SENATE COMMITTEE
ON
ECONOMIC DEVELOPMENT

SUBCOMMITTEE ON
CONSUMER CREDIT LAWS

INTERIM REPORT TO THE

77TH TEXAS LEGISLATURE

TABLE OF CONTENTS

Subcommittee on Consumer Credit Laws
Executive Summary

The Senate Committee on Economic Development Interim Subcommittee on Consumer Credit Laws was created on November 1, 1999, to review and provide recommendations regarding the Senate Committee on Economic Development's Interim Charge Number 3 relating to the convergence of the banking, securities, and insurance industries. The Subcommittee charge reads as follows:

- Review Article 16, Sec. 11 of the Texas Constitution, relating to the maximum rates of interest for contracts entered into in the State.
- Study the effect of usury limits on the various consumer lending entities in the State.
- Evaluate the effect of the pending federal Financial Services Modernization Act on consumer credit laws in Texas.

In order to fully research and address each of these charges, the Subcommittee held two separate hearings in Austin on January 19, and April 25, 2000.

Based upon the research conducted, the Subcommittee makes the following recommendations:

1. Amend Texas law so as to ensure that a sale/leaseback transaction involving consumer goods is defined such that an agreement to defer the payment of a debt and an absolute obligation to repay a debt exists.

2. Amend Texas law to require that businesses offering sale/leaseback transactions provide customers with federal Truth in Lending Act disclosures.

3. The Subcommittee recommends that the Senate Committee on Economic Development monitor the implementation of the Finance Commission's newly-promulgated 7 TAC 1.605.

4. Monitor the progress of federal and state regulators' promulgation of privacy rules connected to the Gramm-Leach-Bliley Act of 1999.

Constitutional Usury Provision: Review Article 16, Sec. 11 of the Texas Constitution, relating to the maximum rates of interest for contracts entered into in the State.

Black's Law Dictionary defines usury as "charging an illegal rate of interest."[1] The Texas Constitution of 1869 abolished all usury laws and prohibited the Legislature from making laws limiting the amounts of interest parties could agree upon for loans of money or other property.[2] The abolishment of any sort of usury limits was the result of the framers' of the Constitution of 1869 belief that it was not the Legislature's place to regulate contracts entered into by the state's citizenry. The lack of any sort of usury provision produced such a sweeping flood of credit abuses, however, that the framers of the Constitution of 1876 reintroduced usury laws to the state.

The usury provision in the Constitution of 1876 provided 8% as the legal rate of interest, but permitted interest at 12% if agreed to by the parties to a contract.[3] By 1891, however, the Legislature felt these limits were too high. Thus, an amendment to Article 16, Section 11 was proposed and adopted which established the legal rate of interest at 6% but permitted parties to a contract to agree to a maximum of 10%.[4] This remained the state of Texas usury law until 1960, when the people of the state approved another amendment to Article 16, Section 11. The law as a result of the 1960 amendment remains in effect today, and provides, in pertinent part:

> The Legislature shall have authority to classify loans and lenders, license and regulate lenders, define interest and fix maximum rates of interest; provided, however, in the absence of legislation fixing maximum rates of interest all contracts for a greater rate of interest than ten per centum (10%) per annum shall be deemed usurious; provided, further, that in contracts where no rate of interest is agreed upon, the rate shall not exceed six per centum (6%) per annum.[5]

Absent legislation to the contrary, it is within this framework that parties lending money to consumers in the State of Texas should be operating. The Subcommittee on Consumer Credit Laws has spent the past five months studying the effects the constitutional and statutory usury limits have had on consumer loans, specifically on loans of under $500 with short loan terms. Additionally, the Subcommittee has been presented with a great deal of testimony regarding the types of businesses offering these loans and the types of transactions in which they are offered.

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[1] Black's Law Dictionary 1545 (6th ed. 1990).

[2] TEX. CONST. of 1869, art. XII, § 44.

[3] TEX. CONST. of 1876, art. XVI, § 11.

[4] TEX. CONST. of 1876, art. XVI, § 11 (1891).

[5] TEX. CONST. of 1876, art. XVI, § 11 (1960).

Effect of Usury Limits on Consumer Lending Entities: Study the effect of usury limits on the various consumer lending entities in the State.

The forty years since the constitution's last usury amendment have given birth to a variety of businesses and business practices which have successfully circumvented Article 16, Section 11's requirements. Some of this circumvention has been statutorily sanctioned; however, other practices are still operating on the perimeter of the law. The main types of transactions the Subcommittee focused on were: Subchapter F loans, sale/leaseback transactions, and payday loans.

