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

CENTER FOR RESPONSIBLE LENDING

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ACKNOWLEDGEMENTS

This report is a culmination of CRL's work on predatory lending issues over the past decade and as such reflects the hard work and dedication of staff both past and present. The report itself, over a year in the making, drew from the expertise and dedication of CRL staff from across the various teams. The authors are deeply appreciative to the CRL Policy, Outreach, and Communications teams for the many hours spent advancing this project.

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FOREWORD

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

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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).

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.

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.

Table 1. Financial Snapshot of a Typical American Household[1]

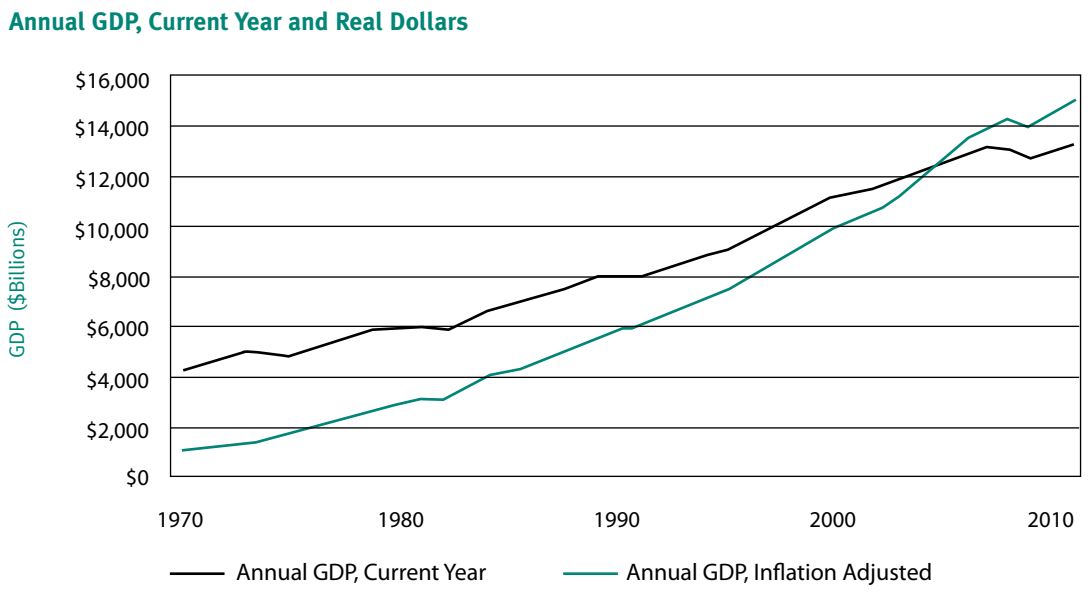
Item	Value ($)
Yearly Income[2] (less taxes and insurance/pension contributions)	$41,516
Annual non–discretionary expenses	$(37,651)
• Housing (including upkeep and operation)	(11,455)
• Transportation	(7,160)
• Food	(5,596)
• Utilities	(3,603)
• Health Care	(3,068)
• Education (including reading)	(594)
• 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.



Source: CRL Tabulations of Bureau of Economic Analysis data

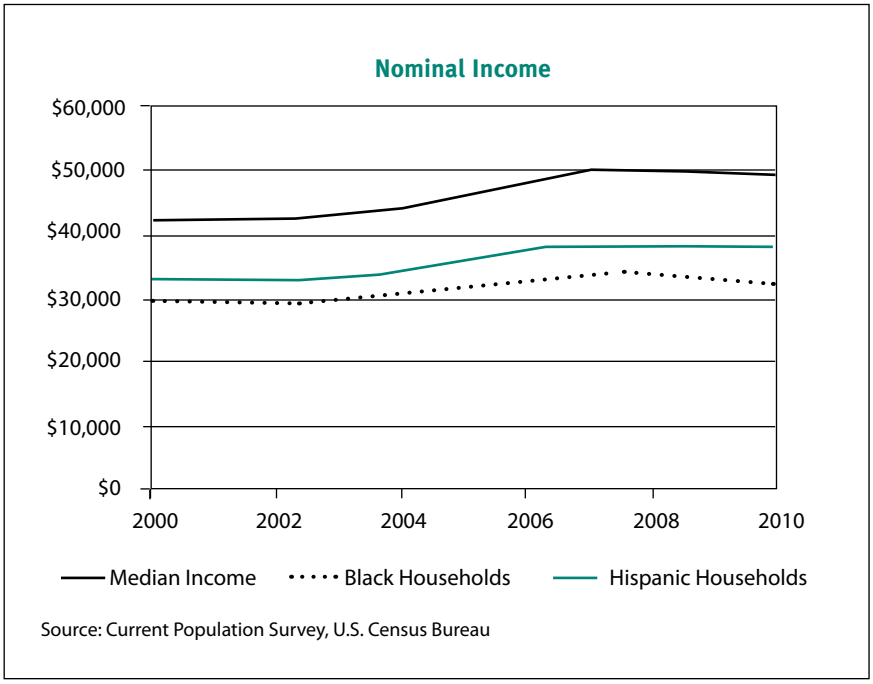
The primary cause of the decline in U.S. GDP was a decrease in consumer expenditures on goods and services, which accounts for about 70% of total U.S. economic activity (Bureau of Economic Analysis, 2012). The economic growth in the decades preceding and years following the recession of 2007–2009 was 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.

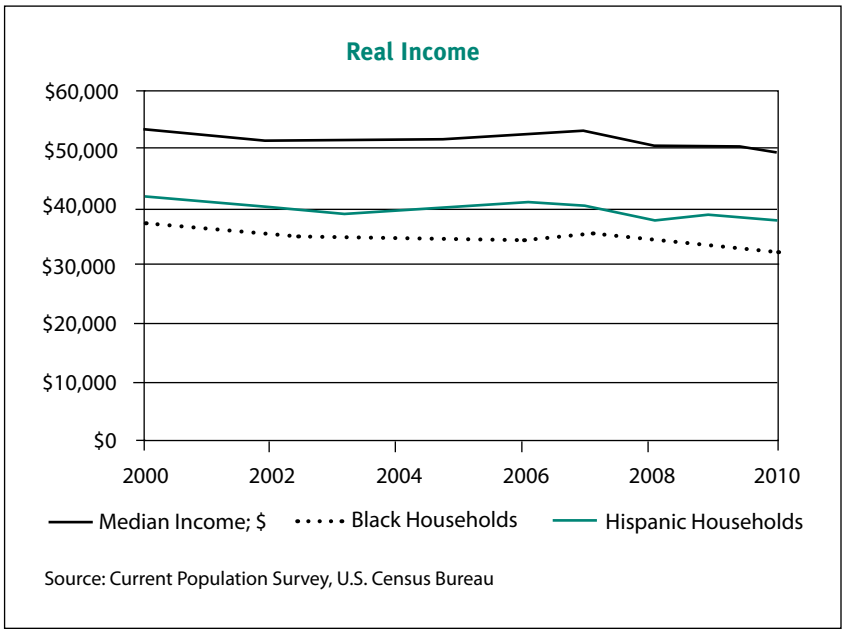
Though vital to Americans' current and future well–being, income growth (or even stability) has not occurred during the last decade. Although the typical household did bring in more nominal income in 2010 relative to 2000 (see Figure 2), all of the income growth was in the years leading up to the recession 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.



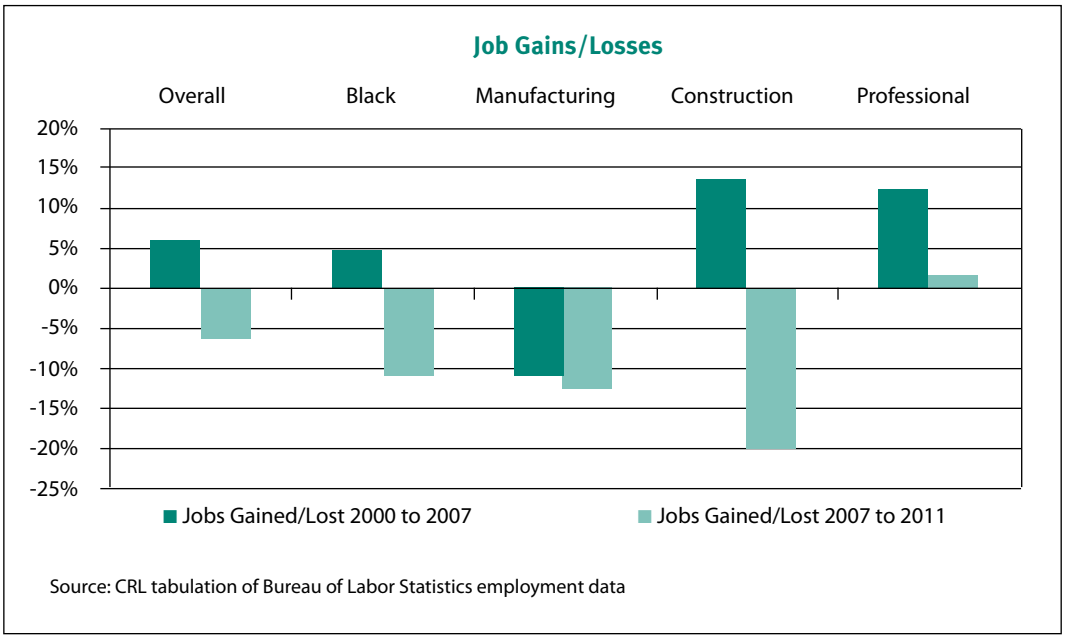
Moreover, nominal income growth paints too rosy a picture of income trends. **When controlling for inflation (see Figure 3), the typical household really had less annual income at the end of the decade than it did at the beginning.** What looked like income "growth" using nominal income at the beginning 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.

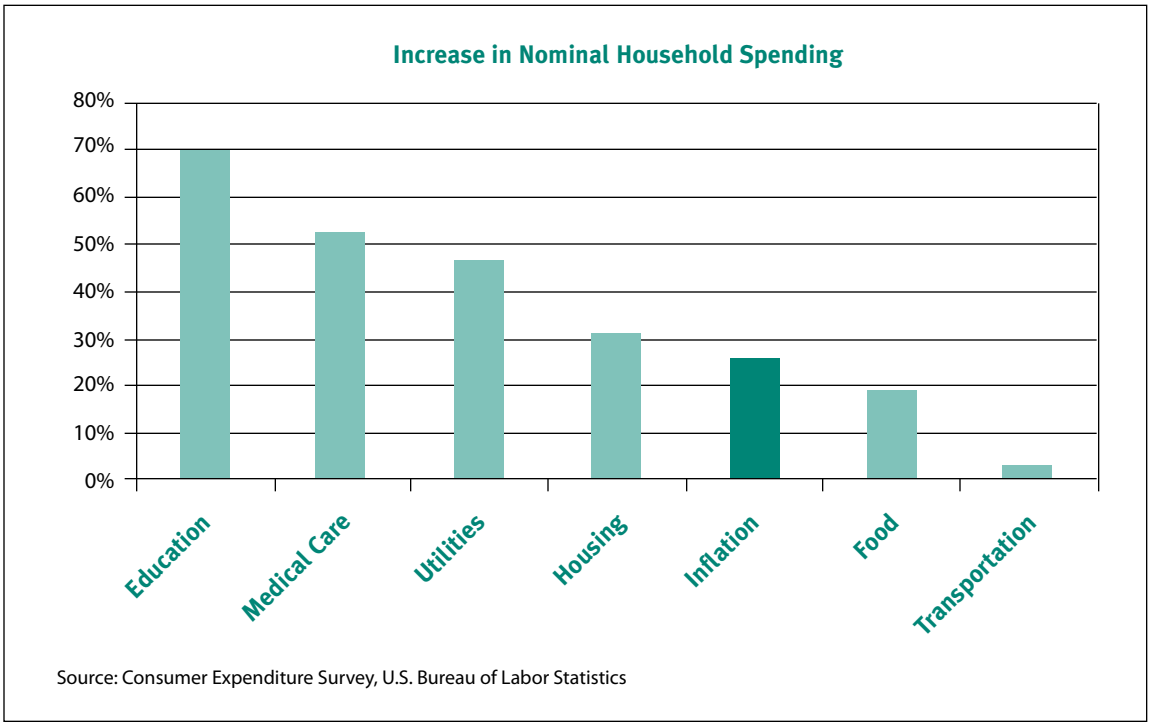


Unemployment reached historic levels for workers of all ages during the recession, but changes in the level of participation in the labor market varied dramatically by age. Participation by workers 16–24 declined throughout the decade, and those declines accelerated during the recession. In contrast, 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.



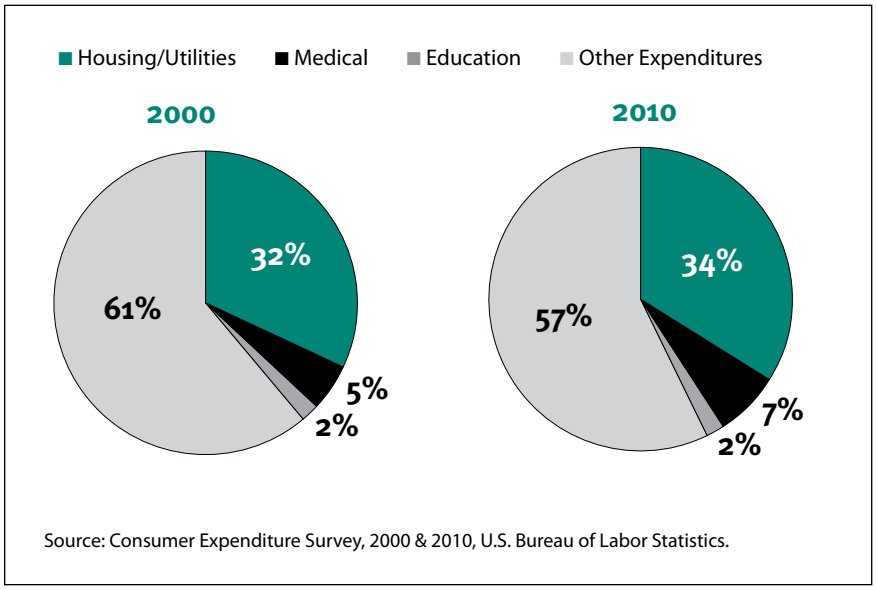
Education expenses were the fastest-growing category during this period, growing at over 2.5 times the rate of inflation from 2000 to 2010. And education costs were growing at a time when families were placing more emphasis on the value of a college degree. Most Americans view a college degree as "absolutely 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



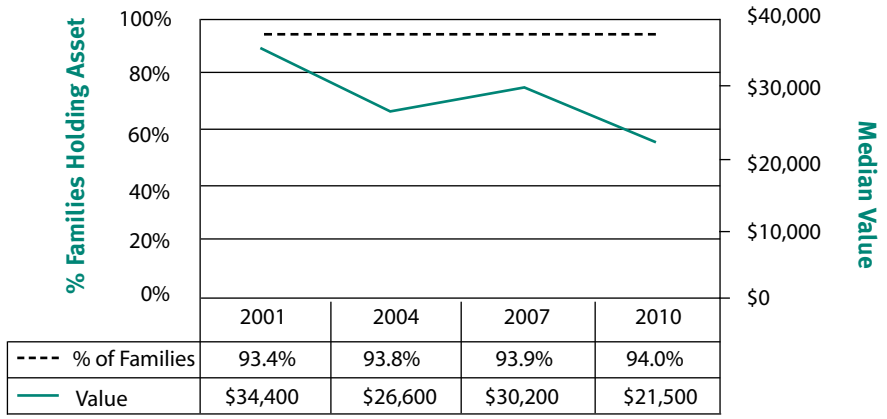
Declining Assets

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.

