



Payday Loan Regulation: Any Interest?

Chris Cirillo

Follow this and additional works at: <https://via.library.depaul.edu/bclj>

Recommended Citation

Chris Cirillo, *Payday Loan Regulation: Any Interest?*, 11 DePaul Bus. & Com. L.J. 417 (2013)
Available at: <https://via.library.depaul.edu/bclj/vol11/iss3/5>

This Note is brought to you for free and open access by the College of Law at Via Sapientiae. It has been accepted for inclusion in DePaul Business and Commercial Law Journal by an authorized editor of Via Sapientiae. For more information, please contact digitalservices@depaul.edu.

Payday Loan Regulation: Any Interest?

Chris Cirillo*

I. INTRODUCTION

Payday loans in their current form are relatively new to the consumer credit industry. In their brief existence, however, their controversial business model has attracted a large constituency of opposition. The critics of payday loans cite stories of low-income borrowers in desperate need of money who turned to payday loans only to have their economic hardships exponentially increased by the inability to pay back the payday loans. But the overall question remains, Do the benefits of payday loans to society outweigh the detriments? Perhaps a more important question, and the one this Note addresses is, What regulations imposed upon payday lenders by the state and federal government allow for a fair and mutually beneficial relationship between the lender and the borrower. More specifically, Are interest rate maximums beneficial in an overall regulatory scheme for payday loans? After all, as of the date of this Note, thirty-two states statutorily authorize high-interest payday loans.¹ This implicitly indicates that these states believe payday loans have the potential to benefit businesses and consumers through a balance of free trade and consumer protection.

States attempt to achieve the optimal balance through different regulatory schemes that act in conjunction with federal regulations. One of the specific regulations that payday loan critics push for as a necessity to ensure consumer protection in all states is an interest rate cap on payday loans.² This Note demonstrates that an interest rate cap is counterproductive to a regulatory scheme attempting to promote ben-

* BBA Finance University of Iowa, May 2010; JD DePaul University College of Law, May 2013. This Note is dedicated to my loving parents John and Carole Cirillo who made every one of my life experiences, educational or otherwise, possible. I would also like to thank the BCLJ staff and Board for their hard work and input, which were more directly focused on making this Note possible.

1. Consumer Fed'n of Am., *Legal Status of Payday Loans by State*, PAYDAY LOAN CONSUMER INFO., <http://www.paydayloaninfo.org/state-information> (last visited Mar. 28, 2013).

2. See Creola Johnson, *Payday Loans: Shrewd Business or Predatory Lending?*, 87 MINN. L. REV. 1, 133 (2002); Uriah King & Leslie Parrish, *Springing the Debt Trap: Rate Caps Are Only Proven Payday Lending Reform*, CTR. FOR RESPONSIBLE LENDING, 4 (2007), <http://www.responsiblelending.org/payday-lending/research-analysis/springing-the-debt-trap.pdf>.

eficial access to payday loans. It also demonstrates that while certain regulations are necessary to ensure fairness because of the payday loan business model, an interest rate cap is an unnecessary fix to problems plaguing the payday loan industry when better suited regulations exist that protect borrowers and promote fairness. This Note argues that the federal regulations currently in place, combined with specific state regulations (absent interest rate caps), can provide a beneficial and fair service to payday loan consumers if utilized in the intended manner.

The central argument in this Note assumes that payday loans are beneficial when used for their intended purpose.³ That intended purpose is to quickly extend a small amount of credit, for a short time period, to borrowers that do not qualify for other types of loans.⁴ The presence of each portion of this intended purpose—quick, small amount, short time period, specific borrower demographic—is essential to payday loans benefitting the borrower and the payday lender. The speed of payday loans comes from a few factors, including that borrowers should take a payday loan only for an emergency, a short-term liquidity need, or an unexpected cost that typically involves a time constraint.⁵ Due to this, the payday lender does not perform an extensive credit check.⁶ Having a driver's license, home address, income verification document, and checking account usually allows a borrower to qualify for a payday loan.⁷

Offering only a small amount for the loan has two effects: (1) it limits the probability that a borrower is unable to pay back the loan on time, which would lead to accumulation of additional finance charges and fines, and (2) it limits the lender's exposure to uncollectible losses. As mentioned, the short time period is an indicator that the intention of these loans is not for long-term debt satisfaction. The high interest rate becomes exponentially more burdensome as the time period for the loan increases.⁸ This means that borrowers should not use payday loans in a continuous or rollover manner. Unpaid balances should exist only for short periods of time. Finally, an accepted conclusion is that payday lenders target borrowers that cannot obtain

3. Ronald J. Mann & Jim Hawkins, *Just Until Payday*, 54 UCLA L. REV. 855, 885 (2007).

4. See Edward C. Lawrence & Gregory Eliehausen, *A Comparative Analysis of Payday Loan Customers*, 26 CONTEMP. ECON. POL'Y 299, 315 (2008).

5. See Chad A. Cicconi, *A Role for Payday Lenders*, 123 BANKING L.J. 235, 244-45 (2006).

6. Michael A. Stegman, *Payday Lending*, 21 J. ECON. PERSP. 169, 169 (2007).

7. *Id.*

8. See Elizabeth Renuart & Diane E. Thompson, *The Truth, the Whole Truth, and Nothing but the Truth: Fulfilling the Promise of Truth in Lending*, 25 YALE J. ON REG. 181, 214 (2008) (“[M]any short-term loans become expensive long-term debt service.”).

credit through another lending institution, but these are the borrowers that are in need of credit, and payday lenders are actually safer in terms of credit borrowing than many other subprime options.⁹

II. BACKGROUND

The mechanics and the history of payday loans are the necessary starting points to understand the payday loan. A payday loan is a small, short-term, high interest loan that typically matures in two weeks and is secured by the promise of the borrower's next paycheck.¹⁰ Other terms for a payday loan include "cash advance loans . . . post-dated check loans, delayed deposit checks, or deferred deposit loans."¹¹ For purposes of this Note, all of these terms are interchangeable, and payday loan is used most often. In a typical payday loan, a borrower borrows a principal of less than \$1,000.¹² The payday lender profits by charging interest during the loan period. At the end of the period, the borrower pays back the principal. If left unregulated, these interest charges can amount to annual percentage rates (APRs) of triple digits.

The APR is the actual cost of borrowing expressed in a yearly percentage rate.¹³ Similar to the APR is a finance charge. A finance charge is the amount in dollars that a borrower pays as interest accumulates on the principal.¹⁴ The interest rate is the percentage a borrower charges (calculated by simple interest or precomputed interest) on the principal. The difference between APR and interest rate is that APR includes any additional fees or charges not included as merely interest charged on the principal.¹⁵

The effect of payday loans on consumers is currently magnified because of the explosion of the payday lender in the 1990s.¹⁶ During the 1990s, demand for short-term credit skyrocketed, causing thousands of payday lenders to enter the market.¹⁷ Statistics from 2006 indicate that payday lenders are one of the largest consumer credit services. Over 15,000 payday loan stores exist, servicing loans that amount to

9. See Mann & Hawkins, *supra* note 3, at 886–88.

10. DEE PRIDGEN & RICHARD M. ALDERMAN, CONSUMER CREDIT AND THE LAW § 5:6 (2012).

11. *Id.* (internal quotation marks omitted).

