CONSUMER CREDIT REDUX

By

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Consumer credit law was a hot topic for legal scholars during the 1970s and 1980s, but its attraction waned in the next two decades no doubt due in part to the dampening effect of the law and economics movement on government intervention and its advocacy. However, the last 5 years have seen a resurgence of scholarly interest in consumer credit law. This is partly because recent market developments have given academics a range of interesting new issues to address and partly because the new generation of legal scholars is economically literate and has been able to draw successfully on developments in law and economics, behavioral economics and other new theoretical perspectives to enrich the debate over the case for regulation. This paper surveys the recent literature on three topics: subprime lending, credit cards and payday loans, with particular reference to the challenges developments in these areas pose for truth-in-lending laws and policies which, at least until very recently, had remained largely unchanged since the hey-day of consumer credit law reform.

1. INTRODUCTION

Michael Trebilcock was a leading figure in the Australian and Canadian consumer protection movements during the 1960s and 1970s. His outstanding contribution in Australia was his co-authorship of the so-called "Adelaide Law School Committee Report" on the Law relating to Consumer Credit and Moneylending ("ALSC Report").[1] The report was commissioned by the Standing Committee of State and Commonwealth Attorneys-General and it proposed sweeping reforms, inspired partly by the United States Consumer Credit Protection Act 1968[2] (the "Truth-in-Lending Act") and the Uniform Consumer Credit Code, both of which pre-dated the ALSC Report by only a matter of months. The ALSC Report was remarkably influential. It led initially to the enactment of

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[1] *Report to the Standing Committee of Commonwealth and State Attorneys-General on the Law relating to Consumer Credit and Moneylending* (Government Printer, Adelaide, February 25, 1969). The other members of the committee were Arthur Rogerson and Michael Detmold.

[2] 15 U.S.C. s.1601.

new consumer credit laws in South Australia[3] and ultimately to the adoption of uniform legislation throughout Australia which is still in place.[4]

Perhaps the most significant part of the ALSC Report was the recommendations relating to truth-in-lending. Citing contemporary United States literature, the committee said:[5]

> "[t]he case for disclosure of effective interest rates turns on the need for a consumer to be able to shop for credit comparatively. At present, interest charges in consumer credit transactions while disclosed as a total sum (*i.e.*, dollars and cents disclosure), commonly are not also disclosed as a rate percentage, or if a rate percentage is disclosed, this is done in a variety of ways which makes comparison by the average consumer of the relative cost of credit being offered by competing sources of credit difficult, if not impossible".

The committee went on to recommend mandatory pre-contractual disclosure of credit cost information, including a standardized annual percentage rate ("APR"), along the lines of the United States model.[6] The measure had two main objectives: first, as the above-quoted passage indicates, to facilitate comparison shopping for credit so that borrowers could choose rationally between competing creditors; and secondly, to inform prospective borrowers about the true cost of credit so that they could choose rationally between borrowing and paying cash. The second objective related to two concerns that were current at the time. The first was that lenders commonly quoted flat rates of interest. A flat rate is calculated on the assumption that the whole of the loan amount is outstanding for the entire repayment period. Since typically the outstanding loan balance diminishes progressively over the period, flat rates understate the true cost of credit. The second concern was that, when quoting interest rates and charges, lenders commonly

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[3] Consumer Credit Act 1972 (S.A.); Consumer Transactions Act 1972 (S.A.).

[4] Consumer Credit Code, enacted in template form by the Consumer Credit (Queensland) Act 1994 and imported into the other States and Territories by adoption legislation enacted pursuant to an inter-governmental agreement (the "Australian Uniform Credit Laws Agreement"): see Anthony Duggan and Elizabeth Lanyon, *Consumer Credit Law* (Butterworths, Sydney, Australia, 1999), para.[1.2.6]. The Consumer Credit Code reflects many of the ALSC Report recommendations and also the work of a later body, known as the "Molomby Committee", which was a committee of the Law Council of Australia established to report on the feasibility of the ALSC Report recommendations: *Report on Fair Consumer Credit Laws* (Government Printer, Melbourne, 1971). There are plans in train to replace the State and territory laws with a federal Consumer Credit Act, supported by a referral of power by the States to the Commonwealth.

[5] ALSC Report, p.25.

[6] *Ibid.* p.28.

omitted additional charges, such as loan setup fees and the like, on the basis that, since these were not part of the lender's return, they should not be treated as interest. On the other hand, from the borrower's perspective such charges are undeniably part of the cost of credit and quoting interest rates or charges without taking them into account is potentially misleading. With these various considerations in mind and in common with the United States precedents, the ALSC Report recommended prescribed methods for APR calculations which assumed a progressively declining principal and which also took into account, as far as practicable, all relevant fees and charges.

Truth-in-lending initiatives were controversial, even at the time of the ALSC Report.[7] The main objections were as follows. (1) By and large, consumers care more about dollars and cents disclosure of credit costs because this is a better indication of what they can afford and the benefits of APR disclosure will most likely be limited to well-educated, affluent borrowers; (2) there is no need for mandatory disclosure because if a creditor's prices are competitive, it will have an incentive to disclose them voluntarily; and (3) excessive emphasis on the APR may cause creditors to compete on this front alone and to cut back on other benefits under the contract ("term substitution"). The counter-arguments included the following: (1) it does not matter whether consumers by and large are rate sensitive because even marginal changes to credit purchasing patterns may increase price competition across-the-board, to the benefit of consumers generally;[8] (2) mandatory disclosure is necessary to solve a collective action problem, namely that individual creditors will not comply on a voluntary basis if the disclosure makes their charges seem higher than the charges of competitors who do not comply; and (3) the benefits of truth-in-lending exceed the costs, including the costs of compliance and any potential costs due to term substitution and the like.

