NEITHER BORROWER NOR LENDER BE: THE FUTURE OF PAYDAY LENDING IN ARIZONA

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This Note examines Arizona's ten-year experiment with authorized payday lending and sets it in the framework of the continuing national policy debate about this high-risk, high-cost consumer financial product. Arizona was one of more than forty states that regulated payday lending by statute, in the process sanctioning interest rates far in excess of the state's existing consumer interest rate cap. When Arizona's deferred presentment statute sunset on June 30, 2010, payday loans lost their privileged status and fell under the purview of Arizona's 36% consumer interest rate cap. The question remained as to how the payday loan industry would respond to this changed regulatory climate. This Note looks at the payday loan industry; it discusses payday lending as it existed in Arizona and looks at the consequences of its loss of authorization there. The Note examines the major arguments both for and against payday lending and considers regulatory schemes that have been tried, with varying success, in other states. It then suggests solutions both for regulation and for improving the cost and availability of small-dollar, short-term credit. Ultimately, the Note argues a state interest rate cap is not sufficient to protect Arizona consumers from the abuses of the payday loan industry; Arizona must first close the statutory loopholes that allow payday lenders to circumvent rate caps. The solution to the payday-lending dilemma will require a multi-pronged approach involving legislation, innovation in lending products, and aggressive enforcement of usury laws.

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INTRODUCTION

When money is lent on a contract to receive not only the principal sum again, but also an increase by way of compensation for the use, the increase is called interest by those who think it lawful, and usury by those who do not.

– Blackstone's Commentaries on the Laws of England

Usury, the practice of charging interest in excess of the principle amount of a loan, has existed since the dawn of civilization.[1] Those without money or goods have always borrowed from those more fortunate. In the absence of external regulation, the interest rate charged is under the control of those with the funds to lend. In the United States, puritan prohibitions on usurious interest capped interest rates in the colonies at around 6% annual percentage rate (APR).[2] Interest rate caps were still in effect in most states until the Supreme Court's decision in *Marquette*[3] eroded the ability of states to control the interest rate charged within their borders.[4] Today credit cards, title loans, pawnshops, and payday lenders all charge interest at rates that would have been considered usurious in previous times. Of these, payday lenders routinely charge interest rates in excess of 450% APR.[5]

Arizona enacted industry-promoted payday lending on April 4, 2000.[6] A central feature of the Arizona statute was an exception to the state usury cap, which allowed payday lenders to charge interest far in excess of the 36% APR consumer lending rate cap.[7] The Arizona statute authorized deferred presentment companies to charge 15% on the face amount of a check held for as short a term as five days,[8] effectively authorizing an annual percentage rate of up to 1288% (although, since the majority of loans were for a two-week period, the typical APR was actually closer to 460%).[9] The statute also included some regulatory features,

1. *See* Wayne Visser & Alastair McIntosh, *A Short Review of the Historical Critique of Usury*, *in* 8 ACCT., BUS. & FIN. HISTORY 175 (1998); *see also* Steven M. Graves & Christopher L. Peterson, *Predatory Lending and the Military: The Law and Geography of "Payday" Loans in Military Towns*, 66 OHIO ST. L.J. 653, 666–68 (2005); DAVID W. JONES, REFORMING THE MORALITY OF USURY: A STUDY OF DIFFERENCES THAT SEPARATED THE PROTESTANT REFORMERS 31–33 (2004).

2. Graves & Peterson, *supra* note 1, at 671.

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

4. *Id.* at 308; *see also* James J. White, *The Usury Trompe L'Oeil*, 51 S.C. L. REV. 445, 450–53 (2000) (noting that *Marquette* institutionalized usurious interest rates by establishing the right of federal banks to import the interest rate from their home state into any state in the nation).

5. Creola Johnson, *Payday Loans: Shrewd Business or Predatory Lending?*, 87 MINN. L. REV. 1, 26–29 (2002).

6. ARIZ. REV. STAT. ANN. §§ 6-1251 to -1263 (2009).

7. *See id.* §§ 6-632(A)(1), 6-1260(H).

8. §§ 6-1251 to -1263. While the usual term of a payday loan is two weeks, the statute allows transactions for as short a period as five days. § 6-1259(B)(14).

9. The statute permits lenders to charge 15% on the face amount of the check which is an effective rate of 17.64%. Multiplying this by 73 (the number of five day periods in a year) the maximum permissible APR under this statute is 1288%. However, because the normal term of a payday loan is two-weeks, the effective rate is typically 459% APR.

such as licensing of payday lenders and limitations on "rollovers" (extensions).[10]

Arizona's deferred presentment statute sunset on July 1, 2010.[11] A ballot initiative designed to extend the authorization for deferred presentment companies (payday lenders) failed in November 2008,[12] as did payday loan legislation proposed in 2010 in the Arizona House and Senate.[13] Although both the ballot initiative and the proposed bills would have addressed some of the perceived shortcomings of the 2000 statute, neither would have significantly lowered the permissible interest rate.[14]

This Note describes the rise of payday lenders in the United States and in Arizona in particular, examines the policy considerations behind regulation of payday lending, and evaluates the success of that regulation in meeting its goals. This Note looks at the failure of most current payday loan legislation and provides a roadmap for reform. Part I looks at the conditions that set the stage for the birth of the payday loan industry. It then examines the structure of the loans, the clients, the benefits and detriments of the industry as it exists today, and regulatory attempts designed to protect consumers. Part II discusses the advent of payday lending in Arizona, the previous regulatory statute, failed proposals for new legislation, the payday-lending industry's initial response to the changed regulatory climate, and how the industry is likely to transform itself in the years ahead. In Part III, the Note looks at proposals to eradicate predatory payday lending, including market innovation, legislation, enforcement, and a comprehensive package of reforms. The situation in Arizona provides a unique opportunity for thoughtful legislation tailored to meet the needs of Arizona consumers.

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10. §§ 6-1251 to -1263.

11. *See* § 41-3102 ("Any new program that is established by the legislature shall include in its enabling legislation a specific expiration date for the program that is not more than ten years after the effective date of the program's enabling legislation.").

12. Payday Loan Reform Act, Proposition 200 (Ariz. 2008); *see infra* Part II.B.

13. H.B. 2161, 49th Leg., 2d Sess. (Ariz. 2010); H.B. 2370, 49th Leg., 1st Sess. (Ariz. 2010); *see also* Howard Fischer, *Payday Industry Loses in Key Vote*, ARIZ. DAILY STAR, Mar. 17, 2010 [hereinafter Fischer, *Payday Industry Loses*], *available at* http://azstarnet.com/news/local/govt-and-politics/article_104bd219-8aed-55df-b239-451046fd45d2.html; Howard Fischer, *Payday Lenders Now Seek Legislative Help, Would Add $1.5M-per-year Incentive*, ARIZ. DAILY STAR, Mar. 12, 2010, *available at* http://www.azstarnet.com/news/state-and-regional/article_a9c86e22-83f0-50f3-b671-0bd3adb5ac80.html.

14. *See* Ariz. H.B. 2161; Ariz. H.B. 2370. The current fee is 15% of the value of the check or effectively 17.5% for a two-week loan (459% APR). The proposed bills would have dropped the fee to 15% of the amount borrowed for the same two-week period (391% APR). *Id.*

I. THE PAYDAY LOAN INDUSTRY

No man of ripe years and sound mind, acting freely, and with his eyes open, ought to be hindered, with a view to his advantage, from making such a bargain, in the way of obtaining money, as he thinks fit: nor (what is a necessary consequence) anybody hindered from supplying him, upon any terms he thinks proper to accede to.

– *J. Bentham, Defense of Usury*

Payday loans are small-dollar, short-duration loans.[15] Customers write a check for the value of the loan plus the fee (interest) and postdate it to their next payday.[16] Although the loan is expensive compared to more conventional types of credit, the immediacy of the funds, with minimal or no credit check, makes it a popular product.[17] This Part looks at the rapid growth of payday lending, the structure of a typical payday loan, and the payday lenders' target clientele. It also examines various arguments for and against the payday-lending industry.

A. The Birth of an Industry

In the American colonial period, borrowing was considered a moral vice, and the culture strongly condemned borrowing money for personal purposes.[18] General usury laws were adopted that created interest rate caps, limiting annual interest to around 6% APR.[19] The majority of these interest rate caps remained in force until the early twentieth century.[20] However, beginning in 1978, a series of court decisions[21] eroded the ability of state governments to control the interest rate

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15. *See* Johnson, *supra* note 5, at 2.

16. Michael S. Barr, *Banking the Poor*, 21 YALE J. ON REG. 121, 149 (2004).

17. SHEILA BAIR, ANNIE E. CASEY FOUND., LOW-COST PAYDAY LOANS: OPPORTUNITIES AND OBSTACLES 6 (2005), *available at* http://www.aecf.org/upload/publicationfiles/fes3622h334.pdf.

18. *See* SIDNEY HOMER & RICHARD SYLLA, A HISTORY OF INTEREST RATES 274 (3d ed., rev. 1996).

19. *See* KATHLEEN E. KEEST & ELIZABETH RENUART, NATIONAL CONSUMER LAW CENTER, THE COST OF CREDIT: REGULATION AND LEGAL CHALLENGES 42 (2d ed. 2000).

20. *Id.* at 42–43.

21. Marquette Nat'l Bank v. First Omaha Serv. Corp., 439 U.S. 299 (1978) (holding that credit card late charges fell within the National Bank Act's definition of interest); Cades v. H & R Block, Inc., 43 F.3d 869 (4th Cir. 1994) (holding that a loan from a Delaware bank made through an H & R Block office in South Carolina did not violate South Carolina's usury laws because H & R Block was not operating as a branch of the bank); Basile v. H & R Block, Inc., 897 F. Supp. 194 (E.D. Pa. 1995) (holding that when a loan was made by an out-of-state bank, under the National Bank Act the law of the bank's location governed); Wiseman v. State Bank & Trust, 854 S.W.2d 725 (Ark. 1993) (holding that a loan made through an Arkansas car dealer with a Tulsa bank, which was a subsidiary of an Arkansas bank holding company, still qualified as an Oklahoma bank subject to Oklahoma usury laws). The *Marquette* decision, as described by one commentator, also held that the National Bank Act—which states that national banks "may take, receive, reserve, and charge on any loan . . . interest at the rate allowed by the laws of the State, Territory, or District where the bank is located," 12 U.S.C. § 85 (1994)—"was to be interpreted expansively, so the debtor's state could not achieve its purpose by giving

of credit products offered in their states and gave federal banks a competitive advantage over state banks.[22] These factors coupled with the higher market interest rates of the 1970s and 1980s led many states to eliminate or relax their regulation of consumer credit.[23] The changing regulatory climate was ripe for the entry of payday lending.[24]

The immediate predecessor to the payday lender was the check casher. Check cashers have been in the United States since the 1930s.[25] They provide check-cashing services for those without traditional banking services.[26] Up until the 1990s, although some check cashers made payday loans as an informal extension of their business, payday lenders did not operate formally.[27] In 1993, Michael Jones, the father of the payday loan industry, opened his first *Check into Cash* in Cleveland, Tennessee.[28] In seven years, the industry went from less than 200 check cashers, making informal payday loans, to 10,000 payday loan stores generating $2 billion per year in revenue.[29] By 2002, the number had doubled to more than 25,000 payday lenders nationwide—more than the number of McDonald's, Burger King, Sears, J.C. Penney, and Target stores combined.[30] In

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different labels to its restrictions, nor could its courts protect local restrictions by somehow defining foreign charges as something other than interest." White, *supra* note 4, at 455.

22. White, *supra* note 4, at 449–50.

23. Chris Peterson, Comment, *Failed Markets, Failing Government, or Both? Learning from the Unintended Consequences of Utah Consumer Credit Law on Vulnerable Debtors*, 2001 UTAH L. REV. 543, 543–44.

