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Evaluating Consumer Access to Short-Term Lending

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Recommendations

- Consumers are worse off when lending options are restricted.
- It is better to promote competition within the short-term lending industry rather than erecting restrictive barriers of entry for new competitors.
- Consumers make lending decisions that they believe are in their best interest.
- Effective APR rates for late payments and bank fees often vastly exceed those of small, short-term loans.

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Introduction

Bankers and business leaders are far from the only Americans that are feeling increasingly anxious over the state of the credit markets. As traditional banks tighten lending standards, many consumers find themselves unable to readily borrow when the need arises, often unexpectedly.

According the July 2008 Senior Loan Officer Opinion Survey on Bank Lending Practices by the Washington, D.C. Federal Reserve Board, about 65 percent of domestic banks indicated that they had tightened their lending standards on consumer loans and credit card loans over the past three months.[1]

The survey goes on to report:

> In addition, [a] considerable fraction of respondents reported having increased minimum required credit scores on both types of consumer loans and reduced the extent to which such loans were granted to customers who did not meet their bank's credit-scoring thresholds. Finally, large net fractions of banks noted that they had lowered credit limits on credit card accounts over the past three months, and increased interest rate spreads on consumer loans other than credit card loans. On balance, about 35 percent of domestic banks—up from roughly 25 percent in the April survey—expressed a diminished willingness to make consumer installment loans relative to three months earlier.[2]

The tightening credit market is affecting all consumers. Many borrowers have the option of dealing directly with a consumer bank or federal or employee credit unions. But those consumers who do not meet bank or credit union lending criteria, particularly when borrowing smaller amounts for short-time periods, may be the most impacted.

Even before the current credit crunch consumers in need of short-term loans (STLs) are often challenged in finding a source of funds. A survey of 521 low-income Texans conducted by Texas Appleseed confirms some of the obstacles facing those in need of small, short-term loans and noted that 60 percent of those surveyed turned to family or friends for loans while 23 percent chose to borrow money from payday lenders. Respondents did not turn to banks nearly as much and 40 percent indicated that they were turned down for loans at banks and credit unions anyway.[3]

Some borrowers in this situation borrow from friends or family. Still others, following a venerable precedent, make their way to the pawnshop. Other options are to skip utility and credit card payments, seek out loan sharks, or file for bankruptcy. Few of these options are optimal for consumers and may ultimately damage a person's long-term credit.

One option available to many of these consumers is known as payday lending. The Texas Appleseed study concluded that rejection from traditional banks and credit unions is a major factor in a consumer's decision making process

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to borrow from payday lenders.[4] For instance, 40 percent of respondents that used payday loans indicated that they were turned away by banks or credit unions.[5] Half of these respondents said they needed short-term loans to pay bills, while 46 percent needed money for gas or groceries. Over a third of people surveyed using payday loans were faced with an emergency.[6]

Short-Term Credit and Related Financial Services

There are many types of financial services that consumers can seek out in order to help them structure their financial life or gain access to credit. The following are some typical options for consumers.

Traditional Bank Loans, Lines of Credit, Credit Cards, and Home Equity Loans

Banks and credit unions offer financial consumers many different options when it comes to loans and credit, but many of these options aren't suitable for a significant portion of borrowers in the short-term credit market. Banks traditionally offer unsecured or secured personal loans, unsecured or secured lines of credit, credit cards and credit card cash advances, or equity lines of credit tied to property or home ownership.

While personal loans may seem like a good option for consumers in need of short-term credit, it isn't always the case that they will be served at a traditional bank. Large minimum loan amounts and strict credit thresholds set limits on what type of consumer may seek out personal loans. For example, the minimum loan amount that can be taken out at Wells Fargo for a personal loan is $3,000[7] while the minimum amount at Capital One is $2,500.[8] Other consumers—particularly those with poor or non-existent credit—who are not discouraged by the loan amounts may be rejected based on lending practices. Those people who are seeking shorter, smaller loans have no options at a traditional bank.

Many banks offer credit cards as a way for consumers to utilize and gain credit. Credit cards provide consumers with an easily accessible source of liquidity for purchasing items or paying bills. Consumers are required to pay down their credit card balance at the end of each month with a minimum payment amount. Those who fail to pay down their balance are subject to interest rate increases and penalty fees. Cardholders can also take out what is known as a "cash advance" which enables consumers to borrow currency against his or her remaining credit card balance. Cash advances are also subject to fees.[9]

According to Donald Morgan of the NY Federal Reserve Bank, 60 percent of short-term borrowers reported that they had maxed out their credit cards and needed access to additional credit to meet other financial obligations such as utility bills.[10] Given no other alternative for access to more credit, these consumers could miss payment on bills and credit cards and be subject to card fees and other penalties.

