Subprime Lending and Alternative Financial Service Providers:

A Literature Review and Empirical Analysis

U.S. Department of Housing and Urban Development
Office of Policy Development and Research

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Executive Summary

The last two decades have been marked by significant changes in consumer financial services. Two significant changes that have been evident are the rapid growth of both subprime mortgage lending and alternative financial service providers (AFSPs), such as check cashers, payday lenders, and pawnshops. A common concern with both of these industries is high fees for their services and disproportionate targeting of low-income and minority households. Another common element regarding these trends is the variety of studies arguing that the growth in use of these higher-cost financial services in low-income and minority communities is due in part to the absence of banks from these areas. But while much has been written in recent years on the growth of these two segments of the financial services market, there is limited research on the extent to which these phenomena are related. The purpose of this study is to examine subprime lending and the prevalence of AFSPs through a common lens to investigate the extent of similarities and differences in the prevalence of these activities in low-income and minority communities.

This study consists of two parts. The first part presents a review of the literature related to subprime lending and AFSPs. It also examines how regulation of financial services can support or hinder the expansion of access to mortgage capital and basic banking services in low-income and/or minority communities while at the same time providing an appropriate level of consumer protection in these new market segments. The second part of the study presents an empirical analysis of association between neighborhood characteristics (including race-ethnicity, income, and credit risk measures) and the patterns of subprime lending and location of AFSPs and banks in the Dallas metropolitan area.

A key conclusion of the literature review is that surprisingly little is known about the factors that have given rise in recent years to products and services as diverse as subprime mortgage loans, payday advances, refund anticipate loans, pawn brokering, check cashing, and bill paying services. These products and services appear to be a market response to the financial service needs of largely low-income, low-wealth, and credit impaired consumers. To date, most of the literature has taken a decidedly supply side orientation, examining whether subprime lenders and AFSPs are more likely to be active in low-income and minority communities and whether banks are less likely to provide mortgage loans or short term advances to low-wealth and credit impaired borrowers.

Only recently has there been serious research on the reasons that many customers turn to nonbanks to meet their need for financial services. As with any market, the inability or unwillingness of some suppliers to serve a particular market is obviously a part of the non-banked customer's decision-making process. But surprisingly little is known about how low-income, low-wealth families make choices in today's increasingly complex capital markets. More needs to be done to better understand why some consumers all too frequently make what appear to be "irrational choices." Of course, many of these seemingly "irrational choices" may be the product of simple fraud and abuse, but behavioral economics literature suggests that the reality is more complex than that. The existing literature suggests that in many cases customers of subprime lenders and AFSPs are, in fact, making rational choices given their circumstances or options in the marketplace. Sorting out how low-wealth, low-income consumers, as well as consumers with poor and or no credit histories, go about making choices between "mainstream" and "alternative" mortgage and financial services is perhaps the biggest challenge facing policy analysts, government officials and regulators operating in the rapidly evolving mortgage and financial services marketplace.

One goal of the empirical analysis of the Dallas metropolitan area was to investigate the importance of neighborhood race-ethnicity and income in explaining subprime lender shares after including controls for neighborhood credit risk. Consistent with previous research, we found that even after including a variety of controls for neighborhood credit risk, neighborhoods where blacks account for a majority of households had much higher subprime shares of originations. Also consistent with previous research, we found that there were notable differences in the significance of the explanatory factors when used to estimate the subprime lender share of refinance loans compared with their significance in the estimate of the subprime lender share of purchase loans. One area ripe for further research is to better understand the differences in geographic patterns of subprime refinance and purchase lending.

The analysis of the Dallas market area was also intended to fill a void in the literature by examining the relationship, if any, between geographic patterns of subprime lending and the location of AFSPs. While there are similarities in the location of AFSPs and the use of subprime lending—most notably in the concentration in lower income neighborhoods—there are also important differences. The most important difference is that while subprime lending is disproportionately concentrated in black neighborhoods, there is no indication that these areas have higher than average levels of AFSPs in Dallas. Instead, AFSPs are most likely to be found in neighborhoods where Hispanics comprise a significant share of the population. However, the multivariate analysis finds that the share having U.S. citizenship is much more important than the race-ethnicity of the neighborhood. This result is in keeping with the argument that unbanked households that comprise an important part of the customer base for check cashers and pawnshops are more likely to be immigrants who are either undocumented or come from countries where it is not common for low-income households to use banks. The multivariate analysis also found that there was little correlation between subprime lending shares and the presence of AFSPs. The lack of any significant overlap in the factors predicting the location of subprime lending and AFSPs suggests that AFSPs and subprime lenders may be serving different market niches.

This study also examined the issue of whether there was a relationship between the presence of banks in a neighborhood and the likelihood of both subprime lending and the presence of AFSPs. With regard to subprime lending, multivariate analysis did not find a strong link between the number of banks in the tract and the subprime lender share. This is not entirely surprising as the argument that a lack of banks in low-income and minority neighborhoods has contributed to the rise of subprime lending is at odds with the fact that there has been significant growth in home purchase mortgage activity in these areas over the last decade. The multivariate analysis did find that banks were more likely to be located in areas where whites account for more than 90 percent of households. But banks were least likely to be found in majority Hispanic areas rather than majority black areas where subprime lending shares are highest. In short, our findings do not provide support for the argument that a lack of banks has contributed to subprime lending growth. Similarly, analysis of the factors associated with the location of AFSPs does not find any support for the argument that these establishments are more likely in neighborhoods where there is a lack of banks.

It would be interesting to pursue this type of analysis in other market areas to see whether there are any consistent findings across markets regarding the importance of race-ethnicity and immigrant status in predicting the location of AFSPs. Further research comparing results from markets with a range of demographic profiles could help shed light on the ways in which the utilization of subprime lending and AFSPs is similar or different.

Summary of Findings

The last two decades have been marked by significant changes in consumer financial services. These changes have resulted from a variety of factors, including innovations in financial markets, bank deregulation, increased capacity and lower cost of computers for storing and analyzing data, and changes in consumer demand for credit. One example of the changes in financial services that has been evident is the rapid growth of subprime mortgage lending. Another trend evident over the last decade has been rapid growth in alternative financial service providers (AFSPs), such as check cashers, payday lenders, pawnshops, and other businesses that make short-term consumer loans. A common thread between the growth of both of these industries are concerns that these firms are charging high fees for their services and are disproportionately targeting low-income and minority households. Another commonality between these trends is that a variety of studies have argued that the growth in use of these higher-cost financial services in low-income and minority communities is due in part to the absence of banks from these neighborhoods.

But while much has been written in recent years on the growth of subprime mortgage lending and the provision of alternative financial services to low-income and minority consumers, there is but limited research on the extent to which these phenomena are related. The purpose of this study is to examine subprime mortgage lending and the prevalence of AFSPs through a common lens to investigate the extent of similarities and differences in the prevalence of these activities in low-income and minority communities.

This study consists of two parts. The first part presents a review of the literature related to subprime lending, alternative financial service providers, and how regulation of these activities and banks can support or hinder the expansion of access to mortgage capital and basic banking services in low-income and/or minority communities while at the same time providing an appropriate level of consumer protection in these new market segments. The second part of the study presents an empirical analysis of association between neighborhood characteristics, including race-ethnicity, income, and credit risk measures, and the patterns of subprime lending and the location of AFSPs and banks in the Dallas metropolitan area. The following sections summarize the findings from each of these parts of this study.

Literature Review

The first part of the study is a literature review that is divided into three broad segments. The first part examines what is known about subprime lending, paying particular attention to studies relating to the apparent concentration of subprime loans in lower-income and/or minority neighborhoods. The next part reviews the growing literature on alternative financial services providers, with particular emphasis on studies that document the characteristics of customers served, the spatial pattern of firm location, and the business models that seem to drive the industry. The third part then focuses on literature that assesses the policy challenges – including the Community Reinvestment Act and other policies relating to regulated depository institutions, as well as policies relating to more general issues of developing a regulatory framework that will ensure an appropriate measure of consumer protection in the face of the rapid changes in the provision of mortgage and financial services. The report

concludes with a brief summary of the common themes from the literature reviewed and what this review suggests about areas for further research.

Subprime Lending

The advent of automated underwriting, credit scoring and risk based pricing, as well as the growing importance of mortgage brokers, national-scale mortgage banking organizations, and expanded secondary mortgage markets produced what some have labeled a "revolution in mortgage finance." Aided by steady economic growth in the 1990s, and more recently by record low mortgage interest rates, the changing structure of the mortgage industry has fostered dramatic increases in subprime lending to low-income people and communities.

Numerous studies have documented the spatial variation in subprime lending across neighborhoods and, in particular, the tendency for subprime lending to be more prevalent in low-income and minority neighborhoods than in others. One set of studies have relied on comparisons of subprime lending shares between neighborhoods of different income and racial-ethnic profiles to conclude that race has been a more important factor than risk in explaining variations in the market shares of subprime lenders. This conclusion has been strengthened by recent studies that have found the prevalence of blacks in a neighborhood to be a significant predictor of subprime lender shares even after controlling for a variety of borrower and neighborhood characteristics, including the share of households in the neighborhood with low credit scores.