24. Graves & Peterson, *supra* note 1, at 672–73. The authors noted:

> Economic forces and legal changes in the 1970s and 1980s began to lay a foundation for resurgence in salary lending . . . . Unprecedented inflation forced the Federal Reserve Board to adopt monetary policy resulting in high long-term commercial interest rates. The high cost of funds made it difficult for banks, credit unions, and other mainstream lenders to loan money within state interest rate caps. It became fashionable for neoclassical economists and legal and economics scholars to goad leaders into abandoning usury laws. State legislatures were increasingly making a habit of granting special permission to lenders to charge higher and higher interest rates. Retail installment stores, pawnshops, and rent-to-own furnishing stores all successfully lobbied for special treatment. Many state legislatures also raised, or even eliminated, their interest rate caps. Moreover, the Supreme Court's decision in *Marquette National Bank v. First of Omaha Service Corp.* . . . encouraged these trends.

Id.

25. Barr, *supra* note 16, at 149.

26. Graves & Peterson, *supra* note 1, at 673.

27. Barr, *supra* note 16, at 149.

28. Charles A. Bruch, Comment, *Taking the Pay out of Payday Loans: Putting an End to the Usurious and Unconscionable Interest Rates Charged By Payday Lenders*, 69 U. CIN. L. REV. 1257, 1262 (2001).

29. *Id.*; Barr, *supra* note 16, at 149–50.

30. Christopher L. Peterson, *Usury Law, Payday Loans, and Statutory Sleight of Hand: Salience Distortion in American Credit Pricing Limits*, 92 MINN. L. REV. 1110, 1111 (2008).

2004, payday lenders made about 65 million loans to almost 10 million households.[31]

The rapid rise of the payday-lending industry has been attributed to three factors: (1) check-cashing companies pursuing new business due to the advent of direct deposit; (2) friendly state legislatures allowing payday lenders to charge fees that, while sounding modest, actually translate into extremely high annual percentage rates; and (3) strong demand due to the increasing number of people with impaired credit.[32] In addition, deregulation of the banking industry decreased the availability of short-term, small-dollar loans.[33]

Two additional factors may have contributed to the rapid expansion of the payday loan industry: the 1996 Electronic Funds Transfer (EFT) initiative by the Treasury Department and the Bush administration's "First Accounts" program in 2001.[34] The EFT initiative was designed to "increase direct deposit of federal checks through low-cost electronic bank accounts for those beneficiaries using higher-cost check cashers."[35] First Accounts established pilot programs designed to bring "unbanked" low-income families into banks and credit unions.[36] The effect of these programs was to enlarge the pool of low-income individuals with bank accounts and little financial experience.

Regardless of the reasons for the rapid expansion the payday loan industry has mushroomed, since its inception in the 1990s. States in which payday lending was once illegal have passed laws that, on the surface, appear to regulate the industry; instead, these laws have authorized and legitimized it, providing the lenders with a firm legal basis from which to operate.[37] Payday loans are now offered by stand-alone companies, check-cashing outlets, pawnshops, online providers, and via toll-free telephone numbers.[38]

B. The Loan Structure

Payday lenders provide short-term consumer loans to low- and moderate-income working people who have checking accounts. The typical payday loan transaction involves the borrower writing a postdated personal check to the lender.[39] The lender advances the borrower a cash amount equivalent to the face

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31. Barr, *supra* note 16, at 150.

32. Michael A. Stegman & Robert Faris, *Payday Lending: A Business Model that Encourages Chronic Borrowing*, 17 ECON. DEV. Q. 8, 8–9 (2003); Barr, *supra* note 16, at 152 ("A number of studies in the 1980s and early 1990s found that nearly 20% of U.S. households were credit-constrained. Moreover, a growing number of individuals have little to no liquid savings. In a financial emergency, they have no 'backup' funds to meet their immediate needs, and may see a payday loan as the only viable solution.").

33. Barr, *supra* note 16, at 152.

34. BAIR, *supra* note 17, at 9.

35. *Id.*

36. *Id.*

37. Graves & Peterson, *supra* note 1, at 674.

38. Stegman & Faris, *supra* note 32, at 10 (citing J.L. Robinson, Presentation at the Financial Service Centers of America Convention, San Diego, Cal.: The Deferred Deposit Industry Payday Advance Product Overview (Oct. 2001)).

39. Barr, *supra* note 16, at 149.

value of the check minus a finance charge.[40] Loan amounts are usually small, not exceeding $500.[41] The lender then holds the check for a specified time (usually two weeks) before depositing it or, more commonly, receiving cash repayment directly from the borrower.[42] In an updated form of the traditional transaction, instead of writing a check, the borrower signs an authorization permitting the lender to debit his bank account, on a future date, for the amount of the loan plus the finance charge.[43] The finance charges on these loans vary by state, with the lowest rates at 7% of the loan amount for a two-week period, resulting in an APR from 235% to in excess of 1000%.[44] If the borrower is unable to repay the loan, he may extend, or "rollover," the loan by paying the original finance charge and then writing a new check for the loan amount plus the new finance charge.[45]

Under the Truth in Lending Act (TILA),[46] payday lenders are required to disclose the cost of credit in terms of annual percentage rate (APR).[47] In addition, all fees associated with providing a payday loan must be calculated as part of the total interest rate charged.[48] While the interest rate calculation under TILA includes all fees incident to the cost of credit,[49] some state statutes characterize certain fees as "not interest," allowing a state to authorize payday loans without violating the existing state interest rate cap.[50]

C. The Customers of Payday Lenders

Payday loan customers are distinguishable from traditional check-cashing clients in that they must have a checking account in order to qualify for a payday loan.[51] According to the Community Financial Services Association—the payday-lending industry's trade and lobbying group in Washington—"payday advance

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40. *Id.*

41. *An Update on Emerging Issues in Banking, Payday Lending*, FED. DEPOSIT INS. CORP. (Jan. 29, 2003), http://www.fdic.gov/bank/analytical/fyi/2003/012903fyi.html.

42. Barr, *supra* note 16, at 149.

43. *Id.*

44. *Legal Status of Payday Lending by State*, CONSUMER FOUND. AM., http://www.paydayloaninfo.org/legal.asp (last visited Apr. 21, 2010) (noting that in some states there are no interest rate caps).

45. *An Update on Emerging Issues in Banking, Payday Lending*, *supra* note 41.

46. 15 U.S.C. § 1605 (2006); Truth in Lending (Regulation Z), 12 C.F.R. § 226 (2009). "The finance charge is the cost of consumer credit as a dollar amount. It includes any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit." 15 U.S.C. § 1605(a); 12 C.F.R. § 226.4(a).

47. 12 C.F.R. § 226.5.

48. *Id.* § 226.

49. *Id.* § 226.4(a).

50. *See, e.g.*, ARIZ. REV. STAT. ANN. § 6-1260(H) (2009) ("The fee charged . . . is not interest for the purpose of any other law or rule of this state.").

51. Barr, *supra* note 16, at 153; *Minutes of Hearing Before S. Comm. on Fin. Insts. & Ret.*, 44th Leg., 2d Reg. Sess. (Ariz. 2000) (summary of remarks by Michael Green, Lawyer, EZ Pay Day Loan Cos.), http://www.azleg.gov/FormatDocument.asp?inDoc=/legtext/44leg/2R/comm_min/Senate/0126FIR.doc.htm.

customers represent the heart of America's middle class."[52] Fifteen percent of Americans have borrowed from payday lenders.[53]

Payday loans appear to be "an increasingly popular credit tool among a growing moderate-income working population" with credit problems and little savings, who view payday loans as a convenient, or perhaps necessary, option for accessing cash in a financial emergency.[54] Payday loan customers tend to be under forty-five years of age and employed.[55] While 52% of payday loan customers make from $25,000–50,000 annually, 29% have household incomes below $25,000.[56] About one-third are homeowners, and 60% are women.[57] Most have graduated from high school, but not college, and about two-thirds have children at home.[58] Many lack the savings, credit history, or financial literacy to avoid purchasing a high-cost credit instrument.[59] The majority (91.6%) of payday advance customers use other types of consumer credit, including bank or retail credit cards or closed-end consumer credit.[60] A common theme among payday borrowers is that they are seriously debt burdened and under significant credit restraints, including poor and impaired credit histories.[61] In comparison to the general population, payday borrowers are three times more likely to have been denied credit or not given as much credit as they applied for in the last five years and four times more likely to have declared bankruptcy.[62]

The payday loan industry locates its businesses in neighborhoods near its target clientele.[63] Target populations include senior citizens, minorities, recent immigrants, and the military.[64]

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52. Daniel Brook, *Usury Country: Welcome to the Birthplace of Payday Lending*, HARPER'S MAG., Apr. 2009, at 41, *available at* www.harpers.org/archive/2009/04/0082451.

53. Adair Morse, Payday Lenders: Heroes or Villains? 1 (Feb. 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=999408 (paper for the 2d Annual Conference on Empirical Legal Studies).

54. Barr, *supra* note 16, at 154; *see also* Regina Austin, *Of Predatory Lending and the Democratization of Credit: Preserving the Social Safety Net of Informality in Small-Loan Transactions*, 53 AM. U. L. REV. 1217, 1222 (2004) ("Payday loans appeal to borrowers who have 'maxed out' or exhausted the limits on their credit cards, find pawning their valuables embarrassing, need a form of lending that does not demand a credit check, or realize that bouncing checks is very expensive.").

55. Barr, *supra* note 16, at 153.

56. BAIR, *supra* note 17, at 8; *see also* Barr, *supra* note 16, at 153.

57. *Minutes of Hearing Before S. Comm. on Fin. Insts. & Ret.*, *supra* note 51 (summary of remarks by Michael Green, Lawyer, EZ Pay Day Loan Cos.); Barr, *supra* note 16, at 153; Bruch, *supra* note 28, at 1271.

58. Brook, *supra* note 52.

59. Barr, *supra* note 16, at 153.

60. Stegman & Faris, *supra* note 32, at 14–15 (citing G. Elliehausen & E.C. Lawrence, Payday Advance Credit in America: An Analysis of Consumer Demand (Georgetown U., McDonough Sch. of Bus., Credit Res. Ctr. Monograph No. 35, 2001)).

61. *Id.* at 9, 14–15.

62. *Id.* at 14–15; Barr, *supra* note 16, at 154.

63. *See* Graves & Peterson, *supra* note 1, at 822–25; Ellen E. Schultz & Theo Francis, *Social Insecurity, High-Interest Lenders Tap Elderly, Disabled*, WALL ST. J., Feb.

Data from the U.S. Department of Housing and Urban Development shows that many payday lenders are clustered around government-subsidized housing for seniors and the disabled.[65] Social Security beneficiaries are particularly attractive customers because they receive monthly government checks deposited directly into their checking accounts.[66]

Payday lenders are disproportionately concentrated among communities of color.[67] Payday lenders have made a "concerted effort to reach out to the African-American community" through "financial education initiatives and partnerships with traditionally black colleges."[68] Recent immigrants are also vulnerable to predatory lenders due to their tenuous personal finances, language barriers, lack of familiarity with credit, and preference for face-to-face cash transactions.[69]

The high concentration of payday loan stores near military bases,[70] complaints that military personnel were the targets of "predatory lenders,"[71] and concerns about the effect of payday loan debt on the morale and combat readiness of the military,[72] caused Congress, in September 2006, to pass legislation authorizing the Department of Defense to regulate loans to military personnel.[73] The regulations impose a limit of 36% APR[74] on loans to military families and preempt any interest rates allowed under state usury statutes.[75]

12, 2008, at A1, *available at* http://online.wsj.com/article/SB120277630957260703.html; Robin A. Prager, *Determinants of the Locations of Payday Lenders, Pawnshops and Check-Cashing Outlets* 2 (Fin. & Econ. Discussion Series, Divs. of Research & Statistics & Monetary Affairs, Fed. Reserve Bd., Working Paper No. 2009-33, 2009), *available at* http://www.federalreserve.gov/Pubs/feds/2009/200933/200933pap.pdf.

