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PAYDAY LENDING, BANK OVERDRAFT PROTECTION, AND FAIR COMPETITION AT THE CONSUMER FINANCIAL PROTECTION BUREAU

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Abstract

The Consumer Financial Protection Bureau (CFPB) is considering new regulation of payday lending and bank overdraft protection. The Dodd-Frank Act, which established the CFPB, recognizes that consumers benefit from competition among providers of consumer credit products. That law requires the CFPB to preserve fair competition by providing consistent regulatory treatment of similar products offered by both bank and nonbank lenders. We illustrate how this mandate for fair competition applies to the regulation of payday lending and bank overdraft protection, products that are offered by different entities but attract an overlapping customer base, compete with each other directly, and raise similar consumer protection concerns. Unequal regulation would provide a competitive advantage for one product over another, resulting in reduced choice and higher prices for consumers, without a corresponding increase in consumer protection. Therefore, as the CFPB considers new regulation of these products, it should be careful to regulate them similarly to preserve fair competition.

***JEL* codes:** D14, D18, G21, G23, G28

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Payday Lending, Bank Overdraft Protection, and Fair Competition

at the Consumer Financial Protection Bureau

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As a reaction to the financial crisis that began in 2008, President Obama signed into law the 2010 Wall Street Reform and Consumer Protection Act, commonly referred to as the Dodd-Frank Act.[1] A centerpiece of the new law was the creation of the Consumer Financial Protection Bureau (CFPB), which was established in response to the perception that the federal consumer protection regime had failed with respect to financial products and the belief that these regulatory failures contributed to the financial crisis. But the CFPB's mandate goes far beyond mortgages and other financial products that were at the heart of the recent recession and reaches all consumer credit products, including small-loan products such as payday loans and pawnshops as well as nonlenders such as mortgage brokers and debt collectors.

In the wake of the financial crisis and the subsequent political response, short-term consumer lending products such as payday loans, bank overdraft protection, and pawnshops have grown in both popularity and regulatory scrutiny.[2] The crisis-induced recession, the retrenchment in retail banking, and the consequences of many of the regulations enacted in the period since the recession began have reduced access to mainstream consumer credit products such as credit cards, home equity loans, and mortgages, thereby increasing demand for alternative credit products.

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[1] Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[2] The Federal Deposit Insurance Corporation's 2011 national survey of unbanked and underbanked households found that from 2009 to 2011 the percentage of U.S. households that used an alternative financial services product rose from 36.3% to 40.9%. FEDERAL DEPOSIT INSURANCE CORPORATION, 2011 FDIC NATIONAL SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS 30, Box 3 (Sept. 2012), http://www.fdic.gov/householdsurvey/2012_unbankedreport.pdf.

The CFPB's mandate to advance the goal of heightened consumer protection is multifaceted. The one on which we focus here is Dodd-Frank's requirement to "enforce Federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive."[3] Dodd-Frank further requires the CFPB to implement a regulatory regime that treats comparable products consistently, regardless of whether they are offered by a bank, a nonbank lender, or some other provider of consumer financial products.[4] The CFPB, in turn, has interpreted this mandate to require it to "[p]romote fair competition by consistent enforcement of the consumer protection laws in the Bureau's jurisdiction."[5]

In short, in pursuing its rulemaking, enforcement, and research capabilities, Dodd-Frank requires that the CFPB not provide a competitive advantage for one product over rival products simply because the rival products happen to be offered by different institutions through different distribution channels. As the architects of Dodd-Frank recognized, providing unequal regulatory treatment to similar products could harm consumers by pushing them to choose among various competing products based on their degree of regulation rather than on their relative economic benefits.[6] In fact, in light of the explicitness of this mandate, failing to take account of this requirement to preserve fair competition could expose the CFPB to litigation risk in the future.

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[3] 12 U.S.C. § 5511(a).
[4] *Id.* § 5511(b)(4) ("Federal consumer financial law is enforced consistently, without regard to the status of a person as a depository institution, in order to promote fair competition").
[5] CONSUMER FINANCIAL PROTECTION BUREAU, SEMI-ANNUAL REPORT OF THE CONSUMER FINANCIAL PROTECTION BUREAU, JULY 1, 2012–DEC. 31, 2012, at 8 (Mar. 2013).
[6] *See* DEPARTMENT OF THE TREASURY, FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION, http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf at 69 (June 17, 2009) ("Fairness, effective competition, and efficient markets require consistent regulatory treatment for similar products. For example, similar disclosure treatment for similar products enables consumers to make

In this article, we examine how the CFPB can advance its mission to promote fair competition with respect to two particular products: payday loans and bank overdraft protection. In fact, the Obama Administration's Treasury Department report that served as the foundation for Dodd-Frank specifically identified overdraft protection as an example of a product that traditionally was not regulated as a credit product, but which should be regulated as such in order to "apply consistent regulation to similar products."[7] The report states, "One example is overdraft protection. These are a form of consumer credit, and consumers often use them as substitutes for other forms of credit such as payday loans, credit card cash advances, and traditional overdraft lines of credit."[8] Because consumers use overdraft protection in the same way they use a credit product and as a substitute for other types of credit, the Administration argued that the new agency should have the authority to regulate it as it would regulate a credit product in order to apply consistent regulation to similar products.

For the purposes of this discussion, we will largely ignore the threshold debates about whether further regulation of either payday lending or overdraft protection is warranted.[9] Instead, we will focus on the second-order question: If the CFPB decides that further regulation is warranted, how should it implement its mandate to preserve fair competition as it applies to payday lending and bank overdraft protection? Concentrating on preserving fair competition

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informed choices based on a full appreciation of the nature and risks of the product and enables providers to compete fairly and vigorously.").

[7] *Id.*

[8] *Id.*

[9] For the purposes of this article, we will assume that the CFPB might consider imposing enhanced regulation of both products. Nonetheless, we are concerned about new regulation that would unduly reduce consumer access to either product, and we fear that the unintended consequences of such regulation could prove harmful to consumers and the economy. For competing sides of the debate, *compare* Nathalie Martin, *Regulating Payday Loans: Why This Should Make the CFPB's Short List*, 2 HARV. BUS. L. REV. ONLINE 44 (2011) (arguing in support of the CFPB regulating payday loans); Creola Johnson, *America's First Consumer Financial Watchdog Is on a Leash: Can the CFPB Use Its Authority to Declare Payday-Loan Practices Unfair, Abusive, and Deceptive?* 61 CATH. U. L. REV. 381 (2012) (same), *with* Jim Hawkins, *The Federal Government in the Fringe Economy*, 15 CHAP. L. REV. 23 (2011) (same).

between these two products is especially useful because they have traditionally been offered by distinctly different institutions through different channels: overdraft protection through banks and payday lending through nondepository small lenders. They have also been regulated by two different levels of regulatory authority: the federal government for bank overdrafts and state governments for payday loans. Finally, they have been primarily regulated through dissimilar approaches: ongoing prudential supervision in the case of bank overdrafts and licensing and an enforcement-based regime for payday lenders.[10] Therefore, examining these two products provides an opportunity to understand both the promise and challenges for the CFPB to create a coherent regulatory framework that can benefit consumers by preserving fair competition.

The integration of consumer protection regulation into one agency provides an unprecedented opportunity to create a systematic regulatory regime that promotes fair competition and benefits consumers. Indeed, promoting fair competition is an essential ingredient of consumer protection, as regulation that inadvertently favors one product over another could have the unintended consequence of simply shifting consumers from one product to another, thereby reducing competition and producing higher prices and lower quality with no enhanced consumer protection.

In this paper, we first describe the regulatory background of the two products. We then describe three considerations that we believe are relevant to the CFPB's implementation of its mandate to preserve fair competition among competing products—similar customers, evidence of competition between the products, and similar consumer protection concerns—that indicate

[10] We recognize at the outset that Dodd-Frank itself places some limits on the CFPB's ability to develop a fully coherent regulatory system due to provisions that limit the federal government's ability to preempt state regulations and the state officials' ability to enforce Dodd-Frank's regulations under some circumstances. *See* Todd J. Zywicki, *The Consumer Financial Protection Bureau: Savior or Menace?*, 81 GEO. WASH. L. REV. 856, 923–26 (2013).

how the CFPB can promote fair competition and consistent enforcement of consumer protection rules.[11]

I. Regulation of Payday Lending and Overdraft Protection

Millions of Americans use payday lending and bank overdraft protection every year, and many consumers use both products, either simultaneously or at different times.[12] Each product serves as a way for consumers to cover a temporary shortfall and thus meet their financial obligations.

Banks offer overdraft protection to allow payment of checks written by customers who have insufficient funds in their bank accounts. Overdraft protection is analogous to a limited line of credit (usually between $300 and $500) that can be triggered by checks, ACH transactions, ATM withdrawals, or point-of-sale (POS) purchases using a debit card. When a customer uses overdraft protection, he or she pays a flat fee established by the financial institution (typically around $30–$35) and a nominal interest rate for the period that the advance is outstanding.

Payday loans are short-term loans (typically about two weeks) provided by nondepository institutions that charge a fee based on the amount borrowed by a customer, usually about $15 per every $100 borrowed. The loans are usually repaid in a single balloon payment that is equal to

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[11] Dodd-Frank itself does not define the CFPB's mission to promote fair competition. One contribution of this article therefore is to provide guidance on how that mission can be defined and executed in practice. Although the CFPB is a new regulatory body, the concept that fair competition benefits consumers and advances the goals of consumer protection policy is not new. The dual mission to preserve competition and provide consumer protection is an integral part of the Federal Trade Commission's mission, and we partly draw on this history to identify the factors that are relevant to determining the interactions between competing products. *See* Zywicki, *supra* note 10, at 877–78.

[12] Estimates vary as to how many people use each product. Moebs Services, for example, estimated that in 2010, 19 million people used payday lending and 13 million used overdraft protection. *See* Press Release, Moebs Services, Payday Loans Are a Better Deal for Consumers Than Overdraft Fees (July 7, 2010) [hereinafter Moebs Services, Payday Loans], http://www.moebs.com/Pressreleases/tabid/58/ctl/Details/mid/380/ItemID/169/Default.aspx. JMP Securities, an industry analyst, estimates that 7 million people use payday lending products each year (combining both brick-and-mortar and online lending). *See* JMP SECURITIES, CONSUMER FINANCE: ONLINE FINANCIAL SERVICES FOR THE UNDERBANKED 15, Fig. 4 (Jan. 9, 2012). The FDIC estimates that at the time of its 2011 survey, 1.7% of U.S. households had used payday lending within the last year. FDIC, SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS, *supra* note 2, at 33.

the principal plus the required fees, and the payment is generally due around the time of the borrower's next payday.

A third product that has evolved in recent years is a bank deposit advance. Offered to deposit-account holders at banks and operating much as payday loans do, deposit advances are typically structured as short-term loans that are repaid out of the next electronic direct deposit to the customer's account, usually the customer's next paycheck. As with payday loans, customers typically pay a flat fee to draw the advance—but unlike payday loans, deposit advances are not due on a scheduled date (i.e., two weeks later). Although comparable to payday loans in structure, deposit advance loans are less risky to underwrite because of the ongoing relationship between the bank and the customer and the likelihood of the upcoming direct deposit that can be drawn against to repay the advance. This ongoing relationship between the customer and the bank may also mean that the processing cost of making the advance is lower than the processing cost of a payday loan. Deposit advances appear to be slightly less expensive than payday loans: approximately $10 for every $100 advanced.

Clearly, these are popular products with significant consumer demand. But the growth in popularity of the products, especially in the aftermath of the financial crisis and subsequent recession, has generated heightened scrutiny from regulators, including the CFPB.