Subchapter F Loans

Chapter 342, Subchapter F, of the Texas Finance Code permits consumer loan offices to make loans of up to $480. Authorized in Texas since1963, the maximum loan amount is set by applying the adjustment in the consumer price index relative to the base index, set in 1967, to the maximum loan amount of $100 established in 1967. Thus, the maximum loan amount of $100 in 1967, is now $480. The maximum charges for one month loans made under Chapter 342, Subchapter F, are based upon a sliding scale. An acquisition fee of $10 plus an additional charge of $4 per $100 borrowed per month is authorized. Thus, the fees charged are:

Amount of Loan	Allowable Charges	APR % 30 days
$ 100	$ 14	168 %
$ 200	$ 18	108 %
$ 300	$ 22	88 %
$ 400	$ 26	78 %
$ 500	N/A	N/A

Subchapter F lenders are licensed, examined, and supervised by the Office of Consumer Credit Commissioner; the loans they make are subject to and in accordance with the applicable laws and regulations enacted by the Texas Legislature, the United States Congress, the Federal Reserve Board, the Consumer Credit Commissioner, and other federal regulatory agencies. The charges on loans made under Subchapter F may not exceed the charges authorized by the Texas Legislature.

To put the demand for these loans into perspective, the Office of Consumer Credit Commissioner estimates that in 1998, Subchapter F lenders made 3, 694, 849 small loans in a total amount of $ 1, 069, 568, 582 to Texas consumers. This dollar amount represents an increase of over 300% since 1985. Thus, over the past fifteen years there has clearly been an increase in need for and utilization of lending services which offer short term consumer loans of less than $500.

Persons other than banks, savings banks, credit unions, or savings and loan associations who make consumer loans in Texas and charge more than 10% per annum are required to be licensed by the Office of Consumer Credit Commissioner.[6] Section 342.051 of the Finance Code also provides that "A person may not use any device, subterfuge, or pretense to evade the application of this section."[7]

The Texas Finance Code, Section 301.002(10), defines a "loan" as "an advance of money that is made to or on behalf of an obligor, the principal amount of which the obligor has an obligation to pay the creditor."[8] A person commits a misdemeanor offense if the person engages in the business of making small consumer loans without a license or other authorization, and each loan made without the proper authority is a separate offense.[9] A person also commits a misdemeanor offense if the person charges interest that is more than twice the amount authorized by statute.[10]

Along with the increased need for readily available sources of cash, there has been an increase in the circumvention of Texas' usury limits. The overwhelming majority of Subchapter F lenders are clearly operating within the limits of the law. In fact, 97.9% had a satisfactory rating of compliance on recent examinations; thus, these are not the lenders about whom there is concern. Rather, the main area of concern lies with entities who are engaging in what appear to be credit transactions, but purport not to be making loans at all.

These entities set up their transactions to closely resemble loans, but they allege that the transactions are not loans, thus they contend, Texas' usury limits do not apply. It is clear, though, that these transactions involve the giving of an amount of money to a customer in return for which the customer must pay some sort of transaction fee. Upon the expiration of the agreement's term, the customer has an obligation to repay the amount of money borrowed. Based on the mechanics of the transaction, it certainly appears that it should fall within the definition of loan discussed above.

Furthermore, the Truth in Lending Act (TILA; 15 U.S.C. 1601 et seq.) requires creditors to disclose the terms and cost of credit they extend to consumers. The TILA defines credit as: the right granted by a creditor to a debtor to defer payment of debt or to incur debt and defer its payment.[11] The Board of Governors of the Federal Reserve System recently revised the official staff commentary to Regulation Z (the Truth in Lending Act is implemented by Regulation Z of the Code of Federal Regulations). The revisions, which became effective on March 24, 2000, include the following statement: "transactions in which parties agree to defer payment of a debt are "credit" transactions regardless of the label used to describe them."[12]

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[6]TEX. FIN. CODE ANN. § 342.051(a) (West 1993)

[7]TEX. FIN. CODE ANN. § 342.051(b) (West 1993)

[8]TEX. FIN. CODE ANN. § 301.002(a)(10) (West 1993)

[9]TEX. FIN. CODE ANN. § 349.502 (West 1993)

[10]TEX. FIN. CODE ANN. § 349.501 (West 1993)

[11]15 U.S.C. 1602 (e).

[12]Commentary to Regulation Z, 12 CFR 226. Please see Appendix C.

Additionally, both state and federal case law hold that a court should consider the substance of a transaction rather than its mere form.[13] In fact, several courts have reasoned that:

> no case is to be judged by what the parties appear to be or represent themselves to be doing, but by the transaction as disclosed from the whole evidence; and, if from that it is in substance a receiving or contracting for the receiving of usurious interest for a loan or forbearance of money the parties are subject to the statutory consequences, no matter what device they may have employed to conceal the true character of their dealings.[14]

Thus, regardless of the labels the parties place on a transaction, or the forms that they use, the classification of the transaction should be determined by its economic reality, not the name it bears.

Recommendation(s):
1. The Subcommittee recommends no changes be made to traditional Subchapter F loans.