64. *See* Austin, *supra* note 54, at 1218.

65. Schultz & Francis, *supra* note 63; Sid Kirchheimer, *Scam Alert: PayDay Lenders Target Social Security Recipients*, AARP BULL. TODAY, June 6, 2008, *available at* http://www.aarp.org/content/aarp/en/home/money/scams-fraud/info-06-2008/scam_alert__payday.html; *see generally* Deanne Loonin & Elizabeth Renuart, Nat'l Consumer Law Ctr., Life and Debt: A Survey of Data Addressing the Debt Loads of Older Persons and Policy Recommendations (Feb. 22, 2006) (unpublished manuscript), *available at* http://ssrn.com/abstract=885398.

66. Kirchheimer, *supra* note 65.

67. *Assets and Opportunities Scorecard*, CORP. FOR ENTER. DEV., http://scorecard.cfed.org/financial.php?page=payday_lending_protection (last visited Apr. 21, 2010); Prager, *supra* note 63, at 2.

68. BAIR, *supra* note 17, at 8.

69. *Id.*; Austin, *supra* note 54, at 1246.

70. Graves & Peterson, *supra* note 1, at 822.

71. Erik Eckholm, *Seductively Easy, Payday Loans Often Snowball*, N.Y. TIMES, Dec. 23, 2006, at A1, *available at* http://www.nytimes.com/2006/12/23/us/23payday.html.

72. Limitations on Terms of Consumer Credit Extended to Service Members and Dependents, 72 Fed. Reg. 50,579, 50,581–94 (Aug. 31, 2007) (to be codified at 32 C.F.R. pt. 232).

73. 10 U.S.C. § 987 (2006).

74. § 987(b). Chapter 49 of title 10, United States Code, was amended to limit the interest rate that can be charged to members of the military to 36%. Similar legislation was passed in Arizona in 2006. ARIZ. REV. STAT. ANN. § 6-1260(I) (2009).

75. 10 U.S.C. § 987(d).

D. The Pros and Cons of Payday Lending

Proponents of payday lending cite its benefits, arguing that it helps borrowers meet unexpected financial crises; is less expensive than bank overdrafts, fills the void created by the withdrawal of mainstream lenders from the small loan market; meets the needs of lower income communities better than mainstream financial institutions; and, when properly regulated, provides a valuable alternative financial service.[76] On the other hand, opponents of payday lending argue that rather than being a handy source of emergency funds, payday loans are being used to meet regular monthly expenses;[77] that lack of competition among lenders keeps prices artificially high; and that payday loans prevent consumers from developing a credit history that would allow them access to mainstream forms of credit.[78] Opponents also argue that the structure of payday loans and the deceptive trade practices of lenders lead to long-term debt and default by encouraging chronic borrowing. This Subsection joins these arguments by analyzing them under the following headings: (1) Uses of Payday Loans: Crisis Management or Ready Cash?; (2) Fees: Cost Justified or Market Failure?; (3) Access to Credit: Is Payday Lending the Problem or the Solution?; and (4) Rollovers: Structural Flaw or Business Model?.

1. Uses of Payday Loans: Crisis Management or Ready Cash?

According to supporters of the industry, payday loans allow individuals to cope with short-term financial disruptions.[79] Low- to moderate-income individuals will turn to payday lenders, despite having bank accounts, because they lack the savings needed to meet unexpected expenses,[80] such as those related to birth, illness, or car repairs. It has even been suggested that "[t]he existence of payday lending increases welfare for households who may face foreclosures or be driven into small property crime in times of financial distress."[81]

Opponents of the payday loan industry dispute the characterization of payday loans as a handy method for meeting financial emergencies. According to the FDIC, the cash flow difficulties of many payday loan customers are "a long-

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76. *See* Barr, *supra* note 16, at 124; Stegman & Faris, *supra* note 32, at 13 (citing Andre Assocs., *Union Bank of California Focus Group Report* (May 2001)).

77. *An Update on Emerging Issues in Banking, Payday Lending*, *supra* note 41; *see also* *Payday Lending*, CTR. FOR ECON. INTEGRITY, http://www.economicintegrity.org/payday06.htm (last visited Apr. 21, 2010); Morse, *supra* note 53, at 9.

78. Richard R.W. Brooks, *Credit Past Due*, 106 COLUM. L. REV. 994, 996–97 (2006).

79. Bart J. Wilson et al., An Experimental Analysis of the Demand for Payday Loans (Apr. 28, 2010) (unpublished manuscript), *available at* http://ssrn.com/abstract=1083796.

80. Barr, *supra* note 16, at 155.

81. Morse, *supra* note 53, at 25; *see also* Donald P. Morgan & Michael R. Strain, *Payday Holiday: How Households Fare after Payday Credit Bans* (Fed. Reserve Bank of N.Y. Staff Reports, Working Paper No. 309, 2008), *available at* http://ssrn.com/abstract=1032621.

term credit characteristic as opposed to a short-term temporary hardship."[82] A study in Arizona showed that 74% of payday loan customers needed their loans simply to pay monthly bills.[83]

2. Fees: Justifiable Costs or Market Failure

Payday lenders contend that their fees compare favorably with, or are less expensive than, bank overdraft charges or late fees.[84] They argue that a payday loan cannot be compared to a consumer loan, as it is usually only made for a two-week period, and that using an annual percentage rate to calculate the cost of a payday loan is misleading because the loans are "not a long term debt."[85]

The industry claims that the high costs associated with payday loans are justified by two considerations: (1) they are paper- and labor-intensive transactions,[86] requiring face-to-face interaction with customers, and (2) they carry a higher risk of default.[87] Payday lenders "face high per-loan and per-store fixed costs in a competitive market."[88] To promote customer convenience, payday lenders "choose to keep longer business hours and operate a higher density of stores than traditional lenders such as banks."[89] The overhead costs involved in payday lending are significant; for example, when the lending fee is $15 on a $100 loan, from 50% to 75% of that $15 is associated with overhead.[90] The majority of

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82. *An Update on Emerging Issues in Banking, Payday Lending*, *supra* note 41.

83. *Payday Lending*, *supra* note 77.

84. Brief for Community Financial Services Association of America as Amicus Curiae Supporting Petitioner at 2, Buckeye Check Cashing v. Cardegna, 126 U.S. 1204 (2005) (No. 04-1264), 2005 WL 1941281 [hereinafter Brief Supporting Petitioner].

85. *Minutes of Hearing Before S. Comm. on Fin. Insts. & Ret.*, *supra* note 51 (summary of remarks by Michael Green, Lawyer, EZ Pay Day Loan Cos.).

86 . Barr, *supra* note 16, at 124.

87. *Id.* at 155. According to Norman Miller, a lobbyist for Arizona Community Financial Services Association, the payday loan industry is a high-risk industry with a loss ratio of 20–25%; since the loans are of such small denominations, there are virtually no collections and losses are just absorbed. *See Minutes of Hearing Before S. Comm. on Fin. Insts. & Ret.*, *supra* note 51 (summary of remarks by Norman Miller, Lobbyist, Ariz. Cmty. Fin. Servs. Ass'n).

88. Paige Skiba & Jeremy Tobacman, The Profitability of Payday Loans 1 (Dec. 10, 2007) (unpublished manuscript), *available at* http://www.economics.ox.ac.uk/members/jeremy.tobacman/papers/profitability.pdf ("Despite charging effective annualized rates of many thousand percent, we find lenders' firm-level returns differ little from typical financial returns. The data are consistent with an interpretation that payday lenders face high per-loan and per-store fixed costs in a competitive market."); *see also* Barr, *supra* note 16, at 124 (stating that the fixed costs of lending translate into higher prices for these short-duration, small-dollar loans to consumers with low wealth and often uncertain or poor credit history).

89. Aaron Huckstep, *Payday Lending: Do Outrageous Prices Necessarily Mean Outrageous Profits?*, 12 FORDHAM J. CORP. & FIN. L. 203, 228 (2007).

90. *Minutes of Hearing Before S. Comm. on Fin. Insts. & Ret.*, *supra* note 51 (summary of statement by Ariz. Cmty. Fin. Servs.); *see also* Skiba & Tobacman, *supra* note 88, at 2.

the lenders' high operating costs are due to wages, occupancy costs, and loan losses.[91]

Opponents of payday lending argue that, in reality, the payday loan industry is vastly profitable. While acknowledging the higher fixed costs of lending due to multiple storefront locations and small-dollar loans, they dispute the high loss figures quoted by the industry, finding losses of less than 15%.[92] Certainly the performance of the major payday loan companies on the New York Stock Exchange suggests that the payday lenders are effectively managing their costs to ensure a profit.[93]

Of significant concern is the lack of price competition in the payday loan industry.[94] Payday lenders regularly charge the maximum permissible interest in states where the product is allowed.[95] While this "may suggest that payday loans are efficiently priced as compared to the relatively high operational costs associated with the product," the alternative explanation may be that "the customers who use the product are sufficiently desperate for cash that the immediacy of the product is more important than the price paid."[96] Although there is no evidence of price collusion or monopolistic behavior among payday lenders,[97] there is a concern that payday loan pricing reflects a market failure.

3. Access to Credit: Is Payday Lending the Problem or the Solution?

According to the payday loan industry, payday lenders, with their numerous neighborhood store locations, are a source of local finance and provide credit to individuals who would not have access to conventional financing.[98] The consolidation of the banking industry, the closure of small branch banks, and the withdrawal of traditional lenders from the small loan market have created a void that the payday lenders have filled.[99]

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91. Huckstep, *supra* note 89, at 228.

92. Skiba & Tobacman, *supra* note 88, at 2 (finding losses of 5%, although other sources cited by Skiba & Tobacman reported losses of 6–15%); *see also* BAIR, *supra* note 17, at 19 (noting that for one payday lender studied, the charge-offs were 13% of fee and interest revenue and 1.7% of total loans originated). The high incidence of rollovers contributes to the low loss ratio and high returns. *See infra* Part I.D.4.

93. Lauren Tara LaCapra, *The Payday Lenders Face Greater Oversight*, THESTREET.COM (Nov. 20, 2009), http://www.thestreet.com/story/10629650/5/payday-lenders-face-greater-oversight.html ("[P]erformance of stocks in the group over the past year has been stellar .... Advance America has appreciated the most, rising more than 300% in the past 52 weeks, followed by Dollar Financial, up 275%; and World Acceptance, roughly 100% higher[] over the same period. First Cash Financial, Cash America and QC Holdings are all up more than 40% in the past year."); *see also* BAIR, *supra* note 17, at 7 (noting that "[f]or the end of 2004, Advance America reported annual revenues of $570.2 million, representing an increase of 16.5 percent over 2003 revenues").

94. BAIR, *supra* note 17, at 29.

95. *Id.*

96. *Id.*

97. *Id.*

98. Morse, *supra* note 53, at 3; Wilson, *supra* note 79.

99. Brief Supporting Petitioner, *supra* note 84, at 2, 4.

Alternative financial service providers, including check cashers, money transmitters, payday lenders, title lenders, and tax preparation services that provide refund anticipation loans, provide a wide range of financial services to low-income communities.[100] Some scholars argue that fringe banks, notably check-cashing establishments, meet the needs of lower income communities better than mainstream financial institutions.[101] They argue that the regulation of fringe creditors could reduce creditworthy borrowers' access to low-cost credit, and suggest that prohibition or regulation of fringe credit may be most costly for those in greatest need of credit—the many among the poor who would otherwise have no access (or would have higher-cost access) to credit in lawful markets.[102]

Opponents of payday lending argue that, rather than limiting access to credit, banning payday lending increases options for borrowers. When payday lending was outlawed in North Carolina, credit unions and finance companies stepped in to fill the gap, offering much lower-cost products.[103] A study by Sheila Bair[104] for the Annie E. Casey Foundation indicated that "payday loan alternatives offered by banks and credit unions in the form of revolving lines of credit are superior to payday loans in terms of customer convenience, speed and privacy."[105]

Another detriment of payday lending is the lack of credit tracking. Lack of credit tracking by payday lenders prevents borrowers from developing a credit history that would enable them to obtain traditional forms of credit.[106] By structurally undermining its customers' access to alternative low-cost credit, the fringe credit market expansion is self-perpetuating.[107] Payday loan transactions neither rely on nor contribute to a consumer's credit history, creating no incentives for maintenance of a positive credit record.[108]

Opponents argue that rather than being dependant on payday lenders for short-term funds, "[p]eople have many strategies and options for handling shortfalls and are generally not relying on one single source of credit."[109] A study by the Center for Community Capital at the University of North Carolina found

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100. Barr, *supra* note 16, at 124.

