

Notes

Rollover, Rollover: A Behavioral Law and Economics Analysis of the Payday-Loan Industry*

On February 26, 2009, two different, but financially related, deals commenced. Somewhere in America, Jamie Johnson, a young married mother of two, walked into a payday-loan store in her neighborhood to get a cash advance on next week's paycheck, thinking that \$300 cash in her purse now was worth the onetime fee of \$45.¹ Meanwhile, in Washington, D.C., a Congressman, thinking of consumers just like Jamie, introduced a new legislative bill. Representative Luis V. Gutierrez (D.-Ill.) and his cosponsors introduced the Payday Loan Reform Act of 2009 (House Bill 1214),² which was referred to the House Financial Services Committee.³ The purpose of the bill is to "amend the Truth in Lending Act to establish additional payday loan disclosure requirements and other protections for consumers."⁴

The contractual deal that Jamie initiated when she entered the payday-loan store has become a commonplace credit transaction that often results in a Scylla-and-Charybdis conundrum of high costs now or higher costs later. Payday loans are generally short-term loans of small amounts offered at extremely high effective interest rates to consumers who have impaired credit histories.⁵ Most transactions begin when a customer enters a payday lender's retail store.⁶ To qualify for these types of loans, a borrower only

* Many thanks to Professor Sean Williams for his insight and guidance into the field of BLE and to my seminar classmates, especially Travis Youngblood, for their valuable input in developing my arguments. I am grateful to the staff and editors of the Texas Law Review for their efforts and excellence in editing this Note. Finally, and most importantly, to my parents, to my fiancé, Conner, and to my Lord and Savior, Jesus Christ—for your love, encouragement, and support in writing this Note, through law school, and for always—thank you.

1. Though Jamie is a composite character, each day American borrowers like her engage in payday-loan transactions. For more information on the average payday borrower, see *infra* subpart I(A).

2. H.R. 1214, 111th Cong. (2009).

3. See *The Payday Reform Loan Act of 2009: Hearing on H.R. 1214 Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Services*, 111th Cong. 1–2 (2009) [hereinafter *Hearing*] (statement of Rep. Luis V. Gutierrez, Chairman, Subcomm. on Financial Institutions and Consumer Credit) (outlining the current state of the payday-lending industry and introducing his proposed bill intended to increase consumer protection).

4. *Id.*

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

6. While most payday lenders have a physical store, there is a trend of payday lending over the Internet. See *infra* text accompanying notes 74–75. See also Mark Flannery & Katherine Samolyk, *Payday Lending: Do the Costs Justify the Price?* 1 (FDIC Ctr. for Fin. Research, Working Paper No. 2005–09, 2005), available at http://www.fdic.gov/bank/analytical/cfr/2005/wp2005/CFRWP_2005-09_Flannery_Samolyk.pdf (estimating the number of payday-lending stores as having grown from 10,000 in 2000 to 22,000 in 2004).

needs a bank account and proof of an income.⁷ “[T]he lender extends a loan on one date, in return for a promise (usually evidenced by a postdated check or by automated clearinghouse (ACH) authorization) to repay the amount of the loan plus a standard fee, typically in the range of \$15 to \$20 per \$100 borrowed.”⁸ A common loan is for \$300 with a fee of \$45;⁹ if this loan had a term of two weeks, the annual percentage rate (APR) would be about 400%.¹⁰ The APR for these loans can vary greatly between states depending on how strict, and strictly enforced, the usury laws may be.¹¹ Another notable (and oft-criticized) feature of these loans is that the terms mature with a balloon payment, under which the borrower must pay either the entire balance of principal and interest or “rollover” the loan for another term and pay an additional fixed fee.¹² This decision increases the costs of these loans for two types of borrowers—those who are not capable of paying off the entire lump sum and those who may be capable of doing so but choose to pay more later so they can pay nothing now.¹³ Thus, like Jamie, real-life borrowers who have considered the cost to be merely a onetime nominal fee often get caught in the “debt trap” of extending the loan for multiple terms, ultimately paying more in interest than the amount of the original loan.¹⁴

7. Mann & Hawkins, *supra* note 5, at 863; Charles A. Bruch, Comment, *Taking the Pay out of Payday Loans: Putting an End to the Usurious and Unconscionable Interest Rates Charged by Payday Lenders*, 69 U. CIN. L. REV. 1257, 1258 (2001).

8. Mann & Hawkins, *supra* note 5, at 861–62 (citations omitted).

9. DONALD P. MORGAN, FED. RESERVE BANK OF N.Y., STAFF REPORT NO. 273, *DEFINING AND DETECTING PREDATORY LENDING 5* (2007), available at http://www.newyorkfed.org/research/staff_reports/sr273.pdf.

10. See Michael S. Barr, *Banking the Poor*, 21 YALE J. ON REG. 121, 154 (2004) (noting that according to a 2001 survey of lenders the median APR was 390% and the average was 470%).

11. See Mann & Hawkins, *supra* note 5, at 880 (describing the importance of effective enforcement in preventing out-of-state payday lenders from moving in and circumventing a state’s usury laws); Flannery & Samolyk, *supra* note 6, at tbl.1 (giving the maximum APR allowed on a fourteen-day, \$100 loan in all states that allowed payday lending as of 2004).

12. See JAMES H. CARR & JENNY SCHUETZ, PROGRESSIVE POLICY INST., *FINANCIAL SERVICES IN DISTRESSED COMMUNITIES: FRAMING THE ISSUE, FINDING SOLUTIONS 8* (2001), available at http://www.pponline.org/documents/bank_part2.pdf (defining balloon payments and including them within a larger group of potentially abusive predatory-lending practices); Philip Bond et al., *Predatory Lending in a Rational World 4* (Fed. Reserve Bank of Phila., Working Paper No. 06–2, 2006) (“Loan terms such as prepayment penalties and balloon payments engender predatory behavior.”). This Note uses the term “rollover” generally to refer to any event that is the economic equivalent of renewing the loan—the borrower receives no new funds, incurs an additional finance charge, and extends the loan for an additional term at the end of which she still owes the entire principal amount of the initial loan. This rollover can be in the form of a true renewal or by getting a new loan that follows immediately upon payment of an existing loan. Another common pattern that customers use to avoid renewal limits is to use the funds from one lender to pay off another lender. See Paul Chessin, *Borrowing from Peter to Pay Paul: A Statistical Analysis of Colorado’s Deferred Deposit Loan Act*, 83 DENV. U. L. REV. 387, 411 (2005) (highlighting anecdotal evidence that consumers may have outstanding payday loans with more than one lender and inferring that this may be done to pay off an outstanding loan of one lender with a loan from another lender).

13. See *infra* subpart III(A).

14. See *infra* subpart III(A).

The bill that Gutierrez introduced has been met with criticism from both sides of the spectrum with consumer advocates at one end and industry supporters at the other. Consumer advocates point out that the bill legalizes loans with APRs of nearly 400% by allowing interest and fees up to fifteen cents on the dollar (which sounds like 15%, but with only a two-week term the effective annualized interest rate is around 400%).¹⁵ Advocates also remark that the bill contains loopholes that payday lenders can easily wriggle out of by altering the form of the payday loan.¹⁶ In fact, some consumer groups are supporting another bill that would cap the APR at 36%,¹⁷ like the specialized bill that passed in 2006 and effectively prohibited payday loans from being offered to military servicemen.¹⁸ In a riposte from the other side, some critics say that the government-imposed price control on payday loans is too strong and will only have negative effects—reducing the supply of short-term credit options and making borrowing more expensive.¹⁹

The current debate surrounding House Bill 1214 is only the most recent episode of a long-running controversy about the payday-lending industry. The remarkably high effective interest rates charged by payday lenders since the industry emerged in the early 1990s have generated a flurry of critical proposals.²⁰ High interest rates alone, however, are not a sufficient basis for regulatory intervention. To the extent that the payday-loan market is an efficient market that benefits both the borrower and the lender, it should be tolerated. But evidence suggests that credit markets do not always result in a mutually beneficial arrangement and that competition fails to correct these market inefficiencies.²¹ “If payday lending is used as a short-term emergency support system, the results are not offensive.”²² Evidence suggests, however, that at least some borrowers are not using these loans for emergency purposes; these borrowers have alternative financial resources but are rolling these loans over multiple times so that the fees truly approach the

15. *Hearing, supra* note 3, at 54 (statement of Jean Ann Fox, Director of Financial Services, Consumer Federation of America).

16. *Id.*

17. Press Release, Ctr. for Responsible Lending, Public Favors 36% Cap on Consumer Loans, Survey Finds (Mar. 30, 2009), <http://www.responsiblelending.org/media-center/press-releases/archives/public-favors-36-cap-on-consumer-loans-survey-finds.html>.

18. Mike Lillis, *Gutierrez Proposes Weak Reform of Payday Lenders*, WASH. INDEP., Apr. 8, 2009, <http://washingtonindependent.com/37761/gutierrez-proposes-weak-reform-of-payday-lenders>.

19. Robert DeYoung, *Congress Takes Aim at Payday Loans*, WALL ST. J., Apr. 14, 2009, at A13.

20. *See* Mann & Hawkins, *supra* note 5, at 857 (citing a number of articles proposing regulations ranging from outright bans to mandatory disclosures).

21. In fact, competition may actually reinforce the problem by compelling lenders to take advantage of consumers' weaknesses. *See* Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373, 1373–76 (2004) (developing a theory, specifically in the context of credit cards, that supports legal intervention even in the presence of perfect competition).

