February 1, 2007

Via e-mail and FedEx

The Honorable J. Dorrance Smith
Assistant Secretary for Public Affairs
U.S. Department of Defense
1400 Defense Pentagon
Room 2E556
Washington, DC 20310-1400
(703) 697-9312

Re: Amendment to CRE petition for correction of August 9, 2006, Department of Defense (DOD) Report On Predatory Lending Practices Directed at Members of the Armed Forces and Their Dependents, pursuant to Public Law 106-554, § 515 and 44 U.S.C. § 3501 et seq. (see 44 U.S.C. § 3516 note), as implemented through the OMB and DOD guidelines

Dear Assistant Secretary Smith:

Upon further review of the subject matter of the DoD report addressed in our September 21, 2006 petition for correction, we have concluded that the DoD report, in addition to being inaccurate and deficient as specified in that original petition, is also deficient in not addressing credit cards as a type of credit mechanism frequently considered "predatory" both by organizations on which DoD relied extensively in its report and by Members of Congress, and which also imposes fees, charges, and other terms (e.g., mandatory arbitration) comparable to the other types of credit addressed in the DoD report.¹

We are therefore amending our petition to assert that the DoD report is incomplete, and therefore deficient with regard to the basic data quality standards of "utility" and "objectivity", due to the absence of an analysis of credit card interest, fees, charges, and terms, and the fees and

¹ DOD has not yet responded to the CRE petition in accordance with its own guidelines. We wish to note that the Data Quality law confers a legal right for an affected person to "obtain" correction of faulty information, and a failure to make a warranted correction, as well as a failure to respond to a petition, is clearly subject to judicial review under the Administrative Procedure Act, 5 U.S.C. §§ 701-06. DoD has also not posted the CRE petition on its data quality website as directed by OMB/OIRA. CRE has therefore made the petition available to the public at http://www.thecre.com/pdf/DOD%20Petition.pdf and will do the same with this amendment if DoD continues to fail to comply with the OMB/OIRA directive.
charges translated into APRs. This amendment asserts that the DoD report must be corrected to include an analysis of credit card credit as a potential type of predatory lending. We are also referencing (with a link), and attaching as Attachment II, the updated version of the paper (Hanson and Morgan, now just Morgan as author in updated version) on whether payday lending should be considered "predatory" that was Appendix III to our September 21 petition. The updated Morgan study has now been published by the Federal Reserve Bank of New York as a Staff Report.

Deficiency of the DoD report with regard to "utility" in not addressing credit cards

The legislation directing DoD to prepare its August 9, 2006 report on predatory lending did not specify any particular types of credit that should be covered by the report; rather, it directed preparation of a report on "predatory lending practices", and it defined this term as "an unfair or abusive loan or credit sale transaction or collection practice." Credit card loans and sale transactions certainly come within this broad definition, and also come within the definitions utilized by DoD in its report. Credit card loans and sale transactions were frequently referred to by Members of Congress as "predatory" during deliberations on other consumer legislation pending at the same time as the directive to prepare the DoD report. In addition, consumer organizations with which DoD consulted in preparing its report also labeled credit cards, and their associated fees, charges and other terms, as predatory. One of those groups, the Center for Responsible Lending, was cited extensively for support in the DoD report.

2 See the citations and quotations in fn. 15 of the attached CRE Memorandum of Law, Feb. 1, 2007. The memorandum of law is Attachment I to this amendment.

3 The statute requiring DoD to prepare the report directed DoD to consult with "consumer groups" in addition to federal financial agencies. In its report, DoD stated (p. 3) that it had consulted with the Consumer Federation of America, the Center for Responsible Lending, the National Association of Consumer Advocates, and the National Consumer Law Center.

4 See, e.g., "A Six-Point Consumer Agenda To Close Growing Gaps in Marketplace Protections", point 3 and p. 3, Consumer Fed'n of Am., Consumers Union, Nat'l Ass'n of Consumer Advocates, Nat'l Consumer Law Ctr., and the U.S. Pub. Interest Research Group, 2005 ("Protect Consumers from Abusive Predatory Lending: Limit unfair mortgage, credit card and personal loan practices that put vulnerable consumers at risk of default and bankruptcy. . . . Congress should enact legislation that provides broad protections for credit card customers, including prohibiting unwarranted fees and interest rate increases. . . ." [Original emphasis]), available at http://www.consumerfed.org/pdfs/consumer6pointagenda.pdf; "Sample Letter to Federal Reserve Board on Credit Card Practices", Nat'l Consumer Law Ctr., 2005 ("We believe that the current abusive practices of the credit card industry are placing millions of consumers in financial jeopardy. . . . Once credit card companies have consumers in their grasp, they set up such an intricate trap of terms, fees, and penalties that many Americans find it hard to pay off their balances. . . . Credit card lenders have rushed to increase junk fees . . . jacking up late payment and over-limit fees . . . They have created traps for unwary consumers . . . ."), available at http://www.consumerlaw.org/initiatives/test_and_comm/031805_cc_samp_comm.shtml; "New Trap Door for Consumers: Card Issuers Use Rubber-Stamp Arbitration to Rush Debts Into Default Judgments", Nat'l Consumer Law Ctr., 2005, available at http://www.consumerlaw.org/news/content/ArbitrationNAF.pdf; the Center for Responsible Lending lists credit cards on its website (http://www.responsiblelending.org/) as a type of predatory lending, and has
Moreover, it appears clear that the recent legislation placing limitations on terms of "consumer credit" extended to members of the military of their dependents was based to a large extent on the DoD report. We have prepared a legal analysis of that recent legislation that concludes that the legislation clearly covers all forms of "consumer credit", including credit cards. A copy of that CRE memorandum of law is Attachment I. Despite the clarity of the law on this matter, it has been reported that credit card companies are arguing to the Secretary of Defense that the law was not intended to cover credit card loans and transactions, presumably based in part on their absence from the preceding DoD report, and that therefore the Secretary should exclude them from the definitions of "creditor" and "consumer credit" when he promulgates the regulations implementing the new legislation. This use of the DoD report illustrates how it fails the "utility" standard of the Data Quality law and guidelines.

Although the DoD report tends to focus on high fees (translated into high APRs) as a basis for defining "predatory", the report does not contain any information on credit card fees and charges and the APRs into which they would be translated. We have supplied such APR information in Attachment II to our attached memorandum of law (Attachment I to this amendment), and the attachment to the memorandum of law shows that on the matter of APRs, credit card charges match or exceed other types of "predatory" credit loans or sales covered by the DoD report, such as payday loans.

The failure of the DoD report to address credit cards makes it deficient with regard to "utility" to its primary intended audience, Congress. In addition, however, the DoD report is now being used to promote similar limitations under State law on consumer credit extended to non-military consumers. This potential spread of regulation of various credit mechanisms, but excluding credit cards, could result in massive distortions in competition in the credit industry and unintended consequences when military borrowers are forced to turn to credit cards, and associated maneuvers such as cash advances and charges over their credit limit, when deprived of the ability to use other credit mechanism stigmatized as "predatory" by the DoD report.

posted, among other materials on credit cards as predatory and abusive, a study by Westrich T. and Bush M of the Woodstock Institute, "Blindfolded Into Debt: A Comparison of Credit Card Costs and Conditions at Banks and Credit Unions", 2005 (discussing late fees, over-the-credit-limit fees, and cash advance fees following Table 6) available at http://woodstockinst.org/document/blindfoldedintodebt_7-5-05_westrich_bush.pdf, an article from Consumer Reports (Nov. 2005) that quotes Senator Dodd as observing that credit cards have turned into "nothing less the wallet-sized predatory loans", available at http://www.wsj.consumerreports.org/wsireport138.html, and a study titled "the Plastic Safety Net: The Reality Behind Debt in America", 2005 (discussing credit card penalty fees and rates as a debt "trap" and binding arbitration clauses as unfair) available at http://www.responsiblelending.org/pdfs/DEMOS-101205.pdf. (All of the above Internet materials were accessed January 2007.)

At 3, 12 & n. 8, 13 & notes 14 and 17, 15 n. 18, 35 & n. 34, 77, 86 n. 39, 87 & n. 43.

Deficiency of the DoD report with regard to "objectivity" in not addressing credit cards

Under the DoD and OMB Data Quality guidelines, the "objectivity" standard requires that data be presented in a "complete, and unbiased manner." With the omission of consideration of "predatory" credit card practices, the DoD report cannot be considered "objective" in the sense of complete and unbiased.

New Staff Report on Predatory Lending from the Federal Reserve Bank of New York

Our original petition cited and quoted from a "working paper" by Hanson and Morgan affiliated with the Federal Reserve Bank of New York. We also attached a copy as Appendix III because the paper was not available on the Internet. A new version of that "working paper" is now being formally disseminated as Staff Report No. 273 by the Federal Reserve Bank of New York, with a request for comments.

We are attaching a pdf version of the Staff Report to the electronic version of this amendment, and a hard copy as Attachment II to the hand-delivered original of this amendment.

The Morgan Staff Report is important because it is based on an economic definition of predatory lending and a rigorous and transparent methodology (rather than an anecdotal or *ad hominem* definition and approach) as a "welfare-reducing provision of credit" that allows lenders to profit "if they can tempt households into 'debt traps'; and it concludes that "payday lenders do not fit our definition of predatory." Following are some other key excerpts from the Staff Report:

"Our findings seem mostly inconsistent with the hypothesis that payday lenders prey on, i.e., lower the welfare of, households with uncertain income or households with less education." At 3 (emphasis added).

"[H]ouseholds with uncertain income who live in states with unlimited payday loans are less likely to have missed a debt payment over the previous year. The latter result is consistent with claims by defenders of payday lending that some households borrow from payday lenders to avoid missing payments on other debt. On the whole, our results seem consistent with the hypothesis that payday lending represents a legitimate increase in the supply of credit, not a contrived increase in credit demand." At 4.

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7 "Predatory Lending?", Sept. 9, 2005. Original petition at 4 n. 7, 10, 18, and Appendix III.

8 Morgan DP, "Defining and Detecting Predatory Lending", January 2007, available at [http://www.newyorkfed.org/research/staff_reports/index.html](http://www.newyorkfed.org/research/staff_reports/index.html) (accessed January 2007). Donald Morgan, Ph.D., is a Research Officer with the Federal Reserve Bank of New York, an adjunct professor of economics at New York University, and an Associate Editor of the Journal of Money, Credit, and Banking. As the Report notes, it does not necessarily reflect the views of the Federal Reserve Bank of New York or the Federal Reserve System.

9 From the Abstract.
"Reformers often advocate usury limits to lower payday loan fees but our evidence suggests that competition among payday lenders (and pawnshops) works to lower payday loan prices." *Id.*

"The high price of payday loans may partly reflect the combination of fixed costs and small loan amounts (Flannery and Samolyk 2005)." At 8.

"A usury limit lowers household welfare." At 8.

"The high cost of payday lending may partly reflect fixed costs per loan. Before payday lending, those fixed costs may have been prohibitive; very small, short-term loans may not have been worthwhile for banks. The payday lending technology may have lowered those fixed costs, thus increasing the supply of credit to low income households demanding small loans. That version of the genesis of payday lending suggests the innovation was welfare improving, not predatory." At 9.

"Costly predation can occur only if imperfect competition enables predators to charge higher than competitive spreads." At 11.

"[H]igher prices are neither necessary or sufficient to conclude that a certain class of credit is predatory." At 14.

"[H]igher payday loan limits are not associated with higher delinquency rates for less educated households, riskier households, or smokers. If anything, we find the opposite: risky households surveyed in 2001 in states with unlimited payday loans were marginally less likely to have missed a debt payment." At 19.

"Second, more stores per capita might also signal higher demand for payday loans (and hence, higher prices) rather than higher supply." At 20 (footnote omitted).

"If payday lenders were exploiting gullible households, we would expect to find higher debt and delinquency rates among easier-to-fool-households (prey) in states with higher payday loan limits. While we do find higher debt for one such set of households, we do not find higher delinquency. On the contrary, delinquency rates were marginally lower for risky households in states with unlimited payday loans." At 22.

"While reformers often advocate usury limits on payday lending, we find some evidence that competition among payday lenders (and pawnshops) may obviate usury limits. Using a small set of data, we find that payday loan rates and fees decline significantly as the number of payday lenders and pawnshops increase. Despite their alleged naïveté, payday borrowers appear sophisticated enough to shop for lower prices. The problem of high prices may reflect too few payday lenders, rather than too many." At 22.
"[W]e find somewhat lower payday prices in cities with more payday stores per capita, consistent with the hypothesis that competition limits payday loan prices."

Abstract.

The New York Federal Reserve Bank Staff Report, unlike the DoD report, which does not employ any rigorous and transparent economic methodology whatever, meets the Data Quality standard of "objectivity" in the DoD and OMB guidelines because its analytical results are generated, "in a financial context," "using sound statistical and research methods" that are explained transparently.

Corrections Sought and Required

1. In addition to the revisions sought in the original petition, the DoD report must be revised to consider extension of credit through credit cards, and their various rates, fees, and charges, as potential predatory lending practices. In particular, the many references by Members of Congress to credit cards as "predatory", and by the consumer organizations with which DoD was directed to consult, should be considered relevant to determining that credit cards must be included.

2. The revised DoD report must consider the more recent (January 2007) Federal Reserve Bank of New York Staff Report by Donald Morgan on whether payday loans should be regarded as "predatory", in substitution for the Hanson and Morgan working paper attached to the original petition. The lack of a transparent economic methodology for determining whether credit mechanisms are "predatory" is a major Data Quality deficiency in the DoD report.

CRE Contacts

Dr. Jim Tozzi, in his capacity as a member of the CRE Advisory Board (see http://www.thecre.com/advisory.html), is the responsible CRE official for this petition. His biography is located at http://www.thecre.com/emerging/Jim_Tozzi_Bio.html. Questions concerning the petition should be addressed to William G. Kelly, Jr., CRE Western Representative, at wgkelly@tetontel.com, office address 11 Dupont Circle, Suite 700, Washington, DC 20036, telephone 202.265.2383.

Sincerely,

/s/

Jim J. Tozzi
Member, Board of Advisors
Center for Regulatory Effectiveness

Attachments (2)
cc w. attach.:  Hon. David S.C. Chu, Under Secretary for Personnel and Readiness and Chief Human Capital Officer
Hon. John G. Grimes, Assistant Secretary for Networks and Information Integration and Chief Information Officer
Leslye A. Arsht, Deputy Under Secretary of Defense for Military Community and Family Policy
Paul S. Koffsky, Acting Deputy General Counsel for Personnel and Health Policy
Joseph Bowab, Associate Director for National Security Programs, Office of Management and Budget
Edward Roback, Acting Chief Information Officer, U.S. Department of the Treasury
Steven R. Malphrus, Director, Management Division, Federal Reserve System
Michael E. Bartel, Chief Information Officer, Federal Deposit Insurance Corporation
CRE Memorandum of Law on
Types of Consumer Credit Covered by the Recent Law
Containing Limitations on Consumer Credit Extended to Members
of the Military or Their Dependents
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Types of Consumer Credit Covered by the Recent Law
Containing Limitations on Consumer Credit Extended to Members
of the Military or Their Dependents
MEMORANDUM OF LAW

SUBJECT: Applicability to all forms of consumer credit, including credit cards and installment loans, of the new legislative limitations on consumer credit extended to members of the armed forces or their dependents

The issue to be addressed is whether this new statute\(^1\) clearly covers "consumer credit" extended via all means, including credit cards and installment loans, other than those means expressly excluded, or whether, because the statute is ambiguous on what is covered, the Secretary of Defense has discretion to interpret, through the implementing regulations authorized by the statute, the term "consumer credit" to exclude certain types of credit mechanisms, including consumer credit extended through credit cards and installment loans, and related interest and fees.

The Plain Language of the Statute

General Principles

We start, as always, with the plain language of the statute. The full text is in Attachment I. If the statute is clear as to what is covered, there is no resort to legislative history or any other extrinsic aids to statutory interpretation. *Circuit City Stores, Inc. v. Adams*, 532 U.S. 105, 119, 121 S.Ct.1302, 1311 (2001); *Ratzlaf v. United States*, 510 U.S. 135, 147, 114 S.Ct. 655, 662 (1994); *CBS, Inc. v. Primetime 24 Joint Venture*, 245 F.3d 1217, 1222 (11th Cir. 2001).

A related principle was established in *Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 104 S.Ct. 2778 (1984). *Chevron* set up a two-part process for statutory interpretation in cases in which agency discretion to interpret the statute is at issue. The first step is to examine the express statutory language. If Congress "has directly spoken to the precise question at issue . . . that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." *Id.* at 842-43. Under step one, "[i]f a court, employing traditional tools of statutory construction, ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect." *Id.* at 843 n. 9. If the court determines that the statute is ambiguous, and Congress has explicitly or impliedly left it to the agency to fill the "gap" and clarify the ambiguity, step two is to ask whether the agency interpretation is a permissible construction -- *i.e.*, a reasonable construction even if not the one the court or someone else would determine to be the most reasonable construction. *Id.* at 843. A court does not address step two unless it finds an ambiguity or gap under step one. *State of New York v. U.S. Envtl. Prot. Agency*, 443 F.3d 880, 884 (D.C. Cir. 2006).

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At this time, although there is no agency interpretation yet at issue, it is appropriate to examine the statutory language, including the overall statutory context, to determine whether the Secretary of Defense has discretion to adopt an interpretation that excludes from coverage of the statute credit cards, installment loans, or other consumer credit instruments -- in other words, whether it is possible to even move from step one of *Chevron* to step two in view of the plain language of the statute.

### Key Language and Provisions

The legislation (hereafter referred to as "section 670" or "the statute") covers terms of "consumer credit" extended to the military or dependents by a "creditor". Subsection (c), on mandatory disclosures, states that it applies to "any extension of consumer credit (including any consumer credit originated or extended through the internet)" (emphasis added). Subsection (e) makes it unlawful for "any creditor" (emphasis added) to impose certain terms. Subsection (h), directing the Secretary of Defense to prescribe implementing regulations, requires that the regulations establish the disclosures required of "any creditor" (emphasis added) "consistent with the provisions of this section." Subsection (i)(5) provides a definition of "creditor" (as one "in the business" of providing consumer credit), and allows the Secretary to establish additional criteria for the definition of "creditor" in the regulations authorized by subsection (h).

Subsection (i)(6) provides a definition of "consumer credit" that specifies two exceptions -- a residential mortgage and a loan used to procure a car or other personal property, with the loan secured by the property -- and otherwise provides that the term will have the meaning provided in the regulations issued by the Secretary. Other than in these two exceptions, and the reference to consumer credit originated or extended through the internet, there is no mention of any specific forms of "consumer credit", such as credit cards, installment loans, or payday advances.

Under subsection (h), the Secretary is directed to define "creditor" and "consumer credit", and to provide "[s]uch other criteria or limitations as . . . [he] determines appropriate"; however, those definitions and criteria or limitations must be "consistent with the provisions of this section [i.e., section 670]."

The use of the term "any" with regard to "consumer credit" and "creditor", and the specification of two exceptions to the meaning of "consumer credit", together with the absence of any other reference to particular forms of credit, are of particular significance under federal caselaw finding that statutory language had a plain meaning. There is considerable and consistent caselaw addressing whether Congress' use of the term "any" means any and all, without exception. There is also considerable caselaw on the statutory construction maxim of "*inclusio unius est exclusio alterius*" (to include one is to exclude the other) that is consistent with regard to specified exceptions that must be considered in light of the two specified exceptions to the definition of "consumer credit".

### The Importance of the Term "Any"

The federal courts, including the Supreme Court, have held that use of the term "any" clearly indicates an unambiguous Congressional intent to be all-inclusive, absent specific
limitations elsewhere in the statute or unless such a reading would result in absurd, farfetched, or anomalous outcomes or violate commonsense presumptions. Congress is presumed to be aware of this body of caselaw when it drafts legislation.

A leading case is *United States v. Gonzales*, 520 U.S. 1, 117 S.Ct. 1032 (1997), in which the Supreme Court held that the term "any" in "any other term of imprisonment" (in a criminal sentencing statutory provision) had an "expansive" meaning in covering both State as well as federal prison sentences. The Court concluded that because Congress did not add any language limiting the term "any", it must read "any" as "all". *Accord, United States v. Monsanto*, 491 U.S. 600, 606-09, 109 S.Ct. 2657, 2661-63 (1989) (statutory language providing for forfeiture of "any property" was plainly all-inclusive, especially when read with other statutory language); *State of New York v. U.S. Envtl. Prot. Agency*, 443 F3d. 880, 884-90, and cases cited therein (D.C. Cir. 2006) (in the absence of Congressional intent to the contrary, "any" physical change pertaining to Clean Air Act new source review must be read as all-inclusive, and to avoid a literal interpretation at *Chevron* step one, it must be shown that as a matter of historical fact, logic, or statutory structure, Congress did not mean what it said when it used the term "any"); *CBS, Inc. v. Primetime 24 Joint Venture*, 245 F.3d 1217, 1222-26 (11th Cir. 2001) (the term "any" means "all" and is not ambiguous, and in the absence of limiting language no resort to legislative history is justified); *United States v. Wildes*, 120 F.3d 468, 469-71 (4th Cir. 1997) (the term "any" is expansive and unambiguous unless a literal reading would produce a result demonstrably at odds with the intent of the drafters or would produce absurd or futile results). *And see Norfolk Southern Ry. Co. v. Kirby*, 543 U.S. 14, 31-32, 125 S.Ct. 385, 397 (2004) (interpretation of "any" in maritime contract clause under federal law as all-inclusive).

An expansive reading of "any" does not apply if other provisions of the statute, or its overall context, show clearly that the expansive meaning was not intended. *United States v. Alvarez-Sanchez*, 511 U.S. 350, 357-58, 114 S.Ct. 1599, 1603-04 (1994) (statutory provision applying to delay in federal arraignment of a person in the custody of "any" law enforcement officer or agency did not include time in the custody of non-federal officers or agencies when the rest of the statute was considered because there could be no "duty" to arraign federally until there was an arrest for a federal offense); *Small v. United States*, 544 U.S. 385, 388-89, 125 S.Ct. 1752, 1754-55 (2005) (although "any" usually demands a broad interpretation, such an interpretation is not appropriate when it would violate commonsense presumptions, and "convicted in any court" did not mean convicted in a court outside the U.S. because it is presumed that when Congress legislates it legislates with domestic concerns in mind and not with extraterritorial application); *Nixon v. Missouri Municipal League*, 541 U.S. 125, 132-41, 124 S.Ct. 1555, 1561-66 (2004) (reading a prohibition applying to telecommunications service provided by "any entity" to preempt state law would be "farfetched" in view of the Constitutional sensitivity of the issue in the absence of some unmistakably clear indication that Congress intended such a result).

In other words, use of the term "any" indicates Congressional intent for an all-inclusive and unambiguous coverage under *Chevron* step one unless there is some very clear indication of Congressional intent to the contrary that is apparent from the statute itself or logic or precedent.

Not only is there no indication in all of section 670 or logic or precedent that the term "any" modifying "extension of consumer credit" or "creditor" should not be given its ordinary
expansive meaning, thereby keeping the analysis within step one of Chevron (plain meaning), but other portions of the statute reinforce the expansive reading.

The Importance of the Specified Exceptions to "Consumer Credit"

The statutory definition of "consumer credit" in subsection (i)(6) states that it specifically does not include, and regulations otherwise defining it cannot include, "(A) a residential mortgage, or (B) a loan procured in the course of purchasing a car or other personal property, when that loan is offered for the express purpose of financing the purchase and is secured by the car or personal property procured." These specific exclusions clearly bring into play the long-standing statutory construction maxim (or canon) of "inclusio unius est exclusio alterius." The literal translation of this Latin is "to include one is to exclude the other." In other words, if Congress has specifically included one thing in a statute, it is inferred that it decided to exclude (or not to include) another (related) thing.

This maxim has been invoked and addressed in thousands of federal cases, sometimes being found applicable and sometimes not. However, that it has sometimes been found inapplicable does not mean that it has lost validity, and the courts have often taken pains to clarify its correct application. In particular, the U.S. Supreme Court has clarified the maxim in recent cases. Those cases caution that the maxim usually only has correct application when Congress has specified more than one in a series of related things, thereby giving rise to the commonsense inference and conclusion that Congress gave careful consideration to what should be included and excluded, and then set out the specific inclusions or exclusions. The most recent Supreme Court explanation of the maxim and its previous cases was in Barnhart v. Peabody Coal Co., 537 U.S. 149, 168-69, 123 S.Ct. 748, 760 (2003):

We do not read the enumeration of one case to exclude another unless it is fair to suppose that Congress considered the unnamed possibility and meant to say no to it. . . . As we have held repeatedly, the canon expressio unius est exclusio alterius does not apply to every statutory listing or grouping; it has force only when the items expressed are members of an "associated group or series," justifying the inference that items not mentioned were excluded by deliberate choice, not inadvertence. [Citations omitted]

The stated exceptions to the statutory definition of "consumer credit" in subsection (i) clearly come within this Supreme Court guidance. Residential mortgages and loans secured by the purchased personal property are stated as explicit exceptions to "consumer credit", so Congress clearly considered what to exclude, and did not exclude anything else, such as unsecured installment loans or credit card transactions. And the two specified exceptions are clearly members of an "associated group or series", justifying an inference that Congress deliberately chose what to exclude. Moreover, the specific inclusion of "any consumer credit originated or extended through the internet" as a type of credit within "any extension of consumer credit" in subsection (c) strengthens the inference that Congress gave careful thought
to what to include or exclude and deliberately chose to exclude only those two types of
"consumer credit" specified in subsection (i). ²

Moreover, the recent case of State of New York v. U.S. Envtl. Prot. Agency in the D.C.
Circuit, 443 F.3d 880, 887 (2006), illustrates how a statute that uses the term "any" and then
provides an express exclusion, adds force to an inference that everything not excluded was
intended to be included. In that case, as a result of application of the expansive interpretation of
"any" combined with application of the maxim, the court determined that the Congressional
intent was clear from the language of the statute and there was no justification for proceeding to
step two of a Chevron analysis. Id. at 889-90.

