



INTERIM REPORT

to the 85th Texas Legislature



HOUSE COMMITTEE ON
INVESTMENTS & FINANCIAL SERVICES



JANUARY 2017

**HOUSE COMMITTEE ON INVESTMENTS AND FINANCIAL SERVICES
TEXAS HOUSE OF REPRESENTATIVES
INTERIM REPORT 2016**

**A REPORT TO THE
HOUSE OF REPRESENTATIVES
85TH TEXAS LEGISLATURE**

**TAN PARKER
CHAIRMAN**

**COMMITTEE CLERK
JULIE YOUNG**



Committee on Investments and Financial Services

January 3, 2017

Tan Parker
Chairman

P.O. Box 2910
Austin, Texas 78768-2910

The Honorable Joe Straus
Speaker, Texas House of Representatives
Members of the Texas House of Representatives
Texas State Capitol, Rm. 2W.13
Austin, Texas 78701

Dear Mr. Speaker and Fellow Members:

The Committee on Investments and Financial Services of the Eighty-fourth Legislature hereby submits its interim report including recommendations and drafted legislation for consideration by the Eighty-fifth Legislature.

Respectfully submitted,

A handwritten signature in cursive script that reads "Tan Parker".

Tan Parker

A handwritten signature in cursive script that reads "Oscar Longoria".

Oscar Longoria

A handwritten signature in cursive script that reads "Dan Flynn".

Dan Flynn

A handwritten signature in cursive script that reads "Phil Stephenson".

Phil Stephenson

A handwritten signature in cursive script that reads "G. Capriglione".

Giovanni Capriglione

A handwritten signature in cursive script that reads "Joe C. Pickett".

Joe Pickett

A handwritten signature in cursive script that reads "Brooks Landgraf".

Brooks Landgraf

Oscar Longoria
Vice-Chairman

Members: Phil Stephenson, Joe Pickett, Dan Flynn, Giovanni Capriglione, Brooks Landgraf

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INVESTMENTS AND FINANCIAL SERVICES COMMITTEE

At the beginning of the 84th Legislative Session, the Honorable Joe Straus, Speaker of the Texas House of Representatives, appointed seven members to the House Committee on Investments and Financial Services (the Committee). The Committee membership included the following appointees: Tan Parker, Phil Stephenson, Joe Pickett, Dan Flynn, Oscar Longoria, Giovanni Capriglione, and Brooks Landgraf.

During the interim, Speaker Straus assigned the Committee the following charges:

1. Study the current state of cybersecurity of financial institutions in Texas. Review state and federal laws, and evaluate what additional steps need to be taken to make financial institutions in Texas more secure.
2. Examine the short-term lending industry in Texas. Study the adequacy of consumer access to credit and the effectiveness of consumer protections, specifically reviewing the consistency and coordination of state law with federal law and local ordinances. Review data-reporting requirements for credit-access businesses and make appropriate recommendations.
3. Evaluate what policies are currently in place to prevent the financial exploitation and financial abuse of aging Texans, and determine what changes need to be made to strengthen protections for this vulnerable population.
4. Study the impact on local communities when community banks are consolidated and how this changes the landscape of banking in Texas. Evaluate how the state can help expand charter opportunities in Texas.
5. Examine the current investment climate and resources available to businesses in Texas. Analyze the effectiveness of existing programs and whether current investment tools are bringing new businesses and new jobs to Texas, and determine whether the current programs are helping established businesses in Texas create jobs. Identify barriers to investment opportunities faced by businesses and investors. This analysis should include but not be limited to: angel investing, crowdfunding, micro-lending, private equity, venture capital, and mezzanine investing. Make appropriate recommendations to ensure investment tools in Texas continue to evolve to help bring jobs to Texas and meet the needs of new and existing businesses in Texas.
6. Conduct legislative oversight and monitoring of the agencies and programs under the committee's jurisdiction and the implementing of relevant legislation passed by the 84th Legislature. In addition to general oversight, the Committee should specifically:
 - a. consider any reforms to state agencies to make them more responsive to Texas taxpayers and citizens;
 - b. identify issues regarding the agency or its governance that may be appropriate to investigate, improve, remedy, or eliminate;

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- c. determine whether an agency is operating in a transparent and efficient manner;
and
 - d. identify opportunities to streamline programs and services while maintaining the mission of the agency and its programs.

CYBERSECURITY

Charge #1: “Study the current state of cybersecurity of financial institutions in Texas. Review state and federal laws, and evaluate what additional steps need to be taken to make financial institutions in Texas more secure.”

Background

Disaster preparedness is not a new idea to the people of Texas. Cybersecurity vulnerability is a significant issue facing our state that can have serious and devastating consequences. Cybersecurity breaches that involve the financial services industry can result in consumers having their credit cards hacked, bank accounts emptied, or can result in banks and other financial institutions or businesses having to bear the cost of "cleaning up" after such abuses.

Advances in computer technology and greater access to data via the Internet have provided cyber criminals an underground market to share stolen information and criminal methodologies. Cybercrime perpetrators no longer require complex skills or techniques and the space offers criminals a large number of potential online victims. The Internet provides an abundant supply of computing resources that can be harnessed to facilitate this criminal activity. High-speed Internet connections, increased bandwidth and an unlimited number of targets allow for large-scale compromises. New technology to keep us safer constantly has to work against competing cyber security criminals trying to find and exploit weaknesses.

Computer Crimes

Title 7, Chapter 33.01 of the Texas Penal Code defines “Computer Crimes” and their penalties as the following:¹

1. Sec. 33.02. BREACH OF COMPUTER SECURITY. (a) A person commits an offense if the person knowingly accesses a computer, computer network, or computer system without the effective consent of the owner.
2. (b) An offense under Subsection (a) is a Class B misdemeanor, except that the offense is a state jail felony if:
 - (1) the defendant has been previously convicted two or more times of an offense under this chapter; or
 - (2) the computer, computer network, or computer system is owned by the government or a critical infrastructure facility.
3. (b-1) A person commits an offense if, with the intent to defraud or harm another or alter, damage, or delete property, the person knowingly accesses:
 - (1) a computer, computer network, or computer system without the effective consent of the owner; or
 - (2) a computer, computer network, or computer system:

¹ Tex. Penal Code §33.01

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- (A) that is owned by:
 - (i) the government; or
 - (ii) a business or other commercial entity engaged in a business activity;
 - (B) in violation of:
 - (i) a clear and conspicuous prohibition by the owner of the computer, computer network, or computer system; or
 - (ii) a contractual agreement to which the person has expressly agreed; and
 - (C) with the intent to obtain or use a file, data, or proprietary information stored in the computer, network, or system to defraud or harm another or alter, damage, or delete property.
4. (b-2) An offense under Subsection (b-1) is:
- (1) a Class C misdemeanor if the aggregate amount involved is less than \$100;
 - (2) a Class B misdemeanor if the aggregate amount involved is \$100 or more but less than \$750;
 - (3) a Class A misdemeanor if the aggregate amount involved is \$750 or more but less than \$2,500;
 - (4) a state jail felony if the aggregate amount involved is \$2,500 or more but less than \$30,000;
 - (5) a felony of the third degree if the aggregate amount involved is \$30,000 or more but less than \$150,000;
 - (6) a felony of the second degree if:
 - (A) the aggregate amount involved is \$150,000 or more but less than \$300,000;
 - (B) the aggregate amount involved is any amount less than \$300,000 and the computer, computer network, or computer system is owned by the government or a critical infrastructure facility; or
 - (C) the actor obtains the identifying information of another by accessing only one computer, computer network, or computer system; or
 - (7) a felony of the first degree if:
 - (A) the aggregate amount involved is \$300,000 or more; or
 - (B) the actor obtains the identifying information of another by accessing more than one computer, computer network, or computer system.
5. (c) When benefits are obtained, a victim is defrauded or harmed, or property is altered, damaged, or deleted in violation of this section, whether or not in a single incident, the conduct may be considered as one offense and the value of the benefits obtained and of the losses incurred because of the fraud, harm, or alteration, damage, or deletion of property may be aggregated in determining the grade of the offense.
6. (d) A person who is subject to prosecution under this section and any other section of this code may be prosecuted under either or both sections.
7. (e) It is a defense to prosecution under this section that the person acted with the intent to facilitate a lawful seizure or search of, or lawful access to, a computer, computer network, or computer system for a legitimate law enforcement purpose.
8. (f) It is a defense to prosecution under Subsection (b-1)(2) that the actor's conduct consisted solely of action taken pursuant to a contract that was entered into with the
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owner of the computer, computer network, or computer system for the purpose of assessing the security of the computer, network, or system or providing other security-related services.

Gramm-Leach-Bliley Act

United States Congress passed the Gramm-Leach-Bliley Act (GLBA) in 1999. This federal act requires financial institutions – defined by the act as “companies that offer consumers financial products or services like loans, financial or investment advice, or insurance”² – to explain their information-sharing practices to their customers and to safeguard sensitive data.³ Compliance with the act is mandatory – it states a policy must be in place to protect information in financial institutions from foreseeable threats in security and data integrity. GLBA applies to financial institutions that collect information from their own customers as well as financial institutions receiving customer information from other financial institutions. However, the collection of information in business or commercial activities does not fall under GLBA regulation.⁴

GLBA contains the Financial Privacy Rule that requires all financial institutions to design, implement, and maintain safeguards to protect customer information. This is conveyed to the customer in the form of a privacy notice.⁵ GLBA also requires financial institutions to notify the customer of any changes to their policies and safeguards.

The Disclosure of Nonpublic Personal Information, or Safeguards Rule of GLBA, places some limitations on how an individual that receives nonpublic customer information from a financial institution can use or further disclose such information.⁶ In addition, it requires financial institutions to develop a written information security plan describing the company’s current preparation and methods of keeping a customer’s nonpublic personal information safe as well as how they plan to continue doing so.

Pretexting protection, or Fraudulent Access to Financial Information, is a portion of GLBA that encourages organizations covered by GLBA to implement safeguards against pretexting. Pretexting has also been dubbed “social engineering” and refers to when someone attempts to gain access to personal nonpublic information when they do not have authority to do so.

² Public Law §106-102

³ Federal Trade Commission, *Gramm-Leach-Bliley Act*, <https://www.ftc.gov/tips-advice/business-center/privacy-and-security/gramm-leach-bliley-act>, Retrieved on October 28, 2016.

⁴ Federal Trade Commission, *In Brief: The Financial Privacy Requirements of the Gramm-Leach-Bliley Act*, July, 9, 2002.

⁵ *Id.*

⁶ *Id.*

Federal Financial Institutions Examination Council

The Federal Financial Institutions Examination Council (FFIEC) was established in 1979 as part of the Financial Institutions Regulatory and Interest Rate Control Act of 1978, and given the authority to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions. This examination is done by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Consumer Financial Protection Bureau.

The FFIEC makes recommendations to promote uniformity in the supervision of financial institutions.⁷ In 2006, the FFIEC added the State Liaison Committee, which includes representatives from the Conference of State Bank Supervisors, the American Council of State Savings Supervisors, and the National Association of State Credit Union Supervisors. This Committee gives states a voting position on the FFIEC.⁸

In 2013, the FFIEC established the Cybersecurity and Critical Infrastructure Working Group (CCIWG) as a permanent structure whose purpose is to improve communication among the FFIEC member agencies and build on existing efforts to strengthen the activities of other interagency and private sector groups.⁹

The FFIEC's website provides multiple resources for financial institutions. Among these resources are joint statements and alerts about potential and existing threats, a cybersecurity awareness website and CEO webinar, a cybersecurity assessment of community institutions, and the Cybersecurity Assessment Tool (CAT).

CAT was developed to assist institutions in identifying their risks and determining how prepared they are for a cybersecurity attack. The CAT consists of an Inherent Risk Profile, followed by measurement of Cybersecurity Maturity. The Risk Profile allows an institution to assess their level of risk.¹⁰

Texas Bankers Electronic Crimes Task Force

In 2010, Charles G. Cooper, the Commissioner of the Texas Department of Banking, created the Texas Bankers Electronic Crimes Task Force ("Task Force") in cooperation with the United States Secret Service. This task force addresses Corporate Account Takeovers (CATO), or business identity theft where cyber thieves gain control of a business' bank account by stealing employee credentials and then initiating fraudulent wire and ACH transactions to

⁷ Federal Financial Institutions Examination Council, About the FFIEC, <https://www.ffiec.gov/about.htm>, Retrieved on October 28, 2016.

⁸ Federal Financial Institutions Examination Council, FFIEC State Liaison Committee (SLC), <https://www.ffiec.gov/slc.htm>, Retrieved on October 28, 2016.

⁹ Federal Financial Institutions Examination Council, Cybersecurity Awareness, <https://www.ffiec.gov/cybersecurity.htm>, Retrieved on October 28, 2016.

¹⁰ See also, Federal Financial Institutions Examination Council, Cybersecurity Assessment Tool User Guide, June 2015.

accounts controlled by the thieves.¹¹ Members of the Task Force are executives from financial institutions and representatives from the Texas Bankers Association (TBA), Independent Bankers Association of Texas (IBAT), Southwestern Automated Clearing House Association (SWACHA), and federal law enforcement agencies. The Task Force is periodically convened as needed to address emerging issues related to electronic threats against the banking industry.

The Task Force's initial objective was to address CATO issues. Senior bank officers with technology oversight responsibilities from a diverse group of banks in terms of size, complexity, and market presence met to develop common sense guidelines to combat corporate account takeovers. Many of the Task Force member banks had customers whose computer systems had been compromised from a corporate account takeover intrusion. Drawing on the experience of the United States Secret Service (North Texas District Office) and IT security and audit firms operating in Texas, a list of valuable recommendations was approved.

The end result was a set of controls and processes in the form of the "Corporate Account Takeover Best Practices" that could assist banks in the identification of risks and the development of meaningful risk management measures.¹² A similar version of these best practices was subsequently released nationally by the Conference of State Bank Supervisors (CSBS), the United States Secret Service, and the Financial Services Information Sharing Analysis Center (FS-ISAC).

In September 2013, the Task Force was reconvened by Commissioner Cooper to elevate the priority and broaden the scope of the banking industry's engagement in addressing cybersecurity concerns. The Task Force set forth to determine what the necessary steps are to make cybersecurity a standard element of bank risk management.¹³

For this particular issue, task force representatives were comprised from approximately a dozen community bank Chief Executive Officers (CEOs) and other senior bank officials who had a demonstrated track record of treating cybersecurity as a standard element of their bank's risk management program. Executives from TBA, IBAT, and SWACHA also participated.

The CSBS's Executive Leadership of Cybersecurity (ELOC) working group developed a series of measures that could be used by all CEOs and Board Members to better manage cybersecurity. The ELOC group stated the most important way to ensure successful execution of the measures hinged on executive leadership establishing the "tone from the top" in order to make cybersecurity a standard element of bank risk management.¹⁴ The task force released their recommendations in December 2014.¹⁵

¹¹ Texas Bankers Electronic Crimes Task Force, About the ECTF, <http://www.ectf.dob.texas.gov/about-ectf>, Retrieved on October 28, 2016.

¹² Texas Bankers Electronic Crimes Task Force, *Best Practices Reducing the Risks of Corporate Account Takeovers*, September 2011.

¹³ Texas Bankers Electronic Crimes Task Force, About the ECTF, <http://www.ectf.dob.texas.gov/about-ectf>, Retrieved on October 28, 2016.

¹⁴ *Id.*

¹⁵ See also, Remarks of Deputy Secretary Raskin at The Texas Bankers' Association Executive Leadership Cybersecurity Conference, December 3, 2014, <https://www.treasury.gov/press-center/press-releases/Pages/jl9711.aspx>.

National Cyber Security Awareness Month

October 2016 was the 13th year in which National Cyber Security Awareness Month (NCSAM) was recognized. Initiated by the U.S. Department of Homeland Security and the National Cyber Security Alliance (NCSA), NCSAM was created as a collaborative effort between government and industry to ensure Americans have the resources to stay safe and secure online.¹⁶

Since its inception, NCSAM has grown exponentially and has reached consumers, small and medium-sized businesses, corporations, and educational institutions across the nation. NCSA's website has many online tools to assist individuals who want to keep their businesses protected and personal information safe.

Financial Services Information Sharing and Analysis Center

The Financial Services Information Sharing and Analysis Center (FS-ISAC) is a resource for the global financial industry of cyber and physical threat intelligence analysis and sharing.¹⁷ It was created in 1999 by the financial services sector as a result of Presidential Directive 63 of 1998 and updated in 2003 as a response to Homeland Security Presidential Directive 7. It mandated public and private sectors must share information about physical and cybersecurity threats and vulnerabilities to help protect the critical infrastructure of the United States. In early 2013 FS-ISAC's Board approved an extension to its charter to share information between financial services firms worldwide and can now continuously gather reliable and timely information from financial services providers, commercial security firms, federal/national, state and local government agencies, law enforcement, and other trusted resources. FS-ISAC is currently active with members and partners across countries and regions throughout North and South America, Europe, the Middle East, and Asia.

The recent successful completion of the FS-ISAC's Critical Infrastructure Notification System (CINS) allows the FS-ISAC to speed security alerts to multiple recipients around the globe near-simultaneously while providing for user authentication and delivery confirmation.¹⁸ FS-ISAC also provides an anonymous information sharing capability across the entire financial services industry. Upon receiving a submission, industry experts verify and analyze the threat and identify any recommended solutions before alerting FS-ISAC members. This assures member firms will receive the latest effective procedures and best practices for guarding against known and emerging security threats.

FS-ISAC membership is recommended by the U.S. Department of the Treasury, the U.S. Office of the Comptroller of Currency, the U.S. Department of Homeland Security (DHS), the

¹⁶ Stay Safe Online, National Cybersecurity Awareness Month, <https://staysafeonline.org/ncsam/>, Retrieved on October 29, 2016.

¹⁷ Financial Services Information Sharing and Analysis Center, About FS-ISAC, <https://www.fsisac.com/about>, Retrieved on October 29, 2016.