22. Aaron Huckstep, *Payday Lending: Do Outrageous Prices Necessarily Mean Outrageous Profits?*, 12 FORDHAM J. CORP. & FIN. L. 203, 207 (2007).

triple-digit APRs.²³ Some intervention may be necessary in the cases where the payday-loan industry involves market failures. The best regulatory schema for the payday-loan industry has been debated by legislators and scholars alike, ranging from outright bans to requiring additional disclosures from lenders.²⁴ The history of regulation with respect to payday loans is an intriguing tapestry of federal and state law, which this Note will lay out as a background for examining House Bill 1214 through a new lens—behavioral law and economics (BLE).

At the same time that the payday-loan industry was growing, a trend in legal academia was also emerging. The rational-actor model, which had been the foundation of neoclassical economics, was called into doubt by behavioral scientists who demonstrated that real people exhibit cognitive biases that create systematic departures from the assumption of unbounded rationality.²⁵ Legal scholars recognized that this insight must be incorporated to generate sound predictions and legal policy,²⁶ so in the last decade a rich literature on BLE has developed.

Despite their almost parallel development, only a few scholars have even mentioned the possibility of using behavioral law and economics in analyzing the payday-loan industry. Oren Bar-Gill, the scholar who reframed the credit-card debate by expounding on the underestimation bias,²⁷ and Elizabeth Warren noted in *Making Credit Safer* that payday loans are “another example of a credit product that can impose substantial costs on imperfectly informed and imperfectly rational borrowers.”²⁸ As Bar-Gill explained with respect to credit cards, many consumers systematically underestimate their future borrowing.²⁹ This underestimation bias is the result of a combination of imperfect self-control, hyperbolic discounting, borrowing a little at a time, and an optimism bias that discounts the likelihood of economic hardship or the borrower’s own forgetfulness.³⁰ Contributing to the legal and academic debate over the payday-loan industry, this Note focuses the lens of BLE on payday loans to demonstrate how some borrowers systematically underestimate their future borrowing, leading to unexpected rollover loans and imposing substantial and unnecessary costs on these borrowers. This Note also demonstrates how lenders are able to exploit these borrowers’ underestimation biases to aggravate the costs incurred in the “debt trap.”

23. *See infra* Part I.

24. *See infra* Part II.

25. *See* Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1477 (1998) (noting that human rationality is bounded because humans have finite cognitive abilities, including limited computational skills and flawed memories).

26. *Id.* at 1476–77.

27. Bar-Gill, *supra* note 21, at 1375.

28. Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 44 (2008).

29. Bar-Gill, *supra* note 21, at 1395.

30. *Id.* at 1395–1401.

While BLE has long contributed to understanding how cognitive biases impact decision making and thus how legal rules should be shaped to regulate those decisions, only recently have scholars turned to directly counteracting these biases as a means of regulation.³¹ Christine Jolls and Cass Sunstein dubbed this legal policy “debiasing through law.”³² Debiasing may not only be an effective way to reduce boundedly rational behavior but also is a middle ground between inaction or simple information disclosure and the aggressive strategy of an outright ban.³³ It “may be far more successful than the mere provision of statistical facts about average risks, and simultaneously far more protective of consumer prerogatives than the strategy of an across-the-board ban.”³⁴ This Note proposes that legislators and scholars should consider debiasing as a potential middle-of-the-road regulatory schema for the payday-loan industry. Consumers who are subject to the underestimation bias and are not using these payday loans for emergency purposes will benefit from debiasing measures that will enable them to avoid what might become a Sisyphean financial situation.³⁵

Part I of this Note draws on empirical research to offer a snapshot of the industry and the “typical” borrower of payday loans. Part II sets the regulatory stage of the payday-loan industry, paying specific attention to the proposed framework under House Bill 1214. Part III lays out the BLE theory with respect to payday lending, specifically showing how the underestimation bias may explain the frequency of payday-loan rollovers. Part IV presents a debiasing solution to increase the effectiveness of the disclosures proposed under House Bill 1214. This Note concludes in Part V.

I. Participants in the Payday-Lending Industry

A. Borrowers

Sympathetic anecdotes regarding payday-loan borrowers like Jamie abound; however, empirical large-scale statistical data on borrower demographics is incomplete and somewhat inconsistent.³⁶ As qualification for a payday loan, a borrower usually must have a checking account and a job, but no other financial information is generally requested from the

31. See Christine Jolls & Cass R. Sunstein, *Debiasing Through Law*, 35 J. LEGAL STUD. 199, 200 (2006) (“[L]egal policy may respond best to problems of bounded rationality not by insulating legal outcomes from its effects, but instead by operating directly on the boundedly rational behavior and attempting to help people either to reduce or to eliminate it.”).

32. *Id.* Jolls and Sunstein suggested that debiasing strategies may play a role in many legal domains, from consumer-safety law to corporate law to property law. *Id.* at 202.

33. *Id.* at 208.

34. *Id.*

35. The image of borrowers as Sisyphus, eternally pushing the rock up the hill only to have it roll back over them, seems particularly apt.

36. Huckstep, *supra* note 22, at 214.

payday-loan provider.³⁷ Even if lenders did acquire more information on borrower demographics, there are very few publicly traded providers who must make public disclosures, and to date, only a few states have implemented databases to track the industry.³⁸ The data that have been made publicly available are from large-scale studies influenced by either consumer or industry advocates.³⁹ So even the limited available data are of “questionable reliability.”⁴⁰ Despite these difficulties, this Note posits that even the most pro-industry view of the payday borrower indicates that there is an opportunity for debiasing mechanisms to assist consumers who are borrowing more than they would rationally prefer.

The picture of the payday borrower typically drawn in the news is that of a poor person who has no better option than taking out a payday loan.⁴¹ Consider these inconsistencies in quantifying how “poor” payday borrowers are on average: The lending industry reports that the median annual income of a borrower is \$35,000.⁴² A Georgetown study that was funded by the Community Financial Services Association (CFSA), a major trade association representing the payday-lending industry, found that over half of payday-loan borrowers have incomes ranging from \$25,000 to \$49,999.⁴³ The CFSA-funded Georgetown study also indicated that most payday borrowers have access to alternative forms of credit, including bank cards.⁴⁴ Only 6.4% of the customers responding to their survey listed the absence of all other alternatives as their most important reason for choosing a payday loan.⁴⁵ Another study also indicated that nearly two-thirds of payday borrowers had more than \$1,000 available in liquid assets.⁴⁶ Compare those data with studies reporting average annual incomes of payday borrowers in

37. Bruch, *supra* note 7, at 1258.

38. Since 2001, the administrator of the Colorado Uniform Consumer Credit Code has collected various data from lenders, including borrower demographics and statistics of loan terms and frequencies. Chessin, *supra* note 12, at 403–05. Michigan requires the commissioner of the Office of Financial and Insurance Regulation to maintain a database that allows lenders to verify whether a customer has another loan open at that time. MICH. COMP. LAWS ANN. § 487.2142 (West Supp. 2009).

39. Huckstep, *supra* note 22, at 214–15.

40. *Id.* at 215.

41. See, e.g., Erik Eckholm, *Seductively Easy, ‘Payday Loans’ Often Snowball*, N.Y. TIMES, Dec. 23, 2006, at A1 (describing three low-income individuals who have struggled with payday-loan fees). Whether payday loans are “better” than such common alternatives as pawn shops, rent-to-own transactions, and bank overdraft fees is beyond the scope of this Note. This Note is simply arguing that some segment of borrowers do have less costly and risky alternatives than a payday loan, and that debiasing will help those borrowers accurately assess the cost of payday loans (including the likelihood of rollover fees) and make better credit decisions.

42. Huckstep, *supra* note 22, at 215.

43. *Id.* at 215–16 (citing GREGORY ELLIEHAUSEN & EDWARD C. LAWRENCE, CREDIT RESEARCH CTR., MONOGRAPH NO. 35, PAYDAY ADVANCE CREDIT IN AMERICA: AN ANALYSIS OF CUSTOMER DEMAND, at iii, 28, available at <http://faculty.msb.edu/prog/CRC/pdf/mono35.pdf>).

44. ELLIEHAUSEN & LAWRENCE, *supra* note 43, at 41–43.

45. *Id.* at 51 tbl.5-23.

46. Bar-Gill & Warren, *supra* note 28, at 45 n.117.

California (\$25,417),⁴⁷ Colorado (\$28,440),⁴⁸ Illinois (\$25,131),⁴⁹ and Wisconsin (\$24,673).⁵⁰ No matter which studies most accurately describe the loan-market participants, clearly payday borrowers are low-to-moderate-income individuals, many of whom have alternative credit sources or easily accessible cash.

The high frequency of repeat borrowers is another descriptive statistic that studies have not uniformly reported yet is still apparent in even the most pro-industry reports. The average borrower has 10, 11, or 12 payday transactions per year according to three respective reports.⁵¹ A Colorado study found that the average was greater than 9 transactions per year from the same lender, but that did not include transactions that a borrower may have had with other lenders, which the study implied could greatly increase that average.⁵² In Illinois, 20% of borrowers have 20 or more payday loans per year.⁵³ A consumer advocate group found that 66% incur at least 5 payday loans per year and that 31% receive more than 12 per year.⁵⁴ The Georgetown study reported that almost 50% of borrowers had at least 7 transactions in the last year and that 22.5% had more than 14 payday loans that year.⁵⁵ Though none of the data converged, all of these studies reveal a high rate of rollover transactions per borrower. The striking feature of this data is that the CFSA study, which should be most favorable to the payday-lending industry, shows that almost a majority of all borrowers are rolling over their loans multiple times.

