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Why Texas' Small-Dollar Lending Market Matters

Texas consistently has one of the highest percentages of unbanked and underbanked populations in the country.[1] Expanding the availability of mainstream financial services—and affordable small-dollar loans, in particular—is vital for the financial stability of residents. Small-dollar loans can augment savings opportunities and can be a step toward helping consumers better manage economic disruption. However, too often consumers turn to high-cost products that are readily available in just about every community within the state. This *e-Perspectives* article, written by Ann Baddour of Texas Appleseed, describes the reasons behind the emergence of the payday lending industry in Texas and how banks and other for-profit and nonprofit organizations are working to create lower-cost options that address the growing frustration among those who advocate against the payday and auto title industry's lending practices.

A Commentary by Ann Baddour, Texas Appleseed

Texas is a major profit center for the payday and auto title lending industry nationally. Former Texas House Speaker Tom Craddick stated at a hearing during the 2011 state legislative session, "Of the four publicly traded companies that deal in [payday lending], they make 60 percent of their profits in the state of Texas."[2]

The primary reason for the high profits coming out of Texas is a climate that allows payday and auto title businesses to operate without caps on fees or other limitations. As a result, many borrowers are trapped in a cycle of debt when these short-term balloon loans are not repaid on time (usually within a required two to four weeks). This business model has produced a small-dollar loan market dominated by payday and auto title loans with annual percentage rates (APRs) of 500 percent and higher. In Texas, the estimated average payday loan borrower can pay up to $840 for a $300 loan; monthly fees for a $4,000 auto title loan often exceed $1,000.[3] High-cost installment loans, with rates exceeding 500 percent APR, are increasingly available. Some in the industry are offering these loans near military bases, using installment structures to get around the federal 36 percent rate cap adopted in 2007 to protect military families from abuses associated with high-cost payday and auto title loans.[4]

Payday and auto title loan store near Goodfellow Air Force Base in San Angelo, Texas. Sign in window advertises, "MILITARY WELCOME."
Photo by Jennifer Allmon, May 2011

Lower-cost small-dollar loan products exist in Texas,[5] but many are not of sufficient scale to compete with payday and auto title loans. To improve and expand small-dollar lending options in Texas, it is critical that the state enforce basic standards for affordable credit. To understand why this is necessary, it is helpful to look at the recent history of small-dollar loan regulation in Texas. By understanding how we got to where we are, we can chart a path forward.

1990–2000: Upholding State Usury Laws

Texas has established usury limits under state law. The state constitution includes a usury cap of 10 percent interest.[6] State law permits lending at higher rates for consumer loans under Chapter 342 of the Texas Finance Code, with a maximum rate charge of 136 percent APR for a two-week, $300 loan and rates averaging 60–80 percent for longer-term installment loans.[7] Licensed consumer lenders must also consider the borrower's ability to successfully repay the loan within the loan term.[8]

Since the early days of payday and auto title lending in Texas, some in the industry have attempted to circumvent state usury limits. In the late 1990s, then-Attorney General John Cornyn filed lawsuits against payday lenders, alleging usurious lending, deceptive trade practices and abusive debt collection practices.

"We cannot allow payday lenders to operate outside the law when making consumer loans, and then have them use the law for the purpose of collecting illegal and outrageous interest," Cornyn said in a May 1999 announcement of a lawsuit against a statewide payday loan company.[9]

In December 1999, a permanent injunction was filed and a settlement reached. The payday loan company, Cash Today, agreed to end its payday lending business and pay $1 million in restitution to Texas consumers. Cash Today had been offering payday loans at 33 percent interest charged every two weeks, or 860 percent APR. Cornyn noted, "This kind of abusive payday lending is illegal in Texas, and those companies who continue this practice will face serious consequences."[10]

In 2000, the Texas Finance Commission adopted rules, still in effect today, establishing lending guidelines to accommodate the short-term nature of payday loans. These rules were designed to ensure that payday lenders complied with the state's standards for licensed consumer lenders. The rules also included provisions to avoid excessive charges on repeat loan renewals and a requirement to assess a borrower's ability to repay the loan on time.[11]

In 2001, the state legislature adopted a law bringing payday lenders under the authority of the Texas Office of Consumer Credit Commissioner (OCCC), a move that placed them squarely under state consumer lending laws. There was a general sense that the issue was resolved, but that was far from true.

