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THE CASE AGAINST NEW RESTRICTIONS ON PAYDAY LENDING

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In the wake of the financial crisis, Congress and federal regulators have moved aggressively to impose new regulations on a variety of consumer credit products. To date, Congress has focused on mortgages (the primary cause of the crisis) and credit cards, which have seen record-high default rates in recent months.

But Congress is also considering new regulations on non-traditional lending products, such as payday lending—although there is no evidence that such products were related in any way to the financial crisis. The principal legislation is H.R. 1214 (the Payday Loan Reform Act of 2009), which, if enacted, would limit the charge for a single-payment loan to an effective 391 percent annual rate ($15 per $100) for a two-week loan. H.R. 1214 also purports to limit borrowers to one loan at a time from a single lender, prohibit rollovers, and limit borrowers to one extended repayment plan every six months. Economic theory and empirical evidence strongly suggest that these paternalistic regulations would make consumers worse off, stifle competition, and do little to protect consumers from concerns of overindebtedness and high-cost lending.

Payday lending, known in earlier eras as “salary lending” or “wage-assignment lending,” has been around in one form or another for over a century, serving as a valuable source of short-term, small-amount lending to wage earners with steady employment but a critical need for short-term emergency funds. Since their inception, regulators have expressed concern about the apparent high cost of short-term, small loans and have tried to regulate their terms as well as those of other forms of consumer credit. As a result,

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much is known about the effect of regulation on borrowers and consumer lending markets, and particularly the lower- and middle-income borrowers who are the ostensible users of these loans.

Economic research strongly supports two basic conclusions about payday lending: First, those who use payday lending do so because they have to, not because they want to. They use payday lending to deal with short-term exigencies and a lack of access to payday loans would likely cause them substantial cost and personal difficulty, such as bounced checks, disconnected utilities, or lack of funds for emergencies such as medical expenses or car repairs. Those who use payday loans have limited alternative sources of credit, such as pawn shops, bank overdraft protection, credit card cash advances (where available), and informal lenders. Although expensive, payday loans are less expensive than available alternatives. Misguided paternalistic regulation that deprives consumers of access to payday loans would likely force many of them to turn to even more expensive lenders or to do without emergency funds. Although payday loans may lead some consumers to be trapped in a “debt trap” of repeated revolving debt, this concern is not unique to payday lending. Moreover, evidence indicates that those who are led into a debt trap by payday lending are far fewer in number than those who are benefited by access to payday loans.

Second, efforts by legislators to regulate the terms of small consumer loans (such as by imposing price caps on fees or limitations on repeated use “rollovers”) almost invariably produce negative unintended consequences that vastly exceed any social benefits gained from the legislation. Moreover, prior studies of price caps on lending have found that that low-income and minority borrowers are most negatively affected by the regulations and the adjustments that they produce. Volumes of economic theory and empirical analysis indicate that further restrictions on payday lending likely would prove counterproductive and harmful to the very people such restrictions would be intended to help.

The Economics of Usury Regulation

Substantive regulation has one intended consequence and several unintended consequences. The intended consequence of price caps on interest rates (often referred to as "usury" regulations) is obvious: Usury regulations limit the interest rate of loans actually made to borrowers. If, for example, a legislature caps interest rates at some fixed percentage, legitimate lenders will not charge interest rates above that rate. But there are also several unintended consequences of usury regulations that can be extremely harmful to consumer welfare. The unintended consequences of usury regulations can be summarized under three basic headings: term re-pricing, product substitution, and credit rationing.

Term re-pricing[2] describes the process by which lenders offset limits of what they can charge on regulated terms by increasing the price of other terms of the loan or related loan products. Term re-pricing is common for many types of consumer credit, but may be less so for payday lending. As discussed in greater detail below, payday loans are very simple and very transparent loans with a small number of terms, especially when compared to especially complex products such as mortgages or credit cards. As a result, payday loans have relatively few terms that can be adjusted in order to make payday lending profitable for the lender. Payday lenders might respond to price caps by increasing the minimum required amount of the loan, so as to amortize the costs of issuing the loan over a higher loan amount.[3] Promoting term re-pricing by increasing the average size of the loan can force borrowers to borrow larger amounts than they prefer or can reasonably manage, thereby reducing the usefulness of the loan and, perversely,

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[2] Term re-pricing is sometimes referred to as "evasion," as they are an effort to "evade" the distorting effects of usury restrictions on credit supply by adjusting unregulated price or other terms of the bargain. *See* Michael Staten, *The Impact of Credit Price and Term Regulations on Credit Supply*, Harvard University Joint Center for Housing Studies UCC 08-8 (Feb. 2008). For instance, during the period of high interest rates in the 1970s and early 1980s, bank credit card issuers imposed annual fees on credit cards in order to make up for the capping on interest rates below the market level. *See* Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAPMAN L. REV. 79, 152 (2000). In days past when most consumer credit was installment credit issued by department stores and other retailers, those retailers could offset their inability to charge market interest rates for store credit by marking up the cost of the goods they sold and thereby burying the cost of the credit losses in an increased cost of goods and services. The practice of charging up-front "points" on home mortgages originated as a mechanism to evade usury ceilings on mortgage interest rates. Lenders may also tie access to credit to the purchase of other goods and services whose price is not regulated. *See* A. Charlene Sullivan, EVIDENCE OF THE EFFECT OF RESTRICTIVE LOAN RATE CEILINGS ON PRICES OF CONSUMER FINANCIAL SERVICES (Credit Research Ctr. Working Paper No. 36, 1980), They may also raise the price for related services that they provide or reduce the availability of other benefits or services, such as providing fewer free services or shorter operating hours. RICHARD L. PETERSON & GREGORY A. FALLS, IMPACT OF A TEN PERCENT USURY CEILING: EMPIRICAL EVIDENCE (Credit Research Ctr. Working Paper No. 40, 1981) The final result will be to limit any intended benefits of the regulation by circumventing the intended effects of the price controls but to make consumers worse off as a group by encouraging a new pricing system that is less efficient and less transparent than that which would otherwise prevail. Furthermore, by making prices less transparent and more heterogeneous, price controls interfere with competition by making it more difficult for consumers to compare prices and other terms among lenders.

[3] *See* Mark H. Haller & John V. Alviti, *Loansharking in American Cities: Historical Analysis of a Marginal Enterprise*, 21 AM. J. LEGAL HIST. 125, 140 (1977) (noting that interest rate caps on small lending operations in the 1930s led to an increase in minimum loan size and an exiting of the market by legal lenders).

promoting over-indebtedness.[4] Many states, however, already strictly limit the maximum size of payday loans; thus that option may be unavailable. As a result of the practical and regulatory difficulties of re-pricing terms, product substitution and rationing of formal credit are probably more likely unintended consequences.

