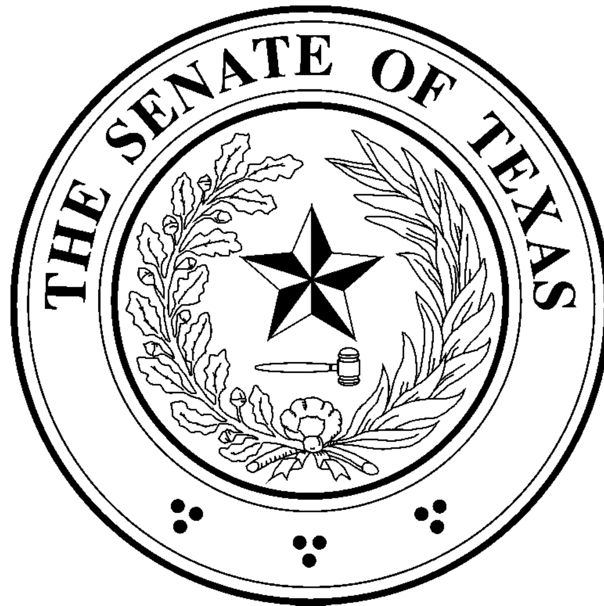
Texas Borderlands 2009

Access to Capital and Credit



Texas Senator Eliot Shapleigh
District 29
El Paso, Texas
February 2009

Predatory lending has become one of the most critical issues facing Texans today, particularly for moderate- and low-income communities. Predatory lending is characterized by excessively high interest rates or fees, abusive or unnecessary provisions that do not benefit the borrower, and unsound business practices. Predatory lenders often target their services to the most vulnerable consumers, including seniors, non-English speakers, and people of color. They look for people who are not adept in financial matters and lack the financial sophistication to scrutinize loans. Nearly every federal financial services regulatory agency has publicly denounced predatory lending and called for more effective regulation to address it. States are implementing a number of initiatives to identify and eliminate predatory financial practices within their borders.

Predatory lending, both in the home lending arena and the consumer lending arena, is a systemic epidemic that affects not just consumer borrowing, but also affects local economies, regional resources, and the statewide economic environment.

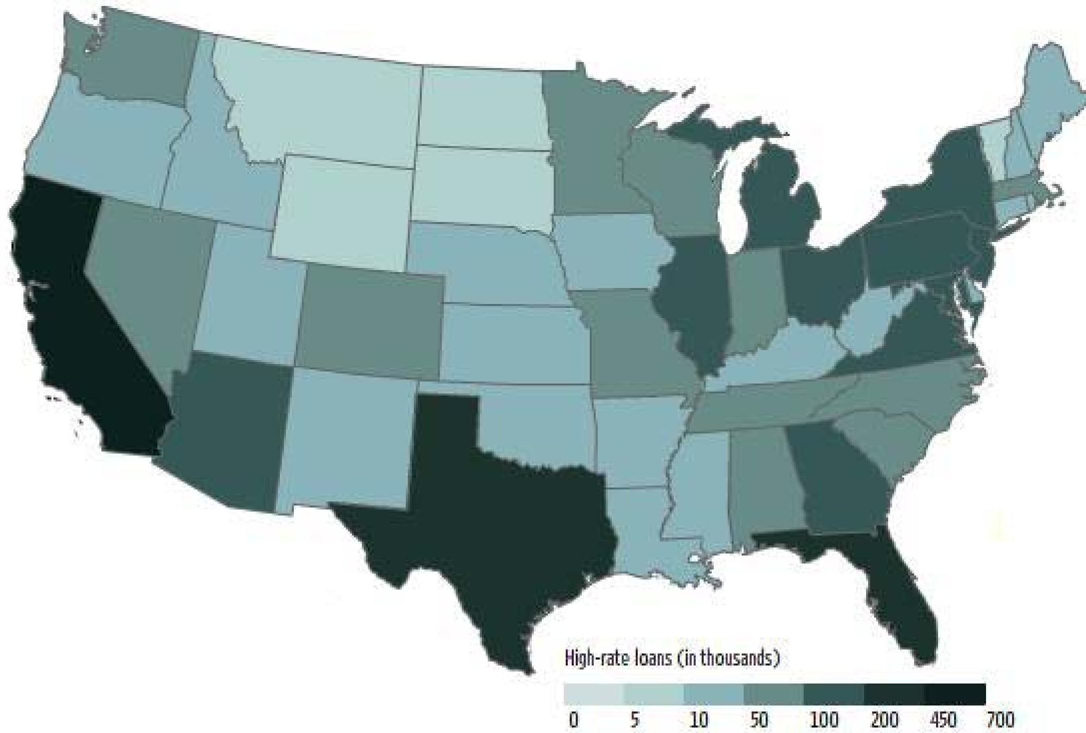
Predatory lending is found in mortgage lending, consumer lending, the refinance loan and credit repair markets, and in business lending and now threatens world economic and credit markets. Some of the very lenders who are involved in subprime lending are also involved in predatory lending. Investment banks eagerly sell high-profit mortgage portfolios to hedge funds that want the high interest payments. Non-rating agencies hope for the best in the housing market and thus provide sterling credit appraisals to those that issue debt, and subprime mortgage brokers become more and more reliant on high volume sales, much as we have seen in the predatory lending market. In each instance, the vicious cycle of providing "crack cocaine" credit to risky borrowers is producing shaky markets in the United States and abroad. This also places future credit markets at risk; the bottom line is clear–income streams do not exist to pay back existing debt.

Countrywide Financial Corporation moved its headquarters to Dallas in December 2004, after receiving a $20 million grant from the Texas Enterprise Fund. On its way to becoming the nation's largest mortgage lender, Countrywide encouraged its sales department to lead potential borrowers to high-cost and sometimes unfavorable loans that resulted in richer commission for the salesman, outsized fees to company affiliates servicing the loans, and soaring stock prices that made the company's executives among the highest paid in the nation. This begs the question: why are we using scarce state resources to subsidize such risky lending practices? Furthermore, how many bad loans, delinquencies, and foreclosures in Texas and other states have Countrywide's practices caused?

The spike in foreclosures has been associated with declines in stock markets worldwide, coordinated national bank interventions, and bankruptcy of several mortgage lenders. Nouriel Roubini, a professor at New York University and head of Roubini Global Economics, predicts a resulting recession in the near future. He contends that if the economy slips into recession, "then you have a systemic banking crisis like we haven't had since the 1930s. The cost could be as high as $1 trillion."[1]

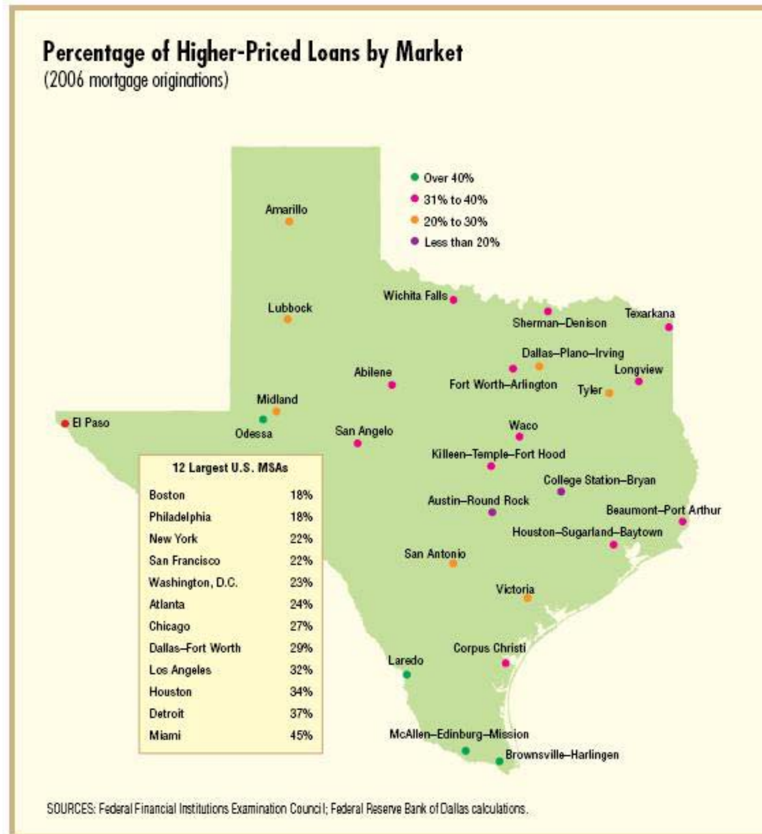
Below, find a national map showing the number of high rate loans issued in 2006, the driving force behind the current foreclosure crisis.

Number of High Rate Loans Issued in 2006



Source: Rick Brooks and Constance Mitchell Ford, "The United States of Subprime," *The Wall Street Journal*, October 11, 2007.

The high number of subprime mortgage loans has finally caught up with Texas and, indeed, the entire country. In fact, the percentage of higher-priced mortgage loans issued in Texas has been above average compared to other states. In Texas' MSAs, 30 percent of loans originated in 2006 were considered higher-priced - at least 3 percentage points above prevailing mortgage rates.[2] As the chart in the next page illustrates, this figure exceeded the percentages in most of the nation's largest metro areas:



Higher-priced loans were heavily used in several of the state's MSAs, particularly along the Texas-Mexico border. In the McAllen- Edinburg-Mission MSA, over 40 percent of the mortgage volume between 2004 and 2006 were high rate loans.

A closer look at the data gives additional insight into which Texans received higher-priced loans. Just under a quarter of upper-income borrowers in Texas were issued higher -priced loans, while nearly half of moderate-income and 44 percent of low-income borrowers received such loans.[3] More than 50 percent of loans issued to Latino borrowers and over 60 percent of loans issued to African-American borrowers were higher priced, while fewer than 20 percent made to Caucasian borrowers were higher priced. [4]

The inevitable result of these numbers is higher foreclosures. In August 2007, Texas reported 16,970 foreclosure filings, the fourth highest total in the nation for the month.[5] These figures represent a 36 percent increase over July 2007, and the state's foreclosure rate of one foreclosure filing for every 532 households was 9th highest among the states.[6]

The chart below gives foreclosures rates for Texas' 25 MSAs:

Texas Foreclosure Rate 2006 Loans
Average: 17.3%

MSA	Projected 2006 Foreclosure Rate
Abilene	16.0%
Amarillo	17.8%
Austin-Round Rock	17.0%
Beaumont-Port Arthur	17.9%
Brownsville-Harlingen	12.5%
College Station-Bryan	15.2%
Corpus Christi	16.4%
Dallas-Plano-Irving	16.9%
El Paso	15.8%
Fort Worth-Arlington	16.8%
Houston-Sugar Land-Baytown	17.6%
Killeen-Temple-Fort Hood	15.8%
Laredo	13.0%
Longview	14.8%
Lubbock	16.4%
McAllen-Edinburg-Mission	11.6%
Midland	16.4%
Odessa	16.4%
San Angelo	16.4%
San Antonio	17.4%
Sherman-Denison	16.5%
Tyler	16.1%
Victoria	13.3%
Waco	17.1%
Wichita Falls	15.6%

Source: Center for Responsible Lending.
http://www.responsiblelending.org

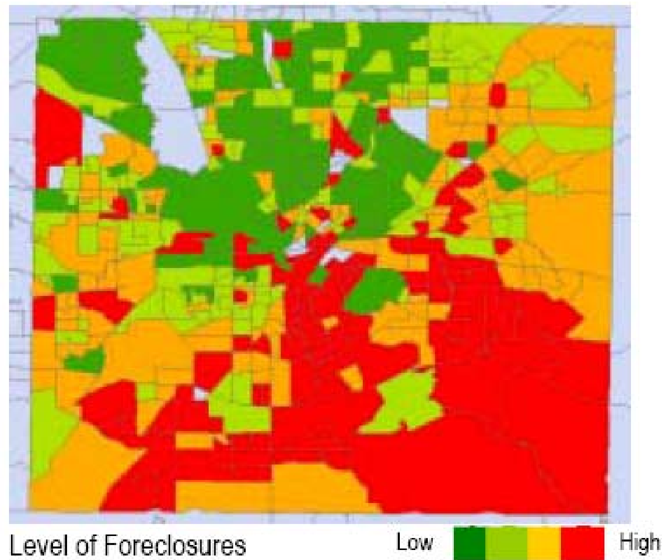
The following chart shows the number of foreclosures in Texas' five largest counties.

