \$250 and not greater than the maximum defined in this section, a charge may be added equal to 6% of the loan proceeds with a minimum of \$17.50 plus a \$5 administrative fee.

(2) The maximum term of any loan made under this section shall be 30 days.

(3) The contract rate of any loan made under this section shall not be more than 3% per month of the loan proceeds after the maturity date. No insurance charges or any other charges of any nature whatsoever shall be permitted, except as stated in subsection (5), including any charges for cashing the loan proceeds if they are given in check form.

(4) Any loan made under this section shall not be repaid by proceeds of another loan made under this section by the same lender or related interest. The proceeds from any loan made under this section shall not be applied to any other loan from the same lender or related interest.

(5) On a consumer loan transaction in which cash is advanced in exchange for a personal check, a return check charge may be charged if the check is deemed insufficient as defined in paragraph (e) of subsection (1) of K.S.A. 16a-2-501, and amendments thereto.

(6) In determining whether a consumer loan transaction made under the provisions of this section is unconscionable conduct under K.S.A. 16a-5-108, and amendments thereto, consideration shall be given, among other factors, to:

(a) The ability of the borrower to repay within the terms of the loan made under this section; or

(b) the original request of the borrower for amount and term of the loan are within the limitations under this section.

(7) This section shall be supplemental to and a part of the uniform consumer credit code.

**History:** L. 1993, ch. 75, § 1; April 8.

**KANSAS COMMENT**

1. This section, which is not part of the uniform act, was adopted in 1993 primarily in response to the development of so-called "payday loans." Payday loans are designed to tie the consumer over until his or her next payday. Thus, they normally are for a term of one or two weeks and are for small dollar amounts. These loans take many forms, with some involving the up-front exchange of the consumer's personal check (which may or may not be post-dated) for a discounted amount of cash and others involving the purchase of discount coupons for merchandise from a particular catalog. Payday loans meet a legitimate credit need for many consumers. At the same time, they are ripe for abuse. As a result, the administrator suggested legislation to fill the gaps in the U3C relating to such loans, and this section is the result.

2. Subsection (1) sets special high-limit rate ceilings for payday loans. Several requirements must be met to take advantage of the special rate ceilings. First, the creditor must be a licensed or supervised lender. Second, the loan must have a "short term"—less than 30 days. See subsection (2). Third, the parties must anticipate that the loan will be repaid in a single payment. What happens if the consumer is unable to make the payment and wants to work out a payment schedule? This issue is not addressed but, presumably, such a workout would be permissible so long as it was truly unanticipated when the loan was originated. Fourth, the cash advance cannot exceed the dollar amount of the first tier for blended rate supervised loans under K.S.A. 16a-2-401. That amount is subject to adjustment, see Kansas comment to K.S.A. 16a-2-401a and, as of July 1, 1996, is \$780. If all of these requirements are met, then the lender may charge the special rates authorized by this section.

3. Creditors should remember that their ability to impose the special rates authorized by this section does not exempt them from the other provisions of the U3C or the disclosure requirements of the CCPA. As a result, the special rates authorized by this section will need to be converted into rather high annual percentage rates for pre-transaction disclosure to the consumer.

4. Other than a return check charge for a personal check given by the consumer in exchange for cash, subsection (3) prohibits other charges of any type from being imposed in connection with a payday loan. This includes insurance charges, charges for cashing a check representing the loan proceeds and, presumably, collection and/or attorney fees now permitted by K.S.A. 16a-2-507.

5. Although not expressly stated, subsection (3) appears to permit the creditor to contract for interest if the loan is not repaid at maturity. This is the clear import of subsection (3), which limits the contract rate to 3% per month of the loan proceeds after the maturity date.

6. Subsection (4) prohibits "snowballing"—the practice of repaying one payday loan with the proceeds of another payday loan from the same lender or a related interest. See K.S.A. 16a-1-301(30).



SHORT TERM CONSUMER LOAN TRANSACTIONS

16 DAY LOAN

AMOUNT FINANCED	FINANCE CHARGE	PAYMENT	APR %
25.00	5.50	30.50	501.88%
30.00	5.50	35.50	418.23%
35.00	5.50	40.50	358.48%
40.00	5.50	45.50	313.67%
45.00	5.50	50.50	278.82%
50.00	5.50	55.50	250.94%
55.00	10.50	65.50	435.51%
60.00	11.00	71.00	418.23%
65.00	11.50	76.50	403.61%
70.00	12.00	82.00	391.07%
75.00	12.50	87.50	380.21%
80.00	13.00	93.00	370.70%
85.00	13.50	98.50	362.32%
90.00	14.00	104.00	354.86%
95.00	14.50	109.50	348.19%
100.00	15.00	115.00	342.19%
105.00	15.00	120.00	325.89%
110.00	15.00	125.00	311.08%
115.00	15.00	130.00	297.55%
120.00	15.00	135.00	285.16%
125.00	15.00	140.00	273.75%
130.00	15.00	145.00	263.22%
135.00	15.00	150.00	253.47%
140.00	15.00	155.00	244.42%
145.00	15.15	160.15	238.35%
150.00	15.50	165.50	235.73%
155.00	15.85	170.85	233.28%
160.00	16.20	176.20	230.98%
165.00	16.55	181.55	228.82%
170.00	16.90	186.90	226.78%
175.00	17.25	192.25	224.87%
180.00	17.60	197.60	223.06%
185.00	17.95	202.95	221.34%
190.00	18.30	208.30	219.72%
195.00	18.65	213.65	218.18%
200.00	19.00	219.00	216.72%
205.00	19.35	224.35	215.33%
210.00	19.70	229.70	214.00%
215.00	20.05	235.05	212.74%
220.00	20.40	240.40	211.53%
225.00	20.75	245.75	210.38%
230.00	21.10	251.10	209.28%
235.00	21.45	256.45	208.22%
240.00	21.80	261.80	207.21%
245.00	22.15	267.15	206.24%
250.00	22.50	272.50	205.31%

## National Banks

Check cashing outlets have formed partnerships with national banks to make payday loans, including in states where check cashers are prohibited from charging typical payday loan rates or extending credit. Eagle National Bank, a federally chartered bank located in Upper Darby, Pennsylvania, makes "Cash Till Payday" loans of up to \$500 through Dollar Financial Group's check cashers in several states.<sup>17</sup> Dollar Financial Group claims that Eagle National Bank is able to export Pennsylvania's deregulated bank loan fees to consumers in other states. Eagle charges up to \$17.50 per \$100 for 14 day payday loans (454% APR). In 1997, Eagle National Bank made 204,499 payday loans, with \$31 million of the bank's loans small consumer loans (36% of loans made).<sup>18</sup> The Comptroller of the Currency gave a "Satisfactory" Community Reinvestment Act rating to the bank in 1998, despite complaints by consumer organizations about the bank's triple-digit interest rate loans.

## The Market for Payday Loans

The market for payday loans is made up of consumers who have personal checking accounts, but who are stretched to the limit financially. These consumers are not even living paycheck to paycheck, but are borrowing against their next paycheck to meet living expenses. Ace Cash Express' Vice President says payday loan customers "tend to be people at the bottom of the middle-class structure in this country."<sup>19</sup> Stephens, Inc., an Arkansas investment company, estimates that the potential market for individuals utilizing store front financial service companies, such as rent to own, check cashing or small loan services, is roughly equivalent to those without an unsecured credit card, or approximately 35 million households.<sup>20</sup>

A Washington regulator says that payday loans are a symptom of whopping credit card debt, as people who are highly leveraged need cash to pay bills.<sup>21</sup> A CFA report on the burden of credit card debt reveals that 55 to 60 million households (55 – 60% of all households) carry credit card balances and that these balances average more than \$7,000.<sup>22</sup> A CFA report shows that the typical household with debt repayment problems has a moderate income and credit card debts of more than \$10,000.<sup>23</sup>

Lenders claim that their customers prefer to borrow from them than to hock their appliances at a pawnshop or to ask their employers for pay advances. Pawnshop loans are always for a fraction of the present value of the used pawned item, making a pawn transaction a poor comparison. The industry argues that consumers use payday loans to cover emergencies or unexpected medical bills. The West Coast Vice President for Check Into Cash claims that 30% of their customers need money to get their cars repaired.<sup>24</sup> If true that payday loan customers

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<sup>17</sup>Prospectus, Dollar Financial Group, Inc., filed with the Securities and Exchange Commission, March 11, 1997, (<http://www.sec.gov/Archives/edgar/data/1028643/0000950130-97-000963.txt>)

<sup>18</sup>OCC Community Reinvestment Act Performance Evaluation, Eagle National Bank, 4/6/98.

<sup>19</sup>Huntley, Helen, "Short loans, high rates, regulator questions," St. Petersburg Times, October 25, 1998, p. H-1.

<sup>20</sup>Stephens Inc., "Specialty Finance Industry Report," January 26, 1998, p. 16.

<sup>21</sup>Muhlstein, Julie, Herald, February 20, 1998. [www.heraldnet.com/stories/98/2/20/julcol19.htm](http://www.heraldnet.com/stories/98/2/20/julcol19.htm)

<sup>22</sup>Brobeck, Stephen, "Recent Trends in Bank Credit Card Marketing and Indebtedness," July 1998.

<sup>23</sup>Brobeck, Stephen, "The Consumer Impacts of Expanding Credit Card Debt," February 1997.

<sup>24</sup>Myers, Jim, Sacramento Business Journal, October 26, 1998.

[www.amcity.com:80/sacramento/stories/102698/focus2.html](http://www.amcity.com:80/sacramento/stories/102698/focus2.html)

have no savings to cover an emergency prescription or repair job, they are the classic "necessitous" borrower who perceive they have no choices but to borrow at triple-digit rates.

### Payday Loans Place Borrowers on a Debt Treadmill

It is not unusual for borrowers to become mired in debt and renew cash advance loans every week or two. Payday loans are structured to make it difficult for consumers to pay in full at the end of the loan period without needing to borrow again before the next payday. A consumer paying off a loan of \$100 to \$300 plus the \$15 to \$45 fee within a few days often finds it difficult to make it to the next payday without having to borrow again.

