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Payday Loan Prohibitions: Protecting Financially Challenged Consumers or Pushing Them over the Edge?

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Abstract

As recovery from the economic downturn continues, American consumers face an unabated need for short-term, small-dollar credit. To cope with this need, millions choose to take out payday loans. Often the subject of controversy and criticism, these loans have become a mainstream credit option, considered by consumers alongside so-called "traditional" credit products offered by banks and credit unions.

This article examines the issues surrounding payday loans, including consumer credit needs, critical options for fulfilling those needs and consumer rationale, from the perspective of Advance America, Cash Advance Centers, Inc., the country's largest non-bank provider of cash advance services.

When faced with a need for short-term credit, consumers weigh all of their options, including those offered by banks, credit unions, and retail lenders. For example, they compare the economic and personal costs associated with options such as overdraft protection fees, the few available bank and credit union advance products and payday loans, as well as fees for late payment or utilities reconnection.

For many consumers, a payday loan from a regulated lender such as Advance America can often be the most affordable financial service available to them when they need it; our company offers low-cost, transparent, and convenient credit with meaningful consumer protections.

However, misconceptions abound. Criticism about the high Annual Percentage Rate (APR) stems from a fundamental misunderstanding of payday loans, which charge a one-time, flat

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fee (typically, $15 per $100 borrowed)—not interest. Similarly, payday loans provide a critical credit option for those coping with urgent, unbudgeted expenses; they do not create additional financial burdens for consumers. These individuals would undoubtedly be worse off without access to credit.

As Americans' credit needs evolve, efforts to restrict access to payday loans and other short-term lending threaten consumer interests. While any form of credit can be abused or misused, well-regulated, transparent services such as payday loans offer consumers a sound choice and effective financial tool for managing short-term financial needs. American consumers depend upon a variety of credit options to meet their diverse needs and expenses. Regulators, consumer groups, and leaders within the financial services industry must collaborate to maintain a wide array of credit offerings and to foster the development of innovative services benefiting the full breadth of consumers.

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I. Introduction

As the United States seeks to recover from a stubborn economic downturn—with progress that seems to ebb and flow—millions of Americans continue to experience difficulty making ends meet. Americans increasingly turn to providers of short-term credit for assistance in covering basic expenses, as well as unexpected costs that overwhelm already-stretched budgets. Their credit options may include "traditional" forms of credit, such as bank and credit union loans, and "alternative" financial offerings, such as overdraft protection services and various retail lending services.

Payday loans are one such retail option available to these consumers, though they are not without controversy.[1] Consumer activist organizations, in particular, often focus on the implied interest rates associated with the service and question the consumer rationale for short-term lending.[2] Yet, independent research shows, as does the industry's extensive data and experience, that lenders charge competitive fees for their services, and—it is critical to note—customers who understand their loans' terms and pricing typically exhibit a reasoned approach to selecting them and consider payday loans to be a valuable and cost-effective service.[3]

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1. "Payday loans" are often referred to as "payday advances" and "cash advances," and in this Article these terms will be used interchangeably.

2. *See, e.g.*, Ted Griffith, *Industry News: County Bank Cuts 'Payday' Ties; High-Interest Loans Had Long Been Under Fire*, NEWS J. (2010), http://www.aaapaydaycash.com/news_release_11.asp (last visited Apr. 5, 2012) ("Activists criticize the loans for their 'sky-high' interest rates, which they say can approach 1,000 percent on an annualized basis.") (on file with Washington and Lee Law Review).

3. *See, e.g.*, Connie Gekler, *Payday Loans are a Valuable Option for Many: Letters*, NOLA.COM (Sept. 11, 2011 1:23 AM), http://www.nola.com/opinions/index.ssf/2011/09/payday_loans_are_a_valuable_op.html (last visited Jan. 21, 2012) (explaining that Advance America "customers understand the costs associated with [its] service and choose a payday advance because it makes personal and economic sense [and that] . . . payday advances provide many hard-working families with a valuable option for managing unexpected and periodic financial difficulties") (on file with Washington and Lee Law Review); *Payday Loans-Quick and Timely Funding!*, YOURPRIVATELOAN.COM (2010), http://yourprivateloan.com/Payday-Loans-Quick-and-timely-funding!.html (last visited Apr. 5, 2012) ("Loads of companies have started to give away loans at competitive prices.") (on file with Washington and Lee Law Review).

How are misperceptions shaped between critics' allegations, on the one hand, and actual loan pricing and what consumers decide in the real world, on the other? If critics could prevent lenders from offering payday loans, would they in fact be acting in the best interests of those who use these loans, or would they instead be eliminating a reliable option for these consumers, ultimately forcing them to choose more costly or less regulated alternatives?

This Article will examine these issues from the perspective of Advance America, Cash Advance Centers, Inc. (Advance America), the country's largest non-bank provider of cash advance services, with over 2,500 centers in twenty-nine states.[4] In 2011, Advance America extended nearly $4 billion in credit to more than 1.3 million Americans.[5]

The periodic needs of millions of consumers for short-term, small-dollar credit will be highlighted, as will their options for obtaining such credit. This Article will also rebut two primary arguments critics make against this industry, specifically the allegations that (1) payday advances are offered at unreasonably high rates, and that (2) these loans cause most customers to sink into a hopeless "cycle of debt," so to speak.[6] Through an exploration of consumers' needs and rationale, this Article will explain that payday advances are often a consumer's least expensive and best available credit alternative—one that consumers would be worse off without.

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4. *See* Advance America, Form 10-K for Fiscal Year Ending December 31, 2011 4–5 (Mar. 15, 2012), *available at* http://files.shareholder.com/downloads/AEA/1749886924x0x555383/DFF29D33-F8BF-4C90-B7E7-44E8682E4988/SEC-AEA-1047469-12-2758_2011_Form10K_15MAR2012.pdf. On February 15, 2012, the company entered into a merger agreement with Mexico's Grupo Elektra S.A. de C.V. *See id.* at 4. If approved, Advance America will become a wholly owned subsidiary of Grupo Elektra. *See id.* at 21.

5. *Id.* at 5.

6. Critics have made numerous attacks on the payday lending industry. It is well beyond the scope of this Article to respond to all of them. Instead, it will focus on the two allegations that appear to have been their core contentions. *See, e.g.*, LAUREN K. SAUNDERS, LEA A. PLUNKETT & CAROLYN CARTER, NAT. CONSUMER LAW CTR., STOPPING THE PAYDAY LOAN TRAP: ALTERNATIVES THAT WORK, ONES THAT DON'T 3 (June 2010), *available at* http://www.nclc.org/images/pdf/high_cost_small_loans/payday_loans/report-stopping-payday-trap.pdf ("Payday loans are very high-cost, short-term loans that ensnare borrowers in a debt trap.").

II. Consumers' Need for Small-Dollar, Short-Term Credit Options

Any discussion of payday lending must be put in the context of the credit needs of American families. Millions of consumers periodically need small-dollar, short-term credit extensions to help them deal with unexpected or unbudgeted expenses. A variety of independent studies and reports extensively document such credit needs, including:

- The Federal Deposit Insurance Corporation (FDIC) issued a widely noted report in December of 2009 which found that about 7.7% of U.S. households, approximately 9 million individuals, were "unbanked," and approximately another 17.9%, about 21 million individuals, were "underbanked."[7] Thus, over 25% of all American households, representing approximately 60 million adults, were in these "underserved" categories in 2009.[8] Not surprisingly, given the continued stagnation of our economy, high unemployment, and ongoing mortgage crisis, this already large number appears to be growing.[9]

- Also in December of 2009, the FINRA Investor Education Foundation published the results of

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7. FED. DEPOSIT INS. CORP., NAT'L SURVEY OF UNBANKED & UNDERBANKED HOUSEHOLDS 10 (Dec. 2009) [hereinafter FDIC SURVEY], *available at* http://www.fdic.gov/householdsurvey/full_report.pdf. The FDIC defined "unbanked" to mean that no one in the household currently had a checking or savings account and defined "underbanked" essentially as households that had a checking or savings account but still relied periodically on alternative financial services such as payday loans or pawn shops. *Id.* at 15. In this Article, the term "financially challenged" consumers will be used to refer collectively to both unbanked and underbanked consumers, including more affluent middle and higher income consumers who nonetheless cannot qualify for unsecured personal loans from traditional banks due to their high debt, their low disposable income levels, and typically their impaired credit history. It should be recognized that payday lenders do not serve the unbanked segment of this market because all payday loan customers must have a bank account.

8. *Id.* at 10–11.

9. *See* David Morrison, *Interchange Cap Likely Leading To More Unbanked Americans*, CREDIT UNION TIMES (Jan. 28, 2011), http://www.cutimes.com/2011/01/28/interchange-cap-likely-leading-to-more-unbanked-americans (last visited Apr. 5, 2012) ("The number of Americans who have bank accounts is likely to drop in the coming months as financial institutions seek to make up the costs of additional regulation with greater fees.") (on file with Washington and Lee Law Review).

the first survey in its National Financial Capability Study, which contains many troubling findings indicating that a very large percentage of our population has serious and often ongoing financial concerns.[10] Among other things, nearly half of those surveyed reported difficulties in paying bills and meeting monthly expenses.[11] The second and broader survey in this study was released in December of 2010 and found that 55% of Americans either spent more than or about equal to their household income and were thus living paycheck to paycheck.[12] Moreover, the study reported that 60% of Americans did not have adequate funds available to cover unanticipated financial emergencies and that nearly 25% periodically used alternative financial products from nondepository financial firms.[13]

- KPMG LLP, the internationally respected audit, tax, and advisory firm, recently reported that its latest analysis of this financially challenged market segment shows that it now includes about 88 million individuals, and an additional 6 million people may join these ranks in the next two years.[14] This report also "indicates that the underserved market is growing quickly because millions of wage-earning adults are unfortunately

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10. FINRA INVESTOR ED. FOUND., INITIAL REPORT OF RESEARCH FINDINGS FROM THE 2009 NATIONAL SURVEY: A COMPONENT OF THE NATIONAL FINANCIAL CAPABILITY STUDY (2009), *available at* http://www.finrafoundation.org/web/groups/foundation/@foundation/documents/foundation/p120536.pdf.

11. *Id.* at 15.

12. *See* FINRA Investor Ed. Found., *Financial Capability Study* (2011), http://www.usfinancialcapability.org/geo.php?id=National (last visited Apr. 5, 2012) (noting that "20% of individuals reported that over the past year, their household spent more than their income", and that 35% "spen[t] about the same as their income") (on file with Washington and Lee Law Review).