Payday lending and overdraft protection traditionally have been regulated by different regulatory jurisdictions pursuing different regulatory approaches. Payday lending has been regulated at the state and local level through oversight, licensing, and prosecutorial enforcement, primarily under traditional consumer protection laws, with a modest federal role. State regulation of payday lending varies widely, from effective prohibition in some states to light regulation in others. Overdraft protection on the other hand has been regulated by federal authorities such as

the Federal Reserve System, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation, and other federal banking regulators, through their safety and soundness and consumer protection missions, relying more on a supervisory and oversight model. In 2003, the OCC took enforcement actions against banks, effectively prohibiting them from offering traditional payday loans through third-party providers.[13] Nevertheless, as described below, some banks today offer bank overdraft protection and deposit advance products that are functionally similar to payday lending.

As a result of this division of regulatory authority, each regulator acts in isolation and may have only a limited knowledge of the full impact that the regulation of one product may have on the consumers and offerors of the alternative products. For example, if consumers view payday lending and overdraft protection as equivalent substitutes, then regulation that restricts or expands access to either product will have a dramatic effect on consumers, depending on the availability and regulation of the other product.

The creation of the CFPB as a consolidated national regulator of consumer credit products provides a historic opportunity to establish a more coherent regulatory framework that can integrate enforcement, supervision, regulation, and research tools in one regulatory agency. Indeed, given the modest spillover effect on interstate commerce or on residents of other states from the use of products such as payday lending,[14] it may be that the sweeping powers of the CFPB to regulate products with largely localized effects *only* makes sense if it uses its authority to provide an integrated regulatory framework that coherently considers the full range of

[13] *See* Office of the Comptroller of the Currency, http://occ.gov/topics/consumer-protection/payday-lending/index-payday-lending.html (last visited October 2013) (summarizing enforcement actions and their effects against banks for allegedly "renting out" charters to payday lenders).
[14] *See* Zywicki, *The Consumer Financial Protection Bureau*, *supra* note 10, at 923–26 (criticizing preemption scheme of Dodd-Frank with respect to the CFPB's powers). Payday lending typically does not raise issues of either systemic risk or deposit insurance that give rise to safety and soundness concerns for banks.

consumer credit products and their interaction. By integrating its regulatory program on payday lending within the framework of a broader consumer protection and competition policy for consumer financial products, the CFPB could achieve the balance and consistency needed for coherent regulation of these products.

To date, the CFPB's forays into both payday lending and overdraft protection have been tentative, but it is clear that both products are high regulatory priorities. In April 2012, the CFPB opened a public inquiry and industry research study to gain insight into overdraft protection.[15] In its request for information, it specifically sought information on how consumers use overdraft programs, the information consumers receive about various banking products, the impact of prior overdraft regulations, and the costs of providing overdraft protection. Perhaps most relevant to this paper, the CFPB sought to determine what "alternatives consumers have for meeting short-term shortfalls."[16] In June 2013, the CFPB issued a white paper that summarized its findings on the use of overdraft protection but provided little analysis of the alternatives available to consumers for meeting short-term shortfalls.[17] The CFPB's actions on overdraft protection follow a variety of actions in recent years by prudential regulators that have imposed limits on overdraft protection, including Federal Reserve amendments to Regulation E[18] and Guidance from the FDIC[19] and the OCC.[20]

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[15] *See* Bureau of Consumer Financial Protection, Impact of Overdraft Programs on Consumers, 77 Fed. Reg. 24687 (Apr. 25, 2012), *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-02-28/pdf/2012-4576.pdf.

[16] Gary Stein, Comment Period on Overdrafts Extended to June 29 (Apr. 25, 2012), http://www.consumerfinance.gov/blog/category/overdrafts/.

[17] CONSUMER FINANCIAL PROTECTION BUREAU, CFPB STUDY OF OVERDRAFT PROGRAMS: A WHITE PAPER OF INITIAL DATA FINDINGS (June 2013). Although the white paper provides some discussion of the cost of overdraft protection to consumers and its value to banks, it does not systematically attempt to determine what alternatives are available to consumers. Nor does it determine whether consumers who reduce their use of overdraft protection then increase their use of other expensive alternatives, or whether less-expensive alternatives (such as a bank line of credit or linked savings account) are actually available to overdraft users. *See* discussion *infra* at n. 67.

[18] Amendments to Regulation E, 74 Fed. Reg. 59,033 (Nov. 17, 2009) (to be codified at 12 C.F.R. pt. 205).

[19] FED. DEPOSIT INS. CORP., FIL-81-2010, FINAL OVERDRAFT PAYMENT SUPERVISORY GUIDANCE (Nov. 24, 2010).

[20] OCC Guidance on Deposit-Related Consumer Credit Products, 76 Fed. Reg. 33,409 (proposed June 8, 2011). The

With respect to payday lending, the CFPB held a high-profile field hearing[21] and published an examination manual for payday lenders that covers issues such as marketing; application and origination processes; payment processing and sustained use; collections, default, and consumer reporting; and third-party relationships.[22] In April 2013, the CFPB published a white paper analyzing data on payday loan and direct deposit advance products, concluding that the findings of the study "raise[d] substantial consumer protection concerns" about both products.[23]

II. Payday Loans and Bank Overdraft Protection Are Used by Similar Customers for Similar Reasons

Payday loan and overdraft protection customers are demographically similar. Both payday loan customers[24] and frequent users of overdraft protection[25] tend to have low to moderate income (but they are not poor), and they have bank accounts. More importantly, users of payday lending,

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substance of these various regulatory actions (amendments to Regulation E and FDIC and OCC guidances) are summarized in Todd J. Zywicki, *The Economics and Regulation of Bank Overdraft Protection*, 68 WASH. & LEE L. REV. 1141, 1155–62 (2012).

[21] Press Release, Consumer Financial Protection Bureau, Consumer Financial Protection Bureau Examines Payday Lending (Jan. 19, 2012), http://www.consumerfinance.gov/pressreleases/consumer-financial-protection-bureau-examines-payday-lending/.

[22] CFPB EXAMINATION PROCEDURES, SHORT-TERM, SMALL-DOLLAR LENDING COMMONLY KNOWN AS PAYDAY LENDING (2013), http://files.consumerfinance.gov/f/201309_cfpb_payday_manual_revisions.pdf.

[23] CONSUMER FINANCIAL PROTECTION BUREAU, PAYDAY LOANS AND DEPOSIT ADVANCE PRODUCTS: A WHITE PAPER OF INITIAL DATA FINDINGS 18 (Apr. 24, 2013) [hereinafter "CFPB, PAYDAY LOANS"].

[24] The CFPB study found that although most payday loan customers were low-income, a quarter of those in its study earned more than $33,876 per year. CFPB, PAYDAY LOANS, *supra* note 23, at 18. Levy and Sledge report that 20% of those who use alternative credit products make above $50,000, consistent with other studies that find a nontrivial percentage of users of payday loans and other products are middle class or even upper-middle class. ROBERT LEVY & JOSHUA SLEDGE, CENTER FOR FINANCIAL SERVICES INNOVATION, A COMPLEX PORTRAIT: AN EXAMINATION OF SMALL-DOLLAR CREDIT CONSUMERS 10 (Aug. 2012), http://www.cfsinnovation.com/content/complex-portrait-examination-small-dollar-credit-consumers. Those who use payday loans typically have higher incomes than those who use pawnshops, rent-to-own, and other lower-tier products. *See* Todd J. Zywicki, *The Case Against New Restrictions on Payday Lending* 9 (Mercatus Center Working Paper No. 09-28, July 2009), *available at* http://mercatus.org/sites/default/files/publication/WP0928_Payday%20Lending.pdf [hereinafter Zywicki, *Payday Lending*] (summarizing studies).

[25] Marc Anthony Fusaro, *Are "Bounced Check Loans" Really Loans? Theory, Evidence and Policy*, 50 Q. REV. OF ECON. & FIN. 492, 499 (2010) [hereinafter Fusaro, *Bounced Check Loans*].

bank overdraft protection, and other alternative credit products share one characteristic above all else: they have poor credit and therefore lack ready access to less-expensive, mainstream credit products, such as credit cards.[26] Understanding who uses these products and why is important to identifying how the products compete.

A. A Profile of Payday Loan Customers

Payday loan customers often, but not always, have impaired credit, which restricts their access to mainstream credit products. Thus, they choose payday loans because such loans are their best available alternative to meet expenses.[27] As a result, when payday loans are restricted, they generally turn to less-preferred, more-expensive alternatives, such as pawnshops or credit card cash advances, and—as will be discussed in detail below—overdraft protection. Alternatively, they may be forced to bounce checks or suffer hardship from an inability either to pay bills or to obtain needed goods and services. Moreover, despite the high cost of payday loans, those who use the product generally are aware of the price and are satisfied with the product.

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[26] LEVY & SLEDGE, *supra* note 24, at 11 (noting that 54% of small-dollar credit users self-report as having poor credit).

[27] Critics of payday loans generally do not disagree with the proposition that those who use payday loans have impaired credit and limited credit choices. Instead they express concern about the cost and other terms of payday loans. It has been argued, for example, that the presence of payday loans in a market might crowd out less-expensive credit alternatives. *See* Creola Johnson, *Congress Protected the Troops: Can the New CFPB Protect Civilians from Payday Lending?*, 69 WASH. & LEE L. REV. 649, 663–66 (2012) (describing responses to the Military Lending Act, which effectively banned payday loans to military members). On the other hand, even if Johnson's anecdotes about market responses to the Military Lending Act are accurate, it is not obvious that the experience with military lending can be generalized, given the role of special military charities and similar entities in promoting low-cost credit products. Moreover, simply because alternative loans are less expensive in financial terms, they might not inherently be more attractive to borrowers. For example, although critics of payday loans often observe that consumers *could* borrow from friends and family instead of taking out a payday loan, many consumers might feel embarrassment or fear strained relations with family and friends from doing so, especially if borrowing for certain purposes rather than others. *See* Zywicki, *Payday Lending*, *supra* note 24, at 16–17. Once these relevant psychological costs are considered, many consumers might rationally believe a high-cost lender to be less expensive overall. Indeed, it is even possible that a loan from an illegal loan shark might have a lower up-front cost than a loan from some legal lenders, although that observation ignores the potential costs of broken kneecaps from nonpayment. As a result, the simple fact that the financial cost may be lower from borrowing from friends and family does not mean that consumers are better off when forced to use that option.

Bhutta, Skiba, and Tobacman find that the payday loan customers in their study had both average and median credit scores below 520, substantially lower than the average score of 680 in the general population. These customers were also more likely than the general population to be delinquent on credit accounts.[28] In addition, the authors find that payday loan customers search intensively for preferred credit before deciding on a payday loan—payday loan applicants had an average of over five credit inquiries during the 12 months leading up to their initial payday loan application, "a level three times higher than [that of] the general population and even considerably higher than [that of] the general 'subprime' population."[29] However, payday loan customers were generally unsuccessful in actually getting credit other than the payday loans and other alternative loan products. "In other words," Bhutta et al. conclude, "first-time payday applicants appear to be searching intensively, but unsuccessfully, for traditional (and presumably cheaper) credit."[30]

Other researchers have also found evidence of credit problems among those who use payday loans. A 2009 study found that 43% of payday loan customers had overdrawn their checking account at least once in the previous 12 months, and 21% were 60 or more days past due on a consumer credit account during the previous 12 months.[31] Fifty-five percent stated that during the preceding five years they had had a credit request denied or limited, and 59% had considered applying for credit but did not because they expected to be denied.[32] Sixteen percent

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[28] Neil Bhutta, Paige Marta Skiba & Jeremy Tobacman, *Payday Loan Choices and Consequences* 10–11 (Vanderbilt University Law & Economics Working Paper No. 12-30, Oct. 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2160947; *see also* LEVY & SLEDGE, *supra* note 24, at 11 (noting that 54% of small-dollar credit users self-report as having poor credit).

[29] Bhutta, Skiba & Tobacman, *supra* note 28, at 11.

[30] *Id.* at 12.

