

## **CHAPTER 2: ACCESS TO CAPITAL AND CREDIT**

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**

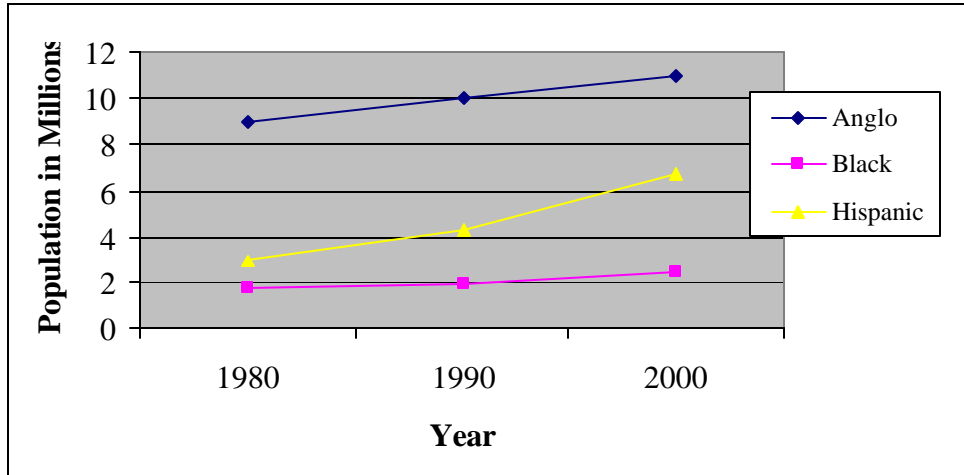
Problems of limited access to capital and credit facing Texas communities will get much worse if significant changes are not made. According to Texas' State Demographer, Steve Murdock, Texas' demographic trends, including changes in the rates and sources of overall population growth, an increase in the 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.<sup>1</sup> 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.<sup>2</sup> 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.<sup>3</sup> 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.<sup>4</sup> 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
<b>Anglo</b>	9,350,297	10,291,680	11,074,716
<b>Black</b>	1,692,542	1,976,360	2,421,653
<b>Hispanic</b>	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.<sup>5</sup>

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.<sup>6</sup> Under current policies, the state demographer predicts that the average Texas household income will decline about \$5,000 to \$6,000 by 2040.<sup>7</sup> 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 second lowest in loan-to-deposit ratio.<sup>8</sup> 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 71 percent, compared to California's 78 percent, meaning that Texas' financial institutions are essentially loaning out 71 cents for every one dollar deposit. In contrast, Indiana and Ohio both have loan-to-deposit ratios well over 130 percent. In fact, Texas is actually ranked 47th among the 50 states for host state loan-to-deposit ratio in 2005, down from 45th in 2004.<sup>9</sup> The chart on the next page, *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  
255 Most-Populous States***

<b>Ordered by Ratio (population in millions as estimated for July, 2004)</b>	<b>2005 Ratio</b>
Indiana (6.2)	149
Ohio (114.6)	131
Michigan (101.1)	99
Wisconsin (55.1)	99
Washington (62.0)	97
Alabama (45.3)	95
Georgia (88.3)	93
Arizona (57.4)	92
South Carolina (42.0)	92
Tennessee (59.0)	92
Minnesota (51.0)	91
Maryland (55.6)	88
Missouri (57.5)	<b>86</b>
Illinois (127.1)	84
Florida (174.0)	83
New York 192.3)	82
California 358.9)	79
North Carolina (85.4)	79
Louisiana (45.2)	78
Virginia (74.6)	76
Massachusetts (64.2)	75

Pennsylvania (124.1)	75
Colorado (46.0)	72
<b>Texas (224.9)</b>	<b>71</b>
New Jersey (87.0)	56

Population Source: United States Bureau of Census; Ratio Data: FDIC, using data as of June 30, 2004

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.<sup>10</sup>

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."<sup>11</sup>

## **Changes in Lending Regulation and Practices**

Lending institutions accumulate capital that can be loaned to individuals or businesses by collecting and holding deposits. The Texas Department of Banking reports that in 2004, over \$315 billion in deposits were held by lending institutions across the state.<sup>12</sup>

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.

