THE CONFERENCE OF STATE BANK SUPERVISORS

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REENGINEERING NONBANK SUPERVISION

Chapter One:
Introduction to the Nonbank Industry

JUNE 2019

About This Paper

The Conference of State Bank Supervisors (CSBS) has developed this paper, *Reengineering Nonbank Supervision*, to serve two primary purposes. First, as a stakeholder awareness document covering state supervision of the nonbank marketplace, and second, as a change document or roadmap to assist state supervisors in identifying the current state of supervision and making informed changes to state supervisory processes. The paper is comprised of several standalone chapters that together will cover the industry supervised by state nonbank financial regulators, the existing system of supervision for nonbanks and the challenges and opportunities for state supervisors in "reengineering" that system.

This first chapter, Introduction to the Nonbank Industry, provides a broad overview of the industry participants that are the primary focus of state nonbank supervisors. We combine these sometimes unlike participants into a single industry of nonbanks due more to jurisdictional coverage and supervisory constructs than similarities between the participants themselves. The common theme is that all of these participants provide or facilitate consumer products and services and fall under the authorities granted to nonbank supervisors (discussed in Chapter Two).

This and future chapters will be available on the CSBS website here.

State financial regulators are the primary regulators of nonbanks operating within the United States. Together, they have forged a series of initiatives, collectively known as CSBS Vision 2020, to modernize nonbank licensing and supervision. This white paper will contribute research and engage discussion on possible actions that might be taken.

Acknowledgements

The paper is staff-developed under the direction of the CSBS Non-Depository Supervisory Committee. In creating this paper, we have interviewed over 80 subject matter experts from industry and state government. Acknowledgement of these experts, as well as identification of authors and support staff, can be found at the webpage listed above.

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CSBS is the nationwide organization of banking and financial regulators from all 50 states, the District of Columbia and the U.S. territories. State regulators supervise state-charted banks and are the primary authority governing nonbank financial services providers, including mortgage providers, money services businesses, consumer finance companies, payday lenders, check cashers and debt collection firms. Created in 1902, CSBS has for more than a century given state regulators a national forum to coordinate supervision and develop policy, provide training to state banking and financial regulators and represent its members before Congress and federal financial regulatory agencies.

CHAPTER ONE

Introduction to the Nonbank Industry

In this opening chapter, CSBS will introduce the state-supervised "nonbank" industry. Our purpose is to provide a concise landscape of the market. This overview will briefly touch on the history of the various industry participants and the products and services they provide. Future chapters of the paper will address each industry segment in greater detail, including a forward perspective developed from interviews with subject matter experts. Industry subject matter experts were relied on heavily for development of this and later chapters covering the industry.

Our discussion of nonbanks should not be confused with what is termed the "shadow banking industry," an informal class of typically very large, bank-like institutions conducting services outside of the regulated banking sector. Although some market analysts include many nonbanks such as mortgage lenders and payments providers alongside money market funds, hedge funds and firms that facilitate repurchase agreements and asset backed securities, the vast bulk of shadow banking does not fall under state financial regulator supervision and is not included in our discussion of the nonbank industry. When we refer to nonbanks or the nonbank industry, we are referring to financial institutions that are responsible for delivering products and services either directly to consumers or related to consumers' use of those products and services and that are supervised or regulated by state nonbank financial regulators.

Currently, there are four primary nonbank industry types under state supervision, some with their own nonbank sub-types:

- Mortgage originators and servicers – providers of mortgage products and services
- Money services businesses (MSBs) – includes money transmitters, payments providers, prepaid/stored value, currency exchangers and check cashers
- Consumer finance – providers of consumer loans, auto loans and small loans such as payday loans
- Debt collectors

In this paper, we also discuss other nonbank financial service providers that do not fall into the mainstream of nonbank supervision but are included due to their size or importance. This category includes credit reporting agencies and bureaus (supervised directly by few state regulators) and non-depository trust companies (typically supervised under the bank regulator side of the agency). There are also several nonbanks supervised by a few state regulators that are not included in this paper due to their minor role in the nonbank financial services marketplace or because they are typically supervised by a different type of regulator. These include institutions such as escrow companies (authorized in only certain states), independently owned automated teller machines (ATMs), credit union service organizations (CUSOs) and title insurance companies (most often under the state insurance commissioner).

Finally, an important and rapidly growing industry type is fintech companies or financial technology firms. Time will tell whether fintechs are an independent industry participant or a mechanism for merging technology with existing financial services. In this paper, we reference fintechs within certain primary nonbank industries (e.g., MSB and consumer finance), but also as a separate category to acknowledge its growing importance to consumers and the marketplace.

Overview of the Nonbank Industry

The nonbank industry, or alternative financial services industry, includes many of the same activities conducted by banks. The difference is that nonbanks, also known as non-depositories, do not have charters or accept deposits, and therefore are not required to carry deposit insurance. Nonbank has become an all-inclusive term covering disparate financial products and services, some of which are not offered by banks.

Regulators and experts agree rapid growth has occurred in the nonbank industry over the last few decades, prompted by two key factors:

- Consumers who do not trust and/or are unqualified to obtain financial services from banks
- The transitioning of loans, loan servicing and collections and money services away from traditional banks

What does the future hold for the nonbank industry? There are three recurring themes from the expert interviews:

- An increase in automation, financial technology ("fintech") or regulatory technology ("regtech")
- A more harmonized market across state lines
- The acquisition or closing of smaller companies as larger companies expand into more states

We will cover these three areas in more detail in later chapters.

Short History of Nonbank Products and Services

Because nonbank products and services run the gamut from mortgage origination and servicing to MSBs and from consumer finance and debt collection to a myriad of other services and products, the history is not homogenous or linear. For instance:

- The consumer finance industry spans back to biblical times but finds its primary roots in pawn dealers in the early 1800s and the use of credit for sewing machines sales in the 1850s.
- As long as there have been loans, there have been debt collectors; however, formalized debt collection companies were established in the 1800s, focusing on unsecured loans on which there was nothing to foreclose.
- Mortgage lending dates to the Industrial Revolution, when mortgages were provided by independent companies to immigrant factory workers to purchase homes. At that time, banks loaned primarily to their depository customers, and their loans were often unavailable to others.
- MSBs found their start through the telegraph business in 1871, and international money transmission developed in coastal cities around the turn of the 20th century through steamship operators transporting funds from immigrant populations back to Europe and Asia.

- Credit bureaus arose in the 19th century from an outgrowth of local boards of trade that collected consumer trade and retail credit information and exchanged the information to track consumers.

Each of these nonbank areas is rich in history and diversity of origin. This opening chapter is only an introduction and overview to nonbanks. Future chapters will delve much deeper into each topic area, including the history and supervision of each industry.

The Nonbanks

Introduction to Nonbank Mortgage

The category of "nonbank mortgage companies" covers an array of industry participants facilitating different parts of the residential[1] mortgage loan process. These participants can be categorized by a combination of business types and license types. The industry can be difficult to understand because a single company may fit into several categories or may have affiliates or subsidiaries that fit into different categories.

A mortgage is a secured loan collateralized by real estate that enables borrowers (mortgagors) to use the property sooner than if they were required to pay the full value of the property upfront. (Diffen, n.d.)

At the highest level, nonbank mortgage companies are categorized into the very broad sectors or functions of originator, servicer and investor. In short, an originator is the mortgage company that originates the loan, and in many cases, makes or funds the loan. A servicer is the company responsible for collecting borrower payments, including principal and interest, taxes and insurance, and then remitting or forwarding those payments to investors. And an investor is a person or organization who purchases and holds mortgage loans and receives the borrower's payments of principal and interest each month.

Mortgage Originators

Several company types fit into the broad sector of mortgage originators. These company or originator types are defined by their role in the origination process and may be banks, credit unions, nonbanks or others (e.g., insurance companies). Based on their role in the origination process, originators include:

Mortgage lenders: companies that loan money that is secured by real estate (often referred to as "mortgage bankers" as opposed to "mortgage brokers") to consumers. The mortgage lender may be a "retail" mortgage originator (meaning they perform all or some of the functions of an originator throughout the loan application and qualification process), or a wholesale lender.[2] A wholesale lender

[1] From this point forward, the term "residential" has been deleted for brevity.

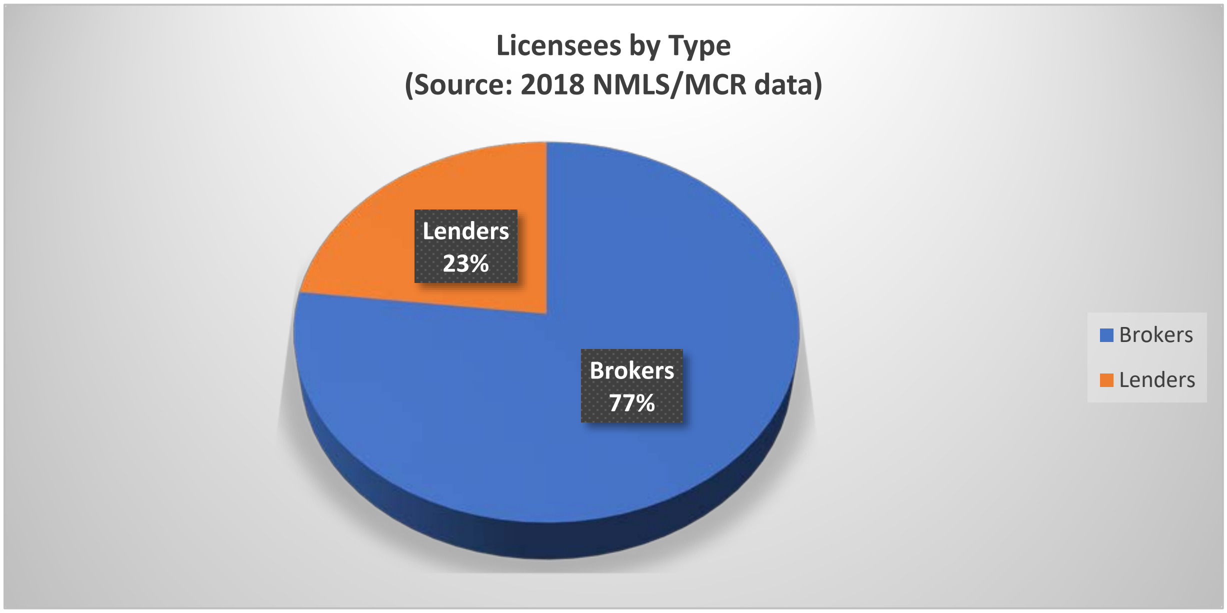
[2] Another term used to describe a lender is correspondent or correspondent lender. These companies may be delegated correspondent lenders that take applications, underwrite, fund and sell loans, or they may be non-delegated correspondent lenders that take applications, fund and sell loans, but depend on other lenders

sources loans through mortgage brokers (and sometimes retail lenders) and has little to no direct contact with the consumer prior to origination but underwrites and funds the loan, takes possession of the closed loan and "books" it as an asset. Suffice it to say that in order to be classified as a mortgage lender (whether retail, wholesale or correspondent), the company must make the loan itself by providing either its own funds or the funds provided by a warehouse lender [see insert] that the mortgage lender has borrowed on a short-term basis.

