TESTING THE SUBSTITUTION HYPOTHESIS: WOULD CREDIT CARD REGULATIONS FORCE LOW-INCOME BORROWERS INTO LESS DESIRABLE LENDING ALTERNATIVES?

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One of the strongest arguments against regulating credit cards is the substitution hypothesis, which states that if a restriction on one form of credit limits access to credit, borrowers will respond by using other, less desirable forms of credit. For low-income consumers, the argument is more powerful still, because their other options are high-cost lenders such as pawn shops and rent-to-own stores. But the substitution hypothesis is more frequently assumed than investigated, and prior empirical research does not support the theory as strongly as has been supposed. The theory is based on a naïve presumption about the constancy of demand for consumer credit and fails to account for a more nuanced view of the role of credit supply. This Article presents original data from a study of low-income women. The findings suggest that lenders, such as pawn shops and rent-to-own stores, may function as complements more than substitutes. In addition, the research uncovered another form of credit that low-income families routinely use and participants evaluated favorably, but that has never been discussed in the academic literature. These findings suggest a more nuanced formulation of the hypothesis that better predicts the consequences of credit card regulation.

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I. INTRODUCTION

As consumer credit card debt continues to soar,[1] a rich variety of proposals to reverse this trend has emerged. These proposals include re-imposing usury caps (i.e., limits on how much interest lenders may charge),[2] prohibiting lenders from collecting on high-interest loans in bankruptcy,[3] mandating that penalty fees reasonably reflect issuers' costs,[4] and increasing fines and providing a private right of action for vi-

1. American households now hold an average of approximately $9,300 worth of credit card debt. *Examining the Billing, Marketing, and Disclosure Practices of the Credit Card Industry, and Their Impact on Consumers: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (2007) (statement of Sen. Christopher Dodd, Chairman, S. Comm. on Banking, Housing, and Urban Affairs), *available at* http://dodd.senate.gov/index.php?q=node/3718/print.

2. ELIZABETH WARREN & AMELIA WARREN TYAGI, THE TWO-INCOME TRAP: WHY MIDDLE CLASS PARENTS ARE GOING BROKE 144–52 (2003).

3. Credit Card Accountability Responsibility and Disclosure Act of 2005, S. 499, 109th Cong. § 311 (2005). This legislation would bar the collection in bankruptcy of loans with interest rates more than 20 percentage points above the federal prime lending rate.

4. Credit Card Reform Act of 2006, S. 2655, 109th Cong. § 3 (2006).

olations of the Truth in Lending Act.[5] Despite major differences among these recommendations, they all must overcome a common counterargument: the substitution of credit hypothesis. According to this hypothesis, any proposal that affects access to credit cards would be counterproductive because people will respond by increasing their use of other, often more dangerous, forms of credit.[6]

The hypothesis is particularly powerful in the context of low-income borrowers. Because they exist on the margins of creditworthiness, any decrease in overall access to credit cards would affect them most dramatically. Moreover, they lack mainstream borrowing alternatives, such as low-cost home equity credit. According to the substitution hypothesis, low-income borrowers would respond to a decrease in credit card availability by increasing their use of even less desirable lenders, such as pawnbrokers and rent-to-own stores.[7] These arguments have been directed primarily at proposals to reinstate usury caps,[8] but any proposal to regulate credit cards must contend with the assertion that the substitution of credit will lead to unintended consequences.

There are two factual contentions implicit in the substitution hypothesis, both of which must be true for the argument to succeed. First, the different kinds of borrowing must, in fact, be interchangeable with one another. There must be some causal relationship such that when use of credit cards decreases, use of other borrowing increases. Second, there must be borrowing options that are "worse" than credit cards. If there is no form of borrowing less desirable than credit cards, it follows that regulation decreasing access to credit cards will not lead low-income people to use less desirable borrowing. The literature to date has focused narrowly on the first premise to the exclusion of the second. Several studies have attempted to demonstrate a relationship between credit card regulation and increases in other types of borrowing, but there has been minimal exploration of the implications of such a shift. One reason for this neglect may be that credit cards are seen as a middle-class form

5. *Examining the Billing, Marketing, and Disclosure Practices of the Credit Card Industry, and Their Impact on Consumers: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (2007) (statement of Travis B. Plunkett, Legislative Director, Consumer Federation of America), *available at* http://www.consumerfed.org/pdfs/Credit_Card_Senate_Testimony_01-07.pdf.

6. Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAP. L. REV. 79, 96 (2000) (arguing that under a legal regime with usury caps on credit cards, "credit card issuers would have fewer customers and pawn shops and rent-to-owns would have more").

7. *See, e.g.*, Timothy J. Muris, *Payment Card Regulation and the (Mis)Application of the Economics of Two-Sided Markets*, 2005 COLUM. BUS. L. REV. 515, 527 ("The growth in credit card credit appears to have resulted primarily from the substitution of cards for alternative, less attractive forms of credit. For instance, many consumers who cannot obtain unsecured credit through credit cards are instead forced to rely on pawn shops and payday lenders."); Zywicki, *supra* note 6, at 83 ("[T]hese policies could have dramatic negative consequences for vulnerable low-income consumers who lack the borrowing options of wealthier individuals and as a result may be driven back into the hands of pawnbrokers, rent-to-own financiers, and loan sharks who flourished prior to the deregulation of the credit card market.").

8. Zywicki, *supra* note 6, at 96.

of borrowing and, thus, are assumed to be less exploitive than credit products aimed primarily at the poor.[9]

But these contentions have been oversimplified in the previous research. Researchers tend to focus on whether substitution occurs at all instead of measuring the extent to which it occurs. The literature frequently presumes that any substitution of credit card borrowing for other forms of borrowing indicates that there is complete substitution between them,[10] without exploring whether they are fully, extensively, or only minimally interchangeable. Correctly framing the interchangeability prong of the hypothesis as a question of degree crystallizes the importance of analyzing the harm of any potential substitution. The hypothesis becomes a cost-benefit test, weighing the harm the regulation is designed to prevent on one side of the scale with the predicted level of harm caused by the expected degree of substitution on the other.

This Article uses original data from a small study of low-income, female consumers as a way of exploring these two interrelated questions with more precision. The study analyzed participants' borrowing histories to assess the degree to which they use different borrowing types as substitutes or complements. It also examined the borrowing use of participants who were unable to obtain their desired level of credit card credit, analyzing whether they used other types of credit more often than their unconstrained counterparts. The current study not only found a low degree of substitution, but also uncovered two reasons why this was the case. First, credit cards offer low-income borrowers significantly more total credit than they can obtain from their other credit options. Although a decrease in the supply of credit from credit cards might result in some increase in borrowing from lenders such as pawn shops and rent-to-own stores, the small-scale nature of these credit sources would prevent them from completely filling the gap. Second, credit cards in and of themselves may serve as spending stimuli, triggering consumers to spend more than they otherwise would. In the case of low-income consumers, whose budgets are already stretched thin, spending more almost necessarily means borrowing more. These findings suggest a need for more research before scholars can draw definitive conclusions about the interchangeability presumption.

The study also asked participants to compare their credit options along two measures and found that the movement of low-income consumers away from credit cards and toward traditionally stigmatized lenders, such as pawn shops and rent-to-own stores, may have fewer negative consequences than the exclusive focus on interchangeability suggests. According to the study, credit cards were among participants' least preferred forms of borrowing. Participants gave rent-to-own stores and credit cards the poorest evaluations, citing how easy it was to lose control

9. *See* discussion *infra* Part IV.A.
10. *See* discussion *infra* Part III.A.

over credit card borrowing and accumulate unmanageable debt.[11] They evaluated pawn shops slightly more positively and gave even more favorable evaluations to a form of credit that is virtually unheard of in the literature: borrowing from mail order catalogs.[12] Participants also judged informal borrowing from friends and family quite positively. The study does have one major limitation: all participants lived in Massachusetts, which effectively prohibits payday lending through its usury statute.[13] Thus, the study was unable to provide data on payday lending.[14]

These results suggest that even if low-income borrowers shifted from credit cards to other options, it would not have the degree of negative consequences previously assumed. If the regulation that caused such a shift provided real benefits to those who continued to use credit cards, these benefits may outweigh the harm caused by substitution. Of course, one small study cannot provide enough information to weigh these costs and benefits precisely, but the low degree of substitution and negative evaluations of credit cards found in the current study indicate that the likelihood of a regulation-favorable balance is high enough to merit further study.

Part II of this Article provides a brief overview of the study's methodology. Part III discusses the interchangeability presumption of the substitution hypothesis. It reviews the empirical literature to date and presents the interchangeability results of the current study in that context. Part IV analyzes what is known about the subjective preferences of low-income borrowers. It reviews the sparse literature on the topic and uses data from the current study to provide a more nuanced analysis, demonstrating that the degree of harm that substitution may cause is, at best, unproven. This Part also explores the product features that low-income consumers evaluate when making borrowing decisions. It argues that the fringe lending products appear to compete more on nonprice attributes than on price, suggesting that regulation that leads credit card issuers to increase interest rates would not necessarily trigger substitution. Part V concludes by arguing that questions of consumer protection should not be avoided on the basis of the largely untested substitution hypothesis.

11. *See* discussion *infra* Part III.C.

12. *See* discussion *infra* Part III.C.

13. MASS. GEN. LAWS ch. 271, § 49 (1971); *see also* Press Release, Commonwealth of Mass. Office of Consumer Affairs & Bus. Regulation, State Orders More Payday Lenders to Cease Activity in Mass.: Unlicensed Lenders Typically Charge Illegal Fees and Interest Rates (May 26, 2006), *available at* http://www.mass.gov/?pageID=pressreleases&agId=Eoca&prModName=ocapressrelease&prFile=06_05_30_lenders.xml. Indeed, only the two participants who mentioned having lived in another state for a substantial period of time had even heard of payday lending.

14. In future research, I plan to study families in jurisdictions with a variety of borrowing regimes.

II. METHODOLOGY

The availability of credit cards to low-income people has exploded in the decades since deregulation.[15] According to the substitution hypothesis, one of the major advantages of this development is that the ability of low-income people to borrow from credit card companies has enabled them to decrease their use of less desirable forms of credit available in what is known as the "fringe banking" or "alternative" credit market.[16] The present study sought to unpack this theory and examine the workings of the substitution hypothesis from the viewpoint of low-income credit consumers.

Fifty low-income women were interviewed for the study. Participants qualified as "low-income" on the basis of eligibility for government-subsidized housing. I sampled only women because the financial pressures experienced by low-income families raising children increase the stakes of their borrowing decisions. Women at this income level are also significantly more likely than men to be raising children.[17] The study paid participants twenty dollars and recorded the interviews on a digital voice recorder. The recordings were transcribed by a professional service.

The study employed a snowball sample, an established method for surveying populations that may be hard to reach through randomized techniques.[18] To conduct a snowball sample, the researcher begins by in-

15. *See* David A. Moss & Gibbs A. Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, 73 AM. BANKR. L.J. 311, 333–37 (1999) (describing the expansion of credit card availability for low- and moderate-income borrowers over the past two and half decades).

16. John Caskey popularized the term "fringe banking" in JOHN P. CASKEY, FRINGE BANKING: CHECK-CASHING OUTLETS, PAWNSHOPS AND THE POOR 1 (1994). Michael Barr uses the term "alternative credit." Michael S. Barr, *Banking the Poor*, 21 YALE J. ON REG. 121, 124 (2004).

17. Creola Johnson, *Payday Loans: Shrewd Business or Predatory Lending?*, 87 MINN. L. REV. 1, 100 n.531 (2002); Sandra J. Newman, *The Implications of Current Welfare Reform Proposals for the Housing Assistance System*, 22 FORDHAM URB. L.J. 1231, 1235 (1995).

18. *See, e.g.*, Jean Faugier & Mary Sargeant, *Sampling Hard to Reach Populations*, 26 J. ADVANCED NURSING 790, 792 (1997); Sarah H. Ramsey & Robert F. Kelly, *Using Social Science Research in Family Law Analysis and Formation: Problems and Prospects*, 3 S. CAL. INTERDISC. L.J. 631, 643 (1994). For examples of research using snowball samples to study legal issues, see José B. Ashford, *Comparing the Effects of Judicial Versus Child Protective Service Relationships on Parental Attitudes in the Juvenile Dependency Process*, 16 RES. ON SOC. WORK PRAC. 582, 584–86 (2006) (using a "convenience sample" of forty to study the effect of judicial and case-worker relationships on perceptions of fairness by parents in the child-protective services process); Elizabeth Chambliss & David B. Wilkins, *The Emerging Role of Ethics Advisors, General Counsel, and Other Compliance Specialists in Large Law Firms*, 44 ARIZ. L. REV. 559, 561 (2002) (investigating "the emerging role of compliance specialists in large law firms" using a snowball sample); Mariano-Florentino Cuéllar, *Refugee Security and the Organizational Logic of Legal Mandates*, 37 GEO. J. INT'L L. 583, 586 n.6 (2006) (using a snowball sample to obtain one of three sets of interviews on "the legal, political, and bureaucratic dynamics affecting refugees' physical security"); Rosanna Hertz, *The Contemporary Myth of Choice*, 596 ANNALS AM. ACAD. POL. & SOC. SCI. 232, 243 n.1 (2004) (reviewing a study in which researcher Phyllis Moen located, through a snowball sample, women who left full-time careers to raise children (citing PHYLLIS MOEN, IT'S ABOUT TIME: COUPLES AND CAREERS (2003))). The difficulty and expense of reaching low-income populations for empirical work is well documented. *E.g.*, Michael S. Barr, Detroit Area Study on Financial Services (Overview), http://www-personal.umich.edu/~msbarr/ (follow "Detroit Area Study" hyperlink; then "Detroit Area Sudy on Financial Services (Overview)" hyper-

terviewing one person or a small group of people who meet the study criteria.[19] Those initial participants are then asked to refer the researcher to other people who may be interested until the desired sample size is reached. Snowball samples are particularly appropriate for qualitative studies, which is how this project began.[20] It was only after the data had been collected and coded that the substitution trends began to emerge. The use of a snowball sample means that my quantitative analysis is necessarily preliminary. I plan to use these results as the basis for developing a larger, randomized sample in future research.

The first section of the interviews elicited information on demographics and financial resources. The study then took comprehensive credit histories regarding each form of borrowing participants had used. The final section of the interviews asked participants to evaluate their credit options and the policies that regulated them.[21] Transcripts were coded and analyzed using content analysis, a standard technique for parsing qualitative data.[22]

III. THE INTERCHANGEABILITY OF CREDIT CARDS AND OTHER FORMS OF BORROWING

A. *Prior Empirical Research*

Almost universally, commentators seeking to understand substitution have focused on the interchangeability prong of the hypothesis. These researchers have studied how other forms of borrowing are used when credit card borrowing is constricted.

Researchers use three basic study designs to assess this element of the hypothesis: time-series, regulatory, and borrowing history. The time-series designs examine how types of non–credit card borrowing have evolved in the face of the explosive growth of credit card borrowing over the past several decades.[23] The argument behind these studies is that if a decrease in other forms of borrowing accompanied this tremendous growth in credit card borrowing, then consumers must have switched to credit cards as their popularity grew.[24]

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link) (last visited Feb. 12, 2009) (summarizing the work done in an ongoing empirical study conducted for the University of Michigan's Institute for Social Research, Survey Research Center).

19. I knew twelve population members from previous work in the community.

20. *See* Angela Littwin, *Beyond Usury: A Study of Credit-Card Use and Preference Among Low-Income Consumers*, 86 TEX. L. REV 451, 456–57 (2008).

21. For a detailed discussion of the study methods and a description of the samples, please see the *Appendix on Methodology* in the companion piece to the article. *Id.*

22. *See generally* KLAUS KRIPPENDORFF, CONTENT ANALYSIS: AN INTRODUCTION TO ITS METHODOLOGY (2d ed. 2004); ROBERT PHILIP WEBER, BASIC CONTENT ANALYSIS 9 (2d ed. 1990).

23. For data on the increase in credit card borrowing, see Edward J. Bird et al., *Credit Card Debts of the Poor: High and Rising*, 18 J. POL'Y ANALYSIS & MGMT. 125, 128 tbl.1 (1999); Moss & Johnson, *supra* note 15, at 334.

24. *See infra* Part III.A.1.

The regulation-based studies take advantage of the "laboratory of the states,"[25] or in one case, the laboratory of the countries,[26] to examine consumer use of non–credit card borrowing when credit card borrowing is constricted by statute. The authors of these studies argue that if tighter restrictions on credit card borrowing are correlated with increased use of borrowing unrestricted by statute, then consumers must be substituting one form of borrowing for the other.[27]

Borrowing-history study designs examine the degree of substitution that occurs on the individual-consumer level.[28] These studies ask whether consumers who borrow with credit cards tend to use other kinds of borrowing more or less than those who do not.[29] The argument is that if credit card borrowing and other borrowing tend to correlate inversely, then consumers are more likely to be using them as substitutes.[30] If instead, consumers who borrow with credit cards tend to use other borrowing types more, then the different borrowing types tend to be complements more than substitutes. The current study offers new data on the interchangeability prong of the substitution hypothesis using this methodology.