***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 1998, home ownership represented 44 percent of gross assets for families earning \$50,000 or less a year.<sup>13</sup> 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.

### **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.<sup>14</sup>

Texas homeowners and homebuyers are receiving significant amounts of mortgage credit from subprime lenders, generally headquartered in other parts of the country.<sup>15</sup> As of March 2002, Texas had a total of 1,212 subprime lenders.<sup>16</sup> The chart below, *Subprime Loans in Texas in 2000*, outlines the amount of subprime lending occurring in this state.

<b><i>Subprime Loans in Texas in 2000</i></b>		
<b>Type of Loan</b>	<b>Number of Loans</b>	<b>Total Value of Loans</b>
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.

<i>Economic Consequences of a Subprime Home Mortgage Loan</i>				
<b>30-Year Fixed-Rate Loan</b>				
<b>House Value:</b>		<b>\$85,000</b>		
<b>Down Payment:</b>		<b>\$4,250 (5%)</b>		
<b>Loan Amount:</b>		<b>\$80,750</b>		
<b>Annual interest rate</b>	<b>Monthly payment</b>	<b>Annual payment</b>	<b>Annual difference from 8%</b>	<b>Lifetime difference from 8%</b>
<b>8%</b>	\$ 592.51	\$ 7,110.18	N/A	N/A
<b>9%</b>	\$ 649.73	\$ 7,796.79	\$ 686.61	\$ 20,598.43
<b>10%</b>	\$ 708.64	\$ 8,503.67	\$ 1,393.49	\$ 41,804.69
<b>11%</b>	\$ 769.00	\$ 9,228.01	\$ 2,117.83	\$ 63,535.05
<b>12%</b>	\$ 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."<sup>17</sup>

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.<sup>18</sup> 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.<sup>19</sup>

<i>Increase in Loans Nationwide</i>			
	<b>Number Originated in 2001</b>	<b>Number Originated in 2002</b>	<b>Percent Increase</b>
<b>Prime Loans</b>	700,638	933,025	33%
<b>Subprime Loans</b>	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 subprime 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.<sup>20</sup>

