

Fall 2011

## Regulating on the Fringe: Reexamining the Link Between Fringe Banking and Financial Distress

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### Recommended Citation

Hawkins, Jim (2011) "Regulating on the Fringe: Reexamining the Link Between Fringe Banking and Financial Distress," *Indiana Law Journal*: Vol. 86 : Iss. 4 , Article 4.

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# Regulating on the Fringe: Reexamining the Link Between Fringe Banking and Financial Distress

JIM HAWKINS\*

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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 the 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.*

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\* Assistant Professor of Law, University of Houston Law Center. For comments on earlier drafts of this Article, I thank John Caskey, Larry Garvin, Adam Levitin, Ronald Mann, Christopher Peterson, Katie Porter, David Zarig, and Todd Zywicki. The Article benefitted from comments on presentations at the University of Houston Faculty Workshop Series, the Teaching Consumer Law Conference, the South Texas College of Law Workshop Series, the Conglomerate Junior Scholars Workshop, the Federal Reserve Community Affairs Research Conference on the Changing Landscape of Community Development, and the Annual Meeting of the AALS Section on Financial Institutions and Consumer Financial Services. I am grateful to Brandi Gill, Eileen Pape, and Kelsey Heaton for research assistance.

*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. Policy makers 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.*

#### INTRODUCTION

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 policy makers 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.<sup>1</sup> 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.<sup>2</sup> 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.<sup>3</sup> 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 policy makers 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.<sup>4</sup> President Obama's focus on financial distress is far from

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1. See, e.g., Ronald H. Silverman, *Toward Curing Predatory Lending*, 122 *BANKING L.J.* 483, 486 (2005) ("This financial system at the fringe includes pawnshops, check cashing outlets, rent-to-own stores, tax refund-anticipation lenders, the makers of car title pawns, cash leasing operations and other second-tier credit providers as well.").

2. Ronald J. Mann & Jim Hawkins, *Just Until Payday*, 54 *UCLA L. REV.* 855, 857 (2007).

3. Errol Louis, Editorial, *How to Spear Credit Sharks*, *N.Y. DAILY NEWS*, Oct. 11, 2009, at 39 ("[Twelve] million borrowers have payday loans, which charge interest rates as high as 400%—a permanent debt trap for people most in need of a fair deal.").

4. President Barack Obama, Remarks by the President on Consumer Financial Protection (Oct. 9, 2009) [hereinafter Remarks, Consumer Financial Protection], available at [http://www.whitehouse.gov/the\\_press\\_office/Remarks-by-the-President-on-Consumer-Financial-Protection](http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-Consumer-Financial-Protection) (linking payday lending to wide-scale financial distress) ("[A] buses like

extraordinary. In the vast majority of the literature on consumer credit, authors assume or argue that fringe banking products cause financial distress.<sup>5</sup>

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, JCPenney, and Wal-Mart locations combined.<sup>6</sup> And, there are more pawnshops than credit unions and banks combined.<sup>7</sup> 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.<sup>8</sup> If regulations ban that credit or make it less accessible or more expensive because policy makers erroneously believe the credit causes distress, those regulations will 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."<sup>9</sup> This Article hopes to shape the growing body of literature analyzing fringe banking<sup>10</sup> and to contribute to the

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these don't just jeopardize the financial well-being of individual Americans—they can threaten the stability of the entire economy.").

5. See *infra* Part II.A.

6. HOWARD KARGER, *SHORTCHANGED: LIFE AND DEBT IN THE FRINGE ECONOMY* 6 (2005).

7. *Id.* at 67.

8. Mann & Hawkins, *supra* note 2, at 876.

9. Patrick Bolton & Howard Rosenthal, *Introduction*, in *CREDIT MARKETS FOR THE POOR* 1, 3 (Patrick Bolton & Howard Rosenthal eds., 2005).

10. E.g., Michael S. Barr, *Credit Where It Counts: The Community Reinvestment Act and Its Critics*, 80 N.Y.U. L. REV. 513 (2005); Richard R.W. Brooks, *Credit Past Due*, 106 COLUM. L. REV. 994 (2006); Jim Hawkins, *Renting the Good Life*, 49 WM. & MARY L. REV. 2041 (2008); Angela Littwin, *Beyond Usury: A Study of Credit-Card Use and Preference Among Low-Income Consumers*, 86 TEX. L. REV. 451 (2008); Christopher L. Peterson,

debate by developing an understanding of 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 situation in which a consumer has unmanageable debt. Finally, I discuss 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 policy makers 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. 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 policy makers 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 dependent on the link between fringe credit and distress. Finally, I offer suggested directions for policy makers to pursue in promulgating fringe banking regulations. Instead of banning fringe credit products, a common response to transactions that cause financial distress, policy makers 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

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*Usury Law, Payday Loans, and Statutory Sleight of Hand: Salience Distortion in American Credit Pricing Limits*, 92 MINN. L. REV. 1110 (2008); Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, *Less Stigma or More Financial Distress: An Empirical Analysis of the Extraordinary Increase in Bankruptcy Filings*, 59 STAN. L. REV. 213 (2006).

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.<sup>11</sup> Academics also use the risk of financial distress to justify changes in other legal regimes as well, such as the bankruptcy system and healthcare.<sup>12</sup> One scholar recently pointed out the overwhelming

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11. See, e.g., RONALD J. MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD MARKETS 188–89 (2006) (supporting specific credit card regulations because of the correlation between credit card use and financial distress); 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”); 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”); 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); 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.”); 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 that reckless lending causes financial distress); Elizabeth Warren, *What Is a Women’s Issue? Bankruptcy, Commercial Law, and Other Gender-Neutral Topics*, 25 HARV. WOMEN’S L.J. 19, 54 (2002) (“If the Federal Reserve adopted more aggressive regulations over predatory mortgage financing, tens of thousands of families that file for bankruptcy to try to save their homes from unscrupulous lenders would be spared.”); Katherine Porter, *The Debt Dilemma*, 106 MICH. L. REV. 1167, 1176 (2008) (book review) (asserting that determining the level of credit card use for individual families suffering financial distress “is critical to formulating effective credit regulation”). 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).

12. See, e.g., Melissa B. Jacoby, *Individual Health Insurance Mandates and Financial Distress: A Few Notes from the Debtor-Creditor Research and Debates*, 55 U. KAN. L. REV. 1247, 1250–51 (2007) (evaluating Massachusetts’s universal health insurance coverage policies by seeing how the efforts to establish universal coverage would affect financial distress); Katherine Porter & Deborah Thorne, *The Failure of Bankruptcy’s Fresh Start*, 92 CORNELL L. REV. 67, 68 (2006) (suggesting adjustments to bankruptcy law because under current laws people emerging from bankruptcy suffer financial distress); Eric A. Posner, *Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract*, 24 J. LEGAL STUD. 283, 284 (1995) (noting that externalities are an important factor in courts’ decision to refuse to enforce contracts).

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.”<sup>13</sup>

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.<sup>14</sup> Additionally, financial woes can cause problems for employees who are less productive because of their preoccupation with debt.<sup>15</sup>

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.<sup>16</sup> If the losses are significant enough, the financial distress of a borrower can plunge the creditor into distress.<sup>17</sup>

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 impose externalities on parties unconnected to the contract.<sup>18</sup> Recent regulatory intervention into consumer credit markets has been focused on curtailing externalities<sup>19</sup> and scholars justifying regulations devote a significant amount of energy to focusing on how credit contracts affect third parties.<sup>20</sup>

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13. Katherine Porter, *The Damage of Debt* (2010) (unpublished manuscript) (on file with author).

14. *See generally* Melissa B. Jacoby, *Does Indebtedness Influence Health? A Preliminary Inquiry*, 30 J.L. MED. & ETHICS 560 (2002) (analyzing studies linking financial distress and illness).

15. Oren Bar-Gill, *The Behavioral Economics of Consumer Contracts*, 92 MINN. L. REV. 749, 788 (2008).

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).

18. *See* Robert M. Lawless, *The Limits of Contract as Product*, 157 U. PA. L. REV. PENNUMBRA 160, 161 (2009) (arguing that lenders “do not fully internalize the costs of harm caused by the products . . . [because] borrowers and their families may experience all sorts of financial and emotional woe from improvident borrowing”).