¹⁸ *Id.*

U.S. Secret Service, and the Financial Services Sector Coordinating Council. The Treasury and DHS rely on the FS-ISAC to disseminate critical information to the financial services sector in times of crisis.

The FS-ISAC recently announced the creation of the Financial Systemic Analysis & Resilience Center (FSARC), which is tasked with identifying, analyzing, and coordinating activities to reduce systemic risk from cybersecurity threats targeting the U.S. financial system. The idea of the FSARC began when the CEOs of eight major banks – Bank of America, BNY Mellon, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street and Wells Fargo – joined forces to develop methods of enhancing the resilience of the critical infrastructure of the U.S. financial system. It is the most recent step in the financial industry's "ongoing commitment to maintaining the integrity of the U.S. financial system through tactics that prevent, detect, and mitigate malicious cyber activity."¹⁹

National Cyber Incident Response Plan

In July 2016, President Barack Obama issued Presidential Policy Directive 41: United States Cyber Incident Coordination.²⁰ As a response to the many cyber incidents that have occurred in recent years, the directive called for the creation of a National Cyber Incident Response Plan (NCIRP) by the U.S. Department of Homeland Security (DHS).²¹

The NCIRP draft was released during the October 2016 NCSAM and defined a nationwide approach to cybersecurity threats and incidents and defines the roles of both federal and non-federal entities when dealing with such threats. It also outlines how the U.S. government will prepare for, respond to, and recover from significant cyber incidents.²²

Once the NCIRP is implemented, DHS's National Cybersecurity and Communications Integration Center (NCCIC)²³ will act as the designated lead for asset response during a significant cyber incident. The NCCIC will also identify and alert other organizations that may be at risk, share anonymized information about the incident as broadly as possible so that other organizations can protect themselves, and distribute threat indicators related to the incident through their Automated Indicator Sharing capability so that their partners can immediately mitigate this particular threat.

The Department of Justice — specifically, the Federal Bureau of Investigation (FBI) and the National Cyber Investigative Joint Task Force (NCIJTF) — is the lead federal agency

¹⁹ Financial Services Information Sharing and Analysis Center, *FS-ISAC Announces the Formation of the Financial Systemic Analysis & Resilience Center (FSARC)*, October 24, 2016.

²⁰ PPD-41

²¹ The White House, Office the Press Secretary, *FACT SHEET: Cybersecurity National Action Plan*, February 9, 2016.

²² Ozment, Andy, U.S. Department of Homeland Security, *National Cyber Incident Response Plan Now Available For Public Comment*, September 30, 2016.

²³ U.S. Department of Homeland Security, National Cybersecurity and Communications Integration Center, <https://www.dhs.gov/national-cybersecurity-and-communications-integration-center>, Retrieved on October 29, 2016.

responsible for threat response in the event of a significant cyber incident.²⁴ The FBI and NCIJTF will conduct appropriate law enforcement and national security investigative activities.

DHS also plays a role in threat response: the U.S. Secret Service investigates financial crimes, and Immigration and Customs Enforcement's Homeland Security Investigations provides threat response for cyber-enabled crimes.

Texas Department of Information Resources

The Texas Department of Information Resources (DIR) sets the information security standards for state agencies and outlines the technological responsibilities for agency leadership, information security officers, and staff.²⁵ DIR is the agency responsible for providing computer network security services. DIR also assists government agencies and educational institutions in keeping critical information resources at these agencies safe. With the development of their statewide cybersecurity framework, the DIR also educates agencies about strategies to prevent security breaches as well as potential and current security threats.

In 2013, S.B. 1597 was passed by the Texas Legislature and requires each state agency to submit a security plan to DIR by October 15th of every even-numbered year which must include the best practices developed by DIR.²⁶

DIR developed an Agency Security Plan template²⁷ in collaboration with the government and the private sector which is identical to the National Institute of Standards and Technology's (NIST) framework: Identify, Protect, Detect, Respond, and Recover.²⁸ The templates can assist state agencies in complying with their reporting requirements, which are not mandatory and can be modified by the agency to suit their particular needs. DIR also created a Security Control Standards Catalog in February 2016 to establish mandatory security controls and their minimum requirements.²⁹

Encompassed in DIR is the Texas Data Center Services Program (DCS) which is dictated by the Texas Cybersecurity Framework.³⁰ According to the DIR website, DCS currently maintains antivirus protection, a network intrusion prevention system, a security incident and event monitor, a host intrusion prevention system, and performance vulnerability scans.³¹

²⁴ Federal Bureau of Investigation, *Countering the Cyber Threat*, July 26, 2016.

²⁵ Texas Department of Information Resources, About DIR, <http://dir.texas.gov/View-About-DIR/Landing.aspx>, Retrieved on October 28, 2016.

²⁶ Tex. S.B. 1597, 83rd Legislature, Regular Session, 2013.

²⁷ Texas Department of Information Resources, *Agency Security Plan Instructions*, February, 26, 2014.

²⁸ National Institute of Standards and Technology, *Framework for Improving Critical Infrastructure Cybersecurity*, February 12, 2014.

²⁹ Texas Department of Information Resources, *Security Control Standards Catalog*, Version 1.3, February, 26, 2016.

³⁰ Texas Department of Information Resources, *Agency Security Plan Instructions*, February, 26, 2014.

³¹ See also, Tere Shade and Wendy Mazzurana, Texas Department of Information Resources, *DIR Basics Series: Data Center Services*, PowerPoint Presentation, March 29, 2016.

Analysis

The committee held a public hearing with invited testimony on April 12, 2016 at the University of Dallas to explore ways in which the state of Texas can ensure that its citizens are prepared against cybersecurity attacks and disasters in the financial services industry.

Charles G. Cooper and Phillip Hinkle from the Texas Department of Banking as well as Steven Bullitt, a former Secret Service agent and current Vice President for the NTT Security Group testified in the first panel before the Committee.

Phillip Hinkle, the Director of IT Security Examinations from the Texas Department of Banking, testified first. Mr. Hinkle serves on the FFIEC and stressed the importance of the Information Sharing and Analysis Centers by which the financial services industry can share threat information and collaborate to discover solutions to cyber security threats. In particular, he explained that FS-ISAC, or the Financial Services Information Sharing and Analysis Center, is the largest and most advanced in the world. Mr. Hinkle also explained how the Texas Bankers Electronic Crimes Task Force ("Task Force") works in collaboration with members of bank trade associations and approximately two dozen banks in addition to the Secret Service.

Mr. Hinkle informed the committee of how the work of the task force has thus far resulted in the development of the best practice guidelines against Corporate Account Takeovers (CATO), which have been adopted by banks across the United States to help protect small businesses, consumers, and banks themselves. He discussed the Executive Leadership of Cybersecurity (ELOC) initiative and informed members how it is supported by the U.S. Treasury Department and FS-ISAC. He stressed that ELOC is by far the most crucial change made to secure the banking industry from cyber threats.

In accordance with the task force's conclusions and recommendations, Texas state-chartered banks were directed by the Department of Banking to complete a cybersecurity risk assessment and evaluation of controls by the end of 2015. In 2016, the Department began evaluating Texas state-chartered banks' readiness to determine if they met the new FFIEC "baseline" cybersecurity level. Commissioner Cooper and Mr. Hinkle reported Texas' state-chartered banks are at the forefront of addressing cybersecurity risk in this arena.

Steven Bullitt testified in conjunction with Commissioner Cooper and Mr. Hinkle. He previously served as a Special Agent with the U.S. Secret Service and was a supervisor over the North Texas Electronic Crimes Task Force. Mr. Bullitt discussed the importance of the private sector being able to prepare and protect its data. He reminded the committee of the importance of always having a backup in the event a bank is hit with ransomware, and the difficulty of having ransomware attacks on smaller banks and businesses with less monetary resources. The panel discussed the importance of Cyber Security Awareness Month in October, organized by the National Cyber Security Alliance, and stressed the need for business owners in Texas to participate, increase their cybersecurity awareness, and learn to better protect their businesses and consumers.

Mr. Bullitt testified that citizens are experiencing the greatest transfer of wealth in history

due to cybersecurity crimes against the financial sector. He referenced FBI reports of \$2.3 billion in losses from business email scams where wiring funds overseas had been reported. Based on these reports, he believes this is only about 10 percent of the actual financial losses we have incurred as a nation.

The second panel consisted of Brett Landry, the Dean of the University of Dallas College of Business (Cybersecurity Master's Program), Ron Fox of the Texas Credit Union Association, Ray David of Point Bank, and Lyle Walden of The Independent Bankers Bank (TIB).

Brett Landry testified and primarily stressed that banking awareness was a crucial element to fighting cybersecurity attacks and explained how proper training of employees could help significantly curb these breaches.

Mr. Landry then testified on "Shadow IT," or having IT that doesn't belong in your infrastructure. He explained this occurs when employees use methods outside their company's secure server such as Dropbox and personal email accounts. He explained that these employees must learn why it's important to not use these outside channels and how they can lead to a breach of security, especially when these programs do not comply with security protocols.

Mr. Landry testified that in addition to Cyber Security Awareness Month, he believes that Texas should do more throughout the year to raise awareness about the growing threats of cybersecurity.

Ray David testified next and explained to the Committee that 90 percent of what is targeted by hackers takes place outside financial services institutions. According to Mr. David, this implies that the "end user," or consumer, is usually where the thieves manage to find a way into the institution or take the customer's money. Therefore, education outside of financial institutions at the consumer level is where improvement is needed.

Mr. David testified on how Point Bank provides training on cybersecurity to businesses and went over the many steps their bank takes to defend themselves from attacks, which includes hiring auditors to test their cybersecurity protocols.

Mr. David then explained how the banks are held accountable for losses when a hacking of a large business occurs such as the 2013 hacking incident involving the discount retailer Target. Mr. David shared his concerns about how smaller cybersecurity attacks do not get the attention of local authorities most of the time and he believes that stronger punishments are necessary for persons caught committing such criminal acts.

Ron Fox followed Mr. David in testifying. He echoed Mr. David's sentiments regarding security breaches at Target and also Home Depot. As a follow-up to Mr. David's remarks, Mr. Fox explained how criminals may get into a company's computer system via malware, such as Target where the hacker got into the system via an air conditioning vendor. He then testified on how the banks and credit unions are ultimately responsible for issuing and cancelling the cards once they are breached. Mr. Fox also discussed the Landry's breach where the criminals manufactured duplicate cards and used them locally in Fort Worth, which meant that the credit

union's monitoring system did not pick up on the fraud until they were alerted by their consumers.

Mr. Fox suggested that if merchants were required to comply with the requirements of the Gramm-Leach-Bliley Act then this step would likely go a long way to add more protections from financial losses. In addition, he shared issues revolving around the significant costs credit unions incur when they have to cover losses and reissue cards, or issue new cards such as the newer "Chip and PIN" technology.

Mr. Fox recommended the committee consider legislation requiring anyone receiving credit card data to be mandated to protect that information. He also suggested legislation to require card recipients to notify their card processor immediately upon detecting a breach and require the breach information be provided to issuing financial institutions by the card processor. Mr. Fox also recommended legislation to allow the card issuer (credit unions and banks) to recover cost and losses from a business's failure to protect or destroy the data and requiring a business taking credit/debit card information to remove the data once the transaction is completed.

Lyle Walden addressed the community banking side of cybersecurity. As TIB is an aggregator for about 1,700 community banks, he gave insight into how threats evolve. He reiterated Mr. David's point that the "weak link" is usually the end user and, since the passage of the Gramm-Leach-Bliley Act in 1999, much guidance has been released by regulators. As the overall market and guidance has improved, he said, many tools including the CATO Best Practices have greatly assisted banks. The guidelines include security awareness training for staff. The training elements also assisted community banks when training their customers so that the end user can receive cybersecurity training.

Mr. Walden praised the FS-ISAC on information sharing and explained that there are many resources for the banks to keep them informed and up to date. Mr. Walden testified that Texas is ahead of the nation as a whole. Historically, financial institutions are risk managers, which puts them in a better position to assess the cybersecurity risks and properly manage and prevent cybersecurity attacks. Mr. Walden concluded his testimony by discussing how working closely with the Texas Department of Banking and other agencies is the best method for keeping Texas at the forefront of cybersecurity awareness and preparedness.

Conclusions

1. The legislature should consider legislation requiring anyone receiving credit card data to protect that information and require anyone taking credit/debit cards to remove the data from their system once the transaction is completed.
2. The legislature should consider legislation to allow card issuers to recover cost and losses from a business' failure to protect or destroy confidential transaction data.
3. The legislature should support fully funding strategies within the Texas Department of Information Resources' (DIR) Legislation Appropriations Request (LAR) to protect the state government's computer network from cybersecurity threats, including security policy and awareness and security services.
4. The legislature should make every effort to promote greater visibility of Cyber Security Awareness Month and the importance of cybersecurity precautions that can safeguard Texas consumers.

SHORT-TERM LENDING

Charge #2: “Examine the short-term lending industry in Texas. Study the adequacy of consumer access to credit and the effectiveness of consumer protections, specifically reviewing the consistency and coordination of state law with federal law and local ordinances. Review data-reporting requirements for credit-access businesses and make appropriate recommendations.”

Background

The short-term lending industry in Texas encompasses auto title loans and single and multiple installment deferred presentment (or payday) loans. It also includes refinancing of these same loans.

Office of Consumer Credit Commissioner

The Office of Consumer Credit Commissioner (OCCC) is the agency charged with examination and enforcement of short-term lending. In Texas, the OCCC monitors certain businesses, including those in the finance sector offering signature or small installment loans, and short-term lending, and pawn loans, as well as credit access businesses.

Each year the OCCC reports on certain financial services and consumer loan products and provides an overview of segments of the consumer financial services market in Texas through an annual comprehensive report that is available online and comes out before the end of each calendar year. In addition, the report fulfills a number of constitutional, statutory and administrative mandates for the publication of information. Both the *2015 Report on Availability, Quality and Pricing of Certain Financial Services and Consumer Loan Products*³² and the *2016 Report on Availability, Quality and Pricing of Certain Financial Services and Consumer Loan Products*³³ are referenced throughout the following sections related to consumer loan products in Texas.

OCCC Regulated Industries

Business Licenses Issued		
License Type	Total 8/31/16	Total 8/31/15
Consumer Loan License	3,804	3,370
Pawnshops	1,574	1,583
Motor Vehicle Sales Finance	8,444	8,096
Commercial Motor Vehicle Sales Finance	29	19

³² Texas Office of Consumer Credit Commissioner. *2015 Report on the Availability, Quality, and Pricing of Certain Financial Services and Consumer Loan Products*. Available at www.occ.texas.gov. Retrieved on February 26, 2016.

³³ Texas Office of Consumer Credit Commissioner. *2016 Report on the Availability, Quality, and Pricing of Certain Financial Services and Consumer Loan Products*. Available at www.occ.texas.gov. Retrieved on December 2, 2016.

Property Tax Lenders	90	91
Credit Access Businesses	2,216	2,944
Professional (Individual) Licenses Issued		
Mortgage Loan Originator	370	379
Pawnshop Employee	7,649	7,281
Business Registrations Issued		
Debt Management /Settlement Providers	108	108
Registered Creditors	7,851	8,170
Refund Anticipation Loan Facilitators	1,536	912
Crafted Precious Metal Dealers	1,106	1,237
Total – all categories	34,777	34,190

Consumer Loans Made	2015	2014	2013
Personal/Secured Loans (342-E)	407,244	331,915	244,644
Small Installment/Signature Loans (342-F)	4,167,450	4,150,111	4,750,605
Pawn Loans (371)	9,027,201	9,137,483	8,626,594
Credit Access Businesses (393)	6,786,025	7,470,141	7,482,992
Total	20,389,935	21,089,650	21,104,835

Consumer Loans: Signature/Small Installment Loans (342-F)

Small installment loans are governed by Texas Finance Code 342-F and are available to customers with minimal security and credit references.³⁴ These loans may be unsecured or secured by personal property, including the holding of a vehicle title; however, lenders rarely file liens (or perfect a security interest) as the costs of filing such liens cannot be recouped from the consumer.

The industry is generally very homogeneous in appearance and practice: storefronts of different companies may be clustered within a specific area, lenders typically charge the maximum loan rates allowed by law, and different lenders may have common borrowers.³⁵ Small consumer loans made under 342-F rates are available to customers with below average credit scores because of their higher rates. A 342-F borrower needs employment income or some other source of steady income in order to qualify for the loan, and the borrower must be able to repay the loan and all other known obligations concurrently.

These lenders depend on repeat business, and many customers end up refinancing their loans several times. In most cases, borrowers can expect to receive their funds the same day they

³⁴ Tex. Fin. Code §342, Chapter F

³⁵ Texas Office of Consumer Credit Commissioner. *2015 Report on the Availability, Quality, and Pricing of Certain Financial Services and Consumer Loan Products*. Available at www.occ.texas.gov. Retrieved on February 26, 2016.

apply. Loan proceeds are typically provided by check. Some lenders may offer loans through the mail where the offer, in the form of a live check, can be cashed outside of a store.

The maximum allowable rates for 342-F loans are determined by statute.³⁶ Most lenders charge the maximum interest rates (installment account handling charge), but some may compete with a lower acquisition charge.

Borrowers with secured loans risk losing their personal property, motor vehicle, or other security to the lender. The lender or third party debt collector may pursue the remaining deficiency or the entire outstanding balance of unsecured loans. A lender may file suit against the borrower or repossess the collateral, and some lenders report the repayment history to consumer reporting agencies.

Small consumer loan borrowers typically run into eligibility issues with other credit products. Possible alternatives are pawn loans, credit card advances, and payday loans.

Credit Access Businesses

Chapter 393 of the Finance Code governs “credit access businesses (CABs),”³⁷ which are credit service organizations that provide payday loans or title loans. CABs obtain credit for a consumer from an independent third-party lender in the form of a deferred presentment transaction, an auto title loan or a payday loan. In Texas, the actual third-party lender is not licensed and the CAB that serves as the broker is the licensee.