This debate was carried on quite vigorously in the academic literature during the decade or so that followed the enactment of the truth-in-lending laws. Scholars also worried about both the timing and content of the truth-in-lending disclosures. One concern was

[7] See ALSC Report, pp 27-28 outlining the main objections.
[8] Alan Schwartz and Louis B. Wilde, "Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis" (1979) 127 *University of Pennsylvania Law Review* 630.

that the legislation requires disclosure in the loan document itself, but this is too late for comparison shopping. By the time consumers get the information, they will already be committed to the deal, psychologically, if not legally.[9] Other concerns related to ways of simplifying the disclosures and making them more prominent.[10] The growth in credit card use during the 1980's prompted another debate over the potential cross-subsidization effects of the truth-in-lending laws. Should credit card issuers be free to charge joining and annual fees on top of finance charges? Opponents argued that these kinds of additional charges compromised the policy behind the truth-in-lending laws by making the APR less reliable as a measure of comparative credit cost. The counter-argument was that prohibiting these fees would give one class of card user a windfall at the expense of another. Many credit card issuers give their customers a choice between paying the outstanding balance of the account in full on the due date or paying a lesser amount. Finance charges are payable if the customer takes the second option, but customers who take the first option get a free ride. In the absence of joining and annual fees, the card issuer will cover the cost of providing "free credit" to the first class of card user by raising the finance charges for the second class of user.[11]

At some point thereafter, scholarly interest in consumer credit law appeared to wane. Writing in 2001, Hynes and Posner noted that "the literature on the regulation of consumer credit is not as lively as it once was. Most contributions were written in the 1970s and early 1980s, and there has been little work in the 1990s other than work on personal bankruptcy".[12] This trend was reflected in law school curricula where courses on

[9] Jonathan M. Landers and Ralph J. Rohner, "A Functional Analysis of Truth in Lending" (1979) 26 *University of California Los Angeles Law Review* 711.

[10] *E.g.*, the United States Fair Credit and Credit Card Disclosure Act 1988 requires disclosure of selected financial details in a "Schumer box" format. The Schumer box is named after the proposer of the legislation. The current Australian legislation also incorporates a measure along these lines: see Duggan and Lanyon, *op.cit.* para.[4.3.8].

[11] In Australia, the credit laws originally prohibited credit card joining and annual fees to preserve the integrity of the truth-in-lending regime. The current laws have removed the prohibition, with a view to avoiding the cross-subsidization problem: Duggan and Lanyon, *op.cit.* para.[3.3.23]. However, it has subsequently become common for credit card issuers not to impose these fees and this has resurrected the cross-subsidization problem: Oren Bar-Gill, "Seduction by Plastic" (2004) 98 *Northwestern University Law Review* 1373, Part 2A.2. See further, Part 3, *infra.*

[12] Richard Hynes and Eric A. Posner, "The Law and Economics of Consumer Finance" (2002) 4 *American Law and Economics Review* 162 at p.? In Canada, Iain Ramsay was a notable exception: see, *e.g.*, "The Alternative Consumer Credit Market and Financial Sector: Regulatory Issues and Approaches" (2001) 35

consumer credit law, once common, largely disappeared off the map. The most likely explanation for this wave of disenchantment is the dominance of the law and economics movement during the period in question which made it unfashionable in many circles to suggest that markets might fail or that legislative intervention was the solution if they did. A second possible explanation is that scholars simply got tired of debating the same old questions and ran out of new ones to discuss. In any event, after a decade or more, consumer credit scholarship is on the rise again with truth-in-lending, in particular, being once more in the limelight.

The new generation of legal scholars in the consumer credit field is for the most part schooled in law and economics and so they are better equipped than many of their predecessors to engage with Chicago school opponents on their own terms and to stake out economically plausible policy positions on regulatory issues. The renewed interest in consumer credit law focuses in particular on three recent developments in consumer credit markets which have generated a host of new issues crying out for scholarly treatment. The first is the subprime mortgage crisis in the United States. The second is the relatively recent phenomenon of mass-marketed credit cards coupled with significant rises in consumer bankruptcy rates. The third is the emergence of the so-called alternative consumer credit market, comprising payday lenders and the like who specialize in short-term loans for small amounts. In Parts 2-4, below, I review some of the more recent literature, outlining the issues these developments have given rise to and identifying the implications for truth-in-lending policy and law reform. Both the subject-matter of this paper (consumer credit) and the methodology (law and economics) testify to Michael Trebilcock's profound influence on my own academic career.

Canadian Business Law Journal 325. But note Ramsay's own despondent conclusion, which tallies with Hynes and Posner's statement: "there remain many [consumer credit] issues on which further empirical and theoretical research is necessary. Yet there seems little interest by academics in Canada in researching these issues": *ibid* 400.

2. SUBPRIME LENDING

Subprime lending is the practice of lending to borrowers whose credit ratings are not good enough to qualify them for loans at prime interest rates. The growth of the sub-prime mortgage market in the United States dates from the 1990s and, according to Zywicki and Adamson, the main factors were: (1) interest rate deregulation, which removed constraints on lenders' ability to price loans based on individual borrower risk; (2) improved underwriting procedures, including the use of credit scoring, which – supposedly, at any rate - facilitated the assessment of risk; and (3) the growth of mortgage securitization, which increased the amount of capital available for home lending and allowed non-bank lenders to enter the home mortgage market.[13]

