Fair Credit Markets: Using Household Balance Sheets to Promote Consumer Welfare

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Access to credit can provide a path out of poverty. Improvidently granted, however, credit also can lead to financial ruin for the borrower. Unfortunately, the various regulatory approaches to consumer lending do not effectively distinguish between these two effects of the lending process. This Article develops a framework, based on the household balance sheet, that effectively distinguishes between lending that is welfare-enhancing for the borrower and lending that is potentially (indeed likely) ruinous and argues that the two types of lending should be regulated in vastly different ways.

From a balance sheet perspective, various kinds of personal loans impact borrowers in vastly different ways. This difference depends on whether the loan proceeds are being used: (a) to make an investment (where the borrower hopes to earn a spread between the cost of the borrowing and the returns on the investment); (b) to fund capital expenditures (homes, cars, etc.); or (c) to fund current consumption (medical care, food, etc.). From a balance sheet perspective, this third type of lending is distinct. Such loans reduce wealth and are correlated with significant physical and mental health problems among borrowers.

Payday loans are the paradigmatic example of the use of credit to fund current consumption. Loans to fund current consumption reduce the wealth of the borrower because they create a liability on the "personal balance sheet" of the borrower without creating any corresponding asset. The general category of loans to fund current consumption includes both loans used to fund unforeseen contingencies, like emergency medical care or emergency car repairs, and those used to make routine purchases. Consistent with the stated justification for creating these lending facilities, which is serving households and communities, the emergency lending facilities of the U.S. Federal Reserve should be made accessible to individuals facing emergency liquidity needs in a partnership with the nation's commercial banks.

Loans that are taken out for current consumption but are not used for emergencies also should be afforded special regulatory treatment. Lenders who make nonemergency loans for current consumption should owe fiduciary duties to their borrowers. Compliance with such duties would require not only much

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greater disclosure than is currently mandated but also would impose a duty of suitability on lenders, which would require lenders to provide borrowers with the most appropriate loan for their needs—among other protections discussed here. These heightened duties also should be extended to borrowers when they take out a loan that increases the debt on a borrower's balance sheet by more than 25%.

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I. Introduction

Access to credit is supposed to serve as a pathway to economic independence and a mechanism for alleviating poverty.[1] Beyond that, access to credit and other financial services is instrumental to ensuring other stated rights and for allowing human flourishing.[2] These characterizations of the crucial, salutary role of credit describe how credit sometimes can be used by the least-advantaged members of society to improve their situations.[3] But there is a dark side to credit. Extensions of credit to vulnerable and financially desperate borrowers can increase the financial vulnerability of such borrowers and even result in their financial ruin.[4]

Oddly, almost no scholarship has attempted systematically to distinguish between harmful, abusive lending and beneficial, welfare-enhancing lending. In particular, the relentless effort to limit the regulation of lending by requiring disclosure of loan terms reflects the view that lending

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1. *See* AMARTYA SEN, DEVELOPMENT AS FREEDOM 39 (Oxford Univ. Press, 2001) (describing availability and access to finance as a significant factor for accessing economic entitlements); Muhammad Yunus, Nobel Lecture (Dec. 10, 2006), https://www.nobelprize.org/prizes/peace/2006/yunus/26090-muhammad-yunus-nobel-lecture-2006-2 [https://perma.cc/P4VD-ZDFQ] (discussing the work of Grameen Bank, which has "give[n] loans to nearly 7.0 million poor people, 97 per cent of whom are women, in 73,000 villages in Bangladesh" to support income-generating activities, housing, students, and micro-enterprise loans).

2. Marek Hudon, *Should Access to Credit Be a Right?*, 84 J. BUS. ETHICS 17, 25 (2009). Professor Hudon cites the claim by Muhammad Yunus that:

> [T]he establishment of a right to credit is critical to poverty reduction and the achievement of other basic rights. If borrowers can create income for themselves, they can take care of the right to food and the right to shelter. Recent evidence indeed suggests that access to credit is instrumental to economic development . . . .

Id.; INT'L COUNCIL ON HUM. RTS. POL'Y, ENHANCING ACCESS TO HUMAN RIGHTS 18 (2004) (describing how "women's NGOs, in tandem with developmental agencies, have been able to initiate small credit groups and income-generating initiatives to begin to counter the lack of access to credit and open up new possibilities to women" and observing that "[a]ccess to . . . credit facilities and markets can unlock new opportunities for the rural poor").

3. Muhammad Yunus, *A National Strategy for Economic Growth and Poverty Reduction*, SUSTAINABLE DEV. NETWORKING PROGRAMME, http://www.sdnbd.org/sdi/issues/IT-computer/prsp-yunus.htm [https://perma.cc/6EZJ-XNTC]; *see also id.* (arguing that access to credit is a human right).

4. Abbye Atkinson, *Rethinking Credit as Social Provision*, 71 STAN. L. REV. 1093, 1161 (2019) (disputing the notion that credit benefits the poor and asserting that "credit of any quality will strip wealth from poorer communities when even repaying the principal alone is difficult, much less the interest. Given the relative economic despair of low-income borrowers, credit presents more interpersonal redistributive danger than it does intertemporal, intrapersonal relief"); *see generally* KEITH ERNST, JOHN FARRIS & URIAH KING, CTR. FOR RESPONSIBLE LENDING, QUANTIFYING THE ECONOMIC COST OF PREDATORY PAYDAY LENDING (2004), https://www.responsiblelending.org/payday-lending/research-analysis/CRLpaydaylendingstudy121803.pdf [https://perma.cc/62KZ-MHFH]; *see also* Philip Bond, David K. Musto & Bilge Yilmaz, *Predatory Mortgage Lending*, 94 J. FIN. ECON. 412, 413 (2009) (examining the pervasiveness of predatory lending practices and the reasons predatory loans cause harm).

inevitably benefits the borrower as long as the borrower knows what she is getting. This Article challenges that orthodoxy.

Building on the simple descriptive point that not all loans are the same, this Article develops the normative corollary of that observation, which is that the law should not treat all loans equally. Historically, access to credit has been categorically and indiscriminately viewed as a good thing because "[a]ccess to credit is considered to be a major springboard for economic development."[5] But extending credit is a good thing if, and only if, it benefits the borrower,[6] and clearly, not all lending benefits the borrower.[7]

The challenge is to fashion and operationalize a regulatory system that reduces or eliminates the incidence of welfare-reducing loans without triggering a corresponding diminution in the supply of welfare-enhancing loans. Another challenge is to create a regulatory regime that provides the same rights and protections to the working poor when they enter the credit markets that are routinely extended to individual and institutional investors in the securities markets.

The analysis presented here is relevant in analyzing all sorts of consumer finance, including the dominant form of such consumer debt,[8] which is credit card debt.[9] The analysis is particularly relevant, however, in analyzing payday loans and other forms of consumer credit directed at lower- and middle-income borrowers, such as single-payment auto title loans and balloon payment loans.

The idea is very simple. Even the most vulnerable and unsophisticated borrower has a concrete plan for how she will use the proceeds of a loan that she is seeking. And the way in which the borrower plans to use the loan

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5. Oren Rigbi, *The Effects of Usury Laws: Evidence from the Online Loan Market*, 95 REV. ECON. & STAT. 1238, 1247 (2013).

6. Of course, one might argue that a particular extension of credit is a good thing even if it harms the borrower, as long as it benefits the lender more. I reject this argument.

7. An entire category of loans, designated as predatory loans, are welfare reducing. *See* DONALD P. MORGAN, DEFINING AND DETECTING PREDATORY LENDING (Fed. Rsrv. Bank of N.Y. Staff Reports No. 273, 2007) (examining and defining predatory lending as welfare reducing). A classic example of a welfare-reducing loan is one in which the lender extends credit that is collateralized by a valuable asset, such as a house, anticipating that the borrower will default in order to obtain ownership of the collateral.

8. Consumer debt is personal debt incurred in purchasing goods (automobiles, houses, food, etc.) or services (medical care, education, etc.) that are used for individual or household consumption. Individuals and families also can incur personal debt by guaranteeing the debt of others and by guaranteeing business debt.

9. Alan Goforth, *Average Household Debt Rises During Pandemic to over $150K*, BENEFITSPRO (Sept. 29, 2021, 5:06 PM), https://www.benefitspro.com/2021/09/29/average-household-debt-rises-during-pandemic-to-over-150k/ [https://perma.cc/5VWG-YWG7]. In addition to credit card debt, debt owed for home mortgage loans, student loan debt, and medical debt are some of the most common forms of consumer debt. *See What Are the Different Kinds of Debt?*, EQUIFAX, https://www.equifax.com/personal/education/covid-19/types-of-consumer-debts [https://perma.cc/YR2P-L57M] (describing the most common types of debt).

proceeds will determine the expected *effect* of a particular loan on her balance sheet at the time that the loan is made. Specifically, depending on how the proceeds are to be used, the effect of a particular loan will be either positive, neutral, or negative on the balance sheet of the borrower. The nature of these effects should determine how the loan is regulated. Generally, borrowers will seek loans for one of three purposes. Specifically, loans will be taken out: (a) to fund an investment by the borrower; (b) to acquire a long-term capital asset; or (c) to fund current consumption. As developed here, the point of this taxonomy is to put into sharp focus the fact that the third category of borrowing is highly problematic because, unlike the other two categories of borrowing, borrowing for current consumption makes the borrower immediately poorer for the simple reason that it adds an ongoing liability to the borrower's balance sheet without adding anything whatsoever to the asset side of the borrower's balance sheet.

Current approaches to regulating loans focus on the ability of borrowers to repay their loans, on limiting the interest rate being charged by lenders, and on requiring disclosures of the finance charge and interest rate being charged as reflected in the Annual Percentage Rate (APR) associated with the loan.[10] All of these approaches ignore the way in which borrowers utilize loan proceeds. In ignoring how loan proceeds are used, the current approach sometimes fails to properly protect financially unsophisticated borrowers from lenders' predatory tactics and sometimes forecloses credit to borrowers who genuinely would benefit from it.

This Article proposes a three-pronged approach to regulating consumer finance. First, loans where the proceeds are used for purposes of current consumption should be singled out for special regulatory treatment. Second, the Federal Reserve's (the Fed) lending facilities should be available at below-market rates to finance borrowing by collateralized borrowers who are seeking funds for emergencies. Third, borrowers who are in the market for credit to fund nonemergency consumption should receive heightened legal protection.

The justification for providing special regulatory scrutiny for loans used for current consumption emerges directly from the balance sheet approach

10. *See, e.g.*, Julia Kagan, *Ability to Repay*, INVESTOPEDIA (Aug. 31, 2021), https://www.investopedia.com/terms/a/ability-to-repay.asp [https://perma.cc/ZT3H-DP7P] ("The ability-to-repay rule is the part of the Dodd-Frank Wall Street Reform and Consumer Protection Act that restricts loans to borrowers who are likely to have difficulty repaying them."); Will Kenton, *Usury Laws*, INVESTOPEDIA (Nov. 23, 2020), https://www.investopedia.com/terms/u/usury-laws.asp [https://perma.cc/SH6P-N2KL] ("Usury laws are regulations governing the amount of interest that can be charged on a loan. . . . These laws are designed to protect consumers."); *What Information Is a Creditor/Lender Required to Disclose About a Credit Card or Loan Product?*, CONSUMERACTION (Feb. 25, 2019), https://www.consumer-action.org/helpdesk/articles/loan_disclosure_requirements [https://perma.cc/L7AK-5WQE] (listing the information a lender is required to disclose about loan products, including APR).

introduced here. The fact that these loans have an immediate, negative effect on the borrower's wealth is reason enough for special regulatory scrutiny.

The justification for making the Fed's lending facilities available at special rates for borrowers who have emergency needs for liquidity is even more straightforward. While the Fed's emergency lending powers historically were deployed sparingly and only to protect the integrity of the banking system, its supervisory and regulatory response to the COVID-19 pandemic broke new ground: not only by making the Fed's credit facilities available to small businesses, but also by explicitly endorsing a policy of "maintain[ing] the supply of credit to U.S. households."[11] The policy of maintaining the supply of credit to U.S. households has, strangely, been used to justify extensions of credit to foreign and international monetary authorities.[12] So, extending credit to actual flesh-and-blood U.S. consumers when they are facing a demonstrable need for short-term credit to pay for legitimate emergencies does not seem to be a stretch. Similarly, the justification for making the Fed's credit facilities available to individuals facing financial distress due to the need for emergency funds is also consistent with other federal lending facilities such as the Paycheck Protection Program.[13]

The third policy prescription in this Article, which would require that borrowers who are in the market for credit to fund nonemergency current consumption receive heightened legal protection, is the easiest of this Article's policy prescriptions to justify. U.S. law provides an elaborate phalanx of legal protections for investors who buy and sell securities.[14] It is easy to show that the justifications for protecting purchasers and sellers of securities apply with even greater force to the more financially vulnerable, less financially sophisticated borrowers who obtain credit to fund nonemergency current consumption.

This Article proceeds as follows. Part II provides a taxonomy of the three different types of credit and describes how these different types of loans have significantly different effects on the balance sheets of the borrowers who obtain such loans. Part II also elaborates on why the balance sheet approach to analyzing lending creates a valuable framework for determining

11. *Coronavirus Disease 2019 (COVID-19)*, BD. GOVERNORS FED. RSRV. SYS. (Apr. 8, 2021), https://www.federalreserve.gov/covid-19-supervisory-regulatory-faqs.htm [https://perma.cc/V26U-XZKE].

12. *Id.*

13. *See Paycheck Protection Program*, U.S. SMALL BUS. ADMIN., https://www.sba.gov/funding-programs/loans/coronavirus-relief-options/paycheck-protection-program [https://perma.cc/HMP9-HN8P] (describing how the program "helps businesses keep their workforce employed during the COVID-19 crisis").

14. *See, e.g.*, *The Laws That Govern the Securities Industry*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/investing-basics/role-sec/laws-govern-securities-industry [https://perma.cc/Z8R7-FWEU] (summarizing securities laws).

how to regulate a particular extension of credit. Additionally, Part II provides a practical guide to the lending taxonomy offered here, focusing on various types of consumer credit, including pawnshop loans, student loans, and, perhaps the most controversial type of consumer loan, payday lending. Moreover, Part II shows how consumer lending sometimes can provide a crucial lifeline for financially distressed borrowers and sometimes can act as a pernicious trap that leads to financial ruin for the unsuspecting borrower. Part III provides an overview of how loans currently are regulated and describes the deficiencies in the current regulatory approach as it applies not only to payday loans but also to other forms of consumer lending, including home mortgage loans. Part IV contains a series of proposals for improving the regulation of consumer lending using the balance sheet approach described here.

Specifically, in Part IV, I make three proposals for improving the regulation of consumer credit. First, I argue that the current regulatory regime does not adequately distinguish between loans that have a material effect on a borrower's balance sheet and those that do not. In light of this, and in order to protect low- and moderate-income borrowers, I recommend a heightened level of regulatory protection for loans that are so significant that they have a transformative effect on a borrower's balance sheet. I define a transformative loan as one that results in a change of more than 25% to the liability side of the borrower's balance sheet. My specific recommendation, which I view as quite modest, is simply that the phalanx of protections routinely afforded to investors who buy and sell securities be extended to borrowers who are borrowing so much money that it will transform their financial situation.

Similarly, in Part IV, I argue that the protections routinely provided to investors in securities transactions should be extended to people who are borrowing to fund current consumption (medical care, food, car repair, etc.). Specifically, I argue that consumers, like financial institutions and businesses, should be able to access the Federal Reserve's emergency lending facilities to obtain funds for emergency purposes, subject to terms and conditions similar to those generally imposed on borrowers in such circumstances. A conclusion follows.

II. Using a Balance Sheet Approach to Create a Taxonomy of Debt

My claim is that the key to developing an operational taxonomy of loans is to analyze how loan proceeds are used by borrowers. I will do this by constructing a hypothetical balance sheet for any prospective borrower and then analyzing how the proceeds from a particular loan affect that balance sheet. The balance sheet consists of three sections: assets (what a person owns and the value of those things), liabilities (what a person owes), and equity (the difference between the value of the assets and the value of the

liabilities).[15] The balance sheet is the standard means of describing the financial condition of a person, household, or firm at a particular point in time and is a standard tool for evaluating the financial condition of a person, household, or firm.[16] It is used by regulators to show the financial condition of households[17] and to guide monetary policy.[18] Balance sheets also are used by economists to explain variations in key macroeconomic conditions such as changes in aggregate demand.[19]

From an individual's perspective, balance sheets measure wealth at a particular moment in time. An individual's wealth is simply the value of all her assets minus all of her debts. Numerous accounting conventions dictate how to record the value of assets and liabilities under Generally Accepted Accounting Principles (GAAP).[20] The balance sheet framework developed here values assets and liabilities on a present value basis. The value of an asset is the present value of the future income stream associated with holding

15. *Balance Sheet Definition*, STRATEGIC CFO, https://strategiccfo.com/balance-sheet-definition [https://perma.cc/5RLR-SSTA]. The balance sheet formula (assets – liabilities = equity) provides a "snapshot" picture of a company's financial condition at a particular point in time. *Id.*

16. *Personal Financial Statement*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/knowledge/other/personal-financial-statement.

17. *Balance Sheet of Households and Nonprofit Organizations, 1952 - 2021*, BD. GOVERNORS FED. RSRV. SYS. (Sept. 23, 2021), https://www.federalreserve.gov/releases/z1/dataviz/z1/balance_sheet/chart [https://perma.cc/7PVJ-92PC].

18. Andrew Benito, Matt Waldron, Garry Young & Fabrizio Zampolli, *The Role of Household Debt and Balance Sheets in the Monetary Transmission Mechanism*, 47 BANK ENG. Q. BULL. 70, 70 (2007).

19. *See, e.g.*, Frederic Mishkin, *The Household Balance Sheet and the Great Depression*, 38 J. ECON. HIST. 918 (1978) (analyzing business cycle developments through theories that emphasize the effects of household balance-sheet changes on aggregate demand); Albert Ando & Franco Modigliani, *The "Life-Cycle" Hypothesis of Saving: Aggregate Implications and Tests*, 53 AM. ECON. REV. 55 (1963) (examining aggregate individual consumption functions); Frederic S. Mishkin, *Illiquidity, Consumer Durable Expenditure, and Monetary Policy*, 66 AM. ECON. REV. 642 (1976) (discussing how the study's liquidity model could shed light on possible economic policy).

20. The Financial Accounting Standards Board (FASB) has been designated by the U.S. Securities and Exchange Commission (SEC) as the authority for establishing financial accounting and reporting standards for not-for-profit and for-profit companies in the United States. *About the FASB*, FIN. ACCT. STANDARDS BD. (Sept. 2021), https://www.fasb.org/facts/ [https://perma.cc/Y25H-7EMU] [https://perma.cc/DVW6-HZJF]. These accounting and reporting standards are referred to as Generally Accepted Accounting Principles (GAAP). *Id.* For example, GAAP in the United States require the valuation of certain fixed assets such as real estate at historical cost, adjusted for any estimated gain and loss in value from improvements and depreciation, respectively, of such assets. On the other hand, assets such as publicly traded equity and debt are recorded on the balance sheet at market value.

that asset.[21] The value of a liability is the present value of the fees, penalties, interest, and principal that are paid over a period of time by the borrower.[22]

Another way of thinking about the balance sheet test is that it is a measure of whether an extension of credit is welfare-enhancing. If a loan results in an improvement in the balance sheet of the borrower, it means that the loan provides an opportunity for the borrower to use the loan proceeds to make herself better off such that the future person repaying the loan in the future is richer than when she took out the loan in the first place.[23] In an important recent article, Professor Abbye Atkinson has observed that:

> [F]or credit to work as social provision, it must be extended on terms that are likely to result in an overall improvement in welfare. Consequently, credit as meaningful social provision for low-income borrowers implies an expectation that notwithstanding their present condition, low-income borrowers will be better off in the future and able to repay their debts without hardship. This is an unduly optimistic expectation given both the high interest rates that low-income borrowers tend to pay and the fact that decades of data suggest that low-income Americans can consistently expect to be in worse economic shape as time passes. Credit is fundamentally incompatible with the entrenched intergenerational poverty that plagues low-income Americans.[24]

The problem with Professor Atkinson's powerful critique is that, while it is often true, it is not *always* true. What is needed, and what the balance sheet test provides, is a framework for distinguishing between loans that hold the promise of making borrowers better off and loans that hold no such promise.[25] It is untrue that credit inevitably has "regressively redistributive consequences" for the middle class.[26] Some, but not all, home loans, education loans, small business loans, and other loans that have positive

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21. Tim Smith, *Asset Valuation*, INVESTOPEDIA (Mar. 16, 2020), https://www.investopedia.com/terms/a/assetvaluation.asp [https://perma.cc/87LB-PEHH]; Jason Fernando, *Present Value (PV)*, INVESTOPEDIA (Feb. 8, 2021), https://www.investopedia.com/terms/p/presentvalue.asp [https://perma.cc/A9A8-CY4W].

