



The State of Lending in America & its Impact on U.S. Households

*A series of studies on how predatory lending
undermines the financial security of U.S. households*



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ACKNOWLEDGEMENTS

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The financial crisis in 2008 rocked the largest financial firms in the United States and pushed the entire economy into deep recession. American families were hit hard by plunging home prices, foreclosures and job losses. Reckless mortgage lending practices fueled a housing boom and bust and left millions of families with unsustainable home loans.

In *The State of Lending in America and its Impact on U.S. Households (State of Lending)*, the Center for Responsible Lending (CRL) assesses the impact of the financial crisis on American families, showing the magnitude of the damage to their financial security—that is, their household balance sheet. In addition, this study looks at a broad range of current lending practices and their impacts.

Two trends are clear. First, families were already struggling to keep up before the financial crisis hit. The gap between stagnant family incomes and growing expenses was being met with rapidly increasing levels of debt. Second, the terms of the debt itself have acted as an economic weight and a trap, leaving families with less available income. This debt often punished those who tried to get ahead by pushing them into long term financial distress, such as foreclosures and crushing levels of student debt.

CRL's research and analysis is particularly important amid the signs of an economic recovery. While many are enjoying the relief of the rebounding stock market and improving job opportunities, many others still struggle. For example, while the overall housing market is reviving, five million families have already lost their homes, an even greater number are still at great risk of foreclosure, and nearly a fifth of mortgage holders owe more than their homes are worth. The impact on families of color is even greater. They were three times as likely to be targeted with abusive subprime loans as other borrowers with the same credit record, and they have lost a generation of hard earned family wealth. The consequences will be profound and long lasting.

Families who experienced foreclosure were uprooted and often lost both their home and their largest financial asset. The large numbers still facing foreclosure are at risk of the same. Those underwater on their home loans face deep financial holes and are unable to sell their homes or move to new jobs. As a result of the crisis, African-American and Hispanic households' wealth plunged nearly in half so that it is now only one twentieth and one fifteenth, respectively, of that of white households. And the unemployment rate for those families is still stuck in the mid-teens, even though the overall unemployment rate has improved.

Legislation enacted in response to the financial crisis put in place important reforms, even though it did not go as far as I and others advocated. Much of the actual new structure and rules were delegated to the financial regulators to set out. Remarkably, many of the firms who would have gone out of business without massive government assistance now are again fighting hard against rules that would prevent the types of financial wagering and over-leveraging that produced the recent crisis.

One important reform was the creation of the Consumer Financial Protection Bureau, consolidating consumer protection into a single agency and providing much needed oversight of the so-called “shadow” or nonbank financial sector. We did a very poor job of protecting consumers prior to the crisis, with disastrous consequences for our economy. We need an agency focused exclusively on consumer protections and the CFPB already has begun setting out strong, uniform consumer protections

for financial products, and taking action against those who engage in deceptive practices. We must not weaken this agency.

Notably, CRL predicted the crash of subprime mortgages in 2006, though its warnings were not heeded. *State of Lending* is again a warning. If abusive lending practices are not reformed, we again will all pay dearly.

To be sure, borrowers also have an obligation to behave responsibly, but to make reasoned choices they must be given full and understandable information about the benefits and risks of credit products and be protected from inherently abusive practices. Abusive practices not only harm the family that loses its home to an unaffordable mortgage, the student saddled with excessive education loans, the person who pays thousands of dollars extra in kickbacks on their loan when they buy a car, or the consumer who receives a “fee harvester” credit card where the charges far exceed the credit extended; they also profoundly harm neighborhoods, communities, and cities, and hold back our entire economy.

Trapping families in financial marginalization keeps them from succeeding and from making their full contribution to the whole community and economy. They are unable to advance and generate prosperity for themselves and are blocked from increasing the prosperity of others as well. We face a choice of returning financial services to a role of advancing economic progress or letting it again become a drain on individual households and a drag on our economy. *State of Lending* sets forth a path for consumer finance to be both profitable for responsible lenders and a tool for success for American families.

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INTRODUCTION

The *State of Lending in America and its Impact on U.S. Households (State of Lending)* tells the story of the financial products that American households use to handle everyday transactions, acquire major assets such as homes and automobiles, build savings and wealth, and provide a secure future for their children.

This report describes how predatory lending practices have sometimes corrupted traditional financial products and undermined the benefits that these products are intended to provide. It outlines how payday loans, excessive overdraft fees, and unfair or deceptive debt collection practices trap borrowers in long-term debt, preventing them from getting ahead or saving for the future. It presents a picture with data of the overall financial status of U.S. households today—income, spending, debts, and wealth—and the centrality of household financial health to our nation’s economic well-being. And it demonstrates the significant role lending practices play in the lives of everyday Americans, and explains why protecting fair, affordable access to credit is vital to the future for both consumers and the American economy.

State of Lending will be released in three parts. The first part tells the story of financial challenges that consumers have faced in the past decade: stagnant incomes, increasing expenses, declining asset values, and higher levels of debt. Combined, these factors have made American households more vulnerable to predatory lending practices. This part of the report also documents both past and current lending abuses in traditional financial products and the impact these have on American families; it includes chapters on *Mortgages*, *Auto Loans*, *Credit Cards*, and *Student Loans*.

The second part of *State of Lending* will cover *Payday and Car Title Loans*, *Overdraft Fees*, and *Bank Payday Loans*—“short-term” financial products that trap consumers in expensive, long-term debt.

The final part of the report will focus on abusive practices in debt collection and include chapters on *Mortgage Loan Collection and Servicing*, *Student Loan Collection and Servicing*, *Debt Settlement*, and *Debt Buyers and “Zombie” Debt*. It will conclude with a chapter documenting how lending abuses often target the same populations and have a cumulative—and particularly disastrous—impact on low-income households and communities of color.

Passage of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act was a turning point in efforts to protect the financial well-being of American families. *State of Lending* demonstrates, however, that considerable threats to household financial security and wealth-building remain. Just as the Credit Card Act of 2009 instituted effective consumer protections against abuses in credit card financing, further regulatory and legislative actions can halt other predatory lending practices that exist today, and prevent the rise of new abuses.

The work of the Consumer Financial Protection Bureau offers a unique opportunity, as this federal agency is specifically charged with protecting consumers from unfair lending practices. Similarly, state regulation and enforcement—along with efforts by financial institutions to adopt responsible lending practices—continue to play an important role. *State of Lending* is intended to outline these opportunities and needs, and inform the critical debate on how to rebuild our economy and invest in the future of American families.



AMERICA'S HOUSEHOLD BALANCE SHEET

The State of Lending in America &
its Impact on U.S. Households

M William Sermons

December 2012



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AMERICA'S HOUSEHOLD BALANCE SHEET

This section presents a picture of the overall financial status of consumers today in terms of income, spending, debts, and wealth. It is based on data from the Consumer Expenditure Survey, the Survey of Consumer Finances and other national data sources. These sources reveal that **since 2000, American families have faced declining real incomes because of high unemployment and stagnant wages, as well as a higher cost of living that has led to greater debt levels and declining assets and wealth.**

Over the past decade, American families have struggled to resist losing economic ground, a situation exacerbated by the deep recession and slow recovery. Many families have experienced a precipitous loss of wealth because of the housing crash, which was sparked by high-risk subprime mortgages. Others have been targeted by lenders and brokers offering high-cost, often deceptive loan products, that leave them worse off. In many cases these borrowers could have qualified for better, more affordable products. High unemployment and underemployment, stagnant wages for the employed, increasing non-discretionary expenses, and limited access to responsible credit have also contributed to significant losses for the typical household. The result is a loss of wealth by households of all races and unprecedented wealth disparities between white households and African-American or Hispanic households (Kochhar, Fry, & Taylor, 2011). All of this comes at a time when the American worker has delivered consistently increasing productivity with little increase in compensation to show for it (Fleck, Glaser, & Sprague, 2011).

The impact of these economic circumstances has been devastating for the typical American household. The most recent available data from the Consumer Expenditure Survey and the Survey of Consumer Finances show that the typical American household has very little economic breathing room (Table 1). After households pay for housing, utilities, food, health care, debt payments (not including mortgage or auto payments), and other expenses, the typical U.S. family has just \$100 left each month. This is enough, perhaps, to meet their expected monthly obligations, but not nearly enough to manage a major unexpected expense or to save for college, retirement, or a down payment for a home purchase.

After households pay for housing, utilities, food, health care, debt payments, and other expenses, the typical U.S. family has just \$100 left each month.

Table 1. Financial Snapshot of a Typical American Household¹

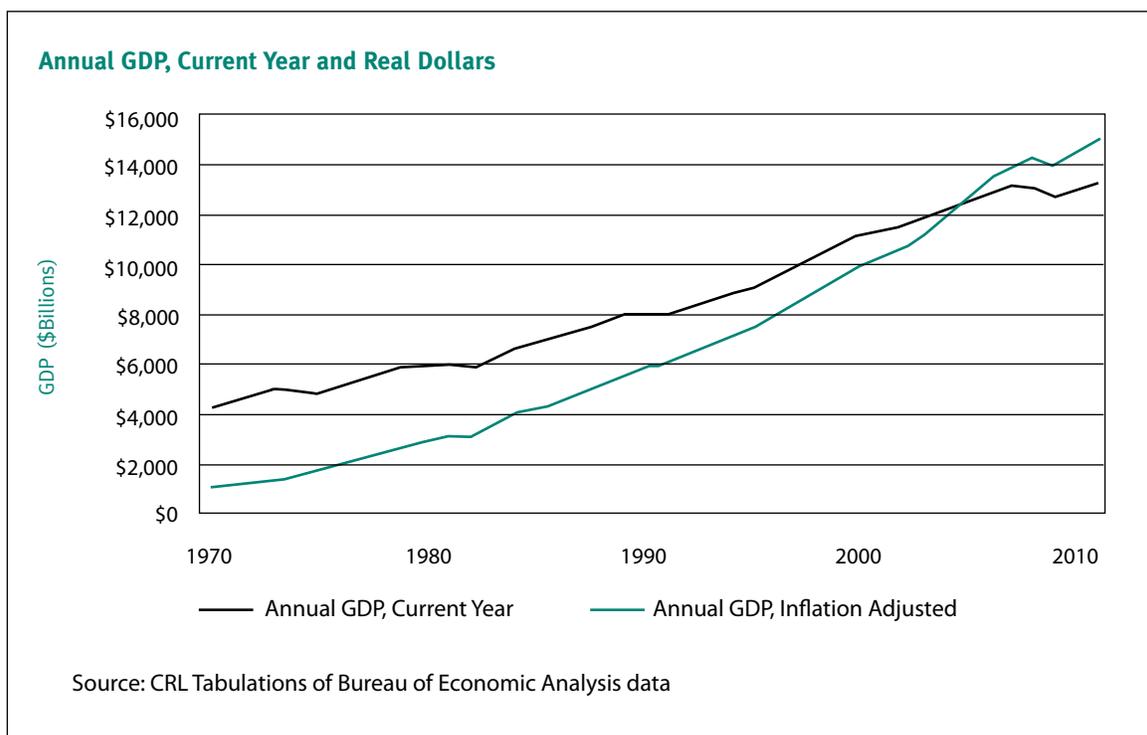
Item	Value (\$)
Yearly Income ² (less taxes and insurance/pension contributions)	\$41,516
Annual non–discretionary expenses	\$(37,651)
• Housing (including upkeep and operation)	(11,455)
• Transportation	(7,160)
• Food	(5,596)
• Utilities	(3,603)
• Health Care	(3,068)
• Education (including reading)	(594)
• Other expenses (excluding alcohol, tobacco, entertainment)	(6,175)
Annual debt payments (excluding mortgage and auto)	\$(2,658)
Discretionary annual income	\$1,207
Loss in home value, 2007 to 2010	\$(19,622)
Loss in total net worth, 2007 to 2010	\$(21,000)

The stagnant finances of American households are no surprise given the dismal performance of the U.S. economy since the middle of the last decade. Figure 1 shows the gross domestic product (GDP), the most commonly-used summary metric of U.S. economic health, from 1970 to 2011 in real (inflation-adjusted) dollars and nominal (non-inflation-adjusted) dollars. The flat real GDP growth and slow nominal growth since 2005 stands out from the trend of generally increasing GDP of the last 40 years. The 16.5% real growth between 2000 and 2010 is less than half the growth rate in each of the prior three decades. The decline in real and nominal GDP from 2007 to 2009 represented the first nominal decline in GDP in 60 years and the largest real decline since the Bureau of Economic Analysis began keeping statistics in 1929.

1 Income, expenses, net worth, and home values from 2010 Consumer Expenditure Survey (Bureau of Labor Statistics, 2000-10) and 2007 and 2010 Survey of Consumer Finances Chartbook (Federal Reserve, 2012) for households in the middle income quintile in both surveys. Loss in home values is an average for those with and without holdings.

2 Yearly income was based on data from the 2010 Consumer Expenditure Survey, Bureau of Labor Statistics (2000-10). From the 2010 income after taxes for the middle quintile of earners, personal insurance and pension contributions were subtracted to get the yearly income in the table.

Figure 1. U.S. Annual Gross Domestic Product, Current Year and Real Dollars, 1970 to 2011.



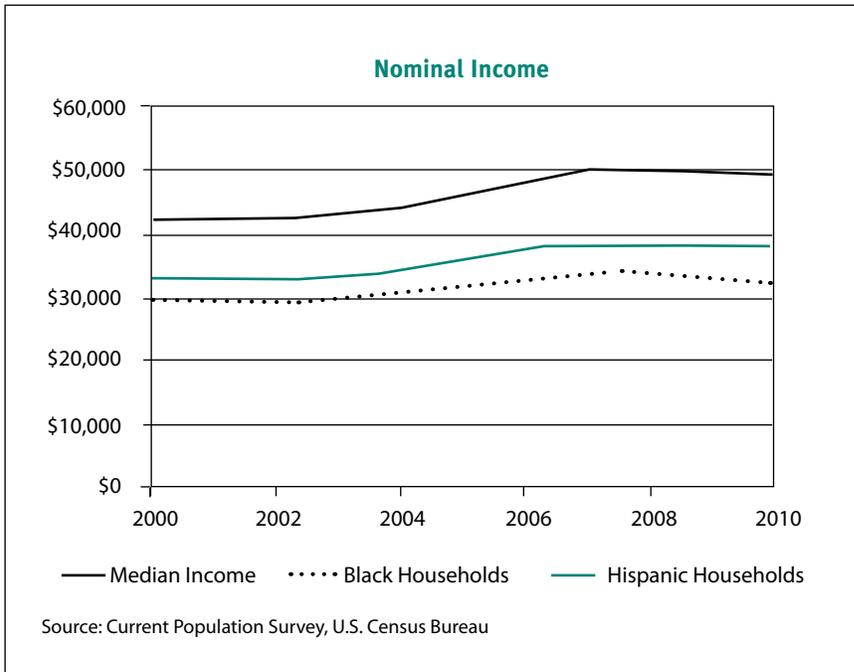
The primary cause of the decline in U.S. GDP was a decrease in consumer expenditures on goods and services, which accounts for about 70% of total U.S. economic activity (Bureau of Economic Analysis, 2012). The economic growth in the decades preceding and years following the recession of 2007–2009 was largely driven by increases in household consumption of goods and services. In order for the U.S. economy to grow again, individual households must find themselves in a position to increase their spending. This will be difficult as long as households continue to face stagnant incomes, increasing expenses, increasing levels of debt, and declining net worth.

Stagnant and Declining Incomes

The typical American family relies on the wages of one or two workers to pay rent, buy food and clothing, commute to and from work, pay for routine and emergency medical care, and otherwise meet their basic needs. Those who can afford to do so also use their wages to build wealth through home ownership, save for retirement, or send their children to college. Having incomes that keep pace with the rising costs of these basic and aspirational needs is essential to the future economic health of the American family.

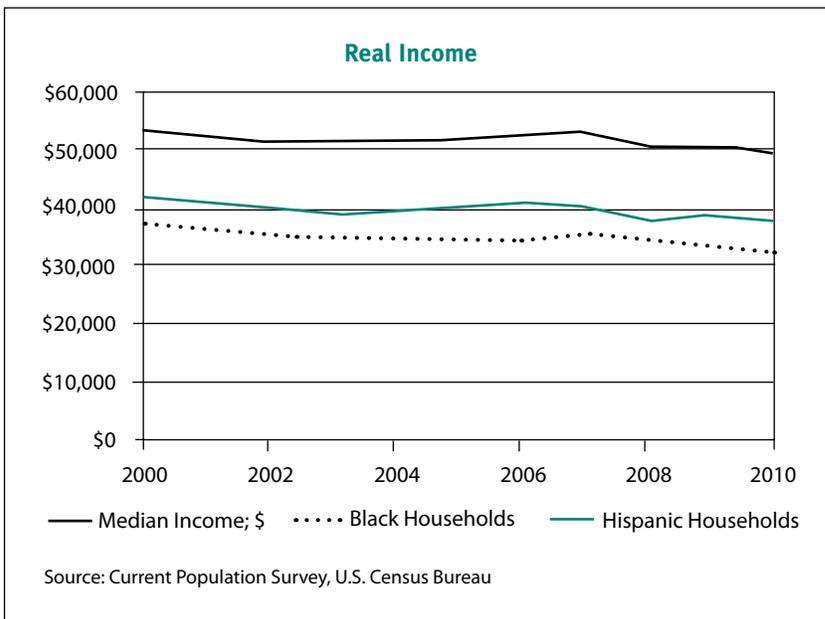
Though vital to Americans' current and future well-being, income growth (or even stability) has not occurred during the last decade. Although the typical household did bring in more nominal income in 2010 relative to 2000 (see Figure 2), all of the income growth was in the years leading up to the recession of 2007 to 2009. Nominal incomes declined throughout the years of the recession and continued to decline as the decade concluded.

Figure 2. U.S. Household Nominal Income, 2000 to 2010.



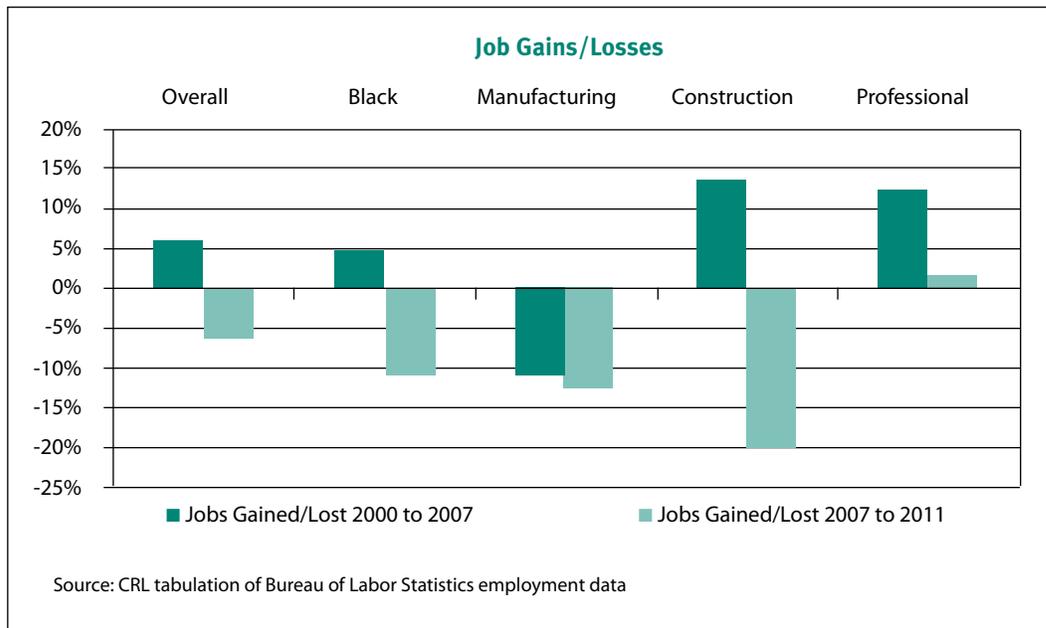
Moreover, nominal income growth paints too rosy a picture of income trends. **When controlling for inflation (see Figure 3), the typical household really had less annual income at the end of the decade than it did at the beginning.** What looked like income “growth” using nominal income at the beginning of the decade was actually a period of stagnant income and ultimately declining income at the end of the decade, when looking at real wages. And though workers made less as the decade progressed, their productivity increased by 20% (Jank & Owens, 2012). Workers appear to be benefitting less from productivity gains than in prior periods.

Figure 3. U.S. Household Real Income, 2000 to 2010.



Declines in income were particularly pronounced for African-American and Hispanic families. One reason for this is the disproportionate impact of job losses on African-American and Hispanic workers. While overall job gains from 2000 to 2007 were erased by the recession, African-American workers lost more than twice the number of jobs between 2007 and 2011 that they gained during the pre-recession part of the decade (see Figure 4). Industries upon which many African-American and Hispanic workers have relied for well-paying, stable employment—namely, manufacturing and construction—suffered job losses of 10% and 20%, respectively. And although the losses in construction followed a boom in the earlier part of the decade, job losses in manufacturing began well before the recession.

Figure 4. U.S. Job gains/losses by sector, 2000 to 2007 and 2007 to 2011.

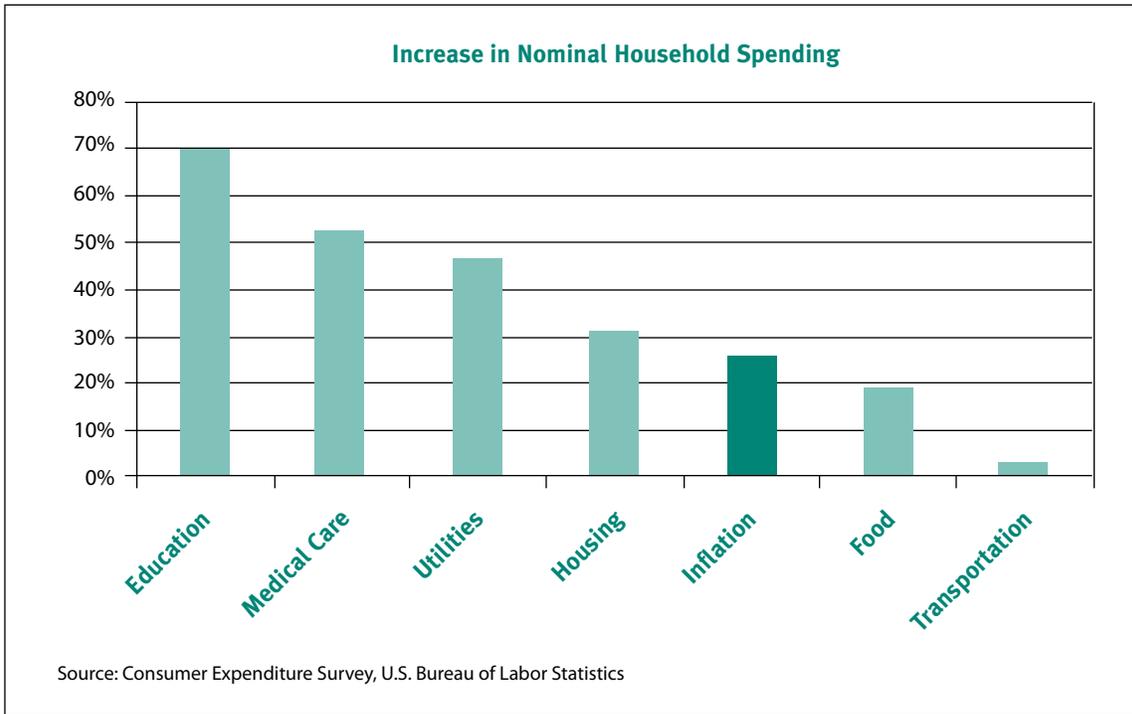


Unemployment reached historic levels for workers of all ages during the recession, but changes in the level of participation in the labor market varied dramatically by age. Participation by workers 16–24 declined throughout the decade, and those declines accelerated during the recession. In contrast, participation by adults over 55 increased through all but the last years of the recession. Declines in retirement resources and lost wealth possibly kept older workers in the labor force longer than earlier cohorts of older workers (BLS, 2010). This longer-than-expected labor participation among older adults, combined with job losses across several sectors, helps to explain the higher unemployment and declining labor participation of younger workers.

Increasing Cost of Living

The declining real incomes of the last decade would not have been so hard on families if the cost of maintaining a household had also remained unchanged. While families would not have had resources to improve their standard of living, they would have at least been able to consume at the same level year after year. Instead, families were faced with increases in basic non-discretionary expenses like food, housing, transportation, medical care, and utilities (Figure 5) with no growth—or sometimes even decreases—in income to pay for these items.

Figure 5. Increase in nominal U.S. household spending by category, 2000 to 2010.



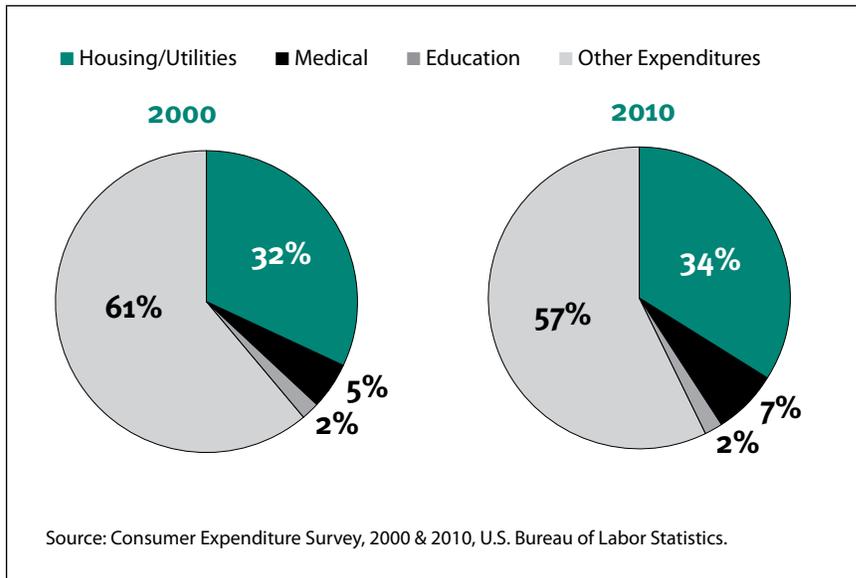
Education expenses were the fastest-growing category during this period, growing at over 2.5 times the rate of inflation from 2000 to 2010. And education costs were growing at a time when families were placing more emphasis on the value of a college degree. Most Americans view a college degree as “absolutely necessary” and the average in-state tuition has doubled in the last 25 years, creating an expense that is equal to almost 20% of a family’s pre-tax income (Warren & Warren, 2004). For more information, see the student lending chapter of *State of Lending*.

Medical expenses have increased at twice the rate of inflation and have the potential to wreak havoc on household finances because they often are unexpected. In their study *Unfairness in Life and Lending*, Harvard researchers find that more than half of all low- and middle-income households attribute a portion of their credit card debt to medical expenses and that 60% of bankruptcies are medically-related.

Together, increases in the costs of medical care, education, and housing/utilities took up a larger fraction of household expenses in 2010 than they did in 2000 (see Figure 6). This has caused households to adjust and reduce their spending in other areas, such as clothing, housewares, entertainment, dining out, and personal care.³ One consequence of the increasing costs of maintaining households has been that household formation has declined and the practice of households doubling-up, or living with friends, extended family, or other non-relatives due to economic hardship has increased over 50% from 2005 to 2010 (National Alliance to End Homelessness, 2012).

³ CRL analysis of *Consumer Expenditure Surveys* (BLS, 2000-10) shows that households reduced spending on clothing, housewares, entertainment, dining out, and personal care from 2008 to 2010.

Figure 6. Proportion of U.S. Household Expenditures for Housing/Utilities, Medical Expenses, Education, and other Expenses, 2000 and 2010



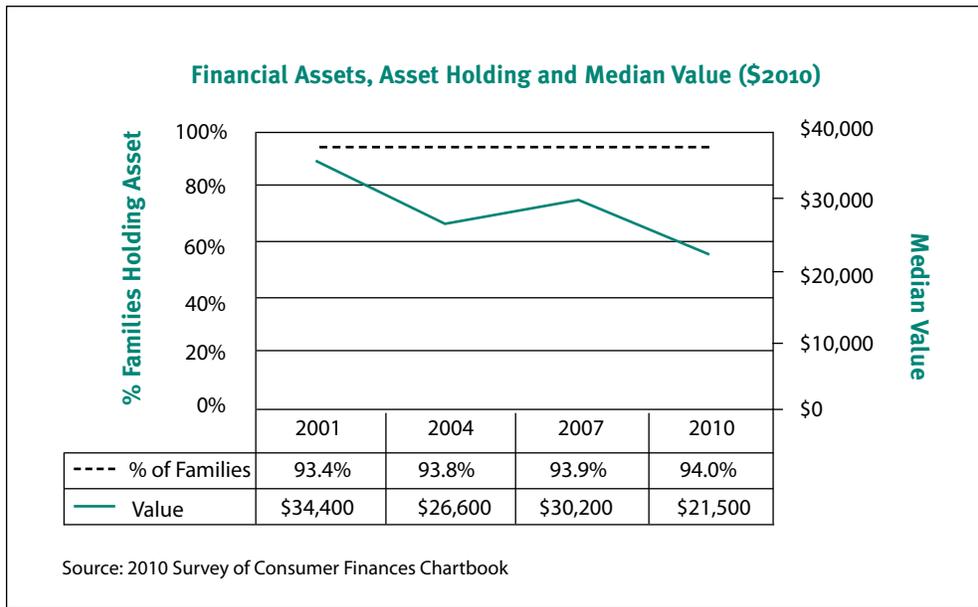
Declining Assets

While the majority of household expenses are covered by wages and social security or other retirement income, households also may rely on their assets to help meet financial obligations. This may include financial assets such as stocks, bonds, checking or savings accounts, and various forms of retirement accounts, as well as non-financial assets, such as a home or an automobile that can be sold or liquidated in some other way (e.g., through a home equity line of credit) in order to cover household obligations.

Data show that the recession depleted household assets. University of Michigan researchers found that households lost value in their homes and other financial assets and also used financial assets to deal with income loss (Stafford, Chen, & Schoeni, 2012). A review of the asset data in the Survey of Consumer Finances shows the same pattern. Figures 7 and 8 show the trend in asset holdings and the median value of held assets for the years 2001, 2004, 2007, and 2010. The data show that inflation-adjusted financial asset values have declined sharply since 2001, from \$34,400 to \$21,500, with the two declines from 2001 to 2004 and from 2007 to 2010 representing the largest percentage and absolute declines in financial asset values since the survey began in 1989.

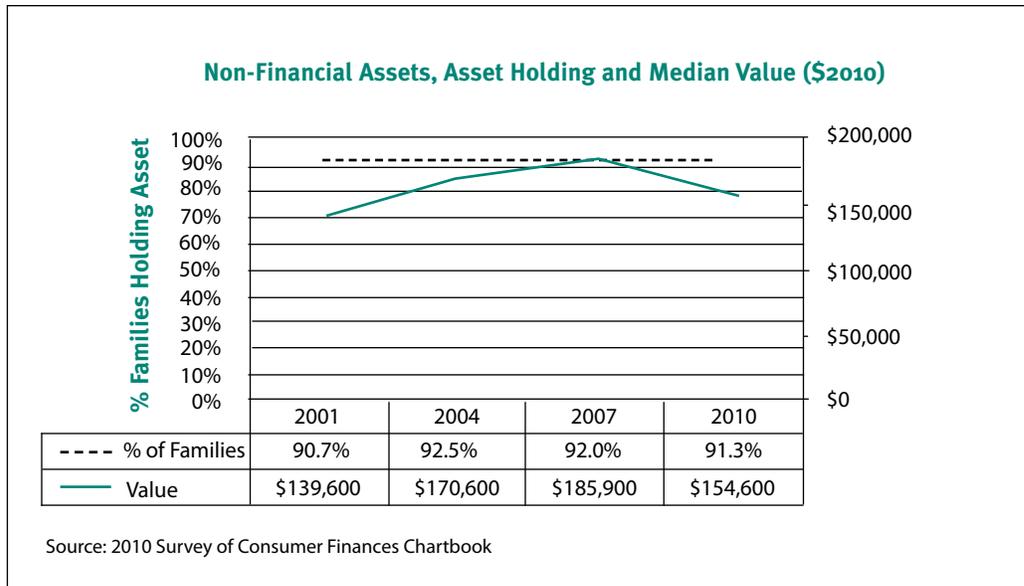
The decline in home prices has harmed millions of US households. Financially struggling homeowners often have been unable to sell their homes or refinance, and many have lost their home to foreclosure. Millions of others have lost some or all of the equity they had in their homes.

Figure 7. U.S. Household Financial Asset Holding and Values, 2001 to 2010.



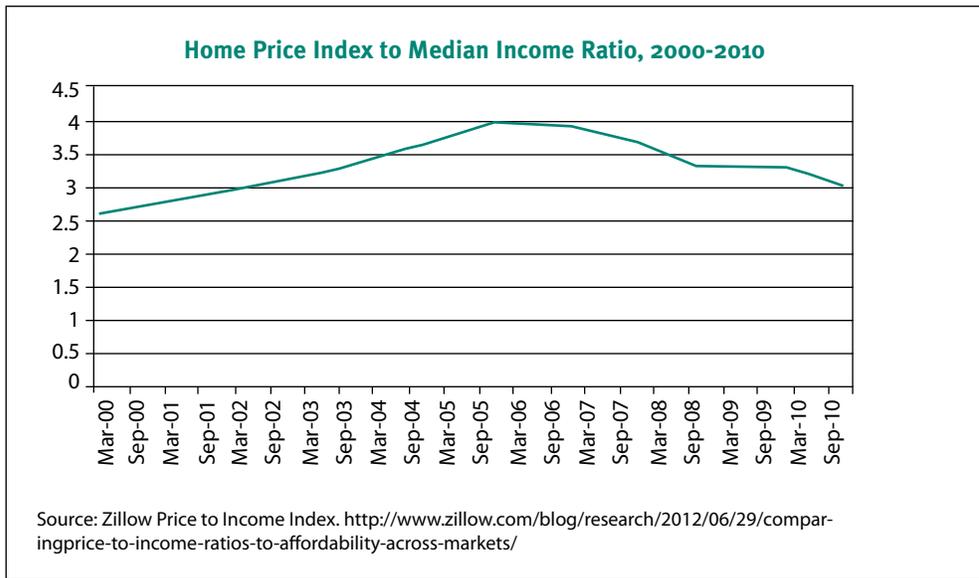
The data also show that while non-financial assets increased in value through 2007, these values declined sharply from 2007 to 2010.

Figure 8. U.S. Household Nonfinancial Asset Holdings and Values, 2001 to 2010.



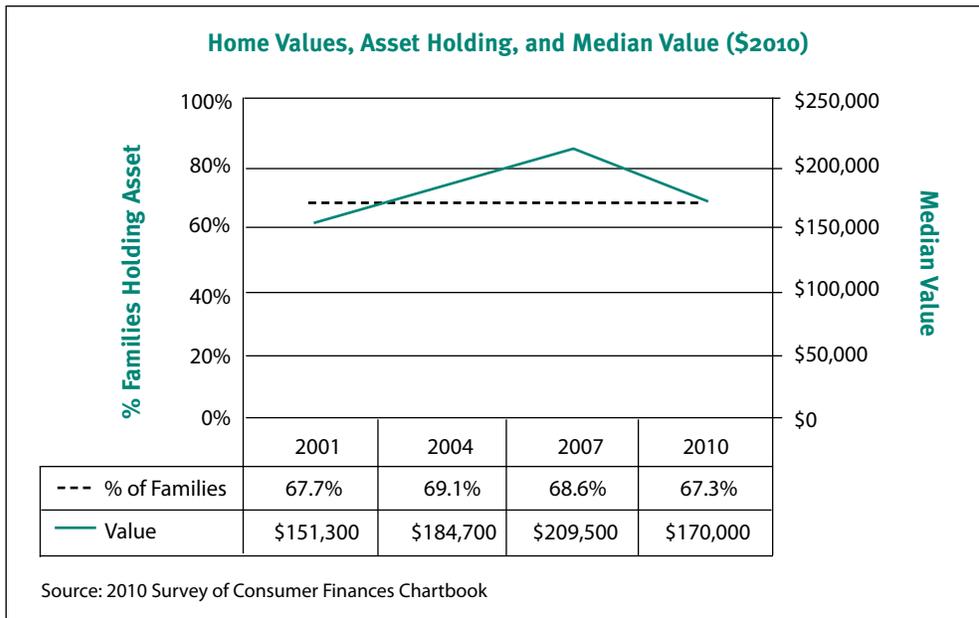
As Figures 9 and 10 reveal, home values drove the rise and fall in non-financial assets from 2001 to 2010. The figures show how home values increased in the years leading up to the housing crisis and then fell precipitously beginning in early 2007. Home prices indexed to income fell by roughly 25% from their peak in 2006.

Figure 9. U.S. Home Prices Relative to Income, 2000-2010



From 2007 to 2010, the median value of primary residences dropped from \$209,500 to \$170,000.

Figure 10. U.S. Household Home Holdings and Values, 2001 to 2010.

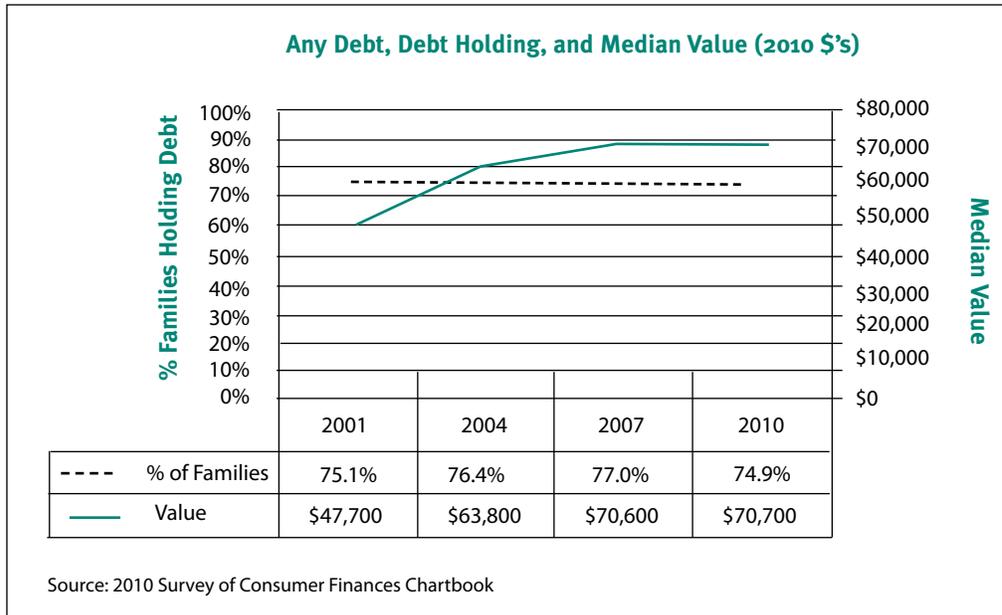


The decline in home prices has harmed millions of U.S. households, often in significant ways. Financially struggling homeowners many times have been unable to sell their homes even at lower prices or refinance into more affordable loans, and many have lost their homes through foreclosure. Since 2007, 10.9 million homes have gone into foreclosure, displacing families and launching them into short- and long-term financial devastation (for more information, see the mortgage chapter of *State of Lending*). In addition, millions of other homeowners have lost some or all of the equity they had in their homes prior to the crisis (Bocian, Smith, & Li, 2012). And the impact has been greater for African-American and Hispanic households, as described later in this report.

Increasing Levels of Debt

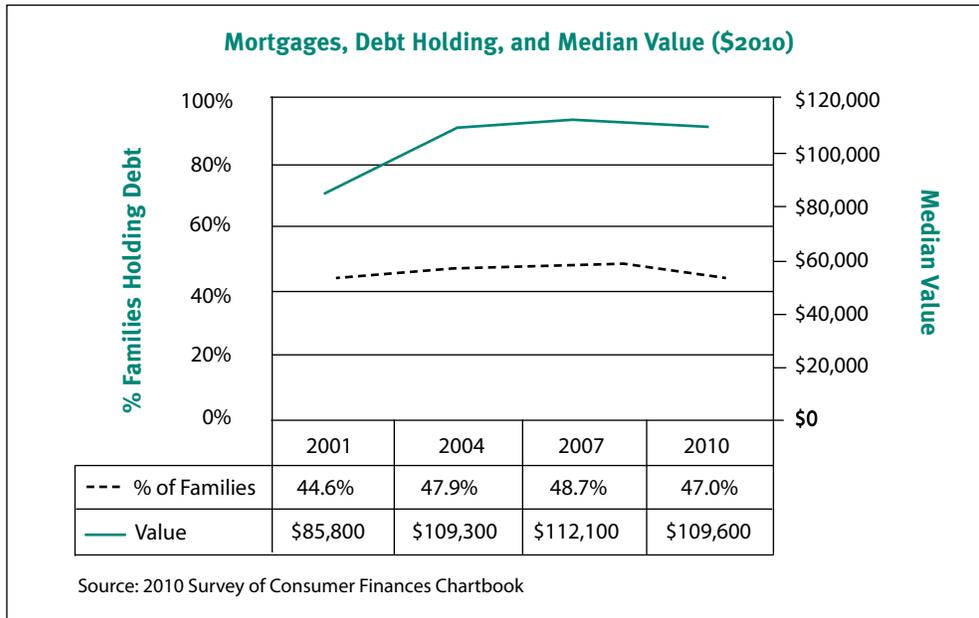
In the face of falling incomes, increasing expenses, and declining asset values, American households have responded in two ways. First, they reduced their spending: In inflation-adjusted terms, the average spending of households with incomes in the middle quintile of earners declined by 5% from \$43,200 in 2000 to \$41,200 in 2010 (BLS, 2000-10). Second, households took on additional debt. Figure 11 shows that median household debt values increased from 2001 to 2007 and then remained flat from 2007 to 2010.

Figure 11. U.S. Household Debt Holdings and Values, 2001 to 2010.



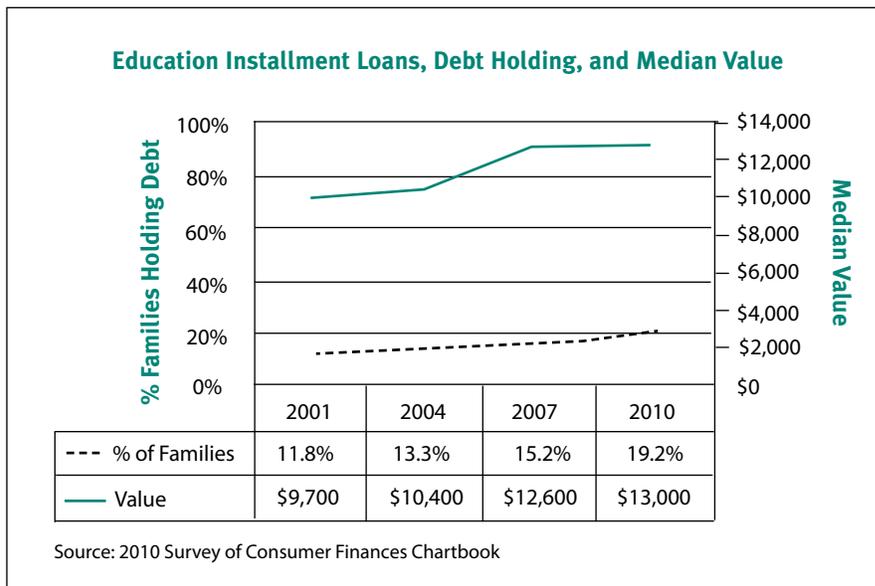
Much of the increases in debt burden in the decade came in the form of larger mortgages, as the cost for new homes climbed between 2000 and 2007. Figure 12 shows increases in mortgage debt and the size of those mortgages between 2001 and 2004. The increases from 2001 to 2004, both in the percentage of households with mortgages and the median value of those mortgages, are the largest documented three-year increases since the Survey of Consumer Finances began in 1989. And while home values declined from 2007 to 2010, the value of the mortgages remained high, eating away at the net worth of American families.

Figure 12. U.S. Household Mortgage Debt Holdings and Values, 2001 to 2010.



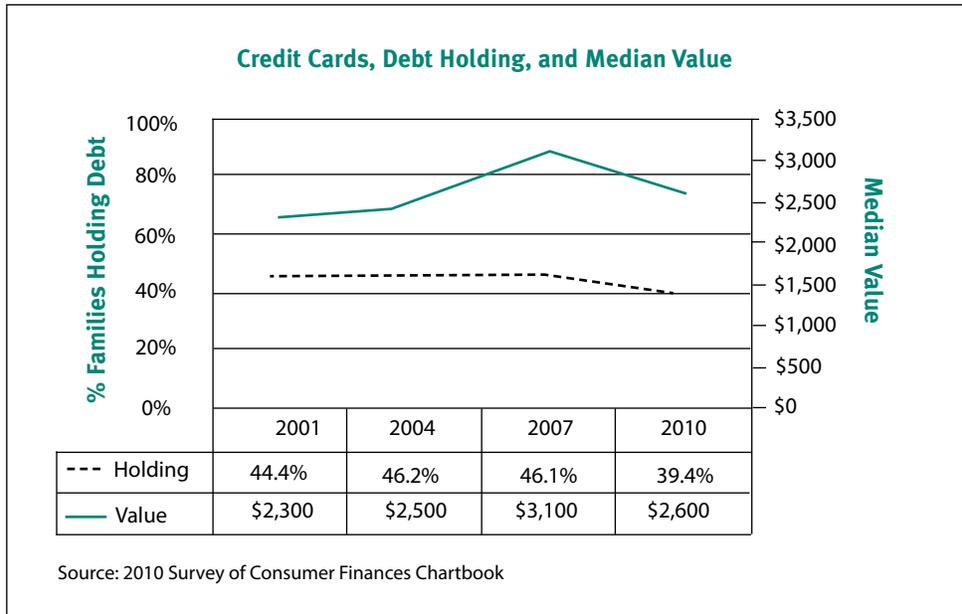
Another area where debt has increased dramatically is student loans. In 2001, one in eight households had an educational installment loan. By 2010, one in five had such a loan. Over that same period, the median size of those loans increased from \$9,700 to \$13,000. That student loans and mortgages accounted for much of the rise in debt levels from 2001 to 2010 is unsurprising. Families chose to incur the kinds of debts that they reasonably expected to pay off in the form of increased future earnings from college degrees and increased home values and equity. The ongoing employment and housing crises mean that these investments have yet to pay off for many who made them. This holds particularly true for those in younger generations. Research by the Pew Research Center, for example, confirms that while student indebtedness has increased for all age groups since 2004, it has risen most sharply for households headed by someone under the age of 44 (Fry, 2012).

Figure 13. U.S. Household Student Loan Holdings and Values, 2001 to 2010.



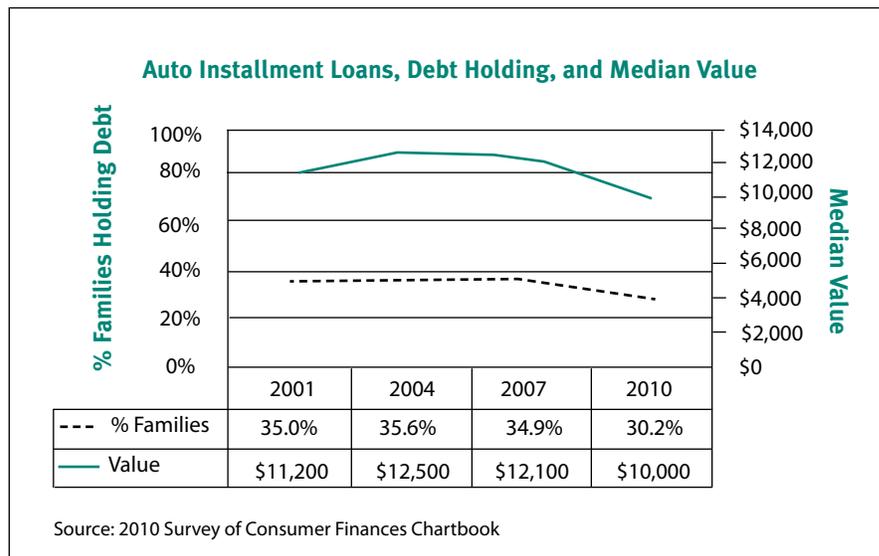
While student loans and mortgages are areas where households increased their levels of debt, families have deleveraged in other areas in the years since 2009. As Figure 14 shows, fewer households had credit card balances in 2010 than in 2001. In fact, fewer households had balances than at any other time since before 1989. The size of consumers' credit card balances also decreased between 2007 and 2010, the only decrease since 1989.

Figure 14. U.S. Household Credit Card Holdings and Values, 2001 to 2010.



Although the credit card deleveraging occurred because of the financial crisis, Figure 15 shows that the deleveraging of auto loans began earlier in the decade, as households responded to their deteriorating income situations by buying used cars instead of new ones and holding onto their cars for longer periods of time (Krishner, 2012). More information about auto lending and auto lending abuses can be found in the Auto Loans section of *State of Lending*.

Figure 15. U.S. Household Auto Loan Holdings and Values, 2001 to 2010.



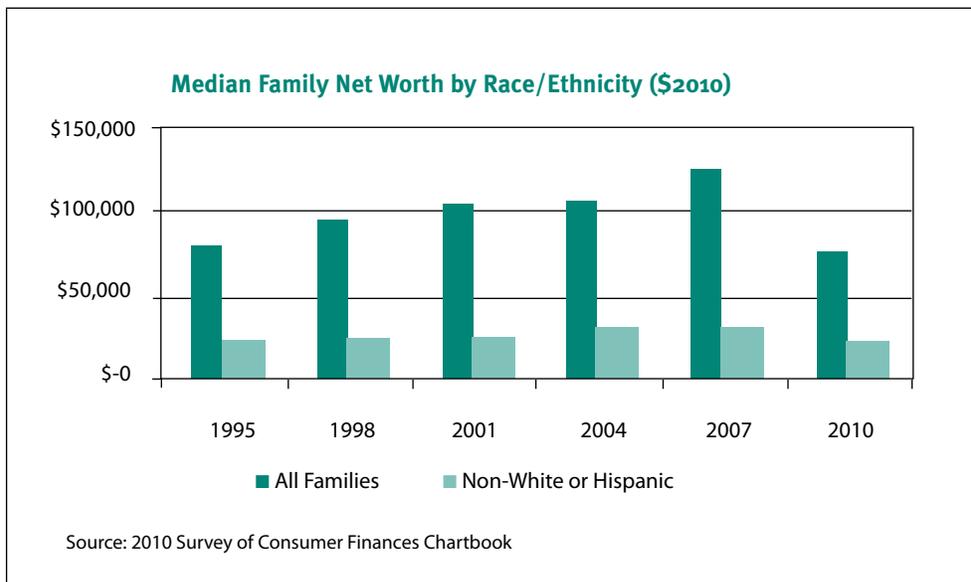
Declining Wealth

The financial health of American families deteriorated from 2000 to 2010 as result of the declining real income, increasing expenses, declining asset values, and increased mortgage and student loan debt. Household net worth is a useful measure of the financial health and capacity of American families. Figure 16 shows that **median family net worth increased for all families each three-year period from 1995 through 2007 and then decreased in 2010 to pre-1995 levels.**

While the Survey of Consumer Finances (used in Figure 16) provides limited data with which to compare declines for non-white households, the Pew Research Center used different data sources and found much larger declines from 2005 to 2009 in net worth for African-American (53% decline) and Hispanic (66% decline) households relative to white households (16% decline). Pew also found that the decline in wealth from 2005 to 2009 resulted in the largest documented wealth gaps between African-American and white households and between Hispanic and white households since the Census Bureau began publishing wealth estimates in 1984 (Kochhar et al, 2011). These data reveal that the recession and slow recovery have led to declining net worth for the average U.S. household and a disproportionate decline for African-American and Hispanic households.

The recession and slow recovery have led to declining net worth for the average U.S. household and a disproportionate decline for African-American and Hispanic households.

Figure 16. U.S. Household Net Worth by Race/Ethnicity



In addition to the differential impact across racial and ethnic groups, there are other demographic differences in the level of decline of household wealth. A review of the wealth data in the 2010 Survey of Consumer Finances by family type and age shows that households on the cusp of retirement and couples with children were particularly hard-hit by the wealth declines between 2007 and 2010. The largest losses were among households headed by those aged 55–65, who lost almost \$90,000 and couples with children, who lost over \$60,000 (41%) in wealth in three years (Federal Reserve, 2012). These are households that may have been counting on that wealth to fund college education for their children or a stable retirement.

Conclusion

America's Household Balance Sheet describes the overall financial status of U.S. households today, but much more of the story remains to be told. Subsequent chapters of CRL's *State of Lending* report describe the mortgages, credit cards, checking accounts, and other financial products that households have used to navigate the treacherous economic terrain of the past decade and their impact on household financial wealth and stability. Rebuilding the tenuous financial balance sheets of American households will require access to safe and affordable credit along with strong protections to prevent predatory lending practices. In each of the following sections, we offer our perspective on how to achieve these two important goals.

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MORTGAGES

The State of Lending in America &
its Impact on U.S. Households

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www.responsiblelending.org

AN INTRODUCTION TO MORTGAGES

Despite the worst housing crisis since the Great Depression, homeownership is still central to the hopes and aspirations of many Americans. Recent polls show that the American public places very high importance on owning a home¹ and that homeownership is more closely associated with living the American Dream than are graduating from college, becoming wealthy, or securing a comfortable retirement. Four out of five Americans believe that buying a home is a better financial decision than renting one (Allstate/National Journal, 2011). This steadfast belief in the importance of homeownership, despite the recent collapse of home values, reflects America's deeply-held conviction that owning a home bestows more financial and non-financial benefits than any other single asset.

The Value of Homeownership

Financial Benefits. Owning a home has long been the most accessible way to build wealth in the United States. Although not without financial risks, homeownership provides the opportunity to build equity through two separate mechanisms.

First, over the long term, housing prices tend to appreciate. Nominal home values have increased, on average, about 5.5% annually between 1977 and 2011.² Although adjusting for inflation lowers the real price appreciation to 0.5-1.5% per year,³ homeowners realize returns on the entire value of the home, not just their initial down payment. Consequently, their overall rate of return is actually higher than real-price appreciation rates would suggest.⁴

Second, because traditional mortgage products require borrowers to pay off a portion of the loan's principal balance each month, over time homeowners gradually reduce their debt and build equity. Therefore, when such traditional mortgages are used, homeownership provides a "forced savings" mechanism for households. This is particularly important because the actual savings rate in the U.S. has been quite low in recent years.⁵ In addition, although the relative cost of owning a home compared with renting depend on a host of factors (e.g., rental prices, prevailing interest rates, property taxes, homeowners' insurance premiums, home maintenance costs, etc.), there are federal tax deductions for mortgage interest, mortgage insurance, and property taxes. These tax deductions, as well as the special treatment of capital gains for primary residences, provide considerable public subsidies for homeownership that enhance its financial benefits (Dietz, 2009).

1 A recent poll commissioned by the Woodrow Wilson Center found that, on a scale of one to ten, homeownership scored an average of 8.6 in terms of importance, with 62 percent giving it a score of ten (Sackett & Handel, 2012).

2 This rate is a CRL calculation derived from the monthly CoreLogic housing price index from January 1976 through March 2012. The index is not adjusted for inflation.

3 Estimates of inflation-adjusted annual returns range from 0.5-1.5% (McBride, 2012).

4 For example, if homes increase, on average, one percent annually after inflation, a borrower who purchased a \$200,000 home would realize a \$2,000 gain in one year. Assuming a ten percent downpayment of \$20,000, that \$2,000 represents a ten percent return on investment.

5 According to the Bureau of Economic Analysis data on personal savings as a percentage of disposable personal income (BEA's definition of personal savings rate), since 1950, personal savings as a percent of disposable income has averaged 7.1%. However, between 2001 and 2011, the average was only 3.6%.

The wealth acquired through homeownership has been a key source of economic mobility and financial security in this country for decades. Home equity can be tapped to start a new business, pay for higher education, and secure retirement. In addition, home equity provides a financial cushion against unexpected financial hardships, such as job loss, divorce, or medical expenses. Perhaps the high value that Americans place on homeownership may be explained, at least in part, by the country's relatively low public subsidization for many of these expenses.

Nonfinancial Benefits. Homeownership also bestows a host of non-financial benefits on individuals and families. Research suggests that children who grow up in home-owning households perform better academically, are more likely to graduate from high school, and are less likely to become teen parents (Dietz, 2003).

In addition, studies have shown homeowners to be happier (Dietz, 2003) and have higher levels of satisfaction than similarly-situated renters (Rohe, Van Zandt, & McCarthy 2001). It is not known exactly why homeowners are happier or more satisfied, but some potential reasons include greater feelings of control, more desirable locations of owner-occupied properties, and the relatively limited tenants' rights in the U.S.⁶ (Immergluck, 2011).

External Benefits. The advantages of homeownership extend beyond the direct benefits to homeowners. Neighborhoods with high homeownership rates tend to have higher property values (Rohe & Stewart, 1996) and consequently higher levels of tax revenues. These resources can then be used to support community assets that benefit all residents such as schools, parks and recreational facilities, and public safety programs. The evidence also suggests that homeownership increases civic engagement, since home owners are more likely to vote and volunteer in civic and philanthropic activities (Rohe et al, 2001).

Homeownership Compensates for Lower Levels of Public Benefits in U.S.

Compared with other countries, U.S. public subsidies for retirement, unemployment, college, and health care are relatively low. The U.S. ranks 26th out of 30 countries in retirement “replacement rates”—the rate at which public retirement systems replace pre-retirement incomes (Anrig, 2011). The U.S. ranks last among OECD countries in terms of generosity of unemployment benefits (Organisation for Economic Co-operation and Development [OECD], 2007), and U.S. public subsidies for higher education also are relatively low. As for health care, of the OECD countries, only Chile was below the U.S. in a ranking of public share of health expenditures (OECD, 2011). **The relatively low level of public subsidy for these expenses may explain why homeownership's role in the American dream is so unshakable: home equity has been critical to helping American families to pay for retirement, education, and health care.**

⁶ Because of a long history of exclusionary zoning policies, in most parts of the country, rental housing is disproportionately concentrated in less desirable neighborhoods.

The Historic Role of the Federal Government in Promoting Homeownership

The federal government has long been involved in the U.S. mortgage markets. Its range of actions, from stemming the tide of foreclosures during the Great Depression to addressing discriminatory redlining in the 1970s, demonstrates a public commitment to expanding access to homeownership that has guided federal policy for decades. Here are several of the major federal actions involving homeownership:

1932: Federal Home Loan Bank Act created the Federal Home Loan Bank System of 12 regional banks, to provide a source of low-cost capital to certain mortgage lenders (primarily Savings & Loans, mutual savings banks, and insurance companies). The Federal Home Loan Banks began lending money in 1933 so that financial institutions could honor customer withdrawals and refinance distressed mortgages.

1933: In response to the Great Depression, Congress created the Home Owners' Loan Corporation (HOLC) to purchase and refinance distressed residential mortgages. HOLC raised money in the bond market to purchase the distressed mortgages and then restructure them from short-term loans with balloon payments into 15-year or 20-year, fully amortizing loans with fixed interest rates.

1934: The National Housing Act created the Federal Housing Administration (FHA) to administer a federal mortgage insurance program to reduce lenders' default risks. By 1938, FHA-insured loans accounted almost 20% of all new mortgage originations. Importantly, FHA established the long-term, low down payment, fixed-rate amortizing mortgage as a tool for expanding homeownership for low-income families. The National Housing Act created the Federal Savings and Loan Insurance Corporation (the precursor of the FDIC) and authorized federally chartered, privately owned National Mortgage Associations. This led to the 1938 amendment that established the Federal National Mortgage Association (now known as Fannie Mae) to buy FHA loans.

1968: The Fair Housing Act prohibited discrimination on the basis of race, religion, and national origin (expanded to include gender in 1988) in the sale, rental, and financing of housing.

1970: Fannie Mae is allowed to purchase private mortgages, and Congress establishes Freddie Mac.

