

## PAYDAY LOANS: THE CASE FOR FEDERAL LEGISLATION

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*Within the last decade, payday lending has grown into a multi-billion dollar industry by aggressively offering its services to cash-strapped borrowers without access to mainstream credit. Consumer advocates insist that stricter state and federal regulations are needed to protect low-income, vulnerable borrowers from questionable payday lending practices, which include triple-digit interest rates, exorbitant rollover fees, frequent failures to disclose loan terms, and coercive collection practices. Industry representatives, however, support a laissez-faire approach to payday lending, suggesting that regulatory paternalism will unfairly limit consumers' freedom to purchase payday loans and harm the interests of borrowers that consumer advocates wish to protect.*

*This note argues in favor of enacting a uniform federal payday loan statute to curb the abuses of payday lenders. While some states have passed small loan regulations and usury statutes, federal banking law currently allows payday lenders to partner with national banks to evade state laws. Congress must remedy this situation since the Office of the Comptroller of Currency (OCC) and the United States Supreme Court continue to support the preemption of state usury laws. The author also explains why free market mechanisms and litigation based on unconscionability claims fail to provide adequate consumer protection. Finally, the author presents a framework for a federal payday loan statute and recommends the creation of payday loan alternatives through more stringent enforcement of the Community Reinvestment Act (CRA) and increased funding for Individual Development Accounts.*

## I. INTRODUCTION

In January 2001, Pam Sanson found herself with a \$300 bill that she could not pay.<sup>1</sup> Desperate for some quick cash, she went to a payday lender and wrote a check for \$375 to cover the \$300 loan plus a \$75 fi-

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1. Mark Niesse, *Some Loans Just Don't Pay off: Payday Stores Thrive; Borrowers Labor to Dig out*, CHI. TRIB., Jan. 20, 2003, Business, at 5.

nance charge. Sanson left with the understanding that the lender would not deposit her check until she came back in two weeks to pay off its face value or paid \$75 to extend the loan.<sup>2</sup> At the time, Sanson was confident that she would be able to pay off the loan the following payday.<sup>3</sup> Her husband soon lost his job, however, and Sanson had to cut her work schedule at Wal-Mart because of surgery. These unexpected hardships left Sanson unable to pay off the interest—which amounted to a 600% annual percentage rate—or the principal on her loan.<sup>4</sup> Sanson's check bounced and USA PayDay threatened to send detectives to put her in jail.<sup>5</sup> In just six months, Sanson accrued \$900 in interest alone without having reduced the amount on her principal.<sup>6</sup>

The payday loan industry has profited from desperate borrowers like Pam Sanson to become one of the fastest-growing sectors of the “fringe banking” industry.<sup>7</sup> Payday loans, also known as “deferred prepayments,” “cash advances,” or “check loans,”<sup>8</sup> are small, short-term loans where the consumer provides a postdated check for the amount borrowed plus a finance charge. The lender holds the check as collateral until the next payday, a period ranging from one to four weeks, with the most common lending period being two weeks. At the end of that time, the borrower can pay off the loan by paying its face value in cash or by allowing the lender to deposit the check. If the borrower cannot pay the loan or does not have enough money in her account to cover the check, then she pays another fee to extend or “rollover” the loan for another period.

According to a 2001 survey, the annual percentage rate (APR) on fees charged by payday lenders ranged from 390% to 7300%, averaging close to 500%.<sup>9</sup> Despite these exorbitant interest rates, payday loans have become increasingly popular among consumers who may not qualify for credit cards or loans through mainstream banks.<sup>10</sup> Consumer advocates have lobbied for more stringent state and federal regulations that impose interest rate caps, limit the number of rollovers allowed per cus-

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2. *Id.*

3. *Id.*

4. *Id.*

5. *Id.*

6. *Id.*

7. The “fringe market” represents a segment of the subprime credit market that focuses on small, short-term, unsecured loans. Credit products offered in the fringe market include payday loans, refund anticipation loans, pawn shops, title loan stores, and rent-to-own outlets. See Lynn Drysdale & Kathleen Keest, *The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and Its Challenge to Current Thinking About the Role of Usury Laws in Today's Society*, 51 S.C. L. REV. 589, 595 (2000).

8. *E.g.*, KATHLEEN E. KEEST & ELIZABETH RENUART, *THE COST OF CREDIT: REGULATION AND LEGAL CHALLENGES* § 7.5.5.3, at 55 (Supp. 2002) [hereinafter *COST OF CREDIT*, Supp. 2002].

9. *Id.*

10. See discussion *infra* Part II.A–B.

tomers, and force lenders to disclose the terms of their loans.<sup>11</sup> Industry representatives, however, argue that payday loans are a valid consumer product, filling a market for small, short-term loans that banks have abandoned.<sup>12</sup> Payday lenders justify the high interest rates on their product as the fair cost of disbursing high-risk, unsecured loans.<sup>13</sup> Like other consumer products, payday loans should be left to market forces of supply and demand, rather than imposing artificial interest rate caps or restrictions.<sup>14</sup> The industry also argues that regulation will actually have the effect of excluding from the credit market high-risk borrowers—the very people that consumer advocates are trying to protect.<sup>15</sup> The paternalistic nature of regulations prevents consumers from exercising their choice to purchase a valid consumer product.<sup>16</sup>

In the absence of a federal statute that regulates payday loans, some states have passed usury laws and small loan statutes.<sup>17</sup> This patchwork of state laws offers inadequate and piecemeal protection to consumers. This note argues that Congress needs to pass a uniform federal payday loan statute to curb the exploitative practices of the industry. A federal

11. For a list of recommended reforms by two consumer advocacy groups, see U.S. PIRG & CONSUMER FED'N OF AM., *SHOW ME THE MONEY! A SURVEY OF PAYDAY LENDERS AND REVIEW OF PAYDAY LENDER LOBBYING IN STATE LEGISLATURES 2*, at <http://www.pirg.org/reports/consumer/payday/showmethemoneyfinal.pdf> (last revised Feb. 2000) [hereinafter *SHOW ME THE MONEY*].

12. See, e.g., Scott Andrew Schaaf, *From Checks to Cash: The Regulation of the Payday Lending Industry*, 5 N.C. BANKING INST. 339, 349 (2001).

13. *Id.*

14. See discussion *infra* Part IV.

15. See discussion *infra* Part IV.

16. See discussion *infra* Part IV.

17. State regulations of payday loans fall into three categories. In Category One, eighteen states, the Virgin Islands, and Puerto Rico require payday lenders to comply with small loan or criminal usury laws that maintain interest rate caps. The rate limits are usually set at thirty-six percent per annum. State laws in this category typically also contain provisions that specify maximum loan amount, length of term, maximum interest rate, and permitted charges. Since payday lenders charge rates that exceed the permissible interest rate, payday loans have been rendered illegal in these states. *COST OF CREDIT*, Supp. 2002, *supra* note 8, § 7.5.5.5, at 56. The states in Category One are Alabama, Alaska, Arkansas, Connecticut, Georgia, Maine, Maryland, Massachusetts, Michigan, New Jersey, New York, North Carolina, North Dakota, Oklahoma, Pennsylvania, Rhode Island, Vermont, and West Virginia. *Id.* § 7.5.5.8, at 60 n.363.

In Category Two, six states have small loan laws that allow payday lenders to operate and charge any interest rate that the parties agree to pay. *Id.* § 7.5.5.5, at 56. Payday lenders can operate as long as they are licensed with the state, and they can legally charge interest rates that exceed the typical small loan rate cap. *SHOW ME THE MONEY*, *supra* note 11, at 4. The states in Category Two are Delaware, Idaho, New Hampshire, New Mexico, South Dakota, and Wisconsin. *COST OF CREDIT*, Supp. 2002, *supra* note 8, § 7.5.5.8, at 60 n.366.

In Category Three, twenty-eight states and the District of Columbia have enacted statutes that authorize payday lending but have specific provisions regulating the maximum loan amount, maximum term, and fees. Generally, these states may require either licensing or registration. *Id.* § 7.5.5.5, at 56. The maximum fees in these states range from \$15 to \$33.50 to borrow \$100 for fourteen days. Schaaf, *supra* note 12, at 358. Eight states permit a maximum fee of \$17.65 per \$100, which amounts to an APR of 459%. *Id.* States in Category Three are Arizona, California, Colorado, Florida, Hawaii, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, North Carolina, North Dakota, Ohio, Oregon, South Carolina, Tennessee, Texas, Utah, Virginia, Washington, and Wyoming. *COST OF CREDIT*, Supp. 2002, *supra* note 8, § 7.5.5.8, at 60 n.367.

statute would not replace existing or future state regulation of payday lenders. Rather, it would only provide minimum standards, allowing states to build upon this regulatory floor by enacting stricter rules. Any proposed legislation should include, at a minimum, the following features:<sup>18</sup>

1. Measures that prohibit or limit practices of payday lenders that take advantage of consumer vulnerability and perpetuate borrower indebtedness.
2. A provision that closes the preemption loophole in the National Bank Act that allows national banks to partner with payday lenders in order to evade state regulations and interest rate caps.
3. An interest rate ceiling.

In order to understand the need for federal legislation, part II provides some background on the payday loan industry, describing the reasons for the growing popularity of payday loans, the demographic profile of targeted customers, and the features of payday loans that make these customers particularly vulnerable.<sup>19</sup> Parts III, IV, and V explain in detail why prohibition of payday lender-bank partnerships and interest rate caps are necessary elements of a federal payday loan statute.<sup>20</sup> Part VI recommends statutory measures for regulating the payday loan industry and a discussion of government and private sector initiatives to create alternatives to payday loans.<sup>21</sup>

## II. BACKGROUND

### A. *Growth of the Payday Loan Industry*

Payday lending has come a long way since its humble beginnings in 1993, when Check Into Cash, Inc. of Tennessee opened the first payday loan store in the United States.<sup>22</sup> One analyst estimates the “mature” market at 25,000 offices generating \$6.75 billion annually in fees alone.<sup>23</sup> In August 2001, the Fannie Mae Foundation reported fifty-five to sixty-nine million payday loan transactions a year with a volume of \$10 to \$13.8 billion, producing \$1.6 to \$2.2 billion in fees.<sup>24</sup> In Illinois, where the

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18. Elizabeth Renuart, an attorney with the National Consumer Law Center, has proposed the Deferred Deposit Loan Act as a model statute for individual states to adopt. See ELIZABETH RENUART, PAYDAY LOANS: A MODEL STATE STATUTE (Oct. 2000), at [http://research.aarp.org/consume/dl16954\\_payday.pdf](http://research.aarp.org/consume/dl16954_payday.pdf). The proposed federal statute in this note incorporates some of Renuart's recommendations.

