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Payday Loan Solutions: Slaying the Hydra (and Keeping It Dead)

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NOTES

PAYDAY LOAN SOLUTIONS: SLAYING THE HYDRA (AND KEEPING IT DEAD)

I. INTRODUCTION

The storefronts and signs are hard to miss. They scream out for attention, usually in bright yellow or red letters, or perhaps green dollar signs. They promise quick cash and easy money. They offer low hassle and no credit checks. Just write them a check and you are out the door with cash in hand. They promise a solution: a payday loan. What they deliver is something else entirely. Rather than provide a path out of debt or a helping hand through a financial shortfall, these loans mostly serve to accelerate a downward spiral of increasing debt and further financial hardship. The payday loan, unlike many mainstream forms of credit, builds wealth only for the lender. The payday loan, by design, leaves borrowers in a worse predicament than the one that drove them to seek it in the first place. Payday loans are a wealth-depleting product that for too long has been allowed relatively free reign throughout the majority of U.S. states.

This Note addresses the broad problem of payday loans in a series of steps, beginning with basic background and proceeding towards a conclusion that not only is government intervention necessary to solve the problems posed by payday loans, but that this intervention must be of a particular character in order to succeed. Part I is this introduction. Part II describes payday loans in terms of operation, evolution and growth, and customer attributes. Part III explores a variety of reasons why payday loans are problematic and focuses on product design, product implementation, and the legal framework

within which payday lenders operate. Part IV creates a model for assessing solutions to these problems, both individually and as a whole. Part V applies that model and evaluates types and degrees of solutions to the payday lending problem. Part VI concludes that an effective solution to payday lending incorporates not only legal restrictions, but also alternative products. These restrictions and alternatives must be mandated at the federal level because of the race-to-the-bottom problem of state-by-state action, the profit-based motivation of mainstream lenders and the failure of deregulation and market operation to solve the problem.

Most academic and legal critiques of payday lending begin with the story of some individual who, faced with desperate financial circumstances, took out a payday loan, only to become trapped in a repeating cycle of debt that eventually cost her far more than the initial loan and ended up causing far greater financial hardship than the loan was initially taken out to remedy. There are many good reasons for such an approach. The anecdote provides a human face for the problem and attempts to make the reader empathize with the borrower's plight. It may also serve to explain the basic operation of the payday lending business model and to describe the cost structure of the loans.

Despite all of these good reasons, this Note does not begin with such a story. While there is certainly a value in telling these stories, individualizing the problem places the emphasis on the individualized circumstances within. The message conveyed, while effective, is limited in scope—such stories focus attention on how payday lending was bad for a particular person and then extrapolate to argue that payday lending is therefore bad for all (or most) people and therefore ought to be constrained or banned. While the conclusion is certainly valid, this Note focuses not on the small scale but rather on the large. Payday lending is a problem that affects society as a whole. Its existence is the result of forces that affect all of us—in particular, it is the result of the failures of a significant national policy trend toward deregulation. The problem of payday lending is simply too large to be contained in any one person's experience.

II. PAYDAY LOANS DESCRIBED

A. Operation

There are several basic definitions of what exactly a payday loan is. One study describes payday loans as financial devices “marketed

as short-term cash advances obtained by submitting a postdated check or electronic checking account information as collateral for the loan.”¹ Another simply defines payday loans as “short-term, high-interest loans against a subsequent paycheck.”²

In a typical transaction, a customer goes to a storefront and writes a check for the amount borrowed plus interest and fees. In Ohio,³ customers were able to borrow up to \$800.⁴ The lender could charge interest on the loan at an amount up to 5% “per month or fraction of a month,”⁵ and the loan could have a term of up to six months.⁶ In addition to interest, the lender could charge loan origination fees of up to \$5 for every \$50 loaned for the first \$500 of the principal and \$3.75 per every \$50 loaned for the remainder of the principal up to the maximum allowed by law.⁷

Typically, a customer paid \$15 per every \$100 borrowed over the standard two-week term for these loans.⁸ This fee structure resulted in an annual percentage rate (APR) of 391%.⁹ At the end of the term, the customer was required to repay the entire loan, along with interest and fees. A customer unable to repay the entirety at the end of the term was faced with two options: default or take out a new loan.¹⁰

¹ OHIO COALITION FOR RESPONSIBLE LENDING, TRAPPED BY DESIGN: PAYDAY LENDING BY THE NUMBERS 3 (2007), available at <http://ohiocoalitionforresponsiblelending.org/Trapped%20By%20Design%20Final.pdf>.

² DAVID ROTHSTEIN & JEFFREY D. DILLMAN, TRAPPED IN DEBT: THE GROWTH OF PAYDAY LENDING IN OHIO 1 (2007), available at <http://www.policymattersohio.org/pdf/TrappedInDebt2007.pdf> [hereinafter ROTHSTEIN & DILLMAN, TRAPPED IN DEBT].

³ Ohio is the focus of this analysis for several reasons. Ohio’s current authorizing statute is typical, Ohio has demographics that mirror the nation, Ohio has been the focus of several intensive studies on payday lending, and, most importantly, Ohio has recently passed comprehensive legislation to reform payday lending within the state. H.R. 545, 127th Gen. Assem., Reg. Sess. (Ohio 2007). References to the Ohio example are consequently dealt with in the past tense, though in many other states the practice continues as described.

⁴ OHIO REV. CODE ANN. § 1315.39(A)(1) (West 2004 & Supp. 2007) (repealed Sept. 1, 2008).

⁵ OHIO REV. CODE ANN. § 1315.39(B) (West 2004 & Supp. 2007) (repealed Sept. 1, 2008).

⁶ OHIO REV. CODE ANN. § 1315.39(A)(2) (West 2004 & Supp. 2007) (repealed Sept. 1, 2008).

⁷ OHIO REV. CODE ANN. § 1315.40(A) (West 2004 & Supp. 2007) (repealed Sept. 1, 2008); OHIO DEP’T OF COMMERCE, DIV. OF FIN. INSTS., PAYDAY LOANS, <http://www.com.state.oh.us/dfi/pub/OCA%20Payday%20Loan.pdf> (last visited Sept. 30, 2008). Payday lenders tend to charge the maximum allowed by law. In fact, a recent study in Ohio noted that they were unable to uncover instances where lenders charged below the legal maximums. ROTHSTEIN & DILLMAN, TRAPPED IN DEBT, *supra* note 2, at 9.

⁸ OHIO COALITION FOR RESPONSIBLE LENDING, *supra* note 1, at 3; OHIO DEP’T OF COMMERCE, DIV. OF FIN. INSTS., *supra* note 7; ROTHSTEIN & DILLMAN, TRAPPED IN DEBT, *supra* note 2, at 1.

⁹ OHIO COALITION FOR RESPONSIBLE LENDING, *supra* note 1, at 3; ROTHSTEIN & DILLMAN, TRAPPED IN DEBT, *supra* note 2, at 1. See generally ELIZABETH RENUART ET AL., TRUTH IN LENDING §§ 3.1–.2 (5th ed. 2003).

¹⁰ ROTHSTEIN & DILLMAN, TRAPPED IN DEBT, *supra* note 2, at 2.

If the customer defaulted, the lender cashed the check. If the check bounced, the borrower not only still owed on the loan and its fees, but also was responsible for an additional \$20 collection charge to the lender, in addition to “any amount passed on from other financial institutions for each check, negotiable order of withdrawal, share draft, or other negotiable instrument returned or dishonored for any reason.”¹¹ The lender could then pursue a civil action to collect on the loan.¹²

The more common option was for the borrower to take out a new loan to pay off the original loan. This happened in several different ways. In some states, lenders allow the customer to “roll over” the loan by extending the term for an additional two weeks—if the customer agrees to pay a new set of interest and fees on the extension.¹³ Ohio law, however, prohibited such “roll overs.”¹⁴ The industry in Ohio responded to the prohibition on “rollover” by structuring “back-to-back” transactions, in which the customer paid off the existing loan and then took out a new loan from the same lender to cover the pay-off.¹⁵ A customer could also obtain a new loan from another lender to pay off the existing loan.¹⁶ The end result of any of these choices is the same: the customer incurs more expenses, still has a loan, and still owes the entire principal.

Going by the averages paints a picture of how the typical payday loan plays out over time. In Ohio, a recent study found that the average payday loan principal was \$328.84.¹⁷ For every two week loan, the borrower pays approximately 15% of the amount borrowed. For a \$100.00 loan, this fee is approximately \$15.00, for a \$200.00 loan, \$30.00, and so on. For the average loan of \$328.84, the two-week cost is \$49.33.¹⁸ If at the end of the two-week term, the borrower cannot pay off the loan in full, the loan is extended, refinanced or paid off with a new loan. Regardless of the exact

¹¹ OHIO REV. CODE ANN. § 1315.40(B) (West 2004 & Supp. 2007) (repealed Sept. 1, 2008). These fees are in addition to any that might be charged by the borrower’s bank for the returned check. *Id.*

¹² OHIO REV. CODE ANN. § 1315.40(C) (West 2004 & Supp 2007) (repealed Sept. 1, 2008). *See also* ROTHSTEIN & DILLMAN, TRAPPED IN DEBT, *supra* note 2, at 11 (stating that legal costs for borrowers may approach the original amount of the loan).

¹³ URIAH KING ET AL., FINANCIAL QUICKSAND: PAYDAY LENDING SINKS BORROWERS IN DEBT WITH \$4.2 BILLION IN PREDATORY FEES EVERY YEAR 3–4 (2006), available at http://www.responsiblelending.org/pdfs/rr012-Financial_Quicksand-1106.pdf.

¹⁴ OHIO REV. CODE ANN. § 1315.41(E) (West 2004 & Supp. 2007) (repealed Sept. 1, 2008).

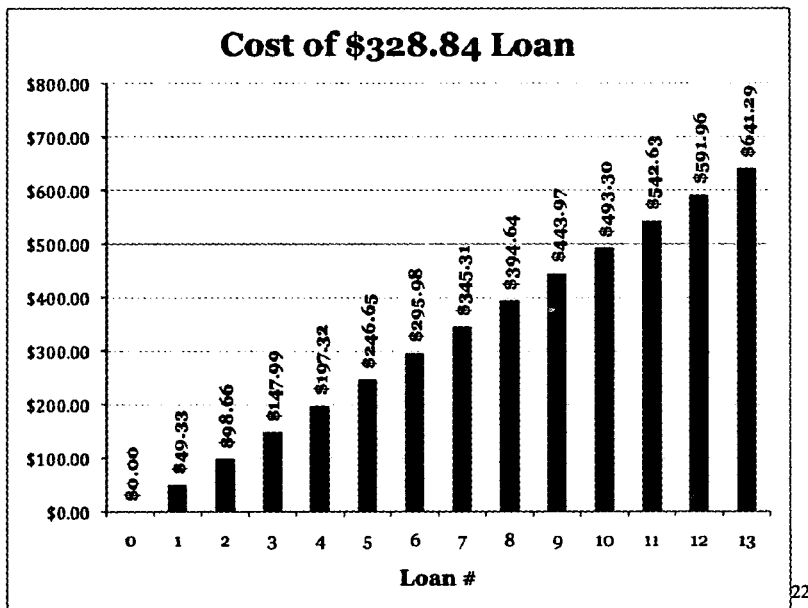
¹⁵ ROTHSTEIN & DILLMAN, TRAPPED IN DEBT, *supra* note 2, at 2; *see also* KING ET AL., *supra* note 13, at 4; OHIO COALITION FOR RESPONSIBLE LENDING, *supra* note 1, at 5.

¹⁶ OHIO COALITION FOR RESPONSIBLE LENDING, *supra* note 1, at 3, 5.

¹⁷ *Id.* at 4.

¹⁸ *Id.*

process, the basic form is the same—another two weeks for another 15% fee. While 15% may not seem all that steep for a one-time transaction, it adds up quickly—especially considering that the average borrower takes out a total of 12.6 payday loans each year.¹⁹ By the thirteenth loan,²⁰ the borrower has paid approximately \$640.00 in fees—almost double the amount actually borrowed.²¹ The following chart illustrates the accumulation of costs:



B. Evolution and Growth

The modern payday loan emerged in the early 1990s. W. Allen Jones is recognized as the father of the modern payday loan, which he

¹⁹ *Id.* at 2, 5 (arriving at 12.6 loans as a conservative calculation based on per-store data and numbers obtained by previous studies assessing the average number of different companies used by borrowers throughout a year). *But see* GREGORY ELLIEHAUSEN & EDWARD C. LAWRENCE, PAYDAY ADVANCE CREDIT IN AMERICA: AN ANALYSIS OF CONSUMER DEMAND 38 (2001), available at <http://www.gwu.edu/~business/research/centers/fsrp/pdf/Mono35.pdf> (suggesting a lower number of renewals and repeat usage).

