

ESSAY

CREDIT PAST DUE

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Well-intentioned critics point to the absence of banks in poor communities as the cause of the sprawl of fringe creditors. This observation may have been true at one time, but presently it is backward—it is the prevalence of fringe creditors that forecloses more traditional credit institutions from poor and working class communities. Foreclosure occurs because fringe creditors deny their customers the most basic prerequisite for access to traditional credit markets: portable evidence of creditworthiness, that is, a credit record. Credit records serve both an ex ante and an ex post function. Prior to making loans, banks use credit records to screen for high default risks. After the loan is made, credit records are used to discourage defaults through lenders' implicit and explicit threats to damage borrowers' credit records if they fail to meet repayment schedules in a timely manner. However, most fringe market transactions neither rely on nor contribute to general measures of creditworthiness. A subtle but important effect of this nonreliance on credit histories is that it undermines the repayment threat in traditional lending markets, which discourages conventional banks from making loans to fringe market consumers. Since banks are less likely to lend to them, fringe customers have reduced incentives to develop and maintain good credit records, leading them to be screened out more often at the loan application stage. The fringe credit market expansion is thus self-perpetuating in the way it structurally undermines its customers' access to alternative low-cost credit.

This Essay suggests a direct response to this problem, while cautioning against over- and underregulation of the fringe credit industry. Simply, what if fringe creditors were encouraged to report credit? With proper reporting, "good" borrowers could establish favorable credit records, which would allow them the option of leaving the fringe market for the lower borrowing rates of the traditional retail credit market.

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INTRODUCTION

What if you needed a new stove or vacuum, but you didn't have any credit cards or the cash on hand or in a bank account? You might buy the appliance using a store credit card if you qualified based on your credit record, but what if you had no credit history? Every day, people in low-income, inner-city communities face this dilemma. Yet, if you look over the shoulders of shoppers in poor, central-city neighborhoods, you might be surprised by the number of credit sales transacted—all without credit cards or bank cards. Walking around these neighborhoods, you will encounter a wide variety of fringe credit institutions and few, if any, chartered banks. These fringe creditors include pawnshops, rent-to-own stores, check-cashing outlets, and various other noncharter lenders offering payday loans, title loans, income tax refund anticipation loans, and so on.¹ Shops offering high-cost, short-term credit and basic banking services line the streets of these communities.² It has not always been this way.

Pawnbrokers and other casual creditors have been drawn to cities as long as there have been cities.³ But not so long ago, local banks and

1. See generally John P. Caskey, *Fringe Banking* (1994) [hereinafter Caskey, *Fringe*]; Michael S. Barr, *Banking the Poor*, 21 *Yale J. on Reg.* 121 (2004), for detailed descriptions of these loan transactions.

2. Fringe banks are also common on the Main Streets of nonurban poor communities, and they have also reached Wall Street: The stocks of some fringe creditors are traded on the over-the-counter market. See Caskey, *Fringe*, *supra* note 1, at 65.

3. Though there are numerous indications of pawnbrokering in ancient societies, "the first clear evidence of specialized pawnbrokers comes in the fifth century CE from China, where pawnshops were run as commercial enterprises by Buddhist monasteries." Elyce J. Rotella, *Pawnbrokering and Personal Loan Markets*, in 4 *The Oxford Encyclopedia of Economic History* 170, 171 (Joel Mokyr ed., 2003). The presence of pawnbrokers in municipalities (in ancient Greece, the Roman Empire, Asia, and Africa) across time is well

branch offices of large depositories were the primary source for basic banking services in urban residential communities. Unfortunately, beginning around the second half of the twentieth century, many of these banking institutions left the city as part of a broader exodus of urban wealth.⁴ The resulting concentration of poverty and the absence of banks promoted the development of credit transactions tailored to the urban poor. These transactions, often viewed as exploitive, first caught the attention of regulators and the courts in the early 1960s.⁵ It would take several more decades for their breadth to be fully appreciated. By the early 1990s, it became clear to interested observers that the fringe urban credit market was no longer “fringe,” nor strictly urban. Fringe creditors, growing well beyond their underground economy roots, have surfaced in mainstream communities throughout the country.

Well-intentioned critics point to bank departures from poor communities as the cause for the recent sprawl of fringe creditors.⁶ However, to a significant extent, this observation has it backward—which is to say, it is the prevalence of fringe creditors that forecloses more traditional credit institutions from poor and working-class communities. Foreclosure occurs because fringe creditors deny their customers the most basic prerequisite for access to traditional credit markets: portable evidence of

documented. Rotella also provides a detailed analysis of the economics of pawnbroking in continental Europe during and before the nineteenth century. See generally Elyce J. Rotella, *Visiting Uncle: Pawnshop Activity and the Business Cycle in the Late Nineteenth Century* (Oct. 19, 1989) (unpublished manuscript, on file with the *Columbia Law Review*). For a discussion of the domestic pawnbroker’s experience, see John P. Caskey, *Pawnbroking in America: The Economics of a Forgotten Credit Market*, 23 *J. Money Credit & Banking* 85 (1991).

4. Even before World War II, federal and state regulations of the banking industry promoted major changes in urban credit markets. See, e.g., Douglas W. Rae, *City: Urbanism and Its End* 93–96 (2003) (discussing such changes in New Haven, Connecticut). During the interwar period, for instance, large retailers became significant sources of consumer credit, in part because state usury laws limited the profits that banks could earn on small loans. See Lendol G. Calder, *Financing the American Dream: A Cultural History of Consumer Credit* 114–23, 199–201 (1999) (discussing growth of U.S. consumer credit); Rosa-Maria Gelpi & François Julien-Labruyère, *The History of Consumer Credit: Doctrines and Practices* 108–13 (2000) (same). Regrettably, many of these retailers also left the city in significant part long ago.

5. See, e.g., *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 450 (D.C. Cir. 1965) (remanding case for trial court to decide whether contracts by furniture company targeted to urban poor were unconscionable); *Jones v. Star Credit Corp.*, 298 N.Y.S.2d 264, 266 (Sup. Ct. 1969) (“[T]he sale of a freezer unit having a retail value of \$300 for \$900 . . . is unconscionable as a matter of law.”); U.S. Fed. Trade Comm’n, *Economic Report on Installment Credit and Retail Sales Practices of District of Columbia Retailers*, at ix (1968) (attempting to understand “the finance charges, prices, gross margins and profits, legal actions taken . . . and assignment relationships between retailers and finance companies” in the furniture industry).

6. See Caskey, *Fringe*, supra note 1, at 90–97 (discussing research on bank closings in urban neighborhoods and observing “that in some urban areas bank branch closings probably increased the demand for fringe banking services”). Yet Caskey also observes that “[i]n other cities, this is unlikely to have been a significant factor.” *Id.* at 97.

creditworthiness. Evidence of creditworthiness—primarily obtained through credit records or histories—is one key mechanism that banks use to assure repayment of most consumer loans, from small, short-term credit card advances to multimillion-dollar mortgages. Credit records serve both an *ex ante* and an *ex post* function. Prior to making loans, banks use applicants' credit histories to screen for high default risks. After the loan is made, credit histories are employed to discourage defaults. Defaults are discouraged by an explicit threat to damage the borrower's credit record for failing to meet a repayment schedule in a timely manner, making future borrowing more costly, perhaps prohibitively so. The more credible and meaningful the threat of damaging one's credit record is, the more likely the borrower will repay the loan and, hence, the more incentive the bank will have to lend to the borrower.⁷ These coercive threats to credit records are necessary for the operation of traditional lending markets: Without them, the costs of lending in these markets would increase nontrivially, leading to fewer loans and loans of smaller amounts.

The fate and practices of fringe lenders, on the other hand, are not so closely tied to credit histories. Most fringe market transactions neither rely on nor contribute to general measures of creditworthiness.⁸ A subtle, but important effect of this nonreliance on histories is that it undermines the repayment threat in traditional lending markets (the *ex post* function of credit records), which discourages conventional banks from making loans to fringe market consumers. Since banks are less likely to lend to them, these customers have reduced incentives to develop and maintain good credit records, leading them to be screened out more often at the loan application stage (the *ex ante* function of credit records). The fringe credit market expansion is thus self-perpetuating in the way it structurally undermines its customers' access to alternative low-cost credit. The problem is exacerbated by the strong interaction of race and class in the communities where fringe operators have a significant presence.⁹ This interaction reproduces raced patterns—some imagined

7. In this case, credible threats require sufficiently forward-looking borrowers and implicit agreements among creditors to avoid borrowers who have previously defaulted.

8. Some fringe creditors subscribe to specialized credit reporting systems. See *infra* note 53. This information, however, tends not to leak into the general credit history pool. See *infra* note 104 and accompanying text (discussing shortcomings of one such system).

9. There is no necessary relationship between what I am characterizing as "fringe credit" and class. It is not unheard of for better-off individuals to use rent-to-own stores for strictly short-term rentals (say, to rent a large screen television for Super Bowl Sunday) with no intention to purchase. See James M. Lacko et al., Fed. Trade Comm'n, Survey of Rent-to-Own Customers 57–58, 66 (2000). While the Federal Trade Commission survey of rent-to-own consumers found that "[t]he use of rent-to-own transactions was significantly higher for respondents who were African American, young, less educated, lower income, had children in the household, rented their residence, and lived in the South," the survey also captured college-educated homeowners with vehicles, credit cards, and active bank accounts. *Id.* at 34–36.

and others real—that perpetuate disadvantaging beliefs and behaviors both within and outside of these communities.

Given this interaction, one may argue that ruling fringe credit transactions (or specific terms) unconscionable can improve the welfare of poor borrowers by making them more able to credibly commit to repay conventional loans.¹⁰ Such a determination, however, would introduce inefficiencies and might be unhelpful and unfair to those who are most in need of credit.¹¹ But what if, instead of doing away with or highly restraining fringe credit transactions, we simply required or encouraged fringe creditors to report credit? With proper reporting, “good” borrowers could establish favorable credit records, which would make them attractive to more traditional lenders. As a consequence, these good borrowers would have the option of leaving the fringe market for the lower borrowing rates of the traditional retail credit market.¹²

The departure of good borrowers will, *inter alia*, cause the rates for the remaining fringe customers to increase.¹³ This result necessarily follows from the fact that as the good borrowers depart, the remaining customers will comprise a more risky pool, which will be charged a higher effective interest rate. Higher prices for these remaining customers will certainly be an undesirable outcome from their perspective (and perhaps society’s perspective too), but it is not an obviously unfair outcome.¹⁴ Good borrowers who are trapped in the current system are now effectively subsidizing these customers. It may be a fine social objective to subsidize borrowing by poor people with risky credit practices and portfolios, but it seems patently unfair to make other poor people (with good credit practices and potential) foot the bill.

Let me be clear here: I am not suggesting that abusive fringe credit practices should be left unregulated. Of course they should be patrolled

10. Many fringe consumers would qualify for lower-cost credit from conventional creditors, but their inability to develop a reputation for repayment supports an inefficient pooling outcome.

11. It may be unfair and inefficient to prohibit fringe credit transactions through regulation or patronizing judicial decree because many among the poor would otherwise not have access (or would have higher-cost access) to credit in lawful markets. See James R. Barth et al., *Benefits and Costs of Legal Restrictions on Personal Loan Markets*, 29 *J.L. & Econ.* 357, 365, 378–79 (1986) (describing ambiguous tradeoffs resulting from constraining creditors’ remedies).

12. Of course, it is true that under the fringe credit reporting proposal, the price of fringe credit transactions will increase, but importantly, these transactions will still be available for those who demand it (though they will lose their current subsidy from those trapped by it).

13. Perhaps the most significant complaint about fringe credit transactions involves the exorbitant interest rates charged—Annual Percentage Rate (APR) figures around 400% or 500% are not uncommon. Charles A. Bruch, *Taking the Pay out of Payday Loans: Putting an End to the Usurious and Unconscionable Interest Rates Charged by Payday Lenders*, 69 *U. Cin. L. Rev.* 1257, 1272 (2001).