101. Stegman & Faris, *supra* note 32, at 13; *see also* Felix Salmon, *Chart of the Day: Payday Lenders' Lobbying Expenditures*, REUTERS (Mar. 2, 2010), http://blogs.reuters.com/felix-salmon/2010/03/02/chart-of-the-day-payday-lenders-lobbying-expenditures/ ("[T]he payday lenders are much better than most financial institutions at providing *convenience*: they're open late, they don't go through arduous know-your-customer routines, and they're not intimidating in the way that many banks and credit unions can be.").

102. Brooks, *supra* note 78, at 998–99 & n.11.

103. Kim R. Manturuk, Ctr. for Cmty. Capital, U. of N.C. at Chapel Hill, Testimony before the Ohio Senate: Assessing the Impact of Payday Lending De-Authorization (May 14, 2008), *available at* http://www.ccc.unc.edu/documents/CCC_Testimony_Ohio_Leg_May_08.pdf.

104. Sheila Bair is now the chairwoman of the Federal Deposit Insurance Corporation.

105. BAIR, *supra* note 17, at 4.

106. Brooks, *supra* note 78, at 996–97.

107. *Id.*

108. *Id.*

109. Manturuk, *supra* note 103, at 3.

that the households surveyed "used an average of between 2 and 3 credit alternatives during their most recent [financial] shortfall."[110] Once payday lending was banned in North Carolina, a survey of households most likely to have needed a payday loan were the most likely to feel that not being able to get one was a positive thing.[111]

4. Rollovers: Structural Flaw or Business Model?

The payday loan industry contends that state regulatory action, including limits on rollovers, protects consumers from building up long-term debt. As stated by the payday industry representative at Arizona Senate hearings on payday lending, regulation of payday lending should limit "the rate that can be charged for issuance of [the] loans," "the number of loans of this type a person can get," "and the number of times the loan can be rolled over so that [people] do not get in the position of building up debt."[112] The payday loan industry's "best practices" recommends limiting the number of rollovers to four.[113]

Critics contend that the structure of payday loans is such that what starts as a short-term need for cash becomes an ongoing financial commitment.[114] With an APR in excess of 400% and a short-term balloon payment required within two weeks,[115] borrowers have little opportunity to accumulate the additional funds needed to pay off the debt.[116] Repayment can account for 25–50% of a borrower's entire take-home income, leaving the borrower inadequate funds for her other obligations, and frequently compelling her to take out a new payday loan almost immediately.[117] Because payday lenders require payment of the principal in full, borrowers unable to pay the entire amount have no option but to renew, or rollover, the loan.[118] At the end of the two-week loan period, the typical payday

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110. *Id.* The Center found that "[p]eople preferred the low- and no-cost options." *Id.* The top three choices for meeting a financial shortfall were pay late or not pay, use savings, or borrow from friends or family; "[t]he least-used options were the costliest ones: auto title loans, bankruptcy, payday loans, and tax advance loans." *Id.*

111. *Id.* at 4.

112. *Minutes of Hearing Before S. Comm. on Fin. Insts. & Ret.*, *supra* note 51 (summary of remarks by Michael Green, Lawyer, EZ Pay Day Loan Cos.).

113. Barr, *supra* note 16, at 158.

114. *Id.* at 149–56.

115. Leslie Parrish & Uriah King, *Phantom Demand: Short-Term Due Date Generates Need for Repeat Payday Loans, Accounting for 76% of Total Volume*, CTR. FOR RESPONSIBLE LENDING (July 9, 2009), http://www.responsiblelending.org/payday-lending/research-analysis/phantom-demand-short-term-due-date-generates-need-for-repeat-payday-loans-accounting-for-76-of-total-volume.html.

116. *See* Austin, *supra* note 54, at 1222 (referencing Lynn Drysdale & Kathleen E. Keest, *The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and Its Challenge to Current Thinking About the Role of Usury Laws in Today's Society*, 51 S.C. L. REV. 589, 632–33 (2000)); Barr, *supra* note 16, at 157; Parrish & King, *supra* note 115 ("A sizeable majority of payday lending volume is generated by payday debt itself—borrowers need to open a new loan shortly after repaying a previous loan because repayment left them with inadequate funds for other needs.").

117. Parrish & King, *supra* note 115.

118. Austin, *supra* note 54, at 1222 (referencing Johnson, *supra* note 5, at 3–4).

borrower, instead of redeeming his check, pays a fee to rollover, or extend, the loan; the lender keeps the check and the borrower has an additional two weeks to redeem it.[119] This repeated cycle of loan renewal extends the duration of payday loans to an average of almost five months.[120] The typical payday loan customer renews his loan approximately ten times and, in one reported instance, sixty-six times.[121] This repeated, chronic borrowing, combined with triple digit APRs, has caused opponents to characterize payday lending as abusive and predatory.[122]

The high incidence of rollovers is not coincidental. Payday lender profits come disproportionately from high-frequency borrowers.[123] Because the financial performance of the payday loan industry is "significantly enhanced by the successful conversion of more and more occasional users into chronic borrowers,"[124] payday loan managers are trained to encourage repeat borrowing and rollovers.[125] A study in North Carolina found that 85% of payday lender

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119. Austin, *supra* note 54, at 1222; Barr, *supra* note 16, at 156. The Southwest Center for Economic Integrity found that 60% of the borrowers needed more than two weeks to repay their loans. *Payday Lending*, *supra* note 77.

120. Bruch, *supra* note 28, at 1272. A survey by the Southwest Center for Economic Integrity in Tucson, Arizona found that, due to repeated rollovers, close to 10% of borrowers surveyed paid back double the amount that they initially borrowed. *Payday Lending*, *supra* note 77.

121. Bruch, *supra* note 28, at 1261; *see also* BAIR, *supra* note 17, at 8 ("[M]ore than half of all payday loan customers use the product more than 6 times a year and . . . at 'mature stores' 37 percent of all customers use the product more than 12 times a year. . . . 91 percent of all payday loans are made to borrowers with five or more payday loans per year . . . ."). One commentator noted:

> Evidence from multiple states points to the fact that significant proportions of payday loan consumers roll their loans over on a frequent, if not habitual, basis. A study of payday borrowers in Illinois found that the median borrower had more than ten loan contracts over a two-year period, and that one-fifth of borrowers had twenty or more contracts in that time. In Wisconsin, 56% of payday borrowers took out at least eleven loans in one twelve-month period. In Indiana, 77% of all payday transactions were rollovers, and the average annual number of loan renewals was ten. In North Carolina, the typical payday loan customer took out seven loans in one year from one lender. The CFSA study found that three-quarters of payday borrowers rolled over their loan at least once[] and that 30% had seven or more rollovers. Using the Wisconsin statistic as an example, the typical payday loan consumer, who takes out eleven two-week payday loans per year, for the average loan amount of $300, at the average 470% APR from the Consumer Federation of America (CFA) survey, spends nearly $600 annually in fees.

Barr, *supra* note 16, at 156–57.

122. Stegman & Faris, *supra* note 32, at 20.

123. Barr, *supra* note 16, at 157; Johnson, *supra* note 5, at 69–70.

124. Stegman & Faris, *supra* note 32, at 25.

125. Brook, *supra* note 52. Managers are encouraged to be on a first-name basis with their customers and to ask about their customers' families. One of the country's biggest payday lenders provides financial incentives to its staff to encourage chronic borrowing by individual patrons. *Check 'n Go*, a payday lender with 1300 stores in thirty-one states has a

revenue in the state came from borrowers receiving five or more payday loans in a year.[126] The "churning" of existing borrowers' loans every two weeks accounts for three-fourths of all payday loan volume: nearly fifty-nine million loans totaling more than $20 billion per year.[127] In contrast, loans to non-repeat borrowers account for just 2% of loan volume, and subsequent loans to repeat borrowers that originate a month or longer after the closing of a previous loan account for only 5% of all loans.[128]

In states that limit rollovers, lenders use a variety of stratagems to evade rollover restrictions, characterizing rollovers as renewals, extensions, or new loans.[129] No matter how the repeat transaction is characterized, the result is a continuous sequence of interest-only payments at short intervals that never reduce the principal.[130] The most common period of time between payday loans is one day or less, suggesting that borrowers, unable to both repay their loans and meet other expenses, are effectively "locked in a cycle of debt."[131]

E. Regulatory Attempts

States have used a variety of techniques in an attempt to regulate payday lending. Some states have tightened restrictions, while others have loosened them to permit greater flexibility for payday lenders.[132] The various regulatory schemes include: (1) states that have small loan interest rate caps or other usury limits that effectively prohibit payday loans; (2) states that have no small loan or usury cap but require licensing of lenders; and (3) states that have specific laws or regulations authorizing payday lending.[133] The most common forms of regulation include rate caps, rollover limits, statewide databases, and criminal prosecution. This section discusses the effectiveness of these attempts at regulation.

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splashy website that offers promotions, including 20% off at Red Envelope and discounts at 1-800-Flowers, "real life" stories, and a financial advice podcast called Talk 'n Cents. *See* CHECKNGO.COM, http://www.checkngo.com/default.aspx (last visited Aug. 31, 2010). The podcast presents various situations in which a borrower might have a need for short-term cash and inevitably concludes that a payday loan is the least expensive option.

126. Graves & Peterson, *supra* note 1, at 664 (citing PETER SKILLERN, CMTY. REINVESTMENT ASS'N OF N.C., SMALL LOANS, BIG BUCK$: AN ANALYSIS OF THE PAYDAY LENDING INDUSTRY IN NORTH CAROLINA (2002), http://web.archive.org/web/20060222075833/www.cra-nc.org/small_loans_big_bucks.pdf (accessed by searching for www.cra-nc.org in the Internet Archive index)); *see also* Stegman & Faris, *supra* note 32, at 21.

127. Parrish & King, *supra* note 115; *see also* BAIR, *supra* note 17, at 8 (noting that "more than half of all payday loan customers use the product more than six times a year, and . . . at 'mature stores' 37% of all customers use the product more than 12 times a year").

128. Parrish & King, *supra* note 115. The fact that most borrowers are long-term customers contributes to the lower than expected loss ration on payday loans.

129. *See infra* Part I.E.2.

130. Drysdale & Keest, *supra* note 116, at 601; *see also* Barr, *supra* note 16, at 156–57.

131. Parrish & King, *supra* note 115.

132. Barr, *supra* note 16, at 158–59.

133. *Id.*

1. Rate Caps

In the states that have no usury ceilings for small loans, payday lenders generally charge higher-than-average interest rates on loans. On the other hand, in states that permit payday lending but cap fees, interest rates on payday loans are somewhat lower than average.[134] Paradoxically, rates on payday loans are the highest in those states where usury ceilings are low enough to effectively prohibit payday lending;[135] in these states, lenders use statutory loopholes to circumvent the statutory rate cap.[136]

2. Rollover Limits

Many states have adopted limits on the number of consecutive times a payday lender may renew a loan. However, state-enacted rollover limits do not appear to affect the percentage of payday borrowers renewing loans or the average number of loans taken out.[137] Rollover limits do not bar lenders from accepting payment for an existing loan and then immediately providing a "new" loan; neither do they prohibit same-day advances, nor prohibit another firm from providing a payday loan to pay off the first firm's loans.[138]

3. Statewide Databases

While some states[139] require the use of a system that ensures that borrowers do not have more than one payday loan out at a time, other states rely simply on borrowers' representations.[140] Failure to regulate the number of outstanding loans a borrower is permitted to have at any given time can result in a borrower having multiple loans out from multiple lenders.[141] Loans can snowball as each new loan is taken out to meet the fees of a previous loan.[142]

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134. *Id.* at 159–60.