12. Lawrence & Ellichausen, *supra* note 4, at 301.

13. BLACK'S LAW DICTIONARY 888 (9th ed. 2009).

14. 12 C.F.R. § 226.4(a) (2012).

15. See PRIDGEN & ALDERMAN, *supra* note 10, § 6:9.

16. See Lawrence & Ellichausen, *supra* note 4, at 299.

17. *Id.*

over \$25 billion.¹⁸ As the practice of payday lending increased, so did the abuse by both lenders and borrowers. States took notice of the negative effects caused by the abuses and started to enact legislation aimed at limiting the scope of potential harm and attempting to inform borrowers of the potential for harm. The federal government also entered the legislation sphere with a focus on balancing the bargaining power of the lender and borrower through complete and accurate disclosures.¹⁹

Part III(A) of this Note explores the federal regulation salient to the issue addressed in this Note. Part III(B) compares two different states' payday loan statutes to highlight the necessary components of an effective statute and the broad range of interest regulations currently in effect. Part IV takes an economic analysis approach to payday loans in general to show that an interest rate cap is unnecessary to achieve what should be the desired goal of regulating payday loans. Part V presents both a policy analysis that demonstrates that payday loans are beneficial when used in the intended way and the potential negative effects of an interest rate cap. Finally, Part VI suggests a hypothetical regulatory scheme that best achieves the beneficial balance for which states, lenders, and consumers strive.

III. REGULATIONS

Payday loan regulations aim to protect consumers from entering potentially hazardous loan agreements while still allowing for a beneficial financial transaction. The most frequent complaints among payday loan critics are that payday loans engage in predatory lending by targeting desperate consumers who have no other options, payday loan store customers sign loan agreements without knowing the essential terms, and the combination of these elements leads to the payday loan customer becoming entrenched in a cycle of debt.²⁰ Recently, these critics have pushed for an interest rate cap on all payday loans as the solution to these problems. The regulations analyzed below illustrate different examples of regulatory schemes, with and without the use of interest rate caps, that attempt to promote the safe and beneficial use of payday loans.

18. *Id.* at 299–300.

19. *See generally id.*

20. *See generally* Tom Lehman, *In Defense of Payday Lending*, THE FREE MKT. (Sept. 2003), http://mises.org/freemarket_detail.aspx?control=454.

A. Federal Regulations (TILA and Regulation Z)

The major federal regulation related to payday loans is the Truth in Lending Act (TILA).²¹ Regulation Z is the regulation that implements TILA, and it contains most of the provisions referred to below.²² TILA and Regulation Z attempt to ensure that borrowers are fully informed about any contract the borrower signs. The portions of Regulation Z that are relevant to this Note are the disclosure requirements for closed-end credit transactions.²³ These requirements protect consumers by providing them with information from which they can make an informed financial choice.²⁴

First, Regulation Z requires that the contract disclose both the amount financed and a brief description of what this entails.²⁵ Regulation Z gives an example of a brief description of amount financed as “the amount of credit provided to you or on your behalf.”²⁶ This is a threshold requirement that essentially ensures that a borrower receives the amount of money required to fulfill the obligation necessitating the payday loan. Next, Regulation Z requires that the contract disclose the finance charge and include a brief description such as “the dollar amount the credit will cost you.”²⁷ Also, Regulation Z requires that the contract disclose the total payments.²⁸ This disclosure illustrates the total amount a borrower will have paid when the borrower has made all scheduled payments on the loan.²⁹ Using only these disclosures, the borrower knows, or should know, the amount of money loaned compared to the total amount that it will cost the borrower in real dollars.

In addition, Regulation Z requires that a lender include the APR in the contract and a description such as “the cost of . . . credit as a yearly rate.”³⁰ The consumer can use the APR to compare this loan contract to another lender’s loan offer based on a normalized rate that is uniformly calculated for all types of loans.³¹ Regulation Z also breaks down individual sections of the loan for consumers to assess each por-

21. Truth in Lending Act, 15 U.S.C. §§ 1601–1651 (2006).

22. See generally 12 C.F.R. § 226 (2012).

23. See generally *id.* §§ 226.17–226.18.

24. THOMAS A. DURKIN & GREGORY ELLIEHAUSEN, TRUTH IN LENDING: THEORY, HISTORY, AND A WAY FORWARD 21 (2011).

25. 12 C.F.R. § 226.18(b)–(c).

26. *Id.* § 226.18(b).

27. *Id.* § 226.18(d) (internal quotation marks omitted).

28. *Id.* § 226.18(h).

29. *Id.*

30. 12 C.F.R. § 226.18(e) (internal quotation marks omitted).

31. See DURKIN & ELLIEHAUSEN, *supra* note 24, at 21 (noting that TILA allows borrowers to compare APRs).

tion related to their individual needs and capabilities. Regulation Z requires that each loan contract contain a payment schedule that includes the number, amount, and timing of each payment.³² This attempts to provide the borrower with a basic tool to assess its ability to meet the obligations of the loan as scheduled.

In addition to the content requirements of Regulation Z, the disclosures must also be in a form that ensures the consumer is made aware of each. The first of these form requirements is that disclosures must be in writing, in a form that the borrower can keep, and grouped together and segregated from everything else, and the itemization of amount financed must be separate from other disclosures.³³ The most important cost disclosures, finance charges and APR, also must appear more conspicuously than the other disclosures.³⁴ Lastly, in order to dispel the notion that borrowers are unaware of any of these essential terms of the loan before agreeing to it, Regulation Z requires that all of these disclosures appear before consummation of the loan.³⁵

Taken together, these requirements rebut many of the assumptions made by opponents of payday loans citing the dangers of a payday loan that require an interest rate cap to correct. First, payday lenders are not preying on the uninformed borrower who does not realize the effect that a high interest loan will have on him financially. A borrower is completely aware of the financial burden of the loan at the time the borrower signs the loan contract. Regulation Z gives the borrower every informational advantage by highlighting the essential loan terms, defining them, and breaking down each variable to show the financial effect as clearly as possible.³⁶ The borrowers are in the best position to assess their specific financial situation and, in particular, their ability to pay back the loan. A payday lender knows very little about the income and expenses of each borrower because of the limited credit check performed by the borrower, so the best thing a lender can do is give the borrower full and specific information that will give the borrower the tools to decide whether the benefits of a particular loan outweigh the costs.³⁷

Of course, TILA's requirements, as implemented by Regulation Z, are effective only if followed. Some proponents of an interest rate cap cite that lenders do not follow TILA or borrowers ignore the TILA

32. 12 C.F.R. § 226.18(g).