The payday-lending industry claims to provide a valuable service to consumers who are in need of emergency cash and do not have access to other credit.⁵⁶ Unfortunately, one of the most valuable pieces of data lacking about this industry is what the borrowers do with the funds procured from the payday loans.⁵⁷ Even so, the frequency of payday-loan rollovers “suggests that borrowers, on average, are not using payday loans exclusively (or even

47. Creola Johnson, *Payday Loans: Shrewd Business or Predatory Lending?*, 87 MINN. L. REV. 1, 99 (2002).

48. Chessin, *supra* note 12, at 405.

49. Johnson, *supra* note 47, at 99.

50. *Id.*

51. Huckstep, *supra* note 22, at 217.

52. Chessin, *supra* note 12, at 410–11.

53. Huckstep, *supra* note 22, at 217–18.

54. KEITH ERNST ET AL., QUANTIFYING THE ECONOMIC COST OF PREDATORY PAYDAY LENDING: A REPORT FROM THE CENTER FOR RESPONSIBLE LENDING 2 (2004), available at <http://www.responsiblelending.org/payday-lending/research-analysis/CRLpaydaylendingstudy121803.pdf>.

55. ELLIEHAUSEN & LAWRENCE, *supra* note 43, at 38–39.

56. See, e.g., Huckstep, *supra* note 22, at 207 (noting that lenders claim that payday loans are only intended to provide a cost-effective means to deal with unexpected short-run cash deficiencies).

57. *Id.* at 220; Mann & Hawkins, *supra* note 5, at 859 n.6.

remotely) for emergency reasons.”⁵⁸ Of the payday borrowers surveyed for the CFSA-funded Georgetown study, 65.7% reported that their most recent advance was obtained because of emergencies.⁵⁹ So even the most pro-industry data suggest that more than a third of payday-loan borrowers are not using the loans for what they were designed—emergencies, which require quick cash loans for a short term. If one-third, or more, of payday-loan borrowers are not using these loans for emergencies, then there is a possibility that they are making a mistake⁶⁰ in obtaining these payday loans and could be debiased in such a way that keeps them from making this mistake.

At the very least, the picture of payday-loan borrowers drawn by existing data suggests a heterogeneous population of borrowers. Some borrowers may be benefiting from these loans—they have no other cash, no better alternative for credit, and have an immediate emergency that must be dealt with before their next payday. Some borrowers may just think they are benefiting because they are uninformed—they may not know the costs of these loans or that they may have better alternative credit options. Some borrowers may (incorrectly) think they are benefiting, not because of a lack of information, but because they are imperfectly rational. They may understand the cost of the loan for one term, but underestimate their future borrowing, and thus underestimate the actual cost of the loan taking into account multiple rollover terms. And, of course, some borrowers might know that they are not benefiting from these loans but have no ability to get off the “debt treadmill,” either because they lack the resources or they lack self-control. Disclosures that are aimed at debiasing payday-loan borrowers will not effectively protect the entire population, but they will be able to make a difference by reducing the number of financial mistakes made by the not-insubstantial portion of the population that has either liquid assets or alternative credit options and does not have an immediate emergency.

B. Lenders

In the United States, the modern payday-loan industry emerged in the early 1990s and has been marked by exceptional growth.⁶¹ Beginning with around 200 payday-lending stores in the early 1990s, industry statistics show that from 2000 to 2004 the number of stores increased from 10,000 to

58. Huckstep, *supra* note 22, at 220.

59. ELLIEHAUSEN & LAWRENCE, *supra* note 43, at 47.

60. In this context and for this Note, a borrower’s “mistake” merely means that this decision was not in line with the long-term preferences of the borrower. If she had been perfectly informed and perfectly rational, then she would have made a different decision. If a person has a cash-flow emergency, then that person has no other choice, and therefore cannot be making a mistake. Of course, the decision to rollover the loan after the emergency has subsided is a separate choice subject to a possible mistake by the borrower.

61. Scott Andrew Schaaf, *From Checks to Cash: The Regulation of the Payday Lending Industry*, 5 N.C. BANKING INST. 339, 339–41 (2001).

22,000.⁶² By 2005, there were more payday-loan stores in the United States than McDonald's, Burger King, Sears, J.C. Penney, and Target stores combined.⁶³ In 2003, somewhere between \$25 billion and \$40 billion in payday loans were issued.⁶⁴

The competitive structure of the payday-loan industry was sketched out by Ronald Mann and Jim Hawkins in *Just Until Payday*.⁶⁵ First, a plethora of small lenders that are not publicly traded dominate the industry.⁶⁶ In fact, more than 75% of all payday stores are owned by these small lenders.⁶⁷ The second set of lenders that play an important role in the industry includes large national providers.⁶⁸ These publicly traded companies operate on the McDonald's business philosophy—replicate a specific business model in as many retail stores nationwide as quickly as suitable locations can be identified.⁶⁹ Banks and traditional finance companies do not play a major role in this particular consumer-credit market.⁷⁰

The business strategy of payday lenders seems to be based on the common belief that customers seek out lenders based on proximity to their workplace.⁷¹ Some academics have argued, in fact, that the only factors a borrower considers are the convenience of the location, ease of the process, and speed of approvals.⁷² The cost of the loan, according to these scholars, is conspicuously absent from the borrower's deliberation.⁷³ Since convenience is important, the industry runs a high density of stores, and the high fixed costs of running these retail stores is used by lenders to justify their high fees.⁷⁴ This convenience factor may also explain the existence of Internet-only payday-loan providers. These web-based lenders avoid the costs of physical retail-branch locations and may be more convenient for those customers who have broadband Internet access.⁷⁵ Convenience being the most important, or only, factor a borrower considers when choosing payday stores does not obviate the need to counteract borrowers' underestimation bias as to the likelihood of rollover loans and inform them about the total costs of the

62. Mann & Hawkins, *supra* note 5, at 861.

63. Christopher L. Peterson, *Usury Law, Payday Loans, and Statutory Sleight of Hand: Saliency Distortion in American Credit Pricing Limits*, 92 MINN. L. REV. 1110, 1111 (2008).

64. Mann & Hawkins, *supra* note 5, at 861.

65. *Id.* at 865–71.

66. *Id.* at 866.

67. *See id.* at 866 (stating that large national providers have less than a quarter of the total stores).

68. *Id.* at 867.

69. *Id.*

70. *Id.* Though banks are not currently involved in the industry, they played a major role in the growth of the industry early in this decade. *Id.* at 868.

71. *See, e.g., id.* at 863.

72. Huckstep, *supra* note 22, at 217.

73. *Id.*

74. *Id.* at 228–29.

75. Mann & Hawkins, *supra* note 5, at 870.

payday-loan transaction. Borrowers will consider the costs of the loan in deciding whether to get a payday loan at all and whether to rollover an existing payday loan. At those two decision points, the convenient location of a payday-loan store will almost certainly not be the determining factor.

One of the most common issues in the debate over regulating the payday-loan industry is whether payday lenders are making extraordinary profits from borrowers mired in a cycle of rollover loans.⁷⁶ If competition has driven prices down so that lenders are not making unreasonable profits and the high price of these loans represents true costs, then the argument asserts that regulation is unnecessary and maybe even counterproductive. One study recently analyzed seven publicly traded payday lenders and compared them to six other publicly traded commercial lenders and one public company with a similar business model to that of payday lenders.⁷⁷ The study found that, despite the high effective interest rates charged, the payday lenders had an average profit margin that was significantly lower than the mainstream commercial lenders and the other public company.⁷⁸ “Even in the absence of supra-competitive profits, legal intervention may be required to prevent the potentially significant welfare costs generated by the underestimation bias.”⁷⁹ As Part III will explain, the payday-loan product is designed and marketed to exploit consumers’ cognitive biases, thereby augmenting the number of consumers who get a payday loan while underestimating the true cost associated with it.

II. Existing and Proposed Regulation of the Payday-Lending Industry

In evaluating the implications of the recently proposed House Bill 1214, an understanding of past and current regulations affecting this industry is useful and appropriate. Both federal law and state law have shaped the industry, each with more force at different times. The regulations may be divided into three sectors: usury laws, other substantive laws, and disclosure laws.

76. See Patrick L. Hayes, *A Noose Around the Neck: Preventing Abusive Payday Lending Practices and Promoting Lower Cost Alternatives*, 35 WM. MITCHELL L. REV. 1134, 1142–43 (2009) (noting that payday-industry officials claim rollovers rarely occur, but state-agency audits and an independent study show that a large majority of payday loans are made to customers with multiple loans per year and that repeat transactions make up a majority of payday lenders’ revenue); Huckstep, *supra* note 22, at 203 (recognizing that one assumption for regulating the payday-loan industry is that payday lenders make extraordinary profits and arguing that without hard data this assumption is unfounded).

77. Huckstep, *supra* note 22, at 204.

78. *Id.* at 227–28. The pure payday lenders had an average profit margin of 3.57%. *Id.* at 227. When all seven of the payday lenders were analyzed, including the pawnshop operators who also made payday loans, the figure grew to 7.63%. *Id.* Starbucks, which has a similar business model, had a profit margin of 9% during the study, while the comparison lenders had a profit margin of 13.04%. *Id.* at 227–28.

79. Bar-Gill, *supra* note 21, at 1377.

A. *Usury Laws*

“Harking back to biblical times, through to the foundation of the American colonies, and later of the American states, usury laws regulated credit by imposing a cap on the interest rate that any lender could charge.”⁸⁰ They were the lynchpin of consumer-credit regulation.⁸¹ The thirteen original American states unanimously adopted usury laws that specified in clear terms a maximum simple nominal annual interest rate between 5% and 8%.⁸² This commitment, drawing originally from a theological and moral tradition, remained strong through the end of the nineteenth century.⁸³ Enforcement problems with early loan sharks at the turn of the century, and calls for social reform, then prompted states to enact more moderate usury limits.⁸⁴ By the mid-twentieth century, most states had created a variety of exceptions for various types of lenders, but all retained some usury limit⁸⁵—that is, until a landmark decision by the U.S. Supreme Court.

