USURY LAW, PAYDAY LOANS, AND STATUTORY SLEIGHT OF HAND: AN EMPIRICAL ANALYSIS OF AMERICAN CREDIT PRICING LIMITS

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INTRODUCTION
Throughout the history of the American republic, all but a small minority of states have capped interest rates on loans to consumers with usury law. But in the

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past twenty years, for a variety of complex historical, macroeconomic, and cultural reasons, these rules have increasingly yielded to a new, largely unregulated credit marketplace. While many different types of businesses have stepped into this breach in the edifice of consumer protection law, payday lenders have been at the financial services industry vanguard. While payday lending was virtually non-existent in 1985, by 2005 it exploded into an industry with over twenty thousand retail outlets nationwide, more than McDonalds, Burger King, Sears, J.C. Penny, and Target Stores combined. Today this industry, despite spending millions on lobbying and public relations, is at the center of an inferno of rage and public controversy.

Although usury law has always been a fertile field for legal and economic commentary, recent payday lending trends have stimulated a thoughtful new crop of law review articles. For example, empirical pieces by Créola Johnson and Paul Chessin paint a troubling picture of payday lenders systematically disregarding state consumer protection laws and intentionally manipulating borrowers into long

2 Recently, the Community Financial Services Association, a trade association of payday loan companies began a multi-million dollar public relations blitz to stem rising criticism of social fallout from their financial products. Stuart Elliott, Critics of Lending Practices Adopt a Harder Edge, N.Y. TIMES, March 6, 2007, C6; Susanne M. Schafer, Payday Loan Industry Acts to Quell Criticism: The Lender’s Trade Group Plans Changes, but Consumer Advocates and Lawmakers Remain Wary, L.A. TIMES, March 8, 2007, at 8; Sue Kirchoff, Payday Lenders Craft User Protections: Voluntary Guides Not Enough, Consumer Advocates Maintain, USA TODAY, February 22, 2007, IB.
3 Robert H. Frank, Payday Loans Are Scourge, but Should Wrath Be Aimed At the Lenders?, N.Y. TIMES, Jan. 18, 2007, C4; Carrie Teegardin, Fierce Debate Over Payday Loans, ATLANTA J. & CONST., Feb. 2, 2007, A1; Don Baylor, Loopholes Allow Loan Sharks to Prey on Hardworking Texans, SAN ANTONIO EXPRESS-NEWS, Feb. 16, 2007, 9B; Bill Graves, Legislators Try to Lasso Payday Loans, THE OREGONIAN, March 29, 2007, B1; Paul Wenske, Payday Loans—Attorney General Seeks Law Restricting Industry: Missouri Demands Reform, The Average Loan Has an Annual Interest rate of 422 Percent, KAN. CITY STAR, Feb. 17, 2007, C1. Even a short survey of the horror stories typical of press coverage of payday lending gives one a sense of the intensity of the public debate on this topic. See, e.g., Bill Graves, Loans Up the Ante for Addict Gamblers, THE OREGONIAN, March 18, 2007, A01 (metal worker and Vietnam War veteran took out 200 different loans all at interest rates of over 300% in a spiral of depression and gambling addiction); Diana B. Henriques, Seeking Quick Loans, Soldiers Race Into High-Interest Traps, N.Y. TIMES, December 7, 2004, A1 (Navy petty officer borrows $500 at 390% which then spirals into chain of loans with $4000 outstanding at interest rates as high as 650 percent); Cheryl L. Reed, The Wild, Wild West in Loans: Lax Laws Let Lenders Charge as Much as They Want While Borrowers Face Triple-Digit Interest, Bankruptcy, CHI. SUN TIMES, Aug. 15, 2004, at 20 (single mother of three borrowed a $1,000 at a 521% interest rate to deal with a financial emergency. Unable to pay the loan back quickly, interest and fees on her debt soon inflated the balance to $10,743); Melissa Wahl, Surge Puts Payday Loans Under Scrutiny: More Regulation is Called for as Customers Struggle with Interest Rates, CHI. TRIB., May 7, 2000, 1 (nurse’s decision to borrow $600 to meet her child support obligations spiraled into $10,000 of interest of over the course of two years); Paul Wenske, Payday Loans; Attorney General Seeks Law Restricting Industry: Missouri Demands Reforms; The Average Loan Has an Annual Interest Rate of 422 Percent, KANSAS CITY STAR, February 17, 2007, C1 (Wal Mart sales associate with family medical problems began borrowing to save his family home. He ended up paying $10,000 a year in interest on 12 different loans).
term debt traps. Michael Barr explored ways the government might facilitate less expensive financial services for vulnerable groups. Steven Graves and I demonstrated that in the absence of strictly enforced usury law, payday lenders cluster around military bases, targeting enlisted personnel and their families. Richard Brooks has argued that government might temper the harsh effects of payday lending by forcing or encouraging the industry to share borrower repayment information with national credit reporting agencies. Ronald Mann and Jim Hawkins have argued that government policy should drive small “Mom and Pop” payday lenders out of business, instead facilitating large payday lending companies motivated by reputational constraints. These and many other thoughtful legal pieces are only one part of similar debates raging in economic, geographic, sociological, and public advocacy literatures.

Surprisingly absent from recent discussion is careful nationwide analysis of the body of law which most directly confronts payday lending’s primary feature: high prices. In the Western intellectual tradition, usury law has historically been the foremost bulwark shielding consumers from harsh credit practices. “The oldest form of continuous commercial regulation”, usury law dates back to the earliest recorded civilizations, and continues to constrain payday lending in many American states. While usury law has generated copious legal analysis at various times in our country, the late 1960s and early 1970s being one example, the

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explosion of payday lending around the country nevertheless prompts several unanswered questions. Precisely how has our usury law changed to allow the growth of payday lending throughout the country? Why are usury laws written the way that they are? Do the changes in usury law tell us anything interesting about how law generally and consumer law in particular is made? And, can careful textual analysis of usury statutes provide useful guidance to policy makers and to the public which must ultimately pass judgment on the national debate over predatory lending? This article is the first research that systematically categorizes, analyzes, and measures state usury statutes with an eye toward answering these questions.

Accordingly, this paper presents an empirical analysis of all fifty state usury laws in two time periods: 1965 and the present. A unique data set was created based on a careful mathematical and legal analysis of each state’s usury statute. First, the study calculated the highest permissible price of a typical payday loan under each state’s usury law. These prices were then translated into an Annual Percentage Rate (APR) format following the federal Truth-in-Lending Act cost of credit disclosure guidelines. Unlike state usury laws, which use a confusing variety of methods for calculating credit prices, the Truth in Lending Act prescribes one uniform, relatively consistent measuring stick for comparing the cost of various forms of credit. Although the Truth in Lending Act requires that all creditors give loan applicants uniform federal price disclosures, it does not require that state legislatures use this federal terminology in state laws. Nevertheless, this study provides a snapshot of what terms state legislatures would have written into law if they had used the uniform federal terminology for expressing their state credit price caps. Second, this study also recorded a variety of qualitative variables relating to the nature of each state’s usury law. For example, the study developed a classification of six different basic methods of capping credit prices used by legislatures in the states and time periods studied. The study analyzed the extent to which these various qualitative variables correlated with how high a price each legislature was willing to tolerate. Finally third, this study creates a new method of measuring how misleading a state usury law is. That is, it compares how each state legislature describes its most expensive permissible payday loan, with how that loan is characterized under federal price disclosure law. It does so by suggesting a new financial concept which I label: salience distortion. For purposes of this paper, salience distortion is the difference between the Annual Percentage Rate of a usury statute’s most expensive permissible loan and the most prominent, or


11 While the concept of salience distortion is my own, the importance of salience as a feature of analysis of consumer decision making was perhaps best championed by Daniel Kahneman and Amos Tversky. See Daniel Kahneman, Maps of Bounded Rationality: Psychology for Behavioral Economists, 93 AM. ECON REV. 1449, 1468 (2003) (revised lecture accepting Nobel prize in economics) (“[T]he likelihood that the subject will detect a mis-weighting of some aspect of the information depends on the salience of cues to the relevance of that factor . . . .”) (emphasis added).
salient, number written in the statutory language limiting the price of the loan. Using this concept, the study develops a scale variable that measures the extent to which the most salient price term in any given state usury law underemphasizes or overemphasizes the true price of credit. While in this article I use salience distortion in the context of credit pricing, this new theoretical concept may prove useful to not only to consumer and commercial law scholars, but also to any scholars studying legislative misuse of numeric information. Potential future applications of this theory include environmental law, tax law, and budget analysis.

Although this article methodologically relies on the federal Truth-in-Lending Act as a tool for evaluating usury laws, the intellectual contribution of this piece is less about truth-in-lending than it is about truth-in-legislation. This article presents three empirical findings: since 1965 usury law has become more lax, more polarized, and (perhaps most interestingly) more misleading. These empirical conclusions give rise to several deeper insights. First, these findings suggest that the language in current state usury laws is not chosen because it helpfully describes some expectation of commercial behavior. Rather, legislatures have chosen the language of most current credit price caps because it sounds in an ancient moral tradition—a mythology of sorts—that roughly delineates popular perception of moral and immoral interest rates.

Second, these findings should serve as compelling evidence of the power of what behavioral economists call “framing effects”. This study demonstrates that every state that has legalized triple digit APR consumer loans to the working poor uses a small, misleading number in their legal text to do so. This suggests that political leaders understand what many traditional neo-liberal economists apparently do not. In the real world how a value is described can be much more important than the value itself. Many state legislatures use small, innocuous numbers in usury law because they are attempting to minimize the public and media outcry over their decision to legalize triple digit interest rate loans.

Finally, this article raises a surprising point about the nature of commercial regulation in a federal system. For years the financial services industry has complained about the high costs of complying with the patchwork of non-uniform consumer protection laws adopted by each state. But, variation in the degree to which credit prices are capped is not what makes state based regulation costly. Rather it is the tremendous variety and ambiguity of methodologies used by states to calculate those price caps which makes compliance difficult. Ironically, it has been credit industry lobbyists who state-by-state have built a host of exceptions (and exceptions to exceptions) into the financial methodology of usury law—all with an eye toward driving up maximum credit prices without appearing to do so—that created the high costs of non-uniformity.

Part I of this Article provides a concise background discussion of American usury law and the payday lending industry. Part II sets out the methodology of this piece, including a basic description of the financial and accounting concepts necessary to measure the effect of usury law on typical payday loans. Part III presents empirical findings. Parts IV and V analyze these findings and offer policy recommendations. Part VI briefly concludes.

