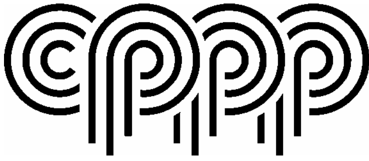

Center *for* Public Policy Priorities

THE POLICY PAGE

An Update on State and Federal Action

900 Lydia Street, Austin, Texas, 78702 PH: 512.320.0222 www.cppp.org

August 15, 2005 For more information: Contact Don Baylor, baylor@cppp.org No. 251

Unregistered and Unregulated: Payday Lenders Put Consumers at Risk and Flout Texas Usury Laws

Since Texas lawmakers defeated HB 846—an industry-backed bill that would have tripled the interest rates on short-term "payday" loans—the Texas payday lending industry has adopted another business model to evade state and federal regulation. In July, Texas-based payday lenders regrouped as businesses operating under Texas' Credit Service Organization Act. As a Credit Service Organization (CSO), a payday lending company dodges both federal guidelines restricting payday loans and the interest rate limits established by the Texas Finance Commission (TFC). Meanwhile, a recent TFC study demonstrates how Texas consumers are being gouged by these high-cost, short-term loans.

****Comment on Payday Lending at the August 18/19 Public Meetings of the Texas Finance Commission – See Pages 3 & 4.**

THE HIGH COST OF PAYDAY LENDING IN TEXAS

In April, the Texas Finance Commission (TFC) released its analysis of consumer loans regulated by the Office of Consumer Credit Commissioner (OCCC), which the commission oversees. The OCCC is responsible for regulating the credit industry and educating consumers and creditors. Using 2003 data, the TFC report examines several short-term loans offered in Texas, including payday loans and signature loans. Major findings of the report are:

- **Loans made by payday lenders using the rates of out-of-state banks – thereby evading interest rate limits established by the TFC – completely dominated the market.** This business model is known as the "rent-a-bank" or "rent-a-charter" model. In 2003, 1.81 million loans – 99.4% of the market – were made through partnerships with out-of-state banks. Fewer than 100,000 payday loans (less than 1%) were made by lenders in compliance with Texas rates.

- **Over 1,150 payday lenders loaned $626 million to Texas consumers.**

- **The average interest on a payday loan (under the rent-a-bank model) was $338 with an average 511% APR (highest APR was 6,570%). Note:** This average rate is four times higher than the maximum interest rate under TFC regulations, which limit the interest on a $350, 14-day loan to 123% APR.

- **A significant percentage of payday loans are renewed or "rolled over."** Over a quarter (25.8%) of payday loans were initiated to pay back a previous loan.

According to a study by the Center for Responsible Lending, a national organization that fights predatory lending, borrowers, on average, take out 8 to 13 payday loans a year from a single payday shop. Typically, these are back-to-back extensions of existing loans (rollovers) where the borrower is basically paying a fee keep the loan afloat, but never paying down the principal owed. Only one percent (1%) of all payday loans go to one-time emergency borrowers who pay their loan within two weeks and don't borrow again within a year.[1]

[1] "Fact vs. Fiction: The Truth about Payday Industry Claims," Center for Responsible Lending, December 2003. http://www.responsiblelending.org/pdfs/CRLpaydaylendingstudy121803.pdf

Although the TFC study did not quantify how much borrowers paid in fees and interest, other studies show that payday loans drain more than $100 million from the pockets of Texas consumers each year.

The TFC report is available on the commission's web site at http://www.fc.state.tx.us/Studies/non-realestate.pdf.

The findings in TFC's report illustrate the need for better consumer protections in the payday loan industry.

THE "CREDIT SERVICE ORGANIZATION" MODEL – NEW NAME FOR AN OLD GAME

Beginning in July, the major Texas-based payday lenders all registered as "Credit Service Organizations" (CSOs), including Advance America, Cash America, First Cash, EZ Pawn, and EZ Cash. Before this, virtually all Texas-based payday lenders operated under the "rent-a-bank" model, partnering with banks headquartered in states with lax or no usury laws. Under this model payday lenders claimed they were loan *brokers*, thereby enabling them to evade Texas usury laws and the short-term interest rates established by the Texas Finance Commission under Section 342 of the Texas Finance Code.

What is a Credit Services Organization? A Credit Services Organization (CSO) is defined under the Texas Credit Services Organization Act (Section 393 of the Texas Finance Code) as an entity or person that provides one of the following services:

- Improving a consumer's credit history or rating;
- Obtaining an extension of consumer credit for a consumer; or
- Providing advice or assistance to a consumer with regard to the previous two services.

Although CSOs are required to register with the Secretary of State, they are **not** licensed by the OCCC, and their fees are completely unregulated.

How does the CSO model work for payday loans? The Texas Credit Services Organization Act (CSOA) permits companies that register as CSOs to act as loan brokers. As CSOs, Texas-based payday lenders are now making loans through Texas-based consumer lending companies that are unregistered and unregulated.

Although the CSO's broker fee is included for purposes of Truth in Lending disclosures, CSOs argue that for purposes of Texas law, the broker fee cannot be treated as interest, since the CSOA has no explicit regulation of fees. This theory arises from a U.S. Fifth Circuit Court of Appeals opinion, in Lovick vs. Rite Money, which held that payments to a registered CSO loan broker could not be treated as interest. This ruling came despite repeated rulings by Texas courts prior to the passage of the CSOA that broker fees could be considered interest. If the payday lenders' reading of the CSOA is correct (despite the lack of language in the Act or legislative history to support such an interpretation), it constitutes a partial repeal of Texas usury laws.

