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EXPOSING THE LOANSHARKS IN SHEEP'S
CLOTHING: WHY RE-REGULATING THE
CONSUMER CREDIT MARKET MAKES
ECONOMIC SENSE

*Diane Hellwig**

INTRODUCTION

Roughly twenty-seven years have passed since the “deregulation” of the credit industry began in America.¹ During this time, personal savings rates have plummeted, bankruptcies have increased seven-fold,² and a fringe credit industry³ has emerged that regularly makes short-term loans at triple-digit interest rates twenty times higher than those charged by credit cards. This Note will demonstrate that the high rates charged by fringe creditors are the result of market failure, not informed bargaining between rational actors. Inadequate disclosure and limited financial education prevent consumers from understanding the full cost and risk of the loans they take out, leading to poor resource allocation.⁴ Furthermore, short-term, high-rate credit imposes significant costs on society. This Note argues that the protection of society from these externalities justifies government intervention, even in the rare case where consumers understand the full implications of their decisions.

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1 The deregulation of interest rates began with the Supreme Court’s holding in *Marquette National Bank v. First of Omaha Service Corp.*, 439 U.S. 299 (1978), described *infra* Part IV.A.

2 See *infra* note 62 and accompanying text.

3 The term “fringe credit industry” is used to describe creditors that provide loans that the primary banking industry declines to make, either because of the loans’ small size or high risk. Characteristics of this industry are explored *infra* Part I.

4 See *infra* Part III.B.

Part I briefly describes payday loans and refund anticipation loans—two fringe credit products that have experienced explosive growth in the last ten years.

Part II provides an in-depth look at the dangerous debt trap these products create for individual debtors. It then examines the heavy societal costs imposed by these loans, including higher bankruptcy rates and increased demand for government welfare programs. Part II concludes by demonstrating the minimal value these loans provide in exchange for their high cost.

Part III explains how the fringe credit market differs significantly from the idealized free market. Current disclosure requirements under the Truth in Lending Act (TILA) have failed to promote informed shopping among borrowers, who get these disclosures too late in the game and are unable to decipher their meaning. In addition, emergency circumstances, privacy concerns, and compulsory tax laws all contribute to noncompetitive rates in the fringe credit market.

Part IV explains the process by which the credit industry became deregulated. The term “deregulation” is not meant to suggest that the credit industry is entirely unregulated. Quite to the contrary, all depository institutions (e.g., banks, credit unions, savings and loans) are subject to the regulatory authority of at least one governmental agency;⁵ usury statutes remain on the books of all fifty states;⁶ and every lender is subject to TILA, the Fair Debt Collection Practices Act, the Federal Trade Commission Act (prohibiting “unfair or deceptive acts or practices in or affecting commerce”⁷), and several other federal regulations.⁸ The credit market is, however, deregulated in two important respects. First, most of the above regulation is aimed at disclosure and prohibiting fraudulent practices, leaving almost complete control over interest rates and fees to the parties. Second, the state laws that do attempt to regulate rates are largely preempted by

5 National banks are regulated by the Office of the Comptroller of the Currency (OCC), national credit unions by the National Credit Union Administration (NCUA), and federal savings and loan associations are regulated by the Office of Thrift Supervision (OTS). See KATHLEEN E. KEEST & ELIZABETH RENUART, NAT'L CONSUMER LAW CTR., *THE COST OF CREDIT: REGULATION AND LEGAL CHALLENGES* 75 (2d ed. 2000). State banks are subject to inspection by state regulators. In addition, the ninety percent of banks that are federally insured are subject to the regulation of the Federal Deposit Insurance Corporation (FDIC). See Elizabeth R. Schiltz, *The Amazing, Elastic, Ever-Expanding Exportation Doctrine and Its Effect on Predatory Lending Regulation*, 88 MINN. L. REV. 518, 542 (2004).

6 See KEEST & RENUART, *supra* note 5, app. A (listing the statutory references for the usury statutes of all fifty states).

7 15 U.S.C. § 45(a)(1) (2000).

8 See Schiltz, *supra* note 5, at 533.

federal law that allows creditors to effectively choose the state whose law will apply to them, regardless of where they do business. Part IV focuses on why these preemptory federal statutes got enacted, how their scope has expanded over time, and the accountability and notice problems they now create.

The problems created by payday loans and refund anticipation loans are significant in both scope and severity. Despite the harmful nature of these products, a confluence of market imperfections and improvident legal rules allows these products to thrive in the deregulated credit market. Throughout this Note, numerous potential fixes for these market and legal failures will be examined. Of these potential solutions, I propose that rate regulation is the most effective, efficient, and fair solution to the problems created by fringe credit. Accordingly, I urge the adoption of a floating interest rate ceiling set at fifty percentage points above the one-month treasury rate—a rate chosen to deter unconscionable and opportunistic loans while leaving the mainstream credit market unregulated. Admittedly, adoption of this rate ceiling would cause a restriction in credit availability and would likely eliminate both payday loans and refund anticipation loans. The purpose of this Note is to demonstrate that the elimination of these products is justified by both social policy and sound economic principles.

I. THE GROWTH OF THE FRINGE CREDIT INDUSTRY

The term “fringe credit industry” describes creditors who provide loans that the primary banking industry will not.⁹ Prior to the deregulation of the credit industry, interest rate ceilings gave all lenders an incentive to avoid making loans that were small, unsecured, or otherwise high risk. The relatively high transaction costs and bad debt expense accompanying these loans made them unprofitable at legal rates. After rate regulation was effectively eliminated, the fringe market began to grow rapidly. The first creditors to take advantage of

9 Although this Note will focus exclusively on payday loans and refund anticipation loans, the fringe credit industry provides several other popular products, including title loans (small loans, typically one month in duration, that are fully secured by the debtor's car title), rent-to-own plans, and traditional pawn shop loans. See, e.g., 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, 597–600 (2000) (discussing pawn and title loans); *id.* at 614–16 (discussing rent-to-own contracts).

deregulation were national banks issuing credit cards.¹⁰ Then, in the 1990s, a new wave of fringe creditors emerged to plug the gaps left behind by credit card companies. These “gaps” consisted of consumers whose financial prospects were so dire that they failed to qualify for credit cards, as well as card-carrying consumers who wanted one more chance after maxing out their credit cards. Although the fringe credit industry provides a number of products, this Note focuses on two that illustrate the range of problems created by short-term, high-rate credit: payday loans and refund anticipation loans.

A. Payday Loans

Payday loans are short-term loans that allow a consumer to borrow against his next payday check using a postdated personal check. The typical payday loan is issued for a seven- to fourteen-day period and carries a fee between fifteen dollars and thirty dollars per \$100 borrowed.¹¹ A \$300 loan will therefore normally cost between forty-five dollars and ninety dollars if it is repaid within two weeks.¹² The average loan fee—\$18.28 per \$100 borrowed—corresponds to an annual percentage rate (APR) of 470%.¹³ Despite this high cost, payday loans are immensely popular. Stores providing these loans first appeared in the early 1990s.¹⁴ By 2000, the number had grown to 12,000, and in 2002 it reached 15,000, a twenty-five percent increase in two years.¹⁵ During this same two-year period, fee revenue tripled from \$1.4 billion to \$4.3 billion.¹⁶

10 Nationwide credit card solicitations actually sparked the litigation that established the *Marquette* exportation doctrine, which effectively ended rate regulation for federal banks. See *infra* Part IV.A.

11 See JEAN ANN FOX, CONSUMER FED’N OF AM., UNSAFE AND UNSOUND: PAYDAY LENDERS HIDE BEHIND FDIC BANK CHARTERS TO PEDDLE USURY 2 (2004), available at <http://www.consumerfed.org/pdlrentabankreport.pdf>.

12 The vast majority of customers actually extend their loans beyond the initial two-week period. See *infra* notes 48–50 and accompanying text.

13 CONSUMER FED’N OF AM. & U.S. PUB. INTEREST RES. GROUP, RENT-A-BANK PAYDAY LENDING: HOW BANKS HELP PAYDAY LENDERS EVADE STATE CONSUMER PROTECTIONS 4 (2001) [hereinafter CFA/PIRG REPORT 2001], available at <http://www.consumerfed.org/paydayreport.pdf>. The single most common fee, charged by thirty percent of the 234 banks surveyed, was fifteen dollars per \$100. *Id.* at 5.

14 See GREGORY ELLIEHAUSEN & EDWARD C. LAWRENCE, PAYDAY ADVANCE CREDIT IN AMERICA: AN ANALYSIS OF CUSTOMER DEMAND 2 (Credit Research Ctr., Georgetown Univ., Monograph No. 35, 2001), available at <http://www.cfsa.net/mediareports/Reports/GeorgetownStudy.pdf>.

15 See FOX, *supra* note 11, at 3–4.

16 *Id.*

Prior to extending credit, payday lenders typically request that applicants provide their last bank statement, their last pay stub, and identification.¹⁷ Payday lenders do not obtain credit bureau reports, although some use a special reporting service that tracks the consumer's recent use of payday loans.¹⁸ Customers supply a postdated check in the amount of the loan plus the finance charge. Alternatively, the lender may ask the customer to sign an agreement authorizing the lender to make an electronic withdrawal from his checking account on the loan's due date.¹⁹ The postdated check aids collection and gives the lender leverage. As long as the borrower has sufficient funds in his checking account on the loan due date, all the lender has to do to collect the loan is deposit the check. The borrower has a strong incentive to ensure sufficient funds are present or else to contact the lender and pay a rollover (i.e., loan renewal) fee. Failure to do either may result in bounced check fees from both the bank and payday lender.

Thirty-three states have adopted legislation that specifically authorizes payday lending, and two additional states permit these loans via their general small loan laws.²⁰ Fifteen states currently have small loan interest rate caps that attempt to prohibit payday lending.²¹ Despite these laws, payday lenders currently operate in every state thanks to a federal law that allows banks to be governed by the state law of their choosing and charter renting, a practice that allows nonbanks to take advantage of this law through contractual partnerships with banks.²² Nearly half of the thirty-three states that explicitly authorize payday lending passed this legislation in the last five years.²³ It is likely that federal preemption and the inability of states to enforce their own laws factored into these changes. The less stringent the law

17 See ELLIEHAUSEN & LAWRENCE, *supra* note 14, at 3.

18 *Id.*

19 See FOX, *supra* note 11, at 6.

20 *Id.* at 30 (listing the states and giving citations to the statutes that authorize payday lending).

21 *Id.* at 29.

22 This preemptory scheme is explained in greater detail in Part IV, *infra*.

23 See FOX, *supra* note 11, at 30 n.110 (listing the thirty-three states that explicitly authorized payday lending as of March 2004 and citations for the authorizing statutes). Two additional states allow payday lending through permissive small-loan laws rather than specific legislation. *Id.* at 30. In contrast, a 1999 memo from a credit-industry trade group listed only seventeen states that then had authorizing legislation. See NAT'L CHECK CASHERS ASS'N, FREEDOM OF CHOICE FOR CONSUMERS: THE TRUTH ABOUT DEFERRED DEPOSIT SERVICES—A REASONED RESPONSE TO THE CFA'S MISREPRESENTATIONS pt. III (1999), available at <http://www.fisca.org/ddresponse.htm#overview>.

adopted by a state, the less likely that lenders will circumvent it²⁴ and the more likely that the states will be able to keep track of the lenders operating in their state.

Although the state schemes vary, a typical payday loan statute requires lenders to be licensed and restricts loan duration, size, renewal options, and fees. Loan size is typically limited to \$500 or less, but five states set their limit between \$500 and \$1000, and four allow any amount.²⁵ As will be explained in Part II.A., the design of most state statutes that attempt to limit duration and loan renewals makes them incredibly easy to circumvent. The rate limitations vary significantly in structure (e.g., a schedule of fees, a flat fee per \$100, or a flat fee plus percent of loan value)²⁶ but are uniformly permissive. Ten states allow any rate to be charged, and even the most restrictive states allow APRs of 390%.²⁷ Although a limit of 390% is preferable to no limitation at all, it is still extremely lenient—roughly comparable to telling a rebellious child that they have a 5:00 a.m. curfew and may only eat a pound of candy per day.

B. Refund Anticipation Loans

Refund anticipation loans (RALs) are short-term loans secured by income tax refunds. The primary providers of RALs are national banks that partner with commercial tax preparers. In exchange for a fee from the bank, the tax preparers advertise the loans, transmit the application to the bank, and disburse the funds to customers.²⁸ Clients pay a flat fee based on the amount of the loan and may pay additional administrative, document preparation, or electronic filing fees.²⁹ The fees charged by RAL providers correspond to APRs ranging from 70–700%.³⁰ In exchange, customers receive a check equal to the amount of their anticipated tax refund less loan fees, tax prepara-

24 Only depository institutions (i.e., banks, credit unions, etc.) have the right to export state law. To take advantage of this privilege, nonbanks must enter into contractual agreements with banks. By complying with state law, the nonbank lenders avoid having to share their profits with a bank.

25 See Fox, *supra* note 11, at 31–33.

26 *Id.*

27 *Id.*

28 See *infra* note 183 and accompanying text (discussing *Cades v. H & R Block, Inc.*, 43 F.3d 869 (4th Cir. 1994), which involved an unsuccessful legal challenge to this type of arrangement).

29 The loan fee that is tied to the loan amount goes to the bank that makes the loan. The administrative fees go to the tax preparers that facilitate the loans. Preparers may not legally tie these fees to the amount of the loan.

