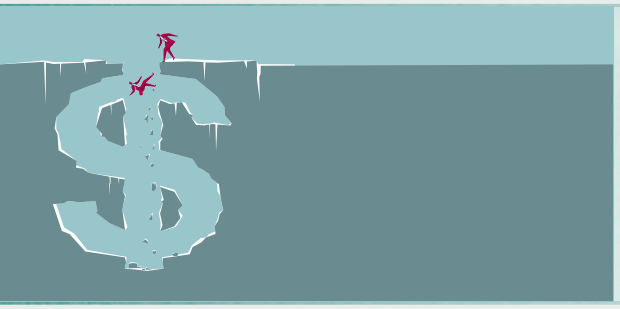

THE CUMULATIVE COSTS OF PREDATORY PRACTICES

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

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CENTER FOR RESPONSIBLE LENDING

www.responsiblelending.org

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FOREWORD

By Michael Calhoun, President

Shortly after the Center for Responsible Lending (CRL) started in 2002, we estimated the total cost of predatory mortgage lending to be $9.1 billion. That figure was of great concern then. Today the costs of all types of abusive lending have become literally incalculable, but the total adds up to *hundreds of billions of dollars*. As a whole, our series on *The State of Lending in America and its Impact on U.S. Households* shows how predatory lending has derailed economic opportunity for millions of Americans and weakened the U.S. economy.

The difference between a fair and affordable loan and a predatory loan often becomes the difference between achieving greater prosperity and falling into a cycle of unending debt.

In previous *State of Lending* chapters, we focused on specific types of loans—mortgages, credit cards, and payday loans, just to name a few—as well as practices in debt settlement and collection. In this final chapter, we take a broader look at the lending landscape. What are common characteristics of abusive loans? Who is most likely to be targeted? What are the costs? Finally, we also look at why predatory lending matters beyond its impact on individuals who are harmed.

Throughout the *State of Lending* series, we have presented data that tally up the dollars lost to abusive lending. This final chapter looks across products at immediate costs, as well as others, such as spillover costs. Some costs are immediate, such as exorbitant interest and excessive fees. Some costs occur over time, painfully, as with loan products that trigger high default rates, commonly leading to the loss of an essential asset such as a house or car.

These costs translate into sharp disparities in economic opportunity. The difference between a fair and affordable loan and a predatory loan often becomes the difference between achieving greater prosperity and falling into a cycle of unending debt. Responsible lending products can create a critical pathway to economic security, especially for low- and moderate-income families. For example, a sustainable car loan may enable a low-income worker to commute to the best job. A fair and affordable home loan can help a moderate-income family secure stable housing and build home equity.

The destruction would have less impact if an abusive loan was typically a one-time event, but this report shows how the damage can be compounded, creating a long-term barrier to upward mobility. Families who lose their home to foreclosure not only forfeit their existing equity, they also lose the opportunity to build savings, since they may be locked out of affordable credit for many years. Students who get loans to finance poor quality education programs find themselves with weak job prospects and heavy debt—debt that usually cannot be discharged in bankruptcy but can be garnished from Social Security benefits. Likewise, in most states creditors of auto and installment loans can seize property and garnish wages for up to 10 years when a borrower defaults on a high-cost loan that was never affordable. Over time, the damage to individuals becomes a community problem as significant spillover effects deplete the wealth of entire neighborhoods and communities.

The burdens of predatory lending fall hardest on those who could benefit most from wealth-building opportunities. For years, studies have shown that low-income families and people of color disproportionately receive abusive loans even when they could qualify for a decent loan. To make matters worse, this chapter shows that borrowers who fall prey to one predatory loan are often vulnerable to other lending abuses. As one example, borrowers trapped in a payday loan may end up paying abusive bank overdraft fees and ultimately lose their bank account—leaving them with high-cost fringe financial products as the only option. In this way, abusive lending systematically denies financial opportunities to families of color and weakens America's middle class—an outcome that ultimately hurts everyone.

Historically, U.S. public policy has played a key role in encouraging responsible credit that supports and strengthens working families. For example, after World War II, affordable loans from the Federal Housing Administration and Department of Veterans Affairs helped lift much of a generation into the middle class—though it is notable that families of color were largely excluded from these loans. Similarly, government-backed affordable student loans have enabled millions to pursue higher education, helping young people improve their prospects while providing the workforce needed for today's business.

Our recent history demonstrates the continuing need for strong public policies to ensure safe and constructive lending. During the build-up to the Great Recession, when government oversight on lending was weak, CRL was among the voices calling for an end to abusive subprime loans, especially the "exploding" adjustable rate mortgages that dominated the market during the worst of the crisis. For years, those calls went unheeded. There is no question that sensible lending rules would have done much to mitigate the enormous damage done by reckless lending.

Today, with key reforms in place and focused oversight by the Consumer Financial Protection Bureau (CFPB), the key task before us is balancing fair lending and access to credit. The challenge policymakers continue to face is how to encourage sustainable lending that helps produce a large, prosperous middle class while also preventing loans that pin families under crushing debt.

This is an achievable goal. In general, the line between "responsible" and "predatory" isn't all that thin. Responsible loans do not come with triple-digit interest rates. They are underwritten to assess affordability. They are not targeted to any particular group. On balance, responsible loans lead to more opportunities for borrowers and make families better off. As we complete the *State of Lending* series, our hope is that lending policies will result in fair and responsible loans that serve to build wealth, providing a path to financial success for **all** families.

EXECUTIVE SUMMARY

In this final chapter of *The State of Lending in America and its Impact on U.S. Households* series, we demonstrate the cumulative high costs of lending abuses, discuss lessons learned from efforts to address predatory lending, and suggest steps for further action. This chapter comprises the following sections:

- *Lending Abuses and Their Costs* describes how various types of lending abuses create excessive costs for families, communities, and the economy. Specific estimates are included where available.
- *Who Pays* discusses ways that consumers use credit and who is most affected by lending abuses. It also provides evidence that borrowers who fall prey to one abusive loan are often vulnerable to other lending abuses.
- *Cumulative Impact* draws from the previous two sections to describe how the costs of lending abuses compound for borrowers and communities.
- *A Role for Regulation* reviews past regulation of financial products and services, which has successfully prevented lending abuses while still preserving access to credit.

In this chapter, we show that the costs of lending abuses are substantial and wide-ranging. Although we cannot estimate the precise cost of all predatory lending practices, those that we can estimate establish that at a minimum hundreds of billions of dollars are drained from borrowers, communities, and the economy.

Specific findings in this chapter include:

- Loans with problematic terms or practices result in higher rates of default and foreclosure/repossession. For example, dealer-brokered auto loans, which often contain abusive provisions, are twice as likely to result in repossession as bank- or credit union-financed auto loans.
- The consequences of default, repossession, bankruptcy, and foreclosure are long-term. For example, one in seven job-seekers with blemished credit has been passed over for employment after a credit check, and borrowers who experience default pay much more for subsequent credit.
- The opportunity costs of abusive loans are significant. For example, during the same period that subprime loans peaked and millions of families unnecessarily lost their homes, families with similar credit characteristics who sustained homeownership experienced on average an $18,000 increase in wealth per family.
- Abusive loans have an impact on the economy as a whole. The foreclosure crisis depleted overall housing wealth and led to millions of job losses; predatory practices have been shown to diminish public trust and confidence in the financial system; and there is evidence that student debt is preventing economic growth, especially for young families.

- Across many financial products, low-income borrowers and borrowers of color are disproportionately affected by abusive loan terms and practices. Families with annual incomes below $25,000–$35,000 are much more likely to receive an abusive loan product. And in most cases, borrowers of color are two to three times more likely to receive an abusive loan compared with a white counterpart. The discriminatory effects of abusive lending clearly contribute to the widening wealth gap between families of color and white families.

- Loans with problematic terms are repeatedly concentrated in neighborhoods of color. Subprime mortgages and payday loans are two examples. Such concentration leads to a net drain of community wealth and value that could have been spent on productive economic activity and meeting vital community needs.

- Debt plays a profound role in the financial lives of most American households, with about three-quarters of households having at least one form of debt and many having multiple forms of debt. Indeed, most consumers are not simply mortgage holders, credit card users, payday loan borrowers, or car-title borrowers; they are likely to participate in more than one of these markets, often at the same time.

- Regulation and enforcement is an effective means for ending lending abuses while preserving access to credit. For example, the Credit Card Accountability and Disclosure Act of 2009 (Credit CARD Act) has continued to give people access to credit cards, while eliminating more than $4 billion in abusive fees and overall saving consumers $12.6 billion annually.

LENDING ABUSES AND THEIR COSTS

Consumer loans help families make large purchases and manage the cost of regular expenditures. Consumers and lenders work together under a specified set of terms and conditions, which can be responsible or abusive. Responsible lending provides fair, affordable, and transparent loans. Abusive loans, on the other hand, carry a host of deceptive and abusive loan features. Consumer loans are not inherently helpful or harmful. Just as a hammer can be used to build a house or take it down, lending can help families build wealth or strip it away.

The *State of Lending in America* series has explored many consumer credit products: mortgages, auto loans, credit cards, student loans, car-title loans, overdrafts, bank payday loans, payday loans, debt settlement, and debt collection. This chapter draws from each of these markets in explaining how lending affects households and how lending abuses harm families.[1]

Responsible loans—such as properly-underwritten, fully amortizing loans—help borrowers gain access to opportunities. A car loan allows a worker to buy an essential asset for commuting to and from a job. A student loan pays for tuition and the job prospects that come with a college degree. A mortgage not only enables a family to purchase shelter, but also allows it to build equity over time. Saving enough cash to send a child to college or to purchase a house outright is impossible for most working families. Access to responsible lending products puts these goals—and the benefits they provide—within reach for families of modest means.

Abusive loans, on the other hand, carry significant costs and lead to consumer harm. Payday and car-title loans, for example, lure borrowers in with the prospect of short-term cash but ultimately saddle borrowers in long-term, high-cost debt. Receiving a predatory loan can trap a borrower in a cycle of debt and prevent wealth-building opportunities for years to come.