Texas Foreclosure Activity - August 2007

County	August 2007 Foreclosures	1 in every # households
Harris	3,176	459
Dallas	3,205	285
Tarrant	2,522	253
Bexar	1,318	435
Travis	678	577

Source: RealtyTrac U.S. Foreclosure Market Report

Here is what the 2005 to 2006 foreclosure activity looked like in Dallas County, the county with the highest number of foreclosures in August 2007:



Source: Texas Department of Housing and Community Affairs

Nationally, the numbers are alarming as well. In the most recent quarterly report issued by the Mortgage Bankers Association, this quarter's foreclosure starts rate is the highest in the 53-year history of the survey, with the previous high being last quarter's rate.[7] According to RealtyTrac, foreclosure filings across the U.S. nearly doubled last month compared with September 2006, jumping from 112,210 to 223,538.[8]

The high rate mortgages that are causing the incredible jump in foreclosure rates are not just limited to minority, low-income borrowers. Indeed, a recent analysis by *The Wall Street Journal* shows that, in addition to low-income areas, high rate lending rose sharply in middle-class and wealthy communities.[9] The problem is not over, either. As much as $600 billion in adjustable-rate subprime loans are due to adjust to higher rates by the end of 2008, thus putting more and more borrowers in precarious financial situations.[10]

As a result of all of these, payday lenders products have come under recent scrutiny by consumer advocates, federal regulators, and the U.S. military. Payday loans are short-term loans with annualized interest rates that range from 300 to 1,000 percent APR. Currently, payday lending operates in 37 states, with a patchwork of state laws and regulations that govern their use. Recent federal actions have spawned significant changes in the payday lending industry. Until recently, payday lending in Texas operated through the "rent-a-bank" or "rent-a-charter" model, in which payday outfits partnered with out-of-state banks to make loans to consumers. This scheme enabled Texas payday lenders to avoid state usury limits and rate limits established by the Office of Consumer Credit Commissioner. Under this arrangement, Texas payday lenders claimed the status of "brokers" and assigned their partner banks as the "lenders'.

Since 2005, however, the Federal Deposit Insurance Commission (FDIC), the primary regulatory agency for federally chartered banks, has effectively this practice. In response nearly

all payday lenders in Texas registered as Credit Services Organizations, pursuant to Chapter 393 of the Finance Code. This move enabled payday lenders to avoid even limited regulation by the Office of Consumer Credit. This switch also enabled some lenders to turn in their OCC licenses.

Texas' CSO statute was intended to provide guidance for entities that offered legitimate debt repair or counseling services to Texans. As such, the CSO statute is overly broad, and not intended to apply to entities that arrange short-term consumer loans in high volume. Since July 2005, most major payday lenders have registered as Credit Services Organizations (CSOs) under Chapter 393 of the Finance Code. This industry move came as the Federal Depository Insurance Corporation (FDIC) began to prohibit its member banks from serving as financial partners with companies doing payday lending.

As CSOs, these payday outfits are no longer subject to Texas' small loan law or regulation by the Office of Consumer Credit. Although the OCCC is obligated to set rates, payday- CSOs are able to circumvent these rates, although Section 342.008 prohibits attempts to evade the law: "A person who is a party to a deferred presentment transaction may not evade the application of this subtitle or a rule adopted under this subchapter by use of any device, subterfuge, or pretense." Under the CSO model, the CSO, or payday lender, charges the consumer with a fee based upon the amount borrowed, and then computes 10% interest on the loan based upon extension of credit made by a third party lender, who has an established relationship with the payday-CSO storefront or Web-based service. The following chart illustrates the fees and interest rates that are often paid on a $300 payday loan:

Fees and Interest Rates (APR) on a $300 Payday Loan

	Current Law-	OCCC rates	CSO	rates
8-day loan	189%	$12.80	1153%	$75.82
10-day loan	161%	$14.00	925%	$76.03
15-day loan	124%	$15.60	621%	$76.54

Source for CSO rates:

Cashnet (subsidiary of Cash America) http://www.cashnetusa.com/fee -schedule-texas.html

Source for OCCC rates:

http://www.occc.state.tx.us/pages/int_rates/deferred%20presentment%20tramsactions%20rate%20charts%20.xls

In a recent Wall Street Journal survey of the nation's top economists, 70 percent said the economy is in a recession and half said that "this year could be worse than the 2001 and 1990-91 downturns."[11] While the American public is in line with economists on the realities of the economy, President Bush has only recognized a "slowdown." He also disagrees with "massive government intervention in the housing market,"[12] despite a new report from Moody's Economy.com which states that 8.8 million homeowners, or 10.3 percent of the total, are "underwater," meaning that they owe more on their homes than the homes are worth. The report

observed that "the last time we saw so many homeowners with so many home values that were worth less than the amount of mortgage they owed was back in the Great Depression." Foreclosures jumped 75 percent nationally for all of 2007,[13] and a recent report from the Joint Economic Committee estimates that over $100 billion in housing wealth will be lost through 2009.

Beyond consecutive month-to-month job losses, a decrease in retail sales, and the housing market crisis, wages remain flat, individual debt is at record levels, and fewer and fewer people have health insurance. Our country faces a very serious and possibly devastating economic downturn. Effective government solutions are needed immediately.

The availability of credit and capital is essential to a healthy economy. Changes in the national and state financial services market have significantly changed the way in which credit and capital are obtained. While market changes have given more people access to a wider variety of services, increased complexity in the lending arena has created a risk for uninformed borrowers. All too often, these borrowers enter into arrangements that provide no net financial benefit and actually result in increased costs. In fact, many borrowers are paying higher than necessary fees and costs or do not have access to adequate financial services, either due to a lack of local services, a limited understanding of available services, or lenders' subjective decisions.

Both the federal and state governments have worked to make capital and credit accessible to borrowers, but legislative actions have yet to make the financial services market fully open to all qualified borrowers. In fact, finding a clear legislative avenue for regulating the financial services industry and developing new programs to make capital more accessible is dangerous. As the following data illustrates, federal laws and regulations often preempt the ability of the state to legislate changes to the financial services marketplace. Further, legislation that might protect or more effectively support consumers has the potential effect of further limiting access to available markets, as state regulation that may burden institutions doing business in Texas threatens to, in effect, drive these institutions to venues with more lenient regulation. The State has the important responsibility to balance the protection of consumers with the development of regulation that supports a thriving financial market.

Growing Population and Changing Demographics

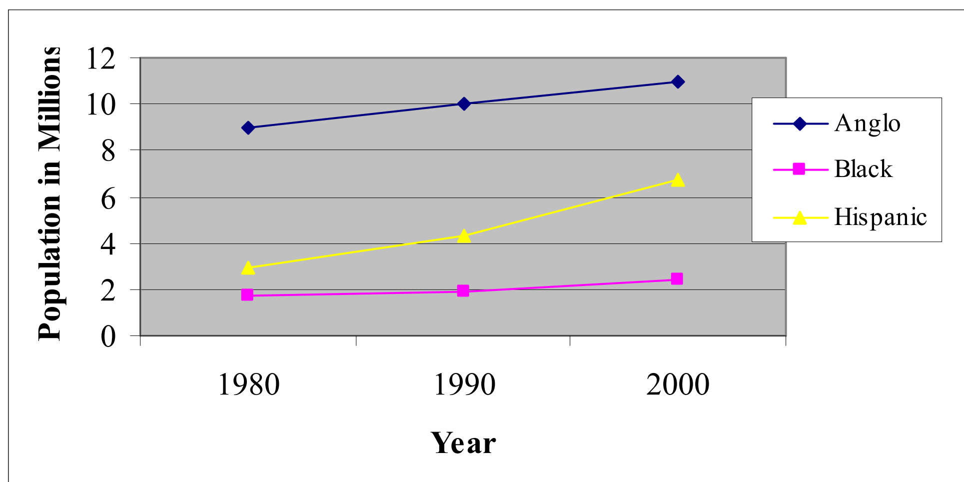
Problems of limited access to capital and credit facing Texas communities will get much worse if significant changes are not made. According to Texas' State Demographer, Steve Murdock, Texas' demographic trends, including changes in the rates and sources of overall population growth, an increase in the non-Anglo population, and the aging of the population, place considerable pressures on the state to address issues relating to access to capital.

First, population growth alone places stress on the banking industry. Murdock testified that for every 10 year period since 1850, Texas population growth has increased at a rate remarkably faster than growth for the United States as a whole. Texas ranks as the second fastest growing state with regard to population in the country behind California, adding nearly 3.9 million people between 1990 and 2000, and is now the second largest state by population size.[14] The addition of so many people translates to new demands on banks for home loans, business

loans, and personal loans.

Significant changes in Texas' ethnic makeup over the past two decades also affect access to capital. The Hispanic population grew by 45 percent between 1980 and 1990 and 54 percent between 1990 and 2000.[15] The Anglo population has also grown, but at an increasingly slower rate - a 10 percent rate in the 1980s and 7.6 percent rate for the 1990s.[16] Furthermore, Black residents still comprise a significantly smaller percentage of the state's population than Anglos and Hispanics but grew at a faster rate than Anglos from 16.77 to 22.53 percent growth in the 1990 to 2000 decade.[17] The graph, *Population Growth by Ethnicity, 1980-2000*, illustrates the disparities in growth rate.

Population Growth by Ethnicity, 1980-2000



Population Growth by Ethnicity, 1980-2000

Race/Ethnicity	1980	1990	2000
Anglo	9,350,297	10,291,680	11,074,716
Black	1,692,542	1,976,360	2,421,653
Hispanic	2,985,824	4,339,905	6,669,666

Source: Austin Community College, Demographics Study

Finally, the changing demographics of the Border and of Texas as a whole are intimately tied to access to capital concerns, as Hispanics, the fastest growing demographic sector, have historically had the most difficulty accessing capital. In 1989, Blacks and Hispanics had a mean household income of $23,303 and $24,354 respectively compared to the mean income of Anglos, which was $40,680. Moreover, by 1999, Hispanic males' median income of $18,324 actually fell $3,477 from the level of earnings enjoyed in 1972, as measured in 1999 dollars. Over the same time period, Hispanic females' incomes remained essentially flat at around $10,000.[18]

For the Texas Border Region, expanded access to capital is even more critical. The Border suffers greatly on most socioeconomic indicators. If it made up a "51st" state, the 43 Border counties would rank 1st in percentage of adult population without a high school diploma, poverty, and unemployment.[19] Under current policies, the state demographer predicts that the

average Texas household income will decline about $5,000 to $6,000 by 2040.[20] The population growth and changing demographics, coupled with the dire need for expanded capital on the Border, demand action from financial markets and the State of Texas to increase access to capital and credit.