14. Of course, one may challenge the fairness of this result if defaults are involuntary in the sense that they are driven by income shocks beyond the borrower’s control.

and prevented. But constraining the fringe credit market is not costless; indeed, it may be most costly for those in greatest need of credit. This Essay develops a framework for understanding some of these costs, which are not always obvious. For example, the regulation of fringe creditors to make them more attractive to borrowers can actually reduce creditworthy borrowers' access to low-cost credit: Ironically, as the fringe market becomes more punitive and unattractive, creditworthy fringe borrowers may be better off as conventional lenders perceive that these borrowers will be less likely to default on unsecured loans since doing so would force them back to the punitive fringe. But for this to work, the conventional lenders would need to know which fringe customers are creditworthy, and all customers would need to know how relatively unattractive the terms of fringe transactions are. Information, it seems, is currently the most underutilized tool in the effort to provide low-income individuals with affordable credit.

The first Part of this Essay describes how this lack of information supports disparate lending patterns across race, as creditors engage in statistical discrimination using racial profiles where credit profiles are lacking. Part II discusses the threats that fringe creditors use to secure repayment that allow them to lend profitably to borrowers without access to payment records and without threatening to blemish favorable credit histories. Part III presents an analytical model that establishes the connection between fringe credit repayment threats and conventional lending in low-income markets. Fringe practices break the link between past repayment behaviors and current access to credit, broadly undermining the value of credit reputations. This link can be reestablished or strengthened by limiting the relevant fringe practices using the unconscionability doctrine or by encouraging fringe lenders to participate in the establishment of credit reputations. These options are considered in Part III. The Essay concludes with an examination of the larger implications of fringe credit reporting and of what the overall costs and benefits may be. An Appendix follows the Conclusion.

I. RACIAL PROFILES AND CREDIT PROFILES

The inability to establish strong credit histories is bad for poor Americans generally and even worse for poor black Americans. Credit profiles and racial profiles are used as proxies for creditworthiness, and when the former is lacking, blacks are disproportionately harmed by reliance on the latter. Consider, for example, a recent study assessing roughly one thousand loans originated in the mid-1990s and purchased by the Freddie Mac Foundation under an affordable housing initiative.¹⁵ After

15. Susan Wharton Gates et al., *Automated Underwriting in Mortgage Lending: Good News for the Underserved?*, 13 *Housing Pol'y Debate* 369, 376 (2002). The Freddie Mac Foundation is a division of Freddie Mac, which, along with Fannie Mae, is a government-affiliated shareholder-owned mortgage firm. See *id.* at 370–71; Freddie Mac,

enough time had passed to see how these loans were actually performing, Freddie Mac had loan officers grade the original loan applicants as good or bad risks.¹⁶ The researchers then had the loan applications graded by a computer program using the same data available to the officers.¹⁷ Perhaps unsurprisingly, the computer program significantly outperformed the human loan underwriters in predicting which loans would pay off and which ones would not.¹⁸ More startling, however, was the fact that the computer program issued twenty-nine percent more loans to racial minorities than the loan officers issued.¹⁹ Were the loan officers explicitly racist or attempting to lose money for their employer? That is unlikely. They were probably just focused, perhaps unknowingly, on the wrong information—the race or race-associated characteristics of the borrower. Knowingly or not, the loan officers probably switched from credit profiling to racial profiling in making their loan decisions.

It is not difficult to see how this shift might occur. Take, for example, employers wishing to avoid hiring workers with criminal propensities. Assume that if these employers can obtain and review the criminal records of job applicants, then individuals with prior convictions will likely be excluded from consideration. Given the greatly disproportionate numbers of African Americans with criminal convictions, one might expect “employer-initiated background checks” would have a disproportionately adverse effect on “the likelihood of hiring African-Americans.”²⁰ But just the opposite may occur; criminal background checks might actually increase the rate of hiring among black job applicants. This could result because without access to evidence of prior convictions or the absence of such convictions, employers might rely excessively on race to predict criminality. That is, employers will switch to racial profiling when they cannot rely on criminal records. Once those records are available, racial profiling and assumptions about criminality will not disadvantage black applicants who do not have a criminal record.

Reliance on the less accurate proxy of race may be more detrimental to overall black job prospects. Indeed, economists Harry Holzer, Steven Raphael, and Michael Stoll show exactly this result in their empirical study of employer-initiated criminal background checks in four metropolitan areas.²¹ They found that “employers that check criminal back-

Frequently Asked Questions About Freddie Mac (2005), at http://www.freddiemac.com/corporate/about/who_we_are/faq.html (on file with the *Columbia Law Review*).

16. Gates et al., *supra* note 15, at 376.

17. *Id.*

18. *Id.* at 378.

19. *Id.* at 380–82.

20. Harry J. Holzer et al., *Perceived Criminality, Criminal Background Checks and the Racial Hiring Practices of Employers* 23 (June 2005) (unpublished manuscript, on file with the *Columbia Law Review*).

21. *Id.* (analyzing effect of employer-initiated criminal background checks on likelihood that employers will hire African Americans).

grounds are in general more likely to hire African-Americans.”²² After testing the findings against controls and finding them significant, the study concluded that “the adverse consequence of employer-initiated background checks on the likelihood of hiring African Americans is more than offset by the positive effect of eliminating statistical discrimination.”²³ Criminal background checks can lead to increased African American hiring because they allow employers to use a more refined measure of prospective employees’ criminal risk than the proxy of race.

Most employers are probably not directly concerned about an applicant’s criminal record; employers are rather engaged in a general assessment of the applicant’s trustworthiness and skill. And since all applicants claim to be trustworthy and skilled, employers cannot rely on these self-proclamations. However, applicants have histories—employment histories, criminal histories, credit histories, rental histories, and so on—that can usefully inform employers. Prospective employers and applicants are often happy to pay the marginal cost of getting these histories to employers, but market failures may undermine the supply of histories.

David Charny and Mitu Gulati describe how labor market inefficiency and inequality may result from the suboptimal supply of histories.²⁴ Imagine a situation where an employer has acquired—through experience and over time—information about the unobservable productivity of its workers, while prospective employers can only observe weak, sometimes useless, signals of productivity. Race, for example, appears to be often used as a signal in hiring decisions.²⁵ When prospective employers draw statistical inferences using race (even if these inferences are unbiased in the statistical sense), productive workers of stigmatized racial groups receive wages below those which their skill levels should command. Skilled workers are offered wages that reflect prospective employers’ perceived distribution of skills within the workers’ racial category; at

22. *Id.* at 3.

23. *Id.* at 31.

24. See David Charny & G. Mitu Gulati, *Efficiency-Wages, Tournaments, and Discrimination: A Theory of Employment Discrimination Law for “High-Level” Jobs*, 33 *Harv. C.R.-C.L. L. Rev.* 57, 77–78 (1998) (observing that employers categorize potential employees on the basis of race when other information is lacking).

25. Evidence for this may be found in résumé audit studies, where two résumés, differing only in that one has a stereotypically black name at the top while the other has a more “traditional” name are sent to prospective employers. Callback rates are substantially lower for résumés bearing stereotypically black names. See, e.g., Marianne Bertrand & Sendhil Mullainathan, *Are Emily and Greg More Employable than Lakisha and Jamal? A Field Experiment on Labor Market Discrimination* 2–3 (Nat’l Bureau of Econ. Research, Working Paper No. 9873, 2003), available at <http://www.nber.org/papers/W9873> (on file with the *Columbia Law Review*); see also Barbara D. Bart et al., *What’s in a Name?*, 12 *Women Mgmt. Rev.* 299, 300, 302 (1997). Another study sent matched pairs of applicants (a set of two black applicants and a separate set of two white applicants, differing “only” in that one applicant in each set had a criminal record). Devah Pager, *The Mark of a Criminal Record*, 108 *Am. J. Soc.* 937, 946–47 (2003). Pager observed that whites with criminal records had higher callback rates than blacks without criminal records. *Id.* at 958.

the same time, current employers who know the workers personally have “no incentive to pay the minority workers higher wages, since there is no fear that other firms will bid away those workers.”²⁶ Additionally, current employers have no incentive to disclose information about the skills of their more productive minority workers because prospective employers would use this information to recruit away strong workers. When prospective employers cannot use applicants’ “histories” in the hiring decision, statistical discrimination using characteristics of some category (or group) to which applicants belong may become a second-best option. This hurts the employer and good applicants.

Prospective employers may avoid inefficient statistical discrimination based on race when better proxies of productivity, such as histories or tests, are available. David Autor and David Scarborough highlighted the losses from race-based statistical discrimination in their recent analysis of 1,363 retail establishments that switched from informal to test-based applicant screening.²⁷ While on average minorities received significantly lower scores on these tests, the testing itself did not lead to reduced minority hiring.²⁸ Moreover, they found that productivity gains after instituting test screenings “were uniformly large among both minority and non-minority hires.”²⁹ Autor and Scarborough’s data “suggest[] that employers were effectively statistically discriminating prior to the introduction of employment testing.”³⁰ Testing allowed firms to identify strong minority workers and to increase their offers within this pool. Just as criminal background checks expanded aggregate employment opportunities for blacks,³¹ testing may also expand black employment opportunities.

Regrettably, there are no reliable tests to immediately establish a person’s creditworthiness. The best evidence of creditworthiness is a history of past credit behavior. Poor people have as much of a past as rich people, but their credit history is often not recorded, and if recorded, often not reported. If, before making a hiring decision, employers screened applicants for creditworthiness (the way lenders do), I doubt that background credit checks would lead to increased hiring of African Americans. Credit records for poor minorities are so woefully inadequate—a lot of people simply are not in the credit reporting system—that there

26. Charny & Gulati, *supra* note 24, at 65.

27. David H. Autor & David Scarborough, *Will Job Testing Harm Minority Workers?* (Nat’l Bureau of Econ. Research, Working Paper No. 10763, 2004), available at <http://www.nber.org/papers/W10763> (on file with the *Columbia Law Review*).

28. *Id.* at 8, tbl. 2.

29. *Id.* at 3.

30. *Id.*

31. It is important to bear in mind that blacks with criminal records will be increasingly penalized in this setting. In her audit study using criminal records, Pager found that whites had callback rates of 17% and 34% respectively for those with and without a criminal record. The comparable figures for blacks were 5% and 14%. Pager, *supra* note 25, at 955, 957–58.

would be relatively few opportunities for employers to Bayesianly update their racial profiles with better information. The hitch is that when it comes to poor minorities, we may invest much more in tracking their criminality than their creditworthiness.

The difficulty for poor minorities is intensified by the interaction of market forces suppressing the formation of credit records. This phenomenon does not result from an explicit conspiracy among lenders to further disadvantage the poor, nor does it necessarily result from a lack of competition in credit markets. The phenomenon materializes from the externality caused by the extraordinary expansion of the fringe credit market. The mechanism is straightforward. Fringe creditors and traditional creditors rely on different threats to assure repayment. These differences are discussed in the next Part. The availability of certain threats can weaken the effect of others.

II. REPAYMENT THREATS

Credit contracts, like other contracts, allow for court-determined remedies in the event of breach. Creditors, however, would be ill advised to rely solely on these remedies; indeed, they generally do not.³² In addition to seeking court remedies for defaults, creditors often pursue or threaten to pursue a variety of self-help options.³³ Though numerous in form, many of these options essentially allow creditors to publicize defaults, thereby damaging the reputations of defaulting debtors. As discussed in the Introduction, threatening to damage a borrower's credit reputation can provide strong incentives for loan repayment. But many creditors demand greater repayment assurances than those provided by threats to reputation.