1974: The Equal Credit Opportunity Act (ECOA) prohibited discrimination on the basis of race, religion, national origin, sex, marital status, or age in any part of a credit transaction. (ECOA protections are not limited to housing finance.)

1975: The Home Mortgage Disclosure Act (HMDA) required lenders to collect and disclose information on lending activity.

1977: The Community Reinvestment Act (CRA) required depository institutions to serve the credit needs of the communities from which they receive deposits.

1986: The Tax Reform Act of 1986 eliminated interest rate deductions for all personal loans except for home mortgages.

1992: The Housing and Community Development Act established affordable housing goals and amended the charter of Fannie Mae and Freddie Mac to reflect the view that they "have an affirmative obligation" to facilitate affordable housing.

2008: Congress passed the Troubled Asset Relief Program (TARP), an attempt to stabilize the financial markets during the collapse of the subprime market. TARP authorized the federal government to purchase or insure up to \$700 billion in "troubled assets," including mortgages originated before March 2008 or any financial instrument based on such a mortgage. This program allowed the Treasury department to purchase complex financial derivatives based on subprime loans, which were defaulting in high numbers.

2008: Congress passed the Housing and Economic Recovery Act (HERA) to stabilize the housing market. It created a temporary first-time home buyer tax credit and provided funds to purchase and redevelop foreclosed properties through its Neighborhood Stabilization Program. It also authorized the Federal Housing Authority to guarantee loans for underwater subprime borrowers whose lenders reduce their principles. HERA also modernized FHA (through the FHA Modernization Act of 2008), raising its loan limits and changing its down-payment guidelines. HERA also strengthened the regulations of and injected capital into Fannie Mae and Freddie Mac.

MARKET AND INDUSTRY OVERVIEW

Traditionally, mortgages were relatively simple transactions between lenders and borrowers. However, in recent decades, the mortgage market has grown in size and complexity. As the market has evolved, the number of market participants—both public and private—has greatly expanded.

U.S. Government

With a few exceptions, the federal government does not directly lend money for mortgages.⁷ Rather, it promotes homeownership through a variety of other mechanisms. Most notably, the federal government offers preferential tax treatment of mortgage interest, property taxes, and capital gains on owner-occupied homes. In addition, the federal government affects the mortgage market by increasing capital liquidity, providing credit enhancements, and overseeing mortgage-market participants.

Liquidity. The federal government promotes homeownership by increasing the availability of mortgage capital through the secondary market activities of the Government-Sponsored Enterprises (GSEs) of Fannie Mae and Freddie Mac. The GSEs do not lend directly to borrowers but rather purchase mortgages that meet certain criteria (called “conforming loan standards”) from private lenders. Once purchased, the GSEs pool the mortgages into investment securities, called mortgage-backed securities (MBSs), backed by the payment streams from the loan pools. This creates capital liquidity in the market; without this secondary market, private lenders would be able to extend far fewer mortgages, since much of their capital would be inaccessible until loans were repaid. By selling the mortgages to the GSEs private lenders’ capital is replenished, allowing them to make new loans.

The GSEs are technically “publicly chartered private corporations,” and their securities are not explicitly guaranteed by the federal government. Nevertheless, there has always been a widespread public perception that the federal government would not allow these institutions to fail. As a result of this implicit guarantee, the GSEs have been able to gain access to funds at lower rates and sell their securities at higher prices than they might have been able to do otherwise, leading to greater liquidity in the mortgage markets. Currently, both Fannie Mae and Freddie Mac are in conservatorship under the federal government, and their future is unclear. Still, there is no question that the GSEs help enhance access to the residential mortgage market by facilitating the constant and stable supply of capital for single-family and multi-family loans.

Another way the federal government increases liquidity is through deposit insurance and by providing funding through the Federal Home Loan Bank system. By insuring deposits up to \$250,000, the Federal Deposit Insurance Corporation (FDIC) and the National Credit Union Administration help private depository institutions maintain a steady supply of capital for making home loans. The 12 Congressionally chartered Federal Home Loan Banks—collectively called the Federal Home Loan Bank System—offer advances to their member-banks at lower rates than they would receive without the implicit guarantee provided by the federal charter. These funds are used to fund mortgage and community development lending.

Credit Enhancements. The federal government also provides credit enhancements to promote home lending through a variety of programs:

⁷ One exception is the Rural Housing Direct Loan Program, a program of the Department of Agriculture, which extends loans to low-income borrowers to purchase homes in rural areas.

- **Federal Housing Administration (FHA):** The FHA provides insurance on loans that meet FHA loan guidelines, which generally are more flexible than underwriting standards for conventional prime loans. FHA loans, which can only be originated by approved lenders, require relatively low down payments but borrowers are charged insurance premiums. In the event that a borrower defaults, the FHA reimburses the lender for losses. The FHA is entirely self-funded, since its capital reserves have been adequate to cover losses and program administration.
- **Veterans Affairs (VA) Loan Program:** Like the FHA, the VA loan program insures loans issued by approved private lenders. However, only U.S. military veterans are eligible to receive VA loans and, rather than purchasing insurance through a premium, the borrower pays a VA loan funding fee, the size of which depends on the size of the loan down payment.
- **Rural Housing Service (RHS) Program:** The Rural Housing Service was created by the Department of Agriculture to promote homeownership in rural parts of the U.S and provides a loan guarantee for low-income borrowers who cannot find financing elsewhere. Like the FHA program, borrowers obtain loans from private lenders and the loan is guaranteed by RHS.⁸
- **Ginnie Mae (Government National Mortgage Association):** Ginnie Mae insures timely payments on securities backed by government-insured mortgages (VA, FHA, and RHS). The federal guarantee on these payments allows the issuers of these securities to receive better prices on these loans.

Oversight. The federal government regulates the mortgage market by passing, interpreting, and enforcing lending laws and by supervising financial institutions that participate in the mortgage market. Several agencies share the responsibility for overseeing lenders: the Federal Reserve Board (the Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Consumer Financial Protection Bureau (CFPB or Bureau). In addition, the Federal Housing Finance Agency (FHFA) oversees Fannie Mae, Freddie Mac, and the 12 Federal Home Loan Banks, ensuring their safety and soundness and guaranteeing that they are fulfilling their charters.

Private Lenders

Despite the strong role the federal government plays in promoting a robust housing market, private lenders relying on private capital fund almost all U.S. mortgages. These lenders generally fall into two basic categories:

- **Portfolio Lenders:** Portfolio lenders are financial institutions that accept deposits, and include commercial banks, savings banks, and credit unions. Their deposits allow them to hold at least some loans as part of their overall investment portfolio. Some portfolio lenders, such as banks, engage in a wide variety of lending activities, while others, such as thrifts, use funds primarily for residential mortgages. These entities are chartered under state and federal law.
- **Mortgage Companies:** Mortgage companies (also called mortgage banks) do not accept deposits and instead rely on investments to finance the mortgages they extend and on the sale of their mortgages to the secondary market to finance payments to investors (Guttentag, 2000). Generally, mortgage companies are chartered under state law.

⁸ The RHS also has another program, the Section 502 program, in which the RHS actually provides the loan.

Brokers and Private Securitized

Over the last few decades, two major developments in the mortgage market fundamentally have altered how it operates. First, lenders began to rely on third-party originators (mortgage brokers). Using brokers enabled lenders to lower their fixed costs and expand operations into new markets without having to hire new loan officers, acquire office space, or invest heavily in consumer marketing. In 2005, at the height of the housing boom, half of all mortgage originations and 71% of subprime originations were brokered (Mortgage Bankers Association, 2006).

Second, Wall Street financial companies began issuing their own mortgage-backed securities (called private label securities) and selling these directly to investors. Unlike Fannie Mae and Freddie Mac, private companies did not have to limit their loan purchases to those meeting the standards set by the GSE regulators. As a result, the growth in the private-label securities market was heavily driven by subprime loans, which the GSEs were not allowed to purchase directly. Between 1995 and 2005, the volume of private-label securities backed by subprime loans increased from \$18 billion to \$465 billion. Meanwhile, the private-label market for “Alt-A” loans,⁹ virtually nonexistent in 1995, reached \$334 billion by 2005.¹⁰

The combination of increased reliance on mortgage brokers and private securitization sparked dramatic changes in the composition of mortgage originations. Between 2001 and 2006, the share of the overall mortgage market comprised by subprime and Alt-A lending increased from 10% to 39%.¹¹ Meanwhile, the market share of government-backed loans (FHA/VA) and GSE-purchased loans declined tremendously. **This change in market composition is particularly notable because of the degree to which it represented a shift away from regulated underwriting and standard products to unregulated ones.**

⁹ The Alt-A market is defined differently by different people. Some define it as the market serving people with good credit but who don't meet the traditional prime underwriting standards, such as documentation standards. Others define it by product, including interest-only and payment option adjustable rate (POARMs) loans as Alt-A products. Finally, others define it as borrowers with credit scores that are somewhere in the “gray area” between subprime and prime.

¹⁰ CRL calculations of FDIC data on agency and non-agency MBS issuance.

¹¹ CRL calculations of data from Inside Mortgage Finance, *2008 Mortgage Market Statistical Annual*. Excludes home equity lines of credit (HELOCs).

Pre-Housing Crisis Shifts in the Mortgage Origination Market

Figure 1. Private Label Issuance of Mortgage-Backed Securities (\$billions)

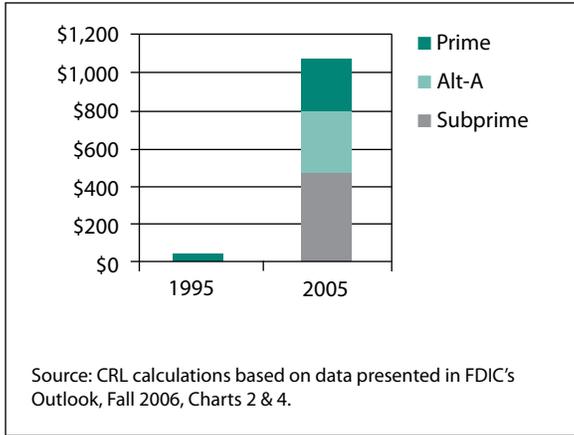


Figure 2. Private Label vs GSE MBS Issuance

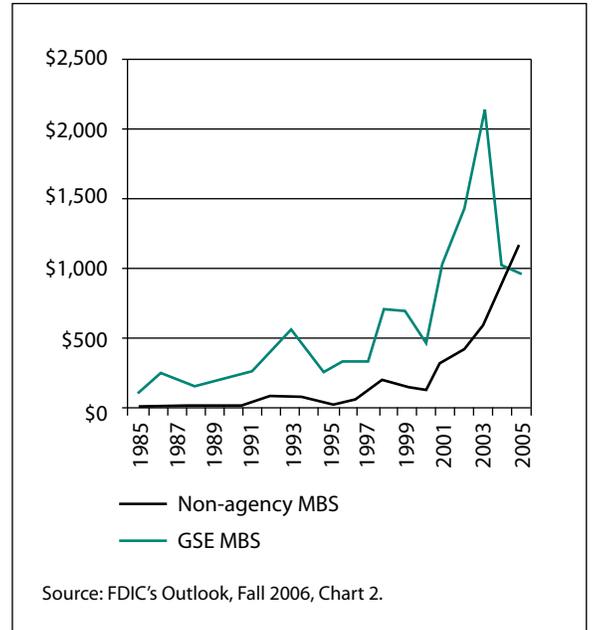


Figure 3. Total Mortgage Market Volume and Market Share of Alt-A and Subprime Loans, 2001-2006

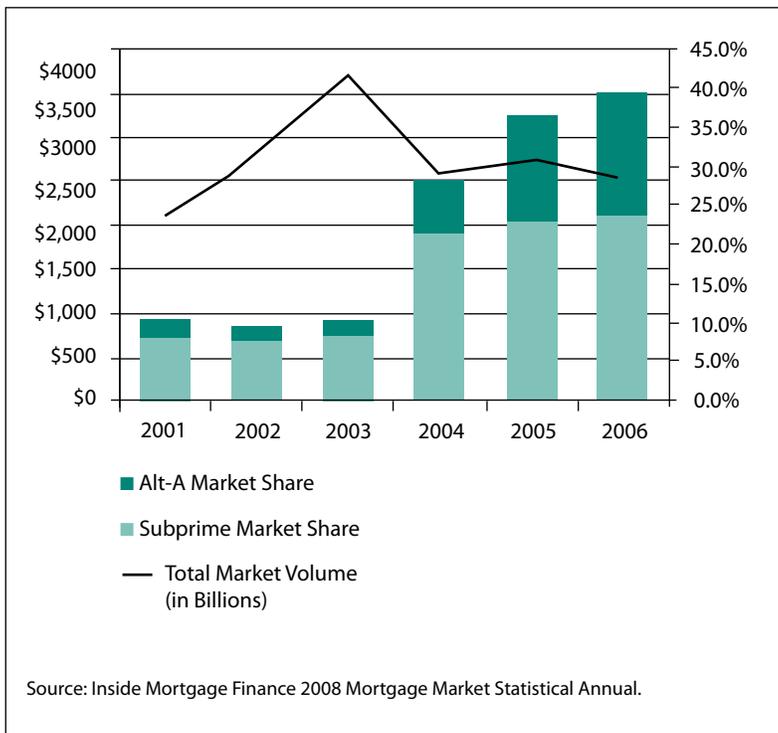
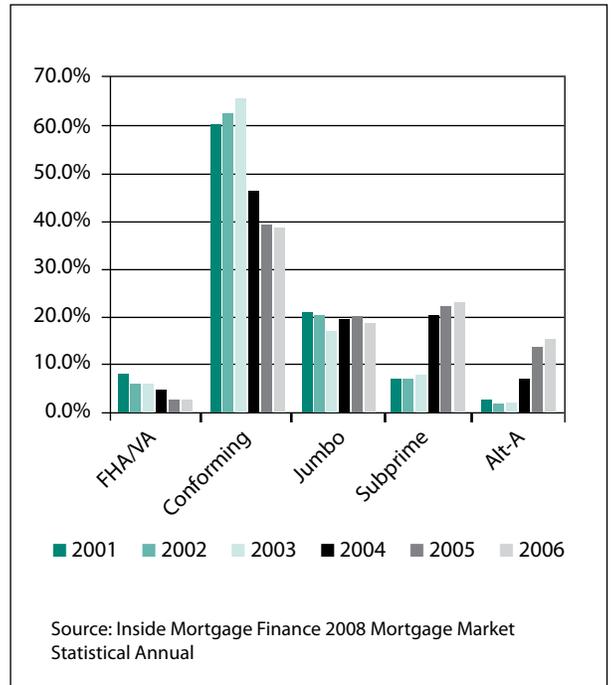


Figure 4. Market Share by Loan Type, 2001-2006



Mortgage Servicers

Servicing a mortgage involves collecting and tracking mortgage payments from borrowers, establishing escrow accounts for their taxes and insurance, and remitting payments for taxes and insurance on behalf of homeowners. Mortgage servicers also determine whether borrowers are delinquent and how to manage delinquent loans, i.e., “loss mitigation.” In addition, some servicers provide foreclosure services and even manage foreclosed properties. Although some lenders service the mortgages they originate, others sell the servicing rights of their loans to other lenders or independent third-party servicers.

Changes in the mortgage market have increased the complexity of mortgage servicing and the challenges faced by the servicing industry. The fundamental responsibility of a servicer is to “manage the relationship among the borrower, the servicer, the guarantor, and the investor/trustee of a given loan.”¹² However, the specific guidelines that servicers must follow in each of their activities—from how mortgage payments are collected to how foreclosed properties are managed—vary depending on the specific language contained in the contractual agreements with lenders (called “Servicing Guides” or “Pooling and Servicing Agreements”).¹³

We will discuss the challenges of the mortgage-servicing industry in the third part of *State of Lending*, available in 2013.

¹² *Alternative Mortgage Servicing Compensation Discussion Paper*, (FHFA, 2011, p.2).

¹³ *Ibid.*

LENDING ABUSES AND PREDATORY PRACTICES

The increased complexity in the mortgage market created a chasm between those who originated loans and those who bore the risk of defaults. Under a “traditional” lending model—where lenders both originated and held their mortgages—lenders had a vested interest in ensuring that borrowers could afford to repay their loans. In the more recent “originate-to-securitize” system, the compensation of brokers, lenders, and securitizers was based on transaction volume, not loan performance. Consequently, many lenders and brokers aggressively marketed and originated loans without evaluating the borrowers’ ability to repay them.

This evolution led to a new breed of dangerous mortgages—such as loans with introductory “teaser” rates that reset after a few years to much higher rates; loans that did not require income verification; and loans with prepayment penalties that locked borrowers into high rates or risky terms. These loans were often made with scant underwriting and marketed without regard for whether they were suitable for the borrowers. Accompanying this expansion of risky loan terms was a deterioration of lending standards. These developments are discussed in more detail in the following *Abuses in Subprime and Alt-A Lending* section.

The severe decline in loan quality was facilitated by two factors. First, the growth in private-label securitization by Wall Street meant that mortgage originators did not need to conform to the lending standards of the GSEs in order to sell their loans. In fact, Wall Street rewarded loan originators for riskier loan products by paying a higher premium for non-conforming loans. At the same time, subprime lenders targeted many of the same borrowers who had been traditionally served by the FHA and VA programs, saddling these borrowers with much riskier debt than they would have received had they gone through the government programs. Worse, evidence suggests that many subprime borrowers could have qualified for conforming or lower-priced loans.¹⁴ Meanwhile, the credit agencies charged with rating the quality of mortgage-backed investments were assigning high ratings to securities backed by these dangerous and unsustainable loans. This gave false assurance to investors that these products were safe.¹⁵

¹⁴ *The Wall Street Journal* reported that 61% of subprime loans originated in 2006 “went to people with credit scores high enough to often qualify for conventional [i.e., prime] loans with far better terms” (Brooks & Simon, 2007).

¹⁵ For a more detailed analysis of the contribution of risky products, irresponsible underwriting, and regulatory failures in creating the crisis, see U.S. Department of Housing and Urban Development’s “Report to Congress on the Root Causes of the Foreclosure Crisis.”

Abuses of the Subprime and Alt-A Markets

Dangerous Loan Terms

Unlike the 30-year fixed-rate loans that dominated the prime market, subprime and Alt-A loans were often structured with initial “teaser” rates that reset to higher rates (common products included “2-28s,” “3-27s,” and interest-only loans) or with payment options where the balance of the loans could increase over time. Prepayment penalties often locked borrowers into these products so that they were unable to refinance into safer, more affordable products.

Poor Underwriting

Subprime loans were commonly originated without a careful evaluation of whether borrowers could afford to repay them. Originators, lenders, and securitizers ignored traditional underwriting criteria—such as debt burden, income levels, and other indicators of loan sustainability—in their push to make as many loans as possible.

Flipping

Serial refinancing or “flipping” —where borrowers were repeatedly refinanced into new loans—was common in the subprime market. Each time refinancing occurred, fees and closing costs were rolled into the loan, stripping equity away from the homeowners in the process.

Steering

Unlike the prime market (where rates are fairly transparent and loan products are relatively standard), subprime rates were rarely published, and the complexity of the loan products made comparison-shopping difficult. Contrary to the beliefs of many borrowers, brokers had

no fiduciary responsibility to find them the best-priced, or even a suitable, loan. Instead brokers had financial incentives to originate higher-priced loans because of yield-spread premiums, which lenders paid to brokers for putting borrowers into more expensive loans, even when they qualified for cheaper ones (Ernst, Bocian, & Li, 2008).

Discrimination/Targeting

There is significant evidence that African-American and Latino borrowers and their neighborhoods were disproportionately targeted by subprime lenders. Borrowers of color were about 30% more likely to receive higher-rate subprime loans than similarly situated white borrowers, and borrowers in non-white neighborhoods were more likely to receive higher-cost loans with risky features such as prepayment penalties (Bocian, Ernst, & Li, 2006).

Mandatory Arbitration

In the early years of the subprime market, many subprime mortgage contracts contained mandatory arbitration clauses. These clauses prevented borrowers from pursuing legal remedies in court if their loan contained illegal or abusive terms.

Single-Premium Credit Insurance

One of the early abuses in the subprime market was single-premium credit insurance, which charged a high up-front fee to cover monthly payments in the event that a borrower could not meet his or her mortgage payment. Benefits under this insurance were rarely paid out.

LEGISLATION AND REGULATION

Federal Regulation

The abusive practices that led to the mortgage crisis were enabled by an out-of-date and fractured federal regulatory system. The problems included the following:

- **Failure to adapt.** Federal regulation failed to adapt to the increasingly complex mortgage market and many of the market participants, such as brokers and servicers, were virtually unregulated at the federal level.
- **Diffusion of responsibility.** Authority for interpreting and enforcing consumer protections was fractured among several agencies, none of which had protecting borrowers as its primary mission.
- **Creation of loopholes.** Federal regulators actively hindered consumer protection at the state level by ruling that strong state anti-predatory lending laws could not be enforced on nationally chartered banks or thrifts (*Neglect and Inaction*, 2009).
- **Weak actions.** Even when agencies did provide limited attention on consumer protection, they tended to rely on disclosure rules and the issuance of nonbinding “guidance” over hard and fast rules.

Borrowers, state regulators, and consumer advocates repeatedly raised concerns about abuses in the subprime market and pointed to evidence demonstrating the destructive consequences of such practices. As early as 2000, consumer groups were not only urging Congress to support new measures to prevent predatory practices, but were calling on the Federal Reserve to act under its existing regulatory authority to “prohibit unfair or deceptive mortgage lending practices and to address abusive refinancing practices” (*Predatory Mortgage Lending*, 2000). However, it was not until July 2008 that the Federal Reserve implemented any rules to ban some abusive, unfair, or deceptive practices; this was some fourteen years after Congress had given the Federal Reserve the authority to do so, and almost two years since the start of the foreclosure crisis.

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

Recognizing the role that inadequate oversight of the mortgage market played in the financial collapse, Congress passed the **Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank)**. Dodd-Frank reformed the mortgage market in two critical ways. First, it explicitly outlined new rules for mortgage lending in order to prevent the specific types of market abuses that prevailed over the last decade. Second, it established the CFPB as a new consumer protection agency to provide focused oversight moving forward.

Explicit Mortgage Reforms of Dodd-Frank

Dodd-Frank’s mortgage provisions are designed to reorient the market back to the well-underwritten, sensible mortgages that have traditionally been used to build wealth for American families. It disfavors the types of loan terms that had been common in the private-label securities market and that have defaulted in great numbers. Dodd-Frank’s reforms will go a long way toward achieving stability and healthy growth in the housing market.

Among the most important aspects of Dodd-Frank is the establishment of an “Ability-to-Repay” standard. Ensuring that a borrower can repay a loan is such a basic tenet of sound lending that, historically, most lenders would not have dreamed of deviating from it. But modern financing arrangements that rewarded lenders based on volume rather than performance provided incentives for lenders to depart from this principle. Dodd-Frank states that loan originators must make a “reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance (including mortgage guarantee insurance) and assessments.”¹⁶

To help enforce the ability-to-repay standard, Dodd-Frank creates a preference against risky loan terms through a category of safe loans called “Qualified Mortgages” (QMs). Lenders who originate QMs receive litigation protection from the ability-to-repay provision. To qualify as a QM loan, a loan must meet the following criteria:¹⁷

- Fully amortizing (i.e., no deferment of principal or interest);
- No balloon payments;
- Points and fees no greater than 3% of the total loan amount;
- Loan term not to exceed 30 years;
- For adjustable-rate mortgages, lenders must evaluate the borrower’s ability to repay based on the maximum rate permitted during the first five years.

In addition, Dodd-Frank:

- *Expands HOEPA protections to include additional high-risk loans* Specifically, Dodd-Frank lowered the limit on up-front points and fees to 5% for loans to be exempt from the requirements for high-cost loans outlined in the Home Ownership and Equity Protection Act (HOEPA, 2004)¹⁸;
- *Prohibits yield-spread premiums* Dodd-Frank prohibited lenders from paying brokers or loan officers compensation that varies with the terms of the loan (other than loan amount). This eliminates brokers’ financial incentive to steer borrowers into unnecessarily expensive loans;
- *Significantly restricts prepayment penalties* In the recent crisis, many borrowers were trapped in expensive, exploding-rate loans because the penalties for refinancing were too steep. Dodd-Frank addressed this by banning the use of prepayment penalties except on fixed-rate loans with an interest rate that does not exceed the conventional rate by more than 1.5%. Even for these loans, prepayment penalties are limited in amount and duration, and borrowers must be offered a loan without a prepayment penalty;

¹⁶ See Dodd-Frank (2010), §1411(a)(2).

¹⁷ In addition, a QM loan may have to comply with additional rules set by the CFPB concerning debt-to-income or alternative measures of ability to repay.

¹⁸ The Home Ownership and Equity Protection Act (HOEPA, 2004) mandates additional requirements and disclosures for “HOEPA loans” that meet at least one of the following two conditions: (1) points and fees that exceed a given threshold; and (2) an annual percentage rate (APR) that exceeds a given rate. Dodd-Frank lowered the points and fees threshold from 8% to 5% and changed the APR spread from 8 points over a Treasury note of comparable maturity to 6.5 points over prime rate (for first liens). Dodd-Frank also expanded HOEPA’s coverage to include purchase loans, whereas it had previously only included refinance loans.

- *Banned single-premium credit insurance and mandatory arbitration;*
- *Required escrows of taxes and insurance for higher-priced mortgages;*
- *Required that lenders document borrowers' incomes.*

Focused Oversight through the new CFPB

Dodd-Frank created the CFPB as an independent consumer watchdog agency with the sole purpose of ensuring that financial transactions, including mortgages, are fair and transparent. Dodd-Frank empowered the CFPB to enforce existing consumer protection laws and regulations and respond to new abuses as they emerge. The agency's effectiveness and independence are supported by the following:

- *Oversight of all market participants* Before the CFPB, there was no federal oversight of many mortgage market participants, such as mortgage companies and brokers. As a result, they were largely free to engage in the reckless business practices that led to the subprime mortgage crisis. Banks, who were more closely supervised, created non-bank affiliates that lacked oversight. And third-party loan originators, mortgage brokers, produced millions of dollars in mortgages without federal scrutiny. The CFPB will be able to regulate the practices of all mortgage-market participants, including banks, non-banks, brokers, and servicers.
- *Stable, nonpartisan funding* Like the OCC, the FDIC, the Federal Reserve, and the FHFA, Congress directed the CFPB to operate with stable funding not subject to the highly political appropriations process. By leaving funding outside the appropriations process, Congress protected the agency from lobbying efforts to weaken the resources available for supervision and enforcement.
- *A clear consumer protection mission* Despite having consumer protection responsibilities, bank regulators of large banks were criticized during the mortgage crisis for having viewed the banks they regulated as “clients” and, as a result, having failed in their consumer protection job. For example, funded by bank assessment fees and fearing that banks might switch to a more lenient regulator, the OCC repeatedly ignored abusive practices by its member-banks. The CFPB is not subject to this conflict of interest because its purview covers all financial institutions that lend to consumers and its only mission is to protect consumers.
- *Research capacity for data-driven policy* Congress vested the CFPB with the capacity and mandate to develop strong research tools to ensure smart and efficient evidence-based rulemaking and oversight.
- *Safeguards to avoid regulatory deadlock* Like the OCC, the FDIC, and the Federal Housing Finance Agency, the CFPB is led by a single Director, who must take responsibility for his or her decisions and the actions of the Bureau. Some who have sought to weaken the CFPB have urged that the Bureau's leadership be turned into a commission that could not act without the approval of a group of commissioners, making the agency subject to the delays, diffusion of responsibility, and deadlock that often accompany a commission structure. Congress thus far has rejected this course.

Foreclosure Crisis Red Herrings: The Community Reinvestment Act and the GSEs

Some observers have charged that the Community Reinvestment Act (CRA) and the affordable housing goals of the GSEs precipitated the explosion of risky lending during the subprime boom by requiring banks to make loans to unqualified borrowers.

The facts do not support these claims:

- CRA has been on the books for three decades, while the rapid growth of subprime and other non-prime loan securitization and the pervasive marketing of risky loan products did not occur until recent years.
- The predominant players in the subprime market—mortgage brokers, independent mortgage companies, and Wall Street investment banks—were not subject to CRA requirements at all. Only six percent of subprime loans were subject to CRA, meaning that they were extended by CRA-obligated lenders to lower-income borrowers within their CRA assessment areas (Kroszner, 2008).
- Studies have shown that loans made to low- and moderate-income homebuyers as part of banks' efforts to meet their CRA obligations have actually performed better than the rest of the subprime market.
- In an analysis of CRA-motivated loans sold to CRL's affiliate Self-Help, a community development financial institution (CDFI), Ding, Quercia, Ratcliffe, and Li (2008) found that the default risk of these loans was much lower than subprime loans made to borrowers with similar income and credit risk profiles. A study by the Federal Reserve Bank of San Francisco found that CRA-eligible loans made in California during the subprime boom were half as likely to go into foreclosure as loans made by independent mortgage companies (Laderman & Reid, 2008).
- Research also shows no evidence that the GSEs' affordable housing targets were a primary cause of the crisis. For example, GSE guidelines prohibited them from purchasing or securitizing subprime mortgages directly. Wall Street firms, not the GSEs, created subprime mortgage-backed securities.
- Although the GSEs did purchase subprime mortgage-backed securities as investments and did receive affordable housing goal credits for those purchases, their share of such purchases was a fraction of that of the private sector, and a decreasing share at that, disproving the argument that the GSEs pushed the market towards unsound, risky lending.
- The mortgages that accounted for most of the GSEs' losses were loans that generally went to higher-income families, not borrowers who received subprime loans. At the end of 2010, among loans acquired by the GSEs between 2005 and 2008, affordable housing-targeted purchases represented less than eight percent of their 90-days delinquent portfolio, only a small share of overall troubled assets held by the GSEs (Seiler, 2010). Most of the GSEs' losses are tied to Alt-A mortgages, and those loans did not count toward their affordable housing targets.
- Research by Robert Avery and Kenneth Brevoort at the Federal Reserve Board has shown that neither CRA nor the GSEs caused excessive or less prudent lending in low- and moderate-income neighborhoods (Avery & Brevoort, 2011).

State Regulation

Long before Dodd-Frank passed, several states recognized the abuses of the subprime market and passed groundbreaking legislation to rein in predatory mortgage lending. For example, a number of states banned specific loan terms that made mortgages unnecessarily risky or expensive, such as prepayment penalties and yield-spread premiums. Today, everyone, regardless of the state in which they own their home, has the protections afforded by federal financial reforms and the CFPB's work. Still, states continue to play a critical role in protecting the financial well-being of consumers.

First, the CFPB does not operate in a vacuum; the agency seeks information and guidance from the states. It is a data-driven agency that by statute may rely on "established public policies" to determine what consumer protections are needed and which policy responses are most effective.¹⁹ To do so, it examines the impact of state laws and regulations. Second, **the states continue to play a vital role in identifying and addressing lending abuses.** Since states will likely be the first to see new abuses and predatory practices, they will be able to respond to threats in their markets even if a federal response is lagging. (Dodd-Frank allowed states to establish stronger mortgage protections than federal standards.) Finally, the enforcement powers of states' Attorneys General increased under Dodd-Frank, since they have the authority to enforce the rules of the CFPB.

State Anti-Predatory Lending Laws

While federal regulators and legislators failed to adequately protect borrowers in the years leading up to the housing crisis, a number of states did take action. North Carolina was the first state to pass a strong anti-predatory lending law to protect borrowers from abusive mortgages. This law banned prepayment penalties on loans under \$150,000, the financing of up-front single-premium credit insurance, and loan flipping that failed to provide a tangible net benefit to the borrower. The North Carolina law also imposed additional restrictions for high-cost loans that exceeded certain point and fee thresholds. Several other states, including New York, Massachusetts, New Jersey, and New Mexico, passed similar legislation in subsequent years.

As subprime lending nationwide became even more aggressive, a new wave of anti-predatory lending legislation began in state legislatures. Ohio enacted the first of this second generation laws in 2006. Among other provisions, that law created an ability-to-repay standard and required a duty of good faith and fair dealing by loan originators. This was followed by mortgage reform in Minnesota and ten other states.²⁰ State anti-predatory lending laws proved to be very effective while not decreasing the availability of capital. Ultimately, these state laws paved the way for the mortgage protections in Dodd-Frank.

¹⁹ Title X § 1031 of Dodd-Frank (2010), "Prohibiting Unfair, Deceptive or Abusive Acts or Practices," specifically states that the CFPB can consider "established public policies" in determining whether a financial practice is unfair.

²⁰ Colorado, Illinois, New Mexico, Maine, Connecticut, New York, North Carolina, Maryland, West Virginia and Massachusetts.

IMPACT ON U.S. HOUSEHOLDS

The predatory lending practices in the mortgage market caused the worst foreclosure epidemic in U.S. history. Since housing prices began their severe decline in early 2007, millions of homes have gone into foreclosure, and millions more remain in distress. The crisis has devastated families and communities across the country and continues to impair economic growth for the nation as a whole.

Impact on Individuals

We estimate that 12 million homes have entered the foreclosure process between January 2007 and June 2012.²¹ The percent of mortgages entering the foreclosure process in any given quarter—historically less than one-half of one percent²²—has more than doubled, and in some cases, tripled, during this crisis. (See Figures 5–6.)²³

Foreclosures can take months or even years to complete; millions of homes that have started the foreclosure process have not yet completed it. By the middle of 2012, 2.1 million homes were in the foreclosure inventory, on their way to foreclosure but not yet there.²⁴ Unfortunately, it is difficult to find data on the actual number of completed foreclosures. CoreLogic estimated that 3.2 million homes completed the foreclosure process between September 2008 and December 2011, with an additional three million homes 90 days or more delinquent or in the foreclosure process.²⁵ These figures are consistent with CRL's estimates that 3.3 million of 2004–2008 first-lien, owner-occupied originations completed the foreclosure process as of February 2012, with an additional 3.2 million of these loans 60 days or more delinquent or in some stage of the foreclosure crisis.²⁶

21 CRL calculation based on 2007-2012q2 MBA National Delinquency Survey, scaled to reflect market coverage. Per MBA's claims, we assume 85% market coverage for 2007q1–2010q2 and 88% coverage for 2010q3 and after.

22 See chart 5 for quarterly foreclosure start rates back to 2000. For annualized rates from 1950–1994, see Elmer and Seelig (1998), *The rising long-term trend of single-family mortgage foreclosure rates*.

23 Not all of these foreclosure starts represent home owners that have lost their homes. First, a small percentage of borrowers are able to avoid foreclosure even after the foreclosure process commences. On very rare occasions, borrowers “self-cure” and become current again on their mortgages. Others work with their lenders to avoid foreclosure through short-sales; although this can still be devastating to the home owner, it is often less financially and emotionally damaging than enduring the entire foreclosure process. In addition, some foreclosures are not of owner-occupied properties but rather of investor-owned properties and, as a result, do not result in home owners losing their house. However, these foreclosures are not without serious harm, both to displaced tenants and to surrounding property owners whose home values decrease.

24 CRL calculation based on MBA National Delinquency Survey to 2012q2, scaled up to assume 88% market coverage in that year.

25 CoreLogic National Foreclosure Report, February 8, 2012. CRL calculations of 90 days + delinquent imputed from CoreLogic's national rate of 90+ delinquency rate, national rate of foreclosure inventory and estimate of 1.4 million homes in foreclosure inventory.

26 Estimates are based on an update of an analysis from CRL's 2011 paper *Lost ground, 2011: Disparities in mortgage lending and foreclosures*. The methodology for this analysis can be found in the paper.

Figure 5. National Foreclosure Starts, 2001-2012

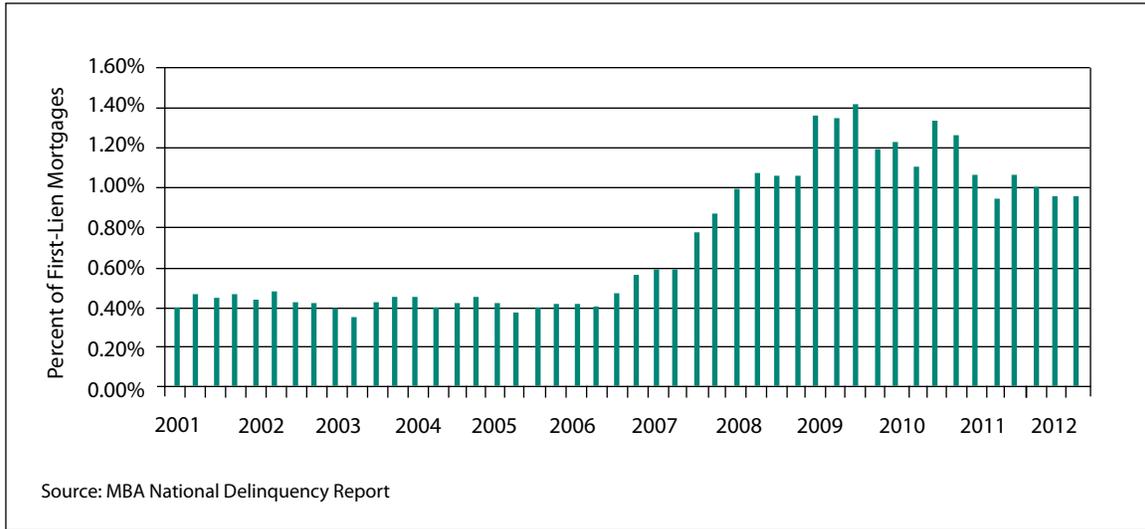
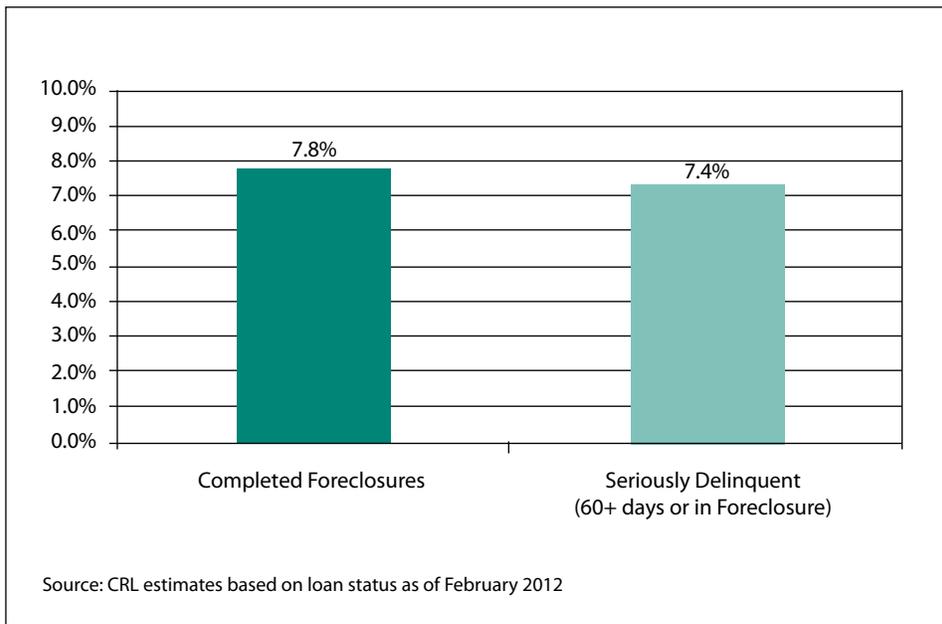


Figure 6. Completed Foreclosures and Serious Delinquencies (2004–2008 First-Lien, Owner-Occupied Loans)



Homeowners with all types of loans are vulnerable to financial stress, especially given high and persistent unemployment rates that have characterized this recession. However, Figure 7 demonstrates that borrowers who received risky loan features had a greater incidence of mortgage defaults.

Figure 7. Loan Status by Feature (2004-2008 Originations)

		Loan Status		
		Completed Foreclosures	Seriously Delinquent	Total
Rate Type	Hybrid or Option ARM	14.7%	10.0%	24.7%
	Fixed Rate or Standard ARM	4.9%	6.4%	11.3%
Prepayment Penalty	Prepayment Penalty	16.7%	12.5%	29.2%
	No Prepayment Penalty	5.9%	5.6%	11.5%
Higher Rate	Higher Rate	17.1%	13.5%	30.6%
	Not Higher Rate	5.9%	6.2%	12.1%

Source: CRL's "Lost Ground, 2011" (updated to reflect loan performance through February 2012).

Note: We define hybrid and payment-option ARM loans as loans with any one of the following characteristics: ARMs with interest-rate resets of less than five years, negative amortization, or interest-only payment schedules. "Higher-rate" is defined as first-lien loans for which the APR spread was 300 basis points or more above Treasuries of comparable maturity.

Foreclosure Demographics

Foreclosures have touched almost every U.S. community, affecting borrowers across racial, ethnic, and income lines. The majority of families who have lost their homes have been middle- or higher-income²⁷ and white non-Hispanics.²⁸ As of February 2012, over 1.9 million white borrowers and 2.3 million middle- or higher-income borrowers who received their loans between 2004 and 2008 had lost their homes to foreclosure.²⁹

However, while the foreclosure crisis has been widespread and the majority of affected borrowers have been white, the crisis has disproportionately affected borrowers of color. 11% of African-American borrowers and 14% of Latino borrowers have already lost their home to foreclosure.³⁰ This compares with 8% of Asian borrowers and 6% of non-Hispanic whites. Although these rates for Asians and whites are extremely high when compared to historic levels, it is significantly lower than the current rate for African-American and Latino borrowers.³¹ (See Appendix 2.)

The disparate impact of the foreclosure crisis on borrowers of color reflects that African-American and Latino borrowers were far more likely to receive higher-rate and other risky loan terms than white borrowers. For example, as Figure 8 shows, African-American borrowers were 2.8 times as likely to receive a higher-rate loan as a white borrower, and Latino borrowers were 2.3 times as likely to receive a loan with a prepayment penalty. As noted earlier, there is evidence that many of these borrowers could have qualified for more affordable and sustainable loans.

27 We define borrower income categories as follows: "low-income" – less than 50 percent of the Metropolitan Statistical Area (MSA) median income; "moderate-income" – at least 50 percent and less than 80 percent of the MSA median income; "middle-income" – at least 80 percent and less than 120 percent of the MSA median income; and "higher-income" – at least 120 percent of MSA median income. The mean incomes for each of the categories are \$26,000 for low-income, \$41,000 for moderate-income, \$61,000 for middle-income, and \$108,000 for higher-income.

28 Borrower race and ethnicity are derived from the HMDA data and refer to the race/ethnicity of the primary applicant. African-American borrowers are those who are classified as "Black or African-American", and can be of any ethnicity. Asian borrowers are those who are classified as "Asian", and can be of any ethnicity. Latinos are those who are classified as "Hispanic or Latino" as their ethnicity and who indicate "White" as their race. "Others" include American Indians, Alaska Natives, Native Hawaiian and other Pacific Islanders, and can be of any ethnicity.

29 Data on completed foreclosures based on an update to CRL's 2011 report *Lost Ground, 2011*. New analysis reflects loan performance through February 2012.

30 The foreclosure rate for borrowers in the "Other" category, which is not shown, is also notably higher, at 9.1 percent. This group includes American Indians, Alaska Natives, and Native Hawaiian and other Pacific Islanders

31 For state-level completed foreclosure rates, please see Appendix.

Figure 8. Incidence and Increased Incidence (Disparity Ratio) of Risky Loan Features by Race/Ethnicity (2004–2008 Originations)

	Incidence of Risky Loan Features (as percent of originations)				Disparity Ratio (versus Non-Hispanic Whites)			
	One or More High Risk Feature	Higher Rate	Hybrid or Option ARM	Prepayment Penalty	One or More High Risk Feature	Higher Rate	Hybrid or Option ARM	Prepayment Penalty
Non-Hispanic White	38.2	12.5	21.5	12.3	NA	NA	NA	NA
African American	62.3	35.3	32.0	24.8	1.6	2.8	1.5	2.0
Latino	61.9	27.9	37.1	28.5	1.6	2.2	1.7	2.3
Asian	48.3	9.8	33.5	15.6	1.3	0.8	1.6	1.3

Note: We define “hybrid” and “option-ARM” loans as loans with any one of the following characteristics: ARMs with interest rate resets of less than 5 years, negative amortization, or interest-only payment schedules. “Higher-rate” is defined as first-lien loans for which the APR spread was 300 basis points or more above Treasuries of comparable maturity. “Risky” is defined as a loan with one or more risky features, including hybrid and option ARMs, loans with prepayment penalties, and loans with higher interest rates.

These racial and ethnic disparities show no signs of abating. Among Latino and African-American households, an additional 11.5% and 13% of loans, respectively, were seriously delinquent, compared with six percent for non-Hispanic whites. Not all of these delinquencies will result in completed foreclosures. But given that the housing market and economic recovery are still weak, more defaults are still to come. It is possible that more than 25 percent of all home loans to African-American and Latino borrowers during this time period will eventually end in foreclosure.

Impact on Communities

When homes go into foreclosures, the negative effects extend beyond individual families, spilling over to nearby residents and the wider community. Foreclosures decrease the values of surrounding properties, causing losses of wealth for neighboring families.

We estimate that \$1.95 trillion in home equity has been lost to property owners who happen to live in proximity to foreclosed homes (Bocian, Smith and Wei, 2012). On average, each affected nearby household lost over \$21,000. Importantly, this “spillover” estimate does not include non-financial negative neighborhood impacts from foreclosures, such as neighborhood blight or increased crime (Kingsley, Smith, & Price, 2009). The estimate also does not account for the direct costs to local governments related to vacant and abandoned properties, which can range from several hundred to tens of thousands of dollars per foreclosure (Kingsley et al, 2009). The \$1.95 trillion spillover estimate is limited to the marginal loss in home values to surrounding property owners, not the total amount of lost equity resulting from the housing collapse. In fact, an estimated \$7 trillion in total home equity has been lost as a result of the collapse in the housing market (Federal Reserve Board [FRB], 2012). (See Appendix A for state-level data.)

Impact on U.S. Financial and Economic Stability

In addition to the damage to individual homeowners and communities, the collapse of the subprime market triggered a much broader economic crisis.³² Through mortgage securitization, subprime defaults spread throughout national and international investments, against which the financial industry was highly leveraged. As a result, more than 400 banks have failed since 2007, compared with the 2000–2007 period in which only 26 banks failed.³³

Despite the government bailout of the financial industry, the U.S. economy suffered extensive damage. The housing market collapsed, and the U.S. was thrown into the deepest recession since the Great Depression, causing high and persistent unemployment that has yet to recede fully.

Figure 9. U.S. Unemployment and Foreclosure Rates



32 The financial losses generated by subprime lending were so extensive because of the high degree to which subprime loans were securitized and packaged into complicated financial instruments, which were then sold to investors throughout the world. Many banks which were not directly involved in originated subprime loans were nonetheless heavily leveraged against such securities.
33 See FDIC Failed Bank List.

Demographics of the Foreclosure Crisis

Figure 10. Number of Completed Foreclosures and Seriously Delinquent Loans by Income (2004–2008 Originations)

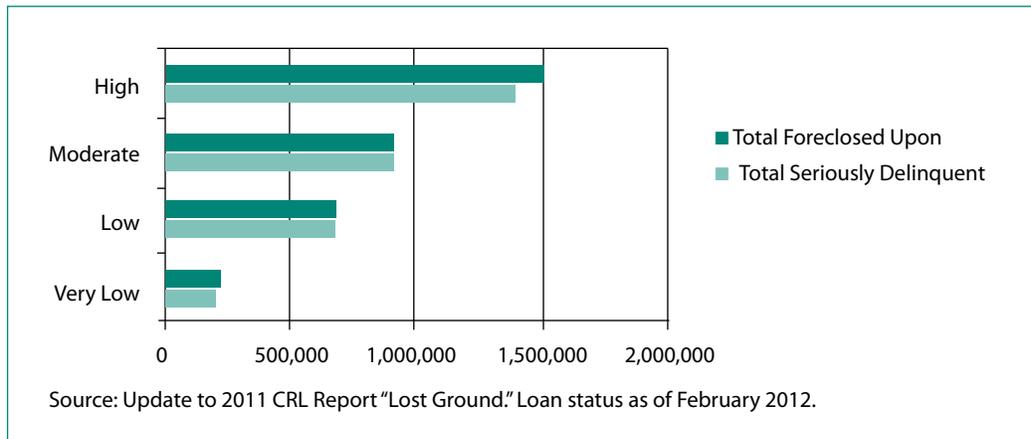


Figure 11. Number of Completed Foreclosures and Seriously Delinquent Loans by Race/Ethnicity (2004–2008 Originations)

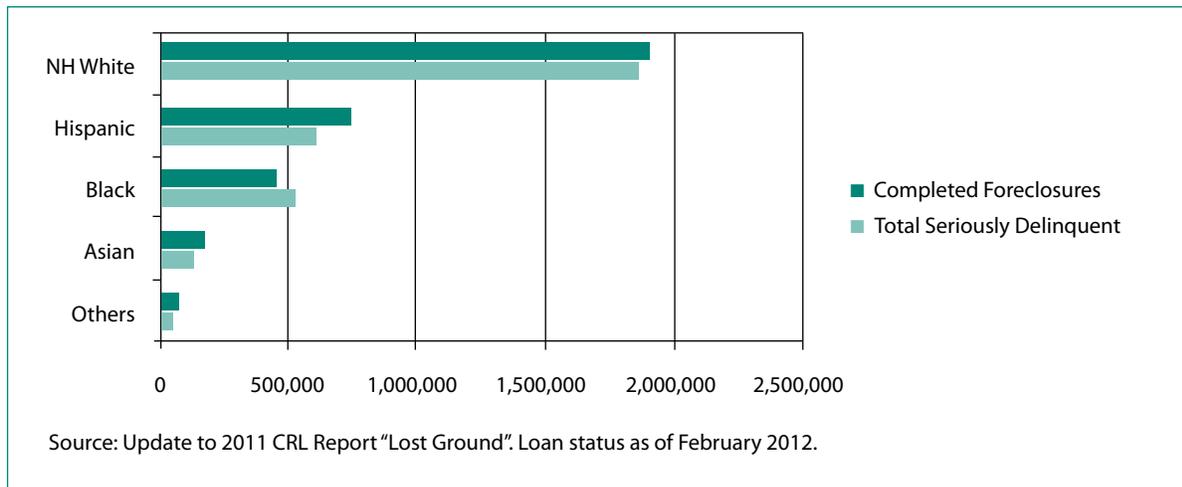
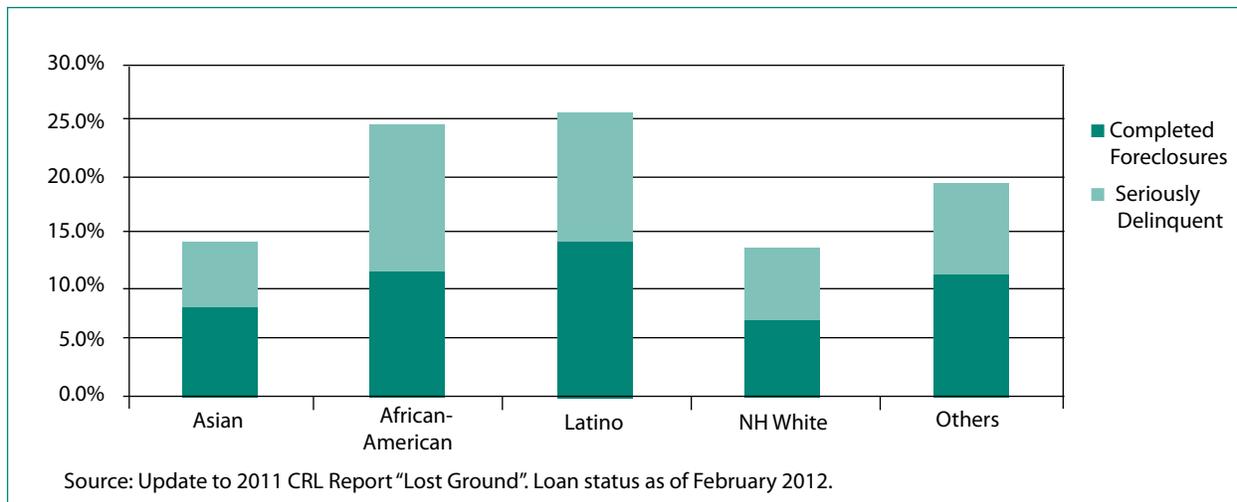


Figure 12. Rates of Completed Foreclosures and Serious Delinquencies, by Race/Ethnicity (2004–2008 Originations)



TODAY'S CHALLENGES

Foreclosure Crisis Nowhere Near the End

Although well into the fifth year of the foreclosure crisis, we are nowhere near the end. During the second quarter of 2012, over 460,000 homes had entered the foreclosure process, and by the middle of the year, more than four million loans were 60 days or more delinquent or in some stage of the foreclosure process.³⁴ Although housing prices have stabilized in most parts of the country, overall housing prices are down 17.4% from five years ago.³⁵ As of 2012q1, an estimated 11 million residential properties, representing 23.7% of loan modifications is declining.³⁶ Despite the high volume of troubled loans, the number of loan modifications is declining. During the first quarter of 2012, fewer than a quarter of a million troubled home owners received a loan modification, down 31 percent from the previous year.³⁷

Figure 13. Homes at Risk Snapshot

	Source	Latest Figure	Change from Prior Year
Number of Foreclosure Starts	CRL calculation based on MBA National Delinquency Survey	463,711 (2012q2)	-3% (vs 2011q2)
Number of Seriously Delinquent Homes*	CRL calculation based on MBA National Delinquency Survey	4,096,110 (2012q2)	-10% (vs 2011q2)
Number of Underwater Homes	CoreLogic Negative Equity Report	11.4 million (2012q1)	-1.4% (vs 2011q1)
Number of Modifications	Hope Now	181,505 (2012q2)	-28% (vs 2011q2)

*60 days+ or in foreclosure

Borrowers Face Barriers to Accessing Mortgage Credit

The housing crisis also has affected the availability of credit for new purchase and refinance loans for current borrowers. Since the collapse of the subprime market, mortgage credit has dried up considerably. As shown in Figure 14, total originations had crept back to 6.9 million loans by 2010, about where it was at the beginning at the decade:

Figure 14. U.S. Mortgage Originations, 2000–2010 (Owner-Occupied Loans, in Millions)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Total	\$6.6	\$11.8	\$14.0	\$19.0	\$12.5	\$12.7	\$11.1	\$8.3	\$5.8	\$7.9	\$ 6.9

Source: Home Mortgage Disclosure Act

34 CRL calculations based on MBA data, scaled to market assuming MBA market coverage of 85–87%.

35 According to FHFA's state housing price indexes, all but eight states saw positive housing price growth between 2011q2 and 2012q2.

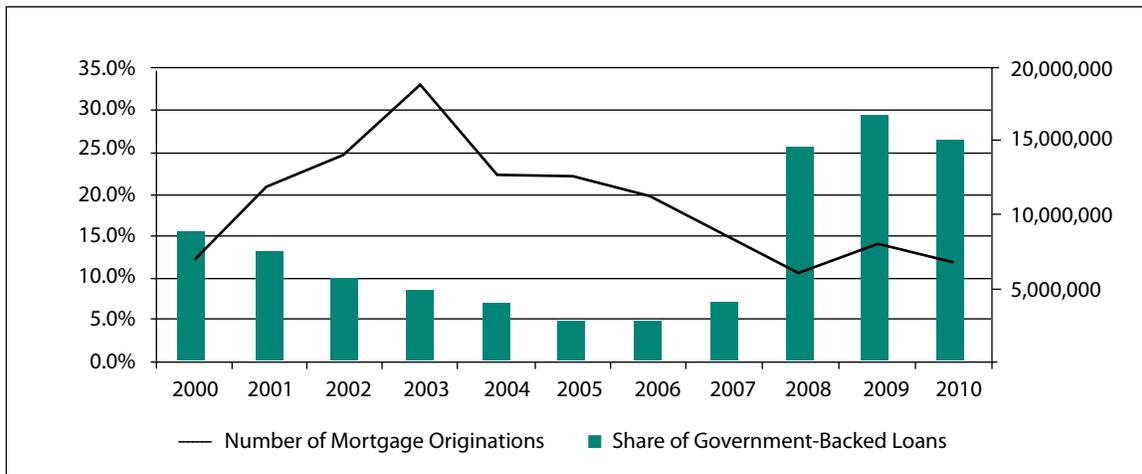
36 CRL calculations based on Mortgage Bankers Association National Delinquency Survey data for 2012q2, scaled to market assuming MBA market coverage of 88%

37 Based on data contained in Hope Now Industry Snapshot.

Contraction of Conventional Credit

The overall decline in lending has been driven by the drop in conventional (non-government-backed) lending. Between 2006 and 2010, the annual number of conventional loan originations declined from 12.1 million to 5.0 million, a decrease of 58.3%.³⁸ While conventional lending volume was especially high in 2006 because of the subprime boom, conventional lending in 2010 was down by 10 percent even compared with the 2000 level. This suggests that the post-boom contraction has gone beyond a normal market correction.

Figure 15. Total Number of Loan Originations and Market Share of Government-Backed Loans, 2000-2010

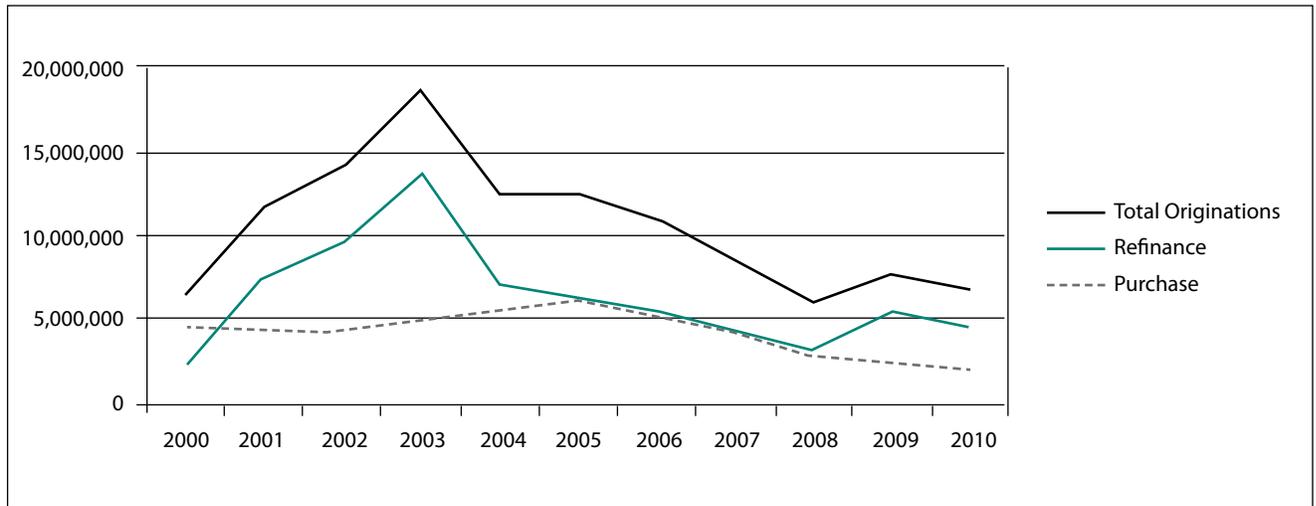


The decline in conventional lending, despite historically low interest rates, is in part due to the tighter lending standards imposed by the GSEs. As Figure 18 demonstrates, the share of conforming, conventional loan volume (in this case, represented by Fannie Mae's purchases) for borrowers with credit scores under 700 has decreased from about 70% in 2000 to under 10 percent today. The average borrower who was denied a conforming loan in August 2012 had a FICO score of 734 (Sreekumar, 2012). **This suggests that the current conventional market may be overemphasizing the role of borrowers' credit profiles and creating an overly tight market, even though the foreclosure crisis was caused by risky products and poor underwriting.**

At the same time that conventional credit has contracted, FHA lending has expanded dramatically. The FHA has always played a critical role in the national effort to expand homeownership opportunities for lower-income and minority families. However, as Figures 14 and 15 demonstrate, during the subprime boom, the FHA lost market share to subprime lenders targeting the same communities. Now with subprime lending gone and conventional credit restricted, the FHA has stepped in with counter-cyclical lending, significantly increasing its market share across demographic groups. Overall, the share of loans with government backing went from 15.5% in 2000, to 5% in 2005, to 26.6% in 2010.