Mortgage brokers: are intermediaries that "broker," or source, loans for a mortgage lender. Typically, a mortgage broker will act as the primary interface between the prospective borrower and the lender. A mortgage broker will advertise or solicit mortgage loans from consumers, assist the consumer through the application process, advise on the best loan for the consumer's needs and process the application documents and borrower information for the mortgage lender's underwriter who will review the loan for approval. The crucial difference between a mortgage broker and a mortgage lender is that the mortgage broker does not establish underwriting guidelines nor approve, make or fund the loan.

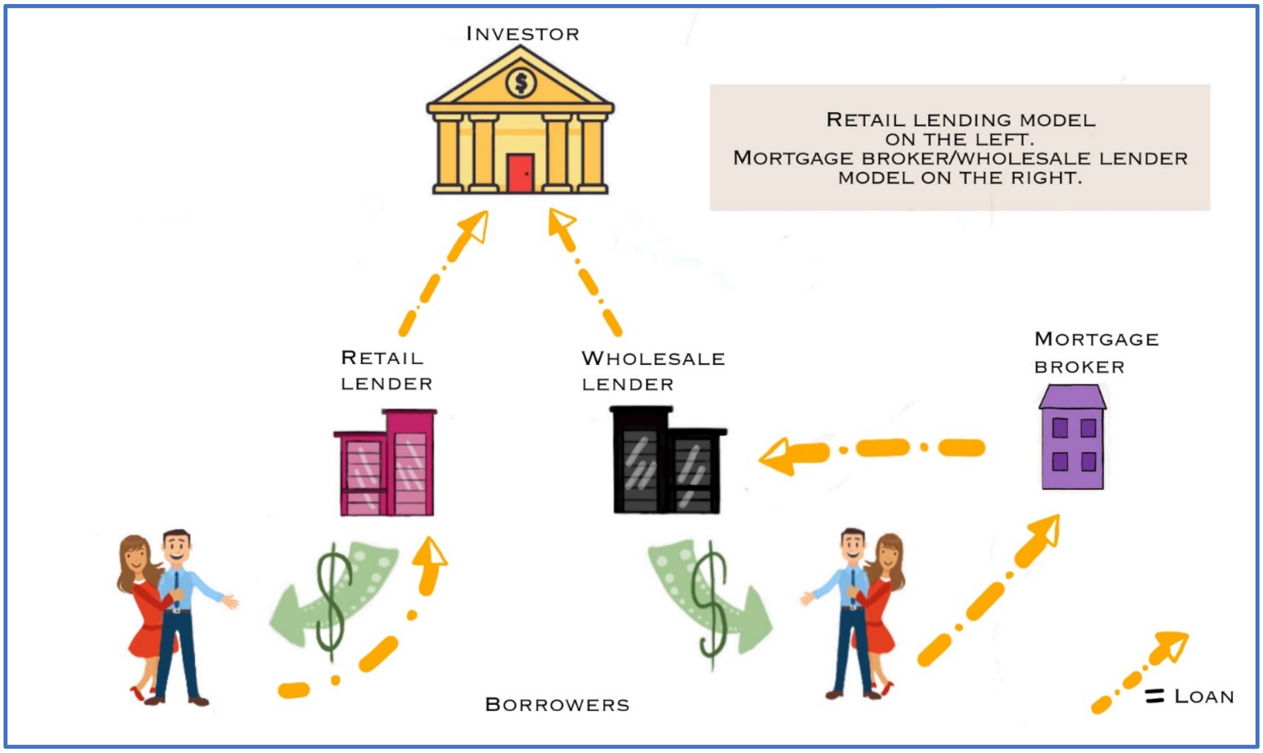
WAREHOUSE LENDER

Warehouse lenders are not "originators." This type of lender differs from wholesale or correspondent lenders in that they don't fund or make the loan to the consumer. Instead, the warehouse lender provides lending facilities or credit lines to mortgage lenders who make the loan, sell the loan to investors and then pay the warehouse lender back, usually very quickly. warehouse lenders are not licensed by the state regulators as a mortgage originator.



(typically the loan purchaser) to underwrite the loans. Correspondents may also buy loans to hold as an investor or as an "aggregator" to sell to investors.

PARTICIPANTS IN THE MORTGAGE ORIGINATION MARKET



Nonbank mortgage companies assist all types of borrowers, from prime borrowers (those deemed likely to make loan payments on time because of good credit history) to those who are credit-challenged or want a more streamlined mortgage experience not always available from the consumer's bank or credit union. Like other nonbanks, they operate without funding from customer deposits, but in most respects, the nonbank mortgage companies originate mortgage loans in the same way as depository institutions (banks and credit unions). The primary difference is that a depository institution will frequently rely on its own or its depositors' funds to make the mortgage loan,[3] whereas a nonbank mortgage company will typically obtain funds for making loans from a larger financial institution or other investor through credit facilities such as a warehouse line of credit.

The conundrum of the mortgage origination industry is that both companies and individuals can be referred to in the same manner. In other words, a mortgage originator can either be a company or a person. When the originator is a person, they are legally termed as a mortgage loan originator, or MLO. Both mortgage originator companies and MLOs are licensed by the state nonbank regulator.

MLOs are employed by or work for mortgage originator companies. To add to the confusion, MLOs can be "licensed" by the state regulator to work for a licensed mortgage originator company, or "registered"

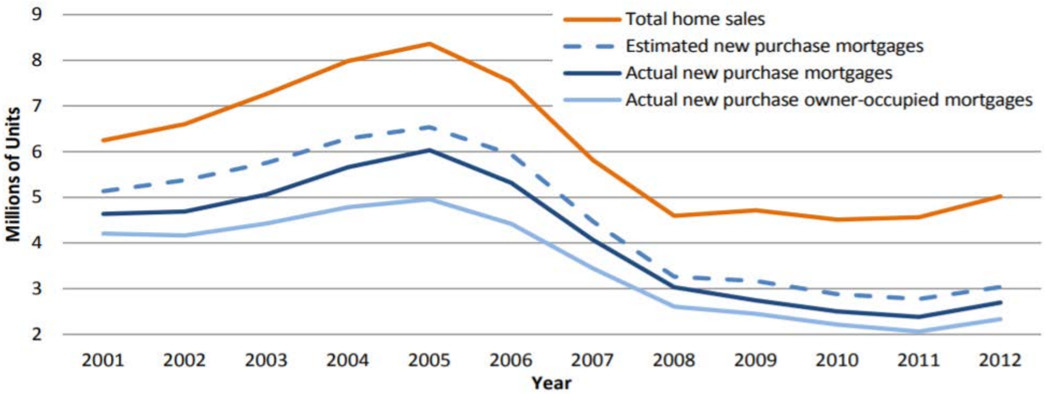
[3] Depository institutions also have access to the Federal Home Loan Bank system established by the Federal Home Loan Bank Act of 1932 as a government sponsored enterprise to support mortgage lending and related community investment. It is composed of 11 FHLBanks, with more than 8,000 member financial institutions. Each FHLBank is a separate, government-chartered, member-owned corporation.

by one of the federal agencies to work for a depository institution (bank or credit union). In fact, companies and MLOs can be both "actively" licensed and registered, known as "dual," depending on their business models.

The table below reflects numbers of companies and their licensed and registered MLOs (individuals) at the end of 2018. (Source: NMLS MCR data)

	Companies	MLOs
Nonbank	17,572	165,240 (licensed)
Depository	9,196	415,291 (registered)
Dual	88	6,957 (both)

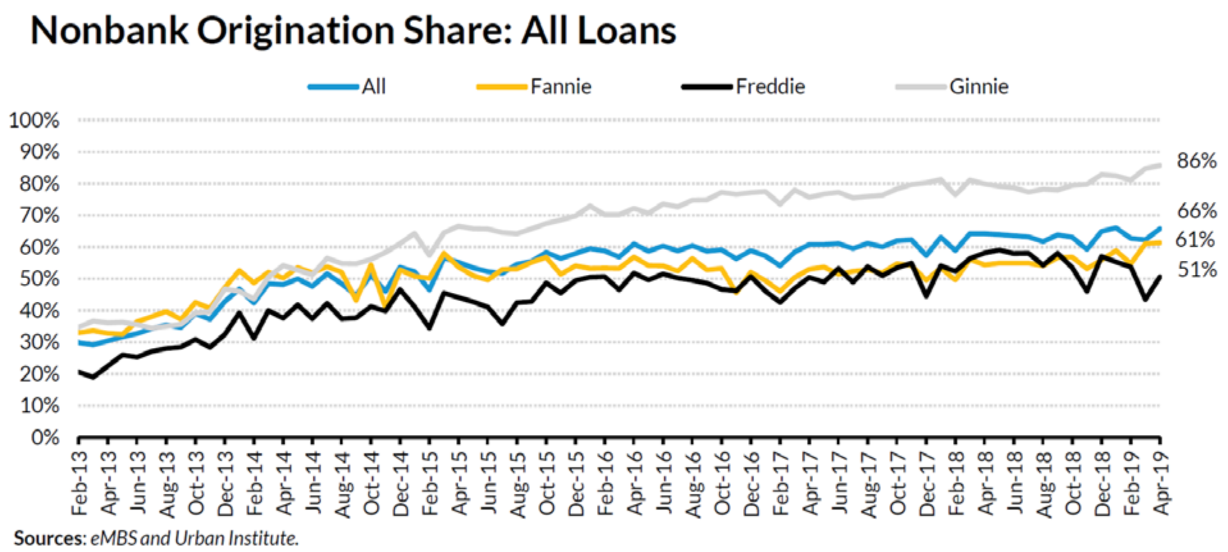
The financial crisis of 2007 – 2008 was a turbulent time for the mortgage industry. According to the Mortgage Lender Implode-O-Meter, a non-governmental web site tracking mortgage company closures monitored by regulators and industry throughout the crisis, approximately 308 mortgage lenders shuttered from 2006 through 2008. The chart below created by the Urban Institute based on home purchase activity alone is a good proxy for the status of the mortgage market before, during and after the crisis.