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. *E.g.*, 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); Bar-Gill & Warren, *supra* note 11, at 58–59 (arguing that the costs of poor consumer decisions “generate a series of negative externalities”); Mann & Hawkins, *supra* note 2, at 884 (noting that financial distress “increases the burden on the social safety net”); Pottow, *supra* note 11, at 411 (“Few

Specifically, people experiencing financial distress are less productive, harming employers and other consumers.<sup>21</sup> Society is harmed as public resources are exhausted by the financially distressed seeking help from the social safety net.<sup>22</sup> At the extreme, the current financial recession is a result of private consumer mortgage contracts causing widespread financial distress.<sup>23</sup>

### 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.<sup>24</sup> However, to determine whether fringe banking transactions cause financial distress, it is essential to understand what financial distress means to the academics and policy makers who use the concept to justify regulations. This subpart argues that most academics and policy

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scholars today maintain that personal bankruptcy is a fully isolated, internalized occurrence between a debtor and creditor alone.”); Janis Sarra, *Economic Rehabilitation: Understanding the Growth in Consumer Proposals Under Canadian Insolvency Legislation*, 24 BANKING & FIN. L. REV. 383, 392 (2009) (“[E]xcessive credit card debt can impose substantial costs on the debtor, family members, and the general welfare safety net, as well as cost consequences from the diminished productive activities of those individuals in financial distress.”).

21. See 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), available at [http://www.defense.gov/pubs/pdfs/report\\_to\\_congress\\_final.pdf](http://www.defense.gov/pubs/pdfs/report_to_congress_final.pdf); 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.”).

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

23. Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. 1073, 1074–75 (2009); John Cassidy, *Interview with Richard Posner*, NEW YORKER BLOG (Jan. 13, 2010), <http://www.newyorker.com/online/blogs/johncassidy/2010/01/interview-with-richard-posner.html#ixzz0dShg9XmX> (“I don’t think we realized there were banking externalities, and that the riskiness of banking could facilitate a global financial crisis. That was a big oversight.”).

24. See, e.g., MANN, *supra* note 11, at 49–51 (examining the relationship between credit cards and financial distress and listing the consequences of financial distress without defining the term); Richard M. Hynes, *Why (Consumer) Bankruptcy?*, 56 ALA. L. REV. 121, 134 (2004) (arguing for changes in nonbankruptcy collection laws for financially distressed consumers without defining the term); Ronald J. Mann & Katherine Porter, *Saving Up for Bankruptcy*, 98 GEO. L.J. 289, 294–98 (2010) (discussing the differences between financial distress and bankruptcy without defining financial distress); Eric S. Nguyen, *Parents in Financial Crisis: Fighting to Keep the Family Home*, 82 AM. BANKR. L.J. 229, 230 (2008) (analyzing whether “parents with school-age children are more likely than their childless counterparts to keep their homes when they face financial distress” without defining financial distress); A. Brooke Overby, *Mortgage Foreclosure in Post-Katrina New Orleans*, 48 B.C. L. REV. 851, 907–08 (2007) (arguing that secondary market interventions are inadequate to prevent financial distress after natural disasters without defining financial distress); Sullivan et al., *supra* note 10, at 214–15 (stating “the data are far more consistent with the hypothesis that increased filings result from increased financial distress” without defining the term).

makers who rely on financial distress use the term to describe consumers who have unmanageable debt.

In the corporate context, there seem 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.<sup>25</sup> Usually financial distress is contrasted with economic distress, which means the firm is not generating sufficient revenue to make a profit.<sup>26</sup>

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”,<sup>27</sup> stating a firm is distressed if it cannot meet its payment obligations, not just its monthly debt service obligations;<sup>28</sup> or asserting a firm is financially distressed if the firm is not viable and unable to meet its monthly debt obligations.<sup>29</sup> One article in the corporate context sums it up: “The terms ‘financial distress’ and ‘insolvency’ are broad and ambiguous.”<sup>30</sup>

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25. E.g., Ted Janger, *Crystals and Mud in Bankruptcy Law: Judicial Competence and Statutory Design*, 43 ARIZ. L. REV. 559, 568 (2001) (“Financial distress arises when the underlying business is sound, but is not earning sufficient income to pay its debts.”).

26. E.g., 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).

27. Ken Heyer & Sheldon Kimmel, *Merger Review of Firms in Financial Distress*, 5 COMPETITION POL’Y INT’L 103, 103 (2009).

28. Charles W. Mooney, Jr., *A Normative Theory of Bankruptcy Law: Bankruptcy As (Is) Civil Procedure*, 61 WASH. & LEE L. REV. 931, 951 n.91 (2004).

29. See Patrick G. Dunleavy, *Reorganization or Liquidation?: Understanding the Valuation Process Can Help with Making the Right Decisions*, AM. BANKR. INST. J., July–Aug. 2009, at 56, 56 (“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.”); 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.”); Rasmussen & Skeel, *supra* note 26, at 87 (defining financial distress as an inability to pay the firm’s bills).

30. Ramesh K.S. Rao, David Simon Sokolow & Derek White, *Fiduciary Duty a la Lyonnais: An Economic Perspective on Corporate Governance in a Financially-Distressed Firm*, 22 J. CORP. L. 53, 62 (1996).

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; 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."<sup>31</sup> Indeed, Porter has argued that people can be "broke without borrowing."<sup>32</sup> 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"<sup>33</sup> or being poor.<sup>34</sup>

This conception of financial distress, however, misses the key component on which most literature on financial distress focuses—debt.<sup>35</sup> 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.<sup>36</sup>

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."<sup>37</sup> Another common indicator of financial

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31. Porter & Thorne, *supra* note 12, at 89.

32. Porter, *supra* note 11, at 1177.

33. Stephen J. Ware, "Medical-Related Financial Distress" and Health Care Finance: *A Reply to Professor Melissa Jacoby*, 55 U. KAN. L. REV. 1259, 1263 n.25 (2007).

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 the inability to pay obligations as they come 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."); CONGRESSWOMEN CAROLYN B. MALONEY, FOREVER IN DEBT: ANTI-COMPETITIVE CREDIT CARD PRACTICES AND THEIR IMPACT ON THE ECONOMY 4 (2008), available at <http://maloney.house.gov/documents/financial/creditcards/20080730CreditCardFINALPub.pdf> ("A high debt burden, or financial distress, occurs when families have unusually large total debt payments relative to their incomes, usually 40 percent.").

36. See Sarra, *supra* note 20, 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."); Sullivan et al., *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.").

37. Sullivan et al., *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. Allison Mann & Ronald Mann, *Debt, Financial Distress, and Bankruptcy Over the Life Course* 9 (Apr. 2010) (unpublished manuscript), available at <http://ssrn.com/abstract=1492845>.

distress is if consumers' debt is larger than their assets,<sup>38</sup> 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.<sup>39</sup>

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.<sup>40</sup> Over-indebtedness only arises when consumers' "current assets are no longer sufficient to offset the present value of future debts"<sup>41</sup> 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?"<sup>42</sup> 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,<sup>43</sup> but this understanding of financial distress exhibits the opposite defect of Ware's definition.

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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 37, at 9.

39. Debt Service Ratio is "after-tax income available to pay minimum debts" and the Financial Obligations Ratio is "minimum debts plus residential leases and other regular payments." Robert M. Lawless, Angela K. Littwin, Katherine M. Porter, John A.E. Pottow, Deborah K. Thorne & Elizabeth Warren, *Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors*, 82 AM. BANKR. L.J. 349, 370 n.75 (2008).

40. See Gianni Betti, Neil Dourmashkin, Mariacristina Rossi & Ya Ping Yin, *Consumer Over-Indebtedness in the EU: Measurements and Characteristics*, 34 J. ECON. STUD. 136, 140 (2007) ("The implication of the [life-cycle-permanent-income] model for understanding consumer indebtedness is that it is optimal for a consumer to be indebted under certain circumstances 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."); 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.").

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

42. Ware, *supra* note 33, at 1263 n.25 (emphasis in original).

43. See, e.g., *In re White Crane Trading Co.*, 170 B.R. 694, 703 (Bankr. E.D. Cal. 1994)

It is underinclusive because not all individuals experiencing financial distress file for bankruptcy.<sup>44</sup> Indeed, studies have found that most people experiencing financial distress do not file for bankruptcy.<sup>45</sup> 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.<sup>46</sup> But, the mere fact that 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.<sup>47</sup>

Although I think most authors use financial distress to mean unmanageable debt, for the purposes of this Article, I do not exclude an inability to pay one's bills from the definition of financial distress. Instead, I evaluate the link between fringe banking and financial distress conceived of as either unmanageable debt or inability to make ends meet.