It has become common to associate the subprime mortgage market with abusive lending practices aimed at exploiting the borrower's lack of sophistication. Examples include making unaffordable loans based on the estimated foreclosure value of the house rather than the borrower's capacity to repay ("asset-backed lending"), charging excessive interest rates ("rent-seeking") or inducing a borrower to refinance a loan repeatedly to earn additional fees ("loan-flipping").[14] Prior to the subprime mortgage crisis, the prevalence of these abuses led to calls for tighter anti-predatory lending laws.[15] Nevertheless, most commentators seem to agree that, while predatory lending is a significant problem, not all subprime loans are predatory. There is a legitimate subprime market which has increased the availability of credit to lower-to- middle-income borrowers, including minority groups who were excluded from the prime market because

[13] Todd J. Zywicki and Joseph D. Adamson, "The Law and Economics of Subprime Lending" (2009) 79 *University of Colorado Law Review* 1, Part I. See also Kathleen C. Engel and Patricia A.McCoy, "A Tale of Three Markets: The Law and Economics of Predatory Lending" (2002) 80 *Texas Law Review* 1253 at 1273-1277. For an account of subprime lending in Canada, see Benjamin Tal, *Sub-Prime as Prime Target: The Surging Non-Conforming Mortgage Market in Canada* (CIBC World Markets: Consumer Watch Canada, October 10, 2006).

[14] See Engel and McCoy, *op.cit.* Part I. As Engel and McCoy explain, asset-backed lending and loan flipping go hand in hand: "predatory lenders manufacture these situations by making asset-based loans in the first place with payments that the borrowers cannot meet. When the borrowers default, as is sure to happen, the lenders offer them an opportunity to escape foreclosure by refinancing": *ibid.* 1263.

[15] For example, Engel and McCoy argue for mandatory suitability standards, which would require a lender to consider the borrower's ability to repay: *ibid.*

lenders stereotyped them as inherently poor credit risks.[16] Furthermore, there is evidence to suggest that borrowers in the legitimate subprime market are not less sophisticated than prime borrowers and that they are equally capable of understanding their loans, provided they have access to the relevant information.[17] The implication is that any response to the predatory lending problem must be sufficiently targeted so as not to discourage legitimate subprime lending. Mandatory suitability requirements, which require the lender to assess the borrower's capacity to repay, may have this effect unless carefully targeted, because: (1) they place too much responsibility on the lender, having regard to informational asymmetries in the mortgage market; (2) given that loan contracts, unlike contracts of insurance, are not contracts of the utmost good faith, such laws create uncertainty about the borrower's obligation to disclose information that may be relevant to the lender's assessment; and (3) more generally, such laws are frequently indeterminate on questions such as what the lender knew or could reasonably have discovered. Indeterminacy increases the risks to the lender and may lead to credit rationing, not just in the predatory lending market, but in the legitimate subprime market as well. [18]

Of course the issue may now have been overtaken by events. The subprime mortgage crisis has brought home to lenders in the most dramatic possible way the perils of lending to uncreditworthy borrowers and it is unlikely that lenders will be reverting *en masse* to this kind of business model any time soon. On the other hand, while the subprime mortgage crisis may have killed the predatory lending market, with luck its effects on

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[16] Patricia A. McCoy, "Rethinking Disclosure in a World of Risk-Based Pricing" (2007) 44 *Harvard Journal on Legislation* 123 [tan 8]. See also Zywicki and Adamson, *op.cit.*Part IC and Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts* (2009) 94 *Cornell Law Review* 1073.
[17] James M. Lacko and Janis K. Pappalardo, *Improving Consumer Mortgage Disclosures: An Empirical Assessment of Current and Prototype Disclosure Forms* (Federal Trade Commission, 2007), discussed in Zwyicki and Adamson, *op.cit.* Part IB. See also Engel and McCoy, *op.cit.*, identifying three separate home mortgage markets- the prime market, the legitimate sub-prime market and the predatory lending market.

[18] See Zwyicki and Adamson, *op.cit.* Part IIIC.3; *cf* Engel and McCoy, *op.cit.* Recent amendments to the truth in lending laws prohibit a creditor from extending credit based on the value of collateral without regard to the consumer's repayment ability, including the consumer's current and reasonably expected income, current obligations, employment, assets other than collateral and mortgage-related obligations: Federal Reserve Board, Truth in Lending ("Regulation Z") 12 CFR ss 226.34 and 226.35 published July 30 2008, effective October 1, 2009 (the "2008 Regulation Z amendments").

legitimate subprime lending will not be permanent and, sooner or later, the market will recover. The following discussion proceeds on this assumption.

While, by definition, predatory lending is not a problem in the legitimate subprime market, borrowers are still at a disadvantage relative to borrowers in the prime market because comparison shopping is harder in the sub-prime market. This raises the concern that some subprime borrowers may have been paying more for their mortgages than if they had better information about the available alternatives. This is the very kind of information failure the truth-in-lending laws were enacted to address but, as Patricia McCoy explains, the truth-in-lending laws were enacted with the prime market in mind and they take no account of the different pricing structure in the subprime market.[19] In the prime market, lenders use "average cost" pricing to set interest charges. In other words, they do not differentiate between individual borrowers and so, for any given product a particular lender may offer, all borrowers pay the same price. The result is to create a competitive environment in which lenders have an incentive to reveal their prices up-front and in which it is relatively easy for borrowers to comparison shop between different lenders. The truth-in-lending laws facilitate comparison shopping by ensuring that lenders quote their prices on a standardized basis.

On the other hand, subprime lenders rely on "risk-based" pricing. In other words, they charge "different borrowers different prices for the same product, ostensibly based on their individual risk".[20] In a risk-based pricing system, the lender cannot determine the price of a loan until the borrower reveals information about their creditworthiness. Sub-prime lenders use the loan application process to generate this information and they charge substantial, non-refundable application fees. In other words, subprime borrowers are subject to a "pay to play" regime.[21]

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[19] McCoy, *op.cit.*
[20] *Ibid.* [tan 13].
[21] *Ibid.* [tan 95].