22. FIN. ACCT. STANDARDS BD., FAIR VALUE MEASUREMENTS AND DISCLOSURES—MEASURING LIABILITIES AT FAIR VALUE 5, 11 (No. 2009-05) (2009) (updating the Accounting Standards Codification to include methods to measure the fair value of a liability).

23. *See* MONICA PRASAD, THE LAND OF TOO MUCH: AMERICAN ABUNDANCE AND THE PARADOX OF POVERTY 239 (2012) ("The welfare state and credit may both be conceptualized as twentieth century versions of reciprocal exchange, marked not only by reciprocity between social actors but also by reciprocity with a more prosperous future.").

24. Atkinson, *supra* note 4, at 1099.

25. *See id.* at 1102 (noting that "credit does not make sense as a form of social provision where economic growth is intractably arrested"). Another powerful component of Professor Atkinson's critique is her point that providing credit is not a substitute for other forms of social assistance to the poor. *Id.* Clearly, she is right that other forms of social assistance are merited and required.

26. *Id.*

effects on the balance sheet of the borrower hold a real promise of lifting the borrower out of poverty. Sometimes, borrowing provides the funds needed to acquire the skills necessary to improve one's financial condition,[27] or obtain the capital necessary to start a business. The success of microfinance projects across the globe as "an important liberating force" and as an "ever more important instrument in the struggle against poverty" is a testament to the transformative possibilities of consumer credit.[28] In other words, credit can be regressively redistributive, but it need not be. The balance sheet test provides a basis for distinguishing regressively redistributive credit from credit that holds the promise of creating a gateway to prosperity.

Professor Atkinson clearly is correct, however, that lending is not a panacea for poverty in general, and it particularly is not a panacea for people with extremely low or highly erratic incomes, and it is not a cure for racial and social inequality. Borrowing has the potential to assist people of all races and classes in improving their lives, but borrowing cannot replace the outright assistance that social justice sometimes requires. Further, borrowing is not a solution to chronic poverty. Borrowing should not be required to allow people to pay for necessities like food, shelter, heat, and electricity. Where a person or a family does not generate sufficient income to cover those expenses, the appropriate solution is a guaranteed minimum income,[29] preferably implemented by a negative income tax.[30]

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27. *Cf.* Raghuram G. Rajan, *Let Them Eat Credit*, NEW REPUBLIC (Aug. 26, 2010), https://newrepublic.com/article/77242/inequality-recession-credit-crunch-let-them-eat-credit [https://perma.cc/F7HT-U3XE] ("[W]e need to think creatively about how Americans can acquire the skills they need to enhance their incomes.").

28. Rajdeep Sengupta & Craig P. Aubuchon, *The Microfinance Revolution: An Overview*, 90 FED. RSRV. BANK ST. LOUIS REV. 9, 9 (2008).

29. Economists on the right and left have been in favor of a guaranteed minimum income. *See* ECONOMISTS' STATEMENT ON GUARANTEED ANNUAL INCOME, GENERAL CORRESPONDENCE SERIES, PAPERS OF JOHN KENNETH GALBRAITH, JOHN F. KENNEDY PRESIDENTIAL LIBRARY, *reprinted in* 1 JYOTSNA SREENIVASAN, POVERTY AND THE GOVERNMENT IN AMERICA: A HISTORICAL ENCYCLOPEDIA 3, 269 (2009) (urging a "national system of income guarantees and supplements"); MILTON FRIEDMAN, THE CASE FOR A NEGATIVE INCOME TAX: A VIEW FROM THE RIGHT (1968), *reprinted in* BASIC INCOME: AN ANTHOLOGY OF CONTEMPORARY RESEARCH 1, 12 (Karl Widerquist, José A. Noguera, Yannick Vanderborght & Jurgen De Wispelaere eds. 2013) ("It would be far better to give the indigent money and let them spend it according to their values."); FRIEDRICH A. HAYEK, THE ROAD TO SERFDOM 120 (1944) (arguing that "in a society which has reached the general level of wealth which ours has attained," there is no reason "some minimum of food, shelter, and clothing, sufficient to preserve health and the capacity to work" should not be "assured to everybody"); Walter Block, *Hayek's Road to Serfdom*, 12 J. LIBERTARIAN STUD. 339, 363 (1996) (quoting Hayek as saying, "I have always said that I am in favor of a minimum income for every person in the country"); *see also* A. B. Atkinson, *The Case for a Participation Income*, 67 POL. Q. 67, 70 (1996) (proposing that "participation income, complementing improved social insurance" is the "route to providing an effective national minimum").

30. *See* FRIEDMAN, *supra* note 29, at 13 (stating that the negative income tax would be "vastly superior" to current government welfare programs).

A. *Borrowing for Investment*

Borrowing that is used to make investments that have a higher return than the cost of the funds borrowed is (hopefully) profitable. The argument against government intervention in this facet of the credit market is strong because private-sector lenders and borrowers can be expected to know better than the government where to allocate capital and at what price.

B. *Borrowing to Fund Capital Assets*

Besides borrowing for the sort of arbitrage gains described above, a second category of borrowing is used to fund the acquisition of capital assets like homes and cars. These capital items may not generate income, but they have real value for the consumer who uses borrowed funds to acquire these assets. This second category of assets might be viewed as having a neutral impact on the balance sheet of the borrower from a purely accounting point of view. The effect of such borrowing, however, is actually positive due to gains from trade. For example, when a person pays $40,000 for a car, one must presume that the car is worth more to the buyer than $40,000, or else the buyer would decline to make the purchase. Here again, there is little if any justification for government involvement in this aspect of the credit markets. The government is unable to ascertain the private value that a consumer places on the items she purchases, and borrowing to purchase such items is justified on the grounds that they are durable goods that will last as long as, if not longer than, the term of the loans procured to fund their purchase.[31]

The point here is not that borrowing to make investments and borrowing to fund capital expenditures always makes borrowers better off in the end. Of course, this is not the case. Even the most carefully researched investment ideas sometimes turn out badly, just as capital investments may seem ill-advised when viewed with the wisdom of hindsight. Rather, the point is that loans to fund investment initiatives and loans to make capital acquisitions make the borrowers better off *ex ante*. These loans benefit the borrowers *ex ante* because they have a positive effect on a borrower's balance sheet when they are made.

Of course, such loans may turn out to have a negative effect on the borrower's balance sheet in the long run. For example, if one borrows $500,000 to buy a $600,000 house, and the value of the house subsequently declines to $400,000, the ultimate effect of the transaction on the borrower's

31. *See, e.g.*, Joshua D. Shackman & Glen Tenney, *The Effects of Government Regulations on the Supply of Pawn Loans: Evidence from 51 Jurisdictions in the U.S.*, 30 J. FIN. SERVICES RSCH. 69, 88 (2006) (finding that governmental restrictions on the behavior of pawnshops reduce the levels of supply and prohibit mutually advantageous behaviors from the perspectives of both lenders and borrowers).

balance sheet will be negative, although the initial effect was neutral. It is unlikely, however, that such a transaction will have a negative effect on a borrower's balance sheet because a rational lender (bank) will not agree to lend to a borrower unless it estimates that the house is worth more than the mortgage. Therefore, we are more confident that such loans will not hurt the balance sheet and will not result in harm to the borrower. When the bank reasonably expects that it can recover the full amount from nothing more than the asset to be purchased, a transaction is less likely to be destructive.

My view is that any loan used to fund or sustain a business and any consumer loan that is used to purchase an asset (such as an automobile or a home) that has a value that is equal to or greater than the amount of money being borrowed to acquire the asset should be encouraged and lightly regulated.[32] Under this analysis, certain loans that long have been viewed with suspicion would be subject to deferential regulatory treatment under the balance sheet approach proposed here because such loans have a neutral effect (or even a positive effect) on the balance sheets of borrowers and are likely to increase the welfare of the borrowers.

As discussed in detail in subpart IV(A), however, for many consumers, a significant, once-in-a-lifetime loan, such as a home loan, will have a material and transformative effect on their balance sheet. Where such transformative loans are being made, the lenders making such loans should be deemed to be in a position of trust and confidence to their borrowers and, as such, these lenders should be subject to the protections routinely afforded to purchasers and sellers of securities under the securities laws.[33]

1. Pawnshop Loans.—The secured loans made by pawnshops provide an example of the implications of the balance sheet framework developed in this Article. Pawnshops typically make very small (usually under $100) loans for short periods of time (usually around two months) while taking physical possession of personal items as collateral. In the standard pawn transaction,

32. The point here is not that these fully collateralized loans are devoid of potential problems and can never turn out badly for the borrower. The point, rather, is that *ex ante*, from a balance sheet perspective, these loans are welfare-increasing from the borrower's perspective. It also is important to recognize that discrimination lowers the returns to investing in capital assets such as education and housing for marginalized groups. This is why special steps must be taken to identify and penalize discrimination in lending markets. Despite discrimination, members of marginalized groups borrow to pay for education for themselves and their children, and they borrow to acquire assets like houses and cars. Even in the face of discrimination, such borrowing can make the borrowers better off. Discrimination, however, by reducing the value of the capital assets being acquired, reduces the upside of such investments below what it would be in the absence of discrimination. For example, if homes in Black neighborhoods are worthless, or if women or minorities are paid less, then borrowing by people in those groups will have lower expected returns. In other words, a loan that might have a positive present value for many people might have a lower (or non-existent) present value for other people because of discrimination.

33. *See infra* subpart IV(A).

the collateral is returned to the borrower upon loan repayment, or ownership automatically transfers to the lender if the borrower does not repay the loan.[34] A pawnshop loan has a neutral or positive impact on the balance sheet of the borrower. The funds received by the borrower are, by hypothesis, worth at least as much as the asset that is held by the pawnshop and used as collateral for the loan, adjusted by the risk that the borrower will be unable to retrieve the item.[35]

One approach to pawnshop lending posits that borrowers pledge items of particularly high actual or sentimental value to pawnshops as a pre-commitment device that encourages borrowers to make repayment.[36] This may very well be the case, but it does not detract from the basic point that pawnshop loans are not problematic from a balance sheet perspective. The fact that such loans can be used by borrowers as a powerful pre-commitment device is an additional reason to view such loans as generally unproblematic.

2. Student Loans.—Another, more difficult category of loans that have been viewed with suspicion, which are generally unproblematic under the balance sheet framework developed here, is student loans. Approximately 42 million, or one in eight Americans, have outstanding student loans.[37] In 2020 there was $1.5 trillion in student debt outstanding,[38] and student loans were the second-largest slice of household debt after mortgages,[39] which, of course, means that there is more student loan debt outstanding than credit card debt.[40]

The math is pretty straightforward. About 75% of student loan borrowers go to college.[41] Ninety-four percent of student loan borrowers owe

34. Shackman & Tenney, *supra* note 31, at 69–70.

35. To be clear, I recognize that many people appear willing to pawn an asset that is a lot more valuable than the loan they receive because they are confident that they will be able to repay the loan they receive from the pawnshop. Thus, another way to conceptualize pawnshop transactions is that the asset remains on the borrower's balance sheet, and it is offset on the liability side by the debt owed to the pawnshop. Where the borrower defaults and the pawnshop takes title to the collateral, the asset is removed from the borrower's balance sheet. In such cases, the pawnshop loans are, *ex post*, welfare-reducing.

36. Susan Payne Carter & Paige Marta Skiba, *Pawnshops, Behavioral Economics, and Self-Regulation*, 32 REV. BANKING & FIN. L. 193, 195–96 (2012).

37. Adam Looney, David Wessel & Kadija Yilla, *Who Owes All That Student Debt? And Who'd Benefit If It Were Forgiven?*, BROOKINGS INST. (Jan. 28, 2020), https://www.brookings.edu/policy2020/votervital/who-owes-all-that-student-debt-and-whod-benefit-if-it-were-forgiven [https://perma.cc/9NB8-VEKS].

38. *Id.*

39. *Id.*

40. *Id.*

41. *Id.*

less than $100,000 on their student loans.[42] Generally speaking, the returns on an investment in a student loan are impressive. The typical U.S. worker with a bachelor's degree earns nearly $1 million more over the course of her career than a similar worker with just a high school diploma.[43] A U.S. worker with a two-year associate's degree earns $360,000 more than a high school graduate.[44]

Assuming no fraud is involved in the transaction,[45] student loans provide a paradigmatic example of a worthwhile investment in human capital. The hope and expectation of the borrower, of course, is that the enhanced earnings power attributable to earning a degree or certification will produce sufficient income to repay the loan and also provide a positive rate of return for the borrower. From a balance sheet perspective, the student loan generates an entry on the liability side of the student borrower's balance sheet. The education that is received with the loan proceeds and the enhanced future stream of income are the corresponding assets.[46]

C. *Borrowing to Fund Current Consumption: Payday Lending*

The balance sheet framework for analyzing consumer lending proposed here reinforces the intuitive and obvious point that people who are forced to borrow to fund current consumption are extremely vulnerable. Such lending runs the risk of creating "a debt treadmill that makes struggling families worse off than they were before they received" the loan in the first place.[47]

The regulatory challenge here is easy to articulate but hard to solve. Lending to fund current consumption sometimes helps borrowers achieve the important goal of what economists call "income smoothing," which helps

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42. *Id. Cf.* Elizabeth Gravier, *How Much the Average American Will Pay in Interest over a Lifetime*, CNBC (Sept. 20, 2021), https://www.cnbc.com/select/how-much-americans-pay-in-interest-over-lifetime/ [https://perma.cc/U3FY-XTQR] (calculating the total amount of interest paid on typical types of loans by an average American over their lifetime).

43. Looney, *supra* note 37.

44. *Id.* The returns on human capital investment in education are not so promising where student loans are incurred to pay for tuition at for-profit schools. For instance, "[t]he default rate within five years of leaving school for undergrads who went to for-profit schools was 41% for two-year programs and 33% for four-year programs. In comparison, the default rate at community colleges was 27%; at public four-year schools, 14%, and at private four-year schools, 13%." *Id.*

45. *See infra* subpart IV(A) (discussing the problem of fraud in the student loan market).

46. Many students, particularly those enrolled in graduate programs in the humanities whose graduates face bleak job prospects, will incur debt to obtain educations. Pursuing an expensive degree with weak job prospects is, of course, an entirely valid personal choice and must be respected. It is important, however, that students understand the costs and benefits associated with the decision to pursue low-payoff educational programs.

47. Susanna Montezemolo, *The State of Lending in America & Its Impact on U.S. Households*, CTR. FOR RESPONSIBLE LENDING 2 (2013), https://www.responsiblelending.org/state-of-lending/reports/10-Payday-Loans.pdf [https://perma.cc/7ZH9-4TEZ].

employees to "manage income and expense variability."[48] The idea is that borrowers may derive significant or even extremely high marginal utility from immediate access to funds and deeply discount the disutility of future repayments.

Economists tout credit access as a means to "alleviate hardship by expanding a household's options when managing consumption over time."[49] The theory is that "[i]f an otherwise credit-constrained household can borrow, even for a short period, it can potentially smooth expenditures around periods of income or consumption shocks, which in the absence of borrowing can lead to adverse events like delinquency on rent payments, eviction, or forgone health care."[50] As Professor Paige Skiba has observed:

> [B]orrowing against future paychecks at [triple-digit interest rates equivalent to 260%–520% annualized percentage rate (APR)] can be worth it if consumers' marginal utility is raised sufficiently to outweigh the expenditure they will make on interest. For example, if a consumer's car breaks down and she would be fired if she could not get to work tomorrow, it may be rational for her to borrow at extremely high interest rather than forgo all wage income for the foreseeable future.[51]

A potentially promising manifestation of this sort of financing is a relatively new fintech application that provides workers with early access to their wages, usually through programs sponsored by employers.[52] These programs ostensibly allow employers to "provide[] employees reasonable access to earned wages in advance of their scheduled payday."[53] In theory, these programs accomplish the legitimate goal of income smoothing by providing workers with "a consistent paycheck every week . . . by setting aside a little bit of money in good weeks, and by giving interest-free credit in

48. *See* Todd H. Baker, *FinTech Alternatives to Short-Term Small-Dollar Credit: Helping Low-Income Working Families Escape the High-Cost Lending Trap* 56–59 (M-RCBG Associate Working Paper No. 75, 2017), https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/files/75_final.pdf [https://perma.cc/ZN38-WYYX] (applauding employer-sponsored paycheck advance programs because they provide "income smoothing").

49. Brian T. Melzer, *The Real Costs of Credit Access: Evidence from the Payday Lending Market*, 126 Q.J. ECON. 517, 521 (2011).

50. *Id.* at 521–22; *see also* Paige Marta Skiba, *Regulation of Payday Loans: Misguided?*, 69 WASH. & LEE L. REV. 1023, 1026 (2012) ("From an economist's perspective, credit in general allows consumers to smooth consumption over time, meaning that they borrow from future good times to help make it through current tough times.").

51. Skiba, *supra* note 50, at 1027.

52. For an excellent treatment of such early wage programs, see Nakita Q. Cuttino, *The Rise of "Fringetech": Regulatory Risks in Earned-Wage Access*, 115 NW. L. REV. 1505 (2021).

53. Baker, *supra* note 48, at 80.

bad weeks."[54] "Additionally, if consumers have a big bill like rent but are short on cash," these apps allow employers to advance extra money.[55]

The rather theoretical accounts of the benefits of short-term, current-consumption lending to alleviate economic hardship described above are in tension with empirical findings that such lending causes borrowers to have greater difficulty paying their rent, mortgage payments, and utility bills.[56] "Among families with $15,000 to $50,000 in annual income, loan access increases the incidence of difficulty paying bills" and causes delays in obtaining needed medical care, dental care, and prescription drugs by 25%.[57]

Thus, short-term borrowing to fund current consumption risks doing more harm than good for at least some borrowers. The solution, however, is not to ban such borrowing. The reality is that working families require such funds on occasion to pay for necessities, including: basic living expenses, home repairs, car repairs, appliance purchases, medical expenses, school expenses, and child-care expenses.[58] For example, the U.S. Census Bureau has reported that about 80% of "[a]lternative financial services credit products," defined as loans from payday lenders, pawnshops, and rent-to-own stores, are for these specific categories of household expenses.[59] Empirically, it appears that payday lenders also offer a positive service to individuals facing financial distress caused by natural disasters.[60] Natural disasters increase foreclosures by 4.5 units per 1,000 homes in the year following the event, but payday lenders mitigate 1.0 to 1.3 units of this increase.[61] Thus, "the existence of payday lending increases welfare for households that might face foreclosures or be driven into small property crime in times of financial distress."[62]

In light of the fact that lending to cover current consumption has significant costs and significant benefits, the only rational policy objective is to manage short-term borrowing for current consumption through humane, efficient regulation. The challenge, therefore, is to develop a mechanism for eliminating, or at least reducing, the incidence of loans that make borrowers worse off without eliminating the opportunity for borrowers in dire need of immediate cash to obtain such funds.

54. *Id.*

55. *Id.*

56. Melzer, *supra* note 49, at 520.

57. *Id.* at 519.

58. Neil Bhutta, Jacob Goldin & Tatiana Homonoff, *Consumer Borrowing After Payday Loan Bans*, 59 J.L. & ECON. 225, 240 (2016).

59. *See id.* at 239–40 (reporting U.S. Census Bureau statistics).

60. Adair Morse, *Payday Lenders: Heroes or Villains?*, 102 J. FIN. ECON. 28, 29 (2011).

61. *Id.*

62. *Id.* at 42.

While there are several types of short-term credit facilities available to fund current consumption,[63] payday loans clearly are the most important and most representative category of consumer debt. As Brian Melzer has observed,

> Payday loans are a particularly interesting category of consumer debt, since for many individuals they constitute the marginal source of credit. The effects of borrowing in this form therefore capture the costs or benefits of credit access on the margin, which are quite relevant in evaluating policies that impose or relax constraints on consumer lending.[64]

The following discussion of payday lending affords insights into the scope of the problem of borrowing for current consumption and provides a justification for the policy recommendations offered here.

Payday loans are small dollar amounts due in full by the borrower's next paycheck, usually in two or four weeks.[65] They are expensive, with APRs of over 300% or even higher.[66] As a condition of the loan, the borrower writes a post-dated check for the full balance, including fees, or allows the lender to debit funds from their checking account electronically.[67]

Other types of loans, though not as popular, have characteristics similar to payday loans. For example, single-payment auto title loans also have expensive charges and short terms, usually of thirty days or less.[68] To obtain these loans, borrowers are required to put up their car or truck title as collateral.[69] A type of longer term loan called a balloon-payment loan requires borrowers to make a series of smaller payments before the remaining balance comes due.[70] These balloon-payment loans often require access to the borrower's bank account or auto title.[71]

As more Americans are living on the edge of insolvency, payday lending has exploded.[72] In the last five years, 5.5% of all adults in the United States

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63. Vehicle title and certain high-cost installment loans are other examples of credit facilities that provide funding for current consumption by low- and moderate-income families. 12 C.F.R. § 1041 (Nov. 17, 2017).

