REGULATING ON THE FRINGE:
REEXAMINING THE LINK BETWEEN FRINGE BANKING AND FINANCIAL DISTRESS

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Critics of fringe banking—products like payday loans, pawn loans, and rent-to-own leases—frequently argue that these products cause borrowers to experience financial distress. This argument has enormous intuitive appeal: Fringe credit is very costly, and usually the borrowers who use it are already in a serious financial bind. Taking on additional debt and paying high prices for it, the reasoning goes, drive them over the brink.

Surprisingly, however, linking financial distress to fringe banking is extremely difficult to do. This Article represents the first attempt to uncover the relationship between fringe banking and financial distress by systematically analyzing the structure of fringe credit markets and characteristics of specific fringe credit transactions. Contrary to the assumptions made by the bulk of the literature, I argue that the link between fringe banking and financial distress is dubious. Because fringe creditors cannot rely on borrowers’ credit scores to predict whether they will be repaid, creditors structure fringe credit products to virtually guarantee repayment. Because repayment is guaranteed by the structure of the transaction, it is nearly impossible for borrowers to take on unmanageable debt loads.

Yet, a significant amount of regulatory intervention into fringe banking markets is premised upon the relationship between fringe banking and financial distress. Policymakers lump fringe credit together with other forms of credit that do cause financial distress, resulting in misguided and overly broad policies. The Article concludes by exploring the policy implications of determining that fringe banking products do not cause distress.

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A common theoretical justification for regulating consumer credit contracts is that borrowing leads consumers to financial distress. Financial distress in turn results in a variety of welfare costs for the borrowers, their families, and the community. The devastation to the national and world economies because of the subprime mortgage crisis is a powerful example of the externalities created through private consumer credit contracts.

When academics and policymakers consider regulating the fringe economy—payday lenders, pawnshops, rent-to-own stores, and the like—we might expect them to turn to financial
distress to justify regulation.\textsuperscript{1} Concerns about financial distress are particularly salient in the fringe economy because consumers of fringe credit are, by very definition, on the financial fringe. They are either poor or lack good credit, and they are unable or unwilling to use mainstream banking services.\textsuperscript{2} Additionally, the terms of credit contracts in the fringe economy are typically very harsh—the costs are high and the consequences of default are severe, causing some to say fringe credit creates a debt trap.\textsuperscript{3} Given these factors, it seems plain that fringe banking leads the consumers who use it to experience financial distress.

President Obama’s push to create a Consumer Financial Protection Bureau confirms the suspicion that policymakers will turn to financial distress to regulate the fringe economy. When justifying the Bureau’s control over fringe credit providers, President Obama invoked financial distress as a harm that new regulations could solve.\textsuperscript{4} President Obama’s focus on financial distress is far from extraordinary. In the vast majority of the literature on consumer credit, authors assume or argue that fringe banking products cause financial distress.\textsuperscript{5}

This Article is the first sustained examination of whether there is a link between fringe banking products and financial distress. In contrast to the assumptions and arguments in most of the literature, I argue that the link between existing fringe banking and financial distress is questionable. Using examples of current fringe financial products, I demonstrate that these products share a series of characteristics that make it very unlikely they cause consumers to experience financial distress. Indeed, the products appear designed to prevent it. Moreover, I assert that it is unlikely any future fringe credit products will cause financial distress because of the structure of the fringe credit market. From these conclusions, I suggest several implications for public policy debates about the fringe economy.

Determining whether fringe banking products produce financial distress is far from merely an academic exercise. The answer has significant consequences for the economy as a whole and for the individuals who depend on fringe credit products. The alternative financial services sector has gained an increasingly prominent place in the American economy. For instance, there are more payday lending and check cashing outlets in the United States than McDonald’s, Burger King, Target, Sears, JC Penney, and Wal-Mart locations combined.\textsuperscript{6} And,
there are more pawn shops than credit unions and banks combined. Regulatory intervention, thus, has the potential to stymie or spur on significant economic activity.

In addition to the effects on the economy as a whole, regulations also affect the people who depend on fringe banking services. For many of those who use fringe banking, it is their only source of legal credit. If regulations ban that credit or make it less accessible or more expensive because policymakers erroneously believe the credit causes distress, regulations remove a source of credit from people who desperately need it. On the other hand, if fringe banking exacerbates financial distress, regulators should step in. Considering the vulnerable consumer group that uses fringe banking, regulators should be especially cognizant of the rationales and effects of their policies.

Yet, despite this important role the fringe economy plays in the lives of millions of Americans, fringe banking products and the laws governing them have typically operated “below the radar screen of most researchers.” This Article hopes to shape the growing body of literature analyzing fringe banking and to contribute to the debate by understanding the relationship between fringe banking and one of the most important bases for regulating consumer credit contracts.

Part I establishes the importance of financial distress as a rationale for intervening into credit markets. In addition to discussing the literature appealing to financial distress, I explore the meaning of financial distress. I argue that, despite the claims of some, most authors use the term financial distress to mean a consumer suffering from unmanageable debt. Finally, I use recent work done in the context of credit cards to illustrate the methods used in that context to link credit cards to financial distress.

The heart of the article is Part II, which advances the claim that the link between fringe banking products and financial distress is dubious. I demonstrate how academics and policymakers repeatedly rely on financial distress to justify fringe credit regulations. Analyzing several forms of fringe credit, however, reveals this reliance is misplaced. Credit in the fringe economy is specifically structured to prevent borrowers from experiencing financial distress.

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7 Id. at 67.
8 Mann & Hawkins, supra note 2, at 876.
Moreover, I demonstrate how the nature of the fringe economy will likely prevent any innovative fringe products from ever causing financial distress.

Finally, Part III suggests three policy implications of recognizing the dubious link between financial distress and fringe banking. First, I urge policymakers and scholars to abandon the faulty heuristic many have applied in supporting fringe credit regulations—that fringe credit sources operate similarly to other consumer credit. Instead of treating all consumer credit the same, I suggest we need to evaluate the specific attributes of credit products when crafting regulations. Second, I suggest avenues for future research justifying fringe banking regulation—avenues that are not dependant on the link between fringe credit and distress. Finally, I offer suggested directions for policymakers to pursue in promulgating fringe banking regulations. Instead of banning fringe credit products, a common response to transactions that cause financial distress, policymakers should pursue less aggressive regulatory interventions that target problems associated with specific harmful attributes of fringe credit products.

I. FINANCIAL DISTRESS AS A JUSTIFICATION FOR REGULATION

This Part observes that academics frequently invoke financial distress as a justification for consumer credit regulation. Recognizing the pivotal role financial distress plays in justifying most consumer credit regulation is important because it reveals the significance of understanding the link between fringe banking and financial distress. Despite frequent use of financial distress, the term is rarely defined, so I work through different potential meanings of the term, concluding that most authors use financial distress to mean that consumers are suffering from unmanageable debt. Trying to define the term is essential in assessing the claim that fringe banking causes “financial distress.” Finally, I use the example of credit cards to demonstrate how recent scholarship has linked consumer credit cards to financial distress. Understanding the evidence that links credit cards and financial distress is significant because the very characteristics of credit cards that link them to distress are absent in products in fringe credit markets.

A. Invoking Financial Distress

Commercial law scholars frequently use financial distress as a basis for regulating consumer credit products.\(^\text{11}\) Academics also use the risk of financial distress to justify changes

\(^{11}\text{See, e.g., Oren Bar-Gill \\& Elizabeth Warren, Making Credit Safer, 157 U. PA. L. REV. 1, 3 (2008) (arguing for the creation of an agency to regulate consumer credit because “[c]onsumer credit products also pose safety risks for customers [and] can lead to financial distress . . . .”); Katherine Porter, The Debt Dilemma, 106 MICH. L. REV. 1167, 1176 (2008) (asserting that determining the level of credit card use for individual families suffering financial distress “is critical to formulating effective credit regulation”); Hawkins, supra note 10, at 2075-76 (positing that a link between financial distress and renting-to-own would provide a viable basis for regulating the rent-to-own industry); John A. E. Pottow, Private Liability for Reckless Consumer Lending, 2007 U. ILL. L. REV. 405, 463 (proposing a liability regime for reckless lending based, in part, on the fact reckless lending causes financial distress); Laurie A. Burlingame, Getting to the Truth of the Matter: Revising the TILA Credit Card Disclosure Scheme to Better Protect Consumers, 61 CONSUMER FIN. L.Q. REP. 308, 336 (2007) (arguing for changes in the Truth in Lending Act “to better avoid financial distress and bankruptcy”); RONALD J. MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD MARKETS 188-89 (2006) (supporting specific credit card regulations because of}
in other legal regimes as well, such as the bankruptcy system and healthcare. One scholar recently pointed out the overwhelming importance of alleviating financial distress in bankruptcy theory, noting that “all existing theories of bankruptcy that attempt to justify a discharge of debt for individuals rest to some degree on eliminating the harms of financial distress.”

Financial distress is harmful to three different groups. First, the individuals experiencing financial distress are, under any definition of the term, distressed. Some have suggested that the stress of debt can cause illness and can exacerbate health problems as people go without medical treatment to service their debt. Additionally, financial woes can cause problems for employees who are less productive because of their preoccupation with debt.

Second, creditors of consumers experiencing financial distress are harmed. Individuals who are financially distressed impose costs on their creditors when they default on their obligations. If the losses are significant enough, the financial distress of a borrower can plunge the creditor into distress.

Finally, and most significantly from a public policy standpoint, financial distress has spillover effects that harm parties completely unrelated to the credit contract. Instead of internalizing the negative consequences of failed consumer loans, borrowers and creditors

the correlation between credit card use and financial distress); Elizabeth Warren, What is a Women’s Issue? Bankruptcy, Commercial Law, and Other Gender-neutral Topics, 25 HARY. WOMEN’S L.J. 19, 54 (2002) (“If the Federal Reserve adopted more aggressive regulations over predatory mortgage financing, tends of thousands of families that file for bankruptcy to try to save their homes from unscrupulous lenders would be spared.”); Creola Johnson, Payday Loans: Shrewd Business or Predatory Lending?, 87 MINN. L. REV. 1, 148 (2002) (“Consumers forced into these transactions already suffer financial distress disproportionate to the rest of the general public. These borrowers should not be forced to resort to credit sources that compound their economic hardship. Accordingly, Congress should act to stringently regulate the payday lending industry as an important step in equalizing consumer protection laws for all consumers, even if true equal credit opportunity remains elusive.”). But see Todd J. Zywicki, The Economics of Credit Cards, 3 CHAP. L. REV. 79, 83 (2000) (arguing that attempts to link bankruptcy and credit cards do not justify regulatory intervention).


13 Katherine Porter, The Damage of Debt (unpublished manuscript, on file with author).


16 MANN, supra note 11, at 50.

17 See, e.g., Linda Kotis, Comment, Chapter 13 and the Family Farm, 3 BANKR. DEV. J. 599, 611-12 (1986) (reporting that the “severe financial distress that farmers are suffering is threatening the stability of farm lenders” and banks that hold farm debt).
impose externalities on parties unconnected to the contract.  

Recent regulatory intervention into consumer credit markets has been focused on curtailing externalities, and scholars justifying regulations devote a significant amount of energy to focusing on how credit contracts affect third parties.

Specifically, people experiencing financial distress are less productive, harming employers and other consumers. Society is harmed as public resources are exhausted by the financially distressed seeking help from the social safety net. At the extreme, the current financial recession is a result of private consumer mortgage contracts causing widespread financial distress.

B. Defining Financial Distress

Although financial distress is often invoked as a justification for regulation, it is rarely defined by the legal scholars who invoke it. However, to determine whether fringe banking

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19 See DONNCHA MARRON, CONSUMER CREDIT IN THE UNITED STATES: A SOCIOLOGICAL PERSPECTIVE FROM THE 19TH CENTURY TO THE PRESENT 11 (2009) (“The state, in general, moved from a strategy of repression through usury interest rate caps to one of protection and management in the interest of promoting a wider social well-being.”).

20 Bar-Gill & Warren, supra note 11, at 58-59 (arguing that the costs of poor consumer decisions “generate a series of negative externalities”); Janis Sarra, Economic Rehabilitation: Understanding the Growth in Consumer Proposals under Canadian Insolvency Legislation, 24 BANKING & FIN. L. REV. 383, 392 (2009) (“Excessive credit card debt can impose substantial costs on the debtor, family members, and the general welfare safety net, as well as cost consequences form the diminished productive activities of those individuals in financial distress.”); Mann & Hawkins, supra note 8, at 884 (noting the financial distress “increases the burden on the social safety net”); Pottow, supra note 11, at 411 (“Few scholars today maintain that personal bankruptcy is a fully isolated, internalized occurrence between a debtor and creditor alone.”); MANN, supra note 11, at 49-50 (arguing that financial distress “imposes substantial costs on third parties—costs that are not considered by the parties to the credit transactions,” such as costs to family members who are dependent on the person experiencing distress, the social safety net which must make more pay outs to distressed individuals, and the economy generally.”).

21 Mark Klock, Financial Options, Real Options, and Legal Options: Opting to Exploit Ourselves and What We Can Do About It, 55 ALA. L. REV. 63, 84 (2003) (“The larger costs of bankruptcy are seen in what is widely termed indirect costs associated with financial distress. These are costs associated with the fact that valuable assets that depreciate over time are underutilized during the litigation process.”); U.S. DEP’T OF DEFENSE, REPORT ON PREDATORY LENDING PRACTICES DIRECTED AT MEMBERS OF THE ARMED FORCES AND THEIR DEPENDENTS 35-36, 45, 86-87 (2006), http://www.usa4militaryfamilies.dod.mil/dav/lsn/LSN/BINARYRESOURCE/BINARYCONTENT/2141721.pdf.

22 Bar-Gill, supra note 15, at 788.


transactions cause financial distress, it is essential to understand what financial distress means to the academics and policymakers who use the concept to justify regulations. This subpart argues that most academics and policymakers who rely on financial distress use the term to mean consumers are suffering under the weight of unmanageable debts.

In the corporate context, there seems to be widely accepted definitions for financial distress. The most common definition of financial distress states that firms experience financial distress when they cannot meet their monthly debt obligations. Usually financial distress is contrasted with economic distress which means the firm is not generating sufficient revenue to make a profit.

Still, even in the context of businesses, the definition is not clear. Other authors seem to employ a variety of other definitions for financial distress in the corporate context, claiming a firm is financially distressed if it is having “difficulty independently staying afloat”; stating a firm is distressed if it cannot meet its payment obligations, not just its monthly debt service obligations; or asserting a firm is financially distressed if the firm is not viable and unable to meet its monthly debt obligations. One article in the corporate context sums it up: “The terms ‘financial distress’ and ‘insolvency’ are broad and ambiguous.”