A class action lawsuit filed in Tennessee described borrowers who renewed cash advance loans 20 to 29 times, paying fees of \$19 to \$24 per \$100 loaned. One plaintiff "rolled over" loans 24 times in 15 months, borrowing a total of \$400 and paying \$1,364 while still owing \$248.<sup>25</sup> Bank Rate Monitor Online described a Kentucky consumer who borrowed \$150 and had paid over \$1,000 in fees over a six-month period without paying down the principal. Her solution was to declare bankruptcy.<sup>26</sup> A Wisconsin news article described a consumer who borrowed more than \$1200 from all five payday lenders in her town and was paying \$200 every two weeks just to cover the fees without reducing principal.<sup>27</sup>

### State Payday Loan Laws

In the last few years, nineteen states and the District of Columbia have adopted legislation or regulations that authorize and regulate payday loans. The District of Columbia, Mississippi, Kentucky, Nevada, and South Carolina legislatures enacted bills in their 1998 session to permit and regulate payday loans.

Alabama's legislature considered a bill but adjourned without adopting pending legislation. Pennsylvania's 1998 legislature adopted a check cashing law that prohibits cashing or advancing money on post-dated checks. A bill to raise the loan amount ceiling in California was withdrawn after consumer advocates objected and proposed amendments to establish reporting requirements for lenders. The Georgia legislature did not adopt bills filed to permit payday lending.

Typical payday loan laws exempt these transactions from usury or interest rate caps, set a maximum fee and term for loans, restrict roll-overs or multiple loans, and require licensing by state regulators. Six state payday loan laws or regulations require lenders to disclose their fees as an Annual Percentage Rate.<sup>28</sup> The maximum fees result in APRs for a \$100 14-day loan range from 261% in Florida to 625% in Colorado. Thirteen of the 20 jurisdictions set the maximum fee at \$15 per \$100 loaned, a 391% APR on a 14 day loan. Sixteen states set a maximum loan term, but only Oklahoma sets a minimum term of 30 days to repay payday loans of \$101 or less.

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<sup>25</sup> Amended Complaint, Bill Goins, et. al, vs CREDITCORP, et al., Circuit Court of Bradley County, Tennessee, par. 20. March 5, 1996.

<sup>26</sup> Rothman, Steven, "Officials Call Payday Financing 'Loan Sharking'," Bank Rate Monitor Online, 2/18/98.

<sup>27</sup> Horst, David, "Hard Lesson Learned in Borrowing on Paycheck; Woman found herself fast in debt to 'payday lenders.'" The Post-Crescent, Wisconsin, January 4, 1998.

<sup>28</sup> Annual Percentage Rate is the cost of credit to the borrower on an annual basis. It is the standard comparison cost of credit required by the federal Truth In Lending Act.

Most states create some type of criminal or administrative penalties. However, only seven states provide for some type of limited private right of action allowing the consumer to obtain relief against the lender. Only a small number prohibit the lender from threatening to file or filing criminal charges against a consumer as a mechanism to collect on the debt. These payday loan laws apply on to check cashers in seven of the nineteen states.

Table One

States With Specific Payday Loan Law/Regulations

State	Maximum Term/Amt.	Maximum Fee %*/\$	Effective APR		TILA Disclosure Req.	Rollover/ Refi Prohibited	Max. Loan At 1 time # / \$
			7 day	14 day			
CA.	30/\$300	15%	782%	391%	N	N	1
CO	/ \$500	<25% or \$25	1250%	625%	Y	Y	2
DC	31/\$1000	10% +fee Up to \$20	782%	391%	N	N	No Limit
FL <sup>cc</sup>		≥10% or \$5	521%	261%	N	N	No Limit
IO	/ \$500	\$15 per \$100 \$10 per \$100 next	782%	391%	N	Y	2
KS	30/\$780	scale of fees <sup>s</sup>	782%	391%	<del>N</del> Y	Y	No Limit
KY	60/\$500	\$15 per \$100 For 14 days	782%	391%	Y	N	2
LA	30/\$500	scale of fees <sup>ss</sup>	521%	261%	N	Y	No Limit
MN	30/\$350	scale of fees <sup>sss</sup>	782%	391%	N	Y	No Limit
MS	30/\$400	18%	938%	469%	N	N	No Limit
MO	10 mon/\$500	\$15/\$100	782%	391%	N	N	No Limit
NE	31/\$500	\$15/\$100	782%	391%	N	N	2
NV		To be set by regulation			N	N	No Limit
NC	31/\$300	15%	782%	391%	N	Y	No Limit
OH	6 mon/\$500	5%/mon. +	782%	391%	N	Y	No Limit
OK	30/\$101	20%	1042%	521%	Y	N	\$100

\* % of face amount of check

<sup>cc</sup> Applies to check cashers only

<sup>s</sup> \$5.50 for loans \$0 to \$50, 10% of loans + \$5 for \$50 to \$100, 7% + \$5 for \$100 to \$250, 6% + \$5 for \$250 - \$300.

<sup>ss</sup> \$5 for loans \$0 to \$99, \$10 for loans \$100 - \$200, \$15 for loans \$201-\$500.

<sup>sss</sup> \$5.50 for loans \$0 - \$50, 10% + \$5 loans \$50 - \$100, 7% + \$5 loans \$100 - \$250, 6% + \$5 for loans \$250 - \$350.



State	Maximum Term/Amt.	Maximum Fee %*/\$	Effective APR		TILA Disclosure Req.	Rollover/ Refi Prohibited	Max. Loan At 1 time # / \$
			7 day	14 day			
SC	31/\$300	15%	782%	391%	Y	Y	No Limit
TN	31/\$500	15% or \$30	782%	391%	Y	Y	3
WA	31/\$500	15% +	782%	391%	N	Y	No Limit
WY	30/	\$30 or 20%	1042%	521%	Y	Y	No Limit

Nineteen states and the United States Virgin Islands do not permit payday loans due to small loan interest rate caps and by specific prohibitions against payday lending by check cashers. States have enforced this ban with varying degrees of enthusiasm. The Attorneys General in Virginia, West Virginia, Pennsylvania, Michigan, and Maryland have brought cases against payday lenders as unlicensed small loan companies. Georgia's Industrial Loan Commissioner ruled in 1998 that payday lending violated the Georgia Industrial Loan Act. Alabama's Department of Banking issued 150 cease and desist orders in mid-1998, charging payday lenders with violating interest rate caps. A consent agreement negotiated between the Alabama Check Cashers Association and the Department of Banking, however, permits payday lending to continue in Alabama under restrictions until the case is heard or the legislature adopts legislation. (See Appendix B).

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\* % of face amount of check



Table Two

States That Prohibit Payday Loans Through Small Loan Law and Check Cashier Law

State	Cap Small Loan Rate	Check Cashier Law Prohibits
Alabama	36%	
Alaska	36%	
Arizona	36%	
Arkansas	17%	
Connecticut	28.52%	Yes
Georgia	57.68%	Yes
Hawaii	24%	
Maine	30%	Yes
Maryland	33%	
Massachusetts	39.86%	Yes
Michigan	25%	
New Hampshire	24%	
Pennsylvania	23.57%	Yes
Puerto Rico	25%	
Rhode Island	36%	
Texas	31.65%	
Vermont	24%	
Virginia	36%	Yes
Virgin Islands	26%	
West Virginia	31%	Yes

Other states permit payday lending due to weaknesses in state laws that govern small loan companies or due to the lack of a usury cap. Twelve states do not cap interest rates for small loan companies, permitting payday lenders to get licenses and charge any rate they choose. Indiana permits payday lending due to its minimum \$33 finance charge for consumer loans. Three of these states (Delaware, New Jersey, and New York) only prohibit check cashiers from making payday loans.

Table Three

States that Permit Payday Loans Through Small Loan Act Provisions

State	Small Loan Act APR on \$200 Loan	Permitted for Check Cashers
Delaware	No Cap	No
Idaho	No Cap	Yes
Illinois	No Cap	Yes
Indiana	\$33 min. finance charge/36% cap	Yes
Montana	No Cap	Yes
New Jersey	No Cap	No
New Mexico	No Cap	Yes
New York	No Cap	No
North Dakota	No Cap	Yes
Oregon	No Cap	Yes
South Dakota	No Cap	Yes
Utah	No Cap	Yes
Wisconsin	No Cap	Yes

CFA Payday Loan Survey

CFA member organizations surveyed payday lenders in eight states to learn the terms of payday loans and whether key disclosures are being made to consumers. Groups in Florida, California, South Carolina, Tennessee, Oregon, Illinois, Virginia, and Pennsylvania called 85 payday lenders during mid-1998 to ask the maximum loan and term, the fee, whether roll-over of loans is allowed, if a written agreement is required, and what the Annual Percentage Rate is the quoted loan. (See Appendix A for state surveys.)

Payday loans are permitted by state law in all of the states surveyed except in Pennsylvania and Virginia. Virginia prohibits payday lending through its check casher law and the small loan act with its 36% interest rate cap. Callers found that payday loans are being made in both Pennsylvania and Virginia. National chain payday loan companies in Western Pennsylvania charge 391% APR for 14-day loans (\$15/\$100 loaned). In Virginia payday loans are being made at Dollar Financial Group check cashers in Tidewater by Eagle National Bank out of Pennsylvania. Eagle charges \$17.50 per \$100 for 14 days or 456% APR.

Fees for payday loans in Florida, South Carolina, California, and Tennessee are capped at rates from 10% in Florida to 15% of the face value of the check. Surveyors were quoted higher

than legal fees in at least one entity in Florida, South Carolina, Tennessee, and California. There is no state fee cap in Oregon and Illinois where payday lenders with small loan licenses can set their own rates. Rates quoted in Oregon ranged from \$15/\$100 to \$20/\$100. Illinois surveyors found the highest rates quoted, ranging from \$18 to \$22/\$100 loaned. Pennsylvania lenders quoted \$15 per \$100 for loans of up to \$300, although there is no legal authority for payday lending in the state. The range of Annual Percentage Rates for \$100 loan for 14 days ranged from 261% to 782% APR.

The size of loans offered by payday lenders ranged from \$100 to \$1,000, with some lenders loaning amounts based on the consumer's take-home pay. Although state payday loan laws typically set 30 or 31-day maximum terms, loan terms quoted to surveyors were most often 14 or 15 days, with some terms as short as "your next payday" and 7 days.

