

TESTING THE SUBSTITUTION HYPOTHESIS: WOULD CREDIT CARD REGULATION FORCE LOW-INCOME BORROWERS INTO LESS DESIRABLE LENDING ALTERNATIVES?

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ABSTRACT

One of the strongest arguments against regulating credit cards is the substitution hypothesis, which states that if a restriction on one form of credit decreases access, borrowers will respond by using other, less desirable forms of credit. For low-income consumers, the argument is more powerful still, because their other options are high-cost lenders such as pawn shops and rent-to-own stores. But the substitution hypothesis has been more frequently assumed than investigated, and the empirical research that has taken place does not support the theory as strongly as has been supposed. The theory is based on a naïve presumption about the constancy of demand for consumer credit and a failure to account for a more nuanced view of the role of credit supply. This Article presents original data from a study of low-income women. The findings suggest that lenders such as pawn shops and rent-to-own stores may function as complements more than substitutes. In addition, the research uncovered another form of credit that low-income families routinely use and participants evaluated favorably, but that has never been discussed in the academic literature. These findings suggest a more nuanced formulation of the hypothesis that better predicts the consequences of credit card regulation.

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I. INTRODUCTION

As consumer credit card debt continues to soar,¹ a rich variety of proposals to reverse this trend has emerged. These proposals include re-imposing usury caps (i.e., limits on how much interest lenders may charge);² prohibiting lenders from collecting on high-interest loans in bankruptcy;³ mandating that penalty fees reasonably reflect issuers' costs;⁴ and increasing fines and providing a private right of action for violations of the Truth in Lending Act.⁵ Despite major differences among these recommendations, for them to succeed they must all overcome a common counter-argument: the substitution of credit hypothesis. Under this hypothesis, if a proposal has any effect on access to credit cards, it will be counterproductive because people will respond by increasing their use of other, often more dangerous, forms of credit.⁶

This argument is particularly powerful in the context of low-income borrowers. They are on the margins of credit-worthiness, and a decrease in overall access to credit cards would affect them most dramatically. Moreover, they lack mainstream borrowing alternatives, such as low-cost home-equity credit. Under the substitution hypothesis, low-income borrowers would respond to a decrease in credit card availability by increasing their usage of even less desirable lenders, such as pawnbrokers and rent-to-own stores.⁷

¹ American households now hold an average of approximately \$9,300 worth of credit card debt. *Examining the Billing, Marketing, and Disclosure Practices of the Credit Card Industry, and Their Impact on Consumers: Hearing Before the Senate Comm. on Banking, Hous., and Urban Affairs*, 110th Cong. (2007) (statement of Sen. Christopher Dodd, Chairman, S. Comm. on Banking, Hous., and Urban Affairs), available at <http://dodd.senate.gov/index.php?q=node/3718/print>.

² ELIZABETH WARREN & AMELIA WARREN TYAGI, *THE TWO INCOME TRAP: WHY MIDDLE CLASS PARENTS ARE GOING BROKE* 144-52 (2003).

³ Credit Card Accountability Responsibility and Disclosure Act of 2005, S. 499, 109th Cong. § 1950 (2005). This legislation would bar the collection in bankruptcy of loans with interest rates more than 20 percentage points above the Federal prime lending rate.

⁴ Credit Card Reform Act of 2006, S. 2655, 109th Cong. § 3592 (2006).

⁵ *Examining the Billing, Marketing, and Disclosure Practices of the Credit Card Industry, and Their Impact on Consumers: Hearing Before the Senate Comm. on Banking, Hous., and Urban Affairs*, 110th Cong. (2007) (statement of Travis B. Plunkett, Legislative Dir., on Behalf of the Consumer Fed'n of Am., Consumer Action and Consumers Union), available at http://www.consumerfed.org/pdfs/Credit_Card_Senate_Testimony_01-07.pdf.

⁶ Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAP. L. REV. 79, 96 (2000) (arguing that under a legal regime with usury caps on credit cards, "credit card issuers would have fewer customers and pawn shops and rent-to-owns would have more." *Id.*).

⁷ See, e.g., *id.* at 83 ("[T]hese policies could have dramatic negative consequences for vulnerable low-income consumers who lack the borrowing options of wealthier individuals

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These arguments have been directed primarily at proposals to reinstate usury caps,⁸ but any proposal to regulate credit cards must contend with the assertion that the substitution of credit will lead to unintended consequences.

There are two factual contentions implicit in the substitution hypothesis, both of which must be true for the argument to succeed. First, the different kinds of borrowing must, in fact, be interchangeable with one another. There must be some causal relationship such that when use of credit cards decreases, use of other borrowing increases. Second, there must be borrowing options that are “worse” than credit cards. If there is no form of borrowing less desirable than credit cards, it follows that regulation decreasing access to credit cards will not lead low-income people to use less desirable borrowing. The literature to date has focused narrowly on the first premise to the exclusion of the second. Several studies have attempted to demonstrate a relationship between credit card regulation and increases in other types of borrowing, but there has been minimal exploration of the implications of such a shift. One reason for this neglect may be that credit cards are seen as a middle-class form of borrowing and, thus, are assumed to be less exploitive than credit products aimed primarily at the poor.

But these contentions have been oversimplified in the previous research. Researchers tend to ask whether substitution occurs at all instead of the extent to which it occurs. The literature frequently assumes that any substitution between credit card borrowing and other forms indicates that there is complete substitution between them,⁹ without exploring whether they are fully, extensively, or only minimally, interchangeable. Once the interchangeability prong of the hypothesis is correctly framed as a question of degree, then the importance of analyzing the harm of any potential substitution crystallizes. The hypothesis becomes an economic balancing test, with the harm the regulation is designed to prevent on one side of the scale and the predicted level of harm caused by the expected degree of substitution on the other.

This Article uses original data from a small study of low-income, female consumers as a way of exploring these two interrelated questions with more precision. First, the study analyzed participants’ borrowing histories to assess

and as a result may be driven back into the hands of pawnbrokers, rent-to-own financiers, and loan sharks who flourished prior to the deregulation of the credit card market.”); Timothy J. Muris, *Payment Card Regulation and the (Mis)Application of the Economics of Two-Sided Markets*, 2005 COLUM. BUS. L. REV. 515, 527 (2005) (“The growth in credit card credit appears to have resulted primarily from the substitution of cards for alternative, less attractive forms of credit. For instance, many consumers who cannot obtain unsecured credit through credit cards are instead forced to rely on pawn shops and payday lenders.” *Id.*).

⁸ Zywicki, *supra* note 6, at 96.

⁹ See discussion *infra* Part III.A.

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the degree to which they use the different borrowing types as substitutes or complements. It also examined the borrowing usage of participants who were constrained from obtaining their desired level of credit card credit, analyzing whether they more often used other types of credit than their unconstrained counterparts. The current study not only found a low degree of substitution, but also uncovered two reasons why this was the case. Credit cards offer low-income borrowers significantly more total credit than they can obtain from their other credit options. Although a decrease in the supply of credit from credit cards might result in some increase in borrowing from lenders such as pawn shops and rent-to-own stores, the small-scale nature of these credit sources would prevent them from completely filling the gap. In addition, credit cards in and of themselves may serve as spending stimuli, triggering consumers to spend more than they otherwise would. In the case of low-income consumers, whose budgets are already stretched thin, spending more almost necessarily means borrowing more. These findings suggest a need for more research before definitive conclusions about the interchangeability presumption can be drawn.

Second, the study asked participants to compare their credit options along two measures and found that movement of low-income consumers away from credit cards and toward traditionally stigmatized lenders, such as pawn shops and rent-to-own stores, may have fewer negative consequences than the exclusive focus on interchangeability suggests. Credit cards were among participants' least preferred forms of borrowing. Participants gave rent-to-own stores and credit cards the poorest evaluations, citing in the latter case how easy it was to lose control over credit card borrowing and accumulate unmanageable debt.¹⁰ They evaluated pawn shops slightly more positively and gave even more favorable evaluations to a form of credit that is virtually unheard of in the literature, borrowing from mail-order catalogs.¹¹ They also judged informal borrowing from friends and family quite positively. The study has one major limitation in this respect. The participants all lived in Massachusetts, which effectively prohibits payday lending through its usury statute.^{12 13}

¹⁰ See discussion *infra* Part III.C.

¹¹ *Id.*

¹² MASS. GEN. LAWS ch. 271, § 49 (1971). See also Press Release, Commonwealth of Massachusetts Office of Consumer Affairs and Business Regulation, State Orders More Payday Lenders to Cease Activity in Massachusetts: Unlicensed Lenders Typically Charge Illegal Fees and Interest Rates (May 26, 2006), available at http://www.mass.gov/?pageID=pressreleases&agId=Eoca&prModName=ocapressrelease&prFile=06_05_30_lenders.xml. Indeed, only the two participants who mentioned having lived in another state for substantial period of time had even heard of pay-day lending.

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These results suggest that even if a shift of low-income borrowers from credit cards to other options did take place, it would not have the degree of negative consequences previously assumed. If the regulation that caused such a shift were to provide real benefits to those who continued to use credit cards, these benefits may outweigh the harm caused by substitution. Of course, one small study cannot provide enough information to weigh these costs and benefits precisely, but the low degree of substitution and negative evaluations of credit cards revealed in the current study indicate that the likelihood of a regulation-favorable balance is high enough to be further studied.

Part II of the Article provides a brief overview of the study's methodology. Part III discusses the interchangeability presumption of the substitution hypothesis. It reviews the empirical literature to date and presents the interchangeability results of the current study in that context. Part IV analyzes what is known about the subjective preferences of low-income borrowers. It reviews the sparse literature on the topic and uses data from the current study to provide a more nuanced analysis, demonstrating that the degree of harm that substitution may cause is, at best, unproven. This Part also explores the product features that low-income consumers evaluate when making borrowing decisions. It argues that the fringe lending products appear to compete more on non-price attributes than price, suggesting that regulation which led credit card issuers to increase interest rates would not necessarily trigger substitution. Part V concludes by arguing that questions of consumer protection should not be avoided on the basis of this largely untested hypothesis.

II. METHODOLOGY

The availability of credit cards to low-income people has exploded in the decades since deregulation.¹⁴ Under the substitution hypothesis, one of the major advantages of this development is that low-income people have been able to borrow from credit-card companies to decrease their usage of less desirable forms of credit available in what is known as the “fringe banking” or “alternative” credit market.¹⁵ The present study sought to unpack this theory

¹³ In future research I plan to study families in jurisdictions with a variety of borrowing regimes.

¹⁴ See David A. Moss & Gibbs A. Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, 73 AM. BANKR. L.J. 311, 333-37 (1999) (describing the expansion of credit card availability for low- and moderate-income borrowers over the past two and half decades).

¹⁵ John Caskey popularized the term “fringe banking” in JOHN P. CASKEY, FRINGE BANKING: CHECK-CASHING OUTLETS, PAWN SHOPS AND THE POOR 14 (1994). Michael Barr uses the

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and examine the workings of the substitution hypothesis from the viewpoint of low-income credit consumers.

Fifty low-income women were interviewed for the study. Participants qualified as “low-income” on the basis of eligibility for government-subsidized housing. I sampled only women because the financial pressures experienced by low-income families raising children increase the stakes of their borrowing decisions. And women at this income level are significantly more likely than men to be raising children.¹⁶

The study employed a snowball sample, an established method for surveying populations that may be hard to reach through randomized techniques.¹⁷ To conduct a snowball sample, the researcher begins by interviewing one person or a small group of people who meet the study criteria.¹⁸ Those initial participants are then asked to refer the researcher to other people who may be interested until the desired sample size is reached. Snowball samples are particularly appropriate for qualitative studies, which is

term “alternative credit.” Michael S. Barr, *Banking the Poor*, 21 YALE J. ON REG. 121, 124 (2004).

¹⁶ Creola Johnson, *Payday Loans: Shrewd Business or Predatory Lending?*, 87 MINN. L. REV. 1, 100 n.531 (2002); Sandra J. Newman, *The Implications of Current Welfare Reform Proposals for the Housing Assistance System*, 22 FORDHAM URB. L.J. 1231, 1235 (1995).

¹⁷ See, e.g., Jean Faugier & Mary Sargeant, *Sampling Hard to Reach Populations*, 26 J. ADVANCED NURSING 790, 790 (1997); Sarah H. Ramsey & Robert F. Kelly, *Using Social Science Research in Family Law Analysis and Formation: Problems and Prospects*, 3 S. CAL. INTERDISC. L.J. 631, 643 (1994). For examples of research using snowball samples to study legal issues, see José B. Ashford, *Comparing the Effects of Judicial Versus Child Protective Service Relationships on Parental Attitudes in the Juvenile Dependency Process*, 16 RES. ON SOC. WORK PRAC. 582, 582 (2006) (using a “convenience sample” of 40 to study the effect of judicial and case-worker relationships on perceptions of fairness by parents in the child-protective services process); Mariano-Florentino Cuellar, *Refugee Security and the Organizational Logic of Legal Mandates*, 37 GEO. J. INT’L L. 583, 586 (2006) (using a snowball sample to obtain one of three sets of interviews on “the legal, political, and bureaucratic dynamics affecting refugees’ physical security”); Rosanna Hertz, *The Contemporary Myth of Choice*, 596 ANNALS 232 (2004) (reviewing a study in which researcher Phyllis Moen located through a snowball sample women who left full-time careers to raise children); Elizabeth Chambliss & David B. Wilkins, *The Emerging Role of Ethics Advisors, General Counsel, and Other Compliance Specialists in Large Law Firms*, 44 ARIZ. L. REV. 559, 561 (2002) (investigating “the emerging role of compliance specialists in large law firms” using a snowball sample). The difficulty and expense of reaching low-income populations for empirical work is well-documented. E.g., Michael S. Barr, Principal Investigator, Survey Res. Ctr., Inst. for Soc. Res., Univ. of Michigan, *Detroit Area Household Financial Services Study* (2006), <http://www-personal.umich.edu/~msbarr/> (follow “Detroit Area Study” hyperlink).

¹⁸ I knew twelve population members from previous work in the community.

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how this project began.¹⁹ It was only after the data had been collected and coded that the substitution trends began to emerge. The usage of a snowball sample means that my quantitative analysis is necessarily preliminary. I plan to use these results as the basis for developing a larger, randomized sample in future research.

The study paid participants twenty dollars and recorded the interviews on a digital voice recorder. The recordings were transcribed by a professional service.

The first section of the interviews elicited information on demographics and financial resources. The study then took comprehensive credit histories regarding each form of borrowing participants had used. The final section of the interviews asked participants to evaluate their credit options and the policies that regulated them. Transcripts were coded and analyzed using content analysis, a standard technique for parsing qualitative data.^{20 21}

III. THE INTERCHANGEABILITY OF CREDIT CARDS AND OTHER FORMS OF BORROWING

A. *Prior Empirical Research*

Almost universally, commentators seeking to understand substitution have focused on the interchangeability prong of the hypothesis. These researchers have studied how other forms of borrowing are used when credit card borrowing is constricted.

Three basic study designs are used to assess this element of the hypothesis: time-series, regulatory, and borrowing history. The time-series designs examine how types of non-credit-card borrowing have evolved in the face of the explosive growth of credit card borrowing over the past several decades.²² They argue that if a decrease in other forms of borrowing accompanied this tremendous growth in credit card borrowing, then consumers must have switched to credit cards as they became more popular.

¹⁹ See Angela Littwin, *Beyond Usury: A Study of Credit Card Use and Preference Among Low-Income Consumers*, 86 TEXAS L. REV 451 (2008).

²⁰ See generally, KLAUS KRIPPENDORFF, CONTENT ANALYSIS: AN INTRODUCTION TO ITS METHODOLOGY (2d ed. 2004); ROBERT PHILIP WEBER, BASIC CONTENT ANALYSIS 9 (2d ed. 1990).

²¹ For a detailed discussion of the study methods and a description of the sample, please see the Appendix on Methodology in the companion piece to this Article. Littwin, *supra*, note 19.

²² For data on the increase in credit card borrowing, see Moss & Johnson, *supra* note 14 at 334; Edward J. Bird et al., *Credit Card Debts of the Poor: High and Rising*, 18 J. OF POL'Y ANALYSIS AND MGMT. 125, 128 Table 1 (1999).

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The regulation-based studies take advantage of the “laboratory of the states,”²³ or in one case, the laboratory of the countries,²⁴ and examine consumer usage of non-credit card borrowing when credit card borrowing is constricted through statutory regime. They argue that if tighter restrictions on credit card borrowing are correlated with increased usage of borrowing unrestricted by statute, then consumers must be substituting one form of borrowing for the others.

Borrowing-history study designs examine the degree of substitution among borrowing types that takes place at the level of the individual consumer. They ask whether consumers who borrow with credit cards tend to use other kinds of borrowing more or less than those who do not. They argue that if credit card borrowing and other borrowing tend to correlate inversely, then consumers are more likely to be using them as substitutes. If instead, consumers who borrow with credit cards tend to use other borrowing types more, then the different borrowing types tend to be complements. The current study offers new data on the interchangeability prong of the substitution hypothesis through this methodology.

Although researchers have focused almost exclusively on the interchangeability prong of the substitution hypothesis, the results have been inconclusive. Many of the individual studies have methodological difficulties, discussed below, that make their specific conclusions problematic. More profoundly, past research has tended to view substitution as an “on or off” proposition; either it exists or it does not. It has not asked *how much* of a substitution effect occurred.

In addition, the previous studies have not assessed the predictive power of their findings. The importance of the substitution hypothesis lies in its accuracy as a prediction. It is based on policy makers’ need to know how much substitution would occur if restrictions on credit card borrowing were imposed. But researchers have not assessed the likelihood that their results are applicable to potential future regulation. This type of work needs to be undertaken.

(1) Time Series Studies

Most of the time-series research relies on national-level data, either from the Survey of Consumer Finances (SCF) or aggregate numbers the Federal Reserve collects in its supervisory capacity. The SCF is a triennial, publicly-available household survey that the Federal Reserve has conducted since

²³ *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

²⁴ See *infra* note 68.

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1962.²⁵ The aggregate data come from various statistical releases the Federal Reserve collates from loan-volume data submitted by banks and other lending institutions.

There are trade-offs between using survey data and aggregate statistics. The SCF has been criticized as underreporting debt.²⁶ In order to facilitate ease of administration, the survey relies on self-reporting of financial variables.²⁷ This presents a high risk of underreporting, both because credit statements can be complex and because study respondents tend to underreport negative or stigmatized information.²⁸

Indeed, the adjusted level of debt found by the recent versions of the SCF is lower than that reported by the Federal Reserve's aggregate measures, such as Federal Reserve Release G.19²⁹ and the federal Flow of Funds Accounts (FFA).³⁰ These measures are based on lender records rather than borrower estimates, so they are unlikely to suffer from underreporting.³¹ Researchers

²⁵ SCF home page, <http://www.federalreserve.gov/Pubs/oss/oss2/scfindex.html>. The survey measures household wealth, income, and debt for a sample of approximately 4,000 families, depending on the response rate of each year's survey.