The truth-in-lending laws require disclosure of the APR, the amount financed, the finance charge and other features of the loan.[22] However, at least until enactment of the 2008 Regulation Z amendments, discussed below, there was a serious timing problem. For fixed rate loans other than refinancing loans, the disclosures were not required until 3 days after the loan application. This meant that the borrower had to pay the application fee to get the disclosures. To comparison shop, a borrower needs more than one price, but to obtain several prices the borrower would have to pay multiple application fees. Particularly given the lower-to-middle income status of the typical subprime borrower, it would almost certainly not be rational for her to incur this expense. The problem was compounded by the fact that the disclosures are no more than a "good faith estimate". As a general rule, lenders were free to change the terms at any time until closing and this made the truth-in-lending disclosures inherently unreliable.[23] Nor could the subprime borrower safely rely on a lender's advertised rates because a lender was free to advertise its best rate, without having to disclose that this rate may not be available to everyone. The truth-in-lending advertising laws were written with the prime market in mind and they assumed homogeneous prices. However in the subprime market, where prices are not homogeneous, the laws were positively harmful because they encouraged lenders to advertise artificially low rates.[24]

The 2008 Regulation Z amendments address some of these concerns, most importantly, by requiring creditors to give consumers transaction-specific cost disclosures within three days after the application and before any fees are charged.[25] However, lenders

[22] Truth in Lending Act 15 U.S.C. s.1601; Truth in Lending Regulations ("Regulation Z") 12 C.F.R. Pt 226. See also Home Ownership and Equity Protection Act Pub.L. 103-325, 108 Stat. 2190 (1994). For details of recent reforms, see n. 25, below.

[23] McCoy, *op.cit.* Part IIB. For fixed rate refinancing loans, the truth-in-lending disclosures were not required until closing and this made them effectively useless because by then the borrower is psychologically and financially committed to the deal: *ibid.*[tan 103] For most variable rate loans, the truth-in-lending disclosures had to be given with the application form. This ameliorated the timing problem affecting the fixed rate loan disclosure requirements, but there was an information overload problem instead. McCoy describes the variable rate disclosure requirements as "obscure", "profuse" and "bewildering": *ibid.* [tan 56]

[24] *Ibid.* Part IIA.

[25] 12 CFR s.226.19. The 2008 Regulation Z amendments implement the Truth in Lending Act, n.22 above and the Home Ownership and Protection Program Act, n,22 above, as amended by the Housing and Economic Recovery Act of 2008, Pub.L. No.1 10-289, 122 Stat.2654 (2008). The Regulation Z amendments came into force on 1 October, 2009. The new disclosure provisions discussed in the text are

remain free to change the quoted APR, subject only to providing a corrected disclosure statement three days before closing, and this means it is still unsafe for the borrower to rely on the initial disclosure.[26] McCoy, by contrast, argues that lenders should be prohibited from altering price quotes except where: (1) good faith subsequent discoveries or events result in a downgrading of the borrower's creditworthiness; (2) the property appraisal is lower than expected so that the estimated loan-to-value ratio is adversely affected; and (3) the prevailing interest rate shifts after the application.[27] McCoy also argues that a lender who advertises an APR for a sub-prime product should have to disclose the full range of APRs for the product and specify that borrowers with poor credit ratings will not qualify for the best price. However, while the new laws enact stricter rules for mortgage advertising, with particular reference to teaser rates, they do not go to the root of the problem McCoy identifies.[28]

Oren Bar-Gill proposes a roughly comparable set of solutions to McCoy's, though his take on the problem is different from hers.[29] McCoy's analysis assumes that borrowers in the sub-prime market are rational and that the problem was one of information failure (lack of access to timely information about the cost of borrowing). Bar-Gill, arguing from a behavioural economics perspective, suggests that the problem was primarily one of imperfect borrower rationality. Many sub-prime borrowers made bad choices because of myopia (an undue focus on the short-term dimensions of the loan contract with insufficient attention to the longer-term dimensions) or over-optimism (under-estimation of the future cost of a deferred-cost contract and over-estimation of future income prospects or re-financing opportunities). Sub-prime contracts, he goes on to say, have two

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part of a package of reforms aimed at predatory lending practices. Other measures include: (1) the prohibition of prepayment penalties; (2) rules to prevent lenders and mortgage brokers from inducing an appraiser to misstate a property's value; and (3), as discussed in n.18, above, mandatory suitability requirements. For an overview of the new laws, see Jacqueline A. Parker, Jeffrey P. Naimon and Catherine M. Brennan, "Truth in Lending Update -2008 (2009) 64 *The Business Lawyer* 471. There have also been numerous developments at the State level: for an overview, see Julie R. Caggiano, "Mortgage and Predatory Lending Law Developments" (2009) 64 *The Business Lawyer* 517; Lynette I. Hotchkiss, "A Loan By Any Other Name – The Advent of the 'Rate Spread' Home Loan" (2009) 64 *The Business Lawyer* 653.

[26] 12 CFR s.226.19(a)(2).

[27] *Op.cit.* [tan 144].

[28] 12 CFR s.226.16 and 226.24. For details, see Parker, Naimon and Brennan, *op.cit.* n.25, above.

