

Payday Lending and Its Abuses: A Survey of Current Regulatory Approaches and Recommendations for the Future

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A payday loan can be defined as “a transaction in which a cash advance is made in exchange for a consumer’s personal check in the amount of the advance plus a fee and where the parties agree that the check will not be cashed or deposited until a designated future date.”¹ These are small, short-term loans—they range from approximately \$100-\$500, and they typically come due on the borrower’s next payday, or in 14 days.² Payday loans are generally conducted through check cashing businesses.

Payday lending is a booming business that has grown tremendously since it emerged as a common form of credit extension in the early 1990s.³ Approximately 65 million payday loan transactions occur annually, and the industry as a whole takes in more than \$2 billion per year in revenue.⁴ As lenders argue, “the broad national popularity of this short term financial product reflects a widespread economic need that is not being met by most traditional mainstream financial institutions.”⁵ For those without sufficient credit to take out a mainstream loan or access to a credit card, payday loans are the only option for emergency cash needs and thus serve an important function. However, payday lending, as it currently operates, has many negative ramifications for borrowers.

In general, the fees charged for such short-term loans translate into extremely high annual percentage rates (APRs). A survey of 235 lenders in 20 states, conducted in 2001 by the Consumer Federation of America and the U.S. Public Interest Research Group, showed that the fees charged for payday loans translated into APRs ranging

¹ 7 Tex. Admin. Code §1.605 (2002).

² Consumer Federation of America and United States Public Interest Research Group, Show Me The Money: A Survey of Payday Lenders and Review of Payday Lending in State Legislatures, February 2001, at 3.

³ Financial Service Centers of America, Freedom of Choice for Consumers: The Truth About Deferred Deposit Services, 1999, at 1.

⁴ Consumer Federation of America and United States Public Interest Research Group, Rent-a-Bank Payday Lending: How Banks Help Payday Lenders Evade State Consumer Protections, 2001, at 4.

⁵ Financial Service Centers, at 1.

from 182%-910%. The average fee for a two-week loan of \$100 was \$18.28, which translates into an APR of 470%.⁶

When those without much financial security take out payday loans with such high fees, they have a hard time paying them off and tend to get trapped in debt. “Few low and moderate income consumers can afford to repay the...check in one lump sum and still have enough to cover other expenses without having to roll-over the loan or borrow again before the next payday.”⁷ In 1999, Indiana’s Department of Financial Institutions conducted a study on payday lending. They found that the average payday borrower took out 10.19 payday loans per year, and 77% of the payday loans in Indiana were rollovers from previous payday loans.⁸ A similar study conducted in Illinois found that the average borrower had 13 loan contracts in the files over the course of a year with an average six-month relationship between borrower and lender before the loans were repaid.⁹ As a result of this study, the Illinois Department of Financial Institutions concluded that payday loan borrowers become “captive.”¹⁰

Furthermore, payday lenders are often deceptive and sneaky in the way that they present these loans to borrowers. They try to disguise loans as sale-like transactions, so that it appears the fees paid for the loans are payment in exchange for a service rather than interest on a loan. Lenders do this as a way of avoiding the state and federal laws that govern interest rates and other aspects of lending, which will be discussed later. Another effect of such deception, however, is that it confuses borrowers and makes it harder to discern the actual extent of the interest rates on these loans.¹¹

Because payday loans provide credit in emergency situations for a segment of the population that might otherwise be left without access to quick cash, payday lending should remain available. However this source of cash should be a fair option that does not take advantage of desperate borrowers and land them on a debt treadmill. As North Carolina Attorney General Roy Cooper explained, “Consumers should have the opportunity for small emergency loans...but [payday lenders are] charging \$17 per \$100 borrowed for a two-week loan. They’re claiming this can help a consumer in an emergency, but a loan like that is like asking for a life boat and being thrown an

⁶ Rent-a-Bank, at 4.

⁷ Rent-a-Bank, at 8.

⁸ Show Me the Money, at 8.

⁹ Show Me the Money, at 8.

¹⁰ Rent-a-Bank, 9

¹¹ Consumers Union, Wolf in Sheep’s Clothing: Payday Loans Disguise Illegal Lending, February 1999, at 3.

anvil.”¹² The challenge is to find a way to keep payday loans available, because they serve an important function, while minimizing their abuses so that they are fair for borrowers.

The purpose of this paper is to assess how this goal can best be achieved through government intervention. First, I will give a survey of current approaches to payday loan regulation on a state and federal level and look at the various efforts that have been taken to both evade and enforce these regulations. Then, I will look more closely at the trajectory payday lending has taken in 3 states as a means of giving substance and perspective to the various regulatory and enforcement approaches. Based on the lessons that can be derived from past and current attempts at handling payday lending, particularly as seen in these 3 states, I will argue that the key to stopping the abuses of payday lending is the enactment of strong, intelligent state laws to regulate payday loans, combined with active enforcement of these laws. Finally, I will show that action by state attorneys general is essential to this approach.