The Statutory Context and Related Provisions

As noted, the usual presumption that attaches to use of the term "any", and the accepted
application of the maxim inclusio unius est exclusio alterius, will give way to strong evidence of
Congressional intent to the contrary that is evident from the statute. This means that
consideration must be given to other provisions of the statute, its structure, and its obvious intent.
In other words, are there other aspect of the statute that indicate clearly that Congress intended to
exclude from its coverage certain types of consumer credit, such as credit card transactions and
installment loans for consumer goods and not secured by the goods, other than those specified
exclusions in subsection (i)?

One might argue that because section 670 requires that creditors shall provide certain
disclosures orally as well as in writing under subsection (c), the statute must contemplate face-to-
face transactions and such a scenario is not compatible with credit cards because cards are
obtained and payments are ordinarily made by mail or electronically. Such an argument will not
stand up to the language of the statute or common sense, however. Subsection (c) specifically
provides that it covers "consumer credit originated or extended through the internet." Such
transactions are subject to the same argument, yet they are covered. It is common knowledge
that a multitude of consumer products may be purchased with a credit card through the internet,
and major credit cards are offered and can be obtained through online application.³ Credit cards

² See also Leatherman v. Tarrant County Narcotics Intelligence and Coordination Unit, 507 U.S. 163, 168, 113 S.Ct. 1160 (1993) (specification of two types of cases in which more particularized pleading
would be required under the Federal Rules of Civil Procedure, along with the encompassing statement
that generally all that would be required is a "short and plain statement", gave rise to application of the
has force only when the items expressed are members of an associated group of series, justifying the
inference that the items not mentioned were excluded by deliberate choice. . . . The maxim . . . can be
overcome by a strong indication of contrary legislative intent or policy. . . . The enumeration of
exclusions . . . indicates that the statute should apply to all cases not specifically excluded." [Footnotes
omitted]).

³ See, e.g.,
http://www.chase.com/ccp/index.jsp?pg_name=ccpmapp/card_acquisitions/unsolicited/page/PFSCreditC
hooseCategory&cat=military (Chase);
http://www.citicards.com/cards/wv/filter1Search.do?constituent=CONSUMER&x=22&y=10 (Citibank),
http://www.discovercard.com/apply/student/ (Discover);
https://www124.americanexpress.com/cards/cda/dynamic.jsp?name=CCSMultiCardLandingPage2&typ
are marketed online to the military specifically, and in competition with other types of credit. Moreover, credit card providers already give oral disclosures in several contexts. New or reissued cards come with an adhesive strip notifying the customer to call a toll-free number for activation. Depending on the provider, some offer recorded messages on terms, etc. Some have customers speak with a live operator. In other circumstances, if a customer purchases an add-on feature such as credit protection, the customer calls a toll free number and a service representative reads the terms and conditions, and the communication is recorded. The specific inclusion of consumer credit originated or extended through the internet indicates that the law does not contemplate face-to-face transactions despite the requirement for oral disclosure of terms in the same subsection (c). The requirement for oral communication of terms for providers of consumer credit in other than face-to-face situations might pose logistical issues, but they are clearly surmountable through the use of telephone communications (including recorded messages).

It might also be argued that since the ordinary interest rates on credit cards are typically under 36 percent, the statute was not aimed at them. However, the statute does not cover just interest rates in the usual sense; rather, it defines "interest" in subsection (i)(3) to include "fees, service charges . . . and any other charge or premium." Such charges can easily take credit cards payments over the 36 percent maximum and into APRs over 400 percent. Attachment II illustrates high APRs that can result from credit cards as well as some other types of consumer loans.

Section 670 was clearly designed to protect military servicemembers and their dependents from any credit charges above 36%, and it would be anomalous, absent some clear indication of Congressional intent to the contrary, to construe the statute to exclude types of credit with charges above 36% that are of a type not specifically excluded from the definition of "consumer credit".

Other provisions of section 670 also have application to credit cards as well as other forms of consumer credit. Subsection (e) also makes it unlawful for a creditor to use a "method of access to a deposit, savings, or other financial account maintained by the borrower", and credit card providers (and other lenders) routinely provide for automatic withdrawal methods to

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5 It should also be kept in mind that currently we are in a low-to-moderate interest rate environment, and even in this environment some sub-prime or "penalty" credit card rates (imposed due to late payment or "universal default") can approach or even exceed the 36 percent statutory maximum.

obtain payments due. Subsection (e) prohibits creditors from requiring borrowers to waive their rights to legal recourse and submit to arbitration, and credit card agreements often require just that unless the cardmember reads the fine print and rejects the arbitration agreement in writing within 30 days. Subsection (e) also prohibits consolidation of credit with the same creditor, a transaction that could often apply to credit cards and installment loans.

On the other hand, there are no provisions of section 670 that do not make sense for credit cards or some other forms of consumer credit while making sense for some others. The overall language and structure of the statute is consistent with an interpretation that when Congress said "any extension of consumer" credit and "any creditor", with only those exceptions that are stated, it meant what it said.

Since this is the case, one might then ask what is the purpose of giving the Secretary regulatory authority to define "consumer credit" and "creditor". Are there areas remaining in which the Secretary can exercise discretion in those definitions? The answer to this is yes. The term "consumer" does not have a self-evident definition. While everyone might be considered a "consumer", credit for "consumer" purposes would likely exclude credit extended for business, investment, gambling, or other purposes. The Federal Reserve found it necessary to adopt a definition of "consumer credit" for purpose of its Truth in Lending regulations that covers credit extended "to a consumer primarily for personal, family, or household purposes." The Secretary's definition of "creditor" would have to address the issue of how to define whether an entity is "in the business" of extending consumer credit, as has the Federal Reserve effectively in its Truth in Lending regulations.

Legislative History

Although the above analysis appears to establish indisputably that section 670 covers all forms of consumer credit other than those types specifically excepted, and therefore it is unnecessary to resort to the legislative history -- and the legislative history cannot override the

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7 See, e.g., http://www.chase.com/ccp/index.jsp?pg_name=ccpmapp/card_servicing/account_access/page/epay_landung1 (accessed January 2007). It might be argued that the prohibition against automatic electronic withdrawals from a borrower's bank account in subsection (e)(5) does not make sense when applied to credit cards because it is a convenience to military borrower's rather than something they need to be protected from. However, such an argument could apply equally to other forms of consumer credit and would appear to amount simply to simply an argument that Congress was unwise to insert such a provision, which is a policy/political argument, not a legal argument.


9 12 CFR § 226(12).

10 12 CFR § 226(17).
plain language of the statute -- courts nevertheless sometimes look to the legislative history to confirm that what appears evident from the plain language is indeed what Congress intended.\(^\text{11}\) The only Congressional report explaining section 670 is the conference report.\(^\text{12}\) The short explanation in the report, just like the statute, does not refer to any particular forms of credit, it refers only to "consumer credit loans", "credit", and "creditors who extend credit".

Although remarks by individual Members of Congress carry little or no legal weight as legislative history, in this case they do show that a number of Members considered credit card companies to be engaging in "predatory" practices when they commented on other pending consumer credit legislation at the same time they were considering legislation pertaining to restrictions on lending to the military.\(^\text{13}\) The same is true for installment loans extended to the military.\(^\text{14}\)

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\(^{11}\) See, \textit{e.g.}, \textit{CBS, Inc. v. Primetime 24 Joint Venture}, 245 F.3d 1217, 1229 n.9 (11th Cir. 2001) ("Notwithstanding that well-recognized and bedrock principle [of not advancing to legislative history when statutory text is clear], sometimes judges who find that legislative history supports and complements the plain meaning of statutory language cannot resist the temptation to set out that history. We have given in to that temptation more than once.").


\(^{13}\) 151 Cong.Rec. H2064, April 14, 2005 (Rep. Sensenbrenner commenting on bankruptcy legislation: "If anyone is 'gaming' our bankruptcy system, it is the credit card companies, who have long been advocating for this bill at the same time they prey on unsuspecting customers . . . [and] there is virtually nothing in this bill that would require creditors to curb their outrageous predatory lending practices that mislead even the most educated consumers into debt."); 151 Cong.Rec. S1836, Mar. 1, 2005 (Senator E. Kennedy commenting on the Credit Card Minimum Payment Warning Act: "[T]his bill does everything the mind of the purveyors of predatory plastic could think up to make cardholders pay in full, and prevent them from getting the 'fresh start' that bankruptcy offers them."); 151 Cong.Rec. S1838, Mar. 1, 2005 ("Predatory credit card companies are doing all they can to urge unsuspecting citizens to pile up huge debts on their credit cards."); 151 Cong.Rec. S2201, Mar. 8, 2005 (Sen. E. Kennedy commenting on the Bankruptcy Abuse Prevention Act and Consumer Protection Act of 2005, S. 256: "We have seen the credit card companies use a self-help remedy for the problem they create by their own indiscriminate and predatory marketing practices."); 151 Cong.Rec. H1975, Mar. 14, 2005 (Rep. Stark commenting on the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, S. 256: "[W]ith all the perks they've awarded to the big credit card companies, Republicans have done nothing to ensure that they are held accountable for their role in this consumer crisis. There is nothing in this bill that stops the abusive, predatory lending that lands too many Americans in bankruptcy in the first place."); 151 Cong.Rec. H1976, Mar. 14, 2005 (Mr. Hastings commenting on the same bills as Mr. Stark, \textit{supra}: "This legislation, masquerading as protection against bankruptcy abuse, is really a protection for credit card companies and their predatory lending practices."); 151 Cong.Rec. H2064, April 12, 2005 (Rep. McDermott: "Credit card companies are an equal-opportunity scourge . . . The marketing is not aggressive. It is predatory. . . . Does this so-called consumer protection action [sic] do anything to address predatory credit card marketing? Nothing, nada, zippo."). Senator Dodd, during hearings on credit card practices in 2005 commented: "Credit card issuers have now become the victims of their own success and are turning credit cards into nothing less than wallet-sized predatory loans. In a time when access to credit is the easiest and cheapest, credit card companies are making more money than ever. Credit card issuers are charging usurious rates and fees and engaging, in my view, in a very serious amount of abusive and deceptive practices, which I believe will have drastic long-term consequences on our country." Hearing
Although non-Congressional statements are entitled to even less (if any) legal weight, numerous consumer organizations supported the legislation that became section 670, and commented: "[T]his important amendment would protect service members who obtain loans after they have enlisted or been mobilized, closing a major loophole in the Service Members Civil Relief Act. It also treats all lenders equally, no matter what type of loan they offer."  

Moreover, after the statute was enacted, various organizations with credit card provider membership also expressed the view that it covered credit cards.


Those Congressional remarks mainly referred to Pioneer Financial Services, an installment loan provider that concentrates on the military, often using a variety of names, websites, and affiliates. 151 Cong. Rec. E1405-06, June 30, 2005 (Rep. Westmoreland: "Pioneer Financial has realized that it can prey on military customers by charging unjustifiable rates, high fees and selling them expensive and often unnecessary credit insurance, and then refinancing the loan within a year to generate more fees."); 151 Cong.Rec. E1487, July 14, 2005 (Rep. Jones: "[T]he New York Times pointed out abusive lending practices by companies like Pioneer Financial . . . . According to that paper, Pioneer charges high rates and hidden fees and has the policy of refinancing their existing loans with the first year for the express purpose of generating more fees. Unfortunately, it's not just one company like Pioneer that requires servicemembers to prey on our Armed Forces personnel."); 151 Cong.Rec. E1466-67, July 12, 2005 (Rep. Meek: "unethical lenders like Pioneer Financial that target vulnerable service members and charge unreasonably high rates and fees and sell them grossly overpriced credit insurance and who then refinance these predatory loans with the first 12 months if possible to generate more unjustifiable fees"); 151 Cong.Rec. E1450, July 11, 2005 (Rep. Davis: "I know about companies like Pioneer Financial that engage in predatory lending with high rates and hidden fees and frequently refinance [sic] loans to generate more fees for the lender while providing little or no benefit to the service member.") (all accessed January 2007).


See the American Bankers Association analysis of section 670, available at http://www.aba.com/aba/documents/winnews/DoD_PayDayWhitePaper_101206.pdf ("The following are just a few examples of the types of traditional products that are thrown into jeopardy by this provision: (1) cash advances on credit cards; (2) checking account overdraft protection services; (3) direct debit for payment of some loans; (4) new products developed as lower-cost substitutes for payday lending; and (5) some debt consolidation loans, including the refinancing of prior debt with the same lender at a lower rate.") (accessed January 2007); the news report of the Independent Community Bankers Ass'n on section 670, available at http://www.icba.org/publications/NewsletterDetailNWT.cfm?ItemNumber=25905#n163833 ("Congress Caps Military Payday Lending: . . . Late fees on credit cards are considered interest charges under the law. . . . It also requires new disclosures and limitations and covers all forms of consumer credit.")
Summary and Conclusions

The plain language of section 670, together with firmly established principles of statutory construction, and further confirmed by legislative history, establishes that section 670 covers all forms of consumer credit, including installment loans and credit cards, with the exception of those forms of credit specifically excepted (residential mortgages and personal property loans secured by the property). The authority of the Secretary to define "consumer credit" and "creditor" in regulations does not extend to allowing him to exclude certain forms of credit other than those specifically excluded by the legislation.

( accessed January 2007); and see also this statement from the American Financial Services Association, available at http://www.spotlightonfinance.org/2006/November/legislative-story3.htm ("The cap [in section 670] applies to unsecured consumer loans such as credit cards and payday advance loans, but not to mortgages or auto loans.") (accessed January 2007).
SEC. 670. LIMITATIONS ON TERMS OF CONSUMER CREDIT EXTENDED TO SERVICEMEMBERS AND DEPENDENTS.

(a) TERMS OF CONSUMER CREDIT.—Chapter 49 of title 10, United States Code, is amended by adding at the end the following new section:

“§ 987. Terms of consumer credit extended to members and dependents: limitations

“(a) INTEREST.—A creditor who extends consumer credit to a covered member of the armed forces or a dependent of such a member shall not require the member or dependent to pay interest with respect to the extension of such credit, except as—

“(1) agreed to under the terms of the credit agreement or promissory note;

“(2) authorized by applicable State or Federal law; and

“(3) not specifically prohibited by this section.

“(b) ANNUAL PERCENTAGE RATE.—A creditor described in subsection (a) may not impose an annual percentage rate of interest greater than 36 percent with respect to the consumer credit extended to a covered member or a dependent of a covered member.

“(c) MANDATORY LOAN DISCLOSURES.—

“(1) INFORMATION REQUIRED.—With respect to any extension of consumer credit (including any consumer credit originated or extended through the internet) to a covered member or a dependent of a covered member, a creditor shall provide to the member or dependent the following information orally and in writing before the issuance of the credit:

“(A) A statement of the annual percentage rate of interest applicable to the extension of credit.

“(B) Any disclosures required under the Truth in Lending Act (15 U.S.C. 1601 et seq.).

“(C) A clear description of the payment obligations of the member or dependent, as applicable.

“(2) TERMS.—Such disclosures shall be presented in accordance with terms prescribed by the regulations issued by the Board of Governors of the Federal Reserve System to implement the Truth in Lending Act (15 U.S.C. 1601 et seq.).

“(d) PREEMPTION.—

“(1) INCONSISTENT LAWS.—Except as provided in subsection (f)(2), this section preempts any State or Federal law, rule, or regulation, including any State usury law, to the extent that such law, rule, or regulation is inconsistent with this section, except that this section shall not preempt any such law, rule, or regulation that provides protection to a covered member or a dependent of such a member in addition to the
protection provided by this section.

“(2) DIFFERENT TREATMENT UNDER STATE LAW OF MEMBERS
AND DEPENDENTS PROHIBITED.—States shall not—

“(A) authorize creditors to charge covered members
and their dependents annual percentage rates of interest
for loans higher than the legal limit for residents of the
State; or

“(B) permit violation or waiver of any State consumer
lending protections for the benefit of residents of the State
on the basis of nonresident or military status of a covered
member or dependent of such a member, regardless of
the member's or dependent's domicile or permanent home
of record.

“(e) LIMITATIONS.—It shall be unlawful for any creditor to
extend consumer credit to a covered member or a dependent of
such a member with respect to which—

“(1) the creditor rolls over, renews, repays, refinances, or
consolidates any consumer credit extended to the borrower
by the same creditor with the proceeds of other credit extended
to the same covered member or a dependent;

“(2) the borrower is required to waive the borrower's right
to legal recourse under any otherwise applicable provision of
State or Federal law, including any provision of the
Servicemembers Civil Relief Act;

“(3) the creditor requires the borrower to submit to arbitration
or imposes onerous legal notice provisions in the case
of a dispute;

“(4) the creditor demands unreasonable notice from the
borrower as a condition for legal action;

“(5) the creditor uses a check or other method of access
to a deposit, savings, or other financial account maintained
by the borrower, or the title of a vehicle as security for the
obligation;

“(6) the creditor requires as a condition for the extension
of credit that the borrower establish an allotment to repay
an obligation; or

“(7) the borrower is prohibited from prepaying the loan
or is charged a penalty or fee for prepaying all or part of
the loan.

“(f) PENALTIES AND REMEDIES.—

“(1) MISDEMEANOR.—A creditor who knowingly violates this
section shall be fined as provided in title 18, or imprisoned
for not more than one year, or both.

“(2) PRESERVATION OF OTHER REMEDIES.—The remedies and
rights provided under this section are in addition to and do
not preclude any remedy otherwise available under law to
the person claiming relief under this section, including any
award for consequential and punitive damages.

“(3) CONTRACT VOID.—Any credit agreement, promissory
note, or other contract prohibited under this section is void
from the inception of such contract.

“(4) ARBITRATION.—Notwithstanding section 2 of title 9,
or any other Federal or State law, rule, or regulation, no
agreement to arbitrate any dispute involving the extension
of consumer credit shall be enforceable against any covered
member or dependent of such a member, or any person who was a covered member or dependent of that member when the agreement was made.

''(g) SERVICEMEMBERS CIVIL RELIEF ACT PROTECTIONS UNAFFECTED.—Nothing in this section may be construed to limit or otherwise affect the applicability of section 207 of the Servicemembers Civil Relief Act (50 U.S.C. App. 527).

''(h) REGULATIONS.—(1) The Secretary of Defense shall prescribe regulations to carry out this section.

''(2) Such regulations shall establish the following:

''(A) Disclosures required of any creditor that extends consumer credit to a covered member or dependent of such a member.

''(B) The method for calculating the applicable annual percentage rate of interest on such obligations, in accordance with the limit established under this section.

''(C) A maximum allowable amount of all fees, and the types of fees, associated with any such extension of credit, to be expressed and disclosed to the borrower as a total amount and as a percentage of the principal amount of the obligation, at the time at which the transaction is entered into.

''(D) Definitions of ‘creditor’ under paragraph (5) and ‘consumer credit’ under paragraph (6) of subsection (i), consistent with the provisions of this section.

''(E) Such other criteria or limitations as the Secretary of Defense determines appropriate, consistent with the provisions of this section.

''(3) In prescribing regulations under this subsection, the Secretary of Defense shall consult with the following:


''(B) The Board of Governors of the Federal Reserve System.

''(C) The Office of the Comptroller of the Currency.

''(D) The Federal Deposit Insurance Corporation.

''(E) The Office of Thrift Supervision.

''(F) The National Credit Union Administration.

''(G) The Treasury Department.

''(i) DEFINITIONS.—In this section:

''(1) COVERED MEMBER.—The term ‘covered member’ means a member of the armed forces who is—

''(A) on active duty under a call or order that does not specify a period of 30 days or less; or

''(B) on active Guard and Reserve Duty.

''(2) DEPENDENT.—The term ‘dependent’, with respect to a covered member, means—

''(A) the member’s spouse;

''(B) the member’s child (as defined in section 101(4) of title 38); or

''(C) an individual for whom the member provided more than one-half of the individual’s support for 180 days immediately preceding an extension of consumer credit covered by this section.

''(3) INTEREST.—The term ‘interest’ includes all cost elements associated with the extension of credit, including fees, service charges, renewal charges, credit insurance premiums,
any ancillary product sold with any extension of credit to a servicemember or the servicemember’s dependent, as applicable, and any other charge or premium with respect to the extension of consumer credit.

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“(4) ANNUAL PERCENTAGE RATE.—The term ‘annual percentage rate’ has the same meaning as in section 107 of the Truth and Lending Act (15 U.S.C. 1606), as implemented by regulations of the Board of Governors of the Federal Reserve System. For purposes of this section, such term includes all fees and charges, including charges and fees for single premium credit insurance and other ancillary products sold in connection with the credit transaction, and such fees and charges shall be included in the calculation of the annual percentage rate.

“(5) CREDITOR.—The term ‘creditor’ means a person—

‘‘(A) who—

‘‘(i) is engaged in the business of extending consumer credit; and

‘‘(ii) meets such additional criteria as are specified for such purpose in regulations prescribed under this section; or

‘‘(B) who is an assignee of a person described in subparagraph (A) with respect to any consumer credit extended.

“(6) CONSUMER CREDIT.—The term ‘consumer credit’ has the meaning provided for such term in regulations prescribed under this section, except that such term does not include

(A) a residential mortgage, or (B) a loan procured in the course of purchasing a car or other personal property, when that loan is offered for the express purpose of financing the purchase and is secured by the car or personal property procured.”.

(b) CLERICAL AMENDMENT.—The table of sections at the beginning of such title is amended by adding at the end the following new item:

“987. Terms of consumer credit extended to members and dependents: limitations.”.

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), section 987 of title 10, United States Code, as added by subsection (a), shall take effect on October 1, 2007, or on such earlier date as may be prescribed by the Secretary of Defense, and shall apply with respect to extensions of consumer credit on or after such effective date.

(2) AUTHORITY TO PRESCRIBE REGULATIONS.—Subsection (h) of such section shall take effect on the date of the enactment of this Act.

(3) PUBLICATION OF EARLIER EFFECTIVE DATE.—If the Secretary of Defense prescribes an effective date for section 987 of title 10, United States Code, as added by subsection (a), earlier than October 1, 2007, the Secretary shall publish that date in the Federal Register. Such publication shall be made not less than 90 days before that earlier effective date.

(d) INTERIM REGULATIONS.—The Secretary of Defense may prescribe interim regulations as necessary to carry out such section. For the purpose of prescribing such interim regulations, the Secretary
Center for Regulatory Effectiveness

is excepted from compliance with the notice-and-comment requirements of section 553 of title 5, United States Code. All interim rules prescribed under the authority of this subsection that are not earlier superseded by final rules shall expire no later than 270 days after the effective date of section 987 of title 10, United States Code, as added by this section.
ATTACHMENT II

APRs ASSOCIATED WITH:
PAYDAY LOANS AND OTHER ALTERNATIVE CONSUMER FINANCE MECHANISMS

Below are ballpark estimates of the effective APR associated with four specific alternative consumer finance options. All estimates are calculated based on a $100 base loan.

APRs for payday lenders are based on a bi-weekly loan as typical and cited in the literature. APRs for credit cards and overdraft checks are based on a monthly billing cycle. Please note that this results in very conservative estimates since payday loans, if they were renewed, would be subject to a second service fee. Thus, the APRs for non-payday alternative consumer loans are about half what is estimated in the literature.

- APR on a loan from payday lender: **520%**
- APR on a credit card cash advance with late fee: **456%** *
- APR on a credit card cash advance with over-the-limit fee: **406%** *
- APR on a credit card cash advance with late fee and over-the-limit fee: **826%** *
- APR on a checking account overdraft: **576%** *

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1 Source: J. P. Caskey, “The Economics of Payday Lending,” April 2002. Caskey states that “lenders typically charge $15 to $25 for each $100 that they advance with a two-week maturity.” The CRE analysis uses the mid-point of $20 and multiplied it by 26, the same methodology Caskey uses to estimate the APR for a $200 loan. See p. 5. The study “Credit Union Payday Alternatives” published in December 2005 by the National Association of Community Credit Unions (NACCU) uses the same methodology. See p. 6.

2 Source: $35 average late fee reported by IndexCreditCards.com in June 2006 + a $3 cash advance fee based on the 2-4% cash advance fee reported by BankRate.com.

3 Source: USA Today, “Credit card fees can suck you in” 12/15/06 citing an average over-the-limit fee is $30.81 reported by CardWeb.com. $3 cash advance fee included in calculations.

4 Based on a $35 late fee, $30.81 over-the-limit fee and a $3 cash advance fee.

5 Source: J. Jerving, “Credit Union Payday Loan Alternatives,” NACCU, December 2005, p. 6. Based on $48 combined bank fee and merchant fee for a bad check. Note, this may not be a consumer loan since the bounced check was not honored – triggering the merchant fee. Thus, the original debt remains in addition to the fees.

* Note: The calculation excludes the customary 30% APR interest.
This paper presents preliminary findings and is being distributed to economists and other interested readers solely to stimulate discussion and elicit comments. The views expressed in the paper are those of the author and are not necessarily reflective of views at the Federal Reserve Bank of New York or the Federal Reserve System. Any errors or omissions are the responsibility of the author.
Defining and Detecting Predatory Lending
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Abstract

We define predatory lending as a welfare-reducing provision of credit. Using a textbook model, we show that lenders profit if they can tempt households into “debt traps,” that is, overborrowing and delinquency. We then test whether payday lending fits our definition of predatory. We find that in states with higher payday loan limits, less educated households and households with uncertain income are less likely to be denied credit, but are not more likely to miss a debt payment. Absent higher delinquency, the extra credit from payday lenders does not fit our definition of predatory. Nevertheless, it is expensive. On that point, we find somewhat lower payday prices in cities with more payday stores per capita, consistent with the hypothesis that competition limits payday loan prices.

Key words: predatory, payday, consumer

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“There is no definition of predatory lending. I don’t know how we can hope to address the problem before we have decided what it is.” (Senator Phil Gramm, American Banker, August 24, 2000).

1 Introduction

“Predatory” is how reformers—consumer advocates, journalists, lawyers, legislators, and some bank regulators—condemn lending practices in the booming subprime credit market. The alleged predators are sub-prime mortgage and payday lenders. Their prey? The lower income, less educated households on the demand side of these growing consumer credit markets.1

Concern about predatory lending is mounting (Figure 1). The term began appearing in American Banker in 1994. Appearances were rare until 2000. By 2004, weekly and even daily appearances were common.

Despite growing concerns about predatory lending, and even regulation to curb it, there seems to be no general definition of predatory lending. The usual criticism is of “unaffordable” credit—loans made at such high rates or in such large quantities that borrowers cannot afford to repay the credit without sacrificing their future standard of living, or in the worst case, their home.

