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- Small Dollar Lending -
How Triple-Digit Annual Percentage Rates Became the Norm
&
How Institutions Can Promote More Affordable Options

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- Small Dollar Lending -
How Triple-Digit Annual Percentage Rates Became the Norm &
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by

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Abstract

- Small Dollar Lending -
How Triple-Digit Annual Percentage Rates Became the Norm & How Institutions Can Promote More Affordable Options

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The University of Texas at Austin, 2013

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Census data show that about 60 million, mostly low-income and minority, American adults either do not have a bank account or have an account but also rely on non-bank financial products to make ends meet. These products, such as payday loans, often have high costs per dollar lent and have historically fallen into gaps in both state and federal regulation. Texas, home of the largest payday lending companies in the country and over 2,500 payday lenders, provides an instructive case study of how small-dollar loan regulation has developed over the years, how non-bank financial institutions navigate the law, and how some organizations with non-profit missions have sought to offer affordable loan alternatives. This paper places current lending regulation in historical context, surveys federal and Texas law related to small-dollar loans prior to and following the financial crisis in 2008, and provides highlights from a federal pilot program designed to encourage banks to offer affordable small-dollar loan products. It also examines the experience of a community development financial institution (CDFI) in

Brownsville, Texas that launched a small-dollar loan program in 2012. The federal pilot and Brownsville cases provide insights regarding the viability of affordable small-dollar products, as well as the challenges facing non-profit-maximizing institutions such as CDFIs when trying to develop loan programs under the current regulatory regime. Ultimately this paper concludes that, while there may always be a market for high-cost non-bank financial services, a combination of federal efforts to promote affordable options at banks and efforts by community-oriented CDFIs can go a long way towards providing lower-cost alternatives for people who currently rely on high-cost, non-bank products.

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Statement of the Issues

A significant portion of Americans, most of whom are low-income and have poor credit histories, do not have access to affordable loans needed to make ends meet between paychecks and in times of financial crisis. Mainstream banks have largely stopped lending to this population because they have deemed it unprofitable to do so. The non-bank lenders that are willing to serve these borrowers do so at high cost and often on terms that borrowers do not initially understand. Attempts to address abuses by non-bank lenders have historically been compromised by the interaction between state and federal law and by the exploitation of regulatory loopholes. This has been particularly true in Texas, which also has one of the largest non-bank lending sectors in the country. Recently, several organizations have taken steps to provide more affordable alternatives to the high-cost products offered by the non-bank financial services sector, but several obstacles to viability remain for these new lenders in the current regulatory environment.

Introduction

On May 26, 2011 outgoing Chairman of the Federal Deposit Insurance Corporation (FDIC), Sheila Bair, gave testimony before the House Subcommittee on Financial Institutions and Consumer Credit regarding her agency's response to the financial crisis of 2008.[1] After reviewing the causes of the crisis and outlining the steps taken by the FDIC in 2008 and 2009 to address bank failures, Chairman Bair turned to the role she believes that economic inclusion must play in achieving the FDIC's mission of promoting confidence in the United States' banking sector.[2] In contrast to the unsafe lending practices that helped cause the subprime mortgage bubble, economic inclusion, she said "is about ensuring that all Americans have access to safe, secure, and affordable banking services" that provide "the opportunity to save, build assets, and achieve financial security."[3]

As Chairman Bair noted, census data show "that some 17 million [American] adults do not have a checking or savings account, and another 43 million adults do have an account but also rely on non-bank financial products to make ends meet."[4] These "non-bank financial products" come in a variety of forms but they are unified by the fact that they are offered by businesses that are not federally insured banks, though they frequently have counterparts in the banking sector.[5] A 2009 survey by the FDIC of what it called the "alternative financial services" sector found that its services are typically

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1 *FDIC Oversight: Examining and Evaluating the Role of the Regulator during the Financial Crisis and Today Before the House Subcommittee on Financial Institutions and Consumer Credit*, 112th Cong. (May 26, 2011) (statement of Sheila C. Bair, Chairman, Fed. Deposit Ins. Corp.), *available at* http://www.fdic.gov/news/news/speeches/chairman/spmay2611.html [hereinafter *Bair Testimony*].
2 *Id*.
3 *Id*.
4 *Id*.
5 FED. DEPOSIT INS. CORP., *Alternative Financial Services: A Primer*, 3 FDIC Q., no. 1, 2009, at 39, *available at* http://www.fdic.gov/bank/analytical/quarterly/2009_vol3_1/Quarterly_Vol3No1_entire_issue_FINAL.pdf.

either transactional or related to extensions of credit and include check cashing,[6] remittance transmission,[7] refund anticipation loans,[8] pawn and car title loans,[9] and payday loans.[10] Though the fees associated with these products are often higher than the interest and finance charges on their bank counterparts, industry groups argue that products such as small-dollar, short-term loans provide a needed service for millions of Americans who have cash shortages but "may not have savings or disposable income."[11]

For more than a decade, however, consumer groups have criticized these non-bank financial products because of the size of the fees they charge consumers, many of whom are from low-to-moderate income households and/or members of minority groups.[12] Legislators and regulators have also responded to concerns about industry

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[6] "Check cashers typically charge 1 to 4 percent of the face value of the check, depending on the check issuer and subject to limitations of state law. About two-thirds of checks cashed at nonbank outlets are payroll checks; another 18 percent are state or federal benefits checks." *Id.* at 40.

[7] Remittances are transfers of funds from a sender in one country to a recipient in another, typically using channels other than regulated bank wires. The United States is the most common origination country, as the service is frequently used by immigrant workers sending funds to relatives in their home country. *Id.* at 40-42.

[8] "Refund anticipation loans (RALs) are short-term loans, usually 7 to 14 days, offered by tax preparers as a purported way to speed the taxpayer's receipt of a tax refund. They are secured by the expected refund, and the RAL fee is deducted from the refund . . . The price of a RAL for an average refund of $2,600 can range from $58 to $136." *Id.* at 44-45 (internal citations omitted).

[9] "Pawn lending is a short-term, secured lending transaction in which the lender typically takes physical possession of the item securing the loan (often jewelry or other personal goods). The lending agreement allows the pawn lender to take possession of and sell the collateral if the borrower does not meet the terms of the agreement. Recent estimates of the overall scale of pawn lending are not available. However, the largest publicly traded pawn lender, Cash America International Inc., with 500 stores in 22 states, reported making $514 million in pawn loans in 2007, with APRs ranging from 12 to 300 percent." *Id.* at 45. Car title loans are similar to pawn loans but take title of the borrower's car as collateral. *Id.*

[10] "Payday loans are short-term loans typically extended to consumers who have a checking account and can prove that they are employed. A check or debit authorization, which is postdated to the borrower's next payday, provides security to the lender. Payday loans typically involve low balances, in the $300 to $500 range, and have a two-week term coinciding with the consumer's pay cycle." *Id.* at 43.

[11] *Myth vs. Reality: Payday lenders target poor people and minorities*, CMTY. FIN. SERV. ASS'N OF AM., http://cfsaa.com/aboutthepaydayindustry/myth-vs-reality.aspx (last visited Apr. 20, 2013) (representing about half of the payday advance firms in the United States).

[12] *See, e.g.* URIAH KING & LESLIE PARRISH, CTR. FOR RESPONSIBLE LENDING, SPRINGING THE DEBT TRAP: RATE CAPS ARE ONLY PROVEN PAYDAY LENDING REFORM 7 (2007), *available at* www.responsiblelending.org/payday-lending/research-analysis/ springing-the-debt-trap.pdf ("In some very limited circumstances, the [payday] borrower pays [the typical fee of] $16 per $100 borrowed to cover an

practices and the perception that consumers of higher-cost non-bank financial products utilize the industry because they do not have affordable alternatives. The Consumer Financial Protection Bureau (CFPB), established by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), was given powers to regulate the safety of non-bank institution financial products, particularly payday loans,[13] and the FDIC has begun to actively promote the development of affordable small-dollar loan products by the banks it oversees.[14]

In many ways, the non-bank financial sector is as much a product of American *bank* regulation as it is of anything. As discussed below, over the years, non-bank entities have stepped in to offer products and services that banks would not, either because laws expressly banned them from doing so or because a variety of factors—legal and otherwise—did not make it profitable to do so.[15] Furthermore, the laws that have arisen to regulate non-bank financial institutions have frequently been affected by state and federal banking regulations and by the attempts of both the U.S. Congress and federal courts to preempt state law to promote national policies.[16]

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expense, and is free of debt as soon as their [next] paycheck arrives. . . . State regulator data demonstrates that only one to two percent of transactions are made to borrowers who take out one loan, pay it off on time, and do not need to borrow again that year."); Creola Johnson, *America's First Consumer Financial Watchdog is on a Leash: Can the CFPB Use Its Authority To Declare Payday-Loan Practices Unfair, Abusive, and Deceptive?*, 61 CATH. U. L. REV. 381, 387-95 (2012) (describing how—in addition to the high per dollar borrowing fees—the automatization of payday loan payments can result in repeated electronic draws on borrowers' empty checking accounts that rack up insufficient funds fees, and describing the high percentage of the payday lending industry's revenues that come from refinancing—"roll-over"—fees, as opposed to coming from the basic fees for the initial loan); TEX. APPLESEED, RESHAPING THE FUTURE OF SMALL-DOLLAR LENDING IN TEXAS 7-9 (2012), *available at* http://www.texasappleseed.net/index.php?option=com_docman&task=doc_download&gid=698&Itemid= (describing the payday lending industry in Texas and synthesizing studies from Texas community groups regarding observed effects of payday loan debt on clients and other community members).

[13] Part III.B.2, *infra*.

[14] Part III.B.1, *infra*. *See also Bair Testimony*, *supra* note 1 (highlighting FDIC initiatives such as its Small-Dollar Loan Pilot program designed to demonstrate how "banks can profitably offer affordable small-dollar loans as an alternative to high-cost credit products, such as payday loans.").

[15] Part I.A & B, *infra*.

[16] Part II.A, *infra*.

Nowhere have the battles over the regulation of non-bank financial institutions and products been more contentious or evident than in the area of payday loans. These loans, which are described in greater detail below, are typically small-dollar ($300-$500), short term (a paycheck cycle) loans extended to borrowers who can prove employment and possession of a checking account.[17] With fees that typically run $10-$20 per term, per $100 lent, if payday loans are refinanced multiple times, they can become very costly for borrowers.[18] The number of payday lending locations in the United States grew from about 500 in 1990 to 22,000 in 2006, having peaked at over 24,000 in 2005.[19] The rapid growth of the industry, the size of its revenues,[20] and concerns about customers who pay thousands of dollars in fees on cash advances of only a couple hundred dollars have led to calls for increased regulation and innovative alternatives to the traditional payday model.[21]

Texas, home of Cash America (the largest payday lender in the country)[22] and about 2,700 payday lending locations in 2010,[23] offers an instructive case study of how

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[17] Part I.C.1, *infra*.
[18] CONSUMER FIN. PROT. BUREAU, CFPB SUPERVISION AND EXAMINATION MANUAL Short-Term, Small-Dollar Lending Procedures 2 (2d. ed. 2012), *available at* http://files.consumerfinance.gov/f/201210_cfpb_supervision-and-examination-manual-v2.pdf [hereinafter CFPB MANUAL]; KING, *supra* note 12, at 7.
[19] LESLIE PARRISH & URIAH KING, CTR. FOR RESPONSIBLE LENDING, PHANTOM DEMAND: SHORT-TERM DUE DATE GENERATES NEED FOR REPEAT PAYDAY LOANS, ACCOUNTING FOR 76% OF TOTAL VOLUME 5, 11 tbl.5 (2009), *available at* http:// www.responsiblelending.org/payday-lending/research-analysis/phantom-demand-final.pdf; *see also About the Payday Advance Industry*, CMTY. FIN. SERV. ASS'N OF AM., http://cfsaa.com/aboutthepaydayindustry.aspx ("Industry analysts estimate that 20,600 payday advance locations across the United States extend about $38.5 billion in short-term credit to millions of working Americans in 19 million households who experience cash-flow shortfalls.").
[20] Though it has recently reported a decline in profits, "[t]he country's largest payday lender and pawn shop operator, Cash America International Inc. . . . [saw] [r]evenue r[i]se 19% from $345.9 [in 2011] to $411.6 million [in 2012], mainly on a 36% jump in consumer loan fees to $180.7 million." *The Payday Lender Cash America Cancels Spin-off After Poor Results*, THE WALL STREET JOURNAL, MARKET WATCH (July 26, 2012, 2:22 p.m.), http://www.marketwatch.com/story/payday-lender-cash-america-cancels-spin-off-after-poor-results-2012-07-26 [hereinafter MARKET WATCH].
[21] TEX. APPLESEED, *supra* note 12, at 10.
[22] MARKET WATCH, *supra* note 20; *Company History*, CASH AMERICA, http://www.cashamerica.com/AboutUs/CompanyHistory.aspx (last visited April 20, 2013)

small-dollar and payday loan regulation has developed over the years, how non-bank financial institutions have navigated these laws, and how some non-profit-maximizing organizations have sought to offer affordable alternatives to high-cost financial products. This paper will explore the evolution of payday lending and its regulation in Texas in the context of national developments related to banking and non-bank financial services. Part I provides overviews of the banking sector, the history of interest rate regulation ("usury") and early small-dollar lending, and modern small-dollar loans. Part II surveys federal and Texas laws related to small-dollar lending regulation prior to the financial crisis in 2008 and 2009. Part III examines changes to Texas and federal law following the financial crisis and the potential effects of these developments. Finally, Part IV examines the case of an affordable small-dollar loan program run by a community development financial institution (CDFI) in Brownsville, Texas. This program, called the Rio Grande Valley Community Loan Center, offers insights regarding the viability of such ventures and the challenges of developing them under the current regulatory regime as a non-profit maximizing CDFI. Ultimately this paper suggests that, while there may always be a market for high-cost, non-bank financial services, a combination of the FDIC's efforts to promote affordable bank options and the encouragement of efforts such as those of the Rio Grande Valley Community Loan Center can help increase the availability of lower-cost alternatives for people who currently rely on high-cost, non-bank products.

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[23] TEX. APPLESEED, *supra* note 12, at 7.

Part I. Banks, Non-Bank Lending, and the "Underbanked"

As concerns have risen in recent years about the cost of non-bank financial services and certain practices in the industry, there have been many calls for regulation on both the state and federal levels. Before turning to a more in-depth discussion of industry regulation on both the federal level and in Texas, it is important to understand the historical and structural context in which existing regulatory regimes developed. This section will provide more detail about banking, the origins of the non-bank financial services industry, and the contemporary consumers of non-bank financial services. It begins with a brief overview of the mainstream banking sector, which is intimately connected with the non-bank financial services industry and affects financial regulation across the board. It then moves to a history of interest rate regulation in the United States and the connection between rate regulation and the emergence of the first non-bank lenders. It concludes with a survey of some scholarly research into the consumers of non-bank financial services, particularly the "unbanked" and "underbanked."

A. Overview of Bank Regulation

In order to understand the regulatory system that governs bank and non-bank lenders (non-bank financial services) in the United States, it is important to identify the basic players and recognize that the current system is largely a function of historical precedent.[24]

The first important distinction concerns whether a financial institution is a depository or non-depository lender. Depository institutions, which take money from

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[24] *See generally* Arthur E. Wilmarth, Jr., *The Expansion of State Bank Powers, The Federal Response, and the Case for Preserving the Dual Banking System*, 58 FORDHAM L. REV. 1133 (1990) (explaining the origins and operation of the dual—state and federal—system for chartering and regulating banks).

customers and generate revenue by lending out deposited funds, have long been the subject of state and federal regulation because they hold funds for the general public.[25] These institutions come in three basic forms: commercial banks, savings and loan associations (sometimes called "thrifts"), and credit unions.[26] The differences among these entities, which have eroded greatly in recent years, originally stemmed from the nature of their ownership, clientele, and lending products.[27] Today the importance of the distinction lies largely in that it dictates the regulations and regulators to which each is subject. The only type of depository institution that will be discussed further in this paper will be commercial banks.[28]

Non-depository institutions such as personal finance companies do not accept public deposits.[29] Instead, they must seek lending capital on the market, which used to mean that they charged borrowers higher rates of interest than depositories to cover their higher capital costs.[30] As with the traditional distinctions among banks, savings and loans, and credit unions, however, the differences between the lending products offered by depository and non-depository institutions have eroded since deregulation allowed depository institutions to branch into less traditional products and non-depositories have

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[25] NAT'L CONSUMER LAW CTR., CONSUMER CREDIT REGULATION: CREDIT CARDS, PAYDAY LOANS, AUTO FINANCE AND OTHER NON-MORTGAGE CREDIT 16 (2012) [hereinafter CONSUMER CREDIT REGULATION]

[26] *Id.* at 17-19.

[27] *See id.* (describing the historical development of the different types of institutions, what lending products they specialized in, and what parts of the credit market they specialized in).

[28] *See id.* at 17 (discussing how some states chartered both "industrial banks," which were more like consumer finance corporations, and "mutual savings banks," which were less like commercial banks than they were like national savings associations and credit unions).

[29] *Id.* at 16.

