SUBJECT: Regulation of payday loan services and lenders

COMMITTEE: Financial Institutions — committee substitute recommended

VOTE: 5 ayes — Solomons, Flynn, Guillen, Orr, Riddle

1 nay — Chavez

1 absent — McCall

WITNESSES: For — Deborah Reyes, Texas Deferred Deposit Coalition and Advance America; Steve Siegfried, CFSA *(Registered but did not testify:* Thomas C. Murphy; Eric Norrington, AceCash Express, Inc.)

Against — Celia Hagert, Center for Public Policy Priorities; Luke Metzger, Texas Public Interest Research Group; Richard Tomlinson; *(Registered but did not testify)* Rebecca L. Anderson, for Deece Eckstein, People for the American Way; Khelan Bhatia, AARP)

On — Leslie Pettijohn, Consumer Credit Commissioner; Rose Ann Reeser, Texas Attorney General

BACKGROUND: SB 317 by Sibley, enacted by the 77th Legislature in 2001, brought deferred presentment transactions, commonly referred to as payday loans, under the regulation of the Office of Consumer Credit Commissioner (OCCC). Payday loans are short-term loans in which a cash advance is made in exchange for a personal check or authorization to debit a deposit account. The amount of the check or authorized debit equals the amount of the advance plus a fee. The lender does not cash or deposit the borrower's check until a designated future date. The Finance Commission makes rules regulating these transactions.

Although lenders with Texas charters are subject to state regulation, lenders that partner with out-of-state banks are not subject to these same usury laws. The vast majority of payday loans occur through lenders that have partnered with out-of-state banks and exported rates from these banks for lending in Texas.

DIGEST:

HB 846 would amend the assets required for applicants for licenses to make consumer loans and would add provisions governing deferred presentment transactions. To be issued a license to make consumer loans, applicants would have to have and maintain net assets for their office of at least $150,000 available for operations. An applicant would not be required to have and maintain total net assets of more than $2.5 million for the operation of all offices at which the applicant engaged in deferred presentment transactions. Finance Code, ch. 342, regarding consumer loans would be amended by adding a subchapter M to govern deferred presentment transactions.

Loan contract. Each deferred presentment transaction would have to be documented by a written agreement that would:

- state the name of the borrower, the transaction date, the amount of the instrument, and the total amount of finance charges, expressed both as a dollar amount and as an annual percentage rate;
- specify the amount of the insufficient funds fee that the lender could charge for a returned instrument;
- set a date, not later than the 45th day after the transaction date, on which the instrument could be deposited, negotiated, or presented for payment; and
- include a prominent disclosure notice explaining the money should be used only to meet short-term cash needs, and renewal or refinance would lead to additional finance charges.

Each deferred presentment transaction also would consist of a notice that the debtor could not have more than $1,000 outstanding at one time and that he could rescind the transaction by 5 p.m. the business day following the transaction.

Loan stipulations. A deferred presentment transaction could provide for a finance charge of no more than $15 for every $100 advanced, and a pro rata finance charge for any incremental amount advanced in excess of a multiple of $100. The charge would be considered fully earned as of the date of the transaction, and the transaction could not be subject to any unauthorized charges.

A lender could not advance more than $1,000 or engage in a deferred presentment transaction with a term of less than seven or more than 45 days. A borrower could rescind the transaction by 5 p.m. on the business

day after the transaction. A lender would not be prohibited from lending both a deferred presentment transaction and another type of authorized consumer loan to the same borrower at the same time.

A lender offering a deferred presentment transaction would post at any place of business where a deferred presentment transaction was made a notice of the charges assessed for the transaction, including an insufficient funds fee.

Process. On receiving an application for a deferred presentment transaction, the lender would determine if the applicant had any outstanding transactions by verifying the accuracy of an affidavit signed by the applicant. A lender would perform a manual investigation or electronic query of the lender's own records and at all affiliate offices for outstanding transactions. If it was determined that an applicant had one or more outstanding deferred presentment transactions in which the amounts advanced equaled or exceeded $1,000, the lender could not enter into the deferred presentment transaction.