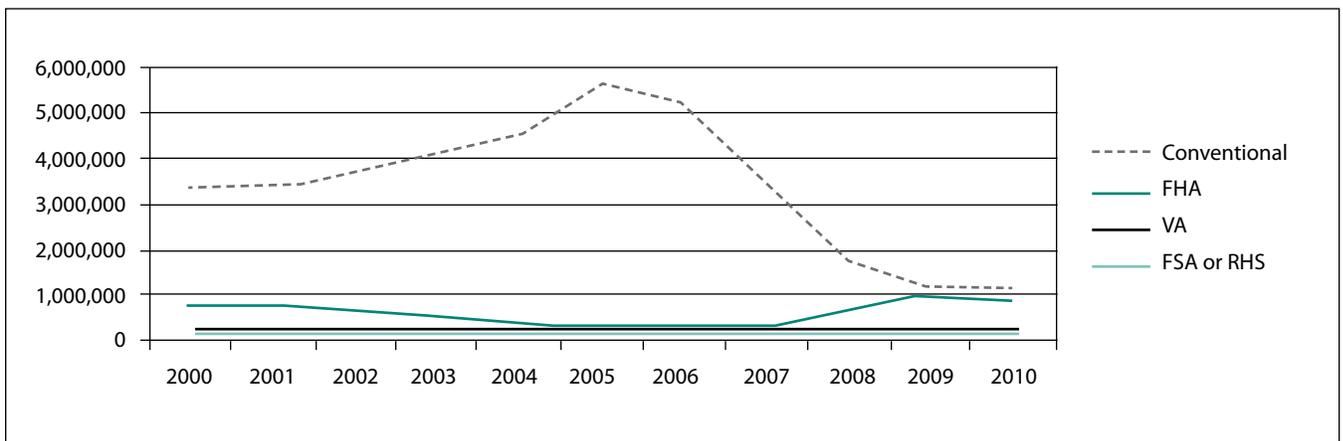
³⁸ CRL analysis of first- and second-lien owner-occupied originations from HMDA data.

Figure 16. Purchase versus Refinance Loan Originations, 2000-2010 (First and Second Lien, Owner Occupied)



Although the total number of loans originated has climbed back to its 2000 level, most of that is refinance lending; purchase loans are still far beneath their numbers from a decade ago. Between 2000 and 2010, purchase loans have fallen by 48%, from 4.4 million to 2.3 million. Once again, this decline has been driven by a sharp drop in conventional lending, with these loans falling 68%. At the same time, FHA purchase loans, having fallen dramatically between 2000 and 2006, have increased dramatically.

Figure 17. Conventional versus Government-Backed Mortgage Purchase Loans, 2000-2010



The drop in conventional purchase loans has been significant for all racial and ethnic groups, but particularly for African-Americans and Latinos. From 2000–2010, conventional purchase lending to African-American and Latino borrowers dropped 83% and 75%, respectively, compared to 67% and 36% for whites and Asians. More of these loans are now government-backed as well: For African-Americans, the share of mortgages used to purchase a home and backed by a government program increased to almost 80% in 2010. For Latinos and whites, the share increased to 73% and 49%, respectively. (See Figure 19.)

These current trends in mortgage credit may be temporary responses to the crisis and could abate once the market fully adjusts to the new regulations and protections of Dodd-Frank. It is critical, however, that this dynamic not result in a new, permanent “dual mortgage market,” where only the highest-wealth borrowers with near-perfect credit can gain access the conventional market, while lower-income and minority borrowers who can be successful home owners are relegated to more expensive FHA loans, or find credit largely unavailable.

Decline in Mortgage Originations by Race/Ethnicity and Credit Score

Figure 18. Fannie Mae Single-Family Volume by Credit Score, 2000 to 2011

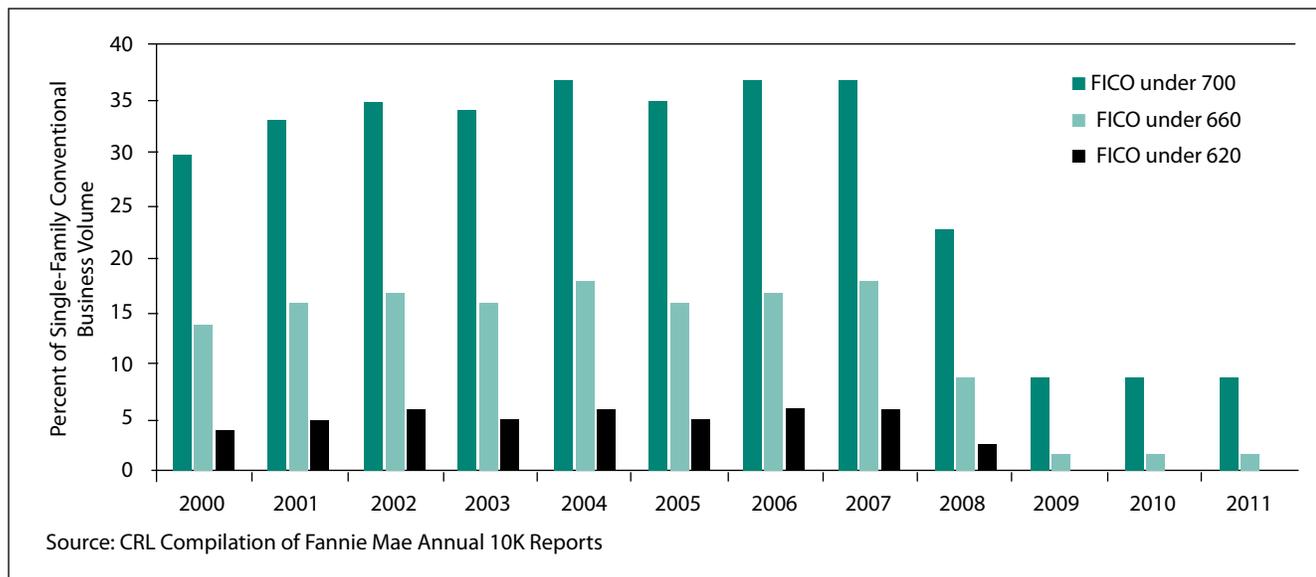


Figure 19. Share of Purchase Originations Comprised by Government-Backed Loans, by Race/Ethnicity, 2000-2010

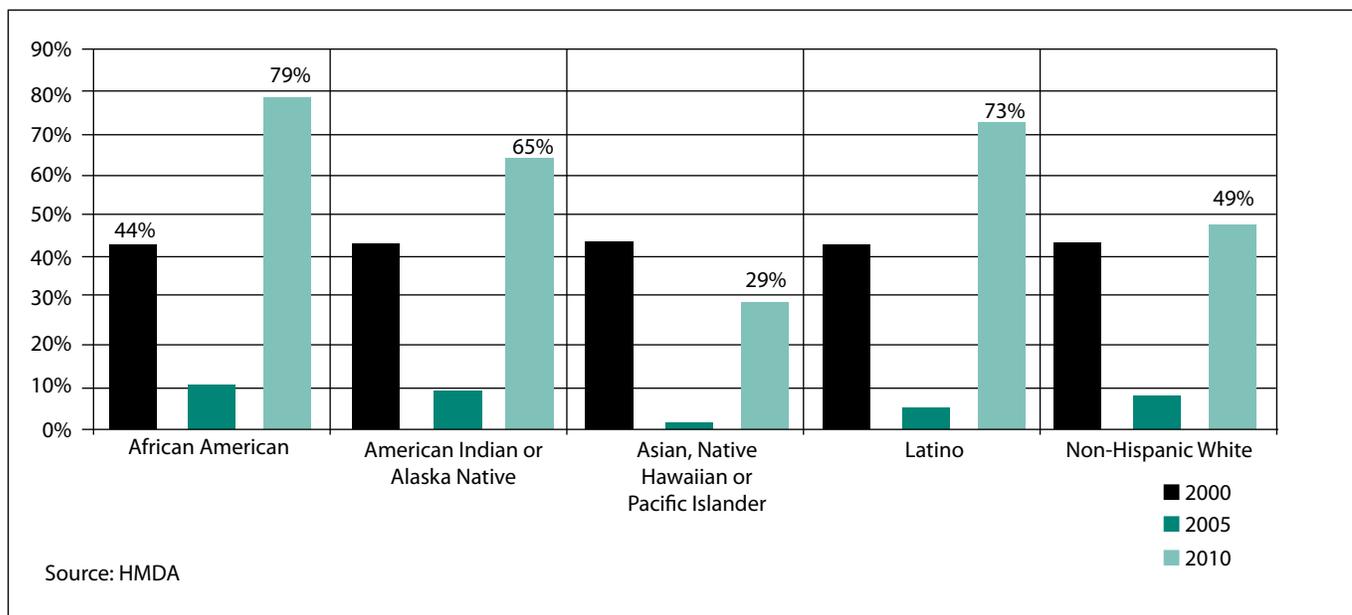


Figure 20. Change in Purchase Loans by Race/Ethnicity, 2000-2010

	Overall	Conventional	Gov't Backed
African American	-52.2%	-82.5%	-14.9
Asian	-18.5%	-35.9%	57.2%
Latino	-45.0%	-74.6%	-2.9%
White	-47.7%	-66.9%	25.7%

Source: HMDA

Down Payment Requirements

One key determinant of access to credit in the next decade will be down payment regulations set by regulators and the market. Federal policymakers are currently considering regulatory and programmatic proposals regarding the design and operation of the secondary market. These include proposals for defining “Qualified Residential Mortgages” (QRMs), a category of home loans established by the Dodd-Frank Act³⁹ and for reforming Fannie Mae and Freddie Mac. For both of these issues, there have been proposals to impose new down-payment requirements as a way to decrease mortgage defaults. Such federally mandated down-payment requirements would be on top of the Dodd-Frank reforms that will already keep the riskiest mortgages out of the secondary market.⁴⁰

The costs of imposing any federally mandated down payment are unacceptably high. Not only would such requirements exclude creditworthy families from homeownership, but they would also undermine the nation’s economic recovery by further depressing the housing market. Consider these facts:

- **Low down-payment loans are not the same as subprime loans and have been successfully used to help families become homeowners for decades.** The current housing crisis was the result of abusive loan terms and practices in the subprime and Alt-A mortgage markets, not low down-payment loans. **Low down payments, when paired with responsible underwriting and safe loan terms, have proven to be a successful strategy for expanding sustainable homeownership for decades.**
- **Arbitrary minimum down-payment requirements would lock middle-income families out of the mainstream market and widen the wealth disparities that already exist between whites and communities of color.** Given median housing prices and incomes, it would take over 20 years for the average family to save a 10-percent down payment plus closing costs. The barriers would be even greater for typical African-American and Latino families, for whom it would take 31 and 26 years, respectively, to save enough to meet such a requirement. Even a 5-percent down-payment requirement would pose significant barriers to homeownership for African-American and Latino borrowers, exacerbating the homeownership gap between whites and families of color. Again, lending history has shown that many families who don’t have the funds for a significant down payment can become successful homeowners.

It would take over 20 years for the average family to save a 10-percent down payment plus closing costs. The barriers would be even greater for typical African-American and Latino families, for whom it would take 31 and 26 years, respectively.

39 Under Dodd-Frank, mortgage lenders that sell their loans into the private secondary market must retain a portion of the loan’s risk unless the loan is designated as a QRM. Federal regulators in charge of defining QRM are the Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, Securities and Exchange Commission, Department of Housing and Urban Development, and the Department of the Treasury.

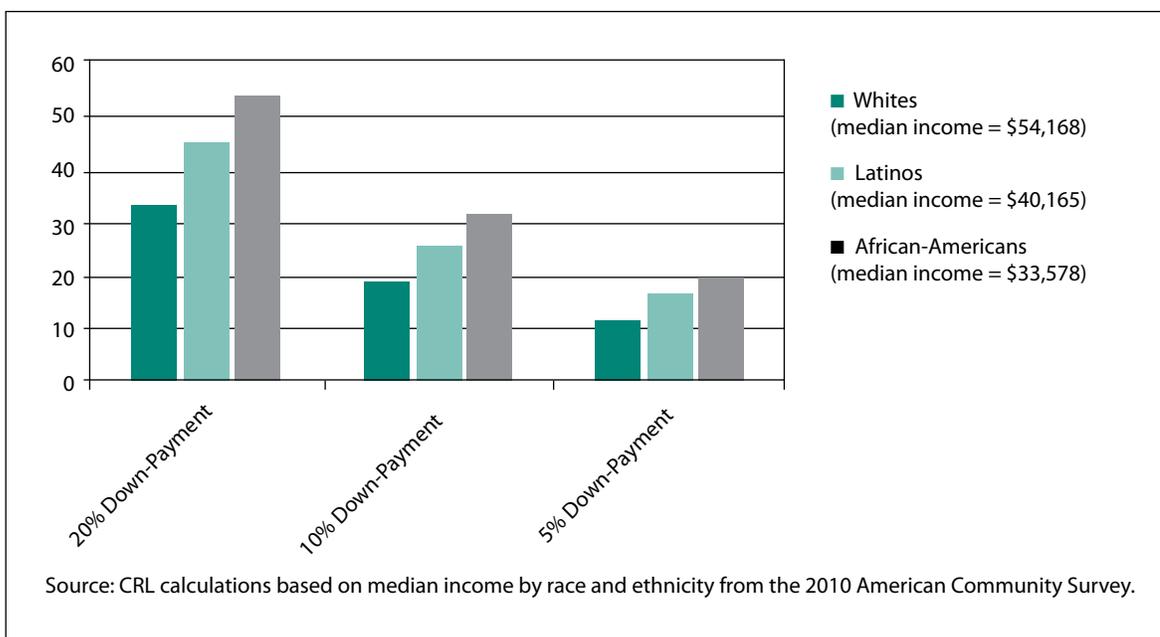
40 Loans with risky product features such as high fees, balloon payments, low teaser rates, or interest-only or negative amortization schedules will automatically be ineligible for preferred secondary market status, as will loans that do not verify borrower income (so-called “no-doc” or “low-doc” loans). The Center for Responsible Lending (CRL) supports these restrictions.

Figure 21. Years to Save by Down-Payment Requirement

	Down-Payment Requirement		
	20%	10%	5%
Cash Required for Down-Payment	\$ 31,620	\$ 15,810	\$7,905
Cash Required for Closing Costs ⁴¹	\$4,662	\$4,820	\$4,900
Total Cash Required at Closing	\$36,282	\$20,630	\$12,804
Number of Years Required to Save Required Cash	36	21	13

Source: CRL analysis

Figure 22. Years to Save Down-Payment, by Race/Ethnicity



- **The high costs of down-payment requirements far outweigh sparse marginal benefits.** Imposing a mandatory minimum down-payment requirement would produce a small reduction in default rates, but the marginal benefit would be dwarfed by the cost of denying millions of families the opportunity to become successful homeowners with mainstream mortgages.

41 According to a 2012 survey, the average closing cost on a \$200,000 mortgage was \$3,754, excluding escrow for taxes and insurance. We assume this can be decomposed into a 1% origination fee plus \$1,754 in fixed fees. Using the 2009 national median property tax rate of 1% and the current average homeowner insurance premium of \$853, we estimate an additional \$1,643 is required at closing to cover escrows for insurance plus six months of taxes. See www.bankrate.com/finance/mortgages/2012-closing-costs/ for survey of closing costs.

Dodd-Frank’s protections against the worst abuses of the subprime and Alt-A markets will go a long way to prevent the types of lending that caused the current crisis. **It is important to bear in mind that down-payment requirements would be layered on top of the other specific underwriting protections in Dodd-Frank, such as the required ability to repay assessment.** As a result, the marginal benefit of reducing defaults through a down-payment requirement must be balanced against the cost of restricting access to affordable mortgages. A recent study by the University of North Carolina’s Center for Community Capital and CRL suggests that the trade-off is not worthwhile.

Looking at large sample of mortgages originated between 2000 and 2008, the UNC/CRL study shows that, after applying Dodd-Frank’s other mortgage protections, a 10-percent down-payment requirement would have had a relatively small benefit in reducing defaults. Specifically, while a 10-percent down-payment requirement would have reduced the default rate from 5.8 percent to 4.7 percent, it also would have locked 30 percent of all borrowers out of the market and would have excluded nine borrowers who are currently successfully paying their mortgage for every foreclosure it would have prevented (Quercia, Ding, & Reid, 2012).⁴² Furthermore, the impact of a 10-percent down-payment standard would be particularly acute for communities of color, as 60 percent of African-American and 50 percent of Latino borrowers who are currently successfully paying their mortgages would have been excluded from the mainstream mortgage market had such a requirement been in place. A five-percent down-payment requirement would have excluded six successful borrowers for every one prevented foreclosure and would have locked out 33 percent of African-American and 22 percent of Latino borrowers.

Figure 23. Exclusion Ratios

	Exclusion Ratio (Number of Performing Loans Excluded: Number of Foreclosures Prevented)
Qualified Mortgage Standards + 20 Percent Down Payment	10:1
Qualified Mortgage Standards + 10 Percent Down Payment	9:1
Qualified Mortgage Standards + 5 Percent Down Payment	6:1

Source: Quercia, Ding and Reid, 2012.

Note: Exclusion ratio for five-percent down-payment not published in original report.

⁴² In contrast, the study shows that a three-percent down-payment requirement reduces the default rate to 5.2 percent while excluding eight percent of borrowers (and would have excluded 6 successful borrowers for every one prevented foreclosure).

Figure 24. Percent of Performing Loans Excluded from the QRM Mortgage Market, Alternate LTV Definitions, by Borrower Race/Ethnicity⁴³ (2004 – 2008 Originations)



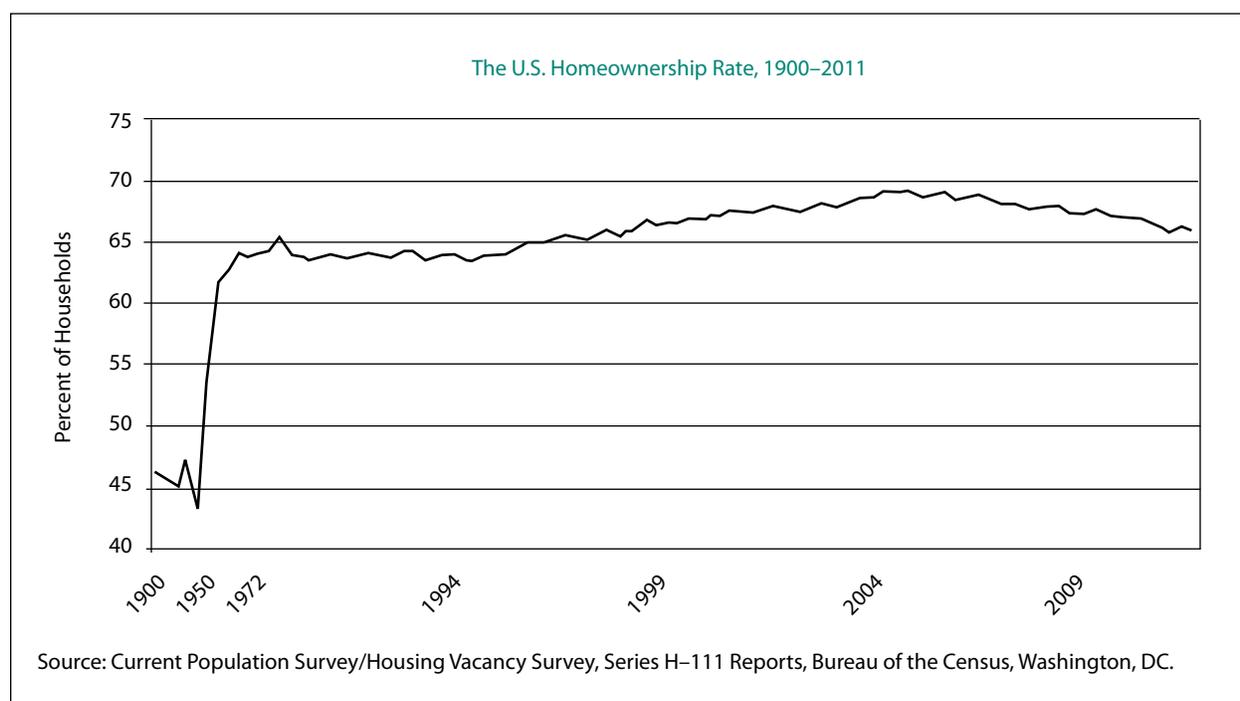
The benefit of down payments in reducing individual borrowers’ default rates could be counteracted by the toll it would take on the larger housing market and economy. Including a down-payment requirement in secondary market standards would depress housing demand, threatening the future recovery of the nation’s housing market and overall economy. By excluding so many families from accessing affordable mortgages, a high down-payment requirement would likely depress home prices, decreasing the home equity of families across the country, and act as a drag on economic growth and employment. In doing so, it could actually undermine its primary objective of reducing individual default rates.

43 Loan status as of February 2011.

MORTGAGE POLICY RECOMMENDATIONS

For the first time since World War II, the homeownership rate in this country is declining. Despite most Americans' steadfast belief in the importance of owning their own home, the combination of high rates of foreclosures and constricted access to credit are preventing many American families from owning their homes. While housing policy must strike the right balance between homeownership and affordable rental housing goals, it is essential that lower-income borrowers and borrowers of color regain access to credit for homeownership and not remain blocked out of the market.

Figure 25.



Federal and state policies should continue to address the true causes of the crisis—abusive loan terms and irresponsible underwriting practices—while also helping families still facing foreclosure and facilitating a stable supply of mortgage financing that ensures access to credit for qualified borrowers:

Protect Reforms that Regulate Harmful Mortgage Products.

Policymakers should not weaken or undermine the mortgage reforms established in the Wall Street Reform and Consumer Protection Act, because this could result in future abusive lending and the possibility of a new foreclosure crisis. The mortgage reforms in the law include provisions that will limit harmful and abusive loan provisions. In addition, these reforms also require that all lenders take the common-sense step of evaluating a borrower's ability to repay a mortgage. These straightforward reforms address the causes of the still ongoing foreclosure crisis, because research has shown that mortgage defaults are strongly tied to abusive loan practices, such as having prepayment penalties, including “exploding” ARMs, and originating loans through mortgage brokers who received kickbacks for placing borrowers in riskier, more expensive mortgages than those for which they qualified. Reversing these reforms and returning to the pre-crisis status quo would have long-term costs for both the economy and individual families.

Promote Reasonable Foreclosure Prevention Activities.

Because the foreclosure crisis is not over and to protect future borrowers facing the prospect of foreclosure, policy makers should require mortgage servicers to provide borrowers with full and fair consideration for loan modifications and other cost-effective alternatives to foreclosure. In particular, servicing standards should prohibit the practice, known as dual tracking, where servicers process a borrower for a foreclosure while the servicer is reviewing the borrower for a loan modification. At the same time, Congress and state legislatures should also fund more housing counseling and legal-aid assistance for home owners who are at risk of foreclosure. Every successful intervention that prevents an unnecessary foreclosure helps home owners, their communities, and the economy as a whole.

Support Mortgage Finance Reform that Prioritizes Broad Market Access.

The timing of mortgage finance reform is uncertain, but policymakers must ensure that a future system balances both broad market access and borrower protections. In assessing this balance, the significant protections against risky lending already included as part of the Dodd-Frank Act must be taken in to account. As a result, further reforms to the GSEs and the secondary market should not add additional loan restrictions and instead must prioritize the issue of equitable access to the mortgage finance system. Policymakers should adopt the following key principles to ensure a robust and secure secondary market:

- **Government Guarantee:** The U.S. government should provide an explicit, actuarially sound guarantee for mortgages in a future secondary market structure. This is an appropriate role for the government to play in the event of a housing-market crash or market disruption. Discussion about the role of private capital in sharing losses is an important part of the conversation, but a catastrophic government guarantee is essential to the future of mortgage finance.
- **Duty to Serve Entire Market:** Mortgage finance reform should require secondary market entities that benefit from federal guarantees to serve all qualified homeowners, rather than preferred market segments. Without a duty to serve the entire market, lenders could recreate the dual credit market that characterized lending during the subprime crisis.
- **Encourage Broad Market Access by All Lenders:** The future mortgage finance system should encourage competition and further broad market access to the secondary capital markets for both small and large lenders. These goals should be met by establishing a cooperative secondary market model of one non-lender entity, owned in equal shares by member-users, that is able to issue guaranteed securities. Such a model of aligned interests will correct the shortcomings of Fannie Mae and Freddie Mac's past and also prevent a further concentrated lending marketplace in the future.

Appendix 1: Foreclosure Spillover Estimates by State

State	Number of Foreclosure Starts	Housing Units Affected by Spillover Impact	Lost Wealth Due to Spillover (in Millions)	Lost Wealth Per Affected Household	Average Home Equity Lost (as % of Total Home Value)
US	10,868,651	92,531,622	\$1,950,324	\$21,077	7.2%
AL	111,068	1,027,026	\$2,526	\$2,460	1.9%
AK	9,294	126,261	\$601	\$4,764	2.1%
AZ	469,923	2,259,997	\$53,540	\$23,690	10.9%
AR	50,052	484,463	\$808	\$1,668	1.3%
CA	1,857,591	12,234,575	\$594,975	\$48,631	11.0%
CO	195,477	1,578,749	\$20,685	\$13,102	6.1%
CT	100,295	1,169,614	\$14,211	\$12,151	4.8%
DE	30,759	295,764	\$1,910	\$6,459	3.4%
DC	16,495	279,023	\$14,773	\$52,944	12.4%
FL	1,560,026	7,954,494	\$286,001	\$35,955	13.8%
GA	467,183	2,842,312	\$20,886	\$7,348	3.8%
HI	32,498	385,323	\$12,777	\$33,158	7.8%
ID	56,904	344,386	\$2,103	\$6,106	3.6%
IL	476,400	4,310,335	\$160,358	\$37,203	13.6%
IN	218,928	1,920,809	\$6,994	\$3,641	3.5%
IA	55,371	629,536	\$1,718	\$2,729	2.4%
KS	54,523	695,949	\$1,988	\$2,856	2.4%
KY	88,664	909,023	\$3,395	\$3,735	3.0%
LA	88,898	1,042,210	\$4,780	\$4,587	2.7%
ME	29,360	235,918	\$881	\$3,735	1.8%
MD	201,748	1,935,476	\$33,724	\$17,424	6.8%
MA	144,963	2,242,050	\$39,753	\$17,731	5.4%
MI	435,314	3,337,048	\$35,924	\$10,765	9.0%
MN	193,707	1,524,530	\$16,777	\$11,005	5.0%
MS	61,270	516,040	\$1,104	\$2,140	2.0%
MO	163,367	1,730,548	\$10,431	\$6,028	4.8%
MT	16,418	140,132	\$295	\$2,104	1.2%
NE	31,616	433,189	\$1,327	\$3,064	2.6%
NV	299,767	983,796	\$56,426	\$57,355	21.5%
NH	38,841	307,496	\$1,587	\$5,162	2.1%
NJ	290,710	3,189,495	\$108,693	\$34,079	10.4%
NM	45,452	477,973	\$2,299	\$4,810	2.7%
NY	359,685	6,198,420	\$257,914	\$41,610	9.2%
NC	239,727	2,288,317	\$6,144	\$2,685	1.6%
ND	4,619	104,262	\$170	\$1,629	1.3%
OH	394,681	3,888,090	\$21,967	\$5,650	5.0%
OK	76,421	902,317	\$2,284	\$2,531	2.4%
OR	117,206	1,126,551	\$11,567	\$10,268	3.8%
PA	241,909	3,620,807	\$25,371	\$7,007	5.2%
RI	39,643	400,079	\$9,315	\$23,283	9.3%
SC	137,693	1,191,321	\$5,077	\$4,262	2.0%
SD	8,429	109,128	\$236	\$2,163	1.7%
TN	173,741	1,540,740	\$4,529	\$2,939	2.4%
TX	513,698	6,592,722	\$21,741	\$3,298	2.4%
UT	88,704	717,291	\$4,978	\$6,940	3.4%
VT	8,520	68,826	\$175	\$2,537	1.2%
VA	234,383	2,205,271	\$32,368	\$14,678	4.5%
WA	177,806	2,086,016	\$21,113	\$10,121	3.2%
WV	24,178	306,255	\$545	\$1,779	1.5%
WI	127,252	1,555,643	\$10,376	\$6,670	4.7%
WY	7,473	86,027	\$203	\$2,357	1.5%

Appendix 1: Foreclosure Spillover Estimates by State

State	Lost Wealth Due to Spillover (in Millions)	Lost Wealth Due to Spillover in Minority Tracts (in Millions)	Percentage of Lost Wealth Coming from Minority Tracts	Lost Wealth Per Affected Household in Minority Tracts	Average Home Equity Lost (as % of Total Home Value) in Minority Tracts
US	\$1,950,324	\$1,015,767	52.1%	\$37,084	13.1%
AL	\$2,526	\$808	32.0%	\$2,502	3.0%
AK	\$601	\$75	12.4%	\$3,982	2.2%
AZ	\$53,540	\$15,505	29.0%	\$27,678	17.2%
AR	\$808	\$130	16.1%	\$1,340	1.6%
CA	\$594,975	\$376,219	63.2%	\$57,909	14.3%
CO	\$20,685	\$5,305	25.6%	\$20,056	11.8%
CT	\$14,211	\$7,011	49.3%	\$25,273	11.5%
DE	\$1,910	\$752	39.4%	\$14,113	9.9%
DC	\$14,773	\$9,867	66.8%	\$55,375	14.8%
FL	\$286,001	\$130,214	45.5%	\$60,259	25.0%
GA	\$20,886	\$9,339	44.7%	\$8,468	5.8%
HI	\$12,777	\$11,351	88.8%	\$32,767	8.0%
ID	\$2,103	\$8	0.4%	\$2,869	3.3%
IL	\$160,358	\$74,988	46.8%	\$57,725	25.3%
IN	\$6,994	\$1,614	23.1%	\$6,152	7.4%
IA	\$1,718	\$51	3.0%	\$3,959	5.3%
KS	\$1,988	\$221	11.1%	\$3,166	4.5%
KY	\$3,395	\$521	15.3%	\$6,167	7.4%
LA	\$4,780	\$1,731	36.2%	\$4,340	3.3%
ME	\$881	\$0	0.0%	\$446	0.7%
MD	\$33,724	\$19,391	57.5%	\$23,431	10.3%
MA	\$39,753	\$13,428	33.8%	\$48,954	15.9%
MI	\$35,924	\$13,752	38.3%	\$21,657	23.3%
MN	\$16,777	\$3,240	19.3%	\$33,393	18.9%
MS	\$1,104	\$359	32.5%	\$1,935	2.5%
MO	\$10,431	\$3,434	32.9%	\$12,890	13.7%
MT	\$295	\$0	0.0%	\$479	0.7%
NE	\$1,327	\$141	10.6%	\$3,824	5.1%
NV	\$56,426	\$18,209	32.3%	\$56,226	27.6%
NH	\$1,587	N/A	N/A	N/A	N/A
NJ	\$108,693	\$74,138	68.2%	\$73,436	23.7%
NM	\$2,299	\$1,110	48.3%	\$4,395	3.0%
NY	\$257,914	\$172,540	66.9%	\$75,476	17.5%
NC	\$6,144	\$1,570	25.6%	\$2,541	2.2%
ND	\$170	\$0	0.0%	\$412	0.7%
OH	\$21,967	\$5,460	24.9%	\$9,544	11.0%
OK	\$2,284	\$345	15.1%	\$2,257	3.2%
OR	\$11,567	\$327	2.8%	\$9,301	4.6%
PA	\$25,371	\$8,195	32.3%	\$12,927	13.7%
RI	\$9,315	\$4,306	46.2%	\$64,373	27.3%
SC	\$5,077	\$514	10.1%	\$2,084	1.8%
SD	\$236	\$0	0.0%	\$568	0.7%
TN	\$4,529	\$1,568	34.6%	\$4,357	4.8%
TX	\$21,741	\$10,447	48.1%	\$2,960	2.7%
UT	\$4,978	\$275	5.5%	\$6,757	4.9%
VT	\$175	N/A	N/A	N/A	N/A
VA	\$32,368	\$11,968	37.0%	\$20,327	7.1%
WA	\$21,113	\$2,108	10.0%	\$12,277	4.3%
WV	\$545	\$3	0.5%	\$1,193	2.1%
WI	\$10,376	\$3,230	31.1%	\$19,119	17.4%
WY	\$203	\$0	0.0%	\$586	0.7%

Appendix 2: Completed Foreclosure and Serious Delinquency Rates by State and Race/Ethnicity, 2004-2008 Originations (Loan Status as of February 2012)

State	Total*		Asian		African-American		Latino		NHWhite	
	Completed Foreclosure	Imminent Risk of Foreclosure								
Alabama	6.5%	6.0%	4.2%	3.6%	10.0%	12.5%	7.8%	6.2%	5.8%	4.6%
Alaska	3.7%	2.6%	4.9%	3.7%	5.2%	5.3%	4.6%	3.3%	3.4%	2.3%
Arizona	14.7%	6.3%	18.1%	6.0%	17.6%	8.0%	21.2%	8.6%	12.8%	5.7%
Arkansas	5.6%	6.5%	5.1%	5.1%	6.3%	13.9%	15.5%	12.3%	4.9%	5.4%
California	11.5%	6.9%	10.6%	6.1%	13.7%	9.0%	17.2%	8.8%	8.8%	6.0%
Colorado	8.6%	4.1%	9.2%	3.9%	16.0%	7.4%	18.7%	6.7%	6.9%	3.6%
Connecticut	3.6%	7.9%	3.1%	5.8%	6.6%	14.6%	7.4%	14.1%	2.9%	6.5%
DC	3.3%	7.2%	3.2%	3.4%	4.9%	8.7%	6.2%	7.3%	1.3%	1.9%
Delaware	3.0%	5.1%	2.8%	4.2%	4.7%	13.1%	3.8%	9.2%	3.0%	5.8%
Florida	10.1%	16.4%	10.5%	15.8%	11.3%	20.6%	14.6%	21.6%	8.6%	14.2%
Georgia	10.3%	7.7%	9.9%	5.2%	15.8%	13.2%	17.3%	10.8%	7.8%	5.5%
Hawaii	3.4%	6.4%	2.2%	5.1%	5.8%	7.5%	5.9%	8.2%	4.1%	6.3%
Idaho	6.8%	4.8%	5.5%	3.4%	10.3%	6.5%	9.7%	7.7%	6.7%	4.7%
Illinois	6.1%	8.6%	4.9%	6.9%	11.0%	15.0%	10.0%	14.0%	4.8%	6.8%
Indiana	7.2%	7.4%	4.4%	4.5%	12.9%	14.0%	9.3%	10.3%	6.7%	6.9%
Iowa	5.1%	4.9%	4.4%	3.7%	9.1%	9.3%	7.3%	7.5%	4.9%	4.7%
Kansas	5.6%	4.4%	5.0%	3.0%	10.7%	9.6%	8.6%	6.6%	5.1%	4.0%
Kentucky	5.5%	6.1%	3.2%	2.9%	9.2%	10.9%	7.1%	7.8%	5.2%	5.7%
Louisiana	4.4%	6.9%	4.1%	4.3%	6.6%	13.9%	5.0%	7.9%	3.7%	5.0%
Maine	3.6%	7.5%	3.6%	6.1%	6.1%	12.6%	4.4%	7.0%	3.5%	7.4%
Maryland	4.1%	7.5%	4.8%	6.1%	5.3%	10.9%	11.7%	12.1%	2.8%	5.4%
Massachusetts	5.0%	6.0%	3.5%	3.1%	11.8%	12.7%	14.4%	11.0%	3.9%	5.3%
Michigan	15.2%	6.2%	9.0%	3.6%	32.2%	12.5%	22.5%	7.7%	12.8%	5.4%
Minnesota	9.8%	4.6%	19.0%	6.0%	24.1%	9.8%	23.4%	7.2%	8.5%	4.2%
Mississippi	7.7%	8.9%	5.6%	6.3%	11.8%	16.3%	11.3%	9.3%	6.2%	6.5%

(Chart continued next page.)

Appendix 2: Completed Foreclosure and Serious Delinquency Rates by State and Race/Ethnicity, 2004-2008 Originations (Loan Status as of February 2012)
(Continued from previous page.)

State	Total*		Asian		African-American		Latino		NH White	
	Completed Foreclosure	Imminent Risk of Foreclosure								
Missouri	7.8%	4.7%	5.3%	3.0%	17.1%	11.1%	10.2%	5.9%	6.7%	4.0%
Montana	3.5%	3.4%	0.8%	3.9%	3.6%	4.4%	4.8%	4.7%	3.4%	3.3%
Nebraska	5.3%	4.0%	4.1%	2.4%	11.3%	10.3%	8.7%	6.2%	4.9%	3.7%
Nevada	19.0%	10.3%	25.0%	11.1%	20.2%	11.6%	25.0%	13.1%	16.8%	9.5%
New Hampshire	6.1%	4.6%	6.0%	2.6%	10.8%	7.6%	12.3%	6.6%	5.9%	4.4%
New Jersey	2.5%	10.2%	2.0%	8.2%	4.4%	16.7%	5.8%	17.5%	1.9%	8.4%
New Mexico	3.3%	5.7%	3.3%	4.8%	5.1%	7.9%	3.9%	7.8%	2.9%	4.5%
New York	2.2%	9.8%	1.8%	7.6%	3.9%	17.5%	4.0%	17.9%	1.8%	7.8%
North Carolina	4.5%	6.1%	3.1%	4.1%	7.6%	12.1%	6.2%	8.9%	3.8%	4.9%
North Dakota	2.1%	2.2%	1.4%	0.0%	4.4%	3.1%	1.7%	4.8%	2.1%	2.2%
Ohio	8.3%	8.2%	5.1%	4.9%	15.9%	15.9%	10.8%	10.1%	7.4%	7.4%
Oklahoma	5.3%	5.5%	3.5%	3.8%	8.6%	10.7%	6.6%	6.4%	5.0%	5.0%
Oregon	5.2%	5.5%	5.2%	4.8%	5.9%	7.7%	8.7%	9.4%	5.1%	5.3%
Pennsylvania	3.0%	6.4%	2.4%	4.6%	5.0%	13.2%	5.0%	11.3%	2.7%	5.5%
Rhode Island	7.5%	7.2%	10.0%	7.3%	15.2%	12.7%	15.9%	12.6%	6.1%	6.2%
South Carolina	4.8%	7.1%	3.8%	5.5%	7.4%	12.7%	7.1%	9.9%	4.3%	6.1%
South Dakota	3.8%	3.3%	4.1%	4.2%	7.7%	4.9%	3.3%	6.2%	3.7%	3.2%
Tennessee	6.9%	6.3%	5.0%	4.4%	13.1%	14.0%	9.3%	7.1%	5.8%	5.0%
Texas	6.5%	5.5%	4.8%	3.3%	13.0%	11.5%	8.3%	7.9%	5.0%	4.0%
Utah	4.9%	4.2%	5.2%	4.1%	7.3%	6.8%	8.2%	7.2%	4.6%	3.9%
Vermont	1.5%	5.2%	0.8%	4.7%	5.9%	8.1%	2.2%	10.1%	1.4%	5.1%
Virginia	6.6%	4.4%	10.1%	4.3%	7.5%	7.9%	22.2%	6.0%	4.6%	3.5%
Washington	4.2%	6.0%	5.4%	6.9%	6.3%	9.8%	6.7%	9.1%	4.0%	5.7%
West Virginia	6.0%	5.2%	8.8%	3.5%	11.2%	8.9%	18.4%	7.0%	5.6%	4.9%
Wisconsin	5.7%	5.4%	7.0%	5.9%	12.7%	13.7%	9.6%	8.9%	5.0%	4.7%
Wyoming	4.0%	2.4%	5.0%	3.4%	7.4%	5.3%	3.9%	3.1%	3.9%	2.3%

Note: Rates based on are based on the methodology derived in the CRL paper "Lost Ground: Disparities in Mortgage Lending and Foreclosures", updated to reflect loan status as of February 2012.

* Rates for "Total" also include borrowers from racial/ethnic categories that are not included in this table and borrowers for whom no race/ethnicity was listed.

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AUTO LOANS

The State of Lending in America &
its Impact on U.S. Households

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www.responsiblelending.org

AUTO LOANS

AN INTRODUCTION TO AUTO LOANS

Automobiles are one of the largest purchases American households will make, only behind the purchase of a home. For most households car ownership is not a luxury but a prerequisite to economic opportunity. Car ownership affects where people can live and significantly expands Americans' options for jobs. As a result, both the affordability and sustainability of auto financing are central concerns for most American families. As noted in *America's Household Balance Sheet*, in the last decade deleveraging of auto loans began as early as 2005. Many households relied on home equity to finance car purchases, and as that market disappeared, those families chose not to purchase a car at all or purchased cheaper vehicles. Households responded to deteriorating income situations by buying used cars instead of new ones and holding onto their cars for longer periods of time. These choices, however, have made families who did enter the market even more vulnerable to abusive auto lending practices as the pressure to increase revenue per sale grew.

Purchasing a car is a complicated endeavor with several moving parts. The sales price, the value of a trade-in, and financing are all separate and negotiable transactions. Any of these elements can have a significant impact on the vehicle's overall cost. When financing a vehicle, consumers have the option to either secure financing directly from a lender, or finance the car at the dealership. If a dealership finances the car purchase, the dealer earns revenue on the sale of the car itself (known as the "front end" of the transaction) and also on the financing and the related sale of add-on products such as extended warranties (known as the "back end" of the transaction).

The explosion of information about car prices on the internet has provided consumers with the ability to more effectively negotiate the sales price of the car. This, in turn, has caused a significant reduction in the profit margin dealers receive on the sale of cars. As such, dealers have come to rely heavily on profits generated after the sale of the car—most significantly from the finance and insurance (F&I) office. The F&I office is where the paperwork for the deal is generated, where the financing terms are offered, and where the sale of additional products such as extended warranties, credit insurance, guaranteed asset protection (GAP) insurance, vehicle service contracts, and the like are sold.

The same level of easily accessible information does not exist for financing options as it does for vehicle price information. Because loan pricing is based on individual risk, the only way for a consumer to compare prices on loans is to go through the loan application process. In the case of dealer financing, the consumer must virtually complete the sales and financing process—the consumer has to pick a car, negotiate the sales price, negotiate the value of a trade-in vehicle, and only then submit an application for financing. The complicated process often times suppresses a consumer's willingness to apply in several places to compare offers.

Access to credit is also a significant issue, and the risk of predatory lending is more acute for consumers with subprime credit scores. Consumers with high credit scores have multiple lenders in their communities offering to make loans to them. However, there are very few lenders with brick and mortar operations willing to make loans available to consumers with subprime credit scores. The auto finance community has admitted as much, stating that subprime consumers' access to credit is largely

online or through the dealer. This leaves subprime consumers to decide between applying for a loan over the internet with a lender the consumer has never heard of, or finance through the dealer.¹ In most cases, the consumer will choose the dealer. Our research and previous lawsuits have shown that subprime consumers often pay a hefty and unwarranted premium due to this dynamic.

The lack of transparency and regulation in auto finance has allowed different predatory practices to thrive throughout the years, creating more expensive and unsustainable loans for consumers. This is especially burdensome on those with subprime credit that have fewer financing options.

The lack of transparency and regulation in auto finance has allowed different predatory practices to thrive throughout the years, creating more expensive and unsustainable loans for consumers.

¹ Quote by Randy Henrick of Dealertrack, Inc., at *The road ahead: selling financing & leasing motor vehicles*, Federal Trade Commission (Roundtable 1, Session 2): “There’s hundreds of lenders online who are looking for subprime customers and make direct loans to customers. And it’s up to the consumer—if they want to do an internet search, they can find them.” See <http://www.ftc.gov/bcp/workshops/motorvehicles/>

MARKET AND INDUSTRY OVERVIEW

Types of Auto Dealers

There are three main types of auto dealers: franchise, independent, and buy here pay here (BHPH).

Franchise Dealers

A franchise dealer has an exclusive franchise to sell or lease a particular brand or brands of cars and trucks. These dealers often have a used car department as well, along with a full-service department (which the manufacturer requires in order for the dealer to perform warranty and recall service), parts department, and F&I office. As it relates to auto financing, franchise dealers typically enter into credit contracts that they sell to banks, finance companies, and credit unions within days of the transactions. Increasingly, franchise dealers are operating affiliated, but separate, Buy Here Pay Here dealerships.

Independent Dealers

Independent dealers are not affiliated with individual manufacturers, and thus are limited to selling used cars. Some larger independent dealers have service departments. Financing at independent dealers usually operates similarly to that at franchise dealers, although there are some dealers that are a hybrid of used-car dealer and Buy Here Pay Here dealer.

Buy Here Pay Here Dealerships

Buy Here Pay Here (BHPH) dealerships specialize in selling older, high-mileage cars to customers with weak or no credit standing. BHPH dealers don't typically sell their credit contracts, but rather retain them either in-house or in an affiliated finance company. BHPH transactions typically last less than two years, and the repossession rate is high—25 to 30% of BHPH deals end in repossession. 82% of BHPH customers have subprime credit scores (Zabritski, 2012c).²

This sector of the industry has seen an increase in market share due to declining credit scores and restricted access to credit. However, the financing is expensive, particularly considering that BHPH dealer vehicles typically are older, high-mileage cars with substantial retail markups. Most BHPH dealers do business as small independent operations. However, some larger chains, such as JD Byrider and DriveTime, have a multi-state presence.

²The used-car buyer at a BHPH dealer has an average 543 credit score, compared to 668 for used-car buyers overall.

Types of Auto Financing

Direct Loans

In a “direct” auto loan, the consumer applies for a loan directly with a lender. Ideally, if the consumer receives preapproval for a loan before shopping for a car, the consumer can take it to their dealer and use it as a guide for what cars might be options price-wise, or, more likely, use it as a negotiating tool for dealer financing.

Dealers would rather handle financing for their customers. If the dealer controls the financing and has the ability to adjust the terms of that financing, then the dealer has more opportunity to sell and finance additional insurance or warranty products. As such, even if a consumer has financing in hand, the dealer will try to find a way to convince the consumer to opt for dealer financing, which increases the profit potential in the deal.

Indirect Loans

Auto financing through the dealer is commonly referred to as “indirect financing,” but is actually a credit transaction directly financed by the dealer. Auto dealers describe their role in the transaction as merely an arranger, but that depiction vastly understates the dealers’ role and responsibility. Unlike loan brokers in other contexts who are not considered creditors, the dealer is the creditor in virtually all car-lending transactions. While the dealer plans to sell the finance contract quickly after the deal is final, the dealer is party to the finance contract.

The dealer does not want to retain ownership of the retail installment sales contract and collect payments into the future. Dealers have to borrow money to pay for the cars they keep on their lot (known in the industry as “floorplan financing”). Since the dealer must pay back the floorplan lender when a car is sold, the vast majority of dealers elects to sell the retail installment sales contract to a third party, such as a finance company, bank, credit union, or other investor.

A borrower purchasing and financing a car through the dealership will first meet the salesperson. The salesperson is the dealership employee who negotiates with the consumer on the price of the car and optional equipment on the car, along with the value of any vehicle to be traded in. Then, the consumer is sent to the F&I office (which can also be referred to as the business office) to complete the paperwork, negotiate the terms of the financing and discuss any additional insurance and protection products.

To facilitate the process, the salesperson will often collect the information needed to determine financing terms before the consumer actually talks to the F&I office. While the consumer is negotiating with the salesperson, the F&I employee communicates with lenders who may be interested in buying the loan. When a consumer applies for credit with the dealer, the dealer sends the consumer’s financial information to one or several potential lenders. Interested lenders then respond to the dealer with offers to purchase that contract, specifying the minimum interest rate and the specific conditions and terms that the lender will require to purchase the loan.

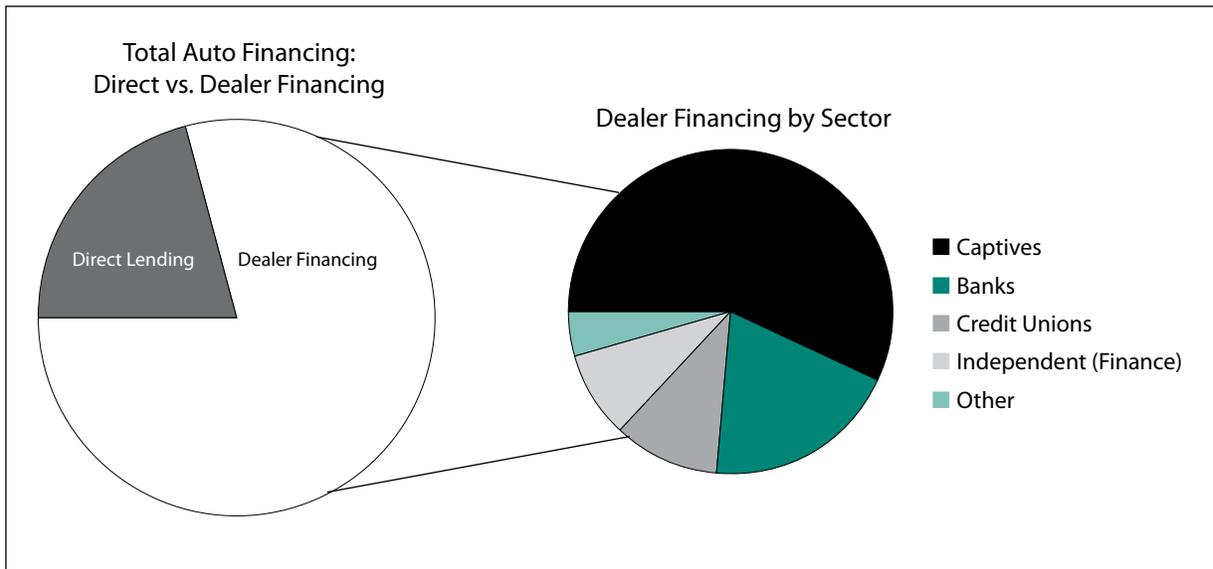
As mentioned earlier, there are many different elements involved in a car purchase transaction, and most of them are presented in the F&I office after the consumer has already been through a lengthy sales process. The length of the loan, the amount of the down payment, whether to include add-on products and the cost of those products, along with the interest rate, are all subject to negotiation.

A common mantra for F&I managers is that all customers should be presented with every product for which they qualify (Eleazer, 2011). What that means for the consumer is that the F&I representative will likely present the consumer with dozens of insurance, extended warranty, and “protection” products, about most of which the consumer is uninformed. For instance, an extended warranty alone has pages of disclosures detailing which components of the car are covered and under what circumstances, along with different deductible levels and length of coverage. A consumer is pressured to decide whether the product is worthwhile in a matter of minutes and what options to take, and then is presented with several other products for consideration.

This magnifies the impact of the consumer’s level of financial savvy on the cost of the overall transaction. Data show that customers acquiring financing outside the dealership are more likely to negotiate the price of a new car and the value of the trade-in vehicle.³ Consumers without the ability to negotiate, especially subprime customers with few, if any, other financing options, often are at the mercy of the dealer (Apgar & Calder, 2005). **We found that consumers who indicated that they trusted their dealer gave them the best rate available paid between 1.9 and 2.1 percentage points more in APR, after controlling for credit risk, than those with a more skeptical outlook** (Davis & Frank, 2009).

The majority of indirect loans are sold to captive finance companies, which are the lending arms of auto manufacturers. However, other finance arms have significant market share, as depicted in Figure 1: The graph also illustrates that dealers also overwhelmingly control the financing market for cars—80 percent of cars financed in the United States are financed through the dealer. This dynamic, coupled with a severe lack of regulatory oversight in auto finance and the perverse incentives that have developed, created a system where the competition is between lenders to place their loans with the dealer, rather than incentives for the dealer to find the best deal for the consumer. As the number of lenders and overall lending volume has decreased since the depths of the recession, this dynamic has shifted some, but certainly not on a permanent basis.

Figure 1: Auto Financing by Lender Channel



Source: Richard Howse, How Different is the Indirect Channel from the Direct Channel?, JD Power & Associates, Mar 31, 2008. Note percentages based on loan volumes for franchised dealers only.

³ CNW Marketing Research, Document 1237: *Haggle over new-vehicle price/trade-in value* (CNW, 2010a). In 2010, people financing through the dealership haggled 48.2% of the time, compared to 66.1% of people acquiring financing elsewhere. Both figures have steadily increased over the past decade.

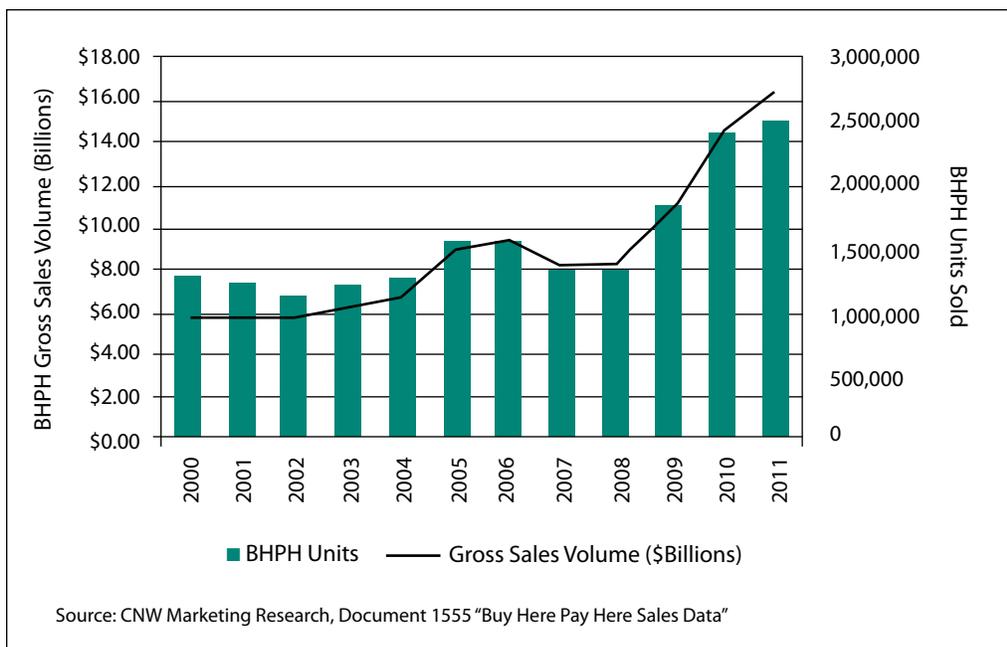
Buy Here Pay Here Dealerships

As previously stated, Buy Here Pay Here (BHPH) dealerships specialize in selling cars to those with blemished credit or no credit history. As of 2nd quarter 2012, 88.3% of BHPH customers are considered subprime (Zabritski, 2012b). This sector of the industry has been gaining market share because of declining credit scores and the tightening of credit caused by the recent recession. Further, franchise dealers and private equity funds are investing in this sector, which was not the case in the past (Bensinger, 2011). The financing at BHPH dealerships is fairly expensive, and the vehicles they sell are older, high-mileage cars sold at a substantial price markup (Carmichael, 2011). Many BHPH dealers do business as small independent operations. However, there are larger chains like JD Byrider and DriveTime that have a multi-state presence. A growing percentage (4.3%) of traditional franchise dealers also has a BHPH operation within their larger company.

The quality of the car is second to the BHPH dealer’s focus on payments and collections. The vehicles sold are seen more as avenues to sell loans. As one industry official put it, “Success in BHPH is about managing portfolio risk and not buying and selling cars.”⁴ There is much more emphasis placed on the ability to repossess the car immediately upon non-payment, especially considering the extremely high default rates endemic in the BHPH market.

Most BHPH dealers do not post prices on the cars on the lot. The dealer first assesses what kind of weekly or biweekly payment the consumer can be expected to pay. Then the consumer is told which car or cars are available to them and the price is set (Taylor III, 2010). BHPH dealers also routinely use devices that prevent the engine from starting or a device that tracks the car’s whereabouts using GPS when the consumer misses a payment. These devices increase the dealer’s ability to repossess cars from delinquent borrowers. Currently, 7 out of 10 BHPH dealers indicate that they install these devices on every vehicle they sell (National Alliance of Buy Here Pay Here Dealers [NABD], 2011b).

Figure 2: Buy Here Pay Here Sales and Volume



⁴ Ken Shilson, Founder of the National Alliance of Buy Here Pay Here Dealers, Points for franchised dealers to consider before entering BHPH space, *Subprime Auto Finance News*, January 18, 2012. (Shilson, 2012b).

Auto Sales and Finance Volume

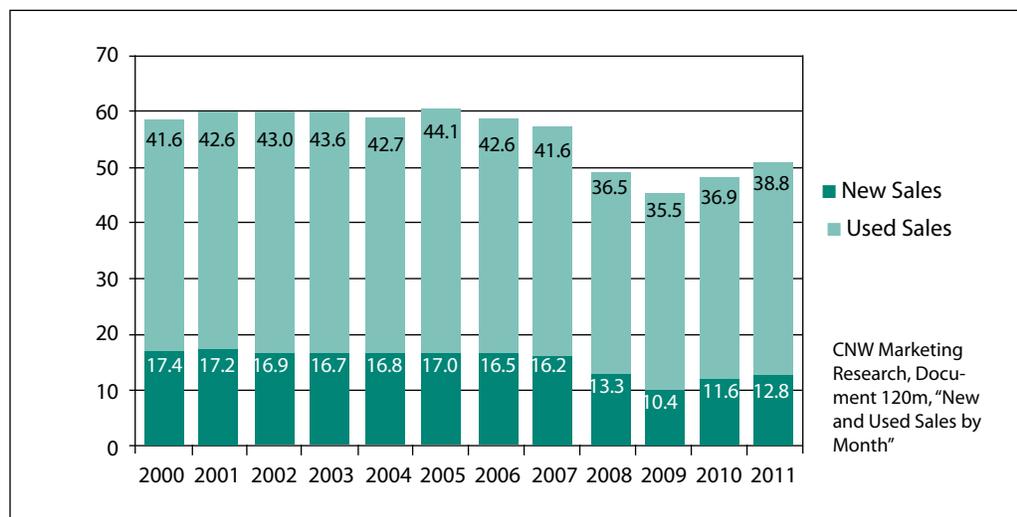
Auto sales and financing declined dramatically prior to and during the recession. Sales of new and used cars dropped 25 percent between its peak in 2005 and its low in 2009. Lending volumes have also decreased during the recession (CNW, 2012). Other forms of lending have also disappeared—before the crisis, at least one in every nine car sales used a home equity loan as a financing vehicle.⁵ This practice rapidly waned after foreclosures reached record highs and home values plummeted (Dash, 2008).

Recently, lending is increasing due to loosening underwriting requirements, significant increases in outside investment in auto lending companies and securities, and the resulting lenders' willingness to assume more risk (Rao & Warlick, 2012).⁶ However, this increased risk includes allowing higher loan-to-value ratios and longer loan terms (as long as 8 years). **The higher loan-to-value ratios allow lenders to finance an increasing number of add-on products, and the longer loan terms allow a dealer to artificially lower a consumer's monthly payment. These practices present significant risk to borrowers.**

Subprime auto lending, which all but vanished during the recession years, has also slowly regained market share (Zabritski, 2012b). Manufacturers offering greater cash incentives to reduce the price of cars, and relative pent-up demand from consumers who waited to replace cars resulted in an increase in sales. As of May 2012, balances among existing auto loans surpassed \$740 billion, representing a 34-month high and a \$43.1 billion increase from the previous year (Equifax, 2012).

Among different credit tiers, deep subprime has the slowest return of available lenders competing for business, which keeps rate pricing relatively high. Larger BHPH chains like JD Byrider and Drive Time report an average credit score of 550 and below for their customers.

Figure 3. U.S. Unit Sales, New and Used in Millions



⁵ CNW Marketing Research, *New sales with home equity loans*, Document 1359 (CNW, 2010b). In 2007, 11.77% of new cars were financed with home equity loans. In 2010, only 4.44% were financed through home equity.

⁶ During the 2nd quarter 2012 Federal Reserve senior loan officer survey, 23% of banks loosened application standards for consumers seeking auto loans that quarter.

