Fringe Lending: The Case for a National Minimum Standard

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Abstract

In the American financial sector, the liberalization of usury laws and legal complexity has allowed for controversial fringe financial products to become widely available. Payday loans, car title loans, and short-term, high-interest installment loans, also referred to as fringe loans, have often been classified as "predatory" and unconscionable. The central question in this controversy is whether increased regulation of fringe loans, or their complete prohibition, is effective to protect consumers from a harmful cycle of debt, or whether regulation will cause more harm than good. Since state legislation is ineffective to limit the negative externalities associated with fringe loans, a federal usury law is arguably necessary to provide a unified standard that limits truly predatory loans while providing for consumer choice as the general rule.

Fringe Lending: The Case for a National Minimum Standard

Payday loans are short-term, high-interest loans secured by a post-dated check or electronic access to a borrower's bank account ("Payday, vehicle title, and certain high-cost installment loans", 2018, p. 1852). These loans, a recent introduction to the American finance industry, can provide short-term liquidity for those without access to traditional credit. However, payday loans and similar products have been criticized for allegedly creating a cycle of debt, charging excessive interest and fees, and engaging in deceptive and fraudulent practices. Payday lending is legally controversial throughout the United States. In some states, payday lending is banned entirely, while in other states, it is allowed with few restrictions.

Literature Review

To properly address the controversy surrounding the appropriate policy response to fringe lending, one must understand the characteristics of these controversial loans. In addition, the historical context of legislation surrounding fringe lending, and broader moral and philosophical considerations concerning usury and interest, must be explored. In addition, evaluating the current legal environment in the United States is necessary. This analysis includes a detailed survey of the status quo with respect to fringe lending regulations in all 50 states. Finally, the social effects of access to fringe loans, including potential negative externalities, must be evaluated to craft an effective solution.

Defining Fringe Lending

There are several distinguishing factors which characterize payday lending. First, payday loans are very short-term loans, generally with a repayment term of one pay period, and are single-payment or "balloon" loans. Secondly, payday loans reflect a high rate of interest (Fox, 1999, p. 1-2). Third, payday loans often have a rollover feature, and are not in practice short-

term, single payment loans. The true "debt-trap" which exists in payday loans is attributable largely to this feature, as a payday loan which cannot be immediately repaid can often be rolled over into a new payday loan, and the interest can quickly compound even over relatively short periods of time due to the high interest rate. Some sources have estimated that approximately 80 percent of payday loans are rolled over (Barth et al., 2016, p. 17).

However, payday loans are only one type of financial product within the broader category of fringe lending. These non-traditional loans are typically issued by non-bank financial institutions and taken out by borrowers with lower incomes and poorer credit histories. While payday loans are the most known type of fringe loans, other financial products have similar features, such as car title loans, pawn shop loans, and high-cost hybrid installment loans (Consumer Financial Protection Bureau, 2017). A 2022 report from the Center for Responsible Lending, which advocates for increased regulation of payday loans, identified the negative characteristics of a payday or car title loan as "a lack of underwriting; access to a borrower's bank account or car as security; structures that make it difficult for borrowers to make progress repaying; excessive rates and fees; and a tendency toward loan-flipping or stressed re-borrowing" (Glottmann et al., 2022, p. 1). Some of these characteristics are quite subjective and therefore difficult to quantify. Nevertheless, state and federal legislation typically singles out short-term loans with annual interest above 36 percent for additional regulation or prohibition (Consumer Financial Protection Bureau, 2017). These loans are referred to as "fringe loans."

Car title loans share many of the controversial features of payday loans. Like payday loans, they are intended for poorer borrowers. However, while payday loans are unsecured, car title loans are secured by the title to a vehicle. Therefore, title loans generally have slightly lower – but still very high – APRs when compared to payday loans. However, because title loans are

secured by the borrower's personal vehicle, borrowers potentially face the loss of reliable transportation in the event of a default (Federal Trade Commission Consumer Advice, 2023).

Pawn shops are a more traditional form of small-dollar lending for low-income borrowers with poor credit. Pawn shops offer loans backed by tangible personal property which the pawn shop takes physical possession of. If the loan is repaid, the pawn shop returns the property which has been pawned, but in the event of a default, the pawn shop takes ownership of the personal property as repayment of the loan (IBISWorld, 2023, p. 63). Like payday lenders, pawn shops charge very high effective APRs. However, pawn shops typically do not cause a cycle of debt in the same manner as payday loans, because the maximum liability of the borrower is limited to the value of the personal property placed as collateral. The pawn shop may seize the collateral, effectively purchasing it at a deep discount, but may not pursue the borrower for additional interest or fees (IBISWorld, 2023, p. 29). In addition, pawn shop loans are not reported to credit bureaus if not repaid, as the pawnbroker's retention of the collateral is equivalent to repayment of the loan (Egan, 2021).

A traditional payday loan involves a single balloon payment. However, "high-cost installment loans" (the term used by the Consumer Financial Protection Bureau) are a hybrid product that involves similar interest rates to payday loans, but over a longer repayment period. Payday installment loans are payday loans which are repaid over multiple subsequent paydays (Consumer Financial Protection Bureau, 2017, p. 54475). In addition, non-bank finance companies offer longer-term installment loans with somewhat lower annualized interest rates when compared to payday loans. The Consumer Financial Protection Bureau found that APRs on such installment loans range from 50 to 90 percent for subprime borrowers in states without rate caps, and 24 to 36 percent in states with rate caps (Consumer Financial Protection Bureau, 2017,

p. 54498). These installment loans are sometimes structured as lines of credit or "flex-pay" loans (Consumer Financial Protection Bureau, 2017). The distinguishing factor of "high-cost installment loans" is that the APR is considerably above the 36 percent threshold, and the loans are short-term loans which involve electronic access to the borrower's checking account.

Historical Context: Interest and Usury

Lending and interest predated modern capitalism (Homer and Sylla, 2005). The Code of Hammurabi included numerous regulations of interest rates and the form and conditions of loans. Hammurabi's Code limited annual interest rates to between 20 and 33 percent, and loans which reflected unlawfully high interest rates were cancelled (Homer and Sylla, 2005, p. 3). Debt slavery was permitted but restricted to three years (Homer and Sylla, 2005, p. 3). In ancient Greece, the laws of Solon eliminated all caps on the legal rate of interest – but also eliminated debt slavery and provided for the full or partial cancellation of many debts (Homer and Sylla, 2005, p. 3) In ancient Rome, lending at interest was socially stigmatized. The Twelve Tables set a maximum legal limit of 8.3 percent annual interest (Homer and Sylla, 2005, p. 45). However, as in Greece, debt slavery was permitted (Homer and Sylla, 2005, p. 4). Over time, debt cancellation recurred as a topic of political debate in Rome. Periodic laws passed in response to economic, agricultural, and/or military crises allowed for the readjustment of loans (Homer and Sylla, 2005, p. 45).