Though some advocates suggest that the absence of prime lending in inner city neighborhoods reflects the fact many banks closed their inner city offices, some recent research suggests that something subtler is at work than simple "redlining." Indeed, the low-income, minority communities that were thought to have had little or no access to mortgage money have seen tremendous growth in both the number of loans and the number of active lenders over the last decade.

Nonetheless, low-income, minority communities do have an apparently disproportionately high concentration of subprime lending activity. One explanation for this pattern is related to differences in how consumers shop for mortgage products. Unfortunately, given the bewildering array of mortgage products available and the complexity of evaluating the cost of these products, even the most sophisticated borrower will find it difficult to evaluate mortgage options. Given that consumers utilize short cut methods to evaluate mortgage options, some brokers may actively promote mortgages that exploit the tendency of borrowers to focus on the amount of monthly payments rather than other more useful measures to evaluate the costs of various mortgage products. Some research supports the notion that in many instances subprime refinance loans are "sold, not sought" in that they result from the extensive and often unsolicited outreach by brokers. In particular, research has found that elderly borrowers, and borrowers in lower-income and/or minority areas succumb to the marketing tactics of aggressive brokers. Other research suggests that subprime borrowers are less knowledgeable about the mortgage process, are less likely to search for the best mortgage rates, and are less likely to be offered a choice among alternative mortgage terms and instruments.

An unintended side-effect of the ongoing efforts to extend home ownership opportunities to less credit worthy consumers – and particularly the rise in subprime lending – is a commensurate increase in foreclosure rates. Employing the best available data on loan performance, researchers at Freddie

Mac estimated that as of mid 2002, the serious delinquency rate for conventional prime loans was 0.55 percent (serious delinquency is defined as loans that are already in foreclosure and/or with payments that are 90 days or more late). In contrast, subprime loans had a serious delinquency rate of 10.44 percent, nearly 20 times higher. Further, the more risky subprime loans examined had rates topping 21 percent. Subprime serious delinquency rates were more than twice those of FHA insured mortgages (4.45 percent). Though hardly in evidence a decade ago, subprime loans are now the most default-prone mortgage segment of the home loan market. Overall, the Freddie Mac data suggest that today, subprime loans account for half of all seriously delinquent loans, while conventional prime and FHA loans each account for about one quarter of all seriously delinquent loans.

While no study has systematically examined foreclosures at the national level, a handful of studies demonstrate increasing foreclosure rates in low-income communities across the country. The roughly ten studies of foreclosure activity in particular metropolitan areas conducted to date, while differing in terms of the quality and extent of available foreclosure data, paint a remarkably consistent picture of the rising incidence of foreclosure, especially in lower-income and minority neighborhoods where subprime lending has been concentrated.

Higher foreclosures among subprime loans in large part are undoubtedly a natural outgrowth of the lower credit quality of borrowers that characterize the subprime market. This effect is reinforced by the fact that collateral value in the subprime market is generally weaker. But it has also been argued that high foreclosure rates are in part the result of predatory lending practices by some lenders in this market segment. There is no general agreement about what constitutes predatory lending. It includes charging higher interest rates than warranted by the risk of the loan, charging excessive fees, and including ancillary products or loan terms that offer little or no benefit to the borrower; and, in extreme cases, it involves fraud related to inflated appraisals or income. However, it is difficult to gauge the extent of predatory lending, as little systematic information exists about loan terms or loan servicing. As a result, existing studies of predatory lending are largely anecdotal, collected by legal and community advocates.

Alternative Financial Service Providers

The next section of the review covers the growing literature on alternative financial services providers, with particular emphasis on studies that document the characteristics of customers served, the spatial pattern of firm location, and the business models that seem to drive the industry. Just as the subprime mortgage market was experiencing rapid growth during the 1990s, there was also rapid growth among firms outside of the system of federally insured financial institutions that provide a range of financial services typically associated with banks. These firms include check cashing outlets, payday lenders, pawnshops, title lenders, tax refund anticipation lenders, small loan firms, and rent-to-own stores. Collectively, these types of firms are generally referred to as alternative financial service providers (AFSP). The rapid growth in the AFSP industry during the 1990s has its roots in a number of factors, including changes in the regulatory environment, rapid increases in immigration, and enhanced technology that enabled AFSPs to lower costs of operations and more recently to check on the credit characteristics of individual customers. Given its diverse origins, the AFSP industry is not monolithic, as different types of firms have grown at different rates over the last few decades. A seminal work by John Caskey in the early 1990s documented the rapid growth in pawnshops and check cashing firms during the 1980s and early 1990s. The late 1990s saw the rise of

the payday lending industry, which offers consumers short-term loans at very high annual interest rates. Most recently, the growth of pawnshops and check cashers seems to have slowed, while the number of payday lenders continues to grow.

Many assessments of the users of alternative financial services focus on whether individuals are "banked" or not, that is whether individuals have access to checking, savings, or other transaction accounts at a bank, savings and loan, credit union or other federal or state regulated banking organizations. As part of their periodic assessment of family finances, the Federal Reserve estimated that in 2001 some 12.7 percent of all American households did not have a checking account, while 9.1 percent did not have any type of transaction account whatsoever. Among families without a checking account in 2001, 50.4 percent reported having had such an account in the past. Though still high, these most recent figures present a slight decline from figures recorded in 1998 and a more substantial decline since 1992 when fully 16.6 percent of families lacked a checking account, and nearly 13 percent had no transaction account. Families that did not have a checking account or other transaction account tended to be disproportionately low income and low wealth, less than 35, nonwhite, foreign born, less educated, and to receive government income support. While the unbanked are more likely to be renters, homeowners nevertheless account for approximately one third of all households who do not have a transaction account of any type.

Various studies also examine how those consumers without a checking, savings, or other transaction account go about obtaining basic financial services including cashing checks, paying bills, and sending wire transfers to family and friends. Though many of the "unbanked" utilize the services of check cashing operations (CCOs) and other alternative financial services providers, somewhat surprisingly, several of these studies note that significant shares of "banked" individuals also frequent these AFSPs. One study of the Chicago area found that unbanked households are 14.6 percent more likely than their banked counterparts to patronize a check casher, while unbanked households residing in a low- or moderate income neighborhood are 7.6 percent more likely to patronize these places than unbanked households residing elsewhere. Even controlling for household and neighborhood income, unbanked blacks and Hispanics are more likely to use these services than whites.

Individuals utilizing the services of payday lenders differ from those who frequent check-cashing establishments, because among other things customers obtaining payday loans by definition have a checking account. One review of the existing literature on payday loan customers found that the typical customer appeared to relatively young, employed, female, married, and a renter. The average income in most of the studies reviewed was approximately $25,000. However, another study found that over half had incomes between $25,000 and $50,000. A study of the clients of payday lenders in North Carolina found that African American families were more than twice as likely to have taken out a payday loan in the last two years than have non-Hispanic white families. In contrast, Hispanics are less likely than non-Hispanic whites to patronize payday lenders, a finding consistent with other research that suggested that low-income Hispanics were more likely to access short-term credit from pawnbrokers than from payday lenders.

A number of studies have examined the spatial distribution of AFSPs to determine whether they are disproportionately found in low-income and minority areas and whether they are more likely in areas that are devoid of banks. The existing literature examining the location of AFSPs generally finds support for the observation that these establishments are, in fact, disproportionately located in low-

income and minority neighborhoods, but they do not provide strong support for the argument that these establishments are more likely to be located in areas where banks are absent.

There remains considerable debate as to why consumers resort to use AFSPs, and whether such use reflects the fact that AFSPs represent a legitimate response to a market need. Some argue that many lower-income consumers cannot afford a traditional bank account because of high maintenance fees, or that the concentration of "unbanked" households in minority neighborhoods reflects the lack of banking organizations with branches located there. Others go further and suggest that the basic business model, at least for payday lenders, is designed to trap unsuspecting borrowers into escalating debt payments. In any event, advocates have pushed for state and federal initiatives to encourage banks to offer low-cost basic accounts to lower-income participants, and have vigorously protested any effort to close a branch bank in a lower-income minority neighborhood.

Recent studies suggest that being unbanked may be less a question of expense and proximity, and more a question of having the right mix of services. Indeed, according to the Survey of Consumer Finance, only 1.2 percent of the unbanked cited lack of convenient hours or locations of branch banks as the reason they did not have a checking account. While a majority of "unbanked" individuals incur costs to secure alternative banking services, in most cases, these costs are not very high. Banks are also often found in close proximity to check cashers, suggesting that proximity is not a significant factor. On the other hand, check-cashing operations also generally offer a wider array of bill paying and money transfer services that are preferred by customers to those offered by mainstream banks. These establishments also have longer hours and may have greater cultural sensitivity to immigrants than mainstream institutions.

With regard to payday lending, one study based on a survey of payday loan users offers a variety of insights into consumer behavior. This study finds that payday advance customers are generally aware of the dollar amount of the finance charge on their most recent new payday advance, but few could recall the actual annual percentage rate (APR). The authors further argue that the focus on dollar costs is consistent with the fact that consumers often turn to payday lenders to avoid other costs – for example fees associated with returned checks and late payments – which are also typically expressed in dollar amounts, not APRs. Most survey respondents reported having some difficulty in managing their credit, with some three-fourths being turned down by a creditor or not given as much credit as they applied for in the last five years. Of those that did have retail or bank credit cards, over half reported not using these cards for fear that they have exceeded their credit limit. Moreover, payday loan customers were almost four times more likely to have filed for bankruptcy than all adults.