Although researchers have focused almost exclusively on the interchangeability prong of the substitution hypothesis, the results have been inconclusive. Many of the individual studies have methodological difficulties, discussed below, that make their specific conclusions problematic. More profoundly, past research has tended to view substitution as an "on or off" proposition; either it exists or it does not. It has not asked *how much* of a substitution effect occurred.

In addition, previous studies have not assessed the predictive power of their findings. The importance of the substitution hypothesis lies in its accuracy as a prediction. It is based on policymakers' need to know how much substitution would occur if they imposed restrictions on credit card borrowing. But researchers have not assessed the likelihood that their results are applicable to potential future regulation. This type of work needs to be undertaken.

1. *Time-Series Studies*

Most of the time-series research relies on national-level data, either from the Survey of Consumer Finances (SCF) or aggregate numbers the Federal Reserve collects in its supervisory capacity. The SCF is a tri-

25. New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).
26. *See infra* note 84.
27. Richard L. Peterson, *Usury Laws and Consumer Credit: A Note*, 38 J. FIN. 1299, 1299 (1983).
28. Michael Barr et al., *Consumer Indebtedness in the Alternative Financial Services Market: Payday Loans and Other Sources of Consumer Credit* (U. Mich. Law, Working Paper, Apr. 2007) (on file with the University of Illinois Law Review).
29. *Id.*
30. *Id.*

ennial, publicly available household survey that the Federal Reserve has conducted since 1962.[31] The aggregate data come from various statistical releases the Federal Reserve collates from loan-volume data submitted by banks and other lending institutions.[32]

There are trade-offs between using survey data and aggregate statistics. The SCF has been criticized as underreporting debt.[33] In order to facilitate ease of administration, the survey relies on self-reporting of financial variables.[34] This presents a high risk of underreporting, both because credit statements can be complex and because study respondents tend to underreport negative or stigmatized information.[35]

Indeed, the adjusted level of debt found by the recent versions of the SCF is lower than that reported by the Federal Reserve's aggregate measures, such as Federal Reserve Release G.19[36] and the federal Flow of Funds Accounts (FFA).[37] These measures are based on lender records rather than borrower estimates, so they are unlikely to suffer from underreporting.[38] Researchers have not been able to definitively conclude which measures of consumer debt are too high and which are too low.[39]

31. SCF home page, http://www.federalreserve.gov/Pubs/oss/oss2/scfindex.html (last visited Feb. 12, 2009). The survey measures household wealth, income, and debt for a sample of approximately 4,000 families, depending on the response rate of each year's survey.

32. *E.g.*, Jonathan Zinman, *Where Is the Missing Credit Card Debt?: Clues and Implications* 2 & n.1 (Fed. Reserve Bank of Phila. Payment Ctr., Discussion Paper No. 07-11, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1031518.

33. Posting of Bob Lawless to Credit Slips, http://www.creditslips.org/creditslips/2007/08/pulliam-weston-.html#more (Aug. 1, 2007, 11:28 p.m.).

34. *See, e.g.*, Brian K. Bucks et al., *Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances*, 92 Fed. Res. Bull. A1, A38 (2006), *available at* http://www.federalreserve.gov/pubs/bulletin/2006/financesurvey.pdf (explaining the protocol the survey uses when respondents are unable or unwilling to provide exact figures). This contrasts with the methodology of the Consumer Bankruptcy Project, which obtains most of its income, debt, and asset data from court records.

35. Underreporting is a concern in research that examines stigmatized topics such as abortion, J. Richard Udry et al., *A Medical Record Linkage Analysis of Abortion Underreporting*, 28 FAMILY PLAN. PERSP. 228, 228–31 (1996); premarital sex, Barbara S. Mensch et al., *The Reporting of Sensitive Behavior by Adolescents: A Methodological Experiment in Kenya*, 40 DEMOGRAPHY 247, 247–68 (2003); and caloric intake among overweight women, Debra C. McKenzie et al., *Impact of Interviewer's Body Mass Index on Underreporting Energy Intake in Overweight and Obese Women*, 10 OBESITY RES. 471, 471–77 (2002).

36. *See* Zinman, *supra* note 32.

37. Rochelle L. Antoniewicz, *A Comparison of the Household Sector from the Flow of Funds Accounts and the Survey of Consumer Finance*s 19–21 (Fed. Reserve Bd. Fin. & Econ. Discussion Series, Working Paper No. 1996-26, 1996), *available at* http://www.federalreserve.gov/pubs/feds/1996/199626/199626pap.pdf.

38. There may be other flaws in its methodology, however. Wendy M. Edelberg & Jonas D.M. Fisher, *Household Debt*, CHI. FED LETTER (Fed. Reserve Bank of Chi., Chi., Ill.), Nov. 1997, at 1–2, *available at* http://www.chicagofed.org/publications/fedletter/1997/cflnov97.pdf (arguing that the SCF is more accurate than the macro data because it is based on direct evidence).

39. Antoniewicz, *supra* note 37, at 10–11 (explaining where the studies diverge but not taking a position as to which is more correct). For another Federal Reserve explanation of the differences, see Ana M. Aizcorbe et al., *Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances*, 89 Fed. Res. Bull. 1, 27 n.30 (2003), *available at* http://www.federalreserve.gov/pubs/bulletin/2003/0103lead.pdf.

Despite this potential major flaw, the SCF is the only public national database of individual household debt.[40]

Researchers using aggregate-level data encounter a different set of problems. The usefulness of aggregate data is limited by the fact that it cannot provide information "on how debt is distributed among households that differ economically and demographically and how these distributions change over time."[41] This is especially problematic in the current context because the increased availability of mortgage and credit card debt to low-income consumers has changed the demographic distribution of debt.[42] An additional difficulty is that many researchers use these statistics to compute the household debt burden.[43] Because a number of households will have none of a given type of debt, the debt burden of households that do have that debt type will be diluted by the zero values of those that do not. As a result, the aggregate measures substantially understate the debt burdens faced by households with debt.

Researchers using time-series data tend to argue for a strong version of the substitution hypothesis, but this research is not specific enough to answer the interchangeability question. The time-series studies conclude that substitution occurred on the basis of findings that non-revolving debt decreased while credit card debt increased. For example, in a 1997 *Chicago Fed Letter*, economists Wendy M. Edelberg and Jonas D.M. Fisher use SCF data to show that from 1989 through 1995, low-income consumers increased their use of revolving debt while exhibiting a corresponding decrease in their use of installment debt.[44] The authors suggest that "there has not been a substantial increase in high-interest debt for low-income households, but that these households have merely substituted one type of high-interest debt for another."[45] Similarly, two additional Federal Reserve studies using aggregate statistics appear to suggest that the non–credit card household debt burden has declined since the beginning of the credit card boom.[46]

Perhaps the strongest support for the existence of a substantial substitution effect comes from Federal Reserve economist Thomas A.

40. The Consumer Bankruptcy Project also studies debt at the household level, but it is limited to families in bankruptcy, so it cannot provide data on questions of borrowing substitution among families who are not financially distressed.

41. Glenn B. Canner et al., *Household Sector Borrowing and the Burden of Debt*, 81 Fed. Res. Bull. 323, 323 (1995).

42. Edelberg & Fisher, *supra* note 38, at 1.

43. *Id.*

44. *Id.*

45. *Id.*

46. Canner et al., *supra* note 41, at 324 chart 2; Karen Dynan et al., *Recent Changes to a Measure of U.S. Household Debt Service*, 89 Fed. Res. Bull. 417, 420 chart 1 (2003). Both articles present data showing that the authors' calculation of the consumer debt burden has increased only slightly over recent decades. The relevance of these findings for the substitution hypothesis is that for the total debt burden to remain relatively constant during a period in which the credit card debt burden was increasing, the non–credit card debt burden must have been decreasing.

Durkin's study of credit cards from 1970 through 2000.[47] He uses evidence from the Federal Reserve's Statistical Release G.19[48] to show that, as use of revolving credit increased from the late 1960s[49] through the turn of the millennium, other consumer credit decreased proportionally.[50] Durkin concludes that a "substantial portion of the new revolving credit probably has merely replaced credit generated by the installment-purchase plans that were common at appliance, furniture, and other durable goods stores in the past."[51]

Inferences such as this one, however, are premature. These studies do not provide enough information to draw conclusions about the degree of substitution between credit card borrowing and the older forms of installment borrowing. First, the installment debt category, in which studies show a decrease, is primarily composed of forms of borrowing that are not plausible substitutes for credit card borrowing, such as car loans and student loans.[52] The decrease in this category may be due in large part to a decrease in car financing as automobile leasing grew in popularity.[53] Second, some of the studies compare minimum credit card payments to periodic installment debt payments, which significantly understates the relative amount of credit card debt.[54]

The problem of juxtaposing credit card debt with an incomparable category of installment debt pervades all of the studies discussed.[55] Recent SCF data suggests that the vast majority of nonrevolving, nonmortgage debt consists of car loans and student loans.[56] In 2004, car loans comprised 55.5% of total installment debt and student loans made up 26.0%, leaving only 18.5% of the total available for loans that could be comparable with credit cards.[57] The 2001 SCF data shows similar results.[58] The aggregate statistics Durkin uses support a similar division be-

47. Thomas A. Durkin, *Credit Cards: Use and Consumer Attitudes, 1970–2000*, 86 Fed. Res. Bull. 623, 623–24 (2000), *available at* http://www.federalreserve.gov/pubs/bulletin/2000/0900lead.pdf.

48. Telephone Interview with Tomas A. Durkin, Div. of Research & Statistics, Fed. Reserve Bulletin (June 22, 2007). The G.19 data is available at Federal Reserve, http://www.federalreserve.gov/releases/g19/ (last visited Feb. 12, 2009).

49. This is when the Federal Reserve started tracking revolving debt separately. Durkin, *supra* note 47, at 624 fig.1.

50. All of these figures exclude mortgage credit. *Id.* at 623.

51. *Id.*

52. *See* Yi-Win Chien & Sharon A. Devaney, *The Effects of Credit Attitude and Socioeconomic Factors on Credit Card and Installment Debt*, 35 J. CONSUMER AFF. 162, 165–66 (2001).

53. *See* Dynan et al., *supra* note 46, at 421–22.

54. *See, e.g.*, Durkin, *supra* note 47, at 624.

55. In the SCF studies, installment includes "automobile loans, student loans, and loans for furniture, appliances, and other durable goods." Bucks et al., *supra* note 34, at A30 n.39. Most of the aggregate research defines installment debt similarly. *See* Durkin, *supra* note 47, at 624 n.1 (defining "non-revolving debt [as] secured and unsecured credit for automobiles, mobile homes, trailers, durable goods, vacations, and other purposes"); Dynan et al., *supra* note 46, at 418 (analyzing a debt category called "nonauto, non-revolving" debt, which includes student, mobile home, RV and marine, and personal loans).

56. Bucks et al., *supra* note 34, at A30.

57. *Id.*

58. *Id.*

tween car, student, and personal loans in recent years.[59] His data show that, as of 1999, consumer nonrevolving debt still comprised a higher share of disposable personal income than consumer revolving debt.[60] This could not be true if most of the nonrevolving debt consisted of personal lines of credit and installment loans.

The only way this data could support the substitution hypothesis is if the level of personal borrowing from stores and finance companies was so high at the beginning of the credit card era that these types of loans accounted for a much larger percentage of nonrevolving debt than they do now. This does not appear to be the case. None of the studies attempt to divide the installment debt statistics into their component parts, and the only older data I found on this precise issue suggested that personal loans have comprised a small percentage of installment debt for several decades. An analysis of the 1962 SCF reveals that only 28% of nonmortgage installment debt was unrelated to automobiles or home repairs.[61] In addition, the proportion of automobile debt in this category declined from 63% in 1962 to 54.8% in 2001, with the current proportion at 55.5% in 2004.[62] This decrease may reflect a raw decline in automobile lending due to the rising popularity of leasing cars, rather than borrowing money to purchase them.[63]

Two of the studies suffer from a second major limitation: they compare the periodic payments on installment loans to the minimum payments due on credit card balances.[64] Though the minimum payment is technically the amount a credit card borrower must pay each month, as of 2004, only 18% of credit card users, or 39% of those who revolve a balance, paid this little.[65] The minimum payment is not comparable to the monthly payment of an installment contract, and using it tends to understate credit card debt.

An additional difficulty is that the minimum payment rate, the percentage of the total balance the consumer must pay, changes periodically. As late as the mid-1980s, some minimum payments required consumers to pay 20% of their balance.[66] In recent years, the minimum payment

59. *See* Durkin, *supra* note 47, at 626.

60. *Id.* at 624 fig.1.

61. This conclusion is drawn from an original analysis of data from the 1962 Survey of Financial Characteristics of Consumers (the predecessor to the SCF). The data is available at http://www.federalreserve.gov/Pubs/OSS/oss2/6263/sfcc6263home.html (last visited Feb. 12, 2009).

62. *Id.*; Bucks et al., *supra* note 34, at A30.

63. Dynan et al., *supra* note 46, at 421–22.

64. *Id.* at 426 (explaining this part of their methodology). For a description of the methodology used to calculate the measure used in Canner et al., *supra* note 41, see Lynn Paquette, *Estimating Household Debt Service Payments*, FED. RES. BANK N.Y. Q. REV., Summer 1986, at 12, 16, *available at* http://www.newyorkfed.org/research/quarterly_review/1986v11/v11n2article2.pdf.

65. *Forty-Two Percent—42%—of Americans Are Making Minimum or No Payments on Their Credit Card Balances, According to the Cambridge Consumer Credit Index*, BUS. WIRE, Mar. 5, 2004, *available at* http://findarticles.com/p/articles/mi_m0EIN/is_2004_March_5/ai_113928683.

66. Paquette, *supra* note 64, at 16. In 1986, the minimum payment was 5% of the balance for bank cards, 8% for store cards, and 20% for gas station cards. *Id.*

rate ranged between 2 and 2.5%[67] of a consumer's credit card balance until 2005 and then gradually increased to 4% pursuant to a 2005 federal directive.[68] A measure using the minimum payment fluctuates with these modifications, making it an inconsistent measure of actual changes in consumer debt.

In addition to these specific methodological issues, the time-series research also suffers from a fundamental difficulty that limits its predictive power. By necessity, this research has examined credit card substitution from the wrong causal direction. Credit card use has only increased over time, but the relevant substitution question is one of a decrease in credit card borrowing. In other words, researchers have examined whether consumers substitute away from other forms of borrowing as credit cards became more available, but it is unclear whether consumers would exercise the same degree of reverse-substitution if credit card availability decreased.

The time-series studies have one final limitation with respect to the interchangeability of borrowing types among low-income consumers that is the focus of this Article. Some of the data sets analyzed in these studies do not include the borrowing types commonly used by low-income consumers. The installment borrowing category typically includes loans from stores, which can be assumed to include rent-to-own stores and mail order lending catalogs,[69] though this is never made explicit. Although it is unclear whether the SCF data includes pawn shop borrowing, it seems unlikely because pawn shop loans are not made on an installment basis. The aggregate Federal Reserve statistics do not include data on pawn broking.[70]

It is important to note that the lack of specific data necessary to evaluate borrowing substitution is not because the time-series studies are inherently flawed. The methodological choices that limit their applicability to the substitution hypothesis may enhance their usefulness for other purposes, such as analyzing changes in the consumer debt burden over time.[71]

2. *Comparative Jurisdiction Studies*

In contrast to the time-series studies, the studies that use the "laboratory of the states" methodology tend to examine the substitution

67. *E.g.*, Melody Warnick, *Credit Card Minimum Payments Rising*, BANKRATE.COM, May 3, 2005, http://www.bankrate.com/brm/news/debt/20050503a1.asp.

68. Joint Press Release, Bd. of Governors of the Fed. Reserve Sys. et al., FFIEC Agencies Issue Guidance on Credit Card Account Management and Loss Allowance Practices (Jan. 8, 2003), *available at* http://www.occ.treas.gov/ftp/release/2003-01.htm.

69. *See infra* Part IV.C.2.

70. CASKEY, *supra* note 16, at 47–48.

71. *See, e.g.*, Dynan et al., *supra* note 46, at 417 (the goal of the article was to update a measure of household debt service ratio to reflect changes in financial markets).

hypothesis more explicitly and analyze directly the debt of low-income consumers. Three studies have addressed the interchangeability question by comparing borrowing use across jurisdictions with different regulatory regimes.

