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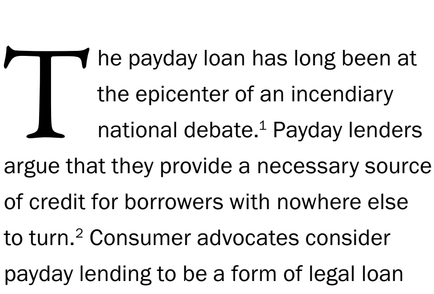
The Verdict Is in

Payday Lending Is Guilty as Charged

BY RON ELWOOD



The payday loan has long been at the epicenter of an incendiary national debate.[1] Payday lenders argue that they provide a necessary source of credit for borrowers with nowhere else to turn.[2] Consumer advocates consider payday lending to be a form of legal loan sharking that traps borrowers into a downward spiral of debt.[3] Who is right?

Convincing evidence supports the consumer advocates.[4] An increasing number of states limit, expressly prohibit, or in effect prohibit payday lending.[5] Federal financial regulators require underwriting and limit payday loans offered by national banks, which are not subject to state payday-lending laws.[6] The U.S. Department of Justice, state banking commissioners, and state attorneys general are cracking down on illegal Internet payday lending.[7] And the new federal regulatory cop on the beat—the Consumer Financial Protection Bureau—held its first hearing on the subject in 2012.[8] The bureau conducted research that, according to a *New York Times* editorial, "discredits once and for all the industry's portrayal of these loans as a convenient option for people who can easily repay the debt on the next payday."[9] *Bloomberg News* reports that the bureau is formulating new rules to bring needed reforms to this market.[10]

The payday-lending industry continues to fend off attacks by resorting to well-worn but fraying defenses such as:

- Payday loans are a bridge for credit-challenged customers to get them through a temporary financial emergency;
- The use of an annual percentage rate (APR) to signal the cost of credit for a payday loan is inapplicable;
- The risks the lenders take justify the rates; and
- A payday loan helps the unbanked, is a straightforward deal, and relieves financial stress.[11]

The facts argue against these defenses. Consumer advocates have long argued that the debt trap is the business plan and that the payday-loan product is intentionally designed to ensnare borrowers in an end-

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1 Steven M. Graves & Christopher L. Peterson, *Usury Law and the Christian Right: Faith-Based Political Power and the Geography of American Payday Loan Regulation*, 57 Catholic University Law Review 637, 646 (2008).

2 Benjamin D. Faller, *Payday Loan Solutions: Slaying the Hydra (and Keeping It Dead)*, 59 Case Western Reserve Law Review 125, 146 (2008) ("[p]ayday lenders and their supporters often argue that bans on payday lending will leave borrowers who cannot access mainstream credit with nowhere to turn").

3 Lauren K. Saunders, National Consumer Law Center, Why 36%? The History, Use, and Purpose of the 36% Interest Cap 4 (April 2013); 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 South Carolina Law Review 589, 599 (2000) ("cycle of renewals can create a 'debt treadmill' or downward spiral effect").

4 See, e.g., Pew Charitable Trusts, Payday Lending in America: Report 2: How Borrowers Choose and Repay Payday Loans 53 (Feb. 2013) (promised benefits do not materialize and borrowers are not better off after taking out payday loans); Editorial, *Cracking Down on Predatory Payday Lenders*, New York Times (Aug. 29, 2013) (payday-lending industry is predatory, traps borrowers into long-term debt, and gouges borrowers with "impossible interest rates").

5 These states include those that (1) have never authorized payday lending; (2) ban payday lending; (3) have revoked authorization for payday lending; (4) have instituted rate caps at or below a 36 percent annual percentage rate (APR); or (5) limit the number of loans per year a borrower may take or use another mechanism to prevent payday-loan churning (see Susanna Montezemolo, *Payday Lending Abuses and Predatory Practices*, in State of Lending in America and Its Impact on U.S. Households 159, 191 (Center for Responsible Lending 2013) (22 states with "significant reforms that eliminate or limit the payday debt trap")).

6 Federal Deposit Insurance Corporation, Guidance on Supervisory Concerns and Expectations Regarding Deposit Advance Products, 78 Fed. Reg. 70552 (Nov. 26, 2013); Office of the Comptroller of the Currency, Department of the Treasury, Guidance on Supervisory Concerns and Expectations Regarding Deposit Advance Products, 78 Fed. Reg. 70624 (Nov. 26, 2013) (requiring covered banks to determine ability to repay loans and effectively limiting deposit advances to six per customer per year).