Secondary Market Volume by Year

Auto lenders have not relied on the secondary market to the same extent that mortgage lenders have historically. As lenders tightened credit to avoid risk, investors also were slower to put money into auto loan asset-backed securities (ABS). Auto ABS issuance was cut in half between 2006 and 2007. Auto loan ABS, however, has grown considerably in the past two years. Subprime auto loans alone have accounted for 24% of auto ABS issuance in 2012 (Henry, 2012b), up from 4% in 2008 (Martin, 2011). Private equity investment in subprime auto finance companies, along with increased investor appetite for ABS to replace mortgage-backed securities (MBS) in their portfolios has fueled this increase (McNally & Snailer, 2012).

Analysts believe that auto ABS issuances will continue to rise toward pre-recession levels due to a boost in auto sales, the return of subprime financing, low interest rates, and relatively low delinquency rates compared to other assets like mortgages (Williams, 2012). However, analysts from Moody's have recently expressed caution that the current subprime market "is exhibiting some characteristics last seen during the early- to mid-1990s, when overheated competition led to poor underwriting and drove unexpectedly high losses that put many smaller lenders out of business" (McNally & Snailer, 2012).

Figure 4. Auto-Backed Securities Volume in Billions

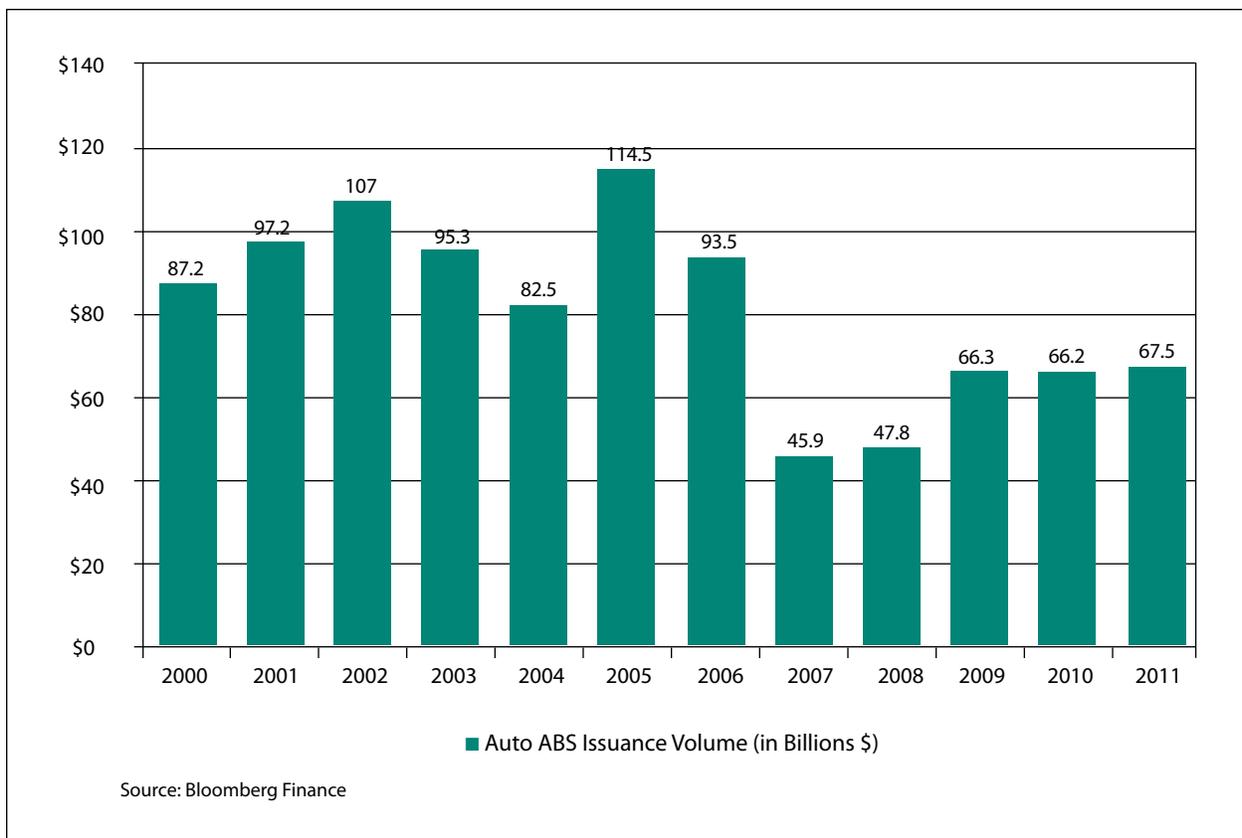
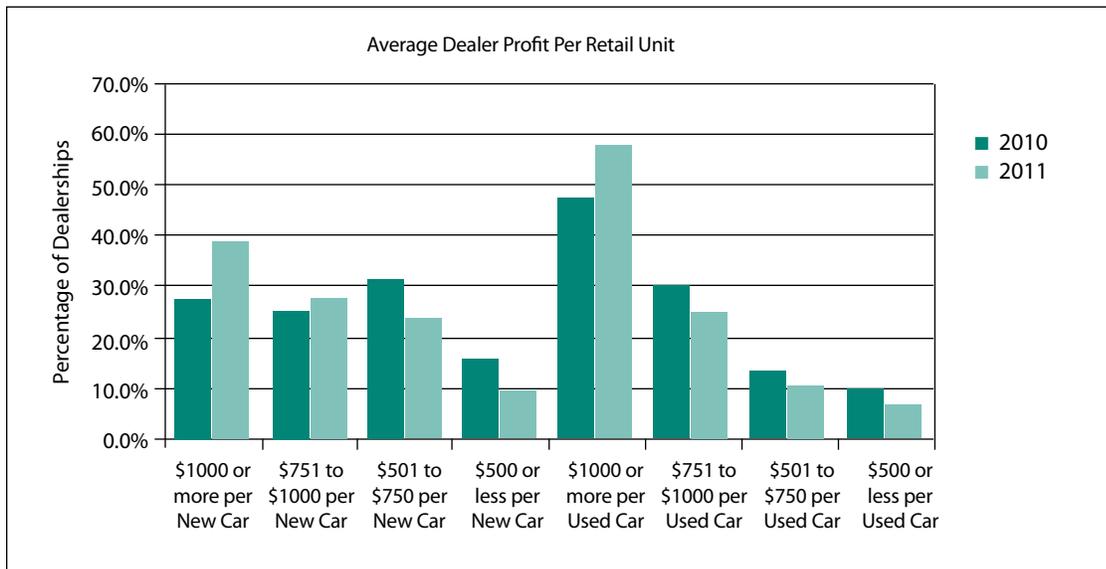
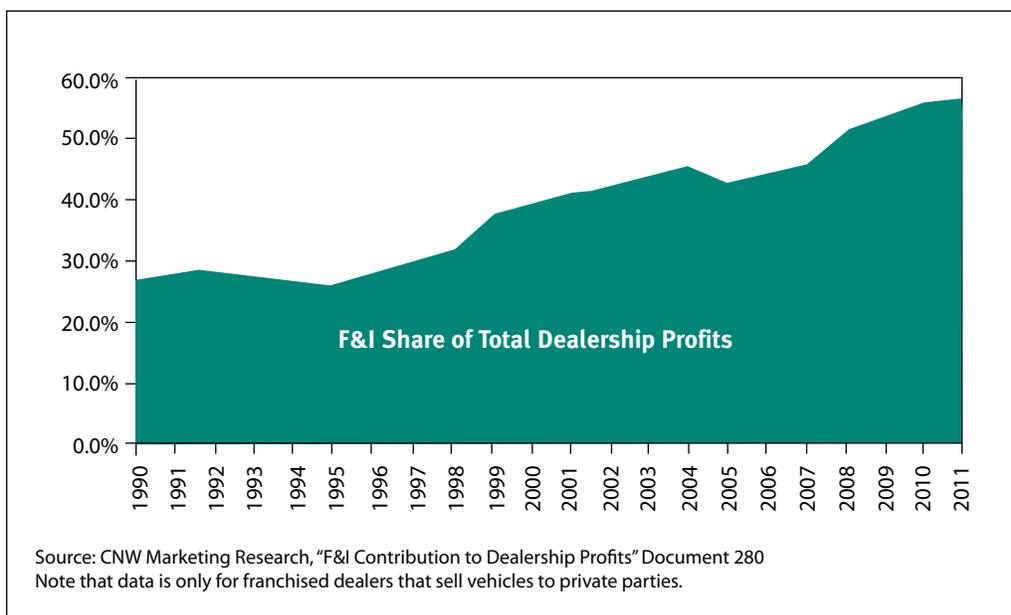


Figure 5. Lender Reliance on Finance and Insurance



In recent years, consumers have greater access to information that allows them to more effectively negotiate the sales price on a car. Consumers can now find information on what a dealer paid for a car, the average selling price in the consumer’s local area, and available incentives and rebates. The increased negotiating power for consumers, plus declining auto sales during the recession, shifted dealer’s reliance from sales to finance and insurance to maintain revenue streams. Gross margin on new vehicle sales has fallen from 5.9% to 4.57% between 2001 and 2011, whereas aftermarket income gross profit and the percentage of consumers buying service contracts increased by almost 10 percentage points during the same period (National Auto Dealers Association, 2012, p.10). **Currently, over half of all profit coming from franchise dealer sales are generated at the F&I office.**

Figure 6. F&I Share of Franchise Dealer Profits



LENDING ABUSE AND PREDATORY PRACTICES

Nearly eighty percent of financed auto sales are financed through the dealer, which effectively gives dealers control over lenders' access to this market (Howse, 2008). The decline in sales over the past five years, coupled with decreasing profit margins on the sale of the cars themselves creates increased pressure on dealers to make up revenue through selling financing and add-on products.

Dealer Rate Markups

In indirect loans, the interest rate that the lender interested in purchasing the loan is willing to accept is called the "buy rate." Lenders also typically allow the dealer to increase the interest rate and keep some or all of the difference between the buy rate and the rate ultimately offered to the consumer. This practice is referred to as "dealer reserve" or "dealer participation." Some lenders offer a flat fee for compensation, particularly in zero-percent incentive promotions. Some lenders cap the amount of dealer interest rate markup, while others allow unlimited markups.

The dealer's ability to mark up the interest rate for its own gain creates a perverse incentive for the dealer to push the consumer into the most favorable loan for the dealer, rather than one that provides the lowest cost for the consumer. The dealer's incentive to create profit through higher interest rates creates an environment of "reverse competition" where lenders are competing for the business of the dealer, not the consumer. It also tilts the playing field against certain lenders (such as credit unions and smaller community banks) that are not willing or able to be aggressive in providing dealer discretion on interest rates. Lenders must compete for a dealer's business by offering larger interest rate kickbacks and incentives, or be willing to be more flexible on underwriting to approve deals faster.

Nationwide, consumers who purchased cars in 2009 paid \$25.8 billion in additional interest due to the dealer's markup of the rate. The average rate markup was 1.01 and 2.91 percentage points for new and used cars, respectively. Data also show that rate markups are significantly correlated with subprime lenders and with higher odds of default and repossession (Davis & Frank, 2011). For example, borrowers with a loan from a subprime finance company that includes an interest rate markup are 33% more likely to lose their cars to repossession. And, consumers are largely unaware of this practice, as 79% of consumers surveyed in North Carolina were not aware dealers could mark up rates without their consent.⁷

Yo-Yo Scams

The yo-yo scam occurs when a consumer is led to believe that their financing arrangement is final or as good as final. The yo-yo scam occurs when, days, weeks, or months later, the dealer asserts the ability to cancel the deal because the dealer decides that none of the offers from lenders to purchase the finance contract are acceptable. Yo-yo scams are possible because of the pervasive "spot delivery" practice where dealers allow consumers to take possession of the car even when the financing is not final. Then, if the dealer cannot meet the lender's terms to purchase the loan, or if the dealer decides that the offer to purchase the loan is insufficient, the dealer asserts the ability to cancel the deal and force the consumer to sign a new loan contract.

⁷ Public Policy Polling survey administered January 15-18, 2010. Findings state that 79% of 494 surveyed respondents, all located in two North Carolina counties, were not aware that dealers have the ability to mark up interest rates.

Frequently, the dealer states that “the lender” has changed its mind and will not finance at the rate or with other terms promised. What has really happened is the dealer has chosen to ignore that it is the creditor and that there is a signed contract with the consumer. Instead, the dealer is shifting the risk of a bad deal completely on the consumer, even though the dealer is in the best position to know whether the risk is too great to allow the consumer to leave the lot with the car.

When the dealer asserts the ability to unilaterally cancel the transaction, this allows the dealer to engage in riskier or deceptive behavior. For instance, the dealer can offer an interest rate that the dealer knows it may not be willing or able to actually provide without the risk of suffering a significant penalty. Instead, the dealer forces the consumer to either agree to a different interest rate or loan terms or return the car to the dealer.

Further, this practice reduces competition and violates the spirit of the Truth in Lending Act (TILA). TILA requires that lenders provide borrowers with the terms of a credit offer so that the borrower may shop effectively between lenders. When a dealer promises a certain interest rate, the consumer relies on that interest rate when deciding whether to shop for additional credit offers. As an industry insider stated recently, “Many stores spot-deliver vehicles based on credit scores and deal structure for the sake of time. The goal is to take the customer out of the market as soon as possible to seal the deal, so the customer is asked to sign an immediate delivery agreement form outlining the deal. We can always re-contract if needed, right?” (Eleazer, 2012)

The dealer may also refuse to return the consumer’s trade-in or down payment, which increases leverage against the consumer. The dealer may also threaten to charge the consumer fees for use, wear and tear, or other items on the new car purchase. In some cases, the dealer may threaten the consumer with prosecution for auto theft if the consumer does not immediately return the car to the dealer. Under this significant pressure, many consumers agree to the new terms.

Research has shown that *low-income* (Davis & Frank, 2009) and *poor-credit* (Davis, 2012) borrowers are much more subject to yo-yo sales. **Consumers involved in yo-yo scams receive interest rates 5 percentage points higher than those that are not.** Those caught in a yo-yo have a difficult time reclaiming their down payment or trade-in, and end up settling for a more expensive deal than the original one they agreed to (Davis, 2012).

Loan Packing

Outside of the sale of the car itself, F&I staff routinely market a litany of add-on products. Products such as vehicle service contracts, GAP insurance (insurance that covers the period when the car is worth less than the amount owed under the loan), credit life and disability insurance, theft deterrent systems, and vehicle upgrades and accessories are often sold bundled as packages advertised in terms of their impact on the monthly payment rather than the overall cost of the car. Marketing add-on products based on their monthly payment versus its overall cost makes expensive products seem less so and are effective in drawing the consumer's attention away from the total cost of the deal. In addition, the prices of add-on products are significantly marked up from their wholesale cost. According to several franchise executives, add-on product sales are more popular revenue streams since the profit margins on car sales are declining and interest rate markups are under higher regulatory scrutiny (Henry, 2012a).

Service contracts, typically the most commonly sold product, can be marked up at by at least 100% or more,⁸ and cost consumers on average \$1,790 per sale (Ly, 2009). Third-party lenders may develop their own add-on products, and create incentives for dealers to pack them into financing. For instance, some lenders will allow a higher loan-to-value ratio if the loan includes that lender's GAP insurance, but will limit the loan-to-value ratio if another vendor's GAP insurance is sold. In more egregious cases, the purchase of some add-on products is falsely represented as required by the lender in order for the loan to be approved.

The average penetration rate during the first three quarters of 2011 was 46% for vehicle service contracts and 34.9% for GAP insurance. Both are increases from the same period in 2010, where the rates were 35% and 32%, respectively (Arroyo, 2012). African-Americans and low-income buyers disproportionately receive overpriced add-on products (Davis & Frank, 2009).

Rolling Negative Equity

“Underwater” consumers owing more on their car than what it is worth are often tempted to roll in their current car's unpaid loan or lease balance into the financing of a new car. Currently, 28.9% of consumers are underwater in their vehicles, and have on average \$4,250 of negative equity in their trade-in (Apicella & Halloran, 2008), putting them in a weaker negotiating position with the dealer. A dealer may promise to pay off the trade-in vehicle's loan while only rolling that balance into the new car loan (Howard, 2008). Just recently, the FTC took enforcement action against four dealerships falsely advertising they would pay off negative equity from a trade-in toward a new car purchase, while actually rolling it into the new car payment (Federal Trade Commission, 2012).

Dealers have several methods to roll negative equity into the financing of a new deal while still keeping monthly payments manageable, including increasing the length of the loan term, or using a manufacturer's rebate to mask the negative equity. Prior study has found that consumers tend to be “myopic” with their car purchases, preferring loans with lower monthly payments even if it means higher total costs (Dasgupta, Siddarth, & Silva-Risso, 2007). As a result, in March 2012, 30.1% of retail sales included loan terms of at least 72 months, up from 24.6% at the same time in 2011, which increases the likelihood of owing more on the loan than the car's value is worth (Overby, 2012).

Buy Here Pay Here Dealerships

Buy Here Pay Here dealerships cater to the subprime borrower that cannot secure financing from traditional lending sources. Traditionally, BHPH dealers make, hold and service all of the loans they finance in-house, and require their customers to pay in-person at the dealership. BHPH dealers typically sell older used cars with APRs around 25%. The cars themselves may be sold at a sales price nearly double what the dealer paid for it wholesale (NABD, 2011a). The dealer usually requires a large down-payment from the consumer and a weekly payment. The dealer's initial investment in the car is recouped within the first year. However, BHPH dealers are known for quick repossessions to recover their collateral at the first sign of delinquency. As one BHPH advisor put it, “collections is the single most important process with the most direct effect and instant impact on whether you are successful or not as a BHPH dealer” (Heasley, 2012). Market data shows that 1 in every 5 BHPH car loans will default, and over 50% of all BHPH loans do not pay out to maturity (Shilson, 2012a).

⁸ Quote by Phil Reed, editor at Edmunds.com. Interview by Lucy Lazarony, *Beware of the extended warranty add-on*, Bankrate.com, January 11, 2005 (Lazarony, 2005).

After repossession, the dealer can simply sell the car again to a different consumer. The ability to repossess the car is enhanced by recent technology that can track the car's whereabouts by GPS and shut off the engine for non-payment. This creates a “churning” effect where the same old, yet expensive, cars are repurposed to the same borrowers that have few real options for affordable auto financing. A recent article found that one in eight used car dealers in California sold at least one vehicle three or more times (Bensinger & Frank, 2012).

Figure 7. Buy Here Pay Here Loan Characteristics and Performance

	2006	2007	2008	2009	2010	2011
Number of Weekly Payments	131	134	129	132	134	135
Average Weekly Payment	\$82	\$85	\$84	\$84	\$85	\$86
Amount Financed	\$8,844	\$9,085	\$9,195	\$9,294	\$9,380	\$9,427
APR	25.1%	28.3%	24.5%	24.4%	25.6%	25.6%
Cost Per Vehicle to Dealer (incl. reconditioning)	\$4,949	\$5,111	\$5,284	\$5,534	\$5,458	\$5,466
% Vehicle Sale Markup	78.7%	77.8%	74.0%	67.9%	71.9%	72.5%
Average down-payment	\$900	\$1,018	\$1,089	\$1,040	\$1,059	\$959
Most frequent month of default after origination	Month 5	Month 4	Month 4	Month 4	Month 4	Month 5
% Loans Written Off	26.2%	27.7%	28.4%	30.1%	30.4%	31.0%
% Past Due Accounts in Collection	20.0%	19.0%	21.0%	20.0%	18.0%	21.0%
% Written Off and Delinquent Loans	46.2%	46.7%	49.4%	50.1%	48.4%	52.0%

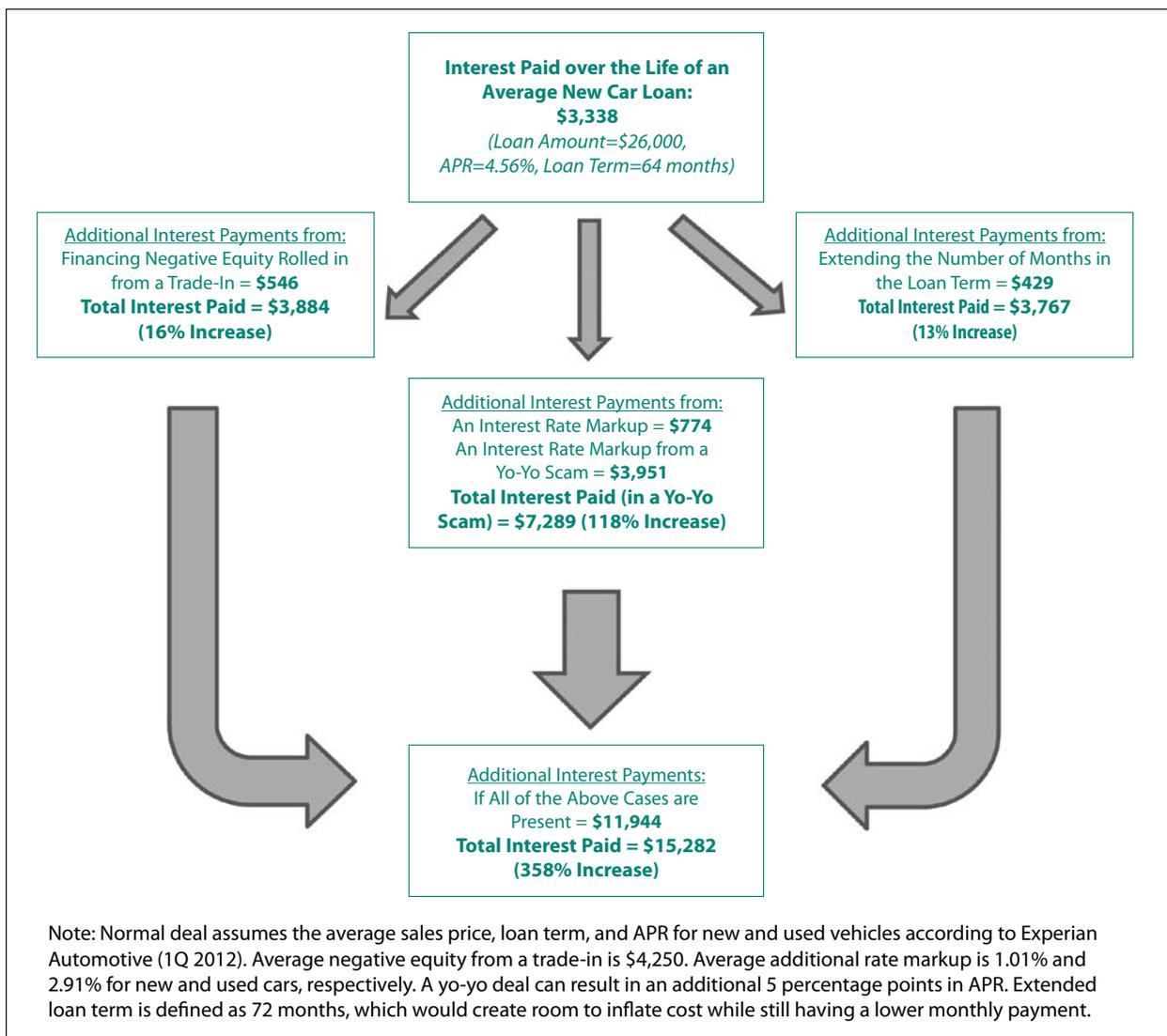
Source: Subprime Analytics/National Association of BHPH Dealers

IMPACT ON US HOUSEHOLDS AND REMAINING CHALLENGES

Cost of Abusive Practices

Each abusive practice in auto finance has its own cost to the consumer. Further, there may be more than one in play on a particular deal, creating a cumulative effect. An uninformed consumer could be charged a higher interest rate than necessary, sold several overly expensive add-on products that do not provide value, and perhaps be vulnerable to a yo-yo scam. The dealer might also extend the loan term to 7 or 8 years to artificially lower a consumer's monthly payment so that the outstanding balance of the loan owed on the consumer's trade-in can be included in the loan. The table below shows the additional interest paid based on figures for an average new car deal. The amount of interest paid over the course of the loan triples if it finances negative equity, has interest marked up in a yo-yo scam, and stretches the loan term to create a lower payment. Note that this example does not include extra costs associated with loan packing.

Figure 8. Additional Interest Payments in a Hypothetical Auto Deal



Subprime Markets and Borrowers

Consumers with credit scores considered prime can find many lenders willing to make loans to them. For those consumers with blemished credit or without a significant credit history, finding a lender is difficult. There are few mainstream institutions that make loans to consumers with low credit scores. The consumer faces a difficult decision, either take a loan from a lender over the internet with whom the consumer has no relationship, or trust the dealer to find financing for them. Our research, both statistical and anecdotal, finds the latter to be the case most of the time. The path a subprime consumer takes to acquire financing deserves attention if there are incentives for the industry to exploit their lack of options with predatory products and practices.

During the recent recession, lenders tightened lending criteria, essentially filtering subprime borrowers out of the traditional market. For the subprime consumer, fewer than one in five were approved for financing as of mid-2009 (Reed, 2009). With many mainstream auto lenders pulling back, many subprime customers were drawn toward finance companies and BHPH dealerships that specialize in selling to customers with impaired credit. Even with financing slowly regaining footing over the past year, many consumers are not confident about their financing options. Nearly two-thirds of consumers surveyed believed it would be just as difficult, if not harder, to obtain an auto loan in 2012 than it was in 2011 (Majority, 2012). As a result, BHPH dealerships gained market share during the recession, as consumers are more credit-challenged and may not believe that they can secure financing elsewhere (Briggs Gammon, 2008). Currently, more than 10 percent of car loans are made by BHPH dealers (Zabritski, 2012a).

Figure 9. Auto Loan Market Share by Credit Tier

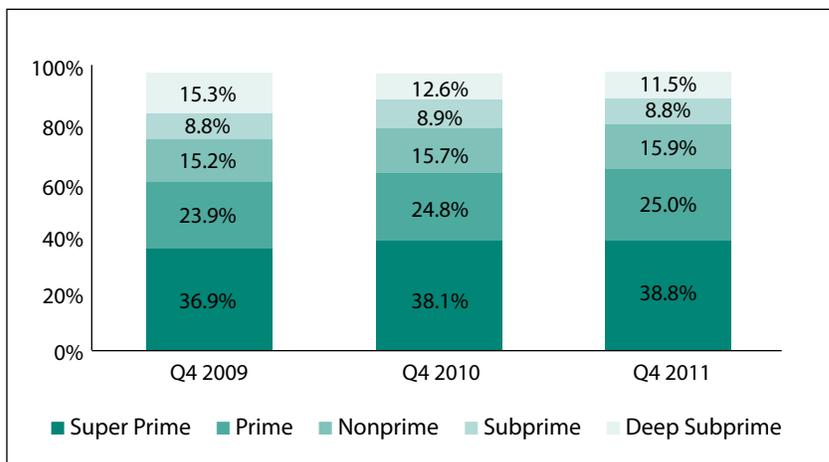
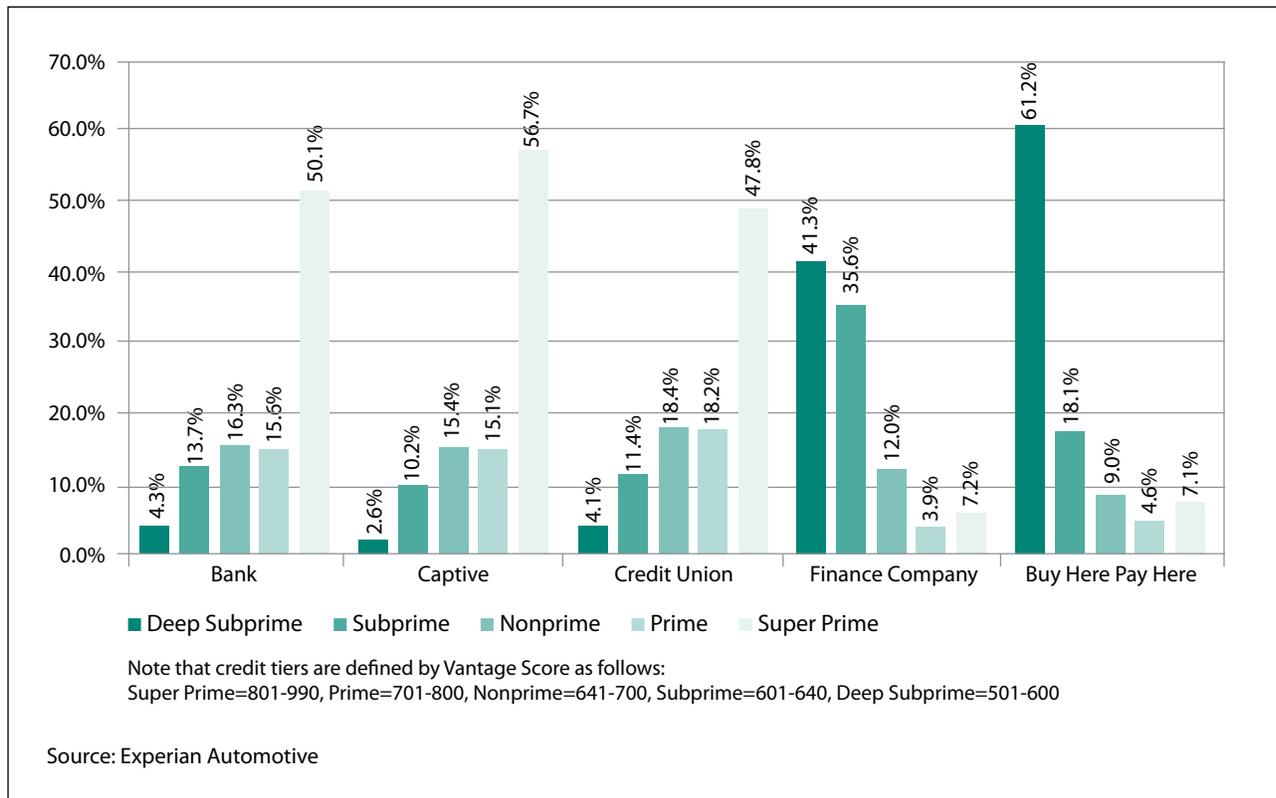


Figure 10. Credit Tier by Auto Lender Type – 3rd Qtr 2012



Delinquency and Repossessions

Like most installment debt, delinquency and repossession rates for auto loans had reached record highs during the recession. Since then, default rates have stabilized more for auto loans than for mortgages and credit cards. A recent study found that consumers are now more likely to pay their car payment before they pay their mortgage or credit card (Blumberg, 2012). However, delinquency rates for auto loans should be viewed very differently from mortgage delinquencies. Many consumers have placed a higher importance on their car for access to their community and employment. Additionally, the foreclosure process allows more time to work with servicers to retain a home than a car if the consumer becomes delinquent.

The auto repossession process is much faster than a home foreclosure process. Most lenders start the repossession process once the consumer is 60 or 90 days past due, and then take between five or six weeks to reclaim the car. In contrast, the foreclosure process can take more than a year on average. This means that delinquent mortgage loans stay on the books far longer, while delinquent auto loans are out of the portfolio fairly quickly. If the auto repossession process were more like the foreclosure process, the equivalent repossession rate would likely be much higher. As such, a skeptical view of the performance of auto loans compared to mortgage loans is warranted.

Figure 11. Comparative View of Foreclosures and Auto Repossessions

A) Average time to process a home foreclosure	378 days
B) Average time to process a car repossession	37 days
C) Auto repossession rate 2Q 2012	0.43%
D) Mortgage foreclosure rate 2Q 2012	4.27%
Auto repo rate if equivalent to foreclosure process time = (A x C)/(B)	4.39%

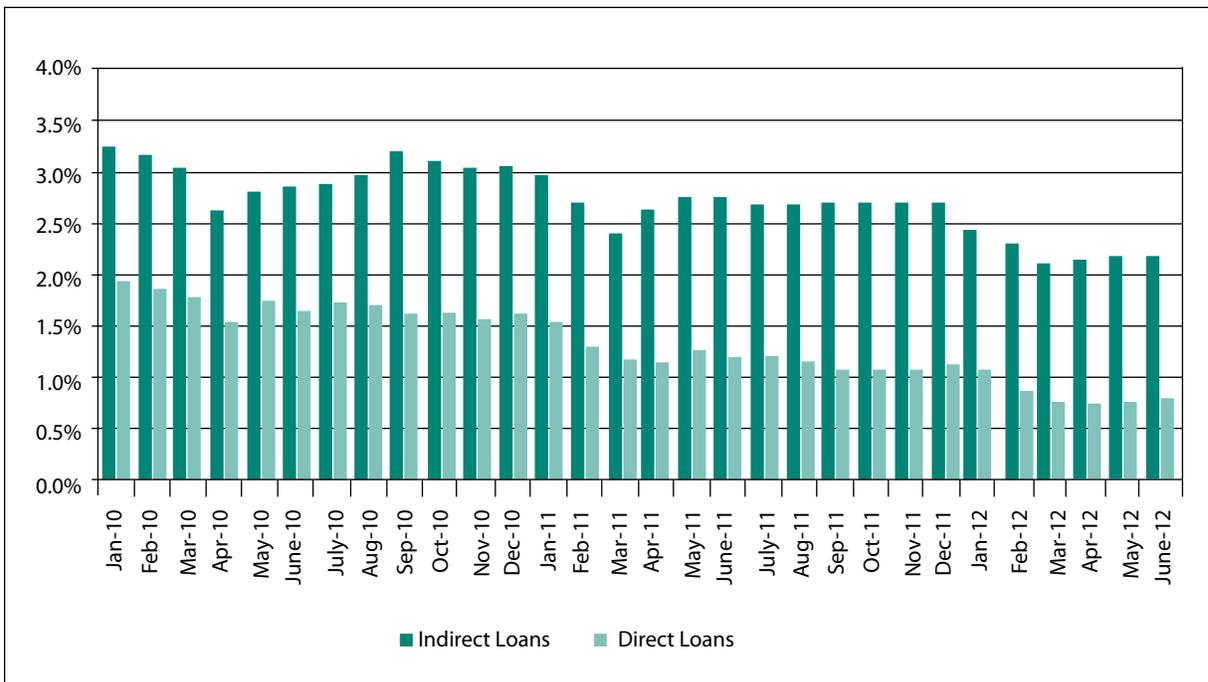
Sources: RealtyTrac (Foreclosure process time), CNW Marketing Research (Repo process time), Mortgage Bankers Association (Foreclosure rate), Experian Automotive (Repossession rate).

We should also note that there is a noticeable difference between delinquency and repossession rates of indirect auto loans arranged by dealerships versus direct loans. In recent months, the delinquency and repossession rates for indirect loans are double and triple the rates for direct loans. Some of this may be explained by differences in the amount of risk each sector is willing to assume. However, predatory practices could also be an explanation for the disparity, as **our research has shown a significant correlation between defaults and rate markups that happen with indirect financing.** With subprime lenders, rate markups cause a 12.4% increased odds of 60-day delinquency, and a 33% increased odds of cumulative loss (Davis & Frank, 2011).

Also, research has shown that the self-help repossession process that car lenders use to regain their collateral when a borrower misses payments is a dangerous undertaking. Unlike a home foreclosure, no judicial officer or law enforcement is involved in the repossession of a car. The lender decides when and how the car will be recovered. As a result, episodes of violence have occurred, including between competing repossession agents (Van Alst & Jurgens, 2010).

Auto Loan Performance

Figure 12: 30-Day Delinquency Rates, Direct and Indirect Loans



Auto Loan Performance (continued)

Figure 13. Repossession Rates per 1,000 Outstanding Auto Loans, Direct and Indirect Loans

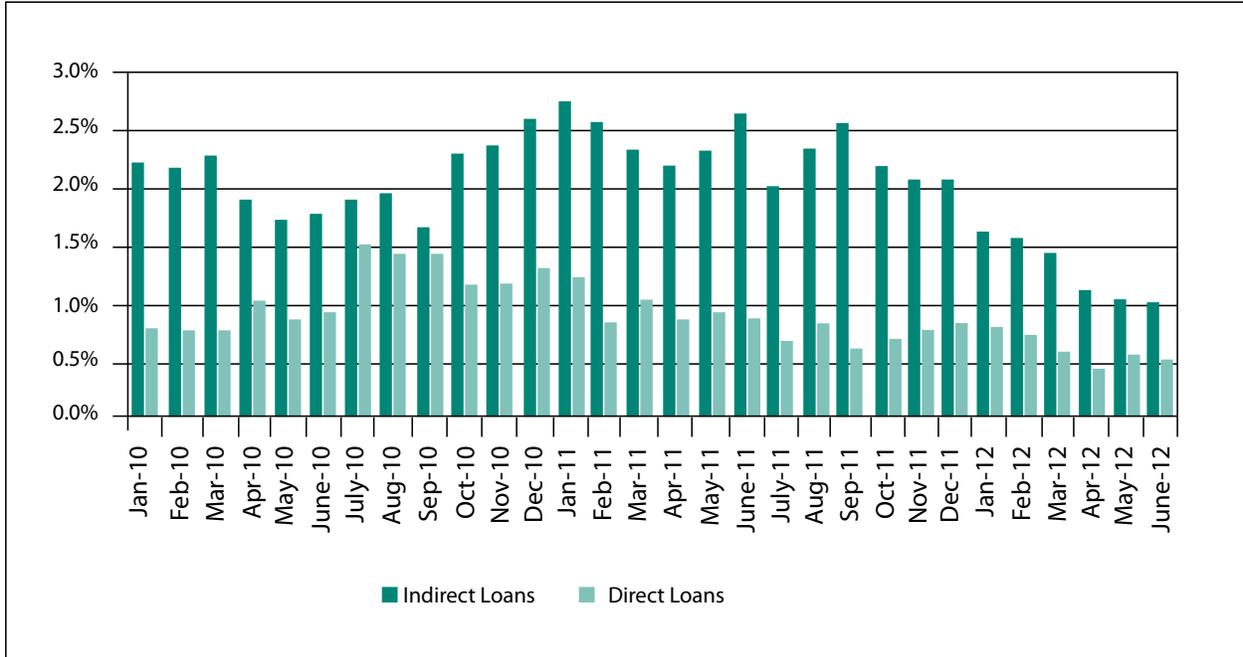
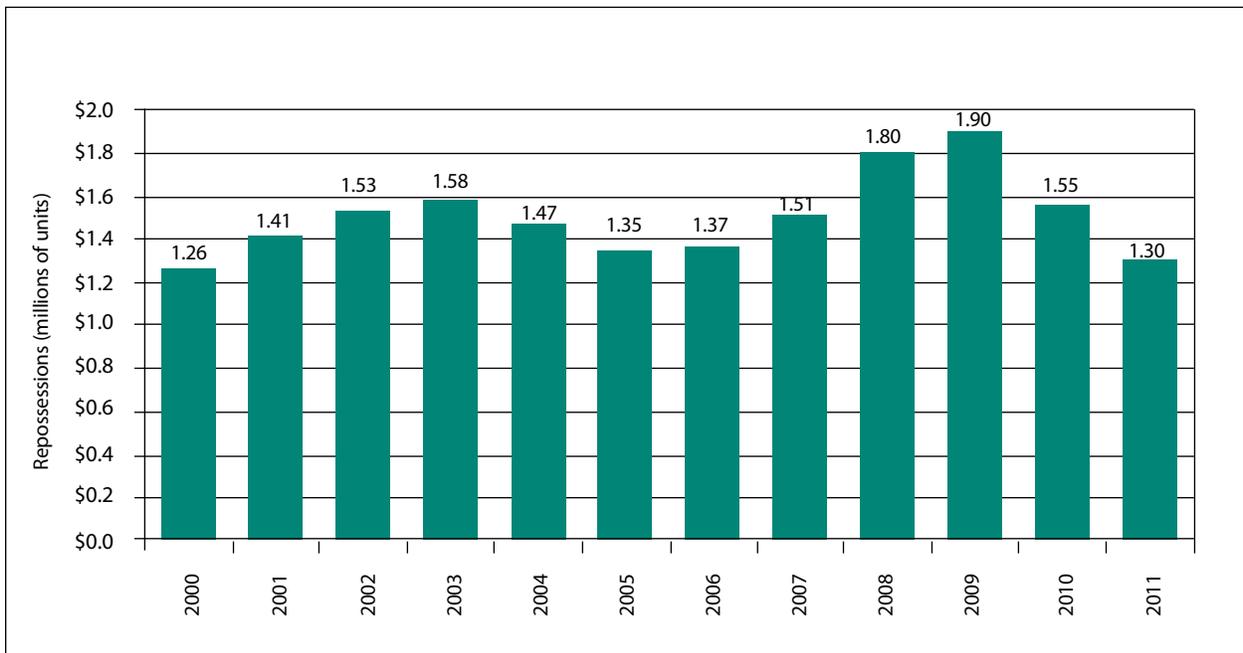


Figure 14. Repossession Totals



LEGISLATION AND REGULATION

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act created the Consumer Financial Protection Bureau (CFPB) to oversee financial institutions and practices, including some aspects of car lending. This Act streamlined consumer protection authority that before was spread among several federal agencies. The Dodd-Frank Act created a bifurcated regulatory system, largely due to the lobbying efforts of the franchise car dealers. The Act exempts dealers that routinely sell or lease cars, sell that financing to unaffiliated third-parties, and that have a service department, from CFPB enforcement or supervisory authority. The practical effect of this carve-out is that franchise car dealers and large independent car dealers with service departments will not be subject to direct CFPB oversight, while smaller independents and BHPH dealers will remain under CFPB's direct jurisdiction. CFPB also has jurisdiction over the lenders who buy car lending contracts from auto dealers.

The Federal Trade Commission (FTC), meanwhile, has been charged with regulating auto dealers since its creation. However, the FTC regulatory process was cumbersome and difficult, and as such the agency had not taken much action on car lending issues. The Dodd-Frank Act streamlined the FTC's regulatory authority for issues related to auto dealers, and the Senate Banking Committee called on the FTC and CFPB to investigate abusive car lending practices (Dodd-Frank, 2010).

During 2011, the FTC conducted listening forum sessions in three cities soliciting input from both consumer advocates and the auto industry to better understand the sales and finance process and to gather data on predatory practices in the industry. Extensive comments have been submitted to the FTC on a number of issues, including rate markups and yo-yo scams. On the heels of the roundtables, the FTC took action on a number of abusive practices and has asked dealers for information about particular practices. Enforcement actions from the FTC include:

- Actions against four dealers for advertising that the dealer would pay off the balance owed on a consumer's trade-in when, in fact, the dealer was rolling the balance owed into the loan used to purchase a new car. Those dealers were required to change their advertising and pay fines.
- An action to prohibit advertisements for companies promising to refinance or modify car loans to lower interest rates for a fee, when in fact those companies did not.

The FTC has also asked for detailed information about "recontracted" finance deals, which are the new contracts signed in the wake of a yo-yo scam. Meanwhile, the CFPB has issued civil investigative demands asking for data about dealer interest rate markups and BHPH lending practices.

States have not taken large steps on these issues. States like California cap the amount of interest rate markups, but our research shows that these caps do little to reduce the financial harm to consumers. Other states have different statutory and/or regulatory provisions designed to curb yo-yo scams. However, despite these laws and regulations yo-yo scams happen often. Most financing contracts include mandatory arbitration clauses, meaning that consumers cannot bring actions against the dealer or the finance company in court. Rather, the consumer must bring their case before an arbitrator picked by the dealer or finance company. This makes it difficult for a consumer to find an attorney willing to take a case to arbitration, and have their grievances heard by an objective body.

Meanwhile, California recently passed legislation designed to protect consumers in BHPH transactions. These new laws require BHPH dealers to offer a 30-day/1000-mile warranty and require that BHPH dealers post the price of the car on the lot. The Governor decided to veto a bill that would have imposed a 17% APR cap on BHPH transactions and would have required BHPH dealers to register as lenders. In his veto message, Governor Brown indicated that he had some concern about the registration requirement and would be open to reconsidering this issue later.

AUTO LOANS POLICY RECOMMENDATIONS

Dealer Rate Markups

Completely divorce dealer compensation from the interest rate borrowers pay on all vehicle loans. Otherwise, dealers are compensated through discretionary pricing where the dealer is incented to make more expensive loans than that for which the borrower qualifies. The Federal Reserve and the Dodd-Frank Act prohibited similar compensation schemes in mortgage lending—compensation cannot be based on the terms of the loan outside of its principal balance. The same standard should be applied with cars. Car dealers can be compensated for their services, but the incentive should be to find the best deal for the consumer, rather than the loan with the most return to the dealer.

Yo-Yo Scams

The FTC, CFPB, and state enforcement officials should prohibit the yo-yo practice, by deeming it an unfair and deceptive act. The use of spot delivery agreements should only be permitted if the condition is related to something other than assignment of the finance contract, or anything in the sole discretion of the dealer. This keeps the dealer from creating an unfair bargaining advantage over the consumer, where the dealer can pressure the consumer into a more expensive deal later on.

Loan Packing

The FTC, CFPB, and state enforcement officials should take action to curb abusive practices related to add-on products, including sales tactics that mislead consumers about the true cost and value of add-on products. Dealers should also be prohibited from representing that the purchase of any ancillary product is a requirement for obtaining financing.

Appendix 3: Rate Markup Volume By State

Rank	State	Dealership Sales (in millions \$)	US Market Share	Rate Markup Volume (in millions)
1	California	\$49,465	10.16%	\$2,621
2	Texas	\$41,153	8.45%	\$2,181
3	New York	\$29,814	6.12%	\$1,580
4	Florida	\$28,181	5.79%	\$1,493
5	Pennsylvania	\$22,751	4.67%	\$1,206
6	Illinois	\$20,405	4.19%	\$1,081
7	New Jersey	\$19,261	3.96%	\$1,021
8	Oklahoma	\$19,135	3.93%	\$1,014
9	Ohio	\$17,763	3.65%	\$941
10	Michigan	\$16,796	3.45%	\$890
11	North Carolina	\$13,745	2.82%	\$728
12	Virginia	\$13,253	2.72%	\$702
13	Georgia	\$12,888	2.65%	\$683
14	Massachusetts	\$12,063	2.48%	\$639
15	Arizona	\$9,935	2.04%	\$526
16	Missouri	\$9,890	2.03%	\$524
17	Maryland	\$9,817	2.02%	\$520
18	Washington	\$8,910	1.83%	\$472
19	Indiana	\$8,692	1.79%	\$461
20	Tennessee	\$8,656	1.78%	\$459
21	Wisconsin	\$8,551	1.76%	\$453
22	Minnesota	\$7,560	1.55%	\$401
23	Colorado	\$7,456	1.53%	\$395
24	Louisiana	\$7,047	1.45%	\$373
25	Connecticut	\$6,627	1.36%	\$351
26	Alabama	\$6,426	1.32%	\$341
27	South Carolina	\$5,834	1.20%	\$309
28	Iowa	\$5,580	1.15%	\$296
29	Kentucky	\$5,550	1.14%	\$294
30	Oregon	\$4,773	0.98%	\$253
31	Kansas	\$4,573	0.94%	\$242
32	Arkansas	\$4,290	0.88%	\$227
33	Utah	\$3,960	0.81%	\$210
34	Mississippi	\$3,422	0.70%	\$181
35	Nevada	\$3,348	0.69%	\$177
36	New Hampshire	\$3,288	0.68%	\$174
37	Nebraska	\$3,275	0.67%	\$174
38	New Mexico	\$2,723	0.56%	\$144
39	West Virginia	\$2,618	0.54%	\$139
40	Maine	\$2,515	0.52%	\$133
41	Montana	\$1,926	0.40%	\$102
42	Idaho	\$1,833	0.38%	\$97
43	Hawaii	\$1,777	0.36%	\$94
44	Rhode Island	\$1,594	0.33%	\$84
45	North Dakota	\$1,580	0.32%	\$84
46	South Dakota	\$1,549	0.32%	\$82
47	Delaware	\$1,358	0.28%	\$72
48	Vermont	\$1,251	0.26%	\$66
49	Wyoming	\$1,027	0.21%	\$54
50	Alaska	\$1,016	0.21%	\$54
	U.S. Totals	\$486,900	100.00%	\$25,800

Sources: Dealer sales figures from NADA Data 2010 report;
rate markup volume calculated from 2010 National Automotive Finance Association survey and CNW Marketing data.

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CREDIT CARDS

The State of Lending in America &
its Impact on U.S. Households

Sarah Wolff

December 2012



www.responsiblelending.org

CREDIT CARDS

AN INTRODUCTION TO CREDIT CARDS

Credit cards have become one of the most ubiquitous purchasing tools in the U.S. over the past few decades. This convenient access to credit has not come without consequences. After home, car, and student loan debt, American households' biggest financial obligation is credit card debt, which currently totals over \$854 billion, an increase of \$172 billion since 2000 (Federal Reserve Board [FRB], 2012a). This increased reliance on credit cards has produced unprecedented levels of debt for American consumers and revenue for the credit card industry.

Many associate this increase in debt primarily with Americans living beyond their means. However, a recent Demos survey found that **many low- and middle-income households rely on credit cards to pay for basic living costs and to help them weather the financial stresses caused by unemployment and medical expenses.** Some 40% of low- and middle-income households surveyed reported using credit cards to pay for basic living expenses (such as rent or mortgage bills, groceries, utilities, or insurance) because they did not have enough money in their checking or savings accounts. For 47% of the households surveyed, out-of-pocket medical expenses made up a portion of their outstanding credit card debt. And of the households who incurred expenses because of unemployment, 86% took on credit card debt as a result (Traub & Ruetschlin, 2012).

In the past, credit card companies took advantage of this reliance by engaging in unfair and deceptive practices. Industry practices frequently included high penalty rates that were unfairly and easily triggered, unclear terms in solicitations and statements, and fee structures and other measures that exploited consumers' biases and tendencies. Credit card issuers believed these techniques would increase revenue; however, recent evidence has been to the contrary. **The passage of the Credit Card Accountability Responsibility and Disclosure (CARD) Act of 2009 has made credit card pricing much clearer without leading to higher rates or decreased access to credit.** The Act banned or curbed many deceptive and unfair practices common in the industry at the time. One outcome for consumers has been more transparent pricing; for example, there are fewer differences between stated rates in credit card solicitations and actual rates that consumers paid for credit. Another outcome has been consumers' improved ability to manage credit card debt. Again—importantly—credit card reform has neither cut credit availability nor raised prices.

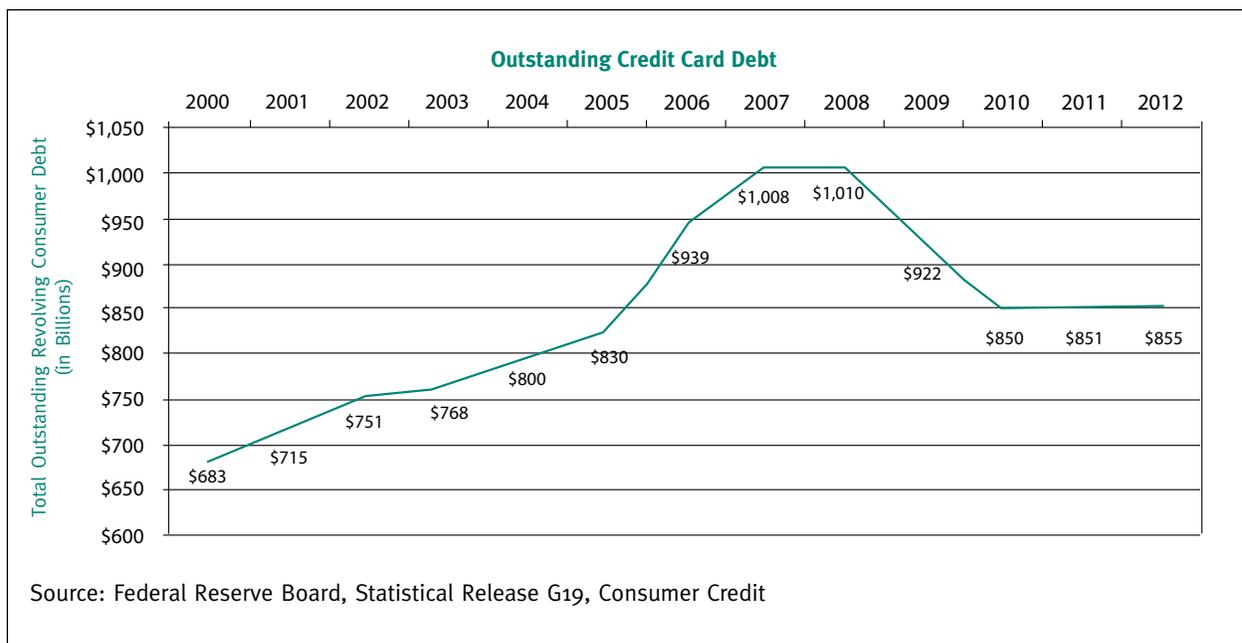
MARKET AND INDUSTRY OVERVIEW

The revolving consumer credit, or credit card, market is large and concentrated. Although there are thousands of credit card issuers, credit card balances are concentrated among a small number of issuers. Two-thirds of credit card balances are owned or securitized by the 14 credit card banks with assets over \$200 million (FRB, 2012b). As shown in Figure 1, outstanding credit card debt totaled \$855 billion in August 2012, up from \$683 billion at the end of 2000, but down from more than \$1 trillion at the end of 2007 and 2008 (FRB, 2012a). As of March 2012, the top five issuers of credit cards were Citigroup, JP Morgan Chase, Bank of America, Capital One, and American Express. These issuers' portfolios totaled \$475 billion in outstanding loans and represent over half of the credit card market (American Banker, 2011).

The credit card market is highly profitable for issuers. In its June 2012 *Report to the Congress on the Profitability of Credit Card Operations of Depository Institutions*, the Federal Reserve Board (Board) reported that the banks that control the vast majority of the credit card market enjoyed net earnings of 5.37%. As an indication of how profitable the credit card business is for banks relative to other activities, the rate of return for all commercial banks is 1.18%. Credit card profits are also reliable. Between 2001 and 2011, the largest credit card banks experienced only a single unprofitable year in 2009, at the end of the recession of 2007 to 2009.

A majority of US households use credit cards: the most recent Survey of Consumer Finances (FRB, 2012c) showed that 68% of consumers had a credit card in 2010. However, fewer than 40% of consumers carried credit card balances in that year—the lowest proportion in the history of the survey. This is a result of consumers reducing their debts in the wake of the recession; median balances decreased by 16.1% from 2007 to 2010.

Figure 1. U.S. Total Outstanding Credit Card Debt (\$ billions)



LENDING ABUSES AND PREDATORY PRACTICES

In the 20 years prior to the Credit CARD Act's effective date in February 2010, credit card issuers increasingly relied on deceptive, unfair pricing practices to boost revenue. Banks justified these practices by saying that these were necessary to mitigate risk; however, many of these practices bore no relation to the costs or risks faced by issuers. Often, lenders were simply exploiting price complexity and consumer behavioral biases (Frank, 2009). Terms in contracts and solicitations were purposefully unclear; policies were buried in fine print and difficult to understand. As a result, consumers paid significantly higher costs than they expected or realized.

CRL research shows that larger issuers were more likely to engage in these bad practices than smaller institutions and that issuers who engaged in one unfair or deceptive practice tended to engage in many (Frank, 2012). The Credit CARD Act curbed or banned many of these, but several continue to hurt consumers and should be addressed by lawmakers and regulators.

Pre-Credit CARD Act Abuses

Complicated Pricing

Before the Credit CARD Act, a Federal Reserve paper described the evolution of the credit card industry as a transition from a straightforward model to one with a “complex set of APRs [annual percentage rates], new and increased fee structures, and sophisticated finance charge computation techniques” (Furletti, 2003). Credit card terms became increasingly complex, including in initial solicitations such as direct mail offers. CRL research found that direct mail offers to consumers became 2.5 times more complicated in 2009 than 1999, as measured by the total number of numeric figures appearing in offers (Frank, 2010). This complexity allowed lenders to hide fees and take advantage of pricing practices that consumers tended to be unaware of, discount, or ignore.

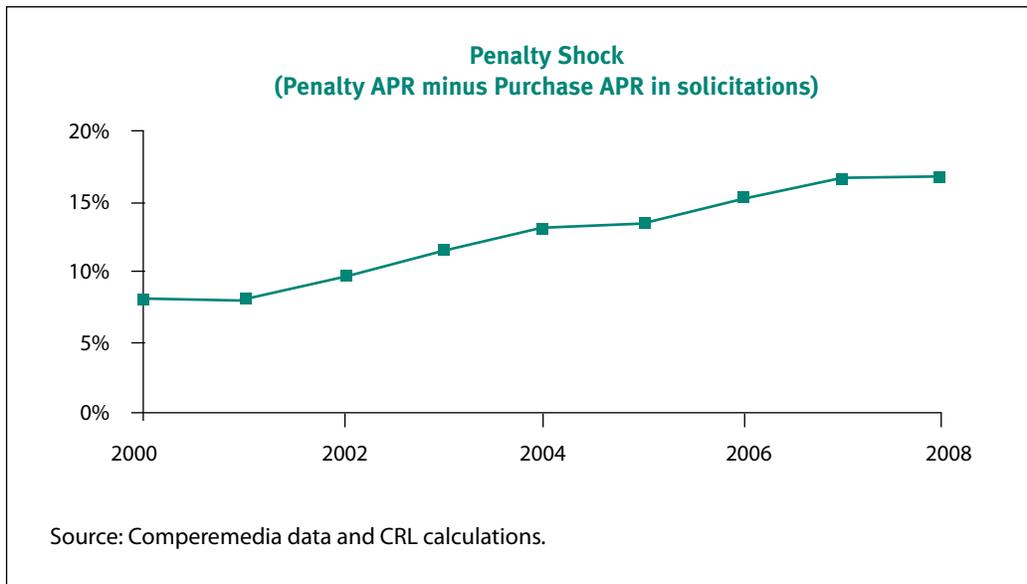
Examples of hidden credit card policies that imposed potentially high and unexpected costs included tiered late fees and minimum finance charge requirements. Tiered late fees allowed issuers to apply increasingly higher late fees on a growing group of cardholders. Issuers designed this complex pricing structure to focus consumers' attention on the lowest fee that could be charged, even though it was the one least commonly incurred. Nine out of ten consumers, for example, had credit card balances of at least \$250, which for most issuers placed the cardholder in the highest late fee tier and triggered the highest possible penalty fee if the consumer paid late (Frank, 2009). Credit card issuers also imposed oversized minimum finance charges, such as a \$2 charge on a penny balance due. International fees could be charged to consumers for international purchases even when those transactions were made in U.S. dollars and at no additional cost to the bank.

Penalty Rates

Penalty rates are a form of hidden, back-end pricing in which the rate increases after the borrower repays late and typically applies to the entire balance owed. Their impact is especially harmful when easily triggered in the teaser period (Frank, 2008). Before enactment of the Credit CARD Act, penalty rates could be triggered when consumers paid their balances as little as one day late. CRL research found that penalty repricing led consumers to underestimate the interest they were paying. As Figure 2 below demonstrates, between 2003 and 2007, both the prevalence of penalty repricing and the disparity between the size of the penalty rate and the rate consumers expected to pay grew (Frank, 2008). In 2008, the average penalty APR was 16.9 percentage points higher than the

average APR consumers paid on purchases (for example, a consumer making one late payment would see their 12% APR raised to 28.9%). We term this disparity “penalty shock” and Figure 2 shows its magnitude in the years prior to the Credit CARD Act. For a household with the average amount of credit card debt (\$10,678 in 2008), penalty repricing on balances would result in additional \$1,800 in interest costs per year. The financial harm was amplified when penalty rates were easily triggered or difficult to undo.

Figure 2. Credit Card Penalty Shock



Bait and Switch and Similar Practices

Widening gaps between rates quoted in solicitations and rates consumers actually paid suggests that bait-and-switch tactics were common in the credit card industry. Similar to this was the use of “pick-a-rate” practices, where issuers manipulated variable rates by tying interest rates to an index and picking the date when the index triggered the largest increase. Research by both CRL and the Federal Reserve provided evidence that this pricing strategy was poorly understood by consumers and bore little relationship to issuers’ risks or costs (Frank, 2009). This change in formula for calculating variable rates resulted in rates averaging 0.3% higher and cost consumers \$720 million a year (Frank, 2009).

Variable rate floors—in which interest rates could never go lower than the starting rate—were another way issuers charged more than consumers expected. This practice was often buried in the fine print of a lengthy and obscure disclosure form, making it hard for consumers to understand it and estimate its cost.