The Lending Environment in Texas

For families and communities to weather the unstable ebb and flow of the economy and move toward the future with certainty, the ability to rely on lending institutions to access capital is imperative. However, in Texas, limited access to capital is hindering stability and growth. Of the top twenty-five most populous states, Texas ranks third lowest in loan-to-deposit ratio.[21] Host state loan-to-deposit ratio is the ratio of total loans within a state to total deposits from the state for all banks with that state as their home state. Texas ranks second in population behind California and has a loan-to-deposit ratio of 75 percent, compared to California's 90 percent, meaning that Texas' financial institutions are essentially loaning out 75 cents for every one dollar deposited. In contrast, Indiana and Ohio both have loan-to-deposit ratios over 110 percent. In fact, Texas is actually ranked 44th among the 50 states for host state loan-to-deposit ratio in 2007, down from 45th in 2004.[22] The chart below, *Host State 2005 Loan to Deposit Ratios*, shows Texas' ratio in comparison to the 25 most populous states.

Host State 2005 Loan-to-Deposit Ratios
25 Most-Populous States

Ordered by Ratio (population in millions as estimated for January 1, 2007	2007 Ratio
Indiana (6.3)	116%
Ohio (11.5)	111%
Wisconsin (5.6)	107%
Georgia (9.5)	106%
Michigan (10.1)	106%
Washington (6.5)	103%
Arizona (6.3)	101%
Tennessee (6.2)	97%
Minnesota (5.2)	94%
Maryland (5.6)	93%
New York (19.3)	93%
Illinois (12.9)	91%
California (36.6)	90%
Florida (18.3)	90%
Missouri (5.9)	90%
South Carolina (4.4)	90%

Alabama (4.6)	89%
North Carolina (9.1)	87%
Massachusetts (6.4)	82%
New Jersey (8.7)	81%
Virginia (7.7)	80%
Pennsylvania (12.4)	79%
Texas (23.9)	**75%**
Colorado (4.9)	74%
Louisiana (4.3)	71%

Population Source: United States Bureau of Census, 2007 Population Estimates; Ratio Data: Federal Reserve, using data released June 12, 2007

The loan-to-deposit ratio is not a perfect measure for assessing the banking industry's performance in Texas, as there are several other factors that are not quantified in the ratio; however, as the ratio is an indicator of economic growth, Texas' low ranking is problematic. Texas appears to be a net importer of capital but does not generate capital for its own communities. Other high population states may be headquartering a large multi-state bank, so they import capital from other states; Texas, however, is not home to any multi-state headquarters.

To demonstrate how problematic a low ratio can be, The Perryman Group (TPG), an economic consulting firm in Waco, Texas, analyzed the strain on the Texas economy because of the low loan-to-deposit ratio. TPG estimated that in the year 2000, losses to the Texas economy due to the low loan-to-deposit ratio represented:

- $55.3 billion in annual Gross State Product;
- $31.7 million in annual personal income; and
- 670,803 permanent jobs.[23]

As a result of Texas' limited ratio, the state as a whole loses billions of dollars in critical business credit each year and suffers corresponding losses in output, income, and jobs. According to Ray Perryman of TPG, "if bank lending had been available in Texas on a par with the rest of the country, the overall output of the state would have been 7.4 percent higher; incomes of Texas workers would have been 7.1 percent higher; and employment would have been 6.7 percent higher."[24]

Changes in Lending Regulation and Practices

Lending institutions accumulate capital that can be loaned to individuals or businesses by collecting and holding deposits. The Federal Deposit Insurance Corporation (FDIC) reports that in 2007, over $329 billion in deposits were held by lending institutions across the state.[25] Over $183 billion, well over half the deposits, are held in banks headquartered outside of Texas.[26]

Texans deposit their money into traditional banks, savings banks and associations, thrifts and credit unions; they also rely on insurance companies, pension funds, and investment

companies for funds. Today, credit is increasingly being offered by non-traditional for-profit companies. These so-called "fringe" lenders may include check cashing companies, pawnshops, payday lenders, auto title lenders, and related financial services outlets. Such lenders are predominantly found in lower-income and minority communities where traditional depository institutions do not locate or have less flexible business hours. Though some representatives of non-traditional lending companies argue that they offer much-needed services in distressed areas, many community members and traditional financial service providers believe that fringe lenders can actually do damage in these communities.

Significant changes have taken place in the financial industry over the past few decades that require Texas to examine the availability of credit and capital. Among these changes is the 1999 passage of a federal financial modernization act known as the Gramm-Leach-Bliley Act (GLBA) which has a significant impact on consumers by making new lending arrangements possible. The Act allows companies to directly provide a new range of products that previously could only be offered by particular types of firms; in essence, since the passage of GLBA, new entities have entered the financial services market, broadening access but reducing regulation. Additionally, federal legislation now allows financial institutions to extend branches across state lines. These legislative changes, in tandem with changes in the practices and procedures of the banking industry, have had both positive and troubling outcomes for the economic environment of this nation.

Mergers and Expansions. The GLBA makes the consolidation of financial services companies possible and seems to be affecting the overall competition in the financial industry marketplace. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, which allowed nationwide bank branching, is also changing the shape of the market, by allowing banks to conduct business in multiple states. In fact, these two federal laws have created a very different lending environment, and the State of Texas must adjust its approach to regulation of financial services in order to fit into this new environment. In other words, in the age of multi-state banking, Texas must entice large banking corporations and institutions to choose to make Texas home, thus drawing deposits from other states and increasing the level of local lending in Texas communities.

Community Reinvestment. A longstanding federal law affecting the availability of credit and other banking services to underserved communities is the Community Reinvestment Act (CRA). Enacted in 1977, the Act is intended to prevent redlining and to encourage banks and thrifts to help meet the credit needs of all segments in their communities. Redlining is the practice of financial institutions defining their assessment areas along income levels in the community, thereby providing loans or services only in certain segments of a geographical area, while ignoring the financial needs of other parts of the community. The CRA was passed to support the policy that low and moderate income neighborhoods should have access to credit to the extent that a bank can conduct business in an area without unreasonably jeopardizing that institution's solvency.

In 1990, an amendment to the CRA required that all CRA evaluations be made public. Each bank and thrift must maintain a public file that contains the public section of its most recent CRA performance review, a list of its services and branches, and written comments from the

public. Unfortunately, CRA evaluations are not conducted at every branch of a multi-branch or multi-state bank. Thus, a branch of a bank may have been evaluated in North Dakota and the CRA record for that branch will represent multiple branches. In the changing banking environment, with the development of large financial services organizations and the spread of branches, finding CRA information that reflects a local community will become increasingly more difficult. As a result, it is not possible to ensure that low and moderate income communities have equal assess to financial services, despite the intent of the CRA.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Personal bankruptcies hit an all-time high in 2005, according to Lundquist Consulting, Inc., a bankruptcy analysis firm based in Middlesex, New York. Spurred by a new anti-debtor law going into effect late last year, more than 2 million Americans sought debt relief from Chapter 7 and Chapter 13 bankruptcy. On October 17, 2005, a new law took effect that represents a major reform in bankruptcy law. By restricting the availability of a discharge in Chapter 7 bankruptcy and substantially reducing the relief available in Chapter 13 bankruptcy, there will be far more hoops for the debtor to jump through to get a fresh start. The process will be more expensive for the debtor and the court system, and there will be an extended period of uncertainty as the players work their way through the changes. In a nutshell, the bill makes it more difficult to wipe out debt through bankruptcy by making it harder to file for protection under Chapter 7, which allows debtors to erase their debt almost entirely. Instead, as many as 100,000 debtors not meeting certain criteria would have to file Chapter 13, which requires debtors to repay a portion of their debt, according to the Consumer Federation of America.

Mortgage Lending

Home ownership is one of the strongest indicators of quality of life in our country, and building equity in one's home is one of the largest asset building mechanisms available to the average family. The textbox on the next page, *What is a Home Equity Loan,* explains this process which is available for some families. In fact, a Federal Reserve Board survey found that in 2004, home ownership represented 50.3 percent of gross assets for families earning $50,000 or less a year.[27] Despite the importance of home ownership, many Texans, especially in the Border Region, find that accessing the necessary credit to buy a home and build equity in a home is virtually impossible. In fact, Texas ranks 44th in the nation for homeownership, despite ranking 4th in home affordability.[28]

What is a Home Equity Loan?

Home equity is the current value of a home less the outstanding mortgage balance. Essentially, it is the amount of ownership that has been built by the holder of the mortgage through payments and appreciation. A home is typically bought through a mortgage. This mortgage is then paid off over a number of years, usually 15 or 30. Once the mortgage is completely paid off, the property belongs to the mortgagor (the buyer). In the interim, the buyer builds up equity in the home.

When a home owner needs an additional loan, one option is to get a home equity loan. This allows the homeowner to borrow against the equity accrued in a mortgaged home. Home equity loans offer significant tax savings due to the fact that the interest paid on the loan is tax deductible. They are often used to consolidate other debt with high interest rates, like credit card debt, to finance large expenses, or to purchase other costly items.

There are two types of home equity loans. The first, most commonly known as a second mortgage, lends out a lump sum of money that must be paid back over a fixed period. Funds borrowed from this loan start accruing interest immediately after the lump sum is disbursed. The second loan is the home equity line of credit, which provides the borrower with a check book or credit card that is used to borrow funds against the home equity on an ongoing basis. Funds borrowed from a home equity line of credit do not begin accruing interest until a purchase is made against the equity.

Texans have been able to borrow against the equity in their homes and use the funds for any purpose since 1998, when a constitutional amendment authorizing home equity loans took effect. No state agency currently has the authority to interpret home equity law, leaving the resolution of questions over the meaning of the law exclusively to the judiciary.

In Texas, factors preventing increased home ownership rates, equity accumulation, or access to adequate housing include: poverty, substandard housing conditions, high housing prices, and the over-use of subprime refinance loans. Additionally, the home-mortgage market has changed significantly since the 1980s when borrowers essentially went through one market for home mortgage loans. In the early 1980s, demand for mortgages exceeded supply. As more lenders were able to originate loans and sell them on the secondary market, however, the market evolved. Packages of home mortgages can be converted into securities and sold to investors. This process, known as securitization, offers much less risk for traditional lenders and is now widespread.

As a result of securitization, non-bank lenders entered the home-mortgage market. Because mortgages could be sold, lenders did not need significant deposits and financial reserves. Therefore, mortgage bankers, finance companies, and others can make and sell loans. The most promising customer base for such lenders exists where traditional banks are not currently located and where unmet demand might exist, typically among low or moderate income borrowers with some level of credit risk.

Subprime Lending

The liberalization of mortgage lending laws, coupled with a higher demand for housing capital, has led to a significant increase in subprime lending and niche market lending. The subprime lending market is an alternative market for accessing capital where the defining characteristics are higher rates and fees. According to the Federal National Mortgage Association (Fannie Mae), subprime mortgages are routinely three to four percentage points or more higher than a comparable prime market loan. Generally, subprime lenders are companies that make loans to borrowers with damaged credit. Borrowers labeled subprime may move and change jobs often, have no credit history or poor credit, and are often low-income individuals. Subprime lending for home purchases reached $140 million in 2000, up from $35 million in 1994.[29]

Texas homeowners and homebuyers are receiving significant amounts of mortgage credit from subprime lenders, generally headquartered in other parts of the country.[30] As of March 2002, Texas had a total of 1,212 subprime lenders.[31] The chart below, *Subprime Loans in Texas in 2000,* outlines the amount of subprime lending occurring in this state.