Product substitution arises when certain types of substantive regulations (such as interest-rate caps) make it impossible to price a particular consumer loan product in a manner that makes it economically feasible for the lender and borrower to enter into a transaction, but when other lending products are available instead. For instance, price caps on payday lending may make it impossible for a lender to price its risk sufficiently for a borrower to obtain a payday loan, but the borrower instead might be able to obtain a pawn loan. If term re-pricing and product substitution are sufficiently flexible, the end result of the regulatory scheme may be simply to change the mix or composition of credit held by consumers, but not the overall amount of debt.[5]

Finally, regulation may result in rationing of credit to particular borrowers if it is impossible for them to obtain any formal credit on affordable terms. Such rationing could force borrowers to turn to the informal sector (friends and family or illegal loan sharks) or to do without credit. Deprivation of access to credit could cause substantial economic and personal harm if it forces the consumer to go without the means to meet necessary expenses such as medical care, car repairs, living expenses, rent, or work-related

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[4] *See* ANNE ELLISON & ROBERT FORSTER, THE IMPACT OF INTEREST RATE CEILINGS: THE EVIDENCE FROM INTERNATIONAL EXPERIENCE AND THE IMPLICATIONS FOR REGULATION AND CONSUMER PROTECTION IN THE CREDIT MARKET IN AUSTRALIA 38 (2008) (noting that in countries with strict interest rate regulations, "Lenders not only reject borrowers who fail the credit score required for any given lending model, they also set lending minimums at a level at which set up and administration costs are not disproportionate to the sum advanced, with this varying according to the pricing model concerned. Typically however, such levels are set significantly above where high risk low income borrowers would want to borrow. The effect of this policy is either to exclude such borrowers from the credit mainstream or to lead them to borrow more than they might otherwise.").

[5] *See* Richard L. Peterson, *Usury Law and Consumer Credit: A Note*, 38 J. FINANCE 1299 (1983).

expenses such as transportation or appropriate work clothing. Put simply, foreclosing viable options for credit because they are thought to be too expensive does not make the need for credit go away—if a low-income person needs $500 for a car repair in order to get to work, eliminating payday lending as an option does not eliminate the need for the car repair. It simply forces the borrower to find funds elsewhere or live without the car, which could adversely affect job performance.

The overall impact of usury regulations is to force lenders and borrowers to change the terms, types, and amounts of consumer credit offered when compared to what they would agree to under a voluntary contract. Economists have almost uniformly concluded that forcing these changes in lending and borrowing behavior is harmful to consumer welfare. If, for instance, a consumer truly preferred to borrow from a pawn shop rather than a payday lender, then she would have chosen to patronize the pawn shop in the first place. Regulations that encourage substitution from one type of high-cost credit to another, or encourage a more confusing and opaque price scheme, are unlikely to make consumer better off. Once lenders make adjustments and offsetting behaviors in response to substantive regulations, it is quickly understood that the benefits to be gained by interest-rate caps are small and the costs from the unintended consequences are extremely large. Consumers are left with fewer choices, higher borrowing costs, and less flexibility.

The Growth of The Payday Lending Industry

Payday lending is part of a general category of consumer credit that is often referred to as non-traditional or fringe lending products. Non-traditional consumer lending products are utilized primarily by younger or lower-income consumers, often with spotty or limited credit or work histories or who otherwise have limited credit choices. Almost by definition, borrowers who make use of non-traditional lending products are those who, for one reason or another, are unable to obtain access to standard mass-marketed lending products like prime mortgages, home equity loans, and credit cards. Like traditional types of lending, such as mortgages or credit cards, non-traditional lending can be misused. But also like traditional credit products, non-traditional credit products serve an important function for most of those who use them. Those who use payday loans frequently have limited options and must choose among an array of options that are relatively unattractive to upper-middle-class borrowers, but payday loans may be relatively attractive compared to the alternatives for those consumers who use them.

Although the name "payday lending" is of relatively recent vintage, the concept of short-term, small-dollar loans to wage-earners is over a century old. Previously known as "salary lenders" or "wage-assignment" lenders, forerunners to payday lending arose in big cities as early as the 1880s as an alternative to pawn shops and "chattel lenders."[6] The reasons given by borrowers for needing salary loans presage the reasons why consumers use payday lending today: to deal with unexpected family illness, pay the costs of moving or rent, or the need for funds for vacation or Christmas.[7] The estimated APR for salary loans was in the neighborhood of 1,000 percent (and the smaller the loan, the higher the interest rate because of the need to defray the fixed costs of lending).[8]

[6] Haller & Alviti, *supra* note 3, at 127-29. Chattel lenders lent money secured by the borrower's furniture or other similar personal possessions.
[7] Haller & Alviti, *supra* note 3, at 128.
[8] Haller & Alviti, *supra* note 3, at 132.

The payday-loan industry grew rapidly during the past two decades, from under 200 offices in the early 1990s[9] to over 22,800 offices at the end of 2005.[10] As payday lending has grown, states have moved aggressively to regulate, or even abolish, payday-loan operations in their states.[11] The federal government has also passed laws to discourage payday lending to members of the military. Still, despite the intense regulatory attention on payday lending in recent years, only about two percent of the population (9 to 14 million people) use payday lenders in any given year; and the aggregate outstanding principal balance of all payday loans at any given time is about two billion dollars. Payday lending is representative of the general range of non-traditional lending products offered in the economy, credit that is used by a relatively small but identifiable subset of the population.

Compared to mainstream products such as mortgages, auto loans, or credit cards, payday loans are a relatively expensive form of credit. In a typical payday loan, a borrower takes $300 today with a promise to repay $350 in two weeks, signing over a post-dated check.[12] The $50 finance charge works out to be an APR of 435 percent using a standard measure of APR. It should be noted that the use of APR—the "annual percentage rate"—is a bit of a peculiar measure for such a short-term loan. Still, the seemingly high price of payday loans leads many to wonder why consumers use this product, especially those who do so regularly.

Who Uses Payday Loans?

[9] John P. Caskey, *Payday Lending*, 12 FINANCIAL COUNSELING AND PLANNING 1-14 (2001).
[10] Katherine A. Samolyk, *Payday Lending: Evolution, Issues, and Evidence, in* HOUSEHOLD CREDIT USAGE (Sumit Agarwal & Brent W. Ambrose eds., 2007).
[11] Michael A. Stegman, *Payday Lending*, 21 J. ECON. PERSPECTIVES 169 (2007).
[12] As a result, almost all payday loan customers have a bank account and are employed.