19. See *infra* Part II.

20. See *infra* Parts III, IV, and V.

21. See *infra* Part VI.

22. Schaaf, *supra* note 12, at 339 nn.3–4.

23. COST OF CREDIT, Supp. 2002, *supra* note 8, § 7.5.5.2, at 54.

24. CONSUMER FED'N OF AM. & U.S. PUB. INTEREST RESEARCH GROUP, RENT-A-BANK PAYDAY LENDING: HOW BANKS HELP PAYDAY LENDERS EVADE STATE CONSUMER PROTECTIONS 2001 PAYDAY LENDER SURVEY AND REPORT 6 (Nov. 2001), available at <http://www.consumerfed.org/paydayreport.pdf> [hereinafter RENT-A-BANK].

payday loan industry was nonexistent until 1995, there are over 500 licensed lenders and nearly 300 additional locations that serve as limited purpose branches.<sup>25</sup>

Industry observers attribute this explosive growth to the absence of traditional small-loan providers in the short-term credit market, high credit card interest rates, and the elimination of state interest rate caps.<sup>26</sup> Deregulation in the 1980s enticed many banks to eliminate “money-losing” services, such as small consumer loans, in favor of higher returns on larger loans.<sup>27</sup> While the return on a \$5000 loan is greater than if \$500 were borrowed, the originating and servicing costs remain the same.<sup>28</sup> Many national financial institutions, which were initially created to make small loans, have chosen to leave that market.<sup>29</sup> As a result, many borrowers, left without access to traditional small loans, turned to payday lenders for their short-term credit needs.<sup>30</sup>

### B. Profile of the Typical Payday Loan Customer

While payday lenders give the impression that they are providing a valuable product to savvy consumers, evidence from various sources indicate that lenders target vulnerable customers who do not have access to information or to credit alternatives that would allow comparison shopping. According to industry sources, the typical payday customer is “a responsible, hardworking middle class American” with an average annual income of \$33,000.<sup>31</sup> These same sources claim that a third of these borrowers own their own homes and that all of them have regular sources of income.<sup>32</sup> In a recent study funded by payday lenders, professors at Georgetown University used data supplied by the industry to conduct telephone interviews of customers. This study reported that 51.5% have moderate incomes, ranging from \$25,000 to \$49,999.<sup>33</sup>

Demographic studies conducted by regulatory agencies paint a bleaker picture than that offered by the industry. The Illinois Department of Financial Institutions reports that the median annual income, accounting for thirty-eight percent of the surveyed borrowers, was \$15,000

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25. Letter from the Woodstock Institute to Sarah D. Vega, Director, Illinois Department of Financial Institutions 1 (Sept. 11, 2000), available at <http://www.woodstockinst.org/dficomments.PDF> [hereinafter Letter to IDFI].

26. RENT-A-BANK, *supra* note 24, at 6; Schaaf, *supra* note 12, at 340.

27. Schaaf, *supra* note 12, at 340–41, 341 n.8.

28. COST OF CREDIT, Supp. 2002, *supra* note 8, § 7.5.5.1, at 54.

29. *Id.*

30. Schaaf, *supra* note 12, at 340 & n.8.

31. *Id.* at 348 (quoting *Forum on Short-Term High-Interest Paycheck Advances*, U.S. Senate Comm. on Governmental Affairs, at 2 (Dec. 15, 1999) (written testimony of Billy Webster, President, CFSA) (on file with N.C. BANKING INST.)).

32. *Id.* at 349.

33. Creola Johnson, *Payday Loans: Shrewd Business or Predatory Lending?*, 87 MINN. L. REV. 1, 99 (2002).

to \$24,999.<sup>34</sup> Nineteen percent of the borrowers in this survey made less than \$15,000.<sup>35</sup> A survey conducted by the Wisconsin Department of Financial Institutions found that the average annual net income was \$18,675 and that sixty percent of the surveyed borrowers were renters, compared to twenty-two percent who owned homes.<sup>36</sup>

Low-income individuals, as well as racial minorities, are less likely than moderate-income white individuals to have transactions with traditional financial institutions.<sup>37</sup> As a result, these “unbanked” individuals are more likely to use payday lenders and other alternative financial services. About seventeen percent of unbanked households use check-cashing outlets, compared to only one percent of households with bank accounts.<sup>38</sup> A 1996 survey by John Caskey showed that sixty-four percent of white families had bank accounts, while only 27.2% of black families and less than three percent of Hispanic, Asian, and Native American households had bank accounts.<sup>39</sup>

The business plan for one check-cashing company describes its customers as “disproportionately [belonging to] minority [groups] with a household income of less than \$25,000, a high school or GED education or less, ages ranging from 18–59 years and female heads of household with dependents.”<sup>40</sup> This same document shows that lenders target welfare recipients, regarding this population as “a fertile market for payday lenders.”<sup>41</sup> The American Association of Retired People found that low-income and minority households were more likely to have check-cashing outlets within one mile of their homes than higher income, nonminority households.<sup>42</sup> Payday loan customers as a whole represent a vulnerable segment of the population, which turns to payday lenders out of desperation. In the absence of alternative sources of low-interest credit, the federal government needs to offer legislative protection to these borrowers.

### C. *Problematic Features of Payday Loans*

#### 1. *Triple-Digit Interest Rates*

In addition to targeting vulnerable communities, consumer advocates find payday loans particularly troublesome because of unique features that trap the unwary consumer. First, payday lenders charge exorbitant interest rates on their loans. If a borrower, for example, requests a

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34. Schaaf, *supra* note 12, at 343–44 n.31.

35. *Id.*

36. RENT-A-BANK, *supra* note 24, at 7.

37. Dory Rand, *Using the Community Reinvestment Act to Promote Checking Accounts for Low-Income People*, 33 CLEARINGHOUSE REV. J. POVERTY L. 66, 67 (1999).

38. *Id.*

39. *Id.*

40. RENT-A-BANK, *supra* note 24, at 8.

41. *Id.*

42. Johnson, *supra* note 33, at 100.

\$100 loan, writes a check for \$115, and receives a cash advance of \$100, then the \$15 fee on that loan translates to an APR of 390%. These rates are even higher than those of organized crime loan sharks in Las Vegas, who traditionally have charged about 5% interest per week, or 260% APR.<sup>43</sup>

## 2. *The “Rollover” Feature*

The short lending period and high interest rates on these loans make the probability of default more likely. In order to avoid defaulting, some borrowers extend their loans by paying another service charge. If a borrower who takes out a loan for \$100 with a \$15 finance charge chooses to extend her loan another two weeks, then she would pay \$30 in finance charges. If the loan were to rollover a third time, then the borrower now pays \$60 in fees without reducing the principal on her \$100 loan.

This rollover option has been cited as the one of the most dangerous features of payday loans. In her testimony before Senator Joseph Lieberman’s Forum on Payday Lending, Jean Ann Fox, Director of Consumer Protection at the Consumer Federation of America, presented the following examples of borrowers who found themselves buried under a mountain of debt because of multiple rollovers:

- After borrowing \$150, and paying \$1000 in fees for six months, a Kentucky borrower still owes the \$150.
- Paying \$1364 in fees over fifteen months, another consumer only reduced the principal balance on [a] \$400 loan to \$248.<sup>44</sup>

Although the industry argues that rollovers are a rare occurrence, with “only a tiny number of transactions resulting in more than one rollover, of the perhaps 10% of transactions that result in any rollovers at all,”<sup>45</sup> statistics from other sources contradict this assertion. Audits from several state agencies show that over a twelve-month period, consumers renewed their loans ten to twelve times on average.<sup>46</sup> One Wall Street analyst writes that “the average customer makes eleven transactions a year, which shows that once people take out a payday loan, they put themselves behind for quite some time.”<sup>47</sup> With multiple rollovers gen-

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43. Chris Di Edoardo, *Payday Loans: Interesting Business*, LAS VEGAS REV.-J., Jan. 28, 2001, at 1F.

44. Testimony of Jean Ann Fox, Director of Consumer Protection, Consumer Federation of America, Before the Forum on Payday Lending 4 (Dec. 15, 1999), <http://www.consumerfed.org/backpage/pdLiebermanhearing.pdf> (last visited Apr. 22, 2004) [hereinafter Fox Testimony].

45. Drysdale & Keest, *supra* note 7, at 606 n.91 (quoting a trade spokesman who testified at the Lieberman Forum).

46. COST OF CREDIT, Supp. 2002, *supra* note 8, § 7.5.5.4, at 55 n.360 (citing statistics showing that the Illinois Department of Financial Institutions found an average of thirteen contracts per customer during an average six-month period; the average number of rollovers per twelve months in Iowa was 12.5; and the average number of rollovers per twelve months in North Carolina was seven).

47. Schaaf, *supra* note 12, at 346.

erating the bulk of revenue for payday lenders,<sup>48</sup> the industry has every incentive to keep its customers in a perpetual cycle of debt.

### 3. *Failure to Disclose Terms of Loan*

One federal statute with relevance to payday loans is the Truth in Lending Act (TILA).<sup>49</sup> Prior to the enactment of TILA in 1968, creditors were not required to use uniform methods of calculating or disclosing interest on loans. As a result, creditors camouflaged extra fees and added on costs to confuse consumers.<sup>50</sup> The lack of uniformity made it impossible for consumers to do any comparison shopping among different sources of credit. Congress tried to remedy this confusion by enacting the TILA<sup>51</sup> and by authorizing the Federal Reserve Board to implement the statute through Regulation Z.<sup>52</sup> The stated purpose of the statute is “to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit, and to protect the consumer against inaccurate and unfair credit billing and credit card practices.”<sup>53</sup> The statute does not control the actual terms of loans, but rather tries to help consumers make intelligent choices from available sources of credit by requiring creditors to use standardized mechanisms of disclosure. TILA’s key provisions require creditors to calculate interest rates as an annual percentage rate,<sup>54</sup> to disclose the total dollar amount of these charges as the “finance charge,”<sup>55</sup> and to display the APR and finance charge more conspicuously than any other disclosure except the creditor’s identity.<sup>56</sup>

Statistics from a number of sources show that many payday lenders do not comply with TILA. In a survey of 235 stores nationwide, only thirty-two percent of payday lenders disclosed even a nominally accurate

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48. The Community Reinvestment Association of North Carolina issued a report entitled “How Payday Lenders Make Their Money” finding that payday lenders in North Carolina made ninety percent of their revenue from borrowers making multiple transactions per year. RENT-A-BANK, *supra* note 24, at 9. In 1999, 420,000 borrowers in North Carolina generated 2.9 million transactions. *Id.*

49. 15 U.S.C. §§ 1601–1693 (2000).