Figure 1: Common Features of Harmful Consumer Lending

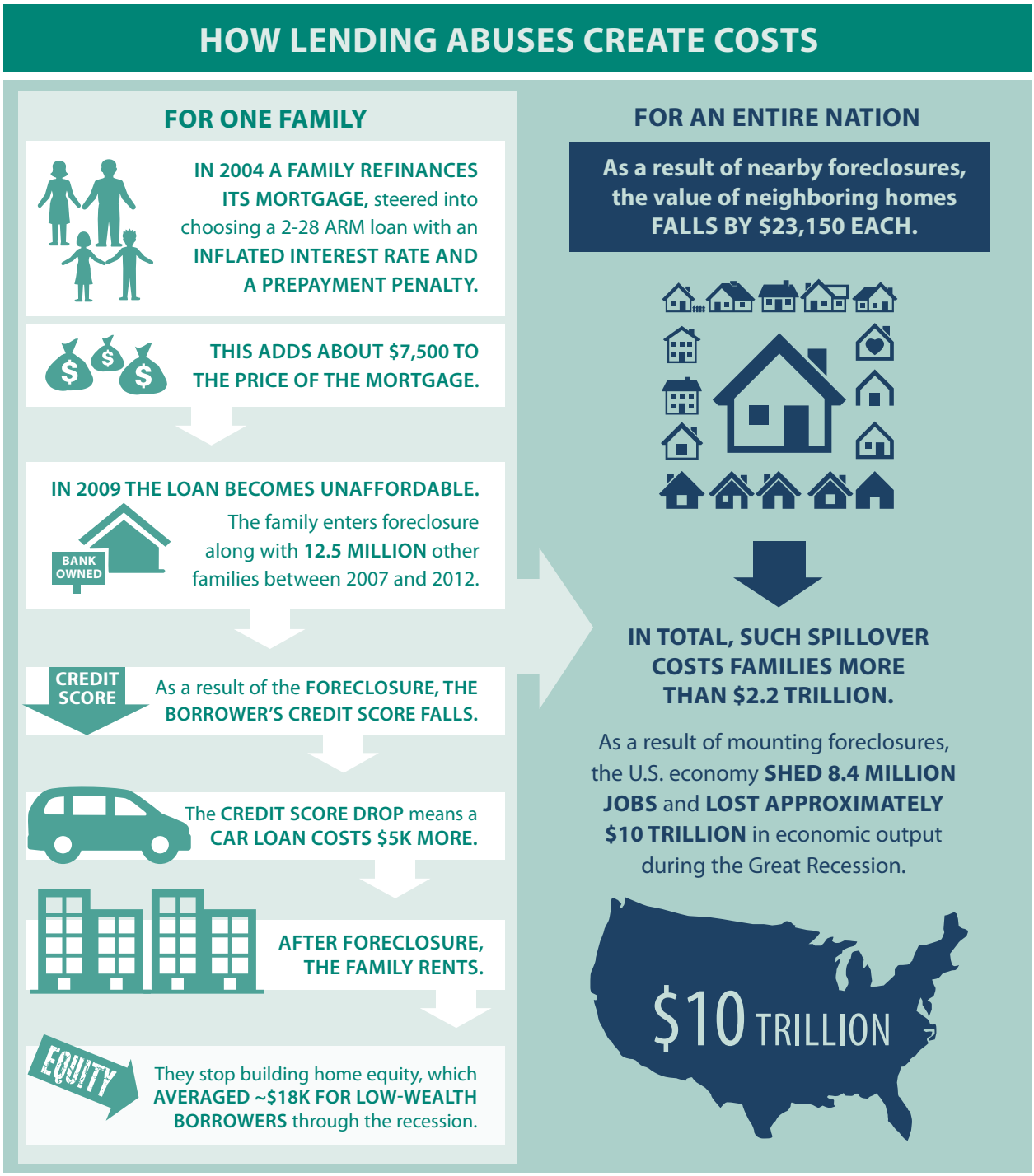
Signs of Abusive Loans

- Deceptive and misleading marketing that presents an incomplete picture of the risks and benefits of the product.
- Misleading documentation and a lack of transparency that make it hard for borrowers to understand the cost and terms of credit.
- Incomplete underwriting that ignores a borrower's ability to repay the loan and afford other essential living expenses.
- Misaligned incentives that drive lenders and other parties (mortgage brokers, automobile dealers) to push loan terms that are not in the best interest of the borrower.
- Unnecessary costs and hidden fees that inappropriately increase the overall cost of credit.
- A loan structure that encourages consumers to take out new loans shortly after repaying an initial loan, trapping the borrower in a cycle of debt.
- Collection and servicing practices or limitations on legal recourse (mandatory arbitration, harsh bankruptcy rules, other abuses and scams) that exacerbate financial damage to borrowers.
- Racial and other targeting (such as targeting neighborhoods of color, military bases, or low-income borrowers), which leads to discriminatory pricing.

1 For a summary of issues related to the products, please see the Appendix to this paper or the other chapters in this series.

The costs of lending abuses are wide-ranging and challenging to estimate. Our attempts here represent a first step at conceiving and quantifying the broad ranging costs of lending abuses. We lay out a framework describing how lending abuses engender costs and, when possible, provide estimates within each type of the scale of costs borne by current consumers.

Figure 2: How lending abuses create costs, a mortgage lending example



Sources: Stein, 2001; Center for Responsible Lending, 2013; MyFICO.com calculator; Freeman & Ratcliffe, 2012; GAO, 2013.

Mortgage lending abuses provide a recent example of how lending abuses introduced costs for borrowers and the community. Specific abuses, such as steering borrowers into loans that were more costly than they qualified for and offering loans with features like prepayment penalties and negative amortization, created immediate and estimable costs reflected in the price borrowers paid for mortgages. In addition, a lack of responsible underwriting meant many borrowers could not afford the payments that came with these loans, resulting in millions of foreclosures. The costs of foreclosure were manifested as lost equity and long-term credit harm for borrowers as well as decreased equity for neighbors and, ultimately, great nation-wide economic costs resulting from the Great Recession.

Costs to Borrowers

The most obvious and easily quantifiable costs of lending abuses, including immediate and long-term costs, are those that fall on borrowers. Immediate costs include excessive fees and interest and the costs associated with being caught in a debt trap. Long-term costs include paying for valueless services, costs that stem from loan default, and opportunity costs.

Excessive Fees and Interest

Throughout history, society has recognized the harm caused by the excessive interest that characterizes usurious lending. Usury has been admonished from its oldest mention in Verdic texts of Ancient India to recent statements from Catholics, including Pope Francis himself, who said: "When a family doesn't have enough to eat because it has to pay off loans to usurers, this isn't Christian! It's not human!" (Allen Jr., 2014).[2] Continuing in this tradition, our modern society continues to seek and place limits on excessive interest and fees. For example, the Credit CARD Act required late and penalty fees to be "reasonable and proportional" to the violation. Similarly, many state laws and the Military Lending Act (MLA) limit interest rates on all consumer loans to 36% APR, drawing a line in the sand indicating the maximum interest rate that may be charged for such loans.

Yet there are still lending products that saddle borrowers with interest and fees that many consider excessive. For example, car-title and payday loans carry triple-digit APRs. Some credit cards, called "fee-harvester" cards, come with up-front fees that exceed 25% of the total credit limit.[3] The CFPB (2014a) recently calculated that bank overdraft fees typically carry an extremely high annual percentage rate.[4]

In addition, some borrowers receive higher-cost loans than other borrowers despite having similar credit credentials. For example, a CFPB analysis of one lender's auto loans revealed that African-American and Latino borrowers were charged more than white borrowers (CFPB, 2013a). Auto dealers can mark up interest rates without disclosure to the borrower, and this lack of transparency facilitates discriminatory pricing. In the mortgage market, African-American and Latino borrowers with credit scores above 660 were more than three times as likely to receive a high-cost mortgage loan relative to white borrowers with the same credit profile (Bocian et al., 2011). In these cases, non-white borrowers paid costs in excess of what would be paid based on their credit risk.

A lack of transparency in the collections process also creates unjustifiable costs for consumers. The Federal Trade Commission (FTC) found that 94% of all sold consumer debts were sold without documentation that confirmed key information such as the identity of the debtor or the amount of the debt (FTC, 2013). As a result, collections companies are able to collect funds for debts the consumer is not obligated to pay.

Debt Traps

Some lending products create a long-term debt trap in addition to imposing high immediate costs. In the *State of Lending* chapters covering car-title, overdraft, payday, and bank payday loans, we described the amount of costly "churn" that borrowers experience when using these products. That

2 For more information, see Visser & McIntosh, 1998.

3 For example, a card with a $400 limit could charge $100 or more in up-front fees, leaving the borrower with just $300 for purchases.

4 A typical borrower overdraws the account by $24 and repays it in 3 days, paying an overdraft fee of $34.

is, because these types of loans are not underwritten for the ability of borrowers to repay the loan and afford essential expenditures, most borrowers run out of money after repaying a loan and quickly need to take out another loan, re-borrowing the principal and paying the high fee over and over again.

A long period of indebtedness compared with a short stated loan term or a high number of loans taken out per year indicate the presence of a debt trap. Payday loans, car-title loans, bank payday loans, and overdraft loans all display these hallmarks. For example, borrowers pay at least $2.6 billion annually as a direct result of churning payday loans (Montezemolo, 2013a).[5]

Borrowers pay at least $2.6 billion annually as a direct result of churning payday loans.

Because of data limitations, we have not been able to calculate a direct estimate of the cost of loan churn for other debt-trap products, although analysis shows that the debt trap exists for significant segments of consumers. For example, car-title borrowers at one lender typically took out nine high-cost loans per year with a typical term of 30 days (Montezemolo, 2013b). Also, more than one-third of borrowers with bank payday loans took out more than 20 loans in a year (Borné & Smith, 2013a). For an important segment of checking account customers, overdraft products are a debt trap: Nearly 2 million accountholders pay 20 or more overdraft fees in a single year (Borné & Smith, 2013b).

Costs for Valueless Services

Consumer costs can also arise from borrowers paying for or financing the cost of something that does not provide the advertised benefit. For example, CFPB has brought seven enforcement actions against lenders and banks that pushed borrowers to pay for credit monitoring, account protection, insurance, and other add-on products that did not provide consumer benefit (CFPB, 2014b). Similarly, consumers are saddled with costs by debt-settlement firms and for-profit colleges, but in too many cases are left with little to show for it.

In the case of debt settlement, the debt-settlement company must settle more than 50% of the consumer's debts to produce a financial benefit that exceeds the costs of the program (Parrish & Harnick, 2014). When companies fail to settle enough debts, consumers incur a net cost.[6] This costs ranges, on average, from $1,000 to $10,000 per consumer, depending on how many debts are settled (Parrish & Harnick, 2014).

Similarly, students at for-profit colleges finance above-average tuition with the promise of improved job prospects and increased income that come from earning a degree. However, many of the programs are very poor quality, and less than one-third of students at four-year, for-profit schools graduate (Parrish & Smith, 2014b). Even graduates may not see the promised job and income benefits touted by the school. A recent CFPB lawsuit against one of the nation's largest for-profit colleges alleges that the school "lured tens of thousands of students to take out private loans to cover expensive tuition costs by advertising bogus job prospects and career services" and then "used illegal debt collection tactics to strong-arm students into paying back those loans while still in school" (CFPB, 2014c).

5 The $2.6 billion figure includes only interest paid for loans taken out within 2 weeks of having paid off another loan. In total, borrowers pay $3.4 billion in payday loan fees annually.

6 By "incur a net cost," we mean that consumers pay more in added fees and interest than they receive as a benefit in the form of written-off debt.

Costs Resulting from Default

Loans with abusive terms have greater default rates and also increase the likelihood of declaring bankruptcy. Defaulting effects longer-term consequences, such as the potential loss of an essential asset (such as a house or car) or credit damage. The latter can lead not only to increased cost of credit, but also higher insurance rates and difficulty finding or maintaining employment.

CRL and others have demonstrated that loans with abusive terms and features result in default and other negative outcomes at often alarming rates:

- Mortgage loans with predatory features made at the height of the subprime lending boom were much more likely to become delinquent and end in foreclosure (Bocian et al., 2011).[7]
- Repossession rates for dealer-brokered auto loans, which are more likely to contain abusive features, are twice that of auto loans financed directly from a bank or credit union (American Bankers Association, 2013).
- One in six car-title loans results in repossession (Montezemolo, 2013b).

7 See the *State of Lending* series chapter on mortgages. The following table (reproduced from that chapter) shows rates of foreclosure and serious delinquency for mortgages made between 2004 and 2008 based upon various loan terms and features.

		Loan Status		
		Completed Foreclosures	Seriously Delinquent	Total
Rate Type	Non-fully-Amortizing 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%
	No Higher Rate	5.9%	6.2%	12.1%

Source: Bocian et al., 2011 (updated to reflect loan performance through February 2012)

Note: We define non-fully-amortizing adjustable rate mortgages (ARMs) as loans with any one of the following characteristics: 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 Treasury notes of comparable maturities.

- Companies that offered credit cards with predatory features experienced higher losses compared with issuers whose cards were more consumer-friendly (Frank, 2012).[8]
- Several studies find that payday loans have high borrower-level default rates. For example, a recent CRL study found that 46% of North Dakota payday borrowers defaulted within 2 years of taking out their first payday loan (Montezemolo & Wolff, 2015).[9] Payday loans have other negative consequences in addition to default; for example, Skiba & Tobacman (2009) found that borrowers are more likely to file for Chapter 13 bankruptcy as a result of taking out a payday loan.