26 Stephen J. Lubben, The Direct Costs of Corporate Reorganization: An Empirical Examination of Professional Fees in Large Chapter 11 Cases, 74 AM. BANKR. L. J. 509, 546 n. 146 (2000). See also Robert K. Rasmussen & David A. Skeel, Jr., The Economic Analysis of Corporate Bankruptcy Law, 3 AM. BANKR. INST. L. REV. 85, 88 (1995) (“Economic distress and financial distress are conceptually distinct. Some firms that are quite healthy in the economic sense nevertheless cannot pay off their bills because they have excessive debt. On the other hand, some firms have no trouble paying their bills because they have sufficient cash on hand yet still are running at an operating loss. Despite the distinction between these two types of distress, they are positively correlated. Firms in economic distress often are in financial distress as well. Indeed, it is often the case that the economic distress is what is causing the financial distress.”); Barry E. Adler, Bankruptcy Primitives, 12 AM. BANKR. INST. L. REV. 219, 222-24 (2004) (applying this framework).


29 See Patrict Dunleavy, Reorganization or Liquidation?: Understanding the Valuation Process Can Help with Making the Right Decisions, 28-6 ABIJ 56, 56 (2009) (“A company in financial distress is defined as an entity that has difficulty or is unable to meet its financial obligations as they come due. In cases of severe financial distress, the company becomes insolvent and may file for bankruptcy under either chapter 7 or 11.”); Rasmussen & Skeel, supra...
In the individual context, scholars have offered a variety of definitions. One possible definition of financial distress is an inability to pay one’s bills or make ends meet. Katie Porter and Deborah Thorne seem to accept this definition because they note some people emerging from bankruptcy are financially distressed because “they struggled to pay their bills” and “were about 4.5 times more likely to have difficulty making ends meet.”31 Indeed, Porter has argued that people can be “broke without borrowing.”32 Stephen Ware, struggling to define the term, has suggested that academics might use it even more broadly to mean having “wants exceeding the means to pay for them”33 or being poor.34

This conception of financial distress, however, misses the key component on which most literature on financial distress focuses—debt.35 Even for those writers who do not explicitly equate distress with debt, debt is at the very least the most important cause of financial distress.36

We can find further proof of the importance of debt in the concept of financial distress by looking at how academics measure financial distress. Researchers have noted the difficulties attendant to deciding how to measure financial distress, but many of the measurements depend on debt. Some scholars studying individuals in distress assert that the “best measure of a typical middle class family’s financial distress is its debt-to-income ratio.”37 Another common indicator

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note 26, at 87 (defining financial distress as an inability to pay the firm’s bills); Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 Colum. L. Rev. 717, 764 (1991) (“[A] corporation is in financial distress when it faces actual or anticipated payment demands to which its own response is or is likely to be inadequate . . . . [A] corporation is in financial distress when its own internal mechanisms for adaptation to actual or anticipated payment demands are severely impaired.”).


31 Porter & Thorne, supra note 11, at 89.

32 Porter, supra note 11, at 1177.


34 Id. at 1264.

35 See Lynn M. LoPucki & George G. Triantis, A Systems Approach to Comparing U.S. and Canadian Reorganization of Financially Distressed Companies, 35 Harv. Int’l L.J. 267, 274-75 n.21 (1994) (arguing that financial distress includes “both the state of balance sheet insolvency (liabilities exceed assets) and inability to pay obligations as they become due”); Jay L. Zagorsky & Lois R. Lupica, *A Study of Consumers’ Post-Discharge Finances: Struggle, Stasis, or Fresh-Start?*, 16 Am. Bankr. Inst. L. Rev. 283, 285 (2008) (“While debt is commonly viewed as a central contributing factor to financial distress, debt is also a central consequence of such distress. When income and assets are insufficient to meet the consumptive needs of a household, the household experiences financial distress—defined as the inability to pay debts as they come due.”);

36 Sullivan, Warren & Westbrook, supra note 10, at 218 (“It shows that the central characteristic of consumer bankruptcy over two decades has been increasing financial distress, marked by rising levels of debt.”); Sarra, supra note 21, at 392 (“Essentially, increased numbers of consumer debtors from all social strata and from diverse regions are experiencing financial distress. Over-extension of credit appears to be a primary driving cause.”).

37 Sullivan, Warren & Westbrook, supra note 10, at 229. A consumer’s debt-to-income ratio is not a perfect measure of distress because a consumer may have significant valuable assets despite having a high monthly debt payment. Mann & Mann, supra note 24, at 9.
of financial distress is if consumers’ debt is larger than their assets, or, put another way, if they have a negative net worth. Regardless of the imperfections in these measurements, the focus of each measurement is the same—debt. Other measurements of distress, such as the Debt Service Ratio and the Financial Obligations Ratio, also focus on debt payment in relation to income.

Merely having some debt does not constitute being financially distressed—the debt has to be unmanageable. Having debt can be economically efficient because it allows people to smooth consumption over their life. Over-indebtedness only arises when consumers’ “current assets are no longer sufficient to offset the present value of future debts” or when consumers cannot make payments and default on their loans.

Stephen Ware is skeptical of definitions of financial distress that focus on unmanageable debt: “Do those who propose it deny that going without what one wants, but cannot afford, can be a source of distress? And if this ‘going without’ is caused by lack of finances then what sort of distress is it but financial distress?” Yet, defining financial distress as merely having wants that exceed resources or experiencing an inability to make ends meet is exceedingly capacious. This definition would include a very rich individual who lacks the funds to buy an airplane the person desires. But the inability to make this purchase does not create harm to the social net or to the medical health of the individual—the harms that scholars’ appealing to financial distress imagine. Financial distress generates spillover effects because people face significant pressure when they are unable to pay their debts.

A variety of sources equate financial distress and bankruptcy, but this understanding of financial distress exhibits the opposite defect of Ware’s definition. It is underinclusive because

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38 Kotis, supra note 17, at 610 (“The debt-to-asset ratio provides the best single measure of the gravity of a farmer’s financial difficulties; a farmer whose debt-to-asset ratio exceeds 40% is probably experiencing financial distress.”). This measure also is incomplete because a consumer could have a negative net worth but not have any trouble paying their monthly debt obligations. Mann & Mann, supra note 24, at 9.


40 Porter, supra note 11, at 1175 (“Higher levels of consumer debt may not be a cause for concern. Borrowing can fuel economic growth, spur entrepreneurial activity, and enhance consumer quality of life.”); Gianni Betti et al., Consumer Over-Indebtedness in the EU: Measurements and Characteristics, 34 J. OF ECON. STUDS. 136, 140-41 (2007) (“The implication of the LC-PI model for understanding consumer indebtedness is that it is optimal for a consumer to be indebted under certain conditions and at certain stages of the life cycle, particularly the earlier stages. If there is no unexpected change to total resources or expenditure requirements and in the absence of any inter-generational transfer mechanism, the consumer’s current assets will be exactly balanced by the present value of his/her debts over all future periods.”)

41 Betti et al., supra note 40, at 140-41.

42 Ware, supra note 33, at 1263 n.25.

not all individuals experiencing financial distress file for bankruptcy. Indeed, studies have found that most people experiencing financial distress do not file for bankruptcy. Over-indebted people can meet their debt-service obligations and avoid bankruptcy by cutting out essential purchases like medicine, and using bankruptcy as the sole measurement of financial distress misses the people in that situation. But, the mere fact people use bankruptcy as a proxy for financial distress demonstrates that debt is at the heart of financial distress. Even for Porter and Thorne who define distress as an inability to pay one’s bills, bankruptcy serves as a proxy for financial distress.

Although I think most authors use financial distress to mean unmanageable debt, for the purposes of this Article, I do not exclude the definition of financial distress as an inability to pay one’s bills. Instead, I evaluate the link between fringe banking and financial distress conceived of as either unmanageable debt or inability to make ends meet. The next subpart uses these conceptions of financial distress and gives the example of credit cards to illustrate how scholars link consumer credit products to financial distress.

C. The Link Between Credit Cards and Financial Distress

This subpart illustrates how scholars link credit products to financial distress by analyzing the case of credit cards. A significant amount of debate has surrounded the question of whether credit cards contribute to distress, but the work linking credit cards to financial failure is better than the work linking any other form of credit to distress. This illustration of credit cards is far from mere background information. It demonstrates the sorts of arguments one would have to make to establish that fringe banking causes financial distress.

word ‘bankruptcy’ conveys essentially the same message as ‘financial distress’ or ‘going out of business.’ The consumer has a sense of urgency and expects lower prices and greater bargaining power.”

44 For the distinction of these terms in the corporate context, see Donald R. Korobkin, The Unwarranted Case Against Corporate Reorganization: A Reply to Bradley and Rosenzweig, 78 IOWA L. REV. 669, 717 (1993) (“Toward this end, it is useful to define two terms—‘financial distress’ and ‘bankruptcy.’ These terms are conceptually distinct. Financial distress is a situation in which a corporation’s capacity to adjust to actual or anticipated payment demands is severely impaired. Bankruptcy, as the term is sometimes used by financial economists, refers specifically to the cancellation of ownership of a firm—or the transfer of such ownership from shareholders to debtholders—resulting from conditions of financial distress. While financial distress is a general economic condition, bankruptcy is a legal and financial event that sometimes results from financial distress.”). 45 Mann & Porter, supra note 24, at 290 (“On the one hand, only a fraction of those in serious financial distress will ever file for bankruptcy. . . . That is, most families in serious financial distress do not file for bankruptcy. In fact, each year foreclosure filings outstrip bankruptcy filings because many families do not even try to use bankruptcy to save their homes. Similarly, thousands of families are subject to collection calls for medical bills, yet the number of bankruptcy filings—even at its pinnacle—represents only a sliver of those struggling with bills.”).

46 Betti et al., supra note 40, at 141.

47 Porter & Thorne, supra note 12, at 118.


Beyond illustrating how the best arguments link credit products to financial distress, examining credit cards is important to the thesis of this Article because of the contrasting ways credit cards and fringe financing work. Policymakers and academics often treat credit cards and fringe credit products as the same, but a careful look at both demonstrates the important ways they are different. More significantly, the very characteristics that link credit cards to financial distress are missing from fringe credit products.

1. Evidence Credit Cards Cause Financial Distress

Ronald Mann’s book Charging Ahead: The Growth and Regulation of Payment Card Markets offers the best evidence to date that credit cards cause financial distress. This section briefly explains his research design and the conclusions he reaches.

To evaluate the effect of credit cards on financial distress, Mann performed a regression analysis on country-level aggregate data from five countries. To isolate the relationship between credit card debt and bankruptcy, he used a multivariate model with credit card debt, consumer debt, and credit card spending as explanatory variables and bankruptcy filings, as a proxy for financial distress, as the dependent variable. To ensure that credit card debt caused the increased bankruptcy rates he observed in various countries and not other variables or country-specific differences, Mann incorporated unemployment and GDP as independent variables, and he incorporated dummy variables. Finally, to establish that the causation relationship ran from credit cards to bankruptcy and not the reverse, his explanatory variable of credit card debt was lagged a year.

Based on this analysis, Mann found that “[e]ven if credit card spending and consumer debt are held constant, an increase in credit card debt—a shift of consumer borrowing from noncard borrowing to card borrowing—is associated with an increase in bankruptcy filings.” With an increase of only $100 per capita of credit card debt, the size of the effect is 165 bankruptcy filings. Using a similar analysis, Mann also found that credit card spending is a significant contributor to consumer debt.

Mann qualifies his findings in several ways, admitting the number of data points is small and his use of country-level data cannot account for individual families’ uses of credit

50 MANN, supra note 11.
51 Id. at 64-65.
52 Id. at 66.
53 Id. at 64-65.
54 Id. at 66.
55 Id.
56 Id. at 53.
57 Id. at 67.
card debt. Some critical commentary suggests similar deficiencies. Yet, still, Mann’s analysis offers a highly credible link between financial distress and credit cards.

2. Characteristics of Credit Cards that Cause Financial Distress

Simply finding that credit cards cause financial distress is not as useful as understanding the mechanisms for how credit cards cause distress. Credit cards have several characteristics that create a link between this form of credit and financial distress.

First, credit cards likely contribute to financial distress because they make it easy to accumulate debt painlessly. For most credit products, every time borrowers want loans, they have to go to the lender, fill out an application, undergo a credit check, and wait for a decision. Credit cards, however, are a form of revolving credit. The borrower makes a single decision to open an account, the lender sets a credit limit, and then the borrower can accumulate debt simply by swiping a card. The borrower does not have to go through the ritual of obtaining a new loan but can unreflectively accumulate debt.

Because of this easy access to credit, consumers spend more using credit cards than other forms of credit. In part, people spend more when using credit cards because of the ease of making payments with a credit card. It is easier to underappreciate the cost of something when paying with a single swipe than when counting out the dollars and cents for the transaction. Similarly, we might expect that people fail to comprehend the full significance of accumulating debt when they do not have to undergo the full ritual of applying for a new loan.

Research confirms this hypothesis, suggesting that consumers using credit cards spend more because of the availability bias. The availability bias is a defect in consumer reasoning: People tend to overestimate the likelihood of some events if those events are easy to remember, but they underestimate the likelihood of other events that are less readily available for the mind.

58 Id. at 62.
59 See Porter, supra note 11, at 1176 (“Applying Mann's insights on these macroeconomic relationships to the behavior of individual families is complex. As Mann acknowledges, aggregate data do not reveal how the effects of credit card use are distributed across individual families. The distribution could show that either a relatively small number of families in bankruptcy borrowed quite heavily on credit cards before bankruptcy or that nearly all families in bankruptcy modestly increased their credit card borrowing before bankruptcy.”).
60 See id. at 1174 (“Mann’s empirical analysis establishes a positive relationship between credit card use and increased consumer debt. Neither the concise nature of the foregoing sentence nor its ‘obviousness’ to an armchair empiricist should diminish the power of Mann’s achievement.”).
61 KARGER, supra note 6, at 42.
62 MANN, supra note 11, at 46. See also Ronald J. Mann, Unsafe at Any Price?, 157 U. PA. L. REV. PENNUMBRA 167, 176 (2009) (“In my view, however troubling the contract terms that dominate current legislative discourse may be, it is much more important to focus on reforms that will respond to the culture of unreflective borrowing and consumption.”). Similarly, accumulating debt in small increments likely causes people to not appreciate the full amount of the debt they are incurring. TERESA A. SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA 170-79 (1989).
to recall.\textsuperscript{63} Studying this bias in the context of credit cards, research has found that people do not think about their past expenditures on credit cards because their decision to spend on a card does not impose the immediate pain of having to part with cash.\textsuperscript{64} Because the experience of spending (and borrowing) is relatively painless due to the revolving nature of credit card debt, people underestimate the significance of accumulating debt.