### 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,<sup>48</sup> but the work linking credit cards to financial failure is better than the work linking any other form of

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("Bankruptcy presents a classic distress scenario. Mere use of the 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."); Richard A. Brown & Susan E. Burhouse, *Implications of the Supply-Side Revolution in Consumer Lending*, 24 ST. LOUIS U. PUB. L. REV. 363, 366 (2005) ("[W]e find that the incidence of household financial distress, as measured by per capita personal bankruptcy filings, has risen dramatically since the mid-1980s.").

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, and yet the number of bankruptcy filings—even at its pinnacle—represents only a sliver of those struggling with bills.").

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

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

48. See Adam Feibelman, *Defining the Social Insurance Function of Consumer Bankruptcy*, 13 AM. BANKR. INST. L. REV. 129, 165 n.197 (2005) (collecting sources arguing for both sides of the debate about whether credit cards cause bankruptcy).

credit to distress.<sup>49</sup> 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.

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. Policy makers 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*<sup>50</sup> 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.<sup>51</sup> To ensure that credit card debt and not other variables or country-specific differences caused the increased bankruptcy rates he observed, Mann incorporated unemployment and GDP as independent variables, and he incorporated dummy variables.<sup>52</sup> 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.<sup>53</sup>

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.”<sup>54</sup> With an increase of only \$100 per capita of credit card debt, the size of the effect is 165 bankruptcy filings.<sup>55</sup> Using a similar analysis, Mann also found that credit card spending is a significant contributor to consumer debt.<sup>56</sup>

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49. See Sean Hannon Williams, *Sticky Expectations: Responses to Persistent Over-Optimism in Marriage, Employment Contracts, and Credit Card Use*, 84 NOTRE DAME L. REV. 733, 741, 786 n.285 (2009) (collecting sources).

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.

Mann qualifies his findings in several ways, admitting the number of data points is small<sup>57</sup> and acknowledging his use of country-level data cannot account for individual families' uses of credit card debt.<sup>58</sup> Some critical commentary suggests similar deficiencies.<sup>59</sup> Still, Mann's analysis offers a highly credible link between financial distress and credit cards.<sup>60</sup>

## 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.<sup>61</sup> 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 rather 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.<sup>62</sup> Similarly, we might expect

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57. *Id.* at 67.

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.” (footnote omitted)).

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.” (footnote omitted)).

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).

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 to recall.<sup>63</sup> 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.<sup>64</sup> 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 decision making.<sup>65</sup> 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.<sup>66</sup> 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.<sup>67</sup> 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."<sup>68</sup>

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,<sup>69</sup> 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

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63. See Steven J. Cleveland, *An Economic and Behavioral Analysis of Investment Bankers When Delivering Fairness Opinions*, 58 ALA. L. REV. 299, 328 (2006).

64. See Dilip Soman, *Effects of Payment Mechanism on Spending Behavior: The Role of Rehearsal and Immediacy of Payments*, 27 J. CONSUMER RES. 460, 471 (2001).

65. See Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373, 1395–1401 (2004).

66. *Id.* at 1375–76.

67. See MARRON, *supra* note 19, at 121.

68. *Id.* at 11.

69. See *id.* at 84–85 (“[The credit card] is also divorced from the specific goods it finances, encompassing the continuous, ongoing process of consumption facilitated through the widening scope of such credit.”).

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.<sup>70</sup> Indeed, in practice, banks do not typically even evaluate borrowers' actual future incomes at all but rely solely on credit scores to gain information about credit usage.<sup>71</sup>

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.<sup>72</sup>

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 sets their credit limit.

This lack of external constraints would not be a problem, of course, 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.<sup>73</sup> For instance, 36.8% of American Express's accounts have credit limits over \$20,000.<sup>74</sup> Some small business owners report their preference for credit cards precisely because they offer "extremely high credit limits."<sup>75</sup> Credit cards aim to allow consumers to borrow one-fifth of their annual salary on a single card alone.<sup>76</sup> These high limits give consumers ample room to accumulate significant debt.

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70. See MARRON, *supra* note 19, at 85; Dilip Soman & Amar Cheema, *The Effect of Credit and Spending Decisions: The Role of Credit Limit and Credibility*, 21 *MARKETING SCI.* 32, 37 (2002).

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." (emphasis in original)).

72. MARRON, *supra* note 19, at 86.

73. See Stephen Koff & Tom Diemer, *U.S. Senate Approves Bankruptcy Revisions*, *PLAIN DEALER* (Cleveland, Ohio), 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* (Cal.), 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.").

74. Harry Terris, *Dissecting Issuer Accounts*, *AM. BANKER*, Dec. 28, 2009, at 9.

75. Mark Glover, *Entrepreneurs Using Plastic for Finances: Credit Cards Overtake Bank Loans*, *SACRAMENTO BEE*, Dec. 30, 1998, at C1.

76. Laura Ruane, *Credit Card Competition Fierce: Banks Pull Out All Stops to Attract More Customers*, *NEWS-PRESS* (Fort Myers, Fla.), June 15, 1999, at 1D ("[C]ard issuers aim for a 5-to-1 income-to-credit ratio. A household with \$50,000 total income probably would

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.

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.<sup>77</sup> They found that students spent more money if their credit limits were higher.<sup>78</sup> 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.<sup>79</sup>

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.<sup>80</sup> Indeed, some have argued that lenders have a much better idea about whether a consumer will default on a loan than the consumer does.<sup>81</sup> 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.<sup>82</sup> 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 policy makers did not believe there was any connection. In fact, both groups frequently assume or argue that fringe credit is linked to financial distress.

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qualify for a \$10,000 credit line . . . ." (quoting president of credit-card monitoring company CardWeb.com)).

77. Soman & Cheema, *supra* note 70, at 38.

78. *Id.* at 39.

79. *Id.* at 32.

80. *Id.* at 36.

81. See Pottow, *supra* note 11, at 432.

82. Soman & Cheema, *supra* note 70, at 50.

Parts II.C and II.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*

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.<sup>83</sup> 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 consumers 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.”<sup>84</sup> Fringe products produce this distress, Karger claims, through “rates and terms that are almost impossible to satisfy.”<sup>85</sup> 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.<sup>86</sup>

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.*”<sup>87</sup> 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

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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 P. CASKEY, *FRINGE BANKING: CHECK-CASHING OUTLETS, PAWNSHOPS, AND THE POOR* (1994). This fact is not surprising, however, because Caskey only spends eight of 150 pages talking about pawnshop regulations. *Id.* at 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. *See id.* at xvi.

87. CHRISTOPHER L. PETERSON, *TAMING THE SHARKS: TOWARDS A CURE FOR THE HIGH-COST CREDIT MARKET* 205 (2004) (emphasis added).

biweekly cycle of income and expenses leaving only enough surplus income to pay the most recent accrual of interest and fees.”<sup>88</sup>

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 fringe financiers.<sup>89</sup> Additionally, he recognizes that pawn loans do not leave consumers indebted to pawnshops.<sup>90</sup> 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.<sup>91</sup> 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.”<sup>92</sup> 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.<sup>93</sup> 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.”<sup>94</sup> 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.<sup>95</sup>

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88. *Id.* at 14.

89. *Id.* at 36.

90. *Id.* at 20.

91. See ROBERT D. MANNING, *CREDIT CARD NATION: THE CONSEQUENCES OF AMERICA’S ADDICTION TO CREDIT 195–225* (2000) (surveying and analyzing fringe credit transactions).

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, at A23.

93. Diane Hellwig, Note, *Exposing the Loansharks in Sheep’s Clothing: Why Re-Regulating the Consumer Credit Market Makes Economic Sense*, 80 NOTRE DAME L. REV. 1567, 1578–79 (2005).

94. Jean Braucher, *Response to Eric Posner*, 7 FORDHAM J. CORP. & FIN. L. 463, 468 (2002).

95. See Kristin Brandser Kalsem, *Bankruptcy Reform and the Financial Well-Being of Women: How Intersectionality Matters in Money Matters*, 71 BROOK. 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

By far the most common claim in the legal literature is that payday lending bankrupts consumers.<sup>96</sup> There are three theories for why payday loans cause financial distress. First, some claim consumers experience financial failure because the costs of payday loans are so high relative to borrowers' incomes.<sup>97</sup> Second, many people claim that payday borrowers repeatedly rollover their loans, transforming what looks like a short-term debt into a long-term obligation.<sup>98</sup> Finally, one recent paper theorizes that interest payments for payday loans tip people on the brink of bankruptcy into bankruptcy.<sup>99</sup> The merits of these three arguments are taken up in Part II.C.

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Truth in Lending Act from pursuing its claim in bankruptcy.” (footnote omitted)).