7 See, e.g., Jessica Silver-Greenberg, *Justice Department Inquiry Takes Aim at Banks' Business with Payday Lenders*, New York Times (Jan. 26, 2014) (U.S. Department of Justice enforcement effort to prevent processing of payments of illegal Internet payday loans by financial institutions' third-party payment processing systems); Jessica Silver-Greenberg & Ben Protess, *New York Tells Online Lenders to Abide by State's Interest Rate Cap*, New York Times (Aug. 5, 2013) (state banking commissioner ordered 35 online lenders to halt loan offerings that violate New York's usury law); Press Release, Minnesota Department of Commerce, Attorney General Swanson and Commissioner Rothman Sue California Outfit over Scheme to Deprive Consumers of State Legal Protections (July 11, 2013) (lawsuit against Internet payday lender for making loans violating Minnesota law).

8 Press Release, Consumer Financial Protection Bureau, CFPB Examines Payday Lending (Jan. 19, 2012).

9 Editorial, *What Lending Rules Should Look Like*, New York Times (March 30, 2014).

10 Carter Dougherty, *Payday-Lending Rules Near as U.S. Agency Sees Debt Traps*, Bloomberg News (March 24, 2014).

11 See, e.g., Chad A. Cicconi, *A Role for Payday Lenders*, 123 Banking Law Journal 235, 245 (2006) (payday lending is a "necessary tool for moderate income families who need emergency cash"); Faller, *supra* note 2, at 136–37 (payday-lending industry claims that APR is an inappropriate measure of cost of payday credit and that payday-loan rates justify risk); Jim Hawkins, *The Federal Government in the Fringe Economy*, 15 Chapman Law Review 23 (2011) ("people who are unbanked … turn to payday lenders" and other fringe lenders); Aaron Huckstep, *Payday Lending: Do Outrageous Prices Necessarily Mean Outrageous Profits*, 12 Fordham Journal of Corporate and Financial Law 203, 206 (2007) ("basic payday lending transaction is fairly straightforward"); Nathalie Martin, *1,000% Interest—Good While Supplies Last: A Study of Payday Loan Practices and Solutions*, 52 Arizona Law Review 563, 577 (2010) (payday-lending industry claims that its products "help people make ends meet").

less cycle of debt.[12] As a result, advocates assert, precious assets are drained from both borrowers and the economy, and this leads to more, not less, financial strain.[13]

After offering a brief historical perspective, I identify and refute the arguments advanced by payday-lending proponents. I conclude that, in the short term, policymakers should act to eliminate the debt cycle endemic to payday lending and, in the long term, foster—with the participation of all sectors—a systemic solution to provide access to credit without the predation inherent in and the financial adversity caused by the traditional payday-lending product. Fostering a systemic solution would strengthen the economy by strengthening family financial stability and security.

Small-Amount, Short-Term Lending at Exorbitant Rates Is Not New

Today's payday-lending industry can be traced to James Eaton, a former credit bureau employee, who reportedly offered the first modern payday loan when he opened Check Cashing Inc. on December 2, 1991, in Johnson City, Tennessee.[14] Two years later W. Allan Jones, Eaton's colleague, opened Check Into Cash, which is described as the first of the national payday-lending chains.[15] These events gave rise to what is now a multibillion dollar industry.[16]

Small-amount, short-term lending at exorbitant rates is not a new phenomenon in America.

But small-amount, short-term lending at exorbitant rates is not a new phenomenon in America. Eaton and Jones are merely links in a chain dating back to the late 1880s, when for-profit lenders began making such loans "at rates often well above the statutory limits."[17] Around the turn of the 20th century came the so-called salary lenders, who offered short-term loans against workers' next paychecks at interest rates ranging from 270 percent to 955 percent.[18] Then, as now, users of these loans sank into financial quicksand and were unable to satisfy the original debt and were thus forced to take out loans perpetually.[19]

Public outrage at these practices ultimately led to the adoption by many states of the Uniform Small Loan Law.[20] The uniform law, which was drafted in 1916, was adopted only after the lending industry, with its formidable resources, blocked consumer protection legislation in state after state, year after year.[21] The new law mandated manageable installment repayments and capped interest rates at between 36 percent and 42 percent APR.[22] Soon after, however, unscrupulous competitors tweaked the loan product design or combed for loopholes to evade the law.[23]

The More Things Change, the More They Stay the Same

The salary lenders of old would more than likely recognize the modern payday-lending model. Payday-loan transactions still require a lump-sum repayment of principal and interest on payday.[24] Borrowers still cannot escape the financial trap that keeps them in continual debt.[25] The industry still possesses seemingly unlimited financial and political resources

