# Texas Appleseed

**Written Testimony for Investments & Financial Services Hearing**
**Ann Baddour, Director Fair Financial Services Project**
**September 14, 2016**

Mr. Chairman and Committee Members,

Thank you for this opportunity to offer testimony on Interim Charge #2, examining the short-term lending industry in Texas. Texas Appleseed is a public interest justice center working to change unjust laws and policies that prevent Texans from realizing their full potential. Working with pro bono partners and collaborators, we develop and advocate for innovative and practical solutions to complex issues. As part of our work, Texas Appleseed also conducts data-driven research to better understand inequities and identify solutions for concrete, lasting change. We are part of a non-profit network of 17 justice centers in the United States and Mexico.

Through our Fair Financial Services project, Texas Appleseed supports fair lending practices in Texas. Texas Appleseed is also part of the Texas Fair Lending Alliance, a coalition of organizations and individuals working to transform the Texas payday and auto title loan market from one reliant on consumers' being trapped in a cycle of debt to one that encourages both borrower and lender success.

Our comments focus on three top line findings included in the scope of the interim charge. They are as follows:

1. Consumer Credit in Texas Increased from 2012 to 2015
2. Lead Generators and Many Online Lenders Escape State Oversight, Putting Consumers at Risk
3. Credit Access Business (CAB) Loan Data Show Consumer Harm

In order to encourage a fair consumer credit market based on borrower and lender success, Texas Appleseed offers the following policy recommendations:

Priority Policy Recommendations:

- **Policy Recommendation 1:** To catalyze the market for lower-cost loans, consider establishing a Community Development Financial Institution (CDFI) investment fund, or investing a portion of economic development funds into CDFIs that offer small dollar loans at 36% APR or less.

- **Policy Recommendation 2:** Given the growth of the online consumer loan market and risks posed by lead generators and online lenders, Texas consumers would benefit significantly from clarifying that Texas consumer lending laws apply to online lenders and establishing lead generators as brokers of consumer lending transactions, creating accountability in this growing market.

- **<u>Policy Recommendation 3:</u>** CAB loans should be brought under existing rate caps for consumer loans in Texas, particularly installment CAB loans. Payday and auto title businesses have often justified high charges for loans by citing the very short loan terms. Data documenting an on-going cycle of refinances and increasing loan terms supports a policy of holding these businesses accountable to the same standards as other consumer lenders in Texas. As an alternative, the unified ordinance, which put basic protections into place to ensure that these loans are, in fact, short-term, could be adopted as state law.

Technical Policy Recommendations:

- **<u>Policy Recommendation 4:</u>** Texas CAB and debt collection laws need further clarification and clear penalties to ensure the wrongful and illegal practices of threatening to file criminal charges and actually filing criminal complaints in the debt collection process are stopped.

- **<u>Policy Recommendation 5:</u>** To the extent that CAB lending continues in its current form, clear standards are needed to ensure that the CAB and third-party lender have no affiliation and that this three-party system is not used to conceal direct lending through common ownership or management of the CAB and third-party lender or through close family relationships among the CAB and third-party lender owners, officers, or employees.

