Center *for* Public Policy Priorities

POLICY PAGE

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As Payday Lending Spreads Across Texas Can it be Reformed or Regulated?

Payday lending, sometimes known as a cash advance, is a small, short-term, high interest loan that is intended to bridge the borrower's cash flow gap between pay periods. High-cost payday loans are considered among the most destructive financial products in the marketplace. With increasingly high lending volume in Texas—well over 2 million loans per year— and exorbitant interest rates (often higher than 500% APR), payday lending products drain over $280 million in earnings from Texas workers each year and pitch many borrowers into an endless cycle of debt.

Across the country, consumer advocates have partnered with religious groups, military organizations, and mainstream financial institutions in an effort to push state regulators and lawmakers to curb payday lending abuses. Some states have passed laws regulating the industry; others have banned payday lending outright. Congress recently extended a 36% interest rate limit for active military. In Texas, there is no state law governing payday loans, although state regulations establish interest rate caps. However, payday lenders are able to skirt Texas' usury limits, state regulation, and federal scrutiny by registering as Credit Service Organizations (CSO). CSOs are classified not as lenders but as entities that extend credit to Texas consumers. A distinction that may leave you scratching your head. Can Texas regulate the industry in a way that protects borrowers from the dangers of payday loans?

The CSO Model – No Regulation, No Accountability

In 2005, the FDIC cracked down on payday lending with strict regulation designed to prevent lenders from evading state usury laws through out-of-state bank partnerships, otherwise known as the "rent-a-bank" model. Most Texas payday lenders responded to the FDIC's crackdown on the rent-a-bank model by registering as Credit Service Organizations (CSO). Under the CSO model, payday loan companies register with the Secretary of State and use an anonymous third-party lender to make loans. The Secretary of State merely serves as a registry for CSOs, and has no authority to regulate or otherwise oversee their activities. Although the CSO statute was intended to apply to entities providing legitimate debt and credit repair services, the Texas Attorney General has concluded that payday lenders' use of the CSO model fits does *not* violate the law. However, it is clear that this shift violates the intent of the Texas CSO Act and the constitutional usury limitations.

CSO loans are even more expensive than the previous "rent-a-bank" product. One major payday lender charges the following fees and interest for a 14-day loan:

Loan Principal	CSO Fee	Interest	APR
$300	$60	$1.13	531%
$500	$100	$1.89	531%

These fees are typical of most payday loans made under the CSO model.

A Texas payday loan costs nearly 20 times as much as a cash advance on a high interest credit card (19.9% APR) over a similar period. Moreover, some lenders are making loans up to $1,000, further increasing the probability of entrapping borrowers in a debt spiral.

Unlike other states, Texas collects scant data on payday loans or the demographics of borrowers. But according to estimates by the Center for Responsible Lending, Texas workers borrowed nearly $1.8 billion in principal balances, plus another $287.7 million in payday loan fees in 2005.[1]

Payday Loan = Dangerous + Defective Product

Although borrowers must be employed and have an active bank account, Texas payday outfits consistently violate the most fundamental principle governing extension of credit: *lending without due regard of the ability to repay*. As a result, most workers are compelled to renew or take out a "rollover" loan to repay the original loan, and the cycle continues.

In other states with reliable and independent data collection systems, several trends have emerged to suggest that a high-cost payday loan is among the most destructive financial products in the marketplace. Among the findings:

- About 90% of payday loans are issued to borrowers with 5 or more transactions per year;
- Over 60% of loans are to borrowers with 12 or more transactions per year;
- The typical payday borrower takes out 9 loans per year and repays $793 on a $325 loan; and
- Only 1 in 100 payday borrowers pays the entire balance by the original due date.[2]

Disturbingly, these findings include data from states such as Florida and Oklahoma that have passed legislation to "reform" payday lending by limiting fees, rollovers, and the number of outstanding loans. These states also have implemented database collection and verification systems to analyze lending data and ensure compliance with state law. Despite these efforts to protect borrowers, lenders in these states have found ways to continue to charge excessive interest rates and take advantage of low-income workers.

Independent research has shown that the typical Oklahoma borrower takes out an average of 9.4 loans per year. The chronic user makes up the bulk of the payday lending business. *Nearly 74% of Oklahoma's payday transactions derived from borrowers who had taken out 10 or more loans in a 12- month period.*[3]

These findings suggest that occasional borrowers typically become habitual users. Moreover, payday outfits rely on the chronic indebtedness of borrowers to maintain a profitable business model.

Is Payday Reform Worthy of Consideration?

In recent years, several states, including Illinois, Florida, and Michigan, have implemented so-called "best-practice" restrictions on payday lending. These measures have included database verification, reporting, and "cooling-off"

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[1] Center for Responsible Lending, *Financial Quicksand*, (2006). See http://www.responsiblelending.org/pdfs/rr012-Financial_Quicksand-1106.pdf

[2] Ibid.

[3] See http://www.veritecs.com/OK_Trends_Aug_2006.pdf

periods, along with limits on fees and consecutive loans. However, after these measures were implemented, payday loan volume and borrower indebtedness continued to rise.

In some cases, these laws were pushed by the industry itself in an effort to evade increasingly strict federal regulations and establish a fertile operating ground under the protection of state laws.

In other cases, consumer groups have pushed the changes through their legislatures only to find the tougher measures offer limited protection for borrowers. In Illinois, for example, some payday lenders devised creative products—including high-cost installment loans— to evade the new reform laws, compelling regulators to clarify legal intent repeatedly. In Michigan, payday lenders have attempted to use the Michigan CSO law to evade a law passed in 2005.

In Texas, the industry has been working for almost eight years to pass a state law regulating payday loans. Last session, HB 846 would have set an interest rate limit of $15 per $100 borrowed, a 780% APR for a 7-day loan. Industry-backed legislation has so far failed to pass the Texas Legislature, the result of opposition from consumer, religious, and military groups and the unwillingness of lawmakers to make such excessive interest rates a permanent feature of state law.

Failed efforts at payday loan “reform” in Texas and other states offer important lessons for the 80th Legislature when it considers payday lending reform:

- The patterns of chronic overuse and debt are likely to continue, and payday lending volume will probably rise;
- Some payday outfits will likely devise other ways to evade the recent reforms; and;
- Payday lenders will most likely continue to disregard borrowers’ ability to repay the loan.

Congress has already begun to address real payday lending reform by extending protection for active-duty service members and reservists. This federal law—effective October 2007—caps annual interest rates at 36%, well below the industry standard that hovers close to 600% APR in Texas.

Recommendations

CPPP recommends the following actions to ensure that Texas workers are protected from excessive fees for short-term loans:

- Close the CSO loophole to apply only to entities that provide legitimate debt and credit repair services;
- Enact legislation to collect payday loan data through a third-party vendor system; and
- Enact legislation that establishes rate limits and other lending protections for active military (similar to federal law).

For more information, see:

http://www.responsiblelending.org/pdfs/rr012-Financial_Quicksand-1106.pdf;

http://www.veritecs.com/news.htm

http://www.cppp.org/research.php?aid=443&cid=2&scid=2

http://www.cppp.org/files/2/financial%20literacy%20pr.pdf

You can find all of CPPP’s research on payday lending at http://www.cppp.org/subcategory.php?cid=2&scid

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