64. Melzer, *supra* note 49, at 550.

65. Payday, Vehicle Title, and Certain High-Cost Installment Loans, 81 Fed. Reg. at 47,864, 47,867.

66. *Id.* at 47,869.

67. *Id.*

68. *Id.* at 47,880 (showing a median APR of 317% for single-payment auto title loans).

69. *Id.* at 47,879.

70. *Id.* at 47,905.

71. *Id.* at 47,986, 47,988.

72. *A Short History of Payday Lending Law*, PEW (July 18, 2012), https://www.pewtrusts.org/en/research-and-analysis/articles/2012/07/a-short-history-of-payday-lending-law [https://perma.cc/X497-HV3G].

have used a payday loan,[73] spending, on average, over $500 in fees.[74] Most of these people are in lower income brackets, with households earning less than $40,000 a year making up 72% of payday borrowers.[75] Stunningly, there are more payday loan storefronts in the United States than there are Starbucks and McDonald's locations combined.[76]

Significantly, a Pew study found that 69% of payday borrowers use their first loans to pay for everyday recurring expenses, like rent, food, groceries, utility bills, and prescription drugs.[77] Only 16% dealt with an unexpected expense, such as a car repair or emergency medical treatment.[78] This is significant from this Article's point of view, which recommends dividing loans for current consumption into precisely these two categories: (1) the less common situations where loan proceeds are used for emergencies and (2) the more common situations where loan proceeds are used for non-emergencies, including everyday recurring expenses.

III. A Brief Critique of Existing Approaches to Regulating Credit

States long have been the primary source of consumer protection law for borrowers,[79] although the legal regime is probably best described as "a patchwork of state and federal laws."[80] Federal law generally is designed "to supplement rather than to supplant state law";[81] although, as shown below, federal regulators have paid significant attention to so-called debt traps. Debt traps are loans that charge high rates of interest and require the entire principal amount to be repaid within a relatively short time, resulting in

73. PEW CHARITABLE TRS., PAYDAY LENDING IN AMERICA: WHO BORROWS, WHERE THEY BORROW, AND WHY 4 (2012), https://www.pewtrusts.org/-/media/legacy/uploadedfiles/pcs_assets/2012/pewpaydaylendingreportpdf.pdf [https://perma.cc/X9SP-C2VG].

74. David Trilling, *Do Payday Loans Exploit Poor People? Research Review*, JOURNALIST'S RES. (Sept. 19, 2016), https://journalistsresource.org/studies/economics/personal-finance/payday-loans-exploit-poor-people-research [https://perma.cc/Y7KL-Q77P].

75. PEW CHARITABLE TRS., *supra* note 73, at 8, 10.

76. Paige Skiba & Jeremy Tobacman, *Do Payday Loans Cause Bankruptcy?*, 62 J.L. & ECON. 485, 485 (2019).

77. PEW CHARITABLE TRS., *supra* note 73, at 14.

78. *Id.*

79. The analysis here focuses on laws protecting consumers from taking on too much debt and from taking on the wrong kind of debt. As such, the discussion here does not consider certain forms of consumer protection for borrowers such as privacy laws, including Section 501 of the Gramm-Leach-Bliley Act, which imposes on financial institutions an "affirmative and continuing obligation to respect the privacy of its customers and to protect the security and confidentiality of customers' nonpublic personal information." 15 U.S.C. § 6801.

80. Edward M. Crane, Nicholas J. Eichenseer & Emma S. Glazer, *U.S. Consumer Protection Law: A Federalist Patchwork*, 78 DEF. COUNS. J. 305, 305 (2011).

81. *See, e.g.*, *id.* at 318 (discussing the interaction between federal and state consumer protection law); Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, §§ 1041–1046, 124 Stat. 1376, 2011–18 (codified as amended in scattered sections of 12 U.S.C.) [hereinafter Dodd–Frank Act] (allowing greater protection under state law).

situations in which borrowers cannot repay the loan on time and are required to roll over the loan, resulting in multiple rollover fees and additional, unanticipated interest payments.[82] This section will first discuss the federal rules that govern the substantive and disclosure-based provision of consumer credit and then examine the protections that exist at the federal level.

A. *Federal Law Consumer Protections*

Until 2010, Congress passed a number of statutes "governing credit card disclosures, lending disclosures, debt collection practices, mortgages, electronic fund transfers, financial data privacy, student loans, credit reporting, discrimination in consumer credit markets, bankruptcy, and so-called 'credit repair' services, among others."[83] These laws "reflected a disclosure-based regulatory framework,"[84] which, as shown below, was of little value in protecting consumers in financial distress.

The Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank),[85] passed in 2010 in the wake of the 2007–2008 financial crisis,[86] reflected a departure from the disclosure-only tradition of federal consumer protection law. Dodd–Frank consolidated financial consumer protection under one legislative framework and created a new enforcement agency, the Consumer Financial Protection Bureau (CFPB), which has authority over most federal financial consumer protection laws.[87] The CFPB's purpose is to "implement and, where applicable, enforce Federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive."[88]

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82. *See* Creola Johnson, *America's First Consumer Financial Watchdog Is on a Leash: Can the CFPB Use Its Authority to Declare Payday-Loan Practices Unfair, Abusive, and Deceptive?*, 61 CATH. U. L. REV. 381, 385 (2012) ("[B]ecause large repayment amounts are due within a short time frame, the majority of payday borrowers cannot repay the entire loan on time and thus must pay multiple rollover fees . . . .").

83. Crane, *supra* note 80, at 314.

84. *Id.* at 315.

85. Dodd–Frank Act, *supra* note 81.

86. *See* John C. Coffee Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1020 (2012) ("[O]nly after a catastrophic market collapse can legislators and regulators overcome the resistance of the financial community and adopt comprehensive 'reform' legislation.").

87. Dodd–Frank gave the CFPB primary regulatory authority over all federal consumer financial laws, including those administered by the Federal Trade Commission (FTC), the Federal Deposit Insurance Corporation, the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System. Dodd–Frank Act, *supra* note 81, §§ 1002, 1022, 1061.

88. *Id.* § 1021(a). The term "Federal consumer financial law" is defined to encompass regulations promulgated by the CFPB, as well as other consumer financial protection laws with the

1. Federal Substantive Protections: Dodd–Frank's Ability-to-Repay Provisions.—In a significant departure from traditional disclosure-only regulation at the federal level, Dodd–Frank amends the Truth in Lending Act to require that mortgage lenders verify a borrower's ability-to-repay before extending credit.[89] Such verification must be based on the borrower's current income (which must be verified through examination of tax returns, payroll receipts, and other reliable third-party information), credit history, current debt, debt-to-income ratio, and employment status, as well as other factors.[90]

The CFPB is required to promulgate regulations prohibiting mortgage lenders from extending credit without making a reasonable, good-faith determination that, at the time the loan is consummated, the borrower is reasonably able to repay the loan and all applicable taxes, insurance, and assessments.[91] A significant contribution of this "ability-to-repay" requirement to the cause of consumer protection was that it limited the ability of lenders to induce borrowers to take out high-cost loans by offering a low fixed introductory or "teaser" rate that remains in place for a short time and then subsequently goes up, often by converting to a floating rate of interest. If a mortgage has a low interest rate that goes up in later years, the lender has to make a reasonable, good-faith effort to determine if the borrower can repay the loan at the likely higher interest rate that will apply subsequently.[92]

A major loophole in the Dodd–Frank Act's effort to protect consumers through the implementation of an ability-to-repay rule was that it applied only in the context of certain mortgage loans and did not apply to the problematic payday, vehicle title, and high-cost installment loans that are the principal focus of this Article.[93] In October 2017, the CFPB, then led by Richard Cordray,[94] issued a rule requiring that lenders making payday loans, and these other sorts of loans, determine whether their borrowers had the ability to repay these loans[95] in order to mitigate the debt trap[96] spiral that

exception of regulations promulgated by the FTC under the Federal Trade Commission Act (FTCA). *Id.* § 1002.

89. *Id.* § 1411.

90. *Id.*

91. *Id.*

92. *What Is the Ability-to-Repay Rule? Why Is It Important to Me?*, CONSUMER FIN. PROT. BUREAU (Sept. 12, 2017), https://www.consumerfinance.gov/ask-cfpb/what-is-the-ability-to-repay-rule-why-is-it-important-to-me-en-1787 [https://perma.cc/3D75-KTJZ].

93. Dodd–Frank Act, *supra* note 81, § 1411.

94. *See* Richard Cordray, Prepared Remarks of CFPB Director Richard Cordray on the Payday Rule Press Call, Consumer Fin. Prot. Bureau (Oct. 5, 2017), https://www.consumerfinance.gov/about-us/newsroom/prepared-remarks-cfpb-director-richard-cordray-payday-rule-press-call [https://perma.cc/L87K-S5G2] (describing the purpose of the payday rule).

95. 12 C.F.R. § 1041 (2017).

96. *CFPB Finalizes Rule to Stop Payday Debt Traps*, CONSUMER FIN. PROT. BUREAU (Oct. 5, 2017), https://www.consumerfinance.gov/about-us/newsroom/cfpb-finalizes-rule-stop-payday-debt-traps [https://perma.cc/N9YU-WU26].

plagues consumers.[97] Under the ability-to-repay provisions, lenders must determine that a borrower would be able to make all payments under the loan and meet basic living expenses and major financial obligations over the term of the loan and for the succeeding thirty days.[98]

On February 6, 2019, with Kathleen Kraninger, a Donald J. Trump-appointed replacement for Richard Cordray, heading the CFPB, the Bureau rescinded the 2017 ability-to-repay protections for payday, vehicle title, and high-cost installment loans.[99] Implausibly, the purported basis for rescinding these rules was that there were insufficient "legal and evidentiary bases" to mandate requiring that borrowers show an ability to repay their loans.[100]

The now-rescinded ability-to-repay protections for certain non-mortgage consumer loans were a small step in the right direction, but they did not provide sufficient protection for vulnerable consumers because they measured only borrowers' ability to repay. Unlike the approach advocated here, they did not measure whether a consumer loan benefitted the borrower because they did not analyze the effect of the loan on the consumer's balance

97. The rule applied to so-called closed-end loans, which include: (1) loans in which the consumer must repay substantially the entire amount of the loan within 45 days from the date of the loan; (2) longer-term balloon-payment loans in which the consumer is required to repay substantially the entire balance of the loan in a single payment more than 45 days from the date of the loan, or otherwise repay the loan through one payment that is more than twice as large as any other payment; (3) loans in which the consumer must repay substantially the entire amount of any advance within 45 days of that advance; (4) loans with multiple advances, in which the consumer is required to repay substantially the entire amount of an advance in a single payment more than 45 days after the date of the advance, or otherwise repay the advance through one payment that is more than twice as large as any other payment; and (5) loans with multiple advances, which are structured in a manner such that "paying the required minimum payments may not fully amortize the outstanding balance by a specified date or time, and the amount of the final payment to repay the outstanding balance at such time could be more than twice the amount of other minimum payments under the plan." 12 C.F.R. § 1041.3. The rule also covered any other loan, like a high-cost installment loan that exceeds an interest rate of 36%. *See id.* (outlining the scope of coverage).

98. 12 C.F.R. § 1041.5(b)(2)(i)–(ii).

99. *See CFPB Payday Loan Changes Scrap Ability to Repay Requirement*, PYMTS.COM (July 9, 2020), https://www.pymnts.com/news/cfpb/2020/cfpb-payday-loan-changes-scrap-ability-to-repay-requirement [https://perma.cc/RG73-2VRN] (describing the CFPB's rationale for rescinding the ability-to-repay requirement).

100. *Payday, Vehicle Title, and Certain High-Cost Installment Loans—Revocation Rule*, CONSUMER FIN. PROT. BUREAU, https://www.consumerfinance.gov/policy-compliance/rulemaking/final-rules/payday-vehicle-title-and-certain-high-cost-installment-loans-revocation-rule [https://perma.cc/6GUF-ZP9K]; CONSUMER FIN. PROT. BUREAU, *Unofficial Redline of the Reconsideration NPRM's Proposed Amendments to the Payday Lending Rule* (2019), https://files.consumerfinance.gov/f/documents/cfpb_payday_unofficial-redline-2019-proposed-amendments.pdf [https://perma.cc/V3JH-N3AF] (noting the rescission of the ability-to-repay rule); *see also*, CENTER FOR RESPONSIBLE LENDING, COMMENTS TO THE CONSUMER FINANCIAL PROTECTION BUREAU NOTICE OF PROPOSED RULEMAKING PAYDAY, VEHICLE TITLE, AND CERTAIN HIGH-COST INSTALLMENT LOANS (May 15, 2019), https://www.responsiblelending.org/sites/default/files/uploads/files/comment-cfpb-proposed-repeal-payday-rule-executive-summary-may2019.pdf [https://perma.cc/CQ2Y-6NNK] (critiquing the CFPB's decision to rescind the ability-to-repay rule).

sheet, and, therefore, the rules did not distinguish between loans that benefitted borrowers and loans that harmed borrowers by reducing their welfare.

2. The Regulation of Short-Term Consumer Lending by the Military.—For years, members of the military were avid consumers of loans for current consumption. For example, in 2017, 44% of active-duty military members took out a payday loan in the previous year, 68% obtained a tax refund loan, 53% used a non-bank check-cashing service, and 57% obtained funds from a pawnshop.[101] Unsurprisingly, several internal Department of Defense studies showed that this widespread borrowing had adverse effects on personnel stress levels and job attentiveness.[102]

The Department of Defense determined for itself that payday lending did more harm than good[103] and succeeded in persuading Congress to enact a statute that caps the interest rate lenders can charge military members up to 36% for products like tax refund loans and payday loans.[104] For example, a study of the effects of payday lending on the job performance of U.S. Air Force personnel found that payday loan access produced a significant decline in overall job performance (as measured by a 3.9% increase in re-enlistment ineligibility) and a concomitant decline in retention.[105]

Air Force personnel who were recipients of payday loans also were found to perform unusually poorly at their jobs as measured by the information contained in their "Unfavorable Information File" (UIF).[106] The UIF is the "official repository of substantiated derogatory data concerning an Air Force member's personal conduct and duty performance."[107] Of course, there is no reason to think that payday loans and other forms of short-term credit used to fund current consumption will produce more positive results for members of the civilian population. In fact, the available evidence shows that those who obtain short-term payday loans are more likely to experience

101. Al Pascual, *Why Are Payday Loans So Popular with the Military?*, AM. BANKER (July 11, 2018), https://www.americanbanker.com/opinion/why-are-payday-loans-so-popular-with-the-military#:~:text=The%20act%20caps%20the%20interest,hamper%20their%20ability%20to%20focus [https://perma.cc/6UKQ-KHAL].

102. U.S. DEP'T DEF., REPORT ON PREDATORY LENDING PRACTICES DIRECTED AT MEMBERS OF THE ARMED FORCES AND THEIR DEPENDENTS 37–39 (2006).

103. *Id.* at 35–36, 45, 86–87.

104. *See* Military Lending Act, 10 U.S.C. § 987(b) (2006) (Creditors "may not impose an annual percentage rate of interest greater than 36 percent with respect to the consumer credit extended to a covered member or a dependent of a covered member.").

105. Scott Carrell & Jonathan Zinman, *In Harm's Way? Payday Loan Access and Military Personnel Performance*, 27 REV. FIN. STUD. 2805, 2808 (2014).

106. *Id.* at 2815. The UIF records incidences of certain suspensions from duty of greater than one month, civilian court convictions, and court martial convictions. *Id.*

107. *Id.*

a range of emotional and physical health issues.[108] Using suicide attempts and deaths as a measure of household distress, Jaeyoon Lee found that accessing payday loans substantially increases suicide risk.[109] Similarly, "access to short-term, expensive payday loans increases hospitalization due to suicide attempts by 10%."[110]

Significantly and highly consistent with the balance sheet approach to consumer debt taken in this Article, unlike short-term loans used for current consumption, loans used to acquire capital assets (i.e., houses) "correlate positively with other socioeconomic indicators" such as lower levels of depression, lower blood pressure, and higher life expectancy.[111] This is because

> Debt that allows for investment in homes . . . and parental education is associated with greater socioemotional well-being for children, whereas unsecured debt is negatively associated with socioemotional development, which may reflect limited financial resources to invest in children and/or parental financial stress. This suggests that debt is not universally harmful for children's well-being, particularly if used to invest in a home or education.[112]

The wrong kind of debt affects not only borrowers themselves, but also their children. Studies indicate that "higher levels of home mortgage and [parental] education debt were associated with greater socioemotional well-being for children, whereas higher levels of and increases in unsecured debt were associated with lower levels of and declines in child socioemotional well-being."[113]

3. Federal Disclosure-Based Consumer Protection.—Until Dodd–Frank came along in 2010, the Consumer Credit Protection Act (CCPA),[114] originally passed in 1968, was the most significant consumer protection law in the country.[115] The CCPA actually contains several important statutory

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108. Elizabeth Sweet, Christopher W. Kuzawa & Thomas W. McDade, *Short-Term Lending: Payday Loans as Risk Factors for Anxiety, Inflammation and Poor Health*, POPULATION HEALTH, 5 POPULATION HEALTH 114, 114 (2018).

109. Jaeyoon Lee, Credit Access and Household Well-being: Evidence from Payday Lending 3 (Jan. 1, 2019) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2915197 [https://perma.cc/2XTT-QNZH].

110. *Id.* at 24.

111. Sweet, *supra* note 108, at 115.

112. Lawrence M. Berger & Jason N. Houle, *Parental Debt and Children's Socioemotional Well-Being*, 137 PEDIATRICS 1, 1 (2016).

113. *Id.*

114. Consumer Credit Protection Act of 1968, Pub. L. No. 90-321, 82 Stat. 146 (codified at 15 U.S.C. §§ 1601–1693r).

115. Crane, *supra* note 80, at 319.

components, most notably the Truth in Lending Act (TILA),[116] the Fair Credit Reporting Act,[117] the Equal Credit Opportunity Act,[118] the Fair Debt Collection Practices Act,[119] and the Electronic Fund Transfer Act.[120]

TILA, the centerpiece of consumer protection regulation at the federal level,[121] broadly applies to any lender that regularly extends credit that is used primarily for personal, family, or household purposes.[122] From a historical perspective, TILA was touted as a "unique and relatively recent strategy for protecting vulnerable consumers from abuse by predatory lenders."[123] The key to effectuating an effective disclosure regime was the requirement that lenders disclose to consumers the cost of their loans, using a standardized methodology and expressed by two key terms: the finance charge and the APR.[124] The premise behind the statute was that uniformly disclosed prices would enable borrowers "to shop for the best deal, thus better protecting themselves and forcing creditors to offer lower prices."[125] Thus, the strongest argument in favor of TILA as a consumer protection device is that it "facilitates comparisons"[126] of credit pricing:

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116. Truth in Lending Act, Pub. L. 90-321, 82 Stat. 146 (1968) (codified at 15 U.S.C. §§ 1601–1667f).

117. Fair Credit Reporting Act, Pub. L. 91-508, 84 Stat. 1127 (1970) (codified at 15 U.S.C. §§ 1681–1681x).

118. Equal Credit Opportunity Act, Pub. L. 93-495, 88 Stat. 1521 (1974) (codified at 15 U.S.C. §§ 1691–1691f).

119. Fair Debt Collection Practices Act, Pub. L. 95-109, 91 Stat. 874 (1977) (codified at 15 U.S.C. §§ 1692–1692p).

120. Electronic Fund Transfer Act, Pub. L. 95-630, 92 Stat. 3728 (1978) (codified at 15 U.S.C. §§ 1693–1693r).

121. *See* RICHARD SCOTT CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, THE LAW OF FINANCIAL INSTITUTIONS 513 (6th ed., 2017) (positing that a philosophy of disclosure in consumer lending "holds some promise to counteract power imbalances and drive unfair or extortionate practices out of the marketplace" and describing TILA as "[t]he most important federal statute that seeks to implement this philosophy of disclosure").

122. 12 C.F.R. § 226.1 (2012). TILA applies to any

> individual or business that offers or extends credit when . . . (i) The credit is offered or extended to consumers; (ii) The offering or extension of credit is done regularly; (iii) The credit is subject to a finance charge or is payable by a written agreement in more than four installments; and (iv) The credit is primarily for personal, family, or household purposes.

