

SB 197 (BLOCK)
AUTHORIZE THE PAYMENT OF REFERRAL FEES BY COMMERCIAL LENDERS
BACKGROUND INFORMATION SHEET

WHAT THE BILL DOES:

Senate Bill 197 would remove a competitive disadvantage that currently plagues licensed commercial lenders in California by authorizing state-licensed finance lenders that make commercial loans to pay referral fees to those from whom they receive business, subject to certain restrictions intended to promote responsible lending.

PROBLEM THE BILL ATTEMPTS TO FIX:

Existing California regulation prohibits California Finance Lenders Law (CFL) licensees from paying any compensation to any person or company that is unlicensed, in exchange for the referral of business. This places CFL licensees that make commercial loans at a competitive disadvantage relative to their direct competitors, who operate as unlicensed merchant advance companies. CFL licensees may offer better loan terms to businesses than their unlicensed competitors, but often lose customers to businesses that lack California lending licenses, because the unlicensed entities can compensate those from whom they receive referrals, while CFL licensees are prohibited from doing so.

According to small business lending experts, referrals are the single most efficient way for commercial lenders to acquire small business customers. Because general purpose advertising is not targeted, it is very inefficient at reaching customers. Word of mouth is by far the most efficient use of marketing dollars, but is an avenue that is closed off to CFL licensees by California's outdated regulations.

WHAT TYPES OF COMPANIES CAN PAY REFERRAL FEES?

Merchant advance companies that serve small businesses represent the most common form of direct competition to commercial lenders licensed under the CFL. Unlike commercial lenders, merchant advance companies do not offer loans. Instead, they offer a variety of non-loan financing options, which include cash advance, purchase order finance, accounts receivable finance, or a combination of these. Generally speaking, business arrangements between advance companies and the firms they fund involve the following: The advance company advances a certain amount of money to a business. In return, the business agrees to remit a certain percentage of its future revenue (typically sales receipts) to the advance company until the advance is paid back. Some merchant advance firms purchase future revenue at a discount; others purchase future sales revenue on a dollar for dollar basis, but charge the business a fee for the transaction. Some contracts require that money be repaid on a daily basis; others require different repayment schedules. There is considerable variety in the ways in which advance transactions are set up; the one thing that remains constant is their being structured to avoid California lending laws.

According to the Department of Business Oversight, merchant advance companies are not required to hold lending licenses, as long as they assume the full risk of nonpayment of the future receipts or accounts receivable. Because merchant advance companies are not technically

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engaged in the business of lending, they are not required to hold a California lending license, and are thus not subject to restrictions on the manner in which they can compensate persons who refer them business.

However, because merchant advance companies typically share the same customer base as commercial lenders, they have a significant competitive advantage over the commercial lenders with which they compete. Often, merchant advance companies offer less favorable terms to small businesses than commercial lenders; however, small businesses never learn about the commercial lenders that offer more favorable terms, because those lenders cannot compensate entities to refer business to them.

HOW DOES SB 197 PROTECT SMALL BUSINESSES?

California's existing prohibition against payment of referral fees by licensed lenders is intended to protect borrowers, by ensuring that they are not steered to loans with unfavorable terms by unlicensed individuals whose referrals are based entirely on the compensation they generate, and not on the extent to which the loan makes sense for the borrower being referred. SB 197 is designed to eliminate the possibility that referral fees paid to unlicensed individuals will result in predatory lending. **The bill allows the payment of referral fees *only* upon consummation of a loan, and requires all loans for which referral fees are paid to adhere to specified best practices for business lending (verify the commercial status of the borrower, minimum loan term of one year, maximum APR of 36%, and rigorous underwriting).**

SPONSORS:

SB 197 is co-sponsored by Opportunity Fund, California's largest not-for-profit commercial lender, and by the California Association of Micro-Enterprise Organizations, a group of over 170 organizations, agencies, and individuals dedicated to furthering micro-business development in California.

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