²⁶ Posting of Bob Lawless to Credit Slips blog, <http://www.creditslips.org/creditslips/2007/08/pulliam-weston-.html#more> (Aug. 1, 2007, 23:28 CST).

²⁷ See, e.g., Brian K. Bucks et al., *Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances*, FED. RES. BULL. A1, A38, (Mar. 22, 2006), available at <http://www.federalreserve.gov/Pubs/oss/oss2/2004/bull0206.pdf> (explaining the protocol the survey uses when respondents are unable or unwilling to provide exact figures). This contrasts with the methodology of the Consumer Bankruptcy Project, which obtains most of its income, debt, and asset data from court records.

²⁸ Underreporting is a concern in research that examines stigmatized topics such as abortion (J. Richard Udry et al., *A Medical Record Linkage Analysis of Abortion Underreporting*, 28 FAMILY PLANNING PERSPECTIVES 228, 228-31 (1996), premarital sex (Barbara S. Mensch, Paul C. Hewett & Annabel S. Erulkar, *The Reporting of Sensitive Behavior by Adolescents: A Methodological Experiment in Kenya*, 40 DEMOGRAPHY 247, 247-68 (2003), and caloric intake among overweight women (Debra C. McKenzie et al., *Impact of Interviewer's Body Mass Index on Underreporting Energy Intake in Overweight and Obese Women*, 10 OBESITY RES. 471, 471-77 (2002).

²⁹ Jonathan Zinman, *Where is the Missing Credit Card Debt? Clues and Implications*, (July 2007) (unpublished working paper, available at http://www.dartmouth.edu/~jzinman/Papers/Zinman_MissingCardDebt_july07.pdf).

³⁰ Rochelle L. Antoniewicz, *A Comparison of the Household Sector from the Flow of Funds Accounts and the Survey of Consumer Finances*, Federal Reserve Board of Governors (June 2000), available at http://www.federalreserve.gov/Pubs/oss/oss2/papers/antoniewicz_paper.pdf.

³¹ However, there may be other flaws in its methodology. Wendy M. Edelberg & Jonas D. M. Fisher, *Household Debt*, CHI. FED. LETTER, Nov. 1997, at 1, 1-2 (1997) (arguing that the SCF is more accurate than the macro data because it is based on direct evidence).

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have not been able to definitively conclude which measures of consumer debt is too high and which are too low.³² But despite this potential major flaw, the SCF is the only public national database of individual household debt.³³

Researchers using aggregate-level data encounter a different set of problems. The usefulness of aggregate data is limited by the fact that it cannot provide information “on how debt is distributed among households that differ economically and demographically and how these distributions change over time.”³⁴ This is especially problematic in the current context because of recent changes in the demographic distribution of debt,³⁵ as mortgage and credit card debt has become more available to low-income consumers. An additional difficulty is that many researchers use these statistics to compute the household debt burden. Because a number of households will have none of a given type of debt, the debt burden of households who do have that debt type will be diluted by the zero values of those who do not. As a result, the aggregate measures substantially understate the debt burdens faced by households with debt.

Researchers using time-series data tend to argue for a strong version of the substitution hypothesis, but in actuality, this research is not specific enough to answer the interchangeability question. The time-series studies conclude that substitution occurred on the basis of their findings that non-revolving debt decreased while credit card debt increased. For example, in a 1997 Chicago Fed Letter, economists Wendy M. Edelberg and Jonas D.M. Fisher use SCF data to show that from 1989 through 1995, low-income consumers increased their usage of revolving debt while exhibiting a corresponding decrease in their usage of installment debt. The authors suggest that “there has not been a substantial increase in high-interest debt for low-income households, but that these households have merely substituted one type of high-interest debt for another.”³⁶ Similarly, two additional Federal Reserve studies using aggregate

³² Antoniewicz, *supra* note 30 (explaining where the studies diverge but not taking a position on which is more correct). For another Federal Reserve explanation of the differences, see Ana M. Aizcorbe et al., *Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances*, FED. RES. BULL. 1, 27 n.30 (January 2003), available at <http://www.federalreserve.gov/Pubs/oss/oss2/2001/bull0103.pdf>.

³³ The Consumer Bankruptcy Project also studies debt at the household level, but it is limited to families in bankruptcy, so it cannot provide data on questions of borrowing substitution among families who are not financially distressed.

³⁴ Glenn B. Canner et al., *Household Sector Borrowing and the Burden of Debt*, FED. RES. BULL. 323, 323 (April 1995).

³⁵ CHI. FED LETTER, *supra* note 31, at 1.

³⁶ CHI. FED LETTER, *supra* note 31, at 3 (cited in Todd J. Zywicki, *An Economic Analysis of the Consumer Bankruptcy Crisis*, 99 NW. U. L. REV. 1463, 1495, n.120 (2005)).

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statistics appear to suggest that the non-credit card household debt burden has declined since the beginning of the credit card boom.³⁷

Perhaps the strongest support for the existence of a substantial substitution effect comes from Federal Reserve economist Thomas A. Durkin's study of credit cards from 1970 through 2000.³⁸ He uses evidence from the Federal Reserve's Statistical Release G.19³⁹ to show that, as usage of revolving credit increased from the late 1960s⁴⁰ through the turn of the millennium, other consumer credit decreased proportionally.⁴¹ Durkin concludes that a "substantial portion of the new revolving credit probably has merely replaced credit generated by the installment-purchase plans that were common at appliance, furniture, and other durable goods stores in the past."⁴²

Inferences such as this one, however, are premature. These studies do not provide enough information to draw conclusions about the degree of substitution between credit card borrowing and the older forms of installment borrowing. First, the installment debt category that the studies show decreased is primarily composed of borrowing such as car loans and student loans that are not plausible substitutes for credit card borrowing. The decrease in this category may be due in large part to a decrease in car financing as automobile leasing grew in popularity.⁴³ Second, some of the studies compare minimum credit card payments to periodic installment debt payments, which significantly understates the relative amount of credit card debt.

The problem of juxtaposing credit card debt with an incomparable category of installment debt pervades all of the studies discussed.⁴⁴ Recent

³⁷ Canner et al., *supra* note 34, at 324 chart 2; Karen Dynan et al., *Recent Changes to a Measure of U.S. Household Debt Service*, FED. RES. BULL. 417, 420 chart 1 (October 2003). Both articles present data showing that the authors' calculation of the consumer debt burden has increased only slightly over recent decades. The relevance of these findings for the substitution hypothesis is that for the total debt burden to remain relatively constant during a period in which the credit card debt burden was increasing, the non-credit card debt burden must have been decreasing.

³⁸ Thomas A. Durkin, *Credit Cards: Use and Consumer Attitudes, 1970-2000*, FED. RES. BULL. 623, 623-24 (September 2000) (cited in Zywicki, *supra* note 36, at 1492, n.111).

³⁹ Phone call to author, Jun. 22, 2007. The G.19 data is available at <http://www.federalreserve.gov/releases/g19/> (last visited Aug. 28, 2007).

⁴⁰ This is when the Federal Reserve started tracking revolving debt separately. Durkin, *supra* note 38, at 624 Figure 1.

⁴¹ All of these figures exclude mortgage credit.

⁴² Durkin, *supra* note 38, at 624.

⁴³ See *infra* note 49.

⁴⁴ In the SCF studies, installment includes "automobile loans, student loans, and loans for furniture, appliances, and other durable goods." Bucks et al., *supra* note 27, at A30, n.39.

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SCF data suggests that the vast majority of non-revolving, non-mortgage debt consists of car loans and student loans. In 2004, car loans comprised 55.5 percent of total installment debt, and student loans made up 26.0 percent, leaving only 18.5 percent of the total available for loans that could be comparable with credit cards.⁴⁵ The 2001 SCF data shows similar results.⁴⁶ The aggregate statistics Durkin uses support a similar division between car, student, and personal loans in recent years. His data show that, as of 1999, consumer non-revolving debt still comprised a higher share of disposable personal income than consumer revolving debt.⁴⁷ This could not be true if most of the non-revolving debt consisted of personal lines of credit and installment loans.

The only way this data could support the substitution hypothesis is if the level of personal borrowing from stores and finance companies was so high at the beginning of the credit card era that these loans accounted for a much larger percentage of nonrevolving debt than they do now. This does not appear to be the case. None of the studies attempt to divide the installment debt statistics into their component parts, and the only older data I found on this precise issue suggested that personal loans have comprised a small percentage of installment debt for several decades. An analysis of the 1962 SCF reveals that only 28 percent of non-mortgage installment debt was unrelated to automobiles or home repairs.⁴⁸ In addition, the proportion of automobile debt in this category declined from 63 percent in 1962 to the current 55.5 percent in 2004 and 54.8 percent in 2001. This decrease may reflect a raw decline in automobile lending due to the rising popularity of leasing cars, rather than borrowing money to purchase them.⁴⁹

Two of the studies suffer from a second major limitation: they compare the periodic payments on installment loans to the minimum payments due on

Most of the aggregate research defines installment debt similarly. *See* Durkin, *supra* note 38, at 624 (defining “non-revolving debt” as “secured and unsecured credit for automobiles, mobile homes, trailers, durable goods, vacations, and other purposes” *Id.* at 624 n.1); Dynan et al., *supra* note 37, at 418 (analyzing a debt category called “nonauto, non-revolving debt,” which includes student, mobile home, RV and marine, and personal loans.” *Id.*).

⁴⁵ Bucks et al., *supra* note 27, at A30.

⁴⁶ *Id.*

⁴⁷ Durkin, *supra* note 38, at 624 Figure 1.

⁴⁸ This conclusion is drawn from an original analysis of data from the 1962 Survey of Financial Characteristics of Consumers (the predecessor to the SCF). The data is available at <http://www.federalreserve.gov/Pubs/oss/oss2/6263/sfcc6263home.html> (last visited Sept. 9, 2007).

⁴⁹ Dynan et al., *supra* note 37, at 421-22.

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credit card balances.⁵⁰ While the minimum payment is technically the amount a credit-card borrower must pay each month, as of 2004, only 18 percent of credit card users, or 39 percent of those who revolve a balance, paid this little.⁵¹ The minimum payment is not comparable to the monthly payment of an installment contract, and using it will tend to understate credit card debt.

An additional difficulty is that the minimum payment rate – the percentage of the total balance the consumer must pay – changes periodically. As late as the mid-1980s, some minimum payments required consumers to pay 20 percent of their balance.⁵² In recent years, the minimum payment rate ranged between 2 and 2.5 percent⁵³ of a consumer's credit card balance until 2005 and then gradually increased to 4 percent pursuant to a 2005 federal directive.⁵⁴ A measure using the minimum payment fluctuates with these modifications, making it an inconsistent measure of actual changes in consumer debt.

In addition to these specific methodological issues, the time-series research also suffers from a fundamental difficulty that limits its predictive power. By necessity, this research has examined credit card substitution from the wrong causal direction. Credit card usage has only increased over time, but the relevant substitution question is one of a decrease in credit card borrowing. In other words, researchers have examined whether consumers substitute away from other forms of borrowing as credit cards became more available, but it is unclear whether consumers would exercise the same degree of reverse-substitution if credit cards became less available.

The time-series studies have one final limitation with respect to the interchangeability of borrowing types among low-income consumers that is the focus of this Article. Some of the data sets analyzed in these studies do not include the borrowing types commonly used by low-income consumers.

⁵⁰ Dynan et al., *supra* note 37, at 426 (explaining this part of their methodology). For a description of the methodology used to calculate the measure used in Canner et al., *supra* note 34, see Lynn Paquette, *Estimating Household Debt Service Payments*, FED. RES. BANK OF N.Y. Q. REV. 16 (Summer 1986).

⁵¹ *Forty-two Percent -42%- of Americans Are Making Minimum Or No Payments on Their Credit Card Balances, According to the Cambridge Consumer Credit Index "Reality Gap" Consumer Plans To Pay Off Debt*, BUS. WIRE, March 5, 2004, available at http://findarticles.com/p/articles/mi_m0EIN/is_2004_March_5/ai_113928683.

⁵² Lynn Paquette, *supra* note 50, at 16. In 1986, the minimum payment was 5 percent of the balance for bank cards, 8 percent for store cards, and 20 percent for gas station cards. *Id.*

⁵³ E.g., Melody Warnick, *Credit Card Minimum Payments Rising*, BANKRATE.COM, May 3, 2005, <http://www.bankrate.com/brm/news/debt/20050503a1.asp>.

⁵⁴ Joint Press Release, Fed. Deposit Ins. Corp., FFIEC Agencies Issue Guidance on Credit Card Account Management and Loss Allowance Practices, NR 2003-01 (Jan. 8, 2003), available at <http://www.occ.treas.gov/ftp/release/2003-01.htm>.

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The installment borrowing category typically includes loans from stores, which can be assumed to include rent-to-own stores and mail-order lending catalogs, discussed in Part IV.C.(2) *infra*, though this is never made explicit. Although it is unclear whether the SCF data includes pawn shop borrowing, it seems unlikely, since pawn shop loans are not made on an installment basis. The aggregate Federal Reserve statistics do not include data on pawn broking.⁵⁵

It is important to note that this lack of specific data necessary for the evaluation of borrowing substitution is not because the time-series studies are inherently flawed. The methodological choices that limit their applicability to the substitution hypothesis may enhance their usefulness for other purposes, such as analyzing changes in the consumer debt burden over time.⁵⁶

(2) Comparative Jurisdiction Studies

In contrast, the studies that use the “laboratory of the states” methodology tend to examine the substitution hypothesis more explicitly and analyze directly the debt of low-income consumers. Three studies have addressed the interchangeability question by comparing borrowing usage across jurisdictions with different regulatory regimes.

The first examined pre-*Marquette*⁵⁷ Arkansas, which had a ten-percent usury cap, and found that the state had higher rates of retail credit and pawnshop usage than other parts of the country.⁵⁸ Retail creditors and pawnbrokers could avoid usury caps by charging higher prices for goods and undervaluing pawned collateral, respectively.⁵⁹

It is unclear how much weight can be placed on these findings, however. The study originally examined local credit markets in four states, two with permissive credit regimes and two with substantial restrictions.⁶⁰ But the results from the other restrictive state did not differ from those of the two permissive states even though the localities had been matched for similar

⁵⁵ CASKEY, *supra* note 15, at 47-48.

⁵⁶ See, e.g., Dynan et al., *supra* note 37, at 417 (the goal of the article is to update a measure of household debt service ratio to reflect changes in financial markets).

⁵⁷ *Marquette Nat'l Bank of Minneapolis v. First Omaha Serv. Corp.*, 439 U.S. 299 (1978). For further discussion of *Marquette*, see *infra* note 70.

⁵⁸ Richard L. Peterson & Gregory A. Falls, *Impact of a Ten Percent Usury Ceiling: Empirical Evidence* 15 (Credit Res. Ctr., Working Paper No.40, 1981, available at <http://www.business.gwu.edu/research/centers/fsrp/pdf/WP40.pdf>; Richard L. Peterson, *Usury Laws and Consumer Credit: A Note*, 38 THE JOURNAL OF FIN., 1299, 1299-1304 (1983).

⁵⁹ *Id.* at 16.

⁶⁰ *Id.* at 3.

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socio-economic profiles.⁶¹ The authors do not explain this result, but perhaps the difference between Arkansas and the other three states was due to that state's especially restrictive usury limit.⁶² The discrepancy may also be explained by the fact that the study's most statistically significant findings were significant only at the 90 percent confidence level.⁶³ Finally, the pawn shop finding may be more reflective of national trends in pawn-broking than local ones. In the late 1970s, the pawn-broking industry was just climbing out of a decades-long slump,⁶⁴ and the study found a total of only ten pawn shops in all four localities,⁶⁵ a result with no statistical significance.⁶⁶ More recent national data suggest that high levels of pawn-shop transactions are correlated with *permissive* usury laws.⁶⁷

Recently, the United Kingdom's Department of Trade and Industry (DTI) and the research group Policis released two reports based on a study comparing the regulated credit economies of Germany and France to the relatively free-market regime of the UK.⁶⁸ The study found that consumers in Germany and France had higher rates of reported illegal borrowing than those in the UK.⁶⁹ These results suggest a high level of substitution between legal and illegal borrowing, although they are difficult to apply to the United States due to the very different mix of borrowing products, lending regulations, and social service safety nets in those three countries.

The DTI/Policis study also performed a comparative analysis of borrowing among U.S. states. However, the analysis suffers from the fact that the

⁶¹ *Id.* at 3, 5.

⁶² In 1979, the year of the study, Arkansas' usury cap of ten percent was below the prime rate. HSH Associates Financial Publishers, *ARM Indexes: Prime Rate, 1975-1979*, available at <http://www.hsh.com/indices/prime70s.html>.

⁶³ Peterson & Falls, *supra* note 58, at 6-7, 9-10, 13-14; Peterson, *supra* note 58, at 1301 Table I. See also John R. Allison & Starling D. Hunter, *On the Feasibility of Improving Patent Quality One Technology at a Time: The Case of Business Methods*, 21 BERKELEY TECH. L.J. 729 (stating that .05 is the "traditional level" for significance of results. *Id.* at 748 n.57).

⁶⁴ CASKEY, *supra* note 15 at 27-30.

⁶⁵ Peterson & Falls, *supra* note 58, at 17.

⁶⁶ *Id.*

⁶⁷ CASKEY, *supra* note 15, at 50-51.

⁶⁸ POLICIS., THE EFFECT OF INTEREST RATE CONTROLS IN OTHER COUNTRIES (2004) [hereinafter DTI REPORT],

http://microfinancegateway.com/files/25620_file_The_effect_of_interest_rate_controls.pdf; POLICIS, ECONOMIC AND SOCIAL RISKS OF CONSUMER CREDIT MARKET REGULATION (2006), http://www.policis.com/financial_services_market_regulation.htm (follow "Economic and Social Risks of Consumer Credit Market Regulation" hyperlink) [hereinafter ECONOMIC AND SOCIAL RISKS].