[31] Gregory Elliehausen, *An Analysis of Consumers' Use of Payday Loans* 43 (Financial Services Research Program Monograph No. 41, Jan. 2009), *available at* http://www.cfsaa.com/portals/0/RelatedContent/Attachments/GWU Analysis_01-2009.pdf.

[32] *Id.* at 33.

of payday loan customers had filed for bankruptcy in the past five years—four times the rate of all consumers.

As a result, those who use payday loans generally either do not have access to preferred types of credit such as credit cards or would trigger expensive fees from credit card use if they continued to use them (such as over-the-limit or late fees). Bhutta, Skiba, and Tobacman found that only 59% of the payday loan applicants in their study had a general-purpose credit card.[33] Of those who had credit cards, the average cumulative credit limit was only $3,000 and the average balance that they carried was about $2,900, leaving very little remaining credit available. Including those payday applicants with no credit cards at all, therefore, 78% had *zero* credit available on credit cards and 4% had less than $50 available. Ninety percent had less than $300 in unused credit available.

Bhutta, Skiba, and Tobacman's findings are consistent with other research that finds payday loans are used by those who lack access to credit cards or who would exceed their credit lines.[34] Lawrence and Elliehausen found that only half of payday loan customers have general-purpose bank credit cards and of that group, over 60% reported that they had refrained from using their card within the year before their latest payday loan because they would have exceeded their credit limit.[35] Even these estimates tend to underestimate the constraints on access to credit card borrowing for many payday loan customers because some payday loan customers choose to maintain some precautionary unused credit card credit lines that can be drawn against

[33] Bhutta, Skiba & Tobacman, *supra* note 28, at 11.
[34] Edward C. Lawrence & Gregory Elliehausen, *A Comparative Analysis of Payday Loan Customers*, 26 CONTEMPORARY ECONOMIC POLICY 299, 305 (2008).
[35] *Id*. at 310.

in an emergency.[36] Levy and Sledge found that only 27% of small-dollar credit users have a credit card, compared with 61% of non-small-dollar credit users.[37] Over half of those who used alternative credit products reported that they did not qualify for a credit card, had "maxed out," or could no longer use their credit cards.[38] Those who use payday loans also are more likely to have paid late fees on their credit cards than other cardholders.[39]

Demand for payday loans has increased in recent years as access to credit cards (especially for younger, lower-income, and higher-risk consumers) has fallen as a result of the financial crisis, the subsequent recession,[40] and subsequent regulations that have further tightened credit access. For example, the Credit CARD Act of 2009 imposed limits on the ability of credit card lenders to adjust credit card terms when cardholders become more risky.[41] As a result, higher-risk borrowers now receive fewer offers of credit and on worse terms than before the enactment of the legislation.[42] In addition, it is estimated that as a result of the financial crisis and regulatory responses such as the Credit CARD Act, credit card lines of credit have been slashed by some $1 trillion just as the onset of the recession and high unemployment increased

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[36] Lawrence & Elliehausen, *supra* note 34, at 305 (citing sources); *see also* Sumit Agarwal, Paige Marta Skiba & Jeremy Tobacman, *Payday Loans and Credit Cards: New Liquidity and Credit Scoring Puzzles?* (Jan. 13, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1327125.
[37] LEVY & SLEDGE, *supra* note 24, at 11. Note that their study includes all small-dollar products, not just payday lending, and ownership of credit cards is likely to be even less common for those who use lower-ranked products such as pawnshops.
[38] *Id.* at 16. Moreover, most payday loan customers have only one or two credit cards, usually with low credit limits; thus they are unable to add accounts sequentially in order to increase their available credit as those with multiple cards and higher credit limits can. Lawrence & Elliehausen, *supra* note 34, at 309.
[39] Michael S. Barr et al., *Consumer Indebtedness in the Alternative Financial Services Market* (U. Mich. Law Working Paper, Apr. 2007).
[40] *See* David Stoesz, *Payday Loans and the Secondary Financial Market* 14–20 (Mar. 26, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2029146.
[41] Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. No. 111-24, 123 Stat. 1734 (2009).
[42] *See* Song Han, Benjamin J. Keys & Geng Li, Credit Supply to Bankrupt Consumers: Evidence from Credit Card Mailings (Mar. 2011) (unpublished manuscript), *available at* http://www-cfap.jbs.cam.ac.uk/news/events/2011/downloads/han_keys_li_credit.pdf.

the demand for credit from many consumers.[43] The combination of reduced credit lines and reduced access to credit for lower-income and higher-risk borrowers has driven a rapid growth in demand for alternative consumer credit products such as payday loans and overdraft protection.[44]

Because of this limited access to mainstream credit products, few who would otherwise use payday loans can switch to less-expensive alternatives such as bank loans or credit cards when payday loans are not available.[45] Instead, many resort to less-preferred products such as pawnshops or even to the outright sale of personal possessions.[46] Others may be forced to use credit cards or credit card cash advances even though doing so will trigger fees that exceed the costs of payday lending and may be even more likely to precipitate financial problems.[47] Still others will increase their use of overdraft protection (as will be discussed).

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[43] Meredith Whitney, Editorial, *America's 'Unbanked Masses*,' WALL ST. J., Feb. 24, 2012, *available at* http://online.wsj.com/article/SB10001424052970204909104577235590714208670.html.

[44] *See* Kevin Wack, *Downfall of Subprime Cards Spawns Opportunity*, AM. BANKER (June 27, 2013).

[45] PEW CHARITABLE TRUSTS, PAYDAY LENDING IN AMERICA: WHO BORROWS, WHERE THEY BORROW, AND WHY 16 (July 2012) [hereinafter PEW, WHO BORROWS], http://www.pewstates.org/uploadedFiles/PCS_Assets/2012/Pew_Payday_Lending_Report.pdf. One study of U.S. consumers found that in states with strict usury ceilings, unbanked consumers tended to substitute pawnshops for payday loans, while those with access to mainstream credit markets made greater use of retail and revolving credit. *See* ANNA ELLISON & ROBERT FORSTER, POLICIS, THE IMPACT OF INTEREST RATE CEILINGS 40 (2008), http://www.policis.com/pdf/International/Australia%20The%20impact%20of%20interest%20rate%20ceilings%20FINAL%2020080326.pdf. While voluntary use of credit cards is usually welfare enhancing, consumers forced to use credit cards because they lack access to payday loans may pay more for credit because of their tendency to trigger fees that may make credit cards more expensive than payday loans. *Id.* at 40.

[46] Many pawnshop borrowers turn to pawnshops only as a last resort after being rejected for a payday loan. *See* Paige Marta Skiba & Jeremy Tobacman, Measuring the Individual-Level Effects of Access to Credit: Evidence from Payday Loans 23 (Jan. 19, 2007) (unpublished manuscript), *available at* http://www.clevelandfed.org/research/conferences/2007/october2/SkibaJMPaper.pdf; ELLISON & FORSTER, THE IMPACT OF INTEREST RATE CEILINGS, *supra* note 45, at 40. Pew found that 57% of payday loan customers in its survey would pawn or sell personal items if payday loans were not available. *See* PEW, WHO BORROWS, *supra* note 45, at 16. Interest rates on pawnshops are comparable to payday loans. JOHN P. CASKEY, FRINGE BANKING: CHECK-CASHING OUTLETS, PAWN SHOPS AND THE POOR 36 (1994). Skiba and Tobacman find that pawn loans have a 90-day term with a monthly interest rate of 20% on loans of $1–$150 and 15% on loans above $150. Skiba & Tobacman, Measuring the Individual-Level Effects of Access to Credit, *supra*, at 11.

[47] ELLISON & FORSTER, THE IMPACT OF INTEREST RATE CEILINGS, *supra* note 45, at 55. Both credit card delinquencies and delinquency-related revenues for issuers are higher in states that outlaw payday lending. *Id.* at 30. Those who use credit card cash advances frequently exhibit a much higher rate of missed payments on mainstream credit loans than those who use payday loans. *Id.* at 62. A 2008 study of Australian low-income consumers found that those who use credit card cash advances also had higher levels of indebtedness on average than payday borrowers. ANNA ELLISON & ROBERT FORSTER, POLICIS, PAYDAY IN AUSTRALIA: A RESEARCH STUDY OF THE USE AND IMPACT OF PAYDAY LENDING IN THE DOMESTIC AUSTRALIAN MARKET 78 (2008), *available at* http://www.policis.com/pdf/International/Payday%20borrowers%20FINAL.pdf.

Consumers typically use payday lending to meet important financial obligations, such as rent, utility bills, and mortgage payments, and rarely for frivolous or discretionary expenditures. Payday loan customers have little or no savings to fall back on.[48] Pew found that 58% of payday loan customers reported that they had trouble paying their bills more than half the time,[49] and 37% said that they have been so desperate that they would take a payday loan on any terms offered.[50] Sixty-nine percent of respondents in another Pew survey confirmed that payday loans are used for expenses such as food, rent, utilities, or mortgage payments, and an additional 16% said that they used a payday loan for an unexpected emergency or expense.[51] Moreover, 62% of payday loan customers stated that if payday loans were unavailable they would be forced to delay paying some of their bills.[52] Only 8% said that they used a payday loan for "something special" such as Christmas gifts, shopping, or a vacation.[53]

Other studies have also found that payday loans overwhelmingly are used to meet pressing expenses such as utility bills, living expenses, rent or mortgage payments, car repairs, or medical bills.[54] Eighty-one percent of those in the Pew survey said that they would "cut back" on

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[48] LEVY & SLEDGE, *supra* note 24, at 14 (66% of those who use small-dollar lending products have no savings and 16% have insufficient savings to pay all their bills).

[49] PEW CHARITABLE TRUSTS, PAYDAY LENDING IN AMERICA, REPORT 2: HOW BORROWERS CHOOSE AND REPAY PAYDAY LOANS 9–10 (Feb. 2013) [hereinafter PEW, HOW BORROWERS CHOOSE], http://www.pewstates.org /uploadedFiles/PCS_Assets/2013/Pew_Choosing_Borrowing_Payday_Feb2013.pdf.

[50] *Id.* at 19. This sense of desperation suggests that if payday loans were not available, customers would have resorted to even more expensive products.

[51] PEW, WHO BORROWS, *supra* note 45, at 13–14.

[52] *Id.*

[53] *Id.* In a study that provides indirect evidence of payday loan customers' behavior, Bertrand and Morse examine what payday loan borrowers do when they receive tax rebates. They find that only 9% of those with outstanding payday loans used their tax rebates for seemingly discretionary consumption expenditures such as "vacations, eating out or entertainment, or gifts, apparel, or electronics" rather than to pay down their outstanding payday loans, which the authors characterize as "not a very large group." *See* Marianne Bertrand and Adair Morse, *What Do High-Interest Borrowers Do with Their Tax Rebates?*, 99 AM. ECON. REV. PAPERS AND PROCEEDINGS OF THE ONE HUNDRED TWENTY-FIRST MEETING OF THE AMERICAN ECONOMIC ASSOCIATION 418, 421 (2009). On the other hand, this estimate may be overstated if some expenditures, such as for apparel purchases, are not entirely "immediate gratification" purchases.