Federal law effectively preempted state usury law under the 1978 Supreme Court decision in *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*⁸⁶ The Court held in *Marquette* that, under Section 85 of the National Bank Act, a national bank may “export” the interest rate allowed under the state usury law where the bank is headquartered to any other state where it does business.⁸⁷ Federal law also gave state-chartered banks this same right.⁸⁸ “Recognizing the opportunity to attract lucrative financial services jobs to their moribund economies, South Dakota and Delaware eliminated their ancient usury laws”⁸⁹ After *Marquette*, banks could charge any interest rate they wanted, anywhere they wanted, even though nearly all states still had usury laws on the books.⁹⁰

While banks were no longer constrained by state usury laws, *Marquette* did not offer similar treatment to other credit institutions.⁹¹ To get around state usury laws in the early part of this decade, national payday lenders took advantage of this federal-preemptive shelter by teaming up with national- and state-chartered banks in what became known as rent-a-charter or rent-a-bank agreements.⁹² Payday lenders and federal- or state-chartered banks

80. Bar-Gill & Warren, *supra* note 28, at 70.

81. *Id.*

82. Peterson, *supra* note 63, at 1117–18.

83. *Id.* at 1116–19.

84. *Id.* at 1119–20.

85. *Id.* at 1119–21.

86. 439 U.S. 299, 318–19 (1978).

87. *Id.* at 312–13.

88. 12 U.S.C. § 1831d(a) (2006).

89. Peterson, *supra* note 63, at 1121–22.

90. *Id.* at 1122.

91. *Id.* at 1123.

92. *See, e.g.*, JEAN ANN FOX & EDMUND MIERZWINSKI, CONSUMER FED’N OF AM. & U.S. PUB. INTEREST GROUP, RENT-A-BANK PAYDAY LENDING: HOW BANKS HELP PAYDAY LENDERS

would enter into partnership agreements whereby the bank would control the issuance of the loans but the payday lender would continue to serve as the front for customers.⁹³ After the loan was issued, the payday lender would buy back a substantial portion of the loan, including the right to receive payment from the customer.⁹⁴ During the time that this business model provided a federal-preemptive shield to usury limits, the payday-loan industry exhibited remarkable growth,⁹⁵ but this protection was short-lived. Federal bank regulators were hostile to this model because of the risks it created for the banking system.⁹⁶ By 2006, as a result of regulations by the OCC and the FDIC, the rent-a-charter era had come to an end,⁹⁷ and with it, state usury law regained its standing against payday loans.

Today, state usury laws generally are more lax than before *Marquette*, but the states have taken a wide variety of stances against the payday-lending industry.⁹⁸ The regulatory regimes in effect today may be roughly divided into three categories: strict prohibition, formal but underenforced prohibition, and explicit toleration.⁹⁹

1. Strict Prohibition.—In general, the northeastern states have limited payday-loan pricing most aggressively.¹⁰⁰ In a study that calculated and compared the maximum permissible APRs allowed in 2007 for a typical payday loan, the northeast region of the United States had a median APR cap of 94%, while every other region had a median of over 300%.¹⁰¹ “Connecticut, Maryland, New Jersey, New York, and Vermont have all retained traditional usury regulation with minimal loopholes or

EVADE STATE CONSUMER PROTECTIONS 14 (2001), available at <http://www.consumerfed.org/pdfs/paydayreport.pdf> (identifying payday lenders that partnered with banks in order to evade interest-rate caps); Chad A. Cicconi, *A Role for Payday Lenders*, 123 BANKING L.J. 235, 239–40 (2006) (noting that around 1,998 payday lenders developed a new business model by affiliating with banks to avoid state usury laws); Mann & Hawkins, *supra* note 5, at 872.

93. Cicconi, *supra* note 92, at 239.

94. *Id.*

95. See *supra* text accompanying notes 61–64.

96. Cicconi, *supra* note 92, at 241.

97. Mann & Hawkins, *supra* note 5, at 872–73. For actions by the OCC with respect to national banks, see OFFICE OF THE COMPTROLLER OF THE CURRENCY, U.S. DEP’T OF THE TREASURY, ADVISORY LETTER 2000-10, PAYDAY LENDING (2000), available at <http://www.occ.treas.gov/ftp/advisory/2000-10.doc>; OFFICE OF THE COMPTROLLER OF THE CURRENCY, U.S. DEP’T OF THE TREASURY, OCC BULLETIN NO. 2001-47, THIRD-PARTY RELATIONSHIPS (2001), available at <http://www.occ.treas.gov/ftp/bulletin/2001-47.doc>; and OFFICE OF THE COMPTROLLER OF THE CURRENCY, U.S. DEP’T OF THE TREASURY, ADVISORY LETTER 2000-9, THIRD-PARTY RISK (2000), available at <http://www.occ.treas.gov/ftp/advisory/2000-9.doc>. For actions by the FDIC with respect to state banks, see Fed. Deposit Ins. Corp., Guidelines for Payday Lending, <http://www.fdic.gov/news/news/financial/2005/fil1405a.html> (last updated Feb. 25, 2005).

98. Peterson, *supra* note 63, at 1138.

99. See Mann & Hawkins, *supra* note 5, at 871–80 (explaining the range of regulations states have employed against payday lending).

100. Peterson, *supra* note 63, at 1139.

101. *Id.*

exceptions.”¹⁰² New York, for example, limits the APR on a typical payday loan to 25%¹⁰³ and, probably as a result, not a single large national payday provider has a location in the state.¹⁰⁴ Through aggressive enforcement by the Attorney General’s Office, the state has effectively eliminated the payday-loan industry in New York.¹⁰⁵

2. *Formal but Underenforced Prohibition.*—Several states have usury limits that apply to payday-lending transactions, but because of underenforcement or special loopholes, payday lending remains a prominent industry in those jurisdictions.¹⁰⁶ Two examples of this type of regulation are Texas and Florida. Both states have legislation specifically purporting to place modest limits on the rates charged for payday loans.¹⁰⁷ But separate statutes in these states allow payday lenders to charge brokerage fees, so that in reality there is no price limit on payday loans at all.¹⁰⁸

3. *Explicit Toleration.*—Some states are more straightforward in their tolerance of payday lending, either by eliminating their usury limit altogether, by exempting payday loans from the usury limit, or by enacting a limit so high that it is practically no limit at all. Seven states took the first position and have no usury laws on their books anymore.¹⁰⁹ Michigan is an example of a state that chose the second position by specifically exempting payday-loan transactions from its usury laws.¹¹⁰ At least thirty-five states allow lenders to charge over 300% APR on a typical payday loan, and Missouri has enacted the highest statutorily allowed interest rate, which is the equivalent of a 1955.36% APR.¹¹¹

Though state usury law has been the primary means of regulating interest rates in recent years, Congress has not completely released its role. Congress recently passed a federal statute that imposes a 36% cap on payday loans to military personnel and their dependants.¹¹² The unique plea of the

102. *Id.* at 1140–41.

103. *Id.* at 1141 tbl.2.

104. Mann & Hawkins, *supra* note 5, at 879–80.

105. *Id.* at 880.

106. *See id.* at 877–78 (noting that a lack of resources or effort makes formal prohibition ineffective); Peterson, *supra* note 63, at 1151 (decrying the state legislatures that have adopted fundamentally misleading statutory limits for credit prices).

107. Peterson, *supra* note 63, at 1152.

108. *Id.*

109. *Id.* at 1138. Delaware, Idaho, Nevada, New Hampshire, South Dakota, Utah, and Wisconsin have completely deregulated interest rates. *Id.* at 1138 n.139.

110. *See* MICH. COMP. LAWS ANN. § 487.2153(1) (West Supp. 2009) (specifying that the service fee “is not interest”).

111. Peterson, *supra* note 63, at 1139. The law allows original interest and fees for a payday loan up to 75% of the initial loan amount. *Id.* “A \$325 loan that grows 75% in 14 days carries an annual percentage rate of 1955.36%.” *Id.*

112. John Warner National Defense Authorization Act for Fiscal Year 2007, Pub. L. No. 109-364, § 670, 120 Stat. 2083, 2266–69 (2006) (codified at 10 U.S.C. § 987 (2006)).

military servicemen, who had been specifically targeted by payday lenders, spurred the enactment of that narrowly tailored bill.¹¹³ House Bill 1214 includes an interest rate cap that, if enacted, will apply more broadly. All payday lenders that are subject to the proposed amendment of the Truth in Lending Act (TILA), regardless of who the borrower may be, would be prohibited from “requir[ing] a consumer to pay interest and fees that, combined, total more than 15 cents for every dollar loaned in connection with a payday loan.”¹¹⁴ For a loan with a duration of two weeks, an average term for these loans, the interest rate limit would be 391% APR.¹¹⁵

For legislators who are not willing to ban payday lending outright within their jurisdiction through usury law, other sharper tools may be applied to address the most offensive aspects of the payday loan: balloon payments and rollovers.

B. Other Substantive Regulations

As with usury limits, a wide spectrum of other substantive regulations are imposed on payday-loan providers. Most states have some form of licensing requirement for commercial payday lenders.¹¹⁶ Other regulations include limits on loan amounts,¹¹⁷ restrictions on collections methods,¹¹⁸ and a private cause of action for any injury resulting from violations of the statute.¹¹⁹ Responding to the troublesome balloon payments, House Bill 1214 proposes a mandatory interest-free extended repayment plan that allows a borrower the option once every six months to repay their payday loan in at least six equal installments.¹²⁰

A majority of the states that regulate payday lending have either limited or prohibited “direct rollover loans.”¹²¹ An increasing number of states also mandate databases that track open payday-loan transactions for all licensed lenders in the state and prohibit lenders from dispersing funds to a borrower

113. See, e.g., Steven M. Graves & Christopher L. Peterson, *Predatory Lending and the Military: The Law and Geography of “Payday” Loans in Military Towns*, 66 OHIO ST. L.J. 653, 659 (2005) (finding “irrefutable geographic evidence” that payday lenders target military servicemembers).