Callers asked payday lenders what the annual percentage rate was for the loans described in the surveys. Only Tennessee lenders quoted triple digit interest rates consistently. Annual percentage rates were also quoted by some lenders in California, Illinois, and Oregon. Other lenders responded with "I don't know," "it's not a loan," or simply quoted the fee.

### Policy Recommendations

- States should enforce current usury and small loan laws that outlaw payday or cash advance loans. Those states without interest rate or usury caps should impose maximum interest limits on loans of \$1,000 or less to prevent rate-gouging with payday loans and other small loans. States that already outlaw cash advance loans made by check cashers should close any loopholes that permit state licensed check cashers to offer cash advance loans provided by banks if those banks are not subject to usury caps.
- Failing an outright ban on cash advance loans, this type of loan should be explicitly regulated through state small loan laws requiring licensing or registration with state banking officials. Disclosures must comply with the federal Truth in Lending Act. There should be an absolute cap on effective annual interest rates. States should limit the size of these loans, set a minimum term that realistically permits the loan to be repaid, require written contracts, forbid multiple loans and roll-over of cash advances into new loans, and prohibit lenders from threatening borrowers with bad check laws if they fall behind on payments. Lenders should not be permitted to bring criminal prosecution for failure to pay cash advance loans on checks and these loans should be treated as unsecured debt for purposes of bankruptcy. States should collect industry-wide data to monitor the business. (See Appendix C.)
- The federal government should close any loopholes that permit national banks to make payday loans in any state that prohibits state check cashers or state chartered financial institutions from making this type of loan. The Comptroller should require banks to comply with the consumer protections in the states where they do business.
- Treasury should adopt consumer protection rules for accounts opened voluntarily by consumers to comply with the federal law requiring electronic deposit of federal checks starting in 1999. Check cashers and other financial service companies are

negotiating agreements with banks to provide access to EFT99 accounts.<sup>29</sup> Check cashers can be expected to offer payday loans based on anticipated delivery of federal benefits through EFT'99 accounts accessible at their stores.

### Advice to Consumers

- Make a realistic budget and build up a nest egg of savings to avoid the need to borrow small sums to meet emergencies and unexpected expenses. Just \$300 in a savings account would save payday loan borrowers the steep fees. Saving the fee on a typical \$300 payday loan for six months will provide a \$300 buffer against financial emergencies.
- Shop for the lowest cost credit available from cash advances on credit cards, small loans from your credit union or a small loan company, an advance on your pay from your employer, and loans from friends or family. Some local community based organizations may make small business loans to individuals. Ask for more time to pay utility bills. Compare both the Annual Percentage Rate (APR) and the finance charge (loan fee stated in dollars) to get the lowest cost credit. Do not simply compare the payday loan fee with a bank bounced check charge. Consider overdraft protection on your checking account.
- If you do use payday loans, borrow only as much as you can afford to pay with your next paycheck and still have enough to make it to the next payday..

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<sup>29</sup> Hybrid bank/check casher accounts are being offered by Benefits Express, DBC Financial, Dollar\$\$\$Direct, NaCCA Preferred card with Citibank, SecureCheck, and QuickAccess. Checklist, Fall, 1998, p. 6, 10.

## Appendix A

### CFA Payday Loan State Surveys

#### Florida

Florida's check cashing law was enacted before payday lending was offered. The 10% cap on check cashing fees has been applied to payday lending as long as the loan is not renewed. The Florida Public Interest Research Group was quoted rates that exceed the 10% fee cap in ten of nineteen instances, with effective APRs ranging from 261% to 573%. The longest loan term was 15 days, with five lenders demanding repayment on the next payday. None of the companies quoted an APR when asked.

#### Florida Payday Loan Survey

#### Florida Public Interest Research Group

Company City	Max. Loan	Max. Term	Fee/ \$100	APR/\$100 14 days	Roll-Over Allowed?
Check Express Inc. Orlando	\$200	14 days	\$12.91	336%	No
CCS Payment Store Sunrise	10 – 15% paycheck	14 days	\$10	261%	Yes
Check Cashing Store Davie	10% of paycheck	14 days/ nxt pay	\$10	261%	No
Cash Cow Ft. Lauderdale	\$100	15 days	\$10/3 days \$22/15 days	573%	Yes
Broward Tags & Cks Ft. Lauderdale	50% of paycheck	Next payday	\$10	261%	No
Ace America's Cash Express Hialeah	\$500	14 days	\$10	261%	Yes \$3.25 late fee
Check Cashing Store Miami	Based on paycheck	Next payday	\$10	261%	Yes
Check Cashers of Fl. Miami	50% of paycheck	Next payday	\$13	338%	Yes
Check Cashers of Sarasota	50% of paycheck	14 days	\$15	391%	No
Sun Check Cashers Sarasota	\$100	Next payday	\$11	286%	No
Pawn Depot Inc. St. Petersburg	\$300	15 days	\$15	391%	Yes

Cash Cow Tallahassee	\$100	15 days	\$22	573%	Yes
Express Title Loans Tallahassee	\$200	7 days	\$10	261%	Yes
Check-N-Go St. Petersburg	\$100	14 days	\$16	417%	No
EZ Cash Tallahassee	\$100	15 days	\$22	573%	Yes
Check-N-Go Tampa	50% of paycheck	14 days	\$16	417%	No
Cash Your Check Tampa	up to 12% monthly income	14 days	\$10	261%	No
24-Hour Checks Cashed, Tampa	\$100	Next payday	\$10	261%	Yes
Ace America's Cash Express Tampa	25% of income	14 days	\$10	261%	No
Fla. Stat. Ann. § 560.201	NA	NA	\$10	261%	NA

### Pennsylvania

Payday lending is not legal in Pennsylvania. The small loan interest rate cap is \$9.50 per \$100 loaned per year, or an APR of 23.57%. Pennsylvania's Attorney General has brought cases against payday lending in Philadelphia. The check cashing law adopted in 1998 prohibits check cashers from making payday loans. The Mercer County Community Action Agency surveyors found payday lending thriving in Western Pennsylvania. All of the six lenders surveyed charged \$15 per \$100, or 391% APR for 14 day loans. One lender set a 7 day maximum term, producing a 782% APR. Only one lender permitted rollovers on loans, while two would lend again the next day. None of those surveyed quoted an APR when asked.

#### **Pennsylvania Payday Loan Survey**

#### **Mercer Co. Community Action Agency**

Company City	Max. Loan	Max. Term	Fee/ \$100	APR/\$100 14 days	Roll-Over Allowed?
American Cash Advance Hermitage, PA	\$300, up to 50% payck	Next payday Up to 14 days	\$15	391%	No, next day advance
Local Cash Advance Hermitage	\$300	Next payday Up to 14 days	\$15	391%	Yes
National Cash Advance Hermitage	\$300, up to 80% payck	Next payday	\$15	391%	No
United Cash Advance Sharon	\$300, up to 70% payck	Next payday Up to 14 days	\$15	391%	No



PayDay Cash Advance Sharon	\$300, up to 50% payck	Next payday Up to 14 days	\$15	391%	No, next day advance
Arctic Cash Advance Sharpsville, PA	\$300	Next payday Up to 14 days	\$15/ 7 days \$22/14 days	573%	No," not a loan"

PA Check Cashing Licensing Act of 1998, § 505 (a) prohibits check cashers from making payday loans.  
7 Pa. Cons Stat. Ann. § 6201 *et seq.* Caps small loan fees at \$9.50/\$100/year or 23.57% APR.

### South Carolina

The Columbia Consumer Education Council called twelve companies advertising payday loans in South Carolina. Legislation adopted in 1998 sets a maximum \$15/\$100 fee and limits loans to \$300 for a maximum term of 31 days. Fees quoted by lenders ranged from \$15 per \$100 to \$30 per \$100 loaned. Although South Carolina law prohibits rollovers, two companies stated that loans could be renewed. None of those surveyed quoted an APR when asked.

**South Carolina Payday Loan Survey**

**Columbia Consumer Education Council**

Company City	Max. Loan	Max. Term	Fee/ \$100 Deducted	APR/\$100 14 days	Roll-Over Allowed?
Check World Columbia	\$125	14 days	\$18.75 Deducted	460%	No
Money Lines Columbia	\$200	Next payday	\$30	782%	No
Payday Chex Ctr Columbia	\$100	Next payday	\$15 Deducted	460%	No
E-Z Check Cashing Columbia	\$500	Next payday Up to 14 days	\$18.75 Deducted	460%	No
Cash Advance Columbia	\$100	Next payday Up to 14 days	\$15 Deducted	460%	No
Fast Check Cashing Columbia	\$200	Next payday Up to 14 days	\$15	391%	Yes
Quick Cash Check Cashing Columbia	\$125	Next payday	\$18.75 Deducted	460%	No
Greenview Check Cashers Columbia	\$100	Next payday	\$15	391%	No
B-n-A Check Cashing Columbia	\$125	14 days	\$18.75	460%	No
Cash-O-Matic Lexington	\$150	14 days	\$22.50 Deducted	585%	No
Instant Check Cashing Columbia	\$125	14 days	\$18.75	460%	Yes
Ace America's Cash Express Orangeburg	\$200	14 days	\$30	782%	No
S. C. Code Ann. § 34-39-110 <i>et seq.</i>	\$300	31 days	\$15	391%	No

## Oregon

The Oregon Public Interest Research Group called five payday lenders in Portland to check on fees. Oregon has no limits on payday loan rates charged by licensed loan companies. OsPIRG found fees ranging from \$15 to \$20 per \$100, with APRs for 14-day loans of 391% to 521%. Three lenders agreed to rollover loans for an additional fee. Two lenders accurately quoted an APR for loans when asked.

### **Oregon Payday Loan Survey**

### **Oregon Public Interest Research Group**

Company City	Max. Loan	Max. Term	Fee/ \$100	APR/\$100 14 days	Roll-Over Allowed?
Check-X-Change Portland	\$100	14 days	\$18	469%	Yes
Check Mart Portland	\$500 25% payck	14 days	\$15	391%	Yes
Cash Connection Portland	\$500 25% payck	14 days	\$15	391%	NA
Payroll Advance Systems Portland	\$200	10 days	\$20	521%	No
Check Cash Portland	\$300	14 days	\$15	391%	Yes

Or. Rev. Stat. § 725.340 Consumer Finance Act applies to payday loans. No cap on fees or limits on loan terms.