96. See, e.g., Sullivan et al., *supra* note 10, at 250–51 (“[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 culture that seems to encourage practices that lead to bankruptcy.”); Lisa Blaylock Moss, Note, *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.” (footnote omitted)); Kelly J. Noyes, Comment, *Get Cash Until Payday! The Payday-Loan Problem in Wisconsin*, 2006 WIS. L. REV. 1627, 1645 (“Wisconsin consumer bankruptcy filings establish that bankruptcy petitioners with payday loans go bankrupt sooner than other debtors . . . .”); Kristina Scott, *Payday Lending*, PRESS-REGISTER (Mobile, Ala.), 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 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.” (footnote omitted)).

98. See, e.g., 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.”); PETERSON, *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.”); Carmen M. Butler & 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.” (footnote omitted)); Beth Musgrave, *Beshear Backs Payday-Loan Rate Cap Interest Would Top Out at 36%; Industry Opposed*, LEXINGTON HERALD-LEADER (Ky.), 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.”).

99. Paige Marta Skiba & Jeremy Tobacman, *Do Payday Loans Cause Bankruptcy?* 2

*B. Policy Makers Rely on Financial Distress to Justify Fringe Banking Regulation*

While it is troubling that academics support fringe banking legislation because of a purported link to financial distress, it is more disturbing that policy makers 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 policy makers 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 results, so determining the relationship between fringe banking and financial distress is important to ensure policy makers craft sound policies.

The most prominent recent example of policy makers 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.<sup>100</sup> 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."<sup>101</sup> The bill gives the Bureau the specific power to take action "to prevent a covered person or service provider 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."<sup>102</sup>

An important justification articulated for the Bureau has been that under-regulated consumer credit products cause financial distress.<sup>103</sup> The Obama

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(Vanderbilt University Law Sch. Law & Econ. Working Paper No. 11-13, Feb. 23, 2011), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1266215](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1266215).

100. The bill establishing the Bureau was signed into law July 21, 2010. President Barack Obama, Remarks by the President at Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act (July 21, 2010), available at <http://www.whitehouse.gov/the-press-office/remarks-president-signing-dodd-frank-wall-street-reform-and-consumer-protection-act>. Representative Barney Frank (D-Mass.) first introduced H.R. 3126 in July of 2009 "[t]o establish the Consumer Financial Protection Agency, and for other purposes" to both the Committee on House Financial Services and the Committee on Energy and Commerce. Consumer Financial Protection Agency Act of 2009, H.R. 3126, 111th Cong. Senate Banking Committee Chairman Christopher Dodd (D-Conn.) released a bill on November 10, 2009 also proposing the creation of a Consumer Financial Protection Agency. Stephen Labaton, *Fed Moves to Limit Overdraft Fees for Debit Cards and A.T.M. Transactions*, N.Y. TIMES, Nov. 13, 2009, at B3.

101. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1011(a), 124 Stat. 1376, 1964 (2010).

102. *Id.* § 1031(a), 124 Stat. at 2005.

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

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 financial distress both 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."<sup>104</sup> 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.<sup>105</sup> In his first State of the Union address, President Obama called for financial reforms to prevent lenders from taking "risks that threaten the whole economy."<sup>106</sup>

Second, the press has furthered the notion that the Bureau is meant to minimize personal financial distress and systemic implications of personal financial woes.<sup>107</sup> 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.<sup>108</sup>

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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, Consumer Financial Protection, *supra* note 4.

105. See David Stout & Stephen Labaton, *Vote Backs a Financial Oversight Body*, N.Y. TIMES, Oct. 23, 2009, at B3.

106. President Barack Obama, State of the Union Address (Jan. 27, 2010), available at <http://www.whitehouse.gov/the-press-office/remarks-president-state-union-address>.

107. See, e.g., 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."); Anne Flaherty, *Consumer Protection Bill Approved: House Panel OK's New Regulator for Loans, Credit Cards*, BOS. GLOBE, Oct. 23, 2009, 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.").

108. Editorial, *To Fix Financial System, Protect Consumers First*, BOS. GLOBE, Oct. 15, 2009, at 18.

A more subtle, although extremely persuasive, means by which the Administration<sup>109</sup> and media<sup>110</sup> 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 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."<sup>111</sup>

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.<sup>112</sup> For instance, in his post for *The*

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109. See *Hearing Before the Subcomm. on Commerce, Trade, and Consumer Protection of the H. Committee on Energy and Commerce*, 111th Cong. 3–4 (2009) (statement of Assistant Secretary Michael Barr), available at [http://republicans.energycommerce.house.gov/Media/file/Hearings/CTCP/070809\\_Consumer\\_Financial\\_Protection\\_Agency/Barr%20Commerce%20Committee%20Testimony%20Final.pdf](http://republicans.energycommerce.house.gov/Media/file/Hearings/CTCP/070809_Consumer_Financial_Protection_Agency/Barr%20Commerce%20Committee%20Testimony%20Final.pdf) (focusing the details of his discussion on problems in the mortgage and credit card industries); Press Release, U.S. Dep't of Treasury, Administration's Regulatory Reform Agenda Moves Forward: Legislation for Strengthening Consumer Protection Delivered to Capitol Hill, available at <http://www.treasury.gov/press/releases/tg189.htm> ("This new agency will implement and enforce the new credit card bill signed into law by President Obama and Congress and have authority to combat the worst abuses in mortgage markets.").

110. See Dennis, *supra* note 107 ("The administration envisions a new agency with broad powers to oversee a range of financial products, from mortgages to credit cards."); Anne Flaherty, *Senate Democrats Aim to Curb Fed: Bill Would Shift Oversight Powers to 3 New Agencies*, BOS. 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."); 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."); Jim Puzzanghera, *Banker Gets an Earful*, L.A. 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.").

111. Joe Nocera, *The Consumer Financial Protection Agency Gets a Big Push . . .*, N.Y. TIMES EXECUTIVE SUITE BLOGS (Oct. 9, 2009), <http://executivesuite.blogs.nytimes.com/2009/10/09/the-consumer-financial-protection-agency-gets-a-big-push>.

112. See 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." (footnote omitted)); Joshua Wright & Todd Zywicki, *Three Problematic Truths About the Consumer Financial Protection Agency Act of 2009*, LOMBARD STREET, Sept. 14, 2009, at 29, 29, available at <http://www.finreg21.com/lombard-street/three-problematic-truths-about-consumer-financial-protection-agency-act-2009> ("The foundational premise of the CFPA is that a failure of consumer protection . . . was a

*Atlantic* opposing the Bureau, Richard Posner notes that the “statute is intended to prevent a repetition of the current financial crisis.”<sup>113</sup> 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.<sup>114</sup>

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.<sup>115</sup> The definition of financial products is expansive, and it includes “extending credit.”<sup>116</sup> 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 arrangements if “(I) the lease is on a non-operating basis [and] (II) the initial term of the lease is at least 90 days.”<sup>117</sup> 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 ninety days. Thus, renting-to-own is probably not covered by this definition of a lease.<sup>118</sup> Still, the Bureau may have authority over rent-to-own contracts either if the Bureau determines that renting-to-own is really an extension of credit, as several courts have done,<sup>119</sup> or if the Bureau wants to define rent-to-own transactions as a financial activity by rule.<sup>120</sup>

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meaningful cause of the financial crisis and that the CFPB would have or could have averted the crisis or lessened its effects.”). In addition to legal academics, consumer advocates explicitly link the need for the CFPB 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)).

113. Richard A. Posner, *The Proposed Consumer Financial Protection Agency Act of 2009*, ATLANTIC (July 4, 2009, 5:25 PM), [http://correspondents.theatlantic.com/richard\\_posner/2009/07/the\\_proposed\\_consumer\\_financial\\_protection\\_agency\\_act\\_of\\_2009.php](http://correspondents.theatlantic.com/richard_posner/2009/07/the_proposed_consumer_financial_protection_agency_act_of_2009.php).

114. Bar-Gill & Warren, *supra* note 11, at 3.

115. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1002(5), 124 Stat. 1956 (2010).

116. *Id.* § 1002(15)(A)(i), 124 Stat. at 1958.

117. *Id.* § 1002(15)(A)(ii), 124 Stat. at 1958.

118. For a more extensive discussion of the Bureau’s relationship to fringe credit, see Hawkins, *supra* note 103.

119. See, e.g., *Perez v. Rent-A-Center, Inc.*, 892 A.2d 1255, 1268 (N.J. 2006) (finding rent-to-own transactions are extensions of credit).

120. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-

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.<sup>121</sup> 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."<sup>122</sup> 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."<sup>123</sup>

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."<sup>124</sup> 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.<sup>125</sup> This reform is needed, the White Paper asserts, to prevent financial crises like the one the country is currently experiencing.<sup>126</sup> Finally, consumer advocates appearing in support of the Bureau testified that fringe banking causes financial distress.<sup>127</sup> In sum, financial distress has been a centerpiece in the policy rationale articulated to the public for the Bureau governing fringe banking transactions.

While the Bureau is the most prominent recent example of policy makers 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<sup>128</sup> and "traps consumers."<sup>129</sup> Support for a

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203, § 1002(5), 1002(15)(A)(xi), 124 Stat. 1956, 1960 (2010) (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, Consumer Financial Protection, *supra* note 4.

122. *Id.*

123. *Hearing Before the Subcomm. on Commerce, Trade, and Consumer Protection of the H. Committee on Energy and Commerce, supra* note 109, at 4.

124. Bar-Gill & Warren, *supra* note 11, at 3.

125. U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 55 (2009), available at [http://www.treasury.gov/initiatives/wsr/Documents/FinalReport\\_web.pdf](http://www.treasury.gov/initiatives/wsr/Documents/FinalReport_web.pdf).

126. *Id.*

127. See *Safeguarding Consumer Protection and the Role of the Federal Reserve: Hearing on H.R. 3126 Before the Subcomm. on Monetary Policy of the H. Comm. on Financial Services*, 111th Cong. (2009) (statement of Lauren Saunders, Managing Attorney of National Consumer Law Center) ("Payday loans are small loans until the next paycheck. . . . The loans trap borrowers in a cycle of debt. . . . The initial debt of a few hundred dollars can explode into thousands of dollars of debt they cannot escape.").

128. 154 CONG. REC. S7969 (daily ed. July 31, 2008) (statement of Sen. Daniel 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.").

129. 155 CONG. REC. E493-94 (daily ed. Feb. 26, 2009) (statement of Rep. Luis

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.”<sup>130</sup>

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.”<sup>131</sup> 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.<sup>132</sup> This regulation was specifically motivated by concerns about distress: “principal reduction helps to prevent such borrowers from being mired into long term debt.”<sup>133</sup> As a final example, Ohio recently passed a payday lending law,<sup>134</sup> and the purpose of the statute was to prevent borrowers from becoming trapped in a cycle of debt.<sup>135</sup>

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.

### *C. Questioning the Link Between Current Fringe Banking Products and Financial Distress*

The previous two subparts argue that academics and policy makers 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 that 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

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Gutierrez) (“[A] major concern addressed in this bill relates to the ‘cycle 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.”).

130. Stacey Kaper, *Battle Lines Form over Rate-Cap Legislation*, AM. BANKER, June 1, 2009, at 1, 2.

131. SARAH D. VEGA, ILL. DEP’T OF FIN. INSTS., SHORT TERM LENDING FINAL REPORT 30 (1999).

132. TENN. CODE ANN. § 45-15-113(d) (2005).

133. TENN. DEPT. OF FIN. INSTS., THE 2008 REPORT ON THE TITLE PLEDGE INDUSTRY 18 (2008).

134. H.B. 545, 127th Gen. Assemb., Reg. Sess. (Ohio 2007).

135. *See Enact a Strong Lending Reform*, CINCINNATI ENQUIRER, May 5, 2008, at 4B.

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,<sup>136</sup> 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-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.<sup>137</sup> The transaction is structured to give customers an easy way out—consumers do not have any obligation to continue making rental payments under the rental agreement.<sup>138</sup> 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.

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136. See Mann & Hawkins, *supra* note 2, at 885–86 (arguing payday lending does not cause bankruptcy); Todd J. Zywicki, *Consumer Welfare and the Regulation of Title Pledge Lending* 41 (George Mason Univ. Mercatus Center, Working Paper No. 09-36, 2009), available at <http://www.mercatus.org/PublicationDetails.aspx?id=28158> (arguing that auto 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"); Petru S. Stoianovici, *Restrictions on Credit: A Public Policy Analysis of Payday Lending I* (Aug. 2008) (unpublished Ph.D. dissertation, Clemson University) (on file with author) (finding no empirical evidence that payday lending increases the number of people filing for bankruptcy).

137. Hawkins, *supra* note 10, at 2047–48.

138. See *The Rent to Own Industry: An Overview*, ASS'N OF PROGRESSIVE RENTAL ORGS., <http://www.rtohq.org/apro-rto-industry-overview.html>.

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.<sup>139</sup> 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.<sup>140</sup> It is possible that these costs could cause consumers to default on other credit obligations<sup>141</sup> or take on additional 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 need<sup>142</sup> or from accumulating savings needed to deal with financial shocks in the future.<sup>143</sup> Any of these scenarios could establish a link to financial distress, depending on what definition one accepts.

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

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139. Hawkins, *supra* note 10, at 2057.

140. Michael Hudson, *Just a Few Bucks a Week: The Rent-to-Own Industry, in* MERCHANTS OF MISERY: HOW CORPORATE AMERICA PROFITS FROM POVERTY 145, 145 (Michael Hudson ed., 1996).

141. Cf. Rafael I. Pardo & Michelle R. Lacey, *The Real Student-Loan Scandal: Undue Hardship Discharge Litigation*, 83 AM. BANKR. L.J. 179, 193 (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. See 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.”); Mann & Mann, *supra* note 37, at 33 (“The relatively limited debt burdens characteristic of younger households suggest not frugality, but a market constraint that lingers even after decades of market and product expansion. When younger households experience financial difficulty, often the main sources of funding to which they can turn are high-cost options that might be as likely to exacerbate financial distress as they are to help the family through the hard times.”).

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.”).

stopping payment on the contract for some time.<sup>144</sup> 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 provides 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,<sup>145</sup> 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.<sup>146</sup> Unlike many collateralized transactions, the pawnbroker actually takes possession of the collateral.<sup>147</sup> 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.<sup>148</sup> 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.<sup>149</sup>

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:

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

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144. See Hawkins, *supra* note 10, at 2084.

145. 15 U.S.C. §§ 1601–67f (2006).

146. See CASKEY, *supra* note 83, at 37; Jarret C. Oeltjen, *Florida Pawnbroking: An Industry in Transition*, 23 FLA. ST. U. L. REV. 995, 1007 (1996).

147. CASKEY, *supra* note 83, at 68.

148. *E.g.*, FLA. STAT. § 537.008(2)(c)(1) (2009).

149. Oeltjen, *supra* note 146, at 1006.

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.<sup>150</sup>

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.<sup>151</sup> 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.”<sup>152</sup> Thus, for those who associate financial distress with having unmanageable debt, pawnbroking by definition can never directly cause financial distress because the debt is self-liquidating.<sup>153</sup>

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

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150. John Mixon, *Fannie Mae/Freddie Mac Home Mortgage Documents Interpreted as Nonrecourse Debt (With Poetic Comments Lifted from Carl Sandburg)*, 45 CAL. W. L. REV. 35, 35–36 (2008) (footnotes omitted). Mixon expands on the significance of deficiencies:

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.

*Id.* at 38 (footnotes omitted).

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

152. PETERSON, *supra* note 87, at 20.

153. See David A. Skeel, Jr., *Racial Dimensions of Credit and Bankruptcy*, 61 WASH. & LEE L. REV. 1695, 1702 (2004) (“Blacks who relied on pawnshops and check-cashing outlets—or more ominously, on loan sharks—had at least some access to credit, but they too were very unlikely to find themselves in bankruptcy even if they failed to repay what they had borrowed. . . . Pawnshop loans are essentially self-liquidating because the pawnshop simply keeps the collateral—whatever it is that the borrower has hocked—if the borrower fails to repay on time.”).

to any surplus the sale of their possessions generates.<sup>154</sup> Pawn customers are almost never upside down in pawn transactions because pawnshops typically only lend around 50% of the value of pawned good.<sup>155</sup> As a result, consumers who do not pay off loans lose wealth because they do not receive the amount they paid for the good or even the current value of the good.<sup>156</sup> Perhaps more significantly, they lose the ability to use the collateral 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.<sup>157</sup> The real loss to consumers is the lost idiosyncratic value the consumer places on the goods.<sup>158</sup> 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 pawned collateral is not tools,<sup>159</sup> so this concern has limited practical importance. Also, most people redeem their pawns,

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154. Oeltjen, *supra* note 146, at 1006.

155. *Id.* at 1005. For evidence from the industry, see EZCORP, INC., ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934, at 4 (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 the 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 EZCORP, INC., *supra* note 155, 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.”); ROBERT W. JOHNSON & DIXIE P. JOHNSON, CREDIT RESEARCH CTR., PAWNBROKING IN THE U.S.: A PROFILE OF CUSTOMERS 16 (1998) (reporting the average pawn loan in 1997 was approximately \$70).