A. *General Fringe Repayment Threats*

Creditors seeking greater assurances may expand their self-help options beyond threats to reputation by taking possessory or security interests in debtors' property or would-be property. For example, stores providing credit for consumer goods on a rent-to-own basis retain title in those goods. Similarly, when issuing payday loans, the moneylender takes physical possession of the borrower's signed check, which is returned when the loan is repaid.³⁴ Possessory and security interests serve two distinct self-help purposes: They mitigate losses when defaults occur, and

32. That is, given a default, creditors rely on other repayment remedies. Of course, creditors also employ *ex ante* strategies to limit defaults and remedy them when they occur. These are essentially screening and bonding strategies, which are discussed in more detail in the text.

33. With some qualifications, these options may be exercised directly or through third parties (e.g., a collection agency).

34. Sometimes, the borrower will provide a signed preauthorization form, allowing the lender to electronically debit the borrower's bank account. See Barr, *supra* note 1, at 149.

they discourage defaults from occurring. In this regard, it is important to distinguish between the collateral and coercion functions of these interests. Though liquidation of collateral is often used to offset losses, the mere threat of liquidation—even if it would not satisfy the debt when carried out—can be a more powerful self-help remedy. Fringe creditors are well aware of this. Rent-to-own outlets and payday shops do not merely use collateral as a backstop against their losses; they use collateral to avoid losses in the first place. To illustrate, consider the facts of *Williams v. Walker-Thomas Furniture Co.*³⁵ In more than a dozen transactions from 1957 through 1962, Ora Lee Williams sought to purchase various appliances and other household items on credit from the Walker-Thomas Furniture Company. Walker-Thomas applied her payments (summing over \$1,000 during the five-year period) on a pro rata basis to the outstanding transactions—leaving her owing, for instance, three cents on two separate items that she began paying for five years earlier and twenty-five cents on a third.³⁶ Under this structure, Walker-Thomas was able to maintain its ownership over all the items, which it attempted to repossess after Williams defaulted.

Though some of the goods under contract by Ms. Williams were durable and could be resold after repossession (including a washing machine and a stereo), other items had thin or nonexistent secondary markets, such as sheets, curtains, and mattresses. It is doubtful that the sheets and curtains served a traditional collateral function for Walker-Thomas. As one commentator has pointed out, “One might even question whether the resale value of such ‘collateral’ would be likely to have exceeded the cost of bringing up a moving van to haul it away.”³⁷ More likely, the sheets and curtains were hostages—so-called “ugly princesses”—that could quite literally be taken in the middle of the night and held to ensure repayment.³⁸ The strength of such repayment threats makes fringe creditors such as Walker-Thomas less reliant on credit histories. Of course, these threats are not exclusively used by fringe creditors,³⁹ nor

35. 350 F.2d 445 (D.C. Cir. 1965).

36. Robert H. Skilton & Orrin L. Helstad, Protection of the Installment Buyer of Goods Under the Uniform Commercial Code, 65 Mich. L. Rev. 1465, 1476–77 (1967).

37. Marvin A. Chirelstein, Concepts and Case Analysis in the Law of Contracts 84 (4th ed. 2001).

38. On the hostage model, see Oliver E. Williamson, The Economic Institutions of Capitalism 170–76 (1985). The offensive terminology “ugly princess” was used to describe a type of hostage that had value to the party handing over the hostage but limited direct value to the receiver. *Id.* at 174 & n.10, 176–77. This type of hostage is particularly effective because it allows the receiver both to commit to not misappropriate the hostage and to destroy the hostage if the other side does not satisfy its obligations.

39. Consider the following recent *Wall Street Journal* report:

When it makes a personal loan, CitiFinancial often asks the holders of personal loans to provide collateral. In some cases, . . . that collateral includes fishing lures and tackle boxes, record albums, tents, sleeping bags and lanterns—items that CitiFinancial would almost certainly never bother to collect in the event of a borrower’s default. Yet insurance is sold on the collateral in case it is damaged or

are they issued only against poor and working-class borrowers.⁴⁰ The aim here is not to establish the uniqueness of these threats in fringe credit transactions. The claim is merely that threats based on possessory and security interests are common and salient features of many fringe credit transactions. Such coercive tactics are less likely to be employed by traditional lenders because they face more stringent state regulation and experience greater reputational and other market constraints on their practices.⁴¹ Additionally, low-income borrowers, having fewer credit alternatives, are more likely to “agree” to subject themselves to such repayment threats.

Lenders who are able to employ coercive repayment threats in a cost-effective manner enjoy a distinct advantage. As their repayment threat becomes more meaningful, these lenders become less reliant on the credit reputation of their customers. Credible and menacing loan sharks do not run credit checks. Nor should they; it would be inefficient. The same is true for pawnshops and, only to a slightly lesser extent, for rent-to-own and payday loan outlets. However, this nonreliance on credit histories among fringe creditors produces an unfortunate spillover effect on “creditworthy” borrowers who would prefer conventional credit transactions. Namely, it weakens their ability to signal a commitment to repay conventional loans. The mechanism through which this occurs is de-

lost. . . . Citigroup officials concede that seizing such collateral would be more hassle than it's worth. But they say providing such collateral on loans still serves a purpose—“to make the borrower more responsible for paying the loan back,” says Ajay Banga, Citigroup's business head of consumer lending.

Paul Beckett, Citigroup's ‘Subprime’ Reforms Questioned, *Wall St. J.*, July 18, 2002, at C1.

40. When Swissair experienced financial difficulty, the owner of its leased fleet covertly repossessed nineteen of its jetliners. To pull off the job, thirty “repo” pilots were summoned late one evening to fly the planes “from Zurich to remote airports in the Bordeaux region of France.” J. Lynn Lunsford, *Fleet Trader: With Airlines in a Dive, Secretive Leasing Firm Plays a Crucial Role*, *Wall St. J.*, Feb. 12, 2002, at A1. Many observers felt that the lease company repossessed the planes simply to shield its assets from other Swissair creditors. *Id.* The company, however, had voiced another motive: to send a message to Swissair and the Swiss government. *Id.* “[I]t got attention at the highest levels.” *Id.* Several days later, the planes were “returned to Switzerland after [the lease company] was assured that another flag carrier would be resurrected from the financial wreckage of Swissair.” *Id.*

41. Informed consumers in conventional credit markets generally ought not to choose loans secured with collateral. See Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 *J. Legal Stud.* 1, 7–8 (1981). Nor is it at all clear that conventional lenders desire to offer such collateralized loans. Joseph Stiglitz and Andrew Weiss showed that if borrowers are risk-averse, then increasing collateral (at any fixed interest rate) may lead to a reduction in profits. Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 *Am. Econ. Rev.* 393, 394 (1981). Hildegard Wette demonstrated a similar adverse-selection result, but with risk-neutral borrowers. Hildegard C. Wette, *Note, Collateral in Credit Rationing in Markets with Imperfect Information*, 73 *Am. Econ. Rev.* 442, 442 (1983); see also Helmut Bester, *Screening vs. Rationing in Credit Markets with Imperfect Information*, 75 *Am. Econ. Rev.* 850, 850 (1985) (using simultaneous choice (of collateral and interest rate) framework to mitigate credit rationing).

scribed in Part III. The next subpart provides a short discussion of the payday loan transaction, which will serve as the basis for the theoretical model in the following Parts.

B. *Payday Lenders' Repayment Threats*

Several emergent factors in the 1980s (including deregulation of the banking industry,⁴² surges in illegal immigration, and the rise of the information revolution⁴³) conspired to create the preconditions for a new industry offering payday loans. Payday loans are short-term loans secured by personal checks dated for a borrower's payday.⁴⁴ From its modest origins, the payday loan industry is now the fastest-growing segment of the fringe credit market.⁴⁵ Since the early 1990s,⁴⁶ the payday lending industry has expanded tremendously,⁴⁷ now processing billions of dollars of loans each year.⁴⁸

42. Lisa Blaylock Moss, *Modern Day Loan Sharking: Deferred Presentment Transactions & the Need for Regulation*, 51 Ala. L. Rev. 1725, 1732 (2000). Banks chose to focus on more profitable sectors of the credit industry, most of which involved substantially larger loans. There is a positive correlation between profitability and loan size since many of the costs of consummating a loan are fixed regardless of the amount of money being borrowed.

43. Caskey, *Fringe*, supra note 1, at 108–09; Barr, supra note 1, at 132–33.

44. Payday loans are also commonly called payday advances, deferred deposit transactions, cash advance loans, check advance loans, post dated check loans, delayed deposit check loans, and deferred presentment services. Bruch, supra note 13, at 1271.

45. *Id.* at 1257.

46. See, e.g., *id.* at 1270 (detailing origin of payday loan industry in 1993 Tennessee). The industry concept can also be traced to the salary-selling industry that was common at the turn of the century. Under this scheme, salary sellers would give workers an advance on their weekly salary at the beginning of the week in exchange for the workers' paychecks at the end of the week. This practice was effectively ended with the adoption of the Uniform Small Loan Laws by many states, which subjected salary selling to small loan laws by specifically making salary selling a loan transaction. See Caskey, *Fringe*, supra note 1, at 31–32. Controversy around salary selling has existed for some time:

Leading newspapers throughout the country have constantly denounced the business of making small loans upon the security of pledge or mortgage of personal property or assignment of wages . . . but the press accounts are soon forgotten by all save the unfortunate clients of the money lenders and the campaign to remedy the conditions surrounding the business has been marked by years of fruitless struggle.

Arthur Ham, *The Campaign Against the Loan Shark* (1912).

47. See Jean Ann Fox, *Consumer Fed'n of Am., Safe Harbor for Usury: Recent Developments in Payday Lending* 4 (1999), available at <http://www.consumerfed.org/pdfs/safeharbor.pdf> (on file with the *Columbia Law Review*). In 2001, there were approximately 12,000 to 14,000 payday loan outlets, each making 100 or more loans per month, and another 8,000 to 10,000 smaller volume payday loan outlets nationally. Consumer Fed'n of Am. & U.S. Pub. Interest Research Group, *Rent-A-Bank Payday Lending: How Banks Help Payday Lenders Evade State Consumer Protections: The 2001 Payday Lender Survey and Report* 4 (2001), available at <http://www.consumerfed.org/pdfs/paydayreport.pdf> (on file with the *Columbia Law Review*) [hereinafter *Rent-A-Bank*].

48. See Bruch, supra note 13, at 1270 (estimating \$45 billion in payday loans in 2002).

The industry has seen such rapid growth, in part, because of the small capital requirements to maintain a profitable payday outlet. Little more than \$100,000 is sufficient to start up the business,⁴⁹ and given the modest operating costs associated with the typical payday lending center,⁵⁰ profits are often quickly realized.⁵¹ The high turnover resulting from the typical two-week loan period can allow a payday lender to earn annual fees of nearly \$100 million with only \$15 million of capital.⁵²

Payday loans generally do not involve credit checks.⁵³ Customers simply fill out an application, providing recent pay stubs, proof of employment, an active checking account, and a home address. Upon verification of the application information, the customer will typically receive approval for a loan ranging from \$100 to \$500. To receive the loan, the customer writes a postdated check for the loan amount plus fees payable to the lender.⁵⁴

Consider the following example: An individual seeking to borrow \$100 might go to a payday loan center, which charges fees of fifteen dollars biweekly for each \$100 borrowed.⁵⁵ The payday lender would ask the borrower to write a check to the lender for \$115, dated two weeks ahead (presumably her next payday). After signing the loan document and receiving the cash, the customer will face three basic options when the loan is due. First, the customer might simply allow the payday lender to deposit the check as a means of satisfying the loan. Second, the customer may choose to “buy back” the check, paying the face value of \$115 in

49. See Jerry L. Robinson & Gerald L. Lewis, *Stephens Inc., The Developing “Payday Advance” Business: The Next Innings: From Emergence to Development* 10 (1999).