Sources: US Census Bureau, National Association of Realtors, HMDA, and Urban Institute calculations.
Note: Actual and estimated purchase mortgages include only first liens.

Through a combination of many factors following the financial crisis, the mortgage origination market has stabilized and grown, once again becoming a centerpiece of the United States economy. These factors included corporate failures, regulatory enforcement, new laws and rules, a new federal agency, safer products and the advent of the Nationwide Multistate Licensing System (NMLS) owned and operated by CSBS. [For more on NMLS, see www.nmls.org]

In 2018, banks and nonbanks together originated an estimated $1.65 trillion in loans (Urban Institute) and the current amount of mortgage debt in the United States (as of March 2019) stands at $10.3 trillion (St. Louis Federal Reserve Bank). Of the $1.65 trillion originated in 2018, nonbanks are estimated to be responsible for over 60% (NMLS, Urban Institute).



An important factor shown in the graph above is that nonbanks are currently originating 86% of the Ginnie Mae portfolio, comprised mostly of FHA and VA loans. These loans are an important source of financing for low-to-moderate income borrowers, minorities and first-time homebuyers. At the same time, these loans have a substantially higher risk profile than conventional originations (Fannie Mae/Freddie Mac), thereby raising the risk profile of nonbanks.

As with almost every industry, technology has had an impact on the mortgage origination industry. Companies both large and small advertise and originate through the internet and mobile apps. Technology is expected to continue to expand and improve the nonbank mortgage origination industry, but some subject matter experts believe that concerns that fintech companies will take over the mortgage business in the coming years are overstated. While consumers will be better able to take advantage of mobile technology to submit applications and obtain information to make decisions, this does not translate to a technology takeover of a business line requiring specialized knowledge and adherence to complex rules, guidelines and consumer protections.

The future of mortgage lending is an extremely complex topic with too many political, market and technology variables to make any accurate prediction. According to interviews with industry subject matter experts, the future of the mortgage industry is likely secure. Their reason is simple: people will continue to desire home ownership, and very few of them will have the money to purchase real estate outright. In fact, the number of millennials is approximately the same as the baby boomer generation upon which the mortgage industry was built. While millennials may purchase homes later due to economic reasons (e.g., student loan debt), or social reasons (e.g., starting families later), they will likely want to eventually purchase a home. These consumers will soon be aging into that 35-year-old cohort which buys homes, producing a potentially huge demand for purchase mortgages.

Mortgage Servicers

The business of mortgage servicing, also called loan administration, has evolved from an in-house accounting function at primarily depository institutions as recently as the 1980s to today's complex business activity that also encompasses multiple assets attracting a variety of bank and nonbank market participants and investors.

At its most basic level, mortgage servicing involves the lifeblood activity of a healthy mortgage market: the collection and recording of routine payments from mortgagors and application of those funds to the principal and interest balances, as well as disbursement of funds to pay insurance and taxes. Embedded in this function is investor and insurer or guarantor reporting, and remittance of payments to the investor (loan owner).

Other primary responsibilities of mortgage servicers include the following duties:

- Loan boarding and transfers from one servicer or system to another
- Cash management
- Customer service and billing
- Delinquency management and collections
- Loss mitigation, default management and loan modifications
- Managing foreclosed properties
- Maintaining adequate technology and systems
- Vendor oversight

Conducting these administrative services for investors earns fees and therefore the "right" to service these loans has significant value to the owner of the mortgage servicing right (MSR) [see insert].

WHAT IS AN MSR?

In basic terms, a mortgage servicing right (MSR) is the contractual right to service a mortgage loan. Effectively, an MSR is an asset if the net present value of the cash flows exceeds the cost of the servicer's obligations to service the associated mortgage loans. The MSR valuation is adjusted on a periodic basis to recognize changes in fair value based on portfolio and market conditions. For example, when mortgage rates rise, MSRs become more valuable as refinancing opportunities decrease and cash flows from MSRs have a longer life than under a lower-rate environment (where high rate loans are refinanced). The converse would be true when rates decrease.

Many factors have led to the evolution of this sector of the mortgage market; in the 1970s, it was the province of domestic thrifts and banks focused on an "originate-and-hold" model. Since then it has been transformed by technology, growth of the secondary markets, specialization of roles and the regulatory and legal landscape both pre- and post-crisis, as well as demographic and market shifts.

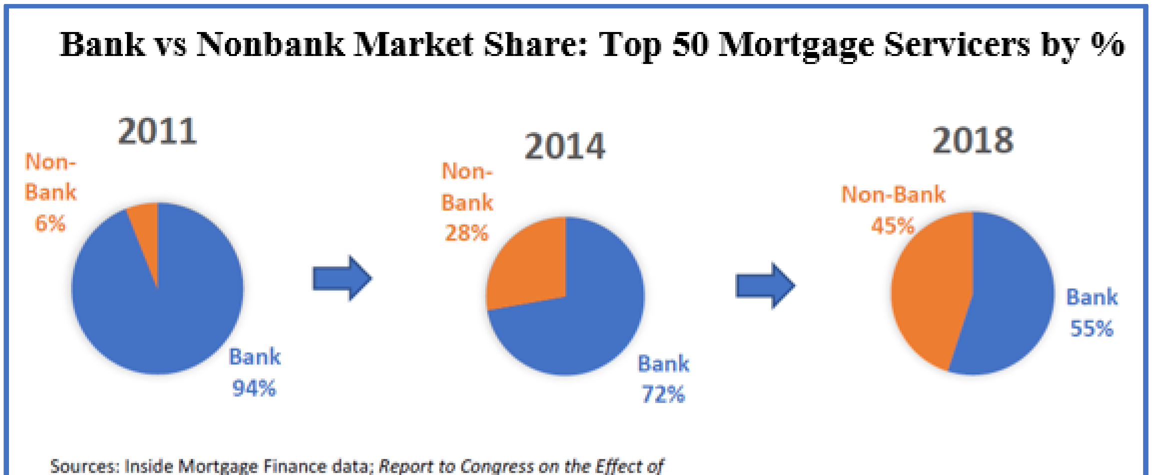
While basic operational functions of a mortgage servicer are the foundation of the business, this sector has transformed into today's market that includes companies engaging not only in the day-to-day business of servicing mortgage loans, but also those providing specialized component services (e.g. default servicing) to mortgage servicers, those providing a variety of financing and hedging options to mortgage servicers and others investing in and buying MSRs as a separate financial instrument. Market participants include traditional banks and thrifts, but also a variety of nonbank lending, servicing and investing entities participating in this market with a range of business models.

There was dramatic growth of nonbank servicers leading up to 2007 on the wave of nonprime lending in the 1990s and early 2000s, which led to an equally dramatic post-crisis shrinkage of the nonbank footprint in servicing as subprime and Alt-A mortgage products all but disappeared from the market. This contraction of the market largely wiped away the nonbank market share of servicing with some estimates reflecting a decline in market share of 82% from 2006 to 2010[4].

By 2011, large bank servicers controlled up to 94% of the mortgage servicing market, despite having been exposed as unprepared and unable to manage the high-touch servicing required by the credit crisis, which led to a forced nationwide moratorium on foreclosures in the fall of 2010 due to faulty processing of the immense volume of defaulted loans. Consent orders with federal banking regulators in April 2011, combined with the National Mortgage Settlement in early 2012 with 49 states and the U.S. Department of Justice and the U.S. Department of Housing and Urban Development, compelled the large banks to begin selling non-performing loans as well as MSRs on delinquent, defaulted and high-risk loan pools in bulk.