33. *Id.* § 226.17(a)(1).

34. *Id.* § 226.17(a)(2).

35. *Id.* § 226.17(b).

36. See *supra* notes 25–34 and accompanying text.

37. DURKIN & ELLIEHAUSEN, *supra* note 24, at 21–22.

disclosures as a reason to institute the interest rate cap and limit the availability of payday loans.³⁸ However, this argument is counterintuitive; it advocates more regulation while positing that payday lenders do not follow the existing regulations. An interest rate cap is just as hard to enforce, if not more so, than disclosure requirements. If lenders are willing to omit disclosures, manipulating interest calculations is not farfetched. A better solution is stricter enforcement and harsher sanctions for violations of TILA. TILA allows for an informed consumer to make an educated decision about his or her need for a loan. An interest rate cap restricts a number of consumers from obtaining a loan, effectively making that decision for them.³⁹

B. State Regulation

1. Delaware

Delaware is one of the least restrictive states regarding the treatment of payday lenders.⁴⁰ The Delaware statute does not limit the interest rate on a payday loan.⁴¹ It does, however, have a number of functional restrictions. One is that a payday loan contract may rollover only four times.⁴² If a borrower cannot make a payment, the borrower has the ability to extend or renew the loan by paying only the finance charge on the date of maturity and leaving the principal to rollover to another repayment period. However, Delaware allows only four rollovers until the lender and the borrower must enter into a repayment agreement, or the lender must pursue some other legally available method to obtain payment from the borrower.⁴³ Another consumer protection provision of the statute is that all payday loans need to have a borrower right to rescission.⁴⁴ This provision provides to a borrower a reflection period to assess the loan transaction, and if the borrower is not comfortable with it, the borrower can return the amount financed and incur no additional costs. Finally, because critics of payday loans also cite unfair and coercive collection practices by payday lenders, Delaware codified a rule that discharges any person

38. See Johnson, *supra* note 2, at 13–18.

39. See *infra* Part IV.

40. As an initial matter, the state statute calls payday loans “short-term consumer loans,” but for continuity, the loans will still be referred to as payday loans here. DEL. CODE ANN. tit. 5, § 2235A (West 2012).

41. *Id.* § 2235A(a).

42. *Id.* § 2235A(a)(1).

43. *Id.*

44. *Id.* § 2235A(a)(2).

imprisoned for debt so that the threat of imprisonment is an empty one.⁴⁵

Delaware also expands on the TILA disclosure requirements by mandating that the lender add three additional statements to every loan contract. The first mandated disclosure is that “[t]he loan is designed as a short-term cash flow solution and not designed as a solution for longer term financial problems.”⁴⁶ This provision conveys the intended purpose of payday loans as discussed above and warns a consumer before they enter a loan contract. The second is that “[a]dditional fees may accrue if the loan is rolled over.”⁴⁷ This statement indicates that borrowers find themselves in more financial distress as the amount of rollovers increases and attempts to guide borrowers once they enter into a loan. Finally, Delaware requires lenders to inform borrowers that “[c]redit counseling services are available to consumers who are experiencing financial problems.”⁴⁸ This provision attempts to inform a borrower that even if all of the other safeguards did not prevent financial problems, the borrower is not beyond help. Although each disclosure appears at the beginning of the process, the content of each attempts to protect the borrower at all stages of the loan.

The TILA disclosures make all essential components of the contract easily and readily identifiable. The Delaware Code expands on this and informs consumers of the intended uses for payday loans,⁴⁹ what a borrower should attempt to avoid once entering into a payday loan,⁵⁰ and where to get help if the borrower falls into financial problems.⁵¹ All of these disclosures prevent a payday lender from taking advantage of borrowers because the borrower benefits as levels of information approach perfect information.⁵²

The functional provisions in the Delaware statute work to protect the payday loan borrower by limiting the negative financial effect from using a payday loan in an unintended way, not by limiting access

45. DEL. CODE ANN. tit. 10, § 7301 (stating that “[w]hoever is imprisoned for debt, damages, or costs, by virtue of any process or commitment, in a civil action (except process or commitment of the Court of Chancery), having resided in this State for one year next preceding such imprisonment, may obtain discharge from such imprisonment upon petition to the Superior Court of the county wherein he or she is imprisoned, and compliance with the provisions of this subchapter”).

46. *Id.* § 2235A(b)(1).

47. *Id.* § 2235A(b)(2).

48. *Id.* § 2235A(b)(3).

49. *Id.* § 2235A(b)(1).

50. DEL. CODE ANN. tit. 5, § 2235A(b)(2).

51. *Id.* § 2235A(b)(3).

52. DURKIN & ELLIEHAUSEN, *supra* note 24, at 24–25.

to payday loans like an interest rate cap. The four rollover limit provision addresses the “spiral of debt” concern that interest rate cap proponents advance as a justification for limiting payday loans. Like the other provisions, this does not limit the amount of interest and effectively price potential borrowers out of a payday loan, but it does “cap” the amount of interest that a borrower can accumulate by stopping charges after four rollovers.

The difference between an interest rate cap and Delaware’s rollover limit is the point of restriction. Interest rate caps impose the restriction at the point of access.⁵³ The Delaware rollover provision restricts at the point of financial hardship. If we accept that payday loans have some benefit when used in the intended manner, allowing payday loans and restricting the ability to use the loan in an unintended manner that causes financial distress seems like a better avenue than restricting access altogether. The borrower’s right of rescission protects against the abusive use of payday loans by recognizing that some borrowers may disregard the warnings and, in desperation, take out a loan without weighing the positives and negatives of the transaction.⁵⁴ Consumer rescission allows the borrower to reflect on the contract possibly after the point of desperation.

If consumer protection starts with full and accurate disclosures intended to prevent poor financial decisions, it ends with limiting the consequences of making the poor financial decisions. Delaware accomplishes this through the section of the Delaware Code that releases borrowers from imprisonment for debt.⁵⁵ So, even after all the protections discussed above regarding a borrower that cannot meet his debt obligations, the borrower will not go to prison for debt.⁵⁶ This is misunderstood in some contexts because the debt may be an underlying reason for which some debtors go to prison.⁵⁷ If a debtor does not repay a loan, the lender can institute a civil action against the debtor. The lender may then obtain a judgment against the debtor ordering him to pay. If the debtor has the ability to pay, yet refuses to do so, he may be arrested. The Delaware Code protects borrowers from going to prison for having unpaid debt, not for refusing to follow court orders.