²⁰ At a two-week term per loan, this equals approximately six months. Because of the nature of the loans and the fee structure, it does not matter whether these six months were contiguous or whether the borrowing was spread throughout the year.

²¹ OHIO COALITION FOR RESPONSIBLE LENDING, *supra* note 1, at 5.

²² *Id.* at 4 (describing the per-loan cost of the average \$328.84 loan as \$49.33 per two-week term).

began making in 1993 in Cleveland, Tennessee.²³ Soon after, payday lending spread and grew quickly. In 1995, for instance, Ohio passed legislation specifically exempting payday lenders from usury laws,²⁴ and the industry rapidly expanded there. Other states that passed authorizing statutes experienced similar growth.²⁵ In the late 1990s payday lenders went to great lengths to characterize themselves not as lenders, but as merely “providing a service for a set fee,” thereby escaping the provisions of the Truth in Lending Act (TILA).²⁶ By 2000, TILA was deemed applicable to payday loans,²⁷ yet payday lending still increased at a furious pace. According to a survey of Ohio Department of Commerce data, there were 107 payday lending locations operating in Ohio in 1996.²⁸ By 2006, that number had increased to 1,562 locations statewide.²⁹ The same study notes ironically that “[t]here are now more check cash lending shops than McDonalds, Burger King, and Wendy’s restaurants combined in Ohio.”³⁰ By late 2007, the total number had expanded to 1,638 locations, representing a further five percent increase.³¹ Other numbers show that the payday lending industry has grown from virtually zero locations in 1993 to approximately 25,000 locations

²³ Richard J. Thomas, *Rolling Over Borrowers: Preventing Excessive Refinancing and Other Necessary Changes in the Payday Loan Industry*, 48 WM. & MARY L. REV. 2401, 2401 (2007); see also Check Into Cash, W. Allan Jones, <http://www.checkintocash.com/allan.htm> (last visited Sept. 23, 2008).

²⁴ H.R. 313, 121st Gen. Assem., Reg. Sess. (Ohio 1995); see also OHIO COAL. FOR RESPONSIBLE LENDING, *supra* note 1, at 2. Usury is the traditional term used to describe high cost loans; most states have usury laws that limit the interest rates that lenders can charge. Ohio, for instance, describes “criminal usury” as “illegally charging, taking, or receiving any money or other property as interest on an extension of credit at a rate exceeding twenty-five per cent per annum or the equivalent rate for a longer or shorter period.” OHIO REV. CODE ANN. § 2905.21(H) (West 2004).

²⁵ See Steven M. Graves & Christopher L. Peterson, *Predatory Lending and the Military: The Law and Geography of “Payday” Loans in Military Towns*, 66 OHIO ST. L.J. 653, 674–75 (2005); see also SHEILA BAIR, *LOW COST PAYDAY LOANS: OPPORTUNITIES AND OBSTACLES* 7 (2005), available at <http://www.aecf.org/upload/publicationfiles/fes3622h334.pdf>.

²⁶ Thomas A. Wilson, *The Availability of Statutory Damages under TILA to Remedy the Sharp Practice of Payday Lenders*, 7 N.C. BANKING INST. 339, 343 (2003).

²⁷ Truth in Lending, 65 Fed. Reg. 17,129 (Mar. 31, 2000) (to be codified at 12 C.F.R. pt. 226) (discussing Official Staff Commentary to Regulation Z § 226.2(a)(14)–2 and the Truth in Lending Act, 15 U.S.C. §§ 1601–1667f).

²⁸ ROTHSTEIN & DILLMAN, *TRAPPED IN DEBT*, *supra* note 2, at 3.

²⁹ *Id.*

³⁰ *Id.*; see also John D. Hawke, Jr., Comptroller of the Currency, Remarks Before the ABA National Community and Economic Development Conference (Mar. 18, 2002), <http://www.occ.treas.gov/ftp/release/2002-24a.txt> (“California alone has more payday loan offices—nearly 2,000—than it does McDonalds and Burger Kings, and other states are not very far behind.”).

³¹ DAVID ROTHSTEIN & JEFFREY D. DILLMAN, *THE CONTINUED GROWTH OF PAYDAY LENDING IN OHIO* 4 (2008), available at http://www.policymattersohio.org/pdf/ContinuedGrowthOfPaydayLendingInOhio2008_0319.pdf [hereinafter ROTHSTEIN & DILLMAN, *CONTINUED GROWTH*].

nationwide by the end of 2006.³² The amount of money handled by these lenders has also grown, from essentially nothing prior to 1993 to approximately \$28 billion in 2006.³³

Payday lending operations are organized in a variety of ways; however, the majority of locations in Ohio are chains or franchises.³⁴ As of 2006, the top ten lenders represented 55 percent of Ohio's payday lending locations, with the top two lenders having well over one hundred locations each.³⁵ Four of Ohio's ten largest lenders were publicly-owned corporations.³⁶ Early on, payday lenders were heavily concentrated in urban areas³⁷ but quickly spread to the rest of the state. In fact, the greatest number of payday lending locations per capita exists in rural counties.³⁸

C. Customers

While there are varying perspectives on the characteristics of payday loan borrowers, some features are certain. The majority of borrowers have jobs (or at least sources of regular income), and all have a checking account.³⁹ Payday loan customers are not the un-banked; rather they are the "underbanked," those who "may lack the savings, credit history, or financial know-how to avoid purchasing a high-cost credit instrument."⁴⁰ There are two competing profiles of the population that make the most use of payday loans. The industry's profile, rooted in the Georgetown Study, describes a typical middle-American.⁴¹ The study found that the majority of payday loan customers had "family incomes between \$25,000 and \$49,999."⁴² This customer also tended to be married, often with children, and below the age of 45.⁴³ The study also found that only a small percentage of customers lacked a high school diploma and that the vast majority of customers had finished high school or had attended some college.⁴⁴ The authors concluded that "a relatively

³² Consumer Fed'n of Am., Payday Loan Consumer Information, <http://www.paydayloaninfo.org/facts.cfm> (last visited Sept. 23, 2008).

³³ *Id.*; KING ET AL., *supra* note 13, at 2.

³⁴ ROTHSTEIN & DILLMAN, TRAPPED IN DEBT, *supra* note 2, at 8.

³⁵ *Id.*

³⁶ OHIO COALITION FOR RESPONSIBLE LENDING, *supra* note 1, at 3-4.

³⁷ ROTHSTEIN & DILLMAN, TRAPPED IN DEBT, *supra* note 2, at 5.

³⁸ ROTHSTEIN & DILLMAN, CONTINUED GROWTH, *supra* note 31, at 3.

³⁹ See ROTHSTEIN & DILLMAN, TRAPPED IN DEBT, *supra* note 2, at 2.

⁴⁰ Michael S. Barr, *Banking the Poor*, 21 YALE J. ON REG. 121, 153 (2004) (defining "underbanked").

⁴¹ ELLIEHAUSEN & LAWRENCE, *supra* note 19, at 28.

⁴² *Id.*

⁴³ *Id.* at 29, 30.

⁴⁴ *Id.* at 33.

small percentage of payday advance customers have low income or low levels of education."⁴⁵ Overall, the Georgetown Study describes the payday loan customer as part of a typical, working, middle-class family who saw payday loans as a valuable service⁴⁶ and used them infrequently,⁴⁷ most often in response to an unexpected expense.⁴⁸ It is worth pointing out that significant faults have been found with the selection of the sample used in, and the funding of, the Georgetown Study; however, the industry and its advocates continue to use it.⁴⁹

Consumer advocate studies reveal a different customer. A study done by the Colorado Administrator of the Uniform Consumer Credit Code revealed that "[t]he 'average' Colorado payday loan borrower is a thirty-six year-old single woman, making \$2,370 per month."⁵⁰ This portrait is corroborated by a study from Illinois, which "found that the average payday loan borrower's salary was just over \$25,000, while the average income for citizens of the state as a whole was over \$31,000."⁵¹ These figures, taken together with other reports, suggest that most borrowers are not typical middle-class Americans, but are hovering somewhere near the edge of poverty.⁵²

The studies show that people use payday loans for a variety of purposes, though the dominant factor remains some sort of unexpected financial crunch. Other reasons often cited include "the speed of the service, the ease of the transactions, the convenience, the personal service, and the lack of viable alternatives," as well as the fact that payday lending outlets have longer and more convenient hours than banks.⁵³ The Georgetown Study also suggested that borrowers choose payday loans for reasons of convenience,⁵⁴ and that many use payday loans to further extend other exhausted sources of

⁴⁵ *Id.* at 55.

⁴⁶ *See id.* at 35 ("Ninety-two percent of customers strongly agreed or somewhat agreed with the statement, 'Payday advance companies provide a useful service to consumers.'").

⁴⁷ *See id.* at 38.

⁴⁸ *Id.* at 47. Recent industry-backed efforts to override Ohio's new restrictive payday loan law rely on the imagery of the payday loan customer as a hard-working, responsible, middle-class person faced with a short-term need for cash to cover unexpected expenses. *See* Jim Siegel, *Payday Lenders Invoke Farm Images for Their Pitch but Sow Half-Truths*, PLAIN DEALER (Cleveland, Ohio), Aug. 12, 2008, at B2 (ranking a statewide television ad as a 3 on a scale from 0 (misleading) to 10 (truthful)).

⁴⁹ Thomas, *supra* note 23, at 2404-06.

⁵⁰ Paul Chessin, *Borrowing from Peter to Pay Paul: A Statistical Analysis of Colorado's Deferred Deposit Loan Act*, 83 DENV. U. L. REV. 387, 405 (2005). The yearly salary calculates out to \$28,440.

⁵¹ Thomas, *supra* note 23, at 2406 (citations omitted).

⁵² *See* BAIR, *supra* note 25, at 8 ("[Borrowers] are middle- and lower-middle-income workers, with 52 percent of households making between \$25,000 and \$50,000 [per year].").

⁵³ Scott Andrew Schaaf, *From Checks to Cash: The Regulation of the Payday Lending Industry*, 5 N.C. BANKING INST. 339, 344 (2001).

⁵⁴ ELLIEHAUSEN & LAWRENCE, *supra* note 19, at 51.

credit.⁵⁵ That study observed that a very small percentage of borrowers resorted to payday loans as an option of last resort.⁵⁶ The high cost of payday loans, however, along with the simple fact that people with access to prime credit products fail to flock to payday lenders for credit, suggest that beneath the other reasons lies one primary motivating factor: most borrowers perceive that they do not have a better option. The evidence suggests that they are, for the most part, correct. Payday loans do fill a gap in the market that is generally not served by mainstream lenders.⁵⁷

III. PAYDAY LOANS ARE PROBLEMATIC

A. Design

The problems associated with payday loans are rooted deep in their design. The fundamental problem is that payday loans, unlike more formalized and mainstream credit options, do not serve as a means of financial improvement for borrowers.⁵⁸ Instead, they often leave borrowers in a worse position than when they sought the loan to begin with.⁵⁹ This effect is no accident.

1. The Debt Trap

The payday lending business model incorporates several features that function to extend loans and prevent borrowers from paying off the loan and walking away free and clear. These features are the short term of the loan coupled with a balloon payment and the lack of an option to repay the loan in installments.⁶⁰ If the customer cannot pay

⁵⁵ *Id.* at v.

⁵⁶ *Id.* at 52 (finding that only six percent of the customers surveyed used payday loans because all other options were closed to them).

⁵⁷ *See id.* at iv (crediting the emergence of payday loans to meeting “unfulfilled demand for very small, short-term consumer loans”); Schaaf, *supra* note 53, at 340–41 (attributing the growth of the payday loan industry “to the deregulation of the banking industry, the absence of traditional small loan providers in the small-sum, short-term credit market, and the elimination of interest rate caps”). Schaaf explains that as banks abandoned the small loan market in the 1980’s in favor of larger loans, customers were left without good options for achieving this sort of credit. *Id.*; *see also* Barr, *supra* note 40, at 152 (pointing to deregulation, the replacement of installment sales with credit card sales, a shift by finance companies from small loans to home equity financing, a decrease in savings, and an increase in the number of people with adverse credit histories as reasons for the rise of payday lending).

