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The First Step in Starting or Expanding Your Finance Company: Indirect or Direct Licensing

POSTED:

Sep 20, 2023

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Understanding the state licensing requirements for your finance company is an imperative first step in a business startup or expansion. Once your business plan is developed and you know what type of goods or services you will finance and the type of credit products and terms you want to offer consumers, it is time to obtain appropriate licensing in the states where you will be offering credit, as finance companies are licensed at the state level. Operating without proper licensing can have serious consequences, such as subjecting you to potential fines, regulatory enforcement and the inability to collect the finance charges for credit you have extended. Therefore, it is important to understand and start the licensing process early in your business development progression.

To determine appropriate licensing for your finance company, you will need to decide between the indirect creditor business model and the direct lender business model. The distinctions between these business models often cause confusion for finance companies and their staff, potentially causing a significant impact on licensing and future operations.

Differences Between the Models

Under an indirect credit business model, a seller of goods or services sells the goods or services to a buyer on credit. The seller is listed as the originating creditor on the credit sale contract, which is often sold and assigned immediately by the seller to a finance company that may have provided the underwriting and forms for the credit sale. After the assignment, the finance company owns the credit sale contract and services and collects on the contract going forward. When credit sale contracts are originated by a seller and then purchased by a finance company, this process is considered indirect credit.

In most states, the extension of indirect credit is considered a retail installment sale or a credit sale and not a loan. This legal distinction is important as it removes the sale from lending usury interest rate limitations and direct lending licensing requirements under state law. The return on a credit sale is referred to as time price differential or finance charge rather than interest. State retail installment sales acts or consumer credit codes often specify allowable finance charges and other fees for retail credit sales, and these rates and fees are distinct from, though they can be similar to, those allowable for loans under state lending laws. Indirect credit often has more requirements to adhere to in the form of the contract used with the borrower than in direct lending. Fewer states require licensing under the indirect credit model and the licensing or registration process is often simpler compared to the direct lending model. However, in some states, in addition to the finance company having a license, the seller of the goods or services may also have to file a registration. This is not the case when financing is provided by a direct lender.

With the direct lending business model, the finance company, as the lender, will originate a loan directly to the consumer. The lender will pay the proceeds of the loan to the consumer directly, or in some cases to the seller, in instances involving the sale of goods or services. The seller will not be considered the creditor, rather the lender will be the originating creditor. The lender may retain the loan on its books for future servicing and collection or the lender may sell the loan. The lender generally must obtain a lender license in each state where it is lending and abide by each state's licensed lender requirements for interest rates and fees that may be charged. Licensing processes and regulatory oversight are generally more extensive for direct lending than for indirect credit.

In either indirect credit or direct lending, the finance company may retain the contract or loan on its books for future servicing and collection or, alternatively, the finance company may sell the loan or contract. If the finance company sells the loan or contract and continues servicing the loan or contract on the purchaser's behalf, the finance company will need additional licensing as a servicer or collector.

This chart summarizes the differences between indirect credit and direct lending:

	Indirect Credit	**Direct Lending**
Who is the originator?	Seller	Finance Company
Is Contract Assigned?	Yes, to the Sales Finance Company	No, the Finance Company owns the contract from the beginning
Laws that Apply	Credit Sales Laws	Consumer Loan Laws

	Indirect Credit	Direct Lending
Terminology	Credit Sale/Contract Time Price Differential/Finance Charge	Loan/Loan Agreement Interest
Finance Company Licensing Needed	Sales Finance License Seller License/Registration – in some states	Lender License

Next Steps

Once you have chosen your business model, you should obtain the applicable licensing needed in the states where you want to purchase credit sale contracts or make loans.

It is also important to operate within the framework of the model you have chosen and not cross over into the other model. For example, as an indirect creditor, your credit is not a loan and should not be referred to as a loan, but as a credit sale or retail installment contract, and the seller must be the originating creditor identified on the contract. The contract or other binding document should show the assignment from the seller to your finance company.

For direct lending, the credit can be referred to as a loan and the finance company lender must be shown as the originating lender on the loan documents. Adhering to the credit or loan requirements, licensing, and using the proper contract form for your chosen model is important to ensure ongoing licensing and other regulatory compliance.

Reinhart's experienced Consumer Finance Practice assists finance companies on a daily basis with their state licensing, contract and compliance needs. Please contact Kristi French, Wendy Collins or your Reinhart attorney to take this critical step together in starting or expanding your finance company.