12 Martin, *supra* note 11. See also Uriah King & Leslie Parrish, Center for Responsible Lending, Springing the Debt Trap: Rate Caps Are Only Proven Payday Lending Reform 1 (2007) (chief operating officer of large payday-lender Cash America explains that "business theory" of payday lending is to "get the customer in and work to turn him into a repetitive customer, long-term customer"); see, e.g., Robert Mayer, *Loan Sharks, Interest-Rate Caps, and Deregulation*, 69 Washington and Lee Law Review 807, 815 (2012) (high rates and short repayment period associated with payday loans as creating debt trap). See also Creola Johnson, *America's First Consumer Financial Watchdog Is on a Leash: Can the CFPB Use Its Authority to Declare Payday-Loan Practices Unfair, Abusive, and Deceptive?*, 61 Catholic University Law Review 381, 392 (2012) (repeat borrowers are source of most of industry's revenues).

13 See, e.g., Creola Johnson, *Payday Loans: Shrewd Business or Predatory Lending?*, 87 Minnesota Law Review 1, 97 (2002) (lending can lead to "even greater financial stress"); Carmen M. Butler & Niloufar A. Park, *Mayday Payday: Can Corporate Social Responsibility Save Payday Lenders?* 3 Rutgers University Journal of Law and Urban Policy 119 (2005) (linking payday lending to broader and adverse economic impact).

14 Daniel Brook, *Usury Country: Welcome to the Birthplace of Payday Lending*, Harper's Magazine, April 2009, at 41–42.

15 *Id.* at 42.

16 Mayer, *supra* note 12, at 837 (since its inception, "payday lending grew from nothing into a $50 billion business").

17 Lendol Calder, Financing the American Dream: A Cultural History of Consumer Credit 50 (1999).

18 Jackson R. Collins, *Evasion and Avoidance of Usury Laws*, 8 Law and Contemporary Problems 54, 55 ([1941]).

19 See Pew Charitable Trusts, *supra* note 4, at 6. See also F.B. Hubachek, *The Development of Regulatory Small Loan Laws*, 8 Law and Contemporary Problems 108, 121 ([1941]) (turn-of-century borrowers were "seldom able to repay the full amount from one pay check" and needed to take new loans, thus repeating process "indefinitely").

20 Jessie Lundberg, *Big Interest Rates Under the Big Sky: The Case for Payday and Title Lending Reform in Montana*, 68 Montana Law Review 181, 184 (2007).

21 John Kilgore, *Legislative Tactics of Unregulated Lenders*, 8 Law and Contemporary Problems 173 ([1941]) (efforts of "loan sharks" to prevent passage of Uniform Small Loan Act).

22 Drysdale & Keest, *supra* note 3, at 619–20. See also Hubachek, *supra* note 19, at 119.

23 See, e.g., Huckstep, *supra* note 11, at 204–5 (salary lenders claimed new practice of "salary buying" was not covered under Uniform Small Loan Act); Rolf Nugent, *The Loan-Shark Problem*, 8 Law and Contemporary Problems 3 ([1941]) (example of misuse of Georgia Building and Loan Act to evade Uniform Small Loan Law).

24 Federal Trade Commission, Consumer Information: Payday Loans (March 2008) (how payday-loan transaction works).

25 See, e.g., Press Release, Consumer Financial Protection Bureau, The CFPB Finds Payday and Deposit Advance Loans Can Trap Consumers in Debt (April 24, 2013) (payday and deposit advance loans being "debt traps" for many).

to combat federal and state reform.[26] And where strong consumer protection laws exist, lenders troll for loopholes and develop other circumvention schemes.[27]

However, more jurisdictions are enacting reform because accumulating evidence calls into question the industry's rationale for the way it does business.[28] Payday loans are not constructive credit options because they do not build or repair credit.[29] Rather, they drain vital assets from borrowers and communities, impede progress toward family financial stability, prevent upward mobility, and hinder macroeconomic growth.[30] In the following section I detail and rebut the industry arguments in defense of the payday loan.

The Arguments in Defense of Payday Lending Fail

In defense of its product, the payday-lending industry has typically relied on a series of arguments. Following are six assertions most often used to defend payday lending along with evidence that calls them into question.