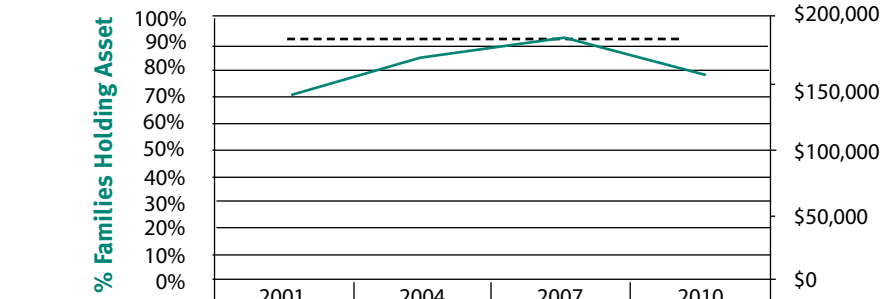


	2001	2004	2007	2010
% of Families	93.4%	93.8%	93.9%	94.0%
Value	$34,400	$26,600	$30,200	$21,500

Source: 2010 Survey of Consumer Finances Chartbook

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.

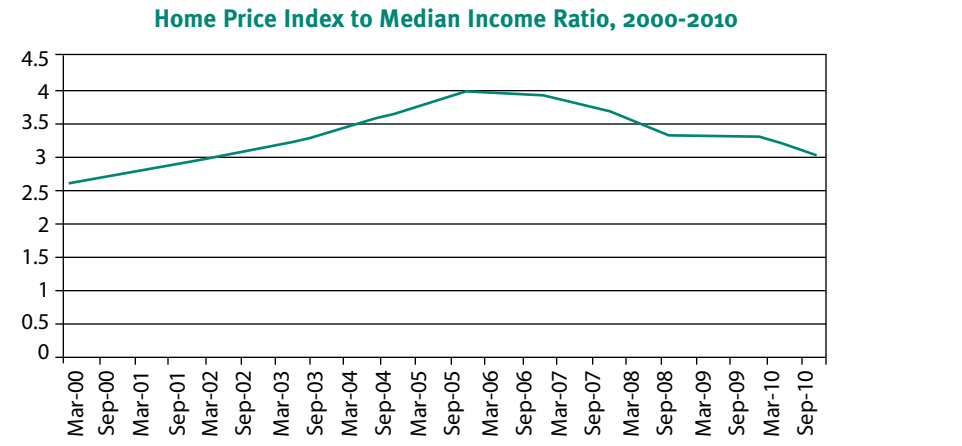


	2001	2004	2007	2010
% of Families	90.7%	92.5%	92.0%	91.3%
Value	$139,600	$170,600	$185,900	$154,600

Source: 2010 Survey of Consumer Finances Chartbook

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.

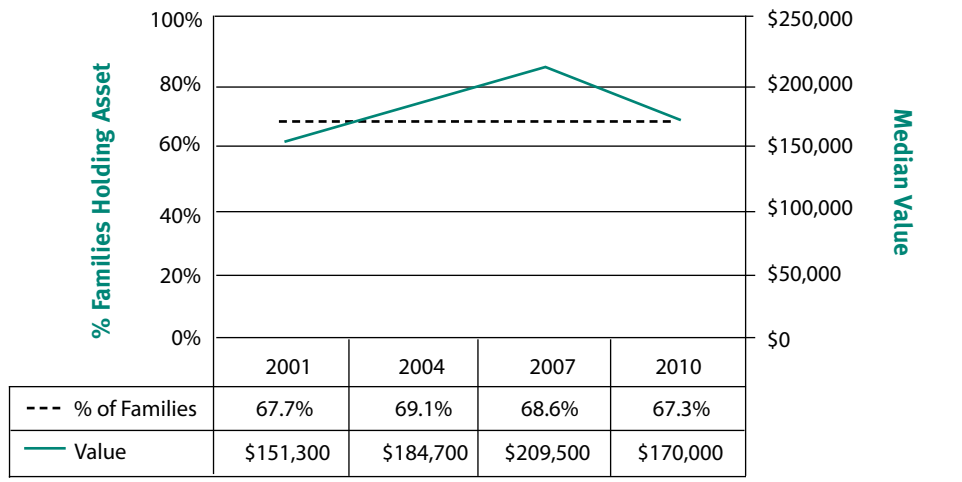
Figure 9. U.S. Home Prices Relative to Income, 2000-2010



Source: Zillow Price to Income Index. http://www.zillow.com/blog/research/2012/06/29/comparingprice-to-income-ratios-to-affordability-across-markets/

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.



	2001	2004	2007	2010
--- % of Families	67.7%	69.1%	68.6%	67.3%
—— Value	$151,300	$184,700	$209,500	$170,000

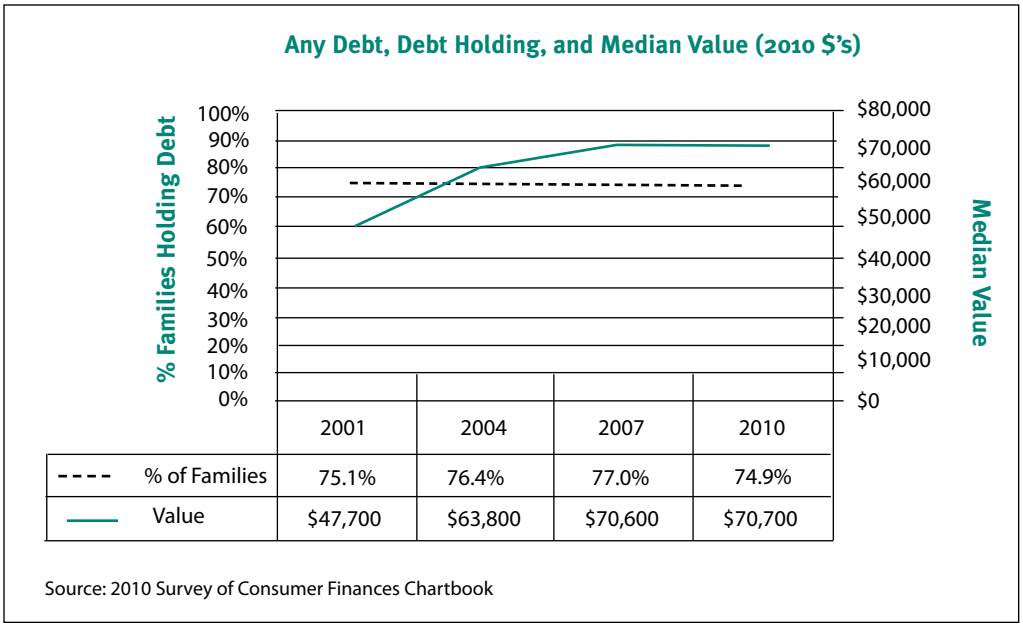
Source: 2010 Survey of Consumer Finances Chartbook

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

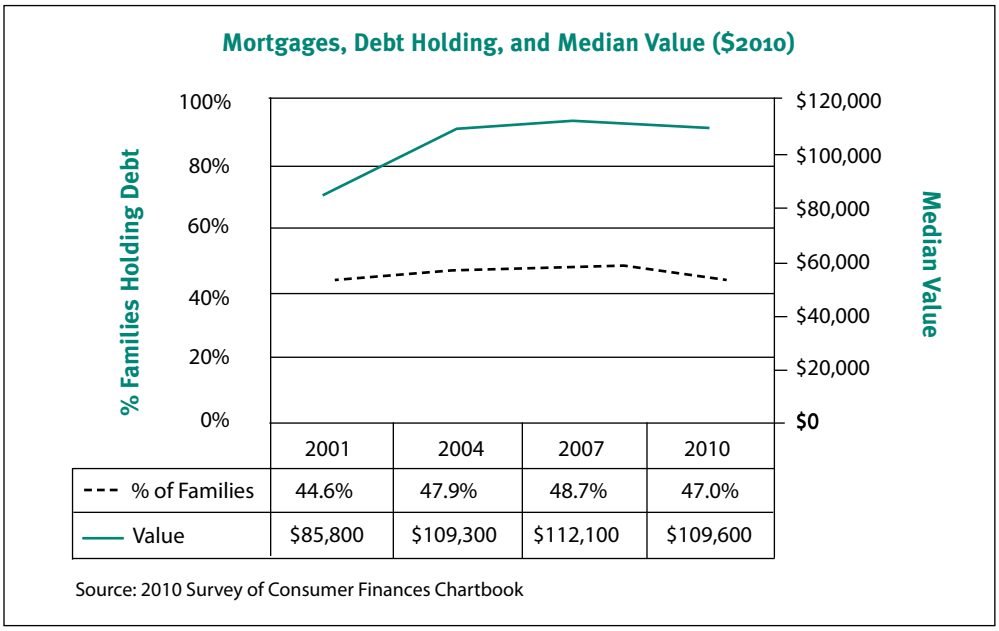
In the face of falling incomes, increasing expenses, and declining asset values, American households have responded in two ways. First, they reduced their spending: In inflation-adjusted terms, the average spending of households with incomes in the middle quintile of earners declined by 5% from $43,200 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.



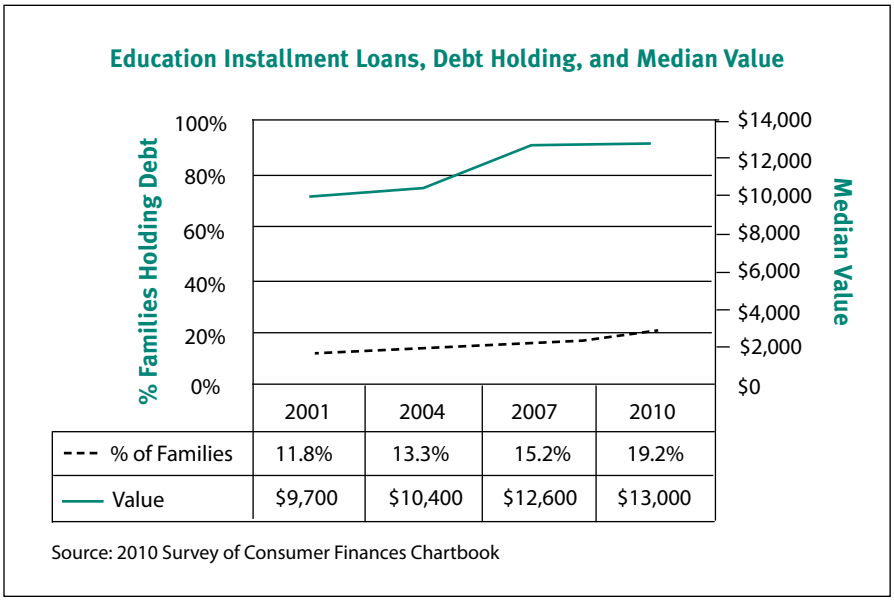
Much of the increases in debt burden in the decade came in the form of larger mortgages, as the cost for new homes climbed between 2000 and 2007. Figure 12 shows increases in mortgage debt and the size of those mortgages between 2001 and 2004. The increases from 2001 to 2004, both in the percentage of 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.



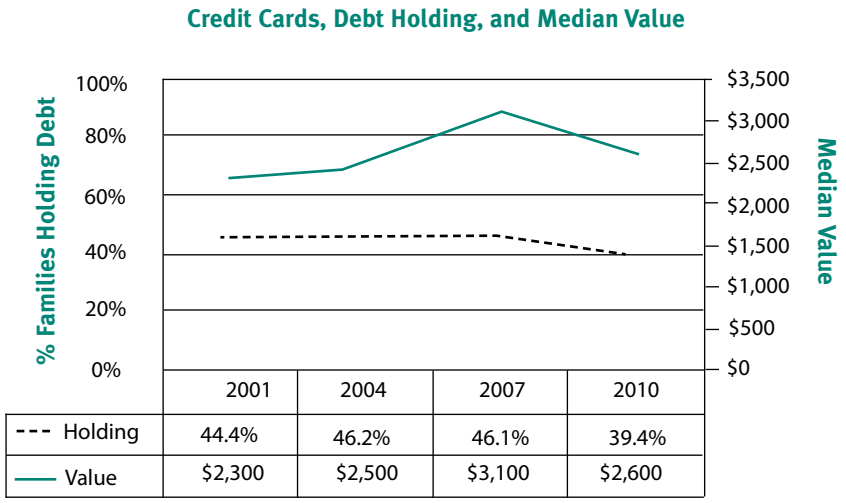
Another area where debt has increased dramatically is student loans. In 2001, one in eight households had an educational installment loan. By 2010, one in five had such a loan. Over that same period, the median size of those loans increased from $9,700 to $13,000. That student loans and mortgages accounted 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.

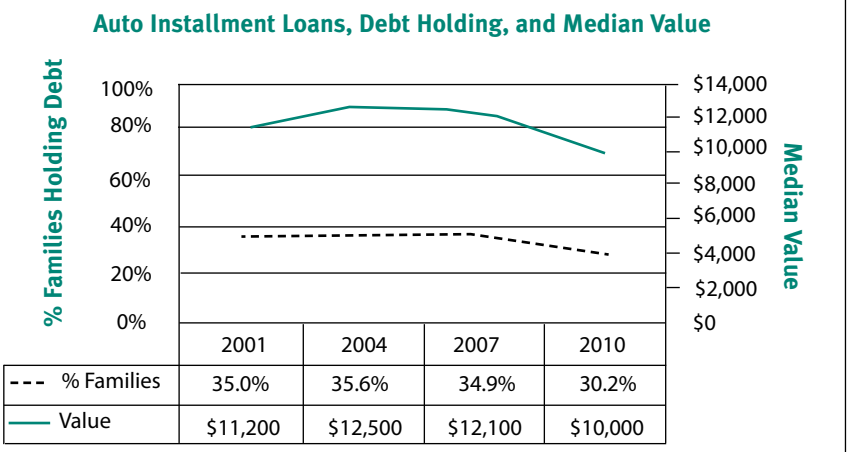


	2001	2004	2007	2010
--- Holding	44.4%	46.2%	46.1%	39.4%
—— Value	$2,300	$2,500	$3,100	$2,600

Source: 2010 Survey of Consumer Finances Chartbook

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.



	2001	2004	2007	2010
--- % Families	35.0%	35.6%	34.9%	30.2%
—— Value	$11,200	$12,500	$12,100	$10,000

Source: 2010 Survey of Consumer Finances Chartbook

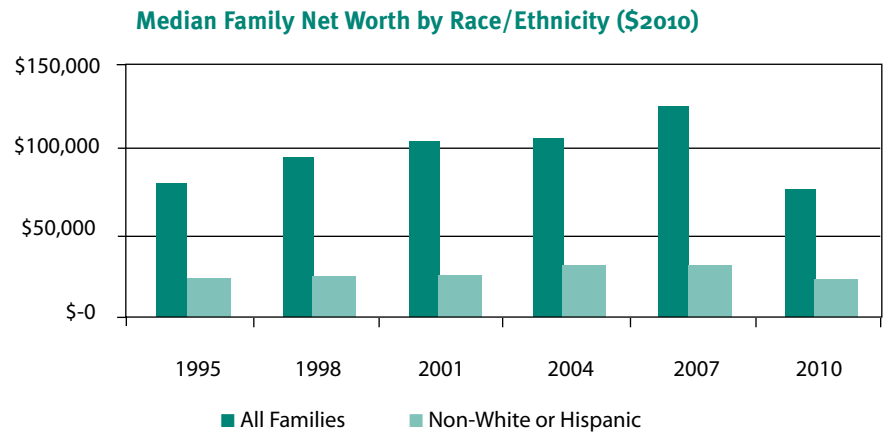
Declining Wealth

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.**

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.

