

I. Executive Summary

II. Table of Contents

I. Executive Summary

II. Table of Contents

III. Introduction of Payday Loans

- A. General Background
 - 1. What are Payday Loans?
 - 2. Historical Attitudes Toward Bank and Market Regulation
 - 3. Regulation of Payday Loans Under Federal Law
 - 4. Other States' Regulation of Payday Loans
 - 5. Current Kansas Law
 - 6. Why is Payday Lending Controversial?
 - 7. The Charging of Interest As a Moral and Social Concern
- B. Payday Loans Within the Framework of Consumer Credit
 - 1. The Role of Credit In Contemporary Economic Life
 - 2. When the Cost of Consumer Credit Matters
 - 3. Valuing Loan Transactions In Accordance With Financial Constraints
- C. Policy Objectives in Payday Loan Regulation
 - 1. Permit Loan Transactions That Benefit the Consumer
 - (a) account for the inequality of the parties' bargaining power
 - (b) facilitate genuine competition within the market
 - (c) address deficiencies in consumer education
 - (d) require the lender to verify the borrower's ability to repay according to the terms
 - (e) give adequate protection to defaulting consumers
 - (f) prevent lenders from generating social and economic costs which they fail to absorb
 - (g) provide for reasonable fees and interest rates
 - (h) prevent payday loans from becoming a frequent or long-term source of credit
 - 2. Facilitate Deeply Held Societal Values
 - (a) prevent usurious lending
 - (b) protect those who are unable to protect themselves
- D. Policy Alternatives in Payday Loan Regulation
 - 1. Study the issue further
 - 2. Promote or provide other lending options
 - 3. Improve consumer decisionmaking through
 - (a) enhancing disclosure requirements
 - (b) allowing buyer's remorse cancellation rights

4. Adjust the regulations governing payday lending practices through
 - (a) requiring determinations of ability to pay
 - (b) delimiting debt collection tactics
 - (c) revising allowable fees, rates, and other loan terms
 - (d) regulating repeat borrowing
 5. Ban payday lending.
- E. Identification of Affected Interests
1. Payday Lenders
 2. Consumers Desiring Small Loans
 3. Competitors to Payday Lending
 4. The Ripple Effect of Payday Lending: Bankruptcy and Its Costs To Third Parties

IV. Analyzing the Policy Alternatives

- A. Further Study
- B. Promote Alternatives to the Payday Loan
- C. Improve Consumer Decisionmaking
- D. Regulate Payday Lender Practices and Loan Terms
 1. Debt Collection and Dispute Issues
 2. Evidence of Ability to Repay Loan
 3. Regulation of Fees, Interest Rates, and Loan Terms
 4. Regulate Repeat Borrowing
- E. Total Ban

V. Legal Analysis

- A. Legal Implementation of Policy Alternatives
- B. Ongoing Regulation and Regulatory Costs
- C. Possible Limitations On State Law
 1. Federal Preemption
 2. Federal Legislation
 3. Constitutional Concerns

VI. Bibliography

III. Introduction of Payday Loans

A. General Background

1. What are Payday Loans?

Payday loans are small, short-term consumer loans in which the borrower gets cash on the spot, in exchange for the borrower's personal check or automatic debit approval. In a typical arrangement, the lender holds the check until an agreed-upon date, usually the borrower's next payday. Unless the borrower returns and pays to extend the loan for another term, the check is cashed, and the loan is repaid. Other names for these loans include payday advances, cash advances, deferred deposit loans, and deferred presentment services.

Payday lenders are, by far, the fastest growing segment of the fringe lending or sub-prime lending market. Other lenders in the sub-prime market include rent-to-own stores, auto title pawn companies, traditional pawn shops, and check cashing outlets. While small loans are not a new phenomenon, the payday loan industry has proliferated largely within the last decade.

According to market analysts, some 20,000-24,000 payday loan outlets were operating in 2001, and some 65 million transactions produced \$2.4 billion in revenue. (PIRG II, p. 6) Wisconsin offers a picture of the radical changes in the industry: in 1996, there were seventeen payday lenders in the state. (PIRG I, p. 19) In July of 1999, almost 200 payday lenders were operating in Wisconsin. (PIRG I, p. 19)

Compared to mainstream sources of credit, the cost of borrowing from payday lenders is extremely high. In survey data assembled by the U.S. Public Interest Research Group (PIRG) and the Consumer Federation of America (CFA), the average APR for payday loans was 474%. (PIRG I, p. 7) Of the lenders surveyed, 56% charged 400% APR or more, and 35% charged more than 500%.

2. Historical Attitudes Toward Bank and Market Regulation

In the last several decades of the nineteenth century and the early decades of the twentieth century, as the industrial revolution reshaped the national life, many scholars and jurists embraced a strongly laissez-faire view of the market. (See Chemerinsky p. 453) With a social ethic substantially based on Darwinian survivalism, the law reflected these views most pervasively from around the turn of the century until the 1930's. In a 1905 case epitomizing the Darwinian social ethos, the Supreme Court rejected state regulation of bakers' work hours (set at ten hours a day and sixty hours a week), because the regulation was deemed to infringe on both parties' freedom to contract. (See *Lochner v. New York*) The freedom to contract was held inviolable, and justice was deemed to have been served by letting each make the deal that was within his or her power to make.

The 1990's saw a resurgence of economic Darwinism, exemplified in a renewed faith in the benign omniscience of the market. While current economic policy is not as unforgiving as the pre-New Deal version, the terrain for sub-prime lending has increasingly taken on characteristics which were last prevalent during the early twentieth century.

Kansas' 1993 passage of a payday loan statute authorizing effective interest rates approaching 400% could be seen as reflecting the trend toward deregulation, and governmental deference to the hand of the market. But where the state has passed legislation precisely setting the rules for the market -- in effect, creating a market where there was none, regulating the

players, and setting prices and terms -- the “free market” explanation seems imprecise at best. It may be just as useful to look toward the political process for an explanation of the shape of current law, but that is a project beyond the scope of this analysis.

3. Regulation of Payday Loans Under Federal Law

Federal law does not specifically regulate payday loans. However, the Truth-in-Lending Act (TILA) applies to payday lenders, as it does to other lenders. It requires the lender to make certain disclosures to the borrower, including a loan’s interest rate, prior to the signing of a loan agreement.

The National Banking Act’s (NBA) provision allowing the exportation of interest rates by national banks from state to state has ramifications for the payday loan industry. Although the legal implications are not entirely clear at the moment, the NBA may open the door for payday lenders who affiliate with national banks to override individual states’ regulation of the payday loan industry. This issue will be addressed in greater detail below.

4. Other States’ Regulation of Payday Loans

Many states proscribe the interest rates which can be charged for loans of various types. For example, loans advanced to credit card holders are capped in many states, including Kansas. K.S.A. § 16a-2-401(2) (2002). A typical cap rate might fall in the eighteen to thirty-six percent range.

The various states’ treatment of payday loans can be divided into three broad categories:

1. states which have low interest rate ceilings or usury caps, or bans on check cashing (twenty states and Puerto Rico);
2. states without interest rate ceilings, and where payday lending is permitted and licensed (six states); and,
3. states where interest rate ceilings exist, but payday lending is granted a statutory safe harbor from rate ceilings which would otherwise apply (twenty-five states and Washington D.C).

5. Current Kansas Law

Kansas falls into the third category. In 1993, it passed legislation, K.S.A. § 16a-2-404, to create a safe harbor for payday lenders. Instead of being subject to the interest rate cap which would otherwise apply (36% APR), licensed or supervised payday lenders are allowed to charge according to a fee scale included in the statute:

| <u>Amount of loan</u> | <u>Charge</u> |
|--|--|
| Less than or equal to \$50 | \$5.50; |
| More than \$50, but not more than \$100 | 10% of the loan proceeds plus a \$5 administrative fee; |
| More than \$100, but not more than \$250 | 7% of the loan proceeds with a minimum of \$10 plus a \$5 administrative fee; |
| More than \$250 and not greater than \$860 | 6% of the loan proceeds with a minimum of \$17.50 plus a \$5 administrative fee. |

The statute has additional requirements:

- (1)(c) --the loan is capped at \$860;
- (2) --the loan term is 30 days or less;
- (3) --the borrower is limited to no more than two loans;
- (4) --the loan must include notice to the borrower of the two loan limit, as well as notice that the lender cannot split loans to increase the lender's proceeds;
- (5) --after the original maturity date, the contract interest rate is limited to 36%, and no additional charges are allowed for "insurance" or for "check cashing;"
- (6) --a loan cannot be repaid with the proceeds of another loan from the same or a related lender;
- (7) --if a check is returned NSF, the lender can charge a returned check fee;
- (8) --factors to be considered in a claim of unconscionable conduct include:
 - a) the borrower's ability to repay within the terms of the loan under this section,
 - b) the original request of the borrower was within the limits of this section.

