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SFA



BILL ANALYSIS

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Senate Bill 503 (Substitute S-5 as reported)
Sponsor: Senator Valde Garcia
Committee: Banking and Financial Institutions

Date Completed: 6-15-01

RATIONALE

The deferred presentment service industry, also known as payday lending or check advance industry, apparently has experienced phenomenal growth in recent years. According to *Online NewsHour* (the transcription of a PBS television program), an estimated 12,000 payday lenders in 30 states and the District of Columbia earned about \$2 billion last year.

In a deferred presentment service transaction, the borrower writes a personal check to the lender for a small loan plus a fee (typically about \$15 to \$20 on a \$100 loan). The lender agrees not to cash the check until the borrower deposits a paycheck, usually within two weeks. At that point, the borrower can either redeem the check with cash or a money order, permit the check to be deposited, or renew the loan by paying an additional fee.

The service is designed for individuals who suddenly find themselves short of cash and are able to pay their loans with their next paycheck. Evidently, however, the service can be financially damaging to many borrowers. An article in *Governing* (December 2000), for example, reports that a study by the Indiana Department of Financial Institutions found that the average borrower in Indiana renewed his or her loan over 10 times before paying off the principal in full.

According to a 1995 declaratory ruling of the Michigan Department of Consumer and Industry Services (described in **BACKGROUND**, below), payday advance transactions are subject to the Regulatory Loan Act. The State does not actually regulate this industry, however, and there are no specific restrictions on the fees that may be charged or the number of times a borrower may renew a loan. Many people believe that regulation of these practices is necessary to provide adequate consumer protection.

CONTENT

The bill would create the "Deferred Presentment Services Act" to do the following:

- **Prohibit a person from engaging in the business of deferred presentment service without complying with the bill.**
- **Require a deferred presentment service transaction to be documented by a written agreement.**
- **Limit the fees that a deferred presentment service provider could charge.**
- **Prohibit new transactions if the issuer of a check had any outstanding transactions.**
- **Prohibit the renewal, extension, or refinancing of a transaction.**
- **Require providers to give certain notices.**
- **Establish payment requirements.**
- **Establish civil infraction penalties and allow civil actions for violations of the bill.**

The term "deferred presentment service" would mean a transaction under a written agreement between a person and the issuer of a personal check in which the person accepted a check from the issuer dated on the date it was written, agreed to hold the check for a period of time before negotiation or presentment, and paid the issuer the amount of the check less the fee permitted under the bill.

Transaction

Written Agreement. A deferred presentment service transaction would have to be documented by a written agreement signed by both the issuer of the check and the provider accepting the check. The written agreement would have to contain the name of the provider, the transaction date, the amount of

the check, and a statement of the total amount of fees charged, expressed both as a dollar amount and as an annual percentage rate. The written agreement would have to authorize the provider to defer presentment or negotiation of the check until a specific date, which could not be later than 31 calendar days following the date of the transaction.

Notice. A provider would have to provide the following notice in a prominent place on each deferred presentment service agreement:

- A) A deferred presentment service transaction is not intended to meet long-term financial needs.
- B) You should use a deferred presentment service transaction only to meet short-term cash needs.

Fee. A provider could charge a service fee for each deferred presentment service transaction. The fee could not exceed an amount equal to 18% of the amount paid by the licensee to the issuer of the check. The fee would have to be considered fully earned as of the date of the transaction and would not be considered interest. No other fees or charges could be charged or collected by the provider for the deferred presentment service transaction.

The maximum amount a provider could pay to the issuer of a check in a transaction would be \$1,000, plus the service fee authorized above.

A provider offering deferred presentment service transactions would have to post at the point of sale a notice of the charges imposed for the transactions.