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.

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



Source: 2010 Survey of Consumer Finances Chartbook

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 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

Delvin Davis

December 2012

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MORTGAGES

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 home[1] 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 Securitizers

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).

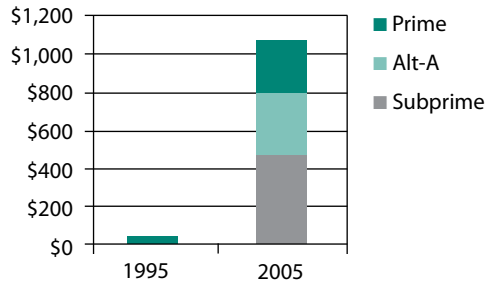
Second, Wall Street financial companies began issuing their own mortgage-backed securities (called private label securities) and selling these directly to investors. Unlike Fannie Mae and Freddie Mac, private companies did not have to limit their loan purchases to those meeting the standards set by the 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).

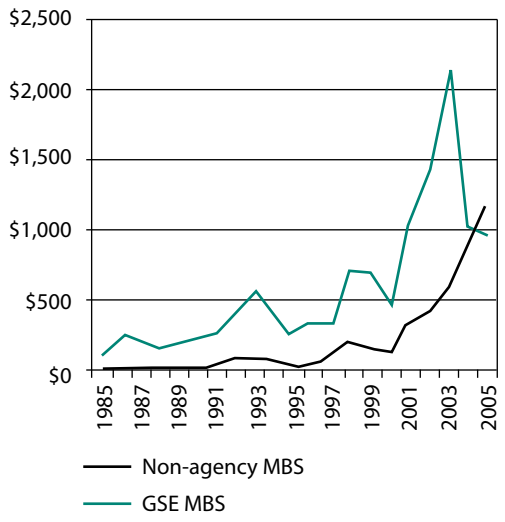
Pre-Housing Crisis Shifts in the Mortgage Origination Market

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



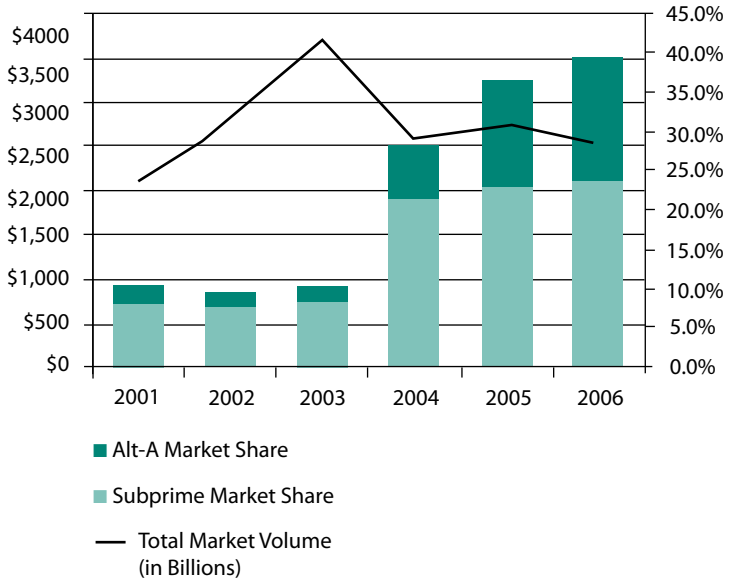
Source: CRL calculations based on data presented in FDIC's Outlook, Fall 2006, Charts 2 & 4.

Figure 2. Private Label vs GSE MBS Issuance



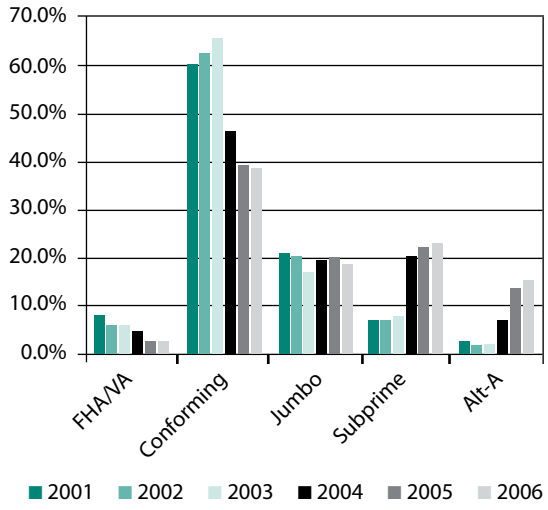
Source: FDIC's Outlook, Fall 2006, Chart 2.

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



Source: Inside Mortgage Finance 2008 Mortgage Market Statistical Annual.

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



Source: Inside Mortgage Finance 2008 Mortgage Market Statistical Annual

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 refinance 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.

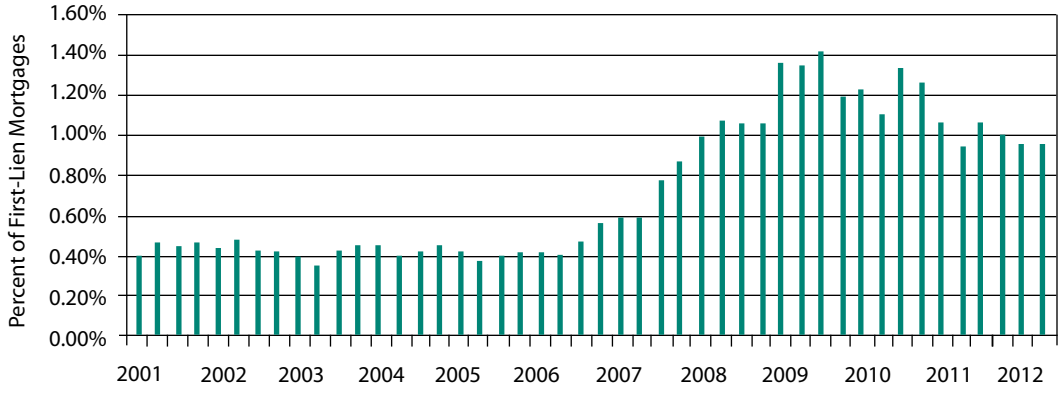
Impact on Individuals

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 percent[22]—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]

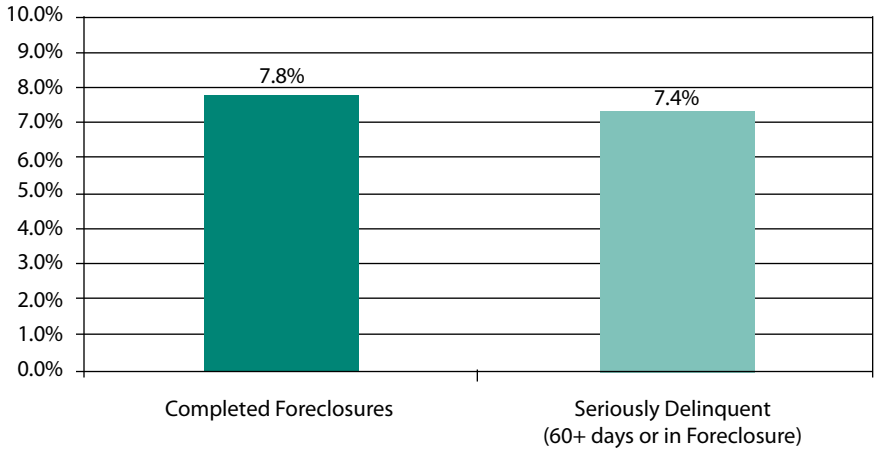
21 CRL calculation based on 2007-2012q2 MBA National Delinquency Survey, scaled to reflect market coverage. Per MBA's claims, we assume 85% market coverage for 2007q1–2010q2 and 88% coverage for 2010q3 and after.
22 See chart 5 for quarterly foreclosure start rates back to 2000. For annualized rates 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



Source: MBA National Delinquency Report

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



Source: CRL estimates based on loan status as of February 2012

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-income[27] 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 Among 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.

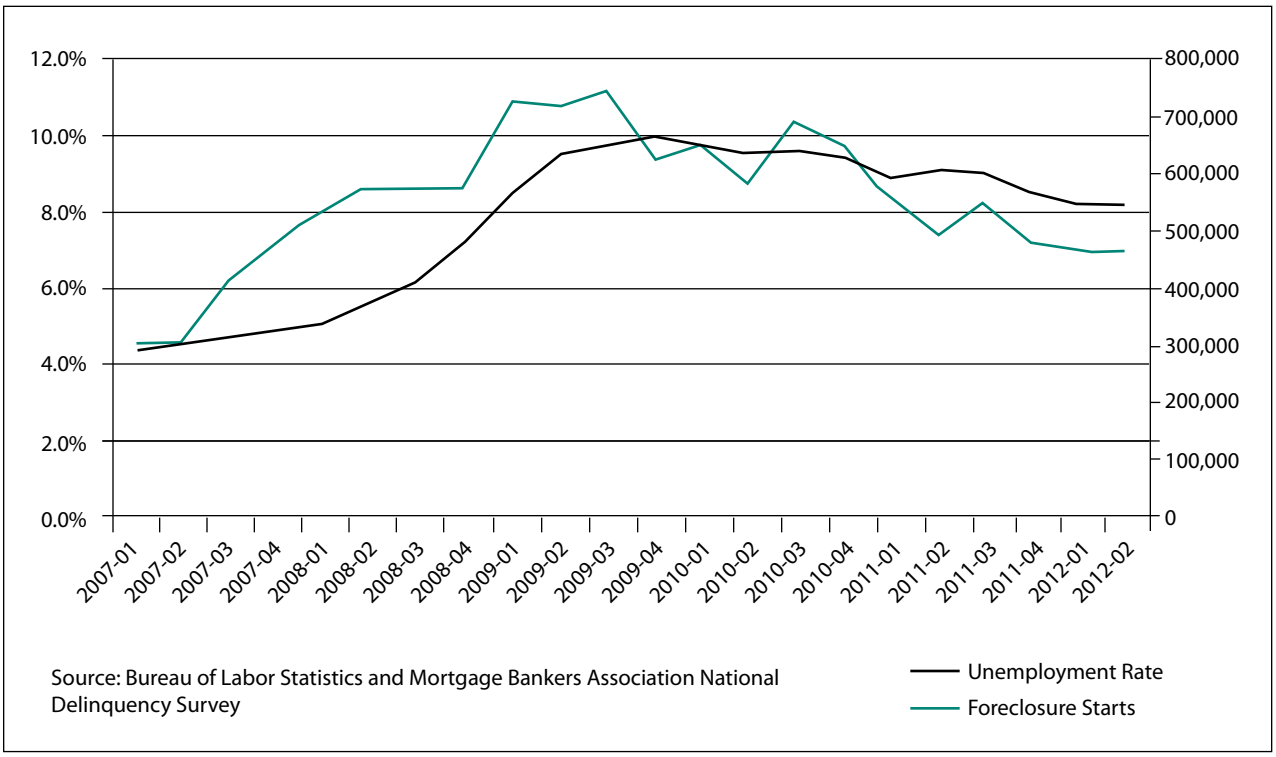
We estimate that $1.95 trillion in home equity has been lost to property owners who happen to live in proximity to foreclosed homes (Bocian, Smith and Wei, 2012). On average, each affected nearby household lost over $21,000. Importantly, this "spillover" estimate does not include non-financial negative 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.

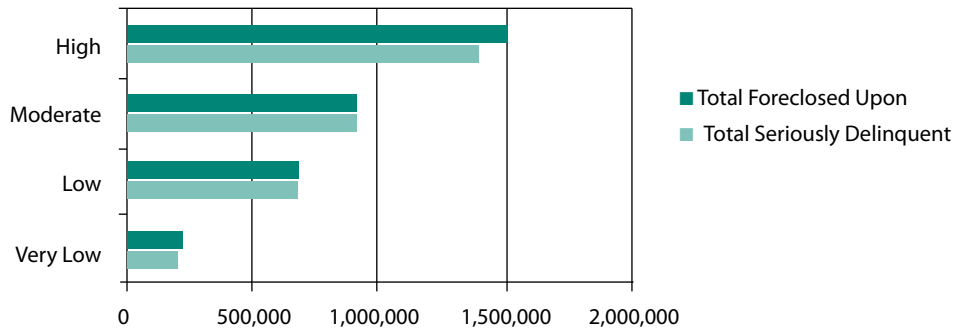
Figure 9. U.S. Unemployment and Foreclosure Rates



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.

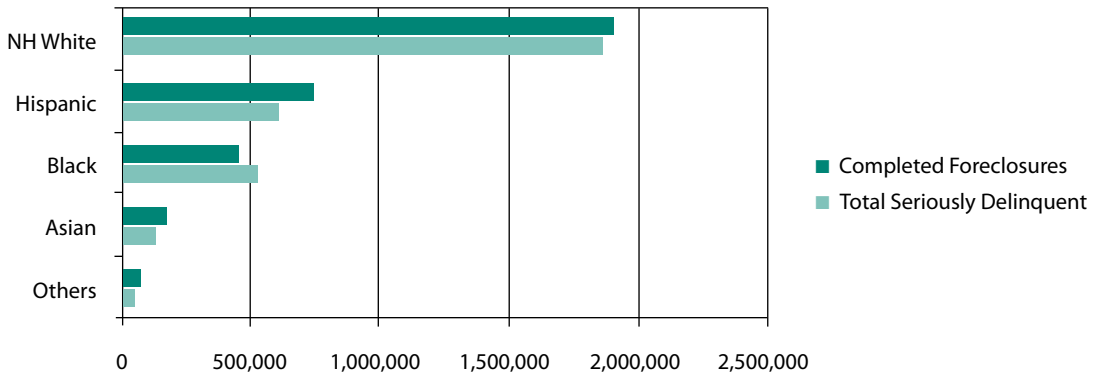
Demographics of the Foreclosure Crisis

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



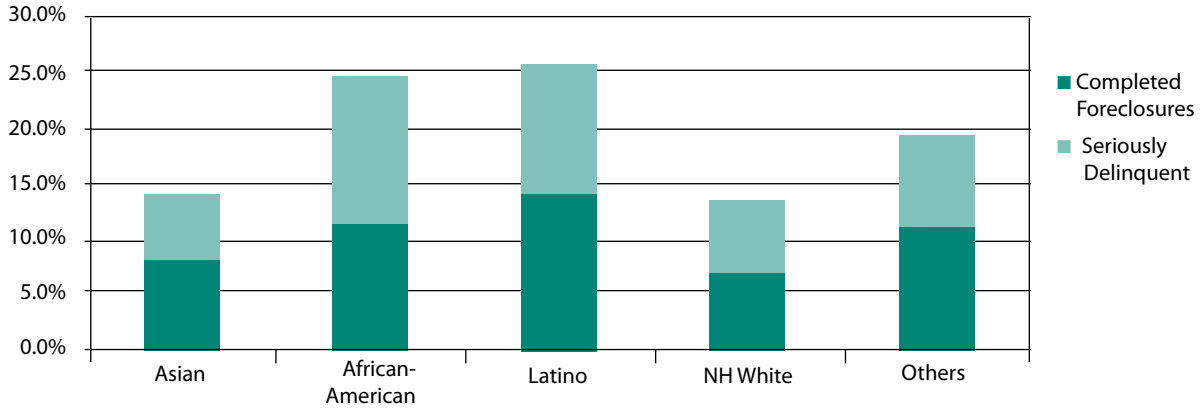
Source: Update to 2011 CRL Report "Lost Ground." Loan status as of February 2012.

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



Source: Update to 2011 CRL Report "Lost Ground". Loan status as of February 2012.

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



Source: Update to 2011 CRL Report "Lost Ground". Loan status as of February 2012.