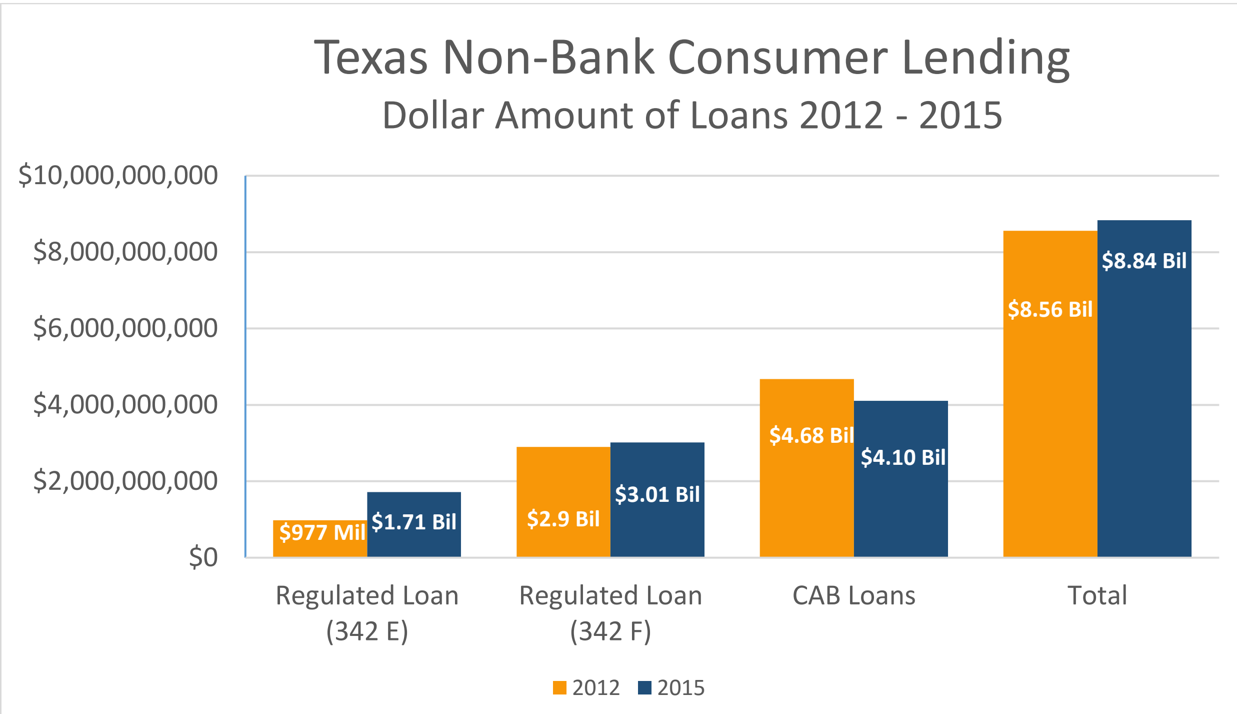
- **<u>Policy Recommendation 6:</u>** The prohibition for charging pre-payment penalties for CAB loans should be clarified to include upfront charges of CAB fees for multi-payment transactions as a pre-payment penalty, in order to uphold the intent of current law.

- **<u>Policy Recommendation 7:</u>** CAB's should be prohibited from arranging loans with third-party lenders that charge late fees in excess of the statutory minimum of $7.50. As the law stands, it allows excessive charges due to the balloon payments that are built into many CAB arranged loans.

The following analysis includes detailed findings supporting the above policy recommendations.

### 1. Consumer Credit in Texas Increased from 2012 to 2015

The dollar amount of nonbank consumer lending[1] in Texas, including new loans and refinances, increased by 3% from 2012 to 2015—from $8.56 billion to $8.84 billion. Compared to a little more than a decade ago (2003), Texas has seen a 112% increase in total dollars lent, from $4.16 billion to $8.84 billion.[2] Pawn loans are not included in this analysis, because 2015 data is not currently available; however pawn lending has followed a similar trend, with a 76% increase in the total dollars lent from 2003 to 2014.[3]




*Source: Texas Appleseed Analysis of regulated lender and CAB data, Texas Office of Consumer Credit Commissioner (2012-2015)*

Compared to 2003, the 2015 data show a 15% decline in 342 E lending, a 98% increase in 342 F lending and a 571% increase in non-rate capped loans (including payday and auto title loans). During that same time period, Texas population increased by 25%.[4]

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[1] Data include 342 E, 342 F, and payday/auto title loans. Prior to 2005, auto title loans were not prevalent in the Texas market. They appear to have expanded with the move to the CSO lending model. It excludes pawn lending. The data do not include pawn loans.

[2] Texas Office of Consumer Credit Commissioner, *Legislative Report: Analysis of Non-Real Estate Consumer Lending Regulated by the Office of Consumer Credit Commissioner*, at 2 (2005). *Available at:* http://www.fc.texas.gov/studies/non-realestate.pdf.

[3] *Id*. *See also* "Pawn Industry Consolidated Volume Reporter Calendar Year 2014," Texas Office of Consumer Credit Commissioner (2015). *Available at:* http://occc.texas.gov/sites/default/files/uploads/misc/pawn-consolidated-2014.pdf. Pawn loan volume in 2003 was $669 million compared to $1.179 billion in 2014.

[4] Texas Population Projections, Texas Department of State Health Services (2015), available at: http://dshs.texas.gov/chs/popdat/ST2015.shtm; and Texas Population Projections, Texas Department of State Health Services (2003), available at: http://dshs.texas.gov/chs/popdat/ST2003.shtm.