The number of active CAB licenses reflects a 26 percent decline through the end of FY16 from 2,944 at the end of FY15. Much of this decline appears to be attributable to consolidation within the industry, concerns over proposed rules in payday, vehicle title, and certain high-cost installment loans by the CFPB, and the effects of municipal ordinance restrictions.³⁸

CAB Licenses	FY14	FY15	FY16
Number of CAB Licenses Issued and Active	3,356	2,944	2,168

CAB Examinations	FY14	FY15	FY16
Number of Examinations	1,031	816	707
Acceptable Level of Compliance	86.6percent	94.5percent	43.14percent
Investigations Completed	6	18	15

The majority of the loan cost is not capped in the case where a CAB is involved. Broker fees charged to borrowers typically depend on the amount of the loan and the length of the term.

³⁶ Tex. Fin. Code §342.251, 342.252, 342.253, 342.254.

³⁷ Tex. Fin. Code §393

³⁸ Texas Office of Consumer Credit Commissioner. *2015 Report on the Availability, Quality, and Pricing of Certain Financial Services and Consumer Loan Products*. Available at www.occ.texas.gov. Retrieved on February 26, 2016.

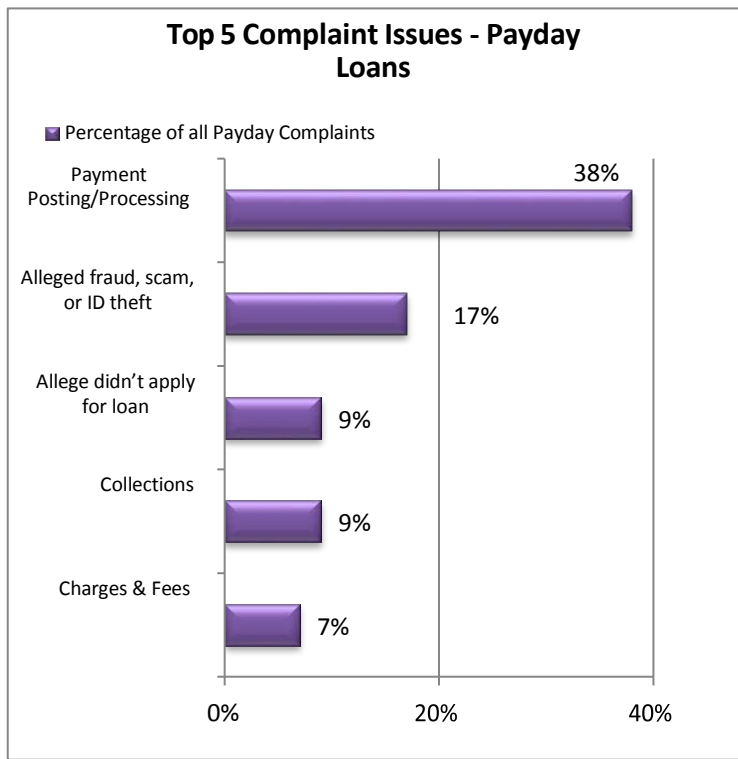
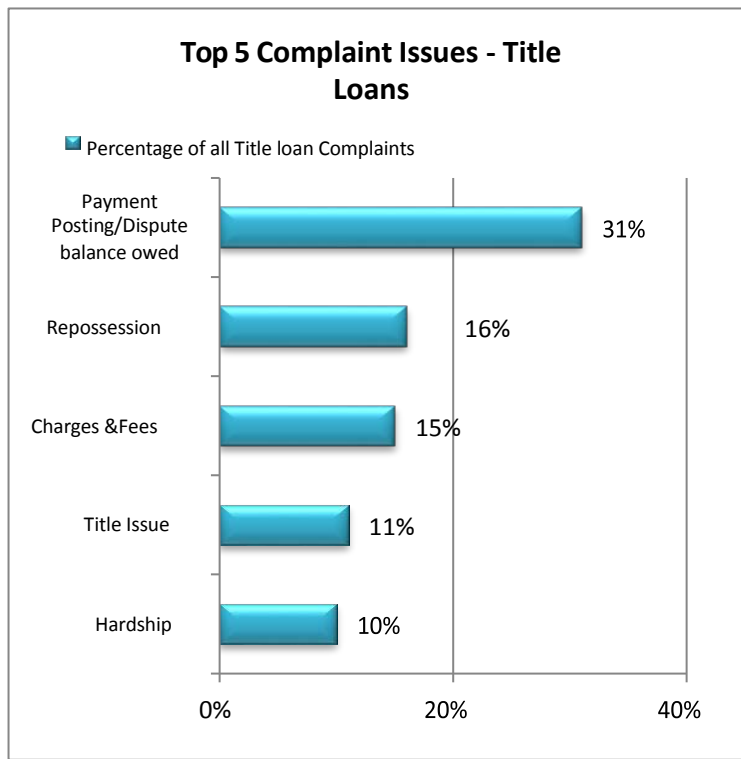
The entire loan may be due in a matter of a few days or broken down over equal payments during the loan term of 180 days or less. Refinancing or renewing payday and title loans is very common which can add to the cost.³⁹ While the loan is guaranteed by the CAB, the borrower will be pursued for the deficiency balance and there is a risk of losing their motor vehicle to the lender or CAB. The creditor may file suit against the borrower, and most report the repayment history to consumer reporting agencies. A borrower may also face attorney fees, repossession fees, and court costs added to the loan balance.

Complaints within this industry predominately pertain to charges and fees, collection practices, posting/processing of payments, and repossessions.

Consumer Complaints					
Fiscal Year	Payday Loans	Title Loans	Total	Percent of all processed complaints	Consumer Restitution
FY16	208	198	406	18.8 percent	\$5,863,539*
FY15	240	194	434	20.4 percent	\$9,780
FY14	283	171	454	23.7 percent	\$20,512

*In FY 2016, an investigation was conducted on complaints regarding repossessions. Due to compliance issues with the notice of disposition and questionable disposition methods, the deficiency balances were waived on 3,271 accounts.⁴⁰

The five recurring complaints for CAB Auto Title and CAB Payday are charted separately below for FY 2016:



³⁹ *Id.*

⁴⁰ *Id.*

The presented statistics below represent data reported to the OCCC from CABs in the annual report for CY2015 with comparison data from the 2014 annual report.⁴¹ The data is continuing the trend towards multiple installment products increasing while single installment products are decreasing.

Data Highlights (All Loan Types)		2015		2014	
Number of payday (deferred presentment) loans obtained		2,410,917		2,451,568	
Number of auto title loans obtained		328,520		367,518	
Number of payday (deferred presentment) refinances		2,063,787		2,523,731	
Number of auto title refinances		551,211		658,309	
Number of vehicles surrendered or repossessed under all auto title loans		37,296		44,042	
Total number of locations reporting		3,153		3,499	
Payday Loans		Single Installment		Multiple Installment	
		2015	2014	2015	2014
Number of consumers for whom the CAB obtained an extension of credit		724,273	844,690	704,985	601,955
Number of extensions of credit obtained by CAB		1,446,582	1,592,479	964,335	859,089
Number of refinances		1,877,570	2,368,312	186,217	155,419
Average Loan Amount*		\$476	\$475	\$540	\$543
Average Fee per \$100 borrowed*		\$23.58	\$23.27	\$166.37	\$150.69
Average original term (in days)*		19	18	160	152
Average number of loans and refinances per consumer		4.59	4.69	1.63	1.69
Title Loans		Single Installment		Multiple Installment	
		2015	2014	2015	2014
Number of consumers for whom the CAB obtained an extension of credit		178,613	251,466	83,682	59,771
Number of extensions of credit obtained by CAB		231,475	299,868	97,045	67,650
Number of refinances		513,594	626,832	37,617	31,477
Average Loan Amount*		\$1,308	\$1,170	\$1,083	\$1,097
Average Fee per \$100 borrowed*		\$16.96	\$19.12	\$89.91	\$96.48
Average original term (in days)*		30	30	169	191
Average number of loans and refinances per consumer		4.17	3.69	1.61	1.66

*Average statistics for individual products are averaged from the four separate quarterly reports, for each calendar year.

Consumer Financial Protection Bureau

The Consumer Financial Protection Bureau (CFPB) is a federal agency that was created in response to the 2008 financial crisis. Their mission is to protect consumers from unfair, deceptive, or abusive practices and take action against companies who break the law, and to inform people about financial information they need when making decisions.⁴² The CFPB implements and enforces federal consumer financial laws.

⁴¹ *Id.*

⁴² <http://www.consumerfinance.gov/about-us/>

CFPB Payday, Vehicle Title, and Certain High-Cost Installment Loans Rule

On June 2, 2016, pursuant to its authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act),⁴³ the CFPB issued a proposed rule to establish 12 CFR part 1041,⁴⁴ which would create regulations of consumer protections for certain consumer credit products.

The rule would apply to short-term consumer loans (i.e., loans where the consumer is required to repay the loan in 45 days or less). The rule would also apply to longer-term consumer loans that: (1) have a term more than 45 days; (2) have an all-in APR over 36 percent (this includes certain fees that are not in a normal APR); and (3) require a leveraged payment mechanism (i.e., the right to obtain payment from the consumer's account or payroll) or a security interest in a motor vehicle.

For both types of covered loans, the creditor would have to comply with either: (1) ability-to-repay requirements, under which the creditor must make a reasonable determination that the consumer can repay the loan, based on a review of income, major financial obligations, and borrowing history, or (2) alternative requirements, which limit the loan amount and the number of covered loans a consumer can have outstanding in a period of time.

The rule would also put limitations on unsuccessful payment transfers from consumers' accounts, and would generally require creditors to report covered loans to a real-time commercial database for tracking information about covered loans.

The CFPB's deadline for official comments on the rule was October 7, 2016. The CFPB has proposed that the rule will be effective 15 months after a final version of the rule is published in the Federal Register.

CFPB Arbitration Rule

On May 5, 2016, the CFPB issued a proposed rule with requirements for arbitration agreements for consumer financial products.⁴⁵ The rule would prohibit creditors from including a class-action waiver in a pre-dispute arbitration agreement. Arbitration agreements would be required to explain that the consumer may file or be a member of a class action lawsuit.

The CFPB's deadline for official comments on the rule was August 22, 2016. The CFPB has proposed that the rule will begin to apply 211 days after a final version of the rule is published in the Federal Register.

⁴³ Public Law §111-203

⁴⁴ Federal Register, Docket Number CFPB-2016-0025, CFPB Proposed Rule on Payday, Vehicle Title, and Certain High-Cost Installment Loans, <https://www.federalregister.gov/documents/2016/07/22/2016-13490/payday-vehicle-title-and-certain-high-cost-installment-loans>

⁴⁵ Federal Register, Docket Number CFPB-2016-0020, CFPB Proposed Rule on Arbitration Agreements, <https://www.federalregister.gov/documents/2016/05/24/2016-10961/arbitration-agreements>

CFPB Debt Collection Rule

On July 28, 2016, the CFPB issued a proposed rule that would apply to third-party debt collectors.⁴⁶ The rule would include requirements for leaving voicemails, requirements for collection by e-mail or text message, limitations on the frequency of contacts with the consumer, and a prohibition on collecting from a consumer's estate within 30 days after the consumer's death.⁴⁷

The CFPB is preparing to convene a Small Business Review Panel to gather feedback from small businesses on the proposal. After the CFPB seeks input from small businesses and other stakeholders, it will publish the rule and allow an additional period for official comments.

U.S. Department of Defense Military Lending Act Rule

On July 22, 2015, the U.S. Department of Defense (DOD) adopted amendments to expand its Military Lending Act (MLA) Rule at 32 C.F.R. pt. 232.⁴⁸ The rule now applies to most consumer loans made to covered military borrowers, including active-duty service members and their dependents. The MLA Rule contains several requirements for loans made to covered military borrowers, including the following: (1) the rule prohibits the creditor from making the loan at a military annual percentage rate (MAPR) over 36 percent (the MAPR is similar to annual percentage rate (APR) but includes additional charges); (2) the rule requires the creditor to provide a disclosure about the MLA Rule and the MAPR to the borrower; and (3) the rule prohibits the creditor from requiring arbitration. The DOD has established a database that creditors can consult to determine whether a consumer is a covered military borrower. Creditors must comply with the amended MLA Rule starting October 3, 2016.

⁴⁶ http://files.consumerfinance.gov/f/documents/20160727_cfpb_Outline_of_proposals.pdf

⁴⁷ Consumer Financial Protection Bureau Considers Proposal to Overhaul Debt Collection Market, Published July 28, 2016, <http://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-considers-proposal-overhaul-debt-collection-market/>

⁴⁸ Federal Register, Docket Number DOD-2013-OS-0133, DOD Final Rule Limitations on Terms of Consumer Credit Extended to Service Members and Dependents, <https://www.federalregister.gov/documents/2016/05/24/2016-10961/arbitration-agreements>

Analysis

The Committee held a hearing with invited testimony on September 14, 2016 at the State Capitol on the topic of short-term lending. Speakers included consumer advocates, industry representatives, the Office of Consumer Credit Commissioner (OCCC), and a municipal representative.

Commissioner Leslie Pettijohn of the OCCC testified first and referenced the *2015 Report on Availability, Quality, and Pricing of Certain Financial Services and Consumer Loan Products* throughout her testimony.⁴⁹

Commissioner Pettijohn testified that 20 million transactions of consumer loans by licensed lenders were made between 2012 and 2014 and the transactions totaled approximately \$10 billion. Total number of loans during this time declined, she explained, but the size of the loans grew consistently while the dollar volume of market remained steady. Three distinct markets exist: traditional small consumer installment lenders (342-F), small and short-term pawn loans, and credit access businesses (CABs) that offer payday or title loans. The average size for each loan is \$672, \$129, and \$713, respectively.

Commissioner Pettijohn testified that the data collected by OCCC shows trends moving away from single-installment payday loan products to multiple installment products instead. The data also shows the average term of multiple installment loans run up to 169 days, while single installment loans run between 19-30 days.

Commissioner Pettijohn testified that the highest rate of new loans is associated with out-of-state institutions and a significant trend currently is moving towards online lending and away from storefront locations.

Commissioner Pettijohn testified next with an analysis of the proposed CFPB rules and explained that the rules would classify loans into two groups: covered loans and non-covered loans. Covered loans would then be further broken down into subgroups: short-term covered loans of 45 days or less or long-term covered loans of 45 days or more, with (1) an all-in APR of 36 percent (all fees included) and a "leverage payment mechanism," an ACH, postdated check, or an auto title.

Commissioner Pettijohn testified that some alternative requirements could be loan size limits (\$500 maximum, for example), restrictions on the size of subsequent loans within 30 days of a prior loan, an effective cut-off limit of three loans, limits to how many loans a borrower could take out in a year, and how long a borrower can be in debt (90 days, for example).

The Committee asked Commissioner Pettijohn to explain how the OCCC tracks how many loans a borrower has taken out, and how municipalities have enforced their regulatory ordinances. She explained that the proposed rule may require creditors to report how many

⁴⁹ Texas Office of Consumer Credit Commissioner. *2015 Report on the Availability, Quality, and Pricing of Certain Financial Services and Consumer Loan Products*. Available at www.occ.texas.gov. Retrieved on February 26, 2016.

covered loans a consumer takes out to a real-time, central commercial database. Municipalities may rely on good-faith efforts by credit agencies to track short-term loans and on the honesty of consumers.

Commissioner Pettijohn also testified in regards to the OCCC's analysis and stated that the proposed rules cast a shadow of uncertainty over the marketplace. When asked about the implications of online lending in this industry by the Committee, the Commissioner responded that challenges include regulating certain institutions, especially those located offshore where there would be jurisdictional issues.

The Committee asked the Commissioner about the implications for Texas of these proposed rules. Commissioner Pettijohn explained that the predictions are quite varying, but because OCCC doesn't have access to transactional data, it's more difficult for them to develop a model. The OCCC is currently trying to ascertain the magnitude of certain kinds of loans.

When asked by the Committee about consumer complaints, Commissioner Pettijohn testified that the highest complaints reported to OCCC regarding short term lending, are the posting and processing of payment and that the alleged consumer didn't apply for the loan.

Scott Houston, Deputy Executive Director and General Counsel for the Texas Municipal League (TML), testified that many cities are regulating the payday industry albeit reluctantly. By 2015, five cities that had adopted ordinances to regulate these loans were sued in response by various short-term lenders. So far, he explained, every case has been decided in favor of municipalities. The legal argument used in most of these cases was that municipal ordinances are preempted by state regulations and this has been rejected by the courts to date.

Mr. Houston testified that the industry has argued for state legislation because it avoids a patchwork system of regulation. In an attempt to diffuse this argument and provide uniformity that lenders could conform with, TML provided the Dallas's municipal ordinance in 2013 as an example to other cities who might adopt something similar since it had withstood legal challenges. Mr. Houston testified 35 cities have adopted almost that exact same ordinance since 2013.

Ann Baddour with Texas Appleseed testified next and discussed the availability of credit with the Committee. Her analysis showed overall access to credit has increased modestly (about 3 percent) between 2012 and 2015. The sharpest increase in lending came from 342-E lenders, which are the lowest-rate lenders. From 2003 to 2015 there was a 112 percent increase in access to consumer credit in Texas, while at the same time there was a 25 percent increase in population. There was a 98 percent increase in 342-F lending, and an astounding 571 percent increase in uncapped payday and auto title lending.

Ms. Baddour testified about some innovative new models which have come on the market in Texas using the licensed lender structure, usually 342-E or 343-F, to increase access at a lower cost.

Ms. Baddour recommended the Committee look for low cost alternatives to the short-

term lending model. She referenced a federal program called the Community Development Financial Institution (CDFI) Fund that has been very successful and suggested Texas consider duplicating it. She explained that the CDFI Fund is designed to support financial service providers who focus on developing communities rather than those that are purely profit-based (although some are for-profit).