Sale/Leaseback Transactions

One industry which has embraced the subterfuge of renaming the loan transaction in order to avoid regulatory oversight by the Office of Consumer Credit Commissioner is the sale/leaseback industry. It should quickly be pointed out here that the sale/leaseback transactions that this subcommittee is concerned with involve the sale and subsequent leaseback of consumer goods. The main question is: are sale/leaseback operators entering into transactions with customers in which there is an agreement to defer the payment of a debt? If there is such an agreement, then the constitutional 10% ceiling should apply absent any legislation to the contrary.

In order to properly answer this question, we must first examine what a sale/leaseback transaction involves. A sale/leaseback transaction is one in which a person who is interested in getting cash takes the serial number from a home appliance into a sale/leaseback company along with his checkbook. The company "purchases" the appliance and then leases it back to the customer. The purchase price is the amount of cash that the customer seeks. Typically, the customer is asked to leave a personal check in the same amount as a "security deposit." The administrative/transaction fee that the business charges the customer for the service is the "lease payment" that the customer must pay in order to continue to use his own appliance.

At the end of the two week lease term, the customer pays the total amount of money loaned, plus a leasing fee of typically thirty to thirty-three dollars per every one hundred borrowed. If the

[13] Espinoza v. Victoria Bank & Trust Co., 572 S.W.2d 816, 823 (1978).

[14] Turner v. E-Z Check Cashing of Cookeville, TN, Inc., 35 F. Supp. 1042, 1048 (M.D. Tenn., 1999). Please see Stedman v. Georgetown Savings and Loan Ass'n, 595 S.W.2d 486, 489 (1979) for a Texas Supreme Court decision holding the same.

customer is unable to repay the amount of cash borrowed, he must renew and extend the loan term or face to consequences of having his personal check, for the same amount, deposited.[15] Sale/leaseback operators claim that their customers have the option of forfeiting the "leased" property as payment in full. It is this ability to turn over the good sold and subsequently leased back that sale/leaseback operators argue prevents there from being a credit agreement. However, the majority of sale/leaseback "borrowers" find that when they try to turn the goods sold over to the operator, the goods are not accepted. Only cash or lease renewals are accepted. Thus, to avoid having their names turned over to local prosecutorial hot check divisions, customers are forced to renew their leases, securing their place in a vicious cycle of debt.

Although the typical sale/leaseback contract is for 15 days, the example below is based upon a thirty day term. Thus, the effective annual percentage rate transaction works out as follows:

Amount of Loan	**Amount Charged**	**APR % 30 days**
$ 100	$ 66	792 %
$ 200	$ 132	792 %
$ 300	$ 198	792 %
$ 400	$ 264	792 %
$ 500	$ 330	792 %

On their face, these figures certainly seem to exceed Texas' constitutional usury limit. As discussed above, Section 342.051(a), Texas Finance Code, requires persons other than banks, savings banks, or savings and loan associations who make consumer loans in Texas and charge more than 10% per year to be licensed by the Office of Consumer Credit Commissioner. At this time, sale/leaseback operators are completely unregulated. Additionally, contrary to Section 342.051(b), Texas Finance Code, it appears that sale/leaseback operators are using subterfuge and/or pretense to evade the application of this section, as they steadfastly maintain that they are not offering loans.[16]

During the 76th Session of the Texas Legislature there were a number of bills filed that sought to monitor sale/leaseback operations. Each of the bills termed sale/leaseback transactions as loans if the amount of money received by the customer from the operator for the sale of his good exceeded the original price paid for the piece of personal property. As loans, the excess amount paid to the customer is interest subject to Subtitle B, Chapter 342, Texas Finance Code. Each of these bills met with a great deal of resistance from sale/leaseback operators statewide, and as a result, none of these bills were successfully passed by the Texas Legislature. However, Senate Bill 88, relating to certain transactions subject to regulation as loans, was passed by the Senate. A copy of Engrossed SB 88

[15]Please see Appendix D for OCCC handout illustrating the nature of a sale/leaseback transaction.

[16]TEXAS FIN. CODE ANN. § 342.051(b) (West 1993)

is found in Appendix E.

Even given these incriminating facts, state regulators have had a difficult time forcing sale/leaseback operators to work within the confines of the law. The operators typically use the following arguments. First, sale/leaseback operators maintain that the service they offer does not qualify as a credit transaction because the sale of a good is involved. Thus, they argue there is no loan, there is simply a lease and no obligation to repay. Sale/leaseback operators further contend that the transaction fee in no way represents interest; rather, it is an administrative fee which represents the cost of doing business. Third, sale/leaseback industry representatives argue that no more regulation is needed given the Deceptive Trade Practices Act (DTPA), the usury statute, and federal Truth in Lending laws.[17] Finally, operators argue again and again that their business practices were tested and found to be legal in a 1991 case filed by Attorney General Dan Morales against a Houston sale/leaseback company.[18]

Subcommittee testimony and research refute the arguments of the operators as follows. First, while it is argued that the sale and subsequent lease of a good is involved, it is important to note that at no time do any goods exchange hands in these transactions. Operators argue that if after the expiration of the two week lease term the client is unable to repay the full amount of money borrowed together with the transaction fee, the client has the option of forfeiting the leased item as repayment. However, the operators have no proof that the consumer good actually exists. Based upon material submitted to and research conducted by this Subcommittee, sale/leaseback operators rarely accept the good(s) as payment.