Regulation of Banks, Subprime Lenders and AFSPs

The third part of the literature review then assesses the policy challenges raised by the changes that have occurred in the financial services industry over the last decade. This review touches upon the Community Reinvestment Act (CRA) and other policies relating to regulated depository institutions, as well as policies relating to more general issues of developing a regulatory framework that will ensure an appropriate measure of consumer protection in the face of the rapid changes in the provision of mortgage and financial services.

Despite the more than twenty-five year history of CRA, only a few studies have attempted to evaluate the impact of the Act on lending and the provision of financial services to low-income and minority people and areas. The research that has been done has largely relied on HMDA data to evaluate variations in lending volumes associated with whether lenders are subject to CRA regulation or not. Prior to the 1990s, research relied on aggregate levels of lending activity at the census tract level for specific metropolitan areas. In general, this research did not produce conclusive results about CRA's impact on credit flows, with some studies finding negative disparities in credit flows to areas with lower median incomes and higher minority concentrations, and others indicating that there was insufficient evidence to support such a claim. Several studies from the 1990s concluded that the influence of CRA on lending volumes was very small compared to changes due to such forces as deregulation and technological advances. Nonetheless, other studies have concluded that CRA has been effective at encouraging banks to lend in low-income and minority communities. But several studies also conclude that the effect of CRA on lending volumes appears to be declining in recent years in large part because regulated depository institutions have come to account for an ever-smaller share of mortgage lending.

With regard to regulation of financial service providers other than banks, the review notes that consumer protection regulations have been slow to adjust to the dramatic changes sweeping the mortgage banking and financial services market place. Most notably, there has not been an expansion of federal oversight of the growing number of nonbank entities engaged in subprime mortgage lending or the provision of check cashing, payday lending and other alternative financial services. The failure to "modernize" consumer protection regulations reflects among other things the continuing divide over appropriate regulatory intervention into the financial services arena. Some argue that expanded regulations are needed to protect consumers from predatory lending or abusive practices of high-cost check cashers and payday lenders. Others contend that new regulations do little good and may even undermine the ability of the financial services sector to create new and cost effective methods for meeting the banking services and credit needs of low-income, low-wealth, and credit impaired borrowers. As a result, there has been a proliferation of legislative activity by states to regulate the activity of these entities.

Observers note that current policy focuses largely on disclosure as a key element for promoting consumer protection. In theory, consumers, when provided with accurate comprehensible information that allows them to both protect themselves and to serve as market police, drive bad actors from the market place. Current examples include the Truth in Lending Act (TILA), which requires disclosure of certain loan terms, and the Real Estate Settlement Procedures Act (RESPA), which mandates a standard for disclosing settlement costs in real estate loan transactions. An alternative approach is regulation by substance, which protects consumers by prohibiting entirely certain features of mortgage contracts. Examples here include state regulations that prohibit the use of some prepayment penalties in high cost mortgages or the financing of single-premium credit life insurance as part of the mortgage transaction. Regulation by substance is often attacked in policy circles as interfering with the operation of the free market. If consumers can obtain better terms on their mortgage by agreeing to accept a prepayment penalty feature – so the argument goes – these regulations limit consumer choice and their capacity to decide what mortgage product is best for them.

Conclusions

The report concludes with a summary of the common themes from the literature reviewed. One key conclusion is that surprisingly little is known about the factors that have given rise in recent years to products and services as diverse as subprime mortgage loans, payday advances, refund anticipate loans, pawn brokering, check cashing, and bill paying services. These products and services appear to be a market response to the financial services needs of largely low-income, low-wealth, and credit impaired consumers. Yet rather than probing the demand side characteristics of the market, until recently much of the literature has taken a decidedly supply side orientation, examining whether subprime lenders and AFSPs are more likely to be active in low-income and minority communities and whether banks are less likely to provide mortgage loans or short term advances to low-wealth and credit impaired borrowers.

Only recently has there been serious research on the reasons that many customers turn to nonbanks to meet their need for financial services. As with any market, the inability or unwillingness of some suppliers to serve a particular market is obviously a part of this decision making process. But surprisingly little is known about how low-income, low-wealth families make choices – and indeed manage to survive – in today's increasingly complex capital markets. The literature that does exist suggests that for many low-wealth and low-income customers having a deposit or checking account or otherwise being "banked" may not be essential or at least worth the cost. Similarly, while obtaining short-term cash advances from a payday lender or pawnbroker may be expensive, these activities may also represent the best choice available given the limited financial strength and weak or non-existent credit history of many individuals. Finally, while the rise of risk-based pricing has helped millions gain access to mortgage credit, it may be understandable that some credit impaired homeowners turn to high-priced subprime lenders to secure funds to repay other consumer debt – even if this transaction brings them just one step closer to a possible foreclosure and resulting financial ruin.

In short, more needs to be done to better understand why some consumers all too frequently make what appears to others to be "irrational choices." Of course, many of these seemingly "irrational choices" may be the product of simple fraud and abuse, but available behavioral economics literature suggests that the reality is more complex than that. Sorting out how low-wealth, low-income consumers, as well as consumers with poor and or no credit histories, go about making choices between "mainstream" and "alternative" mortgage and financial services is perhaps the biggest challenge facing those policy analysts, government officials and regulators operating in the rapidly evolving mortgage and financial services marketplace.

Empirical Analysis of the Dallas Metropolitan Area

The second part of this study presents an empirical analysis of whether there are similarities or differences in the extent to which neighborhood race and ethnicity, income levels, and credit risk measures explain the distribution across neighborhoods of subprime mortgage lending and the location of both alternative financial service providers and regulated depository institutions. This analysis also examines whether the prevalence of subprime lending, AFSPs, and banks in a neighborhood are correlated. It is intended as a preliminary examination of these basic questions. Aside from addressing these questions, other important goals for the study include an investigation of

the availability and usefulness of different sources of data needed to examine these issues and an exploration of analytic approaches needed to support the type of spatial analysis intrinsic to these questions.

Given the effort needed to assemble the necessary data for this study, it focuses on a single market area. The Dallas metropolitan area was chosen for study for several reasons. First, it has a sizeable population of both blacks and Hispanics, providing an opportunity to see whether there are differences between these groups in their association with subprime lending and AFSP and bank locations. Second, Texas has passed legislation allowing payday lending so more restrictive laws governing small loans that exist in some states have not limited this industry in Texas. Finally, data on residential foreclosures were available for the Dallas market area. While findings from this single market area do provide some insights into the relationship between subprime lending and AFSP and bank locations, many of the questions of interest would best be examined by comparing findings across market areas. Hopefully, this work will lay the groundwork for further studies of this type covering other market areas.

Descriptive Analysis

This study begins by exploring various descriptive measures of the neighborhood characteristics where financial service establishments are found. A comparison of the prevalence of subprime lending with the location of AFSPs and banks reveals some interesting similarities and differences. Subprime refinance lending and AFSPs show a fairly strong association with neighborhood income levels in Dallas, with levels in lower-income neighborhoods that are many times higher than in upper-income areas. In contrast, there is not as strong an association between neighborhood income and the prevalence of banks. While very low-income areas are much less likely than other areas to have a bank, across the remaining income categories there is not a large difference. Even in the lowest income areas, banks are nearly twice as likely to be present as AFSPs.

With regard to the race and ethnicity of neighborhoods, however, there are notable differences across neighborhoods in the prevalence of subprime lending and AFSPs. As has been found in previous studies, subprime refinance shares are much higher in neighborhoods where blacks account for a majority of residents, while areas with a Hispanic majority or of mixed race have moderate subprime shares, and majority white areas have the lowest levels. In contrast, there is no evidence that AFSPs are over represented in majority black areas, although they are in majority Hispanic and mixed race areas. Banks, on the other hand, appear to be significantly underrepresented in areas that are mostly black and majority Hispanic areas, and slightly underrepresented in majority black and mixed race areas. For banks, race appears to be a more important factor than income in predicting whether a bank will be present.

A comparison of the location of drug stores and supermarkets provide some indication of the degree to which the location of AFSPs and banks varies from the general location of retail activity. Perhaps not surprisingly, the location of both AFSPs and banks is more strongly associated with race-ethnicity and income than is true of drug stores and supermarkets. However, retail activities of all types are less likely in the lowest-income and mostly black neighborhoods.

As has been noted, one of the concerns with the growth of AFSPs is that these establishments are filling a void in areas where banks are not located. However, in the Dallas area, only a quarter of the tracts without a bank have an AFSP. AFSPs are also somewhat more likely to be in a neighborhood with a bank than not. Nonetheless, areas without banks but with an AFSP are notable in several regards. These areas have a much larger than average Hispanic share and much lower incomes. They also have fewer citizens, more households on public assistance, fewer households with some college education, and higher conventional prime mortgage denial rates – all factors that might be expected to increase demand for AFSPs.