⁵⁸ Regina Austin, *Of Predatory Lending and the Democratization of Credit: Preserving the Social Safety Net of Informality in Small-Loan Transactions*, 53 AM. U. L. REV. 1217, 1255 (2004).

⁵⁹ *Id.* (describing how payday loans not only tend to increase a borrower’s financial hardship, but also fail to reward borrowers for reliability, as would a positive mark on a credit rating).

⁶⁰ *See* KING ET AL., *supra* note 13, at 3. *See also* Charles A. Bruch, *Taking the Pay Out of*

off the loan completely, then he becomes entrapped in the “debt cycle.”⁶¹ Lenders reject any attempts at partial payments, instead forcing a complete refinancing of the loan.⁶² The shortfall or unexpected expense that precipitated the initial loan is quickly dwarfed by the cost of the loan itself—the hole simply grows deeper.⁶³ One author explains:

Once [a borrower] dedicates a large portion of his paycheck to repayment of the first loan, the borrower will likely find it difficult to stretch the remainder of the paycheck until the next payday while continuing to pay regular expenses. Whatever necessitated the first payday loan (e.g., car trouble, a sick child, or marital difficulties) may continue to generate unplanned expenses, making it more difficult for the borrower to scrape by until the next payday. If the borrower loses this battle, he will likely take out a new loan to bridge the gap. Unfortunately, the loan fees associated with this new loan will jeopardize his ability to pay all of his bills in the next period, perpetuating the cycle of dependency.⁶⁴

Payday Loans: Putting an End to the Usurious and Unconscionable Interest Rates Charged by Payday Lenders, 69 U. CIN. L. REV. 1257, 1273 (2001) (noting that the fundamental difference between payday loans and pawns is that while “[a] customer can forfeit his pawn and walk away from the transaction with no liability,” a payday loan customer “cannot simply surrender his security and walk away [because] he remains legally obligated to pay the principal, interest, and extension fees on the loan, and he must deal with the consequences if a lender tries to cash his usually worthless post-dated check”).

⁶¹ Diane Hellwig, *Exposing the Loansharks in Sheep’s Clothing: Why Re-Regulating the Consumer Credit Market Makes Economic Sense*, 80 NOTRE DAME L. REV. 1567, 1576 (2005); see also KING ET AL., *supra* note 13, at 4 (“[O]ver time the borrower finds it harder to pay off the loan principal for good as fees are stripped from their earnings every payday. They are frequently trapped paying this interest for months or even years, and many go to a second or third payday lender in an often fruitless attempt to escape the trap.”) (citation omitted); URIAH KING & LESLIE PARRISH, CTR. FOR RESPONSIBLE LENDING, *SPRINGING THE DEBT TRAP: RATE CAPS ARE ONLY PROVEN PAYDAY LENDING REFORM 7* (2007), available at <http://www.responsiblelending.org/pdfs/springing-the-debt-trap.pdf> (“The high price of a payday loan and the fact that it must be paid off in one lump sum two short weeks later, virtually ensures cash-strapped borrowers will be unable to meet their basic expenses and pay off their loan with a single paycheck.”).

⁶² Thomas, *supra* note 23, at 2412.

⁶³ Lynn Drysdale & Kathleen E. Keest, *The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and Its Challenge to Current Thinking About the Role of Usury Laws in Today’s Society*, 51 S.C. L. REV. 589, 609 (2000) (explaining that the structure of payday loans extends and increases the initial burden that led the customer to the loan in the first place).

⁶⁴ Hellwig, *supra* note 61, at 1576; see also ROTHSTEIN & DILLMAN, *CONTINUED GROWTH*, *supra* note 31, at 10 (“Given the high interest rates and short loan terms, it is difficult for most payday lending customers to pay back their loans on time without resorting to taking out another loan. This is particularly true for families on fixed incomes, such as those receiving

2. Renewal

Some defenders of payday lending suggest that the problem with payday loans is not the loans themselves, but how borrowers use them.⁶⁵ This position, however, assumes that the industry truly intends payday loans to be a one-time, short-term product. There is significant evidence to suggest otherwise.⁶⁶ While lenders continue to characterize their products as intended for short-term use,⁶⁷ studies suggest that the reality is quite different. A North Carolina study showed that more than 50% of payday loan borrowers paid more in interest and fees than the initial value of the loan.⁶⁸ The Center for Responsible Lending (CRL) found that only one percent of loans involved a single transaction, corroborating other studies which also found that lenders depend on “chronic borrowing.”⁶⁹ In fact, the CRL “found that the industry relies almost entirely on revenue from borrowers caught in a debt trap [and that] ninety-one percent of payday loans go to borrowers with five or more loan transactions per year.”⁷⁰ In addition, the CRL found that 90% of lenders’ revenues come from repeat borrowing.⁷¹ The CRL and others have concluded from such data that the payday loan, despite being sold as a one-time deal, is in fact “designed to be renewed.”⁷² The incentive for lenders

Social Security, retirement, or disability payments.”).

⁶⁵ See, e.g., Aaron Huckstep, *Payday Lending: Do Outrageous Prices Necessarily Mean Outrageous Profits?*, 12 FORDHAM J. CORP. & FIN. L. 203, 207 (2007) (analogizing payday loans to taxi service and noting that while the taxi and the payday loans are “cost-effective” for short-term use, long distance use of the taxi and long-term use of the loans are not). The presentation of this model suggests that the blame lies on the consumer for expensive misuse of the service. *Id.*

⁶⁶ See KING & PARRISH, *supra* note 61, at 1 (noting the comment made by Dan Feehan, CEO of Cash America, at an industry conference: “[T]he theory in the business is you’ve got to get that customer in, work to turn him into a repetitive customer, long-term customer, because that’s really where the profitability is.”).

⁶⁷ *Id.* (presenting the industry’s public description of the purpose of payday loans: “‘Since a payday advance is a short-term solution to an immediate need, it is not intended for repeated use in carrying an individual from payday to payday. When an immediate need arises, we’re here to help. But a payday advance is not a long-term solution for ongoing budget management. Repeated or frequent use can create serious financial hardships.’” (quoting CMTY. FIN. SERV. ASS’N, INFORMATION BROCHURE, THE FACTS ABOUT PAYDAY ADANCE SERVICES (2005))); Huckstep, *supra* note 65, at 207 (explaining that the payday lending industry’s stated purpose is to provide short-term borrowing options, not long-term loan products).

⁶⁸ JEAN ANN FOX & EDMUND MIERZWINSKI, CONSUMER FED’N OF AM. & U.S. PUB. INTEREST RESEARCH GROUP, RENT-A-BANK PAYDAY LENDING 9 (2001), available at <http://www.consumerfed.org/pdfs/paydayreport.pdf>.

⁶⁹ KING ET AL., *supra* note 13, at 3; see also Chessin, *supra* note 50, at 411.

⁷⁰ KING ET AL., *supra* note 13, at 3.

⁷¹ *Id.* at 6.

⁷² *Id.* at 3; see also Bruch, *supra* note 60, at 1273–74 (describing the features of payday loans that prevent borrowers from escaping the obligation); Hellwig, *supra* note 61 (observing

to stretch out the loan is significant—the typical borrower ends up paying back \$793 on a \$325 loan, and the lender makes \$468 over a period of 4.5 months.⁷³ Other studies verify these significant profit margins.⁷⁴

3. Rates

At the root of this trap that keeps borrowers cycling through loan after loan is the high cost of these loans. Nationally, payday loans carry an average APR of 470%.⁷⁵ Even in states like Ohio, where the statute placed APRs at the low end of the scale relative to other states, borrowers paid interest and fees in excess of the original loan principal by the fourth month of indebtedness.⁷⁶ The industry defends these rates in two ways. First, the industry argues that APR is not a fair descriptor of the cost of the loans, and, second, they argue that the high cost is justified by the proportionately high risk of the customers served. Both of these defenses are without merit. In fact, the payday lending business is highly profitable with a typical return on sales of 30%.⁷⁷

Industry defenders attack the use of APR rates to describe the cost of payday loans. APR is irrelevant, they argue, because “the short-term nature of [payday loans] limits the utility of using APR to analyze these loans” and “APR emphasis distorts the issue and serves only to inflame bias against lenders.”⁷⁸ Payday lenders, they say, have no way to make money from the product if they are limited to lower fees and rates because of the short term of the loan.⁷⁹

that the industry’s success may be dependant on trapped customers).

⁷³ KING ET AL., *supra* note 13, at 8.

⁷⁴ Michael Bertics, *Fixing Payday Lending: The Potential of Greater Bank Involvement*, 9 N.C. BANKING INST. 133, 136 (2005) (discussing studies showing lenders reap profits of at least 24%, and often much more); JEAN ANN FOX, CONSUMER FED’N OF AM., SAFE HARBOR FOR USURY: RECENT DEVELOPMENTS IN PAYDAY LENDING 3–4 (1999), available at <http://www.consumerfed.org/pdfs/safeharbor.pdf> (pointing to returns ranging between 22.72 percent and 48 percent). *But see* Huckstep, *supra* note 65, at 227 (suggesting lower profit margins and justifying high fees based on expenses and losses).

⁷⁵ FOX & MIERZWINSKI, *supra* note 68, at 4.

⁷⁶ See ROTHSTEIN & DILLMAN, TRAPPED IN DEBT, *supra* note 2, at 9 (describing Ohio APR rates for payday loans as ranging from 367% to 391%); *see also* BAIR, *supra* note 25, at 3 (describing an APR range from 391% to 572% for payday loans nationwide); KING ET AL., *supra* note 13, at 17 (listing state APRs for payday loans in a range from 196% to 574%, with most states in high 300% to mid 400% range).

⁷⁷ Barr, *supra* note 40, at 153.

⁷⁸ Amy A. Minnich, *Rational Regulation of Payday Lending*, 16 KAN. J.L. & PUB. POL’Y 84, 92 (2006).

⁷⁹ *Id.* (“If the fee were limited to 35% annually, as has been suggested, lenders could only charge \$1.35 on a two-week loan for \$100. This fee would not even pay for a store employee to process the loan.”).

The industry's characterization of payday loans as short term, however, fails to reflect the reality of the situation. Studies in Ohio and nationwide have found that the per-person loan volume averages to 7.4 loans annually per borrower, per store, and 8.7 loans per borrower across multiple stores.⁸⁰ Consideration of the fact that many borrowers use multiple stores tends to indicate that these figures are conservative—further calculations, based on industry figures, place the average number of loans per year at 12.6 per borrower.⁸¹ When considered in combination with the standard two-week term for a loan, this average borrower, through repeat lending, is in debt to the lender for over six months out of a given year. As described previously, it is this repeat cycle that not only generates the bulk of lender profits, but also traps the customer in the loans and results in fee and interest payments far in excess of the principal over the average extended loan period.⁸²

The payday lending industry also defends its product by arguing that its fees are proportional to the risk involved in payday loans. This high risk, they argue, comes with the territory; borrowers are much riskier and lack qualifications for other, more mainstream credit products. The payday loan industry claims that much of its attractiveness to customers is that customers are not subjected to credit checks to qualify for a payday loan. In the absence of credit checks, lenders lack an accurate evaluation of the risk involved for each individual customer. Instead, they apply the highest-risk cost structure to every customer and assume that the risk is great. Because customers self-select for the loans, the range of actual risk involved can vary greatly. A survey of annual reports of payday lenders in Colorado conducted by the state revealed that “for the years 1996 through 2004, payday lenders report an average charge-off rate, or loss experience, of 3.34% of their total loan volume,” compared with rates of 2.69% for consumer loans made by banks and 5.15% for credit card companies.⁸³ This loss rate clearly refutes claims by industry groups that their risk rates are significantly greater than conventional lending forms.

⁸⁰ OHIO COALITION FOR RESPONSIBLE LENDING, *supra* note 1, at 4–5.