114. Payday Loan Reform Act of 2009, H.R. 1214, 111th Cong., sec. 2(a), § 129B(d)(1) (2009).

115. See *Hearing*, *supra* note 3, at 50 (statement of Jean Ann Fox, Director of Financial Services, Consumer Federation of America) (“The typical [payday] loan term is about two-weeks. The finance charge for a payday loan ranges from around \$15 per \$100 borrowed to \$30, resulting in annual interest rates from 391 percent to 782 percent for a two-week extension of credit.”).

116. Mann & Hawkins, *supra* note 5, at 874.

117. See, e.g., MICH. COMP. LAWS ANN. § 487.2153 (West Supp. 2009) (imposing a maximum cap for the equivalent of a payday loan at \$600).

118. See, e.g., MODEL DEFERRED DEPOSIT LOAN ACT § 20 (Council of State Gov’ts, Suggested State Legislation 2002) (prohibiting threats of criminal prosecution as a collection tool).

119. See, e.g., MICH. COMP. LAWS ANN. § 487.2173 (creating a private cause of action for a person injured by a licensee’s violation of the Deferred Presentment Service Transactions Act).

120. H.R. 1214, sec. 2(a), § 129B(c).

121. Mann & Hawkins, *supra* note 5, at 897.

listed in the database.¹²² This is a necessary feature to effectively prevent multiple rollovers because otherwise borrowers could evade the statutory prohibition by using a loan from one lender to pay off another. Of course, some of these bans may also be ineffective if, like the Colorado statute, they define “renewals” narrowly, allowing the economic equivalent of rollover loans.¹²³ House Bill 1214 also makes it unlawful for a lender to “rollover a payday loan”¹²⁴ or “make more than 1 payday loan at the same time to a consumer.”¹²⁵ The proposed bill defines the term “rollover” to mean “the extension of an outstanding loan by the payment of only a fee.”¹²⁶

C. Disclosure Requirements

Both state legislatures and Congress have imposed mandatory disclosure requirements on payday-loan providers. Under some state statutes, payday-loan providers may be required to post large signs with these disclosures¹²⁷ and to provide them in the written contract agreement that they give to customers.¹²⁸ These disclosures may include information about the terms of the loan (e.g., the finance charge), information emphasizing the constraints of the relevant statute (e.g., “State law prohibits us from using any criminal process to collect on an agreement.”),¹²⁹ and even precatory advice (e.g., “You should use this service only to meet short-term cash needs.”).¹³⁰

The Truth in Lending Act is the most important federal law currently regulating the payday-loan industry. The plain language of the Act supports the conclusion that payday lenders are subject to TILA’s disclosure requirements because they are creditors that regularly issue “consumer credit.”¹³¹ Though payday lenders initially contended that they were not subject to TILA because they were not extending consumer credit, courts have almost

122. *Id.* at 898. Michigan is one state that prohibits payday lenders from extending funds if the state database indicates that the borrower has more than one transaction open with another lender. MICH. COMP. LAWS ANN. § 487.2154.

123. Chessin, *supra* note 12, at 391; *see also* COLO. REV. STAT. ANN. § 5-3.1-108(1) (West 2002 & Supp. 2009) (barring a lender from renewing a deferred-deposit loan more than once).

124. H.R. 1214, sec. 2(a), § 129B(d)(11).

125. *Id.* § 129B(d)(12).

126. *Id.* § 129B(f)(4). Of course, this definition of “rollover” quite possibly leaves a loophole for a borrower who pays off the loan in full and then immediately receives another loan for that amount. Unlike the Michigan statute, there is no provision to limit alternating between lenders to continue deferring payment of the principal amount. *See supra* note 122.

127. *See, e.g.*, MICH. COMP. LAWS ANN. § 487.2151(1) (prescribing the notice to be posted “in an area to be seen by the customer”).

128. *See, e.g., id.* § 487.2152(n) (directing that the notice be included in the written agreement between the service and the customer).

129. *Id.* § 487.2151(1).

130. *Id.*

131. *See* Johnson, *supra* note 47, at 14 nn.63–64 (citing the Truth in Lending Act and Regulation Z to explain that the statutory language was broad enough to include payday lenders).

unanimously held that payday loans are governed by TILA.¹³² In 2000, the Federal Reserve Board revised its official commentary to Regulation Z, stating that TILA regulates payday loans.¹³³

Accordingly, payday lenders must make certain disclosures required by TILA and Regulation Z.¹³⁴ Two key disclosures required by TILA regarding the cost of the loan are the finance charge (basically, the cost stated in dollars) and the APR (basically, a standardized rate that scales the finance charge to the size and term of the loan).¹³⁵ Since the APR is based on the size and term of the loan and payday loans are far from uniform, the APR would vary greatly between customers. Therefore, it is uncertain whether and how payday lenders would post a uniform APR rate in their store. At least one paper has commented that payday loans typically disclose the APR in their loan documents.¹³⁶

The proposed Payday Loan Reform Act is intended to amend TILA to increase protection of payday-loan consumers by requiring additional disclosures. Payday lenders must provide a “clear and conspicuous description of the terms of the loan, including the total cost of all fees and other charges in connection with the loan stated both as a dollar amount and as an annual percentage rate.”¹³⁷ All of the disclosures required by House Bill 1214 must be in the written loan agreement (in both English and the language in which the loan was negotiated)¹³⁸ and “posted conspicuously in English and Spanish and in not less than 1-inch bold print in the creditor’s public lending area in each physical location, or, if the loan is made using the

132. See *Turner v. E-Z Check Cashing of Cookeville, TN, Inc.*, 35 F. Supp. 2d 1042, 1047 (M.D. Tenn. 1999) (“Courts that have addressed the issue have held, without exception, that deferred presentment transactions are extensions of ‘credit’ under TILA.”); Johnson, *supra* note 47, at 16 (“With one exception, courts addressing the issue have held that payday loans are extensions of credit under TILA.”).

133. See 65 Fed. Reg. 17,129 (Mar. 31, 2000) (adopting comment 2(a)(14)-2 to clarify that payday loans are governed by TILA and thus subject to the disclosure requirements of Regulation Z); see also 12 C.F.R. § 226.2(a)(14) (2009) (defining credit for Regulation Z disclosure rules to include the right to defer payment of debt).

134. The Federal Reserve Board, which was given authority by Congress to issue regulations under TILA, 15 U.S.C. § 1607(d) (2006), promulgated Regulation Z, which prescribes the form, content, and timing of the disclosures required by TILA. 12 C.F.R. §§ 226.1–226.33 (2009). The Federal Reserve Board has also issued official commentary on Regulation Z. 12 C.F.R. pt. 226, supp. 1 (2009). The requirements of Regulation Z are deemed requirements of TILA. 15 U.S.C. § 1602(y); *London v. Chase Manhattan Bank USA, N.A.*, 150 F. Supp. 2d 1314, 1322 (S.D. Fla. 2001) (“[A]s is fully apparent from the text of § 1602(y) of TILA, Congress intended that those regulations, which subsequently were promulgated as Regulation Z, would be authoritative respecting the implementation of TILA’s disclosure provisions.”).

135. See Elizabeth Renuart & Diane E. Thompson, *The Truth, the Whole Truth, and Nothing but the Truth: Fulfilling the Promise of Truth in Lending*, 25 YALE J. ON REG. 181, 187–88 (2008) (discussing the finance charge and APR defined at 15 U.S.C. §§ 1605–1606 (2000)).

136. *Id.* at 198.

137. Payday Loan Reform Act of 2009, H.R. 1214, 111th Cong., sec. 2(a), § 129B(a)(1)(A) (2009). Since TILA already requires disclosure of these terms, this requirement seems to serve as reinforcement of prior law rather than an additional regulation.

138. *Id.* § 129B(a)(1).

Internet, fax or other means, posted conspicuously on the creditor's public internet site."¹³⁹ The most important new disclosure required by House Bill 1214 is this: "WARNING: This loan is not intended to meet long-term financial needs. This loan should be used only to meet short-term cash needs. The cost of this loan may be higher than loans offered by other lending institutions."¹⁴⁰

Since payday lenders must already make disclosures under current and proposed regulations, additional mandatory disclosures aimed at debiasing borrowers would not be unduly burdensome. Borrowers who are making systematic mistakes in obtaining and rolling over payday loans could benefit from regulations requiring disclosures that are more than just informative. As the next Part will show, regulators could better understand and more effectively protect payday-loan borrowers by considering theories in behavioral law and economics.

III. Behavioral Law and Economics Analysis

Behavioral law and economics has provided insight into consumer-credit decision making, with particular attention paid to the effects of the credit-card industry. Oren Bar-Gill used behavioral analysis to explain both the extremely high levels of credit-card borrowing and the unique pricing scheme of credit-card contracts.¹⁴¹ He developed a behavioral theory that he labeled the "underestimation bias"—a combination of biases that produce the underestimation of future borrowing.¹⁴² The foundations of the underestimation bias are imperfect self-control, overoptimism, and hyperbolic discounting.¹⁴³ This Note will show how these factors also contribute to the underestimation of future borrowing in the payday-loan context, resulting in more payday-loan transactions than rational-choice theory would predict. The design and pricing of payday loans may also be partially explained by this theory, as sophisticated lenders use framing devices to take advantage of consumers' underestimation biases.

A. *Underestimation of Future Borrowing*

1. *Imperfect Self-Control.*—"[H]uman beings often take actions that they know to be in conflict with their own long-term interests."¹⁴⁴ Most people who have ever been on a diet recognize that their self-control and willpower are not perfect. Similarly, consumer borrowing decisions are not immune from self-control problems. An individual's long-term interests may

139. *Id.* § 129B(b).