12 C.F.R. § 226.1(c)(1).

123. Christopher L. Peterson, *Truth, Understanding, and High-Cost Consumer Credit: The Historical Context of the Truth in Lending Act*, 55 FLA. L. REV. 807, 814 (2003).

124. BD. GOVERNORS FED. RSRV. SYS. & DEP'T HOUS. & URB. DEV., JOINT REPORT TO THE CONGRESS CONCERNING REFORM TO THE TRUTH IN LENDING ACT AND THE REAL ESTATE SETTLEMENT PROCEDURES ACT 2 (1998), https://www.huduser.gov/Publications/pdf/HUD-11647.pdf [https://perma.cc/3FEW-C6YV].

125. Peterson, *supra* note 123, at 814.

126. Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 657 (1979).

> Prior to TILA, there were no standard or required disclosures or definitions of loan terms, meaning consumers could not effectively compare the interest rates and overall loan costs of competing loan products. Scams and frauds were pervasive. TILA was a response to this problem and was designed to prevent abuses in consumer credit cost disclosures, as well as to create uniform methods for calculating and disclosing borrowing costs.[127]

TILA does not generally limit or regulate the interest rates or fees that lenders can charge to consumers. In the decade leading up to the passage of TILA, consumer credit came to play a central role in the American economy, and policymakers and scholars became concerned that middle-class borrowers were unable to compare the prices of credit due to the wide disparity in the way that lenders calculated and advertised the fees and interest rates they charged on the loans they offered.[128] The problem that TILA sought to address, which was that borrowers could not comparison shop effectively for their loans because the quoted interest rates and fees bore no meaningful relation to each other,[129] was exceedingly narrow in scope, and its remedy—improved disclosure—was modest.

TILA is narrow because it does not assist consumers in determining whether they should borrow or in assessing the likely effects that borrowing will have on their well-being. Rather, TILA assists borrowers only to the extent that it helps consumers shop for the best deal when they do borrow.

4. The Efficacy of the Required Federal Disclosure.—The finance charge and the APR are the two central features of TILA's mandatory disclosure regime. The finance charge reflects the dollar amount of the cost of credit and includes interest and other costs such as origination fees, discount points, and private mortgage insurance.[130] The APR for closed-end credit[131] is the finance charge (expressed as an annualized rate) that can be used to equate mathematically the stream of payments made over the life of the loan to its present value.[132] The finance charge is defined by TILA to be any amount "payable directly or indirectly by the person to whom the credit is extended,

127. Crane, *supra* note 80, at 319.

128. *See* KATHLEEN E. KEEST & GARY KLEIN, NAT'L CONSUMER L. CTR., TRUTH IN LENDING 31 (3d ed. 1995) (describing the complex and varied methods used by creditors to calculate interest, which, in part, motivated TILA's enactment).

129. Peterson, *supra* note 123, at 814.

130. BD. GOVERNORS FED. RSRV. SYS. & DEP'T HOUS. & URB. DEV., *supra* note 124, at 1.

131. Closed-end credit is particular, one-time extension of credit obtained that comes due at a particular point in time. CARNELL, *supra* note 121, at 514. Open-end credit, such as that reflected in credit card debt or in a line of credit, is not restricted to a particular duration and may be used repeatedly. *Id.*

132. BD. GOVERNORS FED. RSRV. SYS. & DEP'T HOUS. & URB. DEV., *supra* note 124, at 1.

and imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit."[133]

The required disclosures are of limited value to consumers, generally,[134] particularly in light of the fact that consumers do not know what the APR is and do not realize that the APR is the primary indicator of a loan's cost.[135] The general value of disclosure is particularly doubtful to borrowers with less income or education who "seem especially likely not to know" the terms of the loans to which they are committing themselves.[136]

The required disclosure regime at the heart of TILA is of especially little value in the context of payday loans and other short-term loans that pose particular challenges for the low- and middle-income borrowers that are the particular concern of this Article for three reasons. The first reason why the information provided in the APR is of little use is that consumers do not understand it.[137] Fully "[85] to 96.1 percent of payday loan customers

133. 15 U.S.C. §1605(a).

134. An FTC survey found that many consumers do not understand, or even identify, key terms. *See* JAMES M. LACKO & JANIS K. PAPPALARDO, FED. TRADE COMM'N, IMPROVING CONSUMER MORTGAGE DISCLOSURES: AN EMPIRICAL ASSESSMENT OF CURRENT AND PROTOTYPE DISCLOSURE FORMS 79 tbl.6.6 (2007), https://www.ftc.gov/sites/default/files/documents/reports/improving-consumer-mortgage-disclosures-empirical-assessment-current-and-prototype-disclosure-forms/p025505mortgagedisclosureexecutivesummary.pdf [https://perma.cc/LR32-H7N5] (using a survey methodology to gauge consumers' understandings of the terms of mortgage loans, which revealed that 95% of respondents could not correctly identify the prepayment penalty amount, 87% could not correctly identify the total up-front charges amount, and 20% could not identify the correct APR amount); *see also* Lynn Drysdale & Kathleen E. Keest, *The Two-Tiered Consumer Finance Services Marketplace: The Fringe Banking System and Its Challenge to Current Thinking About the Role of Usury Laws in Today's Society*, 51 S.C.L. REV. 589, 662 n.441 (2000) (describing one study which found "that only 37% of consumers understood the concept of the APR as the primary indicator of credit price, although over 70% knew what the letters stood for"); Diane Hellwig, Note, *Exposing the Loansharks in Sheep's Clothing: Why Re-Regulating the Consumer Credit Market Makes Economic Sense*, 80 NOTRE DAME L. REV. 1567, 1592 (2005) (reporting on consumer surveys that revealed a lack of consumer knowledge regarding loan costs).

135. Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 30–31 (2008).

136. Brian Bucks & Karen Pence, *Do Homeowners Know Their House Values and Mortgage Terms?* 26–27 (Bd. Governors Fed. Rsrv., Fin. & Econ. Discussion Series, Paper No. 2006-03, 2006), http://www.federalreserve.gov/Pubs/feds/2006/200603/200603pap.pdf [https://perma.cc/XS34-68NN]; *see also* George Day, *Assessing the Effects of Information Disclosure Requirements*, 40 J. MKTG. 42, 49 (1976) (finding that disclosure information benefits middle- and high-income borrowers more than low-income borrowers).

137. In addition, there is evidence that consumers do not act on the information they receive as a result of mandatory disclosures, even when it is provided to them. *See* William N. Eskridge, Jr., *One Hundred Years of Ineptitude: The Need for Mortgage Rules Consonant with the Economic and Psychological Dynamics of the Home Sale and Loan Transaction*, 70 VA. L. REV. 1083, 1113–15 (1984) (presenting studies showing that consumers do not shop around for the best deals); Eric J. Gouvin, *Truth in Savings and the Failure of Legislative Methodology*, 62 U. CIN. L. REV. 1281, 1299 n.66 (1994) (questioning disclosure statutes' assumption "that consumers act as rational wealth-maximizers and will use the information supplied by disclosure statutes to shop around to

reported accurate finance charges paid for their most recent payday loan," while "only 20.1 percent of customers were able to report an accurate annual percentage rate."[138] As Ed Rubin wittily explained, "[TILA] succeeded in making consumers increasingly aware, but it has not managed to explain to them what it is they have been made aware of."[139] More troubling still from the perspective of protecting low- and moderate-income consumers seeking short-term credit to fund current consumption, available evidence indicates that, to the extent that TILA provides benefits by enabling consumers to better shop for attractive loans, these benefits may be "limited to well-educated, affluent borrowers."[140]

Second, "the APR does not, and is not intended to, consider all of the factors that consumers weigh in determining the best loan."[141] For example, "the APR does not, and is not intended to, tell consumers about the financial impact of the amount of [required] payment" on the family balance sheet and on consumers' ability to manage their household liquidity with the added burden of the required payments.[142] Third, the calculation of the APR in the context of short-term, high-price consumer credit is based on a faulty assumption about repayment that leads to serious under-reporting of the cost of such credit. Specifically, payday loans are sold as short-term (usually two-week) credit products that provide fast cash. In fact, however, borrowers actually are indebted for much longer, on average five months per year.[143] Similarly, studies show that 80% of payday loans are rolled over or renewed within fourteen days,[144] and fully half of all payday loans are part of sequences of such loans that consist of ten or more loans in a row.[145] In fact, the majority (60%) of all payday loans are made to borrowers who renew their loans so many times that they end up paying more in fees than the

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get the best deal when . . . [e]mpirical studies have tended to show . . . that consumers do not actually behave that way").

138. Gregory Elliehausen, *Consumers' Use of High-Price Credit Products: Do They Know What They Are Doing?* 29–30 (Networks Fin. Inst. at Ind. State Univ., Working Paper No. 2006-WP-02, May 2006), https://ideas.repec.org/p/nfi/nfiwps/2006-wp-02.html [https://perma.cc/PTY8-62FK].

139. Edward L. Rubin, *Legislative Methodology: Some Lessons from the Truth-in-Lending Act*, 80 GEO. L.J. 233, 236 (1991).

140. Richard Hynes & Eric A. Posner, *The Law and Economics of Consumer Finance*, 4 AM. L. & ECON. REV. 168, 194 (2002) (collecting studies).

141. BD. GOVERNORS FED. RSRV. SYS. & DEP'T HOUS. & URB. DEV., *supra* note 124, at 9.

142. *Id.*

143. PEW CHARITABLE TRS., *supra* note 73, at 2.

144. CONSUMER FIN. PROT. BUREAU, CFPB DATA POINT: PAYDAY LENDING 4–5, 16 (2014), https://files.consumerfinance.gov/f/201403_cfpb_report_payday-lending.pdf [https://perma.cc/MZG3-QUT6].

145. *Id.*

amount of money they originally borrowed.[146] This harsh reality is not reflected in the APR or other legally mandated disclosures.

More often than not, borrowers who obtain payday loans find themselves in the debt trap described herein that, as time goes on, they owe as much or more on the last loan in a loan sequence than the amount they borrowed initially.[147] Similarly, as the number of rollovers increases, so too does the percentage of borrowers who increase their borrowing.[148] Such consumers clearly are having trouble dealing with their debt burden.

It might seem that TILA's required disclosure regime would work well by sending a powerful signal to borrowers in the market for a payday loan that they are entering into very dangerous financial terrain when they pursue a payday loan. But because the loan fees are small in absolute terms, it is easy for consumers to ignore the APR and to focus instead on the fees they must pay.

Reference to a typical payday loan illustrates the point. Payday loans are small-dollar credit products that generally range from $100 to $500 in principal amount, though they may be larger depending on state law.[149] The median payday loan is for $350, and the average size is $392, signaling that there are more consumers with loan sizes substantially above the median than substantially below.[150] Lenders usually charge about $15 per $100 borrowed per two weeks (391% APR).[151] The loans are secured by a claim on the borrower's bank account with a post-dated check or electronic debit authorization.[152]

Utilizing this stylized description of a payday loan, the following chart casts some light on the relevance of TILA disclosures in the context of payday loans and other loans of short duration:

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146. *Id.*

147. *Id.* at 4 (noting that 80% of loans are rolled over, that is, followed by another loan within fourteen days, and for these loan sequences, the last loan is the same size as or larger than the first loan in the sequence).

148. *Id.*

149. PEW CHARITABLE TRS., *supra* note 73, at 14.

150. *See* CONSUMER FIN. PROT. BUREAU, PAYDAY LOANS AND DEPOSIT ADVANCE PRODUCTS 15 (2013), https://files.consumerfinance.gov/f/201304_cfpb_payday-dap-whitepaper.pdf [https://perma.cc/DD46-LT29] (explaining that most loans in the sample clustered around $250, $300, and $500).

151. PEW CHARITABLE TRS., *supra* note 73, at 20.

152. *Id.* at 6.

Table 1

Loan Amount	Loan Fee	Repayment Time	APR[153]
$100	$15.00	15 days	365%
$150	$22.50	15 days	365%
$350	$52.50	15 days	365%
$500	$75.00	15 days	365%

Two facts about the loans described in this chart are likely to be salient from a borrower's perspective. First, of course, the amount of the loan fee will be of acute interest to a borrower. This is a concrete number, and, as such, it is likely to be of more interest than the APR. Of course, to the extent that borrowers are comparing this loan with other loans, the APR is likely to be of great interest. But there is no reason to believe that consumers shop around for payday loans. The TILA is based on the assumption that buyers shop around for loans, but financially distressed borrowers are utilizing payday loans precisely because other sources of credit are unavailable. In addition, there is reason to believe that even consumers who may have options do not avail themselves of such options. For instance, ample studies show that fully 50% of borrowers who take out costly subprime loans are actually qualified for prime loans at significantly better rates.[154]

153. The calculation of the APR is as follows: (1) divide the Finance Charge (e.g., $52.50) by the Amount Financed (e.g., $350.00); (2) multiply the result (0.15) by the number of days in the period for which the APR is being calculated (one year (365 days)); (3) divide the result (54.75) by term of the loan (e.g.,15-days) and express the result (3.65) in percentage terms 365%. The following chart shows a sample of U.S. Payday Loan Interest Rates calculated for a typical Payday loan:

Typical Payday Loan APRs	
California	460%
Florida	304%
Kansas	391%
Kentucky	469%
Mississippi	521%
Missouri	462%
Nevada	652%
New Mexico	175%
Tennessee	460%
Texas	661%

Map of U.S. Payday Interest Rates, CTR. FOR RESPONSIBLE LENDING (Mar. 23, 2021), https://www.responsiblelending.org/research-publication/map-us-payday-interest-rates [https://perma.cc/BC38-SCVG].

154. *See* Edward M. Gramlich, FED. RSRV. BD., *Subprime Mortgage Lending: Benefits, Costs, and Challenges: Remarks at the Financial Services Roundtable Annual Housing Policy Meeting, Chicago, Illinois* (2004) (observing that it is "noteworthy that about half of subprime

B. *State Law Consumer Protection Rules*

To a significant extent, state consumer protection laws resemble the federal regulations described here.[155] States also are, in varying degrees, active in policing unfair and deceptive trade practices.[156]

In recent years, the regulation of payday lending has been on the agenda in many state legislatures.[157] Several states (Arizona, Arkansas, Connecticut, Georgia, Maryland, Massachusetts, New Jersey, New Mexico, New York, North Carolina, Pennsylvania, Vermont, and West Virginia)[158] and the District of Columbia[159] have enacted laws essentially prohibiting payday loans by imposing caps on the interest rates that lenders can charge on short-term borrowing.[160] In other states, such as California,[161] Colorado,[162] and Michigan,[163] payday loans are not banned outright, but they are heavily

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mortgage borrowers have FICO scores above" the threshold that would qualify them to obtain lower-cost prime loans); JAMES H. CARR & LOPA KOLLURI, PREDATORY LENDING: AN OVERVIEW 7 (2001) (showing that 35% of borrowers in the subprime market could qualify for prime market loans); FREDDIE MAC, AUTOMATED UNDERWRITING: MAKING MORTGAGE LENDING SIMPLER AND FAIRER FOR AMERICA'S FAMILIES (Sept. 1996), https://web.archive.org/web/19961104233847/http://www.freddiemac.com/reports/moseley/mosehome.htm [https://perma.cc/4A2P-HKPU] (estimating that between 10 and 35 percent of borrowers who obtained mortgages in the subprime market could have qualified for a conventional loan); *see also* Lauren E. Willis, *Decision-Making and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707, 730 (2006) (summarizing studies and reporting that "[i]t is estimated that as many as half of the borrowers with subprime loans were qualified for lower prime interest rate loans, based on their credit history and loan profile").

155. Crane, *supra* note 80, at 326.

156. *Id.*

157. For example, in the 2020 legislative session, twenty-one states and Puerto Rico had pending legislation regarding payday lending and payday lending alternatives. Heather Morton, *Payday Lending 2020 Legislation*, NAT'L CONF. OF STATE LEGISLATURES (Nov. 20, 2020), https://www.ncsl.org/research/financial-services-and-commerce/payday-lending-2020-legislation.aspx [https://perma.cc/L78Y-QRAS].

158. *See* Aliyyah Camp, *Are Payday Loans Permitted in Your State?*, FINDER (Dec. 17, 2019), https://www.finder.com/payday-loans-in-your-state [https://perma.cc/UEB9-AW4J] (noting that regulations for payday loans vary greatly from state to state).

159. *Id.*

160. *Id.* The state-imposed rate caps are usually 36%. The cap in Connecticut is 12%. CONN. GEN. STAT. §§ 37–4, 37–9 (2021); *see also* CONN. GEN. STAT. §§ 36a-563, 565, 581 (2021); CONN. AGENCIES REG. § 36a-585-1 (2021) (elaborating small loan law and check casher law). Also, there is a usury cap in Connecticut that all lenders have to comply with if they want to operate in the state. *Id.* § 37–4.

161. CAL. FIN. CODE § 23000 (West 2021); CAL. CIV. CODE §§ 1789.30–.39 (West 2021).

162. Colorado imposes a $500 amount limit on payday loans (deferred deposit loans) offered in the state. COLO. REV. STAT. § 5-3.1-106 to -107 (2021). The amount of all outstanding loans of a borrower should not exceed $500 at one given time. Payday loans can be taken for the period starting from 180 days and longer. COLO. REV. STAT. § 5-3.1-103 (2021). The finance charge must not exceed an annual percentage rate of 36%. COLO. REV. STAT. § 5-3.1-105 (2021).

163. MICH. COMP. LAWS §§ 487.2121–.2173. Michigan imposes a $600 limit on the amount that a borrower can take from a single payday lender, with a maximum of two loans from different

regulated. In California, for example, legislation passed in 2019 restricts payday lenders to a maximum of $300 in loans and restricts fees to a maximum of $45.[164] Payday loans, called "deferred deposit transactions" in California, can be taken for a period of no longer than thirty-one days with the maximum finance charge of 15% of the amount advanced and a maximum APR of 460%.[165] No additional charges are allowed for the extension of a loan.[166]

Despite these regulations, in 2020 there were still 2,119 payday lender storefronts in California,[167] and about 12.3 million payday loans were taken out in the state in 2015,[168] the most recent year for which data was available. Also, California's experience with regulating, or attempting to regulate, payday loans illustrates how challenging it can be to regulate them effectively. For example, under California law, banks are generally not subject to interest rate limits.[169] Consequently, when payday lending is regulated, payday lenders turn to so-called "rent-a-bank" schemes, which involve payday lenders processing their loans through a bank in order to render inapplicable statutory interest rate limits on nonbank consumer loans.[170] In 2019, the National Consumer Law Center monitored the earnings calls that several of the largest, publicly traded payday lenders in California had with financial analysts and investors.[171] On these calls, the payday lenders disclosed that they were planning to use banks to enable them to continue making high-cost loans.[172] As one payday lender observed,

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lenders permitted. *Id.* § 487.2153(1)–(2). The maximum term of payday loans in Michigan is 31 days. *Id.* § 487.2153(1). There is a maximum APR of 369%. *Id.* § 487.2153(1)(a). The maximum service fees and finance charges that can be imposed range downward from 15% of the first $100 transaction to 11% of the sixth transaction. *Id.*

164. CAL. FIN. CODE §§ 23035(a), 23036(a) (2021).

165. *Id.*

166. *Id.* § 23036(b).

167. *California Payday Loan Law and Legislation*, USTATESLOANS.ORG, https://www.ustatesloans.org/law/ca [https://perma.cc/N66T-EP5K].

168. *Id.*

169. *New California Law Targets Long-Term Payday Loans; Will Payday Lenders Evade It?*, NAT'L CONSUMER L. CTR. (Oct. 11, 2019), https://www.nclc.org/media-center/new-california-law-targets-long-term-payday-loans-will-payday-lenders-evade-it.html [https://perma.cc/LX3P-L7QE].

170. *Payday Lenders Plan to Evade California's New Interest Rate Cap Law Through Rent-A-Bank Schemes*, NAT'L CONSUMER L. CTR. 1 (Oct. 2019), https://www.nclc.org/images/pdf/high_cost_small_loans/payday_loans/ib-rent-a-bank-plans-oct2019.pdf [https://perma.cc/GD2N-BEBE].

171. *See id.* at 1–3 (quoting transcripts of August 2019 calls by three publicly-traded payday lenders).

172. *Id.* Some courts have blocked these schemes, and litigation is pending in other states challenging these arrangements. *Id.* at 1; *see, e.g.*, Cashcall, Inc. v. Morrisey, No.12-1274, 2014 WL 2404300, at *5, *15 (W.Va. May 30, 2014) (upholding injunction and damages award against payday lender involved in rent-a-bank scheme).