In substance, little has changed in the new model: payday lenders are still making the same kind of loans they did under the rent-a-bank model at the same exorbitant interest rates. Only now, they are doing so in partnership with an unregulated and unregistered Texas-based finance company instead of through an out-of-state bank regulated by the Federal Deposit Insurance Corporation (FDIC).

In a nutshell, the CSO business model:

- Exploits Texas' permissive CSO statute;
- Enables payday lenders to collect similar fee amounts;
- Exempts short-term loans from state and federal consumer protection measures; and
- Could lead to fees that ***exceed*** those charged under the rent-a-bank model and reported in the TFC report.

WHY THE MOVE TO THE CSO MODEL?

The move to the CSO model is the latest step in the payday loan industry's dance around state and federal laws and regulations that limit interest rates or otherwise interfere with their business model. The most recent challenge to the payday loan industry came from federal regulators. In March, the FDIC issued guidelines that would effectively limit borrowers to six payday loans within a 12-month period.[2] These guidelines did not sit well with payday

[2] http://www.fdic.gov/news/news/financial/2005/fil1405.pdf. **Note:** The FDIC is the only agency that still allows its banks to offer payday loans. The Federal Reserve, the Comptroller of the Currency, and the Office of Thrift Supervision have already severed ties between the banks they supervise and storefront payday lenders who claim the banks' rights to export home-state interest rates and to preempt state laws.

lenders, since the majority of their profits come from multiple rollovers and repeat borrowers. According to the Center for Responsible Lending Study, borrowers who get five or more loans account for 91% of payday lender revenues, with only 1% of revenue from one-time borrowers.

Other states have also take action against payday lenders. In 2004, Georgia enacted a law to curb payday lending abuses. The Georgia statute sought to restrict the unfettered operations of payday lenders by:

- Capping the interest rate on small consumer loans at 60% APR, and
- Barring non-bank lenders from partnering with out-of-state banks.

Members of the payday loan industry challenged the Georgia law in court. In June 2005, the U.S. Eleventh Circuit Court of Appeals upheld the Georgia law and rejected industry claims of federal preemption. As the first federal appellate court opinion on the "rent-a-bank" model, the Eleventh Circuit decision affirmed that payday lenders are not brokers if they have a predominant economic interest in the loan. Therefore, they are subject to state usury laws even if they partner with an out-of-state bank.

The Georgia decision gave Texas and other states a precedent to challenge the practice of charter-renting for the purpose of evading state usury laws. For more information, see: http://www.responsiblelending.org/pdfs/GA_bill_summary.PDF and http://www.responsiblelending.org/pdfs/GA_Bankwest_v_Baker.pdf

During the regular session of the 79th Legislature, Texas-based payday lenders responded to the FDIC guidelines and the Georgia law by backing legislation (HB 846) that would have tripled the interest rates established by the Texas Finance Commission. If successful, this move would have eliminated the need for an out-of-state bank partner and with it the pressure to comply with the new FDIC guidelines. HB 846, which would have raised interest rates as high as 780% APR, ultimately failed to pass the Texas legislature under strong bi-partisan opposition.[3] The defeat of HB 846 and the Eleventh circuit decision to uphold the Georgia law, in turn, prompted the move to the CSO model.

[3] For more information on HB 846, see http://www.cppp.org/files/2/GTT%20coalition_HB%20846.pdf.

ACTIONS TEXAS CAN TAKE TO PROTECT CONSUMERS FROM HIGH COST LOANS

In May 2005, 37 Attorneys General, including Texas Attorney General Greg Abbott, penned a letter to the FDIC expressing their collective concern about the negative impact of payday lending on consumers, likening the product to a "debt treadmill." In the letter, the AGs condemned the intentional evasion of state laws and regulations through the use of out-of-state bank partners. Also, they strongly urged the FDIC to advise its banks "not to lend through third party payday lenders where the payday lending entity has the predominant economic interest in the loan and the bank relationship is used as a device to avoid state regulation."[4]

Texas' participation in this FDIC letter coupled with the Eleventh Circuit ruling open the door to new opportunities to protect Texas consumers from unregulated payday loans. Texas lawmakers should take the following steps immediately:

- Enact a law prohibiting state-licensed payday lenders from partnering with out-of-state banks to make loans; and
- Revise the Credit Services Organization Act to eliminate coverage for entities that offer payday loans or similar products.

In the meantime, the Attorney General should take enforcement action against payday lenders for intentional evasion of state laws and regulations, especially pursuant to Section 342.008 of the Texas Finance Code, which states:

> "A person who is a party to a deferred presentment transaction may not evade the application of this subtitle or a rule adopted under this subchapter by use of any device, subterfuge, or pretense. Characterization of a required fee as a purchase of a good or service in connection with a deferred presentment transaction is a device, subterfuge, or pretense for the purposes of this section."

Opportunities for Public Input: On **August 18**, at 3:00 p.m., the Texas Finance Commission's study committee will hold a public meeting to take testimony and vote on the direction and subject of the next TFC

[4] http://www.naag.org/news/pdf/20050510-FDIC-Letter.pdf

study. On **August 19**, TFC will hold a regular public meeting at 9:00 a.m., during which the public is invited to comment on any issue under the jurisdiction of the TFC agencies. Both meetings are at the State Finance Commission Building, William F. Aldridge Hearing Room, 3rd Floor, 2601 North Lamar, Austin, Texas. For more information about the hearings, see http://www.fc.state.tx.us/Packet/meetpacket.HTM.

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