140. *Id.* § 129B(a)(1)(C).

141. Bar-Gill, *supra* note 21, at 1375.

142. *Id.* at 1376.

143. *Id.* at 1395–1401.

144. Jolls et al., *supra* note 25, at 1479.

not be served by borrowing more today, but that has not kept the consumer-loan industry from mushrooming in modern America. One of the major criticisms of credit cards is that they “tempt” consumers to borrow more in the short term than they would prefer in the long run.¹⁴⁵ Credit-card contracts are designed in a way that makes them more prone to self-control problems than, for example, traditional bank loans.¹⁴⁶ A typical bank loan is a closed-end transaction, in which all of the terms of the loan contract are determined up front with no discretion left for a later period.¹⁴⁷ Credit cards, on the other hand, leave the amount and term of the loan open.¹⁴⁸ A consumer may plan on limiting her borrowing to a certain amount, but she is not contractually bound to that intention, so her willpower will be tested continually.¹⁴⁹ By contrast, a closed-end loan may serve as a precommitment device—the consumer may commit beforehand to the total amount of debt associated with that transaction—helping the consumer stay more in line with her long-term financial interests.¹⁵⁰

Although facially similar to traditional closed-end loans, as a practical matter payday loans are more akin to open-ended loans because consumers can roll them over indefinitely.¹⁵¹ For the initial payday loan, the amount of debt and term are determined up front, similar to a typical closed-end loan. But on the next payday when the original term expires, the consumer may decide to prevent a loss now by rolling the loan over for another term, shifting the cost into the future. This rollover decision is a temptation similar to the one credit-card users face when they decide whether to pay off their entire balance or to pay only the minimum payment. Lenders facilitate rollovers so that the option is subject to only minimal transaction costs,¹⁵² essentially turning the payday loan into a fixed-principle loan with an open-ended term.

Imperfect self-control may trigger consumer mistakes in the payday-loan context in two ways. First, consumers who are unaware of their imperfect self-control and plan to take out a onetime payday loan may not consider the possibility of renewing the loan for a longer term. They will underestimate their future borrowing, since when the future comes they may not be able to resist the temptation to extend the loan for two more weeks and incur

145. Angela Littwin, *Beyond Usury: A Study of Credit-Card Use and Preference Among Low-Income Consumers*, 86 TEXAS L. REV. 451, 469 (2008).

146. Bar-Gill, *supra* note 21, at 1395.

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.* at 1395–96.

151. See Johnson, *supra* note 47, at 64–69; Mann & Hawkins, *supra* note 5, at 895–98 (both observing that existing statutes do not effectively prevent indefinite rollovers).

152. See QC Holdings, Inc., Annual Report (Form 10-K), at 8 (Mar. 31, 2005) (“Once the initial application and loan process is completed, future transactions can be processed in only a few minutes.”). Moreover, some payday lenders offer rewards programs for repeat borrowers, creating an additional incentive to rollover their debt. Johnson, *supra* note 47, at 73–74.

the additional unexpected costs of the rollovers, which were not calculated as part of the initial loan. Second, consumers who are aware of their imperfect self-control may (incorrectly) view a payday loan as a closed-end loan and decide to use it as a precommitment device to protect against their own self-control problems.¹⁵³ But when payday comes and they are faced with the option to push the costs back two more weeks, they may discover that their borrowing is not as constrained as they had anticipated. Since the temptation was unanticipated, even though the self-control problem was known, these consumers will have also underestimated their future borrowing.

2. *Optimism Bias.*—Many consumers exhibit overoptimism, which contributes to overall underestimation of future borrowing. “People tend to think that bad events are far less likely to happen to them than to others.”¹⁵⁴ This is the so-called above average effect.¹⁵⁵ Most people think that they are less likely to contract certain diseases or get fired than the average person is, though, of course, that cannot be true for everyone.¹⁵⁶ People do not simply exhibit comparative overoptimism: studies also suggest that the optimism bias affects judgments of actual risks or abilities.¹⁵⁷ For example, people not only think that their probability of getting into an automobile accident is lower than the average person’s, but their estimates are also lower than the actual probability.¹⁵⁸ This unrealistic optimism with respect to automobile accidents is a comparable analogy to the optimism bias in payday loans (e.g., most people think that they are less likely to rollover their payday loan than the average borrower). It also contributes directly to the underestimation of borrowing because, when projecting future expenses, most people will underestimate the probability of high medical bills and car-repair expenses. Like automobile accidents, many other adverse events are both susceptible to overoptimism and directly linked to economic hardships that lead people to borrow more.¹⁵⁹ This optimism is even more pronounced in situations where people perceive that they have some degree of control over whether or not

153. See, e.g., Alan M. White, *Behavior and Contract*, 27 LAW & INEQ. 135, 162 (2009) (reporting one borrower’s decision to get a payday loan rather than a credit card because it seemed to preclude runaway debt).

154. Jolls et al., *supra* note 25, at 1524.

155. Jolls & Sunstein, *supra* note 31, at 204.

156. Christine Jolls, *Behavioral Economics Analysis of Redistributive Legal Rules*, 51 VAND. L. REV. 1653, 1659 (1998).

157. *Id.* at 1660–61.

158. *Id.* at 1660.

159. See Bar-Gill, *supra* note 21, at 1400 (noting that individuals tend to underestimate the probability of job loss and how long it will take to find a new job); David Dunning et al., *Flawed Self-Assessment: Implications for Health, Education, and the Workplace*, 5 PSYCHOL. SCI. PUB. INT. 69, 79–80 (2004) (citing studies of unrealistic optimism about health risks); Jolls, *supra* note 156, at 1659–61 (discussing the evidence of unrealistic optimism in many domains, including contracting diseases, auto accidents, and job loss).

the negative event will occur.¹⁶⁰ Thus, payday-loan borrowers may be over-optimistic regarding the likelihood that they will have fewer expenses and more money in two weeks and, even more, that they will have the self-control to repay the loan on its maturity date.

3. *Hyperbolic Discounting*.—Behavioral economics offers another explanation for the high level of payday-loan rollovers with what has been called hyperbolic discounting, or, more generally, present-biased preferences. Hyperbolic discounting refers to the pattern of extreme impatience that people exhibit in the short run, but which declines over time.¹⁶¹ In economic terms, the hyperbolic discounter applies a larger discount rate to events in the near future and a smaller discount rate to events that seem further off.¹⁶² This intertemporal inconsistency is at odds with the neoclassical discounted-utility model, which assumes that people apply the same discount rate to future events no matter when they occur, but has rich empirical literature supporting it as “a more accurate model of human behavior.”¹⁶³

This conclusion has obvious implications for consumer-credit decisions. The present-biased preferences of hyperbolic discounters suggest that “individuals borrow more . . . than they actually would prefer to borrow given their long-term objectives.”¹⁶⁴ Bar-Gill demonstrated how this framework would apply in the credit-card-decision context and how it leads to an underestimation of future borrowing.¹⁶⁵ It can also be used to describe how a consumer underestimates the total cost associated with the initial payday-loan transaction. In delayed-consequences situations like this one, their “preference reversals”¹⁶⁶ from this inconsistent discounting will lead them to misjudge the amount of their future borrowing. Consider a consumer who is offered a \$100 loan for a \$15 fee payable in two weeks (i.e., the choice between \$100 today and \$115 in two weeks). If the consumer heavily discounts the future reward compared to today’s reward, then she will be willing to pay the high fee to borrow money now. But, even if she currently intends to repay the loan in two weeks because her long-term discount rate is lower, she may change her mind. As two weeks go by, and she arrives at the

160. N.C. Higgins et al., *The Controllability of Negative Life Experiences Mediates Unrealistic Optimism*, 42 SOC. INDICATORS RES. 299, 319 (1997).

161. Jolls et al., *supra* note 25, at 1539.

162. Shane Frederick et al., *Time Discounting and Time Preference: A Critical Review*, 40 J. ECON. LITERATURE 351, 360 (2002) (“[T]he implicit discount rate over longer time horizons is lower than the implicit discount rate over shorter time horizons.”).

163. Littwin, *supra* note 145, at 468; *see also* Bar-Gill, *supra* note 21, at 1396–99 (citing research of hyperbolic discounting in action); Frederick et al., *supra* note 162, at 360–67 (reviewing the empirical evidence of the hyperbolic discounting pattern).

164. Stephan Meier & Charles Sprenger, *Impatience and Credit Behavior: Evidence from a Field Experiment 3* (Research Ctr. for Behavioral Econ. and Decision-Making, Working Paper No. 07-3, 2007), available at <http://www.bos.frb.org/economic/wp/wp2007/wp0703.pdf>.

165. Bar-Gill, *supra* note 21, at 1396–99.

166. Frederick et al., *supra* note 162, at 361.

new “today,” her preference will reverse, and she will again prefer paying a high fee later over paying anything now. Where “today” is constantly changing, people’s preferences for “today” can lead to poor predictions of their future credit decisions.

The underestimation of future borrowing that results from hyperbolic discounting has a compound effect on payday borrowers who are deciding whether to take out an initial payday loan. Consumers are extremely impatient in the present, exhibiting high discount rates in the short term.¹⁶⁷ As demonstrated, they are willing to bear high costs in the future in order to receive a benefit now, so they will accept a high fee payable in two weeks to receive a cash advance now.¹⁶⁸ But since the decision to roll over the loan is in the more distant future and consumers have lower discount rates in the long run, consumers expect to be less willing to pay that high fee then. Consumers’ present impatience is compounded by their underestimation of the likelihood of rollovers because in making their initial decision they will consider their anticipated cost and not the actual cost of the loan. The future cost will not be simply the anticipated, onetime finance charge due on their next payday, but the combined finance charges from all subsequent rollovers. Thus, consumers will both underestimate and heavily discount the total cost of the payday loan. As a result, hyperbolic discounting may cause borrower mistakes—borrowers prefer not to rollover the loans, but in fact do so frequently.