Payday-loan customers are low to middle-income, relatively young, and much less likely to own a home than the average American family.[13] Forty percent of payday-loan customers earn between $25,000-50,000 per year, and 56 percent between $25,000-75,000. On average, payday-loan customers have marginally lower incomes than those who revolve balances on credit cards (in one study, over half of those who revolve balances on credit cards earn $50,000 or above) but tend to have higher incomes than those who borrow from finance companies and substantially higher incomes than those who use pawn shops (64.9 percent of whom earn under $25,000 per year and 83 percent total who earn under $50,000 per year).[14] Similar patterns are observed for age: Payday-loan customers tend to be older than pawnshop borrowers and younger than those who revolve credit card balances.

The primary reason why consumers use payday lenders is because they have an urgent need for credit and because no less-expensive option is available. Eliminating payday lending as an option for financially-stressed consumers would likely make them worse off and force them to use inferior and less-preferred types of credit, such as pawnshops, or to go without credit. Those who use payday loans do so because they face limited options in meeting pressing financial needs: Eliminating payday lending would narrow their limited options still further and would be unlikely to make them better off.

Use of payday loans is almost always precipitated by an unexpected expense that the borrower could not postpone, such as a utility bill, fear of a bounced check, or health expense. In one survey of payday-loan borrowers, 86 percent of respondents reported that they “strongly” (70.8 percent) or “somewhat” agreed (15.7 percent) that their use of a

[13] Michael S. Barr, *Banking the Poor*, 21 YALE J. ON REG. 121, 153 (2004).
[14] Edward C. Lawrence and Gregory Elliehausen, *A Comparative Analysis of Payday Loan Customers*, 26(2) CONTEMPORARY ECONOMIC POLICY 299, 305 (2008).

payday lender was to cope with an unexpected expense.[15] At the time of their most recent payday loan, over 80 percent of payday-loan customers reported that they lacked sufficient funds to deal with the expense.[16] In a study conducted in 2007, 43 percent of payday-loan customers confessed that, in the previous 12 months, they had at least once written a check that overdrew their checking account (in 2001, 68 percent of respondents had done so).[17] Almost 21 percent of payday-loan customers were 60 or more days past due on a consumer credit account during the previous twelve months. Elliehausen found that, in a survey of payday-loan borrowers in 2007, 55 percent stated that during the preceding five years they had had a credit request denied or limited and 59 percent had considered applying for credit but did not because they expected to be denied.[18] Over 16 percent had filed for bankruptcy in the past five years—four times the rate of all consumers.

Elliehausen found that only a minority of payday borrowers fit the stereotype as impulsive borrowers.[19] Jonathan Zinman similarly found that payday-loan customers primarily use their funds for "bills, emergencies, food and groceries, and other debt service."[20] Thirty-one percent of borrowers reported using the funds for emergency expenses, such as car repairs or medical expenses.[21] Only 6 percent said that they used the funds for "shopping or entertainment."

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[15] GREGORY ELLIEHAUSEN, AN ANALYSIS OF CONSUMERS' USE OF PAYDAY LOANS 35 (Financial Services Research Program Monograph No. 41, Jan. 2009).
[16] Lawrence & Elliehausen, *supra* note 14, at 309.
[17] Elliehausen, *supra* note 15, at 43.
[18] Elliehausen, *supra* note 15, at 33.
[19] Elliehausen, *supra* note 15, at 35.
[20] Jonathan Zinman, *Restricting Consumer Credit Access: Household Survey Evidence on Effects around the Oregon Rate Cap* 9 (working paper, Dec. 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1335438.
[21] Zinman, *supra* note 20.

Payday-loan customers also are generally aware of the cost of payday loans. According to Elliehausen, only two percent of payday-loan customers reported that they did not know the finance charge for their most recent new payday loan; 94.5 percent reported finance charges consistent with prevailing market prices.[22] Those who used payday loans most often were also most likely to know the reported APR on their loan.[23] Whatever concerns have been expressed about payday loans, lack of transparency is not one: Payday-loan pricing is simple and easily understood.[24]

Why Borrowers Use Payday Loans

Payday-loan customers thus seem well aware of the price that they are paying, yet they continue to use payday loans. Why? Because, despite the high cost of payday loans, such loans are usually less expensive than the financial alternatives for a cash-strapped borrower.

Many payday-loan customers have recently bounced a check and lack sufficient funds at the time of the payday advance to meet their expenses, suggesting a likelihood of bouncing another check. Research by Federal Reserve economists Donald Morgan and Michael Strain found that when Georgia and North Carolina outlawed payday lending, the incidence of bounced checks, consumer complaints about debt collectors, and chapter 7 bankruptcy filings rose.[25] Direct fees imposed for checks returned for insufficient funds can be quite significant; for example, a bounced check may lead to fees imposed by both

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[22] Elliehausen, *supra* note 15, at 36-37.
[23] Elliehausen, *supra* note 15, at 38.
[24] As one news story characterized payday lending terms, "[N]o surprises, no hidden fees." Douglas McGray, *Check Cashers*, *Redeemed*, N. Y. TIMES MAGAZINE (Nov. 9, 2008).
[25] Donald R. Morgan and Michael R. Strain, *Payday Holiday: How Households Fare after Payday Credit Bans* (Fed. Res. Bank of NY Staff Report no. 309) (Feb. 2008).

the payee as well as the financial institution that may exceed $50 total per transaction, an implied APR far higher than for payday loans.[26] Moreover, these fees are cumulative—bouncing several checks can result in the imposition of substantial fees each time. Dishonored checks also impose indirect costs. If a check is for payment of insurance, the policy will be terminated; and if for utilities (such as telephone or electricity), the bounced check may lead to termination of service, penalties, and a substantial security deposit to reconnect service. Bounced checks may also result in termination of a bank account and even a risk of criminal prosecution.[27] In all, these various costs may exceed hundreds of dollars, a far higher rate than for payday lenders. Bouncing a check is also very damaging to one's credit score, making subsequent access to credit even more difficult.

Many financial institutions offer overdraft protection to guard against bounced checks. For a fixed fee, the bank will honor a check written on an account with insufficient funds. But the APR on these overdraft loans can easily exceed the cost of a payday loan. DeYoung and Phillips estimate that if a bank charges a $20 fee to cover a $100 overdraft, and the customer brings the account back to a positive balance after two weeks, the APR would be 520 percent for just one check.[28] According to a study by the Federal Deposit Insurance Corporation, the average APR on a two-week checking account overdraft is 1,067 percent.

[26] Michael W. Lynch, *Legal Loan Sharking or Essential Service? The Great "Payday Loan" Controversy*, REASON (2002); Michael S. Barr, *Banking the Poor*, 21 YALE J. ON REG. 121, 155 (2004).
[27] According to one news story, at most banks "if you've bounced too many checks you're banned for five to seven years." McGray, *supra* note 24.
[28] Robert DeYoung & Ronnie J. Phillips, *Payday Loan Pricing*, Federal Res. Bank of Kansas City Research Working Paper, RWP 09-07 at p. 6 (Feb. 2009).