Until the Enlightenment, Western culture stigmatized lending at interest. The early church prohibited clergy from lending at interest at the Council of Nicaea, and in the eighth century this prohibition was formally expanded to include all Christians (Murro, 2011, p. 4). This remained the universally accepted position of the church throughout the medieval period, and was reflected in secular legislation (Murro, 2011). Some argue it is the Reformation that

changed the West's view of usury. This is not accurate – even the Reformers who argued that all interest was not immoral maintained that it should remain tightly regulated. The concept of some level of interest or compensation for making a loan was not new. It was not the Reformation, but the Enlightenment, which marked a fundamental shift in the Western view of usury (Bradley, 2020, p. 14). Murro (2011) characterizes the idea that the Reformation rejected the traditional usury doctrine as an "enduring myth" (p. 4).

As a representative example, Swiss Reformer John Calvin (1556/1991) argued that some forms of lending at interest were morally permissible and dismissed the traditional Aristotelian view that interest was unnatural. However, he stated that lending at interest to the poor was always forbidden and listed seven qualifications to any form of lending at interest. Calvin also assumed that the state would tightly regulate interest rates (Calvin, 1564/1991, p. 142). Also, within the Reformed tradition, Question 142 of the Westminster Larger Catechism lists "usury" as a sin forbidden by the Eighth Commandment. However, usury is not defined within the catechism, leaving the question open as to whether this term means all interest or excessive interest charged to the poor ("Westminster Larger Catechism," 2022, p. 385).

While the Reformed tradition was far from economically liberal, it had the most permissive view towards usury. In contrast to Calvin's cautious acceptance of interest in certain circumstances, Martin Luther argued that all interest was morally forbidden, although his reasons were somewhat distinct from the Roman Catholic Scholastics, as they were grounded in Scripture instead of the intricate philosophical arguments of the Scholastics (Singleton, 2009, p. 11). In fact, Luther rejected many of the Scholastic qualifications to the traditional usury doctrine as legalistic loopholes (Singleton, 2009, p. 3-4). Because he rejected all exceptions or qualifications to the traditional view of usury, Luther was if anything more conservative than his

Roman Catholic contemporaries with respect to usury. The Radical Reformers, or Anabaptists, also advocated for the complete abolition of usury (Singleton, 2009, p. 12). Whether it was the Lutherans and the Anabaptists who forbade all lending at interest, or the Reformed tradition which permitted commercial lending at interest with extensive qualifications, the Reformation did not introduce any fundamentally new view of the issue in the Western tradition, although it may have modified the traditional reasoning for its conclusion. It was the Enlightenment, not the Reformation, which would begin to change the West's view of usury.

While classical liberal political philosopher and economist Adam Smith argued for a five-percent interest rate cap in England (Persky, 2007, p. 228), more radical Enlightenment philosophers John Stuart Mill and Jeremy Bentham argued against the entire concept of usury laws. Mill characterized the stigma attached to usury as a "religious superstition" (Rockhoff, 2003, p. 7). Later, G.K. Chesterton argued that Enlightenment philosopher Jeremy Bentham, a committed utilitarian, publishing *A Defense of Usury* marked "the beginning of the modern world" (Persky, 2007, p. 228). Chesterton claimed that the acceptance of usury corresponded with the replacement of the medieval world based on covenant and reciprocal relationships based on personal loyalty and duty with an impersonal world based on contract (Persky, 2007, p. 233). The Enlightenment inaugurated the fundamental shift in the view of interest and usury which would play out in the United States during the twentieth century.

American Society and Usury Laws

Legislation in the colonial era significantly restricted legal interest rates. At the time of the American founding, all states had imposed strict usury caps limiting interest rates (Homer & Sylla, 2005, p. 4). However, the effectiveness of such laws varied. In practice, the market time value of money still applied, and therefore both borrowers and lenders looked for ways to

supersede the price controls. One of the devices used to evade colonial usury laws was the time-price sale, in which a seller would offer an interest-free installment plan, but increase the price of the product if credit was used (Hamilton, 1980). In the United States, usury laws were retained for longer than in Europe, which Rockhoff (2003) attributes to the greater influence of Christian "fundamentalism" (p. 6). However, usury laws were liberalized across the country in the early twentieth century as most states passed the Uniform Small Loan Law, a product of the Progressive Era, which allowed for interest rates of between 24 and 48 percent to be charged on small loans (Hamilton, 1980). However, it would not be until the late twentieth century that interest rates would be almost entirely deregulated across the United States (Sherman, 2009, p. 5). Payday lending in particular is a relatively recent introduction to the American financial sector and did not become widespread until the early 1990s as a result of this wave of financial deregulation (Pew Charitable Trusts, 2012).

Today, most stigma associated with consumer debt has been eliminated. This process mostly took place in the twentieth century. While debt has always existed, modern American society encourages large amounts of consumer debt. Credit card debt, student loan debt, and auto loan debt are all at or near record highs (Richter, 2023). To be clear, this cannot be attributed to changes in the law, rather, changes in cultural and economic conditions are primarily responsible for changes in the law. New fintech companies Affirm and Klarma now offer financing of virtually every purchase. Internet-based lenders even have offered financing for purchasing a pizza (Cooke, 2022).

Moral and Philosophical Issues

The Bible condemns lending at interest in many circumstances. The Law of Moses prohibits charging interest to fellow Israelites (Deuteronomy 23:19-20, English Standard

Version, 2001/2016). The Law of Moses also required the cancellation of all debts every seven years (Deuteronomy 15:1). However, these requirements were limited to the land of Israel, and did not apply to foreigners living outside of Israel. Outside of the Law of Moses, the Bible repeatedly describes lending money at interest in a negative way (e.g. Psalm 15:5, Proverbs 28:8, Ezekiel 18:13). However, all interest is not directly forbidden, only interest charged to fellow Israelites or the poor.

The traditional view that usury can be defined as all loans at any rate of interest has the advantage of simplicity. However, proponents of this view cannot adequately explain why the Old Testament permitted interest on some loans: just not loans to fellow Israelites, or perhaps specifically poor Israelites. It is therefore likely that the prohibition on charging interest was intended to promote a spirit of charity and social cohesion and to avoid the abuse of the natural hierarchies that develop in society. For these reasons, Calvin's view that the charging of interest is morally wrong when it displays a lack of charity appears to be the most persuasive (Calvin, 1564/1991, p. 142). Therefore, there is a moral distinction to be made between a corporate bond and a payday loan issued at 500 percent APR to a poor family.

The Christian church has historically stigmatized lending at interest due to both interpretations of Scripture and natural law (Murro, 2011). The natural law argument against the charging of interest was first clearly articulated by Plato and Aristotle, who argued that money by nature is "barren", a medium of exchange and not a productive asset, and therefore to attempt to multiply money by interest is an unnatural act (Rockhoff, 2003, p. 6-7). Following Aristotle, medieval theologian Thomas Aquinas developed a systematic natural law argument against usury (Murro, 2011, p. 6). However, Aquinas distinguished carefully between unnatural interest and permissible fees. Aquinas argued that compensation for actual loss, opportunity cost or

“cessation of gain”, and failure to pay on time was morally permissible. This second category, known as *lucrum cessans* compensation, was only hesitantly allowed by Aquinas (Rockhoff, 2003, p. 6).