Universal Default

The practice of universal default allowed credit card issuers to routinely charge penalty rates in response to an activity or situation unrelated to the card in question, e.g., when borrowers paid an unrelated credit card or different lender late. In these situations, consumers experienced steep price jumps that were hard to eliminate even when they were current with the card in question.

LEGISLATION AND REGULATION

When signed into law by President Obama in 2009, the Credit CARD Act—sometimes called the “Credit Card Holder’s Bill of Rights”—was the most significant federal consumer financial reform in decades. The goal of this legislation was to ensure fairness and transparency for consumers with credit cards. The Credit CARD Act went a long way toward curbing interest rate hikes, and banning the use of hair-trigger penalty rates, bait-and-switch tactics, and universal default. The terms of credit card contracts are clearer, and changes to them must be made in a timely fashion. Consumers have reported increased awareness of how their credit card is priced and of how to pay down high debt more quickly.

Provisions of the Credit CARD Act went into effect on February 22, 2010. The Federal Reserve Board was charged with implementing the Act, a responsibility which fell to the Consumer Financial Protection Bureau (CFPB or Bureau) after passage of Dodd-Frank in July 2010. The Act included the following provisions:

- Interest rates charged on an existing balance cannot be increased unless a cardholder is 60 days or more behind in payments or has agreed to a variable rate. Customers who face a penalty rate but pay on-time for six consecutive months are thereafter charged the previous, lower rate.
- All payments above the monthly minimum must be applied to the balance carrying the highest interest rate.
- Issuers must only use the current month’s balance to calculate interest charges. Double-cycle billing, or calculating interest using the average of a customer’s current and previous monthly balance, is prohibited. Over-limit fees are allowed only for customers who have explicitly affirmed that they wish to be allowed to exceed the credit limit for a fee.
- Customers must be notified 45 days prior to a major change to terms of a credit card contract.
- Issuers must allow 21 days between mailing a bill and imposing a late fee.
- Fees charged during the first year a credit card account is opened are limited to no more than 25% of the initial credit limit. This limitation does not include application fees, late charges, or permitted over-the-limit fees.
- Two ways of manipulating variable rates are no longer allowed: Issuers can no longer set an initial interest rate as a floor, and they can no longer peg an interest rate to the highest prime rate over a set period. Instead, they must use the current prime rate.
- Issuers must more carefully consider a consumer’s ability to make payments before issuing credit or increasing credit limits.

CFPB Curbs Deceptive Practices

In October 2012, the CFPB took action against American Express stating that the company violated consumer protection laws “at every stage of the customer experience.” The action required American Express to refund \$85 million to 250,000 consumers and end the illegal practices. To date, moves by the CFPB and other regulators to halt deceptive credit card marketing practices have returned nearly a half-billion dollars to American consumers (CFPB, 2012c).

IMPACT ON U.S. HOUSEHOLDS

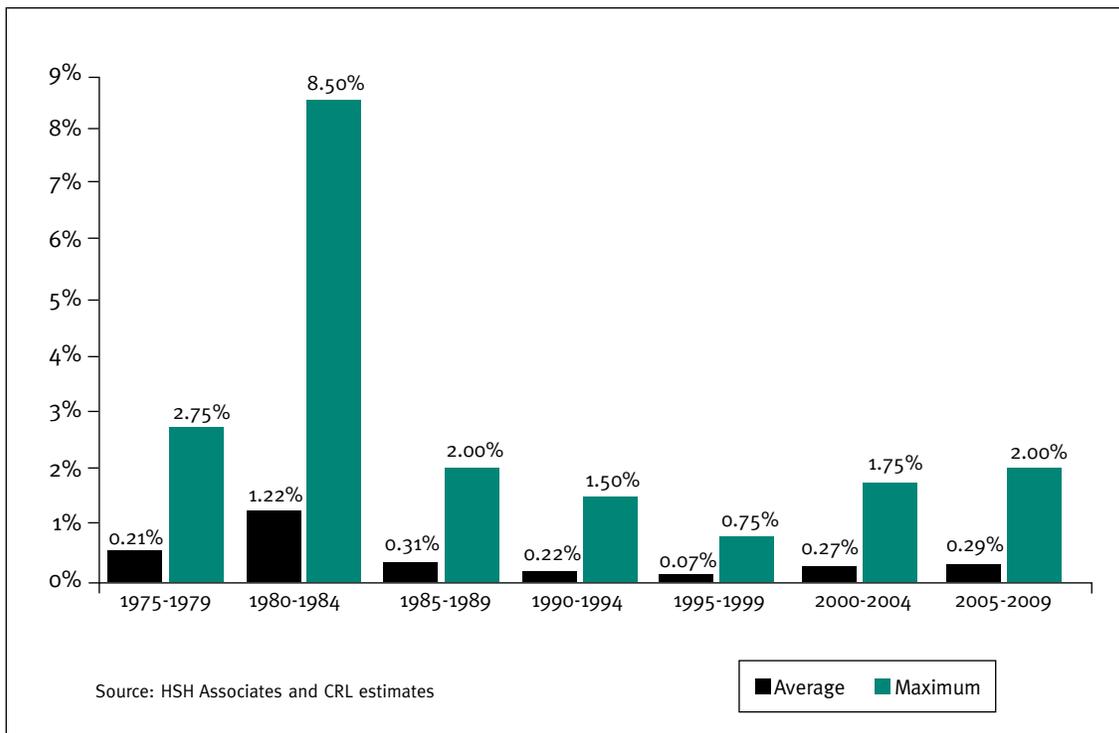
Before the Credit CARD ACT

Before the Credit CARD Act, consumers faced deceptive, unfair practices that harmed their finances. The Act fostered price transparency and fairness, allowing consumers to better manage their debt, without reducing credit availability or making it more expensive.

In 2010, CRL released a study examining the cost associated with deceptive, hidden pricing strategies that consumers faced before the Credit CARD Act. This study found that before the Act (Frank, 2009):

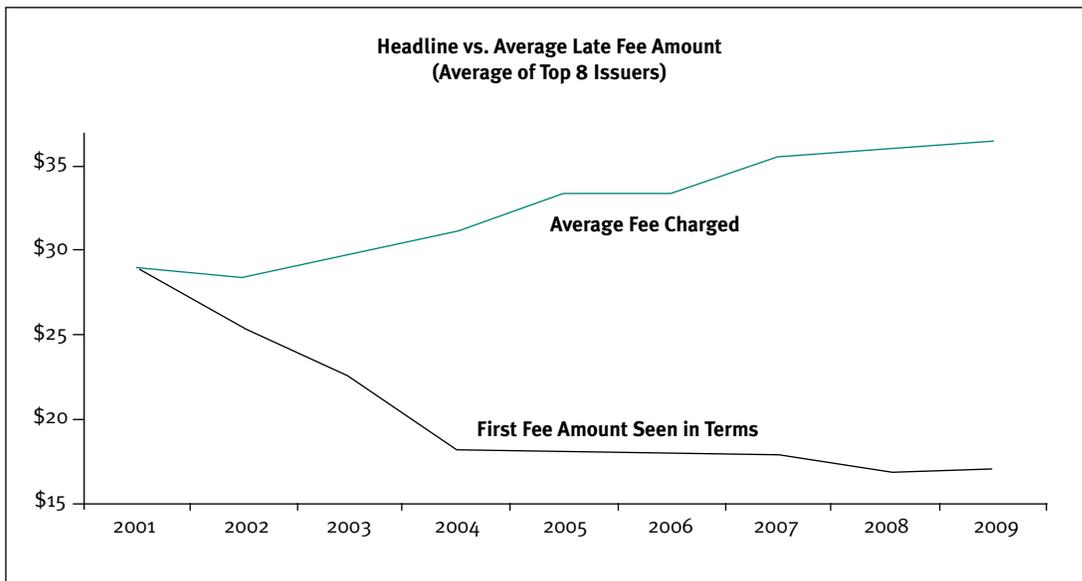
- Miscellaneous fees, such as inactivity fees, international transaction fees, cash advance and/or balance transfer floors, ceilings, and related charges with unclear or misleading terms significantly raised consumer costs.
- As demonstrated in Figure 3, “Pick-a-Rate” pricing increased consumers’ APRs to 0.3% higher on average over traditional pricing, resulting in a total cost to consumers of \$720 million a year (Frank, 2009).

Figure 3. Average and Maximum Interest Rate Increase from Pick-a-Rate Pricing (using 5-year increments)



- As shown in Figure 4, manipulation of tiered penalty charges put nine out of ten consumers in a category where they would have to pay the highest fee if they were late, even with a balance of only \$250.

Figure 4. Trend in Average Late Fee Charged vs. First Fee Consumers See



Furthermore, CRL's 2012 Report *Predatory Credit Card Lending: Unsafe, Unsound for Consumers and Companies* showed that practices that harmed consumers also harmed the credit card industry. Bad practices were a better predictor of consumer complaints and of an issuer's rate of increase in losses during the downturn than an institution's type, size or location. Additionally, consumer safeguards on credit cards enhanced banks' financial health, contrary to industry's past claim that such safeguards undermine it. The research also demonstrated that credit card issuers with higher loss rates before the recession did not, on average, experience a bigger jump in losses during the recession. This shows that having higher-risk customers did not predict which company's problems would grow the fastest.

Consumer safeguards on credit cards enhanced banks' financial health, contrary to industry's past claim that such safeguards undermine it.

Results of the Credit CARD Act

Multiple studies show the Credit CARD Act has increased transparency, reduced unfair fees and penalty charges, and helped consumers pay off balances faster (Frank, 2011). These results contradict those who predicted the Credit CARD Act would lead to a decline in access to credit.

Transparency in pricing resulted in declining balances.

Before the Credit CARD Act, consumers had a hard time understanding the true cost of credit because of limited and confusingly stated information in monthly statements (Consumer Financial Protection Bureau [CFPB], 2011b), issuers must now tell cardholders how long it will take to pay off the current balance if they pay only the minimum due. This information allows consumers to understand costs better and has led many to pay down balances faster. A Demos study, for example, shows that average credit card debt among low- and middle-income indebted households fell to \$7,145 in 2012, down from \$9,887 in 2008.¹ One-third of indebted households in the survey reported

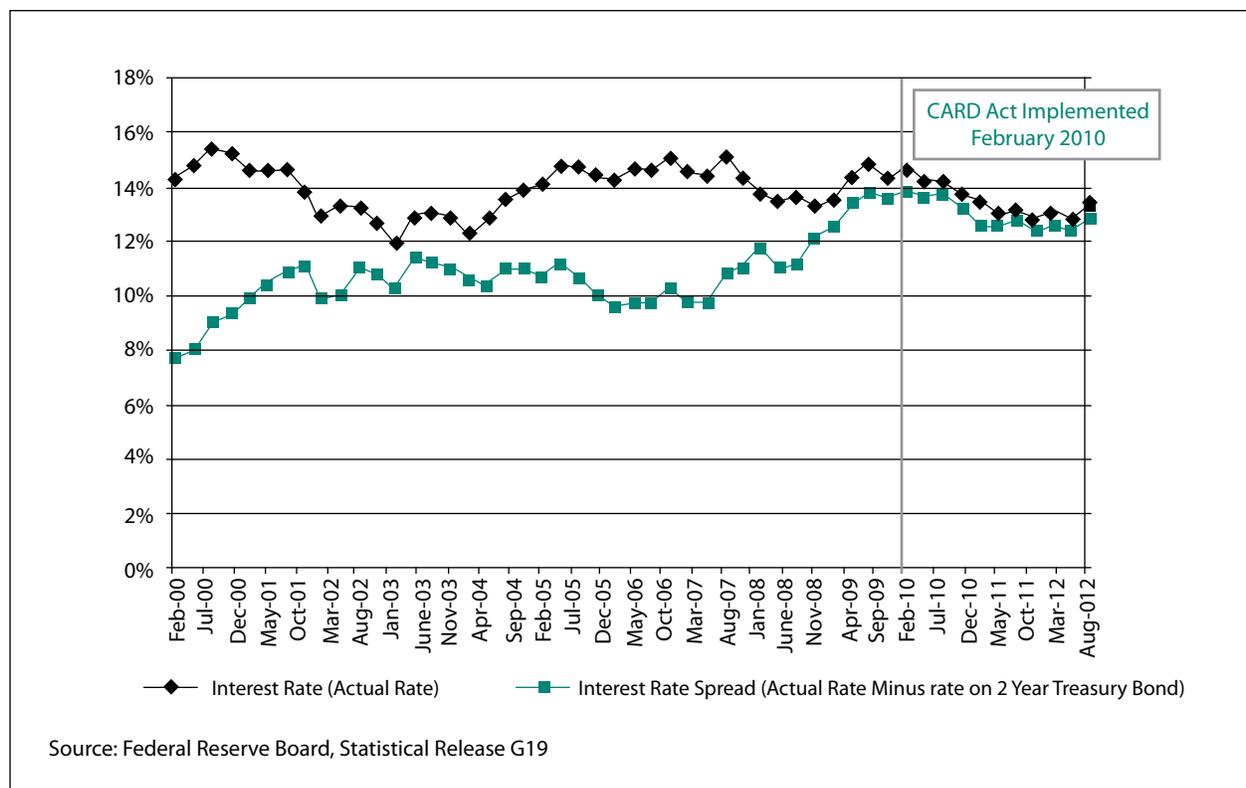
¹ In addition to new credit card disclosures, credit constriction in the market and consumer deleveraging were also likely contributors to the decline in credit card balances.

making larger payments on their credit card debt than they did before the law went into effect (Traub & Ruetschlin, 2012). In addition, Federal Reserve Board data show that consumers paid \$12.1 billion less annually in unanticipated finance charges relative to what they would have paid before passage of the Credit CARD Act (Frank, 2011).

Reform has not raised the price of credit, but has made it clearer

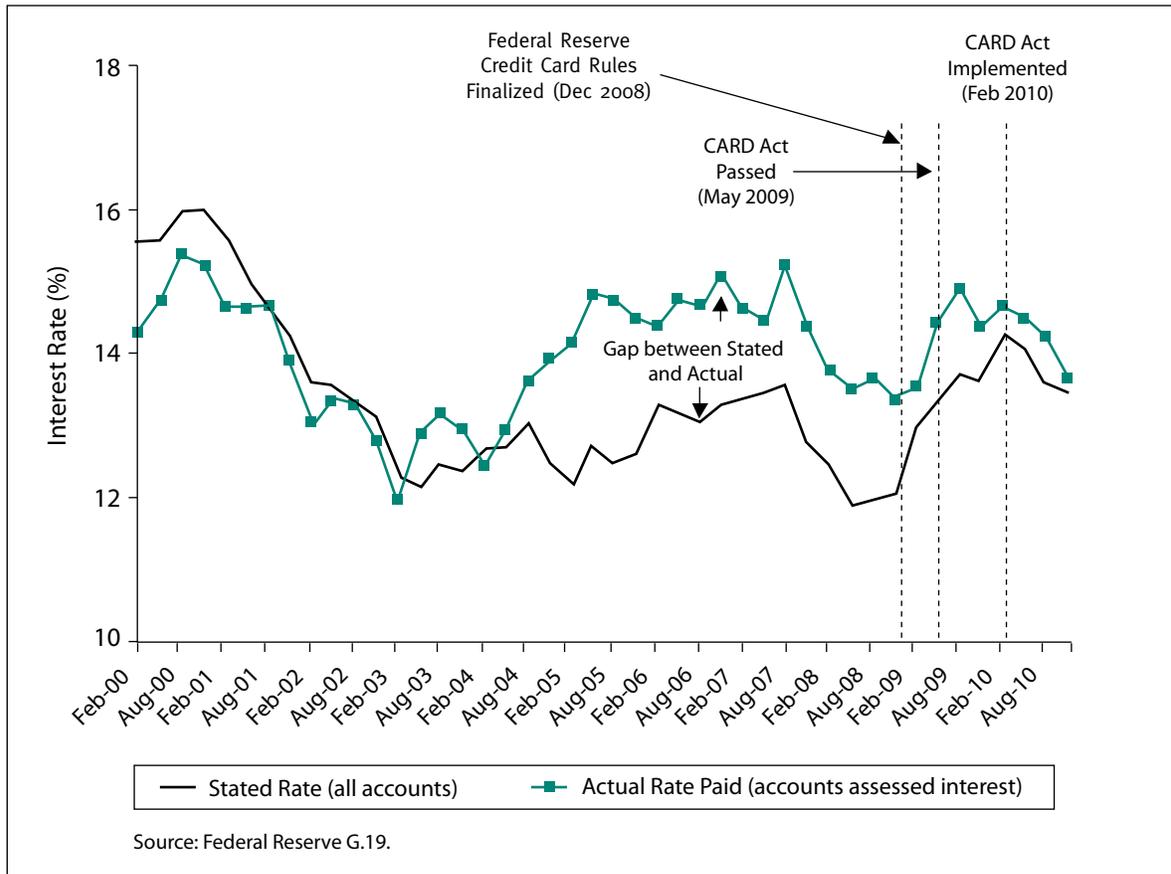
Cardholders are not paying more for credit. CRL research examined the impact of credit card regulation on the actual interest rate paid on credit card accounts assessed interest (Actual Rate) (Frank, 2011). The findings show that while unemployment and the prime rate had statistically significant impacts on the Actual Rate, the development and passage of the CARD Act did not. Since the CARD Act was implemented in February of 2010, both the Actual Rate and the Spread (Actual Rate compared to the 2 Year Treasury rate), has fallen as shown in Figure 5. The Actual Rate in August 2012 was a full 2 percentage points lower than it was in August 2007 and 1.45 points lower than it was when the CARD Act was implemented. Both Actual Rates and the Spread rose between 2007 and 2009; however, research points to economic conditions—not regulation—to explain this trend (Bar-Gill & Bubb, 2012)(CFPB, 2011a).

Figure 5. Credit Card Interest Rates, 2000-2012



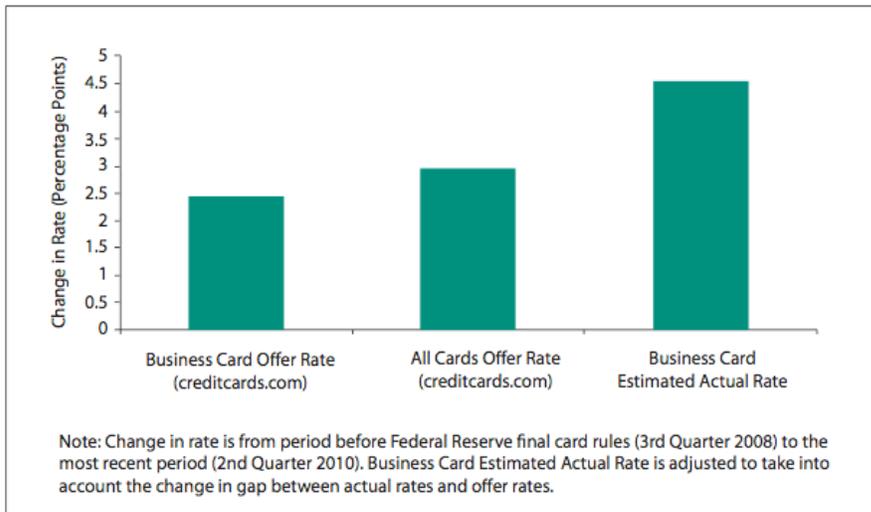
In contrast to the trend in actual rates, stated rates have increased (Frank, 2011). This means **cardholders have a much more realistic idea of what they will actually be paying** and reverses a multi-year trend in which the gap between the advertised price and the actual price widened. Figure 6 below shows the gap narrowing after passage of the Act. Furthermore, CRL research found that the passage and implementation of the CARD Act impacted the difference between the stated and actual rates (Frank, 2011).

Figure 6: Stated Rates and Actual Rates Paid on Consumer Credit Cards



We also find evidence that costs are declining on consumer credit cards by investigating the business card market. Because the Act does not apply to business credit cards, issuers can still affect the overall interest rate through the practices outlawed by the Act in the consumer market. Indeed, the effective rate on business cards has increased relative to consumer cards (Office of Comptroller of the Currency [OCC], 2011). Although advertised rates and actual rates converged for credit cards overall, as noted above, this has not happened for business cards. As figure 7 below shows, the actual rate paid by business cardholders increased more than the rate offered in business card solicitations. This indicates that some of the fees business cardholders actually paid are hidden and not apparent in the published solicitations. In addition, the rate offered for all credit card solicitations—including both business and consumer accounts—rose by more than that for business accounts only, indicating that the consumer accounts are more transparent as a result of the Act.

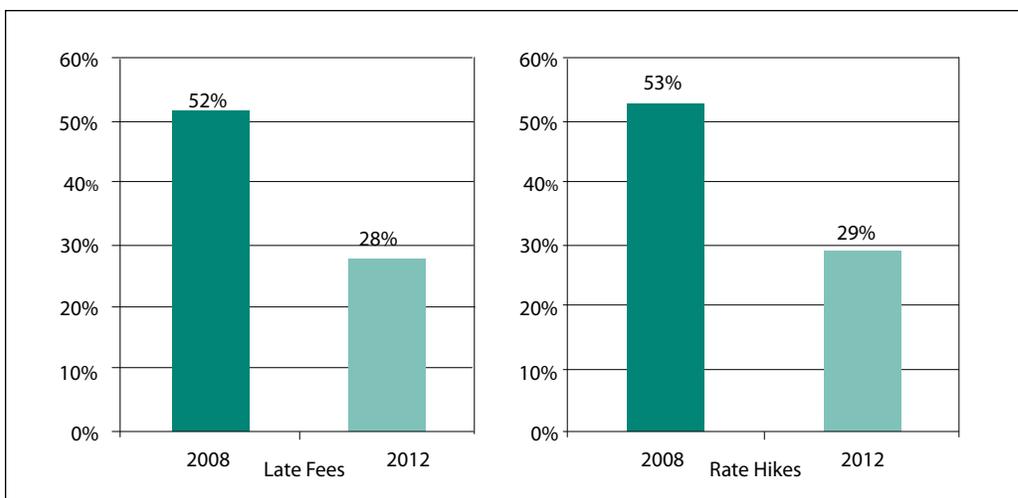
Figure 7: Change in Business and Consumer Offer Rates



In addition, Credit CARD Act provisions have substantially reduced credit card penalty charges and fees. Data presented by the OCC show that the **total amount of late fees paid by consumers dropped by more than half**, from \$901 million in January 2010 prior to the effective date of the late fee rules, to \$427 million in November 2010 after the effective date of the rules. In addition, research found that the number of accounts assessed at least one late fee declined by almost 30% and that the average size of these fees declined from \$35 to \$23 (OCC, 2011).

As shown in Figure 8 below, Demos’s study confirms the OCC data; the number of lower- and middle-income households who reported paying late fees on credit cards fell substantially from 52% in 2008 to 28% in 2012. Similarly, the percentage of reported interest rate hikes declined from 53% in 2008 to 29% in 2012. Those who made late payments also were significantly less likely to experience an interest rate increase. The Credit CARD Act engendered better outcomes for communities of color that were disproportionately affected by abusive practices. Demos found that “African-American and Latino households were especially likely to report a decline in over-the-limit fees in the past two years” (Traub & Ruetschlin, 2012).

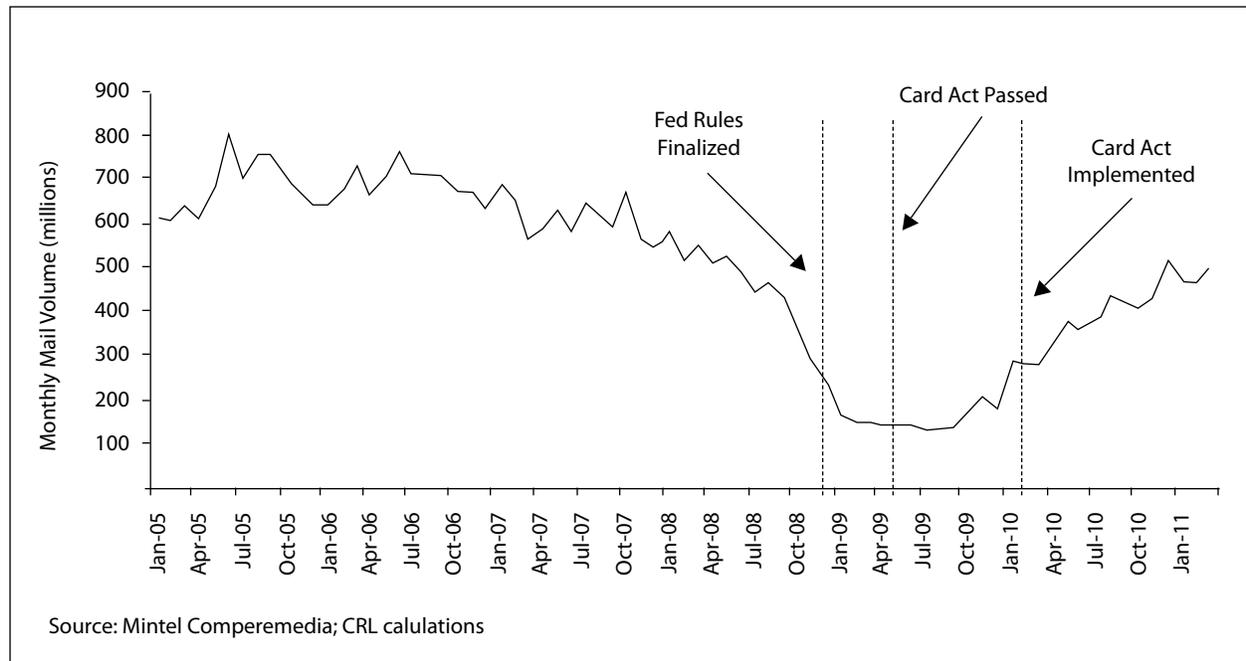
Figure 8. Decline in Credit Card Late Fees and Rate Hikes, after Credit CARD Act



Reform has Not Cut Credit Availability

Opponents of the Credit CARD Act raised fears that the reforms would result in the unintended consequence of restricting consumers' access to credit. This has been proven unfounded. CRL's analysis of direct-mail credit card offers shows that offers have been extended at a volume and rate consistent with economic conditions. In 2008, the volume of mail solicitations for credit cards had been dropping with the sinking economy; since passage of the Credit CARD Act, data show that direct mail volume has risen and continues to do so (Frank, 2011).

Figure 9. Change in Credit Card Mail Volume



REMAINING CHALLENGES

Consumers still face difficult challenges managing credit card debt as a result of the economic slump and predatory practices that the Credit CARD Act did not address. Many reasons for using credit cards remain the same today as before the Act. Consumers still depend on credit cards to pay for basic living expenses and to use as a safeguard against economic instability, such as illness or a job loss. And although the Act outlawed or limited many harmful practices, some are still actively and legally used, including the following:

Aggressive and Deceptive Marketing of “Add-On” Products

Since the Credit CARD Act’s passage, credit card companies have aggressively marketed add-on products such as debt protection and credit insurance. These products promise to pay all or some of credit card debt for borrowers who suffer from a future disability, unemployment, or other financial stress. These products are expensive (costing sometimes in excess of ten percent of the average monthly balance), marketed with hard to understand terms, and generally fail to deliver if they are needed (Government Accountability Office, 2011).

Examples of credit card issuers’ add-on marketing practices that the CFPB has deemed abusive and illegal include:

- misleading consumers that products can improve credit scores and raise credit limits,
- deceiving consumers that the products are mandatory while making it difficult to cancel coverage,
- selling products to cardholders who are already disabled or unemployed and thus ineligible to claim benefits,
- misleading consumers that these products are free or less costly than they are, and
- enrolling consumers for products without their consent and making it difficult to cancel coverage.

The CFPB and other regulators have already taken several significant actions against credit card issuers who engaged in unfair and deceptive practices. Three recent actions against Capital One, Discover, and American Express required the issuers to issue \$425 million in refunds to approximately 6 million consumers who were misled into buying such add-ons (CFPB, 2012a & 2012b).

Disproportionate Rate Increases on New Purchases or Cash Advances

Under the Credit CARD Act, lenders can increase interest rates without limit and for any reason—including universal default—on future purchases, as long as they give 45 days’ notice. This provides no guarantee that a rate hike will be proportional to a consumer’s risk profile. The Act does give consumers the right to reject the rate increase by closing the account and paying it off at their current rate over five years.

Fee Harvester Cards

Fee harvester credit cards are offered to consumers with impaired or no credit histories. These cards offer small amounts of credit with very high fees. One issuer, for example, offered only \$51 in total credit on a \$90 card balance—charging \$20 to open the account and \$19 in reoccurring monthly fees (National Consumer Law Center & U.S. PIRG, 2012). The Credit CARD Act did not eliminate these cards from the marketplace, but it did require that fees charged to open an account be included in the calculation of the fees allowed in the first year. (The Act put in place a 25% limit on total fees allowed in the first year after a person receives a credit card.) Unfortunately, the CFPB has proposed withdrawing a rule that would include these pre-account fees in the calculation. This was in response to a recent federal court decision for the District of South Dakota in *First Premier Bank v. United States Consumer Financial Protection Bureau*.

Prepaid Cards: Fast Growing Volume & Risks

Prepaid cards have a set amount of money loaded onto them, with this balance declining as the cardholder makes purchases or, if permitted, withdraws cash. Some are reloadable, such as general-purpose prepaid cards or prepaid cards used by companies to pay employees or by federal or state agencies to pay benefits. Others, such as prepaid gift cards and prepaid rebate cards, typically are not reloadable.

The market for prepaid cards has exploded in the last seven years. Federal Reserve Board numbers show that while credit and debit card use dwarfs prepaid card use, prepaid cards are the fastest growing segment of these three types of plastic payment. **There were 6 billion prepaid card transactions for \$140 billion in the U.S. in 2009, more than 22% growth from 2006.** That compares with growth of 14.9% for debit card transactions in the same period and a slight decline in credit card use (Federal Reserve Bank of Philadelphia, 2012).

Prepaid cards typically fall under one of two business models:

- a) Those that do not allow purchases beyond the established prepaid amount. Issuers of these cards aren't subject to caps on how much they can charge merchants when customers use their card (swipe fees).
- b) Those that offer small, short-term loans over the prepaid balance but also charge overdraft fees. These issuers are subject to the caps on merchant swipe fees.

Several factors have fueled the popularity of prepaid cards. A growing number of consumers use them instead of debit cards to control their spending and avoid overdraft fees. For the many within this financially vulnerable group who lack a bank account, prepaid cards provide entry into the electronic payments system and allow them to build credit.

Also propelling growth is the increased use of prepaid cards rather than paper checks by federal and state governments to provide Social Security, disability, unemployment insurance, and other benefits. Companies also increasingly offer employees the option of being paid on a prepaid card rather than by check.

At the same time, prepaid cards provide lenders with a way to avoid a new limit on debit card swipe fees (also called interchange fees). This swipe-fee limit does not exist for prepaid cards that do not allow users to spend more than their prepaid limit.

Prepaid credit cards can provide convenience and safety, but these advantages can be quickly eroded by high fees. Many prepaid cards come with significant charges—fees to sign up, deposit money, check a balance, use an ATM, and cancel the account. Because the disclosure of fees varies from card to card—many are hidden altogether—consumers have difficulty knowing what their costs will be, let alone comparison-shopping. In addition, some cards lack deposit insurance, vulnerable to fraud or loss.

The CFPB should ensure that prepaid card fees and terms are reasonable and presented clearly by:

- prohibiting overdraft and credit features;
- prohibiting fees designed to obscure pricing;
- prohibiting mandatory arbitration to settle disputes;
- ensuring access to statements and account information, with no fee charged for contacting customer service, making balance inquiries, and gaining electronic account access;
- requiring deposit insurance for funds; and
- requiring issuers to provide monthly paper statements for no more than the cost of the statement, approximately \$1 per month.

POLICY RECOMMENDATIONS

Defend the Credit CARD Act and Consumer Financial Protection Bureau

Aggressive and deceptive tactics used by lenders prior to the Credit CARD Act led to unnecessarily high card balances and defaults, which harmed consumers and lenders, especially during the economic downturn. By limiting arbitrary and excessive charges and practices that maximize fees charged to the borrower, the Act encouraged more responsible, transparent practices in credit card lending. Multiple studies show the Act has led to increased transparency, reduced unfair fees and penalty charges, and faster balance payoff. These results contradict those who predicted that the Act would lead to a decline in access to credit and increase its cost.

Regulators and lawmakers should consider the overarching benefits of increased transparency and responsible lending when addressing abuses related to other consumer financial products. They should also keep these benefits in mind and reject lobbyists' requests to scale back the authority of the CFPB. Allowing the CFPB to stay true to its mission, including enforcement of the Credit CARD Act, will promote overall economic health.

Address Remaining Abusive Practices

- **Curb aggressive marketing of debt protection and insurance products, and ensure that those products actually benefit the consumer.** As evidenced by recent state and federal enforcement actions, credit card issuers aggressively sometimes market debt-protection products and obscure the true costs and benefits of these products. Further, data from the credit insurance market show that very little of the insurance premium goes to pay claims. Instead, the majority is used to pay for commissions and marketing.
- **Fix loophole on fee harvester cards.** The CFPB should include pre-account fees in the calculation of the maximum fees that may be charged in the first year. This would help put a limit on fee harvesters' large up-front fees and reduce lenders' ability to take advantage of financially vulnerable customers. In addition, the CFPB should issue rules to protect consumers targeted for these cards. The rules should:
 - include all required fees assessed in the first year and in subsequent years in the tests for abusive fee harvester cards through the current rule or a supplemental rule;
 - enforce ability-to-repay requirements under the CARD Act and take action against card programs that create unaffordable, unsustainable debt;
 - deem unfair, deceptive, or abusive any card targeted at consumers with poor credit records that harm credit-worthiness, are unaffordable for a significant share of the target audience, or do not live up to claims of improving credit scores;
 - require credit card fees to be reasonable and proportional to their purpose; and
 - require fees charged before an account is opened be fully refundable if the card is cancelled.

- **Prepaid cards.** Ensure that consumer protections on credit cards extend to prepaid cards by banning overdraft fees, credit features, and mandatory arbitration on prepaid cards.
- **Continued state and federal enforcements.** State Attorneys General and other state and federal regulators should actively enforce the CARD Act, state credit card laws, and general unfair and deceptive trade practices laws against credit card issuers. These enforcement actions are critical tools, necessary for robust enforcement of existing law and to address emerging issues.

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STUDENT LOANS

The State of Lending in America &
its Impact on U.S. Households

Sonia Garrison

December 2012



www.responsiblelending.org

STUDENT LOANS

AN INTRODUCTION TO STUDENT LOANS

Income and employment opportunities are at the heart of wealth accumulation and financial well-being. The current marketplace demands a higher skilled and more educated workforce, even for entry-level workers. Families today see investing in a college education as necessary not only for graduating high school seniors but also for unemployed mid-career workers. And although many have begun to question the rate of return on what has become an increasingly expensive investment, earnings data continue to show large gaps in annual salaries by educational attainment. In 2010, for example, young adults ages 25–34 with a bachelor’s degree earned 50% more than young adults with a high school degree or equivalent, and this gap in earnings has held consistent since 1995 (Institute of Education Sciences, 2012). While a college education does not automatically provide a well-paying job upon graduation, it nevertheless remains critical in today’s competitive job market.

Although post-secondary education has never been more important, it has also never been more expensive. Recent increases to federal grant programs have helped many families who might otherwise be unable to enroll in post-secondary education. Nevertheless, most families still have to rely on loans as an important source of funding. Student loan debt has seen a massive increase, now exceeding the level of national credit card debt and recently topping one trillion dollars (Chopra, 2012)—\$850 billion in federal loans and \$150 billion in private loans (Consumer Financial Protection Bureau [CFPB], 2012). This is higher than any kind of consumer debt other than mortgage loans. Much of this increase can be attributed to the higher number of college enrollees, including students of color and non-traditional students. Still, **the percentage of students taking out loans, as well as the average amount of college debt per student, has steadily increased over the past decade** (College Board Advocacy & Policy Center [CBA&PC], 2011).

The results have made a significant impact on the debt burden of American families. Nearly one in five (19%) US households held student debt in 2010—more than twice the share in 1989 (9%). And student debt per borrower now averages \$23,300 (Federal Reserve Bank of New York [FRBNY], 2012). Student loan defaults are also on the rise: nearly one-third of borrowers who have begun repaying their loans are delinquent (FRBNY, 2012).

MARKET AND INDUSTRY OVERVIEW

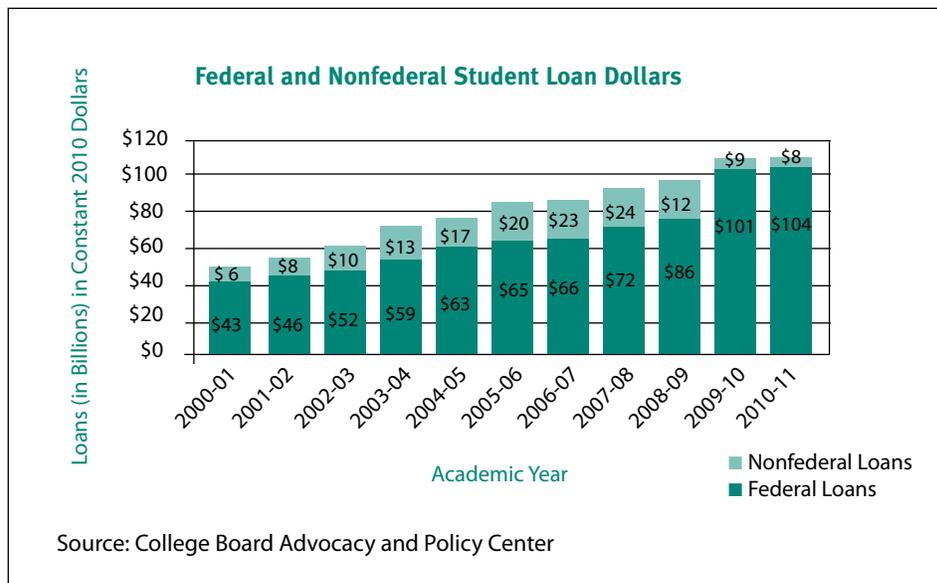
Federal Student Loans

The federal government offers a variety of student loans for undergraduate and graduate students and their parents, including subsidized and unsubsidized Stafford loans, Parent PLUS loans, Grad PLUS loans, and Perkins loans. From 1965 to 2010, most federal student loans were originated by private lenders and guaranteed by the federal government under the Federal Family Education Loan program (FFEL). In the 1990s, concerns over the costs of the program persuaded policymakers to create a direct federal loan program to be administered by the Department of Education (USED). This program was marginalized when Congress passed a law prohibiting the USED from encouraging or requiring colleges to utilize it. As a result, colleges continued to steer student borrowers to the privately originated, federally guaranteed programs, often under marketing pressures from lenders or in some cases as a result of inappropriate financial relationships between the lenders and educational institutions (New America Foundation, 2012) (CFPB, 2012).

In 2010, President Obama signed a law eliminating FFEL loans for all loans made as of July 1, 2010, and requiring all future federal student loans to be originated and administered by the USED. As a result, today all federal loans are originated directly by the federal government. However in FY 2010, \$424 billion in FFEL loan volume remained outstanding (Department of Education [USED], 2011).

The combination of a strong rise in student enrollment, climbing college costs, and increased need for funds have contributed to a significant increase in federal loan volume over the past decade. As Figure 1 demonstrates, from the 2000–2001 academic year to the 2010–2011 academic year, federal loan dollars increased 139% in real 2010 dollars over the past decade.

Figure 1.



Private Student Loans

Private student loans are those that are not made or guaranteed by the federal government. Private student lenders include banks and other non-depository institutions, non-profit organizations (many affiliated with state programs), and some schools that offer or guarantee institutional loans. The large majority of these loans are made by banks and other for-profit lenders.

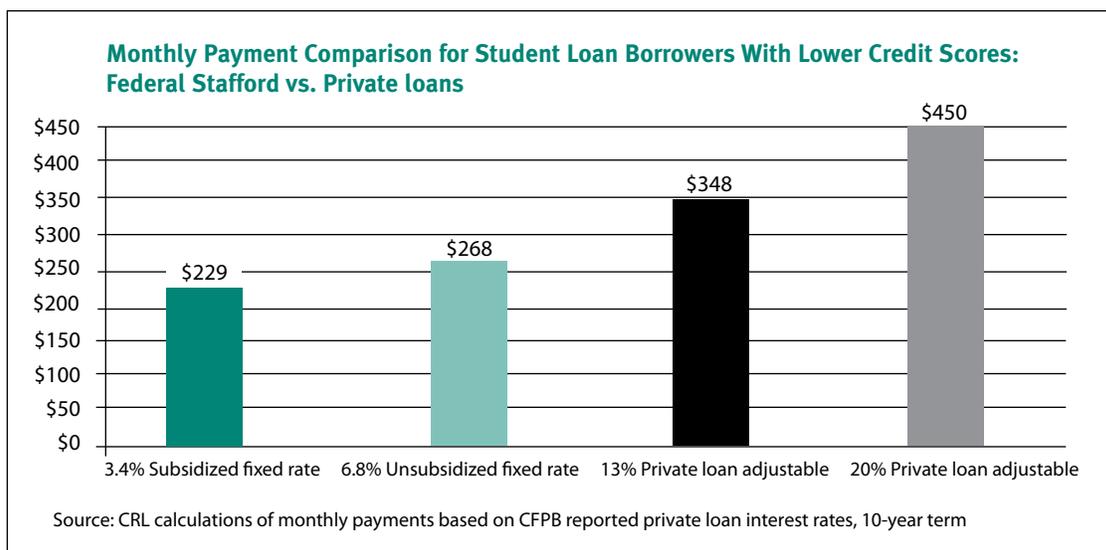
According to the Consumer Financial Protection Bureau (CFPB, 2012), private student loans made up 15% of total student debt outstanding as of January 1, 2012. As with the subprime mortgage boom, private student loan volume exploded between 2004 and 2008 as lenders were able to package and sell these loans to investors in asset-backed securities (ABS). The private market hit peak volume of \$24 billion in 2007–2008, then declined sharply after the economic crash because of credit contraction by financial institutions, the collapse of the ABS secondary market, and increased federal grants and loans. Nevertheless, private student lenders originated nearly \$8 billion of non-government student loans in the 2010–2011 academic year, and many predict that this market segment will grow again if federal loan rates increase or if federal grants and loans are cut back.

LENDING ABUSES AND PREDATORY PRACTICES

High-cost Private Loans

Unlike the interest rates on federal student loans—which are set by Congress and are uniform for all borrowers within a particular loan program¹—private student loans typically have variable, uncapped interest rates that are based on the borrower’s or co-borrower’s credit history. A recent CFPB report on private student loans revealed a wide range of variable interest rates in a sample of private loans originated between 2005 and 2011. Initial interest rates (start rates) ranged from 2.98% to 3.55% at the low end up to 9.5% to 19% at the high end. The Bureau determined that over time, those with the “strongest credits would have paid less than the [fixed unsubsidized] Stafford rate [6.8%], but the average (mean) PSL [private student loan] borrower whose loan was governed by 2011 loan margins would have never paid a lower rate than the Stafford rate. Those with highest rates would have paid between 13% and 20% interest based on historical rates” (CFPB, 2012).² Figure 2 demonstrates that **for those with lower credit scores, federal student loans provide much lower monthly payments than do private student loans.**

Figure 2.



In addition to being significantly more expensive for most borrowers, the private student loans’ uncapped adjustable rates make the overall cost of private loans difficult for students to anticipate, many of whom will not be entering the job market for several years. Private student loans present a great risk of payment shock, particularly those with the highest rates.

Unused Federal Loan Options

Although originally designed to supplement and provide needed funds for students who reached their maximum federal loan limits, today the private loan market also competes with existing federal programs. Since private student loans are generally more expensive and provide far fewer repayment

1 All direct federal loan rates are now fixed interest rate products ranging from 3.4% for subsidized Stafford loans to 7.9% for Direct PLUS loans (those for parents and graduate or professional students).

2 To compare the costs of adjustable rate private loans with the federal Stafford loan rates, the CFPB applied 2011 margins to historical rate data to simulate the interest rate that borrowers in different credit score ranges would have paid over time.

options than federal loans, it is in the best interest of the consumer to exhaust all federal loan options before taking out a private student loan. Unfortunately, **the CFPB study found that “more than 40% of PSL [private student loan] borrowers do not exhaust their Stafford loan eligibility” (CFPB, 2012).** These findings corroborate an earlier study by the Project on Student Debt (PSD, 2010) that found 25% of private loan borrowers in 2007-2008 took out no Stafford loans at all and 27% took out Stafford loans but borrowed less than the full amount.

Lack of Repayment Flexibility and Protections on Private Loans

Federal student loan programs include a variety of repayment options that are often unavailable to private student loan borrowers. Options on federal loans include the income-contingent repayment plan and the income-based repayment plan, both of which allow monthly payments to be calculated as a portion of the borrower’s income. This helps ensure that a borrower can repay their loan without causing undue financial hardship. For borrowers who are unable to make their payments, the federal government offers two options: deferment, in which payment is postponed and interest charges can be waived; and forbearance, in which payments are postponed and interest continues accruing. Most private loans do not offer these types of repayment options, making it harder for borrowers facing financial difficulties to work out a payment solution and prevent default.

Private Student Loans Cannot be Discharged in Bankruptcy

Before 2005, private student loans generally were dischargeable in bankruptcy. Since then, private student loans have been dischargeable only for borrowers who can show that payment would cause “undue hardship” for them or their dependents—something that is exceedingly hard to prove. Private student loans are effectively non-dischargeable in bankruptcy and are treated the same way as child-support debts or criminal fines. The severe treatment of private student loan borrowers was justified as a way to make it harder for students to “abuse” the bankruptcy system, but there is no evidence that this is a real issue. Other provisions in the bankruptcy code, like counseling requirements and the means test, address the abuse concerns.

Questionable Financial and Educational Outcomes at For-Profit Institutions

Although still a small portion of the overall student population (nine percent of total enrollment), the for-profit post-secondary- education industry has enjoyed exponential growth over the last decade. This segment also consumes a disproportionate share of federal student aid and contributes disproportionately to U.S. student debt burden levels and default rates (Nguyen, 2012). In 2009–2010 for-profit institutions received \$32 billion or 25% of total Department of Education funds and \$280 million or 50% of the Department of Veterans Affairs total tuition assistance benefits. Meanwhile, default rates were over twice as high at for-profit institutions than at public colleges and universities. Several recent reports raise important questions about the investment of these public funds; the marketing and recruiting techniques of these institutions; and the educational, employment, and financial outcomes of those who attend these schools (see next section).

For-profit colleges consume a disproportionate share of federal student aid and contribute disproportionately to student debt burdens and default rates.

Note: Many servicing and collection practices produce problematic outcomes for student loan borrowers. These issues will be covered in the “Abuses in Debt Collection” section of State of Lending to be released in the first half of 2013.

IMPACT ON U.S. HOUSEHOLDS AND REMAINING CHALLENGES

Strong Growth of Student Debt

According to a recent poll, “more than three in four (76%) young adults say that college has become harder to afford in the past five years” (ICAS et al, 2011). The inflation-adjusted cost of tuition and fees at public four-year colleges and universities has increased 368% since 1981 and 277% at public two-year institutions. Over the past decade, year-over-year nominal dollar increases have averaged 5.6% (CBA&PC, 2011).

Another study found that “About 65% of students who earned bachelor’s degrees in 2009–10 from the private non-profit four-year colleges at which they began their studies graduated with debt. Average debt per borrower was \$28,100, up from \$22,600 (in 2010 dollars), a decade earlier” (PSD, 2010). Graduating students are increasingly entering a challenging job market saddled with large amounts of debt. Students who have taken on debt but are unable to complete their programs face an even heavier financial burden, as they must pay the debt but do not have a degree that would allow for higher wages. Low-income students and students of color are even more likely to need to rely on student loans and to become saddled with large amounts of debt upon graduation. In 2008, 16% of African-American graduating seniors owed \$40,000 or more in student loans, compared with 10% of whites, 8% of Hispanics, and 5% of Asians (PSD, 2010).

This debt can have long-term implications for these students for years to come, impacting everything from one’s ability to purchase a home to retirement decisions. In fact, Americans 60 and older accounted for nearly five percent of past-due student loan balances (FRBNY, 2012).

Difficulty Assessing Financing Options

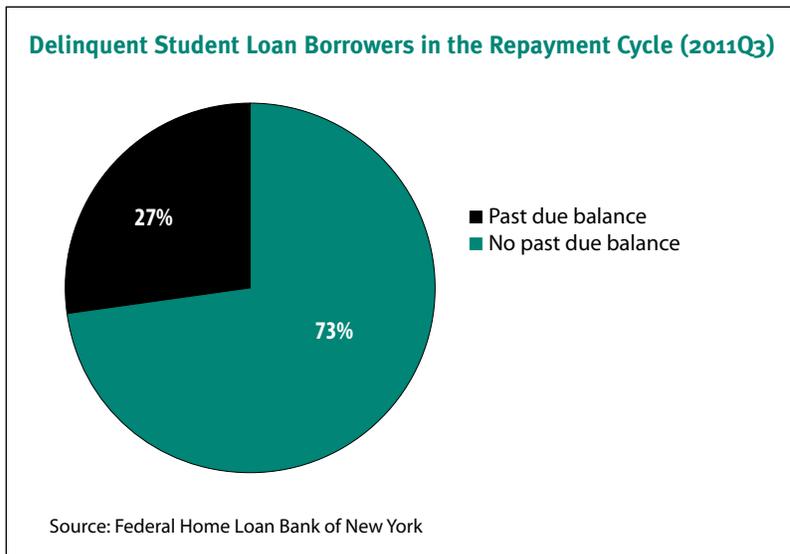
Unfortunately, many borrowers and families face a dizzying array of financial aid options—including grants, scholarships, federal loans, and private loans—and are often confused and unsure about their options. A recent survey of student loan borrowers with high debt levels found that about 65% misunderstood or were surprised by aspects of their student loans or the student loan process. In addition, the survey found, “about two-thirds of private loan borrowers, including those who took out both private and federal loans, said that they did not understand the major differences between their private and federal options” (Whitsett, 2012).

Until recently, little guidance on the financial consequences of those choices was available for students. Although efforts are underway to provide more financial education and greater transparency to the financial aid application and payment process, more work is needed.

Increased Loan Defaults

Higher unemployment and underemployment in recent years has pushed up default rates on student loans; after declining significantly during the 1980s and 1990s, they are once again on the rise. The Federal Reserve Bank of New York reported that, of the 37 million borrowers who have outstanding student loan balances as of third-quarter 2011, 14.4% or about 5.4 million borrowers, have at least one past-due student loan account. See Figure 3. But as the study points out, this figure represents the delinquent fraction of all outstanding student loan debt, including loans that have yet to enter the repayment cycle. In fact, almost half of outstanding debt has not yet entered repayment status. Of the 20 million borrowers that have entered the repayment cycle, 27% are past due (FRBNY, 2012).

Figure 3.



Higher unemployment rates are driving some of the increase in student loan defaults; these are also growing because of higher dropout rates, particularly among for-profit college students.

- **Rate of degree completion**

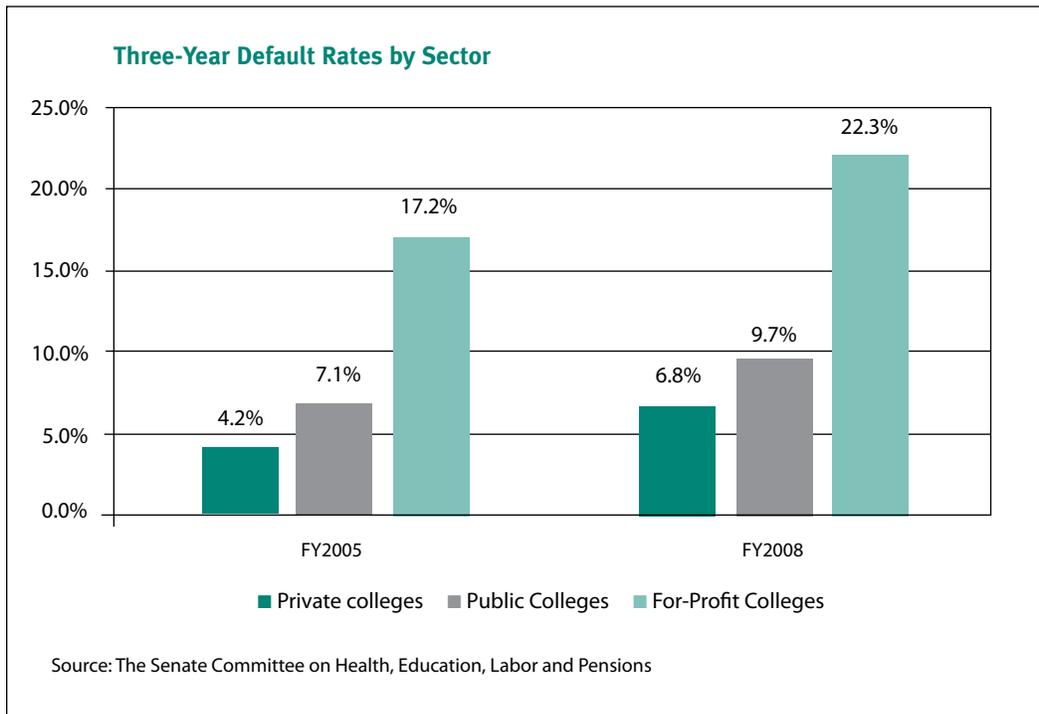
Dropout rates have increased in recent years. Between 2005 and 2009, 29% of all student loan borrowers dropped out of college, up from 23% in 2001. Not surprisingly, borrowers who do not finish their degree are more likely to default on their student loans; one recent study found that “borrowers who dropped out were more than four times more likely than borrowers who graduated to default on their loans: 16.8% versus 3.7%” (Nguyen, 2012).

- **Lower graduation rates and higher default rates at for-profit institutions**

Most students at for-profit colleges get little for their financial investment: the average bachelor degree graduation rate is a paltry 22 percent—one-third the level of not-for-profit colleges (Baum & Payea, 2011). It is small wonder that for-profit institutions have significantly higher default rates than either non-profit public or non-profit private institutions. The industry argues that they are reaching a more vulnerable population and therefore lower graduation rates and higher loan defaults should be expected. However, many policymakers and education advocates question both the educational commitment of these institutions and the cost of the financial burden faced by the majority of students attending these schools.

In July 2012, the U.S. Senate Committee on Health, Education, Labor and Pensions (HELP) released *For Profit Education: The Failure to Safeguard the Federal Investment and Ensure Student Success* (HELP, 2012), reporting on a two-year investigation into the for-profit sector of higher education. The report found that despite accounting for less than ten percent of total enrollment, for-profit students nevertheless make up 47% of federal loan defaults (HELP, 2012). And the three-year default rates for for-profit colleges are two to three times higher than those for public and private non-profit schools, as Figure 4 demonstrates.

Figure 4.



In addition, for-profit schools are more expensive than public institutions with comparable programs. The Senate report found a larger share of revenue paid out in shareholder profits (19%) and marketing and recruiting (23%), while only 17% was spent on instruction (HELP, 2012). For-profit students are also more likely to borrow money and graduate with significant debt burdens. The Senate report found, “fifty-seven percent of Bachelor’s students who graduate from a for-profit college owe \$30,000 or more. In contrast, 25 percent of those who earned degrees in the private, non-profit sector and 12% from the public sector borrowed at this level” (HELP, 2012).

Note: Delinquency and default rates are also influenced by the policies and practices within the student loan servicing industry. This topic will be addressed in the “Abuses in Debt Collection” section of the State of Lending report, to be released in early 2013.

LEGISLATION AND REGULATION

Recent legislative and regulatory efforts have focused on such efforts as preventing fraud in Federal Student Aid programs, increasing the information available to help students make informed decisions regarding their financial aid options, and enhancing repayment options for student loan borrowers. In addition to the Senate HELP Committee report, Congress passed legislation in July 2012 extending the subsidized interest rates on student loans of 3.4% for 7.4 million borrowers for one year.

The current Administration and the CFPB have also come out with several initiatives in response to these policy challenges, including the following:

- The Department of Education established a negotiated rulemaking committee on Federal Student Aid programs focused on preventing the fraudulent use of such funds and improving and enhancing the administration of such funds, including to for-profit schools;
- The Administration introduced the Pay as You Earn plan to enhance borrower repayment options. Qualifying borrowers can now pay as low as ten percent of their monthly income towards their student loan; previously, the minimum was 15%. Loans can also be forgiven after 20 years of payments; previously, loan forgiveness took 25 years;
- The CFPB and the Department of Education issued a report on the private student loan market;
- The CFPB launched its Student Loan Complaint System to help inform the agency of student concerns and potential abusive practices in the student loan industry, documenting 2,900 complaints in seven months. In addition, the CFPB introduced its Financial Aid Shopping Sheet to increase student awareness and education of financial aid options for higher education.

STUDENT LOANS POLICY RECOMMENDATIONS

In order to confront the wide range of challenges that face student borrowers today, lawmakers and regulators will need to use a multi-faceted approach that addresses the cost of the financing and repayment options, simplifies the financial aid process and enhances borrower awareness, and holds educational institutions accountable. Continued cooperation among USED, CFPB, and other regulators is critical to ensuring that effective policies are adopted to address these challenges.

Require School Certification of Private Loans

Given the higher prices and greater repayment risks associated with private loans, students should be encouraged to exhaust their federal and state loan options before acquiring private student loans. Schools should be required to certify the need for and inform students of any untapped federal aid eligibility and the risks of private student loans.

Allow for the Discharge of Private Student Loan Debt in Bankruptcy Court

Congress should change the law so that private student loans are treated the same as any other unsecured consumer debt under the bankruptcy code.

Increase Oversight of For-Profit Education Institutions

Increase federal and state oversight of for-profit institutions, including restricting the use of federal funds for recruiting or marketing purposes, and increasing the percentage of non-federal funds that institutions are required to raise.

Increase Efforts to Help Students Make Wise Decisions about How to Pay for College and Improve Loan Counseling

The CFPB and the Department of Education have recently undertaken efforts to heighten borrowers' awareness of options on how to pay for school and how to compare the costs of attending different schools and different ways of paying for college. The CFPB and the Department of Education should test these tools and disclosures for effectiveness, with a particular emphasis on helping borrowers understand the difference between federal and private loans.

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CAR-TITLE LENDING

The State of Lending in America &
its Impact on U.S. Households

Susanna Montezemolo

July 2013



www.responsiblelending.org

CAR-TITLE LENDING ABUSES AND PREDATORY PRACTICES

Car-title loans are expensive loans averaging more than \$1,000 that are secured by the title to a vehicle that the borrower owns free-and-clear. They are traditionally offered as payday-loan-like single-payment loans with one-month terms, which tend to be renewed multiple times like their payday counterparts. An emerging practice is a movement toward longer-term and still high-cost installment products.

The very structure of car-title loans leads to problems for consumers, including excessive repayment fees and repossessions, as detailed below.

Asset-Based Lending

Asset-based lending generally refers to making loans without evaluating the borrower's ability to repay the loan. Instead, lenders base the decision of whether and how much to lend on the value of the collateral. A classic example of asset-based lending was subprime mortgage loans made in the height of the mortgage bubble of the 2000s, when lenders often did not even ask for proof of borrower income. Borrowers who could not afford their loans had no choice but to continually refinance their loans based on the value of their homes or sell their houses to pay off the loans.¹

Car-title lenders similarly engage in asset-based lending. Car-title loans are based on the value of a borrower's car that is owned free-and-clear, rather than the ability of the borrower to repay the loan and meet other obligations without re-borrowing. A typical car-title loan requires no credit check,² and lenders do not generally ask about monthly expenses or debts. Some do not ask about income³ or require that the borrower have a bank account. Rather than properly underwriting the loans based on a borrower's income and obligations, lenders protect themselves from loan losses by lending only a small percentage (about one-quarter) of the car's consumer resale value (commonly known as "Blue Book" value) and repossessing the vehicle in the event of default.⁴

1 Federal banking regulators issued joint guidance against asset-based lending, which stated: "Loans to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than the collateral pledged, are generally considered unsafe and unsound" (OCC, FRB, FDIC, & OTS, 2001). Notably, these provisions applied to all types of bank-originated credit, not simply mortgages.