[30] *See* LENDOL CALDER, FINANCING THE AMERICAN DREAM 115 (1999) (explaining the differences between how commercial bankers and moneylenders acquire lending capital and how this affects borrowing rates); *see also* CONSUMER CREDIT REGULATION, *supra* note 26, at 16 (explaining that high rate loans were traditionally the purview of non-depository lenders).

moved into areas such as mortgage lending.[31] The formal differences between depository and non-depository lenders, however, still dictate how the entities are regulated.[32]

The next major distinction among financial institutions relates to which government grants an entity's charter. Until the Civil War, states were basically the only governments chartering depository institutions, so essentially all "banks" were creatures of and subject to the laws of the states in which they were chartered.[33] The National Bank Act of 1863, which was aimed largely at funding the Union's involvement in in the war, created the Office of the Comptroller of the Currency (OCC) and empowered it to charter and examine national banks.[34] Though Congress anticipated that the new structure would prompt state banks to voluntarily convert to national charters, few did, resulting in a dual system of bank regulation[35] wherein the choice of whether to be chartered by a state or federal agency[36] would dictate which government entity would be the bank's primary regulator and examiner.[37]

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[31] *See id.* at 16, n.119 (observing that non-depositories have branched into areas such as home equity loans and citing Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473 (2000) for an analysis of how this shift occurred).

[32] CONSUMER CREDIT REGULATION, *supra* note 26 at 16.

[33] Wilmarth, *supra* note 24, at 1153. The First and Second Banks of the United States had been charted in the early nineteenth century to perform the functions of a central bank but after their charters expired, there were no more national banks until the Civil War. *Id.*

[34] THE FEDERAL RESERVE BANK OF NEW YORK, *The Founding of the Fed*, http://www.newyorkfed.org/aboutthefed/history_article.html (last visited March 2, 2013). The National Bank Act was revised in both 1864 and 1865. *Id.*

[35] Wilmarth, *supra* note 24, at 1153-54.

[36] The OCC charters national banks and The National Credit Union Association (NCUA) charters national credit unions. CONN. DEP'T OF BANKING, *The ABCs of Banking: Lesson Two: Banks, Thrifts, and Credit Unions - What's the Difference?*, http://www.ct.gov/dob/cwp/view.asp?a=2235&q=297886 (last visited April 20, 2013). The Office of Thrift Supervision (OTS) used to charter and supervise national savings and loan associations but it was effectively absorbed into the OCC under the Dodd-Frank Wall Street Reform and Consumer Protection Act. Pub. L. No. 111-203, tit. III, §§ 311-313, 124 Stat. 1376 (July 21, 2010).

[37] Christine E. Blair and Rose M. Kushmeider, *Challenges to the Dual Banking System: The Funding of Bank Supervision,* 18 FDIC BANKING REV. no.1, 2006, at 1, *available at* http://www.fdic.gov/bank/analytical/banking/2006mar/article1. The chartering entity will initially assess whether the bank has sufficient capital and competent management. Later it will monitor the institution to ensure that it engages in safe, sound banking practices and complies with other laws related to issues such

Two other federal agencies have supervisory powers over state and federal banks that overlap with those of the banks' primary regulators. These powers include the ability to set standards for safe and sound banking practices (including establishing capital requirements) and to examine the entity for compliance with these standards.[38] The Federal Reserve Board (FRB), which runs the United States' central bank, has supervisory power over all national banks, which must be members of the Federal Reserve System, and over those state banks that choose to be members.[39]

The FDIC, which has provided deposit insurance since the Great Depression, has supervisory power over all the banks it insures.[40] All national banks and state bank that are members of the Federal Reserve System are required to purchase FDIC insurance and all other state banks have the option of doing so.[41] If a state bank is a member of the Federal Reserve System the FRB will be its primary federal regulator and the FDIC will have residual supervisory powers.[42] The FDIC is the sole federal regulator for non-member banks that it insures.[43]

Non-depository institutions have traditionally been subject to less regulation than depository lenders.[44] As businesses, they are usually legal entities that must be formed under and subject to state business laws. Most non-depository institutions will be subject to state and federal regulations specific to their business (lending) activities, particularly

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as fair lending. The regulator will also be charged with writing rules under applicable laws, investigating charges of malfeasance raised against the bank, and closing the bank in an orderly manner if it fails. CONN. DEP'T OF BANKING, *The ABCs of Banking: Lesson Three: Banks and Their Regulators*, http://www.ct.gov/dob/cwp/view.asp?a=2235&q=297888 (last visited April 20, 2013).

[38] *See* THE FEDERAL RESERVE SYSTEM, PURPOSES & FUNCTIONS 60-62 (9th ed. 2005), *available at* http://www.federalreserve.gov/pf/pdf/pf_complete.pdf

[39] Wilmarth, *supra* note 24, at 1160.

[40] *Id.*

[41] *Id.*

[42] *Id.*

[43] *Id.*

[44] CONSUMER CREDIT REGULATION, *supra* note 25, at 16.

state licensing and small loan laws.[45] As will be discussed in greater detail in Part II.A.2, however, non-depository lenders can also be indirectly affected by the regulation of the depository banks when they seek lending capital.

B. USURY AND THE ECONOMICS OF SMALL-DOLLAR LENDING

Interest rate caps are one of the many restrictions that governments place on the business operations of banks and other lenders. In its most simple form, interest is the return that lenders make for giving borrowers the use of their money for a period of time.[46] It can also be thought of as the fee that borrowers pay for being given the ability to use that money.[47] Interest is usually calculated as a percentage of the loan principal, which distinguishes it from most other flat fees and charges associated with borrowing and lending money.

Historically there have been various restrictions—commonly referred to as "usury" laws—on the proportion of the loan principal that lenders could charge as interest.[48] The term "usury" is derived from the Latin "to use" and was originally synonymous with interest (i.e. the fee for using money).[49] However, in the modern sense, the word has come to be defined as "the charging of an illegal rate of interest as a condition to lending money."[50] Thus, in order for interest to be formally considered

[45] *Id*. at 19.
[46] MERRIAM-WEBSTER ONLINE DICTIONARY, *Interest*, http://www.merriam-webster.com/dictionary/interest (last visited April 20, 2013).
[47] *Id*.
[48] CALDER, *supra* note 30, at 113.
[49] MERRIAM-WEBSTER ONLINE DICTIONARY, *Usury*, http://www.merriam-webster.com/dictionary/usury?show=0&t=1363018666 (last visited April 20, 2013).
[50] BLACK'S LAW DICTIONARY, *Usury* (9th ed. 2009).

"usurious," there must be a law establishing a threshold interest rate below which lending will be considered legal.

Though a complete history of usury regulation is beyond the scope of this paper, it is important to understand how usury laws in the United States have been connected to both the refusal of mainstream depository institutions to make small loans and the rise of alternative lending institutions. American usury laws are descendants of European ones but they have persisted in the United States long after many European countries stopped regulating interest rates.[51] Until the emergence of alternative rate ("small loan") laws in the mid-twentieth century, most jurisdictions had an absolute rate ceiling between five and twelve percent a year.[52] This cap applied to all loans regardless of the margin between lenders' costs and revenues.

One problem with having a single usury cap applicable to all types of loans is that such a scheme does not account for variations in lender costs related to acquiring funds and servicing loans. Small-dollar loans have traditionally been relatively expensive to make and service because the costs of running credit checks and handling administrative paperwork is the same for all loans but small loans yield less interest revenue than larger ones, which reduces profit margins for lenders.[53] Because these loans cost so much to make in comparison with the revenue they could generate, regular banks (depository

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[51] CALDER, *supra* note 30, at 114-15.
[52] *Id.* at 115.
[53] *Id.* A two-year study of small-dollar loan programs at state banks conducted by the FDIC in 2008 and 2009 confirmed this financial analysis. As is discussed in more detail in Part III.B(1), the origination and servicing costs of small-dollar loans (under $2500) were barely covered by the 36 percent APR required by the FDIC. FED. DEPOSIT INS. CORP., *A Template for Success: The FDIC's Small-Dollar Loan Pilot Program*, 4 FDIC Q., no. 2, 2010, at 32, *available at* http://www.fdic.gov/bank/analytical/quarterly/2010_vol4_2/FDIC_Quarterly_Vol4No2_SmallDollar.pdf [hereinafter *FDIC Small-Dollar Pilot*].

institutions) did not generally offer them, but that did not mean there was not a market for small-dollar, short-term consumer credit.[54]

As the United States industrialized in the late nineteenth century, more people moved off farms and into cities to take hourly wage jobs related to factory production.[55] A by-product of this industrialization and urbanization processes was that, while people often did not have large incomes, when they did get paid it was in amounts great enough to allow them to rise above the standard of living they had enjoyed in rural communities.[56] This rising standard of living brought with it the desire to make purchases even when consumers did not have cash available between pay days. Because banks would not make the small-dollar, short-term loans necessary to cover these gaps, non-bank lenders began to offer these products outside of the lending channels typically regulated by the law.[57]

Some of these original small-dollar lenders were generally reputable business people like payroll clerks and warehouse operators looking to make a little extra money on the side while charging fees necessary to cover their costs.[58] Others, however, sought high profits and were willing to use coercion to collect their fees.[59] Even though the high rates and scare tactics that these lenders used were technically illegal, borrowers who

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[54] *See* CALDER, *supra* note 30, at 115-16 (discussing how usury caps discriminated against small dollar lending, contrasting the business models of moneylenders and commercial bankers, and citing the growth of the small-dollar market in the latter portion of the nineteenth century).
[55] *Id*. at 116-17.
[56] *Id*. at 116.
[57] *See id*. (providing examples of nineteenth century American small-dollar loan purveyors and quoting William Blackstone's comment that: "Without some profit allowed by law there will be but few lenders, and those principally bad men who will break the law and make a profit and then will endeavor to indemnify themselves from the danger of the penalty by making the profit exorbitant." *Id*. at n.10.).
[58] *Id*. at 118 ("Likely candidates to become engaged in [the small-dollar lending] business were payroll clerks, who lent to employees; storage and warehouse men, who lent on the security of stored furniture; and pawnbrokers, installment furniture dealers, lawyers, bank clerks, insurance agents, and real-estate brokers.").
[59] *Id*. at 119.

accumulated hundreds of dollars in fees and could not pay off their debts were often too frightened to contact law enforcement to prosecute the abusive lenders.[60]

Even when non-bank lending developed into a sizeable urban industry in the late nineteenth century and evidence began to mount that lending practices were creating large debts for borrowers, legislators (mostly on the state level) were largely unwilling to adjust usury laws in a way that would make profitable small-dollar lending a legal business.[61] Usury laws have persisted for a variety of reasons, some moral, some cultural, some political, some avaricious, and some a combination of one or more of the above. There has always been a moral element to the concept of usury—both the sense that charging high interest rates is abusive on the part of the lender and skepticism about the character of borrowers who appear to be taking on debt to live beyond their means.[62] This moralistic influence on policy has long been in tension with economic arguments that might favor allowing higher rates for certain loans in order to make them profitable enough for mainstream lenders to offer.[63]

Another factor in the American usury story is the gap that developed during the industrial age between the sensibilities and economic needs of rural farmers, on the one hand, and those of urban wage workers, on the other.[64] As people left the farm and moved to cities they lost the ability to turn to the land for sustenance during periods of financial instability and, consequently, the need for short-term access to funds increased.[65] Despite this growing need, however, most of the money lent in nineteenth and early twentieth century America was in the form of long-term agricultural loans, so

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[60] *Id*. at 119.
[61] *Id*. at 122.
[62] *Id*. at 111, 113.
[63] *Id*. at 122-23.
[64] *Id*. at 123.
[65] *Id*.

farmers' desire for low interest rates dominated the attention of policy-makers, not the concerns of urban workers who needed cash between paydays.[66] Finally, it is also worth noting that, to the extent that they had political power, abusive lenders lobbied hard to keep usury laws in place, realizing that there would be a smaller market for their services if mainstream lenders could make small dollar loans profitably but not at the exorbitant rates they charged.[67]

Progressive Era reformers saw the misery caused by high-cost, abusive loans and some even came to see the role that indiscriminate usury laws played in creating a market for predatory products. Some reformers attempted to offer alternative loan products subsidized by charitable funds but they could never achieve the loan volume needed to provide serious competition for the predatory lenders.[68] Real change began towards the end of World War I with the passage of small dollar loan laws in many states that legitimized the lending of small amounts at rates higher than the usury caps but below those charged by abusive lenders.[69] This was the first step in the development of the mainstream personal finance industry that eventually produced the modern credit cards needed to fuel a consumer economy that was dependent upon a wider swath of society having ready access to cash.[70] However, these first small dollar loan laws and early personal finance companies were still a long way from the business model of the modern payday lending industry, discussed in the next section.

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[66] *Id*. at 123.
[67] *Id*. at 122.
[68] *Id*. at 120-22.
[69] *Id*. at 134
[70] *Id*. at 16-20 (discussing how modern credit card products actually trace their roots to lending developments during the Progressive Era and World War I).

C. THE TURN OF THE MILLENNIUM SMALL-DOLLAR LOAN

1. The Product

The modern payday loan started in the 1990s as the deregulation of the banking industry and growth of information technology made capital more available and transactions easier to process.[71] For the last decade or so scholars, consumer advocates, and regulators have sought to define the products being offered by these lenders to raise public awareness of and regulate industry practices.[72] In many cases, however, as soon as regulators were able to define payday loans by a set of characteristics, lenders would augment their products to bypass the prevailing legal definition.[73]

The newly created Consumer Financial Protection Bureau's (CFPB) October 2012 examination manual presents a broad definition of payday loans, which it calls "short-term small dollar lending" products.[74] According to the CFPB, there are generally three unifying characteristics of these loan products.[75] First, they are "small-dollar," though the CFPB does not provide a dollar range of what is constitutes "small." Second, they are "short-term," meaning that "borrowers must repay loan proceeds quickly,"

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[71] *See* ROBERT D. MANNING, CREDIT CARD NATION: THE CONSEQUENCES OF AMERICA'S ADDICTION TO CREDIT 195-200, 205-208 (2000) (discussing how the dismantling of the Glass-Steagall Act and other deregulatory acts of the 1990s led banks to withdraw services from low income neighborhoods, how non-bank financial services emerged to fill the gap, and how technological advances—particularly automated check processing—made payday and check cashing services more prevalent).

[72] Robert W. Snarr, Fed. Reserve Bank of Philadelphia, *No Cash 'til Payday: The Payday Lending Industry*, COMPLIANCE CORNER, First Quarter 2002, at CC1, *available at* http://www.philadelphiafed.org/bank-resources/publications/compliance-corner/2002/first-quarter/q1cc_02.pdf; Johnson, *supra* note 12, at 397. *See also* GARY RIVLIN, BROKE, USA: FROM PAWNSHOPS TO POVERTY, INC.: HOW THE WORKING POOR BECAME BIG BUSINESS 118-27, 312-16 (2010) (describing his interactions with payday loan customers, lenders, and consumer advocates, as well as the increasing prevalence of customers with multiple loan roll-overs).

[73] Johnson, *supra* note 12, at 396-401 (describing tactics including increasing loan terms to 121 days when a state statute defined payday loans as those not exceeding 120 days and making loans open-ended—like lines of credit—to get around rate caps); Snarr, *supra* note 72, at CC3 (describing how some payday lenders "devised variations" on their products following adverse state court rulings and other attempts to regulate the industry).

[74] CFPB MANUAL, *supra* note 18, at Short-Term, Small-Dollar Lending Procedures 2.

[75] *Id.*

which usually constitutes a two-week base term but could be as long as 6 months.[76] Finally, "they require that a borrower give lenders access to repayment through a claim on the borrower's deposit account."[77]

Other than the three basic traits, the CFPB manual observes that "other features vary."[78] With respect to payment structures, the manual notes that typical short-term, small dollar loans are "structured to [be paid] off in one balloon payment," though "installment payments and interest-only payments are not unusual."[79] These loans can be "closed-end" or "open" like a line of credit that is continually drawn down and periodically partially repaid. Funds "may be disbursed in cash, on a prepaid card, through the Automated Clearing House ("ACH") network, or by check."[80] Unlike mainstream lenders, providers of small-dollar, short-term loans do not typically conduct extensive investigations into a borrower's credit-worthiness (sometimes called "underwriting").[81] Instead, the main eligibility criteria typically are that the borrower have a job (which will ostensibly produce periodic income) and a checking account that can be debited in the event that the borrower does not actively repay the loan on time.[82]

One of the most frequently discussed characteristics of short-term, small dollar loan products is the aggregate cost of their interest, fees, and other charges. As the CFPB writes, "most loans . . . have finance charges of $15 to $20 per each $100 borrowed," though "finance charges can vary due to factors including differences in state law."[83] Given that the typical payday loan term is two weeks, $15 to $20 per term per $100

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[76] *Id.*
[77] *Id.*
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] *Id.*
[83] *Id.*

borrowed would translate into “391 percent to 521 percent” of the sum borrowed if the fee was paid every two weeks for a year.[84] This calculation (total interest and fees divided by the loan principal) is called the Annual Percentage Rate (“APR”) and is meant to provide a common metric for consumers to compare the aggregate costs of different types of credit over a standard term. Non-bank lenders have argued that APR is misleading in the context of their products, which they say are meant to be used over short periods of time, not for a whole year.[85] Consumer advocates, on the other hand, argue that typical borrowers cannot satisfy the terms of these loans on such a short time frame.[86] Instead, these borrowers have to refinance (“roll-over”) their loans multiple times and/or take out multiple new loans to service their prior obligations, ultimately paying lenders fees in amounts that are several times the value of the original cash advance.[87]

While the non-bank lending sector’s argument regarding the use of the APR metric is valid on its face, recent studies showing that over two-thirds of borrowers in some states take out multiple payday loans each year seem to support the need to use an aggregate measurement of the product’s borrowing costs.[88] It is not clear, however, whether that metric should be an APR calculated by assuming that the base fee would be paid out over a whole year. Determining an appropriate metric would require better data

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[84] *Id.*
[85] *See, e.g Myth vs. Reality: Payday loans are extremely expensive and have exorbitant interest rates*, CMTY. FIN. SERV. ASS’N OF AM., http://cfsaa.com/aboutthepaydayindustry/myth-vs-reality.aspx (last visited Apr. 20, 2013); *see also* S. ECON. DEV., SUBCOMM. ON CONSUMER CREDIT LAWS, INTERIM REP. TO THE 77TH TEX. LEG., 76th Reg. Sess., at 12 (2000), *available at* http://www.lrl.state.tx.us/scanned/interim/76/ec74c.pdf [hereinafter TEX. SUBCOMM. ON CONSUMER CREDIT]
[86] Johnson, *supra* note 12, at 391-94; KING & PARRISH 2007, *supra* note 12, at 7.
[87] *Id.* at 7-8.
[88] *See* PARRISH & KING 2009, *supra* note 19, at 7-9 (offering results of a survey of borrowers in Oklahoma and Florida).

than is currently available regarding issues such as how many times the average borrower rolls over his or her loans each year.