30 See CHI CHI WU & JEAN ANN FOX, NAT'L CONSUMER LAW CTR. & CONSUMER FED'N OF AM., ALL DRAIN, NO GAIN: REFUND ANTICIPATION LOANS CONTINUE TO SAP

tion fees, and filing fees.³¹ This check is available in one to two days, which is seven to ten days sooner than the funds would be available if the taxpayer electronically filed and requested direct deposit without taking out a loan.³² Many taxpayers that take out RALs do not realize that they are taking out a loan rather than receiving an expedited refund from the IRS.³³

The 2004 schedule of fees charged by Household Bank, the nation's largest provider of RALs and H&R Block's RAL partner,³⁴ is presented below. Household's loan fees range from \$29.95 to \$69.95 and correspond to APRs ranging from 106% to 455%. The average administrative fee charged by H&R Block is thirty-two dollars,³⁵ which pushes the total fee for a one-week \$2000 loan to \$102.

TABLE 1. 2004 RAL FEES FOR HOUSEHOLD BANK

Loan Amount	Loan Fee ³⁶	APR ³⁷	APR (with administrative fee) ³⁸
\$200-500	\$29.95	182-455%	377-942%
\$501-1000	\$39.95	122-243%	219-437%
\$1001-1500	\$59.95	122-182%	186-279%
\$1501-2000	\$69.95	106-142%	155-207%

THE HARD-EARNED TAX DOLLARS OF LOW-INCOME AMERICANS 2 (2004), available at <http://www.consumerfed.org/RefundAnticipationLoanReport.pdf>.

31 ALAN BERUBE ET AL., BROOKINGS INST. & PROGRESSIVE POLICY INST., THE PRICE OF PAYING TAXES: HOW TAX PREPARATION AND REFUND LOAN FEES ERODE THE BENEFITS OF THE EITC 4 (2002).

32 *Id.*

33 See *infra* notes 103-04 and accompanying text.

34 Wu & Fox, *supra* note 30, at 8-9. In 2002, Household processed seven million RALs generating \$240 million in income. *Id.*

35 *Id.* at 4-5. H&R Block has expressed its intention to phase out this fee over several years. *Id.* at 5 n.14.

36 See *id.* at 9. The fees listed in Table 1 for loans above \$500 are five to ten dollars less than the fees charged by Santa Barbara Bank & Trust (SBBT), which is the banking partner of Jackson Hewitt, the second-largest tax preparation chain in the country. *Id.* at 9-10. SBBT imposes an additional surcharge of five dollars (for a ten to fifteen dollar total difference) for customers whose refund includes funds from the earned income tax credit. *Id.*

37 The APR ranges in the table were calculated according to the following formula:

$$(\text{loan fee} / \text{amount financed}) \times (365 / \text{days in loan period}) = \text{APR}.$$

To be conservative, a twelve-day loan period was assumed. If the taxpayer's refund was received more quickly, the APR would increase.

38 These calculations include the thirty-two dollar average administrative fee in the finance charge.

RALs are widely popular. From 2000 to 2002, the number of RALs increased eighteen percent from 10.8 million to 12.7 million.³⁹ Roughly one-tenth of all taxpayers,⁴⁰ and one-third of those using a professional tax preparer,⁴¹ obtained a RAL in 2002.

II. CAUSE FOR CONCERN: THE HARMFUL NATURE OF SHORT-TERM HIGH-RATE LOANS

The previous section explained that the markets for both RALs and payday loans are large, and that the latter is growing extremely rapidly. Yet these products carry interest rates that are three to twenty times higher than the interest rate cap that I propose. Am I seriously suggesting that such popular products be eliminated in their entirety? In short, the answer is yes. This section will examine the significant harms that these products impose on both debtors and society as a whole. Part III will then elaborate on the market conditions that make these products popular in spite of themselves.

A. *The Debt Trap*

Although payday loans are advertised as a short-term solution, they can quickly ensnare a debtor in long-term financial trouble. At the average rate of \$18.28 per \$100 borrowed for a two-week period (i.e., 475% APR),⁴² it takes less than twelve weeks (or five rollovers) for the amount of loan fees paid by a customer to exceed the amount borrowed.⁴³ If a loan were allowed to continue at this rate for a full year, the consumer would pay \$4.75 in interest for every dollar borrowed without getting any closer to paying off the loan.

39 WU & FOX, *supra* note 30, at 9.

40 *Id.* at 3.

41 See CHI CHI WU & JEAN ANN FOX, NAT'L CONSUMER LAW CTR. & CONSUMER FED'N OF AM., THE HIGH COST OF QUICK TAX MONEY: TAX PREPARATION, 'INSTANT RE-FUND' LOANS, AND CHECK CASHING FEES TARGET THE WORKING POOR 3 n.3 (2003), available at http://www.consumerfed.org/2003_RAL_report.pdf.

42 CFA/PIRG REPORT 2001, *supra* note 13, at 4. The advertised rate of \$18.28 per \$100 can be converted into an approximate APR by dividing 365 days by the length of the loan period (i.e., fourteen days) to determine the number of loan periods in a year, then multiplying this result by the advertised rate. For example, $365/14 = 26 \times 18.28 = 475\%$. This calculation does not include compound interest because debtors pay interest in the form of renewal fees at the end of each loan period.

43 To determine how long it will take for interest payments to exceed the face amount of a loan, calculate:

$$1/i \times 365 \text{ days}$$

where i = the loan's interest rate expressed as a decimal (i.e., a twenty-five percent APR is equivalent to 0.25). At a rate of 475% ($i = 4.75$), it would take seventy-seven days for interest to exceed principal ($365/4.75 = .2105 \times 365 = 77$).

The credit industry is adamant that analyzing the fees for short-term loans in terms of an APR and examining the long-term consequences of borrowing at those rates is grossly inappropriate.⁴⁴ The industry's largest trade association has likened APR disclosure to "a pedestrian in New York City hailing a cab and asking about the fare to San Francisco."⁴⁵ Creditors prefer to focus on the narrow circumstances in which borrowers find themselves in a bind, take out a loan to avoid late fees, promptly repay the loan in two weeks, and come out ahead financially.⁴⁶ Unfortunately, this scenario is rare in practice.

Empirical research shows that the vast majority of payday loan customers extend their loans beyond the initial two-week period and take out new loans frequently.⁴⁷ In 2003, Iowa regulators reported that nearly half of customers had twelve or more loans from the same lender in 2003.⁴⁸ A nationwide survey conducted by the Consumer Research Center (CRC) found that three-fourths of customers nationwide had rolled over a loan at least once in the prior year and that one-fourth had loans outstanding for more than half the year.⁴⁹ The Coalition for Responsible Lending estimates that two-thirds of payday loan customers receive five or more loans per year and that this category of users generates ninety-one percent of the industry's fee revenue.⁵⁰ More than half of revenue is attributable to customers with

44 See NAT'L CHECK CASHERS ASS'N, *supra* note 23, pt. V (referring to the use of APRs to describe the payday loan industry as "virtually fraudulent"). The National Check Cashers Association, which was subsequently renamed the Financial Service Centers of America (FiSCA), represented approximately 3600 of the 6000 check cashing locations in existence at the time of the report. *Id.* pt. I; see also Drysdale & Keest, *supra* note 9, at 606 (discussing the benefits claimed by the fringe credit industry).

45 NAT'L CHECK CASHERS ASS'N, *supra* note 23, pt. V.

46 See *id.* pt. III.

47 See Drysdale & Keest, *supra* note 9, at 605-09 (summarizing studies of payday loan renewals and repeat business).

48 FOX, *supra* note 11, at 3.

49 See ELLIEHAUSEN & LAWRENCE, *supra* note 14, at 38-39. Throughout this note, I will frequently refer to the results of the phone survey conducted by the CRC, a unit of the McDonough School of Business at Georgetown University. This survey targeted consumers that had recently purchased a payday loan from a member of the Community Financial Services Association of America, an industry trade group that represents approximately half of the payday lending offices in the country. *Id.* at 19. The fact that the survey was conducted with industry cooperation, and that the CRC is often associated with the credit industry, suggests that any bias in the structure or interpretation of the survey would favor creditors.

50 KEITH ERNST ET AL., CTR. FOR RESPONSIBLE LENDING, QUANTIFYING THE ECONOMIC COST OF PREDATORY PAYDAY LENDING 5 (2004), available at <http://www.responsiblelending.org/pdfs/CRLpaydaylendingstudy121803.pdf>. The Center's estimates are consistent with the results of several state examiners. See *id.* at 5 tbl.1 (providing statistics and citations for five states).

thirteen loans or more.⁵¹ These statistics not only suggest the debt trap is a real problem, but also cast doubt on the industry's ability to survive without the business of trapped customers.

Although demand for payday loans is very high, a large portion of this demand is attributable to hardships created by the loans themselves. One loan literally leads to another in a cycle of dependency akin to drug addiction. A payday borrower has only two weeks to earn sufficient funds to repay the loan principal and fees. Once he dedicates a large portion of his paycheck to repayment of the first loan, the borrower will likely find it difficult to stretch the remainder of the paycheck until the next payday while continuing to pay regular expenses. Whatever necessitated the first payday loan (e.g., car trouble, a sick child, or marital difficulties) may continue to generate unplanned expenses, making it more difficult for the borrower to scrape by until the next payday. If the borrower loses this battle, he will likely take out a new loan to bridge the gap. Unfortunately, the loan fees associated with this new loan will jeopardize his ability to pay all of his bills in the next period, perpetuating the cycle of dependency.

Even borrowers who appear to temporarily break free from the debt cycle are vulnerable to relapse. During the period of indebtedness, a debtor who is trying to eliminate his payday loans as quickly as possible must dedicate every dollar of expendable income towards interest payment, leaving no money for maintenance expenses or savings. Many expenses—such as those for eye care, dental care, medication, and routine home or car maintenance—can be delayed, but not avoided entirely. Failure to maintain one's health and property may lead to expensive repairs. Consumers who are caught in the debt trap may also abandon insurance payments to get out, a gamble that can have disastrous consequences.

State legislatures have attempted to protect consumers from this debt trap by regulating loan renewals. Eighteen states prohibit a customer from using the proceeds of a new payday loan to retire an existing one,⁵² and five limit the number of rollovers to three per loan.⁵³ The goal of both prohibitions is easily circumvented, however, because consumers can take out a "new" loan minutes after they retire the first one.⁵⁴ Alternatively, customers may take out a loan from a

51 *Id.* at 5.

52 See ELLIEHAUSEN & LAWRENCE, *supra* note 14, at 6.

53 *Id.*

54 WOODSTOCK INST., REINVESTMENT ALERT NO. 14, UNREGULATED PAYDAY LENDING PULLS VULNERABLE CONSUMERS INTO SPIRALING DEBT 8 (2000), available at <http://woodstockinst.org/document/alert.pdf> (noting that Illinois regulators find that the state's three-rollover limit is regularly circumvented in this manner).

second payday store to repay the loan owed to the first store—an option used by one-third of customers responding to a CRC study.⁵⁵ Even consumers who are not trying to circumvent rollover restrictions will frequently have short gaps between loans because they repay their loan on payday and then try, but fail, to make it two weeks on what remains of their paycheck.

If states want to limit this debt trap more effectively without regulating rates, they can limit the number of payday loans that an individual can receive from any lender during each three-month period, treat each rollover as a separate loan, and create a mandatory reporting system to aid compliance and enforcement. This legislation would reduce the amount of money a consumer can waste on payday loan fees and reinforce the idea that the high rates legally permitted for payday lenders are conditioned on their short-term nature.

However, this type of legislation has two drawbacks. First, the costs of maintaining and enforcing the reporting system would either be borne by the government or passed along to borrowers by creditors. Second, if we assume that consumers would repay their payday loans if they could, then decreasing the number of permitted loans or rollovers will not prevent customers from defaulting, but rather will speed the default process along. Debtors who are prohibited from rolling over their loans may be worse off than if they had never taken out a payday loan, because (1) they will be hit with bounced check fees when the lender deposits their postdated check, (2) they still must face the costs and stigma of default, and (3) the money they spent on loan fees was wasted. For these reasons, legislators should seriously consider placing more significant limitations on the rates charged for payday loans (even if this reduces their availability) rather than creating elaborate schemes to limit loan duration.

Each dollar a consumer dedicates to loan fees and interest payments is money that cannot be spent on current consumption, investment, or savings. When borrowers are trapped in payday loan debt, the effect is a reduction in disposable income that reduces their family's standard of living. Although all consumer debt can have this effect, payday loans are particularly damaging because the high loan fees charged represent a substantial fraction of the borrower's paycheck and borrowers are often deeply indebted prior to taking out the loan.⁵⁶ Living on the brink of insolvency causes many consumers to experience shame, guilt, and high levels of stress, which may nega-

55 See ELLIEHAUSEN & LAWRENCE, *supra* note 14, at 40.

56 Half of all payday loan customers and one-fourth of the adult population have consumer debt burdens that require more than ten percent of their monthly income.

tively affect their mental and physical health, job performance, and family life.⁵⁷

B. Beyond the Consumer: Damage to Society Stemming from the Debt Trap

The previous section illustrated the devastating effect that the debt trap can have on individual debtors. The costs of the debt trap, however, are not borne entirely by the debtor, but also spill over to society. The deregulation of the credit market led to a significant increase in credit availability and aggregate consumer debt. Furthermore, the increased availability of fringe credit has allowed consumers to become highly leveraged, meaning that their debt loads are high in comparison to their assets and earning potential. Unfortunately, the high debt levels and high interest rates that exist in a deregulated credit market tend to (1) adversely affect creditors and consumers in the mainstream credit market, (2) decrease savings rates, (3) increase bankruptcy rates, and (4) increase the cost of government welfare programs.