## Illinois

The Champaign County Predatory Lending Task Force surveyed five payday lenders in Champaign, Illinois and found interest rates ranging from 469% to 573% APR. Illinois Public Interest Research Group surveyed 13 payday lenders in the Chicago area. Illinois does not cap interest rates. The maximum loan quoted was \$1,000 or one week's pay. Five lenders correctly quoted an APR when asked.

### Illinois Payday Loan Survey

### Champaign County Predatory Lending Task Force Illinois Public Interest Research Group

Company City	Max. Loan	Max. Term	Fee/ \$100	APR/\$100 14 days	Roll-over Allowed?
Campus Cash Champaign	\$300	14 days	\$18	469%	Yes
Advance America Champaign	\$300	14 days	\$20	521%	Yes 3 times
Check and Go Champaign	\$1,000 1 wk payck	14 days	\$20	521%	Yes 3 times
Check Into Cash Champaign	\$300	Next payday up to 16 days	\$22	573%	Yes 2 times
Check Advance Champaign	\$300 up to \$500	14 days	\$20	521%	Yes
Azteca-26 <sup>th</sup> St. Currency Chicago	\$500	"Depends"	\$14	365%	Doesn't know
Campus Cash Elmhurst	\$300	14 days	\$18	469%	Yes, one time
Check 'N Go Chicago	Half one week's pay	14 days	\$20	521%	Yes, three times
Insta Cash Advance Chicago	Half one week's pay	Next payday	\$20	521%	Yes
Payday Loans Chicago	\$300	Depends on loan amount	\$20	521%	Yes, three times
Insta Cash Chicago	\$150	Next payday	\$21	547%	No
Pay Day Loan Corp IL Chicago	\$300	14 days	\$20	521%	Yes
Millennium Title, Inc. Des Plains	Half of pay check	14 days	\$10	261%	Yes
Checks-N-Advance Chicago	\$600	14 days	\$15	391%	Yes
Clark Lunt Currency Exchange Corp. Chicago	Half of net pay	Next payday			Yes
79 <sup>th</sup> & Jefferson Exchange, Inc. Chicago	\$150	21 days	\$14	365%	Yes

Colonial Currency Exchange Chicago	\$150	Next payday	\$14	365%	NA
Currency Exchange Chicago	\$100	14 days	\$14	365%	Yes

205 Ill. Comp. Stat. 670/15 Ill. Consumer Installments Loan Act applies to payday lenders. No cap on fees or limits on loan terms.

**Tennessee**

A telephone survey of payday lenders was conducted in central Tennessee by CFA staff. Eight companies quoted fees per \$100 ranging from \$14 to \$17.50 although Tennessee's Deferred Presentment law caps fees a \$15 per \$100. None of the lenders made loans for the maximum 31 day period, while one company set a 7-day loan limit. Almost all of the surveyed lenders quoted a triple-digit interest rate when asked the APR, while five were accurate.

**Tennessee Payday Loan Survey**

**Consumer Federation of America**

Company City	Max. Loan	Max. Term	Fee/ \$100	APR/\$100 14 days	Roll-overs Allowed?
National Cash Advance Shelbyville	\$200	Next payday	\$15	391%	No
Cash Advance Shelbyville	\$200	14 days	\$14	365%	No
America's Cash Advance Tullahoma	\$200	7 days	\$15	391%	No, write loan
Check Into Cash Tullahoma	\$200	14 days	\$15	391%	No, write new loan
Check Exchange Winchester	\$150	14 days	\$17.50	456%	No, write new loan
Cash Express Winchester	\$200	14 days	\$17.50	456%	No, write new loan
National Check Cash Winchester	\$200	14 days	\$17.50	456%	No, write new loan
Quick Cash Winchester	\$100 1 <sup>st</sup> time	14 days	\$17.50	456%	No
Tenn. Code Ann. § 45-17-101 <i>et seq.</i>	\$300	31 days	\$15	391%	No



**California**

California Public Interest Research Group surveyed fifteen payday lenders in Sacramento and Los Angeles. None of the companies quoted an accurate APR for loans.

**California Payday Loan Survey**

**California Public Interest Research Group**

Company City	Max. Loan	Max. Term	Fee/ \$100	APR/\$100 14 days	Roll-over Allowed?
Community Check Cash Los Angeles	\$300	14 days	\$15	391%	Yes
AnyKind Check Cash Los Angeles	\$200	14 days	\$15	391%	Yes
Continental Currency Los Angeles	\$300	14 days	\$15 + \$10 1st time	391%	Yes
Check Cashing Ctr Los Angeles	\$300	Next payday	\$15	391%	Yes
Check Into Cash Sacramento	Based on pay	Next payday	\$15 + \$10 1 <sup>st</sup> time	391%	No
Check-x-Change Sacramento	\$250	14 days	\$15	391%	Yes
Cash Check Sacramento	\$150	Next payday	\$15	391%	No
AnyKind Check Cash Sacramento	\$200	14 days	\$15	391%	Yes
Gold Star Check Cash Sacramento	\$100	14 days	\$15	391%	Yes
Madison Ave. Ck Csh Sacramento	\$250	14-30 days	\$15	391%	Yes
California Ck Cash Sacramento	\$250	15 days	\$15	391%	No
Check & Go Sacramento	Based on paycheck	14 days	\$17.50	456%	No
Cash & Go Sacramento	\$255	14 days	\$15	391%	No
Cash Connection Sacramento	\$300	14 days	\$15	391%	Yes
C&C Check Cashing Sacramento	\$200	14 days	\$15	391%	Yes
Cal. Civ. Code § 1789.30 <i>et. seq.</i> \$300 incl. Fee		30 days	\$15	391%	Yes

**Virginia**

Virginia enforces its small loan and check casher laws to prevent payday lending. The Virginia Citizens Consumer Council conducted a telephone survey of 11 check cashers in Northern Virginia to verify that payday loans were not being offered. The Dollar Financial Group's Almost A Banc locations in Tidewater make 'Cash 'Til Payday' loans through Eagle National Bank, a Pennsylvania institution.

**Virginia Payday Loan Survey**

**Virginia Citizens Consumer Council**

Company City	Max. Loan	Max. Term	Fee/ \$100	APR/\$100 14 days	Roll-overs Allowed?
Almost-A-Banc Newport News Chesapeake Hampton Norfolk Portsmouth Virginia Beach	\$500	14 days	\$17.50	456%	No, New loan

Va. Code Ann. § 6.1-432 *et. seq.* Check cashers are prohibited from making loans or cashing post-dated checks. Consumer Finance Act, Va. Code Ann. § 6.1-272.1 caps interest rates for loans of \$2500 or less at 36% APR.

## Appendix B

### State Actions Involving Payday Lenders

Several states have challenged payday loans as violating state usury laws, as unauthorized small loan lending, or as violations of consumer protection laws. The following state reports illustrate efforts to curb payday lending across the country.

#### Alabama

The Alabama Attorney General issued an opinion July 7, 1994 that payday loans are loans covered by the Alabama Small Loan Act, the Mini-Code and are subject to Truth in Lending disclosure requirements. No action to enforce the 1994 opinion was taken until July 1, 1998 when the Alabama State Banking Department filed cease and desist orders against 150 check cashing companies making payday loans in violation of Alabama's small loan act which prohibits making loans for \$749 or less without a license. The Alabama Check Cashers Association counter sued the state, seeking a declaratory judgment on whether the Alabama Small Loan Act applies to "Payday Loans" and "Catalog Sales." The trade association complaint sought injunctive relief to stop enforcement of the cease and desist orders. The case was assigned to a retired judge for mediation pending trial.<sup>30</sup> The consent agreement issued by Judge Reese October 9, 1998 permits payday lending to continue with restrictions pending a final court ruling or the adoption of legislation in Alabama. Parties to the injunction can make payday loans with fees up to 16.67% of the check including the fee. (This computes to 521% APR if the loan is repaid in 14 days or 1042% APR if repaid in 7 days.) Lenders may not renew or consolidate one payday loan with another, must provide written agreements, and may not file criminal charges for NSF returned checks.<sup>31</sup> Other payday lenders may sign the consent agreement to remain in business pending the final resolution of the case.

Three private class action lawsuits are pending in Huntsville, Alabama involving seven lenders in Huntsville as well as Greenstreet and Dollar Express. Two smaller class actions are in settlement.<sup>32</sup>

#### Florida

The Florida Comptroller, Department of Banking and Finance, sought an emergency cease and desist order June 8, 1998 against Treasure Coast Cash, Inc, an unlicensed Stuart, Florida payday lender. The Comptroller cited Treasure and its principals for unlicensed lending under Chapters 516 and 687, Florida Statutes. Typical loans cost consumers 520% APR, with some payday loans up to 1560%. The Order also cited Treasure for collection practices that used, without authority, letterhead from the Martin County Sheriff's Office. The Comptroller listed violations including unlicensed consumer finance loans, interest in excess of 18% usury limit, and deceptive debt collection practices.

The Florida Department of Banking and Finance also filed an Administrative Complaint for Imposition of Sanctions and Notice of Rights August 28, 1998 against A Tropical Title Loan, Inc, located in Port St. Lucie, FL for unlicensed lending. At least 350 small loans were made at finance charges of 520% APR.

Private class action litigation is underway in Florida against Cash-2-U and Treasure Coast Cash Co, accusing the companies of charging illegal interest and attempting to collect illegal debts.

<sup>30</sup> Alabama Attorney General Opinion No. 94-00210, issued July 7, 1994.

<sup>31</sup> State of Alabama State Banking Department Summary of Consent Order Regarding "Payday Loans," October 14, 1998.

<sup>32</sup> Telephone interview with Lange Clark, Esq., Birmingham, Alabama attorney, 11/2/98.

## Georgia

Georgia's Industrial Loan Commissioner John Oxendine found that EZ Cash, Inc., formerly known as Cash Cow, Inc., a Florida payday lender with branches in Georgia, was making small loans in violation of the Georgia Industrial Loan Act. Investigators testified at hearings in January that Cash Cow loaned money at rates of \$25 per \$100 payable in 15 days, resulting in annual simple interest rates of 600%. In Georgia, it is criminal usury to charge more than 60% interest on loans of less than \$3,000. Although the Company used a variety of devices to obscure the loan, such as discount car title vouchers or check-cashing fees, Georgia officials found that these transactions are loans in violation of state law.