Overdraft protection serves as a substitute for payday lending to guard against bounced checks. Economist Jonathan Zinman found that when Oregon imposed a cap on the finance charge that could be assessed on payday loans, there was a dramatic drop in the number of licensed payday lenders, a short-run deterioration in the overall financial condition of Oregon households, and some evidence that the ban led to an increase in late bill payments and a substitution to greater use of overdraft protection by consumers.[29]

Only half of payday-loan customers have general-purpose bank credit cards. Consumers who do have credit cards generally look to revolving credit card debt as their first source of credit.[30] Those who revolve credit card balances tend to be older, higher-income, and more likely to own a home than payday-loan customers. More importantly, of those payday-loan borrowers who do have credit cards, many were at or near their credit limits and would have incurred over-the-limit and late fees from using them to meet the expense. Over 60 percent of payday-loan customers who own bank cards had refrained from using them within the year before their latest payday loan because they would have exceeded their credit limit, thereby incurring substantial penalties that again would be imposed cumulatively.[31] Those who use payday loans also were more likely to have paid late fees on their credit cards than others.[32] 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

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[29] Zinman, *supra* note 20. The imposition of new regulations on payday lending operations in Virginia in 2008 has led to an estimated 84 percent reduction in the volume of payday loans and a dramatic reduction in the number of licensed payday lending outlets, from 832 to 526. *See* Dena Potter, *Payday Lender Laws Slash Loan Numbers*, WASHINGTON TIMES (June 21, 2009), *available in* http://www.washingtontimes.com/news/2009/jun/21/payday-lender-laws-slash-loan-numbers/.

[30] Lawrence & Elliehausen, *supra* note 14, at 305.

[31] Lawrence & Elliehausen, *supra* note 14, at 310.

[32] Michael S. Barr, et al., *Consumer Indebtedness in the Alternative Financial Services Market*, U. Mich. Law, Working Paper, April 2007.

with multiple cards and higher credit limits can.[33] As with bounced-check fees and overdraft protection, payday-loan customers appear to have correctly recognized that, despite the apparent high cost of payday loans, such loans are still less expensive than available alternatives, which would be to incur even more expensive over-the-limit and late fees on credit cards.[34]

On the other hand, foreclosing payday lending might force some borrowers to substitute to greater use of credit card cash advances or revolving credit. A recent study of U.S. consumers found that in states with strict usury ceilings, unbanked consumers tended to substitute to pawn shops, while those with access to mainstream credit markets made greater use of retail and revolving credit.[35] But those forced to substitute to greater use of revolving credit likely end up paying even higher costs for credit and run into greater financial difficulty.[36] Both credit card delinquencies and delinquency-related revenues are higher in states with interest-rate ceilings that squeeze payday lending out of the market. These credit-constrained borrowers find themselves pushed toward credit-line maximization and difficulty in meeting payments, thereby triggering repeated over-the-limit, late fees, and other behavior-based fees. As credit card lenders have increasingly moved toward risk-based pricing through greater use of such fees, interest-rate restrictions have increased the frequency and amount of these fees, dramatically impacting these borrowers. Interest-rate caps thus force a particular group of consumers to use credit cards more often and in a less efficient manner than they would prefer, exposing them to repeated delinquency and to very high fees. Those who turn to repeated

[33] Lawrence & Elliehausen, *supra* note 14, at 309.
[34] Lawrence & Elliehausen, *supra* note 14, at 309, Table 3 Panel B.
[35] Ellison & Forster, *supra* note 4, at 40.
[36] Ellison & Forster, *supra* note 4, at 55.

use of credit card cash advances to make ends meet fare even worse, showing a much higher rate of missed payments on mainstream credit loans than those who use payday loans.[37] 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, assuming that they can get access to credit cards at all.[38]

The most plausible alternatives for payday-loan customers, therefore, are various other forms of non-traditional lending, such as pawn shops and finance companies. The behavior of payday-loan customers indicates that they prefer payday loans to these alternatives. Consumers deprived of payday loans by overly strict price ceilings are frequently diverted to pawn shops.[39] Pawn shops are especially unappealing: Their cost is comparable to payday loans, but they require the borrower to part with personal property to use as collateral for the loan.[40] Default rates are high.[41] In addition, because the value of the loan is limited by the value of the personal goods pawned, pawn loans tend to be quite small ($76 on average).[42] Because of their small size and high transaction costs,

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[37] Ellison & Forster, *supra* note 4, at 62.
[38] Ellison & Forster, *supra* note 4, at 78.
[39] Paige Marta Skiba & Jeremy Tobacman, *Do Payday Loans Cause Bankruptcy?* (working paper, Sept. 8, 2008), *available in* http://ssrn.com/abstract=1266215; Ellison & Forster, *supra* note 4, at 40. Morgan quotes a CEO of a major pawnshop chain who states that the rise of payday lending has hurt his company. Donald P. Morgan, *Defining and Detecting Predatory Lending*, Fed. Res. Bank of New York Staff Report no. 273, at 5-6 (Jan. 2007). Pawnshop owners in Ohio expected an increase in business of "20 to 25 percent" if Ohio passed a proposed law that would dramatically reduce payday lending. *See* Adrian Burns, *Pawnshops May Win if Payday Lenders Lose* (May 16, 2008).
[40] JOHN P. CASKEY, FRINGE BANKING: CHECK-CASHING OUTLETS, PAWN SHOPS AND THE POOR 36 (1994). Skiba and Tobacman find that pawn loans have a ninety-day term, with a monthly interest rate of 20 percent on loans from $1-$150 and 15 percent on loans above $150. Paige Marta Skiba & Jeremy Tobacman, *Measuring the Individual-Level Effects of Access to Credit: Evidence from Payday Loans*, Working Paper (July 3, 2007).
[41] Skiba & Tobacman, *supra* note 39 (finding that 58 percent of first time-pawns default and only 37 percent are redeemed).
[42] Skiba & Tobacman, *Measuring*, *supra* note 39; *see also* Robert W. Johnson & Dixie P. Johnson, *Pawnbroking in the U.S.: A Profile of Customers* 16 (Credit Research Ctr., Monograph No. 34, 1998) (average loan of $70 with typical range from $35-$260); CASKEY, *supra* note 40, at 44 (finding average payday loan of $50-$70). The average payday loan, by contrast, is $300. Skiba & Tobacman, *Measuring*, *supra* note 40.

pawn shop loans are of limited usefulness in managing financial difficulties, and those who rely on pawnbrokers for loans have a higher incidence of delinquency and higher frequency of missed payments on mainstream credit than those who use payday loans.[43] Even more revealing of consumer preferences is that pawn shop borrowers typically have been turned down for a payday loan and turn to pawnshops only as a last resort.[44] Those who borrow from pawnshops tend to have extremely limited credit options, primarily friends or check-cashers.[45]

