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Supply and Demand for Short-term Loan Services: The Industry's Perspective

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Payday Lending: Realities and Challenges
Austin, Texas

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About the Speaker

J. Scott Sheehan is a shareholder in the Houston and Austin offices of Greenberg Traurig, LLC, an international, multidisciplinary law firm with 1,750 attorneys and governmental affairs professionals in 30 offices across the United States, as well as in Europe and Asia. The firm was selected as the 2007 USA Law Firm of the Year by Chambers and Partners.



Mr. Sheehan's thirty-years of national practice in banking and consumer finance reflects the growth and development of consumer law, including full disclosure, business practices, plain-language, and other key public policy issues. In the area of short-term loan services, Mr. Sheehan pioneered development of the CSO legal model as upheld in *Lovick v. Ritemoney* (5th Cir. 2004), and represented the Texas Bankers Association as amicus curiae in *First Bank v. Tony's Tortilla Factory* (Tex. 1994) regarding the legality of bank "NSF" charges.

Other: *Best Lawyers in America*; *West Publishing* co-author, *Texas Usury Law Handbook*; "Scribes," the American Society of Writers on Legal Subjects; Governing Committee, Conference on Consumer Finance Law; ABA Consumer Financial Services Committee; Payday Loan Bar Association; Chairman, Texas Business Law Foundation; Past Chairman, State Bar of Texas, Business Law Section, and Consumer Law Section; and Past President of the Texas Association of Bank Counsel.

[Presentation to Payday Lending: Realities and Challenges • 1]

Presentation Objectives

- Layout core aspects of the demand and supply for short-term loan services
- Compare eight of the choices consumers have and why short-term loan services from the store-front members of the Community Financial Services of America or the Consumer Service Alliance of Texas are a valid and reasonable consumer choice
- Suggest a CFSA and CSAT scorecard
- Encourage more even-handed perspectives about CFSA and CSAT short-term loan services



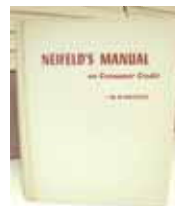
Follow-up Resources

- CFSA and CSAT hope that today's program can clear away some of the unwarranted criticisms and foster increased public support. Below are some reference materials to help that process:
 - » **Community Financial Services Association**
<http://www.cfsa.net>
 - » **Consumer Service Alliance of Texas**
<http://consumerserviceallianceoftexas.org>
 - » Attachment A – CFSA Website Excerpts and Best Practices
 - » **Attachment B – CSAT Website Excerpts, Best Practices, and CSO Existing Regulation**
 - » Attachment C – Background on TX CSO Model

Neifeld's Manual on Consumer Credit

- The "typical consumer of everyday life is more complex than the oversimplification of the [purely "rational man"] ... and is more sturdy and purposeful than [the "irrational" man portrayed by consumer advocates]."
- "The consumer is not merely an economic fact with plus or minus money. He is a complex of habits, prejudices, frustrations, fulfillments, plans and ambitions. **The consumer's use of credit must be considered from the psychological as well as the economic side. Credit [people] must take both into account.**"

*Excerpted from Professor M.R. Neifeld,
Neifeld's Manual on Consumer Credit,
pages 249-250 (Mack Publishing Co. 1961)*



Neifeld's samples of consumer reasons

"[[It's] more satisfactory to have only one place to pay and the amount fits."

"I know it costs more to handle my finances this way but it is well worth the cost to me."

"Above all is the lift to morale when cash emergency needs are met. 'You will never know the relief I felt when my husband and I walked out of the office with the papers all signed and everything taken care of. All my worry was gone.'" "I didn't have to be ashamed owing them money because they are a business concern and what we did was just a business deal between ourselves -- they charge for it."

Excerpted from Professor M. R. Neifeld, *Neifeld's Manual on Consumer Credit*, pages 38-39 (Mack Publishing Co. 1961)

The Short-term Loan Services Market

- The Demand: Consumers want or need short-term credit services for varieties of personal, family and household reasons. Consumers evaluate their alternatives based upon both economic and personal factors of importance to them
- The Supply: Consumers have eight choices for short-term credit: Asking family or friends; paying creditor or vendor late charges; paying bank or credit union deposit account and NSF fees; paying credit card rates and charges; paying fees to short-term loan services providers; using pawnshops; or doing without

It's Important to Understand the Choices

"Policymakers and critics of the . . . [short-term] loan industry must become more informed about these [small loan] markets, and must be much more cautious in their advocacy for further regulating or banning the practice lest they do harm to the consumers they ostensibly seek to protect."