Outstanding Transactions. A provider could not enter into a transaction with the issuer of a check if the issuer had any outstanding deferred presentment service transactions with the provider or any other provider. A provider would have to provide the following notice in a prominent place on each deferred presentment service agreement:

State law prohibits you from having more than 1 deferred presentment transaction outstanding at the same time with this company or with any other person providing deferred presentment services. The maximum amount a person providing deferred presentment

services may pay to you in a deferred presentment service transaction is \$1,000.00 (excluding applicable service fees). Failure to obey this law could create financial hardship for you and your family.

Renewal. A deferred presentment service transaction could not be renewed, extended, or refinanced. Once the issuer of the check had completed a deferred presentment service transaction with a provider, the issuer could enter into a new agreement for deferred presentment services with that provider.

Rescission or Redemption

The issuer of a check held in connection with a deferred presentment services transaction could rescind the transaction at no cost and for any reason if the issuer delivered to the registrant, by 5 p.m. on the business day following the date of the transaction, cash or a cash equivalent in an amount equal to the amount of the issuer's check less the fee charged by the provider.

The issuer of a check would have the right to redeem it from the provider holding the check at any time before the negotiation or presentment of the check by paying the full amount of the check in the form of cash or its equivalent.

Payment

A deferred presentment service transaction would be completed when a check was presented for payment, deposited, or redeemed by the issuer by paying the full amount of the check to the provider holding the check.

A provider would have to pay the proceeds from a deferred presentment service transaction to the issuer of the check in the form of the provider's business check, money order, cash, or any other valid method of monetary transfer. No additional fee could be charged by a provider for cashing the provider's business check. If the issuer requested to be paid in cash, the provider would have to pay the proceeds from the transaction to the issuer in cash. Before a provider could negotiate or present a check for payment, it would have to be endorsed with the actual name under which the provider was doing business.

If a check written in connection with a deferred presentment service transaction were returned from a financial institution due to a closed account, or a stop payment order, a provider could contract for and collect a returned check charge not exceeding \$25, and would have the right to exercise all other civil remedies available by law.

Exemptions

The bill would not apply to the cashing of checks by any of the following: a State or national chartered bank or a State or Federal chartered credit union, savings and loan association, or savings bank; a department or agency of a state or the United States; a foreign bank agency, as defined by the Banking Code; or a corporation or limited liability company with offices or franchises in at least 20 states engaged in the business of cashing checks. The bill also would not apply to the receipt of money by an incorporated telegraph company at an office of the company for immediate transaction by telegraph.

Liability

A provider who violated the bill would be guilty of a civil infraction punishable by a fine of up to \$1,000. If the person knew or reasonably should have known that he or she was in violation of the bill, the person could be punished by a fine of up to \$5,000. Each transaction conducted in violation of the bill would be a separate violation.

A provider that presented a check before the date contained in the agreement would be liable for all expenses and damages caused to the issuer or a financial institution as a result of the violation.

A person injured by a provider's violation of the bill could maintain a civil action against the provider and could recover an amount equal to twice the service fee paid in connection with each deferred presentment service transaction that was found to violate the bill, plus reasonable attorney fees.

The issuer of a check who entered into a deferred presentment service agreement would not be subject to any criminal penalty for entering into the agreement and further would not be subject to any criminal penalty in the event the issuer's check was dishonored.

Other Provisions

A provider would have to maintain accurate and complete books, accounts, and records of its deferred presentment service business, and would have to preserve the books, accounts, and records for at least three years.

A provider could not engage in unfair or deceptive acts, practices, or advertising in connection with a deferred presentment service transaction.

The bill specifies that a person who provided deferred presentment services before the bill's effective date would be considered to have complied with applicable state law if the person provided the services in conformity with any rules or policies then in effect that were issued by a state agency.

BACKGROUND

On April 25, 1995, the Financial Institutions Bureau (now within the Office of Financial and Insurance Services), in the Department of Consumer and Industry Services, issued a declaratory ruling that addressed whether a "payday advance transaction" was subject to the Regulatory Loan Act (In re: Request by Oak Brook/Cash Now Partners d/b/a/ Cash Connection for a Declaratory Ruling...). The business proposed to offer a service in which there would be an oral agreement to hold a present-dated check for up to 14 days. For a fee of 15% (10% to cash the check and 5% to hold it for later presentment), the check would be exchanged for cash, and the issuer of the check would promise to have funds in his or her account on the agreed-upon date.