135. *Id.* In these states, payday lenders either operated outside of the law or imported interest rates from other states by using out-of-state servicers, a practice that has since been banned.

136. *See infra* Part II.D.3.

137. Barr, *supra* note 16, at 158; *see* Johnson, *supra* note 5, at 69–72 (stating that payday lenders repeatedly rollover payday loans even in states with statutes prohibiting this practice, using a variety of stratagems to circumvent the anti-rollover legislation).

138. Barr, *supra* note 16, at 156, 158. In states that limit rollovers, lenders can evade the limits by requiring a borrower to take out a "new loan." The borrower pays the rollover fee (typically $15 per $100) and then writes a new check for the original amount to be held by the lender for another two weeks. In another practice called "touch and go" or "same day advance," the lender takes a cash "payoff" for the old loan and then immediately re-loans with new loan funds. *See* Drysdale & Keest, *supra* note 116, at 601.

139. For example, Florida, Delaware, Idaho, Indiana, and North Dakota.

140. *See, e.g.*, ARIZ. REV. STAT. §§ 6-1259(B)(10), 6-1260(D) (2009) (repealed 2010). In states that limit rollovers but lack reporting systems, borrowers can take out a new loan with a different payday lender and use the proceeds of the new loan to pay off the old obligation.

141. Stegman & Faris, *supra* note 32, at 14–15 ("47% of their respondents had obtained payday loans from more than one company in the 12 months preceding the survey,

Statewide databases, such as Teletrack,[143] offer real time verification of outstanding obligations.[144] These statewide databases are required in Michigan,[145] Illinois,[146] New Mexico,[147] and Virginia.[148] It is not clear, however, whether payday lenders actually comply with the database requirements or can be trusted to list each individual loan on the database system.[149]

The greatest advantage of the statewide databases probably lies in the potential for allowing payday borrowers to establish a credit history. Proper reporting allows "good" borrowers to establish favorable credit records, making them attractive to traditional lenders, and thereby giving them the option of obtaining credit at lower rates from the conventional retail credit market.[150]

4. Criminal Prosecution

In New York, vigorous criminal prosecution of violations of state usury laws has been extremely effective in stamping out payday lending in the state.[151] When payday lenders used subterfuges to disguise their loans as, for instance, "catalog sales," the state "aggressively pursued management of these companies obtaining judgments that [held] owners personally liable."[152] Stubborn enforcement of its 25% criminal usury cap has proven to be a serious deterrent to payday loan companies who consider "flouting the will of the New York legislature."[153]

In Arkansas, the Supreme Court ruled that the state Check Cashers Act, which authorized payday lending, violated the state's constitutional usury cap.[154] Since then, aggressive enforcement by the state's attorney general coupled with private litigation has halted almost all payday lending in the state.[155]

Statutes prohibiting usury are meaningless without aggressive enforcement. In Florida, statutes provide that loaning money at interest rates between 25% and 45% is a misdemeanor and in excess of 45% is a felony.[156]

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and, of these, almost two-thirds used two companies, one-quarter used three companies, and 13% used four or more companies." (citing Elliehausen & Lawrence, *supra* note 60)).

142. Austin, *supra* note 54; *see also* Barr, *supra* note 16, at 156.

143. A non-traditional consumer credit information bureau which provides risk mitigation services.

144. Barr, *supra* note 16, at 151.

145. MICH. COMP. LAWS § 487.2142 (2010).

146. 815 ILL. COMP. STAT. 122/2-15, 122/1-10 (2010).

147. N.M. STAT. ANN. § 58-15-37 (2010).

148. VA. CODE ANN. § 6.1-453.1 (2009).

149. Graves & Peterson, *supra* note 1, at 827–28.

150. Brooks, *supra* note 78, at 996–97.

151. Graves & Peterson, *supra* note 1, at 828–29.

152. *Id.* at 829.

153. *Id.*

154. McGhee v. Ark. State Bd. of Collection Agencies, 289 S.W.3d 18, 28 (Ark. 2008).

155. *Legal Status of Payday Lending by State*, *supra* note 44.

156. FLA. STAT. § 687.071(2)–(3) (2009).

However, loopholes in the Florida statutes allow payday lenders to operate outside of the state usury limits, making enforcement problematic.[157]

II. PAYDAY LENDING IN ARIZONA

Prior to the sunset of its payday lending statute on June 30, 2010, Arizona was one of forty states that permitted and regulated payday lending by statute. Arizona's deferred presentment legislation also authorized, via a statutory exception, interest rates far in excess of the state's maximum consumer interest rate.[158] This section discusses the advent of payday lending in Arizona, the attempts made by the payday loan industry to prevent the statute from sunsetting, and the state of affairs since the sunset.

A. The Advent of Arizona's Payday-Lending Statute

In 2000, Arizona passed legislation[159] that licensed and regulated Deferred Presentment Companies, as payday lending is called in Arizona. When the law was proposed, Arizona was one of only three states west of the Mississippi unfavorable to payday lenders.[160] Payday lenders in Arizona were able to operate only if affiliated with a federal financial institution or licensed by another state authorized to do business in Arizona.[161] At that time, there were four deferred presentment-type companies operating in Arizona, three under a federal exemption and one under a state exemption.[162]

In January 2000, at Senate Committee hearings on Senate Bill 1266, "Deferred Presentment Companies; Licensure," payday loan representatives argued that their industry had an important place in Arizona's economy due to its widespread use.[163] The representatives informed the Committee that the industry was regulated in about thirty-five states, sixteen of which had passed legislation similar to that proposed in Arizona.[164] One industry spokesperson asserted that "[a]ll the surrounding states are protecting their citizens, while Arizona is not."[165]

The payday loan industry recommended the proposed legislation as a "very good, solid piece of regulation in an industry that needs regulation."[166]

157. *See infra* Part II.D.

158. ARIZ. REV. STAT. ANN. § 6-1260(H) (2009) ("The fee charged . . . is not interest for the purpose of any other law or rule of this state.").

159. *Id.* §§ 6-1251 to -1263.

160. H.B. Summary, S.B. 1266, 44th Leg., 2d Reg. Sess. (Ariz. 2000), http://www.azleg.gov/FormatDocument.asp?inDoc=/legtext/44leg/2r/summary/h.sb1266_3-09-00_caucuscow.doc.htm; S. Fact Sheet, S.B. 1266, 44th Leg., 2d Reg. Sess. (Ariz. 2000), http://www.azleg.gov/FormatDocument.asp?inDoc=/legtext/44leg/2r/summary/s.1266fir_passed_by_senate.doc.htm.

161. S. Fact Sheet, S.B. 1266.

162. *Id.*; H.B. Summary, S.B. 1266.

163. *See Minutes of Hearing Before S. Comm. on Fin. Insts. & Ret.*, *supra* note 51.

164. *Id.* (summary of remarks by Michael Green, Lawyer, EZ Pay Day Loan Cos.).

165. *Id.*

166. *Id.*

Representatives explained that the proposed bill would limit "the rate that can be charged for issuance of [the] loans," "the number of loans of this type a person can get," "and the number of times the loan can be rolled over so that [people] do not get in the position of building up debt."[167] The interest rate was described as "the lowest except for one state."[168] Industry representatives emphasized that a payday loan "cannot be compared to a consumer loan" as they are used for different purposes; "[p]ayday loans are not a long-term debt."[169] The Senate Fact Sheet for S.B. 1266 explained the mechanics of deferred presentment including the fees and opportunity for a borrower to rollover the loan at the end of the loan period.[170]

The statute ultimately adopted in Arizona[171] specified licensing requirements for payday lenders[172] and provided that the fees charged for deferred presentment transactions were "not interest for the purpose of any other law or rule in the state."[173] The statute also prohibited rolling over a deferred presentment transaction more than three times, and required that, upon each extension, the customer terminate the previous agreement and sign a separate agreement.[174]

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167. *Id.*

168. *Id.*

169. *Id.*

170. *See* S. Fact Sheet, S.B. 1266, 44th Leg., 2d Reg. Sess. (Ariz. 2000), http://www.azleg.gov/FormatDocument.asp?inDoc=/legtext/44leg/2r/summary/s.1266fir_passed_by_senate.doc.htm. According to the Senate Fact Sheet:

> Deferred presentment companies, often known as payday lenders, offer short term (usually less than 30 days), small loans (usually under $500) against a person's paycheck or other source of income. Typically, customers must prove that they have both an open checking account and a job or steady source of income. The customer reads and signs an agreement that discloses the transaction terms, then writes a personal check for the advance amount plus the fee charged by the lender and immediately receives cash in the value of the check less the fee. For example, a person who needed $200 for two weeks in a state that permitted a 15 percent fee would write a check (postdated for two weeks) for $235.29 ($200 + $35.29 fee) and receive $200.00. The person would have to make sure that there was going to be at least $235.29 in his checking account at the end of the two week period. If the person did not have $235.29 in his checking account at the end of the two-week period, he could extend, or rollover, the loan. A 15 percent fee would be charged again for this extension but based on the original amount of cash needed plus the previous fee amount. Continuing with the above example, the payday lender would charge a $41.52 fee (15 percent fee on $235.29), bringing the total amount owed to $276.81. If the person did not have the money available, he could rollover the loan two more times, increasing his total obligation to $383.13. However, lenders often require consumers to pay off the fee before they will rollover the loan, thereby restricting the new loan to its original amount.

Id.

171. ARIZ. REV. STAT. ANN. §§ 6-1251 to -1263 (2009).

172. *Id.*

173. § 6-1260(H).

174. § 6-1260(I).

Under the statute, the minimum term for a payday loan was five days,[175] and the maximum fee was 15% of the face value of the check.[176] The total amount of fees charged was required to be in writing, expressed both as a dollar amount and as an effective annual percentage rate.[177] Consumers could borrow between $50 and $500.[178] In the event of a default, payday lenders were authorized to pursue civil remedies, but the defaulting customer was not subject to criminal prosecution.[179]

In an attempt to deter consumers from taking out multiple payday loans from different lenders, the statute required licensees to provide notice in each transaction agreement that a customer could not have more than one deferred presentment service agreement outstanding at any given time.[180] In addition, the statute included a provision that the "licensee [should] ask every customer who seeks deferred presentment services whether that customer has any outstanding checks payable to other licensees."[181] However, licensees were not required to take more than "*reasonable measures*" to ensure that a customer had no more than one deferred presentment loan outstanding at one time.[182] Reasonable measures meant relying on a customer's own representation as to whether he had other deferred presentment checks outstanding.[183]

Although this industry-promoted regulatory scheme included apparent protections to borrowers, such as rollover restrictions, fee caps, and limitations on borrowing, its primary effect was to act as the impetus for the rapid expansion of payday lending in the state. There are currently 75 companies operating payday loan stores in Arizona, with about 650 storefront offices.[184]

B. Attempts to Prevent the Statute from Sunsetting

As the sunset date approached, the payday-lending industry made two attempts to extend their statutory authorization. The first, Proposition 200, was placed on the November 2008 election ballot, and the second was proposed to the Arizona legislature in January of 2010. While both proposals provided more consumer safeguards than the then-existing statute, neither succeeded.

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175. § 6-1259(b)(14).

176. § 6-1260(F); *Minutes of Hearing Before S. Comm. on Fin. Insts. & Ret.*, *supra* note 51 (summary of remarks by Michael Green, Lawyer, EZ Pay Day Loan Cos.). This translated into an annual percentage rate of 1288% on a five-day loan or 459% on the standard two-week loan. For calculation, see *supra* note 9.