Another alternative source of credit for payday-loan customers is the informal sector of friends and family.[46] A recent survey of households in low- and moderate-income areas of Los Angeles, Chicago, and Washington found that 53 percent of respondents said they would rely on friends or family to borrow $500 for three months.[47] Angela Littwin's survey of credit use by low-income women found that 93 percent had actually borrowed money from friends and family in the past; and many had lent money to friends and family as well.[48] Ten percent of her subjects have borrowed *only* from friends and family.[49] Elliehausen found that 28 percent of payday-loan customers said that they would have tried to borrow from friends and family if payday loans were not available.[50] But friends and family may not be able or willing to lend when needed or in the amounts needed—a reality reinforced by the fact that most social networks are

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[43] Ellison & Forster, *supra* note 4, at 62.
[44] Skiba & Tobacman, *Do Payday Loans*, *supra* note 39.
[45] *See* PETERSON & FALLS, *supra* note 2; *see also* Robert W. Johnson & Dixie P. Johnson, *Pawnbroking in the U.S.: A Profile of Customers* 47 (Credit Research Ctr., Monograph No. 34, 1998).
[46] LENDOL CALDER, FINANCING THE AMERICAN DREAM 60-64 (1999).
[47] ELLEN SIEDMAN, MOEZ HABABOU, AND JENNIFER KRAMER, A FINANCIAL SERVICES SURVEY OF LOW-AND MODERATE-INCOME HOUSEHOLDS (2005).
[48] Angela Littwin, *Beyond Usury: A Study of Credit Card Use and Preference Among Low-Income Consumers*, at 8.
[49] Angela Littwin, *Comparing Credit Cards: An Empirical Examination of Borrowing Preferences Among Low-Income Consumers* 36 (working paper); *available in* http://ssrn.com/abstract=1014460.
[50] Elliehausen, *supra* note 15, at 39.

limited in scope; most of the friends and family of low-income individuals frequently also have low incomes and thus have limited funds to lend. Many people do not have friends or family to whom they can turn for emergency funds, such as immigrants, orphans, or transients.[51] Perhaps more significantly, people find borrowing from friends and family personally embarrassing and potentially damaging to personal relationships. Informal borrowing may also be less useful than standard credit in managing one's finances because personal acquaintances may be willing to lend only for expenses considered particularly meritorious (such as medical emergencies) and not for other expenses.[52]

A final potential source of credit is illegal loan sharks. In the United States, illegal loan sharking originally arose as an outgrowth of small loan laws that capped the fees and interest rates for small consumer loans at a level that was unprofitable, causing legitimate lenders to raise their minimum loan amounts or to exit the market.[53] Organized crime syndicates looking for new economic enterprises following the repeal of Prohibition entered the market in the 1930s and by the 1950s and 1960s controlled much of the small-loan market in many major American cities.[54]

A recent comparison of France, Germany, and the United Kingdom indicates that stricter regulation of consumer credit, and thus reduced access by higher-risk borrowers to legal credit, is correlated with higher rates of illegal lending activity.[55] In Germany, where credit regulations are among the strictest in Europe, 60 percent of low-income

[51] POLICIS, ECONOMIC AND SOCIAL RISKS OF CONSUMER CREDIT MARKET REGULATION 79 (2006).
[52] ECONOMIC AND SOCIAL RISKS, *supra* note 51.
[53] Haller & Alviti, *supra* note 3, at 140.
[54] Haller & Alviti, *supra* note 3, at 143.
[55] *See* POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 51; POLICIS, THE EFFECT OF INTEREST RATE CONTROLS IN OTHER COUNTRIES (2004).

Germans have had credit applications refused, and almost 10 percent have resorted to illegal lenders. In Italy, anecdotal reports indicate that one result of the turmoil in consumer credit markets during the past year has been an increase in lending by illegal loan sharks to consumers and small businesses.[56]

In 2006, Japan severely tightened its rate ceiling on consumer loans (as in the United States, many consumer loans were also small business loans), resulting in a two-thirds drop in the acceptance of consumer loan applications in the two years following the enactment of the law.[57] During that period there has been a dramatic growth in illegal loan sharking in Japan, primarily run by organized crime ("Yamaken" lenders).[58] Research indicates that use of illegal lenders "has risen rapidly among borrowers who have become shut out of the market as the result of the changes in the regulatory environment."[59] Japanese consumers who admit to having contacted a loan shark during a twelve-month period were twice as numerous among those who were unable to borrow as much as they wanted from a legitimate consumer finance lender (26 percent) as among those who were able to obtain the amount that they wanted (13 percent). Those declined by legitimate lenders were also more likely to contact loan sharks (27 percent) and even more likely among those who had been asked to provide guarantors or collateral for a loan (42 percent).

Credit market exclusion reaches more borrowers in countries with strict interest-rate controls (such as Germany and Japan), and loan-shark borrowers tend to have higher

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[56] Mary Jordan, *As Italy's Banks Tighten Lending, Desperate Firms Call on the Mafia*, WASHINGTON POST p. A01 (March 1, 2009).
[57] POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 51, at 47.
[58] POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 51, at 47-49.
[59] POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 51, at 48 (citing Hiroshi Domoto, *Behavioral Analysis of Consumer Loan Users*, REGIONAL BANKS MONTHLY REPORT (Oct. 2007)).

incomes than where credit restrictions are not as tight.[60] The overwhelming reason that borrowers report resorting to illegal lenders is that they could not borrow from anywhere else (over 80 percent).[61] Self-employed small-businesses people tend to be especially vulnerable to credit market exclusion and loan sharking. As might be expected, lending by illegal lenders is much higher in cost than for legitimate lenders, and collections by illegal lenders rest on threats, intimidation, violence, and forms of exploitation (such as provision of sexual favors when unable to pay).[62] In Japan, there have been high-profile reports of borrowers driven to suicide by the pressures of illegal lenders' collection efforts.[63]

The flexibility of consumer credit markets in the United States has substantially reduced the importance of illegal loan-shark lending. Nevertheless, some borrowers are still excluded from consumer lending markets, even for non-traditional products. This exclusion has given rise to a rapidly growing Internet payday lending market, in part because of state regulations that have threatened the economic viability of bricks-and-mortar payday lending.[64] Internet lending provides a gray-market alternative of questionable legality, claiming authority to operate outside the jurisdiction of borrowers' state laws or claiming sovereign immunity by operating through Indian tribes.[65] Internet payday loans may cost more and be more prone to open-ended rollovers than loans from

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[60] POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 51, at 49.
[61] POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 51, at 50.
[62] POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 51, at 51-52.
[63] POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 51, at 51.
[64] *See* David Burtzlaff, *Present and Future of the Payday Advance Industry*, Presentation to Community Financial services Association of America (March 5, 2009).
[65] *See* Quik Payday Inc. v. Stork, 549 F.3d 1302 (10th Cir. 2008); Suthers v. Cash Advance and Preferred Cash Loans, 205 P.3d 389 (Colo. Ct. App. 2008); Ameriloan v. Superior Court, 169 Cal. App. 4th 81, 86 Cal. Rptr. 3d 572 (2008).

more traditional lenders.[66] The electronic nature of the transaction also raises heightened issues of privacy and security as compared to traditional payday lending.