50. Illinois Senator Paul Douglas, an economist and the father of the Truth in Lending Act, testified during congressional proceedings leading to the passage of the Act that some creditors compounded the cost of credit “by loading on all sorts of extraneous fees, such as exorbitant fees for credit life insurance, excessive fees for credit investigation, and all sorts of loan processing fees which rightfully should be included in the percentage rate statement so that any percentage rate quoted is completely meaningless and deceptive.” 109 CONG. REC. 2027, 2029 (1963) (remarks of Sen. Douglas). For more discussion of the legislative history of the Truth in Lending Act, see ELIZABETH RENUART & KATHLEEN KEEST, TRUTH IN LENDING § 1.1.1, at 33 & nn.4 & 6 (4th ed. 1999). See also Elwin Griffith, *Searching for the Truth in Lending: Identifying Some Problems in the Truth in Lending Act and Regulation Z*, 52 BAYLOR L. REV. 265, 267 n.7 (2000).

51. 15 U.S.C. §§ 1601–1693.

52. 12 C.F.R. § 226 (2003).

53. 15 U.S.C. § 1601(a).

54. 12 C.F.R. § 226.18(e).

55. *Id.* § 226.18(d).

56. *Id.* § 226.17(a)(2).



APR on charts or brochures.<sup>57</sup> Of the stores that did not post APR, only twenty-one percent of clerks verbally disclosed APR upon customer's request.<sup>58</sup> Only twenty-two percent disclosed both fees and APRs on charts or brochures.<sup>59</sup>

In a survey of twenty-two payday lenders in Franklin County, Ohio,<sup>60</sup> Professor Creola Johnson of Ohio State University Moritz College of Law found three types of TILA violations.<sup>61</sup> First, payday lenders failed to provide an APR in response to oral inquiries.<sup>62</sup> TILA does not require a creditor to respond orally to a customer's inquiry on the cost of credit; however, if the creditor chooses to respond orally, he is required to give the APR.<sup>63</sup> Professor Johnson found that only thirty-two percent of the lenders surveyed disclosed the APR.<sup>64</sup> Thirty-two percent denied there was an APR on the loan, while eighteen percent claimed not to know the APR.<sup>65</sup>

Secondly, Franklin County lenders violated TILA's advertising provision requiring a lender to state an APR whenever a finance charge is advertised.<sup>66</sup> While most of the lenders surveyed (nineteen out of twenty-two) posted a fee schedule on signs or placards, the fee schedules of eighty-four percent (sixteen out of nineteen) failed to disclose an APR.<sup>67</sup>

The third type of TILA violation found among Franklin County payday lenders was the failure to provide written disclosure prior to contract formation.<sup>68</sup> Regulation Z requires the creditor to make disclosures "clearly and conspicuously in writing, in a form that the consumer may keep,"<sup>69</sup> and to make those disclosures "before the consummation of the transaction."<sup>70</sup> When surveyors asked loan clerks whether they could take contracts home and review them prior to signing, seventy-seven percent (seventeen of twenty-two) of the clerks refused.<sup>71</sup> Even if a lender explains the credit terms to a consumer, but does not make those disclosures available to the consumer in written form, then the lender has

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57. RENT-A-BANK, *supra* note 24, at 14. In an earlier telephone survey, only 85 of 230 (37%) of lenders surveyed nationally quoted a nominally accurate APR over the phone. SHOW ME THE MONEY, *supra* note 11, at 6.

58. RENT-A-BANK, *supra* note 24, at 14.

59. *Id.*

60. For a description of the methodology used in the survey, see Johnson, *supra* note 33, at 33-34.

61. *Id.* at 45.

62. *Id.* at 37.

63. 15 U.S.C. § 1665a (2000); 12 C.F.R. § 226.26(b) (2003).

64. Johnson, *supra* note 33, at 38.

65. *Id.*

66. 12 C.F.R. § 226.24(b).

67. Johnson, *supra* note 33, at 40.

68. *Id.* at 42.

69. 12 C.F.R. § 225.17(a).

70. *Id.* at § 226.17(b).

71. Johnson, *supra* note 33, at 44.

violated the timing of disclosure requirement in TILA.<sup>72</sup> These surveys demonstrate that TILA compliance among payday lenders is the exception rather than the norm.

#### 4. *Coercive Collection Practices*

Some payday lenders also use intimidation and coercion to collect debts. A lender may deliberately deposit a borrower's check, even with the knowledge of insufficient funds available that would trigger bounced check charges.<sup>73</sup> Lenders also threaten criminal prosecution<sup>74</sup> or civil suits for bad-check writing.<sup>75</sup> The use of criminal prosecution for a bounced check not only gives payday lenders leverage over their customers, but it also gives them a competitive advantage over other lenders.<sup>76</sup> In order to protect consumers, Congress needs to pass federal legislation that prohibits or limits these exploitative practices and provides consumers with a private right of action to give these provisions some regulatory force.

### III. PROTECTING STATE USURY LAWS BY CLOSING THE PREEMPTION LOOPHOLE

#### A. *"Rent-a-Bank": Using National Banks to Preempt State Laws*

A federal payday statute should also include a provision that prohibits payday lenders from partnering with national banks to evade state consumer protection laws. Payday lenders have successfully evaded state small loan statutes and interest rate caps by partnering with national banks in "rent-a-bank" arrangements, also known as "the National Bank Model" and "rate exportation." By affiliating with a national bank, payday lenders argue that they can legally charge triple-digit interest rates even in states that have made those rates illegal. Lenders base this theory on Section 85 of the National Bank Act (NBA), which allows a nationally chartered bank to "take, receive, reserve, and charge on any loan or discount made, or upon any notes, bills of exchange, or other evidences of debit, interest at the rate allowed by the law of the State . . . where the bank is located."<sup>77</sup> In *Marquette National Bank v. First of*

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72. Polk v. Crown Auto, Inc., 221 F.3d 691, 692 (4th Cir. 2000) (holding that the defendant car dealer violated TILA by failing to give a written copy of the terms to the plaintiff until after both parties signed the contract).

73. E.g., SHOW ME THE MONEY, *supra* note 11, at 10.

74. *Id.*; see also Turner v. E-Z Check Cashing of Cookeville, Tenn., Inc., 35 F. Supp. 2d 1042, 1046 (M.D. Tenn. 1999) (involving Patricia Turner, a payday borrower who was threatened with criminal prosecution after her check bounced).

75. SHOW ME THE MONEY, *supra* note 11, at 10.

76. Schaaf, *supra* note 12, at 347.

77. 12 U.S.C. § 85 (2000).

*Omaha Service Corp.*,<sup>78</sup> a landmark United States Supreme Court case interpreting the NBA, a nationally chartered bank in Nevada wanted to bring its credit card business into Minnesota, a state with usury laws that outlawed the high interest rates that the bank wanted to charge.<sup>79</sup> The Supreme Court held that the NBA allows a national bank to charge the interest rate of its home state to residents of other states in interstate lending transactions.<sup>80</sup> Payday lenders affiliated with national banks have tried to extend the *Marquette* ruling to payday loans, arguing that the NBA allows federal preemption of state interest rate caps.<sup>81</sup>

The legal counsel to the Community Financial Services Association of America (CFSA), a trade association for payday lenders, defends the legitimacy of these partnerships: “The payday advance company acts as the servicer and marketer of the loans, and is the interface with the customer. But the bank makes the loan from bank funds.”<sup>82</sup> In practice, however, the bank is merely renting out its charter, contributing nothing more than its location to help payday lenders evade state usury laws.<sup>83</sup> In the typical payday loan-bank partnership, the bank plays a nominal role in the disbursement of the loan. While the bank may underwrite the loan, it often sells back most of the loan obligation immediately.<sup>84</sup> The local storefront then collects consumer information, advances the money, takes the risk, and collects the debt.<sup>85</sup> The partnership between Texas-based ACE Cash Express, the nation’s largest check-cashing company, and Goleta National Bank provides an example of this subterfuge. ACE and Goleta entered an agreement in which ACE offered Goleta loans through its retail storefronts.<sup>86</sup> Within twenty-four hours, ACE bought back ninety-five percent of the loans,<sup>87</sup> entitling it to substantially all of the interest and exposing itself to the risk of nonpayment.<sup>88</sup> In most cases, ACE agreed to indemnify Goleta for any risk it incurred.<sup>89</sup> The bank’s brief participation amounted to nothing more than a disguise for the payday lender’s unlawful practices.

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78. 439 U.S. 299 (1978).

79. *Id.* at 301–02.

80. *Id.* at 308–18.

81. Jerry Robinson, an advocate for the payday loan industry, writes the following in a report to payday lenders and financial institutions: “By using the same principle as credit card companies, payday lenders can offer a payday lending product that is originated by a bank with the payday advance entity acting as marketer and servicer of the loan.” JERRY ROBINSON, PAYDAY ADVANCE—THE FINAL INNINGS: STANDARDIZING THE APPROACH 6 (2000) (on file with author).

82. John Hackett, *Ethically Tainted*, U.S. BANKER, Nov. 2001, Consumer Lending, at 48.

83. *E.g.*, RENT-A-BANK, *supra* note 24, at 15.

84. *Id.*

85. *Id.*

86. COST OF CREDIT, Supp. 2002, *supra* note 8, § 3.4.6.4.1, at 20.

87. *Hudson v. ACE Cash Express, Inc.*, No. IP 01-1336-C H/S, 2002 WL 1205060, at \*3 (S.D. Ind. May 30, 2002); *see also* COST OF CREDIT, Supp. 2002, *supra* note 8, § 3.4.6.4.1, at 20; Hackett, *supra* note 82, at 48.

88. Hackett, *supra* note 82, at 48.

89. COST OF CREDIT, Supp. 2002, *supra* note 8, § 3.4.6.4.1, at 20.

## B. *Legal Challenges to Rent-a-Bank Arrangements*

### 1. *Lawsuits Against Payday Lenders*

In a few cases, consumer plaintiffs and states have successfully challenged the preemption arguments of payday lenders.<sup>90</sup> These rulings, however, are limited to a narrow set of cases where the payday lender, not the national bank, was named as the sole defendant. In Colorado, for example, the Attorney General filed a complaint in state court against ACE, alleging a violation of a state law governing unfair trade practices.<sup>91</sup> ACE removed the case to federal court and argued that the NBA preempts Colorado limitations on multiple rollovers and the interest rate of the original loan fee.<sup>92</sup> The district court rejected ACE's argument.<sup>93</sup> It found that the relationship between ACE and Goleta did not give rise to a preemption claim because the complaint made no claims against Goleta, stating that "[t]he Complaint *strictly* is about a non-bank's violations of *state* law. It alleges *no* claims against a *national bank* under the *NBA*."<sup>94</sup> The Office of the Comptroller of Currency (OCC), the agency that regulates federal banks, filed an amicus brief that sided with the state's usury claim against ACE, asserting that "[t]he standard for finding complete preemption is not met in this case. . . . ACE is the only defendant in this action, and ACE is not a national bank."<sup>95</sup> In a similar lawsuit, a North Carolina district court dismissed ACE's motion for removal, ruling that "Ace is not a national bank and, as such, is not entitled to the protection of the NBA's umbrella."<sup>96</sup>

### 2. *Lawsuits Against National Banks: Judicial Disagreement over Preemption*

Until recently, courts have split on the issue of whether the NBA provides a complete defense against state usury claims when a complaint

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90. See *Goleta Nat'l Bank v. Lingerfelt*, 211 F. Supp. 2d 711, 718 (E.D.N.C. 2002); *Colorado ex rel. Salazar v. ACE Cash Express, Inc.*, 188 F. Supp. 2d 1282, 1284-85 (D. Colo. 2002); *Long v. ACE Cash Express, Inc.*, No. 3:00-CV-1306-J-25TJC, slip op. at 2 (M.D. Fla. June 15, 2001).