6. Why is Payday Lending Controversial?

At the center of the debate surrounding payday lenders is the question of whether or not the industry deserves legitimacy. Does the service provided by payday lenders fulfill a legitimate need for credit at a fair price for the segment of the population who uses it? Or do the high interest rates and fees associated with payday loans render them abusive -- either on their face, or derivatively, by creating an unacceptably high risk that borrowers who are already on the economic fringes will be pushed even further toward financial hardship?

Supporters of the industry tend to focus on the substantial and growing demand for payday lenders' services. They observe that payday lenders are willing to provide consumer credit in a convenient and simple process to those who desire it, at a price which the customer is willing to pay.

Explanations for customers' decisions to patronize payday lenders, despite the extremely high cost of credit, tend to rely on market incentives. For example, the leading industry-sponsored study on payday lending characterizes the typical customer as "hav[ing] high rates of return on investments in household goods . . . which at the margin, makes them insensitive to interest rates on loans." (Elliehausen, 2001, p. iv)

Critics of the industry tend to focus on the cost of the consumer credit which payday lenders provide, the difficulty which economically marginal customers have in shouldering those costs, and the likelihood that the cost of that credit will in many cases drive the customer into even more dire circumstances. They observe that borrowers face a substantial risk that short-term credit from a payday lender will snowball into chronic borrowing. Instead of merely providing short-term credit for an unusual emergency, payday lending, by default, becomes the borrower's line of credit on a long-term basis, at tremendous cost to the borrower.

Explanations for customers' decisions to patronize payday lenders often point to market failures, such as consumer ignorance based on inadequate information, lack of adequate competition, and the imbalance of leverage between the lender and the customer. Other explanations recognize the failure of market theory to account for customers' decision-making, which on its face often escapes rational explanation. This is one way of "explaining" the behavior of persons who under any circumstances lack the capacity for competent market interaction. It also accounts for situations in which consumers act contrary to their interests, despite being sufficiently aware that they are doing so, and that they have better alternatives.

7. The Charging of Interest As a Moral and Social Concern

Simplified market theory assumes that people will make the choices which maximize their economic resources to further their own happiness and well-being. And although many people follow the predictions of the model to a sufficient degree to make it a useful tool for analysis, some subset of humanity persists in conducting their affairs heedless of their own self-interest, to the degree that their ability to function is substantially impaired.

Some may have no other choice for short-term lending, and some may be ignorant of payday lending's true cost. There are others whose ability to process and make use of relevant information is severely limited, and whose behavior regularly defies rational explanation. Others may be aware that they cannot afford payday loans, but are psychologically unable or unwilling to make the decisions necessary to avoid it.

An exclusively economic analysis fails to account for other values which society holds, and wishes to support through its laws. We do not hesitate to regulate, or even entirely proscribe behaviors which are freely-chosen but potentially self-destructive. Gambling, use of alcoholic beverages, and use of drugs, both legal and illegal, all serve as examples, with varying degrees of regulation and proscription.

Concern about the potentially oppressive character of interest on borrowed money is deeply rooted in the moral and ethical codes which exercise the strongest influence on Americans. The Hebrew Scriptures (or Old Testament) bans the charging of interest to those within the tribe, and shows a particular concern for those who are poor, and whose capacity to meet everyday needs is compromised (see, e.g., *Leviticus* 25:35-37).

The Christian church adopted the same concern from its Jewish roots. During the hundreds of years when the Christian church banned the taking of interest *carte blanche*, the prevailing concern was for the vulnerability of the poor in an essentially static economic environment. Within the Muslim religion, beginning in the seventh century, a similar opposition to usury took shape.

Eventually, the *per se* opposition of Judaism and Christianity softened, and a distinction was made between reasonable interest rates, and unconscionable ones. Within Christianity, the traditional term "usury" has generally become synonymous with excessive interest rates.

Many morally and religiously conscientious people continue to oppose usurious loans to economically marginal people, particularly when those loans compromise the borrower's ability to meet basic, everyday needs.

Linked to this centuries-old moral concern is a practical recognition that some people are not in a position -- whether through ill fate, bad planning, or simple lack of skills -- to manage the risks which interest-incurring loans entail. Thus, the U.S. has a long history of individual states regulating interest rates and other terms for a wide range of loans. (See Morris, p. 154) Some regulation continues, despite the anti-regulatory fervor of the 1980's and 1990's. (See Morris, p. 155) Regulation extends to every kind of credit, from real estate loans to operating capital for businesses to consumer credit.

The laws of the individual states have taken these regulatory steps precisely because the market does not always account for the behavior of those who are poor or ignorant. Regulation of loan rates and terms has been one of the means through which society has tried to offer some protection to those who need it.

B. Payday Loans Within the Framework of Consumer Credit

1. The Role of Credit In Contemporary Economic Life

The American economic engine has become increasingly reliant on consumer spending over the past decade. Much of that consumer spending depends on the credit which Americans are offered at every turn, whether through home mortgage refinancings, credit card offers, or payday lenders.

In addition to greasing the wheels of commerce, access to credit has become a virtual necessity for modern life, and is a key component for economic growth and the building of assets for both businesses and individuals. Homes are built and bought, businesses expand, and individuals gain an education through the use of borrowed capital. In each of these instances, the borrower is presumed to gain something which will build wealth in the long run, despite the ongoing cost of the borrowed money. Because credit is such an integral part of economic life, and loans can enhance personal and collective wealth, we want to be sure we do not constrain beneficial loan transactions.

2. When the Cost of Consumer Credit Matters

Consumer credit has a slightly different character than some other types of credit. While most credit is extended on the basis of collateral (real estate, durable goods, income-generating equipment), consumer credit is extended solely on the basis of the lender's estimate of the odds that the borrower will be able to repay the loan. This does not mean that consumer goods cannot have a genuine market value, nor does it suggest that consumer expenditures cannot enhance a person's income-generating capability. But consumer goods are particularly vulnerable to being . . . well, consumed. Some consumer purchases will be necessary, others may offer non-essential utility, but for those on the economic margins, the money spent for them diminishes the resources available for other similarly necessary and useful items. Unlike people with greater resources or better money management skills, those who are on the margins persistently bump up against the wall of their limited resources.

The fact that a particular consumer item is purchased with credit is -- for most people -- inconsequential, especially if the cost of that credit is built into the purchase price. (Example: a purchase made with a credit card, on which the purchaser pays his or her entire balance each month. The retailer will pay a small fee to the bank associated with the card; the consumer pays for that fee through a slight increase in the product price.)

But if that item is purchased with credit at premium prices (e.g., payday loan rates of 400-500%), the effective cost of the item soars. If the payday loan is paid off at the two-week mark, and the borrower has no other debt, the premium paid on the particular item purchased with that borrowed money may be "only" 15-20%. But if the borrower has other loans, as is usually the case, the money spent on servicing the payday loan cannot be used to pay the other loans. In this rather typical scenario, the item purchased has a third tier price tag. The first tier prices the item cost alone, the second tier reflects the immediate cost of the money used to purchase the item based on getting a payday loan (which effectively adds 15-20% up front). The third tier combines item cost, payday loan cost, and the ongoing cost of interest on the money that went to pay fees on the payday loan. The cost of the third tier depends on the type of credit

and the length of the loan. If it is another payday loan, the consumer may soon in effect pay for an item twice, or even worse.

In short, the cost of credit used for the purchase of consumer goods can vary dramatically. Determining whether loans of any particular type are generally beneficial may rest on a complex analysis of the characteristic situations in which a particular type of loan is made, and with an eye toward whether we can reasonably expect the borrower to recognize the full cost of an item at the time a purchasing decision is made.

Analyzing the results of an industry-sponsored research project focused on payday borrowers (“the Georgetown study”), one of the study’s authors observed, “(Payday advance customers) may have difficulty obtaining additional credit from traditional creditors, especially on an unsecured basis. Thus, payday advances give these consumers a little control over their financial situation that they otherwise would not have.” (Elliehausen, p. v) Whether or not this is an accurate portrayal of the payday borrower’s circumstances is precisely the question: does the consumer “gain a little control,” or would it be better described as “losing a little control” to the lender? If a borrower can only receive credit at premium prices, the issue is then whether unsecured credit at such premium prices is generally beneficial. It further raises the question of whether the consumer needs to be restrained for his or her own good.

3. Valuing Loan Transactions In Accordance With Financial Constraints

Placing a proper value on a particular loan transaction is difficult in a number of ways, beginning with the different values that people place on items and experiences. Given the same \$30. budget, one person may prefer to make dinner at home, then go to see a play; a second may prefer to go out to dinner, and then watch television at home, and a third might want to save it for a rainy day.