50. See *id.*

51. See *id.*

52. Rent-A-Bank, *supra* note 47, at 9.

53. Some payday lenders do use a reporting system called “Teletrack,” which maintains records of some fringe transactions. Scott Andrew Schaaf, Note, *From Checks to Cash: The Regulation of the Payday Lending Industry*, 5 N.C. Banking Inst. 339, 352 (2001). Many lenders, however, advertise their products as “no teletrack payday loans.”

54. The customer must also sign a loan document, which must meet the requirements of the Truth in Lending Act, 15 U.S.C. §§ 1601–1667 (2000), including displaying the loan’s APR. See 15 U.S.C. § 1638(4) (requiring disclosure of APR in consumer credit transactions).

55. A fee of fifteen dollars per \$100 borrowed equates to an approximate APR of 390% assuming a fourteen-day term. The national average APR for a payday loan is around 500%, with a corresponding average fee of \$19.23 to borrow \$100 for two weeks. Bruch, *supra* note 13, at 1272; see also Rent-A-Bank, *supra* note 47, at 34 (noting an average APR of “470% and an average fee of \$18.28 to borrow \$100 for two weeks”); Consumer Fed’n of Am. & State Pub. Research Interest Groups, *Show Me the Money!: A Survey of Payday Lenders and Review of Payday Lender Lobbying in State Legislatures* 7 (2000), available at <http://uspig.org/reports/paydayloans2000/showmethemoneyfinal.pdf> (on file with the *Columbia Law Review*) (finding average APR of 474%); Lynn Drysdale & Kathleen E. Keest, *The Two-Tiered Consumer Financial 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, 602 (2000) (noting that two weeks is most common payday loan term).

cash. Some customers may prefer this option to the former, as it avoids the risk that the check will bounce, creating additional fees. Third, the customer might pay an additional fifteen dollars to carry over the loan for an additional two weeks; this practice is commonly referred to as “rolling over” the loan.

Of the three options, the first is often the least attractive; indeed in many cases it is more of a “threat” than an option. The ability to deposit the customer’s check is a strong repayment threat for the payday lender. If the check clears, then the transaction is complete, and the lender is fully satisfied. If the check, however, is returned for insufficient funds, payday lenders warn their customers of severe consequences: Not only can there be substantial additional fees associated with the transaction (both from the payday lender and from the customer’s bank on which the check is drawn), but the lender could also threaten to pursue action under the state’s “bad checks” laws. The force of this repayment threat encourages borrowers to either buy back the check or roll over the loan for what at the time might appear to be a relatively modest fee.⁵⁶

The power of this repayment threat is significant. To illustrate, consider *Watson v. State*, wherein the court observed that James and Brenda Watson (owners of Jak’s Pawn Shop and Check Cashers in Columbus, Georgia) “used the State’s criminal process as [their] collection agency.”⁵⁷ The record of the Watsons’ offenses—contained in “seven volumes of testimony and hundreds of pages of exhibits”—reveals the strong repayment threat of payday lenders.⁵⁸ In return for a payday loan from Jak’s Pawn, customers would write “a check for the full loan amount plus a 20 percent fee, which fee was purportedly classified as one percent interest and 19 percent ‘storage fee.’”⁵⁹ In addition to the check, “an

56. Borrowers may “buy back” the check or “roll over” the loan using cash rather than risk the check being deposited. Given an uneven income stream and the uncertain timing by which checks are processed, allowing the payday lender to attempt to cash the check imposes risks some borrowers would rather avoid. Rollovers, a much debated practice, are common in the industry, with customers known to roll over the same loan ten times or more. Bruch, *supra* note 13, at 1272. Rollovers also represent a significant source of revenues for payday lenders. Ill. Dep’t of Fin. Insts., Short Term Lending: Final Report 6 (2000); Nat’l Endowment for Fin. Educ., *The Debt Cycle: Using Payday Loans to Make Ends Meet* (2002), available at <http://www.nefe.org/pages/whitepaperpaydayloans.html> (on file with the *Columbia Law Review*); Office of the Comm’r of Banks, Report of the Commissioner of Banks to the North Carolina General Assembly on the Subject of Payday Lending 5 (2001), available at <http://www.nccob.com/NR/rdonlyres/2A95D7DA-75C0-49F3-B896-CAC45D947727/0/CheckCashersReporttoGenAssembly.pdf> (on file with the *Columbia Law Review*); Creola Johnson, Payday Loans: Shrewd Business or Predatory Lending?, 87 Minn. L. Rev. 1, 58 (2002); Chris Peterson, Comment, Failed Markets, Failing Government, or Both? Learning from the Unintended Consequences of Utah Consumer Credit Law on Vulnerable Debtors, 2001 Utah L. Rev. 543, 558 & nn.100–103.

57. 509 S.E.2d 87, 89 (Ga. Ct. App. 1998).

58. *Id.* In addition to abusing the State’s “bad check” laws, the Watsons were also convicted of extortion by threats of violence, several counts of arson, and unlawful possession of a submachine gun. *Id.* at 89 n.1.

59. *Id.* at 89.

item of nominal value, such as a jar of dirt or a Bic lighter, would also be given to the Watsons as ‘pledged goods’ pursuant to the pawnbroker regulatory scheme” and presumably to justify the storage fee.⁶⁰ Customers with insufficient funds in their checking accounts soon learned that if they did not roll over the loan, “the Watsons would swear out a warrant for the customer’s arrest [T]o avoid arrest and prosecution . . . the customer would go to the Columbus Government Center in order to pay the check amount, plus fines and court costs.”⁶¹

As extreme as the behavior of James and Brenda Watson may be, it is hardly an isolated practice. One study has recently reported that “[p]ayday lenders filed over 13,000 criminal charges with law enforcement officials against their customers in just one Dallas, Texas precinct in one year.”⁶² The appeal to criminal enforcement is a pervasive and salient threat used by many payday lenders to encourage repayment. The effect of this threat is to weaken these lenders’ reliance on traditional measures of creditworthiness, which lowers the value of such measures for all lenders. The next Part formally demonstrates this mechanism and how it may be countered.

III. ANALYTICAL FRAMEWORK

The following description of a representative consumer is offered to motivate the more formal analysis in the Appendix and the simple model below. The consumer is paid twice monthly, on the first and the fifteenth of the month. She earns \$400 after taxes each pay period. Her first paycheck each month is completely exhausted by her housing expenses and utilities, which are due at the beginning of the month. She thus has no income left for other expenses (such as those related to food, transportation, and child care) during the first half of the month. She will, however, receive an additional \$400 from her mid-month paycheck for the second half of the month. Rather than fasting during the first half of the month and feasting during the second half, our representative consumer reasonably prefers to smooth her consumption over the month. To facilitate this smoothing, assume that the consumer wishes to borrow \$200 for a two-week period at the beginning of each month, which she promises to repay once she receives her second paycheck. Also assume that she is unable to save across periods and that she has no other assets.⁶³

60. *Id.*

61. *Id.* at 90.

62. Drysdale & Keest, *supra* note 55, at 610.

63. The assumption that the consumer cannot save is crucial for the model and therefore worthy of some justification. The poor in many communities clearly do not have savings vehicles available to them. On the other hand, even some extremely disadvantaged communities have well-developed informal savings mechanisms. Yet despite these informal mechanisms, it is noncontroversial to assert that savings portfolios for poor racial minorities are limited. Some would claim, I think wrongly, that preferences, and not

A. *Simple Model of Fringe Credit Externality*

With the description above in mind, imagine a single competitive credit market that offers only unsecured loans at interest rate r . Lenders in this market will not lend to anyone who has defaulted on a prior loan. In deciding whether to grant a loan to a consumer, each lender must assess the chances of repayment by evaluating the consumer's options when the loan is due. If the consumer defaults on the loan, she gets to keep all of her mid-month paycheck. However, she will not be able to borrow from conventional lenders in the future. Her payoff from defaulting may be written as $\$400 + V(0,r)$, where $V(0,r)$ is the discounted present value of being restricted to loans of zero dollars at interest rate r for the indefinite future. If the consumer repays the loan when it is due, then her payoff will include her $\$400$ salary minus the amount of the loan with interest (i.e., $\$200(1+r)$), plus the discounted present value of being able to borrow $\$200$ at interest rate r for the indefinite future. The lender will therefore lend the consumer $\$200$ only if the consumer's payoff from repaying the loan is greater than her payoff from defaulting on the loan:

$$\underbrace{400 - 200(1+r) + V(200,r)}_{\text{repayment payoff}} > \underbrace{400 + V(0,r)}_{\text{default payoff}} \quad (1)$$

Call the satisfaction of inequality 1 (above) the "repayment requirement," which may be rewritten as

$$V(200,r) > 200(1+r), \quad (2)$$

where for notational ease $V(0,r)$ is set equal to zero. When the lender's assessment of the consumer's payoff from repayment (i.e., $V(200,r)$) is greater than her payoff from default (i.e., $200(1+r)$), then the loan will be offered; otherwise it will not.

Imagine now that there is also a competitive fringe credit market that offers highly secured loans and loans with strong repayment threats.

opportunities, account for the limited savings among poor racial minorities. There is no good evidence of race-contingent savings behavior (in part because few studies have sought to identify such behavior, and the limited available evidence points to no racial differences). The savings rate among blacks is generally lower than that of whites, but this difference largely goes away when income is taken into account. It is well established that savings rates increase with income. Still, there is some suggestion that black households exhibit more risk aversion in investment choices and that they have a shorter planning horizon than whites, which has been viewed to indicate impatience, though that is clearly not necessarily the case. The data supporting this suggestion, however, make the claim very speculative. See John Karl Scholz & Kara Levine, U.S. Black-White Wealth Inequality: A Survey 26 (June 9, 2003) (unpublished manuscript, on file with the *Columbia Law Review*). A less stringent claim of limited savings possibilities (as opposed to the more extreme assumption of no savings options) is all that is needed for the model, but I make the extreme assumption of no savings for mathematical convenience.

Fringe creditors in this model are significantly more assured of repayment (compared to conventional creditors), but this assurance costs them more so they must charge more for their loans. Hence the competitive interest rate in the fringe market (r_f) is greater than the competitive interest rate in the conventional market (i.e., $r_f > r$). Importantly, consumers do default with positive probability on their fringe loans (driven, for example, by job layoffs, unexpected medical or other bills, time-inconsistent preferences, or high discount rates), but fringe creditors can optimize and make up for these defaults with their higher fees, secured interests, and strong repayment threats.⁶⁴ Note that in the model, as well as in practice, conventional lenders do not necessarily have an incentive to offer the higher priced fringe loans. The model treats both fringe and conventional markets as competitive, thereby leaving no supracompetitive rents for lenders to appropriate in either market. In practice, conventional lenders limit their participation in fringe markets because the reporting requirements and other regulations that they face set them at a competitive disadvantage with respect to smaller lenders.⁶⁵

64. I say “optimize,” rather than “minimize,” defaults because in practice, fringe creditors maximize their profits by including an expectation of defaults. In some cases, an initial default triggers more fees that (if eventually paid) will make the creditor better off. See, e.g., Oren Bar-Gill, *Seduction by Plastic*, 98 Nw. U. L. Rev. 1373, 1393–94 (2004). Notwithstanding the eventual payoff of an initial default, payday lenders might even advise their employees that if they are not making loans that sometimes lead to defaults they are being too conservative: They are not making enough loans. That is, there is an optimal default rate for payday lenders, which is generally not zero. Joseph Frost, *Research Memorandum on Payday Lending* 6 n.18, 21 (May 1, 2003) (unpublished manuscript, on file with the *Columbia Law Review*).