⁸¹ *Id.* at 5. “A 2001 industry-commissioned study found that the average payday customer borrows from 1.7 payday companies annually. (In the past six years the number of storefronts has more than doubled in Ohio, making the 1.7 figure a conservative current-day estimate.)” *Id.* Using these figures, the Ohio Coalition for Responsible Lending calculated that “Ohio’s actual repeat borrowing level is 12.6 loans, per borrower, per year, from all lenders.” *Id.*

⁸² KING ET AL., *supra* note 13, at 6.

⁸³ Chessin, *supra* note 50, at 408; *see also* Barr, *supra* note 40, at 150 (“The industry reports gross margins of 30%–45% of revenue, with losses at 1%–1.3% of receivables and return on investment of 24%.”).

Lenders also argue that the cost of the loans is justified not only by the increased risk that these loans carry⁸⁴, but also by the simple operational and start-up costs associated with the business model.⁸⁵ The claim that start-up and loan initiation costs eat up the majority of lenders' revenues seems somewhat exaggerated when placed next to figures showing that established stores earn an average of \$18.73 per loan⁸⁶ and that profit appears to repeat with each renewal. Applied to the average of 12.6 loans per borrower per year⁸⁷, this figure shows a profit of \$235.99 over the period of approximately six months covered by those 12.6 loans. This seems to fit well with the data provided by the Ohio Coalition for Responsible Lending which placed the cost of this average loan to the borrower at \$637.⁸⁸ That leaves \$401.01 from this typical loan to cover the operating and initiation costs incurred by the lender, and the remainder, over one-third of the fees, as profit.

Lender behavior in Ohio suggests that even significant reductions in the rates and fees charged would still allow for small loans to be made profitably. After Ohio passed comprehensive legislation in June 2008,⁸⁹ the payday lending industry launched an aggressive campaign to overturn the law, claiming that the new 28 percent rate cap will drive its members out of business.⁹⁰ At the same time, however, a large majority of these lenders have already applied for licensing under House Bill 545, suggesting that they do in fact see a way to continue operation under the rate cap.⁹¹

B. Implementation

1. Market Failure

In addition to the problems explicit in the design of the payday loan are the problems that stem from the way these loans are

⁸⁴ Minnich, *supra* note 78, at 84.

⁸⁵ Mark Flannery & Katherine Samolyk, *Payday Lending: Do the Costs Justify the Price?* 2 (FDIC Center for Financial Research Working Paper No. 2005-09), available at www.fdic.gov/bank/analytical/cfr/2005/wp2005/CFRWP_2005-09_Flannery_Samolyk.pdf.

⁸⁶ *Id.* at 19.

⁸⁷ OHIO COALITION FOR RESPONSIBLE LENDING, *supra* note 1, at 5.

⁸⁸ *Id.*

⁸⁹ H.R. 545, 127th Gen. Assem., Reg. Sess. (Ohio 2007).

⁹⁰ Jim Siegel, *State Bracing for Payday Fight: Well-Funded Lenders Seek Referendum to Keep High Interest Rate*, COLUMBUS DISPATCH, Aug. 8, 2008, at A1. On November 4, 2008, Ohio voters overwhelmingly favored a ballot measure approving the Ohio Legislature's 28 percent rate cap. Laura Johnston, *Voters Keep the Cap on Short-Term Loans at 28 Percent Mark*, THE PLAIN DEALER, November 5, 2008, at X8.

⁹¹ Siegel, *supra* note 90.

marketed, sold, and collected. When market forces are functioning properly, economists generally disdain intervention in and regulation of the markets. Economists recognize that sometimes, however, markets do not function according to theory. Under those circumstances, called market failure, intervention is necessary in order for the markets to function properly and “to ensure fair prices for consumers.”⁹² The current payday lending situation is just such a circumstance. Ohio State Representative William Batchelder, a conservative proponent of payday lending reform, describes the dilemma as follows:

I have always been a vocal supporter of free enterprise, and have opposed needless and burdensome regulation. However, these abusive practices are a threat to the free markets which are so critical to our state’s prosperity. . . . Adam Smith, the great prophet of free enterprise, believed there had to be limitations on interest in order to preserve a free market. What Smith would think of an APR of 300%, I cannot imagine.⁹³

The payday lending market is a failed market. The primary problem is that competition has not driven down prices⁹⁴—most lenders operate at the maximum allowable rate⁹⁵ and compete with each other instead through “location of the store, flashy signs, promises of quick cash, and name recognition.”⁹⁶ The result is that as the number of lenders in the market has increased, prices have not decreased as they ought to in a healthy, functioning market; rather most lenders charge the maximum permitted by law.⁹⁷ This is rooted

⁹² Pearl Chin, *Payday Loans: The Case for Federal Legislation*, 2004 U. ILL. L. REV. 723, 741 (2004) (arguing that where supply and demand fail to regulate prices, government intervention is necessary).

⁹³ Payday Lending Reform Bill, Statehouse Dispatches! Bill’s Blog, <http://www.batchelderforohio.com/blog.cfm?ID=133> (Sept. 14, 2007, 08:38 PM EST); see also KING & PARRISH, *supra* note 61, at 22.

⁹⁴ See Chessin, *supra* note 50, at 408–09 (describing how competition does not determine prices and how prices instead match up with rate caps); see also Hellwig, *supra* note 61, at 1584–89 (observing how duress and secrecy regarding pricing have served to drive prices up and concluding that rate regulation is necessary in this climate of market failure).

⁹⁵ Chin, *supra* note 92, at 740–41 (describing how loan prices have failed to drop as the market has expanded and providing examples of how loan prices adhere closely to state rate maximums).

⁹⁶ Bertics, *supra* note 74, at 143 (discussing the competition tactics of payday lenders that discourage price shopping by making it difficult and costly for customers to compare meaningful features of competitive lending products).

⁹⁷ ROTHSTEIN & DILLMAN, *CONTINUED GROWTH*, *supra* note 31, at 9 (“[D]espite the large number of stores, the market for payday lending in Ohio remains uncompetitive regarding prices of loans, with the vast majority of lenders charging the highest fees and interest rates allowed by

in information asymmetry and the resulting difficulties and costs that discourage customers from engaging in price shopping.⁹⁸ Lenders then take advantage of a borrower's financial predicament to trap them in a loan they cannot pay off. This inequality of power is yet another reason why market failure has occurred.⁹⁹ It is also a key reason why well-off individuals and people in stable financial situations are not flocking to payday lenders in the same numbers as their less-advantaged counterparts. Consequently, we cannot rely on typical market forces to solve the problems associated with payday loans and must resort to regulatory solutions to accomplish the ends that the market cannot.¹⁰⁰

2. Abusive Practices

In addition to the structural and design problems associated with payday loans, there is the additional problem of abusive practices.¹⁰¹ While observers have been unwilling to brand all lenders as engaging in such practices, they have documented that such practices represent the norm, rather than the work of a few bad apples.¹⁰² In a study conducted in Franklin County, Ohio (the "Ohio Study"), researchers found "widespread noncompliance with consumer protection laws and the industry's own self-regulatory guidelines."¹⁰³ These practices, which range from plainly illegal to simply deceptive, include:

law."); Bertics, *supra* note 74, at 142 (discussing payday lending practices and concluding that, because payday lenders are collecting economic rent in the form of disproportionately high costs, the payday lending market is imperfect and ordinary market workings are inadequate to remedy the situation).

⁹⁸ Bertics, *supra* note 74, at 143; Chin, *supra* note 92, at 741–42; Chris Peterson, *Failed Markets, Failing Government, or Both? Learning from the Unintended Consequences of Utah Consumer Credit Law on Vulnerable Debtors*, 2001 UTAH L. REV. 543, 573 (2001).

⁹⁹ See Scott A. Hefner, *Payday Lending in North Carolina: Now You See It, Now You Don't*, 11 N.C. BANKING INST. 263, 267–68 (2007).

¹⁰⁰ Peterson, *supra* note 98, at 573–74.

¹⁰¹ These questionable practices seem not to be confined merely to the regular operation of the payday lending business. After Ohio passed legislation imposing a strict rate cap in June of 2008, the lenders launched a campaign under the name "Ohioans for Financial Freedom." Mark Rollenhagen, *Cap Repeal Solicitors Misleading, Foes Say*, PLAIN DEALER (Cleveland, Ohio), Aug. 13, 2008, at B3. This campaign has allegedly involved a pattern of misinformation, including representations that the industry's proposed ballot measure is a move to lower interest rates, rather than a move to override the rate-cap legislation and allow payday lenders to continue business as usual. *Id.*; see also Siegel, *supra* note 48, at B2 (describing advertising by the industry-backed Ohioans for Financial Freedom as less than truthful).

¹⁰² Creola Johnson, *Payday Loans: Shrewd Business or Predatory Lending?*, 87 MINN. L. REV. 1, 5 (2002).

¹⁰³ *Id.* at 6 (2002).

[R]efusing to provide customers with basic written information about the payday loan transaction, giving consumers false or misleading information about the cost of credit, failing to advertise the cost of credit using APRs, refusing to supply customers with written disclosures prior to contract consummation, claiming no credit check would be conducted but doing so anyway without obtaining consumer consent, including clauses in their loan documents that appear to be illegal or unconscionable, representing that consumers have the right to rescind the contract at no cost, allowing consumers to roll over payday loans in violation of state law, representing to consumers that the lenders have the ability to collect treble damages from defaulting consumers, and intimidating consumers with the threat of physical violence and criminal prosecution.¹⁰⁴

Anecdotal evidence as well as other studies suggest that these sorts of practices are by no means confined to the scope of the Ohio Study and, while not the rule, are certainly the norm in most areas.¹⁰⁵ All these observed practices contribute to the information asymmetries discussed in the prior section on market failure, and the practices prevent customers from getting a clear picture of the deal they have made until it is essentially too late and they see no way out but to keep taking loans until they can acquire enough money to pay off the loan and escape.

C. Federal Law

The lack of federal involvement in the payday lending arena is not due to the federal government's inability to regulate such loans. The emergence of the modern payday loan is rather the direct result of federal policy choices to forego regulation in favor of allowing market forces to govern.¹⁰⁶ The passage into law of the 2007 Defense Authorization Bill, which imposed restrictions and a rate cap of 36% on payday loans offered to military personnel, shows that Congress is fully able to exert its authority in the matter.¹⁰⁷ The amendment

¹⁰⁴ *Id.* at 32–33 (footnotes omitted).

¹⁰⁵ ROTHSTEIN & DILLMAN, CONTINUED GROWTH, *supra* note 31, at 9 (“[S]tore employees were not able to explain to the testers what the annual percentage rate meant.”); Kelly J. Noyes, *Get Cash Until Payday! The Payday-Loan Problem in Wisconsin*, 2006 WIS. L. REV. 1627, 1638–39 (2006) (describing coercive collection practices used even when prohibited).

¹⁰⁶ See DAN IMMERGLUCK, CREDIT TO THE COMMUNITY: COMMUNITY REINVESTMENT AND FAIR LENDING POLICY IN THE UNITED STATES 10 (2004).

¹⁰⁷ John Warner National Defense Authorization Act for Fiscal Year 2007, Pub. L. No. 109–364, § 670, 120 Stat. 2083, 2266–69 (codified as 10 U.S.C. § 987 (2006)).

containing this rate cap was passed in response to widespread observations that lenders were specifically targeting and regularly taking advantage of military personnel.¹⁰⁸ In addition, federal banking agencies have slowly increased their regulation of bank funding of and rate-renting to payday loan operations.¹⁰⁹ Still, the federal government has failed to act in any comprehensive way, such as extending the protections given to military personnel to all Americans with a federal rate cap statute.¹¹⁰

The federal government's failure to deal with payday lending on a broad scale is the result of distinct policy choices based on an ideology that favors market action over regulation.¹¹¹ Even when these choices were made, regulators realized that a move away from regulation to market forces brought "the potential for greater risk and greater uncertainties" and that market forces were incapable of providing the safeguards necessary to protect the financial system from "new and perhaps even unforeseen problems."¹¹²

The market ideology won out, however, with the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, which made significant strides in deregulating the banking industry and in pre-empting state usury laws in the name of competition and efficiency.¹¹³ This active choice to eschew regulation is a key cause of the current payday loan predicament.¹¹⁴ Admittedly,

¹⁰⁸ Graves & Peterson, *supra* note 25, at 659 ("[T]here is irrefutable geographic evidence demonstrating that payday lenders are actively and aggressively targeting U.S. military personnel."); KING ET AL., *supra* note 13, at 13.