Ms. Baddour testified on the success of the Community Loan Center in Brownsville, which created an alternative loan program at 18 percent with a \$20 fee, the lowest permissible lending structure under 342-E, and operated through partnership with employers. It was started with seed money from the CDFI Fund and has expanded significantly throughout Texas as a community-based, yet very centralized, model. The program has now reached over 10,000 loans with more favorable terms for lenders and has no credit assessment. It is available to anyone who has worked for their employer for three months or more. The Government Employees' Credit Union (GECU) of El Paso has also launched a fast-cash loan program with an investment from the CDFI Fund. GECU has distributed over 17,000 loans in over a year and a half and is now a self-sustaining program. When asked by the Committee about the free-market viability of some alternative programs, Ms. Baddour responded that the default rates were in low single digits and many were for-profit.

Ms. Baddour testified that online lending is an area of great concern to Texas Appleseed, and is a category which also includes "lead generators," generally online entities that present themselves as a payday lender, but actually collect personal information and sells them to the highest bidder, often to lenders.

Ms. Baddour's four-year analysis of CAB products found the market driven largely by refinances and fees (about 68 percent of market volume). This dynamic concerns Texas Appleseed, because it suggests predatory behavior. Some recent declines (2012-2015) in volume were derived from refinances. The reduction in principal was very slow compared to payments, which created a very low incentive for a borrower to prevent default as a result.

Jennifer Allmon with the Texas Catholic Conference of Bishops (TCCB) testified next on how the organization first became concerned with the harmful effects of short-term lending when they began seeing an increase in demand for services from charitable ministries. The annual report on CABs in 2015, she explained, reveals only 20 percent of single payment loans are repaid without refinancing, indicating that borrowers are repeatedly purchasing the same products. This, she said, raises the question of market-wide access to credit: if the same consumers are repeatedly buying the same products, what is the true demand for short-term products?

Therefore, Ms. Allmon testified, some consumer protections are needed. One concern Ms. Allmon shared is in regards to the Military Lending Act, which prohibits lenders from lending to military members at rates above 36 percent APR. In San Angelo and Killeen, she reported, there were large signs advertising to military borrowers for short term lenders who clearly were violating this law with terms well in excess of 36 percent, and there was a lack of enforcement capabilities.

Calls for a statewide ordinance, she stated, have been made because only the state can regulate the fee itself. Ms. Allmon said the Credit Service Organization Act (CSO Act) explicitly limits services to 180 days, but CAB loans regularly stretch beyond this.

Ms. Allmon testified that several reforms were called for: first, she recommended clarification and enforcement prohibiting threats of criminal charges for nonpayment. The second reform she suggested was to require disclosures be provided in the same language in which the loan is marketed, especially in Spanish dominant areas, and the third was to enact reasonable regulations by adopting the unified city ordinance at the state level. Her fourth suggestion was to increase the OCC's purview to improve data collection on CABs. She also suggested defining and documenting default rates so we understand the true risks lenders face. Finally, she proposed removing the inconsistencies between annual and quarterly reports.

Richard Hackett, an attorney for Hudson Cook L.L.P., testified next. He said traditional single-pay short term loan structures are going away as a result of federal requirements. He recommended Texas replace credit access with a level-pay long-term product. Mr. Hackett modeled the ideal level-pay longer-term product on current yields of the payday market.

When the CFPB attempted to model how their rules would have an impact on the market, he reported, they got close. An ability-to-repay analysis, he said, consists of income and deduction of basic living expenses. The rationing analysis the CFPB uses is that a consumer can have three loans in a row, then thirty days of a "cooling-off period," then three more loans, and then they can't take out any more loans for the year. This is the non-underwriting alternative, under which the CFPB predicts 72 percent of credit under the market. Mr. Hackett predicted it would be 81 percent and this will make it difficult for businesses to survive.

For the \$1 billion or more of credit left, he explained, there would be a demand for a high yield, longer term, level pay. About a third of people are going to be frozen out of the credit market no matter what.

Rucker Preston with Helping Hands Ministry of Belton, Inc. testified that, according to studies, the public views the short-term loan industry as one that needs reform. At the individual level, 75 percent of Texas voters say they are in favor of payday and auto title loan reform while 85 percent believe that the appropriate rate cap should be 36 percent. The Insight Center for Community Economic Development, he explained, found payday & auto title loan businesses constitute a 24 percent net economic loss to communities.

The lack of regulation from the state places more stress on the private nonprofit sector, Mr. Preston stated, and Helping Hands and the like spend thousands of dollars paying off loans, raising capital for alternative loan solutions, and on resources to educate clients and the community. Additionally, more of their energy is spent signing people up for state and federal benefits and referring people to other agencies (government and nonprofit) for services that the nonprofits cannot provide. Mr. Preston asked the Committee to consider enacting all of the requirements for short-term lenders at the state level that are required at the local level in 35 cities. He also asked the Committee to require loan documents be provided in the consumer's native language and, if requested, be read aloud to the borrower in his or her native language.

Beth Bowman of the Irving Chamber of Commerce testified next and told the Committee that Irving is a community for business and that it is critical to advocate for businesses which will keep jobs in the community. These businesses, she testified, help by giving back to nonprofits and serious consideration should be given to any legislation in this area. Additionally, she said, many people needed this access to credit.

Rob Norcross of the Consumer Service Alliance of Texas testified next and explained the lawsuits in municipalities presented a problem because cities have not enforced the ordinances; therefore, to characterize a dismissal of a lawsuit of the ordinances for lack of standing as a 'win' was inappropriate. The federal proposed rules, he said, had an inconsistent approach in comparison to those used by the municipal ordinances. The municipal ordinances served to increase prices because they set arbitrary limits on the amount of loans. Both rules cannot be employed at the same time, he explained to the Committee. In December 2013, there were 3,502 CABs licensed in the state of Texas and today there are only 2,232. According to Mr. Norcross, the overwhelming majority of the closures are related to the city ordinances. Over 3,200 Texas employees have lost jobs and over \$90 million dollars a year in lost salaries and benefits have been drained from the Texas economy.

Mr. Norcross testified that the ordinances restrict business operations and access to credit by arbitrarily making loans smaller and shorter, but the cities have done nothing to try to decrease the demand for emergency credit. Consumers continue to have financial emergencies and consumers still need credit. If a consumer needs a new tire to get to work, it is impossible to buy two-thirds of a tire because a city ordinance arbitrarily limits the size of your loan. Mr. Norcross explained that as a result, consumers go to the internet for loans, where the prices are higher. Or, they get two loans at the same time at two different stores. Some approach illegal loan sharks whose collection methods may be questionable at best. All of these alternatives forced on consumers by the ordinance are more expensive and hurt the people that the ordinance was designed to protect.

Mr. Norcross stated the Texas Finance Commission has a responsibility to ensure credit is available to every Texan, regardless of geography, race, gender or financial status. He predicted that the impacts of the CFPB proposed rule in combination with the municipal ordinances on the availability of credit for sub-prime consumers will create a crisis in 2018 requiring policy guidance from the Texas Finance Commission for the Texas Legislature during the 86th Legislative Session.

John Colyandro of the Texas Conservative Coalition testified next and said that a state solution would be preemption over local ordinances which would allow access to credit. He testified that there are many concerns over the fees and the APR of these loans but gave examples of how these types of fees and APRs are actually in existence in other industries.

Mr. Colyandro testified that the APR was a misleading way to represent how much consumers are faced with. Better enforcement of state law was necessary if loans were being extended to persons not allowed and if threats of criminal action were occurring.

Steve Minick of the Texas Association of Business (TAB) testified as well. TAB, he said, would not support taxpayer-assisted loans and he believed it was something that we should be concerned about. The cost of this would be passed on to consumers, including extra costs for compliance with municipal ordinances and this, he said, places a strain on the economy. He believed a balance could be found in which would satisfy consumer advocates and industry.

Kathleen Hunker with the Texas Public Policy Foundation (TPPF) testified last and explained that TPPF looks at restrictions and examines whether the restrictions on this industry would make the situation better or worse. Short-term lending, she said, was at the center of controversy but these loans have remained consistently popular and well-used. Payday lending, she said, was a stopgap measure for citizens who were unable to secure loans from a traditional institution such as a bank and most of these consumers only seek these loans after rejection from a traditional institution.

Ms. Hunker testified that many use the loans to handle a recurring expense, and so these loans often helped to restructure an existing debt. While it may not be perfect or ideal, it may have been the best option at the time. If the federal government were to intrude, she said, it would be difficult for Texas to push back, but Texas should take action to eliminate the local efforts of municipalities who were detracting from the ability of consumers to obtain financing when they need it.

Conclusions

1. The legislature should continue to monitor the progress of several proposed rules by the Consumer Financial Protection Bureau on short-term lending, arbitration, and debt collection and further evaluate the effect these rules will have on the short-term lending industry in Texas following their issuance as final rules by the federal agency.
2. The legislature should consider methods of addressing inconsistencies between municipal ordinances and state regulation for the short-term lending industry.
3. The legislature should consider clarifying Texas consumer lending laws so they apply to online lenders. Additionally, the legislature should make it applicable to lead generators (websites posing as lenders) that are collecting personal consumer information and selling it to actual online lenders as brokers of consumer lending transactions.

ELDER FINANCIAL ABUSE AND EXPLOITATION

Charge #3: “Evaluate what policies are currently in place to prevent the financial exploitation and financial abuse of aging Texans, and determine what changes need to be made to strengthen protections for this vulnerable population.”

Background

Seventy-eight million baby boomers in America are currently in or nearing retirement. In Texas and across the nation, this trend of population growth is continuing to increase. During the previous decade, Texas was home to three of the top 10 metro areas in the United States with the fastest-growing senior populations. The Austin-Round Rock metro ranked second nationally with a 53 percent increase, the Houston-Sugar Land-Baytown metro ranked eighth with a 39 percent increase, and the Dallas-Fort Worth-Arlington metro ranked ninth with a 38 percent increase.⁵⁰

The Texas Demographic Center reports 3 million seniors resided in the state in 2014 (11.5 percent of the Texas population). They project 5.9 million seniors will live in Texas by 2030 (15.9 percent) and a staggering 9.4 million seniors by 2050 (17.3 percent).⁵¹

Two primary factors set our elderly population at a higher risk of financial fraud – their net worth is higher compared to other age groups and they risk declining cognitive abilities as they age. This decline in cognitive abilities can range from mild cognitive impairment to Alzheimer’s disease and dementia. Nationally, about half of people in their 80s suffer from "significant cognitive impairment," effectively rendering them incapable of making important financial choices.

Older consumers are often targets for financial abuse because they may have significant assets or equity in their homes and often have a Social Security or a pension coming to them regularly. They may also be especially vulnerable due to isolation, cognitive decline, physical disabilities, or other health problems. Certain factors increase the risk or likelihood an elderly person will be the victim of financial abuse or exploitation.

In 2016, an AARP report revealed impairment of financial capacity as one of the earliest indicators of mild cognitive impairment, Alzheimer's, and other dementias.⁵² This means that sometimes these vulnerable people do not realize their decision-making abilities are declining and continue to make financial decisions that can and do adversely impact them. While states and the federal government have passed hundreds of laws protecting children based on the assumption they are vulnerable and unable to protect themselves, older at-risk adults have been

⁵⁰ Steve Murdock, Michael Cline, P. Wilner Jeanty, Deborah Perez, and Mary Zeying, “Changing Texas,” Texas A&M University Press, 2014

⁵¹ Aging in Texas, Texas Demographic Center, June 2016

⁵² Carp, N. & Wilson, R. (2011). *Protecting Older Investors: The Challenge of Diminished Capacity* (Report No. 2011-04). Retrieved March 10, 2016 from AARP Public Policy Institute: <http://www.aarp.org/ppi/>.

comparatively ignored despite extensive research showing they too are vulnerable.⁵³

The decline in financial loss with two or more conditions can be tracked when you take into account the reduced independence of persons with two of more cognitive conditions.

Types of Elder Financial Abuse

Elder financial exploitation is the illegal or improper use of an older person's funds, property or assets. Proving exploitation in any type of elder fraud case is complicated because the transactions usually occur in secret and victims may make poor witnesses due to cognitive or other impairments, or because they refuse to cooperate with authorities. In recent studies, the Consumer Financial Protection Bureau (CFPB) reports approximately 17 percent of seniors actually reported having been the victim of financial exploitation, but few cases ever come to the attention of protective services.⁵⁴ Studies suggest financial exploitation is the most common form of elder abuse and yet only a small fraction of incidents are reported. Annual losses reported on a nationwide basis were previously estimated at \$2.9 billion in 2011. However, a new study estimates them at approximately \$36.48 billion per year.

The True Link Financial Study utilized in this analysis has broken down the \$36.48 billion into three categories which are explored in further detail below.⁵⁵ Those categories are financial exploitation, criminal fraud, and caregiver abuse. Criminal fraud can be further broken down into two types: traditional scams and identity theft.

Traditional Scams

Traditional scams occur when a stranger uses deception to trick the senior out of their money. Grandparent scams, Nigerian prince emails, Australian Lottery, and Sweetheart examples of scams that would fall in this category. It is estimated that these types of scams cost our seniors \$9.85 billion per year.

Identity Theft

Identity theft occurs when a criminal takes out a credit card or other financial instrument in someone else's name. Typically the criminal will use information they have obtained about the senior's identity, or use a stolen credit card number or checkbook without the senior's consent. It is estimated that losses from this category costs our nation's seniors \$2.91 billion per year, \$773 million of which is card fraud and check forgery and \$2.14 billion is due to criminals opening new accounts or taking out new loans using stolen personal information.

⁵³ Andrew Jay McClurg, *Preying on the Greying*, 65 Hastings L.J. 1099, 2014

⁵⁴ Consumer Financial Protection Bureau, Recommendations and Report for Financial Institutions on Preventing and Responding to Elder Financial Exploitation (March 2016), available at <http://files.consumerfinance.gov/>

⁵⁵ True Link Financial, The True Link Report on Elder Financial Abuse 2015 (Jan. 2015), available at <https://truelink-wordpress-assets.s3.amazonaws.com/wp-content/uploads/True-Link-Report-On-ElderFinancial-Abuse-012815.pdf>.

Caregiver Abuse

Caregiver abuse involves a trusting relationship with the victim. Often times this person is a family member, but they can also be a close neighbor or friend, a lawyer or accountant, a financial manager, or even a paid caregiver. This topic encompasses rewriting wills or powers of attorney, theft by family members or caregivers, or borrowing money hoping the senior will forget.

Occasionally the caregiver is the person who can spot when the elder person is being subject to financial abuse and can intervene to prevent such abuse. When a caregiver is found to have been the cause of financial harm, the solution is often to remove them from the picture. However, removing a caregiver without adding a source of support to help the elderly person leaves them vulnerable as well. If a caregiver who is responsible and is not causing financial harm can review the finances of their elderly loved one every month, it is estimated that \$465 million in losses from fraud and exploitation could be prevented. Below is an example of an activity where financial exploitation by an individual close to the elderly person occurs:

Financial Exploitation

Financial exploitation creates nearly \$17 billion per year in reported losses. Organizations exploiting seniors in this manner are out in the open – on your TV, calling your phone, and sending mailers. They offer free or discount products that come with hidden shipping and handling charges or end up being subscription services. This gray area uses misrepresentations to take advantage of the vulnerability or confusion of seniors.

Results of Financial Abuse

Financial abuse and exploitation affects much more than the bank accounts of our elderly. This abuse has caused some of them to lose their home, their vehicle, or other major assets. Others avoid medical care due to a lack of funds, and meals are skipped. The current estimate by True Link Financial shows 954,000 seniors skipping meals regularly due to this exploitation. Our elderly loved ones may also experience depression, anxiety, and loss of independence if they have to rely on family or the state to assist them when they cannot afford to care for themselves.

A substantial roadblock to prosecuting elder financial predators is the inability to prove that the financial transfers at issue were the result of exploitation rather than legitimate transactions. Many elderly victims "voluntarily" part with their assets. To outsiders, the transfers may look like gifts or loans when in fact they occur because of undue influence, psychological manipulation, and misrepresentation. Even when property is taken in a stealth manner, the incapacity or death of the victim often precludes prosecutors from being able to prove that the transfers were not legitimate. Since elder financial exploitation takes many different forms, it can be hard to identify. An array of "red flags," however, may signal exploitation. Some of these warning signs are behavioral or interpersonal — for example, an older person may appear to be submissive or fearful of a caregiver. Some signals are transactional, such as frequent large withdrawals from an account or uncharacteristic requests to wire money.

Certain government agencies, as well as existing laws, provide current safeguards for our elder population as it pertains to financial safety and wellbeing. Those agencies and laws are explored in the following section.