2. The Customer

Having defined the general parameters of the typical short-term, small dollar loan, this section turns to a brief overview of the non-bank financial services customers. Due to the disparate nature of state regulation of the non-bank financial services industry, it is hard to obtain exact statistics on who uses non-bank financial products. Scholars often offer anecdotes[89] and examples from local surveys[90] to support their arguments. Since the 2009 financial crisis, however, both the FDIC[91] and Federal Reserve[92] have conducted studies of individual borrowing patterns, with a particular focus on borrowers who use non-bank financial services. These national studies, along with more regional work sponsored by branches of the Federal Reserve, provide insight into certain characteristics of non-bank financial services customers.

The 2011 FDIC National Survey of Unbanked and Underbanked Households looked at the relationship between the extent to which a household was "banked" and

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[89] *See* Johnson, *supra* note 12, at 391-92 (offering the example of a single mother in Wisconsin who paid $1360 on a $300 cash advance).

[90] *See* Michael S. Barr, et. al., *Financial Services, Saving, & Borrowing Among Low- and Moderate-Income Households*, FED. RESERVE BANK OF CLEVELAND at 21 (February 6, 2009), *available at* http://www.clevelandfed.org/research/Conferences/2009/2-6-2009/Keys_presentation.pdf [hereinafter *Detroit Financial Services Survey*] (finding that a significant portion of low- to moderate-income users of non-bank financial services had trouble meeting other financial obligations).

[91] FED. DEPOSIT INS. CORP., 2011 FDIC NATIONAL SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS (2011), *available at* http://www.fdic.gov/householdsurvey/2012_unbankedreport.pdf [*hereinafter* 2011 FDIC Survey].

[92] Matthew B. Gross, Jeanne M. Hogarth, & Maximilian D. Schmeiser*, Use of Financial Services by the Unbanked and Underbanked and the Potential for Mobile Financial Services Adoption*, 98 FED. RES. BULL., no. 4, 2012, at 3, *available at* http://www.federalreserve.gov/pubs/bulletin/2012/pdf/mobile_financial_services_201209.pdf.

whether and how much it used alternative financial services products.[93] Respondents were classified as "'unbanked' if they answered 'no' to the question, 'Do you or does anyone in your household currently have a checking or savings account?'"[94] A household was classified as "underbanked" if it (a) had a checking and/or a savings account and (b) "had used non-bank money orders, non-bank check cashing services, non-bank remittances, payday loans, rent-to-own services, pawn shops, or refund anticipation loans (RALs) in the past 12 months."[95] This suggests that the underbanked have access to mainstream banking for basic transactions but that something, whether personal aversion, institutional rejection, or the absence of appropriate loan products, is keeping them from using mainstream banking service for transactions such as credit purchases and fund transfers.

The survey's major findings were as follows. First, within the year prior to the survey "[p]ayday loans were used by 7.9 percent of underbanked and 1.6 percent of unbanked households,"[96] compared with 1.7 percent of all U.S. households.[97] Second, "all underbanked households and 64.9 percent of unbanked households" reported having used an alternative financial service in the last year, as opposed to only 25 percent of the survey population as a whole.[98] Third, 29.5 percent of unbanked households had not used any alternative financial product in the last 12 months, suggesting a reliance on cash transactions.[99] Fourth, the use of alternative financial transactions like money orders was

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[93] 2011 FDIC Survey, *supra* note 91 at 2.
[94] *Id*. at 2, n.2.
[95] *Id*. The FDIC found that "8.2 percent of US households are unbanked" and "20.1 percent of US households are underbanked." *Id*. at 2.
[96] *Id*. at 34.
[97] *Id*. at 33.
[98] *Id*. at 6.
[99] *Id*. at 29.

more common than that of alternative credit products like payday loans.[100] Finally, "[t]he highest unbanked and underbanked rates are found among non-Asian minorities, lower-income households, younger households, and unemployed households."[101]

A more limited study on the use of alternative financial products by low- and moderate-income (LMI) residents of Detroit was presented in 2009 at the Federal Reserve Bank of Cleveland. Within its sample of LMI residents, the study found statistically significantly higher rates of bankruptcy, eviction, and cut-off utilities and phone service within the previous 12 months among users of payday loans than among non-users.[102] It also found that, among subjects who reported experiencing bankruptcy, eviction, and cut-off utilities and phone service within the previous 12 months, a statistically significantly higher proportion had used payday loans than had not used them.[103]

While it is hard to draw sweeping conclusions from these findings—particularly given the extremity of the situation in Detroit related to the auto industry collapse in 2008—there are a few important points. First, there is a much greater usage of payday loans among underbanked individuals than there is in the general U.S. population.[104] Second, this group is more likely to be minority and low-income or unemployed than is the fully banked population. Finally, use of payday products among LMI individuals appears to be correlated with higher likelihood of additional financial hardship. It is not clear whether use of payday products actually caused the bankruptcies, evictions, and

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[100] *Id.* at 33.
[101] *Id.* at 5.
[102] *Detroit Financial Services Survey*, *supra* note 90, at 21.
[103] *Id.* at 22.
[104] This finding demonstrates that unbanked individuals were no more likely to use the product than the general populations, which can probably be partially explained by the fact that ownership of a checking account is usually a prerequisite to taking out a payday loan. *See supra* note 10 (noting that payday customers must have bank accounts).

inability to pay other bills observed in the Detroit study. However, the fact that these products—which often involve fees equal to several times the original loan value—are being used more frequently by groups having trouble managing their broader financial situation should raise questions about whether the market is providing the best financial products for these consumers.

Part II. Before the Great Recession: Pre-2009 Law

As discussed in Part I.A, the United States regulates lending by institution, not by product category, and the system that has developed to govern depository institutions gives state and federal regulators overlapping powers over lenders. The resulting interplay between state and federal regulators and the opportunities for businesses to structure themselves so as to pick the most desirable regulator have had a significant impact on the consumer credit industry and on small-dollar loans in particular.[105]

Because state usury laws have traditionally made it unprofitable for bank lenders to make small-dollar loans, these products have long been the purview of non-bank institutions, which are primarily state-regulated. The small-dollar loan market that developed in the late twentieth century, particularly in Texas, is largely a function of federal legal developments beginning in the 1970s regarding the ability of banks to "import" out-of-state interest rates and the ability of federal laws to override state ones, especially in the areas of rate caps and consumer protection.[106]

Both phenomena relied upon the legal concept of federal "preemption." When it comes to regulating the activities of people and organizations within their borders, states are said to have a general police power that allows them to take any action that is not prohibited by the U.S. Constitution.[107] This is in contrast to federal power, which is limited and does not exist in an area unless authorized by some provision of the

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[105] It has become possible at various times for more heavily regulated depository institutions to use business relationships with non-depository institutions to gain profits from activities that they would not be legally allowed to engage in themselves. *See, e.g.*, RIVLIN, *supra* note 72, at 42-55 (describing a class-action lawsuit brought against Fleet Financial, a non-bank subsidiary of Fleet Bank of Rhode Island, that sold arguably predatory home equity loans to elderly African American homeowners in lower income neighborhoods on the east coast).

[106] Part II.A.1 & 2 *infra*.

[107] ERWIN CHEMERINSKY, CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES 390 (3rd ed. 2006).

Constitution.[108] When both state and federal governments have the power to act in an area and their laws conflict, however, the U.S. Supreme Court has found that, pursuant to the Supremacy Clause of the federal constitution, the federal law will control and the state law will be invalid.[109] As discussed below, lending regulation is an area where both state and federal governments have power and where their laws have been found to conflict, particularly with respect to the regulation of nationally chartered banks operating within state borders.[110]

The next part of this section will outline the main federal laws and legal developments pertaining to small-dollar lending, discussing them as they existed prior to the financial crisis of 2008. It will then move to Texas law, again, as it stood prior to the financial crisis that peaked in 2009 and caused a series of legal reforms.

A. Federal Law

Developments in federal law during the latter portion of the twentieth century have had a substantial impact on lending practices around the country. Beginning with judicial and legislative responses to the high interest rates, inflation, and economic malaise of the 1970s and culminating in the OCC's expansive interpretation of the preemption doctrine in the 2000s, theses changes greatly diminished the ability of state legislators and regulators to control the interest rates and other lending practices of banks operating within their borders.

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[108] *Id.*

[109] *Id.* at 392 (citing Gade v. Nat'l Solid Waste Mgmt. Ass'n, 505 U.S. 88 (1992); Gibbons v. Ogden, 22 U.S. (9 Wheat) 1.211 (1824)).

[110] *See generally* CONSUMER CREDIT REGULATION, *supra* note 25, at 69, 71-73.

1. *Marquette*, Interest Rate Caps, and the Relaxation of Usury Laws

The National Bank Act, which opened the way for national bank charters during the Civil War, also sought to protect these banks from potentially hostile state governments by allowing each one to choose between a federally set interest rate cap and the one set by the state in which the bank was located.[111] In 1978's *Marquette National Bank v. First of Omaha Corporation* the U.S. Supreme Court held that the National Bank Act further allowed federally chartered banks using their state rate caps to use those rates in the other states in which they operate.[112] The decision in *Marquette*, which involved a bank marketing its credit cards in multiple states, was most immediately felt in the area of credit card interest rates.[113] Once banks were allowed to adopt the rates of states with high caps and use them in connection with credit products sold across the country, credit cards became more profitable for lenders and credit became more widely available.[114] Furthermore, as bank deregulation and consolidation proceeded into the 1990s, depository institutions increasingly chose national charters but picked home states with high interest rate caps, which they could now "import" into states with lower caps using the *Marquette* rule.[115]

Marquette gave national banks more freedom to charge higher interest rates at a time in the late 1970s and early 1980s when inflation was relatively high and the economy was not growing quickly. Since the mid-1970s, bank lenders had been caught

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[111] NAT'L CONSUMER LAW CTR., PREEMPTION AND REGULATORY REFORM: RESTORE THE STATES' TRADITIONAL ROLE AS "FIRST RESPONDER" 4 (2009), *available at* http://www.nclc.org/images/pdf/preemption/restore-the-role-of-states-2009.pdf [hereinafter STATES AS FIRST RESPONDER].

[112] *See* Marquette Nat'l Bank v. First of Omaha Corp., 439 U.S. 299, 309-13 (1978) (holding that a national bank is "located" in the state cited on its charter and that the rate of the location state can be used in other states where the bank does business).

[113] STUART VYSE, GOING BROKE: WHY AMERICANS CANT HOLD ON TO THEIR MONEY 50-55 (2008) (describing the connections between *Marquette*, increases in credit card use, and bankruptcy filings).

[114] *Id*. at 50.

[115] MANNING, *supra* note 71, at 88-89.

in an increasingly untenable position by rapidly rising market interest rates (which affected the price of lending capital), competition for depositors from non-bank brokerage houses, and statutory caps on the rates they were permitted to charge borrowers.[116] Following *Marquette*, however, national banks, which competed in the same markets as state banks, could use rate importation to offer products on more profitable terms than were available to state banks that were still constrained by state lending laws.[117]

It was in this context that Congress moved to limit the effect that state usury laws had on state-chartered banks. In an effort to give state banks more flexibility, Congress took steps in the early 1980s to preempt state usury laws for FDIC-insured depository institutions with respect to mortgages and loans in excess of $1000.[118] No federal usury cap was passed to replace the preempted state ones, however, so the burden shifted to the states to affirmatively reenact their usury laws in light of the new federal law to avoid having them completely repealed.[119] Most states responded by acting to preserve their basic usury statutes and the limited exceptions that had existed for small-dollar loans, but the new versions of these laws frequently had higher rate caps than their predecessors.[120] Some states, furthermore, allowed their general usury statutes to be repealed entirely, "allowing parties who were not regulated by special usury statutes to contract for the

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[116] NAT'L COMM'N ON THE CAUSES OF THE FIN. AND ECON. CRISIS IN THE U.S., THE FINANCIAL CRISIS INQUIRY REPORT 29-35 (2011), *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf (describing how interest rate caps and capital requirements put depository institutions at a disadvantage vis-à-vis non-depository financial institutions during the rapid interest rate increases of the 1970s and 1980s); MANNING, *supra* note 71, at 78-80.
[117] *See generally* CONSUMER CREDIT REGULATION, *supra* note 25, at 89-93 (discussing state parity laws and other legal steps taken to allow state banks to compete with national ones in light of rate importation in the 1980s and 1990s).
[118] *Id*. at 8.
[119] *Id*.
[120] *Id*.

payment of any agreed rate."[121] The end result of this process was increasing interest rate flexibility for both state and national depositories and shifting norms regarding the boundaries of what should constitute "fair" interest rates.

2. Rate Importation and Non-bank Lenders

While *Marquette* and other changes in federal law had a rather obvious impact on the practices of depository lenders, their effect was more indirect with respect to loans originated by non-depository institutions. Though indirect, federal law had a substantial impact on small-dollar lending through rate importation in the context of partnerships between national banks and non-bank lenders.

Until 2005 when the OCC and FDIC effectively ended the practice, one tool that non-bank lenders used to circumvent state usury caps and consumer lending laws was something that came to be known as "rent-a-bank" or "rent-a-charter."[122] Under the model, a non-bank lender would partner with a depository institution, frequently based in a state with very permissive lending laws, to offer higher-cost loans in states with more restrictive laws.[123] The loans would technically be originated by the depository institution, which could base its rates on the regulations of its home state. States like Delaware and North Dakota had no interest rate limits so depositories charted by those states could offer unlimited rates to their partners. The non-bank lender would handle all

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[121] *Id*.
[122] *Id*. at 430.
[123] JEAN ANN FOX, CONSUMER FED'N OF AM., UNSAFE AND UNSOUND: PAYDAY LENDERS HIDE BEHIND FDIC BANK CHARTERS AND PEDDLE USURY 11 (2004), *available at* http://consumerfed.org/pdfs/pdlrentabankreport.pdf; *see also* NY v. Cnty. Bank of Rehoboth Beach, DE, RJI No. 01-04-080549, slip op. at 3-5 (N.Y. Sup. Ct. Albany Nov. 20, 2006), *available at* http://www.nclc.org/images/pdf/unreported/NY_v_County_Bank_Decision.pdf (describing the contractual relationship between a Delaware bank, which is not subject to a usury cap, and a payday lender doing business in New York, which has a 25 percent APR usury cap).

of the marketing, applications, underwriting, and collections activities, however, and would actually buy the loan from the bank so that it was the party assuming most of the risk.[124] Thus, for a time, these partnerships appeared to legitimately be offering loans that, when roll-overs accrued, had effective APRs of 500 percent or more in states like New York with usury caps around 25 percent a year.[125] As noted by the Texas Senate Economic Development Subcommittee on Consumer Credit Laws, many Texas non-bank lenders viewed this as an attractive model in the late 1990s and early 2000s.[126]

As individuals and states' attorneys general (such as Eliot Spitzer of New York) started to challenge this practice in the early 2000s[127] the OCC gradually started restricting the actions of its examinees, first by "assert[ing] the right to examine the services performed by the non-bank [partners] 'to the same extent as if the bank were performing these services on its own premises.'"[128] In 2002 Comptroller of the Currency John Hawke stated publically that the right national banks' charters afforded them to preempt state laws was inalienable and announced recent actions taken against a national bank that was found to have been essentially renting its charter to a payday lender.[129] Soon thereafter, the OCC effectively ended the practice among nationally chartered banks by increasing enforcement actions against institutions known to engage in "payday lending activities through third-party lenders," having found that the programs

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124 FOX, *supra* note 123, at 11.

125 *See*, *e.g.*, *Cnty. Bank of Rehoboth Beach*, RJI No. 01-04-080549, slip op. at 3.