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

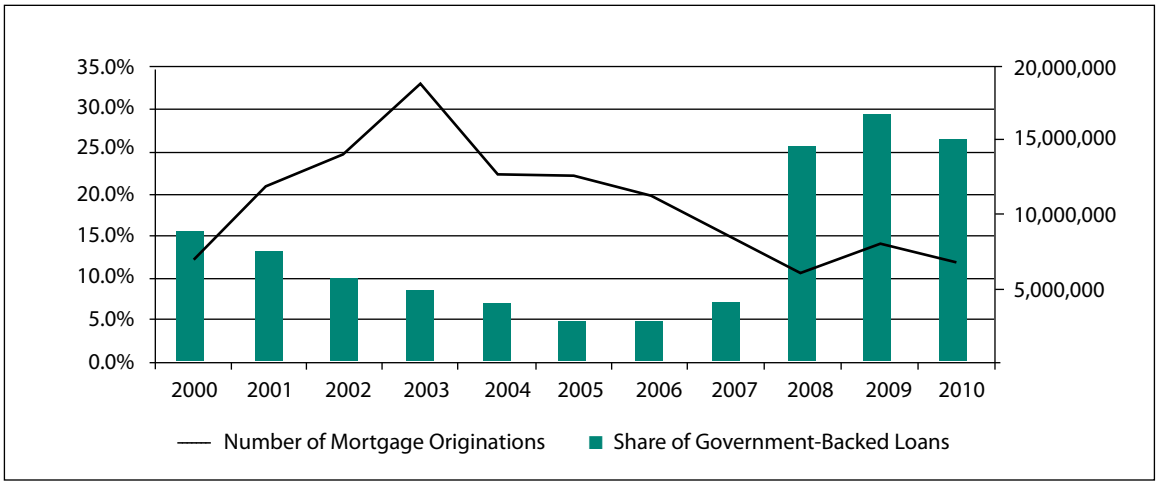
Source: Home Mortgage Disclosure Act

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

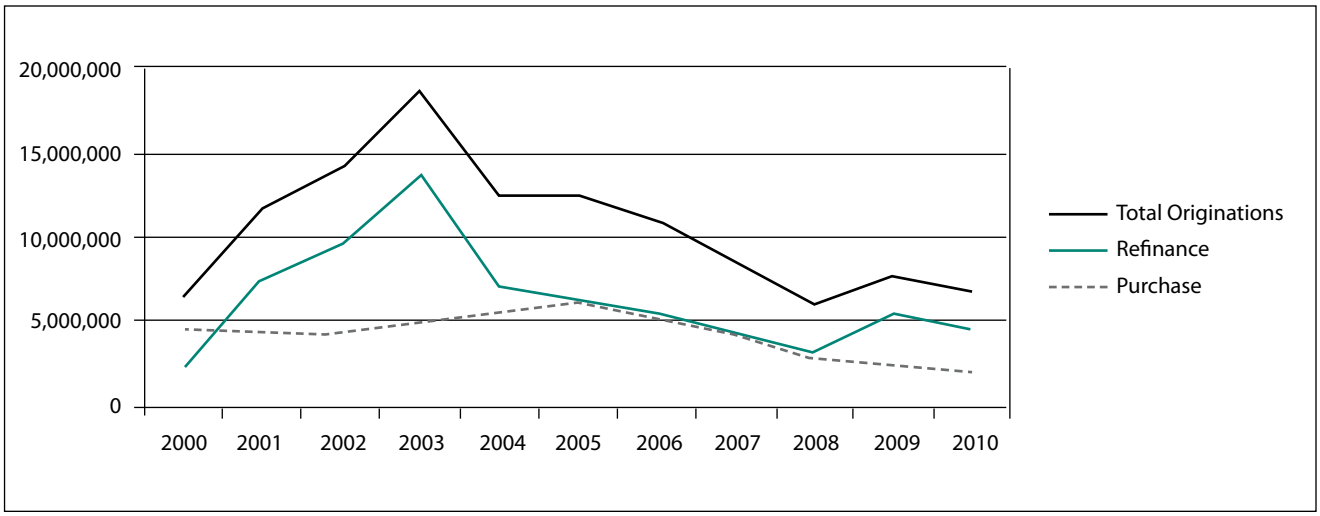


The decline in conventional lending, despite historically low interest rates, is in part due to the tighter lending standards imposed by the GSEs. As Figure 18 demonstrates, the share of conforming, conventional loan volume (in this case, represented by Fannie Mae's purchases) for borrowers with credit 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.

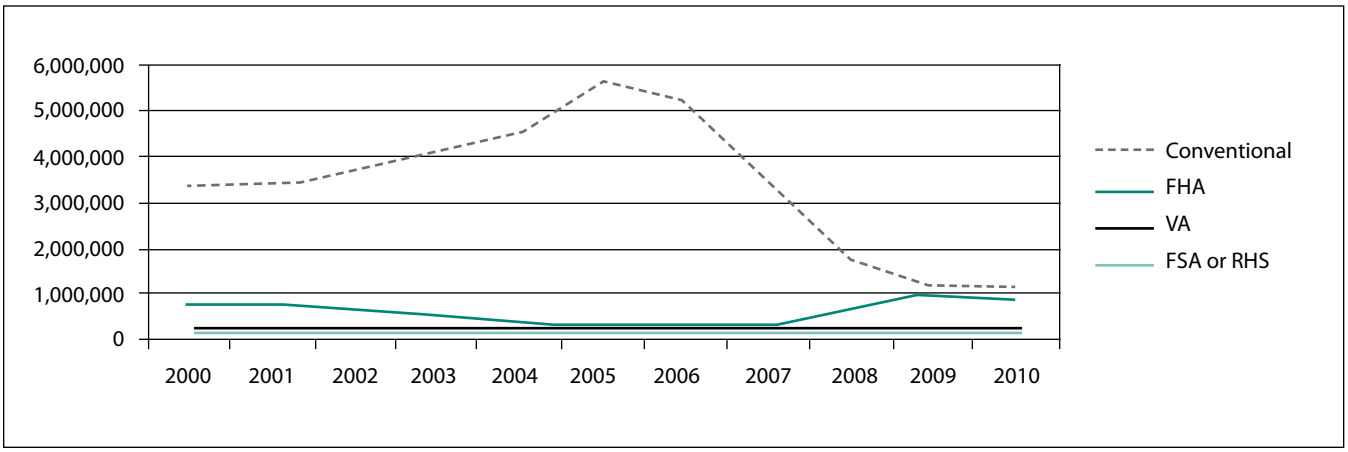
38 CRL analysis of first– and second–lien owner–occupied originations from HMDA data.

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

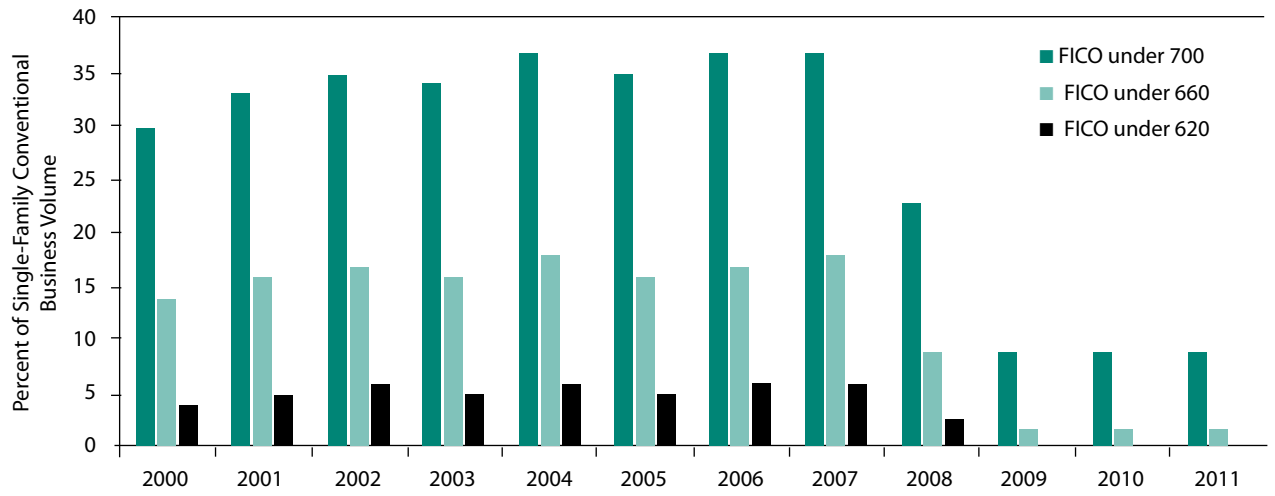


The drop in conventional purchase loans has been significant for all racial and ethnic groups, but particularly for African-Americans and Latinos. From 2000–2010, conventional purchase lending to African-American and Latino borrowers dropped 83% and 75%, respectively, compared to 67% and 36% for whites 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.

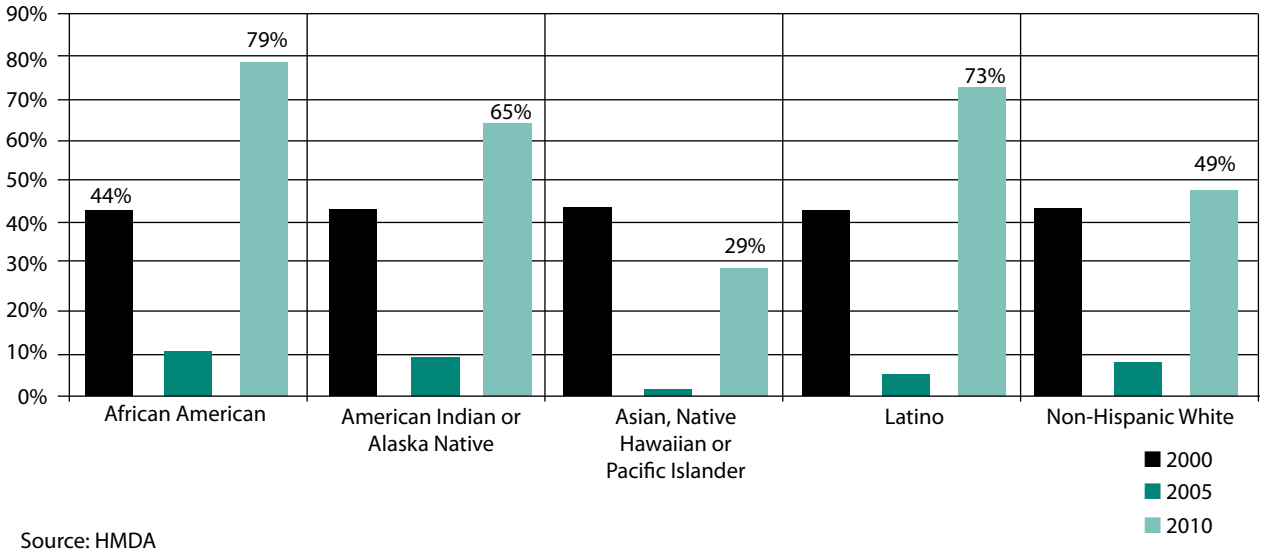
Decline in Mortgage Originations by Race/Ethnicity and Credit Score

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



Source: CRL Compilation of Fannie Mae Annual 10K Reports

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



Source: HMDA

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 Act[39] 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.

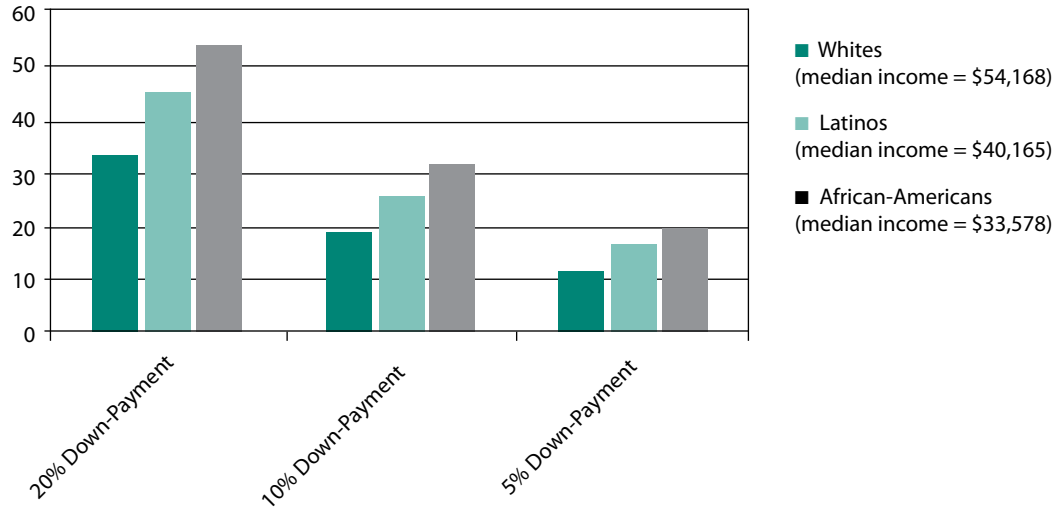
40 Loans with risky product features such as high fees, balloon payments, low teaser rates, or interest-only or negative amortization schedules will automatically be ineligible for preferred secondary market status, as will loans that do not verify borrower income (so-called "no-doc" or "low-doc" loans).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



Source: CRL calculations based on median income by race and ethnicity from the 2010 American Community Survey.

- 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

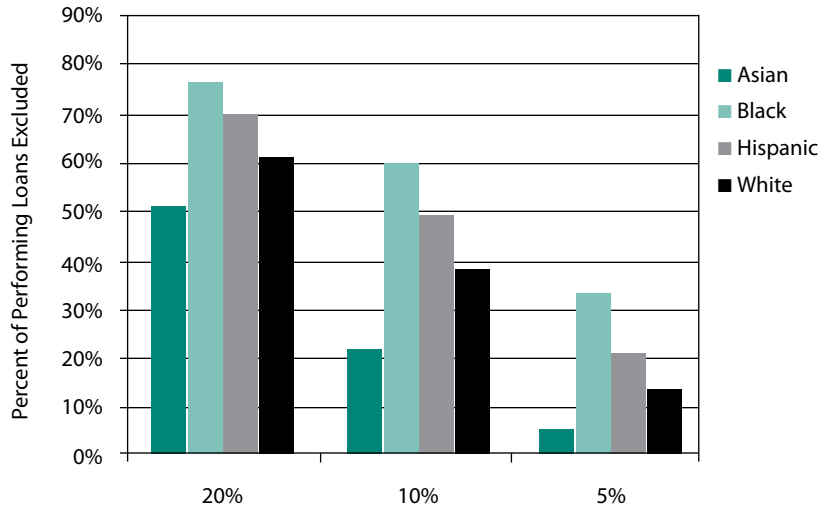
	Exclusion Ratio (Number of Performing Loans Excluded: Number of Foreclosures Prevented)
Qualified Mortgage Standards + 20 Percent Down Payment	10:1
Qualified Mortgage Standards + 10 Percent Down Payment	9:1
Qualified Mortgage Standards + 5 Percent Down Payment	6:1

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/Ethnicity[43] (2004 – 2008 Originations)



Source: Figure 8 from "Balancing Risk and Access: Underwriting Standards and Qualified Residential Mortgages"

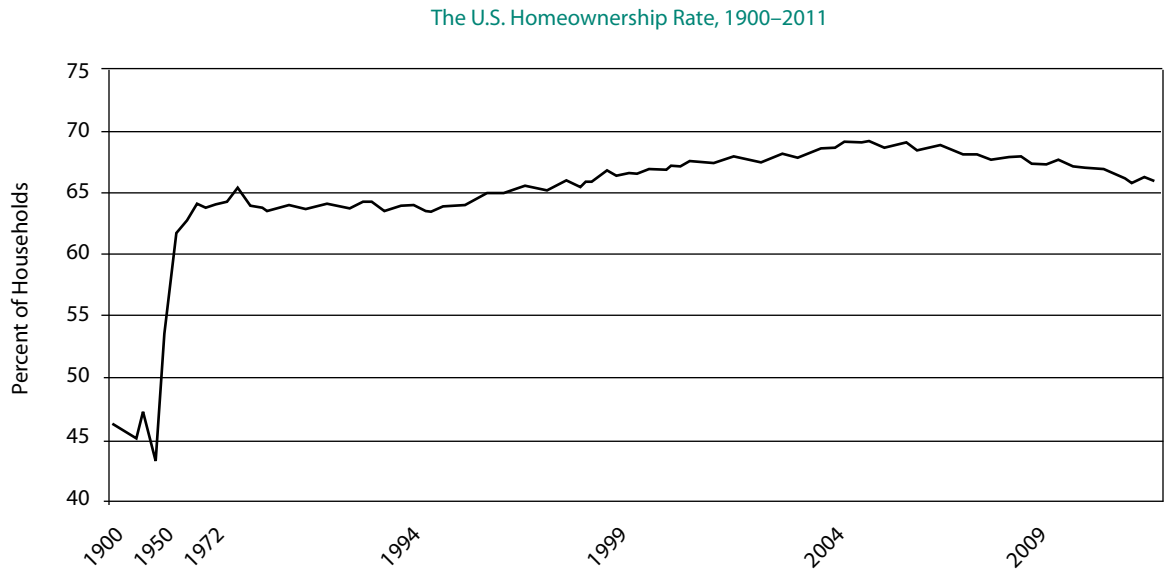
The benefit of down payments in reducing individual borrowers' default rates could be counteracted by the toll it would take on the larger housing market and economy. Including a down-payment requirement in secondary market standards would depress housing demand, threatening the future recovery of the 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.