2001–2011: The Era of Loopholes

To circumvent Texas' attempts to bring some of the lenders into compliance with consumer lending laws, the majority of the Texas payday lending industry began partnering with out-of-state banks and importing interest rates from states with no usury cap. Often called the "rent-a-bank" model, this approach allowed payday loan businesses to get around the 2001 usury law. Payday lenders partnering with out-of-state banks had to be licensed in Texas but were not required to comply with state regulations governing rates and fees.

During the first half of the decade, bills were filed in the Texas Legislature, some to rein in this high-cost lending practice, and others to specifically authorize small-dollar lending at 390 percent APR or higher. None were adopted. Payday lenders' out-of-state bank partnerships remained the market status quo until changes at the federal regulatory level in 2005 caused the industry to rethink its business model.

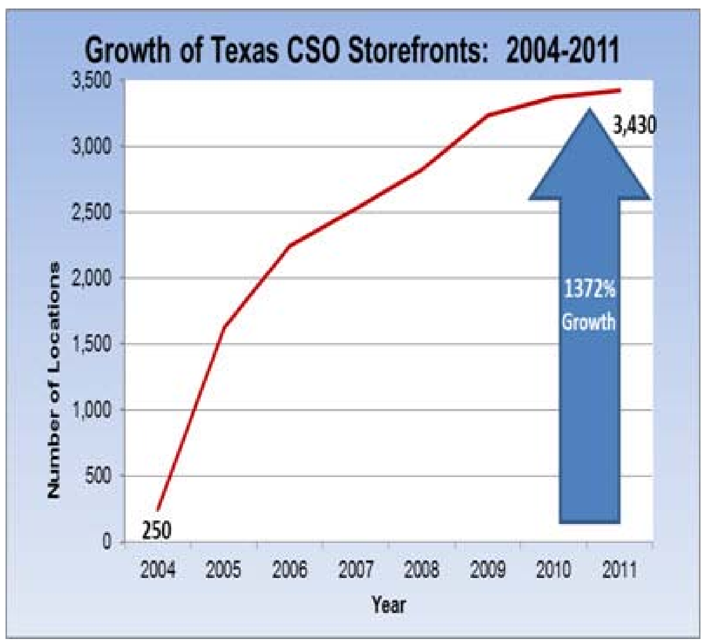
In 2005, the Federal Deposit Insurance Corp. (FDIC) issued revised examination guidelines governing payday lending by FDIC-supervised banks.[12] The guidelines address a variety of issues, including bank safety and soundness concerns, the use of third parties in bank payday lending transactions, and loan rewrites and renewals.

Though the standards do not specify the maximum number of allowable payday loans, they limit outstanding payday loan debt for a customer to no more than three months in a one-year period. For a typical two-week payday loan, this standard translates to a cap of approximately six loans per borrower per year. The ultimate impact of this guideline was the large-scale abandonment of the out-of-state bank partnership business model.

In its place, the payday and auto title industry began to take advantage of a little-known Texas law. They claimed regulation under the Texas Credit Services Organizations (CSO) Act. Passed in 1987 to protect consumers against abusive credit repair businesses, the CSO Act includes a provision that describes "obtaining an extension of consumer credit for a consumer" as a credit services organization activity.

Beginning in the 1990s, a handful of businesses used the CSO Act as a vehicle to engage in high-cost lending in Texas. In 2004, the issue came to a head when the U.S. Fifth Circuit Court of Appeals ruled in *Lovick v. Ritemoney Ltd.* that the fees charged by Texas CSOs to obtain consumer credit for customers do not constitute "usury."[13] A 2006 letter from the Texas Attorney General's Office regarding the legality of the CSO lending model stated, "On its face, the CSO model does not appear to be prohibited under Texas law. … Any discussion of whether this model is the best public policy choice for the state of Texas is one that must be addressed by the legislature and has not been explored by this office."[14]

The Fifth Circuit decision, in combination with the Attorney General letter, led to an explosion of CSO registrations by payday and auto title companies in Texas. In 2004, there were 250 registered CSO locations. By November 2011, there were over 3,400 registered locations, the vast majority being payday and auto title loan businesses. [15]



SOURCE: Texas Appleseed analysis of data provided by the Texas Secretary of State.