Subprime Loans in Texas in 2000		
Type of Loan	**Number of Loans**	**Total Value of Loans**
Home purchase	23,309	$2,082,169,000
Home improvement	2,795	$53,439,000
Refinancing (includes home equity loans)	25,195	$1,637,951,000
Source: Dallas Morning News, June 26, 2002, using Home Mortgage Disclosure Act data.		

The impact of a subprime loan on a borrower can be immense, as demonstrated by the chart on the next page, *Economic Consequences of a Subprime Home Mortgage Loan*. Each additional interest point on a home mortgage means tens of thousands of dollars on the total cost of a mortgage over the life of the loan. These higher payments reduce funds families have for education and other critical living expenses. Moreover, many subprime loans are made by unregulated lenders who are not prohibited from certain practices that can cost homeowners large sums in fees and penalties. In fact, prepayment penalties alone cost homeowners $1.3 billion annually in lost home equity. Such penalties can reach $7,500 on a $150,000 house, as federal regulations do not limit these amounts. While the Texas Constitution protects persons

who obtain home equity loans from such prepayment penalties, Texas does not have the same protections for non-home equity loans. The chart on the next page, *Economic Consequences of a Subprime Mortgage Loan,* describes the fiscal impact of this type of lending.

Economic Consequences of a Subprime Home Mortgage Loan				
30-Year Fixed-Rate Loan **House Value: $85,000** **Down Payment: $4,250 (5%)** **Loan Amount: $80,750**				
Annual interest rate	**Monthly payment**	**Annual payment**	**Annual difference from 8%**	**Lifetime difference from 8%**
8%	$ 592.51	$ 7,110.18	N/A	N/A
9%	$ 649.73	$ 7,796.79	$ 686.61	$ 20,598.43
10%	$ 708.64	$ 8,503.67	$ 1,393.49	$ 41,804.69
11%	$ 769.00	$ 9,228.01	$ 2,117.83	$ 63,535.05
12%	$ 830.60	$ 9,967.26	$ 2,857.08	$ 85,712.32
Source: Texas Low Income Housing Information Service, July 2002, using data from Fannie Mae.				

There are legitimate reasons for subprime loans. For example, a higher interest loan is the market's way of providing credit to borrowers who pose a greater risk of default. According to a September 13, 2005 Federal Reserve Board study, subprime loans have "greatly expanded the availability of home loans to borrowers who, because of weaknesses in their credit profiles, had previously been unable to qualify."[32]

Subprime mortgage loan originations surged by 25 percent per year between 1994 and 2003, resulting in a nearly ten-fold increase in the volume of these loans in just nine years.[33] In hard numbers, subprime mortgage-backed securities grew from $18 billion in 1995 to over $134 billion in 2002. Moreover, *Inside B&C Lending*, an online publication, estimates that a record $665 billion in new subprime mortgages were originated in 2005, a 25.5 percent jump from 2004's $530 billion in total production. The table *Increase in Loans Nationwide* shows that subprime lending has grown faster than prime lending in the past year, primarily due to the fact that subprime lenders continue to originate growing numbers of refinance loans.[34]

Increase in Loans Nationwide

	Number Originated in 2001	**Number Originated in 2002**	**Percent Increase**
Prime Loans	700,638	933,025	33%
Subprime Loans	6,073,987	8,062,713	25%

Source: ACORN

Despite the legitimate need for a subprime lending market, the rapid growth of that market is cause for concern. The increase in subprime lending is joined by a marked increase in home foreclosures. Over the last two decades, homeownership has increased by less than five percent, but foreclosures per home have jumped over 300 percent. In fact, according to the Mortgage Bankers Association, about one in every 15 subrpime loans were in foreclosure in 2003, or 6.6 percent of subprime loans, compared to .53 percent for prime loans.

Moreover, the rapid growth of the more expensive subprime market is attributed by many critics to misdirecting borrowers towards the subprime market. The U.S. Department of Housing and Urban Development (HUD) estimates that in any given year 30 to 50 percent of subprime borrowers nationally could have qualified for a prime loan. Using HUD's lower estimate of 30 percent, the Texas Low Income Housing Information Service (TLIHIS) estimates that in 2000 Texas homeowners overpaid $16 billion in home mortgage payments due to subprime rates, based on 20,767 subprime home purchase loans initiated that year.[35]

Subprime lending particularly plagues Texas' Border Region. A May 2002 national study provided startling data about subprime home refinance loans in the Texas Border Region. The study reports that several Texas Border cities have the highest rates of subprime home mortgage refinance loans in the nation, with El Paso ranking worst among the nation's 311 major cities.[36]

The chart on the next page, *MSA Ranking by Overall Percentage of Subprime Refinance Loans* shows that out of 331 MSAs nationwide, 11 out of the 30 MSAs with the largest percentages of subprime loans are in Texas; seven of these 11 are in the top 10, four of which are Texas Border cities. Nationally, subprime lending comprises about 25 percent of all refinance lending.

MSA Ranking by Overall Percentage of Subprime Refinance Loans

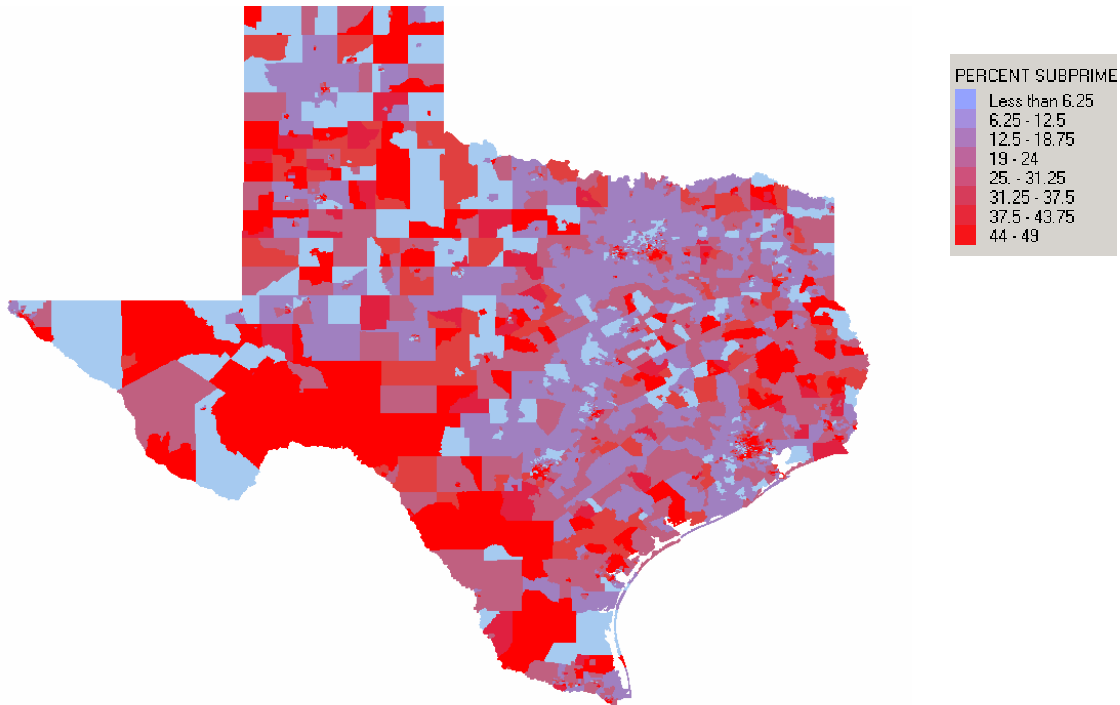
Rank	MSA Name	Population	Conventional Refinance Loans	Percent Subprime
1	**El Paso, TX**	**679,622**	**1,767**	**47.82**
2	**Corpus Christi, TX**	**380,783**	**1,061**	**46.84**
3	**Laredo, TX**	**193,117**	**342**	**45.32**
4	**Killeen-Temple, TX**	**312,952**	**683**	**44.80**
5	**Beaumont-Port Arthur, TX**	**385,090**	**1,160**	**44.48**
6	Miami, FL	2,253,362	10,701	42.67
7	Columbus, GA-AL	274,624	1,799	42.63
8	**San Antonio, TX**	**1,592,383**	**5,270**	**41.90**
9	Memphis, TN-AR-MS	1,135,614	7,577	41.86
10	**Galveston-Texas City, TX**	**250,158**	**944**	**41.63**
11	Fayetteville, NC	302,963	1,814	41.23
12	Enid, OK	57,813	427	40,75
13	Jamestown, NY	139,750	737	40.71
14	Rocky Mount, NC	143.026	872	39.68
15	Buffalo-Niagara Falls, NY	1,170,111	5,218	39.36
16	Daytona Beach, FL	493.175	3.477	38.77
17	Danville, VA	110,156	802	38.53
18	**McAllen-Edinburg-Mission, TX**	**569,463**	**1,345**	**37.62**
19	Sumter, SC	104,646	734	37.33
20	**Victoria, TX**	**84,088**	**220**	**37.27**
21	Goldsboro, NC	113,329	681	37.00
22	Lakeland-Winter Haven, FL	483,924	3,234	36.92
23	Florence, SC	125,761	963	36.55
24	Pine Bluff, AR	84,278	364	36.54
25	New York, NY	9,312,235	23,104	36.50

26	Orlando, FL	1,644,561	10,275	36.18
27	Hickory-Morganton-Lenoir, NC	341,851	3,481	36.08
28	Charlotte-Gastonia-Rock Hill, NC-SC	1,499,293	14,789	36.07
29	**Brownsville-Harlingen-San Benito, TX**	**335,227**	**795**	**35.97**
30	**Houston, TX**	**4,177,646**	**14,552**	**35.70**

Source: Texas Low Income Housing Information Services, using data from the May 2002 *Risk or Race? Racial Disparities and the Subprime Refinance Market* report by the Center for Community Change.

Subprime lending does not only occur in the Border Region. In fact, as the map, *Subprime Lending Across Texas*, on the next page shows, subprime lending spans the state of Texas.

Subprime Lending Across Texas



Source: ACORN

The growth in subprime loans may be accounted for, in part, by the lack of availability of prime lenders in parts of Texas. As the chart, *Number of Home Purchase Loan Originations by Lender Type in 2000*, shows, prime loans accounted for 62 percent of all home purchase loans in Texas, for a ranking of 37th nationally.

Number of Home Purchase Loan Originations by Lender Type, 2000				
State	**Number of Loans**	**Prime Lenders, Conventional Loans**	**Prime Lenders, Government Insured Loans**	**Subprime Lenders, All Loans**
California	605,632	430,040	101,791	65,983
Florida	374,918	268,855	65,714	28,194
Texas	368,880	228,479	85,370	20,767
Illinois	208,326	155,626	36,419	13,695
New York	183,827	140,780	29,174	10,184
Source: Texas Low Income Housing Information Services, July 2002, using data from the May 2002 *Risk or Race? Racial Disparities and the Subprime Refinance Market* report by the Center for Community Change.				

The lending market has changed considerably over the past few decades, bringing new types of lenders into the market and expanding available avenues for accessing credit and capital. However, dangers lurk for uninformed consumers looking to access capital and credit. Paying higher fees and interest rates to own a home leaves consumers struggling to realize the American dream of homeownership.

What makes a subprime loan "predatory"?

It is important to establish that not all subprime loans are "predatory". Because these loans are targeted at people with imperfect credit histories, the subprime lenders can legitimately charge a higher interest rate than a conventional bank loan as a way to compensate for added risk. Nevertheless, empirical studies have shown that there is a weak correlation between the interest rate paid by the subprime borrower and the financial losses wrought by default. In other words, interest rates are extraordinarily high for reasons other than credit risk. A study by Alan M. White for the Fannie Mae Foundation shows that actual losses due to default compose less than one percent of the outstanding loan balance per annum.[37] Clearly, the risk of lending to a person with weak credit is not the only factor that influences the interest rate for subprime loans.