13. *Id.*

14. Press Release, KPMG LLC, KPMG Study: "Underserved" Market Represents Opportunity for Banks (June 6, 2011), http://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/Press-Releases/Pages/Underserved-Market-Represents-Opportunity-For-Banks.aspx (last visited Apr. 5, 2012) (on file with Washington and Lee Law Review). KPMG's report used what appear to be similar groupings for "unbanked" and "underbanked" consumers, defining the first group as those without a transaction account and the latter as "those without access to incremental credit." *Id.*

moving from the 'average' credit score to the 'damaged' credit score due to negative events."[15]

- FICO credit scores of 25.5% of all U.S. consumers are below 600, a level where it is very difficult, if not impossible, for most to obtain unsecured personal loans from traditional banking institutions.[16] Of particular note is the fact that many middle-class consumers' credit ratings have deteriorated and, like many with lower incomes, these consumers cannot qualify for bank loans.[17]

- A new 2011 study released by the National Bureau of Economic Research (NBER) also presents a disturbing picture of many American households' "financial fragility."[18] This study found that almost half of all households, including a sizable portion of solidly middle-class families, reported that they could "probably not" or "certainly not" come up with just $2,000 to deal with an ordinary financial shock of that size, even if given thirty days to do so.[19] The findings were not unique to low-income populations. Roughly 25% of households with an annual income over $100,000 said they would not be able to cope with such an expense.[20]

- Another report from the National Foundation for Credit Counseling (NFCC) concluded that to pay for an unplanned expense of $1,000, instead of being able to rely on savings, 64% of Americans

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15. *Id.*

16. Press Release, Fair Isaac Corp., FICO Scores Drift Down as Economic Factors Weigh on Consumer Credit Risk (July 13, 2010), http://www.fico.com/en/Company/News/Pages/07-13-10.aspx (last visited Apr. 5, 2012) (on file with Washington and Lee Law Review).

17. *See Low Credit Scores Hobble Prospective Homebuyers*, CHICAGO AGENT MAGAZINE (Dec. 6, 2011), http://chicagoagentmagazine.com/low-credit-scores-hobble-prospective-homebuyers/ (last visited Dec. 28, 2011) ("There were many outcomes of the housing boom and bust cycle, but one of the more implicit has been lowering consumer credit scores, a detail that has posed problems for prospective homebuyers seeking a mortgage for their transactions.") (on file with Washington and Lee Law Review).

18. Annamaria Lusardi, Daniel J. Schneider & Peter Tufano, *Financially Fragile Households: Evidence and Implications* 2 (National Bureau of Economic Research Working Paper No. 17072), *available at* http://www.fdic.gov/news/conferences/lusardi.pdf.

19. *Id.* at 3, 10.

20. *Id.* at 12.

> would have to seek out credit elsewhere, such as borrowing from friends or family, securing a cash advance on credit cards, selling or pawning their assets, securing a small loan from a nondepository financial institution, or disregarding other monthly expenses.[21]

Recent federal financial services regulations, such as the Dodd–Frank Wall Street Reform and Consumer Protection Act[22] of 2010, have further exacerbated these needs. Such regulatory measures have led banks to increase fees and qualification requirements for their services, pushing many financially challenged consumers out of traditional financial institutions, and new restrictions on other forms of credit have further constricted the marketplace.[23] Indeed, the amount of consumer credit available to Americans in the first seven months of 2011 decreased to $436 billion from $805 billion extended during the same period in 2006.[24]

The perspectives of payday lenders—through day-to-day experiences serving customers—confirm that a large segment of American households are indeed "financially fragile," living at the margin of their disposable incomes.[25] Faced with the rising cost of gas and high food prices,[26] along with declining personal

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21. Press Release, Nat'l Found. for Credit Counseling, Majority of Americans Do Not Have Money Available To Meet An Unplanned Expense (Aug. 2011) [hereinafter NFCC], http://www.nfcc.org/NewsRoom/newsreleases/FLOI_July2011Results_FINAL.cfm (last visited Apr. 5, 2012) (on file with Washington and Lee Law Review).

22. *See* Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (codified in scattered sections of 12 U.S.C., 15 U.S.C., 31 U.S.C., 7 U.S.C., 18 U.S.C., 42 U.S.C. and 22 U.S.C.) (2011) (making significant changes to financial regulation and supervision).

23. *See* Editorial, *Thank Dodd–Frank for That Fee*, INVESTORS BUS. DAILY, Oct. 3, 2011, at A16 ("BofA says it stands to lose $2 billion from the arbitrary Durbin price-fixing amendment and now has no choice but to make up for the lost revenue some other way.").

24. Press Release, Equifax, Inc., Total Outstanding Consumer Debt Now Nearly Equivalent to Pre-Recession Levels (Nov. 2, 2011), *available at* http://news.equifax.com/index.php?s=18010&item=96820.

25. Lusardi et al., *supra* note 18, at 2.

26. *See US Consumer Prices Rise by Most in 10 Months Because of Higher Gas Costs; Core Inflation Tame*, WASH. POST, Mar. 16, 2012 http://www.washingtonpost.com/business/economy/us-consumer-prices-rise-by-most-in-10-months-because-of-higher-gas-costs-core-inflation-tame/2012/03/16/gQAf80DG

savings,[27] these consumers periodically need short-term, small-dollar loans to cope with unexpected or unplanned expenses.[28] These expenses typically involve medical bills, home and automobile repairs, as well as basic household costs such as utility and credit card bills.[29] Consumers also seek to avoid costly consequences of missing bill payments, including fees associated with reconnecting utilities and checking account overdrafts or late payments on credit cards.[30] Consumers in these situations seek viable avenues for overcoming their financial shortfalls and avoiding related punitive consequences and may consider such services as small-dollar bank and credit union loans (when available), overdraft programs, credit cards, cash advances, and pawn and car title loans.

III. Financially Challenged Consumers' Credit Choices

A. Availability of Small, Short-Term Personal Loans from Traditional Banks

Before discussing payday advances and other alternative credit options, this Article will examine what choices financially challenged consumers have for obtaining small, unsecured personal loans from traditional banks.

S_story.html ("A sharp jump in gas prices drove a measure of U.S. consumer costs up in February. . . . Grocery store prices appear to be leveling off after increasing for most of the past two years.") (last visited Apr. 5, 2012) (on file with the Washington and Lee Law Review).

27. *See* David Reilly, *Declining Savings Augurs Ill for Consumers*, WALL ST. J., Nov. 23, 2011, at C1. ("But that willingness to shop as the wider world drops has come at a cost—a sharp decrease in the savings rate, which is personal savings as a percentage of disposable personal income. That has shown a steady decline to 3.6% in September from 5.8% in June 2010.)

28. *See Short-Term Credit Alternatives*, CONSUMER RIGHTS COALITION, http://consumerrightscoalition.org/useful-resources/short-term-credit-alternatives/ (last visited Apr. 5, 2012) (explaining that "[m]any hard working Americans chose to take out a payday loan, a small, unsecured, short-term cash advance") (on file with Washington and Lee Law Review).

29. *See id.* (noting that expenses arise from cars breaking down, medical needs, appliances breaking, "bounced-check and overdraft protection fees, [and] late bill payment penalties").

30. *Id.*

When a financially challenged consumer who has an established relationship with a bank, such as a checking or savings account, needs to obtain such a loan, logically they might seek to obtain it from their bank. What loan choices will the bank most likely offer? The short answer in most cases appears to be "none."[31] This is not meant as a criticism of banks because banks appear to have understandable and legitimate business reasons for such decisions.

Kelly Edmiston, a Federal Reserve Bank of Kansas City senior economist, has recently noted that, even when banks offer small personal loans, most financially challenged consumers cannot qualify for them:

> Clearly, if access to a traditional lender such as a bank is available, most would-be payday borrowers would be better off seeking short-term funds there. But few banks make small-dollar loans. Even if they did, few typical payday loan borrowers would have sufficient credit standing to acquire such a loan.[32]

For a number of years, banks and credit unions have met their customers' needs for short-term credit through services such as overdraft protection, nonsufficient funds (NSF) transactions, and credit cards. In fact, "credit cards and other revolving debt plans" offered by banking institutions amount to $617.7 billion outstanding in the United States as of June 20, 2011, and now account for by far the largest share of unsecured consumer

31. Some smaller community banks reportedly still make some small-dollar, unsecured personal loans, but the number and total dollar amount of such loans is not readily available. *See An Examination of the Availability of Credit for Consumers: Hearing Before the Subcomm. On Fin. Insts. & Consumer Credit of the H. Comm. on Fin. Servs.*, 112th Cong. 5–6 (2011) (statement of Barry Wides, Dep. Comptroller for Cmty. Affairs, Office of the Comptroller of the Currency) [hereinafter Wides], *available at* http://financialservices.house.gov/Uploaded Files/092211wides.pdf ("Some banks no longer offer unsecured consumer loans."); *see also*, Laura Bruce, *Banks Experiment with Small Loans*, BANKRATE.COM (2012), http://www.bankrate.com/finance/personal-finance/ banks-experiment-with-small-dollar-loans-1.aspx (last visited Apr. 5, 2012) ("To be sure, there are many banks across the country that make small-dollar loans[,] . . . [b]ut by and large, banks have shied away from small loans as it can be difficult to make them profitable.") (on file with Washington and Lee Law Review).

32. Kelley D. Edmiston, *Could Restrictions on Payday Lending Hurt Consumers?*, THE ECON. REV., First Quarter 2011, at 71, *available at* http://www.kansascityfed.org/publicat/econrev/pdf/11q1Edmiston.pdf.

lending.[33] However, many federally insured depositories have been reluctant to enter the small personal loan market.[34] In particular, the majority of banks do not make small loans (e.g., $300–$500) to higher-risk consumers because banks' operating costs tend to be relatively high, and it is very difficult for most banks to make such loans on a profitable, economically viable basis unless they charge high rates.[35] Charging high rates exposes banks to unwanted reputational risks, as critics would make similar arguments against such services as those made against traditional payday loans. Banks and credit unions that offer short-term, cash advance services that are similar to traditional payday loans generally charge relatively high fees and include a number of additional limitations and requirements (e.g., direct deposit of customers' paychecks to ensure prompt repayment) that consumers may find unattractive.[36] Critics of payday lending often attack such bank products as being too costly.[37]

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33. Wides, *supra* note 31, at 2.

34. *See An Examination of the Availability of Credit for Consumers: Hearing Before the Subcomm. on Fin. Insts. & Consumer Credit of the H. Comm. on Fin. Services*, 112th Cong. 3 (2011) (statement of Robert W. Mooney, Dep. Dir. for Consumer Prot. & Cmty. Affairs, FDIC) [hereinafter Mooney], *available at* http://financialservices.house.gov/UploadedFiles/092211mooney.pdf ("[A] series of product and technological innovations and changes in the competitive landscape in banking, among other factors, [have] contributed to a decline in the number of banks offering small loans and an increase in alternative credit providers, such as payday loan stores, auto title lenders, and pawn shops.").

35. *See* G. MICHAEL FLORES, BRETTON-WOODS INC., 2009 FEE ANALYSIS OF BANK AND CREDIT UNION NON-SUFFICIENT FUNDS AND OVERDRAFT PROTECTION PROGRAMS 15 (2010), *available at* http://bretton-woods.com/media/3dba14ccfd97117fffff82a5ffffd523.pdf ("Most banks are unlikely to meet this unmet credit demand due to their cost structure to underwrite individual small credits. Because of these constraints, many banks do not underwrite individual credits under $5,000 and many will not offer individually underwritten unsecured loans to customers.").