However, extending Aquinas’s logic appears to unravel most of the theory, as the time value of money is essentially the opportunity cost or *lucrum cessans*, and the “actual loss” would clearly include things like the lender’s business expenses. In a debt instrument, the market interest rate reflects the time value of money in addition to repayment risk, lending expenses, and profit (the income earned by the lender). Therefore, there does not appear to be anything “unnatural” about lending money for interest as a category. This does not mean that lending money at interest can never be immoral, however, as reflected by the many Biblical passages that condemn it in circumstances when it constitutes a lack of charity or oppression of the poor. However, as a commercial transaction, a debt instrument is not inherently immoral.

For the previously stated reasons, it appears clear that the practices of payday lenders are generally morally wrong. However, not all morally wrong practices necessarily must be prohibited by human law. The biblical teaching regarding the role of civil government is stated most clearly in Romans 13:1-7, which describes the institution of government as a minister of God, sent to punish evil and promote good. However, not every sin or undesirable practice should be prohibited by law. At times banning an evil by force of law could be imprudent. The Old Testament civil law itself regulates, but does not directly prohibit, practices such as slavery (Exodus 21:1-11). Therefore, there is a distinction between morally permissible loans, morally questionable or immoral loans that would nevertheless be imprudent to outlaw due to potential unintended consequences, and unconscionable or fraudulent loans. This third category encompasses loans that should not be condoned or recognized by the law, or “predatory loans.”

The central question, therefore, is whether fringe loans fall in the second or the third of those three categories.

Fringe Lending in the United States: The Status Quo

In the United States, most laws concerning fringe lending are determined at the state level. States have arrived at different results through their legislative processes, and the legal environment in the United States is constantly changing as new laws are adopted or repealed. Rate caps have consistently won broad public support in referendums. Polls also show strong support for rate caps on fringe loans (Lake Research Partners, 2022). These polls consistently show that this support crosses ideological and demographic lines. But while the public is uniformly in favor of tight regulations on interest rates, professional economists are more divided. Among economic experts, “33 percent agreed that a payday loan ban would make consumers better off, while 25 percent disagreed, and 37 percent were uncertain” (Allcott et al., 2021).

Background Legal Issues

Regulations of fringe lending are largely determined at the state level. State laws differ, but in many states, payday lenders historically operated in legal gray areas under the legal argument that their services are simply a form of advance check cashing. However, even in states where they are legal, payday loans have been ruled to be a form of credit, not another financial service, and therefore subject to state usury laws. (Fox, 1999, p. 2-3). Today, this legal strategy has generally been replaced with a more open presentation due to evolving regulations and the continued liberalization of state usury laws.

While many states restrict fringe lending, these laws are limited in their effectiveness due to a 1978 Supreme Court ruling which interpreted the National Banking Act to prohibit states

from enforcing usury laws against federally chartered out-of-state banks (*Marquette Nat. Bank v. First of Omaha Svc. Corp*, 1978). According to this ruling, a nationally chartered bank can charge interest at whatever rate is permitted by federal laws as well as the laws of the state in which it is located, including to residents of other states. This ruling has allowed fringe lenders to affiliate themselves with nationally chartered banks and claim the same legal immunity from state regulation. This controversial legal theory has been characterized as "exportation" by advocates of tighter regulation, such as the Consumer Federation of America (Fox, 1999, p. 9).

However, the *Marquette National Bank* ruling only applies to federally chartered banks, not to other financial institutions. Fringe loans are usually issued by non-bank financial institutions. These entities lack the protection of the National Banking Act's "safe harbor" provision, and can be freely regulated according to the local laws of whatever states they operate in. States are also typically permitted to regulate out-of-state *online* lenders (Consumer Federation of America, 2010). This has partially preserved the effectiveness of state fringe lending regulation. However, due to the *Marquette National Bank* ruling, states cannot regulate out-of-state federally chartered banks, and therefore fringe lenders can still attempt to avoid regulations by affiliating themselves with federally chartered banks. By forming a partnership with a federally chartered bank or other financial institution, a fringe lender can freely operate in other states regardless of local legislation (Fox, 1999, p. 9).

Since money can freely travel across state lines, the lack of clear federal regulation can create a "race to the bottom" between states. States have little incentive to spend political capital on regulating fringe lending within a state if online lenders can continue to lend to state residents regardless of what action is taken. Another legal loophole used to evade state usury laws is fringe lenders affiliating with American Indian tribes. Since tribes are legally sovereign entities,

internet-based lenders collaborate with tribes to establish tribal shell corporations (Zieve et al., 2023). These internet-based payday and installment lenders use tribal sovereignty and sovereign immunity to avoid state regulations and legal liability. This also makes it more difficult for borrowers to utilize bankruptcy protection, as American Indian tribes are legally considered governmental entities, and therefore the execution of a debt owed to them is not automatically stayed upon a bankruptcy filing (Zieve et al, 2023). The legality of this arrangement depends on the degree to which the tribe is involved with the venture. If the tribe bears a meaningful amount of the "economic risk and benefits" of the venture, the arrangement may be legal. (Zieve et al., 2023, p. 17). However, if the connection is entirely spurious, courts will rule against the lenders and criminal liability is possible.

Current State Legislation

The table in Appendix A contains the laws currently in effect (as of December 2023) in all 50 states. States with "high regulations" had interest rate caps of 36 percent or lower, which effectively banned most traditional payday and title loans, as well as hybrid payday installment loans and payday lines of credit. Two states directly prohibit payday lending (Connecticut and West Virginia) regardless of the interest rate or fees. States with "moderate regulations" either ban payday loans but allow title loans and other similar products (e.g. Georgia) or have some meaningful restrictions such as prohibitions of rollovers. States with "low regulations" had no significant state-level restrictions. States may be classified in this category if they have an interest rate cap which is high enough to allow traditional payday lending at APRs of approximately three hundred percent or higher.

Figure 1 (Below) was created based on the data in the table and demonstrates levels of regulation of payday lending and similar consumer credit by state.