126 TEX. SUBCOMM. ON CONSUMER CREDIT, *supra* note 85, at 15.

127 *See* FOX, *supra* note 123, at 11-12 (describing actions by the New York Attorney General and by private citizens in New Jersey).

128 CONSUMER CREDIT REGULATION, *supra* note 25, at 423 (quoting OCC Advisory Letter No. 2000-10 (Nov. 27, 2000), *available at* http://www.occ.gov/topics/consumer-protection/payday-lending/index-payday-lending.html).

129 FOX, *supra* note 123, at 17 (citing a speech by then Comptroller of the Currency John Hawke given February 12, 2002, *available at* http://www.occ.gov/static/news-issuances/speeches/2002/pub-speech-2002-10.pdf).

compromised the institutions' safety and soundness and, in some cases, led to consumer abuse.[130] Thus, when the OCC made it clear that national banks could suffer repercussions for engaging in partnerships to issue payday loans the banks moved away from the business.

When national banks started abandoning rent-a-bank partnerships with alternative lenders the industry turned to state banks, which were mostly regulated by the FDIC and could still charge high interest rates using state laws designed to keep state banks competitive in light of national bank rate importation.[131] In the early 2000s, the FDIC was seen as being relatively permissive about its banks' involvement with payday lenders.[132] The FDIC's 2003 enforcement guidelines restricted the proportion of regulated banks' required capital that could consist of payday loans, but this had little effect on banks that sold their loans into the secondary market rather than holding them as capital.[133] Furthermore, the 2003 FDIC guidance on payday loans "emphasized safety and soundness concerns" but did not prohibit rent-a-bank relationship.[134] The 2005 guideline updates did not prohibit the activity either but enforcement actions were increasingly

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130 CONSUMER CREDIT REGULATION, *supra* note 25, at 430; *see also* FOX, *supra* note 123, at 17 n.60 (quoting the OCC's 2003 Annual Report regarding its actions against "national banks with known payday lending activities through third-party vendors").

131 FOX, *supra* note 123, at 19-20. Fox reports that some banks actually switched from the Federal Reserve System to the FDIC so that it could be subject to the FDIC's more lenient rules about partnering with payday lenders. *Id.* The state banks were able to do this using something called the "most favored lender doctrine," which let them charge the highest rate available to any lender in their state for the type of loan in question. CONSUMER CREDIT REGULATION, *supra* note 25, at 89. This meant that state banks could use the out of state rates that national banks were importing in. *Id.*

132 *See* FOX, *supra* note 123, at 20-24.

133 CONSUMER CREDIT REGULATION, *supra* note 25, at 424.

134 FOX, *supra* note 123, at 22.

critical of the practice and "[w]ithin a few years . . . all FDIC-insured banks had ended their payday partnerships."[135]

3. Consumer Protection

Another result of choosing a national charter was that a bank would be a creature of federal law and regulated by a federal agency.[136] Under the legal doctrine of preemption, this meant that state lending laws in the states where the national banks operated might not apply if those laws were found to conflict with federal regulations. Using this principle, the OCC, issued a series of regulations and advisory letters in the early-to-mid 2000's that restricted the ability of states to enforce their own (often more restrictive) consumer protection laws against national banks.[137] Though the OCC was later found to have exceeded the scope of its powers under the National Bank Act, particularly in the area of sub-prime mortgage lending, the decisions of federal regulators limited the power of state regulators to control some of the lending practices that have been blamed for causing the 2008 financial crisis.[138]

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[135] CONSUMER CREDIT REGULATION, *supra* note 25, at 424; FED. DEPOSIT INS. CORP., DEP'T OF THE TREAS., FINANCIAL INSTITUTION LETTER FIL-14-2005, PAYDAY LENDING PROGRAMS REVISED EXAMINATION GUIDANCE (2005), *available at* http://www.fdic.gov/news/news/financial/2005/fil1405.html.

[136] Marquette Nat'l Bank v. First of Omaha Corp., 439 U.S. 299, 307 (1978).

[137] Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. 1904 (Jan. 13, 2004) (amending 12 C.F.R. pts. 7, 34). The Dodd-Frank Act made substantial changes to the ability of federal regulators to preempt state laws and may effectively overturn the 2004 OCC rule. CONSUMER CREDIT REGULATION, *supra* note 25, at 73-76.

[138] *See* RIVLIN, *supra* note 72, at 214-17 (discussing the effect of OCC preemption on state efforts to regulate subprime mortgage lending). Rivlin's discussion focuses largely on the OCC's attempts to use its preemption powers to prohibit states' attorneys general from suing national banks to enforce *state* laws. The U.S. Supreme Court held that this action exceeded the OCC's preemption powers under the National Bank Act in *Cuomo v. Clearing House Ass'n.* 557 U.S. 519, 536 (2009).

With some notable exceptions,[139] few states were able to maintain strong consumer credit protection laws through the period of deregulation and preemption. Because the United States has chosen to regulate credit by institution type, not product, when states lost regulatory power vis-a-vis their depository lenders as a result of rate exportation and federal preemption it often seemed futile to place strict regulations on non-depository lenders, who would likely find ways to by-pass such rules.[140] Particularly in the years before the financial crisis, this situation magnified the importance of federal consumer protection laws, two of which have implications for small dollar lenders: the Truth in Lending Act (TILA)[141] and the Equal Credit Opportunity Act (ECOA).[142]

TILA, adopted in 1968, is primarily a disclosure regime, meaning that it operates by requiring lenders to make certain information available to consumers prior to the origination of loan rather than regulate the substance of the products and decisions that lenders make[143] The approach is based on the premise that the informed use of credit would be good for the economy as a whole and that it would increase competition among lenders.[144] The required disclosures include, among other things, "the 'Amount Financed,' which is the amount of money of which the consumer will have actual use, the 'Finance Charge,' which is the total dollar cost of the credit, and the 'Annual Percentage Rate' (APR), which expresses the cost of the credit on a yearly basis."[145] Federal

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[139] In 2004 Georgia outlawed payday lending as a public nuisance. CONSUMER CREDIT REGULATION, *supra* note 25, at 412 (citing Ga. Code Ann. §§ 16-7-1 to 16-7-97). North Carolina law places payday loans under the consumer finance act that imposes a 36 percent interest rate cap. CONSUMER CREDIT REGULATION, *supra* note 25, at 418 (citing N.C. Gen. Stat. §53-173).

[140] STATES AS FIRST RESPONDER, *supra* note 111, at 20 (2009).

[141] 15 U.S.C. §§ 1601 to 1666j (2012).

[142] 15 U.S.C. §§ 1691 to 1691f (2012).

[143] *See* AMERICAN JURISPRUDENCE, CONSUMER AND BORROWER PROTECTION §3 (2d ed. 2013) (describing the Act's purpose to ensure information disclosure for consumers).

[144] *See id*. (discussing the Act's purpose of addressing the problems created by information asymmetries in credit transactions).

[145] CONSUMER CREDIT REGULATION, *supra* note 25, at 23-24.

regulations also give specific guidelines on how to calculate these amounts. Some substantive requirements (i.e. more than just disclosures) have been added to TILA in recent years, but they are primarily related to credit cards and lines of credit, not small-dollar, uncollateralized loans.[146]

The Equal Credit Opportunity Act prohibits discrimination in the provision of credit on the basis of race, color, religion, national origin, sex, marital status, or age.[147] It is enforced through Regulation B, which is also now in the portfolio of the CFPB.[148]

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These and other developments in federal law during the last forty years created a banking sector that was much less regulated than it had historically been and that had much greater flexibility to expand business across state lines and diversify product lines beyond checking accounts and traditional thirty-year, fixed-rate mortgages. Federal legal developments also reduced states' ability to control the rates and conditions of lending within their borders. The banks that thrived in this environment often purchased smaller depositories and merged with larger banks in other regions.

The resulting consolidation reduced the prevalence of community banks that could meet the needs of borrowers with lower incomes and weaker credit histories. Non-bank lenders, which frequently found regulatory gaps that allowed them to access capital while still lending at high rates, emerged to fill the need in many communities for small-dollar, short term lending products. Because preemption of state lending laws relied on federal power over national depository institutions created by the National Bank Act, however, the non-bank entities that emerged to dominate the small-dollar industry were

[146] *Id*. at 24.
[147] *Id*. at 44
[148] 12 C.F.R. pt. 1002 (2013).

still subject to many state laws that were not directly affected by federal preemption. Different states have dealt differently with these non-bank lenders. The experience of Texas, to which this paper turns next, provides an example of how one jurisdiction has approached small-dollar lending and how non-bank financial service providers have navigated the resulting regulatory structure.

B. TEXAS LAW

1. Background

Texas has a somewhat varied history regarding the regulation of creditors' ability to charge interest on the money they lend. As discussed above, for a lender's rates to be considered "usurious" the law must establish a ceiling on what is considered to be a legal rate. In 1869, during one of the post-Civil War revisions to the state constitution,[149] Texas also "abolished all usury law and prohibited the Legislature from making laws limiting the amounts of interest parties could agree upon for loans of money or other property."[150] Without a legal limit on rates, lenders could charge whatever borrowers would agree to pay. This effort to allow complete freedom of contract in the state was relatively short-lived, however, and the 1876 Texas Constitution reintroduced legal rate limits following "a sweeping flood of credit abuses" that were perceived to result from the removal of the usury cap.[151]

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[149] *The Constitution: The Radical Republican Constitution of 1869*, TEXAS POLITICS, http://texaspolitics.laits.utexas.edu/7_2_6.html (last visited Apr. 21, 2013).
[150] TEX. SUBCOMM. ON CONSUMER CREDIT, *supra* note 85, at 2.
[151] *Id.*

Though the size of the rate caps have changed over the years, since 1876 the Texas Constitution has controlled usury in the state in the absence of more specific legislation.[152] Article Sixteen, § 11 of the Texas Constitution currently reads:

> The Legislature shall have authority to 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.[153]

Until the 1960's there was no legislation providing more specific regulation of allowable interest rates so the constitutional caps controlled lending in the state.[154]

By the early 1960s legislators were expressing concern both that small dollar loans were expensive for reputable lenders to make and that the consumers were being abused by tactics aimed at circumventing the constitutional rate caps.[155] These concerns led to the passage of the Texas Regulatory Loan Act in 1963,[156] which allowed certain loans under $1,500 to be made at rates higher than the constitutional cap and created a new regulatory agency to monitor the new loan products.[157] The 1963 law was limited in scope,[158] however, and subsequent legislative investigation found pervasive consumer

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152 *Id.*

153 TEX. CONST. art. 16, § 11 (2012).

154 TEXAS USURY LAW HANDBOOK 8 (Dan L. Nicewander et al. eds., 2d. ed. West 2005) [hereinafter USURY HANDBOOK]; *see also* OFFICE OF CONSUMER CREDIT COMM'R, STRATEGIC PLAN 2005-2009, APPENDIX I: HISTORY, http://www.occc.state.tx.us/pages/agency/strat05/i.html [hereinafter OCCC HISTORY APPENDIX] (providing a timeline of consumer credit regulation in Texas).

155 *See id.* ("1958: The Texas Legislative Council reports to the Legislature that, "Small loans are the most expensive of all types of loans to make and service." That council recommends Texas enact a small loan law, citing three primary abuses of borrowers: excessive charges, pyramiding of loans, and harassment of borrowers in collection practices.").

156 TEX. REV. CIV. STAT. ANN. art. 6165b (West 1963), *repealed by* Act effective Oct. 2, 1967, 60th Leg., R.S., ch. 274, § 5, 1967 TEX. GEN. LAWS 659.

157 OCCC HISTORY APPENDIX, *supra* note 154. The agency created, the Office of Regulatory Loan Commissioner, was the processor to the current Office of Consumer Credit Commissioner (OCCC).

158 USURY HANDBOOK, *supra* note 154, at 8 ("Th[e] Act did not deal with retail installment sales and only covered loans of $1,500 . . . or less.").

abuse that was not being addressed by then-existing usury laws.[159] Four years later, however, the legislature passed House Bill 452 (part of the Acts of 23 May 1967),[160] overhauling the Interest, Consumer Credit, and Consumer Protection portion of the state's civil code and making "the first [substantial] attempt to allow usury rates above 10 percent . . . on a large scale" in Texas.[161]

Consumer loans in Texas now fall into two general categories: (1) those that charge under 10 percent a year and are essentially unregulated and (2) those that charge more than 10 percent a year and are regulated by the Office of Consumer Credit Commissioner (OCCC). This occurs because, while § 302.001 of the Finance Code codifies the ten percent constitutional usury rule,[162] Chapter 303 of the Code only requires OCCC licensing and regulation of lenders offering loans at the higher rates allowed by that chapter.[163] There are several classes of higher-rate loans that have their

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[159] *See* Acts 1967, 60th Leg. R.S., ch. 274, § 1, 1967 TEX. GEN. LAWS 608–09, *available at* http://www.lrl.state.tx.us/scanned/sessionLaws/60-0/HB_452_CH_274.pdf (outlining legislative findings leading to the decision to create "a comprehensive code of legislation to clearly define interest and usury, to classify and regulate loans and lenders, to regulate credit sales and services, and place limitations on charges imposed in connection with such sales and services, to provide for consumer education and debt counseling, to prohibit deceptive trade practices in all types of consumer transactions, and to provide firm and effective penalties for usury and other prohibited practices.").

[160] Acts 1967, 60th Leg. R.S., ch. 274, 1967 TEX. GEN. LAWS 608–60.

[161] USURY HANDBOOK, *supra* note 154, at 8. "However, the unspoken purpose of Subtitle 2 of the [Code created by the 1967 Act] was to allow certain Texas lenders (mainly banks) to charge interest rates in excess of the constitutional ceiling of 10 percent per annum on certain installment loans. The trade-off was that, in order to charge such higher rates, these lenders would be subject to licensing (at least for nonbank lenders) and would have certain disclosure requirements as well as other additional duties and prohibitions. Texas lenders were so desirous of charging in excess of the constitutional limit of 10 percent per annum that they willingly and knowingly accepted the additional burdens of licensing, disclosure, and other duties. In 1967, the lenders paid little attention to such duties and prohibitions and completely ignored the stringent penalties created by the [1967 Act]." *Id.* at 9–10.

[162] TEX. FIN. CODE ANN. § 302.001 (West 2012).

[163] *See* USURY HANDBOOK, *supra* note 154, at 100 ("Section 303.201 of the Finance Code [license requirement] only comes into play . . . when the creditor is attempting to charge and interest rate higher than 10 percent per annum under the authority of Chapter 303 of the Finance Code [optional rate ceilings that exceed 10 percent]. Section 303.201 of the Finance Code does not remove the existing option of structuring any direct loan under the 10 percent per annum provision of Sec. 302.001 of the Finance Code or under some usury statute other than the Code, such as the corporate usury statute.").

own regulations; consumer loans charging more than ten percent a year are regulated under Chapter 342.

Though total fees and interest on payday loans often amounts to more than ten percent of the cash advance, these products have never fit cleanly into Texas's regulatory structure. As discussed in Part II.B.2(c), payday lenders in Texas currently register as credit service organizations (CSOs), which are technically considered brokers, not lenders and, as a result, are subject to fewer regulations than consumer lenders operating under Chapter 342.

2. Texas's Regulatory Structure Prior to 2004

(a) Chapter 342

Though the consumer credit laws stemming from 1967's H.B. 452 apply to a variety of loan products, the focus of this paper is small dollar consumer loans charging more than ten percent a year, a category of loans currently regulated by Chapter 342 of the Texas Finance Code. Any loan that is not secured by real property, that "provides for interest in excess of 10 percent a year," that "is extended primarily for personal, family, or household use," and that is made by a "person engaged in the business of making, arranging, or negotiating [such loans]" is subject to Chapter 342.[164] A "person" must be licensed by the OCCC to make, transact, or negotiate a loan that is subject to Chapter 342.[165]

Subchapters E[166] and F[167] provide several options for structuring the interest and fees of consumer loans regulated by Chapter 342. In general, the code regulates the

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[164] TEX. FIN. CODE ANN. § 342.005 (West 2012).
[165] FIN. § 342.051.
[166] FIN. §§ 342.201-342.206.

interest that can be charged on applicable loans by establishing a series of interest rate "ceilings" that apply to certain portions ("brackets") of the dollar amount of the cash advanced the consumer. For example, one provision currently allows lenders to charge 30 percent interest on the first $3,250 of the loan, 24 percent interest on the portion between $3,250 and $6,825, and 18 percent on the amount between $6,825 and $16,250, with $16,250 being maximum amount that can currently be lent under the provision.[168] Subchapter E allows larger amounts to be lent at rates above the usury cap but sets the maximum interest rate of only 30 percent a year.[169] Subchapter F, by contrast, allows smaller amounts of money to be lent under its terms but permits lenders to charge fees that would add up to much higher annual percentage rates (APR), presumably based on the assumption that the loans are short term and so the fees will not typically be charged enough times to reach their theoretical APR.[170]

Both Subchapter E and F have their origins in H.B. 452 of 1967 and their differences relate largely to the ways in which they try to account for all the different product structures that lenders might devise. As previously discussed, Subchapter E applies to larger dollar amounts and allows lower interest rates than does Subchapter F. Its rate ceiling provisions are also based on more conventional interest concepts, whereas Subchapter F appears more concerned with setting ceilings by translating fees charged per unit of cash advanced into annual percentage rates.