91. *Salazar*, 188 F. Supp. 2d at 1282.

92. *Id.* at 1284.

93. *Id.*

94. *Id.* at 1285 (quoting Plaintiff's Reply in Support of Motion to Remand).

95. COST OF CREDIT, Supp. 2002, *supra* note 8, § 3.4.6.4.2, at 21. A longer excerpt from the OCC's brief reads as follows:

The standard for finding complete preemption is not met in this case. While the Defendant's Notice of Removal repeatedly refers to Goleta National Bank using Ace Cash Express, Inc. ("ACE") as its agent to solicit loans . . . ACE is the only defendant in this action, and ACE is not a national bank. Nor do the Plaintiff's claims against ACE arise under the National Bank Act, or other federal law. Although Defendant apparently attempts to appropriate attributes of the legal status of a national bank for its own operations as a defense to certain of Plaintiff's claims, such a hypothetical conflict between federal and state law does not give this court federal question jurisdiction under the doctrine of complete preemption.

*Id.*; see also Johnson, *supra* note 33, at 114.

96. *Goleta Nat'l Bank v. Lingerfelt*, 211 F. Supp. 2d 711, 718 (E.D.N.C. 2002).

is filed against a national bank. In *Anderson v. H&R Block, Inc.*,<sup>97</sup> a case heard by the Eleventh Circuit, the plaintiffs filed suit in state court against a national bank alleging that the interest rates charged on a tax refund anticipation loan (RAL)—a loan in which lenders advance cash against a borrower’s expected income tax refund<sup>98</sup>—violated the common law usury doctrine and an Alabama usury statute.<sup>99</sup> Although the complaint did not refer to any federal law, the district court determined that removal was proper under the doctrine of complete preemption because the NBA provides the exclusive remedies available against a national bank charging excessive interest.<sup>100</sup> The Eleventh Circuit reversed, holding that the NBA does not completely preempt state law usury claims because of the lack of clear congressional intent to permit removal.<sup>101</sup> While the court found evidence in legislative debates of Congress’s desire to protect national banks from state legislation, it did not find that Congress intended to protect national banks from facing suit in state court.<sup>102</sup> While the Third Circuit agreed with this ruling, the Eighth Circuit disagreed, holding that the NBA completely preempts state-law usury claims.<sup>103</sup>

The United States Supreme Court recently resolved this circuit split in *Beneficial National Bank v. Anderson*. In an opinion by Justice Stevens, the Court held that Sections 85 and 86 of the NBA provide the exclusive cause of action for usury claims against national banks and that these sections provide “the requisite pre-emptive force to provide removal jurisdiction.”<sup>104</sup> The Court also found this construction of the NBA to be consistent with prior cases that recognized the special nature of federally chartered banks, noting that “[u]niform rules limiting the liability of national banks and prescribing exclusive remedies for their overcharges are an integral part of a banking system that needed protection from ‘possible unfriendly State legislation.’”<sup>105</sup>

*Beneficial* closes the door on suits seeking damages against a national bank on the basis of state usury laws. In the words of the Court, “there is . . . no such thing as a state-law claim of usury against a national bank.”<sup>106</sup> As discussed previously,<sup>107</sup> however, a plaintiff can still use state usury laws to take action against a nonbank party involved in a rent-a-bank arrangement with a nationally chartered bank. The result is

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97. *Anderson v. H&R Block, Inc.*, 287 F.3d 1038 (11th Cir. 2002).

98. For a more detailed explanation of RALs, see Drysdale & Keest, *supra* note 7, at 612–14.

99. *Anderson*, 287 F.3d at 1040 n.2.

100. *Id.* at 1040.

101. *Id.* at 1041.

102. *Id.* at 1045.

103. *Krispin v. May Dep’t Stores Co.*, 218 F.3d 919 (8th Cir. 2000); *see also Anderson*, 287 F.3d at 1041 n.5.

104. *Beneficial Nat’l Bank v. Anderson*, 123 S. Ct. 2058, 2064 (2003).

105. *Id.* at 2064 (quoting *Tiffany v. Nat’l Bank of Mo.*, 85 U.S. 316 (1874)).

106. *Id.*

107. *See supra* Part III.B.1.

a contradictory state of affairs wherein a nonbank entity can be held liable for violating a usury statute, while a national bank that aids and abets that entity can avoid liability altogether.

The Court's decision in *Beneficial* indicates to national banks partnering with payday lenders that the NBA provides a safe harbor from liability under state law. In the aftermath of the decision, Congress needs to respond in one of several ways: (1) by amending the NBA to expressly indicate that the statute was not intended to protect national banks from facing suit in state courts; (2) by enacting a federal statute that precludes preemption of state laws when a nonbank entity partners with a national bank; or (3) by implementing regulatory measures that expressly prohibit all rent-a-bank arrangements.

### C. *Role of the OCC in Perpetuating Preemption*

The OCC has tentatively stepped into the preemption fray to voice its concern about bank-payday lender partnerships. On November 27, 2000, the OCC issued an Advisory Letter<sup>108</sup> and a joint statement with the Office of Thrift Supervision (OTS).<sup>109</sup> Comptroller John D. Hawke, Jr., and OTS Director Ellen Seidman, urged national banks and federal thrifts "to think carefully about the risks involved in such relationships, which can pose not only safety and soundness threats, but also compliance and reputation risks."<sup>110</sup> The agency has stopped short of closing the preemption loophole or declaring rent-a-bank arrangements unlawful.

Pressure from the OCC caused two national banks to quit their partnerships with payday lenders. Yet in both cases, the OCC did not criticize rent-a-bank arrangements, but rather found these partnerships questionable because of financial safety or soundness reasons.<sup>111</sup> On December 18, 2001, the OCC announced that Eagle National Bank signed a consent order directing it to cease its payday lending activities by June 2002.<sup>112</sup> In a press release accompanying the consent order, the OCC found that Eagle's payday lending program "was conducted on an unsafe and unsound basis, in violation of a multitude of standards of safe and sound banking, compliance requirements, and OCC guidance."<sup>113</sup> A year later in October 2002, Goleta terminated its troublesome two-year partnership with ACE after a passerby found 641 customer loan files in a

108. See OCC Advisory Letter AL 2000-10 (Nov. 27, 2000), available at <http://www.occ.treas.gov/ftp/advisory/2000-10.doc>.

109. See OCC & OTS Joint Release NR 2000-88 (Nov. 27, 2000), available at <http://www.occ.treas.gov/ftp/release/2000-88.doc>.

110. *Id.*

111. COST OF CREDIT, Supp. 2002, *supra* note 8, § 3.4.6.4.2, at 21.

112. See *In re Eagle Nat'l Bank*, OCC Consent Order #2001-104 (Dec. 18, 2001), available at <http://www.occ.treas.gov/ftp/eas/ea2001-104.pdf>.

113. OCC News Release NR 2002-01 (Jan. 3, 2002), available at <http://www.occ.treas.gov/ftp/release/2002-01.doc>; see also COST OF CREDIT, Supp. 2002, *supra* note 8, § 3.4.6.4.2, at 21.

trash bin behind an ACE office in Virginia.<sup>114</sup> Comptroller John Hawke cited this discovery as an example of the dangers of bank-payday lender partnerships: “Ace’s inability to safeguard the files of customers whose loans were brokered at Goleta shows just how risky those relationships can be.”<sup>115</sup> In order to avoid further disciplinary action from the OCC, Goleta agreed to leave the payday loan business and pay a \$75,000 fine.<sup>116</sup> Although these two OCC actions have dealt significant blows to the payday loan industry, the OCC’s cautious language signals to consumers that they should not rely on the OCC to protect their interests. While OCC action has created a “regulatory environment” that “may be unfriendly to payday lenders,” writes one observer, “it also is ineffectual.”<sup>117</sup>

The OCC acknowledges that some national banks have rented out their charters to help payday lenders evade state laws.<sup>118</sup> Yet, the agency also states that it is not opposed to banks making payday loans. “We’ve never said payday lending itself is wrong,” insists OCC spokesman Robert Garsson.<sup>119</sup> In *Hudson v. ACE*, the plaintiff cited the OCC’s consent order against Eagle, arguing that the OCC had taken the position that interstate arrangements between banks and payday lenders were unlawful.<sup>120</sup> The court rejected this argument, pointing out that the OCC “did not opine that interstate payday lending activities were unlawful as a general matter,” but rather that the OCC opposed Eagle’s activities “because they were conducted in a manner that compromised the financial soundness of the bank.”<sup>121</sup> As stated by Michael Stegman, a professor of public policy and business at the University of North Carolina, “national regulators don’t want to disturb the federal exemption, though they hate the use of it. They don’t want to see it eroded. It puts them in a tough spot.”<sup>122</sup>

In her analysis of the payday loan industry, Professor Johnson commends the OCC and suggests that the agency’s reluctance to take further action can be explained by a lack of agency resources to regulate the payday lenders on a case-by-case basis.<sup>123</sup> Another opinion, however, is that the OCC chooses to side with national banks to advance its own interests. Expanding the power of national banks solidifies the agency’s

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114. Ben Jackson & John Reosti, *Goleta Will Quit Payday Loan Biz in OCC Pact*, AM. BANKER, Oct. 30, 2002, at 1.

115. *Id.*

116. *Id.*

117. Hackett, *supra* note 82, at 48.

118. OCC spokesman Robert Garsson stated that the agency “do[es] have a major concern with the way a few national banks have essentially rented out their charters to third-party providers who have no interest in the charter except as a way to evade state and local consumer protection laws.” Jackson & Reosti, *supra* note 114.

119. *Id.*

120. *Hudson v. ACE Cash Express, Inc.*, No. IP 01-1336-C H/S, 2002 WL 1205060, at \*6 (S.D. Ind. May 30, 2002).