342 E lending is seeing a comeback in Texas, with a 76% increase in dollars lent from 2012 to 2015. During the same period, 342 F lending increased by 4% and credit access business (CAB) lending decreased by 12%. **Overall, access to non-bank consumer credit in Texas is robust, and market trends are promising, with the greatest percentage increase in dollars lent over the 2012 to 2015 period driven by the lowest cost loans.**

There are also a variety of innovators moving into the regulated lending space in Texas, with the express goal of offering lower-cost loans. These businesses include the Community Loan Center, Oportun, CreditShop, Fig Loans, and others. Some of this increase in innovative lending is being driven solely by market forces and some has been catalyzed through investments from the federal Community Development Financial Institutions (CDFI) Fund and bank Community Reinvestment Act investments. Outside of the regulated lending space, some credit unions are also making inroads in the small-dollar loan market. For example, catalyzed by an investment from the CDFI Fund, the Government Employees Credit Union in El Paso launched a fast cash loan in the summer of 2014. From July 2014 to March 2016, the credit union made 17,377 loans averaging $621, payable over six months at 27.9% APR.[5]

*Policy Recommendation to promote availability of low-cost consumer credit in Texas:*

**Policy Recommendation 1:** To catalyze the market for lower-cost loans, consider establishing a Community Development Financial Institution (CDFI) investment fund, or investing a portion of economic development funds into CDFIs that offer small dollar loans at 36% APR or less.

**2. Lead Generators and Many Online Lenders Escape State Oversight, Putting Consumers at Risk.**

Technology is changing the small dollar lending market across the country. Online loan transactions make up a growing part of the market. Texas currently lags behind in its state laws. The Office of Consumer Credit Commissioner currently does not have explicit authority to regulate all online lenders doing business with Texas residents. The potential harm to consumers and to businesses following state laws, is that rogue online businesses will skirt state legal standards, engage in abusive collections practices, facilitate identity theft, and they cannot be held accountable.

*Online Payday Lending*

The number of online payday and auto title loans made to Texans is steadily increasing. Real concerns exist about these lenders, with respect to some online lenders' attempts to skirt state laws and the overall security of sensitive consumer information.

As more states regulate payday loans, lenders are increasingly moving to the Internet; revenue from online consumer loans more than tripled from $1.4 billion in 2006 to $4.3 billion in 2013,

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[5] Larry Garcia, "Small Loan Credit Union Lending in El Paso Texas," RAISE Texas Summit (May 11, 2016). *Available at*: http://www.dallasfed.org/assets/documents/cd/events/2016/16raise-Garcia.pdf.

according to data from the investment bank Stephens Inc.[6] Some lenders claim state laws do not apply to them, because they do not have physical storefronts in states.[7] These online lenders may only be licensed in one state, but make loans to borrowers in several states.[8] Some online lenders use even more creative strategies to skirt state laws including operating off-shore or claiming sovereign immunity.[9] In Texas, given the growth of the online lending industry and the potential for some online lenders' murky practices, the Office of the Consumer Credit Commissioner (OCCC) should have the explicit authority to ensure these lenders comply with state law.

*Lead Generators*

Payday and auto title borrowers are particularly susceptible to online scams, given the role of lead generators in connecting would-be borrowers with online lenders. Lead generators create business for payday and auto title lenders by gathering customer information, often through online searches, and selling it to lenders. Many of these sites appear to be online payday and auto title lenders, asking customers to enter their private financial data (such as their Social Security and checking account numbers) in application-like forms. Often, it is not clear to potential borrowers that they are giving this information to a lead generator; and some lead generators require borrowers to give extensive personal information, including personal banking information, Social Security number, date of birth, driver's license information, private address and employment records—all of which can be sold to third parties, putting borrowers at significant risk of identity theft.

Lead generators often sell this information to the highest bidders. Even if a borrower decides not to get a loan or signs a contract with one lender, it may not stop other companies from contacting the borrower or using the borrower's information in other ways. One reporter chronicled her experience entering her (fake) information into a lead generator, noting she received dozens of phone calls over several months, many telling her she had been approved for a loan and asking her to contact them immediately.[10] And all of this, despite the lead generator having said it was a secure site. As one New York regulator put it, "Once you made that application, you basically sent up a red flag with them that you are someone in need of this money, and you need it on a short-term basis . . ., [t]hat's when the vultures come out."