[54] Levy and Sledge find that the most common reasons consumers used small-dollar lending products was for utility bills (36% of respondents), general living expenses (34%), rent (18%), car repairs (16%), and "to help friends and

necessary expenses such as food and clothing if payday loans were unavailable, which suggests that many households could suffer deeply in terms of their ability to provide adequate food, clothing, shelter, and medical care for their families if payday loans were prohibited by regulation.[55] On the other hand, critics argue that even if payday loans are useful to alleviate short-term financial pressures, they are excessively costly and customers often use them to meet chronic budget problems and roll over their initial loans for multiple periods, thereby incurring repeated charges that may eventually exceed even the initial amount advanced and potentially lead to financial harm.[56]

Thus, although the overall effect of payday lending on consumers' welfare has been debated, losing access to payday loans could be harmful to many of those who use them.[57] Morgan, Strain, and Seblani found that in states where payday loans were restricted, bounced check revenues at banks increased.[58] One study found that 25% of payday loan customers reported that a loss of family income (such as from a job loss or reduced hours) created the need

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family" (7%). LEVY & SLEDGE, *supra* note 24, at 11, tbl.2. Ronald Mann finds in a survey of payday loan customers that two-thirds of borrowers used payday loans for expenditures such as rent, utilities, or groceries; 10% used payday loans for emergency expenses and less than 5% used payday loans for option expenditures such as gifts, dining, or entertainment. Ronald Mann, *Assessing the Optimism of Payday Loan Borrowers*, 21 S. CT. ECON. REV. (forthcoming 2014). Jonathan Zinman finds that payday loan customers primarily used their funds for bills, emergencies (such as car repairs or medical expenses), food, and debt service; only 6% said that they used payday loan funds for "shopping or entertainment." Jonathan Zinman, *Restricting Consumer Credit Access: Household Survey Evidence on Effects Around the Oregon Rate Cap* 9 (Fed. Reserve Bank of Phila. Working Paper No. 08-32, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1335438. Analysis of data from the 2007 Survey of Consumer Finances by the Center for American Progress found that the main reasons given by payday loan customers for their loans were "Convenience" (34%), "Emergency" (29%), "Basic consumption need" (21%), and "Home" (9%). *See* AMANDA LOGAN & CHRISTIAN E. WELLER, WHO BORROWS FROM PAYDAY LENDERS? AN ANALYSIS OF NEWLY AVAILABLE DATA at 11 (Center for American Progress, Mar. 2009), http://www.americanprogress.org/issues/2009/03/pdf/payday_lending.pdf.

[55] PEW, WHO BORROWS, *supra* note 45, at 16.

[56] *See* discussion *infra* at notes 160–165 and accompanying text.

[57] *See* Richard Hynes, *Payday Lending, Bankruptcy, and Insolvency*, 69 WASH. & LEE L. REV. 607 (2012) (summarizing research on effects of payday lending and concluding that the overall welfare effect is ambiguous); Paige Marta Skiba, *Regulation of Payday Loans: Misguided?*, 69 WASH. & LEE L. REV. 1023 (2012) (same); John P. Caskey, *Payday Lending: New Research and the Big Question*, Federal Reserve Bank of Philadelphia Research Department Working Paper No. 10-32 (Oct. 2010).

[58] Donald P. Morgan, Michael R. Strain, and Ihab Seblani, *How Payday Credit Access Affects Overdrafts and Other Outcomes*, 44 J. MONEY, CREDIT, & BANKING (2012).

for a payday loan.[59] A majority of those in a Pew study said that access to payday loans relieves stress and anxiety, compared to less than one-third of respondents who said that payday loans increase stress.[60]

B. A Profile of Overdraft Protection Customers

Like payday loan customers, those who use overdraft protection often have impaired credit and limited credit options. A study by Moebs Services research firm, for example, concluded that the only accurate predictor of the propensity to use overdraft protection is the consumers' credit score—those with lower credit scores are more likely to use overdraft protection—and that all other demographic information, including income, is nonpredictive of overdraft protection use.[61] Economist Marc Fusaro also found little correlation between income level and high overdraft use: high-income individuals are just as likely as lower-income individuals to use overdraft protection.[62]

A survey of overdraft users by the Raddon Group found that only 7% of elevated users of overdraft protection describe their personal assessment of their credit rating as "excellent," while 70% describe their credit rating as either "fair" (38%) or "poor" (32%).[63] By contrast, 74% of nonusers of overdraft protection describe their credit rating as "excellent" or "good," and only

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[59] *See* LEVY & SLEDGE, *supra* note 24.
[60] PEW, HOW BORROWERS CHOOSE, *supra* note 49, at 36–38.
[61] Press Release, Moebs Services, Who Uses Overdrafts? (Sept. 29, 2009), *available at* http://www.moebs.com /PressReleases/tabid/58/ctl/Details/mid/380/ ItemID/194/Default.aspx.
[62] Marc Anthony Fusaro, *Hidden Consumer Loans: An Analysis of Implicit Interest Rates on Bounced Checks*, 29 J. OF FAM. & ECON. ISSUES 251, 257, 260 (2008); Fusaro, *Bounced Check Loans*, *supra* note 25, at 499. That many high-use overdraft customers are also high-income consumers should not be surprising because overdraft protection was originally a convenience for higher-income borrowers. Access to overdraft protection has been extended to less-well-off consumers over time.
[63] Raddon Fin. Grp., Inc. *Custom Survey Research Findings* (June 2011). A summary of the study findings can be found in Zywicki, *Overdraft Protection*, *supra* note 20, at 1173 (citing survey by Raddon Group).

9% consider their credit rating to be "poor."[64] Another study finds that those who self-identify as having "poor credit" are also three times more likely to say that access to overdraft protection is "extremely important" than those who self-report as having "excellent credit."[65] Only 10% of frequent overdraft users report that they would use a credit card if overdraft protection were not available, while a majority said that they would be unable to obtain needed funds if overdraft protection were not available.[66] What's more, because those who use overdraft protection frequently have weak credit, they usually cannot qualify for less-expensive options, such as a bank line of credit, which require higher credit scores and much larger minimum loan amounts.[67]

Overdraft protection also is often used to ensure payment of important bills that would otherwise go unpaid or cause bounced checks. For example, eight of nine respondents in a small focus group conducted by ICF Macro (in connection with the Federal Reserve's promulgation of its 2009 amendments to Regulation E regarding overdraft protection programs) said that they would keep their overdraft coverage—even if it meant triggering overdraft fees—because they wanted their checks to clear for important transactions.[68] In addition, according to one large regional bank, when it adopted a new policy of posting overdrafted checks in sequential order from the smallest to the largest dollar amount (as required by the FDIC), the number of checks and ACH (Automatic Clearing House) items that were returned increased by 4%, but the total

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[64] *See* Raddon Group, *supra* note 63; Zywicki, *Overdraft Protection*, *supra* note 20, at 1173 (summarizing findings).

[65] Baselice & Associates, Inc., Banking Survey (Aug. 29–31, 2011) (discussed in Zywicki, *Overdraft Protection*, *supra* note 20, at 1174).

[66] Raddon Group, *supra* note 63; Zywicki, *Overdraft Protection*, *supra* note 20, at 1173 (discussing survey by Raddon Group).

[67] *See* Raddon Group, *supra* note 63; Zywicki, *Overdraft Protection*, *supra* note 20, at 1192 (discussing Raddon Group study). Frequent overdraft users often do not have sufficient funds to maintain a separate savings account that they can link to their checking account to cover overdrafts. Only a minority of banks offer overdraft programs linked to other accounts, such as a line of credit or savings account, instead of traditional overdraft loan programs. *See* CFPB, OVERDRAFT PROGRAMS, *supra* note 17, at 56.

[68] MACRO INT'L INC., REVIEW AND TESTING OF OVERDRAFT NOTICES 8–9 (Dec. 8, 2008), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20081218a6.pdf.

dollar amount of the rejected payments increased by 16%.[69] Moreover, the returned payments included important items such as mortgages, utilities, medical bills, student loan bills, rent, and taxes.[70] Thus, although the FDIC's requirement that smaller payments be cleared first might have reduced the total number of overdrafts by consumers, it also led to a disproportionate return of larger, more important payments—for which consumers presumably might want overdraft protection—while smaller, less-important payments were honored.

Consumer behavior also illustrates the value of overdraft protection to heavier users of the product. For example, the Federal Reserve's amendments to Regulation E required banks to obtain affirmative opt-in consent from consumers of overdraft protection for ATM and point-of-sale debit transactions.[71] Although comprehensive independent analysis of the effect of the regulation's opt-in requirement is lacking, one finding is clear: the likelihood that a consumer will opt in to overdraft protection is positively correlated with the consumer's frequency of use. For example, the CFPB's overdraft protection white paper reports that, while 15.2% of all bank accounts had opted in to overdraft protection following the issuance of the new requirement, the percentage of those accounts that opted in rose as the number of overdrafts increased ranging from 11.3% for accounts that had no overdrafts to 44.7% for those with more than ten overdrafts.[72] A survey by Moebs Services of large banks found that 60–80% of consumers opted in to debit card overdraft protection (with a median of 75%) but that almost all of those who used overdraft protection more than ten times per year did so.[73] A June 2011 survey of its customers

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[69] *See* Zywicki, *Overdraft Protection*, *supra* note 20, at 1190 (describing data obtained from IBC Bank).
[70] *Id.*
[71] *See* 12 C.F.R. § 205.17 (2011).
[72] CFPB, OVERDRAFT PROGRAMS, *supra* note 17, at 31, Fig. 5.
[73] *See* Press Release, Moebs Services, Banks Lower Overdraft Fees as Consumers Choose to Opt-In (Dec. 8, 2010), [hereinafter Moebs Services, Banks Lower Overdraft Fees], *available at* http://www.moebs.com/PressReleases/tabid/58/ctl/Details/mid/380/ItemID/197/Default.aspx ("[A]lmost 100 percent of those using overdrafts 10 or more times in a year, and over 50 percent of those who never overdraw their account, opted-in for overdraft protection.").

by one large regional bank also found that frequent users were much more likely than infrequent users to report that access to overdraft protection was "extremely valuable."[74] The heightened willingness of heavier users of overdraft protection to opt in to coverage is suggestive of the value of the product to those consumers in light of available alternatives.

III. Competition Between Payday Lending and Overdraft Protection

Payday lending and overdraft protection also compete directly for consumers in that many consumers actually use, or could use, both products to achieve the same objectives. Moreover, available evidence indicates that consumers generally choose wisely in deciding which product to use in light of their available options or in deciding whether to use either payday lending or overdraft protection compared to alternative products. Standard economic theory demonstrates that robust competition is a vital source of consumer welfare, and consumer credit is no exception. Thus, regulation should be sensitive to preserving competition that will produce lower prices and higher quality for consumers.

A. Benefits of Competition Within Product Markets

Competition benefits consumers in the alternative consumer credit markets just as it does in any other market, providing consumers with the opportunity for lower prices, innovation, and higher-quality service.[75] Although prices seem high for both payday loans and overdraft protection,

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[74] *See* Zywicki, *Overdraft Protection*, *supra* note 20, at 1158 (citing study by the Raddon Financial Group in June 2011 that 86% of elevated users stated that the availability of overdraft protection was "extremely valuable" while only 2% said it was "[n]ot at all valuable." The percentage of those stating that overdraft protection was "extremely valuable" rose consistently with the intensity of use, from 57% for nonusers of overdraft protection to 86% for elevated users.).

[75] *See* Philip Bond, David K. Musto & Bilge Yilmaz, *Predatory Lending in a Rational World* (Federal Reserve Bank of Philadelphia, Working Paper No. 06-2, Nov. 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract

there is no evidence that either product generates sustainable economic profits (as opposed to normal economic returns).[76] Payday loan prices generally reflect underlying risk and operating costs.[77] There is no evidence of supranormal economic (or monopoly) returns to firms in the payday lending industry, indicating the competitive nature of the market.[78] Barriers to entry in the payday lending market appear to be low.[79]

Competition among payday lenders produces lower prices and higher quality, just as in other markets.[80] Donald Morgan also finds that greater competition among payday lenders generated lower market prices.[81] In addition to competing on price, payday lenders compete on nonprice margins such as convenience, customer service, and responsiveness, all of which are highly valued by payday loan customers.[82]

Those who use payday lending report high levels of satisfaction with their experiences, as would be expected in a highly competitive market with informed consumers. For example, a study published in 2009 by economist Gregory Elliehausen found that 54.7% of borrowers

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_id=875621; *see also* Victor Stango, *Are Payday Lending Markets Competitive?*, REGULATION, Fall 2012, at 26, *available at* http://www.cato.org/sites/cato.org/files/serials/files/regulation/2012/11/v35n3-5.pdf.