What is not helpful is when the jargon of “market analysis” is used to “explain” phenomena in such a way as to cast a rationalizing or organizing principle on behavior that defies economic rationality. This puts the analyst in the untenable position of trying to explain non-rational and even irrational behavior in the terms of economic self-interest. For instance, the authors of the Georgetown study write, “Payday advance customers are primarily moderate-income consumers who are often in early stages of the family life cycle. They are more likely to use consumer credit and tend to have higher levels of consumer debt relative to income than the population as a whole. According to previous research, such consumers typically have high rates of return on investments in household goods. Because of the high return on household investment, they have strong demand for credit, which at the margin makes them insensitive to interest rates on loan.” (Elliehausen, p. iv) This gloss on the circumstances of payday customers ignores the reality that that some forms of credit -- notably, high interest loans -- will adversely affect the consumer’s ability to purchase the household goods on which he or she is purported to have such a high return on investment. The so-called “insensitiv[ity] to interest rates” stands in for the reality that consumers are in one of three unhappy situations: 1) they have no idea how much the credit is actually costing them, 2) they have no regard for their economic self-interest, and are borrowing without concern for the long-term consequences, or 3) they simply have no other choice; i.e., that for whatever reason beyond their control, they are on an unsustainable economic path.

The authors of the Georgetown study use an “Analytical Model for Consumer Credit

Use” adapted from Juster and Shay to describe the use of credit for consumer use. “Consumer credit is typically used to finance the purchase of household durable goods, which provide a return in the form of a stream of services over a period of time. The economic value of the stream of services . . . can be measured in terms of the cost of purchasing those services in the market.

“The value of services of a television, for example, could be measured by the cost of going to the cinema, a concert, or other entertainment activities that would be undertaken if television were not available.” (Elliehausen, p. 11)

Using this form of economic analysis, the authors develop several hypotheticals comparing the cost of using a payday loan with the cost of putting off a necessary car repair, making a late payment on a utility bill, etc. As a description of how payday borrowers rationalize decisions in accordance with market theory, it stretches credibility. Data from the survey undercuts the notion that consumers are consciously weighing the dollars and cents of patronizing a payday lender, versus whatever other alternatives may be available. Eighty-five percent of survey respondents cite convenience of the loan process, convenience of the lender’s location, privacy, or the lack of an alternative as the reason for choosing a payday lender. (p.51) Just under four percent said they chose a payday lender because it was less expensive than their alternative. (p. 51) While convenience (69.9%) is not immune to market theory explanation, its economic value is likely to be quite limited for people with relatively low incomes, who tend to have low opportunity costs.

An essential question entirely absent from the Georgetown study’s analysis is whether payday loan customers are valuing loan transactions in a manner that is consistent with their economic constraints. If they are not making decisions consistent with the limits of their resources, then it matters little what “value” they give to those decisions.

It is clear, with 2001 data showing approximately 65 million transactions totaling \$2.4 billion, that American borrowers want payday loans. (PIRG II, P. 4) Under present law in Kansas, it is quite easy to leverage their resources (their next paycheck) to get the payday loan. The issues for policy makers are these: are these transactions beneficial, despite their high costs? Should borrowers be given the opportunity to leverage their resources to borrow money when doing so is not financially beneficial? And are there ways to limit the negative effects of high cost loans, while making them available for those who might benefit?

C. Policy Objectives in Payday Loan Regulation

The following set of objectives summarizes our primary concerns in addressing payday loans:

1. Permit Loan Transactions That Benefit the Consumer

An analysis of payday loan regulation will give attention to whether payday loans serve the overall interests of those who use them, as well as affected third parties. A part of that analysis will assess whether current regulations:

- (a) account for the inequality of the parties’ bargaining power,
- (b) facilitate genuine competition within the market,
- (c) address deficiencies in consumer education,
- (d) require the lender to verify the borrower’s ability to repay according to the terms,
- (e) give adequate protection to defaulting consumers,

- (f) prevent lenders from generating social and economic costs which they fail to absorb,
- (g) provide for reasonable fees and interest rates, and
- (h) prevent payday loans from becoming a frequent or long-term source of credit.

2. Facilitate Deeply Held Societal Values

Much of our public policy is built around shared notions of justice, fairness, and a concern for the common good. We value individual autonomy, but we also recognize the importance of making common decisions based on the welfare of all, including those who have difficulty looking out for their own interests.

Even when there are two willing parties to a contract, the law will sometimes step in to regulate behavior that violates our values. In the context of lenders and borrowers, we have a long tradition of creating regulations which:

- (a) prevent usurious lending, and
- (b) protect those who are unable to protect themselves.

To a large extent, our moral sensibilities are already manifested in the contours of existing regulation. One way to approach the question is to ask whether, based on our current knowledge, we have struck the right balance in ordering our concerns and priorities.

D. Policy Alternatives in Payday Loan Regulation

Kansas policy makers have a wide range of choices if they choose to address payday lending. From looking at the experiences of other states, and from reviewing the relevant research, the following set of alternatives stand out:

1. study the issue further;
2. promote or provide other lending options;
3. improve consumer decisionmaking through
 - (a) enhancing disclosure requirements,
 - (b) allowing buyer's remorse cancellation rights;
4. adjust the regulations governing payday lending practices through
 - (a) requiring determinations of ability to pay,
 - (b) delimiting debt collection tactics,
 - (c) revising allowable fees, rates, and other loan terms,
 - (d) regulating repeat borrowing; or
5. ban payday lending.

E. Identification of Affected Interests

1. Payday Lenders

Unlike most businesses, payday lenders in Kansas are completely dependent on permissive legislation for their existence. Without the 1993 law granting payday lenders exemption from usury laws, they would not be economically viable, at least with their current business model.

To be certain that their interests are given full consideration, payday lenders have been very aggressive in establishing and funding efforts to encourage legislation that serves the

interests of the industry.

2. Consumers Desiring Small Loans

Consumers are also heavily dependent on legislative decisions for many of the contours of the fringe lending market -- from the existence of various products, to the limits on rates, fees, and other loan terms.

State regulation for the benefit of consumers pervades nearly every aspect of banking and money lending. It would be well within the state's provenance to apply whatever level of regulation it views as in the best interests of its population -- whether that is no regulation at all, or a total ban on payday lending.

It is not easy for the state to account fully in legislation for the needs of those who are unable to look out for their own interests. Anecdotal evidence suggests that where there are no regulated short-term loan options, unregulated lenders (the colloquial term is "loan sharks") will fill the vacuum, at rates comparable to those charged by payday lenders. (See Stegman, p. 31)

3. Competitors to Payday Lending

Payday lending is not the only fringe-lending option for those wanting quick cash. For generations, pawn shops filled this role. Though data appears scarce, some press reports suggest that payday lenders have taken much of the business that formerly was given to traditional pawn shops.

4. The Ripple Effect of Payday Lending: Bankruptcy and Its Costs To Third Parties

Chronic payday lending can facilitate economic instability. This in turn exacts economic costs not only on borrowers, but on those who are forced to absorb their losses -- whether through lost rent payments, personal debts, or even bankruptcy. In addition, there are psychological costs that correlate to economic instability, stemming from the social disruption that accompanies forced moves, loss of utility and phone services, etc.

A study by the Illinois Department of Financial Institutions (DFI) observes that the high rates associated with payday loans often prolong the financial difficulty that precipitated the loan in the first place:

What the industry has failed to mention was that the financial strains placed on consumers were rarely short-lived. Customers playing catch-up with their expenses do not have the ability to overcome unexpected financial hardships because their budgets are usually limited. The high expense of a short term loan depletes the customer's ability to catch-up, therefore making the customer 'captive' to the lender. (Illinois DFI, p. 30, cited by K/D, p.9)

This explains why payday loan use is often associated with bankruptcy. In the Northern District of Illinois, 20-25% of bankruptcy filings show "significant payday loan debts." (Dry/Keest, p. 9) Observers in Tennessee note a correlation between heavy concentrations of payday lenders and the state's high bankruptcy rates. Similar connections between payday loans and bankruptcies have been noted in press coverage in various areas of the country. (Dry/Keest, p. 9) According to the industry-sponsored Georgetown study, 15.4% of payday users had filed for bankruptcy in

the preceding five years. “And even though (an Oklahoma survey) cast long-term relationships with triple-digit lenders in terms of ‘satisfied customers,’ it also noted the high number of bankruptcies listing fringe lenders as creditors -- 13,379 in 1994.” (Dry/Keest, p. 9)

When people go bankrupt, and cannot pay rent, utility bills, and personal debts, it creates a wider circle of victims. When borrowers can only temporarily stave off bankruptcy with payday loans, their problems are exacerbated when they finally do go bankrupt. Because the rate of return is so high, the relationship with a payday lender need not last long before the lender’s investment is recouped, even if the borrower subsequently defaults on all of his or her creditors. In these circumstances, use of payday loans feeds the “snowball of negative consequences.” (Drys/Keest, p. 9) However, disproportionately few of the costs are borne by the industry itself; instead, they are dispensed to other businesses and sectors of society.