There is currently no state oversight of lead generators. Nothing prevents lead generators from passing consumer information on to a variety of entities, including scammers and other financial schemers. <u>In 2014, scammers posed as authorities from the Texas Attorney General's office and called online small payday loan borrowers threatening to issue arrest warrants if they</u>

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[6] Kevin Wack & Joe Adler, *Cheat Sheet: Online Lenders' Legal Minefield*, American Banker (Oct. 1, 2013).
[7] Johnson, Andrew R., *Payday Lender Agrees to Fine, Refunds Western Sky to Pay $1.5 Million in Pact With New York*, Wall Street Journal (Jan. 23, 2014).
[8] Wack & Aldler, supra note 4.
[9] Id. The now defunct Western Sky which claimed immunity from state laws due to its affiliation with a sovereign Indian tribe in South Dakota.
[10] Fessler, Pam, *I Applied for an Online Payday Loan: Here's What Happened Next*, National Public Radio (Nov. 6, 2013) (available at http://www.npr.org/blogs/money/2013/11/06/242351534/i-applied-for-an-online-payday-loan-heres-what-happened-next).

did not pay their debts.[11] The Houston Better Business Bureau noted that "[m]ore than likely what happened was there (sic) information was sold somehow to somebody."[12]

*Policy Recommendation to address challenges raised in this section:*

**Policy Recommendation 2:** Given the growth of the online consumer loan market and risks posed by lead generators and online lenders, Texas consumers would benefit significantly from clarifying that Texas consumer lending laws apply to online lenders and establishing lead generators as brokers of consumer lending transactions, creating accountability in this growing market.

### 3. Credit Access Business (CAB) Loan Data Show Consumer Harm

HB 2594, adopted in 2011, included data collection for payday and auto title loans in order to create objective data to assess the impacts and outcomes of these uncapped loans in Texas.[13] Based on four full years of data collection in Texas, 2012 to 2015, some important trends are emerging.[14]

#### A. Refinances and Fees Drive CAB Loan Volume

Over the four-year period, from 2012 to 2015, refinances and fees made up between 68% and 71% of total CAB loan volume (dollar amount to new loans, refinances and fees). **In 2015, total loan volume was $5.8 billion, with refinances and fees totaling $4.1 billion and new loans at just $1.7 billion.** Over this same time period, average loan APRs ranged from 216% to 738%, depending on the loan product.

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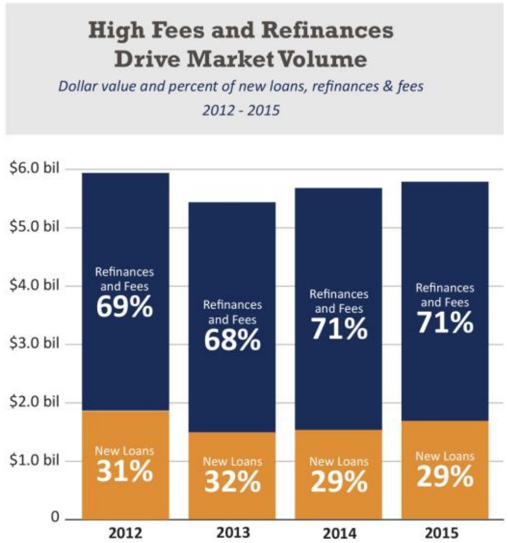
[11] ABC Channel 13 Houston, *Scammers pretending to be with Texas AG's Office to get victims to pay up*, available at http://abclocal.go.com/ktrk/story?section=news/consumer&id=9527789 (May 5, 2014).

[12] *Id.*

[13] Tex. Fin. Code §393.626.

[14] Unless otherwise notes, the following data are from the Texas Appleseed analysis of the Texas Office of Consumer Credit Commissioner CAB data: "Payday and Auto Title Lending in Texas: Market Overview and Trends 2012-2012," Texas Appleseed (June 1, 2016). *Available at*: https://www.texasappleseed.org/sites/default/files/Payday-Auto-Title-Lending-Tx_MktOv-Trends2012-2015Rev.pdf.




*Source:* Texas Appleseed, *Payday and Auto Title Lending in Texas* at 6 (June 2016)

In 2015, looking at loans that were paid in full or defaulted (including the initial loan and all refinances) during the calendar year, 71% of the single payment payday loans and 85% of single payment auto title loans were generated by borrowers who refinanced two or more times. Among installment loans, with average initial loan terms of 160 or more days, 35% of installment payday loans and 45% of installment auto title loans were generated by borrowers who refinanced two or more times.