12 For further elaboration of this concept, see infra note X, and accompanying text.
I. HOW MUCH IS TOO MUCH?

A. Usury Law in the American Tradition

As a nation America has historically been deeply committed to usury law. This commitment sounds in an ancient moral tradition skeptical of the advisability of high cost loans to those with limited means. The immediate forbears of American usury law were English, the Statute of Anne in particular, which capped interest rates with a simple nominal annual rate of five percent.13 English usury law was a product of a theological view of the moral limits of acceptable lending practices.14 While Charlemagne and many other early medieval papal and feudal leaders prohibited taking any interest at all, in the fifteenth and sixteenth centuries many voices in the Catholic Church settled on a five percent limit.15 And in 1461 Pope Paul II gave his tacit approval to charitable pawnshops to charge a six percent simple nominal annual rate.16 Protestant reformers, such as Martin Luther, argued more explicitly that interest rates of five to six percent were moral, and that even eight percent was permissible in some cases.17 Historians speculate that these maxima were at least in part an outgrowth of Roman civil law which at different times capped interest rates at between four and twelve percent.18

The first American usury laws grew directly out shared public consciousness and acceptance of these specific numbers handed down by their moral traditions. The first American usury law, adopted by the Massachusetts colony in 1641, predates the United States Constitution by nearly 150 years.19 That statute echoed Luther’s position, limiting rates to no more than eight percent per annum.20 While the thirteen of the original American states were divided on many legal issues, as illustrated in Table 1, they unanimously adopted usury laws capping interest rates. Early American usury laws were all written in clear terms, specifying a maximum simple nominal annual interest rate. These seminal American statutes were undiluted, trim, and perhaps even elegant in comparison to contemporary statutes which employ a variety of different types of interest rates and include a host of exceptions for various fees and different types of lenders.21

13 Act to Reduce the Rate of Interest, 12 Ann., c. 16 (1713), reprinted in Laurence M. Katz, Comment, Usury Laws and the Corporate Exception, 23 Md. L. Rev. 51, 52 & n.11 (1962).
16 Id. at 78.
17 Id. at 80.
18 Id. at 52.
19 RANSOM H. TYLER, A TREATISE ON THE LAW OF USURY, PAWNS OR PLEDGES, AND MARITIME LOANS 50 (1878). The thirteen colonies ratified the U.S. Constitution 146 years later in 1787.
20 Id.
21 For example, all early American banks accepted the limits of usury law as a matter of course. HOWARD BODENHORN, STATE BANKING IN EARLY AMERICA: A NEW ECONOMIC HISTORY 288 (2003).
Table 1. State Usury Limits at Independence.

<table>
<thead>
<tr>
<th>State</th>
<th>Max. annual rate</th>
<th>Year adopted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Connecticut</td>
<td>6%</td>
<td>1718</td>
</tr>
<tr>
<td>Delaware</td>
<td>6%</td>
<td>1759</td>
</tr>
<tr>
<td>Georgia</td>
<td>8%</td>
<td>1759</td>
</tr>
<tr>
<td>Maryland</td>
<td>6%</td>
<td>1692</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>8%</td>
<td>1641</td>
</tr>
<tr>
<td>N. Hampshire</td>
<td>6%</td>
<td>1791(^a)</td>
</tr>
<tr>
<td>N. Jersey</td>
<td>7%</td>
<td>1738</td>
</tr>
<tr>
<td>N. York</td>
<td>7%</td>
<td>1737</td>
</tr>
<tr>
<td>N. Carolina</td>
<td>6%</td>
<td>1741</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>6%</td>
<td>1700</td>
</tr>
<tr>
<td>Rhode Island</td>
<td>6%</td>
<td>1767</td>
</tr>
<tr>
<td>S. Carolina</td>
<td>8%</td>
<td>1748</td>
</tr>
<tr>
<td>Virginia</td>
<td>5%</td>
<td>1734</td>
</tr>
</tbody>
</table>

\(^a\)Loans payable in tobacco or other property were capped at 8%.

\(^b\)N. H. adopted its first usury statute after independence.

Source: Tyler on Usury (1878).

The public spirit behind these rules is perhaps best exemplified by the thinking of the America’s “first great man of letters”.\(^{22}\) In the preface to the 25\(^{th}\) Anniversary edition of Poor Richard’s Almanac Benjamin Franklin expressed the profound skepticism of the social and moral consequences of consumer over indebtedness generally accepted by Colonial America:

[T]hink what you do when, you run in debt you give to another power over your liberty. If you cannot pay at the time, you will be ashamed to see your creditor; you will be in fear when you speak to him; you will make poor, pitiful, sneaking excuses, and, by degrees, come to lose your veracity, and sink into base, downright lying; for The second vice is lying, the first is running in debt, . . . . When you have got your bargain, you may, perhaps, think little of payment; but creditors, Poor Richard tells us, have better memories than debtors; and in another place says, creditors are a superstitious sect, great observers of set days and times. The day comes round before you are aware, and the demand is made before you are prepared to satisfy it, or if you bear your debt in mind, the term which at first seemed so long will, as it lessens, appear extremely short. Time will see, to have added wings to his heels as well as shoulders. Those have a short lent, saith Poor Richard, who owe money to be paid at Easter. Then since, as he says, The borrower is a slave to the lender, and the debtor to the creditor, disdain the chain, preserve your

freedom; and maintain your independency: be industrious and free; be frugal and free.  

This deep American skepticism of consumer lending entrenched a legal commitment to limited interest rates that continued largely unabated through the end of the nineteenth century. While from time to time states experimented with eliminating usury laws, these experiments tended to be short, and regarded as failures. Collectively the early American commitment to interest rate caps with nominal annual interest rates in this range created a type of folklore, or even a mythology, of the acceptable pricing in the use of money.

American usury law entered a second phase at the beginning of the twentieth century. In the late 1800s, enforcement problems had facilitated the development of a large group of high cost lenders charging triple digit interest rates of 500% and beyond. While these businesses referred to themselves as salary lenders, they were popularly known as loansharks. Unlike the stereotypical Hollywood organized crime imagery (which came much later) turn of the century loansharks did not rely on violence or extortion. But, they did charge extremely high prices for loans with short initial durations that frequently turned into crippling long-term debts. These companies managed to profitably conduct business using a variety of legal ruses and questionable practices including confessions of judgment, developing mutually profitable relationships with magistrate judges, characterizing loans as a salary assignments, and collections through public humiliation.

Led by an exceptionally energetic social reformer named Arthur Ham, a consensus eventually emerged on a new direction for the law. Ham argued that

25 Id.
27 Perhaps fearing the power of the “loanshark” label, contemporary payday lenders have at times tried to exclusively tie the term to ethnically based organized crime syndicates. However, there is no serious historical doubt that the nation’s first loansharks, salary lenders, engaged in essentially the same business model as today’s payday lenders. Payday lenders are loansharks in the most historically correct sense of that word. See LENDOL CALDER, FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT 49-52 (1999); Michelman, *supra* note X, at 112-129; LOUIS N. ROBINSON & MAUDE E. STEARNS, TEN THOUSAND SMALL LOANS: FACTS ABOUT BORROWERS IN 109 CITIES IN 17 STATES 11 (1930); CLARENCE W. WASSAM, THE SALARY LOAN BUSINESS IN NEW YORK CITY 26 (1908); Mark H. Haller & John V. Alviti, Loansharking in American Cities: Historical Analysis of a Marginal Enterprise, 21 AM. J. LEGAL HIST. 125, 133-34 (1977); Peter R. Shergold, The Loanshark: The Small Loan Business in Early Twentieth-Century Pittsburgh, 45 PENN. HIST. 200, 202 (1978).
28 Haller & Alviti, *supra* note X, at 133-34.
29 Id.
the best course for reform would be to raise the old traditional usury limits to a point where more mainstream financial institutions could profitably lend small amounts to working class borrowers. Working with the Russell-Sage foundation, a powerful and well-funded charitable organization funded by the widow of an industrial baron, Ham drafted a model law which most American states eventually adopted in the early part of the twentieth century.

The Russell-Sage Foundation’s model Small Loan Law required consumer lenders to obtain licenses from state governments. In exchange, states gave these licensed lenders special exceptions to the older usury laws (which generally remained on the books) authorizing interest rates of between two and four percent per month, or, between 24 and 42 percent per annum. Competition from mainstream lenders operating under these higher caps, along with aggressive enforcement by courts and state regulators, managed to stamp out salary lending throughout most of the mid-twentieth century.

While the new more moderate usury limits contained in the Russell-Sage-inspired Small Loan Laws undoubtedly legalized many mutually beneficial transactions, they also diluted the traditionally sparing American perspective on usury law. Once states made an exception to the traditional theologically inspired general usury laws, finding a backstop against further creditor encouraged deregulation proved difficult. In the mid-twentieth century each state began to chart its own course, creating exceptions to the traditional usury laws for a variety of types of lenders and in a variety of ways. Nevertheless, despite these changes, through the Vietnam-War era every state in the union retained an interest rate cap more or less intellectually indebted to the Ham-era reforms. During all but the last years of the twentieth century, usury limits were the accepted norm in American consumer protection law.

The third, and still current, period in American usury law began in 1978 with the Supreme Court’s decision in Marquette National Bank v. First of Omaha Service Corp. In this landmark case the Court confronted for the first time the question of what state usury law applies when a national bank lends money to a consumer across state lines: the bank’s home state law or the consumer’s home state law? 33

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32 Michelson, supra note X, at 116-17.
33 Calder, supra note X, at 124-135, 143; Roger S. Barrett, Compilation of Consumer Finance Laws and of Usury, Sales Finance and Allied Laws xiii (1952). Many of the states that did not use the Russell Sage Foundation model law relied on statutes that legalized “Morris Plan” lending, which facilitated higher real prices by using an add-on interest rate, rather than traditional simple actuarial interest rates. Evans Clark, Financing the Consumer 69 (1930); Charles O. Hardy et al., Consumer Credit and Its Uses 32 (1938); Peter W. Herzog, The Morris Plan of Industrial Banking passim (1928); National Consumer Law Center, The Cost of Credit: Regulation and Legal Challenges 39 (1995).
34 Barrett, supra note X, at 677.
35 National Consumer Law Center, Cost of Credit, supra note X, at §2.2.2, 2.3.3.2
36 Id. at § 2.5.
37 Peterson, Truth, Understanding, and High-Cost Consumer Credit, supra note X, at 862-63.
38 For further discussion on this point see infra Part IV surveying usury laws from 1965.
state law?\(^{40}\) In a historically dubious interpretation of the Civil-War era National Bank Act of 1864, the Supreme Court concluded that the bank’s home state law applies.\(^{41}\) This seemingly innocuous holding was a gunshot starting a frenzied race-to-the-bottom in American usury law.\(^{42}\) Recognizing the opportunity to attract lucrative financial services jobs to their moribund economies, South Dakota and Delaware eliminated their ancient usury laws, allowing national banks headquartered there to “export” the non-existence of an interest rate cap to consumers in other states.

State chartered banks were aghast at their national bank competitors’ newfound power and immediately began lobbying Congress for equal treatment.\(^{43}\) Two years later Congress complied. But instead of explicitly preempting usury limits, Congress finessed the issue by granting state banks whatever power already held by national banks.\(^{44}\) State legislatures, who were now powerless to constrain the interest rates charged by any bank headquartered in South Dakota or Delaware, capitulated. Seeing no point in punishing local businesses, every other state in the union passed “parity laws” granting their own local banks the right to charge whatever interest rate South Dakota and Delaware banks could import into their jurisdictions via federal law.\(^{45}\) The end result was what James White called a *trompe l’oleil*—a grand illusion.\(^{46}\) Every state in the union, save two, had relatively aggressive usury law on the books. And yet, even though no legislature had ever passed a law saying as much, the new synthesized usury rule became: any bank can charge any interest rate it wants anywhere it wants.