Default, bankruptcy, foreclosure, and other negative outcomes introduce both immediate and long-term costs. Bankruptcy costs approximately $3,000 for legal fees alone (Lohrentz, 2013). These events also increase the cost of future borrowing by depressing a borrower's credit score. Negative information on a credit report, such as delinquency and default, reduces a borrower's credit score, sometimes causing a significant drop. Bankruptcy and foreclosure, in particular, have large negative impacts as shown in Figure 3.

Figure 3: Negative credit events have a large impact on credit scores

		Starting FICO Score		
FICO score after these events:		~680	~720	~780
	30 days late on mortgage	600–620	630–650	670–690
	90 days late on mortgage	600–620	610–630	650–670
	Foreclosure	575–595	570–590	620–640
	Bankruptcy	530–550	525–545	540–560

Source: Gaskin, 2011

8 This finding is about losses at card issuers and not for consumers. However, issuer losses stem from individual loan defaults, which affect consumers as well as companies.

9 Several other studies have similar findings. An earlier CRL study found that 44% of Oklahoma borrowers defaulted within 2 years of taking out their first payday loan (King & Parrish, 2011). Skiba & Tobacman (2008) found even higher default rates in a study of a large payday lender in Texas. Over half (54%) of payday borrowers paid biweekly defaulted within 1 year of having taken out their first loan. These researchers found in another study that borrowers are more likely to file for Chapter 13 bankruptcy as a result of taking out a payday loan (Skiba & Tobacman, 2009).

Figure 4 illustrates the dollar impact of a depressed credit score. This hypothetical borrower would pay $3,760 more on a new auto loan and almost $55,000 more on a mortgage over the life of the loans at today's interest rates as a result of the credit damage done by foreclosure. It is not unreasonable for riskier borrowers to pay more for credit, but it is unreasonable when that risk is the result of a predatory loan.

Figure 4: Borrower typically pays significantly more for credit following a foreclosure

		Auto purchase	Home purchase
Loan Assumptions	Amount financed	$26,000	$172,000
	Loan term (months)	48	360
	Starting score	780	780
Effect of Foreclosure	Post-foreclosure score	620–640	620–640
	Increase in interest rate	6.5%	1.6%
	Increase in interest paid	$ 3,760	$ 54,034

Source: April 2015 calculation from MyFico.com calculator: http://www.myfico.com/myfico/creditcentral/loanrates.aspx

Credit information increasingly—and controversially—factors into non-lending decisions as well. Products such as Experian's SafeRent Tenant Score and The Landlord Protection Agency's Tenant Scorecard enable landlords to use credit information in leasing decisions. Some landlords establish a credit score floor; potential renters with lower scores are turned away. Auto, homeowner, renter, and life insurance can also be influenced by credit report information (Fremstad & Traub, 2011). In most states, the use of credit profile information results in higher insurance rates for individuals with lower scores, though some states—including Massachusetts, California, and Hawaii—have outlawed the practice. Job-seekers may also have a harder time finding employment if they have blemished credit reports. A Demos survey of low- and moderate-income Americans with credit card debt found that one in seven job-seekers with blemished credit had been passed over for employment after a credit check (Traub, 2013).

Opportunity Costs

Costs for families grow even greater if we consider what likely would have occurred had the borrower received a responsible loan or not been pushed into default. For example, the majority of students at for-profit, four-year colleges do not graduate and would have been better served by earning a degree at a state institution. The opportunity cost for non-graduates is the lifetime income differential between a non-graduate's earnings income and the earnings of those with a four-year degree from a public college.

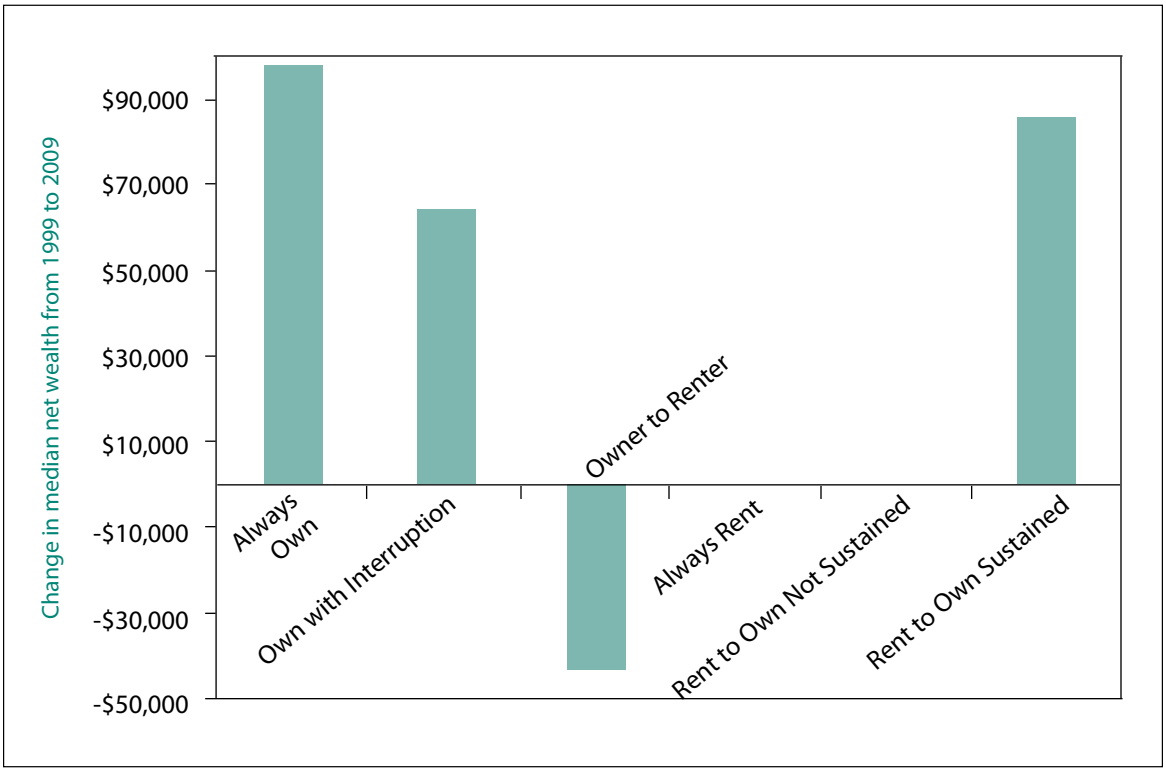
The recent mortgage lending crisis offers some concrete data points from which to explore opportunity costs. In the 2000s, millions of irresponsible subprime mortgages were made that eventually ended in default and foreclosure. Although we cannot know the counterfactual outcome—i.e., what would have happened if the predatory mortgage loans of the 2000s had been made responsibly—the existing evidence shows that products with sound underwriting and responsible features made to subprime borrowers during the same time performed much better than the predatory products peddled to similar borrowers.

For example, loans made to subprime borrowers in the Community Advantage Program (CAP)—30-year, fixed-rate loans without risky features—performed much better than other subprime loans

carrying higher rates and other risky features.[10] The Center for Community Capital found that the CAP loan "serious delinquency" rate (capturing borrowers who were more than 90 days late on a mortgage payment) was one-third that of subprime adjustable-rate loans and one-half that of subprime fixed-rate loans (Freedman & Ratcliffe, 2012). CAP borrowers also built wealth even during this tumultuous period: Median home equity across the portfolio was $18,000, with positive returns on investment of 27% through the third quarter in 2011. And CAP borrowers of all income groups had a higher net worth than similarly-situated renters, both before and after the recession (Freeman & Ratcliffe, 2012).

Researchers at Harvard's Joint Center for Housing Studies documented the opportunity costs by examining data across a wide range of income and house values and covering a variety of housing experiences, from continuously renting to continuously owning (Herbert et al., 2013). They found that between 1999 and 2009, homeowners who sustained homeownership saw an increase in overall wealth of approximately $90,000, including home equity and other sources of wealth. In all cases except for when owners became renters (as in the case of foreclosure), homeownership was associated with wealth accumulation (Herbert et al., 2013).

Figure 5: Sustained homeownership provides households the greatest opportunity to increase household wealth



Source: Herbert et al., 2013

10 The Center for Community Capital studied 46,453 CAP loans, which were made by traditional bank lenders, purchased by the nonprofit Self-Help Ventures Fund (which is affiliated with CRL), and securitized by Fannie Mae (Quercia et al., 2011). The loans were 30-year, fixed-rate loans without risky features (such as prepayment penalties and negative amortization) to subprime borrowers. The CAP's borrowers looked similar to those who received subprime loans elsewhere: Borrowers had lower-than-average credit scores (with half under 680); two-fifths were non-white; and 72% had a down payment of less than 5%. The CAP borrower's median income was approximately $31,000. For more information, see Freeman & Ratcliffe (2012).

Spillover Costs

Borrowers are not the only ones who incur costs from lending abuses; communities and the economy as a whole are also affected by lending abuses. These costs are even more difficult to estimate than the costs that accrue to borrowers. However, there is evidence, and in some cases estimates, demonstrating the effect. Spillover costs include the costs paid by others when a borrower cannot pay, ongoing wealth disparities, a reduction in trust and stability in the financial system, and macroeconomic costs such as recession and reduced economic output.

Others Pay When Borrowers Cannot

When borrowers cannot pay, others may step in to settle the debt. One study found that 19% of borrowers ultimately paid off their payday loan with help from friends and family (Pew, 2012). Furthermore, as the high costs of abusive loans deplete borrowers' resources, they may turn to family and friends, government benefits, or charitable assistance to meet their needs. In these ways, lenders get paid, but others ultimately pay the price.

As the high costs of abusive loans deplete borrowers' resources, they may turn to family and friends, government benefits, or charitable assistance to meet their needs.

Payday and car-title lending are associated with increased reliance on charity or government support. For example, Texas Catholic Charities estimated that nearly half of payday borrowers that received their charitable assistance identified the loans as contributing to their need to ask for help. The charity estimated it spent $1 million in 2010 to help individuals who had payday or car-title debt (Texas Catholic Conference, 2010). In addition, Melzer (2013) found that households who lived within easy access to payday loan stores were 20% more likely to use food stamps and 10% percent less likely to make required child support payments than similar households that did not have access to these stores.

In cases where the government is the lender, the costs of default fall on the taxpayer. For example, taxpayers fund the vast majority of student loans (CFPB, 2012). When borrowers cannot pay, the government (that is, taxpayers) ultimately holds the debt, while the schools have long since been paid.

Lending Inequities Contribute to Wealth Disparities

Wealth helps a household weather income disruption, pay for retirement, and increase its assets over time. Importantly, wealth can be transferred to future generations. Although there is a widening wealth gap between those at the top and the bottom of the economic ladder, there are also disparities among different racial and ethnic groups of similar incomes. Lending abuses, which disproportionately affect non-whites (as is discussed later in this chapter), perpetuate or expand wealth disparities.

Figure 6 shows median wealth for a variety of subgroups. Not surprisingly, homeowners of all races and ethnicities have considerably more wealth than renters. White families have considerably higher dollar amounts of wealth than families of color overall, for both homeowners and renters. In dollar terms, the median wealth gap between people of color and whites is more than $100,000 per household.

Figure 6: Median wealth and measures of relative wealth for selected white and non-white families

	All	Homeowners	Renters
Median Wealth	$77,000	$171,900	$4,800
Median White Wealth	$123,380	$214,550	$6,100
Median Black Wealth	$15,570	$86,100	$2,100
Median Latino Wealth	$15,000	$75,860	$4,470
Black Wealth Gap (White minus Black)	$107,810	$128,450	$4,000
Latino Wealth Gap (White minus Latino)	$108,380	$138,690	$1,630
Black Wealth Ratio (White divided by Black)	7.9	2.5	2.9
Latino Wealth Ratio (White divided by Latino)	8.2	2.8	1.4

Source: CRL calculations of data from Survey of Consumer Finances, 2010

Figure 6 also shows two measures of relative wealth, comparing families of color with whites. Overall, as a ratio, white wealth is 7.9 times that of African-Americans and 8.2 times that of Latinos. Other research has found even higher ratios; for example a 2011 Pew study, using a different national dataset, found the ratio of white to black wealth to be 20-to-1 (Kochhar et. al., 2011).[11] Wealth inequality across races and ethnicities persists for homeowners and renters, though wealth is distributed more equally within each group. White homeowners have 2.5 times the wealth of black homeowners and 2.8 times the wealth of Latino homeowners.