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[167] FIN. §§ 342.251-242.259.

[168] FIN. § 342.201(e). The boundaries of the brackets adjust over time based on statutory formulas that are reported by the OCCC. *See* OFFICE OF CONSUMER CREDIT COMM'R, NOTICE OF RATE CEILINGS, 31 TEX. CREDIT LETTER no. 41, (April 10, 2012), *available at* http://occc.state.tx.us/pages/publications/ccl/2012/0410%20with%20Rate%20Bracket%20Adjustments_1.pdf [hereinafter NOTICE OF RATE CEILINGS].

[169] FIN. § 342.201.

[170] FIN. §§ 342.251, 342.252, 342.259 (setting forth fee limits per unit of cash advanced per month).

Subchapter E has different rules depending on (a) whether a loan has "regular" or "irregular" payment structure and (b) the method the lender wants to use for calculating interest and fees. A "regular" loan is one that is repaid "in installments that are consecutive, monthly, and substantially equal in amount" *and* where the first payment is due within one month and 15 days from the date the loan is made.[171] A loan is considered "irregular" if it does not meet *both* the criteria for being "regular."[172]

Subchapter E also has different rules depending on whether the lender determines interest using "add-on" or "simple interest" calculations[173] and allows lenders to charge administrative fees of $20 to $25, depending on the amount of the loan.[174] A lenders' ability to charge additional administrative fees for refinancing is limited to once or twice a year, depending on the interest rate on the loan.[175] Subchapter E also sets maximum terms for its loans based on the amount of cash advanced, with the maximum term being 60 months for cash advances exceeding $3000.[176]

Subchapter F provides for a different rate structure based on generally smaller loan amounts up to a maximum ceiling currently set at $1300.[177] For cash advances of $100 to the current $1300 ceiling, a lender can charge an "acquisition" fee of not more

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[171] FIN. § 342.001.

[172] *Id*. (defining a loan as irregular if either "payable in installments that are *not* consecutive, monthly, and substantially equal in amount" *or* "the first scheduled installment of which is due *later than* one month and 15 days after the date of the loan.").

[173] FIN. § 342.201; TEX. APPLESEED, *supra* note 12, at 77. The "add-on" method of determining interest owed involves making an up-front calculation of the stated rate times the entire amount of principal advanced, ignoring the fact that if the borrower returns part of the principal with each payment the lender is not deprived of the full amount for the entire duration of the loan. For example, $1000 at 8 percent a year would yield $80 add-on interest during a 12 month repayment plan, which is ultimately 14.5 percent Annual Percentage Rate (APR) because the borrower returns about $83 of the principal each month, meaning the lender can make other uses of it. *Id*.

[174] FIN. § 342.201(f); TEX. APPLESEED, *supra* note 12, at 77–78.

[175] FIN. § 342.201(f); TEX. APPLESEED, *supra* note 12, at 77–78.

[176] FIN. § 342.508.

[177] FIN. §§ 342.251, 342.259; NOTICE OF RATE CEILINGS, *supra* note 168.

than $10 and "an installment account handling charge" that does not exceed the "the ratio of $4 a month for each $100 of cash advance."[178] Variations on this fee structure are laid out for cash advances of less than $100.[179] Subchapter F expressly prohibits lenders from charging or receiving fees not authorized in the subchapter[180] and sets the maximum loan term at six months for cash advances of $100 or less and "one month for each multiple of $20 of cash advanced" for loans of more than $100.[181]

In addition to abiding by interest rate restrictions, Subchapter E and F lenders have to apply for and satisfy the requirements for receiving a license from the OCCC,[182] which is obliged by statute to approve or deny a completed application within sixty calendar days of receiving a completed application or of holding a hearing on the application (if requested).[183] Once a lender has been licensed, it must also comply with a variety of record-keeping, examination, and reporting requirements laid out in the Texas Administrative Code[184] and pay annual fees, some of which are based on loan volume.[185] If a lender wishes to use computer software to maintain the required records and to process the loans it originates and services, that software must also be examined and approved by the state regulator as being able to satisfy the applicable rules regarding issues such as fee calculation and record keeping.[186]

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178 FIN. § 342.252. The "acquisition charge" is considered earned by the lender at the time the loan is made and, thus, not subject to refund if the loan is paid off before the end of the term. FIN. § 342.256(a).
179 FIN. § 342.252.
180 FIN. § 342.254.
181 FIN. § 342.255.
182 FIN. § 342.051; 7 TEX. ADMIN. CODE § 83.302 (2013).
183 FIN. § 342.104(d); 7 TEX. ADMIN. CODE §83.307 (2013).
184 7 TEX. ADMIN. CODE §§ 83.826-83.838 (2013).
185 7 TEX. ADMIN. CODE § 83.310(g) (2013).
186 7 TEX. ADMIN. CODE § 83.831 (2013). *See also Regulated Loan Software Vendors*, OFFICE OF CONSUMER CREDIT COMM'R, http://www.occc.state.tx.us/pages/industry/Reg_Loan/reg_vendors.htm (last visited Apr. 21, 2013).

(b) Non-Bank Lending and Chapter 342

Payday lenders operating in Texas were essentially not regulated until late 2000 when the Finance Commission of Texas approved a rule that expressly authorized "regulated lenders to engage in payday loans under the authority of Subchapter F" of the Finance Code.[187] Before concluding that payday loan products fell "within the purview of Title 4 of [the Code]," the Finance Commission first had to find that (a) the cash advance and repayment model employed by payday lenders constituted a "loan" under the Code and (b) the charges associated with the advance were "interest or compensation for the use, forbearance, or detention of money."[188] Having done so, the Commission promulgated a rule to prescribe "the standards of conduct [to] be used to regulate and enforce [payday loan] transactions within the framework of Chapter 342."[189] To make its intentions clear, in the *Texas Register* entry proclaiming the new Texas Administrative Code Title 7, section 1.605, the Commission wrote that "the rule does not authorize a payday loan transaction outside the context of Subchapter F, Chapter 342 and is designed to pointedly address payday loans within the parameters of Subchapter F."[190]

The new rule defined what it called payday loans or "deferred presentment transactions"[191] and declared that a person making such a loan with an effective annual

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[187] TEX. SUBCOMM. ON CONSUMER CREDIT, *supra* note 85, at 12 ("At the time of the Subcommittee's hearings [in April 2000], payday lenders operating in the Sate of Texas were doing so without regulatory oversight."). The Finance Commission of Texas adopted then- 7 TEX. ADMIN. CODE § 1.605 Payday Loans, Deferred Presentment Transactions in the summer of 2000. 25 Tex. Reg. 6316 (June 30, 2000). The substance of this regulation can currently be found in 7 TEX. ADMIN. CODE § 83.604 (2013). *See* Michael A. Garemko III, *Texas's New Payday Lending Regulations: Effective Debiasing Entails More Than the Right Message*, 17 TEX. J. C.L. & C.R. 211, 226 n.90 (2012) (explaining how the rule moved through the legislative process of reorganizing the administrative code).
[188] 25 Tex. Reg. 6316, 6317 (June 30, 2000).
[189] *Id*.
[190] *Id*.
[191] *Id*. at 6319 ("A transaction in which a cash advance is made in exchange for the consumer's personal 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.").

rate of more than ten percent had to be licensed by the OCCC.[192] Under the rule, lenders would not be able to charge rates higher than those set out in Subchapter F[193] and would have to make a variety of disclosures to borrowers in a written agreement.[194] Furthermore, the rule set absolute monthly rate caps, limiting the degree to which lenders could impose additional charges for renewals within the same month.[195] For instance, if a borrower could not repay a $100 loan at the end of a two week term it could be renewed for another two weeks. However, if the lender had initially charged the statutory maximum finance fee of $11.87 on the $100 loan, when it was renewed (effectively making the term four weeks) the lender could only charge an additional fee equivalent to the difference between the statutory maximum for a two-week term and that for a four-week term.[196] For a $100 loan, the additional charge would only be $1.86 ($13.73 minus $11.87), not an additional $11.87.[197]

(c) The Credit Service Organizations Act

Despite the Finance Commission's 2000 rule, the non-bank financial services industry in Texas has largely managed to bypass the Chapter 342.[198] While it is true that payday loans are not specifically authorized outside the context of Subchapter F,[199] the

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[192] 7 TEX. ADMIN. CODE § 83.604(b) (2013).
[193] 7 TEX. ADMIN. CODE § 83.604(c) (2013).
[194] 7 TEX. ADMIN. CODE § 83.604(e) (2013).
[195] 7 TEX. ADMIN. CODE § 83.604(f)(1) (2013).
[196] 7 TEX. ADMIN. CODE § 83.604(c) (2013); TEX. SUBCOMM. ON CONSUMER CREDIT, *supra* note 85, at14.
[197] 7 TEX. ADMIN. CODE § 83.604(c) (2013) (see the rate schedule).
[198] *See* Deena Reynolds, *A Look at Payday Loans & Current Regulation in Texas*, 8 TEX. TECH. ADMIN. L.J. 321, 335–36 (2007). *See also* Ronald J. Mann & Jim Hawkins, *Just Until Payday*, 54 UCLA L. REV. 855, 884 (2007). Mann and Hawkins specifically discuss how Texas typifies a category of states that have formal usury laws but that do not explicitly define where payday loans fit into their regulatory structures, thus giving the industry opportunities to operate as it desires. *Id.* at 877–78.
[199] *See supra* note 190 and accompanying text.

rules and regulatory actions have not specifically forced all cash advances that have the same effect as payday loans do on consumers under Chapter 342.[200] What has happened is that, instead of becoming licensed lenders under Subchapter F, payday and other non-bank lenders began to operate under a 1987 law called the Credit Services Organizations Act (CSOA).[201] Though the law was originally passed to regulate credit repair businesses,[202] it did not prohibit entities whose primary business was brokering loans (for a fee) from operating under it even if these businesses did not take steps to clean up customers' credit records. This oversight, which came to be known as "the CSO loophole," provided an attractive way for small dollar lenders to bypass Chapter 342.[203]

The CSOA regulates a class of business called "Credit Service Organizations" (CSO) that offer, among other things, the service of "obtain[ing] an extension of consumer credit for a consumer" in exchange for valuable consideration (i.e. money or a

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[200] It is true that Texas Finance Code § 342.051(a) prohibits the use of "subterfuge" to evade application of the state's usury laws but, as discussed Part II.B(3) *infra,* regulators and other interpreters of Texas law have not used this provision to force all alternative lenders under Chapter 342.

[201] "The CSOA was in former Chapter 18 of the Texas Business and Commerce Code, Acts 1987, 70th Leg., ch. 764, § 1 [and] became part of the Texas Finance Code." Lovick v. Ritemoney Ltd., 378 F.3d 433, 442 (2004).

[202] S. Comm. Report, Credit Services Organization Act, H.B. 742, 70th Reg. Sess., at 1 (Tex. 1987), *available at* http://www.lrl.state.tx.us/scanned/srcBillAnalyses/70-0/HB742.pdf ("The federal Fair Credit Reporting Act [of 1970] entitles consumers who are denied credit based on a credit report the right to review and correct the contents oft their credit file at no charge. Reportedly, consumers have paid extensive fees to companies to investigate their credit records. There is a concern that consumers are misled by some operators who promise to solve their credit woes and clean up a bad credit history . . . As proposed, H.B. 742 regulates certain organizations that, with respect to the extension of credit by others, attempt to improve a consumer's credit history or to obtain an extension of credit for a consumer."); Ann Baddour, Commentary, *Why Texas' Small Dollar Lending Market Matters*, E-PERSPECTIVES 12:2 (2012), http://www.dallasfed.org/microsites/cd/epersp/2012/2_2.cfm.

[203] URIAH KING ET AL., CTR. FOR RESPONSIBLE LENDING, FINANCIAL QUICKSAND: PAYDAY LENDING SINKS BORROWERS IN DEBT WITH $4.2 BILLION IN PREDATORY FEES EVERY YEAR 17 (2006), *available at* http://www.responsiblelending.org/payday-lending/research-analysis/rr012-Financial_Quicksand-1106.pdf; J. Scott Sheehan, Memo, *Payday Loan Bar Association – Update and Materials on CSO Model* (Nov.13, 2006), *available at* http://pdlba.com/images/GT_--_Payday_Loan_Bar_--_Update_on_CSO_Model_11-13-06_.doc (laying out the legal case for using the CSO model for payday lending in light of recent developments in Texas law).

promise).[204] The Texas law allows businesses meeting the definition of a CSO to charge "credit service fees" to their customers if they comply with statutory requirements.[205] The version of the law in effect in the early 2000s required CSOs to register with the Texas Secretary of State[206] and meet requirements such as paying a $100 fee,[207] posting bond,[208] making certain disclosures to consumers,[209] and giving customers notice of their right to cancel their contract within three days of signing.[210] CSOs were not subject to licensing and reporting requirements.[211] Without reporting requirements, there was no publically available data on Texas CSOs other than their names, addresses, and the identities of their major shareholders.[212]

The model that payday lenders operating under the CSOA use bears a striking resemblance to the rent-a-bank model. As described in *Lovick v. Ritemoney*, currently the controlling judicial interpretation of the law, the CSO model uses two entities: one that runs the store where borrowers seek loans and brokers the loan, and a second that actually originates the loan (i.e. the lender).[213] A borrower taking out a loan through a CSO has separate contractual obligations to each entity.[214] The borrower agrees to pay interest on

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204 TEX. FIN. CODE ANN. § 393.001(3)(B) (West 2006).
205 Lovick v. Ritemoney Ltd., 378 F.3d 433, 442 (2004).
206 FIN. § 393.101. A registration statement under § 393.101 had to include the name and address of the CSO and major shareholders and information about litigation involving the organization. *Id*. In addition, the statute explicitly forbid the secretary of state from requiring a CSO "to provide information other than information contained in the registration statement." *Id*. The registration had to be renewed annually. *Id*.
207 FIN. § 393.104.
208 FIN. § 393.401. The bond would "be used to pay damages to the state or consumers in the event of a statutory violation." Garemko, *supra* note 187, at 229.
209 FIN. § 393.105.
210 FIN. § 393.202.
211 *Compare* TEX. FIN. CODE ANN. Chap. 393 (West 2006) *with* TEX. FIN. CODE ANN. Chap. 393 (West 2006 & Supp. 2012). The 2011 Texas Legislature added Subchapter G to Chapter 393, which, among other things requires licensing for CSOs and quarterly reports regarding lending activities. Acts 2011, 82nd Leg. ch. 1302 (H.B. 2594), §2.
212 This is information that was required in the disclosures prior to 2011. FIN. § 393.105.
213 Lovick v. Ritemoney Ltd., 378 F.3d 433, 436 (2004).
214 *Id*. at 437.

the loan at a rate not to exceed 10 percent a year to the actual lender, which is regulated by Texas's usury cap.[215] However, the borrower also agrees to pay fees to the other entity, the Credit Service Organization (CSO), for the separate service of arranging (brokering) the loan.[216] The borrower signs a document acknowledging that the broker's fees were "not interest for the purposes of Texas law."[217] Because the CSO does not operate as a "lender" under the usury law or Chapter 342, there is no limit on the number or magnitude of fees that it can charge to the borrower.

3. Lovick v. Ritemoney

In 2004 the Fifth Circuit Court of Appeals issued a decision in *Lovick v. Ritemoney, Ltd.* that blessed the dual party (CSO-lender) business model that allows non-bank lenders to offer small-dollar, short term loans in Texas outside of Chapter 342 rate restrictions.

(a) The Case

In *Lovick* a borrower had sued a credit service organization (CSO) that acted as a broker for loans legally originated by a lender called "Ritemoney, Ltd."[218] The suit was filed in federal court under the federal Racketeer Influenced and Corrupt Organizations Act (RICO), but was predicated on a sub-claim that the CSO was systematically violating Texas's 10 percent usury cap.[219] The plaintiff argued that the arrangement violated Texas law because the CSO's broker's fee was actually attributable to the lender—that it was "disguised interest"—and that the combination of actual interest and fees exceeded 10

[215] *Id.*
[216] *Id.*
[217] *Id.* (citing a clause in the contract signed by the plaintiff-borrower).
[218] *Id.* at 436.
[219] *Id.* at 437.

percent of the principal.[220] The lower court granted the lender-defendant's motion to dismiss on the grounds that the plaintiff had not stated a RICO claim because they had not sufficiently alleged a violation of the state usury law.[221] The Fifth Circuit affirmed.[222]

At the crux of the Fifth Circuit's decision (and now of the legitimacy of the CSO-payday model) is a legal distinction between "interest" (compensation "for the use, forbearance, or detention of money"[223]) and the fees offered in exchange for additional services, such as acting as an intermediary to broker a loan between a borrower and lender. In the court's analysis, fees may constitute "disguised interest" (and therefore usurious) *only if* they are not offered in exchange for a service other than the lending of the money.[224]

According to the Fifth Circuit's analysis, Texas law distinguishes between two types of entities: CSOs (which broker credit for their customers in exchange for consideration)[225] and actual lenders. According to the court, "Texas' usury statutes regulate lenders . . . differentiat[ing] between loans charging interest rates of ten percent or less, which are unregulated, and those charging more than ten percent."[226] On the other hand, the court said, the Credit Services Organization Act (CSOA) regulates CSOs.[227] According to the court, these two laws "work in harmony, permitting a CSO to charge a brokerage fee in connection with its services"[228] and, because "the Texas Legislature ha[d] not restricted the amount of a CSO service fee in proportion to the

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220 *Id*.
221 *Id*.
222 *Id*. at 444.
223 TEX. FIN. CODE ANN. § 301.002(a)(4) (West 2012).
224 *Lovick*, 378 F.3d at 439.
225 *Id*. at 442.
226 *Id*. (internal citations omitted).
227 "CSOA was in former Chapter 18 of the Texas Business and Commerce Code, Acts 1987, 70th Leg., ch. 764, § 1 [and] became part of the Texas Finance Code." *Id*. at 442.
228 *Id*. at 442-43 (citing TEX. FIN. CODE § 393.303 (2004).

services provided" the Fifth Circuit did not think it appropriate that the court substitute its own judgment for that of the legislature and set a cap.[229] As the court went on to explain, the broker-defendant was a valid CSO under the finance code[230] and was allowed to collect the disputed fees and it was legal not to consider those fees attributable to the lender for the purpose of the usury law. *Lovick* thus blessed the CSO "loophole" and cut off the legal debate as to whether payday lenders' service charges were actually interest for usury purposes.