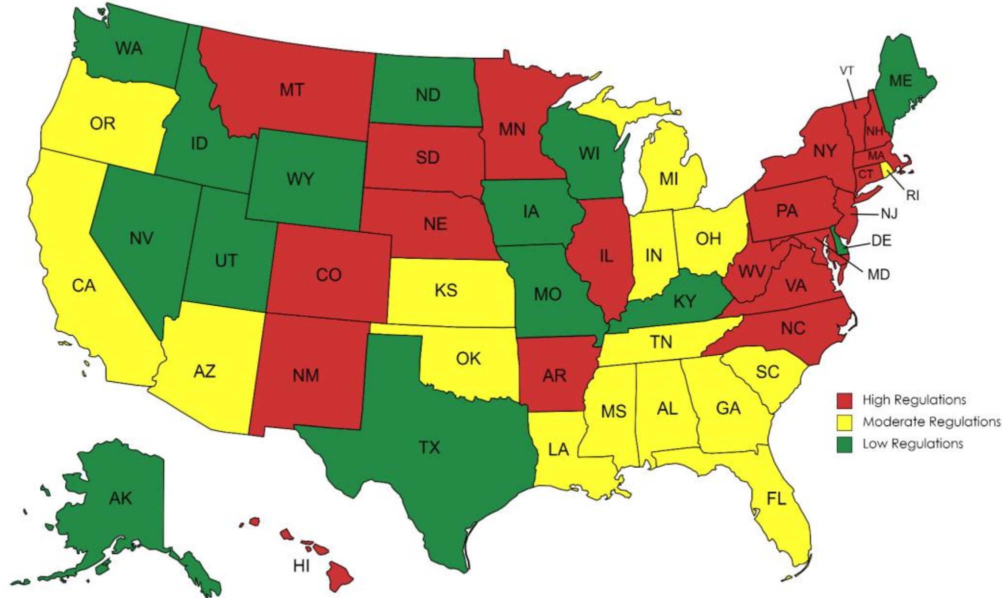


***Figure 1**. Fringe Lending Regulations by State* [1]

In summary, the strictest states impose a usury cap of 36 percent or less, or directly ban the practice of payday lending (Connecticut and West Virginia). In these states, no fringe loans are legally offered. Most states impose some nominal usury cap on payday loans. However, in most cases, these caps still allow triple-digit effective APRs. In addition, most states impose some form of restrictions on rollovers. Only twelve states impose no restrictions on rollovers (Alaska, Idaho, Iowa, Kentucky, Maine, Nevada, Ohio, Oregon, Texas, Utah, Washington, and Wyoming). In addition, six rollovers are permitted in Missouri, and four in Delaware. However, rollover restrictions can be ineffective, as another loan, technically a "new loan," can be issued; a practice legally distinct from rolling over or refinancing the same loan. Most states also restrict the number of outstanding loans.

[1] Image created by the author based on the table of state regulations.

Sixteen states require payday lenders to offer extended repayment plans (Consumer Financial Protection Bureau, 2022). An extended repayment plan involves the refinancing of a payday loan as a longer-term installment loan, to be repaid over several months. However, these programs are rarely used due to a combination of factors, such as limited knowledge and restrictions on eligibility. Usage rates for extended repayment programs range from 0.4 percent in Florida to 13 percent in Washington State (Consumer Financial Protection Bureau, 2022).

In the United States, there is no relationship between fringe lending regulations and rates of poverty. The most recent poverty data is available from the U.S. Census Bureau, published in September 2023, and covers 2022 (U.S. Census Bureau, 2023). Figure 2 (below) contains average poverty rates by levels of fringe lending in regulation (see Appendix A and Figure 1 for individual state classifications).

Regulation Level	Average Poverty Rate
Low	10.3%
Moderate	12.6%
High	10.5%
Total	**11.1%**

Figure 2. *Average Poverty Rate by Fringe Regulation Level*

There appears to be no relationship between levels of regulation of fringe lending and poverty rates. Therefore, there is likely no relationship between fringe lending and poverty rates at the societal level. In addition, there are little differences between similar states with vastly different regulatory regimes. North Dakota and South Dakota have poverty rates of 9.6 percent

and 9.7 percent respectively, and yet while North Dakota has light regulations of fringe lending, South Dakota effectively prohibits payday and title lending via a 36 percent APR cap (Consumer Federation of America, 2023). However, while fringe lending may not have large macroeconomic effects, there could still be social costs of such loans that a low-resolution macroeconomic analysis may not capture.

Social Effects of Fringe Lending

Barth et al. (2016) found that payday lending is more common in states with less restrictive laws (p. 15). This conclusion should seem like common sense. However, more importantly, based on the results of this study, approximately 80 percent of loans are renewed with another loan within fourteen days (Barth et al., 2016, p. 17). Most payday loans are therefore not short-term, one-time loans; they can create a cycle of debt.

Access to payday lending has been shown to harm job performance, specifically in the military. Carrell & Zimnam (2014) found that access to payday lending negatively impacted military job performance and readiness. This was specifically shown in a reduced likelihood to re-enlist, and increased likelihood of sanctions for poor performance (Carell & Zinman, 2014, p. 2808). In addition, access to legal payday loans was linked to financial distress and severe misconduct for Air Force members (Carrell & Zinman, 2014, p. 2830). Carell and Zinman concluded that the most reasonable conclusion given the data was that borrowing led to "financial distress or distraction" (Carrell & Zinman, 2014, p. 2831). In contrast, a 2020 study found no short-term or long-term correlation between bankruptcy filings and new payday loan bans (Dasgupta & Mason, 2020). Likewise, Bhutta et al. (2016) found that consumers generally switch to other forms of high-interest credit if payday loans are banned, such as pawn shop loans (p. 257). However, since pawn shop loans lack a rollover feature like payday loans and limit

consumer liability to the value of the collateral, pawn shop loans may still be a preferable option when compared to payday loans.

Perhaps the most revealing study on the effect of payday lending was performed by Cuffe and Gibbs (2017). Cuffe and Gibbs found that when states restricted payday lending, personal expenditures on alcohol decreased, and more importantly, that the effect was significantly magnified at liquor stores located in close proximity to payday loan storefronts. The authors identified a statistically significant relationship between payday lending access and the purchase of alcohol (Cuffe & Gibbs, 2017, p. 132). In addition, the authors argued that payday lending is often unproductive and is harmful to public health (Cuffe & Gibbs, 2017, p. 132). Cuffe & Gibbs (2017) concluded that “economic theories of time inconsistency and impulsivity underlie some payday loan use” (p. 142).

Along similar lines, Lu (2020) found that there was a statistically significant correlation between new payday loan bans and reductions in suicide and fatal drug overdoses. According to the statistical model, restrictions on payday loans potentially reduce suicide rates by 2.1 percent and fatal drug overdoses by 8.3 percent (Lu, 2020, p. 3). Access to payday loans therefore creates negative externalities (Lu, 2020, p. 26). Likewise, Ma (2021) found that, even after adjustments for demographic and economic changes, access to payday lending was linked to higher opioid overdose death rates (p. 1). Importantly, differences across states were not evaluated to produce this result; instead, legal changes within the same state were evaluated (p. 3-4). This means that cultural, economic, or social differences between states could not account for the correlation because the trend within a state, not between different states, was evaluated.

Is Payday Lending Inherently Predatory?