The first study examined pre-*Marquette*[72] Arkansas, which had a 10% usury cap, and found that the state had higher rates of retail credit and pawn shop use than other parts of the country.[73] Retail creditors and pawnbrokers could avoid usury caps by charging higher prices for goods and undervaluing pawned collateral, respectively.[74]

It is unclear how much weight can be placed on these findings, however. The study originally examined local credit markets in four states, two with permissive credit regimes and two with substantial restrictions.[75] But the results from the other restrictive state did not differ from those of the two permissive states even though the localities had been matched for similar socioeconomic profiles.[76] The authors do not explain this result, but perhaps the difference between Arkansas and the other three states resulted from that state's especially restrictive usury limit.[77] The discrepancy may also be explained by the fact that the study's most statistically significant findings were significant only at the 90% confidence level.[78] Finally, the pawn shop finding may be more reflective of national trends in pawn broking than local ones. In the late 1970s, the pawn broking industry was just climbing out of a decades-long slump;[79] the study found a total of only ten pawn shops in all four localities, a result with no statistical significance.[80] More recent national data suggest that high levels of pawn shop transactions are correlated with *permissive* usury laws.[81]

Recently, the United Kingdom's Department of Trade and Industry (DTI) and the research group Policis released two reports based on a study comparing the regulated credit economies of Germany and France

72. Marquette Nat'l Bank of Minneapolis v. First Omaha Serv. Corp., 439 U.S. 299 (1978). For further discussion of *Marquette*, see *infra* note 85.

73. Richard L. Peterson & Gregory A. Falls, *Impact of a Ten Percent Usury Ceiling: Empirical Evidence* 15 (Credit Research Ctr., Working Paper No. 40, 1981), *available at* http://www.business.gwu.edu/research/centers/fsrp/pdf/WP40.pdf; Peterson, *supra* note 27, at 1299–1304.

74. Peterson & Falls, *supra* note 73, at 16.

75. *Id.* at 3.

76. *Id.* at 3, 5.

77. In 1979, the year of the study, Arkansas's usury cap of 10% was below the prime rate. HSH Associates Financial Publishers, ARM Indexes: Prime Rate, 1975–1979, http://www.hsh.com/indices/prime70s.html (last visited Feb. 16, 2009).

78. Peterson, *supra* note 27, at 1301 tbl.I; Peterson & Falls, *supra* note 73, at 6–7, 9–10, 13–14; *see also* John R. Allison & Starling D. Hunter, *On the Feasibility of Improving Patent Quality One Technology at a Time: The Case of Business Methods*, 21 BERKELEY TECH. L.J. 729, 748 n.57 (stating that 0.05 is the "traditional level" for significance of results).

79. *See* CASKEY, *supra* note 16, at 27–30.

80. Peterson & Falls, *supra* note 73, at 17.

81. *See* CASKEY, *supra* note 16, at 50–51.

to the relatively free-market regime of the U.K.[82] The study found that consumers in Germany and France had higher rates of reported illegal borrowing than those in the U.K.[83] These results suggest a high level of substitution between legal and illegal borrowing, although the results are difficult to apply to the United States due to the very different mix of borrowing products, lending regulations, and social service safety nets in those three countries.

The DTI/Policis study also performed a comparative analysis of borrowing among the United States.[84] Still, the analysis suffers from the fact that the researchers neglected to account for the effects of federal preemption of state usury laws and proceeded from the assumption that state restrictions on credit terms are enforceable.[85] The one exception to these limitations is the study's examination of payday lending, which is no longer effectively preempted by federal law.[86] The study's findings on payday lending support a low level of substitution among payday, pawn, rent-to-own, and auto-title loans.[87] States with the most restrictive pay-

82. POLICIS, ECONOMIC AND SOCIAL RISKS OF CONSUMER CREDIT MARKET REGULATION (2006) [hereinafter ECONOMIC AND SOCIAL RISKS], http://www.policis.com/pdf/Economic_and_Social_Risks_of_Consumer_Credit_Market_Regulation.pdf; POLICIS, THE EFFECT OF INTEREST RATE CONTROLS IN OTHER COUNTRIES (2004) [hereinafter DTI REPORT], http://microfinancegateway.com/files/25620_file_The_effect_of_interest_rate_controls.pdf. In 2005, the Department of Trade and Industry was disbanded with the creation of the Department for Business, Enterprise, and Regulatory Reform and the Department for Innovation, Universities, and Skills.

83. DTI REPORT, *supra* note 82, at 44. The rate was 3% of low-income or credit-impaired borrowers in the UK, compared to 7% in France and 8% in Germany. *Id.*

84. *Id.* at 6–7.

85. *See, e.g.*, *id.* at 6. In 1978, the Supreme Court of the United States effectively held that state usury laws were preempted. Marquette Nat'l Bank of Minneapolis v. First Omaha Serv. Corp., 439 U.S. 299, 319 (1978). In *Marquette*, the Court held that section 85 of the National Bank Act allowed national banks to "export" the interest rate allowed by the bank's home state to customers living in other states. *Id.* at 314. Federal statute gave state-chartered banks this same right in 1980. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (codified as amended in scattered sections of 12 U.S.C.). This prompted a race to the bottom in which credit card issuers moved to states with no usury laws, and some states with strict usury laws relaxed theirs in order to maintain their banking sectors. As a result of this trend, credit card issuers have more control over the interest rates they charge than state regulators. *E.g.*, Christopher L. Peterson, *Federalism and Predatory Lending: Unmasking the Deregulatory Agenda*, 78 TEMP. L. REV. 1, 36–37 (2005).

86. Until the actions of federal regulators in the early 2000s, payday lenders made use of the exportation doctrine by partnering with banks through what became known as "rent-a-charter" agreements. *See, e.g.*, Ronald J. Mann & Jim Hawkins, *Just Until Payday*, 54 UCLA L. REV. 855, 872 (2007). The OCC and the FDIC ended this practice for national and state banks, respectively. For steps taken by the OCC, see OFFICE OF THE COMPTROLLER OF THE CURRENCY, U.S. DEP'T OF THE TREASURY, ADVISORY LETTER 2000-9: THIRD-PARTY RISK (2000), *available at* http://www.occ.treas.gov/ftp/advisory/2000-9.doc; OFFICE OF THE COMPTROLLER OF THE CURRENCY, U.S. DEP'T OF THE TREASURY, ADVISORY LETTER 2000-10: PAYDAY LENDING (2000), *available* at http://www.occ.treas.gov/ftp/advisory/2000-10.doc; OFFICE OF THE COMPTROLLER OF THE CURRENCY, U.S. DEP'T OF THE TREASURY, OCC BULL. NO. 2001-47: THIRD-PARTY RELATIONSHIPS (2001), *available at* http://www.occ.treas.gov/ftp/bulletin/2001-47.doc. For FDIC action, see Fed. Deposit Ins. Corp., Guidelines for Payday Lending, http://www.fdic.gov/news/news/financial/2005/fil1405a.html (last visited Feb. 16, 2009).

87. DTI REPORT, *supra* note 82, at 6.

day lending regimes had lower loan revenues from rent-to-own stores and auto title loans than those with less restrictive systems.[88]

In 2007, Federal Reserve economist Donald Morgan released a study in which he found that payday loan prices in a given area decreased as the number of payday lenders and pawn shops per capita increased.[89] This finding appears to suggest that consumers may view pawn shops and payday loans as substitutes. Indeed, Morgan cites the CEO of a major pawn shop chain claiming that the rise of payday lending has hurt his company,[90] although this statement is weakened by the fact that payday loan customers tend to be from a higher income demographic than pawn shop borrowers.[91] Morgan's methodology also faces other difficulties. Most significantly, he compares prices from 2001 with store numbers in 2005, despite the fact that the payday lending regulatory landscape underwent significant transformation during those four years.[92]

Despite these difficulties, his research suggests an important avenue for future work. Comparative jurisdiction research has been limited by federal legislative preemption of most state lending laws, first recognized in 1978 in *Marquette*.[93] With most state laws effectively preempted, it was difficult to compare borrowing trends in states with differing levels of regulation. A new regulatory development has partially alleviated this problem. In 2000 and 2001, the Office of the Comptroller of Currency (OCC) issued a directive that prevented payday lenders from using the federal preemption,[94] thus allowing states to regulate the industry. States are beginning to use their new power.[95] Even though credit card regulations are still preempted at the federal level, researchers can now study the substitution effects of regulating payday loans on a state-by-state basis. For the first time in decades, restrictions on a widely used form of

88. *Id.* at fig.17. The pawn shop revenue data was mixed, though it was more suggestive of a low level of substitution than a higher one. *Id.*

89. Donald P. Morgan, *Defining and Detecting Predatory Lending* 20–21 (Fed. Reserve Bank of N.Y. Staff Report, Working Paper No. 273, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=962711.

90. *Id.* at 5–6 (quoting JOHN P. CASKEY, FILENE RESEARCH INST., THE ECONOMICS OF PAYDAY LENDING 14 (2002)).

91. CASKEY, *supra* note 90, at 22 tbl.1 (reporting the results of a Credit Research Center that found slightly over half of payday loan customers have annual income between $25,000 and $50,000, with the remaining customers split equally between higher- and lower-income groups). In contrast, only 28.1% of active pawn shop borrowers have incomes ranging from $25,000 to $49,000, and only 7.1% have incomes above that range. ROBERT W. JOHNSON & DIXIE P. JOHNSON, THE CREDIT RESEARCH CTR., PAWNBROKING IN THE U.S.: A PROFILE OF CUSTOMERS 53 (1998), *available at* http://www.business.gwu.edu/research/centers/fsrp/pdf/Mono34.pdf.

92. CTR. FOR RESPONSIBLE LENDING, CRL REVIEW OF *DEFINING AND DETECTING PREDATORY LENDING*, BY DONALD P. MORGAN, FEDERAL RESERVE BANK OF NEW YORK, JANUARY 2007 1–3 (2007), *available at* http://www.responsiblelending.org/pdfs/Review-of-Morgan-paper.pdf. The changes resulted from the OCC and FDIC actions that eliminated "rent-a-charter" agreements, which were discussed in note 86, *supra*.

93. *See supra* note 85 and accompanying text.

94. *See supra* note 86.

95. *E.g.*, Bill Graves, *So Long for 528% Loans—and Also the Lenders?*, OREGONIAN, June 7, 2007, at A01.

borrowing are increasing rather than decreasing, so researchers can study substitution from the correct causal direction: as supply declines.

3. *Borrower History Research*

The third type of interchangeability study examines the borrowing histories of individual consumers. The only research outside of the current study to use this method is Michael Barr's Detroit Area Household Financial Services (DAHFS) study.[96] The DAHFS study surveyed a random, weighted sample of 1,003 low-, moderate-, and middle-income households in the Detroit, Michigan area about all aspects of their credit usage.[97] The study conducted detailed interviews, averaging seventy-six minutes, and thus was able to obtain a rich account of participants' credit histories.[98] The study's substitution analysis focused primarily on payday lending. It compared how participants who do and do not use payday lending use other forms of borrowing. The DAHFS study found that participants who use payday lending were significantly more likely to use other forms of fringe borrowing, such as pawn shops, refund anticipation loans, and rent-to-own stores, than those who did not.[99] It also found that, although payday loan users were no more likely than others to use credit cards, they were significantly more likely to pay only their minimum balance and to have paid late fees.[100] These findings suggest that participants may treat payday lending and other forms of fringe borrowing more as complements than substitutes.[101]

The one limitation of this study is that it did not appear to collect documentary evidence of the study respondents' borrowing transactions.[102] As with the SCF, this presents a risk that participants underreported their borrowing.[103]

B. *The Current Study—A Low Degree of Substitution*

The current study also used the borrowing history methodology to investigate the interchangeability of fringe borrowing types and obtained similar results. Although the current study is much smaller than the DAHFS and uses a nonrandom sample, its methodology is similar in that it used extremely detailed interviews with low-income consumers. The study also collected at least some documentary evidence for nearly all

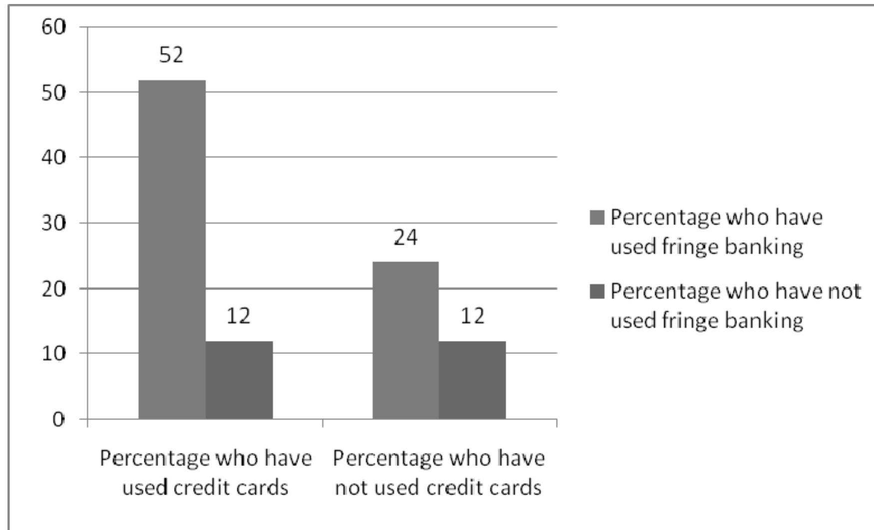
96. Barr et al., *supra* note 28.
97. *Id.* at 5, 13.
98. *Id.* at 12.
99. *Id.* at 15–17.
100. *Id.*
101. *Id.* at 2.
102. *Id.*
103. For this purpose, it likely presents a lower risk than for the SCF because the relevant data is whether a participant has used a form of borrowing, which is easier to recall than precise amounts of debt.

the participants.[104] The goal of this analysis was to develop a preliminary empirical model that can be tested in future studies.

The current research findings correspond with those of the DAHFS study. Study participants tended to use credit cards and fringe borrowing alternatives as complements rather than substitutes. The detailed interview format allowed for investigation of changes in participants' credit consumption over time, and the results of that data showed a low degree of substitution from fringe borrowing alternatives to credit cards as the latter became more available to low-income consumers.

The study found that participants who had borrowed in the fringe banking sector were more likely to have used credit cards than those who had not.[105] These results are shown in Figure 1.

FIGURE 1
PERCENTAGE OF PARTICIPANTS WHO HAVE USED FRINGE BANKING, BY CREDIT CARD USAGE



104. *See* Littwin, *supra* note 20, at 498 n.202 and accompanying text.

105. Unfortunately, the variables that could best test the interchangeability prong of the substitution hypothesis, a participant's current total credit card balance and her lifetime total credit card balance, were not reliable. In the case of the former, the study was able to collect written records documenting most current balances, but participants with larger balances tended to have more complete documentation introducing bias into this variable. The measurement of total lifetime balances suffered from even greater difficulties. Many participants could provide only vague approximations of the amount of credit card debt they had accumulated over the course of their lifetimes, and documents for this figure were difficult to obtain. Though most participants had current credit card statements or were willing to access them for the study, fewer would or could access this information for cards they no longer held. This left me with credit reports, which do not reach back more than ten years. Thus, I did not attempt to analyze this variable because the sparse data I did have was unreliable by the participants' own accounts. It would take a study with much greater resources to obtain this data.

This result suggests that participants are using credit cards and fringe borrowing more as complements than substitutes. Participants who use credit cards are more likely to use fringe borrowing than their credit-card-free counterparts. There could, of course, be substitution between credit cards and fringe borrowing as well. Participants who use both might alternate use depending on a variety of factors, including the favorability of regulatory conditions. A stronger version of the interchangeability prong of the substitution hypothesis, however, would have shown a negative correlation between fringe borrowing and credit card borrowing: participants who used more of one used less of the other.

But these findings apply to all participant credit card usage. They do not isolate the substitution behavior of participants who were unable to obtain as much credit card credit as they preferred. Because credit cards are so accessible, even to low-income consumers, the study was unable to obtain good data on the variables that would be ideal proxies for participants' inability to obtain as much revolving credit as they would like. Only 10% of participants had applied for, but failed to obtain, a credit card. An additional 10% had used credit cards, but were currently prohibited from charging on them by the issuer. With numbers this small, any analysis of them could be misleading.

Despite this limitation, the dramatic increase in availability of credit cards over the past twenty-five years made it possible to examine the interchangeability prong of the substitution hypothesis indirectly by using the ages of the participants as a proxy for credit availability during their adult lives. Older participants were adults when access to credit cards was limited, while younger participants had access to credit cards throughout their adult lives. Under a strong form of the substitution hypothesis, younger consumers should use fringe borrowing alternatives less frequently, all other things being equal.

The median age of the study sample was forty-five in 2005, meaning that the median-aged participant was eighteen years old in 1978, the year that *Marquette* was decided.[106] Thus, exactly half the study sample has experienced the entire current range of post-*Marquette* credit card availability outcomes as adults, whereas the other half has experienced varying fractions thereof. More specifically, 58% of participants were eighteen years old in 1983, when households with incomes under $50,000 held 42% of national consumer debt[107] and 17% of households at or below the federal poverty line had credit cards.[108] Seventy-six percent had reached majority in 1989, when the low- and moderate-income households held 46.3% of consumer debt[109] and approximately 20% of households in po-

106. Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv. Corp., 439 U.S. 299, 299 (1978).