121. *Id.*

122. Hackett, *supra* note 82, at 48.

123. Johnson, *supra* note 33, at 115.

own legitimacy and power.<sup>124</sup> Over the last twenty years, the agency has consistently sided with national banks by issuing letters and opinions upholding the preemption of a particular type of state law.<sup>125</sup>

In an effort to rein in the OCC, Congress enacted the 1994 Interstate Banking Act (IBBEA).<sup>126</sup> Congress declared that OCC rulings on preemption were “inappropriately aggressive” and that the agency overreached its authority by finding preemption of state law in situations where the federal interest did not warrant that result.<sup>127</sup> As a result, the IBBEA requires agencies to publish in the Federal Register for a thirty-day comment period any proposed opinion letter or interpretation finding that the NBA preempts a state law regarding consumer protection, community reinvestment, fair lending, or the establishment of intrastate branches.<sup>128</sup> Because Congress still allows the OCC to determine which state laws are preempted, Congress’s reprimand and the passage of the IBBEA have amounted to nothing more than a slap on the wrist. In the years since the passage of the IBBEA, preemption rulings by the OCC have only accelerated.<sup>129</sup>

In an amicus brief recently filed with the Supreme Court on behalf of Beneficial National Bank,<sup>130</sup> the OCC again showed its inclination to side with national banks. In its brief, the OCC urged the Supreme Court to overturn the ruling of the Eleventh Circuit in *Anderson v. H&R Block*,<sup>131</sup> writing that Section 86 of the NBA gives an exclusive federal cause of action for usury that “displaces any state-law usury claim asserted against a national bank.”<sup>132</sup> As a result, the OCC argued that this federal cause of action completely preempts state claims and urged removal of these claims to federal court.<sup>133</sup> While the Eleventh Circuit

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124. Stacy Mitchell, *Rogue Agencies Gut State Banking Laws*, THE NEW RULES, Fall 2001, at 11, available at <http://www.newrules.org/journal/nrfall01.pdf> (last visited Apr. 23, 2004).

125. COST OF CREDIT, Supp. 2002, *supra* note 8, § 3.4.6.2, at 17–18 (citing two examples in Arkansas and Texas); see also KATHLEEN E. KEEST & ELIZABETH RENUART, THE COST OF CREDIT: REGULATION AND LEGAL CHALLENGES § 2.4.1, at app. D.1.2 (2d ed. 2000) [hereinafter COST OF CREDIT, 2000 ed.] (listing and summarizing OCC interpretive letters relating to the preemption of state laws from 1992 to 2000).

126. COST OF CREDIT, Supp. 2002, *supra* note 8, § 3.4.6.2, at 17.

127. *Id.*

128. *Id.* at 17–18.

129. Mitchell, *supra* note 124, at 6. In 2003, the OCC issued two interpretive letters in response to requests for guidance from federally chartered banks concerned with California and Indiana state agencies that wanted to examine the conduct of the banks and their wholly owned subsidiaries issuing mortgage loans. In both letters, the OCC held that it had exclusive authority to regulate these operations: “States are precluded from examining or requiring information from national banks or their operating subsidiaries or otherwise seeking to exercise visitorial powers with respect to national banks or their operating subsidiaries in [these] respects.” OCC Interpretive Letter #957, 2 (Jan. 27, 2003), available at <http://www.occ.treas.gov/interp/mar03/int957.pdf>; OCC Interpretive Letter #958, 2 (Jan. 27, 2003), available at <http://www.occ.treas.gov/interp/mar03/int958.pdf>.

130. Brief for the United States as Amicus Curiae Supporting Petitioners, *Beneficial Nat’l Bank v. Anderson*, 123 S. Ct. 990 (2003) (mem.) (No. 02-306), available at 2003 WL 1098993.

131. *Anderson v. H&R Block*, 287 F.3d 1038 (11th Cir. 2002).

132. Brief for Petitioners, *Beneficial Nat’l Bank* (No. 02-306), 2003 WL 1098993, at \*2.

133. *Id.* at \*7.



found a lack of congressional intent in the NBA for complete preemption of state law claims,<sup>134</sup> the OCC wrote that “[s]pecific congressional intent to make usury claims removable is not necessary because the removal statute itself evinces Congress’s intent to permit removal.”<sup>135</sup> Furthermore, the OCC argued that the exclusivity of the usury remedy in Section 86 of the NBA advances Congress’s intent in enacting the statute “to ensure a national banking system nationwide in scope and uniform in character that could not be disrupted by state legislation.”<sup>136</sup> While it is unclear what level of deference the Supreme Court may have given to the OCC, the agency’s amicus brief, advisory opinions, and interpretive rulings “constitute a body of experience and informed judgment” to which the Supreme Court and other courts look for guidance.<sup>137</sup> In the absence of congressional measures that explicitly and unambiguously foreclose preemption of state usury laws or prohibit national banks from partnering with payday lenders, both the courts and the OCC will continue to interpret the NBA to allow national banks to circumvent state consumer protection laws without any legal consequences.

#### IV. THE NEED FOR A FEDERAL INTEREST RATE CAP AND THE FAILURE OF THE FREE MARKET APPROACH

Any federal legislation regulating the payday loan industry should also include a usury provision that limits the interest rates that lenders can charge. In opposition to proposed interest rate caps, defenders of the payday loan industry argue that usury laws are overreaching and paternalistic.<sup>138</sup> The industry justifies the high interest rates on their loans as “proportional to the risk undertaken and the service provided” to borrowers who are ignored by traditional financial institutions.<sup>139</sup> Industry advocates also cite the low number of complaints<sup>140</sup> as evidence that consumers are happy with their product and should be left free to choose whether they want to pay the price for the goods and services offered by payday lenders.<sup>141</sup> This silence, however, may have little to do with cus-

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134. *Anderson*, 287 F.3d at 1041.

135. Brief for Petitioners, *Beneficial Nat'l Bank* (No. 02-306), 2003 WL 1098993, at \*27 (discussing 28 U.S.C. § 1441(b), the removal statute).

136. *Id.* at \*24.

137. *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944); *see also* Mitchell, *supra* note 124, at 6 (“The OCC’s opinions carry significant weight in the courts.”).

138. *See* James J. White, *The Usury Trompe L’Oeil*, 51 S.C. L. REV. 445, 466 (2000) (“Contrary to those who claim to befriend the impecunious consumer . . . I think even the poorest consumers are quite savvy. They understand the alternatives and make choices about borrowing that are wise for them even when the decisions seem foolish or wasteful to middle-class observers.”).

139. Schaaf, *supra* note 12, at 349.

140. *Id.*

141. *Id.*; *see also* Julia Nienaber, *The Cost of Cash; Potential Legislation of Payday Loans, or Advances on Pay Provided by Financial Service Companies*, ST. GOV’T NEWS, Jan. 1, 2001, at 28 (quoting one payday lender who says, “It takes an operator about seven good advance transactions to cover just one loss.”).

tomers satisfaction. In a 1999 report, the Illinois Department of Financial Institutions noted that some customers may not have known where to bring their complaints or may not have realized that a violation occurred.<sup>142</sup> The Woodstock Institute, a consumer advocate group, has also found “that many borrowers are embarrassed by their financial situation and reluctant to draw attention to their debt-related problems.”<sup>143</sup>

Industry advocates also argue that usury laws actually harm low-income borrowers by shrinking the availability of credit on the market and by increasing the number of borrowers who are unable to qualify for credit at or below the legal limit.<sup>144</sup> When the market rate for credit exceeds the ceiling, lenders have no incentive to lend because they make no profit or market return.<sup>145</sup> Furthermore, because lenders can no longer use the market interest rate to ration credit to those who are willing to pay the market price, lenders will maximize their profits by turning to “non-price rationing devices,”<sup>146</sup> such as contract terms (requiring larger loans, higher loan fees, higher down payments, shorter maturities) or borrower characteristics (wealth, income, risk, available collateral).<sup>147</sup> As a result, usury laws with low interest rate ceilings favor low-risk, wealthy borrowers and exclude borrowers who are noncompetitive.<sup>148</sup> If the credit market were left alone to regulate itself, then competition among payday lenders would benefit consumers and bring down the cost of their product.<sup>149</sup>

#### A. *Failure of Free Market to Lower Loan Prices*

In the case of payday loans, however, free market mechanisms fail to provide adequate protection to consumers. If the industry were correct about free market mechanisms protecting consumers, then the astounding proliferation of payday loan stores during the last decade should have lowered interest rates and fees on payday loans. Empirical evidence, however, shows that competition among payday loans stores has not given any bargaining leverage to consumers. In fact, the converse is true: competition among payday loan stores has actually exacerbated the problem of borrower delinquency because of excessive solicitation and overlending.<sup>150</sup> Deregulation of small loan rates and the

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142. Nienaber, *supra* note 141.

143. Letter to IDFI, *supra* note 25.

144. Steven W. Bender, *Rate Regulation at the Crossroads of Usury and Unconscionability: The Case for Regulating Abusive Commercial and Consumer Interest Rates Under the Unconscionability Standard*, 31 HOUS. L. REV. 721, 728–29 (1994).

145. See Mark Barry Riley, *Usury Legislation—Its Effects on the Economy and a Proposal for Reform*, 33 VAND. L. REV. 199, 212 (1980).

146. *Id.* at 213–14.

147. *Id.* at 214.

148. *Id.*

149. For an explanation of classic free-market theory as applied to the credit market, see Jarret C. Oeltjen, *Usury: Utilitarian or Useless?*, 3 FLA. ST. U. L. REV. 167, 222–31 (1975).

150. Drysdale & Keest, *supra* note 7, at 661.

increase in payday lenders have resulted in slightly increased loan rates.<sup>151</sup> In Colorado, a state where payday lenders operated for several years without an interest rate cap, the increase in the number of stores had little impact in bringing down the price of loans. From 1997 to 1998, the number of payday loan stores increased from 188 to 218, and the total number of loans increased by 55.9%.<sup>152</sup> During that same period, however, the average APR did not fluctuate.<sup>153</sup> Despite the increased volume of loans, competition did not result in lower interest rates for consumers.

In states where the interest rate cap was relaxed to encourage competition, the price of small loans did not go down, as predicted by fair market proponents. Instead, rates clustered at the cap set by state legislatures. When the Virginia General Assembly increased the statutory cap for loans of \$2500 or less from 31% to 36% APR, the rates went up to the new cap.<sup>154</sup> In a survey of thirteen states where payday lending is authorized, 15% of payday lenders quoted rates higher than allowed.<sup>155</sup> In those same states, an additional 38% of payday lenders quoted rates exactly at the allowable APR.<sup>156</sup> More than half (53%) of all payday lenders surveyed are either at or above the legal limit.<sup>157</sup> Without interest rates caps, consumers would have no protection against the opportunistic pricing of payday lenders.