To economists, this predator-prey concept of credit seems foreign. If credit is so expensive that lenders are earning abnormal profits (given their risks and costs), why don’t new lenders enter the market to compete rates down to fair levels. “Unaffordable” credit also sounds peculiar; how can lenders profit if borrowers cannot repay?

This paper essays predatory lending from an economists’ perspective. We define predatory lending as a welfare reducing provision of credit. That definition seems general enough to cover some of the specific practices—overlending and overcharging, deception, targeting certain consumer segments—condemned by reformers. We show how households can be made worse of by a voluntary credit transaction if lenders deceive households about some variable that increases households’ demand for credit, like their income.

1For a critique of the predatory aspects of payday lending, see King, Parrish, and Tanik (2006)
Information asymmetries are common in credit market models, but the usual assumption, at least in commercial lending, is that borrowers are the better informed party and that lenders have to screen and monitor to assess whether firms are creditworthy. The opposite asymmetry, as we assume here, does not seem implausible in the context of consumer lending. “Fringe” borrowers are less educated than mainstream borrowers (Caskey 2003), and many are first-time borrowers (or are rebounding from a failed first foray into credit). Lenders know from experience with large numbers of borrowers, whereas the borrower may only have their own experience to guide them. Credit can also be confusing; after marriage, mortgages are probably the most complicated contract most people ever enter. Given the subtleties involved with credit, and the supposed lack of sophistication of sub-prime borrowers, our assumption that lenders know better seems plausible.

While lenders might deceive households about several variables that influence household loan demand, we focus on income. We suppose that lenders exaggerate household’s future income in order boost loan demand. Our borrowers are gullible, in the sense that they can be fooled about their future income, but they borrow rationally given their beliefs. Fooling borrowers is costly to lenders, where the costs could represent conscience, technological costs (of learning the pitch), or risk of prosecution. The upside to exaggerating borrowers’ income prospects is obvious—they borrow more. As long as the extra borrowing does not increase default risk too much, and as long as deceiving borrowers is easy enough, income deception and predatory—welfare reducing—lending may occur.

After defining predatory lending, we test whether payday lending fits our definition. Payday lenders make small, short-term loans to mostly lower-middle income households. The business is booming, but critics condemn payday lending, especially the high fees and frequent loan rollovers, as predatory. Many states prohibit payday loans outright, or indirectly, via usury limits.

To test whether payday lending qualifies as predatory, we compared debt and delinquency rates for households in states that allow payday lending to those in states that do not. We focus especially on differences across states households that, according to our model, seem more vulnerable to predation: households with more income uncertainly or less education.

We use smoking as a third, more ambiguous, proxy for households with high, or perhaps
hyperbolic, discount rates. In general, high discounters will pay higher future costs for a given, immediate, gain in welfare. Smokers’ seem to fit that description. What makes the smoking proxy ambiguous is that smokers may have hyperbolic, not just high, discount rates. Hyperbolic discount rates decline over time in a way that leads to procrastination and self-control problems (Laibson 1997). The hyperbolic discounter postpones quitting smoking, or repaying credit. Without knowing whether smokers discount rates are merely high, or hyperbolic, we will not be able to say whether any extra debt for smokers in payday states is welfare reducing.\footnote{Consistent with a high discount rate, Munasinghe and Sicherman (2000) discover that smokers have flatter wage profiles and they are willing to trade more future earnings for a given increase in current earnings. Gruber and Mulainathan (2002) find that high cigarette taxes make smokers ”happier,” consistent with hyperbolic discount rates (because taxes help smokers commit to quitting). DellaVigna and Malmendier (2004) show how credit card lenders can manipulate hyperbolic discounters by front-loading benefits and back-loading costs.}

Given those proxies, we use a difference-in-difference approach to test whether payday lending fits our definition of predatory. First we look for differences in household debt and delinquency across payday states and non-payday states, then we test whether those difference are higher for potential prey. To ensure that any such differences are not merely state effects, we difference a third time across time by comparing whether those differences changed after the advent of payday lending circa 1995. That triple difference identifies any difference in debt and delinquency for potential prey in payday states after payday lending was introduced.

Our findings seem mostly inconsistent with the hypothesis that payday lenders prey on, i.e., lower the welfare of, households with uncertain income or households with less education. Those types of households who happen to live in states that allow unlimited payday loans are less likely to report being turned down for credit, but are not more likely, by and large, to report higher debt levels, contrary to the overborrowing prediction of our model. Nor are such households more likely to have missed a debt payment in the previous year. On the contrary, households with uncertain income who live in states with unlimited payday loans are less likely to have missed a debt payment over the previous year. The latter result is consistent with claims by defenders of payday lending that some households borrow from
payday lenders to avoid missing payments on other debt. On the whole, our results seem consistent with the hypothesis that payday lending represents a legitimate increase in the supply of credit, not a contrived increase in credit demand.

We find some interesting differences for smokers, but those differences are harder to interpret in relation to the predatory hypothesis without knowing *apriori* whether smokers are hyperbolic, or merely high, discounters.

We also find, using a small set of data from different sources, that payday loan rates and fees decline significantly as the number of payday lenders and pawnshops increase. Reformers often advocate usury limits to lower payday loan fees but our evidence suggests that competition among payday lenders (and pawnshops) works to lower payday loan prices.

Our paper has several cousins in the academic literature. Ausubel (1991) argues that credit card lenders exploit their superior information about household credit demand in their marketing and pricing of credit cards. The predators in our model profit from their information advantage as well. Our concept of income delusion or deception also has a behavioral flavor, as well, hence our use of smoking as a proxy for self-control problems. Brunnermeier and Parker (2004), for example, imagine that households *choose* what to expect about future income (or other outcomes). High hopes give households’ current “felicity,” even if it distorts borrowing and other income-dependent decisions. Our households have high hopes for income, and they make bad borrowing decisions, but we do not count the current felicity from high hopes as an offset to the welfare loss from overborrowing.

Our costly falsification (of household income prospects) and costly verification (by counselors) resemble Townsend’s (1979) costly state verification and Lacker and Weinbergs’ (1989) costly state falsification. The main difference here is that the falsifying and verifying comes before income is realized, not after.

More importantly, we hope our findings inform the current, very real-world debate, around predatory lending. The stakes in that debate are high: millions of lower income households borrow regularly from thousands of payday loan offices around the country. If payday lenders raise household welfare by relaxing credit constraints, anti-predatory legislation may lower it.
2 Payday Lending

Payday lenders make small, short-term loans to households. The typical loan is about $300 for two weeks. The typical fee is $15 per $100 borrowed. Lenders require two recent pay stubs (as proof of employment), and a recent bank account statement. Borrowers secure the loan with a post-dated personal check for the loan amount plus fees. When the loan matures, lenders deposit the check.

Payday lending evolved from check cashing much like bank lending evolved from deposit taking. For a fee, check cashiers turn personal paychecks into cash. After cashing several paychecks for the same customer, lending against future paychecks was a natural next step.

High finance charges is the main criticism against payday lenders. The typical fee of $15 per $100 per two weeks implies an annual interest rate of $15 \times 365/14$, or 390 percent. Payday lenders are also criticize for overlending, in the sense that borrowers often refinance their loans repeatedly, and for ”targeting” women making the transition from welfare-to-work (Fox and Mierzewski 2001) and soldiers (Graves and Peterson 2004).

Despite their critics, payday lending has boomed. The number of payday advance offices grew from 0 in 1990 to 14,000 in 2003 (Stegman and Harris 2003). The industry originated $8 to $14 billion in loans in 2000, implying 26-47 million individual loans. Rapid entry suggests the industry is profitable.

Payday lenders present stiff competition for pawnshops, even though the internet, namely E-bay, significantly foreclosure costs for pawnshops (Caskey 2003). The number of pawn shops in the U.S. grew about six percent per year between 1986 and 1996, but growth essentially stalled from 1997 to 2003. Prices of shares in EZCorp, the largest, publicly traded pawn shop holder, were essentially flat or declining between 1994 and 2004, while Ace Cash Express share prices, a retail financial firm selling check cashing and payday loans, rose substantially over that period (Figure 4). EZCorp CEO, Joseph Rotunday, blamed payday lenders for pawnshops’ dismal performance:

The company had been progressing very nicely until the late 1990s.... (when) a new product called payroll advance/payday loans came along and provided our customer base an alternative choice. Many of them elected the payday loan over

Payday lending is heavily regulated (Table 1). As of 2001, eighteen states effectively prohibited payday loans via usury limits, and most other states prices, loan size, and loan frequency per customer (Fox and Mierzwinski 2001). Note that the payday loan limit ranges from 0 (where payday loans are illegal) to 1250. Nine states allow unlimited payday loans.

Payday lenders have circumvented usury limits by affiliating with national or state chartered banks, but the Comptroller of the Currency—the overseer of nationally chartered banks—recently banned such affiliations. The Federal Deposit Insurance Corporation still permits payday lenders to affiliate with state banks, but recently restricted those partnerships (Graves and Peterson 2005).

Regulatory risk—the threat of costly or disabling legislation in the future—looms large for Payday lenders. The Utah legislature is reconsidering its permissive laws governing payday lending. North Carolina recently drove payday lenders from the state by expressly outlawing the practice.

Heavy regulation increases the cost of payday lending. High regulatory risk increases limits entry into the industry and increases the expected return required by industry investors. Driving up costs and driving away investors may be exactly what regulators intended if they view payday lending as predatory.

3 Defining Predatory Lending

We define predatory lending as a welfare reducing provision of credit. Households can be made worse off by borrowing if lenders can deceive households into borrowing more than is optimal. Excess borrowing reduces household welfare, and may increase default risk.

We illustrate our concept of predatory lending in a standard model of household borrowing. Before we get to predatory lending, we review basic principles about welfare improving lending, the type that lets households maintain their consumption despite fluctuations in their income.

The model has two periods: today (period zero) and payday (period one. Household income goes up and down periodically, but not randomly (for now): income equals zero today
and \( y \) on payday. If households consume \( C_t \) in period \( t \), their utility is \( U(C_t) \). Household welfare is the sum of utility over both periods: \( U(C_0) + \delta U(C_1) \), where \( \delta \) equals the household’s time rate of discount. Households with high \( \delta \) value current consumption highly relative to future consumption. In other words, high discounters are impatient.

A digression here on discount rates serves later discussion. In classical economics \( \delta \) is constant. If \( \delta \) changes over time, so does household behavior, even if nothing else changes. If \( \delta(t) \) is hyperbolic, households will postpone unpleasant tasks until current consumption does not seem so precious relative to future consumption (Laibson 1997). With hyperbolic discounting, that day never arrives, so hyperbolic discounters have behavioral problems: they procrastinate. They may never repay debt, much less begin saving. Hyperbolic discounters who start smoking may never quit.

Returning to the model, if the marginal utility of consumption \( (U') \) is diminishing, households will demand credit to reduce fluctuations in their standard of living. Households without credit, however, must fend for themselves (autarky). Welfare under autarky equals \( U(0) + \delta U(y) \). The fluctuations in consumption for households without credit make autarky a possible worst case, and hence, a good benchmark for comparing cases with credit.

If households borrow \( B \) at interest rate \( r \), welfare equals \( U(B) + \delta U(y - (1 + r)B) \). Borrowing increases utility in period zero, when the proceeds are consumed, but lowers utility in period one, when households pay for their borrowing. Rational, informed households trade off the good and bad side of borrowing; they borrow until the marginal utility of consuming another unit today just equals the marginal, discounted disutility of repaying the extra debt on payday:

\[
U''(B) = \delta(1 + r)U''(y - (1 + r)B).
\]

Equation (1) determines household loan demand as a function of their income, their discount rate, and the market interest rate: \( B(y, \delta, r) \). For standard utility functions, household loan demand is increasing in income and decreasing in the discount factor and interest rate: \( B_y > 0; B_\delta < 0; B_r < 0 \). Household welfare with optimal borrowing equals \( U(B(y, r, d)) + \delta U(y - (1 + r)B(y, r, \delta)) \). As long as households follow (1), their welfare with positive borrowing must be higher than without (autarky).

The welfare gain from borrowing depends on the cost of credit production. Suppose the
cost of lending $B$ to a particular household equals \((1 + \rho)B + f\), where \(\rho\) represents the opportunity cost per unit loaned and \(f\) is the fixed cost per loan. Think of \(f\) as the cost of record-keeping and credit check required for each loan, however large or small the loan may be. If the going price for loans is \((1 + r)\) per unit borrowed, the lenders’ profits equal \((r - \rho)B - f\).

With perfect competition among lenders, the loan interest rate is competed down until it just covers the costs of the loan: \(r = \rho + f/B\). Equilibrium \(r\) and \(B\) are determined where that credit supply curve equals demand (1).

Equilibrium in the payday credit market is illustrated in Figure (3). If fixed costs per loan are prohibitively high, the market may not exist. Perhaps the payday lending technology lowered the fixed cost per loan enough to make the business viable.\(^3\) Before the advent of payday lending, households who applied to banks for a very small, short-term loan may have been denied.

Fixed costs per loan imply that smaller loans will cost more per dollar borrowed than larger loans. That means households with low credit demand will pay higher rates than households with high loan demand. Loan demand is increasing in income, so high income households who demand larger quantities of credit will enjoy a ”quantity” discount, while lower income households will pay a ”small lot” premium, or penalty. That price ”discrimination” is not invidious, however; the higher cost of smaller loans reflects the fixed costs of lending. The high price of payday loans may partly reflect the combination of fixed costs and small loan amounts (Flannery and Samolyk 2005).

A usury limit lowers household welfare. Suppose the maximum legal interest rate is \(\bar{r}\). At that maximum rate, the minimum loan that lenders’ cost is \(f/(\bar{r} - \rho) = B\). Low income households with loan demand less than \(B\) face a beggar’s choice: borrow \(B\) at \(\bar{r}\) or do not borrow at all. Such households would be willing to pay more to to avoid going without credit, so raising the usury limit would raise welfare for those households.

Competition is another key determinant of how much households gains from borrowing.\(^3\) Alternatively, or additionally, the demand for small, short term loans may have increased in the mid 1990s. The welfare reform then almost certainly increased demand for such credit as households who once ”worked” at home for the government were forced to go to work in the market.
Even with no competition – monopoly—households cannot be worse off than under autarky. The monopolist raises interest rates until the marginal revenue from higher rates equals the marginal cost from lower loan demand:

\[ B(y, r) = -(r - \rho)B_r(y, r). \]  

At that monopoly interest rate, \( r^m \), household loan demand equals \( B(y, r^m) \). Household welfare under monopoly equals \( U(B_r(y, r^m)) + \delta U(y - (1 + r^m)B_r(y, r^m)) \). Welfare is lower under monopoly because credit costs more and their standard of living fluctuates more (because costly credit reduces their demand for credit) If households borrow from the monopolist, however, they must better off than without credit.

In sum, welfare for rational households is highest if credit is available at competitive prices. If households choose to borrow, they must be at least as well off as they were without credit. Limiting loan rates cannot raise household welfare and may reduce it. Monopoly lenders lower household welfare, but even with a monopolist, households cannot be worse off than without credit.

The high cost of payday lending may partly reflect fixed costs per loan. Before payday lending, those fixed costs may have been prohibitive; very small, short-term loans may not have been worthwhile for banks. The payday lending technology may have lowered those fixed costs, thus increasing the supply of credit to low income households demanding small loans. That version of the genesis of payday lending suggests the innovation was welfare improving, not predatory.

### 3.1 Predation by Income Deception

In the textbook model household welfare cannot be lower than under autarky because households are fully informed and rational. Here we show households how can be made worse off than without credit if predatory lenders can delude households about their (households’) future income.

Suppose that by spending \( C(\tau) \), lenders can convince a prospective borrower that her income on payday will be \( y + \tau \). The cost \( C \) can be interpreted variously as the cost of a guilty
conscience, the risk of prosecution, or the resources spent conning households into believe $\tau$. Households are increasingly skeptical as deception increases: $C'(\cdot) > 0$ and $C''(\cdot) > 0$. $C(\tau)$ might be lower for more gullible households and higher for the more skeptical ones. For the fully rational borrower, the costs of deception are infinite: $C(0) = \infty$.

Our model of costly income deception takes us far from, and in some ways behind, current techniques for modelling information asymmetries. Borrowers here not fully informed, as they operate under the assumption that next period equals $y + \tau$, and that is plainly wrong.\footnote{The models in Townsend (1979) and Lacker and Weinberg (1989) feature costly income verification and falsification (respectively), but we reverse the timing and roles. Here it is the financiers who falsify, not the borrowers, and the deception occurs before deals are done. Alternatively, one could model the information asymmetry here as an adverse selection problem where households know that some creditors misrepresent households’ creditworthiness, but the mis-representers are hard to distinguish from the honest creditors. While that might be an interesting problem, if subprime borrowers can solve that subtle inference problem, why worry about them?}

Our income deception story is closer to the facts than it is to theory. In a study of households’ choice of credit cards plans, Agarwal, Chomsisenghat, Liu, Souleles (2005) find that about 40 percent of households choose sub-optimal plans. Ausubel (1991, 1999) and Shui and Ausubel (2004) find evidence that credit card holders systematically underestimate how much they owe or how long they (will) owe it. Underestimating borrowing is not much different from overestimating future income.\footnote{Income deception is also a common charge against another class of lenders accused of predatory lending: subprime mortgage lenders. In a survey by Stock (2001) of households with foreclosed subprime mortgages in Dayton, Ohio, 42 percent reported that mortgage lender encouraged them to borrow more than they initially intended.}

Though gullible, households borrow optimally given their perceived income. That means they are on their demand curve for credit, where their demand reflects their deluded income expectations. Thus, profits for a predatory lender are $(r - \rho)B(y + \tau, r) - C(\tau) - f$. Optimal $\tau$ is determined by the first-order condition

$$(r - \rho)B_y(y + \tau, r) = C'(\tau),$$

(3)

The predator exaggerates income to the point where the marginal revenue from exaggerating household income (due to increased loan demand) equals the marginal cost of exaggeration.
Note that the incentive to exaggerate income is increasing with the interest spread on loans. In a perfectly competitive loan market spreads are zero so lenders would have no incentive to falsify. Indeed, they could not afford to falsify; the costs of falsification would require higher spreads to compensate, so borrowers would switch to cheaper, honest lenders. Costly predation can occur only if imperfect competition enables predators to charge higher than competitive spreads.

A predatory-monopolist gets to set the loan rate as well. The first-order condition for \( r \) is:

\[
B(y + \tau, r) = -(r - \rho)B_r(y + \tau, r). \tag{4}
\]

The predatory-monopolist raises interest rates until the marginal revenue from higher rates equals the marginal cost in terms of lower loan demand.

The predatory-monopolist does not always charge a higher loan rate than an ordinary monopolist. To see this, express (4) in elasticity terms:

\[
\frac{r - \rho}{r} = - \frac{B(y + \tau, r)}{r} \frac{1}{B_r(y + \tau, r)} = \frac{1}{\varepsilon_r(y + \tau, r)}
\]

where \( \varepsilon_r(y + \tau, r) \) is the elasticity of loan demand with respect to \( r \). Let \( r_{pm} \) and \( r_m \) denote the optimal \( r \) charged by a predatory-monopolist and ordinary monopolist, respectively. Then \( r_{pm} > r_m \) if and only if

\[
\frac{r_{pm} - \rho}{r_{pm}} > \frac{r_m - \rho}{r_m},
\]

or equivalently,

\[
\varepsilon_r(y + \tau, r_{pm}) < \varepsilon_r(y, r_m).
\]

For households with CRRA utility, the elasticity of loan demand with respect to \( r \) does not vary with income, i.e., \( \varepsilon_r(y + \tau, r) = \varepsilon_r(y, r) \).\(^6\) CRRA households with higher income are no less averse to high interest than those with lower income, so when dealing with CRRA households, a predatory-monopolist lends more than an ordinary monopolist but charges the same interest rate.

For other utility functions, exponential for example, the predatory-monopolist lends more and charges higher interest rates than an ordinary monopolist. The exception for CRRA

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\(^6\)If \( U(c) = (c^{1-\gamma} - 1)/(1 - \gamma) \), (1) implies \( B(y, r) = y \cdot b(r) \).
utility is important, nonetheless, as it implies predators are better detected by how much they lend, rather than how much they charge. We use that result later when we test whether payday lending is predatory.

3.1.1 Uncertain Income

When household income is uncertain, predators have another angle: they can exaggerate the probability the household income will be high, thus boosting household loan demand. Uncertain income also means default is possible. If predators accentuate the positive enough, they may push borrowers to the brink of default.

Suppose future income is high \( Y \) or low \( y \) with odds \( \pi \) and \( 1 - \pi \). Expected utility on payday depends on the risk of default, and hence, \( \pi \). It turns out that households with \( \pi \) below some threshold limit their borrowing to avoid that risk. In deriving household’s loan demand below, we impose the no-default constraint that \( B \leq y/(1 + r) \), but then show that the constraint will not bind for households with \( \pi \) below some threshold. Low \( \pi \) households limit their borrowing to avoid owing all their income on when their pay is low. We then show how predators, by exaggerating \( \pi \), can push households to the brink of default.

Household’s choose \( B \) to maximize the Lagrangian function:

\[
U(B) + \delta [\pi U(Y - (1 + r)B) + (1 - \pi)U(y - (1 + r)B)] + \lambda [y/(1 + r) - B],
\]

The FOC for \( B \) is

\[
U'(B) - \delta (1 + r)[\pi U'(Y - (1 + r)B) + (1 - \pi)U'(y - (1 + r)B)] = \lambda. \tag{5}
\]

The no-default constraint is slack \((\lambda = 0)\) if and only if

\[
\pi < \pi \equiv \frac{U'(y/(1 + r)) / \delta (1 + r) - U'(0)}{U'(Y - y) - U'(0)}. \tag{6}
\]
Granting that, household loan demand increases with $\pi$: $B_\pi(Y, y, \pi, r) > 0$. The higher odds of a high paycheck decreases the expected marginal disutility of owing money when pay is low, so households borrow more today.

Suppose predatory lenders can exaggerate $\pi$ by $\tau$ at cost $C(\tau)$. Predators’ exaggeration cannot exceed $\overline{\pi} - \pi$, or else households would borrow to the hilt ($B = y/(1 + r)$) and default would be possible. Default is not necessarily bad for the lender if they raise rates to compensate, but once default is possible, household loan demand decreases with $\pi$. It seems implausible to imagine predators that exaggerate $\pi$ to increase loan demand, then attenuate $\pi$ to increase loan demand even further. "Jerking" borrowers around would surely tip them off.

The predator maximizes the Lagrangian function

$$\nabla \{ (r - \rho)B(Y, y, \pi + \tau, r) - C(\tau) - f + \mu(\overline{\pi} - \pi - \tau) \}. \quad (7)$$

The FOC for $\tau$ is

$$\nabla \{ (r - \rho)B_\tau(Y, y, \pi + \tau, r) - C'(\tau) - \mu \} = 0. \quad (8)$$

Optimal $\tau = \overline{\pi} - \pi$ if and only if the marginal revenue from exaggerating $\pi$ exceeds the marginal cost at that point: $(r - \rho)B_\pi(Y, y, \overline{\pi}, r) > C'(\overline{\pi} - \pi)$. In that case, predators exaggerate $\pi$ until households borrow $y/(1 + r)$, putting them at the brink of default whenever their pay is low. Absent predation, low $\pi$ households would never default. Thus, when household income is uncertain, the overborrowing elicited by predators increases the probability of default. We test that prediction later.

### 3.1.2 Does Risk Deter Predation?

If the probability of default is increasing in the amount households owe (unlike in the model above), lenders incentive to exaggerate income is diminished. Risk may not deter that incentive altogether, however. Suppose household income is distributed $f(y)$, with cumulative distribution $F(y)$. If a household owes $(1 + r)B$, they default with probability $F[(1 + r)B]$. At the margin, the incentive to exaggerate income depends on the hazard rate of default: $f[(1+r)B]/\{1 - F[(1+r)B]\}$. If that hazard rate is sufficiently flat at the household’s optimal
debt level (given the true distribution of income), predators still profit from exaggerating household’s income prospects.

3.1.3 Equity Stripping

If lending is secured by an asset, home equity for example, the incentive to prey increases. Lending another $ to a household with home equity of $E does not increase risk to lenders’ at all, even if the extra unit of borrowing puts household debt service costs beyond current income or cash flow. As the borrower misses a payment, home equity lenders can charge penalties and raise interest rates until the household owes $E - $ where $ represents foreclosure costs. If a predatory lender can con households into borrowing more than their current income affords, predators can eventually strip homeowners’ equity.

3.1.4 Can Credit Counselors Deter Predators?

We have also considered a credit counselor can correct borrowers’ income beliefs, at some cost, and thereby raise borrower welfare by reducing their borrowing to the optimal level. Credit counseling may deter predation, but it does not necessarily eliminate it. Credit counseling may not be profitable because it entails lending smaller amounts at a higher rate (because counseling is costly). Predation can occur in equilibrium if the welfare loss from predation is less than the cost (to a credit counselor) from eliminating the loss.

4 Is Payday Lending Predatory?

Critics condemn payday lending as predatory partly because of the high finance charges. However, the high price of payday credit could reflect high fixed costs per loan, and/or, monopoly power. Nor does a predator-monopolist always charge higher prices than ordinary monopolists. Thus, higher prices are neither necessary or sufficient to conclude that a certain class of credit is predatory.

The other criticism of payday lenders is the frequent rollover of loans. Instead of repaying their loan after two weeks, a substantial fraction of households rollover their loans for many weeks. Those frequent rollovers come closer to our concept of predation ala overborrowing.
If payday lending tempts certain households into over-borrowing, that should be detectable as differences in debt and delinquency rates in states with more liberal payday lending laws.

### 4.1 Empirical Strategy and Data

Using data from the SCF (Survey of Consumer Finance), we compare credit access, debt, and delinquency rates for households in states with more liberal payday laws. We focus on differences for those particular households who, according to our model, are more most vulnerable to manipulation by predatory payday lenders, i.e. "prey." To identify differences that are more likely associated with payday lending, we compare the differences for prey in payday states before and after payday lending arrived on the consumer credit market.