First, the availability of high-rate fringe credit (e.g., payday loans) has a detrimental effect on creditors and consumers that do not use these products.⁵⁸ An economically rational customer will devote his disposable income to paying off debt with high interest rates before that with low rates unless the creditors supplying the latter have more leverage (e.g., the ability to eject the borrower from his home, turn off his utilities, or repossess his car). Unfortunately, this means that the fringe creditors responsible for overextending credit may be the first to get paid out of each new paycheck, leaving creditors that charge relatively low rates holding the bag if the debtor becomes insolvent. Because creditors treat the write-off of bad debts as an expense, this cost is passed on to all customers in the form of higher prices.

Second, the widespread availability of emergency credit discourages savings. Between 1999 and 2003, Americans saved an average of only two percent of their disposable personal income as compared to 9.8% for the period between 1970 and 1984.⁵⁹ Personal savings rates have been decreasing steadily since 1984, regardless of the financial

Nearly one-fifth of payday loan customers have payment-to-income ratios above thirty percent. *Id.* at 45.

57 See George J. Wallace, *The Logic of Consumer Credit Reform*, 82 YALE L.J. 461, 472 (1973) (describing psychological consequences of defaulting on debt).

58 See Drysdale & Keest, *supra* note 9, at 664.

59 Bureau of Econ. Analysis, U.S. Dep't of Commerce, *The National Income and Product Accounts of the United States*, tbl.2.1, at <http://bea.gov/bea/dn/nipaweb/SelectTable.asp?Selected=N#S5> (last revised Feb. 25, 2005) (listing the average annual personal savings rates for each year since 1929). The two percent figure is an average

state of the economy, and hit a sixty-six-year low of one percent in 2004.⁶⁰ Meanwhile, the level of outstanding consumer debt in America has grown to \$9.7 trillion, which is more than double the level of debt carried ten years earlier and is not far behind the U.S. gross domestic product of \$11.6 trillion.⁶¹

Third, low savings rates coupled with high debt loads have played a significant role in the growing number of bankruptcies in this country. In 2003, more than 1.625 million Americans filed for bankruptcy, a seven-fold increase from the 259,160 that filed in 1980.⁶² This growth in bankruptcies is highly correlated to growth in consumer debt levels.⁶³ The greater an individual's debt-to-income ratio, the more dependent he becomes on steady income. Where a consumer has both small amounts of disposable income each month and low levels of savings, he has no buffer to protect himself from unexpected expenses or temporary income loss. A number of adverse events could push him into default. The consumer's high debt load would then make it difficult to recover as new bills continued to roll in. If the debtor resorts to bankruptcy or if lenders use the court systems to collect debt, society must pick up part of the tab in the form of salaries for the judges, administrators, enforcement officials, and clerical employees that run the courts.⁶⁴

of the following annual rates: 2.4% (1999), 2.3% (2000), 1.8% (2001), 2.0% (2002), and 1.4% (2003).

60 The personal savings rate as a percentage of disposable income was 10.8% in 1984 and one percent in 2004. *Id.*

61 Agnes T. Crane, *Consumers Play Key Role in Rates*, WALL ST. J., Sept. 17, 2004, at C5. This debt figure includes mortgage debt as well as consumer credit. *Id.*

62 Analytical Servs. Office, Admin. Office of U.S. Courts, *Judicial Facts and Figures*, tbl.5.2, at <http://www.uscourts.gov/judicialfactsfigures/table5.02.pdf> (last modified Mar. 2003).

63 See PAUL C. BISHOP, A TIME SERIES MODEL OF THE U.S. PERSONAL BANKRUPTCY RATE (Fed. Deposit Ins. Corp., Bank Trends No. 98-01, 1998), available at http://www.fdic.gov/bank/analytical/bank/bt_9801.pdf; DIANE ELLIS, THE EFFECT OF CONSUMER INTEREST RATE DEREGULATION ON CREDIT CARD VOLUMES, CHARGE-OFFS, AND THE PERSONAL BANKRUPTCY RATE 6-10 (Fed. Deposit Ins. Corp., Bank Trends No. 98-05, 1998) (discussing the relationship between rate deregulation, credit availability, and bankruptcy rates), available at http://www.fdic.gov/bank/analytical/bank/bt_9805.pdf; Elizabeth Warren, *The Bankruptcy Crisis*, 73 IND. L.J. 1079, 1080-83 (1998) (summarizing numerous studies that have found a high correlation between consumer debt and bankruptcy and explaining that "consumers' bankruptcies are rising because consumer debts are rising faster than their incomes").

64 See, e.g., KEEST & RENUART, *supra* note 5, at 63 (noting that restricting high-risk credit benefits "traditional lenders or investors who are harmed by the consumer bankruptcies caused by predatory lending"); Wallace, *supra* note 57, at 471.

Fourth, even where payday loan customers avoid defaulting on their loans, as most do, society may end up paying for items for which they failed to save. For instance, if individuals do not save money for retirement, this increases their reliance on Social Security. If they do not save for their children's education, there will be greater reliance on loans, scholarships, and government subsidies to send the next generation to college. If borrowers do not invest money in health insurance, hospitals will end up subsidizing their care and spreading the costs to others.

These societal costs provide a compelling justification for limiting the aggregate level of consumer debt in our society. Adoption of a floating interest rate ceiling would reduce credit availability and provide the dual benefits of protecting consumers from the debt trap and protecting society from the costs and destabilizing effects of high consumer debt loads.

C. The Welfare Drain Caused by Refund Anticipation Loans

Refund anticipation loans, like payday loans, impose significant costs on society. Although RALs do not present the danger that customers will become ensnared in a debt trap (because they are available only once a year), they have a significant, direct effect on the cost and effectiveness of government welfare programs.

The United States government uses tax refunds as an important vehicle for certain welfare payments. Although few people think of the tax system as providing welfare, the Internal Revenue Code is riddled with deductions and credits intended to promote social policies rather than accurately measure income.⁶⁵ Tax deductions based on social policies are named "tax expenditures" to reflect the fact that the government's choice to enact a new deduction or credit for specific taxpayers has a similar effect as other government expenditures—the government must either collect more in taxes from taxpayers as a whole, cut back on other government programs, or else allow the budget deficit to increase.⁶⁶ Because tax expenditures are prevalent, all Americans have a stake in ensuring that refunds reach taxpayers largely intact. If creditors capture \$100 of a tax refund by convincing taxpayers to purchase a RAL, this undermines the goals behind the credit or deduction that led to the refund and forces the general taxpayer population to fund the profits of RAL providers.

⁶⁵ ALAN GUNN & LARRY D. WARD, CASES, TEXT AND PROBLEMS ON FEDERAL INCOME TAXATION 165–66 (5th ed. 2002).

⁶⁶ *Id.* at 165.

The case of the Earned Income Tax Credit (EITC) illustrates how RALs drain government funds from their intended beneficiaries. Approximately forty percent of RAL customers are recipients of the EITC,⁶⁷ a refundable credit designed to raise children and their parents out of poverty while rewarding work rather than dependence on welfare.⁶⁸ Because the credit is refundable, taxpayers can receive the full amount even if their tax liability has already been reduced to zero. In tax year 2000, the program distributed nearly thirty-one billion dollars to low-income workers, which is roughly equivalent to the amount spent on food stamps and Temporary Assistance to Needy Families combined.⁶⁹ The average EITC recipient received a credit of \$1700 in 2002,⁷⁰ which would cost approximately seventy-five dollars in loan fees to receive as a RAL.⁷¹ It is estimated that approximately \$363 million was drained out of the EITC program in 2002 by RAL loan fees alone, not counting e-filing or administrative fees.⁷²

D. *A Lack of Socially Redeeming Value*

The previous three sections have outlined the harm caused by short-term, high-rate credit. This section considers the value provided by this credit, and demonstrates that despite the immense popularity of these loans they provide minimal economic value to debtors. Because payday loans last only two weeks and RALs only one week, consumers cannot rationally use these loans for investment purposes.⁷³ Their role is limited to the avoidance of other costs, such as late payment fees, bounced check fees (charged by both the bank and merchant), damage to the consumer's credit history from default (which may increase the cost of credit in the future), and the opportu-

67 NAT'L CONSUMER LAW CTR. & CONSUMER FED'N OF AM., *TAX PREPARERS PEDDLE HIGH PRICED TAX REFUND LOANS: MILLIONS FROM THE WORKING POOR AND THE U.S. TREASURY* 5-6 (2002) [hereinafter CFA REPORT 2002].

68 ALAN BERUBE, BROOKINGS INST., *REWARDING WORK THROUGH THE TAX CODE: THE POWER AND POTENTIAL OF THE EARNED INCOME TAX CREDIT IN 27 CITIES AND RURAL AREAS* 2 (2003), available at <http://www.brookings.org/dybdocroot/es/urban/publications/berubetaxcode.pdf>.

69 *Id.* at 1-2.

70 *Id.* at 2.

71 See *supra* Table 1.

72 BERUBE, *supra* note 68, at 2.

73 Using loans to finance investments is only rational if the expected return on investment exceeds the cost of funds (i.e., interest rate), which averages 470% APR for payday loans. The presence of such a stellar investment is highly doubtful. The average rate of return in the stock market between 1950 and 1992 was only 12.3%. See Lynn Asinof, *Double-Digit Returns May Be Tougher to Find*, WALL ST. J., July 27, 1992, at C1.

nity cost of missing work due to a broken vehicle. Expenses such as these that can be avoided by taking out a loan occasionally exceed the fees for a two-week loan, making payday loans seem like a rational choice. The value provided by these loans is actually very low, however, for three reasons.

First, a payday loan only seems economically rational when evaluated using an incredibly narrow time frame, which ignores the irrational consumer behavior or economic factors that led to the credit emergency in the first place. If a consumer does not write an insufficient funds check, he will not face bounced check fees, even if he is unable to pay his bills. The decision not to save any money or keep an available credit line in case of emergencies is itself an unwise choice. If the option of a payday loan were eliminated, consumers could adjust their behavior so that the option immediately before payday loans (e.g., maxing out their credit cards or asking family members for loans) would become their new "option of last resort." Admittedly, building up a rainy day fund or asking friends for money may not be realistic options for the poorest consumers. Yet any consumer that finds it impossible to save money due to economic and social factors will find it equally impossible to pay back a payday loan with interest.

Second, the economic rationality of payday loans typically relies on them being paid off within two weeks. A consumer who overestimates his ability to repay on time has effectively traded in debt that came due once a month (the typical billing cycle for credit cards and utilities) for debt that comes due twice as often *and* charges rates twenty-times higher. If the debtor defaults on the payday loan, he will likely be hit with bounced check fees when the lender sends the borrower's check through the payment system at the end of the loan period, making these loans even riskier.

Third, a consumer that does not have other *credit* options in the short term may still have other options. Most consumers are less than two weeks from their next payday when they take out a loan (this is certainly true if they get paid every two weeks), so that they only need to delay expenses for a few days. In the case of a car repair, the consumer could take public transit or ask for a ride from friends. A consumer faced with multiple bills can choose not to pay the ones that have low late payment fees or default consequences until his next payday. Calling creditors to work out a payment plan or asking friends or community groups for help may also be an option. These options will be limited if the debtor has already used the above tactics in past months and is now overdue on most bills. However, such behavior itself calls into question the ability of the consumer to pay off a short-term loan without getting trapped. If the consumer were capable of

straightening out his finances in two weeks, why would he have not already done so?

The value of RALs is even more limited. Even though RALs can be just as expensive as payday loans, they are used by one-third of all taxpayers having their returns professionally prepared. It is doubtful that each of these taxpayers would have sought out a payday loan if his last W-2 or Form 1099 had not happened to arrive in the mail that week.⁷⁴ Even if they had, it is unlikely the loan sought would have been as large as the taxpayer's refund. The fact that such a large number of taxpayers take out loans at last-resort triple-digit rates, when they are not actually faced with an emergency, strongly suggests these consumers do not understand a RAL's true cost.

RALs ostensibly provide two benefits to taxpayers. First, they allow taxpayers to receive their refund one week early. This benefit is overshadowed by the high cost of the loan and the fact that the taxpayer has already been waiting a year to receive his refund. Second, RALs eliminate the need for taxpayers to save money for preparation fees prior to filing. Even without taking out a RAL, however, taxpayers need not save. They need only be capable of parting with \$100 for one week. A taxpayer who is broke can wait until his next payday to pay preparation fees and have his refund back in time to pay end-of-period expenses. Alternatively, low-income taxpayers can take advantage of Free File⁷⁵ or the Volunteer Income Tax Assistance Program (VITA),⁷⁶ both of which provide free tax preparation.

The prior paragraph focused on the benefits of RALs to the borrower. However, RALs also provide benefits to professional tax preparers such as attracting customers and guaranteeing prompt payment for services. The fact that preparers benefit from RALs makes the loan administrative fees they charge borrowers and the helper's

74 A taxpayer cannot file a return until he receives a W-2, which summarizes earnings and withholdings, from each employer who he worked for during the prior year. If the taxpayer earned interest or dividends or received governmental payments such as social security, he must also wait for Form 1099s from each of the sources of this income. These tax documents (i.e., W-2s and 1099s) must be attached to the taxpayer's return at the time of filing.