> [B]ecause we have multiple bank partners, we are confident that we can make that transition. We did this in Ohio last year. It was very seamless. And the effective yield that we are looking at on the product would be very similar to what we have on the market today. So we think the impact would be minimal and this transition would be pretty seamless.[173]

C. *Federal and State Regulatory Responses: Too Much and Not Enough*

Even outright bans on payday lending appear generally ineffective and easy to evade.[174] A notable exception relates to the regulation of loan roll-overs. A loan rollover occurs when an outstanding loan is renewed. Rollovers allow a borrower to make an interest payment in lieu of a principal payment on the due date of an outstanding loan. In the context of payday loans, rollovers extend the loan for an additional pay cycle.[175] After this extension, the borrower "can repay in full, or rollover the loan yet again by making an additional interest payment."[176] Some states, however, forbid rollovers and impose "cooling-off periods" between issuances of consumer loans.[177]

Over 80% of payday loans are rolled over or followed by another loan within fourteen days. The CFPB reported that "[s]ame-day renewals are less frequent in states with mandated cooling-off periods, but 14-day renewal rates in states with cooling-off periods are nearly identical to rates in states without these limitations."[178] Skiba argues that regulations exclusively "focused on restricting rollovers/renewals make sense because they do provide helpful protection to consumers, while other types of regulations (beyond basic information disclosures) generally overreach and inhibit unique opportunities for consumers to increase utility."[179] While Professor

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173. *Payday Lenders Plan to Evade California's New Interest Rate Cap Law Through Rent-A-Bank Schemes*, *supra* note 170, at 2.

174. Skiba, *supra* note 50, at 1043.

175. *Id.* at 1026 n.10.

176. *Id.*

177. FL. STAT. ANN. § 560.404(18)–(19) (West 2021) (prohibiting rollovers and requiring a twenty-four-hour cooling-off period between consecutive loan issuances). Virginia law forbids rollovers. 10 VA. ADMIN. CODE 5-200-80 (2021). Wisconsin allows one renewal and requires a twenty-four-hour waiting period after that renewal, stating that:

> A customer may repay a payday loan with the proceeds of a subsequent payday loan . . . , but if the customer does so, the customer may not repay the subsequent payday loan with the proceeds of another payday loan . . . . A repayment of a subsequent payday loan and the origination of a new payday loan from [a lender] within a 24-hour period shall be considered proof of [a] violation . . . .

WIS. STAT. ANN. § 138.14(12) (West 2021).

178. CONSUMER FIN. PROT. BUREAU, *supra* note 144, at 4.

179. Skiba, *supra* note 50, at 1029; *see also* Susan Payne Carter, *Payday Loan and Pawnshop Usage: The Impact of Allowing Payday Loan Rollovers*, 49 J. CONSUMER AFFS. 436, 454 (2015)

Skiba undoubtedly is correct that the particular problem of rollovers deserves special attention, when one considers the human toll that improvident, welfare-reducing borrowing takes on families, and the clear "link between growing income inequality in the United States and high household indebtedness,"[180] it seems clear that a far more robust regulatory response is needed.

There are three justifications for moving to a new paradigm of consumer lending regulation. First, as noted at the outset of this Article, there is no dispute about the fact that some consumer lending provides benefits to borrowers while other instances of consumer lending cause real harm—and not just economic harm but physical and psychological harm as well. Significantly, the main rationale for not regulating consumer lending is that it is impossible to distinguish beneficial lending from harmful lending, and therefore, regulation should be abjured in order to avoid losing the benefits to consumers that come from such lending.[181]

In particular, the standard economic analysis of consumer lending is wary of regulation that ignores the positive aspects of such lending and instead "demonize[s]."[182] Such lending fails to recognize that "[a]ny regulations that constrain payday borrowing beyond restrictions on rollovers/renewals are suspect because they remove or inhibit the use of a tool that low-income people use to smooth their income stream."[183]

There is considerable merit to this observation but only as long as its core assumption, which is that beneficial borrowing must be jettisoned in order to regulate harmful borrowing, remains valid. The balance sheet framework to consumer lending described in this Article, however, creates the means to fashion regulation that is more tailored in that it can distinguish beneficial lending from harmful lending. Thus, the balance sheet framework developed here creates a justification for regulation simply by eliminating the most prominent objection to regulation. Moreover, the policy recommendation made here to have the Federal Reserve act as a "lender of last resort" for low- and moderate-income households facing emergency liquidity needs would, of course, greatly enhance rather than "remove or inhibit" the ability of low-income people to smooth their income stream.

One reason for more intensive regulation of consumer lending is that the lack of regulation is anomalous and inconsistent with the legal landscape in

(suggesting that a major criticism of payday loans—that they initiate a cycle of debt—is exacerbated by rollovers).

180. Gunnar Trumbull, *Credit Access and Social Welfare: The Rise of Consumer Lending in the United States and France*, 40 POL. & SOC'Y 9, 10 (2012).

181. *See* Skiba, *supra* note 50, at 1029 ("[T]here is a need for a more nuanced examination of payday loans because, in some circumstances at least, the good outweighs the bad.").

182. *Id.*

183. *Id.*

finance. There is venerable literature linking the strength and robustness of U.S. capital markets to both the high quality and the stringency of its consumer protection regime. People who offer and sell securities to people have obligations that are sometimes fiduciary and always "fiduciary in nature."[184] It is inexplicable that these sorts of protections are not extended to borrowers in the consumer lending context, particularly for significant loans that radically transform a borrower's financial status as reflected in the borrower's balance sheet.

An additional justification for regulating consumer credit with a heavier hand is that it is efficient to do so because it lowers agency costs. It is commonplace to defend regulation on the grounds that an agency problem exists and that regulation that reduces such agency costs both benefits consumers and promotes economic efficiency.[185] Of course, an agency relationship is a relationship of trust and confidence. And one could certainly argue that lenders and borrowers are dealing at arm's length, and so the appropriate legal framework is *caveat emptor*, not the fiduciary law applicable to agency relationships.

It is of course true, as Deborah DeMott has observed, that "the defining elements of [an agency] relationship are mutual manifestation of consent, the agent's undertaking to act on behalf of the principal, and the principal's right to control the agent."[186] In the context of consumer credit, one could certainly argue that lenders are not agents of borrowers because they are acting on their own behalf and not on behalf of borrowers. And, of course, one also could argue that the putative principal—the borrower—is not really a principal because borrowers do not have the right to control their agents. But these arguments have been rejected in corporate finance in the context of both broker-dealers and investment advisers,[187] and they also should be rejected in the case of consumer lending. In particular, the fact that securities professionals cannot, as a formal matter, be considered agents has not served as any constraint whatsoever on the imposition of a fiduciary obligation on these economic actors. Rather, regulators and Congress can, of course, simply *create* a relationship of trust and confidence and impose fiduciary duties on economic actors whenever they deem it appropriate to do so. The existence of a common law agency relationship is not a prerequisite to

184. MELANIE L. FEIN, BROKERS AND INVESTMENT ADVISERS STANDARDS OF CONDUCT: SUITABILITY VS. FIDUCIARY DUTY 2 (2010), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1682089 [https://perma.cc/7EY4-JJ95].

185. *See, e.g.*, Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1048 (1995) (defending the mandatory disclosure provisions of U.S. securities laws on the grounds that they mitigate agency costs).

186. Deborah A. DeMott, *The Lawyer as Agent*, 67 FORDHAM L. REV. 301, 302–03 (1998).

187. Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 VILL. L. REV. 701, 742 (2010).

creating such a duty, as is evident from the Investment Advisers Act,[188] which imposes fiduciary duties on investment advisers,[189] notwithstanding the fact that such advisers are not agents under traditional principles of agency:

> Investment advisers . . . have been held by the SEC and the Supreme Court to have the status of "fiduciaries" under the Investment Advisers Act of 1940, even though they do not have that status under agency law (unless they also act as brokers). As fiduciaries, investment advisers are subject to a fiduciary duty to act in the best interests of their customers but are not subject to extensive regulatory standards defining this duty.[190]

And, while broker-dealers, unlike investment advisers, do not owe strict fiduciary duties to their customers (as discussed below), they owe such customers a panoply of "fiduciary-like duties,"[191] including the duty to recommend only investments that are "suitable" for their customers' particular needs[192] and the duty to refrain from excessive trading ("churning") in customers' accounts.[193]

The point is pretty simple. The rather obvious justifications for requiring such duties from broker-dealers and investment advisers who sell securities to customers apply with equal, and probably greater, force to lenders. These lenders, particularly those making loans to fund current consumption by unsophisticated, financially distressed borrowers, are dealing with a clientele that is far more vulnerable than the clientele that faces broker-dealers and

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188. 15 U.S.C. §§ 80b-1–b-21; *see* Santa Fe Indus. v. Green, 430 U.S. 462, 471 n.11 (1977) (acknowledging that the Investment Advisers Act imposes a federal fiduciary duty on investment advisers).

189. The Investment Advisers Act defines an investment adviser as any person or firm which is engaged in the business of providing advice to others or issuing reports or analyses regarding securities for compensation. 15 U.S.C. 80b-2(a)(11).

190. FEIN, *supra* note 184, at 2; *see also* SEC v. Cap. Gains Rsch. Bureau, Inc., 375 U.S. 180, 189, 191–92 (1963) (noting that the Investment Advisers Act of 1940 demonstrates a "congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested") (footnote omitted).

191. FEIN, *supra* note 184, at 17–18; *see also* Cheryl Goss Weiss, *A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty*, 23 J. CORP. L. 65, 101 (1997) (noting that dismissal of a lawsuit may be avoided even if the allegations fall short of fraud and quoting a case that noted relevance of broker-dealer's duty to recommend suitable investments for client).

192. *See* SEC v. Hasho, 784 F. Supp. 1059, 1107 (S.D.N.Y. 1992) (noting that a securities dealer who makes a recommendation implicitly represents to his client that he "has an adequate basis for the recommendation") (citation omitted); *In re* Gerald M. Greenberg Nat'l Ass'n of Sec. Dealers, Inc., Exchange Act Release No. 6320, 40 SEC Docket 133 (July 21, 1960) (discussing broker-dealer's unsuitable recommendations to his customers regarding investments).

193. Charles R. Mills & Ronald A. Holinsky, *Customer Transactions: Suitability, Unauthorized Trading, and Churning*, *in* 1 BROKER-DEALER REGULATION 11–1, 11–59 (Clifford E. Kirsch ed., Practising L. Inst. 2d ed., 2011).

investment advisers. Similarly, the sometimes severe asymmetry of information that often characterizes the relationship between broker-dealers and investment advisers and their clients is a chronic feature of the relationship between those making consumer loans and those receiving such loans.[194]

In fact, the pathologies of chronic rollovers and high incidence of default in the payday lending market are not attributable to a lack of competition but to information asymmetries.[195] One asymmetry that is particularly pronounced in payday lending is that borrowers know little beyond their own individual circumstances, while lenders have better information than borrowers regarding the probability that a consumer loan will have to be rolled over.[196] Because repeat lending is disproportionately profitable, perversely, lenders making short-term consumer loans often are better off if the borrower is unable to repay the loan immediately and has to roll it over, thereby incurring additional fees and payment obligations.[197]

Another information asymmetry relates to the problem that lenders have readier access to information about the universe of alternative credit products potentially available to their customers than their customers do.[198] While not all borrowers who take out payday loans have lower-cost alternatives, many do. If the fiduciary-like obligations that stockbrokers owe their customers in securities markets were extended to lenders in the market for short-term consumer credit, then such lenders would be obligated to advise their clients if they are eligible to receive a lower-cost alternative to a payday loan, even if the payday loan is more profitable for the lender.

IV. Towards a New Regulatory Paradigm

The balance sheet framework advocated in this Article provides a basis for a new regulatory framework. This framework envisions three levels of regulatory protection for consumers: (a) Standard (Truth-in-Lending Act/Anti-Fraud) Protections; (b) Fiduciary-Like Duties; and (c) Access to

194. Of course, the asymmetry of information problems runs in two directions. Borrowers lack critical information about alternative sources of credit that lenders have, and lenders lack critical information that borrowers have about their ability to repay the loans. *See* Will Dobbie & Paige Marta Skiba, *Information Asymmetries in Consumer Credit Markets: Evidence from Payday Lending*, AM. ECON. J: APPLIED ECON., Oct. 2013, at 256, 256 (using administrative data drawn from the payday lending market to present evidence of relevance of asymmetric information).

195. SARAH BEDDOWS & MICK MCATEER, ASS'N OF CHARTERED CERTIFIED ACCTS., PAYDAY LENDING: FIXING A BROKEN MARKET 54 (2014), https://www.accaglobal.com/content/dam/acca/global/PDF-technical/other-PDFs/pol-tp-pdlfab-payday-lending.pdf [https://perma.cc/7X9R-43QD].

196. *Id.* at 56.

197. *Id.*

198. *See id.* at 57–59 (discussing insolvent borrowers' options in event of default and explaining why lenders are disincentivized to inform borrowers of options).

Federal Reserve Lending Facilities. This section will begin by explaining the nature of these regulatory protections. It will then explain which categories of loans qualify for which level of protection.

A. *Standard, Truth-in-Lending Act/Anti-Fraud Protections*

Regulation is costly. Loans between non-coerced, properly informed, and rational lenders and borrowers not only benefit the lenders and borrowers who are parties to the transaction; they also generate benefits more broadly by increasing societal wealth and promoting economic growth, employment, and prosperity. As such, loans that are welfare enhancing from a balance sheet perspective should be lightly regulated. Moreover, unlike emergency loans to finance things like medical care for financially insecure borrowers, loans to fund business investments or to fund purchases of capital goods like houses and cars should not be subsidized by the government.[199]

But light regulation does not mean no regulation. Existing regulations such as the Truth in Lending Act, as well as traditional anti-fraud laws, are desirable because they improve the operation of markets by lowering transaction costs and inculcating trust in the economic system. A major problem in loan markets, as noted above, is asymmetric information between lenders and borrowers. Anti-fraud rules serve an important efficiency-enhancing function of permitting borrowers and sellers to ameliorate this asymmetric information problem under circumstances in which both borrowers and lenders are made better off by reducing such asymmetries. Essentially, anti-fraud rules, by imposing costs in the form of legal sanctions on borrowers and lenders who lie, lower transaction costs by making it rational for contracting parties to trust each other when, in the absence of meaningful legal consequences for lying, it would not be rational for them to do so.

The Truth in Lending Act, which compels lenders to disclose "all relevant loan terms," arguably promotes economic efficiency by providing borrowers with information in a usable format (the APR) that makes it feasible to engage in comparison shopping for the best loan terms.[200] While economists are in general agreement that "[t]he scope, content, and enforcement of mandated price disclosure are central to the design of sound public policy in credit markets,"[201] it is by no means clear that the particular disclosures required by TILA are of much, if any, value to low- and middle-income borrowers who are searching desperately for cash to fund immediate

199. At least they should not be subsidized any more than they already are through programs like the tax deductibility of interest payments on home mortgages.

200. Victor Stango & Jonathan Zinman, *Fuzzy Math, Disclosure Regulation, and Market Outcomes: Evidence from Truth-in-Lending Reform*, 24 REV. FIN. STUD. 506, 506–07 (2011).

201. *Id.* at 507.

consumption.[202] Moreover, even the limited benefits[203] of mandated APR disclosure may be offset by compliance and enforcement costs.[204]

On the other hand, there is no question whatsoever that strict enforcement of anti-fraud laws serves consumers' interests. The commission of fraud and the concomitant problem of under-enforcement of laws barring deceptive and fraudulent practices are significant impediments to the operation of loan markets. The operation of the student loan market is a case in point.

1. Student Loans, Redux.—As discussed above, a major category of potentially welfare-enhancing lending is lending to fund education. From the balance sheet perspective employed in this Article, such lending has the potential to be—and often is—welfare-enhancing because more often than not the increased earnings power attained through education outweighs the present value of the principal and interest costs of the student loans used to fund the borrower's education. And yet, largely because of fraud, many students are duped into assuming significant amounts of very expensive debt by low-quality educational institutions that do not deliver to students the opportunity to develop their human capital that the students are paying for with the student loans they procure.

Unfortunately, the student loan market is rife with fraud. For-profit colleges and universities are a topic of particular concern because the default rates on the loans taken out by their students vastly exceed those of other institutions of higher education, and audit studies have shown that "some for-profits have engaged in highly aggressive and even borderline fraudulent recruiting techniques."[205] Students who attended for-profit colleges filed an astonishing 98.6% of the requests for student loan forgiveness alleging fraud.[206]

202. *See supra* section III(A)(4) (discussing TILA's required disclosures).

203. While the disclosures required by TILA are not particularly valuable, they do represent an improvement over prior disclosure practice. Prior to TILA, lenders typically marketed "low monthly payments" and either shrouded interest rates or presented alternatively defined rates that are nominally lower than APRs. This typically was done by advertising interest rates that failed to reflect declining principal balances and consequently often appeared significantly lower in nominal terms than the APR. *See* NAT'L COMM'N ON CONSUMER FIN., CONSUMER CREDIT IN THE UNITED STATES 169–70, 172 (1972) (discussing historical context leading to TILA as well as the purpose of the law).

204. Stango & Zinman, *supra* note 200, at 509.

205. David J. Deming, Claudia Goldin & Lawrence F. Katz, *The For-Profit Postsecondary School Sector: Nimble Critters or Agile Predators?*, 26 J. ECON. PERSP. 139, 143 (2012).

206. Yan Cao & Tariq Habash, *College Complaints Unmasked: 99 Percent of Student Fraud Claims Concern For-Profit Colleges*, CENTURY FOUND. (Nov. 8, 2017), https://tcf.org/content/report/college-complaints-unmasked [https://perma.cc/SSY6-E3UC] (noting that 76.2%—75,343 claims—of all fraud claims were against schools owned by one for-profit entity, the now-closed

Faced with numerous complaints, at the request of the Department of Education, the U.S. Government Accountability Office (GAO) conducted a series of undercover tests to determine if for-profit colleges engaged in fraudulent, deceptive, or otherwise questionable marketing practices.[207] The GAO also compared those for-profit colleges' tuitions with other colleges in the same geographic region.[208]

GAO undercover agents investigated fifteen for-profit colleges in six states and Washington, D.C. by posing as prospective students applying to those colleges.[209] GAO also investigated what type of follow-up contact a prospective student would receive by entering information on four fictitious prospective students into education search websites. The undercover tests at the fifteen for-profit colleges found that four of the fifteen colleges actually encouraged fraudulent practices by the fictitious prospective students and that all fifteen made "deceptive or otherwise questionable statement[s] to [GAO's] undercover applicants."[210] Specifically, college personnel encouraged four undercover applicants to falsify their financial aid forms to qualify for federal aid—"for example, one admissions representative told an applicant to fraudulently remove $250,000 in savings."[211] Other college representatives exaggerated undercover applicants' salary potential and were not transparent about the college's program duration, costs, or graduation rate despite federal regulations requiring disclosure of that information.[212] For example, staff commonly told GAO's applicants they would attend classes for twelve months a year but stated the annual cost of attendance for nine months of classes, which mislead applicants about the total cost of tuition.[213] Admissions staff used other deceptive practices, such as pressuring applicants to sign a contract for enrollment before allowing them to speak to a financial advisor about program cost and financing options.[214] However, in some instances, undercover applicants were provided accurate and helpful

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Corinthian Colleges). The vast majority of claims—over 94%—were still against for-profit colleges even after Corinthian was removed from the analysis. *Id.*; *see also For-Profit Colleges Linked to Almost All Loan Fraud Claims*, CBS NEWS (Nov. 9, 2017), https://www.cbsnews.com/news/study-most-student-loan-fraud-claims-involve-for-profits [https://perma.cc/463V-SXPR] (discussing the report by the Century Foundation),

207. U.S. GOV'T ACCOUNTABILITY OFF., GAO-10-948T, FOR-PROFIT COLLEGES: UNDERCOVER TESTING FINDS COLLEGES ENCOURAGED FRAUD AND ENGAGED IN DECEPTIVE AND QUESTIONABLE MARKETING PRACTICES 1 (2010).

208. *Id.* at 2.

209. *Id.* GAO selected those colleges based on several factors such as having received "89 percent or more of total revenue from federal student aid" as reported by the Department of Education. *Id.*

210. *Id.* at 7.

211. *Id.* at i.

212. *Id.* at 9–10.

213. *Id.* at 11.

214. *Id.*

information by college personnel, such as not to borrow more money than necessary.[215] In addition, GAO's four fictitious prospective students received numerous, repetitive calls from for-profit colleges attempting to recruit the students when they registered with websites designed to link for-profit colleges with prospective students.[216] Once registered, GAO's prospective students began receiving calls within five minutes.[217] One GAO undercover applicant received over 180 phone calls in a month.[218] Calls were received at all hours of the day—as late as 11 p.m.[219]

Programs at the for-profit colleges GAO tested cost substantially more for associate's degrees and certificates than comparable degrees and certificates at public colleges nearby.[220] A for-profit college offering massage therapy certificates charged over $14,000.[221] However the price of the same certificate from a nearby public college was only $520.[222] Tuition costs at private nonprofit colleges were closer to the costs at for-profit colleges for similar degrees.[223]

Like all other lenders, lenders making student loans are subject to state law anti-fraud rules. The very significant incidence of fraud in the student loan market indicates that the rules are not working as well as they should to mitigate the problem of fraud and raises the question of why fraud appears disproportionately to be a problem in the student loan market. The most likely and plausible explanation for the prevalence of fraud in the student loan market is that this market is characterized by a third-party guarantor—the federal government. The government's role as a guarantor of borrowers' obligations for their student loans creates enormous moral hazard because it makes lenders indifferent to the ability of the students who obtain student loans to repay them.[224]

215. *Id.* at 13–14.