This propensity to spend is even more likely to contribute to runaway debt because people are overly optimistic about how much debt they will eventually incur when they first establish their credit accounts. Behavioral economists have documented an optimism bias in consumer decisionmaking.\textsuperscript{65} In the context of credit cards, this bias causes consumers to underestimate the likelihood that they will experience financial shocks such as expensive medical bills or additional expenses from losing one’s job.\textsuperscript{66} People may have no intention to actually incur unmanageable debt when they establish their credit account, but in reality, many do.

In addition to allowing consumers to accumulate debt painlessly, a second characteristic of credit cards that creates a link to financial distress is the fact that credit cards allow consumers to accumulate significant amounts of debt. The amount of money credit card companies lend to consumers is based on the consumer’s projected future income.\textsuperscript{67} Historically, debt obligations were tied to the value of tangible goods, but early in the twentieth century, salary lenders “began to make loans less on the security of tangible capital that defined traditional pawnbroking and increasingly around the abstract conception of future wages.”\textsuperscript{68}

Lending based on the notion of future wages allows borrowers to access significant amounts of credit because credit cards operate without many of the constraints of other loans. In addition to not being tied to the value of the goods purchased,\textsuperscript{69} credit card limits are not constrained by the amount the consumer is paid during any specific pay period. Instead, companies, theoretically at least, estimate a person’s general future income. If a consumer loses her job, she still has access to the entire credit limit. The access to credit is independent of the consumer’s actual income after the credit limit is approved, and credit card companies frequently increase consumers’ credit limits.\textsuperscript{70} Indeed, in practice, banks do not typically even evaluate

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\textsuperscript{63} Steven J. Cleveland, An Economic and Behavioral Analysis of Investment Bankers When Delivering Fairness Opinions, 58 ALA. L. REV. 299, 328 (2006).
\textsuperscript{64} Dilip Soman, Effects of Payment Mechanism on Spending Behavior: The Role of Rehearsal and Immediacy of Payments, 27 J. CONSUMER RES. 460, 471 (2001).
\textsuperscript{66} Id.
\textsuperscript{67} Id. at 11.
\textsuperscript{68} Id. at 11.
\textsuperscript{69} See id. at 84-85 (“[The credit card] is also divorced from the specific goods its finances, encompassing the continuous, ongoing process of consumption facilitated through the widening scope of such credit.”).
\textsuperscript{70} Dilip Soman & Amar Cheema, The Effect of Credit and Spending Decisions: The Role of Credit Limit and Credibility, 21 MARKETING SCI. 32, 37 (2002); MARRON, supra note 19, at 85.
\end{flushleft}
borrowers’ actual future income at all but rely solely on credit scores to gain information about credit usage.\textsuperscript{71}

Because credit cards do not rely on external restraints other than a person’s credit score, they depend on consumers exercising self-constraint. As Donncha Marron has argued:

The relative absence of external constraints on individual action, in contrast to the characteristics of installment credit, actually requires an increasing need for self-constraint as to a consumer’s momentary impulses, enhanced foresight as to the consequences of their actions and an ability to increasingly manage their own behavior, in an objective and instrumental way, over longer and more complexly interwoven periods of time.\textsuperscript{72}

The net effect of unconstrained credit limits is that people must depend solely on themselves to keep out of unmanageable debt. They are offered access to significant amounts of debt because neither the cost of the goods they are purchasing nor their specific income set their credit limit.

This lack of external constraints of course would not be a problem if credit card limits were set low or were set at an amount guaranteed to be manageable for users. In fact, however, credit card companies offer consumers very high credit limits.\textsuperscript{73} For instance, 36.8\% of American Express’s accounts have credit limits over $20,000.\textsuperscript{74} Some small businesses report their preference for credit cards precisely because they offer “extremely high credit limits.”\textsuperscript{75} Credit cards aim to allow consumers to borrow one fifth of their annual salary on a single card alone.\textsuperscript{76} These high limits give consumers ample room to accumulate significant debt.

Finally, giving consumers high credit limits leads to the last characteristic of credit card transactions that engenders financial distress—the fact consumers use high credit limits as guides of how much debt to incur. Researchers have observed that when credit limits are high, consumers will erroneously assume they can manageably borrow a lot of money.

\textsuperscript{71} Soman & Cheema, supra note, 70, at 36 (“[T]here seems to be no explicit use of future income projections in making credit-limit decisions.”).

\textsuperscript{72} MARRON, supra note 19, at 86.

\textsuperscript{73} See Stephen Koff & Tom Diemer, U.S. Senate Approves Bankruptcy Revisions, PLAIN LEADER, Dec. 8, 2000, at 1C (“The National Consumer Law Center said credit-card companies are actually encouraging high indebtedness, inundating the public with easy-to-get credit cards and high credit limits.”); Editorial, Whose (De)Fault Is It?, SAN JOSE MERCURY NEWS, June 18, 1998, at 10B (“[T]he [credit card] industry claims no culpability for pushing credit cards and high credit limits on people who can’t handle them.”).

\textsuperscript{74} Harry Terris, Dissecting Issuer Accounts, AM. BANKER, Dec. 28, 2009, at 9.


\textsuperscript{76} Laura Ruane, Credit Card Competition Fierce: Banks Pull out All Stops to Attract More Customers, NEWS-PRESS, June 15, 1999, at 1 (“[C]ard issuers aim for a 5-to-1 income-to-credit ratio. A household with $50,000 total income probably would qualify for a $10,000 credit line . . . .”) (quoting president of credit-card monitoring company, CardWeb.com).
Dilip Soman and Amar Cheema conducted a series of experiments with students to test what effect a credit card’s credit limit has on spending behavior. They found that students spent more money if their credit limits were higher. Soman and Cheema theorize that consumers use information such as the credit limit as a signal of their future earnings potential. Specifically, if consumers have access to large amounts of credit, they are likely to infer that their lifetime income will be high and hence their willingness to use credit (and their spending) will also be high. Using one’s credit limit as a heuristic to determine debt levels makes sense because lenders exogenously set limits based, theoretically at least, on very good data about a consumer’s future earning potential. Indeed, some have argued that lenders have a much better idea about whether a consumer will default on a loan than the consumer does. As it turns out, however, banks are not good at determining a consumer’s projected earnings, so credit limits are an unreliable heuristic for consumers to use. Thus, when consumers take on debt based on high credit limits that do not actually mirror future earning potential, we should not be surprised they experience unmanageable debt.

These three characteristics of credit cards are significant not only as an illustration of how a credit product can cause financial distress but also as a point of contrast with fringe banking products. For consumers borrowing on the fringe, none of these characteristics will likely be part of any credit product they use. Part II uses these distinctions and the characteristics of modern fringe credit markets to argue that fringe banking does not cause financial distress.

II. THE DUBIOUS LINK BETWEEN FRINGE BANKING AND FINANCIAL DISTRESS

In this Part, I first establish the prevalence of the claim that fringe banking causes financial distress in academic literature and policy debates. My project of understanding the relationship between fringe credit and distress would be of little significance if scholars and policymakers did not believe there was any connection. In fact, both groups frequently assume or argue that fringe credit is linked to financial distress.

Subparts C and D challenge that claim. I survey the existing forms of fringe credit and analyze their propensity to cause financial distress, defined both as unmanageable debt and an inability to make ends meet. Then, I offer evidence that any future fringe banking products will similarly have no causal connection to financial distress.

A. Academics Frequently Argue that Fringe Banking Causes Financial Distress

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77 Soman & Cheema, supra note 71, at 32.
78 Id.
79 Id.
80 Id. at 36.
81 Pottow, supra note 11, at 432.
82 Soman & Cheema, supra note 71, at 50.
Academics frequently make the claim that fringe banking transactions cause consumers to experience financial distress. More subtly, academics often lump fringe banking products with other consumer credit products which do cause financial distress and treat them all the same.

First, two of the three books that extensively analyze fringe banking explicitly claim that fringe banking products cause financial distress. In his 2005 book *Shortchanged: Life and Debt in the Fringe Economy*, sociologist Harold Karger surveys the abuses in the fringe economy and suggests federal regulations. One of the problems he claims that fringe credit sources create is unmanageable debt: “While the fringe economy makes goods and services available to consumer who can’t otherwise afford them, it also traps them in a cycle of debt. . . . [V]ulnerable consumers are dragged deeper into a quagmire of debt.” Fringe products produce this distress, Karger claims, through “rates and terms that are almost impossible to satisfy.” In addition to these direct claims, Karger also conflates the effects of fringe banking with the effects of credit cards by assuming that fringe products and credit cards have the exact same effect on consumers’ debt loads.

Similarly, law professor Christopher Peterson’s 2004 book *Taming the Sharks: Towards a Cure for the High Cost Credit Market* uses the risk of unmanageable debt to make the case for significant regulatory intervention into the fringe economy. Peterson’s first line of attack against fringe banking products is that they cause bankruptcies: “An excellent first example of an externality associated with high-cost credit transactions is the social costs incurred in bankruptcy. Bankruptcy has proven to be an inevitable result of high-cost credit transactions.”

His assertions about payday lending’s link to bankruptcy is even more specific. He argues that payday loans can become “a trap [some debtors] cannot escape without missing rent, utilities, car payments, or food expenditures. These loans can create a biweekly cycle of income and expenses leaving only enough surplus income to pay the most recent accrual of interest and fees.”

In some ways, Peterson’s claims are more reserved than Karger’s. For instance, while implying that the relationship between bankruptcy and fringe credit sources is strong, he notes that we have no reliable data on what portion of the debt discharged in bankruptcy comes from

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83 The only significant book about the fringe economy that does not discuss the relationship between financial distress and fringe banking products is economist John Caskey’s book *Fringe Banking: Check-Cashing Outlets, Pawnshops and the Poor*. JOHN CASKEY, FRINGE BANKING: CHECK-CASHING OUTLETS, PAWNSHOPS, AND THE POOR (1994). This fact is not surprising, however, because Caskey only spends 8 of 150 pages talking about pawnshop regulations. Id 116-23. He does not make any claims about the link between pawnshops and financial distress.
84 KARGER, supra note 6, at xii.
85 Id. at xv.
86 Id. at xvi.
88 Id. at 14.
fringe financers. Additionally, he recognizes that pawn loans do not leave consumers indebted to pawnshops. Still, like Karger, for the most part, Peterson lumps fringe banking transactions together with other forms of credit, treating them all as if they cause financial distress.

Another influential book is Robert Manning’s Credit Card Nation. Manning’s focus is broader than just the fringe economy, but he devotes significant attention to it. The conclusion of Manning’s analysis is straightforward—he maintains that fringe credit transactions leave consumers deep in debt to lenders: “In sum, as long as the proliferation of corporate loan sharks is not effectively regulated, the most economically disadvantaged will find themselves ensnared in new forms of debt peonage relationships.” This conclusion, like Peterson’s and Karger’s conclusions, treats pawnshops, payday loans, rent-to-own, and auto title lending as having the same effects on people as credit cards.

In addition to these books, legal scholars frequently claim that credit in the alternative financial services sector leads to financial distress. Some scholars claim the increased availability of credit is to blame because it allows “consumers to become highly leveraged” which in turn has caused increased bankruptcy rates. Others posit that fringe products, like payday loans and auto title loans, cause bankruptcies and overindebtedness because they are “low-quality credit at very high rates and with predatory foreclosure rates.” Finally, other sources continue the trend of treating fringe products like payday loans and auto title loans the same as mortgages, claiming they all cause financial distress.

By far the most common claim in the legal literature is that payday lending bankrupts consumers. There are three theories for why payday loans cause financial distress. First, some

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89 Id. at 36.
90 Id. at 20.
92 Id. at 225. Debt peonage is “the system, prevalent in the post-Civil War South, in which debtors were forced to work for their creditors.” Paul Krugman, The Debt-Peonage Society, N.Y. TIMES, Mar. 8, 2005.
95 See Kristin Brandser Kalsem, Bankruptcy Reform and the Financial Well-Being of Women: How Intersectionality Matters in Money Matters, 71 BROOKLYN L. REV. 1181, 1228-29 (2006) (“Another key source of irresponsibility that was highlighted in the bankruptcy reform process was that of predatory lenders—in the home mortgage market, as well as with respect to payday loans and car title loans. Again, this was a hot topic in the media, as well as in the congressional debates themselves. For example, in an attempt to hold these lenders responsible for their contributions to the increase in bankruptcy filings, Senator Durbin offered an amendment that would prohibit a predatory mortgage lender who had violated the Truth in Lending Act from pursuing its claim in bankruptcy.”).
96 See, e.g., Sullivan, Warren, & Westbrook, supra note 10, at 250 (“[C]hanges in credit practices may have permitted debtors to become more indebted when they are under financial stress, thus increasing the number of people who must turn to bankruptcy following a financial reversal and increasing the debt loads they carry when they file for bankruptcy. . . . Even nonhomeowners could stay in the credit game when they were in financial trouble. A new player—the payday lender—made sure that there would be cash to pay the landlord or the daycare center even for those with the worst credit records.”), Catherine E. Vance & Paige Barr, The Facts and Fiction of Bankruptcy Reform, 1 DEPAUL BUS. & COMM. L.J. 361, 415 (2003) (“Payday loans are another example of the
claim consumers experience financial failure because the costs of payday loans are so high relative to borrowers’ incomes. 97 Second, many people claim that payday borrowers repeatedly rollover their loans, transforming what looks like a short term debt into a long term obligation. 98 Finally, one recent paper theorizes that interest payments for payday loans tip people on the brink of bankruptcy into bankruptcy. 99 The merits of these three arguments are taken up in subpart II.C.