While the policy arena lay silent, local charities and faith-based groups reported a growing number of requests for assistance from Texas families indebted to payday and auto title lenders. After months of paying high fees on a payday or auto title loan, these borrowers still owed the entire loan principal and some were threatened with losing their cars. A 2010 survey in Texas by Catholic Charities found that nearly 20 percent of their cash assistance was going to families in financial stress due to payday or auto title loan debt.[16] In response to these factors, some cities adopted zoning ordinances to stem the expansion of these high-cost lenders and resolutions asking the state legislature to take action to limit rate and fee charges for payday and auto title loans.[17]

During the 2011 Texas legislative session, there was a groundswell of popular and bipartisan support to reform the payday and auto title industry. Major state newspapers published editorials in support of reform.[18] More than 50 organizations, associations, churches, cities and individuals from across Texas attended legislative hearings and provided over seven hours of testimony documenting abuses and supporting bills to limit rate and fee charges. Thousands of constituents called or wrote their legislators in support of reform.

Ultimately, only two bills passed. Neither addresses the core complaints of excessive charges and the debt cycle that often accompany these loans, but they are small steps forward for consumers who frequent these establishments. One bill requires detailed cost disclosures and the other establishes licensing under the CSO Act. The licensing bill also calls for data collection to better understand industry operations. Shortly after the session ended, the cities of Dallas and Austin passed local ordinances limiting renewals of payday and auto title loans and requiring each payment to reduce the loan principal by at least 25 percent, but these ordinances face legal challenges.

Looking to the Future

Texas is clearly at a crossroads in the reform process. Before payday and auto title lending took hold in Texas, families met their small-dollar credit needs based on what was available in the market—including licensed finance companies, pawn shops, credit cards, bank and credit union loans, and by turning to family and friends. It is not surprising that, as usury laws were weakened, the market became dominated by high-cost products. An executive administering a payday loan program observed, "Demand [for the payday loan product] is insatiable and customers are not price-sensitive."[19] This assessment describes a market ripe for abuse.

A new Texas Appleseed report, "Reshaping the Future of Small-Dollar Lending in Texas," highlights eight Texas small-dollar loan programs and many national models that offer affordable products. The report includes four major recommendations to expand affordable small-dollar loan options in Texas:

1. Establish a baseline for affordable credit by applying existing state rate and fee caps for consumer loans marketwide;
2. Encourage investment in affordable small-dollar loan products;
3. Provide technical assistance and capital investments to nonprofits to offer more affordable small-dollar loan services to underserved markets; and
4. Engage in outreach and education to financial institutions and consumers about affordable lending options.

In January 2012, Richard Cordray, the new director of the Consumer Financial Protection Bureau (CFPB), held his first field hearing in Birmingham, Ala. His decision to focus the hearing on payday lending speaks to the growing pushback against the industry's lending practices. Cordray didn't mince words. "I want to be clear about one thing: We recognize the need for emergency credit," he said. "At the same time, it is important that these products actually help consumers, rather than harm them."[20]

With the establishment of the CFPB, a federal agency for the first time can supervise not only bank payday lenders but also all nonbank payday lenders.

There is no one-size-fits-all solution to the problem of high-cost consumer loans. Different players can provide access to affordable credit to different segments of the market—employees, nonprofit clients, new immigrants and seniors living on fixed incomes, among others. Together, they can change the lending market by offering consumers better choices. Texas should do better than loans offered at 500 percent interest. Allowing high-cost, small-dollar lending to become an established part of our marketplace, sanctioned by law and policy, hurts our state, our local economies and the financial stability of our families.

About the Author

Ann Baddour is the state director of Texas Appleseed projects aimed at bringing low-income and immigrant consumers into the financial mainstream. Baddour has a Master

of Public Affairs degree from the LBJ School of Public Affairs and a master's degree in Middle Eastern Studies from the University of Texas at Austin. Baddour is a Fulbright Scholar and a nationally recognized expert in financial policy affecting immigrant and low-income communities.