## Kansas

The Kansas Attorney General obtained a 1992 consent judgment against Greenbacks, Inc. d/b/a Advance Checking and Check-Time in a case alleging that consumers were charged \$25 per \$100 loaned, resulting in annual percentage rate of 1,300% for a one-week loan.

## Kentucky

A payday loan complaint brought by Addison Parker, a legal aid attorney with the Appalachian Research and Defense Fund of Kentucky, Inc., resulted in the first published Federal court decision involving payday lending. Judge Joseph M. Hood of the Eastern District of Kentucky issued an order December 11, 1997, refusing to dismiss a complaint against Larry York d/b/a HLT Check Exchange. The Court found the transactions to be interest bearing loans, not check cashing. Judge Hood held that HLT's payday loans were subject to Kentucky's Usury statute, the Kentucky Consumer Loan Act, the Civil RICO statute (18 U.S.C. \_ 1964(c)), the federal Truth In Lending Act, and the Kentucky Consumer Protection Act. The Acting General Counsel for the Kentucky Department of Financial Institutions, which licenses check cashers, filed an affidavit in support of the lender but failed to persuade the judge that payday lending is permitted under Kentucky's check casher law.<sup>33</sup> The case was settled.

At least eight cases are pending in state and federal courts in Kentucky. Judge Hood, of the United States District Court for the Eastern District of Kentucky granted class status in October 1998 in Lucille Riley, et al v. Larry K. York D/B/A Hazard Check Exchange, No. 98-268. Action has been stayed in federal court on other cases while the Kentucky Supreme Court considers issues raised by litigation.

## Maryland

Maryland's Attorney General brought a case against Cash-2-You Leasing, a Maryland company that loaned \$200 at interest rates of 780% APR. The suit alleges that the company attempted to avoid Maryland's usury law that caps rates at 33% APR by having the consumer "sell" a household item which Cash-2-U then "leased" back. For a \$200 loan, the borrower was required to write a check for \$260 payable to the company. If the borrower failed to repay the \$200 loan and \$60 fee after 15 days, the company deposited the check. The Attorney General has charged that the sham "sale-leaseback" transaction is an unfair and deceptive practice used to obfuscate a usurious loan. The case has not been decided.

## Michigan

In 1997, the Michigan Attorney General issued Notices of Intended Action to five check cashers for operating an illegal consumer loan service. Payday loan companies were charging in excess of 1000%

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<sup>33</sup>Memorandum Opinion and Order, Gregory Hamilton and Dana Hamilton v. Larry York d/b/a HLT Check Exchange, LLP, filed December 11, 1997, Eastern District of Kentucky U. S. District Court.

APR. Michigan investigators found that five check-cashing companies charged annual rates of interest ranging from 416 to 1,095 percent while Michigan law allows a 25 percent rate for consumer loans. Michigan's Financial Institutions Bureau issued a ruling in 1995 that cash advances on checks held for future deposit is lending under Michigan's Regulatory Loan Act of 1963.<sup>34</sup> Three of the entities signed assurances of discontinuance to settle the complaints brought by the Attorney General, agreeing to comply with the Michigan Consumer Protection Act and with applicable usury and licensing statutes. The Michigan Financial Institutions Bureau has determined that check cashers who charge their regular check cashing fee plus a 5% interest rate are in compliance with Michigan's general usury law and do not have to be licensed under the Regulatory Loan Act. Since Michigan does not regulate check cashers or set maximum check cashing fees, this decision permits payday loans at unlimited rates without APR disclosure.

### **Oregon**

Within the last year Oregon's Division of Finance and Corporate Securities took regulatory action against three payday loan operations for unlicensed consumer finance activity. The companies were required to return all interest on the loans made prior to licensing, pay a civil penalty to the state, and cease and desist future violations. All three submitted license applications which were approved.

### **Pennsylvania**

The Pennsylvania Bureau of Consumer Protection in Philadelphia settled a case with Universal Financial Enterprises, formerly Instant Check Co., that charged over 700% interest to first make payday loans, then a variation in which they "bought" a household item from the consumer, then "leased" it back under similar terms to the payday loan.

### **South Carolina**

The South Carolina Department of Consumer Affairs closed a 1992 complaint against Speedy Cash, Inc. for making loans without a license from the South Carolina Board of Financial Institutions for making payday loans. Speedy Cash was accused of charging \$60 to lend \$200 for 14-day periods on personal checks held for deposit. Without admitting violations of law, the company ceased operations in South Carolina. The Department got a preliminary injunction against GSC Enterprises in 1994 for illegal and unconscionable collection practices and unlicensed lending. One complaint against GSC involved a \$68 charge to borrow \$100 for two weeks for an effective interest rate of 1632%. The Department filed a third case in 1997 against check cashing outlets, alleging illegal loans, excess charges, violation of Truth in Lending, unconscionable debt collection, and violation of South Carolina's Unfair Trade Practices Act.

### **Tennessee**

James Logan and Richard Fischer, Cleveland, Tennessee attorneys, sued Creditcorp, Inc. d/b/a Check Into Cash, alleging illegal practices and violation of the federal Truth in Lending Act and Fair Debt Collection Act. Check Into Cash settled the case, paying \$2.2 million to the class and \$500,000 in attorneys' fees.<sup>35</sup> A second class action case was settled for an undisclosed sum involving National Check Advance. Seven other payday loan cases are pending in Circuit Court of Bradley County and one case in United States District Court, Eastern Division of Tennessee at Chattanooga is pending decision on plaintiff's motion for class certification.

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<sup>34</sup> Press Release, issued by Attorney General Frank J. Kelley, Michigan, May 8, 1997.

<sup>35</sup> Securities and Exchange Commission, S-1 filing, July 31, 1998, Check Into Cash, p. 6.



## Virginia

Virginia's Attorney General brought a series of cases in 1992 and 1993 against check cashers making payday loans, charging unauthorized small loan lending in violation of the Virginia Consumer Finance Act. In 1994, Virginia's Attorney General reached a \$2.5 million settlement with an Alexandria-based "cash advance" firm, Cash Now Three, which advanced funds against personal checks, held them for 14 days, and charged a service fee of 28 percent of the amount financed, or an effective annual rate of 730%. Cash Now should have been a licensed small loan company in which case they would have been limited by a 36% APR usury cap on loans of \$2500 or less. A Virginia court ruled that the practice of advancing cash against a customer's check dated for sometime in the future constituted the making of loans and that the fees charged greatly exceeded the limits imposed by the Consumer Finance Act.

Allstate Express Check Cashing, Inc., charged a 30% fee that amounted to an effective annual percentage rate of 730 percent when the check was held 15 days. The Circuit Court of the City of Richmond ruled that the owner of Allstate was personally liable for the \$237,254 restitution judgment entered against the company in March 1995. Greenberg was ordered to pay \$30,000 for attorney's fees to the Commonwealth, but the order was overturned by the Virginia Supreme Court. Claims for restitution were filed by 642 former customers.

## West Virginia

In a 1996 case, Cash-N-Go of West Virginia signed a Consent Order with the Attorney General's office. The complaint alleged that Cash-N-Go made loans through its check cashing business without being licensed as a financial company. A permanent injunction was entered to halt the business and to pay refunds. (Circuit Court of Kanawha County, West VA. Civil Action No. 96-C-2291.) Check cashing legislation adopted in 1998 continued the prohibition against payday lending.

## Appendix C

### CFA/NCLC Model State Payday Loan Legislation

In states that chose to permit payday lending, model legislation should be adopted to protect consumers and curb abuses from excessive fees, roll-overs of loans, and punitive collection practices. Key points in a model payday loan law:

- A. Purpose: To regulate delayed deposit loans as a credit transaction and to protect consumers.
- B. Definitions: Broadly define “deferred deposit loan” to cover post-dated and present-dated check loans. Define “licensee” to include direct lenders and other lenders who make deferred deposit loans indirectly, including banks. Define “check” as a negotiable instrument.
- C. Applicability: Act applies to lenders and those who facilitate or act as a conduit for another who may be exempt from state licensing but who makes deferred deposit loans, such as out-of-state national bank making deferred deposit loans through a check casher.
- D. Exemptions: Exempt retail sellers who only incidentally cash checks. Financial institutions would not have to obtain a state license but must otherwise comply with the act.
- E. Licensing: Sets up a state licensing regime with qualifications, bonding, minimum assets, and a public hearing to ascertain whether applicant has a clean record. Gives Commissioner powers to investigate, handle complaints, revoke or suspend a license, and issue regulations. Gives public access to complaint records.
- F. Information and Annual Reports: Requires licensees to keep certain records, file an annual report, and to verify that licensees have not used the criminal process to collect deferred deposit loans. Licensees must file a copy of loan documents and fee schedules with Commissioner.
- G. Required Acts: Sets term of loan to be no less than two weeks per \$50 loaned. Sets maximum loan at \$300 and the minimum at \$50. Require licensee to stamp the back of the check with endorsement that check is being negotiated as a deferred deposit loan and that any holder of the check takes it subject to all claims and defenses of the maker.
- H. Required Disclosures: Requires extensive disclosures including a written agreement describing the loan, an information brochure explaining consumer rights, Truth in Lending disclosures, and clear notice that borrower cannot be criminally or civilly prosecuted under bad check laws. Licensees required to post information at point of sale.
- I. Prohibited Charges: Set maximum annual interest rate for deferred deposit loans at maximum small loan interest rate cap at a rate comparable to small loan laws. Limits charges for NSF fees to the lesser of \$15 or the charge imposed by the financial institution as sole late fee. Unearned interest for prepaid loans must be rebated by actuarial method.
- J. Prohibited Acts: Prohibits licensees from engaging in unfair and deceptive practices, from entering into unconscionable loans, from repaying or refinancing a deferred deposit loan with

the proceeds of another, threatening to use or using the criminal process to collect loans, making repeat loans within 30 days, and selling extras such as insurance with loans.

