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JUST UNTIL PAYDAY

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The growth of payday lending markets during the last fifteen years has been the focus of substantial regulatory attention both in the United States and abroad, producing a dizzying array of initiatives by federal and state policymakers. Those initiatives have had conflicting purposes—some have sought to remove barriers to entry while others have sought to impose limits on the business. As is often the case in banking markets, the resulting patchwork of federal and state laws poses a problem when one state is able to dictate the practices of a national industry. For most of this industry's life, just that has happened—the ability of lenders to take advantage of the laws of the least restrictive states has effectively displaced the laws of more restrictive states. Recently, however, significant changes in the policies of federal regulators have limited the ability of lenders to "export" less restrictive laws. Now, states can effectively police payday lenders within their borders for the first time.

Yet as we enter an era in which states will be able to regulate payday lending more effectively, there has been little clear analysis regarding how they should do so. This Article provides a detailed explanation of the business models and regulatory regimes that exist today, together with a framework of options designed to implement various perspectives regulators might adopt. We emphasize three main points. The first is the unusual nature of payday lending, with very high interest rates accruing against necessarily limited-debt amounts. Unlike other consumer-lending products such as credit cards, the payday loan amount does not increase over time, but the repetitive short-term interest obligation can lead to a recurring-cash annuity for

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the lender. Second, we underscore the limitations of existing legal regimes, which often leave loopholes that permit lenders to avoid the statutory framework; this is a particularly serious problem for the majority of states that have tried to limit rollover lending. Third, addressing the majority of jurisdictions that have not banned payday lending, we advocate a reversal of the current hostility to market activity by large institutions. If the market is to exist, we believe it is better for it to be populated by highly visible national providers than by smaller mom-and-pop providers.

INTRODUCTION

Regulating lenders that offer credit to consumers with impaired credit histories is a tricky business. Consumers want access to credit, lenders want to charge high interest rates to offset relatively high transaction costs and loss ratios, and policy analysts and lawmakers want to protect consumers from foolish behavior, high interest rates, and abusive practices. The spirit of the market is captured by a recent Cash America television advertisement advising that "some things can't wait until payday."[1] In the current market, banks generally refuse to make the short-term, risky loans many of these consumers seek, but fringe-credit providers have risen up in their place, at least some of which engage in deceptive and abusive practices that violate existing law. As the market grows, it becomes ever clearer that the existing regulatory framework is inadequate.

This Article provides a careful look at the difficulties of regulating the most prominent and rapidly growing of these fringe providers—payday lenders. Payday lenders offer short-term loans at high interest rates to consumers with impaired credit histories. In a typical transaction, a customer writes a check to the payday lender for a relatively small sum, such as $230, dating the check for the date of the customer's next paycheck. In exchange, the payday lender gives the customer $200 in cash immediately. On the date of the customer's paycheck, the payday lender collects its loan by depositing the postdated check. The duration, amount, and fee all can differ from provider to provider, but as a general rule, the loans are small, the repayment period is short, and the annualized interest rate is high. In this example, with a fee of $30 for a two-week loan of $200, the annual interest rate is almost 400 percent.

The high interest rates that payday lenders charge have generated a flurry of critical proposals, ranging from calls to end payday lending altogether to proposals for additional disclosures by payday lenders.[2] The existing academic

1. *Cash America Television Advertisement* (Sept. 7, 2006).

2. *See, e.g.*, Michael S. Barr, *Banking the Poor*, 21 YALE J. ON REG. 121 (2004); Richard R.W. Brooks, *Credit Past Due*, 106 COLUM. L. REV. 994, 997 (2006); Carmen M. Butler & Niloufar A. Park, *Mayday Payday: Can Corporate Social Responsibility Save Payday Lenders?*, 3 RUTGERS J.L. & URB. POL'Y 119 (2005); Creola Johnson, *Payday Loans: Shrewd Business or Predatory Lending?*, 87 MINN. L. REV. 1 (2002); Susan Lorde Martin & Nancy White Huckins, *Consumer Advocates vs. the Rent-to-Own Industry: Reaching a Reasonable Accommodation*, 34 AM. BUS. L.J. 385 (1997); Therese Wilson, *The Inadequacy of the Current Regulatory Response to Payday Lending*, 32 AUSTL. BUS. L. REV. 193, 198–206 (2004); Michael Bertics, Note, *Fixing Payday Lending: The Potential of Greater Bank Involvement*, 9 N.C. BANKING INST. 133 (2005); Charles A. Bruch, Comment, *Taking the Pay Out of Payday Loans: Putting an End to the Usurious and Unconscionable Interest Rates Charged by Payday Lenders*, 69 U. CIN. L. REV. 1257 (2001); Diane Hellwig, Comment, *Exposing the Loansharks in Sheep's Clothing: Why Re-Regulating the Consumer Credit Market Makes Economic Sense*, 80 NOTRE DAME L. REV. 1567 (2005); Lisa Blaylock Moss, Note, *Modern Day Loan Sharking: Deferred Presentment Transactions & the Need for Regulation*, 51 ALA. L. REV. 1725 (2000).

literature, however, lacks a frank assessment of the complex regulatory problems that payday lending presents. Scholars calling for intrusive regulation or outright prohibition of payday lending have skipped over the necessary step of explaining precisely what it is about this market that is so offensive as to justify prohibition or regulation. High interest rates standing alone are not a sufficient basis for regulatory intervention. Furthermore, such criticism has failed to explain how the elimination of payday lending would protect consumers who would then be drawn to other, even riskier sources of cash. Thus, our starting point is that a sensible scheme of regulation must rest on a determination that the transactions involve market failures, that the payday lending industry externalizes costs to the rest of society, or that the transactions offend social norms or justice in some other way.[3]

Regulation also cannot proceed sensibly without a rich understanding of the economics of the market, including information about the business model and the competitive structure of the industry. Most of the existing literature focuses on a single feature of the product—the high price—without considering the product's business and regulatory context. Accordingly, in Part I, we attempt to craft a realistic assessment of the business model, competitive structure, and regulatory environment of the existing industry. We draw on existing empirical studies, government reports, as well as our own conversations with regulators and industry participants. As Part I explains, we write at a crucial and unusual moment in the regulatory history of consumer finance. Though the typical pattern for the last half century has been for federal preemption to expand consistently to prevent effective state regulation[4]—exemplified by regulation targeting credit card and subprime mortgage lending—the last few years have witnessed an unparalleled determination by federal regulators to withdraw from the field, leaving the way open for effective state regulation.

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3. So, for example, discussions often focus on the concern that payday lenders might target insular groups, such as minorities, immigrants, or military service people. Payday borrowing by the military has been a hot topic since an August 2006 Department of Defense report estimated that as many as 17 percent of military personnel use payday loans. *See* U.S. DEP'T OF DEF., REPORT ON PREDATORY LENDING PRACTICES DIRECTED AT MEMBERS OF THE ARMED FORCES AND THEIR DEPENDENTS 17 (Aug. 9, 2006), http://www.defenselink.mil/pubs/pdfs/Report_to_Congress_final.pdf. Many military personnel, particularly the young, are persistently cash poor. Yet, they are unlikely to be laid off or to receive their payroll checks late or have them dishonored. So, it is not surprising that check-cashing stores, and the payday lending stores that have grown out of them, often appear near military bases. Moreover, the unstable location of military families makes them more likely to rent and less likely to own homes than similarly situated civilian families. Because the credit-reporting system disadvantages those who do not own homes, military families have a harder time gaining access to mainstream intermediate and long-term credit products, making short-term payday loans relatively more attractive.

4. For a lucid and comprehensive discussion, see Elizabeth R. Schiltz, *The Amazing, Elastic, Ever-Expanding Exportation Doctrine and Its Effect on Predatory Lending Regulation*, 88 MINN. L. REV. 518 (2004).

Responding to that opportunity, Part II analyzes three distinct policy perspectives that individual states might endorse, matched with regulatory schemes that implement those perspectives. Recognizing that no jurisdiction in the United States has adopted a completely laissez-faire approach to the payday lending industry, the three perspectives that we consider lie along a spectrum from total prohibition, to a limited prohibition of indefinite rollover loans, to moderately restrictive licensing requirements.

We first consider whether payday lending should be tolerated at all. To the extent that the payday lending market is inevitably connected with consumer deception and financial distress, we can make out a case for complete prohibition. If consumers use the product because they do not understand the distress into which it can lead them, then it would be plausible to ban the product either on paternalistic grounds or to limit the broader social costs of their financial distress. For us, the strongest counterargument is that the prohibition of payday lending would only lead to a shift of lending activity—borrowers will continue to borrow but will do so using products that are more harmful than payday loans. But many empirical questions remain unanswered, especially about the interaction among fringe-credit products[5] and about the borrower side of this market.[6] Thus, it is difficult to evaluate the societal effect of payday lending.

5. For example, we know little about whether payday loans facilitate or substitute for other borrowing. Although the United Kingdom has produced an interesting report explaining how the various products work, where they are used, and what has happened when jurisdictions have tried to ban particular products, it remains unclear how alternative borrowing products interact with each other and which products are used by which sectors of the middle- and low-income populations. *See* UNITED KINGDOM DEP'T OF TRADE & INDUS., THE EFFECT OF INTEREST RATE CONTROLS IN OTHER COUNTRIES (2004) [hereinafter DTI REPORT], http://microfinancegateway.com/files/25620_file_The_effect_of_interest_rate_controls.pdf. In other words, if we knew that borrowers frequently used payday loans to pay the minimum balances on their credit cards or to recover pawned goods, we might have different concerns than if we thought that these products did not interact.

6. There is little information about the most common uses of the borrowed funds, and, in particular, whether there is reason to believe they encourage spending. The best studies of which we are aware suggest that the great majority of funds are not used for immediate consumption. For example, a study by Gregory Elliehausen and Edward Lawrence concludes that 65 percent of borrowers use the funds for "emergencies," 11 percent for "planned expenses," and 22 percent for "other." Gregory Elliehausen & Edward C. Lawrence, Payday Advance Credit in America: An Analysis of Customer Demand 47 (April 2001) (Monograph #35, Credit Research Ctr., McDonough Sch. of Bus., Georgetown Univ.), http://www.cfsa.net/mediares/Reports/GeorgetownStudy.pdf. Similarly, a study conducted by Environics Research Group on behalf of the Canadian Association of Community Financial Service Providers reports that 92 percent of payday customers ascribe their use of the product to an immediate cash-flow crisis and 4 percent to immediate consumption. Environics Research Group, Understanding Consumers of Canada's Payday Loans Industry 18 (June 9, 2005), *available at* http://www.cpla-acps.ca/english/reports/PaydayLoansReportPresentationJune9.ppt. Also, studies have reached differing conclusions about the demographics of payday borrowers. For example, industry-funded studies suggest that the customer base is relatively well-off. *See id.* at 5 (suggesting that payday loan users in Canada are about as likely to have incomes above $60,000 as below $40,000); *see also* National Endowment for Financial Education, The Debt Cycle: Using Payday Loans to Make Ends

In any event, states that decide that an outright ban is best can eliminate this product if they have the political will to do so. Drawing on the experience of New York, we argue that the key is a hard and fast usury limit, coupled with vigilant enforcement against efforts to import rates from other states. As we explain in Subpart I.C, recent actions of federal banking regulators have limited the ability of banks to force states to permit the importation of out-of-state interest rates. Thus, states for the first time have a realistic option of excluding payday lenders from their borders.

The second possibility is to ban indefinite rollover loans—transactions in which payday customers borrow repetitively instead of repaying their loans. We develop the reasons why indefinite rollover loans might—or might not—trouble thoughtful regulators. In turn, we discuss initiatives necessary to ban these loans effectively. Although many states have adopted legislation purporting to curb rollovers, few, if any, states have enacted legislation that will be successful in that respect. Accordingly, we argue that legislatures should combine a statewide database of all licensed lending transactions with a rule that bans not only immediate rollover transactions but also requires a substantial cooling-off period between transactions.

Finally, we offer a comprehensive set of proposals for jurisdictions that wish to allow licensed lenders to operate within their borders but also want to police abuses. These proposals proceed on two fronts. The first is a microfront, designed to make the product more transparent so that customers can easily and reliably understand the charges they will pay if they use the product. We would retain the licensing regimes that are common in most jurisdictions, but we would add two new initiatives. First, we would ban the sales of associated products, like insurance or membership fees, that increase the cost of credit but are not readily reflected in the price given to customers. Second, we would abandon the misguided Truth In Lending Act disclosure regime[7] in favor of a simpler, more

Meet 9 (undated summary of Feb. 2002 panel discussion) [hereinafter NEFE White Paper], *available at* http://www.nefe.org/pages/whitepaperpaydayloans.html (suggesting that customers typically have incomes between $25,000 and $50,000). On the other hand, at least some independent studies present starker data. *See id.* at 9–10 (suggesting a median income of $23,690 in Chicago payday loan customers). The most that can be said with certainty is that payday lending customers are sufficiently well-off to have bank accounts. Finally, despite pathbreaking studies of consumer bankruptcy, there is little research about the role of fringe products in the finances of the financially distressed. For some evidence on that question, see Robert Mayer, *One Payday, Many Payday Loans: Short-Term Lending Abuse in Milwaukee County* (Loyola Univ. Chi., Working Paper, undated), *available at* http://www.luc.edu/depts/polisci/research/mayer21.pdf.

7. 15 U.S.C. §§ 1601–1667. Many stores compete on the basis of this fee and advertise the information so that it is available even before the borrower enters the store. However, to the extent the products involve hidden fees, a well-crafted disclosure requirement would focus competition on price and service.

comprehensible, and more relevant disclosure of the dollar amount of the fee, stated as a percentage of the loan amount and presented early in the transaction.

The second part of our approach is a macrofront, designed to increase participation in the market by large national providers. The reputational constraints and regulatory supervision of large companies make it easier to identify and eradicate illegal or deceptive practices of those companies. In the current environment, regulators' perspectives on large national providers range from skepticism to hostility, and the largest and most responsible financial institutions are discouraged from participating in this market. The markets are left to entities that are, by definition, less responsible. If local governments want to permit payday lending, then it is important to ensure the involvement of lenders with reputational interests at stake. It is much less clear that banks have any special role in this market because the competencies that cause the large national providers to excel are not necessarily attributes associated with depository institutions. Moreover, the participation of banks in this market could frustrate the efforts of states to implement reasonable regulatory schemes. Still, if banks can in fact compete prudently with the large national providers on an equal footing (that is, without avoiding state regulatory authorities), then they should be encouraged to enter.

I. THE BUSINESS AND THE LAW OF PAYDAY LENDING

A. The Economics of Payday Lending

Payday lending is a significant industry in the United States and it is growing. In 2003, payday lenders advanced somewhere between $25 billion[8] and $40 billion,[9] and from 2000 to 2004, analysts estimate that the number of payday lending stores increased from 10,000 to 22,000[10]—up from around just 200 at the start of the 1990s.[11] In the next ten years, the number of stores is expected to double,[12] though the growth of Internet lending might slow the pace of new-store growth. To understand how this growing industry should be regulated, the first thing to understand is the product.

In financial terms, the product is a very short-term, single-payment loan, in which the lender extends a loan on one date, in return for a promise (usually

8. DTI REPORT, *supra* note 5, at 20.
9. Mark Flannery & Katherine Samolyk, *Payday Lending: Do the Costs Justify the Price?* 1 (FDIC Ctr. for Fin. Research, Working Paper No. 2005-09, 2005), *available at* http://www.fdic.gov/bank/analytical/cfr/2005/wp2005/CFRWP_2005-09_Flannery_Samolyk.pdf.
10. *Id.*
11. JOHN P. CASKEY, THE ECONOMICS OF PAYDAY LENDING 3 (2002).
12. First Cash Fin. Servs., Inc., Annual Report (Form 10-K), at 2 (Mar. 16, 2005).

evidenced by a postdated check[13] or by automated clearinghouse (ACH)[14] authorization) to repay the amount of the loan plus a standard fee, typically in the range of $15 to $20 per $100 borrowed.[15] Notably, the amount of the fee is usually fixed, without regard to the number of days that will elapse between the date of the loan and the fixed repayment date, which is normally the expected date of the borrower's next paycheck.[16]

Historically, the payday loan developed from the check-cashing business as a variant in which the cashier advances a lower amount in return for its agreement to defer presentment of the check.[17] One executive explained the source of the product as follows:

> We have been in the check-cashing business since 1983. Payday loans grew out of that business in the early 1990's. We would cash a personal check on the weekend for 10% of the check, but most payroll checks or government checks we would cash for 3%. So people would come to us on Thursday and ask if we would cash it then and hold it until Monday. For a while we said no we wouldn't do that, then we started trying it out, found there was a demand for cashing post-dated checks, and slowly gravitated into that, charging an extra 5% or so for the extra risk and service. People loved it. Their options, when they are in a bind, are that they can write a check that will go on insufficient funds, but they'll get a charge of $35/check. So if they write three checks for $100 they will get $105 in fees, which is a pretty bad alternative. Or they can accept the late-rent penalty. Or they can put off fixing their car and lose two or three days of work.[18]

To assess the creditworthiness of the borrower, the typical lender (at least if it is one of the major chains discussed in the next Subpart) will collect a few

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13. Advance America, Cash Advance Centers is an example of an operation that only permits customers to obtain payday loans through personal checks. Advance Am., Cash Advance Ctrs., Inc., Annual Report (Form 10-K), at 4 (Mar. 31, 2005).

14. In the automated clearinghouse (ACH) system, direct debits are commonplace. *See generally* RONALD J. MANN, PAYMENT SYSTEMS AND OTHER FINANCIAL TRANSACTIONS 177–97 (3d ed. 2006).

15. *See, e.g.*, First Cash Fin. Servs., Inc., *supra* note 12, at 5 ("Fees charged for short-term advances are generally regulated by state law and range from 13.9% to 40% of the amount advanced per transaction."); QC Holdings, Inc., Annual Report (Form 10-K), at 1 (Mar. 31, 2005) ("[A] fee . . . generally ranges between $15 to $20 per $100 borrowed."). For a survey of different fees calculated as annual percentage rates, see Steven M. Graves & Christopher L. Peterson, *Predatory Lending and the Military: The Law and Geography of "Payday" Loans in Military Towns*, 66 OHIO ST. L.J. 653, 661 (2005).

16. Community Financial Services Association of America, What Is Payday Advance?, http://www.cfsa.net/mediares/bmediares.html (last visited Oct. 27, 2006). See also *infra* note 246 and accompanying text for our discussion of the relation between this aspect of the rate structure and a sensible disclosure scheme.

17. *See* Paul Chessin, *Borrowing From Peter to Pay Paul: A Statistical Analysis of Colorado's Deferred Deposit Loan Act*, 83 DENV. U.L. REV. 387, 393 (2005).