Trends in Regulation, Violations, Attempts at Evasion, and Enforcement

Current Laws

Payday loans fall under both state and federal laws, however they are primarily regulated by the states. Although the states vary widely with regards to how they regulate payday lending, they typically fall into three general categories. Most states have usury laws that establish maximum allowable interest rates. In 17 states, these are the only laws that govern payday loans.¹³ In an additional 28 states, these usury laws exist, but payday loans are statutorily exempted from the general interest rate caps.¹⁴ The states in this category have statutes establishing specific fee limitations and procedural requirements for payday loans. These statutes allow for payday lending by carving out exceptions to the usury law interest rate cap, though most still impose some sort of cap, ranging from 240% APR to 780% APR. (The fees are usually not listed according to APR, but in terms of a maximum fee per amount loaned over a certain period of time.) Many of the statutes also set forth requirements regarding lender

¹² Laura Bruce, “Payday lenders use banks to escape usury laws”, [Bankrate.com](#), February 4, 2002, at 3-4.

¹³ Rent-a-Bank, at 26.

¹⁴ Rent-a-Bank, at 27.

licensing, term length, and rollover procedures.¹⁵ Finally, in 5 states there are no usury laws or interest rate caps, and payday lending is allowed by default.¹⁶

Nationally, there has been a trend in state legislatures towards enacting specific payday loan regulations. The number of states with such regulations has grown steadily since payday loans emerged as a common form of credit in the early 1990s, and in the last year, 4 more states enacted specific payday statutes.¹⁷ There is generally a lot of lobbying activity surrounding the enactment of payday laws, coming from both consumers groups and the payday lenders. Some of the statutes that emerge are actually designed to better regulate payday loans, while others are clearly the products of extensive lobbying by payday lenders. Most regulations fall somewhere in between, with concessions in both directions.

Payday loans are also subject to the federal Truth in Lending Act, as implemented by the Federal Reserve's Regulation Z. It requires that lenders explicitly state their fees, both in terms of the dollar amount charged as well as in APR format. Lenders must also disclose what, if anything, they are taking as a security interest in the case that the loan is not repaid.¹⁸

Violations and Attempts to Evade the Laws

In many instances payday lenders operate in open violation of these various laws, and they commonly employ a variety of tactics in an attempt to evade them.

The 20-state survey of payday lenders, conducted in 2001, showed that state laws are regularly violated, even in states where the legislature has carved out an exception to the usury law to allow payday lenders to charge higher interest rates. In most of the states they surveyed, at least one lender, and often several, charged fees that exceeded the legal limit. Furthermore, they found that the lenders often failed to disclose the APR as required by the Truth in Lending Act—the APR was sometimes posted within the store, but it was rarely quoted by the clerk conducting the transaction or included in the written agreement.¹⁹

¹⁵ Rent-a-Bank, at 28-31.

¹⁶ Rent-a-Bank at 26.

¹⁷ North Carolina Assistant Attorney General Phil Lehman, email to the author, Jan. 2, 2003.

¹⁸ 15 U.S.C. 1601.

¹⁹ Rent-a-Bank, Appendix C, at 1-15.

Beyond these open violations of the law, in states where there payday loan transactions are not explicitly recognized and regulated but are simply covered by usury laws, lenders often try to disguise payday loan transactions as something other than loans, or at least characterize their exorbitant interest rates as something other than interest, so as to avoid the interest rate restrictions and disclosure requirements that they face under state and federal laws. Some of the more common ways of disguising payday loans are sale-leasebacks, advertising and catalog gift certificate sales, and charges for check cashing.

In what is known as a sale-leaseback, the lender claims to buy the borrower's property, and then lease it back to him for a "rental fee." The borrower "rents" his own property until he eventually decides to "buy it back." However the property never changes hands—the lender typically requires the borrower to provide the serial number of the item he is "selling", but the lender does not ask to see the item and does not require proof that the item has not already been "sold" to another lender.²⁰ Essentially, the lender is loaning the amount that he pays to buy the property, and he is charging interest on the loan through the rental fees that borrower pays to lease back the property. Most of the lenders who engage in this practice require that that the borrower provide "a signed check that they can cash if the borrower doesn't make the 'lease' payment [or]...renew the lease at the end of the 14 day period for an additional fee."²¹ This tactic allows lenders to charge much higher fees than are allowed under state laws, and it also serves as a way to evade rollover and disclosure requirements.

Similarly, some lenders sell advertising space or catalog gift certificates to borrowers in exchange for their high fees. With ad sales, the borrower is required to buy advertising space in a newsletter as a condition of receiving a loan. "Each time a customer wants to renew the loan, the company charges an additional ad fee and places another ad in the publication."²² The advertisements themselves are basically useless and generally do not provide the borrowers any opportunity for financial gain, and the fees charged for the advertising space are high, while the interest rates or fees that are attached to the loans are low.²³ This practice allows lenders to charge much higher fees than state usury laws would permit, while appearing to offer low fees or interest rates. The catalog gift certificate approach is similar. The borrower is required to buy a gift certificate that can be redeemed through a mail-order

²⁰ Wolf in Sheep's Clothing, at 3.

²¹ Wolf in Sheep's Clothing, at 3.

²² Wolf in Sheep's Clothing, at 4.

²³ Wolf in Sheep's Clothing, at 4.

catalog as a condition of receiving a loan.²⁴ However, there are generally no catalogs on the premises and the borrower is not given any information about how to redeem the certificate²⁵, so essentially lenders are able to charge additional fees on these loans by forcing borrowers to buy useless gift certificates.

Finally, lenders attempt to disguise interest rates as fees charged for check cashing. Under this approach, the lender separates out the fees for the loan from the fees for the check cashing, even though the exchange of the check for cash is what constitutes the loan itself. The lender charges a small fee or interest rate for the loan, but charges a high fee for the cashing of the check²⁶. As with the other tactics, this practice allows lenders to levy high fees in actuality, while stating that they offer low fees and interest rates on their loans.