In fact, a Dallas-area television station ran a sale/leaseback story in April, 1998, highlighting one sale/leaseback client's difficulties. The client, a seventy-eight year old retiree named Amy Rice, "sold" her TV and VCR to Jiffy Leasing for $500. Ms. Rice was required to leave a postdated check for $695 --- $500 for the sale price and $195 for the fees associated with the two week lease.[19] At the end of the two week period, Ms. Rice was unable to pay the $695 owed. When she offered her TV and VCR to the sale/leaseback operator, the operator laughed and told her that she didn't want the goods, she wanted the $695.[20] This example illustrates the experiences of many sale/leaseback customers who are unable to repay within the designated lease term. With the goods being refused and the customer having an obligation to repay the money, the practical result of the transaction is that the operator takes a check for the amount of money advanced in exchange for the customer's agreement to defer the payment of the debt. Under the Texas Finance Code, this transaction fits the definition of a loan.[21]

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[17]Mr. John Steven Dwyer, Testimony before the House Committee on Financial Institutions (Apr. 6, 2000).

[18]Please note that this case was unreported, so no record of the decision is available.

[19]This works out to be roughly 1016% interest.

[20]*Interview with Amy Rice* (News 8, Spirit of Texas broadcast, Friday, May 1, 1998).

[21]TEX. FIN. CODE ANN. § 301.002(10) (West 1993)

Our second finding regarding sale/leaseback transactions relates to the operators' argument that the fees charged are not interest, but rather represent the costs of their doing business. The operators argue that the high degree of risk of loss associated with their business warrants the exorbitant fees charged. However, many argue that even though the individuals who utilize sale/leaseback businesses typically are not credit worthy, operators are able to turn a profit at a rate lower than an amount that works out to be effectively 792% per annum.[22] The argument that charging anything less than approximately $30 per $100 is not convincing given the fact that Subchapter F lenders are able to operate their businesses for profit by charging $14 for the first $100 borrowed. For those sale/leaseback customers who, because of their poor credit, cannot take advantage of the services offered by Subchapter F lenders, have the option of utilizing the services provided by pawnshops. Pawnshops are able to profitably lend up to $144 at a rate that works out to be 240% APR.

The third argument raised by operators is that no new regulation is needed given the usury provision in the Texas Constitution, the DTPA, and federal Truth in Lending laws. With regard to this argument, the Subcommittee received input on the following. First, to argue on the one hand that the transaction fees charged are not interest and therefore the usury statute does not apply, and on the other hand that no new regulations are needed because the usury statute exists and polices the industry, is extremely circuitous. The flaw in this reasoning is clear.

Second, Texas' Deceptive Trade Practices-Consumer Protection Act is designed to protect consumers against false, misleading, and deceptive business practices, unconscionable actions, and breaches of warranty and to provide efficient and economical procedures to secure such protection.[23] While it goes far to protect Texas consumers against unscrupulous business practices, we must keep in mind that it is a legal remedy. As such, in the matter at hand, the wronged consumer must take legal action against the sale/leaseback operator. That means hiring an attorney, filing the claim, and waiting for that claim's resolution. Even though the consumer is entitled to recover attorney's fees and up to three times actual damages, for the consumer who was clearly having financial difficulties when he went to the sale/leaseback business, this may be too little too late. Additionally, it is simply not good public policy to argue that the existence of a legal remedy (e.g., a lawsuit) should suffice to police an entire industry; this is not consumer protection.

Finally, operators argue that the existence of federal Truth in Lending disclosure requirements in itself warrants that no new Texas laws are needed to monitor the sale/leaseback industry. However, there is no current requirement that the Truth in Lending disclosures must be made in sale/leaseback agreements. In fact, it was not until very recently that the possibility that Truth in Lending disclosures need to be made in sale/leaseback transactions arose. As discussed above, the Board of Governors of the Federal Reserve System recently revised the official staff commentary to Regulation Z. These revisions provide that transactions in which parties agree to defer payment

[22]Please see chart on page 6.

[23]TEX. BUS. & COM. CODE ANN. § 17.44(a) (West 1993)

of a debt are "credit" transactions regardless of the label used to describe them."[24] The Subcommittee received testimony that under this new commentary, sale/leaseback operators are now likely to be required to make Truth in Lending disclosures. That is to say, operators were previously not required to make these disclosures; thus their argument that no new regulation is needed because of the existence of Truth in Lending laws is misleading.