216. *Id.* at 14–15.

217. *Id.* at 15.

218. *Id.*

219. *Id.* at i. To see video clips of undercover applications and to hear voicemail messages from for-profit college recruiters, go to http://www.gao.gov/products/GAO-10-948T [https://perma.cc/6BHH-VRMN]. *Id.*

220. *Id.* at 16–17.

221. *Id.* at 18 tbl.3.

222. *Id.*

223. *See id.* at 16, 18 tbl.3 (stating that at four private nonprofit colleges, a comparable degree was less expensive than at for-profit college).

224. Moral hazard refers to the phenomenon of excessive expenditures that occur due to the recipient of such expenditures being eligible for insurance benefits. In simple terms, moral hazard describes the phenomenon that people are less likely to take care to avoid harms that are covered by insurance. The social cost of moral hazard is the deadweight loss associated with the insurance. Other sources contain important discussions of moral hazard. *See generally* Bengt Holmström, *Moral Hazard and Observability*, 10 BELL J. ECON. 74 (1979); Richard Zeckhauser, *Medical*

The federal government's role with respect to the operation, supervision, and administration of federal student loan programs long has been massive, and in recent decades it has expanded.[225] The government, however, remains a steadfast guarantor of student loan obligations.[226] From 2000 to 2010, most federal student loans were issued under the now-discontinued Federal Family Education Loan Program (FFELP),[227] under which private lenders extended loans to borrowers that the federal government guaranteed against the risk of loss.[228]

The federal government's role in the student loan system has continued to expand as "the federal government's share of all student lending went from 75 percent in 2007–2008 to 93 percent in 2009–2010."[229] For example, in 2008, Congress enacted the Ensuring Continued Access to Student Loans Act (ECASLA), which authorized the Department of Education to purchase outstanding FFELP loans from private lenders.[230] In 2010, Congress enacted

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Insurance: A Case Study of the Tradeoff Between Risk Spreading and Appropriate Incentives, 2 J. ECON. THEORY 10 (1970); Harold Demsetz, *Information and Efficiency: Another Viewpoint*, 12 J.L. & ECON. 1 (1969); Mark V. Pauly, *The Economics of Moral Hazard: Comment*, 58 AM. ECON. REV. 531 (1968); Kenneth J. Arrow, *The Economics of Moral Hazard: Further Comment*, 58 AM. ECON. REV. 537 (1968).

225. *See* KEVIN M. LEWIS & NICOLE VANATKO, CONG. RSCH. SERV., R45917, FEDERAL AND STATE REGULATION OF STUDENT LOAN SERVICERS: A LEGAL OVERVIEW 5 (2019) (stating that "the federal government's direct involvement in the student loan industry" has expanded over time).

226. Wenhua Di & Kelly D. Edmiston, *State Variation of Student Loan Debt and Performance*, 48 SUFFOLK U. L. REV. 661, 664 (2015). Di and Edmiston found that

> The student loan market has undergone substantial reform since the recent recession, such that the federal government's role and programs have changed. For instance, the [FFELP], which provided guarantees (insurance) and, in many cases, borrower subsidies, for qualified privately-issued student loans, was replaced by the [FDLP], under which the federal government provides student loans directly to borrowers.

Id.

227. *See* ALEXANDRA HEGJI, CONG. RSCH. SERV., R43351, THE HIGHER EDUCATION ACT (HEA): A PRIMER 13 (2018) ("For many years the [FFELP] was the primary source of federal student loans . . . ."); Note, *Ending Student Loan Exceptionalism: The Case for Risk-Based Pricing and Dischargeability*, 126 HARV. L. REV. 587, 591 (2012) ("[FFELP] loans accounted for the majority of federally supported loans each year from 2000 to 2010.").

228. *See* Salazar v. King, 822 F.3d 61, 65 (2d Cir. 2016) (citing 20 U.S.C. § 1078(b)-(c); 34 C.F.R. § 682.200) ("Under the [FFELP], private lenders issue subsidized student loans, which are then insured by guaranty agencies (a state or private non-profit organization), which, in turn, are insured by the DOE."); Jamie P. Hopkins & Katherine A. Pustizzi, *A Blast from the Past: Are the Robo-Signing Issues That Plagued the Mortgage Crisis Set to Engulf the Student Loan Industry?*, 45 U. TOL. L. REV. 239, 254 (2014) ("Under the [FFELP], private lenders such as Sallie Mae, working under contract with the federal government, provided 'loan capital' directly to the borrower, which the federal government guaranteed against loss in the event the borrower defaulted. The loan itself originated with the private lender . . . ." (footnote omitted)).

229. John R. Brooks, *The Case for More Debt: Expanding College Affordability by Expanding Income-Driven Repayment*, 2018 UTAH L. REV. 847, 851 (2018).

230. Ensuring Continued Access to Student Loans Act of 2008, Pub. L. No. 110-227, § 7, 122 Stat. 740, 746–48 (2008) (codified at 20 U.S.C. §§ 1087a, 1087f, 1087i-1); Student Loan Servicing

the Student Aid and Fiscal Responsibility Act (SAFRA), pursuant to which the United States government became the issuer of the majority of new federal student loans through the Federal Direct Loan Program (FDLP).[231]

The history of government involvement in the student loan market conclusively shows that while most borrowers derive significant benefits from such support,[232] these benefits are offset by significant costs that come in the form of overconsumption of education by students who fail to complete their intended courses of study and wind up defaulting, thereby ruining their credit and experiencing financial distress.[233]

In light of the particular problems associated with student loans posed by the moral hazard created by government guarantees, special regulatory attention clearly seems to be indicated for student loans. Another reason such loans are likely candidates for special regulatory attention is that they are likely to have a transformative effect on the balance sheets of the students taking out such loans to invest in the development of their human capital.

2. Transformative Loans.—In addition to focusing on whether the effects of a particular loan are positive, neutral, or negative, the balance sheet approach proposed here also advocates that regulation focuses on whether the effects of a particular loan on the borrower's balance sheet are transformative or not. I define a transformative loan as one that results in a

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All. v. District of Columbia, 351 F. Supp. 3d 26, 38 (D.D.C. 2018) (noting that Congress passed the ECASLA in response to the 2008 financial crisis and that the law allowed the DOE to purchase FFELP loans from private lenders until the end of the 2009–2010 school year).

231. *See* Okla. Firefighters Pension & Ret. Sys. v. Student Loan Corp., 951 F. Supp. 2d 479, 484 (S.D.N.Y. 2013) (noting that SAFRA "eliminated the [FFELP] and brought all federal student lending under the [FDLP]").

232. In a sign of the success of many student loans, the Consumer Financial Protection Board, using a sample of borrowers who paid off a student loan between 2013 and 2017, found that many student loan borrowers pay their loans on a steady schedule for a time, and then make a significant final payment to eliminate the outstanding balance months or years before the scheduled repayment term of the loan expired. BUREAU CONSUMER FIN. PROT.'S OFF. RSCH., DATA POINT: FINAL STUDENT LOAN PAYMENTS AND BROADER HOUSEHOLD BORROWING 6, 9, 11 (2018), https://files.consumerfinance.gov/f/documents/bcfp_data-point_final-student-loan-payments-household-borrowing.pdf [https://perma.cc/VCU8-BHDH].

233. Among the costs of defaulting on a student loan are the loss of access to other government programs (including additional student aid), liability for collection fees incurred by the Department of Education and collection agencies, damaging credit, difficulty in accessing normal lending channels, risk of loss of driver's licenses and professional licenses (thereby jeopardizing employment), etc. *Student Loan Default Has Serious Financial Consequences*, PEW CHARITABLE TRS. (Apr. 7, 2020), https://www.pewtrusts.org/en/research-and-analysis/fact-sheets/2020/04/student-loan-default-has-serious-financial-consequences [https://perma.cc/5VKM-N4JB]. *See also* NAT'L CONSUMER L. CTR., *No Way Out: Student Loans, Financial Distress, and the Need for Policy Reform* (2006), https://www.studentloanborrowerassistance.org/wp-content/uploads/2013/05/nowayout.pdf [https://perma.cc/9VHZ-UTEW] (providing reasons why student loan borrowers get into trouble and why problems spiral, describing current government collection policies, and suggesting methods of reform).

change of more than 25% to the value of the liabilities on the borrower's balance sheet. Specifically, a loan that is used to purchase a major asset such as a house or a car might, depending on the assets of the borrower, radically transform that borrowers' balance sheet. Someone with an income of $80,000, assets of $150,000, and liabilities of $25,000 who borrows $300,000 to buy a $375,000 house will experience a significant transformation in their balance sheet.[234]

I argue that lenders who offer what I describe as transformative loans should be held to the same disclosure and consumer protection standards that routinely are applied to broker-dealer firms in the securities context. In previous work with Geoff Miller, Maureen O'Hara, and Gabe Rosenberg, I have argued that borrowers who take out home mortgage loans should receive heightened regulatory protection.[235] Working within a legal paradigm that we characterized as something "Kafka would have loved,"[236] we objected to the fact that the law provides vastly better "consumer protection for people who play the stock market than for people who are duped into buying a house with an exotically structured subprime mortgage."[237] And we decried as "peculiar" the current legal landscape in which homeowners have "almost no recourse under consumer protection laws against people who peddled unsuitable mortgages to them," except in the rare and random situation where "the funds generated by the mortgage financing happened to have been used by the homeowner to purchase securities rather than a house."[238]

In seeking to apply the protections of securities laws to borrowers in the market for subprime home mortgages, no theory has been offered to explain why investor protection should extend to this corner of the consumer lending market but not to the entire market. This seems odd. As Kathleen Engel and Patricia McCoy have observed in their important scholarship on predatory lending, if securities laws protections are "appropriate for financial instruments that have been the traditional province of the affluent, certainly it is appropriate for financial instruments that are peddled to the poorest rung

234. As a result of the loan, the borrower's assets will have increased by $300,000 (from $150,000 to $450,000), an increase of 200%. The borrower' liabilities will have increased by $300,000 (from $25,000 to $325,000), an increase of 1,200%.

235. *See* Jonathan Macey, Geoffrey Miller, Maureen O'Hara & Gabriel D. Rosenberg, *Helping Law Catch Up to Markets: Applying Broker-Dealer Law to Subprime Mortgages*, 34 J. CORP. L. 789, 790, 837 (2009) (arguing that SEC suitability oversight of subprime mortgages may have protected borrowers from defaulting on home loan payments).

236. *Id.* at 790.

237. *Id.*

238. *Id.* at 790–91 (discussing Complaint at 2–3, 9, SEC v. Ainsworth, No. EDCV 08-1350 (C.D. Cal. Sept. 29, 2008), available at http://www.sec.gov/litigation/complaints/2008/comp20768.pdf [https://perma.cc/G32T-GSAD]).

of society."[239] But, thus far, proposals seem limited to certain corners of the consumer lending market, particularly predatory lending.[240] The fact that such loans are likely transformative for borrowers provides a clear justification for singling out them for special regulatory protection.

Oddly, even proposals for regulatory reform that are narrowly focused on the discrete categories of loans that would be characterized as transformative under the framework advanced in this Article are met with criticism. For example, Engel and McCoy made the modest and eminently reasonable proposal to extend the duty of best execution to borrowers in the market for a home mortgage. This proposal to extend only one of the array of protections routinely afforded to investors in securities elicited expressions of deep concern that "[a]dopting inappropriate rules, without further research, in the context of an ill-defined standard, may chill legitimate subprime lending activity in [low- and moderate-income] neighborhoods, producing adverse outcomes . . . ."[241] Similarly, Robert Litan has warned that "[a]dditional statutory measures at the state and local level [to protect borrowers] . . . run a significant risk of unintentionally cutting off the flow of funds to creditworthy borrowers."[242]

Oddly, those urging caution have never offered an explanation for why protections may be "inappropriate" in the context of consumer lending but not in the context of securities transactions. Similarly, there is no basis for the notion that rules and standards that have been fully operational for almost a century in the securities markets and seem to offer protections to retail participants in the securities markets possibly can be described as "ill-defined."[243]

The most likely explanation for what appears to be a bizarre excess of caution in extending the protections of the securities laws to the world of consumer lending is that the public choice dynamics that spawned the creation of the SEC and the promulgation of the securities laws are absent in the context of the consumer lending market. A wealth of research indicates that securities regulations benefit certain groups—particularly investment

239. Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEXAS L. REV. 1255, 1319 (2002). For a skeptical view, see Susan M. Wachter, *Price Revelation and Efficient Mortgage Markets*, 82 TEXAS L. REV. 413, 414–15 (2003).

240. *See* Macey, *supra* note 235, at 790 (proposing SEC jurisdiction over subprime home loans); Engel & McCoy, *supra* note 239, at 441 (2003) ("[S]ince the publication of our original article, a new abuse has emerged, consisting of predatory servicing by agents—a practice that falls outside the purview of most, if not all, predatory lending laws.").

241. *See* Wachter, *supra* note 239, at 415.

242. ROBERT E. LITAN, A PRUDENT APPROACH TO PREVENTING "PREDATORY" LENDING 2 (2001), https://www.brookings.edu/wp-content/uploads/2016/06/02_lending_litan.pdf [https://perma.cc/98MR-8ZYD] (emphasis omitted).

243. Wachter, *supra* note 239, at 415.

banks, accountants, securities analysts, and lawyers at large, well-established firms.[244] The same groups would not benefit from extending the reach of the securities laws to segments of the consumer lending market. As I previously have observed, "[m]eaningful reform . . . has not occurred because lawmakers and bureaucrats lack the incentives to effectuate change."[245] For example, in the mortgage segment of the consumer lending world:

> Mortgage lenders and the banks that structure mortgage-backed securities, in complete contrast, have both the resources and incentives to push to retain the status quo.
>
> Consumers seeking subprime mortgage loans (and consumers on whom such loans are foisted) are not sophisticated and are not able to transform themselves into the sort of well-organized, well-financed interest group that is able to lobby successfully for protection. Moreover, sophisticated borrowers are insulated from problems in the subprime mortgage market by their ability to shop for desirable terms when they are in the market for a mortgage.[246]

One could of course argue that providing enhanced consumer protections such as those afforded under the securities laws to the home mortgage market is a bad idea because such protections are ill-advised in general in the securities context. For example, the securities laws have been rightly criticized because they impose unnecessary costs on market participants.[247] In particular, the securities laws are faulted for providing protections to consumers who are generally wealthy and sophisticated and who either do not require such protections or would receive any necessary protections, including disclosure, even in the absence of regulation, because

244. *See* SUSAN M. PHILLIPS & J. RICHARD ZECHER, THE SEC AND THE PUBLIC INTEREST 51 (Richard Schmalensee ed., 1981) (identifying on the one hand lawyers who prepare legally required disclosure documents and on the other hand securities analysts and other investment professionals who utilize such information as beneficiaries of the current regulatory regime); Jonathan Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 914, 922, 942 (1994) (observing that large, established firms benefit from regulation because it creates barriers to entry and high fixed costs that discourage and eliminate competitors); George J. Stigler, *Public Regulation of Securities Markets*, 37 J. BUS. 117, 124 (1964) (showing that the promulgation of the securities laws benefitted interest groups but had little, if any, effect on consumer protection as measured by the performance of new public offerings of securities).

245. Jonathan Macey, *A Public Choice Approach to the Unequal Treatment of Securities Market Participants and Home Borrowers*, 3 RUSSELL SAGE FOUND. J. SOC. SCI. 94, 99–100 (2017) (providing background on why lawmakers, the SEC, plaintiff's lawyers, and subprime consumers are unable or disincentivized to effectuate reform).

246. *Id.*

247. *See, e.g.*, Stigler, *supra* note 244, at 124 ("[G]rave doubts exist whether if account is taken of costs of regulation, the S.E.C. has saved the purchasers of new issues one dollar." (footnote omitted)).

market participants would be compelled to provide such protections in order to compete successfully.[248]

The argument that securities laws have significant flaws is valid. However, the justifications for providing consumer protections for borrowers in the consumer credit markets in the manner proposed in this Article are considerably stronger than the arguments for consumer protection in the securities markets. The borrowers in the consumer credit markets are poorer and less sophisticated in financial matters than their securities law counterparts. Moreover, unlike investors in securities who can protect themselves by assembling diversified portfolios, consumer borrowers are not investors, and thus the benefits of diversification simply are not available to them.

B. The Framework

Because of the costs of imposing new regulations, I propose applying the enhanced protections only to certain narrow types of consumer lending. Thus, unlike the consumer protection provisions of the securities laws, which are applicable to every transaction no matter how small or how inconsequential to the wealth of the customer, the protections I am proposing would be narrowly tailored on the basis of how the loans are categorized from a balance sheet perspective.

Using the balance sheet framework advanced here, all loans should be assigned to a category based on the purpose of the loan and other factors affecting the borrowers' balance sheet. At one end of the continuum are loans for investment purposes. These loans require the least amount of protection and should be regulated lightly in order to avoid impeding the market. Similarly, a second category of loans—those used to fund capital expenditures—should receive a light regulatory touch. An exception to both categories of loans is a third category: transformative loans such as student loans and housing loans that, if made improvidently, threaten the fundamental financial health of the borrower.

On the other hand, regardless of the amount of the loan, any loan used to fund current consumption should be heavily regulated. Such loans are immediately suspect because they have a negative effect on the balance sheet of the borrower. While this fact alone is sufficient to justify enhanced regulatory attention, additional attention also is warranted because the consumers who seek out such loans are low- and moderate-income borrowers who are often unsophisticated financially and particularly vulnerable to exploitation by predatory lenders.

248. *See id.* at 244 (suggesting that efficient capital markets, not SEC registration requirements, serve as the major protection of investors).

Finally, the approach here further subdivides loans for current consumption by creating a special category for loans taken to fund emergency expenditures. While not strictly compelled by the balance sheet framework, requiring the Fed to fund emergency expenditures is justified on grounds that it has recognized its responsibility to "serve households" and has taken on the responsibility of helping families "better manage cash flow pressures."[249] In the wake of the COVID-19 pandemic, the Fed established emergency lending facilities that provided direct support to state and local governments, small and medium-sized businesses, and large employers.[250] In addition to there being no intellectual basis for barring individuals from accessing Fed borrowing facilities when such facilities are available to small businesses, it seems downright churlish not to extend the availability of such facilities to low- and middle-income borrowers facing genuine emergencies.

The following chart describes the balance-sheet driven regulatory structure proposed here.

Table 2. A New Approach to Regulating Consumer Lending

Loan Type as Determined by Balance Sheet Impact	Anti-Fraud Protection	Fiduciary-Like Duties	Access to Federal Reserve Lending Facilities
Investment ("Spread") Lending	Yes	No	No
Lending to Fund Capital Expenditures	Yes	No	No
Lending to Fund Current Consumption—Non-emergency	Yes	Yes	No
Lending to Fund Current Consumption—Emergency	Yes	Yes	Yes
Transformative Loan (of any type)	Yes	Yes	No

249. *Policy Tools*, BD. GOVERNORS FED. RSRV. SYS., https://www.federalreserve.gov/monetarypolicy/muni.htm [https://perma.cc/D6TY-SEGM].

250. Jerome H. Powell, *Letter to Secretary Mnuchin Regarding Emergency Lending Facilities*, BD. GOVERNORS FED. RSRV. SYS. (Nov. 20, 2020), https://www.federalreserve.gov/foia/letter-from-chair-powell-to-secretary-mnuchin-20201120.htm [https://perma.cc/4YPY-WTDS].