107. Moss & Johnson, *supra* note 15, at 334.

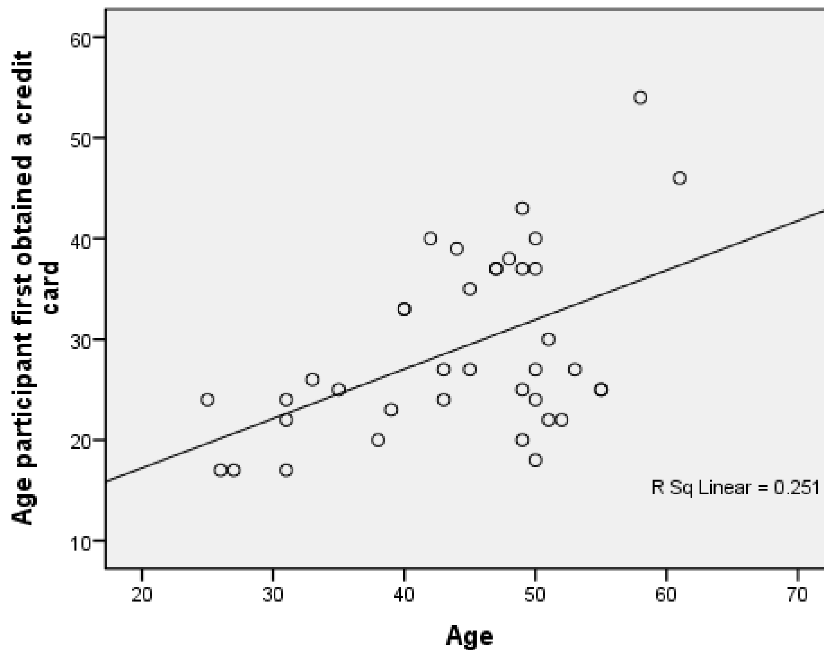
108. Bird et al., *supra* note 23, at 128 tbl.1 (analyzing SCF data).

109. Moss & Johnson, *supra* note 15, at 334.

verty had credit cards.[110] A full 80% of study participants were at least eighteen by 1992, when low- and moderate-income households held 56.1% of consumer debt[111] and approximately 34% of households at or below the poverty line held credit cards.[112]

Not surprisingly then, the study found a strong, positive correlation between the age of the participant and the age at which she obtained her first credit card. As shown in Figure 2, younger participants obtained credit cards when they were younger, whereas older participants did not obtain them until they were older. This is strong evidence of a changing credit card market.

FIGURE 2
YOUNGER PARTICIPANTS OBTAINED CREDIT CARDS WHEN THEY WERE YOUNGER



Under a strong version of the interchangeability prong of the substitution hypothesis, then, older participants should be more likely to have used fringe banking at some point. They would have spent more of their adult lives with less access to credit cards, and they simply would have spent more total years as adults in which to, for example, buy furniture or pawn goods. Instead, the opposite is true. Age varies *negatively* with

110. Bird et al., *supra* note 23, at 128.
111. Moss & Johnson, *supra* note 15, at 334.
112. Bird et al., *supra* note 23, at 128.

the likelihood of ever having borrowed in the fringe banking sector. The median age of participants who had used fringe banking at some point was forty-three, whereas the median age of those who had not was forty-nine.[113] In other words, younger participants were *more* likely to have used fringe banking than older participants, despite greater access to credit cards earlier in life and fewer total years in which to engage in fringe banking transactions. The ages of participants who were still using fringe borrowing at the time of the study show a similar trend. The median age of the participants who were currently using at least one form of fringe borrowing was thirty-seven, whereas the median age for those who were not was forty-seven.[114] These same patterns occur when examining current credit card use and current fringe bank borrowing.

The fact that older participants, who presumably would have obtained credit cards at a younger age had they been available, were also less inclined to use fringe banking during their credit-card-free period indicates that they were unlikely to see the fringe borrowing options as substitutes for credit cards.

There are, of course, alternative explanations for the age- and date-based findings. Older participants might have been less able to recall earlier instances of fringe borrowing. Although this could explain the absence of an age effect, it is a less plausible explanation for a negative relationship with age. Another possibility is that the older participants were less economically stressed, and therefore less in need of borrowing, when they were younger. Perhaps because the social safety net has been shrinking over the last thirty years, more low-income families have been pushed towards credit.[115] A substitution-neutral possibility is that the fringe borrowing sector has grown over the past few decades.[116] Older participants may have had more limited access to fringe borrowing when they were younger and thus had little opportunity to use fringe borrowing in the decades before the credit card boom.[117] Or it could be that borrowing norms have changed over the course of the past three decades, and each successive generation of adults has become increasingly willing to borrow in all forms. The study asked directly about this last possibility—that is, whether participants thought community attitudes towards borrowing had changed since they were growing up. The res-

113. The interquartile ranges show a similar result. For participants who had used fringe borrowing, the age range from the twenty-fifth percentile to the seventy-fifth percentile was thirty-five to forty-nine, whereas it was thirty-eight to fifty-one for those who had not.

114. The interquartile range for participants who were still using fringe borrowing was twenty-seven to forty years old, compared with the one of thirty-nine to fifty years old for those who were not.

115. Bird et al., *supra* note 23, at 126.

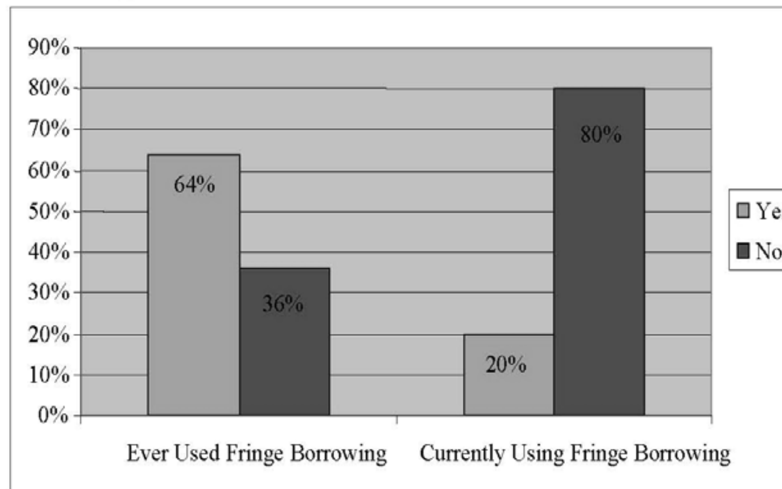
116. *See infra* Part IV.C.2.

117. The fact that the fringe sectors have experienced marked growth as credit card debt has exploded, however, tends generally to undermine the substitution hypothesis. If borrowers have been supporting growth in both sectors over the past few decades, then the overarching trend could not have been one of substituting away from older fringe products towards the newly available credit cards.

ponses varied widely, indicating that, at least in participants' subjective experiences, borrowing attitudes are not the answer. More objectively, the age- and date-related findings must be read in conjunction with the finding that credit card use predicts fringe borrowing use. None of the results provided support for a large degree of substitution in this context, but several findings lent direct support to the opposite conclusion.

There is, however, one major finding that tends to support the substitution hypothesis. Very few participants currently use fringe borrowing, which is a steep decline from the number who have ever used it. This drop is shown in Figure 3. The number of participants who hold credit cards, however, is still high. Of the 76% of participants who have ever used a credit card, nearly two-thirds still have one with an available line of credit.[118] This could suggest a conclusion in keeping with the premise of the time-series studies: as credit cards grew in popularity, fewer participants needed to rely on other forms of borrowing. On the other hand, many participants who have credit cards may not be actively borrowing with them. Some are undoubtedly holding the line of credit in reserve. In addition, several participants commented that lenders that provide goods, such as catalogs and rent-to-own stores, are primarily used when acquiring goods needed to start a household, either after first leaving home or when first immigrating to the United States. The fact

FIGURE 3
PERCENTAGE OF PARTICIPANTS USING FRINGE BORROWING: LIFETIME USAGE VERSUS CURRENT USAGE



118. This makes a total of 50% of all participants who still hold a useable credit card.

that many participants had already established their households by the time of the study could account for the drop in those two types of borrowing. Regardless of the reason, this finding is difficult to reconcile with the age- and date-based findings discussed above and suggests an interesting area for future research.

In conclusion, the interchangeability prong of the substitution of credit is unproven. Much more work in this area is needed before scholars and policymakers can predict with any accuracy the substitution consequences of regulating credit cards. The research to date is limited not only by methodological complications, but also by the framing of substitution questions in terms of "yes" or "no" answers such that either substitution between credit cards and other forms of borrowing exists or it does not. As a result, there has been no development of a methodology or a terminology for discussing the degree of substitution taking place. This, in turn, has led researchers to overlook the necessity of comparing the predicted degree of substitution that would occur to the harm such substitution would cause. The recent wave of payday lending regulation presents a golden opportunity for expanding the scope and precision of these studies.

C. Factors That Explain the Low Degree of Substitution

In addition to the lack of precision in research analyzing the degree of substitution among credit options, there is no research, to my knowledge, that examines the factors that should influence the degree of substitution. Though such modeling is beyond the scope of the current study, it can shed light on why the extent of interchangeability between credit cards and fringe borrowing is unlikely to be the complete one-for-one substitution that is often assumed in the literature.[119]

1. Credit Cards Supply More Credit

The major reason that substitution would almost certainly be incomplete is that fringe borrowing alternatives simply cannot offer income-constrained consumers as much credit as credit cards. A low-income borrower can bear only so many costs at one time. She has only so many items valuable enough to pawn and can manage only so many payments to rent-to-own stores or other installment lenders.[120] With credit cards, the minimum-payment option allows consumers to accrue balances unconstrained by their ability to pay. The balances of the study

119. *See, e.g.*, Zywicki, *supra* note 6, at 96.

120. In a study conducted in 1974, before credit cards became widely available to low-income borrowers, the researchers stated that one of the primary reasons "rationed" consumers could not obtain their preferred amount of credit is that they could not afford the required monthly payments. Orville C. Walker, Jr. & Richard F. Sauter, *Consumer Preferences for Alternative Retail Credit Terms: A Concept Test of the Effects of Consumer Legislation*, 11 J. MARKETING RES. 70, 71 (1974).

participants reflected this difference. Of the thirty-two participants who were either currently using credit cards or currently had a balance, the mean balance was $4,389 and the median was $2,482.[121] In comparison, the mean monthly income for these thirty-two participants was $1,187.75 ($14,253 annually) and the median was $724.50 ($8,694 annually).[122]

The small-scale nature of the fringe borrowing options means that they cannot serve as complete substitutes for credit card borrowing.[123] If access to credit cards were reduced, some low-income consumers might borrow more from catalogs, pawn shops, or rent-to-own stores, although the current data suggest that low-income credit card users are already disproportionately borrowing from these alternatives. Even if these consumers would borrow more, however, they would not be able to borrow nearly as much from these other sources as they can with credit cards.[124]

2. *Credit Cards Act as Spending Stimuli*

The second reason that substitution between credit cards and fringe borrowing would likely be incomplete is that credit cards, in and of themselves, may stimulate spending. Psychology and behavioral economics research has begun to show that credit cards can operate as "spending facilitating stimuli."[125] Several studies have shown a correlation between using credit cards and spending more.[126] Two particularly thorough studies used multiple approaches to show that subjects say they will spend more and actually spend more when exposed to credit cards and credit card insignia.[127] For example, two experiments found that the presence of the MasterCard logo significantly increased the amount that subjects said they would spend on merchandise the experimenters presented.[128] An additional experiment by the same researcher showed that subjects in the presence of MasterCard stimuli donated significantly

121. I had credit reports or credit card statements for twenty-two of these participants. I relied on oral reports for the other eleven.

122. The mean monthly income of all participants was $1,195 ($14,340 annually), and the median was $770 ($9,240 annually).

123. Because no participants had records of their transactions with pawn shops, rent-to-own stores, or catalogs, the data here are incomplete. Only five participants provided remembered estimates of their pawn shop loans, and those ranged from $50 to $500 before interest, with the majority falling under $200. Two participants reported rent-to-own loans totaling $700 to $900. Two participants reported catalog loans of $300 to $800, and two others described monthly payments of $3 to $15.

124. Mann and Hawkins make an analogous argument with respect to payday lending. Mann & Hawkins, *supra* note 86, at 887–94.

125. Richard A. Feinberg, *Credit Cards as Spending Facilitating Stimuli: A Conditioning Interpretation*, 13 J. CONSUMER RES. 348, 354–55 (1986).

126. *Id.* at 348 (reviewing nearly a dozen studies showing such a correlation).

127. *Id.*; Drazen Prelec & Duncan Simester, *Always Leave Home Without It: A Further Investigation of the Credit-Card Effect on Willingness to Pay*, 12 MARKETING LETTERS 5, 6 (2001). Ronald Mann provides a detailed discussion of this research in *Charging Ahead*, where he points out that these results have not been fully replicable. RONALD J. MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD MARKETS 47–48 (2006).

128. Feinberg, *supra* note 125, at 350, 352–53.

more during charity solicitations.[129] Participants in the current study also identified credit cards as spending stimuli. Nearly two-thirds characterized credit cards as "tempting," meaning that they felt "tempted" by credit cards to spend and borrow more than they would if they used another form of payment or credit.[130]

If future studies continue to support these results, consumers may spend more when paying with credit cards than with cash or checks. If so, consumers would be even more likely to spend more than they would if they had to, for example, go to a pawn shop to obtain the cash in the first place. Under these circumstances, the borrowing options will not be interchangeable. Switching from one to another would lead to increases or decreases in spending rather than a neutral substitution of borrowing methods.

IV. THE QUESTION OF HARM

Very little research has explored the question of how much harm would occur if regulation prompted consumers to substitute one form of borrowing with another. There are two main potential explanations for this neglect. First, researchers may have assumed that credit cards are superior to low-income people's alternative credit options because credit cards are identified as middle-class borrowing, whereas the alternatives are thought of as part of a ghettoized "fringe."[131] Second, traditional economic frameworks rely on behavior-based evidence of consumer preferences.[132] If consumers' borrowing behavior is a full expression of their preferences, then the harm caused by substitution is fully captured by the amount of substitution that occurs. Put simply, the traditional framework assumes that what people do is the best evidence of what they like.

A. The Mark of the Middle Class

Commentators may assume that payday lending, pawn shops, and rent-to-own stores are more harmful than credit cards because the former are used exclusively by low-income people, whereas the latter are used by the general population. The thinking may be that if middle-class consumers, who have a wealth of credit options, use credit cards, then credit cards must not be exploitive.

Credit cards have long been associated with the middle and upper classes. They were first developed to meet the needs of business travel-

129. *Id.* at 353–54.

130. For a detailed discussion of these findings, see Littwin, *supra* note 20, at 466–78.

131. CASKEY, *supra* note 16.

132. *See infra* note 155; *see also* Gregory Elliehausen & Edward C. Lawrence, *Payday Advance Credit in America: An Analysis of Customer Demand* 23 (Credit Research Ctr., Monograph No. 35, Apr. 2001), *available at* http://www.business.gwu.edu/research/centers/fsrp/pdf/Mono35.pdf ("The standard economic analysis of consumer behavior focuses on the outcome of decisions.").

ers on expense accounts,[133] and in subsequent decades, issuers capitalized on the aura of exclusivity that evolved from these origins.[134] The transition of credit cards from an exclusive product to a universal one has been gradual;[135] the perception of this transition appears to have been more gradual still and is far from complete. When I have discussed the study in academic circles, commentators are often struck by the depth of credit card penetration within the low-income study sample. This surprise is not limited to upper-middle-class academics; many of the participants themselves discussed credit cards in terms of their exclusivity. Twelve percent stated that they had applied for a credit card in order to see if they could obtain one, and several participants characterized credit card availability to low-income people as a civil rights access issue.[136]

The image of fringe borrowing options such as pawn shops, rent-to-own stores, and payday lending is quite different. Commentators tend to label them as "fringe"[137] or "alternative"[138] credit options, words that identify them as outside the mainstream. Pawn shops in particular have a negative reputation.[139] Participants also characterized pawn shops and rent-to-own stores as low-status. When the study asked if there was status associated with various forms of borrowing, credit cards obtained mixed results, but the most frequent response regarding the fringe credit options was laughter.[140] Moreover, upper-middle-class academic writers are unlikely to have personal experience with alternative forms of borrowing.[141] Academics are much more likely to have used credit cards,[142] and many have undoubtedly had positive experiences.[143] For financially secure consumers, who have the means to avoid interest and late fees, credit cards provide a number of advantages, such as frequent flier miles and interest-free monthly loans during the grace period, at a low cost.[144]

The contrast between unfamiliar borrowing options associated with poverty and those associated with positive personal experiences could

133. DAVID S. EVANS & RICHARD SCHMALENSEE, PAYING WITH PLASTIC: THE DIGITAL REVOLUTION IN BUYING AND BORROWING 53–61 (2d ed. 2005); MANN, *supra* note 129, at 81–85.

134. *See, e.g.*, EVANS & SCHMALENSEE, *supra* note 133, at 186 (recounting American Express's image of exclusivity and advertising slogan, "Membership Has Its Privileges").

135. Bird et al., *supra* note 23, at 126; Moss & Johnson, *supra* note 15, at 325.

136. Littwin, *supra* note 20, at 465.

137. CASKEY, *supra* note 16, at 1; Littwin, *supra* note 20, at 456.

138. Barr, *supra* note 16, at 141.

139. *See, e.g.*, Mann & Hawkins, *supra* note 86, at 891–93.