### B. Quick Cash: Payday Lending and its Critics

\(^{40}\) *Marquette*, 439 U.S. at 310-12.

\(^{41}\) *Id.* See also National Consumer Law Center, *Cost of Credit supra* note X, at § 3.4.5.1.1 (questioning historical accuracy of *Marquette*); Bray Hammond, *Banks and Politics in America from the Revolution to the Civil War* 724 (1957).


\(^{44}\) 12 U.S.C. §§ 1831d(a), 1463(g), 1831(b). See also FDIC General Counsel Opinion No. 10, 63 FED. REG. 19258 (Apr. 17 1998) (interpreting section 521 of the Depository Institutions Deregulation and Monetary Control Act to give state chartered, federally insured banks the same interest rate exporting powers as those granted to national banks under Section 85 of the National Bank Act).


While *Marquette* and its progeny deregulated interest rates chargeable by banks, they did not necessarily do so for non-depository financial institutions. State usury laws, where they remained on the books, did continue to constrain ordinary businesses. Thus, the personal finance companies licensed under state small loan laws still had to comply with those interest rate caps. Yet, in the 1980s the moral authority of those rules became somewhat suspect. Why should banks be allowed to charge any interest rate while other businesses could not? This, along with relatively high prevailing market interest rates brought about by rampant inflation, gave critics of what usury law remained in force ample ammunition to continue battering state usury laws. Emboldened by this new regulatory environment, salary-assignment loan sharks, now using the more colloquial appellation of “payday lender”, reappeared. Since the Federal Trade Commission has declared loans in the form of a salary assignment illegal, payday lenders required a slight variation in contractual formalities. Post-dating personal checks for the anticipated duration of a loan was a convenient substitute.

A contemporary payday loan usually involves an initial balance of between $100 and $500 with $325 being typical. Generally the consumer borrows by writing a personal check to the lender for the loan amount plus an additional fee. While there is no agreed upon source of information for payday loans, the Center for Responsible Lending estimates a typical charge of $52.00 for a $325.00 loan. The borrower “post-dates” the check by writing the due date of the loan one or two weeks in the future, rather than the day on which the consumer actually writes the check. An initial duration of fourteen days is the industry norm. Payday lenders generally do not obtain the borrower’s credit history from one of three national credit reporting companies, nor do they generally report the borrower’s repayment history later on. Instead, payday lenders verify the debtor’s identity by asking for documents or identification such as a driver’s license, recent pay stubs, bank statements, car registration, or telephone bills. Most lenders also call borrowers’ employers to verify a source of income. After the paperwork is complete, the debtor walks away with the loan principal in cash or a check drawn on the lender’s account. When the duration of the loan has expired, the lender is repaid by depositing the borrower’s check. If the debtor lacks the funds to cover the obligation, most lenders will allow her to pay another $52.00 fee in exchange for holding the check another two weeks. If the borrower does nothing, and her check does not clear, most lenders charge an insufficient funds penalty in addition to

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47 16 C.F.R. 444.2(a)(3).
49 Many lenders, including especially internet payday lenders, now obtain consent to debit the borrower’s back account with an ACH transfer, rather than using a check. Mann & Hawkins, supra note X, at 7; Michael S. Barr, Banking the Poor, 21 YALE J. ON REG. 121, 149 (2004).
51 Brooks, supra note X, at 1007.
52 Fox, supra note X, at 989.
accessing another $52.00 charge every two weeks. Assuming a 14-day loan duration, the nominal annual simple interest rate of this prototypical loan is about 417%.\(^{54}\)

Critics of payday lending allege that loans with triple digit nominal annual interest rates by their nature often develop into inescapable debt traps. Generally speaking, a high risk debtor lacking $325.00 of liquid assets on any given day is reasonably unlikely to have $377.00 two weeks later. Studies by industry sponsored think tanks,\(^{55}\) federal regulators,\(^{56}\) state regulators,\(^{57}\) private contractors hired by state governments,\(^{58}\) consumer advocacy organizations,\(^{59}\) and academics\(^{60}\)

\(^{54}\) Office of the Comptroller of the Currency, APRWIN v. 6.0.0. This rate does not include the insufficient funds fee.

\(^{55}\) Gregory Elliehausen and Edward C. Lawrence, Georgetown University McDonough School of Business Credit Research Center, Payday Advance Credit in America: An Analysis of Demand (2001) 39 (about 40 percent of borrowers rolled over more than five times in preceding year, about 20 percent of borrowers who renewed existing loans nine times or more, 10 percent renewed 14 times or more).


\(^{57}\) Report of the Uniform Consumer Credit Code Rev. Comm. And Action of the Colorado Commission on Consumer Credit 16 (Nov. 4, 1999) (reporting instances of as many as thirteen or more refinances); Chessin, Borrowing from Peter to Pay Paul: A Statistical Analysis of Colorado’s Deferred Deposit Loan Act, 83 DENVER U. L. REV. 387 (2005) (discussing official Colorado statistics); Ill. Dept. of Fin. Inst., Short Term Lending: Final Report 30 (1999) (average payday loan customer borrows thirteen times per year and remains indebted for at least six months); Indiana Department of Financial Institutions, Summary of Payday Lender Examination, 1–2 (77% of payday loans are extensions of previously existing contracts); Survey Iowa Division of Banking (2000) (finding an average of 12.8 loans per customer per year); North Carolina Office of the Commissioner of Banks, Report to the General Assembly on Payday Lending, (87% of borrowers roll over payday loans more than once with each individual lender); Washington State Department of Financial Institution, Payday Lending Report 3 (2003) (over thirty percent of borrowers borrow more than ten times per year, almost ten percent borrow twenty times or more per year).


\(^{59}\) Jean Ann Fox and Ed Mierzwinski, Consumer Federation of America & U.S. Public Interest Research Group, Show Me the Money: A Survey of Payday Lenders and Review of Payday Lender Lobbying in State Legislatures 8 (2000); Oregon State Public Interest Research Group, Preying on Portlanders: Payday Lending in the City of Portland (2005) (three out of four payday loan borrowers are unable to pay their loan when it comes due).

\(^{60}\) Johnson, supra note X, at 55-76; Michael A. Stegman & Robert Faris, Payday Lending a Business Model that Encourages Chronic Borrowing, 17 ECON. DEV. Q. 8 (2003).
universally agree that payday borrowers tend to fall into reoccurring debt patterns. Payday loans are not short term debts. Looking past the boilerplate terms written on loan contracts, it is economically more accurate to think of payday loans medium term debts with modest prepayment rates.

Critics of payday lending also allege that those most likely to be caught in debt traps are members of vulnerable groups who can least afford triple digit interest rate pricing. Empirical evidence suggests that black families are five times more likely than whites to take out multiple payday loans.\(^\text{61}\) Payday lenders disproportionately set up locations in poor and minority neighborhoods.\(^\text{62}\) And, payday lenders systematically cluster around military bases with large populations of enlisted personnel.\(^\text{63}\)

Despite targeting a clientele of limited means, payday lending has proven wildly profitable. The evidence suggests that payday lending profits come disproportionately from repeat borrowers.\(^\text{64}\) By one estimate, approximately 90\% of payday lending revenues are based on fees stripped from trapped borrowers.\(^\text{65}\) After only a few extensions of the original loan principal, a borrower can find that she has repaid more than the original balance but still owes the same principal.\(^\text{66}\) The best available nationwide estimate suggests that the average payday loan borrower repays $793.00 for a $325.00 loan.\(^\text{67}\) Industry observers estimate that, even after charge offs, most payday lenders earn a return on assets between ten and twenty times greater than traditional banks.\(^\text{68}\) Responding to these returns, capital


\(^{62}\) Steven M. Graves, \textit{Landscapes of Predation, Landscapes of Neglect: A Location Analysis of Payday Lenders and Banks}, 55 PROF. GEOGRAPHER 303, 312 (2003) (payday lenders disproportionately located in poor and non-white Illinois and Louisiana communities); Anthony Kolb, North Carolina Center for Community Capitalism, Special Analysis of Bank and Check Cashing Locations in Charlotte, N.C. (1999) (four times as many check cashing offices in Charlotte neighborhoods with 70 percent or greater minority populations than in neighborhoods with 10 percent or less minorities).

\(^{63}\) Graves & Peterson, \textit{Predatory Lending and the Military}, supra note X, at 822 (in twelve of the nineteen surveyed states the highest per capita concentration of payday lenders was in a military county).

\(^{64}\) Peter Skillern, Community Reinvestment Association of North Carolina, Small Loans, Big Bucks: An Analysis of the Payday Lending Industry in North Carolina 4 (2002) (finding that 3\% of customers who borrow 25 times or more per year generate 10\% of industry revenue, while 16\% of customers who borrow once per year generated less than 2\% of revenue; borrowers using payday loans five times per year or more account for 85\% of total transactions).


\(^{67}\) King, et al., supra note X, at 8.

has flooded into the payday lending industry transforming financial services offered to lower and middle class borrowers in little more than a decade. In the early 1990s, payday lending was a small peripheral component of the financial services industry with only a few hundred locations nationwide. Today, payday lending is no longer a “fringe” business.69 Between 2000 and 2004 alone, the number of payday lender locations more than doubled from 10,000 to 22,000.70 Investment analysts predict that absent government intervention, this number will nearly double again, growing upwards of 40,000 by 2011.71

A background discussion of the current state of usury law and payday lending demands one additional point. In late 2006 Congress for the first time broke its long silence on the propriety of consumer credit pricing, albeit for a special subset of the population. Recognizing the troubling implications of payday lenders clustering around military installations, Congress adopted a 36 percent interest rate cap on loans to all military personnel and their dependents.72 In hearings preceding passage of the statute Congress pointed to research identifying this pattern.73 Unlike state legislatures, Congress has the power to cap interest rates for both banks and non-depository lenders alike. In passing the 36 percent cap, Congress gave the Department of Defense discretion to decide whether depository and non-depository lenders will both be bound by the same rule. As this article goes to press, the Department of Defense continues to deliberate on the best way to enforce the new legislation.74 Simultaneously, the payday lending industry, with the assistance of allies in Congress, is maneuvering to repeal this legislation either outright or in effect through loophole amendments.75 Looking beyond the debate report finding “licensed payday lenders earned over 30 percent return on investment in the first nine months of legal operation.”

70 Flannery & Samolyk, supra note X, at 10.
72 John Warner National Defense Authorization Act for Fiscal Year 2007, Pub. L. No. 109-364, Sec. 670(a) (2007) (“A creditor . . . may not impose an annual percentage rate of interest greater than 36 percent with respect to the consumer credit extended to a covered service member or a dependent of a covered service member.”).
75 See Stacy Kaper, Military Lending, GSE Reform in Senate Dems’ Sights, AM. BANKER, Nov. 15, 2006, at 1 (Senator Tim Johnson arguing for repeal of the military personnel interest rate cap because: “This time it's military. Who's to say it isn't going to be widows and orphans or other sympathetic groups in the future?”); Rick Maze, S.D. Senator Wants 2nd Look at Payday Loan Cap, MARINE CORPS TIMES, Nov. 17, 2006 (“Sen. Tim Johnson,
over protections afforded to military personnel, the new Congressional usury law may signal a resounding first step in a return to more traditional credit pricing limits.