- K. Enforcement: Civil and criminal remedies, including a private right of action for borrowers to sue for actual, consequential, and punitive damages with \$1,000 minimum penalty per violation. Class actions permitted. Knowing violation of act a misdemeanor, subject to \$1,000 fine or imprisonment not to exceed six months or both.

For a copy of the CFA/NCLC Model State Deferred Deposit Loan Act, send \$10 to Consumer Federation of America, 1424 16<sup>th</sup> Street NW, Suite 604, Washington, DC 20036.

The National Check Cashers Association policy position on payday lending supports state regulation of payday lending, state fee caps and disclosures, maximum loan size of up to \$1,000 with inflation adjustment, and a maximum loan term of 31 days. NaCCA's position on "extensions and rollovers" would limit them to avoid an undue spiraling of obligations. NaCCA also supports limits on multiple deferred deposit transactions by setting a cap on the total amount of all transactions with the same provider. NaCCA supports a Code of Ethical Standards for the deferred deposit industry. ("The Consumer's Choice: The Role of Deferred Deposit Services in Meeting Short Term Financial Needs," National Check Cashers Association, June 8, 1998.)

# SCOR REPORT



Capital Formation Alternatives for Small Companies

Volume 6, Number 1

Dallas, Texas

May 1998

## This Month

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**A User's Manual for  
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## Despite Good Rates, Small Companies Avoid Bank Loans

Lender and customer opinions on the state of small business bank finance vary widely. The loan officers have told the Federal Reserve Bank that small business loan demand is up. CEOs at 430 of the fastest growing companies in the country told Coopers & Lybrand that they intend to use significantly less outside capital.

Business is so good that the country's fastest growing, non-high tech companies are funding their growth from high margins on sales. This startling development was revealed in the May Coopers & Lybrand *Trendsetter Barometer*.

Bank borrowing is at an all-time low among 430 Trendsetter firms. Only 24% applied for bank loans in fourth quarter 1997, compared to 28% in the previous quarter and 30% a year ago. Nearly all of those that applied for new bank loans (23%) were successful.

As bank borrowing activity has declined, plans for the use of non-traditional financing over the next 12 months are also in retreat. Private

placements are planned by only 14% (two points lower than a year ago), private "angel" investments by 12% (two points lower), and venture capital financing by 7% (three points lower).

The Fed's survey of senior loan officers, also for the fourth quarter of last year, produced a somewhat different story. Of the banks responding to the survey (these are among the largest banks in each of the Fed's 12 districts), 15% reported an increase in loan demand from small companies.

The main engine of increase was merger and acquisition capital, with some demand for plant, equipment and inventory financing.

The rise in demand has not reduced interbank competition. A large number of the banks surveyed by the Fed said they had cut their margins. The Cleveland Fed reported that margins "are razor thin." To cover the lower margins, the banks are reducing their risk. But the trend toward lowering standards seems to have come to an

*Continued on page 3. See  
Borrowing*

Senate Financial Institutions & Insurance

Date 2/1/99

Attachment # 5

**Borrowing**

*Continued from page 1*

end. Branch banks reported a slight tightening of standards in response to a weakening of their parents' current or expected capital positions caused by problems in Asia.

The number of Trendsetter firms adding new bank credit also declined: 25% increased credit availability, and 2% decreased it (a net of 23% increasing, two points less than a year ago). The amount of new credit declined substantially to 11.0% of revenues from 19.1% a year ago (a drop of 42%).

The Trendsetter CEOs think things are slowing down. The decline in bank financing activities follows the direction of a 14% slowing of revenue growth for Trendsetter firms, to a 23.1% gain at the close of 1997 (from 26.9% at year-end 1996).

"Looking ahead to the next 12 months, these firms plan to reduce their major new investments of capital, which explains why more of them are not seeking additional bank financing commitments now," says Edmund Galvin, Chicago partner, Entrepreneurial Advisory Services, Coopers & Lybrand.

"Last quarter, only 26% of CEOs said lack of capital for investment will be a potential barrier to growth in the year ahead, one point less than last year. Many of these firms continue to enjoy healthy margins, and some may have the flexibility to finance a larger portion of their activities from cash flow."

A small majority of the banks reported that their business borrowers were more vulnerable to a business downturn than they used to be.

"Declining bank borrowing activity and favorable interest rates for

new loans make an intriguing equation," says Galvin. "Ironically, the rate paid by Trendsetter firms for new bank loans declined by 10 basis points in fourth quarter 1997, to an average of 9.24%-- the same as a year ago when the prime interest rate was a full 25 basis points lower."

Trendsetter firms that negotiated new rates paid even less—only 8.93% (28 basis points below average).

These lower rates were obtained mostly by larger growth firms, with 100 or more employees, which obtained a rate of 8.79% (71 basis points lower than smaller firms).

Despite interbank competition, the cost of bank loans is likely to go up later this year, according to Michael Cosgrove, publisher of *Econoclast*, a newsletter which tracks interest rates. Cosgrove expects Fed concern about inflation to trigger an interest rate increase of 500 basis points (half of one percent) later this summer.

**High Tech Growth Firms Are Less Reluctant to Borrow**

More high tech than non-tech firms view lack of capital for investment as a potential barrier to growth in the year ahead (27% versus 24%). A larger percentage of high tech firms also completed new bank loans than non-tech firms (27% versus 20%), and paid more for their bank loans (9.30% versus 9.12%).

"Perhaps the reason high tech firms are more active in their borrowing and paying more for loans is due, in part, to their involvement in Asia," says Galvin. "The fact is, twice as many high tech as non-tech Trendsetter firms have business activities in Asia--

**SEC Proposes to Restrict Secondary Sales of 504 Stock**

The Securities and Exchange Commission is asking for comments on a proposal to put SCOR securities under Rule 144 which would make them untransferrable for one year.

The Commission is also considering making Rule 504 available only for private placements.

The release (33-7541) has been posted on [www.sec.gov](http://www.sec.gov). ■

23% versus 11%. These high tech firms may be seeing bargain assets abroad right now and may be making opportunistic acquisitions. The purchasing power of the strong dollar may more than compensate for the comparatively higher interest rates they are paying." In addition, more high tech than non-tech firms have increased their credit—27% (up four points) versus 23% (down four points).

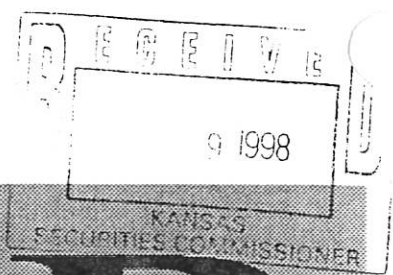
High tech firms also built up a larger amount of available credit than non-tech firms (13.4% of revenues versus 8.6%).

Coopers & Lybrand's *Trendsetter Barometer* is developed and compiled with assistance from the opinion and economic research firm of Business Science International.

*Trendsetter Barometer* interviewed CEOs of 430 product and service companies identified in the media as the fastest growing U.S. businesses over the last five years. The surveyed companies range in size from approximately \$1 million to \$50 million in revenues/sales. Half of these CEOs say their companies are recognized as high tech firms. ■



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# SCOR REPORT



*Capital Formation Alternatives for Small Companies*

*Volume 5, Number 4*

*Dallas, Texas*

*March, 1998*

## This Month

## Registration is not a Problem, but Selling is a Challenge

**Registration is not a Problem, but Selling is a Challenge**—page 1 *Issuers responding to survey have few complaints about registration process, but ask for help in selling.*

**California Quits Regional Review: Others Join**—page 3 *New Department of Corporation Commissioner questions under which state chose to participate in Regional and Coordinated Equity Reviews.*

**Audited Financial Statements: Necessity or Undue Expense?**—page 4 *While many states permit issuers seeking to raise less than \$500,000 to forego the expense of an audit, but it might not be the wise move.*

Small corporate issuers have changed their minds about SCOR. More than half the respondents to a recent survey reported that they would do another direct public offering. Several said they had already done a second offering, or were in the process.

Three years ago, almost every respondent said something to the effect that if he had known how much work was involved, he would never have done the first offering. This time, only 29% of the respondents said they would not do another direct public offering, while 52.5% said they would. The rest were unsure.

Only one respondent said the process was too time-consuming and that management does not have the time to solicit stock sales. In previous years, that remark was made by almost 80% of the respondents.

Of the 1,176 surveys sent out, 112 were returned as undeliverable and 55 were completed and returned.

Since only 5.2% of the companies surveyed returned the questionnaire,

the sampling is too small to make any generalizations. However, it is worth noting that almost half the companies responding said they broke escrow. Twenty-six companies said they broker escrow. Six said no impound was imposed and 23 said they failed to break escrow. Two of the companies that failed to break escrow reported found money from other sources.

In one case, a single investor bought 51% of the offering and in another, the company was purchased by a public company. One company withdrew the offering. However, only 27 companies disclosed how much they raised.

The reported success rate is significantly higher than previous surveys and may indicate that direct public offerings are achieving greater acceptance among both investors and issuers.

About half the respondents, 27 companies, said they intend to list on a secondary securities market. Two of the 27 are already listed, one on the

*Continued on page 3. See Survey*

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## California Quits Regional Review: Others Join

California is no longer processing applications for Western Regional or Coordinated Equity Reviews, but that is not the same thing as dropping out of the program, according to California Department of Corporations Commissioner, Dale Bonner.

The difference is that Mr. Bonner called for a halt in processing until the DoC had had a chance to review its regulations to see if it could participate in the programs without fear of a successful challenge.

Mr. Bonner said the question is not whether California should participate in the regional and coordinated equity review programs, "the question is how we can do it consistent with the laws we are working with here in California. We are simply in the process of trying to confirm whether I have got to make some changes in other regulations that allows me to review certain applications under the coordinated process and others under our traditional process."

For Mr. Bonner, the point is that regional and coordinated equity reviews create a dual system which may be unfair to California companies wishing to sell only in California, since they would have to adhere to a higher standard than coordinated filers would.

Mr. Bonner denied that the decision to stop processing was the result of interdepartmental politics. Bonner said the decision to participate in the programs was taken by fiat rather than through a proper review of the statutes.

Keith Bishop, who proceeded Mr. Bonner as Commissioner, said that

his objection while commissioner was to modernize the DoC's approach to securities regulation, and to find ways of making the process less costly for small business issuers.