36. *See id.* at 15–16 (explaining some limitations on bank payday-type loans, including that "customers must have an account with a direct deposit for a time period from one month to six months, in order to qualify"); *see also* VICTOR STANGO, ARE CREDIT UNIONS VIABLE PROVIDERS OF SHORT-TERM CREDIT? 2 (2010), *available at* http://faculty.gsm.ucdavis.edu/~vstango/Credit%20union%20monograph.pdf ("The short-term loans offered by credit unions generally carry greater restrictions on approval and repayment, meaning that risk-adjusted prices for credit union payday loans may not be lower at all.").

37. *See, e.g.*, SAUNDERS ET AL., *supra* note 6, at 2 ("A number of other alternatives are considerably cheaper than a traditional payday loan but fall

Banks and credit unions continue to provide overdraft services as their primary short-term credit offering.[38] While such overdraft programs generally are quite profitable for depositories, they frequently are far more costly to consumers than payday advances.[39] This has been well documented in the FDIC's Study of Bank Overdraft Programs.[40] This FDIC study showed, among other things, that the median overdraft was $36, but the median fee to cover overdrafts was $27.[41] This has been further illustrated by a 2011 study conducted by the Consumer Federation of America, which found that overdraft fees of the fourteen largest U.S. banks, when expressed in APR terms, ranged from 884% to 3,250%.[42]

The FDIC overdraft study also reported that a "significant share of banks (24.7% of all surveyed banks and 53.7% of large banks) batch processed overdraft transactions by size, from largest to smallest, which can increase the number of

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short of being a safe and affordable alternative. . . . Some credit union small loans are admittedly better than a payday loan but are considerably too expensive and have too short a repayment period.").

38. *See* Patrick O'Shaughnessy, *Advance America, Cash Advance Centers' CEO Discusses Q3 2011 Results - Earnings Call Transcript*, SEEKING ALPHA (Oct. 27, 2011 8:00 AM), http://seekingalpha.com/article/302813-advance-america-cash-advance-centers-ceo-discusses-q3-2011-results-earnings-call-transcript (last visited Apr. 5, 2012) ("[M]ost banks and credit unions continue to provide overdraft services and courtesy pay as their primary source of short-term credit to their customers.") (on file with Washington and Lee Law Review).

39. *See* David Sanford Jones, *Payday Lending - A Better Alternative than NSF/Overdraft Products: Analysis of 2009 Overdraft and Payday Loan Analysis-Where is the Consumer Credit*, G+ (Aug. 18, 2010), https://www.gplus.com/mortgage-finance/insight/payday-lending-a-better-alternative-than-nsf-overdraft-products-50093 (last visited Apr. 5, 2012) ("Bank NSF/Overdraft protection fees are a more expensive form of short term credit extension to most Americans. The lower cost Payday Loan is an attractive product, with more accessibility and a proven track record.") (on file with Washington and Lee Law Review).

40. *See* FDIC, STUDY OF BANK OVERDRAFT PROGRAMS ii (Nov. 2008) [hereinafter FDIC STUDY], *available at* http://www.fdic.gov/bank/analytical/overdraft/ FDIC138_Report_Final_v508.pdf (explaining that the results of the study were intended to help "policymakers make better-informed policy decisions and . . . help the public better understand the features and costs related to automated overdraft programs").

41. *Id.* at iii, v.

42. CONSUMER FEDERATION OF AMER., 2011 CFA SURVEY OF BIG BANK OVERDRAFT LOAN FEES & TERMS 3 (2011) [hereinafter CFA], *available at* http://www.consumerfed.org/pdfs/OD-14BankSurvey-ChartAugust2011.pdf.

overdrafts."[43] Moreover, a number of customers were heavy repeat users of overdraft protection services.[44] "Customers with five or more NSF transactions accrued 93.4 percent of the total reported NSF fees";[45] those "with 10 or more . . . accrued 84 percent of"[46] these fees; and those "with 20 or more NSF transactions accrued over 68 percent of the reported fees."[47] "The FDIC issued guidance in November 2010 urging banks to 'not process transactions in a manner designed to maximize the cost to consumers.'"[48] In November 2011, Bank of America agreed to a $410 million settlement with customers for processing account transactions to make it more likely that they would incur overdraft fees.[49] Other banks, including Wells Fargo and Citibank, face lawsuits related to their overdraft programs.[50] An analysis conducted by Pew Health Group's Safe Checking in the Electronic Age Project, examining more than 250 checking accounts offered online by the ten largest banks in the United States shared similar findings.[51] According to Pew, the median

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43. FDIC STUDY, *supra* note 40, at iii. Banks' financial incentives for processing overdrafts on a high-to-low basis are quite substantial. *See* Jeff Horwitz, *Union Bank Email Show Overdraft's Seedy Underbelly*, AM. BANKER (Sept. 27, 2011), http://www.americanbanker.com/issues/176_187/union-bank-overdraft-1042547-1.html (last visited Apr. 5, 2012) ("CAST Management Consultants promised that by processing customers' daily checking and debit transactions based on the highest to the lowest dollar values, instead of in chronological order, Union Bank could drastically increase how many 'insufficient funds' fees clients paid.") (on file with Washington and Lee Law Review).

44. FDIC STUDY, *supra* note 40, at iv. ("Although almost 75 percent of consumer[s] . . . had no NSF transactions, . . . almost 12 percent of consumer . . . had 1 to 4 NSF transactions, 5.0 percent had 5 to 9 NSF transactions, 4.0 percent had 10 to 19 NSF transactions, and 4.9 percent had 20 or more NSF transactions.").

45. *Id.*

46. *Id.*

47. *Id.*

48. Catherine New, *Predatory Payment Processing Has Largely Stopped, But Remains Legal*, HUFFINGTON POST (Nov. 22, 2011, 5:23 PM), http://www.huffingtonpost.com/2011/11/22/overdraft-fees-banks_n_1107985.html (last visited Apr. 5, 2012) (on file with Washington and Lee Law Review).

49. *Id.*

50. *See id.* ("The Bank of America suit is just one of several pending against banks, including related litigation against Wells Fargo and Citibank.").

51. *See* PEW HEALTH GROUP, HIDDEN RISKS: THE CASE FOR SAFE & TRANSPARENT CHECKING ACCOUNTS 1 (Apr. 2011), *available at* http://www.

overdraft penalty fee associated with these accounts was $35.[52] If applied to the median overdraft amount of $36 identified by the FDIC "with a repayment period of seven days, the APR, or annual percentage rate, on the typical overdraft would be over 5,000 percent—a costly way to address credit needs."[53] Pew's analysis also found that banks typically cap the number of overdrafts per day that a customer may incur, but, given the range of caps in place at major banks, customers could still "be charged $140 or more per day in overdraft fees."[54]

Furthermore, an analysis by Bretton Woods, Inc., a financial services consulting firm, found that NSF and overdraft fees charged by banks and credit unions in 2009 exceeded $38 billion and had been "the single greatest component of bank and credit union profitability for the past several years," with such programs generating an estimated 74% of banks' service charge income and 80% of credit unions' fee income.[55] This study found that the average U.S. household with a banking account incurred approximately thirteen NSF and overdraft fees in 2009 with an annual cost per household of $376.[56] But the 20 million households that are particularly active users of these services paid an average of $1,504 annually.[57]

Federal banking regulators have sought to limit banking institutions' overdraft charges, and regulatory changes adopted in 2010 required consumers to opt-in to certain types of bank overdraft programs.[58] Moebs Services, Inc., an economic research firm that conducts periodic studies of overdraft fees, recently

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pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Safe_Checking_in_the_Electronic_Age/Pew_Report_HiddenRisks.pdf (explaining "five practices that put consumers at financial risk, potentially exposing them to high costs for little benefit").

52. *Id.* at 2, 12.

53. *Id.* at 12.

54. *Id.*

55. FLORES, *supra* note 35, at 11.

56. *Id.* at 4.

57. *Id.*

58. 12 C.F.R. § 205.17 (2010). Effective July 6, 2010, Regulation E requires that bank and credit union customers to opt in to authorize debit card overdrafts. *Id.* No opt-in is required in ATM transactions as long as the ATM displays a notice allowing the consumer to opt out of the transaction if it would incur an overdraft fee. *Id.*

reported that despite federal regulators' efforts to curtail fee-based overdraft programs, which in 2010 had resulted in a decline in consumer usage of overdrafts, the recent trend has been a pronounced shift back to such programs as more "consumers (77 percent of more than 130 million checking accounts) have" voluntarily opted in to use this convenient but expensive credit service.[59]

B. The FDIC's Small-Dollar Loan Pilot Program

Federal regulators also have sought to encourage federally insured banks to offer short-term, small-dollar loans that can be an alternative, less expensive option to traditional payday loans for financially challenged consumers.[60] The FDIC has been especially active in this regard and began a two-year pilot program in early 2008 that was intended to show "how banks can profitably offer affordable small-dollar loans as an alternative to high-cost credit products, such as payday loans and fee-based overdraft protection."[61] Loans in this program included what the FDIC categorized as "small-dollar loans (SDLs) of $1,000 or less and nearly small-dollar loans (NSDLs) between $1,000 and $2,500."[62] SDLs averaged approximately $700, or about twice the size of a typical payday advance, and NSDLs averaged approximately $1,700.[63] Initially, thirty-one banks participated in the program, and twenty-eight were in this pilot project when it

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59. Moebs Services, *Overdraft Revenue Shown To Be Rising Like a Phoenix: A Quarter of American Consumers Intentionally Overdraw Their Checking Account*, ENHANCED ONLINE NEWS (Sept. 21, 2011, 8:33AM), http://eon.businesswire.com/news/eon/20110921005103/en/Moebs/Moebs-Services/Mike-Moebs (last visited Apr. 5, 2012) (on file with Washington and Lee Law Review).

60. *See* FDIC, *A Template for Success: The FDIC's Small-Dollar Loan Pilot Program*, FDIC QUARTERLY, 2010, Volume 4, No. 2, at 28 (2010) [hereinafter FDIC Pilot], *available at* http://www.fdic.gov/bank/analytical/quarterly/2010_vol4_2/FDIC_Quarterly_Vol4No2_SmallDollar.pdf ("The pilot was a case study designed to illustrate how banks can profitably offer affordable small-dollar loans as an alternative to high-cost credit products such as payday loans and fee-based overdraft programs.").

61. *Id.*

62. *Id.* at 30.