II. METHODOLOGY: THE ANATOMY OF A PRICE CAP

This study is unique in that no research has yet systematically measured state usury laws by translating them into a single uniform terminology. Because states have written their usury laws with a hodgepodge of different accounting methods and legal terminology, policy makers, the press, and the public cannot easily compare the extent to which different states have actually provided meaningful consumer protection to their residents. This study explores whether these different methods create significant variations in prices that can be more accurately revealed by using one actuarially sound pricing terminology. This is possible because while there is no accepted method for capping loan prices, there is a uniform national method of comparing loan prices. Indeed, the federal Truth in Lending Act (TILA), adopted in 1968, was designed to do exactly this: provide an accurate way to compare loans.76 The premise behind this study is to use that federal price comparison tool to compare and contrast the most expensive payday loans allowed in each state.

Thus, this article measures usury law by calculating the most expensive typical payday loan permissible in each state. Currently the best available evidence estimates that the prototypical American payday loan involves a cash advance of $325.00 for fourteen days.77 Assuming a hypothetical loan with these two characteristics, one can calculate a maximum dollar amount that a lender may legally charge in any state.78 The price of each state’s most expensive permissible loan is then expressed using the uniform credit pricing terminology created by the federal Truth in Lending Act.

Under the Truth in Lending Act, there are four key components in the pricing of a payday loan: the amount financed, the finance charge, the total of payments, and an annual percentage rate. An amount financed is roughly equivalent to the principal of the loan—that is “the amount of credit of which the consumer has actual use.”79 A finance charge includes all charges incident to the extension of credit.

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76 15 U.S.C. § 1601(a) (“It is the purpose of this subchapter to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him . . . .”).

77 King, et al., supra note X, at 18-19. Unfortunately, there are no publicly available statistics estimated a national mean payday loan principal or initial duration. The King, Parrish, and Tanik study comes as close as possible by compiling information from industry sources as well as information from 19 different state regulators. Id.

78 Many states allow different types of lenders to charge different prices based on what type of loan is offered and whether the necessary licensing have been met. In selecting which price rate cap to measure, this study analyzed each potential cap in each statute, selecting the cap which would allow the highest price for the hypothetical loan studies. Any necessary licensing requirements were presumed satisfied.

credit expressed as a dollar amount. Roughly speaking, the finance charge is the price of a loan. Importantly, as defined under federal law, the finance charge includes not only interest paid on the loan, but also most fees and closing costs. “Total of payments” refers to the total amount of money a borrower must repay under the loan contract. Accordingly, in a payday loan the total of payments is generally equivalent to the amount financed plus the finance charge. Finally, the annual percentage rate, or “APR” as it is commonly abbreviated, is an actuarially sound measure of the cost of credit expressed as a yearly rate that relates to the amount and timing of value received by the consumer to the amount and timing of payments made. Although the APR is expressed as a rate, it is not an interest rate. Rather it is simply an annualized expression of the ratio between the finance charge and the amount financed.

Comparing loans with an annual percentage rate is much more accurate than attempting to make comparisons with the ambiguous notion of an interest rate. Although it is common to speak casually about credit in terms of an interest rate, this concept is surprisingly ambiguous and subject to manipulation. Interest rates can be quoted in terms of a daily, monthly, annual, or any other nominal time period. Interest rates can be calculated as simple or effective rates. Nominal interest rates can be calculated as simple rates, as add-on rates, or discount rates—all of which can in some loans generate widely varying prices. Moreover, unlike an APR, none of these concepts capture the added price of ancillary fees or closing costs associated with a loan. Unless one clarifies and understands the math and accounting behind all of these terms, the concept of an “interest rate” is essentially meaningless and prone to great mischief. In contrast, the concept of annual percentage rate is defined and prescribed by federal law. Quoting an APR is more reliable because the concept is based on an actuarially sound methodology that

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81 12 C.F.R § 226.4 defines which fees are included within the finance charge disclosure. Late fees and other contingent charges are not included within the definition of a finance charge. Id. at § 226.4(c)(2). Congress and the Federal Reserve Board of Governors have come under criticism for making exceptions for some fees, particularly with respect to real estate loans. For example, in a home mortgage, money paid by the consumer to the lender to acquire a credit report is counter intuitively not considered a charge incident to the extension of credit.. 12 C.F.R. § 226.4(c)(7)(iii). However, most of the more controversial exceptions are not relevant to this study.
82 In installment loans the total of payments is equivalent to the sum of all scheduled payments. RHONER & MILLER, supra note X, at 5.05[8].
83 The total of payments disclosure is optional in single payment loans. 12 C.F.R. § 226.18 n.44. Prepaid finance charges need not be included in the total of payments. RHONER & MILLER, supra note X, at 5.05[8]. In most payday loans no prepaid finance charges are involved. Accordingly, the total of payments in a payday loan will generally be the sum of the finance charge and the amount financed.
84 12 C.F.R. 22.22(a)(1).
86 Simple interest accrues on money borrowed but not previously accrued interest. BLACKS LAW DICTIONARY (8th ed. 2004). An effective, or compound, interest rate includes interest both on the money borrowed as well as previously accrued interest. Id.
87 These terms are discussed further infra notes X through X and accompanying text.
generates a uniform standardized “yardstick” upon which all types of loans can be compared.\footnote{Pridgen & Alderman, \textit{supra} note X, at 6:9.}

This study examines loan price limits in two time periods: current law and the law in force in 1965. Mid-twentieth century usury laws were used to provide a basis of comparison to current law, illustrating how usury law has changed in recent generations. The year 1965 was chosen in particular because it provides a good snapshot of traditional usury laws in force throughout most of the twentieth century. By the mid-1960s the Russell-Sage Foundation’s influential model small loan law was in its fully mature seventh draft.\footnote{George G. Bogert, \textit{The Future of Small Loan Legislation}, 12 CHI. L. REV. 1, 4 (1944).} All fifty states had been admitted to the Union. The financial hardship and trauma associated with the Great Depression and the Second World War were receding, and the so-called “greatest generation” had assumed control of government. The year 1965 also predates passage of the Consumer Credit Protection Act in 1968, which complicated consumer law by shifting the focus of policy making away from contract restrictions to disclosure.\footnote{Peterson, \textit{Truth, Understanding, and High Cost Credit}, \textit{supra} note X, at 122-23.} Finally, the American Bar Association published Barbara Curran’s treatise on consumer credit pricing in 1965, leaving a useful historical record and cogent legal classification of usury limits upon which this study relies.\footnote{BARBARA CURRAN, AMERICAN BAR ASSOCIATION, \textit{TRENDS IN CONSUMER CREDIT LEGISLATION} (1965).}

To compare current usury laws to those in effect in 1965, the current typical payday loan size of 325.00 was inflation adjusted to its relative value in the earlier time period. Because, generally speaking, legislation adopted in 1965 would have governed loans made in the subsequent year, this study converted 2006 dollars (the most recent year with conversion factors available at the inception of this project) into 1966 dollars using Consumer Price Index a conversion factor of 0.161 suggested by Dr. Robert Sahr.\footnote{Robert C. Sahr, Consumer Price Index (CPU) Conversion Factors 1800 to estimated 2016 to Convert to Dollars of 2006, \texttt{http://oregonstate.edu/cla/polisci/faculty/sahr/cv2006.pdf} (2007).} Accordingly, this study estimates that a typical contemporary loan of $325.00 would have had a value of approximately $52.33 in loans governed by 1965 usury law.

In 1965 states limited prices on a two week loan $52.33 in one of four basic ways. First, thirty-five states articulated their price limit with a simple monthly or annual nominal interest rate cap.\footnote{Simple interest rates are also referred to as actuarial interest rates. NATIONAL CONSUMER LAW CENTER, \textit{THE COST OF CREDIT} § 4.2 (3d. ed. 2005). Calculation of a simple interest rate is a matter of multiplying the principle by the interest rate by the term of the loan \textit{Id}.} Second, seven states capped prices with an “add on” interest rate cap.\footnote{In an add-on interest rate the lender pre-computes interest at the outset of the loan for the full term of the loan as if the principal did not decline over the course of the loan. \textit{Id.} at 4.2.2. This distinction is important in installment loans since the amount of money actually available to the borrower declines as the consumer makes each payment. Thus, in an installment loan, an add-on interest rate significantly understates that actual price of the loan in comparison to a simple interest rate. For purposes of this study the distinction between}
cap.95 And finally, one state used a fee schedule listing a specific dollar amount which lenders could charge for a loan of the size studied.96 For each state, standard accounting rules were followed to generate the largest permissible finance charge for an inflation adjusted typical fourteen day payday loan.97 When a statute authorized an ancillary fee in addition to interest, this fee was included in the finance charge if current federal law would require disclosure of that fee as part of the finance charge under TILA regulations.98 Next, the study used the Office of the Comptroller of the Currency’s publicly available APR calculation software, APRWIN v.6, to determine the maximum permissible APR for our hypothetical loan in each state.99

Where price limits in 1965 were generally expressed in terms of an interest rate, many states now limit prices in relation to the size of a loan rather than the add-on and simple interest rates does not come in to play because the hypothetical loan in question is single payment loan.

95 Similar to an add-on interest rate, lenders that use a discount interest rate pre-compute the interest at the outset of the loan for the full duration of the loan. But, with discount interest, the lender subtracts or discounts the interest from the “face amount” of the loan. The National Consumer Law Center’s Cost of Credit treatise provides a helpful example: in a one year loan of $1000.00 at an 8% discount interest rate, the pre-computed interest will be $80.00. If this interest is discounted, then the borrower walks away from origination with $920 in actual principal. Id. at § 4.3.3. In installment loans, discount interest rates undergraduate actual credit prices in comparison both to simple interest rates and add-on interest rates.

96 This state was Mississippi. Curran, supra note X, at 161. Mississippi’s Small Loan Regulatory Act included a schedule of maximum monthly charges for loans of $99.00 or less. For loans of between $51.00 and $60.00, interest and service charges could not exceed $2.06 per month. A helpful explanation of the statute is included in Early v. Williams, 123 So.2d 446, 447-48 (Miss. 1960). Unfortunately, the statute does not specifically address how to calculate maximum permissible charges for loans with durations less than one month. Making an educated guess, this study calculated a maximum permissible charge for the hypothetical fourteen day loan by multiplying the monthly limit by twelve in order to extrapolate an annual maximum charge of $24.72. This represents an actuarial annual nominal interest rate of 47.23867%. Using this rate we found a maximum charge for our 14 day loan of $9481642, which rounded to $95e. Mississippi’s strategy for capping prices is probably rare because, unlike interest rate caps, it does not naturally adjust with inflation. In this regulatory environment the usury limit actually declines over time.