Source: Current Population Survey/Housing Vacancy Survey, Series H–111 Reports, Bureau of the Census, Washington, DC.

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 to 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)

	Total*		Asian		African-American		Latino		NH White	
State	Completed Foreclosure	Imminent Risk of Foreclosure	Completed Foreclosure	Imminent Risk of Foreclosure	Completed Foreclosure	Imminent Risk of Foreclosure	Completed Foreclosure	Imminent Risk of Foreclosure	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.)

	Total*		Asian		African-American		Latino		NH White	
State	Completed Foreclosure	Imminent Risk of Foreclosure	Completed Foreclosure	Imminent Risk of Foreclosure	Completed Foreclosure	Imminent Risk of Foreclosure	Completed Foreclosure	Imminent Risk of Foreclosure	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

Delvin Davis

December 2012

CENTER FOR RESPONSIBLE LENDING
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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.

2 The 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.

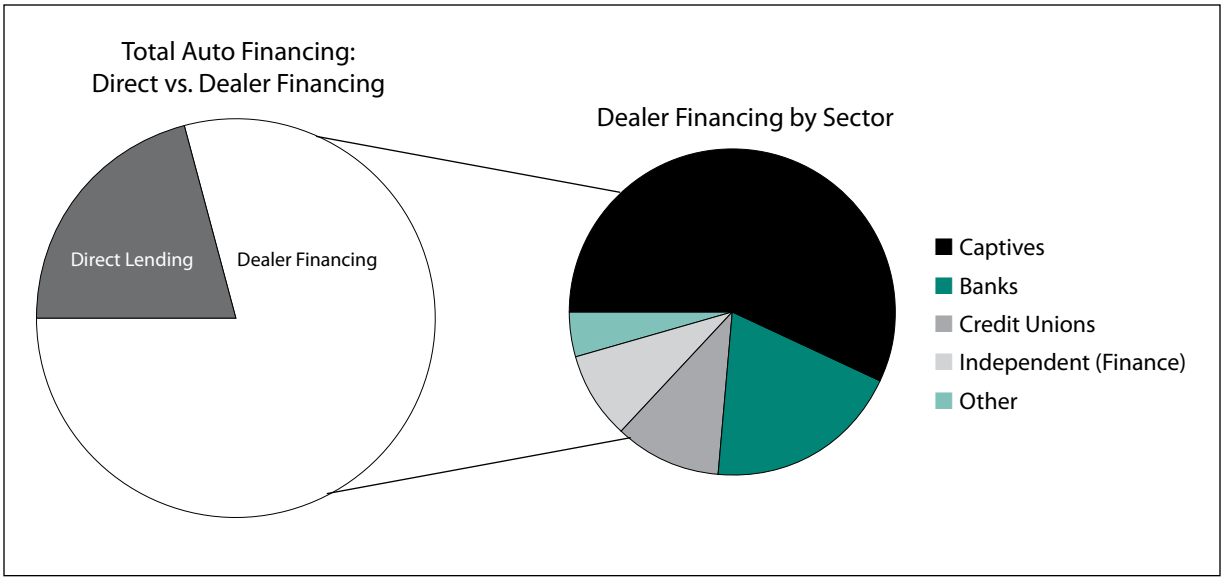
As mentioned earlier, there are many different elements involved in a car purchase transaction, and most of them are presented in the F&I office after the consumer has already been through a lengthy sales process. The length of the loan, the amount of the down payment, whether to include add-on products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

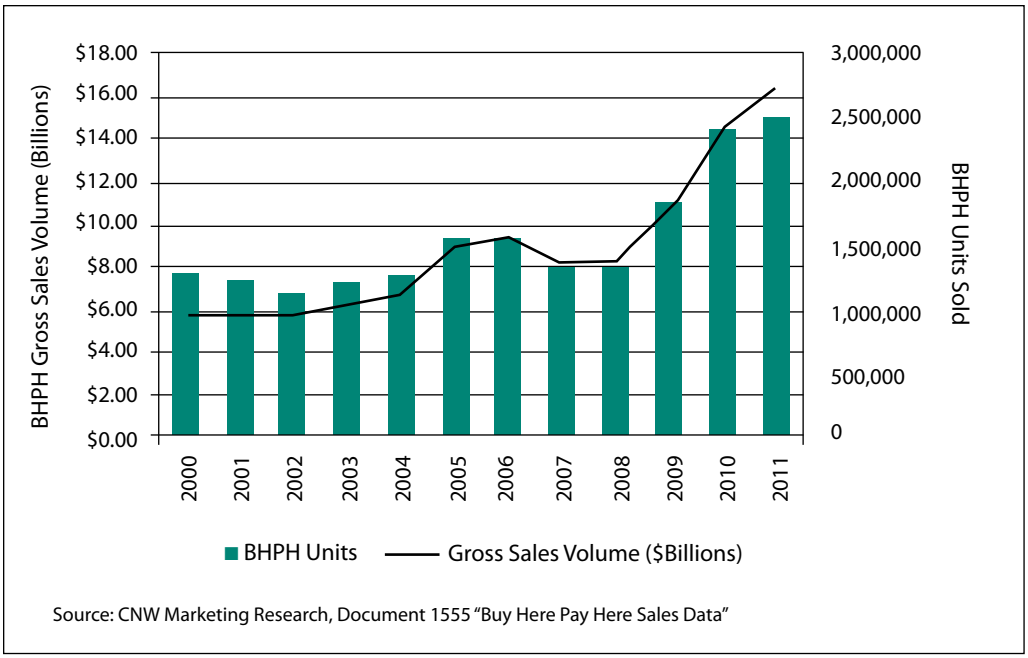
Buy Here Pay Here Dealerships

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



Source: CNW Marketing Research, Document 1555 "Buy Here Pay Here Sales Data"

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

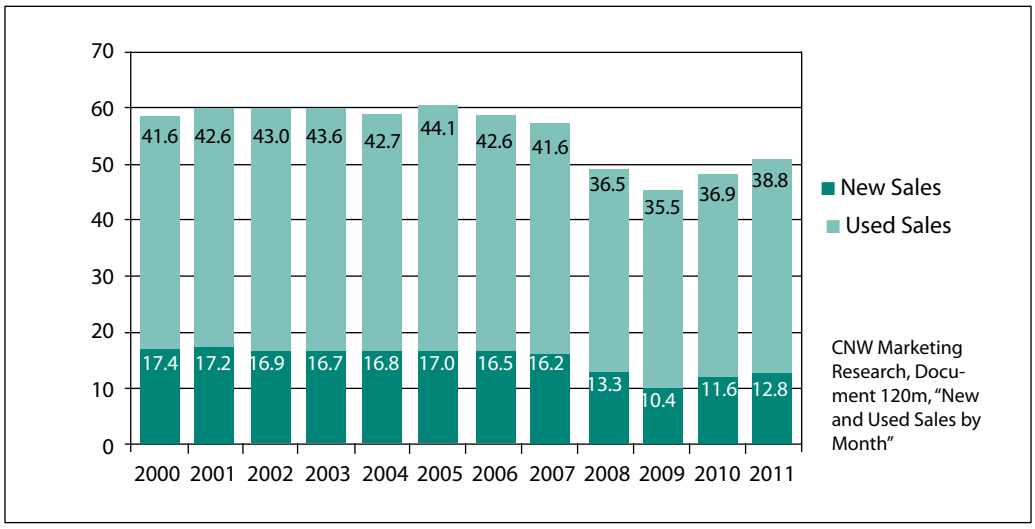
Auto sales and financing declined dramatically prior to and during the recession. Sales of new and used cars dropped 25 percent between its peak in 2005 and its low in 2009. Lending volumes have also decreased during the recession (CNW, 2012). Other forms of lending have also disappeared—before the crisis, 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



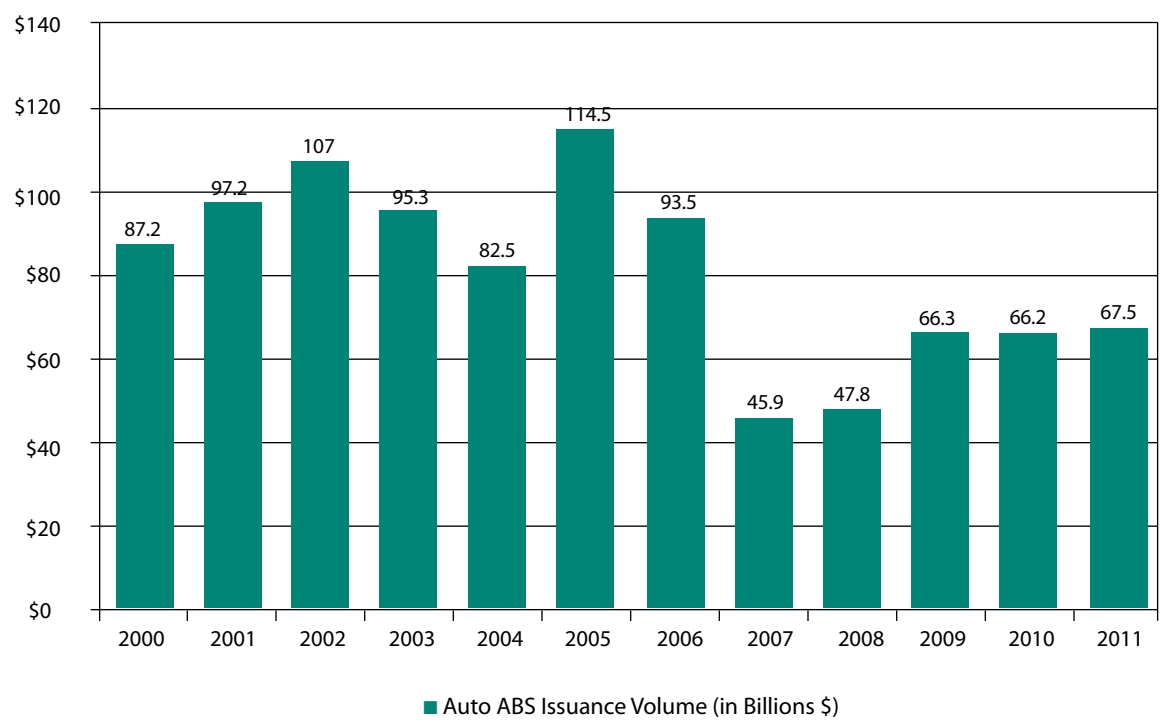
5 CNW Marketing Research, *New sales with home equity loans,* Document 1359 (CNW, 2010b). In 2007, 11.77% of new cars were financed with home equity loans. In 2010, only 4.44% were financed through home equity.
6 During the 2nd quarter 2012 Federal Reserve senior loan officer survey, 23% of banks loosened 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).

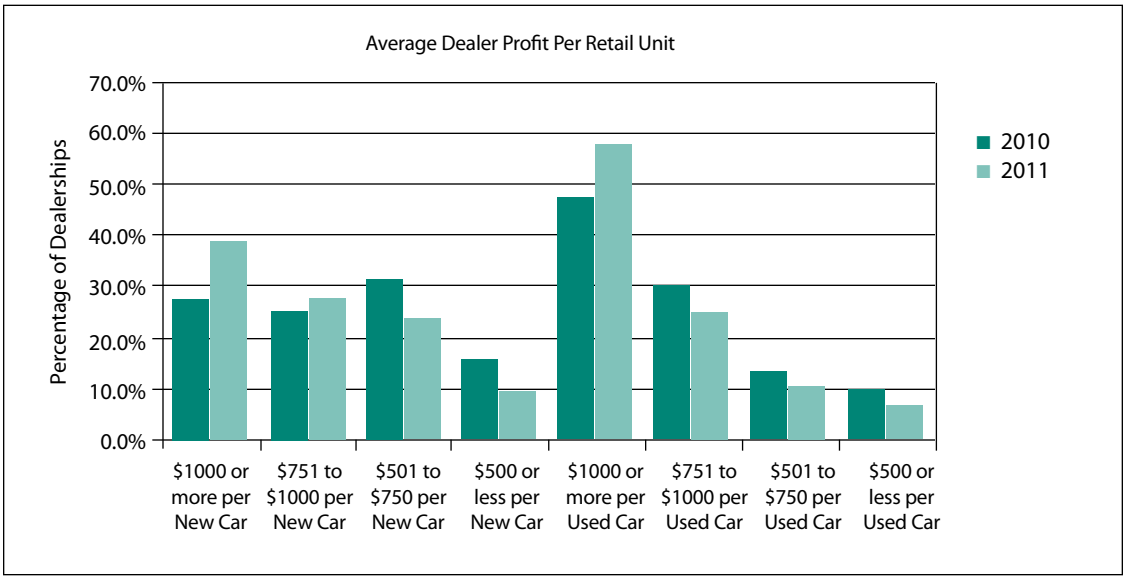
Analysts believe that auto ABS issuances will continue to rise toward pre-recession levels due to a boost in auto sales, the return of subprime financing, low interest rates, and relatively low delinquency rates compared to other assets like mortgages (Williams, 2012). However, analysts from Moody's 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



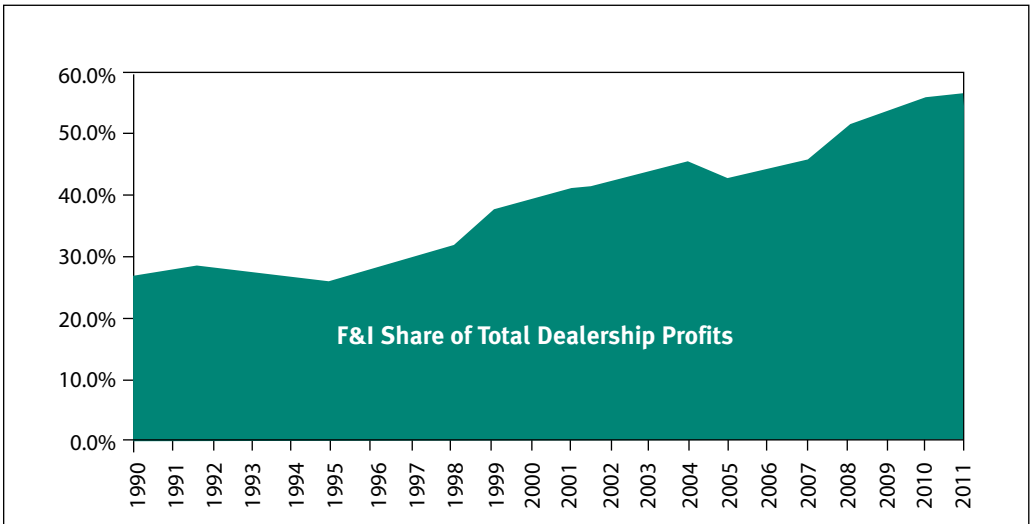
Source: Bloomberg Finance

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



Source: CNW Marketing Research, "F&I Contribution to Dealership Profits" Document 280
Note that data is only for franchised dealers that sell vehicles to private parties.