The Georgetown study contained a piece of unremarked information which has significant social implications. All of the 5,430 people whom the surveyors called had taken out a payday loan in the previous six-month period. When the survey was conducted, nearly one-fourth of those customers -- 23.8% -- could not be reached because their telephone number was no longer valid. While it is impossible to know the full implications of that information, one can hypothesize that for a significant portion of the 23.8%, this correlates to financial trauma. One thinks of a range of possibilities, from mere loss of phone service to loss of a place to live. In any case, it is near-certain that the survey’s results are significantly distorted by prescreening those who are most likely to have suffered the worst effects of payday loan costs.

IV. Analyzing the Policy Alternatives

A. Further Study

Topics to Research

A number of states, including North Carolina, Iowa, Illinois, Indiana, Wisconsin, and New Mexico have collected data and/or undertaken reviews of payday lending. In addition, the payday loan industry has sponsored a study (the Georgetown study) of payday loan borrowers. These have provided valuable information regarding the practices and problems associated with payday lending. However, questions remain unanswered, and further research would be useful.

1) In a survey of states which set maximum rates by statute, 15% of payday lenders quoted prices higher than allowed by state law. (PIRG, p. 13) While some of these lenders may have evaded state limits by affiliating with a national bank, others may have been ignoring applicable regulations. There is no data regarding whether lenders comply with Kansas’ fee and rate structures.

2) There is little information regarding the uses to which payday loan money is put, nor do we have any idea how preventable the circumstances generally are. The Georgetown study asked borrowers the purpose of their last payday loan, dividing responses into four categories:

- a) unplanned expenses (47.2%)
- b) temporary income reduction (18.5%)
- c) planned expenses (11.9%)
- d) other (22.5%)

But without knowing more about the events which actually occurred, and the larger context in

which the financial difficulty arose, this information is nearly meaningless. A thorough study of payday borrowers could answer these questions.

3) Information regarding payday loan customers' alternatives is very thin (the Georgetown study asked customers if they "considered" other alternatives, without asking whether other alternatives were truly available.) It would be useful to know what percentage of payday loan customers could have gotten credit elsewhere. It would also be helpful to know whether customers were aware of any other means for meeting their immediate needs or delaying their obligations, and what those means were.

4) What, if any, sources of credit have payday lenders displaced? At least one press report has linked payday loans to the shuttering of traditional pawns. (Kokomo article) What might be the implications of that change?

5) Do we need to train students and selected other groups in practical financial matters?

a) High schools -- study the feasibility of making appropriate financial education a part of high school education.

b) Welfare to Work participants -- study the appropriate use of financial education to help this economically vulnerable group manage their financial resources.

Effectiveness in Meeting Policy Objectives

While further study will not change anything on the ground, it could be a very useful step in tailoring Kansas law to address problems specific to the state. Because of the dearth of information on borrowers' circumstances and alternatives, much useful research could be done in this area. This would benefit not only Kansas, but the numerous other states who are facing decisions regarding payday lending.

B. Promote Alternatives to the Payday Loan

Kansas may want to work with private banks and credit unions to try to create products which can compete with payday lenders, yet offer reasonable rates. The state could look to models which have already demonstrated their low cost and effectiveness, and work with banks and employers to develop good programs. The state may decide to have no direct role in program implementation. However, if no bank or credit union takes the opportunity on its own, the state may want to consider subsidizing start-up costs for pilot programs.

Effectiveness in Meeting Policy Objectives

To have genuine competition in the market, there must be a range of competing alternatives with comparable products. Arguably, no such variety exists in the small loan market. Banks and credit unions have largely withdrawn from the small loan market, probably a result of widespread access to credit cards. Other small loan sources in the sub-prime market include auto title pawns and traditional pawn shops. Compared to payday loans, they can be similarly expensive and less convenient.

The cost of making a small loan is necessarily more expensive on a percentage basis than a large loan, since transaction costs are likely to be similar no matter the size of the loan. The payday loan industry has argued that this justifies the extreme APRs which payday loans carry. In addition, payday lenders defend high APRs by citing a high risk of default. One analyst of the industry has framed the issue, "(do) fringe lenders genuinely price for risk, or instead create risk

and take advantage of imperfect market conditions?" (Keest and Drysdale, p. 4)

The data is not entirely conclusive on these issues. While transaction costs are undoubtedly high, default rates are quite low. Return on investment in the industry is very high, and the industry is expanding very rapidly.

One could speculate that this indicates significant unmet need for the product, and that when the market is adequately serviced, prices will become more competitive. Some data supports this view: the North Carolina study indicates an inverse relation between an outlet's APR and its profitability; i.e., the lower the APR, the higher its profitability. (Stegman, p.) In North Carolina, APR was generally a function of the length of the loan period. Fees tended to be about the same whether the loan was for a week or a month; therefore, lenders with longer loan periods had lower APRs. It appears that borrowers were doing some shopping, and patronizing lenders who offered longer loan periods.

But how the market will develop is unpredictable. The United States went through a period of widespread access to small loans in the early part of the twentieth century, and one contemporaneous observer described the effect of greater competition and lower prices as follows:

"A time came when there were too many licensed lenders and too many dollars seeking to be lent. Competition so far had been effective only to a very limited extent in reducing the rates of charge. Instead, it took the form of excessive solicitation and overlending. This in turn led to the borrower's delinquency which fostered collection abuses." (Hubachek, *The Development of Regulatory Small Loan Laws, 1941* at 121-22, cited in Drys/Keest p. 661[25])

This suggests that there are risks to the consumer inherent in the economics of high interest small loans which the market cannot be relied on to control. However, if managed properly, the market may also offer some solutions.

In 2001 the North Carolina State Employees Credit Union (NCSECU) decided to offer its customers an alternative to payday loans. (Stegman, p. 29) NCSECU introduced the Salary Advance Loan (SALO) as a renewable line of credit with a maximum loan of \$500. and an APR of 11.75, available only to those with direct deposit. (Nilson, 2000) Each loan is automatically repaid from the next paycheck. SALO has been extremely popular, with over 40,000 loans in the first nine months. The risks are low for the credit union, and the cost is reasonable for its customers. In addition, anecdotal evidence indicates that very few SALO users continue to patronize payday lenders.

Although the program has been a financial success for NCSECU, and has given its participating members a reasonably priced alternative to payday loans, the program has shown the intractability of one problem for some borrowers. Just as rollovers outnumber new loans by a 3:1 margin in the payday loan industry, SALO data has shown similar rates of repeat borrowing. This raises an issue which will be addressed later -- the phenomenon of borrowers who use credit as a financial leash, and control their spending based on how much credit they are given.

Since NCSECU saw SALO as a tool to wean members from payday lenders and give them a chance to regain financial control, they remain concerned about those who continue to use the SALO program on a regular basis. NCSECU has responded with help for repeat

borrowers, offering debt management services and telephone-based financial counseling.

Although not every lender can duplicate NCSECU's efficiency, some are finding ways to challenge the payday lenders' claims that their high costs are necessary. A Florida credit union has taken steps to offer products similar to payday loans, and it expects to begin lending with APRs ranging from 20% to 45%. (Drys./Keest [26])

It is useful to remember that most payday borrowers have a relatively secure source of income; otherwise, they would not have the "payday" that provides security for their loan. With the help of modern practices such as electronic direct deposit, it should not be so very difficult for more traditional banking and credit sources to come up with ways of turning that security into a lower-cost credit alternative.

It is difficult to gauge how cost-effective state efforts might be in this area. An inability to generate any unsubsidized private initiatives would suggest that the state's costs could be quite high. On the other hand, if the state's work with the private sector leads to successful expansion into the payday loan market, and high-cost loans are displaced in substantial numbers by reasonably priced products, one could project a high yield -- in terms of social and economic stability -- for a minimal state investment. One would expect it to be especially cost-effective in high-use urban areas.

C. Improve Consumer Decisionmaking

The state can take steps to enhance the borrower's ability to make sound financial decisions. Once the borrower has made inquiries or has begun negotiating with a lender, the state can still help the borrower by requiring the lender to disclose certain useful information in a clear, accessible way. This suggests two aspects of disclosure requirements: the means of disclosure, and the contents of disclosure.

To make comparison shopping easier, the state could require use of a state-designed disclosure form. This form would include standardized terms, beginning with the TILA-required APR information, and any other contents which the state would choose to require. These further requirements could include warnings about the effects of high-cost credit, and alternatives which a customer may want to pursue. For instance, the customer may benefit from knowing about area services for the temporarily displaced or unemployed; likewise, they may be unaware that some utility companies have programs to assist those who can demonstrate eligibility.