Our final rebuttal point relates to the argument that the legality of sale/leaseback businesses was tested and proven in the 1991 case against Personal Rental.[25] In that case, the Attorney General filed suit against a Houston sale/leaseback business for disguising loans as leases and charging illegally high rates of interest. The case was tried before a jury and the jury found that the transactions in question were in fact leases, and thus, that there were no violations of Article 16, Section 11. However, there were two distinguishing facts in that case from sale/leaseback operations today. First, the operator in the Personal Rental case **did** accept the "sold" good in lieu of payment. As pointed out above, this is not typically the case; certainly it was not true for Amy Rice. The case against Personal Rental was somewhat unique because it was one of the few companies that accepts the good(s) sold as payment. Second, and more importantly, at the time the Personal Rental Case was filed, the Texas Finance Code did not contain a definition of "loan." It was not until 1997, with the passage of House Bill 2180, that the Finance Code contained a workable definition of loan. Thus, operators' repeated use of this Houston case as the basis for the legality of their businesses is inappropriate because if brought under today's definition of loan, the result may have been different.

It is interesting to note that the industry places a great deal of emphasis on whether the transaction is "done correctly." The repeated emphasis placed on this phrase seems to point to the fact that industry representatives recognize that there are operators who are not doing these transactions correctly, who are taking advantage of economically disadvantaged consumers, and breaking federal and state laws while doing so. The reliance on this phrase also seems to point to the fact that the operators themselves recognize there is a very narrow loophole in this area of Texas law; and it is only within this loophole that they can "legally" continue to operate their businesses.

Before we close this area of our discussion, there is one additional issue regarding sale/leaseback operations that warrants being discussed. The issue is the enforcement of the sale/leaseback agreement. As mentioned above, many sale/leaseback customers are unable to repay their loan at the end of their lease term. If operators refuse to accept the good sold as payment of the debt, the customer has limited options. He can either renew the lease term for another two weeks, forcing him to pay an additional leasing transaction fee, or he can do nothing, which means that the operator will deposit the checks initially left with him. If the operator deposits these checks, they will likely bounce. After all, when the company asked the customer to write the check for the amount he borrowed, plus a fee, it in all probability knew that the customer did not have the funds in his account to make good on the check; that's why he needed the loan.

[24]Commentary to Regulation Z, 12 CFR 226. Please see Appendix C.

[25]Please note that this case was unreported, thus no record of the decision is available.

The Consumers Union, Southwest Regional Office, reports that the Travis County District Attorney's office will not accept a check for prosecution as theft by check if they know that it was taken with the knowledge that it would not be cashed, or would be held for any length of time. But the District Attorney, handling thousands of bounced checks each year, may not be able to differentiate one from another. Justices of the Peace, who prosecute people for Issuance of a Bad Check (Section 32.41, Texas Penal Code), also a misdemeanor charge, do not require proof that the check was not held. Therefore, Justices of the Peace sometimes act as the collection agent for these lenders. It is this use of the criminal justice system to enforce civil contracts that the Subcommittee finds to be particularly disturbing, especially given our constitution's strict prohibition against imprisonment for debt.[26]

Recommendation(s):

1. Amend Texas law so as to ensure that a sale/leaseback transaction involving consumer goods is defined such that an agreement to defer the payment of a debt and an absolute obligation to repay a debt exists.

2. Amend Texas law to require that businesses offering sale/leaseback transactions provide customers with federal Truth in Lending Act disclosures.

Payday Loans

The Subcommittee heard testimony on a number of different types of lenders which fall under the blanket term of payday lenders. The term generally describes a lender who lends small amounts of money, generally up to $500, for short periods of time against the consumer's next paycheck. These loans come in a variety of forms: deferred check presentations, catalog sales, forced sale of a product or service, and payday loans. The focus for purposes of this report will be on payday loans. Unlike sale/leaseback operators, payday lenders concede that they are undoubtedly entering into transactions with customers in which there is an agreement to defer the payment of a debt. Because there is an absolute obligation to repay, the service agreements offered by payday lenders contain adequate disclosures in accordance with state and federal law. The main questions concerning this industry, then, relate to the terms of the transactions, specifically: the amount of interest that can be charged; the number of loans a particular customer can have outstanding with any one company at any given time; the number of times the transaction may be rolled over; and the types of collection practices in which borrowers may engage. Before turning to these questions, an explanation of the nature of the payday loan transaction is warranted.

The mechanics of a payday loan are as follows: a person in immediate need of cash leaves a personal check with a payday lender in exchange for cash. If the borrower is trying to borrow $200, for example, he is told to write one or two checks for the amount of cash he is to receive, which in this case will be $200, and for the transaction fee, which is typically $33 per $100 borrowed. At the end of the loan term, the borrower is expected to return to the business with $266 cash in order to

[26] TEX. CONST. of 1876, art. I, § 18.

pay off the loan. If he does so, his checks are returned to him.[27]

If the borrower is unable to repay the cash advanced to him, he has two options. The first option available to the borrower is to renew the loan. In our example, this would mean writing another check for $66 to extend the loan for two more weeks. The second option is for the borrower to do nothing and allow the lender to deposit the checks he initially left. This does not create a problem if at the end of the loan term the borrower has sufficient funds in his checking account. However, it is frequently the situation that the borrower does not have sufficient funds in his checking account to cover the checks; thus the checks will most likely be returned for non-sufficient funds (NSF). When the checks are returned NSF, the lender often turns this non-paying customer's name over to a local hot check agency for criminal prosecution. As with sale/leaseback companies, payday lenders who resort to this sort of tactic misuse the criminal justice system in an attempt to enforce civil contracts.