A PAYDAY LOAN IS A BRIDGE LOAN

For the vast majority of borrowers, a payday loan is a lure into a debt trap.[31] The industry contends that payday loans serve as "financial taxis," which are meant to handle emergencies and to get borrowers from one payday to another.[32] The facts, however, do not bear out these assertions and, in fact, show the opposite is true. Borrowers often find themselves worse off after getting involved with payday lenders.[33]

Most payday borrowers do *not* use payday loans as they are advertised (i.e., for unexpected, temporary financial emergencies).[34] In fact, the onetime use of a payday loan is the exception because profitability depends on repeat, long-term use.[35] The average payday borrower is indebted to a payday lender for nearly seven months out of the year. Fully 25 percent of borrowers have loans outstanding for more than ten months of the year.[36]

That payday lending results in long-term indebtedness should come as no surprise. Borrowing a significant percentage of income against the next paycheck unavoidably creates a cash-flow problem for the next pay period—and the one after that, and the one after that.[37] The resulting predicament leaves borrowers little alternative but to roll over the existing loan, take a new one, or borrow from one payday lender to pay off another.[38] There is evidence that

26 See, e.g., Lise Olsen, *Payday Lenders Spent Big in Election 2012*, San Antonio Express-News, Dec. 27, 2012 (generous campaign contributions to legislators who will be "reviewing proposed reforms"); Cary Spivak & Patrick Marley, *Payday Lenders Giving Lobbyists Big Paydays to Stop Interest Cap*, Milwaukee-Wisconsin Journal Sentinel, Aug. 2, 2009 (attempt to regulate Wisconsin payday-lending industry is "a bonanza for the Madison lobbying corps," with 27 lobbyists registering for industry to fight reform). See also Christopher L. Peterson, *Usury Law, Payday Loans, and Statutory Sleight of Hand: Salience Distortion in American Credit Pricing Limits*, 92 Minnesota Law Review 1110, 1111, 1151–52 (2008) ("well-funding payday industry lobby" spends "millions on lobbying").

27 See, e.g., Allison S. Woolston, *Neither Borrower Nor Lender Be: The Future of Payday Lending in Arizona*, 52 Arizona Law Review 853, 869 (2010) (prevalent use of loopholes to evade state rate caps on payday loans). The most recent circumvention scheme involves payday lenders partnering with Indian tribes to claim sovereign immunity in the attempt to evade state and federal consumer protection laws (see, e.g., Nathalie Martin & Joshua Schwartz, *The Alliance Between Payday Lenders and Tribes: Are Both Tribal Sovereignty and Consumer Protection at Risk?*, 69 Washington and Lee Law Review 751, 787 (2012)). Regulators and advocates continue to seek to close the loopholes as they arise (see, e.g., *Ohio Neighborhood Financial Incorporated v. Scott*, No. 11CA010030, 2012 WL 5994934, at *14 (Ohio Ct. App. Dec. 3, 2012), appeal allowed, 2013-Ohio-1622, 986 N.E.2d 29 (2013) (finding that payday lender had illegally circumvented Ohio Short-Term Lender Law); *Federal Trade Commission v. Payday Financial LLC*, 935 F. Supp. 2d 926 (D.S.D. 2013) (denying payday lender's claim that payday lender's purported affiliation of tribe relieves federal agency of jurisdiction to prosecute unfair and deceptive practices against lender)).

28 See, e.g., Karen K. Harris, Payday Loans Harm the Economy, Not Just People, Shriver Brief (June 3, 2013).

29 Michael Kenneth, *Payday Lending: Can "Reputable" Banks End Cycles of Debt?*, 42 University of San Francisco Law Review 659, 668 (2008) (payday lending is "dead-end credit" because it does not improve or repair credit ratings).

30 See, e.g., Graham McCaulley & Brenda Procter, University of Missouri Extension, Show-Me Predatory Lending: Where Does the Money Go? (Jan. 2012) (payday lending "undermines a family's financial stability [leading to] greater difficulty in meeting other basic expenses"); Tim Lohrentz, Insight Center for Community Economic Development, The Net Economic Impact of Payday Lending in the U.S. 3 (March 2013) ("payday lending industry caused *a net loss* in economic activity").

31 Pew Charitable Trusts, *supra* note 4, at 6 ("Only 14 percent of borrowers can afford enough out of their monthly budgets to repay an average payday loan").

32 Community Financial Services Association of America, Is a Payday Advance Appropriate for You? (n.d.).

33 See, e.g., Brian Meltzer, *The Real Costs of Credit Access: Evidence from the Payday Lending Market*, 126 Quarterly Journal of Economics 517, 519 (2011) (use of payday loans actually "increases the likelihood of financial distress").