⁶⁹ DTI REPORT, *supra* note 68, at 44. The rate was 3 percent of low-income or credit-impaired borrowers in the UK, compared to 7 percent in France and 8 percent in Germany. *Id.*

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researchers neglected to account for the effects of federal preemption of state usury laws and proceeded from the assumption that state restrictions on credit terms are enforceable.⁷⁰ The one exception is the study's examination of payday lending, which is no longer effectively preempted by federal law.⁷¹ The study's findings here support a low level of substitution among payday, pawn, rent-to-own, and auto-title loans. States that had the most restrictive payday lending regimes had lower loan revenues from rent-to-own stores and auto title loans, than those with less restrictive systems.⁷²

In 2007, Federal Reserve economist Donald Morgan released a study in which he found that payday loan prices in a given area decreased as the number of payday lenders and pawn shops per capita increased.⁷³ This finding appears to suggest that consumers may view pawn shops and payday

⁷⁰ See, e.g., DTI REPORT, *supra* note 68, at 6. In 1978, the United States Supreme Court effectively held that state usury laws were preempted. *Marquette*, 439 U.S. at 319. In *Marquette*, the Court held that section 85 of the National Bank Act allowed national banks to "export" the interest rate allowed by the bank's home state to customers living in other states. *Id.* at 299. Federal statute gave state-chartered banks this same right in 1980. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified as amended in scattered sections of 12 U.S.C.). (cited in Elizabeth R. Schiltz, *The Amazing, Elastic, Ever-Expanding Exportation Doctrine and Its Effect on Predatory Lending Regulation*, 88 MINN. L. REV. 518, 566 (2004). This prompted a race to the bottom in which credit card issuers moved to states with no usury laws, and some states with strict usury laws relaxed theirs in order to maintain their banking sectors. As a result of this trend, credit card issuers have more control over the interest rates they charge than state regulators. E.g., Christopher Peterson, *Federalism and Predatory Lending: Unmasking The Deregulatory Agenda*, 78 TEMP. L. REV. 1, 36-37 (2005).

⁷¹ Until the actions of federal regulators in the early 2000s, payday lenders made use of the exportation doctrine by partnering with banks through what became known as "rent-a-charter" agreements. See, e.g., Ronald J. Mann & Jim Hawkins, *Just Until Payday*, 54 UCLA L. REV. 855, 872 (2007). The OCC and the FDIC ended this practice for national and state banks, respectively. For steps taken by the OCC, see OFFICE OF THE COMPTROLLER OF THE CURRENCY, U.S. DEP'T OF THE TREASURY, ADVISORY LETTER 2000-9: THIRD-PARTY RISK (2000), <http://www.occ.treas.gov/ftp/advisory/2000-9.doc>; OFFICE OF THE COMPTROLLER OF THE CURRENCY, U.S. DEP'T OF THE TREASURY, ADVISORY LETTER 2000-10: PAYDAY LENDING (2000), <http://www.occ.treas.gov/ftp/advisory/2000-10.doc>; OFFICE OF THE COMPTROLLER OF THE CURRENCY, U.S. DEP'T OF THE TREASURY, OCC BULL. NO. 2001-47: THIRD-PARTY RELATIONSHIPS (2001), <http://www.occ.treas.gov/ftp/bulletin/2001-47.doc>. For FDIC action, see Fed. Deposit Ins. Corp., *Guidelines for Payday Lending*, <http://www.fdic.gov/regulations/safety/payday> (last visited Sep. 7, 2007).

⁷² DTI REPORT, *supra* note 68, at 37 Figure 17. The pawn shop revenue data was mixed, though it was more suggestive of a low level of substitution than a higher one. *Id.*

⁷³ Donald P. Morgan, *Defining and Detecting Predatory Lending* 20-21 (Fed. Res. Bank of N.Y. Staff Report, Working Paper No. 273 2007) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=962711.

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loans as substitutes. Indeed, Morgan cites the CEO of a major pawnshop chain claiming that the rise of payday lending has hurt his company,⁷⁴ although this statement is weakened by the fact that payday loan customers tend to be from a higher income demographic than pawn shop borrowers.⁷⁵ Morgan's methodology has some difficulties, however. Most significantly, he compares prices from 2001 with store numbers in 2005, despite the fact that the payday lending regulatory landscape underwent significant transformation during those four years.⁷⁶

His research, however, suggests an important avenue for future work. Comparative jurisdiction research has been limited by federal legislative preemption of most state lending laws, first recognized in 1978 in *Marquette*.⁷⁷ With most state laws effectively preempted, it was difficult to compare borrowing trends in states with differing levels of regulation. A new regulatory development has partially alleviated this problem. In 2000 and 2001, the Office of the Comptroller of Currency (OCC) issued a directive that prevented payday lenders from using the federal preemption,⁷⁸ thus allowing states to regulate the industry. States have already begun using their new power.⁷⁹ Even though credit card regulations are still preempted at the federal level, researchers can now study the substitution effects of regulating payday loans on a state-by-state basis. For the first time in decades, restrictions on a widely-used form of borrowing are increasing rather than decreasing, so researchers can study substitution from the correct causal direction: as supply declines.

⁷⁴ *Id.* at 5-6 (quoting John P. Caskey, Filene Res. Inst., *The Economics of Payday Lending* 1, 14 (2002)).

⁷⁵ Caskey, *supra* note 74, at 22 Table 1 (reporting the results of a Credit Research Center which found that slightly over half of payday loan customers have annual income between \$25,000 and \$50,000, with the remaining customers split equally between higher- and lower-income groups). In contrast, only 28.1 percent of active pawn shop borrowers have incomes ranging from \$25,000 to \$49,000, and only 7.1 percent have incomes above that range. Robert W. Johnson & Dixie P. Johnson, *Pawnbroking in the U.S.: A Profile of Customers*, THE CREDIT RES. CTR. 53 (1998), available at <http://www.business.gwu.edu/research/centers/fsrp/pdf/Mono34.pdf>.

⁷⁶ *CRL Review of Defining and Detecting Predatory Lending*, By Donald P. Morgan, Federal Reserve Bank of New York, (Center for Responsible Lending), Feb. 2007, at 1-3, available at <http://www.responsiblelending.org/pdfs/Review-of-Morgan-paper.pdf>. The changes resulted from the OCC and FDIC actions that eliminated "rent-a-charter" agreements, discussed *supra* note 68.

⁷⁷ See *supra* note 70.

⁷⁸ See *supra* note 68.

⁷⁹ *E.g.*, Bill Graves, *Oregon Hammers Those 528% Loans*, THE OREGONIAN, June 7, 2007, at A01.

(3) Borrower History Research

The third type of interchangeability study examines the borrowing histories of individual consumers. The only research outside of the current study to use this method is Michael Barr's Detroit Area Household Financial Services (DAHFS) study.⁸⁰ The DAHFS study surveyed a random, weighted sample of 1,003 low- moderate- and middle-income households in the Detroit, Michigan area about all aspects of their credit usage.⁸¹ The study conducted detailed interviews, averaging 76 minutes, and thus was able to obtain a rich account of participants' credit histories.⁸² The study's substitution analysis is primarily focused on payday lending. It compares how participants who do and do not use payday lending use other forms of borrowing. The DAHFS study found that participants who use payday lending were significantly more likely to use other forms of fringe borrowing, such as pawn shops, refund anticipation loans, and rent-to-own stores than those who did not.⁸³ It also found that, although payday loan users were no more likely than others to use credit cards, they were significantly more likely to pay only their minimum balance and have paid late fees.⁸⁴ These findings suggest that participants may treat payday lending and other forms of fringe borrowing as complements more than substitutes.⁸⁵

The one limitation of this study is that Barr et al. did not appear to collect documentary evidence of the study respondents' borrowing transactions.⁸⁶ As with the SCF, this presents a risk that participants underreported their borrowing.⁸⁷

B. The Current Study – A Low Degree of Substitution

The current study also used the borrowing history methodology to investigate the interchangeability of fringe borrowing types and obtained similar results. Although the current study is much smaller than the DAHFS, and its sample is non-random, its methodology is similar in that it used extremely detailed interviews with low-income consumers. However, it was able to collect at least some documentary evidence for nearly all the

⁸⁰ Michael S. Barr, et al., *Consumer Indebtedness in the Alternative Financial Services Market*, (U. Mich. Law, Working Paper, April 2007) (on file with author).

⁸¹ *Id.* at 5, 13.

⁸² *Id.* at 12.

⁸³ *Id.* at 15-17.

⁸⁴ *Id.*

⁸⁵ *Id.* at 2.

⁸⁶ *Id.*

⁸⁷ For this purpose, it likely presents a lower risk than for the SCF because the relevant data is whether a participant has used a form of borrowing, which is easier to recall than precise amounts of debt.

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participants.⁸⁸ The goal of this analysis was to develop a preliminary empirical model that can be tested in future studies.

The current research findings correspond with those of the DAHFS study. Study participants tended to use credit cards and fringe borrowing alternatives as complements rather than substitutes. The detailed interview format allowed for investigation of changes in participants' credit consumption over time, and the results of that data showed a low degree of substitution from fringe borrowing alternatives to credit cards as the latter became more available to low-income consumers.

The study found that participants who had borrowed in the fringe-banking sector were more likely to have used credit cards than those who had not.⁸⁹ These results are shown in Table 1.a. There was also a significant positive correlation between participants' credit-card usage and their fringe-banking usage, even after controlling for age, education and income.⁹⁰ These results are displayed in Table 1.b.

⁸⁸ See Littwin, *supra* note 19, at note 202 and surrounding text.

⁸⁹ Unfortunately, the variables which could best test the interchangeability prong of the substitution hypothesis, a participant's current total credit card balance and her lifetime total credit card balance, were not reliable. In the case of the former, the study collected written records documenting most current balances and tended to have more complete documentation for the larger-balance participants. However, whenever this variable was added to any regression it decreased the overall regression fit by a large margin. My best theory is that I have an outlier problem with this variable. Over seventy-five percent of participants' credit card balances were under \$5,000, but the top five percent of balances were \$19,000 or higher. In a sample this small, a skewed distribution is highly problematic. My measurement of total lifetime balances suffered from even greater difficulties. Many participants could provide only vague approximations of the amount of credit-card debt they had accumulated over the course of their lifetimes, and documents for this figure were difficult to obtain. Though most participants had current credit-card statements or were willing to access them for the study, fewer would or could access this information for cards they no longer held. This left me with credit reports, which do not reach back more than ten years at the most. Thus, I did not attempt to analyze this variable because the sparse data I did have was unreliable by the participants' own accounts. It would take a study with much greater resources to obtain this data.

⁹⁰ The regression with the best fit for testing use of fringe-borrowing as an dependent variable had an overall p value of .02 and included age, education, income, and use of credit cards as the independent variables. Use of credit cards was significant at p = .035.

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Table 1.a. – Percentage that Have Ever Used Fringe Borrowing by Credit Card Usage

	Ever used a credit card	Never used a credit card
Ever used fringe borrowing	52	12

Table 1.b. – Factors Significant in Whether Participants Have Used Fringe Borrowing (Any Credit Card Usage Regression)

<i>Independent Variables</i>	<i>Coefficients</i>
<i>Age</i>	-.06 (.04)
<i>Education</i>	-.48*** (.19)
<i>Income</i>	.00 (.00)
<i>Ever had a credit card</i>	1.91** (.92)
<i>Number of Observations</i>	50
<i>Overall Regression Fit +</i>	.02

p < .01***

p < .05**

p < .10*

+ Results were calculated using an ordered logistic regression, the appropriate test for ordinal dependent variables. R2 is not reliable for these regressions, so I have instead included the Overall Regression Fit.

Dependent Variable: Any Use of Fringe Borrowing (yes or no)

Unstandardized coefficients are reported. Standard errors are numbers in parenthesis.

The longer a participant had been using credit cards, the more likely she was to use fringe borrowing. The number of years a participant had been using credit cards significantly predicted the likelihood that she was currently using fringe borrowing. These results are shown in Table 2.

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Table 2 – Factors Significant in Whether Participants Currently Use Fringe Borrowing

<i>Independent Variables</i>	<i>Coefficients</i>
<i>Age</i>	-.41** (.18)
<i>Education</i>	-.69* (.42)
<i>Income</i>	.00 (.17)
<i>Number of Years Using Credit Cards</i>	.32** (.17)
<i>Number of Credit Cards Participant Holds But Cannot Use</i>	-.20 (.48)
<i>Number of Observations</i>	36
<i>Overall Regression Fit +</i>	p = .005

p < .01***

p < .05**

p < .10*

+ Results were calculated using an ordered logistic regression, which is the appropriate test for ordinal dependent variables. R2 is not reliable for these regressions, so I have instead included the Overall Regression Fit.

Dependent Variable: Current Use of Fringe Borrowing (yes or no)

Unstandardized coefficients are reported. Standard errors are numbers in parenthesis.

These two results suggest that participants are using credit cards and fringe borrowing more as complements than substitutes. Participants who use credit cards and have used them longer are more likely to use fringe borrowing than their credit-card-free counterparts. There could, of course, be substitution between credit cards and fringe borrowing as well. Participants who use both might alternate use depending on a variety of factors, including the favorability of regulatory conditions. However, a stronger version of the interchangeability prong of the substitution hypothesis would have shown a negative correlation between fringe borrowing and credit card borrowing such that participants who used more of one used less of the other.

But these findings apply to all participant credit card usage. They do not isolate the substitution behavior of participants who were unable to obtain as much credit card credit as they preferred. Because credit cards are so accessible, even to low-income consumers, the study was unable to obtain good data on the variables that would be ideal proxies for participants'

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inability to obtain as much revolving credit as they would like. Only ten percent of participants had applied for, but failed to obtain a credit card. An additional ten percent had used credit cards, but were currently prohibited from charging on them by the issuer. With numbers this small, neither of these figures generated any significant results.

However, the dramatic increase in availability of credit cards over the past twenty-five years made it possible to examine the interchangeability prong of the substitution hypothesis indirectly by using the ages of the participants as a proxy for credit availability during their adult lives. Older participants were adults when access to credit cards was limited, while younger participants had access to credit cards throughout their adult lives. Under a strong form of the substitution hypothesis, younger consumers should use fringe borrowing alternatives less frequently, all other things being equal.

The median age of the study sample was 45 in 2005, meaning that the median-aged participant was eighteen years old in 1978, the year that *Marquette* was decided.⁹¹ Thus, exactly half the study sample has experienced the entire current range of post-*Marquette* credit-card availability outcomes as adults, while the other half has experienced varying fractions thereof. More specifically, 58 percent of participants were eighteen years old in 1983, when households with incomes under \$50,000 held 42 percent of national consumer debt⁹² and 17 percent of households at or below the federal poverty line had credit cards.⁹³ Seventy-six percent had reached majority in 1989, when the low- and moderate- income households held 46.3 percent of consumer debt⁹⁴ and approximately 20 percent of households in poverty had credit cards.⁹⁵ A full eighty percent of study participants were at least eighteen by 1992, when low- and moderate-income households held 56.1 percent of consumer debt⁹⁶ and approximately 34 percent of households at the poverty line held credit cards.⁹⁷

Not surprisingly then, the study found a strong, positive correlation between the age of the participant and the age at which she obtained her first credit card. In regressions, age is the only factor that predicts age of first credit card with any significance. Younger participants obtained credit cards when they were younger, while older participants did not obtain them until

⁹¹ *Marquette*, 439 U.S. at 299.

⁹² Moss & Johnson, *supra* note 14, at 334.

⁹³ Bird et al., *supra* note 22, at 128 Table 1 (analyzing SCF data).

⁹⁴ Moss & Johnson, *supra* note 14, at 334.

⁹⁵ Bird et al., *supra* note 22, at 128.

⁹⁶ Moss & Johnson, *supra* note 17, at 334.

⁹⁷ Bird et al., *supra* note 22, at 128.

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they were older. This is strong evidence of a changing credit card market. The regression with the best overall fit is summarized in Table 3.

Table 3 – Factors Significant in Age of First Credit Card

<i>Independent Variables</i>	
<i>Age</i>	.48*** (.14)
<i>Education</i>	-.42 (.51)
<i>Income</i>	.00 (.00)
<i>Constant</i>	13.18 (10.19)
<i>Number Of Observations</i>	39
<i>R2</i>	0.26

p < .01***

p < .05**

p < .10*

Dependent Variable: Age of First Credit Card

Unstandardized coefficients are reported. Standard errors are numbers in parenthesis.

Under a strong version of the interchangeability prong of the substitution hypothesis, older participants should be more likely to have used fringe banking at some point. They would have spent more of their adult lives with less access to credit cards, and they simply would have spent more total years as adults in which to, for example, buy furniture or pawn goods. Instead, the opposite is true. The two factors which were consistent, significant predictors of whether a participant has ever used fringe banking are her age and her education. Age, however, varies *negatively* with the likelihood of ever having borrowed in the fringe-banking sector. In other words, younger participants are significantly *more* likely to have used fringe banking than older participants, despite greater earlier access to credit cards and fewer total years in which to engage in fringe-banking transactions. The education variable was more straightforward. The less education a participant has, the more likely she is to use fringe banking. These findings are displayed in Table 4. These same patterns occur when examining current credit card usage and current fringe-banking borrowing, as shown above in Table 2.

The fact that older participants, who presumably would have obtained credit cards at a younger age had they been available, were also less inclined

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to use fringe banking during their credit-card-free period indicates that they were unlikely to see the fringe-borrowing options as substitutes for credit cards.

Table 4 – Factors Significant in Whether Participants Have Ever Used Fringe Borrowing

<i>Independent Variables</i>	
<i>Age</i>	-.13** (.06)
<i>Education</i>	-.53** (.23)
<i>Income</i>	.00 (.00)
<i>Date Of First Credit Card</i>	-.05 (.05)
<i>Number Of Observations</i>	39
<i>Overall Regression Fit +</i>	p=.03

p < .01***

p < .05**

p < .10*

+ Results were calculated using an ordered logistic regression, the appropriate test for ordinal dependent variables. R2 is not reliable for these regressions, so I have instead included the Overall Regression Fit.

Dependent Variable: Any Use of Fringe Borrowing (yes or no)

Unstandardized coefficients are reported. Standard errors are numbers in parenthesis.

There are, of course, alternative explanations for the age- and date-based findings. Older participants might have been less able to recall earlier instances of fringe borrowing. While this could explain the absence of an age effect, it is a less plausible explanation for a significant negative relationship with age. Another possibility is that the older participants were less economically stressed, and therefore less in need of borrowing, when they were younger. Perhaps because the social safety net has been shrinking over the last thirty years, more low-income families have been pushed towards credit.⁹⁸ A substitution-neutral possibility is the that fringe-borrowing sector has grown over the past few decades.⁹⁹ Older participants may not have had more limited access to fringe borrowing when they were younger and thus

⁹⁸ Bird et al., *supra* note 22, at 3.

⁹⁹ See *infra* Part IV.C.(2).