18. Interview with Anonymous (spring 2006) (on file with authors).

pieces of information about the borrower, including proof of identification, evidence of income, and a current bank statement.[19] The store will evaluate past borrowing history and those criteria using a software program, functionally parallel to the credit scoring that credit card issuers use to evaluate their customers.[20] In some cases, though certainly not all, the data might be checked against a database with information about prior behavior available from a company like TeleTrack.[21] If the loan is approved,[22] the funds are advanced immediately.[23] If the loan goes into default, it is difficult to generalize about collection processes, which plainly vary. For the large providers, however, collection efforts typically stop short of litigation, largely because of the small amounts at stake and the limited likelihood of enforcing a judgment against a defaulting payday loan customer.[24]

The industry depends heavily on retail-store locations, generally because of the sense that many customers will travel only to the store that is nearest their place of employment. As described in an Federal Deposit

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19. *See generally* Charles Gerena, Fed. Reserve Bank of Richmond, *Need Quick Cash?*, REGION FOCUS (Summer 2002), *available at* http://www.richmondfed.org/publications/economic_research/region_focus/summer_2002/feature3.cfm. For specific lenders describing their own requirements, see Advance Am., Cash Advance Ctrs., Inc., *supra* note 13, at 4 (noting that customers usually must have "proof of identification, a pay stub or other evidence of income, and bank statement"); First Cash Fin. Servs., Inc., *supra* note at 12, at 5 ("To qualify for a short-term advance, customers generally must have proof of steady income, a checking account with a minimum of returned items within a specified period, and valid identification."); QC Holdings, Inc., *supra* note 15, at 3 ("To obtain a payday loan from us, a customer must complete a loan application, maintain a personal checking account, have a source of income, and not otherwise be in default on a loan from us.").

20. *E.g.*, ACE Cash Express, Inc., Annual Report (Form 10-K), at 9 (Sept. 12, 2005) ("For the short-term consumer loans we offer, the customer's application data is electronically transmitted to our centralized computer system, which scores the loan with a proprietary loan-scoring system. An approval or denial is communicated back to the store, where the required loan documentation or adverse action form is printed for the customer."); First Cash Fin. Servs., Inc., *supra* note 12, at 5 ("Computer operating systems in the Company's payday advance stores allow a store manager or clerk to recall rapidly customer check cashing histories, short-term advance histories, and other vital information.").

21. The industry sources to whom we have spoken suggest that they do not use sources like TeleTrack regularly because its data are so spotty that it is not often useful. One explained that it only lowers the rate of default by about 25 percent. Interviews with Anonymous (spring 2006) (on file with authors).

22. We have not found any public information about denial rates, but interviews with industry sources suggest that approval rates are quite high (in the range of 90 percent). *Id.* Presumably this means that 90 percent of the people that have the relevant information receive loans, not that 90 percent of the people that enter the store seeking a loan are successful.

23. *See* Advance Am., Cash Advance Ctrs., Inc., *supra* note 13, at 4 ("Immediately upon completion of the approval process, the customer is given cash or a check . . . ."); SHEILA BAIR, UNIV. OF MASS. AT AMHERST, LOW-COST PAYDAY LOANS: OPPORTUNITIES AND OBSTACLES 24 (2005), http://www.consumercreditresearchfoundation.org/_files/AnnieECaseyStudy.pdf.

24. Sources in the industry advise us that defaulted payday loan debt sells for about three cents on the dollar, considerably less than the ten to twelve cents on the dollar for which first-run defaulted credit card debt sells. Interviews with Anonymous (spring 2006) (on file with authors).

Insurance Corporation (FDIC) study by Mark Flannery and Katherine Samolyk, the typical store is surprisingly small, with an outstanding loan portfolio of less than \$100,000 and annual revenues of about \$350,000. As stores age, their profitability increases substantially—a typical new store will make fewer than 1000 loans per year, while a mature store will make more than 8500 loans per year.[25] Because so many of a store's costs are fixed, the costs per loan from the mature stores are much lower than the costs per loan from the newer stores.[26]

It is generally thought that repeat customers are important to the business model.[27] Flannery and Samolyk report that about 46 percent of all loans are either renewals of existing loans or new loans that follow immediately upon the payment of an existing loan (rollovers).[28] At the same time, however, Flannery and Samolyk find no evidence that loan rollovers and repeat borrowers affect store profits beyond their proportional contribution to total loan volume.[29]

It is possible that the Flannery and Samolyk study understates this phenomenon. For example, a study by the Center for Responsible Lending, using data from North Carolina regulators, reports that 91 percent of loans are made to borrowers with five or more loans per year.[30] Similarly, Paul Chessin's recent analysis of Colorado data suggests that about 65 percent of loan volume in the state comes from customers that borrow more than twelve times per year. Chessin notes a particular pattern—"borrowing from Peter to pay Paul"—in which customers avoid renewal limits by alternating between lenders, using the funds from each lender to pay off the other in turn.[31]

Although loss rates are lower than the riskiness of the customer base might suggest, losses still consume a substantial portion of industry revenues.

25. Flannery & Samolyk, *supra* note 9, at 9. In the Federal Deposit Insurance Corporation (FDIC) study, a mature store was one more than four years old. *Id.* at 8–9.

26. *See* ERNST & YOUNG TAX POLICY SERVS. GROUP, THE COST OF PROVIDING PAYDAY LOANS IN CANADA 39–43 (2004) [hereinafter E&Y CANADA STUDY], http://www.cpla-acps.ca/english/reports/EYPaydayLoanReport.pdf. Chris Robinson at York University has made this same point: Large operations have lower costs than small operations, allowing larger lenders to make a profit with stricter rate caps. CHRIS ROBINSON, REGULATION OF PAYDAY LENDING IN CANADA (2006), *available at* http://www.acorn.org/fileadmin/Centers/Press/Report/Payday_Lending_Canada.pdf#search=%22acorn%20study%20payday%20lenders%20canada%22; *see also* James Daw, *Consumer Protection in the Wind on Payday Loans*, TORONTO STAR, May 30, 2006, at D6 (discussing the Robinson report).

27. The dependency makes sense. We know from annual reports that rollover loans are faster and easier for customers to obtain than the initial loan and that they are less expensive for lenders to process. *See* QC Holdings, Inc., *supra* note 15, at 8 ("Once the initial application and loan process is completed, future transactions can be processed in only a few minutes.").

28. Flannery & Samolyk, *supra* note 9, at 12–13 fig.2.

29. *Id.* at 2.

30. KEITH ERNST ET AL., QUANTIFYING THE ECONOMIC COST OF PREDATORY PAYDAY LENDING 2 (2004), http://www.responsiblelending.org/pdfs/CRLpaydaylendingstudy121803.pdf.

31. Chessin, *supra* note 17, at 411.

In Flannery and Samolyk's sample, for example, losses and collection expenses amounted to roughly $6 per loan at mature stores and about $9 per loan at young stores.[32] When added to local operating expenses, but excluding any allocation for overhead for the chain, this produces a total cost per $100 of $11 for mature stores and $14 for young stores, an amount sufficiently below the typical fee of $15 to $20 per $100 to leave an opportunity for profitable operation.[33] The multivariate analysis that Flannery and Samolyk provide suggests one other key point of interest: The costs of serving high-frequency borrowers are much less than the costs of serving low-frequency borrowers. This is true, they emphasize, both because the loss ratios are significantly lower for high-frequency borrowers and because the operating costs are lower.[34] As sources in the industry explained to us, a loan to a first-time borrower is likely to require verification of the validity of a telephone number and a bank account, as well as some investigation of the identity of the borrower.[35] Those steps—which are costly in the context of a loan with a fee of only $30—can be omitted for repeat customers. Also, the mere fact that a borrower is a repeat borrower provides valuable information about reliability: This is a customer with a demonstrated propensity to repay, something that a first-time customer will not have demonstrated.

B. The Competitive Structure of the Payday Lending Industry

Because an understanding of the competitive landscape is important to designing a sensible set of policy recommendations, it is useful to sketch the basic structure of the payday lending industry. For present purposes, four sets of players are important: mom-and-pop providers, large national providers, banks, and Internet providers.

1. Mom-and-Pop Providers

First, there is a very large and vaguely defined set of local providers that we might euphemistically call mom-and-pop providers. Because these entities are not publicly traded, it is hard to generalize about them. A couple observations, however, are useful. On the one hand, the fact that much of the growth of the larger providers has come from acquisitions of mom-and-pop

32. Flannery & Samolyk, *supra* note 9, at 10. This is consistent with the loss rates that Paul Chessin reports. *See* Chessin, *supra* note 17, at 408 (reporting loss rates of about 3.3 percent).
33. Flannery & Samolyk, *supra* note 9, at 10.
34. *Id.* at 16–17.
35. Interviews with Anonymous (spring 2006) (on file with authors).

providers[36] might suggest that the larger providers are crowding out these smaller providers—just as surely as Borders, Barnes & Noble, and Amazon.com crowd out local independent booksellers. On the other hand, the majority of stores in the industry are still small shops, as large national providers have less than 5000 locations, far less than a quarter of the total stores. The mom-and-pop providers still dominate the market.

The most important question about these mom-and-pop providers is how they have managed to make money in this industry without the benefit of the payday lending statutes (discussed below) that exempt them from usury limits in the range of 20 to 30 percent.[37] We see two possibilities. One is that these providers are more efficient in their business practices than the large national providers (which clearly cannot operate profitably by making loans at such a low rate).[38] The other is that the small size of these providers allows them to operate under the radar in more or less chronic violation of applicable laws governing usury and debt collection. We have no direct evidence on this point, but the best indirect evidence points toward the latter hypothesis. In particular, the high fixed costs that tend to make larger lenders more efficient than smaller lenders suggest that the first hypothesis is not accurate.[39]

36. As we explain above, mature stores are more likely to have a customer base of repeat borrowers and are likely to be more profitable than new stores. Moreover, to the extent that the mom-and-pop providers have chosen the best locations, the larger providers will be at a disadvantage if they try to compete by opening new stores. Thus, many of the larger providers find it more profitable to grow by acquisition than by development of new locations. *E.g.*, First Cash Fin. Servs., Inc., *supra* note 12, at 3 ("Because of the highly fragmented nature of both the pawn industry and the payday advance industry, as well as the availability of certain regional chains and 'mom & pop' sole proprietors willing to sell their stores, the Company believes that certain acquisition opportunities may arise from time to time.").

37. *See* discussion *infra* Part I.C.

38. The Flannery and Samolyk study suggests a rate (excluding overhead and central operating expenses) of about $14 per $100. Flannery & Samolyk, *supra* note 9, at 10. Our interviews with industry professionals suggest that this rate is probably a bit high, especially for multiline stores that have more products against which to offset the fixed costs of a branch. Interviews with Anonymous (spring 2006) (on file with authors). But they all agree that the lowest possible cost estimate under current circumstances is greater than $10 per $100. Interestingly, in the view of our industry sources, the cost of credit losses (estimated at about $3 per $100) far exceeds the cost of funds (less than $1 per $100).

39. Consider, for example, the "loan shark predator." *See* Duwayne Escobedo, *Loan Shark Predator: Tale of Alabama Man's Payday Lending Schemes*, INDEP. NEWS, July 20, 2006, *available at* http://www.inweekly.net/article.asp?artID=3233 (discussing felony criminal charges against John Gill, Jr., a wealthy Alabama resident being pursued by consumer-finance regulators for illegal-lending activities in Alabama, Colorado, Florida, Georgia, Louisiana, New York, North Carolina, South Carolina, Texas, Virginia, and Washington).

2. Large National Providers

The second group is the large national providers, a set of aggressively growing, publicly traded companies that are moving rapidly into as many jurisdictions as possible with as many locations as possible. These businesses operate on a McDonald's philosophy—with a specific business model to be replicated in as many retail outlets nationwide as they can identify suitable locations.[40]

Although the annual reports of these large national providers trumpet their unique characteristics, to the outsider, these companies seem analogous to McDonald's, Burger King, and Wendy's, all trying to pursue very similar business models, hoping to get the best locations for their chain as rapidly as possible. A brief description of the five largest players is adequate to illustrate the point. The largest pure payday lender in the country is Advance America, with 2408 stores in thirty-four states.[41] Dollar Financial Corporation is the second largest, with about 1300 stores, but it is much more of an international player than Advance America (with 345 of its stores in Canada and 459 in the United Kingdom).[42] The two other key players leverage their dominance in other consumer-finance products into a major presence in this market. ACE Cash Express is a major payday lender based on its status as the largest owner and operator of check-cashing stores, with 1371 stores in thirty-seven states.[43] Similarly, Cash America, the leading pawn lender in the country, makes payday loans from about 700 locations, mostly in its pawn shops.[44] Finally, QC Holdings has a 371-store chain built on its claim to have been one of the inventors of the modern payday loan product in the early 1990s.[45]

3. Banks

The third group of players in the industry is banks. At first glance, it should seem odd that banks—whose credit card lending practices suggest plenty of appetite for risky consumer lending—do not play a major role in this market. But as we write, there are no banks that play a direct role of

40. *E.g.*, Cash Am. Int'l, Inc., Annual Report (Form 10-K), at 1 (Feb. 28, 2005), *available at* http://www.cashamerica.com/pdf/CashAm10k05.pdf.
41. Advance Am., Cash Advance Ctrs., Inc., *supra* note 13, at 1.
42. Dollar Fin. Corp., Annual Report (Form 10-K), at 3 (Sept. 22, 2005).
43. ACE Cash Express, Inc., *supra* note 20, at 3.
44. Cash Am. Int'l, Inc., *supra* note 40, at 4.
45. QC Holdings, Inc., *supra* note 15, at 1.

consequence in the payday lending market.[46] To be sure, from about 2000 to 2005, banks facilitated the growth of the national payday lending providers by partnering with them, so that the providers could avoid local usury restrictions through the shelter of federal rules preempting the application of those restrictions to banks. As we discuss below, that practice is largely, if not entirely, a thing of the past.[47]

It is also true that most of the large national payday lenders are funded by some of the largest banks. For example, press reports suggest that Wells Fargo provides funding for Advance America and Cash America, that JPMorgan Chase provides funding for Cash America and ACE Cash Express, and that Bank of America and Wachovia provide a syndicated credit line to Advance America. On the equity side, Fidelity Funds is the largest single stockholder in ACE Cash Express, and JPMorgan and Bank of America both own more than 1 percent of Cash America.[48] But despite those investments, the role of banks in the current market is indirect and marginal. We discuss in the closing section of Part II some reasons why we think this is unfortunate.

4. Internet Providers

The hardest sector of the industry to understand is the Internet-only providers. It is clear that they exist; indeed, they have their own search aggregator (paydayloanoffers.com), which provides advice on the best available payday loan terms on any given day. You need only Google "payday loans," and you will see a large group of sponsored and natural links to online providers. To get a sense for the most successful providers, we looked at the sponsored-links websites that appeared when we conducted searches on "payday loans" on

46. Wells Fargo Bank does offer a payday lending product: Direct Deposit Advance. *See* Wells Fargo Checking—Direct Deposit Advance Terms and Conditions, https://www.wellsfargo.com/wf/checking/dda/terms (last visited Nov. 12, 2006). We discuss this product in note 257. One reason banks do not play a more direct role is cultural. Subprime borrowers might not want to use banking services even if banks offered payday loans. Commentators from the United States, Canada, and Australia have noted this problem. *See* NEFE White Paper, *supra* note 6, at 13 (discussing the distaste payday customers have for the "mahogany and brass" atmosphere of U.S. banks); IAIN RAMSAY, ACCESS TO CREDIT IN THE ALTERNATIVE CONSUMER CREDIT MARKET 36 (2000), http://cmsweb.ca/epic/internet/incmc-cmc.nsf/vwapj/ramsay_e.pdf/$FILE/ramsay_e.pdf (suggesting that Canadians with low incomes are distrustful of banks because banks are intimidating and treat lower-income customers poorly); DEAN WILSON, CONSUMER LAW CTR. VICT. LTD, PAYDAY LENDING IN VICTORIA—A RESEARCH REPORT 80 (2002), http://www.consumer.vic.gov.au/CA256902000FE154/Lookup/CAV_Credit_Research/$file/payday.pdf (attributing the preference of Australian consumers for payday lenders to the perception that banks provide bad service to consumers).

47. *See infra* notes 69–77 and accompanying text.

48. *JPMorgan, Banks Back Lenders Luring Poor With 780 Percent Rates*, BLOOMBERG NEWS, Nov. 23, 2004, http://www.bloomberg.com/apps/news?pid=71000001&sid=ayYDo5tpjTY8.

Google, Yahoo!, and MSN.[49] These searches produced a total of eight sites: mycashnow.com (Google, Yahoo!, and MSN), tendollarpaydayloan.com and paydayselect.com (Google and Yahoo!), nationalfastcash.com and 1000-easy-payday-loan.com (Yahoo! only), paydayok.com (Google only), and cashadvancenetwork.com and instantcashloantillpayday.com (MSN only). Several things are interesting about those search results, starting with the fact that the dominant rate for the most prominent advertisers in the online market appears to be about $10 per $100, significantly below the $15 per $100 rate that seems to be the benchmark rate for the retail locations of the large national providers,[50] and considerably lower than the typical rate identified in a major 2004 survey by the Consumer Federation of America (CFA).[51] Also, the Internet providers are all Internet fronts, meaning that little about the firms is evident from the websites. A careful reading of the website will not reveal whether a bank is involved, in most cases will not give a brick-and-mortar location for the lender,[52] and does not suggest whether any of the large national providers are involved. The only information of significance about the lawfulness of the transactions is an assertion that the transactions are governed by the law of the lender's location.[53]

49. These searches produce different results, even on the same day. We report here a set of companies found based on repeated searches on May 14 and 15, 2006.

50. The rates at the sponsored-link websites varied. *See* 1000 Easy Payday Loan, http://www.1000-easy-paydayloan.com (providing $10 per $100); Payday Loans and Cash Advances at PayDay OK, http://www.paydayOK.com (same); Ten Dollar Payday Loans, http://www.tendollarpaydayloans.com (same); *see also* Cash Advances at Payday Select, http://www.paydayselect.com ($15 per $100); Quick and Affordable Cash Advances, http://www.mycashnow.com ($18 per $100); Cash Advance Network, http://www.cashadvancenetwork.com ($30 per $100); Instant Payday Loans, http://www.instantcashloantillpayday.com ($30 per $100); National Cash Fast, http://www.nationalcashfast.com (unspecified rates) (all last visited Nov. 12, 2006).

51. JEAN ANN FOX & ANNA PETRINI, CONSUMER FED'N OF AM., INTERNET PAYDAY LENDING: HOW HIGH-PRICED LENDERS USE THE INTERNET TO MIRE BORROWERS IN DEBT AND EVADE STATE CONSUMER PROTECTIONS 22 (2004) [hereinafter CFA SURVEY], http://www.consumerfed.org/pdfs/Internet_Payday_Lending113004.pdf.

52. Of the eight sites, only paydayselect.com and paydayok.com offered any address; both offered (different) post office boxes in Ruidoso, New Mexico. The CFA survey suggests that this is not a new problem. *See id.* at 20–22. Those sites now list Delaware addresses and show licenses indicating that they are subject to Delaware law.