34 Pew Charitable Trusts, Payday Lending in America: Who Borrows, Where They Borrow, and Why 4–5 (July 2012).

35 See, e.g., Robert DeYoung & Ronnie J. Phillips, Federal Reserve Bank of Kansas City, No. RWP-09-07, Payday Loan Pricing 7 (Feb. 2009) ("The profitability of payday lenders depends on repeat borrowing"); and Leslie Parrish & Uriah King, Center for Responsible Lending, Phantom Demand: Short-Term Due Date Generates Need for Repeat Payday Loans, Accounting for 76% of Total Volume 5 (July 9, 2009) (borrowers taking out a single loan accounted for just 2 percent of total payday-loan activity).

36 Consumer Financial Protection Bureau, Payday Loans and Deposit Advance Products: A White Paper of Initial Data Findings 23 (April 24, 2013).

37 Pew Charitable Trusts, *supra* note 34.

38 See, e.g., Zoë Elizabeth Lees, Payday Peonage: Thirteenth Amendment Implications in Payday Lending, 15 The Scholar: St. Mary's Law Review on Race and Social Justice 63, 88 (2012) (borrowers must take out next payday loan to repay previous payday loan); Johnson, *supra* note 12, at 10–11 (borrowers unable to pay loan when due must roll it over); Paul Chessin, *Borrowing from Peter to Pay Paul: A Statistical Analysis of Colorado's Deferred Deposit Loan Act*, 83 Denver University Law Review 387, 411 (2005) (borrowers often "obtain a payday loan from one lender in order to pay off an outstanding payday loan due another lender").

That payday lending results in long-term indebtedness should come as no surprise.

the debt cycle is fed by lenders who train and incent their employees to keep the customers borrowing indefinitely.[39] It is this characteristic especially that led the Center for Responsible Lending to call the payday loan "a defective product."[40] Some suggest it is not the product itself but rather consumer misuse of the product that causes financial harm.[41] However, advocates decry blaming the victim for falling deeper into debt; they argue that the product design forces borrowers to take out repeated loans because the repayment of prior loans leaves them with inadequate funds.[42]

YOU MAY NOT APPLY AN APR TO A TWO-WEEK LOAN

You most certainly may apply an APR to a two-week loan—and should—when the vast majority of payday borrowers are in debt for a substantial portion of the year, as conclusive evidence shows to be the case.[43] The industry argues that use of the APR inappropriately inflates and unfairly creates a misperception of the true cost of the loan.[44] The argument would have merit if borrowers were indebted to payday lenders for just a small portion of the year. Because borrowers are indebted for a substantial portion of the year, the industry's argument fails.

THE RISK JUSTIFIES THE RATES

No, in fact the risk does not justify the rates. The Consumer Financial Protection Bureau defines risk-based pricing as offering "different consumers different interest rates or other loan terms, based on the estimated risk that the consumers will fail to pay back their loans."[45] First, payday lenders do not differentiate among consumers because they do not alter rates based on a borrower's ability to pay.[46] Second, payday loans, though high-cost, are not high-risk.[47] Even as some industry defenders continue to claim that the risk justifies the rate, other industry supporters concede that most payday loans do not end in default because repayment is virtually guaranteed through automatic debit agreements.[48] Default rates on payday loans are low.[49] In sum, there is simply no quantifiable, risk-based justification for the excessively high rates payday lenders charge.[50]

A PAYDAY LOAN IS A PRODUCT TO HELP THE UNBANKED

In actuality the unbanked are typically ineligible for a payday loan. A bank account and an automatic debit authorization are prerequisites to obtaining payday loan credit.[51] The payday lender, with such authorization, is often the first in line to drain the account when the employer directly deposits the paycheck.[52] Payday lenders suggest that taking payday loans is a cheaper alternative to bouncing checks.[53] However, evidence strongly suggests that payday loans cause borrowers to bounce checks and to incur overdraft and other bank fees.[54] Payday loans do not serve the unbanked but are likely to cause banked borrowers to incur additional costs.

A PAYDAY LOAN IS A STRAIGHTFORWARD TRANSACTION THAT BORROWERS CLEARLY UNDERSTAND

The mechanical simplicity of the payday transaction masks its hidden complexities, while its casual nature belies its dangers. There is significant informational asymmetry between payday lenders and payday borrowers. This asymmetry results in the inability of consumers to predict accurately the

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39 See, e.g., Jim Siegel, *Are Blacks Main Target of Payday Lenders?*, Columbus Dispatch, Sept. 13, 2007 (Michael Donavan, former district director of operations of large national payday-loan chain, Check 'n' Go, describes how company trained salespeople "'to keep customers dependent, to make sure they keep re-borrowing—forever, if possible'"); see also Graves & Peterson, *supra* note 1, at 643 ("Investigations by federal banking regulators and statements of former payday lending employees confirm that payday lenders create compensation incentives encouraging employees to manipulate borrowers into long-term borrowing").