Payday Lending and Public Policy: What Elected Officials Should Know

Tom Lehman, Ph.D., Associate Professor of Economics

Indiana Wesleyan University, Marion, IN

Available at: http://www.cfsa.net/payday_lending_public_policy_highlights.html

CSAT Survey

■ What the recent CSAT Survey shows about demand, supply, and consumer choice

- » Cypress Research Group Study: CSAT commissioned an independent survey by Cypress Research Group (www.cypress-research.com) that will be published this month
- » Sample findings:
 - Four main options. This study finds that consumers mostly use four of the alternatives when they need a small value, short-term, non-secured loan: allow routine household bills to be late; use bank overdrafts; obtain short-term loan services; or obtain a credit card advance.

CSAT Survey

■ What the CSAT Survey shows about demand, supply, and consumer choice – continued

- Financial options. Almost all (89%) of small loan service customers in the Texas survey have overdraft protection on their checking accounts or credit cards with available credit. One-half have both.
- Consumers do compare. During their most recent financial shortfall, 85% of the consumers considered at least one other viable option, the most common being "allowing bills to be late" (35%), "asking friends or family" (15%), or using overdraft protection (15%).

Comparing the Alternative Choices

- Doing without
- Asking family or friends
- Paying creditor or vendor late charges
- Using pawnshops
- Paying credit card rates and charges
- Paying bank or credit union deposit account fees
- Paying bank direct deposit advance fees
- Paying fees to short-term loan service providers



Comparing The Alternatives

■ Doing Without

This is a laudable goal, but it isn't always what the consumer wants or needs nor does it address the real-life emergencies that arise.

CFSA and CSAT members caution consumers in writing to think about their options before making a choice. Banks have similar disclosures in their line of credit products.

■ Asking family or friends

"Some [consumers] take pride in fighting adversity without calling on family or friends. 'Relatives wouldn't solve the problem because if we owed anyone anything I would be ashamed every time I looked at that person.'" "It is easier and cheaper to borrow from a loan company than to owe a lot of people small amounts.'" M.R. Neifeld, Neifeld's Manual on Consumer Credit, pages 38-39[Mack Publishing Co. 1961]

Comparing The Alternatives

■ Paying creditor or vendor late charges and other fees

» Sample charges:

5% late charge if payment amount is late 10 days = 1800% Rate
(5%/10 days X 365 days = 1825% annual rate)

\$15 late charge regardless of payment amount

\$50 late fee/reconnect fee

» Other considerations:

- Besides various charges, there is potential interruption of important household services and other inconvenience
- Adverse payment history

Comparing The Alternatives

■ Using pawnshops

» Sample rate and terms: \$20 per \$100 per month (240% APR). One to three month pawn terms, with possibility of some extensions. Loan must be secured by a pawned item of sufficient value.

» National Pawnshop Association:

<http://www.nationalpawnbrokers.org>

» Other features:

- Give up possession of the property during the pawn and can't use it.
- No obligation to repay. The consumer can walk away but loses the pawned item.
- Potentially significant difference between the loan amount and the value of the item. This valuation shortfall is because the pawnshop like any other merchant has to be able to resell the item for more than its cost.

Comparing The Alternatives

■ Paying Credit Card Rates and Charges

» Sample rate and terms:

18% Annual Percentage Rate; 2-4% minimum payments

Tiered late charges: \$15 (up to \$100); \$29 (\$100-\$1000); \$39 (over \$1000)

Cash advance fees: Greater of 3.2% or \$6.50

Over-the-limit fees: \$33

- » Sample considerations: **A complicated mix of factors.** Among other considerations, credit cards can be too easy to use without forethought. On the other end, some consumers want to hold on to any available credit on the credit card as a back up for additional emergencies.

Comparing The Alternatives

■ Paying bank or credit union deposit account and NSF fees

- » Sample rate and terms: **\$30 NSF for each item.**

- » Not subject to APR disclosures and difficult to compare: This fee is considered a deposit account service fee and is not subject to an APR disclosure. E.g., Regulation Z, Official Staff Commentary ¶ 4(b)(2). Whether this fee represents a higher or lower cost depends upon the number of items and the expected time frames.

- » Service fee: By law, bank **"bounce protection" features cannot guarantee in advance that the bank will pay an item.** The fee must be chargeable whether the bank honors or dishonors the item.