75 Free File is a program sponsored through the IRS website that provides free online tax preparation and e-filing for up to sixty percent of taxpayers. See Internal Revenue Serv., Dep't of the Treasury, *Free File Help Center & Frequently Asked Questions: Who Is Eligible for Free File?*, at http://www.irs.gov/efile/article/0,,id=118993,00.html#basics_3 (last visited Jan. 30, 2005).

76 VITA is a program in which local volunteers provide free tax advice to individuals with incomes below \$36,000. See Internal Revenue Serv., Dep't of the Treasury, *VITA and TCE*, at <http://www.irs.gov/individuals/article/0,,id=119845,00.html> (last visited Mar. 28, 2005).

fee they receive from the lender (which gets built into the loan fee charged to borrowers) seem even more unreasonable.⁷⁷ It also suggests that a usury law that limited RAL fees to rates below what is currently charged would not necessarily have a substantial impact on loan availability. Preparers may be willing to waive a portion of the fees they currently receive in order to preserve the other benefits they receive from RALs.

In summary, the benefits provided to consumers by payday loans and RALs are minimal, while the cost and risk of such loans is high. At first glance, this conclusion appears to contradict fundamental principles of market theory. If these loans fail to provide value beyond their cost, why are they so popular? One explanation is that these loans create negative externalities—costs borne by society rather than the parties who choose how much credit to supply and demand. Further explanations are explored in the next Part, which details the ways in which the fringe credit market differs from the idealized free market.

III. WHY THE PAYDAY LOAN MARKET DIFFERS SIGNIFICANTLY FROM THE IDEALIZED FREE MARKET

A. *Vulnerable Clientele*

1. The Role of Duress and Secrecy in Driving Up Prices

Consumers in the fringe credit market are united by a common trait—they desperately need or want cash and believe they have no suitable alternatives. Currently, the average payday loan carries an interest rate thirty times higher than the average credit card rate.⁷⁸ The rates for RALs are five to fifty times higher than those charged for credit cards.⁷⁹ Individuals who are willing to pay such a high premium for fringe credit either (1) do not fully understand the cost and risk of this credit as it compares to their alternatives or (2) do not

77 See *infra* Part III.C.2 for an explanation of why the fees charged for RALs are not justified by risk or transaction costs.

78 See Ruth Simon & Jennifer Saranow, *Credit Cards Start to Bump Up Rates*, WALL ST. J., Oct. 6, 2004, at D2 (reporting that the average rate charged for credit cards with variable rates at the end of 2003 was 13.86%). In contrast, the average payday loan fee corresponds to a rate of 470%. See CFA/PIRG REPORT 2001, *supra* note 13, at 4.

79 See Wu & Fox, *supra* note 30, at 2 (reporting that RAL fees correspond to APRs between seventy percent and 700%); Simon & Saranow, *supra* note 78 (reporting an average credit card rate of 13.86%).

have any alternatives. The majority of fringe credit customers appear to fall into the first category,⁸⁰ but the latter is worth examining.

One of the primary ways that fringe creditors compete successfully with the mainstream credit market is by exhibiting greater risk tolerance than other lenders. Payday lenders advertise that a job and a checking account are all that is needed to obtain same-day cash, which attracts customers who have bad credit histories or few assets to offer as collateral. However, it also attracts consumers who actively participate in the mainstream market⁸¹ but who turn to payday loans when unexpected expenses arise after they have exhausted their savings and credit card limits.⁸² Because these customers have nowhere else to turn, they are extremely vulnerable to price gouging.

Opportunities for price gouging are accentuated by payday borrowers' common desire for privacy. Consumers may be embarrassed by their financial problems, especially if these problems stem from unwise investments or purchases. The unexpected expenses that the consumer faces may be attributable to an addiction, marital difficulty, or other underlying problem that the individual wants to keep confidential. Consumers are willing to pay a substantial premium to avoid asking friends or family members for a loan or going to a government or charitable agency for help. Individuals may also be reluctant to cut expenditures that would signal to their friends or colleagues that they are in financial trouble, which further fuels demand for payday loans.

Although consumers obviously value the confidentiality offered by payday loans, this attribute of the market presents three problems. First, it suppresses the exchange of information regarding prices, creditor reputations, and alternatives to the fringe market. Potential borrowers concerned about privacy are unlikely to ask their friends for advice on where to get a good price on emergency credit. Furthermore, borrowers cannot share complaints about a creditor without admitting they took out a loan. A consumer who was already embarrassed about his financial problems may become even more so if he feels he "should have known better" than to agree to bad loan

80 See *infra* Part III.B.2.

81 Ninety-two percent of payday loan customers had at least one consumer loan outstanding (e.g., a home mortgage, auto loan, product payment plan, or credit card) at the time they took out their payday loan. See ELLIEHAUSEN & LAWRENCE, *supra* note 14, at 42.

82 Although fifty-seven percent of payday loan customers surveyed by the CRC had bank credit cards, only six percent considered using them as an alternative to a payday loan, which suggests that these consumers either did not understand the rate difference between these options or had no open credit remaining on their credit cards. See *id.* at 42, 50.

terms. Borrowers may be more comfortable discussing credit issues if their friends and family regularly use fringe credit. Unfortunately, this creates a problem of its own: if none of the borrower's acquaintances are financially savvy, he may never have been exposed to good credit terms, making it difficult to recognize bad ones.⁸³

Second, creditors can discourage comparison shopping by structuring the loan process in a manner that capitalizes on customers' desire for privacy. Many payday lenders phone the bosses or human resource managers of first-time applicants to verify employment.⁸⁴ Often this verification occurs before debtors are shown TILA disclosures for a loan.⁸⁵ Debtors have a strong incentive not to shop between lenders because they want to avoid the embarrassment and potential job instability that could result from their boss receiving multiple phone calls in a short time period.⁸⁶

Third, hiding problems does not make them go away. Many of the underlying problems that lead debtors to resort to payday loans are not one-time events that can be resolved in two weeks. The money that an individual devotes to hiding his problems (i.e., payday loan fees) is money that is not available for solving them. If a debtor cannot afford to continue paying rollover fees or bumps up against statutory renewal limits, he will be forced into default and will have to ask for the help he had been avoiding. If default occurs in the first twelve weeks, the payday lender will suffer a loss on the account. However, if the debtor continues to make payments for at least twelve weeks before defaulting, the payday lender will break even and any additional profits he makes will come at the expense of the entity that eventually bails the debtor out.

2. The Role of Rate Regulation in Protecting Consumers from Unconscionable Bargains

The prior section demonstrated that consumers in the fringe credit industry are vulnerable to price gouging and unconscionable creditor conduct. Rate regulation plays a valuable and necessary role in deterring such conduct. Although much of this Note focuses on

83 See Christopher L. Peterson, *Truth, Understanding, and High-Cost Consumer Credit: The Historical Context of the Truth in Lending Act*, 55 FLA. L. REV. 807, 897 (2003) ("[A]ll reliable shopping information must at some point be obtained on a first hand basis. If virtually no one in a family or neighborhood has access to reliable and effective shopping information, then there is no basis for an effective informal word of mouth shopping process to begin.").

84 *Id.* at 895.

85 *Id.*

86 *Id.* at 896.

averages, these averages pale in comparison to the highest payday loan fees charged in practice. For instance, the highest rate charged in Missouri for the one-year period ending September 30, 2004, was 1278%.⁸⁷ While there are limits to what customers will agree to and to what they will actually pay before defaulting, those limits are much higher than one may initially expect. One out of ten customers surveyed by the CRC had continuously rolled over a loan for at least fourteen weeks, which means they paid more in interest than they received from the loan. A number of customers have paid triple the amount of their original loan and still had property seized by predatory lenders after they default.⁸⁸

Although the unconscionability and fraud doctrines should theoretically prevent egregious loans, there are two benefits to using rate regulation as a substitute or supplement to these doctrines. First, federal rate regulation could reduce litigation costs by providing a bright line rule of what rates are acceptable.⁸⁹ As long as the rule remains "whatever the parties agree to," there are bound to be loans that shock the conscience and motivate consumer advocates to litigate. Rate regulation would reduce the need for such protective litigation and make it easier to dispose of cases once they arise.

Second, rate regulation is warranted because the fraud and unconscionability doctrines provide little actual protection. These doctrines place the cost and burden of enforcement on the very people that are least able to afford litigation or understand their legal rights. Consumer loans involve such small amounts that bringing these cases on an individual basis is cost prohibitive. Even if attorneys were willing to work for free, the damage award for an individual case would have minimal deterrent effect. Therefore, enforcement depends entirely on government regulators and class actions.

Unfortunately, the ability of class actions to deter unconscionable and fraudulent conduct is declining due to the increased use of mandatory arbitration clauses that prohibit class treatment.⁹⁰ The Federal Arbitration Act requires courts to enforce arbitration clauses

87 Letter from D. Eric McClure, Commissioner of Finance, State of Missouri, to Matt Blunt, Governor, State of Missouri 2 (Jan. 18, 2005), available at <http://www.missouri-finance.org/pdfs/survey.pdf>.

88 See Drysdale & Keest, *supra* note 9, at 606–07 (summarizing six egregious cases that made headlines).

89 See KEEST & RENUART, *supra* note 5, at 64.

90 See Marjorie Wengert, Annotation, *Cause of Action Against Payday Loan Creditors for Violating Disclosure Requirements of the Federal Truth in Lending Act*, 26 CAUSES OF ACTION 2D 409, § 36, at 473 (2004).

according to their terms,⁹¹ even if the clause is part of an adhesion contract, unless they find the arbitration clause itself void “upon such grounds as exist at law or in equity for the revocation of any contract”⁹² (e.g., fraudulent inducement or unconscionability). If the arbitration clause itself is not found to be unconscionable, a consumer’s claim that other provisions of the contract are unconscionable must be decided in accordance with the procedures set forth in the arbitration agreement (e.g., no class arbitration).⁹³ Where an arbitration agreement is silent on the issue of class arbitration, the arbitrator is responsible for determining what the parties intended.⁹⁴ Statutory claims are not exempt from arbitration unless the plaintiff can show that Congress intended to create an unwaivable right to a judicial forum⁹⁵ or that the terms of the arbitration clause would prevent the plaintiff from vindicating her statutory rights.⁹⁶ The majority of courts have held that Congress did not intend to grant consumers an unwaivable right to bring TILA claims as a class and that collective action is not necessary for a consumer to vindicate her rights.⁹⁷ The Ninth Circuit stands alone in its willingness to invalidate clauses that

91 See 9 U.S.C. § 4 (2000) (“A party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration may petition . . . for an order directing that such arbitration proceed in the manner *provided for in such agreement.*” (emphasis added)).

92 *Id.* § 2.

93 See *Prima Paint Corp. v. Hood & Conklin Mfg. Co.*, 388 U.S. 395, 406 (1967).

94 *Green Tree Fin. Corp. v. Bazzle*, 539 U.S. 444, 452 (2003) (plurality opinion).

95 See *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 628 (1985) (“Having made the bargain to arbitrate, the party should be held to it unless Congress itself has evinced an intention to preclude a waiver of judicial remedies for the statutory rights at issue.”).

96 See *id.* (“By agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum.”); see also *Green Tree Fin. Corp. v. Randolph*, 531 U.S. 79, 90–92 (2000) (finding that large arbitration costs could preclude a litigant from vindicating her statutory rights, but requiring proof that such costs were likely to be incurred).

97 See *Randolph v. Green Tree Fin. Corp.*, 244 F.3d 814, 818 (11th Cir. 2001) (holding that arbitration is not “inherently inconsistent” with the TILA enforcement scheme”); *Bowen v. First Family Fin. Servs., Inc.*, 233 F.3d 1331, 1338 (11th Cir. 2000) (noting that “the legislative history of § 1640 shows that Congress thought class actions were a significant means of achieving compliance with the TILA” but holding that Congress did not intend to “confer upon individuals a non-waivable right to pursue a class action”); *Johnson v. West Suburban Bank*, 225 F.3d 366, 370–78 (3d Cir. 2000) (same).

ban class arbitration in consumer contracts on the basis of unconscionability.⁹⁸

Even if not barred by the loan contract, class actions are often inappropriate because of the fact-specific nature of unconscionability and fraud claims. The presence of substantive unconscionability in the form of outrageous rates is not sufficient for recovery.⁹⁹ Plaintiffs must also prove procedural unconscionability, such as a disparity in education levels coupled with deceptive or heavy-handed sales tactics. Unless these unconscionable procedures were uniformly applied to customers, borrowers will have difficulty obtaining class certification.

B. Imperfect Information in the Fringe Market: Why TILA Disclosure Does Not Work

Economic models of the free market assume that consumers have knowledge of the alternatives available to them as well as the full costs and benefits of these alternatives, allowing them to choose the option that they believe maximizes their self-interest.¹⁰⁰ But the reality of the fringe credit market contrasts sharply with this assumption. Congress attempted to improve consumer access to accurate information in 1968 when it passed TILA.¹⁰¹ Twelve years later it tried again, substantially revising TILA in response to the widespread belief that the first version caused information overload and was ineffective.¹⁰² Unfortunately, current disclosure requirements remain ineffective for two

98 See Wengert, *supra* note 90, § 39 (describing California's approach to class arbitration); see also *Ting v. AT&T*, 319 F.3d 1126, 1150 (9th Cir. 2003) (finding an arbitration clause that prohibited class arbitration unconscionable, reasoning that the clause was one sided despite its technical applicability to both parties because AT&T would never have reason to sue its customers as a class). The *Ting* court also struck down a confidentiality clause because it unfairly favored the "repeat player" and prevented consumers from building a case of intentional misconduct. *Id.* at 1151–52.