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.<sup>21</sup>

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***

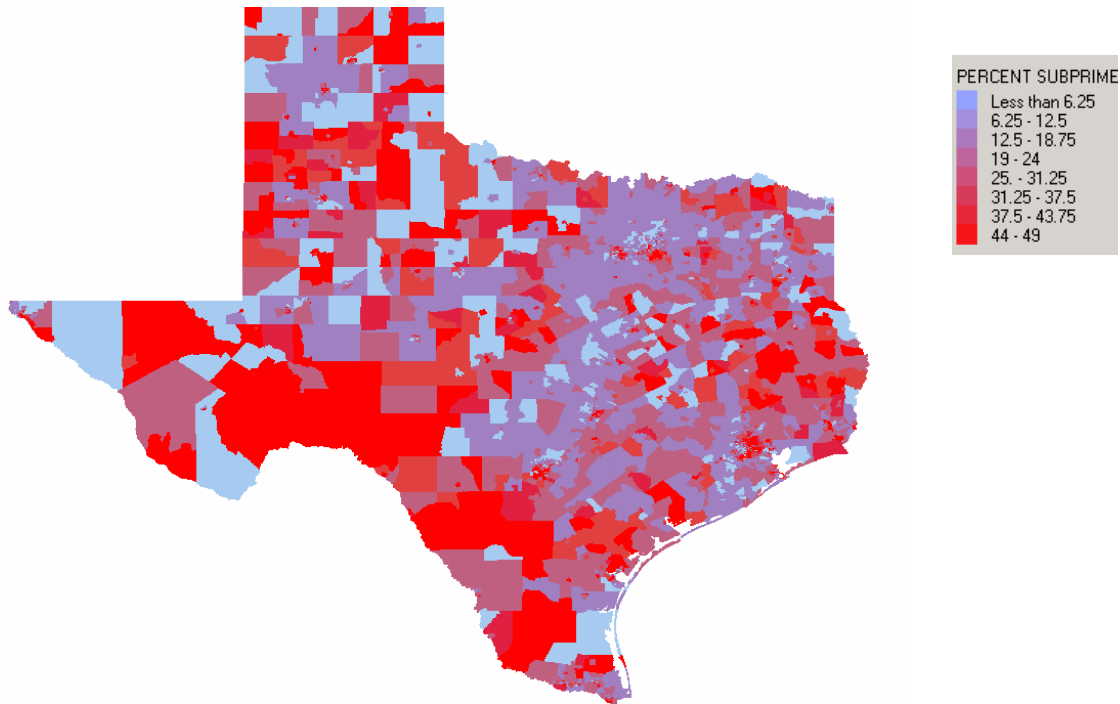
<b>Rank</b>	<b>MSA Name</b>	<b>Population</b>	<b>Conventional Refinance Loans</b>	<b>Percent Subprime</b>
<b>1</b>	<b>El Paso, TX</b>	<b>679,622</b>	<b>1,767</b>	<b>47.82</b>
<b>2</b>	<b>Corpus Christi, TX</b>	<b>380,783</b>	<b>1,061</b>	<b>46.84</b>
<b>3</b>	<b>Laredo, TX</b>	<b>193,117</b>	<b>342</b>	<b>45.32</b>
<b>4</b>	<b>Killeen-Temple, TX</b>	<b>312,952</b>	<b>683</b>	<b>44.80</b>
<b>5</b>	<b>Beaumont-Port Arthur, TX</b>	<b>385,090</b>	<b>1,160</b>	<b>44.48</b>
6	Miami, FL	2,253,362	10,701	42.67
7	Columbus, GA-AL	274,624	1,799	42.63
<b>8</b>	<b>San Antonio, TX</b>	<b>1,592,383</b>	<b>5,270</b>	<b>41.90</b>
9	Memphis, TN-AR-MS	1,135,614	7,577	41.86
<b>10</b>	<b>Galveston-Texas City, TX</b>	<b>250,158</b>	<b>944</b>	<b>41.63</b>
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
<b>18</b>	<b>McAllen-Edinburg-Mission, TX</b>	<b>569,463</b>	<b>1,345</b>	<b>37.62</b>
19	Sumter, SC	104,646	734	37.33
<b>20</b>	<b>Victoria, TX</b>	<b>84,088</b>	<b>220</b>	<b>37.27</b>
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	<b>Brownsville-Harlingen-San Benito, TX</b>	<b>335,227</b>	<b>795</b>	<b>35.97</b>
30	<b>Houston, TX</b>	<b>4,177,646</b>	<b>14,552</b>	<b>35.70</b>

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.

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

## **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.<sup>22</sup> 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.<sup>23</sup>

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***

<b>MSA</b>	<b>Number of loans</b>	<b>Amount of Loans (\$000)</b>	<b>Number of Loans Per Capita</b>	<b>Amount of Loans Per Capita</b>
<b>El Paso</b>	7,272	191,937	0.0107	\$282.42
<b>Corpus Christi</b>	6,052	163,590	0.0159	\$429.61
<b>San Antonio</b>	24,567	708,340	0.0154	\$444.83
<b>Brownsville/Harlingen/ San Benito</b>	4,860	166,883	0.0145	\$497.82
<b>McAllen/Edinburg /Mission</b>	7,756	316,784	0.0136	\$556.29
<b>Austin/San Marcos</b>	25,989	793,885	0.0208	\$635.23
<b>Laredo</b>	2,984	122,728	0.0155	\$635.51

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.<sup>24</sup> 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