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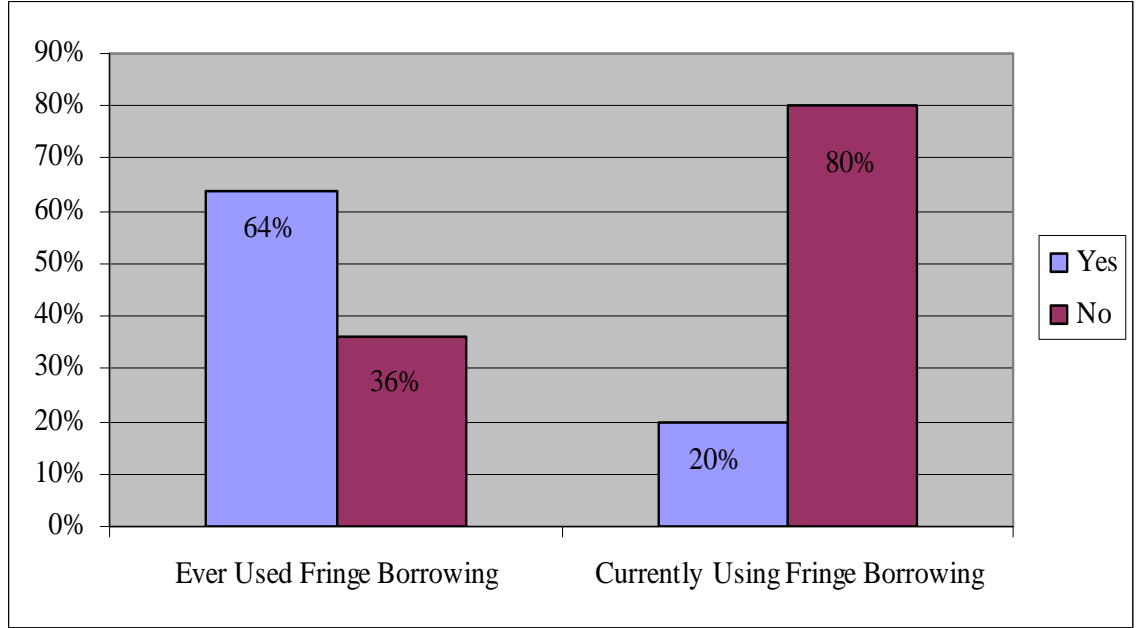
have had little opportunity to use fringe borrowing in the decades before the credit card boom.¹⁰⁰ Or it could be that borrowing norms have changed over the course of the past three decades, and each successive generation of adults has become increasingly willing to borrow in all forms. The study asked directly about this last possibility – that is, whether participants thought that community attitudes towards borrowing had changed since they were growing up. The responses varied widely, indicating that, at least in participants' subjective experiences, borrowing attitudes are not the answer. More objectively, the age- and date-related findings must be read in conjunction with the finding that credit card usage predicts fringe-borrowing usage. None of the statistically significant results provided support for a large degree of substitution in this context, but several findings lent direct support to the opposite conclusion.

There is, however, one major finding that tends to support the substitution hypothesis. Very few participants currently use fringe borrowing, and this is a steep decline from the number who have ever used it. This drop is shown in Figure 6. The number of participants who hold credit cards, however, is still high. Of the 76 percent of participants who have ever used a credit card, nearly two-thirds still have one with an available line of credit.¹⁰¹ This could suggest a conclusion in keeping with the premise of the time-series studies: that, as credit cards grew in popularity, fewer participants needed to rely on other forms of borrowing. On the other hand, many participants who have credit cards may not be actively borrowing with them. Some are undoubtedly holding the line of credit in reserve. In addition, several participants commented that lenders that provide goods, such as catalogs and rent-to-own stores, are primarily useful acquiring the goods needed to start a household, either when first leaving home or when first immigrating to the United States. The fact that many participants had already established their households by the time of the study could account for the drop in those two types of borrowing. Regardless of the reason, this finding is difficult to reconcile with the age- and date-based finding discussed above and suggests an interesting area for future research.

¹⁰⁰ However, the fact that the fringe sectors have experienced marked growth as credit card debt has exploded tends generally to undermine the substitution hypothesis. If borrowers have been supporting growth in both sectors over the past few decades, then the overarching trend could not have been one of substituting away from older fringe products towards the newly available credit cards.

¹⁰¹ This make a total of fifty percent of all participants who still hold a useable credit card.

Figure 6 – Percent of Participants Using Fringe Borrowing: Lifetime Usage Versus Current Usage



In conclusion, the interchangeability prong of the substitution of credit is unproven. Much more work in this area is necessary before scholars and policymakers can predict with any accuracy the substitution consequences of regulating credit cards. The research to date is limited not only by methodological complications, but also by the framing of substitution questions in terms of “yes” or “no” answers such that either substitution between credit cards and other forms of borrowing exists or it does not. As a result, there has been no development of a methodology or a terminology for discussing the degree of substitution taking place. This, in turn, has led researchers to overlook the necessity of comparing the predicted degree of substitution that would occur to the harm such substitution would cause. The recent wave of payday lending regulation presents a golden opportunity for expanding the scope and precision of these studies.

C. Factors That Explain the Low Degree of Substitution

In addition to the lack of precision in research analyzing the degree of substitution among credit options, there is no research, to my knowledge, that examines the factors that should influence the degree of substitution. While such modeling is beyond the scope of the current study, it can shed light on why the extent of interchangeability between credit cards and fringe

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borrowing is unlikely to be the complete one-for-one substitution that is often assumed in the literature.¹⁰²

(1) Credit Cards Supply More Credit.

The major reason that substitution would almost certainly be incomplete is that the fringe borrowing alternatives simply cannot offer income-constrained consumers as much credit as credit cards. A low-income borrower can bear only so many costs at one time. She only has so many items valuable enough to pawn and can manage only so many payments to rent-to-own stores or other installment lenders.¹⁰³ With credit cards, the minimum-payment option allows consumers to accrue balances unconstrained by their ability to pay. The balances of the study participants reflected this difference. Of the thirty-two participants who were either currently using credit cards or currently had a balance, the mean balance was \$4,389, and the median was \$2,482.¹⁰⁴ In comparison, the mean monthly income for these thirty-two participants was \$1187.75 (\$14,253 annually), and the median was \$724.50 (\$8,694 annually).¹⁰⁵

The small-scale nature of the fringe borrowing options means that they cannot serve as complete substitutes for credit-card borrowing.¹⁰⁶ If access to credit cards were reduced, some low-income consumers might borrow more from catalogs, pawn shops, or rent-to-own stores, although the current data suggest that low-income credit-card users are already disproportionately borrowing from these alternatives. Even if these consumers would borrow

¹⁰² See, e.g., Zywicki, *supra* note 6, at 96.

¹⁰³ In a study conducted in 1974, before credit cards became widely available to low-income borrowers, the researchers state that one of the primary reasons “rationed” consumers cannot obtain their preferred amount of credit is that they cannot afford the required monthly payments. Orville C. Walker, Jr. & Richard F. Sauter, *Consumer Preferences for Alternative Retail Credit Terms: A Concept Test of the Effects of Consumer Legislation*, 11 J. OF MKTG. RES. 70, 71 (Feb. 1974).

¹⁰⁴ I had credit reports or credit-card statements for 22 of these participants. I relied on oral reports for the other 11.

¹⁰⁵ The mean monthly income of all participants was \$1195 (\$14,340 annually), and the median was \$770 (\$9,240 annually).

¹⁰⁶ Because no participants had records of their transactions with pawn shops, rent-to-own stores, or catalogs, the data here are incomplete. Only five participants provided remembered estimates of their pawn-shop loans, and those ranged from \$50 to \$500 before interest, with the majority falling under \$200. Two participants reported rent-to-own loans totaling \$700-\$900. Two participants reported catalog loans of \$300-\$800, and two other described monthly payments of \$3-\$15.

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more, however, they would not be able to borrow nearly as much from these other sources as they can with credit cards.¹⁰⁷

(2) Credit Cards Act as Spending Stimuli.

The second reason that substitution between credit cards and fringe borrowing would likely be incomplete is that credit cards, in and of themselves, may stimulate spending. Psychology and behavioral economics research has begun to show that credit cards can operate as “spending facilitating stimuli.”¹⁰⁸ Several studies have shown a correlation between using credit cards and spending more.¹⁰⁹ Two particularly thorough studies used multiple approaches to show that subjects say they will spend more and actually spend more when exposed to credit cards and credit card insignia.¹¹⁰ For example, two experiments found that the presence of the MasterCard logo significantly increased the amount that subjects said they would spend on merchandise the experimenters presented.¹¹¹ An additional experiment by the same researcher showed that subjects in the presence of MasterCard stimuli donated significantly more during charity solicitations.¹¹² Participants in the current study also identified credit cards as spending stimuli. Nearly two-thirds characterized credit cards as “tempting,” meaning that they felt “tempted” by credit cards to spend and borrow more than they would if they used another form of payment or credit.¹¹³

If future studies continue to support these results, then consumers may spend more when paying with credit cards than with other payment systems. If consumers spend more with credit cards than they would when paying by cash or check, then they would be even more likely to spend more than they would if they had to, for example, go to a pawn shop to obtain the cash in the first place. Under these circumstances, the borrowing options will not be interchangeable. Switching from one to another would lead to increases or decreases in spending rather than a neutral substitution of borrowing methods.

¹⁰⁷ Hawkins & Mann make an analogous argument with respect to payday lending. Hawkins and Mann, *supra* note 71, at 37-43.

¹⁰⁸ Richard A. Feinberg, *Credit Cards as Spending Facilitating Stimuli: A Conditioning interpretation*, 13 J. OF CONSUMER RES. 348 (1986).

¹⁰⁹ *Id.* at 348 (reviewing nearly a dozen studies showing such a correlation).

¹¹⁰ *Id.*; Drazen Prelec & Duncan Simester, *Always Leave Home Without It: A Further Investigation of the Credit-Card Effect on Willingness to Pay*, 12 MKTG. LETTERS 5 (2001).

Ronald Mann provides a detailed discussion of this research in *Charging Ahead*, where he points out that these results have not been fully replicable. RONALD J. MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD MARKETS 46-47 (2006).

¹¹¹ Feinberg, *supra* note 108, at 350, 352-53.

¹¹² *Id.* at 353-54.

¹¹³ For a detailed discussion of these findings, see Littwin, *supra* note 19 at Part II.C.

IV. THE QUESTION OF HARM

Very little research has explored the question of how much harm would occur if regulation prompted consumers to substitute one form of borrowing with another. There are two major potential explanations for this neglect. First, researchers may have assumed that credit cards are superior to low-income people's alternative credit options because credit cards are identified as middle-class borrowing, whereas the alternatives are thought of as part of a ghettoized "fringe."¹¹⁴ Second, traditional economic frameworks rely on behavior-based evidence of consumer preferences.¹¹⁵ If consumers' borrowing behavior is a full expression of their preferences, then the harm caused by substitution is fully captured by the amount of substitution that takes place. Put simply, the traditional framework assumes that what people do is the best evidence of what they like.

A. *The Mark of the Middle Class*

Commentators may assume that payday lending, pawn shops, and rent-to-own stores are more harmful than credit cards because the former are used exclusively by low-income people, whereas the latter are used by the general population. The thinking may be that if middle-class consumers, who have a wealth of credit options, use credit cards, then credit cards must not be exploitive.

Credit cards have long been identified with the middle and upper classes. They were first developed to meet the needs of business travelers on expense accounts,¹¹⁶ and in the decades since, issuers have capitalized on the aura of exclusivity that evolved from these origins.¹¹⁷ The transition of credit cards from an exclusive product to a universal one has been gradual,¹¹⁸ but the perception of this transition appears to have been more gradual still and is far from complete. When I have discussed the study findings in academic circles, commentators are often struck by the depth of credit card penetration within

¹¹⁴ CASKEY, *supra* note 15.

¹¹⁵ See *infra* note 135. See also, Gregory Elliehausen & Edward C. Lawrence, *Payday Advance Credit in America: An Analysis of Customer Demand* 23 (April 2001) (Monograph #35, Credit Research Center, The George Washington University School of Business, <http://www.business.gwu.edu/research/centers/fsrp/Publications.html>. ("The standard economic analysis of consumer behavior focuses on the outcome of decisions." *Id.*)

¹¹⁶ Mann, *supra* note 106, at 81-85; DAVID S. EVANS & RICHARD SCHMALENSEE, *PAYING WITH PLASTIC: THE DIGITAL REVOLUTION IN BUYING AND BORROWING* 53-61 (2d. ed. 2005).

¹¹⁷ See, e.g., *id.* at 186 (recounting American Express' image of exclusivity and advertising slogan, "Membership Has Its Privileges.").

¹¹⁸ Moss & Johnson, *supra* note 14; Bird et al., *supra* note 22, at 12.

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the low-income study sample. This perception is not limited to upper-middle-class academics. Many of the participants themselves discussed credit cards in terms of their exclusivity. Twelve percent stated that they had applied for a credit card in order to see if they could obtain one. And several participants spoke of credit card availability to low-income people as a civil-rights access issue.¹¹⁹

The image of fringe credit options such as pawn shops, rent-to-own stores, and payday lending is quite different. Commentators tend to label them as “fringe”¹²⁰ or “alternative”¹²¹ credit options, words that conceptualize them as out of the mainstream. Pawn shops in particular have a negative reputation.¹²² Participants also thought of pawn shops and rent-to-own stores as low-status. When the study asked if there was status associated with the various forms of borrowing, credit cards obtained mixed results, but the most frequent response regarding the fringe credit options was laughter.¹²³ Moreover, middle-class academic writers are unlikely to have personal experience with alternative forms of borrowing.¹²⁴ Academics are much more likely to have used credit cards,¹²⁵ and many have undoubtedly had positive experiences.¹²⁶ For financially secure consumers, who have the means to avoid interest and late fees, credit cards provide a number of advantages, such as frequent flier miles and interest-free monthly loans during the grace period, at a low cost.¹²⁷

This contrast between unfamiliar borrowing options associated with poverty and positive personal experiences with credit cards could easily lead to assumptions about the superiority of the latter. But credit cards are a very different product when used by low-income consumers. In fact, a large part of the success of credit cards is due to the bundling of two products – a payment device and a borrowing option – into one small card. Several commentators

¹¹⁹ Littwin, *supra* note 19, at n.56 and surrounding text.

¹²⁰ CASKEY, *supra* note 14; Littwin, *supra* note 19.

¹²¹ Barr, *supra* note 14.

¹²² See, e.g., Hawkins and Mann, *supra* note 71, at 41-42.

¹²³ Littwin, *supra* note 19, at n.33.

¹²⁴ Fringe borrowing customers tend to have lower incomes than academic writers. See *infra* Part III.C.(2).

¹²⁵ By 1998, 95 percent of households in the highest-income quintile held bank-issued credit cards, and 86 percent of households in the second-highest quintile had them. Durkin, *supra* note 38, at 626 Table 2.

¹²⁶ In *Charging Ahead*, Ronald Mann describes his experiences presenting his research to groups of legal and financial professionals, many of whom believe that they have outsmarted their issuers by receiving more benefits from their credit cards than they pay for. Mann, *supra* note 110. Mann argues that most of them are mistaken. *Id.* at 128.

¹²⁷ Issuers, however, do tend to charge annual fees for cards with rewards programs. Ronald Mann, “Contracting” for Credit, 104 MICH. L. REV. 899, 914 (2006).

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have divided credit card users into “transactors,” who use credit cards predominately for payment purposes, and “revolvers,” who regularly carry a balance.¹²⁸ There is a large class difference between these two types of users. In the current study of low-income consumers, only one participant was an exclusively transactional user of credit cards,¹²⁹ and not a single participant mentioned frequent flier miles or the other rewards benefits that are so valued by financially secure users.

Survey of Consumer Finance (SCF) data also support the existence of this class segmentation. Although higher-income families are more likely to have credit cards,¹³⁰ lower-income families are more likely to struggle with debt. Low-income households have much higher debt-to-income ratios than their high-income counterparts across all income quintiles.¹³¹ This is despite that fact that low-income consumers are less likely to be homeowners with mortgage or home-equity debt.¹³² SCF data also shows that revolvers are more likely to be black or Hispanic and to have less education than transactors.¹³³

A small number of commentators have recognized the class implications of this market segmentation, expressing concern that the interest paid by the less financially secure revolvers is cross-subsidizing the frequent flier miles of the transactors.¹³⁴ But nobody has discussed the impact on public policy debates of the fact that credit cards are two products disguised as one. It is easy for policymakers to view credit cards through the lens of their familiar, positive transacting experiences and fail to grasp fully the difference between

¹²⁸ Adam J. Levitin, *The Antitrust Superbowl: America's Payment Systems, No-Surcharge Rules, and the Hidden Costs of Credit*, 3 BERKELEY BUS. L.J. 265 317-18 (2005) (although Levitin mockingly refers to “transactors” as “deadbeats” because they generate less revenue for issuers); Mann, *supra* note 106, at 138 (referring to these two groups as “convenience users” and “borrowers”); Zywicki, *supra* note 6, at Part II.A. (using the terms “convenience users” and “revolvers” *Id.*).

¹²⁹ Interview with Respondent ABB.

¹³⁰ Durkin, *supra* note 38, at 626 Table 2. This trend remained consistent as between each income quintile from at least 1970 through 1998. Unfortunately, the author did not indicate whether these differences between income quintiles were statistically significant.

¹³¹ Bucks et al., *supra* note 27, at A35 Table 14. This trend remained stable from at least 1995 through 2004, although the authors did not indicate statistical significance.

¹³² See, e.g., Bucks et al., *supra* note 27, at A22 Table 8 (showing that homeownership increases with income).

¹³³ Duleep Delpchitre & Sharon A. DeVaney, *Credit Card Usage among White, African American and Hispanic Households*, 52 CONSUMER INTERESTS ANNUAL 466 (2006).

¹³⁴ Mann, *supra* note 106, at 138 (arguing that this type of cross-subsidization is less likely to exist now than in the past because issuers have become more sophisticated about segmenting the market); Levitin, *supra* note 128, at 317-18 (citing ambiguity in the literature about whether transactors' credit card usage is subsidized by the interest paid by revolvers).

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their experiences and those of financially insecure revolvers. Recognizing that the convenience credit card usage is largely out of reach to the poor and the financially struggling segments of the middle class will enable policymakers to evaluate the revolving product more precisely and place it in context with other fringe borrowing services.

B. The Value of Studying Subjective Preferences

The second possible explanation for why academics have neglected to investigate the degree of harm that would be caused by a high level of regulatory-driven credit product substitution is due to traditional economic assumptions about borrower behavior. Neo-classical economics often views consumer behavior as a complete statement of consumer preferences.¹³⁵ The thinking is that preferences are revealed by the choices consumers make.¹³⁶ So if more consumers use credit cards than rent-to-own stores – a result found by the current study – then more consumers prefer credit cards to rent-to-own stores.¹³⁷ Therefore, the level of harm created by a credit-card regulation that caused some consumers to substitute rent-to-own borrowing for credit card borrowing could be perfectly captured by counting the number of consumers who made that switch. Under this framework, studying the degree of harm beyond the degree of objective substitution behavior is redundant at best and inaccurate at worst.¹³⁸

While examining actual consumer behavior is a useful approach, it has significant limitations as a means of understanding the substitutability of credit-card borrowing. Borrowers must be fully informed and fully rational in order for their borrowing decisions to wholly capture their borrowing preferences. In addition, this traditional approach does not take account of the fact that borrowing is a relatively long-term transaction and therefore that preferences may change over the course of the loan.¹³⁹

Borrowing transactions are particularly vulnerable to preference reversal because a consumer seeking credit faces an immediate benefit and a more

¹³⁵ Paul Samuelson, *A Note on the Pure Theory of Consumer Behavior*, 5 *ECONOMICA* 61 (1938).