[76] It is important to stress that we are referring here to *economic* profits—i.e., risk-adjusted returns above the opportunity cost of the inputs used (what the assets would receive in a competitive market), not merely accounting profits. Thus, it is possible to recognize accounting profits while receiving no economic profits once the opportunity cost and risk of the product are considered. *See Economic Profits (or Loss)*, INVESTOPEDIA.COM, http://www.investopedia.com/terms/e/economicprofit.asp.

[77] Mark Flannery & Katherine Samolyk, *Payday Lending: Do the Costs Justify the Price?* (FDIC Center for Financial Research Working Paper No. 2005/09, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=771624.

[78] *See* Paige Skiba & Jeremy Tobacman, The Profitability of Payday Loans 2 (Dec. 10, 2007) (unpublished manuscript), *available at* http://www.cpla-acps.ca/english/reports/Vanderbilt%20Oxford%20profitability%20study%2012%2010%202007.pdf.

[79] Zywicki, *Payday Lending*, *supra* note 24, at 28. For example, there are twice as many licensed payday lenders in California as there are McDonald's restaurants, indicating the ease of entry. *See* http://www.csun.edu/~sg4002/research/mcdonalds_by_state.htm.

[80] Robert DeYoung & Ronnie J. Phillips, *Payday Loan Pricing* 29 (Fed. Reserve Bank of Kan. City, Working Paper No. 09-07, 2009), *available at* https://www.kansascityfed.org/PUBLICAT/RESWKPAP/PDF/rwp09-07.pdf.

[81] DONALD P. MORGAN, FED. RES. BANK OF NEW YORK, DEFINING AND DETECTING PREDATORY LENDING 22 (Jan. 2007), http://www.consumerservicealliance oftexas.org/Donald%20Morgan%20Fed%20Study%20-%20Defining%20and%20Detecting%20Predatory%20Lending.pdf.

[82] Stango, *supra* note 75, at 27; LEVY & SLEDGE, *supra* note 24, at 4 ("The top 3 loan attributes that mattered most to [small-dollar credit] consumers were: quick access to money, ability to qualify, and clear terms.").

reported being “very satisfied” and 33.7% reported being “somewhat satisfied” with their most recent payday loan. By contrast, only 5.1% were “somewhat dissatisfied” and 5.7% were “very dissatisfied.”[83] Levy and Sledge similarly found that a majority of those who used small-dollar lending products (such as payday lending and pawnshops) reported having a satisfactory experience.[84] Research by the Pew Foundation found that 62% of payday loan customers said that they would use payday loans again if they needed money.[85]

Consumers also are attracted to payday lending because they feel that the pricing is simple, transparent, and understandable.[86] According to a survey by the Pew Trust, for example, 86% of payday loan customers said that the terms and conditions of payday loans are clear,[87] and Elliehausen found that only 2% of payday loan customers did not know the finance charge on their loan.[88] In fact, many payday loan customers prefer payday loans because they have had negative experiences with more complicated products such as credit cards and bank accounts.[89]

The growth in the use of overdraft protection also came in response to competition and consumer demand in the banking industry. Like payday lending, the retail banking industry is highly competitive[90] and there is no evidence of supranormal profits arising because of the

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[83] Elliehausen, *supra* note 31, at 42. Of those who were dissatisfied, most thought the prices were too high.
[84] LEVY & SLEDGE, *supra* note 24, at 5.
[85] PEW, HOW BORROWERS CHOOSE, *supra* note 49, at 49.
[86] LEVY & SLEDGE, *supra* note 24, at 4 (reporting that “clear terms” is one of the main characteristics liked by users of payday lending and other short-term lending products).
[87] PEW, HOW BORROWERS CHOOSE, *supra* note 49, at 17.
[88] Elliehausen, *supra* note 31, at 35–38. 94.5% of payday loan customers reported paying finance charges consistent with prevailing market rates. *Id.* Caskey reports a survey of California payday loan customers in which 92% of customers stated that they were aware of the fees on their payday loan before they borrowed. *See* Caskey, *supra* note 57, at 7.
[89] *See* Zywicki, *Payday Lending*, *supra* note 24.
[90] *See* David S. Evans, Robert E. Litan & Richard Schmalensee, Economic Analysis of the Effects of the Federal Reserve Board’s Proposed Debit Card Interchange Fee Regulations on Consumers and Small Businesses 33 (Feb. 22, 2011) (unpublished manuscript), *available at* http://www.federalreserve.gov/ SECRS/2011/March/20110308 /R-1404/R-1404_030811_69120_621655419027_1.pdf.

operation of overdraft protection programs.[91] Overdraft protection traditionally was available only to high-income or well-connected customers for whom overdrafts would be paid when they had short-term liquidity problems.[92] The creation of automated overdraft protection, however, led banks to extend access to the product beyond its traditional elite, high-income customer base.

Since the creation of automated overdraft protection, use of the product has spread very quickly. The FDIC found in its 2008 report of 462 FDIC-supervised banks that 86% of banks "operated some form of an overdraft program" and that 40.5% of all banks offered automated overdraft programs.[93] Among larger banks with over $1 billion in assets, 76.9% offered automated overdraft programs.[94] Approximately 70% of banks with overdraft programs implemented their automated programs after 2001.[95] A 2011 study by the FDIC found that 70% of banks with assets of $38 billion or more, 54% of midsized institutions, and 32% of banks with assets of less than $1 million operated automated overdraft programs.[96] A survey of 575 community banks undertaken in connection with the CFPB's overdraft protection study found that 71% of banks with over $250 million in assets use some degree of automated overdraft

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[91] Although measures of return on assets and measures of return on equity are simply approximations of underlying economic profits, neither measure reflects the presence of economic rents compared to the opportunity cost of capital and it is not clear that the return on assets rose over the period during which access to overdraft protection increased. *See* http://research.stlouisfed.org/fred2/series/USROA (return on assets); http://research.stlouisfed.org /fred2/series/USROE?rid=55 (return on equity). We are not aware of anyone who has argued that economic rents *were* present as a result of increased access to overdraft protection. Indeed, return on equity for large banks was virtually constant from the early 1990s until the time of the financial crisis; *see* http://research.stlouisfed.org/fred2 /series/USG15ROE?rid=55; and return on assets was largely unchanged as well, *see* http://research.stlouisfed.org /fred2/series/USG15ROA?rid=55.

[92] *See* Zywicki, *Overdraft Protection*, *supra* note 20, at 1151.

[93] *See* FED. DEPOSIT INS. CORP., FDIC STUDY OF BANK OVERDRAFT PROGRAMS 5 (2008) [hereinafter FDIC STUDY OF BANK OVERDRAFT PROGRAMS], *available at* http://www.fdic.gov/bank/analytical/overdraft/FDIC138_Report _ Final_v508.pdf (describing the study, which consisted of a general analysis of the availability of overdraft programs and a detailed evaluation of these individual programs).

[94] *Id.* at 5 tbl.III-1.

[95] *Id.* at 8 tbl.III-4.

[96] FDIC, SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS, *supra* note 2, at 16.

protection.[97] As the use of ATMs and point-of-sale debit cards has increased, banks have also extended overdraft protection to those products.[98]

One major reason for the growth of overdraft protection (along with the growth of debit card use and the interchange fees it generated) was its link to the expansion of free checking accounts.[99] From 2001 to 2009, the percentage of accounts at large banks that qualified for free checking increased from 7.5% to 76% and the average minimum balance required for free checking fell from $440 in 2001 to $186 in 2009.[100] Consumers migrated to banks that offered the combination of free checking and overdraft protection, especially low-income consumers who either could not afford the monthly maintenance fees or high minimum balances necessary to obtain free checking or had limited credit options and thus valued access to overdraft protection.[101] Revenue from overdraft protection and other sources also enabled banks to increase other services valued by customers, such as free online banking, or to increase customer service by adding more convenient branch locations and operating hours.[102] The combination of overdraft protection, free checking, and increased access to new customers increased the market share of those banks and imposed competitive pressure on other banks to respond.[103]

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[97] CFPB, OVERDRAFT PROGRAMS, *supra* note 17, at 14.

[98] According to the FDIC study, 81% of banks that operated automated overdraft programs allowed overdrafts to be paid at ATMs and POS debit card terminals. FDIC, SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS, *supra* note 2, at 9–10, 10 tbl.III-8.

[99] *See* Zywicki, *Overdraft Protection*, *supra* note 20, at 1163–66.

[100] Evans, Litan & Schmalensee, *supra* note 90, at 35–36.

[101] It should be stressed that the overwhelming majority of consumers, including responsible low-income consumers, pay no or few overdraft fees each year and thus in fact do receive checking with no service or other charges. *See* Zywicki, *Overdraft Protection*, *supra* note 20, at 1163–66.

[102] *See* Zywicki, *Overdraft Protection*, *supra* note 20, at 1178 (discussing value of products in "free checking" bundle).

[103] *See* Marc Anthony Fusaro, Consumers' Bank Choice and Overdraft Volume: An Empirical Study of Bounce Protection Programs (Dec. 2003) (unpublished manuscript), *available at* http://faculty.atu.edu/mfusaro/fusaro overdraftvolume.pdf [hereinafter Fusaro, Consumers' Bank Choice]. This competitive growth may not be specifically because all customers consciously desire to have access to overdraft protection (although surely some do) but because consumers value the combination of terms and account features banks offer in combination with overdraft protection. In particular, increased use of overdraft protection enabled banks to offer accounts with free

On the other hand, overdraft programs carry risk for banks when some customers do not repay negative account balances. The CFPB estimates, for example, that charged-off, uncollectible overdraft advances were about 14.4% of the net overdraft fees charged by banks in 2011.[104] The competitive success of combining terms associated with overdraft protection—e.g., free checking, higher quality, and a variety of free services—over the competing model of monthly maintenance fees and minimal services suggests that consumers preferred the former to the latter.

The role of overdraft fees in the competitive process was illustrated by the financial industry's response to the Federal Reserve's amendments to Regulation E in 2009, which imposed new limits on overdraft protection programs. According to Evans, Litan, and Schmalensee, "within days" of the Fed's announcement of its new overdraft rules, banks started scaling back access to free checking, imposed new fees, and eliminated services for consumers.[105] The number of accounts eligible for free checking fell 11 percentage points in one year—from 76% in 2009 to 65% in 2010—a figure that translates to approximately 20 million accounts.[106] The decline in 2010 is part of a larger trend that has seen access to free checking plunge in recent years, reversing the gains of the prior decade in terms of mainstreaming many American financial consumers.[107] On top of Regulation E, access to free checking has been reduced by the lingering effects of the financial crisis and subsequent recession, as well as the Durbin Amendment to Dodd-Frank (which became effective in 2010)

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checking or other lower fees, which increased access for lower-income consumers who otherwise could not afford accounts with the higher monthly fees or high minimum balances necessary to qualify for free checking accounts.

[104] CFPB, OVERDRAFT PROGRAMS, *supra* note 17, at 17.

[105] Evans, Litan & Schmalensee, *supra* note 90, at 40.

[106] *Id.* at 41.