97 Where the usury law used a monthly nominal interest rate, a maximum APR on our hypothetical fourteen day loan was calculated by first converting the monthly nominal interest rate into an annual nominal interest rate by multiplying the monthly rate by 12, the number of months in a year. Next, a finance charge was calculated based on the maximum annual nominal interest rate extrapolated from the monthly limits. Thus, for Alaska’s 1965 price limit, which allowed a finance charge of 4% per month on the first $300 of credit, we assumed twelve equal periods producing an annual nominal interest rate of 48%. A finance charge based on this cap was obtained by taking $I = \frac{p \cdot r \cdot t}{365}$, where $p$ is principal, $r$ is the annual nominal interest rate, and $t$ is the loan term in days. This generates a finance charge of $I = \frac{5233 .48 .14}{365} = .96$.

98 Thus, a “service fee” would be included in the finance charge, but a late payment fee would not. 12 C.F.R. § 226.4.

speed it grows over time. Accordingly, measuring current price caps required adjusting methodology to account for two newer methods used by state legislatures. First, some states now impose price limits on payday loans relative to the amount of money borrowed by the consumer in any given transaction. For example, Kansas currently caps payday loan prices at fifteen percent of the amount borrowed.100 In a payday loan of typical size and duration, this limits the lender’s finance charge to $48.75. This article classifies price limits of this type as amount financed caps. Second, some states impose price limits relative to the amount which the consumer must repay upon completion of the loan contract. For example, Arizona caps loan prices at fifteen percent of the amount a consumer is scheduled to repay at the terminal date of the loan.101 So, for a typical payday loan in Arizona, a lender can legally charge up to $57.35. This article classifies price limits of this type as total of payment caps. For states with both amount financed caps or total of payment caps this study calculated the highest dollar amount, rounded to the nearest cent, permitted for a typical payday loan. This dollar amount was next converted into an annual percentage rate using the Office of the Comptroller of the Currency’s APR calculation software.102

In addition to measuring permissible annual percentage rates under state usury laws, this Article also creates a new method of measuring how much a usury statute underemphasizes or overemphasizes the price of a loan in comparison to federal disclosure law. The central concept in this new method of analyzing usury laws is referred to as the salience distortion associated with a price cap. Salience distortion is defined as the difference between the annual percentage rate of a usury statute’s most expensive permissible loan and the most prominent, or salient, number written in the statutory language limiting the price of the loan.

The notion of salience as it is used here merits some further explanation. Because currency is numerical, in any statute which caps the price of a loan, the legislature must at some point pick a number or numbers. While this is true of every usury law, the specific number chosen by a legislature only has meaning in relation to other variables associated with the law in question. For example, one legislature might adopt a usury limit of eight percent per year while another might adopt a cap of eight percent per month. Both legislatures would have chosen to feature the same number in the language of the statute, but the latter cap is twelve times higher than the former because there are twelve months per year. Theoretically, if it wanted to do so, a legislature could instead adopt an interest rate cap of eight percent per century—which would create a price cap much, much lower than either the monthly or annual cap. Or a legislature could adopt a cap of 8 percent per second, which would generate an extremely high price limit. Of course no state has chosen to do either because centuries and seconds are not convenient temporal units of measurement in the context of loans. The point here is simply

100 Kan. Stat. Ann. § 16a-2-404 (2006) (“[A] licensed or supervised lender may charge an amount not to exceed 15% of the amount of the cash advance.”).
101 AZ. REV. STAT. § 6-1260(F) (2006) (“A licensee shall not directly or indirectly charge any fee or other consideration for accepting a check for deferred presentment or deposit that is more than fifteen per cent of the face amount of the check for any initial transaction or any extension.”).
that if it chooses to do so, a legislature can pick a small number and create a relatively high price limit. Or, it can pick a large number and create a relatively low price limit. Legislatures can feature whatever number they want in a usury law. The concept of salience in this study merely gives weight to the legislatures linguistic choice, irrespective of the actual price generated.

To this end, several guidelines were used in ascribing a most salient number to each statute. If state’s price limit was expressed with an interest rate cap, that interest rate is presumed to be the most salient number in the statute. This statement holds irrespective of the nominal time limit referred to in the statute. For example, in an interest rate cap of three percent per month, the most salient number is presumed to be three. Yet, if the statute has an interest rate cap of 36 percent per year, the most salient number is 36, even though the actual price allowed is the same as the three percent monthly cap. Similarly, in keeping with the ancient convention of describing credit with interest rates, where a law authorized ancillary fees (such as a service fee) the interest rate is nevertheless presumed to be the more salient number. Moreover, in states where the price limit was expressed with a fraction, the numerator divided by the denominator is presumed to be the most salient number in the statute. For example, Connecticut limits loan prices to $17.00 per $100.00 per year—or seventeen percent. So, the most salient number in the Connecticut usury law is presumed to be seventeen. The same concepts hold in states using amount financed caps and total of payment caps.

The notion of salience distortion builds on the assignment of a salient number to each statute by contrasting it to the maximum annual percentage rate permitted by the statute for a given loan. Thus, a statute’s salience distortion was generated by subtracting the statute’s most salient number from its maximum permissible annual percentage rate. The greater the difference between the most salient number and the annual percentage rate, the higher the salience distortion. For example, current Virginia law states that payday lenders may charge “an amount not to

103 Some states use tiered caps based on different loan amounts. For example, New Hampshire’s 1965 statute capped prices at a limit of $16 per year per $100 loaned on the first $600 of principal, then $12 per $100 on principal in excess of $600. Curran, supra note X, at 162. Because this study is focusing on a typical payday loan, the most salient number the percentage rate applicable to the amount financed. Thus, this ascribed the number 16 as New Hampshire’s most salient number in 1965. In states where the two pricing tiers were applied to the loan, the study selected the percentage rate applicable to the preponderant amount of principal lent.

104 Lawmakers and creditors have used interest rates as the central component of credit pricing and usury limits since the first recorded civilizations. See Peterson, Taming the Sharks, supra note X, at 45-75 (discussing ancient usury laws and loan terms); Homer & Sylla, supra note X, passim (cataloguing prevailing interest rates in major human civilizations).

105 Like Connecticut, virtually all states that express their price limits with a fraction use the number 100 in the denominator, in effect translating a dollar amount into a percentage. One exception was North Carolina’s 1965 usury limit. That statute limited loan prices to $1.00 per $5.00 per year—which is just another way of imposing a 20 percent annual interest rate cap. Curran, supra note X, at 163. Dividing one by five, the most salient number in this statute is presumed to be 20.

106 Thus, the most salient number in Kansas’ current cap of fifteen percent of the amount advanced to a consumer is fifteen. Kan. Stat. Ann. § 16a-2-404.
exceed fifteen percent of the amount of the loan proceeds advanced to the
borrower.”107 Fifteen percent of a $325.00 loan is $48.75. A finance charge of this
amount in a loan with an intended duration of 14 days would carry an annual
percentage rate of about 391%. Given these facts, this study assigns the current
Virginia statute a salience distortion score of 376. Like Virginia, any statute with a
low salient number and a high maximum APR would have a large salience
distortion. Conversely, a statute with a salient number that happens to be the same
as the maximum APR would have a salience distortion of zero. The innovation of a
salience distortion variable is that it creates quantifiable measurement of the extent
to which the number featured in a usury law underemphasizes or overemphasizes
the uniform national descriptive standard in credit price comparison.

III. FINDINGS: THE ATTENTION OF AMERICAN USURY LAW

Applying these methodologies to state usury laws leads to three empirical
findings: (1) usury law has become more lax, (2) usury law has become more
polarized, and (3) usury law has become more misleading. This part takes each
finding in turn.

A. Usury Law has Become More Lax

In virtually every measurable way usury law has become much more lax since
1965. In 1965 every state in the union had a usury limit on consumer loans. Today
nine states have completely deregulated interest rates within their borders.108 In
1965 banks were bound to comply with all state usury laws. Today banks are free
to charge whatever interest rate they choose within the loose and changing
tolerances chosen by banking regulator for their safety and soundness guidelines.
In 1965 no state had law either explicitly or implicitly authorizing prices with an
annual percentage rate of over 300%. Today, at least 36 states have law allowing
lenders to charge over 300%.109 In 1965 usury laws were drafted with sufficient
rigidity that 45 states held actual allowed annual percentage rates to 60% or
under.110 In 2007 the number of states accomplishing this has fallen to only
seven.111 The Appendix following this Article includes a complete list of annual
percentage rates on maximum state usury limits, along with a national rank for
each state.

While a strong deregulatory trend existed across the country, not every region
abandoned usury law with equal disregard. Figure 1 compares the median
maximum permissible annual percentage rate for five regions around the country in
both time periods. The Northeastern states have tended to limit consumer loan

108 States with no credit price limit whatsoever include: Delaware, Idaho, Nevada, New
Hampshire, New Mexico, Oregon, South Dakota, Utah, and Wisconsin.
109 This figure excludes Texas and Tennessee, both of which, in fairness should be included.
110 The five states allowing more than 60% were: Georgia, Maryland, Oklahoma, South
Carolina, and Wisconsin.
111 These states are: Connecticut, Maryland, New Jersey, New York, North Carolina,
Vermont, and West Virginia.
purchasing most aggressively. In 1965 the median actual annual percentage rate of the state usury limit on an inflation adjusted typical payday loan was 30%. By 2007 this median more than tripled to 94%. In other regions of the country 1965 usury laws resolved to a median of 36%. By 2007 every region outside the Northeast had a regional median of over 300%. By far, the most laissez faire region of the country is currently the Mountain West with a regional median of 652%.

Figure 1. Median APR of State Usury Limits on Typical Payday Loans by Region: 1965 & 2007.

Taking the Northeast and Mountain West regions as examples, Tables 2 and 3 provide specific state-by-state usury limit information. In 1965 every Northeastern state capped credit prices. Eight of eleven states capped prices at an APR of 36% or below. Delaware, Maryland, and Pennsylvania all had comparable limits on interest rates. But each of these states also allowed special fees in addition to interest which drove their actual prices much higher than their regional counterparts. Maryland, in particular, allowed a one time fee of $4.00 at the origination of every loan. Because of the relatively small principal, $52.33, of an inflation adjusted typical payday loan, the initial fee drove Maryland's actual maximum permissible annual percentage rate up to 205%, the fourth highest in the nation at that time. Maryland later closed this loophole, settling on a much more consumer protective cap of around 33% APR. Maryland's '65 limit of 205%, does not seem out of the ordinary in comparison to regional 2007 limits. Two Northeastern states, Delaware and New Hampshire, have deregulated completely. Rhode Island has adopted a payday lending authorization statute capping credit prices proportional to the amount of money financed resulting in a limit on payday loan prices of around 391%. Massachusetts, Maine, and Pennsylvania all have traditional interest rate limiting usury laws but allow relatively high special fees that generate actual APR limits of around 201%, 183%, and 94% respectively. Connecticut, Maryland, New Jersey, New York, and Vermont have all retained traditional usury regulation with minimal loopholes or exceptions.