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

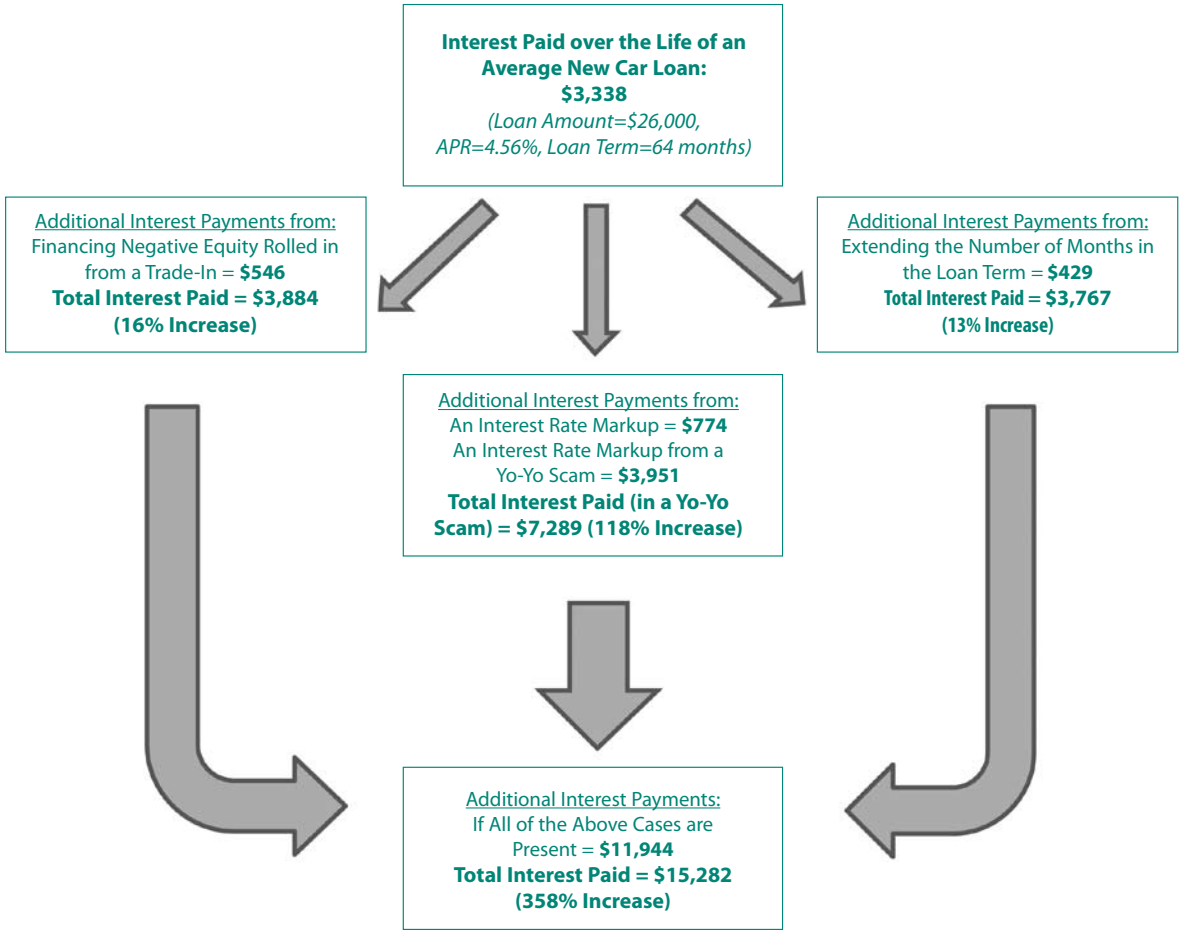
	2006	2007	2008	2009	2010	2011
Number of Weekly Payments	131	134	129	132	134	135
Average Weekly Payment	$82	$85	$84	$84	$85	$86
Amount Financed	$8,844	$9,085	$9,195	$9,294	$9,380	$9,427
APR	25.1%	28.3%	24.5%	24.4%	25.6%	25.6%
Cost Per Vehicle to Dealer (incl. reconditioning)	$4,949	$5,111	$5,284	$5,534	$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

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



Note: Normal deal assumes the average sales price, loan term, and APR for new and used vehicles according to Experian Automotive (1Q 2012). Average negative equity from a trade-in is $4,250. Average additional rate markup is 1.01% and 2.91% for new and used cars, respectively. A yo-yo deal can result in an additional 5 percentage points in APR. Extended loan term is defined as 72 months, which would create room to inflate cost while still having a lower monthly payment.

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

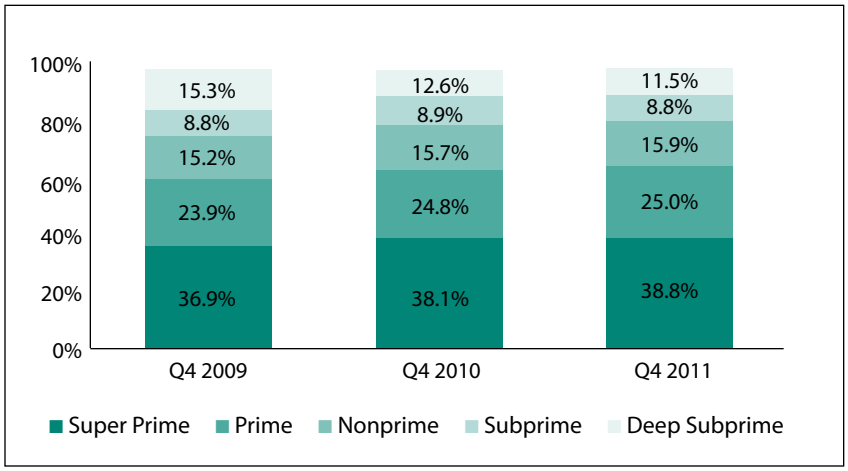
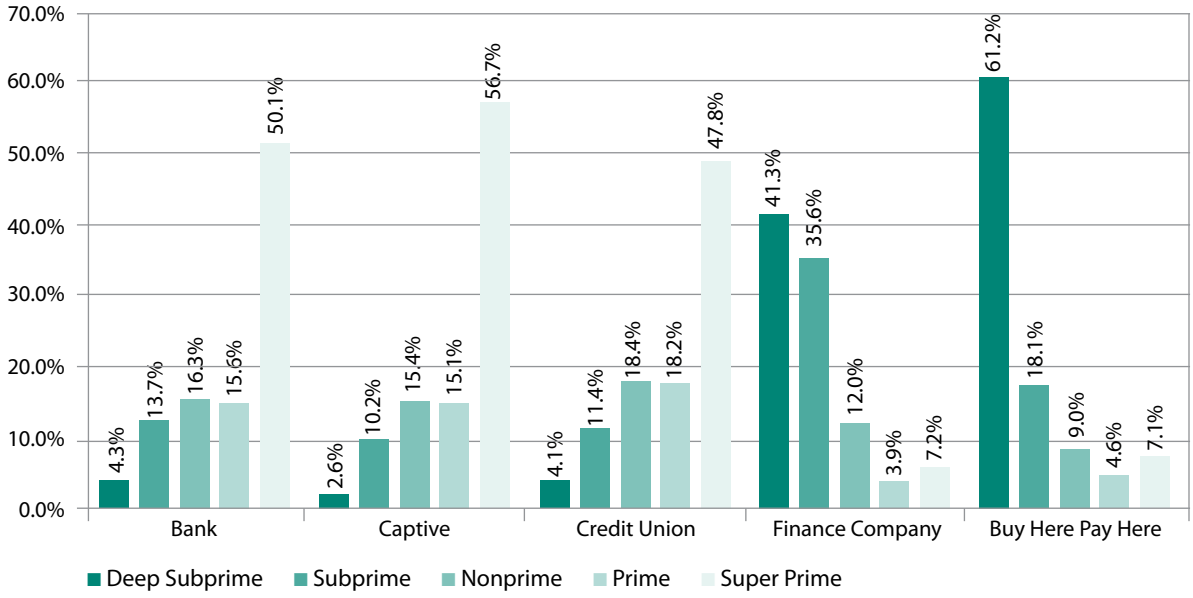


Figure 10. Credit Tier by Auto Lender Type – 3rd Qtr 2012



Note that credit tiers are defined by Vantage Score as follows:
Super Prime=801-990, Prime=701-800, Nonprime=641-700, Subprime=601-640, Deep Subprime=501-600

Source: Experian Automotive

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%

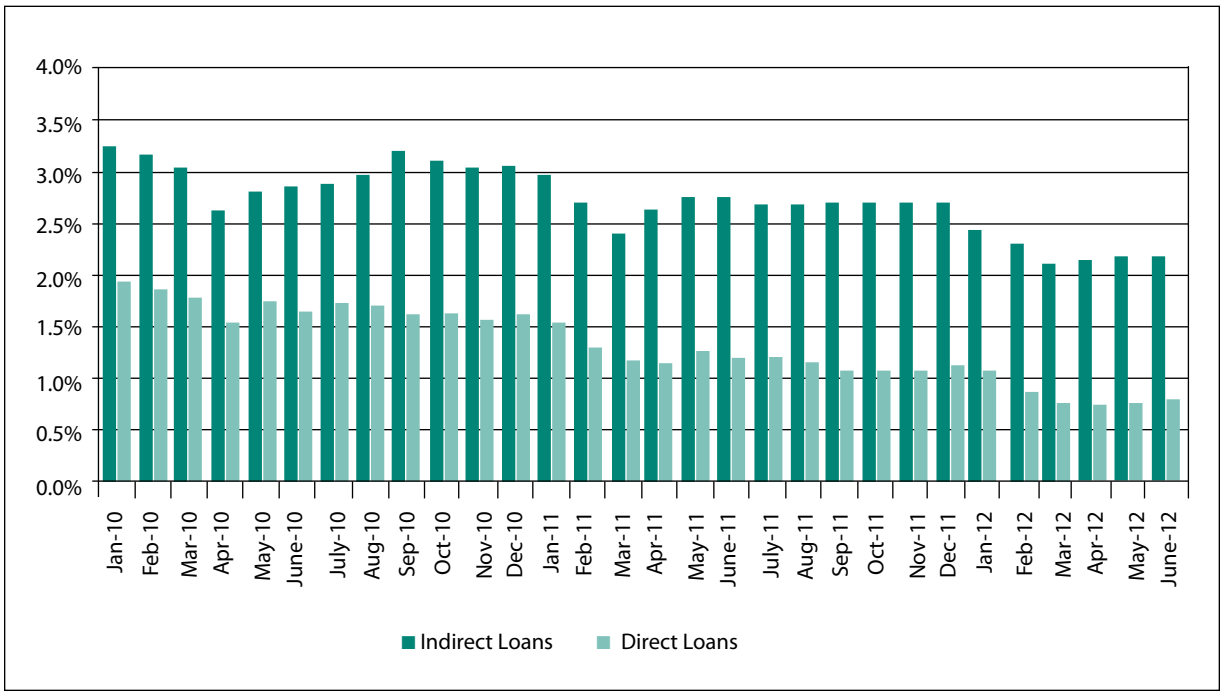
Sources: RealtyTrac (Foreclosure process time), CNW Marketing Research (Repo process time), Mortgage Bankers Association (Foreclosure rate), Experian Automotive (Repossession rate).

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

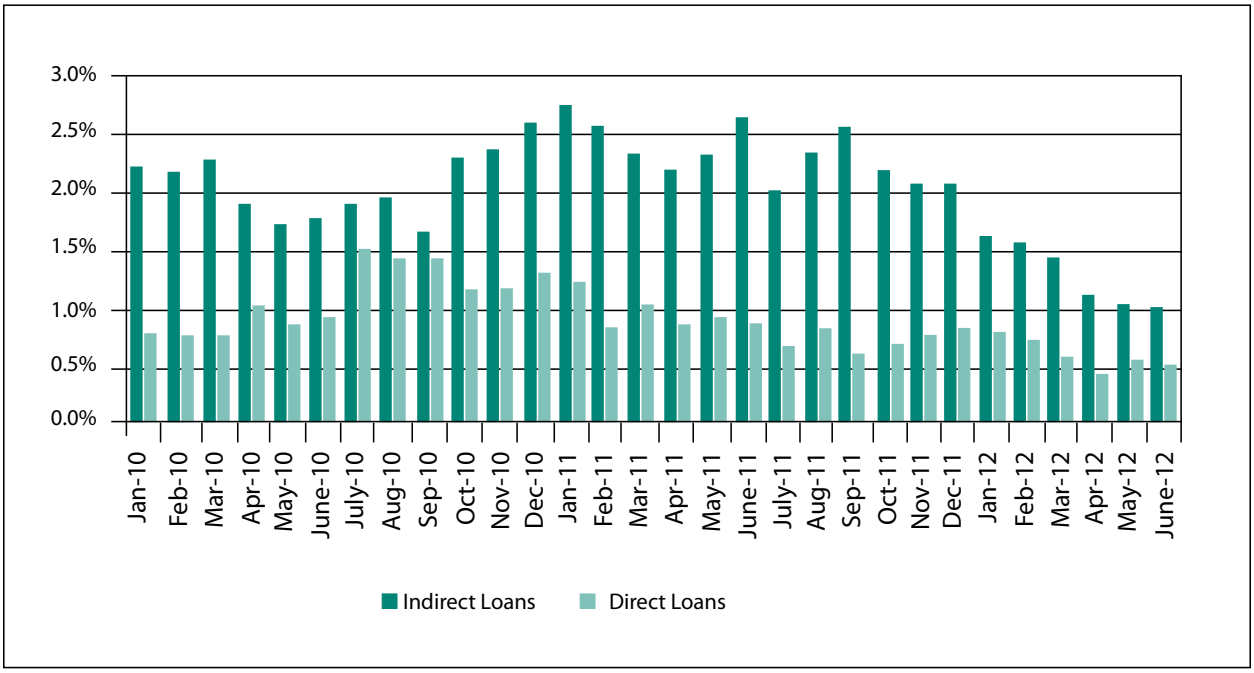
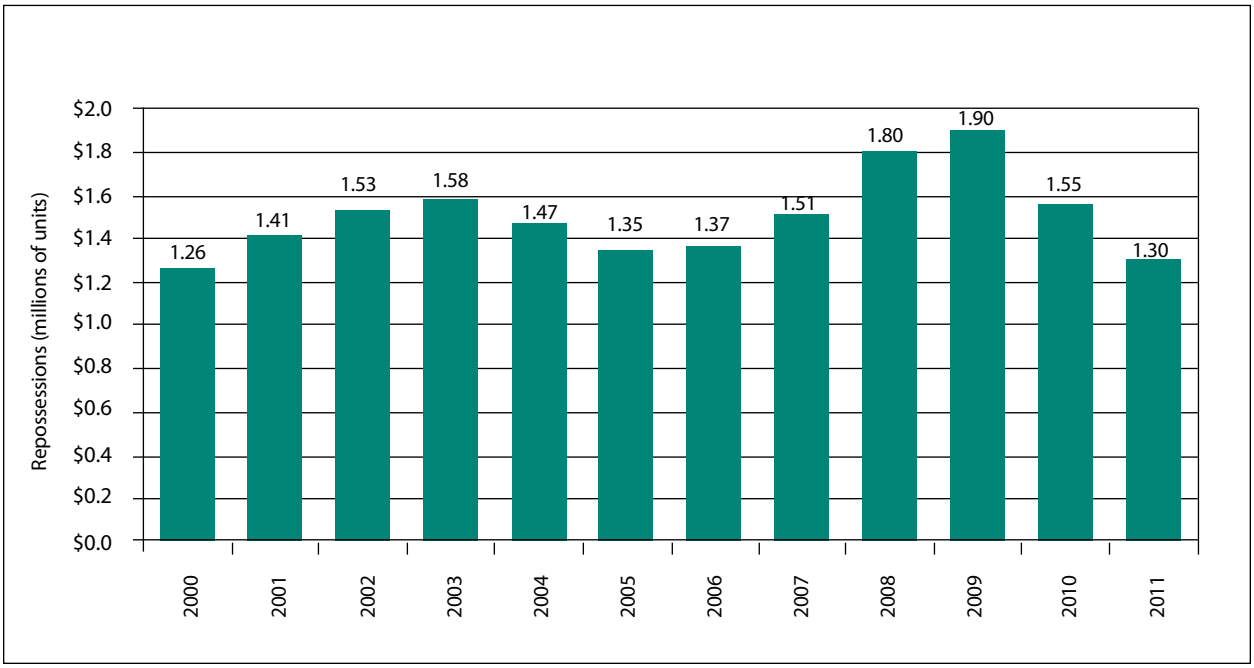


Figure 14. Repossession Totals



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

CENTER FOR RESPONSIBLE LENDING

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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.