The Bureau concluded that, "...there is clearly an obligation on the part of the customer to repay the cash sum advanced together with an agreed upon additional charge..., and thus it is a loan as that term is used under the Regulatory Loan Act". (That Act applies to loans for which interest is charged at a greater rate than otherwise allowed by law, and requires lenders under the Act to be licensed by the State.) According to the Bureau, "...the Payday Advance, as described, falls within the class of loans intended to be regulated by the Legislature when it enacted the Regulatory Loan Act."

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate

Supporting Argument

The bill would regulate deferred presentment services by restricting fees, interest charges, and loan limits, and prohibiting loan renewals or multiple loans in order to protect consumers from becoming trapped in a cycle of continuous borrowing. The bill could substantially reduce the abusive nature of deferred presentment service transactions by ensuring that loans remained short-term. In addition, the bill would clearly establish the lending process and its ramifications by requiring the transactions to be documented by a written agreement and requiring providers to give certain notices to a borrower.

Response: Licensure or registration would provide for actual oversight by the State of industry practices, and more effective consumer protection. Under the bill, a consumer would have the burden of proving a violation.

Opposing Argument

The bill would legitimize an industry that profits from exploiting the financial desperation of its customers. These lenders prey on the vulnerability of people living paycheck to paycheck. Lenders charge exorbitantly high interest fees for the short-term loan period, which often leads to continuous or frequent borrowing for many consumers. The appropriate price level for deferred presentment loans should be based on the costs of operating the business, allowing for reasonable but not excessive profits.

The bill would not vastly improve the lending process. The use of a personal check makes collection easier for lenders because borrowers can be threatened with criminal charges for writing fraudulent checks. This gives lenders a collection advantage that no other creditor can use, but fails to protect consumers who are unaware of the lending process.

Response: The bill contains a number of provisions designed to prevent abuses. In particular, a transaction could not be renewed or refinanced, and an issuer could not have more than one outstanding transaction at a time. The bill also specifies that an issuer would not be subject to any criminal penalty if his or her check were dishonored.

Opposing Argument

The bill would make it legal for providers to commit what otherwise would be criminal usury. Under the bill, a provider could charge up to 18% to hold a \$1,000 check for 31 days. This means that the issuer would have to pay \$180 for the service, which would amount to an annualized interest rate over 200%, without compounding. In contrast, the State's general usury law allows an unregulated lender to charge only 7% under a written agreement (MCL 439.31). Charging more than 25% in simple interest per annum "or the equivalent rate for a longer or shorter period" is criminal usury, which carries a penalty of imprisonment for up to five years and/or a maximum fine of \$10,000 (MCL 438.41). A licensee under the Regulatory Loan Act is limited to the rate allowed by the Credit Reform Act, which prohibits regulated lenders from charging any rate of interest or finance charge for an extension of credit that exceeds 25% per annum (MCL 445.1854). In its 1995 declaratory ruling, the Financial Institutions Bureau held that a payday advance service (closely resembling the proposed deferred presentment service) was subject to the Regulatory Loan Act. The Bureau also stated, "...engaging in this type of transaction without a license and full compliance with all of the provisions of the Act, would constitute a violation of the Act, as well as the general usury laws, and the Criminal Usury Act." Instead of legalizing these transactions, the State should enforce existing laws that protect consumers.

Response: Since a deferred presentment transaction could not be refinanced or renewed under the bill, the annualized interest rate would not apply. Also, since the Regulatory Loan Act does not refer to this type of service, there is no current State regulation.

Legislative Analyst: N. Nagata
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FISCAL IMPACT

The bill would have an indeterminate fiscal impact. Enforcement costs and fine revenue would depend on the number of violations.

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.