65. Conventional lenders have significant reporting and processing requirements imposed by the Office of the Comptroller of the Currency (OCC). It costs each lender a small, but not trivial, amount of money to process every loan it makes. Frost, *supra* note 64, at 42. While not significant for larger loans, this reduces the profitability of small loans, like those issued by payday lenders. This can be observed if one compares states that impose usury limits on payday loans with those that impose no limits. *Id.* at 32–47. Ironically, in those states that set a maximum APR on payday lenders, the average APR was greater than in states without limits. The logic behind this perverse outcome is the following: States that imposed limits reduced competition among payday lenders (with many of them simply going out of business). Some local lenders then formed alliances with national banks similar to the relationship described in *Jenkins v. First American Cash Advance of Georgia, LLC*, 400 F.3d 868, 871 (11th Cir. 2005). Since national banks are not bound by state usury limits, these alliances were able to charge higher rates of interest (under the exportation model), and there were fewer competitive forces to keep them in check since the number of payday lenders in those jurisdictions was reduced by the usury cap. At first glance it may appear that these national alliances were engaged in price gouging, but closer inspection reveals that many of them were charging higher rates just to offset the expense of processing the loans. Whereas before, an independent payday lender could make the decision on the spot, under the national alliances, there were faxes back and forth, as well as copying and documenting the transaction to satisfy the OCC. It was just more expensive to make the loan. Frost, *supra* note 64, at 43–47. There are two other reasons why conventional lenders do not offer fringe loans. First, some care about their reputations and do not want to be associated with that industry. Second, the OCC has been putting pressure on the 2,600 national banks not to engage in fringe transactions and

To see the consequence of the fringe market presence, consider again the conventional lender's assessment of the chances of repayment by the consumer when the conventional loan is due. If the consumer defaults on the loan, she keeps all of her mid-month paycheck. The default will, however, prevent her from receiving future loans in the conventional market, but she will still be able to borrow in the fringe market since her default history does not matter there. The repayment requirement is now:

$$V(200,r) - V(200,r_f) > 200(1+r) \quad (3)$$

Comparing inequality (2) (without the fringe market) and inequality (3) (with the fringe market), it is clear that the consumer's repayment payoff is reduced when fringe credit is available.⁶⁶ The consumer's implicit punishment for defaulting on her conventional loan is weakened by the presence of fringe lenders, who do not agree to avoid lending to consumers with default histories. Conventional lenders, therefore, are less willing to offer loans to the consumer in this environment. As the formal model in the Appendix demonstrates, it is not the case that the conventional lenders will necessarily not lend to consumers; conventional lenders are simply willing to lend less than they would otherwise.⁶⁷

The existence of the fringe credit market reduces conventional creditors' incentive to lend. The economic incentive for consumers to repay conventional loans decreases because the repayment threat—the implicit agreement of no future loans from all conventional lenders in the event of default—is less effective when borrowers have credit options that are not tied to past repayment behavior. In this way, fringe creditors undermine consumers' reputation for repayment (being trustworthy), where reputation (trustworthiness) is understood in the stylized manner reflected in the repayment requirement. This form of trustworthiness is what Russell Hardin calls “encapsulated,” where one party trusts a second party because the first knows that it is in the economic interest of the second party to act in a trustworthy manner with respect to the first.⁶⁸ Avner Greif similarly characterized this economic incentive—as opposed to an ethical or social motive—to develop a reputation of honesty in his

to limit alliances with fringe lenders. Finally, it is important to point out that some conventional lenders, such as CitiFinancial, have been engaged in fringe transactions. Beckett, *supra* note 39; cf. Ebonya Washington, *The Impact of Banking and Fringe Banking Regulation on the Number of Unbanked Americans*, 41 *J. Hum. Resources* 106, 125–29 (2006) (finding that state regulation of fees charged by check cashers and banks increased access to low-cost banking services for low-income minority households).

66. That is, in the model conventional lenders assess the consumer's payoff from repayment (with the presence of fringe lenders) to be lower (i.e., $V(200,r) - V(200,r_f)$) while her payoff from default is unchanged.

67. This is so because the only constraint on default is the higher interest rates of the fringe lenders ($r_f - r > 0$).

68. Russell Hardin, *Trust and Trustworthiness* 3 (2002).

study of the medieval Maghribi traders.⁶⁹ This is an old and pervasive phenomenon; most credit markets could not exist without it.

The economic incentive to develop a repayment reputation for unsecured credit does not go away when fringe credit is available; rather, it becomes more acute. Since no one can be “trusted” to repay conventional loans unless the borrower is the type who can be deterred from default by the prospect of having to pay higher interest rates and fees in the fringe market, it is now in the interest of such borrowers to identify themselves as “trustworthy” in this particular manner. Borrowers can identify themselves as such by taking out and paying off smaller loans with conventional creditors, thereby developing a good credit history.⁷⁰ Borrowers can also establish themselves as trustworthy based on their fringe credit market transactions, but only if fringe creditors record and report the repayment practices of their borrowers.

Timely payoffs of fringe loans are meaningful signals of borrowers’ creditworthiness since defaults occur in that market too. Conventional creditors would be glad to have this information. Creditworthy fringe borrowers should also be eager to have their repayment behaviors reported. A good credit record is like a coupon that borrowers can take to the (conventional) bank to get a discount on their loan purchases. Fringe borrowers with poor repayment histories are not directly nor immediately hurt by credit reporting. They simply are not offered the coupon, and therefore they have to keep paying the same high prices for their loan purchases. In the long run, however, as creditworthy borrowers increasingly depart for the conventional market, the fringe credit market will have to raise its prices, which will hurt those borrowers who are ultimately unattractive to conventional lenders. Yet at the same time, higher fringe prices will help departing borrowers by widening the gap between conventional and fringe interest rates (i.e., $r_f - r$) and thereby further deterring defaults on conventional loans, which increases the willingness of conventional lenders to offer *them* loans.

But what will become of those borrowers who are stuck in the fringe market, facing even higher prices than before? While not glossing over this undesirable eventuality, we ought to think carefully about whether this cost is sufficient to discourage credit reporting by fringe lenders. Here are some countervailing considerations. First, not all creditworthy borrowers will leave the fringe market, which should moderate the increases in fringe prices. Second, and related, fringe creditors compete

69. Avner Greif, *Reputation and Coalitions in Medieval Trade: Evidence on the Maghribi Traders*, 49 *J. Econ. Hist.* 857, 858–59 (1989).

70. This is the observed pattern, for instance, among students who are offered credit cards with low limits by traditional banks. Many of these banks also offer secured credit cards, which allow students and other borrowers without established credit histories to develop repayment reputations.

with conventional lenders on many dimensions, not just interest rates.⁷¹ Fringe credit reporting will increase the competition between fringe and conventional lenders; heightened competition will force fringe lenders to offer better products, and this will benefit those customers who are stuck, as well as those who choose to remain, in the fringe market.⁷² Beyond these consolations, if one is still troubled about the likely higher rates that will be paid by poor people stuck in the fringe market, one must present a compelling argument for why other poor people should be taxed to avoid this outcome. There certainly are possible arguments,⁷³ but these arguments must be weighed against the benefits of generating good credit histories for the creditworthy borrowers. Opposing these benefits for creditworthy borrowers because it might hurt the remaining fringe borrowers is akin to arguing that if able inner-city households develop strong credit histories, then they will have greater access to mortgage financing, which will draw them out to the suburbs, leaving the inner city worse off as its strongest members depart. The argument is not implausible, but it is one-sided without addressing the benefits to those households who are given more and better options.

B. *Limits of Unconscionability*

In the four-month period from June to September 2002, Charlene Jenkins received at least eight payday loans from First American Cash Advance of Georgia.⁷⁴ In exchange for each loan, Jenkins executed a promissory note and an arbitration agreement, which a district court found to be unconscionable.⁷⁵ The case, *Jenkins v. First American Cash Advance of Georgia*, has made its way to the Supreme Court docket this term, raising *inter alia* the question of whether the plaintiff's adhesion claim went specifically to the arbitration clause or to the general loan agreement, a characterization which will determine whether the arbitrator or a federal

71. Fringe creditors often dominate conventional creditors in terms of convenience of location, a factor that will remain salient, especially as conventional lenders increasingly rely on online products, which—through the digital divide—will make conventional banks less convenient and less accessible to many fringe borrowers. Fringe creditors also offer their customers the convenience of conducting various other transactions on site. See Caskey, Fringe, *supra* note 1, at 56.

72. Of course, if fringe lenders cannot compete to keep their creditworthy customers, then the services of fringe lenders may actually degrade.

73. For example, one could argue that these individuals all live in the same community and that the slightly better-off poor have a direct responsibility for those worse-off members of their own community.

74. 400 F.3d 868, 871 (11th Cir. 2005), petition for cert. filed, 74 U.S.L.W. 3162 (U.S. Sept. 12, 2005) (No. 05-347). Actually, "First American, which is located in Georgia, managed and serviced loans for [First National Bank (FNB) of South Dakota]; however, FNB set the credit scoring criteria for the loans and funded the loans." *Id.*

75. See *id.* at 873. The Eleventh Circuit reversed the district court directly, in part, by finding that it is the arbitrator who must determine whether the loan agreement (which includes the arbitration clauses) was unconscionable. See *id.* at 876–77 (citing *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 403–06 (1967)).

court has authority to rule on the payday lender's arbitration clause.⁷⁶ But regardless of who decides, the unconscionability doctrine can serve an important function in the context of the fringe credit externality described in the last Part. Fringe creditors break down the "linkage between past conduct and a future utility stream,"⁷⁷ which discourages conventional creditors from lending to fringe customers. This linkage could be restored by prohibiting or restricting fringe credit transactions. Such a restriction may be achieved through a liberal expansion of the unconscionability doctrine, which allows courts to strike down oppressive contracts or specific terms due to procedural or substantive concerns about the agreement.⁷⁸

While perhaps a questionable independent justification for expanding unconscionability, *undermining repayment reputation* among poor consumers might be added to the long list of concerns expressed about fringe credit transactions.⁷⁹ Certainly the failure to report good credit can be an abusive practice. For instance, in the late 1990s it was discovered that commercial lenders were widely engaged in the practice of sending incomplete reports to the principal credit bureaus, presumably in an attempt to maintain a captive customer base or perhaps just out of negligence.⁸⁰ One might argue that it is unconscionable for payday lenders not to report credit payment histories to agencies, ensuring that their customers lack a "meaningful choice" of credit providers.

Placing fringe credit transactions at greater risk of being found unconscionable will allow borrowers to commit more credibly to repayment. This results because broad application of the unconscionability doctrine would constrain fringe credit transactions, leaving fewer fringe credit alternatives for borrowers and thus making conventional credit market threats more compelling. Conventional creditors, therefore, would be

76. See Petition for Writ of Certiorari, *Jenkins*, 74 U.S.L.W. 3162 (No. 05-347), 2005 WL 2275948, at *1 (asking whether Eleventh Circuit Court of Appeals erred in determining that arbitrator must decide whether to enforce arbitration clause of contract when underlying contract is found unenforceable).

77. Greif, *supra* note 69, at 858.

78. Arthur Leff first articulated the difference between procedural and substantive unconscionability. This distinction goes to the question of whether a contract is deemed unconscionable based on the way in which the contract was made or the "process of contracting"—procedural unconscionability—or the resulting contract itself—substantive unconscionability. Leff's distinctions are now widely employed by the courts. See Arthur Allen Leff, *Unconscionability and the Code—The Emperor's New Clause*, 115 U. Pa. L. Rev. 485, 487 (1967).

79. For example, the following practices among payday lenders are often characterized in the language of unconscionability by consumer advocates and courts: payday lenders' high interest rates (excessive price, substantive); the rollover payment system design (substantive and procedural); payday lenders' nonapplication of payments that are made toward the principal (substantive and procedural); inclusion of unfair clauses in payday lender contracts; and standard form contracts that might include such clauses. See generally Johnson, *supra* note 56.

80. See discussion *infra* note 105 and accompanying text.

more willing to lend to these customers, and they will in turn have more incentive to invest in developing a good credit history.