As discussed above, the payday lenders typically charge $33 per every $100 borrowed. The interest rate on such transactions work out to be:

Amount of Loan	**Amount Charged**	**APR % 30 days**
$ 100	$ 33	792 %
$ 200	$ 66	792 %
$ 300	$ 99	792 %
$ 400	$ 142	792%
$ 500	$ 175	792%

If the transaction fees charged are treated as interest, then they certainly look as though they violate Texas law, both constitutional and statutory.

Payday lenders differ from sale/leaseback operators in that they seek state regulation. Through their trade association, the Community Financial Services Association of America, payday lenders nationwide are lobbying state legislatures to enact payday loan acts. Thus, any arguments regarding the benefits or evils of payday loans must be viewed taking this desire to be regulated into account. That being said, payday lenders offer the following arguments to those who question the continued viability of their business practices under current Texas law. First, lenders argue that the payday lending industry serves an important consumer need that is not being met by traditional financial institutions. This need takes the form of short-term loans of less than $500. The industry argues that its customers, all of which are employed and make roughly $33,000 per year, simply need

[27]Please see Appendix E for OCCC handout of the nature of a deferred presentment transaction, which is also referred to as a payday loan and a deferred check presentation.

small loans to cover unexpected expenses that arise between paydays. Lenders argue that existing institutions do not offer this type of lending services.

Second, lenders argue that using annual percentage rate as a means to compare payday advance fees to the cost of other financial transactions is inappropriate. Lenders contend that their customers are making short-term cash flow decisions for fixed periods of time, not long-term credit or loan decisions. As such, their fees should be viewed as just that, fees.

Finally, lenders reiterate that they want to conduct their business within a regulated environment. The Community Financial Services Association advocates a regulated structure which allows for transaction fees of no more than $15 per every $100 borrowed, up to $500, and no more than four renewals per loan.[28] The Association believes that small business lenders will support this figure because there are profits to be made at this rate. It is within this regulated environment that payday lenders feel their industry will receive the legitimacy that it deserves.

In answer to both the lenders' first and second arguments, it is helpful to revisit Subchapter F lenders. As discussed in detail above, Subchapter F lenders are authorized to lend up to $480. They have statutorily-set rate structures for short-term loans, and the rates charged by Subchapter F lenders are considered to be interest. Because the interest on these loans exceeds the constitutionally set maximum, Subchapter F lenders are licensed by the Office of Consumer Credit Commissioner, as required by the provisions of Section 342.051(a), Texas Finance Code. As discussed above, Subchapter F lenders are able to conduct their businesses within this regulatory scheme for profit. An important difference between the operations of Subchapter F lenders and those of payday lenders needs to be raised here: Subchapter F lenders loan money for a minimum of thirty days and typically over several months; payday lenders typically offer loans on fifteen day terms. Thus, payday lenders are arguably providing a service that is not currently being offered. Lenders argue that there is a tremendous need for this service in the State of Texas; however, because payday lenders are not licensed, there is no way to estimate exactly how many payday lending transactions are being made annually in the State of Texas.

At the time of the Subcommittee's hearings, payday lenders operating in the State of Texas were doing so without regulatory oversight. However, since our April hearing, the Texas Finance Commission approved 7 TAC § 1.605.[29] The new rule was adopted under Texas Finance Code, §11.304, which authorizes the Finance Commission to adopt rules to enforce Title 4 of the Texas Finance Code. Section 1.605 authorizes regulated lenders to engage in payday loans under the authority of Subchapter F, Chapter 342 of the Texas Finance Code. This new rule defines a payday loan as a:

transaction in which a cash advance is made in exchange for the consumer's personal

[28]Mr. Eric Norrington, Community Financial Services Association, Testimony before Subcommittee on Consumer Credit Laws, January 19, 2000.

[29]7 TAC § 1.605. Please see Appendix F.

check, or in exchange for the consumer's authorization to debit the consumer's deposit account, in the amount of the advance plus a fee and where the parties agree that the check will not be cashed or deposited, or that the consumer's deposit account will not be debited, until a designated future date.[30]

The rule, along with the comments submitted to the Finance Commission through the Office of the Consumer Credit Commissioner, clearly state that the payday loan transaction creates for the consumer an absolute obligation to repay, and this obligation for repayment classifies payday loan transactions as loans within the statutory definition of a loan. The charge associated with the payday advance is, therefore, interest.