Some commentators have also claimed that the elimination of payday lending may cause consumers to make increased use of auto-title lending, where consumers provide their car title (or the functional equivalent, such as a copy of their keys) to secure a loan, typically for about half of the value of the car.[67] One consumer rights activist argued that the recent severe regulatory restrictions on payday lending in Virginia resulted in a substitution to increased auto-title lending.[68] On the other hand, Zinman found no significant substitution to auto-title lending in Oregon after its ban on payday lending.[69] Although there is little research on the demographics of consumers who use auto-title loans or the substitution between payday and auto-title lending, intuition suggests that, although auto-title lending resembles pawnbroking, auto-title customers might have higher incomes and higher wealth than payday-loan customers, as evidenced by their sufficient income and wealth to own and maintain an operating vehicle. It is plausible that auto-title lending may be a preferred type of consumer credit product compared to payday lending; thus an elimination of payday loans may not result in a large substitution to auto-title lending. On the other hand, eliminating auto-title lending could increase payday loans, as it would likely force those consumers who have been using auto-title loans to move a rung down the consumer credit ladder.

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[66] Jean Ann Fox & Anna Petrini, *Internet Payday Lending: How High-priced Lenders Use the Internet to Mire Borrowers in Debt and Evade State Consumer Protections* (Consumer Federation of America, Nov. 30, 2004).
[67] Potter, *supra* note 29.
[68] Jay Speer, executive director of the Virginia Poverty Law Center, claims that the dramatic reduction in payday lending in Virginia that followed a tightening of the state's payday lending regulations led to an increase in auto title lending: "The good news is that there are less payday loans. The bad news is that they just shifted to car-title lending." Potter, *supra* note 29.
[69] Zinman, *supra* note 20.

Some payday-lending customers may find themselves in a "debt trap," rolling over loans repeatedly or borrowing from one lender to pay off another, thereby worsening, rather than alleviating, financial distress. But research indicates that these borrowers are a minority of payday-loan customers.[70] On average, access to payday loans appears to make it *easier*, not more difficult, for low-income borrowers to manage their finances—in other words, the number of borrowers made better off by access to payday loans exceeds the number who might potentially be made worse off.[71] While some scholars have found a limited correlation between use of payday loans and some kinds of bankruptcy filings,[72] others have found no correlation,[73] and still others find that eliminating payday lending actually increases bankruptcy filings.[74] Bankruptcy filings rose dramatically in Japan following its imposition of strict interest-rate controls, reversing a period of decline.[75]

At the same time, interest-rate restrictions do little to reduce problems of over-indebtedness among low-income households, as term re-pricing and product substitution simply shift consumers to different products. In fact, a report by *Policis* concludes that interest-rate ceilings may exacerbate over-indebtendess problems, as regulation promotes an increase in loan size and loan maturity in order to cover the administrative costs of making the loan. Increased loan size tends to increase overall indebtedness, and an

[70] In one study only 3.2 percent of payday loan customers expressed the view that payday loans made it difficult for them to get out of debt. Elliehausen, *supra* note 15, at 42.
[71] Morgan, *Defining and Detecting*, *supra* note 44.
[72] Skiba & Tobacman, *Do Payday Loans*, *supra* note 41 (finding that use of payday loans may increase likelihood of filing Chapter 13 bankruptcy); Bart J. Wilson, David W. Findlay, James W. Meehan, Jr., Charissa P. Wellford, and Karl Schurter, *An Experimental Analysis of the Demand for Payday Loans* (working paper, April 1, 2008), *available in* http://ssrn.com/abstract=1083796.
[73] Petru S. Stoianovici & Michael T. Maloney, *Restrictions on Credit: A Public Policy Analysis of Payday Lending* (working paper, Oct. 2008), *available in* http://ssrn.com/abstract=1291278.
[74] Morgan & Strain, *Payday Holiday*, *supra* note 25.
[75] POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 51, at 73.

increased use of longer-term installment debt locks borrowers into less-flexible debt arrangements, increasing their vulnerability to income and expense shocks.[76] As noted, foreclosing some types of products may cause a shift to other products (such as revolving credit and credit card cash advances) that are laden with behavior-based fees that more marginal borrowers are most likely to trigger and which might result in even higher effective costs than payday lending. A study of Australian low-income households found that borrowers who took cash advances on credit cards were almost twice as likely to become insolvent as other low-income credit users.[77] Thus, eliminating payday loans might paternalistically protect some consumers from unwise and impulsive decisions but would likely harm the larger number of consumers who would lose a valuable option for managing their finances.

A survey of payday-loan customers in Australia found that twice as many respondents thought that lack of access to payday loans would make it more likely that they would get into financial trouble than who thought that they would be less likely to get into trouble.[78] Twice as many also said that they would have more trouble affording essentials if they did not borrow from payday lenders as believed that it would be easier to afford essentials. Significantly more payday-loan users claimed that payday loans made it easier, rather than more difficult, to pay current bills or meet expenses, and 60 percent of those with no other credit options thought that they would have more difficulty paying bills without access to payday lending.

Moreover, as recent events have made clear, the risk that consumers will misuse credit to become recklessly over-indebted is not unique to payday lending or other non-

[76] POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 51, at 74, 78.
[77] POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 51, at 78.
[78] POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 51, at 28.

traditional lending products, but can also include mortgages, credit cards, student loans, and auto loans. Yet no one proposes to abolish mortgages or student loans because of the risk that some consumers will misuse them or lenders may overreach. While there may be some cases where payday loans pushed a borrower into bankruptcy, there are many other cases where payday loans enabled a borrower to cope with an unexpected financial disruption that otherwise might have precipitated bankruptcy, and still other cases where a borrower was headed toward bankruptcy. In fact, given the small dollar amounts at stake, payday lending is much less likely to prove fatal to a household's balance sheet than other obligations, such as an excessive mortgage or other debts.[79]

The concern over further constricting available lending options is especially pronounced in the current dysfunctional credit market environment. Banks and other lenders are drastically reducing consumer lending, just at the moment when consumers are especially in need of credit to deal with employment interruptions and unexpected expenses. Anecdotal reports indicate that as a result of this reduction of access to credit, and especially a dramatic reduction in the availability of credit-card credit, middle-class consumers and small businesses increasingly are turning to non-traditional lenders, such as payday loans and pawnshops.[80] Banning payday lending in these uncertain times

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[79] Elliehausen has observed that 40 percent of bankruptcy filers who list payday loans on their bankruptcy schedules have only one payday loan and the average amount of those payday loans was $350, which was 1.3 percent of the bankrupt's unsecured debt and the cost of servicing the debt was only about 2.4 percent of the bankrupt's average net monthly income. Elliehausen, *supra* note 15, at 58. Many of those with more payday loans or higher levels of payday loan debt would likely have filed bankruptcy anyway, thus payday loans simply delayed the bankruptcy filing or coincided with the slide into bankruptcy, thus payday loans did not trigger the bankruptcy filing.