### B. Theoretical Problems of Free Market Credit Regulation

There are also theoretical problems with the free market argument. In a perfect market, the forces of supply and demand might adequately regulate the price of goods and services; however, inherent imperfections in the credit market necessitate government intervention to ensure fair prices for consumers.<sup>158</sup> Payday lenders take advantage of the unequal bargaining power of the parties resulting from asymmetrical access to information and the absence of alternatives to the consumer.<sup>159</sup> While lenders have extensive knowledge about the credit market, the typical borrower targeted by payday lenders is unsophisticated about her credit options.<sup>160</sup> Because of the complex nature of the credit market, access to

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151. Fox Testimony, *supra* note 44, at 7.

152. *Id.*

153. *Id.*

154. *Id.*

155. RENT-A-BANK, *supra* note 24, at 13.

156. *Id.* at 14.

157. *Id.*

158. Fox Testimony, *supra* note 44, at 5.

159. See Drysdale & Keest, *supra* note 7, at 661–62; see also Fox Testimony, *supra* note 44, at 5.

160. See Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1280 (2002); see also Drysdale & Keest, *supra* note 7, at 626–37 (discussion of the profile of typical borrowers); *supra* Part I.B.

information is vital for the consumer to choose rationally among credit options.

Many payday lenders, however, have made comparison shopping difficult by withholding information from consumers. As discussed earlier, very few payday lenders disclose the annual percentage rates or finance charges on their loans.<sup>161</sup> The absence of other small loan alternatives also gives payday lenders more leverage over the consumers. People who borrow from payday lenders tend to be disconnected from mainstream credit sources and are unlikely to have had previous experience with legitimate lenders.<sup>162</sup> As a result, these consumers tend “to be convenience-driven, not price sensitive.”<sup>163</sup> This combination of informational asymmetries and market power disparities means that competition will not ensure consumers adequate protection.

### C. Using Interest Rate Caps to Prevent Recession

In addition to protecting individual consumers, usury laws also function as an important macroeconomic tool, preventing the destabilizing effects of consumer indebtedness by limiting the oversupply of credit to high risk borrowers. Society has an interest not only in protecting individual consumers, but also in controlling the aggregate effect of the oversupply of credit.<sup>164</sup> Recent studies indicate that consumers have the highest level of debt in U.S. history,<sup>165</sup> approaching one trillion dollars,<sup>166</sup> while employment opportunities have diminished.<sup>167</sup> At the same time, the deregulation of interest rates makes credit more readily available to borrowers who are more likely to default. The danger of large-scale default could trigger a recession. By shrinking the supply of credit, usury ceilings can mitigate the destabilizing effects that might contribute to recession.<sup>168</sup> Society's interest in indebtedness implicates policy matters that are best determined by the legislature, not the market. Federal legislation should include interest rate caps to structure the relationship between borrowers and lenders.

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161. See *supra* Part II.C.3.

162. See Engel & McCoy, *supra* note 160, at 1281 (stating that predatory lenders sometimes use census data to find neighborhoods with high percentages of people who may lack market sophistication).

163. Fox Testimony, *supra* note 44, at 7; see also Engel & McCoy, *supra* note 160, at 1297–98.

164. See Robin A. Morris, *Consumer Debt and Usury: A New Rationale for Usury*, 15 PEPP. L. REV. 151, 172 (1988) (arguing that usury laws, despite their anticompetitive effects, should be used as a macroeconomic tool that protects society from the destabilizing effects of consumer indebtedness).

165. *Id.* at 165–66.

166. *Id.* at 166.

167. *Id.* at 164.

168. *Id.* at 165–67.

## V. UNCONSCIONABILITY: AN INEFFECTIVE ALTERNATIVE TO INTEREST RATE CAPS

Some critics of usury laws sympathize with the goals of consumer protection, but argue that usury laws produce too many negative side effects on the market<sup>169</sup> and fail to ensure fairness to consumers.<sup>170</sup> The contract doctrine of unconscionability has been proposed as a middle ground between consumer advocates arguing for usury laws and lenders favoring a free market approach.<sup>171</sup> This section argues, however, that the uncertainty of unconscionability standards, the cost of litigation, the difficulty of succeeding on a claim, and the unique features of payday loans make the unconscionability approach an ineffective means of regulating the unfair practices of payday lenders.

### A. Defining Unconscionability

More than one scholar considers the doctrine of unconscionability one of the most important and widely debated areas in contract law.<sup>172</sup> Before its codification, unconscionability was recognized as a common law principle in courts of equity. The standards in U.C.C. § 2-302 have since been adopted in the Second Restatement of Contracts § 208 and in almost every state's uniform code governing consensual transactions.<sup>173</sup> U.C.C. § 2-302 reads, in part:

If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.<sup>174</sup>

The U.C.C. offers no clear definition of unconscionability, but gives some guidance in the Comments: “[T]he basic test is whether, in the light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the mak-

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169. See *supra* Part IV.

170. Bender, *supra* note 144, at 728 (“[A] fixed ceiling on rates doesn’t necessarily ensure fair bargains. Usury statutes impose an arbitrary cap on rates without regard to the operational costs of the particular lender, the degree of risk the individual borrower presents, or the borrower’s level of sophistication.”).

171. *Id.* at 725.

172. Marvin A. Chirelstein writes that “[t]he ‘unconscionability’ principle . . . has been discussed at greater length and with more intensity, I think, than any recent issue in the contracts field.” MARVIN A. CHIRELSTEIN, *CONTRACTS* 73 (2d ed. 1993). Karl Llewellyn, who is credited with the authorship of the codified version of the unconscionability doctrine in the Uniform Commercial Code § 2-302, describes this provision as “perhaps the most valuable section in the entire Code.” E. ALLAN FARNSWORTH, *CONTRACTS* § 4.28, at 324 (2d ed. 1990).

173. Bender, *supra* note 144, at 735.

174. U.C.C. § 2-302(1) (2001).

ing of the contract.”<sup>175</sup> Citing a precodification decision in *Williams v. Walker-Thomas Furniture Co.*,<sup>176</sup> courts have defined unconscionability as “an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party.”<sup>177</sup> Although U.C.C. § 2-302 governs only “transactions in goods,” it has also been applied by analogy to other kinds of contracts,<sup>178</sup> including loan agreements between lenders and borrowers.<sup>179</sup>

### B. Arguments for Unconscionability

#### 1. Resistant to Evasion by Lenders

Proponents of the unconscionability approach argue that usury laws should be repealed and replaced with unconscionability remedies. One of the purported advantages of using the unconscionability standard to regulate the credit market is that it is more resistant to evasion than usury laws. Usury regulations recognize a violation only when certain elements are present, which may include the existence of a loan, an obligation to repay principal, interest charged in excess of the allowed maximum, and usurious intent.<sup>180</sup> Lenders can restructure their transactions to avoid the narrow definitions of these elements. As discussed earlier, the payday loan industry is particularly adept at restructuring loans in order to escape state regulations.<sup>181</sup> A payday lender partnered with a nationally chartered bank can legally charge a triple-digit interest rate that exceeds the allowable state rate.<sup>182</sup> Even if a borrower can prove usurious intent, some courts have recognized this evasion of state law as technically legal.<sup>183</sup> Under an unconscionability regime, however, all terms of an agreement between payday lender and borrower would be subject to scrutiny because unconscionability operates in the realm of contract law.<sup>184</sup>

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175. *Id.* § 2-302(1) cmt. 1.

176. 350 F.2d 445 (D.C. Cir. 1965).

177. *Id.* at 449.

178. FARNSWORTH, *supra* note 172, § 4.28, at 552.

179. Bender, *supra* note 144, at 737.

180. *Id.* at 739 n.94.

181. See *supra* Part III.A (discussing rate exportation and preemption of state usury laws).

182. See *supra* Part III.A (discussing rent-a-bank arrangements).

183. See *Marquette Nat'l Bank v. First of Omaha Serv. Corp.*, 439 U.S. 299, 317–18 (1978); *supra* Part III.A; see also *Hudson v. ACE Cash Express, Inc.*, No. IP 01-1336-C H/S, 2002 WL 1205060, at \*4 (S.D. Ind. May 30, 2002) (finding that the lending arrangement between a payday lender and a national bank was lawful under the National Bank Act § 85 “even if the purpose of the arrangement was to avoid application of state usury laws”).

184. Bender, *supra* note 144, at 740.

## 2. *Flexibility and Fairness*

Another supposed advantage of applying the unconscionability standard to consumer credit loans is its flexibility. Usury laws impose an arbitrary cap on interest rates without regard to the operating costs of the loan, the risk incurred by the lender, and the sophistication of the individual borrower. In contrast, an unregulated credit market subject only to contract requirements of unconscionability, good faith, and fair dealing results in fairer results for both the lender and borrower. The lender extending a loan to a high-risk borrower can charge a competitive—albeit high—rate that is nonetheless fair. According to Professor Steven Bender, a supporter of the unconscionability standard, every borrower, no matter how credit risky, would have access to a fair rate that is justified by the circumstances of the loan.<sup>185</sup> This arrangement arguably would also benefit high-risk consumers who would otherwise borrow from illegal sources driven underground by usury laws.<sup>186</sup>

### C. *Problems with Unconscionability*

#### 1. *Uncertainty of Unconscionability Standard: Substantive vs. Procedural Unconscionability*

Subsequent courts and scholars have attempted to refine the definition in *Williams* by distinguishing between substantive and procedural unconscionability. Some courts have ruled that substantive unconscionability—“unreasonably unfair terms” in the form of an unfair price or outcome—is sufficient to invalidate a contract. Other courts have interpreted the *Williams* holding and the U.C.C. to require both substantive and procedural unconscionability—“the absence of meaningful choice” during the negotiation of contract terms. These courts would find that unfair price alone, absent proof of further bargaining misconduct or “bargaining naughtiness,”<sup>187</sup> does not meet the standard for unconscionability. Examples of procedural unconscionability include the use of fine print and convoluted language in the contract, one party’s lack of understanding, and unequal bargaining power.<sup>188</sup> The legislative history of U.C.C. § 2-302 does not provide a resolution to this debate.<sup>189</sup> Most courts applying § 2-302 interpret Comment 1 to permit a “sliding scale”

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185. *Id.* at 741.

186. *Id.*; see also Riley, *supra* note 145, at 213–14 (arguing that usury laws have a negative effect on high-risk borrowers by excluding them from the credit market).

187. FARNSWORTH, *supra* note 172, § 4.28, at 332 n.44 (citing a term coined by Arthur Leff).

188. *Id.* at 332–33.