Before the sale or assignment of instruments held by a lender as a result of a deferred presentment transaction, the lender would place a notice on the instrument that would read: "This is a deferred presentment transaction instrument."

A deferred presentment transaction would be completed when the lender presented the instrument for payment or initiated an Automated Clearing House (ACH) debit to the borrower's bank account to collect on the instrument or the borrower redeemed the instrument by paying the full amount of the instrument to the lender.

Consecutive transactions. A consecutive transaction would be a transaction between a borrower and a lender in which the borrower:

- paid in cash the finance charge for a deferred presentment transaction and engaged in another such transaction with the lender before the end of the same business day; or
- refinanced all or part of the finance charges and advance of the deferred presentment transaction with a new deferred presentment transaction with the lender before the end of the same business day.

A lender could not enter into more than two consecutive transactions following an initial deferred presentment transaction. Each consecutive transaction would require a 10 percent reduction in the principal amount of the debt.

At the time a borrower entered into a second consecutive deferred presentment transaction, the lender would furnish the borrower reference information on consumer credit counseling agencies or services and any other educational materials furnished to the lender by the consumer credit commissioner.

If a borrower entered into a second consecutive deferred presentment transaction, the lender would provide an option to repay the loan under a written repayment plan. The terms of the repayment plan would be required to be conspicuously disclosed to the borrower and would require the borrower to:

- repay the loan in a minimum of four equal installments, with one installment due on each of the next succeeding dates on which the borrower received regular wages, compensation, or other income;
- pay a processing fee for administration of the payment plan of 10 percent of the amount of the advance for each deferred presentment transaction, not to exceed $20; and
- agree to not enter into an additional deferred presentment transaction during the repayment plan term.

Payment. An instrument would mean a personal check or authorization to transfer or withdraw funds from an account of a borrower made payable to a lender or third-party provider. A lender could pay the advance from a deferred presentment transaction to the borrower in the form of a business instrument, money order, or cash, or in another available form chosen by the borrower. The lender or third-party provider could not charge an additional finance charge or fee for cashing the lender's business instrument.

A lender could not negotiate or present an instrument for payment unless the instrument was endorsed with the business name of the lender nor accept more than one check in exchange for the advance.

Before the lender negotiated or presented the instrument, the borrower could redeem any instrument held by the lender as a result of a deferred

presentment transaction if the borrower paid the full amount of the instrument to the lender.

A lender would honor a repayment agreement entered into with a borrower, including one negotiated through a military counselor or a third-party credit counselor.

If an instrument held by a lender was returned from a payor financial institution due to insufficient funds, a closed account, or a stop-payment order, the lender could use civil means to collect the face value of the instrument. In addition, the lender could assess and collect a one-time insufficient funds fee of $20 or less per returned instrument and could not collect any other fees as a result of default.

A borrower would not be subject to a criminal penalty for entering into a deferred presentment transaction agreement unless the borrower intentionally or knowingly made a materially false or misleading written statement to obtain the loan or issued a check for the payment of money knowing that the issuer had no account with the bank at the time the check was issued.

Collection. A lender could not contact a borrower's employer about a deferred presentment debt, communicate facts about a borrower's indebtedness to an employer, or threaten criminal prosecution to collect an amount due under a deferred presentment transaction agreement.

A lender could not garnish the wages of a borrower who was a member of the armed forces or engage in collection activity against a member of the armed forces or national guard member on active duty.

Third-party providers. A third party provider would mean a person who transacted or negotiated a deferred presentment transaction by providing services in cooperation with and for the benefit of a lender. If a deferred presentment transaction was offered at the place of business of a third-party provider, the provider would:

- provide the commissioner a sample copy of the form of a written deferred presentment transaction agreement and copies of any subsequent modifications to this form if the provider participated in the preparation, execution, delivery, or custody of the agreement;

- post the required notice of charges for deferred presentment transactions;
- make available to applicants the name, address, and telephone number of the lender making the deferred transaction; and
- comply with licensing, recordkeeping, and recording provisions.