99 See *Iberia Credit Bureau, Inc. v. Cingular Wireless LLC*, 379 F.3d 159, 167 (5th Cir. 2004) (noting that "a provision must possess features of both adhesionary formation and unduly harsh substance" in order to be invalidated for unconscionability).

100 See Robin A. Morris, *Consumer Debt and Usury: A New Rationale for Usury*, 15 PEPP. L. REV. 151, 156 (1988) (explaining that free market theorists believe that the bargaining dialogue between lenders and borrowers will lead to "the price and amount of credit that is in the individuals' and society's best interests," but criticizing this theory because it "presumes equal aptitude, intelligence, information, and vigor on the parts of both borrower and lender").

101 Truth in Lending Act, Pub. L. No. 90-321, 82 Stat. 146 (1968) (codified as amended at 15 U.S.C. §§ 1601–1677 (2000)); see Regulation Z, 12 C.F.R. § 226 (2004).

102 Truth in Lending Simplification and Reform Act (Depository Institutions Derogulation & Monetary Control Act of 1980), Pub. L. No. 96-221, 94 Stat. 168 (1980) (codified at 15 U.S.C. §§ 1601–1646 (2000)).

main reasons. First, information is not made available sufficiently early to be useful. Second, disclosure is made in terms that the majority of consumers do not understand. In particular, the APR—the centerpiece of TILA disclosures—is ignored or misunderstood by the majority of consumers.

1. Too Little, Too Late

The disclosures required by TILA come too late in the process to facilitate comparison shopping. In the absence of customer inquiry, TILA does not require any disclosure until immediately before the loan document is signed. By that time, a consumer looking for a payday loan will have invested time and money in getting to the store, visiting with a clerk, and filling out an application. The transportation and opportunity costs of repeating this process for multiple stores would likely exceed the fees saved by comparison shopping. Even if a consumer wished to continue shopping after seeing the first disclosure, he may not have time to do so. Payday loans are designed for emergency expenses that the borrower believes cannot wait for the next payday, and the consumer likely spends the bulk of his day at work.

The anticompetitive effect of delayed disclosure is more pronounced in the market for RALs. Traditionally, RALs were advertised as “rapid refunds” or “money now,” not as loans. Providers are now legally required to describe these products as loans in their advertisements,¹⁰³ but it is unclear whether this message reaches consumers.¹⁰⁴ Because lenders are not required to give any indication of a RAL’s cost in advertisements, customers typically remain unaware of the amount (or even the existence) of loan fees until after their tax returns are substantially completed. If a customer dislikes what he sees in the disclosures, he can choose not to apply for the RAL. However, he cannot file the return or take it to a competing RAL provider for a cost comparison until after he pays the tax preparation fees that were incurred prior to disclosure. Unfortunately, a major reason that customers take out RALs in the first place is that they have not saved

103 See INTERNAL REVENUE SERV., DEP’T OF THE TREASURY, PUB. NO. 1345, HANDBOOK FOR AUTHORIZED IRS E-FILE PROVIDERS OF INDIVIDUAL INCOME TAX RETURNS 74–75 (2000), available at <http://www.irs.gov/pub/irs-utl/pub1345.pdf>.

104 A 1996 study found that half of taxpayers did not know that they had taken out a loan even after they had signed the documents. See CFA REPORT 2002, *supra* note 67, at 22. This study was conducted before RAL providers began advertising RALs as loans. The current state of consumer awareness is unknown.

money to pay these fees in advance and wish to have them deducted from their refund (i.e., rolled into the loan).

An additional obstacle to comparison shopping is that RAL providers generally require borrowers to e-file and to instruct the IRS to deposit their refund directly with the lender as repayment. Preparers typically waive e-filing fees for returns they prepare. However, a customer who walks away with his return in paper format in search of better RAL terms would likely have to pay this e-filing fee to any competing RAL provider. This additional e-filing fee likely counteracts any savings in RAL fees, making the attempt to compare TILA disclosures unprofitable.

2. "Meaningful Disclosure" in a Financially Illiterate Nation

The second major problem with disclosure as a substitute for rate regulation and other consumer protections is that it assumes that consumers will understand the disclosure they are given. In this respect, the required disclosures for financial products differ significantly from those required for tangible products. Manufacturers and distributors of tangible products are held strictly liable for failure to warn consumers of dangers presented by a product that are not obvious to the average consumer.¹⁰⁵ Even dangers from misuse of products must be disclosed if the misuse is foreseeable.¹⁰⁶ Most importantly, manufacturers must design warnings so that they will reach and be *understood* by the consumer. In contrast, the products marketed by creditors need only make those disclosures specifically required by TILA, which fail to take into account the level of financial sophistication of the typical borrower.

The two most important price disclosures required by TILA are the finance charge and the APR.¹⁰⁷ The finance charge is "the sum of all charges, payable directly or indirectly by the person to whom the credit is extended, and imposed directly or indirectly by the creditor

105 See Robin Cheryl Miller, Annotation, *Cause of Action in Strict Tort Liability for Failure to Warn of Danger in Use of Product*, 29 CAUSES OF ACTION § 6, at 20–21 (2004). Courts generally apply one of three tests to determine if a defendant had a duty to warn consumers of a specific danger. A duty to warn may arise where (1) a product is "dangerous to an extent beyond that which would be contemplated by the ordinary consumer of the product possessing the knowledge common to the community of such consumers," (2) the danger presented by the product was not "open and obvious," or (3) the product is unreasonably dangerous in light of all relevant factors, including the obviousness of the danger. *Id.* The first test is derived from RESTATEMENT (SECOND) OF TORTS § 402(a) cmt. i (1965).

106 See Miller, *supra* note 105, § 7, at 32.

107 Peterson, *supra* note 83, at 880.

as an incident to the extension of credit.”¹⁰⁸ The finance charge includes interest and most of the fees necessary to obtaining the loan, but does not include avoidable fees such as those for late payment.¹⁰⁹

The APR is “a measure of the cost of credit, expressed as a yearly rate, that relates the amount and timing of [money] received by the consumer to the amount and timing of payments made.”¹¹⁰ In many respects, the APR is the centerpiece of TILA disclosures. TILA specifically requires that when advertising the rate of a finance charge¹¹¹ or “responding orally to any inquiry about the cost of credit, a creditor, regardless of the method used to compute finance charges, shall state rates only in terms of the annual percentage rate.”¹¹² Similarly, no advertisement may state the dollar amount of a finance charge without including the APR and the terms of repayment.¹¹³

Despite the prominent role of the APR in TILA disclosures, most consumers do not understand the significance of this credit term or even take note of it. A nationwide study sponsored by the Consumer Federation of America found that thirty percent of Americans did not know what the letters APR stand for, and sixty-three percent did not realize that this rate was the primary indicator of a loan’s cost.¹¹⁴ An earlier study targeted at college students found that seventy-eight percent of college juniors and seniors did not understand how to use the APR to make price comparisons.¹¹⁵ A CRC survey of payday loan customers confirms that borrowers often ignore or misunderstand APR disclosures. The study found that although seventy-eight percent of customers remembered being told an APR, only twenty percent were willing to venture a guess as to what it was.¹¹⁶ Of the customers providing an answer, forty-one percent believed they had paid a rate below thirty percent APR.¹¹⁷ This suggests that consumers confuse the

108 15 U.S.C. § 1605(a) (2000).

109 See 12 C.F.R. § 226.4(c)(1) (2004) (listing fees that need not be included in the finance charge, including “[a]pplication fees charged to all applicants for credit, whether or not credit is actually extended”).

110 *Id.* § 226.22(a)(1).

111 15 U.S.C. § 1664(c).

112 *Id.* § 1665a. In limited circumstances (inapplicable to payday loans and RALs), TILA allows disclosure of a “periodic rate” or “simple annual rate” in addition to the APR. *Id.*

113 *Id.* § 1664(d).

114 See Drysdale & Keest, *supra* note 9, at 662 n.441.

115 *Kiddie Credit Cards: Hearings Before the Subcomm. on Consumer Credit and Ins. of the House Comm. on Banking, Fin., and Urban Affairs*, 103d Cong. 40 (1994) (statement of Ruth Susswein, Executive Dir., Bankcard Holders of Am.).

116 ELLIEHAUSEN & LAWRENCE, *supra* note 14, at 49.

117 *Id.*

APR and the add-on rates (e.g., fifteen dollars per \$100 for two weeks)¹¹⁸ and may explain why consumers do not balk at the idea of paying rates twenty times higher than their credit cards. The consumers may wrongly believe that payday loans are only ten percentage points higher than credit card rates.

In contrast to the minimal awareness of APRs, ninety-six percent of customers surveyed by the CRC could recall the finance charge they paid.¹¹⁹ The finance charge is more memorable because it resembles the price tags the consumer is accustomed to seeing. Consumers know how to compare a forty-five-dollar loan fee against a thirty-dollar late fee. They are less likely to know how to use a loan's APR to make comparisons. How much more expensive is it to borrow \$300 for two weeks at a 500% APR instead of a twenty-five percent APR? The answer is approximately fifty-five dollars,¹²⁰ but it is an answer that the average consumer cannot calculate. The credit industry's attitude towards APR disclosure also makes it likely that the importance of the APR is downplayed in discussions between lenders and customers.

If consumers are aware of the finance charge, then why does it matter that they do not understand APR disclosure? The APR performs two vital roles that the finance charge, standing alone, cannot. First, it facilitates price comparisons. Second, it provides information on the cost of the loan if it does extend beyond the initial finance period, a common occurrence for payday loans.

The primary purpose of disclosing APRs is to provide a standardized price tag that allows consumers to compare their options.¹²¹ A payday loan with a 480% APR really is nineteen times more expensive than a credit card loan with a twenty-five percent APR and sixty times more expensive than a home loan with an eight percent APR. Where a loan is both small and short term, the finance charge that corresponds to a 480% APR may seem reasonable (e.g., thirty-seven dollars for a two-week \$200 loan with a 480% APR).¹²² But the finance charge on a credit card would be cheap in comparison (e.g., two dollars).¹²³ Furthermore, if the consumer paid his credit card bill in full each month, this two-week loan would fall within his grace period and

118 *Id.*

119 *Id.* at 48.

120 The answer derives from the following formula:

$$\$300 \times 500\% \text{ APR} \times 14/365 \text{ days} = \$57.53.$$

$$\$300 \times 25\% \text{ APR} \times 14/365 \text{ days} = \$2.88.$$

$$\$57.53 - \$2.88 = \$54.66.$$

121 See Drysdale & Keest, *supra* note 9, at 603.

122 $\$200 \times 480\% \text{ APR} \times 14/365 \text{ days} = \$36.82.$

123 $\$200 \times 25\% \text{ APR} \times 14/365 \text{ days} = \$1.92.$

would cost him nothing. Worse yet, this thirty-five dollar difference compounds every two weeks so that a \$200 payday loan that is rolled over twice will cost the debtor \$105 more than if he had used his credit card. Although savings or credit cards may not be an option in the short term, a consumer who understood how to make the above comparisons would have a strong incentive to keep an open line of credit in the future so that he would never again have to take out a payday loan.

The second important function of the APR is to signal the risk to the consumer of misjudging his ability to repay the loan within the finance period. A consumer who takes out a high-rate short-term loan may genuinely believe that he will be able to pay off the entire loan in two weeks so that the cost of the loan will be limited to the stated finance charge. However, there is always a risk that the consumer's judgment about his ability to repay is wrong. The consumer may miscalculate his budget or be confronted with additional emergency expenses the next week. Late fees, bounced check fees, and the continued accrual of interest are the price that a consumer pays for being wrong. The higher the APR, the greater the consequences of the continued accrual of interest that results from delayed repayment. Where a rational consumer realizes that there is a risk of default, the consequences of default should factor into his cost-benefit analysis. Because customers currently pay little attention to the APR as a signal of the risk and consequences of default, they have a tendency to demand more high-rate credit than they otherwise would.

The fact that consumers currently do not understand the risk of payday loans is underscored by the fact that some consumers purposely choose these loans over other available credit sources. Only 6.4% of payday loan customers responding to a CRC survey listed the absence of all other alternatives as their primary reason for taking out a payday loan.¹²⁴ According to a payday loan trade group, one reason stated by customers for preferring payday loans despite their higher cost is that these loans "discipline the consumer to make immediate repayment," saving them from the burden of overwhelming credit card debt.¹²⁵ Allegedly, a few consumers even take out payday loans despite having liquid assets because they fear they would not have the discipline to replenish their savings once depleted.¹²⁶ If these industry claims are true, then the same consumers who appreciate the "re-

124 See ELLIEHAUSEN & LAWRENCE, *supra* note 14, at 51 tbl.5-23.

125 NAT'L CHECK CASHERS ASS'N, *supra* note 23, pt. II.

126 See ELLIEHAUSEN & LAWRENCE, *supra* note 14, at 16.

payment discipline" imposed by payday loans should also appreciate governmental regulation.¹²⁷

The average consumer shows little understanding of the terms used in TILA disclosures, which contributes to his misunderstanding of the true cost and risks of various credit options. This lack of consumer awareness makes it unlikely that borrowers are purchasing the optimal amount or type of credit necessary to maximize their well-being.¹²⁸ I propose three potential solutions to this problem: (1) financial education, (2) better disclosure, and (3) rate regulation.