[29] Bar-Gill, *op.cit.* n.16.

key characteristics (1) complex pricing structures and (2) a shifting of the costs from the front-end to the back-end of the payment schedule, and these are both rational supply-side responses to imperfect borrower rationality. Bar-Gill sees improved APR disclosure as a potential solution to the complexity problem because it reduces all elements of the cost of borrowing to a single, readily comprehensible measure. It is also potentially a solution to the cost deferral problem because, properly calculated, the APR captures both the short- and long-term costs of the loan and so it may act as an antidote to borrower myopia and over-optimism. Like McCoy, Bar-Gill proposes measures to ensure timely and reliable APR disclosure to sub-prime borrowers. He also proposes a requirement for inclusion in the APR of items that are currently excluded (for example, title insurance fees, appraisal fees and credit report fees) and factoring into the APR the probability of prepayment (a key variable in assessing the longer-term cost of borrowing) .[30]

3. CREDIT CARDS

There has been a resurgence of scholarly interest in credit card regulation, triggered in part by rises in the number of consumer bankruptcies and the prominence of credit card over-indebtedness among the reported causes.[31] The leading contribution is Oren Bar-Gill's "Seduction by Plastic", which uses behavioral economics to construct a theory of credit card pricing based on consumer misperception of risk.[32] Building in part on Bar-Gill's work, Ronald Mann has traced the development of the global credit card market and identified a direct correlation between levels of credit card penetration in different countries and consumer bankruptcy rates,[33] while Angela Littwin has tested Bar-Gill's

[30] *Ibid.* Part VI. The 2008 Regulation Z amendments only partially implement Bar-Gill's first proposal (see text at n.26, above), and they do not address his other proposals at all.
[31] The figure was 7.0 *per* 1,000 population in the U.S. prior to the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act Pub.L. No.109-8, s.119, Stat.23 (2005), compared to 4.00 *per* 1,000 population in Canada: see Anthony Duggan, "Consumer Bankruptcy in Canada and Australia: A Comparative Perspective" in Janis Sarra (ed), *Annual Review of Insolvency Law 2006* (Thomson Carswell, Toronto, 2007), 856.
[32] *Op.cit.*n.11, *supra.*
[33] *Charging Ahead: The Growth and Regulation of Payment Card Markets* (Cambridge University Press, 2006).

theory empirically through interviews with low-income women about credit card use.[34] Among the conclusions these studies draw are that the truth-in-lending disclosure requirements for credit cards are based on a fundamental misconception about consumer decision-making, that if disclosure laws are to work at all they must be reformed to take account of how consumers behave in real life and that, in any event, disclosure laws are not sufficient. The following is a short account of the main arguments.

A puzzling feature of the credit card market on the supply side is that credit card interest rates are very high relative to the costs faced by issuers, despite apparently intense competition. A puzzle on the demand side is that credit card interest rates are very high relative to alternative sources of credit, and yet credit cards are now the major form of consumer borrowing.[35] According to Bar-Gill, the key to both puzzles lies in consumers' systematic under-estimation of their future borrowing.[36] The problem is a function of both imperfect self-control and optimism bias. Imperfect self-control, in turn, has a number of features including: (1) incremental foolishness (credit cards facilitate piecemeal borrowing and it is less forbidding to chalk up a large debt a little at a time than it is to borrow the whole amount all at once); (2) susceptibility to temptation (at the time of acquiring her card, the consumer may resolve not to borrow on it, but when the time comes to pay her monthly balance the temptation to make only the minimum payment may prove irresistible); and (3) hyperbolic discounting, which underlies both (1) and (2) (the benefits of borrowing accrue in the short term, but the costs accrue only in the longer term and consumers may over-estimate the short-term benefits relative to the longer term costs). Optimism bias means that, at the time of acquiring the credit card, consumers may underestimate the risk of future hardships that may necessitate borrowing, for example accident, illness or unemployment.

If consumers systematically under-estimate future borrowing but, nevertheless, are sensitive to short-term costs, the card issuer has an incentive to price its product

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[34] "Beyond Usury: A Study of Credit Card Use and Preference among Low-Income Consumers" (2008) 86 *Texas Law Review* 451.
[35] Bar-Gill, *op.cit.* Part IIA.1.
[36] *Ibid.* Part IIIA.

accordingly. More particularly, the card issuer will want to charge high interest rates and large late fees and over-limit fees but, by the same token it will compensate by offering low, or zero, annual fees and transaction fees as well as introductory, short-term interest rates (teaser rates).[37] As Bar-Gill explains, this pricing structure distorts competition because, instead of focusing on interest rates and fees, firms compete on the short-term perks (annual fees and transaction fees, teaser rates and benefits programs). It also leads to allocative inefficiencies (too many credit cards and excessive credit card borrowing, relative to consumers' unrevealed preferences) and distributional inequities.[38]

The truth in lending laws require initial disclosure of basic price information, including the APR, details of fees and charges, the method of determining account balances and calculating the finance charge for each billing cycle, the credit limit and the rules governing payment. They also require certain disclosures in each billing cycle statement, including opening and closing account balances, transaction details, details of payments made during the billing cycle, the finance charge for the billing cycle, the balance on which the finance charge was computed and a statement of how the balance was determined.[39] The aims are to facilitate consumer choice between: (1) competing credit cards; (2) credit card and non-credit card borrowing; and (3) cash and credit card purchases. Earlier generation scholars were skeptical about the utility of the credit card disclosure requirements because, without a standardized approach to pricing, comparison between credit cards would be just too difficult for the average consumer and also because the true cost of credit card borrowing is a function not only of the variables the disclosure requirements address, but also of how individual consumers time their purchases and repayments.[40] However, the behavioral economic analysis outlined above suggests a more fundamental set of concerns.