140. Littwin, *supra* note 20, at 462 n.33.

141. Fringe borrowing customers tend to have lower incomes than academic writers. *See infra* Part III.C.1.

142. By 1998, 95% of households in the highest-income quintile held bank-issued credit cards, and 86% of households in the second-highest quintile had them. Durkin, *supra* note 47, at 626 tbl.2.

143. In *Charging Ahead*, Ronald Mann describes his experiences presenting his research to groups of legal and financial professionals, many of whom believe that they have outsmarted their issuers by receiving more benefits from their credit cards than they pay for. MANN, *supra* note 127, at 128. Mann argues that most of them are mistaken. *Id.*

144. Issuers, however, tend to charge annual fees for cards with rewards programs. Ronald Mann, *"Contracting" for Credit*, 104 MICH. L. REV. 899, 914 (2006).

easily lead to assumptions about the superiority of credit cards. But credit cards are a very different product when used by low-income consumers. In fact, a large part of the success of credit cards is due to the bundling of two products—a payment device and a borrowing option—into one small card. Several commentators divide credit card users into "transactors," who use credit cards predominately for payment purposes, and "revolvers," who regularly carry a balance.[145] A large class difference separates these two types of users. In the current study of low-income consumers, only one participant was an exclusively transactional user of credit cards,[146] and not a single participant mentioned frequent flier miles or other rewards benefits that are so valued by financially secure users.

Survey of Consumer Finance (SCF) data also support the existence of this class segmentation. Although higher-income families are more likely to have credit cards,[147] lower-income families are more likely to struggle with debt. Low-income households carry much higher debt-to-income ratios than their high-income counterparts across all income quintiles,[148] even though low-income consumers are less likely to be homeowners with mortgage or home equity debt.[149] SCF data also shows that revolvers are more likely to be black or Hispanic and to have less education than transactors.[150]

A small number of commentators recognize the class implications of this market segmentation, expressing concern that the interest paid by the less financially secure revolvers is cross-subsidizing the frequent flier miles of the transactors.[151] But nobody has discussed the impact of the dual roles of credit cards in public policy debates. It is easy for policymakers to view credit cards through the lens of their familiar, positive transacting experiences and fail to fully grasp the difference between their experiences and those of financially insecure revolvers. Recognizing that the convenience of credit card use is largely out of reach to the poor and the financially struggling segments of the middle class will ena-

145. *See* MANN, *supra* note 127, at 138 (referring to these two groups as "convenience users" and "borrowers"); Adam J. Levitin, *The Antitrust Superbowl: America's Payment Systems, No-Surcharge Rules, and the Hidden Costs of Credit*, 3 BERKELEY BUS. L.J. 265, 317–18 (2005) (although Levitin mockingly refers to "transactors" as "deadbeats" because they generate less revenue for issuers); Zywicki, *supra* note 6, at 101 (using the terms "convenience users" and "revolvers").

146. Interview with Respondent ABB.

147. Durkin, *supra* note 47, at 626 tbl.2. This trend remained consistent as between each income quintile from at least 1970 through 1998. Unfortunately, the author did not indicate whether these differences between income quintiles were statistically significant.

148. Bucks et al., *supra* note 34, at A35 tbl.14. This trend remained stable from at least 1995 through 2004, although the authors did not indicate statistical significance.

149. *See, e.g.*, *id.* at A22 tbl.8 (showing that homeownership increases with income).

150. Duleep Delpechitre & Sharon A. DeVaney, *Credit Card Use Among White, African American and Hispanic Households*, 52 CONSUMER INTERESTS ANN. 466 (2006).

151. MANN, *supra* note 127, at 138–39 (arguing that this type of cross-subsidization is less likely to exist now than in the past because issuers have become more sophisticated about segmenting the market); Levitin, *supra* note 145, at 317–18 (citing ambiguity in the literature about whether transactors' credit card use is subsidized by the interest paid by revolvers).

ble policymakers to evaluate the revolving nature of credit cards more precisely, placing it in context with other fringe borrowing services.

B. The Value of Studying Subjective Preferences

Traditional economic assumptions about borrower behavior might also explain why academics have neglected to investigate the degree of harm that could result from a high level of regulatory-driven credit product substitution. Neoclassical economics often characterizes consumer behavior as a complete statement of consumer preferences;[152] choices consumers make reveal their preferences.[153] So if more consumers use credit cards than rent-to-own stores—a result found by the current study—then more consumers prefer credit cards to rent-to-own stores.[154] Therefore, the level of harm created by a credit card regulation that caused some consumers to substitute rent-to-own borrowing for credit card borrowing would be perfectly captured by counting the number of consumers who made that switch. Under this framework, studying the degree of harm beyond the degree of objective substitution behavior is redundant at best and inaccurate at worst.[155]

Although examining actual consumer behavior is a useful approach, it has significant limitations as a means of understanding the substitutability of credit card borrowing. Borrowers must be fully informed and fully rational for their borrowing decisions to wholly capture their borrowing preferences. In addition, this traditional approach does not account for the fact that borrowing is a relatively long-term transaction and therefore that preferences may change over the course of the loan.[156]

Borrowing transactions are particularly vulnerable to preference reversal because a consumer seeking credit faces an immediate benefit and a more distant cost. The defining characteristic of a credit transaction is that the borrower receives a benefit at the time of loan initiation in exchange for a cost to be borne later, at the time of repayment. This time division is particularly salient in credit card borrowing because, due to the minimum-payment system, a consumer might not experience, or even understand, the repayment costs until months or years after she has initiated the loan. Behavioral economic research suggests that many people have a poor ability to compare current costs and benefits with fu-

152. P.A. Samuelson, *A Note on the Pure Theory of Consumer's Behavior*, 5 ECONOMICA 61 (1938).

153. *Id.*

154. This latter result was not supported by the current study.

155. In addition, behavioral data is considered a more objective lens into people's preferences than subjective data, and it also avoids participant reliability problems. For example, participants may have faulty memories or give answers that present their behavior in a positive light. *See* Walker & Sauter, *supra* note 120, at 72 ("Since stated preferences may be more 'rational,' or in other ways different from actual behavior, the results of this type of analysis should be evaluated with caution.").

156. *See generally* Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373 (2004) (discussing how credit card borrowing can lead to preference reversal).

ture costs and benefits in accordance with their own future preferences.[157] So the decision a consumer makes at the time of loan initiation will not necessarily reflect her preferences once she internalizes the costs of repayment.

The current study bears out this idea. Approximately two-thirds of participants reported that the availability of credit cards "tempted" them to spend or borrow more in the short term than they would prefer in the long term.[158] Thus, behavior may not accurately reflect borrowing preferences, but rather only preferences at the time of loan initiation, when the benefits of the loan are more prominent in the consumer's mind than the costs. Asking consumers to consciously weigh both the costs and benefits of different borrowing types has the potential to yield more accurate long-term preferences.

What's more, of the little research that has been done in this area, much indicates that subjective preferences do not necessarily accord with market behavior. In one intriguing study from the early 1970s, researchers sought to examine the likely effects of a then-new Minnesota law regulating the interest rate and service charges on consumer retail credit.[159] The study surveyed consumers about their preferences for different types of consumer credit plans. One was the standard credit plan offered by retailers before the interest-rate restrictions took effect, whereas the others were plans the researchers hypothesized that retailers would offer as a result of the new law.[160] The study found that the regulation-free plan retailers were already offering was the one that consumers consistently preferred the least.[161] This finding contradicts the rational borrower model, under which lenders would already be offering the most-preferred plan. These results are all the more interesting because they clearly came as a surprise to the researchers themselves.[162]

More recently, the Credit Research Center[163] sought to explore consumer attitudes towards and understanding of credit cards.[164] The study

157. *See* Shane Frederick et al., *Time Discounting and Time Preference: A Critical Review*, 40 J. ECON. LITERATURE 351 (2002); David Laibson, *Golden Eggs and Hyperbolic Discounting*, 112 Q.J. ECON. 443 (1997); Littwin, *supra* note 20, at 467 (citing Ted O'Donoghue & Matthew Rabin, *Doing It Now or Later*, 89 AM. ECON. REV. 103 (1999)).

158. Littwin, *supra* note 20, at 466–67.

159. Walker & Sauter, *supra* note 120, at 70–71. This study was conducted in 1971, before the federal preemption of state usury laws was recognized in 1978. *See* discussion *supra* note 85. Therefore, the Minnesota usury law in question would have an impact on consumer credit transactions. The statute's focus on consumer retail credit is also indicative of the time in that credit cards were not yet widely available. *See, e.g.*, Moss & Johnson, *supra* note 15, at 325–26.

160. Walker & Sauter, *supra* note 120, at 74 fig.1.

161. *Id.*

162. *Id.* at 73 (stating that the results are "inconsistent with the hypothesis concerning overall preference rankings").

163. In August 2006, the senior staff of the Credit Research Center moved from Georgetown University's McDonough School of Business to establish the Financial Services Research Program at George Washington University School of Business.

164. Reported in Durkin, *supra* note 47, at 627–33. The fact that an institute that, at least as of 1998, was largely funded and partially governed by the credit industry produced such a study is an im-

found a surprisingly high amount of negative opinion in light of the continual increase in consumer credit card use over the past few decades.[165] Of the nearly five-hundred households surveyed, 51% of all families and 42% of bank card holding families thought that using credit cards was a "bad thing." In comparison, 33% of all families and 42% of bank card holding families thought it was a "good thing."[166] Though the traditional objective preferences framework would expect consumer opinion of credit cards to rise as use rises, negative opinions of credit card use increased (and positive opinions decreased) dramatically from those expressed in similar surveys conducted in 1970 and 1977.[167]

Even more strikingly, the more respondents used the borrowing feature of credit cards, the more likely they were to believe that using credit cards was bad. For example, although 42% of all bank card holders thought credit cards were bad, 49% of bank card holders with three or more cards, 57% of those with a revolving balance of $1,500 or more, 59% of those who hardly ever pay the outstanding balance in full, and 63% of those who hardly ever pay more than the minimum payment held a negative opinion of credit card use.[168] This is strong evidence of consumers' subjective preferences not matching their objective borrowing behavior.

On the other hand, the Credit Research Center also found that bank card holders are generally satisfied with their own credit card companies.[169] Federal Reserve economist Thomas Durkin suggests that these seemingly contradictory opinions are due to consumers' happiness with their own credit card experiences and their concern about the effects of the high availability of credit on "the other guy."[170] But when discussing stigmatized matters such as debt, consumers may find it easier to admit negative feelings generally rather than admit to personal struggles with debt.[171] Another possible explanation is that participants were satisfied with their relationship with their issuers, but less happy with the effects of credit cards on their finances. Ninety percent agreed that, "[m]y credit

plicit acknowledgement by market participants of the importance of studying subjective preferences. *See* Robert Cwiklik, *Ivory Tower Inc.: When Research and Lobbying Mesh*, WALL ST. J., June 9, 1998, at B1 (stating that the Credit Research Center's 1998, $450,000 budget was largely funded by the credit industry and that 70% of its advisory counsel members were industry representatives); *see also* Elizabeth Warren, *The Market for Data: The Changing Role of Social Sciences in Shaping the Law*, 2002 WIS. L. REV. 1, 8, 11–15.

165. Durkin, *supra* note 47, at 627.

166. *Id.* at 627 tbl.3. That left only 17% of all families and 15% of bank card holding families who thought that credit card use was "good, with qualification," "bad, with qualification," or "both good and bad." *Id.* The current study found analogous polarization of opinion about credit cards. I interpret this finding in Part IV.B, *infra*.

167. Durkin, *supra* note 47, at 627.

168. *Id.* at 628.

169. *Id.* at 629 tbl.4.

170. *Id.* at 628, 630.

171. This is why, for example, when the current study asked about use of loan sharks, it asked whether participants had ever used loan sharks themselves and also whether they knew of anyone who had used them. *See* discussion *infra* Part IV.C.3.

card companies treat me fairly," but 81% disagreed that credit card interest rates were reasonable.[172] The current study found similarly ambivalent reactions.[173]

C. The Current Study—Comparing Preferences

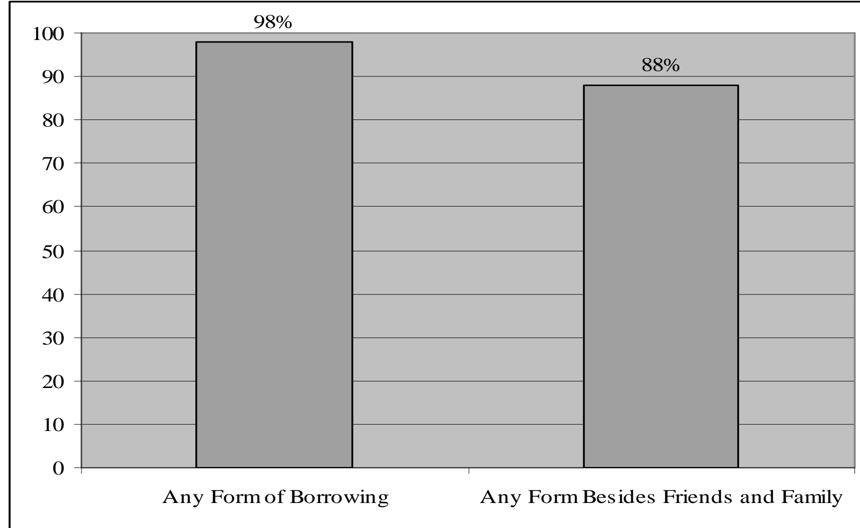
Although the above studies have begun to illuminate borrowers' subjective evaluations of different borrowing options, an analysis of the harm of borrowing substitution needs to compare borrower assessments of the different credit types. Almost all low-income consumers' credit options have significant drawbacks, so examining borrowers' appraisal of each option in and of itself—while crucial—does not provide enough information for a complete analysis. For example, knowing that low-income consumers largely evaluate both credit cards and rent-to-own stores negatively does not answer the question of whether regulating credit card borrowing in favor of rent-to-own store loans would have positive, negative, or neutral consequences for consumers. An understanding of how consumers compare the two tools will inform that judgment.

1. A Variety of Borrowing

The current study suggests that borrowing is widespread among low-income families: virtually all participants in the current study had borrowed money at some point in their lives. In addition, the vast majority had moved beyond borrowing only from their friends and family and sought credit in the formal lending sector. These results are displayed in Figure 4.

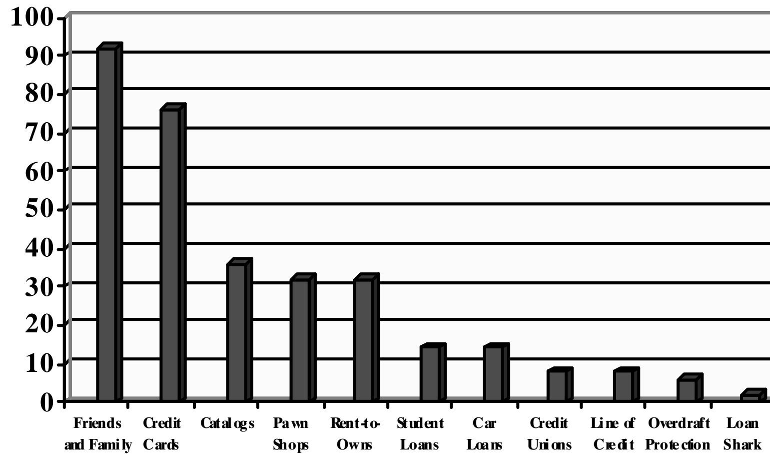
172. Durkin, *supra* note 47, at 629 tbl.4.
173. *See* discussion *infra* Part IV.C.3.

FIGURE 4
PERCENTAGE OF PARTICIPANTS WHO HAD BORROWED



Participants had also used a wide variety of credit services, as shown in Figure 5.[174]

FIGURE 5
PERCENTAGE OF PARTICIPANTS WHO HAD USED EACH BORROWING TYPE



There are several points worth noting about the types of borrowing participants had accessed. First, despite the democratization of credit

174. Again, payday lending is illegal in Massachusetts, which accounts for its lack of representation among the forms of borrowing participants have used. *See supra* note 13 and accompanying text.

that has taken place in recent years, by far the most common form of credit is still informal borrowing from friends and family. The prevalence of informal borrowing suggests that, if regulation of credit card lending were to take place, much of the resulting substitution would be with the informal sector.[175] Second, the 76% of participants who had used credit cards support the claim that the democratization of credit card lending is well underway.[176] Nearly half of the study respondents received welfare or means-tested disability payments, and to qualify for the study, participants had to live in government-subsidized housing,[177] so the high penetration of credit cards within this group was significant.