Table 2. Maximum Annual Percentage Rates of Northeastern State Usury Limits on Typical Payday Loans, 1965 & 2007

<table>
<thead>
<tr>
<th>State</th>
<th>1965 Max</th>
<th>1965 APR</th>
<th>2007 Max</th>
<th>2007 APR</th>
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<tbody>
<tr>
<td>NE</td>
<td></td>
<td>36%</td>
<td>36%</td>
<td>36%</td>
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<tr>
<td>South</td>
<td></td>
<td>36%</td>
<td>36%</td>
<td>36%</td>
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<tr>
<td>MidW.</td>
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<td>36%</td>
<td>36%</td>
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<td>MtnW.</td>
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<td>36%</td>
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<tr>
<td>West</td>
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<td>36%</td>
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<td>National</td>
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<td>36%</td>
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</table>
Like the Northeast, in 1965 every Mountain West state limited the prices of loans with a duration and principal comparable to today’s payday loans. These 1965 limits ranged between 20% and 42%, with four states settling on a mode of 36%. In 2007, three states, Idaho, New Mexico, and Utah have deregulated their permissible loan prices altogether. The remaining states now have only half-hearted limits on loan prices that range between Arizona’s 460% cap to Montana’s lender friendly 652% legal maximum—the highest cap in the nation on a loan of the studied size and length.

Table 3. Maximum Annual Percentage Rates of Mountain West State Usury Limits on Typical Payday Loans, 1965 & 2007

<table>
<thead>
<tr>
<th>State</th>
<th>1965 Max. APR</th>
<th>1965 APR Rank</th>
<th>2007 Max. APR</th>
<th>2007 APR Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arizona</td>
<td>36%</td>
<td>13</td>
<td>460%</td>
<td>16</td>
</tr>
<tr>
<td>Colorado</td>
<td>36%</td>
<td>13</td>
<td>496%</td>
<td>15</td>
</tr>
<tr>
<td>Idaho</td>
<td>36%</td>
<td>13</td>
<td>unlimited</td>
<td>1</td>
</tr>
<tr>
<td>Montana</td>
<td>20%</td>
<td>44</td>
<td>652%</td>
<td>10</td>
</tr>
<tr>
<td>N. Mexico</td>
<td>36%</td>
<td>13</td>
<td>unlimited</td>
<td>1</td>
</tr>
<tr>
<td>Utah</td>
<td>36%</td>
<td>13</td>
<td>unlimited</td>
<td>1</td>
</tr>
<tr>
<td>Wyoming</td>
<td>42%</td>
<td>10</td>
<td>521%</td>
<td>13</td>
</tr>
</tbody>
</table>

In summary, the 1965 median usury limit on an inflation adjusted typical payday loan was approximately 36% APR. In 2007 the median national usury limit on a typical payday loan has grown ten times over to an astonishing APR of 398%. It is perhaps not a coincidence that the recent Pentagon-backed legislation

112 Average maximum permissible annual percentage rates provide a somewhat less statistically useful picture. The 1965 national mean was a somewhat misleading 51.7% APR. The 1965 national mean was strongly influenced by five outlier states that allowed unusually large one time fees at origination. These states included Georgia, Maryland, Oklahoma, South Carolina, and Wisconsin. Calculating a national average for 2007 is not
reestablishing a traditional usury limit for loans to military personnel caps prices at an APR of 36%—the 1965 national median.  

**B. Usury Law has Become More Polarized**

By every measure of spread, the state limits on consumer loan pricing became more polarized between 1965 and 2007. Initially, the range of all state usury limits on typical payday loans has more than doubled from 257 percentage points to 635 percentage points in 2007. As illustrated in side-by-side box plots in Figure 2, the 25th percentile in an ordering of maximum permissible state usury limits on typical payday loans grew seven times over from 30% to 215%. The 75th percentile grew more than fourteen times over from 37% to 534%. Statisticians sometimes look to the interquartile range of a set of observations to determine how compressed those observations are. Interquartile range is simply the difference between the 75th percentile and the 25th percentile. Figure 2 graphically illustrates interquartile range by including the 25 state usury limits that fall within this range inside the shaded box for both years. In 1965 the interquartile range was only 7 percentage points. In 2007 the interquartile range of maximum permissible annual percentage rates on typical payday loans has grown to 319 percentage points. Thus, the prices allowed by 1965 usury laws were far more concentrated than those permitted today.

meaningful because of the nine states that have no limit whatsoever. In these states, presumably the legal maxima are infinite. Because an average gives equal weight to outlying observations, the current national average maximum legal annual percentage rate on typical payday loans is also infinite.


114 Statisticians calculate range by subtracting the smallest observation from the largest observation of a given variable. ALAN AGRESTI & CHRISTINE FRANKLIN, STATISTICS: THE ART AND SCIENCE OF LEARNING FROM DATA 57-58 (2007).
Where possible, statisticians also prefer to describe the spread of data with a measurement of standard deviation. Standard deviation measures the typical distance from the mean for a given set of observations.\(^{115}\) While a standard deviation of 1965 law is readily figured, calculating a standard deviation of 2007 maximum permissible annual percentage rates on typical payday loans requires a further assumption. Because currently nine states have no limit on credit prices whatsoever (an infinite cap), a standard deviation for all states would provide a meaninglessly distorted measure of spread. Still, attributing the highest 2007 cap (Montana) to those unlimited states, gives a conservative, lower-bound measure of the standard deviation. Given this safe assumption, the standard deviation of state usury law maximum permissible annual percentage rates on typical payday loans grew from 57.3 in 1965 to 207.9 in 2007.

What is the significance of these findings? This decompression of state credit price maxima further illustrates the shattered national consensus on usury law. But perhaps more interestingly, this finding shows that state legislatures have

\(^{115}\) Standard deviation is the square root of the variance in a set of observations. Variance, in turn, is the average of the squared deviations from a mean. Standard deviation is expressed as: \(s = \sqrt{\frac{\sum(x - \bar{x})^2}{n-1}}\). For a helpful introduction see ARGESTI & FRANKLIN, supra note X, at 57-58.
not been able to find a principled method of capping prices. In 1965, whether they were right or wrong in doing so, the vast majority of state legislatures loosely agreed about the point at which credit prices become antisocial. Today, the law evidences no such agreement. At least those states that have no usury limits whatsoever can point to the neo-liberal Benthamite arguments against the paternalism of government intervention in the marketplace. In contrast, what is the commercially justifiable reason why Montana lenders need an annual percentage rate of 652 percent to run a profitable business while across the border in Washington, lenders can get by on 392 percent? Why should short term lenders in Massachusetts need special fees amounting to an annual percentage rate of 183% on a typical payday loan when lenders in Connecticut are only allowed 17%? Is there something beyond the *fait accompli* of raw political power that justifies what governments have done to the traditional American notion commercial law and order? These empirical findings demand that an intellectually responsible defense of the current usury law include a principled answer to these questions.

### C. Usury Law has Become More Misleading

While there is now tremendous variety in the actual annual percentage rates allowed by state law, there is far less variety in the numbers most prominently featured within usury statutes. This is to say that the numerical language chosen by state legislatures to cap credit prices does not transparently reflect the regulatory environment it produces. This subsection explains that although legislatures have raised usury limits, they have simultaneously changed the method of capping prices to continue to describe those higher prices with roughly the same smaller numbers used back in 1965. In a word, legal limits on credit prices have become more misleading.

Table 4 divides all state usury laws for 1965 and 2007 into classes based on how each statute goes about limiting prices: (1) with simple nominal interest rate limit, (2) an add-on interest rate limit, (3) a discount interest rate limit, (4) a specified dollar amount, (5) a percentage limit on the amount financed, (6) a percentage limit on the proportion of the total of payments, or (7) no limit at all.  

116 N represents the number of states using each method. Next, the table provides an average of the most prominent, or salient, number featured in the language of each state law for each type of cap.  

117 In both 1965 and 2007, these average salient numbers all fall within a relatively tight compression. Average salient number for each type of limit type fall between 15 and 43—numbers similar to the simple nominal annual interest rates generally used in old Ham-era Small Loan Laws. Yet, the mean of salient numbers in usury statutes do not rise appreciably along with the average permissible annual percentage rate allowed under each statute. For example, the average number written by state legislatures that cap prices in proportion to a borrowers’ total of payments is 15. This, even though these same state legislatures currently tolerate loans at about 452% APR. Nationwide, the 41 state legislatures that cap credit prices currently choose to describe their price

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116 These methods of limiting credit prices are explained *supra* at note X and accompanying text.

117 The guidelines used to designate the most salient number are explained *supra* note X and accompanying text.
limitation with numbers averaging out to 19. However, if these same price limits are described in the context of a typical payday loan, using the federal price disclosure terminology, the average number produced is 382%.

### Table 4. Salience Distortion by Usury Limit Type, 1965 & 2007

<table>
<thead>
<tr>
<th>Type of Usury Limit</th>
<th>1965</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Smpl. Nmnl.</td>
<td>35</td>
<td>9</td>
</tr>
<tr>
<td>Add-on</td>
<td>7</td>
<td>5</td>
</tr>
<tr>
<td>Discount</td>
<td>7</td>
<td>2</td>
</tr>
<tr>
<td>Fee Schedule</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>% Amt. Fin.</td>
<td>0</td>
<td>15</td>
</tr>
<tr>
<td>% Tot. Pymnt.</td>
<td>0</td>
<td>11</td>
</tr>
<tr>
<td>Unlimited</td>
<td>0</td>
<td>9</td>
</tr>
<tr>
<td>TOTAL</td>
<td>50</td>
<td>50</td>
</tr>
</tbody>
</table>

*Mean excludes states with unlimited permissible rates.

Salience distortion, the new scale variable proposed by this study, describes the difference between price limiting numbers chosen by state legislatures and the actual annual percentage rates allowed by those numbers. For example, the state with the highest salient distortion in the country for the typical payday loan studied was Montana. The Montana legislature chose to cap payday loan prices by limiting the finance charge to 25% of the loan’s principal. Seemingly similarly, the New York legislature has capped loan finance charges at an interest rate of 25%. Both states feature the number 25. New York’s no-exception, simple, nominal, annual cap does in fact limit the permissible annual percentage rate to 25%. In stark contrast, the Montana statute tolerates annual percentage rates up to about 652%. While the salience distortion in New York is zero, Montana’s salience distortion is 627.

Replicating this analysis nationwide leads to an inescapable and profound conclusion: There is a strong correlation between permissible annual percentage rates and salience distortion. This finding is best illustrated by the scatterplot in Figure 3. This chart plots the maximum annual percentage rate for every state price cap included in this study along the Y axis. The X axis tracks the salience distortion score assigned to these same statutes. For every state studied in both 1965 and 2007, as the price permitted by the legislature rises, so too does the severity with which those legislatures mislead about the actual cost of the allowed loans. Statisticians usually measure the correlation of two scale variables with a statistic known as Person’s Correlation, which is named after the statistician who invented the concept in 1896.\(^{118}\) Pearson’s Correlation is a way of summarizing the strength

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\(^{118}\) ARGESTI & FRANKLIN, *supra* note X, at 103-05.
of a linear relationship between two variables with a single figure that ranges between -1 and +1. The stronger the relationship between the variables the closer the correlation figure is to ±1. With a correlation value of .998, Figure 3’s scatterplot of the relationship between permissible annual percentage rates and salience distortion shows a virtually certain positive correlation. What exactly does this mean? The analysis suggests that the higher the payday loan price limit a state chooses, the more misleading that state was in the language it used to create the limit.