- » Limits on flexibility: **Generally, the banks are required to charge off the debt within 60 days.** OCC, FRB, FDIC, and NCUA, Joint Guidance on Overdraft Protection Plans (February 2005).

Comparing The Alternatives

■ Paying bank or credit union deposit account and NSF fees

Example: Consumer wants to write four checks of \$125 each, or some other combination involving four checks totaling \$500.

\$100 loan service fee (5X \$20) versus \$120 NSF fees (4X \$30)

If the bank pays the checks, the bank's \$120 NSF fees are still more than the loan service fee of \$100. If the bank at its option dishonors the checks, which the bank has a right to do, the consumer still owes \$120 in NSF fees and could face additional charges of \$120 (4X \$30) by the merchants or creditors who received the bounced checks.

By paying the \$100 loan service fee, the consumer can use the \$500 to pay the four people and avoid paying higher "bad check" fees of either \$120 or \$240.

Comparing The Alternatives

■ Paying bank direct deposit advance fees -- Line of credit programs

» Sample bank formal "line of credit" programs:

"Checking Account Advance" by **US Bank**; "Early Access" by **Fifth Third Bank**; and "Direct Deposit Advance" by **Wells Fargo**

» Sample fees: \$10 per \$100 for up to 35 days, but repaid out of next direct deposit.

» APR Disclosure: Assumes a monthly billing cycle regardless of when the next direct deposit is made. Example: "To compute the **Annual Percentage Rate** (cost of funds over a year) we take the **Finance Charge** as a percent of the Advance amount and multiply it by the number of statement cycles within a year. For example, \$100 Advance with a \$10 fee = $\$10/\$100 = 10\% \times 12 \text{ Cycles} = 120\% \text{ APR.}$ "

https://www4.usbank.com/internetBanking/en_us/transfer/CheckingAcctAdvanceTerms.jsp

Comparing The Alternatives

■ Paying bank direct deposit advance fees -- Continued

» Sample repayment language:

“When subsequent electronic deposits of \$100 or more are made into your checking account, an automatic repayment of your outstanding advance and Finance Charge will be made. . . For example, if you receive your paycheck every two weeks, an outstanding advance and Finance Charge will be repaid on the same day the Bank receives the next paycheck that is electronically deposited after you took the advance, even if you took the advance only one or two days before your paycheck was deposited.”

https://www.wellsfargo.com/downloads/pdf/checking/dda/termsandconditions_english.pdf

Comparing The Alternatives

■ Paying bank direct deposit advance fees -- Continued

“Plan ahead – and understand that this type of borrowing is expensive. For example, if you receive your paycheck every two weeks and need a \$200 advance for approximately two months, the \$200 advance will be repaid with your next paycheck and you may need to take another advance. In this scenario, in the absence of other sources of income, you would need to initiate the advance 4 times during the two month period and would incur a total of \$80 in Finance Charges.”

https://www.wellsfargo.com/downloads/pdf/checking/dda/termsandconditions_english.pdf

Comparing The Alternatives

■ Paying bank direct deposit advance fees -- Continued

» Sample variation in Bank effective rates (\$10 per \$20 until next direct deposit) depending upon when next direct deposit is received

1 Day = 3600% (10% X 360 unit periods = 3600%)

1 Week = 520% (10% X 52 unit periods = 520%)

½ month = 240% (10% X 24 unit periods = 120%)

1 month = 120% (10% X 12 unit periods = 120%)

For simplicity, these rates are based upon nominal unit periods rather than 365-day calculations.

Comparing The Alternatives

■ Paying fees to short-term loan service providers – CFSA and CSAT Alternative

» Sample fees: \$15-\$20 per \$100 for two weeks.

» Sample Annual Percentage Rate:

15% for 15 days = 365% (15%/15 days X 365 days = 365%)

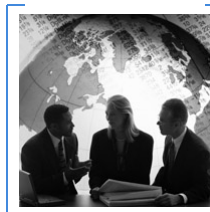
20% for 15 days = 486% (20%/15 days X 365 days = 486%)

» Other considerations:

- Storefront convenience and allows for planning. Coming in to the store to pay promotes forethought.
- Flexibility to obtain more time by rollover for another term at same rate. Best practice to convert transaction to an installment payout after a prolonged sequence of rollovers.
- No adverse credit history if repay on time.