Defining a “predatory loan” is difficult. Market interest rates can fluctuate based on a variety of factors. Therefore, there is no bright-line distinction based on interest rates that distinguishes a predatory loan from a non-predatory loan. In a traditional loan, the interest rate compensates for three primary costs or risks borne by the lender: (1) the time value of money, (2) lending expenses, including the income of the lender, and (3) the repayment risk. Traditionally, repayment risk is part of the cost of doing business and leads to a higher interest rate; the lender wants the loan to be repaid. If payday lenders operate in a different way, there is a strong case for legally treating payday loans, and fringe loans which share many features, differently.

The Debt-Trap Business Model

There is a compelling case to be made that a distinguishing factor between traditional lending and payday lending is that the risk that the loan is not repaid is a cost of doing business for a traditional lender, but for a payday lender, it is the desired result; the payday lender benefits when a debtor cannot repay their debt due to the rollover feature, which is utilized in some form in 80 percent of cases (Barth et al., 2016, p. 17). Payday lenders also challenged regulations requiring them to verify borrowers’ ability to repay. According to a *Harvard Law Review* article, payday lenders consider a lack of underwriting to be a significant competitive advantage (“Payday, vehicle title, and certain high-cost installment loans,” 2018, p. 1858). Therefore, the lack of underwriting is a *feature* of payday lending, not an *abuse* of payday lending, which puts these loans in a different category when compared to many other financial products (Consumer Financial Protection Bureau, 2017).

ACE Cash Express is one of the largest providers of fringe loans. In 2022, there were 979 ACE Cash Express locations in the United States (Consumer Financial Protection Bureau, 2022). ACE’s parent company, Populus Financial Group, generated $1.5 billion in annual revenue

(Console, 2023). Its CEO is commonly quoted in newspaper and magazine articles in defense of the fringe lending industry. Therefore, its practices do not reflect isolated abuses by individual lenders, but industry standard practices. In a page from an internal training manual provided for ACE Cash Express employees [Appendix B], ACE described its own business model as a cycle of debt (Consumer Financial Protection Bureau, 2014). The diagram was entitled “The Loan Process,” and displayed a circular process, with the following steps. According to the ACE training manual, first, “[t]he customer applies for a short-term loan at an ACE location”, which is then approved. Then “[t]he customer exhausts the cash and does not have the ability to pay.” After this, “ACE contacts the customer for payment or offers the option to refinance or extend the loan.” However, “[t]he customer does not make a payment and the account enters collections.” Then, the circular diagram has returned to the starting point and begins again, with another loan being made to the same consumer (Consumer Financial Protection Bureau, 2014).

Based on its own internal documents, ACE Cash Express’s business model depicts a customer who defaults on an ACE Cash Express loan being approved for another loan from ACE Cash Express while the first loan is in collections. A creditor benefiting from a debtor defaulting on a loan may seem counterintuitive or even unreasonable. Perhaps the training manual was simply unclear and intended to depict the process beginning again with a new loan to a new borrower, although court records do not reflect ACE Cash Express ever asserting that the training manual’s intent was mischaracterized. However, the rollover feature is the key to this aspect of the payday lending industry. A borrower without the means to repay a loan can choose between bankruptcy and paying a fee to roll over the loan. This repeated process can leave borrowers in a cycle of debt, as fees and accrued interest are capitalized and quickly compound at triple-digit APRs (Consumer Financial Protection Bureau, 2014).

Alternative Policy Responses to Fringe Lending

In addition to the policies that many states have implemented [See Appendix A], some authors and political figures have proposed other policies in response to the problems in the fringe lending industry. The alternative proposals that will be evaluated are publicly funded personal loans, including postal banking and universal service, and the regulations passed in 2017 by the Consumer Financial Protection Bureau, which include mandatory underwriting.

Publicly Funded Personal Loans: A Viable Option?

Advocates of publicly funded personal loans agree that fringe loans are harmful to consumers. However, they also assert that banning fringe lending would reduce access to consumer credit and harm borrowers (McLeod, 2020). To reduce harmful fringe loans while not reducing access to credit, these individuals propose that the federal government should either provide or underwrite small-dollar loans to borrowers with high credit risk. There are two variations of this proposal: postal banking and universal service.

The Postal Banking Act of 2020, introduced by Senators Kirsten Gillibrand and Bernie Sanders, would require that the United States Postal Service provide various financial services including small-dollar loans, checking and savings accounts, debit cards, and check cashing (White, 2020). Under this proposal, small-dollar loans would be offered in amounts up to $500 per loan, or $1,000 per year in total, at a highly subsidized interest rate equivalent to the one-month Treasury bill yield (Gillibrand & Sanders, 2020).

Offering a different solution, a 2020 *George Mason Law Review* article proposes a “universal service fund”. Under this policy, banks would be taxed in proportion to their revenue to establish and maintain a designated fund which would be used to provide subsidized personal loans to low-income and low-credit borrowers, underwritten by private banks (McLeod, 2020, p.

644). Under this proposal, the transaction costs of the loan would be subsidized by the federal government, and the loans would also be guaranteed by the federal government. In the event of a default, the lender would be reimbursed for all principal and interest by the federal government, and the U.S. Treasury would attempt to collect the debt (McLeod, 2020, p. 647).

Both variations of this proposal have significant flaws. The underlying assumptions are often unrealistic. Gillibrand and Sanders (2020) argue that the one-month Treasury rate should be “good enough for any American”. However, no Americans, even those with the best credit, pay the one-month Treasury rate on any loan. This rate would be so heavily subsidized that it would create substantial market distortions and require substantial spending on the program. While Gillibrand and Sanders estimate an annual increase of $9 billion in revenue for the USPS, even if this is an accurate estimate, it completely neglects the costs associated with the program (Gillibrand and Sanders, 2020).

Additionally, publicly funded personal loans would create direct competition between a heavily subsidized government program and private companies which may have otherwise established suitable competition to fringe lenders. This market distortion is likely to create significant unintended consequences. Finally, both versions of this proposal create a moral hazard, especially the loan-guarantee proposal. Lenders will have no incentive to verify a borrower’s ability to repay if the principal and interest is guaranteed by the federal government. If default rates are higher than expected, the program would be far more expensive than initially expected, like the federal student loan program, which lost the federal government tens of billions of dollars per year even prior to recent changes (Cooper, 2016).

2017 CFPB Rules

In 2017, the Consumer Financial Protection Bureau established new regulations on fringe loans, including payday loans, car title loans, and high-cost (hybrid) installment loans (Consumer Financial Protection Bureau, 2017). These rules did not implement a direct rate cap but did implement several additional regulations. The primary regulation implemented through the 2017 rules was the ability to repay rule, which was also the aspect of the rules which payday lenders most strongly opposed. Under the 2017 rule, lenders were required to verify borrowers' monthly income, monthly expenses, and debt-to-income ratio (Consumer Financial Protection Bureau, 2017, p. 54473). In addition, lenders were prohibited from attempting to withdraw funds from a consumer's checking account if two previous attempts had failed due to non-sufficient funds (Consumer Financial Protection Bureau, 2017, p. 54473). Finally, lenders were required to submit information about outstanding loans to a consumer reporting/information system (Consumer Financial Protection Bureau, 2017, p. 54473-74).