189. Bender, *supra* note 144, at 748.

whereby an usually high degree of either kind of unconscionability may permit a lesser showing of the other.<sup>190</sup>

Most courts agree that procedural unconscionability is not enough.<sup>191</sup> But less clear is whether substantive unconscionability in the form of an unfair interest rate should invalidate a contract. Is unfair pricing on a loan enough to show unconscionability, or must a court also find procedural unfairness? The inherent uncertainty of the unconscionability standard makes this approach less desirable as a consumer remedy than a usury law that clearly prohibits excessive pricing on loans.

## 2. *Reliance on Subjective and Fact-Based Determinations*

A finding of unconscionability depends on the subjective determination of a judge, who applies the facts of each case to make a decision. This fact-based process of adjudication creates several problems and draws criticism from lenders, consumer advocates, and scholars. First of all, lenders decry the subjective nature of the unconscionability doctrine. The U.C.C. offers no clear definition of unconscionability, but rather allows the courts to consider a number of factors to determine if an agreement resulted in “unfair surprise.”<sup>192</sup> Lenders are subsequently left without objective standards that inform them in advance of litigation whether their loans are valid.<sup>193</sup> Bender himself admits that “[t]here is some truth to the accusation that the unconscionability standard is uncertain.”<sup>194</sup> Secondly, consumer advocates worry that expensive fact-based adjudication makes unconscionability claims inaccessible to most borrowers who want to bring a suit.<sup>195</sup> In order to get relief, a plaintiff who is already burdened with the cost of an unfair loan must then bear the costs of litigation. Finally, the adjudication and enforcement of unconscionability claims also have a larger societal effect by increasing the caseload of courts and the administrative costs of litigation.<sup>196</sup>

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190. See *id.* at 747; see also FARNSWORTH, *supra* note 172, § 4.28, at 334 & n.50 (“A court may weigh all elements of both substantive and procedural unconscionability, and conclude that the contract is unconscionable because of the overall imbalance.”).

191. See COST OF CREDIT, 2000 ed., *supra* note 125, § 11.7.2, at 533 & n.464 (citing cases in which courts found that procedural irregularities were insufficient to make a finding of unconscionability).

192. U.C.C. § 2-302 cmt. 1 (2001).

193. Bender, *supra* note 144, at 744.

194. *Id.*

195. *Id.* at 745; see also Engel & McCoy, *supra* note 160, at 1301; Morris, *supra* note 164, at 173–74.

196. See Riley, *supra* note 145, at 222 (“Each review of an agreement would require evidence, opinions as to reasonableness and market rate, and a hearing. This would be a significant addition to the caseload of already burdened judicial and administrative systems.”).



### 3. *Difficulty of Succeeding on Unconscionability Claims for Unfair Interest Rate Pricing*

The difficulty of succeeding under an unconscionability standard might have the possible effect of dampening the incentive to bring these lawsuits.<sup>197</sup> Although some consumers have successfully litigated claims against lenders,<sup>198</sup> courts have been reluctant to invalidate contracts solely on the basis of unfair pricing without some proof of additional bargaining misconduct.<sup>199</sup> There are several factors that explain this judicial reluctance. First, as one contracts scholar explains, a party can rarely claim the price term of an agreement as an unfair surprise.<sup>200</sup> In some cases, although not with payday loans, the price terms may be negotiable.<sup>201</sup> Secondly, if a court finds the price terms of a loan agreement unconscionable, the court cannot simply invalidate that clause and enforce the rest of the agreement. It must, rather, invalidate the entire contract, something that a court will decline to do in the absence of further showing of unfairness.<sup>202</sup> To the layperson, a triple-digit APR on a consumer loan would seem shocking enough to justify a finding of unconscionability. Indeed, under a usury regime, a lender who charges above the determined cap would commit a per se violation. Under an unconscionability standard, however, borrowers have prevailed only with respect to nonprice terms in loan contracts.<sup>203</sup> An unconscionability claim is better

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197. After a flurry of U.C.C. § 2-302 cases in the 1960s and 1970s, the number of cases has slowed down to a trickle. See Bender, *supra* note 144, at 761 & n.204 (quoting one commentator who speculates that this decrease may be attributed to “doctrinal disarray” from “confused judicial reasoning” in price unconscionability cases).

198. For examples of cases in which lenders succeeded on unconscionability claims against payday lenders, see *Jackson v. Check ‘N Go of Ill.*, 193 F.R.D. 544, 546 (N.D. Ill. 2000) (holding that unconscionability can be inferred from the “commercial unreasonableness” of the terms without a showing of “gross disparities in the bargaining positions or commercial experience of the parties”); *Donnelly v. Illini Cash Advance, Inc.*, No. 00 C094, 2000 WL 1161076, at \*2 (N.D. Ill. Aug. 16, 2000) (citing from and upholding ruling in *Jackson*). The above cases cited but distinguished a Seventh Circuit decision finding that the existence of substantive unconscionability alone did not result in an invalid contract. *The Original Great Am. Chocolate Chip Cookie Co. v. Siegel*, 970 F.2d 273, 281 (7th Cir. 1992) (“The presence of a commercially unreasonable term, in the sense of a term that no one in his right mind would have agreed to, can be relevant to drawing an inference of unconscionability but cannot be equated to it.”). Unlike the Illinois payday loan cases above, the plaintiffs in *Great American* were “not vulnerable consumers or helpless workers,” but “business people who bought a franchise.” *Id.* But see COST OF CREDIT, 2000 ed., *supra* note 125, at 535 & n.482 (providing examples of unsuccessful unconscionability challenges to interest rates).

199. See FARNSWORTH, *supra* note 172, § 4.28, at 329 (“Courts have been more reluctant to pass judgment on the fairness of the price term than to pass judgment on the fairness of a particular clause . . .”).

200. *Id.*

201. *Id.*

202. *Id.* at 329–30.

203. Engel & McCoy, *supra* note 160, at 1300.

sued to challenge a creditor's manipulation of noninterest rate terms that result in an unfair price.<sup>204</sup>

Judicial reluctance to find interest rate prices unconscionable can also be attributed to the difficulty of determining what a fair price might be. In the absence of U.C.C. guidance, the courts, in the words of Professor Bender, have "blunder[ed] through their analysis of substantive fairness"<sup>205</sup> without specifying what makes an interest rate unfair or excessive.<sup>206</sup> In determining a fair interest rate, a court may look at four factors: (1) the lender's costs in obtaining the money lent; (2) the lender's cost in making and administering the loan; (3) the risk of inflation; and (4) the risk of default.<sup>207</sup> An unconscionability claim of unfair interest rate pricing may be defeated by proof of commercial realities that justify the high price.<sup>208</sup> For payday lenders who traditionally serve high-risk borrowers, this proof is easy to produce.

Unconscionability claims should still be available to consumers as a way of challenging payday lenders. But the unconscionability standard should be applied in conjunction with federal and state usury laws. Even Professor Bender, an advocate for adopting an unconscionability standard, admits that "intense spot treatment" in the form of usury laws may be needed to regulate certain sectors of the credit market that are resistant to increased competition and bargaining equality.<sup>209</sup> Usury laws provide an objective standard for what constitutes an unconscionable interest rate. By relying on court intervention and leaving judges to decide when an interest rate is unconscionable, the judiciary starts to intrude on a legislative function. Although the U.C.C. does give the court discretion to invalidate an unconscionable contract,<sup>210</sup> the lack of objective standards invites the courts to overreach into policy considerations that should be determined by the legislature. On the other hand, a federal payday loan statute with an interest rate cap enacted by Congress would provide an objective standard on which all parties to an agreement could base their expectations.

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204. COST OF CREDIT, 2000 ed., *supra* note 125, at 536. In most cases in which courts find price unconscionability, other elements of unconscionability are also present. See FARNSWORTH, *supra* note 172, § 4.28, at 330 n.34.

205. Bender, *supra* note 144, at 774.

206. *Id.* at 774 & n.270 (citing cases in which courts found interest rates unconscionable or oppressive without explanation).

207. *Id.* at 774-75.

208. See Bender, *supra* note 144, at 776-77; Engel & McCoy, *supra* note 160, at 1301.

209. Bender, *supra* note 144, at 807-08.

210. U.C.C. § 2-302 cmt. 2 (2001) ("Under this section the court, in its discretion, may refuse to enforce the contract as a whole if it is permeated by the unconscionability . . .").

## VI. RECOMMENDATIONS

### A. *Proposed Features of a Federal Payday Loan Statute*

The existing patchwork of state and federal laws has failed to curtail the exploitative practices of payday lenders. In order to provide uniform protection to consumers, Congress should pass a federal Payday Loan Statute that addresses some of the more serious problems of payday loans. Any proposed legislation should include the following features:

- Measures that prohibit or limit the practices of payday lenders that perpetuate borrower indebtedness. Specifically, the statute should limit or prohibit the number of rollovers. Also, it should impose a minimum term of no less than two weeks for each \$50 owed on the loan. If a borrower takes out a \$100 loan, for example, then she would be given four weeks to repay the loan. Consumers should also be permitted to make partial payments at any time without charge.
- A limit on the total amount a customer can borrow.
- Disclosure requirements that codify elements of the TILA.
- A provision that closes the preemption loophole in the NBA by prohibiting national banks from making payday loans or partnering with affiliates who make payday loans.
- A federal interest rate ceiling.
- Language that provides for a private right of action and makes lenders liable to the consumer for damages and attorney fees. Without the threat of civil liability, lenders have no incentive to comply with the provisions of the statute.

Passage of federal payday loan legislation will not be easy. Two bills previously introduced in Congress,<sup>211</sup> vigorously contested by the banking industry and by a Republican-controlled Congress,<sup>212</sup> failed to secure enough votes for passage. Consumers might have to wait for power to change hands in Congress before seeing the passage of a payday loan statute that protects their interests.

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211. On March 15, 2001, Representative John LaFalce of New York, senior Democrat on the House Financial Services Committee, introduced H.R. 1055. Also known as the Federal Payday Loan Consumer Protection Amendments of 2001, the proposed legislation would have prohibited all federally insured banks from making payday loans either directly or through an affiliate. H.R. 1055, 107th Cong. (1st Sess. 2001); *see also* Johnson, *supra* note 33, at 134. Representative Bobby Rush of Illinois also introduced H.R. 1319, entitled the Payday Borrower Protection Act. The bill's provisions included a \$300 maximum loan amount and an interest rate cap of 36% APR. H.R. 1319, 107th Cong. (1st Sess. 2001); *see also* Johnson, *supra* note 33, at 134.

212. Johnson, *supra* note 33, at 134 ("While LaFalce has strong support from other Democrats, a bill that completely bans payday lending in the hands of a Republican-controlled committee is not politically viable.").