[107] Since that time, access to free checking has continued to fall. By 2012, the percentage of accounts eligible for free checking had fallen to 39%. *See* Claes Bell, Checking Fees Rise to Record Highs in 2012, http://www.bankrate .com/finance/checking/checking-fees-record-highs-in-2012.aspx#slide=1 (Sept. 24, 2012). At the same time, many consumers have become unable to afford bank accounts: the FDIC reports that between 2009 and 2011, the number of unbanked Americans increased by 1 million and the number of underbanked by 3 million. FDIC, SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS, *supra* note 2.

that imposed limits on debit card interchange fees and generated compensating increases in other banking fees.[108]

The growth of access to overdraft protection is largely consistent with consumer preferences, especially among frequent users of the product. According to a 2009 survey by the American Bankers Association (ABA), of those consumers who had paid an overdraft fee in the past twelve months, 96% wanted the bank to cover their payment.[109] A 2010 survey by the ABA found that 69% of those who paid overdraft fees in the previous twelve months were happy that the payment was covered.[110] Overall, available information indicates that the vast majority of overdraft customers self-report that they are happy that overdraft protection is available and that they value the ability to be free to use overdraft protection when they need it.[111] Consumers also report that they generally understand the terms and costs of overdraft programs.[112]

Economist Mark Fusaro estimates that, on average, consumers gain a surplus of approximately $50 per year, or $2 billion economy-wide, from the availability of overdraft protection plus the accompanying benefits of avoiding nonsufficient funds (NSF) fees and maintaining lower precautionary balances.[113] Fusaro and Ericson conclude that overdraft protection generally benefits middle-class bank consumers and is neutral for low-income consumers.[114] They conclude that eliminating overdraft protection "through excess regulation

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[108] Dodd-Frank Act, Pub. L. No. 111-203, § 902(a)(2).
[109] Press Release, Am. Bankers Ass'n, ABA Survey: More Consumers Avoid Overdraft Fees (Sept. 9, 2009) [hereinafter ABA 2009 Survey], *available at* http://www.aba.com/aba/documents/press/ConsumerOverdraftSurvey 2009.pdf.
[110] Press Release, Am. Bankers Ass'n, ABA Survey: Most Customers Avoid Overdraft Fees (Sept. 15, 2010) [hereinafter ABA 2010 Survey], *available at* http://www.aba.com/Press/Pages/091510ConsumerOverdraftSurvey.aspx.
[111] *Id.* at 1174.
[112] *See* ICF MACRO, DESIGN AND TESTING OF OVERDRAFT DISCLOSURES: PHASE TWO iii (Oct. 12, 2009), http://www .federalreserve.gov/newsevents/press/bcreg/bcreg20091112a4.pdf.
[113] *See* Fusaro, Consumers' Bank Choice, *supra* note 103, at 3.
[114] *See* Marc Anthony Fusaro & Richard E. Ericson, *The Welfare Economics of "Bounce Protection" Programs*, 33 J. CONSUMER POLICY 55, 71 (2010).

would hurt the most vulnerable population the most, as they have the fewest alternatives to maintain necessary liquidity."[115]

B. Benefits of Competition Across Product Markets: Payday Lending and Overdraft Protection

Economic analysis indicates that payday loans and overdraft protection compete with each other. Economists Brian T. Melzer and Donald P. Morgan have studied consumer decision making with respect to the choice between payday lending and overdraft protection to illustrate the manner in which they compete.[116] Payday loans and overdraft protection are offered on very different price terms, a fact that Melzer and Morgan used as a natural experiment for testing whether consumers choose rationally between them.[117] Payday loans typically charge $15 for every $100 borrowed (which was also the case when Melzer and Morgan conducted their study). Overdraft protection plans charge a flat fee per overdraft, regardless of the size of the check that triggers it. At the time of their study, Melzer and Morgan reported an average overdraft fee of $27.[118] Therefore a payday loan is less expensive when covering a single payment of $180 or less, but above that amount, overdrafts are less expensive.[119] This differential pricing scheme also creates a

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[115] *Id*.
[116] *See* Brian T. Melzer & Donald P. Morgan, Competition and Adverse Selection in a Consumer Loan Market: The Curious Case of Overdraft vs. Payday Credit 1-2 (Dec. 2, 2009) (unpublished manuscript), *available at* http://www.newyorkfed.org/research/staff_reports/sr391.pdf.
[117] It should be noted that price is not the only way in which the two products compete. For example, overdraft protection advances are more convenient and can be triggered at the point of making a purchase or paying a bill, anytime in the world 24 hours a day, thereby avoiding the "shoe leather" costs of obtaining a payday loan and the need to plan ahead to have sufficient funds available to cover transactions. *See* Zywicki, *Overdraft Protection*, *supra* note 20, at 1167–70. On the other hand, borrowers may prefer payday loans because defaulting on the payday loan does not jeopardize their access to a bank account (although it may eliminate access to further payday loans). This indicates that consumers shop among products with considerations such as convenience and access, not just price.
[118] Melzer & Morgan, *supra* note 116, at 1.
[119] The equivalence is $27/$180 = $15/$100. The CFPB cites one estimate that the average overdraft fee increased from $21.57 in 1998 to $31.26 in 2012. *See* CFPB, OVERDRAFT PROGRAMS, *supra* note 17, at 17 (citing Bankrate.com). Obviously, if the average fee for overdrafts increases or payday loan fees decrease, the break-even point will increase as well. In addition, if a consumer chooses to roll over an initial payday loan rather than paying it off at its maturity, it might be argued that payday loans are more expensive. But this potential is functionally

potentially adverse selection problem because rational consumers will select the option that gives them the lowest price for their particular transaction.[120]

Melzer and Morgan's analysis confirms that when payday loans are available, the two products compete and consumers generally choose rationally whether to use overdraft protection or payday lending to cover a particular transaction. Where payday loans are available, the number of overdrafts and bounced checks *falls* (as consumers use payday loans to cover some checks that otherwise might bounce),[121] but the dollar amount of the average overdraft *rises*, perhaps because payday loans are used to cover smaller checks.[122]

Subsequent research by Morgan, Strain, and Seblani on the impact of state payday loan bans also found that consumers substitute between the two products.[123] As predicted, they found that when a state bans payday lending, overdraft revenues increase at banks, whereas allowing payday lending results in a decline in bank overdraft fee revenues.

Consumers also identify the two products as competitive substitutes. One survey found that a quarter of those who frequently use overdraft protection say that they would switch to payday lending if overdraft protection were not available.[124] A survey of Australian payday loan customers by the Policis research group found that if payday loans were not available,

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identical to that of overdraft protection in that the customers must pay off both the item that triggered the overdraft and the fee. If the customers are left with insufficient funds to pay for new items, they will trigger a new overdraft and a new fee. As a result, the fact that many consumers roll over their payday loans does not seem to change the underlying comparison in any meaningful sense. If multiple payments must be covered, a single payday loan usually will be less expensive than multiple overdrafts.

[120] *See* Melzer & Morgan, *supra* note 116, at 1 (noting that this "selection is adverse to overdraft providers in two ways; funding large overdrafts costs more, and if the credit is not repaid, lenders lose more").

[121] *See id.* at 17.

[122] *See id.* at 20. They also find that where payday loans are available, banks reduce the availability of "free" checking for accounts *without* direct deposit, but not for those *with* direct deposit. According to the authors, direct deposit serves as insurance for the bank against "hit and run" customers who open an account without direct deposit, intending to make large overdrafts that will never be repaid, and then switch to using payday loans to meet short-term credit needs. *See id.* at 20–21.

[123] Morgan, Strain & Seblani, *supra* note 58.

[124] Raddon Group, *supra* note 63; Zywicki, *Overdraft Protection*, *supra* note 20, at 1173 (citing survey by Raddon Group).

approximately 20% of payday loan customers said that they would increase their use of overdraft protection.[125] Jonathan Zinman also finds some evidence that the use of overdraft protection increased after Oregon imposed strict regulations on payday loan prices.[126]

In fact, the increasing convergence between nonbank payday lending and short-term bank lending products may be best illustrated by the direct deposit advance that has been developed by banks in recent years. This product is functionally similar to payday loans.[127] As previously mentioned, with a direct deposit advance, bank customers can have the bank deposit funds into their bank accounts as an advance against an expected direct deposit credit (such as a paycheck). The bank can then withdraw the loan amount plus a fee directly from the customer's next direct deposit.[128] According to an analysis by the Center for Responsible Lending, the typical cost of bank direct deposit advance loans is $10 per $100 borrowed, and the typical loan term is approximately 10 days, producing an estimated APR of 365%, very similar to that of payday loans.[129] In fact, the CFPB's white paper on payday lending and deposit advance recognizes that these two products have "general similarities in structure, purpose, and . . . consumer protection concerns"[130] and "particularly in the consumer protection issues they raise."[131]

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[125] *See* ELLISON & FORSTER, PAYDAY IN AUSTRALIA, *supra* note 45, at 92.
[126] Zinman, *supra* note 54.
[127] *See* REBECCA BORNE, JOSHUA FRANK, PETER SMITH & ELLEN SCHLOEMER, CENTER FOR RESPONSIBLE LENDING, BIG BANK PAYDAY LOANS: HIGH-INTEREST LOANS THROUGH CHECKING ACCOUNTS KEEP CUSTOMERS IN LONG-TERM DEBT (July 2011), *available at* http://www.responsiblelending.org/payday-lending/research-analysis/big-bank-payday-loans.pdf.
[128] If the customer does not deposit sufficient funds within 35 days to repay the loan, the bank can repay the amount due via an overdraft of the customer's account.
[129] *Id.* at 5. Of course, the APR varies according to the fees associated with the loan as well as the loan duration. For example, a loan outstanding for 10 days had an estimated APR of 365% while a loan of one month had an estimated APR of 120%. *Id.*
[130] CFPB, PAYDAY LOANS, *supra* note 23, at 6.
[131] *Id.* at 6–7. The CFPB notes some differences between the two products based on their credit risk and business costs. *Id.* at 7–8. However, these product differences are largely unrelated to the consumer protection issues discussed here.

The fee-based nature of payday loan pricing and overdraft protection suggests another similarity between the products: In both cases, it might be more appropriate to think of the charges either as a product or service price or as a convenience fee, rather than as a payment of interest. For example, payday loan customers pay for the service of having money advanced to them. They do not receive a discount for early loan repayment, as would be the case if the product price reflected accrued interest, and the fee is not based on the number of days the loan is outstanding. Similarly, the primary pricing for overdraft protection is a flat fee for the convenience of payment of the check, rather than interest for the time the overdraft is outstanding.[132] More fundamentally, regardless of whether both products are classified as "credit" with the prices converted into an associated inferred APR or both are classified as charging a price or fee for a product or service, their term structure is essentially identical and should be considered so for regulatory purposes. In other words, if the price terms of payday lending are converted into an inferred APR and subjected to regulation on that basis, the price terms of overdraft protection should be as well.

C. History Lessons on Regulation and the Value of Preserving Fair Competition in Consumer Credit Markets

Dodd-Frank's recognition of the importance of maintaining a fair competitive market for consumer credit products is confirmed by experience.[133] In the United States, consumer financial products historically were regulated on the state level in an ad hoc, product-by-product regulatory framework tailored to the unique characteristics of each product as it emerged. Thus, as various new products were developed (often spurred by efforts to create products that would

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[132] Overdraft protection generally has a modest finance charge or flat daily fee so long as a negative balance exists, but the initial convenience fee is the primary price component. *See* Zywicki, *Overdraft Protection*, *supra* note 20, at 1175.
[133] *See* THOMAS A. DURKIN, GREGORY ELLIEHAUSEN, MICHAEL STATEN & TODD J. ZYWICKI, CONSUMER CREDIT AND THE AMERICAN ECONOMY (Oxford University Press, forthcoming 2014).

fall outside consumer credit regulations), they were governed by different regulatory schemes designed specifically for the features of those products.[134] For example, industrial banks (originally known as Morris Plan banks after Arthur J. Morris, who first conceived the idea), first appeared in 1910. Under the Morris Plan, lenders would offer a loan at the legal rate permitted by the state's usury law, but they also would require the borrower either to purchase a hypothecated, non-interest-bearing certificate from the bank or to make monthly deposits into a non-interest-bearing savings account equal to one-twelfth of the original principal amount.[135] This particular structure, while functionally equivalent to paying interest on a loan, was held to fall outside existing regulatory limits. As a result, Morris Plan banks spread rapidly at the expense of functionally identical products having different formal structures that caused them to fall under existing regulations.