Further options for disclosure requirements come from the Office of the Comptroller of the Currency (OCC). In 2000, the OCC issued an advisory letter to CEOs, department and division heads, and other relevant personnel of national banks "to ensure that any national bank that engages in payday lending does so in a safe and sound manner and does not engage in abusive practices that would increase the compliance, legal, and reputation risks associated with payday lending and could harm the bank's customers." (Miller, p. 140) The OCC advisory suggests that banks (and any associated third-party vendors) supply, in addition to the required TILA disclosures, a written disclosure form, given to the borrower before the loan is made, which informs him or her:

- “--of all loan terms and fees (including any applicable ATM fees) associated with the loan;
- of the risks and potential problems of short-term borrowings and the

consequences of abuse;

--that alternative forms of short-term credit exist that might be less expensive and more suitable and advantageous to the borrower; and

--of the full cost of a hypothetical transaction that involves multiple renewals in accordance with these criteria, and the possible consequences of allowing the check to bounce, including the imposition of fees for insufficient funds from the borrower's own bank and the payday lender, and the loss of checking account privileges, if applicable.

"Such disclosures should be reasonably understandable and designed to call attention to the nature and significance of the information." (Miller, p. 145)

Finally, the state might want to help borrowers avoid bad decisions by creating buyer's remorse cancellation rights for a brief time following the making of a loan. For example, the state could require payday lenders to grant borrowers a full refund of fees and interest if they return the loan amount within one or two days.

Effectiveness in Meeting Policy Objectives

The argument for allowing interest-bearing loans relies on certain presumptions about the context in which those loans are generated. Jeremy Bentham's influential 1787 paper on usury helped lay the groundwork for modern market understandings of the role of borrowed money in economic development. (Morris, 1988, p. 156[3].) Bentham wrote:

No man of ripe years and sound mind, acting freely, and with his eyes open, ought to be hindered, with a view to his advantage, from making such a bargain, in the way of obtaining money, as he thinks fit: nor (what is a necessary consequence) anybody hindered from supplying him, upon any terms he thinks proper to accede to. (Morris, 156, citing Bentham, *Defense of Usury*, in 3 *The Works of Jeremy Bentham* 3-29, ed. J. Bowring, 1962)

As Morris observes, Bentham's theory assumes "an idealized bargaining dialogue between borrower and lender . . . presum[ing] equal aptitude, intelligence, information, and vigor To the extent that these presumptions about borrowers and lenders and their interaction are untrue, the unregulated market is not 'free' and does not yield the results postulated by free market theorists" (Morris p. 156)

Whether a particular segment of the market functions to the advantage of all parties indicates whether the market is working properly. When consumers in one segment of the market consistently fail to make decisions which serve their own economic interests, then we can say either that the market is failing, or that market theory is inapplicable to that segment of the market.

We can be fairly certain that the market cannot be effective if market actors cannot make meaningful cost comparisons. Although payday borrowers are generally aware of the cost in dollars of an individual transaction, they are rarely aware of the how the cost compares to other consumer credit. (See Elliehausen, p. 49) According to the Georgetown study, 78% of payday borrowers recalled receiving APR information, but of that number, only 20.1% could report an

APR. Of this 20.1% reporting, a full 40.8% believed that their APR was under 30%. Another 15.8% believed their APR was less than 200%. Since these numbers are well below actual market APRs, they indicate borrower misunderstanding. The data therefore indicates that less than one in ten understand the cost of a payday loan relative to other forms of credit. This is particularly surprising since over half of those taking out payday loans own credit cards, and of those with credit cards, about three in four report a credit card APR that is within the market range, and therefore presumably accurate. (Elliehausen, p. 42)

Expanding disclosure requirements may help customers make useful and accurate comparisons between the costs of a payday loan and other alternatives. One survey of payday lenders found that only 32% of outlets disclosed a relatively accurate APR. (PIRG, p. 14) “Of stores that failed to post an APR in (their) materials, only 21% of clerks verbally disclosed an APR upon the customer’s request.” PIRG p. 14

Disclosure might also give needed information to some percentage of borrowers who are unaware of the risks of high-cost credit, and of other options for meeting their immediate needs. Inexperienced borrowers who have just begun using consumer credit might benefit the most from disclosure requirements, since they seem least likely to be aware of the information which disclosures would provide.

The buyer’s remorse cancellation right would eliminate the worst cases of interest-rate abuse, such as the one-day loan at over 7000% interest cited in an Indiana study. Community Financial Services Association of America (CFSA), a payday loan industry trade group, publishes a list of “Best Practices” for its members. Included is a borrower’s right of rescission until the close of business the next business day. The 2000 OCC advisory letter to bank leaders also suggests a one-day right of rescission.

It is very difficult to determine the degree to which borrowers’ decisionmaking would be improved if these steps were taken. While there is ample evidence that borrowers do not understand the cost of payday loans relative to other forms of credit, there is also evidence that the decision to borrow from a payday lender is driven primarily by non-economic factors, such as convenience.

The cost to the state of implementing changes in disclosure requirements and requiring a one-day right of rescission would be minimal. Some small cost might be incurred if the state were to design a disclosure form.

D. Regulate Payday Lender Practices and Loan Terms

Kansas currently regulates fees and interest rates, and some other aspects of payday loans. It might choose to revise regulations to address problems that have come to light in states that have studied payday loan practices.

1. Debt Collection and Dispute Issues

The state may want to reform or standardize the process through which lenders recover on defaulting borrowers. Among the issues that have arisen are:

a) Mandatory arbitration clauses which require the borrower to pay arbitration costs, regardless of who is at fault.

b) Unconscionable collection activities. The State of Indiana’s Summary of its study of payday lending listed a number of “[a]ctivities the Licensees engage in that may be considered

unconscionable” and included the following:

- (1) Request judge issue bench warrants for failure to appear when pursuing judgment.
 - (2) Implying the police will arrest delinquent customers.
 - (3) Licensees do not pay much attention to the note itself. Should legal action become necessary they go to court on the basis of the bad check, not the note.
 - (4) Collection of treble damages (possible under some NSF penalties).
- (IN Dpt of Fin. Inst., p. 1)

The remedy for the mandatory arbitration clauses does not require banning their use; it would only require a fair apportioning of costs. For example, the law might be revised to require the party at fault to pay the cost of arbitration.

Possible remedies for oppressive collection tactics include:

- a) banning collection actions based on checks returned for NSF,
- b) banning payday lenders from collecting fees for checks returned for NSF,
- c) require that lenders post notices informing customers that they cannot be criminally prosecuted for having a check returned NSF or defaulting on a loan.

Effectiveness in Meeting Policy Objectives

Taking action in this area might be compared to treating the symptoms of a disease -- it does not cure the underlying problem, but it alleviates some of the worst side effects. It would bring payday lending collection efforts in line with other creditors. Under current law, some of payday lenders’ coercive tactics, which are banned in the context of other debt, can occur because a check returned for NSF is always an element of a payday loan default.

Some payday lenders reject these oppressive tactics. The CFSA’s “Best Practices” call for lenders to refrain from threatening or pursuing criminal action due to a returned check or a loan default. On the other hand, payday lenders in one Dallas precinct filed 13,000 criminal charges against defaulting customers. (Drys./Keest, p. 9)

Kentucky recently addressed the issue by passing a statute requiring that lenders post notices informing customers that they cannot be criminally prosecuted for giving a check which is returned NSF. (Ky. Rev. Stat. Ann 368.100(18), cited by Drys/Keest, p. 611-12 [10].

Regulation in this area may induce payday lenders to take more responsibility for avoiding loans to those who are high risks for defaulting. By reducing lenders’ ability to rely on bad check laws, they have a stronger incentive to make sure that their recovery will be within the normal terms of the loan agreement, rather than through bounced check fees.

One characteristic distinguishing modern society from previous centuries is our decriminalizing of debtors. While debtors may carry civil liability, they are not (absent fraud) subject to criminal prosecution.

By using bad check laws to prosecute borrowers who were simply unable to pay their loan, payday lenders have obscured the categorical distinction. Changing the law to reflect the circumstances of the person using a post-dated check to make a loan would help restore some civility and fairness to the process, and would result in the borrower being treated similarly to other borrowers who are unable to meet their obligations.

Regulating and restraining aggressive collection procedures would also help restore a legitimate distinction between “loan sharks” and payday lenders. Anecdotal evidence suggests that the cost of illegal credit through loan sharks is similar to the cost of payday lenders -- 20% for two weeks, according to one “street” source. However, loan sharks have characteristically earned their moniker because of their onerous collection practices. The industry would benefit from avoiding collection behavior which many view as unconscionable.

The state would have little cost associated with implementing restrictions on collection practices. In fact, because incentives would be higher for payday lenders to do adequate background checks, the cost to the state might diminish as a result of lenders’ reduced use of courts for judgments on defaulting borrowers.

2. Evidence of Ability to Repay Loan

To prevent defaults, as well as problems associated with repeat borrowing, the state may want to require lenders to do sufficient backgrounding on borrowers to be certain that the loan can be paid according to its terms.