Researchers studying wealth inequality have found that homeownership is particularly important in explaining the large wealth gap between whites and non-whites. Shapiro (2013) found that a major factor in the gap was whether someone owned a home and for how long. In fact, virtually all of the studies that followed homeowners and renters over time have found that homeownership leads to greater wealth, all else being equal (Herbert et al., 2013). This was true particularly for lower-income households and families of color. Homeownership, funded in large part by mortgages, mitigates the overall wealth disparity between white and non-white families. Lending abuses that cause higher costs and risk of foreclosure exacerbate existing wealth inequities.

Predatory Lending Destabilizes and Erodes Trust in the Financial System

The financial system itself suffers as the result of the abusive practices of some banks and lenders. These costs can manifest as higher losses, reduced trust, and lower levels of participation in the financial system.

Predatory lending practices can generate costs for financial institutions as well as for their customers. For example, CRL examined the relationship between credit card practices and loss rates during the economic downturn and found that firms that employed harmful practices had higher losses (Frank, 2012). Interestingly, the use of these practices was the best predictor of losses—better than firm size, type, or geography.

11 The Survey of Consumer Finances is only one of the nationally-representative datasets with information on family wealth. Pew analyzes data from the Survey of Income and Program Participation (SIPP), another popular source of data for examining the wealth gap. The SIPP and SCF include different household assets and, as a result, the SIPP tends to provide lower estimates of overall wealth. For example, the SIPP doesn't include defined-benefit pension plans, the cash value of life insurance policies, the value of household furnishings and jewelry, and future claims on Social Security as assets.

Lending abuses by one firm can also lead to losses at other firms, since a single consumer may have loans from multiple lenders. Consumers under financial stress frequently need to choose which debt payments to make, repaying one lender while going delinquent on other debts. Recent research of consumer behavior found that auto loans top a consumer's "payment hierarchy," putting other lenders, such as mortgage lenders and credit card companies, at greater risk (Komos et al., 2012). In another example, junior mortgage lien holders commonly prevented loan modification and short-sale arrangements between borrowers and the first-lien holders during the foreclosure crisis. As a result, loans went to foreclosure rather than modification or short-sale, and primary mortgage lenders took a greater loss.[12]

Abusive lending practices can also contribute to distrust of the financial system, sparking other negative economic outcomes. Federal Reserve Board member Sarah Bloom Raskin (2013) attributes much of the public's current lack of trust in the financial system and banks to their unfair and deceptive lending practices of the past, in particular subprime mortgage lending, adding that payday lending and overdraft fees magnify "the public's lack of trust and confidence." Actions that tend to decrease overall economic activity (such as preferring cash) increased with low levels of trust (Sapienza & Zingales, 2009; Sapienza & Zingales, 2011).

Bank payday loans and high-cost overdraft programs have been shown to drive consumers out of the banking system entirely. Twenty-three percent of never-banked and 30% of previously-banked households cite costly products, previous troubles, or general distrust of banks[13] as the reason they do not have an account (FDIC, 2012).

Macroeconomic Costs

The U.S. and global economies rest on a foundation of the financial lives of millions of individuals. As a result, lending abuses that harm individuals have the potential to create macroeconomic costs.

Mortgage Lending

The Great Recession provides a vivid example of how lending abuses affecting individuals can affect the macroeconomy. Problems in the subprime market spilled over to communities with the greatest concentration of subprime mortgages and to the broader economy. The 12.5 million homes that went into foreclosure between 2007 and 2012 cascaded through the housing market and resulted in declines in home equity wealth for many homeowners, even those who owned their homes outright. Overall, housing wealth fell $7 trillion from its peak in 2005 to its trough in 2011.

The Great Recession provides a vivid example of how lending abuses affecting individuals can affect the macroeconomy.

12 One analysis showed that although 39% of properties in foreclosure in 2012 had multiple liens, only 4% of short-sales comprised loans with multiple liens (Bloomquist, 2012).

13 These percentages are the sum of the following reasons: "Can't open an account due to ID, credit, or banking history problems"; "Don't like dealing with and/or don't trust banks"; "Bank account fees or minimum requirements are too high"; "Previously had an account but the bank closed it."

Figure 7: Household real estate wealth fell dramatically following the collapse of subprime mortgages

Source: Federal Reserve Flow of Funds (release Z1, B.100(49)), Not inflation adjusted.

The housing market collapse triggered the Great Recession, the worse economic downturn since the Great Depression. The recession cost 8.4 million jobs, and the U.S. economy lost an estimated $10 trillion in economic output (GAO, 2013).

In testimony about the crisis, Federal Reserve Chairman Alan Greenspan identified subprime mortgages as "undeniably the original source of the crisis" (Greenspan, 2008). A congressional report also identified "the terms of these loans and . . . loosening underwriting controls and standards" as the fundamental causes of the crisis (U.S. Department of HUD, 2010).

Although many Americans felt the effects of the recession, low-income and minority neighborhoods shouldered a disproportionate share of the losses. Nearly one-quarter of loans in low-income neighborhoods and one-fifth of loans in neighborhoods of color led to foreclosure or serious delinquency, with significant implications for the long-term economic viability of these communities (Bocian et al., 2011). As of 2013, $2.2 trillion in home equity had been lost to property owners whose own homes were not threatened by foreclosures, but who lived near foreclosed homes, with half of these losses—$1.1 trillion—in communities of color (CRL, 2013). In addition to this monetary cost, these neighborhoods faced blight and increased crime (Kingsley et al., 2009). Concentration of foreclosures was one factor in neighborhood deterioration, but one study also implicated the failure of bank-owners of foreclosed properties to invest in the maintenance and upkeep of these properties in neighborhoods of color compared with white neighborhoods (NFHA, 2014).

Student Lending

The amount of outstanding student loan debt has grown rapidly over the decade to the point where student debt now eclipses any other consumer debt other than mortgages.[14] This has raised concerns over the broad and long-lasting negative consequences that this debt load may cause. Students pursue all kinds of degrees by taking on student debt. Particularly troubling are the debts taken on by students at for-profit colleges, which offer questionable financial benefit to students in the long run and rely heavily on students taking out federally subsidized debt (U.S. Senate HELP Committee, 2012). CFPB (2013b) accepted and analyzed public comments on student loans on this topic; commenters noted that student loan debt can:

- Delay or prevent the purchase of a home or car.
- Prevent an entrepreneur from accessing the financing necessary to start a new business.
- Reduce retirement savings for young workers and parents nearing retirement.
- Discourage graduates from pursuing socially beneficial careers (such as teaching) that require expensive advanced degrees.
- Substitute dollars on loan payments rather than more productive consumer spending.

There is evidence to support these concerns. Recent research has found high levels of debt (above $10,000) reduce the probability that a student will graduate, particularly among students of color (Zhan, 2012; Zhan, 2013). In addition, the Federal Reserve Bank of New York's consumer panel shows that young consumers with student loan debt held fewer asset-based debts (mortgages and auto loans) and had lower credit scores in 2012 than non-borrowers, the opposite of pre-recession trends (FRBNY, 2013). Young renters have been found to allocate a larger share of their monthly budgets to student loan debt, perhaps hampering their ability to save for a future down payment or afford a mortgage payment (JCHS, 2014).

Figure 8: Young consumers with student loans have fewer asset-based debts and lower credit scores in 2012

	With Student Loan Debt	Without Student Loan Debt
Mortgage ownership for 30-year-old consumers	22.8%	24.1%
Auto loan ownership for 25-year-old consumers	29.9%	30.0%
Credit score for 30-year-old consumers	633	658
Credit score for 25-year-old consumers	625	640

Source: Federal Reserve Bank of New York, 2013

14 The Federal Reserve's Quarterly Report on Households Debt and Credit showed student debt to be the largest non-housing component of outstanding consumer debt as of the third quarter of 2013.

Spending by young, educated workers has historically been an important component of overall consumer spending. Also, the act of household formation, which has been depressed in the years since the recession, boosts homeownership and the general economy. High levels of student loan debt threaten to temper the historically positive impact college graduates have had on the nation's economy.

Payday Lending

Payday loans also create externalities that affect the macroeconomy. One study found that the money payday borrowers spent on fees and interest would have been more efficiently spread through the economy if it had remained in the pockets of the borrowers. Payday lending led to a net drain of nearly $1 billion and over 14,000 jobs from the economy in 2012 (Lohrenz, 2013).

Unknown Costs

In some instances, publicly available data, such as state payday loan regulatory data or Home Mortgage Disclosure Act data, provide critical information that helps to quantify the cost and scale of abuses and hold lenders accountable for abusive practices. CRL and others have used these data to estimate the costs of particular lending abuses—costs that have been cited throughout this chapter. However, comprehensive public data are not available for all consumer loans. For example, comprehensive data about the terms and use of consumer installment loans are largely not publicly available.[15] More information would be helpful in improving understanding of how installment loans work and addressing specific abuses within the market.

In other areas, we are missing key pieces of data that are necessary to fully estimate the scale or scope of abuses. For example, we do not know how many debts the typical debt-settlement program participant settles, making it difficult to estimate how many consumers benefit or suffer and by how much (Parrish & Harnick, 2014). In another case, although we can estimate the impact of predatory auto lending practices such a "yo-yo" scams and financing negative equity on the total cost of an individual loan, public data are not available to estimate with confidence how many people these predatory practice affect or whether specific populations are targeted (Davis, 2012). Policymakers and regulators at the state and federal level should continue to require data from lenders, analyze data they collect, and make data available for public review.

15 SEC filings and other sources do provide some important information about such loans.

WHO PAYS

Consumer debt is widespread. The 2013 Survey of Consumer Finances shows that three-quarters (74.5%) of families held some type of consumer debt. All types of American families held debt, including 52.4% of the lowest-income and 84.5% of the highest income households, along with 72.9% of non-white and 75.3% of white households.

Abusive lending practices, some of which are widespread, therefore have the potential to affect nearly every American. For example, approximately 36 million checking accounts are overdrawn at least once annually (Borné & Smith, 2013b). And 77 million credit files—about one in three—include a debt in collections (Ratcliffe et al., 2014).

Not only do most households carry debt, but also many households use more than one type of consumer-credit product, as Figure 9 illustrates. CRL analysis of one national survey shows that 62% of consumers with a credit card also had a mortgage, and 89% of consumers with a mortgage also had at least one credit card. Using multiple products is also common practice for those who use non-traditional financial products, such as payday and car-title loans. For example, 55% of car-title borrowers also have received a payday loan.

Figure 9: Consumers use multiple credit products[16]

Consumers who have a …	Also have a …				
	Car-Title Loan	Credit Card	Mortgage	Payday Loan	Student Loan
Car-Title Loan		71.3%	68.0%	54.5%	35.4%
Credit Card	8.5%		61.9%	11.0%	19.6%
Mortgage	8.9%	88.8%		10.2%	20.3%
Payday Loan	37.3%	62.8%	68.3%		37.4%
Student Loan	15.2%	71.7%	80.8%	23.7%	

Source: CRL analysis of National Financial Capability Study state-by-state survey, 2012

These patterns emphasize the interconnections between consumer credit markets. Consumers are not simply mortgage holders, credit card users, payday loan borrowers, or car-title borrowers; they are likely to participate in more than one of these markets, often at the same time. Below we will present evidence that the use of one abusive product is not only correlated with but can also prompt a borrower to take out another risky loan.

Disproportionate impact on some communities

Certain types of families are most affected by predatory lending, and some communities see greater concentrations of abusive loans. Data illustrating who receives abusive loan products are not uniformly available. Nonetheless, the data that are available indicate that lending abuses disproportionately affect low-income families and people of color.