B. Policymakers Rely on Financial Distress to Justify Fringe Banking Regulation

While it is troubling than academics support fringe banking legislation because of a purported link to financial distress, it is more disturbing that policymakers do the same thing. This subpart presents evidence of this from several statutes that affect the fringe banking industry, focusing primarily on a bill that was passed by Congress and signed by President Obama in July 2010. It is important to demonstrate that policymakers do in fact rely on financial distress because otherwise this Article has theoretical implications but little practical significance. As the following hopes to prove, however, financial distress is a central justification for fringe banking regulations. Even if the ultimate effects of these regulations are positive for reasons other than preventing financial distress, it is disturbing to realize a key rationale behind them was flawed. And, more often than not, faulty reasoning yields faulty

culture that seems to encourage practices that lead to bankruptcy.”); Lisa Blaylock Moss, Modern Day Loan Sharking: Deferred Presentment Transactions & the Need for Regulation, 51 ALA. L. REV. 1725, 1727 (2000) (“On a practical level, these short-term lenders prey upon less-sophisticated consumers, sending many into an unending cycle of indebtedness and contributing to record-high levels of personal bankruptcy in the United States.”); Kelly J. Noyes, Get Cash Until Payday! The Payday-Loan Problem in Wisconsin, 2006 WIS. L. REV. 1627, 1645 (2006) (“Wisconsin consumer bankruptcy filings establish that bankruptcy petitioners with payday loans go bankrupt sooner than other debtors . . . .”); Kristina Scott, Payday Lending, PRESS-REGISTER, Nov.22, 2009, at A19 (“[P]ayday lending is a broken product that ensnares borrowers in unmanageable debt. . . . [U]sing payday loans doubles the risk a borrower will end up in bankruptcy within two years . . . .”).

97 See, e.g., Blaylock Moss, supra note 96, at 1742 (“The high rates alone contribute to unmanageable levels of personal indebtedness among low and modest income households, sending many desperate consumers into a downward spiral of indebtedness which ultimately forces them into bankruptcy.”).

98 See, e.g., Carmen M. Butler and Niloufar A. Park, Mayday Payday: Can Corporate Social Responsibility Save Payday Lenders?, 3 RUTGERS J.L. & PUB. POL’Y 119, 121 (2006) (“Over 70% of consumers were repeat consumers, taking from two to nineteen loans during a one-year period. These statistics, including lending fees and the rate of repeat consumers, help illustrate how consumers can easily become trapped in a web of accumulated loans and finance charges that can ultimately lead to grave debt or bankruptcy.”);PETE RSON, supra note 87, at 14 (“These loans can create a biweekly cycle of income and expenses leaving only enough surplus income to pay the most recent accrual of interest and fees.”); JEAN ANN FOX & ED MIERZWINSKI, SHOW ME THE MONEY: A SURVEY OF PAYDAY LENDERS AND REVIEW OF PAYDAY LENDER LOBBYING IN STATE LEGISLATURES 8 (2000) (“These loans are designed to keep consumers in perpetual debt.”); Beth Musgrave, Beshear Backs Payday-Loan Rate Cap Interest Would Top Out at 36%; Industry Opposed, LEXINGTON HERALD-LEADER, Dec. 16, 2009, available at 2009 WLNR 25268444 (“A July report by the Center for Responsible Lending showed that many people borrow from one lender to pay off another. Consumer advocates say this often causes a cycle of debt that traps consumers.”).

results, so determining the relationship between fringe banking and financial distress is important to ensure policymakers craft sound policies.

The most prominent recent example of policymakers using financial distress to justify fringe banking regulations is President Obama’s successful efforts to pass a financial reform bill that creates a new federal bureau within the Federal Reserve to regulate financial products called the Bureau of Consumer Financial Protection.100 The Dodd-Frank Wall Street Reform and Consumer Protection Act establishes, “in the Federal Reserve System, an independent bureau to be known as the ‘Bureau of Consumer Financial Protection,’ which shall regulate the offering and provision of consumer financial products or services under the Federal consumer financial laws.”101 The bill gives the Bureau the specific power to take action “to prevent a person from committing or engaging in an unfair, deceptive, or abusive act or practice under Federal law in connection with any transaction with a consumer for a consumer financial product or service.”102

An important justification articulated for the Bureau has been that under-regulated consumer credit products cause financial distress.103 The Obama Administration, the press, and legal academics have all emphasized that the Bureau’s goal is to prevent financial distress. First, the Obama Administration has stressed that past unregulated lending caused both financial distress to individuals and to the economy generally. For instance, in a speech in October 2009, one of President Obama’s central messages supporting the Bureau was that predatory financing practices leave people financially distressed: “But my concern are the millions of Americans who behaved responsibly and yet still found themselves in jeopardy because of the predatory practices of some in the financial industry.”104 The President has also stressed the negative externalities generated through unregulated lending, criticizing the big financial firms for opposing the Bureau after taxpayers bailed them out.105 In his first State of the Union address,

102 Id. §1031.
103 In another article, I report empirical data on the justifications offered in the media and government reports for the Bureau regulating fringe credit. I found that 15% of articles that justify the Bureau covering fringe credit give the link to financial distress as a rationale. Jim Hawkins, The Federal Government in the Fringe Economy, 14 CHAP. L. REV. (forthcoming 2011).
104 Remarks by the President on Consumer Financial Protection, Oct. 9, 2009, 2:37 PM EDT.
105 Stout & Baton, supra note 100, at B3.
President Obama called for financial reforms to prevent lenders from taking “risks that threaten the whole economy.”

Second, the press has furthered the notion that the Bureau is meant to minimize personal financial distress and systemic implications of personal financial woes. A Boston Globe editorial makes plain the editorialists’ understanding that the Bureau is a solution to the externalities caused by consumer lending:

The new Consumer Financial Protection Agency proposed by the Obama administration is needed to correct obvious flaws in the financial system and to prevent a repeat of last year’s economic collapse. Predatory marketing of subprime mortgages was a root cause of the current recession. Those toxic loans were bundled in opaque mortgage-backed securities that went hurtling through the global financial system, destroying enormous sums of investor wealth and nearly paralyzing credit markets. Nothing could be more clearly in the national interest than to avoid a recurrence of that financial pathology.

A more subtle, although extremely persuasive, means by which the Administration and media have promoted the idea that the Bureau’s purpose is minimizing financial distress is by focusing attention on the credit products under the Bureau’s jurisdiction that most commonly

107 Anne Flaherty, Consumer Protection Bill Approved, BOSTON GLOBE, Oct. 23, at 8 (“The proposed Consumer Financial Protection Agency is a cornerstone to Obama’s broader plan to clamp down on Wall Street and prevent much of the reckless lending that contributed to last year’s near-collapse of the market.”); Brady Dennis, Consumer Groups Praise Idea of Financial Protection Agency, WASH. POST, July 17, 2009, at A13 (“The idea is to help safeguard Americans against deceptive and abusive lending practices that contributed to the current crisis.”).
110 Anne Flaherty, Senate Democrats Aim to Curb Fed, BOSTON GLOBE, Nov. 11, 2009, at 6 (“Among the top points of contention is Dodd’s desire to create a Consumer Financial Protection Agency to protect consumers taking out home loans or using credit cards against predatory lending and surprise interest rate hikes.”); Jim Puzzanghera, Banker Gets an Earful, LOS ANGELES TIMES, Oct. 2, 2009, at B1 (“Liberals have sharply criticized it for taking 14 years—from 1994 to 2008—to adopt rules to protect consumers from unscrupulous mortgage lending. The Obama administration has hammered the Fed on that point as well, a major reason it has proposed shifting consumer protection powers from the Fed and other regulators to the new Consumer Financial Protection Agency.”); Stephen Labaton, Leading Senator Pushes New Plan To Oversee Banks, N.Y. TIMES, Sept. 20, 2009, at A1 (“Like the president, Mr. Dodd supports the creation of a new consumer financial protection agency to both write and enforce new rules protecting households from credit cards and mortgages with abusive or deceptive terms.”); Dennis, supra note 107, at A13 (“The administration envisions a new agency with broad powers to oversee a range of financial products, from mortgages to credit cards.”).
cause financial distress and externalities: credit cards and mortgages. One statement by an 
editorialist typifies the focus on credit cards and mortgage lending: “The country needs a 
regulator that will keep financial consumers from being taken to the cleaners by their bank or 
their mortgage broker or their credit card issuer.”

Finally, academics have recognized that the Administration has justified the Bureau 
because the subprime mortgage crisis subjected individuals and the worldwide economy to 
financial distress. For instance, in his post for The Atlantic opposing the Bureau, Richard 
Posner notes that the “statute is intended to prevent a repetition of the current financial crisis.”

More significantly, Oren Bar-Gill and Elizabeth Warren’s article Making Credit Safer, which is 
the academic foundation for the Bureau, employs financial distress as a justification for creating 
a federal agency to regulate consumer credit:

Consumer credit products also pose safety risks for customers. Credit cards, 
subprime mortgages, and payday loans can lead to financial distress, bankruptcy, 
and foreclosure. Economic losses can be imposed on innocent third parties, 
including neighbors of foreclosed property, and widespread economic instability 
may affect economic growth and job prospects for millions of families that never 
took on a risky financial instrument.

If the Bureau were only intended to cover credit cards and mortgages, this rationale may 
make sense, but the bill empowers the Bureau to regulate the fringe economy. The bill governs 
“consumer financial product[s],” which are defined as “financial product[s]” used for household 
purposes. The definition of financial products is expansive, and it includes “extending 
credit.” Thus, the plain language of the bill explicitly reaches every fringe banking transaction 
discussed in this Article except rent-to-own transactions because each of these transactions 
explicitly involves an extension of credit. The bill does cover leases like rent-to-own

111 Joe Nocera, The Consumer Financial Protection Agency Gets a Big Push . . ., NY TIMES EXECUTIVE SUITE 
BLOGS, Oct. 9, 2009. 
112 Joshua Wright & Todd Zywicki, Three Problematic Truths About the Consumer Financial Protection Agency Act 
about-consumer-financial-protection-agency-act-2009 ( “The foundational premise of the CFPA is that a failure of 
consumer protection . . . was a meaningful cause of the financial crisis and that the CFPA would have or could have 
averted the crisis or lessened its effects.”); Lawless, supra note 18, at 161 (“The proposal is far from fanciful. A bill 
to establish such a commission was introduced before the 110th Congress, and such a proposal will be attractive to 
leaders of the 111th Congress, who will want to report to constituents that they took some action against the reckless 
consumer lending that is blamed for the current economic woes.”). In addition to legal academics, consumer 
advocates explicitly link the need for the CFPA with financial distress. See Dennis, supra note 107, at A13 (“It 
targets the most significant underlying causes of the massive regulatory failures that have harmed millions of 
Americans.”) (quoting Travis Plunkett, legislative director for the Consumer Federation of America).
114 Bar-Gill & Warren, supra note 11, at 3.
115 Consumer Financial Protection Act of 2010 §1002(5).
116 Id. §1002(15)(A)(i).
arrangements if "(i) the lease is on a non-operating basis [and] (ii) the initial term of the lease is at least 90 days." 117 Rent-to-own leases are non-operating leases because the lessee retains ownership at the end of the lease, but most initial lease terms are not 90 days. Thus, renting-to-own is probably not covered by this definition of a lease. 118 Still, the Bureau may still have authority over rent-to-own contracts if either the Bureau determines that renting-to-own is really an extension of credit, as several courts have done, 119 or if the Bureau wants to define rent-to-own transactions as a financial activity by rule. 120

Not only does the statute’s language cover fringe banking products, the Administration, in supporting the Bureau, specifically has stated the bill includes fringe banking products and that these products are included because they cause financial distress. In a speech supporting the Bureau, President Obama invited a woman who had taken out a payday loan to serve as an example of the type of transactions the Bureau would regulate. 121 In his speech, he specifically linked payday lending to wide scale financial distress: “[A]buses like these don’t just jeopardize the financial well-being of individual Americans—they can threaten the stability of the entire economy.” 122 Other members of the Administration testifying to Congress also stress that fringe banking products would be under the Bureau’s umbrella: “A wide range of credit products are offered—from payday loans to pawn shops, to auto loans and car title loans, many from large national chains—with little supervision or enforcement.” 123

The academic underpinnings of the Bureau also stress the link between financial distress and fringe banking products. Bar-Gill and Warren’s pivotal article claims “payday loans can lead to financial distress, bankruptcy, and foreclosure.” 124 The Treasury’s White Paper in support of the Bureau emphasizes the need for “comprehensive reform” that goes beyond reform to credit cards and mortgages. 125 This reform is needed, the White Paper asserts, to prevent financial crises like the country is currently experiencing. 126 Finally, consumer advocates appearing in support of the Bureau testified that fringe banking causes financial distress. 127

117 Id. §1002(15)(A)(ii).
118 For a more extensive discussion of the Bureau’s relationship to fringe credit, see Hawkins, supra note 103.
120 See Consumer Financial Protection Act of 2010 §1002(A)(xi) (defining “financial activities” as “such other financial product or service as may be defined by the Bureau, by regulation, for purposes of this title”).
121 Remarks by the President on Consumer Financial Protection, Oct. 9, 2009, 2:37 PM EDT.
122 Id.
124 Bar-Gill & Warren, supra note 11, at 3.
126 Id.
sum, financial distress has been a centerpiece in the policy rationale articulated to the public for the Bureau and for the Bureau governing fringe banking transactions.

While the Bureau is the most prominent recent example of policymakers using financial distress to intervene into fringe credit markets, it is not the only example. On the federal level, legislators supporting payday lending reforms emphasize that payday lending creates a cycle of debt\textsuperscript{128} and “traps consumers.”\textsuperscript{129} Support for a recent bill to reform the Bankruptcy Code came from consumer advocates because payday loans, among other credit sources, force “borrowers into bankruptcy despite their best efforts to shave down principal.”\textsuperscript{130}

Financial distress has also been a central concern for state regulators. A report on short-term lending in Illinois emphasized the expense of fringe banking and claimed this expense “depletes the customer’s ability to catch-up, therefore making the customer ‘captive’ to the lender.”\textsuperscript{131} Tennessee’s statute governing auto-title lenders has a principal reduction feature that requires borrowers make a 5% principal reduction payment upon the third renewal of their loan.\textsuperscript{132} This regulation was specifically motivated by concerns about distress: “principal reduction helps to prevent such borrowers from being mired into long term debt.”\textsuperscript{133} As a final example, Ohio recently passed a payday lending law,\textsuperscript{134} and the purpose of the statute was to prevent borrowers from becoming trapped in a cycle of debt.\textsuperscript{135}

This subpart is not intended to criticize either the Bureau or other state or federal regulations themselves. All of these regulations may be justified and beneficial market interventions. The point of the subpart is to show that an important foundation for many of these regulations is a link between financial distress and fringe banking. The next subpart evaluates that link and concludes it is extremely difficult to establish. As a result, it turns out regulators have been largely placing their trust in a faulty rationale.