Effectiveness in Meeting Policy Objectives

This requirement would work against the convenience which is touted by lenders and valued by payday loan customers. Yet it may not be possible to lend responsibly without it.

With most types of credit, the lender will go to considerable effort to determine whether the borrower is a good credit risk. Those who have shopped houses and mortgages have likely discovered that lenders have income-based formulas for determining how much a person “should” spend for a house payment. The limits to borrowing are thus imposed by the market, based on what the borrower can spend while maintaining a high probability that the borrower will repay his or her loan according to its terms.

No such concern for the borrower’s long-term financial well-being exists in the payday loan industry. Payday lenders usually require proof of a job and a valid checking account -- just enough to make sure that the borrower is a low risk when the loan comes due a week or two later. Payday lending depends on a model of high returns on a short-term relationship. Thus while the market covers its own risk, it fails to address the sustainability of the borrower’s financial patterns.

The borrower who relies on the market to tell him or her what he or she can afford will find that, insofar as they rely on payday lenders, that faith is misplaced. This raises the question of whether the consumer needs to be restrained for his or her own good.

The OCC advisory letter regarding payday lending noted, “As with all lending, a bank should not make a payday loan without a reasonable assurance that the loan will be repaid at maturity. At a minimum, such assurance must entail analysis of information about the borrower’s continued employment or other recurrent source of income, or the borrower’s reasonable expectation that additional income or other deposit will be received on a date certain and that such income or deposit will retire the loan.”

“[Renewals] indicate a loan has been made without a reasonable expectation of repayment at maturity.” Miller, 144-45 [17]

Considering the number of loans which constitute renewals, a requirement that genuinely assesses the ability of the borrower to pay according to the terms of the loan could substantially

diminish the number of renewals. However, it is difficult to see how the state would enforce such a requirement. Unless the state heavily interjected itself in creating loan approval standards, such a requirement appears much more difficult and expensive to enforce than, e.g., a blanket ban on renewals.

3. Regulation of Fees, Interest Rates, and Loan Terms

Kansas has a variety of options if it chooses to revise the regulations regarding fees, interest rates, and loan terms:

1) Kansas could choose to remove the special statutory status of payday lenders. This would likely make the business unprofitable, since payday lenders depend on the statutory safe harbor to exceed the otherwise applicable usury limits.

2) Kansas could change the fees and interest rates. Since the maximum rates are set by the statute, the state could change them if it determines there is a more equitable fee structure. This might include changing allowable fees for successive loans within a set time period (see section on repeat borrowing).

3) Kansas could lengthen the minimum loan term (see section on repeat borrowing).

4) Kansas could require lenders to structure repayment periods according to the size of loan. For instance, the law could require that any loan over \$100. would need to be repaid in a minimum of two pay periods lasting at least a month, and every additional \$100. would extend the loan period by a month.

This option recognizes the difficulty that many lenders have in repaying a loan in a single pay period. The prevalence of repeat borrowing suggests that loan terms often fail to account for borrowers' ongoing expenses, and ignore actual ability to meet the terms of the loan.

5) Kansas may want to ensure that its laws are being followed through adequate enforcement remedies. These could include civil penalties such as loan forfeiture, and criminal penalties such as fines and imprisonment for purposeful violation of the law. (see Model Law)

6) Kansas may want to ban "loan arrangers" from participating with banks to import fees and interest rates which in the absence of federal preemption would violate state law.

Effectiveness in Meeting Policy Objectives -- The Problem of Interest Rate Importation

The high fees and interest rates associated with payday loans remain perhaps their most controversial characteristic. In Kansas, the state is directly implicated in the industry's high fees, because it is one of twenty-four states (plus the District of Columbia) which grant payday lenders special exemptions from consumer credit laws and usury caps, and instead put in place a "maximum allowable" fee structure. Compared to other states which allow payday loans, Kansas' maximum fees and rates are toward the low end of the scale, with an APR of 390% on a \$100. loan. (The PIRG survey uses a \$100. loan for purposes of comparison.)

But even if Kansas chooses to change its fee structure and interest rate caps, another issue looms. Because the National Banking Act allows interest rate importation by national banks, payday lenders across the country have been forging relationships with banks to avoid the fee and interest rate caps which many states impose. For example, Virginia has a usury cap of 36% APR, but payday lenders nevertheless operate with impunity by importing bank rates from the home state of a "partnering" bank. (PIRG, p. 17)

It is unclear whether the NBA truly supports this construal of the law. The OCC and the

Office of Thrift Supervision (OTS) have warned payday lenders that they “should not assume that the benefits of a bank charter, particularly with respect to the application of state and local law, would be available to them.” (OCC letter) But the questionable legal status of the practice has not put a stop to it. Except where states have directly addressed the issue through targeted state laws making loan “facilitators,” or “loan arrangers” subject to the law, lenders have continued to operate unhindered by state statutory limits. Predictably, payday lenders throughout the country affiliate with banks chartered in states without usury caps, or with very generous safe harbor laws for payday lenders, and effectively bypass many of the states’ efforts to protect their citizens.

Current Kansas law does not apply to those who “facilitate” loans for affiliated banks. Thus, payday lenders in Kansas can ignore the current Kansas law regulating fee and interest rate structures -- the Kansas’ payday loan statute -- by affiliating with national banks.

While Kansas cannot ban the importation of interest rates by banks, it is unclear whether the state can ban loan “facilitators” from assisting national banks in their efforts to import fee and interest rates. The state can probably ban payday lenders from participating with banks to ignore consumer protection laws.

Some states have already taken measures to plug this loophole. In 2000, Colorado passed a law applying their payday loan law to “loan arrangers,” but they explicitly exempted its application to fees and interest rates. (PIRG II, p. 23) Last year, Maryland “prohibited companies from brokering unsecured closed-end loans that violate Maryland’s 33% APR small loan cap.” (PIRG II, p. 23) Massachusetts included a similar provision in its Small Loan Act, which set usury limits and capped fees. The law applies to both banks and brokers, and was designed specifically to prevent interest and fee importation by non-bank entities. (PIRG II, p. 22)

Regardless of the regulatory choices that Kansas makes in this area, it does not appear that implementation or enforcement costs will deviate substantially from current levels. One possible exception is if Kansas would eliminate the safe harbor statute, and payday lenders would no longer be able to afford to make small loans within the usury cap. Assuming no payday lenders could survive financially, there would be no lenders to regulate.

4. Regulate Repeat Borrowing

Kansas has a number of alternatives if it wishes to address the problem of repeat borrowing and chronic use. The state could:

1. allow renewals, but with “soft” verification requirements -- e.g., the borrower would need to certify the inability to pay, the reason for the change in circumstances from the time the original loan was made, and the basis for a current expectation of timely repayment.
2. set the minimum loan term at 31 days.
3. require a 30- or 60-day respite between loans.
4. prohibit borrowers from carrying more than one payday loan at a time.
5. reduce fees for any second loan within a set period of time.
6. extend regulations to non-national bank entities, to prevent flouting of otherwise applicable state law through importation.
7. limit renewals to one or two, or ban them within a set period of time.
8. apply borrower’s renewal limitations to all lenders, and make each lender responsible

for abiding by the limits.

Effectiveness in Meeting Policy Objectives

No aspect of payday lending deserves closer scrutiny than the issue of chronic borrowing. This usually occurs through rollovers -- the renewal of an existing loan by merely paying the fee, and leaving the principal as an ongoing loan. Repeat borrowing is particularly pernicious because the fees are just as pricey the second and third time around, even though the rationale for the high fees and rates -- that payday lending is for rare, emergency use -- no longer holds. The on-going costs of high fees and APRs at 300-600% create a dire risk to the borrower. Numerous cases have come to light in which borrowers get caught in a cycle of debt, and end up renewing every two weeks, or going from lender to lender, without ever managing to pay down the principal.

For some people, credit can have an addictive element, where the only limit is available credit. Others may simply view available credit as an indication of how much they can spend, where available credit serves as the leash on spending. In the Georgetown study, sixty-one percent of payday borrowers who had a credit card refrained from using it in the year prior to the survey date because their credit limit would have been exceeded. (Elliehausen, p. 44) As already noted, NCSECU had a similar problem with many of its SALO users. Even though the product was moderately priced, many customers found it difficult to avoid taking out a new loan each pay period. (p. 29 Stegman)

Another indication of its addictive character comes from the North Carolina study. A modest number of current welfare recipients -- only 10% -- have taken out a payday loan in the last eighteen months. But of those 10%, 40% have become chronic users, averaging at least one loan a month over the last two years. (Stegman, p. 12)

Some states have attempted to regulate repeat borrowing by limiting the number of rollovers. But rollover limits are easily circumvented with a practice called "touch and go," in which the old loan is paid off with cash, and a "new" loan is made on the spot. Several studies have indicated that rollover rates are not lower in states which purport to limit them. This suggests that the laws have not been effective. Even if present law prevented rollovers, that alone would not solve the problem, since a borrower may take out loans from more than one lender at a time. Borrowers can simply borrow from a second lender to pay off the first.