¹³⁶ *Id.*

¹³⁷ This latter result was not supported by the current study.

¹³⁸ In addition, behavioral data is considered a more objective lens into people's preferences than subjective data, and it also avoids participant reliability problems. For example, participants may have faulty memories or give answers that present their behavior in a positive light. See Walker & Sauter, *supra* note 103 ("Since stated preferences may be more 'rational' or in other ways different from actual behavior, the results of this type of analysis should be evaluated with caution." *Id.* at 72).

¹³⁹ See generally, Oren Bar-Gill, *Seduction by Plastic*, 98 *NW. U. L. REV.* 1373 (2004) (discussing how credit card borrowing can lead to preference reversal).

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distant cost. The defining characteristic of a credit transaction is that the borrower receives a benefit at the time of loan initiation in exchange for a cost to be borne later, at time of repayment. This time division is particularly salient in credit-card borrowing where – due to the minimum-payment system – a consumer might not experience, or even understand, the repayment costs until months or years after she has initiated the loan. Behavioral economic research suggests that many people have a poor ability to compare current costs and benefits with future costs and benefits in accordance with their own future preferences.¹⁴⁰ So the decision a consumer makes at the time of loan initiation will not necessarily reflect her preferences once she internalizes the costs of repayment.

The current study bears out this idea. Approximately two-thirds of participants reported that the availability of credit cards “tempted” them to spend or borrow more in the short term than they would prefer in the long term.¹⁴¹ Thus, behavior may not accurately reflect borrowing preferences, but rather only preferences at the time of loan initiation, when the benefits of the loan are more prominent than the costs in the consumer’s mind. Asking consumers to consciously weigh the costs and benefits of different borrowing types has the potential to yield more accurate long-term preferences.

Moreover, much of the little research that has been done in this area has found that subjective preferences do not necessarily accord with market behavior. In one intriguing study from the early 1970s, researchers sought to examine the likely effects of a then-new Minnesota law regulating the interest rate and service charges on consumer retail credit.¹⁴² The study surveyed consumers about their preferences for different types of consumer credit plans. One was the standard credit plan offered by retailers before the interest-rate restrictions took effect, while the others were plans the researchers hypothesized that retailers would offer as a result of the new law. The study found that the regulation-free plan retailers were already offering was the one that consumers consistently preferred the least.¹⁴³ This

¹⁴⁰ See Littwin, *supra* note 19 (citing Ted O’Donoghue & Matthew Rabin, *Doing It Now or Later*, 89 THE AM. ECON. REV. 103 (1999); David Laibson, *Golden Eggs and Hyperbolic Discounting*, 112 THE Q. J. OF ECON. 443 (1997); Shane Frederick et al., *Time Discounting and Time Preference: A Critical Review*, 40 J. OF ECON. LITERATURE 351 (2002)).

¹⁴¹ Littwin, *supra* note 19, at Part III.C.

¹⁴² Walker & Sauter, *supra* note 103. This study was conducted in 1971, before the federal preemption of state usury laws was recognized in 1978. See *supra* note 70. Therefore, the Minnesota usury law in question would have an impact of consumer credit transactions. The statute’s focus on consumer retail credit is also indicative of the time in that credit cards were not yet widely available. See, e.g., Moss & Johnson, *supra* note 14.

¹⁴³ Walker & Sauter, *supra* note 103, at 74 Figure 1.

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contradicts the rational borrower model, in which lenders would already be offering the most-preferred plan. These results are all the more interesting because they clearly came as a surprise to the researchers themselves.¹⁴⁴

More recently, the Credit Research Center¹⁴⁵ sought to explore consumer attitudes towards and understanding of credit cards.¹⁴⁶ The study found a surprisingly high amount of negative opinion in light of the continual increase in consumer credit card usage over the past few decades.¹⁴⁷ Of the nearly 500 household surveyed, 51 percent of all families and 42 percent of bank-card holding families thought that using credit cards was a “bad thing.” In comparison, 33 percent of all families and 42 percent of bank-card holding families thought it was a “good thing.”¹⁴⁸ Though the traditional objective preferences framework would expect consumer opinion of credit cards to rise as their usage of them did, negative opinions of credit card usage increased (and positive opinions decreased) dramatically from those expressed in similar surveys conducted in 1970 and 1977.

Even more strikingly, the more respondents used the borrowing feature of credit cards, the more likely they were to believe that using them was bad. For example, although 42 percent of all bank-card holders thought credit cards were bad, 49 percent of bank-card holders with three or more cards, 57 percent of those with a revolving balance of \$1,500 or more, 59 percent of those who hardly ever pay the outstanding balance in full, and 63 percent of those who hardly ever pay more than the minimum payment held this negative

¹⁴⁴ *Id.* at 73 (stating that the results are “inconsistent with the hypothesis concerning overall preference rankings”).

¹⁴⁵ In August, 2006, the senior staff of the Credit Research Center moved from Georgetown University’s McDonough School of Business to establish the Financial Services Research Program at George Washington University School of Business.

¹⁴⁶ Reported in Durkin, *supra* note 38, at 627-33. The fact that an institute that, at least as of 1998, was largely funded and partially governed by the credit industry produced such a study is an implicit acknowledgement by market participants of the importance of studying subjective preferences. See Robert Cwiklik, *Ivory Tower Inc.: When Research and Lobbying Mesh*, WALL ST. J., Jun. 9, 1998, at B1 (stating that the Credit Research Center’s 1998 \$450,000 budget was largely by the credit industry and that 70 percent of its advisory counsel members were industry representatives); Elizabeth Warren, *The Market for Data: The Changing Role of Social Sciences in Shaping the Law*, 2002 WIS. L. REV. 1 (2002).

¹⁴⁷ Durkin, *supra* note 38, at 627.

¹⁴⁸ *Id.* That left only 17 percent of all families and 16 percent of bank-card holding families who thought that credit card usage was “good, with qualification;” “bad, with qualification;” or “both good and bad.” The current study found analogous polarization of opinion about credit cards. I interpret this finding *infra* in Part III.C.(3).

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opinion of credit card usage.¹⁴⁹ This is strong evidence of consumers' subjective preferences not matching their objective borrowing behavior

On the other hand, the Credit Research Center also found that bank-card holders are generally satisfied with their own credit card companies.¹⁵⁰ Federal Reserve economist Thomas Durkin hypothesizes that these seemingly contradictory opinions are due to consumers being happy with their own credit card experiences, but concerned about the effects of the high availability of credit on "the other guy."¹⁵¹ But when discussing stigmatized matters such as debt, consumers may find it easier to admit negative feelings generally than to admit personal struggles with debt.¹⁵² Another possible explanation is that participants were satisfied with their relationship with their issuers – ninety percent agreed that, "my credit card companies treat me fairly," – but less happy with the effects of credit cards on their finances – eighty percent disagreed that credit card interest rates were reasonable.¹⁵³ The current study found similarly ambivalent reactions.¹⁵⁴

C. The Current Study – Comparing Preferences

Although the above studies have begun to illuminate borrowers' subjective evaluations of different borrowing options, an analysis of the harm of borrowing substitution needs to compare borrower assessments of the different credit types. Almost all low-income consumers' credit options have significant drawbacks,¹⁵⁵ so examining borrowers' appraisal of each option in and of itself – while crucial – does not provide enough information for a complete analysis. For example, knowing that low-income consumers evaluate both credit cards and rent-to-own stores largely negatively does not answer the question of whether regulating credit card borrowing in favor of rent-to-own store loans would have positive, negative, or neutral consequences for consumers. An understanding of how consumers compare the two tools is necessary to inform that judgment.

(1) A Variety of Borrowing

The current study suggests that borrowing is widespread among low-income families. Virtually all participants in the current study have borrowed money at some point in their lives. In addition, the vast majority had moved

¹⁴⁹ Durkin, *supra* note 38, at 628.

¹⁵⁰ *Id.* at 629 Table 4.

¹⁵¹ *Id.* at 628, 630.

¹⁵² This is why, for example, when the current study asked about use of loan sharks, it asked whether participants had ever used loan sharks themselves and also whether they knew of anyone who had used them. See discussion *infra* Part III.C.(3).

¹⁵³ Durkin, *supra* note 38, at 629 Table 4.

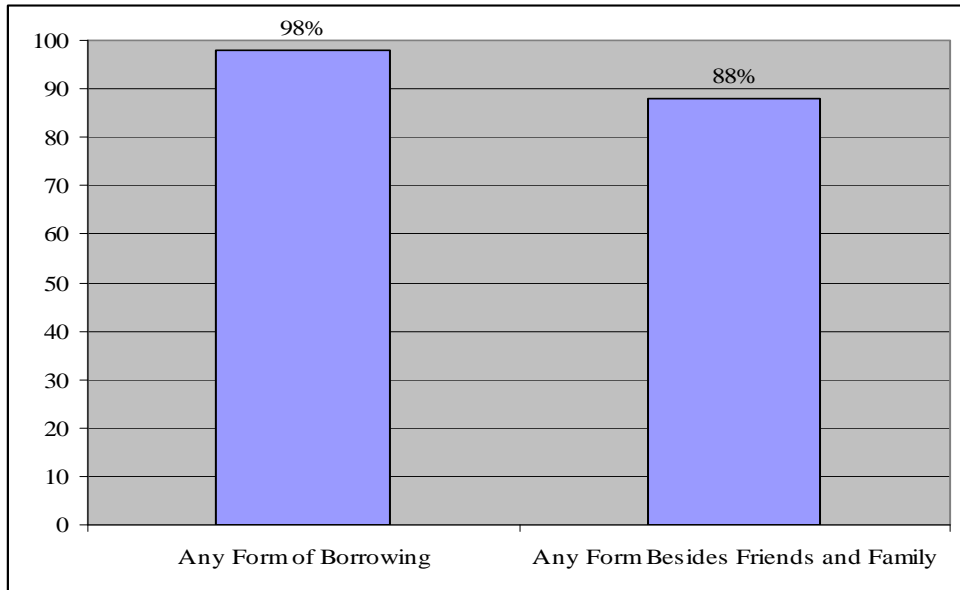
¹⁵⁴ See discussion *infra* Part III.C.(3).

¹⁵⁵ See *infra* this section.

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beyond borrowing only from their friends and family and sought credit in the formal lending sector. These results are displayed in Figure 2.

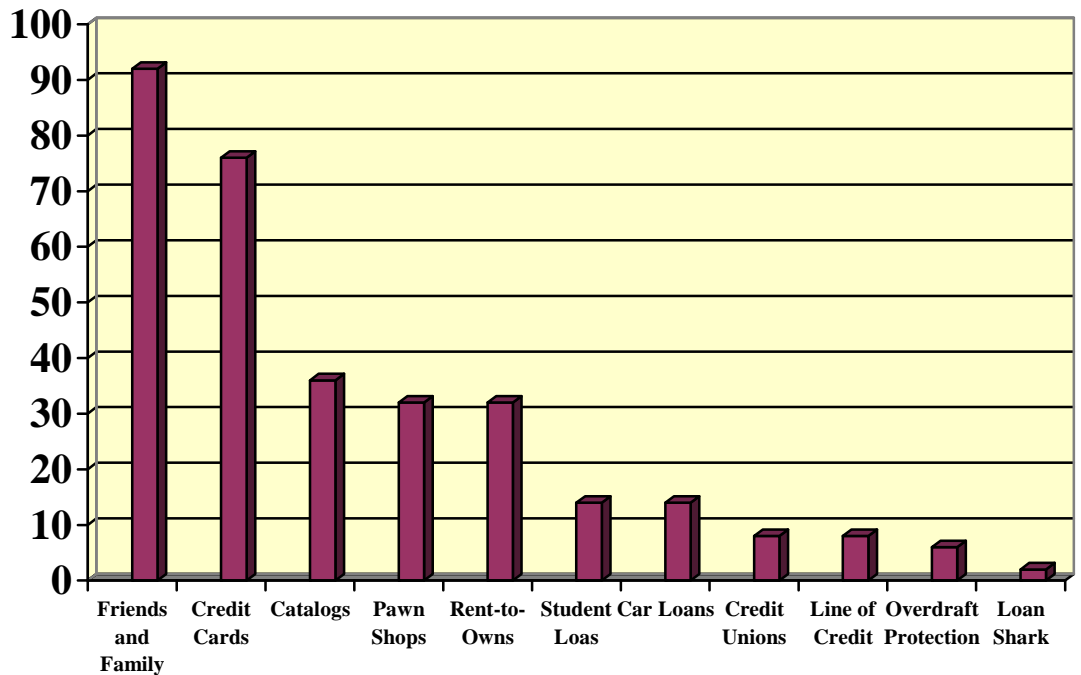
Figure 2 – Percent of Participants Who Have Borrowed



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Participants had also made use of a wide variety of credit services, as shown in Figure 3.¹⁵⁶

Figure 3 – Percent of Participants Who Have Used Each Borrowing Type



There are several points worth noting about the types of borrowing participants have used. First, despite the democratization of credit that has taken place in recent years, by far the most common form of credit was still informal borrowing from friends and family. The prevalence of informal borrowing suggests that, were regulation of credit card lending to take place, much of any substitution that occurred would be with the informal sector.¹⁵⁷ On the other hand, the 76 percent of participants who had used credit cards supports the claim that the democratization of credit card lending is well

¹⁵⁶ Again, payday lending is illegal in Massachusetts, which accounts for its lack of representation among the forms of borrowing participants have used. *See supra* note 12.

¹⁵⁷ *See also* LENDOL CALDER, FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT 60-64 (1999) (suggesting that credit cards replaced some borrowing from pawn shops and friends and family).

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underway.¹⁵⁸ Nearly half the study respondents received welfare or means-tested disability payments, and to qualify for the study, participants had to live in government-subsidized housing,¹⁵⁹ so the high penetration of credit cards within this group is significant.

Third, the next most common form of credit is borrowing from mail-order catalogs. This is a form of borrowing in which a consumer purchases goods from a catalog on credit and pays for them with monthly installments. Catalog borrowing is almost never mentioned in the legal literature,¹⁶⁰ and I had not heard of it before I began the study. Yet over one-third of the participants have used it, slightly more than have used either the widely familiar pawn shops or rent-to-own stores.¹⁶¹

Finally, these data suggest that the perception that low-income consumers do not have regular access to “middle-class” forms of borrowing other than credit cards is accurate. The lack of mortgage and home-equity borrowing is a function of the parameters of the research because the study required that participants live in subsidized rental housing.¹⁶² But other forms of “middle-class credit” are represented at low levels as well. Only 14 percent of participants had used student loans and car loans. Eight percent had borrowed from a credit union and obtained a personal line of credit from a bank. Even bank overdraft protection, which has been criticized by some consumer

¹⁵⁸ For other evidence, see Moss & Johnson, *supra* note 14; Bird et al., *supra* note 22.

¹⁵⁹ See Littwin, *supra* note 19, Appendix on Methodology.

¹⁶⁰ A Lexis-Nexis search revealed only six law-review articles mentioning the company, none of which discussed its lending operations. Matthew G. McLaughlin, Comment, *The Internet Tax Freedom Act: Congress Takes a Byte Out of the Net*, 48 CATH. U. L. REV. 209 (1998) (discussing taxation of mailing lists); Edward A. Morse, *State Taxation of Internet Commerce: Something New Under the Sun?*, 30 CREIGHTON L. REV. 1113 (1997) (discussing internet taxation); Steven J. Forte, *A Cyberspace Perspective: Use Tax Collection on Internet Purchases: Should the Mail Order Industry Serve as a Model?*, 15 J. MARSHALL J. COMPUTER & INFO. L. 203 (1997) (discussing internet taxation); H. Beau Baez III, *The Rush to the Goblin Market: The Blurring of Quill's Two Nexus Tests*, 29 SEATTLE UNIV. L. R. 581 (2006) (discussing out-of-state retailers that do not collect sales tax); Suzanna Sherry, *Haste Makes Waste: Congress and the Common Law in Cyberspace*, 55 VAND. L. REV. 309 (2002) (discussing internet jurisdiction); Joel R. Reidenberg, *Data Protection Law and the European Union's Directive: The Challenge for the United States*, 80 IOWA L. REV. 497 (1995) (discussing data privacy). See also Joseph B. Cahill, “Where It's Due: Credit Companies Find Tough Rival at Bottom Of Consumer Market --- Fingerhut's Experience Shows ‘Subprime’ Lending Takes Gimmicks, a Lot of Grit --- A Toll on Customers, Too,” WALL ST. J. Dec. 29, 1998, at A1. (“Little-known outside low-income groups -- its customers have an average household income of \$27,700. . . .” *Id.*).

¹⁶¹ See *infra* notes 183-199 and surrounding text.

¹⁶² See Appendix on Methodology.

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advocates,¹⁶³ but nonetheless requires a bank account, was used by only 6 percent of respondents. These figures actually slightly overstate participant usage of middle-class borrowing because some participants have used more than one form of it. Only forty percent of participants have used any of these borrowing types. These low rates – as well as participants’ strong preferences for middle-class borrowing options, as will be seen below – underscore the importance of the project that commentators such as Michael Barr have undertaken, that of “banking” low-income consumers and otherwise expanding their financial options.¹⁶⁴

(2) The Borrowing Options of Low-Income Consumers

The borrowing options primarily used by low-income consumers are not well understood. Unlike with credit card financing¹⁶⁵ or home-mortgage loans,¹⁶⁶ there is little literature available on how fringe borrowing functions in practice, who uses it, and why.

Rent-to-own stores and pawn shops, by contrast, have attracted less interest recently. In a rent-to-own transaction, a customer obtains an item – usually furniture, electronic equipment, or an appliance¹⁶⁷ – through installment credit. If she does not make all the payments, the store can repossess, and she will be deemed to have been renting all along. Most rent-to-own stores require weekly payments,¹⁶⁸ and a typical contract has a loan period of between one and two years.¹⁶⁹ A rent-to-own contract does not specify interest. Rather, the interest is built into the purchase price, which is typically 2 to 2.5 times what one would pay in a retail store.¹⁷⁰

¹⁶³ See, e.g., Press Release, Center for Responsible Lending, The \$30 Doughnut (Jul. 11, 207), available at http://ga3.org/crl/notice-description.tcl?newsletter_id=13016480.

¹⁶⁴ Barr, *supra* note 14.