It is when the interest rate exceeds the amount it would take to offset risk that a subprime loan can be considered "predatory". Of course, subprime lending has many distinguishing characteristics. One of these characteristics is prepayment penalties. Experts estimate that roughly 80% of all subprime lenders contain prepayment penalties, which lock the borrower in a higher interest rate even when that person has improved his/her credit score and is in a better position to pay off the principal. Prepayment penalties cost borrowers thousands of dollars in interest payments that would have been avoided in a conventional prime loan.[38]

Subprime Lending On the Border

In the report, *The Border Effect-Subprime and Predatory Lending on the Texas-Mexico Border,* Michelle Marie Milner analyzes the current empirical studies released on

subprime lending in the Borderlands. The Report shows that Texas as a whole has seen a spike in subprime lending, but the occurrence of such lending is especially pronounced along the Mexican border.[39] One of the studies citied in Milner's report, A 2002 study by the Center for Community entitled, "Risk or Race: Racial Disparites in Subprime Mortgage Lending" found that 42.2% of mortgages on the Border were subprime.[40] The study also found that Blacks and Hispanics were disproportionately represented as holders of subprime mortgages.[41] The following charts compare the occurrence of subprime lending in Texas MSAs:

Subprime Home Refinance Loan Incidence in Border MSAs 2000

	Rank	Total Refinance Loans	Total Subprime Loans	Percent Subprime
El Paso	1	1767	845	47.8
Laredo	3	342	155	45.3
McAllen[77]	18	1345	506	37.6
Brownsville[78]	29	795	286	35.9
		4249	1792	42.2%

Adapted from: Calvin Bradford, *Risk or Race? Racial Disparities and the Subprime Refinance Market.* (Washington, D.C.: Neighborhood Revitalization Project of the Center for Community Change, May 2002), p. 28. Online. Available: http://www.communitychange.org.

Home Refinance Subprime Loan Incidence in Texas MSAs 2000

	Rank	Total Refinance Loans	Total Subprime Loans	Percent Subprime
Corpus Christy	2	1061	497	46.8
Kileen/Temple	4	683	306	44.8
Beaumont/P.Arthur	5	1160	516	44.5
San Antonio	8	5270	219	41.9
Galveston/Tex City	10	944	393	41.6
Victoria	20	220	82	37.3
Houston	30	14552	5195	35.7
Sherman/Dennison	34	509	179	35.1
Amarillo	41	961	328	34.1
Lubbock	45	711	241	33.9
Brazoria	50	829	277	33.4
Wichita Falls	57	412	135	32.4
Texarkana	65	463	148	31.9
San Angelo	71	293	91	31.1
Dallas	75	13276	4049	30.5
Longview/Marshall	78	651	198	30.4
Tyler	94	540	158	29.3
Austin/San Marcos	113	5709	1599	28.0
Odessa/Midland	116	663	185	27.9
Waco	117	564	157	27.8
Ft.Worth/Arlington	143	6485	180	26.1
Abeline	144	292	76	26.0
Bryan-Coll. Station	259	3174	594	18.7
		59,422	15,803	26.6%

Adapted from: Calvin Bradford, *Risk or Race? Racial Disparities and the Subprime Refinance Market.* (Washington, D.C.: Neighborhood Revitalization Project of the Center for Community Change, May 2002), pp. 28-34. Online. Available: http://www.communitychange.org

Small Business Lending

Business ownership is an important factor in Texas' economy, and access to capital and credit are essential for the creation and growth of successful businesses. Businesses generate employment in the areas in which they locate, thereby increasing income that fuels the economy. In fact, small businesses create 60 to 80 percent of all new jobs in any given year, according to the Small Business Association. Moreover, the overall Texas economy is dependent on the

success of small businesses in particular, as such businesses employ about 52 percent of the workforce.[42] Given the overwhelming presence of small business in the business sector, there is no question that maintaining a healthy economy relies in part on maintaining accessible avenues of capital for small business owners.

Meeting the Capital Needs for Texas' Small Businesses

There were approximately 25 million small businesses in the United States in 2004, according to the Small Business Administration. In Texas there are over 440,000 small businesses, defined by the Finance Commission of Texas as non-agricultural, non-depository, for-profit firms operating with 100 or fewer employees. According to the Finance Commission, most small businesses in Texas are retail and service oriented, generating revenues of less than $500,000. They are likely to have small payrolls of less than ten employees under a sole proprietorship structure.[43]

In 2003, lending institutions loaned over $275 billion to small businesses across the county. In all loan size categories, large banking institutions issued the majority of loans to small businesses. Despite the 800,000 loans issued to small businesses in 2003, not all small businesses can access necessary capital. In some Texas communities, a small business has a much greater chance of obtaining funding than it might in other communities.

Lending decisions are based on many factors, and analysis is required to determine and compare lenders' performance, but these differences can result in some communities having better economic environments than others. The chart on the next page, *Comparison of Seven Regions in Texas: Small Business Lending by Commercial Banks, 2000*, shows the differences in amounts of small business loans per capita. The variations show that even when population is accounted for, small business owners in some communities appear to have less access to capital.

Comparison of Seven Regions in Texas: Small Business Lending by Commercial Banks, 2000

MSA	Number of loans	Amount of Loans ($000)	Number of Loans Per Capita	Amount of Loans Per Capita
El Paso	7,272	191,937	0.0107	$282.42
Corpus Christi	6,052	163,590	0.0159	$429.61
San Antonio	24,567	708,340	0.0154	$444.83
Brownsville/Harlingen/ San Benito	4,860	166,883	0.0145	$497.82
McAllen/Edinburg /Mission	7,756	316,784	0.0136	$556.29
Austin/San Marcos	25,989	793,885	0.0208	$635.23

Source: Testimony of Mayor Ray Caballero, City of El Paso, to the Subcommittee, on Senate Business and

Commerce Committee, Interim Charge #4. May 2002. Data collected from Census Bureau and Federal Financial Institution Examination Council.

Factors Influencing the Flow of Small Business Capital

Mergers and Acquisitions

Recently, banks, bank holding companies, and other lending institutions have begun to merge, creating giant conglomerates that struggling small business owners must face in trying to access much needed capital and credit. A February 12, 2004 report by the United States Small Business Administration Office of Advocacy states that bank consolidation can limit small business access to credit. In regions with high levels of consolidation, the study found reductions in small business access to bank credit, especially in credit limits.[44] The chart on the next page, *Comparison of Market Shares for Deposits, Amount of Small Business Loans in Selected Texas Markets,* illustrates the correlation between large market shares held by the huge banking institution that was created by the merger of JP Morgan Chase and Bank One in Spring 2004 and the amount of small business lending for that area. It is clear that the amount loaned out to small businesses is far less than the amount of local deposits held. As small businesses are a driving force for local economies, it is imperative that lending institutions support them.

Comparison of Market Shares for Deposits, Amount of Small Business Loans in Selected Texas Markets

(Business Loans to Entities with less than $1 million in Revenue)
As of June 30, 2003

Market	Deposit Share for Chase and Bank One	Dollar Share in Small Business Loans
Austin	20.81%	8.57%
Dallas	21.97%	11.58%
Fort Worth	21.54%	7.96%
San Antonio	4.50%	5.58%
Houston	42.99%	12.78%

Source: Deposit Share information, Texas Department of Banking

Bank Branch Locations and Creating Relationships with Lenders

For small businesses trying to access capital through traditional lending sources, one of the most important tools available is the relationship the business owner can develop with the lender. Small businesses trying to satisfy the criteria to qualify for loans face great challenges because many do not have the publicly available, transparent information for lenders to review. Therefore, in credit approval gathering information about the firm's owner becomes just as important as gathering information about the firm itself. Lenders find that developing a working relationship with a firm head allows the lender to have a better understanding of the business operations and potential.

Where bank branches are located is an important determinant in small business lending patterns. CRA requirements and guidelines ensure that banks provide services to customers in their assessment areas; further, banks must identify their assessment areas in terms of their location. In other words, a bank must serve its neighborhood. Because of these statutory requirements that lending institutions must serve their local communities, as branches spread and move to new neighborhoods, new relationships are developed. Customers from low and moderate neighborhoods who are now getting the opportunity to create relationships with their local bank are increasing their access to lending.

Credit Scoring and Securitization

Credit scoring is a system creditors use to help determine whether to extend credit to a borrower. By implementing a formula, the goal is to reduce the inherent biases of lenders' decision makers. Information about the borrower's credit experiences, such as bill-paying history, the number and type of accounts held, late payments, collection actions, outstanding debt, and the age of accounts, is collected from a credit application and a credit report. Creditors compare this information to the credit performance of consumers with similar profiles and awards points for each factor that helps predict who is most likely to repay a debt. A total number of points -- a credit score -- helps predict how creditworthy the borrower is.

Credit securitization, where pools of loans are used as collateral for securities that are then purchased by investors, does not yet account for a large amount of small business credit, and it is not clear how securitization will ultimately affect small business lending.

The inflexibility of credit scoring and securitization could very easily result in arbitrary and unreasonable decisions as to which borrower a bank chooses to finance. Business lending decisions necessarily must be based on a wide array of criteria, ranging from the owner's history, to the economic environment, to the sector or industry market in the area.

A Small Business' Ability to Provide Financial Information and a Credible Business Plan

Lenders consider a number of factors in assessing a business' worthiness for a loan. They evaluate the supporting financial information submitted by the business, the availability of collateral that can be offered as security, indications of the business' ability to succeed in the future, and related items. Successful borrowers can demonstrate their viability as a borrower through their business plans and the thoroughness of their applications. Business owners who lack access to accounting systems or specialists in law, accounting, and other professions could be at a disadvantage in obtaining credit.

The success of small businesses is paramount to the development and maintenance of a healthy Texas economy. For the small business sector to succeed as a whole, capital and credit must be made readily available. While lenders certainly need to maintain the autonomy to assess borrowers and lend according to sound business standards, capital still needs to reach the pockets or tills of small businesses. The financial community, the State, and local communities must work to help small businesses gain access to capital and succeed.

Predatory Lending

Market changes in the financial services industry that have given more people access to a wider variety of services have also created a complex web of available services that can be confusing to even the most savvy consumer. The complexity of the emerging financial services market creates a particular danger for the uninformed or inexperienced borrower who may enter into lending arrangements that give him no net financial benefit, cause him to pay more than necessary given his credit risk, and potentially lead to foreclosure, bankruptcy, and the loss of his home. This complexity and the abuse of inexperienced borrowers have created one of the most critical policy issues facing the financial services industry and the regulatory agencies charged with monitoring that industry – predatory lending.

There is no thorough definition of what constitutes predatory lending. Instead, it is usually defined in terms of lending practices that, in combination, are said to impose substantial hardships on the borrower with little or no accompanying benefit. Developing a clear understanding of predatory lending is difficult because of the complexity of determining the appropriate level of fees and costs for a given level of risk. Generally speaking, predatory lending is characterized by excessively high interest rates or fees, harmful loan terms, including balloon payments, large pre-payment penalties and underwriting that ignores a borrower's ability to repay the loan, and abusive or deceptive practices. Identifying an excessively high rate or fee as opposed to one that is appropriate, given a borrower's credit rating, is very subjective, however. While traditional loans result in fees that are about one to two percent of the loans, excessive fees can total up to eight percent of a traditional loan. For certain types of loans, some lenders try to justify charging fees that total almost as much as the loan itself. Still, lenders argue that the risk associated with certain loans justifies the addition of high fees.