63. *Id.*

concluded in the fourth quarter of 2009.[64] During the two-year pilot, only 18,163 SDLs, totaling $12.4 million, and 16,294 NSDLs, totaling $27.8 million, were originated.[65] Although delinquency ratios for both loan categories were "much higher than for general unsecured 'loans to individuals,'" the FDIC reported that charge-off ratios were "in line with the industry average."[66]

Based on the experience gained in this pilot effort, the FDIC put forth a so-called "template" to demonstrate how other banks might design and deliver products such as those offered during the pilot program.[67] This template is as follows[68]:

Table 1

A Safe, Affordable, and Feasible Template for Small-Dollar Loans

Product Element	Parameters
Amount	$2,500 or less
Term	90 days or more
Annual Percentage Rate (APR)	36 percent or less
Fees	Low or none; origination and other upfront fees plus interest charged equate to APR of 36 percent or less
Underwriting	Streamlined with proof of identity, address, and income, and a credit report to determine loan amount and repayment ability; loan decision within 24 hours
Optional Features	Mandatory savings and financial education

Source: FDIC

It should be noted that this small-dollar loan template is called "feasible" rather than "profitable."[69] While the FDIC has

64. *Id.* at 29
65. *Id.* at 30.
66. *Id.* at 31.
67. *Id.* at 28.
68. *Id.* at fig.1.
69. *See id.* at 30 ("The pilot resulted in a template of essential product design and delivery elements for safe, affordable, and feasible small-dollar loans that can be replicated by other banks.").

proclaimed the success of this pilot program, the agency's analysis of the program's outcome essentially acknowledges that the small-dollar loans offered were not shown to be profitable in a normal commercial sense. Instead, these were touted as "a useful business strategy for developing or retaining long-term relationships with customers" and a means "to cross-sell additional products."[70] The FDIC reported:

> Program and product profitability calculation are not standardized and are not tracked through regulatory reporting. Profitability assessments can be highly subjective, depending on a bank's location, business model, product mix, cost and revenue allocation philosophies, and many other factors. Moreover, many of the banks in the pilot are community banks that indicated they either cannot or choose not to expend the resources to track profitability at the product and program level.
>
> Nevertheless, as a general guideline, pilot bankers indicated that costs related to launching and marketing small-dollar loan programs and originating and servicing small-dollar loans are similar to other loans. However, given the small size of SDLs and to a lesser extent NSDLs, the interest and fees generated are not always sufficient to achieve robust short-term profitability. Rather, most pilot bankers sought to generate long-term profitability through volume and by using small-dollar loans to cross-sell additional products.[71]

The FDIC is to be commended for seeking to promote lower-cost, small-dollar loans. However, one must question whether most bankers will adopt the FDIC's view of profitability and be willing to offer such loans under the terms of the "feasibility" template and on a scale large enough to meet the credit needs of the extremely large financially challenged market.[72] When

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70. *Id.* at 32. Participating banks also may have benefited from what may be termed regulatory "goodwill" for offering smaller loans and also from favorable Community Reinvestment Act consideration. *Id.*

71. *Id.*

72. Organizations representing the cash advance industry have found considerable fault with the FDIC's claimed successes under the pilot program. *See, e.g.*, FIN. SERV. CTRS. OF AM., INC., THE FDIC SMALL DOLLAR LOAN PILOT PROGRAM: A CASE STUDY OF A MISGUIDED APPROACH TO SATISFYING CONSUMERS' NEED FOR SMALL DOLLAR CREDIT (Oct. 2009), *available at* http://www.rtoonline.com/images/fdicsdlcritique.pdf (stating that the FDIC has realized that "the Guidelines it has promulgated are not conducive to a profitable small dollar loan

considering the safety and soundness implications of banks utilizing the template on a large scale, it would seem very challenging, to say the least, to follow this model.

In any case, payday lenders like Advance America, whose cost structures typically are significantly lower than federally insured banks, have found it impossible to profitably make small cash advance loans under a 36% APR cap as the FDIC advocates. For example, under a 36% APR cap, a typical payday advance of $300 would yield a total fee of $4.14. It would appear that no lender—not a credit union, not a bank, and not a payday lender—can make such loans to many customers for less than thirty cents a day without subsidization or ceasing operations because of the losses incurred on such loans. The following chart illustrates how a lender would lose money under a 36% APR cap (which means a lender could only charge a fee of $1.38 on a $100, two-week cash advance), considering only a modest level of loan losses and without any provision for operating expenses:

Table 2

36% APR Analysis for Every 100 Loans

	$100 Loan	$350 Loan
Revenue per loan	$1.38	$4.38
Total loan amount	$10,000	$30,000
Revenue on 96 loans	$132.48	$420.48
Loss assumption 4.0% of volume	$400.00	$1,200.00
Net revenue	($267.52)	($779.52)

Source: Stephens Inc.

*Parenthesis indicate negative net revenue.

Payday lenders have experienced these economic realities in states where such caps have been imposed because they have not been able to cover the cost of basic operating expenses, such as wages, rent, and utilities, let alone the costs of loan losses.[73] This

product").

73. *See, e.g.*, Emilie Ritter, *Payday Lenders Close Operations in Montana,*

is precisely why industry opponents have advocated a 36% APR cap on payday loans—they understand that it is in effect a loan prohibition. For example, a representative of the Center for Responsible Lending, which has led a campaign to prohibit payday lending in various states, said that when Ohio policymakers passed a 28% APR cap several years ago, they "fully understood that [an APR cap] would ban the product . . . , [a]nd I think, frankly, that was the intent."[74] Lenders in states that have imposed such caps have been forced to close hundreds of loan centers, costing thousands of employees their jobs and leaving consumers with fewer, and in many cases far more expensive, credit choices.[75] Indeed, according to an Urban Institute study conducted for the Treasury Department, prohibiting payday loans is associated with just a 35% decline in the use of payday loans; in states that have implemented such measures, consumers instead use costlier, less regulated loans, such as Internet payday loans, or travel across state lines to obtain short-term credit.[76]

It would be reasonable to conclude that this harsh economic reality is why, two years after the pilot program began, the number of banks offering such loans apparently has not

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NPR (Nov. 17, 2010), http://www.npr.org/2010/11/17/131378384/payday-lenders-close-operations-in-montana (last visited Apr. 5, 2012) ("There's a new cap on how much interest payday lenders in Montana may charge. Voters there approved the measure earlier this month. Now, the payday loan industry says hundreds of jobs will be lost.") (on file with Washington and Lee Law Review).

74. Drew Ruble, *Borrowed Time?*, BUSINESS TN, Sept.–Oct. 2008, at 10.

75. *See, e.g.*, *Payday Loan Company Closing Oregon Stores: Check Into Cash Blames Legislature's New Law for Demise of Business*, PORTLAND TRIBUNE (Oct. 30, 2009), http://www.portlandtribune.com/news/story.hp?story_id=120527663621387900 (last visited Apr. 5, 2012) ("When the legislature passed the 36 percent limit the company closed many of its stores. No longer able to offer payday loans, Check Into Cash tried to meet customer needs by offering check cashing services and a new loan product, which weren't popular.") (on file with Washington and Lee Law Review).

76. *See* SIGNE-MARY MCKERNAN, CAROLINE RATCLIFFE, & DANIEL KUEHN, URBAN INST., PROHIBITIONS, PRICE CAPS, AND DISCLOSURES: A LOOK AT STATE POLICIES AND ALTERNATIVE FINANCIAL PRODUCT USE 22 (Nov. 2010), *available at* http://www.urban.org/uploadedpdf/412306-Prohibitions-Price-Caps-and-Disclosures.pdf; *see also* JEAN ANN FOX & ANNA PETRINI, CONSUMER FED'N. OF AM., INTERNET PAYDAY LENDING: HOW HIGH-PRICED LENDERS USE THE INTERNET TO MIRE BORROWERS IN DEBT AND EVADE STATE CONSUMER PROTECTIONS 4 (Nov. 30, 2004), *available at* http://www.consumerfed.org/pdfs/Internet_Payday_Lending113004.PDF ("Payday lending has expanded from check cashing outlets, pawn shops and payday loan outlets to the Internet.").

expanded. At a September 2011 hearing before the House Financial Institutions and Consumer Credit Subcommittee, the FDIC's Deputy Director of Consumer Protection and Community Affairs, Robert Mooney, said that twenty-six of the twenty-eight banks participating in this FDIC Pilot continue to offer the loans today.[77] But he did not identify any instances in which the lending was profitable, nor did he report that other banks are offering small loans based on the "feasibility" template. Rather, he said that the program allowed participating banks to develop long-term customer relationships.[78] He also commented in oral remarks during the hearing that this was "the primary reason they engaged in the program."[79] It stands to reason, though it seems hard for industry critics to acknowledge, that if such loans could be offered at a profit, more banks would already be doing so—thus increasing competition with nondepository lenders for financially challenged consumers' short-term, small-dollar loan business. In reality, while investing in relationships by offering unprofitable loans may be justified in some instances, this does not appear to be a viable strategy for effectively meeting the needs of the tens of millions of financially fragile consumers.

Credit unions have also begun offering more short-term credit options to their members.[80] More than 500 credit unions across the country offer such loans, which often are labeled as payday advance alternatives and in some cases specifically are termed payday loans.[81] Administrators of these programs often claim that they are less expensive than traditional payday loans based on the comparative APRs of the services. However, while credit unions may disclose a seemingly low APR, their loans often involve additional membership, application, and loan origination fees that are frequently hidden in the fine print of their loan

77. *See* Mooney, *supra* note 34, at 6. Elsewhere the FDIC has said that thirty-one banks participated in this program and twenty-eight remained at the end. FDIC Pilot, *supra* note 60, at 29.

78. *See* Mooney, *supra* note 34, at 5 ("[M]ost Pilot bankers indicated that small-dollar loans were a useful business strategy for developing or retaining long-term relationships with consumers.").

79. *Id.* at 3.

80. *See* Ben Hallman, *More Credit Unions Offering Payday Loans*, WASH. POST, May 31, 2011, at A08 ("[M]ore credit unions are competing directly with traditional payday lenders, selling small, short-term loans.").

81. *Id.*

agreements.[82] In one such example, a major credit union advertises a 15% APR on its small-dollar, short-term loans, but these loans also involve a $39.95 application fee and a $10 annual membership fee, which, when included in the calculation, result in an APR of over 350%.[83] And, it should be noted that, as with banks, credit unions' main short-term credit offering is higher-cost overdraft services, which generally involve an approximately $25 fee per overdraft, according to Moebs.[84] Consumer advocates have not necessarily supported all of these credit union programs.[85]

The following chart, using data from Advance America, shows the costs associated with comparable loan products based on a fourteen-day loan:

Table 3

Storefront Payday Loan

Disclosed as $15 flat fee per $100

Principal	$100	$200	$300	$400
One Flat Fee	$15	$30	$45	$60
Total	**$115 (391% APR)**	**$230 (391% APR)**	**$345 (391% APR)**	**$460 (391% APR)**

Credit Union Loan

Disclosed as 15% APR + $39.95 application fee

Principal	$100	$200	$300	$400
Fees	$40.52 ($39.95 Fee + $.57 in Interest)	$41.10 ($39.95 Fee + $1.15 in Interest)	$41.66 ($39.95 Fee + $1.71 in Interest)	$42.25 ($39.95 Fee + $2.30 in Interest)
Total	**$140.52 (1053% APR)**	**$241.10 (534% APR)**	**$341.66 (361% APR)**	**$442.25 (274% APR)**

From the perspective of payday lenders, there is no objection to innovative private sector programs that can provide consumers with lower cost products through banks or other lenders to help meet their short-term, small-dollar credit needs.[86] Nor is there

82. Ben Hallman, *Some Short-Term Loans Carry Equivalent Of 876% Interest Rate*, I WATCH NEWS (May 27, 2011, 2:00 AM), http://www.iwatchnews.org/2011/05/27/4754/credit-unions-remake-themselves-image-payday-lenders (last visited Dec. 29, 2011) (on file with Washington and Lee Law Review).