¹⁰⁹ See KING & PARRISH, *supra* note 61, at 6 (describing how the FDIC's action in 2005 closed the last opportunity for payday lenders to operate under the "rent-a-charter" model, whereby lenders partnered with banks located in states without strong payday lending limits and then took advantage of the ability of those banks to export their rates to continue to charge high rates in states that had enacted rate limitations on payday lending products); FDIC, Financial Institution Letter FIL-14-2005, Payday Lending Programs Revised Examination Guidance (Mar. 1, 2005), available at <http://www.fdic.gov/news/news/financial/2005/fil1405.pdf> (providing the final regulatory cut-off for banks involved in rate exportation "rent-a-charter" partnerships with payday lenders). The FDIC's action significantly increased states' abilities to ban payday lending and high interest rates within their borders without those efforts being undermined by rate structures imported from other less restrictive states. KING & PARRISH, *supra* note 61, at 6.

¹¹⁰ See 10 U.S.C. § 987 (2006).

¹¹¹ See E. GERALD CORRIGAN, FEDERAL RESERVE BANK OF MINNEAPOLIS, 1980 ANNUAL REPORT ESSAY: A NEW LAW, A NEW ERA 1, 4-7 (1980), available at <http://minneapolisfed.org/pubs/ar/ar1980.cfm> (describing greater competition and less regulation as primary goals of The Depository Institutions Deregulation and Monetary Control Act of 1980).

¹¹² CORRIGAN, *supra* note 111, at 7, 5.

¹¹³ Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (codified as amended in scattered sections of 12 U.S.C and 15 U.S.C.).

¹¹⁴ Foremost among the reasons attributed to the rise of payday lending is the deregulation of the banking industry. As was intended, banks moved away from small loan products towards more profitable products in the atmosphere of increased competition created by deregulation. CORRIGAN, *supra* note 111, at 4-5 (describing the market theory behind deregulation and

the true roots of payday lending lie far deeper, in features of the human condition that are unlikely to be changed easily, if at all. The first of these features is poverty in all its forms. Poverty and need present the opportunity for the payday loan, which offers quick cash to those who do not have it and minimal up-front complication. Where there is such need, there will also be someone willing to exploit it. The opportunity for profits is simply too good for some to pass on. These causes are enormous problems in and of themselves, and they are not so easily changed. The policy choice to eschew regulation, however, is susceptible to change, and presents the most realistic and clear path to effectively and definitively eliminating not only the problems of payday loans, but also whatever exploitative form attempts to supplant them. A bit of hope for such change exists in the fact that deregulationist ideology is no longer as unassailable as it once was. In the wake of recent financial upheaval triggered by the mortgage lending collapse, some strong proponents of deregulation have come to admit not only that “the deregulation . . . of banking has been a factor in the current credit crisis,” but that, in retrospect, deregulation may be at the root of many of the nation’s recent crises.¹¹⁵

D. State Law

In the absence of any meaningful federal action, states have addressed payday lending in their own ways. The range of responses has varied greatly, but the result has been that the majority of states permit, and even encourage, payday lending within their borders. States have taken a variety of approaches to payday lending, and while no two approaches are identical, they can be categorized into a few general categories: explicit toleration,¹¹⁶ under-enforced prohibition,¹¹⁷ true prohibition,¹¹⁸ and direct prohibition.

anticipating the effects of federal banking deregulation); Barr, *supra* note 40, at 152 (attributing payday lending’s rise to the deregulation of the banking industry and to the resulting increase in competition that led banks to cut less profitable products such as small value consumer loans); see also Huckstep, *supra* note 65, at 205 (crediting banking deregulation in the 1980s as playing a role in enabling the rise of payday lending); Schaaf, *supra* note 53, at 340 n.8 (describing how banking deregulation led banks to eliminate services, including small unsecured loans).

¹¹⁵ Posting of Richard Posner to The Becker-Posner Blog, http://www.becker-posner-blog.com/archives/2008/04/reregulate_fina.html (Apr. 28, 2008, 12:35 PM). Alan Greenspan has also recently acknowledged flaws in his free-market ideology and admitted that deregulation of financial markets was in some respects an error. Edmund L. Andrews, *Greenspan Concedes Flaws in Deregulatory Approach*, N.Y. TIMES, Oct. 24, 2008, at B1.

¹¹⁶ Ronald J. Mann & Jim Hawkins, *Just Until Payday*, 54 UCLA L. REV. 855, 874 (2007).

¹¹⁷ *Id.* at 877.

¹¹⁸ *Id.* at 879.

Explicit toleration is the most common state approach and is generally characterized by state statutes that specifically authorize lenders to engage in the practice of making payday loans.¹¹⁹ Most of these statutes are based on model legislation created by the Community Financial Services Association (CFSA), a payday lending industry trade group.¹²⁰ The model legislation provides that “[l]oans can only be made for \$500 or less; loans can only be renewed one time; borrowers can rescind a loan within a day; lenders must obtain licenses to operate; lenders cannot use threats of criminal prosecution as a collection tool; and . . . fees are capped at 20 percent of the first \$300 lent and 7.5 percent of any funds lent over \$300.”¹²¹ Ohio followed a variation of this approach beginning in 1995.¹²²

The second most common state approach, under-enforced prohibition, is characterized by “a formal prohibition of payday lending, coupled with a lack of resources or effort adequate to make the prohibition effective.”¹²³ The states taking this approach have generally left usury laws in place without making provisions for payday lending, but have been unable or unwilling to use these existing laws to effectively curb payday lending activity.¹²⁴ Texas typifies this approach: while Texas law caps interest rates at 24 percent and limits fee structures such that maximum fees are approximately one-third of the typical fees for payday loans, lenders have found ways to avoid these limits, and payday lending continues to exist in Texas as in states with permissive regulatory approaches.¹²⁵

Some states, in particular New York, have taken the approach described as true prohibition.¹²⁶ New York has preserved strict usury limits and coupled these limits with strict enforcement by the attorney general’s office, with the result that no major payday lenders have established a foothold within the state.¹²⁷ The effective difference between true prohibition and that of under-enforced prohibition lies at least as much in enforcement practices as in the law.¹²⁸ This suggests

¹¹⁹ *Id.* at 874.

¹²⁰ *Id.* at 874–75.

¹²¹ *Id.* (footnotes omitted).

¹²² OHIO REV. CODE ANN. §§ 1315.35–44 (West 2004 & Supp. 2008) (repealed Sept. 1, 2008); H.R. 313, 121st Gen. Assem., Reg. Sess. (Ohio 1995); see *supra* Part II.A (discussing the basic elements of Ohio’s payday loan laws).

¹²³ Mann & Hawkins, *supra* note 116, at 877.

¹²⁴ *Id.*

¹²⁵ *Id.* at 878–79. See also Deena Reynolds, *A Look at Payday Loans & Current Regulation in Texas*, 8 TEX. TECH. ADMIN. L.J. 321, 339–40 (2007) (concluding that Texas’ approach to regulating payday lending has failed).

¹²⁶ Mann & Hawkins, *supra* note 116, at 879.

¹²⁷ *Id.* at 880.

¹²⁸ *Id.* (“The difference, it seems, is not in the usury limit but in the ability of regulators to bring and prevail in litigation to enforce those limits.”).

that states willing to devote the effort and attention to keeping payday lending out of their jurisdictions can enjoy significant success—so long as they never allow payday lending to establish a foothold.

For states that have bowed to the payday lending industry and adopted the explicit toleration approach, the opportunity for true prohibition has passed. These, states, if they wish to eradicate an established payday lending presence, must deal directly with the issue. North Carolina and Georgia are the two states that have so far taken this approach, though not without facing some resistance.¹²⁹ Both states enacted tough rules coupled with aggressive enforcement.¹³⁰ This type of solution is the only effective way to eliminate payday lending and free borrowers from the debt trap.¹³¹ The latest CRL study, which analyzed the effectiveness of the various restrictions used to curb payday lending, concluded that rate caps on small loans are the only measure that can provide consumers access to affordable credit without abusive consequences.¹³² In reaching this conclusion, the authors evaluated the effects of renewal bans and other attempts at mitigating the effects of payday loans. Limits on the number of outstanding loans, payment plan options, income-based loan amount limits, databases used for enforcement, and statutes aimed narrowly at the current form of payday loan all failed to stop lenders from “trapping borrowers in long-term debt.”¹³³ According to the CRL, only states “which enforce a comprehensive interest rate cap at or around 36 percent for consumer loans [in general] have solved their debt trap problem.”¹³⁴ The viability of these interest rate

¹²⁹ KING ET AL., *supra* note 13, at 5. More recently, the District of Columbia has also joined this grouping with legislation capping interest rates at 24 percent going into effect in January 2008. Jordan Weissman, *Credit Unions Slowly Fill Void as Payday Lenders Leave D.C.*, WASH. POST, July 26, 2008, at D1. Ohio is following along the same path, passing a 28 percent cap in June 2008 to go into effect in September 2008. Jim Siegel, *Interest-Rate Cap of 28%*, COLUMBUS DISPATCH, June 3, 2008, at B1; Press Release, Ctr. for Responsible Lending, Families Save Billions as Ohio Joins 14 States and DC in Rejecting Predatory Payday Lending (June 2, 2008), available at <http://www.responsiblelending.org/press/releases/trap-is-sprung-in-the-buckeye-state.html>. The Center for Responsible Lending now recognizes fifteen states plus the District of Columbia as having rejected payday lending, including recent additions of Arkansas, New Hampshire, and Oregon. *Id.*

¹³⁰ See Hefner, *supra* note 99, at 264–65 (suggesting that North Carolina and Georgia have taken substantial steps to eliminate the rent-a-charter business by payday lending shops).

¹³¹ This is true not only for states that have previously allowed payday loans, but also for states that have successfully kept out payday loans through existing and enforced usury limits and rate caps. The only difference is that newly enacted bans eliminate payday loans, while existing rate caps kept them out in the first place.

¹³² KING & PARRISH, *supra* note 61, at 19.

¹³³ *Id.* at 12–18.

¹³⁴ *Id.* at 19 (explaining that Connecticut, the District of Columbia, Georgia, Maine, Maryland, Massachusetts, New Jersey, New York, North Carolina, Oregon, Pennsylvania, Vermont, and West Virginia have all achieved success through enforcing interest rate caps).

caps has increased significantly in the wake of the effective end of rent-a-charter agreements with out of state banks.¹³⁵

IV. ASSESSING THE PROBLEM

A. Goals

The North Carolina ban on payday lending and its relative success has brought to light a few issues worthy of consideration. In the wake of the ban, researches have noticed two significant changes. First, with the enactment of a comprehensive rate cap, payday lending as we know it has ceased to exist in North Carolina.¹³⁶ Second, the disaster predicted by payday lending advocates was avoided. Payday lenders and their supporters often argue that bans on payday lending will leave borrowers who cannot access mainstream credit with nowhere to turn.¹³⁷ However, “small loans from consumer finance companies, credit unions, and other financial institutions have flourished while charging rates at or below the rate cap.”¹³⁸ The same has happened in the District of Columbia in the wake of an early 2008 interest rate cap, where credit unions have moved to offer small-dollar loans with reasonable rates and longer repayment terms.¹³⁹ The borrowers who previously used payday loans have found other, more economical alternatives.¹⁴⁰ These observations highlight the

¹³⁵ See *supra* note 109 and accompanying text.

¹³⁶ KING & PARRISH, *supra* note 61, at 6 (explaining that payday lenders exited North Carolina in the wake of the rate cap and the end of lender partnerships with out of state FDIC insured banks).

¹³⁷ *Id.* at 21.

¹³⁸ *Id.* at 20–21 (explaining that several new lending products have developed which operate within the rate cap and still are profitable for lenders).

¹³⁹ See Jordan Weissman, *Credit Unions Slowly Fill Void As Payday Lenders Leave D.C.*, WASH. POST, July 26, 2008, at D1 (acknowledging, however, that some borrowers have also crossed the border into Virginia or looked to the Internet for payday loans).