Adult Protective Services

Texas Adult Protective Services (APS), a division of the Texas Department of Family and Protective Services (DFPS), is the state program responsible for investigating reports of abuse, neglect, and exploitation of adults who are elderly (defined as anyone over the age of 65) or have disabilities. APS trains law enforcement and bank tellers in how to deal with the financial exploitation of the elderly. They also run a website called "It's Everyone's Business," which provides resources to prevent adult abuse and exploitation.⁵⁶ In October of every year they conduct a campaign on how to recognize and prevent financial exploitation and they organize an elder abuse awareness campaign each May.⁵⁷

APS does not investigate financial scams or fraud by strangers. They focus on investigating paid caretakers (including Medicare and Medicaid), family members, and individuals who have an ongoing relationship with the alleged victim.⁵⁸ Title 40, Part 19, Rule 705.1011 of the Texas Administrative Code defines "financial exploitation" as:

- (a) In this chapter, when an alleged perpetrator is a caretaker or paid caretaker, family member, or other individual who has an ongoing relationship with the alleged victim, financial exploitation is defined as the illegal or improper act or process of an alleged perpetrator using, or attempting to use, the resources of the alleged victim, including the alleged victim's social security number or other identifying information, for monetary or personal benefit, profit, or gain without the informed consent of the alleged victim. There is no informed consent when it is:
- (1) not voluntary;
 - (2) induced by deception or coercion; or
 - (3) given by an alleged victim who the actor knows or should have known to be unable to make informed and rational decisions because of diminished capacity or mental disease or defect.
- (b) In this chapter, when an alleged perpetrator is a caretaker, family member, or other individual who has an ongoing relationship with the alleged victim, financial exploitation excludes Theft in Chapter 31 of the Texas Penal Code.
- (c) In this chapter, when an alleged perpetrator is a paid caretaker, financial exploitation includes, but is not limited to, Theft in Chapter 31 of the Texas Penal Code.⁵⁹

Chapter 48 of the Human Resources Code governs APS investigations and includes a

⁵⁶ <http://www.dfps.state.tx.us/everyonesbusiness/>

⁵⁷ https://www.dfps.state.tx.us/Adult_Protection/Adult_Protective_Services_Conference/

⁵⁸ https://www.dfps.state.tx.us/Contact_Us/report_abuse.asp

⁵⁹ 40 Tex. Admin. Code §705.1011(a-c)

mandatory reporting law.⁶⁰ Chapter 48.052 makes it a Class A misdemeanor offense for a person who knowingly fails to report when they have cause to believe that a person who is elderly or disabled has been or is currently being abused, neglected, or exploited. Reporting in good faith without malicious intent provides the reporting party with immunity from liability. This reporting law applies without exception to persons whose professional communications are generally confidential (i.e. attorneys, clergy members, social workers, medical practitioners).⁶¹ A person determined by APS to have committed financial exploitation must have a due process hearing prior to the agency sharing information about the individual or the case particulars with financial institutions, employers, or others. In addition to a report to APS, financial institutions may also call law enforcement and file a report with the federal Financial Crimes Enforcement Network (FinCEN).⁶²

Of significant note, the above definition does not include financial exploitation when the situation involves a perpetrator other than a paid caretaker, caretaker, or family member. Nor does it cover a situation where there is not an ongoing relationship. In order to determine if an adult has been exploited financially or is at risk of being exploited financially and therefore needs protective services, APS uses a series of three assessments as set out in Rule 705.6101 of the Texas Administrative Code. First, a Safety Assessment is made to determine the current danger factors and whether immediate action is necessary, followed by a Risk of Recidivism Assessment to determine how at risk the person is of being a repeat victim in the twelve months following the incident. Finally, a Strength and Needs Assessment follows where APS develops a service plan appropriate for the person's needs.⁶³

If APS finds an elderly person has been abused, neglected, or financially exploited, and if APS has reason to believe they are incapacitated, they must refer them to the Department of Aging and Disability Services for guardianship under Human Resources Code 48.209.⁶⁴ A family member or caretaker may apply for guardianship, or a person may be appointed a guardian by the court if they do not have family members or caretakers. A temporary guardian may also be appointed by a court in order to address immediate circumstances and to protect a person or their estate in an interim period before a professional or family member is approved and appointed. If a professional guardian is appointed, they must be certified and are subject to training and education requirements. H.B. 1438 of the 84th Legislative Session extended the requirement for guardians to receive criminal background checks to a ward's family members.⁶⁵

If an employee who is charged with caring for an elderly individual is found to have committed exploitation, neglect, or abuse, the employee is listed in the Employee Misconduct Registry created by the Health and Safety Code.⁶⁶ This database is public and any person whose name is listed there will be permanently denied employment at certain facilities in addition to being subject to criminal prosecution. An annual search of the registry is mandated for

⁶⁰ 48 H.R.C. 48.052

⁶¹ 48 H.R.C. 48.051

⁶² <https://www.fincen.gov/resources/filing-information>

⁶³ 40 Tex. Admin. Code §705.6101

⁶⁴ 2 H.R.C. §48.209

⁶⁵ Tex. H.B. 1438, 84th Leg., R.S. (2015)

⁶⁶ 4 H.S.C. §253.007

employees.⁶⁷

Texas Penal Code

Texas Penal Code Chapter 32.53 establishes a felony of the third degree if a person "intentionally, knowingly, or recklessly causes the exploitation of a child, elderly individual, or disabled individual."⁶⁸ Enhancements are provided for offenses elsewhere in the code such as theft or fraud when the victim is an elderly person.

Under Penal Code 32.45(b), an offense regarding fiduciary violation is deemed as: "A person commits an offense if he intentionally, knowingly, or recklessly misapplies property he holds as a fiduciary or property of a financial institution in a manner that involves substantial risk of loss to the owner of the property or to a person for whose benefit the property is held."⁶⁹ With respect to the guardianship issues, a fiduciary includes a trustee, guardian, administrator, executor, conservator, and receiver as well as an attorney in fact or agent appointed under a durable power of attorney as provided by Chapter XII of the Texas Probate Code.⁷⁰ Enhancements are also provided in this section if the person victimized is elderly.⁷¹

State Securities Board

The Texas Securities Act provides for the registration of securities offered or sold in Texas.⁷² It also provides for the registration of firms and individuals who sell securities or render investment advice in the state. The State Securities Board is charged with administering this act, which includes comprehensive provisions designed to protect the investing public. The State Securities Board investigates fraudulent investment schemes (particularly those targeting seniors), takes enforcement actions, and refers matters for civil or criminal enforcement action. Instructions for reporting this fraud can be found on their website.⁷³

The State Securities Board has many educational resources, including a publication to assist APS employees titled "The ABCs for APS Professionals," a step-by-step guide to identify and report investment fraud.⁷⁴

The State Securities Board's website also includes a link to "Serve Our Seniors."⁷⁵ The North American Securities Administrators Association (NASAA) created Serve Our Seniors for

⁶⁷ 4 H.S.C. §253.0075

⁶⁸ 7 Tex. Pen. Code §32.53

⁶⁹ 7 Tex. Penal Code §32.45(b)

⁷⁰ 2 Tex. Probate Code §752

⁷¹ 7 Tex. Penal Code §32.45(d), (West 2011).

⁷² The Securities Act, Tex. Rev. Civ. Stat. Ann. arts. 581-1 to 581-44. (West 2010 & Supp. 2015).

⁷³ Tex. State Securities Board <https://www.ssb.texas.gov/securities-professionals/enforcement/report-suspected-violation>

⁷⁴ Tex. State Securities Board, *ABCs for APS Professionals*, retrieved March 10, 2016 from: https://www.ssb.texas.gov/sites/default/files/ABCs_for_APS_Professionals_brochure.pdf

⁷⁵ Serve Our Seniors, <http://serveourseniors.org/>

citizens to utilize when they seek information about regulatory, legal, and policy issues. The website includes resources for persons in the securities industry, caregivers, policymakers, and investors nationwide to assist individuals and entities as they endeavor to keep our elderly population financially secure. In addition, model legislation, the legislative priorities of NASAA, their testimony and comment letters, and other helpful links can be found on the site by interested parties.⁷⁶ The Model Act to Protect Vulnerable Adults from Financial Exploitation was developed by the NASAA Committee on Senior Issues and Diminished Capacity.⁷⁷ An overview of the act after the comment, testimony, and revision period is as follows:

Application:

Under the act, “eligible adults” include those age 65 or older and those adults who would be subject to the provisions of a state’s adult protective services statute. “Qualified individuals” include broker-dealer agents; investment adviser representatives; those who serve in a supervisory, compliance, or legal capacity for broker-dealers and investment advisers; and any independent contractors that may be fulfilling any of those roles.

Mandatory Reporting:

Qualified individuals who reasonably believe that financial exploitation of an eligible adult may have occurred, been attempted, or is being attempted, must promptly notify Adult Protective Services and their state securities regulator. During the comment process, some commenters noted that a mandatory reporting requirement could increase reports to state agencies. The number of unsubstantiated reports should be kept to a minimum given the ‘reasonable belief’ standard upon which a report is required to be made.

Notification:

The act authorizes disclosure to third parties only in instances where an eligible adult has previously designated the third party to whom the disclosure may be made. Importantly, the model act directs that disclosure may not be made to the third party if the qualified individual suspects the third party of the financial exploitation.

Delayed Disbursements:

The act provides broker-dealers and investment advisers with the authority to delay disbursing funds from an eligible adult’s account for up to 15 business days if the broker-dealer or investment adviser reasonably believes that a disbursement would result in the financial exploitation of the eligible adult. If the broker-dealer or investment adviser delays a disbursement, it must notify people authorized to transact business on the account (unless these individuals are suspected of the financial exploitation), notify the state securities regulator and the adult protective services agency, and undertake an internal review of the suspected exploitation. Under the model, the securities regulator or adult protective services agency may request an extension of the delay for an additional 10 business days. Extensions beyond that could be ordered by a court.

Immunity:

⁷⁶ Serve Our Seniors <http://serveourseniors.org/about/policy-makers/nasaa-model-act/>

⁷⁷ Serve Our Seniors <http://serveourseniors.org/about/policy-makers/nasaa-committee-on-senior-issues-and-diminished-capacity/>

The act's immunity provisions are applicable to the reporting of suspected financial abuse to governmental agencies, the disclosure of information to designated third parties, and the decision to delay disbursements. The immunity provisions provide immunity from administrative and civil liability for qualified individuals, broker-dealers, or investment advisers who, in good faith and exercising reasonable care, comply with the provisions of the act.

Records:

*The act requires that broker-dealers and investment advisers comply with requests for information from APS agencies or law enforcement in cases of suspected or attempted financial exploitation. The act further clarifies that the granting of such access shall not be construed to subject the records of the broker-dealer or investment adviser to a state's public records laws.*⁷⁸

Texas Office of the Attorney General

The Office of the Attorney General (OAG) encompasses the Consumer Protection Division (CPD).⁷⁹ The OAG investigates the financial exploitation of seniors in long-term care facilities that receive federal Medicaid funds. The Texas Business and Commerce Code gives authority to the CPD to enforce the Deceptive Trade Practices-Consumer Protection Act.⁸⁰ An act or practice calculated to deprive a consumer older than 65 of money or other property is eligible for an enhanced civil penalty under the act.⁸¹

The CPD also conducts educational outreach to seniors on financial exploitation, and the OAG's website provides a multitude of information for seniors as well as bank employees on how to protect themselves, estate planning, financial fraud, and more.⁸²

Consumer Financial Protection Bureau

The Consumer Financial Protection Bureau (CFPB) provides additional resources online to help older Americans better protect themselves financially.⁸³ In March 2016, the CFPB released an advisory and report to financial institutions with broad recommendations to prevent and quickly address elder financial exploitation.⁸⁴

While the CFPB does not expect a financial institution to adopt all protocols, policies, and procedures as proposed due to varying size and risks, the CFPB provided ten key recommendations for institutions: train staff to prevent, detect, and respond to elder financial abuse, use technology to monitor for signs of exploitation, report all cases of confirmed or

⁷⁸ <http://serveourseniors.org/about/policy-makers/nasaa-model-act/>

⁷⁹ Texas Attorney General, Consumer Protection Division. <https://texasattorneygeneral.gov/cpd/consumer-protection>

⁸⁰ Tex. Bus. & Com. Code §17.46(a)

⁸¹ Tex. Bus. & Com. Code § 17.47(c)(2)

⁸² <https://texasattorneygeneral.gov/seniors/senior-texans-page>

⁸³ <http://www.consumerfinance.gov/older-americans/>

⁸⁴ Recommendations and Report to Financial Institutions on Preventing and Responding to Elder Financial Exploitation, Consumer Financial Protection Bureau.

suspected exploitation to the appropriate government authorities, file Suspicious Activity Reports (SARs) to FinCEN, expedite requests from APS, law enforcement, and other government entities investigating reports of financial abuse for documentation, comply with the Electronic Fund Transfer Act (EFTA) and Regulation E, allow for information sharing with trusted third parties with the consent of older account holders, offer protective services tailored to older consumers, coordinate with law enforcement and APS, and organize awareness efforts.

Recent Federal Legislation

In June 2016, the U.S. House Financial Services Committee passed H.R. 4538, entitled the "Senior Safe Act,"⁸⁵ to protect financial institutions and advisors from legal liability by giving them immunity if they were to disclose financial exploitation of senior citizens to a regulator, as long as the advisor has received training from their firm on the identification and reporting of suspected elderly exploitation. In June, the Financial Services Institute (FSI) met with lawmakers at the U.S. Capitol to discuss the legislation. As of July 12, 2016, the bill had passed favorably out of the U.S. House of Representatives and FSI was seeking co-sponsors for the Senate version.

⁸⁵ Senior Safe Act of 2016, H.R. 4538 (2016)

Analysis

The Committee met for a public hearing with invited testimony on March 29, 2016 at the State Capitol to explore the topic of elder financial abuse and evaluate ways to strengthen protections to prevent the financial exploitation of the vulnerable elderly population.

The first panel of speakers was comprised of Commissioner John Morgan of the State Securities Board, Beth Engelking of Adult Protective Services (APS), Tim Morstad of AARP of Texas, and Raymond Lynch of Wells Fargo.

State Securities Board Commissioner John Morgan testified first and illustrated that the State Securities Board has conducted outreach to senior groups throughout the state, and has content on its website⁸⁶ to assist seniors who may potentially be victims of fraudulent investment schemes. Commissioner Morgan also believes the North American Securities Administrators Association (NASAA) Model Act would provide useful recommendations for any legislative changes determined to be appropriate in Texas.

Commissioner Morgan explained how financial institutions who know their customers are sometimes better able to recognize fraud and then can alert authorities who can properly investigate and ensure elderly citizens are kept safe. For this reason, he suggested it may be beneficial to create a mechanism where financial authorities can freeze funds and that changes to the laws surrounding financial institutions are needed in order to give them greater ability to protect the vulnerable elderly population.

Tim Morstad testified next and recommended more collaboration between agencies and institutions, refining definitions in state law, improving enforcement, and providing greater funding to state agencies tasked with investigating and preventing elder financial abuse.

According to Mr. Morstad, AARP focuses much of their work on educating its members. Mr. Morstad explained how AARP utilizes its "Fraud Watch" network⁸⁷ to provide the latest information on scams and raise awareness. Through Fraud Watch, seniors or their relatives/caretakers can sign up for watchdog alerts whereby they will be alerted of recent scams.

Beth Engelking explained the two programs APS has: an in-home program and provider investigation program. APS's in-home program investigates individuals in the community who live in their own residences or with family members. Their provider investigation program investigates caretakers for persons with mental health issues or intellectual development disabilities who receive services from state agencies.

Most of Ms. Engelking's presentation focused on the in-home program since this is where APS sees the majority of their investigations take place. APS completed 78,000 investigations in 2015 but she believes many more cases go unreported.

⁸⁶ <https://www.ssb.texas.gov/investors/seniors>

⁸⁷ <http://www.aarp.org/money/scams-fraud/fraud-watch-network>

Ms. Engelking testified that APS's jurisdiction over elder financial abuse is limited due to their requirement of an ongoing relationship. This limitation makes it difficult for APS to take action against an outsider targeting an elderly individual. Therefore, she suggests expanding the scope of what APS is able to investigate. Many other states of similar size and scope to Texas look at the issue from the victim's perspective and consider whether the act deprives the victim of assets, instead of what the perpetrator gained in the long run. However, Ms. Engelking explained that expanding the scope may in turn require additional resources be provided to the program. In regards to APS personnel, Ms. Engelking stated APS needs forensic accountants to help with more complicated investigations.

Ms. Engelking's recommended that the ambiguity of the statute for mandatory reporting be addressed. She believes the statute needs to be clear that financial institutions are required to report and are given immunity from criminal or civil information if the report is made in good faith.

Ms. Engelking also testified on the sharing of information among stakeholders and explained that if APS currently has an open investigation and a financial institution is not involved, they are not able to statutorily share information. Giving them the ability to call the institution and tell them there is an open investigation may help to preserve the funds for the elderly person.

Raymond Lynch testified next and illustrated how gaps in the current statutes virtually tie a financial institution's hands when it comes to preventing discovered financial abuse or exploitation from taking place. In addition, privacy laws prevent the institution from sharing information with family members.

Mr. Lynch next provided explanations of legislation from other states, which he believes will assist Texas in better protecting its elder population. Specifically, he referenced legislation passed in Washington and Delaware which gives financial services companies the right to freeze bank accounts or reject certain transactions by the elder victim or the perpetrator. The legislation would also allow APS and law enforcement to instruct a financial services company to freeze an account if exploitation is suspected. In the instance that an account is frozen, utility payments, mortgage payments, and other regular transactions would be allowed to go through so that the account holder would not be adversely affected during the investigation process.

Mr. Lynch then explained the Uniform Power of Attorney Act (UPAA), which would allow a bank that files a report of abuse to reject the power of attorney and not allow a transaction to go through. In Texas, a bank is not legally permitted to stop a transaction in this manner, but 17 other states have adopted this legislation to allow banks to do so. He said a portion of the UPAA allows the bank to file a petition with the court and ask them to review the situation and 26 states have adopted this portion. Mr. Lynch testified that this current time gap between when an abuse is discovered and when a bank can take action to prevent it causes a problem because legally a bank can be sued when they refuse to honor a transaction when they suspect abuse.

The second panel to testify included Lynda Ender, Age Director at the Senior Source,

Laura Davis and Patricia Sitchler, from the Real Estate Probate and Law Section of State Bar of Texas, and Kim Chamberlain with the Securities Industry and Financial Markets Association.

Lynda Ender testified on reforming assistance mechanisms as the elder population is increasing rapidly due to baby boomers aging and the growing amount of monetary loss in this area. Ms. Ender testified that, according to the True Link Report on elderly financial abuse, seniors lose \$36.48 billion each year due to financial exploitation which is more than 12 times what has been reported before. According to the report, 36.9 percent of seniors are affected by financial abuse within any five-year span.

Ms. Ender testified that the Elder Financial Safety Center is a model that can be replicated throughout the state. As a collaborative effort, the Elder Financial Safety Center works closely with the Dallas Probate Court, the Dallas District Attorney's Office, and the Senior Source, a United Way social service agency. Each of these stakeholders serves clients, across all socio-economic levels, through programs such as prevention services, education and awareness, and financial counseling.

Ms. Ender testified that the Elder Financial Safety Center has prevented the loss of more than \$27 million in Dallas County over the past two years. The Elder Financial Safety Center estimates that the state could prevent the loss of \$7 billion if a program such as theirs was enacted in all Texas counties.