From 2012 to 2015, total fees collected by CABs in Texas increased by 34%, from $1.24 billion to $1.67 billion, despite a 9% drop in the dollar amount of new loans. Based on the state-reported fee data, it is not surprising that Texas continues to have some of the highest fees in

**Cost to borrow $300 per two week pay period**[15]

| | Max. allowed by state law | Payday Lender A | Payday Lender B | Payday Lender C | Payday Lender D |
|---|---|---|---|---|---|
| **Florida** | $35 | $35 | $35 | $33 | $35 |
| **Alabama** | $52.50 | $52.50 | $52.50 | $52.50 | $52.50 |
| **Texas** | No limit | $61 | $91 | $61 | $67 |

*Source: Pew Charitable Trusts, *How State Rates Affect Payday Loan Prices* Fact Sheet (April 2014).

the country, particularly for payday loans. The chart above, based on a 2014 survey by Pew Charitable Trusts, shows the different rates charged by the same four lenders for the same payday loan in three different states. In Texas, where there are no fee caps, borrowers pay significantly higher fees.

[15] This figure is reproduced from the following report: Pew Charitable Trusts, *How State Rates Affect Payday Loan Prices* Fact Sheet (April 2014), available at http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Fact_Sheets/Safe_Checking/State-Rate-Limits-Fact-Sheet.pdf.

B. Growth in CAB Installment Lending Parallels Sharp Increase in Total CAB Fees

Installment payday and auto title lending grew by 112% from 2012 to 2015, with a particularly notable growth in installment payday lending. In 2012, installment payday lending made up 11% of the total CAB market volume (dollar amount of new loans, refinances, and fees). In 2015, it increased by 138%, to a total of 27% of the CAB total market volume. During the same time period, installment payday loan fees jumped 225%, from $254 million in 2012 to $827 million in 2015. **Fees from installment payday loans made up 49% of all fees collected by CABs (2015)**. In 2015, the average APR for an installment payday loan in Texas was 567%. Without any refinances, a $500 installment payday loan cost $1,354 to repay over 160 days.[16] With refinances, fees are even higher. In addition to increasing fees, loan terms for installment loans are on the rise. In 2012, the average loan terms for installment payday and auto title loans were 98 and 146 days respectively. In 2015, average loan terms were 160 days for installment payday loans and 169 for installment auto title loans. **For Texas borrowers the longer loan terms have simply translated into more fees.**

In theory, installment payday loans should be easier for borrowers to pay back than single payment balloon loans. However, when coupled with uncapped fees and innovative product structures, installment payday loans often quickly drain family financial resources. The two most common installment loan structures that we have observed in the Texas market are: 1. fully amortizing loans, often with terms of 168 days (12 bi-weekly payments); and 2. balloon loans, often with five monthly fee only payments or 11 bi-weekly payments and a final payment that includes the entire loan principal plus a final fee payment. Both loans are problematic, as detailed below.[17]

The example of a fully amortizing loan is based on a 168 day installment payday loan offered at 581.72% APR. [18] The original loan principal is $1000. Total payments due over the loan period amount to $2,945.57.

**Example: Fully Amortizing Installment Payday Loan**

| Number of Bi-Weekly Payments | Total Principal and Interest Payments | Total Fees Paid | Total Paid | % of Principal Remaining | Remaining Principal |
|---|---|---|---|---|---|
| 0 | $0 | $0 | $0 | 100% | $1,000 |
| 4 | $135.30 | $846.74 | $982.04 | 88% | $875.54 |
| 6 | $250.26 | $1,222.80 | $1,473.06 | 77% | $766.00 |
| 8 | $418.33 | $1,545.75 | $1,964.08 | 60% | $603.35 |
| 10 | $665.94 | $1,789.16 | $2,455.10 | 36% | $361.16 |
| 12 | $1,032.52 | $1,913.45 | $2,945.97 | 0% | $0 |

[16] Texas Appleseed, "2015 State of Texas Data Sheet" (September 2016).

[17] Variations on these structures exist, including partial principal repayment built into the loan and pre-charged fees that are due in full in the event of pre-payment.

[18] The loan data is based on a July 2015 loan contract from The Cash Store. The loan was originated in Austin, Texas and the contract provided to Texas Appleseed by the borrower (contract on file with the author).

Based on the amortization of the loan, after 6 payments, half of the loan period, a borrower has made total payments equal to nearly 1.5 times the amount borrowed, but still owes 77% of the loan principal. Borrowers who must refinance at this point in the loan process often end up owing the entire original loan principal after the refinance, because of additional refinance fees rolled into the loan, and therefore must begin the amortization process anew. Because of the exceptionally high fees charged, the total cost to borrowers is the equivalent of a single payment loan renewed eight or nine times. If the loan is renewed, particularly in the first half of the loan period, then any benefit derived from amortization is lost.