Regression Analysis Results

While the descriptive analysis provides some insights into the factors associated with the prevalence of subprime lending, AFSPs, and banks, regression analysis is used to evaluate the relative importance of each of these factors in explaining the observed patterns. The first step in this analysis was to estimate separate ordinary least square regression models for the share of refinance and purchase loans made by subprime lenders in 1999, 2000, and 2001. The results of the subprime lending share models are consistent with findings from previous research. Neighborhoods where blacks account for a majority of households have much higher subprime lender shares than other neighborhoods even after controlling for a variety of neighborhood characteristics. In Dallas, the differences were fairly large, with neighborhoods that are more than 90 percent black having subprime lender shares of refinance mortgages that are up to 30 percentage points higher than areas where whites account for 90 percent of households. Also in keeping with previous research, while the association between the neighborhood black share and the subprime lender share is diminished slightly by the inclusion of other neighborhood characteristics, including credit risk measures, the association remains quite large and statistically significant. In contrast, there is little association between the share of Hispanics in a neighborhood and subprime lending shares. This is also consistent with previous research that has found a weaker association between Hispanic neighborhoods and subprime lending activity.

In comparison to race-ethnicity, neighborhood income levels are less strongly associated with subprime lender shares in Dallas, although subprime lender shares are higher in the lowest-income areas. Among the other factors examined, in all estimated models the share of homeowners moving between 1995 and 1998 was consistently negatively associated with subprime lender shares. This indicates that borrowers in areas with a more active home sales market are less likely to use subprime lenders. In the refinance models, a higher share of adults with some college education consistently reduced the use of subprime lenders, suggesting that higher levels of financial literacy may lower the reliance on subprime lenders. However, this association is less consistent in the purchase models. Similarly, the capitalization rate, measured as the ratio of median gross rents to median house values, is a consistent predictor of subprime refinance shares, but is less consistently associated with subprime purchase shares.

One of the purposes of this study is to examine the usefulness of alternative measures of credit risk at the neighborhood level for analyzing geographic variations in subprime lending shares. Three different credit risk measures were evaluated, including the denial rate on conventional prime mortgage applications, the rate of residential foreclosures, and FHA delinquency and claims rates. The principal conclusion that can be drawn from the results of this analysis is that the conventional

prime mortgage denial rate from HMDA is a fairly consistent predictor of subprime lending shares. When lagged by a year the variable was significant in five of the six models estimated. The results were much less consistent for FHA delinquency and claim rates and residential foreclosure rates. None of these latter variables were significant in any of the estimated refinance models, although the FHA delinquency rate and residential foreclosure rate were both significant in all three subprime purchase share models, while the FHA claims rate was significant in the purchase share model using data from 1999. There was not a significant difference in the explanatory power of the models using different credit risk measures, so it did not appear that any one measure held an advantage over another. Given that the HMDA denial rate measure is readily available and more consistently significant, in the absence of credit score data this measure may be the best option to proxy for neighborhood credit risk in analysis of subprime lending shares.

Another goal of this study was to examine the relationship, if any, between the prevalence of subprime lending and the location of AFSPs. Given that the literature has found that both subprime lending and AFSPs are more common in minority and lower income communities, it was expected that these activities would be concentrated in the same neighborhoods. One test for a relationship was to include a count of AFSPs in the models predicting subprime lending shares. In most cases, no statistically significant association was found. However, in a few cases, mostly in the subprime purchase share models, the number of AFSPs was found to have a negative association with subprime lending shares. Thus, areas with greater numbers of AFSPs had somewhat *lower* subprime lender shares. While the association may be a spurious correlation, it may also be an indication that subprime lenders and AFSPs are serving different market niches. Another test of the association between subprime lending and AFSPs was to include the subprime lending share in the models predicting the number of AFSPs in the neighborhood. These models found no statistically significant association between subprime lending shares and the number of AFSPs in a neighborhood.

An indirect test of an association between AFSPs and subprime lending is to compare the relative importance of other explanatory variables in predicting the location of these activities, most notably race-ethnicity and income. The modeling results show significant differences in these dimensions. While subprime lender shares are strongly associated with areas where blacks are a majority, AFSPs are no more likely to be located in black neighborhoods than they are to be in areas where whites account for a majority. In contrast, while there was no association between neighborhoods where Hispanics constitute a majority of households and the prevalence of subprime lending, AFSPs are much more likely to be located in these neighborhoods. However, this association is not statistically significant once the share of the population who are citizens is included in the model. Thus, at least in Dallas, the location of AFSPs is not strongly associated with a neighborhood's racial-ethnic composition, but it is associated with the presence of immigrants. Finally, it is true that both AFSPs and subprime lending are more likely in lower income areas, but the association between neighborhood income and AFSPs is not as strong as it is for subprime lending.

This study also attempted to evaluate whether neighborhood credit risk was associated with AFSP location. Based on the results of the subprime lender share models, the HMDA conventional prime denial rate was selected as the proxy for neighborhood credit risk. However, this variable was not found to be significantly associated with AFSP location.

Finally, a last goal of this analysis was to evaluate the extent to which the presence of banks was associated with either subprime lending shares or AFSP locations. As with AFSPs, the count of banks was included as an independent variable in both the subprime lending share models and vice versa. The number of banks was not significant in any of the subprime lender share models. However, in the model predicting the number of banks there was a weak negative association. That is, areas with higher subprime lending shares were found to be less likely to have banks. While consistent with the argument that a lack of banks is associated with more subprime lending, the fact that the number of banks was not significant in predicting subprime lending makes it difficult to draw this conclusion from these results.

Some indirect support for the argument that a lack of banks may be related to high shares of subprime lending comes from the fact that neighborhood minority share is found to be a statistically significant factor in predicting the number of banks in a neighborhood. Specifically, areas where whites account for more than 90 percent of households are predicted to have more banks than any other neighborhood type. But in contrast to subprime lending patterns, the fewest banks are in areas with a majority of Hispanic households, while areas where blacks make up 90 percent of more of households have about the same number of banks as areas where whites are a majority.

With regard to the relationship between the location of AFSPs and banks, our modeling results suggest that there is a strong tendency for retail activity to cluster as the strongest predictor of the location of all of the retail establishments examined—including AFSPs, banks, drug stores, and supermarkets—is the presence of any other type of retail activity. The results do not provide any support for the argument that AFSPs are filling a void left by banks. There are also few similarities in the other factors predicting the presence of banks and AFSPs. While race is an important predictor of banks presence, it is not for AFSPs. The importance of neighborhood race-ethnicity and income for bank presence is highlighted all the more by the fact that these characteristics are essentially not a factor in predicting the presence of drug stores or supermarkets. Importantly, this study found that for AFSPs, the share of citizens among the population is the single most important predictor of these establishments along with having income in the lower quartile of neighborhoods. This finding suggests that, at least in Dallas, the location of AFSPs is much more strongly related to where immigrants live than where minorities generally are found.

Part I

Literature Review

Section 1: Introduction

The last two decades have been marked by significant changes in consumer financial services. These changes have resulted from a variety of factors, including innovations in financial markets, bank deregulation, increased capacity and lower cost of computers for storing and analyzing data, and changes in consumer demand for credit. One example of the changes in financial services that has been evident is the growth of subprime mortgage lending. Another trend evident over the last several years has been rapid growth in alternative financial service providers (AFSPs), such as check cashers, payday lenders, pawnshops, and other businesses that make short-term consumer loans.[1] A common thread between the growth of both of these industries are concerns that these firms are charging usurious fees for their services and are disproportionately targeting low-income and minority households.

But while much has been written in recent years on the growth of subprime mortgage lending and the provision of alternative financial services to low-income and minority consumers, there is limited research on the extent to which these phenomena are related. Nonetheless, there are common themes in studies and reports examining subprime lending and the AFSP industry. For example, some analysts have focused on supply side factors, arguing that the withdrawal of regulated depository institutions from lower-income and/or minority neighborhoods has created a vacuum that is now being filled by newly created subprime lending operations and AFSPs. Others focus more on demand side factors, including the fact that many lower-income and/or minority consumers lack the needed information and knowledge to shop effectively for financial services generally, and hence are easily swayed by the sophisticated product design and marketing outreach of a variety of new companies, including subprime lenders, AFSP, and other new entrants into the consumer credit marketplace. Another important demand side factor is the tendency for lower-income households to have poor credit records and thus to have greater difficulty accessing prime sources of credit.

Recognizing that both supply and demand forces are likely to be at work, this literature review will examine the demographic, social, and economic forces that have given rise to the emergence of subprime lending and alternative financial services. While in many ways these two trends are distinct, the review will highlight the various ways in which the trends are related to a common set of underlying causal factors. In addition, the literature review highlights important policy issues that emerge from the rapidly changing mortgage and banking services marketplace – particularly challenges relating to how to create an appropriate regulatory framework that both supports the expansion of access to mortgage capital and basic banking services in low-income and/or minority communities while at the same time providing an appropriate level of consumer protection in these new market segments.

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[1] There are a variety of names used to identify this collection of financial institutions, such as alternative, non-mainstream, or non-traditional financial service providers, outlets, or institutions. While the term "nonbank" is appealing, because a defining characteristic of these firms is that they are outside the more heavily regulated realm of banks, this term excludes credit card companies as a comparison group. For lack of a better term, we will use the term "alternative financial service providers" to represent the broad class of businesses that provide services that compete with banks and credit card companies.