16 The frequencies show what percent of consumers who used the product given in the row also used the product given in the column. For example, 8.5% of credit card borrowers also had a car-title loan. Consumers were asked if they currently had mortgages, credit cards, and student loans, but asked if they had used payday or car-title loans over the previous 5 years.

For example, African-American and Latino borrowers with credit scores above 660 were more than three times as likely as white borrowers with the same credit profile to receive a high-cost mortgage loan (Bocian et al., 2011). African-American and Latino borrowers, as well as low-income families and communities, are also targets for debt-trap products and other abusive lending practices.

In another example, the median family income for students at for-profit colleges is approximately 50% of the national median household income.[17] Also, lower-income borrowers experience specific abusive lending practices (such as yo-yo scams in auto lending) at greater rates.

Figure 10: Low-income borrowers particularly affected by lending abuses

Car-Title Lending	Average gross income for borrowers is below $25,000
Payday Lending	Average gross income for borrowers is between $30,000–$35,000
Student Lending	Median family income for enrollees at for-profit colleges is under $25,000
Auto Lending	One-quarter of car buyers with incomes under $25,000 experienced a yo-yo scam
Overdrafts	Those with the most bank overdraft fees had incomes below $50,000

Sources: Montezemolo, 2013b; Montezemolo, 2013a; GAO, 2011; Davis & Frank, 2009; Borné & Smith, 2013b.

People of color are also particularly affected by lending abuses. Figure 11 displays "disparity ratios," which show the rate that populations of color receive abusive loan features relative to whites. In almost all cases, families of color receive predatory loans at higher rates than white borrowers. For example, the payday loan incidence rate is twice as high for African Americans as it is for whites.

In addition, as confirmed by a number of studies, African-American and Latinos pay more for the same types of loans after controlling for credit qualifications. For example, a CFPB analysis of one bank's auto lending practices found that relative to whites, African Americans paid an additional 29 basis points, and Latinos paid an additional 20 basis points, all else being equal—differences that were statistically significant. Similar discrepancies have also been documented throughout the auto lending market (Coehn, 2006).

17 The national median household income, according to the U.S. Census Bureau's combined American Community Survey for 2008–2012, was $53,046.

Figure 11: Non-white borrowers received loans with abusive features at higher rates than white borrowers

	African-Americans compared with whites	Latinos compared with whites
Subprime Mortgages		
One or more high-risk feature	1.6	1.6
Higher rate	2.8	2.2
Non-fully amortizing loan	1.5	1.7
Prepayment penalty	2.0	2.3
Payday Loans	2.2	1.0
Enrollment at for-profit colleges	2.8	1.5
Auto Loans with Dealer Mark-up	1.7	Data not available

Note: We calculated disparity ratios for each demographic group relative to whites. A disparity ratio of 1.0 indicates that both demographic groups had the same percentage of loans with the given abusive feature. Disparity ratios higher than 1.0 indicate a concentration of the abusive feature in the target (non-white) group.

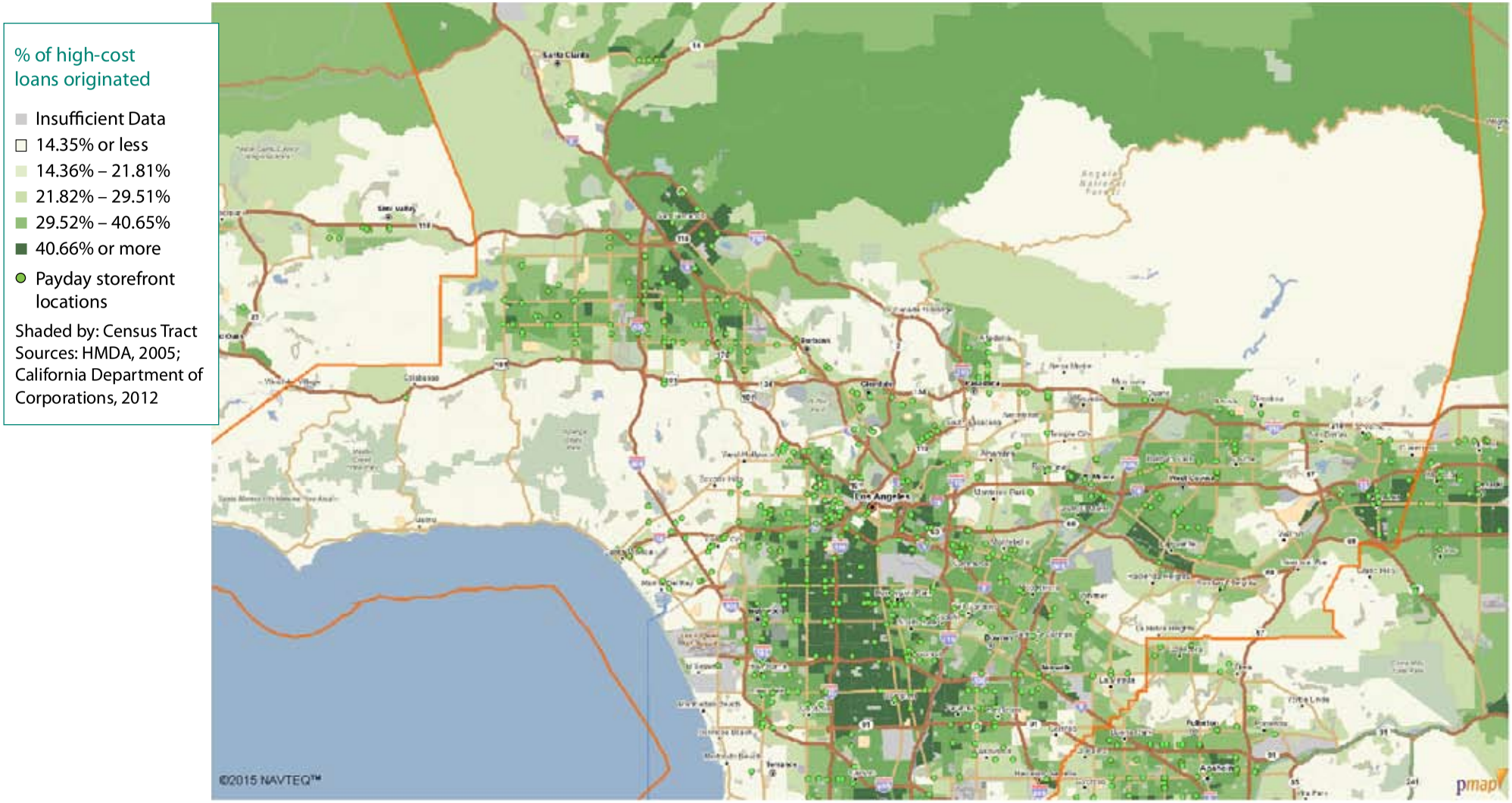
Sources: Mortgage disparity ratios from Bocian, 2013. CRL analyzed data from the following data sources to calculate the other disparity ratios: Pew, 2012 for payday lending; Parrish & Smith, 2014b for for-profit college enrollment; and Cohen, 2006 for auto lending.

Other specific groups—like the elderly and military servicemembers—also have been shown to be disproportionately affected. These families are among the least capable of absorbing added costs of predatory loans, as they are also those with the tightest budgets and most vulnerable balance sheets.

Abusive loans can also be geographically concentrated. In the 2000s, neighborhoods with high concentrations of low- and moderate-income families and/or families of color had higher concentrations of subprime mortgage originations. Payday lending storefronts, for example, are also highly concentrated in neighborhoods of color. CRL examined payday lending storefront locations in California and found that these stores were 2.4 times more concentrated in African-American and Latino communities, all else being equal (Li et al., 2009). CRL also analyzed North Carolina payday storefront locations prior to passage of the state's payday loan rate limitation, finding that African-American neighborhoods had three times as many payday stores per capita compared with white neighborhoods, all else being equal (King et al., 2005).

The geographic concentrations also reflect the fact that individual borrowers often have multiple kinds of risky loans. Figure 12 shows that Los Angeles County neighborhoods with high concentrations of high-cost mortgage loans at the height of the subprime lending boom are the same locations where payday stores chose to locate in 2012.

Figure 12: Payday loan store locations had high concentrations of high-cost mortgages originated in 2005 in Los Angeles County



Loan Stacking

Although some consumers generally can successfully use multiple responsible credit products simultaneously, the dangers escalate when loans carry predatory features. As described earlier, costly "churn" occurs when loans are not underwritten in light of the borrower's income and expenses, and as a result, borrowers re-borrow the principal and pay high fees over and over again. This problem is exacerbated when borrowers respond by "stacking" multiple types of loans together; for example, a car-title borrower who is about to lose his or her car to repossession might take out a payday loan to try to stay afloat.

Loan-stacking is very difficult to study because few existing data sources include detailed product information for all consumer-credit products.[18] Despite these data challenges, we offer below two cases of loan stacking drawn from recent history. These cases illustrate the interaction between seemingly distinct product markets and the ways in which stacking can magnify costs and risks for consumers.

Payday Lending and Overdrafts

Many payday borrowers pay high loan fees as well as overdraft or non-sufficient funds (NSF) fees directly resulting from the payday loan. This happens because payday lenders structure the agreements to automatically pay themselves back at the end of the loan term (either by cashing a check used to secure the loan or by directly gaining electronic access to the borrower's bank account). If the borrower has insufficient funds in their account to repay the lender, the bank may cover the transaction but charge an overdraft fee—typically $35 (Borné & Smith, 2013a). Otherwise, it will deny the transaction but charge a NSF fee, also typically $35 (CFPB, 2013c). In a survey, Pew (2013) found that 27% of payday borrowers said that payday loans "directly cause checking account overdrafts." Recent research from CFPB (2013d) finds that the majority of payday loan customers pay overdraft fees either caused by the payday loan payment or by another transaction.

CRL analyzed a representative sample of checking-account transactions from 2011 and 2012 and determined that nearly two-thirds (64%) of accounts that had payday loan activity within this period also paid at least one overdraft charge or NSF fee, compared with only one-quarter (25%) of accounts without payday activity[19] (Montezemolo & Wolff, 2015). In addition, this analysis found that nearly half (44%) of payday borrowers incurred an overdraft or NSF fee in the 14 days following a payday transaction.

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18 Existing publicly available sources for analyzing consumer credit fall into two types, both of which are insufficient for fully understanding the range of consumer experience.

1. The first type of data includes data that detail a single loan market (e.g., HMDA data on mortgage originations, state payday lending databases). These data provide critical detailed information about the market and terms of a single consumer credit product. However, researchers can only analyze consumer use of the product covered by the data.
2. The second data available are consumer level data (Federal Reserve Bank of New York's Consumer Credit Panel). These data include multiple types of consumer credit that a single household uses but provide few details about the terms of each product. Importantly, some key predatory products are not included in these data. (For example, payday lending is not a part of the Federal Reserve Bank of New York's consumer credit panel dataset.)

To fully understand the consumer experience, including a single household utilizing multiple products, these data need to be expanded to include more borrower information in the first type and more products and product details in the second.

19 We can only identify payments made through the ACH network in our data. Virtually all internet and bank payday payments are done through ACH, and approximately 15% of storefront borrowers use ACH payment.

Figure 13: Accounts with overdraft and payday transactions

	At least one overdraft or NSF fee	Total accounts	Percent of accounts with both overdraft NSF and payday transactions
At least one payday transaction	80	125	64%
No payday transactions	652	2,596	25%
Total accounts	732	2,721	27%

Source: CRL calculations of Lightspeed checking account data, 2011–2012

It is quite telling that making a payday loan payment caused one-third of payday borrowers to overdraw their checking accounts (Montezemolo & Wolff, 2015). A series of transactions shown in Figure 14 illustrates how this occurred for one elderly borrower.[20] On October 3rd, this borrower:

(a) received her income of her monthly Social Security deposit of $831 (item 7);

(b) made payments on deposit advance loans from her bank (items 1, 2, 3) and took out a new deposit advance loan (item 4);[21]

(c) made purchases at a gas station and two grocery stores (items 5, 8, 13); and

(d) repaid two payday loans (items 11, 14).