The example of a balloon payment installment payday loan is based on a five-month contract offered at 484.67% APR.[19] The $300 loan is repayable over five monthly payments. A balloon installment payday loan functions almost identically to a single payment payday loan, except that the contract effectively builds in multiple renewals.

**Example: Balloon Installment Payday Loan**

| Number of Monthly Payments | Total Fees | Total Interest and Principal | Total Paid | % of Principal Remaining | Remaining Principal |
|---|---|---|---|---|---|
| 0 | $0 | $0 | $0 | 100% | $300 |
| 1 | $132 | $0 | $132 | 100% | $300 |
| 2 | $264 | $0 | $264 | 100% | $300 |
| 3 | $396 | $0 | $396 | 100% | $300 |
| 4 | $528 | $0 | $528 | 100% | $300 |
| 5 | $660 | $312.72 | $972.72 | 0% | $0 |

Based on the loan payment schedule, after four scheduled payments, the borrower will have paid fees equal to nearly double the amount borrowed and still owe the entire loan principal. If the loan is refinanced on the sixth payment, because the borrower cannot afford the balloon principal and fee payment, then the entire cycle of repeated fee payments begins again.

## C. Data Show that CABs Profit Even When Borrowers Fail

Though the CAB data do not include specific default measures, there are two data points that offer insight into loan default rates. The first is auto repossessions for loans secured by a vehicle title and the second is the number of times a CAB paid the third-party lender under their guaranty of the loan. Generally, the CAB only pays on the guaranty if the loan is not paid according to the contract terms.

The rate of auto title repossession among single payment auto title loans arranged by CABs nearly doubled over the four-year period, from 10% in 2012 to 19% in 2015. Single payment

[19] The loan data is based on a March 2016 loan contract from Advance America. The loan was originated in Austin, Texas and the contract was provided to Texas Appleseed by the borrower (contract on file with the author).

auto title loans made up 83% of the total dollar volume of the CAB auto title loan market in 2015. The high repossession rate indicates that these businesses are profiting despite a high rate of borrower failure.

The data documenting the number of times a CAB paid the third-party lender under their guaranty of the loan show that in 2015, CABs paid the third-party lender in 32% of all transactions, and 36% of all installment loan transactions. When comparing the number of guarantees paid to the total number of borrowers, the ratio is 1 to 1 across all CAB loan products. These high rates could be an indicator of high rates of default or high rates of difficulty making payments on time for the loans, calling into questions the effectiveness of the underwriting used. The high rates of payment on the guaranty do not seem to impact fee revenue, which continues to rise.

**The high repossession rates and the high rates of payment of the guarantees point to a misalignment in the market, where borrower success is not essential to increased profitability.**

*Policy Recommendation to address challenges raised under subheadings A through C:*

**Policy Recommendation 3:** CAB loans should be brought under existing rate caps for consumer loans in Texas, particularly installment CAB loans. Payday and auto title businesses have often justified high charges for loans by citing the very short loan terms. Data documenting an on-going cycle of refinances and increasing loan terms supports a policy of holding these businesses accountable to the same standards as other consumer lenders in Texas. As an alternative, the unified ordinance, which puts basic protections into place to ensure that loans are, in fact, short-term, could be adopted as state law.

D. Additional Findings

- Illegal Threats of Criminal Prosecution and Filing of Criminal Complaints Continue to Be a Problem

Texas has a long history of not criminalizing debts. The Republic of Texas Constitution drafted in 1836 clearly states, “No person shall be imprisoned for debt in consequence of inability to pay” and the current Texas Constitution’s Bill of Rights states, “No person shall ever be imprisoned for debt.” Texas Penal Code Chapters 31 and 32 both establish that a returned check or payment, in the case of a transaction where a post-dated check is accepted, does not meet the legal standard to establish theft or fraud. In addition, the Texas Legislature clarified the matter in 2011 by adding §393.201(c)(3) to the Texas Finance Code, prohibiting CABs from pursuing criminal charges related to a check or debit authorization except in cases of documented criminal conduct. State and federal debt collection laws also include language prohibiting wrongful threats of criminal charges, including Texas Finance Code § 392.301 and the Fair Debt Collections Practices Act, 15 USC § 1692(e).