We want to control for a host of other variables that might affect credit supply or demand, so we compute the differences using multi-variate regression analysis. Using SCF data on household $h$ in state $s$, we estimate regressions of the form:

$$D_{hs} = f(PREY_{hs} \cdot \text{PAYDAY LIMIT}_s \cdot 2001, \text{CONTROLS}_{hs}) + \epsilon_{hs}. 
\quad (9)$$

$D$ equals one of three dependent variables: DENIED, DEBT$_{NM}$, and DELINQUENT. DENIED equals one for households who reported being denied credit over the year before the survey (0 for other households).\textsuperscript{7} DEBT$_{NM}$ equals non-mortgage debt owed by households. DELINQUENT equals one of households that reported missing any debt payments over the year before the survey (zero for other households).

DENIED and DELINQUENT are discrete variables so we estimate those regressions \textit{via} Probit. DEBT$_{NM}$, though continuous, is truncated zero, so that regression is estimated \textit{via} Tobit.

The key independent variables are the interactions: $PREY_{hs} \cdot \text{PAYDAY LIMIT}_s \cdot 2001$ $PREY_{hs}$ is one of three indicators of potential marks for predators, discussed momentarily. PAYDAY LIMIT$_s$ equals the limit on payday loans in state $s$. We include another dummy, UNLIMITED, equal to one for states that allow unlimited payday loans (zero for

\textsuperscript{7}More precisely, DENIED = 1 for households reporting that they were turned down for credit previous year, given less credit than they demanded, or did not apply for credit because they expected to be denied. DENIED = 0 otherwise.
other states). The dummy variable 2001 equals one for households surveyed in 2001 or zero
for households surveyed in 1995. Thus, the coefficients on \( PREY_{hs} \cdot PAYDAY\ LIMIT_s \cdot 2001 \)
indicate whether any difference in dependent variable \( D \) for prey in states with higher payday

\( PREY_{hs} \) is one of three indicators of potential marks, i.e., households must vulnerable
to predatory lending. \( UNCERTAIN\ INCOME \) equals one for households who reported being
uncertain about their future income (0 for other households). \( NO\ COLLEGE\ DEGREE \)
equals one for households without a college degree (0 for households with a degree). Less
educated households and households with uncertain income may be easier to fool, so those
two prey proxies follow more or less from our model.

Our third proxy is more \textit{ad hoc}. \( SMOKER \) equals one if the head of the household
reported being a smoker (0 if not). If smoking implies hyperbolic discounting, then smokers
may be vulnerable to predatory lending. However, if smoking implies high, but not hyper-
bolic discounting, then payday lenders cannot prey on smokers, even though they may help
smokers satisfy their high demand for credit.

\textit{CONTROLs} is a long list of financial variables (income, squared, assets), demographic
variables (age, marital status, family size, race, gender, urban, job tenure), economic vari-
ables (county unemployment), attitudinal variables (”thinks credit is a bad idea”) bank
concentration (local market bank herfindahl), bank regulatory history (years since branch-
ing and interstate banking were permitted), and lastly, household bankruptcy exemptions.
Our control set is essentially as in Gropp et al. (1997) except we use bankruptcy exemptions
as of 1999 from Lehnert and Maki’s (2002).

\footnote{Caskey (2002) figures there were fewer than 200 payday lenders at the at the begin-
ing of the 1990s. Rotunday, the CEO of EZ Corp (a pawnbroker) did not notice competition from payday lenders until the late 1990s (see above). Based on those observations, we compare household debt and delinquency from the SCF in 1995 (”before payday lending”) and 2001 (”after payday lending”).}

\footnote{In econometric terms, we are conducting difference-in-difference-in-difference analyses. First we estimate differences in dependent variable \( D \) for households that are potential prey, \( dD \). Then we estimate the difference in \( dD \) for prey living in states that allow higher payday loans, \( ddD \). That second difference might be significant all the time, just by coincidence, so we estimate the difference in \( ddD \) between 1995 and 2001, \( dddD \). That third difference indicates whether differences in \( dD \) for prey changed after Payday lending arrived on the market.}
Table 2 reports provides summary statistics for all the regression variables.\footnote{The SCF in 1995 and 2001 covered 2,780 and 2,917 households, or 5,697 households in total. We study the area-probability sample that excludes the ”list sample” of wealthy households (as wealthy households seem less subject to predatory lending). Household’s state of residence are not publically available, so all our statistics and regressions were calculated by authorized analysts in the SCF Group at the Federal Reserve Board of Governors. Note that this confidential dataset contains 4,449 households whereas the public version only includes 4,442 households. This is due to the exclusion of 7 extremely wealthy households from the public dataset for disclosure reasons. The SCF actually comprises 5 separate datasets or “implicates” wherein missing data are multiply imputed. All our estimates and standard errors are computed using the Repeat Imputation Inference (RII) techniques. See Montalto and Sung (1996) for an accessible introduction to RII.} Twenty-one percent of households were denied credit in the year before the survey. Sixteen percent of households missed a payment. Mean debt (non-mortgage) was $11,500, but median debt was only $2300.\footnote{We also ran our regressions for low (below median) income. Non-mortgage debt for that sample averaged $6700, so a $300 difference associated with payday lending might be detectable. We did not find any such difference, however. The SCF does not ask households about payday loans specifically. We experimented with debt from “finance and loan companies,” a category that should comprise payday lenders, but because the subset of households with debt from such institutions was so small, the Tobit estimates did not converge.} Note the prevalence of potential prey: 68 percent of households lacked a college degree, 31 percent were uncertain about their income, and 29 percent smoked. Fifty-six percent of households lived in states with payday lending, but just three percent of households lived in states with unlimited payday loans.

4.1.1 Identification

Our strategy is to compare debt and delinquency for certain subsets of households that \textit{a priori} seem more susceptible to predation. But what if Payday lending represents an increase in the supply of credit? How can we distinguish predatory, i.e., artificial, increases in loan demand from legitimate increases in loan supply?

Our key identifying assumption is that if indeed Payday lenders increase credit supply, they increase supply to all households, not just potential prey (see Appendix). That is not a strong assumption. It merely means payday lenders do not discriminate one way or another against \textit{non-prey}. Granting that, we can identify any excess debt or delinquency among
prey as evidence that payday lenders artificially boost credit demand.

4.2 Regression Results (Table 3)

Column 1 reports \textit{dprobit} (DENIED) regression coefficients. \textit{Dprobit} calculates the change in probability (DENIED = 1) as the indicator variables switch on or off. Risky households (with uncertain income) and less educated households (without a college degree were) surveyed in 1995 were 5.4 percent and 6.6 percent more likely to have been denied credit than their safer, more educated counterparts. Given all the other controls, those differences suggest that riskier, less educated households were more credit constrained in 1995. Those constraints were certainly no looser in states that would (eventually) allow unlimited payday loans. On the contrary, risky households in unlimited payday loan states surveyed in 1995 were more likely to be denied credit than their counterparts in other states. By 2001, however, risky households and less educated households living in states with unlimited payday loans were 14.1 percent and 15.0 percent \textit{less} likely to have been denied credit. That pattern of differences and the change over time suggests that payday lending, at least in unlimited quantities, has increased credit access for riskier, less educated households.

Roughly the same differences and changes over time are apparent for smokers. Smokers surveyed in 1995 were 4.3 percent more likely to be turned down for credit, regardless of their state. Smokers surveyed in 2001 were significantly less likely to be turned down, the higher the limit on payday loans in their state. A one standard deviation increase in the PAYDAY LIMIT ($234) reduces the probability (DENIED) by 6.3 percent.

Column 2 reports \textit{Tobit} (DEBT_NM) regression coefficients. Less educated households in states unlimited payday loan states were were surveyed in 2001 had higher debt than their counterparts in states with limited payday loans. That difference, though only marginally significant, is consistent with the predatory hypothesis.

Column 3 reports \textit{dprobit} (DELINQUENT) regression coefficients. In general, delinquency rates were not higher for \textit{prey} surveyed in 2001, even those living in states with higher or unlimited payday limits. On the contrary, risky households (with uncertain income) surveyed in 2001 were nine percent \textit{less} likely to have missed a payment if their state
allowed unlimited payday loans.  

In sum, our findings suggest that riskier, less educated households, and smokers, were less likely to be turned down for credit if their state allowed unlimited or larger payday loans. That might indicate that payday lenders relax credit constraints, or, that the limits on payday loans do in fact bind. Debt is significantly higher for households with uncertain income in payday states in 200. That difference, though only marginally significant, seems consistent with the predatory hypothesis. However, higher payday loan limits are not associated with higher delinquency rates for less educated households, riskier households, or smokers. If anything, we find the opposite: risky households surveyed in 2001 in states with unlimited payday loans were marginally less likely to have missed a debt payment.

5 Does Competition Work in Payday Lending?

The main complaint against payday lenders are their high fees. The 390 percent annual rate implied by a $15 fee per $100 per two week loan strikes critics as usurious or unconscionable, hence the many states with usury limits on payday loan prices. Economists might expect competition among payday lenders and pawnshops to drive prices down to the level that just covered the costs of producing the loans. This section presents evidence consistent with the hypothesis that competition works; using a small data set of ”found” data, we find lower payday prices in cities with more payday lenders and pawnshops per capita.

The data on payday loan prices are from 2001 survey conducted by the U.S. Public Interest Research Group (PIRG) and the Consumer Federation of American of 235 payday lenders located in 62 cities and twenty states (and D.C.). In their analysis of the data,  

Regressions estimated over the set of households with low (below median) income yielded qualitatively similar differences (same signs and magnitudes) to those noted in Table 3 and 4, though in some cases the differences were less significant, particularly the differences associated with unlimited payday loans. The fraction of households live in states with unlimited payday loans was small, and the fraction of low income households in those states was even smaller, so the loss of significance mostly reflects higher standard errors in the estimates, not smaller coefficients.

Payday loans are very small so it is not necessarily inconsistent to find looser credit constraints in payday states without finding higher debt.

Most surveys were conducted by employee or volunteer visits to payday offices, although some were
Fox and Mierzwinski (2001, p. 14) observed that about half the lenders charged fees at or above the usury limit set by the states. “If competition were really working..., ” they conclude, ”we would expect many more firms to offer and advertise lower rates.” The PIRG survey lacked a measure of competition, however, so they did not test their conclusion that competition fails in payday lending.

Our data on the number of payday stores in various cities are from Graves and Peterson (2005). Their study pinpoints the location of payday stores by zip code in twenty states with military bases to see if payday lenders ”target” soldiers. They demonstrate conclusively that payday lenders do cluster around bases; for example, the 92054 zip code comprising Camp Pendelton had 22 payday outlets, 17 more than expected given the population in that zip.

To see if competition works in the payday credit market, we matched Graves and Petersons’ (2005) data on the number of payday lenders with PIRGs’ (2001) data on payday loan prices and fees. The number of cities that overlapped in the two studies was 37 (Table 4A).15

These ”found” data are biased against the competition hypothesis for at least two reasons. First, the number of payday stores tabulated by Graves and Peterson (2005) will overstate competition if some stores have the same owner. Second, more stores per capita might also signal higher demand for payday loans (and hence, higher prices) rather than higher supply.16

The regressions in Table 4B (and Figure 3) indicate that payday prices decline as the number of payday stores per capita increases. An extra 50 payday stores/10000 (about conducted by phone. The surveyors did not borrow from the payday lenders; they simply looked for signs posting fees or asked store clerks to quote fees.

15PIRG’s (2001) survey covered multiple payday lenders per city. We use the average loan rate and fee for payday lenders in the same city. We obtain similar results using medians instead of means.

16That second bias is distinctly possible here, because Graves and Petersons’ (2004) study covered states with military bases, and soldiers may have high demand for payday loans. A third possible source of bias: payday prices are from 2001, but the numbers on stores are from 2004-5. Stores in 2004 should be correlated stores in 2001, but the cities where payday stores grew fastest in the interim may be those with the highest prices in 2001 (hence inviting new entry).
one standard deviation) is associated with a $0.50 drop in the loan price (column 1).\footnote{Without the extreme (fee = $30) observation, the coefficient on Payday lenders/100,000 equals .0074. (p = 0.091).}

Payday store prices also decline as the number of pawnshops per capita increases (column 2), consistent with other evidence that payday lenders pawnshops are in competition. In fact, we cannot reject the hypothesis that the more pawnshops per capita has the same effect on payday prices and more payday stores.

\section{Conclusion}

"Predatory" is an inflammatory term used to condemn high prices, excessive lending, and other allegedly dubious practices by payday lenders and subprime mortgage lenders. However, even reformers admit that "predatory" is hard to define, so that is where our paper starts. We define predatory lending as a welfare reducing provision of credit, and we show how a voluntary transaction can make borrowers worse off if lenders contrive to increase loan demand by exaggerating households’ income prospects. Predation in our model resembles advertising; advertisers accentuate how much pleasure their product brings, while predators attenuate how much a loan will cost (in terms of future well-being). We show that lenders will prey as long as the extra revenue from larger loans exceeds the cost of fooling households into overborrowing and any associated increase in default risk.

Our concept of predatory lending may not correspond to the specific practices of payday lenders and subprime mortgage lenders that reformers condemn, but it comes close. Both lenders are accused of entrapping borrowers in a cycle of refinancings and delinquency by lending more than households can afford. The predators in our model lend excessively, and the extra debt leads to higher risk of delinquency. Reformers also condemn payday lenders for "targeting vulnerable consumers" (PIRG 2001) that are less sophisticated. The predators in our model naturally prey on households that are easier to fool.

Our model helps distinguish predatory lending from the other kind of lending, the kind that helps households maintain consumption even as their income fluctuates. While reformers tend to focus on the interest rates charged by alleged predators, our model shows that
predators do not always charge more than ordinary lenders. Predators always lend more, however, and the extra debt may push borrowers to the brink of default. If payday lenders were exploiting gullible households, we would expect to find higher debt and delinquency rates among easier-to-fool-households (prey) in states with higher payday loan limits. While we do find higher debt for one such set of households, we do not find higher delinquency. On the contrary, delinquency rates were marginally lower for risky households in states with unlimited payday loans. Risky households and less educated households were also less likely to report being turned down for credit if their state allowed unlimited payday loans.

Those findings of lower delinquency and looser credit constraints applies for only to the very small subset of households in are sample, but they are still tantalizing; despite its high cost, perhaps payday loans help risky households better manage their finances? It will take more data to confirm that particular conjecture, however. In general, we caution that our data are very indirect since we cannot specifically identify households who borrowed from a payday lender.

The differences we find for smokers are interesting, but harder to interpret in terms of predatory lending. Smokers in states with higher payday limits are less likely to be turned down for credit. The looser credit constraints could mean that smokers have high loan demand (because they have discount rates) and that payday lenders help satisfy that urge, or it could mean that smokers have hyperbolic discount rates (that make them procrastinators) and that payday lenders exploit that (we do not find higher delinquency rates for smokers in payday states, however). We cannot distinguish those interpretations without further tests.\textsuperscript{18}

While reformers often advocate usury limits on payday lending, we find some evidence that competition among payday lenders (and pawnshops) may obviate usury limits. Using a small set of data, we find that payday loan rates and fees decline significantly as the number of payday lenders and pawnshops increase. Despite their alleged naiveté, payday borrowers appear sophisticated enough to shop for lower prices. The problem of high prices may reflect too few payday lenders, rather than too many. If scrutiny and prosecution risk

\textsuperscript{18}Smoking might also simply be a better way to identify the socioeconomic class that borrows from payday lenders.
limit entry into payday lending, the lack of competition may drive rates higher. In the end, the simple fact that payday lenders have triumphed over pawnshops suggests that payday lending raises household welfare by providing a preferable alternative.\textsuperscript{19}

\textsuperscript{19}The extra (or more convenient) credit can be welfare reducing only for households with behavioral problems that make them borrow too much to begin with.
References


6.1 Appendix: Identification Algebra

Suppose loan demand and supply for household $h$ in state $s$ equals

$$B^d_{hs} = -ar_{hs} + bP_s + cP_{hs} + \tau P_s p_{hs} + z_{hs}$$ \hspace{1cm} (10)$$

$$B^s_{hs} = +dr_{hs} + eP_s + fP_{hs} + \tau' P_s p_{hs} + \eta_{hs};$$ \hspace{1cm} (11)$$

where $P_s$ equals one if state $s$ allow payday lending and $p_{hs}$ equals one if household $h$ in state $j$ is potential prey, e.g., a household with uncertain income. The coefficients $a$ and $d$ measure the interest sensitivity of loan demand and supply, respectively. We assume $a \geq 0$ and $d \geq 0$. The coefficients $c$ and $f$ allows for any inherent and legitimate differences in loan demand and supply for prey. The coefficients $b$ and $e$ allows for any general, legitimate differences in loan demand and supply in states with payday lending. We make no assumption about $c, f, b,$ and $e$.

The equilibrium quantity of debt for household $h$ in state $s$ equals

$$B_{hs} = \frac{(db - ae)P_{hs} + (dc - af)p_{hs} + (d\tau - a\tau')P_s p_{hs} + d\eta_{hs} - a\eta_{hs}}{d - a}.$$ \hspace{1cm} (12)$$

The difference in debt for prey in payday states for prey equals

$$\frac{\delta^2 B_{hs}}{\delta P_s \delta p_{hs}} = \frac{d\tau + a\tau'}{d + a}.$$ \hspace{1cm} (13)$$

The predatory hypothesis implies $\tau > 0$. We can identify whether $\tau > 0$ by comparing debt levels for prey across payday and non-payday states as long as $\tau' = 0$, i.e., as long as payday lenders are equally willing to supply credit to prey and non-prey alike.
Figure 1
Growing Predatory Concerns

Number of articles containing "predatory" in American Banker, 1994-2004 (quarterly)
Figure 2
Payday share prices (AACE) have risen. Pawnshops (EXPW) have fallen.
Figure 3

Interest rate

Supply

Supply

Demand

Fixed cost (high)

Fixed cost (low)

Borrowing
Figure 4
More Payday Stores—Lower Payday Prices

Regression: Fee/$100 = 17.5 - 0.011 \times \text{Payday/100,000}
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**Table 3 Differences in Denial, Debt, and Delinquency in States with Higher Payday Limits**

Reported are regression coefficients (robust standard errors). DENIED = 1 for households who were denied credit in year before survey (0 otherwise). DEBT_NM equals household’s non-mortgage debt. DELINQUENCY = 1 if households reported missing debt payment in previous year. PAYDAY LIMIT = state limit on payday loans (0 to $1250). UNLIMITED = 1 for the nine states without limits, 0 otherwise states. 2001 = 1 for households surveyed in 2001 (0 for households surveyed in 1995). Regressions estimated over 5697 households in 1995 and 2001 SCF.

<table>
<thead>
<tr>
<th>Dependent Variable (model)</th>
<th>DENIED (DProbit)</th>
<th>DEBT_NM (Tobit)</th>
<th>DELINQUENT (DProbit)</th>
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<tr>
<td>Payday Limit X Uncertain X 2001</td>
<td>-6.84E-06 (9.18E-05)</td>
<td>2.33E-04 (9.42E-04)</td>
<td>-8.39E-05 (9.16E-05)</td>
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<td>Unlimited X Uncertain X 2001</td>
<td>-0.141*** (0.029)</td>
<td>-0.241 (1.200)</td>
<td>-0.090* (0.052)</td>
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<td>0.001 (0.001)</td>
<td>3.61E-05 (8.93E-05)</td>
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<tr>
<td>Unlimited X No College X 2001</td>
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<td>2.722* (1.479)</td>
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<td>Payday Loan Limit</td>
<td>2.17E-05 (6.29E-05)</td>
<td>9.72E-04 (6.82E-04)</td>
<td>1.67E-05 (5.34E-05)</td>
</tr>
<tr>
<td>Unlimited Payday Loans?</td>
<td>-0.125*** (0.039)</td>
<td>0.039 (0.801)</td>
<td>0.001 (0.069)</td>
</tr>
<tr>
<td>Uncertain Income?</td>
<td>0.054** (0.024)</td>
<td>-0.081 (0.203)</td>
<td>-9.61E-04 (0.023)</td>
</tr>
<tr>
<td>No College Degree?</td>
<td>0.065*** (0.022)</td>
<td>-0.151 (0.247)</td>
<td>0.009 (0.021)</td>
</tr>
<tr>
<td>Smoker?</td>
<td>0.043* (0.023)</td>
<td>-0.400** (0.189)</td>
<td>0.034 (0.024)</td>
</tr>
<tr>
<td>2001 Dummy</td>
<td>-0.007 (0.037)</td>
<td>-0.168 (0.410)</td>
<td>-0.072** (0.033)</td>
</tr>
<tr>
<td>Payday Limit X 2001</td>
<td>4.29E-05 (8.67E-05)</td>
<td>-5.84E-04 (0.001)</td>
<td>7.46E-05 (7.32E-05)</td>
</tr>
<tr>
<td>Unlimited Payday X 2001</td>
<td>0.404* (0.208)</td>
<td>-1.689 (1.270)</td>
<td>0.049 (0.124)</td>
</tr>
<tr>
<td>Uncertain X 2001</td>
<td>-0.012 (0.030)</td>
<td>-0.308 (0.312)</td>
<td>0.044 (0.035)</td>
</tr>
<tr>
<td>No College X 2001</td>
<td>0.003 (0.034)</td>
<td>-0.373 (0.441)</td>
<td>0.024 (0.032)</td>
</tr>
<tr>
<td>Smoker X 2001</td>
<td>0.035 (0.034)</td>
<td>0.442 (0.269)</td>
<td>0.033 (0.033)</td>
</tr>
<tr>
<td>Payday Limit X Uncertain</td>
<td>8.02E-06 (6.50E-05)</td>
<td>-9.56E-05 (6.96E-04)</td>
<td>2.95E-05 (6.68E-05)</td>
</tr>
</tbody>
</table>

Table 3 continues . . .
Table 3 (continued)

<table>
<thead>
<tr>
<th>Term</th>
<th>Coefficient</th>
<th>Standard Error</th>
<th>t-statistic</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unlimited Payday X Uncertain</td>
<td>0.308**</td>
<td>0.137</td>
<td>-2.267</td>
<td>0.023</td>
</tr>
<tr>
<td>Payday Limit X No College</td>
<td>-0.635</td>
<td>0.137</td>
<td>-4.675</td>
<td>0.000</td>
</tr>
<tr>
<td>Unlimited Payday X No College</td>
<td>0.081</td>
<td>0.124</td>
<td>0.654</td>
<td>0.511</td>
</tr>
<tr>
<td>Payday Limit X Smoker</td>
<td>0.828</td>
<td>0.124</td>
<td>6.744</td>
<td>0.000</td>
</tr>
<tr>
<td>Age (years)</td>
<td>0.002</td>
<td>0.002</td>
<td>1.072</td>
<td>0.286</td>
</tr>
<tr>
<td>Age Squared</td>
<td>0.000***</td>
<td>0.000</td>
<td>10.758</td>
<td>0.000</td>
</tr>
<tr>
<td>Income</td>
<td>-0.011***</td>
<td>0.003</td>
<td>-6.775</td>
<td>0.000</td>
</tr>
<tr>
<td>Income Squared</td>
<td>0.000***</td>
<td>0.000</td>
<td>6.954</td>
<td>0.000</td>
</tr>
<tr>
<td>Assets</td>
<td>0.006</td>
<td>0.005</td>
<td>2.015</td>
<td>0.044</td>
</tr>
<tr>
<td>Married?</td>
<td>-0.027</td>
<td>0.018</td>
<td>-1.594</td>
<td>0.113</td>
</tr>
<tr>
<td>Family Size</td>
<td>0.017***</td>
<td>0.004</td>
<td>10.877</td>
<td>0.000</td>
</tr>
<tr>
<td>Non-White?</td>
<td>0.090***</td>
<td>0.014</td>
<td>7.767</td>
<td>0.000</td>
</tr>
<tr>
<td>Male?</td>
<td>-0.024</td>
<td>0.016</td>
<td>-1.289</td>
<td>0.200</td>
</tr>
<tr>
<td>Rural?</td>
<td>-0.029**</td>
<td>0.013</td>
<td>-2.791</td>
<td>0.006</td>
</tr>
<tr>
<td>Years at Current Employer</td>
<td>-0.003***</td>
<td>0.001</td>
<td>-10.645</td>
<td>0.000</td>
</tr>
<tr>
<td>Thinks Credit Is Bad Idea?</td>
<td>-0.003</td>
<td>0.011</td>
<td>-1.192</td>
<td>0.239</td>
</tr>
<tr>
<td>County Unemployment Rate</td>
<td>0.003</td>
<td>0.003</td>
<td>2.381</td>
<td>0.018</td>
</tr>
<tr>
<td>Years Instate Branching Permitted</td>
<td>0.002**</td>
<td>(7.22E-04)</td>
<td>3.497</td>
<td>0.001</td>
</tr>
<tr>
<td>Years Interstate Branching Permitted</td>
<td>-9.59E-04</td>
<td>(6.95E-05)</td>
<td>-1.359</td>
<td>0.176</td>
</tr>
<tr>
<td>Local Market Herfindahl</td>
<td>0.000</td>
<td>0.001</td>
<td>0.010</td>
<td>0.990</td>
</tr>
<tr>
<td>Bankruptcy Exemption</td>
<td>0.000</td>
<td>0.000</td>
<td>1.791</td>
<td>0.074</td>
</tr>
<tr>
<td>Bankruptcy Exemption X Assets</td>
<td>0.000</td>
<td>0.001</td>
<td>1.791</td>
<td>0.074</td>
</tr>
</tbody>
</table>
**Table 4A  Statistics on Payday Loan Prices and Stores across 37 U.S. Cities**

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>Median</th>
<th>Std. Dev.</th>
<th>Min</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price (per $100 borrowed)(^1)</td>
<td>17.1</td>
<td>16.8</td>
<td>2.6</td>
<td>14.6</td>
<td>30.0</td>
</tr>
<tr>
<td>Payday Stores (per 100K)(^2)</td>
<td>43.6</td>
<td>17.7</td>
<td>52.1</td>
<td>3.2</td>
<td>169.4</td>
</tr>
<tr>
<td>Pawnshops (per 100k)(^3)</td>
<td>30.0</td>
<td>12.0</td>
<td>47.1</td>
<td>1.0</td>
<td>240.3</td>
</tr>
<tr>
<td>Population</td>
<td>31.2</td>
<td>10.2</td>
<td>64.2</td>
<td>.21</td>
<td>3,695</td>
</tr>
</tbody>
</table>

\(^4\) Overlapping cities in Fox and Mierzwinski (2001) and Graves and Peterson (2005).