(b) What it wrought

The presence of payday and auto-title lenders had grown dramatically in Texas during the late 1990s and 2000s as regulations relaxed and banks took advantage of rate importation.[231] Initially the growing industry used the rent-a-bank model to take advantage of the higher interest rates that some non-Texas banks were allowed to charge.[232] In 2005, however, the FDIC started taking steps that made the rent-a-bank model unattractive for regulated depositories.[233] The confluence of the *Ritemoney* decision blessing the CSO-brokered loan model and the FDIC's decision to reign in the rent-a-bank model led to the CSO becoming the dominant business form for alternative lenders in Texas.[234] A review of OCCC annual reports regarding licensed lenders between 2005 and 2010 illustrates the trend.

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[229] *Lovick*, 378 F.3d at 443.
[230] *Id*. at 442.
[231] *See* TEX. APPLESEED, *supra* note 12, at 7 (citing data about payday lending growth in Texas during the first decade of the twenty-first century).
[232] *See* Lawrence Meyers, *Payday Lenders Strike Back*, THE MOTLEY FOOL (July 29, 2005) *available at* http://www.fool.com/investing/small-cap/2005/07/29/payday-lenders-strike-back.aspx (discussing how the FDIC's move to limit state bank rate importation helped push lenders in Texas to exploit the CSO loophole).
[233] *See supra* notes 132-35 and accompanying text.
[234] *See supra* note 203 and accompanying text.

In 2005, Subchapter F lenders brokered 1,633,805 payday loans worth $644,775,840 (presumably using the rent-a-bank model).[235] By 2007 there were no Subchapter F brokered payday loans in Texas.[236] Furthermore, between 2005 and 2010 the number of Subchapter F payday loans *made* (as opposed to brokered) dropped from 488,448 in 2005 to 7,316 in 2010, a 98 percent reduction.[237] In 2012, the first year that CSOs were required to report data to the OCCC, they made 4,118,322 payday and auto title loans.[238] During that year, borrowers paid fees of $1,243,084,205 on those loans.[239]

In stark contrast to Chapter 342 and related OCCC regulations, pre-2011 Chapter 393 required very little of CSOs other than that they register and pay a small fee to the state. There were no record-keeping or examination requirements related to items such as the number and amount of loans originated and default rates, nor were there consumer protection requirements regarding issues such as notice of default, timely release of liens, or the like.[240] Without the type of reporting requirements to which Chapter 342 lenders have been subject, it was almost impossible to track data on the industry other than the

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235 OFFICE OF CONSUMER CREDIT COMM'R, REGULATED LENDER CONSOLIDATED VOLUME REPORT (2005), http://www.occc.state.tx.us/pages/publications/consolidated_reports/Regulated%20Lender%202005.pdf

236 OFFICE OF CONSUMER CREDIT COMM'R, REGULATED LENDER CONSOLIDATED VOLUME REPORT (2007), http://www.occc.state.tx.us/pages/publications/consolidated_reports/Reg%20Rpt%20Calendar%20Year%202007.pdf. The 2008, 2009, and 2010 reports also show no brokered payday loans. OFFICE OF CONSUMER CREDIT COMM'R, *News Releases and Publications*, http://www.occc.state.tx.us/pages/publications/index.html (follow links for Regulated Lender reports at bottom right of page).

237 *Compare* OFFICE OF CONSUMER CREDIT COMM'R, REGULATED LENDER CONSOLIDATED VOLUME REPORT (2010) *with* OFFICE OF CONSUMER CREDIT COMM'R, REGULATED LENDER CONSOLIDATED VOLUME REPORT (2005), http://www.occc.state.tx.us/pages/publications/index.html (follow links for Regulated Lender reports at bottom right of page).

238 TEX. IMPACT, CONSUMER IMPACTS OF CREDIT SERVICES SENATE BILL 1247, *available at* http://texasimpact.org/sites/default/files/Consumer%20Impact%20Analysis.pdf (data on the total number of deferred presentment loans and title loans—both single payment and installment—made in 2012 compiled from reports made by CSOs to the OCCC, which are *available at* http://www.occc.state.tx.us/pages/publications/index.html).

239 TEX. IMPACT, *supra* note 238 ("Total Amount of fees paid by Texas Consumers").

240 *See supra* notes 206-212 and accompanying text.

volume of CSO registrations.[241] As a result, while the numbers of CSOs grew and the anecdotes about adverse customer outcomes seemed to proliferate,[242] it was hard to paint an accurate picture of the industry in Texas or engage in studies to explore issues such as whether high concentrations of welfare and food stamp use in a particular area were associated with an increased presence or use of alternative lending products.

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241 *See* TEX. APPLESEED, *supra* note 12, at 10 (describing the changes to CSO regulation caused by the 2011 bills and how they will increase public information available about these businesses).

242 *See* TEX. APPLESEED, *supra* note 12, at 7, 13-16, 21-22 (providing statistics on industry growth in Texas between 2004 and 2010 and evidence from anecdotes and limited surveys about customer experiences).

Part III. Post-Financial Crisis Developments

The 2008-2009 financial crisis brought subprime lending into the national spotlight and spurred calls for increased regulation of the alternative lending industry. A full account of the legislative battles that led to new regulations in Texas and to the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 is beyond the scope of this paper. These statutes did, however, create noticeable changes for CSOs in Texas and for the purveyors of non-bank financial services around the country.

A. Changes to Texas State Law

Following *Lovick v. Ritemoney* in 2004, it became clear that legal challenges to the CSO model were not the way to increase regulation of non-bank lenders in Texas. In the wake of the 2008-2009 recession and revelations about the role that sub-prime lending played in causing the economic crash, however, consumer advocates found the momentum to make regulation of CSOs, and therefore payday lending, an issue in the 2011 Texas legislative session. As had occurred in previous sessions, consumer advocates proposed a bill that would have overturned *Lovick* by amending the Finance Code to prevent CSOs from charging fees to broker credit from third parties, a cornerstone of the CSO model for payday lending.[243] That bill never made it out of committee but after substantial negotiation between consumer advocates and

[243] Garemko, *supra* note 187, at 231-32.

representatives of the non-bank lending industry,[244] the Texas legislature passed two bills—H.B. 2592 and H.B. 2594—that increase regulation of payday lending in Texas.[245]

The bills that eventually passed imposed more strict licensing and disclosure requirements on CSOs than had previously existed[246] but they did not rewrite the CSOA to prevent loan brokers from registering under the law (i.e. "close the CSO loophole").[247] The efficacy of the disclosure requirements will largely be dictated by how they are implemented by the OCCC.[248] Licensing was especially important because, prior to the 2011 law, there was almost no mechanism in place through which to monitor the activities of CSOs. As is apparent from the 2012 CSO data discussed above, licensing requirements produced data reporting that will give regulators and scholars a better picture of what CSOs are doing in the marketplace.

There was other proposed legislation that never made it out of committee that would have "closed the loophole" by preventing CSOs from acting as brokers for extensions of credit from third party lenders.[249] House Bill 410, offered by Representatives Tom Craddick and Eddie Rodriguez, would also have made it clear that credit service fees charged under the CSOA should be considered interest for the purpose

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244 *See id.* at 231-42 (detailing three of the bills on credit service organizations filed during the 2011 session and the legislative process that produced the two bills that eventually passed and were signed into law).

245 Act of May 23, 2011, 82d Leg., R.S., ch. 1301, 2011 TEX. GEN. LAWS 3717 (codified at TEX. FIN. CODE ANN. §§ 393.221-.224 (West Supp. 2012)), *available at* http://www.capitol.state.tx.us/tlodocs/82R/billtext/html/HB02592F.htm; Act of May 23, 2011, 82d Leg., R.S., ch. 1302, 2011 TEX. GEN. LAWS 3719 (codified as amendments to TEX. FIN. CODE ANN. ch. 14 (West 1998), ch 393 (West 2006 & Supp. 2012)), *available at* http://www.capitol.state.tx.us/tlodocs/82R/billtext/html/HB02594F.htm. *See also* 7 TEX. ADMIN. CODE §§ 83.1001-.5002 (2011), §§ 83.6001-.6008 (2012) (Fin. Comm'n of Tex., Rules for Credit Access Businesses) (regulations adopted under the authority of H.B. 2592 and H.B. 2594).

246 Garemko, *supra* note 187, at 235, 239.

247 *Id.* at 233-35.

248 *See id.* at 242 (discussing the choices the Finance Commission made regarding rule writing following the passage of the bills).

249 *Id.* at 231 (citing Tex. H.B. 410, 82d Leg., R.S. (2011)).

of determining whether a business was complying with usury law.[250] Such a change would have overturned the logic of *Lovick*, which relied heavily on the premise that CSOs collect fees for service, which do not qualify as "interest" for the purpose of determining whether the lender-partner violated lending laws.[251]

A new bill aimed at further regulating CSOs was introduced during the 2013 legislative session but it is uncertain whether it will have enough support to become law.[252]

B. DEVELOPMENTS AT THE FEDERAL LEVEL

Developments at the federal level since the financial crisis of 2008 are likely to affect the world in which alternative financial service providers operate. Though a full survey of these developments is beyond the scope of this paper, two that are of particular importance are discussed in this section. First, the FDIC has increasingly been encouraging depository institutions to provide small-dollar lending products on terms that it deems "affordable" for borrowers who do not qualify for prime credit products. Though it is unclear how wide an impact the FDIC's efforts will have, the results of a pilot program it initiated in 2008 may provide the evidence that depository institutions need to encourage them to experiment with affordable small-dollar loans. Second, and perhaps most important, is passage of the Dodd-Frank Wall Street Reform and Consumer

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[250] *Id*. at 232 (citing H.B. 410).
[251] Lovick v. Ritemoney Ltd., 378 F.3d 433, 444 (2004).
[252] *See* Emily Mathis, *Hot List: Day 105 of the Legislature*, TEXAS OBSERVER (Monday, April 22, 2013, at 8:38 CST), http://www.texasobserver.org/hot-list-day-105-of-the-legislature/ (explaining how the payday bill—Senate Bill 1247—was pulled from debate the previous week for lack of support); Chris Hooks, *Payday Lending Bill Pulled From Floor After Raucous Debate*, TEXAS TRIBUNE (April 18, 2013), http://www.texastribune.org/2013/04/18/payday-lending-bill-pulled-floor-after-raucous-deb/ (describing the floor battle over Senate Bill 1247 and the various factions involved).

Protection Act of 2010 (Dodd-Frank).[253] Much of the Act focused on the practices of financial institutions related to the derivative and mortgage markets that were blamed for creating the financial crisis[254] but the Act also has important provisions regarding consumer finance,[255] including the creation of the Consumer Financial Protection Bureau (CFPB).[256]

1. FDIC Small-Dollar Loan Pilot Program

In February of 2008, the FDIC began a pilot program "designed to illustrate how banks can profitably offer affordable small-dollar loans as an alternative to high-cost credit products, such as payday loans."[257] The agency selected 31 depository institutions, many of which were community banks,[258] to participate in the two-year pilot.[259] Applicant banks had to meet certain safety and soundness requirements and propose a small-dollar loan program that was "generally consistent with the . . . Small-Dollar Loan

[253] Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010) (codified in scattered sections of 12 U.S.C.).
[254] *See* CONGRESSIONAL RESEARCH SERV., THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: ISSUES AND SUMMARY 2-3 (July 29, 2010), *available at* http://www.llsdc.org/attachments/files/232/CRS-R41350.pdf [hereinafter DODD-FRANK SUMMARY] (describing the subprime crisis of 2008 and the regulatory response focused on controlling systemic risk in financial markets).
[255] *Id*. at 10-12 (giving an overview of the consumer protection portions of the Act). Dodd-Frank also placed restrictions on the preemption powers of federal banking regulators such as the OCC, "expan[ding] enforcement authority of state attorneys general and banking regulators," and expanding remedies available under TILA. CONSUMER CREDIT REGULATION, *supra* note 25, at 9-10. The preemption issue is less relevant for non-depository lending regulation now because all consumer protection has been consolidated in the CFPB. DODD-FRANK SUMMARY, *supra* note 254, at 11.
[256] Dodd-Frank, tit. X (codified at 12 U.S.C. §§ 5481-5603).
[257] *FDIC Small-Dollar Pilot*, *supra* note 53, at 28.
[258] *Id*. at 32.
[259] FED. DEPOSIT INS. CORP., *Introduction to the FDIC's Small-Dollar Loan Pilot Program*, 2 FDIC Q., no. 3, 2008, at 23-24, *available at* http://www.fdic.gov/bank/analytical/ quarterly/2008_vol2_3/2008_Quarterly_Vol2No3.html [hereinafter *FDIC Pilot Introduction*].

Guidelines" issued by the FDIC in June 2007.[260] After close to two years of participating in the pilot "[a]lmost all of the pilot bankers indicated that [they found] small-dollar lending [to be] a useful business strategy and that they [would] continue their . . . programs beyond the pilot."[261] Highlights of the pilot's outcomes and lessons are as follows.

Between the second quarter of 2008 and the fourth quarter of 2009, the "participating banks made more than 18,100 [small-dollar loans]," defined as loans of $1,000 or less, "with a principal balance of $12.4 million and almost 16,300 [loans between $1,000 and $2,500] with a principal balance of nearly $27.8 million."[262] The delinquency rate for the small-dollar loans was around 9 percent for much of 2009, though it climbed to 11 percent in the fourth quarter.[263] The rate for the $1,000-$2,500 fluctuated between 6.4 and 10.9 percent during 2009.[264] These delinquency rates were much higher than the roughly 2.5 percent rate for "general unsecured loans to individuals."[265] However, "charge-off ratios" (i.e. default rates) for both classes of pilot program loans (around 5-6 percent) were in keeping with the industry averages for defaults on unsecured credit.[266]

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260 *Id*. The FDIC's Small-Dollar Loan Guidelines, issued on June 19, 2007, can be found at http://www.fdic.gov/news/news/press/2007/pr07052a.html. Some of main features of the 2007 Guidelines were "[l]oan amounts of up to $1,000, [p]ayment periods that extend beyond a single paycheck cycle, [a]nnual percentage rates (APRs) below 36 percent, [l]ow or no origination fees, [n]o prepayment penalties, and [s]treamlined underwriting." *FDIC Pilot Introduction*, *supra* note 259, at 23.
261 *FDIC Small-Dollar Pilot*, *supra* note 53, at 28.
262 *Id*. at 30.
263 *Id*.
264 *Id*.
265 *Id*. at 31.
266 *Id*. at 31-32. The FDIC looked at charge-off rates for both general unsecured loans and credit cards based on the premise that borrowers who can qualify for credit cards frequently use them for the kind of short-term credit for which pilot borrowers were using their loans. *Id*. at 32.