This practice of designing substantively identical loan products to conform to the narrow letter of the law was ubiquitous. Within any particular state, different lenders would offer similar products that were structured differently and thus called forth different regulations. As new products were designed to avoid regulation, legislatures would create a new set of laws tailored to the new product's particular characteristics. Economist Robert W. Johnson wrote in 1968 that

> the result of this ad hoc development of legislation is clearly demonstrated, for example, in New York, where there are separate statutes regulating installment loans by commercial banks, loans by industrial banks, banks' check-credit plans, revolving charge accounts, motor vehicle installment sales financing, installment financing of other goods and services, insurance premium financing, loans by consumer finance companies, and loans by credit unions. In these nine statutes there are 14 different ceilings on consumer finance charges.[136]

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[134] *See id.* at chapter 11.

[135] Jarret C. Oeltjen, *Usury: Utilitarian or Useless?*, 3 FL. ST. U. LAW REV. 167 (1975); IRVING S. MICHELMAN, CONSUMER FINANCE: A CASE STUDY IN AMERICAN BUSINESS 197–203 (2nd ed. 1970).

[136] Robert W. Johnson, *Economic Rationale of the Uniform Consumer Credit Code*, 23 J. FIN. 303, 305 (1968).

The end result was a patchwork of product-by-product regulations with a thicket of inconsistent rules that governed everything from permissible interest rates to loan size.[137] These inconsistent laws artificially segmented consumer loan markets and dampened competition, which, as economist Robert P. Shay notes, "fostered monopolistic or oligopolistic markets with accompanying higher prices for credit."[138]

In fact, regulation itself could facilitate collusion among lenders, especially on interest rate ceilings.[139] For example, David H. Rogers's study of consumer banking in New York noted that rates charged by different types of lenders "closely followed" the statutory ceilings provided by state law for the different types of lenders and that there was significant market segmentation in the size of loans offered by different types of lending institutions.[140] Economists have found similar effects for interest rate ceilings on credit cards[141] and payday loans.[142] Disparate regulation of substitute products further distorted the market because capital tended to flow to less regulated markets, thereby expanding the market share of favored products and reducing the share of products subject to tight regulation.[143] As a result, although the products were substantively similar, their respective market shares often depended on their relative regulatory treatment rather than on consumer preferences and fair competition.

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[137] DAVID H. ROGERS, CONSUMER BANKING IN NEW YORK 33 (1974). Rogers notes that in New York, for example, industrial banks could offer loans of up to $5,000 at 6% per year and commercial banks could offer loans of $500–$3,500 per year at an interest rate of 12% on unpaid balances. Licensed small-loan companies, however, could make loans of up to $300 at 3% per month for the first $150 and 2.5% above $150. Credit unions offered very small loans at lower rates (federal credit unions offered unsecured loans of $50 at 1% per month), but because they were available to members only, they were irrelevant for many customers. *Id.*

[138] Robert P. Shay, *The Impact of the Uniform Consumer Credit Code upon the Market for Consumer Installment Credit*, 33 LAW & CONTEMP. PROBS., 752 (1968).

[139] *See* Christopher R. Knittel & Victor Stango, *Price Ceilings as Focal Points for Tacit Collusion: Evidence from Credit Cards*, 93 AM. ECON. REV. 1703 (2003) (Interest rate ceilings can facilitate collusion among lenders. Price ceilings, while not binding, make it easier for lenders to choose an interest rate at which all of them could set their price.).

[140] ROGERS, *supra* note 137, at 33.

[141] Knittel & Stango, *supra* note 139.

[142] DeYoung & Phillips, *supra* note 80.

[143] *Id.*

In addition to promoting the use of some products relative to others, regulation also encouraged lenders to modify certain terms and features of their products in order to avoid formal restrictions. Thus, where terms (such as interest rates) were regulated and other terms were unregulated, lenders could alter the terms on the unregulated margins in order to offset the inability to freely set terms on the regulated margins. For example, credit card issuers who were unable to charge a market rate of interest imposed annual fees on cardholders.[144] Once interest rates were effectively deregulated, however, annual fees quickly disappeared, consistent with expressed consumer preferences and spurring intense competition among credit card issuers.[145]

But forcing lenders to go through this term repricing process was usually harmful both for borrowers and for competition.[146] The terms that were regulated were usually the most prominent and important terms, such as the interest rate. The offsetting adjustments, however, tended to occur on less prominent margins; as a result, this term-repricing process made products more heterogeneous and less transparent.[147] These market adjustments also created a competitive advantage for those products that were easier to modify for term-repricing purposes, namely more complex products that have multiple price points. This, in turn, resulted in a competitive disadvantage for simpler products with more transparent terms.[148]

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[144] Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAP. L. REV. 79, 155–65 (2000). In addition to dampening competition and reducing ownership of credit cards, there were distributional consequences from this term repricing. Annual fees are highly regressive, as traditionally annual fees were independent of the amount charged on the card or whether the cardholder revolved. Moreover, the combination of lower interest rates with higher annual fees forced those consumers who paid their balances in full to subsidize those who revolved from month to month, a cross-subsidy of questionable value.
[145] *Id.*
[146] DURKIN ET AL., *supra* note 133, at chapter 11.
[147] *Id.*
[148] Consumers could also be harmed indirectly by these regulations. For example, personal loan companies increased the minimum size of the loans that they would write, thereby amortizing the costs of making the loan over a larger principal amount, which artificially reduced the stated APR on the loan to bring it within the statutory requirements. But requiring a larger loan size meant that only higher-income borrowers could qualify for the loans, and those who

This history lesson is relevant to the regulation of overdraft protection and payday lending today. Overdraft protection is embedded in bank accounts (which have numerous and diverse terms and features). As a result, it might be easier for banks to offset losses due to new regulations on overdraft protection than it would be for a payday lender to redesign its product to offset the impact of new regulations. As noted earlier, when access to overdraft protection was scaled back in response to regulation, banks reduced the availability of free checking and raised fees (such as monthly account maintenance fees) that are relatively easy substitutes for overdraft protection fees. This action was potentially harmful to consumers who would not have chosen that combination of terms and prices on their own.[149]

Payday lending, by contrast, is a relatively simple product with fewer price points. It could therefore be more difficult for payday lenders to alter their product's terms in order to adjust to regulations such as those on allowable fees. For example, a state's imposition of APR caps has usually been the death knell for the payday lending industry in that state because of the industry's inability to redesign the product to preserve its viability.

In some cases, although payday lending has disappeared after regulation has been imposed, payday lenders have converted to providers of other high-cost lending products such as installment loans, or consumers have shifted to alternative lending products such as auto title loans. In some instances, consumers may have crossed into nearby states or gone online to access loans that were unavailable at home due to state regulation.[150] The CFPB is prohibited from

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qualified were often required to borrow more than they would have preferred, thereby potentially exposing them to greater risk of financial distress. James M. Ackerman, *Interest Rates and the Law: A History of Usury*, 1981 ARIZ. ST. L.J. 61, 89 (1981).

[149] *See* discussion *supra* notes 105–108 and accompanying text (describing market response to imposition of Regulation E).

[150] *See* Midwest Title Loans, Inc. v. Mills, 593 F.3d 660 (7th Cir. 2010); Brian T. Melzer, *The Real Costs of Credit Access: Evidence from the Payday Lending Market*, 126 Q. J. ECON. 517 (2011) (noting that residents in states that do not allow payday lending can cross over to states that permit it); Matt Volz, *Montana Tribes Offer High-Interest*

imposing interest-rate ceilings,[151] but if it imposes regulations on payday lending that reduce some sources of revenue or increase costs (such as reducing rollovers), payday lenders may be forced to alter the product dramatically in order to preserve its viability. This suggests that even facially neutral regulations can have a disparate competitive impact based on the relative ease with which some products can be redesigned to meet formal rules. The CFPB should keep this in mind when considering the regulation of payday lending and overdraft protection.

Widespread deregulation of consumer lending markets in the 1980s and 1990s modernized the regulatory regime and eliminated regulatory-induced artificial product segmentation, which in turn spurred competition among different types of lenders.[152] Rather than imposing substantive regulation tied to particular product attributes, regulators shifted to more generally applicable market-reinforcing regulatory systems such as the Truth in Lending Act and disclosure regulations. This development prompted competition among products, which benefitted consumers through lower rates, higher quality, and greater innovation.[153]

These history lessons support Dodd-Frank's requirement to create a fair competitive structure for consumer lending markets. Regulations that favor some products over others will tend to divert consumers to the more favorably regulated product, even though the products are substantively similar. This result harms consumers and furthers no regulatory purpose.

Loans Online, WASHINGTONTIMES.COM, Dec. 6, 2011, http://www.washingtontimes.com/news/2011/dec/26/montana-tribes-offer-high-interest-loans-online/?page=1&utm_medium=RSS&utm_source=RSS_Feed; *but see* PEW, WHO BORROWS?, *supra* note 45, at 5 (arguing that banning bricks-and-mortar payday lending does not increase the use of online payday lending).

[151] 12 U.S.C. § 5517(o).

[152] Thomas A. Durkin & Gregory Elliehausen, Interinstitutional Competition for Consumer Credit at the End of the Twentieth Century (June 2000) (unpublished manuscript), *available at* http://faculty.msb.edu/prog/CRC/Publications%20PDF%20files/Manuscripts_interinstitutional_competition.pdf; Dean F. Amel, Arthur B. Kennickell & Kevin B. Moore, *Banking Market Definition: Evidence from the Survey of Consumer Finances* (Working Paper No. 2008-35, July 7, 2008), *available at* http://www.federalreserve.gov/pubs/feds/2008/200835/200835pap.pdf.

[153] Durkin & Elliehausen, *supra* note 152.

IV. Payday Lending and Overdraft Protection Raise Similar Potential Consumer Protection Concerns

The consumer protection regulatory concerns raised by payday lending and overdraft protection are similar as well, lending further support to Dodd-Frank's premise that they should be regulated in an even-handed manner.[154] Otherwise, policies that artificially favor one product over another (thereby pushing consumers to greater use of the advantaged product), not only will produce higher prices, but will provide no corresponding increase in consumer protection. As noted earlier, the initial Treasury Department report that served as the basis for Dodd-Frank recognized that bank overdraft protection was used like a credit product by many consumers and thus should be subjected to similar regulation.[155] Because overdraft protection had not traditionally been regulated as credit, the report argued, consumers "may not overtly think of the plans as credit." The report expressed concern that "Consumers may not, therefore, take the same care in their use of overdrafts that they take with other, more overt credit products."

The similarity in potential consumer protection concerns is most clear when comparing bank deposit advance products with payday loans, which, as noted earlier, are very similar both in structure and in the consumer protection concerns they raise.[156] In fact, in its analysis of these two products, the CFPB stated that "the current repayment structure of payday loans and deposit advances, coupled with the absence of significant underwriting, likely contributes to the risk that some borrowers will find themselves caught in a cycle of high-cost borrowing over an extended

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[154] We assume for the sake of argument that these consumer protection concerns are well supported by economic analysis and empirical evidence, although the factual basis for several of the asserted rationales for regulation is highly questionable. *See, e.g.*, Stoesz, *supra* note 40; Marc Anthony Fusaro & Patricia J. Cirillo, *Do Payday Loans Trap Consumers in a Cycle of Debt?* (Nov. 16, 2011), *available at* http://ssrn.com/abstract=1960776; Jim Hawkins, *Regulating on the Fringe: Reexamining the Link Between Fringe Banking and Financial Distress*, 86 IND. L.J. 1361 (2011).

[155] *See* DEPARTMENT OF THE TREASURY, FINANCIAL REGULATORY REFORM, *supra* note 6, at 69.