¹⁴⁰ See UNC CTR. FOR CMTY. CAPITAL, NORTH CAROLINA CONSUMERS AFTER PAYDAY LENDING (2007), available at http://www.ccc.unc.edu/documents/NC_After_Payday.pdf (noting that consumers are better off in the absence of payday lending). *But see* DONALD P. MORGAN & MICHAEL R. STRAIN, FED. RES. BANK OF N.Y., PAYDAY HOLIDAY: HOW HOUSEHOLDS FARE AFTER PAYDAY CREDIT BANS (2007), http://www.newyorkfed.org/research/staff_reports/sr309.pdf (arguing that payday loan bans have actually harmed consumers); Cmty. Fin. Serv. Ass'n of Am., Survey by University of North Carolina Finds Consumers Face Costly Short-term Credit Choices Since Payday Loans Exited the State (2007), <http://www.cfsa.net/UNC.html>. Consumer advocates, however, have defended the bans with responses to Morgan and the payday lending industry. See Press Release, UNC Ctr. for Cmty. Capital, Response to Payday Industry Misrepresentation of Study Findings (Dec. 4, 2007), available at <http://www.ccc.unc.edu/documents/ResponseToCFSA.pdf>; Ctr. for Responsible Lending, CRL Critique of “Payday Holiday: How Households Fare After Payday Credit Bans” by Donald P. Morgan and Michael R. Strain (Rev. Jan. 2008), <http://www.responsiblelending.org/pdfs/crl-morgan-critique-12-10.pdf>.

necessarily two-part goal for opponents of payday lending. First, payday lending must be banned; second, consumers must have fair and effective alternatives. These alternatives are necessary for two reasons. First, without alternatives, the predictions of the payday loan industry that consumers will lack credit options may come true. Second, in the absence of good alternatives, the lending market could go underground, or new lending forms may emerge on the margins of the law,¹⁴¹ just as payday loans themselves did in the 1990s.¹⁴²

B. Hercules and the Hydra

In ancient Greek mythology, the second labor of Hercules was to slay the Lernaean Hydra.¹⁴³ The Hydra was a huge creature with nine heads that primarily occupied itself by “go[ing] forth into the plain and ravag[ing] both the cattle and the country.”¹⁴⁴ The Hydra’s strength lay in the fact that each time one of its many heads was cut off or smashed, two would grow back in its place, rendering the creature even more dangerous than before.¹⁴⁵ Hercules was able to slay the Hydra only with the help of his companion, “Iolaus who, by setting fire to a piece of the neighbouring wood and burning the roots of the heads with the brands, prevented them from sprouting.”¹⁴⁶ Hercules was thus able to slay the Hydra’s eight mortal heads; the ninth, immortal head he severed and buried beneath a rock.¹⁴⁷

The story of Hercules and the Hydra illustrates the payday lending dilemma.¹⁴⁸ The many heads of the Hydra are the various forms of short-term high cost lending. When one form is banned or restricted, new forms emerge to take its place, just as the Hydra’s heads grew

¹⁴¹ See, e.g., Hefner, *supra* note 99, at 272 (describing how new, disguised forms of lending arose in North Carolina following the expiration of the authorizing statute on payday lending in 2001); Mary Spector, *Taming the Beast: Payday Loans, Regulatory Efforts, and Unintended Consequences*, 57 DEPAUL L. REV. 961, 983–95 (2008) (describing in detail how payday lenders are reorganizing as credit service organizations (“CSOs”) to avoid rate regulation); Jeremy LaMarche, Comment, *Payday Lenders Under Attack, Seek Protection in Cyberspace*, 19 LOY. CONSUMER L. REV. 218 (2007) (explaining how payday lenders have moved to new schemes on the Internet as states have developed more restrictive approaches to payday lending).

¹⁴² See Huckstep, *supra* note 65, at 204–05 (attributing the emergence of early 20th century salary loans and modern payday loans to a lack of alternatives for people with short-term cash flow problems).

¹⁴³ 2 APOLLODORUS, *THE LIBRARY* 187 (James George Frazer, trans., G.P. Putnam’s Sons 1921).

¹⁴⁴ *Id.* at 187–89.

¹⁴⁵ *Id.* at 189.

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ After this Note was written, but prior to its publication, another author recognized the value of the Hydra analogy and used it to illustrate that, “like the mythical beast Hydra, the payday loan is resistant to attempts to tame it.” Spector, *supra* note 141, at 962.

back two-fold. The immortal head, which drives the re-growth, represents the root causes of the payday loan, poverty and greed, which will continue to exist even if the rest of the monster is slain.¹⁴⁹

As Hercules found when he battled the Hydra, simply destroying one of the heads was not enough to kill the beast; in fact his efforts initially left the Hydra with more heads—making it even more dangerous. Such is the danger with attacks on payday loans that seek only to ban those loans. Merely cutting off the head (banning the loans) is not enough, for new forms will arise to take its place. Only when Iolaus discovered a way to keep the heads from growing back was Hercules able to gain an advantage over the Hydra. Similarly, in order to solve the payday loan problem, something more than just a ban is necessary. This is a process well documented in history.

C. *The Historical Cycle*

The payday loan and its modern compatriots are in no way new features on the American landscape; in fact, their roots go back much farther, to the very roots of exchangeable currency.¹⁵⁰ Not only is the loan type recurring, but the loan's life cycle follows a recurring pattern. The basic cycle begins with the emergence of a new form of lending product. While the form is new, the basic concept is the same: the loan is short-term, for a relatively small amount of money, has a high cost, and is aimed at people lacking adequate access to more formalized credit. After its debut, this new loan spreads and grows. After some time, as more and more people find themselves trapped, harmed, or disadvantaged in some way by the loan, public outcry leads to an examination of the loans. In reaction to this outcry, lawmakers then ban or severely restrict the practice. This ban or restriction is the equivalent of Hercules crushing or cutting off one of the Hydra's heads.

The underlying circumstances that led to the form's growth remain, however. The immortal head of the Hydra carries on, and without additional action, more heads sprout in the place of those destroyed. In the void left by the eradication of its predecessor, a new form begins to develop, and the cycle repeats itself.¹⁵¹ As with attacks

¹⁴⁹ It is worth noting that Hercules never actually killed the Hydra; its ninth head was immortal. *Id.* This situation is mirrored by the payday loan dilemma, where the heart of the problem is likewise incapable of being eliminated completely. See *supra* Part III.C (discussing poverty and greed as the deepest roots of payday lending).

¹⁵⁰ See SIDNEY HOMER & RICHARD SYLLA, A HISTORY OF INTEREST RATES, 25–31 (3d ed. 1991).

¹⁵¹ See Michael Kenneth, *Payday Lending: Can "Reputable" Banks End Cycles of Debt?*, 42 U.S.F. L. REV. 659, 712 (2008).

on the Hydra, the greatest danger is that as new forms return, they often have greater complexity and variety. Where before there was one head, now there are two. Consequently, a solely prohibitory reaction to high-rate lending is at best a temporary solution, and at worst provides a catalyst for even worse practices to emerge.¹⁵² This very argument is a favorite of some who favor retaining payday lending.¹⁵³

This historical cycle is further illustrated by two additional examples from different eras.¹⁵⁴ The first such instance occurred in the middle ages in Europe.¹⁵⁵ Despite the Catholic Church's general prohibition on usury, different sorts of lending proliferated under various exceptions;¹⁵⁶ by the fifteenth century, usurious lending was frowned upon yet tolerated as a "necessary evil."¹⁵⁷ Interest rates for small loans in that era, often made by pawnshops, ranged from 32.5% to 300%, while unsecured loans from medieval loan sharks were often as high as 1300% yearly.¹⁵⁸ General objections to usurious lending grew into concrete efforts by governmental institutions to not only ban manifest usury, but to create public institutions to provide alternative sources of credit at significantly lower rates in the range of six to ten percent.¹⁵⁹ These new institutions were called "*mons pietatis*" and functioned as a sort of "public pawnshop financed by charitable donations and run for the benefit of the poor."¹⁶⁰ As these institutions grew, they evolved into bank-like institutions and began to lend to people other than the poor.¹⁶¹ This series of events not only fits the general model of loan, objection, and ban, but also went one step further towards providing an alternative. The alternative was a necessary part of the solution, however; prior to the *mons pietatis*, efforts to curb usury had been limited in effectiveness.¹⁶²

¹⁵² Mann & Hawkins, *supra* note 116, at 886–88 (explaining that bans on payday lending may expose borrowers to even worse options).

¹⁵³ *Id.* at 859 ("[T]he prohibition of payday lending would only lead to a shift of lending activity—borrowers will continue to borrow but will do so using products that are more harmful than payday loans").

¹⁵⁴ These examples are by no means exclusive; many other eras have had their own version of the payday loan. *See, e.g.*, Spector, *supra* note 141, at 969–75 (describing several historical instances of usurious small loans).

¹⁵⁵ HOMER & SYLLA, *supra* note 150, at 77–79.

¹⁵⁶ *See generally id.* at 69–74 (describing the concept of usury in the middle ages).

¹⁵⁷ *Id.* at 78.

¹⁵⁸ *Id.* at 72.

¹⁵⁹ *Id.* at 78–79.

¹⁶⁰ *Id.* at 79.

¹⁶¹ *Id.*

¹⁶² *See, e.g.*, Spector, *supra* note 141, at 969–70 (noting how twelfth century lenders were able to evade prohibitions against usury).

A more recent version of the cycle occurred in the United States in the early twentieth century as a form of salary selling. Described as the work of “[t]he better class of modern loan shark[s],” the practice of salary selling involved a worker taking a loan a week before his paycheck and then repaying the loan by handing over the paycheck when it arrived.¹⁶³ This type of loan was generally targeted at the “emerging lower middle class of urban American society,” which lacked access to more mainstream credit sources and who often faced needs that exceeded their finances.¹⁶⁴ The favored rate for the small loan was the “five for six,” where a worker would borrow five dollars at the beginning of the week to be repaid, plus one dollar, at the end of the week.¹⁶⁵ Depending on the term, these loans carried interest rates ranging from 520% to 1040%.¹⁶⁶ The news media played a role in publicizing the predicament that many borrowers found themselves in, as did nonprofit organizations and even courts.¹⁶⁷ This type of salary loan was outlawed and disappeared as states adopted the Uniform Small Loan Laws and passed usury statutes.¹⁶⁸ Changing economic circumstances allowed this approach, which depended on reputable lenders filling the need previously met by salary lenders, to achieve relative success for a time.¹⁶⁹

The modern payday loan has followed the same path as its predecessors. We are currently in the outcry stage, about to break into the post-payday loan era. At this point, having generally committed to do something to curtail payday lending,¹⁷⁰ we face a crucial choice: do we want to fall into the same cycle and see new forms arise to replace payday loans, or do we want to break the cycle? The approach of this Note from this point forward assumes the latter.

¹⁶³ *Id.* at 428; Bruch, *supra* note 60, at 1267–68; Graves & Peterson, *supra* note 25, at 669–70.

¹⁶⁴ Graves & Peterson, *supra* note 25, at 670.

¹⁶⁵ HOMER & SYLLA, *supra* note 150, at 428; Bruch, *supra* note 60, at 1267; Graves & Peterson, *supra* note 25, at 670.

¹⁶⁶ HOMER & SYLLA, *supra* note 150, at 428; Graves & Peterson, *supra* note 25, at 670; *see also* Bruch, *supra* note 60, at 1268 (describing interest rates of 270% to 955% for similar schemes).

¹⁶⁷ Graves & Peterson, *supra* note 25, at 670–72.

¹⁶⁸ Bruch, *supra* note 60, at 1268; Graves & Peterson, *supra* note 25, at 672.

¹⁶⁹ Graves & Peterson, *supra* note 25, at 672. The success lasted as long as government regulation reigned in banks’ profit motive; after deregulation in the 1980s opened up the market, reputable lenders quickly abandoned these small loans in favor of more profitable products. *See supra* Part III.B (discussion on deregulation and federal policy).

¹⁷⁰ *See* Hefner, *supra* note 99, at 270–71 (noting the general trend towards curtailing payday loans at both state and federal levels).