[80] Gary Fields, *People Pulling Up to Pawnshops Today Are Driving Cadillacs and BMWs*, WALL ST. J. (Dec. 30, 2008); *Jeff Swiatek, More Middle-Class Families are Learning that Payday Loans Add Up*, INDIANAPOLIS STAR (Feb. 3, 2009) ("Payday loans, typically a way working-class people get cash in a pinch, are increasingly being sought by middle-income families living without a cash cushion. Lenders and others say the short-term loans are being taken out by people who used to get needed cash from a bank, a credit union or a credit card. With the recent credit crunch and recession, high-interest payday loans have

would whipsaw these middle-class consumers, driving them still further down the "lending ladder" to pawnshops or other products.

Consumer Satisfaction with Payday Loans

Consumers generally report high levels of satisfaction with their satisfaction with payday lenders. Elliehausen finds that 87 percent of borrowers report being "very" (54.7 percent), or "somewhat" (33.7 percent), "satisfied" with their most recent payday loan. Only 10 percent, by contrast, where somewhat or very dissatisfied.[81] This high satisfaction with payday lending may seem surprising in light of the seemingly high costs paid by payday-loan customers.

This confluence of high costs and general satisfaction with the product seems to be a product of several factors. First, as noted, pricing of payday loans is highly transparent: Consumers understand the cost they are paying and contrast the clear prices of payday loans with other banking and credit products (such as credit cards and overdraft protection) which have more complex pricing schemes. Payday-loan customers frequently report that they had had negative experiences with banks or credit cards in the past when they were surprised by bounced-check or over-the-limit fees and thus prefer the transparency and predictability of payday-lending terms. They may not like the costs, but they seem to feel that they are being treated fairly. They also know with a high degree of certainty the precise consequences of default if they do not pay, in contrast to many

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become an alternative."). Layaway, which had been completely replaced by credit cards, has returned to department stores as well.

[81] Of those who were dissatisfied, most thought the costs were excessive. Only about 16 percent said that their dissatisfaction stemmed from the feeling that payday loans made it "too difficult to get out of debt." Elliehausen, *supra* note 15, at 42.

other types of consumer credit, such as credit cards.[82] Second, payday-loan customers understand—often from hard experience—the limited range of choices and are realistic about the costs of payday lending when compared to the high expense and inconvenience of their alternatives. Finally, there seems to be a high degree of non-price competition in payday-lending services. Many payday-lending consumers have had relatively negative experiences with traditional financial institutions—bounced checks, harassment for unpaid bills, and the general demoralizing experience of a less-educated, less-sophisticated consumer interacting with a banking and financial system that is perceived as being unwelcoming and unhelpful to lower-income consumers with financial struggles. Customers appreciate that payday-loan outlets are friendly, helpful, customer-service oriented, and treat them more respectfully than traditional lending institutions.[83] Banks may not be as responsive to providing cash quickly. For instance, a bank may require waiting several days for a check to clear before advancing cash against it, whereas payday lenders will extend cash immediately. Payday lenders are also speedier than banks and more willing to work with customers to approve them, as well as offering a variety of services valued by low-income borrowers that traditional banks do not. This respectful and customer-friendly attitude appears to be highly valued by moderate-income consumers. Of those surveyed in a study who expressed satisfaction with their most recent payday loan, the most common reasons expressed for their satisfaction were that it was an “easy convenient process/little paperwork” (41.3 percent), they were able to obtain “needed money quickly” (36.5 percent), and a “courteous/professional/friendly

[82] POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 51, at 91.
[83] McGray quotes one payday lending customer, for instance, who states of the payday lending company, “They treat me with respect, they’re really nice.” McGray, *supra* note 24.

staff" (23.9 percent).[84] Price control regulations would invariably lead payday lenders to scale back the provision of these non-price product attributes valued by consumers.[85]

Scholars have found that access to payday loans even can serve an important role in improving consumer welfare and quality of life. Adair Morse finds that access to payday lending improves the ability of households to respond to natural disasters, as reflected in a reduction in the number of home foreclosures and larcenies below what would be expected following a natural disaster.[86] Economists Dean Karlin and Jonathan Zinman found in a study of South African consumers that access to high-cost credit (comparable to payday lending) provided significant benefits for borrowers across a wide range of economic and "well-being" outcomes, such as higher-quality diet, improved physical well-being, and more stable employment.[87] Although not an ideal type of credit, for these consumers payday loans are better than no credit at all, making it possible for them to smooth out financial disruptions. Finally, and significantly, research in Europe finds that 90 percent of low-income households report feeling anxious that they cannot count on getting cash credit in a crisis, and almost a quarter feel overly dependent on their families for funds in a crisis.[88] In addition, 60 percent suffer frustration from not being able to buy things that they could afford if they could spread the cost of purchase; 40 percent report having to forego major items that they need but cannot afford.

Overall, economic theory, empirical evidence, and surveys of payday-loan customers all suggest that payday lending serves a beneficial role for many consumers by

[84] Elliehausen, *supra* note 15, at 41.
[85] *See* Zywicki, *supra* note 2 (noting that in the 1970s in states with strict usury regulations, department stores were less likely to offer amenities such as free gift wrapping; and banks' hours were shorter).
[86] Adair Morse, *Payday Lenders: Heroes or Villains?* Working Paper (Jan. 2009).
[87] Dean Karlan & Jonathan Zinman, *Expanding Credit Access: Using Randomized Supply Decisions to Estimate the Impacts* (working paper, June 25, 2007).
[88] POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 51, at 28.

providing short-term emergency credit at lower cost and less inconvenience than available alternatives. While some users of payday loans may end up in a "debt trap," those who do so are a minority, and eliminating payday lending would probably hurt the many more people who use payday lending to meet short-term exigencies than it would help through paternalistic restrictions. Eliminating payday lending would force many consumers to shift to less-preferred (and more expensive) forms of borrowing, such as overdraft protection, pawnshops, Internet payday lenders, or worse. Others would find themselves without credit, resulting in bounced checks and an inability to service necessities such as utility bills and car repairs. Given the limited choices available to needy consumers to meet short-term borrowing exigencies, it is unlikely that further restricting their limited options will improve their situation.