Additionally, extremely high interest rates can signal predatory lending practices. Excessive interest rates indicate that the loan is high risk, but no risk should justify an interest rate so high that paying back the loan becomes impossible. In scenarios where the rate is this exorbitant, it is more prudent for the borrower to be turned down for a loan than to take the loan, default, and then be in a less stable economic situation. However, where we see the highest interest rates are in lending situations that cater to the most vulnerable borrower.

Finally, the practice of referring borrowers to the higher interest subprime market is particularly insidious because those borrowers least afford to be stripped of their equity or life savings and have the fewest resources to defend themselves against predatory practices. Speculation that the subprime market is a breeding ground for predatory lending rings true when statistics show that subprime lending is disproportionately concentrated among minorities, low-income, and elderly homeowners.[45] Many in the industry argue that the disproportionate concentration is only a reflection of the greater risk posed by these borrowers based on their credit ratings; Fannie Mae, on the other hand, has stated that the racial and economic disparities in subprime lending cannot be justified by credit quality alone. According to Fannie Mae, loans to lower-income borrowers perform at similar levels as loans to upper-income people, and recent research has shown that once the lower prepayment risk is taken into account, mortgages to low- and moderate-income borrowers perform better than other mortgages.[46] In other words, low- and moderate-income borrowers do not pose a greater risk of default than upper-income borrowers.

The Relationship Between Subprime Lending and Predatory Lending

While not all subprime lenders engage in predatory practices, these problems do pervade much of the subprime industry. In 2002, two of the largest subprime mortgage lenders – Household Financial Corporation and The Associates – announced settlements of $484 million and $240 million, respectively, for engaging in predatory lending practices. Both cases assert claims regarding the sale of credit insurance in connection with mortgage loans and personal loans. The Household settlement requires the company to provide restitution to borrowers and modify its future loan procedures. In addition to ceasing the sale of credit insurance, Household will also limit prepayment penalties on home loans to the first two years of the loan, limit points and origination fees to 5 percent, and improve disclosures made to consumers.

The Associates case settles claims brought against the lender by the Federal Trade Commission (FTC), and a nationwide class action settlement of litigation brought in California by private litigants. The FTC charged that The Associates, one of the nation's largest subprime lenders, engaged in systematic and widespread deceptive and abusive lending practices. Further, the class action suit alleged that The Associates packed mortgage loans with unwanted and unnecessary insurance products and engaged in improper loan refinancing practices. In addition to the prohibited settlement provisions, Citigroup Inc., who acquired The Associates in 2000, voluntarily adopted a series of consumer-oriented initiatives meant to address any lingering public opinion concerns. These two settlements are the largest in American history for any type of consumer complaints, and indicate a changing regulatory environment in which predatory lenders will be held accountable for their actions. However, they still fall horribly shy of the amount of financial damages inflicted on vulnerable borrowers.

Types of Predatory Lending

Payday Loans. Predatory lending practices are more widespread than just high interest rates or high mortgage fees. Payday loans are one of the more prominent and prolific forms of abusive lending. Deferred presentment transactions, or payday loans, are designed to be short term, emergency loans for people who have no alternative. By catering to the most vulnerable community of borrowers, payday lenders have free reign to charge excessive interest rates without concern that their customers will reject the services. In fact, many payday loans result in triple digit percentage rates because the borrowers are identified as extremely high-risk, and lenders feel justified in charging incredibly high interest rates. The financial burden on the borrower and the damage to his credit if the check bounces create a serious pressure on the borrower to refinance loans he cannot pay back, creating an onerous cycle of increasing fees. The chart on the next page, *Payday Loan Rates*, outlines the typical interest rates associated with these loans.

Payday Loan Rates

Loan Amount	Equivalent Rate – 7 days	Equivalent Rate – 10 days	Equivalent Rate – 14 days
$ 100	569.92%	413.55%	309.47%
$ 150	396.29%	292.00%	222.48%
$ 200	309.47%	231.23%	178.98%
$ 250	257.17%	194.62%	152.99%
$ 300	222.48%	170.33%	135.57%
$ 350	197.70%	152.99%	123.13%
$ 400	178.98%	139.89%	113.87%
$ 450	164.54%	129.78%	106.60%
$ 500	152.99%	121.69%	100.79%

Research shows that the payday lending business model is designed to keep borrowers in debt, not to provide one-time assistance during a time of financial need. According to a December 2003 Center for Responsible Lending study of payday lending industry data, borrowers who receive five or more loans a year account for 91 percent of the lenders' business. In fact, payday lenders collect the vast majority of their fees from borrowers trapped in a cycle of repeated transactions, where borrowers are forced to pay high fees every two weeks just to keep an existing loan outstanding that they cannot afford to pay off.[47]

Members of the military and their families are prime targets for payday lenders. Military personnel are paid regularly, never get laid off, and face penalties for failing to repay debts, making them a wise investment for payday lenders because the chances of default are very slim. Lenders know they will recoup their money because they can call the commanders of soldiers who do not pay their debts. Soldiers who do not pay can face a court-martial and, in some cases, can be discharged. In 2005, Senator Shapleigh was able to protect Texas' military personnel and their families from predatory payday lenders with the passage of S.B. 1479. S.B. 1479 prohibits lenders from taking certain actions against military personnel, including barring collection activities during deployment and requiring lenders to make disclosures to military customers regarding these restrictions.

The Air Force has recently stepped in to curb the influence of payday lenders. The Air Force Aid Society has begun to offer its own short-term loans to members of the Air Force who are having trouble meeting monthly expenses. The Society's new Falcon Loans offer as much as $500 interest-free loans to meet essential payments such as food, rent, utilities, emergency travel, or repairs. No permission from superior officers is necessary to receive a Falcon Loan, eliminating the risk of court martial that is often associated with defaulting on payday loans.[48]

Despite the lax regulations in the general community and the ability to prey on vulnerable borrowers without much oversight, payday lenders in Texas continue to grab for more

opportunity. In the 78th Legislature, an industry-supported "regulation" bill was introduced that would have actually allowed lenders to legally charge over 800 percent annual percentage rates. The bill was created and supported by the industry in anticipation of coming regulations at the federal level. By creating "regulations" in Texas, lenders could argue that no federal rules are needed because states are meeting that need. However, when compared to the current environment in Texas, the bill was exposed as a wolf in sheep's clothing. Current regulation allows up to 222 percent interest rates on these loans, which is problematic in and of itself, but far better than the proposed 800 percent rates. Moreover, the bill did nothing to protect Texans from out-of-state lenders setting up shop in Texas and not abiding by any of our State's lending protections and would have created a false sense of consumer protection.

The industry-backed bill failed when a majority of Texas Senators, rallied by Senator Shapleigh, agreed to block its passage. However, a few months later, the industry found another way to avoid potential regulation. In July 2005, Texas-based payday lenders regrouped as businesses operating under Texas' Credit Service Organization Act. As a Credit Service Organization (CSO), a payday lending company dodges both federal guidelines restricting payday loans and the interest rate limits established by the Texas Finance Commission (TFC).

Prior to the July business model changes, virtually all Texas-based payday lenders operated under the "rent-a-bank" model, partnering with banks headquartered in other states with lax or no usury laws. Under that model, payday lenders, claiming to work as brokers, were able to evade Texas usury laws and other state lending regulations. While this previous model has been incredibly lucrative for payday lenders, who were free to charge exorbitant interest rates and do business with virtually no regulation, recent FDIC regulations and recent actions by state regulators around the country have begun to chip away at the free-reign of the payday lenders.

The proposed bill last Spring would have tripled the interest rates that payday lenders could charge under Texas law and eliminated the need for an out-of-state bank partner, thereby eliminating the pressure to comply with new FDIC guidelines. This defeat, along with a recent Eleventh circuit court decision to uphold a Georgia law prohibiting the "rent-a-bank," prompted payday lenders to change tactics and adopt the CSO model. According to a letter by the Attorney General of Texas, state law will have to change to close this predatory lending loophole.

Loan Flipping. Another practice, known as loan flipping, is commonly carried out through non-traditional lenders. On *ABC News*, *Prime Time Live* a most egregious incident of loan flipping was disclosed in 1997.

> *"…an elderly gentleman who had never learned to read or write wanted to purchase meat on credit. A home equity lender loaned him the money…The gentleman did not understand he was mortgaging his home and pledging 50 percent of his monthly income. Seventeen days later, the lender contacted the gentleman again and convinced him to take out a larger loan, at a higher rate of 19 percent, to pay off all his debts. The gentleman was 'flipped' again in 42 days and again 26 days later. Each time he was charged a 10 percent financing fee… He was flipped 11 times in less than 4 years. By the time he*

was interviewed…he had a $50,000 mortgage on his home, which he had owned free and clear, and $25,000 of this amount was financing fees."[49]

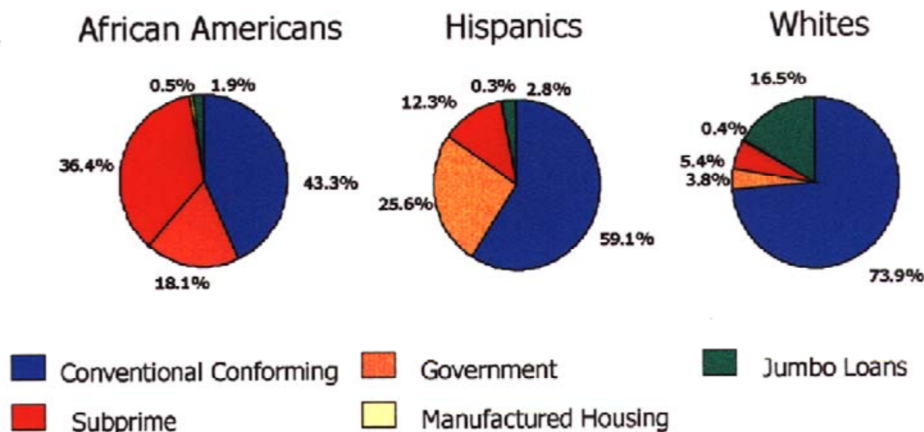
This is an unfortunate example of the industry preying on the elderly, who often are not given complete information.

Targeting Minorities. Targeted marketing to households on the basis of race, ethnicity, age, gender, or other personal characteristics unrelated to creditworthiness, unreasonable or unjustified loan terms, and outright fraudulent behavior often indicate predatory lending[50]. In Texas, there are indications that targeting minorities for higher interest rate loans is a regular practice. African-Americans and Hispanics still have homeownership rates that are significantly lower than rates for the general population--about 48 percent compared to the national rate of 68 percent.

While lending patterns do vary by geographic location, the disproportionate level of higher interest rate loans in minority areas is troubling. In urban areas and in high African-American census tracts around the country, lending is dominated by government programs such as FHA and/or by subprime lenders.

A recent study, *Risk or Race? Disparities and the Subprime Refinance Market*, substantiates that minority borrowers, specifically Hispanics and African Americans, historically suffer from the highest percentages of subprime home refinance loans. The chart below, *Subprime and Government Loans Dominate Minority Lending Across the Nation*, demonstrates the high levels of subprime lending to minorities, with 12.3 percent of Hispanics receiving loans from subprime lenders, compared to only 5.4 percent of Whites.

Subprime and Government Loans Dominate Minority Lending Across the Nation



Source: Michael T. Hernandez, March 14, 2002, Report to the Subcommittee on Interim Charge 4, of the Senate Business and Commerce Committee.