40 Press Release, Center for Responsible Lending, Momentum Builds Against All Types of Payday Loans: States, CFPB, Others Have Clear Authority to Act (Oct. 4, 2013).

41 See, e.g., Marty Schladen, *Payday-Lending Official: Borrowers Responsible for Their Decisions*, El Paso Times, Dec. 29, 2013 (Texas finance commissioner and vice president of major national payday lender Cash America asserted that borrowers themselves were to blame for falling into cycle of debt).

42 Martin, *supra* note 11, at 570–78.

43 See, e.g., Consumer Financial Protection Bureau, *supra* note 36; Pew Charitable Trusts, *supra* note 34, at 4. See also Uriah King & Leslie Parrish, Center for Responsible Lending, Payday Loans, Inc.: Short on Credit, Long on Debt 1 (March 31, 2011) (in their first year, borrowers are indebted to payday lenders for average of 212 days).

44 William M. Webster IV, *Payday Loan Prohibitions: Protecting Financially Challenged Consumers or Pushing Them over the Edge?*, 69 Washington and Lee Law Review 1051, 1081 (2012) (use of APR distorts true cost of payday loan").

45 Consumer Financial Protection Bureau, What Is Risk-Based Pricing (June 13, 2013).

46 Michael Bertics, *Fixing Payday Lending: The Potential of Greater Bank Involvement*, 9 North Carolina Banking Institute Journal 133, 138 (2005) (survey results of Ohio payday lenders "revealed that payday lenders are quite willing to allow individuals to obtain multiple loans simultaneously without any determination of the individual's ability to repay the loans").

47 Kenneth, *supra* note 29, at 688.

48 See, e.g., Aimee A. Minnich, *Rational Regulation of Payday Lending*, 16 Kansas Journal of Law and Public Policy 84 (2006) (payday loans "are riskier" than other forms of credit); Ronald J. Mann & Jim Hawkins, *Just Until Payday*, 54 University of California Los Angeles Law Review 855, 885 (2007) (low default rates); Jim Hawkins, *Regulating on the Fringe: Reexamining the Link Between Fringe Banking and Financial Distress*, 86 Indiana Law Journal 1361 (2011) (high likelihood of repayment).

49 Pew Charitable Trusts, *supra* note 4, at 18 ("Loss rates at the larger payday lenders are about 3 percent" of total funds loaned).

50 Charles A. Bruch, *Taking the Pay out of Payday Loans: Putting an End to the Usurious and Unconscionable Interest Rates Charged by Payday Lenders*, 69 University of Cincinnati Law Review 1257, 1280 (2001).

51 Faller, *supra* note 2, at 152.

52 Johnson, *supra* note 12, at 389 ("[T]he majority of payday lenders now have consumers sign contracts that allow electronic debits to their bank accounts to facilitate payment of the entire loan").

53 Thomas A. Wilson, *The Availability of Statutory Damages Under TILA to Remedy the Sharp Practice of Payday Lenders*, 7 North Carolina Banking Institute Journal 339, 342 (2003).

54 Alan M. White, *Behavior and Contract*, 27 Law and Inequality 135, 159 (2009) (activation of automatic withdrawal feature of loan leads to greater insufficient fund fees upon default).

The mechanical simplicity of the payday transaction masks its hidden complexities.

length of indebtedness they will experience or assess the financial jeopardy into which they are placed by using payday loans. Sociologists, economists, and financial analysts have all identified the "difficulty [consumers have] in accurately estimating the costs" of a payday loan."[55] Even industry supporters admit that payday-lending transactions tax the cognitive capabilities of the typical customer.[56] In truth, the vast majority of payday borrowers are imperfectly informed and imperfectly rational.[57]

Consumers of course know the dollar amount of the fee charged on a payday loan.[58] However, they suffer from a deep misunderstanding ... of the true cost of the loans.[59] Consumer confusion stems from, among other sources:

- math innumeracy,[60]
- limitations in analytical ability leading to miscalculations about fees and renewals,[61]
- a lack of understanding of Truth in Lending Act disclosures,[62] and
- an aspirational belief that the use of the product will indeed be short-term.[63]

Further, payday lenders often intentionally withhold or manipulate disclosures to the detriment of full borrower awareness of the costs of the transaction.[64] And borrowers often do not anticipate or factor in the costs of repeated rollovers, leading to a significant misbelief of what the loan will actually cost.[65]