2 Martin & Adams (2012) state in their survey of all car-title lending stores in Albuquerque, NM, "Income requirements in the loans were lenient to non-existent." Certainly, these are how the loans are marketed. For example, TitleMax—a leading national car-title loan company—states on its website, "Your credit score doesn't matter. TitleMax can give you a title loan whether you have good credit, bad credit, or no credit. And your credit score isn't affected by applying/obtaining a title loan with TitleMax." Elsewhere on the website, it states: "You do not need good credit. TitleMax does not check your credit or use your credit history in any way during the approval process" (TitleMax, 2013).

3 For example, Zywicki (2010) states, "**Lenders may** [emphasis added] verify employment, income, and perform a credit check, but the practice is not uniform. Most scrutiny focuses on the value of the car rather than the borrower."

4 Lenders sometimes state that they lend a higher percentage of the car's value, but this is based off of the vehicle's wholesale value (known as the "Black Book" value, which is similar to a dealer's trade-in value). The Black Book value is lower than the Blue Book value.

A title lending industry trade group, the American Association of Responsible Auto Lenders (AARAL), wrote in a 2011 comment letter to the Consumer Financial Protection Bureau (CFPB): “The loan we provide is secured by a first lien on the customer’s vehicle and the amount of the loan is based on an appraisal of the value of the vehicle. By contrast, many other alternative financial service providers make an unsecured loan primarily based on an evaluation of the consumer’s credit.”

In a law review article, Martin & Adams (2012) write:

With few exceptions, title lenders have no interest in whether the consumer borrowing the money can afford to pay back the loan or make the monthly interest payments. Ability to repay is not part of the underwriting process. [Emphasis added.] Nor need it be in order for lenders to collect their loan and then some. Since some lenders lend at 40% of value or less, they can rely on [repossessing and selling] the car if the borrower stops making the monthly payments. These practices also explain why some title lenders sell used cars as well. Only in this context would a lender loan \$4,000 to someone who makes just \$980 a month. By structuring a loan with \$580 monthly payments from a person who makes less than \$1,000 a month, a lender can assure that he or she will end up with the payments for some period, and then the car.

CRL and the Consumer Federation of America (CFA) analyzed litigation records made public during litigation against a large Delaware-based car-title lender.⁵ To our knowledge, this is the first-ever analysis of class action car-title data, and we present findings from this analysis throughout this *State of Lending* chapter. These data—which include records from 561 auto title borrowers—support Martin & Adams’s analysis. Figure 1 shows that the median loan-to-value ratio among borrowers in these data is 26%, while the median APR is 300%; that is to say, borrowers paid very high interest for loans with significant excess collateral.

Figure 1: Loan Characteristics from CFA/CRL Car-Title Data

Median Loan Size	\$845
Median Car Value (Blue Book Value)	\$3,150
Median Loan-to-Value Ratio	26%
Median APR	300%

Balloon Payments and Repeat Borrowing

Many car-title loans combine balloon payments with a short (30-day) loan term, requiring the borrower to repay the full principal plus a substantial fee in just one month. Most borrowers cannot repay the full amount due (principal plus interest) in one payment after just a month and still be able to pay their other expenses. As a result, they end up in a cycle of debt, taking out one loan after another in an effort to stay financially afloat; a loan that is advertised as short-term ends up creating a long-term debt treadmill.

⁵ Records were made available to CRL and CFA by Robert F. Salvin, Esq., Community Justice Project, made public through *Salvatico v. Carbucks of Delaware, Inc.* For additional information about the data and analysis, see Fox, Feltner, Davis, & King (2013).

Car-title lenders exploit the mistaken perception that these loans are short-term by sometimes offering the first single balloon payment loan for “free” or at a reduced rate,⁶ knowing that borrowers will be hard-pressed to pay back even only the principal borrowed in a month. These lenders lure borrowers in with the prospect of a “free” loan but enjoy significant fees after borrowers take out additional loans in rapid succession. The President of TitleMax, one of the largest car-title lending companies with stores in multiple states, highlighted the cycle of debt in a deposition: “Customer loans are typically renewed at the end of each month and thereby generate significant additional interest payments” (Robinson III, 2009). State data support the existence of a cycle of debt as well. For example, in 2010—the latest year reported—over 90% of loans in Tennessee were renewed, and only 12% of loans taken out that year were paid in full as of the end of the year (Tennessee DFI, 2012).

Threat of Repossession

As detailed in the following section, most car-title borrowers are low-income consumers who rely on their cars to commute to and from work. Repossession poses a real threat to employment and causes additional fees to be added to the balance of the loan. Paying back the loan is the top financial priority of borrowers, as the consequences of not doing so can be immediate and severe: Lenders use GPS devices to locate the car for repossession (Martin & Adams, 2012). Some even place a tracking device in the car that allows them to turn off the engine remotely.⁷ Repossession is not an infrequent occurrence; for example, fully 60% of 2008 New Mexico car-title borrowers lost their car that year to repossession.

6 For example, according to the latest New Mexico car-title regulator report, the APRs on loans made in 2011 ranged from 0% to 717%, indicating that some borrowers received a “free” first loan (New Mexico Financial Institutions Division, 2012).

7 For example, according to a CNN article, “A company based in Arizona said they have GPS systems installed on the cars so they can track the cars and shut them off remotely if they don’t receive payment on time” (Neiger, 2008).

IMPACT ON U.S. HOUSEHOLDS

Car-title borrowers generally have low or moderate incomes. Regulators in Illinois (Veritec, 2013) and New Mexico (New Mexico Financial Institutions Division, 2010) report that car-title borrowers in their states have average gross incomes of under \$25,000 (\$24,531 and \$24,493, respectively). Zywicki (2010) found that about half of all car-title borrowers are unbanked, lacking access to both mainstream and subprime credit.

Income Impact and Loan Churning

The combination of short-term balloon payments and minimal underwriting is particularly harmful to borrowers taking out traditional 30-day car-title loans. Figure 2 highlights that borrowers earning a typical income of \$25,000 per year cannot afford to repay the average loan amount of \$1,042—even a “free” loan with no fee—in a one-month loan term. If they did, they would not have enough money left over for basic living expenses. To stay afloat financially, they need to extend the loan by re-borrowing the principal and paying the fee multiple times in an expensive cycle of loan churn.

Figure 2: A 30-Day Car-Title Loan Results in a Debt Trap, Even with No Fee

Cost of a 30-Day Car-Title Loan for a Borrower Earning \$25,000/Year in Gross Income		
	\$0 per \$100 fee ("free" loan, 0% APR)	\$25 per \$100 fee (300% APR)
30-Day Income		
Before-tax income	\$2,083	\$2,083
Income taxes paid or (received, such as through the Earned Income Tax Credit)	(\$16)	(\$16)
After-tax income	\$2,099	\$2,099
Social Security & pension payments	\$102	\$102
Net one-month income	\$1,997	\$1,997
Car-Title Loan Cost		
Fee due on average car-title loan of \$1,042	\$0	\$261
Total payment due on average \$1,042 car-title loan	\$1,042	\$1,303
Amount remaining to cover all other expenses	\$955	\$694
30-Day Essential Expenditures		
Food	\$357	\$357
Housing	\$977	\$977
Transportation (incl. insurance, gas, maintenance)	\$389	\$389
Health care	\$221	\$221
Total essential expenditures	\$1,942	\$1,942
Funds remaining (or deficit) after paying auto title loan and essential expenditures	(\$987)	(\$1,248)

Source: 2011 Consumer Expenditure Survey, Bureau of Labor Statistics, for households earning \$20,000–\$29,999 annually.

BORROWER STORIES

Whether structured as single-payment 30-day loans that require multiple renewals or as longer-term, high-cost installment loans, car-title loans create a long-term cycle of debt. These borrowers highlight the long-term cost of these loans:

JEFFREY SIMMONS, 56, of Glendale, Arizona, took out a \$2,000 title loan with 156% APR to pay for repairs after his car broke down so he could travel to his dialysis appointments three times a week. Living off of a fixed income of \$1,300 in monthly disability payments, he paid only interest on the loan for the first five months. When the balance was due in the sixth month, he refinanced. Of his current monthly \$308 car-title payment, only \$28 goes to principal. His car continues to break down, and he takes a bus to his dialysis appointments. Simmons advises, **“Try to stay away from them. You will never pay that stuff back”** (Brodesky and O’Dell, 2013).

JAMES HAGA of Marion, Virginia took out a \$1,600 300% APR title loan on his truck. Ultimately, the lender repossessed his truck—worth \$13,000—after having collected \$4,500 (nearly three times the amount borrowed) in payments (Kirchhoff, 2006).

After repaying the principal due on the “free” loan, a typical borrower has \$955 remaining to pay \$1,942 in essential expenditures, leaving a deficit of \$987. The situation is worse for borrowers who pay the fee of \$261,⁸ who end up with a deficit of \$1,248. Many borrowers have other expenses not included in the chart above—such as child care, clothing, other debt obligations, and the like—and face even greater difficulty in repaying the loan.

Car-title loans are structured to be unaffordable. The only way most borrowers can meet the obligations of the 30-day balloon payment while meeting their other monthly expenses is either to pay only the fee and extend the loan or to take out a new loan shortly after repaying the old one. Many borrowers remain indebted until they default or receive an atypical cash infusion—such as a tax refund—that allows them to finally pay off the balance.

TitleMax data highlight this cycle of repeat borrowing, with a 30-day loan being “typically renewed eight (8) times,” according to a deposition of the former CEO (Robinson III, 2009). Nine monthly loans per year (one loan plus eight renewals) puts the typical borrower in expensive, high-cost auto title debt three-quarters of the year. Figure 3 highlights the average cost of taking nine loans per year for the average loan size of \$1,042.⁹

Borrowers who take out the typical nine title loans in a year pay back over three times the amount borrowed: \$3,391 in payments for a \$1,042 loan. This is the case even though they use a car typically worth more than \$4,000—well over three times the loan amount—for collateral.

Figure 3: Total Borrower Cost of a Typical 30-Day Car-Title Loan

Average principal borrowed (see Appendix 1)	\$1,042
Fee for first loan (\$1,042*25%)	\$261
8 additional renewal fees (\$261*8)	\$2,088
Total fees paid	\$2,349
Total amount paid in principal and fees for a \$1,042 loan	\$3,391
Average car value *	\$4,008

* Average car value assumes a 26% loan-to-value ratio (the median in the CRL/CFA data set).

⁸ Based on the typical fee of \$25/\$100 borrowed.

⁹ See Appendix 1 for the average loan size calculation.

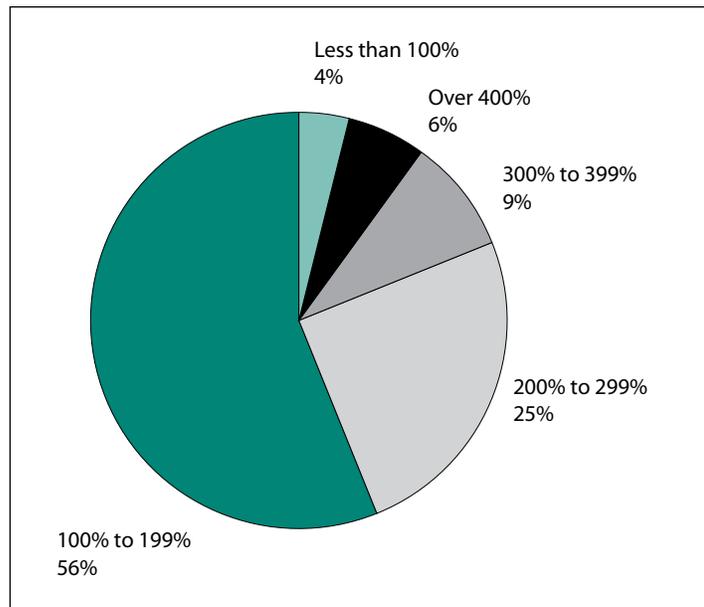
BORROWER STORIES

After his daughter returned from serving in Iraq and asked for financial help to relocate her family, **PRESTON WHITE, 63**, took out a title loan on his pickup truck from a store in Killeen, Texas. The 30-day, \$4,000 loan carried a 375% APR. White had already spent his life savings on paying for treatment for his wife's pancreatic cancer and soon realized that his fixed income left him only enough money to cover the fees, not the principal. He recognized the cycle of debt: **"In four months, I could have paid more than what I went to the store for in the first place, and still owe the original loan amount,"** he said. **"Never in my wildest imagination did I think that such a loan product could even exist. You assume the system will have usury laws and protect you from such things. . . . Everybody's got to make a profit, but there should be no place for usury in the 21st century."** He was ultimately able to retire the debt by taking out a loan at 16% APR through a credit union (Gogoi, 2010).

ALICIA AND CLINTON LUMMUS of Conyers, Georgia, took out a \$525 car-title loan after injuries forced them both to stop working. Over eight months, they made payments totaling \$1,056—more than twice the amount borrowed—but ultimately fell behind on payments. The lender repossessed the vehicle, worth \$14,000—and was able to keep any excess money from the sale of the vehicle, since Georgia law allows the lender to do so (Kirchhoff, 2006).

CRL and CFA litigation data analysis provides further evidence that a car-title loan typically becomes a long-term cycle of debt.¹⁰ The average borrower was indebted for six months. Around one in six borrowers (16%) was in continuous debt for at least one year. Figure 4 highlights how much borrowers paid in fees as a percentage of the amount that they borrowed. 96% paid at least as much in fees as they received in principal; 40% paid at least twice as much in fees as they received in principal; 15% paid at least three times as much; and 6% paid at least four times as much.

Figure 4: Fees Paid by Car-Title Borrowers as a Percentage of Loan Amount



Source: CRL/CFA proprietary data set on file with CRL.

Repossession

The threat of repossession of the vehicle that serves as collateral for a loan is a key incentive for borrowers to pay off their loans. According to a report from the National Consumer Law Center, every state allows lenders to repossess vehicles without a court order, and most of these repossessions are carried out by unlicensed individuals. These “self-help” repossessions can lead to bodily injury, trauma, or even death for the borrower, which “shows present flaws in the present system for automobile repossessions” stemming from the lack of basic legal protections afforded to auto owners (Van Alst & Jurgens, 2010).

¹⁰ For more information on these data, see footnote 5.

BORROWER STORIES

SHANELL WHITE of Elk Grove, California, needed money to pay for rent after her expenses increased when she began to care for her niece. She took out a \$3,900 installment title loan using her car—worth \$12,000—as collateral. After having paid nearly \$10,500 over three years, she was told she still owed the full principal that she had borrowed. The lender repossessed and sold the car yet still sent her a bill for the loan after. **“To me, it’s just modern-day loan shark-ing. People are being taken advantage of;”** she concluded (Said, 2013).

SEAN received a \$1,500 car-title loan, which he renewed over 40 times—paying over \$11,500 in interest—before receiving help from family to pay off the principal. He said, **“I was too embarrassed to ask my parents for the initial loan money, [but] ended up borrowing money from them to make some of the payments and ultimately had to ask them to pay off the whole loan, after losing tons of money along the way”** (Martin & Adams, 2012).

Car-title lenders claim that they repossess a relatively small number of vehicles compared with the number of loans made. However, the more relevant statistic is the number of repossessions relative to the number of borrowers, since most 30-day car-title borrowers take out many loans. In our litigation data set, one in six borrowers (17%) incurred a repossession fee, typically \$350–\$400, which averaged half of the borrower’s outstanding balance.

Martin & Adams (2012) found even higher repossession rates in New Mexico between 2004 and 2008. Over this time, annual repossession rates ranged from 20% to 71%, depending on the year that the loans were made. Some of these borrowers ultimately paid back the loan (with substantial additional repossession and other fees). However, as shown in Figure 5, **the rates of vehicle loss increased substantially from 2004, when the rate was 15%, to 2008, when 60% of borrowers permanently lost their vehicles.** This suggests that more borrowers got into trouble as they were unable to get out of their loans.

Figure 5: New Mexico Car-Title Repossession and Vehicle Loss Rates by Customer

Year	2004	2005	2006	2007	2008
Repossession Rate by Customer	28.7%	20.2%	53.1%	47.5%	71.2%
Vehicle Loss Rate by Customer	14.6%	13.0%	41.0%	37.0%	60.1%

Source: Martin & Adams, 2012

Repossession and other fees are added to a borrower’s running balance. As a result, despite the low loan-to-value ratio of the initial loan, nearly all proceeds of the repossession sale go directly to the lender.

MARKET AND INDUSTRY OVERVIEW

Market Size

As highlighted in Appendix 2, 30 states—including the District of Columbia (DC)—do not have a noticeable presence of high-cost car-title lenders. More than half (53%) of American adults live in areas where these loans are not offered.

Twenty-one states have a significant presence of car-title lending. **Car-title lenders in these states originate an estimated 2.0 million car-title loans each year worth \$1.9 billion in annual loan dollar volume, not including churn.¹¹ We estimate that borrowers pay \$4.3 billion in fees alone on these loans.**

In addition, the Military Lending Act of 2006 (MLA) put in place protections from abusive lending practices for active-duty service members and their families. These protections include setting a 36% maximum annual interest rate for certain types of consumer credit and banning the use of an automobile title as security for a consumer credit loan. As a result, car-title loans cannot legally be made to active-duty service members or their dependents regardless of where they live. The MLA was enacted after the Defense Department grew concerned about active-duty service members becoming deeply indebted to high-cost lenders, including title lenders, which put their security clearances and their financial well-being at risk (DOD, 2006).

Types of Loans

30-Day Balloon Loans

30-day car-title loans are still the dominant market product, and are structured similarly to payday loans. Figure 6 highlights some similarities between these loans. Lenders market both as short-term: one pay period (typically two weeks) for a payday loan, and one month for a title loan. Lenders do not engage in underwriting for either product. As a result, borrowers repeatedly take out loans because they cannot afford to pay off the loan and cover their living expenses. Both types of loans carry very high costs, typically triple-digit annual interest rates.

¹¹ For our estimates on loan volume and fees paid, see Appendix 3. For information on methodology, see Appendix 4. Note that these estimates are updated from CRL's publication from earlier this year, "Driven to Disaster" (Fox, Feltner, Davis, & King, 2013). This is because since publication of "Driven to Disaster," several state car-title loan regulators have issued updated regulatory reports that have allowed us to make new estimates.

Figure 6: Similarities between Payday and 30-Day Balloon Payment Car-Title Loans

Features	Payday Loans *	30-Day Balloon Payment Car-Title Loans
Typical Loan Size	\$350	\$1,042
Fee Charged	\$15 per \$100 borrowed	\$25 per \$100 borrowed
Underwriting for Affordability	None	None
Typical Loan Term	14 days, but often renewed	30 days, but often renewed
Typical APR	322%	300%
Collateral	Post-dated check or electronic bank account access	Title to vehicle
Typical Number of Renewals	9	8

* Data on payday loans from CFPB (2013).

Longer-Term Installment Loans

Despite the prevalence of 30-day balloon car-title loans, high-cost installment title loans are increasingly common. Installment car-title loans are offered in Texas, Illinois, New Mexico, and California. Borrowers pay off these amortizing installment products over a period of months or sometimes years. Their triple-digit annual interest rates mean that over the course of the loan, they perform similarly to a 30-day balloon loan that is refinanced multiple times. That is, installment loan borrowers pay more in interest than they receive in principal. Two examples are highlighted in figure 7: The Cash Store, a Texas-based car-title lender, charges 577% APR for a five-month installment car-title loan in which borrowers pay \$1,700 to borrow just \$1,000 (Cashstore.com, 2013). In Illinois, on average borrowers paid \$2,030 in interest alone for an \$893 loan, with an average loan term of over a year (392 days) and an APR of 212% (Veritec, 2013).

Figure 7: Installment Car-Title Borrowers Pay More in Fees Alone Than They Receive in Principal

	Principal Borrowed	Interest Paid	Total Paid	Loan term	APR
The Cash Store (Texas Car-Title Lender)	\$1,000	\$1,700	\$2,700	154 days	577%
Illinois average figures from regulator report	\$893	\$2,030	\$2,923	392 days	212%

LEGISLATION AND REGULATION

Car-title lending, like payday lending, began to surface in the 1990s when states exempted the car-title industry from consumer usury limits of around 36% APR. States without car-title lending generally simply have not acted to exempt title lenders from these usury limits. It is important to note that although many lenders argue that they cannot make loans at less than triple-digit rates, others continue to make small loans within these limits, with or without a car-title as collateral. For example, some banks and credit unions offer refinancing on car loans that include cash out to the owner. In addition, the FDIC's two-year Small-Dollar Loan Pilot Program—which featured unsecured loans of \$2,500 or less at a maximum 36% APR for a loan term of at least 90 days—resulted in 34,400 loans with a principal balance of \$40.2 million (Miller, Burhouse, Reynolds, & Sampson, 2010).

Of the 21 states with car-title lending, 17 have explicitly authorized car-title lending at triple-digit APRs or have set no rate cap. Over half of these 17 states have no limits on the interest or fees that lenders may charge.

Four states (California, Kansas, Louisiana, and South Carolina) have not explicitly authorized car-title lending, but lenders exploit loopholes or definitional weaknesses in state law to make these loans at triple-digit annual rates to borrowers:

- Car-title lenders in Kansas avoid a 36% annual rate cap that applies to closed-end small loans by calling the loans open-ended (Plunkett & Hurtado, 2011).
- In South Carolina, car-title loans are typically made for at least \$601 to avoid the small loan rate cap that covers smaller loans. Similarly, in California, car-title loans are made for over \$2,500 to avoid state laws that apply to smaller loan amounts.
- Although Louisiana specifically rejected an attempt to authorize car-title lending, car-title lenders operate under the terms of the Louisiana Consumer Credit Law by making title loans for more than \$350 for a loan term of over two months.

Even in states that explicitly allow car-title loans at triple-digit APRs, lenders sometimes charge higher rates through a loophole or another statute not intended for their product. For example, even though the Missouri Title Loan Law allows unlimited interest rate charges, it requires a 10% principal reduction upon the third refinancing. To avoid this modest principal reduction requirement, lenders offer car-title loans under the state's small loan law (Hathaway, 2010).

Several states also authorize installment car-title loans. California, for example, authorizes consumer installment loans up to \$5,000, whether unsecured or secured by real or personal property, including liens on motor vehicles.¹² Likewise, New Mexico allows for car-title installment loans.¹³ Illinois explicitly provides for “title-secured loans” in amounts up to \$40,000.¹⁴

In Texas, car-title installment loans are explicitly authorized.¹⁵ However, most title lenders in Texas, whether offering traditional car-title loans or car-title installment loans, do so under the Credit Services Organization law.¹⁶ Under this scheme, lenders position themselves as credit services organization (CSOs) and broker loans on behalf of borrowers. This allows title lenders to charge the maximum interest rate allowed on the underlying loan plus an addition brokerage fee.

12 California Finance Lender Law, Cal. Fin. Code § 22203

13 New Mexico Bank Installment Act, N.M. Stat. Ann. § 58-1-1, et seq.

14 Illinois Consumer Installment Loan Act, 205 Ill. Comp. Stat. §§ 670/15(a)

15 Tex. Fin. Code § 342.001, et seq.

16 Tex. Fin. Code §393.602

POLICY RECOMMENDATIONS

- The Consumer Financial Protection Bureau should promulgate regulations that rein in unfair, abusive, and deceptive car-title loan terms. Lenders should be required to evaluate a borrower's ability to repay the loan and meet other expenses without taking out a subsequent loan.
- Many states with car-title lending have caps of around 36% on the annual interest rates that may be charged for small loans. States that have granted exemptions to these interest rate limits to car-title lenders should revoke them, and states that have not should refrain from doing so.
- States that continue to authorize car-title lending should require that loans be structured as installment products with amortizing equal monthly payments, full consideration of the borrower's ability to repay the loan and afford other expenses, and reasonable rate limitations.
- State policymakers and regulators must remain vigilant in enforcing or strengthening their state lending laws. They should rein in evasion from car-title lenders, who sometimes seek to take advantage of narrow definitions, loopholes, or gaps in laws to charge higher rates than the legislature intended.
- In the event of a default, borrowers must be provided important consumer protections, including notice prior to repossession or sale of the vehicle, a right to redeem the vehicle, and a ban on deficiency balances (in which the borrower owes fees to the lender if the sale of their car does not cover the outstanding debt owed). Sale of repossessed vehicles should be commercially reasonable with any surplus returned to the borrower.
- In addition to substantive protections, the Consumer Financial Protection Bureau and states with car-title lending should collect and make public more data on title lending to allow for policy analysis on the borrower impact and various public policies in place to regulate the practice.

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Appendix 1: Weighted Average Car-Title Loan Amount

	Average Car-Title Loan Amount	Number of Car-Title Stores
Illinois	\$893	437
New Mexico	\$959	194
Texas ¹	\$1,089	2,258
Virginia	\$976	378
Total		3,267
Weighted Average	\$1,042	

¹ Texas provided data on both single-payment and installment car-title loans. To determine the average loan amount, we calculated the total loan volume (including both types of loans) and divided by the total number of loans (including both types of loans). In addition, Texas reported a total of 2,094 single-payment car-title lenders and 986 installment car-title lenders. Because we do not know how many stores make both types of loans, we included only the number of single-payment lenders. The number of stores in Texas may therefore be higher.

Appendix 2: Presence of Car-Title Lending by State

21 States with a Significant Presence of Car-Title Lending (at least \$4 Million/Year Loan Volume, not including refinances)

Alabama (defined as a pawn transaction)
Arizona
California (>\$2,500)
Delaware
Georgia (defined as a pawn transaction)
Kansas (open-ended)
Louisiana (>\$350, loan term of over two months)
Idaho
Illinois
Mississippi
Missouri
Nevada
New Hampshire
New Mexico
South Carolina (>\$600)
South Dakota
Tennessee
Texas
Utah
Virginia
Wisconsin

30 States (including DC) without a Significant Presence of High-Cost Car-Title Lending

Alaska
Arkansas
Colorado
Connecticut
District of Columbia
Florida
Hawaii
Indiana
Iowa
Kentucky
Maine
Maryland
Massachusetts
Michigan
Minnesota
Montana
Nebraska
New Jersey
New York
North Carolina
North Dakota
Ohio
Oklahoma
Oregon
Pennsylvania
Rhode Island
Vermont
Washington
West Virginia
Wyoming

Appendix 3: Estimate of State and National Car-Title Loan Dollar Volume, Excluding Refinances

State	# Stores	Total # Loans	Total Loan Volume
Alabama	672	152,544	\$158,950,848
Arizona	479	108,733	\$113,299,786
California	281	63,787	\$66,466,054
Delaware	56	12,712	\$13,245,904
Georgia	375	85,125	\$88,700,250
Idaho	108	24,516	\$25,545,672
Illinois * ¹	437	59,673	\$53,314,357
Kansas	86	19,522	\$20,341,924
Louisiana	180	40,860	\$42,576,120
Mississippi	360	81,720	\$85,152,240
Missouri	343	77,861	\$81,131,162
Nevada	197	44,719	\$46,597,198
New Hampshire	43	9,761	\$10,170,962
New Mexico *	194	41,080	\$27,090,228
South Carolina	352	79,904	\$83,259,968
South Dakota	89	20,203	\$21,051,526
Tennessee *	837	334,658	\$253,843,036
Texas * ²	2,258 ²	475,681	\$518,216,079
Utah	251	56,977	\$59,370,034
Virginia *	378	128,446	\$125,381,561
Wisconsin	162	36,774	\$38,318,508
TOTAL	8,138	1,955,256	\$1,932,023,417

The \$1.9 B in non-churn principal results in \$4.3 B in fees, assuming the typical eight renewals of the original loan and a typical fee of \$25/\$100 borrowed/loan.

For information on methodology, see Appendix 4.

* Figures from these states are regulator reported. (All other figures are estimated using methodology in Appendix 4.)

¹ Illinois reported the number of loans from January–September 2010; we have imputed a yearly figure using the monthly average from the reported numbers.

² Texas provided data on both single-payment and installment car-title loans. To get the average loan amount, we calculated the total loan volume (including both types of loans) and divided by the total number of loans (including both types of loans). In addition, Texas reported a total of 2,258 single-payment car-title lenders and 1,301 installment car-title lenders. Because we do not know how many stores make both types of loans, we included only the number of single-payment lenders. The number of stores in Texas may therefore actually be higher.

Appendix 4: Methodology for Determining National and State Car-Title Market

Overall methodology: We estimated the level of car-title lending in states that do not report it by multiplying the number of stores in each state by the average number of loans per store (227—see calculation below) by the average loan size from Appendix 1 (\$1,042). We then estimated total fees paid, assuming the typical eight renewals or extensions of the original loan. To do so, we multiplied the total national non-churn loan volume by 25% (the typical fee) and then multiplied the result by nine to account for the original loan and eight renewals.

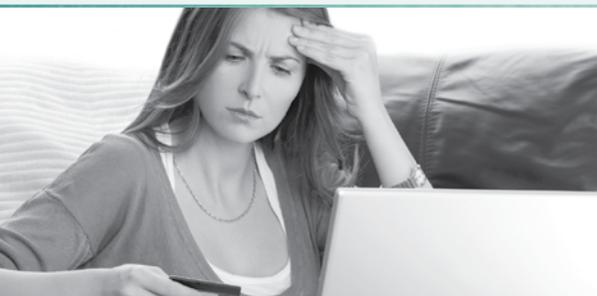
Methodology for number of stores in each state: In Texas, the regulator provided the number of entities reporting for both installment and single-payment title loans. In Illinois, the regulator emailed the approximate number of car-title locations in the state. In California, Idaho, Illinois, Kansas, Mississippi, New Mexico, Tennessee, Utah, and Virginia, the state regulator provided a list of locations licensed to provide title loans. In Missouri, our estimate accounts for both the regulator’s reported number of title loan licensees as well as title lenders operating under separate small loan licenses (Hathaway, 2010). Title lenders in Alabama, Arizona, Delaware, Louisiana, Nevada, South Carolina, and South Dakota do not obtain specific title loan licenses but instead are part of a larger group of small loan licensees. As a result, we attempted to identify which of this larger group of lenders provide title loans through internet searches and phone calls to these companies. Title lenders in Georgia are not licensed by the state, so we estimated the number of locations through examination of the Yellow Pages and internet searches.

Methodology for average number of loans per store: We used data from the states that report the number of car-title stores and number of car-title loans to estimate a number of loans/store. See below for that calculation.

Weighted Average Number of Loans Per Store Annually, Not Including Renewals

State	# car-title stores	# loans	Avg # loans/store
Illinois	437	59,673 ¹	137
New Mexico	190	41,080	216
Tennessee	762	209,155	274
Texas	2,258	475,681	211
Virginia	378	128,446	340
Total	4,025	914,035	
Weighted Average			227

¹ Veritec (2013) provided the number of loans in Illinois from January–September 2012. We imputed the yearly equivalent by taking the monthly average and multiplying by 12.



HIGH-COST OVERDRAFT PRACTICES

The State of Lending in America &
its Impact on U.S. Households

Rebecca Borné & Peter Smith

July 2013



www.responsiblelending.org

LENDING ABUSES AND PREDATORY PRACTICES

Many financial institutions use abusive overdraft programs to unfairly drain their customers' checking accounts, putting consumers on a treadmill of high-cost credit. Abusive overdraft programs drive consumers out of the banking system; indeed, they are the leading reason consumers lose their checking accounts (Campbell, Martinez & Tufano, 2008). Overdraft programs also crowd out better products by removing incentives for banks to offer lower-cost, manageable ways to deal with financial shortfalls (Bair, 2005).

Abusive overdraft programs drive consumers out of the banking system; indeed, they are the leading reason consumers lose their checking accounts.

Overdraft programs began as ad hoc courtesies banks would occasionally provide customers; they were never intended to become a routinely administered, extremely high-cost credit product.

Overdrafts occur when there are insufficient funds in a customer's checking account to cover a transaction, but the bank lends the money to the account holder and pays the transaction anyway. With high-cost overdraft programs, a fee is charged per overdraft transaction and the bank repays itself the overdraft amount and fees, in full, from the customer's next deposit. Banks often offer lower-cost overdraft products, like an overdraft line of credit carrying a reasonable annual percentage rate or an automatic transfer from a savings account or credit card, but financial institutions often automatically place, or steer, customers into the high-cost program. This chapter addresses high-cost overdraft programs.

The predatory characteristics of high-cost overdraft programs include:

- high cost, with the fee vastly disproportionate to the size of the overdraft
- balloon repayment
- very short repayment term
- lack of appropriate underwriting that assesses the customer's ability to repay the loan without taking out another loan shortly thereafter
- manipulation of posting order to increase fees
- the bank's repaying itself before all other debts or expenses, directly from the customer's next deposit of wages or exempt federal benefits (such as Social Security, disability, military or veteran's pay or benefits).

In 2012, the Consumer Financial Protection Bureau (CFPB) launched an inquiry into overdraft programs, noting that overdraft practices have the "capacity to inflict serious economic harm" (Cordray, 2012). In June 2013, CFPB released a white paper documenting its initial findings, concluding that concerns about overdraft practices that regulators have identified for years—including that a significant segment of consumers incur large numbers of overdraft fees, and that even those with "moderate" overdraft usage may pay hundreds of dollars annually—persist today (CFPB, 2013).

High-cost product: high fee, balloon repayment, very short repayment term

CRL's findings here confirm that overdraft programs charge an extremely high cost for credit. Our analysis of 2011 checking account data from Lightspeed Research¹ finds the median overdraft fee charged is \$35. The average fee has not decreased in recent years (the median in 2007 was \$34), despite decisions by some banks to offer “tiered” overdraft fees (\$10 or \$15 for the first overdraft and higher fees for subsequent overdrafts).

The effective cost of an overdraft is a function of the size of the transaction that triggered the overdraft and the number of days the overdraft is outstanding. Overdrafts are repaid when the bank repays itself from the borrower's next deposit within a short period, averaging three days for ATM transactions and two days for debit card purchases.

As transaction sizes can differ significantly by transaction type, we determine cost per dollar overdrawn by category based on the type of triggering transaction.

Because debit card transactions tend to be small and trigger average overdrafts of only \$20, they incur the most expensive fees in terms of cost per dollar overdrawn (\$1.75). Typically, the overdraft fee is nearly twice the size of the debit card overdraft itself. This is particularly striking since transactions on debit cards can be declined, at no cost to the consumer, when the account lacks sufficient funds.

The overdraft fee is nearly twice the size of the debit card overdraft itself.

Figure 1: Median Overdraft Statistics by Trigger Type

Transaction Type	Transaction Amount	Overdraft Amount	Days until Repayment	Overdraft Fee (\$35 per \$1 Overdrawn)
Debit Card	\$23	\$20	2	\$1.75
Other Electronic ²	\$50	\$47	1	\$0.73
Check	\$72	\$55	1	\$0.56
ATM	\$100	\$90	3	\$0.39

While the analysis above is based on a median overdraft fee of \$35, many banks also add a “sustained overdraft fee” once the account has remained overdrawn for several days. At some banks, this is a one-time additional fee in the \$35 range; at others, it is a fee in the \$6-\$8 range charged daily until the account balance is returned to positive. Some banks have implemented “limits” on overdraft fees in recent years, but these limits typically still allow for daily fees in the hundreds of dollars (Consumer Federation of America [CFA], 2012).

Extension of overdrafts to debit card transactions

Financial institutions transformed debit cards into high-cost overdraft products.

As recently as 2004, 80% of financial institutions declined debit card transactions that would have overdrawn a customer's account (Fusaro, 2007). But over the course of a few years, banks and credit unions regularly began allowing these transactions to go through, charging a large overdraft fee for each one.

¹ Please see Appendix for discussion of methodology.

² As discussed further below, “Other Electronic” transactions include automated clearinghouse (ACH) transactions, such as on-line bill payments, as well as purchases made on-line not clearly identified in the data as debit card transactions.

Banks and credit unions have long defended overdraft fees by saying they protect customers from bounced checks, which typically trigger insufficient funds (NSF) fees and potentially merchant fees. But the same justification could not be made for debit card purchases, since there are no NSF or merchant fees charged for debit card transactions that are declined at check-out when the customer's account is short.³

In addition to being unjustifiable as protection against NSF transactions, overdraft fees on debit cards tend to be particularly harmful because of their effective cost and their frequency. As discussed above, overdrafts triggered by debit cards tend to be smaller than the fees they trigger, and debit card transactions for everyday purchases tend to be more numerous than paper checks. Thus, there is significant potential for numerous overdrafts to be incurred over a short period of time at a very high cost.

Further, a large majority of consumers repeatedly have stated that they prefer that banks decline debit card overdrafts rather than approve them in exchange for the typical fee (Parrish, 2008) (The Pew Center on the States, 2012).

Federal Reserve Board rule made modest regulatory improvements.

In response to widespread criticism and complaints around high-cost overdraft programs, in 2010 the Federal Reserve Board implemented a basic consent requirement for overdraft fees on everyday ("one-time") debit card purchases and ATM withdrawals (Federal Reserve Board, 2009). This rule required that financial institutions obtain a customer's "opt-in" to overdraft coverage on these types of transactions before they could charge an overdraft fee on them. However, requiring consumer consent did not alter the fundamentally abusive features of overdraft programs.

Still, the Board's opt-in rule coincided with a significant shift in the marketplace. The largest debit card issuer, Bank of America, stopped charging high-cost overdraft fees on everyday debit card transactions altogether, reporting afterward that customer complaints had dropped sharply and that satisfaction levels had risen (Moynihan, 2010). HSBC also stopped charging high-cost overdraft fees on one-time debit card transactions, as well as at the ATM. Citibank has never charged overdraft fees on debit card or ATM transactions. With these three banks' policies, 25% of the twelve largest banks, accounting for approximately 40% of the twelve largest banks' deposits, do not charge high-cost overdraft fees on everyday debit card purchases (CFA, 2011) (FDIC, 2011b). In addition, JPMorgan Chase Bank does not charge overdraft fees on ATM withdrawals.

The largest debit card issuer, Bank of America, stopped charging high-cost overdraft fees on everyday debit card transactions altogether.

Nonetheless, three-fourths of the nation's largest banks and large numbers of smaller banks and credit unions continue to charge overdraft fees on debit card purchases, ATM withdrawals, or both. Further, many financial institutions have aggressively marketed overdraft "opt-in," targeting customers who are likely to generate the most fees (Parrish, 2010) (CRL, 2011). CRL's 2011 survey found that the majority of customers who opted-in to overdraft programs misunderstood their options or were misled by information from the bank.⁴ Clearly, consumer "opt-ins" are not evidence of consumer preference.

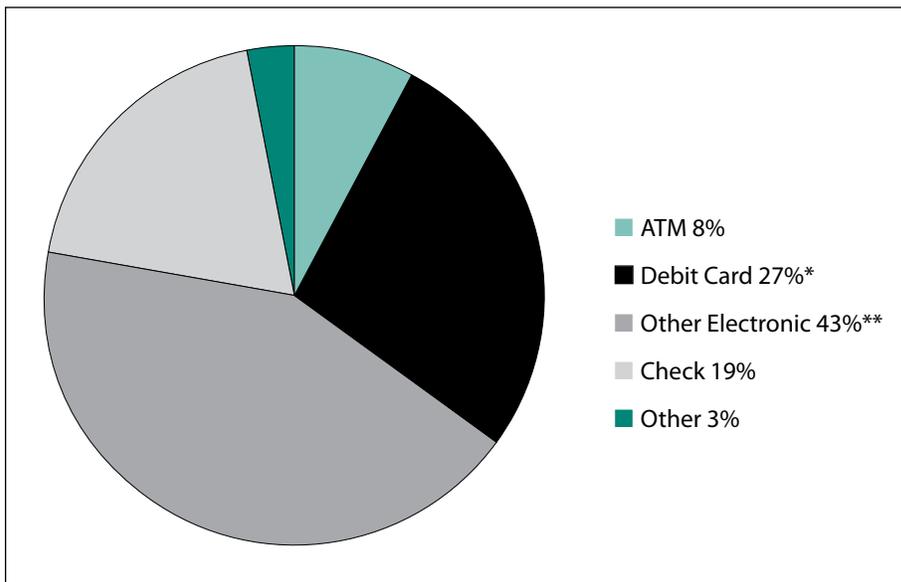
³ The Board has indicated that charging declined transaction fees on ATM or one-time debit card transactions "could raise significant fairness issues" (Federal Reserve Board, 2009).

⁴ For almost half of those who opted in, simply stopping the bank from bombarding them with opt-in messages by mail, phone, email, in person, and online banking was a factor in their decision. Sixty percent (60%) of consumers who opted in stated that an important reason they did so was to avoid a fee if their debit card transaction was declined. In fact, a declined debit card transaction costs consumers nothing. Sixty-four percent (64%) of consumers who opted in stated that an important reason they did so was to avoid bouncing paper checks. In fact, the opt-in rules cover only debit card and ATM transactions, not checks (CRL, 2011).

Our analysis of 2011 data—the first full year following implementation of the opt-in rule—indicates that the types of transactions the Board intended the opt-in rule to cover are still triggering a very large percentage of all overdraft fees: **Debit card purchases and ATM transactions still triggered at least 35% of all overdraft fees.** This figure likely understates the percentage of overdrafts subject to the opt-in rule; another 43% of overdrafts were triggered by on-line transactions, but whether these on-line transactions were one-time debit card transactions (subject to the opt-in rule) or recurring debit card or electronic automated clearinghouse (ACH) (e.g., bill pay) transactions (not subject to the opt-in rule), was not clearly discernible in the data.

Further, this 35% figure understates the percentage of overdraft fees triggered by the kinds of discretionary transactions the Board intended the opt-in rule to cover because it excludes ACH transactions—often discretionary in nature—made through payment services like Paypal. Whether these transactions are processed as a debit card or an ACH transaction depends only on whether a customer chooses a debit card number or a routing and checking account number for payment.⁵ Discretionary transactions processed as ACH transactions are triggering overdraft fees regardless of whether or a not an account holder has opted in.

Figure 2: Percent of Overdraft Loans Triggered by Type of Transaction



* Transactions categorized as “Debit Card” are those that were clearly identifiable in the Lightspeed data as such. However, these likely do not represent the entire universe of “Debit Card” transactions in the data. See text above for further explanation.

** “Other Electronic” transactions include automated clearinghouse (ACH) transactions, such as on-line bill payments, as well as purchases made on-line not clearly identified in the data as debit card transactions. See text above for further explanation.

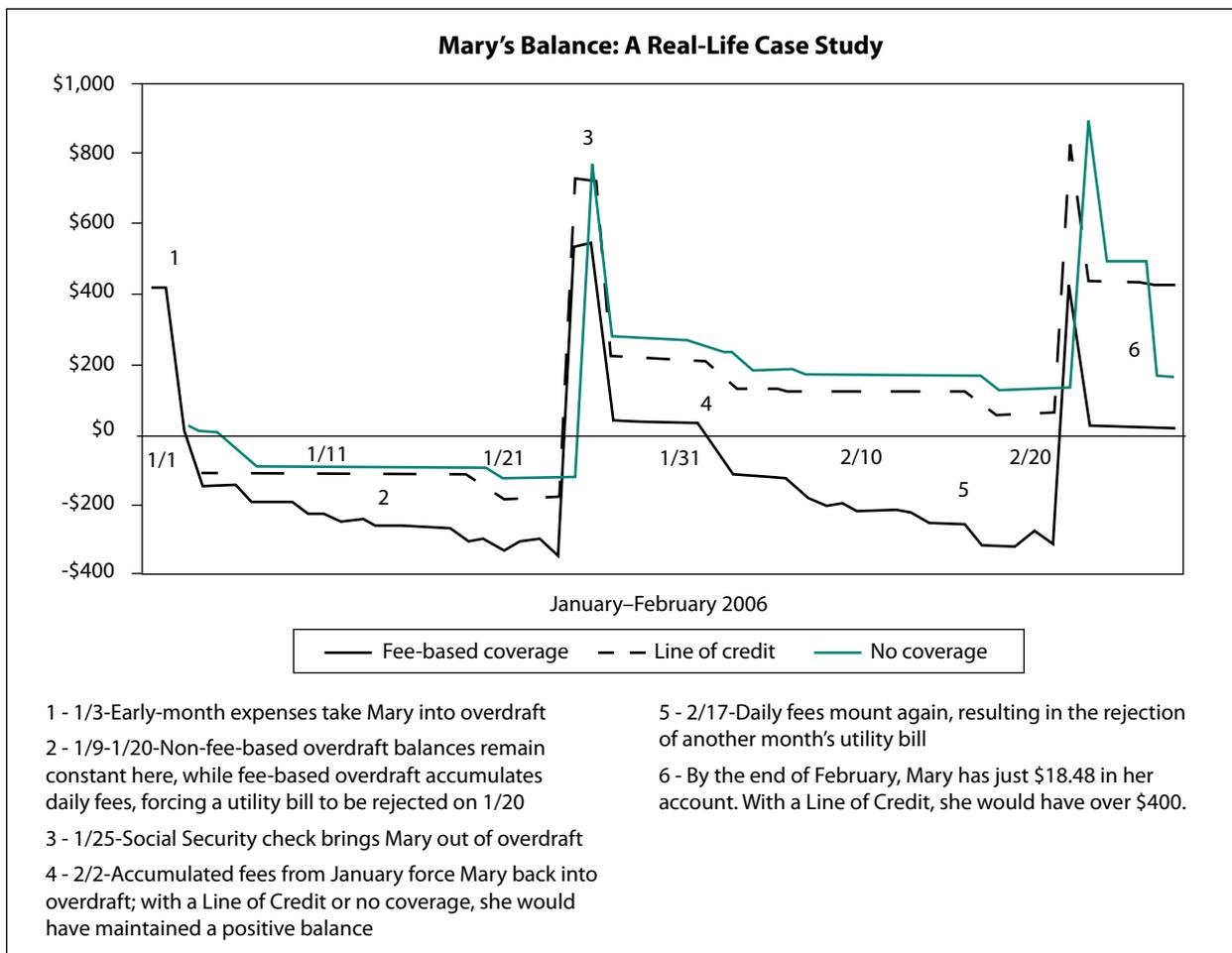
⁵ Though we observed a significant number of Paypal purchases in our data, we were unable to determine whether the purchase was processed as a debit card or an ACH transaction, and thus, whether the overdraft fee on the purchase would have been subject to the opt-in rule or not. All Paypal transactions are captured in the “Other Electronic” category.

CFPB's recent white paper provides further evidence that the opt-in rule has not eliminated the substantial harm overdraft fees triggered by debit cards inflict. Frequent overdrafters whose debit cards could no longer trigger overdraft fees saved \$694 on an annualized basis versus those from whom banks obtained consent forms and continued collecting these fees (CFPB, 2013).

The CFPB study further found that, at several banks studied, involuntary account closures (most commonly due to negative balances, which are most commonly due to overdrafts) were more than 2.5 times as high for customers who had opted in than for those who had not (CFPB, 2013).

No assessment of ability to repay, leaving borrowers worse off

In CRL's report on the impact of overdraft fees on older Americans, we graphed two months of actual checking account activity of one panelist (whom we call Mary) from our database.⁶ Mary is entirely dependent on Social Security for her income. We also graphed what her activity would have been with an overdraft line of credit and with no overdraft coverage at all.



⁶ CRL analyzed 18 months of bank account transactions, from January 2005 to June 2006, from participants in Lightspeed Research's Ultimate Consumer Panel (Halperin & Smith, 2007).

During January and February of 2006, Mary overdrew her account several times and was charged \$448 in overdraft fees. At the end of February, she had \$18.48 in her account. She was trapped in a destructive cycle, using the bulk of her monthly income to repay costly overdraft fees.

With an overdraft line of credit at 18% annual interest over the same period, Mary would have paid about \$1 in total charges for her overdrafts instead of \$448 in overdraft fees. Even if Mary had no overdraft coverage at all, she would have been better off than she was with high-cost overdraft. Five of her transactions, totaling \$242, would have been declined—two point-of-sale transactions and three electronic transactions. She would have been charged no fee for the two point-of-sale transactions. She may have been charged an insufficient funds (NSF) fee and a merchant fee (for a returned transaction) for each of the three declined electronic transactions.⁷ She also may have been charged late fees if any of the electronic transactions were bills. Even if Mary had been charged an NSF fee, a merchant fee, and a late fee for each of the three electronic transactions, her ending balance, after payment of the declined transactions, still would have been far higher than the \$18.48 left in her account with fee-based overdraft coverage.

Mary's situation illustrates a problem common among the repeat overdrafters who pay the majority of overdraft fees: Overdraft fees beget more overdraft fees. Not only do overdraft programs not assess a borrower's ability to repay an overdraft loan without having to re-borrow shortly thereafter, **but overdraft loans are structured in a way likely to lead to repeat overdrafts by those least able to afford them.** Customers struggling financially are unlikely to be able to both repay one or a number of overdraft loans and the associated high fees in one lump sum and continue to meet ongoing expenses; as a result, consumers must borrow again before the end of the next pay cycle. Over time, the repeated fees strip away consumers' cash assets, leaving them financially worse off than when they first overdrafted and unable to meet obligations they otherwise could have met even with no overdraft coverage at all. Former FDIC Chair Sheila Bair has noted that “[r]epeat use of fee-based overdraft protection doesn't make sense for anyone” (Block, 2010).

Manipulating posting order of transactions to increase fees

Another common practice in high-cost overdraft programs is reordering the customer's transactions to post larger dollar items before smaller ones. This practice drives the account negative more quickly so that each smaller transaction posted subsequently posts against a negative balance and triggers an additional overdraft fee. As a federal judge found in 2010, manipulation of posting order can turn what would have been one overdraft fee into ten (Gutierrez v. Wells, 2010).

Manipulation of posting order can turn what would have been one overdraft fee into ten.

⁷ When a financial institution bounces a check or electronic ACH transaction instead of paying it as an overdraft, the financial institution typically charges an insufficient funds (NSF) fee. A merchant may also charge a fee for the returned transaction.

The following example illustrates the practice of transaction reordering:

Scenario A

Starting balance \$90	
Customer buys in this order:	
coffee	\$5
gas	\$30
clothing	\$100*
*triggers a \$34 overdraft fee	

Under A, the \$100 clothing item came out of the checking account last, so there was enough money in the account to cover the previous expenses. The account holder was charged one \$34 fee.

Scenario B

Starting balance \$90		Bank subtracts in this order:	
coffee	\$5	clothing	\$100*
gas	\$30	gas	\$30*
clothing	\$100	coffee	\$5*
*triggers a \$34 overdraft fee			

Under B, the bank subtracted the largest item first—\$100 for clothing—even though that transaction actually occurred last. With high-to-low ordering, the actual order the transactions occurred in doesn't matter. The largest comes out first, which leaves less money in the account to cover the smaller ones. Under this scenario, the account holder was charged three overdraft fees, totaling \$102.

Many banks maintain that posting transactions in order from highest to lowest amount benefits consumers because it helps to ensure that larger, and presumably more important, transactions are paid rather than declined. We know of no evidence that supports this contention.

With respect to debit card transactions, extensive litigation findings have completely discredited the supposed benefit of high-to-low posting (*Gutierrez v. Wells*, 2010). Once the bank authorizes a debit card transaction, the bank must pay the merchant for it; thus, all debit card transactions authorized are paid, regardless of whether there are sufficient funds in the account upon settlement and regardless of the order in which transactions are posted.

Many banks have been sued for high-to-low posting of debit card transactions. To date, at least 14 banks, including several large ones, have settled.⁸ One prominent decision proceeded to trial and resulted in a \$200 million judgment for the consumers after the trial judge held that Wells Fargo had violated California's state law prohibiting unfair and fraudulent practices. The judge found that "the only motives behind the challenged practices were gouging and profiteering" and that high-to-low transaction clearing is "a trap that would escalate a single overdraft into as many as ten through the gimmick of processing in descending order" (*Gutierrez v. Wells Fargo*, 2010). The Ninth Circuit overturned the unfairness holding, determining that the bank's posting order practices were preempted by federal regulation, but it upheld the holding that Wells Fargo had affirmatively misled its customers about its posting practices (*Gutierrez v Wells Fargo*, 2012).

Even for checks and ACH transactions, the asserted benefits of high-to-low posting are not compelling. Banks typically have a negative limit beyond which they will decline a customer's overdraft transaction; for example, they may pay transactions that put a customer's balance \$300 or \$500 below zero, but not further. If that negative limit is not reached, the only impact of high-to-low posting is that it maximizes fees. This is illustrated by the scenarios above, where the bank pays the clothing purchase under either scenario; the only difference in the scenarios is the number of fees the customer is charged. Further, if a transaction is large enough, it will often be declined because it exceeds the negative limit permitted on the account, regardless of the order in which the transactions are posted; again, the only impact of high-to-low posting is that it maximizes fees. Thus, the frequency with which high-to-low posting harms customers clearly far exceeds any rare occasion on which it may result in an important item being paid.

Routine high-to-low posting is a significant generator of repeat overdraft fees. [And the reality, as demonstrated in our real-life case study above, is that for consumers paying the majority of overdraft fees, repeat overdraft fees actually make it less likely that any transaction, regardless of its size, will ultimately be paid.](#)

⁸ The settlements that have been part of a large multi-district litigation (MDL), not all of which have received final court approval, include Bank of America (\$410 million), Citizens Bank (\$137.5 million), JPMorgan Chase Bank (\$110 million), TD Bank (\$62 million), Union Bank N.A. (\$35 million), Bank of Oklahoma (\$19 million), Commerce Bank (\$18.3 million), Associated Bank (\$13 million), Harris Bank (\$9.4 million), Intrust Bank (\$2.7 million), Iberia Bank (\$2.5 million), and Great Western Bank (\$2.2 million). Other settlements of cases related to transaction posting order that were not consolidated into the MDL include Bank of Hawaii (\$9 million) and Fifth Third Bank (\$9.5 million).

Manipulation of posting order continues to be a widespread problem: A recent Informa Research Service report found that at least 14 of the largest 20 banks post some transactions in order from highest to lowest (Informa Research Service, 2012). As ACH transactions proliferate and often account for numerous purchases in a single day, posting those transactions from highest to lowest can harm consumers on the same scale as posting debit card transactions from highest-to-lowest. Recognizing the impact that posting order of any transaction type has on its customers, in 2011, Citibank began posting checks and ACH transactions in order from lowest to highest, noting, “We think this is the right thing to do” (Carrns, 2011).

In 2011, Citibank began posting checks and ACH transactions in order from lowest to highest, noting, “We think this is the right thing to do” (Carrns, 2011).

Banks sometimes point to testing or surveys to support the notion that consumers want checks and ACH transactions posted from high-to-low. But these instruments usually ask consumers only whether they would like their most important items to be paid first and don't mention that posting order would usually make very little difference in whether or not an important item is paid. These surveys also do not ask whether having an important item paid on a rare occasion is worth being charged a large number of overdraft fees on many other occasions.

There are still further indications that high-to-low posting does not benefit consumers. Banks using automated programs, which rely on computerized decision-making, are far more likely to post transactions high-to-low than banks without automated programs (FDIC, 2008). Consultants marketing automated overdraft programs have long promised massive increases in fee revenues (Impact Financial Services, 2013), but we have seen no marketing promising that the automated programs help to ensure consumers' most important items get paid. In addition, financial institutions don't market the “benefit” of high-to-low posting to their customers; even in their account disclosures, they often simply say they post transactions “at their discretion” or that they “reserve the right to” post high-to-low.

Finally, not all banks engage in this practice; in fact, many likely never have. After many of the largest banks had long been posting high-to-low (Fox, 2005), the FDIC found that 58% of banks without automated programs, and even 30% of banks with automated programs, were posting transactions from smallest to largest (FDIC, 2008).

Automatic repayment from the customer's account

The bank virtually guarantees itself repayment of overdrafts and fees by taking the entire overdraft amount plus the associated fees immediately from the customer's next deposit in one balloon repayment, before any other payments from the account are made. This automatic repayment severely limits the consumer's ability to make a measured decision about the order in which to cover his or her debts and other, often essential, expenses, such as food or prescription medicines. It also discourages sound underwriting, as the bank, likely to be able to collect the overdrafts and fees directly from the next deposit, has little incentive to ensure overdrafts are affordable for the borrower. Not only does this practice harm banks' customers, but it also harms other lenders and businesses by leaving their customers financially worse off.

An emerging problem: overdraft fees on prepaid cards

Prepaid debit cards are a rapidly growing market. In 2009, there were six billion prepaid transactions totaling \$140 billion, marking an average annual increase of 22% since 2006 (Federal Reserve System, 2011). Research has shown that prepaid card users are often more vulnerable consumers—unbanked or underbanked, lower income, or public benefit recipients (National Consumer Law Center [NCLC] on behalf of its low income clients, CRL, & CFA, 2012).

Like purchases made with traditional debit cards, purchases on prepaid cards can be declined at the time of purchase. But many prepaid card issuers will pay the transaction anyway and charge a high fee for each overdraft, turning a prepaid card into a postpaid one. This is particularly problematic since many card users may be using prepaid cards because overdraft fees drove them out of the banking system in the first place.⁹

⁹ Please see NCLC, CRL, and CFA, 2013, for a more detailed discussion of the problems with associated with credit features on prepaid cards.

IMPACT ON U.S. HOUSEHOLDS

CRL's analysis of 2011 data estimates that over 36 million Americans' checking accounts become overdrawn annually, with almost eight million account holders incurring more than six overdraft fees each year. **Almost four million Americans incur more than 12 overdraft fees within a one-year period.** Nearly two million Americans pay over 20 or more overdraft fees per year, translating to \$700 or more in overdraft fees annually.

The FDIC's 2010 overdraft guidance cautioned that repeat overdraft fees can result in “[s]erious financial harm” for “customers with a low or fixed income.” That guidance advised that more than six overdraft fees within a twelve-month period was excessive for any account holder. But our analysis of 2011 data finds that **two-thirds of overdraft fees are incurred by account holders paying more than six fees per year.**

Figure 3: Distribution of Repeat Overdraft Users

Percent of account holders who overdraft	Number of fees incurred	Percent of all overdraft fees paid
21.6%	More than 6	66.4%
10.8%	More than 12	47.1%
5%	20 or more	28.7%

Source: Lightspeed 2011 data

CFPB's recent study similarly found that approximately 28% of consumer accounts at the study banks experienced an overdraft or NSF incident in 2011, and over a quarter of those accounts incurred more than 10 overdraft or NSF fees during the year (CFPB, 2013).

Two CRL surveys, in 2006 and 2008, found that account holders who overdrew frequently were more likely to be lower income, non-white, single, and renters when compared to the general population. Respondents reporting the most overdraft incidents were those earning below \$50,000 (Parrish, 2008).

Communities of color, seniors, young adults, and military families are also hit hard by overdraft fees:

- **Communities of color.** Multiple surveys have found that communities of color bear a disproportionate share of high-cost overdrafts (CFA, 2005) (James & Smith, 2006). Civil rights groups have expressed concern about the impact these fees have on communities they represent (Leadership Conference on Civil and Human Rights, 2010a and 2010b).
- **Seniors.** Older Americans aged 55 and over paid \$6.2 billion in overdraft fees in 2008—\$2.5 billion for debit card/ATM transactions alone—and those heavily dependent on Social Security paid \$1.4 billion (Parrish & Smith, 2008) (Parrish, 2009). Banks repay themselves and collect fees directly from Social Security income, which would be protected from creditors in other creditor/debtor contexts.¹⁰
- **Young adults.** Young adults, who tend to earn relatively little as students or new members of the workforce, paid \$1.3 billion in overdraft fees in 2008 (Parrish & Smith, 2007) (Parrish, 2009). Because they are more likely to use a debit card for small transactions than older adults, they were paying \$3 in fees for every \$1 overdrawn on a debit card when the national average was \$2 in fees for every \$1 overdrawn (Parrish & Smith, 2007). The 2008 FDIC Survey found that young adults were the most likely to overdraw their accounts, with 46% of all young adults overdrawing their accounts in the previous year (FDIC, 2008).

The problem is exacerbated by deals banks make with universities to provide school ID cards that double as debit cards. Banks pay the partner school for exclusive access to the student population and sometimes split the fee revenue they collect on debit card transactions with the university (Parrish & Smith, 2007). These programs, already popular before the Credit CARD Act of 2009 (the CARD Act), have only grown more so as an alternative to campus credit card marketing after the CARD Act made the latter more difficult (Dilworth, 2012).