83. *Id.*

84. Moebs Services, *supra* note 59.

85. *See* SAUNDERS ET AL., *supra* note 6, at 1 ("But payday loan alternatives are not all created equal. Some are considerably more affordable and safer than payday loans. Others differ little from the loans offered by traditional payday lenders.").

86. Governmental, nonprofit, and industry groups continue to explore new

objection to government agencies like the FDIC encouraging such programs, provided certain lenders' products are not subsidized by taxpayer dollars. Such an arrangement would result in unfair competition with lenders that did not benefit from similar subsidies. "Consumers thrive in a competitive, regulated financial services environment."[87] But comparable short-term credit options ought to be governed by similar regulations, including uniform disclosure requirements, to ensure that consumers are equipped with all of the information they need to compare services. Such an approach would provide equitable treatment for lenders without limiting valuable consumer choices.

IV. The Payday Loan Option

Although some banks and credit unions continue to explore ways to offer lower cost, small-dollar credit products to financially challenged consumers, Advance America sees no convincing evidence that such efforts can be expected to help more than a very small percentage of consumers who have urgent credit needs today, tomorrow, and for the foreseeable future.[88] Therefore, public policy attention should be directed toward further evaluating alternative credit choices available to these higher credit risk consumers. Advance America believes that a more realistic and objective analysis than has heretofore been made by industry critics and some government officials shows that payday loans provided by regulated lenders are a sensible and effective

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and innovative ways to provide additional affordable small, short-term credit options for financially challenged consumers. *See, e.g.*, RACHEL SCHNEIDER & MELISSA KOIDE, CTR. FOR FIN. SERVICES INNOVATION, HOW SHOULD WE SERVE THE SHORT-TERM CREDIT NEEDS OF LOW-INCOME CONSUMERS? 1 (Mar. 2010), *available at* http://cfsinnovation.com/system/files/Research_Paper_Credit_Symposium_Mar25 2010_0.pdf ("This paper . . . discusses the demand for short-term credit and examines credit products that hold potential to meet that demand.").

87. Jamie Fulmer, *Short-Term Lending Helpful*, CFED (Sept. 16, 2011, 4:17 PM), http://blogs.cfed.org/cfed_news_clips/2011/09/shortterm-lending-helpful.html (last visited Apr. 5, 2012) (on file with Washington and Lee Law Review).

88. Similarly, while credit counseling, consumer financial education, savings, and always handling personal financial matters in responsible manner should be strongly encouraged, it would seem unrealistic to expect that most financially challenged consumers' credit needs will be ended by such initiatives.

means for many consumers to handle their short-term, small-dollar credit needs.

Data show that payday advances are often the least costly credit alternative, and they provide financially challenged consumers with a valuable financial management tool to avoid experiencing worse financial problems, including facing the costs and penalties of missing bill payments, submitting them late, or resorting to unregulated loans.[89]

Payday advances are generally under $500 and normally due on the borrower's next payday.[90] The average loan is between $300 and $400, and the typical fee is $15 per $100 borrowed over an average repayment period of two to four weeks.[91] This is a fixed, flat fee based on the total amount borrowed;[92] interest is not compounded and late fees are not charged.[93] Millions of consumers who are not able to or choose not to obtain credit products from banking institutions select Advance America and other regulated payday lenders to meet their periodic credit needs.[94] They report using the service to manage short-term cash crunches such as unexpected expenses (e.g., medical costs, home repairs, or car repairs), to prevent late fees on bills, to avoid bouncing checks, and to help bridge a temporary reduction in income. [95]

The traditional storefront payday-advance industry accounted for over 110 million loan transactions, amounting to over $29.8 billion in credit extended, to approximately 19 million consumers in 2011.[96] Moreover, Advance America, for example,

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89. *See infra* Part V, at fig.1.

90. *See, e.g.*, GREGORY ELLIEHAUSEN, GEO. WASH. SCH. OF BUS., AN ANALYSIS OF CONSUMERS' USE OF PAYDAY LOANS vi (Jan. 2009), *available at* http://www.cfsaa.com/portals/0/RelatedContent/Attachments/GWUAnalysis_01-2009.pdf.

91. *Id.*

92. *Id.* at 60.

93. *Id.* at 38.

94. *See* Advance America, Cash Advance, *Frequently Asked Questions*, http://www.advanceamerica.net/apply-for-a-loan/faqs (last visited Apr. 5, 2012) ("Since 1997, millions of customers have trusted Advance America to provide convenient financial solutions to meet their needs.") (on file with Washington and Lee Law Review).

95. ELLIEHAUSEN, *supra* note 90, at 42.

96. STEPHENS INC., PAYDAY LOAN INDUSTRY: INDUSTRY LOOKING MORE

focuses primarily on providing cash advance service to middle-income working individuals.[97] The following table shows selected demographics of the customers which Advance America serves:

Table 4[98]

	Advance America Customers	**U.S. Census 2010**
Average Age (years)	42	39
Median household income	$54, 373	$50,046
Percentage homeowners	48%	65%
Percentage with high school diplomas	94%	85%

Advance America's stores are located in population centers and areas where customers live, work, and shop. These facilities are professional, modern, and inviting. They are generally found in high density retail areas within reputable shopping centers, and they are often near large, nationally recognized anchors such as well-known supermarkets, Walmart, Radio Shack, and other chains with thousands of locations around the country.[99] This is done for the convenience of customers, who represent a broad demographic segment and cannot be fairly grouped based on race, sex, religion, or similar characteristics.

Further, payday customers are not the "unbanked," as some critics claim, because underwriting requirements for an advance include a checking account and proof of employment or a steady source of income. Two-thirds of Advance America's customers have at least one other financial option available to them that

ATTRACTIVE AS DEMAND EXPECTED TO INCREASE (2012).

97. A significant segment of middle-class Americans now essentially live paycheck to paycheck and have limited abilities to meet unexpected expenses. *See* Lusardi et al., *supra* note 18; NFCC, *supra* note 21.

98. This data is based on a survey by Advance America of approximately 385,000 of its randomly selected customers across all states that performed a transaction between November 1, 2010, and October 31, 2011 [hereinafter Advance America Customer Survey] (on file with the Washington and Lee Law Review). Internal research also suggests that Advance America's customers may have other financial options available to them that offer quick access to money, and over half have major credit cards and overdraft protection on their checking accounts.

99. Advance America Cash Advance, *You Might Be Surprised What You Learn,* http://www.advanceamerica.net/surprised/about (last visited Apr. 5, 2012) (on file with the Washington and Lee Law Review).

offers quick access to money, and approximately half have major credit cards and overdraft protection on their checking accounts.[100]

Consumers find payday loans to be convenient and easy to understand; they know precisely what they are getting and what it is costing them.[101] A payday loan is one of the most transparent financial products on the market. The loan terms are simple, and the fee is fully and prominently disclosed both as an implied APR and as a dollar amount. Not surprisingly, according to Advance America's surveys and data, over 97% of customers are satisfied with the company's services.[102] Our state regulators report very few customer complaints (less than 50 such complaints were filed with regulators out of over 10 million transactions in 2010).[103] Repayment statistics demonstrate the affordability of payday loans, as more than 90% of customers repay their loans on time.[104] Payday advances sometimes are mistaken for other forms of short-term credit, but these services are distinct. For example, car title or pawn shop loans require collateral or personal property as security. Consumer installment loans offered by nondepository lenders and, when available, by some insured depositories typically involve larger dollar amounts and lengthier repayment periods than payday advances, resulting in a higher debt obligation and a longer-term commitment for consumers.[105]

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100. Advance America Customer Survey, *supra* note 98.

101. The application process for a payday advance is straightforward and transparent: the customer visits a lender center; provides identification, proof of employment, and a bank statement; completes an application form; signs a credit agreement; writes a check to the lender for the amount of the loan and fee; makes an appointment to return and repay the advance; receives their cash or check advance; and returns on the appointment date to repay the loan on their next payday (usually in two to four weeks) and reclaims their check or may simply have the check deposited.

102. Advance America Customer Survey, *supra* note 98.

103. This information is taken from the results of an Advance America 2010 survey of state regulators (on file with the Washington and Lee Law Review).

104. Advance America Cash Advance, *Myth vs. Fact: The Truth About Cash Advances*, http://www.advanceamerica.net/about-us/myth-vs-reality (last visited Apr. 5, 2012) (on file with the Washington and Lee Law Review).

105. *See* Larry Meyers, *Payday Loans vs. Installment Loans*, PAYDAY LOAN FACTS (Jan. 2011), http://www.paydayloanfacts.com/blog/credit-options/payday-loans-vs-installment-loans/ (last visited Apr. 5, 2012) ("Borrowers for this product are in need of larger amounts than they obtain via a payday loan and for a longer period.") (on file with the Washington and Lee Law Review).

In addition, regulated payday lenders offer customers less costly loans than unregulated Internet lenders and extend more consumer safeguards.[106]

The domestic cash-advance industry is subject to both state and federal regulation.[107] Payday advances are currently allowed under the laws of thirty-one states.[108] State laws typically limit the principal amount of an advance, set maximum fees, provide for minimum and maximum loan terms, limit a customer's ability to renew an advance, allow customers the right to rescind the transaction before the end of the next business day, and require various disclosures. Laws in many jurisdictions as well as the payday advance industry's self-imposed policies give borrowers the right to repay their loan over an extended period of time, without incurring additional fees, if they cannot pay as initially promised.[109] To enforce these provisions, state regulators generally require lenders to meet specified licensing requirements, file periodic written reports on business operations, and undergo state audits and exams to ensure compliance with applicable laws.[110] State regulators also impose

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106. *See generally* JEAN ANN FOX & ANNA PETRINI, CONSUMER FED. OF AMERICA, HOW HIGH-PRICED LENDERS USE THE INTERNET TO MIRE BORROWERS IN DEBT AND EVADE STATE CONSUMER PROTECTIONS: A CFA SURVEY OF INTERNET PAYDAY LOAN SITES (Nov. 2004), *available at* http://www.consumerfed.org/pdfs/CFAsurveyInternetPaydayLoanWebsites.pdf.