Lenders also commonly affiliate with national banks or banks chartered in states with lax payday laws as another approach to evade both state usury laws and explicit payday regulations. Under the National Bank Act, national banks are granted most favored lender status, which allows them “to charge the higher of the interest rate permitted for banks in the state where the bank is located or 1% above the Federal Reserve Bank discount rate on 90-day commercial paper.”²⁷ The 1978 Supreme Court decision, *Marquette National Bank v. First of Omaha Service Corporation*, established that national banks can export their interest rates across state lines—they can operate under the interest rate laws of the state in which they are located no matter where they are operating.²⁸ State-chartered banks are likewise subject to the regulations of the state in which they are chartered or 1% above the Federal Reserve discount rate under The Depository Institutions Deregulation and Monetary Control Act of 1980, which extended most favored lender status “to any federally insured commercial bank, savings and loan, or credit union.”²⁹ And these state-chartered banks have also carried their rates across state lines based in the theory of exportation accepted by the Supreme Court for national banks. Based on these loopholes, payday lenders have attempted to evade state usury laws and explicit payday loan regulations by affiliating with national and state banks that are not subject to such interest rate restrictions.

Enforcement

²⁴ Wolf in Sheep’s Clothing, at 4.

²⁵ *Cashback Catalog Sales v. Price*, 102 F. Supp. 2d 1375 (S.D. Georgia 2000).

²⁶ *Hartke v. Illinois Payday Loans*, 1999 U.S. Dist. LEXIS 14937 (C.D. Ill. 1999).

²⁷ Rent-a-Bank, at 17.

²⁸ *Marquette Nat’l. Bank v. First of Omaha Service Corp.*, 439 U.S. 299 (1978).

²⁹ Rent-a-Bank at 17.

In response to these open violations of the laws and tactics to evade the laws, state attorneys general and federal agencies have taken action against payday lenders, and actual borrowers have pursued both individual and class actions against lenders based on a variety of claims.

State attorneys general, on the whole, have not been particularly aggressive with regards to payday lending and they have not pursued any sort of multi-state action against payday lenders. On an individual basis, however, some attorneys general have worked to halt the abuses of payday lending. They have pursued enforcement actions against lenders that violate state usury laws and specific payday regulations³⁰, and they have also gone after payday lenders engaged in unfair and deceptive trade practices as prohibited by individual state UDAP statutes.³¹ This has included targeting lenders who use tactics like the sale-leaseback and advertising sales to claim they are not actually offering loans. Attorneys general in a couple of states have attempted to interpret existing state laws to prohibit payday lending by issuing informal opinions³². They have also advised legislatures and governors against loosening the restrictions on payday lenders³³. Recently, and in what appears to be a growing trend, attorneys general have brought actions to keep lenders affiliated with national banks from evading their state laws. These actions have been pursued on the grounds that the banks themselves are so detached from the transactions that they are not actually offering the loans, and the payday lenders who are in fact offering the loans cannot preempt state laws under the National Bank Act.³⁴ Despite these efforts in some states, however, there hasn't yet been any systematic, aggressive effort by attorneys general to stop the abuses of payday lending.

The Office of the Comptroller of the Currency (OCC), which regulates national banks, has also recently started to target the practice of lenders using affiliations with national banks to avoid state laws. Last year it forced two banks, Goleta National Bank and Eagle National Bank, to stop providing payday loans through Ace Cash Express and Dollar Financial Group. The OCC also filed civil charges against another bank, People's National

³⁰ See Oregon Department of Justice, press release, Feb. 1, 2002; Pennsylvania Attorney General's Office, press releases, Apr. 22, 1999, Jun. 23 1999, and Oct. 5, 1999; Texas Attorney General's Office, press releases, Dec. 17, 1999 and Oct. 31, 2000; North Carolina Attorney General's Office, press releases, Feb. 12, 2002 and Oct. 17, 2002.

³¹ See Texas Attorney General's Office, press release, Oct. 31, 2000; North Carolina Attorney General's Office, press release, Oct. 17, 2002; Florida Attorney General's Office, press release, Feb. 6, 2001.

³² See Florida Attorney General Bob Butterworth, informal opinion, May 1, 2000; Indiana Attorney General Jeff Modisett, informal opinion, January 19, 2000.

³³ Laura Tomaka, "Short-term lending falls under scrutiny of lawmakers and regulators", Firstline Midwest, November 2000, at 2.

³⁴ See North Carolina Attorney General's Office, press release, Dec. 13, 2002; Colorado Department of Law, press release, May 6, 2002; Ace Cash Express, press release, Jan. 1, 2003.