In sum, many borrowers clearly are not acting in an informed and economically rational manner when taking payday loans. As two of the most frequently cited defenders of the industry acknowledge, "[i]t is simply not plausible ... 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."[66]

PAYDAY LENDING DOES NOT LEAD TO FURTHER FINANCIAL DISTRESS

Payday lending does not relieve financial stress; it exacerbates financial problems.[67] Payday borrowers are more likely to end up in bankruptcy.[68] Borrowers also often find themselves buried under a cascade of defaults regarding other expenses, such as mortgage, rent, utility bills, medical bills, and credit card bills.[69] Payday lending has been linked to the destruction of military families.[70] Such lending is associated with negative effects on societal externalities that have an adverse impact on state and local economies.[71]

Ensure Short-Term, Small-Amount Credit at Reasonable Terms

Even payday lending's most strident critics would agree that, for a segment of financially struggling consumers, there is a significant demand for short-term, small-dollar loans. The industry continues to benefit from the perception that the provision of its product must be tolerated because there is no alternative for many borrowers to obtain this necessary credit.[72]

55 Rhys Bollen, *"There Is No Alpha": Bounded Rationality in the Mutual Funds Market*, 28 Banking and Finance Law Review 225, 236 (2013).

56 Mann & Hawkins, *supra* note 48, at 881.

57 Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 University of Pennsylvania Law Review 1, 10 (2008).

58 Mann & Hawkins, *supra* note 48, at 881 (customers "might well understand the specific fees" associated with first payday-loan transaction).

59 Martin, *supra* note 11, at 563.

60 *Id.* at 616.

61 Neil Bhutta, Divisions of Research and Statistics and Monetary Affairs, Federal Reserve Board, Payday Loans and Consumer Financial Health 5 (Sept. 2013).

62 Diane Hellwig, *Exposing the Loansharks in Sheep's Clothing: Why Re-Regulating the Consumer Credit Market Makes Economic Sense*, 80 Notre Dame Law Review 1567, 1595 (2005). See also Stephanie Ben-Ishai, *Regulating Payday Lenders in Canada: Drawing on American Lessons*, 23 Banking and Finance Law Review 323, 353 (2008) (1992 study finds that "50 per cent of Americans [including those with a university degree] were unable to understand the terms under [the Truth in Lending Act], or even know where to look for these terms").

63 Pew Charitable Trusts, *supra* note 4, at 19.

64 Ben-Ishai, *supra* note 62, at 326, 353 ("Many payday lenders hide basic information about their loans from consumers" and exploit consumers with "English-language difficulties").

65 Karen E. Francis, *Rollover, Rollover: A Behavioral Law and Economics Analysis of the Payday-Loan Industry*, 88 Texas Law Review 611, 614 (2010) ("[B]orrowers systematically underestimate their future borrowing, leading to unexpected rollover loans and imposing substantial and unnecessary costs on these borrowers").

66 Mann & Hawkins, *supra* note 48, at 884.

67 See, e.g., Brian Meltzer, *The Real Costs of Credit Access: Evidence from the Payday Lending Market*, 126 Quarterly Journal of Economics 517, 541 (2011) (use of payday loans actually "increases the likelihood of financial distress").

68 See, e.g., Paige Marta Skiba & Jeremy Tobacman, *Do Payday Loans Cause Bankruptcy* 1, 8 (Vanderbilt Law and Economics Research Paper No. 11-13, Nov. 9, 2009); Jacqueline S. Akins, *Lending to the Military*, 64 Consumer Finance Law Quarterly Report 145 (2010); Michael S. Barr, *Financial Services, Saving, and Borrowing Among Low- and Moderate-Income Households: Evidence from the Detroit Area Household Financial Services Survey*, in Insufficient Funds: Savings, Assets, Credit, and Banking Among Low- and Moderate-Income Households 66–69 (Michael S. Barr & Rebecca M. Blank eds., 2009); Kelly J. Noyes, Comment, *Get Cash Until Payday! The Payday-Loan Problem in Wisconsin*, 2006 Wisconsin Law Review 1627, 1634 (2006); and Robert Mayer, *Payday Lending and Personal Bankruptcy*, 50 Consumer Interests Annual 76, 81 (2004).

69 See, e.g., Graves & Peterson, *supra* note 1, at 646 (citing Rick Jurgens, National Consumer Law Center, Utilities and Payday Lenders: Convenient Payments, Killer Loans 26–28 (June 2007) (linking payday lending to other credit defaults)).