**Table 4B  More Payday Stores…Lower Payday Prices?**

Ordinary least squares coefficient estimates (robust standard errors). Dep. Var. = Price per $100

<table>
<thead>
<tr>
<th></th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payday Stores</td>
<td>0.013**</td>
<td>-</td>
<td>-0.009</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>(0.005)</td>
<td>(0.007)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pawnshops</td>
<td>-</td>
<td>-0.013**</td>
<td>-0.006</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.006)</td>
<td>(0.006)</td>
<td></td>
</tr>
<tr>
<td>Payday Stores + Pawnshops</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-0.008**</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(0.003)</td>
</tr>
<tr>
<td>Population</td>
<td>-0.007**</td>
<td>-0.006**</td>
<td>-0.007**</td>
<td>-0.007**</td>
</tr>
<tr>
<td></td>
<td>(0.003)</td>
<td>(0.003)</td>
<td>(0.003)</td>
<td>(0.003)</td>
</tr>
<tr>
<td>Constant</td>
<td>17.86***</td>
<td>17.66***</td>
<td>17.66***</td>
<td>17.83***</td>
</tr>
<tr>
<td></td>
<td>(0.710)</td>
<td>(0.648)</td>
<td>(0.714)</td>
<td>(0.703)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>R²</th>
<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>0.069</td>
<td>0.059</td>
<td>0.073</td>
<td>0.073</td>
</tr>
</tbody>
</table>

\(P\) value for F-Test:

(Payday Store = Pawnshop)

*** Significant at the 99% level  ** Significant at the 95% level
CRE Memorandum of Law on
Types of Consumer Credit Covered by the Recent Law
Containing Limitations on Consumer Credit Extended to Members
of the Military or Their Dependents
MEMORANDUM OF LAW

SUBJECT: Applicability to all forms of consumer credit, including credit cards and installment loans, of the new legislative limitations on consumer credit extended to members of the armed forces or their dependents

The issue to be addressed is whether this new statute clearly covers "consumer credit" extended via all means, including credit cards and installment loans, other than those means expressly excluded, or whether, because the statute is ambiguous on what is covered, the Secretary of Defense has discretion to interpret, through the implementing regulations authorized by the statute, the term "consumer credit" to exclude certain types of credit mechanisms, including consumer credit extended through credit cards and installment loans, and related interest and fees.

The Plain Language of the Statute

General Principles

We start, as always, with the plain language of the statute. The full text is in Attachment I. If the statute is clear as to what is covered, there is no resort to legislative history or any other extrinsic aids to statutory interpretation. Circuit City Stores, Inc. v. Adams, 532 U.S. 105, 119, 121 S.Ct.1302, 1311 (2001); Ratzlaf v. United States, 510 U.S. 135, 147, 114 S.Ct. 655, 662 (1994); CBS, Inc. v. Primetime 24 Joint Venture, 245 F.3d 1217, 1222 (11th Cir. 2001).

A related principle was established in Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 104 S.Ct. 2778 (1984). Chevron set up a two-part process for statutory interpretation in cases in which agency discretion to interpret the statute is at issue. The first step is to examine the express statutory language. If Congress "has directly spoken to the precise question at issue . . . that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." Id. at 842-43. Under step one, "[i]f a court, employing traditional tools of statutory construction, ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect." Id. at 843 n. 9. If the court determines that the statute is ambiguous, and Congress has explicitly or impliedly left it to the agency to fill the "gap" and clarify the ambiguity, step two is to ask whether the agency interpretation is a permissible construction -- i.e., a reasonable construction even if not the one the court or someone else would determine to be the most reasonable construction. Id. at 843. A court does not address step two unless it finds an ambiguity or gap under step one. State of New York v. U.S. Envtl. Prot. Agency, 443 F.3d 880, 884 (D.C. Cir. 2006).

At this time, although there is no agency interpretation yet at issue, it is appropriate to examine the statutory language, including the overall statutory context, to determine whether the Secretary of Defense has discretion to adopt an interpretation that excludes from coverage of the statute credit cards, installment loans, or other consumer credit instruments -- in other words, whether it is possible to even move from step one of *Chevron* to step two in view of the plain language of the statute.

**Key Language and Provisions**

The legislation (hereafter referred to as "section 670" or "the statute") covers terms of "consumer credit" extended to the military or dependents by a "creditor". Subsection (c), on mandatory disclosures, states that it applies to "any extension of consumer credit (including any consumer credit originated or extended through the internet)" (emphasis added). Subsection (e) makes it unlawful for "any creditor" (emphasis added) to impose certain terms. Subsection (h), directing the Secretary of Defense to prescribe implementing regulations, requires that the regulations establish the disclosures required of "any creditor" (emphasis added) "consistent with the provisions of this section." Subsection (i)(5) provides a definition of "creditor" (as one "in the business" of providing consumer credit), and allows the Secretary to establish additional criteria for the definition of "creditor" in the regulations authorized by subsection (h).

Subsection (i)(6) provides a definition of "consumer credit" that specifies two exceptions -- a residential mortgage and a loan used to procure a car or other personal property, with the loan secured by the property -- and otherwise provides that the term will have the meaning provided in the regulations issued by the Secretary. Other than in these two exceptions, and the reference to consumer credit originated or extended through the internet, there is no mention of any specific forms of "consumer credit", such as credit cards, installment loans, or payday advances.

Under subsection (h), the Secretary is directed to define "creditor" and "consumer credit", and to provide "[s]uch other criteria or limitations as . . . [he] determines appropriate"; however, those definitions and criteria or limitations must be "consistent with the provisions of this section [i.e., section 670]."

The use of the term "any" with regard to "consumer credit" and "creditor", and the specification of two exceptions to the meaning of "consumer credit", together with the absence of any other reference to particular forms of credit, are of particular significance under federal caselaw finding that statutory language had a plain meaning. There is considerable and consistent caselaw addressing whether Congress' use of the term "any" means any and all, without exception. There is also considerable caselaw on the statutory construction maxim of "*inclusio unius est exclusio alterius*" (to include one is to exclude the other) that is consistent with regard to specified exceptions that must be considered in light of the two specified exceptions to the definition of "consumer credit".

**The Importance of the Term "Any"**

The federal courts, including the Supreme Court, have held that use of the term "any" clearly indicates an unambiguous Congressional intent to be all-inclusive, absent specific
limitations elsewhere in the statute or unless such a reading would result in absurd, farfetched, or anomalous outcomes or violate commonsense presumptions. Congress is presumed to be aware of this body of caselaw when it drafts legislation.

A leading case is *United States v. Gonzales*, 520 U.S. 1, 117 S.Ct. 1032 (1997), in which the Supreme Court held that the term "any" in "any other term of imprisonment" (in a criminal sentencing statutory provision) had an "expansive" meaning in covering both State as well as federal prison sentences. The Court concluded that because Congress did not add any language limiting the term "any", it must read "any" as "all". *Accord, United States v. Monsanto*, 491 U.S. 600, 606-09, 109 S.Ct. 2657, 2661-63 (1989) (statutory language providing for forfeiture of "any property" was plainly all-inclusive, especially when read with other statutory language); *State of New York v. U.S. Envtl. Prot. Agency*, 443 F3d. 880, 884-90, and cases cited therein (D.C. Cir. 2006) (in the absence of Congressional intent to the contrary, "any" physical change pertaining to Clean Air Act new source review must be read as all-inclusive, and to avoid a literal interpretation at *Chevron* step one, it must be shown that as a matter of historical fact, logic, or statutory structure, Congress did not mean what it said when it used the term "any"); *CBS, Inc. v. Primetime 24 Joint Venture*, 245 F.3d 1217, 1222-26 (11th Cir. 2001) (the term "any" means "all" and is not ambiguous, and in the absence of limiting language no resort to legislative history is justified); *United States v. Wildes*, 120 F.3d 468, 469-71 (4th Cir. 1997) (the term "any" is expansive and unambiguous unless a literal reading would produce a result demonstrably at odds with the intent of the drafters or would produce absurd or futile results). *And see Norfolk Southern Ry. Co. v. Kirby*, 543 U.S. 14, 31-32, 125 S.Ct. 385, 397 (2004) (interpretation of "any" in maritime contract clause under federal law as all-inclusive).

An expansive reading of "any" does not apply if other provisions of the statute, or its overall context, show clearly that the expansive meaning was not intended. *United States v. Alvarez-Sanchez*, 511 U.S. 350, 357-58, 114 S.Ct. 1599, 1603-04 (1994) (statutory provision applying to delay in federal arraignment of a person in the custody of "any" law enforcement officer or agency did not include time in the custody of non-federal officers or agencies when the rest of the statute was considered because there could be no "duty" to arraign federally until there was an arrest for a federal offense); *Small v. United States*, 544 U.S. 385, 388-89, 125 S.Ct. 1752, 1754-55 (2005) (although "any" usually demands a broad interpretation, such an interpretation is not appropriate when it would violate commonsense presumptions, and "convicted in any court" did not mean convicted in a court outside the U.S. because it is presumed that when Congress legislates it legislates with domestic concerns in mind and not with extraterritorial application); *Nixon v. Missouri Municipal League*, 541 U.S. 125, 132-41, 124 S.Ct. 1555, 1561-66 (2004) (reading a prohibition applying to telecommunications service provided by "any entity" to preempt state law would be "farfetched" in view of the Constitutional sensitivity of the issue in the absence of some unmistakably clear indication that Congress intended such a result).

In other words, use of the term "any" indicates Congressional intent for an all-inclusive and unambiguous coverage under *Chevron* step one unless there is some very clear indication of Congressional intent to the contrary that is apparent from the statute itself or logic or precedent.

Not only is there no indication in all of section 670 or logic or precedent that the term "any" modifying "extension of consumer credit" or "creditor" should not be given its ordinary
expansive meaning, thereby keeping the analysis within step one of Chevron (plain meaning), but other portions of the statute reinforce the expansive reading.

The Importance of the Specified Exceptions to "Consumer Credit"

The statutory definition of "consumer credit" in subsection (i)(6) states that it specifically does not include, and regulations otherwise defining it cannot include, "(A) a residential mortgage, or (B) a loan procured in the course of purchasing a car or other personal property, when that loan is offered for the express purpose of financing the purchase and is secured by the car or personal property procured." These specific exclusions clearly bring into play the long-standing statutory construction maxim (or canon) of "inclusio unius est exclusio alterius." The literal translation of this Latin is "to include one is to exclude the other." In other words, if Congress has specifically included one thing in a statute, it is inferred that it decided to exclude (or not to include) another (related) thing.

This maxim has been invoked and addressed in thousands of federal cases, sometimes being found applicable and sometimes not. However, that it has sometimes been found inapplicable does not mean that it has lost validity, and the courts have often taken pains to clarify its correct application. In particular, the U.S. Supreme Court has clarified the maxim in recent cases. Those cases caution that the maxim usually only has correct application when Congress has specified more than one in a series of related things, thereby giving rise to the commonsense inference and conclusion that Congress gave careful consideration to what should be included and excluded, and then set out the specific inclusions or exclusions. The most recent Supreme Court explanation of the maxim and its previous cases was in *Barnhart v. Peabody Coal Co.*, 537 U.S. 149, 168-69, 123 S.Ct. 748, 760 (2003):

We do not read the enumeration of one case to exclude another unless it is fair to suppose that Congress considered the unnamed possibility and meant to say no to it. . . . As we have held repeatedly, the canon *expressio unius est exclusio alterius* does not apply to every statutory listing or grouping; it has force only when the items expressed are members of an "associated group or series," justifying the inference that items not mentioned were excluded by deliberate choice, not inadvertence. [Citations omitted]

The stated exceptions to the statutory definition of "consumer credit" in subsection (i) clearly come within this Supreme Court guidance. Residential mortgages and loans secured by the purchased personal property are stated as explicit exceptions to "consumer credit", so Congress clearly considered what to exclude, and did not exclude anything else, such as unsecured installment loans or credit card transactions. And the two specified exceptions are clearly members of an "associated group or series", justifying an inference that Congress deliberately chose what to exclude. Moreover, the specific inclusion of "any consumer credit originated or extended through the internet" as a type of credit within "any extension of consumer credit" in subsection (c) strengthens the inference that Congress gave careful thought
to what to include or exclude and deliberately chose to exclude only those two types of
"consumer credit" specified in subsection (i).²

Moreover, the recent case of State of New York v. U.S. Envtl. Prot. Agency in the D.C.
Circuit, 443 F.3d 880, 887 (2006), illustrates how a statute that uses the term "any" and then
provides an express exclusion, adds force to an inference that everything not excluded was
intended to be included. In that case, as a result of application of the expansive interpretation of
"any" combined with application of the maxim, the court determined that the Congressional
intent was clear from the language of the statute and there was no justification for proceeding to
step two of a Chevron analysis. Id. at 889-90.

The Statutory Context and Related Provisions

As noted, the usual presumption that attaches to use of the term "any", and the accepted
application of the maxim inclusio unius est exclusio alterius, will give way to strong evidence of
Congressional intent to the contrary that is evident from the statute. This means that
consideration must be given to other provisions of the statute, its structure, and its obvious intent.
In other words, are there other aspect of the statute that indicate clearly that Congress intended to
exclude from its coverage certain types of consumer credit, such as credit card transactions and
installment loans for consumer goods and not secured by the goods, other than those specified
exclusions in subsection (i)?

One might argue that because section 670 requires that creditors shall provide certain
disclosures orally as well as in writing under subsection (c), the statute must contemplate face-to-
face transactions and such a scenario is not compatible with credit cards because cards are
obtained and payments are ordinarily made by mail or electronically. Such an argument will not
stand up to the language of the statute or common sense, however. Subsection (c) specifically
provides that it covers "consumer credit originated or extended through the internet." Such
transactions are subject to the same argument, yet they are covered. It is common knowledge
that a multitude of consumer products may be purchased with a credit card through the internet,
and major credit cards are offered and can be obtained through online application.

² See also Leatherman v. Tarrant County Narcotics Intelligence and Coordination Unit, 507 U.S. 163,
168, 113 S.Ct. 1160 (1993) (specification of two types of cases in which more particularized pleading
would be required under the Federal Rules of Civil Procedure, along with the encompassing statement
that generally all that would be required is a "short and plain statement", gave rise to application of the
has force only when the items expressed are members of an associated group of series, justifying the
inference that the items not mentioned were excluded by deliberate choice. . . . The maxim . . . can be
overcome by a strong indication of contrary legislative intent or policy. . . . The enumeration of
exclusions . . . indicates that the statute should apply to all cases not specifically excluded." [Footnotes
omitted]).

³ See, e.g.,
http://www.chase.com/ccp/index.jsp?pg_name=ccpmapp/card_acquisitions/unsolicited/page/PFSCreditC
hooseCategory&cat=military (Chase);
http://www.citicards.com/cards/wv/filter1Search.do?constituent=CONSUMER&x=22&y=10 (Citibank);
http://www.discovercard.com/apply/student/ (Discover);
are marketed online to the military specifically, and in competition with other types of credit. Moreover, credit card providers already give oral disclosures in several contexts. New or reissued cards come with an adhesive strip notifying the customer to call a toll-free number for activation. Depending on the provider, some offer recorded messages on terms, etc. Some have customers speak with a live operator. In other circumstances, if a customer purchases an add-on feature such as credit protection, the customer calls a toll free number and a service representative reads the terms and conditions, and the communication is recorded. The specific inclusion of consumer credit originated or extended through the internet indicates that the law does not contemplate face-to-face transactions despite the requirement for oral disclosure of terms in the same subsection (c). The requirement for oral communication of terms for providers of consumer credit in other than face-to-face situations might pose logistical issues, but they are clearly surmountable through the use of telephone communications (including recorded messages).

It might also be argued that since the ordinary interest rates on credit cards are typically under 36 percent, the statute was not aimed at them. However, the statute does not cover just interest rates in the usual sense; rather, it defines "interest" in subsection (i)(3) to include "fees, service charges . . . and any other charge or premium." Such charges can easily take credit cards payments over the 36 percent maximum and into APRs over 400 percent. Attachment II illustrates high APRs that can result from credit cards as well as some other types of consumer loans.

Section 670 was clearly designed to protect military servicemembers and their dependents from any credit charges above 36%, and it would be anomalous, absent some clear indication of Congressional intent to the contrary, to construe the statute to exclude types of credit with charges above 36% that are of a type not specifically excluded from the definition of "consumer credit".

Other provisions of section 670 also have application to credit cards as well as other forms of consumer credit. Subsection (e) also makes it unlawful for a creditor to use a "method of access to a deposit, savings, or other financial account maintained by the borrower", and credit card providers (and other lenders) routinely provide for automatic withdrawal methods to


5 It should also be kept in mind that currently we are in a low-to-moderate interest rate environment, and even in this environment some sub-prime or "penalty" credit card rates (imposed due to late payment or "universal default") can approach or even exceed the 36 percent statutory maximum.

obtain payments due. Subsection (e) prohibits creditors from requiring borrowers to waive their rights to legal recourse and submit to arbitration, and credit card agreements often require just that unless the cardmember reads the fine print and rejects the arbitration agreement in writing within 30 days. Subsection (e) also prohibits consolidation of credit with the same creditor, a transaction that could often apply to credit cards and installment loans.

On the other hand, there are no provisions of section 670 that do not make sense for credit cards or some other forms of consumer credit while making sense for some others. The overall language and structure of the statute is consistent with an interpretation that when Congress said "any extension of consumer" credit and "any creditor", with only those exceptions that are stated, it meant what it said.

Since this is the case, one might then ask what is the purpose of giving the Secretary regulatory authority to define "consumer credit" and "creditor". Are there areas remaining in which the Secretary can exercise discretion in those definitions? The answer to this is yes. The term "consumer" does not have a self-evident definition. While everyone might be considered a "consumer", credit for "consumer" purposes would likely exclude credit extended for business, investment, gambling, or other purposes. The Federal Reserve found it necessary to adopt a definition of "consumer credit" for purpose of its Truth in Lending regulations that covers credit extended "to a consumer primarily for personal, family, or household purposes." The Secretary's definition of "creditor" would have to address the issue of how to define whether an entity is "in the business" of extending consumer credit, as has the Federal Reserve effectively in its Truth in Lending regulations.

Legislative History

Although the above analysis appears to establish indisputably that section 670 covers all forms of consumer credit other than those types specifically excepted, and therefore it is unnecessary to resort to the legislative history -- and the legislative history cannot override the

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7 See, e.g., http://www.chase.com/ccp/index.jsp?pg_name=ccpmapp/card_servicing/account_access/page/epay_landing1 (accessed January 2007). It might be argued that the prohibition against automatic electronic withdrawals from a borrower's bank account in subsection (e)(5) does not make sense when applied to credit cards because it is a convenience to military borrower's rather than something they need to be protected from. However, such an argument could apply equally to other forms of consumer credit and would appear to amount simply to simply an argument that Congress was unwise to insert such a provision, which is a policy/political argument, not a legal argument.


9 12 CFR § 226(12).

10 12 CFR § 226(17).
plain language of the statute -- courts nevertheless sometimes look to the legislative history to confirm that what appears evident from the plain language is indeed what Congress intended.\textsuperscript{11}

The only Congressional report explaining section 670 is the conference report.\textsuperscript{12} The short explanation in the report, just like the statute, does not refer to any particular forms of credit, it refers only to "consumer credit loans", "credit", and "creditors who extend credit".

Although remarks by individual Members of Congress carry little or no legal weight as legislative history, in this case they do show that a number of Members considered credit card companies to be engaging in "predatory" practices when they commented on other pending consumer credit legislation at the same time they were considering legislation pertaining to restrictions on lending to the military.\textsuperscript{13} The same is true for installment loans extended to the military.\textsuperscript{14}

\textsuperscript{11} See, e.g., CBS, Inc. v. Primetime 24 Joint Venture, 245 F.3d 1217, 1229 n.9 (11th Cir. 2001) ("Notwithstanding that well-recognized and bedrock principle [of not advancing to legislative history when statutory text is clear], sometimes judges who find that legislative history supports and complements the plain meaning of statutory language cannot resist the temptation to set out that history. We have given in to that temptation more than once." [Citation omitted]).


\textsuperscript{13} 151 Cong.Rec. H2064, April 14, 2005 (Rep. Sensenbrenner commenting on bankruptcy legislation: "[I]f anyone is "gaming' our bankruptcy system, it is the credit card companies, who have long been advocating for this bill at the same time they prey on unsuspecting customers . . . [and] there is virtually nothing in this bill that would require creditors to curb their outrageous predatory lending practices that mislead even the most educated consumers into debt."); 151 Cong.Rec. S1836, Mar. 1, 2005 (Senator E. Kennedy commenting on the Credit Card Minimum Payment Warning Act: "[T]his bill does everything the mind of the purveyors of predatory plastic could think up to make cardholders pay in full, and prevent them from getting the 'fresh start' that bankruptcy offers them."); 151 Cong.Rec. S1838, Mar. 1, 2005 ("Predatory credit card companies are doing all they can to urge unsuspecting citizens to pile up huge debts on their credit cards."); 151 Cong.Rec. S2201, Mar. 8, 2005 (Sen. E. Kennedy commenting on the Bankruptcy Abuse Protection Act and Consumer Protection Act of 2005, S. 256: "We have seen the credit card companies use a self-help remedy for the problem they create by their own indiscriminate and predatory marketing practices."); 151 Cong.Rec. H1975, Mar. 14, 2005 (Rep. Stark commenting on the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, S. 256: "[W]ith all the perks they've awarded to the big credit card companies, Republicans have done nothing to ensure that they are held accountable for their role in this consumer crisis. There is nothing in this bill that stops the abusive, predatory lending that lands too many Americans in bankruptcy in the first place."); 151 Cong.Rec. H1976, Mar. 14, 2005 (Mr. Hastings commenting on the same bills as Mr. Stark, supra: "This legislation, masquerading as protection against bankruptcy abuse, is really a protection for credit card companies and their predatory lending practices."); 151 Cong.Rec. H2064, April 12, 2005 (Rep. McDermott: "Credit card companies are an equal-opportunity scourge. . . . The marketing is not aggressive. It is predatory. . . . Does this so-called consumer protection action [sic] do anything to address predatory credit card marketing? Nothing, nada, zippo."). Senator Dodd, during hearings on credit card practices in 2005 commented: "Credit card issuers have now become the victims of their own success and are turning credit cards into nothing less than wallet-sized predatory loans. In a time when access to credit is the easiest and cheapest, credit card companies are making more money than ever. Credit card issuers are charging usurious rates and fees and engaging, in my view, in a very serious amount of abusive and deceptive practices, which I believe will have drastic long-term consequences on our country.") Hearing
Although non-Congressional statements are entitled to even less (if any) legal weight, numerous consumer organizations supported the legislation that became section 670, and commented: "[T]his important amendment would protect service members who obtain loans after they have enlisted or been mobilized, closing a major loophole in the Service Members Civil Relief Act. It also treats all lenders equally, no matter what type of loan they offer."

Moreover, after the statute was enacted, various organizations with credit card provider membership also expressed the view that it covered credit cards.

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14 Those Congressional remarks mainly referred to Pioneer Financial Services, an installment loan provider that concentrates on the military, often using a variety of names, websites, and affiliates. 151 Cong. Rec. E1405-06, June 30, 2005 (Rep. Westmoreland: "Pioneer Financial has realized that it can prey on military customers by charging unjustifiable rates, high fees and selling them expensive and often unnecessary credit insurance, and then refinancing the loan within a year to generate more fees."); 151 Cong. Rec. E1487, July 14, 2005 (Rep. Jones: "[T]he New York Times pointed out abusive lending practices by companies like Pioneer Financial . . . . According to that paper, Pioneer charges high rates and hidden fees and has the policy of refinancing their existing loans with the first year for the express purpose of generating more fees. Unfortunately, it's not just one company like Pioneer that requires servicemembers to prey on our Armed Forces personnel."); 151 Cong. Rec. E1466-67, July 12, 2005 (Rep. Meek: "unethical lenders like Pioneer Financial that target vulnerable service members and charge unreasonably high rates and fees and sell them grossly overpriced credit insurance and who then refinance these predatory loans with the first 12 months if possible to generate more unjustifiable fees"); 151 Cong. Rec. E1450, July 11, 2005 (Rep. Davis: "I know about companies like Pioneer Financial that engage in predatory lending with high rates and hidden fees and frequently refinance [sic] loans to generate more fees for the lender while providing little or no benefit to the service member.") (all accessed January 2007).


16 See the American Bankers Association analysis of section 670, available at [http://www.aba.com/aba/documents/winnews/DoD_PayDayWhitePaper_101206.pdf](http://www.aba.com/aba/documents/winnews/DoD_PayDayWhitePaper_101206.pdf) ("The following are just a few examples of the types of traditional products that are thrown into jeopardy by this provision: (1) cash advances on credit cards; (2) checking account overdraft protection services; (3) direct debit for payment of some loans; (4) new products developed as lower-cost substitutes for payday lending; and (5) some debt consolidation loans, including the refinancing of prior debt with the same lender at a lower rate.") (accessed January 2007); the news report of the Independent Community Bankers Ass'n on section 670, available at [http://www.icba.org/publications/NewsletterDetailNWT.cfm?ItemNumber=25905#n163833](http://www.icba.org/publications/NewsletterDetailNWT.cfm?ItemNumber=25905#n163833) ("Congress Caps Military Payday Lending: . . . Late fees on credit cards are considered interest charges under the law. . . . It also requires new disclosures and limitations and covers all forms of consumer credit.")
Summary and Conclusions

The plain language of section 670, together with firmly established principles of statutory construction, and further confirmed by legislative history, establishes that section 670 covers all forms of consumer credit, including installment loans and credit cards, with the exception of those forms of credit specifically excepted (residential mortgages and personal property loans secured by the property). The authority of the Secretary to define "consumer credit" and "creditor" in regulations does not extend to allowing him to exclude certain forms of credit other than those specifically excluded by the legislation.

(accessed January 2007); and see also this statement from the American Financial Services Association, available at http://www.spotlightonfinance.org/2006/November/legislative-story3.htm ("The cap [in section 670] applies to unsecured consumer loans such as credit cards and payday advance loans, but not to mortgages or auto loans.") (accessed January 2007).
ATTACHMENT I


SEC. 670. LIMITATIONS ON TERMS OF CONSUMER CREDIT EXTENDED TO SERVICEMEMBERS AND DEPENDENTS.