\textbf{C. Questioning the Link Between Current Fringe Banking Products and Financial Distress}

\textsuperscript{128} 154 CONG. REC. S7969 (daily ed. July 31, 2008) (statement of Sen. Akaka) (“Loan flipping often leads to instances where the fees paid for a payday loan well exceed the principal borrowed. This situation often creates a cycle of debt that is hard to break.”).

\textsuperscript{129} 155 CONG. REC. E493–94 (daily ed. Feb. 26, 2009) (statement of Rep. Gutierrez) (“‘[C]ycle of debt’ that too often traps consumers when they cannot repay their payday loan when first due. As a result, many payday lenders force borrowers to rollover their payday loan or obtain a new loan to pay off the initial loan, while piling on additional fees.”).

\textsuperscript{130} Stacey Kaper, \textit{Battle Lines Form Over Rate-Cap Legislation}, AM. BANKER, June 1, 2009, at 1.

\textsuperscript{131} SARAH D. VEGA, \textit{SHORT TERM LENDING FINAL REPORT, ILLINOIS DEPARTMENT OF FINANCIAL INSTITUTIONS} 30 (1999).

\textsuperscript{132} TENN. CODE ANN. § 45-15-113(d).

\textsuperscript{133} TENNESSE DEPT. OF FINANCIAL INSTITUTIONS, \textit{THE 2008 REPORT ON THE TITLE PLEDGE INDUSTRY} 18 (Feb. 20, 2008).


\textsuperscript{135} \textit{Enact a Strong Lending Reform}, CINCINNATI ENQUIRER, May 5, 2008, at 4B.
The previous two subparts argue that academics and policymakers rely on financial
distress as a significant justification for intervening in fringe credit markets. As I have noted,
this view has intuitive appeal. We might suspect that people excluded from mainstream credit
sources because of poor or nonexistent credit histories or low incomes would be the most likely
to suffer financial distress because of the fringe credit sources they are forced to use.

Surprisingly, however, the sources of credit in the fringe banking industry are specifically
designed to insulate the borrower from experiencing financial distress. While it may be unlikely
fringe banking firms are particularly concerned with the overall financial well-being of their
customers, members of the industry have structured their lending activity to prevent losses due to
nonpayment by largely avoiding repayment issues altogether. It is precisely because fringe
borrowers are vulnerable to financial distress that fringe bankers structure transactions to prevent
it.

The following sections survey the different financial products available in the fringe
economy and demonstrate how the fringe banking industry insulates consumers from financial
distress. Because the definition of financial distress is unclear, I analyze fringe banking in light
of the two most prominent definitions of financial distress, evaluating fringe credit’s propensity
to cause people to suffer from unmanageable debt and its likelihood to cause people to lack the
ability to make ends meet in their financial lives. Regarding unmanageable debt, demonstrating
that there is no link between fringe credit markets and distress is relatively straightforward
because most fringe credit is specifically designed to prevent unmanageable debt. Evaluating the
effect of fringe credit on consumers’ abilities to make ends meet is much more complicated and
unsure because it is difficult to establish with much certainty the secondary effects of fringe
transactions.

Some previous scholarship has contended that some specific fringe products do not cause
borrowers to declare bankruptcy, but no other research systematically surveys the
characteristics of all forms of fringe banking products to evaluate the link between bankruptcy
and fringe credit. Furthermore, none of the current research addresses the broader question of
whether fringe banking products cause financial distress and not just bankruptcy.

1. Rent-to-Own

In rent-to-own transactions, customers obtain possession of goods by making weekly
rental payments. If the customer completes all the rental payments under the contract, the rent-

136 Todd J. Zywicki, Consumer Welfare and the Regulation of Title Pledge Lending, (George Mason Univ. Mercatus
(arguing that title loans are relatively unlikely to be fatal to consumer’s balance sheet because of “the relatively
small dollar amounts at stake and inherent limits on the amount of the loan”); Hawkins & Mann, supra note 8, at
885-86 (arguing payday lending does not cause bankruptcy); Petru S. Stoianovici & Michael T. Maloney,
Restrictions on Credit: A Public Policy Analysis of Payday Lending (unpublished draft, Oct. 2008) at 1 (finding no
empirical evidence that payday lending increases the number of people filing for bankruptcy).
to-own store gives the customer title to the good. But, if the customer fails to pay, the only consequence is that the store repossesses the good.137 The transaction is structured with an easy way out for consumers—consumers do not have any obligation to continue making rental payments under the rental agreement.138 The consumer does not borrow any money from the rent-to-own store and does not make any long term agreements to pay the store anything.

This ability to get out of the arrangement is the structural component of the transaction that makes it very difficult to establish a link between renting-to-own and financial distress if financial distress means suffering under unmanageable debt. Rent-to-own customers are never in a position where they are unable to pay their debts or service their monthly debt payments because they do not take on any debt obligations.

To say that rent-to-own transactions are structured to avoid debt is not to say they are without costs to consumers. Thus, even though the rent-to-own transaction itself does not involve unmanageable debt, it could cause consumers to take out unmanageable debt or it could inhibit families’ abilities to make ends meet as a secondary effect of the transaction. The obvious downside to renting-to-own is that consumers do not acquire title to the good until completing all the payments on the contract, so consumers risk losing the equity they have acquired in the goods if they stop making payments.139 Also, even if they do end up owning the goods, they have paid substantially more for the goods than if they had bought them outright.140 It is possible that these costs could cause consumers to default on other credit obligations141 or take on other debt to make sure they can make their rental payments. Also, it is possible that paying high fees for rent-to-own would prevent consumers from being able to pay for other services they want or need142 or from accumulating savings needed to deal with financial shocks in the future.143 Any of these scenarios could establish a link to financial distress, depending on what definition one accepts.

139 Id. at 2057.
141 Cf. Rafael I. Pardo & Michelle R. Lacey, The Real Student Loan Scandal: Undue Hardship Discharge Litigation, 83 AM. BANKR. L.J. 179, 192 (2009) (“[I]t could very well be that some nondefaulting student-loan debtors suffer financial distress but do not default because they prioritize repayment of their student loans over other debts.”).
142 Mann & Mann, supra note 24, at 23 (“The relatively limited debt burdens characteristic of younger households suggest not frugality, but a lingering market constraint. When younger households experience financial difficulty often the main sources of funding to which they can turn are high-cost options that well might exacerbate financial distress instead of helping the family through the hard times.”); Betti et al., supra note 40, at 140-41 (“[O]ver-indebtedness can arise: the consumer’s current assets are no longer sufficient to offset the present value of future debts. In such a situation, the predetermined optimal consumption path is no longer sustainable and the consumer would be forced onto a lower consumption path that could mean a severe disruption to the pre-established standard of living.”).
143 MANNING, supra note 91, at 217 (“Those who beat the odds rarely accumulate much equity for future emergency loans—even when they pay off the ownership lease.”).
But, I do not think these concerns provide evidence that renting-to-own causes financial distress even as a secondary effect of the transaction. First, the best empirical evidence indicates rent-to-own customers do not lose equity that they have built up through numerous rental payments because the largest rent-to-own stores allow customers to pick up where they left off in rental contracts even after stopping payment on the contract for some time.\(^{144}\) Second, although it is possible that the high costs of rent-to-own cause consumers to default on other debts, there is no evidence of this effect. It is certainly true that the effects of high costs are more severe on people with lower incomes, but this argument more aptly criticizes the pricing of fringe credit than providing evidence of distress. Thus, even when looking at the secondary effects of renting-to-own, little evidence links rent-to-own and financial distress.

2. **Pawnbroking and Auto Title Lending**

Unlike rent-to-own transactions, pawnbroking and title lending do explicitly involve consumers taking on debt. In both transactions, the lender makes a loan to customers, and the customers are obligated by the loan agreement to pay back the loan with interest. Lenders are subject to the Truth-in-Lending-Act,\(^ {145}\) and the loans generally operate like any other consumer credit. Two important characteristics set pawn and auto title loans apart from other sources of credit—the amounts of the loans are usually quite small and customers have an escape hatch if they cannot pay off the loan. These two characteristics cast serious doubt on the assertion that pawnbroking and auto title lending cause financial distress.

First, in pawn transactions, the customer gives the pawnshop some form of personal property that the pawnshop holds as collateral for the loan given to the customer.\(^ {146}\) Unlike many collateralized transactions, the pawnbroker actually takes possession of the collateral.\(^ {147}\) If the customer cannot pay off the loan after a period specified by the state statute, the pawnbroker has the right to sell the pawned good.\(^ {148}\) If the sale does not generate sufficient funds to pay off the loan, the customer is not liable for any deficiency. Alternatively, if the lender recovers more than the loan from the sale, the customer is not entitled to any surplus.\(^ {149}\)

Most collateralized loans do not prevent financial distress because they are recourse loans. Borrowers are liable for the full amount of the loan and must pay that amount if the sale of the collateral does not cover the debt. John Mixon explains how recourse debts work in the context of mortgages and how they can result in financial distress:

\(^{144}\) Hawkins, *supra* note 10, at 2057.
\(^{147}\) *CASKEY*, *supra* note 83, at 37.
\(^{148}\) Oeltjen, *supra* note 146, at 1001.
Recourse promissory notes impose personal liability on borrowers for the total amount borrowed. The mortgage pledges the land (for present purposes, a personal residence) as security. If the borrower defaults, the lender can foreclose, have the land sold, and apply the proceeds to reduce the debt. But the note obliges the borrower to repay the borrowed amount in full and he or she is personally liable for deficiency if foreclosure sale proceeds do not satisfy the debt. The deficiency can be reduced to judgment and recorded in county records, where it hovers over the debtor for ten or more years. The judgment has the practical effect of disabling the debtor from participating in the normal credit market, authorizing seizure and sale of all non-exempt assets, and, where allowed, subjecting wages to garnishment.  

When a person gets upside down in a loan—when the loan amount is higher than the worth of the goods—the consequences can be serious, and the loan can cause the debtor to declare bankruptcy.

Pawn transactions, however, are different than the standard collateralized loan because they are nonrecourse loans. If pawn customers do not have the money to pay off the loan, they do not have to pay. They can just walk away and not worry about if the sale will cover the debt. Even those very critical of fringe banking recognize the benefit of this structure: “One positive feature of pawn credit is its tendency to be naturally short-term and terminal. Unlike payday loans where consumers often are forced to repay their loans over relatively long periods, a defaulting pawn debtor simply forfeits the personal item left with the pawnbroker as collateral.” Thus, for those who associate financial distress with having unmanageable debt, pawnbroking conclusively can never directly cause financial distress because the debt is self-liquidating.


The matter of deficiencies after foreclosure is important. A congressional report estimates that subprime mortgages alone will generate two million foreclosures. House values in some parts of the United States have dropped dramatically, and many distressed owners find it virtually impossible to sell at prices anywhere near their mortgage debt. If two million foreclosures produce an average of twenty thousand dollars deficiency each, the lingering liability could total forty billion dollars. Even if actual judgments or collection efforts reach only one-tenth of that amount, four billion dollars is still a big hit on that part of society that has just been through financial disaster and is least able to pay. Moreover, the liability is formal, but not real. The borrowers will not pay because they have few, if any, assets to attach in satisfaction of the judgment. The only recovery in most cases will be the pittance professional bill collectors extract.

151 Id. at 38.

152 Id. at 36-37 (“Nonrecourse obligations . . . impose no personal liability for deficiency after foreclosure except for claims for waste and foreclosure costs.”).

153 See David A. Skeel, Jr., *Racial Dimensions of Credit and Bankruptcy*, 61 WASH. & LEE L. REV. 1695, 1720 (2004) (“Blacks who relied on pawnshops and check-cashing outlets—or more ominously, on loan sharks—had at
The secondary effects of pawn loans are less determinate. The obvious problem with pawn loans is that people who pawn goods lose out on any equity they own in the goods beyond the amount of the loan. By law, pawn borrowers are not entitled to any surplus the sale of their possessions generates.Pawn customers are almost never upside down in pawn transaction because pawnshops typically only lend around 50% of the value of pawned good. As a result, consumers who do not pay off loans lose wealth as a result of the deal because they do not receive the amount they paid for the good or even the current value of the good. Perhaps more significantly, they lose the ability to use the collateral they have lost in the future to obtain other loans when they need them. For some people, the equity they have in their possession functions as their savings account and the loss of that equity means they will be unable to obtain credit.

Still, consumers pawning goods usually do not experience serious financial loss by losing the good because the value of most pawned goods is small. The real loss to consumers is the lost idiosyncratic value the consumer places on the goods. People who lose their grandmother’s wedding ring from not paying off a pawn loan experience a personal tragedy, but the consequences are not financial and are mostly internalized.