He declined to discuss the steps involved in California's decision to participate in regional review for Regulation A offerings, saying that Mr. Bonner was now the Commissioner and the calls are up to him.

Without California, the Western Region now covers 10 states with the addition of New Mexico. The Midwest Region has suffered no such desertions and now stands at nine states with North and South Dakota to total nine states. New England is unchanged.

The Western Region now includes: Alaska, Arizona, Colorado, Idaho, Montana, Nevada, New Mexico, Oregon, Utah and Washington.

The Midwest Region now includes: Illinois, Indiana, Iowa (for offers up to \$1 million), Kansas, Michigan, Missouri, North Dakota (for offers up to \$1 million), South Dakota and Wisconsin.

While Regional Review enjoyed a certain measure of immediate acceptance, Coordinated Equity Review, the process designed not only to streamline the Blue Sky process for SB-1 and SB-2 offerings, but also to speed them through the process, is not meeting with the same acceptance.

So far, only 17 issuers have requested Coordinated Equity Review. That is fewer than one offering for every two states that have agreed to participate in the program.

However, the reaction of the attorneys and issuers who have used the CER program has been generally favorable. One issuer used CER to clear in 37 states in three weeks even though the offering involved a number of merit issues which would usually have held up registration in a number of states.

### Survey

OTC Bulletin Board and the other on the American Stock Exchange.

### Suggested Improvements

Issuer attitude to the regulatory process in changing as well. This time, only two issuers mentioned greater uniformity among states as a way of improving the process.

In previous surveys and at meetings of the SEC-Small Business Forum, this subject got a great deal of attention with suggestions ranging from the wholesale preemption of the states from the registration process to the creation of system in which if one state clears and offering, it should be available in every state. This year, only one individual made each suggestion. The change may be the result of the regional review process.

Complaints about individual states have also declined. Respondents picked only three states to complain about. The complaints were about how specific states handled what could be put in the biography section of the offering document, what could be said in the advertisements and the fees charged. One issuer suggested that the issuer manual and forms be made available on a cd-rom.

Most of the suggested improvements involved the selling process and not registration. The underlying

*Continued on page 4*

## Audited Financial Statements: Necessity or Undue Expense?

By John Perkins,  
Attorney-at-Law  
Jefferson City, Missouri

The proposed recommendations of the Sixteenth Annual Government-Business Forum for Small Business were recently mailed out to the participants. Among those recommendations are that Regulation A be amended to require audited financial statements and that audited financial statements should not be required for startup companies selling to non-accredited investors under Regulation D Rules 505 and 506. Should small businesses and persons involved in raising capital for small be concerned or excited about these suggestions. For a number of years regulators have tried to find the appropriate requirements for financial statements.

The Securities and Exchange Commission in Regulation A has not required audited financial statements. It was thought that by not requiring audited financial statements there would be cost savings to small businesses using Regulation A to raise money. However, most offerings done under Regulation A have audited financial statements. This is because most states require Regulation A offerings to have audited financial statements, and because it is difficult to find a CPA who will be involved in a public offering without having performed an audit.

Many states while limiting Regulation A have had exemptions and provisions under SCOR to allow offering under \$500,000 to not have audited financial statements. However, should companies take advantage of provisions providing for unaudited financial statements when they exist?

I would suggest that any company which is doing a public offering and which believes that it will be successful in raising the money it is seeking, should pay the extra cost and have audited financial statements for the offering. First, the cost is not that much greater, particularly for a startup company.

Second, companies that are using public money, including offerings under Regulation A and SCOR, have a responsibility to the investors to give them the best information about the company. By having audited financial statements the Company will be forced to gather information for the audit, make sure it has the appropriate documentation for actions taken, and will have its financial information in a format that is recognized all across the country and overseas.

Third, companies seeking public money should have an exit plan for the investors. That exit plan will most

likely involve the creation of a secondary market, through listings on an exchange or market. All such markets require current audited financial information. Even emerging markets in cyberspace, like the Direct Stock Market, plan to require current audited financial information, in order to use their services.

Fourth, audited financial statements give an offering credibility. Most offerings under Regulation A and SCOR offerings have no track records for investors to rely upon. Investors are relying upon management to run the company profitably. Most of these companies were previously owned and operated by one or two people. The need for board meetings, reports, procedures for expenditures are often sloppy at best and non-existent at worst. Audited financial statements are small indication of management's commitment to running the company in a professional manner.

While adding an extra up-front expense to the offering, audited financial statements will in the long term be a solid investment. It will increase the marketability of the security being sold and will position the company to move its securities into a secondary market. It is an investment that no small business planning to seek public money should pass up.

### ABOUT THE AUTHOR

John R. Perkins is in private practice specializing in SCOR offerings and providing expert testimony. He served as Commissioner of Securities in Missouri (1983-1995), and as Chief of Enforcement (1981-1983).

He is currently chairman of Investus, a not-for-profit investor education organization, and a member of the Direct Stock Market advisory board.

### Survey

ing complaints seem to be that the general public does not know enough about direct public offerings to accept them and that the issuer should have been told what his chances of success were before he attempted to do the offering.

Although almost half the respondents said they planned to list their securities on a secondary market, only one commented on the need for a secondary market.

Complaints about professional help were also down. Two issuers complained about the cost of accountants and lawyers and one noted that he was unable to find a broker who would sell the offering.



# SCOR REPORT

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Two Successful Issuers Explain How They Sell Securities—page 2

Klein's Name Missing From Wit Capital's Top Bosses—page 3

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LLC Employment Tax Break Could End—page 7

DPOs Fare Better on Bulletin Board This Year—page 8

California Bill Seeks to Create Accredited Investor Venture Funds—page 10

Incompatible Components Endanger Small Company Exemption—page 11

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## How and Where Small Companies Find Capital

By Gus Koehler, Ph.D., Senior Policy Analyst, California Research Bureau, California State Library, Sacramento, CA

**Editor's Note:** The following is the first in a series of articles excerpted from *Business Capital Needs in California: Designing a Program* by Gus Koehler, Ph.D., and Rosa M. Moller, Ph.D., of the California Research Bureau of the California State Library.

As a company develops, its financing needs and available sources for capital change. Business financing can be divided into two stages: early-stage and later-stage.

Early-stage financing funds the founding of a company until it is about to make a profit, and includes seed, start-up, first stage and some second stage funding (see definitions below). Later-stage financing includes second stage, mezzanine, bridge and expansion financing. Later-stage financing can lead to making a public stock offering, sale of the company or expansion.

- *Seed financing:* Capital provided to an entrepreneur to prove a concept or to develop a product. It rarely covers initial marketing costs.

- *Start-up financing:* Capital provided to companies for product development and initial marketing. Companies are generally in the process of organizing or are less than a year old. They have not yet sold their product commercially. Key managers are assembled, a business plan developed and some market studies conducted.

- *First stage financing:* Capital provided to companies that have expended their initial capital (often in developing a prototype), requiring funds to initiate commercial manufacturing and sales.

- *Second stage financing:* Working capital for the initial expansion of a company that has growing accounts receivable and inventories. Although the company has made progress, it may not be showing a profit yet.

*Continued on page 3. See*

**Capital**



## Klein's Name Missing From Wit Capital's Top Bosses

Andrew D. Klein, who envisioned Wit Capital, the digital stock market in which retail investors will buy and sell NASDAQ listed stocks directly from other investors, leaving market makers out of the loop, seems himself to be out of the loop.

The management team includes angel-investor Robert Lessin as Chairman and CEO and former Schwab & Co. vice chairman Ronald Readmond as president and COO.

William Tkacs has been brought on board from Cowen & Company to head the Wit Capital private equity group, and Matthew Carbone, formerly of Salomon Smith Barney, will be senior investment banker. Both reportedly bring team members from their former jobs.

Earlier, Francine Sommer, a 20-year veteran of the venture capital and media industry, was hired to lead its newly formed Angel™ Funds Group.

Asked about Klein's position, a company spokesman said, "Andy Klein will always have a significant position in the company," but no title or job description was mentioned.

Attempts to reach Klein through Wit Capital and Spring Street Brewing failed.

In the meantime, Wit Capital closed its third round financing. The company reports that the investors include "influential venture capitalists and financiers." The two-year-old Wit Capital has raised close to \$20 million.

According to Lessin, Wit Capital is poised for revolution: "We are going to redefine the initial public offering process and build the first global network of angel investors. We are also going to launch the world's first digital stock market through which retail investors will trade NASDAQ and listed shares directly with other investors and thus avoid spreads."

Wit Capital's plans present something of a conundrum. To achieve its goals, Wit Capital will have to be a NASD broker dealer, which it is. But, what it wants to do is make the market maker function obsolete. Since a number of other NASD members make their living as market makers, it is hard to see how the organization can straddle those two positions. ■

### Capital

*Continued from page 1*

- *Mezzanine financing:* Capital for a major company expansion when sales volume is increasing and the company is breaking even or is profitable. The additional capital supports further expansion, marketing or development of an improved product.

- *Bridge financing:* Financing for a company expecting to go public within six months to a year.

- *Expansion stages:* Capital supports expanded manufactur-

ing, marketing and other capabilities to meet growing opportunities, including designing new products and refining manufacturing processes.

Capital requirements vary with the firm's stage of life.<sup>2</sup> *The 1995 White House Conference on Small Business* defined a firm's need for seed and start-up capital as between \$250,000 to \$5 million.<sup>3</sup> A new business requires \$4.2 million to \$16.5 million (or more, depending on the industry) in funding for its first five years.<sup>4</sup>

- *Seed or conceptualizing the company:* \$50,000 to \$250,000.

- *Start-up:* \$ 100,000 to \$ 1 million.

- *First stage* (involving product prototype, proof of concept, some marketing, etc.): \$250,000 to \$2 million.

- *Second stage:*

Expansion of marketing: \$1 million to \$5 million;

Expansion of production capabilities: \$3 million to \$10 million.

- *Mezzanine, Bridge, and Expansion* (leading to public offering): \$2 million to \$20 million.

Most small, rapidly growing companies, the so-called Gazelles, cannot generate the money they need. In California, four-fifths of the Gazelles have annual revenues of less than \$5 million. Of these, about 16% have sales of less than \$500,000. Clearly, these firms cannot meet their capital requirements if their retained earnings do not keep up with their rapid growth without turning to external sources of capital.