In 2020, the CFPB revoked the mandatory underwriting provision, which was the most substantial portion of the regulation (Cooper, 2020). However, the implementation of the other two regulations implemented by the CFPB has been stayed by a Fifth Circuit Court of Appeals ruling related to the funding structure of the CFPB. This ruling was appealed to the United States Supreme Court and is currently under consideration in the current (2023-2024) court term (*Consumer Financial Protection Bureau v. Community Financial Services Association of America*, 2023). The merits of the rule itself are not in question, only whether the Consumer Financial Protection Bureau is constitutional in its current form.

While the 2017 CFPB rules are reasonable, reinstating them is neither superior to nor a substitute for the policy proposal below. First, action taken by the CFPB is less likely to create certainty within the industry, because (1) the constitutionality of the CFPB is questionable, (2) an

action taken by an executive agency can be more easily reversed, and (3) the CFPB lacks enforcement mechanisms and full legislative power. Secondly, the rules do not go far enough in substantively regulating the loan conditions themselves, and they allow for "ability to repay" to be verified based solely on the borrower's personal statement. Therefore, while the proposal would incorporate the mandatory underwriting provision, it would provide a more comprehensive framework, and would take the form of a statute, not an administrative rule.

Policy Proposal: National Standards for Fringe Lending

Based on the literature review and statistical analysis, at a minimum, fringe lending regulations are not detrimental to society. In addition, payday loans and comparable products are clearly predatory loans because they are issued without consideration of the borrower's ability to repay and because increased access to payday loans is linked to negative externalities such as unemployment and abuse of alcohol (Cuffe & Gibbs, 2017; Carrell & Zinman, 2014). Finally, it is evident that a patchwork of federal and state laws leaves many legal uncertainties surrounding fringe lending in the United States, and that internet-based lenders, as well as the *Marquette National Bank* ruling, undermine the ability of states to properly address fringe loans.

The U.S. Constitution grants the federal government authority to regulate interstate commerce (U.S. Const. art. I, § 8). A federal law is necessary to provide a consistent national standard, prevent the circumvention of state usury laws, and prevent a "race to the bottom". A national usury law would be modeled on Virginia's 2020 Fairness in Lending Act and would impose rate caps that differ based on the time and duration of the loan. Therefore, a two-week loan could contain a higher annualized interest rate to compensate for the fixed cost of making the loan. A 36 percent annual interest rate cap could be considered, together with an allowance for fixed fees to cover the lender's fixed cost. The permissible fixed fees are to be modeled on

Virginia's lending regulations and would be indexed for inflation annually (Pew Charitable Trusts, 2020). Importantly, compounding these fees would not be permitted. In addition, this national law would incorporate the 2017 CFPB regulations concerning mandatory underwriting and codify the other elements of this regulation which were retained in 2020. Loans made in violation of these laws would be unenforceable, and failure to pay such unlawful loans could not be reported to a credit bureau.

The implementation of this legislation would take place in two phases. The 2017 CFPB regulation was effective January 16, 2018 (Consumer Financial Protection Bureau, 2017), and fully enforceable in 2019. As a general principle, a 9 to 18-month timeline seems ideal for this type of undertaking. Therefore, the underwriting and bank account access portions of this legislation would be implemented beginning on November 2, 2024, and all aspects of the legislation would be fully enforceable as of May 24, 2025. This would give adequate time for compliance, resolution of any legal challenges, and public engagement.

Answering Objections to Restricting Fringe Loans

Additional regulations on fringe loans, while broadly popular, are not entirely uncontroversial. Professional economists are closely divided on the question of banning payday loans (Allcott et al., 2021). While there is some merit to many of the objections to restricting fringe loans, on balance, there is persuasive evidence that fringe loans harm consumers and are inherently predatory.

Consumer Choice

The most basic objection to restrictions on fringe loans is that individuals voluntarily choose to enter into these arrangements, and that the law should not restrict such personal decisions. Writing for the libertarian Foundation for Economic Education, economist George C.

Leef asserts the following as axiomatic: “You can’t make people better off by taking options away from them” (Leef, 2008). This seems logical, and usually is. However, in this case, there are two reasons why this objection should be rejected.

First, if fringe lending is inherently immoral and has negative effects on individuals and society, there is a compelling argument for prohibiting it, just like gambling and drug use. Secondly, many fringe loan borrowers are not rational actors, and therefore the argument from economic efficiency is inapplicable. Cuffe and Gibbs (2017) point out that “economic theories of time inconsistency and impulsivity underlie some payday loan use” (p. 142). This is in the context of a study showing that payday loans are often used for alcohol, entertainment, and other non-essential purchases. In these cases, it would be difficult to sympathize with borrowers. However, (1) people who are struggling to provide necessities for themselves and their families will also often not necessarily be concerned with making the most efficient and rational decisions, and (2) this fact still refutes the practical argument that banning fringe lending undermines economic efficiency. Whether out of irrationality or desperation, borrowers rarely function as rational economic actors.

For these two reasons, consumer preference should not be the sole criterion for whether the government should sanction a fringe loan contract. However, the objection based on consumer preference does make a correct point in that it is both impractical and unwarranted for the government to step in and prohibit all contracts that it determines to be detrimental. There are many financial decisions that people can make that are harmful to themselves, and not all of them should be illegal. This is why the proposal is narrowly tailored to address new financial products with a high potential for abuse, and contains a 36 percent usury cap, which is still a very high interest rate.

Arbitrariness of Usury Caps

Opponents of restricting or banning fringe loans often assert that usury laws and other regulations are arbitrary (Adams, 2020). It is true that there is no real difference between a 35.99% interest rate and a 36.01% interest rate. However, most practical issues of legislation are not matters of discovering a universal, objective law. They cannot be arrived at through *a priori* and deductive reasoning; instead, *a posteriori*, inductive reasoning must be used. Traffic laws provide another example of this inevitable fact. A speed limit of ten miles per hour for the average local road is indisputably too slow, while a speed limit of one hundred miles per hour is indisputably too fast. But within that middle ground, some discretion is inevitable. Inevitably, there must be "arbitrariness" in crafting a solution to the problem of predatory lending.

Unintended Consequences

The strongest argument against restrictions of fringe lending is that such regulations can have unintended consequences. The unintended consequences objection takes two complementary forms: (1) that restrictions on high-interest consumer loans reduce access to credit in a detrimental way, and (2) that regulations simply allow for illegal loan sharks to take the place of legal fringe lenders. Thomas Miller of the libertarian Cato Institute objected to Virginia's legislation to restrict payday and other fringe loans, stating, "[g]overnment interference in a market lowers quality or raises prices, or does both" (Miller, 2020).