Notes

1. "The Most Unbanked Places in America," by Ethan Geiling, *The Inclusive Economy* (blog), Corporation for Enterprise Development, Dec. 14, 2011, http://cfed.org/blog/inclusiveeconomy/the_most_unbanked_places_in_america/.
2. Texas State Rep. Tom Craddick, statement before the Texas House Committee on Pensions and Investments, March 22, 2011.
3. Because no Texas-specific data are currently available, the cost estimate for payday loans in Texas is based on data from Oklahoma, where the average payday borrower uses nine loan transactions per year. The estimate assumes a $20 per $100 borrowed charge per loan transaction, which is on the lower end of charges observed in the Texas market. See "Oklahoma Trends in Deferred Deposit Lending," Oklahoma Deferred Deposit Program, Veritec, June 2010, p. 8. The auto title loan cost is based on the common market charge of $25 per $100 borrowed per month.
4. See "Report on Predatory Lending Practices Directed at Members of the Armed Forces and Their Dependents," U.S. Department of Defense, Aug. 9, 2006, www.defense.gov/pubs/pdfs/report_to_congress_final.pdf. The Military Lending Act was passed in 2006 as a provision of the National Defense Authorization Act for Fiscal Year 2006. See 32 C.F.R. Part 232 for the rules implementing the act.
5. See "Reshaping the Future of Small-Dollar Lending in Texas: Alternatives to High-Cost Payday and Auto Title Loans," Texas Appleseed, January 2012, www.texasappleseed.net.
6. Texas Constitution, art. 16, sec. 11.
7. Allowable charges vary based on the size and duration of the loan. The highest permissible charges include a $10 acquisition fee and a charge of $4 per $100 borrowed each month the loan is outstanding. The law also permits prepayment penalties and late fees.
8. *7 Texas Admin. Code, sec. 83.852.*
9. "Cornyn Files Suit in Austin and McAllen Against 'Payday' Lenders: Illegally Charging Up to 860% Interest Rate," press release, Office of the Attorney General of Texas, May 12, 1999, www.oag.state.tx.us/newspubs/newsarchive/1999/19990512paydayloans.htm
10. "Cornyn Announces $1 Million Settlement with 'Payday' Lender Cash Today, Companies to Pay Restitution to Consumers and End Illegal Business Practices," Office of the Attorney General of Texas, Dec. 17, 1999, www.oag.state.tx.us/newspubs/newsarchive/1999/19991217cashtoday.htm.
11. *7 Texas Admin. Code, sec 83.604.*
12. "Guidelines for Payday Lending," Federal Deposit Insurance Corp., Feb. 25, 2005, www.fdic.gov/news/news/financial/2005/fil1405a.html.
13. *Lovick v. Ritemoney Ltd.,* 378 F.3d 433 (5th Cir. Tex. 2004).
14. Letter from Barry R. McBee, First Assistant Attorney General, Office of the Attorney General of Texas, to Ms. Leslie Pettijohn, Consumer Credit Commissioner, Jan. 12, 2006.
15. Historical CSO registration data were compiled by Texas Appleseed through data requests to the Texas Secretary of State starting in 2007. Registration numbers prior to 2007 were estimated based on the year of first registration reported for all 2007 registered locations.
16. "2010 Catholic Charities Survey on Payday and Auto Title Loan Use," Texas Catholic Conference and the Center for Health and Social Policy, LBJ School of Public Affairs, February 2011.
17. At least 15 cities and counties have passed ordinances to limit local payday and auto title lending and resolutions asking for reform at the state level, including: Arlington, Austin, Bexar County, Brownsville, El Paso, Garland, Irving, Lubbock, Mesquite, Midland, Richardson, Rowlett, Sachse, San Antonio and Travis County.
18. Newspapers that published editorials in support of reform include *Amarillo Globe-News, Austin American-Statesman, Dallas Morning News, Houston Chronicle* and *San Antonio Express-News.*

19. Trent Sorbe, senior vice president, Metapay, "Market Response to a Need: Auditing the Small-Value, Short-Term Credit Landscape," Center for Financial Services Innovation (CFSI) webinar, Sept. 9, 2008, available at: http://cfsinnovation.com/node/330409?article_id=330409.
20. "Remarks by Richard Cordray at the Payday Loan Field Hearing in Birmingham, Ala.," Richard Cordray, Consumer Financial Protection Bureau, Jan. 19, 2012, www.consumerfinance.gov/speech/remarks-by-richard-cordray-at-the-payday-loan-field-hearing-in-birmingham-al/.

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