107. *See* ELLIEHAUSEN, *supra* note 90, at 7–10; *see also* ADVANCE AMERICA, REGULATED, TRANSPARENT CREDIT: SHORT-TERM LENDING GOVERNED BY EXTENSIVE FEDERAL, STATE REGULATIONS, *available at* http://www.advanceamerica.net/documents/regulations.pdf.

108. Advance America is a founding member of the Community Financial Services Association (CFSA), which is the payday advance industry's leading trade group. CFSA has taken a lead in advocating responsible state legislation to regulate the industry and has also adopted a mandatory set of Best Practices that must be followed by its members. Many of these Best Practices requirements exceed what is required in some states' laws. Among other things, it requires that CFSA members offer customers who are unable to pay their loan on time an extended payment plan that allows the loan to be repaid through a series of smaller installments. *See generally CFSA Member Best Practices*, CMTY. FIN. SERVS. ASS'N AM., http://cfsaa.com/cfsa-member-best-practices.aspx (last visited Apr. 5, 2012) (on file with the Washington and Lee Law Review).

109. *See, e.g.*, 10 VA. ADMIN. CODE § 5-200-33 (2011) ("If an eligible borrower elects an extended payment plan, a licensee shall permit the borrower to repay the amount owed in at least four equal installments over a term of at least 60 days.").

110. *See, e.g.*, *id.* § 5-200-75 (listing the information that must be included

fines or other penalties on payday lenders for failure to comply with such laws.[111] Additionally, lenders like Advance America do not pursue criminal prosecution if a loan is not repaid, and consumers' credit ratings are not harmed if they are unable to pay as agreed.

V. Weighing All Options

When financially challenged consumers are faced with periodic unexpected or unplanned expenses—as everyone certainly is—many first consider whether to obtain credit at all. As part of this deliberation, they weigh the consequences of disregarding their financial obligations, which can be catastrophic. Those who do so can find that:

> [Their immediate financial problem can] easily snowball out of control and have serious consequences. Skipping the rent or mortgage payment, and neglecting to pay credit cards or loans will cause late fees to be added to the debt, putting negative marks on the credit report, resulting in a lower credit score. Well-meaning individuals who are already living on the financial edge may never be able to catch up, exacerbating the problem for months or years down the road.[112]

Most of these consumers ultimately decide obtaining credit is the preferable option and seek to cope with their financial shortfalls through an alternative credit product.[113] Certainly, payday loans are not their only option. A range of credit options are available in today's marketplace, and this variety of products is appropriate.

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by payday lenders in their required annual report).

111. *See, e.g.*, VA. CODE ANN. § 6.2-1828(B) (2011) (granting the Attorney General, "[u]pon . . . referral by the [State Corporation] Commission," authority to seek, and Virginia circuit courts the authority to order, "damages and such other relief allowed by law" for violations of Virginia payday lending laws).

112. NFCC, *supra* note 21.

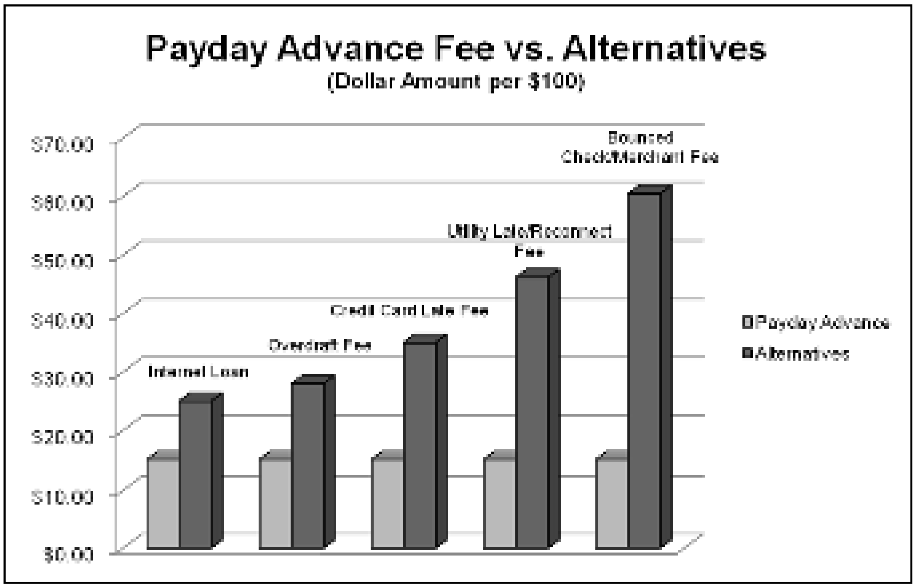
113. The term "alternative credit product" as used in this Article refers to credit products other than unsecured, small, personal loans offered by insured depository institutions and includes products offered by nondepository financial services providers (such as small installment loans, payday loans, and pawn and title loans) and fee-based products and services offered by depositories (such as overdraft protection and credit card advances).

Different alternatives appeal to these consumers for a variety of reasons, and no single credit option is always the best in every circumstance. Some may be able to borrow from family or friends, but not everyone has this option, and many who do have this option elect not to take it because they are embarrassed to do so. A relative few may be able to get a suitable small personal loan from a bank or credit union. Others may qualify for a somewhat larger, longer term loan from a finance company or installment lender, though such credit can expose them to a higher level of debt and will likely involve significantly higher rates than those offered to low-risk, more affluent customers.

In Advance America's experience, many of our customers typically weigh their credit options and select their lower cost alternative. Others do not and simply select what they deem to be the most convenient irrespective of the cost involved. For example, millions of consumers utilize fee-based bank and credit union overdraft protection programs extensively. Their check is covered and the credit extension is made quite conveniently, but the fee for doing so is generally significantly more costly than a payday loan.[114] Consumers who do compare the costs, as well as the convenience, of their options will find that obtaining a payday advance from a regulated lender is not only convenient but often considerably less expensive than many competing alternatives such as overdraft fees, credit card late fees, utility reconnect fees, and NSF and merchant bad-check fees. The following chart illustrates the relative costs of these alternatives:

114. *See* CFA, *supra* note 42.

Figure 1[115]



Given the costs of the likely available options, it is not surprising that millions of consumers choose payday loans to help them address their pressing credit needs. Advance America's belief, based on its extensive experience with its customers, is that most select a cash advance because it is less costly than their other likely available options, and they consider it affordable and most suited to their needs. This is especially true when customers need cash quickly to avoid high NSF, overdraft, and credit card late fees, but it also applies in numerous other situations. Customers are also often influenced to some extent by other factors such as the convenience of being able to obtain a loan promptly in an attractive location, on very understandable terms, with limited simple paperwork, and during hours when other credit sources may not be available. In short, while a payday loan is not the best option for the consumer in some cases, in many

115. Data for this Figure are based on a typical payday advance fee compared to the cost of alternative loan options. Costs for alternative loan options have been derived from CFSAA.com, Stephens, Inc., the Moebs Services 2010 Fee Revenue Study, Bankrate.com, Readex Research National Data on Short-Term Credit Alternatives 2006, and the Moebs Services 2010 Financial Pricing Survey.

others it is, and millions of consumers select it.

VI. Critics' Favorite Attack: "Outrageous" Interest Rates and Excessive Profits

Much of the concern over payday advances has been based on consumer advocacy groups' inflammatory allegations that payday lenders are charging customers exorbitant interest rates, which cause many people to believe lenders are making excessive profits. From the perspective of the payday lending industry, those who make such claims seriously mislead the public and frequently do so intentionally. Payday advance lenders have no doubt that their most vocal critics know that the fees charged for small, short-term cash advances are reasonably priced and are not generating extreme profits. However, these critics continually allege lenders are charging outrageous rates, focusing on the implied annual percentage rate disclosed by lenders, typically a triple-digit number. Such an approach advances their political agenda but misleads many people to immediately think unconscionable fees are being charged.[116]

The misconception stems from a widespread misunderstanding of how the fee charged for a payday advance translates into an APR. The typical one-time, flat fee for a payday advance is $15 per $100 borrowed for a two-week period, which in most cases is the time between customers' paychecks.[117] The total amount a customer will repay for such a loan is $115; they will not pay any interest.

In other words, the stated APR of 391% for a two-week payday advance is not an accurate representation of the cost of an advance. It is an implied, theoretical annual rate for an advance,

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116. Many in the consumer finance industry suspect that the real goal of many advocacy groups that attack payday loans (and often other short-term, small-dollar credit products) is to limit the availability of such products so much that Congress would be forced to pass some type of credit subsidy plan to enable certain lenders (e.g., credit unions) to offer below market rate loans on a mass basis to financially challenged consumers because so many millions of these voters would be desperate for credit availability.

117. InstantLoan, *Rates*, http://instantloan.net/rates.php (last visited Apr. 5, 2012) ("Traditional payday loans work by offering consumers a flat, one-time fee for each $100 they take out. . . . Typical consumers pay between $15 and $18.") (on file with the Washington and Lee Law Review).

and it assumes that payday advances are extended twenty-six times (every two weeks) during a year, with the customer paying a new fee each time.

Table 5

$15 Typical Advance Fee (per $100 Borrowed) **X 26** # of Consecutive 14-day Pay Cycles **=391%** Implied APR

This is a flawed assumption. Consumers generally utilize the service for a relatively short period of time—weeks or months, not years. Furthermore, virtually all state laws prohibit loans from being extended twenty-six times; in fact, such rollovers typically are either prohibited or limited by law to one or two times.[118] Clearly, APR is a more suitable cost measurement of longer term loans, such as mortgages or student loans, and can only be used accurately to compare loans of the same or similar duration.

Critics describe the loan cost in terms of an APR, which distorts the true cost of a payday loan because it makes it appear that the lender is charging an actual interest rate of 391% or more of the amount borrowed.[119] The quick (but quite incorrect) math for many people who are unfamiliar with payday loans and APR calculations is that for a $100 loan for two weeks, a payday lender would charge about $400. If this were true, the fee would be totally unjustifiable and clearly unconscionable. Of course, this is not the case.

The fact that the APR is not an accurate measurement of the cost of short-term credit is widely recognized in the financial services industry. For example, in testimony given in a hearing before the Subcommittee on Financial Institutions and Consumer Credit of the U.S. House of Representatives' Financial Services Committee, witnesses from the American Bankers Association (ABA), the Credit Union National Association, and the

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118. *See, e.g.*, 10 VA. ADMIN. CODE § 5-200-35(B) (2011) ("If a borrower does not obtain an extended payment plan or extended term loan in connection with his fifth payday loan in 180 days, the borrower shall not be eligible for another payday loan until 45 days after . . . the fifth payday loan is paid or otherwise satisfied in full.").