177. § 6-1260(B).

178. § 6-1260(A).

179. § 6-1260(J).

180. § 6-1260(C).

181. *Id.*

182. § 6-1259(B)(10) (emphasis added).

183. § 6-1260(D).

184. Mary Rice, *Operation Sunset to End Payday Lending in Arizona*, PERSONAL MONEY STORE, MONEY BLOG (June 10, 2010), http://personalmoneystore.com/moneyblog/2010/06/10/operation-sunset-arizona/.

1. Proposition 200

In an effort to maintain the status quo, the payday-lending industry, under the guise of Arizonans for Financial Reform, placed Proposition 200 on the November 2008 ballot. According to the sponsors, Proposition 200 would "bring dramatic pro-consumer reform to payday lending and preserve consumer choice."[185] The proposition ostensibly included a rate cut,[186] eliminated rollovers, created a repayment plan for customers who could not meet their obligations, and inhibited a borrower's ability to obtain more than one loan at a time.[187] Another proposed change to the then-existing statute included keeping the minimum loan term at five days, but capping the maximum term at thirty-five days.[188] In an effort to discourage rollovers, Proposition 200 also provided for a twenty-four-hour "cooling off period," which required consumers to wait twenty-four hours between paying off one loan and taking out another.[189] In addition to requiring that lenders offer free repayment plans to borrowers unable to meet their obligations, the proposed bill provided for credit reporting of the repayment plan, thus giving borrowers the opportunity to build a credit history.[190] Finally, Proposition 200 required a commercially reasonable method of verification, to ensure that customers were eligible for deferred presentment before entering into an agreement.[191] There was no sunset provision in Proposition 200 and, therefore, no termination date for the proposed new statute.[192]

Pro-Proposition 200 groups spent $14.6 million in support of their bill, while opponents spent only $360,000.[193] In the end, Proposition 200 was defeated by a 20% margin.[194]

2. Rejected Legislation: H.B. 2161 and H.B. 2370

In January of 2010, legislation was proposed in the Arizona House and Senate to amend the then-existing deferred presentment statute and to prevent it

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185. *Initiative, Referendum and Recall Applications*, ARIZ. DEP'T OF STATE, OFFICE OF SEC'Y OF STATE, http://www.azsos.gov/election/2008/General/Initiatives.htm (last updated June 27, 2008).

186. Rather than charging 15% of the amount of the check, lenders would have been restricted to charging 15% of the principal: the effective APR would have decreased from 1288% to 1090% on a five-day loan and from 459% to 390% on the standard two-week loan.

187. *Initiative, Referendum and Recall Applications*, *supra* note 185.

188. *Id.*

189. *Id.*

190. *Id.*

191. *Id.*

192. *Id.*

193. MATT SUNDEEN, CTR. FOR POLICY ENTREPRENEURSHIP, COLORADO PAYDAY LENDING UPDATE 4 (Nov. 2008), http://www.c-pe.org/documents/payLendUpdate.pdf. The vast amounts spent by the payday loan industry in defense of their bill and their livelihood suggest that payday lending in Arizona is probably quite profitable.

194. *Id.*

from sunsetting.[195] The bills attempted to address many of the criticisms of payday lending, including rollovers, multiple loans, inadequate information disclosure, and lack of credit reporting. They proposed setting a $500 maximum on the amount of deferred presentment transactions a customer could have out at any given time and mandated a consumer reporting service database to ensure that customers did not exceed that threshold.[196] The bills required disclosure agreements in plain English or Spanish, with "words, sentences and paragraphs . . . as short as reasonably possible."[197] Like Proposition 200, they also proposed reducing the permissible fee for deferred presentments from 15% of the face value of the check to 15% of the principle borrowed.[198] In addition, the bills contained a provision intended to prohibit rollovers, stating that "a licensee may not for a fee extend the presentment of deposit of a check" and requiring licensees both to provide customers with repayment plans upon request and to report customers' borrowing and payment history to a consumer reporting service database.[199]

H.B. 2161 was withdrawn from consideration when it became clear that not a single democrat on the House Banking and Insurance Committee would support the bill, and H.B. 2370 was rejected by the Senate Appropriations Committee.[200]

C. The Current State of Affairs

Deferred presentment companies in Arizona can no longer charge interest in excess of the statutory maximum rate for consumer lenders. All loans, including short-term loans, are limited to 36% interest (APR) plus 5% for administrative expenses.

Two payday-lending companies in Arizona have announced plans to pull out of the state. *Check 'n Go* announced that it would close all thirty-four of its locations in Arizona, and *Advance America* has announced plans to close all forty-seven of its stores in Arizona.[201] However, other lenders have not been so easily discouraged. By early June 2010, about 200 storefront lending locations in Arizona had filed applications to convert their licenses to either car title loan brokers or pre-paid debit card providers,[202] neither of which are subject to the 36% statutory rate cap.[203]

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195. H.B. 2370, 49th Leg., 1st Sess. (Ariz. 2010); H.B. 2161, 49th Leg., 2d Sess. (Ariz. 2010).

196. Ariz. H.B. 2370; Ariz. H.B. 2161.

197. Ariz. H.B. 2370; Ariz. H.B. 2161.

198. Ariz. H.B. 2370; Ariz. H.B. 2161. This would have decreased the effective APR from 1288% to 1090% on a five day loan and from 459% to 390% on the standard two-week loan. For calculation, *see supra* note 9.

199. Ariz. H.B. 2370; Ariz. H.B. 2161.

200. *See* Fischer, *Payday Industry Loses*, *supra* note 13.

201. Michelle Price, *Arizona Payday Lenders Leave State After Voters, Legislature Let High-Interest Loans Expire*, HUFFINGTON POST (July 9, 2010), http://www.huffingtonpost.com/2010/07/09/arizona-payday-lenders-le_n_641676.html.

202. *See, e.g.*, *Prepaid Debit Cards*, ACE CASH EXPRESS, http://www.acecashexpress.com/prepaid-debit-cards.aspx (last visited July 4, 2010).

203. Rice, *supra* note 184.

1. Car Title Loans

Car title loans allow consumers to obtain cash from lenders in return for signing over the title of their cars. Typically, payment is due in full within thirty days of the loan. Lenders tend to require only minimal income verification and no credit check, making these loans popular among the low-income population.[204] By statute, title lenders in Arizona can charge interest ranging from 10–17% per month or 120–204% APR.[205] In addition to high interest, car title loans usually include a number of additional fees, such as processing fees, document fees, late fees, origination fees, and lien fees.[206] In some cases there is even a mandatory roadside assistance fee.[207] Consumers can pay anywhere from $80 to $115 in fees, even for loans as small as $500.[208]

Some car title loans are "interest only": the borrower pays only interest on the loan for a set period of time, usually more than thirty days, with a balloon payment due at the end of the term.[209] Default on title loans can result in repossession of the vehicle.[210] Because car title loans are over-secured, with the lender typically lending only 25–50% of what the vehicle is actually worth, repossession means loss of the vehicle owner's remaining equity,[211] as well as the potential loss of his only means of transportation. This result could be far more financially devastating to the borrower than the constant stream of payments required on a payday loan.

In mid-June 2010, before the date of the sunset, Arizona Attorney General Terry Goddard announced an aggressive enforcement strategy to ensure that the conversions of payday lenders into title lenders were not simply an end-run around the law.[212] The attorney general promised to closely scrutinize transactions, shut down lenders, and pursue civil penalties and injunctive relief in cases of violation.[213]

2. Prepaid Debit Cards

Prepaid debit cards provide a steady source of income to providers, but also come with benefits to card users. Users are encouraged to deposit their

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204. Christopher Nager, *Why Car Title Loans Are a Bad Idea*, CNN (Oct. 8, 2008), http://www.cnn.com/2008/LIVING/wayoflife/10/08/aa.car.title.loans/index.html.

205. ARIZ. REV. STAT. ANN. § 44-291(G) (2009).

206. Nager, *supra* note 204.

207. *Id.*

208. *Id.*

209. *Id.*

210. *Id.*

211. *Id.*

212. In particular, he noted that he wanted to ensure that car title loans were not used as an excuse to lend to borrowers who did not actually have cars. *See* Terry Goddard, Ariz. Att'y Gen., *Making Sure the Sun Sets on Payday Loans*, ARIZ. ATT'Y GEN. (June 15, 2010), http://www.azag.gov/messages/Making%20Sure%20Sun%20Sets%20on%20Payday%20Loans.html.

213. *Id.*; *see also* Michelle Price, *Arizona AG Warns Payday Lenders about New Law*, ABC NEWS (June 9, 2010), http://abcnews.go.com/Business/wirestory?id=10870563&page=1.

government benefit checks and paychecks directly to the debit card. The providers charge fees for card use and/or monthly account fees for maintaining the card.[214] The user is theoretically unable to overdraw the debit card, so the card potentially provides a handy way for the user to manage his budget without incurring bank account maintenance and overdraft fees.[215] However, the same website that states that it is not possible to overdraw the debit card also states that, in the event of an overdraft, the borrower is responsible for all overdraft fees.[216] Overdrawing a prepaid debit card could result in substantial fees for the provider. Fees charged by providers of prepaid debit cards are not subject to the consumer interest rate cap.[217]

Thus far the response of the payday loan industry to the new regulatory climate in Arizona has been quite restrained, with about a third of payday lenders converting into providers of car title loans and prepaid debit cards. However, judging by the response of the industry to regulation in other states, this is only the beginning. Existing Arizona statutes contain loopholes that will enable payday lenders to continue to operate legally and profitably by simply changing the name of their service.[218] The next section explores these loopholes and the likely next move of the payday loan industry in this unending shell game.

D. The Future for Arizona

The payday loan industry is adept at circumventing state usury laws;[219] it has aptly been characterized as a "hydra."[220] This section discusses the statutory loopholes that payday lenders have used to evade usury caps and regulatory legislation in other states and examines similar loopholes that exist in Arizona statutes. The most likely transformation will be of payday lenders into credit service organizations and/or providers of open-ended loans. However, there are

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214. *Prepaid Debit Cards*, *supra* note 202.

215. *Id.*

216. *Id.*

217. *See* ARIZ. REV. STAT. ANN. § 44-1205(A)(1) (2009). Fees on check cards are not regulated under Arizona statutes.

218. *See infra* Part II.B.

219 In Ohio, when legislation passed that capped the state's interest rates at 28%, as many as 1000 of the state's 1600 payday lenders sought alternative licenses available under the Ohio Small Loan and Ohio Mortgage Loan Acts. When Oregon passed restrictions on payday lending, two days later payday lenders "flooded the regulator's office applying for consumer lending licenses that gave them an end run around the law." Adrian Burns, *Payday Lenders Contemplate Plan B (Business First of Columbus)*, WOODSTOCK INST. (June 13, 2008), http://www.woodstockinst.org/press-clips/woodstock-in-the-news/payday-lenders-contemplate-plan-b-business-first-of-columbus/. In New Mexico and Illinois, after legislation was passed that put restrictions on payday lending, payday lenders shifted to high-rate lending through installment loan provisions. *Id.*; Nathalie Martin, *1000% Interest - Good While Supplies Last: A Study of Payday Loan Practices and Solutions*, 52 ARIZ. L. REV. 571 (2010).

220. Benjamin D. Faller, *Payday Loan Solutions: Slaying the Hydra (and Keeping it Dead)*, 59 CASE W. RES. L. REV. 125 (2008) (using "hydra" throughout); Mary Spector, *Taming the Beast: Payday Loans, Regulatory Efforts, and Unintended Consequences*, 57 DEPAUL L. REV. 961, 962 (2008).

other potential loopholes in the Arizona statutes that lenders may be able to use to their advantage as well.