The Finance Commission's adoption of 7 TAC §1.605 goes far in the regulation of payday lenders. However, even if these new rules had not been promulgated, payday lenders would now be required to provide their customers with Truth in Lending Act disclosures. As discussed above, the Board of Governors of the Federal Reserve System recently revised the official staff commentary to Regulation Z. This new commentary provides that transactions in which parties agree to defer the payment of a debt are credit transactions. Thus, payday loans now fall under the definition of a "credit transaction." As credit transactions, Truth in Lending Act disclosure statements must be given with each payday loan. The Board of Governors' decision to amend the official staff commentary to Regulation Z to include payday loans as credit transactions clearly indicates that the growth of the payday loan industry is an issue that warrants monitoring.

Subsection (c) of the rule provides that a licensee may not charge an amount that exceeds the authorized rates found in § 342.253, Texas Finance Code. Exhibit 1 to 7 TAC §1.605 (c) sets out these maximum rates, which range from $11.87 for a 14 day loan of $100 to $16.53 for a 14 day loan of $350. The interest rates for these loans are 309.47% and 123.13%, respectively. Section 1.605 further requires that the payday loan transaction must be documented by a written agreement signed by the borrower and the licensee. This agreement must disclose the following: the name of the licensee, the transaction date, the amount of the check, a statement of the total amount charged, expressed as both a dollar amount and as an annual percentage rate (APR), and the earliest date on which the check may be deposited.[31] The agreement must also contain a notice of the name and address of the Office of Consumer Credit Commissioner and the telephone number of the consumer helpline.

Section 1.605(f)(1) provides the guidelines for duplicate and multiple loans. The comments to 7 TAC 1.605 provide that subsection (f) clarifies that multiple and duplicate loans are limited. It is intended to clarify how the agency will enforce the provisions relating to obligations on more than one loan contract and how the agency will enforce the maximum rate provision relative to multiple loans within the same month to the same borrower or multiple rollovers. The relevant text of the provision reads as follows:

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[30] 7 TAC § 1.605(a)(2).

[31] 7 TAC § 1.605(e)(2).

> In accordance with Texas Finance Code §342.501 a lender and a borrower may renew a loan, but the loan must be converted from a single payment balloon loan to a declining balance installment note. Alternatively, the payday loan or deferred presentment transaction may be renewed without limitation to the number of renewals where the effect of the total amount of charge would not exceed the total amount authorized by §342.252 having due regard for the amount of the cash advance and the time the cash advance is outstanding. The result is that the acquisition charge may only be earned once in a month and the installment account handling charge may continue to be earned on a equivalent daily charge basis in accordance with the limitations of Subchapter F. In lieu of a renewal, a lender and a borrower may agree to extend the maturity date of the existing payday loan or deferred presentment transaction.[32]

In other words, this means that the acquisition fee ($10 on a loan of $100 or more) may only be assessed to the same borrower once in a month. Thus, the number of loans outstanding is not limited, but a lender may not split loans into smaller increments to obtain a higher charge. Furthermore, while the number of rollovers is not limited, the amount of charge is limited to the maximum a lender would otherwise get for the extended term. For example, if a payday lender makes a $100 payday loan for two weeks, the lender may earn $11.87. If the borrower and lender decide to extend ("rollover") the loan for two more weeks, the lender may earn $1.86, in effect the same amount that the lender would have earned for a $100 loan of 28 days, a total of $13.73.

Finally, regarding the collection practices lenders may use, Section 1.605(f)(2) provides that because a payday lender accepts a personal check from a borrower knowing that the borrower does not have the funds available at the time of acceptance, it is generally not appropriate for a lender to file charges against a borrower for issuance of a bad check under § 32.41 of the Texas Penal Code. Thus, Section 1.605(f)(2) effectively ends certain lenders' misuse of the criminal justice system to enforce civil contracts.

<u>Recommendation(s)</u>:

1. The Subcommittee recommends that the Senate Committee on Economic Development monitor the implementation of the Finance Commission's newly-promulgated 7 TAC 1.605.

Other Issues Considered

The subcommittee received a considerable amount of testimony on the exportation of interest rates. Federal law provides that a federal savings association may charge interest at the higher of either one percent above the discount rate on 90-day commercial paper in effect in the savings association's federal reserve district *or* the rate allowed by the laws of the state in which the savings

[32] 7 TAC 1.605(f)(1).

association is located.[33] Federal savings banks rely on Section 85 of the National Bank Act and on 12 CFR § 560.2 for preemption authority[34]. Furthermore, the Code of Federal Regulations provides that a savings association located in a state may charge interest at the maximum rate permitted to any state-chartered or licensed lending institution by the law of that state.[35]

The practical effect of these federal laws and regulations is that several lending companies doing business in Texas are relying upon relationships with national banks and importing the banks' interest rates from other states into Texas to bypass Texas' limit on interest rates. The theory of those companies participating in this type of transaction is that it functions similarly to a credit transaction; thus it is allowable under the federal law set out above. This trend toward interest rate importation is troubling for a number of reasons. First, those companies who are exporting the interest rates of out of state banks are operating in the State of Texas completely free from regulation by the Texas Office of Consumer Credit Commissioner. Serious consumer protection concerns arise in this lending environment. If there is a problem, Texas regulators' hands will be tied in assisting the consumer because federal law, and thus the Office of the Comptroller of the Currency, the Administrator of National Banks, is involved.