To accomplish this task, this literature review is divided into three broad segments. Chapter 2 examines what is known about subprime lending, paying particular attention to studies relating to the apparent concentration of subprime loans in lower-income and/or minority neighborhoods. The next chapter reviews the growing literature on alternative financial services providers, with particular emphasis on studies that document the characteristics of customers served, the spatial pattern of firm location, and the business models that seem to drive the industry. Chapter 4 then focuses on literature that assesses the policy challenges – including the Community Reinvestment Act and other policies relating to regulated depository institutions, as well as policies relating to more general issues of developing a regulatory framework that will ensure an appropriate measure of consumer protection in the face of the rapid changes in the provision of mortgage and financial services. The report concludes with a brief summary of the common themes from the literature reviewed and what this review suggests about areas for further research.

Section 2: Subprime Lending

According to HMDA data, between 1993 and 2001 the volume of mortgages originated by subprime lenders grew by ten-fold, from about 100,000 mortgages to more than a million (Joint Center, 2004). Further evidence of the rapid growth in subprime lending is evident in data from Inside Mortgage Finance, which indicates that the value of subprime mortgage originations increased from $35 billion in 1994 to $213 billion in 2002 (Inside Mortgage Finance, 2003). A notable characteristic of subprime lending is that it has grown most rapidly in minority and, to a lesser extent, low-income neighborhoods. While the advent of more flexible underwriting standards provides opportunities for more households to access mortgage credit, there have been concerns that some subprime lenders have used predatory practices to charge excessive fees and interest rates, impose loan terms that are disadvantageous to borrowers, sell products financed by the mortgage that have little value to the borrower, and originate loans that are unlikely to be affordable for the borrower. In extreme cases, these predatory practices may lead to loss of the home through foreclosure. Even in less extreme cases, borrowers can pay much more in interest rates and fees than is warranted by the degree of credit risk they represent. Finally, whether predatory or not, to the extent that subprime loans exhibit higher foreclosure rates, this type of lending can impose costs and/or destabilize the lower-income communities where subprime lending tends to concentrate.

This chapter will review four strands of literature, beginning with an assessment of the relationship among the growth of automated underwriting, risk based pricing, and secondary market securitization and the overall growth of subprime lending. The second strand provides largely descriptive information on the patterns of subprime lending by neighborhood characteristics. The next strand involves studies that have used multivariate techniques to examine the factors associated with the prevalence of subprime lending, either at the individual or neighborhood level. Finally, the review will examine literature that has investigated the relationship between subprime lending and mortgage foreclosure trends, including the potentially negative impacts that high rates of subprime foreclosures can impose on lower-income inner city communities.

2.1. Market Trends and The Rise of Subprime Lending

The advent of automated underwriting, credit scoring and risk based pricing, as well as the growing importance of mortgage brokers, national-scale mortgage banking organizations, and expanded secondary mortgage markets produced what some have labeled a “revolution in mortgage finance.” Aided by steady economic growth in the 1990s, and more recently by record low mortgage interest rates, the changing structure of the mortgage industry has fostered dramatic increases in subprime lending to low-income people and communities. This section summarizes existing literature on these trends and their implications for the evolution of the subprime market.

2.1.1. Structural Shifts in the Banking and Mortgage Banking Industries

The subprime first mortgage business emerged in the early 1990s as falling interest rates made it possible for home equity lenders to refinance existing high-rate first mortgages and allow borrowers to cash out some of their accumulated equity to pay down credit card debt or finance other purchases

in the process. Instead of needing a second mortgage to pay off high-cost debt, borrowers were now able to do so with a single loan that often lowered the interest on their primary housing debt as well reducing other monthly interest expenses. Due to the improved lien position (from second or third to first), these loans had lower levels of credit risk, broadening their appeal among secondary market investors. The final stage in this process, the purchase money subprime mortgage, emerged as industry expertise and technological advances made it possible to price the combined risk associated with lower credit quality of the borrower, reduced downpayment, and less certain collateral value of the home being financed.

To understand changes in the subprime lending market, it is first important to examine the dramatic restructuring of the both the retail and mortgage banking industries over the past 25 years. As documented by a series of studies by Federal Reserve Board Researchers (Avery et al., 1997, and Avery et. al 1999a) structural shifts have dramatically altered the retail banking industry. For example, from 1975 to 1997, the number of banking organizations dropped by 40 percent, as a result of industry consolidation and a substantial number of bank failures (Avery et al., 1999a).

Regulatory changes also supported the consolidation of the financial services industry. As described in a recent report by the Joint Center for Housing Studies, at the federal level, interstate branching became a reality in the 1990s (Joint Center 2004).[2] This opened opportunities for commercial banks to expand beyond the boundaries that had been in place since the depression, and enabled larger organizations to further enhance the scale and scope of their operations through merger and acquisition. The results were dramatic. For example, Federal Reserve Board data indicate the scale of the consolidation in the mid 1990s. From 1993 to 1997 alone, the number of banking institutions acquired in a merger or acquisition totaled 2,829, or 21 percent of the total (Avery et al., 1999a).

These changes had dramatic implications for the mortgage industry. As discussed by the Joint Center (2004), lacking the scale economies to compete in an increasingly automated business, many smaller banks and thrifts abandoned their mortgage lending activities entirely. At the same time, several large independent mortgage and finance companies continued to compete head to head with banking organizations in mortgage markets across the country. The largest, Countrywide Financial, made more than $250 billion in home purchase loans in 2002. But many other independent mortgage banking operations have either failed to grow over the past decade, or merged with or were acquired by a large banking operation. Using data from Inside Mortgage Finance, the Joint Center (2004) reports that in 2002, the top 25 originators accounted for 78 percent of the $2.5 trillion in loans originated that year. As recently as 1990, the top 25 originators accounted for 28.4 percent of an industry total of less than $500 billion in home mortgages.

One important implication of the restructuring of the industry was the declining importance of bank deposits as a funding source for mortgages. Historically, deposit-taking institutions, such as thrifts and commercial banks, originated the bulk of mortgages through branch-based retail lending operations. In 1980, nearly half of all mortgages were originated by thousands of thrifts, while commercial banks originated another 22 percent (U.S. Department of Housing and Urban Development, 1997). Moreover, for much of the period of the 1980s, the secondary market was in its infancy. During the 1980s, many deposit-taking institutions held the loans they originated. Although

[2] For a more detailed discussion of mortgage market regulation see Michael Barr (Forthcoming, 2004)

mortgage insurance was an important element for Federal Housing Authority (FHA) and other government-backed loans, the private mortgage insurance industry was still developing, and underwriting standards and mortgage documents varied considerably from one institution to another. As a result, third party investors were reluctant to purchase mortgages that lacked standardized features and adequate credit enhancements to reduce risk (Joint Center, 2002).

Over the past two decades this system has changed, as the secondary market developed and matured, and new mortgage delivery origination system substantially replaced an origination system that was linked to the location of banking institutions.[3] According to data gathered by *Inside Mortgage Finance* (2003), even as late as 1990, less than half of all mortgages were securitized and sold into the secondary market – a figure that was bolstered by the fact that at that point Ginnie Mae was securitizing virtually 100 percent of all FHA loans. Today, nearly 70 percent of all home mortgages are securitized and sold into the secondary market, due largely to the growing presence of Freddie Mac and Fannie Mae in the marketplace. The ability to package and sell loans to the secondary market reduced the need to hold deposits (or other sources of cash) to fund mortgage loans. The government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, along with private mortgage conduits mandated standardization of loan contracts and thus streamlined and rationalized mortgage markets – helping to foster an increasingly efficient mortgage delivery system.[4]

Closely paralleling the shifts in the broader mortgage market were equally dramatic changes in the subprime originations industry. As discussed in a recent report by the Neighborhood Housing Services of Chicago (NHS of Chicago, 2004), the subprime lending industry emerged from the activities of household finance companies extending debt consolidation, home improvement loans, or other types of second mortgages. This initial phase began in the 1970s and grew through the 1980s, receiving a boost from the Tax Reform Act of 1986, which repealed the tax advantaged status of interest on non-housing consumer debt. Second lien home equity lending continued through the 1990s but most of the major finance companies that had led the revolution in credit-sensitive lending were eventually purchased or ceased operation, and the survivors now play a minor role in the market relative to refinance and purchase money lenders (Fortowsky and LaCour-Little 2002).

Beginning in the late 1990s prime lenders began moving heavily into subprime lending, a trend enhanced by the enactment of the 1999 Gramm, Leach, Bliley Financial Services Modernization Act (GLBA), which fostered the growth and development of large, diversified financial services corporations. For some this involved purchasing leading subprime outfits, while others grew through a combination of mergers and acquisitions, as well by expanding existing operations – so called organic growth (NHS of Chicago, 2004). As is true for the broader mortgage industry, these shifts promoted substantial consolidation among subprime lenders. According to the Joint Center (2004), in 2002 the top 25 subprime lenders, along with their affiliated brokers and correspondents, accounted for over 88 percent of total subprime volume while the top five accounted for nearly 40 percent of

[3] For a more complete discussion of the factors influencing the growth of mortgage lending in the 1990s see Joint Center for Housing Studies, 2002.