1. Credit Service Organizations

When faced with unfavorable regulation, payday lenders in Texas, Florida, and Virginia re-organized as credit service organizations (CSOs).[221] CSOs take fees in exchange for brokering loans from other companies.[222] As CSOs, payday lenders partner with anonymous third-party companies (which may have close ties to the payday lenders themselves) to make payday loans beyond the scope of state price limits.[223] Although the underlying loan itself generally complies with state law, the companies also assess a brokering fee, thereby generating a price far in excess of the state usury limit.[224] As a result, "many payday lenders in Florida, and virtually the entire industry in Texas," ignore the statutory price limits and generate "the bulk of their revenue from fees nominally associated with brokering, but functionally identical to interest."[225]

Arizona law authorizes a credit service organization to receive a fee for "[o]btaining an extension of credit for a buyer" or for providing assistance to the buyer in obtaining credit.[226] The statute goes on to define "extension of credit" as "the right to defer payment of debt or to incur debt and defer its payment, which is offered or granted primarily for personal, family or household purposes."[227] While the statute specifies contract and disclosure requirements, it fails to place any restrictions on fees that can be charged for the service. As CSOs have had a long and successful history in other states, payday lenders in Arizona will undoubtedly avail themselves of this statutory loophole and reorganize as CSOs.

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221. Peterson, *supra* note 30, at 1152–53. When the Virginia legislature capped the interest rate on small consumer loans at 36% APR and mandated the creation of a statewide database to screen all prospective borrowers, a website for the payday loan industry suggested lenders should convert their businesses into either internet payday loan providers or credit service organizations. VIRGINIA PAYDAY LOAN LAWS, http://www.paydayloanlegislation.com/virginia.html (last visited Aug. 31, 2010) ("We suggest you concentrate your research on the Payday Loan Internet Model and the Credit Services Organization . . . . Although our discussion focuses on the Texas Credit Services Organization Model, you and your team may determine it is appropriate for a multiplicity of states.").

222. Peterson, *supra* note 30, at 1152–53.

223. *Id.*

224. *Id.*

225. *Id.*; *see also Payday Loan Fee Schedule*, CASHNETUSA, http://www.cashnetusa.com/fee-schedule.html (last visited Aug. 20, 2010) (indicating that loans in Ohio, Maryland, and Texas would be provided through a credit service organization). Some towns in Texas have taken to zoning out payday lenders as a reaction to the legislature's lack of response to the CSO loophole. Pallavi Gogogoi, *Costly Cash: In Texas, Towns Try Zoning Out Payday Lenders*, DAILYFINANCE, http://www.dailyfinance.com/story/credit/costly-cash-in-texas-towns-try-zoning-out-payday-lenders/19380708/ (last visited Aug. 31, 2010).

226. ARIZ. REV. STAT. ANN. § 44-1701(2) (2009).

227. § 44-1701(3).

2. Open-Ended Loans

In response to the Virginia rate cap described above, some lenders in Virginia started offering a different kind of loan—an open-ended loan.[228] The Virginia usury rate cap does not apply to the interest charged on an open-ended loan; the only requirement is that lenders provide a twenty-five-day interest free grace period.[229]

As in Virginia, while Arizona statutes cap the rate that can be charged on *closed-end* consumer loans,[230] there is no maximum rate specified for *open-ended* loans. Under Arizona law, a consumer loan is defined as "the direct *closed-end loan* of money in an amount of ten thousand dollars or less that is subject to a finance charge."[231] The maximum interest rate on these consumer loans is set at 36% APR.[232] However, no maximum rate is specified for open-ended loans or check loan accounts. Nothing would prevent payday lenders in Arizona from following the example of the lenders in Virginia and converting their closed-end loans into open-ended loan products to avoid the rate caps on consumer loans.

3. Other Loopholes

While CSOs and open-ended loan products will undoubtedly be the first refuge of payday lenders, at least two additional potentially exploitable loopholes exist in Arizona statutes: advance fee loan brokers and debt management companies.[233]

Arizona's statutory provision authorizing advance fee loan brokers defines an advance fee loan broker as a person "who for an advance fee or in the expectation of an advance fee either directly or indirectly makes or procures, attempts to make or procure or offers to make or procure . . . a loan of money or extension of credit."[234] The statute makes no mention of a maximum fee that can be charged. There seems to be no reason that payday lenders could not reorganize as advance fee loan brokers to avoid the consumer interest rate cap.

A debt management company can charge a fee to a debtor by "assuming

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228. Kimball Payne, *Payday Lenders' Loophole Narrowed*, DAILY PRESS, Dec. 14, 2009, *available at* http://articles.dailypress.com/2009-12-14/news/0912130080_1_payday-lenders-open-end-credit-allied-title-lending; *see* Aries Keck, *Predatory Lenders Find Loophole in New Lending Law*, PUB. NEWS SERV. (July 30, 2009), http://www.publicnewsservice.org/index.php?/content/article/9939-1.

229. Keck, *supra* note 228; Payne, *supra* note 228.

230. *See* ARIZ. REV. STAT. ANN. §§ 6-632(A)(1), 6-635(A)(4) (providing that on a consumer loan in an original principal amount of $1000 or less, a consumer loan rate of 36% and an origination fee of not more than 5% up to a maximum of $75 may be charged).

231. *Id.* § 6-601 (emphasis added).

232. § 6-632(A)(1) ("A licensee may contract for and receive finance charges on consumer loans that are not more than the following amounts . . . . On a consumer loan in an original principal amount of one thousand dollars or less, a consumer loan rate of thirty-six per cent.").

233. *Id.* §§ 6-701(4), 6-1301.

234. § 6-1301(2).

the responsibility of debt management."[235] The fee may not exceed a retainer fee of $39 and a monthly interest charge of .75% of the principal (not to exceed $50).[236] It is unclear from the statute how often the retainer fee could be charged, but it is conceivable that a payday lender would find a way to charge repeated retainer fees for its "debt management services."

4. Internet Providers of Payday Loans

Internet payday lenders provide yet another regulatory challenge for Arizona and a convenient means for payday lenders to sidestep state usury caps. A brief survey of internet sites suggests that at least some internet lenders are bound by the usury laws of the various states. The sites *Check 'n Go* and *Ace Cash Express*, for instance, do not provide loans in over twenty states where payday lending is explicitly, or de facto, prohibited by interest rate caps.[237] On the other hand, as of August 20, 2010, *Cash Net USA* provided payday loans in twenty-five states, installment loans in one state, payday and installment loans in two states, CSO loans in three states, and a "loan matching service" in seventeen states and the District of Columbia, but no loans in Arizona or Pennsylvania.[238]

Although online payday lending has much of the speed and convenience of traditional storefront lending, such as immediate approval and next day availability of funds, it lacks the personal touch of the neighborhood store.[239] To address the lack of personal contact, internet loan providers like *Check 'n Go* have friendly, interactive websites with links to Facebook, Twitter, and YouTube, as well as podcasts and videos describing how payday loans "help ordinary people survive life's small crises."[240]

A salient feature of internet payday loans is that they are often structured to make repayment difficult.[241] In addition, internet payday lenders are among the most aggressive collectors.[242] Many loans are set up to automatically rollover unless the customer notifies the lender three days in advance of the due date that he or she wants to pay off the loan.[243] According to Stephen A. Cox, President and CEO of the Council of Better Business Bureaus, "[u]nlike a payday loan that you might get from a local business, online payday loans require your bank account number and, as a result, the borrower is at the mercy of the lender as more money

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235. § 6-709(C).

236. § 6-709(C)(1).

237. ACE CASH EXPRESS, http://www.acecashexpress.com (last visited Aug. 31, 2010); CHECK 'N GO, http://www.checkngo.com (last visited Aug. 31, 2010).

238. *Payday Loan Fee Schedule*, *supra* note 225.

239. *See* White, *supra* note 4, at 463 ("Payday lenders might find a way to conduct transactions over the Internet and escape local usury laws entirely . . . ; however, whether such lenders need a face-to-face meeting to properly evaluate their risk and to induce payment remains to be seen.").

240. CHECK 'N GO, *supra* note 237.

241. Nathalie Martin, *Many Internet Payday Loans Are Unenforceable*, CREDIT SLIPS (May 30, 2008, 1:18 PM), http://www.creditslips.org/creditslips/payday_lending/.

242. *Id.*

243. *Id.*

than they counted on is withdrawn from his or her account."[244] In one reported incident, a borrower repeatedly mailed certified checks for the full loan amount after the notice period but before the monthly due dates, the lender repeatedly refused to cash the checks, making it almost impossible for the borrower to repay the loan.[245]

While payday loans made by lenders who do not comply with state laws cannot be enforced,[246] it is unlikely that the typical consumer is aware either of the fact that the lender is violating state laws or that the loan is unenforceable. In addition, once lenders have access to a borrower's bank information, the process of blocking access to a borrower's account can be slow and cumbersome.

III. WHERE DO WE GO FROM HERE?

Arizona has the opportunity to make meaningful changes that will positively affect the availability of affordable credit to the former customers of payday lenders. This section discusses innovative solutions to the problem of providing low-dollar, short-term credit to low-income borrowers. It describes the steps that Arizona will need to take to enforce any form of interest rate regulation and concludes with a vision for the future in Arizona.

A. Hope for the Future: Market Innovation

Loan product innovation could potentially have the greatest positive effect in the attempt to curb payday lending. As one commentator stated:

> If the existence of payday lending is valuable for those facing personal disaster, then regulators should strive to make access to finance easier and more affordable, not to ban it. . . . [E]fforts should be focused on opening up the market for product innovation in high-risk and short-term personal finance.[247]

A study by Sheila Bair found that depository institutions have inherent advantages in providing lower-cost, small-dollar credit products.[248] These advantages include: (1) minimized operational costs due to their preexisting infrastructure; (2) the ability to minimize credit losses through the use of direct deposit and automatic deductions for repayment; (3) the ability to derive revenue from a variety of products and services to their customers; and (4) the privacy, speed, and convenience inherent in revolving lines of credit linked to checking accounts.[249] The Bair study concluded that "if depository institutions can match

244. *BBB Warns Against Deceitful Online Payday Lenders*, BETTER BUSINESS BUREAU (Mar. 2, 2010), http://www.bbb.org/us/article/bbb-warns-against-deceitful-online-payday-lenders-17855.

245. Martin, *supra* note 241.

246. *Id.*

247. Morse, *supra* note 53, at 26.

248. BAIR, *supra* note 17, at 28.

249. *Id.* at 28–29.

payday lenders' speed and convenience with a lower priced product, they should be well positioned to capture significant market share."[250]

Bank overdraft protection could provide a viable alternative to payday loans. Although many banks already offer this,[251] lowering the fees and allowing repayments over a longer time period than is presently the norm would make it more attractive and affordable.[252] Overdraft protection can be provided at lower cost than payday loans because there is no need for face-to-face interaction, and transactions can take place electronically and automatically at low risk and cost to banks.[253] Repayment could be by direct debits from the customer's account scheduled over a "reasonably long time period," a period longer than the current two weeks for a payday loan or thirty days for a bank overdraft.[254] To allow customers to meaningfully compare the costs to other credit options, overdraft protection should be subject to the same disclosure requirements under TILA as other extensions of credit.[255]

Although many banks are reluctant to enter the small-dollar, short-term loan market due to the difficulty of making a profit without charging high rates,[256] other banks have chosen to offer these types of loans as a community service.[257] Their goal is "to provide affordable financial services to [their] customers to allow them to improve their social and economic status."[258] In return, providing this service benefits the bank by attracting customers who will eventually use other

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250. *Id.*

251. Many banks are actually in direct competition with payday lenders through their overdraft protection programs. The overdraft protection fees generate substantial returns for the banks that offer them. In a 2003 study, approximately 66% of depository institutions offered fee-based overdraft protection with the majority charging between $20 and $25 per overdraft. BAIR, *supra* note 17, at 10–11. The banks may be reluctant "to cannibalize profits through the development of other lower-cost forms of small dollar credit." *Id.* at 13.