Laura Davis testified that the Real Estate and Probate Section of the Texas Bar Association has discussed addressing how power of attorney privileges can be abused. They are considering legislation to allow, in instances where an individual has power of attorney and an agent is asked to act upon it, an agent may refuse the action if they had a "good faith belief" that the request was not valid or the agent didn't have authority to perform the act. Ms. Davis also explained a second item of consideration, whether a bank who has power of attorney could refuse a request if they were aware someone or the bank had made a report to a law enforcement agency alleging abuse or exploitation by the agent or a person acting on behalf of the agent.

In concluding her remarks, Ms. Davis urged lawmakers to remember that the majority of powers of attorney are valid and suggested that a delicate balance between protecting elder persons in order to prevent exploitation and not forcing them into guardianship, which is a lengthy, expensive process for seniors, is much needed.

Patricia Sitchler then testified how a significant technology gap exists between providing online resources and the lack of computer accessibility in the aging population. She stated that the Consumer Protection Division of the Office of the Attorney General's website is very helpful to seniors and easily understandable. However, many elderly individuals do not have access to the internet and cannot gain information from this website or any other helpful sites. Ms. Sitchler recommends this information be distributed by other means that are more accessible to seniors, such as the newspaper or a mailer.

Ms. Sitchler next provided an overview of the Senior Safe Act and also FINRA's proposal to name a third party that financial institutions could call in the event they suspected

wrongdoing. While she provided substantial feedback on the system of investigating financial exploitation, she cautioned that the effort to protect seniors should not go too far because it could hurt the people who are responsibly assisting their elderly loved ones.

Kim Chamberlain testified that SIFMA supports the Senior Safe Act and also supports the third party solution recommended by Ms. Sitchler. SIFMA believes that legislation creating a voluntary reporting pathway would allow broker dealers to report suspect transactions to designated state agencies without fear of liability. SIFMA also supports broker dealers being permitted to voluntarily reach out to a family member in the event they believe fraud has occurred and it should not be restricted to a designated family member the elderly person has signed for.

Ms. Chamberlain supports the temporary hold on accounts in cases where fraud is suspected and recommended a 15-day period initially with more days if the investigation needed it, and that the temporary hold should become permanent once exploitation is confirmed. She requested that legislation not limit broker dealer's ability to act under existing law or through agreement with a client. Ms. Chamberlain explained that there are only four states currently with safeguards similar to this in place.

Michele Stevens was the final speaker at the hearing. She testified on the importance of internal training in banks so employees are able to recognize the signs of elder exploitation. Under First Financial's "Fraud Busters" program, employees are trained to notice sudden changes in account patterns, such as large cash withdrawals or requests to wire money to foreign countries. She went on to explain how educating the public as a whole within their community, including local civic organizations and churches, can allow the elderly or their family/caregivers to be aware of what abuse looks like.

Ms. Stevens described how the bank works in partnership with local law enforcement along with Adult Protective Services and the Better Business Bureau. They utilize these partnerships when they suspect a client is being exploited. The "Fraud Busters" program tracks dollars that have been saved from leaving the bank due to an employee's watchful eye, and First Financial estimates approximately \$1.9 million have been saved in the past two years. Ms. Stevens advocated for more work to be done on the local, state, and federal level regarding training for employees as well as increasing public awareness on how to avoid these exploitations from happening to our vulnerable elderly population in Texas.

Conclusions

1. The legislature should consider legislation to allow financial institutions to notify an individual reasonably associated with a potential victim in order to permit a short term freeze on the account(s) holding the elder's funds so a Court may consider whether the account(s) should remain frozen pending further Court hearing. The legislature should also consider a provision whereby certain regular account payments are permissible and monitored by the financial institution.
2. The legislature should consider adopting a statute that provides a financial institution may hold a proposed transaction for a period of 10 business days following the filing of a financial elder abuse report about the proposed transaction. The proposed transactions could be held for another 30 business days at the request of an investigating federal or state agency, or the financial institution may seek injunctive relief from a court of competent jurisdiction.
3. The legislature should consider legislation to increase awareness on elder financial abuse in an effort to reduce these crimes against some of the most vulnerable in our society.

COMMUNITY BANKING

Charge #4: “Study the impact on local communities when community banks are consolidated and how this changes the landscape of banking in Texas. Evaluate how the state can help expand charter opportunities in Texas.”

Background

Community banks are known as "relationship banks" for good reason in Texas. Relationship banking allows community banks to make decisions based on local knowledge and nonstandard data obtained through long-term relationships, rather than employ models-based underwriting used by larger banks. The community bank is also better able to structure business and mortgage loans for small businesses and for ranchers and farmers, whose payments may be structured around specific events such as when the farmer finalizes sales for crops or the rancher finalizes sale for cattle. They provide critical local lending support to citizens in Texas — more than 60 percent of all small business loans under a million dollars. More than 75 percent of agricultural loans also originate from community banks in Texas.

Since community banks serve the particular community in which they find themselves, this means that not just the small businesses but also the individual citizens of the community use that same bank. This established relationship, cultivated over generations of Texans, does not exist with large banks.

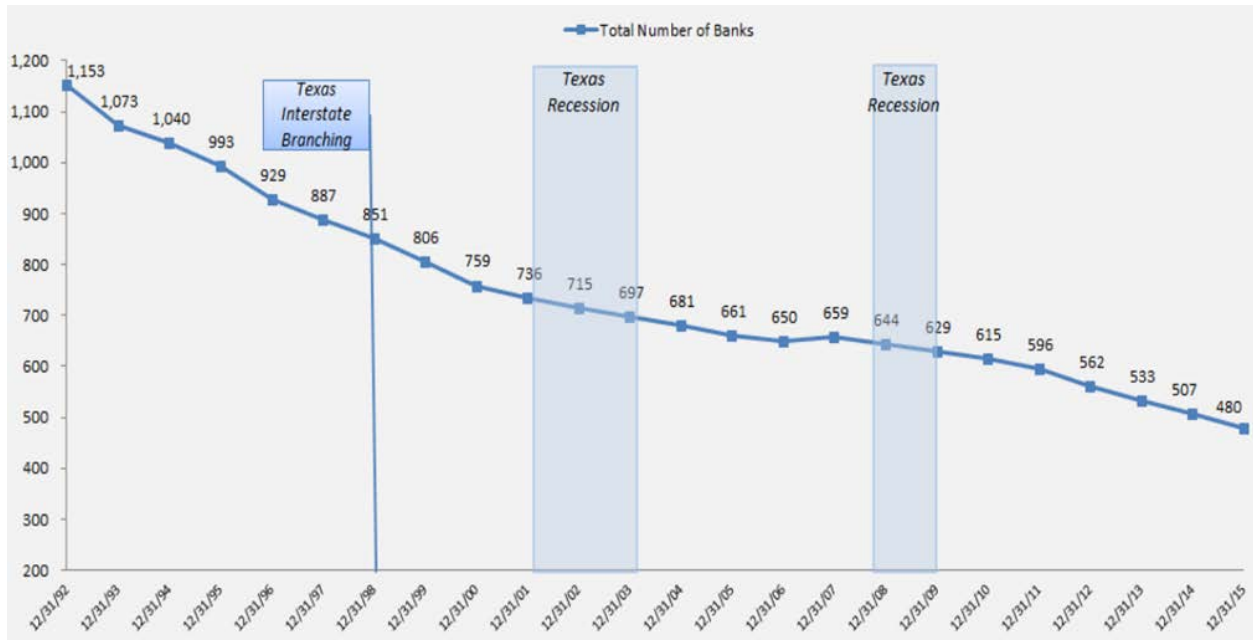
As the FDIC explains, community banks are more likely than larger banks to be privately owned and locally controlled.⁸⁸ They usually aren't traded on major exchanges even when they have public shares, which allows them to weigh interests of shareholders, customers, employees, and local community.

With the exception of a few banks exceeding \$10 billion in assets, almost all the commercial banks headquartered in Texas that were involved in a merger over the last decade met at least one of the following federal banking regulatory criteria for consideration as a community bank when the merger became effective: the \$1 billion asset threshold of the Office of the Comptroller of the Currency (OCC); the Federal Reserve's \$10 billion asset threshold;⁸⁹ or the FDIC's definition based on traditional relationship banking and limited geographic scope.⁹⁰ Using these criteria, almost all Texas commercial bank mergers from 2006 to 2015 involved a community bank in some form.

⁸⁸ Long-Term Trends in Rural Depopulation and Their Implications for Community Banks, FDIC Quarterly 2014, Volume 8, Number 2, p. 44.

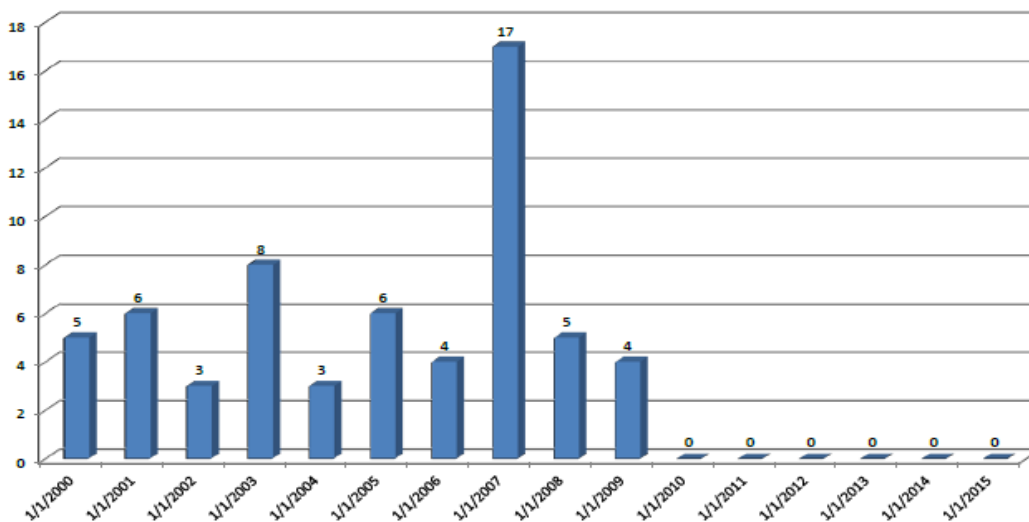
⁸⁹ Supervisory Policy and Guidance Topics, Board of Governors of the Federal Reserve System.

⁹⁰ Defining the Community Bank, FDIC Community Banking Study, December 2012.



Unfortunately, community banks have been on the decline in Texas. Currently, there are 477 Texas banks, but there were 2,000 in 1985. Since December 31, 2010, Texas has seen 138 banks depart for various reasons. This decline is mirrored nationally as well. Activity related to the creation of de novo banks in the state has been nominal, as seen in the following chart.

Number of De Novo State Bank Charters In Texas Since 2000



Legislative History

The passage of the Glass-Steagall Act⁹¹ following the stock market crash of 1929 sought to control reckless and sometimes fraudulent underwriting of securities by creating the Federal Deposit Insurance Corporation as well as a strict barrier between commercial and investment banking activities.⁹² The McFadden Act of 1927 and its 1933 amendments also confined national banks to branching within their own state and only to the same process state banks could branch.⁹³ For a large portion of U.S. history, restrictions on interstate and intrastate branch banking produced a banking system that consisted of thousands of small independent banks.⁹⁴

The Douglas Amendment⁹⁵ to the Bank Holding Company Act of 1956⁹⁶ prohibited the interstate acquisition of a bank by a bank holding company unless specifically authorized by the laws of the state where the bank was located. No states had such laws at the time when the Bank Holding Company Act was passed, but some form of interstate entry law was adopted in nearly every state between the early 1980s and the passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (IBBEA).⁹⁷

Changes to the banking system began in the 1970s after states began relaxing restrictions on Glass-Steagall. In a series of decisions responding to applications by Citicorp, J.P. Morgan, Chase Manhattan and other banks seeking to enter the securities business in 1986-87, the Federal Reserve Board of Governors voted to reinterpret Section 20 of the Glass-Steagall Act, which bars commercial banks from owning companies that are “principally engaged” in securities trading. Under the Federal Reserve's new interpretation, this section allows commercial banks (or, more precisely, their holding companies) to derive up to 5 percent of their gross revenue from dealing in certain types of securities, including commercial paper and municipal bonds.⁹⁸ The Federal Reserve also voted in 1989 to expand the types of securities commercial banks could deal in.

Passage of the IBBEA in 1994 removed many of the remaining restrictions on interstate banking.⁹⁹ It allowed banks to open branches across state lines and to acquire banks in any other state under a uniform, nationwide standard.

In 1996, the Federal Reserve once again reinterpreted Glass-Steagall to allow commercial

⁹¹ Banking Act of 1933 (Glass-Steagall Act), 48 Stat. 162 (1933).

⁹² Mitchell, S. *Glass-Steagall Act & the Volcker Rule*. Institute for Local Self-Reliance. (Oct. 26, 2010). Retrieved from <https://ilsr.org/rule/glass-steagall-act-the-volcker-rule/>.

⁹³ Bradford, Frederick A.; Wells, Christopher. "McFadden Banking Act." *Dictionary of American History*. 2003. Encyclopedia.com.. Retrieved from www.encyclopedia.com on September 26, 2016.

⁹⁴ Economic Brief: Explaining the Decline in the Number of Banks Since the Great Recession, McCord et al., Federal Reserve Bank of Richmond, p. 1.

⁹⁵ The Douglas Amendment, codified at 12 U.S.C. §1842(d).

⁹⁶ *Bank Holding Company Act of 1956*, codified at 12 U.S.C. §1841, et seq. (1956).

⁹⁷ Riegle-Neal Interstate Banking and Branching Efficiency Act, codified at 12 U.S.C. §1811. (1994).

⁹⁸ Mitchell, S. *Glass-Steagall Act & the Volcker Rule*. Institute for Local Self-Reliance. (Oct. 26, 2010). Retrieved from <https://ilsr.org/rule/glass-steagall-act-the-volcker-rule/>.

⁹⁹ Economic Brief: Explaining the Decline in the Number of Banks Since the Great Recession, McCord et al., Federal Reserve Bank of Richmond, p. 2.

banks to derive a maximum of 25 percent of revenue from non-banking activities. Paul Volcker, the chairman of the Federal Reserve at the time, dissented in the vote, arguing for an updated Glass-Steagall instead. Finally, in 1999, Congress passed the Gramm-Leach-Bliley Act, which fully repealed Glass-Steagall with the notion that big banks could monitor themselves.

Dodd-Frank

Banking regulation changed further following the Great Recession of 2007-2009 with the passage of the federal Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) in 2010.¹⁰⁰ Dodd-Frank was passed as a response to the recession and was intended to be “a sweeping overhaul of the United States financial regulatory system, a transformation on a scale not seen since the reforms that followed the Great Depression,” according to President Barack Obama in June 2009. Major provisions of Dodd-Frank include the Volcker Rule, the Consumer Financial Protection Bureau (CFPB), capital and liquidity requirements, the Financial Stability Oversight Council (FSOC), derivatives regulations, and terms on “too big to fail” and living wills. Some portions of Dodd-Frank are still in the implementation phase but the majority have been slowly implemented since its passage in 2010.

The Volcker Rule prohibits depository banks from proprietary trading and was similar to provisions in the Glass-Steagall Act. It does this by limiting banks’ investments in hedge funds and private equity funds. Proprietary trading activities by commercial banks played a major role in the 2008 crisis and caused bank losses that placed depositors’ funds and taxpayer dollars at risk.

The Consumer Financial Protection Bureau (CFPB) was created as an independent financial regulator to oversee consumer finance markets and was given the power to write new rules, supervise certain financial companies, and enforce consumer protection laws through fines and other methods.

Capital and liquidity requirements were also changed by Dodd-Frank. The largest institutions are now required to hold up to 9.5 percent of their assets in liquid capital such as cash, government bonds, or other assets deemed to have a very low-risk profile. Prior to the financial crisis, some of the larger institutions only had \$1 in capital to protect against every \$50 in liabilities (a leverage ratio of 50:1). The new requirement, approximately \$1 for every \$10 in liabilities, is intended to keep the bank from requiring a drastic government bailout.

The Financial Stability Oversight Council (FSOC), composed of leadership and deputies of the Treasury Department and independent financial regulators, was created in order to identify and monitor risks to the financial system. It is responsible for designating systemically important financial institutions (SIFIs).

Authority to regulate “over-the-counter” derivatives trading was given to the Securities Exchange Commission (SEC) and the Commodities Futures Trading Commission. “Over-the-

¹⁰⁰ Consumer Financial Protection Act of 2010 (Dodd-Frank Act), codified at 12 U.S.C. §5301 et seq.

counter” describes a financial trade that is not conducted on a formal exchange but instead is negotiated and carried out by private parties. Dodd-Frank mandated that firms conducting this type of trading use a clearinghouse to do so in order to reduce overall risk by requiring collateral deposits and monitoring the credit-worthiness of firms conducting these trades.

Another major provision of Dodd-Frank gave the FDIC “orderly liquidation authority” — the ability to wind down a large, failing financial institution as an alternative to bankruptcy. It also required large banks to create “living wills” — detailed plans explaining how they would manage their own failure without contaminating the broader financial system. Banks unable to submit an acceptable plan could theoretically be broken down into smaller institutions.

Texas Legislation

Texas amended its own constitution twice in the 1980s with respect to community banking: first in 1984 with the passage and voter approval of H.J.R. 29 of the 68th Legislature of 1983,¹⁰¹ which provided state-chartered banks the same rights and privileges as national banks, and again in 1986 with the passage and voter approval of S.J.R. 4 of the 69th Legislature of 1986,¹⁰² which authorized branch banking under certain circumstances. The 1980s were an especially turbulent period for the Texas banking industry due to the ongoing national savings and loan crisis.¹⁰³

Texas initially opted out of IBBEA's interstate branching provisions but eventually agreed to allow for interstate branching¹⁰⁴ through the passage of H.B. 2066 during the 76th Legislative Session,¹⁰⁵ which authorized interstate operations of financial institutions in accordance with federal law.