While fairness is the ostensible basis for the invocation of the unconscionability doctrine in most cases, the justification in this case is efficiency, making this a somewhat uncommon—though not unique—approach to the unconscionability doctrine.⁸¹ As a general matter, the unconscionability doctrine is properly considered inefficient. Here is the argument behind that claim: Absent duress, fraud, and other failures of the bargaining process, efficiency is not served by rescinding seemingly volitional agreements (assuming there are no externalities). If both parties were not at least as well off with the agreement (in expected terms) as without it, then at least one party would have an incentive not to enter into such an arrangement. In this way, freely chosen contractual agreements are Pareto-improving. Disregarding these contracts through unconscionability is akin to moving back to the pre-Pareto-improving position.⁸² Inefficiency results because parties will have inadequate incentive to enter into Pareto-improving agreements *ex ante*, knowing that they are unenforceable *ex post*.⁸³

The typical efficiency challenges to unconscionability assume (usually implicitly) well-functioning markets and full rationality.⁸⁴ By challenging these assumptions, a few scholars have advanced the use of unconscionability to bring about more efficient outcomes. For example, recognizing moral hazard created by the welfare state, Eric Posner has argued that unconscionability reduces inefficient risk taking.⁸⁵ Russell

81. See, e.g., Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 *U. Chi. L. Rev.* 1203, 1255–90 (2003) (explaining how unconscionability doctrine should be modified to deal with specific inefficiencies in credit transactions); Eric A. Posner, *Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract*, 24 *J. Legal Stud.* 283, 304–07 (1995) (analyzing unconscionability doctrine from perspective of efficiency and incentives).

82. Of course, after new information is revealed, one or both parties may prefer to depart from the initial agreement, and that departure may be efficient. Employing unconscionability in this manner will have *ex ante* efficiency implications.

83. Though these comments are based on allocative efficiency, similar arguments may be made concerning investment efficiency and unconscionability.

84. The assumption of adequately functioning markets does not require competitive market conditions. Even under monopoly conditions, unconscionability may undermine efficiency. See Korobkin, *supra* note 81, at 1211–16 (“Relaxing the assumption of perfect competition and instead assuming a single monopolist seller . . . does not affect the conclusions presented above: Sellers will still provide efficient terms in form contracts and buyers would be made worse off if courts were to refuse to enforce those terms.”); George L. Priest, *A Theory of the Consumer Product Warranty*, 90 *Yale L.J.* 1297, 1320–25 (1981) (noting that empirical evidence does not support theory that warranty terms are one-sided due to firms’ market power); Alan Schwartz, *A Reexamination of Nonsubstantive Unconscionability*, 63 *Va. L. Rev.* 1053, 1071–76 (1977) (arguing that there will be same quality contracts under monopoly and competition).

85. Posner, *supra* note 81, at 285 (arguing that restrictive contract doctrines like unconscionability reduce incentives for taking credit risks).

Korobkin has observed that since merchants select (often inefficient) terms to take advantage of consumers' bounded rationality, unconscionability may be employed to police resulting inefficiencies.⁸⁶ Carol Rose has hinted that loss aversion, which can erode confidence in markets, may be optimally addressed by the unconscionability doctrine. That is, since losses resonate with consumers more significantly than gains, the unconscionability doctrine may be used to cabin loss "overreaction" and nervousness about market participation.⁸⁷ A number of economists have also advocated general legal restrictions on private agreements to deal with undesirable externalities,⁸⁸ information asymmetries,⁸⁹ and credible commitment concerns; these form the basis of the present analysis.⁹⁰

86. See Korobkin, *supra* note 81, at 1207 ("By recognizing purchasers' bounded rationality as the most important root cause of inefficiency in form contracts, courts can modify their use of unconscionability analysis to increase both social welfare generally and buyer welfare specifically."). While not endorsing unconscionability in this context, Oren Bar-Gill makes a similar argument concerning salient terms. That is, being aware of behavioral biases among consumers (e.g., underestimation of future defaults), "sophisticated sellers would rationally attempt to lure consumers with low prices and attractive short-term perks, while loading their contracts with provisions that impose high costs on consumers in the event of breach." Bar-Gill, *supra* note 65, at 1433.

87. See Carol M. Rose, *Giving, Trading, Thieving, and Trusting: How and Why Gifts Become Exchanges, and (More Importantly) Vice Versa*, 44 Fla. L. Rev. 295, 309–14 (1992).

88. See, e.g., Philippe Aghion & Patrick Bolton, *Contracts as a Barrier to Entry*, 77 Am. Econ. Rev. 388, 389, 399 (1987) (describing monopolists' use of contracting to limit competitors' market entry and social cost of that limitation); Tai-Yeong Chung, *On the Social Optimality of Liquidated Damage Clauses: An Economic Analysis*, 8 J.L. Econ. & Org. 280, 281–82, 299 (1992) (arguing that contractual penalty clauses are inefficient in preventing competition with parties to contract); Paul H. Rubin, *Unenforceable Contracts: Penalty Clauses and Specific Performance*, 10 J. Legal Stud. 237, 240, 243, 246 (1981) (discussing courts' unwillingness to enforce penalty clauses and specific performance as potentially efficient means to maximize contracting parties' use of "self-enforcing" contracts).

89. See, e.g., Philippe Aghion & Benjamin Hermalin, *Legal Restrictions on Private Contracts Can Enhance Efficiency*, 6 J.L. Econ. & Org. 381, 403 (1990) (describing how restrictions on private agreements in presence of asymmetric information may limit problem of adverse selection and resulting market failures); Janusz Ordovery & Andrew Weiss, *Information and the Law: Evaluating Legal Restrictions on Competitive Contracts*, 71 Am. Econ. Rev. 399, 403–04 (1981) (suggesting that regulations using unconscionability to eliminate price variation across homogenous goods caused by imperfect information may be Pareto-improving). For the adverse selection problem, see generally George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. Econ. 488 (1970) (discussing examples of adverse selection in automobile, credit, insurance, and employment markets).

90. Economists have devoted much attention to the problem of credible commitments and contractual enforcement. See, e.g., Oliver Hart, *Firms, Contracts and Financial Structure* 2–4, 73–88 (1995) (using example to show effects of uncertainty and commitment on contract creation); Williamson, *supra* note 38, at 163–205 (examining credible commitments in both unilateral and bilateral situations); Thomas C. Schelling, *An Essay on Bargaining*, 46 Am. Econ. Rev. 281, 282–87 (1956) (arguing that bargainers conveying credible commitments have more bargaining power). The present analysis is closest to that of Garance Genicot, who demonstrated that the existence of bonded labor

A sharp tradeoff is realized by using unconscionability to undermine the fringe credit externality. On the one hand, such a restriction on fringe transactions would help low-risk borrowers get cheaper credit and provide them with stronger incentives to invest in credit history development. On the other hand, the cost of this gain is that high-risk, low-income borrowers will be prevented from engaging in transactions that both they and fringe creditors find valuable. Fringe creditors would be unwilling to lend to these high-risk borrowers because the unconscionability doctrine would undermine the enforcement of their agreements. Whereas without an expansion of unconscionability, low-risk borrowers are harmed because they are less able to commit credibly to conventional creditors, with an expansion of unconscionability, high-risk borrowers are harmed because they are less able to commit credibly to fringe creditors. Those borrowers who are considered “high risk” will have fewer credit opportunities—both from conventional creditors and the now-restricted fringe markets under the expanded unconscionability framework. Hence, while potentially efficient, the unconscionability outcome may not be very just, particularly since high-risk, low-income borrowers are in many respects those most in need of short-term credit.

Of course, as discussed above, credit reporting will also impact high-risk, low-income borrowers in potentially positive ways, but also (and maybe more likely) in some negative ways. The difference between fringe credit reporting and unconscionability in terms of their efficiency implications is ultimately a matter of degree rather than of kind. But in terms of autonomy, the two interventions are quite different in kind. One aims to increase contractual options between low-income borrowers and conventional creditors, while the other aims to limit credit transactions between low-income borrowers and fringe creditors. At this point, it is important to stress that I firmly believe that the unconscionability doctrine serves an important and useful practical purpose, particularly in the fringe market. That purpose is largely justice, not efficiency. Yet it is undeniable that welfare may sometimes be improved by constraining choice through the unconscionability doctrine or some other mechanism. The obvious worry is whether courts can recognize those times.

C. Limits of Fringe Credit Reporting

People find themselves in the fringe market for a variety of reasons. Some are there because of circumstances beyond their control; others arrive there through their own choices, which may be thoughtful and sound, or ill considered and seemingly irrational. The credit reporting intervention proposed in this Essay would preserve the fringe market for

markets and serfdom undermines laborers' access to efficient credit markets. See Garance Genicot, *Bonded Labor and Serfdom: A Paradox of Voluntary Choice*, 67 *J. Dev. Econ.* 101, 103 (2002) (“[T]he existence of bonded labor hinders the development of welfare enhancing credit opportunities for the laborers.”).

those who need or prefer it, while providing an exit option to those who are trapped by it. That, at least, is what should happen according to the model. Let us now briefly consider some of the real-world constraints on the credit reporting intervention.

Credit reporting is regulated by the Fair Credit Reporting Act (FCRA), which is enforced by the Federal Trade Commission.⁹¹ Enacted in 1970⁹² and amended (with stronger consumer protections) in 1996,⁹³ the FCRA requires that information providers refrain from giving information known to be erroneous and that they help correct errors that customers identify. Inaccuracies are not violations; the FCRA requires bureaus to use “reasonable procedures to assure maximum possible accuracy,”⁹⁴ where reasonableness is based on comparing the costs and benefits of accuracy.⁹⁵ The Act also includes various measures that encourage consumers to correct errors, such as limitations on costs for obtaining reports (free when the report led to an adverse decision);⁹⁶ obligations for credit information users to remind customers of their rights;⁹⁷ and limits on the length of reinvestigations.⁹⁸ These measures notwithstanding, significant problems in our credit reporting system persist.

For example, in the late 1990s, commercial lenders holding roughly one-half of all consumer credit stopped reporting credit limits and high balances on at least some of their credit card accounts.⁹⁹ Hunt hypothesized that the underreporting might have been a result of the relatively “intense competition” for new credit card customers.¹⁰⁰ Pagano and Jappelli also suggested that fear of competition limits information sharing, citing evidence from the United States as well as Britain and Italy.¹⁰¹ The

91. 15 U.S.C. §§ 1681–1681x (2000 & Supp. III 2003). A very brief history of credit reporting in the United States is described in Robert M. Hunt, *The Development and Regulation of Consumer Credit Reporting in America* app. at 29–30 (Fed. Reserve Bank of Phila., Working Paper No. 02-21, 2002), available at <http://www.phil.frb.org/files/wps/2002/wp02-21.pdf> (on file with the *Columbia Law Review*).

92. Fair Credit Reporting Act, Pub. L. No. 91-508, sec. 601, §§ 601–622, 84 Stat. 1114, 1127–36 (1970) (codified as amended at 15 U.S.C. §§ 1681–1681x).

93. Consumer Credit Reporting Reform Act of 1996, Pub. L. No. 104-208, secs. 2401–2422, §§ 603–624, 110 Stat. 3009, 3009-426 to -454 (codified as amended at 15 U.S.C. §§ 1681–1681x) (amending Fair Credit Reporting Act).

94. 15 U.S.C. § 1681e(b).

95. Hunt, *supra* note 91, at 17; see also *Bryant v. TRW, Inc.*, 689 F.2d 72, 79 (6th Cir. 1982) (discussing “little added effort” it would have taken to correct inaccuracies); *Houston v. TRW Info. Servs., Inc.*, 707 F. Supp. 689, 693 (S.D.N.Y. 1989) (“Evaluating the reasonableness of an agency’s procedures involves balancing the potential harm from inaccuracy against the burden on the agency of safeguarding against such inaccuracy.” (citing *Stewart v. Credit Bureau, Inc.* 734 F.2d 47, 51 (D.C. Cir. 1984))).