[4] See Kendall and Fishman, 1996 especially the chapter by Lewis S. Renieri, "The Origins of Securitization, Sources of Its Growth, and Its Future Potential," pp 17-30.

total volume. Compare this to 1996 when the top 25 subprime lenders claimed only a 47 percent share and the top 5 only 20 percent.

2.1.2. The Origination of Subprime Mortgages

The growth and consolidation of the mortgage industry was aided by the creation of a highly automated origination system. As discussed in a number of textbooks on the topic, including the excellent texts by Brueggeman and Fisher (2001), Kendall and Fishman (1998), and Fabozzi and Modigliani (2002), this new system was anchored by the growing use of credit scores in mortgage lending, as well as the creation of automated underwriting systems. New technology and marketing approaches enabled lenders to reach customers through mass media and to interact with them via phone, fax, and Internet. Lenders merged the "back office" functions needed to originate, underwrite, and service loans and created automated regional processing centers, leaving them less dependent on the physical location of their branches to reach customers.

Key to the new origination system was the advent of highly automated credit scoring and risk based pricing algorithms (Collins, Case, and Belsky, 2004). The advent of risk-based pricing meant that, rather than charging a single rate to all qualified borrowers, the mortgage market sorts borrowers into risk buckets based on factors such as their demonstrated ability to handle debt repayment, stability of employment, extent of documentation of their financial information, and the loan-to-value ratio. While the sorting algorithms and resulting classifications vary among lenders, generally subprime mortgages are defined in terms of FICO score ranges. Using data from *Inside B&C Lending*, the NHS of Chicago (2004) estimates that some 70 percent of all subprime loans originated in 2002 were classified as A- grade (FICO score 580 or greater), while 11 percent were classified as B grade (FICO 560 to 579), 8 percent C (FICO 549 to 559, and 11 percent D (FICO less that 549).

In addition to the creation of loans to match differing risk profile, there has been substantial change in the way loans are originated. Unlike the branch bank dominated system of the 1970s, today, loans are originated through one of three channels: retail, correspondent, or broker. Retail activity is most akin to traditional lending where employees of a banking or mortgage banking organization reach out to potential customers, complete a mortgage application, and underwrite and fund loans for those who meet the underwriting standards. Many retail mortgage lending operations conduct business from branch operations, though increasingly the marketing and even closing of loans is done by telephone or over the Internet. Once funded, a retail loan may be held in portfolio by the lender, sold to another lender, or packaged and sold to the secondary market.

Just as technology has fostered consolidation among mortgage banking operations, it has also enabled dramatic growth in the number of smaller mortgage brokerage and correspondent lending firms. Correspondent lenders, for example, are typically smaller mortgage brokers, thrifts or community banks who operate much like retail lenders in that they take applications, underwrite and fund mortgages. While loans are funded in the name of the correspondent, they are made in compliance with established underwriting standards and sold to a larger wholesale lender under prearranged pricing and loan delivery terms. Brokers, in contrast, do not fund loans, but simply identify potential customers, process the paper work, and submit the loan application to a wholesale lender who underwrites and funds the mortgage directly.

As reported by the Joint Center (2004), over the past ten years, there has been a substantial rise in the number of firms engaged in mortgage brokerage and correspondent lending activities. In 2002, there were 44,000 firms (with some 240,000 employees) engaged in mortgage brokerage and correspondent lending activities, almost double the number of firms operating in 1995 and up markedly from the estimated 7,000 firms operating in 1987.[5] In 2002, retail lending accounted for 40.2 percent of total origination volume, while brokers (30.8 percent) and correspondent lenders (29.0 percent) accounted for the rest.[6]

Both prime and subprime mortgages are originated through each of these three channels. Estimates of the market share of each segment tend to be imprecise but generally place the retail share between 30 and 40 percent. There is a broad consensus that retail lending is less important in the subprime market. Inside Mortgage Finance (2003), for example, puts the retail share of 2002 subprime originations at 34 percent, compared with nearly 41 percent for the prime market.[7] The publication estimates that the broker channel accounted for 45 percent of subprime originations, a share fully 15 percentage points higher than for prime mortgages (30 percent).

2.1.3. Securitization of Subprime Mortgages

According to Ranieri (1996) – an individual widely credited as being one of the architects of the current secondary market – mortgage securitization was devised in the 1970s in response to the fear that the (then healthy) thrift industry would not be capable of supplying sufficient capital to meet mortgage market demand as the baby boomers entered their peak homebuying years.[8] After earlier fits and starts the first widely successful transactions were completed in the early 1980s, taking pools of existing loans from thrift balance sheets and lodging them with Freddie Mac to issue 'pass-through' securities based on the cash flow from monthly payments on the loans in the pool. As the challenges facing thrifts mounted through the 1980s, billions of dollars worth of loans in thrift portfolios were securitized, along with an ever-growing share of newly originated loans.

Despite playing an increasingly central role in the nation's housing finance system, the power of securitization to attract capital to the mortgage market remained limited by the fact that only thirty-year fixed-rate mortgages could be securitized and only into thirty-year pass-through securities. In order to broaden the marketplace appeal of the product, Wall Street worked with the GSEs to devise new types of securities called collateralized mortgage obligations (CMOs), which divided or 'tranched' cash flows from a pool of mortgages into claims of differing lengths and payment periods. When issued with Freddie Mac or Fannie Mae guarantee of timely payment of principal and interest,

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5 Wholesale Access Mortgage Research and Consulting. 2003. "Mortgage Brokers 2002," Press Release, August 13. Available at http://www.wholesaleaccess.com/8.6.03.mb.shtml.

6 Estimates from Inside Mortgage Finance, 2003. These figures closely approximate data presented in *2002 Mortgage Industry Directory*, a publication of the National Mortgage News. They estimated that in the first quarter of 2002, the retail channel accounted for only 39.7 percent of all lending, with the broker and correspondent share totaling 29.9 and 30.4 percent respectively.

7 Mingelgrin and colleagues (2002) put retail share of subprime originations at less than 20 percent.

8 In addition to Ranieri (1996), the history of the growth of securitization is drawn also from Brendsel (1996) and Fink (1996).

these new securities offered nearly risk free returns above Treasury Bonds of equivalent maturities and were priced at extremely competitive rates relative to investment alternatives such as corporate bonds. When issued by Ginnie Mae the securities carried the full faith and credit of the US government and, again were a competitive alternative for the investor looking for a return modestly above the U.S. Treasury rate.

While the financial innovation of varying maturities succeeded in attracting additional capital to the mortgage market, several key legal and regulatory impediments restricted securitization's full flowering. Among the most important were state-level restrictions on the ability of some investors to purchase pass-throughs and CMOs, limitations on the nature and extent of cash flow tranching imposed by the Department of the Treasury, and other tax issues (Ranieri 1996). These problems were addressed by passage of Secondary Mortgage Market Enhancement Act of 1984 and the Tax Reform Act of 1986. Together, these acts created the Real Estate Mortgage Investment Conduit (REMIC) that cleared up lingering tax issues, and gave Wall Street tremendous flexibility to construct securities with widely ranging maturities and previously prohibited characteristics.[9]

The successful securitization of conforming mortgages led to the securitization of other assets, such as auto loans, credit card receivables, equipment leases, student loans, and manufactured home loans. Issues backed by collateral other than conforming mortgages are collectively referred to as asset-backed securities (ABS). This includes those backed by subprime mortgages, which Wall Street calls Home Equity Lending (HEL), in reference to the origins of the industry in second-mortgage lending and the continuing dominance of cash-out refinance loans. Securitization of subprime mortgages has increased steadily as the volume of originations has grown. Between 1995 and 2003 the value of home equity securities outstanding increased nearly tenfold, from $33.1 to $313.5 billion. In 2002 the net increase in securitized loans outstanding was equal to nearly half of the $213 billion worth of subprime loans originated. While still dwarfed by the multi-trillion dollar agency market, subprime mortgage securities (i.e., HEL ABS) are the now the second largest share of the $1.6 trillion in ABS outstanding, trailing only credit-card receivables ($402 billion), and ahead of auto loans ($229 billion).[10]

According to mortgage industry experts, the benefits of securitization are many fold. Cowan (2003) explains, for example, that the securitization process allows risk to be isolated and reallocated among investors most willing to assume it. Those willing to take on some credit risk can purchase junior securities in varying loss positions. Because credit events pose minimal problems for most investors, the key source of differentiation among securities derives from prepayment risk and interest rate risk. By creating tranches of differing durations and exposure to prepayments, securitization can also help investors manage these risk factors as well.

According to Roever (1998), securitization conveys many advantages to borrowers as well. First, it increases credit access by bringing more capital to the mortgage market. It does so by increasing the

[9] REMIC status simplifies the legal, regulatory and accounting obstacles associated with issuing multiple asset classes and removes the threat of double taxation at the federal level for a securities issue backed by mortgages (Singer 2001b).

[10] The source of these statistics for securities outstanding is the Bond Market Association and for originations is Inside B&C Lending.

pool of investors for whom investing in mortgages is possible and/or desirable and by recycling the capital raised by selling securities back through the mortgage market. The second benefit is lower mortgage costs. By designing mortgage securities meeting the risk and return requirements of a variety of investors, the cost of the capital funding mortgage loans can be reduced. Some share of this reduction is passed on to borrowers. At the same time, securitization has added to the overall complexity of the mortgage process and raised important policy issues. Unlike a simple transaction between a borrower and lender, securitization adds numerous players to the process, which can make it difficult to sort out responsibility when loans go bad. This can be particularly challenging with respect to default and foreclosure, especially in situations where the foreclosure was triggered by abusive practices on the part of the lender.