The problem is partly that, contrary to the assumption on which the legislation is based, the under-estimation bias makes consumers insensitive to credit card interest rates but

[37] *Ibid.*, Part IIIB.
[38] See text at n.11, *supra.*
[39] Truth-in-Lending Act, 15 U.S.C. s.1637.
[40] See text at n.11, *supra* and see generally Duggan and Lanyon, *op.cit.* Chapter 3.

there is more to the story than that. As mentioned above, the first of the statutory goals is to facilitate consumer choice between competing credit cards. However, faced with a choice between a card with an X *per cent* APR and a $Y annual fee and a card with an APR of more than X *per cent* and no annual fee, the under-estimation bias may lead consumers to prefer the second card even, though, measured objectively, the first card is a better deal. Assume, though, that measured objectively the two cards offer the same deal, in other words, the first card's annual fee yields the same return to the lender as the second card's interest rate premium. Even under these conditions, the consumer may be worse off choosing the second card. The explanation has to do with the diminishing marginal utility of money. Assume that the consumer's need to borrow does not arise until some time after she acquires the card. If she chooses the first card she will pay the additional amount (the annual fee) upfront when she is still financially stable. But if she chooses the second card, she will not become liable for the additional amount (the interest premium) until she needs to borrow, at which point she is likely to value the additional amount more highly than before her financial situation deteriorated.[41]

The second aim of the truth-in-lending laws is to facilitate consumer choice between credit card and non-credit card borrowing. This choice typically arises at the time the consumer decides to borrow, in other words, not to pay the monthly account balance in full. The truth-in-lending laws apparently assume that, at this point, the consumer has the option of borrowing from another source and using the proceeds to pay off the card. In practice, however, the transactions costs of switching may be prohibitive so that the consumer is effectively locked in. In theory, the consumer should anticipate the risk of lock-in at the time of acquiring the card and factor it into her choice. On the other hand if the under-estimation bias is in play, the consumer will discount the costs of lock-in relative to the short-term benefits the card offers.[42] The third aim of the truth-in-lending laws is to facilitate consumer comparison between cash and credit card purchases. This

[41] Bar-Gill, *op.cit.* Part IVA.1. In fact, as Bar-Gill goes on to explain, the consumer's welfare loss is likely to be greater than the analysis in the text implies. This is because the *ex ante* probability that the consumer will pay interest is less than 1 and the second card issuer will need to increase its interest rate to compensate for the risk. In other words it is inherently more likely that, measured objectively, the second credit card will be a worse deal than the first.

[42] The argument in the text is an adaptation of Bar-Gill's explanation for the appeal of teaser rates: *ibid.* Part IIIB.3.

choice becomes relevant at the point of purchase. The legislation presupposes that the consumer will calculate the cost of borrowing and measure it against the cost of paying cash. However, to accurately measure the cost of credit card borrowing, the consumer needs more than just the information the disclosure requirements address. She also needs to be aware of the point in the billing cycle at which the purchase is made and to know for sure how long it will be before she pays off the account in full. Furthermore, if she is subject to the under-estimation bias, she may discount the likelihood that, if she uses the card, she will not pay the account balance in full when the next monthly statement arrives and this may skew her choice in favour of using the card.

As Ronald Mann has pointed out, having regard to the behavioral biases outlined above, the current truth-in-lending disclosure requirements are "ineffective and largely a waste of money".[43] "Collectively, the system produces complicated paper disclosures that are not comprehensible to the typical consumer." "The information contained in the disclosures is not particularly useful" and "consumers are unlikely even to read the disclosures and most unlikely to act more intelligently if they do".[44] To meet these objections, Mann and others propose a more robust set of disclosures at the point of borrowing, namely the point at which the consumer decides whether to pay the monthly account balance in full. At present, the disclosure requirements for monthly statements of account focus exclusively on "mechanical information" necessary to explain the account's status.[45] Under Mann's proposals, the account statement would also have to include "the date by which a cardholder would pay her balance in full if she made no further purchases and continued to make equal monthly payments in an amount equal to the last monthly payment".[46] In a variation on the same theme, Bar-Gill –inspired by the success of mandatory warnings on cigarette packaging – has suggested a statement along the lines of: "Debt Increasing – At current repayment rate, it will take you 34 years to

[43] *Op,cit.* 159.
[44] *Ibid.* These conclusions are supported by the findings of a 2007 study on the efficacy of current credit card disclosure requirements. The study found that consumers failed to understand key disclosure items and lacked fundamental understanding of how credit card accounts work: Macro International, *Design and Testing of Effective Truth in Lending Disclosures* (2007), 52, quoted in Oren-Bar Gill and Elizabeth Warren, "Making Credit Safer" (2008) 157 *University of Pennsylvania Law Review* 1 at 28.
[45] Mann, *op.cit.* 160.
[46] *Ibid.* 160-161.

repay your debt and you will end up paying 300% of the principal".[47] Recently enacted reforms include a disclosure requirement along these lines.[48] Mann also proposes point-of-sale disclosures to facilitate consumer choice between cash and credit card payment and to prevent consumers from inadvertently incurring over-limit fees and the like.[49] Beyond truth-in-lending, other measures proposed to counter the under-estimation bias include the following: (1) stricter regulation of unsolicited credit card offers; (2) unbundling the payment and credit functions of credit cards, for example, by requiring issuers to allow automatic payment of balances from the consumer's chequing account; and (3) subordinating credit card debt in consumer bankruptcies.[50] Items (1) and (2) aim to limit the consumer's exposure to temptation,[51] while Item (3) aims to encourage responsible lending.[52]

4. PAYDAY LENDING

Payday lending developed out of the cheque cashing business in the early 1990s and it is now a thriving industry with more storefronts in the United States than McDonalds and Starbucks combined.[53] Payday lenders specialize in short-term, single payment loans for