### B. *Creating Alternatives to Payday Loans*

#### 1. *Enforce Community Reinvestment Act to Increase Participation of Banks*

In the meantime, the federal government should take the lead in creating incentives for mainstream banks to conduct business in low-income areas so that borrowers will not have to rely on payday lenders. One way of doing this is through more stringent enforcement of the Community Reinvestment Act (CRA). Enacted by Congress in 1977, the CRA requires federally insured financial institutions “to demonstrate that their deposit facilities serve the convenience and needs of the communities in which they are chartered to do business.”<sup>213</sup> More specifically, the CRA’s purpose is to require banks to meet the credit needs of all segments of the community in which they are chartered, low-income and wealthy alike.<sup>214</sup> Depending on the type of bank, one of four regulatory agencies conducts CRA exams to make sure that financial institutions are complying with the law.<sup>215</sup>

Banks are examined by three criteria: (1) the lending test, which looks at the number and dollar amount of loans, the amount of lending in the assessment area, the geographic distribution of loans to borrowers of different income groups, and community development lending; (2) the service test, which looks at the effectiveness of bank marketing and technical support provided to communities; and (3) the investment test, which looks at grants and investments to community organizations for affordable housing, economic development, and other community projects.<sup>216</sup> Based on these criteria, a bank receives an overall rating of “Outstanding,” “Satisfactory,” “Needs Improvement,” or “Substantial Non-Compliance.”<sup>217</sup> Banks have two incentives for complying. If a bank receives a favorable rating, then it will not be evaluated as often.<sup>218</sup> Furthermore, an agency may use a poor CRA rating to reject a bank’s application to expand its business or merge with another bank.<sup>219</sup>

Partnerships with payday lenders should be a factor that lowers a bank’s CRA score. Agency enforcement of the CRA has been inconsistent and ineffectual. In 1999, the OTS placed Crusade Bank under regulatory supervision for offering payday loans and other risky loan prod-

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213. 12 U.S.C. § 2901(a)(1) (2003).

214. See Rand, *supra* note 37, at 71.

215. The Federal Reserve regulates state-chartered banks that are members of the Federal Reserve System. The Federal Deposit Insurance Corporation (FDIC) regulates state-chartered banks and saving banks that are not members of the Federal Reserve System. The Office of Thrift Supervision (OTS) regulates savings associations whose deposits are insured by the FDIC. The Office of the Comptroller of Currency (OCC) regulates national banks. NAT’L CTR. ON POVERTY LAW, CRA AND SUSTAINABILITY 3 (2002) (on file with author).

216. *Id.* at 4.

217. *Id.* at 5.

218. *Id.*

219. *Id.*

ucts through National Cash Advance.<sup>220</sup> In 2000, the OTS gave Crusade Bank a “needs to improve” rating.<sup>221</sup> At the same time, the OCC gave Eagle National Bank a “satisfactory” rating, despite comments filed by national consumer organizations protesting Eagle’s partnership with the payday lender Dollar Financial.<sup>222</sup> In its examination of Eagle, the OCC only considered the bank’s activities in four counties surrounding its Illinois headquarters, ignoring the 250 locations where Dollar offers payday loans in low-income neighborhoods.<sup>223</sup> In order to discourage further manipulation of the CRA, federal regulators should downgrade scores for banks that offer payday loans through any of their locations or affiliates. Failure to do so will erode the remedial purposes for which the CRA was enacted.

## 2. *Encourage Bank Accounts for the Unbanked*

In addition to imposing penalties on banks that fail to comply with the CRA, Congress and regulatory agencies should also create positive incentives for banks to extend their services to individuals without bank accounts. Increased access to banks is a crucial step in moving lower-income individuals into the financial mainstream and away from reliance on payday lenders. The federal government should work with local groups to convince banks that offering financial services to unbanked individuals is a profitable endeavor. Over the last twenty-two years, CRA agreements between community organizations and banks have created over one trillion dollars of investments by banks in low-income and minority communities.<sup>224</sup> Financial institutions that offer products tailored to the unbanked have met with success rather than losses or excessively risky activity as predicted by critics.<sup>225</sup> In one year, Bank One’s Alternative Banking Program opened one thousand checking accounts and over five hundred savings accounts for unbanked families in only six Chicago neighborhoods.<sup>226</sup> The program enjoys a retention rate of over eighty percent.<sup>227</sup> All of these account holders would have been ineligible for traditional Bank One accounts because of insufficient credit histories.<sup>228</sup> By offering services to the unbanked, financial institutions not only improve their CRA scores, but also profit from an untapped market eager for their products.

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220. RENT-A-BANK, *supra* note 24, at 24.

221. *Id.*

222. *Id.*

223. Mitchell, *supra* note 124, at 10.

224. Rand, *supra* note 37, at 71.

225. See Michael S. Barr, *Access to Financial Services in the 21st Century: Five Opportunities for the Bush Administration and the 107th Congress*, 16 NOTRE DAME J.L. ETHICS & PUB. POL’Y 447, 450 (2002).

226. *Id.* at 463.

227. *Id.*

228. *Id.*

### 3. *Encourage Asset Accumulation and Savings Through IDAs*

Finally, the federal government should continue to provide funding for Individual Development Accounts (IDA) to help break the cycle of poverty and debt that makes individuals vulnerable to payday lenders. IDA programs set up savings accounts for participants at local banks and financial institutions.<sup>229</sup> Every dollar deposited by participants is matched by government and private funds.<sup>230</sup> After completing a financial education component, which includes regular attendance at classes and meetings with credit counselors,<sup>231</sup> participants can use their matched funds toward the purchase of a home, postsecondary education, small business capitalization, or some other approved asset.<sup>232</sup>

By focusing on asset accumulation rather than short-term cash needs, IDAs address the underlying conditions that create reliance on payday cash outlets and other predatory lenders.<sup>233</sup> The purchase of a home or small business enables participants to enter the financial mainstream as self-sufficient investors, not consumers.<sup>234</sup> Furthermore, assets provide a financial foundation that makes people less vulnerable to emergencies.<sup>235</sup> Finally, the financial literacy component teaches participants how to save and manage money to avoid living from paycheck to paycheck.<sup>236</sup>

In 1998, Congress passed the Assets for Independence Act (AFIA),<sup>237</sup> which authorized the U.S. Department of Health and Human Services to administer a \$125,000,000 IDA demonstration project over five years.<sup>238</sup> The money goes directly to nonprofit organizations that

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229. See Ctr. for Soc. Dev., IDAs, at [http://gwbweb.wustl.edu/csd/Areas\\_work/Asset\\_building/IDAs/index.htm](http://gwbweb.wustl.edu/csd/Areas_work/Asset_building/IDAs/index.htm) (last visited Apr. 23, 2004).

230. *Id.*

231. *Id.*

232. *Id.* For more background on IDAs, see the website for the Corporation for Enterprise Development at <http://www.cfed.org>.

233. See Ctr. for Soc. Dev., *supra* note 229 (“Information about repairing credit, reducing expenditures, applying for the Earned Income Tax Credit, avoiding predatory lenders, and accessing financial services helps IDA participants to reach savings goals and to integrate themselves into the mainstream economic system.”).

234. *Id.*

235. *Id.*

236. For a detailed discussion of the policy rationale behind IDAs, see MICHAEL SHERRADEN, *ASSETS AND THE POOR: A NEW AMERICAN WELFARE POLICY* (1991). The idea for IDAs was first proposed by Sherraden, director of the Center for Social Development at Washington University, St. Louis. For biographical information on Sherraden, see <http://gwbweb.wustl.edu/people/fac/sherraden.html>. See also Barr, *supra* note 225, at 469–73 (recommending an expansion of IDA programs to combat predatory lending); Tom Riley, *Individual Development Accounts: Downpayments on the American Dream*, *PHILANTHROPY MAG.*, Jan./Feb. 1999, <http://www.philanthropyroundtable.org/magazines/1999/january/riley.html> (last visited Apr. 23, 2004) (explaining advantages and components of IDA programs).

237. Assets for Independence Act, Pub. L. No. 105-285 §§ 401–416, 112 Stat. 2702, 2759–72 (1998) (codified as amended at 42 U.S.C. § 604 note (2000)).

238. See *id.* §§ 405, 411, 416, 112 Stat. at 2764–65, 2769, 2772.

administer IDA programs.<sup>239</sup> Since AFIA's inception, the Department of Health and Human Services has funded 123 programs in forty-one states.<sup>240</sup> At the end of September 2001, grantees reported a total of 151 first homes purchased, 126 small businesses capitalized, and 128 withdrawals for postsecondary education.<sup>241</sup> IDAs have enjoyed bipartisan support, both in state legislatures and in Congress.<sup>242</sup> At least twenty-six states have authorized IDA programs, with legislation pending in five states.<sup>243</sup> Given the early successes of IDAs, the federal government should continue to support policies that expand IDAs.

## VII. CONCLUSION

Payday lenders have established a pattern of exploiting unwary consumers and using legal subterfuge to dodge state laws. Despite the aggressive and explosive growth of the industry, competition among lenders has not resulted in fairer prices for consumers because of the absence of credit alternatives. The unconscionability doctrine has not provided adequate protection to consumers because of the vagueness of the standard and the cost of litigating cases in court. The industry's use of aggressive tactics to evade state regulation makes state interest rate caps useless. Federal agencies regulating financial institutions have consistently sided with the banking industry.

For these reasons, Congress needs to take the lead in regulating the payday loan industry by passing legislation that imposes a federal interest rate cap on payday loans, closes the loophole that allows preemption of state laws, and prohibits rollovers and other practices that perpetuate indebtedness. By passing a federal payday loan statute and creating policy initiatives that make mainstream financial institutions and credit sources more accessible to lower-income individuals, Congress can show that it listens not to the demands of the powerful and vocal banking industry, but to the needs of ordinary citizens like Pat Sanson struggling to pay their bills.

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239. Partnership Accounts for Individual Development (PAID), a nonprofit group based in Champaign, Illinois, is a recipient of AFIA funds. Since the program's inception in 2001, fifty participants have successfully graduated and purchased their desired asset. Telephone Interview with Sarah Lee, Program Director, PAID (Nov. 20, 2003).

240. Admin. for Children & Families, Program Overview: Individual Development Accounts (Assets for Independence Demonstration Program), at <http://www.acf.hhs.gov/programs/ocs/demo/ida/background.html> (last visited Apr. 23, 2004).

241. *Id.*

242. See William Bole, *Researchers Prove IDAs, Adopted by Gore, Bush Actually Yield Savings*, WELFARE TO WORK, July 24, 2000, [http://gwbweb.wustl.edu/csd/Areas\\_Work/Asset\\_building/News\\_articles/researchersprove.html](http://gwbweb.wustl.edu/csd/Areas_Work/Asset_building/News_articles/researchersprove.html) (last visited Apr. 23, 2003).

243. Corp. for Enter. Dev., Individual Development Accounts: A Tool for Building Savings and Wealth, <http://www.cfed.org/main/indivAssets/BuildingTool.htm> (last visited Apr. 23, 2004).