2.1.4. Trends in Subprime Servicing

New technology fostered the consolidation of other segments of the mortgage industry as well. Nowhere is this trend more evident than in mortgage servicing and securitization. Today, the top five organizations now service almost 40 percent of all loans, against 10 percent a decade ago (Cutts and Green 2003). The subprime market has not reached this degree of consolidation. Indeed, the NHS of Chicago (2004) argues that this reflects the fact that the subprime market itself is relatively young, and has yet to realize fully the potential cost reductions linked to scale economies. Alternatively, lack of consolidation could indicate a difference in borrower characteristics that make subprime servicing less conducive to consolidation.

There exist only a few studies that have examined the factors supporting consolidation in the servicing industry. More than a decade ago Follain and Zorn (1990) predicted that the unbundling of traditional thrift functions, including servicing, in response to regulatory changes in the 1980s would lead to increased 'specialization' of these functions in the overall mortgage market. Interestingly, Follain and Zorn were unsure about the impact of economies of scale on specialization or consolidation among servicers. Rossi (1998) addressed this issue in a study examining the cost structure of the mortgage banking industry designed to evaluate future consolidation trends in origination and servicing. He notes that an earlier study by the Mortgage Bankers Association showed servicing costs at mortgage banking operations with less than 5,000 loans were double those of mortgage banks with more than 70,000 loans. Using 1990-1992 balance sheet and income statement data from mortgage banks, Rossi finds that substantial economies of scale in servicing exist even at the highest output sizes. He claims that servicing is particularly amenable to scale economies because of the extent to which its requirements can be automated and involve information sharing. Rossi (1998) concludes that as of the early 1990s mortgage banking was an industry characterized not only by scale economies, but also by declining costs due primarily to servicing.

According to the NHS of Chicago (2004), it remains an open question as to whether the subprime sector will realize the scale economies so prominent in the prime market. The NHS of Chicago report notes that one question that continues to divide the industry is whether there are meaningful differences in the best approach to servicing subprime as opposed to prime borrowers. Obviously prime borrowers differ from subprime borrowers since on average prime borrowers have superior credit backgrounds, tend to have larger cash reserves and more stable employment histories than subprime borrowers. Prime borrowers also have greater sources of emergency cash, such as friends

and relatives with funds available to help them get through a rough patch. In combination, these features make prime borrowers less likely to become delinquent or to default on their loans.

One additional source of difference relates to the greater prevalence of inappropriately originated loans in the subprime market. To the extent that broker malfeasance produces loans for which borrowers are marginally qualified, delinquencies and defaults will also be higher, and servicing will be more challenging. Cutts and Van Order (2002) have also suggested that subprime borrowers may be more likely to 'borrow' from the note holder by deliberately not paying their loan for a month or two in order to address other financial concerns. When they come current a few months later they take the penalty for doing so as an interest payment on what amounts to a short-term loan.

The NHS of Chicago report (2004) notes that these differences suggest the need for a very different and higher-cost approach to servicing subprime borrowers, one that potentially requires increased human contact and hence reduced scope for economies of scale to operate. Collateral is also likely to be weaker because it tends more often to be located in marginal neighborhoods and because the subprime owner may have fewer resources available to maintain the home's quality. In addition, subprime loans tend to be smaller and the homes less expensive, meaning that less equity is typically available to reward the effort and expense of going through foreclosure. Further, as the preceding paragraph suggests, even fairly severe delinquencies are not necessarily indicative of the subprime borrower's lack of willingness to remain in the home. Given the high cost of foreclosure it is therefore almost always preferable for the lien holder to employ a workout if the delinquent borrower has the ability and willingness or the desire to do so.

Another key issue is servicers' differing incentives for pursuing loss mitigation in the prime and subprime markets. Cutts (2003a: 2) claims that servicers in the conforming market are very price conscious because they are compensated by "a flat servicing fee with fee/bonus incentives from investors for achieving low incidences of default. Thus, any change in practice that streamlines processes, reduces the incidence of foreclosure and REO, or increases the cure rate on delinquent loans will result in a direct increase in profitability for the servicer." In the subprime market where third party servicing is less common, servicers are more often in line to take the first losses due to default and delinquency (referred to in the servicing industry as having 'skin in the game'). This investor role provides stronger incentive to avoid foreclosures than do the bonus fees.

Because risk levels are less well established in the subprime market and because the risk of credit losses is higher, potential returns to investors in residual security tranches from minimizing credit losses are much larger on a subprime than a prime securities issue. Therefore, subprime servicers holding residual risk can devote additional effort to foreclosure avoidance and loss mitigation beyond what would be economic in the prime market with the expectation of making it up via improved performance of the residual interest in the securities they hold. This is true even in comparison to a prime market servicer holding a residual interest in a loan pool because the payoff for success is larger in the subprime market to compensate for the demonstrably higher credit risk of the borrowers.

2.2. Patterns of Subprime Lending

The availability of HMDA data and identification by the U.S. Department of Housing and Urban Development (HUD) of subprime lender specialists that report HMDA data have greatly facilitated

the analysis of trends in subprime lending at the neighborhood level in metropolitan statistical areas (MSAs) throughout the country.[11] As a result, there is a fairly rich literature on this topic. This section briefly reviews the descriptive studies on these topics, paying specific attention to the spatial variation in subprime lending, as well as the spatial variation in income, credit history and other factors that might contribute to the observed patterns.

2.2.1. Spatial Variation in Subprime Lending

Numerous studies document the spatial variation in subprime lending and particularly the tendency for subprime lending to be more prevalent in low-income and minority neighborhoods than in others. Using 2000 HMDA data, Scheessele (2002) reports that while subprime lenders accounted for 16.4 percent of refinance loans in high-income neighborhoods (areas with incomes greater that 120 percent of area median), these lenders accounted for 36.3 percent of these loans in low-income areas (areas with incomes less than 80 percent of area median). The disparity in market share by neighborhood racial composition is even more striking. In 2000 subprime lenders accounted for 14.3 percent of refinance loans in neighborhoods where Blacks comprise less than 30 percent of the population, but 47.8 percent in areas where Blacks account for more than half of the population—more than three times as high a share.

This pattern is evident in a large number of market areas throughout the country. The importance of race as a factor in the geographic distribution of subprime lending is demonstrated by a comparison of subprime lenders' share of refinance loans in high-income Black neighborhoods compared to low-income areas where Blacks comprise a relatively small share of the population. Scheessele finds that in 2000, subprime lenders accounted for 42.2 percent of refinance loans in high-income areas where Blacks make up more than half of the population. In comparison, subprime lenders accounted for only 29.5 percent of refinance loans in low-income areas where Blacks were less than 30 percent of the population.

Given the availability of HMDA data at the census tract level, most studies of subprime lending patterns provide information on individual MSAs as well national totals. The most comprehensive reporting of MSA level data is in Bradford (2002), which covers all MSAs in the country, while ACORN (2002) provides information on the 60 largest MSAs. Both of these studies provide data on subprime lenders' share based on the race of the borrower, while Scheessele reports data on subprime lenders' shares by neighborhood income and racial composition for 27 metro areas. These studies have found that while there is a broad range across markets in subprime lenders' market shares both overall and for specific classes of borrowers and neighborhoods, subprime lending has grown significantly in virtually all parts of the country and the concentration of subprime activity in low-income and minority communities is not restricted to just a few markets.

The Joint Center for Housing Studies (2004) provides further documentation of what they call the "Prime Lending Gap" in minority neighborhoods. In 2001, prime conventional lenders accounted for

[11] Since HMDA data do not include loan terms (such as interest rate or points), there is no way to identify subprime loans from reported data. Through a series of phone interviews and review of industry literature, Scheessele (1999) created a list that identified those lenders that exclusively or primarily make subprime loans.

nearly three quarters of all home purchase lending to whites, but less than 50 percent of lending to Hispanics and only 40 percent of lending to African Americans. Noting that there are noticeable income differences, on average, between borrowers of different race and ethnicity, the Joint Center argues that the racial gap in prime home purchase lending persists even after controlling for borrower income. In addition, the share of African Americans and Hispanics refinancing their homes with conventional prime loans also trails the white share in each of the income categories presented. This is despite the fact that refinance lending is generally considered to be less risky than home purchase lending because loan to value ratios tend to be lower and lenders can review the payment history on the current loan to determine whether to extend new financing.

In recent years, many researchers have focused on what they call the "risk or race question" arguing that it is "race" not "risk" that explains the persistent prime lending gap.[12] For example, in a comprehensive review of neighborhood lending patterns in Chicago in the late 1990s, Immergluck and Wiles (1999) observed that conventional prime lenders served higher-income white areas, while FHA and subprime lending was concentrated in lower-income and minority communities. Characterizing this as a "dual mortgage market," they noted that the racial disparities were too great to be explained by differences in the credit quality of the borrowers. Instead, they argued that the observed patterns resulted from the failure of "mainstream lenders" to seek out credit worthy borrowers in lower-income and minority communities.