While this linear relationship between price and distortion is apparent form even a casual glance at Figure 3, it is important to remember there is nothing inherent in the nature of credit or usury law that predetermines the strength of correlation between these two variables. If, for example, a state legislature chose to allow payday loans with a 500% annual percentage rate, that legislature could choose to describe that price limit with the number 500. A state that did this would have a salience distortion of zero, placing it by itself in the far upper left corner of

\[ r = \frac{1}{n} \sum \left( \frac{x - \overline{x}}{s_x} \right) \left( \frac{y - \overline{y}}{s_y} \right), \]

where \( r \) is the correlative value, \( n \) is the number of observations, \( x \) is the salience distortion value for a statute, \( y \) is the APR for a statute, and \( s \) represents the standard deviations for each variable. For further explanation of these concepts see id.

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119 Pearson’s Correlation, is represented as: \( r \) = \( \frac{1}{n} \sum \left( \frac{x - \overline{x}}{s_x} \right) \left( \frac{y - \overline{y}}{s_y} \right) \), where \( r \) is the correlative value, \( n \) is the number of observations, \( x \) is the salience distortion value for a statute, \( y \) is the APR for a statute, and \( s \) represents the standard deviations for each variable. For further explanation of these concepts see id.
IV. ANALYSIS AND POLICY RECOMMENDATIONS

These findings give rise to three intellectual contributions: (1) a cultural point second a behavioral-economic point, and then a political point. Next, this Part sets out several policy recommendations.

A. Social Norms of Commercial Morality and the Mythology of Credit Pricing

First, a cultural point: Legislatures have chosen the numeric language in American usury laws because those numbers sound in an ancient moral folk-wisdom on the tolerability of interest rates. Policy makers, the press, and the American people understand the morality and advisability of credit prices through a lens created by the decisions of religious, political, and cultural leaders of our historical tradition. Today’s legislatures refuse to use numbers transparently reflective of actual credit prices because to do so would put them in contention with the moral wisdom of people like Pope Paul II, Martin Luther, Benjamin Franklin, and Arthur Ham. Each of these individuals led their people on credit issues at transformative cultural moments. In doing so, each sanctioned annual interest rates, as this concept is generally understood, at between 6% and 36%. Our society has imbued numbers within this range with a moral authority—a mythology of sorts—when these numbers reference the price of loans. Legislatures deploying these numbers in price caps that authorize triple digit interest rates perpetuate a something of a legislative fraud against those Americans (and there are many) who have trouble recognizing the difference.

Using numbers within a range of 6 to 36 to create triple digit APR price limits of 300% or more insulates legislatures from the political fall-out of their decision. Usury law in general, and payday lending regulation in particular always make for hotly contested, controversial bills. This type of legislation tends to live or die in the final moments of legislative cycles and subject to the most bare-knuckle political tactics. Legislatures that adopt usury laws so completely at odds with ancient moral visionaries and longstanding legal traditions are understandably nervous. Hiding the import of that legislation within misleading language has proven too tempting for many state legislatures to pass up. Like guilty children

120 Similarly, if a state wanted to, it could create a price cap generating a low annual percentage rate, but describing that rate with a high number. This would place the state in the bottom right corner of the chart. Ironically, I am aware of no state has ever overemphasized its usury limit. Apparently there is no political capital to be gained from aggressively regulating while pretending you are not.

121 See discussion supra Part II.
sweeping a broken vase under the sofa, a majority of American legislatures have adopted fundamentally misleading mechanisms for limiting credit prices.\textsuperscript{122} Arkansas provides a particularly poignant example. In 1965 Arkansas courts strictly enforced the simple nominal annual interest rate cap of 10\% included in the Arkansas state Constitution.\textsuperscript{123} Currently the Arkansas legislature has adopted a statute which purports to allow 10\% of the face value of a payday loan check, plus an additional fee of $10.00.\textsuperscript{124} While the current statute just echoes the number 10, the actual price difference for a typical payday loan is an APR of about 10\% versus an APR of 423.40\% for each time period. What is perhaps even more troubling is that subsequent to 1965 the people of Arkansas recognized that at true 10\% limit is too low, and amended the constitution to limit simple nominal annual interest rates to a more reasonable 17\% per annum.\textsuperscript{125} Admarbly stating the legally obvious, the Supreme Court of Arkansas has held that the current state payday lending authorization statute is unconstitutional and contrary to the will of the people of Arkansas.\textsuperscript{126} Defying its own Supreme Court, the Arkansas legislature, with the collusion of state regulators, has facilitated evasion of its own Constitution, siding instead with the well funded payday lending industry lobby. Hundreds of Arkansas payday lenders now openly charge predatory prices in violation of the state constitution.\textsuperscript{127}

Special mention should also be made of unusual loopholes in Texas and Florida. Both of these states have legislation that purports to place modest limits on the prices of typical payday loans.\textsuperscript{128} What makes these states unusual are obscure

\textsuperscript{122} Twenty-two states’ credit price limits create a disparity of over 350 percentage points between the actual APR of their most expensive permitted payday loan and the number featured in the statute. These states are: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Hawaii, Illinois, Indiana, Kansas, Kentucky, Mississippi, Missouri, Montana, Nebraska, North Dakota, Oklahoma, Rhode Island, South Carolina, Virginia, Washington, and Wyoming. Based on the methodology of this study, an additional six states can be said to distort their true price limit on a typical payday loan by 250 to 350 percentage points. These states include: Florida, Georgia, Iowa, Louisiana, Michigan, and Ohio.


\textsuperscript{125} Ark. Const. art. 19, \S 13.

\textsuperscript{126} Luebbers v. Money Store, Inc., 40 S.W.3d. 745, 749-50 (Ark. 2001) (“[T]he mere fact that the transaction has been given a certain form by the General Assembly will not exempt it from the scrutiny of the court, which is bound to exercise its judgment in determining whether or not the form of the transaction is a device to cover usury.”).


\textsuperscript{128} Texas has not passed a separate usury statute granting licensed payday lenders authority to charge a fees unique to payday loans. Accordingly, payday lenders in Texas are subject to the state’s traditional small loan law that limits interest rates at 48 percent per annum, plus a an additional loan “acquisition” fee of up to ten dollars per loan—generating an APR of 128\% on a typical payday loan. Florida has adopted a licensing statute for payday lenders that includes a price limit of ten percent of the advance plus a “verification fee” of no more
statutes that authorize companies called “Credit Service Organizations” to take a fee in exchange for brokering loans from other companies. Under these statutes payday lenders partner with anonymous third party companies (which likely have close ties to the payday lender itself) to make payday loans outside the scope of state price limits. In these arrangements the underlying loan itself generally complies with state law, but the companies also assess a brokering fee that generates a price that far in excess of the usury limit. As a result, many payday lenders in Florida, and virtually the entire industry in Texas, simply ignore the price limits in state law by generating the bulk of their revenue from fees nominally associated with brokering, but functionally identical to interest. While this study evaluated Florida and Texas price limits based on their plain meaning, in reality these two states should probably be considered in a class similar to Delaware, South Dakota, Utah, Idaho, Nevada, and other states that have no price limits on payday loans whatsoever.

Ironically, many of the state legislatures that surreptitiously authorize triple digit interest rate payday lending also adopt statutory provisions requiring that payday lenders follow the uniform price disclosure conventions of the Truth in Lending Act. As a legal matter these rules are completely pointless since payday lenders must comply with the federal law anyway. But, such provisions are not culturally pointless. Passing a law that is merely duplicative of some preexisting rule is a classic legislative tactic used to look like you are doing something when you are not. Legislators that want to pretend to address payday lender abuses need to fill up their bills with something. What is so particularly insincere about these provisions is that they remind payday lenders to use accurate price disclosure when dealing with consumers, while at the same time these legislatures ignore those conventions when talking to the press.

B. Legislative Exploitation of Bounded Rationality: Framing Effects and Anchoring in Usury Law


129 Pamela Yip, Tightening Payday Lending Loopholes, DALLAS MORNING NEWS, March 5, 2007, 1D; Richard Burnett, Some Payday Lenders Flout State’s Reform Law: They Say the Law Doesn’t Apply Because they are Exempt or Peddle Loans via the Web, ORLANDO SENTINEL, April 1, 2007, A1; Don Baylor, Loopholes Allow Loan Sharks to Prey on Hardworking Texans, SAN ANTONIO EXPRESS-NEWS, Feb. 16, 2007, 9B.

130 See, e.g. Fla. Stat. § 560.404(e)(13) (2006) (“For each deferred presentment transaction, the deferred presentment provider must comply with the disclosure requirements of 12 C.F.R., part 226, the federal Truth-in-Lending Act, and Regulation Z of the Board of Governors of the Federal Reserve Board.”).

Legislative decisions to express credit price caps with relatively small numbers take advantage of the bounded rationality of readers, including potential critics, of those statutes. Two cognitive distortions, framing effects and anchoring, are particularly relevant. With respect to the former, psychologists and behavioral economists have presented compelling evidence that the way financial information is presented, or “framed”, can profoundly and predictably influence the human choices. For example, people are more averse to medical treatments when identical risk data is framed as a mortality rate than as a survival rate. Consumers treat identical investment risks differently depending on whether they are presented as a gamble or insurance. Moreover, “[i]ndividuals will perceive a penalty for using credit cards as a loss and a bonus for using cash as a gain; this although the two situations are, from an economic and end-state perspective, identical.”

Similarly, there is no objective mathematical difference between a typical payday loan limited in price with a 391% annual percentage rate cap and one limited with a cap of 15% of the loan principal. Both expressions limit the finance charge on a two week loan of $325 to about $48.75. But, the empirical findings in this study strongly suggest there is a profound difference in the way these two numerical expressions are understood. The fact that not a single legislature chose to describe this functionally identical price limitation using an annual percentage rate (which is, after all, the federal national standard) suggests that legislatures are aware that the APR cap is perceived as higher than the amount financed cap.

Furthermore, behavioral economic research has demonstrated an “anchoring” effect that leads to a closely related observation. People tend to rely too heavily on first impressions when assessing risk and value. This is to say, we tend to “anchor” on early estimates and fail to sufficiently revise our perception of price or risk when further information comes to light. Research suggests anchoring on the early estimate of the value of a lawsuit tends to disrupt later settlement

negotiation. Even accountants conducting audits anchor on early estimates and insufficiently corrected their judgments. Marketing professionals have absorbed these lessons and systematically design sales tactics to exploit this pattern in judgment making.

Perhaps then we should not be too surprised if legislatures have taken to the same strategy. The empirical findings in this paper suggest that legislatures use small numbers in usury legislation to frame the public debate and comprehension of the law to their political advantage. By proposing legislation with, for example, a price limit of 15% of the amount financed, legislators anchor the perception of their opponents, the press, consumer advocates, and the public. Everyone that reads the price cap will initially anchor on a price expression that underemphasizes cost. As further investigation of the financial significance of such a limit comes to light, that new information must psychologically contend with the earlier label. For those who lack the financial expertise to easily distinguish the tremendous mathematical difference between a cap proportional to a loan principal and an interest rate cap, the true value of price limit becomes obscured and, thus, less objectionable.