### Risk Financing and Business Stage of Development

Early-stage financing is far riskier than later-stage financing (See Chart 1, page 4). Two factors account for higher early-stage risks. First, a firm may need to grow faster than its ability to generate internal capital from profits. Increased debt financing (one way of generating capital), when combined with expenditures of internally generated capital can, under some conditions, cause a negative cash

*Continued on page 4. See Capital*

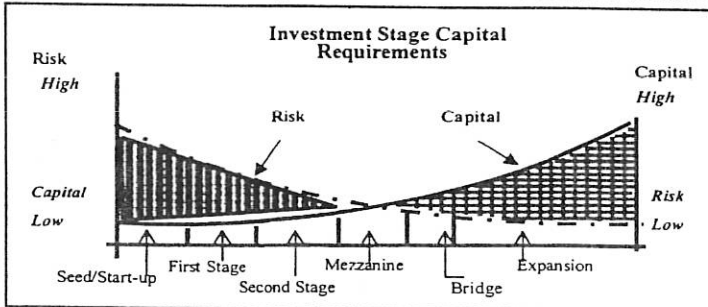


**Capital**

Continued from page 3

flow. Second, untried technology, difficult management problems and other risks associated with company development increase early-stage risks (These factors are discussed below.)

Companies cannot grow faster than their retained earnings unless



**Chart 1**—Source: Adapted from Robert Risser, "The Local Connection: Mentoring Angels and Entrepreneurs", Michigan High Technology Infrastructure for Commercialization, 1996

they are able to obtain outside capital. The following ratios must remain balanced for a firm to be healthy:

- Annual sales to inventory,
- Current assets to current liabilities,
- Cash and equivalents to accounts payable, and
- Debt (short- and long-term) to equity ratio.<sup>5</sup>

If a company's sales and payroll double in volume, it must also nearly double:

Owners, Family & Friends.....	73%
Outside Investors	
Venture Capitalists.....	1%
Business Angels.....	12%
Banks.....	8%
Alliances With Other Businesses.....	6%
Source: SBA, "Capital Needs for Innovative Small Businesses and Entrepreneurship in the 21st Century," September 1995	

- Inventory—to meet customer demands in a timely way;
- Trade accounts receivable and payable—because sales have doubled;
- Capital equipment—to produce more of the product;
- Facilities—to make room for

additional employees and equipment; and

- Equity—to keep debt-to-equity ratios balanced.

A firm's ability to raise capital is also

associated with the risks inherent to its stage of development. These risks can be grouped into six categories:

1. *Technology risks:* Does the technology or product work as expected? Can intellectual property be protected? How will rivals respond to the introduction of a new product?
2. *Nature of firm's assets:* Are assets tangible—i.e., machines, buildings, land or physical inventory?—or intangible, such as trade secrets? When assets are intangible (and thus difficult to retain and/or sell), raising outside financing from traditional sources may be difficult.
3. *Manufacturing risk:* Can the product be reliably manufactured at an acceptable cost that is competitive in the market place?
4. *Management risk:* Does the management team have the experience and capability required to manage a rapidly growing company? Is management risk-averse or over optimistic? Is the founding

entrepreneur likely to take detrimental actions that the investors can not observe, such as funding high profile, but unnecessary projects at the investors' expense?

5. *Market growth risk:* Will the market grow fast enough or be large enough to justify the investment?

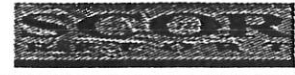
6. *Overall degree of uncertainty:* Based on the above factors, are outcomes so large as to generate a high level of uncertainty?<sup>6</sup>

Clearly, the earliest stages of a firm's development have the highest risk. Not only must the new technology be proven, but also the chances for successfully manufacturing and marketing the product to an unknown customer are uncertain. Furthermore, management may lack the capacity to expand the company. For example, the engineer or scientist who developed the technology may not know how to market it or how to manage an expanding company. Even though firm capital needs are low, the risk of investment loss is high.

Risks associated with later first and second stage financing are reduced because the product technology works and initial manufacturing tests have been passed. The risks that remain are associated with the firm's assets and developing a management team to guide growth. At this stage capital needs are high and risk of failure is reduced. Also, the possibility of getting a quick return on investment is higher.

**Gazelles are Less Stable Than Slower Growing Firms**

The faster a firm grows, the higher the risk. The firm must be able to quickly expand by increasing production and hiring new employees. Fluctuations in number of employ-



Sources of Equity Capital		
Business Needs	Sources	Market Structure
Under \$250,000	Founders, Family, Friends Investment Clubs, Cooperatives	Local
\$200,000 - \$5 million	Business Angels	Networked and Geographically Concentrated
\$5 million+	Venture Capital: Domestic Corporate Foreign	Networked and Geographically Concentrated.

**Table 2**—Adapted from: Office of Advocacy, U.S. Small Business Administration, "ACE-Net" presentation.

ees or "volatility" are an indirect measure of this growth process. Higher volatility indicates a high rate of restructuring and growth, accompanied by a greater risk of success or failure.

Gazelles are much more volatile than slower growing firms. Twenty-five percent of the California Gazelles are highly volatile, compared to only 10% of all firms. Gazelles are more volatile because they face higher risks. These risks are associated with:

- *Higher product and manufacturing risk:* Producing new and experimental products in high-risk sectors increases both the chances of dramatic success or failure.
- *High rate of manufacturing which is tied to market growth risks:* The rate of growth may exceed the ability to obtain capital and to manage a higher rate of manufacturing, causing failure.\*
- *Overall degree of uncertainty is high:* market demand may undergo sudden expansions or contractions

\*Smaller Firms helped pull California out of the 1995 recession, even though they had a noticeably lower survival rate (67%) than larger firms (83%) (1991-1995). The Employment Development Department attributes this to the fact "that the smallest firms generally lack the financial resources needed to survive. For example, small firms usually are not as well capitalized as larger firms, nor do they have the same ability to attract credit." Also, They may have management and other problems that increase their risk of failure.

requiring a just-in-time workforce and access to just-in-time capital. Dynamically balanced capital, management, and marketing are necessary to succeed.

The timely availability of early-stage financing and assistance to reduce risk can have a substantial, positive effect on a firm's immediate growth, employment and long-term revenues. Fast growing companies that received funding from investors two to three years after start-up produced 30% higher revenues and raised nearly five times more money than those receiving bank financing.<sup>7</sup>

Another study found that venture-backed companies increased their employment by 45% in their first five years.<sup>8</sup> Constraints on capital limit many forms of internal business investment, particularly research and development, that are key to Gazelle development in all industry sectors.<sup>9</sup>

### Estimate of Gazelle Early-Stage Capital Needs

There is little current California data on the financing needs of Gazelles or small businesses generally. This makes it very difficult to confirm that a funding gap exists or to ascertain its size. Several surveys are instructive.

Surveys of firms in Southern California conducted in 1993-94 found a considerable level of pent-up loan demand. From 30% to 40% of the firms surveyed had been in business less than five years. Between 35% to 45 % of all surveyed firms planned to expand in the next two to three years, depending on location.

More than 50% stated they would expand if financing were available. Of those actually planning expansions, about 35% needed access to business loans.

A majority of these firms required a loan of less than \$50,000, nearly 15% needed a loan between \$51,000 and \$ 100,000, with the remainder of firms (about 13%) requiring \$101,000 to \$250,000 or more.<sup>10</sup>

A 1996 survey found that 30 % of the Orange County businesses surveyed identified lack of access to

*Continued on page 6. See  
Capital*

Number of Investment Rounds by Stage of Investment (1991)		
Investment Stage	Private Individuals: # of Investment Rounds and % of Invested \$	Venture Capital: # of Investment Rounds and % of Invested \$
Seed	52 (29%)	11 (6%)
Start-Up	55 (31%)	38 (22%)
First Stage	29 (16%)	56 (32%)
Second Stage	26 (15%)	46 (27%)
Third Stage	10 (6%)	19 (11%)
Bridge	5 (3%)	3 (2%)
Totals:	177 (100%)	173 (100%)

**Table 3**—Source: M. L. Lohr, MCM Systems, Inc., presentation to Defense Conversion Panel, California



# KANSAS

Bill Graves  
Governor

OFFICE OF THE SECURITIES COMMISSIONER

David Brant  
Commissioner

**TESTIMONY IN SUPPORT OF SENATE BILL No. 122**  
**Amendments To The Kansas Securities Act**  
Financial Institutions and Insurance Committee      Kansas Senate

**DAVID BRANT**  
Kansas Securities Commissioner  
February 1, 1999

Mr. Chairman and members of the committee, thank you for this opportunity to testify in support of Senate Bill No. 122 which makes some minor amendments to the Kansas Securities Act.

Summary. Senate Bill No. 122 would conform the anti-fraud provisions of the Act to also pertain to investment advisers as already provided in the Model Uniform Securities Act. The amendments would enhance and clarify the agency's anti-fraud enforcement authority over both state registered investment advisers and federal covered advisers (as defined in K.S.A. 17-1252(o)).

Fiscal Impact. There should be no fiscal impact.

Policy Implications and Impact on the Agency Strategic Plan. In 1996, Congress enacted the National Securities Markets Improvement Act ("NSMIA") which ended a 14-month long debate over proposed reforms to federal and state securities regulation.

A significant NSMIA change was to divide the regulation of investment advisers between the states and the SEC. The states are now the sole regulator of investment advisers managing less than \$25 million in client assets ("state covered advisers"), while the SEC retains the primary responsibility for investment advisers managing mutual funds or large portfolios ("federal covered advisers").

Thus, federal covered advisers are no longer licensed by the state, but now submit "notice filings" to the Securities Commissioner. The only regulatory authority the state has over federal covered advisers is to investigate and bring enforcement actions with respect to fraud or deceit.

The proposed Model amendments would bring Kansas law into conformity with a number of other states and would enhance investor protection by clarifying the agency's anti-fraud enforcement authority over investment advisers. Investors are increasingly utilizing the services of investment advisers and state regulation should be prepared for future complaints.

Senate Financial Institutions & Insurance

Date 2/1/99

Attachment # 6