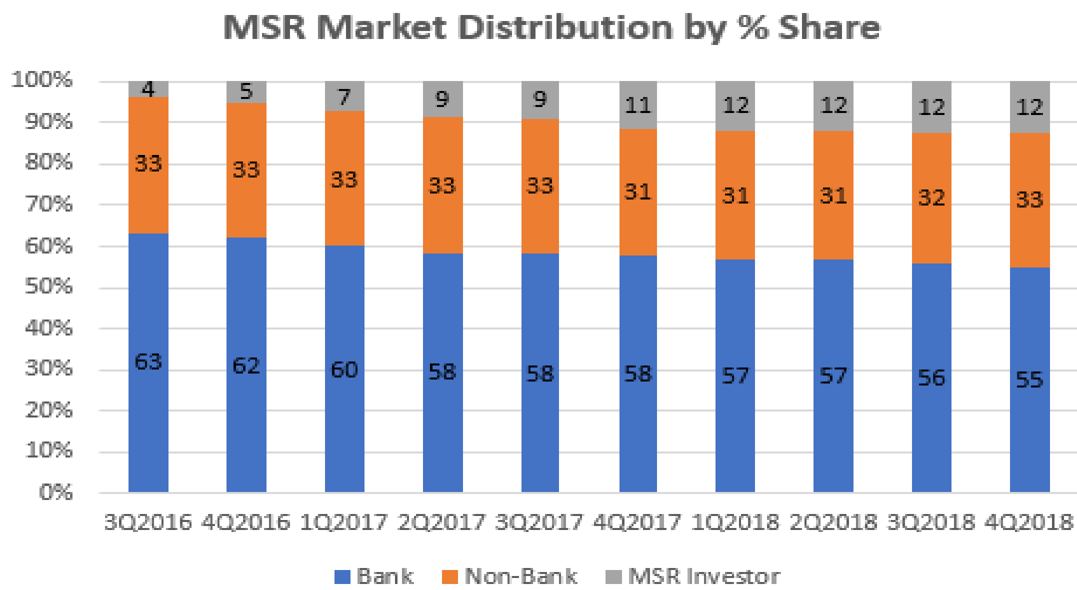
Nonbank "specialty" servicers, focused on troubled loans, stepped in to take over this business, typically buying large bulk portfolios of MSRs or entire servicing platforms directly from banks. In 2014, the Urban Institute estimated that "the volume of loans managed by nonbank specialty servicers has grown in recent years at a remarkable rate—between 30% and 350%—while servicing by the largest bank servicers has stagnated or declined."

The upshot as of 2019 is a mortgage servicing market with virtual parity between banks and nonbanks. The evolution has followed the crisis-era consolidation within bank to post-crisis movement to nonbanks, and now to the growing presence of "passive" MSR investors utilizing sub-servicers. The following charts show this evolution:



Sources: Inside Mortgage Finance data; *Report to Congress on the Effect of Capital Rules on Mortgage Servicing Assets*, Federal Reserve, June 2016.

[4] Kaul, Karan and Laurie Goodman, Urban Institute. 2016. "Nonbank Servicer Regulation". Accessed at http://www.urban.org.



Sources: Calculations from Inside Mortgage Finance data.

Today's nonbank mortgage servicing market appears deep and liquid, however potential risks in the market bear attention in the coming months and years. These risks include interest rate volatility and economic downturns, as well as the possibility of banks returning more robustly to the market. In subsequent chapters we will discuss these risks more fully and how a thin capital and liquidity cushion at nonbanks can jeopardize the health of the industry, raising risks for consumers and cautions by regulators.

Introduction to Money Services Business

Money services businesses (MSBs), and specifically money transmitters, play a vital role in providing financial services to consumers and small businesses across the country. Countless Americans use MSBs every day to pay bills, purchase items online or send funds to family members and friends domestically and abroad. MSBs are especially integral to those less likely to use traditional banking services. Over one-quarter of U.S. households use nonbank financial institutions, including money transmitters.[5]

The term MSB is very broad and describes many types of business models. Further confusing the matter is the diversity of products some MSBs offer: a check casher might issue money orders, a bill payer might issue prepaid cards, and a money transmitter might also provide a stored value product. However, except for check cashers, all MSB activities are subject to similar financial, consumer, and procedural requirements. This makes sense: check cashers provide customers with funds, while the other activities involve customers giving the company funds.

Pursuant to the Uniform Money Services Act amended 2004 (UMSA), MSBs are nonbank entities that do not accept deposits or make loans like traditional banks or financial institutions. Rather, they provide

[5] U.S. Department of Treasury, National Money Laundering Risk Assessment, June 12, 2015. https://www.treasury.gov/resource-center/terrorist-illicit-finance/Documents/National percent20Money percent20Laundering percent20Risk percent20Assessment percent20– percent2006-12-2015.pdf.

alternative mechanisms for persons to make payments or to obtain currency or cash in exchange for payment instruments. MSBs engage in the following types of financial activities:

- money transmission (e.g., wire transfers);
- the sale of payment instruments (e.g., money orders and traveler's checks);
- Prepaid or stored value (e.g. prepaid cards and digital wallets)
- check cashing; and
- foreign currency exchange.

As defined by the Financial Crimes Enforcement Network (FinCEN), an MSB includes anyone doing the business described by the UMSA plus the U.S. Postal Service.

While all states except Montana have passed laws covering MSBs, no two laws are identical and some lack basic similarities. Even the 12 states adopting the UMSA have differences or different interpretations of the law. All of this makes describing the regulation of MSBs difficult, but not impossible.

For this paper we use the term MSB to mean state supervised nonbanks providing the services of money transmission and check cashing. Money transmission will be used broadly, encompassing funds transfers, sale of payment instruments, and prepaid or stored value. Following is a description of each of the current business types and services included in our use of the term MSB:

Money Transmitters

Money transmission is the selling or issuing of payment instruments, stored value, or receiving money or monetary value for transmission. (UMSA)

- Money transmitters conduct the business of accepting and transmitting funds.
- Sellers of payment instruments, sometimes called check sellers, conduct the business of selling checks, drafts, money orders, or other commercial paper that consumers and businesses use for transmission of money or payment for goods and services (e.g., payment of a utility bill).
- Prepaid/stored value providers hold monetary value evidenced by an electronic record, such as a prepaid card or a digital wallet.
- Foreign currency exchangers exchange the money of one government for money of another government.

FITTING VIRTUAL CURRENCY INTO THE LANDSCAPE

Virtual currency is a digital representation of value used as a medium of exchange, a unit of account, or a store of value, but does not have legal tender status as recognized by the U.S. government. Virtual currency does not include the software or protocols governing the transfer of the digital representation of value. Virtual currency does not include stored value redeemable exclusively in goods or services limited to transactions involving a defined merchant, such as rewards programs. (STATE REGULATORY REQUIREMENTS FOR VIRTUAL CURRENCY ACTIVITIES CSBS MODEL REGULATORY FRAMEWORK Sept. 15, 2015)

When virtual currency is used in lieu of money (fiat currency) for any of the activities included under money transmission, the activity is typically still considered money transmission.

Check Cashers

Check cashing is receiving payment for cashing checks. A consumer or business presents a check (often a paycheck) to the check casher and receives the amount identified on the check less a fee (typically a few dollars). The check casher then presents the check to the issuing bank for payment, taking the risk that the check will not be honored as good funds.

MSBs and Fintech

Consistent with CSBS policy,[6] many states do not differentiate the above listed activities when performed with virtual currency in lieu of money (fiat currency).

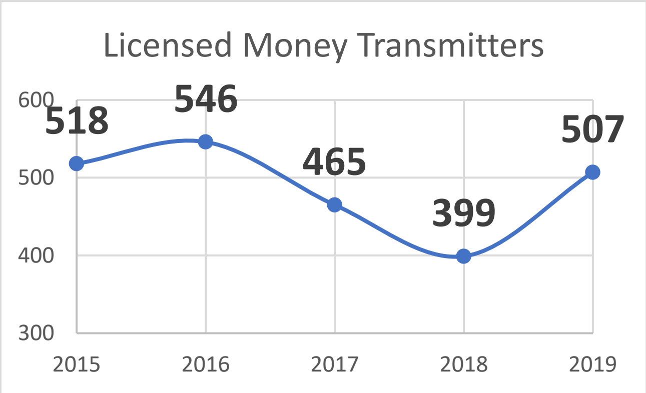
MSBs were early fintechs, leveraging technology to create new business models, new delivery channels, automated decisions, and partnerships with traditional banks. Moving money across continents and across oceans inherently requires technological innovation. While MSBs are at the cutting edge of technology today, their history of deploying advanced technology goes far back in time to the telegraph and international undersea cables for transmission of money.

Size and Scope of the MSB Industry

A dynamic shift has occurred in the money transmission industry over the past decade. Of the 64 currently operating licensees that were formed in the 1990s, 78% utilize an agent-based business model, where people handle the transaction. Since 2010, conversely, 75% of the 133 newly formed companies utilize a business model without agents but facilitated by technology.

The impact on the market by these firms has been astounding. Using NMLS data, CSBS can identify fintechs by putting parameters around the data of fintech companies. Using conservative estimates, fintechs collectively accounted for more than 55% of all transaction volume in 2018.

The states have held exclusive jurisdiction over MSBs for over a hundred years. State supervision of MSBs began at the turn of the 20th century when states began protecting their resident's funds as immigrant populations sent money by steamship back to Europe and Asia. The earliest state money transmitter laws as we know them – licensure with the state banking department and bonding requirements – date back to 1907.



One Market, Multiple Segments, Stiff Competition

Since 2015, the average state has seen a 68% increase in licensees, from 69 to 116 licenses. The state-by-state licensing increase reflects the geographic expansion of a handful of very large companies that now dominate the market. As of Q1 2019, a total of 71 companies are licensed in 40 or more states, compared to just 37 in 2015—an increase of 92%. These 71 companies

[6] Model Regulatory Framework for Virtual Currencies, *available at* https://www.csbs.org/model-regulatory-framework-virtual-currencies ("... activities involving third party control of virtual currency, including for the purposes of transmitting, exchanging, holding, or otherwise controlling virtual currency, should be subject to state licensure and supervision.").

are responsible for 80% of the $1.39 trillion transacted in the United States in 2018. The four very largest were alone responsible for 60% of all funds transferred or stored, each transacting over $100 billion in 2018.

Accordingly, while states have exclusive jurisdiction within their borders, the money transmission business is national – and often global – in nature. As companies transcend state borders, state sovereign jurisdiction itself automatically transforms into one of shared supervision, creating compelling arguments that the only way to effectively regulate is as a streamlined “state system” utilizing collective resources on a national basis (to be discussed in a future chapter).

How much money moves through MSBs?

In 2018, state licensed MSBs moved over $1.39 trillion in funds. This is a significant increase from 2017.