Is There A Market Failure in the Payday Loan Industry?

Despite apparent satisfaction and welfare-improvement for consumers, payday lending is still criticized as being unduly expensive, suggesting a market failure that permits payday lenders to exploit consumers. In economic terms, it is suggested that there are economic "rents" or "profits" embedded in payday-loan operations that allow lenders to charge higher prices than they could in a more competitive market and thereby to transfer wealth from consumers to lenders. If this were true, it might be argued that if regulators could somehow ascertain the hypothetical price that might prevail in a competitive market, price regulation would not actually restrict payday-loan operations but simply eliminate a wealth transfer from consumers to lenders. Empirical evidence tends to rebut these concerns.

It is highly unlikely that there is a systematic market failure in the payday-lending market. The market is highly competitive: The number of payday-loan outlets has grown dramatically during the past decade, and payday lenders appear to compete aggressively for customers. Barriers to entry are low.

Standard economic theory predicts that where competition is strong and barriers to entry are low, competition tends to dissipate any economic profits in the industry and to improve consumer welfare.[89] Empirical evidence supports this inference in the payday-loan industry. Where competition is stronger, payday-lending costs are lower.[90] Regulation that reduces the number of payday lenders, therefore, would likely result in higher prices for consumers.

Interest-rate ceilings, on the other hand, may have the counterproductive effect of reducing competition and encouraging implicit collusion among lenders. Scholars have postulated that interest rate caps have been found to provide a "focal point" for pricing consumer loans, leading loan prices to drift toward fixing on the statutorily mandated maximum. Economists have found a focal-point effect with respect to interest rates on both payday loans[91] as well as credit cards.[92] Studies repeatedly find that interest rates are set by the forces of supply and demand, not regulation. [93]

Moreover, despite the cost of payday loans, there is no indication that payday lenders are earning economic profits from their activities once risk and cost are taken into

[89] Philip Bond, David K. Musto, & Bilge Yilmaz, *Predatory Lending in a Rational World*, Federal Reserve Bank of Philadelphia Working Paper 06-2 (Nov. 2006).
[90] Morgan, *Defining and Detecting*, *supra* note 44; DeYoung & Phillips, *supra* note 28.
[91] DeYoung, *supra* note 28.
[92] Christopher R. Knittel & Victor Stango, *Price Ceilings as Focal Points for Tacit Collusion: Evidence from Credit Cards*, 93 AM. ECON. REV. 1703 (2003).
[93] *See* POLICIS, ECONOMIC AND SOCIAL RISKS, *supra* note 51, at 32; Staten, *supra* note 2.

account.[94] Payday loans are small in amount, unsecured, and risky, especially for lenders to new borrowers. Providing many small loans to consumers at low cost has been a perennial problem through history.[95] Default rates are high as compared with other forms of credit. Payday loans, like most consumer loans, are also very costly to originate and service—many of the costs of lending are fixed costs that vary little with the loan size, whether $300 or $300,000. These expenses include rent, employee time, collection costs, paperwork, credit checks, and other expenses. Thus, the underlying fixed costs of payday loans are high relative to the small loan size: a short-term, unsecured loan, to risky borrowers, made by highly personal interactions by employees and customers. These high costs and risk largely explain the high price of payday lending.[96] Given the low barriers to entry in the payday lending market and the competitive nature of the market, it would be surprising if economic profits could be sustained.

Conclusion: The Costs of Substantive Price Regulation Exceed the Benefits

For almost as long as there has been consumer credit, regulators have tried to limit the prices that can be charged for those loans. Price regulation, however, has three unintended consequences: (1) term re-pricing, (2) product substitution, and (3) rationing. Examining all of these unintended consequences, economists and regulators have concluded that once all of the offsetting behaviors have been taken into account, the costs of price caps and other substantive regulation exceed the benefits. The offsetting behaviors taken by lenders and borrowers in response to price-control efforts tend to

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[94] *See* Paige Skiba & Jeremy Tobacman, *The Profitability of Payday Loans*, Working Paper (Dec. 7, 2006).
[95] CALDER, *supra* note 46; CASKEY, *supra* note 40.
[96] Mark Flannery and Katherine Samolyk, *Payday Lending: Do the Costs Justify the Price?* (working paper, June 23, 2005).

make pricing less transparent and more heterogeneous, thereby making it more difficult for consumers to compare among different offers and thereby also stifling competition. Product substitution forces consumers who need credit to use less-preferred forms of credit, such as forcing them to use pawnshops instead of payday lenders. Finally, some consumers will have credit to them rationed and will be unable obtain credit at all, or may be forced to turn to informal or even illegal lenders.

Those who use payday lending do so primarily because they have to, not because they want to. They use payday lending to deal with short-term exigencies that would hurt them even more, such as high costs for bounced checks, overdraft fees, disconnected utilities, or for necessary expenditures such as medical expenses or car repairs. Some payday-loan customers may use payday loans irresponsibly, becoming trapped in a cycle of debt. But this group is the minority of borrowers. The overwhelming bulk of the evidence indicates that payday lenders provide a valuable service for many low-income consumers. Payday-loan customers have limited credit options: Consumers who use payday lending are not likely to be made better off by misguided paternalistic regulations that narrow their options still further.

Prior studies of the impact of usury restrictions have found that low-income and minority borrowers are those most negatively affected by the regulations and the adjustments that those regulations produce.[97] As one study summed up the impact, once all of the various adjustments are made in response to interest-rate ceilings, "substantial numbers of some consumer groups will be less satisfied with the new credit terms. It is ironic that customers who are most likely to be dissatisfied are those who are traditionally

[97] ROBERT W. JOHNSON & A. CHARLENE SULLIVAN, RESTRICTIVE EFFECTS OF RATE CEILINGS ON CONSUMER CHOICE: THE MASSACHUSETTS EXPERIENCE (Credit Research Ctr. Working Paper No. 35, 1980).

considered to be the primary beneficiaries of such legislation—those in the lower socioeconomic groups."[98] Further restrictions on payday lending would likely prove counterproductive and harmful to the very people they are intended to help.

[98]Orville C. Walker, Jr. & Richard F. Sauter, *Consumer Preferences for Alternative Retail Credit Terms: A Conceptual Test of the Effects of Consumer Legislation*, 11 J. MKTG. RESEARCH 70, 78 (1974); *see also* Richard F. Sauter & Orville C Walker, Jr., *Retailers Reactions to Interest Limitation Laws—Additional Evidence*, 36 J. MKTG. 58 (1972), John J. Wheatley & Guy G. Gordon, *Regulating the Price of Consumer Credit*, 35 J. MKTG. 21 (1971).