C. *Fiduciary-Like Duties*

Current policy proposals for extending securities-market style consumer protections to consumer lending are limited in two ways. First, as noted above, such proposals have been restricted to subprime mortgage borrowers rather than to all borrowers. Second, these proposals focus narrowly on the suitability requirement, which requires investment professionals selling securities to have a reasonable basis to believe a recommended transaction or investment strategy is suitable for the customer.[251] "Suitable" is generally defined to be appropriate in light of the "customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs [and] risk tolerance."[252]

The obligation of suitability seems particularly well-matched to payday lending and other short-term lending for consumption purposes. Policymakers have long been concerned that participants in this market lack sophistication.[253] A related concern raised in this Article is that borrowers

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251. *FINRA Rules Section 2111: Suitability*, FINRA [hereinafter *FINRA*], https://www.finra.org/rulesguidance/rulebooks/finra-rules/2111 [https://perma.cc/ELR3-36Z7]. Rule 2111 requires that a broker-dealer recommending a security to a customer "have a reasonable basis to believe" that the "transaction or investment strategy" involving the security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. *Id.* A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation. *Id.*; *see also* Yerv Melkonyan, *Regulation Best Interest and the State–Agency Conflict*, 120 COLUM. L. REV. 1591, 1601 (2020) (restating the Rule 2111 requirements for suitability and explaining that Rule 2111 clarifies broker-dealers' "fundamental responsibility of fair dealing"). Melkonyan notes

> Three core obligations comprise the so-called suitability rule: (1) the reasonable basis obligation, "requir[ing] a member or associated person to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors"; (2) the customer-specific obligation, "requir[ing] that a member or associated person have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile"; and (3) the quantitative stability obligation, "requir[ing] a [FINRA] member . . . to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile."

Id. at n.55 (alterations in original) (emphasis omitted).

252. *FINRA*, *supra* note 251.

253. An alternative to utilizing a suitability standard in the consumer lending market would be to require borrowers to receive counseling from third parties before taking out substantial loans. This approach has been attempted in the context of consumer bankruptcies with scant success. The Bankruptcy Abuse Prevention Consumer Protection Act of 2005 (BAPCPA) required all individual bankruptcy filers to complete a pre-bankruptcy credit counseling course and a pre-discharge debtor education course. Bankruptcy Abuse Prevention Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005) (codified in scattered sections of 11 U.S.C.); 11 U.S.C. § 109(h); FED.

who access this market are unable to handle the risks associated with short-term borrowing to fund current consumption. The suitability rule is narrowly tailored to unsophisticated borrowers because the sophistication of the investor is a critical factor in determining whether a broker–dealer has violated her obligation to recommend only suitable investments to her clients.[254] Borrowers who are financially sophisticated and well-versed in the particular financial instruments involved in a specific transaction are generally unsuccessful in asserting suitability claims.[255]

Some clarification of traditional suitability law is required in order to smooth the transition of the legal concept from the securities markets to the markets for consumer lending. First, there is some, but by no means universal, support for the proposition that the suitability rule only applies to securities transactions in which the broker-dealer makes a *recommendation* of securities to her customer.[256] To avoid confusion, lenders who are funding

R. BANKR. P. 1007(b)(7). Providers are not allowed to charge more than $50 for each course without special approval from the United States Trustee. 28 C.F.R. §§ 58.21, .34. Moreover, providers are required to waive the fees whenever a client demonstrates "a lack of ability to pay," such as when the client's household income is below 150% of the poverty line. *Id.* The U.S. Trustee program maintains a list of approved course providers. *Credit Counseling and Debtor Education Courses*, U.S. CTS., https://www.uscourts.gov/services-forms/bankruptcy/credit-counseling-and-debtor-education-courses [https://perma.cc/E3XZ-PX2W]. However, in practice, it is usually the client's bankruptcy lawyer who directs the client to take the courses online or by phone. Lois R. Lupica, *The Costs of BAPCPA: Report of the Pilot Study of Consumer Bankruptcy Cases*, 18 AM. BANKR. INST. L. REV. 43, 48 (2010). The poor quality and lack of availability of the counseling services are a persistent problem. *See* Katherine A. Jeter-Boldt, *Good in Theory, Bad in Practice: The Unintended Consequences of BAPCPA's Credit Counseling Requirement*, 71 MO. L. REV. 1101 (2006) ("BAPCPA's credit counseling requirement is severely harming debtors . . . ."). Although the bankruptcy code does not provide a standard curriculum, the providers must cover a list of topics to "assist debtors in understanding personal financial management." 11 U.S.C. § 111(d)(1). There is no indication that these courses are useful to the people who take them. Richard L. Stehl, *The Failings of the Credit Counseling and Debtor Education Requirement of the Proposed Consumer Bankruptcy Reform Legislation of 1998*, 7 AM. BANKR. INST. L. REV. 133, 150 (1999). Moreover, the people and businesses offering these courses lack accountability. Karen Gross & Susan Block-Lieb, *Empty Mandate or Opportunity for Innovation: Pre-Petition Credit Counseling and Post-Petition Financial Management Education*, 13 AM. BANKR. INST. L. REV. 549, 553 (2005).

254. Banca Cremi, S.A. v. Alex. Brown & Sons, Inc., 132 F.3d 1017, 1028 (4th Cir. 1997).

255. Macey, *supra* note 235, at 820 (citing Padgett v. Dapelo, 826 F. Supp. 99, 99–100 (S.D.N.Y. 1993) (explaining that educational background is an important factor in deciding whether the client was fleeced)).

256. *See* Grosso v. Salomon Smith Barney, No. 03-MC-115, 2003 WL 22657305, at *3 (E.D. Pa. Oct. 24, 2003) (finding no liability under NYSE and NASD suitability rules where there was no recommendation by the broker-dealer); J.W. Barclay & Co., Exchange Act Release No. 239, 81 SEC Docket 1156, 1173–74 (Oct. 23, 2003) (finding a recommendation as a precursor to finding liability). The recommendation requirement, however, "is broadly, but not universally, observed." Macey, *supra* note 235, at 821 (citing ALAN R. BROMBERG & LEWIS D. LOWENFELS, ON SECURITIES FRAUD AND COMMODITIES FRAUD 13–436 (2d ed., 2008)). Moreover, the recommendation requirement appears to be losing its potency over time. *See* Frederick Mark Gedicks, *Suitability Claims and Purchases of Unrecommended Securities: An Agency Theory of*

short-term borrowing to fund current consumption should not be able to avoid liability by claiming that they did not recommend the loan to their customers. Payday lenders advertise broadly,[257] and they are adept at avoiding restrictions placed on their marketing efforts.[258]

Requiring a recommendation as a trigger for imposing a suitability obligation would create a major loophole for lenders, and it is especially important to avoid loopholes when regulating payday lending. As Diane Standaert, former Director of State Policy at the Center for Responsible Lending, observed, "[s]ubterfuge is as core to the payday lenders' business model as is trapping borrowers in a cycle of debt."[259]

Besides bringing clarity to the issue of when the suitability requirement would apply to loans used to fund current consumption, dropping the recommendation requirement would have the added benefit of imposing on lenders a duty of inquiry. In order to know if they are legally obligated to comply with the suitability standard proposed here, lenders would have to determine how the proceeds of the loans they propose to make will be used. The fact that lenders are willing to make loans to fund current consumption is sufficient to justify regulation in light of the effects that such loans have on borrowers' balance sheets.

In the consumer credit context, the suitability requirement means that the specific loans obtained by a borrower must fit her needs.[260] In the securities context, this facet of the suitability rule is known as "product suitability." Product suitability focuses on the product itself and the attributes of the product that bear on the client.[261] In the context of borrowing to fund current consumption, product suitability would require that the borrower have sufficient financial wherewithal to be reasonably likely to repay the loan when the loan comes due and would not have to continually refinance the loan. An additional benefit of a suitability requirement would be to help sometimes short-sighted borrowers estimate how long they will remain in

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Broker-Dealer Liability, 37 ARIZ. ST. L.J. 535, 540–43 (2005) ("Despite the apparent bounds placed on suitability liability by the recommendation requirement, broker-dealer liability for damages in private actions for breach of suitability obligations is a matter of serious and increasing concern within the industry.").

257. *See* Coulter Jones, Jean Eaglesham & AnnMaria Andriotis, *How Payday Lenders Target Consumers Hurt by Coronavirus*, WALL ST. J. (June 8, 2020), https://www.wsj.com/articles/how-payday-lenders-target-consumers-hurt-by-coronavirus-11591176601 [https://perma.cc/G8NT-KZDQ] ("Lenders that target struggling borrowers for loans with triple-digit interest rates have overcome yearslong efforts to restrict their lending and are pitching their products to consumers in need of cash during the coronavirus pandemic.").

258. Kevin Wack, *Payday Lenders Are Finding Ways Around Google's Ad Ban*, AM. BANKER (Oct. 11, 2017), https://www.americanbanker.com/news/payday-lenders-are-finding-ways-around-googles-ad-ban [https://perma.cc/D274-YHL9].

259. *Id.* (quoting Standaert).

260. *FINRA*, *supra* note 251.

261. Macey, *supra* note 235, at 815.

debt, taking into consideration the probability that the borrower will be unable to repay the principal and so will have to roll over the original loan.

In addition to product suitability, suitability also requires that the transaction be suitable for the customer. In particular, a consumer loan is unsuitable in cases in which the lender knows or should know that the transaction involves excessive fees.[262] As applied, this aspect of suitability translates into a rule that forbids lenders from extending a payday loan or other short-term loan to a customer if another type of loan would allow the customer to reach her objectives at lower cost.

Another facet of the securities regulation consumer protection regime that should extend to the short-term consumer credit markets is the set of so-called anti-churning rules that forbid excessive trading.[263] In the consumer lending context, loan renewals are the analogue to churning. It appears that this form of churning is an integral part of the world of short-term consumer lending for current consumption. The case of the payday loan chain ACE Cash Express (ACE) illustrates the point. In 2014, an ACE internal training manual mistakenly became publicly available, and it revealed a business model focused on trapping borrowers into a tragic cycle in which customers "exhaust" the cash that they have borrowed and are then given the opportunity to refinance. When there is a default on the initial loan, the customer is forced to apply for another payday loan.[264] The analogy to churning is inescapable.

Extending the suitability and anti-churning rules to the consumer loan market is a very modest proposal in context. When customers in securities markets retain the services of investment advisers, they get the benefits of fiduciary duties—the highest level of consumer protections provided by law.[265] Imposing fiduciary duties on lenders would require lenders to put the interests of their clients ahead of their own economic interests and, when offering a loan to a client, to use the same degree of care that an ordinarily prudent person uses when managing her own assets.

The imposition of fiduciary duties on lenders would require such lenders to perform a thorough analysis of the available options to borrowers and make only those loans that are in the best interests of clients based on a

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262. Mills & Holinsky, *supra* note 193, at 11–20.

263. *See id.* at 11–59 (explaining anti-churning rules).

264. *CFPB Finds ACE Cash Express Used Abusive, Illegal Tactics*, CTR. FOR RESPONSIBLE LENDING (July 10, 2014), https://www.responsiblelending.org/media/cfpb-finds-ace-cash-express-used-abusive-illegal-tactics [https://perma.cc/T3KH-R4Y8].

265. Investment advisers are regulated by the SEC under the Investment Advisers Act of 1940 (Advisers Act) as fiduciaries, and a fiduciary standard of care is applied to the advice given to their clients. *General Information on the Regulation of Investment Advisers*, U.S. SEC. & EXCH. COMM'N (Mar. 11, 2011), https://www.sec.gov/divisions/investment/iaregulation/memoia.htm [https://perma.cc/Y8EM-VATU]; Michael Finke & Thomas P. Langdon, *The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice*, J. FIN. PLAN., July 2012, at 28, 29.

thorough analysis of all information reasonably available. The suitability requirement advocated here is weaker than the fiduciary requirement. The suitability requirement compels the lender to offer borrowers only those loans that reasonably provide actual benefits to clients. In particular, while a fiduciary standard would require a lender to place his or her interests below that of the client, the suitability standard only requires that a lender reasonably believe that any recommendations made are appropriate for the client, in terms of the client's financial needs, objectives, and unique circumstances. The suitability requirement proposed here also would require that brokers not charge excessive fees and refrain from improperly rolling over (churning) their clients' outstanding loans.

In a nutshell, the suitability standard proposed here would require lenders to provide suitable investments to customers and to treat them fairly, but it would not require lenders to act in the best interests of their customers.

One might, quite reasonably, wonder why a fiduciary standard should not be applied to lenders. The primary reason for stopping short of advocating a fiduciary standard is that the imposition of such a standard would both limit consumer access to credit and raise the cost of such credit. It is very costly for investment advisers to comply with the fiduciary standard that applies to them, and there is no reason to believe that lenders could comply at a lower cost.[266] The higher cost of complying with fiduciary obligations risks driving lenders to limit their practice to affluent investors who can afford to bear the costs of regulatory compliance.[267]

Proposing that suitability and anti-churning protections be extended to borrowers in the market for short-term credit to cover current consumption is not radical. In fact, the proposal would merely bring the legal protections available to consumers in the credit markets in line with the protections routinely afforded to buyers and sellers of securities. On the general subject of regulatory symmetry, the next section of this Article advocates restoring the availability of the Fed's emergency lending facilities to individuals and households who require short-term liquidity to meet immediate emergency needs.

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266. *See* Finke & Langdon, *supra* note 265, at 29 (explaining the costs when investment advisors comply with the fiduciary standard).

267. At least one empirical study, however, found "no evidence that the broker-dealer industry is affected significantly by the imposition of a stricter legal fiduciary standard on the conduct" of broker-dealers. *See id.* at 36 (discussing the high costs of complying with the fiduciary standard that applies to investment advisers). The fact remains, however, that investment advisers tend to serve high-wealth clients, while broker-dealers serve a middle-class clientele that is more analogous to the demographics of consumers in the market for consumer credit.

D. Access to Federal Reserve Lending Facilities for Emergencies

Businesses of all kinds rely on short-term debt to keep their operations running smoothly. People are no different. In particular, people with low incomes and few (if any) savings sometimes have an acute need for capital. In developed economies, "central banks often step in to act as a 'lender of last resort' during crises—an emergency source of credit for otherwise solvent firms until normal credit market functions are restored."[268] There is ample precedent for extending the central bank's lending powers to individuals.

1. Emergency Lending to Individuals: The Historical Precedent.—The source of the Fed's authority to lend money is Section 13(3) of the Federal Reserve Act.[269] The nature of the Fed's delegated authority has evolved over time. The original intention of the Federal Reserve Act was to ameliorate the liquidity crises experienced by regional U.S. banks as a consequence of seasonal demands for cash by the farmers and small businesses that made up most of their clientele.[270] As Parinitha Sastry observes in her excellent history of the Federal Reserve's emergency lending powers:

> Every fall, farmers needed cash to pay field hands, and commodity merchants needed credit to purchase and carry harvest inventories or, to use the terminology of the time, "move the crops." Banks' excess reserves would shrink in response to the increased demand for cash and credit, triggering a surge in interest rates. Even minor disruptions to the financial system during intervals of such seasonal strain could escalate rapidly to a perilous financial crisis. Later, during the winter, merchants would pay back their loans from the receipts on exports and

268. Tim Sablik, *The Fed's Emergency Lending Evolves: The Fed Is Using Emergency Lending Powers It Invoked During the Great Recession to Respond to COVID-19 — But It Cast a Wider Net This Time*, FED. RSRV. BANK RICH.: ECON. FOCUS, Second/Third Quarter 2020, at 14, 14, https://www.richmondfed.org/-/media/richmondfedorg/publications/research/econ_focus/2020/q2-3/federal_reserve.pdf [https://perma.cc/TXR6-VXM4].

269. 12 U.S.C. § 343. The Fed initially was granted the power to lend in emergency situations in 1932 in the Emergency Relief and Construction Act, which added Section 13(3) to the Federal Reserve Act. Section 13(3) gave Federal Reserve Banks the authority to "discount" for any "individual, partnership, or corporation" notes "indorsed or otherwise secured to the satisfaction of the Federal [R]eserve bank[s]," subject to a finding by the Federal Reserve Board (now the Board of Governors of the Federal Reserve System) of "unusual and exigent circumstances." The section has subsequently been amended. Emergency Relief and Construction Act of 1932, Pub. L. No. 302, § 210, 47 Stat. 709, 715 (1932) (current version at 12 U.S.C. § 343).

270. Parinitha Sastry, *The Political Origins of Section 13(3) of the Federal Reserve Act*, 24 ECON. POL'Y REV. 1, 4 (2018).

final sales to consumers, currency and coin paid to field hands would find its way into circulation, and interest rates would subside.[271]

The Federal Reserve Act addressed this problem by creating a system of regional Reserve Banks that were authorized to provide liquidity for the farmer- and small business-facing commercial banks in their regions.[272] Liquidity was provided by the regional Federal Reserve Banks by purchasing their commercial loans for cash.[273] Each Reserve Bank had an actual physical window where member banks came for these exchanges, which is why such lending is referred to as lending at the discount window.[274]

Initially, the Fed was authorized to make loans only to banks. Businesses and individuals did not have access to the discount window.[275] With the Great Depression that followed the stock market crash of 1929 came an unprecedented and dramatic collapse in the economy that the liquidity provided to banks at the regional Federal Reserve discount windows was insufficient to address.[276] In addition to dramatic declines in industrial production, wholesale prices, and personal income, individuals (like businesses) had unprecedented demands for liquidity. This demand took the form of "internal drains of lawful money," as "the American people ran to their banks and withdrew their deposits for currency and gold" and in turn "strained the banking system," which "led to temporary suspensions and outright failures" of banks across the country.[277]

Herbert Hoover's solution was to expand the authority of the regional Federal Reserve banks to lend money. Unfortunately, Hoover did not succeed in obtaining statutory authority to do this, largely because of opposition from Senator Carter Glass, the ranking member of the Senate Banking Committee.[278] Generally speaking, Senator Glass was opposed to any policy

271. *Id.* at 4–5 (citations omitted); *see also* EDWIN WALTER KEMMERER, NAT'L MONETARY COMMISSION, SEASONAL VARIATIONS IN THE RELATIVE DEMAND FOR MONEY AND CAPITAL IN THE UNITED STATES, S. DOC. NO. 588, at 29, 222 (2d Sess. 1910) (explaining that the fall season precipitates demand for cash in response to crop movements, which raises interest rates, diminishes bank reserves, and curtails loans).

272. Sablik, *supra* note 268, at 14.

273. *Id.*

274. Such transactions are now electronic, of course. *Id.*

275. This is why the Fed is referred to sometimes as a "banker's bank." *Id.*

276. *See id.* at 14 (stating that "it was not enough for the Fed to support banks if those banks were reluctant or unable to make loans for productive ventures").

277. Sastry, *supra* note 270, at 13.

278. *Id.* at 14; *see also Glass Opposes Change in Federal Reserve: Senator Declares Frozen Assets Would Be Dumped Under Hoover Plan*, N.Y. TIMES (Oct. 9, 1931), https://www.nytimes.com/1931/10/09/archives/glass-opposes-change-in-federal-reserve-senator-declares-frozen.html?searchResultPosition=1 [https://perma.cc/3A88-5Y35] (stating that Senator Carter Glass adamantly opposed rediscount rules that would allow some groups to "dump their frozen assets" into the Federal Reserve System).

that would allow an entity that was not a member of the Federal Reserve System to borrow from the Federal Reserve.[279]

Significantly, and highly relevant to the argument being made here, as the Depression wore on into the early 1930s, banks' unwillingness to lend to people and businesses came to be viewed as a major stumbling block to recovery.[280] In 1932, Speaker of the House John Nance Garner announced a plan to revive the economy.[281] Garner proposed to give the Reconstruction Finance Corporation (RFC), which had recently been formed to provide temporary direct advances to established industries that could not obtain credit,[282] the authority to make loans to individuals. Specifically, the RFC would have broad authority "to make loans . . . to any person"[283] and would have no limitations on what projects the loans could finance.[284]

In Hoover's view, "[t]he fatal difficulty is the Speaker's insistence upon provision that loans should also be made to individuals, private corporations, partnerships, States, and municipalities on any conceivable security and for every purpose. Such an undertaking . . . makes the Reconstruction Corporation the most gigantic banking and pawnbroking business in all history."[285] Proponents of the legislation countered with the argument that several European central banks had the power to lend directly to individuals when such loans were collateralized and that the power to lend broadly on appropriate collateral was an inherent central banking power.[286]

Predictably, Hoover vetoed the bill on the grounds that he opposed giving the government the power to grant loans "for any conceivable purpose

279. *Creation of a Reconstruction Finance Corporation: Hearings on S.1 Before the S. Comm. on Banking & Currency*, 72d Cong. 42–43 (1931).

280. *See* MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES, 1867–1960, at 330 (1963) (noting that the suspension of all business activities in 1933 caused unprecedented bank failures, some of which never recovered).

281. Sastry, *supra* note 270, at 19.

282. Herbert Hoover, *Special Message to Congress on the Economic Recovery Program* (Jan. 4, 1932), https://www.presidency.ucsb.edu/node/207494 [https://perma.cc/SG24-WC2Q]; *see* Herbert Hoover, 31st President of the United States, Statement on Emergency Relief and Construction Legislation (May 27, 1932), https://www.presidency.ucsb.edu/node/206982 [https://perma.cc/JAG4-NC8J] [hereinafter Hoover Emergency Relief Statement] (stating that Garner insisted that the RFC make loans to "any individual, any private corporation, any partnership, any State, or any municipality on any conceivable kind of security and for any conceivable purpose"). Among the established industries to which the RFC could provide direct advances were agricultural credit agencies, financial institutions, and railroads. SEC'Y TREASURY, FINAL REPORT ON THE RECONSTRUCTION FINANCE CORPORATION 3 (1959).