Our nation is in desperate need of financial education. Currently, only four states require students to complete a course that covers personal finance before graduating from high school.¹²⁹ In a 2004 study sponsored by the Jump\$tart Coalition for Personal Financial Literacy, most high school seniors failed a financial literacy test, answering only half of the questions correctly.¹³⁰ Jump\$tart has administered variations of this exam four times since 1998 with similar results.¹³¹ The combination of widespread financial ignorance and a rapidly growing, largely unregulated credit market presents a dangerous mix.

Although financial education has the potential to improve understanding of current disclosures, its effectiveness is limited. First, soci-

127 Nearly three-fourths of payday loan customers surveyed by the CRC agreed "the government should limit interest rates even if the limitations caused fewer consumers to be able to get credit." *Id.* at 35.

128 See Peterson, *supra* note 83, at 883 ("Without accurate information about the quality and especially the price of any good, no person can minimize their opportunity costs, since they cannot compare the value of that product to their next best option.").

129 NAT'L COUNCIL ON ECON. EDUC., SURVEY OF THE STATES: ECONOMIC AND PERSONAL FINANCE EDUCATION IN OUR NATION'S SCHOOLS IN 2002, at 4 (2002), available at <http://www.jumpstartcoalition.com/upload/NCEE2003.pdf>. The four states requiring financial education are Idaho, Illinois, Kentucky and New York. *Id.*

130 See News Release, Kristy Thomas, Jump\$tart Coalition for Personal Financial Literacy, Financial Literacy Improves Among Nation's High School Students 1 (Apr. 1, 2004), available at [http://www.jumpstart.org/fileuptemp/FINAL_PR_Jump\\$tart_2004_Survey.doc](http://www.jumpstart.org/fileuptemp/FINAL_PR_Jump$tart_2004_Survey.doc). The exam was administered to 4074 students in 215 schools across the nation, *id.* at 2, and included thirty-one questions on the topics of income, money management, saving and investment, and credit and spending. The exam and answers can be accessed at <http://www.jumpstartcoalition.com/upload/2004%20Survey%20with%20answers.pdf> (last visited Apr. 1, 2005).

131 Contrary to the title of the Jump\$tart news release, test results were five percent lower than when the survey was first conducted in 1997 and had only improved 0.3% over the prior year. See LEWIS MANDELL, JUMP\$TART COALITION FOR PERS. FIN. LITERACY, OUR VULNERABLE YOUTH: THE FINANCIAL LITERACY OF AMERICAN 12TH GRADERS 9 (1998).

ety may not have an opportunity to educate everyone who needs the information. Second, not all consumers who currently lack the skills necessary to analyze TILA disclosures have the capacity and aptitude to develop them.¹³² Converting dollars to percentages and back again may present a challenge, especially when rates are subject to change (e.g., introductory teaser rates, penalty rates). In addition to considering the finance charge and APR, consumers must determine the relative importance of the minimum finance charges, late fees, insufficient fund fees, and over-limit fees, and then factor these into their rate analysis.

A second alternative is to improve disclosure. If fringe creditors were required to make disclosures that would pass muster under products liability law, these disclosures would look far different than TILA currently requires. Imagine a hazard sign followed by the message:

WARNING! Intended for emergency use only. Consult other creditors before signing. CAUTION! Over half of customers at this store had three or more rollovers last year, costing them a minimum of \$60 for each \$100 borrowed.¹³³

While I do not suggest that products liability law actually be extended to financial products, I believe legislators should take a lesson from this body of law in designing disclosures. The timing of disclosures must also be improved if they are to be effective. One option would be to require creditors to include price disclosures in all advertisements, or to have a state-sponsored website where consumers could access the price information and disclosures for all licensed lenders.

Although relying upon disclosure coupled with education to protect consumers has an intuitive appeal, there are several weaknesses in this approach. First, too much disclosure will be ignored, and no amount of disclosure will help those in duress (i.e., those who are faced with an emergency and no credit alternatives). Second, lenders can use oral statements to undermine written disclosures. It is easier to police the terms of a loan than the conversations between lenders and customers. Third, disclosure may have little effect in counteracting the strong consumer desire for immediate consumption, which is

132 See Morris, *supra* note 100, at 173 ("Incapacitation may also cause the borrower to misestimate risks in the credit bargaining process. Providing information will not help borrowers who are unable to participate in the bargaining process . . .").

133 See ELLIEHAUSEN & LAWRENCE, *supra* note 14, at 39 tbl.5-11 (showing that 53.7% of customers surveyed had three or more rollovers).

reinforced daily by countless advertisements.¹³⁴ For these reasons, rate regulation is necessary for full protection.

In recent years, the ability of private individuals to aid in the enforcement of TILA through class actions has declined due to the increased use of mandatory arbitration clauses that prohibit class actions.¹³⁵ If Congress is going to continue to rely on disclosure as its primary mode of consumer protection, it should seriously consider amending TILA to specify that the right to class action is unwaivable to facilitate actions by private attorneys general.

C. Why the Market Will Not Correct Itself: Obstacles to Competition in the Fringe Credit Market

1. Incentives to Avoid Price Competition

Theoretically, interest rates will drop and industry growth will subside once supply is sufficient to meet demand and competition amongst lenders begins to drive down profits. Even if TILA disclosures are ineffective, the barriers to market entry are low and creditors are free to advertise their prices, which should spark competition. Unfortunately, fringe creditors have compelling reasons not to advertise prices, which in turn limits competition.

The primary reason that fringe creditors are reluctant to compete on price is that TILA requires all credit advertisements that include price to include the APR.¹³⁶ A lender cannot advertise that his fees are two dollars lower than his competitor without also advertising that his fees still correspond to a 400% APR. Such an advertisement would likely draw attention and criticism from a wide array of citizens who are currently oblivious to the rates charged by fringe creditors. In addition, the advertisements may inadvertently educate customers about the size of the price gap between the prime and fringe market. A 400% APR viewed by itself in a loan office may not raise warning bells for a customer. But if that same customer saw that APR in the privacy of his own home, he might compare it to the credit card solicitations he received in the mail and be persuaded to avoid these loans in the future. Lenders avoid these dangers by focusing their advertisements on convenience, speed, and credit availability.

134 See Wallace, *supra* note 57, at 473 (noting that consumer counseling is rarely effective "because of the strong consumer biases in favor of immediate gratification and an unwillingness to take full account of future hardship and risk").

135 See *supra* Part III.A.2 for a description of how arbitration clauses inhibit consumers from bringing unconscionability and fraud claims.

136 15 U.S.C. § 1664(d) (2000).

Although lenders do not compete on price, they still have a strong incentive to fight for market share. The two primary ways in which payday lenders compete are through risk tolerance and convenience. Although risk tolerance plays a critical role in allowing the payday loan industry to compete with other types of credit, its role in differentiating payday lenders is limited. Once a lender has agreed not to look at the customer's credit history, it cannot do much more to lower its standards. Eliminating the job or bank account requirement would cause bad debt and collection expenses to skyrocket. The remaining options are to lend a larger percentage of the customer's anticipated income, stack one loan on top of another, or allow the continuous rollover of loans. A customer who cannot obtain an additional rollover from one payday lender may then go to a second "more competitive" lender to obtain a loan to pay off the first. Unfortunately, these are all factors that increase the likelihood of getting caught in a debt trap that ends in bankruptcy.

The second factor through which payday lenders compete is convenience. Because lenders offer nearly identical products, have similar risk tolerances, and do not advertise prices, convenience of store locations and store hours become the deciding factors for many consumers.¹³⁷ Unfortunately, convenient access to loans that are not intended for frequent use and that are difficult to repay encourages irresponsible use of these products.

2. Governmental Support of the Noncompetitive RAL Market

The market for RALs is unique in that it is directly tied to the market for tax preparation services and tax preparation is mandated by the federal government. Tax preparers need not (and rarely do) advertise prices for RALs or tax preparation to attract customers. Instead, they advertise convenience, reliability, and the ability to obtain refunds quickly. Many consumers will choose their RAL provider based exclusively on who they trust to do their taxes. Others will focus on who can get their money to them fastest. By the time taxpayers learn the price for this speed, it is too late to take their business else-

¹³⁷ Three out of five borrowers surveyed by the CRC listed "quick, easy process" as the most important reason for choosing a payday loan over another loan source. See ELLIEHAUSEN & LAWRENCE, *supra* note 14, at 51 tbl.5-23. Another 10.9% based their decision on convenient location. *Id.* Strangely, only 6.4% claimed that their choice was based on having "no other alternative." *Id.* If true, this bolsters the argument that consumers do not understand the relative cost of credit sources.

where.¹³⁸ RAL providers can then charge monopoly prices for these loans.

The traditional justification for allowing creditors of small loans to charge a higher rate of interest is the increased transaction costs and risk of default that accompany such loans. Yet neither factor explains the high loan fees charged for RALs. Providers typically pass transaction costs along to RAL customers in the form of separate administrative, application, document preparation, or electronic filing fees. These loan fees and processing fees are piled on top of substantial tax preparation fees, which already compensate the preparer for collecting most of the information needed to process the loan application.¹³⁹ Because transaction costs are covered by these separate fees, the loan fee should be based entirely on the time value of money (which is negligible for a one week loan) and on risk.

Ironically, the risk of default for a RAL is relatively low. Unlike traditional loans, RALs do not require borrowers to take any action on the loan's due date. The RAL agreement signed by each taxpayer authorizes the preparer to have the tax refund directly wired from the IRS to the bank that extended the loan, giving the consumer no opportunity to default.¹⁴⁰ The only risks the bank faces are that the refund was incorrectly calculated, the taxpayer has a lien on his refund,¹⁴¹ or the return is fraudulent. To counteract the first two risks, RAL providers typically delay loan approval for up to two days.¹⁴² If an electronically filed return contains an error, such as a transposed social security number, the IRS will notify the preparer within forty-eight hours.¹⁴³ E-filed returns that survive this filter are over ninety-nine percent accurate.¹⁴⁴ This service deters fraudulent returns, because a would-be swindler must not only risk severe federal penalties and produce fake W-2s, but also provide valid social security numbers

138 See *supra* Part III.B.1 for discussion of why comparison shopping is nearly impossible in the RAL market.

139 The average preparation fee for each U.S. customer was \$133 in 2004. H&R BLOCK, INC., 2004 ANNUAL REPORT 22 (2005) (reporting \$2,119,772 in preparation fees for 15,903 returns), available at http://media.corporate-ir.net/media_files/NYS/HRB/reports/AR2004.pdf.

140 Drysdale & Keest, *supra* note 9, at 614 (noting that the lender has a right of setoff against the refund and that the boilerplate language of RAL contracts also may contain a right of setoff for debts owed to affiliates of the lender).

141 Tax liens are equivalent to the Financial Management System debts described *infra* note 145.

142 BERUBE ET AL., *supra* note 31, at 4.

143 H&R BLOCK, INC., TAX FACTS: WHY E-FILING MAKES SENSE 1 (n.d.), available at http://www.hrblock.com/presscenter/facts/taxfactspdf/132_E-filing.pdf.

144 *Id.*

and birth dates that have not yet been run through the e-file system that tax year. In addition to testing return accuracy, the IRS's Debt Indicator program allows creditors to find out, within forty-eight hours, whether any tax liens exist on the taxpayer's refund.¹⁴⁵ Creditors cannot entirely avoid the risk that a government agency other than the IRS has a lien on the taxpayer's refund because not all such liens are reported through the Debt Indicator.¹⁴⁶ If a taxpayer's refund is offset, however, he remains liable for repaying the difference between the amount of his RAL and the actual refund received by the bank. In conclusion, RALs present only minimal risks, which cannot justify charging triple-digit interest rates in addition to loan administrative fees.

IV. THE ROUTE TO FEDERAL PREEMPTION

How did credit regulation become so permissive? The answer is federal preemption. Traditionally, consumer protection and usury restrictions were considered the province of the states. During the last twenty-five years, however, federal control has increased significantly. Understanding this progression is important for two reasons. First, it explains how usury law devolved into its current state. Second, it highlights an obstacle that state legislatures must overcome if they wish to pass effective regulations protecting consumers.

A. *Marquette and the Rise of the Exportation Doctrine*

The preemption of state usury law began with the National Bank Act of 1864.¹⁴⁷ Section 85 currently provides that a national bank may charge "interest at the rate allowed by the laws of the State, Territory, or District where the bank is located, or at a rate of 1 per centum in excess of the discount rate on ninety-day commercial paper . . . , whichever may be the greater."¹⁴⁸ Since 1873, courts have interpreted this language as conferring "most-favored lender" status on national banks, which allows the banks to apply the highest rate allowed by the

145 *Id.* The Debt Indicator signals whether the taxpayer owes a debt to the IRS or one of the agencies managed by the Financial Management System (FMS), which may be offset against the refund. See INTERNAL REVENUE SERV., *supra* note 103, at 85. FMS debts "are for past due student loans, child support, Federal taxes, state taxes, or other governmental agency debts." *Id.*

146 INTERNAL REVENUE SERV., *supra* note 103, at 49.

147 National Bank Act of 1864, ch. 106, § 30, 13 Stat. 108, 108 (current version codified at 12 U.S.C. § 85 (2000)). Note that it is common practice to refer to § 85 of the National Bank Act, even though § 85 refers to the statute's location in the code, not the original bill.