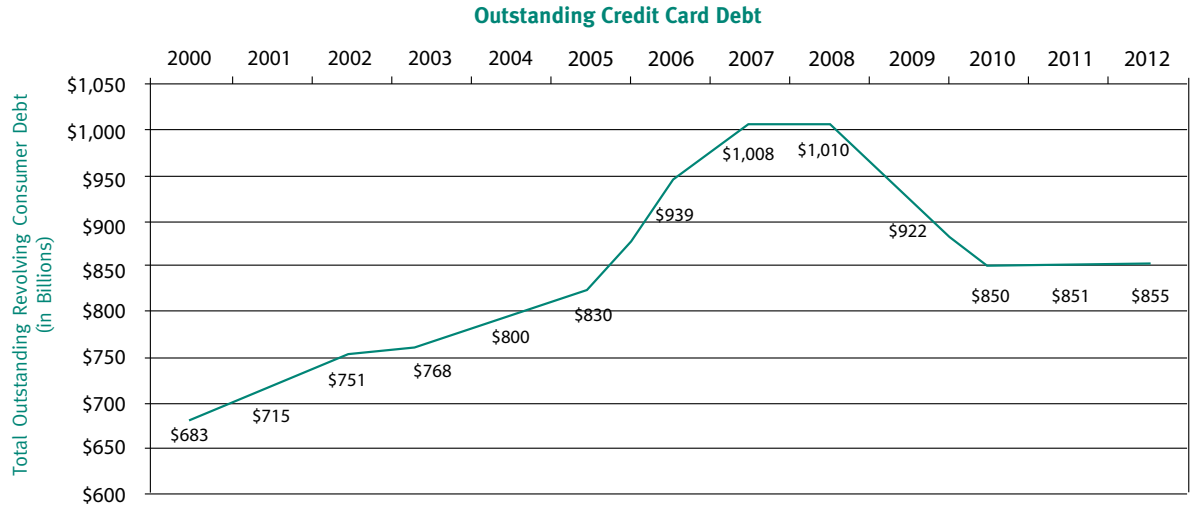
MARKET AND INDUSTRY OVERVIEW

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 in 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)



Source: Federal Reserve Board, Statistical Release G19, Consumer Credit

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 finances 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.

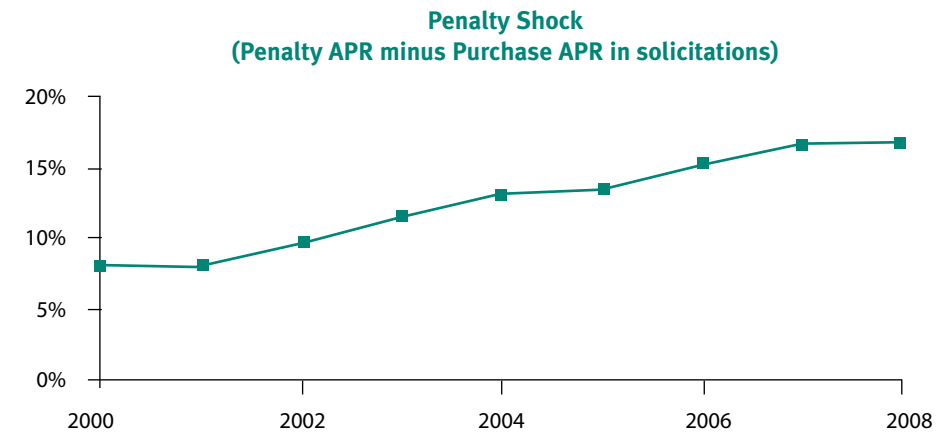
Examples of hidden credit card policies that imposed potentially high and unexpected costs included tiered late fees and minimum finance charge requirements. Tiered late fees allowed issuers to apply increasingly higher late fees on a growing group of cardholders. Issuers designed this complex pricing 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



Source: Comperemedia data and CRL calculations.

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

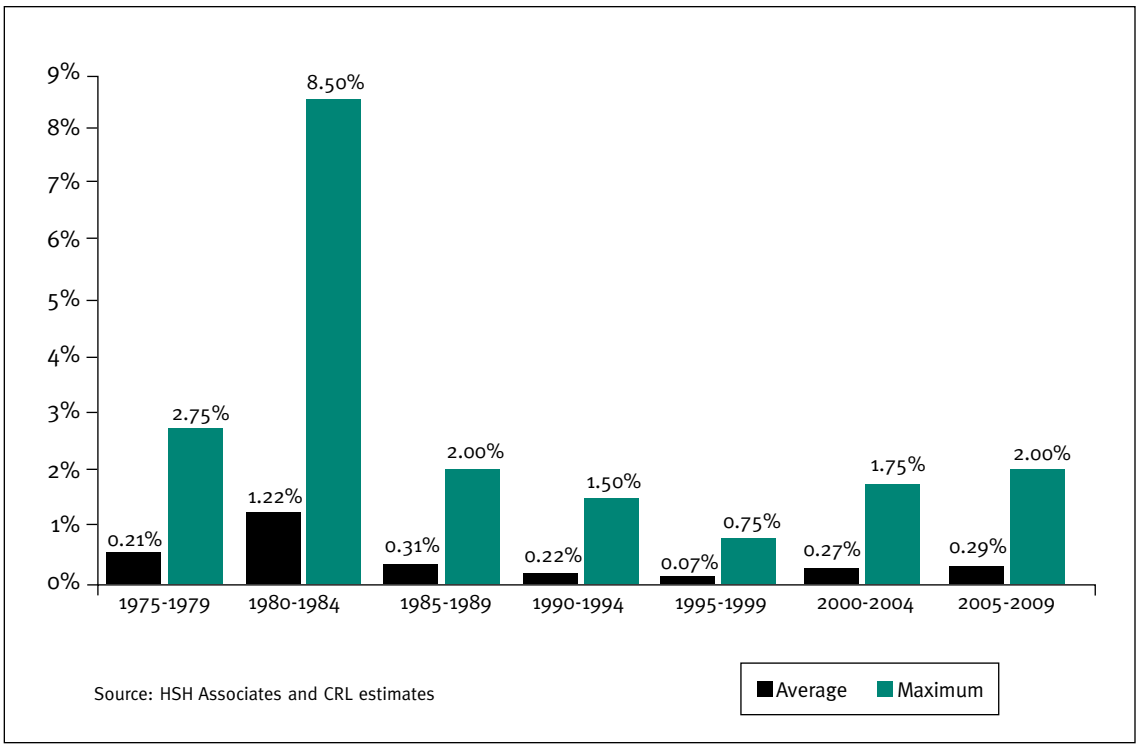
Before the Credit CARD ACT

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).

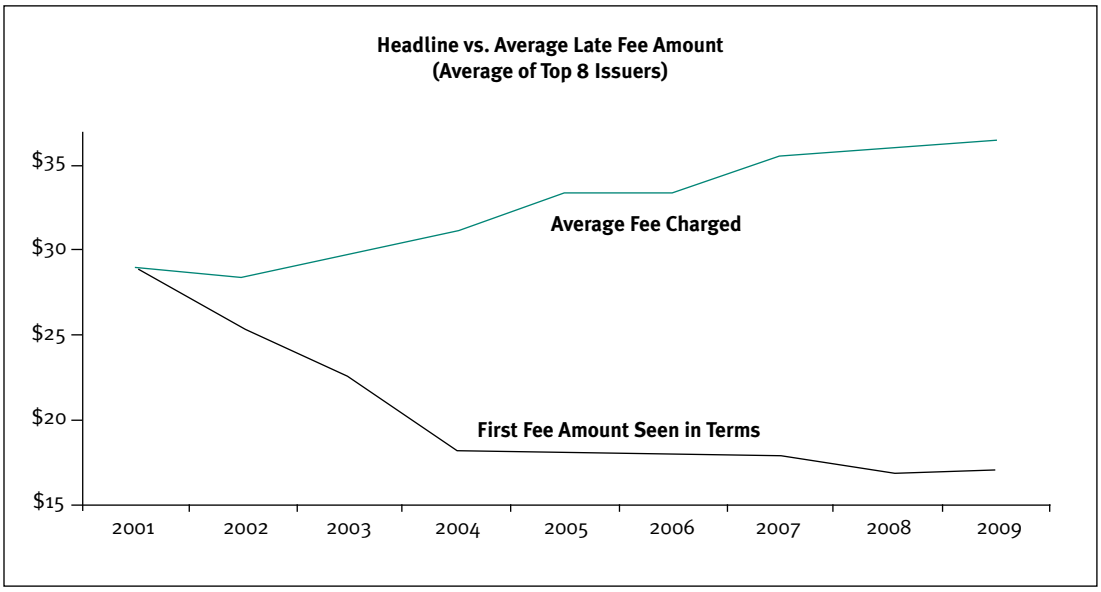
Figure 3. Average and Maximum Interest Rate Increase from Pick-a-Rate Pricing (using 5-year increments)



Source: HSH Associates and CRL estimates

- 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

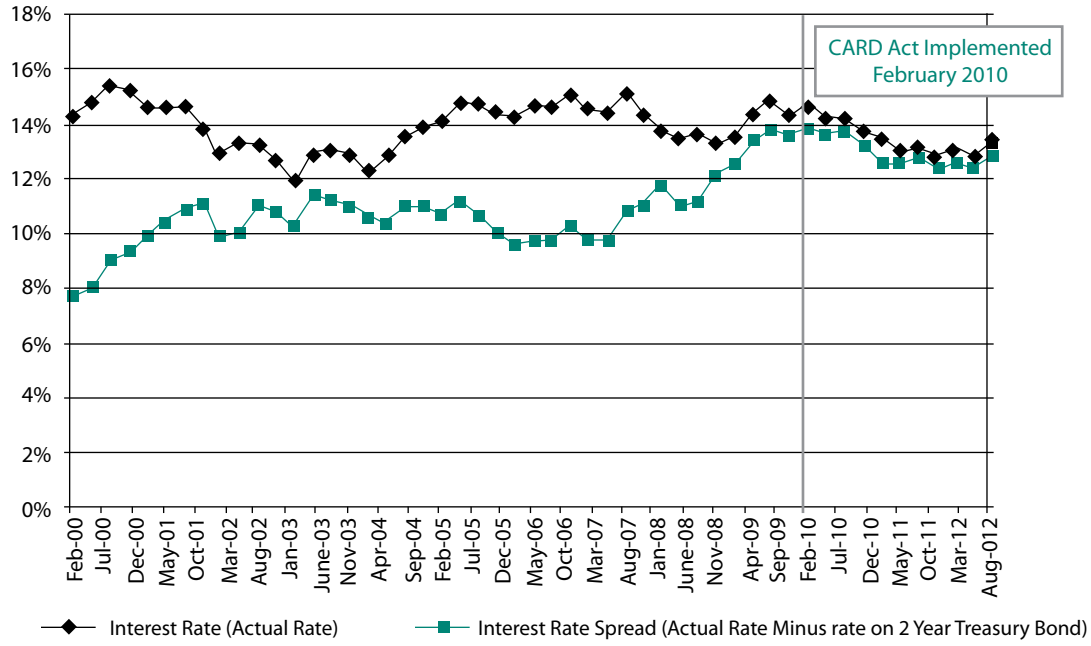
1 In addition to new credit card disclosures, credit constriction in the market and consumer deleveraging were also likely contributors to the decline in credit card balances.

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).

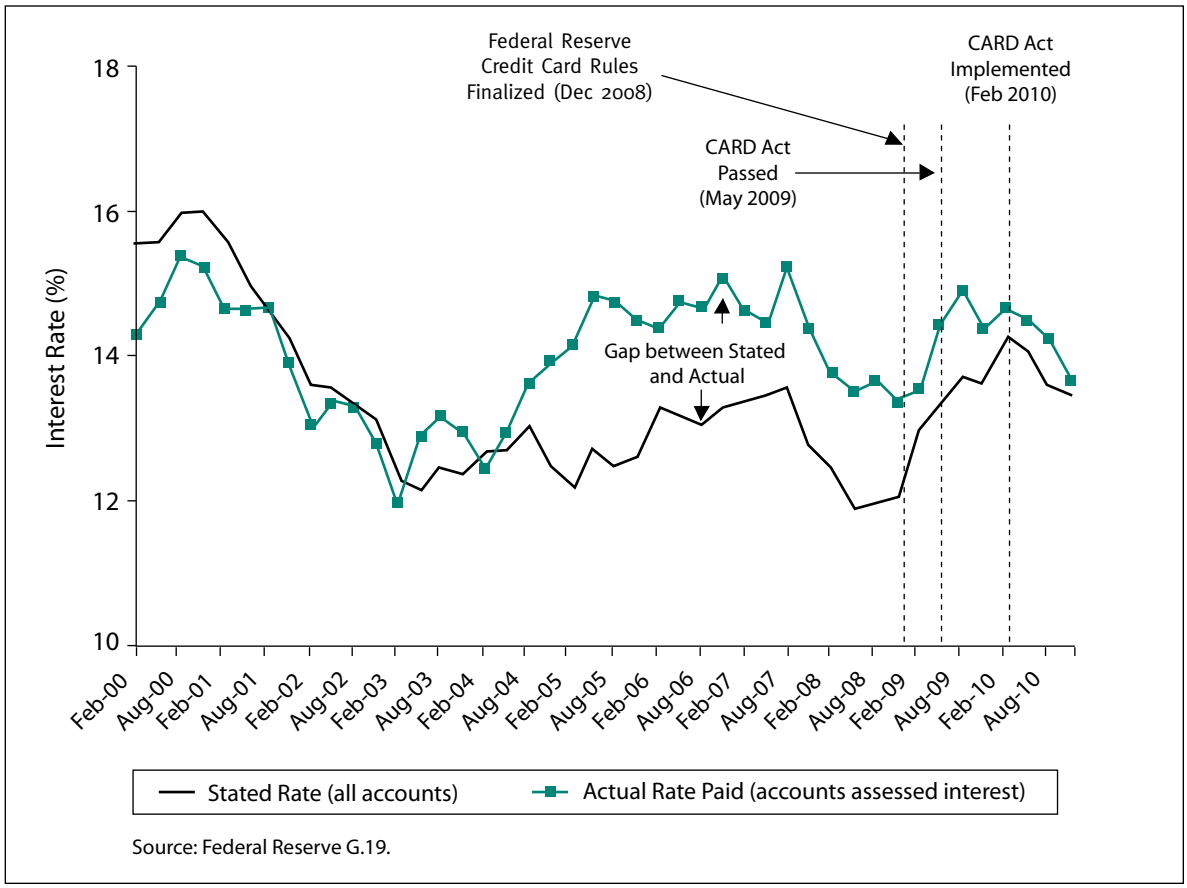
Figure 5. Credit Card Interest Rates, 2000-2012



Source: Federal Reserve Board, Statistical Release G19

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 by 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).