Bank, but the charges are currently being contested³⁵. The OCC based its action against Goleta National on the grounds that it was engaged in unsafe and unsound practices that compromised its ability to safeguard customer files. Essentially, the bank was too detached from the actual provision of the loans to adequately supervise procedures. The action against Eagle National was based on the grounds that the bank had risked its financial viability by concentrating too heavily in payday lending. As a result of these OCC actions, it is thought that payday lenders will gravitate more towards affiliating with state banks that are chartered in states without any usury laws or with lax payday loan laws as a way to avoid the usury laws. The Federal Deposit Insurance Corporation is the regulatory body in charge of such banks, but to date it has not been involved in any enforcement actions relating to payday lending.³⁶

Borrowers themselves have also gone after payday lenders through a number of lawsuits, which are generally brought as class actions.³⁷ The most common claims brought in these private actions are for violations of the Truth in Lending Act, alleging that lenders failed to accurately disclose the APR, or that lenders did not make clear that they had a security interest in the post-dated check. Along with these claims, borrowers have also sued payday lenders under RICO, which provides a remedy for those injured by the collection of an unlawful debt when other elements of coordinated activity can be shown. "For RICO purposes, an unlawful debt is a gambling debt or a debt that is usurious under federal or state law," and a usurious debt arises when the interest charged exceeds the interest rate allowed by law.³⁸ In a few instances, borrowers have brought claims for violations of state UDAP statutes based on the deceptive tactics that lenders used in offering their loans, such as the advertising and catalog gift certificate sales. Several of these private lawsuits have been certified as class actions and have survived motions to dismiss and summary judgment motions, but in most cases there is no information available about the lawsuit beyond these initial actions. Presumably, the payday lenders are settling with these borrowers.

³⁵ Paul Beckett, "Payday Loans are Dealt Blow By Federal Banking Regulator", Wall Street Journal, Oct. 30, 2002.

³⁶ Consumer Federation of America, press release, Jan. 3, 2002.

³⁷ See *Hartke*; *Cashback*; *Van Jackson v. Check 'N Go*, 123 F. Supp. 2d 1079 (N.D. Ill. 2000); *Jump v. ACP Enterprises*, 224 F. Supp. 2d 1216 (N.D. Ind. 2002).

³⁸ *Cashback* at 1382.

A Closer Look at Legal Trends and Enforcement Actions

To provide a better sense of what these various regulatory schemes and enforcement efforts look like in practice, I will explore the trajectory of payday loan regulation and the status of the payday lending industry in three states: Texas, North Carolina, and Florida.

Texas

State usury laws in Texas cap the interest rates on small loans at 10% APR when they are offered by an unlicensed lender, and at 90% APR when offered by a licensed lender.³⁹ Until an exception was carved out to allow for payday lending in June 2000, these interest rate caps were the governing law for payday loans. However, several lenders operated in violation of this statute by offering payday loans at rates ranging from 650% to 860% APR.⁴⁰

Some of the lenders operated in open violation of the law, by operating typical payday lending operations. A Consumers Union survey of 27 lenders, conducted in 1999, showed that 4 lenders in Austin and Dallas were openly offering 2-week loans of up to \$400, with fees of approximately \$30 per \$100 loaned.⁴¹

Other lenders tried to disguise their loans as legal transactions, by employing the sales-leaseback and advertising sales tactics previously discussed. For example, at some stores borrowers were charged \$33 per line of advertising space, and were required to buy one line of advertising space for every \$100 loaned.⁴² Essentially the lenders charged \$33 per \$100 loaned in addition to the fee actually attached to the loan, but made it appear that they had low interest rates. The advertisements were printed in publications that were distributed to other payday borrowers, and most contained personal greetings such as “Happy Valentines Day Bev” or “God Loves You.”⁴³ Of the 27 stores surveyed, 12 engaged in sale-leaseback practices, 7 sold advertising, and 4 sold catalog gift certificates.⁴⁴

In response, Attorney General John Cornyn filed suits against the lenders EZ-Cash, Quick Cash, and Cash Today in May 1999. The lawsuits alleged violations of the state usury law because of the high interest rates that were being charged, as well as violations of the Deceptive Trade Practices Act, based on the fact that the lenders

³⁹ Wolf in Sheep’s Clothing, at 4.

⁴⁰ Texas Attorney General’s Office, press release, Sep. 21, 1999.

⁴¹ Wolf in Sheep’s Clothing, at 2.

⁴² Wolf in Sheep’s Clothing, at 3.

⁴³ Wolf in Sheep’s Clothing, at 4.

⁴⁴ Wolf in Sheep’s Clothing, at 2.

used deceptive tactics to disguise the loans.⁴⁵ A jury found that E-Z Cash and Quick Cash had in fact violated the usury law and the Deceptive Trade Practices Act, and held the lenders liable for the interest overpayments they had received and for civil penalties.⁴⁶ Attorney General Cornyn settled with Cash Today for \$1 million, and they agreed to stop offering payday loans in Texas.⁴⁷

Soon after this enforcement action by the attorney general, the Texas Finance Commission established regulations that technically fell within the context of existing law, but in fact carved out an exception to allow payday loans, setting an annual fee limit of 390% APR. These regulations require that rollovers of payday loans be converted from single payment balloon loans to declining balance installment loans, and call for lenders to post fee schedules in their offices. They also require each lender to make a good faith effort to assess the likelihood that a borrower will be able to repay a loan before providing it. The Finance Commission justified these regulations on the grounds that it was necessary to recognize the practice of payday lending because it had become so common, and these rules would minimize the abuses that might arise from such loans.⁴⁸ However, consumers groups argued for more stringent rules that were rejected by the Finance Commission, and they believe the lobbying efforts of payday lenders influenced the enactment of the regulations.⁴⁹

Even though the law now recognizes and allows payday lending in Texas, payday lenders are still violating the law there. A survey conducted in 2001 by Consumers Union studied the lending activity of 21 payday lenders in Texas. None of the lenders surveyed were in compliance with the new payday loan regulations. Most lenders were charging \$33 for a two-week loan of \$100. This translates into an APR of approximately 800%, far in excess of the 390% APR allowed under the new regulation.⁵⁰

Despite these documented violations of the law, there has been no action by the Texas Attorney General since the Finance Commission officially recognized payday loans. In 2000, after the new regulations were enacted, a group of individual borrowers filed suit in federal court against several lenders, but the Attorney General did not intervene. The borrowers claimed violations of the Truth in Lending Act, RICO, the state payday regulations, and the Texas Deceptive Trade Practices Act. The class was certified in September of 2000, but there is no information

⁴⁵ Texas Attorney General's Office, press releases, Sept. 21, 1999 and Dec. 17, 1999.