On October 4th, she was assessed a $35 overdraft fee (item 15) directly tied to the previous day's $288 payday loan payment (item 14).[22]

Figure 14: Example transactions for a payday borrower who overdrafts as a result of making a payday payment

Item #	Date posted	Amount debited	Amount credited	Transaction description
1	10/03	($19.50)		Deposit advance payment for loan taken out on 09/09
2	10/03	($16.50)		Deposit advance payment for loan taken out on 09/08
3	10/03	($220.00)		Deposit advance payment for loan taken out on 09/08
4	10/03		$500.00	Deposit advance loan proceeds deposited 10/01
5	10/03	($4.72)		Gas purchase 10/01
6	10/03	($55.00)		Check card purchase 10/01
7	10/03		$831.00	Social Security paycheck
8	10/03	($125.69)		Grocery store purchase 10/03
9	10/03	($32.50)		Bank payday loan payment for loan taken out on 09/02
10	10/03	($260.00)		Bank payday loan payment for loan taken out on 09/09
11	10/03	($293.75)		Payday loan payment
12	10/03	($6.95)		Fee for bill pay on 10/01
13	10/03	($34.67)		Grocery store purchase 10/01
14	10/03	($288.75)		Payday loan payment
15	10/04	($35.00)		Overdraft fee for $288.75 10/03 Payday Loan Payment

20 This example is taken from Montezemolo & Wolff, 2015.

21 CRL usually refers to deposit advance loans as "bank payday loans," as they are short-term loans repaid on the customer's next direct deposit.

22 The overdraft fee was actually assessed on October 4th but was clearly labeled as being tied to the specific payday loan payment on October 3rd.

Cash-out Mortgage Refinances for Debt Consolidation in the Subprime Boom

During the subprime mortgage boom, many lenders sold borrowers "cash-out" mortgage refinance loans. Borrowers who took out such loans already owned their homes and had built up equity. By refinancing, these borrowers liquidated some or all the equity they had built up and therefore increased the amount of principal they owed.

Many borrowers who took out such loans at this time used at least some of the proceeds to make payments on non-mortgage debt. Greenspan & Kennedy (2007) found that between 1991 and 2005, cash-out refinancing and the total amount of home equity used to pay down non-mortgage debt rose dramatically. In 2005 alone, they found that homeowners cashed out more than $140 billion of home equity to pay down other debts, including unsecured debts like credit cards.

Cash-out refinances were particularly common in the subprime market. The majority of subprime loans made during the boom were used to refinance rather than purchase a home, and the majority of the refinance loans in the subprime market provided cash out (CRL, 2007). Only 10% of these loans went to first-time home buyers. Cash-out refinances represented 83% of subprime refinances in 2004 and only 47% of prime refinances (James & Robinson, 2005).

Expensive hidden fees were common features of credit cards during this time, and this may have made refinancing other debts into a mortgage seem like an appealing alternative. In fact, then-Federal Reserve Chairman Alan Greenspan cited this as a smart financial move for American households at that time (Greenspan, 2004). However, refinancing resulted in borrowers taking on greater amounts of secured debt (in a mortgage) in order to pay off unsecured debt (in the form of credit card debt). The increased debt backed by their homes, coupled with abusive and unaffordable terms of many of these mortgages, dramatically increased the likelihood borrowers would lose their homes.

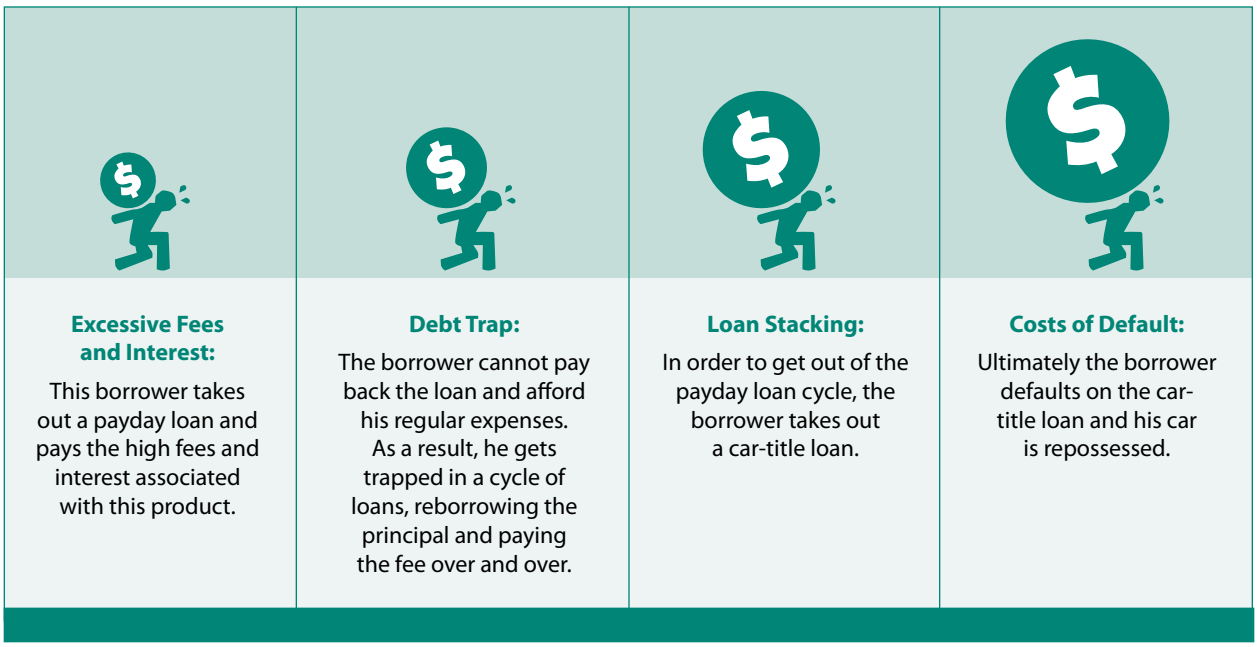
CUMULATIVE IMPACT

At best, the costs of lending abuses are isolated to a single loan that is paid off with capped (albeit excessive) costs borne by the borrower. However, the costs of predatory lending can also compound. As described in this chapter, many borrowers face excessive fees or interest rates, an inescapable cycle of debt, lost opportunities for wealth-building, and impaired credit from defaults brought about by an abusive loan. They may see costs compound as the use of one predatory loan product spurs the use of yet another abusive loan. And if their communities are particular targets for predatory lending, they—and future generations—face a disproportionate impact compared with other communities.

Figure 15 shows a theoretical—but completely likely—example of costs compounding for a borrower. In this case, a payday loan borrower pays excessive fees and interest and becomes caught in a debt trap, incurring high immediate costs. The borrower is overwhelmed and, attempting to stay afloat, takes out a car-title loan to pay off the payday loan, incurring additional costs resulting from loan-stacking. Ultimately, the borrower defaults and loses his or her car, a critical asset for getting to and from work. This example highlights why focusing only at the immediate cost of the fee paid on the initial loan significantly underestimates the costs this abusive loan ultimately caused for the borrower.

As described previously, certain populations and communities are more likely to receive loans with abusive features of all types. This creates another form of cumulative impact. For example, because of new mortgage lending laws, abusive subprime mortgages are largely gone from today's mortgage market. However, the locations where these loans were most highly concentrated in the 2000s also have high concentrations of payday loans today. In addition, the populations that were most likely to receive abusive subprime loans a decade ago are also those most likely to receive loans with other abusive features today. In this way, the costs of one kind of abusive lending follow on the costs of previous lending abuses. Over time, communities struggle to get ahead as they bear compounding costs.

Figure 15: Example of Compounding Costs for Borrowers



A ROLE FOR REGULATION

With the costs so high for borrowers, communities, and the economy, it is essential that policymakers make and enforce strong regulations to eliminate abusive financial practices and promote responsible lending. Indeed, recent regulations of financial products have saved consumers billions of dollars. For example, the Credit CARD act is estimated to have saved consumers $12.6 billion annually (Argawal et al., 2014).

Policies that guide lenders to make responsible loans help ensure that lending has the positive impacts it promises.

The U.S. has made strides since the financial crisis to improve regulation and hold lenders accountable for the impact of their products. The Credit CARD Act and the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) are examples of recent laws that protect consumers and set the stage for fair competition by establishing basic rules and standards. The Dodd-Frank Act put in place important consumer protections for mortgage lending and created CFPB to ensure fairness for consumers in the financial marketplace. The Credit CARD Act limited credit card practices that harmed consumers. States have also taken action to reign in abusive lending practices in areas from mortgages to payday lending. Regulators have also taken action by issuing new rules and enforcing existing rules. Recent rules governing bank payday lending issued by FDIC and OCC are an example of how such actions can improve the marketplace for consumers. In this section we review recent reforms and highlight areas where more work is needed.

Consumers and policymakers alike seek to harness the positive potential of lending. Lenders, ultimately concerned most with their bottom line, may be able to succeed both in circumstances where borrowers succeed and when borrowers fail depending on their business model, as we've seen throughout the *State of Lending in America* series. Policies that guide lenders to make responsible loans help ensure that lending has the positive impacts it promises. Regulations should create a marketplace that encourages fair competition and protects consumers.

Existing Laws & Regulations

The Dodd-Frank Act supports sustainable mortgage lending

The Dodd-Frank Act put in place new requirements for mortgages in the wake of the subprime crisis, including the Ability-to-Repay and Qualified Mortgage (QM) reforms. The Act restricted risky product features by allowing mortgages that fall into a QM category to be exempt from some liability provisions in the law. In addition to meeting one of four "pathways" to underwriting for affordability,[23] QM loans meet all of the following basic product feature requirements:

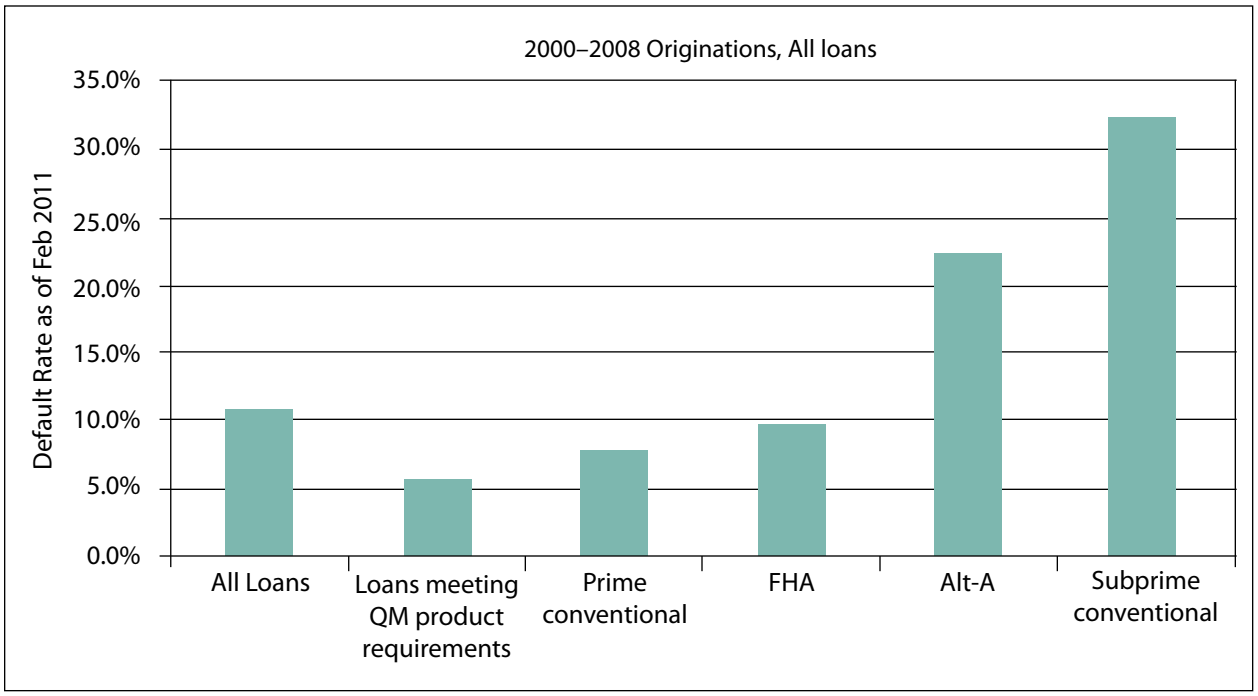
- Full amortization,
- Points and fees no greater than 3% of the total loan amount,
- Loan term not to exceed 30 years, and
- Evaluation of the borrower's ability to repay adjustable-rate mortgages based on the maximum rate permitted during the first 5 years.