53. Of the eight, only three identify what that law is: Mycashnow.com selects the law of Grenada, MyCashNow—Disclosures, http://www.mycashnow.com/Cash-Today-disclosure.php (last visited Mar. 4, 2007), and paydayselect.com and paydayok.com select the law of New Mexico. It is unlikely these choice-of-law clauses are enforceable because most states' long-arm statutes permit states to enforce their own laws for loans to citizens within the state. For a detailed account of this jurisdictional issue, see Frank Burt et al., *Journey to the Fringe: A Survey of Select Fringe Lending Products*, *in* CONSUMER FINANCIAL SERVICES LITIGATION INSTITUTE (11TH ANNUAL), at 349, 381–82 (PLI Corporate Law & Practice, Course Handbook Series No. 8565, 2006).

Several possibilities exist about these lenders, all of which are speculative in the absence of direct evidence that we have been unable to obtain. One possibility is that the only way these lenders can profit at the low rates is by cheating. There certainly is considerable indirect evidence to support that perspective. For example, the CFA survey suggests that the overwhelming majority of these lenders charge fees that far exceed the maximum permitted under the law of the location of their customers.[54] Similarly, many of these lenders may violate federal law by forcing borrowers to grant them electronic access to their bank accounts.[55] There are other possibilities, of course. One regulator who has dealt with some of these providers suggests that they can profit at rates lower than the large national providers because they avoid the costs of retail-branch locations.[56] This raises the possibility that the market for payday loans is segmented, between the relatively low-income customers that seek out lenders based solely on retail proximity to their employer and the relatively better-off customers that use broadband Internet access and Google searches to find their payday lender of choice.[57]

This is not to say that there is no fraud in the Internet payday lending industry. On the contrary, illegal lending is common in this sector.[58] For example, both New York[59] and Pennsylvania[60] have had recent notable enforcement actions against Internet providers. It is not clear to us, however, that those kinds of providers are the providers purchasing sponsored advertisements on Google or other major Internet search engines. Rather, they seem to us a sort of Internet underworld much like the brick-and-mortar underworld that populates some share of the mom-and-pop providers. Recent activity in the industry—most notably the acquisition by Cash America (a large national operation) of a major licensed

54. *See generally* CFA SURVEY, *supra* note 51, at 22.

55. *See generally id.* at 34 (discussing the Electronic Fund Transfer Act, 15 U.S.C. § 1693k (1998), which prohibits a credit transaction conditioned on electronic access to the borrower's deposit account).

56. Interview with Sealy Hutchings, Gen. Counsel, Tex. Office of the Consumer Credit Comm'r, in Austin, Tex. (Feb. 28, 2006).

57. One website specializing in payday loans in Houston illustrates how the Internet may enhance competition among lenders generally. Cash Advance Loan Houston promises to display five lending options for people seeking a payday loan in Houston. *See* Houston Cash Advance Loans, http://www.cash-advance-loan-houston.com (last visited Jan. 11, 2007).

58. *See* Associated Press, *Payday Lenders Use Internet to Avoid Law*, USA TODAY (Dec. 1, 2004), *available at* http://www.usatoday.com/tech/news/2004-12-01-usurious-lending-online_x.htm.

59. *See* Press Release, Office of N.Y. State Attorney Gen. Eliot Spitzer, Internet Concerns Top Consumer Complaints (Feb. 8, 2006), *available at* http://www.oag.state.ny.us/press/2006/feb/feb08a_06.html (discussing enforcement action against New York Catalog Sales).

60. *See* Press Release, Pa. Office of Attorney Gen., Commonwealth Shuts Down Alleged Illegal Web-Based "Payday Lending" Scheme (Sept. 28, 2005), *available at* http://www.attorneygeneral.gov/press.aspx?id=670 (discussing enforcement action against Ace Pays).

Internet lender (CashNetUSA)[61]—might presage consolidation in this sector similar to the consolidation that has been occurring in the brick-and-mortar sector.

C. The Regulatory Structure of the Payday Lending Industry

1. Federal Regulations

The recent enactment of the Talent-Nelson amendment[62]—which imposes a 36 percent cap on many loans to military personnel and their dependents—has given prominence to the possibility that federal law might someday limit the operations of payday lenders more broadly.[63] For now, however, the role of federal law is limited. Although there is no federal licensing regime for payday lenders, and certainly no federal rate ceiling, the Consumer Credit Protection Act affects the operations of payday lenders in important ways. Most importantly, the Truth in Lending Act (TILA) requires conspicuous disclosure of finance charges and interest rates, communicated in dollar amounts and percentages.[64] If, as we argue below, TILA plays an important role in confusing consumers in this market, it is a significant, albeit perverse, part of the regulatory regime.

What is more interesting is federal displacement of state regulation. For example, section 85 of the National Bank Act permits any national bank to charge an interest rate as high as the maximum rate permitted by the laws of the state where the bank is "located."[65] Since the U.S. Supreme Court's 1978 decision in *Marquette National Bank of Minneapolis v. First of Omaha*

61. *See* Erick Bergquist, *Cash America Buying Online Lender Licensed in 27 States*, AM. BANKER, July 11, 2006. Consistent with this discussion, Cash America's chief executive officer, Daniel Feehan, commented that CashNetUSA "is one of the few companies that we have found operating in this space that has gone through the very rigorous process of getting licensed state by state and organizing their technology to deliver documents in accordance with state laws." Spotlight on Financial Services—Forecasts and Statistics, Online Payday Loans (Sept. 2006), http://www.spotlightonfinance.org/2006/September/product-story2.htm.

62. John Warner National Defense Authorization Act for Fiscal Year 2007, Pub. L. No. 109-364, § 670, 120 Stat. 2083 (to be codified at 49 U.S.C. § 987).

63. In our view, the case for regulating borrowing by military personnel is weak. If there is a link between financial distress and payday lending, it affects both civilian and military populations. *See* Morgan Stanley Equity Research, Advance America: Initiating With an Underweight-V Rating 25 exhibit 20 (Jan. 25, 2005) (on file with authors) (table showing inverse correlation between median income level in a state and the number of households per branch). Further, military personnel are not likely to be more susceptible to cognitive biases than the low-income civilians who routinely use these products.

64. 15 U.S.C. § 1601 (1998 & Supp. 2006); 12 C.F.R. § 226.4 (2006). Courts and regulators have clarified that the Truth in Lending Act (TILA) governs payday loans. *See* 12 C.F.R. § 226 (Supp. I 2007), § 226.2(a)(14) (2006) (concluding that payday loans are covered by the Regulation Z disclosure rules); Turner v. E-Z Check Cashing of Cookeville, TN, Inc., 35 F. Supp. 2d 1042, 1047 (M.D. Tenn. 1999) ("Courts that have addressed the issue have held, without exception, that deferred presentment transactions are extensions of 'credit' under TILA.").

65. 12 U.S.C. § 85 (2001 & Supp. 2006).

Service Corp.,[66] it has been clear that a bank is located, for purposes of that provision, in the state of the bank's headquarters. Thus, a national bank located in a state with no usury limit (like South Dakota or Delaware) can import that rate into any other state in which it does business.[67]

Federal law also gives state-chartered banks a parallel right to import rates, under section 27 of the Federal Deposit Insurance Act:

> In order to prevent discrimination against State-chartered insured depository institutions, . . . [any FDIC-insured] bank . . . may, notwithstanding any State constitution or statute which is hereby preempted for the purposes of this section, . . . charge on any loan . . . interest . . . at the rate allowed by the laws of the State . . . where the bank is located.[68]

Banks in this country, for various historical reasons, have had little interest in participating directly in the payday lending market. During the early years of this decade, however, many banks partnered with large national providers so that those providers could use the federal preemptive shelter available to the banks to operate programs that otherwise would have violated state usury laws.[69] This activity—generally decried as "rent-a-bank" or "rent-a-charter" programs[70]—ultimately came under scrutiny by federal regulators.

One by one, those regulators barred banks under their supervision from participating in payday lending programs operated by third parties. For nationally chartered banks, the comptroller of the currency took action in 2000 and 2001 to prevent national banks from teaming up with state banks.[71] The Federal Reserve did not take formal action to stop the activity of national banks or of those state banks that are members of the Federal Reserve.[72]

66. 439 U.S. 299, 310–12 (1978).

67. *See* Schiltz, *supra* note 4, at 552–53.

68. 12 U.S.C. § 1831d(a) (2001); *see* BankWest, Inc. v. Baker, 411 F.3d 1289 (11th Cir. 2005) (applying this provision to a bank involved in payday lending), *vacated as moot*, 446 F.3d 1358 (11th Cir. 2006) (per curiam); Schiltz, *supra* note 4, at 565–69 (discussing the 1980 adoption of this provision).

69. *See* Chad A. Cicconi, *A Role for Payday Lenders*, 123 BANKING L.J. 235, 239–40 (2006).

70. *E.g.*, Pearl Chin, Note, *Payday Loans: The Case for Federal Legislation*, 2004 U. ILL. L. REV. 723, 732 (2004).

71. *See* OFFICE OF THE COMPTROLLER OF THE CURRENCY, U.S. DEP'T OF THE TREASURY, ADVISORY LETTER 2000-9: THIRD-PARTY RISK (2000), http://www.occ.treas.gov/ftp/advisory/2000-9.doc; OFFICE OF THE COMPTROLLER OF THE CURRENCY, U.S. DEP'T OF THE TREASURY, ADVISORY LETTER 2000-10: PAYDAY LENDING (2000), http://www.occ.treas.gov/ftp/advisory/2000-10.doc; OFFICE OF THE COMPTROLLER OF THE CURRENCY, U.S. DEP'T OF THE TREASURY, OCC BULL. NO. 2001-47: THIRD-PARTY RELATIONSHIPS (2001), http://www.occ.treas.gov/ftp/bulletin/2001-47.doc.

72. Indeed, both Chairman Greenspan and Chairman Bernanke have taken quite benevolent views of the industry. *See* Letter from Alan Greenspan, Chairman, Fed. Reserve Bd., to Rep. Melvin L. Watt (Jan. 2, 2001) (copy on file with author) (recounting the preference "that markets and competition—enhanced by appropriate disclosures—regulate loan terms and conditions"); Letter from Alan Greenspan, Chairman, Fed. Reserve Bd., to Rep. Pat Tiberi (Aug. 16, 2004) (copy on file with author) (reiterating the view that no action is necessary with regard to payday lending); Ben S. Bernanke,

But concerns of regulators about the transparency of operations did cause one large partnering bank to leave the Federal Reserve System to avoid the scrutiny of federal regulators.[73]

Since the FDIC had not acted, state banks remained relatively free to engage in this activity. Thus, the County Bank of Rehoboth Beach, Delaware gained considerable notoriety for its continued participation.[74] In July 2005, however, the FDIC issued its *Guidelines on Payday Lending*.[75] Although these regulations do not directly prohibit partnering with third-party payday lenders, they do impose onerous capital requirements and compel institutions to "[l]imit the number and frequency of extensions, deferrals, [and] renewals."[76] In practice, these new regulations have made it impractical for state-chartered banks to continue partnering with the major national providers. Accordingly, by early 2006, the "rent-a-charter" era had come to an end.[77]

Chairman, Fed. Reserve Bd., Remarks at the Fifth Regional Issues Conference of the Fifteenth Congressional District of Texas, (June 13, 2006), *available at* http://www.federalreserve.gov/boarddocs/speeches/2006/20060613/default.htm (praising the spread of payday lenders as a source of alternative financial services for lower-income families).

73. First Bank of Delaware relinquished its Federal Reserve membership in 2003, and thus became subject to regulation by the FDIC. *See* Letter from Jean Ann Fox, President, Consumer Fed'n of Am., to Donald E. Powell, Chairman, FDIC (Oct. 9, 2003), *available at* http://www.consumerfed.org/pdfs/fdicletter10-2003.pdf. To get a sense for the concerns of the applicable regulator (the Federal Reserve Bank of Philadelphia), see the skeptical comments about the safety and soundness of payday lending in Robert W. Snarr, Jr., *No Cash 'til Payday: The Payday Lending Industry*, COMPLIANCE CORNER (Fed. Reserve Bank of Phila., Phila., Pa.), 1st Quarter 2002, at CC1, *available at* http://www.phil.frb.org/src/srcinsights/srcinsights/pdf/ccq1.pdf.

74. For instance, Dollar Financial had an important relationship with the County Bank of Rehoboth Beach. *See* Dollar Fin. Corp., *supra* note 42, at 11.

75. *See* FDIC: Guidelines for Payday Lending, http://www.fdic.gov/regulations/safety/payday (last visited Mar. 4, 2007).

76. *Id.*

77. The clearest signal is the Eleventh Circuit's per curiam decision in April 2006 to dismiss as moot a major case involving a challenge by several state-chartered banks to a Georgia law designed to exclude the partners of those banks from operating in Georgia. BankWest, Inc. v. Baker, 446 F.3d 1358 (11th Cir. 2006) (per curiam), *vacating as moot*, 411 F.3d 1289 (11th Cir. 2005). The annual reports from large payday lenders filed in the second half of 2005 confirm that payday lenders got the message. *See, e.g.*, ACE Cash Express, Inc., *supra* note 20, at 9 ("The revised FDIC guidelines became effective on July 1, 2005, and affect the loans offered at our stores by Republic Bank. In fiscal 2006, we have introduced two new loan products to our Texas customers and one new loan product to our customers in Arkansas and Pennsylvania that provide alternatives to the loan product offered by Republic Bank. These new loan products will provide consumers who exceed the maximum allowable payday loans under the revised FDIC guidelines access to the credit they require."); Dollar Fin. Corp., *supra* note 42, at 11 ("The Payday Lending Guidance, among other things, limits the period a borrower may have payday loans outstanding from any FDIC-insured bank to three months during a twelve-month period. As a result of the Payday Lending Guidance, we are transitioning from the bank-funded consumer loan model to the company-funded consumer loan model in most of the states where we previously offered bank-funded consumer loans. As part of this transition, we terminated our relationship with County Bank and amended our relationship with First Bank, in each case by mutual agreement.").

2. State Regulations

As federal regulators remove the protective umbrella of federal law, we enter an era in which states will be free to make their own choices about payday lending. As far as we can tell, all states that tolerate payday lending have some scheme of licensing or regulation.

The first question, however, is whether states will tolerate payday lending at all. On that question, current state law varies greatly.[78] In an effort to provide an orderly description of the landscape as it exists today—a snapshot at the end of the rent-a-charter era—we identify three distinct regulatory regimes: explicit toleration; formal, but underenforced prohibition; and true prohibition. We recognize the difficulties of understanding the actual regulatory practices in any particular state. But there is considerable illustrative value in summarizing some representative examples. For this purpose, we have chosen Michigan as an example of explicit toleration, Texas as an example of formal but underenforced prohibition, and New York as an example of true prohibition.

a. Explicit Toleration

State law related to payday lending varies greatly, but the most common situation is a statute that explicitly authorizes the practice. The Community Financial Services Association (CFSA), a trade group representing the major payday lenders, has supported a model bill in numerous state legislatures in recent years,[79] and has had noted success in obtaining adoption: The CFSA website claims that a majority of the states have adopted "balanced, responsible legislation," which presumably resembles their bill.[80] The model bill contains several notable features: Loans can only be made for $500 or less;[81] loans can only be renewed one time;[82] borrowers can rescind a loan within

78. For detailed breakdowns of the different state laws governing payday lending, see Flannery & Samolyk, *supra* note 9, at 30 tbl.1; Moss, *supra* note 2, at 1740. The most comprehensive and accessible information is at NAT'L CONSUMER LAW CTR., 2005 SUMMARY OF STATE PAYDAY LOAN ACTS (2005), http://www.consumerlaw.org/action_agenda/payday_loans/content/NCLC_SUMMARY.pdf.

79. The Community Financial Services Association (CFSA) supports the Deferred Deposit Loan Act, *see* Email from Kara J. Marshall, Staff Attorney, Cmty. Fin. Servs. Ass'n, to Jim Hawkins (May 25, 2006, 16:37:43 CST) (on file with authors), adopted by the Committee on Suggested State Legislation of the Council of State Governments, *see* Deferred Deposit Loans, *in* 61 SUGGESTED STATE LEGISLATION 34, 34–37 (2002) [hereinafter Model Deferred Deposit Act], http://www.csg.org/programs/ ssl/documents/2002.pdf. For a discussion of the lobbying and the model bill, see Chessin, *supra* note 17, at 398.

80. The Community Financial Services Association of America, http://www.cfsa.net/regulated_states.html (last visited Feb. 6, 2007).

81. Model Deferred Deposit Act, *supra* note 79, § 6 at 35.

82. *Id.* § 8 at 36.

a day;[83] lenders must obtain licenses to operate;[84] lenders cannot use threats of criminal prosecution as a collection tool;[85] and, most striking, fees are capped at 20 percent of the first $300 lent and 7.5 percent of any funds lent over $300.[86]

Michigan's 2005 adoption of the euphemistically named Deferred Presentment Service Transactions Act is a good example of a statute that draws from the CFSA's model act and tolerates payday lending.[87] This is a detailed statute, with thirty-three sections divided into four articles. Setting aside the first article (which offers a title and a series of definitions),[88] the remaining articles deal with licensing,[89] regulation of the transaction,[90] and remedies.[91] The licensing article requires a license for any company engaged in the business of "deferred presentment service transactions," except for a federally insured bank.[92] The statute defines "deferred presentment service transaction" to include any transaction in which the licensee agrees to pay the customer a sum of money, in exchange for a fee, and then to "[h]old a customer's check for a period of time before negotiation, redemption, or presentment of the check[ ]."[93] To obtain a license, the licensee must show a net worth of at least $50,000 per location, up to a maximum requirement of $250,000, as well as "the financial responsibility, financial condition, business experience, character, and general fitness to reasonably warrant a belief that the applicant will conduct its business lawfully and fairly."[94] Each licensee is also obligated to post a $50,000 surety bond.[95]

Of greatest interest, Michigan's licensing article includes a provision—which is *not* in the CFSA's model act—that requires the state commissioner of the office of financial services to develop a statewide database "that has real-time access through an internet connection . . . [and] is accessible at all times to licensees," which will, among other things, allow any licensee to "[v]erify whether a customer has any open deferred presentment service transactions with any licensee . . . ."[96]

83. *Id.* § 6 at 35.
84. *Id.* § 16 at 37.
85. *Id.* § 20 at 37.
86. *Id.* § 5 at 35.
87. *See* Deferred Presentment Service Transactions Act, ch. 487, 2005 Mich. Legis. Serv. 244 (West) (codified at MICH. COMP. LAWS ANN. §§ 487.2121–.2173 (West Supp. 2006)).
88. MICH. COMP. LAWS ANN. §§ 487.2121–.2122 (West Supp. 2006). For other similar examples, see CAL. FIN. CODE §§ 23000–23106 (West 1999 & Supp. 2006); 815 ILL. COMP. STAT. ANN. § 122/1-1 (West 1999).
89. MICH. COMP. LAWS ANN. §§ 487.2131–.2142 (West Supp. 2006).
90. *Id.* §§ 487.2151–.2160.
91. *Id.* §§ 487.2165–.2173.
92. *Id.* § 487.2131.
93. *Id.* § 487.2122(1)(g).
94. *Id.* § 487.2132.
95. *Id.* § 487.2134.
96. *Id.* § 487.2142.