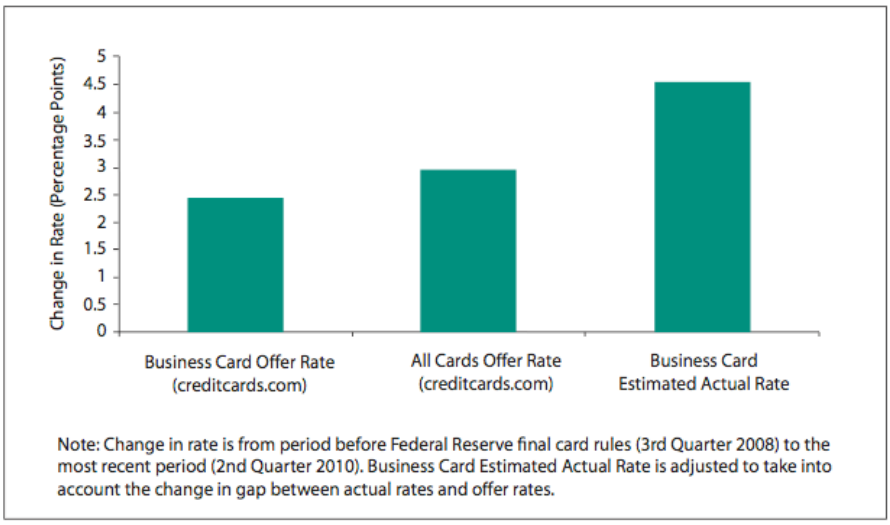
Figure 6: Stated Rates and Actual Rates Paid on Consumer Credit Cards



Source: Federal Reserve G.19.

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.

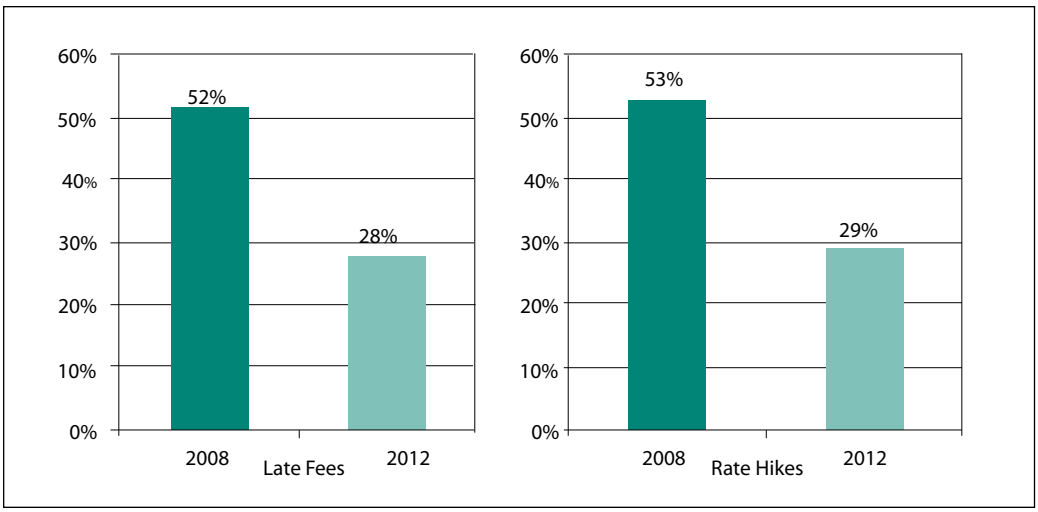
Figure 7: Change in Business and Consumer Offer Rates



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).

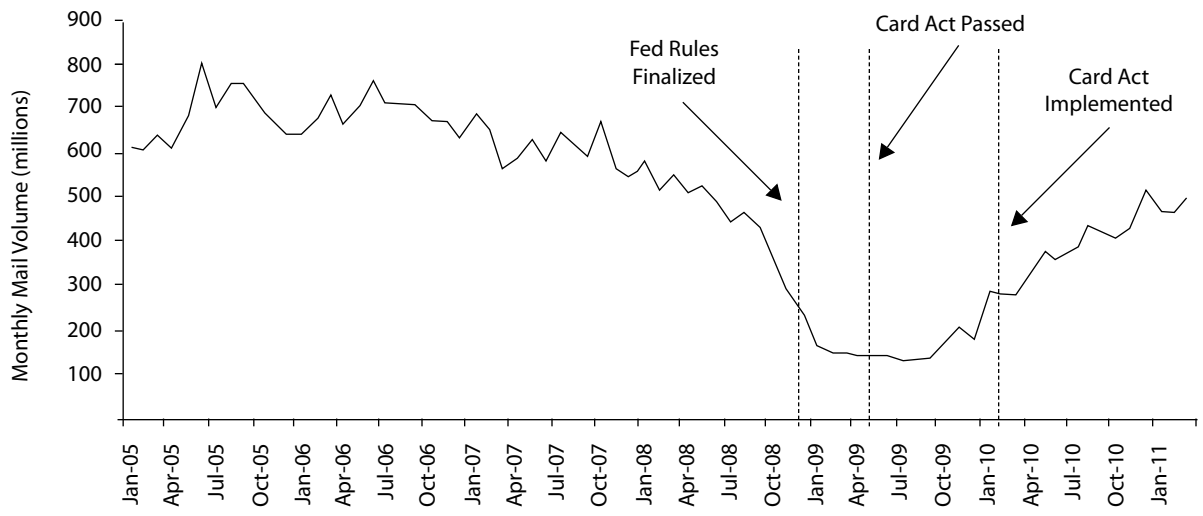
Figure 8. Decline in Credit Card Late Fees and Rate Hikes, after Credit CARD Act



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



Source: Mintel Comperemedia; CRL calulations

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

CENTER FOR RESPONSIBLE LENDING

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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).

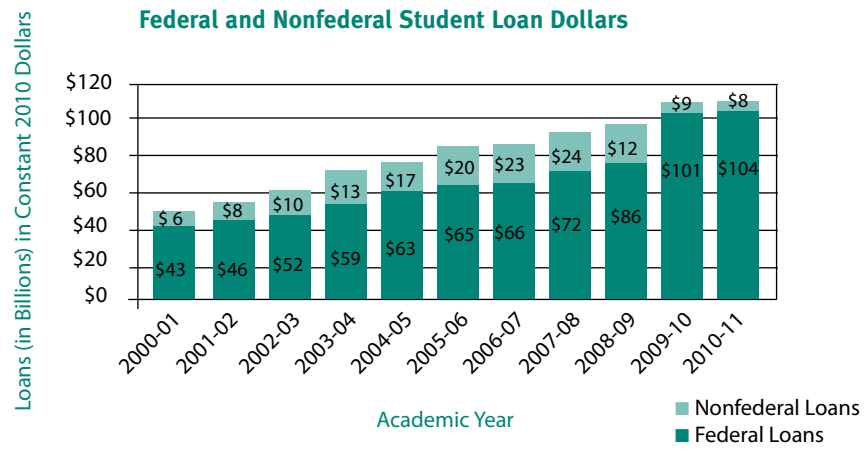
Federal Student Loans

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.



Source: College Board Advocacy and Policy Center

Private Student Loans

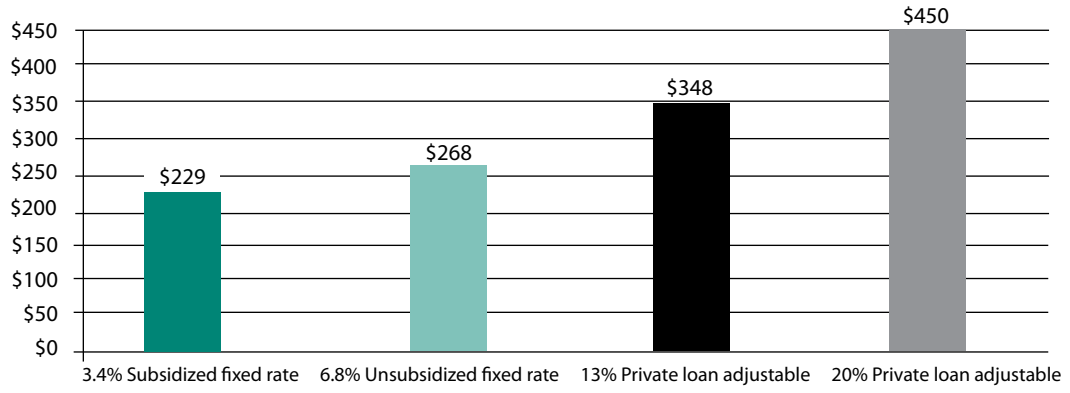
Private student loans are those that are not made or guaranteed by the federal government. Private student lenders include banks and other non-depository institutions, non-profit organizations (many affiliated with state programs), and some schools that offer or guarantee institutional loans. The large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

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 program[1]—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.



Source: CRL calculations of monthly payments based on CFPB reported private loan interest rates, 10-year term

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

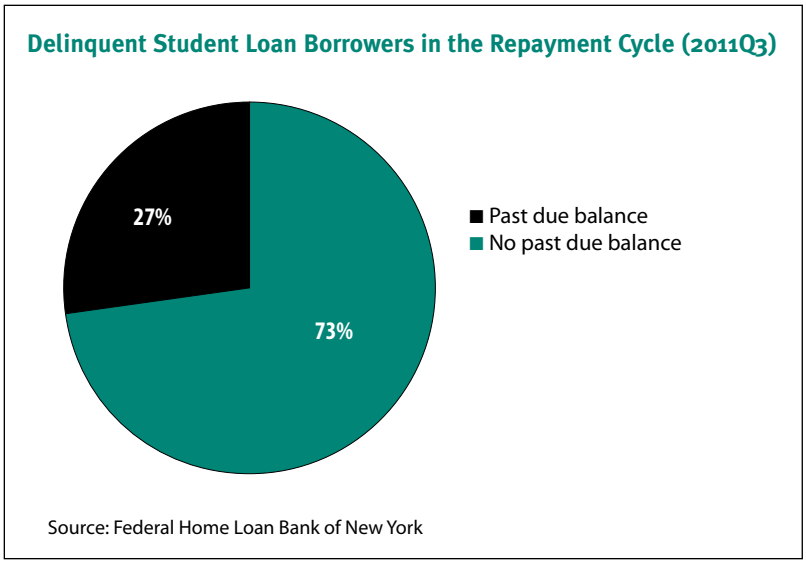
Unfortunately, many borrowers and families face a dizzying array of financial aid options—including grants, scholarships, federal loans, and private loans—and are often confused and unsure about their options. A recent survey of student loan borrowers with high debt levels found that about 65% misunderstood 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

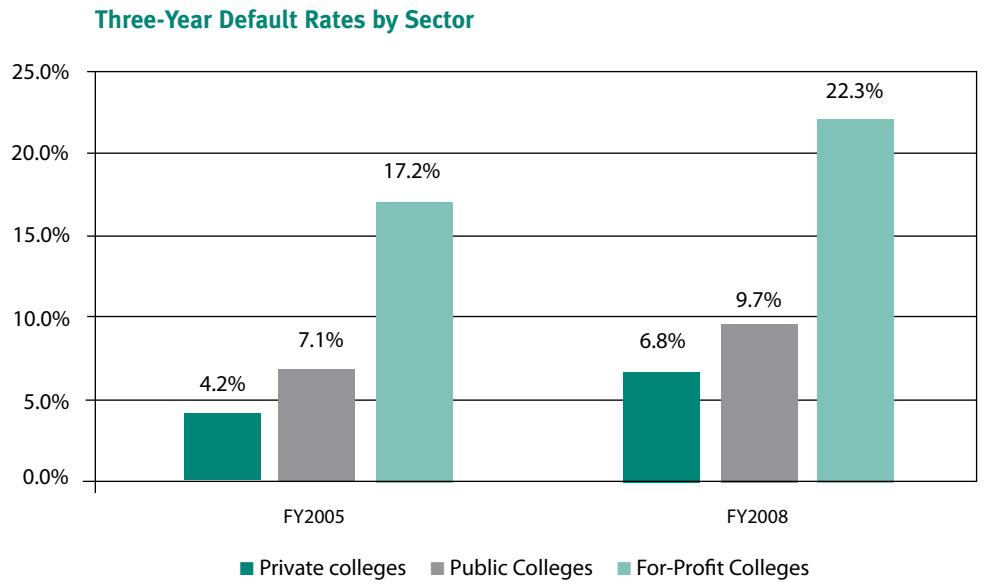
  Dropout rates have increased in recent years. Between 2005 and 2009, 29% of all student loan borrowers dropped out of college, up from 23% in 2001. Not surprisingly, borrowers who do not finish their degree are more likely to default on their student loans; one recent study found that "borrowers who 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.



Source: The Senate Committee on Health, Education, Labor and Pensions

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

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CENTER FOR RESPONSIBLE LENDING

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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 income[3] 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 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
Heath 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.

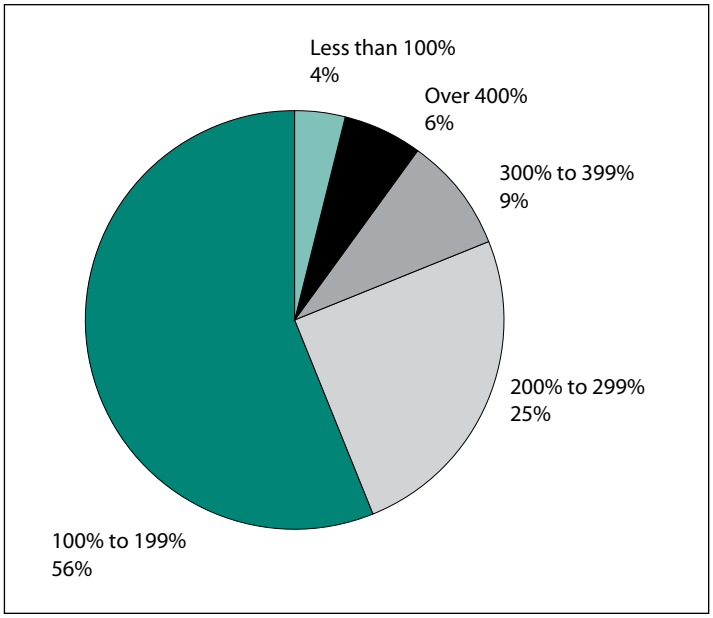
BORROWER STORIES

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 sharking. 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.

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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