The Indiana DFI study reported that 77.2% of borrowers renewed loans, and the average number of renewals per customer was 10.1. (IN DFI Summary) Wisconsin's DFI reported that 53% of loans were rolled over. Of the 321 borrowers analyzed for the Wisconsin report, 87 took out 1-5 loans, and 82 took out 6-10. One hundred borrowers took out between 11 and 19 loans, and 52 took out more than 20 loans. With an average loan time of two weeks, it appears that 152 of 321 borrowers carried a payday loan for at least five months out of the year. The Illinois DFI found an average of 13 loans per customer. (Drys/Keest, p. 9) The North Carolina study showed that "38 percent of all customers took out between one and three loans in 2000, and accounted for 12 percent of total payday lending revenues. In contrast, 18 percent of all borrowers took out a new loan or rolled over an existing loan at least once a month throughout the whole year, and they generated 40 percent of all gross payday loan fees." (Skillern 2002, cited in Stegman, p. 22)

The pattern is consistent throughout the various studies: although many borrowers take

out relatively few loans, a substantial percentage of borrowers get caught in repeat borrowing, and have difficulty extricating themselves. The Georgetown study, which has substantially lower renewal numbers than the state studies (probably due to the prescreening inherent to the methodology, as previously described), nevertheless shows that 19.8% of borrowers renewed at least nine times in the course of the previous year.

We can do an estimate using typical numbers to see the effect on the repeat borrower. We will assume that the borrower is at the low end of the 19.8%, with only nine renewals:

- one original loan plus nine renewals
- original loan of \$250., at a cost of \$16. per hundred (both are near industry average)
- fees for original loan and renewals: $\$40. \times 10 = \$400.$

The borrower has spent \$400. to borrow \$250. for 20 weeks, without reducing the \$250. loan principal. It is not merely the rare “one-in-a-hundred” borrower who faces this dilemma. According to the Georgetown study’s conservative figures, nearly one in five payday borrowers will be in worse financial condition than this hypothetical borrower.

The OCC advisory letter previously cited states: “Multiple renewals -- particularly renewals without a reduction in the principal balance, and renewals in which interest and fees are added to the principal balance, are an indication that a loan has been made without a reasonable expectation of repayment at maturity.” Miller, p. 145 [17]

Following are the various policy alternatives, each with an analysis of its strengths and weaknesses:

1. allow renewals, but with “soft” verification requirements -- e.g., the borrower would need to certify the inability to pay, the reason for the change in circumstances from the time the original loan was made, and the basis for a current expectation of timely repayment.

--this proposal emphasizes the borrowers’ responsibility, and serves mostly as a “teaching” exercise. There is little reason to think it would reduce the incidence of repeat borrowing, since it has no teeth.

2. set the minimum loan term at 31 days.

--Among the primary reasons postulated for rollovers is that loan terms are too short (generally two weeks) to allow a realistic chance of recovery from a temporary setback. Another factor is that loans will sometimes come due before the next paycheck. A 31-day minimum addresses both of these issues.

3. require a 30- or 60-day respite between loans.

--This would insure that payday loans would be used to address a particular shortfall, and would prevent them from turning into long-term lending.

4. limit renewals to one or two, or ban them within a set period of time. In addition, limit patronage to one lender at a time.

--Without some way of preventing multiple loans from different lenders, all the other safeguards are meaningless.

5. reduce fees for any second loan within a set period of time.

--As short-term lending becomes longer-term, the price should go down.

6. extend regulations to non-national bank entities, to prevent flouting of otherwise applicable state law through importation.

--As many states have already discovered, state regulation is only partially effective unless the issue of payday outlets “piggybacking” on banks chartered in states with favorable laws is addressed. As previously observed, this can be done by making the payday lending statute applicable to “loan arrangers” and the like.

7. apply borrower’s renewal limitations to all lenders, and make each lender responsible for abiding by the limits.

--This prevents the borrower from walking across the street to make a loan which he or she is barred from making with the initial lender.

Kansas may want to employ an effective means of enforcing limits on repeat borrowing. Simple rollover limits have been ineffective in other states, so Kansas may want to pursue other options.

The authors of a North Carolina study have suggested that borrowers be required to sign an oath stating they do not have other payday loans; however, they also suggest looking into means which are less reliant on good-faith.

“To help enforce the customer ban against multiple loans outstanding from more than one lender, (regulatory agencies) should look into how existing credit reporting technology might be adapted for regulatory purposes . . . many payday lenders already incorporate this tracking technology into their risk management systems, and (regulatory agencies) could require all licensed companies to report all payday loans to a specified reporting agency. Then, once the state decided . . . the minimum time that must elapse before an individual is eligible to take out another payday loan, from the same or different lender, tracking technology could be used as an enforcement tool.” (Stegman, p. 32)

Some lenders already use a subscription screening device which determines whether a would-be borrower is currently borrowing money from another payday company. (Stegman, p. 22) Requiring lenders to access a common database appears to be a reasonable requirement to avoid multiple outlets lending to a single customer.

The cost of regulation and enforcement for each of these proposals appears to be in line with current regulatory costs. However, costs could rise if the state required each lender to maintain current reporting to a state agency.

Compliance with regulations designed to limit renewals will be costly to the payday lending industry. The business model of the industry relies disproportionately on the chronic user for income, and any success at weaning the chronic user will reduce lenders’ incomes. In addition, any verification requirements which would rely on database access or a subscription service will add some cost to those who are not already using similar services.

E. Total Ban

Kansas could place a per se ban on payday loans.

Effectiveness in Meeting Policy Objectives

It is difficult to see what would be gained by a per se ban. No incentive would remain for competitors to develop a reasonably priced alternative, comparable to the program developed by

NCSECU.

On the other hand, simply abolishing the safe harbor statute which allows payday lenders to ignore the otherwise applicable usury cap would leave market incentives intact. North Carolina pointedly illustrates the difference between a total ban and removing the industry's safe harbor. In 2001, North Carolina let the sunset provision on its payday lender safe harbor statute go into effect. While state-chartered payday lenders were no longer able to charge their typical fees, the NCSECU program, offering payday loans at 11.75 APR, continued unabated.

Legal Analysis

A. Legal Implementation of Policy Alternatives

1. Further Study

If the Legislature initiates further study of payday lending, it will need to designate appropriate parties and provide funding. In Illinois, for example, the state Department of Financial Institutions (DFI), which regulates payday lenders, carried out and summarized research on payday lenders and borrowers in the state. A similar study in Wisconsin was carried out by Wisconsin DFI, using information assembled by the state's Division of Banking, the regulatory agency responsible for payday lending oversight. The studies gave primary attention to lending/borrowing patterns, but also included some information summarizing borrower demographics.

The Office of the State Bank Commissioner (OSBC) is Kansas' organ for regulating state chartered financial institutions, including payday lenders. The OSBC is headed by a Governor-appointed Commissioner. A Deputy Commissioner and seven field examiners are dedicated to monitoring Consumer and Mortgage Lending for the entire state. In addition, the OSBC's Division of Consumer and Mortgage Lending has personnel dedicated to Education and Communications. The OSBC would be uniquely situated to develop information which could address questions such as lenders' compliance with Kansas' payday regulations, and changes in the institutions engaged in sub-prime lending.

Questions regarding the payday borrower might be assigned to an independent research firm, or to university researchers. For example, the North Carolina study of payday lending was assembled by two professors at the University of North Carolina. Questions regarding the borrowers' overall circumstances, and their alternatives to payday lending might be addressed in this way.

Questions regarding the financial education of high school students could be addressed to the state Board of Education?, while the question of appropriate financial education of welfare recipients could be addressed by ...?

2. Promote Alternatives to the Payday Loan

The State Bank Commissioner, or a designated representative (possibly including the OSBC's field examiners) seems especially well-suited to serve as a state ambassador to financial institutions, in an attempt to enlist their commitment to pursuing reasonably priced alternatives to the payday loan. If the legislature wanted to take a more aggressive stance, it could hire a company to provide consultants or financial analysts to work with banks. It might wish to

designate someone such as the governor or the State Bank Commissioner to make the proper appointments.

3. Improve Consumer Decisionmaking
4. Regulate Payday Lender Practices and Loan Terms

The Kansas Uniform Consumer Credit Code, or U3C, regulates consumer credit for the state of Kansas, in K.S.A. 16a-1-101 through 16a-9-102. Within the U3C, Kansas has a statute solely dedicated to regulating payday loans -- K.S.A. 16a-2-404.

If the policy alternatives in sections #3 (consumer decisionmaking) and #4 (regulation of payday lender practices and loan terms) are pursued, the changes will be reflected in K.S.A. 16a-2-404. These include:

- (a) enhancing disclosure requirements,
- (b) allowing buyer's remorse cancellation rights;
- (a) requiring determinations of ability to pay,
- (b) delimiting debt collection tactics, and
- (c) revising allowable fees, rates, and other loan terms.