Another avenue for consumers looking for short-term credit is a home equity line of credit through their bank. A home equity line of credit is a form of credit in which a person's home serves as collateral. Typically, a person's home is their most valuable asset and many homeowners use home equity lines of credit to pay off major expenses.[11] This option is only available to those seeking short-term credit who are homeowners, not renters. The Appleseed survey found that renters are more likely to seek out payday loans.[12]

Short-Term Loan Options: Direct Deposit Loans, Cash Advances, and Payday Lending

For those consumers in need of smaller, short-term cash loans that are not served by traditional banking institutions, there are some other options that may keep them from having to go without meeting their financial needs. Certain banks offer what is known as a "direct deposit loan" in which funds are made available in a person's account before their next direct deposit from their employer. It is essentially allows a person to have access to future guaranteed funds. This type of loan is known by many different names including, a "cash advance loan," a "payday loan," "or a "salary advance loan." Those seeking payday loans are not unbanked nor are they unemployed.[13]

Some credit unions have begun experimenting with salary advance or payday loans.[14] The North Carolina State Employees Credit Union is one example. However, Dan Mica, the president of the Credit Union National Association (CUNA), indicated in an interview for *USA Today* that many of these loan programs were barely breaking-even due to the poor credit quality of borrowers.[15] Given this scenario, it is unlikely that credit unions will engage in the short-term lending market in large numbers.

Consumer credit service organizations (CSOs) have come in to fill the market for smaller, short-term loans not offered by banks and credit unions. A CSO provides retail financial and credit services to consumers, including securing or obtaining short-term loans (STLs).

CSOs are not lenders, but rather a CSO will help consumers in need of a STL locate a third-party lender (TPL) who is willing to issue loans to short-term borrowers. These loans, in turn, are underwritten based on the lender's risk criteria and are oft en secured by the CSO by a letter of credit or issuance of guarantee. Retail financial services organizations are not primary lenders and should not be confused with the third-party lenders that actually charge interest on short-term loans.

The Texas Constitution sets a limit on interest rates at 10 percent per annum, unless otherwise set by the Legislature.[16] All short-term lenders must abide by this constitutional provision by law unless exempted or given special consideration by law. Payday or cash advance lenders are subject to this cap in Texas.

Other Retail Financial Alternatives: Pawn Shops, Prepaid Debit/Phone Cards, and Money Orders

Another option available for consumers in need of immediate or short-term funds is to pawn certain possessions. When someone "pawns" an item what it really means is that they will get a short-term cash loan with that item as the collateral. Pawn shops are regulated under state law (Texas Finance Code Chapter 371). Typically, a borrower will enter into an agreement with a pawn broker and a contracted period of time. The broker may charge what is known as a "finance charge" on any transaction. After the transaction has been made, the person who pawned the item will have a set period of time to repay the loan with interest and reclaim their personal property. If they are unable to repay, the item becomes the property of the pawn broker. According to the Texas State Attorney General's Office, pawns shops can have a maximum rate of 240 percent APR.[17]

In addition to the services mentioned in previous sections, retail financial service organizations, including CSOs, may provide consumers with access to prepaid debit or phone cards. This gives consumers the option to pre-load a debit card with a specific amount of cash, which then allows consumers to control or limit spending based on the value one the card. Similarly, pre-paid phone cards enable consumers to control the specific costs of long-distance telephone service.

Retail financial service providers in Texas may also help consumers secure money orders. A money order is an alternative form of payment when a consumer doesn't want to send a personal check. Money orders do nothing to help people in need of short-term credit and only serve as a form of direct payment.

Examination of current proposals to regulate CSOs in Texas

Eighteen bills that would in some way regulate short-term lending have been filed in the Texas Legislature's current session. These are: House Bill 212, HB 410, HB 656, HB 661, HB 1323, HB 2592, HB 2593, HB 2594,and HB 3786 as well as Senate Bill 143, SB 251, SB 253 and SB 1862. With the exception of HB 2592, HB 2593, and HB 2594, they are all generally the same bill. SB 143 and SB 251 taken together are the equivalent of SB 253, and HB 410, 656, 661, and 1323 are identical to SB 253. HB 212 is the portion of the other bills that is identical to SB 143.

These bills generally create a section of Chapter 302 in the Finance Code to explicitly prohibit third-party fees to arrange or guarantee certain extensions of consumer credit. As written, a third party fee is prohibited if that fee is in regard to an extension of credit secured by a non-purchase money security interest in personal property, and the proceeds of are used for personal, family or household purposes.