Due to the particularly large population of Hispanics in the Border Region and Texas as a whole, high rates of subprime lending to minorities have profound implications for these areas. In fact, of the ten MSAs with the largest percentages of subprime loans made to Hispanic borrowers, six are in Texas.

Percentage of Subprime Refinance Loans for All Hispanic Census Tracts				
Rank	**MSA**	**Population**	**Number of Conventional Refinance Loans**	**Percent Subprime**
1	Corpus Christi, TX	380,783	118	75
2	San Antonio, TX	1,592,383	678	60
3	El Paso, TX	678,622	534	59
4	Albuquerque, NM	712,738	210	52
5	Laredo, TX	193,117	267	48
6	Brownsville-Harlingen, TX	335,227	229	43
7	McAllen-Edinburg, TX	569,463	649	42
8	Tucson, AZ	843,746	225	41
9	Miami, FL	2,253,362	1,919	41
10	Orange County, CA	2,846,289	101	38
Source: John Henneberger, Texas Low Income Housing Information Services, using data from the May 2002 *Risk or Race? Radical Disparities and the Subprime Refinance Market* Report by the Center for Community Change				

Though some representatives of non-traditional lenders argue that they offer much needed services in distressed areas where traditional lenders are inaccessible, many community members and traditional financial service providers assert that fringe lenders do nothing to help build wealth in their communities. The irony of the decry of the traditional lender rests in the fact that it is the inaccessible nature of the mainstream lending market that has led to the proliferation of fringe lenders and the growth of predatory lending. As James Carr in a report for the Fannie Mae Foundation said, "Predatory lending is an outlying consequence of the ineffectual financial markets that exist in many lower-income and minority communities. Predatory lending practices thrive in an environment where competition for financial services is limited or lacking, and where excessive marketing of subprime loans and fringe financial services are occurring."[51] Mainstream financial service companies may denounce predatory lending and nontraditional lenders, but the mainstream market is, in essence, reason for its proliferation.

Pawnshops and Sale/Leaseback Agreements. In the 1980s, Congress and most states threw out interest-rate caps and other vital protections. Supporters of deregulation said it would spark competition and drive rates down. While deregulation did spark competition, studies show that the competition is more about who can charge the most. Since deregulation, fringe lenders and potential predatory lenders have exploded onto the scene. Today all but two Southern states allow pawnshops to charge annual rates of 240 percent on loans. The number of pawnshops has doubled in the past decade to about 10,000. At least five pawn chains are publicly traded.

"Rent-to-own" stores have replaced small neighborhood merchants with a new, cleaner look…and higher prices. These stores sell TVs and furniture on installment plans at prices that consumer advocates say equal interest rates of 100, 200, even 300 percent. The number of rent-to-own stores has grown from about 2,000 to 7,500 since the early 1980s. While not overtly predatory, like loan flipping, pawnshops, "rent to own" stores, and sale/leaseback businesses still prey on the vulnerable borrower with poor or no credit history.

High Interest Credit Cards. Credit cards have become a common form of currency for millions of Americans. Between 1989 and 2001, according to the Center for Responsible Lending, credit card debt in the U.S. almost tripled from $238 billion to $692 billion.[52]

While some cardholders use their credit for occasional purchases, working families of limited means have come to rely on "plastic" to weather economic downturns or to simply make ends meet. College students and other minors have also become attractive targets for the marketing of cards that contain hidden transfer charges, exorbitant late fees and exploding interest rates. In effect, the credit card industry has identified its ideal customers as those who no longer pay off their balances, but instead grow increasingly indebted to their creditors by making inadequate minimum monthly payments.

Average card debt per household with at least one credit card topped $9,300 in 2004, more than triple the average in 1990. Consumer bankruptcies have skyrocketed from 287,463 in 1980, the dawn of card-industry deregulation, to just over 1.5 million in 2004. And, changing laws and regulations have given credit card companies virtual carte blanch to charge fees and fines. Universal default, allowing all creditors to raise interest rates if a borrower is late on any payment, and limitless late fees are just two examples of how credit card lenders are predatory.

Fighting Predatory Lending

Predatory lending has been publicly denounced by almost every federal financial services regulatory agency and is included on the legislative agendas of many consumers' and special interest groups. In Texas, the Consumer's Union, Appleseed Texas and the AARP have all declared predatory lending to be a major concern for their constituents.

Moreover, the United States Congress and several states have also attempted to curb predatory lending practices through legislative action, and some courts are beginning to side with consumers against lenders using abusive practices. Laws that specifically relate to predatory lending include:

- the federal Fair Housing and Equal Credit Opportunities Act, 15 U.S.C. §1691c(c), which prohibits discrimination against applicants for credit on the basis of age, race, sex, marital status, or other prohibited factors;
- Section 5 of the Federal Trade Commission Act, 15 U.S.C. §45, which prohibits unfair or deceptive acts or practices in or affecting commerce; and,
- the Home Ownership Equity Protection Act (HOEPA).

HOEPA is the most comprehensive statute for addressing fair lending in high-cost loans secured by homes. In response to the anecdotal evidence about abusive practices involving high-

cost home secured loans, in 1994, the Congress enacted the HOEPA, which imposes disclosure requirements and substantive limitations (for example, restricting short-term balloon loans) on home-equity loans with rates or fees above a certain percentage or amount. The law, as amended by the Federal Reserve Board in 2001, regulates first-lien mortgage loans if the Annual Percentage Rate (APR) exceeds the rate for treasury securities with a comparable maturity by more than eight percentage points.

Additionally, some predatory lending practices might violate various federal and state consumer protection laws like the Truth in Lending Act, which requires certain disclosures and establishes substantive requirements in connection with consumer credit transactions. Every state has adopted at least one statute that generally prohibits unfair or deceptive business practices. These statutes are usually broad and interpreted liberally; therefore, they can be used for attacking alleged abusive lending practices. Moreover, some states do attempt to regulate the lending industry in a way that protects consumers. For instance, Chapter 342 of the Texas Finance Code includes some general measures meant to protect consumers against problematic lending practices. Unfortunately, Chapter 342 is overly broad in some areas and includes multiple exceptions that leave great loopholes in the regulatory scheme.

Although these laws represent advances, still, determining which law covers which practice is difficult. Unfortunately, the laws do not clearly define what acts are illegal and do not cover many abusive or coercive acts. The complex regulatory environment of the United States' dual banking system leaves great gaps in oversight and regulation.

Federal Preemption

In general, state laws apply to the operations of national banks. As far back as 1869 and as recently as 1997, the United States Supreme Court affirmed that national banks "are subject to the laws of the State, and are governed in their daily course of business far more by the laws of the State than of the nation."[53] While federal regulatory control over banking has expanded over time, the Supreme Court affirmed in Atherton v. FDIC, 117 S. Ct. 666 (1997), that historically, its decisions have held federal banks subject to state law.

However, a state law is preempted, and does not apply to national banks, if it creates a direct conflict with a federal law, discriminates against national banks, or significantly interferes with or places an undue burden on the authorized activities of national banks. Under the Supremacy Clause of the United States Constitution, when the federal government acts within the sphere of its authority, federal law is paramount over, and preempts, inconsistent state law. Although the nature and degree of inconsistency necessary to require preemption has been expressed in a variety of ways, the controlling issue has been summarized as whether, under the circumstances of a particular case, the state law may "stand as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[54]

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the Riegle-Neal Act) establishes specific rules to govern the applicability of certain types of state laws to the interstate operations of national banks and out-of-state banks. Under this Act, the laws of a host state concerning community reinvestment, consumer protection, fair lending, and the

establishment of intrastate branches apply to each host state branch of an out-of-state national or state chartered bank “to the same extent as such State laws apply to a branch of a bank chartered by that State.”

The Office of the Comptroller of the Currency (OCC) is the agency responsible for ensuring, through examinations and administrative enforcement proceedings, that national banks comply with federal and state laws. Therefore, unless expressly authorized by federal law, states do not have authority to examine national banks, or to take administrative actions for the purpose of enforcing state law against national banks. However, it is also clear that authorized state officials can bring judicial actions (e.g., actions for declaratory or injunctive relief) to enforce their laws against national banks.[55]

However, in January of 2004, states' rights to combat abusive lending practices were further limited through the expansion of federal control. In January 2004, the OCC issued a rule identifying types of state laws that are preempted for national banks, including mortgage lender/broker licensing laws and anti-predatory lending laws. In addition, the OCC has reserved for itself enforcement of all rules against national banks and their operating subsidiaries. State regulators no longer have authority to pursue wrongdoing in this area against these entities.

In essence, Texas is now barred from licensing, examining, and otherwise regulating state-chartered corporations that are subsidiaries of national banks. This shields non-banking firms like title companies, finance companies, leasing companies, and mortgage brokerages that are owned by national banks from state licensing and examination requirements that ensure professional conduct and protect consumers.

Moreover, Texas is no longer able to respond to local economic needs. Instead, the OCC preemption has undermined states laws and state oversight, thus eliminating the unique American dual banking system and moving America towards a centralized, European-style regulatory model. This "one size fits all" approach requires problems in one or a few states to be solved with federal legislation applicable to all states. Such an imbalance threatens the viability of the states' historic role in serving as laboratories for innovation in new products and consumer protection, as well as a safety valve against the imposition of out-dated or rigid regulatory control.

Nationwide Crackdown on Payday Lending

Due to the negative social costs associated with payday lenders, many states are beginning to place strict regulations on such businesses. The New Hampshire Senate recently passed a 36% cap on annual interest rates, placing New Hampshire among almost a dozen other states that have capped rates at around 36%. According to the Center for Responsible Lending, such a cap on interest rates is the only proven way to end the common practice of trapping borrowers into a long-term cycle of high-interest debt. Other states, such as Virginia and Kentucky, are forcing payday lenders to reduce their loan costs at the risk being shut down. A new Virginia law, if signed by the Governor, would reduce payday costs by 18%, making the typical payday lending firm in Virginia 15% less profitable. The hope is to reduce the costs to borrowers while also slowing the growth of payday lending businesses. Taking one step further,

the Kentucky Legislature is attempting to deny payday lenders access to electronic bank accounts to secure their loans, making it increasingly difficult for such lenders to expand the scope of their business.[56]

Such crackdowns have also been occurring in states closer to Texas. In March 2008, Arkansas Attorney General Dustin McDaniel issued a stern message to all payday lenders in the state: shut down or face lawsuits. The Arkansas Constitution prohibits charging interest rates about 17%, as does the Arkansas Deceptive Trade Practices Act. Payday lenders will argue that the Check Cashers Act gives them immunity, as it says that checks written before the date that it is cashed does not count as "interest". The attorney general, however, is determined to shut them down. "Charging consumers interest in the range of 300 to 500 percent is unlawful and unconscionable and it is time that it stops", McDaniel said in a statement released by the attorney general's office. It is unclear whether Texas will follow suite and place strict regulations on predatory lending practices in the upcoming legislative session.[57]

Exorbitant Interest and the Bible

It is fair to say that faith-based groups have a substantial voice in Texas politics. Those interested in fighting predatory and subprime lending, therefore, could attract support among religious groups by emphasizing the Bible's prohibition against usury. For instance, Exodus 22:25 and 22:26 read respectively: "If you lend money to any of My people who are poor among you, you shall not be like a moneylender to him; you shall not charge him interest," and "If you ever take your neighbor's garment as a pledge, you shall return it to him before the sun goes down". A broad political coalition will likely be needed to curb the growth of predatory lending in Texas, and this issue has the potential to bring economic liberals and religious conservatives together. An appeal to Biblical scripture concerning usury could be an effective strategy for consumer advocates who are eager to end predatory lending in Texas.[58]