⁴⁶ Texas Attorney General's Office, press release, Oct. 31, 2000.

⁴⁷ Texas Attorney General's Office, press release, Dec. 17, 1999.

⁴⁸ 7 Tex. Admin. Code §1.605 (2002).

⁴⁹ Consumers Union, Press release, Feb. 18, 2000.

available about this case subsequent to class certification. Presumably, the lenders settled with this class of borrowers.⁵¹

North Carolina

The North Carolina usury law states that for loans under \$3000, lenders can charge a maximum interest rate of 36% APR on the first \$600 loaned and 15% APR on the remainder. In addition, lenders can charge a processing fee up to 5% of the amount of the loan, provided that this fee is not assessed more than twice a year.⁵²

In 1997, the legislature carved out an exception to the usury law for payday loans. This exception allowed lenders who accepted post-dated checks to charge 15% of the face amount of the check. The law established a maximum term of 31 days, but it did not set a minimum term—thus it allowed lenders to charge 15% of the amount loaned, regardless of the term. For a 14-day loan, this translated into an APR of 459%. Despite its loose interest rate allowance, the law did prohibit rollovers or extensions.⁵³

In 2001, the North Carolina Office of the Commissioner of Banks conducted a study of payday lending under these regulations, and reported its findings to the North Carolina General Assembly. Its report indicated that in practice, loans were most commonly offered for 2 weeks or less, and thus the interest rates were extremely high.⁵⁴ It also noted that there were several violations of the prohibition on rollovers,⁵⁵ and even when the loans were not rolled over or extended, a large portion of borrowers tended to take out multiple loans per year—35% of borrowers took out more than 10 loans per year, and 14% of borrowers took out more than 19 loans per year.⁵⁶

Based on this report by the Office of the Commissioner of Banks, the legislature allowed the payday regulations to sunset in August 2001. Payday loans are now regulated by the usury law, which caps the APR for loans below \$600 at 36%, plus a 5% fee.⁵⁷ But since the changeover, payday lenders have employed a variety of tactics to evade the state usury law.

⁵⁰ Consumers Union, *Sale-Leaseback Lenders Defy Regulation*, February 2001, at 3.

⁵¹ *Henry v. Cash Today* 199 F.R.D. 566 (S.D. Tex. 2000).

⁵² N.C. Gen. Stat. §53-173 (2002).

⁵³ North Carolina Office of the Commissioner of Banks, “Report to the General Assembly on Payday Lending”, Feb. 22, 2001, at 2.

⁵⁴ North Carolina Office of the Commissioner of Banks, at 3.

⁵⁵ North Carolina Office of the Commissioner of Banks, at 2.

⁵⁶ North Carolina Office of the Commissioner of Banks, at 6.

⁵⁷ Rent-a-Bank, at 17.

Lenders here have been engaged in the sale-leaseback tactic that was previously discussed in detail, as well as an offshoot of that practice, under which loans are disguised as vehicle lease programs. With this car lease disguise, the lender offers consumers loans of \$500 to \$3000, through a transaction that looks like a car sale. In exchange for the cash advance, “the car title is...transferred to [the lender] and the consumer keeps the car and enters into a thirteen month lease. The consumer must make monthly payments that include a transfer fee of \$35, a lease tax of 6%, a road tax of 3%, and an interest rate of approximately 20% per month.”⁵⁸

Payday lenders have also employed an offshoot of the advertising and catalog gift certificate sales tactic, under which they disguise loans as contracts for internet service. Under this scheme, the lenders contracts with the borrowers to provide one year of internet service. When the borrower signs the contract, the lender provides a cash rebates ranging from \$100-\$500. Then the borrower is obliged to make twice-monthly payments over the course of the year for the internet service, which entitles him to use the internet for a few hours each month at a computer terminal in the lending office. The rates charged for the internet service, as compared to the amounts loaned through the cash rebate, translate into interest rates far higher than those permitted under the state usury law.⁵⁹

Attorney General Roy Cooper has filed several lawsuits against lenders who employ these practices, alleging that they are operating in violation of both the state usury law and the North Carolina UDAP statute. Last February he filed complaints against three lenders who were selling internet access to disguise their loans,⁶⁰ and in October he targeted a lender who was engaging in the sale-leaseback tactic to disguise loans as appliance and car sales.⁶¹

Payday lenders in North Carolina have also aggressively pursued partnerships with national and state-chartered banks since the law changed. By November of 2001, lenders operating in the state were affiliated with 7 different banks, including 4 national banks and 3 banks that were chartered in states with lax payday laws.⁶²

Last year, Attorney General Cooper filed a complaint against the lending chain, Ace Cash Express, based on its affiliation with Goleta National Bank. The complaint alleged that despite its partnership with Goleta National,

⁵⁸ North Carolina Attorney General's Office, press release, Oct. 17, 2002.