(a) TERMS OF CONSUMER CREDIT.—Chapter 49 of title 10, United States Code, is amended by adding at the end the following new section:

"§ 987. Terms of consumer credit extended to members and dependents: limitations

(a) INTEREST.—A creditor who extends consumer credit to a covered member of the armed forces or a dependent of such a member shall not require the member or dependent to pay interest with respect to the extension of such credit, except as—

"(1) agreed to under the terms of the credit agreement or promissory note;
"(2) authorized by applicable State or Federal law; and
"(3) not specifically prohibited by this section.

(b) ANNUAL PERCENTAGE RATE.—A creditor described in subsection (a) may not impose an annual percentage rate of interest greater than 36 percent with respect to the consumer credit extended to a covered member or a dependent of a covered member.

(c) MANDATORY LOAN DISCLOSURES.—

"(1) INFORMATION REQUIRED.—With respect to any extension of consumer credit (including any consumer credit originated or extended through the internet) to a covered member or a dependent of a covered member, a creditor shall provide to the member or dependent the following information orally and in writing before the issuance of the credit:

"(A) A statement of the annual percentage rate of interest applicable to the extension of credit.
"(B) Any disclosures required under the Truth in Lending Act (15 U.S.C. 1601 et seq.).
"(C) A clear description of the payment obligations of the member or dependent, as applicable.

"(2) TERMS.—Such disclosures shall be presented in accordance with terms prescribed by the regulations issued by the Board of Governors of the Federal Reserve System to implement the Truth in Lending Act (15 U.S.C. 1601 et seq.).

(d) PREEMPTION.—

"(1) INCONSISTENT LAWS.—Except as provided in subsection (f)(2), this section preempts any State or Federal law, rule, or regulation, including any State usury law, to the extent that such law, rule, or regulation is inconsistent with this section, except that this section shall not preempt any such law, rule, or regulation that provides protection to a covered member or a dependent of such a member in addition to the
protection provided by this section.

(2) DIFFERENT TREATMENT UNDER STATE LAW OF MEMBERS
AND DEPENDENTS PROHIBITED.—States shall not—

(A) authorize creditors to charge covered members
and their dependents annual percentage rates of interest
for loans higher than the legal limit for residents of the
State; or

(B) permit violation or waiver of any State consumer
lending protections for the benefit of residents of the State
on the basis of nonresident or military status of a covered
member or dependent of such a member, regardless of
the member’s or dependent’s domicile or permanent home
of record.

(e) LIMITATIONS.—It shall be unlawful for any creditor to
extend consumer credit to a covered member or a dependent of
such a member with respect to which—

(1) the creditor rolls over, renews, repays, refinances, or
consolidates any consumer credit extended to the borrower
by the same creditor with the proceeds of other credit extended
to the same covered member or a dependent;

(2) the borrower is required to waive the borrower’s right
to legal recourse under any otherwise applicable provision of
State or Federal law, including any provision of the
Servicemembers Civil Relief Act;

(3) the creditor requires the borrower to submit to arbitration
or imposes onerous legal notice provisions in the case
of a dispute;

(4) the creditor demands unreasonable notice from the
borrower as a condition for legal action;

(5) the creditor uses a check or other method of access
to a deposit, savings, or other financial account maintained
by the borrower, or the title of a vehicle as security for the
obligation;

(6) the creditor requires as a condition for the extension
of credit that the borrower establish an allotment to repay
an obligation; or

(7) the borrower is prohibited from prepaying the loan
or is charged a penalty or fee for prepaying all or part of
the loan.

(f) PENALTIES AND REMEDIES.—

(1) MISDEMEANOR.—A creditor who knowingly violates this
section shall be fined as provided in title 18, or imprisoned
for not more than one year, or both.

(2) PRESERVATION OF OTHER REMEDIES.—The remedies and
rights provided under this section are in addition to and do
not preclude any remedy otherwise available under law to
the person claiming relief under this section, including any
award for consequential and punitive damages.

(3) CONTRACT VOID.—Any credit agreement, promissory
note, or other contract prohibited under this section is void
from the inception of such contract.

(4) ARBITRATION.—Notwithstanding section 2 of title 9,
or any other Federal or State law, rule, or regulation, no
agreement to arbitrate any dispute involving the extension
of consumer credit shall be enforceable against any covered
member or dependent of such a member, or any person who
was a covered member or dependent of that member when
the agreement was made.

‘‘(g) SERVICEMEMBERS CIVIL RELIEF ACT PROTECTIONS
UNCHANGED.—Nothing in this section may be construed to limit
or otherwise affect the applicability of section 207 of the
Servicemembers Civil Relief Act (50 U.S.C. App. 527).

‘‘(h) REGULATIONS.—(1) The Secretary of Defense shall prescribe
regulations to carry out this section.

‘‘(2) Such regulations shall establish the following:

‘‘(A) Disclosures required of any creditor that extends consumer
credit to a covered member or dependent of such a
member.

‘‘(B) The method for calculating the applicable annual
percentage rate of interest on such obligations, in accordance
with the limit established under this section.

‘‘(C) A maximum allowable amount of all fees, and the
types of fees, associated with any such extension of credit,
to be expressed and disclosed to the borrower as a total amount
and as a percentage of the principal amount of the obligation,
at the time at which the transaction is entered into.

‘‘(D) Definitions of ‘creditor’ under paragraph (5) and ‘consumer
credit’ under paragraph (6) of subsection (i), consistent
with the provisions of this section.

‘‘(E) Such other criteria or limitations as the Secretary
of Defense determines appropriate, consistent with the provisions
of this section.

‘‘(3) In prescribing regulations under this subsection, the Secretary
of Defense shall consult with the following:


‘‘(B) The Board of Governors of the Federal Reserve System.

‘‘(C) The Office of the Comptroller of the Currency.

‘‘(D) The Federal Deposit Insurance Corporation.

‘‘(E) The Office of Thrift Supervision.

‘‘(F) The National Credit Union Administration.

‘‘(G) The Treasury Department.

‘‘(i) DEFINITIONS.—In this section:

‘‘(1) COVERED MEMBER.—The term ‘covered member’ means
a member of the armed forces who is—

‘‘(A) on active duty under a call or order that does
not specify a period of 30 days or less; or

‘‘(B) on active Guard and Reserve Duty.

‘‘(2) DEPENDENT.—The term ‘dependent’, with respect to
a covered member, means—

‘‘(A) the member’s spouse;

‘‘(B) the member’s child (as defined in section 101(4)
of title 38); or

‘‘(C) an individual for whom the member provided more
than one-half of the individual’s support for 180 days immediately
preceding an extension of consumer credit covered
by this section.

‘‘(3) INTEREST.—The term ‘interest’ includes all cost elements
associated with the extension of credit, including fees,
service charges, renewal charges, credit insurance premiums,
any ancillary product sold with any extension of credit to a servicemember or the servicemember’s dependent, as applicable, and any other charge or premium with respect to the extension of consumer credit.

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“(4) ANNUAL PERCENTAGE RATE.—The term ‘annual percentage rate’ has the same meaning as in section 107 of the Truth and Lending Act (15 U.S.C. 1606), as implemented by regulations of the Board of Governors of the Federal Reserve System. For purposes of this section, such term includes all fees and charges, including charges and fees for single premium credit insurance and other ancillary products sold in connection with the credit transaction, and such fees and charges shall be included in the calculation of the annual percentage rate.

“(5) CREDITOR.—The term ‘creditor’ means a person—

‘‘(A) who—

‘‘(i) is engaged in the business of extending consumer credit; and
‘‘(ii) meets such additional criteria as are specified for such purpose in regulations prescribed under this section; or
‘‘(B) who is an assignee of a person described in subparagraph (A) with respect to any consumer credit extended.

“(6) CONSUMER CREDIT.—The term ‘consumer credit’ has the meaning provided for such term in regulations prescribed under this section, except that such term does not include

(A) a residential mortgage, or (B) a loan procured in the course of purchasing a car or other personal property, when that loan is offered for the express purpose of financing the purchase and is secured by the car or personal property procured.’’.

(b) CLERICAL AMENDMENT.—The table of sections at the beginning of such title is amended by adding at the end the following new item:

‘‘987. Terms of consumer credit extended to members and dependents: limitations.’’.

(c) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraph (2), section 987 of title 10, United States Code, as added by subsection (a), shall take effect on October 1, 2007, or on such earlier date as may be prescribed by the Secretary of Defense, and shall apply with respect to extensions of consumer credit on or after such effective date.

(2) AUTHORITY TO PRESCRIBE REGULATIONS.—Subsection (h) of such section shall take effect on the date of the enactment of this Act.

(3) PUBLICATION OF EARLIER EFFECTIVE DATE.—If the Secretary of Defense prescribes an effective date for section 987 of title 10, United States Code, as added by subsection (a), earlier than October 1, 2007, the Secretary shall publish that date in the Federal Register. Such publication shall be made not less than 90 days before that earlier effective date.

(d) INTERIM REGULATIONS.—The Secretary of Defense may prescribe interim regulations as necessary to carry out such section. For the purpose of prescribing such interim regulations, the Secretary
Center for Regulatory Effectiveness

is excepted from compliance with the notice-and-comment requirements of section 553 of title 5, United States Code. All interim rules prescribed under the authority of this subsection that are not earlier superseded by final rules shall expire no later than 270 days after the effective date of section 987 of title 10, United States Code, as added by this section.
APRs ASSOCIATED WITH:
PAYDAY LOANS AND OTHER ALTERNATIVE CONSUMER FINANCE MECHANISMS

Below are ballpark estimates of the effective APR associated with four specific alternative consumer finance options. All estimates are calculated based on a $100 base loan.

APRs for payday lenders are based on a bi-weekly loan as typical and cited in the literature. APRs for credit cards and overdraft checks are based on a monthly billing cycle. Please note that this results in very conservative estimates since payday loans, if they were renewed, would be subject to a second service fee. Thus, the APRs for non-payday alternative consumer loans are about half what is estimated in the literature.

- APR on a loan from payday lender: **520%**
- APR on a credit card cash advance with late fee: **456%**
- APR on a credit card cash advance with over-the-limit fee: **406%**
- APR on a credit card cash advance with late fee and over-the-limit fee: **826%**
- APR on a checking account overdraft: **576%**

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1 Source: J. P. Caskey, “The Economics of Payday Lending,” April 2002. Caskey states that “lenders typically charge $15 to $25 for each $100 that they advance with a two-week maturity.” The CRE analysis uses the mid-point of $20 and multiplied it by 26, the same methodology Caskey uses to estimate the APR for a $200 loan. See p. 5. The study “Credit Union Payday Alternatives” published in December 2005 by the National Association of Community Credit Unions (NACCU) uses the same methodology. See p. 6.

2 Source: $35 average late fee reported by IndexCreditCards.com in June 2006 + a $3 cash advance fee based on the 2-4% cash advance fee reported by BankRate.com.

3 Source: USA Today, “Credit card fees can suck you in” 12/15/06 citing an average over-the-limit fee is $30.81 reported by CardWeb.com. $3 cash advance fee included in calculations.

4 Based on a $35 late fee, $30.81 over-the-limit fee and a $3 cash advance fee.

5 Source: J. Jerving, “Credit Union Payday Loan Alternatives,” NACCU, December 2005, p. 6. Based on $48 combined bank fee and merchant fee for a bad check. Note, this may not be a consumer loan since the bounced check was not honored – triggering the merchant fee. Thus, the original debt remains in addition to the fees.

* Note: The calculation excludes the customary 30% APR interest.
This paper presents preliminary findings and is being distributed to economists and other interested readers solely to stimulate discussion and elicit comments. The views expressed in the paper are those of the author and are not necessarily reflective of views at the Federal Reserve Bank of New York or the Federal Reserve System. Any errors or omissions are the responsibility of the author.
Defining and Detecting Predatory Lending
Donald P. Morgan
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Abstract
We define predatory lending as a welfare-reducing provision of credit. Using a textbook model, we show that lenders profit if they can tempt households into “debt traps,” that is, overborrowing and delinquency. We then test whether payday lending fits our definition of predatory. We find that in states with higher payday loan limits, less educated households and households with uncertain income are less likely to be denied credit, but are not more likely to miss a debt payment. Absent higher delinquency, the extra credit from payday lenders does not fit our definition of predatory. Nevertheless, it is expensive. On that point, we find somewhat lower payday prices in cities with more payday stores per capita, consistent with the hypothesis that competition limits payday loan prices.

Key words: predatory, payday, consumer

Morgan: Federal Reserve Bank of New York (e-mail: donald.morgan@ny.frb.org). The author thanks John Caskey, Gerhard Fries, Andreas Lehnert, Ryan Morgan, Karen Pence, Ian Wallace, and Jeremy Stein for comments and assistance and extends special thanks to Song Han and Sam Hanson for their collaboration, Jean Ann Fox and Stephen Graves for data, and the Stockholm Institute of Financial Research for hosting Morgan. The views expressed in this paper are those of the author and do not necessarily reflect the position of the Federal Reserve Bank of New York or the Federal Reserve System.
“There is no definition of predatory lending. I don’t know how we can hope to address the problem before we have decided what it is.” (Senator Phil Gramm, American Banker, August 24, 2000).

1

1Introduction

“Predatory” is how reformers—consumer advocates, journalists, lawyers, legislators and some bank regulators—condemn lending practices in the booming subprime credit market. The alleged predators are sub-prime mortgage and payday lenders. Their prey? The lower income, less educated households on the demand side of these growing consumer credit markets.¹

Concern about predatory lending is mounting (Figure 1). The term began appearing in American Banker in 1994. Appearances were rare until 2000. By 2004, weekly and even daily appearances were common.

Despite growing concerns about predatory lending, and even regulation to curb it, there seems to be no general definition of predatory lending. The usual criticism is of “unaffordable” credit—loans made at such high rates or in such large quantities that borrowers cannot afford to repay the credit without sacrificing their future standard of living, or in the worst case, their home.

To economists, this predator-prey concept of credit seems foreign. If credit is so expensive that lenders are earning abnormal profits (given their risks and costs), why don’t new lenders enter the market to compete rates down to fair levels. “Unaffordable” credit also sounds peculiar; how can lenders profit if borrowers cannot repay?

This paper essays predatory lending from an economists’ perspective. We define predatory lending as a welfare reducing provision of credit. That definition seems general enough to cover some of the specific practices—overlending and overcharging, deception, targeting certain consumer segments—condemned by reformers. We show how households can be made worse of by a voluntary credit transaction if lenders deceive households about some variable that increases households’ demand for credit, like their income.

¹For a critique of the predatory aspects of payday lending, see King, Parrish, and Tanik (2006)
Information asymmetries are common in credit market models, but the usual assumption, at least in commercial lending, is that borrowers are the better informed party and that lenders have to screen and monitor to assess whether firms are creditworthy. The opposite asymmetry, as we assume here, does not seem implausible in the context of consumer lending. “Fringe” borrowers are less educated than mainstream borrowers (Caskey 2003), and many are first-time borrowers (or are rebounding from a failed first foray into credit). Lenders know from experience with large numbers of borrowers, whereas the borrower may only have their own experience to guide them. Credit can also be confusing; after marriage, mortgages are probably the most complicated contract most people ever enter. Given the subtleties involved with credit, and the supposed lack of sophistication of sub-prime borrowers, our assumption that lenders know better seems plausible.

While lenders might deceive households about several variables that influence household loan demand, we focus on income. We suppose that lenders exaggerate household’s future income in order boost loan demand. Our borrowers are gullible, in the sense that they can be fooled about their future income, but they borrow rationally given their beliefs. Fooling borrowers is costly to lenders, where the costs could represent conscience, technological costs (of learning the pitch), or risk of prosecution. The upside to exaggerating borrowers’ income prospects is obvious—they borrow more. As long as the extra borrowing does not increase default risk too much, and as long as deceiving borrowers is easy enough, income deception and predatory—welfare reducing—lending may occur.

After defining predatory lending, we test whether payday lending fits our definition. Payday lenders make small, short-term loans to mostly lower-middle income households. The business is booming, but critics condemn payday lending, especially the high fees and frequent loan rollovers, as predatory. Many states prohibit payday loans outright, or indirectly, via usury limits.

To test whether payday lending qualifies as predatory, we compared debt and delinquency rates for households in states that allow payday lending to those in states that do not. We focus especially on differences across states households that, according to our model, seem more vulnerable to predation: households with more income uncertainty or less education.

We use smoking as a third, more ambiguous, proxy for households with high, or perhaps
hyberbolic, discount rates. In general, high discounters will pay higher future costs for a
given, immediate, gain in welfare. Smokers’ seem to fit that description. What makes the
smoking proxy ambiguous is that smokers may have hyperbolic, not just high, discount rates.
Hyperbolic discount rates decline over time in a way that leads to procrastination and self-
control problems (Laibson 1997). The hyperbolic discounter postpones quitting smoking,
or repaying credit. Without knowing whether smokers discount rates are merely high, or
hyperbolic, we will not be able to say whether any extra debt for smokers in payday states
is welfare reducing.2

Given those proxies, we use a difference-in-difference approach to test whether payday
lending fits our definition of predatory. First we look for differences in household debt
and delinquency across payday states and non-payday states, then we test whether those
difference are higher for potential prey. To ensure that any such differences are not merely
state effects, we difference a third time across time by comparing whether those differences
changed after the advent of payday lending circa 1995. That triple difference identifies any
difference in debt and delinquency for potential prey in payday states after payday lending
was introduced.

Our findings seem mostly inconsistent with the hypothesis that payday lenders prey on,
i.e., lower the welfare of, households with uncertain income or households with less education.
Those types of households who happen to live in states that allow unlimited payday loans
are less likely to report being turned down for credit, but are not more likely, by and large,
to report higher debt levels, contrary to the overborrowing prediction of our model. Nor are
such households more likely to have missed a debt payment in the previous year. On the
contrary, households with uncertain income who live in states with unlimited payday loans
are less likely to have missed a debt payment over the previous year. The latter result is
consistent with claims by defenders of payday lending that some households borrow from

2Consistent with a high discount rate, Munasinghe and Sicherman (2000) discover that smokers have
flatter wage profiles and they are willing to trade more future earnings for a given increase in current earnings.
Gruber and Mulainathan (2002) find that high cigarette taxes make smokers ”happier,” consistent with
hyperbolic discount rates (because taxes help smokers commit to quitting). DellaVigna and Malmendier
(2004) show how credit card lenders can manipulate hyperbolic discounters by front-loading benefits and
back-loading costs.
payday lenders to avoid missing payments on other debt. On the whole, our results seem consistent with the hypothesis that payday lending represents a legitimate increase in the supply of credit, not a contrived increase in credit demand.

We find some interesting differences for smokers, but those differences are harder to interpret in relation to the predatory hypothesis without knowing *apriori* whether smokers are hyperbolic, or merely high, discounters.

We also find, using a small set of data from different sources, that payday loan rates and fees decline significantly as the number of payday lenders and pawnshops increase. Reformers often advocate usury limits to lower payday loan fees but our evidence suggests that competition among payday lenders (and pawnshops) works to lower payday loan prices.

Our paper has several cousins in the academic literature. Ausubel (1991) argues that credit card lenders exploit their superior information about household credit demand in their marketing and pricing of credit cards. The predators in our model profit from their information advantage as well. Our concept of income delusion or deception also has a behavioral flavor, as well, hence our use of smoking as a proxy for self-control problems. Brunnermeier and Parker (2004), for example, imagine that households *choose* what to expect about future income (or other outcomes). High hopes give households’ current “felicity,” even if it distorts borrowing and other income-dependent decisions. Our households have high hopes for income, and they make bad borrowing decisions, but we do not count the current felicity from high hopes as an offset to the welfare loss from overborrowing.

Our costly falsification (of household income prospects) and costly verification (by counselors) resemble Townsend’s (1979) costly state verification and Lacker and Weinbergs’ (1989) costly state falsification. The main difference here is that the falsifying and verifying comes before income is realized, not after.

More importantly, we hope our findings inform the current, very real-world debate, around predatory lending. The stakes in that debate are high: millions of lower income households borrow regularly from thousands of payday loan offices around the country. If payday lenders raise household welfare by relaxing credit constraints, anti-predatory legislation may lower it.
2 Payday Lending

Payday lenders make small, short-term loans to households. The typical loan is about $300 for two weeks. The typical fee is $15 per $100 borrowed. Lenders require two recent pay stubs (as proof of employment), and a recent bank account statement. Borrowers secure the loan with a post-dated personal check for the loan amount plus fees. When the loan matures, lenders deposit the check.

Payday lending evolved from check cashing much like bank lending evolved from deposit taking. For a fee, check cashiers turn personal paychecks into cash. After cashing several paychecks for the same customer, lending against future paychecks was a natural next step.

High finance charges is the main criticism against payday lenders. The typical fee of $15 per $100 per two weeks implies an annual interest rate of $15\times365/14$, or 390 percent. Payday lenders are also criticized for over-lending, in the sense that borrowers often refinance their loans repeatedly, and for ”targeting” women making the transition from welfare-to-work (Fox and Mierzewski 2001) and soldiers (Graves and Peterson 2004).

Despite their critics, payday lending has boomed. The number of payday advance offices grew from 0 in 1990 to 14,000 in 2003 (Stegman and Harris 2003). The industry originated $8$ to $14$ billion in loans in 2000, implying 26-47 million individual loans. Rapid entry suggests the industry is profitable.

Payday lenders present stiff competition for pawnshops, even though the internet, namely E-bay, significantly foreclosed costs for pawnshops (Caskey 2003). The number of pawn shops in the U.S. grew about six percent per year between 1986 and 1996, but growth essentially stalled from 1997 to 2003. Prices of shares in EZCorp, the largest, publicly traded pawn shop holder, were essentially flat or declining between 1994 and 2004, while Ace Cash Express share prices, a retail financial firm selling check cashing and payday loans, rose substantially over that period (Figure 4). EZCorp CEO, Joseph Rotunday, blamed payday lenders for pawnshops’ dismal performance:

The company had been progressing very nicely until the late 1990s.... (when) a new product called payroll advance/payday loans came along and provided our customer base an alternative choice. Many of them elected the payday loan over

Payday lending is heavily regulated (Table 1). As of 2001, eighteen states effectively prohibited payday loans via usury limits, and most other states prices, loan size, and loan frequency per customer (Fox and Mierzwinski 2001). Note that the payday loan limit ranges from 0 (where payday loans are illegal) to 1250. Nine states allow unlimited payday loans.

Payday lenders have circumvented usury limits by affiliating with national or state chartered banks, but the Comptroller of the Currency—the overseer of nationally chartered banks—recently banned such affiliations. The Federal Deposit Insurance Corporation still permits payday lenders to affiliate with state banks, but recently restricted those partnerships (Graves and Peterson 2005).

Regulatory risk—the threat of costly or disabling legislation in the future—looms large for Payday lenders. The Utah legislature is reconsidering its permissive laws governing payday lending. North Carolina recently drove payday lenders from the state by expressly outlawing the practice.

Heavy regulation increases the cost of payday lending. High regulatory risk increases limits entry into the industry and increases the expected return required by industry investors. Driving up costs and driving away investors may be exactly what regulators intended if they view payday lending as predatory.

3 Defining Predatory Lending

We define predatory lending as a welfare reducing provision of credit. Households can be made worse off by borrowing if lenders can deceive households into borrowing more than is optimal. Excess borrowing reduces household welfare, and may increase default risk.

We illustrate our concept of predatory lending in a standard model of household borrowing. Before we get to predatory lending, we review basic principles about welfare improving lending, the type that lets households maintain their consumption despite fluctuations in their income.

The model has two periods: today (period zero) and payday (period one. Household income goes up and down periodically, but not randomly (for now): income equals zero today
and \( y \) on payday. If households consume \( C_t \) in period \( t \), their utility is \( U(C_t) \). Household welfare is the sum of utility over both periods: \( U(C_0) + \delta U(C_1) \), where \( \delta \) equals the household’s time rate of discount. Households with high \( \delta \) value current consumption highly relative to future consumption. In other words, high discounters are impatient.

A digression here on discount rates serves later discussion. In classical economics \( \delta \) is constant. If \( \delta \) changes over time, so does household behavior, even if nothing else changes. If \( \delta(t) \) is hyperbolic, households will postpone unpleasant tasks until current consumption does not seem so precious relative to future consumption (Laibson 1997). With hyperbolic discounting, that day never arrives, so hyperbolic discounters have behavioral problems: they procrastinate. They may never repay debt, much less begin saving. Hyperbolic discounters who start smoking may never quit.

Returning to the model, if the marginal utility of consumption (\( U' \)) is diminishing, households will demand credit to reduce fluctuations in their standard of living. Households without credit, however, must fend for themselves (autarky). Welfare under autarky equals \( U(0) + \delta U(y) \). The fluctuations in consumption for households without credit make autarky a possible worst case, and hence, a good benchmark for comparing cases with credit.

If households borrow \( B \) at interest rate \( r \), welfare equals \( U(B) + \delta U(y - (1 + r)B) \). Borrowing increases utility in period zero, when the proceeds are consumed, but lowers utility in period one, when households pay for their borrowing. Rational, informed households trade off the good and bad side of borrowing; they borrow until the marginal utility of consuming another unit today just equals the marginal, discounted disutility of repaying the extra debt on payday:

\[
U''(B) = \delta(1 + r)U''(y - (1 + r)B). \tag{1}
\]

Equation (1) determines household loan demand as a function of their income, their discount rate, and the market interest rate: \( B(y, \delta, r) \). For standard utility functions, household loan demand is increasing in income and decreasing in the discount factor and interest rate: \( B_y > 0; B_{\delta} < 0; B_r < 0 \). Household welfare with optimal borrowing equals \( U(B(y, r, d)) + \delta U(y - (1 + r)B(y, r, \delta)) \). As long as households follow (1), their welfare with positive borrowing must be higher than without (autarky).

The welfare gain from borrowing depends on the cost of credit production. Suppose the
cost of lending $B$ to a particular household equals \((1 + \rho)B + f\), where \(\rho\) represents the opportunity cost per unit loaned and \(f\) is the fixed cost per loan. Think of \(f\) as the cost of record-keeping and credit check required for each loan, however large or small the loan may be. If the going price for loans is \((1 + r)\) per unit borrowed, the lenders’ profits equal \((r - \rho)B - f\).

