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Licensing and Regulation of Short-Term Credit Providers

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Many critics of short-term lending are under the false assumption that consumers of short-term credit are unsophisticated, uninformed, or victims of predatory lending. However, a recent study conducted by Gregory Elliehausen at George Washington University showed that consumers of short-term loans make informed choices and have considered alternative measures.[1]

These findings are consistent with those published by Texas Appleseed. Their April 2009 survey of payday borrowers showed that almost 40% of Texas short-term credit consumers tried—and were turned down—to use a bank or credit union for the funds they sought.[2] Consumers of small, short-term loans are not uninformed; it is just that they have few alternatives for taking out loans between $300 and $500, which are typically unavailable at banks or credit unions.

A vibrant, competitive short-term lending market is necessary for the financial well-being of many Texans. Many borrowers use small, short-term loans to help pay off monthly bills, make rent payments, and even buy food and gas. Restricting or cutting off access to the only available short-term, micro* loans will have very real unintended consequences for consumers who use these financial products.

Regulating Credit Service Organizations

HB 3744 and HB 3304 would require that all credit service organizations (CSOs)—those businesses that help consumers secure payday or direct-deposit loans—be licensed by the Office of the Consumer Credit Commissioner (OCCC) and comply with certain regulatory requirements. Specifically, the OCCC would establish an enforcement mechanism for real-time data collection to monitor CSO compliance and be able to conduct on-site inspections of businesses, files, paperwork, correspondence, accounts, records, safes, and vaults. Furthermore, these two bills would authorize a representative of the OCCC to administer oaths to individuals and examine them under oath on-the-spot.

It is certainly acceptable for CSOs to be regulated. As with any market, there is room for regulations concerning fraud, abuse, or coercion. However, HB 3744 and HB 3304 would create redundant regulatory mechanisms by expanding oversight powers to the OCCC. Credit service organizations are already operating in a regulatory environment and must adhere to many federal and state regulations, including:

- Texas Finance Code Chapter 393
- Federal Truth in Lending Act (15 USC §1601 et seq.)
- Texas Finance Code Chapter 302
- Texas Deceptive Trade Practices Consumer Protection Act (Texas Business and Commerce Code §17.41 et seq.)
- Texas Debt Collection Practices Act (Texas Finance Code Chapter 392)
- Federal Debt Collection Practices Act (15 USC §1692 et seq.)

*Micro loans are characterized by the relatively small amount of credit being borrowed. They are also typically shorter in duration than other, more standard loans.

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- Regulation B (12 CFR part 202)
- Regulation Z (12 CFR part 226)
- Federal Trade Commission Regulations (16 CFR part 313 and 16 CFR part 314)

Chapter 393 of the Texas Finance Code—dealing with credit service organizations—requires that CSOs register and file with the Secretary of State's Office and pay a fee of $100. This chapter of the code also specifies what information must be disclosed to the consumer and that all transactions are stated in a written contract. Furthermore, there are provisions in this chapter protecting consumers against fraud and deceptive conduct. Any violation of these statutes is considered a criminal offense and violators are subject to prosecution by the Office of the Attorney General.

The costs of increasing the regulatory burden on credit service organizations will ultimately be borne by those consumers who can ill-afford a marginal increase in lending costs. Elliehausen highlights the fact that operating expenses are greater relative to loan size for small loans.[3] These higher operating expenses necessitate higher interest rates or charges in order for businesses to break even on micro loans.

Increasing regulatory burdens on credit service organizations, erecting barriers of entry into the market, and raising operating costs for existing businesses will result in higher costs for borrowers, when they can get a loan at all. Because of the marginal nature of these loans, price changes can significantly affect both supply and demand. With the additional regulatory burdens, many loans will become unprofitable and consumers will no longer be able to get them.

Additionally, the existing language of the bill stipulates that the Finance Commission set "reasonable" fees that can be charged by CSOs for securing loans on behalf of consumers. While no one is debating the relatively high fees associated with short-term borrowing, there is agreement that a genuine demand or need exists for this market.

As previously noted, these higher fees are necessitated in part by the small size of the loans. Market participants are better equipped to decide for themselves on how much they are willing to accept in fees. Fees capped below the established market rate will most likely cause businesses that facilitate short-term lending to be driven out of the market. In turn, a reduction in the number of operating businesses will reduce competition and hurt consumer choice.

It is evident that many people use small, short-term loans to what they perceive as their benefit in times of necessity. A recent analysis of payday loan customers showed that a majority of people surveyed believed that these loans were beneficial to them and that their experience was positive.[4] Like any other form of credit, payday loans can be used irresponsibly by some consumers. However, for many people payday loans provide a valuable option in times of financial hardship.

Driving up the costs of these loans through increased regulation and bureaucratic oversight will result in diminished consumer choice. Effective APR caps set below the market rate, whether they are set by the Legislature of the Office or the Consumer Credit Commissioner, will not be adequate for businesses to remain profitable. In an industry that is already sensitive to marginal costs, it seems counter-intuitive to increase costs for businesses as well as consumers. ✯

Endnotes

[1] Gregory Elliehausen, "An Analysis of Consumers' Use of Payday Loans," Financial Services Research Program Monograph No. 41 (Jan. 2009).

[2] Texas Appleseed, "Short-term Cash, Long-term Debt: The Impact of Unregulated Lending in Texas" (Apr. 2009) 11.

[3] Elliehausen (Jan. 2009).

[4] Ibid.

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