⁵⁹ North Carolina Attorney General's Office, press release, Feb. 12, 2002.

⁶⁰ North Carolina Attorney General's Office, press release, Feb. 12, 2002.

⁶¹ North Carolina Attorney General's Office, press release, Oct. 17, 2002.

⁶² Rent-Bank, at 17.

Ace was the actual lender because it carried 90% of the debt on each loan offered.⁶³ Attorney General Cooper argued that this set-up prevented Ace from preempting the North Carolina usury law with the laws of California, where Goleta National is located. Ace argued that it was in fact entitled to operate under the interest rate laws of California because its affiliation made Goleta National the true lender. However, the substantive issue of who constituted the actual lender was never reached because the case was settled in December. Under the terms of the settlement, Ace “has agreed to drop claims that its affiliation with a nationally chartered bank makes it immune to state regulation.” It will not make any loans within North Carolina for the next year, and once it reenters the market it will operate according to state laws.⁶⁴ While this settlement seems like a major feat, it is important to note that Ace’s ability to affiliate with Goleta National had already been terminated by the OCC enforcement action in October. As Assistant North Carolina Attorney General Phil Lehman explained, “This action against Ace has not really resolved anything.”⁶⁵ However, he also expressed hope that future actions against these affiliations with national banks might be successful even without an OCC enforcement action to back them up. “Ace’s model of buying back a 90% participation in each loan made it vulnerable to challenge. Other payday lenders use different models and we will continue to look at them.”⁶⁶

Florida

Until 2001, when the Florida legislature carved out an exception to its laws to explicitly allow for and regulate payday lending, the statutory scheme was unclear with regards to payday loans. The state usury law capped interest rates at 18% APR for loans of \$25,000 or less. However, the Money Transmitters Code of 1994 allowed registered check cashers to charge up to 10% of the face amount of a personal check or money order as a fee for check cashing, plus the fees allowable for verification costs, which were to be established by administrative rule. The subsequent administrative rule established that check cashers could additionally charge the actual cost of verifying the borrower’s “identity, residence, employment, credit history, account status, or other necessary information,” up to \$5 per transaction.⁶⁷

⁶³ Lehman email.

⁶⁴ North Carolina Attorney General’s Office, press release, Dec. 13, 2002.

⁶⁵ Lehman email.

⁶⁶ Lehman email.

⁶⁷ Florida Attorney General Bob Butterworth, informal opinion, May 1, 2000.

Payday lenders thus operated in Florida by calling their services check-cashing, although the checks were actually not cashed until two weeks after the initial transaction. This allowed them to charge \$15 for each two-week loan of \$100 (10% of the face value of the check, plus a \$5 verification fee), which amounts to 390% APR. When it was time for a check to be cashed, according to the deferred deposit date agreed upon by the borrower and the lender, if the borrower did not have the cash in his account he could cash another check with the lender (and pay an additional 10% plus a \$5 fee) to cover the initial check, essentially rolling over the loan for an additional fee.⁶⁸

In response to these practices, Florida Attorney General Bob Butterworth issued an informal opinion in May 2000, explaining that in his opinion a “transaction whereby a company provides cash to the consumer who, in return, provides a personal check that is held by the company for a certain time period and covers the amount of cash provided as well as a fee charged for advancing the cash, constitutes a loan subject to the usury laws.”⁶⁹ He conceded that despite his opinion on the matter, the check cashing provisions of the Money Transmitters Code did allow registered check cashers to engage in check cashing of post-dated checks, charging 10% plus \$5 in fees. However, he argued that if these transactions were “extended, renewed, or in any way continued with the imposition of additional fees,” this would take them out of realm of check cashing and make them loans subject to the usury laws. In addition, he argued that all such deferred deposit transactions conducted by non-registered check cashers constituted loans subject to the usury laws.⁷⁰

Despite this clarification of the law by the attorney general, lenders continued to renew payday loans while charging the fees allowed under the check-cashing statute, rather than conforming to the state usury laws.

In response, a class of borrowers that had experienced such rollovers filed suit against the lenders Ace Cash Express and Cash Express. The borrowers alleged that the lenders had violated state usury laws by providing loans with interest rates that exceeded the 18% APR allowed on loans under \$25,000, and that the lenders had violated the Florida Deceptive and Unfair Trade Practices Act, by claiming they were engaged in check-cashing when they were actually providing loans.⁷¹ Attorney General Butterworth intervened in the suit.⁷² The lenders in question were registered as check cashers under the Money Transmitters Code, and they had charged fees consistent

⁶⁸ *Betts v. Ace Cash Express*, 827 So. 2d 294 (Florida, 5th Dist. 2002).

⁶⁹ Florida Attorney General Bob Butterworth, informal opinion, May 1, 2000.

⁷⁰ Florida Attorney General Bob Butterworth, informal opinion, May 1, 2000.

⁷¹ *Betts* at 296.