70 U.S. Department of Defense, Report on Predatory Lending Practices Directed at Members of the Armed Forces and Their Dependents 39 (Aug. 9, 2006).

71 See, e.g., Butler & Park, *supra* note 13.

72 See, e.g., William Isaac, *Why Payday Loans Are Good for Millions of People*, American Banker (Aug. 13, 2013) (consumers are unable to obtain short-term loans from banks).

But there are alternatives. Credit unions and Community Development Financial Institutions (or CDFIs as they are often known) around the country have established models, providing small-amount loans at reasonable interest rates, payable within a brief term, often through an installment repayment plan.[73] New ideas, such as lending circles, are emerging to deal with access-to-short-term-credit problems that build credit scores.[74] The problem is that these alternatives, however successful, are typically isolated and serve limited numbers of borrowers.

The long-term solution to ensuring access to desperately needed credit is to scale these successful alternatives and develop a nationwide system of suppliers of short-term credit whose goal is not to foster perpetual indebtedness but rather to facilitate individual and family financial stability and macroeconomic growth by offering access to needed credit under reasonable terms. Such an effort is ambitious but never more timely. Cooperation among the public, private, nonprofit, and philanthropic sectors, along with the communities affected, will be critical.

In the meantime, policymakers should look to states that have achieved needed reform to correct the fundamental flaw in the payday-lending model: the debt trap. Delaware and Washington State, for example, have limited to five and eight, respectively, the number of loans a borrower may take per year.[75] Evidence suggests these policies have been effective in reducing the debt cycle that is so destructive to borrowers.[76]

Create a New System

For most borrowers, payday loans do not, as the industry insists, provide a financial bridge over temporarily troubled financial waters. On the contrary, because the norm is a long-term slide deeper and deeper into debt, more often than not, such loans push borrowers to the financial brink. Without question, there is a void in the financial markets for responsible short-term credit. But the payday-lending business model that emerged to fill the void exploits financially desperate consumers by charging unconscionable and unjustifiable interest rates, and, worst of all, trapping the most financially vulnerable in unending debt.

Policymakers often are paralyzed when the debate about payday lending ensues. They are disturbed about the propensity of borrowers to fall into the debt trap, but they are reluctant to shut off access to payday credit, despite its high costs and questionable impact. However, the same characteristics that define the subprime payday loan—the willful absence of underwriting, unaffordable balloon payments, loan churning, excessive interest, unsustainable loan terms and conditions—defined the subprime mortgages whose proliferation precipitated the economic collapse in the mid-2000s and have now been thoroughly discredited.

Payday lending erodes assets and creates financial insecurity among borrowers. Financially healthy families undergird a financially stable economy. The payday loan is symptomatic of the collective and systemic failure to provide access to reasonably priced, short-term, small-amount credit.

Policymakers must first reform laws to limit the likelihood that payday loan borrowers will fall into the debt trap. They should then facilitate the creation of a new system that offers the necessary credit to move families forward and not push them farther behind. Success will by no means be easy, but the status quo is unacceptable. If the will is there, the way will inevitably follow.

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73 See Laura Choi, *From Cashing Checks to Building Assets: A Case Study of the Check Cashing/Credit Union Hybrid Service Model* (Federal Reserve Bank of San Francisco, Working Paper No. 2013-01, Jan. 2013); Richard Piersol, *Credit Unions Launch Alternative to Payday Loans*, Lincoln Journal Star (Oct. 19, 2011) (Nebraska credit union loans of up to $500 at 18 percent APR, payable within 60 days); Lauren K. Saunders et al., National Consumer Law Center, Stopping the Payday Loan Trap 19–21 (June 2010) (alternative payday-loan products offered by credit unions in Connecticut, Florida, Iowa, Maryland, New York, New Jersey, North Carolina, Virginia, and Washington, and Community Development Financial Institution lender offering small dollar loans in California and Texas).

74 See Mission Asset Fund, Lending Circles (2014).

75 See Del. Code Ann. tit. 5, § 2235A (2013); Wash. Rev. Code Ann. § 31.45.073 (2013). At present, 15 states and the District of Columbia confront the debt-cycle problem by capping interest rates. Some states have never authorized payday lending; they subject any payday loan to the state's usury cap. Others have eliminated the high-interest payday loan; they subject—through legislation or ballot initiative—any such offering to an APR cap of not more than 36 percent (Montezemolo, *supra* note 5, at 33).

76 Montezemolo, *supra* note 5, at 14 (borrowing patterns before and after enactment of Washington State law show that law "appears to have been successful in greatly lowering the level of payday lending debt trap and associated fees").

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