53. See *infra* Part IV.

54. See Kelly D. Edmiston, *Could Restrictions on Payday Lending Hurt Consumers?*, FED. RES. BANK OF KAN. CITY ECON. REV. 63, 69 (2011).

55. DEL. CODE ANN. tit. 10, § 7301.

56. See *Dealing with Payday Loan Collection Agencies*, ACTION PAYDAY LOANS (Nov. 4, 2008, 11:35 AM), http://www.actionpaydayloans.com/news/dealing_with_payday_loan_collection_agencies.html.

57. See Johnson, *supra* note 2, at 89–90.

The interest rate cap suggested by the opponents of payday loans is an assertion that consumers are not able to make financially responsible decisions even with all relevant information and safeguard protections. The states that do not impose interest rate caps such as Delaware find that consumers can make informed decisions but that payday lenders have unequal bargaining power. Due to this inequality, states like Delaware add additional requirements to balance the bargaining power of the lender and the borrower.

2. Texas

For a complete analysis, it is useful to compare Delaware's deferential restrictions of payday loans to a state with a more restrictive approach that includes interest rate caps. Texas is a good choice to compare because states with interest rate caps lower than Texas usually impose the cap in order to cap payday lenders out of the market completely rather than actually regulate operational stores.⁵⁸ Some of the functional requirements beyond an interest rate cap are that "[t]he borrower must have a right to prepay the loan and redeem the check at any time prior to the due date."⁵⁹ Also, "[i]f the loan is prepaid in full, the lender must refund any unearned finance charges,"⁶⁰ and the "lender must not keep borrower's postdated check for more than 31 days."⁶¹

Additionally, Texas has some similar disclosure requirements to Delaware and some additional disclosure requirements. One additional disclosure requirement in Texas is that "[t]he agreement must also contain a notice of the name and address of the Office of Consumer Credit Commissioner and the telephone number of the consumer helpline."⁶² Texas also has a provision that is similar to the Delaware disclosure requirement about the intended use for a payday loan. Texas requires that a lender disclose the following statement to all potential payday loan borrowers: "This cash advance is not intended to meet long-term financial needs. This loan should only be used to meet immediate short-term cash needs. Renewing the loan rather than paying the debt in full when due will require the payment of additional charges."⁶³ Finally, Texas requires that the payday

58. See Consumer Fed'n of Am., *Texas State Information*, *supra* note 1.

59. 7 TEX. ADMIN. CODE § 83.604(e)(4) (2013).

60. *Id.*

61. *Id.* § 83.604(e)(5).

62. *Id.* § 83.604(e)(3).

63. *Id.* (internal quotation marks omitted).

lender post the fee schedule.⁶⁴ The fee schedule is referred to as an interest rate cap and is discussed further below.

The Texas payday loan statute states that a lender only “may charge an amount that does not exceed the rates authorized in Texas Finance Code, §§ 342.251–342.259.”⁶⁵ The statute includes a fee schedule that outlines the finance charge and APR allowed based on the amount financed and the term of the loan.⁶⁶ Noticeably, the Texas statute does not contain some of the consumer protection provisions that Delaware enacted, arguably because Texas imposes an interest rate cap instead.

One provision in the Texas statute explicitly excludes a limitation on the amount of times that a lender can rollover a payday loan as long as the interest does not exceed the amount authorized by the statute.⁶⁷ Texas’s statute also does not contain a provision that allows a borrower the right of rescission on the contract. The exclusion of these two provisions supports the argument that Texas takes the approach of limiting the availability of payday loans instead of restricting the effects of the payday loan. Texas does not have the most restrictive interest rate caps for the amount of interest a lender can charge, but the fee schedule essentially takes any subjective analysis by the lender or borrower out of the payday loan. The lack of a provision limiting rollovers leads to the conclusion that Texas also does not believe rollovers are dangerous to payday borrowers because rollovers do not harm borrowers or other safety provisions in the law adequately protect the borrower. A fair conclusion is that Texas believes that the interest rate cap limits the potential dangers sufficiently. The next section addresses the problem with this belief based on economics and the benefits borrowers miss because of an interest rate cap.

IV. ECONOMIC ANALYSIS

An economic analysis of the payday loan model provides an additional justification that interest rate caps do not benefit the majority of borrowers in the long run. The most basic analysis to start with is the supply and demand for payday loans. A July 2004 study done by

64. 7 TEX. ADMIN. CODE § 83.604(e)(6).

65. *Id.* § 83.604(c).

66. *Id.*

67. *Id.* § 83.604(f)(1) (stating that, “[a]lternatively, the payday loan or deferred presentment transaction may be renewed without limitation to the number of renewals where the effect of the total amount of the interest charge would not exceed the total amount authorized by Texas Finance Code, § 342.252 and § 342.259 having due regard for the amount of the cash advance and the time the cash advance is outstanding”).

Policis, an independent social and economic research group formed for the public in the U.K., found uniform demand for credit across low-income housing irrespective of the regulatory nature of territory.⁶⁸ In the study, Policis surveyed U.S. states with and without interest rate caps, as well as Germany, France, and the U.K., and found that the demand for credit among low-income housing did not shift for multiple forms of credit.⁶⁹

However, interest rate caps do impact the supply side of payday loans. A lender under a regulatory scheme that limits chargeable interest with a cap will be unwilling to make a loan to the riskier consumer unless the lender increases other charges because the lender cannot compensate for the risk of default by raising the interest rate. Thus, the supply side for low-income credit is reduced in areas with interest rate caps.⁷⁰

The Policis study suggests that some lenders shift costs from up front interest to back-end ancillary charges when confronted with an interest rate cap in order to make up for the lost interest.⁷¹ The study indicated that the overall cost of credit as a percentage of the loan is not affected in areas with interest rate caps, but as noted, the charges are merely shifted to back-end costs.⁷²

As is the case in most industries with high demand that have a price cap, the demand does not disappear when demand exceeds supply. Those borrowers who are regulated or capped out of that market seek similar substitute markets.⁷³ This makes perfect sense in the area of payday loans. For example, a low-income borrower experiences car trouble and needs quick cash for the repair in order to get to work. She lives in an interest rate capped area. She has poor credit and is not able to obtain a payday loan because her risk of default to the lender is too high for the lender to take a chance with a limit on the amount of interest lenders are allowed to charge. Unfortunately, our

68. U.K. DEP'T OF TRADE & INDUS., *THE EFFECT OF INTEREST RATE CONTROLS IN OTHER COUNTRIES* 10 (2004), available at <http://www.bis.gov.uk/files/file53896.pdf>.

69. *Id.* at 10–16.