The substantive article that regulates transactions focuses primarily on disclosure. Thus, licensees must post large signs (in 36-point type) emphasizing to customers several of the constraints the Act imposes, including the following statements: "[W]e must . . . give you a copy of your signed agreement"; "[s]tate law prohibits us from using any criminal process to collect on an agreement"; "[s]tate law entitles you to information regarding filing a complaint against us if you believe that we have violated the law."[97] The signs must also include precatory advice, such as the admonition that "[y]ou should use this service only to meet short-term cash needs."[98] The same notices must be included in a written agreement that the customer signs.[99]

There are also substantive restrictions. First, the maximum transaction is capped at $600,[100] and a licensee cannot extend funds if a search of the state database indicates that the borrower has more than one transaction open with another licensee.[101] This provision is important, given empirical evidence suggesting that borrowers often obtain payday loans from multiple providers.[102] Second, although the statute is not clearly written, it appears to cap the maximum fee at a declining amount, starting at $15 for the first $100, and declining to $11 for the sixth $100.[103] Third, the licensee cannot tie the purchase of any other financial service to the deferred presentment service transaction.[104] The licensee can require arbitration in its contracts only if the licensee agrees to bear all of the costs and if the arbitration occurs no more than ten miles from the borrower's address as stated in the agreement.[105] Finally, the statute prohibits criminal penalties for failure to pay checks given in deferred presentment service transactions.[106]

97. *Id.* § 487.2151(1).

98. *Id.*

99. *Id.* § 487.2152.

100. *Id.* § 487.2153(1). This is $100 greater than the model bill's limit.

101. *Id.* §§ 487.2153(2), 487.2154.

102. *See* Chessin, *supra* note 17, at 411–12 (suggesting that this is common in Colorado); Mayer, *supra* note 6, at 5–6.

103. MICH. COMP. LAWS ANN. § 487.2153(1)(a) (West Supp. 2006). The statute states that a licensee can charge a service fee. *Id.* § 487.2153(1). It then states that the licensee "may charge both of the following as part of the service fee." *Id.* One of the items that follows is a database verification fee, if approved by the commissioner (not yet in place). *Id.* § 487.2153(1)(b). The other is the sliding-scale fee discussed in the text. *Id.* § 487.2153(1)(a). The statute as written seems to permit the possibility that the lender could charge some other fee as part of the "service fee." Governor Granholm's press release praising the bill when she signed it, however, explicitly adopts the interpretation discussed in the text. Press Release, Office of the Governor, Governor Granholm's Consumer Protections Against Payday Lenders Wins Legislative Approval (Nov. 9, 2005), http://www.michigan.gov/gov/0,1607,7-168-23442-129955—,00.html.

104. MICH. COMP. LAWS ANN. § 487.2160(a) (West Supp. 2006).

105. *Id.* § 487.2152(3).

106. *Id.* § 487.2158(4).

Equally significant is what the statute does not regulate. First, notice that these provisions do *not* impose a limit on rollover transactions. On that point, the statute grants the customer what seems to us an unpalatable option, which is unlikely to be attractive to any large group of customers: A customer that enters into eight transactions in any twelve-month period must be granted the option to repay the outstanding debt in three installments, with one installment due on each subsequent payday.[107] Second, the statute grants a direct exemption from usury laws, explicitly providing that the service fee that the statute authorizes "is not interest."[108] Because the normal usury limit in Michigan is 10 percent,[109] some exemption obviously is necessary for this type of business to operate.[110]

The final article, related to remedies, includes straightforward provisions that permit customers to file complaints with the commissioner[111] and permit the commissioner to investigate those complaints, issue cease and desist orders, suspend or revoke licenses, and impose fines.[112] Lastly, the statute creates a private cause of action for any "person injured by a licensee's violation" of the act, including a right to reasonable attorney's fees.[113]

b. Underenforced Prohibition

The second common pattern in recent years has been a formal prohibition of payday lending, coupled with a lack of resources or effort adequate to make the prohibition effective.[114] The prohibition normally takes the form of a usury limit that has no specific exception authorizing payday lending transactions. The ineffectiveness of usury limits is apparent from participation in the market not only by small, under-the-radar, local providers, but also by large national

107. *Id.* § 487.2155.

108. *Id.* § 487.2153(1).

109. *Id.* § 438.101.

110. Lest that rate seem unrealistic, you should recall that federal law preempts the state rule with respect to many important lending transactions, including home mortgages and loans issued by federally insured banks. *See* MANN, *supra* note 14, Assignment 20; James J. White, *The Usury Trompe L'Oeil*, 51 S.C. L. REV. 445 (2000). Michigan can retain such a low rate primarily because the rate does not apply to transactions of financial significance.

111. MICH. COMP. LAWS ANN. § 487.2165 (West Supp. 2006).

112. *Id.* §§ 487.2165–2168.

113. *Id.* § 487.2173.

114. There are obvious public-choice explanations for underenforcement. The lenders might have sufficient influence on policymakers in these states to ensure that regulators will not actually exclude them. A second possibility is resource limitations. Many jurisdictions, for example, may not be accustomed to devoting the level of resources to financial regulatory enforcement that is typical of New York in the era of Eliot Spitzer. Finally, efforts to enforce anti-payday loan legislation would have been more difficult until the events of the last few years limited the ability of payday loan providers to avoid regulation by the states in which they lend.

providers, which typically have operated under the shelter of an out-of-state bank. Here, Texas provides a good example.[115]

Like many states, Texas has a complex set of usury ceilings with different levels applicable to different kinds of loans. In general, however, the highest permissible ceiling for loans below $250,000 is capped at 24 percent.[116] Yet, Texas has, for many years, had a special statute to permit low-dollar consumer-finance transactions, referred to as "cash advance loans."[117] The problem, however, is that this statute does not authorize charges at a level typical of the standard payday lending product. Specifically, the maximum charge it permits is capped at a fixed fee of $10 per $100 of cash advance, plus $4 per month. So, for a loan of $300 for two weeks (a typical product), the maximum fee would be $16,[118] much less than the $45 fee the typical payday lender would charge based

115. Although we do not discuss it in detail here, Canada provides an even starker example. Formally, Canada's federal usury limit of 60 percent, Canada Criminal Code, R.S.C., ch. C-46 § 347(2) (2006), would make payday lending illegal. Yet, the evidence suggests that payday lending has been flourishing in recent years, unfettered by prosecution. The *Toronto Star* reported that as of 2005, there had been no prosecutions against payday lenders. Jim Rankin & Nicole MacIntyre, *Loans Firm Curbed*, TORONTO STAR, Aug. 31, 2004, at A1. The highly visible growth of the payday lending industry, however, has produced a backlash in the last year or so, reflected in a growing number of highly visible actions challenging what, in some cases, might be flagrantly illegal activity. *E.g.*, Kilroy v. A OK Payday Loans, Inc., No. S041137, 151 A.C.W.S. (3d) 927 (B.C.S.C. Aug. 9, 2006), *available at* 2006 A.C.W.S.J. LEXIS 6646 (holding in a class action that the rates charged by payday lenders exceeded the criminal statutory limit); Daw, *supra* note 26 (describing police action against one payday lender in Manitoba); Carol Goar, *Payday Loan Industry in Court*, TORONTO STAR, Feb. 1, 2006, at A18; Jim Rankin, *Suit Against Payday Lender Gets a Boost*, TORONTO STAR, Mar. 6, 2006, at A12; *Class Action Certified in Payday Loan Case*, CBC NEWS, May 12, 2006, http://www.cbc.ca/money/story/2006/05/12/rentcash.html?ref=rss. The standard product issued by the large lenders apparently complies with usury laws by offering the borrowers the option of repaying loans in cash with only 60 percent interest. If the borrower is unable to repay in cash, the lender cashes a check (charging the standard payday loan rate as a check-cashing fee) and uses the proceeds to repay the loan. *See, e.g.*, Dollar Fin. Corp., *supra* note 42, at 18–19.

It remains to be seen whether the adoption by the Canadian Payday Loan Association of a voluntary code of compliance will stem criticism. The Code of Best Business Practices bans, among other things, rollover loans and associated products. Canadian Payday Loan Ass'n, Code of Best Business Practices, http://www.cpla-acps.ca/english/consumercode.php (last visited Mar. 4, 2007). It does not, however, specifically regulate the basic rates that members charge, *id.*, which is the basis for much of the existing litigation. The situation is now drawing substantial attention at the federal level, where the Standing Senate Committee on Banking, Trade and Commerce has published a detailed report concluding that the spread of payday lenders is "alarming, since we do not believe that they are adequately regulated." STANDING SENATE COMM. ON BANKING, TRADE & COMMERCE, CONSUMER PROTECTION IN THE FINANCIAL SERVICES SECTOR: THE UNFINISHED AGENDA 79 (2006). For a lucid and balanced discussion of the Canadian situation, see Jacob Ziegel, *Payday Loan Bedlam Cries Out for Legal Fix*, NATIONAL POST, Mar. 15, 2006, at FP23.

116. TEX. FIN. CODE ANN. § 303.009 (Vernon 2006) (ceiling based on twice the federal T-bill rate that floats between 18 and 24 percent per annum).

117. *Id.* ch. 342.

118. $10 + (0.5)($4)(3).

on a $15 per $100 fee schedule. Accordingly, Texas is listed prominently on the CFSA website as a state with laws "that are unfavorable" to the industry.[119]

Yet, when we review annual reports for the large national providers, we discover that most of them—Advance America, Cash America, Ace Cash Express, Dollar Financial Corp., and QC Holdings—have locations in Texas.[120] Indeed, several companies even locate their principal offices in Texas.[121] In each case, the annual reports indicate that the lenders do not operate directly in Texas; rather, they operate using rates imported through their partnership with an out-of-state bank, most often County Bank of Rehoboth Beach, Delaware.[122] As discussed above, the FDIC's decision to stop this kind of rate importation has driven County Bank and similar banks from this business. Thus, it appears that Texas and similarly situated states will have an opportunity in the next few years to make a real choice about whether to tolerate payday lending.[123]

c. True Prohibition

The final existing regulatory outcome is outright prohibition of payday loans. A good example of this approach is in New York, where the general usury limit is 6 percent per annum,[124] with an exception that permits banks to charge 16 percent per annum.[125] What raises our interest, however, is the utter absence

119. CFSA, STATES RESPOND TO EMERGING INDUSTRY 1 (2003), http://www.cfsa.net/govrelat/pdf/states%20respond%20to%20emerging%20industry.pdf.

120. We should also add two regional publicly traded providers with a substantial presence in Texas: EZCorp and FirstCash.

121. First Cash Fin. Servs., Inc., *supra* note 12, at 1; Cash Am. Int'l, Inc., *supra* note 40, at 1.

122. *E.g.*, Dollar Fin. Corp., *supra* note 42, at 11.

123. There is one particular problem that Texas regulators face, which arises from Texas's odd credit service organizations statute, TEX. FIN. CODE ANN. ch. 393 (Vernon 2006). That statute permits brokers to charge a fee for finding credit for distressed borrowers. It has found favor in recent years as a vehicle for consumer lenders to avoid usury restrictions by charging a brokerage fee that is parallel to the standard interest charges lenders would charge. Indeed, as we understand it based on interviews with Texas's Office of Consumer Credit Commissioner, most payday lenders operating in the state as of 2006 rely on this structure. *See* Erick Bergquist, *One More Reason to Pursue Alternate Models in Payday*, AM. BANKER, Feb. 28, 2006 (discussing reliance on a credit service organization model by national providers losing their bank partners but wishing to continue operations in Texas); Interview with Sealy Hutchings, *supra* note 56. Surprisingly enough, the Fifth Circuit recently has validated this apparently evasive tactic. *See* Lovick v. Ritemoney Ltd., 378 F.3d 433, 436 (5th Cir. 2004) (dismissing RICO claims brought by borrower from car-title lender). It remains to be seen whether Texas courts would adopt the same view, especially if the litigation were brought by the Office of Consumer Credit Commissioner, rather than a private plaintiff. There also is the likelihood that the Texas Legislature might explicitly close this loophole entirely as part of payday lending legislation currently under consideration.

124. N.Y. GEN. OBLIG. LAW § 5-501 (McKinney 2001).

125. N.Y. BANKING LAW § 14-a(1) (McKinney 2001); *see also* Seidel v. 18 E. 17th St. Owners, Inc., 598 N.E.2d 7 (N.Y. 1992) (discussing the relative severity of New York usury laws).

of New York locations from the annual reports of the large national providers. Not a single one of those providers appears to have locations in New York.

Interested in how this can be so—given the ease with which bank-partnered providers have operated in Texas—we spoke to an officer in the New York Attorney General's Office responsible for usury enforcement.[126] He stated that New York has managed to exclude payday lenders only through conspicuously aggressive enforcement. Thus, he is quite confident that the large national providers know that they would face litigation immediately if they opened stores in New York. In his view, the out-of-state national providers, even if they rented charters from an out-of-state bank (like County Bank), could not possibly prevail because the loans in fact are made by the national providers, not by the banks.[127] The difference, it seems, is not in the usury limit but in the ability of regulators to bring and prevail in litigation to enforce those limits. As the rent-a-charter era closes, it should be even easier for states like New York to repel the national providers, if they choose to do so.[128]

II. POLICY PERSPECTIVES ON PAYDAY LENDING

If we are correct, the rapid growth of payday lenders, coupled with the end of the rent-a-charter era, presents state legislatures and policymakers with a sharply defined opportunity to decide the terms, if any, on which payday lending should be tolerated. Existing scholarship has provided little guidance for policymakers wrestling with those questions. Scholars generally have proposed increased regulatory oversight based on the assumption that regulation, or even prohibition, is self-evidently desirable. In our view, the rationales for regulating payday lending markets are difficult to assess. We try here to sketch what seem to us the most obvious arguments for, and against, different rationales for regulation.

In general, we suggest three perspectives that policymakers might adopt. First, policymakers might conclude that the market is inherently objectionable, and thus that laws should be enacted that in practice prohibit

126. Interviews with Anonymous (spring 2006) (on file with authors).

127. This argument was successful in Georgia, where a state statute designed to prevent rent-a-charter operations in the state bars rate importation if the bank's local agent retains more than 50 percent of the revenues (which apparently is always the case in these relationships). Efforts by the large national providers to enjoin operation of the statute as preempted failed at the trial court and before a panel of the Eleventh Circuit, before the case ultimately was dismissed as moot, apparently because of the cessation of this kind of banking activity discussed above in Subpart I.C. BankWest, Inc. v. Baker, 411 F.3d 1289 (11th Cir. 2005), *vacated as moot*, 446 F.3d 1358 (11th Cir. 2006).

128. Consider, for example, *Betts v. McKenzie Check Advance of Fla.*, 879 So. 2d 667 (Fla. Dist. Ct. App. 2004) (holding that a payday loan was usurious because it was consummated *before* Florida adopted its deferred presentment statute to validate the industry).

payday lending. As discussed above, this is the approach in New York.[129] Second, policymakers might conclude that the industry should be tolerated, but only if it can succeed without depending on a regular practice of repetitive lending. Third, policymakers might conclude that, on balance, the market should be tolerated but that the potential for abuse is sufficient to justify some form of intrusion or supervision of the market. Regulated tolerance of some form has been chosen in the bulk of American jurisdictions, the United Kingdom, and most Australian jurisdictions.[130] We note in passing the possibility that policymakers might conclude that the costs of any plausible regulatory intervention are likely to exceed the benefits, and thus, that no regulation is appropriate. This approach has not found favor in any jurisdiction of which we are aware; therefore, we do not discuss it in detail. Rather, the Subparts that follow provide a critical analysis of the first three perspectives.

A. Should Payday Lending Be Banned?

1. The Case Against Payday Lending

The case against payday lending, though not often articulated, is easy to discern. Like most consumer financial transactions, payday lending transactions tax the cognitive capabilities of the typical customer in ways that lead to market failures of one sort or another. Thus, a person with normal experiences, normal time constraints, and normal intelligence does not easily evaluate the risks and rewards of a payday lending transaction. First, the customer is likely to encounter some difficulty in forming an accurate estimate of the costs of the transaction. If the lender is forthcoming, the customer might well understand the specific fees directly attendant on a successful transaction: perhaps a $30 fee

129. Several other states in the United States, the Australian state of Tasmania, France, and Germany also adopt this regulatory posture. While some Australian states allow payday lending, Tasmania has banned it. *See* WILSON, *supra* note 46, at 39 (citing a 48 percent cap in New South Wales, and describing Tasmania's prohibition). In France, the Code de la Consommation sets out the procedure for establishing ceilings on rates each quarter at one-third above the average market rates. CODE DE LA CONSOMMATION art. L313-3 (Fr.). In Germany, key judicial decisions in 1978 and 1980 established the rate ceilings at, as a rule of thumb, twice the national average rate for the type of loan. DTI REPORT, *supra* note 5, at 8. These rate caps effectively eliminate payday lenders from both France and Germany. *See id.* at 16, 41 (explaining that high-risk borrowers in France either use state-owned pawnbroking services or credit cards); *id.* at 16 (noting that Germany has no subprime-lending options).

130. The British Consumer Credit Act allows courts to review transactions after the fact. *See infra* note 217. In Australia, the Uniform Consumer Credit Code (UCCC) covers the overwhelming majority of these transactions. Under the UCCC, payday lenders must disclose the annual percentage rate (APR) in advertisements and before entering into the loan agreement. UNIF. CONSUMER CREDIT CODE, 2001, §§ 14, 15, 143 (Austl.). Also, the UCCC empowers courts to review unconscionable interest rates, *id.* § 72, and to reopen unjust transactions, *id.* § 79.

to borrow $200. The customer is less likely to be sure, however, of costs that might relate to an unsuccessful transaction. For example, if the check given to the payday lender bounces when it is deposited, the customer's depositary bank is likely to assess a fee in an amount unknown to the customer standing at the payday lender's retail counter. More generally, the customer might have a poor understanding of the costs she would incur if her failure to repay the payday loan ultimately results in financial distress. To make matters worse, there is every reason to think that common decisionmaking problems like the availability heuristic and the optimism bias cause the typical consumer to give inadequate weight to the risk that the transaction will turn out poorly.[131]

Second, there is some reason to be concerned that customers will do such a poor job of comparing alternative lending transactions that the market will not force prices to a competitive level. For one thing, customers will have great difficulty comparing the pros and cons of the products that compete against payday loans. For example, comparing a depository bank's overdraft product to a payday loan requires considerable sophistication. The customer would need a good estimate of the number of checks he would be likely to bounce, as well as a good way of aggregating overdraft fees and discounting them to an interest rate that he could compare to the effective interest rate on a payday product. Because the effective rates in both cases really would depend on accurate forecasts of the customer's use of the products in the future, even accurate disclosures of the applicable fee structures would not make that task easy.[132]

Moreover, even for the customers focused on comparing alternative payday lending products, there is little reason to be sanguine about the robustness of competitive forces. Research indicates that payday lenders almost uniformly charge the highest rate permissible in their jurisdiction.[133] Nothing suggests price collusion or monopolistic concentrations within the market,[134] but several other factors likely account for the lack of price competition. For starters, the disclosures that the Truth in Lending Act requires in this market operate principally to confuse consumers and aggravate the difficulties of comparison shopping, a point we discuss in more detail below.[135] It also is true that borrowers

131. *See generally* Edward L. Glaeser, *Paternalism and Psychology*, 73 U. CHI. L. REV. 133 (2006).
132. *But see* BAIR, *supra* note 23, at 29 (concluding that payday customers do compare costs between payday loans and overdraft fees based on evidence that customers use payday loans to avoid overdrafting their accounts).
133. *See* Chessin, *supra* note 17, at 409 (presenting evidence that about 90 percent of lenders in Colorado charge the statutory maximum rate); Chin, *supra* note 70, at 741 ("In states where the interest rate cap was relaxed to encourage competition, the price of small loans did not go down, as predicted by fair market proponents. Instead, rates clustered at the cap set by state legislatures.").
134. BAIR, *supra* note 23, at 29.
135. *See infra* notes 236–253 and accompanying text.

that require money immediately may have a limited taste for price shopping.[136] This problem is exacerbated by the small size of the loans, which makes the gains from even a major price difference quite small as an absolute matter.[137]

The third and perhaps most serious competitive problem comes from the market structure. As discussed above, it is widely thought—at least by the large national providers—that location is of paramount importance.[138] Thus, the retail store that is most conveniently located for a particular customer based on her residential and commuting patterns has a strong advantage over all other stores. Moreover, because the profitability of an individual location depends on building a relatively large portfolio of transactions and customers, there is a natural limit on the density with which profitable locations can be established. That limit well might hinder the effectiveness of price competition. On the other hand, the apparent clustering of payday lending stores in suitable neighborhoods suggests that this problem can be overstated.