283. H.R. 12353, 72d Cong. (1932).

284. *Id.* President Hoover staunchly opposed Garner's bill, calling it "the most gigantic pork barrel ever proposed to the American Congress. It is an unexampled raid on the Public Treasury . . . [and a] squandering of money," that would give the newly-formed RFC unrestricted powers to make loans indiscriminately. Hoover Emergency Relief Statement, *supra* note 282.

285. Hoover Emergency Relief Statement, *supra* note 282.

286. Sastry, *supra* note 270, at 20.

on any conceivable security to anybody who wants money."[287] In response, Carter Glass introduced an amendment to Section 13 of the Federal Reserve Act that became what we now know as Section 13(3).[288] The amendment empowered the Federal Reserve Board "in unusual and exigent circumstances" by a supermajority vote of five of its seven members, to lend money by discounting "for any individual or corporation" eligible collateral, provided that the "individual or corporation" seeking the loan provided "evidence" that she was "unable to secure adequate credit accommodations from other banking institutions."[289]

Of course, it was generally presumed that President Hoover would veto this expansion of the Fed's lending power, but in a surprise move, on July 13, 1932, President Hoover decided not to oppose the introduction of Section 13(3) into the Federal Reserve Act, despite the fact that it permitted direct lending by the Fed to cash-strapped individuals who could provide collateral for the loans.[290] On July 21, 1932, the provision became law.[291] And so the Federal Reserve was authorized to make advances to "individuals, partnerships, or corporations" that were secured by U.S. government securities even in the absence of unusual or exigent circumstances and without a supermajority vote of the Board of Governors.[292]

In the Federal Deposit Insurance Corporation Improvement Act (FDICIA), Congress expanded the types of collateral that could be used by borrowers seeking loans under Section 13(3).[293] Loans to individuals were

287. Herbert Hoover, 31st President of the United States, Veto of the Emergency Relief and Construction Bill (July 11, 1932), https://www.presidency.ucsb.edu/node/207170 [https://perma.cc/9KKB-BL2E].

288. Sastry, *supra* note 270, at 20–22.

289. 75 CONG. REC. 14,981 (1932). Subsequently the language was amended to include partnerships as well. Sastry, *supra* note 270, at 22.

290. Sastry, *supra* note 270, at 20–22; *see also Final Relief Action Likely Today, House Having Passed Bill*, N.Y. TIMES (July 14 1932), https://timesmachine.nytimes.com/timesmachine/1932/07/14/issue.html [https://perma.cc/3JRU-9Z2W] (reporting that Senator Glass received a phone call from President Hoover, who told Glass that the administration did not oppose the Glass amendment to authorize loans made by the Federal Reserve Banks to industries when credit on suitable security is unavailable).

291. 75 CONG. REC. 15492, 15621 (1932).

292. Emergency Banking Relief Act of 1933, Pub. L. No. 73-1, § 403, 48 Stat. 1, 7 (amending Section 13 of the Federal Reserve Act).

293. Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, § 473, 105 Stat. 2236, 2386 (codified in scattered sections of 12 U.S.C.). FDICIA amended Section 13(3) of the Federal Reserve Act. The new version provided that

> In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal Reserve bank . . . to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal Reserve bank:

still permitted.[294] The loans had to be collateralized, but the collateral needed only to be "secured to the satisfaction of the Federal reserve bank."[295]

The Fed made ample use of Section 13(3) during the financial crisis of 2007–2008. Of particular concern to Congress in the wake of that financial crisis was that the Fed had provided direct assistance (bailouts) to a number of well-connected Wall Street firms while ordinary Americans were suffering.[296] The Fed's bailout of the investment bank Bear Stearns, which involved a government purchase of $30 billion in the bank's assets and a Fed-backed emergency loan of nearly $13 billion, raised particular concerns about crony capitalism.[297]

Congress responded to the Federal Reserve's controversial use of Section 13(3) to bail out the very financial institutions that caused the financial crisis by narrowing that authority in the Dodd–Frank Act. Such lending must now be made in connection with a "program or facility with broad-based eligibility," cannot "aid a failing financial company" or "borrowers that are insolvent," and cannot have "the purpose of assisting a single and specific company avoid bankruptcy" or similar resolution.[298] In

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> *Provided*, That before discounting any such note, draft, or bill of exchange for an individual or a partnership or corporation the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions.

12 U.S.C. § 343.

294. 12 U.S.C. § 343.

295. *Id.* For a discussion of the Fed's discretion in lending, see Peter Conti-Brown, Yair Listokin & Nicholas R. Parrillo, *Towards an Administrative Law of Central Banking*, 38 YALE J. ON REG. 1, 69–70 (2021); *see also* Peter Conti-Brown & David Skeel, *Using the Federal Reserve's Discount Window for Debtor-in-Possession Financing During the COVID-19 Bankruptcy Crisis* 13, BROOKINGS: HUTCHINS CTR. ON FISCAL & MONETARY POL'Y (2020), https://www.brookings.edu/wp-content/uploads/2020/07/Conti-Brown-Skeel.pdf [https://perma.cc/P5MT-SCRL]. Exploring the regulatory decisions the Fed will face should it adapt debtor-in-possession financing markets to respond to the bankruptcy crisis spurred by COVID-19 pandemic, Professors Conti-Brown and Skeel note that

> The Federal Reserve Act provides ample discretion for the Fed to determine the value and nature of collateral presented to the discount window, so long as the loans offered are "secured to the satisfaction" of the lending Federal Reserve Bank. This phrase has become important, used as it was to justify the failure to prevent the bankruptcy of Lehman Brothers. It lacks statutory definition and had no meaning in common law.

Id.

296. *See* Arthur Long, *Revised Section 13(3) of the Federal Reserve Act*, AM. B. ASS'N: BUS. L. TODAY, Mar. 2019, at 1–2 (stating that "the intent of the revisions was to preclude loans like those to JPMorgan/Bear Stearns and AIG").

297. Scott Sumner, *When Deregulation Becomes Crony Capitalism*, ECONLOG (Apr. 7, 2018), https://www.econlib.org/archives/2018/04/when_deregulati.html [https://perma.cc/A727-GA4R].

298. 12 U.S.C. § 343(3); Long, *supra* note 296, at 1.

addition, the prior approval of the Secretary of the Treasury now is required before the Federal Reserve can establish a Section 13(3) lending program.[299]

There is ample historical precedent for making the central bank's lending facilities available to individuals. Indeed, from 1932 until 2010, the operative statute, Section 13(3) of the Federal Reserve Act, explicitly permitted the Fed to lend to individuals as long as the loans were properly collateralized. Recently, the government substantially has increased its efforts to expand the availability of credit beyond banks. In the wake of the COVID-19 crisis, the Federal Reserve established the Main Street Lending Program ("Program") "to support lending to small and medium-sized for-profit businesses and nonprofit organizations that were in sound financial condition before the onset of the pandemic."[300] Under these programs, the Fed purchases shares ("participations") in eligible loans that are submitted through a portal by eligible lenders. The program is designed to provide support to small- and medium-sized businesses in order to relieve "financial strain."[301]

The government does (and should) play an active role in helping individuals to navigate financial crises. Immediately in response to the unprecedented job losses that occurred in the wake of the COVID-19 pandemic, Congress responded with the passage of the CARES Act,[302] which supplemented existing unemployment insurance benefits with an additional

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299. 12 U.S.C. § 343(3); Long, *supra* note 296, at 1. In its current form, Section 13(3) provides that:

> In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine . . . to discount for any participant in any program or facility with broad-based eligibility, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal reserve bank: *Provided*, That before discounting any such note, draft, or bill of exchange, the Federal reserve bank shall obtain evidence that such participant in any program or facility with broad-based eligibility is unable to secure adequate credit accommodations from other banking institutions.

12 U.S.C. § 343(3)(A).

300. *Main Street Lending Program*, BD. GOVERNORS FED. RSRV. SYS., https://www.federalreserve.gov/monetarypolicy/mainstreetlending.htm [https://perma.cc/H3ES-9KX7].

301. *Main Street Lending Program: For-Profit Businesses Frequently Asked Questions* 11, FED. RSRV. BANK BOS. (Dec. 29, 2020), https://www.bostonfed.org/mslp-faqs [https://perma.cc/K57T-YD55].

302. The Coronavirus Aid, Relief, and Economic Security (CARES) Act, Pub. L. No. 116-136, 134 Stat. 281 (2020) (codified at 15 U.S.C. §§ 9001–9081).

$600 per week beginning in the week ending March 21, 2020.[303] And it responded again in December 2020, with a second round of payments.[304]

The CARES Act provided for Economic Impact Payments to American households of up to $1,200 per adult for individuals whose income was less than $99,000 (or $198,000 for joint filers) and $500 per child under 17 years old—or up to $3,400 for a family of four.[305] The second round of payments, or "EIP 2," is generally $600 for singles and $1,200 for married couples filing a joint return. In addition, those with qualifying children will also receive $600 for each qualifying child.[306]

Both payments were made available to tax filers with adjusted gross income up to $75,000 for individuals and up to $150,000 for married couples filing joint returns. Eligible taxpayers who filed tax returns for either 2019 or 2018 automatically received an economic impact payment of up to $1,200 for individuals or $2,400 for married couples and up to $500 for each qualifying child.[307] Additionally, the IRS used the information on the Form SSA-1099 and Form RRB-1099 to generate $1,200 Economic Impact Payments to Social Security recipients who did not file tax returns in 2018 or 2019. Recipients received these payments as a direct deposit or by paper check, just as they would have normally received their benefits.[308]

Thus, taken in the historical and contemporary context, the proposal here to extend the Fed's emergency lending powers to employed individuals and families facing short-term, emergency liquidity needs seems modest. The following section explains how the facility would operate.

2. Emergency Lending to Individuals: Implementation.—Borrowers' need for collateral is an immediate challenge to implementing a policy of allowing Fed lending to consumers who need emergency funding. And, of course, defining what constitutes an "emergency" is another obstacle to be reckoned

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303. Miguel Garza Casado, Britta Glennon, Julia Lane, David McQuown, Daniel Rich & Bruce A. Weinberg, *The Aggregate Effect of Fiscal Stimulus, Evidence From The COVID-19 Unemployment Supplement* (Nat'l Bureau of Econ. Rsch., Working Paper No. 27576, 2020).

304. News Release, Internal Revenue Serv., Treasury and IRS Begin Delivering Second Round of Economic Impact Payments to Millions of Americans, IR-2020-280 (Dec. 29, 2020), https://www.irs.gov/newsroom/treasury-and-irs-begin-delivering-second-round-of-economic-impact-payments-to-millions-of-americans [https://perma.cc/WU4K-ZDYQ].

305. *Economic Impact Payments*, U.S. DEP'T TREASURY, https://home.treasury.gov/policy-issues/coronavirus/assistance-for-american-families-and-workers/economic-impact-payments [https://perma.cc/8FVC-DQLN].

306. News Release, Internal Revenue Serv., *supra* note 304.

307. News Release, Internal Revenue Serv., Economic Impact Payments: What You Need to Know, IR-2020-61 (Mar. 30, 2020), https://www.irs.gov/newsroom/economic-impact-payments-what-you-need-to-know [https://perma.cc/RHN2-UUQZ].

308. Press Release, U.S. Dep't Treasury, Social Security Recipients Will Automatically Receive Economic Impact Payments (Apr. 1, 2020), https://home.treasury.gov/news/press-releases/sm967 [https://perma.cc/GG2F-9A86].

with from an implementation point of view. Other facets of implementation are less challenging. The Fed is able to effectuate wire transfers through banks in order to move funds into customers' accounts; although, it would be feasible, as others have suggested, for the Fed to allow individual borrowers to open accounts either at the Fed itself or in a bank account maintained by the Post Office.[309]

a. Collateral.—Payday loans, unlike pawnshop loans, home loans, and car loans, do not require collateral. Rather than take collateral, lenders require borrowers to give their permission to electronically remove money from the borrower's bank account, credit union, or prepaid card account; or to provide a signed, post-dated check for the repayment amount that the lender can deposit when the loan is due.[310] Under federal law, lenders cannot condition a payday loan on obtaining an authorization from the consumer for "preauthorized" (recurring) electronic fund transfers.

Borrowers should not be required to put up traditional collateral in order to receive an emergency loan to obtain funds to cover emergency expenses. Rather, the Fed should treat the borrower's future income stream as collateral. When borrowers apply for a payday loan, the lender confirms the applicant's income and checking account information and, upon such confirmation, delivers cash in as little as fifteen minutes either directly at a payday lending store or online by the next morning with an electronic transfer.[311] If the loan is issued at a physical location, the borrower will be expected to return to the store to repay when the loan is due.[312] The lender deposits the borrower's previously-written check or withdraws the loan amount plus interest from the borrower's account if repayment is not made

309. *See* David Portilla, Will Giles & Danjie Fang, *Federal Reserve Checking Accounts and Postal Banking: Highlights of the Policy Debate*, DEBEVOISE & PLIMPTON: DEBEVOISE UPDATE 2–3 (Aug. 24, 2020), https://www.debevoise.com/-/media/files/insights/publications/2020/08/20200824-federal-reserve-checking-accounts-and.pdf [https://perma.cc/2JF7-MFZG] (describing the current scope and proposed expansions to financial services offered by the U.S. Postal Service); Morgan Ricks, John Crawford & Lev Menand, *Central Banking for All: A Public Option for Bank Accounts*, GREAT DEMOCRACY INITIATIVE 1 (June 2018), https://rooseveltinstitute.org/wp-content/uploads/2021/08/GDI_Central-Banking-For-All_201806.pdf [https://perma.cc/XJ6E-VA6G] (proposing a program offering the general public the option to have a bank account at the Federal Reserve); Mehrsa Baradaran, *It's Time for Postal Banking*, 127 HARV. L. REV. F. 165, 166 (2014) (advocating for government support and subsidies to promote banking through the U.S. Postal Service for unbanked or underbanked Americans); Mehrsa Baradaran, *How the Poor Got Cut Out of Banking*, 62 EMORY L.J. 483, 486–87 (2013) (tracing the decline of and advocating for renewed support for government-sponsored banking that serves low-income Americans).

310. *Do I Have to Put Up Something as Collateral for a Payday Loan?*, CONSUMER FIN. PROT. BUREAU (June 5, 2017), https://www.consumerfinance.gov/ask-cfpb/do-i-have-to-put-up-something-as-collateral-for-a-payday-loan-en-1595/ [https://perma.cc/2C2T-8JF6].

311. *What Is a Payday Loan?*, NERDWALLET (July 22, 2020), https://www.nerdwallet.com/article/loans/what-is-a-payday-loan [https://perma.cc/E44C-UWWN].

312. *Id.*

on time. Online payday lenders will initiate an electronic withdrawal once repayment is due.[313] As such, the borrower, by providing access to her bank account in the form of a signed check or permission to electronically withdraw money from her account, provides security in the form of a legal claim on future earnings that is tantamount to actual collateral.[314]

In addition to serving as a substitute for payday loans, the Fed emergency lending program proposed here would enable borrowers to avoid taking out other types of high-cost loans, such as vehicle title loans, to fund emergency spending. Vehicle title loans are a type of credit product in which the lender takes a security interest in the borrower's vehicle,[315] with the value of the vehicle determining the amount that can be borrowed.[316] Borrowers who have received vehicle title loans keep possession of their cars or trucks while the loans are outstanding.[317]

Low- and middle-income borrowers who earn a steady income, have collateral such as a car or truck, or receive recurring deposits such as social security or unemployment benefits should be able to receive emergency funding from the Fed when they experience a bona fide emergency that can be ameliorated by an immediate infusion of cash. Moreover, I argue that such loans should be forgiven to the extent that the borrower is unable to repay the loan due to exigent circumstances such as illness or job loss. In this way the loan program will be less likely to cause a borrower to become impoverished.

b. What Is a Bona Fide Emergency?—Generally speaking, the proposal here is to allow access to Fed borrowing only for an emergency. An emergency is a "sudden, urgent, unexpected event requiring immediate action, usually requiring help."[318] The reason why emergencies require immediate attention is that emergencies can lead to disaster if left alone or unattended.[319] Thus, an emergency involves a serious, unexpected, and often

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313. *Id.*

314. CONSUMER FIN. PROT. BUREAU, SUPPLEMENTAL FINDINGS ON PAYDAY, PAYDAY INSTALLMENT, AND VEHICLE TITLE LOANS, AND DEPOSIT ADVANCE PRODUCTS 1–2 (2016), https://files.consumerfinance.gov/f/documents/Supplemental_Report_060116.pdf [https://perma.cc/9LPG-LE2V].

315. *Id.* at 1.

316. *Id.*

317. *Id.*

318. *The Difference Between Emergency and Disaster*, CITY OF OXNARD, CAL. https://www.oxnard.org/the-difference-between-emergency-and-disaster/ [https://perma.cc/99HJ-5ZBU].

319. WORLD HEALTH ORG., PANAFRICAN EMERGENCY TRAINING CTR., ADDIS ABABA, DISASTERS & EMERGENCIES TRAINING PACKAGE: DEFINITIONS 10 (2002), https://apps.who.int/disasters/repo/7656.pdf [https://perma.cc/J7UQ-2YJ5]. A disaster is considered to be an "unexpected . . . calamity that causes substantial loss or damage of physical property and resources, livelihood and infrastructure." Sumaiya Sadeka, Mohd Suhaimi Mohamad & Md. Sujahangir Kabir Sarkar, *Disaster Experiences and Preparedness of the Orang Asli Families in Tasik Chini of*

dangerous situation requiring immediate action. To be an emergency, something that requires quick or immediate attention must occur.

The point here is simply that the term "emergency" can be defined with sufficient precision to generate decision rules about when a borrower is, or is not, facing an emergency. Funding to pay for access to immediate health care when such care is reasonably required plainly constitutes funding for an emergency. In addition, funding used in order to keep one's job or otherwise to retain a steady income qualifies as emergency funding. An example of emergency funding includes loans used to pay for unexpected or emergency childcare responsibilities. It often will be the case that a working person with little or no savings will have a friend or relative provide childcare services. If a person's regular childcare becomes unavailable, emergency funding should be available when needed to pay for the increased marginal cost of substitute childcare for a reasonable period of time until the original childcare arrangements can be replaced. Similarly, if funds are needed for emergency vehicle repairs to enable a person to return to work, those funds should be available to individuals at the Fed's discount window.

V. Conclusion

Here I argue for both less regulation and more regulation of consumer lending. On the side of less regulation, I argue that vigorous enforcement of state common law anti-fraud rules is all that is necessary and appropriate for regulating loans that have a positive effect on the balance sheets of borrowers.

But in certain contexts, more regulation is clearly needed. In particular, certain short-term loans, such as payday loans, whose proceeds generally are used to fund current consumption, deserve close and focused regulatory attention. Specifically, I argue that lenders should be deemed to be in a position of trust and confidence with borrowers seeking to fund current consumption because borrowers should be entitled to rely on their lenders in these contexts for information and advice. Borrowers in such markets should receive the same protections as investors have received for almost a century when making transactions in securities markets. In particular, borrowers in the short-term credit markets who are seeking funds for current consumption should receive the protections of the suitability and the anti-churning rules in order to enable borrowers to avoid falling into the "debt trap" of ever-increasing financial obligations generated by the necessity of continually rolling over what ostensibly was a short-term extension of credit. Lenders

Malaysia: A Conceptual Framework Towards Building Disaster Resilient Community, 6 PROGRESS DISASTER SCI., Mar. 2020, at 1, 2 (2020), https://www.sciencedirect.com/science/article/pii/S2590061720300077?via%3Dihub [https://perma.cc/36S6-AXVK]; *see also* Ronald W. Perry, *What Is a Disaster?*, *in* HANDBOOK OF DISASTER RESEARCH 12 (Havidán Rodríguez, Enrico L. Quarantelli & Russell R. Dynes eds., 2007) (discussing scholars' complementary definitions of disaster).

should be required to steer such borrowers to the best deals available. Currently, the neediest borrowers often are steered to the worst deals available.

Most radically, I argue that we should begin to: (1) normalize the notion that the Federal Reserve has a role in providing liquidity to U.S. households and (2) recognize that the Fed should be doing this on an ongoing basis and not only during pandemics or global financial crises. To do this, I propose that the Federal Reserve play a role in providing liquidity to low- and middle-income U.S. households who are forced into short-term loan markets to pay for household emergencies such as car repairs and emergency medical care. Such liquidity would take the form of forgivable loans.