B. Design and Pricing of Payday Loans

In a perfectly competitive and efficient market, the price of the loan should equal its marginal cost.¹⁶⁹ Though there is evidence of competition in the credit-card and payday-loan markets, neither market exhibits this feature. Bar-Gill demonstrated how behavioral biases contribute to the unique pricing scheme of credit cards and specifically showed that competition compelled sellers to take advantage of consumers’ weaknesses in their pricing.¹⁷⁰

Credit cards are priced in such a way that long-term contingent elements (e.g., long-term interest rates and late fees) are overpriced, while short-term noncontingent elements (e.g., annual fees and teaser rates) are underpriced.¹⁷¹ The underestimation bias explains why borrowers are less sensitive to the long-term elements and, thus, why competition in the credit-card industry has focused on the short-term elements to which borrowers pay more attention.

167. See *supra* notes 161–62 and accompanying text.

168. See Barr, *supra* note 10, at 154 (summarizing a 2001 survey revealing nearly all charged APRs in payday loans to be in excess of 300%).

169. See Bar-Gill, *supra* note 21, at 1377 (explaining that marginal-cost pricing, by aligning private incentives with the social objective of welfare maximization, creates a situation whereby goods and services are produced only when the benefit exceeds the cost, and thus an optimal allocation of resources is achieved).

170. *Id.* at 1373.

171. *Id.* at 1394–95.

Payday loans exhibit a pricing scheme similar to credit cards in that the long-term element (i.e., the rollover fee) is priced higher relative to marginal costs than the short-term element (i.e., the initial loan fee). Though all the fees are the same dollar amount, the marginal cost of a renewed loan to a repeat borrower is lower than the marginal cost of the initial loan. The costs associated with high-frequency borrowers are much less than the costs of serving low-frequency borrowers,¹⁷² and lenders can take advantage of economies of scale. Both operating costs and loss ratios are significantly lower for high-frequency borrowers, for whom the lenders have already verified the validity of their identification and bank account, and who have a demonstrated propensity to pay.¹⁷³ Payday lenders may compete on the nominal value of the finance fee, but market forces have not compelled the structure of the loan to adjust to the marginal costs of rollover loans. Rather, lenders are able to benefit from borrowers' systematic underestimation of rolling over their loan and, thus, their inelasticity with respect to the costs of the rollover fee. Payday lenders amass more than 90% of their profits from borrowers who have five or more rollovers during a year.¹⁷⁴ Essentially, this distorted pricing scheme means that repeat borrowers paying multiple rollover fees are cross-subsidizing onetime borrowers who only pay the initial loan charge. This distributive effect suggests that legal intervention should be considered.¹⁷⁵

Not only is the pricing designed for payday lenders to profit from the debt trap of rolling over multiple loans, but sophisticated lenders are also able to "frame" the loan decision in such a way as to exploit consumers' underestimation biases. Framing the way financial information is presented can profoundly and predictably impact an individual's choice.¹⁷⁶ In fact, evidence of framing effects has shown that "decision makers are generally quite passive and therefore inclined to accept any frame to which they are exposed."¹⁷⁷ Payday loans are described, marketed, and even named as short-term loans—cash advances just until payday¹⁷⁸—encouraging

172. Mann & Hawkins, *supra* note 5, at 865.

173. *Id.*; QC Holdings, Inc., *supra* note 152, at 8 (discussing the speed and efficiency of processing repeat transactions once the initial loan application has been processed).

174. Bar-Gill & Warren, *supra* note 28, at 44. The study that Bar-Gill and Warren cite reports that "91% of all payday loans are made to borrowers with five or more payday loans per year." ERNST ET AL., *supra* note 54, at 5. Assuming their data are correct, the profit that was actually amassed from those loans should actually be more than 90% after taking into account the lower costs associated with repeat borrowers. Of course, the accuracy of any profit estimates depends on the accuracy of the underlying data, which is uncertain here. See *supra* subpart I(A).

175. See Bar-Gill, *supra* note 21, at 1377 (arguing that these same welfare costs are generated by the underestimation bias in the credit-card market and provide a prima facie case for legal intervention).

176. Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCI. 453, 453 (1981).

177. Daniel Kahneman, *Preface* to CHOICES, VALUES, AND FRAMES, at ix, xv (Daniel Kahneman & Amos Tversky eds., 2000).

178. Mann & Hawkins, *supra* note 5, at 857.

borrowers to underestimate the likelihood of rolling over the loan into longer-term debt. Lenders frame the price as a single (though oft-repeated) payment of a small fixed fee, so that a borrower will consider only the nominal \$30 payment made to extend the loan for two more weeks, and not the long-term accumulated interest of \$1080 on a loan rolled over and rolled over and rolled over . . . for eighteen months. Potential borrowers are inclined to accept the frame that the lenders have provided, making them even more likely to ignore the possibility that the loan might be rolled over and cost more than the initial fee. Just as lenders have been able to actively obscure the total costs and term of these credit products through framing, debiasing may also be accomplished by specific framing of the information provided in the requisite payday-loan disclosures.

IV. Debiasing Proposal

A. *Debiasing as a Means of Regulation*

The underestimation bias exhibited by borrowers and the inefficient, possibly exploitive, market for payday loans call for improved regulations. Where some borrowers may benefit from access to relatively convenient short-term cash advances, other borrowers bear the burden of increasing debt costs, sometimes without even realizing it. This heterogeneity calls into question both ends of the regulatory spectrum—strict usury law, which effectively limits customer choice by eliminating payday loans as an option, and complete deregulation, which effectively limits consumer protection by allowing lenders to design and market these loans in any manner. Prohibiting unlimited renewals and rollovers is a less drastic option than either of those two and directly addresses the most objectionable aspect of the payday loan. Some states have already enacted regulation purporting to do this, though the effectiveness of these statutes has yet to be fully determined.¹⁷⁹ Also, to the extent that payday lenders rely on profits from rollovers, this regulation would effectively ban the entire market.¹⁸⁰ Disclosure requirements provide another alternative that accommodates consumer choice, imposes minimal additional costs, and attempts to protect consumers as well. The mandatory information disclosures currently required under TILA, and those proposed under House Bill 1214, while providing a middle-ground regulatory scheme, have one major drawback: they will not effectively prevent borrowing mistakes by the segment of the consumer population exhibiting the underestimation bias and, consequently, will not effectively prevent them from getting caught in the debt trap of multiple rollover loans. By providing statistical information and general warnings, these disclosures

179. See *supra* text accompanying notes 121–26 (discussing the potential loopholes in renewal bans).

180. See Mann & Hawkins, *supra* note 5, at 895 (mentioning a study that indicates profitability might depend on rollovers, suggesting that a ban on rollovers could eliminate the market).

may remedy imperfect information, but they cannot remedy imperfect rationality.

Consider the impact of one warning required by the proposed House Bill 1214 on consumers who display the biases discussed in Part IV. Both the loan contract and a sign with at least one-inch font must state: “WARNING: This loan is not intended to meet long-term financial needs. This loan should be used only to meet short-term cash needs. The cost of this loan may be higher than loans offered by other lending institutions.”¹⁸¹ An overoptimistic borrower who reads that warning at the payday-loan store will think that it does not apply to her because she only has a short-term cash need and things will be better when she gets her next paycheck. A hyperbolic discounter will likewise dismiss the warning because she thinks now that she would not choose such an expensive loan in the long-term, but that it is worth it for the present short-term situation. Since the credit decisions of these borrowers will not be affected by straight information and warnings like this one, these regulations are *ex ante* limited in their effectiveness. In order to impact more, perhaps all, of the payday-borrower population, legislators should consider requiring additional disclosures aimed at debiasing potential borrowers.

A variety of debiasing strategies have been proposed with varying degrees of proven success and large-scale feasibility.¹⁸² Christine Jolls and Cass Sunstein recently proposed and explored the possibility of using some cognitive biases to counteract others.¹⁸³ This strategy would implement the availability heuristic and framing to correct the optimism bias.¹⁸⁴ “The availability heuristic refers to the tendency of people to overestimate the likelihood that particularly vivid and salient events will occur.”¹⁸⁵ An event that invokes a more vivid mental image will be more “available” when individuals make decisions and thus disproportionately impact those judgments.¹⁸⁶ Since overly optimistic individuals underestimate the likelihood that adverse events will happen to them, making those adverse events more vivid or available is a promising debiasing strategy. Illustrations and concrete narratives are two effective methods for making an occurrence more available. The Canadian Health Ministry, for example, recently required cigarette packs to bear graphic pictures of cancerous gums and lungs in a fairly

181. Payday Loan Reform Act of 2009, H.R. 1214, 111th Cong., sec. 2(a), §§ 129B(a)(1)(C)(i), (b)(1) (2009).

182. For a review of debiasing strategies and their effectiveness with respect to the overoptimism bias, see Sean Hannon Williams, *Sticky Expectations: Responses to Persistent Overoptimism in Marriage, Employment Contracts, and Credit Card Use*, 84 NOTRE DAME L. REV. 733, 748–53 (2009).