Some pawn transactions involve people pawning the tools required for their livelihood, and losing these tools could render the consumer unemployable, causing financial distress. But, the vast majority of the collateral pawned is not tools, so this concern has limited practical

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154 Oeltjen, supra note 146, at 1001.
155 Id. at 1005. For evidence from the industry, see EZCORP, Inc., Annual Report (Form 10-K), at 4 (Sept. 30, 2009) (“We generally lend from 25% to 65% of the pledged property’s estimated resale value depending on an evaluation of these factors.”).
156 In part pawn borrowers lose wealth because they paid much more for the goods than they get through the loan.
See Karger, supra note 6, at 67 (“Appraisals are low—jewelry appraises at whole value, guns at 60% of blue book value, and appliances at 10%-30% or less of their original cost.”).
157 Caskey states that average pawnshop loan was for around $60 in 1991, which translates to around $93 in 2008 dollars. Caskey, supra note 83, at 26. Assuming the amount loaned is around half the value of the goods, on average, people lose less than $100 when they do not pay off pawn loans. See also Robert W. Johnson & Dixie P. Johnson, Pawnbroking in the U.S.: A Profile of Customers 16 (Credit Research Ctr., Monograph No. 34, 1998) (reporting the average pawn loan is $70); EZCORP, Inc., supra note xx, at 4 (“The pawn loan amount varies depending on the valuation of the item pawned, but our average U.S. pawn loan amount typically ranges between $80 and $120.”).
159 Johnson & Johnson, supra note 157, at 16 (reporting survey results that people pawn jewelry most frequently, followed by electronic equipment, guns, hunting equipment and fifth, tools); Karen Underwood, Staying Afloat: More People Turn to Pawn Shops for Quick Buck as Economy Sours, HIGH POINT ENTER., Nov. 17, 2008, (reporting that “[g]old, silver, diamonds and coins are hot sellers” at pawn shops.); Patricia Older, People Turn to Pawnshops to Make Ends Meet, PICAYUNE ITEM, Dec. 1, 2009, available at http://picayuneitem.com/local/x546309603/People-turn-to-pawn-shops-to-make-ends-meet (“[N]owadays [pawnshops] see] mostly firearms, music equipment, and gold.”); EZCORP, Inc., supra note xx, at 4 (“Collateral for our pawn loans consists of tangible personal property, generally jewelry, consumer electronics, tools, sporting goods and musical instruments. Approximately 65% of our pawn loan collateral is jewelry, and the vast majority of that is gold jewelry.”).
importance. Also, most people redeem their pawns, further reducing the number of consumers who pawn and lose something required for their livelihood.\(^{160}\)

Pawn transactions have some positive secondary effects as well. For instance, pawn loans often prevent financial distress by converting the value of a good into cash which can be used to pay for necessities to make ends meet.\(^{161}\) Pawnshops provide essential access to credit for people experiencing financial shocks who may have nowhere else to turn.\(^{162}\) This access is arguably more important than income in avoiding hardship.\(^{163}\) Surprisingly, in European countries with restricted access to credit, people are more likely to be overindebted than in countries with more access because liquidity constraints prevent consumers from efficiently smoothing their consumption.\(^{164}\)

Another secondary effect of the nature of pawnbroking is that people are unlikely to flippantly incur substantial amounts of debt. If someone is pawning an item of personal importance, they are more likely to understand the gravity of their actions than when they are just swiping their credit card.\(^{165}\) The physical act of taking property to the pawnshop can itself be quite difficult\(^{166}\) and borrowers lose possession of their goods immediately,\(^{167}\) so borrowers experience immediate pain in taking out pawn loans. This pain should prevent consumers from thoughtlessly accumulating debt. Additionally, because the size of pawn loans is set at around half the value of the collateral, borrowers cannot take on significant amounts of debt because the value of the collateral constrains them. Thus, while there is a risk that pawning tools will land

\(^{160}\) See John P. Caskey, Pawnbroking in America: The Economics of a Forgotten Credit Market, 23 J. MONEY, CREDIT, & BANKING 85, 90V (1991) (reporting default rates on pawn loans from 3.9–30.2 depending on the state’’); EZCORP, Inc., supra note xx, at 4 (“Through our lending guidelines, we maintain an annual redemption rate (the percentage of loans made that are repaid, renewed or extended) between 76% and 79%.”).

\(^{161}\) Oeltjen, supra note 146, at 1008 (“Pawnbrokers state that their customers feel compelled to tell them why they are pawning their possessions and that, instead of borrowing to finance luxuries such as vacations, ‘they’re borrowing $ 500 for food on the table’ or ‘to satisfy an unexpected need, pay bills or buy groceries.’ Another pawnbroker commented, ‘We have a lot of people come in here with sick kids and they need a prescription or food or Pampers, and where are they going to get it?’”).

\(^{162}\) Betti et al., supra note 40, at 145 (“Households with low and/or uncertain incomes often have limited access to credit or rapidly exhaust the credit that they have. Households in this situation are particularly vulnerable to negative shocks.”).

\(^{163}\) CASKEY, supra note 83, at 121 & n.8.

\(^{164}\) See Betti et al., supra note 40, at 153 (“There is clear evidence to support the existence of a liquidity constraint, particularly in European countries where consumers have less access to credit market. In these countries, overindebtedness seemed to be severer and more widespread than in countries with accessible consumer credit markets.”). On the importance of debt as a way to smooth consumption, see Richard A. Posner, Have We Lost the Moral Values That Undergird a Commercial Society?, at http://www.becker-posner-blog.com/archives/2008/06/have_we_lost_th.html (last visited Jan. 13, 2009) (“At the same time, now that we have efficient debt instruments that in former times did not exist or were extremely costly, the role of personal debt . . . in human welfare is more apparent than it was. Apart from its role in solving short-term liquidity problems resulting from delay in the receipt of income, debt enables consumption to be smoothed over the life cycle.”).

\(^{165}\) See supra note 61 and accompanying text.

\(^{166}\) See CASKEY, supra note 83, at 112 (arguing consumers’ costs in transporting collateral give pawnshops a local monopoly power).

\(^{167}\) See supra note 146.
some people in financial distress, other characteristics of pawnbroking suggest that the
transaction prevents, not engenders, financial distress.

Title lending is similar to pawnbroking in that consumers obtain loans by using their cars
as collateral. Title lending customers borrow money usually for 30 days at a time, and title
lenders takes title of their cars as collateral but allow the customer to continue to possess the
vehicle.168 Like pawn loans, most title loans are nonrecourse.169 Thus, like in pawn transactions,
consumers have a safety hatch they can use if they cannot pay off the loan—they can walk away
with the money and lose their vehicle. Thus, assuming financial distress means an inability to
pay one’s debts, the title loan borrower literally cannot fall into this category because of the auto
title loan.

Like pawn loans, however, title loans are typically oversecured,170 so people walking
away without their vehicle lose the surplus that could be generated from the sale of the vehicle.
Additionally, consumers are not compensated for the payments they have already made on the
loan if the vehicle is sold, representing a further loss of money.171 These losses could in turn result in people taking on unmanageable debts or failing to make ends meet. And, unlike pawn
loans, the stakes are higher with title lending both because the loan amounts are typically
higher172 and because customers could lose a method of transportation to their jobs if they fail to
pay and the lender repossesses their car.

Despite the fact consumers lose their car and larger amounts of the equity in the vehicle,
existing evidence does not link title lending to financial distress. The vast majority of title loans
do not default and result in the lender repossessing the vehicle.173 So, the actual number of
people who lose access to a vehicle and their equity in the vehicle because of title lending is low.
Also, the loan amounts are still relatively small. The American Association of Responsible Auto
Lenders reports that the average loan size is $700.174 A study by the Consumer Federation of
America similarly found that “[t]ypical car title loans are for relatively small amounts, with the

168 Zywicki, supra note 136, at 11-12.
ANN. § 37-3-413(5) (2009).
170 Jean Ann Fox & Elizabeth Guy, Driven into Debt: CFA Car Title Loan Store and Online Survey, CONSUMER
(noting the most frequent “loan-to-value set at 50 to 55 percent of the car’s value”). Some title lenders appraise the
car at the lowest possible value (the wholesale price in bad condition) and then offer 50% or 33% of that value.
KARGER, supra note 6, at 167.
171 KARGER, supra note 6, at 167.
172 See Zywicki, supra note 136, at 11 (“Typical car title loans are for relatively small amounts, with the median
minimum loan $175 and the median maximum loan $2,500.”).
173 See id. at 12 (reporting that lenders indicated 8% of loans result in repossession). See also Annesley H. DeGaris,
Car Title Lending, 2 AMERICAN ASSOCIATION FOR JUSTICE: AAJ ANNUAL CONVENTION REFERENCE MATERIALS
(July 2007) (reporting 10% of title loans result in repossession). Determining exactly what percent of borrowers
have cars repossessed is difficult, as both Zywicki and DeGaris report repossessions per loan, not per customer, and
customers often rollover each loan multiple times. What percentage of borrowers experience repossession is an
important piece of information missing from current scholarship on title lending.
174 Zywicki, supra note 136, at 11.
median minimum loan $175 and the median maximum loan $2,500.”\textsuperscript{175} Thus, assuming the loan to value ratio is close to 50%, the typical loss for consumers is $700 in equity in the car, assuming the title lender does not give any surplus of the sale of the vehicle to the borrower. $700 is a significant loss to someone without substantial savings or earning capacity relative to their wealth, making it difficult to estimate the real the effects of these defaults. But, without evidence about the number of borrowers losing their vehicles, the number of customers with alternative means of transportation, and the significance and extent of lost equity, there simply is not evidence that demonstrates title lending causes distress.

Because lenders are generally limited to selling the collateral as the sole recourse against the borrower in pawn and title lending transactions, the link between financial distress as unmanageable debt and these transactions is impossible to establish. Even applying a broader definition of distress as inability to make ends meet and looking at the secondary effects of these transactions, the link to distress is still far from clear. Like rent-to-own, the lenders have structured the transaction to prevent the total financial breakdown of the people who use them.

3. **Secured Credit Cards**

Secured credit cards operate like normal credit cards except the borrower deposits funds with the lender that serve as the collateral for the credit card.\textsuperscript{176} The credit limit for the card is usually set at the same amount of money that the borrower has placed in a restricted account with the lender.\textsuperscript{177} Around half of credit unions offer secured cards,\textsuperscript{178} as well as many banks.\textsuperscript{179} In a survey of lower income Americans, John Caskey found that 18% of households carried secured credit cards.\textsuperscript{180} Banks market these cards to people with poor credit histories or sporadic employment records, advertising “No Credit Requirements” and “No Income Requirements” and promoting the fact that positive credit information will be reported to credit bureaus.\textsuperscript{181}

Secured credit cards work like pawn and title lending transactions to give customers a way out if they cannot repay the loan to the lender. If the consumer cannot pay back the loan, the lender simply applies the deposit to the outstanding debt and returns any surplus to the borrower. It is highly unlikely that a borrower would experience financial distress because

\textsuperscript{175} Fox & Guy, supra note 170, at 11.
\textsuperscript{176} Julie L. Williams et al., *Developments in Credit Card Practices and Related Actions by the OCC to Protect Consumers*, 60 BUS. L. 691, 692 (2005).
\textsuperscript{177} Id.
\textsuperscript{180} JOHNP. CASKEY, LOWER INCOME AMERICANS, HIGHER COST FINANCIAL SERVICES 13 (1997).
borrowers essentially are using money they have already saved to secure the debt. In fact, some commentary challenges whether secured credit cards even offer credit.

In addition to providing an escape hatch, secured credit cards also constrain borrowing, which prevents the credit from becoming the cause of financial distress. Normal credit cards have such a strong potential to lead consumers to financial distress because consumers can qualify for and borrow a large percentage of their annual salary. With secured cards, however, the credit limit is set by the amount the borrower deposits with the lender, preventing the borrower from getting a very high loan or becoming overextended.

4. Payday Loans

The clearest link between a fringe banking product and financial distress is payday lending. Payday loans are short-term, high-interest loans where the borrower typically writes a check to the lender for the amount of the loan plus the interest and post-dates the check to the date of the borrower’s next paycheck, usually two weeks later. Unlike rent-to-own, payday lending is a credit product, and unlike pawn loans, title loans, and secured credit cards, payday loans do not have an escape hatch that permits borrowers to exit the transaction if they are unable to pay off the loan.

Although it is not structured with an automatic escape hatch, payday lending is similar to other fringe loans because payday lending has a stringent cap on how much credit consumers can obtain—the consumer’s next paycheck. An individual lender will not permit a borrower to obtain more than their biweekly salary. Even if the borrower goes to multiple lenders, it is unlikely they could get a loan for more than their biweekly salary. Lenders report payday loans to Teletrack, a credit bureau for fringe credit transactions, and lenders check Teletrack before extending loans to ensure potential borrowers have not taken out other payday loans. As a result of this cap, most payday loan amounts are low, averaging $300. In many states, statutes disallow loans over $500, guaranteeing relatively low loan amounts. Thus, payday lending avoids the excessive debt burden that most often causes unmanageable debt. An inability to pay one’s debts is unlikely because the borrower never owes very much money relative to their income.

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182 KARGER, supra note 6, at 56, 59.
183 See Angela Littwin, Testing the Substitution Hypothesis: Would Credit Card Regulations Force Low-Income Borrowers into Less Desirable Lending Alternatives?, 2009 U. ILL. L. REV. 403, 448 n.249 (“There is a product known as a secured credit card, but it does not actually offer the borrower any credit. The putative borrower must send the issuer a deposit in the amount of the borrower's line of 'credit.'”).
184 Mann & Hawkins, supra note 8, at 857.
185 Johnson, supra note 11, at 103. Some states have databases that licensed lenders can use to verify if someone has already taken out a payday loan. MICH. COMP. LAWS ANN. §487.2142 (West Supp. 2009).
Several researchers have studied the link between payday lending and bankruptcy, coming to different conclusions. Some assertions that payday lending causes bankruptcy are easy to dismiss because they merely note a correlation between people having payday loans and people declaring bankruptcy. It is not surprising people who declare bankruptcy have payday loans because these loans are often a last resort before filing bankruptcy. But, a mere correlation does not establish that payday loans drove the debtors to bankruptcy.

In one important analysis, however, Paige Marta Skiba and Jeremy Tobacman conclude payday loans cause bankruptcy. They report that “loan approval for first-time applicants increase the two-year Chapter 13 filing rate by 2.48 percentage points.” Their findings are significant because others have also begun using the study to claim that payday loans cause people to file bankruptcy without interrogating the bases for Skiba and Tobacman’s findings.

The conclusion that payday lending causes bankruptcy, however, is too blunt. First of all, Skiba and Tobacman only found that payday loans affect Chapter 13 bankruptcies, not Chapter 7 bankruptcies. Their full sample “shows little association between [payday] loan approval and Chapter 7 bankruptcy . . . ” Thus, when discussing Chapter 7 bankruptcies, the conclusion is that payday loans do not cause bankruptcy. Claims based on their work that “a single payday loan of only $300 increases the chance of a bankruptcy filing by 2.84 percent” are simply inaccurate. Additionally, this is an odd output from their models. If payday lending pushes

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188 Compare Skiba & Tobacman, supra note 99, at 1 (concluding payday lending causes people to be more likely to declare Chapter 13 bankruptcy), with Donald P. Morgan & Michael Strain, Payday Holiday: How Households Fare After Payday Credit Bans (Federal Reserve Bank of N.Y., Working Paper No. 309, 2008), available at http://www.newyorkfed.org/research/staff reports/sr309.pdf (finding that the abolition of payday lending in Georgia and North Carolina increased the number of people declaring Chapter 7 bankruptcy); Stoianovici & Maloney, supra note 136, at 1 (finding no empirical evidence of a link between payday lending and increased bankruptcy filings).