¹⁶⁵ See, e.g., Zywicki, *supra* note 6; Bird et al., *supra* note 22; Durkin, *supra* note 38; Walker & Sauter, *supra* note 103; Littwin, *supra* note 19.

¹⁶⁶ See, e.g., Canner et al., *supra* note 34; Michael S. Barr, *Credit Where It Counts: The Community Reinvestment Act and Its Critics*, 80 N.Y.U. L. REV. 513 (2005); Quintin Johnstone, *Private Mortgage Insurance*, 39 WAKE FOREST L. REV. 783 (2004); Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255 (2002); Michael H. Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 VA. L. REV. 489 (1991).

¹⁶⁷ James M. Lacko et al., *Study of Rent-to-Own Consumers*, Federal Trade Commission Bureau of Economics Staff Report ES-2, April 2000, available at <http://www.ftc.gov/reports/renttoown/renttoownr.pdf> [hereinafter FTC Report].

¹⁶⁸ See, e.g., Interviews with Respondents X66, 9JK, and B63; Hawkins, *infra* note 252, at 9.

¹⁶⁹ Singe-Mary McKernan et al., *Empirical Evidence on the Determinants of Rent-to-Own Use and Purchase Behavior*, 17 ECON. DEV. Q. 33, 34 (2003).

¹⁷⁰ *Id.* at 34. CASKEY, *supra* note 15, at 80 (citing Roger M. Swagler & Paula Wheeler, *Rental Purchase Agreements: A Preliminary Investigation of Consumer Attitudes and Behaviors*, THE J. OF CONSUMER AFFAIRS 145 (1989)).

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In the most recent comprehensive research of rent-to-own industry customers, the researchers found that 4.9 percent of U.S. households had used rent-to-own stores in the past five years, with 2.3 percent having used them in the past year.¹⁷¹ Interestingly, the study also found that 75 percent of customers were satisfied with their experience and that the primary reason for dissatisfaction was high pricing.¹⁷² Rent-to-own customers are more likely to be African-American, younger, less educated, and less financially secure than the general population.¹⁷³

Even less has been written about the operation of pawn shops in practice.¹⁷⁴ A pawning loan begins when a customer posts collateral in exchange for cash, commonly worth approximately half the value of the collateral.¹⁷⁵ The customer has no legal obligation to redeem her collateral, but if she fails to do so within the specified term – usually one to three months¹⁷⁶ – the item becomes the property of the pawn broker.¹⁷⁷

Evidently, as of the late 1990s, jewelry was the type of good most frequently pawned, followed by consumer electronics.¹⁷⁸ The average pawn shop loan size was approximately \$70, with typical loans ranging in size from \$35 to \$260.¹⁷⁹ As of the mid-1990s, pawn shop interest rates averaged over 200 percent per year.¹⁸⁰ Like rent-to-own customers, pawn shop borrowers are less well educated, less likely to be married, less likely to be white, and less financially secure than the general population.¹⁸¹

¹⁷¹ McKernan, *supra* note 169; FTC Report, *supra* note 167.

¹⁷² FTC Report, *supra* note 167, at ES-11.

¹⁷³ McKernan, *supra* note 169, at 35.

¹⁷⁴ Despite being published over a decade ago, John Caskey's book *Fringe Banking* remains the definitive work on the subject. CASKEY, *supra* note 15. In *Fringe Banking*, Caskey analyzed the few sources of data about pawn shops that were publicly available and collected data predominately through interviews with pawnbrokers. *Id.* The only other comprehensive empirical research on pawn shops appears to be the Credit Research Center's study, published in 1998. Johnson & Johnson, *supra* note 75. This study consists of a non-random sample of 1,820 pawn shop customers.

¹⁷⁵ CASKEY, *supra* note 15, at 42.

¹⁷⁶ *Id.* at 39.

¹⁷⁷ *Id.* at 37.

¹⁷⁸ *Id.*

¹⁷⁹ Johnson & Johnson, *supra* note 75, at 16. Caskey finds \$50-\$70. CASKEY, *supra* note 15, at 44.

¹⁸⁰ CASKEY, *supra* note 15, at 36.

¹⁸¹ Johnson & Johnson, *supra* note 75, at 37-47. The finding on race may be biased by the fact that the study focused on pawn shops in urban areas. On the other hand, within the pawn shops the researchers studied, black customers were more heavily represented among the population of active borrowers, while white customers were more heavily represented among those present for shopping purposes only. *Id.*

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Beginning in the mid-1970s and continuing through the 1990s, pawn broking witnessed a significant expansion across the United States. The number of pawn shops nearly doubled from 1988 to 1998 alone.¹⁸² As of 2003, the industry had a revenue of \$4.8 billion.¹⁸³

Almost nothing has been published on borrowing from mail-order catalogs. There appear to be no empirical studies on this type of borrowing, and discussion of it in the academic literature is negligible.¹⁸⁴ The information presented here was culled from newspaper and trade magazine articles, company web sites, attempts to contact the companies, and data from the current study.

The dominant catalog lender in the United States is Fingerhut, owned by the Petters Group, in Minnesota.¹⁸⁵ The company sells a variety of goods, but its “meat and potatoes” are “electronics, jewelry and housewares.”¹⁸⁶ Most of the current study participants used it to purchase housewares. When a customer purchases an item, either online or through Fingerhut’s direct-mail catalog, she can pay the entire purchase price then, or she can select the monthly financing option, which is priced at “as low as” anywhere from \$5.99 to \$59.99 “per month with Fingerhut credit.”¹⁸⁷ Fingerhut has its own credit-application process, and an approved Fingerhut member may purchase Fingerhut items on monthly installment up to her credit limit. When a customer makes the monthly payment, she is not charged separate interest, which is instead built into the installment plan price.¹⁸⁸ Fingerhut also charges a late fee of \$14.90 and assesses a financing charge with an APR of

¹⁸² Johnson & Johnson, *supra* note 75, at 7 (reporting that the number of pawnshops increased from 6,900 in 1988 to 13,000 in 1998).

¹⁸³ DTI REPORT, *supra* note 68, at 15 Figure 8.

¹⁸⁴ See *supra* note 160.

¹⁸⁵ The only other catalog with a proprietary lending system that I have been able to locate is Popular Club. This seller adds an addition twist because it encourages customers to become “club leaders,” which appears to be the equivalent of being a representative for Avon or Tupperware. www.popularclub.com.

¹⁸⁶ Kris Oser, *The Start-up That Isn't*, DIRECT, Sept. 1, 2003, at 11.

¹⁸⁷ Fingerhut, <http://www.fingerhut.com/productgroup.aspx?offergroupid=38106&categoryid=290> (last visited Sept. 9, 2007). Fingerhut declined to release the number of months an installment plan typically requires. Email from Lisa Bilcik, Vice President, Corporate Counsel, Fingerhut, to author (Sept. 20, 2006, 13:43:21 EST) (on file with author). But a Wall Street Journal article cites payment plan lengths of 15 to 18 months. Cahill, *supra* note 160.

¹⁸⁸ Fingerhut Credit Application, <https://www.fingerhut.com/FingerhutCredit.aspx?ref=welcomeroffer&subref=HeaderLink> (last visited Sept. 9, 2007); Cahill, *supra* note 160.

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24.9 percent on any unpaid balance.¹⁸⁹ In other words, for each item purchased on credit, the debtor commits to a plan of fixed monthly payments over a pre-specified number of months. Until recently, Fingerhut even issued its customers coupon books like those used for car loans or mortgage payments.¹⁹⁰

Fingerhut's business model is based on lending to low- and moderate-income customers. Historically, Fingerhut's customer base has had an average household income below \$30,000 and purchased from the catalog almost exclusively on credit.¹⁹¹ The company consistently markets itself as a supplier of credit. Its main web page is titled, "Fingerhut – Home – Your Home Shopping Catalog with Low Monthly Payments." Its print catalog covers feature the words "low monthly payments" in large, bold type. Fingerhut specifically markets itself to customers who have difficulty obtaining credit elsewhere. Its web site proclaims in large type, "Welcome to easy credit," and "We say **yes** when others say **no!**"¹⁹²

Fingerhut has a tumultuous recent corporate history that illustrates the importance of this lending model to its success. Founded in 1949, it ran a successful catalog borrowing operation for half a century.¹⁹³ In 1999, Federated Department Stores purchased the company for \$1.7 billion as a means of expanding its online distribution channels.¹⁹⁴ The purchase was not a success, due in part to Federated's attempt to shift Fingerhut customers from an installment credit model to revolving credit plans.¹⁹⁵ In 2002, Federated sold Fingerhut in pieces. The Petters Group and Ted Deikel, the former CEO

¹⁸⁹ Fingerhut, <http://www.fingerhut.com/productgroup.aspx?offergroupxid=38106&categoryxid=290> (last visited Sept. 9, 2007).

¹⁹⁰ Mark Del Franco, *Private-Label Credit Cards: Risky Business?*, CATALOG AGE (Jan. 1, 2002).

¹⁹¹ Cahill, *supra* note 160.

¹⁹² Fingerhut, <http://www.fingerhut.com> (last visited Sept. 9, 2007).

¹⁹³ Oser, *supra* note 186.

¹⁹⁴ Neal St. Anthony, *Petters Sees Gold in Brand of Old; He'll Bank on its Technology, Recognition*, MINNEAPOLIS STAR-TRIB., Apr. 26, 2005, at 1D.

¹⁹⁵ A consensus emerged among industry observers that the Federated-owned Fingerhut's deviation from its installment credit model was a major factor in its near-collapse. A catalog industry trade publication argued that Fingerhut's problems began in 1999 because it shifted from installment payment plans to revolving credit plans. Paul Miller, *Fingerhut Fixing Credit Mess*, CATALOG AGE, Mar. 1, 2001. In the first year of this switch, Fingerhut lost nearly \$400 million in unpaid credit bills. *Id.* As an industry analyst explained, the company's executives "assumed that the customer would behave the same under both [credit] methods. . . . But they were wrong, and their mistake was to roll out the program before properly testing it." *Id.*

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of the company and son-in-law of its founder, formed FAC Acquisitions to purchase most of those remnants for an estimated \$100 million.¹⁹⁶

The new owners have sought to return Fingerhut to its pre-Federated glory and appear to be making qualified progress towards this goal.¹⁹⁷ As Fingerhut rebuilds itself following the Federated disaster, it has returned to the installment lending structure: “The business model is the original Fingerhut: Focus on sub-prime credit customers, grant them a credit line, sell them general merchandise on time and increase their credit as they establish a solid payment record with the company.”¹⁹⁸

Interestingly, though a little-known company dominates the mail-order lending business in the United States, borrowing from catalogs is quite common in Europe. Mail order credit is the most popular form of borrowing for British¹⁹⁹ and German²⁰⁰ low-income consumers.

(3) Participants’ Comparison of Credit Cards to Other Forms of Fringe Borrowing

Although rent-to-own stores, pawn shops, and catalogs are rarely used by middle-class borrowers, and commentators thus tend to conceptualize them as outside the mainstream,²⁰¹ it should not be assumed that they are any “worse” than the more familiar products such as credit cards from the perspective of low-income borrowers. My preliminary evidence casts doubt on the conception that borrowing from credit cards is somehow “better” than borrowing from fringe-banking alternatives.²⁰² Participants evaluated credit cards approximately equally with rent-to-own stores and less highly than pawn shops and catalogs. Of course, one study with a snowball sample of 50 consumers is not enough to answer the question fully, but at the very least, these findings suggest that further investigation is needed.

¹⁹⁶ *Id.*; Cahill, *supra* note 160. Petters later bought out Ted Deikel’s share. Vicki M. Young, *Fingerhut Returns: Focus on Growth*, WWD, Apr. 22, 2003.

¹⁹⁷ At its peak, Fingerhut had 10,000 employees, but was down to 200 in 2003. Oser, *supra* note 186. As of 2005, the company had sales of \$175 million and more than 400 full-time employees. St. Anthony, *supra* note 194.

¹⁹⁸ Oser, *supra* note 186.

¹⁹⁹ DTI REPORT, *supra* note 68, at 18 Figure 11.

²⁰⁰ ECONOMIC AND SOCIAL RISKS, *supra* note 68, at 31, Chart 10b.

²⁰¹ *See, supra*, Part III.A.

²⁰² Because I am comparing forms of borrowing, this discussion is limited to the borrowing capacity of each option discussed. For pawn shops, that means that I only included data relevant to the scenario where a person uses an item as collateral for a loan, not when she sells the item outright. Similarly, I only include data related to revolving credit-card usage, as opposed to transactional usage. Transactional usage does not seem to be a priority for this population, as only one participant who used credit cards had never regularly revolved a balance. *See supra* note 129.

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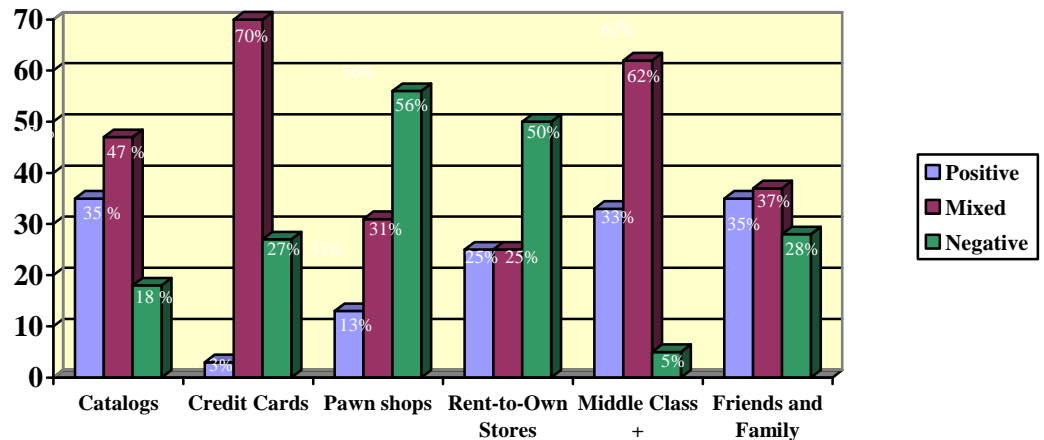
In order to understand the subjective desirability of borrowing alternatives, the study asked participants to evaluate credit cards and the other forms of lending to which they had access. First, as a participant described her experience with a borrowing type, she was asked whether the experience had been a positive, negative, or mixed. I refer to this measure as “experience scores.” Second, participants were asked to rank all forms of borrowing to which they had access. I call this measure “rankings.” These two variables measured different opinions, because the experience-score variable covered only lending in which the participant had actually participated, whereas the ranking variable covered all forms of borrowing to which they believed they had access. In addition, the rankings measure required participants to evaluate more subtle distinctions between forms of borrowing to which they gave the same rating. They produced similar results.

To compare the experience scores, I translated the three options of positive, neutral/mixed, and negative into a numerical scale and then compared the medians of the different borrowing types using a K-sample equality of medians test.²⁰³ I next compared borrowing from rent-to-own stores, pawn shops, catalogs and credit cards against the forms of “middle class” borrowing participants had used. The “middle class” borrowing category is a loose approximation, including student loans, car loans, credit-union loans, and any form of loan originating from a bank. I did not have sufficient observations for any of these borrowing types to compare them individually. I recognize that categorizing all these forms of borrowing as “middle class” is somewhat inaccurate, because sometimes these borrowing types can be geared toward the low-income community. There was no way to disaggregate, for example, the prime-rate car loans from the sub-prime car loans, so I used the above approximation. One indication of the accuracy of this approximation was that of the twenty-one observations that fell in this category, only one had a negative experience score. Figure 4 presents the total percentage of participants who gave each borrowing type positive, mixed, and negative ratings.

²⁰³ I performed Fisher’s exact test. I used the medians instead of the means, because means are not considered robust for ordinal data. *See, e.g.,* W. LAWRENCE NEUMAN, *SOCIAL RESEARCH METHODS: QUALITATIVE AND QUANTITATIVE APPROACHES* 349 (6th ed. 2006).

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Figure 4 – Percent of Participants Rating Each Borrowing Type Positive, Mixed, or Negative



+ Category includes student loans, car loans, credit-union loans, bank overdraft protection, and personal lines of credit from banks

As shown in Figure 4, participants gave middle-class borrowing, catalogs, and informal borrowing from friends and family more positive experience scores than negative, although with informal borrowing, the results are close. In contrast, credit cards, pawn shops, and rent-to-own stores each had at least twice as many negative experience scores as positive. The most striking point about the credit card experience scores, however, is the high percentage of mixed evaluations. A close examination of the transcripts reveals that this may be a function of participants balancing the positive and negative features of credit cards. For example, many participants who gave credit cards a mixed experience score seemed to be balancing the positive value they received from credit cards on the borrowing end and the negative experiences they had on the repayment end. This mixed evaluation of credit cards disappears in the rankings data, where participants evaluated them much more negatively.

As shown in Table 5.a., statistical analysis supports this division of borrowing types into two broad categories, one composed of the more-preferred options and one of those that were less-preferred. On a general level, participants significantly preferred middle-class borrowing, informal borrowing, and catalogs over pawn shops, rent-to-owns and credit cards. This divide is clearest with respect to middle-class borrowing. It always has significantly higher experience scores than credit cards, pawn shops, and rent-

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to-own stores, but there is no significant difference between it and catalogs and friends and family. This trend is weaker with respect to catalogs and friends and family. Participants scored them significantly better than credit cards, suggestively better than pawn shops, and not at all better than rent-to-own stores.

Table 5.a. – Comparison of Borrowing Types: Measure 1, Experiences Scores

<i>Borrowing Type</i>	<i>Credit Cards</i>	<i>Pawn Shops</i>	<i>Rent-to-Own Stores</i>	<i>Friends and Family</i>	<i>“Middle-Class” Borrowing+</i>
<i>Catalogs</i>	catalogs scored higher**	catalogs scored higher*	no significant difference	no significant difference	no significant difference
<i>Credit Cards</i>		no significant difference	no significant difference	friends and family scored higher**	middle-class scored higher***
<i>Pawn Shops</i>			no significant difference	friends and family scored higher*	middle-class scored higher***
<i>Rent-to-Own Stores</i>				no significant difference	middle-class scored higher**
<i>Friends and Family</i>					no significant difference

***p < .01 using Fisher’s exact probability test

** p < .05 using Fisher’s exact probability test

* p < .10 using Fisher’s exact probability test

+ Category includes participant ratings of student loans, car loans, credit-union loans, bank overdraft protection, and personal lines of credit from banks.

It is also useful to specifically examine how participants scored credit cards. The experience scores participants gave credit cards were significantly lower than middle-class borrowing, catalogs, and friends and family – and are statistically indistinguishable from pawn shops and rent-to-own stores. These results are excerpted in Table 5.b.