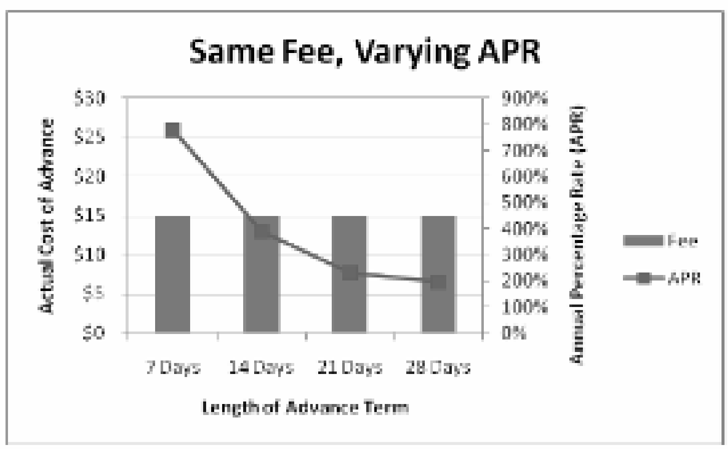
119. An APR calculation can provide a useful comparison tool when evaluating the cost (fees, interest, and other charges) of longer term loans like home mortgages, but Advance America believes that they are extremely misleading when used for short-term, small-dollar loans.

Independent Community Bankers of America, all noted this fact.[120] The ABA testimony, for example, explained:

> Any time an annual percentage rate is calculated for a term less than a year, the inclusion of a fixed fee, even a modest one, will distort and overstate the APR. The shorter the repayment period, the greater the APR will appear in instances where there is a fixed fee. This means that the sooner the consumer repays, the greater the calculated APR—a difficult concept to explain to consumers, as it appears that paying earlier actually increases the cost of credit.[121]

The following chart, based on a typical payday advance fee of $15 per $100 borrowed, illustrates how the same fee of $15 for a payday advance gives a dramatically different APR as the loan term changes:

Figure 2



120. *See H.R. 627, the Credit Cardholders' Bill of Rights Act of 2009; and H.R. 1456, the Consumer Overdraft Protection Fair Practices Act of 2009: Hearing Before the Subcomm. On Fin. Institutions & Consumer Credit of the H. Comm. on Fin. Serv.,* 111th Cong. 84–106, 107–18, 118–25 (2009) (statement of Kenneth J. Clayton, Senior Vice President/General Counsel, American Bankers Association Card Policy Council; statement of Linda Echard, President and CEO, ICBA Bancard, on behalf of the Independent Community Bankers of America; statement of Douglas Fecher, President and CEO, Wright–Patt Credit Union, Inc., on behalf of the Credit Union National Association), *available at* http://financialservices.house.gov/media/file/hearings/111/111-17.pdf.

121. *Id.* at 105 (statement of Kenneth J. Clayton).

It should be noted that although describing payday advance costs in APR terms is politically advantageous to industry critics, these figures are not very helpful to most customers, who find disclosure of the fee as a dollar amount to be much clearer than the confusing, "make-believe" APR figure.[122]

In summary, with respect to rates charged by payday lenders, Advance America feels that critics' emphasis on the implied APR rates of cash advances is quite misleading.[123] It usually causes those who do not use payday loans and who have little understanding of how such APRs are calculated to believe that consumers are being charged incredibly and unjustifiably high actual interest rates. This in turn results in many jumping to the incorrect conclusion that lenders are making excessive profits. On the other hand, consumers who use payday loans understand the cost of the loan in terms of the actual fee charged (even though many appear to be confused by and disregard the APR disclosure), and payday lenders hear no outcry from customers themselves that lenders are making unreasonable profits.

Specifically with regard to payday lenders' profits, Advance America's data illustrate that it makes only reasonable profits, which actually are considerably lower than many other businesses. The company's one-time fees for its cash advances are priced to provide a fair profit after covering the costs of operating more than 2,500 brick-and-mortar loan centers as well as company overhead expenses and the cost of loan losses that occur when some

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122. *See* Edmiston, *supra* note 32, at 65. *See generally* THOMAS A. DURKIN, HARV. JT. CTR. FOR HOUSING STUDIES, SHOULD CONSUMER DISCLOSURES BE UPDATED? (2008), *available at* http://www.jchs.harvard.edu/publications/finance/understanding_consumer_credit/papers/ucc08-10_durkin.pdf (discussing history and issues regarding APR calculations).

123. While Advance America believes that using APRs for short-term credit products is inappropriate, to the extent that an APR calculation is required on any such product it should be required on all such products and should be calculated to include all credit costs. Currently, this is not the case. Banks and credit unions, for example, are not required to disclose the cost of their fee-based overdrafts in APR terms. Similarly, as more credit unions are offering payday loan-like products, they are able to use an understated APR disclosure, which does not include significant fees, that makes it appear their loans are much less expensive than is in fact the case. It would be far clearer to consumers and fairer for competing financial services providers if the total credit costs, including all interest and fees, were required to be disclosed as a total dollar amount and as a percentage of the total amount of credit extended.

individuals do not repay their loans as agreed. The following charts demonstrate that Advance America's profits are clearly reasonable and are well below those of many other corporations:

Table 6

Cost Per $100 Loan Analysis

	Per $100 Loan	% of Revenues
Revenue	$16.00	
Loss rate @ 18.6%	2.98	18.6%
Store operating expenses	9.09	56.8%
Corporate expenses & other	1.73	10.8%
Interest expense	0.13	0.8%
Profit	$2.08	13.0%
Total cost	$13.92	

Source: AEA Company documents, Stephens Inc.

*Loss rate cited is national average loss rate for public payday lending companies.

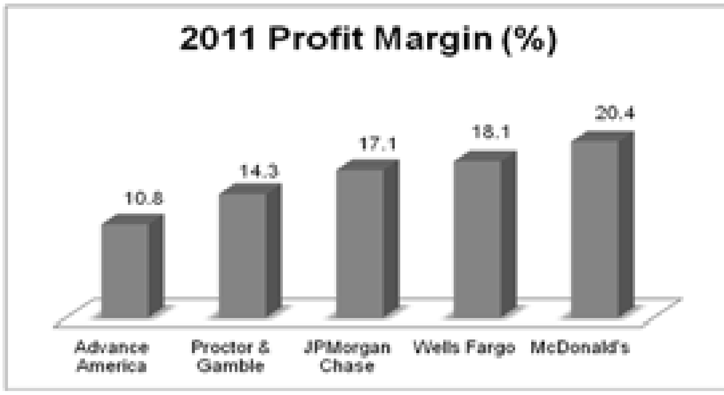
Table 7

Historical Cost Per $100 loan

	Per $100 Loan				
	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Revenue	$16.16	$16.11	$16.66	$15.52	$16.00
Loss Rate*	3.36	3.85	5.03	3.35	2.33
Store operating expenses	8.77	8.87	8.87	8.87	8.39
Corporate expenses & other	1.37	1.42	1.70	1.48	1.78
Interest expense	0.18	0.24	0.26	0.19	0.13
Profit	$2.50	$1.52	$1.20	$2.10	$2.33
Total cost	$13.66	$14.59	$14.46	$13.72	$13.32

[illegible]
[illegible]

Figure 3[124]



In addition to industry data such as that presented above, third-party studies have confirmed that payday lenders are not making excessive profits by charging unfair fees[125]:

> This study finds that the industry's proffered justifications for high service fees, and by extension high APRs, may be justified by both high store expenses and high loan losses. In addition, this study finds that payday lender profit margins are less than half that of their mainstream lending counterparts.
>
> . . . .
>
> These figures indicate that payday lenders are not overly profitable organizations. Contrary to conventional wisdom,

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124. The information in this Figure is derived from each company's publicly available 2011 income statement, which can be found at AOL Daily Finance, www.dailyfinance.com. The calculation used to arrive at these figures for stock symbols AEA, PG, JPM, WFC, and MCD is (Net Income After Taxes ÷ Revenue) x 100 = Net Profit Margin.

125. *See, e.g.*, Mark J. Flannery & Katherine Samolyk*, Payday Lending: Do the Costs Justify the Price?* 21–22 (FDIC Ctr. for Fin. Research, Working Paper No. 2005-09, 2009), *available at* http://www.fdic.gov/bank/analytical/cfr/2005/wp2005/CFRWP_2005-09_Flannery_Samolyk.pdf; *see also* ERNST & YOUNG, THE COST OF PROVIDING PAYDAY LOANS IN A US MULTILINE OPERATOR ENVIRONMENT: A STUDY PREPARED ON BEHALF OF THE FINANCIAL SERVICE CENTERS OF AMERICA 26–27 (Sept. 2009), *available at* http://www.fisca.org/Content/NavigationMenu/Resources/ForMediaPolicymakers/InformationKit/FiSCA_Final_09.03.09_Sent_to_Client.pdf.

> these firms fall far short of profits for mainstream commercial lenders.[126]

It is also quite informative to consider the rate and profit issue in the context of the 36% APR rate cap favored by industry critics and the FDIC. This has been done by Stephens Inc., an independent investment banking firm, as a part of its June 6, 2011 detailed analysis of the payday loan industry. Stephens gives the following analysis using Advance America (AEA) data:

> We looked at AEA's cost structure as a proxy for the industry. AEA's store operating expenses, excluding loan loss provisions, were approximately $138,000 per average store in FY10. In addition, its corporate overhead and interest expense per average store were about $26,000 and $1,900, respectively, for the year. When adding all the costs together and dividing by 12, the average monthly cost to operate a store is around $13,825, which does not include loan losses. Therefore, if losses were zero and assuming the average loan size at $350, AEA would need to make approximately 3,150 loans a month just to break even at 36 percent APR. For the entire year of 2010, the average AEA store wrote about 4,060 loans, or about 338 per month.
>
> Our point of this exercise is to show that at 36 percent APR, it is basically impossible for a storefront lender to make money offering small dollar loans. Storefronts are there for the customer's convenience, but there are significant costs involved. We could include banks in this discussion as well because they would need to cover branch expenses. The reason the payday loan industry originated to begin with was due to traditional banks not making small loans to consumers because it became unprofitable.[127]

VII. "Cycle of Debt" or "Important Debt Management Tool"?

The second overarching contention of the payday lending industry's critics is that payday advances cause consumers to sink into a "cycle of debt" whereby they fall increasingly and hopelessly behind in their financial obligations.[128] In essence, they argue that

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126. Aaron Huckstep, *Payday Lending: Do Outrageous Prices Necessarily Mean Outrageous Profits?*, 12 FORDHAM J. CORP. & FIN. L. 203, 227–28 (2007).

127. STEPHENS INC., PAYDAY LOAN INDUSTRY: INDUSTRY LOOKING MORE ATTRACTIVE AS DEMAND EXPECTED TO INCREASE 23 (2012).

128. *See, e.g.*, Michael Kenneth, *Payday Lending: Can "Reputable" Banks*

financially challenged borrowers would be much better off in dealing with their periodic short-term credit needs if payday loans were prohibited.