The laws of other states, and "model" laws constructed by industry trade groups (e.g., CFSA) and consumer protection organizations (e.g., NCLC) offer examples for Kansas, if it chooses to enact policy alternatives into law. The Colorado U3C provides an example of a disclosure provision intended to enhance consumer understanding. Colorado's "Deferred Deposit Loan Act," § 5-3.1-104, contains the following:

§ 5-3.1-104. Notice to consumers. A lender shall provide the following notice in a prominent place on each loan agreement in at least ten-point type:

“A DEFERRED DEPOSIT LOAN IS NOT INTENDED TO MEET
LONG-TERM FINANCIAL NEEDS.

A DEFERRED DEPOSIT LOAN SHOULD BE USED ONLY TO MEET
SHORT-TERM CASH NEEDS.

RENEWING THE DEFERRED DEPOSIT LOAN RATHER THAN
PAYING THE DEBT INFULL WILL REQUIRE ADDITIONAL FINANCE
CHARGES.”

The Colorado U3C also provides an example of a Buyer's Remorse Cancellation Right:

§ 5-3.1-106. Maximum loan amount -- right to rescind. (1) A lender shall not lend an amount greater than five hundred dollars (2) A consumer shall have the right to rescind the deferred deposit loan on or before 5 p.m. the next business day following the loan transaction.

Colorado also offers an example of a restriction on the practices of payday lending. In this case, the statute limits payday loan renewals:

§ 5-3.1-108. Renewal. (1) A deferred deposit loan shall not be renewed more than once.

5. Total Ban

Enactment could be accomplished by replacing K.S.A. 16a-2-404 with a statute prohibiting the making of payday loans.

B. Ongoing Regulation and Regulatory Costs

Any regulation stemming from a change in the payday loan statute, aside from a total ban, would be carried out by the OSBC, under already existing authority.

Because of fees and statutory assessments on the institutions it regulates, the OSBC is entirely self-supporting. The cost of regulating payday lenders is not likely to be significantly affected by any of the proposed policy alternatives. If a minor change is anticipated, it could be accounted for by making an appropriate adjustment to the statutory assessment, in the same legislation which adopts a change in the payday loan statute. Under any circumstances, it is not foreseeable that taxpayers would be responsible for any part of the cost of regulation.

C. Possible Limitations On State Law

1. Federal Preemption

The National Banking Act allows banks to “import” the fees and interest rates of their home state into any other state in which they choose to do business. However, the degree to which this preempts state regulation of payday lenders remains unclear.

As already noted, several states have recently addressed the importation problem by making those who arrange or facilitate loans subject to all the consumer protections which are afforded customers of banks chartered in-state. Colorado’s “Deferred Deposit Loan Act,” § 5-3.1-102 (5) contains the following definitions:

(5) (a) “Lender” means any person who offers or makes a deferred deposit loan, who arranges a deferred deposit loan for a third party, or who acts as an agent for a third party, regardless of whether the third party is exempt from licensing under this article or whether approval, acceptance, or ratification by the third party is necessary to create a legal obligation for the third party.

(b) Lender includes, but is not limited to, a supervised financial organization as defined in section 5-1-301 (45).

(c) Notwithstanding that a bank, saving and loan association, credit union, or supervised lender may be exempted by federal law from this code’s interest rate, finance charges, and licensure provisions, all other applicable provisions of this code apply to both a deferred deposit loan and a deferred deposit lender.

The Colorado law specifically recognizes federal exemption from the state code’s interest rate caps and licensure provisions. Therefore, when Colorado sought to enforce its consumer protection laws applicable to “loan arrangers” in a recent action, it did not challenge the loan arranger’s use of an imported interest rate. It only challenged the payday outlet’s practices which violated the state law limiting renewals. *See Colorado ex rel. Salazar v. ACE Cash*

Express, 188 F.Supp.2d 1282 (2002).

No state can prevent a national bank or its subsidiary from using its home state interest rates in any program which it administers. The participation of loan “facilitators” muddies the waters. Can they be required to avoid participation in any loan which exceeds state interest rate caps, or are they protected by their affiliation with a national bank, and the preemptive reach of the NBA? Are they still subject to consumer protection laws, even if usury caps are preempted?

Legal action has largely been at the state level. Until enough cases work their way through state courts, the scope of state regulation of “loan arrangers” will remain unclear.

2. Federal Legislation

Some Senators and Congressmen have expressed concern about payday lending, focusing primarily on the use of the National Banking Act to circumvent state regulation. However, there is no indication that interest in the issue is widespread enough that movement on the issue is foreseeable.

3. Constitutional Concerns

It is highly unlikely that regulation of payday lending could run afoul Constitutional snags, whether based on equal protection, due process, or regulatory takings objections. The courts have given broad deference to legislative efforts to protect consumers by regulating economic transactions.

All of the proposed policy alternatives appear rationally related to consumer protection, thus meeting the requirements of the Rational Basis Test, which the Supreme Court has articulated as the relevant standard for economic regulation.

VI. BIBLIOGRAPY

U.S. Senate, Forum on Payday Lending, Sen. Joseph Lieberman [Comm. On Governmental Affairs], (December 15, 1999).

Drysdale, Lynn and Kathleen Keest, The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and its Challenge to Current Thinking About the Socio-Economic Role of Usury Laws in Today's Society, 51 So. Car. L. Rev. 589 (2000)

Fox, Jean Ann, States Grant a Safe Harbor for Usury: Recent Developments in Payday Lending, (Consumer Federation of America, Sept., 1999)[<http://www.consumerfed.org/publist.html>].

Immergluck, Daniel and Marti Wiles, Unregulated Payday Lending Pulls Vulnerable Consumers into Spiraling Debt, REINVESTMENT ALERT # 14 (Woodstock Institute, March 2000).

18 NCLC REPORTS Consumer Credit & Usury Ed. 9 (November/December 1999), "Spotlight: Payday Lending"

Public Interest Research Groups and Consumer Federation of America, Show Me the Money! A Survey of Payday Lenders and Review of Payday Lender Lobbying in State Legislatures, (February, 2000) [<http://www.pirg.org/reports/consumer/payday/index.html>]

Schmedemann, Deborah A., Time and Money: One State's Regulation of Check- Based Loans, 27 Wm. Mitchell L. Rev. 973 (2000)

Payday loan arrangers have tried to claim that state law is preempted by national banking law, and that by their affiliation national banks, they become exempt. When the state of North Carolina tried to enforce its consumer protection laws against payday lender/arranger ACE Cash Express (ACE), ACE and its national bank affiliate, Goleta National Bank, filed suit in Federal Court. They argued that federal banking law preempted North Carolina's attempts to regulate them. In May 2002, North Carolina's motion to dismiss was granted, leaving the ongoing state action intact. The Court rejected ACE's claim that its federal preemption argument merited federal jurisdiction through the National Banking Act, saying it was "far from being either facially conclusive or readily apparent." *Goleta National Bank v. Lingerfelt*, 211 F. Supp.2d 711, 717 (2002)

In another 2002 case, a federal court in Colorado directly rejected a similar argument in a case also involving ACE Cash Express. When ACE ignored Colorado's statutory change making "loan arrangers" subject to Colorado's payday loan law, the state filed suit against it. ACE sought removal to federal court, claiming federal preemption from state consumer protection laws, including the state's attempt to limit rollovers. Again, ACE's claim rested on its affiliation with Goleta National Bank. In remanding the case back to state court, the District Court held that ACE is not a national bank, nor does its relationship with Goleta invoke preemption law, stating, "(t)he Complaint *strictly* is about a non-bank's violation of *state* law." *Colorado ex rel. Salazar*, 188 F.Supp.2d 1282, 1285)

Neither of these cases

Thus it appears that Kansas may have a viable avenue for addressing the issue of importation. The laws of Colorado or Maryland appear to have successfully extended state regulation to payday lenders/arrangers affiliated with national banks.

Judging from the experience of other states, Kansas will need to address the issue of importation, if it wishes to see its statutory limits respected.

(ACE Cash Express's response was to claim their loans were secured; they began to ask customers to name some consumer item they owned as collateral -- an act which in turn violates Maryland's Consumer Loan Law.) In Colorado, ACE has gone to court to try to claim

The whole federal charter issue

--current interpretations, Mass?

--avoiding the issue by making sure legislation applies to outlets, (see NCLC model law)

What are barriers to change?

--Ideological -- idea that it would interfere with the market.

-- it is a govt made market; it is up to the govt to take responsibility for it.

, most policy alternatives, if chosen for implementation, would require revision or revocation of the statute. Maryland, Massachusetts, and Colorado have all enacted legislation to extend consumer protections to all The National Consumer Law Center has constructed a "Model Deferred Deposit Loan Act." which offers a