Sector	2017 Total $ Volume	2018 Total $ Volume	Year Over Year Change
Money Transmission	$684.3 billion	$831.5 billion	22%
Payment Instruments	$189.9 billion	$175.2 billion	-8%
Stored Value	$229.3 billion	$294.9 billion	29%
Check Cashing	$16.8 billion	$14.1 billion	-16%
Currency Exchange	$4.4 billion	$5.4 billion	23%
Virtual Currency	$11.5 billion	$69.5 billion	504%
Total:	**$1.13 trillion**	**$1.39 trillion**	**23%**

Introduction to Consumer Finance

While the term “consumer finance” can be a very broad reference to any financial transaction involving a consumer, for the purposes of this paper, we cover consumer finance or consumer lending narrowly as a subset of lenders that are not mortgage lenders. Even with this narrowed coverage, consumer finance is one of the broader categories of participants within the nonbank marketplace. It includes companies that make consumer loans (secured and unsecured) for personal, family or household purposes, including personal loans, auto loans and student loans; as well as consumer lending companies that provide small dollar credit, which includes payday loans, and vehicle title loans, a class of high-interest credit secured by the borrower’s vehicle title. The categories of consumer loans can be perplexing as state law and licensing requirements may include any or all these loans in a master consumer finance law, or in separate laws covering each loan type individually.

In addition to the company types or products identified above, consumer finance products can be marketed and provided to borrowers in many ways: physical retail locations, over the phone, through the mail, online via the internet and mobile device apps. The structure of loans is relevant as well; bifurcated into categories of installment (equal payments over time) and single pay, as well as single pay that become installment loans. In this section on consumer finance, some of the marketing and delivery mechanisms are briefly discussed, as well as other products that may be considered part of consumer finance; however, the primarily concern is the five product types identified above.

USURY RATE

Most states have established a usury rate that cannot be exceeded unless an entity is specifically excepted or exempt from the usury statute. State laws establishing legal loan rates vary from 5% to 30%. Consumer loans and legalized payday and vehicle title loans enjoy exemptions from state usury limits provided the entity is licensed to conduct the authorized business. However, a license in one state does not provide a lender the authority to "export" its rates to another state. The lender must be appropriately licensed in each state where its loans exceed the rate of usury.

Consumer finance products are widely popular with the "unbanked" and "underbanked" as well as consumers that simply do not like banks or credit unions. However, even bank customers rely on consumer finance companies to meet their credit needs (note that a requirement of a payday loan and online lending is that the borrower have a checking account). Consumer lending is the practice in which money is lent to an individual (secured and unsecured) for personal, family or household purposes, also known as consumptive debt or personal loans. Typically, these loans will be repaid in installments.

Auto loans are used for the purchase of new and used cars and are secured by the car itself. Auto leases are included in this category as well.

Small dollar credit, sometimes called microloans, includes payday and vehicle title loans, with loans typically being less than $5,000. Small dollar credit may be provided online or through brokers marketing on the internet. Typically, these loans will be repaid in a single payment that includes both the borrowed amount and the fee or interest. An estimated 15 million people annually use these products to meet their financial needs. (Center for Financial Services Innovation, n.d.)

Vehicle title lending, or title lending, is a short-term, high cost loan that is secured by the title to the borrower's vehicle and payable in single or multiple installments. Vehicle title lending is not auto lending. Vehicle title lending is supervised by less than half of state nonbank financial regulators.

Online lending is the delivery mechanism for both single payment and installment products. When consumers conduct online searches for loans, lead generators or brokers send consumers to companies offering loan products in the consumer's state.

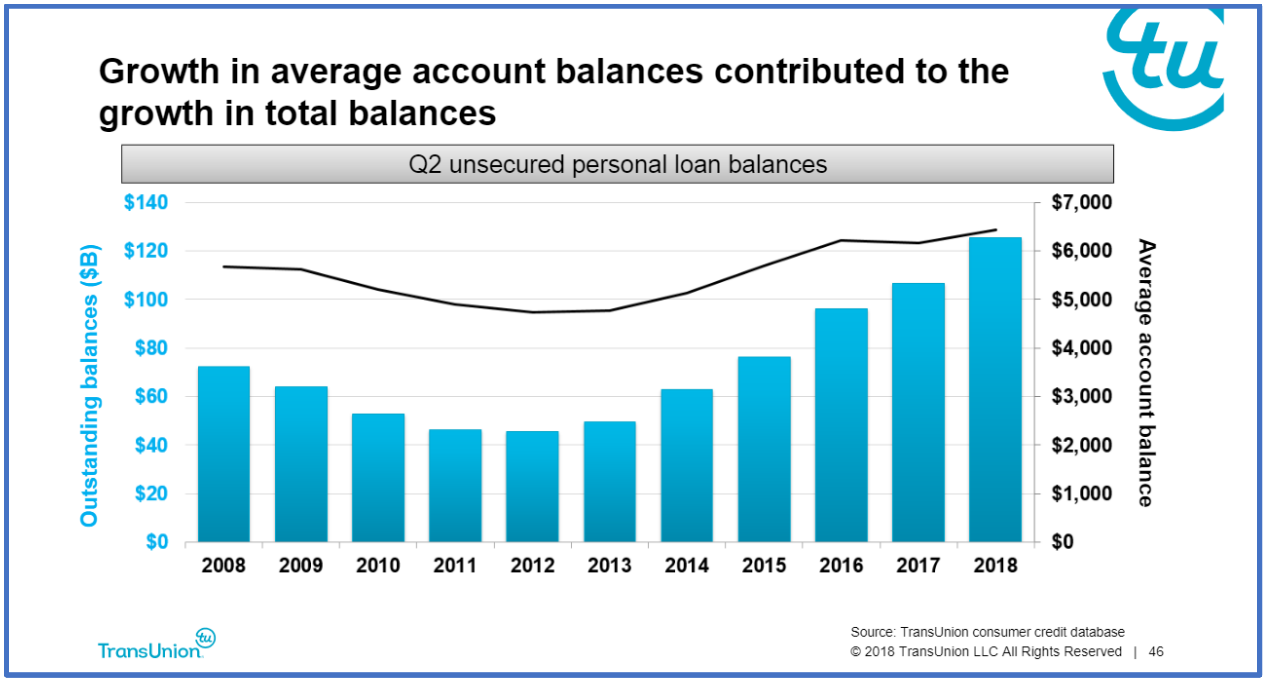
Other products such as pawn loans, check cashing (discussed under The MSB Industry), and retail installment sales contracts vary by coverage and may or may not be considered extensions of credit or loans.

The above product areas and industry participants are discussed in greater detail below.

Personal or Consumer Lending

Personal loans may be secured or unsecured. They are frequently made for amounts ranging from $1,500 to $30,000 and for periods of time ranging from two years to five years with payments due monthly. Common interest rates range from an annual percentage rate of around 16% to 36%, depending on market conditions.

While we do not yet have data on the nonbank personal loan market, analysis by national credit bureau TransUnion from Q2 2018 placed outstanding unsecured personal loan balances at a high of $125.4 billion, up 17.5% from the previous year, based on 19.5 million accounts, up 12.5% since Q2 2017 (the largest public filer in this sector reported $12 billion in loans for 2018). TransUnion estimates the delinquency rate on personal loans to be 3.21%, which was up slightly from 2017. The TransUnion graph below shows origination volume growing with the average personal loan at approximately $6,400 in the first quarter of 2018.



TransUnion's Q4 2018 Industry Insights Report found that personal loan balances increased $21 billion in the last year to close 2018 at a record high of $138 billion. Much of this growth was driven by online loans originated by fintechs, often referred to as "peer-to-peer," "marketplace" or "platform" lending, connecting borrowers to investors who are willing to buy or invest in the loan. Borrowers repay the loan in installments which cover the loaned amount plus fees and interest.

Auto Lending

When a consumer finances a motor vehicle purchase through a bank or nonbank lender the terms of the loan dictate that the lender is purchasing the car for the borrower with an agreement the borrower will pay back the loan over a predetermined length of time, plus interest.

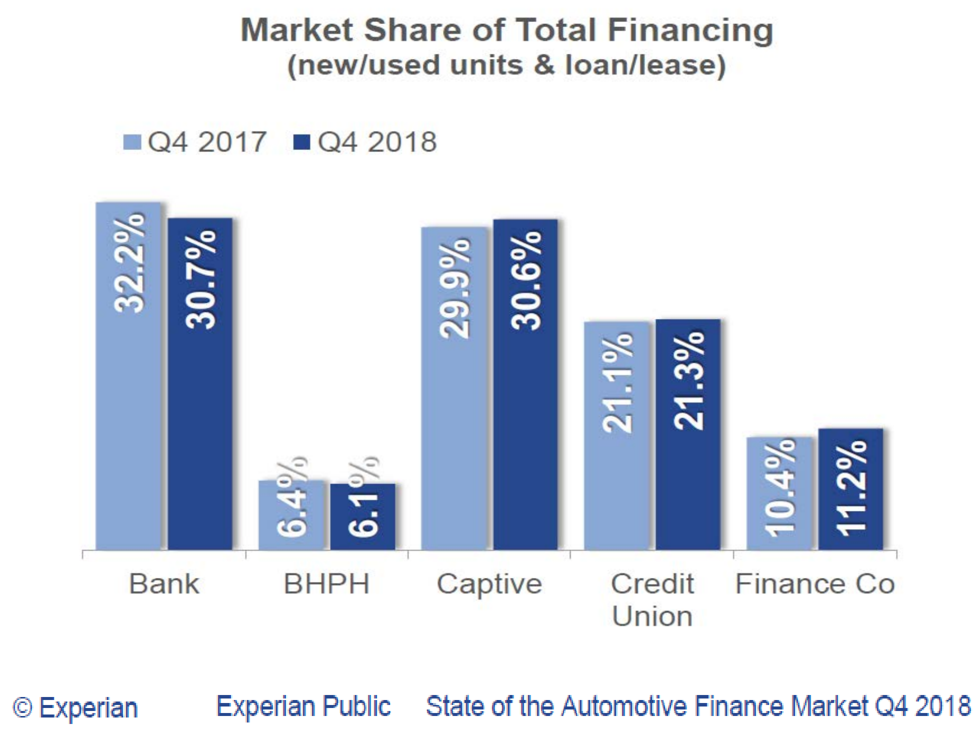
The table below identifies market share of the auto finance industry for Q4 2018. Nonbanks include captive lenders affiliated with the auto manufacturer and independent finance companies. Together, this nonbank sector makes up $463.8 billion, or 39%, of the financing market for both new and used cars.