It is important to remember that the FDIC pilot was conducted in 2008 and 2009, during the height of the economic crisis, and that small-dollar loan consumers would not typically be using the high-cost products if their economic situations afforded them access to alternative sources of cash or lower borrowing rates. In that context, it is possible that the pilot program had higher delinquency rates (which reflect late payments, not defaults) than general, unsecured loans during the same period because the economic crisis hit people of lesser economic means more severely than it did the general population.[267] The fact that the percentage of loans actually "charged-off" (i.e. counted as a loss by lenders because repayment was deemed unlikely) was roughly the same in the pilot as in the general population, however, suggests that pilot borrowers were no more likely to actually default than other borrowers who may have stronger credit histories and more stable financial situations. It is also in keeping with one of the most important lessons learned from the pilot program: "a longer loan term is key to [small-dollar lending] success because it provides more time for consumers to recover from a financial emergency than the single pay cycle for payday loans."[268]

Ultimately, the pilot bankers' positive attitude about their small dollar loan programs seemed to have less to do with their profitability than with their utility as a tool with which to build relationships with borrowers who might ultimately purchase other banking services.[269] More specifically, most of the bankers "indicated that costs related to launching and marketing [the] programs and originating and servicing small-dollar loans are similar to other loans."[270] However, "the small size of [the loans]" tended not

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[267] *See id*. at 30 (noting the "adverse local economic conditions" in the discussion of delinquency rates).
[268] *Id*. at 28.
[269] *Id*. at 32.
[270] *Id*. at 32.

to generate interest and fees "sufficient to achieve robust short-term profitability."[271] Many of the bankers seemed to recognize, however, that offering small-dollar loans that previously underbanked customers might use in lieu of payday loans, however, might allow the bank to develop relationships with new customers to whom they might "cross-sell additional [financial] products."[272]

The participants' lending models varied but their experiences allowed the FDIC to identify some of the "essential product design and delivery elements for safe, affordable, and feasible small-dollar loans that [could] be replicated by other banks."[273] The resulting template had the following features: (1) a loan amount of $2,500 or less, (2) a term of 90 days or more, (3) an APR of 36 percent or less, (4) low or no origination or other upfront fees and never fees which, combined with interest, raised the APR above 36 percent, (5) streamlined underwriting to reduce lender costs and offer quick application-to-origination turn-around for borrowers, and (6) optional (for bankers) mandatory saving and financial education for borrowers.[274] Furthermore, recognizing that increased profitability will likely make small-dollar loan programs more appealing to a wider variety of banks, the FDIC report on the pilot also suggested ways for lenders to reduce costs through techniques such as electronic withdrawal payments and employer-based lending.[275]

It is possible that the results of the FDIC pilot will convince other depository lenders to offer affordable small-dollar products. As is discussed in the next section, some scholars have argued that a resurgence of bank-based small-dollar lending will fill

[271] *Id*. at 32.
[272] *Id*. at 32.
[273] *Id*. at 28.
[274] *See id*. at 28 fig.1 (listing template component summary).
[275] *Id*. at 36.

the void if the Consumer Financial Protection Bureau passes regulations that reduce the profitability of the contemporary non-bank small-dollar loan model. Given the relatively limited scope of the FDIC pilot, however, particularly the fact that it was largely limited to community banks with supportive management, it is unclear whether the model can take hold on a national scale at the scope of the current non-bank financial services sector.

2. The Consumer Financial Protection Bureau

The CFPB, created by Title X of Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), has been charged with "implement[ing] and, where applicable, enforce[ing] Federal consumer financial law consistently for the purpose of ensuring [1] that all consumers have access to markets for consumer financial products and services and [2] that markets for consumer financial products and services are fair, transparent, and competitive."[276] To carry out its statutory purpose, the CFPB was given both rule-writing and enforcement powers but was banned from instituting a federal usury cap for consumer loans.[277] In general, the CFPB was given the power to "prescribe rules and issue orders and guidance, as may be necessary or appropriate to enable the Bureau to administer and carry out the purposes and objectives of the Federal consumer financial laws, and to prevent evasions [of those laws]."[278] This provision transferred rule-writing authority for several federal rules—including TILA[279] and ECOA[280]—to the CFPB from the agencies originally in charge of them. In addition to taking over rule-

[276] 12 U.S.C. §5511(a) (Supp. 2012)
[277] 12 U.S.C. § 5517(o).
[278] 12 U.S.C. § 5512(b)(1).
[279] 12 U.S.C. § 5581(12)(O)
[280] 12 U.S.C. § 5581(12)(D)

writing for existing consumer financial protection laws, the CFPB was given the specific power of writing rules prohibiting unfair, deceptive, and abusive acts and practices (UDAAP) by the lenders over which it has enforcement power.[281]

The ability of the CFPB to enforce the rules it writes and to examine regulated entities (i.e. go in and examine books, etc.) is dictated by the type of institution. The CFPB has exclusive examination and primary enforcement power over depository institutions with assets in excess of $10 million (large financial institutions).[282] It has the same powers over "covered" non-depository lenders that (among other things) offer payday loans.[283] This means that the CFPB should have examination and enforcement power over CSOs in Texas offering payday and auto title loans. The rules that the CFPB writes still apply to depository institutions with less than $10 million in assets but "the CFPB has the authority only to accompany prudential regulators on examinations" of these smaller banks.[284]

Of the powers granted to the CFPB, its authority to write and enforce rules regarding unfair, deceptive, and abusive acts and practices (UDAAP) has the most potential to impact the small-dollar lending industry. As scholar Creola Johnson has recently written, though the CFPB does not have the power to institute a federal usury cap, by writing rules that bring practices commonly associated with payday lending under

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281 12 U.S.C. § 5531(b) ("The Bureau may prescribe rules applicable to a covered person or service provider identifying as unlawful unfair, deceptive, or abusive acts or practices in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service. Rules under this section may include requirements for the purpose of preventing such acts or practices.").
282 Johnson, *supra* note 12, at 411 n.208 (citing 12 U.S.C § 5515).
283 12 U.S.C § 5514.
284 Johnson, *supra* note 12, at 411.

the UDAAP ban, federal law could make it difficult for abusive small-dollar lenders to operate legally.[285]

Under Dodd-Frank, the CFPB can find an act or practice to be "unfair" if it (A) "causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers" *and* (B) if that "injury is not outweighed by countervailing benefits to consumers or to competition."[286] Johnson argues that research has found "substantial injury" to payday consumers caused by common practices such as "high interest rates, short maturity dates, single balloon payments, multiple rollover and refinancing fees, and repetitive electronic bank-account access."[287] This injury should qualify as "not reasonably avoidable," Johnson argues, because payday borrowers frequently have limited knowledge of and access to less costly credit products and, at the time they enter payday contracts, they have no reason to anticipate that lenders will engage in practices such as repeatedly debiting bank accounts for financing fees in ways that build up insufficient funds charges.[288] If some or all of these practices are found to be "unfair" by the CFPB, Johnson argues that they should be banned or restricted through mechanisms such at placing limits on back-to-back loans, establishing minimum maturity periods, and requiring installment (rather than balloon) payments.[289]

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[285] *Id*. at 415.
[286] 12 U.S.C. § 5531(c) ("In determining whether an act or practice is unfair, the Bureau may consider established public policies as evidence to be considered with all other evidence. Such public policy considerations may not serve as a primary basis for such determination.").
[287] Johnson, *supra* note 12, at 415.
[288] *Id*. at 417-18. Johnson bases her argument on the "unavoidable" standard applied by the FTC and courts applying FTC rules related to unfair practices in the context of non-financial consumer products. The FTC definition of "unfair" is essentially the same as the one in Dodd-Frank. *Compare* 15 U.S.C. § 45(n), *with* 12 U.S.C. § 5531(c).
[289] Johnson, *supra* note 12, at 422.

Dodd-Frank does not define "deceptive" for the purpose of the UDAAP powers it gives the CFPB.[290] Johnson argues that, because Dodd-Frank adopted the definition of "unfair" that has been used by the Federal Trade Commission (FTC) to enforce similar rules in the context of other consumer products, the CFPB should also look to the FTC's interpretations of the term "deceptive."[291] One articulation of the FTC's interpretation of "deceptive act" is "a representation, omission, or practice, . . . that is likely to mislead consumers acting reasonably under the circumstances, and . . . the representation, omission, or practice is material."[292] Among other things, Johnson argues that practices such as offering roll-overs, refinancing fees, and back-to-back loans should qualify as "deceptive" because many borrowers who have accumulated substantial fees in connection with these products did not understand at the time of the initial contract that a large portion of the fees they paid would not reduce the principal of their loans and that it would thus be expensive to pay off these loans over time.[293]

Finally, the CFPB has two options for finding that a practice is "abusive" when connected with the offering of a consumer financial product or service. To find that an act or practice is "abusive," the CFPB must determine that it either "materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service;" or that the act or practice

> takes unreasonable advantage of (A) a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service; (B) the inability of the consumer to protect the interests of the

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[290] *Id*. at 423; *see also* 12 U.S.C. § 5531 (providing standards for finding unfair and abusive acts but not deceptive ones).
[291] Johnson, *supra* note 12, at 423.
[292] *Id*. (quoting Cliffdale Assocs., Inc., 103 F.T.C. 110, 164-65 (1984) (citing FTC Policy Statement on Deception from James C. Miller III, Chairman, FTC, to Rep. Dingell, Chairman, Comm. on Energy & Commerce, House of Representatives (Oct. 14, 1983), *available at* http://www.ftc.gov/bcp/policystmt/ad-decept.htm)).
[293] Johnson, *supra* note 12, at 423-24.

> consumer in selecting or using a consumer financial product or service; or (C) the reasonable reliance by the consumer on a covered person to act in the interests of the consumer.[294]

Johnson argues that this definition of "abusive" should cover both the typical payday practices that she discussed in the context of unfair and deceptive bans *and* the practice of "failing to assess the borrower's ability to repay" the loans before originating them.[295] If the CFPB promulgates rules under its unfair, deceptive, or abusive acts or practices powers that would be violated by typical payday lending practices, these practices could be prevented as unlawful on both the state and federal levels.[296]

C. WHAT WILL IT ALL MEAN?

It is too soon to tell what the effect will be for non-bank lenders around the country of the FDIC's attempts to encourage banks to offer small-dollar loans and of the CFPB's new powers. At least in Texas, it appears likely that the current model, where the CSO charges relatively high fees to broker a loan between the borrower and a bank that charges 10 percent annual interest on the actual loan, is here to stay. Having acknowledged that fact, however, a variety of non-profit-maximizing organizations are experimenting with lending models that attempt to provide short-term, small-dollar loans at annual percentage rates (APR) far below 100 percent.[297] One such organization

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[294] 12 U.S.C. § 5531(d)

[295] Johnson, *supra* note 12, at 425.

[296] *See* CONSUMER CREDIT REGULATION, *supra* note 25, at 31 (explaining that Dodd-Frank—12 U.S.C. § 5536(a)(1)(A)—makes it unlawful to offer a product that is not in conformity with federal consumer financial law, and that such illegality may allow consumers of such products to void the contracts under state law).

[297] *See* TEX. APPLESEED, *supra* note 12, at 45-61 (profiling six Texas organizations that are offering "loan products that make a difference). This is similar to what a man named Martin Eakes did with sub-prime mortgage lending in North Carolina in the 1980's and '90's, some of these groups are attempting to show that it is possible to operate sustainable, non-charitable businesses providing credit to sub-prime borrowers without charging the fees that have made payday lenders so much money in the last twenty years. RIVLIN, *supra* note 72, at 85-103.

operating out of Brownsville, Texas has been piloting a model where the lender partners with local employers and is able to offer a small-dollar loan at about 22 percent APR by reducing overhead and underwriting costs. The experience of this organization, the Rio Grande Valley Multibank's Community Loan Center (CLC), is detailed in the following section.

Part IV. Working Within the System: The Rio Grande Valley Multibank's Small-Dollar Loan Program[298]

The Rio Grande Valley Community Loan Center (CLC) is a wholly-owned, for-profit subsidiary of an entity called the Rio Grande Valley Multibank (the Multibank).[299] The Multibank was founded in 1995 with the mission "to improve the economic conditions of people in the Rio Grande Valley [in Texas] through the cooperative efforts of [its] investment partner shareholder institutions."[300] The Multibank is a Community Development Financial Institution (CDFI),[301] which allows it to access certain federal funds designated for community development purposes.[302] Furthermore, other financial institutions that are subject to Community Reinvestment Act (CRA) examination can get

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[298] In addition to the publicly available sources cited, the information in this section is the product of personal communications with the managers and contractors of the CLC during the Fall of 2012 and Winter/Spring of 2013. Nick Mitchell-Bennett, the Executive Director of the Community Development Corporation of Brownsville, TX (which operates the CLC for the Multibank) gave presentations on the CLC at the Texas Community Economic Development Policy Summit at the Texas State Capitol on October 4, 2012 and at the office of the Texas Association of Community Development Corporations on February 20, 2013. In addition to the information gleaned from these presentations, this author has had personal correspondence with Mr. Mitchell-Bennett and with Eva Woodfin, the CLC's Small Dollar Loan Coordinator. Both Mr. Mitchell-Bennett and Ms. Woodfin work at and can be reached at 901 E. Levee Street Brownsville Texas, 78520; 956-541-4955.

[299] TEX. APPLESEED, *supra* note 12, at 49; *The Community Loan Center*, RGV CMTY. LOAN CTR., http://rgvcommunityloancenter.com/tclcgrn.html (last visited Apr. 22, 2013).

[300] *Id.* The Multibank started with "six investing stockholder banks covering the investment area of Cameron County" and has since expanded its investment area to include Hidalgo, Starr, and Willacy Counties in March 2001" with three additional equity investor banks. *Id.*

[301] TEX. APPLESEED, *supra* note 12, at 49.

[302] "CDFI certification is a designation conferred by the CDFI Fund and is a requirement for accessing financial and technical award assistance from the CDFI Fund through the CDFI Program, Native American CDFI Assistance Program, and certain benefits under the [Bank Enterprise Award] Program to support an organization's established community development financing programs." *Community Development Financial Institution Fund*, CDFI FUND, U.S. DEP'T OF THE TREASURY, http://www.cdfifund.gov/what_we_do/programs_id.asp?programID=9. There are currently approximately 1000 certified CDFIs in the United States. *Id.* (listed on "List of Certified CDFIs with Recertification Application Due Dates" under "Supplemental Resources" at the bottom of the page).

credit for investing in CDFIs, which makes it easier for institutions with CDFI certification to access affordable capital.[303]

In the late 2000s the members of the Brownsville public service community determined that a shortage of reasonably priced small-dollar loans was having a negative impact on area residents.[304] In the terms used in the 2011 FDIC survey discussed above, most of the affected residents were largely "underbanked" in that they had basic accounts but were turning to alternative lending institutions (such as payday and title lenders) because, "due to credit problems or other barriers, they often [could not] access bank loans."[305] To address this need the Multibank began researching the feasibility of launching its own small-dollar lending program and, in September 2010, incorporated the Community Loan Center (CLC) to operate the loan program.[306] The CLC started making loans in October of 2011.[307]

A. GETTING STARTED

In addition to keeping a relatively low APR for borrowers, two of the primary considerations in the development of the CLC's program were (a) to build a model that would ultimately be sustainable, i.e. that could cover its overhead with interest and

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[303] *See* Community Reinvestment Act, Interagency Questions and Answers Regarding Community Reinvestment, Notice, 75 Fed. Reg. 11642, 11648 (March 11, 2010) (advising that making loans to financial intermediaries such as CDFIs qualifies as making "community development loans" for the purpose of the CRA). *See also Community Reinvestment Act: Background & Purpose*, FED. FIN. INST. EXAMINATION COUNCIL, http://www.ffiec.gov/cra/history.htm (providing an overview of the CRA)(last visited Apr. 22, 2013).

[304] TEX. APPLESEED, *supra* note 12, at 49.

[305] *Id.* at 50.

[306] KEVIN JEWELL, LAUNCHING A SMALL DOLLAR LOAN PROGRAM: THE EXPERIENCE OF THE RIO GRANDE VALLEY MULTIBANK'S COMMUNITY LOAN CENTER 2 (2012) (on file with author). The CLC's Articles of Incorporation were originally filed on August 26, 2010 under the name "Consumer Loan Center" but had to be amended to change the name to "Community Loan Center." The Certificate of Correction reflecting the desired name was filed on September 1, 2010. The Articles of Incorporation and Certificate of Correction are on file with the author and are available through the Texas Secretary of State.

[307] *Id.* at 2.

service fees and replenish lending capital through repayment of loans,[308] and (b) the desire to operate as a regulated lender under Chapter 342, rather than as a CSO under Chapter 393.[309] To achieve sustainability under the stricter regulation of Chapter 342 the CLC had to address two of the main issues that have long plagued small-dollar lenders. First, the per-dollar origination and servicing costs are higher the smaller the dollar value of a loan's principal.[310] This is because, while the gross administrative costs associated with originating and servicing an individual loan (employee salaries, office overhead, etc.) remain relatively constant regardless of the loan size, the per-dollar cost goes up for smaller loans because they yield less revenue in the form of interest payments before being retired. A second issue is that many consumers of small-dollar loans use the product because they do not have the credit necessary to access mainstream borrowing options such as credit cards. Such borrowers often have heightened risk profiles, forcing lenders to prepare for higher losses than they would when serving borrowers with better credit histories.[311]

Payday and auto title lenders have addressed these issues by charging fees that put the effective APR of their small-dollar loan in the triple digits[312] but the CLC was committed to keeping its loans "affordable," causing it to create a more conventional

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[308] Personal communication with Nick Mitchell-Bennett.

[309] *See* JEWELL *supra* note 306, at 3 (discussing Multibank's decision not to use the "CSO loophole" because "it is widely viewed as a misuse of the original intent of the CSO statute.").

[310] *FDIC Small-Dollar Pilot*, *supra* note 53, at 32. *See also* JEWELL, *supra* note 306, at 4 ("Higher loan balances have lower per-dollar origination and servicing costs"). *Cf.* 2011 FDIC Survey, *supra* note 91 at 7 (about a quarter of banks surveyed about barriers to providing small dollar loan products for the unbanked and underbanked reported concerns about profitability).

[311] *See FDIC Small-Dollar Pilot*, *supra* note 53.