V. SOLVING THE PROBLEM

A. Rate Cap

The first step in ending payday loans is to impose a rate cap. So far, several states have successfully taken this approach. A state-by-state solution is not enough, however. The federal government is responsible for deregulating the financial sector and for allowing the the payday loan monster to emerge; consequently, the federal government must also be responsible for solving the problem. The rate cap at 36% for military personnel¹⁷¹ is a first step; all that remains is for Congress to extend those protections to the rest of the country. Otherwise, lenders will continue to find new ways to subvert state regulatory schemes and the Hydra will live on.¹⁷²

B. Alternatives

As suggested by the story of Hercules and the Hydra, the payday lending situation requires something more than just a rate cap if a long-term solution is desired. This something more is a viable alternative to meet the demand and to fill the void left by the cessation of payday lending after rate caps or bans are implemented.¹⁷³

1. Banks

Mainstream banking institutions are best suited to provide alternatives to payday lending.¹⁷⁴ Prior to deregulation, banks played

¹⁷¹ John Warner National Defense Authorization Act for Fiscal Year 2007, Pub. L. No. 109-364, § 670, 120 Stat. 2083, 2266 (codified as 10 U.S.C.S. § 987 (2006)).

¹⁷² See Hefner, *supra* note 99, at 272-73 (describing ways in which lenders attempted to subvert North Carolina law after the expiration of the payday loan authorizing statute in 2001); LaMarche, *supra* note 141, at 221-22 (discussing how lenders have moved towards Internet-based operations as states have begun to restrict traditional payday lending operations); Spector, *supra* note 141, at 962-63 (describing how payday lenders are reorganizing as CSOs to subvert new rate regulation); Weissman, *supra* note 139 (observing that as payday lenders have departed, some borrowers have crossed state lines or turned to the Internet for loans).

¹⁷³ See *supra* Part IV.A (discussing goals).

¹⁷⁴ In the following sections, the term "bank" is used loosely to describe banks and other mainstream lending institutions of like character. Credit unions are considered separately, for while credit unions have been instrumental in developing alternatives in some cases, they are inherently limited by the common bond membership feature, which means credit union products will be inherently limited to serving a restricted subset of the population, see NAT'L CREDIT UNION ADMIN., FACTS ABOUT FEDERAL CREDIT UNIONS (2007), http://www.ncua.gov/Publications/brochures/FCUFacts/FactFedCreditUnion_A2.pdf (describing common bond limitation on membership). Still, credit unions can play an important role when prospective borrowers are members or qualify for membership. Credit unions with community charters, for instance, are able to reach a broader population than traditional forms. See Weissman, *supra*

a far more active role in the small consumer loan market than they do currently. Bank departure from this market helped to create the credit void that payday lending developed to fill.¹⁷⁵ A return to the small consumer loan market is certainly not an alien role for banks. More importantly, though, banks are particularly suited to reach out to payday loan customers, because they already have a relationship with these individuals—one of the basic requirements for a typical payday loan is that the borrower has a checking account.¹⁷⁶ These already-existing relationships not only can make it easy for banks to market payday loan alternatives, but they also have the potential to reduce bank costs ordinarily associated with bringing new customers into the systems. In addition to already having relationships with the relevant population, banks also have the necessary resources and infrastructure to implement payday loan alternatives effectively and efficiently.¹⁷⁷

Banks are also subject to forces which suggest that they are not only capable of providing alternatives, but that they are well-suited to ensuring that those alternatives are fair and helpful to borrowers. Banks have reputational concerns that play a significant role in constraining their behavior and keeping them from engaging in practices that could reflect badly on their images.¹⁷⁸

Additionally, banks can benefit substantially from providing payday loan alternative products. Various credit union and alternative provider programs have shown that small value short-term loans can be provided at fair rates and can still generate profits for the

note 139.

¹⁷⁵ See *supra* Part III.B (discussion on deregulation and federal policy). But see Mann & Hawkins, *supra* note 116, at 889 (“[B]efore consumer credit was deregulated in the United States, banks would not make small, unsecured, high-risk loans to borrowers because of the high transaction costs associated with such loans.”). The present lack of widely-available alternatives is a point raised by industry defenders in response to rate caps and bans. In an article discussing a lender-backed campaign to repeal Ohio’s new rate cap, Kim Norris, an industry spokesperson, is quoted as saying that borrowers “can’t go to a bank and get a \$100 loan. No bank offers it.” Siegel, *supra* note 90. Bank entry solves this problem.

¹⁷⁶ Payday loan customers are not the un-banked, but the under-banked. See BAIR, *supra* note 25, at 10; Barr, *supra* note 40, at 153.

¹⁷⁷ BAIR, *supra* note 25, at 28; William J. Clinton & Arnold Schwarzenegger, Op-Ed., *Beyond Payday Loans*, WALL ST. J., Jan. 24, 2008, at A17 (“[M]ore than 90% of non-bank alternatives [such as payday lenders] are located within one mile of a bank or credit union branch.”).

¹⁷⁸ BAIR, *supra* note 25, at 10 (stating that banks are concerned about activity that might “invit[e] criticism from media, public policy officials, and consumer advocates”); Bertics, *supra* note 74, at 156–57. While reputational risk has been a deterrent to banks considering entry into the payday lending market, it also holds the potential to serve as a check on banks once they become involved in alternative products.

lenders.¹⁷⁹ Banks can also benefit from an expanded customer base and from customers who are able to build wealth through fairly-priced credit and thereby enter the financial mainstream.¹⁸⁰ Banks have an incentive to see customers work their way towards financial stability in a way that payday lenders do not—banks generally do well when their customers do well,¹⁸¹ while payday lenders do well when their customers do not.¹⁸²

A final reason why banks are particularly suitable to the role of providing affordable alternatives to payday loans is because banks, as part of a regulated industry, have an ongoing responsibility to serve the public good.¹⁸³ The following sections explore this responsibility in ever-increasing phases, from what banks want to do, to what banks can be incentivized to do, and finally to what banks must be required to do. Taking on the role of providing affordable payday loan alternatives falls into this final phase.

2. Voluntary Bank Entry

Having concluded that existing banking institutions are well-suited to provide payday loan alternatives, the next question that arises is how such institutions move into that role. There are three different approaches to bringing banks into the role of providing alternatives to payday loans. The least interventionist solution is for voluntary bank entry.¹⁸⁴ Under this approach, the rate cap is the end of government action; beyond that, anyone may or may not move to fill the post-payday loan void, provided of course that they fall within the limits of the rate cap itself and other laws.¹⁸⁵ This model, where

¹⁷⁹ Matt Carr, *CUs to Fill Payday Gap? Maybe*, AM. BANKER (New York), Nov. 7, 2007, at 1; see also BAIR, *supra* note 25, at 21–27 (describing case studies of several payday loan alternative lending programs and noting how several of these programs have been profitable for the lenders despite high-risk borrowers and low interest rates and fees). *But see* Weissman, *supra* note 139 (noting that some credit unions do not make money on small dollar loans, but see them instead as a way to introduce new members to more mainstream products).

¹⁸⁰ See Clinton & Schwarzenegger, *supra* note 177 (suggesting that fair lending products can help to grow the economy and bring new customers into the financial mainstream).

¹⁸¹ While some bank products, such as overdraft protection products, do take advantage of customers' financial troubles, banks usually are served better by solvent and prosperous customers, who are better able to pay off loans and make use of a greater variety of bank products and services. *Infra* notes 197–99 and accompanying text.

¹⁸² See *supra* Part III.A.2 (discussing how payday lending profits depend on repeated use of loans, which in turn depends on the inability to pay the loan off and escape the cycle of debt).

¹⁸³ See *infra* Part V.B.4.

¹⁸⁴ This approach is advocated by a recent article, which recognizes that regulatory and public image pressures, as well as financial and institutional resources make banks excellent candidates for providing payday loan replacements. The author takes the position that banks "should be 'invited' to take over the industry." Kenneth, *supra* note 151, at 662.

¹⁸⁵ Variations on this type of approach have been touted as part of a payday loan solution by a variety of authors. See, e.g., OHIO COALITION FOR RESPONSIBLE LENDING, *supra* note 1, at

implemented, has not been unsuccessful. In North Carolina, for instance, the North Carolina State Employees Credit Union (NCSECU) Salary Advance Loan provides interest rates of 12% on short-term loans and incorporates a mandatory savings component aimed at building a financial cushion for borrowers to lessen the need for a loan in the first place.¹⁸⁶ In addition, recent studies show that borrowers facing financial shortfalls used a variety of sources to help them cope; the absence of payday lending did not significantly affect their ability to get through financial emergencies.¹⁸⁷

The emergence of a fair alternative and the continuing ability of people to meet financial shortfalls seem at first to satisfy the criteria for success.¹⁸⁸ The problem, however, is not only that alternatives such as that provided by the NCSECU lie in the hand of the market, but also that the NCSECU product, specifically, is significantly limited in the population to whom it is available.¹⁸⁹ In this case, Hercules and Iolaus have not fully slain the Hydra; rather they have left the finishing of the job to anyone who happens to pass by. In North Carolina, the first passerby happened to be well-suited to the task, and was able to keep some of the Hydra's heads from coming back. However, this localized achievement should not be mistaken for a complete solution. NCSECU's program, as good as it may be, is not only subject to market forces,¹⁹⁰ but is severely limited by the nature of credit unions and membership requirements.¹⁹¹ Despite the initial positive results in North Carolina, this solution of allowing the market to fill the void is not nearly enough to ensure the availability of fair and effective alternatives to payday lending. The fundamental problem with allowing a market-based solution is that such an approach is what created the payday loan in the first place.¹⁹²

9; Bertics, *supra* note 74, at 149; Hefner, *supra* note 99, at 287; Mann & Hawkins, *supra* note 116, at 905-07.

¹⁸⁶ BAIR, *supra* note 25, at 21-22; KING & PARRISH, *supra* note 61, at 20. *See also* BAIR, *supra* note 25, at 22-26 (describing case studies of several other alternative programs in various states).

¹⁸⁷ UNC CTR. FOR CMTY. CAPITAL, *supra* note 140, at 4-6.

¹⁸⁸ *See supra* Part IV.A (discussing goals, in particular the goal of maintaining borrower options).

¹⁸⁹ *See supra* note 163 (discussing limitations of credit unions).

¹⁹⁰ If the loan product is not profitable, continuation is highly unlikely, even for a credit union. *See NAT'L CREDIT UNION ADMIN*, *supra* note 171 (describing the emphasis on service rather than profit and the cooperative nature of credit unions).

¹⁹¹ *See supra* note 174 (discussing limitations of credit unions).

¹⁹² Granted, the environment of deregulation from which the payday loan arose did not provide for strict rate caps, as are present in the post-payday loan environment. While the rebirth of rate caps surely limits the ability of lenders to escalate rates into triple-digit APRs, the creativity that is likely to result from an otherwise open field is more than likely to be channeled

Relying on the market to fix the problem not only invites further failure,¹⁹³ but is unlikely to involve the institutions best suited to provide a workable alternative to payday loans—banks. Despite being well-suited to the task, there are many reasons why banks have been reluctant to enter this market on their own.¹⁹⁴ This reluctance is rooted in concerns about profitability, reputational risk, and a perception, based on regulatory agency approaches to rent-a-charter agreements with payday lenders, that regulators disfavor such activity.¹⁹⁵ Banks have also responded to the collapse of the subprime market and the related financial crisis by reigning in credit across the board.¹⁹⁶ This newfound caution and increasingly risk-averse lending practices will likely increase banks' reluctance to offer new products to customers perceived as high-risk. Even more importantly, banks will be reluctant to create low-cost, small dollar credit products because of the threat such products pose to bank profits from existing overdraft protection products.¹⁹⁷ These products, characterized as services rather than as a form of credit to avoid falling under the Truth In Lending Act,¹⁹⁸ can be even more expensive than payday loans. This high cost yields high profits; overdraft protection products represent a significant source of profits for banks that offer the service.¹⁹⁹ Despite their ongoing obligation to serve the public good, it is unreasonable to expect most banks to forego this income to offer low-cost, short-term, small-dollar consumer loans, especially considering the additional deterrents provided by concerns about profitability, reputation, and regulatory hostility.

towards increasing profits for lenders rather than towards helping out low to middle income borrowers experiencing financial shortfalls.

¹⁹³ See *supra* Part III.B.1 (discussing market failure); *supra* Part II.B (discussing reasons for the birth of payday loans); *supra* Part III.C (describing federal deregulation policy choice).

¹⁹⁴ See BAIR, *supra* note 25, at 10.

¹⁹⁵ *Id.* See also Bertics, *supra* note 74, at 153.