It is indisputable that good intentions are not sufficient. Therefore, if restricting fringe loans would in fact harm consumers, even if *being* a payday lender is immoral on a personal level, restricting fringe loans through the law would not be desirable. However, it is not self-evident that *all* laws have unintended consequences that outweigh the benefits. Miller's argument in favor of the continual availability of fringe lending contains a hidden premise.

Miller argues that government regulation [always] “lowers quality or raises prices, or does both” (Miller, 2020). His argument starts with the major premise: *Government regulation always lowers quality or raises price*. Miller's conclusion is *Therefore, the government should not increase regulations of payday loans*. The missing minor premise within this argument is: *Greater availability of payday loans is desirable*. However, this unproven premise is the entire point of contention. The question is whether fringe lending has a net positive impact compared to the alternative, or whether it is in the same category as gambling. Based on the studies previously evaluated, as well as the statistical analysis of state-level poverty rates and fringe loan regulations, fringe lending cannot be directly tied to negative *societal-level* outcomes. Whether that is due to the low resolution of the statistical tools used or the lack of effect cannot be stated with confidence. However, there is evidence of harm on the *individual* level (Cuffe & Gibbs, 2017; Carrell & Zinman, 2014).

There is little persuasive evidence that restricting fringe loans has a net negative effect on either individual consumers or the broader economy. Opponents of additional regulations often assert that if fringe lending is banned, then borrowers will be left without options or simply go without basic needs (Adams & Berlau, 2021, p. 6). However, while this may be true for some individuals, there is little evidence that this is true in most cases. A 2022 survey found that after an Illinois rate cap law was implemented, 24 percent of those who would have otherwise borrowed payday loans used a credit card, 23 percent withdrew money from a savings account, 21 percent asked for assistance from family or a charitable organization, and 20 percent waited until the next paycheck (Lake Research Partners, 2022, p. 6). All these options are generally less financially dangerous than payday lending.

Appropriateness of APR-Based Metrics

Supporters of continual availability of fringe lending argue that since fringe loans are short-term, an annualized rate overestimates the actual cost of the loan by compounding certain fixed costs necessary to make a short-term loan profitable (Adams & Berlau, 2021, p. 1-2). There is limited validity to the claim that the APR is not a correct metric of how to calculate the actual cost of a short-term loan. Since fringe loans have a short repayment period and require certain fixed administrative costs, an APR metric may be misleading. However, this assumes that the loan is not rolled over, and is truly intended to be a short-term, one-time loan, which the ACE Cash Express diagram contradicts (Consumer Financial Protection Bureau, 2014). Empirical data shows that 80 percent of payday loans are rolled over with another loan within 14 days (Barth et al., 2016, p. 17). In addition, payday loan contracts often structure these "fixed fees" as percentage rates which accrue interest (Alpha Omega Consulting Group, n.d.).

Conclusion

New fringe financial products such as payday loans, title loans, and high-cost hybrid installment loans have sparked significant controversy. While some claim that these loans offer a last resort to those in difficult financial straits, others argue that fringe loans are inherently fraudulent, predatory, and unconscionable. American law has traditionally reflected the latter position, but state usury laws have gradually been liberalized throughout the twentieth century to permit the widespread availability of fringe loans. These loans cause negative externalities to individuals and society (Carrell & Zinman, 2014; Lu, 2020; Ma, 2021; Cuffe & Gibbs, 2017) and do not provide a net economic benefit. Because money can freely travel across state lines and legal precedent restricts states' ability to regulate fringe loans, a national standard is necessary. This national standard will respect individual financial choices while eliminating truly predatory

products. Creating a national standard is necessary and proper to ensure a consistent and appropriate level of regulation of fringe financial products such as payday and title loans.

Appendix A: Table of Fringe Lending Regulations by State

State	Rate Cap	Other Restrictions	Summary
Alabama	Yes; 17.5% of principal (up to 455% APR)	Only one rollover permitted, and only one outstanding loan at a time per lender	Moderate Regulation
Alaska	Yes; 15% of principal per two weeks (390% APR)	N/A	Low Regulation
Arizona	Yes; 36% APR cap for unsecured consumer loans less than $3,000; title loans capped at up to 17% monthly interest (up to 204% APR)	N/A (Payday loans effectively prohibited; title loans allowed)	Moderate Regulation
Arkansas	Yes; 17% APR cap	N/A (Payday and title lending effectively banned due to APR cap)	High Regulation
California	Yes; 15% of principal (up to 390% APR)	Only one rollover allowed; only one outstanding loan at a time per lender	Moderate Regulation
Colorado	Yes; 36% APR cap	N/A (Payday and title lending effectively banned due to APR cap)	High Regulation
Connecticut	Yes; 36% APR cap	Payday lending directly banned; title loans effectively prohibited by APR cap, legality of "cash advance" unclear (Harper, 2023).	High Regulation
Delaware	No	Rollovers restricted to four; maximum of five outstanding loans per lender per customer	Low Regulation
Florida	Yes; 10% of principal (up to 260% APR)	Rollovers banned; only one payday loan may be outstanding per customer across all lenders	Moderate Regulation
Georgia	Yes	Payday lending banned; title loans allowed	Moderate Regulation
Hawaii	Yes; 36% APR cap	N/A (Payday and title lending effectively banned due to APR cap)	High Regulation

Idaho	No	N/A	Low Regulation
Illinois	Yes; 36% APR cap	N/A (Payday and title lending effectively banned due to APR cap)	High Regulation
Indiana	Yes; 10-15% of principal (up to 390% APR)	Rollovers prohibited; no more than one loan permitted at the same time	Moderate Regulation
Iowa	Yes; 15% of principal (up to 390% APR)	N/A	Low Regulation
Kansas	Yes; 15% of principal (up to 390% APR)	Rollovers prohibited; no more than two outstanding loans per lender at the same time.	Moderate Regulation
Kentucky	Yes; 15% of principal (up to 390% APR)	Maximum of $500 borrowed per lender; rollovers not restricted	Low Regulation
Louisiana	Yes; 16.75% fixed charge (up to 436% APR) or 36% APR	Rollovers allowed, but 25 percent of principal must be repaid each time	Moderate Regulation
Maine	Yes; 10-20% of principal (up to 513% APR)	No additional restrictions	Low Regulation
Maryland	Yes; 33% APR cap on small consumer loans	N/A (Payday and title lending effectively banned due to APR cap)	High Regulation
Massachusetts	Yes; 23% APR cap on small consumer loans	N/A (Payday and title lending effectively banned due to APR cap)	High Regulation
Michigan	Yes; 11-15% of principal (up to 390% APR)	All rollovers banned; maximum loan term of 31 days	Moderate Regulation
Minnesota	Yes; 36% APR cap	N/A (Payday and title lending effectively banned due to APR cap)	High Regulation
Mississippi	Yes; 20% of principal (maximum of 521% APR)	Rollovers banned	Moderate Regulation
Missouri	Yes; 75% of principal over two-week period (maximum of 1955% APR)	Up to six rollovers permitted	Low Regulations
Montana	Yes; 36% APR cap	N/A	High Regulation