70. Tom Lehman, *Payday Lending and Public Policy: What Elected Officials Should Know* 10 (Aug. 2006) (unpublished manuscript), available at <http://www.coalitionforfinancialchoice.org/pdf/Payday%20Lending%20Public%20Policy.PDF> (“[L]egislated price ceilings and caps are a prescription for disaster in any market because, to the extent that they are binding, they distort prices and throw supply and demand into permanent disequilibrium. To put it less technically, state regulations that hold finance charges on payday loans below the market-clearing level will lead inevitably to an excess of demand over supply, creating shortages in the small loan market and preventing marginal borrowers from obtaining credit in emergency situations.”).

71. U.K. DEP'T OF TRADE & INDUS., *supra* note 68, at 24–25.

72. *Id.*

73. See Edmiston, *supra* note 54, at 80–82.

hypothetical person's car troubles do not disappear. She must obtain credit in some other way. A bank will not give her a loan because of her poor credit. The most likely scenario is that she will seek out other subprime credit options that are even less regulated.⁷⁴

Examples of less regulated subprime credit options include pawnshops, loan sharks, or “paying” with money she does not have—overdrafting, bouncing a check, or exceeding a credit card limit.⁷⁵ All of these come with substantial fees similar to those if the borrower defaults on a payday loan. However, for the most part, payday lenders do not report defaults to credit agencies.⁷⁶ Therefore, if a payday lender existed and was able to charge enough interest on a loan to the hypothetical borrower, the borrower may be better off even if she defaults on the payday loan. In fact, a payday loan would have a better chance of having no adverse consequences at all because the person may be able to pay back the loan when her next paycheck comes, and the only negative effect is the payment of interest that accrued during the short period the loan was open.

A recent study suggested that the possible effects may be more than just speculation. The study found that consumers in counties with restrictive payday lending statutes were more likely to have a lower credit score than their counterparts in areas with less restrictive regulations.⁷⁷ The study performed a statistical regression that removed other possible variables that impact credit rating, such as income and employment numbers, and concluded that lack of access to payday loans is statistically related to lower credit ratings.⁷⁸

Logically, if a consumer is in need of credit, she can obtain it from a payday lender, obtain it from another lender, or not obtain it. Reform targeting payday loans must have the goal of either changing the relationship with the target—here, payday lenders—of the reform or diverting the loan transactions from the target. Changing the relationship with payday lenders through the use of interest rate caps limits the supply of payday loans, which effectively diverts a segment of the population to other lenders. The goal of interest-rate-cap advocates must be to enable the consumer to use a safer, more equitable source

74. *See id.*

75. This is not to say that other options do not exist. Other options—such as payment plans with creditors, credit union loans, advances from employers, emergency assistance programs—exist; however, it is just as likely that these programs are not feasible because creditors are often unwilling to enter the plans and employers are unwilling to advance the loans, so the speed and convenience of payday loans make them the best option.

76. *See Edmiston, supra* note 54, at 72.

77. *Id.* at 76.

78. *Id.* at 77.

of credit or not get the credit at all. So, if the regulation achieves that goal there would be greater use of safer and more equitable “mainstream credit” in areas with payday loan restrictions compared to areas without restrictions; however, no increase in the use of mainstream credit would indicate that consumers are resorting to less credible lenders or not getting the credit at all.

This hypothesis was tested, and the results indicated that borrowers in areas that impose interest rate caps borrow slightly *less* from mainstream credit providers.⁷⁹ This is the opposite of what an interest rate cap seeks to accomplish. The difference between the areas is not statistically significant, so it is essentially no different, but that still means that those borrowers capped out of the payday loan market did not substitute the safer mainstream credit providers for payday loans.⁸⁰ No data exists that measures the subprime lender market accurately enough to know what sources of credit low-income borrowers resorted to without access to payday loans. The two possibilities are that the low-income borrowers did not obtain the credit they needed, or the borrowers sought credit from another type of creditor. States must decide whether payday loans are more dangerous than borrowers defaulting on other obligations or resorting to other subprime forms of credit; regardless, strong support exists for allowing access to payday loans.

V. POLICY

To some, the most objectionable portion of a payday loan is the idea that payday lenders can charge sky-high interest in order to profit as much as they please because the payday loan user’s demand is so great that the lenders have enough bargaining power to charge an unreasonable amount. However, this policy argument—that payday lenders should not be able to profit exponentially at the expense of desperate borrowers—is not supported by the lender’s cost to revenue ratio of providing such a loan. Ernst & Young recently performed a study for the Financial Services Center of America (FiSCA) that surveyed a variety of multiline stores—stores that offered more than just payday loans—for their financial information during 2008–2009 in order to figure out the costs and revenues of conducting business.⁸¹ The study found that the average cost for a lender to provide a payday

79. *See id.* at 80.

80. *See id.*

81. *See The Cost of Providing a Payday Loan in a US Multiline Operator Environment*, ERNST & YOUNG, 1–6 (Sept. 2009), http://www.fisca.org/Content/NavigationMenu/Resources/ForMedia/PolicyMakers/InformationKit/FiSCA_Final_09.03.09_Sent_to_Client.pdf.

loan to a customer was \$13.89 per \$100 payday loan.⁸² Additionally, the study found that the average revenue generated by the payday loan was \$15.26 per \$100 payday loan, making for a pretax profit of \$1.37.⁸³ Additionally, the study found that the average amount financed for a payday loan was \$379, the average cost of making a \$379 payday loan was \$52.63, and the average revenue was \$57.85, making for a pretax profit of \$5.22 per \$379 loan.⁸⁴

The \$15.26 of revenue produced from a \$100 loan indicates a loan with an APR of close to 400%.⁸⁵ Even assuming that the payday lender collects on every loan that would drive the lender's bad debt cost down to zero in the study, the cost of making the payday loan is still \$10.15, which the payday lender essentially "sells" for \$15.26. This assumption removes the argument that payday lenders increase their own cost by providing a loan that is too costly to pay back. The resulting \$5.11 pretax profit is hardly something that needs a reallocation of bargaining power through the use of an interest rate cap.

One further point on APR is that it may be misleadingly high to the casual observer because consumers are more familiar with long-term loans. A typical payday loan, used for ease of analysis, is a two-week \$100 loan with a \$15 interest charge.⁸⁶ So ultimately, the borrower will borrow \$100 and pay \$115 back to the lender in two weeks. This yields an APR of 391%. If the borrower analyzing the loan looks only at the loan amount and APR, the loan appears to be outrageous. However, a \$15 charge that can be paid back in two weeks is not as outrageous as it appears. Anyone with a debit card that has incurred an ATM transaction fee may be surprised by a comparison. A simple calculation will show why.

The typical payday loan APR is calculated by (1) dividing the finance charge by the amount financed, (2) multiplying by the number of days in a year, (3) dividing by the term of the loan, and, finally, (4) multiplying by 100 to show the number in percentage form. In the example above, the calculation would go as follows: finance charge = \$15; amount financed = \$100; number of days in a year = 365; and term of loan = 14 days.

$$\begin{aligned} \$15/\$100 &= .15 \\ .15 * 365 \text{ days} &= 54.75 \end{aligned}$$

82. *Id.* at 19.