183. Jolls & Sunstein, *supra* note 31, at 209–11.

184. *Id.*

185. Williams, *supra* note 182, at 751.

186. *Id.*

successful attempt to use the availability heuristic to reduce smoking.¹⁸⁷ People tend to respond to personalized narratives even when they would not respond to statistical information.¹⁸⁸

In addition to debiasing through the availability heuristic, Jolls and Sunstein suggested the use of framing effects to counteract cognitive biases.¹⁸⁹ People are not inclined to change the frame in which they receive information. Moreover, people often perceive outcomes as either gains or losses relative to a neutral reference, and they weigh losses more heavily than gains.¹⁹⁰ This loss aversion implies that framing an outcome as a loss rather than a gain will generally affect how people respond.¹⁹¹ “[E]xploit[ing] the extra weight attached to losses may counteract bounded rationality in the form of optimism bias.”¹⁹² In a recent dispute over a government advertising campaign regarding the effects of breast-feeding on newborn health, both sides of the dispute showed an intuitive understanding of framing effects and loss aversion.¹⁹³ Breast-feeding advocates favored advertisements that would refer to the risks of leukemia and other diseases from not consuming breast milk, whereas opponents of breast-feeding recommended emphasizing the advantages of breast-feeding.¹⁹⁴ Advertising the risks (losses) from not breast-feeding would have a greater impact on behavior.

Personal narratives framed to emphasize the likelihood of losses in a payday-loan transaction may do well to debias overoptimism in consumers, but the underestimation of future borrowing attributable to imperfect self-control and hyperbolic discounting may require a disclosure tailored specifically to the borrower. With respect to credit-card contracts, Bar-Gill has argued that “[u]se patterns should be added to the list of required disclosures.”¹⁹⁵ Requiring lenders to provide each borrower with personalized data of how she has used—and is predicted to use—her credit card could be a major factor in reducing consumer-credit mistakes.¹⁹⁶ Both

187. *Id.* (citing D. Hammond et al., *Impact of the Graphic Canadian Warning Labels on Adult Smoking Behaviour*, 12 *TOBACCO CONTROL* 391, 391–92 (2003)).

188. See George Loewenstein et al., *Statistical, Identifiable, and Iconic Victims*, in *BEHAVIORAL PUBLIC FINANCE* 32, 33 (Edward J. McCaffery & Joel Slemrod eds., 2006) (“Several lines of research have shown that individual cases motivate people more powerfully than statistics, even when the latter are objectively more informative.”).

189. Jolls & Sunstein, *supra* note 31, at 210.

190. Dilip Soman, *Framing, Loss Aversion, and Mental Accounting*, in *BLACKWELL HANDBOOK OF JUDGMENT AND DECISION MAKING* 379, 383 (Derek J. Koehler & Nigel Harvey eds., 2007).

191. *Id.*

192. Jolls & Sunstein, *supra* note 31, at 210.

193. *Id.* at 206.

194. *Id.*

195. Oren Bar-Gill, *The Behavioral Economics of Consumer Contracts*, 92 *MINN. L. REV.* 749, 798 (2008).

196. See *id.* at 798–800 (explaining that use-pattern disclosures provide consumers with information about use of the product, which is essential for an informed choice and efficient operation of the credit-card market).

point-of-sale disclosures and point-of-borrowing disclosures could make consumers aware of events that may trigger increased penalties or fees.¹⁹⁷ Credit-card issuers acquire detailed statistics on consumers' use patterns and have sophisticated databases and algorithms that predict future use, whereas consumers may have the relevant information but lack the sophisticated algorithms to consolidate and analyze it to predict their own future use.¹⁹⁸ Similar personalized-use-statistics disclosures regarding the number of rollovers a payday-loan borrower has accumulated may be an effective means to counteract her underestimation of future borrowing by revealing her past borrowing.

Disclosures utilizing these debiasing mechanisms will help counteract the underestimation bias, which leads to excessive rollovers. Though these measures are only a partial solution for a portion of the borrowing population, they have potential to make a significant impact by reducing the welfare costs imposed by repetitive borrowing mistakes. Debiasing should not adversely affect borrowers who are already benefitting from payday-loan transactions because, unlike usury limits, it should not limit access to credit. Implementation also should not impose substantial costs, as disclosure requirements are already in place. Congress and others informed in this industry could develop a disclosure to effectively balance the impact of debiasing and information overload; this Note offers examples of possible disclosures that incorporate the analysis above.

B. Model Debiasing Disclosures

1. Specific Narrative Disclosure.—An effective debiasing disclosure may include a vivid narrative of a borrower who has fallen into the debt trap and a frequency statistic regarding rollover rates, stated explicitly in terms of the costs and losses. The required disclosures under House Bill 1214 must be in 14-point boldface font in the written loan document,¹⁹⁹ like the example narrative below:

Jamie Johnson received a two-week payday loan of \$300. Her next paycheck did not go as far as she expected, so she renewed her loan for another \$45 fee. Four months later, Jamie paid off her loan. Jamie paid \$660 to pay off her \$300 loan plus \$360 in fees.

197. *Id.* at 800 (explaining Ronald Mann's point-of-sale proposal to prevent inadvertent fees and proposing his own point-of-borrowing disclosure).

198. *Id.* at 799–800. “Credit card issuers often have more information about how a consumer will use the credit card than the consumer herself.” *Id.* at 799.

199. Payday Loan Reform Act of 2009, H.R. 1214, 111th Cong., sec. 2(a), § 129B(a)(1)(C) (2009).

9 out of 10 payday loans are issued to borrowers with 5 or more payday loans a year.

This example narrative of Jamie Johnson is only one debt-trap scenario out of a wide spectrum that could be used. The \$360 total fee is the result of a borrower who rolls over her initial loan seven times. According to existing studies, seven rollovers may be a conservative estimate of the average borrower's rollovers in a year.²⁰⁰ The frequency statistic "9 out of 10 payday loans are issued to borrowers with 5 or more payday loans a year" was drawn from a report by the Center for Responsibility.²⁰¹ This frequency was chosen out of the many alternatives as a salient statistic that would be more effective at counteracting the above-average effect. Using numerals as opposed to percentages also reduces the likelihood of consumer mistakes because "people have a greater intuitive understanding of whole numbers than percentages."²⁰²

A personal narrative will not only be more available to consumers in a way that will counteract their underestimation of future borrowing but also will more effectively inform them of the costs of the payday loan. Overwhelming evidence suggests that current financial disclosures do not adequately inform most consumers because they generally do not understand what the APR is or how it works.²⁰³ A few lines relating the actual experience of another payday-loan customer and the costs that he or she incurred will help consumers understand the real costs of the loan, even if they cannot grasp the complexity of the APR.

2. *Personalized-Use-Statistics Disclosure.*—Use-statistics disclosures, similar to those proposed by Bar-Gill for credit cards, should also be required by payday lenders.²⁰⁴ Borrowers who display hyperbolic discounting and imperfect self-control underestimate their future use of rollovers.²⁰⁵ This misperception of future personal use, in addition to the persistent above-average effect, may limit the effectiveness of a general disclosure statement about the average payday loan borrower. If lenders are required to tell borrowers each time they apply for a loan the number of payday loans that the borrower has obtained from all lenders in the state in the past year, then a borrower will more likely be able to accurately assess the likelihood of future

200. See *supra* notes 51–55 and accompanying text. According to the CFSA-funded study, the median number of renewals in a twelve-month period was less than four. ELLIEHAUSEN & LAWRENCE, *supra* note 43, at 38–39. But other studies report average renewals much higher; an Indiana study, for example, revealed that, on average, borrowers had ten renewals in a twelve-month period. Schaaf, *supra* note 61, at 346.

201. ERNST ET AL., *supra* note 54, at 2.

202. Renuart & Thompson, *supra* note 135, at 219.

203. Bar-Gill & Warren, *supra* note 28, at 27–32.

204. See *supra* notes 195–98 and accompanying text (discussing Bar-Gill's arguments favoring point-of-sale and point-of-borrowing disclosures that reveal consumers' use patterns).

205. Bar-Gill, *supra* note 21, at 1395–1401.

rollovers and the resulting actual cost of the loan. An even stronger debiasing version of personal-use statistics would be to require the lenders to tell each payday-loan borrower the total amount of fees in dollars they have paid in the past year. By calculating the accumulated costs for the borrower (e.g., \$1080) rather than merely the number of rollovers (e.g., seven), these disclosures become more salient, and the loss more apparent.

V. Conclusion

As Representative Gutierrez has recognized, payday-loan borrowers may need more protection than current regulations provide. What he may not have recognized is that general precatory advice and statistical information about the loans will not affect the decisions of the significant number of borrowers who underestimate their likelihood of borrowing for a much longer term than the original two-week loan. Using insight from BLE, and empirical data from previous studies, this Note has shown that at least some segment of the population of borrowers is making a mistake by getting a payday loan and incurring unexpected additional costs. These borrowers have cheaper alternatives than a payday loan with triple-digit effective interest rates but underestimate the total costs of the payday loan because they have imperfect self-control, exhibit hyperbolic discounting, and are overly optimistic. The pricing and design of payday loans respond to this underestimation by framing the costs as a onetime fixed fee while procuring the most profits and revenue from the many additional fees that the lenders charge as the borrower rolls her loan over and over again.

Legislators have many options for regulating this industry. Direct limitations on the interest rate through usury laws have historically been the method of choice, but now very few states impose truly limiting usury rates. Rollover bans are another mechanism to protect consumers from making these costly mistakes, but few today are efficiently drafted and enforced. Disclosures, which impose few of the negative externalities that the far more aggressive usury laws and rollover bans do, are at the forefront of payday regulation today. Along with the disclosures proposed by House Bill 1214, vivid narratives of average or typical borrowers who have rolled their loan into long-term debt should be used to counteract the short-term frame that lenders have marketed. In addition to this salient narrative of borrowers in financial stress, lenders should be required to tell each borrower how many times she has personally rolled over her previous loans. This individualized information is feasible in many states that currently have statewide payday-loan databases, and it would not be prohibitively expensive to enact in those that do not. These debiasing measures would mitigate cognitive error without limiting the options of borrowers who rationally choose payday loans. One day Jamie Johnson, and borrowers like her, may begin to recognize the true cost of a payday loan, which includes the risk of rollover after rollover.

—*Karen E. Francis*