Nebraska (Moore, 2020)	Yes; 36% APR cap	N/A (Payday and title lending effectively banned due to APR cap)	High Regulations
Nevada	No	N/A	Low Regulation
New Hampshire	Yes; 36% APR cap on consumer loans	N/A (Payday and title lending effectively banned due to APR cap)	High Regulation
New Jersey	Yes; 30% APR cap on consumer loans	N/A (Payday and title lending effectively banned due to APR cap)	High Regulation
New Mexico (Waters, 2022).	Yes; 36% APR cap on consumer loans	N/A (Payday and title lending effectively banned due to APR cap)	High Regulation
New York	Yes; 25% APR cap on consumer loans	N/A (Payday and title lending effectively banned due to APR cap)	High Regulation
North Carolina	Yes; 36% APR cap	N/A (Payday and title lending effectively banned due to APR cap)	High Regulation
North Dakota	Yes; 20% fee permitted (521% APR)	Only one rollover allowed; maximum of $600	Low Regulation
Ohio	Yes; 28 percent APR cap and 10% fixed fee permitted	Loans only allowed for more than 90 days to 1 year; equal repayment schedule required	Moderate Regulation
Oklahoma	Yes; 15% fixed fee up to $300; 10% over $300	Rollovers banned; no more than one payday loan allowed across all lenders	Moderate Regulation
Oregon	Yes; 36 percent APR cap; fixed, non-compounding finance charge of up to 10% permitted	Loan term must be at least 31 days	Moderate Regulation
Pennsylvania	Yes; 6 percent general APR cap	N/A (Payday and title lending effectively banned due to APR cap)	High Regulation
Rhode Island	Yes; 10 percent fixed fee (281% APR)	Only one rollover allowed; maximum of $500; no more than three loans per borrower total	Moderate Regulation

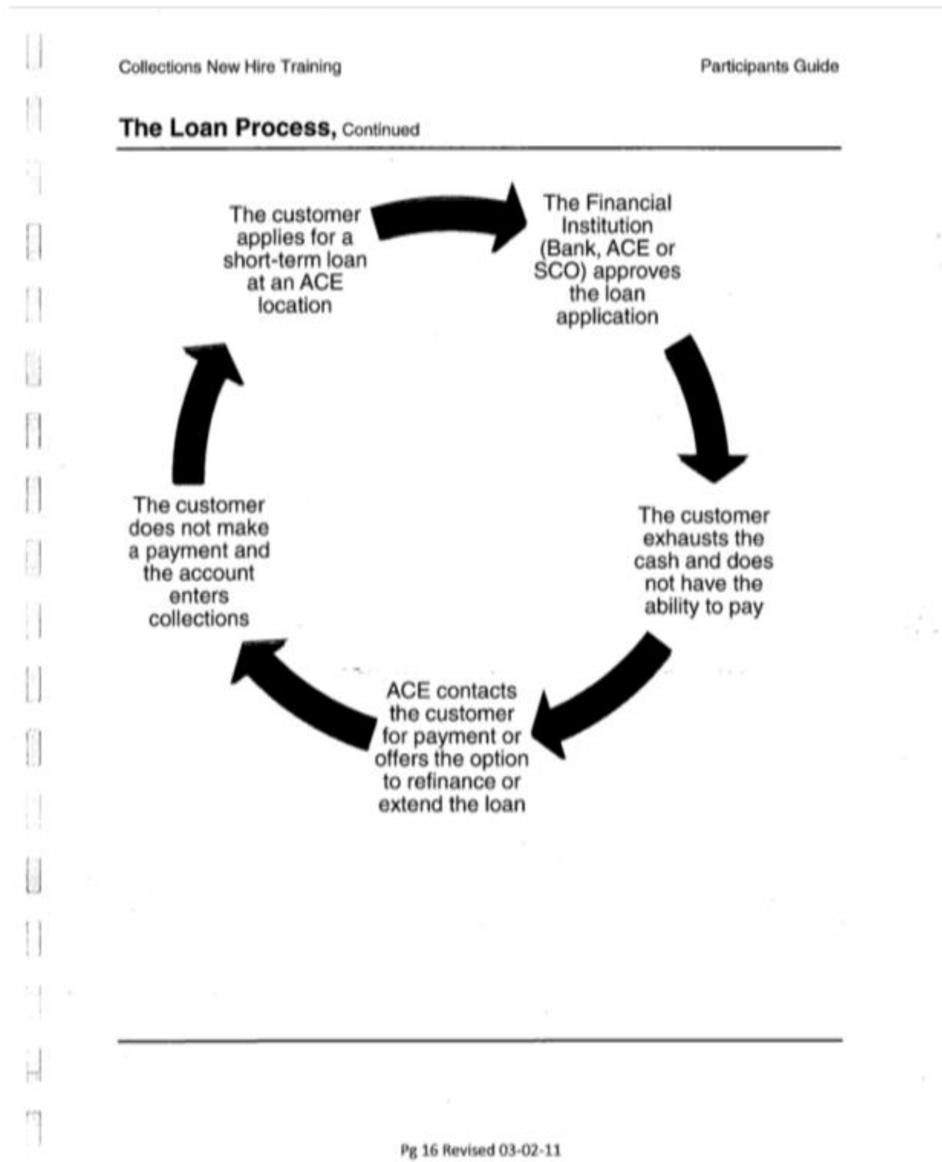
South Carolina	Yes; 15 percent fixed fee (391% APR)	Rollovers banned; maximum of $500; no more than one payday loan allowed	Moderate Regulation
South Dakota	Yes; 36 percent APR cap on all consumer loans	N/A	High Regulation
Tennessee	Yes; 15 percent fixed fee (391% APR)	Rollovers banned; maximum of $500; no more than three loans per borrower total	Moderate Regulation
Texas	No	N/A	Low Regulation
Utah	No	N/A	Low Regulation
Vermont	Yes; 18 percent APR cap	Payday loans directly banned	High Regulation
Virginia	Yes; 36 percent APR cap	Loans only allowed for a term of 4-24 months	High Regulation
Washington	Yes; 15 percent per two weeks under $500; 10 per two weeks over $500	Maximum of 8 payday loans per person per year	Low Regulation
West Virginia	Yes; 31 percent rate cap on consumer loans	Payday and title lending banned	High Regulation
Wisconsin	No	Maximum of one rollover	Low Regulation
Wyoming	Yes; greater of 20 percent monthly interest or $30 fixed fee	N/A	Low Regulation

(Data from Consumer Federation of America, 2023)[2].

[2] The individual pages used are cited individually in the References page.

Appendix B: ACE Cash Express Training Manual

This image was released as part of a public court record related to a civil lawsuit between the Consumer Financial Protection Bureau and ACE Cash Express (Consumer Financial Protection Bureau, 2014).



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