148 12 U.S.C. § 85 (2000).

state for *any* lender authorized to make similar loans, regardless of whether that lender is a state bank.¹⁴⁹

The full importance of § 85 of the National Bank Act was not felt until 1978, when the Supreme Court determined that a bank is "located" in the state where it is chartered.¹⁵⁰ Accordingly, in *Marquette National Bank v. First of Omaha Service Corp.*, the Court held that § 85 authorizes a national bank to charge all of its customers the maximum interest rate permitted by the law of the state where it is chartered even if that rate would otherwise be considered usurious under the state law of the bank's nonresident customers.¹⁵¹ The Court fully acknowledged that "the 'exportation' of interest rates" authorized by its decision could "significantly impair the ability of States to enact effective usury laws."¹⁵² However, the Court left it up to Congress to make any changes it deemed fit, noting "the protection of state usury laws is an issue of legislative policy, and any plea to alter § 85 to further that end is better addressed to the wisdom of Congress than to the judgment of this Court."¹⁵³

Soon after the Supreme Court decided *Marquette*, states began a race to the bottom, competing for national bank charters by loosening their usury restrictions. Delaware and South Dakota were two of the first states to eliminate restrictions on credit card lending, and both were amply rewarded in the form of increased tax revenue from bank charters.¹⁵⁴ Banks around the country used the threat of re-chartering to pressure their state legislatures into relaxing rate regula-

149 See *Marquette Nat'l Bank v. First of Omaha Serv. Corp.*, 439 U.S. 299, 314 (1978) (citing *Tiffany v. Nat'l Bank of Mo.*, 85 U.S. (18 Wall.) 409, 413 (1873)). The Missouri law at issue in *Tiffany* limited state banks to eight percent interest, but allowed individuals to charge ten percent. *Tiffany v. Nat'l Bank of Mo.*, 85 U.S. (18 Wall.) 409, 411 (1873). The Court concluded that Congress's intent was not only to level the playing field, but also to give federal banks a competitive advantage over all other lenders, so that they would be "National favorites." *Id.* at 413; see KEEST & RENUART, *supra* note 5, at 78 (describing the history of the "most-favored lender" doctrine).

150 *Marquette*, 439 U.S. at 310. The Court noted that "congressional debates surrounding the enactment of [§ 85] were conducted on the assumption that a national bank was 'located' for purposes of the section in the State named in its organization certificate." *Id.*

151 *Id.* at 313.

152 *Id.* at 318.

153 *Id.* at 319.

154 See KEEST & RENUART, *supra* note 5, at 82-83 n.144. South Dakota experienced a 900% increase in tax revenue from banks between 1980 and 1987. *Id.* (citing *Small Is Usurious*, *ECONOMIST*, July 2, 1988, at 26). During this same period, Delaware's revenue increased even more dramatically, from \$2.4 million to forty million dollars. *Id.*

tion.¹⁵⁵ Faced with this threat and the knowledge that their own laws were powerless to protect their citizens from loans made by out-of-state banks, many states softened their usury restrictions to prevent an exodus of card-issuing banks. Currently, the least restrictive states provide that lenders may charge any amount of interest and fees on consumer loans so long as the parties agree.¹⁵⁶ Nine states currently take this approach.¹⁵⁷

B. *Congressional Expansion of Federal Preemption*

Following *Marquette*, Congress has twice passed legislation that expanded the reach of the exportation doctrine. The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA),¹⁵⁸ was enacted in response to (1) concerns that the *Marquette* decision had placed state-chartered banks at a competitive disadvantage to federal banks¹⁵⁹ and (2) a credit crunch caused by the clash of record-high inflation and state interest rate ceilings that did not float with inflation.¹⁶⁰ DIDMCA extended the benefits of the National Bank Act—including the ability to export interest rates across

155 See Christopher C. DeMuth, *The Case Against Credit Card Interest Rate Regulation*, 3 YALE J. ON REG. 201, 215–16 (1986) (explaining that Citibank moved its operations to South Dakota after unsuccessfully lobbying the New York legislature to remove usury limits).

156 The language of South Dakota's statute section 54-3-1.1, entitled "Rate of interest set by written agreement—no maximum or usury restriction," is illustrative of this approach:

Unless a maximum interest rate or charge is specifically established elsewhere in the code, there is no maximum interest rate or charge, or usury rate restriction between or among persons, corporations, limited liability companies, estates, fiduciaries, associations, or any other entities if they establish the interest rate or charge by written agreement.

S.D. CODIFIED LAWS § 54-3-1.1 (Michie 1999 & Supp. 2003).

157 The nine states are Delaware, Idaho, Illinois, Montana, New Mexico, Oregon, Utah, South Dakota, and Wisconsin. See KEEST & RENUART, *supra* note 5, app. A, at 557. Note that Montana allows "regulated lenders" (i.e., banks, credit unions, and similar entities) to charge any rate the borrower agrees to, MONT. CODE ANN. § 32-5-301 (2003), but it limits nonbank licensed payday lenders to a fee of twenty-five percent of the check. *Id.* § 31-1-112. The other eight states listed, as well as Nevada and New Hampshire, place no interest or fee restrictions on licensed payday lenders. See FOX, *supra* note 11, at 31–33.

158 Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, §§ 521–523, 94 Stat. 132, 164–66 (codified at 12 U.S.C. §§ 1831d, 1463(g), 1785(g) (2000)).

159 *Id.* § 521, 94 Stat. at 164 (stating that the Act's purpose is "to prevent discrimination against State-charted insured banks . . . with respect to interest rates").

160 KEEST & RENUART, *supra* note 5, at 92 n.229.

state lines and to charge the alternative federal ceiling (one percent in excess of the discount rate on ninety-day commercial paper)—to all federally insured state banks, savings and loans, and credit unions.¹⁶¹ The resulting expansion in federal preemption was startling—over ninety percent of all banks are federally insured.¹⁶²

In 1994, Congress dealt an additional blow to state law by passing the Riegle-Neal Interstate Banking and Branching Efficiency Act (Riegle-Neal),¹⁶³ which gave national banks and federally insured state banks the power to branch across state lines.¹⁶⁴ Prior to this Act, state law controlled the ability of banks to branch and generally prohibited interstate branching. Thus, when the Supreme Court decided *Marquette* and Congress passed DIDMCA, most banks had a physical presence in only one state—the state where they were chartered. This limited the exportation doctrine to banking that could be conducted through the mail (i.e., credit cards), and required that banks actually relocate to take advantage of permissive laws outside their home states. Riegle-Neal broadened the exportation doctrine by allowing banks to establish a physical presence in multiple states and by specifying that the host states' laws would not apply to national banks unless these laws fit into one of four categories *and* survived federal preemption.¹⁶⁵ Where these conditions were not met, national banks could

161 Congress modeled the statutory language of section 521 of DIDMCA after § 85 of the National Bank Act. Courts have construed section 521 as providing the same benefits to federally insured state banks that federal banks receive under § 85. See *Greenwood Trust Co. v. Massachusetts*, 971 F.2d 818, 827 (1st Cir. 1992) (“The historical record clearly requires a court to read the parallel provisions of [DIDMCA] and the Bank Act *in pari materia*.”); Robert C. Eager & C.F. Muckenfuss, III, *Federal Preemption and the Challenge to Maintain Balance in the Dual Banking System*, 8 N.C. BANKING INST. 21, 41–42 (2004).

162 BENJAMIN J. KLEBANER, *AMERICAN COMMERCIAL BANKING: A HISTORY* 142 (1990).

163 Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, §§ 101–102, 108 Stat. 2338, 2339–43 (codified at 12 U.S.C. §§ 1842(d), 1831u(a)(1) (2000)).

164 See 12 U.S.C. § 1831u(a)(1) (2000) (“Beginning on June 1, 1997, the responsible agency may approve a merger transaction under section 1828(c) of this title between insured banks with different home States, *without regard to whether such transaction is prohibited under the law of any State.*” (emphasis added)); Eager & Muckenfuss, *supra* note 161, at 44 (explaining that Riegle-Neal “reversed national policy dating from the Jackson era that the states should determine where banks may establish branches”).

165 Riegle-Neal provides that “[t]he laws of the host State regarding community reinvestment, consumer protection, fair lending, and establishment of intrastate branches shall apply to any branch in the host State of an out-of-State national bank . . . except—(i) when Federal law preempts the application of such State laws to a national bank.” 12 U.S.C. § 36(f)(1)(A). Despite being couched in deferential language, this provision automatically preempted the application of all state laws that did

apply the laws of their home state to branch offices they established in foreign states. Although Rieggle-Neal originally left the interstate branches of state banks subject to host state law,¹⁶⁶ the Act was amended in 1997 to give state banks the same ability as national banks to disregard host state law.¹⁶⁷

C. *Administrative Expansion of the Exportation Doctrine*

Interpretations issued by the Office of the Comptroller of the Currency (OCC) after Rieggle-Neal's passage have given banks extreme flexibility in choosing the state law they wish to apply. A national bank is now considered to be located in both its home state and any state where it has a branch.¹⁶⁸ For each loan, banks are instructed to apply the law of the state where the loan is "made." Making a loan includes three functions: approval, extension of credit, and disbursement of funds.¹⁶⁹ If all three are performed in a single branch office, the national bank must apply the usury law of the branch state. If the functions are split between locations, however, the national bank can elect to apply the law of its home state or that of the branch, as long as the loan has "a clear nexus" to the branch state.¹⁷⁰ Lenders who wish to avoid applying branch state law can easily manipulate the loan transaction to accomplish this goal. For instance, where the approval of a loan is determined by "non-discretionary criteria that will be applied mechanically," the loan is deemed to be "approved" at the location where those non-discretionary criteria were chosen, no matter where they are later applied.¹⁷¹

A bank's ability to export the state law of its choosing does not stop with numeric interest rates, but rather extends to a laundry list of fees that fit within the OCC's definition of interest. In *Smiley v. Citibank (South Dakota), N.A.*,¹⁷² the Supreme Court found the definition

not fit into one of the four listed categories and left those categories subject to federal preemption. See Eager & Muckenfuss, *supra* note 161, at 45.

166 See Eager & Muckenfuss, *supra* note 161, at 47-48.

167 *Id.*; see 12 U.S.C. § 1831a(j)(1) ("The laws of a host State . . . shall apply to any branch in the host State of an out-of-State State bank to the same extent as such State laws apply to a branch in the host State of an out-of-State national bank.").

168 Office of the Comptroller of the Currency, Interpretive Ltr. 822, at 3 (Feb. 17, 1998), reprinted in KATHLEEN E. KEEST & ELIZABETH RENUART, NAT'L CONSUMER LAW CTR., THE COST OF CREDIT: REGULATION AND LEGAL CHALLENGES CD-ROM (2d. ed. supp. 2003).

169 *Id.* at 14.

170 *Id.*

171 *Id.* at 12.

172 517 U.S. 735 (1996).

of interest as used in the National Bank Act ambiguous and held it should therefore defer to the judgment of the OCC, the agency charged with enforcement of the banking laws.¹⁷³ In response to the pending *Smiley* litigation,¹⁷⁴ the OCC had drafted the following proposed regulation, defining interest as

any payment compensating a creditor or prospective creditor for an extension of credit, making available of a line of credit, or any default or breach by a borrower of a condition upon which credit was extended. It includes, among other things, the following fees connected with credit extension or availability: numerical periodic rates, late fees, not sufficient funds (NSF) fees . . . , overlimit fees, annual fees, cash advance fees, and membership fees.¹⁷⁵

Ironically, the definition of “interest” chosen by the OCC is much broader than the definition of “finance charge” used in TILA. Banks are therefore able to export high fees from their home state that they are not required to include in the calculation of the APR for a loan. Although the OCC’s definition of interest is currently beyond legal challenge, this discrepancy should make the definition suspect from a policy perspective.

D. Charter Renting: Expanding the Exportation Beyond Banks

Exemption from state usury law does not stop with banks. Any entity can potentially take advantage of lax usury law by contracting with a bank in a creditor-friendly state. This practice, known as “charter renting,” is illustrated by the facts of *Krispin v. May Department Stores Co.*¹⁷⁶ In 1996, a Missouri-based department store assigned all of its credit card accounts to the May National Bank of Arizona, a wholly owned subsidiary it had recently created.¹⁷⁷ The store sent letters to customers informing them of the change in account ownership. The bank then promptly raised late fees to a level that was illegal under Missouri usury law. Each night, pursuant to a contractual agreement with the bank, the store purchased a 100% interest in the bank’s receivables, which transferred the entire risk and reward of the loans to the store. The store continued to play an active role in collection and marketing efforts.¹⁷⁸ Ignoring the purpose and economic substance of this arrangement, the Eighth Circuit held that because the bank

173 *Id.* at 739.

174 *Id.* at 740.

175 12 C.F.R. § 7.4001(a) (2004).

176 218 F.3d 919 (8th Cir. 2000).

177 *Id.* at 921.