Third, the next most common form of credit is borrowing from mail order catalogs. This is a form of borrowing in which a consumer purchases goods from a catalog on credit and pays in monthly installments. Catalog borrowing is almost never mentioned in the legal literature,[178] and I had not heard of it before I began the study. Yet over one-third of the participants had used it—slightly more than the number that had used either the widely familiar pawn shops or rent-to-own stores.[179]

Finally, these data confirm the perception that low-income consumers do not have regular access to "middle-class" forms of borrowing other than credit cards. The lack of mortgage and home equity borrowing is a function of the parameters of the research because the study required that participants live in subsidized rental housing.[180] But other forms of "middle-class credit" were represented at low levels as well. Only 14% of participants had used student loans and car loans. Eight percent had borrowed from a credit union and obtained a personal line of credit from a bank. Even bank overdraft protection, which has been criticized by

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175. *See also* LENDOL CALDER, FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT 60–64 (1999) (suggesting that credit cards replaced some borrowing from pawn shops and some from friends and family).

176. For other evidence, see Bird et al., *supra* note 23, at 126; Moss & Johnson, *supra* note 15, at 323–26.

177. *See* Littwin, *supra* note 20, app. at 503.

178. A LexisNexis search revealed only six law review articles mentioning the mail order company, none of which discussed its lending operations. H. Beau Baez III, *The Rush to the Goblin Market: The Blurring of Quill's Two Nexus Tests*, 29 SEATTLE U. L. REV. 581 (2006) (discussing out-of-state retailers that do not collect sales tax); Steven J. Forte, *Use Tax Collection on Internet Purchases: Should the Mail Order Industry Serve as a Model?*, 15 J. MARSHALL J. COMPUTER & INFO. L. 203 (1997) (discussing Internet taxation); Edward A. Morse, *State Taxation of Internet Commerce: Something New Under the Sun?*, 30 CREIGHTON L. REV. 1113 (1997) (same); Joel R. Reidenberg, *Setting Standards for Fair Information Practice in the U.S. Private Sector*, 80 IOWA L. REV. 497 (1995) (discussing data privacy); Suzanna Sherry, *Haste Makes Waste: Congress and the Common Law in Cyberspace*, 55 VAND. L. REV. 309 (2002) (discussing Internet jurisdiction); Matthew G. McLaughlin, Comment, *The Internet Tax Freedom Act: Congress Takes a Byte Out of the Net*, 48 CATH. U. L. REV. 209 (1998) (discussing taxation of mailing lists); *see also* Joseph B. Cahill, *Where It's Due: Credit Companies Find Tough Rival at Bottom of Consumer Market—Fingerhut's Experience Shows 'Subprime' Lending Takes Gimmicks, a Lot of Grit—A Toll on Customers, Too*, WALL ST. J., Dec. 29, 1998, at A1 ("Little-known outside low-income groups—its customers have an average household income of $27,700 . . . .").

179. *See infra* notes 198–215 and accompanying text.

180. *See* Littwin, *supra* note 20, app. at 503.

some consumer advocates[181] but nonetheless requires a bank account, was used by only 6% of respondents. These figures actually slightly overstate participant use of middle-class borrowing because some participants had used more than one form of it. Only 40% of participants had used any of these borrowing types. These low rates—as well as participants' strong preferences for middle-class borrowing options—underscore the importance of the project that commentators such as Michael Barr have undertaken, that of "banking" low-income consumers and otherwise expanding their financial options.[182]

2. *The Borrowing Options of Low-Income Consumers*

The borrowing options primarily used by low-income consumers are not well understood. Unlike with credit card financing[183] or home-mortgage loans,[184] there is little literature available on how fringe borrowing functions in practice, who uses it, and why. Rent-to-own stores and pawn shops, by contrast, have attracted less interest recently. In a rent-to-own transaction, a customer obtains an item, usually furniture, electronic equipment, or an appliance,[185] through installment credit. If she does not make all the payments, the store can repossess the item, and she will be deemed to have been renting all along. Most rent-to-own stores require weekly payments,[186] with a typical loan period between one and two years.[187] A rent-to-own contract does not specify interest. Rather, the interest is built into the purchase price, which is typically two to two and a half times what one would pay in a retail store.[188]

In the most recent comprehensive research of rent-to-own industry customers, the researchers found that 4.9% of U.S. households had used rent-to-own stores in the past five years, and 2.3% had used them in the past year.[189] Interestingly, the study also found that 75% of customers

181. *See, e.g.*, Press Release, Ctr. for Responsible Lending, The $30 Doughnut (July 11, 2007), http://ga3.org/crl/notice-description.tcl?newsletter_id=13016480.

182. Barr, *supra* note 16, at 123–25.

183. *See, e.g.*, Bird et al., *supra* note 23; Durkin, *supra* note 47; Littwin, *supra* note 20; Walker & Sauter, *supra* note 120; Zywicki, *supra* note 6.

184. *See, e.g.*, Michael S. Barr, *Credit Where It Counts: The Community Reinvestment Act and Its Critics*, 80 N.Y.U. L. REV. 513 (2005); Canner et al., *supra* note 41; Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255 (2002); Quintin Johnstone, *Private Mortgage Insurance*, 39 WAKE FOREST L. REV. 783 (2004); Michael H. Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 VA. L. REV. 489 (1991).

185. JAMES M. LACKO ET AL., FED. TRADE COMM'N BUREAU OF ECON., STUDY OF RENT-TO-OWN CONSUMERS ES-2 (2000) [hereinafter FTC REPORT], *available at* http://www.ftc.gov/reports/renttoown/renttoownr.pdf.

186. *See, e.g.*, Interviews with Respondents X66, 9JK, and B63; Jim Hawkins, *Renting the Good Life*, 49 WM. & MARY L. REV. 2041, 2054 (2007).

187. Signe-Mary McKernan et al., *Empirical Evidence on the Determinants of Rent-to-Own Use and Purchase Behavior*, 17 ECON. DEV. Q. 33, 34 (2003).

188. CASKEY, *supra* note 16, at 80 (citing Roger M. Swagler & Paula Wheeler, *Rental-Purchase Agreements: A Preliminary Investigation of Consumer Attitudes and Behaviors*, J. CONSUMER AFF. 145, 147 (1989)); McKernan et al., *supra* note 187.

189. FTC REPORT, *supra* note 185, at ES-1; McKernan et al., *supra* note 187.

were satisfied with their experience and that the primary reason for dissatisfaction was high pricing.[190] Rent-to-own customers are younger and less likely to be white, well-educated, or financially secure than the general population.[191]

Even less has been written about the operation of pawn shops in practice.[192] A pawn shop loan begins when a customer posts collateral in exchange for cash, commonly worth approximately half the value of the collateral.[193] The customer has no legal obligation to redeem her collateral, but if she fails to do so within the specified term, usually one to three months,[194] the item becomes the property of the pawn broker.[195] Evidently, as of the late 1990s, jewelry was the good pawned most frequently, followed by consumer electronics.[196] The average pawn shop loan size was approximately $70, with typical loans ranging in size from $35 to $260.[197] As of the mid-1990s, pawn shop interest rates averaged over 200% per year.[198]

Beginning in the mid-1970s and continuing through the 1990s, pawn broking witnessed a significant expansion across the United States. The number of pawn shops nearly doubled from 1988 to 1998 alone.[199] As of 2003, the industry had a revenue of $4.8 billion.[200] Like rent-to-own customers, pawn shop borrowers are less well-educated, less likely to be married, less likely to be white, and less financially secure than the general population.[201]

Almost nothing has been published on borrowing from mail order catalogs. No empirical studies have been undertaken, and discussion of this type of borrowing in the academic literature is negligible.[202] The information presented here was culled from newspaper and trade maga-

190. FTC REPORT, *supra* note 185, at 1.

191. McKernan et al., *supra* note 187, at 35.

192. Despite being published over a decade ago, John Caskey's book *Fringe Banking* remains the definitive work on the subject. CASKEY, *supra* note 16. In *Fringe Banking*, Caskey analyzed the few sources of data about pawn shops that were publicly available and collected data predominately through interviews with pawnbrokers. *Id.* at xiii. The only other comprehensive empirical research on pawn shops appears to be a Credit Research Center's study, published in 1998. JOHNSON & JOHNSON, *supra* note 91. This study consists of a nonrandom sample of 1,820 pawn shop customers. *Id.* at 32.

193. CASKEY, *supra* note 16, at 42.

194. *Id.* at 39

195. *Id.* at 37.

196. *Id.* at 44.

197. JOHNSON & JOHNSON, *supra* note 91, at 16. Caskey finds $50 to $70. CASKEY, *supra* note 16, at 44.

198. CASKEY, *supra* note 16, at 36.

199. JOHNSON & JOHNSON, *supra* note 91, at 7 (reporting that the number of pawn shops increased from 6,900 in 1988 to 13,000 in 1998).

200. DTI REPORT, *supra* note 82, at 15 fig.8.

201. JOHNSON & JOHNSON, *supra* note 91, at 37–47. The finding on race may be biased by the fact that the study focused on pawn shops in urban areas. On the other hand, in the pawn shops the researchers studied, black customers were more heavily represented among the population of active borrowers, whereas white customers were more heavily represented among those present for shopping purposes only. *Id.* at 43.

202. *See* sources cited *supra* note 178.

zine articles, company Web sites, attempts to contact the companies, and data from the current study.

The dominant catalog lender in the United States is Fingerhut, owned by the Petters Group, in Minnesota.[203] The company sells a variety of goods, but its "meat and potatoes" are "electronics, jewelry and housewares."[204] Most of the current study participants use it to purchase housewares. When a customer purchases an item, either online or through Fingerhut's direct-mail catalog, she can pay the entire purchase price then, or she can select the monthly financing option, which is priced on a sliding scale based on her account balance.[205] Fingerhut has its own credit application process, and an approved Fingerhut member may purchase Fingerhut items on monthly installment up to her credit limit. When a customer makes the monthly payment, she is not charged separate interest, which is instead built into the installment plan price.[206] Fingerhut also charges a late fee and assesses a financing charge on any unpaid balance.[207] In other words, for each item purchased on credit, the debtor commits to a plan of fixed monthly payments over a prespecified number of months. Until recently, Fingerhut even issued its customers coupon books like those used for car loans or mortgage payments.[208]

Fingerhut's business model is based on lending to low- and moderate-income customers. Historically, Fingerhut's customer base has had an average household income below $30,000 and purchased from the catalog almost exclusively on credit.[209] The company consistently markets itself as a supplier of credit. Its main web page is titled, "Your Home Shopping Catalog with Low Monthly Payments."[210] Its print catalog covers feature the words "low monthly payments" in large, bold type. Fingerhut specifically markets itself to customers who have difficulty obtaining credit elsewhere. Its Web site recently proclaimed in large type: "Welcome to easy credit" and "We say yes when others say no!"

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203. The only other catalog with a proprietary lending system that I have been able to locate is Popular Club. This seller adds an additional twist because it encourages customers to become "club leaders," which appears to be the equivalent of being a representative for Avon or Tupperware. *See* Popular Club, http://www.popularclub.com (last visited Feb. 16, 2009).

204. Kris Oser, *The Start-Up That Isn't*, DIRECT, Sept. 1, 2003, at 11.

205. Fingerhut, Customer Service: Fingerhut Credit, http://www.fingerhut.com/help.aspx?question=414 (last visited Feb. 16, 2009) (showing monthly payments of $5.99 for balances between $5.99 and $44.99, $55.99 for balances between $800 and $1,099.99, and 5% of the balance for balances over $1,400). Fingerhut declined to release the number of months an installment plan typically requires. E-mail from Lisa Bilcik, Vice President, Corporate Counsel, Fingerhut, to author (Sept. 20, 2006, 13:43:21 EST) (on file with author). But a *Wall Street Journal* article cites payment plan lengths of fifteen to eighteen months. Cahill, *supra* note 178.

206. Cahill, *supra* note 178; Fingerhut Credit Application, https://www.fingerhut.com/FingerhutCredit.aspx?ref=welcomeoffer&subref=HeaderLink (last visited Feb. 16, 2009).

207. Fingerhut, Customer Service: Fingerhut Credit, http://www.fingerhut.com/help.aspx?question=413 (last visited Feb. 17, 2009).

208. Mark Del Franco, *Private-Label Credit Cards: Risky Business?*, CATALOG AGE, Jan. 6, 2002, at 16.

209. Cahill, *supra* note 178.

210. Fingerhut, http://www.fingerhut.com (last visited Jan. 9, 2009).

Fingerhut has a tumultuous recent corporate history that illustrates the importance of its lending model to its success. Founded in 1949, it ran a successful catalog borrowing operation for half a century.[211] In 1999, Federated Department Stores purchased the company for $1.7 billion as a means of expanding its online distribution channels.[212] The purchase was not a success, due in part to Federated's attempt to shift Fingerhut customers from an installment credit model to revolving credit plans.[213] In 2002, Federated sold Fingerhut in pieces. The Petters Group and Ted Deikel, the former CEO of the company and son-in-law of its founder, formed FAC Acquisitions to purchase most of the remnants for an estimated $100 million.[214]

The new owners have sought to return Fingerhut to its pre-Federated glory and appear to be making qualified progress towards this goal.[215] As Fingerhut rebuilds itself following the Federated disaster, it has returned to the installment lending structure: "The business model is the original Fingerhut: Focus on sub-prime credit customers, grant them a credit line, sell them general merchandise on time and increase their credit as they establish a solid payment record with the company."[216]

Interestingly, though a little-known company dominates the mail order lending business in the United States, borrowing from catalogs is quite common in Europe. Mail order credit is the most popular form of borrowing for British[217] and German[218] low-income consumers.

3. *Participants' Comparison of Credit Cards to Other Forms of Fringe Borrowing*

Although rent-to-own stores, pawn shops, and catalogs are rarely used by middle-class borrowers, and commentators tend to conceptualize them as outside the mainstream,[219] it should not be assumed that they are

211. Oser, *supra* note 204, at 9.

212. Neal St. Anthony, *Petters Sees Gold in Brand of Old; He'll Bank on Its Technology, Recognition*, STAR TRIB. (Minneapolis-St. Paul, Minn.), Apr. 26, 2005, at D1.

213. A consensus emerged among industry observers that the Federated-owned Fingerhut's deviation from its installment credit model was a major factor in its near-collapse. A catalog industry trade publication argued that Fingerhut's problems began in 1999 because it shifted from installment payment plans to revolving credit plans. Paul Miller, *Fingerhut Fixing Credit Mess*, CATALOG AGE, Mar. 1, 2001, at 5. In the first year of this switch, Fingerhut lost nearly $400 million in unpaid credit bills. *Id.* As an industry analyst explained, the company's executives "'assumed that the customer would behave the same under both [credit] methods. . . . But they were wrong, and their mistake was to roll out the program before properly testing it.'" *Id.*

214. *Id.* at 20 (anticipating Federated sale of Fingerhut); Cahill, *supra* note 178. Petters later bought out Ted Deikel's share. Vicki M. Young, *Fingerhut Returns: Focus on Growth*, WWD, Apr. 22, 2003, at 22.

215. At its peak, Fingerhut had 10,000 employees, but was down to 200 in 2003. Oser, *supra* note 204, at 9. As of 2005, the company had sales of $175 million and more than 400 full-time employees. St. Anthony, *supra* note 212.

216. Oser, *supra* note 204, at 9.

217. DTI REPORT, *supra* note 82, at 18 fig.11.

218. ECONOMIC AND SOCIAL RISKS, *supra* note 82, at 31 chart 10b.

219. *See supra* Part III.A.

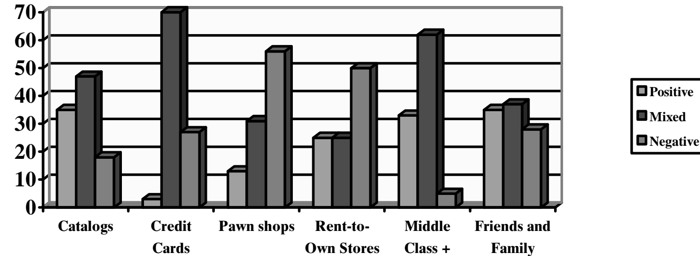
any "worse" than the more familiar products, such as credit cards, from the perspective of low-income borrowers. My preliminary evidence casts doubt on the conception that borrowing from credit cards is somehow "better" than borrowing from fringe banking alternatives.[220] Participants evaluated credit cards approximately equally with rent-to-own stores and less highly than pawn shops and catalogs. Of course, one study with a snowball sample of fifty consumers is not enough to answer the question fully, but at the very least, these findings suggest that further investigation is needed.

In order to understand the subjective desirability of borrowing alternatives, the study asked participants to evaluate credit cards and the other forms of lending to which they had access. First, as a participant described her experience with a borrowing type, she was asked whether the experience had been positive, negative, or mixed. I refer to this measure as "experience scores." Second, participants were asked to rank all forms of borrowing to which they had access. I call this measure "rankings." These two variables measured different opinions because the experience-score variable covered only lending in which the participant had actually participated, whereas the ranking variable covered all forms of borrowing to which they believed they had access. In addition, the rankings measure required participants to evaluate more subtle distinctions between forms of borrowing to which they gave the same rating. They produced similar results.