C. Federalism and the Compliance Costs of Usury Law

A final insight raised by these findings speaks to the nature of our federal system and the continuing debate over the appropriate level of government to address predatory lending policy. Our federal system of government has placed policy makers, judges, advocates and scholars in the position of periodically reevaluating whether the federal, state, or local governments should make decisions on consumer policy. In recent years the general trend of banking industry sentiment has favored national policy making. The rationale usually given is that non-uniform state policy making imposes a higher regulatory compliance cost than justified by its benefits. In this view, designing loan products compliant with fifty different regulatory environments is simply too complex. While there is clearly merit to this argument, this study hints at a slightly more interesting, nuanced view of the costs of compliance.

State government choices about the level at which to set a price limit do not by themselves impose significant compliance costs. Under the federal Truth in Lending Act and, more fundamentally, as a matter of basic accounting, all lenders must calculate the cost of their loans. Recognizing whether a particular loan exceeds a legal limit is accomplished at a glance. Rather what creates high compliance costs are the tremendous and ambiguous variety of methods of calculating price caps. While this study identified six different ways that state legislatures cap prices, it is by no means a simple task to recognize which method a legislature has chosen. Moreover, there are many significant exceptions in different jurisdictions for special fees, or types of lenders within these basic classes of usury limits. For each methodology and each exception there are frequently questions left.

unanswered by the statute forcing regulators and courts to guess at legislative intent. The result is that each state is forced to develop its own unique and robust jurisprudence of credit pricing. Understanding and complying with these different bodies of law created by the variety of usury law methodologies is complicated and time consuming.

Perhaps these methodological choices would be justified if they were necessary to effectuate some important government purpose—in this case the protection of vulnerable consumer borrowers. But, from a consumer perspective, what is important is not the method by which a cap is set, but rather the extent to which that cap constrains the market. The point here is that the characteristics of state usury law that create high compliance costs are not those characteristics which protect consumers. In each state legislature, as creditors have fought for authorization to charge higher and higher prices, they have pushed an inefficient regulatory apparatus that covers their efforts to raise permissible credit prices. As a matter of political reality, adoption of lax usury limits led legislators to turn to misleading accounting methodology, which in turn raised compliance costs for the credit. The counterintuitive irony is that high cost lenders actually advocated for the very exceptions and loopholes that have raised the compliance costs associated with non-uniform state policy making. The current design of credit price limits is not only misleading, compliance is also unnecessarily expensive.

V. POLICY RECOMMENDATIONS

While the American consumer credit regulatory system is in need of many reforms, this Article most directly augurs in favor of three policy recommendations. First, usury laws should be written in annual percentage rate format. This is to say, that in the twenty-first century our consumer credit usury law and disclosure law should be linked. The same policy arguments which led reformers in the 1960s to create a uniform method of disclosing loan prices apply, perhaps with even more force, in the context of usury limits. The variety of methodologies used to express price limits has left the door open to those who wish to mislead the public and the press on the true meaning of credit price limits with a variety of confusing and counterintuitive pricing methodologies. Moreover, these various methodologies have imposed unnecessary costs of compliance on well-meaning creditors with little or no consumer protection provided as a result. While there is no disputing the fact that federal Truth in Lending regulations include some significant loopholes and exceptions, these problems pale in comparison to the legal charades found in a majority of state credit price limitations.139 Particularly troubling have been those states which have de-linked...

139 One particularly important loophole that would need attention lies in the relationship between non-contingent administrative fees and the finance charge in open-end credit. In open end loans the finance charge cannot be calculated in advance because neither the lender nor the borrower knows how much the money will be advanced ahead of time. Currently Regulation Z requires disclosure of the annual percentage rate that will be applied to balances incurred by the borrower. But fees, such as annual participation fees are not included in the annual percentage rate, even though these fees meet the classic expression of a finance charge: a cost incident to the extension of credit. The potential loophole is this: if
credit price limits from time. Price limits expressed as a percent of the principal
loaned or the amount to be repaid, are poor methods of limiting credit prices
because they ignore the most important variable in the true cost of credit: time.

Some have argued that annual percentage rates are not meaningful in the
context of payday loans because these loans are intended as a short term form of
credit. Instead, these critics generally assert that payday loans are more easily
compared with a dollar amount. First, there is no empirical evidence to support this
claim. Second, while focusing on a dollar amount might simplify comparison of
one payday loan to another payday loan, it confuses the more important price
comparison to other types of debt such as credit cards, pawnshop loans, home
mortgages, and personal loans from finance companies, banks, or credit unions.
Annual percentage rates are the yardstick our society uses to express loan prices.
Using one yardstick for mainstream loans such as mortgages and credit cards and
another yardstick for payday loans creates a dangerous opportunity to mislead
borrowers. Too many consumers cannot easily distinguish a 15% annual
percentage rate on a credit card and a payday loan with a payment of 15% of the
amount borrowed (which carries an APR of about 391% in a typical loan). Third,
to the extent that comparison of a dollar amount is useful for payday loan
borrowers, the Truth in Lending Act facilitates exactly this with a finance charge
disclosure. Consumers are already entitled to disclosure of a dollar amount.

Fourth, policy makers must recognize that despite consumers’ intentions, payday
loans are long term forms of credit. Consumers that resort to payday loans over the
course of their lives and consumers that are trapped by high payday loan prices do
use payday loans over the course of years, making annual percentage rates a
fundamentally appropriate measure of cost. Finally, independent of payday loan
borrowers themselves, the expression of usury limits in our law should reflect our
national tradition of expressing credit prices in a nominal annual format.
Throughout the history of our republic, credit prices have most commonly been
understood in a nominal annual interest rate format. Departing from this tradition
has frustrated the ability of the press and the voting public to understand the law
and to exercise their will. Indeed, that was probably the point.

Second, we should reestablish traditional usury limits of no higher than 36% APR.
Liberal economists condemned credit price restrictions asserting that they
inefficiently prohibit mutually beneficial transactions. In this view, demand for

the usury limit is expressed as an annual percentage rate, could payday lenders restructure
depts as open end loans and then charge large administrative fees which are not included
within the usury limit? The answer is that along with usury limits expressed as annual
percentage rates, legislatures, regulators, and courts must vigilantly guard against sham
transactions designed to avoid the price limit. This, of course, has always been the challenge
solution might be requiring an annual statement period where lenders are required to rebate
any money collected in excess of 36% of the amount of credit actually extended to the
borrower. Over the course of a year, the a lender would not be allowed to charge more in
non-contingent fees and interest than 36% of the actual credit extended to the consumer. If
administrative fees pushed this rate over the cap, then the lender would be required to rebate
the excess fees.

140 Mann & Hawkins, supra note X, at 903 n.242.
Usurious credit will fund a black market that charges higher prices to insure against the risk of being caught and which specializes in violence. Counter arguments include the assertion that borrowers are not receiving mutually beneficial exchange because they lack sufficient information, are irrationally discounting the value of future wealth, or are simply suspending rational price comparison because of desperate circumstances. Usury law apologists also argue that many borrowers willing to borrow from nonviolent legal lenders may be unwilling or unable to borrow in a black market, decreasing the volume of usurious loans to the point that gains from the rule outstrip utility losses. Usury limits may also provide strong signaling effects which improve borrower shopping behavior. Usury limits may provide a rough form of social insurance. Usury limits provide a moral compass protecting creditors from their own avarice. And, usurious loans may have significant externalities not reduced by rational bargaining where it does exist. This debate is, of course, at least several hundred years old.

What this study adds to that debate is a vivid aide mémoire of the law as it was throughout all but the most recent few years in American history. One cannot be an ardent advocate of unregulated credit pricing and also unapologetically eulogize the founding fathers of our nation. Each of the signatories to the declaration of independence and every delegate at the U.S. Constitutional Conventions returned home to states with meaningful usury law. The “greatest generation” weathered the Great Depression and the Second World War with usury limits in place. And the sustained economic growth throughout the 1950s and 1960s, including extensive consumer finance of a host of goods and services, took place in a usury limited credit market. The snapshot of usury law in 1965 provided by this study should serve as a reminder that not long ago every state in the nation limited credit prices well below our current national median limit. From a historical perspective a 36% APR price limit—the 1965 national median—strikes a reasonable compromise in the age old usury law debate.

Finally third, usury limits should apply to all lenders irrespective of their mission, charter, or ownership. While the Russell Sage era small loan laws succeeded in inducing mainstream creditors into the consumer lending market, the legacy of these special usury laws has become a patchwork of exceptions, subterfuge, and disrepair. State after state now retains skeletons of usury law stripped bare by federal preemption, state legislative exceptions, and regulatory neglect. The all to common maze of general usury laws (both constitutional and statutory), small loan usury laws, special retail installment loan usury laws, motor vehicle financing usury laws, industrial loan act usury laws, pawnbroker usury limits, parity statutes, and deferred presentment acts serves no one’s interests. The bedrock principal of equal treatment under the law suggests that states should adopt, and the federal government should facilitate, more transparent usury legislation. Old special usury limits applicable only to one licensed class of lenders or another should be cleared out and replaced with a single, clear limit applicable equally to all.

VI. CONCLUSION

This Article presents an empirical analysis of prices tolerated by all fifty state usury laws in both 1965 and 2007. The study calculated the highest permissible
price of a typical payday loan for each state and time period and then expressed these prices as annual percentage rates following federal Truth-in-Lending Act guidelines. Moreover, this study proposes a new statistical concept, labeled salience distortion, to measure the difference between a usury law’s maximum annual percentage rate and the number most prominently featured within the text of each usury statute. While in this piece salience distortion measures credit pricing, the theoretical concept could easily be adapted to study a wide range of legislation. The empirical analysis in this article leads to three findings: since 1965 usury law has become much more lax, more polarized, and more misleading. This Article argues that with accounting sleight of hand, many state legislatures now use small, innocuous numbers in usury laws in an attempt to minimize the public and media outcry over their decisions to legalize triple digit interest rate loans. Abandoning the expression of loan price limits with simple nominal interest rates has allowed legislatures to frame the public debate over usury in a way that understates the recent national departure from the American historical tradition of aggressive credit price regulation.

142 Possible future applications of the salience distortion concept could include analysis of the Environmental Protection Agency’s automobile fuel economy disclosure standards, the description of revenue generated by various tax laws, and the use of off-budget funding for wars.
## APPENDIX

Table A. State Usury Limit Data for Inflation Adjusted Typical Payday Loans, 1965.

<table>
<thead>
<tr>
<th>State</th>
<th>Cap Type</th>
<th>Finance Charge</th>
<th>Total of Payments</th>
<th>APR</th>
<th>Salient Number</th>
<th>Salience Distortion</th>
<th>APR Rank</th>
<th>Salience Distortion Rank</th>
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<td>35.87%</td>
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<td>32</td>
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<td>27</td>
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### Table B. State Usury Limit Data for Typical Payday Loans, 2007.

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<th>Salient Number</th>
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<th>APR Rank</th>
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<td>456.29%</td>
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<td>460.06%</td>
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