<b>Market</b>	<b>Deposit Share for Chase and Bank One</b>	<b>Dollar Share in Small Business Loans</b>
<b>Austin</b>	20.81%	8.57%
<b>Dallas</b>	21.97%	11.58%
<b>Fort Worth</b>	21.54%	7.96%
<b>San Antonio</b>	4.50%	5.58%
<b>Houston</b>	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.<sup>25</sup> 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.<sup>26</sup> 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*

<b>Loan Amount</b>	<b>Equivalent Rate – 7 days</b>	<b>Equivalent Rate – 10 days</b>	<b>Equivalent Rate – 14 days</b>
<b>\$ 100</b>	569.92%	413.55%	309.47%
<b>\$ 150</b>	396.29%	292.00%	222.48%
<b>\$ 200</b>	309.47%	231.23%	178.98%
<b>\$ 250</b>	257.17%	194.62%	152.99%
<b>\$ 300</b>	222.48%	170.33%	135.57%
<b>\$ 350</b>	197.70%	152.99%	123.13%
<b>\$ 400</b>	178.98%	139.89%	113.87%
<b>\$ 450</b>	164.54%	129.78%	106.60%
<b>\$ 500</b>	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.<sup>27</sup>

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.

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."<sup>28</sup>*

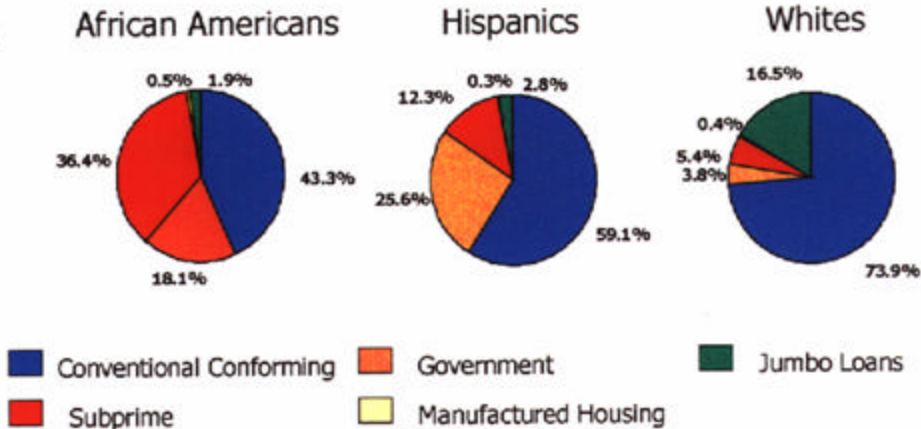
This is an unfortunate example of the industry preying on the elderly, who often are not given complete information.

**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<sup>29</sup>. 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.

<i>Percentage of Subprime Refinance Loans for All Hispanic Census Tracts</i>				
<b>Rank</b>	<b>MSA</b>	<b>Population</b>	<b>Number of Conventional Refinance Loans</b>	<b>Percent Subprime</b>
<b>1</b>	Corpus Christi, TX	380,783	118	75
<b>2</b>	San Antonio, TX	1,592,383	678	60
<b>3</b>	El Paso, TX	678,622	534	59
<b>4</b>	Albuquerque, NM	712,738	210	52
<b>5</b>	Laredo, TX	193,117	267	48
<b>6</b>	Brownsville -Harlingen, TX	335,227	229	43
<b>7</b>	McAllen-Edinburg, TX	569,463	649	42
<b>8</b>	Tucson, AZ	843,746	225	41
<b>9</b>	Miami, FL	2,253,362	1,919	41
<b>10</b>	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 decay 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."<sup>30</sup> 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.<sup>31</sup>

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 blanche 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.”<sup>32</sup> 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.”<sup>33</sup>

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.<sup>34</sup>

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.

### *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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<sup>1</sup> Testimony before the Senate Business and Commerce Committee, subcommittee on Interim Charge #4, by Steve Murdock, State Demographer, Department of Rural Sociology, Texas A & M University, January 9, 2002.

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