- **Military families.** Military families remain vulnerable to overdraft programs, even though Congress took action to protect them from payday loans and other predatory lending practices through the Military Lending Act of 2006. Financial institutions have taken advantage of their ability to charge overdraft fees to a captive audience on bases. An executive of one turnkey overdraft system vendor has said, “If you happen to be a bank that’s on a military post, you’re probably doing twice as much [overdraft] activity as any other bank” (Berenson, 2003).

Overdraft and bounced check fees are also the leading cause of involuntary bank account closures and a significant cause of voluntary account closures, resulting in greater numbers of unbanked households (FDIC, 2009) (Barr, 2008) (Campbell, Martinez & Tufano, 2008).

¹⁰ Federal law protects Social Security benefits from garnishment by creditors (Social Security Act, 1939) but does not apply when the bank repays itself as creditor, as with overdraft loans and fees.

MARKET AND INDUSTRY OVERVIEW

Fifteen years ago, overdraft programs were low-cost or free courtesy services—transfers from a consumer’s other accounts or low-cost lines of credit—and they were used primarily to cover paper checks. Since then, overdraft programs have evolved into a high-cost credit product, applied primarily to electronic transactions, that strips money from consumers’ accounts and drives them into debt. Ultimately, abusive overdraft programs make it harder for struggling consumers to meet their obligations, lead to account closures, and drive families out of the banking system.

CRL estimates that overdraft fees cost consumers \$16.7 billion in 2011.

Growth of these high-cost overdraft programs was spurred in the 1990s and early 2000s by consultants marketing automated overdraft programs promising dramatic fee revenue increases to banks (Impact Financial Services, 2008 & 2013) (Moebs Services, Inc., 2008 & 2013). Some consultants offered the software at no risk, instead charging banks a percentage of the increased fee revenue generated (Impact Financial Services, 2008 & 2013).¹¹

Growth of these programs was also facilitated by federal regulators, who, as described in the following section, failed to take meaningful action while these programs became ubiquitous.

CRL estimates that overdraft fees cost consumers \$16.7 billion in 2011.¹² Overdraft fees exploded for a decade, reaching \$23.7 billion in 2008 and continuing to climb through 2009 (Parrish, 2008). Since then, overdraft fees have declined but still remain significantly higher than in 2004 when CRL first estimated annual overdraft fees (Duby, Halperin, & James, 2005).

The decline since 2009 is likely due in part to changes in regulations effective mid-2010; the decision by some large banks, including Bank of America and HSBC, to stop charging overdraft fees on one-time debit card transactions; some banks’ elimination of high-to-low posting order on debit card transactions in response to extensive litigation challenges; and some banks’ imposition of daily limits on the number of fees or de minimus overdraft thresholds under which the banks do not charge a fee. It appears likely that, absent meaningful reform, overdraft fees paid annually will only increase going forward as banks succeed in collecting opt-in forms from new customers at the time of account opening. Indeed, CFPB recently found that opt-in rates among study banks of accounts that were opened during 2011 were generally higher than for existing accounts (CFPB, 2013).

11 For an early discussion on the growing problem of overdraft fees, see CFA and NCLC, 2003.

12 This figure does not include non-sufficient funds (NSF) fees banks charge when they bounce checks or ACH payments. See appendix for calculation of the estimate.

LEGISLATION AND REGULATION

Overdraft fees grow as bank regulators fail to act consistently

As mentioned above, the growth in high-cost overdraft programs has been fostered by federal banking regulators, whose lack of meaningful action has allowed overdraft abuses to persist and to grow.

The national bank regulator, the Office of the Comptroller of the Currency (OCC), recognized several overdraft practices as problematic as early as 2001, when a bank asked the OCC for a “comfort letter,” or explicit approval, for the high-cost overdraft program it wanted to implement. Rather than providing this approval, the OCC articulated a number of compliance concerns about the program, including (a) “the complete lack of consumer safeguards” including the lack of limits on the numbers of fees charged per month, (b) similarities between overdraft fees and other “high interest rate credit,” and (c) lack of efforts by banks to identify customers with excessive overdrafts and meet those customers’ needs in a more economical way (OCC, 2001).

Despite these concerns, the OCC and other federal banking regulators failed to act on overdraft practices until 2005. At that time, the Federal Reserve Board chose to regulate high-cost overdraft programs under the Truth in Savings Act’s Regulation DD instead of the Truth in Lending Act’s Regulation Z (Federal Reserve Board, 2005), even while acknowledging that overdrafts are “credit” (OCC, Federal Reserve Board, FDIC & National Credit Union Administration, 2005).

This decision had several harmful implications, including that the cost of overdraft loans was not required to be disclosed in annual percentage rate (APR) terms, as credit typically is. This makes it difficult for consumers to compare the cost of overdraft loans to lower-cost credit options, like lines of credit or credit cards. It also enabled financial institutions to more easily characterize overdrafts as a courtesy service rather than high-cost credit.

Also in 2005, the banking regulators issued joint supervisory guidance applicable to high-cost overdraft programs (OCC, Federal Reserve Board, FDIC, & National Credit Union Administration, 2005). This guidance included best practices for administering overdraft programs, including limiting overdraft coverage to checks alone (i.e., excluding debit card and other transaction types); establishing daily limits on fees; monitoring excessive usage; and obtaining affirmative consent to overdraft coverage. The guidance also cautioned banks against potential violations under the Equal Credit Opportunity Act for steering or targeting customers for high-cost overdraft programs. But regulators generally did not enforce the guidance, and banks widely ignored it. In fact, in the seven years following the issuance of the guidance, the OCC has taken only one enforcement action against one small bank using the guidance (OCC, 2010).

Five years later, in 2010, the Federal Reserve Board implemented the opt-in rule for one-time debit card transactions discussed earlier. Although a helpful advance, this guidance still failed to address fundamental problems with the product, including failing to provide limits on the frequency or size of overdraft fees.

Recognizing the need for more substantial action, the FDIC implemented its own guidance in mid-2011 applicable to the state-chartered banks it supervises. The guidance advised banks to curb excessive overdraft fees—identifying more than six fees in a 12-month period as “excessive”—and advising banks to stop posting transactions in order from highest to lowest (FDIC, 2010) (FDIC, 2011a). Unfortunately, no other regulators have followed suit.

As a result, banks and credit unions today have differing overdraft practices, either voluntarily or because they are subject to differing guidelines from their prudential regulator. Most large banks charge overdraft fees on debit card and ATM transactions, while a few don't. Most large banks continue posting transactions in order from highest-to-lowest, while some have stopped. Regulators have created an unlevel playing field, and financial institutions continue to have strong incentives to engage in a race to the bottom.

Congressional proposals have not advanced

Because regulators have failed to act, there have been several attempts in the past decade by members of Congress to reform overdraft through legislation. Their proposals include the following:

- Prohibiting overdraft fees on debit card and ATM transactions for members of the military
- Prohibiting reordering transactions to increase overdraft fees
- Requiring that overdraft fees to be “reasonable and proportional” to the cost of the transaction
- Limiting the number of overdraft fees that can be charged to six per year

To date, these legislative efforts have not advanced.

Consumer Financial Protection Bureau

In February 2012, the Consumer Financial Protection Bureau (CFPB) announced that addressing high-cost overdraft programs was an early priority. It noted that overdraft programs can cause serious economic harm and disproportionately impact more vulnerable consumers. CFPB solicited public input on consumer experiences with overdraft practices (CFPB, 2012) and launched a study based on data it is collecting from a number of the largest banks (Cordray, 2012).

“[O]verdraft practices have the capacity to inflict serious economic harm.” – Richard Cordray, Director, Consumer Financial Protection Bureau

In June 2013, CFPB released a white paper detailing its initial findings. Its study found that customers who are charged overdraft fees on debit cards are at greater risk of paying high fees and are more likely to have their account involuntarily closed. CFPB concluded that [the range of complex practices banks engage in that impact overdraft fees](#) “raises questions about the degree to which even the most sophisticated consumer could readily anticipate and manage the cost of engaging in a series of transactions” It further concluded that certain practices and procedures may be causing the “kind of consumer harm that the federal consumer protections laws are designed to prevent” (CFPB, 2013). CFPB’s study of overdraft practices, including analysis of account-level data, is ongoing.

POLICY RECOMMENDATIONS

Effective reform of today's overdraft practices is needed to ensure that bank accounts are a safe place for all consumers to protect their earnings and save for the future. Such reform must address the key harmful features of the product. It cannot be limited to curbing deceptive marketing or improving disclosures. Requiring financial institutions to obtain consumers' "opt-in" only establishes the basic consent requirement that already exists for most financial products. Consent requirements did not remove the need for substantive reforms for mortgage or credit card practices, and the same is true of overdraft programs.

Without substantive reform of the product, the fees overdrafts generate provide financial institutions too powerful an incentive to ensure that customers continue to incur overdraft fees—an incentive that will continue to outweigh even the best disclosures.

Our preferred policy prescription is the prohibition of overdraft fees on debit card and ATM transactions paired with provisions that prevent maximizing fees from overdraft fees on checks and other electronic transactions. Absent prohibition of all debit card and ATM overdraft fees, policymakers should limit the number of such fees that can be charged and mandate that the dollar amount of those fees be reasonable and proportional to the bank's cost of providing the service.

Prohibit overdraft fees on debit card and ATM transactions, which financial institutions can easily decline at no cost to the customer.¹³ As CFPB's recent study indicates, ending fees triggered by debit card and ATM transactions would limit a significant number of excessive fees. Citibank has never charged such fees, and HSBC has stopped charging them. Bank of America, the largest debit card issuer, stopped overdraft fees on one-time debit card transactions in 2010. JPMorgan Chase does not charge these fees on ATM withdrawals. Policymakers should level the playing field for all banking institutions, preventing a "race to the bottom."

Prohibit overdraft fees on prepaid cards. As with other debit cards, transactions on prepaid cards when the card lacks sufficient funds can easily be declined at the point of purchase. Further, a card whose name indicates it is "prepaid," and which many consumers use to avoid overspending, should have no credit feature at all; it is not a postpaid card, after all.

Assess the implications of the increasing percentage of overdraft fees triggered by electronic transactions, including one-time ACH transactions that are substantively indistinguishable from one-time debit card purchases.

Prohibit manipulation of posting order to increase fees. Financial institutions should be required to minimize fees through posting order whenever feasible. A safe harbor should be provided for banks that post checks and electronic transactions in order from lowest to highest and that post no transactions in order from highest to lowest. Consistent with the FDIC's 2011 guidance, posting transactions in order from highest to lowest is inappropriate for any transaction type, including checks and ACH transactions.

¹³ If overdrafts continue to be allowed on debit cards, then debit cards with overdrafts should be regulated as credit cards under the Truth in Lending Act.

Limit the number of overdraft fees, including “sustained” overdraft fees, that financial institutions can charge customers, consistent with FDIC guidance that charging more than six overdraft fees in a 12-month period is excessive. Repeated overdrafts function as an exorbitantly priced credit product that is not appropriate for anyone on a routine basis.

Require that overdraft fees be reasonable and proportional to the amount of the underlying transaction and to the cost to the bank of covering the overdraft. This is consistent with the FDIC’s overdraft guidance and rules governing penalty fees on credit cards.

Require that the cost of overdrafts be disclosed as an annual percentage rate. Regulators acknowledge that overdraft payments by financial institutions are indeed credit, and all credit products should carry price tags that allow for consistent comparison to other credit products.

Prohibit overdrafts and fees from being repaid automatically from the customer’s checking account. This is especially important when the customer’s funds are exempt funds that are protected from debt collection in other contexts. This would be consistent with (1) longstanding prohibitions on wage garnishment; (2) a more recent Treasury rule prohibiting deposit of Social Security funds to prepaid cards with payday loans where repayment is triggered by the deposit; and (3) the prohibition against offsetting a depositor’s debt against funds the bank holds on deposit, already applicable to credit cards under the Truth in Lending Act.

APPENDIX

For our analyses of 2011 data, we examined the transactional data of 1,582 checking accounts from a nationwide sample of U.S. credit card holders, generally representative across geography, household income, and credit scores, tracked by Lightspeed Research Inc.¹⁴ Participating account holders provide Lightspeed access to all of their checking account activity occurring during their period of participation, including deposits, paper checks, electronic bill payments, debit card purchases, fees, and miscellaneous charges or credits that are posted to the account.

2011 Overdraft Market Calculation

To develop our estimate of the size of the overdraft market, we apply the same general methodology we applied to obtain our 2008 estimate:

- (A) Total population age 18 and over* 240 million
- (B) Population without a bank account** 28 million
- (C) Total adults with a bank account (C = A - B) 212 million
- (D) Adults impacted by at least one overdraft incident (C x 17.2%^) 36 million

*US Census

**The FDIC's Alliance for Economic Inclusion estimates that as many as 28 million people in the United States are Unbanked.

^CRL LightSpeed analysis finds that 17.2% of checking accounts incurred an overdraft fee in 2011.

2011 Overdraft Fee Volume Calculation

To develop our 2011 estimate of total overdraft fee volume, we apply the same general methodology we applied to obtain our 2008 and 2006 estimates—drawing service charge revenue from publicly available call report data, and estimating the portion of that service charge revenue that is attributable first to overdraft and insufficient (NSF) fees together, and then to overdraft fees alone.

CFPB's June 2013 white paper provides the share of service charges on deposit accounts that is attributable to overdraft/NSF fees for the small sample of large banks it studied. That share is 37%. We tally the service charge revenue from the ten largest banks (ranked by total deposits)¹⁵ from those banks' publicly available FDIC 2011 Call Report Data, which equals \$19.5 billion. We then apply the 37% to that figure, estimating that the overdraft/NSF fees generated by the ten largest banks equal \$7.2 billion.

As CFPB notes, the portion of service charges on deposit accounts generated by overdraft/NSF fees at large banks tends to be smaller than it is at smaller banks given the larger portion of deposit account revenue generated by commercial accounts at larger banks. Thus, for all other banks and credit unions, we apply a ratio of 62% which, as CFPB notes, was reported by the Independent Community Bankers of America in its 2012 survey of member banks as the portion of those banks'

14 Lightspeed requires that participants have internet access, which may lead to selection bias. A survey conducted by the Pew Internet & American Life Project from November 14-December 8, 2012, reveals higher internet usage among younger Americans versus older Americans and among higher income Americans versus lower income Americans (Pew, 2012).

15 CFPB has not disclosed which or how many banks it studied. For purposes of our estimate, we apply the 37% ratio to the ten largest banks ranked by deposit size: JPMorgan Chase Bank, Bank of America, Citibank, Wells Fargo Bank, U.S. Bank, PNC Bank, TD Bank, HSBC, BB&T, SunTrust Bank.

service charges attributable to overdraft/NSF fees. We sum all service charges on deposit accounts at all banks except the ten largest banks from the FDIC Call Report Data (\$14.7 billion) and total fee income from credit unions per the National Credit Union Administration (NCUA) Call Report Data (\$6.9 billion). Together, these total \$21.6 billion in total service charges. We then apply the 62% to that figure, estimating that the overdraft/NSF fees generated by all financial institutions except the ten largest banks as \$13.4 billion.

We then sum \$7.2 billion and \$13.4 billion to reach estimated total overdraft/NSF fees from all financial institutions of \$20.6 billion.

Finally, to disaggregate that \$20.6 billion to determine the portion of it that is solely attributable to overdraft fees, we use transaction descriptions in the 2011 Lightspeed Research Database to compute that 81.2% of the overdraft/NSF fees in the database were overdraft fees.¹⁶ We apply that 81.2% to the \$20.6 billion to determine a final estimate of total overdraft fee volume of \$16.7 billion.

Dollars in Billions

Service charge income from largest 10 banks by total deposits	\$ 19.4	*
Estimated share generated by overdraft and NSF fees	<u>37%</u>	^
Estimated overdraft/NSF fees collected from largest 10 banks	\$ 7.2	(A)
Service charge income from all other banks	\$ 14.7	*
Service charge income from all credit unions	<u>6.9</u>	**
Total service charge income from all other banks + all credit unions	\$ 21.6	
Estimated share generated by overdraft and NSF fees	<u>62%</u>	^^
Estimated overdraft/NSF fees collected from all other banks + credit unions	\$ 13.4	(B)
Total overdraft and NSF fees collected	\$ 20.6	(A) + (B)
Estimated share of total overdraft/NSF fees attributable to overdraft fees alone	<u>81%</u>	^^^
Estimated total overdraft fees alone	<u>\$ 16.7</u>	

- * Computed from FDIC 2011 Statistics on Depository Institutions
- ** Per NCUA 2011 Call Report Data
- ^ Per 2013 CFPB Study of Overdraft Programs (reflecting 2011 data)
- ^^ Per 2012 ICBA Overdraft Payment Services Study
- ^^^ Per CRL analysis of 2011 LightSpeed Research Database

¹⁶ Overdraft fees are denoted in the data by such terms as “overdraft fee,” “returned item paid,” or “OD fee.” NSF fees are denoted in the data by such terms as “insufficient funds fee,” “returned item unpaid,” or “NSF fee.”

The CFPB’s recent study similarly found that, at the median, study banks paid 83% of transactions that exceeded the customer’s available balance in 2011 and returned 17% unpaid (CFPB, 2013).

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PAYDAY LENDING ABUSES AND PREDATORY PRACTICES

The State of Lending in America &
its Impact on U.S. Households

Susanna Montezemolo

September 2013



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PAYDAY LENDING ABUSES AND PREDATORY PRACTICES

Payday loans—high-cost small loans averaging \$350 that usually must be repaid in a single payment after two weeks—are designed to create a long-term debt trap. Whether they receive the loans online, in storefronts, or through banks,¹ the vast majority of borrowers cannot both repay the loan and cover all their basic living expenses until their next payday. As a result, they typically take out multiple loans within a short timeframe, paying repeated fees to do so. Payday loans create a debt treadmill that makes struggling families worse off than they were before they received a payday loan.

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The following five payday lending practices contribute to the creation of a debt treadmill for borrowers:

- **Lack of underwriting for affordability.** The payday lending business model depends on borrowers' *inability* to afford their loan and their subsequent need to borrow—paying more fees—multiple times.
- **High fees.** Payday lenders typically charge the maximum possible rate allowed in a state. As a result, the annual percentage rate (APR) on payday loans is often 400% or higher.
- **Short-term due date.** Most borrowers cannot repay their payday loan principal within a two-week period—let alone the principal plus a fee. In fact, some payday lenders offer a “free” first payday loan with no fee,² knowing that borrowers who cannot afford to repay the principal in two weeks will incur many repeat borrowings and fees in subsequent pay periods.
- **Single balloon payment.** The entire payday loan balance typically is due in one lump sum; combined with the short-term due date, this single-payment feature makes payday loans especially difficult to repay.
- **Collateral in the form of a post-dated check or access to a bank account.** The consequence of not repaying a payday loan is that the check used as collateral will be deposited or ACH transaction debited, which puts lenders “first in line” to be paid (rather than being “just another bill”).³ Because the payday loan is tied to the borrower's payday, the lender can be reasonably sure the check will clear. Most borrowers will simply run out of money to cover their expenses before the end of the month, often taking out more payday loans (and paying more fees) to pay for the expenses.

Any of these five factors alone creates problems for borrowers. Together, they create a high likelihood of repeat borrowing and a long-term cycle of debt.

1 For more information on bank payday lending, see the accompanying bank payday chapter of *State of Lending*.

2 For example, <http://www.checknittle.com/> advertises several times on its website “First loan FREE!” for new customers. Website visited 7/9/13.

3 Melzer (2012) provides support for the notion that households prioritize paying off payday loans before their regular expenses. Melzer compared the likelihood of using food stamps and paying child support of low- and moderate-income households (earning between \$15,000 and \$50,000 annually) in states with and without payday lending storefronts. He found that those with payday loan access are 20% more likely to use food stamps and 10% less likely to make child support payments. He concludes, “these findings suggest that as borrowers accommodate interest and principal payments on payday loan debt, they prioritize loan payments over other liabilities like child support payments and they turn to transfer programs like food stamps to supplement the household's resources.”

The high level of payday loan “churn”—when borrowers either directly renew loans or pay back a loan but take out another shortly thereafter—underscores the existence of a long-term debt trap. The Center for Responsible Lending (CRL) published “Phantom Demand” (Parrish & King, 2009), which quantified the level of loan churn by examining the length of time between successive payday loans. The paper found that most successive loans are originated shortly after a previous loan is paid back. **Half of repeat loans were opened at the borrower’s first opportunity,⁴ 87% within two weeks, and 94% within one month of the previous loan.**

As “Phantom Demand” concluded, this rapid re-borrowing indicates that very few borrowers can clear a monthly borrowing cycle without borrowing again. Using a one-month definition of loan churn—appropriate for households paid on a monthly basis (such as public benefit recipients) and those managing major expenses and obligations on a monthly basis⁵—82% of overall payday loan volume is due to loan churn.⁶ If loan churn is defined more narrowly as taking out a subsequent loan within two weeks of the previous loan—consistent with the most common pay period length for most payday borrowers—76% of total payday loan volume is still due to loan churn.⁷

IMPACT ON U.S. HOUSEHOLDS

Cost of Loan Churn

Loan churning dramatically increases payday lending fees without providing borrowers with access to new credit. We estimate that loan churn in states with no restrictions on payday lending costs borrowers at least \$2.6 billion in excess fees annually.⁸ This number is lower than that in “Phantom Demand,” which found that loan churn causes borrowers to pay an extra \$3.5 billion in fees annually.⁹

Loan churn in states with no restrictions on payday lending costs borrowers at least \$2.6 billion in excess fees annually.

This lower level of fees attributable to loan churn is the result of consumer-friendly changes in state laws since the publication of “Phantom Demand.” Several states have enacted laws eliminating high-cost payday lending. For example, Arizona voters upheld the planned sunset on the law that allowed payday lenders to charge 400% annual interest rates, and as a result the state’s 36% APR limit for unsecured consumer loans went back in effect in 2010. Similarly, in 2010, Montana voters approved a 36% APR limit for payday loans, which previously had been offered at 400% APR.¹⁰ In addition, this

4 We say “first opportunity” because some states have mandatory cooling-off periods in which borrowers may not take out a new loan immediately after having paid off a previous loan. For example, Florida has a 24-hour cooling-off period.

5 CFPB (2013) analyzed payday borrower pay frequency. Although most borrowers (55%) were paid biweekly or twice a month, one-third (33%) were paid monthly. The remainder (12%) were paid weekly.

6 This 82% figure represents the percent of *all* payday loans that were originated within a month of paying off a previous loan. In contrast, when looking only at payday loans to repeat borrowers, 94% were originated within a month of paying off a previous loan.

7 This 76% figure represents the percent of *all* payday loans that were originated within two weeks of paying off a previous loan. In contrast, when looking only at payday loans to repeat borrowers, 87% were originated within two weeks of paying off a previous loan.

8 If loan churn is defined as taking out a payday loan within one month of having paid back a prior loan, borrowers pay an excess of \$2.8 billion in annual fees. If it is defined as taking out a loan within two weeks of having paid back a prior loan, borrowers pay an excess of \$2.6 billion in fees each year. Note that this loan churn number, consistent with “Phantom Demand,” does not include data from banks or unlicensed lenders. For more information, see Appendix 1.

9 The “Phantom Demand” estimate used the narrow two-week definition of churn.

10 Montana’s 36% APR rate cap also applies to car-title and consumer installment loans.

loan churn estimate is conservative because it excludes several states where statutory changes have allowed for payday lending to continue in some form but have limited the debt trap, for example by limiting the number of loans in a 12-month period¹¹ or by coupling extended minimum loan terms with limits on fees and refinancing incentives.¹²

Impact of Loan Churn on Individual Borrowers

“Phantom Demand” found that loans are most often taken out in rapid succession (within two weeks of closing a prior loan), and thus the actual impact of repeat transactions is simply repaying fees to float the same debt rather than being extended new credit each time. The Consumer Financial Protection Bureau (CFPB) recently published a white paper with data from 15 million payday loan transactions from 1.5 million borrowers and covering one year of activity. This is the most comprehensive data set on payday lending ever compiled and analyzed.

The CFPB white paper confirms the findings from “Phantom Demand”: “Two-thirds of payday borrowers in our sample had 7 or more loans in a year. Most of the transactions conducted by consumers with 7 or more loans were taken within 14 days of a previous loan being paid back—frequently, the same day as a previous loan was repaid” (CFPB, 2013). **The median borrower in the CFPB sample took out ten payday loans from a single lender during the year, paying \$458 in fees alone for \$350 in non-churn principal** (CFPB, 2013). These numbers are most likely conservative, as they did not examine borrower experiences across lenders.

Other analyses using less extensive data sets confirm the CFPB findings. For example, Appendix 2 highlights data from state regulator databases showing that borrowers on average take out nine loans per year, paying back \$504 in fees alone for \$346 in non-churn principal. A report on payday lending from the Pew Safe Small-Dollar Loans Research Project similarly finds that borrowers take out an average of eight 18-day loans during the year and are indebted 144 days (40%) each year, paying on average \$520 in fees alone for an initial loan of \$375 (Pew, 2012). A study from the Center for Financial Services Innovation (CFSI) (Levy & Sledge, 2012) estimates that payday borrowers take out 11 loans annually and are in payday loan debt 150 days (41%) each year. Even payday lender data confirm heavy borrowing: Advance America, the nation’s largest payday lending company, consistently reports that its customers take out an average of eight loans per year (Dougherty 2013).

Figure 1 highlights why this debt trap is so pernicious for families: simply put, a payday borrower earning \$35,000 per year¹³ cannot afford to repay even a “free” payday loan (for which no fee is charged) while covering their two-week essential expenditures:

11 For example, Delaware and Washington State have limited the number of loans a borrower may take out over the course of a year to five and eight loans, respectively. There is evidence that national payday lenders are evading Delaware’s law by migrating to the state’s installment lending statute in order to continue to offer unrestricted triple-digit-APR debt trap loans. Washington State, however, has strong underlying small loan laws that prevent similar evasion, and thus the state has been able to enforce and monitor its law.

12 For example, Virginia has a minimum two-pay-period loan term, which translates into about a one-month minimum loan term for those paid biweekly. Oregon has a minimum 31-day loan term, along with a fee limit of 36% annual interest plus the lesser of \$30 or 10% of the principal borrowed. Colorado has an extended minimum loan term of six months; limitations on fees, including making the origination fee proportionately refundable (thus decreasing the incentive to churn loans); and a prohibition on the sale of ancillary products. Because “Phantom Demand” based its churn calculations on a two-week product, which is churned more frequently than longer-term loan products, we excluded these states in the loan churn calculations in *State of Lending*.

13 The Consumer Financial Protection Bureau, in its recent white paper on payday lending, found a median *net* borrower income of \$22,476 and a mean of \$26,167 (CFPB, 2013). Although most states do not provide income information about payday borrowers, Illinois reports an average payday borrower gross income of \$33,157 (Veritec, 2013). In Colorado, the average gross annual income of payday borrowers is \$29,724 (Colorado AG, 2012).

Figure 1: A Two-Week Payday Loan Results in a Debt Trap, Even with No Fee

Cost of a Two-Week Payday Loan for a Borrower Earning \$35,000/Year in Gross Income			
	\$0 per \$100 ("free" loan, 0% APR)	\$15 per \$100 (391% APR)	\$20 per 100 (521% APR)
Two-Week Income			
Before-tax income	\$1,346	\$1,346	\$1,346
Income taxes paid	\$1	\$1	\$1
After-tax income	\$1,345	\$1,345	\$1,345
Social Security & pensions payments	\$84	\$84	\$84
Net two-week income	\$1,261	\$1,261	\$1,261
Payday Loan Cost			
Payday loan fee	\$0	\$53	\$70
Payment due on \$350 (average-sized) payday loan	\$350	\$403	\$420
Amount remaining to cover all expenses	\$911	\$859	\$841
Two-Week Essential Expenditures			
Food	\$205	\$205	\$205
Housing	\$516	\$516	\$516
Transportation (incl. insurance, gas, maintenance)	\$246	\$246	\$246
Health care	\$106	\$106	\$106
Total essential two-week expenditures	\$1,073	\$1,073	\$1,073
Money remaining in paycheck after paying payday loan (deficit)	(\$162)	(\$215)	(\$232)

Source: 2011 Consumer Expenditure Survey, Bureau of Labor Statistics, for households earning \$30,000-\$39,999 annually.

Regardless of whether a payday loan is offered for “free” (as many initial loans are) or for a fee of \$15-\$20 per \$100 borrowed, a typical borrower will be unable to meet his or her most basic obligations and repay the payday loan debt in a two-week period. Within one pay period, borrowers may have enough money to either repay their payday loan or meet very basic expenses, but not both. The situation is even worse for the many families who have other expenses not captured here, such as child care, clothing, and other debt obligations.

Another CRL study, “Payday Loans, Inc.,” (King & Parrish, 2011) tracked payday borrowers for two years after having taking out their first payday loan. Those findings illustrated the negative impact of a debt trap that worsens over time, including:

- **Payday loans for repeat borrowers increased in size and frequency over time.** Active borrowers (those taking out at least one loan in each six-month period of the second year) took out an average of nine loans in the first year and 12 loans in the second year.
- **Overall, borrowers were indebted an average of 212 days (58%) of the first year and continued to be indebted over half of the second year.** Leaving out the 15% of borrowers who took out only one loan in the two-year period, the remaining borrowers were indebted 345 days (63%)

of their first 18 months and 432 days (59%) of the full two-year period. This is similar to the CFPB's white paper, which found that the average payday borrower was in debt 199 days (55%) of the year.

- A significant share of borrowers became late or defaulted on their payday loan, triggering more fees and placing their bank account at risk. **Thirty-seven percent of the payday borrowers experienced default in the first year of borrowing; within the first two years, 44% did.** This finding is consistent with Skiba & Tobacman (2008b), who examined data from a large Texas-based payday lender and found a 54% default rate. High levels of loan churn mean that even borrowers who default often pay substantial fees, often paying the payday loan fee multiple times before ultimately defaulting.

Other Studies Demonstrating Further Negative Consequences

Other studies have found other important negative consequences of taking out payday loans, including the following:

- **Losing bank accounts.** Research has shown that access to payday loans is linked to increased rates of involuntary bank account closures, which makes routine financial transactions more expensive and risky (Campbell, Jerez, & Tufano, 2008).
- **Becoming delinquent on other debts.** Agarwal, Skiba, & Tobacman (2009) found that once credit card users began borrowing from payday lenders, they were 92% more likely to become delinquent on their credit card payments. In addition, Melzer (2011) compared low- and middle-income households¹⁴ living in areas with and without storefront payday lenders. He found that people with access to the loans were 25% more likely to have difficulty paying bills and 25% more likely to delay needed medical care. Melzer states,

I find no evidence that payday loans alleviate economic hardship. To the contrary, loan access leads to increased difficulty paying mortgage, rent and utilities bills. . . . Counter to the view that improving credit access facilitates important expenditures, the results suggest that for some low-income households the debt service burden imposed by borrowing inhibits their ability to pay important bills.

- **Filing for bankruptcy.** One study (Skiba & Tobacman, 2008a) found that payday borrowers nearly doubled their chances of filing for bankruptcy compared with households of similar financial status who were denied a payday loan.

Borrowers who ultimately default on a payday loan face a litany of other negative consequences:

- **Additional financial stress,** with both the payday lender charging non-sufficient-funds (NSF) fees and the borrower's bank assessing NSF and/or overdraft fees, both of which average about \$30-35.
- **Legal ramifications,** such as wage garnishment and potential court action.
- **Having their debt sold to a collection agency,** which can negatively affect credit reports and scores and also can lead to repeated solicitations for payment or even illegal harassment and debt collection scams.¹⁵

14 Melzer limits his analysis to those earning between \$15,000 and \$50,000 annually.

15 For an example of an illegal payday debt collection scam, see FBI (2010).

Characteristics of Payday Loan Borrowers

According to the Pew Safe Small-Dollar Loans Research Project (2012), 12 million American adults (5.1%) used a payday loan in 2010, and 5.5% of American adults used payday loans in the prior five years.¹⁶ As detailed below, these borrowers tend to be low-income, young, and female. In addition, although most payday borrowers are white, people of color are more likely to receive payday loans, and payday lending storefronts are more likely to locate in neighborhoods of color. Historically, storefront payday lenders have targeted members of the military, setting up shop right outside military bases, but this has changed since passage of the Military Lending Act in 2006.

- **Income.** CFPB (2013) included some information on payday borrowers in its analysis of payday lending data from a number of lenders. It found a median borrower net income of \$22,476.¹⁷ In addition, it analyzed the sources of income, finding that although most (75%) receive their income through employment, nearly one in five (18%) receive income through public assistance and benefits. The remainder (7%) do so through retirement or another source.
- **Demographic information.** Pew (2012) included information on the demographic makeup of payday loan borrowers obtained through a nationally-representative telephone survey. Pew's report noted,

Most borrowers are white, female, and are 25 to 44 years old. However, after controlling for other characteristics, there are five groups that have higher odds of having used a payday loan: those without a four-year college degree; home renters; African Americans; those earning below \$40,000 annually; and those who are separated or divorced.

That African Americans and Latinos are more likely to receive payday loans is not surprising, since payday lenders disproportionately locate in neighborhoods of color. A 2009 CRL study of the location of payday loan shops in California found that payday lenders are eight times more likely to be located in African American and Latino neighborhoods than in white neighborhoods. Even after controlling for other factors like income, the study found that payday lenders were 2.4 times more concentrated in neighborhoods of color (Li, Parrish, Ernst, & Davis, 2009).

- **Military targeting.** Historically, payday lenders also have targeted members of the military, setting up shop just outside military bases. In response to Department of Defense (DoD) appeals to protect service members and their families from abusive loans, Congress enacted the Military Lending Act of 2006 (MLA), which set a 36% APR limit on payday loans to members of the military and their families. The MLA also prohibited lenders from holding a post-dated check or using electronic access to a borrower's bank account as collateral.

DoD (2008) concluded that the MLA “has established a balanced approach in using the regulation to curb products with demonstrated high costs and balloon payments, while working with Federal and state governments to protect Service members and their families.” Military financial counselors and legal assistance officers report limited use of payday and car-title loans, and the

¹⁶ The 2010 number is derived from analysis of administrative data, whereas the five-year usage figure is derived from a survey in which borrowers self-reported their usage of payday loans. Generally, administrative data are more reliable.

¹⁷ CFPB remains the most comprehensive source for income data, since it examined 15 million payday loans to 1.5 million borrowers in 33 states. Only a few state regulators provide income information. In Colorado, the average gross annual income of a payday borrower is \$29,724 (Colorado AG, 2012). In Illinois, the average payday borrower's gross annual income is \$33,157 (Veritec, 2013). Note that total household income for a payday borrower could be higher than these numbers, for example if another household member brings in an income.

Navy Marine Corps Relief Society reports a savings in relief funds from no longer having to rescue as many “active duty personnel entrapped by the predatory loan industry” (DoD, 2008).¹⁸

However, some problems remain. Fox (2012) demonstrates that some lenders have exploited definitional loopholes in the law to offer high-cost, abusive products using open-ended or installment credit to active-duty service members and their families. Jowers (2010) highlights that banks offering open-ended payday loans are able to circumvent the MLA.

Borrower Use of Payday Loans

The evidence shows that the majority of payday borrowers are trying to address budget gaps caused by recurring, everyday expenses; they are not trying to address the occasional emergencies payday lenders claim are the key reasons borrowers to take out loans. For example, Pew (2012) found that despite payday lender claims to the contrary, 69% of payday loans are taken out for recurring expenses, with only 16% for unexpected emergencies, 8% for “something special,” and 2% for “other.” Similarly, Bhutta, Skiba, & Tobacman (2012) state that payday loans do not go to people who are managing temporary short-term income shocks, but rather to people with “extremely persistent weakness in credit record attributes” over the long term. Levy & Sledge (2012) similarly found that payday loans primarily cover recurring expenses.

That payday loans are for everyday, recurring expenses suggests a structural budget problem where expenses exceed income, which helps explain why it is so difficult to pay off even a “free” payday loan, especially one with a two-week balloon payment. High-priced, short-term debt is inherently unsuitable for borrowers coming up short on regular expenses. Each loan leaves them with significantly less income to meet the next round of expenses, which leads them to continue to pay payday loan fees in a cycle of debt.

High-priced, short-term debt is inherently unsuitable for borrowers coming up short on regular expenses.

Pew (2012) also asked borrowers what they would do if they did not have access to payday loans. Eighty-one percent said they would cut back on expenses, and many would delay paying some bills, borrow from friends and family, or sell or pawn personal possessions. These survey findings are consistent with the results of a focus group Pew conducted of former payday borrowers in New Hampshire, which has eliminated high-cost payday lending from the state. In these focus groups, borrowers said that they would turn to lowering overall expenses and re-budgeting, borrowing from friends and family, using payment plans for bills, and the like. Interestingly, these are the same options that payday borrowers who do not default ultimately take advantage of in order to retire their payday debt. The difference is that borrowers who do not have access to payday loans do not pay the high fee multiple times first.

These findings are consistent with a study from the University of North Carolina’s Center for Community Capital (2007). The study examined the impact of the state’s 36% APR limit, which eliminated high-cost payday lending there. Researchers concluded that the absence of storefront payday lending had no significant impact on the availability of credit for North Carolina households. Those who faced a financial shortfall in the absence of payday lending chose to delay paying a bill, tap into savings, borrow from friends and family, visit a pawnshop, or take advantage of other

¹⁸ After implementation of the MLA, the Navy Relief Society reported that it spent significantly less each month to help members entrapped in predatory loans (from \$100,000 per month before implementation to \$40,000 per month after) (DoD, 2008).

available options. In addition, more than twice as many former payday borrowers reported that the absence of payday lending had had a positive rather than a negative effect on them; nearly 90% of households thought that the loans were bad for their finances.

MARKET AND INDUSTRY OVERVIEW

The payday lending industry includes both bank and non-bank lenders.¹⁹ Non-bank lenders offer payday loans via two primary channels: through storefronts (with typical APRs of over 400%) and over the internet (with typical APRs often exceeding 600%). No matter how these loans are offered, they are structured to create a long-term cycle of debt for borrowers.

Lending Activity and Major Players

According to Stephens Inc., a privately-held investment firm that also issues investment analysis on payday and related lending institutions, the storefront payday lending industry has slumped from an estimated high of just over 23,500 stores in 2007 (Stephens Inc., 2008) to under 19,000 by 2010 (Stephens Inc., 2011). Stephens estimated storefront loan volume shrank from \$43 billion in 2007 (Stephens Inc., 2008) to slightly less than \$30 billion in 2010 (Stephens Inc., 2011). However, in that same period, internet payday loan volume more than doubled from an estimated \$6.7 billion in 2007 (Stephens Inc., 2008) to approximately \$14.3 billion in 2010 (Stephens Inc., 2011).

Our analysis shows that 16,341 payday stores are located in states without substantive restrictions on payday lending, with total loan dollar volume (including churn) of \$19.9 billion and total fees collected of \$3.4 billion.²⁰

16,341 payday stores are located in states without substantive restrictions on payday lending, with total loan dollar volume (including churn) of \$19.9 billion and total fees collected of \$3.4 billion.

Although the industry has always had a number of locally owned “mom-and-pop” shops, nine major operators run almost 50% of the estimated number of stores. Five of these lenders (listed alphabetically) are publicly traded, stock-owned companies. (The names in parentheses are the primary names for their payday stores):

- Texas-based Cash America started out 30 years ago as a pawn shop operator but moved into payday lending in 2000. It operates more than 660 locations that offer payday-like products; Texas is its largest storefront state. Additionally, its CashNetUSA subsidiary appears to be the largest online lender in the country. Combining its international business with U.S. operations, Cash America appears to derive more revenues from payday lending than any other firm.
- Pennsylvania-based DFC Global (Money Mart) has seen its number of storefronts decline gradually to slightly more than 300, with the bulk of those operating in California and Florida. The company has expanded aggressively outside the U.S., building storefronts and online operations across Europe and in Canada.

¹⁹ For more information on bank lenders, see the accompanying Bank Payday Lending chapter of *State of Lending*.

²⁰ See Appendix 3 for more information.

- EZCORP (EZ Money) is another Texas-based pawn store operator that has diversified into payday products, offering them at more than 450 U.S. stores, with more than half of them located in Texas. It recently purchased an online lending outfit and stated in an investor call that it intends to more than double its online lending volume within the next year.
- Texas-based First Cash Financial Services (First Cash Advance and Cash and Go) is a pawn shop operator that also engages in payday lending. Despite having previously made payday loans in its stores in multiple states as recently as 2011, it has reduced its domestic payday footprint primarily only to Texas.
- Kansas-based QC Holdings (Quik Cash) focuses on storefront payday lending, with a heavy concentration in Missouri and California. Its store count has shrunk from almost 600 in 2006 to fewer than 450 in 2013.

The other four major players in the industry are privately held or subsidiaries of larger entities. As a result, there is limited public information available on their operations:

- Begun in the 1990s, South Carolina-based Advance America is the largest storefront lender in the country, operating an estimated 2,500 stores, down from more than 2,800 stores in 2007. It operates almost exclusively as a storefront business, although it offers online loans through a partnership with Cash America's CashNetUSA. In Spring 2012, Mexico-based Grupo Elektra, a major supplier of both consumer electronics and financial services in Mexico, acquired Advance America and has since operated the stores as a U.S. subsidiary.
- Texas-based Ace Cash Express diversified into payday lending as a sideline to its primary business of providing check-cashing services. More than 1,300 of its estimated 1,700 retail locations offer payday loans. The company also is emphasizing car-title lending and prepaid debit cards, and it makes online loans in Canada through Zippy Cash.
- Tennessee-based Check Into Cash bills itself as the "father" of the payday industry, claiming that founder Allan Jones first developed the concept in the early 1990s. The company has more than 1,100 stores spread across the U.S. and recently bought a UK-based payday operator.
- Ohio-based CNG Financial (Check 'n Go) primarily operates as a payday lender, though it has also engaged in car-title lending, check cashing, and other operations. It has scaled back its store count from more than 1,350 in 2007 to a reported 1,025. It has also established an online operation.

Other national storefront operators include Allied Cash Advance, Amscot, Approved Cash Advance, Community Choice Financial (doing business as Checksmart), Moneytree, and PLS Loan Store. Many of these national storefront lenders also make loans over the internet.

The online industry is far harder to track; other than Cash America, few lenders report in detail on their operations. In recent years, some payday lenders have associated with Native American tribes to set up online lending operations that they claim are exempt from compliance with state consumer standards, as discussed in more detail below.

Industry Business Model

Two-Week Payday Loans

The payday lending industry is heavily reliant on repeat borrowers for its revenue. The leading payday industry trade association—the Community Financial Services Association (CFSA)—states in a recent letter to the CFPB, “[i]n any large, mature payday loan portfolio, loans to repeat borrowers generally constitute between 70 and 90% of the portfolio, and for some lenders, even more” (Miller, 2013).

Stephens Inc. (2011) also underscores this reliance: “In a state with a \$15 per \$100 rate, an operator . . . will need a new customer to take out 4 to 5 loans before that customer becomes profitable.” Indeed, Dan Feehan, CEO of Cash America, remarked at a Jeffries Financial Services Conference in 2007, “. . . [T]he theory in the business is [that] you’ve got to get that customer in, work to turn him into a repetitive customer, long-term customer, because that’s really where the profitability is.” Lender marketing materials offer incentives to promote frequent loan usage, such as discounts to promote repeat borrowing.

In addition, data from state payday lending databases highlight that repeat borrowing continues to fuel the payday lending business model. Figure 2 highlights the percentage of loans made to borrowers who receive five or more and 12 or more loans per year, both of which we also reported in CRL’s 2006 report “Financial Quicksand” (King & Parrish 2006). State regulator data from 2010 and 2011 indicate that, on average 91% of loans go to borrowers with five or more loans in a year, compared with 90% in our 2006 analysis. Similarly, on average, 65% of loans go to borrowers with 12 or more loans in a year, compared with 62% in 2006. This provides evidence that the payday lending industry’s debt trap business model has not changed over time.

In 2005, the Federal Deposit Insurance Corporation (FDIC) issued payday lending guidelines, highlighting the significant risks that these loans pose for borrowers, as well as safety and soundness risks for financial institutions that offer them or partner with institutions that do so.²¹

Although these guidelines only apply to FDIC-supervised banks, they provide an important reference point for what constitutes a debt trap. The guidelines state in part that covered banks should “ensure that payday loans are not provided to customers who had payday loans outstanding at **any lender** [emphasis in the original] for a total of three months during the previous 12 months. When calculating the three-month period, institutions should consider the customers’ total use of payday loans at all lenders” (FDIC, 2005). This guidance would allow approximately six two-week loans or three 30-day loans.

Our analysis using the latest data available from state regulators demonstrates that 85% of loans go to borrowers with seven or more loans in a year, more than the maximum level of indebtedness recommended by the FDIC. CFPB (2013) similarly found: “Three-quarters of all loan fees generated by consumers in our sample come from those with more than 10 transactions during this [one-year] period.”

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21 These guidelines effectively ended the “rent-a-bank” scheme, in which storefront payday lenders partnered with national banks to evade state laws.

Figure 2: Repeat Borrowing Continues to Fuel Payday Lending

State	Time Period	% of loans to borrowers with 5+ loans/year	% of loans to borrowers with 7+ loans/year	% of loans to borrowers with 12+ loans/year
Florida	June 2010-May 2011	92%	85%	63%
Kentucky	Jan. 2011-Dec. 2011	93%	88%	70%
Oklahoma	Nov. 2010-Oct. 2011	91%	84%	61%
South Carolina	Jan. 2011-Dec. 2011	90%	82%	53%
Average		91%	85%	62%
Average from “Financial Quicksand” (published in 2006)		90%	not available	62%

Source: State regulator reports of annual payday loan activity reported by state-regulated databases.

It is important to note that all of the states that report data on loan frequency—Florida, Kentucky, Oklahoma, and South Carolina—have codified industry-touted “best practices”—such as extended payment plans, rollover bans, and cooling-off periods that are typically only one or two days long—that purportedly ensure that borrowers are not caught in a debt trap. In reality, though, the data make clear that these payday industry-designed provisions do not prevent the cycle of debt. In Florida, for example, borrowers are limited to one outstanding loan at a time, may not roll over a loan, must wait 24 hours after paying off a loan before taking out another loan, and may enter a repayment plan at any point before they default for no charge. Despite these provisions, 63% of Florida loans go to borrowers with 12 or more loans per year, and 85% go to borrowers with seven or more loans per year.

Installment Payday Loans

The market for non-bank payday loans has become more complex in recent years, with many lenders also providing high-cost installment payday loans in which borrowers make multiple payments, rather than the traditional single balloon payment.”²² In some states—including Colorado, Illinois, New Mexico, and South Carolina—the installment product dominates the payday lending market. **In many cases, these installment loans are so costly that they are the equivalent of a payday loan with multiple renewals effectively incorporated into the product.**

In Illinois and Colorado, the move toward installment loans was precipitated by new state laws that regulated both the structure and pricing of payday loans. Despite legislative limits on the cost of these loans, payday installment loans in Illinois and Colorado are still very expensive, featuring triple-digit APRs. In other states—such as New Mexico, South Carolina, Missouri, Delaware, and Texas—payday lenders offer installment products as a way to evade even minimal regulatory requirements for single-payment payday loans, allowing them to operate in an environment with few or no regulatory restrictions.²³ For example, in Texas, although single-payment loans make up the majority of the payday loan volume in the state, some payday lenders also offer payday loans structured with installment

22 For more information on Illinois and Colorado, see Appendix 4.

23 For example, the New Mexico payday lending law applies only to loans of between 14 and 35 days that are secured by a post-dated check or ACH access. Martin (2010) wrote, “In the end, this narrow definition of payday lending defanged the legislation. The industry quickly switched to loan products that fell outside the statute, namely longer loans or those not involving a post-dated check; these loans are not regulated at all.”

payments. EZCorp (EZMoney) advertises a payday installment loan with a 126-day term, carrying a 560% APR, resulting in \$960 in charges for a \$700 payday loan (EZ Money, 2013). Similarly, in Missouri, Advance America offers online payday loans payable in installments with a 182-day minimum loan term, carrying a 297% APR, resulting in \$1,586 in charges for a \$1,500 loan (Advance America, 2013).

Whether payday installment loans are explicitly authorized or made through subterfuge, their costs can be as excessive as single-payment payday loans. In Illinois in 2011, for example, borrowers paid more in interest than they received in principal for payday installment loans: \$232.5 million in interest paid vs. \$223.1 million in principal received. Indeed, Martin (2010) conducted interviews with New Mexico payday installment borrowers, which revealed that their experience differed little, if at all, from the single-payment payday borrowers. Despite their installment terms, these loans share the same troublesome characteristics as other payday loans: a lack of underwriting, requiring access to a borrower's bank account as security, and charging excessive fees that result in patterns of repeat borrowing.

LEGISLATION AND REGULATION

Historically, states had usury limits in place that prevented payday and other high-cost loans from being made. The storefront payday loan industry rapidly expanded when many states exempted payday lenders from these usury caps in the 1990s (Drysdale & Keest, 2000). Since then, the states and the federal government have ramped up their regulation of these products.

State Approaches to Regulation

The trend at the state level over the past decade has been toward greater scrutiny of payday lending products. Numerous states have ended the authorization of payday loans or put in place new limits; state voters have consistently supported ballot initiatives aimed at eliminating high-cost payday lending. For example, voters in Arizona and Montana voted to bring payday lenders under a 36% APR limit in 2008 and 2010, respectively. Similarly, in 2008, voters in Ohio defeated a ballot initiative that would have overturned the state's 28% APR payday loan rate cap.²⁴ In addition, since 2005, no state has authorized payday lending.

Numerous states have ended the authorization of payday loans or put in place new limits; voters have consistently supported ballot initiatives aimed at eliminating high-cost payday lending from states.

Appendix 5 lists the legal status of payday lending by state, divided into two categories:

- 29 states with no substantive restrictions on payday lending.
- 22 states, including the District of Columbia (DC), with significant payday lending reforms that either eliminate or limit the debt trap. Of these states, 16 states (including DC), which represent 34% of the U.S. adult population, have put in place rate caps that eliminate the payday lending debt trap. Six other states, representing 8% of the U.S. adult population, have enacted reforms that limit but do not completely eliminate the debt trap.

²⁴ Despite this rate limit, payday lenders in Ohio are illegally offering very high cost payday loans by exploiting loopholes in the law. These illegal payday loans are under court scrutiny, with two courts having ruled that the loans are being made illegally and the Ohio Supreme Court set to weigh in. For more information on subterfuge in Ohio, see Rothstein (2009).

The Strongest Approach: Setting Maximum APRs to Eliminate the Debt Trap

Sixteen states, including DC, have ended or never allowed the payday debt trap by enforcing historic usury limits. Generally, these are around 36% APR. For example, New York subjects small-dollar loans to a 25% APR ceiling. Similarly, New Jersey has set a 30% ceiling and Arkansas a 17% ceiling. Pew (2012) concluded that in these most restrictive states without high-cost storefront payday lending, “95 of 100 would-be borrowers elected not to use payday loans at all—just five borrow online or elsewhere,” such as through banks.²⁵ Importantly, in recent years, payday lenders have attempted to replace these rate limits with laws allowing 300% APR or higher but have been unsuccessful because of broad opposition from policymakers and their constituents in those states.

Laws that Decrease the Payday Lending Debt Trap

Several other states have sought to limit the payday lending debt trap through policies such as limiting the number of loans a borrower may take out in a year or extending the minimum loan term to up to six months. In Delaware and Washington State, for example, borrowers are limited to five and eight payday loans per year, respectively, which regulators enforce through the use of a statewide payday loan database.

Delaware’s law went into effect in 2013, so no data are yet available. However, there is evidence that some national payday lenders have migrated to the state’s installment lending statute in order to continue to offer unrestricted triple-digit-APR debt trap loans. If payday loans were the quick, emergency fix that they are marketed to be, then payday lenders should have been unaffected by the new law, which sought to curb the debt trap. That lenders are evading the law provides further evidence that long-term, repeat re-borrowing is at the core of the payday lending business model, as data from other states have consistently found.

Washington State, however, has strong underlying small loan laws that prevent similar evasion, and thus the state has been able to enforce and monitor its payday loan law. Figure 3 analyzes the Washington State data before and after the new law went into effect. The law appears to have been successful in greatly lowering the level of payday lending debt trap and associated fees in the state, along with the number of borrowers: Between 2009 (before the law went into effect) and 2011 (the most recent year of data after the law took effect), the number of payday borrowers decreased by 43%. In addition, the annual loan dollar volume decreased by 76% or over \$1 billion; the number of annual loans decreased by 74% or 2.4 million; and the number of payday stores decreased from 603 to 256. As a result, borrowers paid \$136 million or 75% less in annual payday loan fees.

Despite the limitation on the number of loans allowed per borrower and an increase in the allowable loan size to \$700, the average loan size decreased by \$30 (from \$412 to \$382). The average fee stayed

25 To determine this statistic, Pew (2012) asked borrowers in “permissive” states (that do not restrict payday lending) and “restrictive” states (that prohibit payday lending) whether they had used storefront or other types of payday loans (such as online or bank) in the previous five years. Permissive states averaged 522 storefront borrowers per 10,000 people over the five-year period, whereas restrictive states averaged 129 storefront borrowers per 10,000 people. (Restrictive state borrowers might have received a storefront loan before a change in the state law, moved between states over the five-year period, or crossed the border to a neighboring state with storefronts.) Researchers concluded that restrictive state laws led to 393 fewer storefront payday borrowers per 10,000 people (522-129). These are “would-be” payday borrowers. In addition, permissive states averaged 137 online/other payday borrowers per 10,000 people, whereas restrictive states averaged 158 per 10,000 people. This led to the conclusion that in restrictive states there are an additional 21 online borrowers per 10,000 people (158-137). By dividing the additional online borrowers (21) by the reduced storefront borrowers (393), researchers concluded that 95% of would-be borrowers do not use payday loans at all; only 5% take out loans through the internet and banks.

approximately equal, but the average APR decreased from 256% in 2009 to 182% in 2011, largely because the average loan term increased by nine days (from 19.6 days in 2009 to 28.7 days in 2011).

On average, borrowers took out substantially fewer loans in the wake of the new law. Whereas borrowers took out an average of 7.9 loans per year in 2009, in 2011 they took out an average of just 3.7 loans, a decrease of 54%. As a result, the average number of total days of payday borrower indebtedness decreased by 32%, from 155 days in 2009 to 105 days in 2011. This is a longer period of indebtedness than the three-month maximum level recommended in the 2005 FDIC guidelines, but it is substantially lower than before the law was implemented.

The vast majority of borrowers did not reach the eight-loan limit after the new loan went into effect; in 2011, 24% of customers reached the eight-loan limit, up from 16% in 2010. Customers reaching the eight-loan limit in 2011 were indebted on average 230 days of the year, well above the FDIC guideline recommendation.

Figure 3: Analysis of Washington State Data

	2009 (before new law)	2010 (after new law)	2011 (latest data under new law)	2011 vs. 2009
Total Loan Volume	\$1,336,028,845	\$434,111,743	\$326,673,119	\$1.0 billion (76%) lower
Total # Loans	3,244,024	1,093,776	855,829	2.4 million (74%) fewer
Total # Borrowers ¹	410,041	280,587	233,835	176,206 (43%) fewer
Avg # loans per borrower	7.9	3.9	3.7	4.3 (54%) fewer
Total Fees	\$183.4 million	\$61.3 million	\$46.6 million	\$136.8 million (75%) lower
Average Loan Term (in days) ²	19.6	28.6	28.7	9.1 days longer
Average Total # Days of Indebtedness	155	111	105	50 days (32%) fewer
Average Loan Amount	\$412	\$397	\$382	\$30 lower
Average Fee Amount	\$57	\$56	\$55	\$2 lower
Average fee/\$100 borrowed	\$13.73	\$14.12	\$14.29	\$0.56 higher
Average APR	256%	180%	182%	74 points lower
% of customers reaching 8-loan limit (approximately 230 days of indebtedness) ³	N/A	16%	24%	N/A
# stores	603	424	256	347 (58%) fewer
Installment plan usage ⁴	N/A	13%	10%	N/A

Source: Washington State Department of Financial Institutions Payday Lending reports for 2009, 2010, and 2011

1 The 2010 and 2011 figures are from the state's Department of Financial Institutions (DFI) report and represent data collected from a statewide database, including loans to a single customer from multiple lenders. The state did not have a database in place in 2009, and the DFI figure reported comes from reports to DFI from lenders covering 90% of the market.

2 This metric reported not from database but rather from reports filed by individual companies covering 90% of the market in 2009 and 96% of the market in 2010 and 2011.

3 As of Jan. 1, 2010, borrowers could take out a maximum of eight loans per year.

4 As of Jan. 1, 2010, all borrowers are entitled to an installment plan at any time prior to default.

Some states have codified extended loan terms under the theory that the balloon two-week payment is a key factor in creating the debt trap. For example, as highlighted in Appendix 4, Colorado effectively eliminated the traditional single-payment two-week payday lending model and moved borrowers to a high-cost installment product through enactment of a package of reforms in 2010. These reforms limited interest and fees,²⁶ made the origination fee proportionately refundable (thus lessening the incentive to churn loans), extended the minimum loan term to six months, and prohibited the sale of ancillary products.

Despite the six-month minimum loan term, in 2011—the first full calendar year in which the law was in effect—loans were repaid after an average of 104 days, or 3.5 months. However, borrowers took out an average of 2.3 loans from a single lender during the year and were in debt an average of two-thirds (240 days) of the year. This marks a substantial increase in total days of indebtedness over 2009 (the last full year that the balloon payment model was in effect), when borrowers took out 7.5 two-week loans from a single lender and were in debt 40% (147 days) of that year. Indeed, even with the provisions in the Colorado law in place to decrease the incentive to churn loans—such as proportionately refundable origination fees—lenders still have an incentive to flip loans in order to keep customers in debt over a longer period of time.

Total fees paid decreased from \$95 million in 2009 to \$54 million in 2011, a decrease of over \$41 million (43%), in large part owing to the significant price restrictions in the new Colorado law. On average, in 2011, borrowers paid \$282 in interest on an average initial loan of \$380; in 2009, they paid \$476 in fees annually on an average initial loan of \$368. The number of Colorado payday borrowers appears to have decreased only slightly from 2009 (279,570) to 2011 (247,441).²⁷

In addition to six-month payday loans, Colorado authorizes consumer installment loans of up to \$1,000, but lenders may not hold a post-dated check with these loans. Consumer installment loans carry an average fee of \$80, principal of \$380, and loan term of 82 days, which equates to a 93% APR. Repeat refinancing is persistent in this market as well; for example, the Colorado Attorney General brought an enforcement action in 2010 against one national consumer installment company for refinancing loans in order to maximize fees (Gillentine, 2010).

Two other states have extended loan terms as part of their reform efforts. Virginia increased the minimum payday loan term to twice the length of a borrower's pay period and put in place a 45-day cooling-off period in which a borrower may not take out another payday loan after his or her fifth loan. However, Virginia also simultaneously increased the allowable fees, resulting in payday loans that carry the same or higher APRs as before the extended loan terms went into effect. Oregon has a 31-day minimum loan term, along with restricted fees (to 36% annual interest plus an origination fee of the lesser of \$10 per \$100 borrowed or \$30). Less is known about the impact of these laws because data in the state regulators' annual reports are limited.

26 The 2010 law, which allows payday loans of up to \$500 in principal, limits fees to 45% annual interest; plus a one-time finance charge of 20% of the loan amount up to \$300 and 7.5% over \$300; plus a monthly maintenance fee of \$7.50 per \$100 borrowed, up to \$30, after the first month. Colo. Rev. Stat 5-3.1-105. These fees combine to cost 191% APR on the average contracted loan and are, importantly, refundable *pro rata* upon prepayment. They mark a significant reduction from the preceding law, which resulted in an average APR of 319%.

27 These figures likely overstate the number of borrowers because Colorado does not have a database to track borrowers across payday lenders; instead, when one borrower takes out payday loans from multiple lenders, he or she is counted as multiple borrowers.