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[47] *Op.cit*. text at n.194.
[48] Credit Card Accountability, Responsibility and Disclosure Act of 2009, S.414, s.201. The new legislation also prohibits certain fees and interest rate and fee increases and these measures may go some small way towards countering the consumer behavioral biases Bar-Gill identifies: *ibid.*, Title I. For proposed similar reforms in Canada, see draft Credit Business Practices Regulations and proposed amendments to Cost of Borrowing (Retail Association) Regulations SOR/2002-263 , released May 21, 2009.
[49] *Op.cit.* 161-165.
[50] *Ibid.* 207; Bar-Gill, *op.cit.* Part V, *passim.* Mann also proposes, among other things: (1) banning credit card marketing to minors and college students; (2) banning rewards programs; (3) setting mandatory minimum repayment levels and (4) taxing defaulted credit card debt: *loc.cit.* In relation to Item (1), the recently enacted reforms restrict the issuance of credit cards to students and under-age consumers, but stop short of an outright ban: Credit Card Accountability, Responsibility and Disclosure Act of 2009, S.414, Title III. The reforms do not address Mann's Items (2)-(4).
[51] Measure (2) has echoes of Ulysses and the Sirens: Ulysses, knowing that he would be unable to resist the Siren's song once he was within hearing range, instructed his crew to tie him to the mast so that he would not steer the ship towards them: Bar-Gill, *op.cit.* text at n.7. Likewise with Measure (2): the consumer, knowing she will be unable to resist the borrowing urge when it comes time to pay her monthly account, constrains her choice upfront by opting into an automatic payment system.
[52] Mann, *op.cit.* Chapter 15; Bar-Gill, *op.cit.* Part VB.2. Mann worries that Measure (3) may not be particularly effective, given that in most consumer bankruptcies there are no returns to creditors anyway, and his solution is to propose a tax on defaulted credit card debt as well.
[53] Paige Marta Skiba and Jeremy Tobacman, *Do Payday Loans Cause Bankruptcy?* (Vanderbilt Faculty of Law Working Paper, 8 September, 2008) available at http://www.law.vanderbilt.edu/faculty/faculty-personal-sites/paige-skiba/download.aspx?id=2221, text at n.1.

small amounts ostensibly to help customers deal with temporary financial problems by tiding them over until the next payday. In a typical transaction, the consumer gives the lender a cheque, post-dated to the consumer's next payday, in return for a cash advance which is less than the face value of the cheque. When the next payday arrives, the lender either collects on the loan by depositing the post-dated cheque or rolls over the original advance taking a new post-dated cheque in exchange. The difference between the amount of the loan and the face value of the cheque covers the lender's costs, including the risk of default, and the rest is profit. Given the small size and short duration of payday loans, interest rates are typically very high. For example, for a $200 loan for two weeks with a $30 fee, the APR is close to 400 *per cent.*[54] Payday lenders frequently do not run formal credit checks, satisfying themselves instead with a few basic pieces of information about the borrower, including proof of identification, evidence of income and a current bank statement.[55]

The size of payday loan interest rates has been an ongoing source of controversy. Some critics assume that they are symptomatic of lenders exploiting borrower ignorance about credit costs and use this as a reason for saying the industry should be outlawed. But this overlooks the fact that, while the APR may be high, the amount of the fee itself is not. Payday loans have the advantages of convenience and flexibility. They are quick, easy to access and relatively stress-free. It may be perfectly rational for a consumer to pay a fee of, say, $30 in return for these benefits. In any event, some borrowers may have no choice: if a consumer has a low income, is over the limit on her credit card and does not qualify for other mainstream forms of credit, she may have nowhere else to go in an emergency except to a payday lender, even though she knows it will cost more than the other alternatives. Moreover, from the lender's perspective the higher charges are not necessarily unreasonable having regard both to the costs of setting up the loan and the risk of default.[56]

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[54] Ronald J. Mann and Jim Hawkins, "Just Until Payday" (2007) 54 *UCLA Law Review* 855 at 857.
[55] *Ibid.* 862-863.
[56] See Ramsay, *op.cit.* 359-362.

On the other hand, consumers may be paying too much for the benefits a payday loan has to offer due to lack of competition between payday lenders: research in the United States indicates that payday lenders almost uniformly charge the highest permissible rate in their jurisdiction.[57] Mann and Hawkins suggest a number of reasons for the absence of price competition, including: (1) the likelihood that if a borrower needs money immediately, she will not take the time to comparison shop; (2) the high cost of comparison shopping relative to the amount of the typical payday loan; and (3) the strong advantage that the store which is nearest to a particular customer will have over other stores which are further away. The truth-in-lending laws are supposed to stimulate competition in consumer credit markets by facilitating comparison shopping, but the legislation presupposes that lack of information is the only serious obstacle to comparison shopping. In any event, the truth in lending laws do not do a particularly good job of informing the payday borrower. The main problem is the emphasis the legislation places on APR disclosure. The APR may be a good measure of relative credit cost for ordinary loans, but studies suggest that APR disclosure for payday loans is at best ineffective and at worst counter-productive.[58] It is ineffective because, according to the research, payday lending borrowers are more interested in the amount of the finance charge and typically do not understand APR disclosures. It is potentially counter-productive because, given that a lender's set-up costs typically do not vary depending on the size and duration of the loan, the APR over-states the cost of credit for small, short-term loans. Lenders may be discouraged from complying with the legislation by the requirement to disclose what appear to be extortionate APRs. Another defect in the legislation is that it does not require the disclosures until the point of contracting, but this is too late to be useful because by then the deal is done.