158. Ronald J. Mann, *Verification Institutions in Financing Transactions*, 87 GEO. L.J. 2225, 2243–44 (1999).

159. EZCORP, INC., *supra* note 155, 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.”); 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); Patricia Older, *People Turn to Pawnshops to Make Ends Meet*, PICAYUNE ITEM (Miss.), Dec. 1, 2009, available at <http://picayuneitem.com/local/x546309603/People-turn-to-pawn-shops-to-make-ends-meet> (“[N]owadays [a local pawnshop] sees mostly firearms, music equipment, and gold.”); Karen Underwood, *Staying Afloat: More People Turn to Pawn Shops for Quick Buck as Economy Sours*, HIGH POINT ENTER. (N.C.), Nov. 17, 2008 (reporting that “[g]old, silver, diamonds and coins are hot sellers” at a local pawn shop).

further reducing the number of consumers who pawn and lose something required for their livelihood.<sup>160</sup>

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 and to make ends meet.<sup>161</sup> Pawnshops provide essential access to credit for people experiencing financial shocks who may have nowhere else to turn.<sup>162</sup> This access is arguably more important than income in avoiding hardship.<sup>163</sup> 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.<sup>164</sup>

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.<sup>165</sup> The physical act of taking property to the pawnshop can itself be quite difficult,<sup>166</sup> and borrowers lose possession of their goods immediately,<sup>167</sup> so borrowers experience immediate pain

160. See John P. Caskey, *Pawnbroking in America: The Economics of a Forgotten Credit Market*, 23 J. MONEY, CREDIT, & BANKING 85, 90 tbl.1 (1991) (reporting default rates on pawn loans from 13.9–30.2% depending on the state); EZCORP, INC., *supra* note 155, 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. See 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, ‘[t]hey’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?’” (alteration in original)).

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 [sic]. In these countries, over-indebtedness 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?*, BECKER-POSNER BLOG (June 15, 2008), <http://www.becker-posner-blog.com/2008/06/have-we-lost-the-moral-values-that-undergird-a-commercial-society--posner.html> (“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 62 and accompanying text.

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

167. See *supra* text accompanying note 147.

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 some people in financial distress, other characteristics of pawnbroking suggest that the transaction prevents, not engenders, financial distress.

Auto title lending is similar to pawnbroking in that consumers obtain loans by using their cars as collateral. Title lending customers borrow money usually for thirty days at a time, and title lenders take title of their cars as collateral but allow the customer to continue to possess the vehicle.<sup>168</sup> Like pawn loans, most title loans are nonrecourse.<sup>169</sup> 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,<sup>170</sup> 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.<sup>171</sup> 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 higher<sup>172</sup> 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.<sup>173</sup> So, the actual number of people who lose access to a vehicle and their

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168. Zywicki, *supra* note 136, at 11–12.

169. See ALA. CODE § 5-19A-6 (2010); DEL. CODE ANN. tit. 5 § 2260 (2010); MONT. CODE ANN. § 31-1-816(2)(i) (2010); S.C. CODE ANN. § 37-3-413(5) (2009).

170. JEAN ANN FOX & ELIZABETH GUY, CONSUMER FED'N OF AM., DRIVEN INTO DEBT: CFA CAR TITLE LOAN STORE AND ONLINE SURVEY 2 (2005), available at [http://www.consumerfed.org/pdfs/Car\\_Title\\_Loan\\_Report\\_111705.pdf](http://www.consumerfed.org/pdfs/Car_Title_Loan_Report_111705.pdf) (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. Zywicki, *supra* note 136, at 11.

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.

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 for its members is \$700.<sup>174</sup> A study by the Consumer Federation of America similarly found that “[t]ypical car title loans are for relatively small amounts, with the median minimum loan \$175 and the median maximum loan \$2,500.”<sup>175</sup> 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 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.<sup>176</sup> 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.<sup>177</sup> Around half of credit unions offer secured cards,<sup>178</sup> as well as many banks.<sup>179</sup> In a survey of lower-income Americans, John Caskey found that 18% of households carried secured credit cards.<sup>180</sup> Banks market these cards to people with poor credit histories or sporadic employment records, promoting the fact that positive credit information will be reported to credit bureaus.<sup>181</sup>

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174. Zywicki, *supra* note 136, at 11.

175. FOX & GUY, *supra* note 170, at 11.

176. Julie L. Williams, Michael S. Bylsma, Stephen G. Van Meter & Kathryn D. Ray, *Developments in Credit Card Practices and Related Actions by the OCC to Protect Consumers*, 60 BUS. LAW. 691, 692 (2005).

177. *Id.*

178. Pat Curry, *10 Questions Before Getting a Secured Credit Card*, BANKRATE.COM, <http://www.bankrate.com/finance/credit-cards/10-questions-before-getting-a-secured-credit-card-1.aspx>.

179. *E.g.*, *U.S. Bank Secured Visa Card*, U.S. BANK, <http://www.usbank.com/credit-cards/secured-card.html>.

180. JOHN P. CASKEY, *LOWER INCOME AMERICANS, HIGHER COST FINANCIAL SERVICES* 13 (1997).

181. *E.g.*, *U.S. Bank Secured Visa Card*, *supra* note 179.

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 borrowers essentially are using money they have already saved to secure the debt.<sup>182</sup> In fact, some commentary challenges whether secured credit cards even offer credit.<sup>183</sup>

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.<sup>184</sup> 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.<sup>185</sup> As a result of this cap, most payday loan amounts are low, averaging around \$300.<sup>186</sup> In many states, statutes disallow loans over \$500, guaranteeing relatively low loan

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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 2, at 857.

185. Johnson, *supra* note 11, at 61. 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).

186. Paige Marta Skiba & Jeremy Tobacman, *Measuring the Individual-Level Effects of Access to Credit: Evidence from Payday Loans* (Sept. 7, 2007) (working paper).

amounts.<sup>187</sup> 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.

Several researchers have studied the link between payday lending and bankruptcy, coming to different conclusions.<sup>188</sup> 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.<sup>189</sup> It is not surprising that people who declare bankruptcy have payday loans because these loans are often a last resort before filing bankruptcy.<sup>190</sup> 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 for "first-time applicants near the 20th percentile of the credit-score distribution who identify the local average treatment effect, access to payday loans causes chapter 13 bankruptcy filings over the next two years to double."<sup>191</sup> 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.<sup>192</sup>

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187. The model legislation for many payday lending laws is the Deferred Deposit Loan Act, which has a \$500 cap. COUNCIL OF STATE GOVERNMENTS, SUGGESTED STATE LEGISLATION 34, 35 (2002), available at [ssl.csg.org/dockets/22cycle/2002sslvolume/2002sslvol.pdf](http://ssl.csg.org/dockets/22cycle/2002sslvolume/2002sslvol.pdf).

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. Staff Reports, No. 309, 2008), available at [www.newyorkfed.org/research/staff\\_reports/sr309.pdf](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), and Stoianovici, *supra* note 136, at 1 (finding no empirical evidence of a link between payday lending and increased bankruptcy filings).

189. See, e.g., Lynn Drysdale & Kathleen E. Keest, *The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and Its Challenge to Current Thinking About the Role of Usury Laws in Today's Society*, 51 S.C. L. REV. 589, 609–10 (2000) (reporting several sources that claim payday lending causes bankruptcy but that merely note "the high number of bankruptcies listing fringe lenders as creditors"); Noyes, *supra* note 96, at 1645 (claiming "Wisconsin consumer bankruptcy filings establish that bankruptcy petitioners with payday loans go bankrupt sooner than other debtors," in part because "about 15% of bankruptcy petitioners listed a payday lender as a creditor").

190. See Mann & Mann, *supra* note 37, at 19.

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."); *Abusive Credit Card Practices and Bankruptcy: Three ABI Members Testify Before Senate Judiciary Subcommittee*, AM. BANKR. INST. J., May 2009, at 10–11 ("High-interest-rate debt is financial quicksand. . . . Even small debts at high interest rates can increase the chance of a

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. They “find no significant effects on chapter 7 bankruptcies” related to payday lending.<sup>193</sup> 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.<sup>194</sup> This is an odd output from their models. If payday lending pushes 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 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.<sup>195</sup> 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.”<sup>196</sup> The consumers who declare bankruptcy after taking out payday loans, they note, were “already severely financially stressed” before taking out the payday loan.<sup>197</sup> Similarly, other research uses individuals taking out a payday loan as a proxy for financial distress,<sup>198</sup> 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 tip financially stressed payday loan applicants into bankruptcy.”<sup>199</sup> Because payday loans have short durations, they suspect that “payday interest payments may take priority and borrowers may fall further behind on other accounts.”<sup>200</sup> They estimate that the cumulative interest payments to payday lenders were 6.5% of the total annual interest burden of consumers declaring bankruptcy.<sup>201</sup> They make this estimation by assuming that the other debt the consumer held had an annual interest rate of 15%.<sup>202</sup>

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

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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%. 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 2.