Most recently, S.B. 1791 passed during the 84th Legislative Session and created a statutory new account form in the Estates Code. It also required a financial institution to disclose certain information to a customer at the time the customer selected or modified an account.¹⁰⁶

¹⁰¹ H.J.R. 29, 68th Legislature, Regular Session, 1983.

¹⁰² Tex. S.J.R. 4, 69th Legislature, 2nd Called Session, 1986.

¹⁰³ Savings and Loan Crisis, Federal Reserve History, November 2013.

¹⁰⁴ Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Federal Reserve History, November 2013.

¹⁰⁵ Tex. H.B. 2066, 76th Legislature, Regular Session, 1999.

¹⁰⁶ Tex. S.B. 1791, 84th Legislature, Regular Session, 2015.

Analysis

The Conference of State Bank Supervisors (CSBS) and the Federal Reserve held a conference on community banking research and policy September 30-October 1, 2015 in St. Louis, Missouri. At the conference it was announced that a national survey was conducted from April through July 2015 called "Community Banking in the 21st Century." 974 community banks with assets less than \$10 billion in 39 states participated.¹⁰⁷ Approximately 60-70 percent of the banks in Texas who were contacted responded to the survey, which amounted to more than 20 percent of all survey respondents.

The survey revealed that regulatory compliance accounted for 11 percent of all personnel expenses and 38 percent of accounting and auditing expenses for community banks. Regulatory compliance also accounted for 16 percent of the banks' data processing expenses, 20 percent of their overall legal expenses, and 48 percent of their overall consulting expenses. This survey, if seen as a representation of the community banking industry, implies a hypothetical compliance cost to community banks of \$4.5 billion annually. This \$4.5 billion is approximately 22 percent of the community banks' annual income.

The survey also showed that the breadth of mortgage lending activities has narrowed. Commercial real estate lending topped the product lines of the banks at 74 percent. In 2014, 75 percent of banks responding to the survey named one- to four-family mortgages as a primary product line. This dropped to 69 percent in the 2015 survey, due to regulatory changes affecting QM (loans more conservatively underwritten and therefore less likely to default) and non-QM mortgages. Respondents identified retirement services as an expansion in their product line that they viewed as promising. Few banks offered payroll cards, student loans, or reverse mortgages and also appeared among the top services banks planned to continue avoiding going forward. Online loan applications, mobile banking, and personal financial management tools were top among products to be introduced.

Direct input from community bankers supplemented the survey and came from town hall meetings, which state regulators held with their community banks. Common themes which emerged from the town hall meetings with community bankers included the idea that a lack of clear regulatory expectations and perceived aggressive examination tactics led many of the banks to hire more compliance personnel and third-party auditors, both of which are in high demand and caused the banks to incur high expense.

Bankers in oil-producing states such as Texas said they had been struggling with the impacts of price declines on the quantity and quality of their energy-lending portfolios. Rural state bankers, reported difficulty competing with Farm Credit System lenders and both reported challenges in attracting and maintaining employees.

Comments that were universal among most bankers were that safety and soundness exams were more helpful and meaningful than compliance exams, and the regulation was seen as

¹⁰⁷ Community Banking in the 21st Century. (2015). Conference of State Bank Supervisors. Retrieved from <https://www.communitybanking.org/documents/Community-Banking-in-the-21st-Century-2015.pdf>.

unduly burdensome. Texas submitted its state-specific commentary culled from the Independent Bankers Association of Texas' member-mortgage survey,¹⁰⁸ which was as follows:

Mortgage Lending

The reason for the qualified mortgage (QM) and ability- to-repay rules was to avoid systemic risk in the market in case of loan default. If community banks issue loans and keep them in their portfolios, they are fully incented to ensure that the loans do not enter default. A small bank that holds its loans in a portfolio does not present a systemic risk to the system and should be allowed to grant QM status to its portfolio loans.

In addition, the licensing requirements for anyone who interacts with a mortgage loan, along with new requirements from the Truth in Lending Act, have led to community banks hiring mortgage specialists, a cost that is difficult to justify when making fewer than 500 loans per year. Community bankers in Texas feel that, beyond the asset-size exemption threshold, reporting under the Home Mortgage Disclosure Act should be limited if an institution makes fewer than 500 loans per year.

Community banks are typically best suited to help borrowers who may need non-conforming loans. However, the Independent Bankers Association of Texas found that 48 percent of its member banks have been limited in making mortgage loans and 8 percent have stopped entirely.

Fair Lending

With fair lending, it feels as though regulators are trying to tell banks exactly how much they can charge their customers. This has caused community banks to abandon some types of loans, as they are no longer profitable. Some long- term customers of community banks are no longer able to receive a loan at their bank and are turning to payday lenders, paying a higher interest rate than they were before. This is the same problem consumers currently face with new insufficient fund rules; if consumers cannot easily access credit at their banks, they will turn to less regulated entities for help.

Bank Secrecy Act Compliance

Community banks in Texas also face undue reporting requirements through the Bank Secrecy Act. The threshold of \$10,000 for completing a suspicious activity report (SAR) has been the same for a long time, with no regard for inflation or changing circumstances. A change in the threshold or a simplified SAR form would go a long way in easing regulatory burden."

The Federal Reserve has been motivated by past conferences of the CSBS to review issues facing community banks such as the challenges posed by the increased regulatory burden of Dodd-Frank. Their internal review looks at how these regulations impact community banks and evaluates ways in which modifications would positively impact community banks. The

¹⁰⁸ IBAT Member Survey (2014). Independent Bankers Association of Texas. Retrieved from <http://www.ibat.org/PDFs/2014/02/07/2014-ibat-member-mortgage-survey>.

Federal Reserve Board of Governors acted on Congressional authority and raised the size threshold for small bank holding companies from \$500 million to \$1 billion, which provided relief to more than 470 banking firms.¹⁰⁹ In addition, the Federal Reserve actively participated in hearings intended to allow for open dialogue between banks and regulators and held by federal regulatory agencies held under the Economic Growth and Regulatory Paperwork Reduction Act of 1996.¹¹⁰

In their Community Banking Initiative,¹¹¹ the FDIC interviewed community bankers and sought to obtain financial data to understand how regulation and supervision affect bank performance. The nine community bankers interviewed voiced their opinion which was largely that the regulations most burdensome to them were the Bank Secrecy Act and the USA Patriot Act passed after September 11, 2001's devastating attacks. No one regulation or practice was particularly affecting their institution they explained, but the increase in regulation and its associated cumulative costs (increased staff to comply with regulation coupled with increased time per employee spent completing duties associated with regulatory compliance) was the cause of cumulative strain to the organization over time.

The American Bankers Association claims that regulatory compliance costs as a share of operating expenses are two and a half times greater for small banks than for larger banks. Community banks have expressed concern regarding the costs of complying with the new regulations established by Dodd-Frank and capital requirements established under an international agreement known as BASEL III.

On the other hand, there are those who dispute the argument that Dodd-Frank is having a negative impact on community banks, citing increased community bank earnings as evidence. Other factors cited in government reports and academic literature as incentives for community banks to grow through mergers and acquisitions include persistent drought, low interest rates, and rural depopulation.

Reports on the condition of the Texas banking system released in the years following passage of Dodd-Frank attributed subsequent increased merger activity to banks looking for growth amid improved economic conditions and to banks seeking economies of scale due to increased regulatory costs and competition with larger institutions.¹¹² There were very few commercial bank mergers in Texas between 1966 and 1986, but there was a large spike in merger activity in 1987 and 1988. Bank merger activity hit a low point in the years following the 2007-2009 recession, followed by an increase in merger activity beginning in 2012.

Asset size of community banks in Texas has increased. In 1992, institutions with less

¹⁰⁹ Small Bank Holding Company Policy Statement (April 9, 2015). Board of Governors. Retrieved from www.federalreserve.gov.

¹¹⁰ Economic Growth and Regulatory Paperwork Reduction Act of 1996, codified at 12 U.S.C. §1311.

¹¹¹ FDIC, Community Banking Study, December 2012. Retrieved from www.fdic.gov/regulations/resources/cbi/study/htm on September 26, 2016.

¹¹² Condition of the Texas State Banking System, September 2012, Texas Department of Banking and Texas Department of Savings and Mortgage Lending, p. 1.; Condition of the Texas State Banking System, September 2013, Texas Department of Banking and Texas Department of Savings and Mortgage Lending, p. 1.

than \$100 million in assets represented almost 80 percent of Texas banks.¹¹³ By the end of 2015, such institutions represented less than 30 percent of Texas banks. The majority of Texas banks now have between \$100 million and \$1 billion in assets.²³ The chart below provided by the FDIC illustrates increasing assets while the number of banks has decreased.¹¹⁴

FDIC – Insured Institutions

Assets in Millions

Year	TEXAS		NATIONALLY	
	Institutions	Assets	Institutions	Assets
2015	480	\$451,731	6,182	\$15,967,923
2014	507	\$445,838	6,509	\$15,553,660
2013	533	\$433,612	6,812	\$14,722,801
2012	562	\$436,752	7,083	\$14,450,669
2011	596	\$397,418	7,357	\$13,892,115
2010	615	\$374,626	7,658	\$13,318,948
2009	629	\$371,354	8,012	\$13,086,777
2008	644	\$364,988	8,305	\$13,841,148
2007	659	\$345,837	8,534	\$13,033,934
2006	650	\$255,944	8,680	\$11,861,855
2005	661	\$237,641	8,833	\$10,879,267
2004	681	\$215,455	8,976	\$10,107,379
2003	697	\$200,187	9,181	\$9,075,653
2002	715	\$216,906	9,354	\$8,435,858

Presented by the Texas Department of Banking 6

Source: FDIC

Decreased market share has occurred for community banks headquartered in Texas with less than \$1 billion in assets in commercial and industrial lending, agricultural lending, commercial real estate lending, and small business lending.

A 2014 report suggested that keeping up with the changing regulatory environment was difficult for smaller institutions and healthy banks had begun to consider selling to larger firms.¹¹⁵ The Texas Department of Banking reported in 2014 that certain standards relating to Dodd-Frank "have some community bankers expressing that they will no longer be offering mortgage loans or will be reducing their presence in the mortgage lending arena."¹¹⁶

The smallest community banks, those with less than \$100 million in assets, perform slightly worse than their larger competitors in certain FDIC performance indicators such as the

¹¹³ Number of Institutions by Asset Size, Texas FDIC-Insured Commercial Banks, 1992-2015.

¹¹⁴ Changes in Number of Institutions, Texas FDIC-Insured Commercial Banks, 1965-2014; Table 3-1: Number of Institutions by Asset Size, Texas FDIC-Insured Commercial Banks, 1992-2015.

¹¹⁵ Condition of the Texas State Banking System. (September 2014) Texas Department of Banking and Texas Department of Savings and Mortgage Lending.

¹¹⁶ Condition of the Texas State Banking System. (September 2014) Texas Department of Banking and Texas Department of Savings and Mortgage Lending.

percentage of unprofitable institutions and return on assets. For example, a greater percentage of banks with less than \$100 million in assets were unprofitable in 2015 as compared to banks with a larger asset size. Despite declines in 2010, returns on assets across categories have exceeded prerecession levels at the beginning of 2006.

Community banks, larger financial institutions, related trade associations, and other parties in Texas have sought multiple reforms to Dodd-Frank and the rules created in accordance with its provisions. Many regulatory concerns were addressed by financial provisions included in the Fixing America's Surface Transportation (FAST) Act — a federal highway bill enacted in late 2015. In the FAST Act, Section 503 of the Gramm-Leach-Bliley Act was amended to eliminate the annual privacy notice requirement and to require banks to send out privacy disclosures only when their privacy policies and practices have changed. Section 10 of the Federal Deposit Insurance Act was also amended to increase the asset cap of banks eligible from \$500 million to \$1 billion for extended bank exam cycles of 18 months.

Hearing Testimony

The Committee held a public hearing with invited testimony on April 12, 2016 at the University of Dallas to review the impact of community bank consolidation and how to expand charter opportunities in Texas.

Charles G. Cooper, the Commissioner of the Department of Banking, testified first before the Committee. Community banks have 17 percent of the total volume of deposits among all banks and over 50 percent of small business loans in Texas, he explained to the Committee. Their highest percentage comes from agricultural loans where they make over 70 percent of the loans. He explained that Texas is losing a community bank per day and while the size of assets has doubled, the number of banks has gone down.

Commissioner Cooper testified that there were many reasons for banking failures but bad loans and fraud were among the top reasons. He addressed a question from the Committee on de novo banks and explained that the last de novo in Texas was the Bank of Round Rock in 2009, which has done very well since it was chartered. The Commissioner testified that very little de novo activity has occurred nationwide and the activity has mostly been those leaving the industry.

Commissioner Cooper cited regulatory burden as a possible reason for consolidation. The regulatory burden has trickled down to smaller banks, he explained, and the cost of compliance for such smaller banks is much higher. Mr. Cooper expressed his optimism that were a de novo bank to submit a proper application, he was confident the applicant would be able to get FDIC insurance. When asked by the Committee about what was needed for a good charter, the Commissioner explained that it depended on the particular business model but \$30 million would likely be needed in an urban area. A rural bank starting with a lower amount would possibly be able to get a charter, but it would be difficult to then move to a metropolitan area.

A community suffers in many ways when its bank is consolidated or leaves,

Commissioner Cooper explained. Bigger banks generally have higher fees and are less convenient for the community. A loss of personal care also occurs because a bigger bank may not have the same level of connection to the community that was built with the smaller bank over decades. Additionally, persons needing small business loans are not able to get them from the bigger bank because big banks do not try to scale their loans to the individual applicant.

Celeste Embrey of the Texas Bankers Association testified next and she went on to explain that consolidation was driving the loss of community banks nationwide at an alarming rate of one per day. Regulatory costs associated with Dodd-Frank were attributable to this decline, she said, and caused smaller banks to have to merge with medium-sized banks. When this merging occurred, much of the charitable good work done in those communities disappeared.

Ms. Embrey explained that often times new state legislation, such as the 84th Legislature's S.B. 1791, has been extremely difficult to implement and ended up increasing compliance costs for customers. For this reason, she explained, consulting banks prior to enacting such legislation would help determine what the actual costs would be.

Steve Scurlock of the Independent Bankers Association of Texas (IBAT) spoke next and explained that a business model for a small bank was necessary but that regulatory burden made such a model impossible. Dodd-Frank, Mr. Scurlock explained, was an over-reaction to a problem and had left "too big to fail" still in existence. Enforcement of Dodd-Frank's rules was very rigid and unwieldy, with the federal government's attempt to protect the consumer resulting in further harm to them. In some instances, small town consumers have been driven into the arms of sub-prime lenders because larger banks do not provide certain services and this poses a serious risk for market stability.

When asked by the Committee why there are not more de novo banks, Mr. Scurlock said that it was difficult to start a de novo bank, and regulatory burdens make it extremely difficult for these banks to turn a profit.

When asked what the Legislature could do in order to improve the community banking sector and help it to expand, Mr. Scurlock praised the Legislature, saying it was doing a great job currently by supporting regulatory agencies. Self-Directed, Semi-Independent (SDSI) was an extremely helpful tool the Legislature had already put in place which allowed agencies to attract and retain quality personnel.

Ray David of Point Bank testified last on the panel. He explained the many ways in which Point Bank gives back to the community, by donating money to various community organizations and also by being a board member or advisory member for fundraising purposes for many of the organizations. Community banks get involved, he explained, and higher compliance costs hinder their ability to get involved. Point Bank spends \$500,000 per year to meet their compliance costs, which requires them to have more assets. A de novo bank, he said, was a very expensive undertaking, which likely wouldn't see profits for at least three years and must surrender a lot of capital to get to a profit-making point.

Conclusions

1. The legislature should continue to urge the U.S. Congress to enact regulatory relief that would strengthen the community banking industry.
2. The legislature should consider amending Section 113 of the Texas Estates Code to streamline the statutory new account form created by S.B. 1791. This change would likely alleviate additional regulatory burdens and costs S.B. 1791 has placed on community banks.
3. The legislature should consider keeping the financial regulatory agencies' SDSI status in the Finance Code instead of moving it to the Government Code.

INVESTMENT CLIMATE IN TEXAS

Charge #5: “Examine the current investment climate and resources available to businesses in Texas. Analyze the effectiveness of existing programs and whether current investment tools are bringing new businesses and new jobs to Texas, and determine whether the current programs are helping established businesses in Texas create jobs. Identify barriers to investment opportunities faced by businesses and investors. This analysis should include but not be limited to: angel investing, crowdfunding, micro-lending, private equity, venture capital, and mezzanine investing. Make appropriate recommendations to ensure investment tools in Texas continue to evolve to help bring jobs to Texas and meet the needs of new and existing businesses in Texas.”

Background

Every company in Texas was, at one point, a "startup." The formation of new companies is the stimulus of the American economy — new jobs are created with the formation of a company and the economy expands as a result. Texas has had continued growth of startups across the state with Austin being a leading location for emerging tech startups over the last several years. The Kauffman Foundation identified Austin as the highest ranked metropolitan area in the nation for startup activity with Houston, San Antonio, and Dallas all in the top 15 metros.¹¹⁷

The capital-funding ecosystem is essential to developing, supporting, and growing these new businesses. The ecosystem encompasses angel investors/groups, venture capital (seed stage to late-stage investing), commercial banks that provide working capital and venture debt, private equity firms for growth capital and mergers and acquisitions (M&A), and investment banks for M&A and Initial Public Offerings (IPOs). A strong investment climate must have access to investment resources across the funding spectrum in order to ensure sufficient capital is available at all stages of growth.