For some, the failure of market forces to drive prices to a competitive level would be an adequate basis for governmental intervention. The basic argument, articulated most effectively by Stewart Macaulay and Art Leff, and previously applied by one of us to the credit card market,[139] is that a government inappropriately cedes regulatory power to a private enterprise when it allows businesses to define the terms of commerce in industries in which competitive forces do not constrain the terms.

For others, however, the patent futility of crafting regulatory solutions to all instances of market failure will make it important to identify some harm to be addressed. In the consumer-credit area, the harm comes from the financial distress that attends poor decisionmaking by customers in the market.[140]

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136. BAIR, *supra* note 23, at 29.

137. John Pottow suggests an apt analogy to tipping on small checks, where many of us routinely round up to the nearest dollar, even if it results in a percentage tip that is far beyond our normal practices on substantial purchases. Interview with John Pottow (spring 2006) (on file with authors).

138. Flannery & Samolyk, *supra* note 9, at 10. *See, e.g.*, ACE Cash Express, Inc., *supra* note 20, at 17 ("We believe that the principal competitive factors in the check cashing and short-term consumer loan (also known as payday loan) industry are location, customer service, fees, convenience, range of services offered, speed and confidentiality."); First Cash Fin. Servs., Inc., *supra* note 12, at 3 ("Management seeks to locate new stores where demographics are favorable and competition is limited."); *id.* at 7 ("The Company believes that the primary elements of competition in these businesses are store location . . . ."); QC Holdings, Inc., *supra* note 15, at 8 ("We believe that the primary competitive factors in the payday loan industry are store location and customer service.").

139. *See* Ronald J. Mann, *"Contracting" for Credit*, 104 MICH. L. REV. 899 (2006) (discussing Stewart Macaulay, *Private Legislation and the Duty to Read—Business Run by IBM Machine, the Law of Contracts and Credit Cards*, 19 VAND. L. REV. 1051 (1966), and Arthur Alan Leff, *Contract as Thing*, 19 AM. U. L. REV. 131, 144 (1970)).

140. This paragraph summarizes an argument made in more detail in chapter 5 of RONALD J. MANN, CHARGING AHEAD 60–72 (2006).

Specifically, there is good reason to think that financial distress generates costs for society as a whole that are not borne by the parties to the transaction. Thus, the loss from financial distress does not end when a single creditor fails to obtain repayment from the loan that it has advanced. Rather, financial distress has a series of broader effects. It increases the burden on the social safety net: Those in distress are unlikely to contribute funds to support the social safety net, but are quite likely to draw on the resources others have contributed. This is particularly true if financial distress leads to illness; some data, principally in work by Melissa Jacoby,[141] suggests such a link. Those in financial distress are likely to have trouble finding gainful employment, which means that the rest of society will not receive the positive spillover effects that would otherwise accrue from the exercise of their human capital. Finally, financial distress is likely to impose costs on dependent family members.

In sum, the best case against payday lending is that the market is plagued by cognitive failures, unlikely to be well policed by competitive forces, and likely to generate external costs borne by the rest of society. It is simply not plausible, the argument goes, that a person of ordinary capacity would sensibly decide to borrow money at a rate of 400 percent, using a loan that, in most cases, is likely to remain outstanding for months, if not years. In assessing the weight of this problem, it bears noting that those who will be harmed by the market failure are systematically likely to be far from the top of the distribution of income and wealth.

2. The Case in Favor of Payday Lending

As the discussion in Part I suggests, a majority of American jurisdictions in recent years have adopted legislation that specifically authorizes payday lending. It would be naive to suppose that the legislators that voted for those bills carefully evaluated the relevant social interests. Nevertheless, several arguments support the legislation, three of which seem substantial: the benefits of permitting lending; the relatively weak link between lending and financial distress; and the likelihood that a ban on payday lending will lead borrowers to shift to credit products that are relatively worse for borrowers who would otherwise use payday loans.

141. *See* Melissa B. Jacoby, *Does Indebtedness Influence Health? A Preliminary Inquiry*, 30 J.L. MED. & ETHICS 560 (2002)

a. The Benefits of Allowing Payday Lending

The first point is simple, reflecting a general suspicion of wholly paternalist intervention in consumer-credit markets. The one thing that we know for sure about payday lending is that it is attractive to a large number of consumers in the Western economies that tolerate it. The product's rapid growth is not limited to the United States, but is apparent in Australia, Canada, and the United Kingdom as well.[142] Moreover, because the overwhelming majority of payday lending transactions do not result in default on the part of the borrower, there is some reason to think that many of the transactions benefit both the borrower and the lender.

It is easy for upper-middle-class academics that study the topic to think that this lending is unduly risky and that those that engage in it would be better advised to tighten their belts and resist the temptation to borrow. It will be much less clear to the borrower—almost by definition a person struggling to make it from paycheck to paycheck—that the transaction involves a luxurious excess. We of course know very little about exactly what the customers of payday lenders do with the funds that they borrow. Surely some of them use the funds on vicious habits that reflect poor choices, but just as surely at least some of the borrowers are responsible individuals using the funds to purchase food or medicine.[143]

b. Payday Lending and Financial Distress

The second point in favor of payday lending focuses on a weak link in the discussion in Part II.A.1, which assumes that toleration of the payday lending market substantially increases the incidence of financial distress. Although there must be *some* transactions in which the additional funds available from a payday lender tip the scale toward insolvency, these small loans probably do not contribute substantially to financial distress and insolvency. A comparison

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142. The first payday lender in Australia appeared in 1998, and by 2001, eighty-two payday lending businesses were offering 12,800 loans a month. WILSON, *supra* note 46, at 34. Though currently a small industry, experts predict it will grow along the same lines as in the United States. *Id.* at 11. In Canada, one survey reports that nearly a million Canadians, about one in every thirty-two people, have used a payday loan at least once. Richard Brennan, Nicole MacIntyre & Jim Rankin, *Ontario Has Begun Payday Lender Probe: Loan Industry Is Unregulated*, TORONTO STAR, June 22, 2004, at A17. There are more than 1200 payday lending stores in Canada, and reports estimate that payday lending generates more than a billion dollars a year in revenue. *See* Rankin & MacIntyre, *supra* note 115, at A1; ACORN CANADA, PROTECTING CANADIANS' INTEREST: REINING IN THE PAYDAY LENDING INDUSTRY 2 (2004).

143. *See supra* note 6 (discussing the available evidence).

to the credit card market—where the relationship between card use and financial distress is pronounced—is illuminating.

First, unlike credit card lending, payday lending has a limited potential to spiral into escalating levels of borrowing. Thus, we would not expect to see files of bankrupt borrowers with tens of thousands of dollars of claims from payday lenders. Credit card lenders often hold claims of that size, but payday loans, by the nature of the business, are self-limiting: They are not going to grow to an amount that equals the expected take-home pay from the borrower's next paycheck. Indeed, in most of the jurisdictions that have adopted authorizing statutes, the statutes include a specific maximum cap—like the $600 cap in the Michigan statute.[144] When coupled with a reliable database of all providers,[145] these provisions should prevent payday lending from contributing to the spiral of ever-increasing indebtedness that is such a major part of the problem with credit card debt.

Thus, one way to think about the payday loan is that it is, at worst, a second, relatively small unsecured line of credit available to borrowers after they have maxed out their credit cards. Perhaps the availability of this line will lead some borrowers to wait longer before they surrender to inevitable bankruptcy, but that effect seems much less significant than the effect of the often much larger credit card line behind which the payday lender will come. Indeed, it is possible that the payday loan could even help speed the bankruptcy filing, because the borrower could use a payday loan to borrow the funds needed to file for bankruptcy.

c. Forcing Borrowers Into Worse Markets

The most important justification for the payday lending market concerns the secondary effects of bans on payday lending. The point of such bans is to keep consumers from borrowing funds because of insufficient financial planning. The core problem, however, is that bans are unlikely to keep consumers from borrowing. Rather, the evidence suggests that bans may well cause consumers to borrow from sources that provide products that are less beneficial—products that consumers are more likely to avoid in markets that tolerate payday lending.

We start from the premise that the desire of consumers to borrow is to a large degree a function of economic development.[146] Governments can take

144. MICH. COMP. LAWS ANN. § 487.2153(1) (West Supp. 2006).

145. For discussion of such databases, see *infra* text accompanying note 210.

146. MANN, *supra* note 140, at 106–18. This might be because economic development is associated with the development of an enforcement infrastructure that fosters credit markets. *See* Simeon Djankov et al., *Debt Enforcement Around the World* (Nat'l Bureau of Econ. Research, Working Paper No. 12807, 2006).

steps to ensure that the credit is made available in ways that benefit society as much as possible and harm those that use the credit as little as possible.[147] But it is, generally speaking, quite difficult to prevent consumers from borrowing by eliminating a particular method of extending credit. Thus, for example, the effect of Japan's longstanding ban on credit card lending by banks was not to bolster the frugality of the Japanese populace. Rather, it was to enhance the market share of Japanese consumer lending held by relatively unsavory nonbank lenders.[148] More broadly, a recent study by the United Kingdom's Department of Trade and Industry (DTI) bolsters this intuition with its finding that consumer demand for borrowing in countries with usury ceilings was the same as demand in countries without ceilings: The same number of people required credit, and people generally had the same aggregate level of debt-service-to-income ratios.[149]

As the example of New York discussed above illustrates, it is far too simple to suggest that usury regulation can never drive out high-cost borrowing. It is true, however, that it requires two things that few jurisdictions have: both a broad and inclusive usury statute (so that lenders cannot easily switch to substitute transactions that are unregulated), and an aggressive enforcement regime (so that lenders cannot operate unlawfully below the radar).[150]

Working from the premise that risky lending will not be eradicated in many jurisdictions, the natural question is where consumers are going to get the funds if they can not get them from payday lenders. Echoing a prominent Australian commentator, some might say that "the risk of borrowers turning to

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Economic development also might be associated with long-term political stability necessary to foster credit markets. *See* Mark J. Roe, *Legal Origins, Politics, and Modern Stock Markets*, 120 HARV. L. REV. 460 (2006). Our thoughts on that debate are beyond the scope of this Article.

147. The Talent-Nelson Amendment is a good example. John Warner National Defense Authorization Act for Fiscal Year 2007, Pub. L. No. 109-364 § 670, 120 Stat. 2083 (to be codified at 49 U.S.C. § 987). The military would take away the product that the military personnel are using without either addressing the conditions that make the product attractive or facilitating a more reasonably priced alternative. The 36-percent rate caps likely will make the national chains inaccessible to military families. We can expect to see those families depending more heavily on subprime credit cards, pawn shops, rent-to-own providers, and unlicensed payday lenders, all of which in the long run are likely to be worse for those families than the prohibited payday loans. Interviews with representatives of large payday lending firms suggest that military personnel are only about 1 percent of their customers and that those personnel (and their dependents) will be immediately excluded from their customer base. Interviews with Anonymous (spring 2006) (on file with authors).

148. MANN, *supra* note 140, at 106–18; Ronald J. Mann, *Credit Cards and Debit Cards in the United States and Japan*, 55 VAND. L. REV. 1055 (2002).

149. DTI REPORT, *supra* note 5, at 10, 12. Economists also have suggested that the demand for credit by high-risk borrowers is relatively inelastic. *See* Susan Block-Lieb & Edward J. Janger, *The Myth of the Rational Borrower: Rationality, Behaviorism, and the Misguided "Reform" of Bankruptcy Law*, 84 TEX. L. REV. 1481, 1497 (2006) (discussing theories of Joseph E. Stiglitz and Andrew Weiss).

150. As we discuss in the concluding pages of this Article, sensibly chosen usury limits can serve another function: to segment the market between legitimate providers (that can profit from lawful transactions) and less efficient illegitimate providers (who are priced out of the market by the usury limit).

less reputable fringe credit providers does not seem enough to justify the continuation of current practices in the payday lending industry."[151] In our view, however, a fair look at the evidence makes that conclusion fairly debatable. To us, the evidence makes it at least possible that the consumers that have made payday lenders so profitable have done so for one general and rational reason: The products of payday lenders provide a better mix of benefits and risks than the competing products consumers would choose if payday lenders were banned. The most persuasive source here is the DTI report, which concludes a survey of European and American markets with this view: "Where low-income borrowers have more than one credit option, consumers' choices in relation to lending models appears [sic] rational on both cost and utility grounds."[152] Though scholars in many jurisdictions—Canada,[153] Australia,[154] and of course the United States[155]—often assert that low-income borrowers act irrationally when they use payday loans, they have not provided evidence to support those assertions. A quick glance at five of the leading alternatives to payday lending shows the sense in Jim White's perspective: "I think even the poorest consumers are quite savvy. They understand the alternatives and make choices about borrowing that are wise for them even when the decisions seem foolish or wasteful to middle-class observers."[156]

(1) Banks

An effective attempt to ban payday lending might be successful if banks were to take the place of fringe payday lenders that currently provide credit to subprime borrowers. Michael Barr has made sound recommendations for products that banks could offer to compete with payday lenders.[157] And Sheila Bair's recent extensive report on the potential role of banks in payday lending (Bair Report) provides a thoughtful and promising analysis of several business models that banks might use to operate profitably in this market.[158] We remain skeptical, however, that banks could fill the place of payday lenders without substantially duplicating the product payday lenders offer.

151. Wilson, *supra* note 2, at 165.
152. DTI REPORT, *supra* note 5, at 12.
153. RAMSAY, *supra* note 46, at iii, 24.
154. Wilson, *supra* note 2, at 163.
155. *See* Hellwig, *supra* note 2, at 1582 (assuming consumers are irrational because they use payday loans over longer periods).
156. White, *supra* note 110, at 466.
157. Barr, *supra* note 2, at 163–64.
158. BAIR, *supra* note 23, at 34–37.

For one thing, history suggests that banks will not operate in these markets unless they are permitted to charge higher rates. For example, before consumer credit was deregulated in the United States, banks would not make small, unsecured, high-risk loans to borrowers because of the high transaction costs associated with such loans.[159] In Germany's and France's strict rate-cap environments, high-risk borrowers are simply excluded from accessing credit; banks do not fill in the gap left by payday lenders.[160]

To be sure, as the Bair Report discusses, there have been numerous policy initiatives in this country designed to support active participation by depository institutions.[161] But for the most part, the low-rate programs that the Bair Report discusses (involving rates in the range of 12 to 20 percent per annum) are not profitable.[162] Those we have spoken to in the industry assert with great confidence that banks will profit from a payday lending product that undercuts the existing market only by hiding back-end fees or tying the product to some other service on which the banks profit substantially.[163] At the core, the problem is that the payday lending product competes directly with the overdraft product,[164] and banks that wish to market the overdraft will not want to offer unprofitable or break-even, short-term lending products.[165]

Moreover, borrowers likely have little to gain by shifting to the overdraft product. The overdraft is characterized by cascading fees—a fee in the range of $20 to $30 for each check that the customer bounces each month.[166] The payday product, by contrast, contemplates a single fee, in the same range, that covers an advance for the entire remainder of the payroll period. Upon payment of that single fee, the customer can use the funds to pay each of the obligations that would have resulted in separate overdraft fees. Admittedly, the interest rates on the payday lending product are high. But the product has two advantages over the overdraft product. First, and most importantly, it seems fairly clear that overdraft products are more expensive than payday lending products. They often escape criticism largely because existing regulations in this country

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159. Hellwig, *supra* note 2, at 1569–70.

160. DTI REPORT, *supra* note 5, at 40.

161. BAIR, *supra* note 23, at 21–28.

162. For instance, neither the Windward Community Federal Credit Union's product, which has a 12 percent APR, nor the North Side Community Federal Credit Union's product, which has a 16.5 percent APR, are profitable. *Id.* at 22–23, 26. For discussion of a more recent credit-union effort, see Katie Kuehner-Hebert, *CUs in Ohio Team Up to Offer Payday Alternative*, AM. BANKER, July 13, 2006.

163. Interviews with Anonymous (spring 2006) (on file with authors).

164. *See* Barr, *supra* note 2, at 163–64.

165. BAIR, *supra* note 23, at 34 ("Why offer a small dollar line of credit linked to a checking account at an 18% APR if a bank can collect many multiples of that by assessing a $17 to $35 fee each time a customer overdraws his/her account?").

166. *Id.* at 10–13.

treat those products as if they do not involve credit,[167] even when they are marketed in a way that contemplates regular advances. Second, and relatedly, the payday lending product is relatively transparent (especially as we envision it in the discussion below), with a price that is simple for customers to understand. The overdraft product, by contrast, is much harder for customers to price, if only because it frequently will be difficult for them to predict when they are issuing checks that will bounce.

Because all payday lending customers have some bank account—an account on which their repayment check must be drawn—there is certainly the potential for bank competition. In the end, however, the message we take from the Bair Report is that banks that work very hard on this problem with the help of regulators might develop the ability to serve with profit some small number of the less troubled customers of payday lenders. In reality, regulators are not comfortable that they adequately can supervise the extremely high-volume, low-amount lending transactions in which sophisticated payday lenders engage. Moreover, the costs of branch banking are likely to make it hard for banks to compete directly against the most sophisticated payday lenders, which will be able to establish highly dispersed retail locations more cheaply than banks.

(2) Subprime Credit Cards

Another obvious alternative to payday lending is the subprime credit card. If payday loans were banned, at least some payday lending customers could shift to subprime credit card products. This is perhaps the most perverse outcome. If forcing customers to overdrafts is bad because they are expensive and opaque, shifting consumers to credit cards is much worse.[168] Also, as discussed above, it appears that many payday lending customers are already using credit cards to their fullest extent. Thus, it seems unlikely that a ban on payday lending would result in a shift to credit card lending. Rather, it would result in a shift to the less appealing products discussed in the three Subparts that follow.