Congress enacted these reforms in response to the mortgage crisis of the 2000s, in which subprime and near-subprime mortgages with risky features—such as lack of underwriting, interest-only or negatively amortizing loans, high points and fees, and prepayment penalties—defaulted at much higher rates than subprime loans without these features. For example, between 2000 and 2008, "Alt-A" mortgages—near-subprime loans with risky features—defaulted at a rate that was four times that of loans originated at the same time that met the QM standard. The effects of abusive mortgage lending have been made all-too-clear by the Great Recession, but responsible mortgage lending remains an important tool for households to build wealth. Policymakers can, and have, put policies in place to promote responsible mortgage lending.

23 These options include:

1. Loans underwritten to a back-end debt-to-income ratio of 43% or below, without a balloon payment.
2. Loans eligible for a federal guarantee based on agency approved underwriting criteria including "compensating factors."
3. Loans originated by small lenders and held in portfolio that are underwritten in a way that considers debt-to-income.
4. Balloon loans originated by lenders in rural or underserved areas and held in portfolio that are underwritten in a way that considers debt-to-income (after a two-year period of transition for all small creditors).

Figure 16: Default Rates for QM-Like Loans Are Substantially Lower



Source: Quercia et al., 2012

The success of the Credit CARD Act

The Credit CARD Act reigned in some of the worst abuses in this market: hair-trigger penalty re-pricing; bait-and-switch tactics; and "universal default," in which a borrower's interest rate could jump as a result of a late payment on a different account. The law also put limits on certain fees and required fees to be "reasonable and proportional" to the violation. Research from a variety of sources has documented the benefits of this law.

- Cardholders have a much more realistic idea of what they will actually by paying. The difference between the interest rate advertised and the actual interest rate that consumers paid dropped significantly after the Credit CARD Act was passed and implemented, and the dates various parts of the Credit CARD Act took effect had a statistically-significant impact on this decline (Frank, 2011).
- Limits on specific fees saved consumers $4 billion in 2012. CFPB (2013e) analyzed 85%–90% of all credit card accounts and found that late fees declined on average by approximately $6, resulting in savings of $1.5 billion for consumers. CFPB also found that the incidence of over-the-limit fees fell from 7.9% to 0.4%, saving customers approximately $2.5 billion. It also found that overall costs for card holders declined by 1.9% (CFPB, 2013e).[24]
- Consumer savings totaled $12.6 billion. An academic analysis of 150 million credit card accounts found that overall borrowing costs declined after the implementation of the Credit CARD Act, for a total savings of $12.6 billion per year (Argarwal et al., 2014).

24 In addition to these specific findings, CFPB's report contradicted industry claims that the CARD Act raised prices for consumers and reduced access to credit.

Successful state payday lending reforms

Many states have taken steps to limit payday lending and to eliminate or at least significantly reduce the costly debt trap these loans create for borrowers. Twenty-one states, including the District of Columbia, have put in place significant reforms that either eliminate or limit the debt trap. Fifteen of these states have rate caps, which effectively eliminate the payday lending debt trap. Six other states have adopted policies that significantly limit payday lending in other ways.

For example, North Carolina has a 36% APR usury limit that applies to payday loans. In 2001, lawmakers allowed the law authorizing payday lending to sunset, and subsequent strong enforcement actions meant that storefront payday lenders closed up shop in the state by 2006. Lower-cost products remain; for example, one product—offered by the largest credit union in the state, the North Carolina State Employees Credit Union— has a maximum APR of 12% and an automatic savings component that has resulted in members saving $29 million in credit union savings accounts (SECU, 2013).[25] Research by the University of North Carolina's Center for Community Capital (2007) documented that the rate cap benefited North Carolinians, and that most low- and moderate-income residents—even those who had previously used payday loans—welcomed the change. Researchers concluded, "[m]ost surveyed households consider themselves better off or unaffected by the closing of payday loan stores." Households found a variety of ways to manage financial stresses and expressed their happiness that payday loans were no longer in the state.

Researchers at Pew (2012) found restrictive state laws effectively limited payday borrowing and that state restrictions on storefront lending did not drive customers to other payday loan sources (online or from banks). They found that 95% of would-be storefront payday borrowers found alternative ways to make ends meet while just 5% took out payday loans from other sources.

Future Areas for Regulation

In laying out a vision for improved regulation of financial markets in the wake of the Great Recession, the White House identified promoting "transparency, simplicity, fairness, accountability, and access" as goals for the regulation of consumer financial markets (U.S. Department of Treasury, 2009). These goals remain important and relevant as the U.S. continues to restructure rules that govern consumer financial products, and CFPB works to enforce those rules. The Credit CARD Act and state payday laws show how regulation can be effective and result in significant savings. Additional significant reforms have recently come into effect. For example QM rules, which prevent the worst of the subprime mortgage lending abuses, took effect in January 2014, and FDIC and OCC issued rules limiting payday lending by banks in November 2013.

25 Savings through 12/31/2012. For more information about the terms and structure of this product, see the information on their website: https://www.ncsecu.org/PersonalLoans/SalaryAdvance.html

CONCLUSION

As we have identified throughout the *State of Lending* series, more work needs to be done. Consumer credit has the power to change household budgets and balance sheets as well as to affect the health of communities and the national economy. Loans allow borrowers to take the first step down a new path for themselves and their family. The loans' terms and conditions profoundly affect the direction of that path and whether it will bring them closer to or further away from their goals. Regulations that protect consumers at this critical juncture are and will continue to be important for borrowers, communities, and our country.

Loans allow borrowers to take the first step down a new path for themselves and their family. The loans' terms and conditions profoundly affect the direction of that path and whether it will bring them closer to or further away from their goals.

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APPENDIX: Overview of lending topics covered in *The State of Lending in America series*

This Appendix provides a summary of the lending topics covered in prior *State of Lending* chapters.[26]

Abuses in Traditional Lending

Mortgages

Mortgages are a critical financial tool that enable families to both gain access to stable housing and build long-term wealth. Abuses in mortgage lending over the past decade have saddled families with unsustainable loans that have engendered millions of foreclosures and destroyed generational wealth building opportunities. Thankfully, the worst lending practices of the subprime boom—including loans with prepayment penalties, negative amortization, and no documentation of income—were eliminated in the Dodd-Frank Act and are no longer part of the mortgage market.

Although these consumer protections have been critical for consumers, the market has now shifted to the other extreme: Overly restrictive credit requirements are preventing homeownership. The Urban Institute has estimated that credit score requirements placed on new mortgage originations have resulted in approximately 1.2 million fewer loans per year (Goodman et al., 2014). This means that fewer creditworthy families are able to take advantage of one of the most accessible ways to build wealth in the United States.

Policy Recommendations:

- Protect reforms that regulate harmful mortgage products.
- Promote effective foreclosure prevention activities and promote loan modification programs that assist homeowners who are behind on mortgage payments/in danger losing their homes to foreclosure.
- Avoid mandated downpayment requirements that limit access to mortgage credit for low-wealth families.
- Support mortgage finance reform that prioritizes broad access to the mortgage market for all qualified borrowers, including:
  - An explicit, actuarially sound guarantee from the U.S. government for mortgages in a future secondary market structure;
  - Federally-mandated requirements that all secondary market entities that benefit from federal guarantees serve all qualified homeowners, rather than preferred market segments; and
  - A future mortgage finance system which encourages competition and offers broad market access to the secondary capital markets for both small and large lenders.

26 For more information, please read the full chapters at http://www.responsiblelending.org/state-of-lending/

Auto Loans

For many American families, a car is not merely a luxury, but rather is a basic necessity and a prerequisite to opportunity. Driving can open the door to employment, education, health care, and other options that are necessary for a safe and productive life.

Cars are often the largest household purchase a family will make. In fact, cars are the most common nonfinancial asset held by American families (Bricker et al., 2012). Auto financing done well helps families fairly acquire an asset that expands access to economic opportunity. Despite the importance of cars in our communities, however, buying and financing a vehicle remains a challenging task for consumers who often encounter several hidden abuses along the way. Car buyers—especially those of low and moderate incomes—can be subject to a wide array of tricks and scams that can even cost more than a car is worth.

Abuses in the auto lending market—especially in the subprime auto lending market—have existed for some time, but the subprime market has grown significantly in recent years. Growth within the subprime auto market suggests that more and more consumers are at risk and likely victims of auto lending abuses. Dealer interest rate mark-ups, yo-yo scams, and potentially worthless add-on products written into sales contracts end up costing consumers billions every year—and sometimes their car as well. High interest rates and increasingly lax underwriting contribute to consumers taking on loans they cannot afford, as evidenced by rising subprime auto loan payment defaults and delinquencies. All of these factors create an array of layered risks, some very similar to those present in the housing market before the mortgage collapse, and all merit the attention of regulators and policymakers alike.

Policy Recommendations:

- Divorce auto dealer compensation from the interest rate borrowers pay on all vehicle loans, thus reducing the risk of egregious marked-up interest loans for consumers.
- Prohibit yo-yo scams by prohibiting the dealer from unwinding a finance contract after allowing the consumer to leave with the car.
- 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.

Credit Cards

Credit card debt is the fourth largest source of debt for American households, after mortgages, student loans, and auto loans. Past abuses in the credit card markets—including high interest rates, unfair terms, and bait-and-switch tactics with due dates—added considerable costs to cardholders. The most egregious offenses were remedied by the Credit CARD Act. As a result, credit card pricing today is much more fair and transparent. Even the credit card industry agrees that the post-Credit CARD Act market is better for both consumers and the industry, confirming that consumer protections really work.

However, problems still remain, including deferred-interest cards, fee harvester cards, and aggressive selling of add-on products and services.

Policy Recommendations:

- Defend the Credit CARD Act.
- Curb aggressive marketing of debt protection and insurance products and ensure that those products actually benefit the consumer.
- Fix loopholes on fee harvester cards.
- Ensure that consumers are not surprised by high fees on deferred-interest/zero-interest credit cards.

Student Loans

In 2010, one in five U.S. households carried some form of student loan debt, up from one in eight households in 2004. By the end of 2014, student loan debt was the largest source of consumer debt besides mortgages, surpassing credit card, auto, and other debt. Today, over $1 trillion in student loan debt is outstanding.

Multiple issues affect student loan debt, both during origination and in the servicing and collection of this debt. Federal student loans are not underwritten like other loans; instead, borrowers rely on receiving an education that will allow them to obtain a well-paying job that will provide them with an ability to repay their debt. The poor quality of many programs at for-profit schools and their often aggressive and deceptive marketing tactics can leave students with large amounts of debt (both federal and private), while failing adequately to prepare students for their chosen profession. Many students are then left with an unmanageable debt burdens and few job prospects, causing for-profit attendees to make up a disproportionate share of those who default on student loan debt.