[156] CFPB, PAYDAY LOANS, *supra* note 23, at 44; *see also* discussion at notes 127–131 and accompanying text.

period of time."[157] The CFPB also expressed concern that both products essentially provide the lender with direct access to the borrower's bank account in order to withdraw the funds at the time of the borrower's next payday or direct deposit without further action by the borrower or formal protections from the lender's collection activity.[158] Regulators also generally claim that both products are intended to be used as short-term loans to meet exigencies and emergency expenses, not for long-term sustained or repeated expenses or for non-emergencies.[159]

Consumer activists are also concerned that some consumers overuse payday lending when less-expensive alternatives are available[160] and that it is used disproportionately by lower-income and younger consumers.[161] Moreover, critics of payday lending protest the alleged unfairness of apparent cross-subsidies among different groups of payday loan customers. They claim that those borrowers who roll over payday loans repeatedly (and thus generate repeated fees with modest expense and credit risk to the lender) essentially subsidize borrowing by those who use loans less frequently and more episodically.[162] They also express concern that payday lenders have direct access to consumers' bank accounts and thereby can withdraw funds (by cashing the borrower's

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[157] *Id.* Elliehausen found, however, that only 10% of payday loan customers expressed dissatisfaction with their experiences, and of those, only about 16% said that it was because they thought that payday loans made it "too difficult to get out of debt." Overall, therefore, only about 2% of all payday loan customers disliked payday loans because they made it too hard to get out of debt. Elliehausen, *supra* note 31, at 42.

[158] *Id.* The CFPB provides no support for its normative classifications of legitimate versus illegitimate uses of short-term lending. Nevertheless, whether this justification for regulation is valid, our point here is that it is equally present for both payday lending and overdraft protection. For example, industry analysts JMP Securities claim that the majority of those who borrow from traditional storefront payday lenders use the funds to cover recurrent expenses, whereas those who borrow from online payday lenders are more likely to do so in order to cover discretionary and emergency expenses. *See* JMP SECURITIES, *supra* note 12, at 19. If it is true that online payday lending is not used as frequently as storefront lending for recurring expenses, that fact would seem to be irrelevant to the proper regulatory treatment of the two products.

[159] CFPB, PAYDAY LOANS, *supra* note 23, at 43.

[160] *See* PEW, WHO BORROWS, *supra* note 45, at 16–18; PEW, HOW BORROWERS CHOOSE, *supra* note 49, at 36–38.

[161] CFPB, PAYDAY LOANS, *supra* note 23, at 15–20; PEW, WHO BORROWS, *supra* note 45, at 8–12. Neither the CFPB nor Pew expressly state why this disparity carries a normative dimension, but presumably they believe the disproportionate use by low-income consumers to be problematic.

[162] This concern is often more implied than directly stated. *See* Nathalie Martin, *1,000% Interest—Good While Supplies Last: A Study of Payday Loan Practices and Solutions*, 52 ARIZ. L. REV. 563, 573–74 (2010) (arguing that the greatest profits in payday lending are made from repeat customers).

check) or even cause the borrower to incur overdraft fees if the account has insufficient funds to cover the check.[163] Finally, although borrowers appear to clearly understand the terms of payday loans,[164] some critics argue that consumers are fundamentally confused about the full expected cost of their loans, and, in particular, have unrealistically low estimates of both the amount of time it will take them to repay the loan and the fees that they eventually will incur.[165] As a result, consumers may roll over their payday loans repeatedly, incurring high fees that result in financial harm.

The CFPB has expressed consumer protection concerns regarding overdraft protection that mirror those for payday lending and deposit advance products. In its white paper on overdraft protection, the CFPB expressed concern that some consumers overuse overdraft protection rather than turning to less-expensive alternatives.[166] In its "Notice and Request for Information" issued in February 2012, the CFPB also expressed concern that the heavy use of overdraft protection may result in long-term damage to a person's finances.[167] The CFPB also noted that a minority of

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[163] *See* PEW, HOW BORROWERS CHOOSE, *supra* note 49, at 33 (reporting that 27% of payday loan borrowers stated that a withdrawal by a payday lender caused an overdraft).

[164] *See* discussion *supra* notes 86–88 and accompanying text.

[165] Oren Bar-Gill and Elizabeth Warren state, for example, "The design of the payday loan as a short-term cash advance that is oftentimes continuously renewed for prolonged periods of time responds to consumers' underestimation of the likelihood and cost of loan rollover." Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 55 (2008). Remarkably, however, they cite no authority whatsoever for this unqualified statement. In particular, they offer no discussion about whether consumer errors, although present, might be unbiased between overestimation and underestimation of the expected time it will take to repay a loan. *See* Todd J. Zywicki, *The Behavioral Law and Economics of Fixed-Rate Mortgages: And Other Just-So Stories*, 21 S. CT. ECON. REV. (forthcoming 2014) (noting that behavioral economics predicts that consumer errors will be systematically biased and reporting evidence that rejects the hypothesis). In fact, recent studies indicate that although consumers may make mistakes about how long they expect it will take to repay a payday loan, there is no evidence that they systematically underestimate either the expected number of loan rollovers or how long their loan will likely be outstanding. *See* Ronald Mann, *Assessing the Optimism of Payday Loan Borrowers*, 21 S. CT. ECON. REV. (forthcoming 2014) (finding that 60% of payday borrowers accurately estimate how long it will take them to repay their loans and that errors are randomly distributed between overestimates and underestimates of time); *see* Marianne Bertrand & Adair Morse, *Information Disclosure, Cognitive Biases and Payday Borrowing*, 66 J. OF FINANCE 1865, 1878 (2011) (concluding that payday loan customers reported a mean estimate of how long it would take to repay a payday loan that was correct). Bertrand and Morse also note that the form that required disclosures take may reduce consumer confusion and, if so, will enable consumers to use the products more efficiently.

[166] CFPB, OVERDRAFT PROGRAMS, *supra* note 17, at 54–58; *but see supra* note 67 and accompanying text (questioning whether less-expensive alternatives are available or appropriate for many overdraft protection users).

[167] CFPB, Impact of Overdraft Programs, *supra* note 15, at 15–16.

customers pay a disproportionate share of all overdraft fees, thereby subsidizing free riders who do not.[168] In addition, the CFPB points out that the FDIC noted that low-income and younger consumers paid a disproportionate share of overdraft fees.[169] Finally, the CFPB and consumer activists have argued that consumers lack adequate information and are often confused about the full cost and conditions associated with the use of overdraft protection.[170]

The consumer protection concerns about payday lending, deposit advance, and overdraft protection are all similar: consumers are not fully aware of the cost, they use those products instead of less-expensive alternatives, and the high cost and limited underwriting can create a cycle of debt for a minority of users. If the consumer protection concerns are similar, therefore, it should not matter whether the offeror is a bank or nonbank lender; neither should the formal structure or classification of the terms matter. If, for example, the CFPB is concerned that these products can create a cycle of debt for some consumers, then a regulatory regime that simply shifts consumers from one product to the other will further no coherent regulatory purpose.[171]

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[168] CFPB, Impact of Overdraft Programs, *supra* note 15, at 14–15; Zywicki, *Overdraft Protection*, *supra* note 20, at 1181–84.

[169] CFPB, Impact of Overdraft Programs, *supra* note 15, at 4; *see also* CFPB, OVERDRAFT PROGRAMS, *supra* note 17, at 18 ("Thus, the [FIDC] study raised concerns that consumers from potentially vulnerable groups may shoulder a disproportionate share of NSF and overdraft fees and checking account costs"). Again, it is not stated expressly why this point is relevant, but it is suggested that this income disparity in product use is normatively problematic. In fact, the best predictor of overdraft use appears to be the borrower's creditworthiness, not income, age, or any other demographic. *See* Zywicki, *Overdraft Protection*, *supra* note 20, at 1164–65 (discussing studies). The FDIC did not control for the borrower's credit score in concluding that low-income and younger borrowers are disproportionately likely to use overdraft protection, nor did the CFPB note this caveat in its characterization of the study.

[170] CFPB, Impact of Overdraft Programs, *supra* note 15, at 9–10.

[171] In fact, other consumer credit products raise many of these same consumer protection concerns. The CFPB should therefore avoid imposing regulatory burdens on payday lending and overdraft protection that would divert consumers to products such as pawnshop loans. For example, Levy and Sledge note that underestimating how long it will take to repay a loan is not unique to payday loan borrowers. *See* LEVY & SLEDGE, *supra* note 24, at 21 (noting that 32% of payday lending borrowers reported taking longer than expected to repay their loans, as compared to 32% of auto title loan borrowers, 29% of pawnshop loan borrowers, and 20% of bank deposit advance borrowers); *see also* ELLISON & FORSTER, THE IMPACT OF INTEREST RATE CEILINGS, *supra* note 45, at 62. Thus, to the extent that restricting access to payday loans or overdraft protection causes consumers to substitute pawnshops or auto title loans, the results will not advance any coherent consumer protection purpose.

V. Conclusion: Fair Competition and Consumer Protection

The stated justification for the CFPB is that a single agency with highly specialized expertise in consumer lending and the full array of regulatory tools (research, supervision, and enforcement) can craft a consumer financial protection agenda that will be superior to an agency with a more general consumer protection agenda (such as the Federal Trade Commission) or an agency primarily focused on safety and soundness issues (such as prudential bank regulatory agencies). Further, the stated justification is that a national agency with the authority to regulate the full scale of consumer credit products, from mortgages to payday loans, can create a more coherent and modern regulatory regime than one balkanized among the states or divided across myriad federal regulators.

The regulation of payday lending and bank overdraft protection provides a compelling example of the CFPB's potential to execute its dual mandates to promote consumer protection and fair competition. The two products traditionally have been offered by different lenders and regulated differently. Yet they compete with each other and raise similar consumer protection concerns. The CFPB has the potential to integrate this fragmented regulatory structure into a coherent and consumer-friendly regulatory regime, provided that it appreciates the interdependencies between the products.

Both economics and history lead to the conclusion that consumers benefit from a consumer protection regime that considers the interactions among different products and the competition that they provide to one another. Chopping up the market by writing different rules for similar products balkanizes the regulatory regime, dampens competition, and produces higher prices and lower quality for consumers. At the same time, if various products present similar consumer protection concerns, then there is little benefit from unequal regulations that simply shift consumers from one product to a competitor.

A final concern in this context is that interest groups may have differential influences on regulators and thus may be in a position to lobby for regulations that provide them with a competitive advantage.[172] Payday lending operations remain highly local, distributed throughout the country; even chain payday lenders are highly localized in their customer base and operations. Overdraft protection, by contrast, is provided by banks, which have a much more organized lobbying operation in Washington, D.C., and thus may have a greater opportunity to influence regulators in a manner that will give them a competitive advantage over payday lenders.[173] On the other hand, banks offering overdraft protection must contend with potentially conflicting and overlapping supervision from prudential regulators as well as from the CFPB. Even-handed regulation can reduce this potential for agency capture by the institutions the agency regulates by limiting the opportunity for loopholes and special treatment. Representatives of nonbank lender associations, for example, have expressed concern about the potential for a "bank-centric" culture at the CFPB.[174] Thus, the CFPB should take special care that it is not co-opted by either industry and used as a tool to reduce competition between products. In addition, given Dodd-Frank's express requirement that the CFPB preserve fair competition as part of its mission, a failure to regulate in an even-handed manner will expose the agency to litigation challenges.

Competition and consumer choice can be powerful vehicles for improving consumer welfare and consumer protection. By keeping this in mind, the CFPB can ensure that its policies are truly beneficial to consumers.

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[172] *See* MAXWELL STEARNS & TODD J. ZYWICKI, PUBLIC CHOICE CONCEPTS AND APPLICATIONS IN LAW (2009) (describing how special interests can use regulation strategically to gain a competitive advantage over rivals).
[173] *See* Todd Zywicki, *Economic Uncertainty, the Courts, and the Rule of Law*, 35 HARV. J.L. & PUB. POL'Y 195 (2012) (identifying the rule of law as restraining special interest legislation).
[174] *See, e.g.*, Hearing of the United States House of Representatives, Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit, Hearing on the Effects of the Dodd-Frank Act on Small Financial Institutions, Testimony of Chris Stinebert, President and CEO, The American Financial Services Association (Mar. 2, 2011).