Figure 6 presents the total percentage of participants who gave each borrowing type positive, mixed, and negative experience scores. The "middle class" borrowing category is a loose approximation, including student loans, car loans, credit-union loans, and any form of loan originating from a bank. I did not have sufficient observations for any of these borrowing types to compare them individually. I recognize that categorizing all these forms of borrowing as "middle class" is somewhat inaccurate because these borrowing types can be geared toward the low-income community. There was no way to disaggregate, for example, the prime-rate car loans from the sub-prime car loans, so I used the above approximation. One indication of the accuracy of this approximation was that only one of the twenty-one observations that fell within this category had a negative experience score.

220. Because I am comparing forms of borrowing, this discussion is limited to the borrowing capacity of each option discussed. For pawn shops, that means that I included only data relevant to the scenario where a person uses an item as collateral for a loan, not when she sells the item outright. Similarly, I include only data related to revolving credit card use, as opposed to transactional use. Transactional use does not seem to be a priority for this population, as only one participant who used credit cards had never regularly revolved a balance. *See supra* note 146.

FIGURE 6
PERCENTAGE OF PARTICIPANTS RATING EACH BORROWING TYPE POSITIVE, MIXED, OR NEGATIVE



+ Category includes student loans, car loans, credit-union loans, bank overdraft protection, and personal lines of credit from banks.

As shown in Figure 6, participants gave middle-class borrowing, catalogs, and informal borrowing from friends and family more positive experience scores than negative, although the results are close with informal borrowing. In contrast, credit cards, pawn shops, and rent-to-own stores each had at least twice as many negative experience scores as positive. The most striking point about the credit card experience scores, however, is the high percentage of mixed evaluations. A close examination of the transcripts reveals that this may be a function of participants balancing the positive and negative features of credit cards. For example, many participants who gave credit cards a mixed experience score seemed to balance the positive value they received from credit cards on the borrowing end against the negative experiences they had on the repayment end. This mixed evaluation of credit cards disappears in the rankings data, where participants evaluated them much more negatively.

The second measure produced similar results, as shown in Figure 7.[221] For this measure, participants ranked their borrowing options from most to least preferred. Once again, middle-class borrowing[222] and informal borrowing occupy the positive side of the spectrum, with more than three times as many positive rankings as negative rankings in both cases. Participants ranked catalogs less positively than they experience-scored them, giving them an equal number of positive and negative rank-

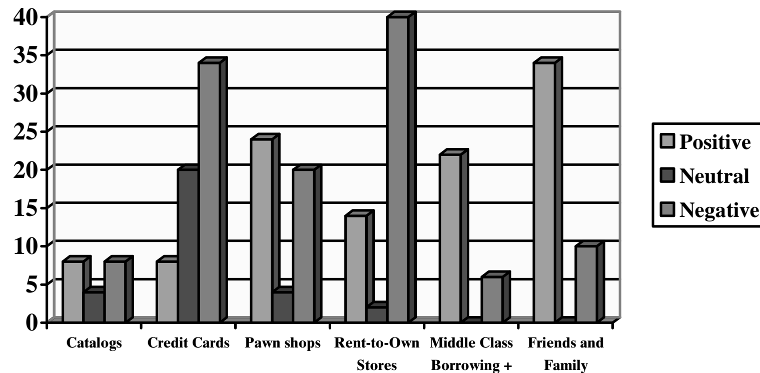
221. Because several participants grouped their rankings in a way that made them impossible to code accurately (e.g., "they're all bad"), the sample size here is small. An additional number of participants gave answers such as, "Pawn shops are good, and the rest are bad," so I analyzed the ranking data twice, once coding these answers as ties and once dropping them from the analysis. The two analyses produced analogous results. For the sake of simplicity, I report only one analysis. I chose the one that excluded the ties because the data was more precise. When a participant said "the rest are bad," I did not collect data on exactly which borrowing type she was including.

222. All of the negative rankings for middle-class borrowing were of bank overdraft protection. Car loans, student loans, loans from credit unions, and personal lines of credit from banks never received negative rankings.

ings. On the other hand, participants gave pawn shops much higher rankings than experience scores. This change seems to partly reflect the positive evaluations of pawn shops by participants who had not used them, but it also appears to reflect the negative experiences of participants who had used pawn shops but thought more positively of them when they compared them to their other options. Participant reaction to credit cards and rent-to-own stores remained negative. More than twice as many participants ranked both forms of borrowing negatively than those who ranked both positively.

FIGURE 7

PERCENTAGE OF PARTICIPANTS GIVING A POSITIVE, NEUTRAL, OR NEGATIVE RANK FOR EACH BORROWING TYPE (INCLUDES ALL PARTICIPANTS)



+ Category includes student loans, car loans, credit-union loans, bank overdraft protection, and personal lines of credit from banks.

Though the comparisons with catalogs, rent-to-own stores, pawn shops, informal borrowing, and middle-class borrowing seem to indicate that credit cards are one of the least-preferred forms of borrowing, one qualification to this conclusion is the striking absence of loan sharking. One of the core tenets of the substitution hypothesis is that the fewer legal borrowing options accessible to low-income consumers, the more likely they will be to resort to illegal borrowing.[223] In fact, when usury re-

223. *See, e.g.*, HERVÉ MOULIN, COOPERATIVE MICROECONOMICS: A GAME-THEORETIC INTRODUCTION 7 (1995) ("[T]here is the concern that a well-intentioned politician who invokes ethical principles to interfere with the market process . . . is likely to be countereffective . . . . [I]llegal usury is more expensive because the borrower must pay a premium to insure the lender against the risk of being caught . . . ."); David A. Skeel, Jr., *Racial Dimensions of Credit and Bankruptcy*, 61 WASH. & LEE L. REV. 1695, 1723 (2004) ("Faced with restrictive usury rules, lenders can be expected to cut back on credit. This could have the effect of steering marginal borrowers who need credit toward much less attractive forms of credit, such as pawnshops or even loan sharks."); Therese Wilson, *The Inadequacy of the Current Regulatory Response to Payday Lending*, 32 AUSTL. BUS. L. REV. 193, 199 (2004) (citing Press Release, Austl. Office of Fair Trading, Payday Predators Panned (Aug. 31, 2000)).

strictions were first loosened in the early twentieth century, the primary objective was to combat illegal lending by encouraging high-interest legal lenders to enter the market and give low-income consumers alternatives.[224] One way to interpret the lack of loan sharking found by the current study is that the high availability of credit cards is meeting the community's credit needs and leaving little demand for loan sharks. Another possibility is that study participants were unwilling to disclose loan shark borrowing during interviews.

Both of these explanations are unlikely. Addressing the second interpretation first, the study consciously framed questions about loan sharking in ways that evoked as little stigma as possible. After participants listed the types of credit they had used, they were asked if they had borrowed money from anybody else in the community, such as a neighbor or a casual acquaintance. Only once they rejected that possibility did the study mention the term "loan sharking" by name. If both forms of the question produced a negative answer, the study then asked if participants knew of or had heard of anyone who used informal community lending. The objective of this last question was to probe for any loan sharking in the community and to give participants who may have been afraid to discuss their own loan-sharking experiences the option to speak of loan sharking in terms of the story of "a friend." These efforts produced low results. Only one participant had borrowed from a loan shark, and one additional participant thought it was currently being practiced in her community. This does not appear to be a decrease that occurred as credit card availability increased, however. Even though half the sample had come of age before the effective deregulation of credit cards rates and an even greater number of participants had been adults as credit cards gradually became accessible to low-income borrowers,[225] just one participant recalled that loan sharking had existed in her youth. (Her grandfather had been a loan shark.)

The most plausible explanation for this dearth of responses is that loan sharks generally do not lend to the lowest-income tier of poor women. Not surprisingly, there is hardly any information about the practice, but from the little that does exist, it appears that the typical borrowers are men, usually either immigrants seeking to start small businesses or those with gambling debts. Recent newspaper accounts of loan-sharking practices have focused only on illegal lenders who extend credit to small

224. Christopher L. Peterson, *Truth, Understanding, and High-Cost Consumer Credit: The Historical Context of the Truth in Lending Act*, 55 FLA. L. REV. 807, 861–63 (2003). On the other hand, the relationship between legal and illegal credit may be symbiotic. Credit historian Lendol Calder argues that the rise of loan sharking in the late nineteenth century mirrored the rise of retail credit, as many of those who fell behind on their retail installment debts would turn to loan sharking. CALDER, *supra* note 175, at 55.

225. *See supra* notes 120–23 and accompanying text.

businesses in immigrant communities[226] and to those with gambling debts.[227] In addition, loan sharks have historically served a slightly higher-income customer base.[228]

4. Explaining Participants' Preferences

In sum, the results of this comparative analysis suggest that, from the subjective perspective of a preliminary sample of those most affected, credit cards are no more desirable than pawn shops and rent-to-own stores and are less desirable than every other form of borrowing. This analysis does, however, leave a major question in its wake: if credit cards are less desirable than catalogs and informal borrowing and only equally as desirable as rent-to-own stores and pawn shops, then why have more than twice as many participants borrowed with credit cards than with any other formal type of credit? First, it is worth reiterating that the more likely a participant was to use credit cards, the more likely she was to use fringe banking as well.[229] Second, borrowing from friends and family is still more popular than credit cards.[230] In addition, it is almost certain that participants were restricted by creditworthiness from obtaining as much "middle class" credit as they would have liked.

But aside from these minor qualifications, the substantive answer to this question lies in insights provided by behavioral economics, that transactions in which the costs and benefits are temporally separated are subject to preference reversal. Credit cards are an extreme case of this type of transaction because the benefits are available immediately, but the costs do not become apparent until later, often much later.

The experiences of the current study participants show how this effect can operate. Eighty-seven percent of participants who had used credit cards did not understand them at first.[231] There were many sources of misunderstanding, but they all led to a significant underestimation of the amount the participants would eventually need to repay. Because of the minimum-payment option, this is not a short-term misunderstanding corrected when a credit card user receives her first bill. Unlike a traditional installment loan where the specified regular payment guarantees an end date to the loan, the minimum payment for a credit card is often too low

226. Dexter Filkins, *In Some Immigrant Enclaves, Loan Shark Is the Local Bank*, N.Y. TIMES, Apr. 23, 2001, at A1 (describing loans made by illegal lenders to immigrant small businesses).

227. Joseph Kelly, *Caught in the Intersection Between Public Policy and Practicality: A Survey of the Legal Treatment of Gambling-Related Obligations in the United States*, 5 CHAP. L. REV. 87, 141 (2002) (describing informal lenders in Quebec casinos who lend casino chips instead of cash, execute their transactions in casino restrooms, and charge rates as high as 10% per day); Jeff Benedict, *A Losing Hand*, HARTFORD COURANT, May 8, 2005, at C1 (stating that problem gamblers may turn to loan sharks and describing the breakup of a loan-sharking ring at the Foxwoods Casino in Connecticut).

228. CALDER, *supra* note 175, at 52 ("Loan sharks catered to a class of borrowers that overlapped the high end of the pawnbroker's clientele.").

229. *See* discussion *supra* Part III.B.

230. *See supra* Part III.B fig.3.

231. For a detailed discussion of this finding, see Littwin, *supra* note 20, at 496.

to decrease the overall balance.[232] This feature makes it easy to ignore and difficult to estimate the future costs of borrowing. The importance of this type of misunderstanding is evidenced by credit card issuers' opposition to legislation requiring them to print how long it would take a borrower to pay off her balance if she made only the minimum payment.[233] In addition, credit card bills often feature the minimum payment due more prominently than the total balance.[234] Such emphasis suggests that credit card issuers expect consumers to underestimate the eventual total costs of making the minimum payment.

This ability to delay the costs of credit card borrowing explains why participants frequently evaluated credit cards negatively, despite their use of them. The cost delay and the low evaluations are mediated by a model of credit card borrowing by low-income people that emerged. Although the data set is small, it can still provide a preliminary model to be tested with a larger sample.

This model consists of a three-stage cycle. In the first stage, the participant obtains a credit card, most frequently to have in case of emergency. Forty percent of participants identified emergency use as an advantage of credit cards. The next most cited advantage of having credit cards was their purchasing power, at 34%. Twenty percent of participants said that credit cards were a good way to improve one's credit history, and another 12% obtained a credit card to see if they could get one.

In the second stage, she is "tempted" to use it[235] and finds herself charging regularly and paying less than the full balance. Many participants described themselves as happy with credit cards in this stage, and logically so; they were experiencing the benefits of credit card borrowing but not the costs. As one participant explained:

> You don't think. You can buy now and pay later, but you don't get the connection really. . . . I just thought it was like getting something right now. I didn't think. Now I would think it through of course. But then it wasn't like, I've got to pay for this next month.[236]

Another participant described a similar thought process: "Just basically—I'm going to spend this money. And I'm not going to . . . not that I

232. *See* MANN, *supra* note 126, at 193–95.

233. The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCA) included a weak minimum-balance disclosure requirement. *See* 15 U.S.C. § 1637(b) (2006). For a discussion of the ineffectiveness of this provision, see MANN, *supra* note 126, at 161. In 2002, California passed a stronger disclosure requirement. Julia Lane, *Will Credit Cardholders Default over Minimum Payment Hikes?*, 18 LOY. CONSUMER L. REV. 331, 344 (2006). Card issuers challenged the bill in court and won on the grounds that it was preempted by federal banking laws such as the National Bank Act. *See, e.g.*, *id.*

234. Redacted participant credit card bills (on file with author).

235. *See* Littwin, *supra* note 20, at Part IV.

236. Interview with Respondent V22.

was not going to pay it back. I don't think that when you're young you realize about it."[237] This phase can last for several years.

There were three common ways participants described the end of this second stage of the cycle. For some, the credit card issuer cut off the line of credit or refused to raise the credit limit beyond the participant's current balance. For others, the minimum payments became unaffordable. Often participants experienced a combination of these two. A credit card issuer might raise the interest rate, making it harder to meet the minimum payment. As one participant related, "They were lovely at first. But then I wasn't paying them fast enough, so they upped the APR, which made it harder to keep at the minimum, I mean . . . made it harder to pay more than the minimum every month."[238] A third group of participants realized themselves that their total balance was becoming unsupportable.

Whatever the reason participants entered the third stage of the cycle, once they reached that point, they then began the long process of paying down their balances. Some continued to charge occasionally, although most claimed to have had a cognitive shift and focused on not accumulating more debt. Some continued charging makes sense, in that these are all households with extremely tight budgets.

Most participants whose backgrounds with credit cards resemble this model experience the three stages only once. Indeed, because the third stage of the cycle can last for years, many were still in the process of paying down their original wave of credit card debt. More than one participant asked for advice about filing for bankruptcy during her interview.[239] Of those who had completed the cycle once, many had sworn off credit cards altogether.[240] Some swore off credit card *debt*, but continued to keep one card in case of emergencies or with the intention of becoming transactional users. A minority of those in the latter category found themselves "tempted" to use credit card borrowing again—or found themselves pulled in that direction by adverse events[241]—and thus for them, the cycle began anew.

5. *Assessing Benefits and Harm*

Understanding the features of the various credit options that consumers find beneficial and harmful is necessary in order to weigh the pos-

237. Interview with Respondent 99Z.

238. Interview with Respondent 803.

239. As part of its human subjects protections, the study developed a list of resources where participants could seek help with debt issues. When a participant asked for bankruptcy advice, she was given this list and referred to those resources that offered bankruptcy services.

240. This corresponds to findings from the Consumer Bankruptcy Project that a majority of bankruptcy filers decline the many credit card offers they receive after bankruptcy. *See* Katherine Porter, *Borrowing After Bankruptcy* (forthcoming 2008), *available at* http://www.utexas.edu/law/academics/centers/clbe/assets/Porter.pdf.

241. Interview with Respondent 283.

itive and negative consequences of credit substitution. It was the ability to accumulate a balance before understanding its full cost that participants cited as the major drawback of credit cards. None of the other borrowing options available to low-income consumers has this negative characteristic. Each of those forms of credit has other drawbacks, however. It is through comparing the advantages and disadvantages of the other fringe borrowing options to those of credit cards that a fuller picture of the potential effects of credit substitution begins to emerge.

The positive and negative characteristics of the borrowing types available to low-income consumers can be grouped into three broad categories: transparency/manageability, security (or lack thereof), and versatility. I group transparency and manageability together because they arise in the same products and capture two dimensions of whether consumers understand "what they are getting into" when they begin using the product. As used here, transparency refers to two closely related attributes. The first is whether a product's fees and other negative features are easily perceived by the consumer at the beginning of the transaction. The second is "usage transparency," or whether a consumer can predict her own behavior with respect to the product. A product that lacks this "usage transparency" is one that consumers frequently end up using in a manner that is inconsistent with their initial expectations.[242] Usage transparency bleeds into manageability because it is often consumers' inability to forecast how they will use a product that leads them to feel unable to control their borrowing and to accumulate unmanageable debt.[243]

The term security here has its standard commercial-law meaning: whether the loan is secured or unsecured, i.e., whether the lender has the right to collateral if the borrower defaults. Versatility refers to the flexibility the borrower has in spending the credit. If the borrower receives cash or its equivalent, the borrowing type is versatile. If the type of credit limits what she can purchase with it, it is less versatile.