167. Both the Bair Report and Michael Barr note that banks benefit from the fact that overdraft fees are not subject to the TILA's requirement of disclosing the APR because consumers do not appreciate the relative costs of this form of credit. *Id.* at 34; Barr, *supra* note 2, at 164. Consumer advocates are pressing for an amendment to Regulation Z that would apply the TILA to bounced-check-protection programs. *See* Mark E. Budnitz, *Developments in Payment Systems Law*, 10 J. OF CONSUMER & COM. L. 5 (2006).

168. *See generally* MANN, *supra* note 140, at 45–72.

(3) Pawnshops

In our view, one of the first places consumers would turn to if payday loans were not available would be pawnshops.[169] Pawnshops operate by giving consumers a loan in exchange for a possessory interest in a piece of personal property. The interest becomes an ownership interest after a specified period if the consumer is unable to repay the principal and interest on the loan. John Caskey's classic and comprehensive 1994 study of pawnshops details the boom in pawnshops during the 1970s and 1980s.[170] Caskey found that borrowers use pawnshops when they have no other alternative source of credit.[171]

The product bears the obvious disadvantage, as compared to the payday loan, that an adverse financial outcome results in the direct and permanent loss of personal property of the consumer.[172] Moreover, because consumers typically have no right to the surplus from the sale of repossessed property, the ultimate costs are likely to be considerably more than the stated interest rate would suggest.[173] In a normal secured loan, a secured creditor can sell the collateral if the debtor defaults on the loan.[174] If the sale generates more money than the amount of the debt, however, the creditor must return the excess to the borrower.[175] In a pawn transaction, the borrower pledges a piece of property in exchange for money, but the borrower is never obligated to redeem the property[176] and cannot be held liable for the debt.[177] But if the borrower does not redeem the pledge by paying back the loan and fees, the property is simply

169. There is some debate about whether payday lenders and pawnshops serve the same constituency. Dean Wilson argues that, in Australia, pawnbrokers and payday lenders do not serve the same consumers, because only 15 percent of people taking out payday loans had used pawnbroker in last 12 months. WILSON, *supra* note 46, at 68. If that pattern is true here, it would suggest that the regular customers of pawnbrokers are a step farther along the path to financial distress than the regular customers of payday lenders.

170. JOHN P. CASKEY, FRINGE BANKING: CHECK-CASHING OUTLETS, PAWNSHOPS, AND THE POOR 84–110 (1994).

171. *Id.* at 78.

172. Johnson, *supra* note 2, at 102. John Caskey also notes that involving property in the transaction makes the transaction less convenient for borrowers. CASKEY, *supra* note 170, at 68.

173. Lynn Drysdale & Kathleen E. Keest, *The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and Its Challenge to Current Thinking About the Role of Usury Laws in Today's Society*, 51 S.C. L. REV. 589, 600 (2000). Caskey reports that "[n]onredemption rates of 10–30% are typical in the states for which there are data." CASKEY, *supra* note 170, at 41.

174. U.C.C. § 9-601 (1999).

175. *Id.* § 9-608(b).

176. *See, e.g.*, TEX. FIN. CODE ANN. § 371.170 (Vernon 2006) ("A pledgor is not obligated to redeem pledged goods or to make a payment on a pawn transaction.").

177. *See, e.g.*, *id.* § 371.171 ("A pawnbroker may not enter an agreement requiring the personal liability of the pledgor in connection with a pawn transaction.").

forfeited to the pawnbroker,[178] and the borrower has no right to any surplus value the pawnbroker acquires through the borrower's forfeiture. Given the likelihood in most cases (at least in the United States) that the property would be exempt from execution, the lost property would have been protected even in the event of a bankruptcy proceeding, if only the consumer could have borrowed funds from an unsecured lender like a payday lender.

There is some reason to think that consumers recognize these problems. Thus, the DTI report summarizes evidence that U.S. consumers choose payday lending over pawnbrokers precisely because payday loans do not require surrendering assets.[179] A similar distaste for pawnshops apparently exists in the United Kingdom,[180] although it is "doorstep" lending, rather than payday lending, that is the fringe-lending product of choice.[181]

Nor is there much reason to think that consumers would benefit from lower interest rates if they used pawnbrokers. Loans made by pawnbrokers generally have interest rates at least as high as, if not higher than, payday loans. For instance, title loans, a form of pawnbroking in which consumers give a security interest in their cars to the pawnbrokers in exchange for a loan, can have annual percentage rates (APRs) of almost 1000 percent.[182] There also is evidence that pawnshops fail to solve the problem of habitual borrowing, as Caskey found that 70 to 80 percent of pawnbrokers' business was repeat customers.[183]

There is also a general sense that the step from the payday lending market to the pawnbroker market is a step toward a less reputable lender. Publicly held companies operate fewer than 6 percent of the pawnshops in the United States,[184] whereas an increasing share of payday lending locations are operated by a group

178. *See, e.g.*, *id.* § 371.169(c) ("Pledged goods not redeemed on or before the 30th day after the original maturity date may, at the option of the pawnbroker, be forfeited to the pawnbroker.").

179. DTI REPORT, *supra* note 5, at 12.

180. *Id.* at 20.

181. The "doorstop" lending market generally involves small, short-term loans (like payday loans), but it emphasizes door-to-door solicitation and collection. *See Doorstep Lenders "Overcharging"*, BBC NEWS, Apr. 27, 2006, http://news.bbc.co.uk/1/hi/business/4949544.stm. For discussion of that market, see the Competition Commission's website regarding an inquiry into anticompetitive practices. Competition Commission, Welcome to the Home-Page of the Home Credit Inquiry, http://www.competition-commission.org.uk/inquiries/current/homecredit/index.htm (last visited Nov. 9, 2006).

182. Drysdale & Keest, *supra* note 173, at 598–99. Of course, just as with payday lending, it may well be that a focus on the nominal interest rate is misleading. To a pawnshop customer, what is important is the customer's personal valuation of the goods being pawned, and the customer surely understands that the goods will be lost unless the customer can repay the loan.

183. CASKEY, *supra* note 170, at 42. On the other hand, pawnshop lending bears the advantage (compared to payday lending) that the product is less likely to enmesh the borrower in the long string of repetitive interest payments for the same loan; if the borrower can not redeem the pawn, it will lose the pawn, but it will not continue rolling the loan over until it has paid the amount of the obligation several times over.

184. White, *supra* note 110, at 458–59.

of large publicly traded companies.[185] At least in the United States, this is associated with a stigma against pawn shops: "[T]he [pawnbroking] industry has difficulty shaking the 'pawnbroker stigma.' The composite image of the pawnbroker is that of a shady, unkempt, over-weight character working out of a filthy, run-down, back street hock shop . . . providing continuing support to 'druggies' and other 'low lifes' in exchange for pawns of stolen goods."[186]

(4) Rent-to-Own

In rent-to-own (RTO) transactions, consumers acquire goods, such as televisions or furniture, in exchange for periodic payments. Consumers make either weekly or monthly payments to the renting party. If the consumer cannot make the payment, the consumer must return the goods.[187] Eventually, the consumer owns the goods after paying for a specified period.[188] The RTO industry is "a $4.5 billion industry of approximately 7,500 stores with about 3.5 million customers."[189] RTO lenders appear to compete directly with payday lenders. As the DTI report cogently notes, the relation between RTO transactions and payday loan regulation is demonstrated by the facts that RTO transactions are permitted in most U.S. states but are concentrated in states with the fewest other credit options for lower-income individuals[190] and are stronger in states with interest-rate ceilings.[191]

The consumer preference for payday loans over RTO transactions is quite sensible. For one thing, RTO transactions are not governed by the Fair Debt Collection Practices Act.[192] RTO transactions functionally require consumers to pay very high interest rates to obtain goods, such as, in one example, paying $1709 to obtain a 20-inch television with a retail price of under $300.[193] RTO transactions have the undisclosed processing fees of payday loans[194] and the

185. *Id.* at 459.

186. Jarret C. Oeltjen, *Florida Pawnbroking: An Industry in Transition*, 23 FLA. ST. U. L. REV. 995, 995 (1996). Survey evidence from Australia suggests a similar perspective. Thus, Australians report that they prefer payday loans over pawn transactions because pawnbrokers are less professional than payday lenders, and because going to a pawnshop reveals a greater admission of desperation or is more demeaning. WILSON, *supra* note 46, at 79.

187. For a comprehensive discussion, see Martin & Huckins, *supra* note 2.

188. *Id.* at 385.

189. *Id.*

190. DTI REPORT, *supra* note 5, at 14.

191. *Id.* at 13. For a detailed account of state laws on rent-to-own transactions, see Martin & Huckins, *supra* note 2, at 396–400.

192. Martin & Huckins, *supra* note 2, at 391.

193. *Id.* at 401.

194. *Id.* at 403–04.

behavior-driven late fees of credit cards.[195] RTO dealers list retail prices of their goods much higher than the market value of the goods to confuse consumers.[196] Therefore, RTO transactions not only have the adverse effects of pawnshop lending (customers lose their property), but they also have much less transparent pricing to the customer (because of the long sequence of payments required to purchase). Indeed, RTOs might be the worst product for consumers, pairing a risk of forfeiture for nonpayment with the most serious cognitive problems.

(5) Illegal Sources

Finally, when borrowers have no other legal credit options, they will seek illegal credit options. For instance, evidence confirms that loan sharks remain common in Australia.[197] Responsible Australian policymakers, like then minister of fair trading Judy Spence, have claimed that banning payday lending would lead directly to individuals with low incomes patronizing loan sharks.[198] The DTI's arguably self-interested take on illegal lending in the United Kingdom versus illegal lending in France and Germany suggests a similar relation: "The credit impaired in France and Germany appear more likely to use illegal lenders than in the U.K. where there are legal credit options for such borrowers."[199] Thus, the DTI reports, 3 percent of UK borrowers admit to using illegal lenders, as opposed to 7 percent in France and 8 percent in Germany.[200] Comparing people who have been denied a loan reveals an even greater difference, with 4 percent in the United Kingdom admitting using illegal lenders, contrasted with 12 percent in France and 10 percent in Germany.[201] If we assume that illegal sources of credit and the extralegal collection methods on which they rely are disadvantageous as compared to legal sources, then we should worry about legal rules that will expand the market share for the illegal products.

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195. *Id.* at 403–04.
196. Drysdale & Keest, *supra* note 173, at 615–16.
197. Wilson, *supra* note 2, at 165.
198. *Id.* at 165 (citing Press Release, Australian Office of Fair Trading, Payday Predators Panned (Aug. 31, 2000)).
199. DTI REPORT, *supra* note 5, at 44.
200. *Id.*
201. *Id.* For more detailed survey research on that topic, see POLICIS, ECONOMIC AND SOCIAL RISKS OF CONSUMER CREDIT MARKET REGULATION (2006), *available at* http://www.policis.com/financial_services_market_regulation.htm.

We are largely agnostic about the merits of the arguments presented above. In our view, the discussion about these arguments is important because policymakers deciding whether to authorize payday lending should start by deciding exactly why they do—or do not—think it contributes to the welfare of their constituents. Those for whom the arguments in favor of payday lending are not persuasive should be reluctant to support the spread of payday lending in their jurisdiction. Those who (like most legislators in this country) cannot justify a complete ban on payday lending should read on to consider precisely what type of lending they should tolerate.

B. Should Repetitive Payday Lending Be Banned?

A distinct question is whether habitual use of payday loans should be tolerated. As discussed in Part I, it is clear that rollover payday loans are common in the industry. Indeed, the Flannery and Samolyk study contemplates that the profitability of the large national providers might depend on rollover payday loans.[202] In some cases, the results can be startling. For example, one recent enforcement action targeted an illegal series of rollovers in which one borrower paid over $19,500 in interest over eight years on a series of loans that eventually reached a principal balance of $1875.[203] This raises the prospect of an intermediate policy perspective: A state might tolerate payday loans in the abstract, but prohibit rollover loans. Indeed, this is not a hypothetical perspective. Most of the states that have adopted legislation authorizing payday loans have modified the model CFSA statute in ways designed to make rollover lending more difficult. Unfortunately, as we discuss below, it appears that none of the statutes that prohibit rollover loans has been drafted in a way effective to prevent customers from becoming trapped in an indefinite cycle of payday borrowing.

Whether a prohibition on rollover loans makes sense depends, in part, on whether such a ban would effectively abolish the payday lending market altogether. If a ban on rollover loans would effectively ban the market entirely, or drive all reputable providers from the market, which is much the same thing from a policy perspective, then a policymaker contemplating a ban on rollover loans should consider its goals.

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202. For our discussion of why rollovers play an important role in lender profitability, see *supra* notes 27–28 and accompanying text.

203. *See* Press Release, Wash. State Dep't of Fin. Insts., DFI Bans Payday Lender from the Industry and Orders Restitution to Consumers (Sept. 11, 2006), *available at* http://www.dfi.wa.gov/consumers/news/2006/expressit.htm.

1. The Case for and Against Banning Repetitive Lending

Many commentators—and a good number of legislators—operate on the assumption that proof that a substantial number of payday loan customers are frequent users self-evidently demonstrates the impropriety of the business. The argument often proceeds as follows: An example is given of a small loan that a customer has rolled over month after month, resulting in the customer having paid hundreds of dollars in interest but never having paid down the principal.[204] From this example, we are to conclude rollovers are illegitimate.

Yet the policy basis for that perspective is difficult to articulate. For one thing, if the total amount of funds extended by the payday lender is capped,[205] it is difficult to understand why it would matter that the borrower might borrow repeatedly from the same (or a different) lender. At worst, this indicates that the borrower's overall debt has increased, more or less permanently, by the total amount available from a payday lender. Even in the most dramatic examples—in which a customer pays $1000 to maintain a $150 debt over a period of eighteen months—the customer's level of debt never increases beyond $150.[206]

A comparison to credit card borrowing is illustrative. It seems unlikely that many people that borrow up to twice their annual income on credit cards ultimately pay off the entire amount of the indebtedness without suffering from the effects of financial distress. With payday loans, however, if the maximum borrowing is capped at something less than a twelfth or a twenty-fourth part of annual income, it seems at first glance much less problematic than credit card borrowing.

The high interest rates of payday loans, however, can produce shocking outcomes like the one discussed above—a loan at the standard $15 rate rolled over for eighteen months. Can we really believe that the customer is better off with that product than he would have been if he had paid $5 or $10 extra every two weeks to amortize the loan balance slightly?

Moreover, the structure of the product leads to all-or-nothing transactions: payoff followed by rollover. Thus, as a matter of framing, the borrower each week faces a choice between paying $30 to keep the loan for another

204. *See, e.g.*, Chin, *supra* note 70, at 729 (citing the following example: "[A]fter borrowing $150, and paying $1000 in fees for six months, a Kentucky borrower still owes the $150").

205. This is true both as a matter of the economics of the product and as a feature of the regulatory regime. For instance, even under the model legislation that the CFSA supports, loan amounts are capped at $500. Model Deferred Deposit Act, *supra* note 79, § 6(1) at 35.

206. Thirty dollars for each of the thirty-six rollover periods would amount to $1080. This assumes that the borrower is dealing with a reputable provider that charges no back-end fees of any kind.

two weeks or paying $230 to repay the loan all at once. If the borrower looks each week at the $30, the borrower will pay inadequate attention to the long-term outcome: $1080 in interest paid for an eighteen-month loan of $200.

The framing problem also creates perverse incentives for lenders. In a market in which generating a reliable income stream is the goal, the lender can be less concerned with monitoring the likelihood of repayment than with the likelihood of a paycheck that promises the capacity to make a continuing stream of rollover payments. It may be a different mechanism than the more familiar model of the credit card issuer, but the outcome is much the same; the principal difference is that the payday lender need invest only $200 to generate $60 per month, while the credit card issuer will need to invest $3000.[207]

In the end, the case for banning rollover loans comes down to the policy implications of the deeply repetitive borrower discussed above. Is it tolerable for borrowers to pay the fees of the payday product without any limitation? Even legislators immune from paternalistic impulses are likely to insist upon *some* limit on rollover loans. Thus, it is perhaps not surprising that the model deferred deposit loan act promulgated by the CFSA bans more than one direct repeated rollover loan.[208]

2. The Mechanics of Banning Repetitive Lending

Turning to the policy choices of current legislators, a rollover ban is the response of choice among states. The great majority of those states that regulate payday lending have adopted rules that limit repetitive lending by limiting or preventing direct rollover loans.[209] The problem, however, is that a limitation on rollover loans requires two additional features if it is to have any effect on repetitive borrowing.

First, a state must maintain a database of all licensed providers, require lenders to consult that database before making loans, and make prohibitions on repetitive lending applicable to the entire pool of licensees. Without such

207. Assuming monthly payments of about 2 percent of the outstanding balance.

208. *See* Model Deferred Deposit Act, *supra* note 79, § 8 at 36. Of course, that ban is written in a way that is practically ineffective. But it is relevant to us that that even the CFSA is unwilling to publicly defend indefinite rollover lending.

209. Rollover bans are part of the regimes in Alabama, Alaska, Arizona, Arkansas, California, Colorado, Delaware, Florida, Hawaii, Idaho, Illinois, Indiana, Iowa, Kentucky, Louisiana, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, North Dakota, Oklahoma, Oregon, Rhode Island, South Carolina, South Dakota, Tennessee, Utah, Virginia, Washington, and Wyoming. PayDay Loan Consumer Information, http://www.paydayloaninfo.org/states.cfm (last visited Mar. 4, 2007).

a database, the borrower that wishes to borrow repetitively need only cycle its borrowings between more than one lender, just as a distressed consumer need only use cash advances on one credit card to make a minimum payment required to keep a second card active. These databases are increasingly common—Delaware, Florida, Idaho, Indiana, and North Dakota all have implemented them in the last few years.[210]

The second necessary feature is an effective cooling-off period between loans.[211] These periods exist in a number of states, with periods ranging from one to seven days,[212] typically imposed after a long string of borrowing. Indiana's provision[213] (the most restrictive), requires a seven-day cooling-off period after six consecutive transactions. As far as we can tell, however, only Indiana has *both* a cooling-off period and a limit on repetitive lending that is policed by reference to a statewide database. This, then, is the closest any state has come to enacting an effective ban on repetitive payday lending. And even there, a reasonable skeptic might say that the cooling-off period is too short to be effective. No period less than fourteen days will ensure that a typical borrower with a two-week pay cycle is forced to go through an entire cycle without obtaining funds from a payday lender.

In sum, most legislatures have determined that the best outcome is some form of an intermediate policy: restricting or prohibiting the kinds of repetitive payday lending transactions that indicate that a customer is irretrievably enmeshed with payday loans. But few (perhaps none) of the legislatures that have taken that policy view have adopted a system that is likely to eliminate repetitive payday borrowing.

210. *Id.* For a typical statute, see FLA. STAT. § 560.404(18)–(19) (2003).

211. The CFSA's model statute includes a ban on rollover loans, but includes neither a statewide database nor a cooling-off period. *See* Model Deferred Deposit Act, *supra* note 79, § 8 at 36.