⁷² Florida Attorney General’s Office, press release, Feb. 6, 2001.

with the check cashing provisions of that law, but they had consistently renewed transactions with borrowers. For periods of time as long as a year, the lenders allowed borrowers to keep cashing new checks, with additional fees, as a means of covering their old checks. The borrowers in the suit and Attorney General Butterworth alleged that these renewals placed the transactions in the realm of lending rather than check-cashing, consistent with the attorney general's informal opinion on the matter.⁷³

The state trial court dismissed the borrowers' complaint, accepting the lenders' argument that they had simply engaged in check cashing, as allowed by the Money Transmitters Code. The borrowers and Attorney General Butterworth appealed, but the Court of Appeal of Florida found that the complaint had been properly dismissed given that check cashing was permitted under the Money Transmitters Code and there was no prohibition against the extensions or renewals.⁷⁴

In the interim, between when the suit was filed and when it was ultimately dismissed, the state legislature amended the Money Transmitters Code to specifically address deferred deposit transactions. The new law allows the same fee per transaction of 10% plus \$5, but it specifically outlaws rollovers or extensions of the loans and bans lenders from issuing a new loan within 24 hours of the expiration of a previous loan. It also bans lenders from issuing loans to borrowers who have any outstanding payday loans with other payday lenders or loans that have expired within the last 24 hours. Under this law, payday loans are conducted through a state database that indicates each borrower's status. Lenders are required to consult the database before offering a loan, and likewise must record all the loans that they have provided in the database. The law also deals with the problem of borrowers being unable to pay back their loans. So long as the borrower informs the lender of his inability to cover the loan before the due date, he is granted a 60-day grace period to pay back the loan, after which the lender can attempt to collect on the debt. As a condition of receiving this grace period, the borrower is required to obtain credit counseling.⁷⁵

This is a relatively stringent law, and it is designed to keep emergency cash available to those in need while preventing the rollovers that tend to land borrowers on a debt treadmill. The Florida Attorney General supported this law, and as Jeff Jones, Special Counsel and Inspector General to the Florida Attorney General, explained, "It could have been stronger, but this is pretty good legislation. What's most problematic [with payday lending] is the

⁷³ *Betts*, 295-296.

⁷⁴ *Betts*, 297-299.

⁷⁵ Fla. Stat. §§ 560.401-560.408 (2002).

rollover, and this legislation handled it.”⁷⁶ He thinks that payday lending has been reduced to some extent by this new law, but he is not certain how many lenders are actually following the law. Even if the law is being violated, however, he thinks that the law does a good job of confining the enforcement task for the Attorney General’s Office. “Now that there is a statute, he explained, “the legislature has in essence made the ground rules for how you can do this activity legally. From the Attorney General perspective, our job is to go after lenders who do not abide by these rules.”⁷⁷ Mr. Jones thinks this statute was the right way to go in terms of payday loan regulation. “The activity was occurring anyway, and this was a good way of trying to deal with it.”⁷⁸

As part of the Attorney General’s efforts to enforce the new state laws, the Florida Attorney General recently settled with Ace Cash Express based on its attempt to evade Florida payday regulations through an affiliation with Goleta National Bank. Ace has agreed to stop conducting rollovers and exceeding the fees allowed by Florida law, and will pay \$500,000 in penalties.⁷⁹

Strong Intelligent State Payday Laws Plus Active Enforcement is the Key

The successes and failures of the various regulatory schemes and enforcement efforts that have been pursued in this area, as outlined above, provide several lessons. On the whole, they suggest that that the key components to stopping the abuses of payday lending are strong, intelligent state payday laws and active enforcement efforts.

State laws need to be enacted that recognize and specifically regulate payday loans. Leaving these loans under the realm of state usury laws has proven ineffective. The state usury law previously governed these loans in Texas, and it currently governs in North Carolina. These laws are very stringent—the interest rate caps that come through usury laws like these are so low that they effectively ban payday loans as they commonly operate. However, usury laws do not specifically address payday loans. Even though usury laws are strong with regards to interest rates, this lack of specificity makes them easy to evade and difficult to enforce. Lenders try to evade usury laws by claiming that they are not actually offering loans, using the various tactics that have been employed in

⁷⁶ Special Counsel and Inspector General to the Florida Attorney General, Jeff Jones, phone interview, Dec. 31, 2002.

⁷⁷ Jones interview.

⁷⁸ Jones interview.

⁷⁹ Ace Cash Express, press release, Jan. 1, 2003.

Texas and North Carolina. And because these laws contain such strict interest rates caps that almost all payday loans violate them, the violations are so plentiful that even the most active attempts at enforcement will seem futile. North Carolina Attorney General Cooper, who has been very active in his attempts to stop violations of the usury law, has consistently expressed a desire to see specific payday regulation enacted. After a recent settlement with a lender, he said, “We may have put one payday lender out of business in the short term, but we need a long term solution—a strong state payday lending law that protects consumers.”⁸⁰ His Assistant Attorney General Phil Lehman agrees. He explained that while the usury law prohibits lenders from offering payday loans with high interest rates, it does not cover things like rollovers. He believes that “strong state legislation, with sufficient consumer protections and anti-brokering language, is the best way to regulate payday lending and to resist preemption.”⁸¹

Specific payday laws need to be stringent enough that they truly crackdown on the abuses of payday lending. The confusing check-cashers statute that previously applied to payday lenders in Florida did recognize and attempt to regulate payday loans, but it was a weak law. It allowed high fees, and was silent on the topic of rollovers. Because it was not sufficiently stringent, Attorney General Butterworth could not even use this statute to halt the abuses of payday lending in Florida—he tried to work around the law and place these loans back under the umbrella of the usury law, but he was unsuccessful. As the situation in Florida showed, a weak payday regulation is even worse than no payday regulation at all.