Second, and more importantly, the interest rates being legally imported into the State of Texas are very high. The lending companies want to affiliate with an out of state, federally chartered savings bank for this very reason because the return on their money is much higher at higher rates of interest. For example, the State of Nevada has no usury limits, and in the State of Colorado up to 45% may be charged. These high rates do not afford Texas consumers the protections Texas law and regulators strive to provide.

Finally, Texas' low interest rate ceiling is driving Texas business out of state. In the 1980's, our state's restrictive usury laws drove credit card banks to flee the state. Given our current lending environment, many of those testifying before this Subcommittee expressed concern for lenders currently holding state charters. They fear that if the situation does not improve, it is likely that these lenders will seek federal charters in states with lender-friendly interest rates. The result being that not only will our state's usury laws potentially drive business out of state, they will also provide a disincentive for new lending entities who are considering locating here.

[33] 12 USCA § 1463(g)(1).

[34] 12 CFR § 560.2(a) reads, in pertinent part: "federal savings associations may extend credit as authorized under federal law . . . without regard to state laws purporting to regulate or otherwise affect their credit activities."

[35] 12 CFR § 560.110(b).

Gramm-Leach-Bliley Act of 1999: Evaluate the effect of the pending federal Financial Services Modernization Act on consumer credit laws in Texas.

The most important piece of federal banking legislation in more than sixty years was signed into law by President Clinton on November 12, 1999. The Gramm-Leach-Bliley Act (the Act or GLB), which is also known as the Financial Services Modernization Act, breaks down many of the traditional barriers which separated the banking industry from securities and insurance firms.[36] While existing regulatory structures will remain intact, the GLB allows banks, securities, and insurance companies to structure their businesses by using either the affiliate or operating subsidiary structure.

A detailed discussion of the GLB on the whole was not entered into by this Subcommittee because in general terms the GLB does not impact consumer credit laws. However, the subcommittee did enter into a fairly detailed discussion of Title V of the Act. Title V of the GLB is entitled "Privacy." The GLB clearly mandates that financial institutions may not disclose nonpublic personal information to a nonaffiliated third party *unless* the consumer is given the opportunity to "opt-out" of the information sharing. The opt-out provision is found in Section 502(b), and provides that:

> a financial institution may not disclose personal information to a nonaffiliated third party unless – (a)such financial institution clearly and conspicuously discloses to the consumer, in writing or in electronic form or other form permitted by the regulations prescribed under section 504, that such information may be disclosed to such third party; (b)the consumer is given the opportunity, before the time that such information is initially disclosed, to direct that such information not be disclosed to such third party; and (c)the consumer is given an explanation of how the consumer can exercise that nondisclosure option.[37]

At each of its hearings, the Subcommittee heard testimony regarding current Texas law which protects consumers' privacy even under this new federal law. Some of the more interesting testimony included the following. First, there are currently over five hundred privacy-related laws on the books in Texas. These laws are clearly designed to protect the privacy rights of Texas citizens. If they are not adequately protecting our rights, this may be because the laws we have are not being enforced or because some legislative adjustments need to be made. If there is a lapse in protection, testimony indicated that the solution is not to pass new laws that could potentially complicate matters; but to fix whatever problems exist with current law.

Second, even if a consumer chooses *not* to opt out of financial institutions' information sharing, there are limits to the government's access to financial records. These limits are included in existing federal laws such as the Fair Credit Reporting Act, the Electronic Fund Transfer Act, the Truth-in-Lending Act, the Fair Credit Billing Act, the Truth-in-Savings Act, the Expedite Funds

[36]Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102 (1999).

[37]15 U.S.C.A. § 6802(b) (1999).

Availability Act, the Equal Credit Opportunity Act, the Electronic Communications Privacy Act, and the Right to Financial Privacy Act.

Finally, the Subcommittee heard testimony cautioning against passing "knee-jerk" reaction legislation. Because many of the practical effects of the GLB are still unknown, the Subcommittee heard cautionary testimony on the prudence of using the 77th Session of the Texas Legislature as a fact-finding, research-oriented session with regard to privacy laws. This approach is wise because it prevents the passage of legislation which could potentially do more harm than good. This approach is being urged nationwide. In fact, the June 2000 publication of the American Legislative Exchange Council made the following observation in its discussion of the rush of some state legislatures to pass more privacy laws as a result of the GLB: in their haste, legislatures could complicate the federal implementation process, negate the goals of GLB and even duplicate existing federal laws.[38]

Recommendation(s):
1. Monitor the progress of federal and state regulators promulgation of privacy rules connected to the Gramm-Leach-Bliley Act of 1999.

[38]Matt Lathrop, *Consumer Privacy: Is More Legislation Really Necessary?*, Inside ALEC, JUNE 2000, at cover page.