Auto Finance Industry

Industry	Market Share	Volume
Banks	31.2 %	$ 368,200,000,000
Credit Unions	29.4 %	$ 346,300,000,000
Captive Lenders (mfr affiliated)	22.2 %	$ 262,100,000,000
Independent Finance Companies	17.2 %	$ 201,700,000,000
	100 %	$ 1,178,300,000,000

(Source: Experian. Loans no leases)

An additional participant in the auto finance market is "buy here pay here" or BHPH. BHPH financing is facilitated by the car dealership itself. These loans are often made to borrowers who have difficulty obtaining financing through one of the four lender types in the table above. The following graph shows change in the market with growth towards nonbanks and includes both loans and leases, as well as BHPH dealerships.

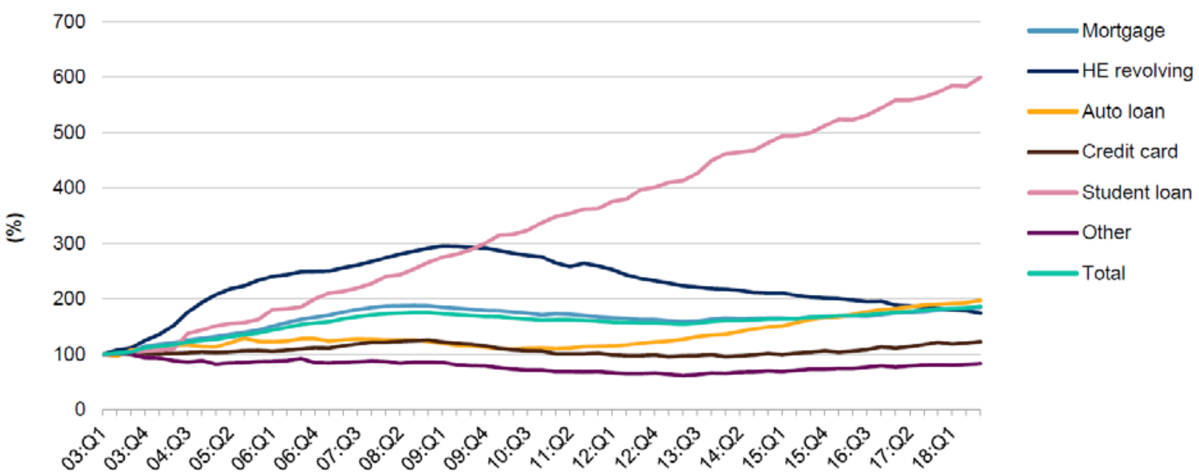


Student Loans

Outstanding student loan balances currently comprise $1.6 trillion owed by approximately 45 million consumers. Federal Direct Loans and other government-owned education loans comprise the majority of this segment of the consumer finance market. Privately held federal and private label student loans have been decreasing for some time and comprise around eight percent of the market today. (Source: U.S. Department of Education)

According to Standard & Poor's Financial Services LLC, "[T]he total balance of student loans is now almost 6 [times] what it was in 2003. No other segment of consumer debt has a balance more than 2 [times] what it was in 2003 as student loans have grown for longer and more consistently than all other forms of consumer debt."

Consumer Debt Growth Trends, First-Quarter 2003 Outstanding Balance = 100%



Source: Federal Reserve Bank of New York.

State regulator coverage of student lending is a complex topic. Some states claim jurisdiction over student loans regardless of the lender or source of funds and some states have jurisdiction over private colleges making loans. Usury limits may or may not apply to student loans. Much of student lending under government programs is financed by banks outside the jurisdiction of state nonbank regulators. However, several states have jurisdiction over the servicing of student loans, including loans made by banks but serviced by student loan servicers.

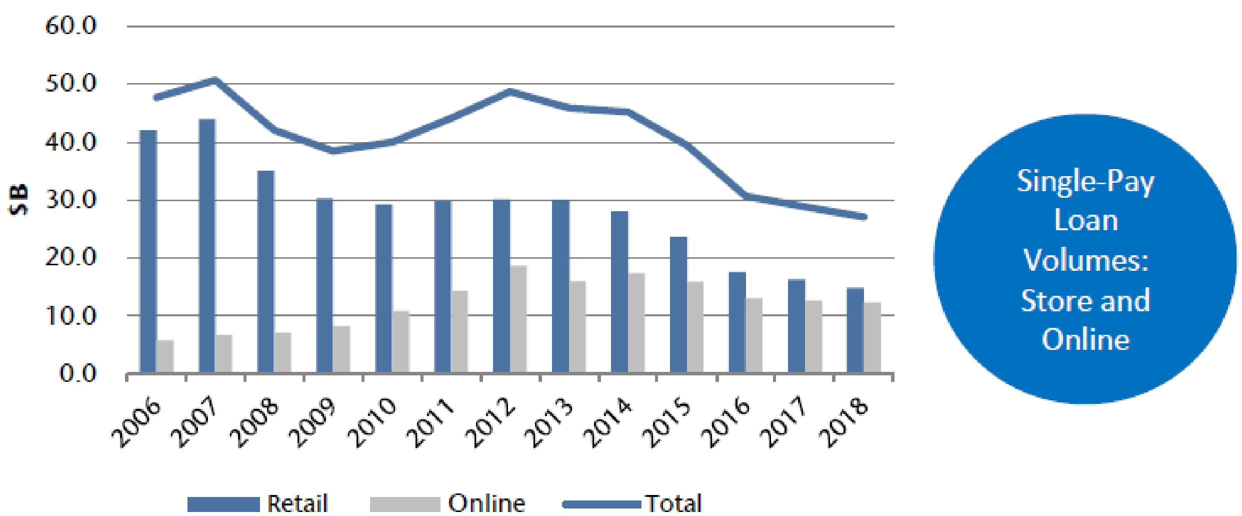
Small Dollar Credit

Small dollar credit is comprised of payday lending, vehicle title lending and online brokering/lending. The process involves the lending of money to borrowers via these products under state specified terms and conditions. It is a demand-driven business backed by the statistic that nearly half of all Americans live paycheck to paycheck and cannot come up with $2,000 in the event of an emergency (Servon, 2017). According to the Consumer Financial Services Association of America (CFSA), this number could be closer to $400, and 40% of Americans report that they spend more than they earn.

Payday lending (also known as deferred deposit loans), is accepting personal checks or an authorization to electronically debit payment from that person's account and giving that person money that is equal to the check/debit minus a transaction fee. The lender agrees not to cash the check or process the debit until an agreed-upon date, by which time the borrower is expected to pay off the loan, so the check is not cashed.

According to John Hecht of Jeffries LLC, payday lending volumes for both store front and online lending decreased significantly from 2015 through 2018. Over this four-year period, volumes fell approximately 26% from $39.5 billion to $29.2 billion.

Payday Lending Market



Source: CFSA, Company documents, Jefferies estimates
Based on company information from ACE Cash Express, Check into Cash, CNG Financial, Cash America, Enova, QC Holdings, Community Choice, Speedy Cash
Note: Industry data includes annualized figures for ACE Cash Express, Check into Cash, CNG Financial, QC Holdings, Community Choice

According to the Consumer Financial Protection Bureau (CFPB), the primary channel through which consumers obtain payday loans, as measured by total dollar volume, is through state-licensed storefront locations; however, about 50% of total payday loan revenue is generated through online lending. According to one industry analyst, there were an estimated 14,348 storefronts in 2017, down from the industry's peak of over 24,000 stores 10 years earlier. In 2017, the Bureau noted that there were at least 10 payday lenders with approximately 200 or more storefront locations. CFPB estimates that the number of consumers using payday loans may be as high as 12 million. (Source: https://www.regulations.gov/document?D=CFPB-2019-0006-0001)

CSBS research shows that 33 states license payday lenders and seven states specifically identify payday loans as illegal. Eleven states have laws that make payday loans impractical because of usury or allowable interest rate limitations (inclusion of Washington D.C. in this category equals 51 states).

Vehicle title loans are a type of credit product in which the lender takes a security interest in the borrower's vehicle and the loan approval and amount is primarily based on the vehicle's value, rather than a credit check and traditional underwriting. While some vehicle title loans are structured to be repaid with a single payment due in about 30 days, … [others] … have longer loan terms and are repayable in installments. Vehicle title installment loans are available in 18 states, some of which allow both single-payment and installment loan structures. In a 2016 study by the CFPB, the median APR on a vehicle title loan was 259%. (ConsumerFinance.gov, 2016)

Online loans are not so much a type of product as a means of marketing and providing small dollar credit. Here online loans are differentiated from the fintech product discussed above by the dollar amount and payment structure: smaller loans (e.g., $500 to $2,000) and single payment or installment structure. While online loans may not be marketed as payday loans, they are typically thought of as payday or deferred presentment loans made online.

The process for online loans involves the consumer shopping online and submitting an online application. The lender might approve them instantly or require copies of paystubs or proof of residency, depending on the lender and type of loan.

As mentioned above, online borrowers must have a checking account, as the money loaned via an online lender is deposited into a bank or credit union account and usually repaid by an automatic debit to the same account. According to the Online Lenders Alliance (OLA), lenders require automatic debit or Automatic Clearing House (ACH) for payment of 90% of these loans.

According to Clarity Services, a part of Experian, the volume of online payday (single payment) loans roughly doubled from 2014 to 2018, and the volume of online installment loans grew 7.4 times during the same period. The number of unique borrowers for online installment loans has increased by approximately 30% yearly for the past three years, while unique borrowers declined for online single pay loans over the last two years. Based on the data, it appears that single pay borrowers are more likely to exit the online market or migrate to online installment loans. Further, Clarity research shows that there has been a trend toward higher online loan amounts over the last five years. For example, the percentage of funded loan amounts between $500 and $2,000 represented 43% of all loans in 2014 and increased to 60% in 2018.