¹⁹⁶ Sudeep Reddy, *U.S. News: More Banks Tighten Lending Standards*, WALL ST. J., Aug. 12, 2008, at A3. Banks must realize, though, that their own practices may significantly heighten the risk of loans made to risky customers. When banks offer fair products at reasonable rates to low- and moderate-income borrowers, that risk can be managed into profit for the bank and financial stability for the borrower. See, e.g., Theresa Dixon Murphy, *Third Federal's Quarterly Profit up 19 Percent*, PLAIN DEALER (Cleveland, Ohio), Feb. 12, 2008, at C1 (describing how one bank's practice of making "loans to risky borrowers at interest rates that are the same as or better than those given to top-tier borrowers" has resulted in solid profits as other lending institutions face financial crisis).

¹⁹⁷ See BAIR, *supra* note 25, at 10–13; Kenneth, *supra* note 151, at 712 (noting that banks' "lucrative revenue stream" from overdraft products may pose the largest barrier to banks stepping up to provide payday loan-replacing products and services).

¹⁹⁸ See BAIR, *supra* note 25, at 11, 13.

¹⁹⁹ See *id.* at 12.

3. Incentivized Bank Entry

Consequently, governmental institutions must go beyond merely suggesting that banks enter the post-payday loan void and must provide incentives to encourage banks to offer low-cost, short-term, small-dollar consumer loans.²⁰⁰ Accordingly, the Federal Deposit Insurance Corporation (FDIC) has created a set of Affordable Small-Dollar Loan Guidelines for its member banks interested in entering the small-dollar, short-term consumer loan market.²⁰¹ These Guidelines not only outline general criteria for such loans, but also note that “such products offered in a responsible, safe and sound manner will warrant favorable Community Reinvestment Act (CRA) consideration.”²⁰² This favorable CRA consideration can be a valuable incentive for banks unsure of entering this new market because of the role such consideration plays in agency evaluation of bank applications to expand or merge their business.²⁰³

The Ohio payday loan legislation, H.B. 545, offers another type of incentive approach and, in doing so, addresses several of the concerns raised regarding payday loans. In addition to implementing a fee-inclusive rate cap at 28%,²⁰⁴ H.B. 545 provides banks with an incentive in the form of small loan-linked deposits, which are below market rate deposits made by the state with participating institutions to subsidize the cost of providing these new small loan products.²⁰⁵

While these incentive approaches represent a move in the right direction, they fail to address the fundamental problem that plagues the voluntary model. Hercules and the Hydra are once again illustrative. In this version, Hercules and Iolaus decapitate the Hydra but do not complete the task by burning the monster’s necks to prevent the heads from growing back. Rather, they offer to give a positive recommendation for anyone who steps in to finish the job, or perhaps they help a passerby to buy a weapon suitable for finishing off the Hydra. As was the case with the voluntary approach to providing an alternative to payday loans, this analogy shows the faults with the incentive approach. Once again, this approach relies on the

²⁰⁰ See Clinton & Schwarzenegger, *supra* note 177.

²⁰¹ Press Release, FDIC, Affordable Small Loan Guidelines (Dec. 4, 2006), <http://www.fdic.gov/news/news/press/2006/pr06107a.html>.

²⁰² *Id.*

²⁰³ See *infra* note 213 and accompanying text.

²⁰⁴ H.R. 545, 127th Gen. Assem., Reg. Sess. (Ohio 2007) (adding as OHIO REV. CODE § 1321.35(C): “‘Interest’ means all charges payable directly or indirectly by a borrower to a licensee as a condition to a loan, including fees, loan origination charges, service charges, renewal charges, credit insurance premiums, and any ancillary product sold in connection with a loan made pursuant to sections 1321.35 to 1321.48 of the Revised Code”).

²⁰⁵ H.R. 545 (changes to OHIO REV. CODE §§ 135.63, .68–.70).

market to create a solution. The history of the payday loan and its predecessors is rife with the failure of markets to adequately serve people outside of the credit mainstream with wealth-building rather than wealth-depleting products.²⁰⁶ The risk is that, despite the incentives, banks may not see enough reasons to enter this market when other, more profitable alternatives exist.²⁰⁷

4. Mandatory Bank Entry

The third approach to bringing banks into the role of providing alternatives to payday loans is the most heavy-handed. Unlike the voluntary and incentive options standing alone, the mandate approach eliminates reliance on markets and *requires* banks to offer low-cost, short-term, small-dollar consumer loans to their customers. Such a requirement can be made through the structure and enforcement provisions of the CRA. This mandate should not come alone, however; banks ought to be given incentives as well. The incentives described in the previous section, such as offering positive CRA credit, offer a good starting point as to what sort of carrots are appropriate to pair with the stick. By eliminating the role of the market, the mandate approach solves the problems associated with its lesser siblings. Hercules and Iolaus not only decapitate the Hydra, but they personally ensure that the heads will not grow back.

While free-market adherents may recoil from such a solution, there are in fact legitimate and long-standing bases for such an approach. Even Alexander Hamilton, writing on the role of a national bank, acknowledged that such an institution existed first to serve the public good; private profits were to remain secondary.²⁰⁸ A more modern recognition of this public purpose exists in the CRA. The CRA was created because many banks regularly refused to lend to a segment of the population based on geographic location, a practice known as “redlining.”²⁰⁹ To end this practice, Congress not only indicated its preference that banks “make loans in their local communities and in [low to middle income] neighborhoods,” but also “threaten[ed] sanctions for banks that do not comply.”²¹⁰ Congress recognized that “regulated financial institutions have continuing and affirmative

²⁰⁶ See *supra* Part IV.A (discussing goals); *supra* Part IV.C (presenting the historical pattern of high-cost lending).

²⁰⁷ See *supra* notes 197–99 and accompanying text.

²⁰⁸ Alexander Hamilton, *Report on a National Bank*, in 1 REPORTS OF THE SECRETARY OF THE TREASURY OF THE UNITED STATES 54, 67 (1837).

²⁰⁹ RICHARD D. MARSICO, *DEMOCRATIZING CAPITAL: THE HISTORY, LAW AND REFORM OF THE COMMUNITY REINVESTMENT ACT* 11 (2005).

²¹⁰ *Id.*

obligation to help meet the credit needs of the local communities in which they are chartered.”²¹¹ Viewed in light of Hamilton’s observation, Congress was acknowledging that federally regulated banks were in fact placing profit above public good. In fact, Senator William Proxmire, the CRA’s primary sponsor, described the Act as ““provid[ing] that a bank charter is indeed a franchise to serve local convenience and needs, including credit needs.””²¹²

While the CRA empowered federal banking agencies to assess a bank’s performance and to deny bank expansion applications if that performance was inadequate,²¹³ Congress attempted to draw a clear line between “allocating credit and influencing bank lending decisions.”²¹⁴ Credit allocation, generally understood as “establish[ing] lending quotas [or] requir[ing] banks to lend to particular persons,” was strongly disfavored, even by CRA supporters.²¹⁵ Yet there is an inherent contradiction in threatening to penalize banks for avoiding certain markets,²¹⁶ while at the same time taking the position that banks should remain free to determine “amounts, types, terms, or recipients of loans.”²¹⁷ Looking further, it is apparent that Congress’s position on credit allocation in the CRA was one of scope. Broad mandates to influence banks to meet their “continuing and affirmative obligation”²¹⁸ to provide lending products appropriate to their communities are permissible,²¹⁹ but the regulatory role stops short of interfering with individual loan applications.²²⁰ Within these bounds, the CRA provides a basis for requiring banks to provide fair alternatives to payday loans. The void created with the end of payday loans is equivalent to the void left by banks through the practice of redlining.²²¹ To influence banks to cover that territory through the threat of penalties is consistent with the purpose and goals of the CRA.

²¹¹ 12 U.S.C § 2901(a)(3) (2000).

²¹² MARSICO, *supra* note 209, at 14–15 (quoting *Community Credit Needs: Hearings on S. 406 Before the S. Comm. on Banking, Housing, and Urban Affairs*, 95th Cong. 2 (1977) (statement of Sen. William Proxmire)). Even opponents of the CRA acknowledged their support of its purpose to provide credit to inner city areas. *Id.* at 15.

²¹³ *See id.* at 18–19; Chin, *supra* note 92, at 750.

²¹⁴ MARSICO, *supra* note 209, at 11.

²¹⁵ *Id.* at 11–12, 21–22.

²¹⁶ Geography was used in the CRA as a proxy for economic class; the problem was that banks would not lend to low and middle income people, who happened to live in the same area as each other. *See id.* at 11, 13.

²¹⁷ *Id.* at 12, 29–30.

²¹⁸ 12 U.S.C § 2901(a)(3) (2000).

²¹⁹ *See* MARSICO, *supra* note 209, at 22 (declaring as legitimate the CRA’s requirement for banks to serve public purposes and needs).

²²⁰ *Id.*

²²¹ *See supra* note 209 and accompanying text.

The FDIC's Affordable Small Loan Guidelines provide a starting point for integrating a payday loan alternative into the structure of the CRA. While the current approach is to offer positive CRA credit for banks that offer lending products within the guidelines,²²² a more thorough approach could involve applying the stick portion of the CRA in addition to offering a carrot. Congress need only determine that banks located in communities affected by payday lending²²³ have a "continuing and affirmative obligation" to meet the need for affordable short-term, small dollar consumer credit, and then enforce that obligation by applying the positive and negative CRA credit structure to banks' involvement in this market. If banks offer appropriate products, they should receive positive credit, as with the FDIC guidelines. If banks fail to meet the need, or offer inappropriate products, they ought to be penalized with negative evaluations of their practices.

There remains an even stronger option for mandating bank entry, though it should be reserved for use only if a CRA credit-based solution fails to produce the bank entry necessary to fill the post-payday loan void. As noted by Senator Proxmire in his explanation of the CRA, "[b]anks and thrifts are indeed chartered to serve the convenience and needs of their communities."²²⁴ If the purpose of the bank charter is truly for service of the public good,²²⁵ then it stands to reason that failure to serve that good could constitute grounds for revocation of that charter. Certainly such a step is significant, and would likely be unreasonable if such a penalty were given solely for the failure to provide affordable small loans. Such a failure, however, could weigh heavily on a consideration of a bank's practices as a whole. In the light of the present sub-prime crisis and rampant bank behavior favoring profits over the public good, such a solution might not be so far-fetched as it would have been just a few years ago.²²⁶

²²² See FDIC, *supra* note 201.

²²³ While earlier in their development, payday lenders tended to cluster in urban areas, by 2006, payday lending had established a strong presence throughout the state of Ohio. ROTHSTEIN & DILLMAN, CONTINUED GROWTH, *supra* note 31, at 4. Similar patterns exist across the nation. Hawke, *supra* note 30 ("California alone has more payday loan offices—nearly 2,000—than it does McDonalds and Burger Kings, and other states are not very far behind.").

²²⁴ MARSICO, *supra* note 209, at 14 (quoting 123 CONG. REC. 17,630 (1977) (statement of Sen. William Proxmire)).

²²⁵ See also Hamilton, *supra* note 208, at 67.

²²⁶ As noted previously, even market advocate Richard Posner has admitted that rampant deregulation may have been a mistake. See Posner, *supra* note 115.

VI. CONCLUSION

This Note attempts to look beyond the surface of the payday lending problem and to reveal and address the reality behind the reasons. While the main reasons behind the payday lending problem—poverty and greed—appear to be with us whether we like it or not, other causes are well within our reach to address. This Note has shown through an analysis of the debt trap phenomena—the industry’s dependence on repeat business, and the high rates charged—that payday loans are problematic by design. Furthermore, the implementation of payday loans is problematic because of profound market failure and widespread abusive practices.

The reasons for these design and implementation problems are rooted in federal and state laws. By choosing to favor deregulation and free market ideologies, the federal government not only created circumstances that led to the birth of the payday loan, but also created a legal vacuum that states moved to fill in a variety of ways, some effective and some not. Having established the problem, this Note uses a model based on the myth of Hercules and the Lernaean Hydra to determine that an effective solution to the payday loan problem as a whole requires not only prohibitive action, such as rate caps, but also effective and affordable alternatives.

These alternatives are best provided by banks, not only because of their position and resources, but also because of the deep-seated obligations that banks have to serve the public good. Market-based, voluntary plans for bank entry lack the ability to bring banks to the role of providing affordable payday loan alternatives; plans based on incentivizing banks likewise fall short. Concluding it is necessary to mandate that banks provide alternatives, this Note provides suggestions on how both the Community Reinvestment Act evaluation system and challenges to bank charters might be used to accomplish this goal.

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