212. Cooling-off periods are part of the regimes in Alabama (one day), Illinois (seven days), Indiana (seven days), North Dakota (three days), and Oregon (one day). *See also*, *e.g.*, Johnson, *supra* note 2, at 66 ("[I]n Iowa and other states that prohibit rollovers but allow a customer to have two loans with the same lender, lenders could claim technical compliance with the state law prohibition against rollovers while allowing consumers to continually roll an existing loan into a new loan as long as the lender does not exceed the maximum loan amount. This possible end-run around the rollover prohibition prompted the Iowa Division of Banking to issue an interpretive bulletin informing lenders that the prohibition on rollovers means that they cannot issue a new loan to a consumer until at least one day after payment of the previous loan . . . . Unlike Iowa, other states have not even tried to clarify the interrelationship between statutes that prohibit rollovers and statutes that allow multiple outstanding loans. Therefore, payday lenders in these states may practice rollovers even where it is technically illegal.") (footnotes omitted); PayDay Loan Consumer Information, *supra* note 209.

213. IND. CODE § 24-4.5-7-108, -404 (2006).

C. How to Design Regulatory Schemes That Target Abuse

Finally, we consider the view that the payday lending model should be permitted to function without substantial constraint to the product itself. That does not suggest, however, that the industry should be immune from regulation. As discussed above, no U.S. jurisdiction has adopted that perspective. The task, rather, is to define the purpose of these regulatory schemes, as a precursor to assessing how well they work.

In general, the two most obvious bases for regulation in a jurisdiction that wishes to allow payday lending would be (1) to limit the cognitive problems discussed above; and (2) to limit the likelihood of abusive conduct by lenders. Thus, the discussion above presents the view that payday lending might be permitted because, in the range of prices and attributes at which the product typically is offered, the product is attractive to even well-informed customers, particularly when it is compared to high-cost alternatives like overdraft products and risky products like credit cards, pawnshop lending, and RTO transactions. At the same time, even in the jurisdictions that regulate the market, it is hard to deny that transactions occur on terms outside those normal parameters.[214] This might be because the lenders charge fees that differ from those that they disclose. Or it might be because the lenders charge fees that grossly exceed the specified limits—fees far beyond the amounts necessary for a well-organized business to profit. Or it might be because the lenders package the payday lending product with other related products for which they charge unreasonable amounts, all with the purpose of charging unlawfully high fees.[215] In general, it is safe to assume that some lenders engage in this conduct with an intention to profit through avoidance of industry norms or legally prescribed limits. The task, then, is to devise a regulatory regime that will allow legitimate providers to proceed with as little burden as possible while hampering the activities of those that currently operate with flagrant illegality.[216]

Logically, the first question in designing a scheme to limit abuse is whether the abused customers can solve the problem themselves, simply by enforcing

214. *See, e.g.*, ConsumersUnion.org, Study: Payday Lenders Continue to Ignore State Laws Related to Fees and Protections (July 2, 2003), *available at* http://www.consumersunion.org/pub/core_financial_services/000203.html (survey of thirty-one payday lenders in Texas indicating that none were in compliance with applicable state law).

215. This seems to have been the preferred practice of the "loan shark predator" discussed above. *See* Escobedo, *supra* note 39.

216. We do not address the problem of regulating Internet payday lending. Our impression is that effective regulation of that sector will have to come first from the U.S. Congress. A good place to start, however, would be to require that lenders provide a brick-and-mortar address of their headquarters.

their rights through litigation.[217] For several reasons, that seems implausible. As Iain Ramsay points out in the Canadian context, "[t]he small amounts at stake mean that few individuals are likely to litigate in the event of a dispute."[218] Even if attorneys were to work for free or operate under a fee-shifting mechanism, the small damages involved might not deter lenders.[219]

Moreover, the nature of the customer base makes reliance on litigation problematic. Lower-income people have fewer professional contacts, so it is harder for them to enforce their rights.[220] In Australia, commentary suggests that "low-income consumers will not have the resources to apply to court to complain of hardship or unconscionability."[221] Even if they had the resources to find attorneys and pay court fees, studies show that "low-income consumers are unlikely to take legal action in relation to a loan dispute, on the basis of factors such as cost, a sense of powerlessness, and a fear of acrimonious disputes."[222] Thus, even recognizing that payday lending customers are not the poorest segment of U.S. society, we remain skeptical that direct litigation alone will allow victimized customers to enforce regular compliance with articulated regulatory requirements.

Trying to fill the gap, we suggest a two-part approach. First, we suggest a number of direct transactional regulations, many (but not all) of which appear in one form or another in the deferred presentment statutes recommended by

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217. Other countries purport to regulate payday loans through judicial review. For example, the British Consumer Credit Act empowers courts to lower interest rates that are unconscionable or "extortionate and grossly exorbitant." Consumer Credit Act, 1974, c. 14, § 39 (Eng.); Moneylenders Act, 63 & 64 Vict. 155, c. 51, § 1 (1900) (Eng.). Similarly, several Canadian provinces regulate excessive credit charges and credit contracts by allowing courts to reopen consumer transactions that are unconscionable. *See, e.g.*, Alberta Unconscionable Transactions Act, R.S.A., ch. U-2, § 2 (2000) (empowering judges to review and alter transactions in which "the cost of the loan is excessive and . . . the transaction is harsh and unconscionable . . . ."); Manitoba Unconscionable Transactions Relief Act, R.S.M., ch. U20, § 2 (1987) (same); New Brunswick Unconscionable Transactions Relief Act, R.S.N.B., ch. U-1, § 2 (1993) (same); Newfoundland and Labrador Unconscionable Transactions Relief Act, NFLD. R.S., ch. U-1, § 3 (1990) (same); Prince Edward Island Consumer Protection Act, R.S.P.E.I., ch. U-2, § 2 (1988) (same). Also, some Canadian borrowers have sought judicial review of payday transactions—both individually and through class actions. *E.g.*, Affordable Payday Loans v. Beaudette, 2004 Carswell Ont. 3210, 2004 WL 1663120 (Ont. S.C.J.) (July 29, 2004); Jim Rankin, *Borrow in Haste Repay Forever*, TORONTO STAR, Nov. 21, 2005, at B03. The Australian Uniform Consumer Credit Code similarly empowers courts to review unconscionable interest rates and to reopen unjust transactions. UNIF. CONSUMER CREDIT CODE, 2001, §§ 70, 72 (Austl.).

218. RAMSAY, *supra* note 46, at 18.

219. Hellwig, *supra* note 2, at 1587.

220. RAMSAY, *supra* note 46, at 19.

221. Wilson, *supra* note 2, at 162.

222. *Id.* at 163–64 (citing HAZEL GENN, PATHS TO JUSTICE: WHAT PEOPLE DO AND THINK ABOUT GOING TO LAW 101 (1999)).

the CFSA.[223] Second, and of considerably more consequence, we consider indirect actions to enhance the reliability of the industry by increasing the participation of large and well-qualified lenders.

1. Direct Regulation of the Transactions

Our proposal for direct regulation has two separate features: (1) transparency; and (2) disclosure. First, we would bar ancillary fees and sanctions in order to simplify the fees and sanctions involved in the product and to enhance the likelihood that competition will occur along a few dimensions that customers more easily might understand.[224] Second, we recommend focusing disclosures on the amount of the fees. The existing interest-rate-based disclosures mandated by the Truth in Lending Act are more likely to confuse than to illuminate.

a. Transparency

One of the difficulties in regulating payday lenders has been the ability of lenders to add ancillary products and services to the payday lending products. That practice allows the lenders to avoid statutory limits on fees.

For example, payday lenders in some cases have avoided fee ceilings by selling insurance with the credit product, enabling the lenders to comply with rate ceilings while generating revenue through products that most consumers probably do not want.[225] Another similar practice is to force consumers to purchase advertising space (for sayings such as "Go Cowboys!") in the lender's newsletter[226] or to purchase gift certificates for worthless products in catalogs.[227] Perhaps more blatantly, lenders simply create new fees and dub them membership fees or service or administrative fees that should not count as part of the

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223. It might at first glance seem odd that a credible regulatory program could rest in large part on legislation drafted by the interested community, but it seems more sensible if we accept the premise of the last part of this Article: that reputational and capital market constraints will force the large national providers to behave differently than small mom-and-pop providers. If the large national providers can operate more cheaply than the small mom-and-pop providers, they benefit from rules that firmly sanction shady corner cutting, from which the reputational and capital-market constraints (by hypothesis) exclude the large national providers.

224. For a good model provision, see H.R. 5122, 109th Cong. § 670 (2006) (enacted) (detailing the limitations on terms of consumer credit extended to servicemen and dependents).

225. For example, Canadian lender Stop N' Cash used this practice successfully to avoid Canada's 60 percent rate ceiling. Jim Rankin, *Payday Lender Wins Insurance Go-Ahead*, TORONTO STAR, Nov. 17, 2004, at A20. The practice of adding insurance to loans also seems to be prevalent in France, allowing lenders to obviate the strict regulation of the APR. DTI REPORT, *supra* note 5, at 7–8.

226. Johnson, *supra* note 2, at 20–21.

227. Moss, *supra* note 2, at 1729–30.

interest charged for the transaction.[228] Another recent practice is loan splitting, in which a single loan is split into several checks, presumably to present the customer with at least a threat of multiple check-bouncing fees upon default.[229] A related problem arises whenever the lenders take checks rather than ACH transfers. It is clear that at least some lenders use possession of checks as a device to threaten borrowers with the prospect of prosecution for uttering a hot check.[230] However unlikely such a prosecution might be in fact, the threat in at least some cases might have real bite; it seems unlikely that a lender that used ACH transfers rather than checks could make such a threat effective.[231]

For the most part, these practices are tolerated in jurisdictions in which unreasonably low rate caps otherwise would prevent payday lenders from operating.[232] In our view, however, a sensible regulatory scheme would enact limits that would allow reputable businesses to operate (as discussed in Part I), but would restrict the ability of payday lenders to package other products or fees with that service. The full cost of any goods or services purchased contemporaneously with the lending transaction would count against the applicable fee cap and would have to be disclosed as such.[233] The purpose is a simple one. If the product and its pricing can be made as simple as possible—so

228. Rankin & MacIntyre, *supra* note 115, at A1 (describing the lending practice in Canada); WILSON, *supra* note 46, at 46 (explaining lending practice in Australia); DTI REPORT, *supra* note 5, at 7–8 (describing the lending practices in France and Germany). Dollar Financial Corp. admits in its Annual Report to engaging in this practice in Canada: "A federal usury ceiling applies to loans we make to Canadian consumers. Such borrowers contract to repay us in cash; if they elect to repay by check, *we also collect, in addition to the maximum permissible finance charge, our customary check-cashing fees*." Dollar Fin. Corp., *supra* note 42, at 18–19 (emphasis added).

229. *See* Press Release, Wash. State Dep't of Fin. Inst., State Files Largest Case Against Payday Lender (Aug. 16, 2006), *available at* http://www.dfi.wa.gov/consumers/news/2006/check_n_go.htm.

230. *See* Ronald H. Silverman, *Toward Curing Predatory Lending*, 122 BANKING L.J. 483, 488 (2005).

231. Interestingly, the large national providers to whom we have spoken generally prefer ACH transfers, because the transaction costs of processing them are lower than the transaction costs of processing checks. Interviews with Anonymous (spring 2006) (on file with authors). They also scoffed at the idea that they could profit by repeatedly depositing checks or by running repeated ACH entries against the customer's account. In their view, only the uninformed would view that as a useful threat. Although it would expose the customer to repeated charges from its depositary bank, it would harm the chances that the payday lender would collect in two ways. First, because the depositary bank would charge the fees directly against the customer's account (something the payday lender cannot do), the charges would deplete funds available to the customer to repay the loan voluntarily. Secondly, the activity would motivate the customer not to repay the loan. Because (in the view of these sources) the collection remedies of payday lenders are so limited, their main chance of collection from a borrower in distress is by fostering a good relation with the borrower. Antagonistic collection techniques, in their view, are distinctly counterproductive. *Id.* It is difficult to assess how widely those views are shared (or practiced).

232. Scholars often remark on how payday lenders continue to restructure themselves to avoid regulation. *See* Barr, *supra* note 2, at 158–60 (explaining how lenders expend resources to avoid low caps by creating inefficient rent-a-charter relationships); WILSON, *supra* note 46, at 46 (describing Australian lending practices); RAMSAY, *supra* note 46, at 5 (describing lending practices in Canada).

233. *See, e.g.*, MICH. COMP. LAWS ANN. § 487.2160 (West Supp. 2006).

that there is a single fee[234]—it increases the likelihood that borrowers accurately will understand (and compare) the cost of borrowing.[235]

b. Disclosure

Requiring parties to disclose information is a common form of consumer-protection regulation.[236] In this context, as discussed above, the Truth in Lending Act,[237] like similar regulations in countries such as Australia[238] and Canada,[239] imposes a uniform interest-rate disclosure obligation on payday lenders.[240]

Regardless of the merits of such regulation, several aspects of the payday lending industry make the current mandatory disclosures counterproductive. The most basic problem is that TILA communicates the wrong information to borrowers: the annual percentage rate. While the APR may provide a good comparison mechanism for loans generally,[241] studies suggest that requiring APR disclosures on payday loans is ineffective.[242] An Australian survey found that

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234. To be sure, this recommendation leaves unsolved the problem of overdraft fees assessed by the customer's bank when payday lenders unsuccessfully attempt to collect checks from their customers. Our vision of a single fee is undermined if the banks at which defaulting borrowers have their accounts impose substantial overdraft fees when the checks that they have given their payday lenders bounce. Because those banks are not a party to the lending transaction, however, it is harder to justify regulating the fees that they can charge; these bounced checks, after all, are not all that different from any other bounced checks issued by their customers.

235. We are skeptical of Chris Robinson's proposal for Canada that rates be determined either by a fixed rate per amount borrowed (plus a set per loan fee and an interest rate), or by different fees for different amounts borrowed (for example, 12 percent for the first $250 borrowed and 6 percent for everything higher than that amount). *See* Daw, *supra* note 26, at D6. Even if this scheme works under finance theory, we worry that the average borrower would find it difficult to understand these more complex pricing schemes.

236. *See* MANN, *supra* note 140, ch. 13.

237. 15 U.S.C. §§ 1601–1693 (2000).

238. UNIF. CONSUMER CREDIT CODE, 2001, §§ 14–15 (Austl.) (governing contracts); *id.* § 143 (governing advertisements).

239. *E.g.*, Manitoba Consumer Protection Act, R.S.M., ch. C200, § 4(3) (1987); Newfoundland and Labrador Consumer Protection Act, NFLD. R.S., ch. C-31, § 16 (1990); Nunavut Consumer Protection Act, R.S.N.W.T., ch. C-17, § 5 (1988); Prince Edward Island Consumer Protection Act, R.S.P.E.I., ch. C-19, § 16 (1988); Yukon Consumer Protection Act, S.Y.T., ch. 40, § 5 (2002).

240. 15 U.S.C. § 1632 (2000).

241. *See* Hellwig, *supra* note 2, at 1593 (arguing that APRs are important tools).

242. Graves and Peterson argue the opposite. They claim that APRs are appropriate because (1) many borrowers roll over loans, so payday loans "often compound for durations coming close to or exceeding a year"; (2) "annualized interest rates [for loans] are the uniform metric which all mainstream creditors use to compare prices"; and (3) borrowers would confuse loan prices quoted "as a percent of the principal borrowed" with APRs from other products. Graves & Peterson, *supra* note 15, at 662–63. We find this reasoning unpersuasive. Studies do not suggest that rollover loans typically extend for a year. At most, Graves and Peterson's research established that *some* borrowers rolled over loans 12.5 times—less than half of a year in the worst scenario. *Id.* at 663. Also, even if APRs were useful in mainstream credit (which we doubt), that does not tell us how we should disclose

78 percent of Australians measured the cost of their payday loans in a dollar amount, not in an interest rate,[243] suggesting that people do not think of payday loans in terms of an abstract rate but rather a concrete cost. Evidence from the United States backs up this claim; previous scholars have found that although most people do not understand APR disclosures,[244] they do understand the finance charge, which is a dollar amount.[245]

Interest-rate disclosures are misleading because the amount of the fee charged generally does not depend on the number of days until the borrower's payday.[246] An interest-rate disclosure would suggest that the rate changes every day depending on which day in the pay cycle the borrower obtains the loan, when actually the cost is uniform throughout that cycle. This confusion does nothing to help consumers evaluate competing products.

The current regulatory scheme is also problematic because consumers often get the information too late in the process for it to be useful.[247] Most courts merely require that the lender provide the required disclosure sometime before the contract is signed, but consumers have no opportunity to comparison shop if they receive the disclosure immediately before the deal is done.[248] The model act supported by CFSA follows this same pattern. Lenders must disclose the APR, but only when the customer signs the contract—not before, when the customer might still be interested in price comparisons.[249] A sensible scheme would require that the basic fee be prominently posted so that consumers could compare the fees available from different providers without incurring substantial transaction costs.

Finally, there is, at least presently, a substantial problem of noncompliance. A study of payday lenders in Ohio suggests that 68 percent of payday

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pricing information to people using fringe products. It is essential to evaluate the specific credit mechanism in question. As Sunstein observes, "[b]ecause of bounded rationality, some frames will have more of an impact than others. For those who suffer from serious forms of bounded rationality, steps like those in the Truth in Lending Act may well do little good." Cass R. Sunstein, *Boundedly Rational Borrowing*, 73 U. CHI. L. REV. 249, 261 (2006). Finally, annualized interest rates are not the uniform-pricing guide in short-term lending: Overdraft fees from banks—a major competitor for payday loans—are not expressed in terms of APR but in simple dollar amounts.

243. WILSON, *supra* note 46, at 77.

244. Hellwig, *supra* note 2, at 1591–92.

245. *Id.* at 1593.

246. *Cf., e.g.*, ACE Cash Express, Inc., *supra* note 20, at 3 (reporting that loans are made "until the customer's next payday"); Cash Am. Int'l, Inc., *supra* note 40, at 4 ("These cash advance loans generally have a loan term of 7 to 45 days and are generally payable on the customer's next payday."); Ten Dollar Payday Loan.com's payment schedule, TenDollarPaydayLoan.com, Frequently Asked Questions, http://www.tendollarpaydayloan.com/faqs.asp (last visited Mar. 4, 2007).

247. Hellwig, *supra* note 2, at 1590–91.

248. Bertics, *supra* note 2, at 148–49.

249. Model Deferred Deposit Act, *supra* note 79, § 3 at 35.

lenders either failed to disclose interest rates or disclosed them inaccurately.[250] In part, a simple desire to hinder competition may be the cause,[251] but it is also surely attributable in part to the mismatched disclosure scheme that requires lenders to advertise rates in terms that seem absurdly high even for relatively mainstream products.[252]

The best solution, from our perspective, is to adopt a simple disclosure scheme, with which reputable lenders readily can comply. We would require lenders to display in a prominent way the fee per $100 borrowed. This disclosure requirement solves the problems identified above: It (1) tracks with the survey data that customers use their actual cost to make decisions and not an interest percentage;[253] (2) eliminates the confusion caused by different interest rates for different time periods; (3) ensures borrowers obtain the information up front at little cost; and (4) encourages compliance by allowing lenders to avoid stating misleadingly high APRs.