Price, of course, is an additional factor. But participants' reactions to price seemed to correlate more closely with their opinions of characteristics other than with price itself. For example, the best estimates indicate that pawn shops and rent-to-own stores have similar interest rates. If anything, pawn shops' interest rates appear to be higher.[244] But, as will

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242. *See* Oren Bar-Gill, *Informing Consumers About Themselves* 6 (N.Y. Univ. Law and Econ. Research Paper Series, Working Paper No. 07-44, 2007), *available at* http://ssrn.com/abstract=1056381.

243. *See* Littwin, *supra* note 20, at 466–78.

244. On a national level, Caskey estimated in the early 1990s that the unregulated market rate for pawn shop transactions was approximately 240% per year. CASKEY, *supra* note 16, at 39. Rent-to-own store interest rates are consistently estimated to be between 100 and 150%. Because nearly every transaction reported in the current study took place in Massachusetts, local interest rates are more relevant, but these are difficult to determine. In Massachusetts, localities regulate pawn shop interest, setting annual percentage rates ranging from 36 to 120%. MASS. GEN. LAWS ch. 140, §§ 70, 72, 78 (2002); Donna Roberson & Mike Beaudet, *State Fails to Curb Usurious Pawnshop Rates*, BOSTON GLOBE, Apr. 30, 2007, at A1. Technically, the state Division of Banks must approve these local inter-

be discussed below, participants expressed a higher level of satisfaction with pawn shop prices than those of rent-to-own stores. The ultimate interest rates that consumers pay on credit cards are difficult to determine because they can compound over several years and—in the case of participants and others struggling with credit card debt—include numerous flat-fee charges such as late and overlimit fees that are effectively part of the interest-rate price. But participants commented that they ended up paying two to three times the principle in interest, even though the participant with the highest documented APR was paying 30.99%.[245]

Catalog interest rates are even more difficult to determine because the major catalog company will not release information on either the number of monthly installments a borrower must pay for any given purchase or how it determines that figure.[246] Still, an attempt to purchase merchandise from the company in order to answer these questions revealed that, at least impressionistically, its prices are much higher than what one would pay at a standard retail establishment.[247] Participants were unhappy with catalog prices, but not as unhappy as they were with those of rent-to-own prices. Due to this inconsistency in participants' subjective price assessments and the lack of objective data about fringe credit pricing, I treat participants' comments about price as a proxy for their overall evaluation of the borrowing type, rather than a separate factor of its own.

The lack of transparency and manageability in credit card borrowing figured prominently in participants' overall assessment of the borrowing type. Credit cards might have received even lower evaluations if they were not both versatile and unsecured. Credit cards are extremely versatile. They can be used almost anywhere cash is accepted, and in some cases, they are preferred over cash.[248] And the vast majority of credit card borrowing is unsecured.[249]

est rates, MASS. GEN. LAWS ch. 140, § 78 (2002), and it has set an annual limit of 36%, but the regime is so complex that the Attorney General is reluctant to enforce it until new legislation is enacted. Roberson & Beaudet, *supra*. The state and local restrictions appear to be routinely violated. *Id.* The study was unable to impute local rent-to-own interest rates because such a determination requires an appraisal of the merchandise's value.

245. Interview with Respondent 9YY.

246. E-mail from Lisa Bilcik, Vice President, Corporate Counsel, Fingerhut, to author (Sept. 20, 2006, 13:43:21 EST) (on file with author).

247. I had difficulty bringing myself to purchase anything because the prices were so far above what I intuitively expected to pay for the merchandise. Shipping costs further increased the total. At nearly $8.00, shipping represented approximately 28% of my $27.87 balance, meaning that my first installment payment of $5.99 did not even fully cover the shipping charges. In addition, I was charged a $1.00 processing fee each month I made an installment payment.

248. Littwin, *supra* note 20, at 462–63.

249. There is a product known as a secured credit card, but it does not actually offer the borrower any credit. The putative borrower must send the issuer a deposit in the amount of the borrower's line of "credit." The borrower may then charge up to the amount she has on deposit, as though she had an unbanked debit card. *See, e.g.*, Interview with Respondent 803. Secured credit cards were disfavored by participants, and none of them were currently using one. Every participant who had used a secured credit card had also used at least one unsecured card.

On the other hand, participants had such negative opinions about the lack of transparency and manageability that the other two factors were unable to fully mitigate the damage. Participants expressed frustration, anger, and sadness about credit cards. The qualitative data illustrate some of the harm participants experienced. One participant summed up her failure to understand the workings of credit cards until after she had already accumulated a large balance as, "Once you get it, it's way over your head."[250] Another participant described it this way:

> The advantage is that you can go out and get things that you do really need, that's without the wait. The disadvantage is paying back, like you're paying back at least twice. And you don't realize it because you're so happy that you got . . . what it was that you needed or whatever it is. But in the long run it hurts. It truly hurts.[251]

One participant's experience with credit cards was so negative that she compared loan sharking favorably to credit cards:

> [With loan sharks] you know what the situation is before you get into it. . . . But with the credit card companies, they're going to drain you slowly and take everything away from you. With the loan sharks, they might beat you up or whatever, but they're not going to come and take your house or your car or whatever is yours. They're not going to put you out on the streets. That's why I said I would much rather deal with them.[252]

The fact that credit cards regularly change their terms further exacerbates the issue. Participants felt that credit card issuers changed the rules once they had accumulated a balance and could not easily exit the relationship. As one participant described:

> And then all of a sudden, we're up to 29%, and they brought in the over-the-limit fees, and they brought in those late fees. And now all of a sudden, it's like if you were late on this one, these five companies can now raise your interest, because you were late on this credit card that has got nothing to do with them. That's when all of these tricks started to come into play.[253]

Another participant discussed the phenomena more generally: "My understanding was once you and the company committed to a certain amount, they would not fluctuate . . . and we wouldn't be hit with the higher interest rate years later, and that's the predicament that a lot of us have gotten into."[254] Repeatedly, participants commented that at least they understood other forms of fringe borrowing ahead of time, but each of the fringe borrowing alternatives—pawn shops, rent-to-own stores, and catalogs—either requires security, lacks versatility, or both.

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250. Interview with Respondent 64F.

251. Interview with Respondent 803.

252. Interview with Respondent A26.

253. Interview with Respondent 283 (Admittedly, this is the participant whose grandfather was a loan shark, so her views may be colored by this experience.).

254. Interview with Respondent 224.

With respect to transparency, pawn shops are the exact opposite of credit cards. In a pawn shop transaction, the cost of the loan is internalized immediately, as the borrower must physically surrender her collateral to obtain the loan. In this way, the borrower must face the cost of the transaction at the time she receives the benefit. Borrowers are still vulnerable to overestimating their ability to redeem their collateral within the required time period, but prior research suggests that pawn shops are manageable in this respect: the vast majority of borrowers do redeem their collateral.[255]

In addition, the fact that pawn shop loans are generally small[256] makes them more manageable still. As one participant explained, "As long as you don't get too much money, then you're okay, because you know you're bound to pay it back. . . . So if you get less money, then you're more likely to get [your collateral] back."[257] A second participant echoed and elaborated on this idea: "They're pretty useful I think because you can either leave it or get it back. And they don't charge much. You don't get much. So you don't have to worry."[258]

Pawn shop borrowing also gives the consumer the highest level of versatility possible. The borrower receives cash, the most fungible option available. Pawn shop borrowing is, however, secured, and this has two negative consequences. First, there is the possibility of losing one's collateral permanently. One speaker expressed regret over losing jewelry she had inherited from her grandmother in her native country,[259] while another described her horror at her inability to stop a friend from posting her wedding ring so she could buy drugs.[260] On the other hand, two participants favorably described pawning and redeeming gold chains and other jewelry in accordance with their cash flow.[261] The second negative consequence of the security requirement is that it makes pawn shops inaccessible to people who do not own items of value. A few participants mentioned that they had nothing to post as collateral.[262]

Though pawn shop interest rates were generally considered fair,[263] rent-to-own stores were considered overpriced. This feature was discussed perhaps even more often than repossession. Several people described rent-to-own stores as "rip-off[s],"[264] and others stated that they charged three times as much as standard retail stores.[265] This negative

255. JOHNSON & JOHNSON, *supra* note 91, at 17.
256. *See supra* note 205 and accompanying text.
257. Interview with Respondent K72.
258. Interview with Respondent 921.
259. Interview with Respondent 99Z.
260. Interview with Respondent B63.
261. Interview with Respondents 20Y and U67.
262. *See, e.g.*, Interview with Respondent 803.
263. *See supra* note 244 for actual interest rates.
264. Interview with Respondents V22, X66, and 921.
265. Interview with Respondents CC3 and 2AU. The recent FTC study on rent-to-owns suggests that prices are two to two and a half times those of retail stores. *See supra* note 185.

perception of price corresponds with the fact that rent-to-owns perform poorly in the transparency/manageability-versatility-security evaluation system. Unlike borrowing from credit cards, pawn shops, and catalogs, which each have two positive characteristics and one negative on this scale, rent-to-own borrowing has two negatives and one positive. This borrowing type both requires security and lacks versatility. The transparency/manageability attribute is the only positive characteristic of rent-to-own transactions. Rent-to-own borrowing, like all installment borrowing with nonvariable payments, requires regular, specified payments. The borrower will feel the impact of the loan quickly and, where the loan is ultimately not affordable, she will have concrete indicators alerting her to this fact.

Repossession featured prominently in the discussions of rent-to-owns. Some participants had had their furniture repossessed. Most described this as an embarrassing experience, although one saw it as a convenient way to return merchandise with which she was dissatisfied.[266] The most common concern about repossession was that the store never refunded any of the customer's previous payments, even when the customer had paid off most of the loan. Presumably, from the store's perspective, this reflects the fact that the participant has been "renting" the furniture during the life of the loan. Participants, however, considered the goal of owning a central feature of the transaction, and this appearance of inequity was a major strike against rent-to-own stores. Participants' identification of this feature demonstrates a certain sophistication about borrowing. The return of a borrower's equity in the collateral is, at least in theory, a tenet of repossession in secured transactions under article 9 of the Uniform Commercial Code.[267] In most states, rent-to-own stores are governed by separate statutes that allow them to escape this requirement.[268] That participants unknowingly identified the major difference between rent-to-own borrowing and other forms of secured borrowing against personal property suggests that it is worth examining the costs and benefits of bringing rent-to-own transactions under article 9.

Rent-to-own stores are limited further by the fact that they sell only goods. No matter how large their selection, a customer cannot, for example, borrow to pay her rent or her babysitter. As one participant explained, "[Y]ou can only get so much from rent-a-center. All you can do is get furniture. You can't go there and get a gallon of milk and a loaf of bread if your kids were starving or something."[269] This limits the usefulness of rent-to-own stores in financial emergencies, and protection from emergencies was one of the major reasons participants sought credit.[270]

266. Interview with Respondent X66.

267. *See* U.C.C. § 9-615(d)(1) (2006).

268. *See* Hawkins, *supra* note 186, at 2081; Alan M. White & Cathy Lesser Mansfield, *Literacy and Contract*, 13 STAN. L. & POL'Y REV. 233, 259 n.160 (2002).

269. Interview with Respondent K72.

270. *See supra* Part IV.C.4.

Catalogs suffer this same versatility disadvantage. Catalog credit is valid only for the purchase of nonperishable goods and hence unusable for regular expenses like groceries and utility bills,[271] making it useless in emergencies. On the other hand, because catalog borrowing is a form of installment lending, it meets the criteria for transparency and manageability in the same way rent-to-own stores do. Because the price is conceptualized from the beginning in terms of what the customer will pay each month, interest included, borrowers can more easily weigh the costs of the purchase at the time they acquire the benefits. And catalog borrowing is unsecured: the catalog lenders do not take a security interest in the merchandise they send. This may reflect either the difficulty of repossessing from customers dispersed across the country or the fact that much of the merchandise they sell consists of items like clothing and toys that do not retain their value over time. These relatively positive aspects of catalog borrowing are reflected in participants' assessment of price. Some participants thought that the merchandise was of low quality, and a few thought that the prices were too high, but these concerns were not as widespread or negatively expressed as those about credit cards or rent-to-own stores.

Table 1 provides a summary of which borrowing types possess which characteristics.

TABLE 1
POSITIVE PROPERTIES OF CREDIT CARDS AND THE THREE MAJOR FORMS OF FRINGE BORROWING

	Credit Cards	*Pawn Shops*	*Rent-to-Owns*	*Catalogs*
Transparency/ Manageability				
Versatility				
Lack of Security				

One advantage to analyzing substitution issues this way is that it simplifies the framework and clarifies what is at stake. The participants in the current study revealed that these three characteristics heavily influenced their estimation of the tradeoffs between the different borrow-

271. Of course, there is some fungibility here. If a household purchases its personal hygiene items and cleaning products on Fingerhut credit, it frees up funds for groceries and bills. On the other hand, very low-income households have a low ability to make these kinds of substitutions because so much of their income is received through nontransferable benefits like food stamps and rent subsidies.

ing types. Their negative overall evaluation of credit cards suggests that perhaps the transparency/manageability factor carries the most weight.

The ambiguous effect of price on participants' subjective evaluations has interesting implications in and of itself. It is easy to assume that equal price means equal value, but this analysis suggests that sub-prime lenders may compete, and low-income consumers may make borrowing decisions, predominantly on the basis of other, nonprice attributes. If this is the case, regulators and lenders have more flexibility to experiment with changing nonprice characteristics to improve low-income borrowers' options. Obviously, changing these characteristics will have a price and risk impact for lenders. Pawn shop and rent-to-own store borrowing is secured because it enables lenders to extend credit to risky borrowers. And the catalog model may be successful because lender control of both the price and quality of the merchandise may enable the lender to profit even when the borrower defaults.

But this framework also suggests that experimentation is worthwhile because borrowers may very well be willing to pay more for changes. For example, credit card borrowing has always been associated with revolving payment plans, which some analysts assume is what accounts for their popularity.[272] But credit card lending is the only form of small-scale, unsecured borrowing that has ever allowed consumers such incredible flexibility in how they spend. It is entirely possible that consumers are drawn to these characteristics and would prefer more transparent and manageable payment plans.[273] There is no reason why credit card issuers could not offer, for example, installment payments. To the extent that issuers profit from the deception inherent in the lack of transparency of the current repayment system, issuers could raise total prices to compensate for more manageable plans. As more consumers experience the negative effects of the current revolving payment plans, they may be willing to pay more to avoid them.

This has analogous implications for changes implemented by law. A regulation that increased the transparency of credit card practices and caused issuers to seek the lost revenue elsewhere would still leave them considerable room to increase interest rates without triggering substitution away from their products.

272. Durkin, *supra* note 47, at 624 ("Thus, the revolving [debt] component's share has been growing relative to the nonrevolving component's share, reflecting consumer preference and technological change; many consumers seem to like the convenience associated with prearranged lines of credit . . . .").

273. The development of credit card plans that would be more manageable for low-income borrowers is a major focus of the other article based on the current study. Littwin, *supra* note 20, at 485–88.

V. CONCLUSION

The effects of the substitution hypothesis are unproven at best. Given its potential impact on how consumers would experience credit regulation, surprisingly little is known about how the hypothesis might operate in practice. To my knowledge, prior to the current study, no one has explored the comparative value low-income borrowers place on their different credit options. Middle-class bias and traditional economic methodologies have caused the assumption that all regulation-driven substitution away from credit cards is harmful. But the current study suggests that credit cards are actually among low-income consumers' least-preferred sources of credit, meaning that there is no "worse" alternative to which they would turn if credit card access were reduced.

Of course, consumer preferences are not monolithic. Some low-income consumers who value credit cards highly would be negatively affected if access to credit cards were constrained as certain highly profitable credit terms were regulated. But the data presented here suggest that any harm associated with such constriction is much smaller than previously assumed. When balanced against the benefits of the particular regulation being considered, the overall cost-benefit analysis may weigh far more heavily in favor of credit regulation.

The few studies that have examined the other part of the hypothesis, the interchangeability prong, suffer from methodological limitations that restrict their application to the substitution issue. More importantly, they do not attempt to specify how much substitution is taking place. Some substitution does not mean complete substitution. Once the relationship between low-income consumers' use of credit cards and other credit options is examined, the unlikelihood of complete substitution among low-income borrowers becomes clear. Simply put, credit cards offer low-income consumers more credit than any other option. Moreover, findings from the current study suggest that low-income consumers who use credit cards are more likely than their credit-card-free counterparts to be using other credit alternatives already. If credit card issuers restricted credit in the wake of regulation, these borrowers would likely end up with less total credit.

The question of whether the larger-scale borrowing that credit cards supply *should* be available to low-income consumers is one that I address in the companion paper to this Article.[274] But whatever one may believe is the correct way to resolve that complex normative issue, this Article demonstrates that the blanket assertion that credit substitution nullifies any gains from credit card regulation is overblown. Proposals to regulate credit card terms or conditions should be evaluated on the merits of each proposal, balancing the benefits against the potential harms of substitution, harms that may in fact be quite modest. Putting the substitution

274. *Id*.

hypothesis in proper perspective will enable more effective consideration of credit card regulation and perhaps allow efforts to protect low-income consumers to begin anew.