Payday laws must be not only strong, but also intelligent. By intelligent, I mean that they should be enacted with an eye to how and if they can be effectively followed and enforced—laws with strong prohibitions on payday lending are useless if they are so sweeping and lacking in detail that they cannot be easily followed and enforced.

For example, North Carolina’s old law that recognized and attempted to regulate payday loans was actually rather strong—it completely banned rollovers or extensions. However, this sweeping ban was ineffective because the law otherwise allowed lenders to offer loans with high interest rates, and did not set up a mechanism to ensure that these loans could be paid back or that the ban could be effectively enforced. Lenders there openly violated the ban on rollovers, and evaded it by accepting new checks to replace the old ones rather than simply charging an additional fee. The violations were so numerous that effective, meaningful enforcement was impossible.

⁸⁰ North Carolina Attorney General’s Office, press release, Dec. 13, 2002.

The current Texas law is more intelligent. It permits rollovers, but requires that a rolled over loan be converted to a declining installment rather than a balloon payment. It also requires that lenders assess whether borrowers will be likely to pay off the loans before they offer them. This law is headed in the right direction, because it takes into account how loans might be paid back and sets up a system to facilitate the repayment process, and it also tries to minimize the need for rollovers by requiring each lender to make a good faith effort to assess the likelihood that loans will be repaid. However, this law is still somewhat deficient because it does not provide any mechanism to allow for easy enforcement of the law. Despite these provisions, lenders can and do violate the regulations because there is no system to ensure compliance.

The new payday law in Florida is a good example of the kind of strong, intelligent law that is needed. It prohibits rollovers, but provides a good system to ensure that loans will actually be repaid through the 60-day grace period and the requirement that borrowers only take out one loan at a time. And it provides a mechanism, in the form of the state database, by which regulators can ensure compliance. Even if there are still violations of the law, they are likely minimized by the database requirement, and because of the specificity of the regulations, enforcement efforts are confined to a manageable realm.

Strong, intelligent laws like Florida's are key, but they must be accompanied by active enforcement efforts. A law becomes useless if it is not enforced, and in this area, where payday lenders have consistently demonstrated that will not follow laws if they can get away with violating them, this is especially true. For example, the law in Texas is imperfect, but it is better than many payday laws. However, the Texas Attorney General's Office has done very little, if anything, to enforce this law. Because of this, payday lenders consistently violate the laws with impudence.

The abuses of payday lending can be stopped, or at least minimized, with strong, intelligent state payday laws and active enforcement of these laws. But all the elements must be met for this approach to be truly effective. Strong laws that do not give consideration to the likelihood of compliance and the ease enforcement will not achieve much, even if active attempts are made to enforce them. Similarly, even intelligent laws will be ineffective if they are not actually enforced. In combination, however, the enactment and enforcement of stringent, well-reasoned laws will go a long way towards stopping the negative ramifications of payday lending.

⁸¹ Lehman email.

Action by Attorneys General is Essential to This Approach

Attorneys general are essential players in both ensuring that strong, intelligent laws are enacted and in enforcing them—in order to make headway with this approach to halt the abuses of payday lending, state attorneys general must become more active.

When it comes to enacting payday laws, if we want to ensure that these laws are sufficiently stringent as well as practical and well reasoned, attorneys general must work with legislatures in the development of these laws. Payday lenders have poured a lot of resources into lobbying for state payday laws—they consistently push for weak laws that exempt payday loans from the usury laws, but do not provide effective regulation. As the protectors of consumer interests, attorneys general must advise legislatures to ensure that lobbying efforts do not sway legislatures to enact weak laws. They also need to work with regulators to ensure that these laws are intelligent and will allow for effective enforcement. Attorneys general are the primary enforcers of payday regulations, so they know what will and will not work in practice. Their advice is essential to ensure that payday laws contain mechanisms that will encourage compliance and will allow for effective enforcement.

Attorneys general are also essential to the enforcement of these laws. Beyond the fact that it is their duty to enforce them, current and past experiences have shown that the other avenues by which enforcement can occur are not sufficient. While several class action suits have been filed against payday lenders, these are designed to secure money for borrowers who have been injured by lenders—because they are generally settled rather litigated, they likely do little to compel future compliance with the laws. Furthermore, class actions are not common enough that are protecting the majority of borrowers. Consumers would be better served by more active enforcement of payday laws by attorneys general. Similarly, the actions that the OCC has taken against national banks that affiliate with payday lenders have been helpful. But these efforts would be more effective if a group of attorneys general worked with the OCC and the FDIC to halt such affiliations—in coordination, attorneys general and these federal agencies could use the state laws regarding payday lending in combination with OCC and FDIC regulations that require sound banking practices to systematically halt the use of partnerships with national and state-chartered banks to evade payday regulations. Though there are other means by which payday laws can be enforced, increased efforts by state attorneys general are key to achieving systematic, broad-based enforcement.

Conclusion

As is clear, there have been a variety of attempts to stop the abuses of payday lending through government intervention. Because this is such a new form of credit extension, regulation up until now has operated to some extent by trial and error. Some approaches have been successful, while others have failed miserably. The lessons that have emerged suggest that states should enact specific regulations to handle payday lending rather than relying on usury laws, that these laws must be strong and well reasoned, and that active enforcement of these laws is essential. In order to carry out this approach, state attorneys general must increase their involvement in this area—they are vital not only as enforcers, but also in terms of assisting legislatures to ensure that payday laws can be reasonably followed and enforced.