96. 15 U.S.C. § 1681j(b).

97. *Id.* § 1681g.

98. *Id.* § 1681i(a)(1)(C).

99. Hunt, *supra* note 91, at 18.

100. *Id.*

101. Marco Pagano & Tullio Jappelli, *Information Sharing in Credit Markets*, 48 *J. Fin.* 1693, 1710 (1993).

leading U.S. credit bureaus responded to the strategic underreporting among creditors by threatening to limit their access to the credit reporting system.¹⁰² The threatened creditors quickly began to send more complete information.¹⁰³

It is worth noting that this threat would have been relatively weak if it were issued to fringe creditors. As discussed in this Part, fringe creditors rely significantly less on credit histories than do conventional creditors. While some payday lenders do participate in a specialized credit reporting system called “Teletrack,” which tracks consumers’ use of member payday institutions,¹⁰⁴ the threat of being dropped from the Teletrack system would have a limited impact on many fringe lenders. Heightened scrutiny of credit reporting by fringe lenders may be required, given their incentive to distort and their immunity from private sanctions. Furthermore, even without an incentive to distort, credit scoring by the big national agencies has been characterized by significant inconsistencies and errors,¹⁰⁵ and consumers in the fringe credit market may be the least able to discover and correct errors when they occur.

Assuming that strategic reporting, inconsistencies, and errors are minimized—substantial assumptions to be sure—fringe credit reporting poses other concerns. The increased costs of tracking, maintaining, and reporting repayment behavior are direct expenses that must be shouldered by fringe creditors, their consumers, third parties, or some combination of these actors. These actors may also face other indirect costs because credit histories are used in a variety of noncredit transactions. Insurance companies, for example, are increasingly using informa-

102. Hunt, *supra* note 91, at 18.

103. *Id.*

104. See Schaaf, *supra* note 53, at 352 (describing use of Teletrack by North Carolina payday lenders). The Teletrack data are not part of the larger shared information the credit bureaus and conventional creditors use. The disincentive of payday lenders to share this information outside of their network is obvious: They would lose their best customers to conventional lenders that offer lower rates. There also exist other smaller bureaus that serve niche markets: Personal finance companies participate in lenders’ exchanges that maintain records of those who get credit from their members. Examples are a medical credit bureau serving mainly doctors and dentists, automated bureaus serving retailers who accept personal checks and banks evaluating customers opening checking accounts, and a bureau for telephone companies. Hunt, *supra* note 91, at 12.

105. Credit scores from the three national reporting agencies “can vary substantially regardless of whether the individual had a generally good or bad credit history, and, as a consequence, ‘millions of consumers are at risk of being penalized by inaccurate . . . credit scores.’” Robert B. Avery et al., *Credit Information Reporting and the Practical Implications of Inaccurate or Missing Information in Underwriting Decisions 5–6* (Joint Ctr. for Hous. Stud., Harvard Univ., Working Paper No. BABC 04-11, 2004), available at http://www.jchs.harvard.edu/publications/finance/babc/babc_04-11.pdf (on file with the *Columbia Law Review*) (quoting Consumer Fed’n of Am. & Nat’l Credit Reporting Ass’n, *Credit Score Accuracy and Implications for Consumers 36* (2002), available at <http://www.ncrainc.org/documents/CFA%20NCRA%20Credit%20Score%20Report.pdf> (on file with the *Columbia Law Review*)).

tion contained in credit reports to determine premiums.¹⁰⁶ It is worth emphasizing that these insurers are using credit reports to evaluate insurance loss potential—not creditworthiness. They do not, for instance, consider the insured’s income or occupation data available in the credit report. Rather, they look at factors such as the length of the credit history, the types of credit accounts held, bankruptcies, judgments, collections, and delinquencies. Individuals with stronger credit records with regard to these factors are offered lower insurance premiums, while those with weaker records face higher premiums. Therefore, mandatory credit reporting of fringe transactions will raise the costs of insurance for some (while lowering it for others).

On the whole, whether mandatory credit reporting is desirable depends on many factors, including the likelihood of defaults among the fringe consumer population and whether these defaults are involuntary. That is, assume (reasonably) that low-income consumers are simply more likely to have income flow interruptions, leading to negative marks on their credit records. These consumers may prefer to avoid the credit rating system. To illustrate why, consider the insurance premium effect described above, where insurance firms charge higher rates to their customers with short or no credit histories, few elite credit accounts, and delinquencies. Imagine that there are three discrete rates associated with credit categories of consumers: bad credit (\$120 premium), no credit (\$100 premium), and good credit (\$90 premium). Further, imagine that due to interruptions in their income flows, there is a fifty percent chance (beyond the consumers’ control) that there will be a delinquency noted each period (e.g., month or year) on their credit record. Thus, by choosing to avoid the credit rating system, a representative fringe customer has an expected insurance premium of \$100, whereas if the customer has a credit history, then the expected premium is \$105 (that is, \$120 (50%) + \$90 (50%)). This customer would be made worse off with respect to insurance premiums as a result of forced reporting.

The possibility of interruptions in income flow may also discourage otherwise creditworthy fringe consumers from leaving the fringe market. For many—but not all—fringe transactions, the costs of default are fixed, which provides fringe credit consumers with a form of insurance against unexpected costs associated with disruptions in income. The minimizing costs of default may be more important than minimizing interest payments (while in compliance) for individuals who are most likely to default, namely those living paycheck to paycheck. Note that while many fringe credit institutions allow for this type of hedging (e.g., pawnshops and rent-to-own stores), payday loan outlets do not.

106. See ConsumerAffairs.Com, Insurance Companies Scrutinizing Customers’ Credit Reports (June 18, 2002), at http://www.consumeraffairs.com/news02/ins_credit.html (on file with the *Columbia Law Review*).

Even if they have steady and predictable income streams, creditworthy low-income consumers might also rationally choose avoidance of the credit rating system. The key here is that fringe creditors compete with banks and each other on prices and a number of other terms, such as service and convenience. If some customers are drawn away from fringe institutions, then the capacity of these institutions may shrink to the point of offering fewer services and maintaining fewer outlets. This might leave some creditworthy consumers worse off: those consumers who preferred the prior pooled equilibrium fringe package (i.e., higher rates and better convenience) over either of the separated packages now available to them (e.g., lower rates and reduced convenience of "banks" or higher rates and reduced convenience of check-cashing outlets).

CONCLUSION

Credit reporting and scoring of fringe transactions could benefit millions of low-income Americans looking for nothing more than a chance to finance a home, a car, or an education for their children at the same low rates that the middle class has appreciated for many years. Fringe credit reporting would also serve to undermine racial profiling in credit transactions and would substantially improve borrowing opportunities for African Americans and other minorities. At the same time, such a program is not costless. Tracking, maintaining, and reporting repayment behavior are direct expenses that fringe creditors will pass on (at least in part) to their consumers. The costs that are not passed on to consumers will be absorbed by fringe creditors, which will have a constraining effect on the number of fringe creditors and the services they offer. Those consumers who prefer fringe creditors for their convenience (as well as those who are too risky for conventional creditors) will therefore be worse off. Beyond convenience, some creditworthy fringe borrowers may prefer fringe credit as a means of hedging against catastrophic loss. A low-income consumer living paycheck to paycheck may be more interested in minimizing the costs of default (e.g., having the television repossessed by the rent-to-own outlet) than in minimizing interest payments using a credit card and facing escalating fees and other financial penalties that can often follow such catastrophic events as a job loss, necessary car repair, or medical injury. These consumers who rationally hedge using fringe markets may not welcome the constraining effect of credit reporting on fringe credit transactions.

Even if these concerns are managed, there would undoubtedly be those who would question the value of fringe reporting. A skeptic might ask, why would conventional creditors pay attention to repayment histories based on severe threats, such as repossession of rent-to-own items or criminal sanctions under state bad check laws? Does this history really offer any information about a borrower's general creditworthiness, or just his or her responsiveness to severe threats? But conventional creditors

pay attention to mortgage payment histories based on foreclosure threats. Short of physical harm, it is difficult to imagine a threat more severe than loss of one's home.

Alternatively, the skeptic might question whether fringe borrowers would pay attention to repayment histories. This question raises a deep cynicism about the disproportionately minority fringe consumer population. For this reason, it ought to be spelled out explicitly. At its core, the question suggests that threats to damage a borrower's credit record due to late or missed payments may not necessarily discourage default in communities that do not stigmatize bad credit. As an analogy, consider criminal records. Some argue that the threat of going to prison no longer functions effectively as a deterrent to crime in black inner-city communities because going to prison has become a "badge of honor."¹⁰⁷ A similar theory about oppositional culture among black students posits that black children perform poorly for fear of being called "white."¹⁰⁸

In the credit-reporting context, if bad credit is treated with ambivalence within a particular community, or even regarded as a source of pride, then the negative credit reporting threat may be less effective in ensuring compliance with the terms of the borrowing agreement.¹⁰⁹ I do

107. See Anton Antonowicz, *I Was the Stereotype*, *Mirror* (London), Aug. 22, 2005, at 6 (describing person working in community to dispel idea that prison is badge of honor); Mariano Castillo & Rhea Davis, *Neighborhood Fights Gangs in Court*, *San Antonio Express-News*, Mar. 28, 2005, at 1A (describing gang members who say "going to prison is a badge of honor"); Mimi Silbert, *Op-Ed.*, *Wrong Way to Get Tough*, *N.Y. Times*, Jan. 29, 1994, at 19 (describing how some people "dream" of being incarcerated). Such is not necessarily true, however. See, e.g., Kate Gurnett & Breea Willingham, *Prison Fashions Popular Lineup*, *Times Union* (Albany, N.Y.), Feb. 15, 2005, at B1 (describing rapper who launched line of prison-inspired clothing as saying that prison is not badge of honor).

108. The theory that black children fear that if they excel in school they will be labeled as "acting white," and therefore underperform in the classroom, was first advanced in a 1986 study in a Washington, D.C. high school. See "Acting White": Is It the Silent Killer of the Educational Aspirations of Inner-City Blacks?, 17 *J. Blacks Higher Educ.* 93, 93 (1997). More recent studies have found that black students' educational aspirations are as high as those of whites. *Id.* at 94. However, the theory of an "oppositional culture" among black students should not yet be rejected summarily, see Douglas B. Downey & James W. Ainsworth-Darnell, *The Search for Oppositional Culture Among Black Students*, 67 *Am. Soc. Rev.* 156, 156 (2002), but rather current data supporting the theory must be questioned, see *id.* at 161-62.

109. However, ambivalence toward debt does not seem to be contained within particular communities, but is instead society-wide. See 151 *Cong. Rec.* S1813 (daily ed. Mar. 1, 2005) (statement of Sen. Frist) ("Bankruptcy has become so common that it has lost the stigma it had even a short generation ago."); Nathalie Martin, *The Role of History and Culture in Developing Bankruptcy and Insolvency Systems: The Perils of Legal Transplantation*, 28 *B.C. Int'l & Comp. L. Rev.* 1, 23 (2005) (noting also that despite this ambivalence, consumers still feel guilty about being unable to pay their debts). Personal guilt as a result of negative credit reporting may therefore function more effectively in deterring default than societal norms regarding acceptability of bad credit. See Phil Fiorini, *Debt More Expensive, in Case You're Not Noticing*, *J. & Courier* (Lafayette, Ind.), May 1, 2005, at 9C ("The survey by KRC Research for ACA International, the Association of Credit and Collection Professionals also showed that nearly three of four Americans

not accept the often unsupported assertion that the black community normalizes illegitimate or delinquent behaviors.¹¹⁰ But if one does, then fringe credit reporting should be embraced, not rejected. The real economic benefits of lower-cost short-term loans, greater access to mortgage financing, and other forms of advantageous credit that would accrue to reliable borrowers in the fringe market should undermine the alleged norms of delinquent credit behaviors in the larger community.