The False Promise of Industry “Best Practices”

Many states that allow payday lending have codified industry-promoted “best practices” that supposedly offer strong consumer protections, such as renewal bans, one- or two-day cooling-off periods, and payment plans that give borrowers more time to pay off a loan. The data clearly show, however, that such laws do nothing to end the long-term debt trap for borrowers.

For example, payday lenders routinely circumvent renewal bans by having borrowers pay off their loan and immediately take out another or, if there is a short cooling-off period in place (generally 24-48 hours), taking out a new loan at the end of the cooling-off period. In “Springing the Debt Trap” (King & Parrish, 2006), CRL researchers found that in Florida and Oklahoma, which have codified these industry “best practices,” about half of subsequent loans were opened at the borrower’s first opportunity, and nearly 90% were made in the same pay period as the previous loan was paid off.

Some states have enacted laws codifying the industry best practice of allowing borrowers the option to request an extended payment plan. Though these plans seem to offer a way for borrowers to get out of payday loan debt, they rarely achieve this goal. Payday lenders often ensure that the terms of a plan are more expensive in the short term for borrowers, who would typically have to pay more to enter into a payment plan agreement than to simply renew their loan and pay a new fee.²⁸ In addition, although payday lenders are generally required to furnish borrowers with information about the availability of payment plans, they have little incentive to advertise these plans aggressively or cast them in a positive light.

Even in states with relatively consumer-friendly repayment plans, usage is infrequent. For example, Washington State allows anyone to enter an extended payment plan at any time prior to default for free. Under the extended payment plan, borrowers have between 90 and 180 days to repay the loan, depending on the original loan amount. Despite these seemingly consumer-friendly loan terms, in 2011, only 9.5% of loans were converted to installment loans under this option.

Finally, although a key feature of payday lending is that anyone with a checking account and a source of income can qualify for a loan, a few states have enacted limited “ability to repay” measures that purport to prevent borrowers from getting more money than they can afford to pay back. Requiring a real evaluation of the affordability of a payday loan is essential; unfortunately, however, key elements in determining a borrower’s true ability to repay are absent in state laws. In general, these laws limit the total amount of payday loan debt to 20-25 percent of the borrower’s gross (pre-tax) monthly income. However, the typical borrower takes out a payday loan for two weeks, rather than a month. This means that a person can qualify to take out a loan for 40-50 percent his or her gross income over a two-week period. Compounding this problem is that these provisions only consider pre-tax income.

Figure 1 shown previously highlights that a borrower earning \$35,000 per year would not be able to afford a \$350 loan even with no fee, yet the typical state ability-to-repay standard would allow that borrower to take out a payday loan for almost twice that amount (\$673). Finally, existing ability-to-repay provisions fail to take into account a borrower’s other legal obligations, such as a mortgage or rental payment, car loan, or minimum credit card payment, much less other recurring expenses. Without knowing these, it is impossible for a payday lender to accurately assess a borrower’s ability to both repay the loan and meet other existing obligations.

28 For example, a borrower taking out a \$325 loan pays just \$52 to extend the loan (either through a direct renewal or by taking out a loan shortly after paying back the previous loan) compared with \$94 to pay the first installment of a typical amortizing payment plan (King & Parrish, 2006).

EVASION ATTEMPTS

Payday lenders have attempted to evade consumer protections or offer loans in states where high interest rates are illegal. State and federal regulators have been generally successful at enforcing laws against these attempts. Examples include the following:

Rent-a-Bank: In the early 2000s, some large payday lending chains attempted to evade state anti-payday lending laws by partnering with small banks that may not be subject to state payday regulation. Federal banking regulators intervened to stop this practice in 2000 and 2005 by prohibiting rent-a-bank arrangements, and—in the case of the FDIC—establishing a 90-day borrower indebtedness limit in a 12-month period.²⁹

Tribal lending: Tribal sovereign immunity generally bars states from enforcing their laws against Native American tribes, though federal laws and regulations still apply. Some payday lenders have sought to partner with Native American tribes for the specific purpose of offering loans otherwise not permitted by state or tribal law.

²⁹ For more information, see the “Federal Approaches to Regulation” section to the right.

Federal Approaches to Regulation

Until the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) created the CFPB and gave it the power to regulate payday lenders, federal regulation of payday lending was limited. Nevertheless, the trend at the federal level, like that at the state level, has been to take steps to curb the payday lending debt trap, including through the following legislative and regulatory actions:

- In 2000, the Office of the Comptroller of the Currency (OCC) issued an advisory letter that put an end to the rent-a-bank scheme among its regulated banks, stating that “payday lending can pose a variety of safety and soundness, compliance, consumer protection, and other risks to banks.” Noting that some payday lenders were partnering with banks, the advisory letter continued, “Payday lenders entering into such arrangements with national banks should not assume that the benefits of a bank charter, particularly with respect to the application of state and local law, would be available to them” (OCC, 2000).
- In 2005, the FDIC issued payday lending guidelines that ended the “rent-a-bank” scheme in which payday lenders partnered with small banks in order to evade state law. Among other provisions, these guidelines advised against making a payday loan to a customer who had already been in payday loan debt for three months during a twelve-month period. In addition, in 2007, the FDIC issued affordable small-dollar loan guidelines “to encourage financial institutions to offer small-dollar credit products that are affordable, yet safe and sound, and consistent with all applicable federal and state laws” (FDIC, 2007). The 2007 guidelines advise that loans be reasonably priced, with a maximum APR of 36% and minimal or no fees, and repayable in affordable installments.

EVASION ATTEMPTS

Choice of law: While some internet lenders comply with the laws in the states in which they operate, others erroneously claim that “choice of law” allows them to comply only with the laws in the states in which they are headquartered (generally those with minimal or no payday loan regulations). State regulators have had some success in enforcing their own state laws, such as interest rate caps, against internet lenders when the borrower resides in their state. However, Fox (2011) highlighted that even when internet lenders technically comply with state laws, they sometimes still take loan applications for borrowers in these states and serve as lead generators, selling the information to other internet companies that are willing to make the loan in violation of the state’s law.

Credit Service Organizations (CSOs): Under this scheme, lenders position themselves as credit services organization (CSOs) and broker loans on behalf of borrowers. This allows payday lenders to charge the maximum interest rate allowed on the underlying loan plus an additional brokerage fee. For example, a third-party lender might finance a \$300 loan at the legal interest rate of 36% APR, receiving \$4.14 in interest. The payday lender, posing as a CSO, would receive an additional \$60 fee to serve as the broker—essentially to arrange for the loan and collect and guarantee the fee to the third-party lender. The borrower

- In 2006, Congress passed the Military Lending Act (MLA), which put in place for active-duty military and their families a 36% APR rate cap and prohibited the holding of a post-dated check as security for any credit product covered under the law. The law charged DoD with determining which credit products would be covered, and the 2007 DoD regulations included closed-end, but not open-end, payday loans. DoD has concluded that the law has worked to curb abusive lending practices, and military relief societies as well as financial counselors have reported limited use of these products. However, the narrow definition of covered credit under the regulations means that high-cost payday-like installment loans and open-end lines of credit remain legal.

A recent amendment to the MLA has given the CFPB and the Federal Trade Commission enforcement authority over the law. The Conference Report accompanying the amendment also called for DoD to review the regulations to address continuing predatory lending and to report back to Congress within one year (U.S. House of Representatives, 2012). DoD recently solicited public comment as part of that review, seeking input in particular on the scope of credit that should be covered under the regulations. A diverse range of constituencies and state and federal policymakers urged a broad definition of covered credit to address current abuses and prevent circumvention of the law’s intent.

- The Federal Trade Commission (FTC) has brought several enforcement actions against illegal online lending practices.³⁰ For example, in 2011, the FTC brought enforcement action against Payday Financial, also known as Western Sky Financial (doing business as Lakota Cash and Big Sky Cash), and its owner, Martin Webb. The FTC alleged that the defendants charged undisclosed and inflated fees and collected on loans by illegally threatening borrowers with arrests and lawsuits (FTC, 2011).

³⁰ The Consumer Federation of America has compiled a list of FTC actions against payday lenders as of February 2012. This can be viewed at <http://bit.ly/17jnISO>.

EVASION ATTEMPTS

would pay \$64.14 in total fees for a two-week, \$300 loan, resulting in an APR of over 550%.

This type of subterfuge has been shut down in nearly every state in which the payday lenders have attempted it (including California, Maryland, Florida, and Michigan). In the two remaining states (Texas and Ohio),³¹ it is currently under scrutiny—by the legislature in Texas and by the courts in Ohio.

Despite these attempts at evasion, states with interest rate caps that prohibit high-cost payday loans have been very successful in enforcing those laws. In fact, Pew (2012) found that only 1.29% of adults in the most restrictive payday states report having borrowed from a payday storefront over the prior five years, and only 1.58% of residents in those states had borrowed online or from another source (such as a bank).

In 2012, the FTC brought enforcement action against several defendants, including AMG Services, Inc. (doing business as 500FastCASH and USFastCash) and one of its owners, Scott Tucker. According to the FTC, the defendants violated a wide range of federal consumer protection laws—including the Federal Trade Commission Act, the Truth in Lending Act, and the Electronic Fund Transfer Act—when they claimed they would charge borrowers a one-time finance fee and instead “made multiple withdrawals from borrowers’ bank accounts and assessed a new finance fee each time, without disclosing the true costs of the loan. The defendants also falsely threatened that consumers could be arrested, prosecuted, or imprisoned for failing to pay and that the defendants would sue them if they did not pay” (FTC, 2012).

Currently, the CFPB has the power to supervise, bring enforcement actions, and regulate all payday lenders, regardless of size or type. This means that for the first time, payday lenders receive supervisory scrutiny even when they are located in states with little or no regulation. The Bureau also has the authority to use its Unfair, Deceptive or Abusive Acts and Practices (UDAAP) authority to bring an end to the debt trap.

³¹ For more information on subterfuge in Ohio, see Rothstein (2009).

POLICY RECOMMENDATIONS

The following policy provisions would address the payday lending cycle of debt:

- Congress should enact a 36% APR limit applicable to all borrowers, similar to what it enacted for active-duty military and their families in the Military Lending Act.
- The CFPB should promulgate regulations that require payday lenders to:
 - determine borrowers' ability to repay the loan and afford their regular expenses without taking out another payday loan.
 - limit the length of time payday lenders can keep borrowers in debt, consistent with the FDIC's 2005 payday loan guidelines, which limit payday loan indebtedness to a maximum of 90 days over a twelve-month period, the equivalent of six two-week loans or three 30-day loans.
 - prohibit lenders from requiring a post-dated check or electronic access to the borrower's checking account as a condition of extending credit.
- Federal regulators—including the Department of Justice, FTC, and CFPB—should use their enforcement authority against payday lenders to address violations of law.
- States should continue to put in place 36% APR limits applicable to payday loans.
- States should vigorously enforce their laws against unlicensed lenders and should work in partnership with federal regulators to address attempts at subterfuge.
- In addition to implementing substantive protections, the CFPB should continue to collect and make public detailed data on payday loan use, and states that do not collect or make public such data should do so.

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Appendix 1: Cost of Payday Loan Churn in States without Meaningful Regulation of Payday Lending

State	Total Cost of Churn with One Month Definition (82% multiplier)	Total cost of Churn With Two-Week Definition (76% multiplier)
Alabama	\$190,295,996	\$176,371,899
Alaska	\$4,648,090	\$4,307,986
California	\$474,226,587	\$439,527,081
Florida	\$256,373,927	\$237,614,860
Hawaii	\$2,690,567	\$2,493,696
Idaho	\$26,961,607	\$24,988,807
Illinois	\$5,759,916	\$5,338,459
Indiana	\$57,856,740	\$53,623,320
Iowa	\$30,559,714	\$28,323,637
Kansas	\$53,658,898	\$49,732,637
Kentucky	\$92,496,000	\$85,728,000
Louisiana	\$148,679,862	\$137,800,848
Michigan	\$89,135,094	\$82,613,014
Minnesota	\$7,419,962	\$6,877,038
Mississippi	\$213,795,260	\$198,151,704
Missouri	\$102,425,544	\$94,930,992
Nebraska	\$26,373,448	\$24,443,684
Nevada	\$63,735,185	\$59,071,635
New Mexico	\$3,854,000	\$3,572,000
North Dakota	\$5,658,000	\$5,244,000
Oklahoma	\$44,526,000	\$41,268,000
Rhode Island	\$5,785,099	\$5,361,799
South Carolina	\$51,250,000	\$47,500,000
South Dakota	\$28,170,921	\$26,109,634
Tennessee	\$162,777,305	\$150,866,771
Texas	\$559,839,898	\$518,876,003
Utah	\$21,559,843	\$19,982,294
Wisconsin	\$18,416,597	\$17,069,041
Wyoming	\$8,841,523	\$8,194,582
Total	\$2,757,771,584	\$2,555,983,419

We use the most recent data available from each state's payday lending regulator and provide estimates in states with limited or no data. The data exclude loans from banks and unlicensed lenders.

Appendix 2: Average Number of Loans Per Borrower Per Year

Average Number of Loans Per Borrower Per Year in States without Meaningful Regulation of Payday Lending

State	Average # loans per borrower	Total # loans in state	Total # borrowers
Florida	8.8	7,338,912	833,967
Kentucky	10.0	2,079,822	207,982
New Mexico	6.4	83,022	12,934
Oklahoma	8.8	1,026,417	116,638
South Carolina	7.9	1,063,945	135,155
TOTAL		11,592,118	1,306,677
Weighted avg	8.9		

These statistics imply that a borrower on average receives one non-churn loan and eight flips, based on findings from CRL's "Phantom Demand" (Parrish & King, 2009). This translates into a borrower paying back \$504 in fees alone for \$346 in non-churn principal, given a median loan size from state regulator data of \$346 and median fee of \$56. This compares with CFPB (2013), which found that the typical borrower takes out ten loans from a single lender during the year, paying \$458 in fees alone for \$350 in non-churn principal.

Average Number of Loans per Borrower in States that Limit the Payday Lending Debt Trap

State	Average # loans per borrower	Total # loans in state	Total # borrowers
Colorado ¹	2.3	444,333	247,441
Oregon ²	3.9	131,757	33,833
Virginia ³	3.2	470,062	147,162
Washington ⁴	3.7	855,829	233,835
Weighted avg	3.5		

1 Colorado has a six-month minimum loan term, coupled with a fee limitation and restrictions on repeat refinancing. For more information on Colorado, see Appendix 4.

2 The minimum loan term in Oregon is 31 days, and fees are limited to 36% APR plus 10% of the principal borrowed, up to \$30.

3 The minimum loan term in Virginia is two pay periods, and there is a mandatory 45-day cooling-off period after the fifth payday loan in six months, enforceable through a database.

4 Washington State limits the number of payday loans to eight per year, enforceable through a database.

These data highlight that states that have enacted significant reforms short of an APR have had some success in lowering the rate of loan churn. Whereas in low-regulation payday states, the average loans/borrower is nearly 8, in these states with some structural changes to limit the debt trap, it is less than half that (3.5). However, the number of loans is not always indicative of the number of days of indebtedness; for example, in Colorado—where the average annual number of loans is 2.3—the average annual days of indebtedness is 240.

Appendix 3: Payday Lending Statistics by State

Payday Lending Statistics for States without Meaningful Regulation of Payday Lending

State	# of Stores	Source ¹	Avg. # loans/store ²	Payday Loan Dollar Volume (Including Churn) ³	Source	Total Payday Fees ⁴	Source	Avg. Loan Amt. ⁵	Source
Alabama	1,070	Regulator	3,541	\$1,326,104,500	Estimated	\$232,068,288	Estimated	\$350	Assumed
Alaska	34	Regulator	2,550	\$34,900,146	Regulator	\$5,668,403	Estimated	\$403	Regulator
California	2,119	Regulator	5,797	\$3,276,629,497	Regulator	\$578,325,106	Estimated	\$263	Regulator
Florida	1,275	Regulator	5,756	\$2,906,456,786	Regulator	\$312,651,131	Regulator	\$396	Regulator
Hawaii	15	Stephens	3,541	\$18,590,250	Estimated	\$3,281,179	Estimated	\$350	Assumed
Idaho	213	Regulator	2,170	\$165,060,286	Regulator	\$32,880,009	Imputed	\$357	Imputed
Illinois	522	Regulator	265	\$46,020,498	Imputed	\$7,024,288	Imputed	\$333	Regulator
Indiana	376	Regulator	4,220	\$502,850,000	Regulator	\$70,557,000	Regulator	\$317	Regulator
Iowa	218	Regulator	3,904	\$294,098,537	Regulator	\$37,267,944	Imputed	\$346	Regulator
Kansas	352	Regulator	3,541	\$436,251,200	Estimated	\$65,437,680	Estimated	\$350	Assumed
Kentucky	578	Regulator	3,598	\$677,500,000	Regulator	\$112,800,000	Regulator	\$326	Regulator
Louisiana	931	Regulator	3,541	\$1,153,834,850	Estimated	\$181,316,905	Estimated	\$350	Assumed
Michigan	646	Regulator	3,541	\$800,620,100	Estimated	\$108,701,335	Estimated	\$350	Assumed
Minnesota	74	Regulator	4,572	\$127,043,568	Regulator	\$9,048,734	Regulator	\$376	Imputed
Mississippi	1,036	Regulator	3,541	\$1,283,966,600	Estimated	\$260,725,926	Estimated	\$350	Assumed
Missouri	934	Regulator	2,505	\$716,320,800	Imputed	\$124,909,200	Imputed	\$306	Regulator
Nebraska	180	Regulator	3,527	\$182,225,167	Imputed	\$32,162,742	Regulator	\$350	Assumed
Nevada	339	Stephens	3,541	\$420,139,650	Estimated	\$77,725,835	Estimated	\$350	Assumed
New Mexico	121	Regulator	686	\$31,200,000	Regulator	\$4,700,000	Regulator	\$375	Regulator
North Dakota	56	Regulator	1,940	\$34,800,000	Regulator	\$6,900,000	Regulator	\$320	Regulator
Oklahoma	358	Regulator	2,867	\$404,600,000	Regulator	\$54,300,000	Regulator	\$394	Regulator
Rhode Island	29	Regulator	6,327	\$70,549,986	Regulator	\$7,054,999	Estimated	\$385	Imputed
South Carolina	367	Regulator	2,899	\$416,200,000	Regulator	\$62,500,000	Regulator	\$391	Imputed
South Dakota	126	Stephens	3,541	\$156,158,100	Estimated	\$34,354,782	Estimated	\$350	Assumed
Tennessee	1,208	Regulator	3,791	\$1,124,696,366	Regulator	\$198,508,909	Estimated	\$221	Regulator
Texas	2,617	Regulator	2,240	\$3,061,174,112	Imputed	\$682,731,583	Imputed	\$522	Regulator
Utah	116	Regulator	3,541	\$142,121,576	Estimated	\$26,292,492	Estimated	\$346	Regulator
Wisconsin	423	Regulator	603	\$76,652,781	Regulator	\$22,459,265	Imputed	\$300	Regulator
Wyoming	87	Regulator	3,541	\$107,823,450	Estimated	\$10,782,345	Estimated	\$350	Assumed
Total	16,420			\$19,994,588,807		\$3,363,136,078			

Notes: The data exclude loans from banks and unlicensed lenders. We use the most recent data available from each state as of the writing of this report. In general, “regulator” indicates a metric directly reported by the state regulator. “Imputed” refers to a metric that is imputed from other data directly reported from a regulator. For example, an average fee could be imputed by dividing total fees by the number of loans. “Estimated” means a metric that we estimated using assumptions that we outline below.

1 When regulator data were unavailable, we used the figures from the 2011 Stephens, Inc. annual report (based on 2010 payday loans).

2 We estimated the average number of loans per store for states that do not provide these data by calculating the weighted mean from the states that do so. This weighted mean is 3,541.

3 For states that did not report payday loan volume, we estimated it by multiplying the number of payday stores in the state times the average number of loans per store (3,541) times the median loan size from CFPB (2013) (\$350).

4 For states that did not report total fees, we estimated it by using the statutory maximum rate, since the evidence shows that payday lenders charge the maximum allowable amount. For states with no statutory maximum, we used the median rate charged by storefront lenders that publish their rates.

5 For states that did not report average loan amount, we assumed the \$350 median from CFPB (2013).

Appendix 3: Payday Lending Statistics by State (Continued)

Payday Lending Statistics for States that Impose Some Significant Restrictions on Payday Lending

State	Payday Loan Dollar Volume	Source	Total Payday Fees	Source	Avg. Loan Amt.	Source
Colorado ⁶	\$167,042,409	Regulator	\$54,054,658	Regulator	\$379	Regulator
Maine ⁷	The Maine regulator does not collect overall loan dollar volume or fee figures. However, in an email on file with the author, the Principal Credit Examiner noted that there were only seven payday lending storefronts in the state. The email stated, "Of the licensed payday lenders in Maine, the bigger companies, such as Republicash, did more business in Maine. The total [dollar] volume of loans reported by some of the larger companies ranged from about 1 million to about 4 million per year. Some of the smaller, Maine-based companies reported much less in volume with a range of approximately a few thousand dollars up to \$50,000 per year. This trend has not changed in the last few years."					
Oregon ⁸	\$66,174,976	Regulator	\$7,279,247	Regulator	\$266	Regulator
Washington ⁹	\$326,673,119	Regulator	\$46,666,858	Regulator	\$382	Regulator
Virginia ¹⁰	\$185,679,381	Regulator	\$42,047,046	Estimated	\$395	Regulator

6 Colorado has a six-month minimum term, coupled with a fee limitation and restrictions on repeat refinancing. For more information on Colorado, see Appendix 4.

7 Maine prohibits the advance of money on a post-dated check except for "supervised lenders" and limits fees to \$5 for loans up to \$75, \$15 for loans from \$75.01-\$250, and \$25 for loans over \$250.

8 The minimum loan term in Oregon is 31 days, and fees are limited to 36% APR plus 10% of the principal borrowed, up to \$30.

9 Washington State limits the number of payday loans to eight per year, enforceable through a database.

10 The minimum loan term in Virginia is two pay periods, and there is a mandatory 45-day cooling-off period after the fifth payday loan in six months, enforceable through a database.

Appendix 4: Analysis of Colorado and Illinois Payday Installment Lending Data

COLORADO ANALYSIS

Colorado 2011 Installment Data (First Full Year of Installment Loan Data)

Total Loan Volume	Total # Loans	Total # of Borrowers ¹	Total contracted fees	Total actual fees	Avg. contracted loan size	Avg. contracted fee	Avg contracted loan term (days)
\$167,042,409	444,333	279,570	\$105,439,820	\$54,054,658	\$375.45	\$236.99	188
Avg. contracted APR	Avg. actual loan	Avg actual fee	Avg. actual loan term (days)	Avg. actual APR	Avg # loans per borrower ²	Avg total # days of indebtedness	
191%	\$379.39	\$122.77	104	131%	2.3	240	
		% of Borrowers					
Total # loans paid in full in 2011	297,985						
Paid in full within one month of origination	40,367	14%					
between 1-2 months	41,797	14%					
between 2-3 months	38,705	13%					
between 3-4 months	41,110	14%					
between 4-5 months	43,439	15%					
more than 5 months	92,567	31%					

Source: Regulator report.

1 This figure may overstate the number of borrowers because Colorado does not have a database in place to track borrowers across lenders; instead, when one borrower takes out payday loans from multiple lenders, he or she is counted as multiple borrowers.

2 This figure comes from Colorado regulator examination results published in the state's 2012 publication "Payday Lending Demographic and Statistical Information."

Appendix 4: Analysis of Colorado and Illinois Data (Continued)

COLORADO ANALYSIS

Colorado 2009 Payday Data (last full year before new law implemented)

\$576,242,827	Total payday loan dollar volume
1,565,481	Total # of loans
279,570	Total # borrowers ³
\$95,087,316	Total Fees
\$368.09	Avg. Loan Size
\$60.74	Avg. Fee
319%	Avg. APR
18.9	Avg. loan term (days)
7.8	Avg. # loans per borrower ⁴
148	Avg. total # days of indebtedness

Source: Regulator report.

³ This figure may overstate the number of borrowers because Colorado does not have a database in place to track borrowers across lenders; instead, when one borrower takes out payday loans from multiple lenders, he or she is counted as multiple borrowers.

⁴ This figure comes from Colorado regulator examination results published in the state's 2010 publication "Payday Lending Demographic and Statistical Information."

Difference, 2009 vs. 2011 (Before and After New Law)

Change in loan volume	(\$409,200,418)	(71%)
Change in total fees (using actual 2011 fees)	(\$41,032,658)	(43%)
Change in avg. total # of days of indebtedness	92	62%
Change in # of borrowers	(32,159)	(12%)

Appendix 4: Analysis of Colorado and Illinois Data (Continued)

ILLINOIS ANALYSIS

Illinois Installment Payday Loans

Month	# Transactions	Total principal	Total fees
July 2011	9,038	\$5,211,518	\$5,751,358
August 2011	40,266	\$23,157,656	\$24,710,181
September 2011	32,889	\$18,543,177	\$19,888,700
October 2011	33,444	\$19,104,433	\$20,572,643
November 2011	34,638	\$20,526,126	\$21,577,037
December 2011	46,336	\$28,181,000	\$29,131,885
January 2012	30,612	\$17,687,605	\$18,148,319
February 2012	19,504	\$11,517,621	\$11,695,991
March 2012	27,082	\$16,087,086	\$16,415,875
April 2012	34,025	\$20,444,034	\$20,971,113
May 2012	39,626	\$24,080,864	\$24,267,715
Total	347,460	\$204,541,120	\$213,130,816
Monthly Average	31,587	\$18,594,647.25	\$19,375,529
Year estimate	379,047	\$223,135,767	\$232,506,345
		Average loan amount	Average fee amount
		\$588.68	\$613.34

Appendix 4: Analysis of Colorado and Illinois Data (Continued)

ILLINOIS ANALYSIS

Illinois Balloon Payday Loans

Date	Transaction volume	Advance Amount	Fees
July 2011	2,476	\$868,598	\$129,153
August 2011	12,980	\$4,401,897	\$670,326
September 2011	12,509	\$4,137,631	\$630,337
October 2011	13,079	\$4,302,481	\$656,815
November 2011	13,036	\$4,276,771	\$653,910
December 2011	15,126	\$5,087,072	\$775,759
January 2012	13,222	\$4,400,352	\$673,079
February 2012	9,510	\$3,217,219	\$492,062
March 2012	10,814	\$3,550,186	\$543,618
April 2012	11,914	\$3,932,698	\$601,685
May 2012	12,948	\$4,305,554	\$657,213
Total	127,614	\$42,480,460	\$6,483,958
Monthly Average	10,635	\$3,540,038	\$540,330
Year Estimate	138,249	\$46,020,498	\$7,024,288
		Average loan amount	Average fee amount
		\$332.88	\$50.81
Total Loan Volume (installment & balloon)	\$269,156,265		
% of loan volume installment	83%		
% of loan volume balloon	17%		
Total fees (installment & balloon)	\$239,530,632		
% of fees installment	97%		

Appendix 5: Legal Status of Payday Loans By State

States with No Meaningful Regulation of Payday Lending (29 total)
Alabama
Alaska
California
Florida
Hawaii
Idaho
Illinois
Indiana
Iowa
Kansas
Kentucky
Louisiana
Michigan
Minnesota
Mississippi
Missouri
Nebraska
Nevada
New Mexico
North Dakota
Oklahoma
Rhode Island
South Carolina
South Dakota
Tennessee
Texas
Utah
Wisconsin
Wyoming

Appendix 5: Legal Status of Payday Loans By State
States that Eliminate or Limit the Payday Debt Trap (22 Total)

States and DC that Eliminate the Payday Debt Trap Through APR Limits (16 total)	States with Reforms that Limit but Do Not Eliminate the Payday Lending Debt Trap (6 total)
Arizona	Colorado ²
Arkansas	Delaware ³
Connecticut	Maine ⁴
District of Columbia	Oregon ⁵
Georgia	Washington ⁶
Maryland	Virginia ⁷
Massachusetts	
Montana	
New Hampshire	
New Jersey	
New York	
North Carolina	
Ohio ¹	
Pennsylvania	
Vermont	
West Virginia	

1 Ohio law—which voters elected not to overturn in a 2008 referendum—limits payday loans to 28% APR, with a 31-day minimum loan term and a maximum of four loans per borrower per year. Nevertheless, payday lenders are illegally exploiting loopholes and continuing to make triple-digit two-week loans. The payday lender evasion of the law is currently under court scrutiny. For more information, see Rothstein (2009).

2 Colorado has a six-month minimum loan term, coupled with a fee limitation and restrictions on repeat refinancing. For more information on Colorado, see Appendix 4.

3 Delaware limits borrowers to five loans per year, enforceable through a database, although there is evidence that national lenders are evading Delaware’s law by migrating to the state’s installment lending statute in order to continue unfettered triple-digit-APR debt trap loans.

4 Maine prohibits the advance of money on a post-dated check except for “supervised lenders” and limits fees to \$5 for loans up to \$75, \$15 for loans from \$75.01-\$250, and \$25 for loans over \$250.

5 The minimum loan term in Oregon is 31 days, and fees are limited to 36% APR plus 10% of the principal borrowed, up to \$30.

6 Washington State limits borrowers to eight loans per year, enforceable through a database.

7 The minimum loan term in Virginia is two pay periods, and there is a mandatory 45-day cooling-off period after the fifth payday loan in six months, enforceable through a database.



BANK PAYDAY LENDING

The State of Lending in America &
its Impact on U.S. Households

Rebecca Borné & Peter Smith

September 2013



www.responsiblelending.org

LENDING ABUSES AND PREDATORY PRACTICES

In spite of public controversy and warnings from regulators, a few national and regional banks are routinely making payday loans, marketed under more appealing names. As shown by previous research and discussed here, these loans are promoted as a short-term solution to a financial shortfall, but in fact they keep borrowers trapped in extremely high-cost debt for a significant portion of the year.

Bank payday loans are structured in the same way as other payday loans. The bank deposits the loan amount directly into the customer's account and then repays itself in full, plus a very high fee, directly from the customer's next incoming direct deposit of wages or funds such as Social Security checks. If the customer's direct deposits are not sufficient to repay the loan, the bank typically repays itself anyway within 35 days, even if the repayment overdraws the consumer's account, triggering high overdraft fees for subsequent transactions.

The great majority of banks do not offer payday loans, but as of August 2013 we are aware of at least six that do: Wells Fargo Bank, U.S. Bank, Regions Bank, Fifth Third Bank, Bank of Oklahoma and its bank affiliates,¹ and Guaranty Bank.

The federal prudential banking regulators—who have long expressed concern about payday lending and who stopped banks from partnering with non-bank payday lenders years ago—have recently expressed serious concern about bank payday lending and proposed guidance that would put in place important protections. In addition, the Consumer Financial Protection Bureau (CFPB) recently released initial findings based on its analysis of bank payday data, expressed concern based on those findings, and indicated that it will take further action to address those concerns. CFPB's findings are noted throughout this chapter, and the supervisory developments are discussed in the Legislation and Regulation section at the end.

Extremely high-cost credit

Banks impose fees in the range of \$7.50 to \$10 per \$100 borrowed for bank payday loans.² CRL's latest analysis of checking account data for the year 2011 found that the average bank payday loan term is 12 days—that is, the bank repays itself from the borrower's next direct deposit an average of 12 days after extending the credit (Borné and Smith, 2013).³ The CFPB's recent white paper similarly found that 12 days was the typical period a bank payday borrower had an outstanding advance balance before it was repaid (CFPB, 2013).

This cost and loan term translate to an annual percentage rate (APR) ranging from 225% to 300%, an extremely high cost for credit, particularly since the lender virtually guarantees repayment by putting itself first in line when a direct deposit hits the account.

1 Bank of Albuquerque, Bank of Arizona, Bank of Arkansas, Bank of Kansas City, Bank of Texas, and Colorado State Bank and Trust.

2 While it continues to charge \$10 per \$100 borrowed during a borrower's first year of payday loan use, as it did in 2011, Regions Bank recently began charging \$7 per \$100 borrowed under certain circumstances for customers whose first Regions payday loan was taken out at least one year prior (Regions, 2013).

3 The median loan term is 12 days; the mean loan term is 14 days. For a detailed discussion of our methodology, please see Appendix A.

Predatory loan structure that drives account holders into a cycle of debt

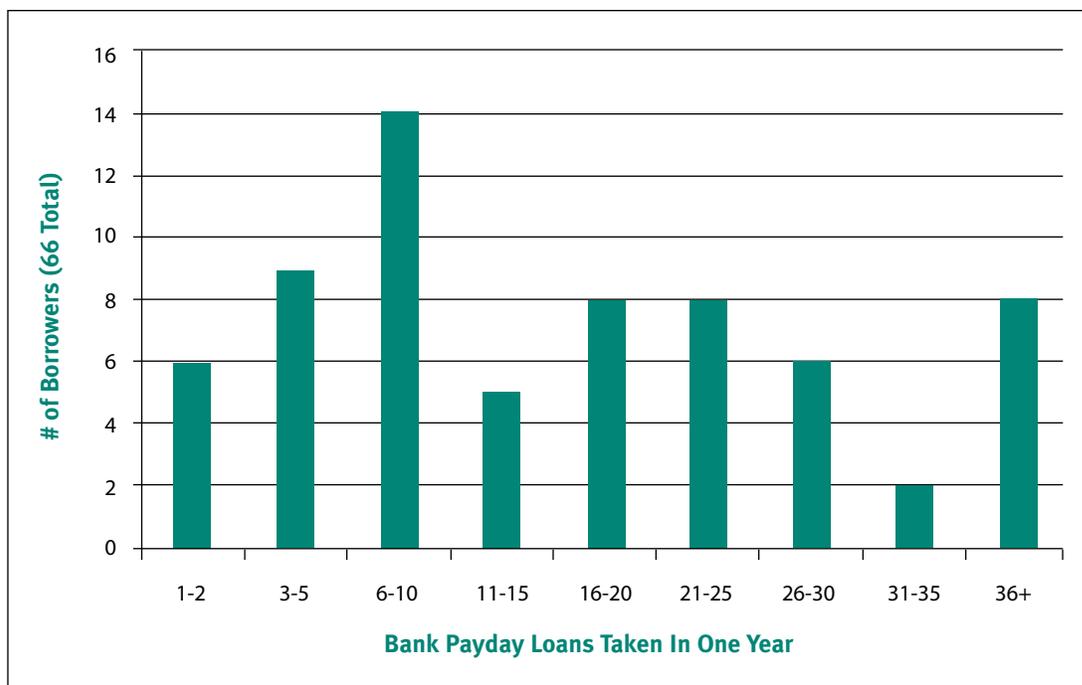
The fundamental structure of payday loans—a very high cost and short loan term with a balloon repayment—coupled with a lack of traditional underwriting makes repeat loans highly likely. Borrowers already struggling with regular expenses or facing an emergency expense with minimal savings are typically unable to repay the entire lump-sum loan and fees and meet ongoing expenses until their next payday. Consequently, the borrower often must take out another loan before the end of the pay period to meet other expenses, paying yet another fee and becoming trapped in a cycle of repeat loans. Indeed, bank payday lenders have little incentive to assess a borrower’s ability to repay the loan, as the bank has direct control over the customer’s account and can repay itself first.

Our analyses of 2010 and 2011 bank payday lending data quantified the long-term cycle of high-cost payday loan debt (Borné, Frank, Smith & Schloemer, 2011) (Borné & Smith, 2013). We found that [the median bank payday borrower took out 13.5 loans in 2011 and was in bank payday loan debt at least part of six months annually](#)—that is, a typical borrower had one or more bank payday loans outstanding at some point during six discrete calendar months during the year (Borné & Smith, 2013).

[The mean number of loans was 19](#), far higher than the median, because over a third of borrowers had more than 20 loans (Borné & Smith, 2013).

As Figure 1 illustrates, many borrowers take out twenty, thirty, or more loans annually (Borné & Smith, 2013):

Figure 1: Bank Payday Loans Taken in One Year

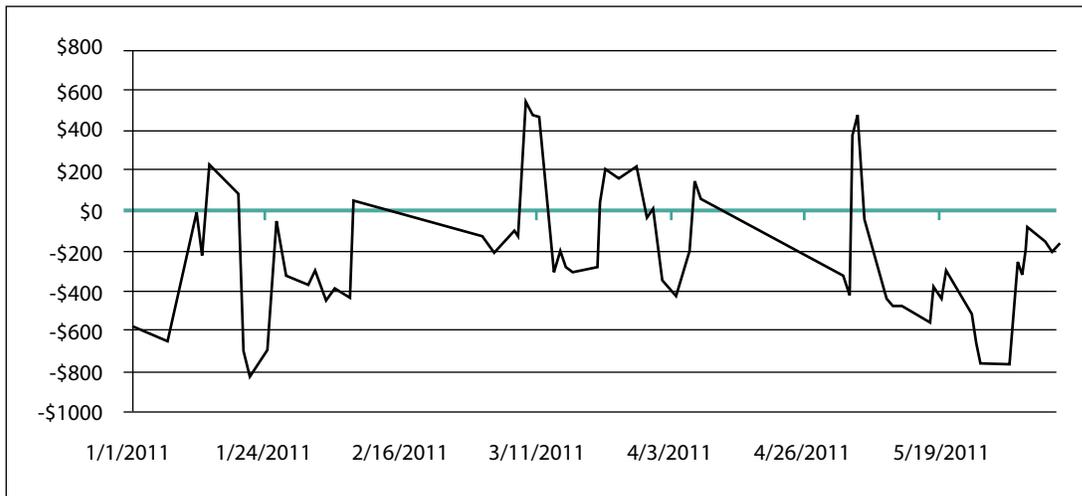


Similarly, the CFPB recently found a median number of 14 advances per borrower, amounting to an average of 112 days of indebtedness per borrower during the year (CFPB, 2013). Further, a sizeable portion of borrowers (14 percent) took out a median of 38 advances averaging \$200 each, yet paid interest ranging from \$570 to \$760 (over an average 254 days of debt).

Both CRL's and CFPB's findings demonstrate that bank payday loans trap customers in a cycle of debt, refuting the banks' claim that these products are meant for occasional use to manage a short-term cash shortfall and not as long-term credit.⁴

A real-life case study from our database of bank payday borrowers provides an example of repeat loans to one borrower over the course of a six-month period:

Figure 2: Melinda's Checking Account Balance – January to June 2011



Melinda is a 33-year-old residing in Texas. During the five-and-half-months of account activity CRL was able to observe, Melinda had 19 bank payday loans, typically grouped into clusters of two-to-three loans extended over the course of a few days each month.⁵ The median loan size was only \$100, yet Melinda paid \$233.50 in fees. She also incurred 21 overdraft fees during this period. At the end of the period, her account remained in the red.

Increased likelihood of overdraft fees

Banks have pitched their payday loans as a way for customers to avoid overdrafts and associated fees (Burbach, 2013).⁶ But, as noted above, if the customer's direct deposits are not sufficient to repay the loan, the bank typically repays itself anyway within 35 days, even if the repayment overdraws the consumer's account, triggering high overdraft fees for subsequent transactions.

4 Every bank we know of making payday loans tells customers the product is intended for short-term rather than long-term use. For an example from each of these banks, see Appendix B.

5 See Appendix A for discussion of the database we analyzed; Melinda provided her account activity to the database for five-and-a-half months.

6 For example, Wells Fargo Bank's product agreement provides a chart comparing borrowing \$300 for 30 days as costing \$22.50 with the deposit advance (payday loan) product versus \$70 with overdraft (assuming two overdraft items at \$35 each) and also states: "If you find yourself in a situation where the funds in your . . . checking account may be insufficient to cover checks or other items that will post to your deposit account, you may choose to advance from [the direct deposit advance] service to avoid the overdraft . . . The Direct Deposit Advance service is an expensive form of credit, and while the advance fee may be lower than an overdraft or insufficient funds fee, you may want to consider speaking with a banker regarding overdraft protection options that may be available to you" (Wells Fargo, 2013).

CRL analysis finds that [nearly two-thirds of bank payday borrowers incurred overdraft fees, and these borrowers were three times as likely to incur overdraft fees as bank customers as a whole.](#)⁷

The CFPB's analysis found similar results, with 65 percent of bank payday borrowers incurring overdraft or non-sufficient funds fees, which was more than three-and-a-half times the portion of customers eligible for a bank payday loan who did not take one out (CFPB, 2013). The CFPB further found that a quarter of the bank payday borrowers most heavily steeped in the cycle of debt incurred an average of 18 or more overdraft or non-sufficient funds fees during the 12-month period (CFPB, 2013).

These findings are consistent with what consultants selling bank payday loan software have promised banks: that payday lending will result in little-to-no “overdraft revenue cannibalization” (Fiserv, 2011b). They also confirm prior research finding that non-bank payday loans often exacerbate overdraft fees, leading to checking account closures (CRL, 2009).

For an illustration of how bank payday loans create a debt trap and cause overdraft fees for a Social Security recipient, see Figure 3 in the “Impact on U.S. Households” section of this chapter.

Ineffective “safeguards” that do not prevent a cycle of debt

Banks often point to “safeguards” they have in place on payday loans to ensure that borrowers do not become mired in a long-term debt trap; these include installment plans and “cooling-off periods,” when banks will not extend the customer another payday loan following repayment of one or more loans. The data discussed above demonstrate that these “safeguards,” as banks currently design them, are not effective, as borrowers spend large portions of the year in debt.

[Banks that permit installment repayment plans make these plans difficult to qualify for or obtain.](#) Wells Fargo Bank’s “payment plan” (which allows payments in \$100 increments rather than balloon repayments) is available only to customers who have already been in balloon payment loans in three consecutive months and have at least \$300 in bank payday debt outstanding (Wells Fargo, 2013). Regions Bank’s installment option is available only to borrowers who call the bank prior to taking out the advance and explicitly request an installment plan, while the bank places any borrowers who request a payday loan online, at a branch, or over the phone without specifying the installment option into the default balloon repayment structure (Regions, 2013).

[Banks’ cooling-off periods allow borrowers to become mired in a cycle of debt before the cooling-off period is triggered.](#) Wells Fargo Bank’s cooling-off policy, for example, allows six consecutive months of loans before a one-month cooling-off period is triggered (Wells Fargo, 2013). After six consecutive months with loans, a borrower will typically have paid hundreds of dollars in fees and still owe the original principal on the loan. By contrast, if provided an affordable installment loan at the outset, the borrower would have repaid all or a substantial portion of the loan after six months.

These bank “safeguards” are the same ones that non-bank payday lenders have long touted but that have proven to be ineffective in that context as well (King & Parrish, 2007).⁸

⁷ The prevalence of overdraft use among bank payday users is 63.6%, compared with 17.2% overall and 20.2% at banks that make payday loans. See Appendix A.

⁸ CRL examined millions of loans across several states that adopted similar “best practices” to ostensibly reform payday loans. Nevertheless, there was no measurable reduction in repeat borrowing. For example, over 60 percent of all loans from these states go to borrowers with 12 or more transactions in a year (CRL, 2007).

Research has shown that payday lending often leads to negative financial outcomes for borrowers; these include difficulty paying other bills, difficulty staying in their home or apartment, trouble obtaining health care, increased risk of credit card default, loss of checking accounts, and bankruptcy (Argawal, Skiba & Tobacman, 2009) (Jerez & Tufano, 2011) (Skiba & Tobacman, 2008).

Senior citizens

Senior Americans are particularly at risk. Our recent analysis of bank payday loans made in 2011 finds that **more than one-quarter of bank payday borrowers are Social Security recipients**. This finding is consistent with the 2010 data, which found that nearly one-quarter of all bank payday borrowers were Social Security recipients (Borné, Frank, Smith, & Schloemer, 2011).

Many senior Americans are financially vulnerable. From 2005 to 2010, the Great Recession led to a 13 percent decrease in net worth for households headed by someone age 65 or older (U.S. Census Bureau, 2005 and 2010). Coupled with declines in the value of their largest assets—homes and retirement assets—many older Americans struggle with limited incomes. More than 13 million older adults are considered economically insecure, living on \$21,800 a year or less (National Council of Aging, 2011). People over age 55 make up the fastest-growing segment of people seeking bankruptcy protection (Brandon, 2010).

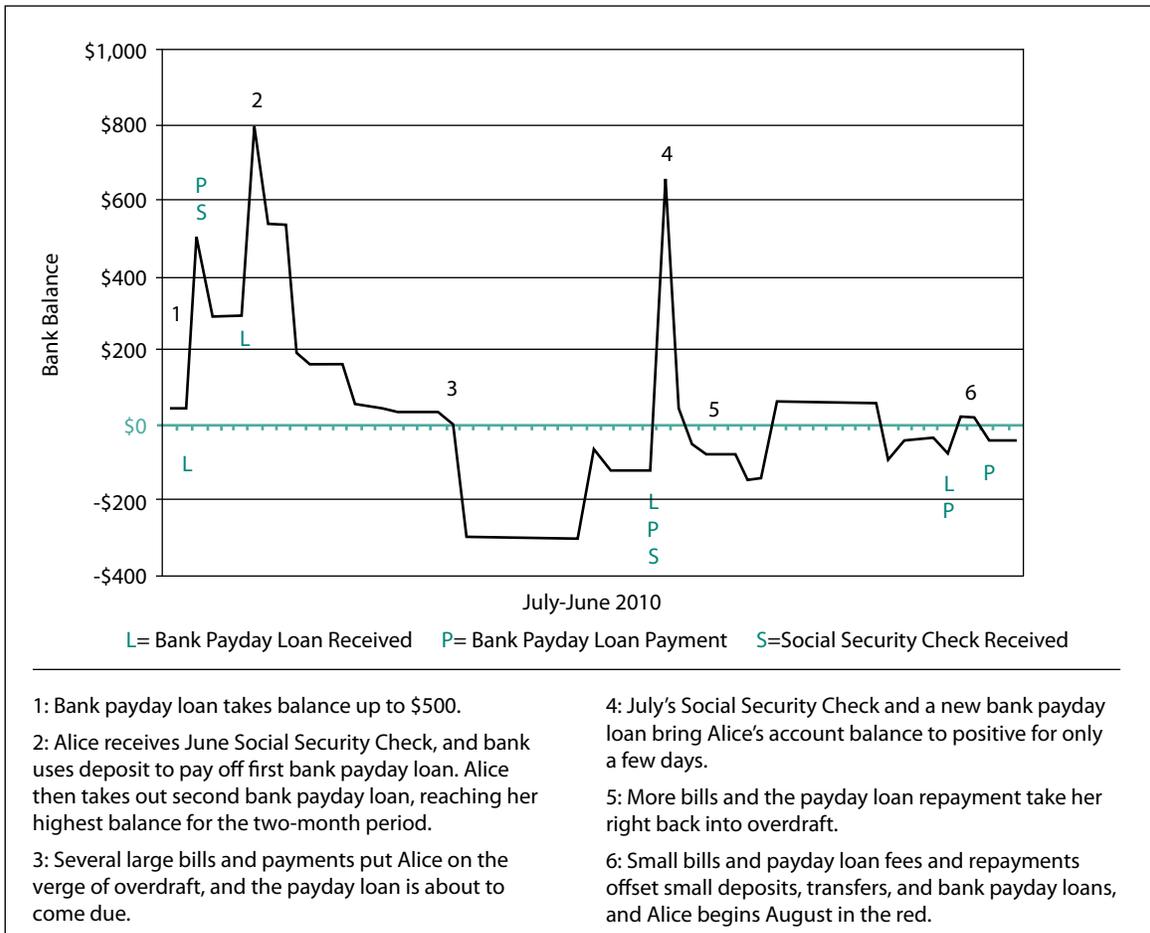
The threat bank payday loans pose to Social Security recipients became more pronounced on March 1 of this year, when electronic distribution of government benefits became mandatory (Dept. of Treasury, 2010). Benefits that have been distributed by paper check, often to those most financially vulnerable, are now directly deposited to checking accounts or prepaid cards. As part of the new rule, the Treasury Department prohibited government deposits to prepaid cards that allow payday loans out of concern that these credit products would siphon off exempt benefits.⁹ However, benefits deposited into traditional checking accounts remain at risk to bank payday loans, where banks repay themselves the loan amount before any other expense or creditor.¹⁰

Figure 3 below demonstrates the impact that bank payday loans have on a Social Security recipient, an account holder in CRL's 2010 database whom we call Alice. Alice's primary source of income is Social Security. The figure maps two months of her checking account activity. The line on the graph represents Alice's account balance. It goes up when she receives a direct deposit or other deposit or when a payday loan or overdraft loan are extended on her account. It goes down when checks, bill payments, debit card transactions, or other withdrawals are posted to the account, or when the bank collects the payday loans (after a direct deposit is received) or overdrafts and related fees.

⁹"In order to prevent Federal payments from being delivered to prepaid cards that have payday lending or 'account advance' features, we are prohibiting prepaid cards from having an attached line of credit if the credit agreement allows for automatic repayment of a loan from a card account triggered by the delivery of the Federal payment into the account. Our intention is that this restriction will prevent arrangements in which a bank or creditor 'advances' funds to a cardholder's account, and then repays itself for the advance and any related fees by taking some or all of the cardholder's next deposit." 75 Fed. Reg. at 80338.

¹⁰In its discussion, Treasury cited Regulation E's prohibition on compulsory electronic repayments as the comparable protection on traditional checking accounts, *id.*, but this prohibition is typically not read to apply to single-payment loans, as bank payday loans typically are. Thus, federal benefits direct deposited to traditional checking accounts remain vulnerable to bank payday loans.

Figure 3. Bank Payday on a Fixed Income



This graph demonstrates that bank payday loans only briefly increase Alice's account balance. Several days later, when the principal and fees (in this case \$10 per \$100 borrowed) are collected in one lump sum, Alice's account balance drops dramatically and overdraft fees soon follow. **At the end of a two-month period, during which Alice spent 47 of 61 days in payday loan debt, she is again left with a negative balance, in an immediate crisis.**

Military service members

Members of the military are also vulnerable to bank payday lending, even though they are protected by law from other payday loans. In 2006, the Department of Defense and base commanders expressed concern that troops were incurring high levels of high-cost payday loan debt, which was threatening security clearances and military readiness (Department of Defense, 2006). Congress then prohibited making payday loans to service members and their families, but banks structure their loans in a way that attempts to evade this law,¹¹ even making payday loans on military bases (Fox, 2012).

“This problem with . . . payday lending is the most serious single financial problem that we have encountered in [a] hundred years.”

—Admiral Charles Abbot, US (Ret.),
President of Navy-Marine Corps Relief Society
(Senate Testimony, 2006)

11 The regulation under the law covers only “closed-end” loans. 32 CFR 232.3(b). Banks categorize their payday loans as “open-end,” even though the due date for the loan, much like a closed-end loan, is fixed as the next deposit date or, at the latest, after 35 days.

MARKET AND INDUSTRY OVERVIEW

As of August 2013, CRL has documented that the following banks are making payday loans: Wells Fargo Bank, U.S. Bank, Regions Bank, Fifth Third Bank, Bank of Oklahoma and its bank affiliates, and Guaranty Bank.

Though the number of banks making these loans remains small, there are clear signals that bank payday lending may grow rapidly. Fiserv, Inc., a provider of software systems to the financial industry, has actively promoted a bank payday software product it calls “Relationship Advance.” Fiserv has reported significant interest in the product: “The pipeline is extremely strong. We’ve had some very nice mid-tier signings over the last three, four months and we see this as an interesting driver of ... high-quality recurring revenue . . .” (Fiserv, 2011a).

Fiserv’s marketing of the Relationship Advance product has included promises that a bank’s revenue from the product “will be greater than all ancillary fee revenue combined” within two years (Fiserv, 2011b).

A widespread public outcry against bank payday lending, along with regulatory action discussed below, appears to have slowed its expansion recently.¹² We are not aware of any large banks that have begun making payday loans since early 2011. In fact, Regions Bank recently ceased making payday loans in North Carolina—a state that does not permit storefront payday lending—in response to public and state attorney general opposition (Ranii, 2013).

“Payday loans are like a consumer needing a life preserver being thrown an anvil.”

—North Carolina Attorney General Roy Cooper, discussing Regions Bank’s payday loan product (Ranii, 2012)

¹² CRL documented much of the media coverage of bank payday lending and public concerns expressed about the product in an issue brief published in March 2013 (CRL, 2013a).

LEGISLATION AND REGULATION

Nearly half of all states prohibit or significantly restrict payday lending. However, banks are making payday loans not only in states that permit payday lending but also, through the doctrine of federal preemption, in states that prohibit or meaningfully limit the product from non-bank lenders.

Bank payday lending clearly falls within the purview of both the prudential banking regulators (the Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC) and Federal Reserve Board (the Board)), which are responsible for the safety and soundness of the banks they supervise, and the Consumer Financial Protection Bureau, responsible for consumer financial protection generally. Indeed, bank payday loans pose serious safety and soundness concerns, including that they violate the basic safety and soundness principle of lending based on the borrower's ability to repay a loan; they pose severe reputational risk, as evidenced by sweeping negative reaction to these products (CRL, 2013a); and they risk violation of consumer protection laws, which itself poses safety and soundness risk (CRL, 2013b).

“[L]oans that have been accessed repeatedly or for extended periods of time are evidence of ‘churning’ and inadequate underwriting.”

—OCC, 2013; FDIC, 2013

In April 2013, the OCC and the FDIC proposed supervisory guidance addressing bank payday lending (OCC, 2013) (FDIC, 2013). These proposals focus on a fundamental problem with payday lending: the lender's failure to determine the borrower's ability to repay the loan, and meet other expenses, without reborrowing. The proposals would require that banks assess the borrower's ability to repay based on a borrower's inflows and outflows over a six-month period. They also would impose a limit on the number and frequency of payday loans banks can make.

Public comments on the proposed guidance were due June 30, 2013; as of August 2013, the proposed guidance had not been finalized.

The Federal Reserve Board, which supervises Fifth Third Bank and Regions Bank, did not propose supervisory guidance with explicit underwriting guidelines as the OCC and the FDIC did. The Board did, however, issue a supervisory statement emphasizing the “significant consumer risks” bank payday lending poses (Federal Reserve Board, 2013). The Board highlighted the CFPB's recent findings of sustained and harmful repeat usage and underscored that examiners should thoroughly review bank payday products for compliance with laws prohibiting unfair and deceptive practices. The Board also underscored that the product is subject to state law.

These supervisory developments are indeed warranted, particularly in light of the analysis of payday loan data CFPB released in April 2013. Based on that data, CFPB concluded that there is “substantial probability” that consumers will be indebted for longer than anticipated, that “the potential consumer harm is persuasive that further attention is warranted,” and that CFPB “expects to use its authorities” to address payday lending.

The prudential regulators' recent supervisory steps are also consistent with concerns they have expressed about payday lending for many years. In the early 2000s, payday lenders were partnering with banks to use bank preemption law to skirt state restrictions on payday loans. The federal banking regulators, noting safety and soundness and consumer protection risks stemming from payday lending, put an end to this so called "rent-a-bank" practice. The OCC's 2000 response to rent-a-bank highlighted concerns about abusive lending practices associated with payday lending, including multiple renewals (OCC, 2000). The FDIC's guidelines addressing payday lending raised similar concerns, and they further urged that no customer should be in such high-cost debt for more than three months in any 12-month period (FDIC, 2005).

"This guidance is necessitated by the high risk nature of payday lending . . . (also known as deferred deposit advances)."

—FDIC, 2005

Payday lending is "unsafe and unsound and unfair to consumers."

—OCC, 2012

More recently, the FDIC had announced that it was "deeply concerned" about payday lending by banks and was investigating the practice (FDIC, 2012). And in July of 2012, the OCC testified before the House of Representatives that payday lending is "unsafe and unsound and unfair to consumers" and that the profitability of payday loans "is dependent on effectively trapping consumers in a cycle of repeat credit transactions, high fees, and unsustainable debt" (OCC Congressional testimony, 2012). The agency further noted the importance of the protections that the Military Lending Act provides members of the military and their dependents by "restricting the cost and terms of . . . abusive credit products" (OCC Congressional testimony, 2012).

POLICY RECOMMENDATIONS

1. The OCC and FDIC should finalize their proposed supervisory guidance, preserving in particular the proposed underwriting requirements that aim to ensure borrowers have the ability to repay their loan without reborrowing, and the limit on the number and frequency of payday loans. The guidance should also clarify that safe and sound banking principles require that interest and fees be reasonable; consistent with the FDIC's affordable small loan guidelines, cost should equate to no more than 36 percent in annualized interest rate terms, subject to more restrictive state usury laws.
2. The Federal Reserve Board should likewise issue supervisory guidance addressing bank payday loans that clarifies appropriate underwriting procedures, limits the number of loans, and requires that fees be reasonable.
3. The CFPB should use its authority to ensure lenders are not trapping borrowers in a cycle of payday loans. It should also make improvements to existing consumer regulations, including the APR disclosure under the Truth in Lending Act and protections against mandatory automatic repayment under the Electronic Fund Transfer Act.

APPENDIX A

For our analyses of 2010 and 2011 data, we used checking account data from a nationwide sample of U.S. credit card holders, generally representative across geography, household income, and credit scores, tracked by Lightspeed Research Inc. (Lightspeed).¹³ Participating account holders provide Lightspeed access to all of their checking account activity occurring during their period of participation, including deposits, paper checks, electronic bill payments, debit card purchases, fees, and miscellaneous charges or credits that are posted to the account.

Bank Payday Loan Statistics

The following figure shows the key statistics from our 2011 and 2010 analyses of bank payday loan data, using Lightspeed's checking account data from 66 and 55 American checking account holders, respectively, who received bank payday loans.

	2011	2010
Mean Bank Payday (BP) loan size	\$185	\$201
Median BP loan size	\$100	\$140
Mean BP loan repayment time	14 days	10.7 days
Median BP loan repayment time	12 days	10 days
Mean number of BP loans per year	19.2 loans	16.4 loans
Median number of BP loans per year	13.5 loans	14 loans

To determine the number of months during 2011 during which a typical borrower had a bank payday loan outstanding, we manually computed the number of discrete calendar months during which each bank payday borrower in our Lightspeed database had a bank payday loan outstanding for any portion of the calendar month. From those figures we computed the median, arriving at six months.

Likelihood of Overdraft Fees Calculation

The following chart demonstrates our calculation that borrowers taking out bank payday loans are three times as likely to incur an overdraft fee as bank customers as a whole:

Panelists from banks making bank payday loans	N=742
Panelists from banks making bank payday loans that paid overdraft fees	N=150 (20.2%)
Panelists that received bank payday loans	N=66 (8.9%)
Panelists that received bank payday loans and paid overdraft fees	N=42 (63.6% of bank payday borrowers)
Increased likelihood of overdraft fees for bank payday borrowers	$63.6\%/20.2\% = 3.15x$ as likely

¹³ Lightspeed requires that participants have internet access, which may lead to selection bias. A survey conducted by the Pew Internet & American Life Project from November 14-December 8, 2012, reveals higher internet usage among younger Americans versus older Americans and among higher income Americans versus lower income Americans (Pew, 2012).

APPENDIX B

Every bank CRL knows of making payday loans tells customers the product is intended for short-term rather than long-term use:

Wells Fargo Bank: “Advances are intended to assist with short-term cash needs and are not recommended as a solution for your long-term financial needs” (Wells Fargo, 2013).

US Bank: “Checking Account Advance is a loan product designed for short-term credit needs. We do not recommend ongoing use of the Checking Account Advance service” (U.S. Bank, 2013).

Fifth Third Bank: “[Early Access is a] line of credit used to assist our customers with short-term, financial emergencies or unexpected financial needs” (Fifth Third, 2013).

Regions Bank: “Ready Advance is an open-end credit plan that is designed to provide you with funds when you have an emergency or other unexpected expense. Ready Advance is not intended for customers who need to repay an extension of credit over an extended period of time. Ready Advance should not be used for planned purchases, discretionary spending, or regular monthly expenses” (Regions, 2013).

Bank of Oklahoma: “The service is designed to help our customers meet their short-term borrowing needs, but is not intended to provide a solution for longer-term financial needs” (Bank of Oklahoma, 2011).

Guaranty Bank: “This service . . . is designed to help our customers meet their short term needs and is not intended to provide a solution for longer-term financial needs or recurring expenses that you can plan for” (Guaranty Bank, 2013).

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About the Center for Responsible Lending

The Center for Responsible Lending is a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, one of the nation's largest community development financial institutions.

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