Despite laws prohibiting the criminalization of civil debts, a 2014 study by Texas Appleseed identified at least 1,500 instances from 2012 to 2014, where CABs filed criminal complaints in order to collect on a bad debt.[20]

In addition to the actual filing of criminal complaints, Texas consumers are disproportionately targeted with wrongful threats of criminal charges by debt collectors collecting on defaulted payday loans. According to a study of debt collection complaints filed with the Texas Attorney General in fiscal year 2014, 14.7% of the complaints catalogued were related to illegal threats of criminal charges.[21] An examination of payday loan debt collection complaints filed with the Consumer Financial Protection Bureau from October of 2013 to June of 2016 shows an even higher incidence of such complaints in Texas. Twenty percent of Texas payday loan debt collection complaints were for threats of jail time, compared to 13% for all other states.[22]

*Policy Recommendation to address challenges raised in this section:*

**Policy Recommendation 4:** Texas CAB and debt collection laws need further clarification and clear penalties to ensure the wrongful and illegal practices of threatening to file criminal charges and actually filing criminal complaints in the debt collection process are stopped.

- Further Definition Needed to Ensure Third-Party Lenders are In Fact Separate from CABs

In October of 2015, Texas Appleseed released a report that examines the ownership structure of CABs and third-party lenders based on the publicly available data in 2012.[23] The report was nearly three years in the making, including two years of open records litigation to gain access to the public data about third-party lenders working with CABs in Texas.

The study has two concerning top line findings:

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[20] Texas Appleseed Complaint submitted to CFPB Director Cordray, FTC Chairwoman Ramirez, Texas Attorney General Abbott, and Consumer Credit Commissioner Pettijohn (Dec. 17, 2014). *Available at:* https://www.texasappleseed.org/sites/default/files/Complaint-CriminalCharges-PaydayBusinesses-Final2014.pdf.

[21] Mary Spector and Ann Baddour, "Collection Texas-Style: An Analysis of consumer Collection Practices in and out of the Courts," *Hastings Law Journal* vol 67:1427 at 1442 (June 2016). *Available at*: http://www.hastingslawjournal.org/wp-content/uploads/Spector_Baddour-67.5.pdf .

[22] From Oct. 2013 to June 28, 2016, 961 payday loan debt collection complaints were received by the CFPB from Texas; 178 of them were for illegal jail threats. CFPB consumer complaints available at www.consumerfinance.gov.

[23] Texas Appleseed, "Pulling Back the Curtain: Shining a Light on Payday and Auto Title Loan Businesses in Texas," (Oct. 2015). *Available at*: https://www.texasappleseed.org/sites/default/files/Pulling%20Back%20the%20Curtain_0.pdf.

- Though there is the appearance of competition in this market space, the capital is largely concentrated. We found that 4% of the third party lenders in Texas served 77% of all the CAB store locations;[24] and
- Nearly one-quarter of all third-party lenders had some form of overlapping ownership with a CAB—in the case of five third-party lenders, it was exactly the same ownership.[25]

The legality of the CAB lending model hinges on the total separation of the CAB and its third-party lender or lenders. The intent of the law is quite clear—that the loans be offered, "by others".[26] The 2006 Texas Attorney General letter about the legality of the model asserts that the entities must be "truly independent".[27] Prominent attorneys working for CABs have also asserted a clear standard of independence: "the CSO and the third-party lender must be unaffiliated, with no common ownership, no common directors, officers or employees and with no financial relationship."[28]

In order to ensure the full separation of the CAB and the third-party lender, it is also essential that a family relationship, at a minimum one of the first degree, be included under a standard of common ownership. We found, in the study, at least thirteen cases where one family member or group of family members owned the CAB and another the affiliated third-party lender. These arrangements are a thinly veiled attempt to get around the standards of separation in the law.

*Policy Recommendation to address challenges raised in this section:*

**Policy Recommendation 5:** To the extent that CAB lending continues in its current form, clear standards are needed to ensure that the CAB and third-party lender have no affiliation and that this three-party system is not used to conceal direct lending through common ownership or management of the CAB and third-party lender or through close family relationships among the CAB and third-party lender owners, officers, or employees.

[24] *Id.* at 10.
[25] *Id.* at 20-21.
[26] Tex. Fin. Code §393.001(3).
[27] Letter from Barry R. McBee, First Assistant Attorney General to Ms. Leslie Pettijohn, Commissioner, Office of Consumer Credit Commissioner, at 2 (Jan. 12, 2006).
[28] Scott Sheehan, Connie Kondik, and Bob Manning, Payday Loan Bar Associations, Update on the CSO Model at 3 (2006). *Available at:* http://r.search.yahoo.com/_ylt=A0LEVvRwfNZX_1kAMuYnnIlQ;_ylu=X3oDMTEybTZmdDNsBGNvbG8DYmYxBHBvcwMxBHZ0aWQDQjI2MDhfMQRzZWMDc3I-/RV=2/RE=1473703153/RO=10/RU=http%3a%2f%2fpdlba.com%2fimages%2fUpdate_on_CSO_Model.ppt/RK=0/RS=B9JabFh1QebUKW3.dgyWNB4JniI- .