83. *Id.* at 23–24.

84. *Id.* at 25.

85. *See infra* Part V (discussing how to calculate APR).

86. *See, e.g.,* Alex Gomory, *Payday Loans vs. Installment Loans*, LOANS.ORG (Dec. 12, 2011, 11:08 AM), <http://loans.org/payday/articles/payday-vs-installment>.

$$54.75/14 \text{ days} = 3.91$$

$$3.91 * 100 = 391\% \text{ APR}$$

Compare this to the simple debit card fee that millions of people experience. If a person withdraws \$50, \$50 is the amount financed. In this hypothetical, the finance charge is a \$1 transaction fee. The withdrawer obviously pays it when the transaction occurs so the term is one day. If the transaction fee is considered an interest charge, the premise being that interest on a loan is a cost to have access to liquidity, and a debit fee also is a liquidity cost, What would the APR be? Here is the calculation:

$$\begin{aligned} \$1/\$50 &= .02 \\ .02 * 365 &= 7.3 \\ 7.3/1 &= 7.3 \\ 7.3 * 100 &= 730\% \text{ APR} \end{aligned}$$

The calculation above illustrates that it is important to keep perspective when analyzing the numbers. The \$1 withdrawal fee does not seem as objectionable as the hypothetical APR. The APR is inflated largely due to the one-day period. Similarly, although the APR calculation for a payday loan seems high, it is deceptive to those accustomed to viewing interest in longer terms. Also, APR is largely irrelevant to borrowers compared to the actual dollar cost.⁸⁷ If payday loans work in their most mechanical manner, a borrower borrows \$100 today for an emergency and writes a postdated check for \$115 dated for the maturity of the loan. The borrower gets paid from work sometime within the next week or two. At the end of the loan term, the payday lender will cash the check, which will decrease the borrower's recently increased checking account.

The cause of concern for most opponents is that not all loans end up working this way, and much of their argument against payday loans with unlimited interest charges is policy driven on the premise that unlimited interest hurts borrowers.⁸⁸ The counterargument to this concern is to analyze whether an interest rate cap is an effective solution.⁸⁹ This analysis is still based on empirical data and theory, but it combines different points of analysis to hypothesize the outcome.

The economics of payday loans indicate that capping interest rates limits the supply of loans.⁹⁰ A good illustration of this is New York,

87. Lehman, *supra* note 70, at 9.

88. *See id.* at 12.

89. *See id.* at 9-10.

90. *See id.* at 10.

where state regulation caps interest for payday loans at 25%.⁹¹ Not one payday lender exists in New York.⁹² This supports the theory that capping interest at a low enough rate will effectively eliminate all willing suppliers from the market. North Carolina and Georgia are two other states that have no payday lenders. Although Georgia eliminated payday loans through statute,⁹³ and North Carolina effectively eliminated payday loans through restrictions including capping interest,⁹⁴ this does not affect the analysis. The mechanism for eliminating payday loans is not important to this portion of the analysis because the comparison of limiting the supply of payday loans through an interest rate cap and eliminating them through some other avenue leaves at least some segment of consumers in the same position—without access to a payday loan.

Daniel P. Morgan and Michael R. Strain researched the effects of the payday loan ban in Georgia and South Carolina in depth with their article, *Payday Holiday: How Households Fare After Payday Credit Bans*.⁹⁵ Their findings showed overall increases in North Carolina and Georgia for bounced checks, complaints to the Federal Trade Commission about lenders and debt collectors, and Chapter 7 bankruptcy filings compared to households in states that allow payday lending.⁹⁶ They concluded that the negative correlation—a decrease in reduced payday credit options increases credit problems—does not support the hypothesis that payday loans with high interest rates cause borrowers to fall into a spiral of debt, but it does support the idea that payday loans are a preferable substitute to other subprime options that increase credit issues.⁹⁷ The study also compared the numbers for each state pre-payday loan ban (Georgia, May 2004; North Carolina, December 2005) and post-payday loan ban.⁹⁸ It found that consumers were worse off after the payday loan ban in both states using three

91. See N.Y. PENAL LAW § 190.40 (McKinney 2012). Although New York has no statute specifically addressing payday loans, section 190.40 criminalizes collecting interest on any loan exceeding 25% APR. *Id.*

92. Mann & Hawkins, *supra* note 3, at 879–80.

93. GA. CODE ANN. § 16-17-1(e) (West 2012).

94. See Consumer Fed'n of Am., *supra* note 1 (“Payday lending is not specifically authorized and is defacto prohibited by several state small loan rate caps. These states include . . . North Carolina . . .”).

95. See generally Donald P. Morgan & Michael R. Strain, *Payday Holiday: How Households Fare After Payday Credit Bans* (Fed. Reserve Bank of N.Y., Staff Reports No. 309, Nov. 2007), available at http://www.newyorkfed.org/research/staff_reports/sr309.pdf.

96. *Id.* at 3.

97. See *id.* at 21–22.

98. *Id.* at 10, 21–22.

indicators: bounced checks (and fees), complaints to the FTC about lenders, and bankruptcy filings.⁹⁹

The Morgan and Strain article analyzed what effect the lack of payday loans had on those missing an obligation to pay by measuring the amounts of complaints filed with the FTC for reasons related to what they call “informal bankruptcy” or the effects of not making payment on debt.¹⁰⁰ The data supports the finding that after payday loan bans in Georgia, complaints to the FTC substantially increased.¹⁰¹ Included in the complaints measured were complaints against lenders and debt collectors.¹⁰² With fewer lenders in the market, the logical effect is that complaints against lenders would decrease, especially if the lenders regulated out of the market were harmful to borrowers. However, the study found that complaints increased even after controlling for unemployment, which means the strength of the state’s economy was not a factor in the analysis.¹⁰³ The fact that complaints increased against lenders and debt collectors from the year prior to the payday loan ban to the year after the ban indicates that borrowers were actually more frustrated with credit facilities after the removal of the predatory payday lender.

The best way to regulate payday lenders for borrowers and lenders is still a highly contested issue, and obviously the lack of uniformity across state regulations indicates that state governments do not agree. Instead of merely critiquing regulations that do not work in the next section, this Note suggests what regulations would work. In doing so, this Note outlines a hypothetical payday loan regulatory structure that has the best chance of benefitting all interested parties.

VI. SUGGESTED REGULATORY FRAMEWORK

As an initial matter, this Note accepts that TILA is beneficial in a payday lending regulatory scheme and incorporates all of the TILA requirements as a necessity. It is also important to keep in mind the effects that these regulations should aspire to have when considering a new framework. The regulations need to balance keeping the cost of conducting business for the payday lender at a level where it operates

99. *See id.* at 21–22.