In addition, the bills create a new section in Chapter 393 of the Finance Code prohibits a CSO from assisting a consumer in getting an extension of consumer credit. The way the law is written, by not allowing CSOs to operate under Chapter 393, they would be forced to operate under the regulations in Chapter 342 of the Finance Code.

SB 1862 and HB 3786 were filed following a hearing on SB 251 and SB 253. These bills are updated versions of the previous bills. The effects of these bills are substantially similar to the previous bills mentioned. Specifically, the bill prohibits CSOs from charging, contracting for, or receiving a fee for assisting in securing a loan, and if there is a fee in violation of this provision, it is to be considered interest. The bill creates a 15 percent cap on finance changes and regulates the maximum amount that can be loaned at 35 percent of the borrower's gross monthly income. Additionally, the bill restricts CSOs from renewing, rolling over, or otherwise consolidating a loan for a fee, and forces CSOs to accept partial payment with no additional fees. Even if the borrower only gives partial payment, the lender must offer a repayment plan, and cannot impose default charges on that repayment plan. Regardless of

the borrower's ability to repay, the CSO cannot increase fees, charge for non-payment, or seek criminal charges against a borrower. Finally, the bill imposes strict reporting requirements on CSOs which would then be required to report to the Credit Commissioner.

HB 3021 requires CSOs to implement a multitude of best practices. These include examples like registering with the secretary of state, fully outlining contracts and terms, giving the borrower the power to rescind within three days after signing the contract, and participating in self-policing of the industry.

HB 2592, HB 2593, and HB 2594 are also bills that increase regulation of CSOs. HB 2592 requires all CSOs to post all fees, post a notice with specific language telling the consumer how he should use pay-day or auto title loans, and disclose the annual APR of all interest and fees to be charged.

HB 2593 restricts the amount that CSOs can lend, and also prohibits them from charging fees once 25 percent or more of the principal amount is paid, regardless of when or if the rest is ever paid.

HB 2594 creates a sub-chapter to Chapter 393 of the Finance Code, entitled Subchapter B-1. The bill requires CSOs to register with the Consumer Credit Commissioner, requires annual renewal and an annual renewal fee. The Commissioner can then approve or deny the renewal application. Additionally, Subchapter B-1 would give the Commissioner the power to revoke or suspend a registration if the commissioner finds evidence to warrant the belief that the business will be operated lawfully and fairly.

Consumer impact of proposed restrictions short-term consumer lending

Consumers of short-term lending are not unsophisticated or uninformed. Much of the time, these consumers have tried to find credit elsewhere, through institutions such as banks and credit unions, but were turned down. The following analyses discuss the impact the above proposals would have on consumer access to short-term lending.

Many of the bills filed in Texas altogether ban the fees that short-term lenders can charge in a borrowing transaction. Without the ability to charge adequate fees, the cost to stay in business for these credit service organizations will be higher than the profits they make. Therefore, banning these fees would effectively regulate this credit option out of the competitive marketplace.

The consumer is the most appropriate person to determine whether the fees he or she is paying are appropriate. In a competitive marketplace, consumers decide the price point. Competition keeps prices low and the quality and choice of products and services high. It promotes improvements to make products better and more tailored to help the consumer. Increasing government control over prices—in this case fees—will only hamper innovation and harm consumers that currently access short-term credit lending.

Recent Attempts at Finding a "Sweet-Spot" Miss the Point

Credit Service Organizations charge a finder's fee for helping consumers locate and secure short-term loans from a third-party lender. The most recently filed bills are aimed at finding the regulatory "sweet-spot." The sweet-spot is a term to describe the level at which fees can be capped and still allow the CSOs to compete in the marketplace.

This notion is flawed because the sweet-spot is what the borrowers and lenders agree to in a market transaction. The fees currently being charged by lenders represents the consensus among market participants, and capping fees below the established market value will reduce the number of short-term lenders and the lending options and choices for consumers seeking out immediate or emergency short-term loans, most of whom are urban members of the lower-middle class.[18] Thus, legislation to restrict access to short-term loans would disproportionately harm lower-income Texans.

The argument against sweet-spot regulation is bolstered through empirical data. New Hampshire has passed a law capping short-term loan interest rates at 36 percent, and that cap forced many payday lending locations to close.[19] Similar caps have passed in Pennsylvania and Arkansas with similar effects.[20] A study by the Federal Reserve Bank of New York concluded that state bans on payday credit in Georgia and North Carolina had caused more people to bounce checks, file for Chapter 7 bankruptcies, and experience greater difficulty with lenders and debt collectors.[21]

The Problem with Moving CSO Regulation to Chapter 342

Although the problems with rate caps and prohibition of fees has been previously mentioned, another notion that must be addressed is the fact that almost all of the filed bills prohibit credit service organizations from extending credit under Chapter 393 of the Finance Code. By doing so, the bills would force CSOs to operate under Chapter 342 of the Finance Code. In addition to moving CSOs under the regulatory jurisdiction of the Consumer Credit Commissioner, Chapter 342 would also impose rate caps that are currently not in place under Chapter 393.