Records. A lender would file an annual report with the commissioner that stated for the preceding calendar year:

- the assets and liabilities at the beginning and end of the year;
- the lender's income, expense, gain, and loss, a reconciliation of surplus or net worth with the balance sheets, and the ratios of the profits to the assets reported;
- the total number of deferred presentment transactions made;
- the total number of outstanding deferred presentment transactions;
- the minimum, maximum, and average dollar amount of the instruments whose presentments were deferred;
- the average number of days the presentment of an instrument was deferred;
- a statement that the lender had not used criminal process or caused criminal process to be used to collect payment on a deferred presentment transaction; and
- the total number and dollar amount of returned checks and debit authorizations, transactions in which the face value of the instrument was recovered by the lender, and instruments charged off on the accounting records of the lender.

The commissioner would set a date by which the reports would have to be filed under oath. The commissioner annually would prepare a consolidated analysis and recapitulation of these reports to the Legislature and the governor. Aggregate data would be public information.

Regulation. Only an authorized lender could engage lawfully in the deferred presentment transaction business, and a transaction made by a person other than a lender would be a deceptive trade practice actionable under Deceptive Trade Practices-Consumer Protection Act. A licensed lender would maintain a separate license for each location where business was conducted.

A licensed lender could be examined and investigated in accordance with provisions pertaining to the investigation of consumer lenders in Finance

Code, sec 342.552 and sec. 342.553. The consumer credit commissioner or the commissioner's representative could examine and investigate a third-party provider's place of business, and the provider would give these individuals free access to its place of business and pay any fees to cover the costs of examination. During an examination, the examiners could administer oaths and examine persons on any subject pertinent to a matter that the commissioner was authorized to investigate.

Rules governing deferred presentment transactions would not apply to a credit services organization or the services of a credit services organization in connection with a loan having an interest rate of 10 percent a year or less. General provisions for lenders under Finance Code, ch. 341 and ch. 342, would apply to a lender unless those provisions were inconsistent with specific rules governing deferred presentment transactions.

The bill would take effect September 1, 2005.

SUPPORTERS SAY:

Between 2001 and 2003, outstanding payday loans grew from $103 million to $612 million. CSHB 846 would strike a balance between strong consumer protections and a regulatory framework that would allow reputable lenders to stay in business and offer loans directly to the increasing number of Texans who have exhibited a compelling demand for this credit product.

Payday loans are not targeted specifically to low-income families. More than 50 percent of the people in Texas who use this product earn between $25,000 and $50,000 per year. A $1,000 loan limit would be appropriate to meet the loan needs of many middle-income people without unduly burdening them with debt. Most payday lenders use income testing as a criterion for extending a loan so that people whose salaries could not support such an extension of credit would receive only the appropriate amount of funds. During 2003, nearly 77 percent of borrowers paid off their loans on time or early.

CSHB 846 would provide specific protections for military personnel who chose to use this service. The protections would include, among others, prohibiting the garnishment of military wages, banning attempts by lenders to contact the military chain of command to collect payment, and deferring collection activity for deployed military customers or guardsman and reservists called to active duty.

The bill would provide extensive consumer protections, including limits on the amounts of fees that could be charged and the number of times a transaction could be renewed, requirements for an extended repayment plan, and a 10 percent pay-down requirement for the principal on a loan. These protections would keep consumers out of the cycle of debt often cited when consumers have been victimized by unscrupulous lenders. The bill would include provisions on consumer education and disclosures so the borrower would be well-informed about the commitment being made and could rescind if they had concerns after signing an agreement.

CSHB 846 would reduce the cost of payday loans to Texas consumers, who currently pay $17 to $24 per $100 borrowed from out-of-state banks and about $30 per hundred to Internet and disguised payday lenders. The bill would lower the market rate to a maximum of $15 per $100, giving Texans a cheaper alternative. Nationally, 36 states have studied this issue and enacted legislation allowing an average fee of $17.50 per $100. In fact, Indiana and Kansas, having previously enacted overly restrictive fees averaging about $12.50 per $100, recently repealed those rates in favor of a $15 fee.