100. Morgan & Strain, *supra* note 95, at 15–21. The authors of the study make three arguments for why FTC complaints are a good measure for the effects: (1) complaints measure welfare because, for the most part, a borrower will only complain when pushed to a certain extent that the borrower would otherwise not reach; (2) monthly data makes a specific event’s effect more measurable; and (3) it is intuitive that complaints equate to problems. *Id.* at 16.

101. *See id.* at 15–17.

102. *Id.* at 17.

103. *See id.* at 23.

profitably while lending to economically stable borrowers and limiting the possibility of harm to the borrower.¹⁰⁴ Essentially, the regulations need to make payday loans beneficial to lenders and borrowers, not a one-sided affair for either. The regulatory framework this Note suggests as the best way to achieve this balance is an approach that makes both a quick, individualized assessment of the costs and benefits of payday loans by the borrower and the lender prior to the loan and a debt safety net after the lender makes the loan.

The proposed regulatory scheme below differs from an interest rate cap by using specific criteria to determine which borrowers should have access to payday loans. The regulations differ from an interest rate cap because, instead of either eliminating a category of borrowers from the market or shifting revenue from interest payments to other fees,¹⁰⁵ the proposed scheme allows the borrower and the lender to make a greater specific, personalized inquiry into whether the payday loan is beneficial while not substantially raising the cost of making the loan for the lender. The borrower's assessment of whether a payday loan is worthwhile depends heavily on the question, Can I pay this loan back according to these terms? The factors that bear on the answer to this question are the terms of the loan and the borrower's specific financial situation, which are what the regulatory scheme aims to determine in an efficient and effective manner.

This scheme starts by providing the borrower with full and accurate disclosures to increase the accuracy of the borrower's personal assessment of whether the loan is beneficial for the borrower, which TILA effectively does,¹⁰⁶ and adds additional informational safeguards to provide a low-cost benefit to potential borrowers; thus, this regulatory framework would include additional disclosure requirements, similar to Delaware's requirements.¹⁰⁷ The additional disclosures by Delaware inform consumers of the intended uses for payday loans, how to handle a payday loan in the most beneficial manner, what to avoid once entering into a payday loan, and where to get help if the borrower falls into financial problems.¹⁰⁸

104. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 1011, 1021(a), 1031(c), 124 Stat. 1376, 1963, 1979, 2005 (2010) (codified in scattered sections of the U.S. Code) (establishing the Consumer Financial Protection Bureau, stating that its purpose is to ensure fair practices for consumers, and defining unfair practices as practices that are "likely to cause substantial injury to consumers which is not reasonably avoidable by consumers" or where "such substantial injury is not outweighed by countervailing benefits to consumers or to competition").

105. See *supra* Part IV.

106. See, e.g., DURKIN & ELLIEHAUSEN, *supra* note 24, at 211; see also *supra* Part III(A).

107. See *supra* notes 46-48 and accompanying text.

108. See *supra* notes 46-48 and accompanying text.

In addition to TILA, another pre-loan regulation should require that lenders make an individualized assessment of each borrower, on a limited scale, through specific screening measures such as income verification. TILA and income verification allow the borrower and lender to assess the financial position of a potential borrower; however, in the payday loan market, specific financial obligations also have a large impact on the effectiveness of the loan. In order to prevent a payday loan from being used in an unintended and potentially harmful manner, a payday loan statute should have pre- and post-loan provisions that specifically address these potentially negative consequences. Two effective pre-loan provisions are a limit on the number of outstanding payday loans a borrower may have and a limit on the total number of payday loans a borrower may take out in a calendar year.

These preemptive pre-loan measures, while effective, are not perfect.¹⁰⁹ A complete payday loan statute should also include post-loan regulations that are reactive to potentially harmful situations. The most concerning negative consequence is a borrower falling into a debt spiral.¹¹⁰ An effective regulation that could limit the spiral's magnitude is a restriction on the number of rollovers for a loan because it effectively cuts off the cycle of over-leveraging before it becomes uncontrollable.

The disclosure requirements allow the borrower to make a personal assessment of whether the loan is right for his specific situation by disclosing the terms and allowing the borrower to apply the obligations imposed by the terms to the borrower's financial situation.¹¹¹ However, it is well documented that some of these borrowers will act irrationally and not make the best decision for their situation,¹¹² so the lender also must engage in a limited individual assessment of the borrower's ability to repay the loan through the use of income verification and an assessment of other loan obligations. Finally, if these initial screening mechanisms fail, the best way to limit the damage is to prevent excessive rollovers. The regulatory structure that follows assumes TILA requirements are in place and also incorporates the Delaware disclosure requirements.

109. DURKIN & ELLIEHAUSEN, *supra* note 24, at 212.

110. See Carmen M. Butler & Niloufar A. Park, *Mayday Payday: Can Corporate Social Responsibility Save Payday Lenders?*, 3 RUTGERS J.L. & URB. POL'Y 119, 121-24 (2006).

111. See 12 C.F.R. § 226.1(b) (2012) ("The purpose of this regulation is to promote the informed use of consumer credit by requiring disclosures about its terms and cost.")

112. See Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 55 (2008).

A. *Income Verification*

Once the borrower is fully informed about the obligations and characteristics of the loan through the TILA and Delaware disclosures, a lender should assess the ability of the borrower to repay the loan. As previously stated, the intention of the loan is to be a quick and easy way to obtain credit, so a full blown credit check is counterproductive. A quick and simple analysis of whether a borrower can meet his obligations is based upon the difference between a borrower's income and expenses.

An effective way to insure that a borrower has enough incoming cash flow is through an income verification mechanism. For example, the Illinois payday lending statute achieves this through requiring a payday lender to obtain income verification from a borrower that shows documented income from the last thirty days.¹¹³ The statute does not directly state this, but the statute limits the amount a lender can loan to borrowers based on their "gross monthly income,"¹¹⁴ and the statute defines gross monthly income as "monthly income as demonstrated by official documentation of the income, including, but not limited to, a pay stub or a receipt reflecting payment of government benefits, for the period 30 days prior to the date on which the loan is made."¹¹⁵

A short income verification process, such as that required by Illinois, adds negligible cost to the lender and is one safeguard that increases the probability that the borrower has an income source that will allow the borrower to pay back the loan.¹¹⁶ Although this provision may seem duplicative because the term payday loan assumes that a borrower is getting a paycheck to turn over to the lender at the end of the loan, requiring the borrower to prove and the lender to verify that the borrower does in fact have income, it should not be overlooked. This regulation restricts access to payday loans to those that have the ability to pay lenders back because borrowers have periodic access to cash.

B. *Outstanding and Yearly Loan Limits*

The payday loan statute should also address specific cash outflows through a limit on the number of payday loans a borrower may obtain at a given time and in a given year. The Ohio payday loan statute

113. 815 ILL. COMP. STAT. ANN. 122/1-10, 2-5(e)(2) (West 2012).