Feedback from Advance America customers and supporting data undermine this viewpoint, showing that it is not only wrongheaded; it is patently contrary to reality, common sense, and consumers' best interests. Although some borrowers use payday loans irresponsibly, just as some do with credit cards, overdrafts, and other credit products, the overwhelming majority of cash advance customers use their loans responsibly to manage their financial obligations. Advance America customers report high levels of satisfaction—recent customer feedback surveys found that more than 90% of customers rated the service as good or excellent and 93% said they would consider Advance America in the future.[129] Further, among more than 10 million transactions nationwide, fewer than fifty Advance America customers filed complaints with state agencies in 2010.[130]

These customers' credit needs are immediate and cannot wait for the development of other low-cost credit options at some later point—these consumers need credit, and they need it today. It must also be recognized that their need for supplemental credit is often not an isolated occurrence. In many instances, they will need to utilize payday loans or other small, short-term credit options periodically over a number of months to manage their finances as different needs arise. Thus, the present concern and focus should be on ensuring they have access to as many regulated options for managing their financial difficulties as possible, including payday loans. As has been noted, traditional banks typically do not offer such consumers affordable, unsecured, small personal loans. In addition, the degree to which credit unions will be able to offer lower cost, alternative payday loan products is uncertain. In any case, such loans would not be available to the millions of consumers who are not credit union members.[131] And, while many parties, including payday lenders, are seeking to find ways to

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End Cycles of Debt?, 42 U.S.F. L. REV. 659 (2008), *available at* http://usf.usfca.edu/law/academic/journals/lawreview/printissues/v42i3/SAN303.pdf.

129. Advance America Customer Survey, *supra* note 98.

130. *Id.*

131. *See* STANGO, *supra* note 36.

lower loan costs and to develop innovative credit products, there is no known realistic immediate or near-term scenario where significantly less expensive new products will be available on a large-scale, commercially viable basis. Indeed, a staff report from the Federal Reserve Bank of New York found that "banning payday loans is not, by itself, going to motivate competitors to lower prices or invent new products."[132] Likewise, while credit counseling and consumer financial education efforts can be helpful and should be encouraged, consumer behavior on financial matters cannot reasonably be expected to change significantly enough in the immediate or near term to help but a small fraction of financially challenged consumers secure significantly less costly credit.

In this environment, Advance America and other regulated payday lenders provide millions of consumers with a valuable option—a product that is widely accessible, transparent, affordable, and significantly less costly than the primary alternatives.[133] These are key reasons why consumers choose payday advances and not other less favorable and more costly alternatives. Consumers with limited credit choices are selecting, more frequently than ever, one such less favorable option: obtaining loans from unregulated offshore Internet lenders who charge significantly higher fees than traditional payday lenders. These foreign lenders operate illegally without complying with state and federal consumer protection laws that are followed by legitimate, domestic, regulated payday lenders.[134]

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132. DONALD MORGAN & MICHAEL R. STRAIN, FED. RESERVE BANK OF N.Y., STAFF REPORT NO. 309, PAYDAY HOLIDAY: HOW HOUSEHOLDS FARE AFTER PAYDAY CREDIT BANS 27 (2008), *available at* http://www.newyorkfed.org/research/staff_reports/sr309.pdf. This study concluded: "While our findings contradict the debt trap/addiction hypothesis against payday lending, they are consistent with alternative hypothesis that payday credit is cheaper than the bounce 'protection' that earns millions for credit unions and banks." *Id*. at 26 (citation omitted).

133. When payday loans are not available, some consumers in certain instances will be able to find a relatively inexpensive option (e.g., a low- or no-cost small loan from a friend or family member), but in the vast majority of cases the financially challenged consumer will be forced to choose a credit option that is more costly than a payday loan and therefore more likely to make his or her debt problems worse than would have been the case if the payday loan had been available.

134. Press Release, Fed. Trade Comm'n, FTC Charges Internet Payday Lenders with Failing to Disclose Key Loan Terms and Using Abusive and

The arguments of those who would "protect" financially challenged consumers by denying them access to less costly payday loans make no sense.[135] Giving consumers fewer and more expensive credit alternatives to choose from will clearly worsen their financial situation, and those who are "teetering on the brink" of personal financial disaster will be much more likely to be "pushed over the edge." As Donald Morgan of the Federal Reserve Bank of New York has noted:

> While our findings contradict the debt trap/addiction hypothesis against payday lending, they are consistent with alternative hypothesis that payday credit is cheaper than the bounce "protection" that earns millions for credit unions and banks. Forcing households to replace costly credit with even costlier credit is bound to make them worse off.[136]

By contrast, instead of "trapping" consumers, payday loans provide most individuals with a temporary financial helping hand that gives them a reasonable and affordable opportunity to manage a short-term cash crunch while protecting their credit standing.[137]

Policymakers need to recognize this fact; as the Federal Reserve Bank of New York's Kelly Edmiston has pointed out:

> Policymakers in many states have restricted the practice of payday lending. Critics of the practice claim that payday lenders take advantage of borrowers by charging exorbitant fees and targeting at-risk populations. They also claim that payday lending causes borrowers to fall into debt spirals, which create unmanageable cycles of debt.
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> . . . .
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> The evidence showed that consumers in low-income counties may have limited access to credit in the absence of payday loan options. As a result, they may be forced to seek more costly

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Deceptive Collection Tactics (Nov. 12, 2008), *available at* http://www.ftc.gov/opa/2008/11/cashtoday.shtm.

135. *See* MORGAN & STRAIN, *supra* note 132, at 26 (citation omitted).

136. *Id.* at 28.

137. Naturally, not all payday customers, despite their best efforts, will be able to overcome their financial problems, but most do although it often takes time to do so. About 90% repay their loans on time, but due to their continuing underlying "financially fragile" situation, for a period of time they may well need to obtain additional cash advances to meet either continuing or new expenses. Providing such cash advances is clearly more "pro-consumer" than forcing them to seek more costly credit elsewhere.

> sources of credit. The evidence also showed that, in counties without access to payday lending, consumers have a lower credit standing than consumers in counties with access.
>
> The preponderance of evidence suggests that some consumers will likely face adverse effects if payday lending is restricted.[138]

It is also important to point out that the total annual cost for most customers using payday advances is relatively modest. A typical customer who obtains an average loan of $400 for a fee of $60 about eight times per year will only pay $480 (on a total principal of $3,200) to meet his or her family's year-long needs for such supplemental credit. Yet for this modest cost industry critics would deny customers this credit option and force them to seek more expensive alternatives that will worsen their financial status.

More researchers now appear to be willing to remind critics and policymakers that the benefits of payday lending must be weighed in the ongoing public policy debate, which we believe has all too often been skewed against our industry by biased, one-sided, and paternalistic arguments. Increasingly, academic experts are concluding what Advance America believes is the more enlightened and correct view:

> Lack of access to emergency funds can be detrimental to consumers. For instance, every bounced check can incur substantial fees and impose indirect costs. . . . Bouncing a check may also result in termination of a bank account and even a risk of criminal prosecution, while also damaging the individual's credit score, making subsequent access to credit even more difficult.
>
> Payday loan customers are not fools; they have carefully weighed all of their options and chosen the best alternative they can afford. Payday lending customers choose this financing option over an array of relatively unattractive options, such as pawn shops, bank overdraft protection, credit card cash advances (where available), and informal lenders or loan sharks. For instance, according to a study by the Federal Deposit Insurance Corporation, a customer repaying a $20 debit overdraft in two weeks would incur an average Annual Percentage Risk (APR) of 3,520 percent . . . .
>
> . . . .

138. Edmiston, *supra* note 32, at 83.

> Misguided paternalistic regulation that deprives consumers of access to payday loans is likely to force many of them to turn to even more expensive lenders or to do without emergency funds.[139]

VIII. Conclusion

In our nation's current economic environment, the need for affordable short-term credit is not abating. Indeed, as economic uncertainty and regulatory efforts evolve, the need for such credit is growing as an unprecedented number of Americans are living paycheck to paycheck. Reliable access to credit allows them to manage unexpected or unplanned expenses when they arise.

While some banks and credit unions have begun to offer short-term loans or account advances, most banking institutions do not offer short-term, small-dollar, unsecured personal loans, and many financially challenged consumers cannot qualify for other traditional forms of credit because of their credit records. The short-term bank and credit union programs that do exist are often inaccessible to such consumers due to the various fees and conditions of these services. Despite attempts by regulators and other parties to encourage these institutions to offer such loans at no more than 36% APR, it does not appear that banks can be expected to do so to any significant degree because making the loan would not be profitable. And various other efforts to develop innovative credit programs that can meet these consumers' needs have shown little or no progress.

Existing credit options, therefore, ought to be preserved, not reduced. Regulators, consumer groups, and leaders within the financial services industry must foster the development of services that serve the full breadth of American consumers. One possible solution may be to establish a framework that enables bank and nonbank entities to collaborate on creating a short-term credit continuum. This would facilitate consumers' seamless movement through various credit products and services as appropriate to their specific financial needs and unique situations. Additionally, this arrangement would help migrate higher risk customers from higher

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139. TODD ZYWICKI & ASTRID ARCA, MERCATUS POLICY CTR., THE CASE AGAINST NEW RESTRICTIONS ON PAYDAY LENDING 2 (No. 64, Jan. 2010) (citation omitted), *available at* http://mercatus.org/sites/default/files/publication/MOP64_FMWG_Payday%20Lending_web.pdf.

cost products to prime or near-prime products based on actual repayment experience; it would also combine bank-insured status, which allows providers to offer higher dollar products such as mortgages and business loans, with a nonbank consumer focus, resulting in an innovative product mix.

Such a system would allow unbanked consumers who currently use alternative financial services to move into a mainstream bank or credit union and would allow nondepository lenders to offer more traditional services to accommodate those who prefer nonbank financial services. This system could also help to spur the development of neighborhood financial services centers that would offer check cashing, money transfer, microcredit loans, and prepaid debit cards, along with other secured and unsecured traditional bank products, which would leverage the physical plant cost structure of nonbanks and the cost-of-capital insured status of banks.

In the absence of further innovation, however, financially challenged consumers must still have a variety of credit options available to them, including payday loans. And they deserve a regulatory framework that balances access to credit alternatives with affordability—one that enables consumers to compare financial services and to evaluate them based on the associated costs and consequences. Roughly 19 million consumers obtained payday loans from regulated lenders last year. They benefited from having access to an affordable, cost-competitive, and transparent service—one that is valued by the vast majority of customers. Payday loans provide many consumers with a simple, effective, and affordable means of managing short-term financial difficulties and allow them the chance to work through their problems.

If industry critics succeeded in eliminating payday loans, consumers would be forced to choose less regulated or more expensive credit options or, in some instances, may not be able to obtain credit at all. They may fall behind on bills and other payments, leading to additional fees and penalties or causing the loss of personal property. Consumers do not benefit from such a scenario.

Consumers should be smart about their money and savings. Any form of credit can be abused. But it is time for policymakers and other interested parties to acknowledge that, for millions of financially challenged Americans, payday loans are a sound choice and an effective financial tool for managing short-term financial needs.