The U.S. Securities and Exchange Commission has issued a report on the expenses of publicly traded companies offering small, short-term loan services. Store operating expenses, loan loss reserves and interest expense comprise over 86 percent of the pretax revenue earned on every $100 loaned. Chapter 342 limits a charge of $11.87 for a $100 loan with a 14 day term. With costs averaging over 15.93 percent per $100 loaned, CSOs would be operating at a loss under Chapter 342 price cap regulations. It would not be very long before Texans would be denied access to small, short-term loans under Chapter 342 rates.

The arguments for moving CSO regulation from Chapter 393 to Chapter 342 incorrectly assume that there are no regulations currently in place regarding CSOs. Retail financial service providers in Texas are subject to many consumer protection regulations including:

- Texas Credit Service Organization At (Texas Finance Code Chapter 393
- Texas Deceptive Trade Practices Consumer Protection Act (Texas Business and Commerce Code §17.41 et seq.)
- Texas Constitutional Article XVI, §11
- Texas Finance Code Chapter 302
- Federal Truth in Lending Act (15 USC §1601 et seq.)
- Regulation Z (12 CFR part 226)
- Texas Debt Collection Practices Act (Texas Finance Code Chapter 392)
- Federal Debt Collection Practices Act (15 USC §1692 et seq.)
- Federal Equal Credit Opportunity Act (15 USC §1691 et seq.)
- Regulation B (12 CFR part 202)
- Federal Trade Commission Act (15 USC §41 et seq.)
- Federal Gramm Leach Biley Privacy Laws (15 USC §§6801 et seq.)
- Federal Trade Commission Regulations (16 CFR part 313 and 16 CFR part 314)
- Dodd-Frank Financial Industry Reform Act of 2010
- Consumer Financial Protection Bureau

Conclusion

As credit markets continue to tighten, it is important for Texas consumers to have access to a variety of financial options. Many people who are turned away by traditional banks or credit unions are often left in a precarious situation of limited choices, most of which lead to higher debts, late payments, or bank fees. Critics cite what they claim to be high fees and APR rates in their condemnation of payday loans and credit service organizations. But factoring in these types of charges for the purpose of calculating APR interest rates on short-term loans does not draw an accurate comparison with other annualized loans. Additionally, effective APR rates for late payments and bank fees often vastly exceed those of small, short-term loans.

Critics fail to look at the all sides of the issue and take into account the alternatives consumers face. However, consumers in need of short-term loans and credit are generally aware of the alternatives to taking out loans, such as skipping payments or bouncing checks. They understand that a competitive and vibrant short-term credit market provides them consumer choice and access to needed financial services. There is and will continue to be a market demand for small, short-term loans. The Legislature should not restrict access to these. ✯

Endnotes

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About the Author

Ryan Brannan joined the Texas Public Policy Foundation's Center for Economic Freedom in 2009. Since joining the Foundation, he has written and worked on numerous regulatory issues, such as telecom, electricity, insurance, tort reform and property rights. Specifically Ryan has done work on net neutrality, broadband deployment, windstorm insurance, homeowner's insurance, eminent domain, regulatory takings, tort reform, renewable energy, smart meters, franchise fees, etc.

In addition, Ryan has several years of legal experience, working on corporate litigation matters including patents, copyright infringement and contract disputes. He has also worked in a Dallas medical-malpractice defense firm working on med-mal issues, hospital regulatory disputes, health care law and other forms of insurance defense.

Ryan established and served as Director of The Dallas Philanthropic Society, a 501(c)(3) non-profit. He also returned to school in the evenings to earn his M.B.A. from the Cox School of Business at Southern Methodist University, concentrating in Strategy and Entrepreneurship. At SMU, Ryan was a member of the Cox Leadership Forum and contributed to the SMU business plan competition.

He received his Juris Doctorate at the University of Oklahoma where he was a member of the American Indian Law Review, Dean's List, Dean's Counsel, and several trial teams including the National Trial Team. He received special recognition in advocacy and public service by receiving the Dean's Award for Advocacy and the Dean's award for Service, respectively. Ryan graduated with honors from Southern Methodist University with a Bachelor's in Political Science and minor in History.

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