114. *Id.* § 2-5(e)(2).

115. *Id.* § 1-10.

116. See, e.g., *Applying BI to Payday Lending Regulatory Solutions*, VERITEC, <http://www.veritecs.com/PaydaySolution.aspx> (last visited Mar. 29, 2013).

does both. Ohio requires that a lender verify that the borrower does not have any other payday loans outstanding¹¹⁷ and that a borrower may take out a total of only four payday loans in a calendar year.¹¹⁸ The latter provision is one that not many other states impose as a restriction, but makes logical sense to promote the beneficial and intended use of a payday loan because payday loans are not intended to meet recurring obligations, and limiting the number per year prevents this type of recurring use.

In order for a lender to check the borrower's payday loan history, all payday lenders must engage in recordkeeping that shares data with the other lenders in the state. This requirement is already in place in thirteen states through the use of the Veritec database.¹¹⁹ Veritec is a database accessible by all payday lenders in those states, and it allows payday lenders to input and look up data on payday borrowers. States that require lenders to input all payday loans into the Veritec database typically require that the lender input the identifying criteria of a borrower,¹²⁰ the loan terms, and the date of the loan.¹²¹ The lender requires this information anyway in order to make the loan, so inputting this into a shared database adds minimal inconvenience to the lender and produces expansive bookkeeping benefits. States that require lenders to use the Veritec database allow lenders and regulatory agencies to pull up information on a borrower within seconds by signing into a password-protected account and simplify lenders' compliance with the limitations on outstanding and yearly loans.¹²²

In order for the lender to comply with the proposed regulations, the lender needs to simply identify the borrower, bring up the borrower's transactions from the database, and then check if the borrower has any other open payday loans or has taken out a payday loan more than four times within the last year. This regulation and accompanying database entry requirement restricts access to payday loans from those that use payday lending in an improper and financially dangerous manner.

117. OHIO REV. CODE ANN. § 1321.41(E) (West 2012).

118. *Id.* § 1321.41(R).

119. See *Collaborative Government Solutions*, *supra* note 116 (listing collaborations with state agencies in Illinois, Wisconsin, Virginia, Alabama, Florida, Indiana, Kentucky, Michigan, New Mexico, North Dakota, South Carolina, Oklahoma, and Washington on tracking payday or similarly defined loans).

120. Examples include name, birthdate, social security number, address, and phone number.

121. See, e.g., 815 ILL. COMP. STAT. ANN. 122/2-15 (West 2012).

122. See *Applying BI to Payday Lending Regulatory Solutions*, *supra* note 116.

C. Rollover Limits

The final component of this regulatory framework is a ban on rollovers to prevent a borrower from the “debt cycle.” The opponents of payday loans cite the idea that a borrower may not rollover a current loan but can take out a new loan to repay the old one as a loophole that payday lenders use to circumvent a rollover ban and entrap their borrowers in a debt cycle.¹²³ This of course fails to take into account regulatory schemes, such as the one proposed, that have built-in protection against this by limiting the number of outstanding payday loans a borrower may have at any one given time. Using the danger of a debt cycle as the justification of an interest rate cap takes into account too many assumptions that may or may not be true.¹²⁴ The justification goes like this: payday loan users are low-income borrowers that have limited excess capital to pay these unlimited interest charges on payday loans, so they default on the loan, rollover the loan, thereby accruing more interest, and are unable to pay that when it comes due.¹²⁵ This debt cycle has no end because the borrower is never able to repay the charges from the previous period.¹²⁶

Instead of assuming that uncapped interest rates will lead to the debt cycle, limiting the amount of rollovers stops the cycle by restricting the amount of rollovers. In this situation the charges stop. In fact, a recent study performed by Marc Anthony Fusaro and Patricia J. Cirillo¹²⁷ found that the levels of interest on payday loans had no relation to the ability of a borrower to pay back a loan.¹²⁸ The study tracked payday loans given to borrowers that carried no interest charge and those with normal high interest rates, and found that the ability of borrowers to repay the loan was not dependent on the APR.¹²⁹ Their conclusion was that the amount of rollovers a borrower uses is based on factors other than the interest rate, which means regulating the interest rate does not limit rollovers.¹³⁰

123. See *Rollover Bans Don't Stop Payday Trap*, CTR. FOR RESPONSIBLE LENDING (Apr. 9, 2009), <http://www.responsiblelending.org/media-center/press-releases/archives/rollover-bans-don-t-stop-payday-trap.html>.

124. See, e.g., Donald Rieck, “*Predatory Reporting*” on Payday Lending?, STATS, http://stats.org/stories/2008/how_bad_payday_loans_july18_08.html (last updated July 21, 2008).

125. King & Parrish, *supra* note 2, at 7–8.

126. *Id.*

127. No relation to the author of this Note.

128. See Marc Anthony Fusaro & Patricia J. Cirillo, Do Payday Loans Trap Consumers in a Cycle of Debt? 28–30 (Nov. 16, 2011) (unpublished manuscript), available at ssrn.com/abstract=1960776.

129. See *id.* at 22, 27.

130. See *id.* at 28.

Although an interest rate cap does not stop a cycle of debt, a well-crafted rollover limit will. An example of a rollover limit that achieves this is the Alabama statute, which requires that the outstanding balance of a loan be paid after the initial loan period and limits a borrower to a maximum of one rollover.¹³¹ This requirement effectively stops debt from accruing after a maximum of one rollover. If the borrower cannot repay the outstanding balance in full, the payday lender has the option of offering the borrower an extended repayment option of four equal monthly installments of the remaining balance.¹³² This restriction takes into account events that occur over the span of the loan and acts as a stopgap to the flood gates of insurmountable debt without assuming what will occur. A well-crafted rollover limit, such as the one utilized in Alabama, effectively prevents the debt cycle from occurring, not an interest rate cap as illustrated by the Fusaro and Cirillo study.

VII. CONCLUSION

If one thing is clear about the current state of payday loans, it is that most borrowers and regulators do not agree about the best way to deal with them. State regulations range from completely banning payday loans to imposing little more than the federal disclosure requirements on payday lenders. The disagreement may not be settled anytime soon because it comes down to balancing the limitations of the potential harm and the maximum potential benefit; the outcome depends on too many factors for a one-size-fits-all regulatory structure. Interest rate caps undoubtedly limit the potential harm to borrowers but do so at the expense of the benefits the loans provide them. Although the regulatory structure suggested above may not be perfect, the economics and policies supported by studies indicate that it has a better chance of providing benefits and limiting danger than an interest rate cap.

131. ALA. CODE § 5-18A-12(b) (LexisNexis 2013).

132. *Id.* § 5-18A-12(c).