194. *Abusive Credit Card Practices and Bankruptcy: Three ABI Members Testify Before Senate Judiciary Subcommittee*, *supra* note 192, at 10–11 (statement of Adam Levitin).

195. See *supra* note 43 and accompanying text (noting the important distinction between the two concepts).

196. Skiba & Tobacman, *supra* note 99, at 17.

197. *Id.* at 3.

198. Mann & Mann, *supra* note 37, at 9–10.

199. Skiba & Tobacman, *supra* note 99, at 17.

200. *Id.* at 17.

201. *Id.*

202. *Id.*

Federal Reserve reports that the average annual percentage rate (APR) for all credit cards in 2009, for example, was between 13.22–14.90%, a figure in line with Skiba and Tobacman’s assumption.<sup>203</sup> Credit card companies, however, charge risky customers, like those who would be driven to take out a payday loan, significantly more than other customers.<sup>204</sup> Most credit card debt held by individuals with poor credit is more likely to be at a rate above 20%.<sup>205</sup> By using a more realistic assumption of a 20% APR for consumer non-payday loan debt, cumulative interest payments due to payday loans only constitute 4.87% of the customers’ overall cumulative interest payments in Skiba and Tobacman’s study.<sup>206</sup> If the average rate of the other credit is 25%, cumulative interest payments because of payday loans are only 3.89% of total interest payments. Thus, Skiba and Tobacman’s argument that payday loans contribute to financial distress because they make up 6.5% 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.”<sup>207</sup> 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 rates of bankruptcies for applicants within a 0.5 standard deviation of the credit score threshold and not a difference for applicants within a 0.01 standard deviation of approval threshold.<sup>208</sup> Caskey explains the significance of the different credit scores between the two populations:

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.<sup>209</sup>

The other two theories in legal literature for why payday loans create financial distress similarly run into problems creating a plausible causation argument. First,

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203. FEDERAL RESERVE STATISTICAL RELEASE, CONSUMER CREDIT G.19 (July 2009), available at <http://www.federalreserve.gov/releases/g19/Current/g19.pdf>.

204. See MANN, *supra* note 11, at 190.

205. For instance, Robert Manning suggests 19.8% APR would be a “moderate” APR for someone with poor credit. MANNING, *supra* note 91, at 218.

206. I obtained this figure using the calculation Skiba and Tobacman use in their analysis:  $\$1841 * 18\% / 34,000 * 20\%$ . See Skiba & Tobacman, *supra* note 99, at 17.

207. John P. Caskey, *Payday Lending: New Research and the Big Question* 30 (Research Dep’t Fed. Reserve Bank of Phila., Working Paper No. 10-32, 2010), available at <http://ssrn.com/abstract=1696019>.

208. *Id.*

209. *Id.* at 30–31.

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.”<sup>210</sup> 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 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 a lot of 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.<sup>211</sup> 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.”<sup>212</sup> 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.<sup>213</sup> 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.<sup>214</sup>

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. Policy makers and academics cannot rely on financial distress as a basis to justify intervention into these markets as the products

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210. PETERSON, *supra* note 87, at 14.

211. Mann & Hawkins, *supra* note 2, at 896.

212. *Id.*

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 31 (2009) (reporting that 58.3% of unbanked people who stated they had used a payday loan reported using it once or twice a year).

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 passably legal.<sup>215</sup> 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<sup>216</sup> 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.<sup>217</sup> 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.<sup>218</sup> In other credit markets, creditors lend based on the borrower's

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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.”).

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.”).

217. *See supra* Part I.C.

218. *See* KARGER, *supra* note 6, at 42 (“Neither trust nor the presumption of goodwill exists in the fringe economy . . .”).

creditworthiness as predicted by credit scores.<sup>219</sup> 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.<sup>220</sup> Lenders assume borrowers will not reliably pay back their debts, so they structure the transactions to ensure repayment through other means.<sup>221</sup> Unless in the future fringe lenders are suddenly inclined to take on substantial risk, this characteristic is unlikely to change.

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 one-twenty-sixth of the consumer’s annual income. Payday lenders do rely in some part on the borrower’s creditworthiness because they check Teletrack to determine if the borrower has taken out or defaulted on previous payday loans.<sup>222</sup> As noted in Part 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 when they enter 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.

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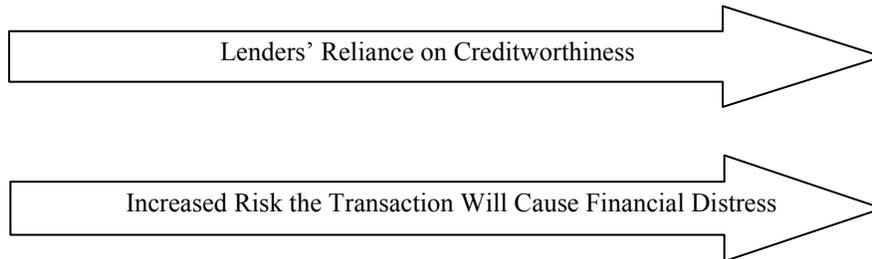
219. *See id.* (observing that loans to the middle class are “secured by the borrower’s creditworthiness”).

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.”).

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 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 . . .”).

222. KARGER, *supra* note 6, at 74.

*Figure 1: The Relationship Between Creditworthiness and Distress*  
 Pawnshops, Auto Title Loans, Payday Loans, Mainstream Credit  
 Cards, and Secured Credit Cards



In terms of financial distress, the effect of constraints is straightforward. Borrowers cannot accumulate as much debt with fringe products as with other credit sources, so they cannot become as prone to experience distress. More significantly, because lenders use means other than credit history to ensure repayment, 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.<sup>223</sup> 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 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.<sup>224</sup> 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

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223. *See id.* at 42.

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).

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 policy makers 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: Policy makers should stop justifying fringe banking regulations because of a supposed link between fringe banking and financial distress. Policy makers 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 decision making, positing that consumers making choices about products operate with bounded rationality. Consumers overestimate the likelihood of some events occurring<sup>225</sup> while underestimating the likelihood of others;<sup>226</sup> they are overly optimistic about their futures;<sup>227</sup> they lack defined, stable preferences;<sup>228</sup> and they use faulty heuristics or shortcuts in reasoning.<sup>229</sup>

Just as cognitive limitations affect consumers, they also affect legislators.<sup>230</sup> Indeed, some have argued that cognitive biases have a greater effect on public

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225. Patricia A. McCoy, *A Behavioral Analysis of Predatory Lending*, 38 AKRON L. REV. 725, 736 (2005) (reporting studies that found that "people tend to overestimate the probability of compound events").

226. Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373, 1400 (2004) (noting that people underestimate the likelihood they will incur substantial debt on their credit cards).

227. *Id.*

228. Colin Camerer, Samuel Issacharoff, George Loewenstein, Ted O'Donoghue & Matthew Rabin, *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism"*, 151 U. PA. L. REV. 1211, 1214–15 (2003).

229. See Adrian Vermeule, *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 . . .").

230. See KURT WEYLAND, LEARNING FROM FOREIGN MODELS IN LATIN AMERICA POLICY REFORM 278 (2004) (arguing policy makers adopting market reforms are affected by availability heuristics, representativeness heuristics, and anchoring heuristics); Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 20–36 (2003) (discussing how the SEC is affected by behavioral limitations); Frank B. Cross &

decision making than private decision making.<sup>231</sup> One specific bias that research has identified in the context of policy making is the availability bias.<sup>232</sup> If a consequence is memorable, vivid, and easily retrievable, policy makers are apt to overestimate the likelihood that consequence will occur.