The CFPB's 2016 report, Supplemental findings on payday, payday installment, and vehicle title loans, and deposit advance products, compares small dollar credit installment loans for vehicle title, storefront payday and online payday. (see table below)

	Loan amount (average)	Loan amount (median)	APR (average)	APR (median)	Payment frequency
Vehicle title installment loans	$1,098	$710	250%	259%	Bi-weekly or monthly
Payday installment loans (all)	$1,291	$1,000	268%	249%	Weekly, bi-weekly, semi-monthly, or monthly
Sub-set of payday installment loans by origination channel					
Storefront payday installment loans	$1,295	$1,000	237%	248%	Weekly, bi-weekly, semi-monthly, or monthly
Online payday installment loans	$2,122	$2,400	279%	221%	Bi-weekly or monthly

Today's consumer finance industry faces challenges ranging from technology to regulation. Technology brings innovation to consumers, opportunity to lenders and competition to the market. While some companies have embraced technology, providing all their services online, others remain firmly rooted in "brick and mortar" retail locations, while many have become hybrid companies offering products in both physical and virtual places. Feeding the technology challenge is consumer expectation of convenience and almost instant access to services.

Complying with a myriad of state-specific rules, regulations and licensing requirements further challenges the industry. Today, this challenge manifests itself primarily with those lenders embracing technology to reach consumers across multiple jurisdictions. But each state has unique requirements that consumer finance lenders must comply with, making it more challenging for companies seeking expansion through the internet.

No overarching legislation similar to the federal SAFE Act for mortgage lending has been proposed for the consumer finance industry. State licensing requirements are varied and limitations on loans are applied differently from state to state. In some states, loans are categorized by dollar amount borrowed, but not in other states. Some states have requirements controlled by loan type or loan purpose, and most states differ on dollar limits, and allowable rates, fees, costs and add on products. Conducting a consumer finance business requires an understanding of a very technical industry with a patchwork overlay of laws. But to the consumer, any type of credit is just a loan, despite these challenges faced by lenders.

Introduction to Debt Collection

Most consumers do not want to be in debt, much less delinquent, but the situation often occurs after one of three major life events changes their payment plan: a divorce, an unexpected job loss or a medical issue.

According to a 2014 study by The Urban Institute, roughly 77 million Americans, or about one third of adults, have a debt in collection (not including mortgage debt) such as a credit card balance or medical or utility bill that is more than 180 days past due and has been placed in collections. (Unifund, n.d.)

Debt collectors collect consumer and non-consumer debt. Consumer debt refers to debt created to buy things that can be consumed. The debt collection industry can be categorized into two major groups, with companies often conducting business in both:

Debt Collection for Others: Known as third-party debt collectors or collection agencies, these businesses contract with creditors to collect on bad debt, receiving a fee for their efforts.

Debt Buyers: Companies that purchase delinquent debt from creditors and then collect on that debt, generating revenue from the difference between the cost of debt and the amounts recovered.

FAIR DEBT COLLECTION PRACTICES ACT

In 1977, the Fair Debt Collection Practices Act (FDCPA) created collection standards, regulating how, when and by whom people can be contacted by debt collectors. It is an amendment to the Consumer Credit Protection Act, as Title VIII of that Act.

Debt collection and receivables portfolios are outsourced to third parties like many other business services, for example, payroll services. At some point, it is not cost effective for creditor companies to keep debt collection servicing in-house. Generally, creditors do not want to be debt collectors, and most creditors enlist third-party debt collection agencies at some point in the collection process. Debt collectors act as separate companies under contract with a creditor to collect debts on their behalf for a fee. As a last resort, creditors sell off their debt portfolio to reclaim a portion of what is owed. For instance, a private student lender will sell a portfolio of defaulted loans as the last stage of the lender's debt recovery attempts.

Industry subject matter experts identify several benefits to creditors using third-party debt collectors:

- They are specialized and regulated. Some collectors only deal with healthcare collections while others will work with credit cards. The Association of Credit and Collection Professionals (ACA International) reports 60% to 70% of its members work in the healthcare debt collection space.
- They are experts in the proper methods of communicating regarding delinquent accounts. They know the why, where and how of legally contacting consumers.
- They understand compliance under the FDCPA. For a creditor, it is not efficient or economical to train staff on debt collection compliance, in addition to other responsibilities.

Debt buyers are considered debt collectors even though they own the accounts. According to the Receivables Management Association International, the ability of debt buyers to purchase distressed accounts from originating creditors provides benefits to originating creditors and to consumers and businesses that rely on available credit and reasonable interest rates for their purchasing needs. (Receivables Management Association International White Paper – the Debt Buying Industry – April 2015)

Today, debt buyers most often purchase medical or telecommunications accounts, and occasionally the debt assets of a collection agency going out of business. They then offer debt settlements to consumers, earning revenue from the difference between purchase price and settlement amount.

Most debt collection takes place in the verticals of revolving student loans, credit cards, auto finance, mortgage lending, and medical expenses. Debt collection has evolved from a less-than reputable industry to a regulated profession. In 2016, the debt collection industry reported it employed 129,000 people and paid employees $4.9 billion. Industry participants combined returned $67.6 billion to creditors. (International Association of Collection Services, n.d.)

Unfortunately, bad debt is likely here to stay, whether it be in large volume via the aforementioned areas or in smaller numbers reflected in library fines, back child support, utility payments, court fees, or parking fines. As long as unpaid debt exists, creditors will need debt collectors to assist in recovery. Yet despite this integral role in the credit system, debt collectors are often stigmatized as a source of consumer harm, largely stemming from earlier questionable collection practices. According to industry participants, there are two questions for debt

A GLOBAL VIEW OF HOUSEHOLD DEBT

CONNOR HAYS NOVEMBER 2018

BLOOM ECONOMIC RESEARCH DIVISION

United States – [W]hile household debt levels and ratios fell immediately in the wake of crisis as consumers deleveraged, household debt has been back on the rise in absolute terms since 2012 and surpassed pre-crisis levels in 2016. As of the second quarter of 2018, U.S .household debt outstanding stands at $15.4 trillion. ... Given that the United States has surpassed its pre-crisis peak in household debt there has been some consternation among policymakers and commentators, with the New York Times remarking, “Americans have now borrowed more money than they had at the height of the credit bubble in 2008, just as the global financial system began to collapse.” Sam Fleming, writing for *Financial Times* (Bloom Economic Research Division, 2018), notes that increasing household debt has “exposed some categories of borrower to financial strain as they try to keep up with their obligations.” Financial strain is beginning to show up in the credit card market, as overdue credit card debt touched a seven-year high in early 2018. Increasing strain is especially true for student borrowers, who have had to take on ever increasing amounts of debt in order to finance their educations and keep their heads above water within the labor market. And while the Great Recession was precipitated by subprime mortgages and a cascade of defaults, it’s not the mortgage market that is facing a slew of loans in arrears, but the student loan market where the delinquency rate has shot up to worrisome highs. Student loan debt doesn’t present the same type of systemic risk as mortgage debt does in the United States, but if incomes remain stagnant, rising interest rates could push a significant portion of borrowers into serious delinquency or default. Given that debt has been fueling consumer spending, a hit to a large portion of student borrower’s creditworthiness and thus their ability to take on loans for other purchases such as homes, cars, and consumer goods, could precipitate a credit crunch or greater macroeconomic downturn.

collectors: What is the most efficient way to collect debt and how can the industry rid itself of its stigma?

Experts believe the industry is in transition, with fewer collection agencies in existence today than a decade ago. There is a high barrier of entry since agencies need to be licensed in every applicable state in which they operate. In addition, as the economy changes and grows and debt collection becomes more technology-oriented, many mom-and-pop debt collectors are closing or being absorbed by larger companies which can keep abreast of federal and state regulations.

The end picture of nonbank lending is debt and the entire nonbank marketplace needs to become anticipatory of the issues that will arise as a result. The amount of household debt in this country stood at $15.6 trillion year-end 2018 (Federal Reserve Board of Governors).[7] Add to this medical debt and other unpaid accounts and Americans have an extraordinary amount of debt. People have longer life spans, less savings and greater debt along with expectations that are becoming difficult for them to satisfy. Consumers have desires for more goods and services and little patience for delays in obtaining them (e.g., high-priced automobiles, online food service, Amazon purchasing), which may result in increasing or hastening the accumulation of consumer debt. This means the number of people able to pay this increasing debt on time and in full is likely to decline.

Introduction to Credit Reporting

The nonbank marketplace also includes the credit reporting industry. This segment of nonbank industries typically does not provide services directly to or for consumers, but rather provides information about consumers to users and creditors. Due to the amount and type of consumer credit and personal information obtained, held and furnished, the credit reporting segment is a vital part of the nonbank marketplace.

In simple terms, a credit reporting agency (CRA) is a third party that assembles, evaluates or retains a variety of consumer financial information. A credit bureau is not formally or legally defined, but it is a third party that holds and provides that consumer information to make a credit decision. Credit bureaus are considered a narrow field of CRAs, so not all consumer reporting agencies are credit bureaus, but all credit bureaus are consumer reporting agencies.

There are three national credit bureaus: Equifax, Experian and TransUnion, and a host of regional or local CRAs. According to the Fair Isaac Corporation (FICO), "[W]hile most of the information collected on consumers by the three credit bureaus is similar, there are differences. For example, one credit bureau may have unique information captured on a consumer that is not being captured by the other two, or the same data element may be stored or displayed differently by the credit bureaus."

In a February 2019 report to Congress, the U.S. Government Accountability Office identified the following "participants" in the consumer credit process:

- Consumers are individuals whose information is collected and shared to make eligibility decisions, such as for credit, insurance or employment.

[7] Board of Governors of the Federal Reserve System, Z.1 Financial Accounts of the United States, 19 https://www.federalreserve.gov/releases/z1/20180920/html/d3.htm.