Texas Wide Open for Business, which provides resources for people looking to open a business in Texas, says, “with low taxes, a predictable regulatory climate and a skilled workforce, Texas leads the nation in economic growth. The Texas Economic Development Corporation (TxEDC) and the Governor's Economic Development & Tourism Division (EDT) offer many services to facilitate location research, identify valuable incentives, explore financing options, and employ TxEDC support services. In nearly every category, Texas has the advantage in state-to-state comparisons.” Texas Wide Open for Business is a website powered by the Governor’s Office, TexasOne Program, and the Texas Economic Development Corporation.¹¹⁸

Private Equity Investments

A private equity firm is an investment manager that makes investments into operating

¹¹⁷ Wiens, J. & Morelix, A. *Startup Activity in America: A Look at Startup Policy and the Kaufman Index*. The Kaufman Foundation (August 31, 2016). Retrieved from www.kauffman.org.

¹¹⁸ Texas Wide Open For Business, <https://texaswideopenforbusiness.com>.

companies through a variety of loosely affiliated investment strategies including leveraged buyout and growth capital. The private equity market in Texas is significantly more mature than sources of early stage capital.

Crowdfunding

Crowdfunding is usually done through Internet-mediated registries. The State Securities Board (SSB) is currently accepting applicants to be a Texas Crowdfunding Portal. To be eligible, the applicant must comply with rules set forth on the SSB's website.¹¹⁹ Crowdfunding is expected to grow in Texas significantly in the years ahead in order to assist entrepreneurs looking for early stage capital.

Mezzanine Financing

Mezzanine financing is a hybrid of debt and equity financing, typically used to finance the expansion of existing companies. Mezzanine debt capital generally refers to the middle layer of financing between a company's senior debt and equity. When mezzanine debt is used in conjunction with senior debt it reduces the amount of equity required in the business. The lender has the right to convert to an ownership/equity interest in the company if the loan isn't paid back in time and in full. The owners face little dilution and maintain their control of the business; the company's total cost of capital is reduced; and the mezzanine debt has a flexible payment term that is structured as "self-liquidating" and is paid off over time. This debt structure does require interest payments over time. It's treated as equity on a company's balance sheet and sometimes this makes it easier for the company to obtain standard bank financing. To attract mezzanine financing, a company usually must demonstrate a track record in the industry with an established reputation and product, a history of profitability, and a viable expansion plan for the business (e.g. expansions, acquisitions, IPO).

Microlending

Microlending typically provides small amounts of money to very poor fledgling entrepreneurs to encourage self-sufficiency and to end poverty, particularly in developing countries. The economic stimulus bill of 2009¹²⁰ granted \$54 million to the Small Business Administration in order to enable micro-lenders to lend to more small business owners.

Most microlending programs in the United States offer loans under \$35,000 to small businesses with less than five employees, with an interest rate typically between 5-18 percent. The higher interest rate can be a deterrent to some companies, but the opportunity to receive a loan which could give their emerging company the boost it needs is considered beneficial by many companies.

¹¹⁹ Texas State Securities Board, www.ssb.texas.gov/texas-securities-act-board-rules/texas-intrastate-crowdfunding.

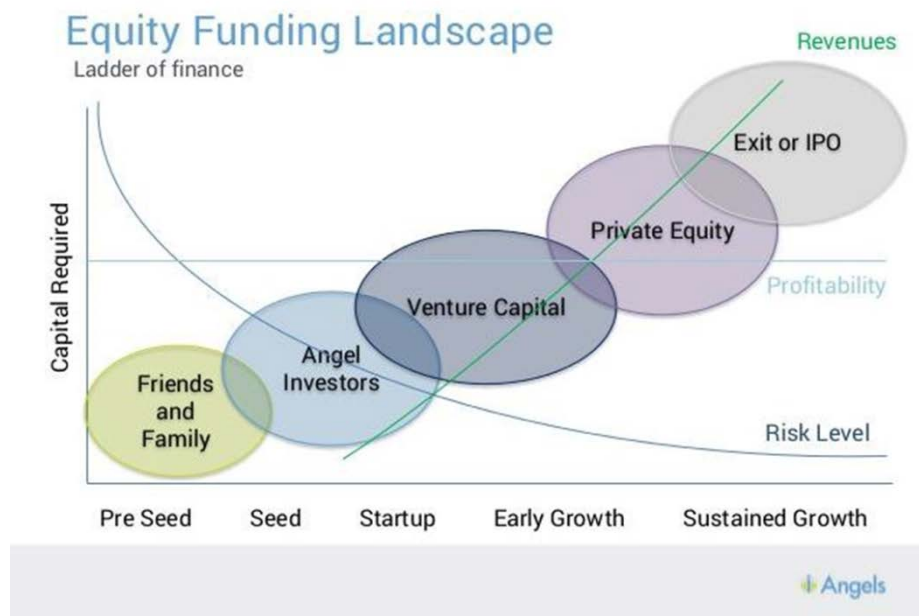
¹²⁰ American Recovery and Reinvestment Act of 2009, codified at Pub.L. 111-5.

Angel Investing

An angel investor is an affluent individual who provides capital for a business start-up, usually in exchange for convertible debt or ownership equity.

In 2015, Texas as a region completed the fourth greatest amount of angel investor deals (10.3 percent of the overall number of deals in the United States). California (20.9 percent), the Southeast Region (12.2 percent) and the New England Region (11.9 percent) had more deals in that same time period. While this distribution is a positive sign for angel investing in Texas, the share of dollars invested by angel investors indicates areas of possible concern as Texas was only 6.9 percent of the total share of angel dollars invested and was significantly behind California (17.9 percent), the Northeast Region (15.0 percent), the Great Lakes Region (12.2 percent), and the Northwest region (9.8 percent).

The chart below, provided by the Angel Institute,¹²¹ demonstrates how crucial angel investors are to helping a company. Often, friends and family are where a business receives its initial monetary support. To grow to the point where venture capital and private equity are willing to take a chance and invest, the company must rely on angel investors. This critical funding bridges the gap and allows the company to develop and show potential for large-scale success.



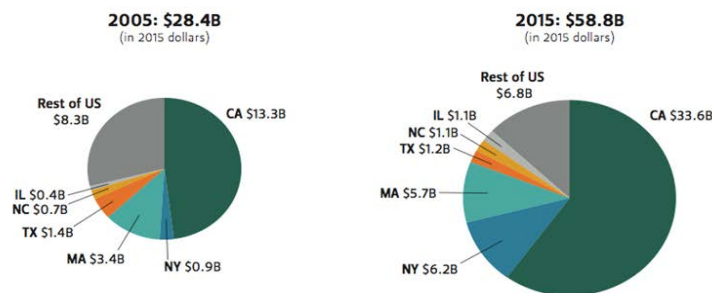
¹²¹ Hamburg, K. (2015) The HALO Report: 2015 Annual Report. *The Angel Institute*. Retrieved from www.angelresourceinstitute.org.

Venture Capital Investing

In 2015 Texas was ranked fifth in the nation for the amount of venture capital invested within the state itself. There is a significant gap between the venture capital funding of the top 3 states and the rest of the country. According to the 2016 National Venture Capital Association/PWC/Moneytree Report,¹²² Texas only had venture capital investments of \$1.17 billion across the state while California had \$33.67 billion, New York had \$6.23 billion, and Massachusetts had \$5.71 billion for CY2015. Washington State invested \$1.2 billion across a smaller number of deals than Texas. The venture capital invested in Texas was only 2% of the \$58.8 billion in total venture capital investments nationwide for 2015.¹²³

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FIGURE 1 — VENTURE CAPITAL INVESTMENTS IN THE U.S. GREW BY MORE THAN 100% FROM 2005 TO 2015



SOURCE PWC Moneytree and the U.S. Bureau of Economic Analysis

These numbers are all significantly higher than ten years ago, in 2005 as seen in the chart above. Back then, the total venture capital investments were \$28.4 billion, with California still leading the pack at \$13.3 billion, Massachusetts at \$3.4 billion, and Texas rounding out third place with \$1.4 billion.

TABLE 1 — 10-YEAR GROWTH RATES FOR SIX TOP VENTURE CAPITAL STATES

New York	577%
Illinois	175%
California	151%
U.S. Average	107%
Massachusetts	68%
North Carolina	57%
Texas	-19%

SOURCE PWC Moneytree and the U.S. Bureau of Economic Analysis

¹²² MoneyTree Report (2016). Pricewaterhouse Coopers National Venture Capital Association. Retrieved from www.pwcmoneytree.com/reports.

¹²³ MoneyTree Report (2016). Pricewaterhouse Coopers National Venture Capital Association. Retrieved from www.pwcmoneytree.com/reports.

In terms of the number of deals tracked by the National Venture Capital Association (NVCA), California led the nation with 1,773 venture deals, followed by New York with 462, Massachusetts with 426, and Texas with 163.

According to the NVCA, “As more cities, states and municipalities dedicate greater resources to foster the growth of their local ecosystems, venture investors are taking notice and deploying capital across much larger areas of the country. This not only helps the entrepreneurs themselves but local economies as well through job creation and sustained economic growth.”

When capital supply is too low, talented entrepreneurs developing fundable companies are disadvantaged when negotiating deal terms and are forced to either move to a geography where abundant capital supply is available or simply abandon efforts to develop a high-growth business.

Texas Emerging Technology Fund

H.B. 1188 of the 79th Legislative Session created the Texas Emerging Technology Fund (ETF) under the Economic Development and Tourism Division of the Office of the Governor.¹²⁴ It was launched with \$200 million to help create jobs and develop the economy of Texas. The 80th and 81st Legislatures increased the total funds under management to approximately \$500 million. A 2011 report by the State Auditor's Office found that the ETF lacked transparency and the state had not properly tracked its performance. During the 84th Legislative Session, H.B. 26¹²⁵ and S.B. 632¹²⁶ effectively ended the ETF and replaced it with the Governor's University Research Initiative, which will receive \$40 million from the state budget and whose mission is to attract top-notch researchers to Texas public schools.

Texas Enterprise Fund

The Texas Enterprise Fund (TEF) was created in 2003.¹²⁷ Approximately \$45 million was transferred to the TEF when the ETF was being phased out. It's a cash grant used as a financial incentive tool for projects offering significant projected job creation and capital investment. To date, it has awarded over 100 grants totaling more than \$500 million across a wide variety of industries and projects. Companies such as Apple, Cabela's, and 3M are just a few of the many who have received awards from the Fund. Since its creation, TEF grant recipients have pledged to generate over \$21 billion in capital investments and nearly 70,000 new jobs in the state.

The Economic Development & Tourism Division of the Office of the Governor administers the TEF, with each applicant undergoing a thorough 11-step due diligence process. An analytical model is applied uniformly to each applicant so Texas sees a full return on its

¹²⁴ Tex. H.B. 1188, 79th Legislature, Regular Session, 2005.

¹²⁵ Tex. H.B. 26, 84th Legislature, Regular Session, 2015.

¹²⁶ Tex. S.B. 632, 84th Legislature, Regular Session, 2015.

¹²⁷ Tex. S.B. 1771, 78th Legislature, Regular Session, 2003.

investment within the period of a project contract due to the resulting increase in estimated sales tax revenues.

While the TEF has certainly assisted many projects and companies, the eligibility requirements make smaller companies and startup companies ineligible to receive the grant. Some requirements include: “Projected new job creation must be significant – past recipients have typically created more than 75 jobs in urban areas or more than 25 in rural areas,” and “The project must have community involvement from the city, county, and/or school district, primarily in the form of local economic incentive offers.”

Analysis

The Committee held a public hearing on April 12, 2016 at the University of Dallas and heard invited testimony on the charge. Some invited guests who could not be present at the hearing provided written testimony.

The first panel of speakers was comprised of Jamie Rhodes, the Chairman of the Alliance of Texas Angel Investors (ATAN), Bill Cone, a founding member of South Coast Angel Network, Les Kreis, Steelhead Capital Management and a founding member of Cowtown Angels, and Jorge Varela, with Cowtown Angels.

Jamie Rhodes testified first before the Committee. He stated that ATAN has invested more than \$40 million in over 100 companies. Not only do ATAN and other angel networks across the state provide financial support, Mr. Rhodes explained that ATAN has developed "best practices" for startups and distributes these with new companies they have growing relations with. In addition to mentoring new companies, ATAN also cultivates relationships between investors in different cities.

Mr. Rhodes provided the Committee with a HALO Report,¹²⁸ (a national survey of angel group investment activity) which shows Houston and Austin as two of the 10 most active angel groups in the nation. Texas Angels are ahead of those located in New York, Chicago, and Silicon Valley. He stated that Texas alone accounts for 10% of the angel funding in the nation, and currently outranks the 9.5% of angel funding in New York.

Mr. Rhodes testified that while Texas Angels provide great access to funds, he believes the absence of the Emerging Technology Fund will have a negative impact on the state economy.

Bill Cone testified next and provided a chart showing the "entrepreneurial ecosystems" within Texas and discussed how to build one in cities that don't currently have one. Mr. Cone explained how angel networks syndicate deals they invest in and share their due diligence, thus reducing risk to investors with regards to newly forming companies.

Mr. Cone also testified on how the angel groups assist clients in an area where funding of more than \$2 million but less than \$5 million is needed, which allows companies to avoid going to venture capital firms.

Les Kreis discussed how traditional bank lenders that used to lend money to startups are no longer able to do so and that the angel market was created to fill the gap.

Mr. Rhodes followed up on his testimony and explained that ATAN accounts for \$40 million or more of the money invested in small or early-stage businesses, while all angel investors across Texas (including ATAN) make up about \$168 million, according to the Angel Research Institute. He emphasized that 80% of the money being invested in Texas is by Texas companies.

¹²⁸ HALO Report (2015). Angel Resource Institute. Retrieved from www.angelresourceinstitute.org.

Mr. Kreis testified on the possibility of creating a matching fund whereby the state could invest alongside angel investors and discussed the pros and cons of such a program with the Committee. He also recommended additional funding and support for the smaller incubators who support startups and who prepare companies to ask angel investors for funding.

Jorge Varela testified last on this panel. Early stage capital, he testified, is an important part of economic development for any state and is happening internationally, so the state's competitors are not just nationwide but also around the world. A state can expect high returns from high-risk, early stage investments in companies.

Mr. Varela explained how Cowtown Angels has invested \$15 million in eighteen companies and has raised \$55 million through syndication. Incubators make it much more likely that a company will succeed because it gives the company the coaching, mentoring and networking structures the company needs.

Mr. Varela testified how Texas can learn from the positive aspects of the Emerging Technology Fund (ETF). He recommended that Texas could create a sliding scale of investment risk caps based on the stage of development of the company, thus the state would not lead the investment and take on the risk. Mr. Varela recommended prioritizing technology coming out of universities over other investments. He provided the state of New Jersey as an example of a comprehensive approach that successfully implemented a sliding scale of this nature.

Larry Skelding from the Austin Chamber of Commerce provided written testimony to the Committee. He wrote that small, innovative high-growth companies struggle to access the capital they need in Texas because they do not qualify for traditional debt sources.

Mr. Skelding advocated for state programs targeting small businesses. Without capital supply, Texas loses experienced talent and entrepreneurs, and the long tail of the economic benefits of jobs, successful exits and IPOs.

Larry Peterson, the Executive Director for the Texas Foundation for Innovative Communities, also provided written testimony to the Committee. He explained that increasing Texas' competitiveness in innovation-intensive industries is one of the most valuable targets for policy. He went on to explain that Texas currently has a formula of low costs, relatively low taxes, moderate regulatory burden and tort restraint which help it to weather downturns much better than other states. He wrote that the net productivity of a region is what determines its prosperity. Mr. Peterson believes Texas has attracted venture capital from other states, but that this trend has decreased recently.

Mr. Peterson recommended the state implement an Economically Targeted Initiative (ETI), which would not require an appropriation or legislation from the state. An ETI provides a means to leverage state trust funds (retirement funds and endowments) for the secondary purpose of building a state venture industry. Texas currently maintains more than \$200 billion in such funds, of which tens of billions are invested in alternative investments such as private equity and venture funds – primarily in other states. All of these trust funds are currently empowered to

make co-investments with leading venture funds into Texas companies, or give tiebreaker preference to Texas-based fund managers, but there is no systematic disclosure or promotion of this information. With over \$200 billion in assets, a small nudge is all that is needed. It is likely that only \$60 million in new investment per year would eventually establish a domestic Texas venture industry.

Mr. Peterson wrote that there are numerous fund-of-funds and co-investment programs, mostly funded by the federal SSBCI program on a one-time basis, or supported by the state through contingent tax credits. In this way, no direct appropriation is made, but future revenues are used as collateral to raise funds from the private sector. Managed prudently, the returns cover return of capital and program expenses, and can even yield a small surplus for the state. In the worst case, the state forgoes some amount of future revenues through exercised tax credits.

David Altounian, Assistant Professor of Entrepreneurship at St. Edward's University and a partner in Capital Factory in Austin, provided some insight through his written testimony from the Capital Funding Landscape at St. Edward's. Their research suggests a complete network of funding firms is necessary to develop growing entrepreneurial communities and successful companies. The three largest metro areas for venture funding (Silicon Valley, Boston, and New York) also had the highest amount of funding sources in their immediate areas. He advocated the importance of the funding network in two ways: 1) density within a segment of funding sources (angel groups, venture capital, commercial banks, etc.) encourages competition and syndication among deals, and 2) increased access to sources in other funding segments (angel-funded companies having access to venture capital investors, venture capital-invested companies having access to investment bankers, and the like).

Research from St. Edward's demonstrates that angel investors and venture capital firms invest and take risk with the intent on achieving a positive return on their investment, he explained. This is done through M&A and IPO activity and requires private equity firms and investment banking relationships. Identifying programs and opportunities to encourage M&A and IPO activity for Texas businesses would likely drive more investment and larger funding rounds long-term.

Conclusions

1. The legislature should consider finding new ways to create sources of early stage capital in Texas for startup entrepreneurs. This is an essential ingredient in the future prosperity of Texas.
2. The legislature should explore methods of facilitating improved relations between investors and incubators across the state in order to strengthen support for new startup companies.
3. The legislature should continue to analyze co-investing models and fund-of-funds programs in other states. Once an evaluation is completed, the legislature should consider developing Texas-specific legislation with a holistic approach that engages support organizations, including Angel networks and venture capital groups.