Annualized percentage rates are a deceiving comparison for the cost of loans. CSHB 846 would prohibit lenders from renewing a loan more than twice, and it would require a 10 percent reduction of the principal amount upon each renewal. Moreover, consumers could enter into an extended repayment plan to repay the debt. These restrictions would provide a clear solution so consumers could avoid getting trapped in a "cycle of debt."

Many consumers have choices in financing short-term needs, and they routinely choose payday loans over other options. Fees for payday loans generally are less than fees for bouncing a check, overdraft protection, or late fees on bills. Suggested alternatives that would further restrict this market would result in a no-win situation for Texans. A restrictive rate would prohibit most businesses from operating here, and the hundreds of thousands of Texas consumers who chose this credit option would be forced to do business with either more expensive out-of-state banks, unregulated Internet payday lenders, or scam operators.

Consumers would also benefit from more competition in the marketplace, since the bill would put Texas-based banks and businesses on a more equal competitive footing with out-of-state banks. Market forces would

drive current rates, even those of lenders affiliated with out-of-state entities, down in response to the need to compete.

OPPONENTS SAY:

Although the intent to regulate payday lenders is good, CSHB 846 would allow lenders to prey even more on poor and working-class families. This bill actually would increase the cap on interest rates consumers pay on loans to $15 per $100 loan. For an average loan of two weeks, this would be the equivalent of 390 percent APR—almost one-third higher than the cap allowed under current law. Texas already requires payday lenders to comply with the state's small loan and criminal usury laws. Lowering the maximum allowable rate to $11 per $100 borrowed would bring the total cost of payday loans down to a more manageable level.

Studies have demonstrated that payday lenders disproportionately set up shop outside military bases. Payday lenders prey on these consumers who may have specialized needs, offering loans up to $1,000 against a future payroll check guaranteed by the government.

Many low-income borrowers find themselves unable to repay their loan amount plus fees at the end of the loan term, and these individuals are forced to carry their debt past the original term, incurring more fees in the process. Although the bill would allow borrowers to engage in at most three consecutive transactions, new fees would be added each time, and the borrower would only be required to pay down 10 percent of the principal. In addition, even when a borrower paid off one loan, that borrower still could obtain another one the next day. The FDIC suggests as a standard that an individual not obtain more than six total loans in one year, and it would be easy for consumers to exceed this number. Even if borrowers pay off their loans on time, many still over-use this service. This bill would not provide enough protections to advance a borrower out of a cycle of debt.

CSHB 846 would not protect Texas borrowers from higher rates charged by lenders affiliated with out of state banks. Lenders with a base of operations in a state that does not regulate payday loans may export higher rates to their affiliates, and Texas's working poor would still bear the consequences of unscrupulous business practices by unregulated, out-of-state interests. Other lenders with the freedom to break the ties from out-of-state banks would still stand to gain more in profits even while charging smaller transaction fees because they would not have to provide a share of

profits to an affiliate bank. This would leave lenders plenty of room to reduce fees below $15 per $100 and still earn a profit.

CSHB 846 would set the maximum allowable loan amount at $1,000 per loan. This is higher than the maximum allowable loan amount in other states that regulate payday lending. Out of 35 states that regulate payday loans, Idaho is the only one that allows a $1,000 maximum loan amount. Most of the 34 others set the maximum loan at $500 or less. Even with a 45-day term, a $1,000 loan is equal to 75 percent of a minimum wage worker's gross salary during that time period. That would be like a middle-income family earning $40,000 taking out a $3,500 loan for 45 days.

Income testing would not prevent a low-income person from obtaining the full $1,000 permissible because income-based lending is a part of lender practice and would not be included. Even if one lender refused to provide an individual $1,000, that person could go to another lender to obtain the remaining funds.

NOTES:

The original bill would have included lower net asset requirements for license applicants, a fee cap of $16.50 per $100 loaned, and a 5 percent principal pay down.

The original bill did not include as extensive plain language and disclosure requirements, the limitation to two consecutive transactions with a 10 percent reduction to principal, an explanation of completion of a deferred presentment transaction, a payment plan, certain stipulations for payments, limitation of insufficient funds fee charges, certain annual reporting requirements, exemption of credit service organizations, prohibitions on abusive collection practices, and military protections.