[312] CFPB MANUAL, *supra* note 18, at Short-Term, Small-Dollar Lending Procedures 2; *but see Myth vs. Reality: Payday lenders' high fees help the industry make billions in profits*, CMTY. FIN. SERV. ASS'N OF AM., http://cfsaa.com/aboutthepaydayindustry/myth-vs-reality.aspx (last visited Apr. 20, 2013) (arguing that APR is not an appropriate measure of payday lending fees because the loans are short-term).

product with an APR well under the 36 percent recommended by the FDIC.[313] In developing its program, the CLC researched existing low-cost small dollar loan programs[314] such as the "Salary Advance Loan" offered by the North Carolina State Employees' Credit Union (NCSECU)[315] and the "Save it!" loan developed by the Mountain Association for Community Economic Development (MACED) in Eastern Kentucky.[316] The experience of MACED was particularly instructive because it provided an example of a non-depository institution that had offered loans through partnerships with local employers and conducted an analysis of the economic realities of running such a program.[317]

The CLC's research lead them to the conclusion that they would have to drastically minimize overhead and servicing costs in order to offer small-dollar loans within the parameters of Chapter 342 without requiring long-term subsidies to cover administration of the program. The NCSECU and MACED loan program experiences demonstrated that administrative costs could be reduced by limiting the need to have

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313 The FDIC's Small-Dollar Loan Guidelines, issued on June 19, 2007, can be found at http://www.fdic.gov/news/news/press/2007/pr07052a.html.

314 JEWELL, *supra* note 306, at 3

315 *Salary Advance Loan*, N.C. STATE EMP. CREDIT UNION, https://www.ncsecu.org/personalloans/salaryadvance.html (last visited April 8, 2013). The Salary Advance Loan is paid by electronic fund transfer from the borrower's credit union account at the subsequent pay day. *Id.* Rates are based on the balance that the employee maintains in a separate savings account at the credit union that serves as collateral for the small dollar loan. *Id.* The highest rate is currently only 12 percent APR though. *Id.*

316 DESIGNING AN EFFECTIVE AND VIABLE ALTERNATIVE TO PAYDAY LENDING: LESSONS FROM THE SAVE IT! LOAN, MOUNTAIN ASS'N FOR CMTY. ECON. DEV., http://www.maced.org/files/CCFI%20Learning%20Brief%202010%20web.pdf (last visited April 22, 2013) [*hereinafter* MACED REPORT]. The MACED loan product offered through employers, was paid back through payroll deductions, and diverted some of the payments to create savings for the borrowers. *Id.* at 2. After some adjustments to the product the program was set so that loans could have a principal value of $375-$600, carried an 18 percent annual interest rate and $20 application fee, and had 4-10 month terms. *Id.* at 3.

317 *Id.*

physical store locations and moving most client interaction online.[318] The CLC also largely adopted MACED's model of partnering with local employers to access a pool of potential borrowers and using payroll deductions to facilitate loan payments.[319] This arrangement had the added benefit of serving certain underwriting functions (i.e. vetting the likelihood that a borrower will repay a loan) in that it made employment verification easier and provided a tie between the lender and a major institution in the borrower's life. Tying directly with employers also could reduce some of the risks of not getting paid back because the loan payment is taken off the top of the borrower's salary and reduces one of the friction points that can reduce the likelihood of getting paid back.[320]

Though the CLC refined its product during its first year of operation,[321] the program currently works as follows.[322] Partner employers sign an agreement called a memorandum of understanding (MOU) with the CLC agreeing to let the CLC offer loans to employees and agreeing to use their payroll systems to divert monthly payments to the CLC. Employees are eligible for loans if they are 18 years of age, have social security numbers and bank accounts, and have worked for the employer for at least three months. Eligible employees can take out loans in an amount that is the lesser of one-half their monthly take-home pay or $1000. Borrowers pay a one-time $20 finance charge and then 18 percent interest on the amount financed. Loan terms can be up to twelve months. The combination of interest and fees produces an APR of about 22 percent.

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[318] Personal communication with Nick Mitchell-Bennett; JEWELL, *supra* note 306, at 4 ("The small-dollar nature of the proposed loan product provides little overhead for the costs of origination and servicing, so the Community Loan Center wanted [loan servicing] software that automated as much of the process as possible.").

[319] *See* MACED REPORT, *supra* note 316, at 2; Jewell, *supra* note 306, at 3.

[320] *Id*. at 9 (discussing Nick Mitchell-Bennett's experience that potential lending capital investors view the payroll deduction feature as reducing the risk that funds with will be lost).

[321] *Id*. at 4;

[322] *Loan Program Details*, RGV CMTY. LOAN CTR., http://rgvcommunityloancenter.com/lpdetails.html (last visited Apr. 22, 2013); Personal communication with Nick Mitchell-Bennett.

To finance the launch of the program, the Multibank applied for and received a financial assistance award of $1 million from the U.S. Treasury Department's Community Development Financial Institutions Fund in 2009.[323] The awarded funds were designated as follows: "$306,250 in capital funds, $61,250 in initial loan loss reserves, and $527,000 in startup and staffing funds."[324] The CLC used part of the startup and staffing money to hire a former mortgage banker familiar with state lending regulation to run the program and to retain lawyers to guide them through the process of becoming licensed by the OCCC.[325] The licensing process proved much more time-consuming and expensive than the CLC had anticipated.[326] According to an internal report, "the Multibank spent roughly a quarter million dollars [$250,000] over two years [on building a program that met regulatory requirements] before making the first loan in October 2011."[327]

B. GETTING LICENSED

Because the CLC was planning to lend money for personal use at rates above 10 percent a year, the CLC had to apply for a lending license from the OCCC.[328] The application involves, among other things, submitting financial statements, organizational documents such as the Certificate of Formation, a business plan, proposed loan documents, and background information about the owners and administrators of the

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[323] *Awardee Profiles Details: Greater Brownsville Community Development Corporation*, CDFI FUND, U.S. DEP'T OF THE TREASURY, http://www.cdfifund.gov/awardees/db/profile.asp?controlnumber=206R47ICMH178KP197GAS185RXF215FWAMHFC216KUGR247SYBISTX78BO206HQAXRINN108&programName=FA (last visited April 22, 2013). The Rio Grande Valley Multibank was formerly known as the "Greater Brownsville Community Development Corporation." *Id.*
[324] JEWELL, *supra* note 306, at 3.
[325] *Id.*
[326] *Id.* at 5.
[327] *Id.*
[328] *See* Part II.B.2(a), *supra*.

applicant business.[329] The CLC was eventually issued a license to lend in July 2011, nine months after first submitting its application.[330]

The major challenge in the application process was securing approval for the online software platform needed to reduce origination and servicing costs. Under the Texas Administrative Code, regulated lenders have a series of on-going record-keeping requirements.[331] If an applicant for a lending license plans to use computer software to administer loans and otherwise comply with the record-keeping requirement, the applicant must use software that has already been approved by the OCCC as being capable of fulfilling the regulatory requirements or submit proprietary software for approval concurrent with the lending application.[332] Because the CLC needed a program that could take over most of the roles typically performed by personnel at the lending store, the team developing the program concluded that the organization would need to create proprietary software that would have to be approved by the OCCC.[333]

The CLC identified and contracted with a software vendor that was willing to adapt one of its existing products to the CLC's specifications and submit it for OCCC approval.[334] The software was submitted for approval in December of 2010, one month after the CLC's basic lending application was submitted to the OCCC.[335] After two

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329 *Regulated Lender Licensing Kit*, OFFICE OF CONSUMER CREDIT COMM'R, http://www.occc.state.tx.us/pages/industry/Lic_frms/Reg/Rkit(040413).pdf (last visited Apr. 22, 2013).
330 JEWELL, *supra* note 306, at 2.
331 7 TEX. ADMIN. CODE §83.828 (2013).
332 7 TEX. ADMIN. CODE §83.831 (2012); *see also* Jewell, *supra* note 306, at 4-5 (describing the CLC's experience applying for a license for its software).
333 JEWELL, *supra* note 306, at 4-5 ("[T]he Community Loan Center wanted software that automated as much of the [lending] process as possible. In particular, they desired software that supported web-based loan applications, electronic contract signature, and automated batch servicing. Unfortunately, only a handful of vendors provide software licensed by the OCCC, and none of the available licensed products fully met CLC's need.")
334 *Id.* at 5.
335 *Id.*

rejections of the software based on concerns that it was not completely aligned with regulatory requirements regarding issues such as interest computation, the CLC decided to launch its program using less comprehensive (but already OCCC-approved) loan servicing software.[336] The software developer with which it had been working was eventually able to get a program approved that provided many, but not all, of the services the CLC desired to minimize its administrative costs.[337]

The CLC was finally licensed in July 2011 and started making loans in October of that year.[338] Its loan product meets the interest rate, term, and other requirements of both Subchapters E and F but, though its license covers both subchapters, the CLC has chosen to only make loans under Subchapter F.[339]

C. Outcomes to Date

The program has generally been quite successful and, having used up most of the administrative funds provided by the Treasury Department grant, the CLC is projecting that its revenue will cover costs after less than two years of operation.[340] During its first fifteen months the CLC made over 1100 loans worth a total of over $1 million[341] and these loans are overwhelmingly being paid back in a timely manner. In December 2012, it had 89 delinquent loans, which represents about 8 percent of the loans originated by the

336 *Id*.
337 Personal communication with Nick Mitchell-Bennett.
338 JEWELL, *supra* note 306, at 2.
339 Personal correspondence with Nick Mitchell-Bennett, April 2, 2013. According to CLC Small Dollar Loan Coordinator Eva Woodfin, because the CLC's product satisfied the requirements of both subchapters, it chose to be licensed under both in order to maximize organizational flexibility in the future. However, because the CLC's lending software could only generate one type of loan documents, it chose to lend exclusively under one of the subchapters and tailor all of the organization's documents to that set of provisions. Personal correspondence with Eva Woodfin, April 9, 2013.
340 Personal communication with Nick Mitchell-Bennett.
341 The data in this section is based on a financial report covering October 2011 to December 31, 2012 that was submitted to the CLC's Board of Directors. (On file with the author).

program[342] and appears comparable to the experience of the FDIC pilot participants. About $34,000 (6.6 percent of receivables) was 30-120 days delinquent and another approximately $28,000, representing about 5 percent of accounts receivable, was more than 120 days delinquent. The delinquency rate tended to be lower earlier in the calendar year, increased as more loans were issued, peaked in September, and had another small increase during December. These delinquencies have not all resulted in defaults and the CLC only had to write off about $3,800 in 2012.

The CLC's small dollar loan program has grown from five employer-partners at the end of 2011 to twenty-two in December 2012.[343] These employers are a range of sizes—the smallest having 5 employees and the largest having 1700[344]—and have varying degrees of employee participation in the loan program. Some of the smallest firms had the highest rates of loans per employer in 2012[345] but the larger firms varied with respect to the pervasiveness of usage.[346] In recruiting participants, "the CLC target[ed] employers with a high percentage of staff with low to moderate income,"[347] but it is unclear why some employers generate more participation than others.

Interviews conducted for an internal review during the spring of 2012 "suggest that borrowers view[ed] the [CLC] as an affordable source of funds" and the main criticism has been that borrowers would like the ceiling on the loan amount to be higher than the current $1000.[348] The human resources personnel who administer the program

[342] *Id.*
[343] *Id.*
[344] Eleven had 20 or fewer employees, seven had between 21 and 100, three had between 101 and 500, and one had over 1000. *Id.*
[345] Two of the ten-employee employers had 9 loans in 2012, for a rate of .9 loans per employee. *Id.*
[346] A 500-employee employer had .63 loans per employee in 2012 but the 1700-employee firm only had .06 loans per employee.
[347] Jewell, *supra* note 306, at 6.
[348] *Id.*

from the employer perspective (helping borrowers access applications, verifying employment for the CLC, and setting up payroll deductions) also had a "generally positive" view of the program and did not find it especially cumbersome or burdensome.[349] Finally, though the CLC staff is optimistic about the program's future prospects, the development and launch phases were much more time-consuming and expensive than they had anticipated[350] and efforts to reduce overhead costs and secure additional lending capital are on-going.

The experience of the CLC seems to demonstrate that there is a market for small dollar loans that are more expensive than mainstream, prime credit but that are cheaper than the triple-digit APRs that many pay on payday and auto title loans. Furthermore, like the depository institutions that participated in the FDIC pilot program, the CLC's relatively modest delinquency rates suggest that the underbanked are not necessarily bad credit risks. Finally, and perhaps most important for a discussion of lending regulation, however, the CLC's experience demonstrates the high costs involved in developing and launching a program that complies with Chapter 342 lending regulations instead of using the CSOA. Thus, although the CLC's program is adding employer partners, increasing loan volume, and is on track to achieve sustainability in the coming year, the ability of other non-profit-maximizing organizations in Texas to replicate the model may be limited by the extent of the start-up costs.

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[349] *Id*. at 6-7.
[350] *Id*. at 5.

Part V. Final Analysis and Recommendations

As long as there are consumers who do not qualify for credit cards and other mainstream ways of accessing credit between paychecks and in times of crisis, there will always be a market for the products that small-dollar lenders provide. Historically, when legitimate forms of small-dollar lending have been banned, underground or subversive markets develop for the products. Acknowledging that higher cost small dollar loans will probably never disappear, the issue for policy makers becomes how to ensure that such products are provided in ways that do not result in borrowers—who often do not have many assets and live paycheck to paycheck—diverting their scarce financial resources to paying fees to lenders worth several times the amount of the cash advanced.

On the federal level, the CFPB has been given the tools to regulate unfair, deceptive, and abusive acts and practices. While it might be possible to use these tools to effectively drive payday lenders out of business, the CFPB should be mindful that, historically, other predatory actors have filled the void left when higher cost small-dollar lending has been banned. The FDIC's recent attempt to encourage mainstream lenders to offer small dollar products at below 36 percent APR may be successful but it is too soon to tell how many banks will start offering these products and, if they do, what effect this will have on the non-bank lending sector. Furthermore, it is important to note that the FDIC's primary authority is over state, not national, banks. While the findings of its pilot program may persuade national banks to adopt small-dollar loan programs, it is likely that some combination of the OCC and Federal Reserve Board would have to be involved in encouraging such movement. If larger, national banks do decide to enter the market for affordable small dollar loans they will have to be mindful of the fact that personal interaction and a degree of flexibility has often been essential to making such programs work. For instance, in the CLC case, the connections between the lender and the borrower's employer, as well as the CLC's willingness to work with delinquent borrowers, helped prevent many delinquencies from turning into defaults. The kind of standardized, rigid customer-service models employed by many large corporations would have to be modified to account for this aspect of developing successful relationships with typical small-dollar loan consumers.

In the absence of either stricter regulation of non-bank lenders (like closing the CSO loophole in Texas) or a critical mass of mainstream banks providing affordable small-dollar loan alternatives, the next best option appears to be state-based lenders that are committed to creating sustainable lending programs while still charging lower rates than the non-bank financial sector has demonstrated that the market will bear. In Texas, examples like the CLC may offer a viable model for organizations geared towards public service rather than profit maximization. Its employer-based, software-centric model appears to have addressed many of the inefficiencies related to servicing small-dollar loans that have made this type of lending so prohibitively expensive for community oriented organizations in the past. For an organization that can raise the seed capital necessary to form an initial loan fund and to cover administrative costs before the program starts generating interest and fee revenue, this might be a viable option.

The CLC is a for-profit organization, however, owned by a CDFI dedicated to community development in a particular geographic area. The up-front costs of getting licensed and obtaining the type of software needed to operate under the model in Texas might be too costly for 501(c)(3) organizations, which are limited in their ability to generate profits through commercial activities and may have trouble accessing lending capital because of regulations regarding their ability to produce non-public benefits. This is particularly frustrating given that non-profit organizations might be able to access community development grant money unavailable to for-profit entities.

In Texas, small-dollar lending at the rates needed to cover servicing costs is regulated by Chapter 342 of the Finance Code and OCCC regulations. The experience of the CLC demonstrates that the process of building a program that complies with the regulatory requirements—particularly securing the software needed to reduce origination and servicing costs enough to make a viable business model—can be quite costly and time-consuming. If the CLC's experience—where it took two years (nine months of which were spent responding to OCCC concerns that delayed licensing) and almost $250,000 to develop and license a program before loans could be made and start generating revenue—is typical, it seems unlikely that many other community development oriented organizations will be able to enter the market in Texas.

One partial solution that has been recommended by some consumer advocates is that the Finance Commission of Texas could allow provisional licenses for Community Development Finance Institutions (CDFI) to make small dollar loans while their applications are pending before the OCCC. While there is always a risk of abuse, a provisional license that allows a CDFI to begin originating loans after meeting some basic criteria would allow these organizations to expedite the process of generating revenue needed to cover some of the administrative costs of getting a program launched. Furthermore, if the applicant is also awaiting approval of proprietary software the provisional license could require it to use software that has already been approved by the OCCC until the full license is issued for the program and proprietary software. If the state decided that consumers benefit from CDFI involvement in the market and wanted to promote that involvement, the OCCC could also takes steps to help low-resource organizations develop loan programs by providing resources such as model small-dollar loan documents that had been predetermined to meet agency standards. This would reduce both their need to retain expensive legal counsel and the overall start-up costs of the program.

If policy-makers believe that, as Sheila Bair said, we should be working for economic inclusion of citizens on all parts of the socioeconomic spectrum, and if they want low-to-moderate income borrowers to have access to small-dollar, short-term credit at rates less than 300-500 percent APR, they may need to take a multi-pronged approach. This would mean promoting and facilitating the development of small dollar programs by both for-profit banks and organizations like CDFIs whose missions are broader than mere profit-maximization.

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