2. Indirect Reforms: Fostering a Better Class of Lenders

The preceding Subpart discusses ways to enhance the transparency of the payday lending market, hoping to foster some competition through the provision of simple and accessible information. The central point of our proposal, however, is to draw a line between mainstream payday lending transactions, which are to be tolerated, and extramarket, abusive transactions, which are to be pursued and sanctioned aggressively.

Our proposal for fencing off abusive transactions has two parts. The first is the simplest: drawing a line between the mainstream payday lending market and the abuses that involve fees not justified by ordinary costs and competitive pressures. The landscape of U.S. regulation makes it clear that states can see the difference between regulatory systems that involve fee caps that close off

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250. Johnson, *supra* note 2, at 46.

251. *See id.* at 25.

252. *See* Hellwig, *supra* note 2, at 1597; Johnson, *supra* note 2, at 25. Canadian payday lenders have also balked at disclosing APRs. Canadian Ass'n of Cmty. Fin. Serv. Providers, *Payday Loan Association Supports Consumer Protection Legislation and Consumers' Right to Full Disclosure*, July 29, 2005, http://www.globeinvestor.com/servlet/ArticleNews/story/CNW/20050729/1307295753 ("'The Ontario Government has asked all lenders in the province to disclose an annual cost of borrowing, even if a loan is taken out for only a few days. While this is like asking hotels to disclose a daily room rate of $200 as an annualized figure of $73,000, we are advising association members to respect the law and disclose accordingly,' says [Bob] Whitelaw.").

253. A glance at the websites of Internet payday loan providers suggests both that this is a piece of information that consumers generally find valuable and, less happily, that providers with high rates have a penchant for shrouding this figure rather than blazoning it upon their home screen (or, as with tendollarpaydayloan.com, incorporating it into their domain name).

the market for reputable payday lending and those with realistic fee caps and usury ceilings that will permit profitable activity by reputable lenders. If we are right that mom-and-pop lenders are both less efficient than the national providers and also more likely to engage in abusive behavior (as both common sense and our interviews indicate[254]), a fee cap in the range of $15 to $20 could be quite beneficial, because it might force many of the mom-and-pop lenders from the market.[255] This would be particularly true if the cap were combined with an effective disclosure regime like the one discussed above.

The second part of our proposal is more difficult: encouraging participation in the market by large and reputable lenders. Although regulators and consumer activists for the most part have decried efforts by large financial institutions to move into this market,[256] we urge exactly the opposite approach. If this market is left largely unregulated, then numerous benefits flow from having the actors in the market include the largest and most reputable institutions.[257] It may be that such an environment will lead to participation in the market by large banks that currently refrain from participating.[258] However,

254. Interviews with Anonymous (spring 2006) (on file with authors).

255. Michael Barr has pointed out to us that mom-and-pop providers strongly opposed the Michigan statute discussed above because they did not believe they could operate profitably at a rate of $20 per $100. Interview with Michael Barr (spring 2006) (on file with authors). Recently, Chris Robinson, a Canadian finance professor, has proposed a similar cap on payday fees so severe that smaller payday lenders would be driven out of business and replaced by large chains and mainstream financial institutions. Daw, *supra* note 26, at D6.

256. Some commentary explicitly condemns the involvement of publicly held companies in payday lending because such companies allow upper- and middle-income people to profit from making unreasonable loans to the poor. RAMSAY, *supra* note 46, at 4; Michael Hudson, *Introduction* to MERCHANTS OF MISERY: HOW CORPORATE AMERICA PROFITS FROM POVERTY 2, 2 (Michael Hudson ed., 1996) ("There's another place you can run across the poverty industry these days: Try the stock pages of your newspaper. More and more, the merchants who profit from the disadvantaged are owned or bankrolled by the big names of Wall Street . . . ."). Publicly held banks like JPMorgan Chase already finance payday lenders, so public companies already participate in payday lending. *See supra* note 48 and accompanying text. Our suggestion is that they do so directly.

257. Wells Fargo's participation as a payday lender suggests that this argument is more than just theoretical. Wells Fargo's payday product implements many of the microlevel suggestions we made above: The finance charge is stated in a clear dollar amount ($2 for every $20 borrowed), the payment is withdrawn automatically from the borrower's checking account, and rollovers are limited (a borrower can only obtain twelve consecutive advances before being forced to wait a month). Wells Fargo, Direct Deposit Advance Source Agreement—Terms and Conditions, https://www.wellsfargo.com/wf/checking/dda/terms (last visited Nov. 12, 2006). Wells Fargo also permits borrowers to borrow only half of the amount of the direct deposit, making repayment more likely. *Id.* It is not clear that this product complies with Electronic Fund Transfer (EFTA) Act § 913, 15 U.S.C. § 1693 (2006), because it appears to condition the advance on a right to collect by a preauthorized funds transfer. Perhaps Wells Fargo could have designed the product as an "overdraft credit plan" exempt from EFTA coverage, *see* 12 C.F.R. § 205.10(e)(1) (2006), but the actual product description does not provide any support for that treatment.

258. Bertics, *supra* note 2, at 143–44.

as the Bair Report suggests, there is some reason to think that those institutions will never be as competitive in this market as entities more focused on payday lending and associated check-cashing services.[259] It also is true that banking regulators might have justifiable concerns about their ability to monitor the kind of low-document, high-volume lending involved here. Our goal, however, is to remove artificial barriers to entry, so that the lenders best placed to operate in this market can enter it without reputational or unjustified regulatory sanction. If the most effective financial structure for this industry involves direct participation by large financial institutions, we think that regulators should consider that premise when designing regulatory schemes.[260] In our view, the rapid spread of the product and the profitability of the industry suggests that regulators need do little to induce participation by large, well-capitalized companies.

The most obvious benefit of participation by large institutions is that they have much more to lose from noncompliance.[261] It also is much easier to monitor a small number of large chains than to monitor thousands of separately operated providers. In addition, large institutions that fail to develop policies that ensure compliance with regulations can be forced to pay extremely large fines, in an amount adequate to deter misconduct.[262]

Large publicly traded companies also must fear the adverse effects on their market capitalization that are likely to ensue if they engage in behavior that is portrayed as unpalatable or illegal in the mass media. We have seen this already. For example, when the Office of the Comptroller of the Currency (OCC) and the FDIC prohibited payday lenders from partnering with national banks to avoid unfavorable interest-rate caps, the stock price of several publicly

259. *See supra* notes 161–167 and accompanying text.

260. Michael Barr is the most creative and articulate proponent, emphasizing the cost effectiveness of direct-debit collection by banks as well as the benefits to borrowers of a short-term lending product that would amortize rather than remain at a fixed balance. Barr, *supra* note 2, at 163–64. It is unclear whether such a product can be made profitable. Moreover, as discussed above, *see supra* note 257, the product might not comply with EFTA § 913. The best answer to that problem, however, surely would be to amend EFTA § 913 to permit the products in question.

261. This echoes Michael Barr's point that fines against large entities are more meaningful because they are more likely to have the capital to pay them. Michael Barr, *Access to Financial Services in the 21st Century: Five Opportunities for the Bush Administration and the 107th Congress*, 16 NOTRE DAME J.L. ETHICS & PUB. POL'Y 447 (2002); *see also* Ronald J. Mann, *Regulating Internet Payment Intermediaries*, 82 TEX. L. REV. 681 (2004). For a related discussion of why banks are less prone to aggressive lending than their nondepository agents, see Christopher L. Peterson, *Preemption, Agency Cost Theory, and Predatory Lending by Banking Agents: Are Federal Regulators Biting Off More Than They Can Chew?* 25–29 (Univ. of Fla., Working Paper, 2006), *available at* http://ssrn.com/abstract=932698.

262. This assumes, of course, that the relevant regulators are willing to focus their attention on issues of consumer protection, whereas so often in the past they have been concerned solely with capital adequacy and financial stability. The shift of authority to state regulators discussed in the Introduction and Part I offers good reason to think that regulators, at least in some states, will focus on these questions.

held payday lenders dropped 10 percent or more.[263] Similarly, after the corporate scandals of the last few years, the officers of large entities realistically will fear substantial criminal penalties if they allow their businesses to operate in a way that does not reflect a serious effort to comply with applicable regulations.

Prosecutions of larger entities are also much more useful as a regulatory matter. If the government finds a sole payday lending store violating a regulation, the importance of a prosecution is minimal—it only affects the small number of transactions at that store. In contrast, if a large entity violates regulations in all of its stores across the country, prosecutors have the opportunity to affect the many transactions at all of these stores by prosecuting that one entity. In addition, if the number of potential violators is smaller—that is, if a small number of entities offer all the payday loans in the United States in contrast to the large number of small payday lenders currently offering loans, the government will be able to pursue a larger percentage of the violators.

Further, prosecuting large companies would have a greater deterrent effect on other payday lenders than prosecuting small payday lenders. Deterrence is a function of the actor's perception of the severity of the punishment and the likelihood of being prosecuted. Prosecutions of large companies receive publicity, and publicizing prosecutions makes would-be violators think that the risk of being prosecuted is greater.

Another noted benefit in enforcing compliance with large companies is that it is much easier for regulators to monitor the activities of a small number of relatively large companies than it is to monitor the activities of a large number of small and evanescent competitors. Aside from the simple economies of scale, publicly traded companies are more likely to have detailed data about their operations. Furthermore, the data is more likely to be reliable than it is for smaller companies that are unlikely to rely on independent auditors. All in all, the emergence of large-scale entities into the market would ease the task of the supervisory regulator.

A market composed of large actors also solves some of the problems with civil enforcement noted at the beginning of Part II.C. Because the policies of large entities often would be uniform across a large number of transactions, class actions would be a more viable mechanism for pursuing actions challenging abusive practices.

263. Flannery & Samolyk, *supra* note 9, at 20 n.31. Our primary argument is not that large payday lenders worry that the public might think their conduct is unsavory, but rather that these large providers worry that the public might consider their conduct illegal, so that investors would not consider them strong investments. Yet, to the extent that publicly held companies account for ethical investors in setting policies, encouraging large providers may curb unsavory lending practices.

Although it is harder to be sure, there also is some reason to think that entry into the market by larger and better-capitalized companies ultimately could lead to better products and prices for the customers in the market.[264] The most obvious reason for this is that high-quality payday lending, like other developed forms of lending, is a business that depends heavily on sophisticated information technology and standardized operations for which there are substantial economies of scale.[265] What little empirical evidence we have seen suggests that this is a serious issue.[266]

To see how this works, consider the annual report of Cash America International, Inc., one of the largest payday lenders in the United States.[267] This firm has grown steadily through acquisitions in the past few years, using a simple model in which it takes over a promising location and then rapidly improves the profitability of the location through installation of the company's centralized management and standardized operations.[268] Other large payday lenders also boast that their proprietary computer information systems and point-of-sale technology are pivotal components that increase their stores' productivity and allow them to effectively expand through acquisitions.[269]

264. *See* Samuel Hanson & Donald P. Morgan, Predatory Lending? (May 4, 2005) (unpublished manuscript, on file with author) (concluding through empirical analysis that payday lending rates are significantly lower in jurisdictions with a greater number of lenders per capita).

265. *See* Barr, *supra* note 2, at 157–58 (making a similar argument about consolidation).

266. *See* Morgan Stanley Equity Research, *supra* note 63, at 16 exhibit 10 (using data from several large chains to illustrate correlation between costs of operation and size of chain).

267. Cash Am. Int'l, Inc., *supra* note 40, at 1.

268. *Id.* ("The Company's growth over the years has been the result of its business strategy of acquiring existing pawnshop locations and establishing new pawnshop locations that can benefit from the Company's centralized management and standardized operations. In 2003, the Company expanded this strategy to include acquiring existing cash advance locations and establishing new cash advance locations."). *See also*, Dollar Fin. Corp., *supra* note 42, at 6 (noting that "our centralized support centers [are] a competitive advantage").

269. First Cash Fin. Servs., Inc., *supra* note 12, at 3 ("The Company utilizes a proprietary computer information system that provides fully integrated functionality to support point-of-sale retail operations, inventory management and loan processing. Each store is connected on a real-time basis to a secured off-site data center . . . ."). *See also* ACE Cash Express, Inc., *supra* note 20, at 5 ("To better service our customers and manage our stores in the most profitable manner, we have developed proprietary information systems, including a point-of-sale system and a management information system, designed for the efficient delivery of our financial services with the proper balance of corporate management. Our in-house information systems team has built a reliable and scalable technology infrastructure that will allow us to grow our business without significant additional capital expenditures. . . . By implementing our Operational Goals and information systems, we are typically able to increase revenue and gross margin in our acquired stores and to enhance the acquired stores' service offerings."); Dollar Fin. Corp., *supra* note 42, at 6 ("Our proprietary systems are used to further improve our customer relations and loan servicing activities, as well as to provide a highly efficient means to manage our internal as well as regulatory compliance efforts."); *id.* at 16 ("The point-of-sale system, together with the enhanced loan-management and collections systems, has improved our ability to offer new products and services and our customer service.").

The problems for smaller companies are easier to see. Smaller companies are less likely than the larger players to have ready access to credit services, such as TeleTrack, to determine if applicants have other outstanding payday loans or credit problems.[270] Smaller companies are less likely to have specialized central processing, which seems to be highly efficient in this industry.[271] Indeed, because the larger companies for the most part are companies that have other products (check-cashing services being the most common), the ability to spread administrative costs over more locations and products seems to be quite important. For example, Ernst & Young's study of Canadian payday lenders confirms that lenders with different types of products and not just payday loans had significantly lower costs per $100 of payday loans.[272] In the end, the data we have about the industry—principally from the FDIC study (in this country) and the Ernst & Young study (in Canada)—strongly suggest that economies of scale give the larger lenders lower costs of doing business, and thus higher profitability.[273]

One last consideration relates to the way that payday loan transactions interact with the credit-reporting system. Because payday lenders do not report positive transactional data to the three large consumer-reporting agencies, there is a concern that the payday borrowers will not form credit histories that would facilitate mainstream borrowing.[274] This issue gained prominence with the passage of the Fair and Accurate Credit Transactions Act of 2003 (FACT Act). Section 312 of the FACT Act requires the Federal Trade Commission (FTC) and federal banking agencies to prescribe guidelines to ensure the accuracy and integrity of information furnished to consumer-reporting agencies (CRAs).[275] Section 318 requires the FTC to conduct an ongoing study of the accuracy and completeness of consumer-credit reports and to report on four specific topics related to credit-report accuracy, including—of relevance here—whether there are any common financial

270. Barr, *supra* note 2, at 151.
271. *See* Flannery & Samolyk, *supra* note 9, at 11 (describing such costs for payday lenders).
272. E&Y CANADA STUDY, *supra* note 26, at 34.
273. Flannery & Samolyk, *supra* note 9, at 2; E&Y CANADA STUDY, *supra* note 26, at 46.
274. Academics have noted this problem. *See* Barr, *supra* note 2, at 124; *see also* Brooks, *supra* note 2, at 997.
275. Fair and Accurate Credit Transactions Act of 2003, Pub. L. No. 108-159, 117 Stat. 1952 [hereinafter FACT Act]. As part of that process, these agencies have solicited comments on the types of errors, omissions and other problems that may impair the accuracy and integrity of information provided to consumer-reporting agencies, including the omission of "potentially significant information about the consumer account or transaction, such as credit limits for or positive information about the account." Federal Trade Commission, Interagency Advance Notice of Proposed Rulemaking, 71 Fed. Reg. 14,419 (Mar. 22, 2006) (to be codified at 16 C.F.R. pts. 660-61).

transactions not generally reported to the CRAs that would provide useful information in determining a consumer's credit rating.[276]

The first interim report emphasized that information related to utilities and rent payments would be most likely to address the problem of "thin" credit reports; the report mentions payday lending in passing, but does not suggest that the information would be sufficiently predictive of creditworthiness to make its omission a matter of concern.[277] This makes sense, given the limited information about creditworthiness to be gained from a pattern of payday borrowing and repayment. Still, a requirement to report information to the CRAs would advantage the large national providers, because their access to information technology allows them to comply at lower costs.

The real problem is that the market for consumer borrowing currently falls into two starkly different sectors: (1) credit card borrowing and unsecured bank lending, both of which operate with interest rates in the range of 15 to 30 percent; and (2) payday lending, which operates with interest rates in the range of 400 to 500 percent. There is little reason to think that the risk profiles of borrowers justify the rate discontinuity between these sectors. Rather, the distinction is that the borrowers whose needs cannot be met with the highly specialized products offered by banks in the 15 to 30 percent range are lumped into a single category in which the principal criterion that currently is evaluated is the possession of a few recent pay stubs, with a single (high) rate charged to all in the category.

The challenge is to encourage some lenders to offer products that fill that large gap. The existing initiatives all have started with mainstream lenders offering products with prices slightly higher than their existing mainstream products, but targeting them at the very risky pool that presently purchases the high-priced payday lending product. The problem with that approach is that it involves lenders that are unfamiliar with both the customer base and the products that are attractive to that base attempting to design products that will be safe and desirable to those customers. That is not an impossible task, but it is an ambitious one.

History suggests that a more fruitful approach would be to start with the entities that already know the customers and what they want. In an ideal world, competition among sophisticated entities could force the providers of the very expensive product to develop ways to carve out less risky segments of their

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276. FACT Act, Pub. L. No. 108-159, 117 Stat. 1952.

277. FED. TRADE COMM'N, REPORT TO CONGRESS UNDER SECTIONS 318 AND 319 OF THE FAIR AND ACCURATE CREDIT TRANSACTION ACT OF 2003, at 80–82 (Dec. 2004), http://www.ftc.gov/reports/Facta/041209factarpt.pdf.

customer pool, charging them ever lower prices. In the credit card industry in the last two decades, this approach has resulted in a highly segmented array of interest rates, which includes a marked lowering of interest rates for customers that are relatively creditworthy. There is every reason to think that the same advances that information technology has brought to the credit card industry in this country could be useful in the payday lending industry as well. Thus, our hope is that a set of large, profit-oriented entities, with free rein to deploy information technology to learn more about characteristics of their customers that relate to the likelihood that they will be profitable, could help advance the payday industry.

CONCLUSION

Payday lending regulation should respond to the problems that require intervention. In that vein, we pursued three goals in this Article. First, we looked at the facts. By engaging empirical studies and the annual reports from the leading businesses in the industry, we were able to provide a balanced description of the business and economics of payday lending and its alternatives. Although existing empirical research fails to answer many of the important questions, it does allow us to provide some insight into why consumers rationally might prefer the product to its alternatives and how businesses can profit from lending to those consumers. Our balanced approach also allows us to recommend more pointed inquiries for future empirical research.

Second, we tried to provide more careful analysis of the regulatory alternatives than the existing scholarship. If legislators can be encouraged to think clearly about the alternatives before them and choose regimes that have the potential to accomplish their policy goals, legislation that is unenforced or ineffective on its face would be less common.

Finally, and most importantly, we provided grounds for counteracting the existing hostility to an active role in this market for large publicly traded providers. If this market is to be tolerated, the market should be populated by large companies motivated by the reputational constraints that attend participation in the public finance markets, not the fly-by-night operators that are so common today.