The Bush Administration's Role in Predatory Lending Practices

In a February 2008 Op-Ed in the Washington Post, Governor Eliot Spitzer of New York accused the Bush Administration of actively protecting mortgage lenders who engaged in predatory lending. New York, in addition with several other states, enacted laws aimed at banning loans with misrepresented terms, hidden costs and fees, and "teaser" rates that ballooned exponentially. The Bush Administration, however, set out to prevent such a crackdown on banks that engaged in predatory lending. Through a small federal agency called the Office of the Comptroller of the Currency (OCC), the Administration called upon the 1863 National Bank Act as a means of rendering all state legislation against predatory lending practices inoperative. The Administration's actions were so appalling that all 50 state attorneys general actively fought the new rules. Governor Spitzer attempted to open an investigation into possible discrimination cases in subprime lending in New York, but was halted by an OCC federal lawsuit. This is but one example of how the Bush Administration was able to stymie state action against predatory lending at the expense of the consumer. As the subprime crisis continues to ripple through the economy, many are wondering why the federal government defended the very banks that are now set to foreclose on the homes of countless American families. Had the states been able to pursue their anti-predatory lending agendas without the Bush Administration's roadblocks and

lawsuits, Governor Spitzer argues that the current subprime and foreclosure crisis could have been avoided.[59]

Alternatives to Payday Lending: Non-profit Financial Cooperatives

Non-profit financial cooperatives have proven to be an effective, consumer-friendly alternative to payday lending. The specific case of the State Employees' Credit Union (SECU) of Raleigh, North Carolina is a promising example. As opposed to payday lenders who thrive on their members' insolvency, The stated mission of the SECU is to break the cycle of debt completely. This is achieved by adding a savings component to the loan, which automatically deducts 5% of the borrowed amount and places it in the member's savings account. This assists the member with future expenses, and perhaps more importantly, teaches financial literacy to people who are highly vulnerable to racking up a lifetime of debt. The SECU of Raleigh allows members to borrow up to $500 a month at a low interest rate of 12%, which can be paid back with funds from their next paycheck. As a result, the members are able to avoid the exorbitant interest rates of payday lenders, and are in a much better position to pay off the principal on their loan.

The difference in the amount of savings provided by the SECU in comparison to a typical payday lender is extraordinary. A payday lender usually charges about $15 per $100 borrowed, which translates into a cost of $150 million per every $1 billion loaned to customers. For every $1 billion loaned by SECU, in contrast, customers are only charged $5.9 million. This is a difference of roughly $149 million, and this money would stay in the hands of customers, not payday lenders.

SECU customers, protected from the exorbitant interest rates of payday lenders, have been given the opportunity to break the cycle of debt. In fact, many SECU members have already done just that. To date, members of a special SECU program who had no previous savings now have a cumulative savings exceeding $13.2 million. Clearly, the SECU's emphasis on financial literacy and automatic savings deductions has allowed many to escape the cycle of insolvency that keeps payday lenders profitable but perpetuates negative savings.[60]

Latino-Oriented Banks

Raleigh, North Carolina is the home of a new movement in personal finance: the Latino-oriented bank. Started by David Flores, a former senior vice president at Chase Manhattan Bank, Nuestro Banco offers services specially tailored to the needs of the growing Hispanic population in the United States. For instance, Nuestro Banco offers check cashing services for new immigrants, as well as small business loan applications in Spanish. Furthermore, a bilingual and bicultural staff is intended to make Hispanic customers feel comfortable when making financial decisions. Nuestro Banco, though clearly a niche bank in Raleigh, is hoping to become mainstream as the Hispanic population in the US grows. It is predicted that the Hispanic population in the US will triple by 2050, reaching 102 million people. Much of this population will be first and second-generation Americans, who require different financial services and needs than other groups. Latino-oriented banks are one way to offer the Hispanic community access to capital and financial services tailored to their needs.[61]

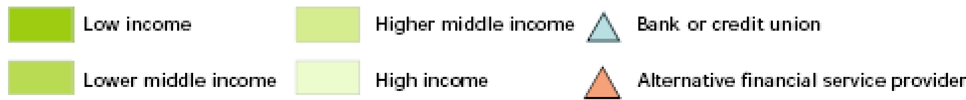
The Cost of Payday Lending on El Paso

The major financial institutions of El Paso are located in the affluent areas, where the risk of default on loans is relatively low. Sound financial institutions such as banks and credit unions are rare in low-income neighborhoods of El Paso. Consequently, lower income neighborhoods have a higher proportion of payday lending institutions to banks than do affluent areas. The following study by the Center for Public Policy shows the relationship between neighborhood income and the presence of different financial institutions:

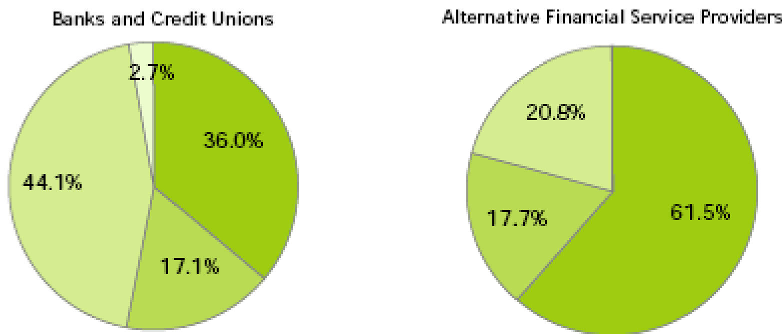
City Profile: El Paso

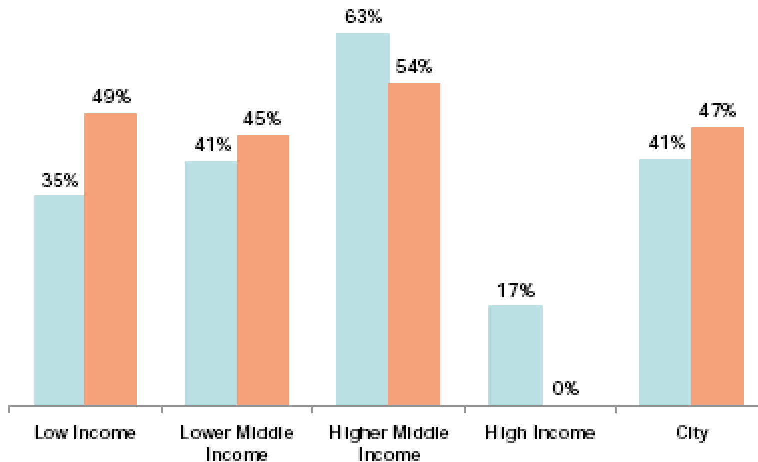
Basic Financial Services Infrastructure (estimates)

Number of non-bank check cashers	61	Number of payday lenders	59
Total value of checks cashed	$140,666,436	Total value of payday loans	$103,083,777
Total fees on checks cashed	$3,516,661	Total fees on payday loans	$16,751,114
Number of pawnshops	40	Number of banks and credit unions	111
Total value of pawn loans*	$9,617,234	Major banks, by number of branches	Bank of America, Wells Fargo, First National, Chase, State National



Distribution of Financial Services Branches, by Neighborhood Income





Source: http://www.cppp.org/files/2/ElPaso.pdf

It is apparent from these figures that the cost of payday loans in El Paso is substantial. The high degree to which El Pasoans rely on payday lenders for financial assistance should be a major source of concern for policy makers, as payday lending often leads to long-term indebtedness for its costumers.

The Growing Payday Loan Business in Texas

Because the Payday Loan Industry is unregulated in Texas, the requirements for receiving a loan are minimal. To qualify, borrowers must simply have a checking account and proof of regular employment. The borrower typically writes a postdated check for the loan, including a fee. The borrower then returns on payday to pay off the loan (partially or entirely), or else the lender will cash the check. The incentive to return on payday is substantial, for a bounced check could mean criminal charges and additional fees. Texas does not place a cap on the amount of interest a payday lender can charge, meaning that interest rates can reach up to 700% percent annually.

What is especially alarming is that almost 99% of payday lending clients are repeat customers. A recent study by Morgan Stanley also found that the average customer of paycheck lenders took out nine short-term loans a year. In short, taking a payday loan is practically never a one-time solution to a financial problem. The ballooning of interest payments traps thousands of people in debt that is virtually inescapable.

Payday lenders, however, have everything to gain from a repeat customer rate of 99%. The Center for Responsible Lending estimates that the typical payday lending firm enjoys a profit margin of 34%. The environment of large profits and minimal government interference in Texas ensures that this industry will continue to grow, especially in the low per-capita income areas of the Borderland.[62]

Texas' Authority

While Texas' regulatory powers are limited, the State and localities can develop and implement creative solutions for increasing access to capital and wealth for low-income residents. For struggling small business, grants or low-interest rate loans are available for start-up capital. For first-time homebuyers, the state has developed targeted programs to assist specific constituencies.

Many states work to combat predatory lending and increase access to capital through financial literacy programs designed to develop a better informed and more conscientious consumer base. Without the knowledge and skills to make strategic financial decisions, Texans cannot make the transition from home renters to homeowners, small business dreamers to small business owners, check cashing customers to depository customers, and from high risk, high interest rate borrowers to competitive borrowers.

Most financial institutions are for-profit entities that must determine the viability and security of potential borrowers before any lending can occur. In assessing a borrower's credit worthiness, the fiduciary soundness and savvy of that borrower is paramount. Given the importance of this soundness, increasing the knowledge and skills of the borrower greatly increases his ability to access credit and build capital. While states and regulators must tread carefully so as not to drive legitimate lenders out of tightly regulated markets, strengthening the borrowing power of the consumer through financial literacy programs can be done in a way that benefits both borrower and legitimate lender. Many states have created such programs, either through legislation or regulatory changes.

In 2005, under the leadership of Senator Shapleigh and Representative Beverly Woolley (R-Houston), Texas passed two important pieces of legislation to fight predatory lending by increasing consumer literacy.

S.B. 851

S.B. 851 by Senator Shapleigh directs the Texas Education Agency (TEA) to establish a financial literacy pilot program in up to five school districts to provide students with the knowledge and skills necessary to make critical personal financial decisions. The bill also requires TEA to report to the legislature by January 1, 2007, on the implementation and effectiveness of the pilot program. Senator Shapleigh envisions pilot projects that incorporate personal financial lessons at various grade levels, creating a comprehensive multi-year approach to teaching financial literacy. Moreover, a pilot program will allow schools to develop and test programs, helping develop a strong and effective model for teaching financial soundness that other schools can then emulate. S.B. 851 marks a great step toward creating a financially savvy and successful workforce for tomorrow. This bill took effect on June 17, 2005.

H.B. 492

Senator Shapleigh sponsored H.B. 492 by Representative Beverly Woolley (R-Houston), which amends the Texas essential knowledge and skills to require instruction in personal

financial literacy in one or more courses required for high school graduation. This requirement will help to provide students with the knowledge and skills necessary to make critical financial decisions.

Increasing access to capital and credit is important for all Texans, but particularly for Texans and Texas communities struggling to improve their economic stability and success. The State faces significant challenges in ensuring that all areas of Texas have access to capital and credit. Given the changing demographics in the state, and historical patterns of lending, it behooves the state's economy to explore all available avenues for achieving a healthy lending environment. Steps should be taken to ensure that all Texans are knowledgeable consumers capable of generating positive credit histories; lenders offer fair and reasonable credit terms; and borrowers have access to capital sufficient for their legitimate needs.

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