As a partial solution to these problems, Mann and Hawkins suggest "a simple disclosure regime, with which reputable lenders readily can comply".[59] The law should require lenders to prominently display in their stores a sign indicating their charges expressed as an amount *per* $100 borrowed. Measures along these lines have recently been enacted in

[57] See Mann and Hawkins, *op.cit.* 882.
[58] *Ibid.* 903-905.
[59] *Ibid.* 905.

some Canadian provinces.[60] Manitoba goes further by requiring on the sign a clear warning that "payday loans are high cost loans".[61] The aim, presumably, is to encourage consumers to search for non-payday lending alternatives and also to address the concern that, due to the under-estimation bias, consumers may discount the risk of being unable to repay the loan when making the decision to borrow.[62] In an attempt to address the disclosure timing problem, most provinces give the borrower a 48 hour cooling-off period following the making of the advance.[63]

For the reasons mentioned earlier, truth-in-lending initiatives are not likely to substantially increase price competition in the paylending market. For this reason, many jurisdictions impose interest rate caps.[64] One concern with interest rate caps is that, if the figure is set too low it may drive firms out of the market, assuming the legislation is enforced. On the other hand, if the rate is set too high, it may force prices up because lenders will view it as an invitation to charge the maximum.[65] Some critics favour low interest rate caps as a form of prohibition on payday lending. However, this perspective arguably overlooks both the benefits of payday lending to low-income consumers and the risk that, in the absence of a payday lending market, consumers may turn to other, even more costly, sources of credit such as pawnshops, rent-to-own operators and loan sharks.[66] Lawmakers continue to wrestle with this dilemma and, not surprisingly, the outcomes vary from one jurisdiction to another. For example, in Canada, Quebec has set an interest rate cap of 35 *per cent* (APR) and, as a result, there are no payday lenders in the province. At the other extreme, Nova Scotia has set its maximum at $31 *per* $100, preferring to rely on the competition the government says is present in the market as a

[60] For a survey of the Canadian provincial initiatives, see Stephanie Ben-Ishai, "Regulating Payday Lenders in Canada: Drawing on American Lessons" (2008) 23 *Banking and Finance Law Review* 323.
[61] Consumer Protection Amendment Act (Payday Loans) SM 2006, amending Consumer Protection Act CCSM c.C-200; Payday Loans Regulation, Man.Reg. 99/207, s.16(3).
[62] See Mann and Hawkins, *op.cit.*881-882.
[63] See Ben-Ishai, *op.cit.* for details.
[64] Mann and Hawkins, *op.cit.* 871-880 (United States); Ben-Ishai, *op.cit* Part C (Canada).
[65] Ramsay, *op.cit.* 385-387.
[66] Mann and Hawkins, *op.cit.* 886-895.

means of keeping prices down, while Ontario is somewhere in the middle with a maximum of $21 *per* $100 borrowed.[67]

Critics of the payday lending industry also target rollovers as a source of abuse. The concern is that, while the charge for a single loan might not be high, the cumulative charges for repeated rollovers may be significant and the consumer may end up paying hundreds of dollars in interest without any reduction in the principal.[68] Payday lenders have an incentive to promote rollovers because set-up costs are lower for repeat loans than they are for initial ones. By the same token, the under-estimation bias may cause a consumer, at the time of taking out a loan, to discount the risks that she will be unable to repay it, that she will need to roll the loan over and that she may end up trapped in a debt cycle.[69] Or the consumer, faced each payday with a choice of paying $30 to keep a $200 loan going for another pay period or repaying the whole amount may focus too much on the $30 and give insufficient attention to the long-term accumulation of charges.[70] With these concerns in mind, many jurisdictions prohibit rollovers. However, as Mann and Hawkins point out, prohibiting repeated loans from the same lender is pointless if, as is the case in most jurisdictions, the consumer remains free to cycle her borrowings between one lender and another.[71] Furthermore, to the extent that the payday lending business model depends on rollovers, a rollover prohibition may be tantamount to a prohibition of payday lending.[72] Some jurisdictions have adopted the intermediate policy of limiting the number of successive rollovers and imposing a cooling-off period on the consumer once she reaches the prescribed number.[73] This measure addresses the second of the two objections to prohibition raised above, but it overlooks the first one. Disclosure is the least intrusive policy option. For example Michigan, while not prohibiting rollovers, requires payday lenders to display a large sign containing information of various sorts

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[67] Byron Williams, *Regulation of the Payday Lending Industry in Manitoba: The Consumer Perspective* (paper presented at the 38th Annual Workshop on Commercial and Consumer Law, Manitoba, October 3 and 4, 2008).
[68] Mann and Hawkins, *op.cit.* 896.
[69] Bar-Gill and Warren, *op.cit.* text at nn 101 and 102 and at nn 146-149, Ramsay, *op.cit.* 371.
[70] Mann and Hawkins, *op.cit.* 896-897.
[71] *Ibid.* 897-898.
[72] *Ibid.* 895.
[73] *Ibid.*898.

and also this warning: "you should use this service only to meet short-term cash needs".[74] The measure is akin to mandatory warnings for cigarettes and certain medications such as sedatives and the objective is to address the under-estimation bias.

5. CONCLUSION

Consumer credit law was a hot topic for legal scholars during the 1970s and 1980s, but its attraction waned in the next two decades no doubt due in part to the dampening effect of the law and economics movement on government intervention and its advocacy. However, the last 5 years have seen a resurgence of scholarly interest in consumer credit law. This is partly because recent market developments have given academics a range of interesting new issues to address and partly because the new generation of legal scholars is economically literate and has been able to draw successfully on developments in law and economics, behavioral economics and other new theoretical perspectives to enrich the debate over the case for regulation. In this paper, I have tried to convey the flavour of the new wave consumer credit scholarship, though space constraints have precluded me from exploring the details or closely debating the merits of the various regulatory initiatives the literature promotes. Michael Trebilcock's scholarly preoccupation over the past 35 years has been with "how to blend market ordering and state action so as to devise an institutional mix that will enhance human freedom, equality and self-realization opportunities".[75] He would be gratified, I think, by how his old field of consumer credit law has developed in the years since he left it to apply his unique brand of "law-and-economics with soul"[76] to other subject areas.

[74] See *ibid.* 876 for details.
[75] Karl E. Klare, Back Cover Note on Michael J. Trebilcock, *The Limits of Freedom of Contract* (Harvard University Press, Cambridge, Mass. 1993).
[76] *Ibid.*