Loan servicing and debt relief for distressed borrowers are also critical student debt issues. The CFPB has found that student loan borrowers often fall victim to loan servicer errors, egregious fees, and lack of disclosure. Many borrowers are not adequately informed about their loan repayment options. These failures can be addressed and corrected by proper regulation. Finally, some students are encouraged to take out more costly and risky private student loans, when safer federal programs are still available to them.

Policy Recommendations:

- Increase state and federal oversight of for-profit educational institutions to end abuses in that sector.
- Ensure that the Department of Education requires and enforces the higher standard of consumer protection by its contractors servicing and collecting federal student loans.
- Require school certification of private student loans to prevent over-borrowing and encourage students to exhaust their federal loans first, and end unfair and deceptive practices in this sector.
- Allow for the discharge of federal and private student loan debt in bankruptcy court, and ensure that distressed borrowers access repayment plans to avoid default.

Debt-Trap Lending

Car-Title Loans

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. Car-title loans use the car—an essential asset for most families—as collateral and generally require full repayment within a month. Borrowers typically cannot afford to repay these loans and pay their regular living expenses, so they typically take out loan after loan, re-paying the substantial fee to re-borrow the principal. The threat of repossession, which can put in danger borrowers' ability to get to work and earn a living, means that they prioritize paying the loans, even if they cannot afford them. The typical car-title borrower takes out nine one-month loans per year at 300% APR, paying $2,349 in fees alone for a loan of only $1,042. The national car-title market is large: CRL estimates that there are over 8,100 stores that originate 2 billion loans per year, with borrowers paying $4.3 billion in fees.

Policy Recommendations:

- States and Congress should limit the APR on car-title loans to 36%.
- CFPB, which is poised to promulgate rules addressing the car-title lending debt trap, should require lenders to determine the borrower's ability to repay the loan without re-borrowing, including consideration of income and expenses.
- 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.
- States should vigorously enforce their laws and work in partnership with federal regulators to address attempts at subterfuge.
- Federal regulators—including the Department of Justice, FTC, and CFPB—should use their enforcement authority to address violations of law.
- Borrowers in default should receive 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). In addition, the sale of repossessed vehicles should be required to be commercial reasonable, with any surplus returned to the borrower.

Overdraft Loans

Overdraft fees cost consumers approximately $16.7 billion every year. Overdraft loans originally started a courtesy extension of credit to consumers for shortfalls in their checking accounts, but they have since turned into a revenue-creating machine for banks. The median overdraft fee is $35, and the median size of the triggering transaction is under $20, which results in a very high-interest, very short-term loan.

Public pressure and lawsuits have led some of the biggest banks to stop some egregious practices, such as reordering transactions to maximize overdraft fees. Some banks have chosen to stop charging overdraft fees on some transactions, including debit card transactions, and several have introduced accounts without overdraft fees at all. The rise of "extended overdraft" fees, however, marks a trend in the opposite direction.

Policy Recommendations:

- Prohibit overdraft fees on debit card and ATM transactions, which financial institutions can easily decline at no cost to the consumer.
- Prohibit overdraft fees on prepaid cards.
- Assess the implications of the increasing percentage of overdraft fees triggered by electronic transactions, including one-time ACH transactions that are substantively indistinguishable from one-time debit card purchases.
- Prohibit manipulation of transaction posting order to increase fees.
- Limit the number of overdraft fees, including "extended" overdraft fees, that financial institutions can charge customers.
- Require that overdraft fees be reasonable and proportional to the underlying transaction and to the cost to the bank of covering the overdraft.
- Require that the costs of overdrafts be disclosed as an annual percentage rate.

Bank Payday Loans

Up until recently, some banks made direct payday loans to their checking account customers. These loans came with average APRs between 225% and 300%, and they created a cycle of debt that ensnared borrowers into repeat borrowing. In 2014, however, FDIC and OCC put in place guidance that required strong consumer protections for these loans. As a result, all banks are now backing away from these loans and ceasing this portion of their business, although one bank has introduced a new product that is lower-cost but still problematic. Still, the FDIC/OCC guidance represented a huge victory for consumers, especially financially vulnerable borrowers and their families.

Policy Recommendations:

- The Federal Reserve Board should issue supervisory guidance addressing bank payday loans that clarifies appropriate underwriting procedures, limits the number of loans, and requires that fees be reasonable.
- CPFB should use its authority to ensure lenders are not trapping borrowers in a cycle of payday loans. It should also make improvements to existing consumer regulations, including the APR disclosure under the Truth in Lending Act, and protections against mandatory automatic repayment under the Electronic Funds Transfer Act.

Payday Loans

Payday loans are marketed as quick and easy solutions to a financial emergency but often only worsen financial problems. Borrowers take out a small-dollar loan (typically for $350) and write a post-dated check or provide electronic account access to secure the loan, which is due in full on their next payday (usually two weeks later). Lenders are thus "first in line" to be repaid on the day when the borrower should be most able to do so—his or her payday.

The very structure of payday loans—lack of underwriting for affordability, high fees, short-term due date, single balloon payment due on a borrower's payday, and collateral in the form of a post-dated check or electronic access to the bank account—means that payday borrowers typically enter into a cycle of debt. That is, borrowers typically pay back a loan, run out of money a few days later, and then have to re-borrow from the lender. The typical borrower takes out 10 loans per year, repaying over $450 in fees lone for a $350 loan. Payday borrowers pay $3.4 billion in fees annually, at least $2.6 billion of which is due to loan churn (when a new loan is taken out shortly after a prior loan is repaid).

Policy Recommendations:

- States and Congress should enact a 36% APR limit applicable to all borrowers, similar to what Congress enacted for active-duty military and their families in the Military Lending Act.
- CPFB, which is poised to promulgate payday lending rules, should:
  - require lender to evaluate borrowers' ability to repay the loan without re-borrowing, including consideration of income and expenses;
  - not provide a safe harbor for loans that are poorly, or not at all, underwritten;
  - not sanction any series of repeat loans or rollovers; and
  - establish an outer limit on the length of indebtedness that is no longer than the FDIC's 2005 guidelines (90 days in a 12-month period).
- Federal regulators—including the Department of Justice, FTC and CFPB—should use their enforcement authority against payday lenders to address violations of law.
- States should vigorously enforce their laws against unlicensed lenders and should work in partnership with federal regulators to address attempts at subterfuge.

Abusive Debt Collection & Debt Settlement

Debt Collection/Buying

Once a consumer obtains a loan, an entirely different set of actors and rules comes into play in collecting the loan should it go into default. If a borrower is unable to make payments on a loan for a certain period of time, the lender will typically deem the obligation to be in default and attempt to collect on the debt. The lender can do so by pursuing the borrower itself using an internal collections department or by outsourcing collection activities to a third-party debt collector or law firm. After a certain amount of time, the lender will deem the debt "uncollectable" and will charge-off the account on its records. At this point, the lender will often sell the debt to a debt buyer, a specialized

company that purchases charged-off and other delinquent debts to collect on the debts itself or by hiring collection agencies or law firms to collect for it. According to the FTC, debt buying is one of the most significant changes in the debt collection industry in recent years.

In the U.S., more than one in seven adults is being pursued by debt collectors for an average debt of $1,500. In 2013, the Federal Trade Commission (FTC) received over 200,000 complaints about debt collection—the highest number of complaints on any topic other than identity theft.

The third-party debt collection industry has grown tremendously over the past few decades, with 2010 revenue more than 6.5 times that of 1972, after controlling for inflation (Hunt, 2013). Currently, banks sell charged-off debts without any warranties and retain no liability for inaccuracies in the information passed on or the amounts claimed to be owed, and banks are also not liable for any debt-buyer abuses. According to an FTC analysis, only six percent of debt accounts purchased by some of the largest debt buyers in 2009 came with any documentation. Private companies buy billions of dollars of charged-off debt from banks each year, and some companies use abusive and unlawful methods to collect on that debt, which too often the targeted consumers do not even owe. Overwhelmed courts make the problem worse by awarding judgments to debt buyers based on false, forged, or misleading information.

Consumers (many of whom are of low and moderate incomes) are being sued for old debts without their knowledge and often with little proof of the claims. As a result, debt-buying companies are taking advantage of financially-distressed consumers and have overwhelmed state court systems, extracting billions of dollars in judgments against consumers around the country for debts that may not even be owed.

Policy Recommendations:

Federal regulators should:

- Hold banks accountable for the debts they sell and require banks to conduct more oversight of the debt sales process and the debt buyers to whom they sell. Banks should also be required to repurchase accounts that are not collectible due to insufficient documentation.
- Prohibit debt buyers from initiating debt-collection efforts unless they can substantiate and verify the debt being sought.
- Prohibit the sale or collection of, and lawsuits on, time-barred debt.
- Prohibit certain accounts from being sold under any circumstances, including accounts that have been paid in full, settled, or discharged in bankruptcy; those that lack documentation; and those for which the debtor is deceased and no responsible party remains. Likewise, prohibit banks from selling accounts that are subject to protections under various federal laws, such as accounts of active-duty service members subject to SCRA protections and accounts that are currently subject to bankruptcy law protections. Similarly, prohibit accounts that are currently in active settlement or for which the bank has received a recent payment from being sold.
- Clarify and improve available remedies for harmed consumers.

States should:

- Require more detailed and accurate evidence when debt buyers file lawsuits.
- Tighten evidentiary requirements for obtaining a judgment.
- Require judicial review to ensure protection of exempt funds to pay debt-collection judgments and settlements and to ensure the consumer's ability to pay.
- Vigorously enforce laws and regulations against debt collectors, debt buyers, and debt collection law firms. Ensure more consumers have legal representation.

Debt Settlement

Debt-settlement companies offer the promise of settling a consumer's debt for a fraction of what they owe. Debt-settlement companies offer to negotiate down the outstanding debt owed (usually from credit cards) to a more manageable amount so that a consumer can become debt free. Unfortunately, debt-settlement programs carry significant risks that may result in consumers becoming even worse off.

In order to enroll into debt-settlement programs, the service provider requires the consumer to default on their debt, which typically results in fees, increased interest rates, and sometimes even lawsuits from creditors. Even after assuming all this risk, consumers are offered no guarantees; in fact, some creditors refuse to negotiate with debt-settlement companies at all. Even if a settlement is reached on one debt, the fees accumulating on other debts may wipe out any savings the settlement might have achieved. Moreover, a consumer unable to keep up with the new settlement arrangement risks falling back into default, and now without the fees paid to the debt-settlement company for negotiating the agreement.

In 2010, FTC promulgated a new debt-settlement rule, which included a ban on collecting fees in advance for debt-settlement services. As a result, today debt-settlement companies may collect fees only when a settlement agreement has been reached and at least one payment has been made by the consumer to the creditor. The FTC rule also provided greater protections for the dedicated accounts in which consumers save for future settlement agreements and standards for what debt-settlement companies must disclose to prospective customers. In addition, it prohibited particular marketing tactics, which it found to be misleading. Although these consumer protections improved debt-settlement programs for consumers, consumers must settle at least two-thirds of the debt they enroll in a debt-settlement program to benefit, a result that many will not achieve.

Policy Recommendations

States that do not currently permit debt settlement should not authorize the practice until the industry can demonstrate that a large majority of their clients are able to realize a positive change in financial position. In addition, we recommend the following:

- Debt-settlement providers should be required to conduct a personalized evaluation of a prospective client and conclude that the debt-settlement program is likely to provide a net benefit and is affordable.
- Debt-settlement companies should be required to provide consumers with some form of refund or concession if they end up worse off after they enroll in a debt-settlement program.
- Debt-settlement companies should be required to report on the outcomes achieved for their clients.
- States that allow debt settlement should establish meaningful limitations on fees.
- Any debt-settlement laws and regulations enacted at the state or federal levels should include all debt-settlement providers, including attorneys and others whose activities are not covered by the FTC rule.
- CFPB, FTC, and states should continue investigations of debt-settlement companies to ensure compliance with existing and new regulations or laws that are promulgated in the future.

NOTES

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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