In the consumer credit context, policy makers are likely to overestimate the probability 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 the role of consumer credit in the current economic downturn.<sup>233</sup> 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 policy makers considering credit regulations.<sup>234</sup>

As this Article demonstrates, this heuristic is faulty. Some shortcuts in reasoning are necessary because people have to live life without doing an exhaustive analysis of every decision.<sup>235</sup> But, if a heuristic is misleading, policy makers must reject it because a faulty heuristic results in bad policies.<sup>236</sup> 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

Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 CARDOZO L. REV. 333, 367 (2006) ("Government officers, like private informational intermediaries and others, are subject to self interest and heuristics that may lead them to make unwise decisions."); Cass R. Sunstein, *On the Divergent American Reactions to Terrorism and Climate Change*, 107 COLUM. L. REV. 503, 537 n.188 (2007) ("Even if many heuristics mostly work well in daily life, a sensible government can do much better than to rely on them."). Mario Rizzo and Glen Whitman have provided an extended argument for how behavioral constraints undermine the ability of legislators to pass effective regulations. See generally Mario J. Rizzo & Douglas Glen Whitman, *Little Brother Is Watching You: New Paternalism on the Slippery Slopes*, 51 ARIZ. L. REV. 685 (2009); Douglas Glen Whitman & Mario J. Rizzo, *Paternalist Slopes*, 2 N.Y.U. J. L. & LIBERTY 411 (2007).

231. See generally Edward L. Glaeser, *Paternalism and Psychology*, 73 U. CHI. L. REV. 133 (2006).

232. See *supra* Part I.C; see also Richard H. Pildes & Cass R. Sunstein, *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 . . .").

233. See Jeffrey J. Rachlinski, *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").

234. Rachel R. Jones, Note, *Risky Business: Barriers to Rationality in Congress*, 36 ECOLOGY L.Q. 467, 482 (2009).

235. See Vermeule, *supra* note 229, at 1179.

236. Jeffrey J. Rachlinski & Cynthia R. Farina, *Cognitive Psychology and Optimal Government Design*, 87 CORNELL L. REV. 549, 572 (2002) ("[G]overnment is apt to make bad choices when government decisionmakers rely on misleading heuristics . . .").

figure more prominently into debates about fringe markets. Second, it will affect the sorts of policies policy makers 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.<sup>237</sup> 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.<sup>238</sup>

Some of the literature already seeks to justify fringe banking regulation on the basis of paternalism,<sup>239</sup> courts have recognized its significance,<sup>240</sup> and critics of the Bureau have argued that the Bureau is premised on paternalism as a hidden rationale.<sup>241</sup> But, when compared to other credit devices like credit cards, researchers have spent little effort establishing the arguments for paternalistic intervention into fringe credit markets.<sup>242</sup> If paternalistic concerns over defective decision making are to replace financial distress, more research needs to be done to understand how consumers make decisions in the fringe economy. Thus, this

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237. See generally Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998).

238. See generally Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. CHI. L. REV. 1159 (2003).

239. See, e.g., Susan Block-Lieb & Edward J. Janger, *The Myth of the Rational Borrower: Rationality, Behavioralism, and the Misguided "Reform" of the Bankruptcy Law*, 84 TEX. L. REV. 1481, 1543 (2006) (suggesting payday lenders capitalize on consumers' overconfidence they will not have to rollover); Hawkins, *supra* note 10, at 2050 (arguing for rent-to-own regulations based on liberation paternalism); Alan M. White, *Behavior and Contract*, 27 LAW & INEQ. 135, 159 (2009) (positing that payday lenders use "framing" to alter "consumer's preferences by defining the menu from which choices are made").

240. See *Midwest Title Loans, Inc. v. Mills*, 593 F.3d 660, 663–65 (7th Cir. 2010).

241. See Posner, *supra* note 113 ("What is new in the proposed CFPB statute though not mentioned in it is 'behavioral economics' [as a basis for paternalistic intervention]."); Wright & Zywicki, *supra* note 112 ("These intellectual architects of the CFPB assert that irrational consumer behavior is at the heart of the financial crisis, and that the CFPB is needed to 'nudge' consumers toward better decision making in lending markets.").

242. See, e.g., Lawrence M. Ausubel, *Credit Card Defaults, Credit Card Profits, and Bankruptcy*, 71 AM. BANKR. L.J. 249, 264–67 (1997); Lawrence M. Ausubel, *The Failure of Competition in the Credit Card Market*, 81 AM. ECON. REV. 50, 73–75 (1991); Bar-Gill, *supra* note 226; Tom Brown & Lacey Plache, *Paying with Plastic: Maybe Not So Crazy*, 73 U. CHI. L. REV. 63, 65–67 (2006); James M. Hunt, Renee A. Florsheim, Anindya Chatterjee & Jerome B. Kernan, *Credit Cards as Spending-Facilitating Stimuli: A Test and Extension of Feinberg's Conditioning Hypothesis*, 67 PSYCHOL. REP. 323, 329–30 (1990).

Article joins others in the call for researchers to explore paternalism as a basis for fringe banking regulations.<sup>243</sup>

### *C. Policy Directions*

If policy makers 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.<sup>244</sup> This information is meant to protect people from entering into transactions when they are uninformed or misinformed.<sup>245</sup> Other regulations protect people from impulsive decisions, such as statutes that permit borrowers to rescind loans within a few days of taking them out.<sup>246</sup> The law also protects people it judges to lack the capacity to rationally enter fringe transactions, like minors.<sup>247</sup> Finally, some judicial decisions protect people

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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., Consumer Rental Purchase Agreement Act, H.R. 1767, 110th Cong. § 1010(a) (2007) (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”); FLA. STAT. § 537.008 (2009) (requiring similar disclosures for title loans); 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); 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 borrower’s check).

245. See Cass R. Sunstein, *Boundedly Rational Borrowing*, 73 U. CHI. L. REV. 249, 251 (2006) (“A key question is why people might be excessive rather than optimal borrowers. . . . [B]orrowers 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).

247. CAL. FIN. CODE § 21207 (2009).

from waiving important rights.<sup>248</sup> To the extent that research can develop paternalistic rationales for these sorts of regulations, the fact that fringe banking cannot be linked to financial distress is inconsequential because these regulations can be justified 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, such as financial distress, that they must be heavily regulated. Banning fringe banking transactions<sup>249</sup> 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.”<sup>250</sup> 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.<sup>251</sup> 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 a 36% interest rate in 2007.<sup>252</sup> Within one year, 75% of the lenders left Oregon.<sup>253</sup> 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.<sup>254</sup> While these statutes take the form of price regulations, they function really as bans on fringe credit.<sup>255</sup> The conclusion of this Article should

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248. See *E-Z Cash Advance, Inc. v. Harris*, 60 S.W.3d 436, 442 (Ark. 2001) (holding an arbitration agreement in a payday lending contract was unenforceable); *Muhammad v. Cnty. Bank of Rehoboth Beach, Delaware*, 912 A.2d 88, 100–01 (N.J. Sup. Ct. 2006) (voiding a similar arbitration agreement).

249. See, e.g., GA. CODE ANN. § 16-17-2 (2009) (banning payday lending in Georgia).

250. Pottow, *supra* note 11, at 412 n.34.

251. See, e.g., CONN. GEN. STAT. § 42-248(a) (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); 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.”).

252. See OR. REV. STAT. § 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 . . . .”), *repealed by* Or. Laws Spec. Sess., ch. 23, § 34 (2010) (maintaining the same 36 percent standard but “excluding a one-time origination fee for a new loan”).

253. Bill Graves, *Oregon’s Payday Lenders All But Gone*, OREGONIAN (Portland), July 6, 2008, at A01.

254. Jim Siegel, *Fixing Payday-Loan Law Is Legislators’ Job, State Says*, COLUMBUS DISPATCH, Feb. 20, 2009, at 03B.

255. See Littwin, *supra* note 10, at 454 n.7 (explaining how usury limits can effectively restrict credit products).

force regulators to reconsider these sorts 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 thus lose their livelihood,<sup>256</sup> many pawn regulations require that the pawnbroker hold property for an extended period of time after the borrower first takes out the loan.<sup>257</sup> 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.<sup>258</sup> Some title lending statutes even require the lender to allow the borrower to redeem the vehicle up until the time of the actual sale.<sup>259</sup> 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.<sup>260</sup> In the context of payday lending, some statutes mitigate the distress that frequent rollovers may cause by allowing borrowers to pay off the principal due on the loan in installments.<sup>261</sup> 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.

#### 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 policy makers place on 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 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.

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256. *See supra* Part II.C.2.

257. *See, e.g.*, CAL. FIN. CODE § 21201 (2009) (requiring pawnbrokers to hold pawned good for four months).

258. *E.g.*, FLA. STAT. § 537.008(2)(c)(1) (2009).

259. *See id.* § 537.012(3).

260. *See supra* Part II.C.2.

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).

Future research into fringe banking must look to new rationales for regulation, and policy makers 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.