- CRAs are companies that assemble or evaluate consumer information for the purpose of furnishing consumer reports to third parties who use the reports to determine consumer eligibility for employment, or products and services such as credit and insurance.
- Furnishers are entities such as nonbank lenders, banks or credit card companies that provide CRAs with consumer information (e.g., account openings, bill payments or delinquency information). CRAs use this information, along with other information, including from public records such as bankruptcies, to compile consumer reports.
- Users are nonbank lenders, banks, credit card companies, employers or other entities that use consumer reports to make eligibility decisions for individual consumers. Users vary in the specific information they request from CRAs and how they interpret the data. Some institutions, such as nonbank lenders, may act as both furnishers and users.

There are also vendors who provide data (including public records) to consumer reporting agencies, generally for a fee.

In January 2019, the CFPB listed 48 consumer reporting companies. They are regulated, supervised and examined via federal agencies, state attorneys general, state regulators, and the private rights of action in federal and state courts. Currently, only Maine licenses these companies, while Maryland requires registration. Maine, Maryland and New York hold enforcement authority. At this writing, additional legislation is pending in New York and Illinois.

Introduction to Non-depository Trust

An additional participant in the nonbank marketplace is the non-depository trust, a company that fulfills a fiduciary[8] responsibility to consumers and provides investment advice. It operates like the trust department of a bank but does not take deposits or make loans. These trust companies are usually independent businesses or operated by independent investment banks and financial services firms. The trust's focus is fiduciary, acting as a trustee or guardian in the administration of funds, estates, stock transfers and registration, and other related services. These trust companies, also known as independent or corporate trust companies, are different than family trusts because they are chartered to provide fiduciary services to the public. They may have hundreds or thousands of clients while family trusts may serve one or a few families.

A non-depository trust is created when a trustor gives another party, the trustee, the right to hold title to property or assets for the benefit of a third party, the beneficiary. Trusts are established to provide legal protection of the trustor's assets.

These trust companies are regulated by the states in which they are chartered and registered to conduct business, or if they are chartered under the National Bank Act, by the Office of the Comptroller of the Currency (OCC). Most non-depository trust companies are state-chartered and examined regularly. The total number of "pure" non-depository trust companies in the U.S. is estimated to be around 400, with 345 of these holding state charters and 55 holding national charters. (April 2019, Thomas C. Blank, Shumaker, Loop & Kendrick, LLP)

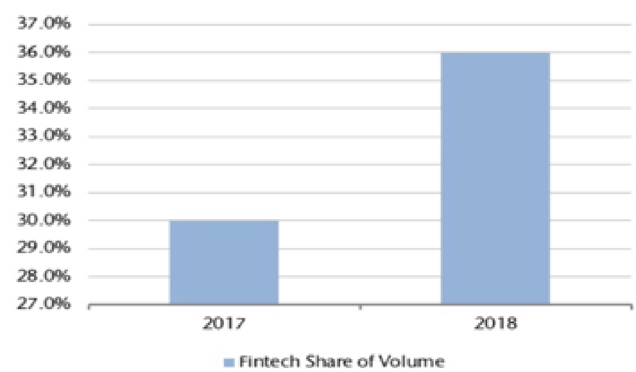
[8] A fiduciary is a person or organization that acts on behalf of another person or persons to manage assets.

Fintech and Emerging Products and Services

Fintech lending products and fintech payment services are technology-driven distribution channels of age-old products. Fintech mortgage and consumer loan services focus on automated information gathering and underwriting. The loans themselves still must be perfected (appropriately documented and filed) to secure the lien. Money transmission and stored value transactions performed online are still payments transactions. Just like agent-based business models, fintech payments companies typically rely on banks to settle funds between accounts. Fintech accounts settled are between the company and the consumer, whereas agent account settlement is between the company and agents.

For most fintech products and services, the value added is not product-based, but rather based on time, ease of use, and cost. It is faster for consumers to complete credit forms online, and faster for underwriting to be performed using algorithms created to implement credit policies. If fintech products are sold to a secondary market, digital packaging and underwriting is quicker and easier. When the costs historically associated with financial services is reduced by technology, products are often less expensive and more efficient, characteristics that present both benefits and risks for consumers.

Growth in Fintech Share of Personal Loans



(Source: Jeffries, TransUnion)

Why do nonbanks matter?

According to Lisa Servon, professor of city and regional planning at the University of Pennsylvania and author of *The Unbanking of America: How the New Middle Class Survives (2017),* the four largest banks in the country hold 50% of U.S. deposits. At the same time, the FDIC finds in a 2017 survey that 6.5% of households in the United States were unbanked in 2017, and an additional 18.7% of U.S. households (24.2 million) were underbanked, meaning the household had a checking or savings account but also obtained financial products and services outside of the banking system. (FDIC.gov/householdsurvey/)

"Too many people lack access to safe, affordable financial services that are easy to understand, easy to use, and designed to help them attain financial health."
- Lisa Servon, author of The Unbanking of America: How the New Middle Class Survives

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Some may view the alternative financial services offered by nonbanks as unnecessary or duplicative in a bank centric world. But there are more payday lending stores than Starbucks and McDonald's locations combined, and more mortgage loans and auto loans are being made by nonbanks than banks or credit unions, illustrating a clear demand and need for nonbanks. And while community banks sit at the core of America's financing, there are capacity, ubiquity and sometimes reputation issues for smaller banks filling the void in the marketplace between the giant banks and consumers. The concentration of banking services in a few of the biggest, coupled with a high degree of unbanked/underbanked households helps explain the growth of nonbanks across almost every sector of the financial services industry, and there are no indications that this growth will subside.

Nonbank experts state the industry was established to meet consumer needs and to deliver services via different channels and often in a more cost-effective manner. Yet, the industry did not emerge without controversy. In the 1900s, there were challenges concerning usury. Then issues arose regarding regulation of the industry because there is a perceived low barrier to entry for aspiring nonbanks. Additional controversies focused on consumer abuses that led to varying statutes and regulations by the states and federal government.

Innovators from outside the banking industry are determining how to further service the nonbanked and underbanked populations. They have found three tangibles valued by alternative financial services customers:

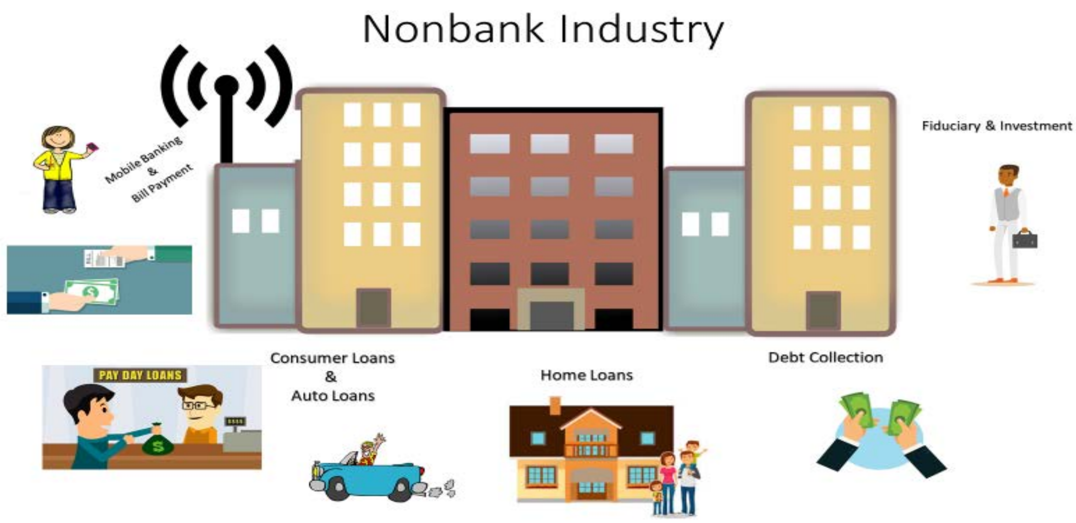
1. Lower cost/greater liquidity
2. Greater transparency
3. Better service

Servon adds that these customers are financially insecure, resulting from declining wages, increasing income volatility and eroding public and private safety nets. Their mistrust stems in part from the changes in the regulatory environment since the 2008 foreclosure financial crisis. The nonbanked and underbanked also take note of the cultural difference between banks and nonbanks, with the latter embracing a more entrepreneurial nature and therefore providing more personalized or customized services.

But the story here goes well beyond the non or underbanked. The financial services provided by nonbanks are heavily used by consumers, primarily those with bank accounts. Consider that mortgage loans, payday loans and online loans all require a bank account for the transactions to occur. And it is highly unlikely mainstream consumer lenders will make a loan to a consumer who is completely unbanked.

Further, consumers involuntarily opt into the use of nonbanks through mortgage servicing, student loan servicing and debt collection, each of which process millions of consumer transactions per year. In other words, consumers have no choice whether they transact business with nonbanks in these areas, or with which nonbanks they will transact the business.

CSBS hopes to impress upon the reader that the nonbank industry is not only dynamic but also very large and growing and permeates virtually every sector of the marketplace and consumers' financial lives. In closing this chapter, we offer you an image of these varied nonbanks pressed into one company, offering all the services of a single large bank and possibly more.



Closing

The goal of this opening chapter to the Reengineering Nonbank Supervision paper is to provide a high-level overview of multiple participants composing the nonbank industry and provide a sense of not only the complexities of such a diverse marketplace, but also the vital role this industry plays in almost every aspect of consumers' financial needs.

In forthcoming chapters, CSBS will delve deeper into the underpinnings and history of the industry, including the need participants fulfilled and the challenges they met. We will also discuss the benefits and future of each participant and state supervision specific to that business type.

CSBS will also publish chapters covering the state nonbank system of supervision and how the system interfaces with other systems of supervision, enforcement and market controls. The final chapter in the paper will address challenges and opportunities for the state system and provide a roadmap for "reengineering" state nonbank supervision.

An electronic version of this chapter is available at https://www.csbs.org/csbs-white-paper-reengineering-nonbank-supervision

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