With perfect competition among lenders, the loan interest rate is competed down until it just covers the costs of the loan: \(r = \rho + f/B\). Equilibrium \(r\) and \(B\) are determined where that credit supply curve equals demand (1).

Equilibrium in the payday credit market is illustrated in Figure (3). If fixed costs per loan are prohibitively high, the market may not exist. Perhaps the payday lending technology lowered the fixed cost per loan enough to make the business viable.\(^3\) Before the advent of payday lending, households who applied to banks for a very small, short-term loan may have been denied.

Fixed costs per loan imply that smaller loans will cost more per dollar borrowed than larger loans. That means households with low credit demand will pay higher rates than households with high loan demand. Loan demand is increasing in income, so high income households who demand larger quantities of credit will enjoy a “quantity” discount, while lower income households will pay a ”small lot” premium, or penalty. That price ”discrimination” is not invidious, however; the higher cost of smaller loans reflects the fixed costs of lending. The high price of payday loans may partly reflect the combination of fixed costs and small loan amounts (Flannery and Samolyk 2005).

A usury limit lowers household welfare. Suppose the maximum legal interest rate is \(\bar{r}\). At that maximum rate, the minimum loan that lenders’ cost is \(f/(\bar{r} - \rho) = B\). Low income households with loan demand less than \(B\) face a beggar’s choice: borrow \(B\) at \(\bar{r}\) or do not borrow at all. Such households would be willing to pay more to avoid going without credit, so raising the usury limit would raise welfare for those households.

Competition is another key determinant of how much households gains from borrowing.

\(^3\)Alternatively, or additionally, the demand for small, short term loans may have increased in the mid 1990s. The welfare reform then almost certainly increased demand for such credit as households who once "worked" at home for the government were forced to go to work in the market.
Even with no competition – monopoly–households cannot be worse off than under autarky. The monopolist raises interest rates until the marginal revenue from higher rates equals the marginal cost from lower loan demand:

\[
B(y, r) = -(r - \rho)B_r(y, r). \tag{2}
\]

At that monopoly interest rate, \(r^m\), household loan demand equals \(B(y, r^m)\). Household welfare under monopoly equals \(U(B_r(y, r^m)) + \delta U(y - (1 + r^m)B_r(y, r^m))\). Welfare is lower under monopoly because credit costs more and their standard of living fluctuates more (because costly credit reduces their demand for credit) If households borrow from the monopolist, however, they must better off than without credit.

In sum, welfare for rational households is highest if credit is available at competitive prices. If households choose to borrow, they must be at least as well off as they were without credit. Limiting loan rates cannot raise household welfare and may reduce it. Monopoly lenders lower household welfare, but even with a monopolist, households cannot be worse off than without credit.

The high cost of payday lending may partly reflect fixed costs per loan. Before payday lending, those fixed costs may have been prohibitive; very small, short-term loans may not have been worthwhile for banks. The payday lending technology may have lowered those fixed costs, thus increasing the supply of credit to low income households demanding small loans. That version of the genesis of payday lending suggests the innovation was welfare improving, not predatory.

### 3.1 Predation by Income Deception

In the textbook model household welfare cannot be lower than under autarky because households are fully informed and rational. Here we show households how can be made worse off than without credit if predatory lenders can delude households about their (households’) future income.

Suppose that by spending \(C(\tau)\), lenders can convince a prospective borrower that her income on payday will be \(y + \tau\). The cost \(C\) can be interpreted variously as the cost of a guilty
conscience, the risk of prosecution, or the resources spent conning households into believe $\tau$. Households are increasingly skeptical as deception increases: $C'(\cdot) > 0$ and $C''(\cdot) > 0$. $C(\tau)$ might be lower for more gullible households and higher for the more skeptical ones. For the fully rational borrower, the costs of deception are infinite: $C(0) = \infty$.

Our model of costly income deception takes us far from, and in some ways behind, current techniques for modelling information asymmetries. Borrowers here not fully informed, as they operate under the assumption that next period equals $y + \tau$, and that is plainly wrong.\footnote{The models in Townsend (1979) and Lacker and Weinberg (1989) feature costly income verification and falsification (respectively), but we reverse the timing and roles. Here it is the financiers who falsify, not the borrowers, and the deception occurs before deals are done. Alternatively, one could model the information asymmetry here as an adverse selection problem where households know that some creditors misrepresent households' creditworthiness, but the mis-representers are hard to distinguish from the honest creditors. While that might be an interesting problem, if subprime borrowers can solve that subtle inference problem, why worry about them?}

Our income deception story is closer to the facts than it is to theory. In a study of households’ choice of credit cards plans, Agarwal, Chomsisenghat, Liu, Souleles (2005) find that about 40 percent of households choose sub-optimal plans. Ausubel (1991, 1999) and Shui and Ausubel (2004) find evidence that credit card holders systematically underestimate how much they owe or how long they (will) owe it. Underestimating borrowing is not much different from overestimating future income.\footnote{Income deception is also a common charge against another class of lenders accused of predatory lending: subprime mortgage lenders. In a survey by Stock (2001) of households with foreclosed subprime mortgages in Dayton, Ohio, 42 percent reported that mortgage lender encouraged them to borrow more than they initially intended.}

Though gullible, households borrow optimally given their perceived income. That means they are on their demand curve for credit, where their demand reflects their deluded income expectations. Thus, profits for a predatory lender are $(r - \rho)B(y + \tau, r) - C(\tau) - f$. Optimal $\tau$ is determined by the first-order condition

$$(r - \rho)B_y(y + \tau, r) = C'(\tau),$$  \hspace{1cm} (3)

The predator exaggerates income to the point where the marginal revenue from exaggerating household income (due to increased loan demand) equals the marginal cost of exaggeration.
Note that the incentive to exaggerate income is increasing with the interest spread on loans. In a perfectly competitive loan market spreads are zero so lenders would have no incentive to falsify. Indeed, they could not afford to falsify; the costs of falsification would require higher spreads to compensate, so borrowers would switch to cheaper, honest lenders. Costly predation can occur only if imperfect competition enables predators to charge higher than competitive spreads.

A predatory-monopolist gets to set the loan rate as well. The first-order condition for \( r \) is:

\[
B(y + \tau, r) = -(r - \rho)B_r(y + \tau, r). \tag{4}
\]

The predatory-monopolist raises interest rates until the marginal revenue from higher rates equals the marginal cost in terms of lower loan demand.

The predatory-monopolist does not always charge a higher loan rate than an ordinary monopolist. To see this, express (4) in elasticity terms:

\[
\frac{r - \rho}{r} = -\frac{B(y + \tau, r)}{r} \frac{1}{B_r(y + \tau, r)} = \frac{1}{\varepsilon_r(y + \tau, r)}
\]

where \( \varepsilon_r(y + \tau, r) \) is the elasticity of loan demand with respect to \( r \). Let \( r_{pm} \) and \( r_m \) denote the optimal \( r \) charged by a predatory-monopolist and ordinary monopolist, respectively. Then \( r_{pm} > r_m \) if and only if

\[
\frac{r_{pm} - \rho}{r_{pm}} > \frac{r_m - \rho}{r_m},
\]

or equivalently,

\[
\varepsilon_r(y + \tau, r_{pm}) < \varepsilon_r(y, r_m).
\]

For households with CRRA utility, the elasticity of loan demand with respect to \( r \) does not vary with income, i.e., \( \varepsilon_r(y + \tau, r) = \varepsilon_r(y, r) \).\(^6\) CRRA households with higher income are no less averse to high interest than those with lower income, so when dealing with CRRA households, a predatory-monopolist lends more than an ordinary monopolist but charges the same interest rate.

For other utility functions, exponential for example, the predatory-monopolist lends more and charges higher interest rates than an ordinary monopolist. The exception for CRRA

\[^6\text{If } U(c) = (c^{1-\gamma} - 1)/(1 - \gamma), \text{ (1) implies } B(y, r) = y \cdot b(r).\]

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utility is important, nonetheless, as it implies predators are better detected by how much
they lend, rather than how much they charge. We use that result later when we test whether
payday lending is predatory.

3.1.1 Uncertain Income

When household income is uncertain, predators have another angle: they can exaggerate
the probability the household income will be high, thus boosting household loan demand.
Uncertain income also means default is possible. If predators accentuate the positive enough,
they may push borrowers to the brink of default.

Suppose future income is high \((Y)\) or low \((y)\) with odds \(\pi\) and \(1 - \pi\). Expected utility
on payday depends on the risk of default, and hence, \(\pi\). It turns out that households with \(\pi\)
below some threshold limit their borrowing to avoid that risk. In deriving household’s loan
demand below, we impose the no-default constraint that \(B \leq y/(1+r)\), but then show that
the constraint will not bind for households with \(\pi\) below some threshold. Low \(\pi\) households
limit their borrowing to avoid owing all their income on when their pay is low. We then
show how predators, by exaggerating \(\pi\), can push households to the brink of default.

Household’s choose \(B\) to maximize the Lagrangian function:

\[
U(B) + \delta[\pi U(Y - (1+r)B) + (1-\pi)U(y - (1+r)B)] + \lambda y/(1+r) - B,
\]

The FOC for \(B\) is

\[
U'(B) - \delta(1+r)[\pi U'(Y - (1+r)B) + (1-\pi)U'(y - (1+r)B)] = \lambda. \tag{5}
\]

The no-default constraint is slack \((\lambda = 0)\) if and only if

\[
\pi < \pi \equiv \frac{U'(y/(1+r))/\delta(1+r) - U'(0)}{U'(Y - y) - U'(0)}. \tag{6}
\]
Granting that, household loan demand increases with $\pi$: $B_\pi(Y, y, \pi, r) > 0$. The higher odds of a high paycheck decreases the expected marginal disutility of owing money when pay is low, so households borrow more today.

Suppose predatory lenders can exaggerate $\pi$ by $\tau$ at cost $C(\tau)$. Predators’ exaggeration cannot exceed $\pi - \pi$, or else households would borrow to the hilt ($B = y/(1 + r)$) and default would be possible. Default is not necessarily bad for the lender if they raise rates to compensate, but once default is possible, household loan demand decreases with $\pi$. It seems implausible to imagine predators that exaggerate $\pi$ to increase loan demand, then attenuate $\pi$ to increase loan demand even further. "Jerking" borrowers around would surely tip them off.

The predator maximizes the Lagrangian function

$$ (r - \rho)B(Y, y, \pi + \tau, r) - C(\tau) - f + \mu(\overline{\pi} - \pi - \tau). \tag{7} $$

The FOC for $\tau$ is

$$ (r - \rho)B_r(Y, y, \pi + \tau, r) - C'(\tau) - \mu = 0. \tag{8} $$

Optimal $\tau = \overline{\pi} - \pi$ if and only if the marginal revenue from exaggerating $\pi$ exceeds the marginal cost at that point: $(r - \rho)B_r(Y, y, \overline{\pi}, r) > C'(\overline{\pi} - \pi)$. In that case, predators exaggerate $\pi$ until households borrow $y/(1 + r)$, putting them at the brink of default whenever their pay is low. Absent predation, low $\pi$ households would never default. Thus, when household income is uncertain, the overborrowing elicited by predators increases the probability of default. We test that prediction later.

3.1.2 Does Risk Deter Predation?

If the probability of default is increasing in the amount households owe (unlike in the model above), lenders incentive to exaggerate income is diminished. Risk may not deter that incentive altogether, however. Suppose household income is distributed $f(y)$, with cumulative distribution $F(y)$. If a household owes $(1 + r)B$, they default with probability $F[(1 + r)B]$. At the margin, the incentive to exaggerate income depends on the hazard rate of default: $f[(1+r)B]/\{1-F[(1+r)B]\}$. If that hazard rate is sufficiently flat at the household’s optimal
debt level (given the true distribution of income), predators still profit from exaggerating household’s income prospects.

3.1.3 Equity Stripping

If lending is secured by an asset, home equity for example, the incentive to prey increases. Lending another $ to a household with home equity of $E does not increase risk to lenders’ at all, even if the extra unit of borrowing puts household debt service costs beyond current income or cash flow. As the borrower misses a payments, home equity lenders can charge penalties and raise interest rates until the household owes $E - \epsilon$, where \epsilon represents foreclosure costs. If a predatory lender can con households into borrowing more than their current income affords, predators can eventually strip homeowners’ equity.

3.1.4 Can Credit Counselors Deter Predators?

We have also considered a credit counselor can correct borrowers’ income beliefs, at some cost, and thereby raise borrower welfare by reducing their borrowing to the optimal level. Credit counseling may deter predation, but it does not necessarily eliminate it. Credit counseling may not be profitable because it entails lending smaller amounts at a higher rate (because counseling is costly). Predation can occur in equilibrium if the welfare loss from predation is less than the cost (to a credit counselor) from eliminating the loss.

4 Is Payday Lending Predatory?

Critics condemn payday lending as predatory partly because of the high finance charges. However, the high price of payday credit could reflect high fixed costs per loan, and/or, monopoly power. Nor does a predator-monopolist always charge higher prices than ordinary monopolists. Thus, higher prices are neither necessary or sufficient to conclude that a certain class of credit is predatory.

The other criticism of payday lenders is the frequent rollover of loans. Instead of repaying their loan after two weeks, a substantial fraction of households rollover their loans for many weeks. Those frequent rollovers come closer to our concept of predation a la overborrowing.
If payday lending tempts certain households into over-borrowing, that should be detectable as differences in debt and delinquency rates in states with more liberal payday lending laws.

### 4.1 Empirical Strategy and Data

Using data from the SCF (Survey of Consumer Finance), we compare credit access, debt, and delinquency rates for households in states with more liberal payday laws. We focus on differences for those particular households who, according to our model, are more most vulnerable to manipulation by predatory payday lenders, i.e. "prey." To identify differences that are more likely associated with payday lending, we compare the differences for prey in payday states before and after payday lending arrived on the consumer credit market.

We want to control for a host of other variables that might affect credit supply or demand, so we compute the differences using multi-variate regression analysis. Using SCF data on household $h$ in state $s$, we estimate regressions of the form:

$$ D_{hs} = f(PREY_{hs} \cdot PAYDAY\ LIMIT_s \cdot 2001, CONTROLS_{hs}) + \epsilon_{hs}. \quad (9) $$

$D$ equals one of three dependent variables: DENIED, DEBT\_NM, and DELINQUENT. DENIED equals one for households who reported being denied credit over the year before the survey (0 for other households).\footnote{More precisely, DENIED = 1 for households reporting that they were turned down for credit previous year, given less credit than they demanded, or did not apply for credit because they expected to be denied. DENIED = 0 otherwise.} DEBT\_NM equals non-mortgage debt owed by households. DELINQUENT equals one of households that reported missing any debt payments over the year before the survey (zero for other households).

DENIED and DELINQUENT are discrete variables so we estimate those regressions via Probit. DEBT\_NM, though continuous, is truncated zero, so that regression is estimated via Tobit.

The key independent variables are the interactions: $PREY_{hs} \cdot PAYDAY\ LIMIT_s \cdot 2001$ $PREY_{hs}$ is one of three indicators of potential marks for predators, discussed momentarily. PAYDAY\ LIMIT$_s$ equals the limit on payday loans in state $s$. We include another dummy, UNLIMITED, equal to one for states that allow unlimited payday loans (zero for
other states). The dummy variable 2001 equals one for households surveyed in 2001 or zero for households surveyed in 1995. Thus, the coefficients on \(\text{PREY}_{hs} \cdot \text{PAYDAY \ LIMIT}_s \cdot 2001\) indicate whether any difference in dependent variable \(D\) for prey in states with higher payday loan limits changed between 1995 and 2001.

\(\text{PREY}_{hs}\) is one of three indicators of potential marks, i.e., households must vulnerable to predatory lending. \(\text{UNCERTAIN \ INCOME}\) equals one for households who reported being uncertain about their future income (0 for other households). \(\text{NO \ COLLEGE \ DEGREE}\) equals one for households without a college degree (0 for households with a degree). Less educated households and households with uncertain income may be easier to fool, so those two prey proxies follow more or less from our model.

Our third proxy is more ad hoc. \(\text{SMOKER}\) equals one if the head of the household reported being a smoker (0 if not). If smoking implies hyperbolic discounting, then smokers may be vulnerable to predatory lending. However, if smoking implies high, but not hyperbolic discounting, then payday lenders cannot prey on smokers, even though they may help smokers satisfy their high demand for credit.

\(\text{CONTROLS}\) is a long list of financial variables (income, squared, assets), demographic variables (age, marital status, family size, race, gender, urban, job tenure), economic variables (county unemployment), attitudinal variables (“thinks credit is a bad idea”) bank concentration (local market bank herfindahl), bank regulatory history (years since branching and interstate banking were permitted), and lastly, household bankruptcy exemptions. Our control set is essentially as in Gropp et al. (1997) except we use bankruptcy exemptions as of 1999 from Lehnert and Maki’s (2002).

\(^8\)Caskey (2002) figures there were fewer than 200 payday lenders at the at the beginning of the 1990s. Rotunday, the CEO of EZ Corp (a pawnbroker) did not notice competition from payday lenders until the late 1990s (see above). Based on those observations, we compare household debt and delinquency from the SCF in 1995 (“before payday lending”) and 2001 (“after payday lending”).

\(^9\)In econometric terms, we are conducting difference-in-difference-in-difference analyses. First we estimate differences in dependent variable \(D\) for households that are potential prey, \(dD\). Then we estimate the difference in \(dD\) for prey living in states that allow higher payday loans, \(ddD\). That second difference might be significant all the time, just by coincidence, so we estimate the difference in \(ddD\) between 1995 and 2001, \(dddD\). That third difference indicates whether differences in \(dD\) for prey changed after Payday lending arrived on the market.
Table 2 reports provides summary statistics for all the regression variables.\textsuperscript{10} Twenty-one percent of households were denied credit in the year before the survey. Sixteen percent of households missed a payment. Mean debt (non-mortgage) was $11,500, but median debt was only $2300.\textsuperscript{11} Note the prevalence of potential prey: 68 percent of households lacked a college degree, 31 percent were uncertain about their income, and 29 percent smoked. Fifty-six percent of households lived in states with payday lending, but just three percent of households lived in states with unlimited payday loans.

4.1.1 Identification

Our strategy is to compare debt and delinquency for certain subsets of households that \textit{a priori} seem more susceptible to predation. But what if Payday lending represents an increase in the supply of credit? How can we distinguish predatory, i.e., artificial, increases in loan demand from legitimate increases in loan supply?

Our key identifying assumption is that if indeed Payday lenders increase credit supply, they increase supply to all households, not just potential prey (see Appendix). That is not a strong assumption. It merely means payday lenders do not discriminate one way or another against \textit{non-prey}. Granting that, we can identify any excess debt or delinquency among

\textsuperscript{10}The SCF in 1995 and 2001 covered 2,780 and 2,917 households, or 5,697 households in total. We study the area-probability sample that excludes the ”list sample” of wealthy households (as wealthy households seem less subject to predatory lending). Household’s state of residence are not publically available, so all our statistics and regressions were calculated by authorized analysts in the SCF Group at the Federal Reserve Board of Governors. Note that this confidential dataset contains 4,449 households whereas the public version only includes 4,442 households. This is due to the exclusion of 7 extremely wealthy households from the public dataset for disclosure reasons. The SCF actually comprises 5 separate datasets or “implicates” wherein missing data are multiply imputed. All our estimates and standard errors are computed using the Repeat Imputation Inference (RII) techniques. See Montalto and Sung (1996) for an accessible introduction to RII.

\textsuperscript{11}We also ran our regressions for low (below median) income. Non-mortgage debt for that sample averaged $6700, so a $300 difference associated with payday lending might be detectable. We did not find any such difference, however. The SCF does not ask households about payday loans specifically. We experimented with debt from ”finance and loan companies,” a category that should comprise payday lenders, but because the subset of households with debt from such institutions was so small, the Tobit estimates did not converge.
prey as evidence that payday lenders artificially boost credit demand.

### 4.2 Regression Results (Table 3)

Column 1 reports \textit{dprobit}(DENIED) regression coefficients. \textit{Dprobit} calculates the change in probability(DENIED = 1) as the indicator variables switch on or off. Risky households (with uncertain income) and less educated households (without a college degree were) surveyed in 1995 were 5.4 percent and 6.6 percent more likely to have been denied credit than their safer, more educated counterparts. Given all the other controls, those differences suggest that riskier, less educated households were more credit constrained in 1995. Those constraints were certainly no looser in states that would (eventually) allow unlimited payday loans. On the contrary, risky households in unlimited payday loan states surveyed in 1995 were more likely to be denied credit than their counterparts in other states. By 2001, however, risky households and less educated households living in states with unlimited payday loans were 14.1 percent and 15.0 percent \textit{less} likely to have been denied credit. That pattern of differences and the change over time suggests that payday lending, at least in unlimited quantities, has increased credit access for riskier, less educated households.

Roughly the same differences and changes over time are apparent for smokers. Smokers surveyed in 1995 were 4.3 percent more likely to be turned down for credit, regardless of their state. Smokers surveyed in 2001 were significantly less likely to be turned down, the higher the limit on payday loans in their state. A one standard deviation increase in the PAYDAY LIMIT ($234) reduces the probability(DENIED) by 6.3 percent.

Column 2 reports \textit{Tobit}(DEBT_NM) regression coefficients. Less educated households in states unlimited payday loan states were were surveyed in 2001 had higher debt than their counterparts in states with limited payday loans. That difference, though only marginally significant, is consistent with the predatory hypothesis.

Column 3 reports \textit{dprobit}(DELINQUENT) regression coefficients. In general, delinquency rates were not higher for \textit{prey} surveyed in 2001, even those living in states with higher or unlimited payday limits. On the contrary, risky households (with uncertain income) surveyed in 2001 were nine percent \textit{less} likely to have missed a payment if their state
allowed unlimited payday loans.  

In sum, our findings suggest that riskier, less educated households, and smokers, were less likely to be turned down for credit if their state allowed unlimited or larger payday loans. That might indicate that payday lenders relax credit constraints, or, that the limits on payday loans do in fact bind. Debt is significantly higher for households with uncertain income in payday states in 200. That difference, though only marginally significant, seems consistent with the predatory hypothesis. However, higher payday loan limits are not associated with higher delinquency rates for less educated households, riskier households, or smokers. If anything, we find the opposite: risky households surveyed in 2001 in states with unlimited payday loans were marginally less likely to have missed a debt payment.

5 Does Competition Work in Payday Lending?

The main complaint against payday lenders are their high fees. The 390 percent annual rate implied by a $15 fee per $100 per two week loan strikes critics as usurious or unconscionable, hence the many states with usury limits on payday loan prices. Economists might expect competition among payday lenders and pawnshops to drive prices down to the level that just covered the costs of producing the loans. This section presents evidence consistent with the hypothesis that competition works; using a small data set of "found" data, we find lower payday prices in cities with more payday lenders and pawnshops per capita.

The data on payday loan prices are from 2001 survey conducted by the U.S. Public Interest Research Group (PIRG) and the Consumer Federation of American of 235 payday lenders located in 62 cities and twenty states (and D.C.) In their analysis of the data,

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12 Regressions estimated over the set of households with low (below median) income yielded qualitatively similar differences (same signs and magnitudes) to those noted in Table 3 and 4, though in some cases the differences were less significant, particularly the differences associated with unlimited payday loans. The fraction of households live in states with unlimited payday loans was small, and the fraction of low income households in those states was even smaller, so the loss of significance mostly reflects higher standard errors in the estimates, not smaller coefficients.

13 Payday loans are very small so it is not necessarily inconsistent to find looser credit constraints in payday states without finding higher debt.

14 Most surveys were conducted by employee or volunteer visits to payday offices, although some were
Fox and Mierzwinski (2001, p. 14) observed that about half the lenders charged fees at or above the usury limit set by the states. “If competition were really working..., ” they conclude, “we would expect many more firms to offer and advertise lower rates.” The PIRG survey lacked a measure of competition, however, so they did not test their conclusion that competition fails in payday lending.

Our data on the number of payday stores in various cities are from Graves and Peterson (2005). Their study pinpoints the location of payday stores by zip code in twenty states with military bases to see if payday lenders “target” soldiers. They demonstrate conclusively that payday lenders do cluster around bases; for example, the 92054 zip code comprising Camp Pendleton had 22 payday outlets, 17 more than expected given the population in that zip.

To see if competition works in the payday credit market, we matched Graves and Petersons’ (2005) data on the number of payday lenders with PIRGs’ (2001) data on payday loan prices and fees. The number of cities that overlapped in the two studies was 37 (Table 4A).15

These ”found” data are biased against the competition hypothesis for at least two reasons. First, the number of payday stores tabulated by Graves and Peterson (2005) will overstate competition if some stores have the same owner. Second, more stores per capita might also signal higher demand for payday loans (and hence, higher prices) rather than higher supply.16

The regressions in Table 4B (and Figure 3) indicate that payday prices decline as the number of payday stores per capita increases. An extra 50 payday stores/10000 (about conducted by phone. The surveyors did not borrow from the payday lenders; they simply looked for signs posting fees or asked store clerks to quote fees. 

15PIRG’s (2001) survey covered multiple payday lenders per city. We use the average loan rate and fee for payday lenders in the same city. We obtain similar results using medians instead of means.

16That second bias is distinctly possible here, because Graves and Petersons’ (2004) study covered states with military bases, and soldiers may have high demand for payday loans. A third possible source of bias: payday prices are from 2001, but the numbers on stores are from 2004-5. Stores in 2004 should be correlated stores in 2001, but the cities where payday stores grew fastest in the interim may be those with the highest prices in 2001 (hence inviting new entry).
one standard deviation) is associated with a $0.50 drop in the loan price (column 1).\footnote{Without the extreme (fee = $30) observation, the coefficient on Payday lenders/100,000 equals .0074. (p = 0.091).} Payday store prices also decline as the number of \textit{pawnshops} per capita increases (column 2), consistent with other evidence that payday lenders pawnshops are in competition. In fact, we cannot reject the hypothesis that the more pawnshops per capita has the same effect on payday prices and more payday stores.