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Table 5.b. – Comparison of Borrowing Types: Measure 1, Experiences Scores

<i>Borrowing Type</i>	<i>Catalogs</i>	<i>Pawn Shops</i>	<i>Rent-to-Own Stores</i>	<i>Friends and Family</i>	<i>“Middle-Class” Borrowing+</i>
<i>Credit Cards</i>	catalogs scored higher**	no significant difference	no significant difference	friends and family scored higher**	middle-class scored higher***

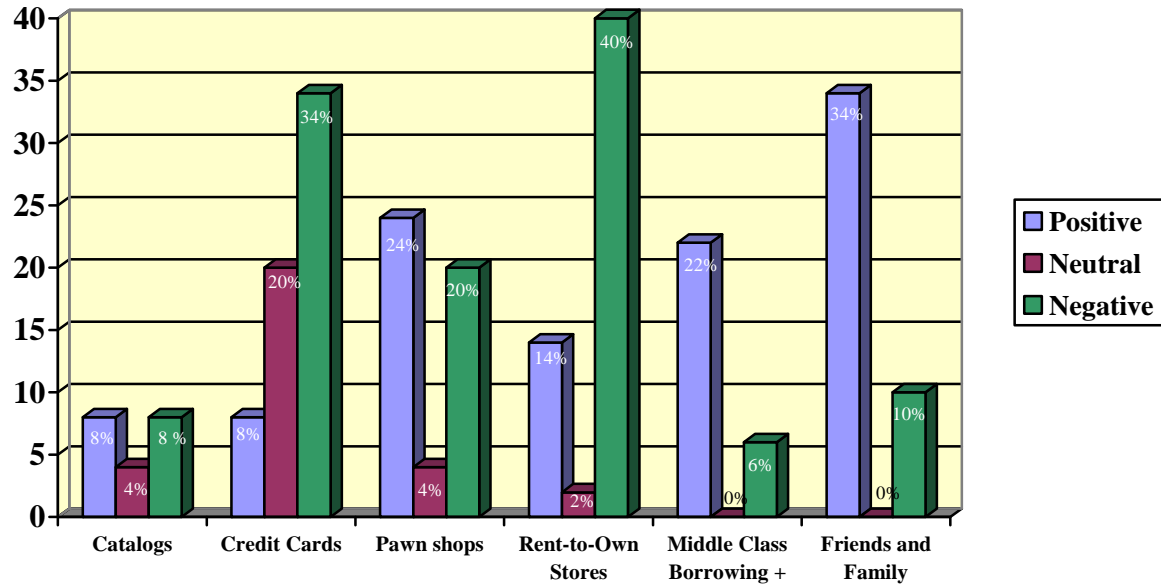
The second measure produced similar results,²⁰⁴ as shown in Figure 5. For this measure, participants ranked their borrowing options from most- to least-preferred. Once again, middle-class borrowing²⁰⁵ and informal borrowing occupy the positive side of the spectrum, with more than three times as many positive rankings as negative rankings in both cases. Participants ranked catalogs less positively than they experience-scored them. Catalogs received equal numbers of positive and negative rankings. On the other hand, participants gave pawn shops much higher rankings than experience scores. This change seems to partly reflect the positive evaluations of pawn shops by participants who had not used them, but it also appears that some participants had negative experiences with pawn shops, but thought more positively of them when they compared them to their other options. Participant reaction to credit cards and rent-to-own stores remained negative. More than twice as many participants ranked both forms of borrowing negatively as positively.

²⁰⁴ Because several participants grouped their rankings in a way that made them impossible to code accurately, (i.e., “they’re all bad,”), the sample size here is small, which may account for the lower number of significant findings. An additional number of participants gave answers such as, “Pawn shops are good, and the rest are bad,” so I analyzed the ranking data twice, once coding these answers as ties, and once dropping them from the analysis. The same comparisons were significant in both analyses. For the sake of simplicity, I report only one analysis. I chose the one that excluded the ties because the data was more precise. When a participant said “the rest are bad,” I did not collect data on exactly which borrowing type she was including.

²⁰⁵ All of the negative rankings for middle-class borrowing were of bank overdraft protection. Car loans, student loans, loans from credit unions, and personal lines of credit from banks never received negative rankings.

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Figure 5 – Percent of Participants Giving a Positive, Neutral, or Negative Rank for Each Borrowing Type (Includes all Participants)



When significance is analyzed, the borrowing options divide into three broad categories. See Table 6.a. Middle-class and informal borrowing form a positive category. They are always significantly preferred to credit cards and rent-to-own stores, which form the negative group. The rankings of middle-class borrowing and informal borrowing were significantly higher than those of credit cards and rent-to-own stores at the one-percent level. Catalogs and pawn shops compose a neutral category. With one exception,²⁰⁶ there were no significant differences between the rankings of pawn shops and catalogs and those of any other form of borrowing.

²⁰⁶ Participants ranked pawn shops significantly higher than credit cards.

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Table 6.a. – Comparison of Borrowing Types: Measure 2, Rankings

<i>Borrowing Type</i>	<i>Credit Cards</i>	<i>Pawn Shops</i>	<i>Rent-to-Own Stores</i>	<i>Friends and Family</i>	<i>“Middle-Class” Borrowing+</i>
<i>Catalogs</i>	no significant difference	no significant difference	no significant difference	No significant difference	no significant difference
<i>Credit Cards</i>		pawn shops ranked higher**	no significant difference	friends and family ranked higher***	middle-class ranked higher***
<i>Pawn Shops</i>			no significant difference	No significant difference	no significant difference
<i>Rent-to-Own Stores</i>				friends and family ranked higher***	middle-class ranked higher***
<i>Friends and Family</i>					no significant difference

***p < .01 using Fisher’s exact probability test

** p < .05 using Fisher’s exact probability test

* p < .10 using Fisher’s exact probability test

+ Category includes participant ratings of student loans, car loans, credit-union loans, bank overdraft protection, and personal lines of credit from banks.

Table 6.b. highlights the results for credit cards. Participants ranked credit cards more negatively than all of the credit options but catalogs and rent-to-own stores. As between those two types of borrowing, credit cards showed no statistical difference.

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Table 6.b. – Comparison of Borrowing Types: Measure 2, Rankings

<i>Borrowing Type</i>	<i>Catalogs</i>	<i>Pawn Shops</i>	<i>Rent-to-Own Stores</i>	<i>Friends and Family</i>	<i>“Middle-Class” Borrowing+</i>
<i>Credit Cards</i>	no significant difference	pawn shops ranked higher**	no significant difference	friends and family ranked higher***	middle-class ranked higher***

***p < .01 using Fisher’s exact probability test

** p < .05 using Fisher’s exact probability test

* p < .10 using Fisher’s exact probability test

While the comparisons with catalogs, rent-to-own stores, pawn shops, informal borrowing, and middle-class borrowing seem to indicate that credit cards are one of the least-preferred forms of borrowing, one qualification to this conclusion is the striking absence of loan sharking. One of the core tenets of the substitution hypothesis is that the fewer legal borrowing options accessible to low-income consumers, the more likely they will resort to illegal borrowing.²⁰⁷ In fact, when usury restrictions were first loosened in the early twentieth century, the primary objective was to combat illegal lending by encouraging high-interest legal lenders to enter the market and give low-income consumers alternatives.²⁰⁸ One way to interpret the lack of loan sharking found by the current study is that the high availability of credit cards

²⁰⁷ See, e.g., Therese Wilson, *The Inadequacy of the Current Regulatory Response to Payday Lending*, 32 AUSTL. BUS. L. REV. 159, 165 (2004) (citing Press Release, Australian Office of Fair Trading, Payday Predators Panned (Aug. 31, 2000)) (cited in Mann, *supra* note 70, at 43 n.198; David A. Skeel, Jr., *Racial Dimensions of Credit and Bankruptcy*, 61 WASH. & LEE L. REV. 1695, 1723 (2004) (“Faced with restrictive usury rules, lenders can be expected to cut back on credit. This could have the effect of steering marginal borrowers who need credit toward much less attractive forms of credit, such as pawnshops or even loan sharks.”); HERVE MOULIN, COOPERATIVE MICROECONOMICS: A GAME-THEORETIC INTRODUCTION 7 (1995) (“[T]here is the concern that a well-intentioned politician who invokes ethical principles to interfere with the market process . . . is likely to be countereffective . . . illegal usury is more expensive because the borrower must pay a premium to insure the lender against the risk of being caught . . .” *Id.*) (cited in Christopher L. Peterson, *Truth, Understanding, and High-Cost Consumer Credit: The Historical Context of the Truth In Lending Act*, 55 FLA. L. REV. 807, 903 n.440 (2003).

²⁰⁸ Peterson, *supra* note 207, at 862-63. On the other hand, the relationship between legal and illegal credit may be symbiotic. Credit historian Lendol Calder argues that the rise of loan sharking in the late nineteenth century mirrored the rise of retail credit, as many of those who fell behind on their retail installment debts would turn to loan sharking. CALDER, *supra* note 157, at 55.

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is meeting the community's credit needs and leaving little demand for loan sharks. Another possibility is that study participants were unwilling to disclose loan shark borrowing during interviews.

Both of these explanations are unlikely. Addressing the second interpretation first, the study consciously framed questions about loan-sharking in ways that evoked as little stigma as possible. After participants listed the types of credit they had used, they were asked if they had borrowing money from anybody else in the community, such as a neighbor or a casual acquaintance. Only once they rejected that possibility did the study mention the term "loan sharking" by name. If both forms of the question produced a negative answer, the study then asked if participants knew of other people who used informal community lending or had even heard of anyone using it. The objective of this last question was to probe for any loan sharking in the community and to give participants who may have been afraid to discuss their own loan-sharking experiences the option to speak of loan-sharking in terms of the story of "a friend." These efforts produced low results. Only one participant had borrowed from a loan shark, and one additional participant thought it was currently being practiced in her community. However, this does not appear to be a decrease that occurred as credit card availability increased. Even though half the sample had come of age before the effective deregulation of credit cards rates and an even greater number of participants had been adults as credit cards gradually became accessible to low-income borrowers,²⁰⁹ just one participant recalled that loan sharking had existed in her youth. (Her grandfather had been a loan shark.)

The most plausible explanation for this dearth of responses is that loan sharks generally do not lend to the lowest-income tier of poor women. Not surprisingly, there is hardly any information about the practice, but from the little that does exist, it appears that the typical borrowers are men, usually either immigrants seeking to start small businesses or those with gambling debts. The only recent newspaper accounts of loan sharking practices have focused on illegal lenders who extend credit to small businesses within immigrant communities²¹⁰ and those associated with gambling.²¹¹ In addition,

²⁰⁹ See *supra* notes 103-106.

²¹⁰ Dexter Filkins, *In Some Immigrant Enclaves, Loan Shark Is the Local Bank*, N.Y. TIMES, April 23, 2001, at A1 (describing loans made by illegal lenders to immigrant small businesses) (cited in Regina Austin, *Of Predatory Lending and the Democratization of Credit: Preserving the Social Safety Net of Informality in Small-Loan Transactions*, 53 AM. U. L. REV. 1217, 1257 n.124 (2004)).

²¹¹ Joseph Kelly, *Caught in the Intersection Between Public Policy and Practicality: A Survey of the Legal Treatment of Gambling-Related Obligations in the United States*, 5 CHAP. L. REV. 87, 141 (2002) (describing informal lenders in Quebec casinos who lend casino chips

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historically, loan sharks have served a slightly higher-income customer base.²¹²

(4) Explaining Participants' Preferences

In sum, the results of this comparative analysis suggest that, from the subjective perspective of a preliminary sample of those most affected, credit cards are no more desirable than pawn shops and rent-to-own stores and are less desirable than every other form of borrowing. This analysis does, however, leave a major question in its wake – if credit cards are less desirable than catalogs and informal borrowing and only equally as desirable as rent-to-own stores and pawn shops, then why have more than twice as many participants borrowed with credit cards than with any other formal type of credit? First, it is worth reiterating that the more likely a participant was to use credit cards, the more likely she was to use fringe banking as well.²¹³ Second, borrowing from friends and family is still more popular than even credit cards.²¹⁴ In addition, it is almost certain that participants were restricted by credit-worthiness from obtaining as much “middle class” credit as they would have liked.

But aside from these minor qualifications, the substantive answer to this question lies in the point from behavioral economics, discussed *supra* in Part IV.B., that transactions in which the costs and benefits are temporally separated are subject to preference reversal. Credit cards are an extreme case of this type of transaction because the benefits are available immediately, but the costs do not become apparent until later, often much later.

The experiences of the current study participants show how this effect can operate. Eighty-seven of participants who had used credit cards did not understand them at first.²¹⁵ There were many sources of misunderstanding, but they all led to a significant underestimation of the amount they would eventually need to repay. Because of the minimum-payment option, this is not a short-term misunderstanding corrected when a credit-card user receives her first bill. Unlike a traditional installment loan where the specified regular payment guarantees an end date to the loan, the minimum payment for a credit

instead of cash, execute their transactions in casino restrooms, and charge rates as high as ten percent per day); Jeff Benedict, *A Losing Hand; Casino Gambling Can Bring Financial Problems -- Especially to Those Who Can Least Afford Them*, HARTFORD COURANT, May 8, 2005, at C1 (stating that problem gamblers may turn to loan sharks and describing the breakup of a loan-sharking ring at the Foxwoods Casino in Connecticut).

²¹² CALDER, *supra* note 157, at 52 (“Loan sharks catered to a class of borrowers that overlapped the high end of the pawnbroker’s clientele.” *Id.*).

²¹³ See discussion *supra* Part III.B.

²¹⁴ See *supra* Part III.B Figure 3.

²¹⁵ For a detailed discussion of this finding, see Littwin, *supra* note 19, at Part III.D.(1).

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card is often too low to decrease the overall balance.²¹⁶ This feature makes it easy to ignore the future costs of borrowing and difficult to estimate those costs when one tries. The importance of this type of misunderstanding is evidenced by credit card issuers' opposition to legislation requiring them to print how long it would a borrower to pay off her balance if she made only the minimum payment.²¹⁷ In addition, credit card bills often feature the minimum payment due more prominently than the total balance.²¹⁸ If issuers did not expect consumers to underestimate the eventual total costs of making the minimum payment, they would not emphasize the minimum payment this way.

This ability to delay the costs of credit-card borrowing explains why participants frequently gave credit cards low experience scores, despite their usage of them. The cost delay and the low experiences scores are mediated by a model of credit-card borrowing by low-income people that emerged. Although the data set is small, it can still provide a preliminary model to be tested with a larger sample.

This model consists of a three-stage cycle. In the first stage, the participant obtains a credit card, most frequently to have in case of emergency. Forty percent of participants mentioned emergency usage as an advantage of credit cards. The next most cited advantage of having credit cards was their purchasing power, at 34 percent. Twenty percent of participants said that credit cards were a good way to improve one's credit history, and another 12 percent obtained a credit card to see if they could get one.

In the second stage, she is "tempted" to use it²¹⁹ and finds herself charging regularly and paying less than the full balance. Many participants described themselves as happy with credit cards in this stage, and logically so; they were experiencing the benefits of credit-card borrowing but not the costs. As one participant explained:

You don't think. You can buy now and pay later, but you don't get the connection really.... I just thought it was like getting something right now. I didn't think. Now I would think it

²¹⁶ See Mann, *supra* note 106.

²¹⁷ BAPCPA included a weak minimum-balance disclosure requirement. 15 U.S.C. § 1637(b) (1988). For a discussion of the ineffectiveness of this provision, see Mann, *supra* note 106, at 16. In 2002, California passed a stronger disclosure requirement. Card issuers challenged the bill in court and won on the grounds that it was preempted by federal banking laws such as the National Bank Act. See, e.g., Julia Lane, *Will Credit Cardholders Default over Minimum Payment Hikes?*, 18 LOY. CONSUMER L. REV. 331, 344 (2006).

²¹⁸ Redacted participant credit card bills, on file with author.

²¹⁹ See Littwin, *supra* note 19, at Part II.C.

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through of course. But then it wasn't like, I've got to pay for this next month."²²⁰

Another participant described a similar thought process: "Just basically – I'm going to spend this money. And I'm not going to . . . not that I was not going to pay it back. I don't think that when you're young you realize about it."²²¹ This phase can last for up to several years.

There were three common ways participants described the end of this second stage of the cycle. For some, the credit-card issuer cut off the line of credit or refused to raise the credit limit beyond the participant's current balance. For others, the minimum payments themselves became unaffordable. Often participants experienced a combination of these two. A credit card issuer might raise the interest rate, making it harder to meet the minimum payment. As one participant related, "They were lovely at first. But then I wasn't paying them fast enough, so they upped the APR, which made it harder to keep at the minimum, I mean . . . made it harder to pay more than the minimum every month."²²² A third group of participants realized themselves that their total balance was becoming insupportable.

Whatever the reason participants entered the third stage of the cycle, once they reached that point, they then began the long process of paying down their balances. Some continued to charge occasionally, although most claimed to have had a cognitive shift and focused on not accumulating more debt. Some continued charging makes sense, in that these are all households with extremely tight budgets.

Most participants whose backgrounds with credit cards resemble this model experienced the three stages only once. Indeed, because the third stage of the cycle can last years, many were still in the process of paying down their original wave of credit card debt. More than one asked for advice about filing for bankruptcy during their interviews.²²³ Of those who had completed the cycle once, many had sworn off credit cards altogether.²²⁴ Some swore off credit card *debt*, but continued to keep one card in case of emergencies or with the intention of becoming transactional users. A minority of those in the latter

²²⁰ Interview with Respondent V22.

²²¹ Interview with Respondent 99Z.

²²² Interview with Respondent 803.

²²³ As part of its human subjects protections, the study developed a list of resources where participants could seek help with debt issues. When a participant asked for bankruptcy advice, she was given this list and referred to those resources which offered bankruptcy services.

²²⁴ This corresponds to findings from the Consumer Bankruptcy Project that a majority of bankruptcy filers decline the many credit card offers they receive after bankruptcy. See Katherine Porter, *Borrowing After Bankruptcy* (forthcoming 2008).

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category found themselves “tempted” to use credit card borrowing again – or found themselves pulled in that direction by adverse events²²⁵ – and thus for them, the cycle began anew.

(5) Assessing Benefits and Harm

Understanding the features of the various credit options that consumers find beneficial and harmful is necessary in order to weigh the positive and negative consequences of credit substitution. It was the ability to accumulate a balance before understanding its full cost that participants cited as the major drawback of credit cards. None of the other borrowing options available to low-income consumers have this negative characteristic. Each of those forms of credit has other drawbacks, however. It is through comparing the advantages and disadvantages of the other fringe borrowing options to those of credit cards that a fuller picture of the potential effects of credit substitution begins to emerge.