252. An example of such innovation is Citibank's Checking Plus, the only overdraft protection program offered by Citibank. Checking Plus is a revolving unsecured line of credit linked to a customer's checking account, accessed when a customer overdraws the account. Customers can also access CheckingPlus if they are in need of a short-term loan. The credit line can be accessed using an ATM or by online transfer of funds into their account. The variable interest rate is currently 15.75% to 16.25%. Payments are automatically deducted at monthly intervals from customers' checking accounts. The default repayment schedule is 1/60th of the outstanding balance. BAIR, *supra* note 17, at 48; *Checking Plus*, CITIBANK ONLINE, https://online.citibank.com/US/JRS/pands/detail.do?ID=CheckingPlus (last visited Aug. 31, 2010).

253. Barr, *supra* note 16, at 163–64.

254. *Id.*

255. BAIR, *supra* note 17, at 13; Barr, *supra* note 16, at 163–64. Improved disclosure of the costs of overdraft protection would allow consumers to make more informed decisions about whether to use it and is likely to competition among lenders. BAIR, *supra* note 17, at 12.

256. BAIR, *supra* note 17, at 38.

257. *Id.* at 47.

258. *Id.*

bank products and services.[259] In addition, banks offering payday loan alternatives could be eligible for Community Reinvestment Act credit.[260]

One successful form of market innovation is occurring in North Carolina. The North Carolina State Employees Credit Union (NCSECU) offers its members a reusable line of credit called a salary advance loan (SALO) with a maximum loan of $500 and an APR of 11.75%. It is available to all members who receive their salary by direct deposit, and advances are repaid automatically from the borrower's next direct payroll deposit.[261] The product has been tremendously popular with more than 40,000 loans (almost $15 million) originated in the first nine months to more than 9000 members.[262] Total charge-offs during this period totaled only $30,000 (.2% of cumulative loan principal).[263]

The SALO features a mandatory savings component, requiring that 5% of each advance be placed in a special savings account.[264] If a borrower withdraws funds from this savings account, he is restricted from receiving a loan advance for six months.[265] The mandatory savings component has provided additional benefits to the NCSECU by generating $6 million in new deposits in less than eighteen months and creating increased security for SALO loans.[266] The savings component is popular with NCSECU members, giving many of them their first opportunity to build up any significant savings.[267]

In Colorado, an innovative non-profit, America's Family, offers a combination of low-cost loans, one-on-one financial coaching, and direct referrals to community services.[268] America's Family offers loans at 19.9% with a six-month to one-year repayment period, but requires that borrowers undergo mandatory financial coaching.[269]

In Wisconsin, Minnesota, and Michigan, GoodMoney,[270] a partnership between Goodwill Industries and local credit unions,[271] offers short-term loans for

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259. *Id.*

260. *Id.* at 38. "The Community Reinvestment Act is intended to encourage depository institutions to help meet the credit needs of the communities in which they operate, including low- and moderate-income neighborhoods, consistent with safe and sound operations. It was enacted by the Congress in 1977 (12 U.S.C. 2901) . . . ." *Community Reinvestment Act*, FED. RESERVE BD., http://www.federalreserve.gov/dcca/cra/ (last updated July 10, 2008).

261. Stegman & Faris, *supra* note 32, at 28.

262. *Id.*

263. *Id.*

264. BAIR, *supra* note 17, at 53.

265. *Id.*

266. *Id.* at 55.

267. *Id.*

268. *Financial Stability for Working Families*, AMERICA'S FAMILY, http://www.amfol.com/ (last visited Aug. 31, 2010).

269. *Id.*

270. *GoodMoney*, PROSPERA CREDIT UNION, http://www.goodmoneystore.com/ (last visited Aug. 31, 2010).

$9.90 per $100 borrowed.[272] At GoodMoney, borrowers are encouraged to "consolidate their debt in lower-interest term loans and to use other credit union services like automatic savings."[273] If borrowers cannot repay a loan after rolling it over twice, GoodMoney will give them the loan interest free in return for attending a free credit counseling session with a nonprofit service.[274] Despite its good intentions, in just over two years the program had made only 5600 payday loans—a tiny inroad into the payday loan industry in the region.

Market innovation in short-term, small-dollar loan products can generate benefits for both lenders and consumers. The success of SALO is a vivid indication of this potential. When accompanied by a mandatory savings component and/or financial literacy counseling, innovative lending can provide the means for borrowers to break out of the cycle of debt, creating long-term positive welfare changes for borrowers and communities.

B. Regulation

Arizona should pass new payday loan legislation capping interest rates, lengthening repayment terms, and mandating credit reporting.

1. Interest Rate Cap

Loans by depositary institutions may be a better solution to the needs of borrowers than payday lending, as detailed above. However, it may not be possible to stamp out alternative short-term loans by fringe credit providers. Some payday industry players no doubt have and will continue to make use of other authorized high-priced lending mechanisms, such as auto title loans. Therefore, it may be prudent for Arizona to pass new payday-lending legislation capping interest rates at a level high enough to encourage the entry of mainstream lenders into the short-term loan market. Although the NCSECU and other innovative lenders have successfully offered loan programs with rates below Arizona's 36% APR cap, it may be necessary to raise the rate cap in order to encourage mainstream lenders to compete with payday lenders. While the rate may exceed the current 36% APR, the level should be far below the previously authorized rate.

2. Longer Minimum Terms

Lenders should also be required to provide longer minimum terms on loans, with one or two months the absolute minimum. In addition, payday lenders should be required to set up installment repayment plans at the outset and these should be regulated for affordability to the debtor. Longer loan periods and periodic repayment plans would prevent "short-term balloon loans," which are

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271. *See id.* (listing local credit unions: Prospera Credit Union (North Central Wisconsin); Superior Choice Credit Union (Northern Wisconsin and Minnesota); and Delta County and Frankenmuth Credit Unions (Michigan)).

272. John Leland, *Non-Profit Payday Loans? Yes, to Mixed Reviews*, N.Y. TIMES, Aug. 28, 2007, at A14, *available at* http://www.nytimes.com/2007/08/28/us/28payday.html.

273. *Id.*

274. *Id.*

repeatedly refinanced, from becoming a "debt trap" for consumers.[275] Longer terms with the same percentage charge would also decrease the effective interest rate. For instance, in Arizona, setting the minimum term for a payday loan at one month, rather than the five days permitted by the current statute, would decrease the effective APR from 1288% to 212%.[276] It could be preferable to have an initial period where no repayment is expected, followed by gradual payoff. The minimum payoff period could be based on four pay periods for the employee. For example, a debtor might have a month's minimum use of the funds, followed by payoff over at least another month, in weekly installments for debtors paid weekly. If the debtor is paid every two weeks or every month, longer repayment plans—for a minimum of four pay periods—could be required.

3. Credit Reporting

Payday lenders should be required to report credit, thus allowing borrowers to build up credit histories that would free them from the need to use the fringe credit industry.[277] Legislation mandating that payday lenders report borrowers' performance to credit bureaus would give responsible borrowers the opportunity to pursue alternative credit products based on their credit history.[278]

C. Necessary Steps to Enforcement

No form of regulation or interest rate cap will be effective in Arizona until the statutory loopholes are removed. Arizona must take steps to prohibit lenders from reorganizing as credit service organizations, debt management companies, advance fee loan brokers, or some other type of short-term credit provider not subject to regulation and interest rate caps. Car title lenders and prepaid debit card services need to be monitored and regulated to prevent abusive lending practices.

One example of comprehensive regulation to eliminate statutory loopholes has been proposed in Ohio.[279] The proposed legislation would prohibit payday lenders from charging fees to process their own checks or money orders.[280] It would place restrictions on debt adjustors and CSOs from engaging directly, or indirectly, in any fraudulent or deceptive act, including knowingly acting in or abetting a scheme to evade the fee restrictions spelled out in the bill.[281] In addition, the bill would expand the authority of the Attorney General's Office to prosecute violations of the new law, with explicit statutory authority to go after unlicensed

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275. Barr, *supra* note 16, at 163.

276. While the normal term of a payday loan is two weeks with an effective APR of 456%, the current statute permits payday loans for as little as five days.

277. *See supra* Part I.D.3; *see also* Brooks, *supra* note 78, at 996–97.

278. Barr, *supra* note 16, at 163.

279. H.B. 209, 128th Gen. Assemb., Reg. Sess. (Ohio 2009–2010).

280. *See* Richard Cordray, Ohio Att'y Gen., *Legislature Moves to Fix Payday Lending Loophole*, SPEAKOUTOHIO BLOG (Sept. 2009), http://www.ohioattorneygeneral.gov/PaydayLoanBill. Text of the bill is available at http://www.legislature.state.oh.us/BillText128/128_HB_209_I_Y.pdf.

281. Cordray, *supra* note 280.

lenders, including internet payday lenders, and to prosecute them for unfair, deceptive, and unconscionable collection practices.[282]

Arizona should consider similar legislation aimed at preventing lenders from circumventing the state usury cap.

D. The Way Forward

Abusive payday lending can only be eradicated through a comprehensive series of reforms. The abusive lending practices of payday lenders are neither new nor unique. In the early twentieth century, the "salary lender" or "loan shark" preyed in a similar fashion on the lower income working class population.[283] However, in the 1920s, an innovative package of reforms, sponsored by the Russell Sage Foundation, effectively eradicated the salary lender for most of the twentieth century.[284] These reforms involved a multi-pronged attack on salary lenders, which included: (1) authorizing mainstream lenders to compete at higher interest rates; (2) aggressive enforcement by courts and state regulators; (3) a refusal by the courts to allow lender subterfuges to conceal illegal rates; (4) a media campaign against salary lenders; and (5) low-cost charitable alternatives to salary loans.[285] Although modern payday lenders are a well-organized multi-billion-dollar business, the same combination of techniques used to combat abuses by salary lenders should be effective in combating today's "payday loan problem."

In the search for a solution to the payday loan problem, Arizona should look back to the success of the Russell Sage Reforms: providing a lower-cost alternative to payday loans could effectively eradicate the payday loan industry. In order to make these small-dollar loans profitable for mainstream financial providers, Arizona may need to authorize lending at interest rates above the state usury cap of 36%. Arizona should vigorously enforce its lending statutes, close statutory loopholes, and aggressively pursue lenders who attempt to evade the regulations. Banks, credit unions, and private foundations should be encouraged to compete with payday lenders by offering alternative, lower-cost products. Improved financial disclosure by lenders would help borrowers to meaningfully evaluate their credit options. The media should work to inform the public of financial alternatives and the risks involved in borrowing from fringe credit providers. Without these comprehensive changes, payday lenders will continue to evade state usury statutes, operate illegally, or through internet providers.

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282 *Id.*

283. In the early twentieth century, energetic social reformer Arthur Ham and the nonprofit Russell Sage Foundation initiated a movement to do away with the salary lending industry and the "loan shark problem." Ham argued that the best way to eliminate salary lenders was to raise the traditional usury limits to a point where it would be profitable for mainstream financial institutions to loan to working class borrowers. Under the Russell Sage Foundation's Small Loan Law, consumer lenders were required to be licensed. In return, states gave these licensed lenders special exceptions to the older usury laws, authorizing interest rates of 24% to 42% per year. Peterson, *supra* note 30, at 1120.

284. *Id.*

285. *Id.*

CONCLUSION

There are no short-term solutions to the debt issues of the poor and their need for alternative forms of credit. States, such as Arizona, must work to ensure that statutory protections are in place for borrowers and explore alternative means of providing low-interest credit to those in greatest need. We must look back to the success of the Russell Sage Reforms and its multi-pronged attack on salary lenders. The solution to the payday lending dilemma will include encouraging mainstream lenders to provide competitive products; aggressive enforcement by courts and state regulators; a refusal by the courts to allow lender subterfuges that conceal illegal rates or circumvent laws; information for both the consumer and the public through media attention and meaningful rate disclosures; and low-cost charitable alternatives to payday loans. Rather than simply regulating an industry, Arizona has the opportunity to make long-term positive changes that will improve the financial well-being of its citizens.

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