6 Conclusion

"Predatory" is an inflammatory term used to condemn high prices, excessive lending, and other allegedly dubious practices by payday lenders and subprime mortgage lenders. However, even reformers admit that "predatory" is hard to define, so that is where our paper starts. We define predatory lending as a welfare \textit{reducing} provision of credit, and we show how a voluntary transaction can make borrowers worse off if lenders contrive to increase loan demand by exaggerating households’ income prospects. Predation in our model resembles advertising; advertisers accentuate how much pleasure their product brings, while predators attenuate how much a loan will cost (in terms of future well-being). We show that lenders will prey as long as the extra revenue from larger loans exceeds the cost of fooling households into overborrowing and any associated increase in default risk.

Our concept of predatory lending may not correspond to the specific practices of payday lenders and subprime mortgage lenders that reformers condemn, but it comes close. Both lenders are accused of entrapping borrowers in a cycle of refinancings and delinquency by lending more than households can afford. The predators in our model lend excessively, and the extra debt leads to higher risk of delinquency. Reformers also condemn payday lenders for ”targeting vulnerable consumers” (PIRG 2001) that are less sophisticated. The predators in our model naturally prey on households that are easier to fool.

Our model helps distinguish \textit{predatory} lending from the other kind of lending, the kind that helps households maintain consumption even as their income fluctuates. While reformers tend to focus on the interest rates charged by alleged predators, our model shows that
predators do not always charge more than ordinary lenders. Predators always lend more, however, and the extra debt may push borrowers to the brink of default. If payday lenders were exploiting gullible households, we would expect to find higher debt and delinquency rates among easier-to-fool-households (prey) in states with higher payday loan limits. While we do find higher debt for one such set of households, we do not find higher delinquency. On the contrary, delinquency rates were marginally lower for risky households in states with unlimited payday loans. Risky households and less educated households were also less likely to report being turned down for credit if their state allowed unlimited payday loans.

Those findings of lower delinquency and looser credit constraints applies for only to the very small subset of households in our sample, but they are still tantalizing; despite its high cost, perhaps payday loans help risky households better manage their finances? It will take more data to confirm that particular conjecture, however. In general, we caution that our data are very indirect since we cannot specifically identify households who borrowed from a payday lender.

The differences we find for smokers are interesting, but harder to interpret in terms of predatory lending. Smokers in states with higher payday limits are less likely to be turned down for credit. The looser credit constraints could mean that smokers have high loan demand (because they have discount rates) and that payday lenders help satisfy that urge, or it could mean that smokers have hyperbolic discount rates (that make them procrastinators) and that payday lenders exploit that (we do not find higher delinquency rates for smokers in payday states, however). We cannot distinguish those interpretations without further tests.18

While reformers often advocate usury limits on payday lending, we find some evidence that competition among payday lenders (and pawnshops) may obviate usury limits. Using a small set of data, we find that payday loan rates and fees decline significantly as the number of payday lenders and pawnshops increase. Despite their alleged naiveté, payday borrowers appear sophisticated enough to shop for lower prices. The problem of high prices may reflect too few payday lenders, rather than too many. If scrutiny and prosecution risk

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18Smoking might also simply be a better way to identify the socioeconomic class that borrows from payday lenders.
limit entry into payday lending, the lack of competition may drive rates higher. In the end, the simple fact that payday lenders have triumphed over pawnshops suggests that payday lending raises household welfare by providing a preferable alternative.\textsuperscript{19}

\textsuperscript{19}The extra (or more convenient) credit can be welfare reducing only for households with behavioral problems that make them borrow too much to begin with.
References


6.1 Appendix: Identification Algebra

Suppose loan demand and supply for household $h$ in state $s$ equals

$$B_d^{hs} = -ar_{hs} + bP_s + cp_{hs} + \tau P_sp_{hs} + z_{hs} \quad (10)$$

$$B_s^{hs} = +dr_{hs} + eP_s + fp_{hs} + \tau P_sp_{hs} + \eta_{hs} \quad (11)$$

where $P_s$ equals one if state $s$ allow payday lending and $p_{hs}$ equals one if household $h$ in state $j$ is potential prey, e.g., a household with uncertain income. The coefficients $a$ and $d$ measure the interest sensitivity of loan demand and supply, respectively. We assume $a \geq 0$ and $d \geq 0$. The coefficients $c$ and $e$ allows for any inherent and legitimate differences in loan demand and supply for prey. The coefficients $b$ and $f$ allows for any general, legitimate differences in loan demand and supply in states with payday lending. We make no assumption about $c, f, b$, and $e$.

The equilibrium quantity of debt for household $h$ in state $s$ equals

$$B_{hs} = \frac{(db - ac)P_{hs} + (dc - af)p_{hs} + (d\tau - a\tau')P_sp_{hs} + dz_{hs} - a\eta_{hs}}{d - a} \quad (12)$$

The difference in debt for prey in payday states for prey equals

$$\frac{\delta^2 B_{hs}}{\delta P_s\delta p_{hs}} = \frac{d\tau + a\tau'}{d + a} \quad (13)$$

The predatory hypothesis implies $\tau > 0$. We can identify whether $\tau > 0$ by comparing debt levels for prey across payday and non-payday states as long as $\tau' = 0$, i.e., as long as payday lenders are equally willing to supply credit to prey and non-prey alike.
Figure 1
Growing Predatory Concerns

Number of articles containing "predatory" in American Banker, 1994-2004 (quarterly)
Figure 2
Payday share prices (AACE) have risen. Pawnshops (EXPW) have fallen.
Figure 4
More Payday Stores—Lower Payday Prices

Regression: Fee/$100 = 17.5 - 0.011 \times \text{Payday/100,000}

Graves and Peterson (2005)

Average Fee/$100 Across Cities (Fox 2001)

Payday Stores/100,000 Across Cities (Graves and Peterson 2005)
<table>
<thead>
<tr>
<th>State</th>
<th>Allows Payday</th>
<th>Payday Loan Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>No</td>
<td>0</td>
</tr>
<tr>
<td>Alaska</td>
<td>No</td>
<td>0</td>
</tr>
<tr>
<td>Arkansas</td>
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<td>0</td>
</tr>
<tr>
<td>Connecticut</td>
<td>No</td>
<td>0</td>
</tr>
<tr>
<td>Georgia</td>
<td>No</td>
<td>0</td>
</tr>
<tr>
<td>Indiana</td>
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<td>0</td>
</tr>
<tr>
<td>Maine</td>
<td>No</td>
<td>0</td>
</tr>
<tr>
<td>Maryland</td>
<td>No</td>
<td>0</td>
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<tr>
<td>Massachusetts</td>
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<td>Michigan</td>
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<td>Vermont</td>
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<td>0</td>
</tr>
<tr>
<td>Virginia</td>
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<td>0</td>
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<tr>
<td>Hawaii</td>
<td>Yes</td>
<td>300</td>
</tr>
<tr>
<td>Montana</td>
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</tr>
<tr>
<td>South Carolina</td>
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<td>Louisiana</td>
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<td>Minnesota</td>
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<tr>
<td>Texas</td>
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<tr>
<td>Illinois</td>
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<td>400</td>
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<td>Mississippi</td>
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<tr>
<td>Missouri</td>
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</tr>
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<td>Nebraska</td>
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<td>North Dakota</td>
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<td>Ohio</td>
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<td>Tennessee</td>
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<td>Washington</td>
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<td>Oklahoma</td>
<td>Yes</td>
<td>730</td>
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<td>Kansas</td>
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<td>860</td>
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<td>District of Columbia</td>
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<td>Nevada</td>
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<td>1250</td>
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<td>Delaware</td>
<td>Yes</td>
<td>No Limit</td>
</tr>
<tr>
<td>Idaho</td>
<td>Yes</td>
<td>No Limit</td>
</tr>
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<td>New Hampshire</td>
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<td>No Limit</td>
</tr>
<tr>
<td>New Mexico</td>
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<td>No Limit</td>
</tr>
<tr>
<td>Oregon</td>
<td>Yes</td>
<td>No Limit</td>
</tr>
<tr>
<td>South Dakota</td>
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<td>No Limit</td>
</tr>
<tr>
<td>Utah</td>
<td>Yes</td>
<td>No Limit</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>Yes</td>
<td>No Limit</td>
</tr>
<tr>
<td>Wyoming</td>
<td>Yes</td>
<td>No Limit</td>
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</table>
Table 2 Sample Statistics
Statistics calculated over 5,697 households in area-probability samples in 1995 and 2001 Survey of Consumer Finance

<table>
<thead>
<tr>
<th>Variable</th>
<th>Units</th>
<th>Mean</th>
<th>Std. dev.</th>
<th>Median</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Dependent variables:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Denied Credit in Last Year?</td>
<td>Yes = 1; No = 0</td>
<td>0.21</td>
<td>0.41</td>
<td>0.00</td>
</tr>
<tr>
<td>Non-mortgage Debt</td>
<td>($10,000)</td>
<td>1.15</td>
<td>3.25</td>
<td>0.23</td>
</tr>
<tr>
<td>Delinquent on Any Debt Payment in Last Year?</td>
<td>Yes = 1; No = 0</td>
<td>0.16</td>
<td>0.37</td>
<td>0.00</td>
</tr>
<tr>
<td><strong>State Payday Lending Regulations</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payday Loan Limit</td>
<td>($)</td>
<td>230.12</td>
<td>234.31</td>
<td>300.00</td>
</tr>
<tr>
<td>Unlimited Payday Loans?</td>
<td>Yes = 1; No = 0</td>
<td>0.03</td>
<td>0.18</td>
<td>0.00</td>
</tr>
<tr>
<td>Payday Loan Permitted?</td>
<td>Yes = 1; No = 0</td>
<td>0.56</td>
<td>0.50</td>
<td>1.00</td>
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<td><strong>Proxies for “Prey:”</strong></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Uncertain Income?</td>
<td>Yes = 1; No = 0</td>
<td>0.31</td>
<td>0.46</td>
<td>0.00</td>
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<td>No College Degree?</td>
<td>Yes = 1; No = 0</td>
<td>0.68</td>
<td>0.46</td>
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<td>Smoker?</td>
<td>Yes = 1; No = 0</td>
<td>0.29</td>
<td>0.45</td>
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<td><strong>Control variables:</strong></td>
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<tr>
<td>Years Since State Permitted Intra-state Branching</td>
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<td>16.00</td>
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<td>Years Since State Permitted Interstate Branching</td>
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<td>12.15</td>
<td>3.55</td>
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<td>Local Market Herfindahl</td>
<td>max = 100</td>
<td>14.71</td>
<td>8.59</td>
<td>13.17</td>
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<tr>
<td>Bankruptcy Exemption</td>
<td>($10,000)</td>
<td>11.15</td>
<td>23.65</td>
<td>3.00</td>
</tr>
<tr>
<td>Bankruptcy Exemption X Assets</td>
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<td>5.18</td>
<td>40.54</td>
<td>0.36</td>
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<tr>
<td>Household Age</td>
<td>Years</td>
<td>47.04</td>
<td>16.84</td>
<td>44.00</td>
</tr>
<tr>
<td>Age²</td>
<td>Years²</td>
<td>2,496.54</td>
<td>1,756.62</td>
<td>1,936.00</td>
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<tr>
<td>Income</td>
<td>($10,000)</td>
<td>5.25</td>
<td>9.42</td>
<td>3.62</td>
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<tr>
<td>Income Squared</td>
<td>($100,000,000)</td>
<td>116.28</td>
<td>2,319.81</td>
<td>13.13</td>
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<tr>
<td>Assets</td>
<td>($1,000,000)</td>
<td>0.34</td>
<td>1.72</td>
<td>0.11</td>
</tr>
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<td>Married?</td>
<td>Yes = 1; No = 0</td>
<td>0.59</td>
<td>0.49</td>
<td>1.00</td>
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<tr>
<td>Family Size</td>
<td>persons</td>
<td>2.43</td>
<td>1.40</td>
<td>2.00</td>
</tr>
<tr>
<td>Non-White?</td>
<td>Yes = 1; No = 0</td>
<td>0.24</td>
<td>0.42</td>
<td>0.00</td>
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<td>Male?</td>
<td>Yes = 1; No = 0</td>
<td>0.72</td>
<td>0.45</td>
<td>1.00</td>
</tr>
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<td>Rural?</td>
<td>Yes = 1; No = 0</td>
<td>0.25</td>
<td>0.43</td>
<td>0.00</td>
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<tr>
<td>Years at Current Employer</td>
<td></td>
<td>6.65</td>
<td>9.23</td>
<td>2.00</td>
</tr>
<tr>
<td>Thinks Credit Is Bad Idea?</td>
<td>Yes = 1; No = 0</td>
<td>0.30</td>
<td>0.46</td>
<td>0.00</td>
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<tr>
<td>County Unemployment Rate</td>
<td></td>
<td>5.08</td>
<td>1.83</td>
<td>4.70</td>
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</table>
Table 3 Differences in Denial, Debt, and Delinquency in States with Higher Payday Limits
Reported are regression coefficients (robust standard errors). DENIED = 1 for households who were denied credit in year before survey (0 otherwise). DEBT_NM equals household’s non-mortgage debt. DELINQUENCY = 1 if households reported missing debt payment in previous year. PAYDAY LIMIT = state limit on payday loans (0 to $1250). UNLIMITED = 1 for the nine states without limits, 0 otherwise states. 2001 = 1 for households surveyed in 2001 (0 for households surveyed in 1995). Regressions estimated over 5697 households in 1995 and 2001 SCF.

<table>
<thead>
<tr>
<th>Dependent Variable (model)</th>
<th>DENIED (DProbit)</th>
<th>DEBT_NM (Tobit)</th>
<th>DELINQUENT (DProbit)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Payday Limit X Uncertain X 2001</strong></td>
<td>-6.84E-06 (9.18E-05 )</td>
<td>2.33E-04 (9.42E-04 )</td>
<td>-8.39E-05 (9.16E-05 )</td>
</tr>
<tr>
<td><strong>Unlimited X Uncertain X 2001</strong></td>
<td>-0.141*** (0.029)</td>
<td>-0.241 (1.200)</td>
<td>-0.090* (0.052)</td>
</tr>
<tr>
<td><strong>Payday Limit X No College X 2001</strong></td>
<td>9.60E-05 (9.80E-05 )</td>
<td>0.001 (0.001)</td>
<td>3.61E-05 (8.93E-05 )</td>
</tr>
<tr>
<td><strong>Unlimited X No College X 2001</strong></td>
<td>-0.150*** (0.026)</td>
<td>2.722* (1.479)</td>
<td>0.036 (0.134)</td>
</tr>
<tr>
<td><strong>Payday Limit X Smoker X 2001</strong></td>
<td>-2.74E-04 *** (9.31E-05 )</td>
<td>2.18E-05 (8.04E-04 )</td>
<td>-4.71E-05 (8.63E-05 )</td>
</tr>
<tr>
<td><strong>Unlimited X Smoker X 2001</strong></td>
<td>0.054 (0.153)</td>
<td>-0.798 (1.207)</td>
<td>-0.036 (0.086)</td>
</tr>
<tr>
<td>Payday Loan Limit</td>
<td>2.17E-05 (6.29E-05 )</td>
<td>9.72E-04 (6.82E-04 )</td>
<td>1.67E-05 (5.34E-05 )</td>
</tr>
<tr>
<td>Unlimited Payday Loans?</td>
<td>-0.125*** (0.039)</td>
<td>0.039 (0.801)</td>
<td>0.001 (0.069)</td>
</tr>
<tr>
<td>Uncertain Income?</td>
<td>0.054** (0.024)</td>
<td>-0.081 (0.203)</td>
<td>-9.61E-04 (0.023)</td>
</tr>
<tr>
<td>No College Degree?</td>
<td>0.065*** (0.022)</td>
<td>-0.151 (0.247)</td>
<td>0.009 (0.021)</td>
</tr>
<tr>
<td>Smoker?</td>
<td>0.043* (0.023)</td>
<td>-0.400** (0.189)</td>
<td>0.034 (0.024)</td>
</tr>
<tr>
<td>2001 Dummy</td>
<td>-0.007 (0.037)</td>
<td>-0.168 (0.410)</td>
<td>-0.072** (0.033)</td>
</tr>
<tr>
<td><strong>Payday Limit X 2001</strong></td>
<td>4.29E-05 (8.67E-05 )</td>
<td>-5.84E-04 (0.001)</td>
<td>7.46E-05 (7.32E-05 )</td>
</tr>
<tr>
<td>Unlimited Payday X 2001</td>
<td>0.404* (0.208)</td>
<td>-1.689 (1.270)</td>
<td>0.049 (0.124)</td>
</tr>
<tr>
<td>Uncertain X 2001</td>
<td>-0.012 (0.030)</td>
<td>-0.308 (0.312)</td>
<td>0.044 (0.035)</td>
</tr>
<tr>
<td>No College X 2001</td>
<td>0.003 (0.034)</td>
<td>-0.373 (0.441)</td>
<td>0.024 (0.032)</td>
</tr>
<tr>
<td>Smoker X 2001</td>
<td>0.035 (0.034)</td>
<td>0.442 (0.269)</td>
<td>0.033 (0.033)</td>
</tr>
<tr>
<td><strong>Payday Limit X Uncertain</strong></td>
<td>8.02E-06 (6.50E-05 )</td>
<td>-9.56E-05 (6.96E-04 )</td>
<td>2.95E-05 (6.68E-05 )</td>
</tr>
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</table>

Table 3 continues . . .
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<th>Table 3 (continued)</th>
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<td>Unlimited Payday X Uncertain</td>
<td>0.308**</td>
<td>0.163</td>
<td>0.103</td>
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<td></td>
<td>(0.137)</td>
<td>(0.904)</td>
<td>(0.109)</td>
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<tr>
<td>Payday Limit X No College</td>
<td>-1.04E-04</td>
<td>-4.35E-04</td>
<td>-6.62E-05</td>
</tr>
<tr>
<td></td>
<td>(6.95E-05)</td>
<td>(7.25E-04)</td>
<td>(6.26E-05)</td>
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<tr>
<td>Unlimited Payday X No College</td>
<td>0.081</td>
<td>-0.571</td>
<td>-0.019</td>
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<td></td>
<td>(0.124)</td>
<td>(0.859)</td>
<td>(0.071)</td>
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<tr>
<td>Payday Limit X Smoker</td>
<td>8.22E-05</td>
<td>-3.56E-04</td>
<td>1.65E-05</td>
</tr>
<tr>
<td></td>
<td>(6.41E-05)</td>
<td>(5.54E-04)</td>
<td>(6.27E-05)</td>
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<tr>
<td>Unlimited Payday X Smoker</td>
<td>0.119</td>
<td>0.475</td>
<td>0.038</td>
</tr>
<tr>
<td></td>
<td>(0.122)</td>
<td>(0.798)</td>
<td>(0.086)</td>
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<tr>
<td>Age (years)</td>
<td>0.002</td>
<td>0.113***</td>
<td>0.004**</td>
</tr>
<tr>
<td></td>
<td>(0.002)</td>
<td>(0.026)</td>
<td>(0.002)</td>
</tr>
<tr>
<td>Age Squared</td>
<td>0.000***</td>
<td>-0.002***</td>
<td>0.000***</td>
</tr>
<tr>
<td></td>
<td>(0.000)</td>
<td>(0.000)</td>
<td>(0.000)</td>
</tr>
<tr>
<td>Income</td>
<td>-0.011***</td>
<td>0.114***</td>
<td>-0.005**</td>
</tr>
<tr>
<td></td>
<td>(0.003)</td>
<td>(0.034)</td>
<td>(0.002)</td>
</tr>
<tr>
<td>Income Squared</td>
<td>0.000***</td>
<td>0.000**</td>
<td>0.000**</td>
</tr>
<tr>
<td></td>
<td>(0.000)</td>
<td>(0.000)</td>
<td>(0.000)</td>
</tr>
<tr>
<td>Assets</td>
<td>0.006</td>
<td>0.129</td>
<td>0.012***</td>
</tr>
<tr>
<td></td>
<td>(0.005)</td>
<td>(0.107)</td>
<td>(0.004)</td>
</tr>
<tr>
<td>Married?</td>
<td>-0.027</td>
<td>0.576***</td>
<td>-0.026</td>
</tr>
<tr>
<td></td>
<td>(0.018)</td>
<td>(0.186)</td>
<td>(0.017)</td>
</tr>
<tr>
<td>Family Size</td>
<td>0.017***</td>
<td>0.005</td>
<td>0.020***</td>
</tr>
<tr>
<td></td>
<td>(0.004)</td>
<td>(0.049)</td>
<td>(0.004)</td>
</tr>
<tr>
<td>Non-White?</td>
<td>0.090***</td>
<td>-0.252**</td>
<td>0.039***</td>
</tr>
<tr>
<td></td>
<td>(0.014)</td>
<td>(0.120)</td>
<td>(0.013)</td>
</tr>
<tr>
<td>Male?</td>
<td>-0.024</td>
<td>0.120</td>
<td>-0.003</td>
</tr>
<tr>
<td></td>
<td>(0.016)</td>
<td>(0.146)</td>
<td>(0.016)</td>
</tr>
<tr>
<td>Rural?</td>
<td>-0.029**</td>
<td>-0.099</td>
<td>0.023*</td>
</tr>
<tr>
<td></td>
<td>(0.013)</td>
<td>(0.127)</td>
<td>(0.014)</td>
</tr>
<tr>
<td>Years at Current Employer</td>
<td>-0.003***</td>
<td>0.022***</td>
<td>0.000</td>
</tr>
<tr>
<td></td>
<td>(0.001)</td>
<td>(0.007)</td>
<td>(0.001)</td>
</tr>
<tr>
<td>Thinks Credit Is Bad Idea?</td>
<td>-0.003</td>
<td>-0.302**</td>
<td>0.006</td>
</tr>
<tr>
<td></td>
<td>(0.011)</td>
<td>(0.119)</td>
<td>(0.010)</td>
</tr>
<tr>
<td>County Unemployment Rate</td>
<td>0.003</td>
<td>0.031</td>
<td>0.001</td>
</tr>
<tr>
<td></td>
<td>(0.003)</td>
<td>(0.033)</td>
<td>(0.003)</td>
</tr>
<tr>
<td>Years Instate Branching Permitted</td>
<td>0.002**</td>
<td>0.002</td>
<td>6.84E-04</td>
</tr>
<tr>
<td></td>
<td>(7.22E-04)</td>
<td>(0.008)</td>
<td>(6.75E-04)</td>
</tr>
<tr>
<td>Years Interstate Branching Permitted</td>
<td>-9.59E-04</td>
<td>0.054</td>
<td>0.002</td>
</tr>
<tr>
<td></td>
<td>(0.003)</td>
<td>(0.042)</td>
<td>(0.003)</td>
</tr>
<tr>
<td>Local Market Herfindahl</td>
<td>0.000</td>
<td>-0.001</td>
<td>-0.001</td>
</tr>
<tr>
<td></td>
<td>(0.001)</td>
<td>(0.006)</td>
<td>(0.001)</td>
</tr>
<tr>
<td>Bankruptcy Exemption</td>
<td>0.000</td>
<td>0.002</td>
<td>0.001**</td>
</tr>
<tr>
<td></td>
<td>(0.000)</td>
<td>(0.003)</td>
<td>(0.000)</td>
</tr>
<tr>
<td>Bankruptcy Exemption X Assets</td>
<td>0.000</td>
<td>0.004</td>
<td>0.000</td>
</tr>
<tr>
<td></td>
<td>(0.001)</td>
<td>(0.006)</td>
<td>(0.000)</td>
</tr>
</tbody>
</table>
**Table 4A  Statistics on Payday Loan Prices and Stores across 37 U.S. Cities**

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>Median</th>
<th>Std. Dev.</th>
<th>Min</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price (per $100 borrowed)&lt;sup&gt;1&lt;/sup&gt;</td>
<td>17.1</td>
<td>16.8</td>
<td>2.6</td>
<td>14.6</td>
<td>30.0</td>
</tr>
<tr>
<td>Payday Stores (per 100K)&lt;sup&gt;2&lt;/sup&gt;</td>
<td>43.6</td>
<td>17.7</td>
<td>52.1</td>
<td>3.2</td>
<td>169.4</td>
</tr>
<tr>
<td>Pawnshops (per 100K)&lt;sup&gt;3&lt;/sup&gt;</td>
<td>30.0</td>
<td>12.0</td>
<td>47.1</td>
<td>1.0</td>
<td>240.3</td>
</tr>
<tr>
<td>Population</td>
<td>31.2</td>
<td>10.2</td>
<td>64.2</td>
<td>.21</td>
<td>3,695</td>
</tr>
</tbody>
</table>

<sup>1</sup> Fox and Mierzwinski (2001)  
<sup>2</sup> Graves and Peterson (2005)  
<sup>3</sup> Yellowpages.com.  
<sup>4</sup> Overlapping cities in Fox and Mierzwinski (2001) and Graves and Peterson (2005).

---

**Table 4B  More Payday Stores…Lower Payday Prices?**

Ordinary least squares coefficient estimates (robust standard errors). Dep. Var. = Price per $100

<table>
<thead>
<tr>
<th></th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payday Stores</td>
<td>0.013**</td>
<td>-</td>
<td>-0.009</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>(0.005)</td>
<td>(0.007)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pawnshops</td>
<td>-</td>
<td>-0.013**</td>
<td>-0.006</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.006)</td>
<td>(0.006)</td>
<td></td>
</tr>
<tr>
<td>Payday Stores + Pawnshops</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-0.008**</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(0.003)</td>
</tr>
<tr>
<td>Population</td>
<td>-0.007**</td>
<td>-0.006**</td>
<td>-0.007**</td>
<td>-0.007**</td>
</tr>
<tr>
<td></td>
<td>(0.003)</td>
<td>(0.003)</td>
<td>(0.003)</td>
<td>(0.003)</td>
</tr>
<tr>
<td>Constant</td>
<td>17.86***</td>
<td>17.66***</td>
<td>17.66***</td>
<td>17.83***</td>
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<tr>
<td></td>
<td>(0.710)</td>
<td>(0.648)</td>
<td>(0.714)</td>
<td>(0.703)</td>
</tr>
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</table>

<table>
<thead>
<tr>
<th></th>
<th>0.069</th>
<th>0.059</th>
<th>0.073</th>
<th>0.073</th>
</tr>
</thead>
</table>

*P value for F-Test: 0.86

(0 Payday Store = Pawnshop)

*** Significant at the 99% level  ** Significant at the 95% level