What Can We Fairly Conclude

- Choosing a short-term loan service is a valid and reasonable choice based upon both economic and personal factors of importance to consumers.
- These short-term financial services are "not predatory," provide meaningful benefits, are subject to price competition, and taking them away harms consumers. (Morgan, Federal Reserve Bank of New York Staff Reports, Defining and Detecting Predatory Lending, January 2007, and Payday Holiday, November 2007).



The CFSA and CSAT Scorecard

- The retail store businesses represented by CFSA and CSAT are dedicated to responsible business practices.
- CFSA and CSAT members represent private sources of capital to meet consumer demand and do not depend upon government-insured deposits or government assistance.
- CFSA and CSAT members provide reasonable services on competitive terms without significant complaint and only have profit margins in the 7-8% range, certainly well within the bounds of legitimate business enterprise in the United States. See A. Huskstep, 12 Fordham J. Corp. & Fin. L. 204, 227-28 (2007).
- Websites:
 - » <http://www.cfsa.net/>
 - » <http://consumerserviceallianceoftexas.org>

The CFSA and CSAT Scorecard

- CFSA and CSAT members utilize various consumer protection measures and operate without any significant degree of consumer complaints.
- CFSA and CSAT members are in favor of responsible regulation and self-regulation, including "best practices" and consumer complaint procedures.
- CFSA and CSAT members comply with the vast array of federal and state laws and only rely upon legal models that have substantial legal support. The CSO model in Texas is an example of using a legal model that had substantial legal support before it was utilized and is subject to substantial existing regulation as shown on Attachment B.

CSO Model

- We were asked to discuss the CSO model. Here's a synopsis, and the handouts cover this in more detail.
 - » CSO legal model was pioneered in Texas starting in about 2001 and led to the early test case of *Lovick v. Ritemoney*, 378 F.3d 433 (5th Cir. 2004), which upheld the model.
 - » The CSO model is based upon established Texas law that (a) distinguishes between loan services by the CSO (e.g., arranging a loan, guarantying a loan, or issuing a letter of credit) and a loan by an independent third-party lender at a general-usury-law rate (e.g., 10% per annum).
 - » Usage of the CSO model expanded in July 2005 when loan service providers looked for legitimate alternatives due to the FDIC's revised policies on short-term loans under the bank-agent model.

CSO Model

- » [Existing CSO regulation](#). The CSO model in Texas is already subject to substantial regulation as shown in Attachment B. Consumers may file complaints with the Texas Attorney General, the Federal Trade Commission, and against the bond for each location filed with the Texas Secretary of State.

Examples include:

[Texas Credit Service Organization Act](#) (Tex. Fin. Code Chapter 393). Secretary of State registration; \$10,000 bond per location; full disclosures; 3-day right to cancel; and remedies for actual and punitive damages, attorneys' fees, and piggy-back application of the Texas Deceptive Trade Practices Consumer Protection Act.

[Texas Deceptive Trade Practices - Consumer Protection Act](#) (Tex. Bus. & Comm. Code § 17.41). Treble damages in certain circumstances, and attorney's fees.

[Texas Constitution Art. XVI, §11 and Texas Finance Code Chapter 302](#). Lender is limited to 10% per annum accrual interest.

CSO Model

[Other key federal and state laws regulating CSO and lenders](#): Federal Truth in Lending Act (15 USC § 1601) and Regulation Z (12 CFR part 226); Texas Debt Collection Practices Act (Tex. Fin. Code Chapter 392) and Federal Debt Collection Practices Act (15 USC § 1692); Federal Equal Credit Opportunity Act (15 USC § 1691) and Regulation B (12 CFR part 202); Federal Fair Credit Reporting Act (15 USC § 1681) and Regulation V (12 CFR part 222); Federal Trade Commission Act. (15 USC § 41); Federal Gramm-Leach-Bliley privacy laws (15 U.S.C. §§ 6801 & 6821); and Federal Trade Commission Regulations (16 CFR part 313 and 16 CFR part 314).

The CSAT website has hyperlinks to each of these referenced laws.

CSO Model

- » In addition to these substantial regulations, CSAT members are self-regulated through CSAT's "best practices."
- » The CSO model is potential available in several other states based upon laws dating back to the 1960s or earlier that provide "rate election" statutes on the degree of regulation.

Closing Remarks

- "Consumers seem to like the convenience . . . and prefer [these products as being] cheaper than most alternatives . . ."
- "Banning [these products] might please [competitors and consumer advocates], but it's hard to see how actual consumers would benefit."

The Wall Street Journal, "Mayday for Payday Loans,"
page A16, April 2, 2007