The implications of fringe credit reporting are numerous—some good, some bad. The actual reporting by fringe creditors may present serious problems, not to mention the difficult issue of who ought to pay for fringe credit reporting. Still, general fringe credit reporting could benefit millions of low-income consumers, with even potentially greater benefits accruing to low-income racial minorities. It would also undoubtedly impose costs on many others. This is a tradeoff that should be explicitly considered. It is, to be sure, largely an empirical question. This Essay has hopefully contributed some useful theoretical groundwork to support the necessary empirics.

believe it has become more acceptable the past decade for consumers not to pay their debts.”); Dan Ackman, *Are You a Good Bankrupt or a Bad Bankrupt?*, *Forbes.com*, Mar. 9, 2005, at http://www.forbes.com/home/strategies/2005/03/09/cx_da_0309topnews.html (on file with the *Columbia Law Review*) (“Bankruptcy is as American as apple pie.”). Further, young people seem to associate high credit card debt with a badge of honor, and they are still targeted by credit card companies (presumably because of their projected likelihood of repayment over time). See R. Grant Seals, *Op-Ed.*, *Credit Card Firms Don’t Do Their Homework*, *Reno Gazette-J.*, May 4, 2003, at 10C.

110. See, e.g., Dinesh D’Souza, *The End of Racism* 24 (1995) (arguing that black underclass suffers not from lack of opportunity or racism, but from “excessive reliance on government, conspiratorial paranoia about racism, a resistance to academic achievement as ‘acting white,’ a celebration of the criminal and outlaw as authentically black, and the normalization of illegitimacy and dependency”). Any pattern of delinquent credit practices in the black community must take into consideration wealth and income differences between blacks and nonblacks, historical and continuing discriminatory practices by conventional lenders against blacks, and the disincentive to develop strong credit records produced by the fringe credit-market externality.

APPENDIX

This appendix presents a more formal sketch of the claims presented in the text.¹¹¹ Its aim is to demonstrate two specific points. First, the existence (and prevalence) of the fringe credit market in low-income communities undermines the willingness of creditors to offer unsecured credit. Second, fringe credit reporting can expand the rate of unsecured credit in these communities.

A. Setup

Consider an economy with competitive credit markets and a large number of infinitely lived consumers. The relevant time periods are months, which are divided into two subperiods (which correspond to pay periods). Let δ represent the per subperiod discount rate of these consumers (implying a per period rate of δ^2). Consumers each earn $2e$ each period, but only have e available for flexible consumption: consumption of nonhousing and nonutility items. Each consumer's per-period utility from flexible consumption is defined by $U(c_1, c_2) = U(c_1) + \delta U(c_2)$, where c_i represents subperiod flexible consumption. Assume that $U(\cdot)$ is twice continuously differentiable with $U_c(\cdot) > 0$ and $U_{cc}(\cdot) < 0$. As above, the model is simplified by further assuming that consumers have no assets and that saving is not possible.

B. Fringe Credit Markets Do Not Exist

Assume, for the moment, there are no fringe creditors: Only conventional creditors who issue unsecured credit exist. Creditors can observe previous defaults by borrowers from the conventional credit market. Otherwise borrowers are indistinguishable. No conventional creditor will lend to a borrower who has a history of default. A nondefaulting consumer who borrows B each period at interest rate r from conventional creditors each period enjoys a per period utility of $U(B) + \delta U(e - B(1 + r))$, which implies a life-time discounted utility of

$$V(B, r) = \frac{1}{1 - \delta^2} \{U(B) + \delta U(e - B(1 + r))\} \quad (1)$$

Though the consumer would like to choose a loan of size $\tilde{B} = B(r)$, where $B(r)$ maximizes $V(B, r)$, the creditor will provide a loan of amount B at interest rate r only if the consumer is expected to possess the ability¹¹² and willingness to repay.¹¹³

111. The basic structure of the formal model here builds on Genicot's thoughtful analysis of bonded labor. See Genicot, supra note 90.

112. Her expected earnings must be sufficient to pay off the loan amount plus interest.

113. Paying off the loan at the end of each period must provide her with greater expected utility than defaulting.

$$e \geq B(1+r) \quad (\text{ability}) \quad (2)$$

$$U(e - B(1+r)) + \delta V(B,r) \geq U(e) + \delta V(0,r) \quad (\text{willingness}) \quad (3)$$

The term $V(0,r)$ represents the lenders' commitment to refuse to offer future loans to defaulting borrowers. Borrowers who repay continue to have access to loans. Inequality (3) can be rewritten as

$$U(e) - U(e - B(1+r)) \leq \delta [V(B,r) - V(0,r)] \quad (4)$$

where the left hand side of inequality (4) represents the borrower's gain from defaulting, while the right hand side represents the costs of default. Based on inequality (4), the lender will choose a loan amount B to ensure that the gains of defaulting are less than its costs to the borrower. Equation (1) and inequality (4) can be used to construct the willingness to repay constraint. Plugging equation (1) into inequality (4) we get the following:

$$W(B,r) \equiv U(B) - U(0) - \frac{1}{\delta} [U(e) - U(e - B(1+r))] \geq 0 \quad (5)$$

while inequality (2) can be rewritten to form the ability to repay constraint.

$$e - B(1+r) \geq 0 \quad (6)$$

The set of feasible loans, β —that is, the set of loans that the creditors would offer consumers—must satisfy both inequalities 5 and 6. The maximum loan, \hat{B} , that the bank would offer the consumer is $\hat{B} = \sup B \in \beta$. Note that \hat{B} is nondecreasing in earnings e ; that is, creditors tend to reduce the maximum loan amount when expected earnings fall and vice versa. Based on these constraints, banks have incentive to offer a loan of up to \hat{B} at interest rate r to the consumer if and only if she has never defaulted on a loan.¹¹⁴ Consumers will borrow $B^* = \min\{\tilde{B}, \hat{B}\}$ and repay B^* with interest each period.¹¹⁵

C. Fringe Credit Markets Exist

Now assume that there is a competitive fringe credit market, where consumers may receive perfectly secured loans of amount B_f (at r_f). Fringe creditors are perfectly assured of repayment, but this assurance leads to greater costs, such that $r_f > r$. To see the consequences of the fringe market, consider consumers' willingness to repay other loans. The presence of a competitive fringe credit market allows defaulting consum-

114. The interest rates are exogenously determined in the model.

115. Since $U_{cc}(\cdot) < 0$, consumers prefer to smooth their consumption over time. Consumers would like to choose the maximum they can up to \hat{B} , but are constrained by the maximum the bank will offer them, \tilde{B} . They will therefore borrow \hat{B} if $\tilde{B} > \hat{B}$ and \tilde{B} otherwise.

ers an additional alternative to $V(0,r)$, namely, borrowing from fringe creditors. Therefore, in order for consumers to repay conventional loans, the following two inequalities below must be satisfied:

$$U(e - B(1+r)) + \delta V(B,r) \geq U(e) + \delta V(0,r) \tag{7}$$

$$U(e - B(1+r)) + \delta V(B,r) \geq U(e) + \delta V(B,r_f) \tag{8}$$

where $B^f(r_f)$ is the optimal and feasible amount the consumer could borrow from the fringe market. Combining these inequalities gives us,

$$U(e - B(1+r)) + \delta V(B,r) \geq U(e) + \delta \max\{V(0,r), V(B_f,r_f)\} \tag{9}$$

Defining $\Delta = \max(V(B^f,r_f), V(0,r)) - V(0,r) \geq 0$, then inequality (9) can be expressed as

$$U(e) - U(e - B(1 + r)) \leq \delta[V(B,r) - V(0,r) - \Delta] \tag{10}$$

Hence, the willingness to repay constraint when the fringe market exists may be described as $W(B,r,r_f)$, which equals

$$U(B) - U(0) - \frac{1}{\delta} \{U(e) - U(e - B(1 + r))\} - (1 - \delta^2)\Delta \geq 0 \tag{11}$$

The last term reflects consumers' reduced incentive to repay given the additional outside value in the fringe market.

Claim: Let the feasible set of B in the conventional market be β (and $\hat{B} = \sup B \in \beta$) when the fringe market does not exist, and let it be β^f (and $\hat{B}^f = \sup B \in \beta^f$) when the fringe market exists. Then $\beta^f \subset \beta$ and $\hat{B}^f \leq \hat{B}$. That is, having the fringe market reduces the conventional creditor's incentive to lend.

Proof: Since $\Delta = \max(V(B^f,r_f), V(0,r)) - V(0,r) \geq 0$, clearly $W(B,r,r_f) \leq W(B,r)$. If some $B \in \beta^f$, it means $W(B,r,r_f) \geq 0$. Therefore, $W(B,r) \geq 0$ so that $B \in \beta$. But when $\Delta > 0$, the reverse is not true. In sum, $\beta^f \subset \beta$ and thus $\hat{B}^f \leq \hat{B}$. QED.

D. Adding Fringe Credit Reporting

Assume that with probability π borrowers are "safe" (i.e., holding steady jobs that pay e) and "risky" with probability $(1 - \pi)$ (i.e., holding jobs that pay e with likelihood p , where $0 < p < 1$, and nothing with likelihood $(1 - p)$ each pay period).¹¹⁶

It is only meaningful to consider the effect of fringe market reporting in the pooling equilibrium, where safe borrowers and risky borrowers would borrow the same amount in the conventional market, if they could. Define $R^S(B)$ to be the discounted net return for the conventional credi-

116. That is, π is the proportion of safe types in the pool of eligible borrowers (i.e., those with no history of defaults) and $(1-\pi)$ is the proportion of risky types.

tor if the borrower is of safe type and $R^R(B)$ to be the discounted expected net return for the creditor if the borrower is of the risky type. Given the willingness to repay constraints, $R^S(B) > R^R(B)$ because with probability p , the risky borrower cannot repay, and there is a net loss for the creditor.

When there is no fringe market reporting, conventional creditors would lend B to anyone without a default history, where $B \in \beta = \{B: \pi R^S(B) + (1 - \pi)R^R(B) \geq 0\}$; fringe market reporting would lead conventional creditors to lend B to anyone without default history, where $B \in \beta' = \{B: \pi R^S(B) + (1 - \pi)pR^R(B) \geq 0\}$.

The last set is derived from the fact that among the risky borrowers, proportion p are reported to have no default by fringe creditor (suppose there was only one period of history), while proportion $1 - p$ are reported to have default history. Since conventional creditors lend only to those without default histories

(i.e., proportion $\frac{\pi}{\pi + (1 - \pi)p}$ are safe, while proportion $\frac{(1 - \pi)p}{\pi + (1 - \pi)p}$

are risky), the pool of risky borrowers is reduced, and they should therefore be willing to lend more (weakly) to the current pool of borrowers.

Claim: $\beta \subset \beta'$ and thus $\hat{B} \leq \hat{B}'$. That is, having fringe reporting provides incentive for conventional creditors to lend more.

Proof: If there is a positive return from lending B to risky borrowers (i.e., $R^R(B) \geq 0$), then lending B to safe borrowers also generates a positive return (i.e., $R^S(B) > R^R(B) \geq 0$). Hence B is feasible in both cases, but when $R^R(B) < 0$ and $R^S(B) < 0$, then B is not feasible in either case. Finally, there will be cases where $R^R(B) < 0$, but $R^S(B) > 0$. In these cases $B \in \beta$ implies that $\pi R^S(B) + (1 - \pi)R^R(B) \geq 0$ so that $\pi R^S(B) + (1 - \pi)pR^R(B) > \pi R^S(B) + (1 - \pi)R^R(B) \geq 0$. Therefore $B \in \beta'$. But the reverse may not be true, which implies that $B \subset \beta'$ and therefore $\hat{B} \leq \hat{B}'$. QED.