178 *Id.* at 921–22.

originated the loans, Arizona law should determine the legality of the fees.¹⁷⁹ The court relied on the Fifth Circuit's statement in *FDIC v. Lattimore Land Corp.*¹⁸⁰ that the "non-usurious character of a note should not change when the note changes hands,"¹⁸¹—a rule with a pedigree dating back to 1833.¹⁸²

In *Cades v. H & R Block, Inc.*,¹⁸³ the Fourth Circuit allowed the extension of the exportation doctrine to RALs. Even though the defendant H&R Block office solicited customers, assisted them in completing loan documents, and disbursed the loan checks,¹⁸⁴ the Court found the decision to approve the loan was made by Beneficial National Bank in Delaware and that the loans would therefore be judged by lenient Delaware law.¹⁸⁵ Tax preparers now make ample use of charter renting and the exportation doctrine.¹⁸⁶ RALs are too large to fall under the protection of most payday loan statutes,¹⁸⁷ but too expensive to be permitted by most "small loan" laws.¹⁸⁸ Furthermore, the IRS explicitly forbids tax preparers from making RALs directly or through a related financial institution, which forces preparers to partner with other lenders.¹⁸⁹

179 *Id.* at 924.

180 656 F.2d 139 (5th Cir. 1981).

181 *Id.* at 148–49. In *Lattimore*, the court held that a loan that was originated by a state bank would not be subject to the usury provisions of the National Bank Act if it was later assigned to a national bank. *Id.* at 147. National banks could therefore accept assignment of loans that had been legally made by an out-of-state bank even if the loans carried rates or charges that exceeded those allowed by the national banks' home states. *Id.*

182 See *Nichols v. Fearson*, 32 U.S. (7 Pet.) 103, 109 (1833) (stating that one of the "cardinal rules in the doctrine of usury" was that "a contract, which, in its inception, is unaffected by usury, can never be invalidated by any subsequent usurious transaction").

183 43 F.3d 869 (4th Cir. 1994).

184 *Id.* at 873.

185 *Id.*

186 See *Drysdale & Keest*, *supra* note 9, at 612–13.

187 The payday loan laws of twenty-six states prohibit loans greater than \$500. See *FOX*, *supra* note 11, at 31–33.

188 See, e.g., KY. REV. STAT. ANN. § 288.530 (Banks-Baldwin 2001) (allowing small loans up to \$15,000, but limiting interest to three percent per month for the first \$1000 and two percent for the excess). If RAL providers were forced to comply with this law, they would be limited to charging ten dollars for a ten day \$1000 loan.

189 See INTERNAL REVENUE SERV., *supra* note 103, at 51 ("An Authorized IRS *e-file* Provider that is also the return preparer, and the financial institution or other lender that makes a RAL cannot be related taxpayers within the meaning of [18 U.S.C.] § 267 or § 707.").

Nonbank payday lenders likewise use charter renting extensively to avoid state regulation,¹⁹⁰ although the practice is likely to wane as more states enact payday loan laws that explicitly permit high rates¹⁹¹ and federal bank regulators show increased hostility to payday lenders. In recent years, the OCC has cracked down on selected types of charter renting that it considers dangerous to national banks. In a November 2000 bulletin, the OCC warned that “payday lending carries significant credit, transaction, reputation, and compliance and legal risks that raise supervisory concerns.”¹⁹² The OCC expressed specific concern over “[c]ontractual agreements with third parties that originate, purchase, or service payday loans,”¹⁹³ noting that the risk of contracting with these parties “can be excessive if management and directors do not exercise . . . effective oversight and controls.”¹⁹⁴

Despite the warnings, national banks continued to exercise little or no supervision over their payday lending partners. This lack of supervision, coupled with the frequent legal transgressions of payday lenders,¹⁹⁵ led the OCC to commence enforcement proceedings against national banks, forcing them to end their partnerships with payday lenders. By the end of 2003, the OCC had terminated all existing partnerships.¹⁹⁶ Note that the OCC’s opposition to charter renting stems from the danger it poses to the safety and soundness of banks, not from a belief that such “lending activities [are] unlawful as a general matter.”¹⁹⁷ Accordingly, the OCC has never attacked charter renting arrangements between national banks and RAL providers.

190 As of March 2004, eleven of the thirteen largest payday lenders used charter renting to make loans in at least some states. Fox, *supra* note 11, at 14.

191 See *supra* note 24 and accompanying text for a discussion of why the exportation doctrine gives states an incentive to pass legislation permitting payday lending if they want to have any control over it.

192 Office of the Comptroller of the Currency, Advisory Ltr. 2000-10, at 3 (Nov. 27, 2000), available at <http://www.occ.treas.gov/ftp/advisory/2000-10.doc>.

193 *Id.*

194 *Id.* (quoting Office of the Comptroller of the Currency, Advisory Ltr. 2000-9 (Aug. 29, 2000)).

195 The case of Eagle National Bank illustrates the typical circumstances that led to regulatory action. The OCC found Eagle’s partner, Dollar Financial Group, “failed to consistently follow the bank’s underwriting criteria, violated federal law relating to privacy notices and Truth in Lending disclosures, and opened stores in some states and began originating payday loans without the bank’s knowledge or approval.” Fox, *supra* note 11, at 17.

196 Schiltz, *supra* note 5, at 593; see also Fox, *supra* note 11, at 16 (“As a result of enforcement actions, no federally chartered bank or thrift rents its charter to payday lenders.”).

197 *Hudson v. Ace Cash Express, Inc.*, No. IP 01-1336-C H/S, 2002 WL 1205060, at *6 (S.D. Ind. May 30, 2002) (upholding the legal validity of a charter renting arrange-

The impact of the OCC enforcement actions on the ability of payday lenders to evade state law has thus far been negligible. Each of the payday loan companies that lost its national bank partner subsequently found refuge in a state-chartered bank regulated by the FDIC.¹⁹⁸ Although the FDIC warns banks that failure to properly manage relationships with payday loan providers presents substantial risks, the agency's recently issued guidelines do not prohibit charter renting and are generally considered amenable to the practice.¹⁹⁹ A significant portion of the payday loan industry, including eleven of the thirteen largest lenders, partners with FDIC-regulated banks to make loans in at least some states.²⁰⁰

E. Lack of Notice and Accountability: Problems with the Current Usury Law and Proposals for Reform

The combined effect of the National Bank Act, *Marquette*, DIDMCA, Riegle-Neal, and recent OCC interpretations is that states are preempted from applying their own law towards the protection of their citizens anytime a loan is made by a federally insured depository institution (or an entity that has a contractual partnership with one) that is not chartered within that state. Federal law defers to the judgment of the state where the lender bank is chartered or operating a branch, which effectively allows lenders to choose their own law. The lenders that wish to make questionable loans are also the ones most likely to search out the state with the least restrictive banking law. Therefore, as long as one state in the Union places no restrictions on usury, that is the law that will apply to *all* predatory lenders.

This system of federal preemption, which preempts the usury laws of most states while leaving the decision of what should replace them up to the least restrictive state legislatures, is objectionable for two reasons. First, it eliminates accountability. Consumers are affected by laws made in a state where they have no representation and no ability to vote lawmakers out of office. The state leaders in permissive credit regulation earn the bulk of charter revenue, but must deal with only a small portion of the costs created by their decision. The creditor-friendly laws of South Dakota, one of the least populous

ment between Goletta National Bank and Ace Cash Express after the OCC had already issued an order requiring Eagle National Bank to end a similar arrangement).

198 Fox, *supra* note 11, at 14 (listing payday lenders that are currently partnered with FDIC-insured banks).

199 See FDIC Guidelines for Payday Lending, 6 Fed. Banking L. Rep. (CCH) ¶ 64-127 (July 11, 2003), available at <http://www.fdic.gov/regulations/safety/payday>; Fox, *supra* note 11, at 19-20.

200 Fox, *supra* note 11, at 14.

states, get to trump those of California and New York. Meanwhile, Congress gets to pretend that it is deferring to state law, while it is really deferring to the will of the banking industry and abrogating the law of the citizens of a majority of states. Second, the current system is deceptive. Consumers are lulled into a false sense of security by the erroneous belief that the laws of their home state are available to protect them. Ironically, the states where citizens have lobbied for restrictive usury law are the states least likely to have their own law applied to loans made within their borders.²⁰¹

Despite the expansive scope of federal preemption, state usury law remains important in at least two respects. First, state usury laws continue to apply to depository institutions (i.e., banks, savings and loans, credit unions) chartered within the state. Second, it continues to apply to all creditors that are not depository institutions and are not "charter renting" from one. Several states also attempt to prevent charter renting by prohibiting licensed lenders from facilitating loans for an out-of-state bank. The ability of such laws to withstand legal challenge is uncertain, however, because federal law preempts the application of state laws to national banks where such laws would "prevent or significantly interfere with the national bank's exercise of its powers."²⁰² Although these state laws do not purport to apply to national banks (i.e., they only apply to the national banks' potential lending partners), they still significantly interfere with national banks' activities.

The notice and accountability concerns presented by the current state of the law can be addressed in two ways. First, Congress could specify a maximum interest rate that applies to all federally insured banks. Alternatively, Congress could amend the National Bank Act and DIDMCA to specify that the law of the borrower's state (i.e., the state where the borrower is a citizen) applies.²⁰³ If national banks

201 See James A. White, *The Usury Trompe l'Oeil*, 51 S.C. L. Rev. 445, 448 (2000) (noting "the sternest state laws are the first to be undermined and the quickest to fall").

202 *Barnett Bank v. Nelson*, 517 U.S. 25, 33 (1996). Recent OCC regulations have taken an even more expansive view, claiming preemption of all state laws that would "obstruct, impair, or condition a national bank's ability to fully exercise its Federally authorized . . . lending powers." Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. 1904, 1916 (Jan. 13, 2004) (to be codified at 12 C.F.R. § 7.4008(d)(1)).

203 The law could also be amended to apply the laws of the state where the consumer received the loan proceeds or filled out the application, although this is not advisable. While this proposal would allow consumers more freedom to travel to other states to obtain the loan they desired, it would be problematic for states that chose to prohibit risky loans to control the cost of their welfare programs and bank-

were not allowed to export their home state law, this would likely increase transaction costs by forcing banks to monitor multiple state laws and preventing them from using uniform policies, forms, and marketing materials. However, these costs should not be overstated. First, all businesses that conduct interstate business must monitor state law developments. Second, the laws of many states overlap, which cuts down on the number of necessary policy variations. Allowing states to apply their own laws to loans involving their residents would allow for valuable experimentation between the states. Citizens could debate the tradeoffs between cost, protection, and credit availability in their state legislatures.

The purpose of this Note is not to take a side on the issue of whether state or federal law should control,²⁰⁴ but rather to implore all legislatures to rethink their current credit law. If federal law is going to preempt state law, Congress should be responsible for choosing that law rather than deferring to Delaware. Although it is admittedly doubtful that Congress would be willing to adopt my proposed floating interest rate ceiling of fifty percentage points above the one-month treasury rate, it is equally doubtful that it would adopt the “no limits” policy of the least restrictive states. As long as the exportation doctrine and charter renting are allowed to continue, state law will be influenced by the knowledge that any restrictive law will be circumvented.

CONCLUSION

Thanks to an absence of effective rate regulation, the fringe credit market continues to grow steadily. This Note has demonstrated that much of the demand in this market is attributable to debtors who are (1) trapped in a vicious debt cycle caused by the fringe credit market itself, (2) under duress, and/or (3) misinformed about the costs and risks of this credit. The heavy cost of fringe credit is borne not only by debtors, but also by society, which must make provision for

ruptcy courts. Traveling to other states to get a loan is also wasteful, and there is no reason to expect that individuals know the laws of the state where they take out a short-term loan (even though we have a legal presumption that they do), especially if they are traveling. Finally, this rule wouldn't work for credit cards, where the “loans” are made in all different locations. Focusing on the law of the consumer's citizenship solves these problems.

204 The benefits and drawbacks of having uniform federal law applied to national banks, as compared to subjecting federal banks to state law, was debated in Congress recently, following the OCC's issuance of Final Rules on National Bank Preemption. For a summary of the Congressional debate, which took place January 28, 2004, see Eager & Muckenfuss, *supra* note 161, at 32-36.

bad debt expense and the welfare needs of citizens. In addition, millions of tax dollars are diverted each year from the low-income taxpayers for whom they are intended into the hands of RAL providers.

The harms and market imperfections presented by fringe credit can be addressed in a variety of ways, including improving financial education; modifying disclosure laws to require that information be provided earlier and tailored to consumers, allowing class arbitration to enforce consumer protection laws, limiting the number of payday loans a consumer can take out each year, and limiting the rates that creditors may charge. While each of these approaches has some potential, this Note has demonstrated that any solution that does not include rate regulation is unlikely to be effective in protecting consumers from unconscionable, predatory loans.

In addition to providing vital protection to consumers, interest rate ceilings are an effective and efficient means of limiting the costs and risks that excessive indebtedness pose to society. In the absence of government intervention, creditors and borrowers have little incentive to consider these societal costs, which leads to an oversupply of credit. Rate regulation can be used to restrict aggregate consumer debt levels and discourage creditors from making excessively risky loans. Rate regulation would also prevent RAL providers from taking advantage of the inherently noncompetitive nature of this market to charge excessive rates, and would reduce or eliminate the drain that RALs currently impose on tax-based social welfare programs.

For all of these reasons, I advocate a return to rate regulation, and propose a floating interest rate ceiling set at fifty percentage points above the one-month treasury rate. For this proposal to be effective, the cooperation of Congress is needed to undo the current system of preemption, rate exportation, and charter renting that places the responsibility for rate regulation in the hands of the states but hinders their ability to enforce these regulations.