The positive and negative characteristics of the borrowing types available to low-income consumers can be grouped into three broad categories: transparency/manageability, security (or lack thereof), and versatility. I group transparency and manageability together because they arise in the same products and capture two dimensions of whether consumers understand “what they are getting into” when they begin using the product. As used here, transparency refers to two closely related attributes. The first is whether a product’s fees and other negative features are easily perceived by the consumer at the beginning of the transaction. The second part of transparency is usage transparency, or whether a consumer can predict her own behavior with respect to the product. A product that lacks this usage transparency is one where consumers frequently end up using it in a manner that is inconsistent with their initial expectations.²²⁶ Usage transparency bleeds into manageability, because it is often consumers’ inability to forecast how they will use a product that leads them to feel unable to control their borrowing and results in the accumulation of unmanageable debt.²²⁷

The term security here has its standard commercial-law meaning: whether the loan is secured or unsecured, i.e., whether the lender has the right to collateral if the borrower defaults. Versatility refers to the flexibility the borrower has in spending the credit. If she receives cash or its equivalent, the borrowing type is versatile. If the type of credit limits what she can purchase with it, then it is less versatile.

²²⁵ Interview with Respondent 283.

²²⁶ See Oren Bar-Gill, *Informing Consumers About Themselves* (forthcoming).

²²⁷ See Littwin, *supra* note 19, at Part II.C.

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Price, of course, is an additional factor, but participants' reactions to price seemed to correlate more closely with their opinions of other characteristics of the borrowing types than with price itself. For example, the best estimates indicate that pawn shops and rent-to-own stores have similar interest rates. If anything, those of pawn shops appear to be higher.²²⁸ But, as will be discussed below, participants expressed a higher level of satisfaction with pawn shop prices than those of rent-to-own stores. The ultimate interest rates that consumers pay on credit cards are difficult to determine, because they can compound over several years and – in the case of participants and others struggling with credit card debt – include numerous flat-fee charges such as late and overlimit fees that are effectively part of the interest-rate price. But participants commented that they ended up paying two to three times the principle in interest, even though the participant with the highest documented annual percentage rate (APR) was paying 30.99 percent.²²⁹

Catalog interest rates are even more difficult to determine because the major catalog company will not release information on either the number of monthly installments a borrower must pay for any given purchase or how it determines that figure.²³⁰ However, an attempt to purchase merchandise from the company in order to answer these questions revealed that, at least impressionistically, its prices are much higher than what one would pay at a standard retail establishment.²³¹ Participants were unhappy with catalog

²²⁸ On a national level, Caskey estimated in the early 1990s that the unregulated market rate for pawn shop transactions was approximately 240 percent per year. CASKEY, *supra* note 15, at 39. Rent-to-own store interest rates are consistently estimated to be between 100 and 150 percent. *See supra* note 170). Because nearly every transaction reported in the current study took place in Massachusetts, local interest rates are more relevant, but these are difficult to determine. In Massachusetts, localities regulate pawn shop interest, setting annual percentage rates ranging from 36 to 120. MASS. GEN. LAWS ch. 140 §§ 70, 72, 78 (2002); Donna Roberson, *State Fails to Curb Usurious Pawnshop Rates*, BOSTON GLOBE, April 30, 2007, at A1. Technically, the state Division of Banks must approve these local interest rates (MASS. GEN. LAWS ch. 140 § 78 (2002)), and it has set an annual limit of 36 percent, but the regime is so complex that the Attorney General is reluctant to enforce it until new legislation is enacted. Roberson. The state and local restrictions appear to be routinely violated. Roberson. The study was unable to impute local rent-to-own interest rates because such a determination requires an appraisal of the merchandise's value.

²²⁹ Interview with Respondent 9YY.

²³⁰ Email from Lisa Bilcik, Vice President, Corporate Counsel, Fingerhut, to author (Sept. 20, 2006, 13:43:21 EST) (on file with author).

²³¹ I had difficulty bringing myself to purchase anything because the prices were so far above what I intuitively expected to pay for the merchandise. Shipping costs further increased the total. At nearly \$8.00, shipping represent approximately 28 percent of my \$27.87 balance, meaning that my first installment payment of \$5.99 did not even fully cover the shipping

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prices, but not as much as they were with those of rent-to-owns. Due to this inconsistency in participants' subjective price assessments and the lack of objective data about fringe credit pricing, I treat participants' comments about price as a proxy for their overall evaluation of the borrowing type, rather than a separate factor of its own.

The lack of transparency and manageability in credit card borrowing figured prominently in participants' overall assessment of the borrowing type. Credit cards might have received even lower evaluations if they were not both versatile and unsecured. Credit cards are extremely versatile. They can be used almost anywhere cash is accepted, and in some cases, they are preferred over cash.²³² And the vast majority of credit card borrowing is unsecured.²³³

On the other hand, participants had such negative opinions about the lack of transparency and manageability that the other two factors were unable to fully mitigate the damage. Participants expressed frustration, anger, and sadness about credit cards. The qualitative data illustrates some of the harm participants experienced. One participant summed up her failure to understand the workings of credit cards until after she had already accumulated a large balance as, "Once you get it, it's way over your head."²³⁴ Another participant described it this way:

The advantage is that you can go out and get things that you do really need, that's without the wait. The disadvantage is paying back, like you're paying back at least twice. And you don't realize it because you're so happy that you got what it was that you needed or whatever it is. But in the long run it hurts. It truly hurts.²³⁵

One participant's experience with credit cards was so negative that she even compared loan sharking favorably to credit cards in this respect:

[With loan sharks] you know what the situation is before you get into it.... But with the credit card companies, they're going

charges. In addition, I was charged a \$1.00 processing fee each month I made an installment payment.

²³² Littwin, *supra* note 19, at Part I.B.

²³³ There is a product known as a secured credit card, but it does not actually offer the borrower any credit. The putative borrower must send the issuer a deposit in the amount of the borrower's line of "credit." The borrower may then charge up to the amount she has on deposit, as though she had an unbanked debit card. *See, e.g.* Interview with Respondent 803. Secured credit cards were disfavored by participants, and none of them were currently using one. Every participant who had used an secured credit card had also used at least one unsecured one.

²³⁴ Interview with Respondent 64F.

²³⁵ Interview with Respondent 803.

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to drain you slowly and take everything away from you. With the loan sharks, they might beat you up or whatever, but they're not going to come and take your house or your car or whatever is yours. They're not going to put you out on the streets. That's why I said I would much rather deal with them.

...²³⁶

Further exacerbating this issue is the fact that credit cards regularly change their terms. Participants felt that credit card issuers changed the rules once they had accumulated a balance and could not easily exit the relationship. As one participant described:

And then all of a sudden, we're up to 29 percent, and they brought in the over-the-limit fees, and they brought in those late fees. And now all of a sudden, it's like if you were late on this one, these five companies can now raise your interest, because you were late on this credit card that has got nothing to do with them. That's when all of these tricks started to come into play.²³⁷

Another participant discussed the phenomena more generally: "My understanding was once you and the company committed to a certain amount, they would not fluctuate...and we wouldn't be hit with the higher interest rate years later, and that's the predicament that a lot of us have gotten into."²³⁸

Repeatedly, participants commented that with the other forms of fringe borrowing, at least they understood them ahead of time, but each of the fringe borrowing alternatives – pawn shops, rent-to-own stores, and catalogs – either requires security, lacks versatility, or both.

With respect to transparency, pawn shops are the exact opposite of credit cards. The cost of the loan is internalized immediately, as the borrower must physically surrender her collateral to obtain the loan. In this way, the borrower must face the cost of the transaction at the time she receives the benefit. Borrowers are still vulnerable to overestimating their ability to redeem their collateral within the required time period, though prior research suggests that pawn shops are manageable in this respect: the vast majority of borrowers do redeem their collateral.²³⁹

In addition, the fact that pawn shop loans are generally small²⁴⁰ makes them more manageable still. As one participant explained, "As long as you

²³⁶ Interview with Respondent A26.

²³⁷ Interview with Respondent 283.

²³⁸ Interview with Respondent 224.

²³⁹ Johnson & Johnson, *supra* note 75 at 17.

²⁴⁰ See *supra*, note 182 and surrounding text.

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don't get too much money, then you're okay, because you know you're bound to pay it back.... So if you get less money, then you're more likely to get [your collateral] back."²⁴¹ A second participant echoed and elaborated on this idea: "They're pretty useful I think because you can either leave it or get it back. And they don't charge much. You don't get much. So you don't have to worry."²⁴²

Pawn shop borrowing also gives the consumer the highest level of versatility possible. The borrower receives cash, the most fungible option available. Pawn shop borrowing is, however, secured, and this has two negative consequences. First, there is the possibility of losing one's collateral permanently. One speaker expressed regret over losing jewelry she had inherited from her grandmother in her native country,²⁴³ while another described her horror at her inability to stop a friend from posting her wedding ring so she could buy drugs.²⁴⁴ On the other hand, two participants favorably described pawning and redeeming gold chains and other jewelry in accordance with their cash flow.²⁴⁵ The second effect of the security requirement is that it makes pawn shops inaccessible to people who do not own items of value. A few participants mentioned that they had nothing to post as collateral.²⁴⁶

Pawn shop interest rates were generally considered fair.²⁴⁷ Rent-to-own stores, on the other hand, were considered overpriced. This feature was discussed perhaps even more often than repossession. Several people described rent-to-own stores as "rip-off[s],"²⁴⁸ and others stated that they charged three times as much as standard retail stores.²⁴⁹ This negative perception of price corresponds with the fact that rent-to-owns perform poorly in the transparency/manageability-versatility-security evaluation system. Unlike borrowing from credit cards, pawn shops, and catalogs, which each have two positive and one negative characteristics on this scale, rent-to-own borrowing has two negatives and one positive. The borrowing type both requires security and lacks versatility. The transparency/manageability attribute is the only positive characteristic of rent-to-own transactions. Rent-

²⁴¹ Interview with Respondent K72.

²⁴² Interview with Respondent 921.

²⁴³ Interview with Respondent 99Z.

²⁴⁴ Interview with Respondent B63.

²⁴⁵ Interview with Respondents 20Y and U67.

²⁴⁶ *See, e.g.*, Interview with Respondent 803.

²⁴⁷ *See supra* note 228 for actual interest rates.

²⁴⁸ Interview with Respondents V22, X66, and 921.

²⁴⁹ Interview with Respondents CC3 and 2AU. The recent FTC study on rent-to-owns suggests that prices are 2 to 2.5 times those of retail stores. *See supra* note 167.

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to-own borrowing, like all installment borrowing with non-variable payments, requires regular, specified payments. The borrower will feel the impact of the loan quickly and, where the loan is ultimately not affordable, she will have concrete indicators alerting her to this fact.

Repossession featured prominently in the discussions of rent-to-owns. Some participants had had their furniture repossessed. Most described this as an embarrassing experience, although one saw it as a convenient way to return merchandise with which she was dissatisfied.²⁵⁰ The most common concern about repossession was that the store never refunded any of the customer's previous payments, even when the customer had paid off most of the loan. Presumably, from the store's perspective, this reflects the fact that the participant has been "renting" the furniture during the life of the loan. Participants, however, considered the goal of owning a central feature of the transaction, and this appearance of inequity was a major strike against rent-to-own stores. Participants' identification of this feature demonstrates a certain sophistication about borrowing. The return of a borrower's equity in the collateral is, at least in theory, a tenet of repossession in secured transactions under Article 9 of the Uniform Commercial Code.²⁵¹ In most states, rent-to-own stores are governed by separate statutes that allow them to escape this requirement.²⁵² That participants unknowingly identified the major difference between rent-to-own borrowing and other forms of secured borrowing against personal property suggests that it is worth examining the costs and benefits of bringing rent-to-own transactions under Article 9.

Rent-to-own stores are limited further by the fact that they sell only goods. No matter how large their selection, a customer cannot, for example, borrow to pay her rent or her babysitter. As one participant explained, "[Y]ou can only get so much from rent-a-center. All you can do is get furniture. You can't go there and get a gallon of milk and a loaf of bread if your kids were starving or something."²⁵³ This limits their usefulness in financial emergencies, and protection from emergencies was one of the major reasons participants sought credit.²⁵⁴

²⁵⁰ Interview with Respondent X66.

²⁵¹ U.C.C. § 9-615 (d)(1) (2006).

²⁵² See Alan M. White & Cathy Lesser Mansfield, *Literacy and Contract*, 13 STAN. L. & POL'Y REV. 233, 266 n.160 (2002); Jim Hawkins, *Renting the Good Life* 1, 8 (U. of Texas Law, Law and Econ. Res. Paper No. 111, 2007) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1003784#PaperDownload (follow link to "Download Document").

²⁵³ Interview with Respondent K72.

²⁵⁴ See *supra* Part IV.C.(4).

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Catalogs suffer this same versatility disadvantage. Catalog credit is only valid for the purchase of non-perishable goods and hence inapplicable to regular expenses like groceries and utility bills,²⁵⁵ making it useless in emergencies. On the other hand, because catalog borrowing is a form of installment lending, it meets the criteria for transparency and manageability in the same way rent-to-own stores do. Because the price is conceptualized from the beginning in terms of what the customer will pay each month, interest included, borrowers can more easily weigh the costs of the purchase at the time they acquire the benefits. And catalog borrowing is unsecured. The catalog lenders do not take a security interest in the merchandise they send. This may be due to the difficulty of repossessing from customers dispersed across the country, or it may reflect the fact that much of merchandise they sell consists of items like clothing and toys that do not retain their value over time. This relatively positive picture of catalog borrowing is reflected in participants' assessment of price. Some participants thought that the merchandise was of low quality, and a few thought that the prices were too high, but these concerns were not as widespread or negatively expressed as those about credit cards or rent-to-own stores.

Table 7 provides a summary of which borrowing types possess which characteristics.

Table 7 – Positive Properties of Credit Cards and the Three Major Forms of Fringe Borrowing

	<i>Credit Cards</i>	<i>Pawn Shops</i>	<i>Rent-to-Owns</i>	<i>Catalogs</i>
<i>Transparency/ Manageability</i>				
<i>Versatility</i>				
<i>Lack of Security</i>				

²⁵⁵ Of course there is some fungibility here. If a household purchases its personal hygiene items and cleaning products on Fingerhut credit, it frees up funds for groceries and bills. On the other hand, very low-income households have a low ability to make these kinds of substitutions because so much of their income is received through non-transferable benefits like food stamps and rent subsidies.

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One advantage of analyzing substitution issues this way is that it can simplify the framework and clarify what is at stake. The participants in the current study revealed that these three characteristics heavily influenced their estimation of the tradeoffs between the different borrowing types. Their negative overall evaluation of credit cards suggests that perhaps the transparency/manageability factor has the most weight.

The ambiguous effect of price on participants' subjective evaluations has interesting implications in and of itself. It is easy to assume that equal price means equal value, but this analysis suggests that sub-prime lenders may compete – and low-income consumers may make borrowing decisions – predominantly on the basis of other, non-price attributes. If this is the case, regulators and lenders have more flexibility to experiment with changing non-price characteristics to improve low-income borrowers' options. Obviously, changing these characteristics will have a price and risk impact for lenders. Pawn shops and rent-to-own store borrowing is secured because it enables lenders to extend credit to risky borrowers. And the catalog model may be successful because lender control of both the price and quality of the merchandise may enable the lender to profit even when the borrower defaults before completing payment.

But this framework also suggests that experimentation is worthwhile because borrowers may very well be willing to pay more for changes. For example, credit card borrowing has always been associated with revolving payment plans, and some analysts have assumed that that is what accounts for their popularity.²⁵⁶ But credit card lending is the only form of small-scale, unsecured borrowing that has ever allowed consumers such incredible flexibility in how they spend their credit. It is entirely possible that consumers are drawn to these characteristics and would prefer more transparent and manageable payment plans.²⁵⁷ There is no reason why credit card issuers could not offer, for example, installment payments. To the extent that issuers profit from the deception inherent in the lack of transparency of the current repayment system, they could raise total prices for more manageable plans, and as more consumers experience the negative effects of the current payment plans, they may be willing to pay more to avoid them.

²⁵⁶ Durkin, *supra* note 38, at 624 (“Thus, the revolving [debt] component’s share has been growing relative to the nonrevolving component’s share, reflecting consumer preference and technological change; many consumers seem to like the convenience associated with prearranged lines of credit...” *Id.*).

²⁵⁷ The development of credit card plans that would be more manageable for low-income borrowers is a major focus of the other Article based on the current study. Littwin, *supra* note 19.

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This has analogous implications for changes implemented by law. A regulation which increased the transparency of credit card practices and caused issuers to seek the lost revenue elsewhere would still leave them considerable room to increase interest rates without triggering substitution away from their products.

V. CONCLUSION

The effects of the substitution hypothesis are unproven at best. Given its potential impact on how consumers would experience credit regulation, surprisingly little is known about how the hypothesis might operate in practice. To my knowledge, prior to the current study, no one has explored the comparative value low-income borrowers place on their different credit options. Middle-class bias and traditional economic methodologies have meant that all regulation-driven substitution away from credit cards has been assumed to be harmful. But the current study suggests that credit cards are actually among low-income consumers' least-preferred sources of credit, meaning that there is no "worse" alternative to which they would turn if credit card access were reduced.

Of course, consumer preferences are not monolithic. Some low-income consumers who value credit cards highly would be affected negatively if access to credit cards were constrained as certain highly profitable credit terms were regulated. But the data presented here suggest that any harm associated with such constriction is a much smaller than has previously been assumed. When balanced against the benefits of the particular regulation being considered, the overall cost-benefit analysis may weigh far more heavily in favor of credit regulation.

The few studies that have examined the other part of the hypothesis, the interchangeability prong, suffer from methodological limitations that restrict their application to the substitution issue. More importantly, they do not attempt to specify how much substitution is taking place. Some substitution does not mean complete substitution. Once the relationship between low-income consumers' usage of credit cards and other credit options is examined, the unlikelihood of complete substitution among low-income borrowers becomes clear. Simply put, credit cards offer more credit than any other option low-income consumers have. Moreover, findings from the current study suggest that low-income consumers who use credit cards are more likely than their credit-card-free counterparts to be using other credit alternatives already. If credit card issuers restricted credit in the wake of regulation, these borrowers would likely end up with less total credit.

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The question of whether the larger-scale borrowing that credit cards supply *should* be available to low-income consumers is one that I address in the companion paper to this Article.²⁵⁸ But whatever one may believe is the correct answer to that complex normative issue, this Article demonstrates that the blanket assertion that credit substitution would nullify any gains from credit card regulation is overblown. Proposals to regulate credit card terms or conditions should be evaluated on the merits of each proposal, balancing the benefits against the potential harms of substitution, harms that may in fact be quite modest. Putting the substitution hypothesis in proper perspective will enable more effective consideration of credit card regulation and perhaps allow efforts to protect low-income consumers to begin anew.

²⁵⁸ Littwin, *supra* note 19.