- Prepayment Penalty Prohibition Is Evaded By Upfront Fee Charges

Prepayment penalties are explicitly prohibited for CABs. Texas Finance Code §393.201(c)(1) states that a credit access business contract must "contain a statement that there is no prepayment penalty." A conflicting statement in the law allows CABs to "assess fees for its services as agreed to between the parties" and on any periodic basis.[29] Businesses are getting around the prepayment penalty prohibition in the installment lending market by pre-charging all fees for the entire 160 day plus loan term on the front end of the loan. For example, a CAB auto title loan contract from October of 2015 includes the required statement that there is no prepayment penalty, but it also states, in what appears to be sub 10-point font that, "your CSO-CAB Fee is earned on the day I receive and accept a loan and receive the funds from the loan."[30] The loan was for $2,000 with 12 bi-weekly payments and a CSO-CAB fee of $1,829.70. In this particular instance, the borrower came in after two-weeks to pay off the loan. She paid the scheduled $167.15 fee payment plus the $2,033 for the loan ($2,000 plus the lien filing fee), and was shocked to know that she still owed $1,710.45, as she was explicitly told that there was no prepayment penalty. In the case of this loan, she was being asked to pay an effective APR of 2,523% in order to repay the loan after two weeks. Though there may not technically have been a prepayment penalty, there was a very steep effective one through charging all CAB fees upfront. The result for this borrower is that her car was repossessed—despite paying $2,200 within two weeks of taking out the loan.

*Policy Recommendation to address challenges raised in this section:*

**Policy Recommendation 6:** The prohibition from charging prepayment penalties for CAB loans should be clarified to include upfront charges of CAB fees for multi-payment transactions as a prepayment penalty, in order to uphold the intent of current law.

- Late Payment Fees By Third-Party Lenders Excessive

The third-party lenders in CAB transactions make loans under Chapter 302 of the Texas Finance Code, governing loans of 10 percent interest or less. Under §302.001(d), "…a loan providing for a rate of interest that is 10 percent a year or less may provide for a delinquency charge on the amount of any payment in default for a period of not less than 10 days in an amount not to exceed the greater of five percent of the amount of the payment or $7.50." Because most CAB loans are either balloon loans or the loans are due in full upon default, the result for borrowers is fees far in excess of $7.50. The five percent provision applies not just to the minimum payment due, but to the entire principal and interest payment due on the loan. For a $500 loan, that means a $25 late fee, but for a $5,000 loan, which is not uncommon in the auto title lending space, the late fee is $250.

[29] Tex. Fin. Code §393.602(b).
[30] Check-N-Title Finance Credit Access Business CSO-CAB Service Agreement for a loan made in Dallas, Texas on September 14, 2015 (contract on file with the author).

The provision in the law that allows a 5% charge was designed for a usual payment on an installment loan (based on the minimum amount of $7.50) rather than a percentage of a balloon loan amount. The result for consumers is an excessively high hurdle to get back on track with the loan. No data is collected on the amount of these excessive late payment fees paid by Texas borrowers, but the numbers are likely high. A recent contested CAB bankruptcy filing sheds some light on the returns for the third-party lenders generated by these fees.[31] Court filings show rates of return for investors in Storehouse Lending LLC, which was the third-party lender for KJC Auto Title Loan Corporation, averaging around 15% and reaching as high as 20%, suggesting that the high late fees increase the returns for third-party lenders in the neighborhood of 50 to 100 percent.

*Policy Recommendations to address challenges raised in this section:*

**Policy Recommendation 7:** CAB's should be prohibited from arranging loans with third-party lenders that charge late fees in excess of the statutory minimum of $7.50. As the law stands, it allows excessive charges due to the balloon payments that are built into many CAB arranged loans.

In conclusion, we appreciate the opportunity to offer written testimony on this Interim Charge. Please contact Ann Baddour at abaddour@texasappleseed.net with any questions or requests for additional information.

[31] *Storehouse Lending LLC v. KJC Auto Title Loan Corporation*, Cause No. 352-282616-15 (352nd Jud. Dist. Tex. Dec. 29, 2015) (Exhibit E attached to Plaintiff's Original Petition).