190 Mann & Mann, supra note 24, at 9.

191 Skiba & Tobacman, supra note 99, at 1.

192 See Steven M. Graves & Christopher L. Peterson, Usury Law and the Christian Right: Faith-Based Political Power and the Geography of American Payday Loan Regulation, 57 CATH. U. L. REV. 637, 646 (2008) (“Payday lending may also tip consumers teetering on the edge of insolvency into bankruptcy, thereby frustrating the collection efforts of other creditors who otherwise might have been able to collect.”); Rosemary Gambardella, Abusive Credit Card Practices and Bankruptcy: Three ABI Members Testify before Senate Judiciary Subcommittee, 28-4 ABIJ 10, 10-11 (2009) (“High-interest-rate debt is financial quicksand. . . . Even small debts at high interest rates can increase the chance of a bankruptcy filing. A study by Professors Paige Marta Skiba and Jeremy Tobacman found that a single payday loan of only $300 increases the chance of a bankruptcy filing by 2.84 percent. High-interest-rate debt strongly correlates with bankruptcy, which suggests that it contributes to consumer financial distress and bankruptcy filings.”).

193 Skiba & Tobacman, supra note 99, at 12.

194 Gambardella, supra note 192, at 10-11.
people to bankruptcy, why would it only affect Chapter 13 bankruptcies and not Chapter 7? Skiba and Tobacman offer no reason for the anomalous result.

More importantly for the purposes of this Article, the study does not purport to claim that payday lending causes financial distress but instead only asserts payday lending causes people to file for bankruptcy. As explained above, these two concepts are not identical.\textsuperscript{195} Skiba and Tobacman find that payday loans constitute a very small part of consumers’ debt obligations: “Payday loan debt outstanding is therefore a small fraction of the $34,000 of unsecured debt that these bankruptcy filers had on average.”\textsuperscript{196} The consumers who declare bankruptcy after taking out payday loans, they note, were “already severely financially stressed” before taking out the payday loan.\textsuperscript{197} Similarly, other research uses individuals taking out a payday loan as a proxy for financial distress,\textsuperscript{198} suggesting that people take out payday loans because they are experiencing distress and not that payday loans cause distress.

The most significant problem with the study, however, is that there is no plausible explanation for how payday loans could cause bankruptcy. Skiba and Tobacman claim the harm of payday lending is that the interest payments on payday loans might be sufficient to “to tip the balance into bankruptcy” for people already experiencing financial distress.\textsuperscript{199} Because payday loans have short durations, they suspect that “payday interest payments may take priority and borrowers may fall further behind on other accounts.”\textsuperscript{200} They estimate that the cumulative interest payments to payday lenders were 11% of the total annual interest burden of consumers declaring bankruptcy.\textsuperscript{201} They make this estimation by assuming that the other debt the consumer held had an annual interest rate of 15%.\textsuperscript{202}

This explanation seems unlikely. Their assumption of a 15% annual interest rate, for which they do not provide any basis in the paper, is probably wrong. The Federal Reserve reports that the average annual percentage rate (APR) for all credit card in the last quarter was 14.90%, a figure in line with Skiba and Tobacman’s assumption.\textsuperscript{203} Credit card companies, however, charge risky customers, like those who would be driven to take out a payday loan, significantly more than other customers.\textsuperscript{204} Most credit card debt held by individuals with poor credit is more likely to be at a rate above 20%.\textsuperscript{205} By using a more realistic assumption of a

\textsuperscript{195} See \textit{supra} note 43 (noting the important distinction between the two concepts).
\textsuperscript{196} Skiba & Tobacman, \textit{supra} note 99, at 20-21.
\textsuperscript{197} \textit{Id.} at 3.
\textsuperscript{198} Mann & Mann, \textit{supra} note 24, at 9.
\textsuperscript{199} Skiba & Tobacman, \textit{supra} note 99, at 3.
\textsuperscript{200} \textit{Id.} at 10.
\textsuperscript{201} \textit{Id.} 20-21.
\textsuperscript{202} \textit{Id.} at 20.
\textsuperscript{203} \textsc{Federal Reserve Statistic Release, Consumer Credit G.19} (Sept. 2009), \textit{available at} http://www.federalreserve.gov/releases/g19/Current/g19.pdf.
\textsuperscript{204} Mann, \textit{supra} note 11, at 190.
\textsuperscript{205} For instance, Robert Manning suggests 19.8% APR would be a “moderate” APR for someone with poor credit. Manning, \textit{supra} note 91, at 218.
20% APR for consumer non-payday loan debt, cumulative interest payments due to payday loans only constitute 8.3% of the customers’ overall cumulative interest payments in Skiba and Tobacman’s study.\textsuperscript{206} If the average rate of the other credit is 25%, cumulative interest payments because of payday loans are only 6.6% of total interest payments. Thus, Skiba and Tobacman’s argument that payday loans contribute to financial distress because they make up 11% of consumers’ annual interest payment overstates the magnitude of the problem.

John Caskey has pointed out a final problem in Skiba and Tobacman’s paper. Skiba and Tobacman compare people who were denied for a payday loan with people who were accepted, and the way the two populations were determined was by a clear credit score threshold set by the lender who gave Skiba and Tobacman data. But these two populations are likely “systematically different . . . in both observable and unobservable ways.”\textsuperscript{207} The differences are more pronounced if the two populations compared have different credit scores, and Skiba and Tobacman’s data only show a statistically significant difference in rate of bankruptcies for applicants within a 0.5 standard deviation of the credit score threshold and not a difference for applicants within a .01 standard deviation of approval threshold.\textsuperscript{208} Caskey explains the significance of the different credit scores between the two populations:

\begin{quote}
It could be, for example, that applicants with higher credit scores have more debts with traditional lenders or more assets to protect. If so, when they face financial difficulties they may be more likely to file for Chapter 13 bankruptcy, while applicants with lower credit scores simply ignore their creditors, who also ignore them since there is almost nothing to gain from someone with few assets, little income, and a terrible credit history.\textsuperscript{209}
\end{quote}

The other two theories in legal literature for why payday loans create financial distress similarly run into problems creating a plausible causation argument. First, some commentary argues that payday loans are too expensive for people. The argument makes sense. The high cost of the credit causes distress because people are spending money servicing their loan instead of using the money to make ends meet: “For such debtors, payday loans may become a trap they cannot escape without missing rent, utilities, car payments, or food expenditures. These loans can create a biweekly cycle of income and expenses leaving only enough surplus income to pay the most recent accrual of interest and fees.”\textsuperscript{210} As discussed above, this argument proves too much. It would allow people to establish links between financial distress and any expensive product or service. More importantly, this argument is overstated. If borrowers are rolling over a payday loan for $300, it means every paycheck the borrower is paying $45 on average in

\begin{footnotesize}
\textsuperscript{206} I obtained this figure using the calculation Skiba and Tobacman use in their analysis: $567/0.2*$34,000. See Skiba & Tobacman, \textit{supra} note 99, at 20-21.


\textsuperscript{208} \textit{Id.}

\textsuperscript{209} \textit{Id.} at 31-32.

\textsuperscript{210} Peterson, \textit{supra} note 87, at 14.
\end{footnotesize}
interest. It is highly unlikely that a $45 payment every other week will substantially exacerbate significant financial distress, although, admittedly, it will cost the borrower money.

The final theory of how payday lending causes financial distress is that borrowers roll loans over and over, creating a long term debt obligation. Even with the reality of rollovers, which are a significant problem, two facts make it unlikely that rollovers alone cause serious financial distress. First, even if a consumer rolls over a payday loan, the total amount of the indebtedness is capped at the amount of the loan. So, it is impossible for the consumer’s debt to spiral out of control: “Even in the most dramatic examples—in which a customer pays $1000 to maintain a $150 debt over a period of eighteen months—the customer’s level of debt never increases beyond $150.” Second, most payday loan obligations are not rolled over for substantially long terms. The most damning evidence of the frequency of rollovers suggests that the average borrower takes out 12.5 payday loans a year. Half a year may be a long time to have a loan designed to be two weeks long, but when compared to other forms of debt, it is relatively short-term. Also, other survey data suggest that most people who use payday loans do so once or twice a year.

In the end, payday loans operate just like other fringe banking products. They are structured, like the other forms of credit, to prevent borrowers from suffering financial distress because they do not allow borrowers to take on large amounts of debt. This cap on debt limits the likelihood that a payday loan will cause the borrower to incur unmanageable debt or be unable to make ends meet. For each of the forms of credit discussed here, the link between the credit and financial distress is either nonexistent or tenuous. Policymakers and academics cannot rely on financial distress as a basis to justify intervention into these markets as the products currently exist. The next subpart extends this argument by contending that any innovations in fringe credit products will likely share similar characteristics to current products, undermining the link to financial distress.

**D. Structural Components of the Fringe Economy that Make Links to Financial Distress Unlikely in the Future**

Some critics of fringe bankers claim that there are no limits on what fringe credit providers will do to make money. Firms will create any product, the reasoning goes, that is

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211 Mann & Hawkins, supra note 8, at 896.
212 Id. at 896.
213 See Steven M. Graves & Christopher L. Peterson, Predatory Lending and the Military: The Law and Geography of “Payday” Loans in Military Towns, 66 OHIO ST. L.J. 653, 663(2005) (collecting studies showing the frequency of rollovers; the one with the largest number of rollovers is presented here).
214 FEDERAL DEPOSIT INSURANCE CORPORATION, FDIC NATIONAL SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS, Dec. 2009, at 31 (reporting that 58.3% of unbanked people who stated they had used a payday loan reported using it once or twice a year).
passably legal.\textsuperscript{215} This subpart argues that in addition to legal constraints, there are significant structural constraints in fringe credit markets that limit the sorts of transactions fringe providers can create and that these constraints produce specific characteristics of fringe credit products. Constraints stem from the fact that lenders do not trust financially marginalized people to repay their loans. Because fringe lenders are unwilling to take on the risk of nonpayment, they must structure the transaction to have the total amount of debt be low, and the amount of the debt must be tied to a tangible source of repayment, either collateral or an upcoming paycheck. Any innovative products in fringe credit markets will of necessity have these characteristics and thus will be unlikely to cause financial distress. Indeed, the very fact that alternatives to fringe banking have not arisen\textsuperscript{216} is some evidence that structural constraints in these markets dictate the nature of the transactions.

Characteristics of fringe credit products obverse each of the characteristics of credit cards that link credit card debt to financial distress.\textsuperscript{217} While credit card limits are set at very high levels and allow debt to spiral out of control, the amount of debt incurred through fringe credit products is significantly constrained. Credit cards make incurring debt easy because they are revolving debt, but incurring debt is more difficult in fringe credit markets because fringe credit is nonrevolving debt. Finally, people incur debt up to the unrealistic limits credit card companies set for consumers, but consumers using fringe credit products have realistic debt obligations. The opposing characteristics of mainstream credit card debt and fringe credit products demonstrate how the latter are unlikely to engender financial distress now or in the future.

The most significant characteristic of fringe credit products is that the amount of the debt is constrained. Simply put, fringe creditors will not lend significant amounts of money to borrowers because they do not trust that borrowers will pay them back.\textsuperscript{218} In other credit markets, creditors lend based on the borrower’s creditworthiness as predicted by credit scores.\textsuperscript{219} In the fringe economy, however, lenders explicitly advertise that they perform “no credit checks,” and for the most part, they do not use any technology to judge borrowers’ creditworthiness.\textsuperscript{220} Lenders assume borrowers will not reliably pay back their debts, so they structure the transactions to ensure repayment through other means.\textsuperscript{221} Unless in the future fringe lenders are suddenly inclined to take on substantial risk, this characteristic is unlikely to change.

\textsuperscript{215}KARGER, supra note 6, at 4 (“These fringe economy services are equivalent to an economic Wild West where just about any financial scheme that’s not patently illegal is tolerated.”).
\textsuperscript{216}Id. at 104 (“Although the fringe economy saps the income and assets of poor families and communities, no simple or effective alternative to fringe lending has arisen that doesn’t harm low-income people.”).
\textsuperscript{217}See supra subpart I.C.
\textsuperscript{218}KARGER, supra note 6, at 42 (“Neither trust nor the presumption of goodwill exist in the fringe economy . . . .”).
\textsuperscript{219}See id. (observing that loans to the middle class are “secured by the borrower’s creditworthiness.”).
\textsuperscript{220}See MARRON, supra note 19, at 142 (“In practice, [fringe creditors] do not deploy technologies of credit scoring constituting individuals as risks nor feature as junctures within a national credit reporting assemblage which derive and calibrate the consumer’s capacity to self-govern.”).
\textsuperscript{221}See id. at 15 (“[N]ewly ascendant payday lenders, pawnbrokers, and rent to own retailers offer an ersatz alternative to credit cards and personal loans for the poor and the marginalized, but in ways that make no pretence
One common structure secures repayment through collateral. This is a likely avenue for new fringe credit products as well because it ensures the lender will be able to recover the debt without relying on the borrower for repayment. Payday loans operate without collateral but still are constrained by the amount of the borrower’s next paycheck. While credit card companies issue credit limits that are around one fifth of a borrower’s annual income, payday lenders restrict loan totals to 1/26th of the consumer’s annual income. Payday lenders do rely in some part of the borrower’s creditworthiness because they check Teletrack to determine if the borrower has taken out or defaulted on previous payday loans.\footnote{KARGER, supra note \textit{6}, at \textit{74}.} As noted in subpart II.C.4, the most plausible link between a fringe banking product and financial distress is payday lending. Ironically, the more lenders depend on creditworthiness to extend credit, the greater the likelihood the transaction will cause financial distress. The better someone’s credit history is coming into a credit transaction, the higher the risk they face that the transaction will cause them to experience distress. Figure 1 is a pictorial representation of this observation.

\textit{Figure 1: The Relationship Between Creditworthiness and Distress}

![Figure 1: The Relationship Between Creditworthiness and Distress](image)

In terms of financial distress, the effect of constraints is straightforward. Borrowers cannot accumulate as much debt as with fringe products as other credit sources, so they cannot become as prone to experience distress. More significantly, because lenders use other means to ensure repayment other than credit history, borrowers’ debts are usually paid off even if they cannot pay, making it impossible for them to take on unmanageable debt through fringe credit products.

In addition to the constraints on the amount of debt, any new fringe transaction is likely to be nonrevolving debt, a second common characteristic of fringe credit. All current forms of fringe banking are nonrevolving because they all have fixed balances which cannot be increased without taking out a new loan.\footnote{\textit{Id.} at \textit{42}.} Any future fringe products that are collateralized will be nonrevolving because in order to increase the loan amount, the consumer has to bring in new that such consumers can or are in a position to govern themselves. They generate coercive practices redolent of their nineteenth-century forebears, compelling a regime of repayments . . . .\textcita
collateral. Even possible fringe products based on future income are likely to be nonrevolving because lenders have a strong interest in verifying the amount of future income. Some statutes even require that extensions of fringe loans be made in a separate agreement. So, if a borrower wants a higher debt amount, a lender is likely to require the borrower to separately apply to prove the income is forthcoming. Because fringe credit is inevitably nonrevolving, consumers are much less likely to thoughtlessly incur significant amounts of debt. Experiencing this immediate pain discourages consumers from taking on debt, limiting their exposure to distress.

Finally, unlike credit cards, borrowers in fringe markets are not driven to accumulate debt by lenders setting unrealistic credit limits and borrowers following their lenders’ leads. Fringe creditors set loan amounts either based on the value of the collateral or the borrower’s next paycheck. Both of these amounts are realistic for the borrower to pay off. Thus, because the loan amounts are realistic for the borrower to repay, borrowers in the fringe economy are not prone to use their lenders’ assessment on their credit limits as proxies for how much debt they should accumulate. Unless fringe creditors become willing to take on substantially more risk in the future, it is unlikely that borrowers will have much higher credit limits.

III. POLICY IMPLICATIONS

The conclusion that fringe banking does not lead to financial distress will surprise many academics and policymakers who have relied on this rationale to justify fringe banking regulation. This Part charts out the implications of reaching this conclusion and hopes to reshape the academic and policy debates about fringe banking regulation.

A. Revealing and Rejecting a Faulty Heuristic

The most significant policy implication of this Article’s claim is also the most obvious: Policymakers should stop justifying fringe banking regulations because of a supposed link between fringe banking and financial distress. Policymakers have employed a faulty heuristic when considering the effect of fringe credit products by lumping fringe credit transactions together with other credit products like credit cards and mortgages and assuming that all credit products have the potential to cause financial distress. This faulty heuristic, in turn, leads to misguided and overly broad fringe banking regulations.

Behavioral economists have offered significant evidence against the rational actor model of consumer decisionmaking, positing that consumers making choices about products operate with bounded rationality. Consumers overestimate the likelihood of some events occurring.

224 For instance, Florida’s title loan statute states: “A title loan agreement may be extended for one or more 30-day periods by mutual consent of the title loan lender and the borrower. Each extension of a title loan agreement shall be executed in a separate extension agreement . . . .” Fla. Stat. § 537.011(3) (2009).

225 Patricia A. McCoy, A Behavioral Analysis of Predatory Lending, 38 Akron L. Rev. 725, 736 (2005) (reporting studies that found "people tend to overestimate the probability of compound events").
while underestimating the likelihood of others\textsuperscript{226}; they are overly optimistic about their futures\textsuperscript{227}; they lack defined, stable preferences\textsuperscript{228}; and they use faulty heuristics or short cuts in reasoning.\textsuperscript{229}

Just as cognitive limitations affect consumers, they also affect legislators.\textsuperscript{230} Indeed, some have argued that cognitive biases have a greater effect on public decisionmaking than private decisionmaking.\textsuperscript{231} One specific bias that research has identified in the context of policymaking is the availability bias.\textsuperscript{232} If a consequence is memorable, vivid, and easily retrievable, policymakers are apt to overestimate the likelihood that consequence will occur.

In the consumer credit context, policymakers likely overestimate the likelihood that any single credit product is going to lead to financial distress because financial distress is a vivid consequence of unmanageable debt. Academics’ and legislators’ tendencies to equate fringe credit products with financial distress is not surprising given the publicity afforded to the role of consumer credit in the current economic downturn.\textsuperscript{233} The media’s extensive coverage of the links between subprime mortgages and current economic malaise makes financial distress “more retrievable, imaginable, compelling, or memorable” to policymakers considering credit regulations.\textsuperscript{234}

\textsuperscript{227} Id.
\textsuperscript{229} See Adrian Vermeule, \textit{Emergency Lawmaking After 9/11 and 7/7}, 75 U. CHI. L. REV. 1155, 1179 (2008) (“To cope with bounded information and rationality, it is common to adopt simple heuristics, or decisionmaking maxims. Such heuristics can misfire in systematic ways . . . .”).
\textsuperscript{232} See supra subpart I.C. See also Richard H. Pildes & Cass R. Sunstein, \textit{Reinventing the Regulatory State}, 62 U. CHI. L. REV. 1, 60-61 (1995) (“‘Availability’ means that people’s assessment of one risk depends, at times, on how readily similar events come to their minds. When this effect is at work, people will overestimate the probability that an event will occur if the occurrence of similar events comes easily to mind . . . .”).
\textsuperscript{233} Jefffrey J. Rachlinski, \textit{Bottom-Up Versus Top-Down Lawmaking}, 73 U. CHI. L. REV. 933, 958 (2006) (describing “anecdote-driven legislation” which is a response to “a social problem that becomes so vivid and salient, that it instills an exaggerated sense of urgency in the public eye”).
As this Article demonstrates, this heuristic is faulty. Some short cuts in reasoning are necessary because people have to live life without doing an exhaustive analysis of every decision. But, if a heuristic is misleading, policymakers must reject it because a faulty heuristic results in bad policies. Regulators and academics need to stop conflating fringe banking and credit cards and instead look to the specific characteristics of different consumer credit products.

Rejecting this heuristic will affect policy debates in two ways, discussed in the next two sections. First, it will make other justifications for regulation more prominent. Most significantly, in the absence of externalities, paternalism should figure more prominently into debates about fringe markets. Second, it will affect the sorts of policies policymakers should implement.

B. The Importance of Paternalism

By advancing the claim in this Article, I am not arguing that no justifications exist for interfering in fringe credit markets. If financial distress cannot be invoked, researchers supporting regulations will have to focus on other theoretical justifications for regulating. Paternalism is perhaps the most apt justification for regulating credit markets that do not exacerbate financial distress because it does not rely on the existence of externalities. Paternalism, especially the libertarian paternalism that responds to cognitive limits identified by behavioral economics, aims to protect people from bad decisions, so it can justify regulations even if a credit transaction has no negative effects on third parties.

Some of the literature already seeks to justify fringe banking regulation on the basis of paternalism, courts have recognized its significance, and critics of the Bureau have argued that the Bureau is premised on paternalism as a hidden rationale. But, when compared to other

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235 Vermeule, supra note 229, at 1179.
241 See Posner, supra note 113 (“What is new in the proposed CFPA statute though not mentioned in it is ‘behavioral economics’ [a basis for paternalistic intervention].”); Wright & Zywicki, supra note 112 (“These intellectual architects of the CFPA assert that irrational consumer behavior is at the heart of the financial crisis, and that the CFPA is needed to ‘nudge’ consumers toward better decision making in lending markets.”).
credit devices like credit cards, researchers have spent little effort establishing the arguments for paternalistic intervention into fringe credit markets.242 If paternalistic concerns over defective decisionmaking are to replace financial distress, more research needs to be done to understand how consumers make decisions in the fringe economy. Thus, this Article joins others in the call for researchers to explore paternalism as a basis for fringe banking regulations.243

C. Policy Directions

If policymakers reject the notion that fringe banking causes financial distress and turn to other policy rationales like paternalism, it will shape the sorts of fringe banking regulations they adopt. This subpart offers a first pass at delineating types of regulations that appear to respond to fears about financial distress from those that have other rationales. A comprehensive review of all current and proposed fringe banking regulations is beyond the scope of this Article, but exploring a few examples illustrates the way regulators will have to rethink their approach to regulating credit markets for the poor.

Some regulations appear to be completely separable from financial distress as a rationale for regulation and instead rely on fairness, paternalism, or similar justifications that relate to protecting only the parties to the transaction. For instance, many states have mandatory disclosure requirements that provide consumers with information about the transaction.244 This information is meant to protect people from entering into transactions when they are uninformed or misinformed.245 Other regulations protect people from impulsive decisions, such as statutes that permit borrowers to rescind loans within a few days of taking them out.246 The law also


243 See John Caskey, Fringe Banking and the Rise of Payday Lending, in CREDIT MARKETS FOR THE POOR 40 (Patrick Bolton & Howard Rosenthal eds., 2005) (suggesting that further research to guide regulations is required to determine if payday loan consumers suffer from cumulative cost neglect and a lack of self-control, two common behavioral biases used as foundations for paternalistic regulations).

244 See, e.g., FLA. STAT. ANN. § 539.001(8)(b)(6) (West 2009) (requiring the front of pawn tickets to disclose the amount of the loan, the annual percentage rate, the maturity date of the pawn, and similar information); FLA. STAT. § 537.008 (2009) (requiring similar disclosures for title loans); IOWA CODE § 533D.9(2) (2008) (requiring payday lenders give written notice to borrowers of the fee, the annual percentage rate, and the date the lender will deposit the borrowers check); Consumer Rental Purchase Agreement Act, H.R. 1767, 110th Cong. § 1010(a) (2007), available at http://thomas.loc.gov/cgi-bin/query/z?c110:H.R.1767: (proposing a federal law that would require rent-to-own stores “(1) A brief description of the property. (2) Whether the property is new or used. (3) The cash price of the property. (4) The amount of each rental payment. (5) The total number of rental payments necessary to acquire ownership of the property. (6) The rental-purchase cost.”).

245 Cass R. Sunstein, Boundedly Rational Borrowing, 73 U. CHI. L. REV. 249, 251 (2006) (arguing people may make suboptimal borrowing decisions because “borrowers might not be adequately informed of the costs and benefits of borrowing. They might not read the fine print; they might believe that short-term ‘teaser rates’ are actually long-term, or at least neglect the fact that such rates will have only a small beneficial effect on their finances.”).

246 See MICH. COMP. LAWS ANN. §487.2151(6) (West Supp. 2009) (permitting borrowers to rescind payday loans within a day of taking them out).
protects people it judges to lack capacity to rationally enter fringe transactions, like minors. Finally, some judicial decisions protect people from waiving important rights. To the extent that research can develop paternalistic rationales for these sorts of regulations, the fact fringe banking cannot be linked to financial distress is inconsequential because these regulations can be justified just without reference to externalities created by the transaction.

Other regulations, however, appear to be premised on the belief that fringe banking products have such severe consequences like as financial distress that they must be heavily regulated. Banning fringe banking transactions is the clearest example of regulations that must rely on severe consequences like financial distress as a rationale for drastic market intervention. John Pottow has suggested that “the case for legal intervention is strengthened by the degree to which externalities pervade.” If the legal intervention is more drastic, such as prohibiting the transaction entirely, the case for that intervention must be stronger.

Price caps can have the same effect as outright bans if the caps make operating fringe banking firms impossible. Some price caps are high enough that fringe business can still operate profitably. Other states, however, have set price caps that drive all fringe lenders affected by the cap to leave the state or to engage in illegal practices. For instance, Oregon restricted payday lenders to charging 36% interest rate in 2007. Within a year, 75% of the lenders left Oregon. After Ohio imposed a 28% interest rate cap on payday lending, hundreds of payday lenders left the state completely, and the lenders who stayed created new fees to obviate the cap. While these statutes take the form of price regulations, they function really as bans on fringe credit. The conclusion of this Article should force regulators to reconsider these sorts

247 CAL FIN CODE § 21207 (2009).
249 Pottow, supra note 11, at 412 n.34.
250 See, e.g., IOWA CODE § 533D.9(1) (2008) (setting pawn prices at prices similar to the market price in other states: “A licensee shall not charge a fee in excess of fifteen dollars on the first one hundred dollars on the face amount of a check or more than ten dollars on subsequent one hundred dollar increments on the face amount of the check for services provided by the licensee, or pro rata for any portion of one hundred dollars face value.”); CONN. GEN. STAT. ANN. § 42-248(a) (West 2009) (forbidding “a rent-to-own agreement in which the total of rental payments necessary to acquire ownership exceeds twice the cash price of the rented property,” which approximates market prices in other states).
251 See ORS § 725.622(1) (2007) (“A lender in the business of making payday loans may not: Make or renew a payday loan at a rate of interest that exceeds 36 percent per annum . . . .”).
254 See Littwin, supra note 10, at 454 n.7 (explaining how usury limits can effectively ban credit products).
of drastic measures because they cannot depend on externalities associated with financial distress to justify intervention.

Finally, there are regulations that seem aimed at preventing financial distress as a secondary effect of fringe credit products. Insofar as the secondary effects of fringe banking are indeterminate, regulators worried about the consequences of fringe credit might consider these sorts of regulations. For instance, perhaps in response to the concern that carpenters will pawn their tools or musicians their instruments and lose their livelihood, 256 many pawn regulations require that the pawnbroker hold property for an extended period of time after the borrower first takes out the loan. 257 Similarly, some title lending statutes require that the lender hold the vehicle for thirty days after the maturity date of the loan before repossessing and selling it. 258 Some title lending statutes even require the lender to allow the borrower to redeem the vehicle up until the time of the actual sale. 259 These requirements could avert the financial crisis that might result if the lender repossesses the vehicle quickly after default and the borrower has no way to get to work. 260 In the context of payday lending, some statutes mitigate the distress that frequent rollovers may cause by allowing borrowers to pay off the principle due on the loan in installments. 261 This Article has argued it is unlikely fringe banking produces financial distress as a secondary effect, but to the extent this claim is necessarily tentative, regulators may consider these sorts of policies as a prophylactic measure to prevent adverse consequences of fringe credit products.

IV. CONCLUSION

To ensure a solid foundation for fringe banking regulations, it is essential that regulators address the real problems that fringe banking creates. Regulators cannot craft sensible regulations by importing problems created by other forms of credit into the fringe banking arena. This Article has documented the significant reliance academics and policymakers place in the assertion that fringe banking causes financial distress. This reliance is misplaced, and the result is a substantial amount of regulation directed at solving a problem that does not exist.

By examining how fringe banking products operate, I demonstrated that current fringe banking products largely eliminate the potential for borrowers to incur unmanageable debt. Some do so by ensuring repayment through collateral, and others constrain the amount of debt a borrower can incur at a reasonable level. Because fringe creditors will always be concerned

256 See supra subpart II.C.2.
259 Id. § 537.012(3).
260 See supra subpart II.C.3.
261 See Mich. Comp. Laws Ann. §487.2160(a) (West Supp. 2009) (mandating that customers who take out eight payday loans in a year be given the option to repay the principle debt in three installments each due on the borrower’s paydays).
about repayment, it is unlikely any future products in fringe credit markets will extend credit without collateral or tight limits on the amount of credit.

Future research into fringe banking must look to new rationales for regulation, and policymakers should avoid faulty heuristics that lump fringe banking with other distinct forms of credit. Fringe banking regulations are needed to ensure the well-being of the consumers who borrow in the fringe economy. Implementing regulations to prevent financial distress, however, are misguided and have the potential to harm the very consumers they are meant to protect.