Researchers at HUD similarly concluded that a lack of competition from prime lenders has enabled subprime lenders to gain a growing share of mortgage lending activity in lower-income and minority communities. In addition, they noted that racial discrepancies in lending patterns existed at the borrower level and that upper-income African American borrowers were twice as likely as lower-income, white borrowers to hold subprime refinance loans. Finally, based on their summary of several HUD-funded studies, Fishbein and Bunce (2000) concluded that a portion of borrowers whose credit would allow them to qualify for lower cost conventional prime loans were nonetheless receiving subprime loans. They also found that the higher interest rates charged by subprime lenders could not be fully explained by neighborhood and/or borrower risk factors.

Similarly, Calem, Gillen and Wachter (2003) examined spatial variation in subprime lending across census tracts in Chicago and Philadelphia. In addition to detailed borrower data, this study incorporated a variety of tract-level measures drawn from the 2000 Census.[13] Of note was their use of tract-level risk measures, including the share of properties in foreclosure, as well as the share of individuals within the tract with very low or no credit scores. The credit score data was obtained from CRAWiz®, a product of PCI Services of Boston, that provides software and tract level data for analyzing mortgage lending patterns. The credit information was obtained by PCI Services from the credit reporting agency, Experian. In particular, they found that "even after inclusion of the full set of explanatory variables, in both cities we find a strong geographic concentration of subprime lending in neighborhoods where there is a large population of African American homeowners" (2002: 14).

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[12] The phrase "risk or race" was suggested by a compressive study of subprime lending patterns prepared for the Center for Community Change. See Bradford, 2002.

[13] Census variables provided detail on income, education, and race/ethnicity.

Though some advocates suggest that the absence of prime lending in inner city neighborhoods reflects the fact many banks closed their inner city offices, the Joint Center (2004) study suggests that something subtler is at work than simple "redlining." Indeed, communities that previously had little or no access to mortgage money have had significant growth in lending. For example, in 1993, in predominantly minority, lower-income census tracts, there were 15.7 home purchase loans made on average. These loans were made by an average number of 8.4 lenders, including an average of 2.4 of the nation's top 25 lenders. By 2001 these figures had jumped to 30.3 loans, made by an average of 15.1 lenders, including 5.9 of the nation's top 25 lenders.

The Joint Center argues that while automated systems make it easy to process applications for prospective buyers with credit characteristics that fall within the norms of standard programs, the entry of large, well-capitalized players into the lower-income market segment, does not mean that the new mortgage delivery system necessarily provides "competitive pricing" to all market participants. Even as automation has lowered the cost of reaching borrowers with well-established credit, it remains a more complicated – and thus more expensive – proposition to identify programs that fit the needs of families with little or no credit history. As a result, an increasingly large segment of the subprime market is now left to smaller scale brokers and others who develop the local knowledge and contacts to engage in the "high touch" lending needed to reach out to the traditionally underserved.

2.2.2. The Credit Characteristics of Borrowers

As discussed above, subprime lending is most prevalent in low-income and minority neighborhoods. Of course, it might be expected that subprime lending would be more prevalent in these areas as low-income households are more likely to have higher credit risks and so are more likely to use subprime financing. As suggested in the Treasury-HUD study (2000), to some extent these geographic disparities may reflect geographic variations in credit characteristics of borrowers, differences in the types of loans generally obtained (e.g., small balance loans), and less competition from mainstream lenders. However, while these factors are generally accepted to play a role in explaining the observed pattern, there has been relatively little research that directly tests these hypotheses. The lack of research in this area reflects a lack of readily available information about the credit characteristics of borrowers and the spatial distribution of lenders to support such studies.

One study that has examined the distribution of credit scores by neighborhood characteristics is Avery et al. (1997a). These researchers obtained credit score information for all individuals residing in 994 zip codes representing a stratified random sample taking into account region, metropolitan status (i.e., central city, suburban or rural), and median household income.[14] The data on individuals was used to create household level credit scores, which were then further aggregated to create median household credit scores for each sampled zip code. Avery et al. then regressed a series of zip codes characteristics on the median household credit score to determine the extent to which neighborhood

[14] Zip code areas have an average population of about 30,000, making them more than seven times larger than the average census tract, which is a more common definition of neighborhood for statistical analysis. Because they are larger, they will also be more heterogeneous than census tracts. One might expect that the greater heterogeneity would make it more difficult to find an association between zip code characteristics. However, despite their large size, the analysis by Avery et al. finds a number of statistically significant and sizeable associations.

credit scores varied with these characteristics. They find that the characteristics with the greatest association with credit scores included having poverty rates over 25 percent, unemployment rates over 9 percent, minority shares of the population over 30 percent, less than 10 percent of the population over age 60, and being located in the East South Central census region. Characteristics with statistically significant but smaller in magnitude associations with credit scores included having median house values below 80 percent of the area median, median incomes below 80 percent of the area median, less than 70 percent of adults graduated from high school, and being located in the West South Central or South Atlantic census regions.[15] While this study does not examine the relationship between mortgage lending patterns and credit scores, it does indicate that low-income and minority areas do tend to have lower median household credit scores.

One study that does include measures of credit risk in examining mortgage use at the borrower level is Pennington-Cross, Yezer and Nichols (2000a). This study benefits from a unique data set on homebuyers that includes a variety of risk measures that are not generally available, including credit history and non-housing debt levels. The study also includes geographic area characteristics, although most of these are at the metropolitan area and not the neighborhood level. The authors conclude that subprime borrowers do, in fact, have higher risk characteristics than borrowers in the conventional or FHA market segments, indicating that the subprime market is appropriately targeted at high-risk borrowers. Nonetheless, they also find that Black and Asian borrowers have higher probabilities of obtaining subprime financing even after controlling for the risk factors of credit score, debt levels, and income.

Pennington-Cross and Nichols (2000b) analyze average credit scores by a variety of borrower characteristics and conclude that credit scores are lower for lower-income borrowers, but the differences are not large. The average FICO score for borrowers with income below $30,000 was 709.2, compared to an average of 726 for borrowers with income above $100,000. In contrast, there was much greater variation in average FICO scores by loan-to-value ratio (LTV), with low LTV borrowers (less than 65 percent) averaging 748.8, compared to 671.6 for borrowers with LTVs above 100 percent. This analysis pertains to average borrower income, rather than average neighborhood income. So while there is little variation in credit score by household income, there might be greater variation by neighborhood income. Pennington-Cross and Nichols do compare the average credit score for borrowers in underserved and served census tracts. Since underserved status is based on the racial composition and income level of the neighborhood, this provides some indication of neighborhood variation in credit scores. Underserved areas are found to have an average FICO score of 702.1, compared to 723.0 for served areas. This provides some support for the argument that these areas are associated with greater credit risk, but, as with differences by household income levels, the magnitude of the average differences is not large.

Concerned that the observed racial disparities in access to prime lending simply reflect difficult to capture differences in credit worthiness, Pennington-Cross, Yezer and Nichols (2000b) examined issues related to credit risk and mortgage lending and estimated the probability that an individual

[15] To give a sense of the degree of association between neighborhood credit scores and household income levels, they find that in zip codes with median incomes less than 80 percent of the area median 29.5 of individuals have scores of 602 or lower, compared to 14.9 percent of individuals in zip codes with median household incomes above 120 percent of the area median.

borrower selected a conventional prime, subprime, or FHA insured mortgage. The study analyzed a database of home purchase loans that combined HMDA data with data from FHA administrative files, a sample of real estate transactions, and a measure of borrower credit quality. While the study confirmed that borrower income, debt, credit history and neighborhood factors significantly influence the pattern of mortgage lending, race and ethnicity still appeared to be key determinants in explaining why African Americans, Native Americans, and Hispanics are less likely to have access to lower-cost, prime home purchase loans than whites.

Another recent study provides support for the argument that at least some subprime borrowers would likely qualify for prime loans. Using detailed data on borrower and loan characteristics including measures of risk, researchers from Freddie Mac (Lax, et al, 2000) found that the interest rate differential between prime and "A-" loans could not be justified by differences in credit risk of these borrowers—even when the authors make conservative assumptions about the loss rates and servicing costs of these loans.

In a recent paper, Courchane, Surette and Zorn (2004) examined whether minority borrowers were "inappropriately" channeled into the subprime segment. The study explored mortgage lending patterns using FICO scores and other traditional measures of risk as well as what the authors described as "borrower self-assessed credit risk factors"[16] gathered from a survey of mortgage borrowers. The paper confirmed that whether borrowers obtain subprime or prime mortgages depends in large measure on risk-related mortgage underwriting variables, including FICO score, LTV, and the ratio of monthly housing costs to income (or "Front-End Ratio"). Nonetheless, other factors not related to borrower risk are also significant and suggest that some borrowers may be improperly receive subprime mortgages. These factors include borrower age, market channel, ethnicity and shopping behaviors.

The addition of measures of market knowledge, search behavior, and choices available contributed significantly to explaining borrower outcomes. The authors concluded that the superior performance of the "full" model in explaining whether a borrower obtained a prime or subprime loan implies that credit risk alone may not fully explain why borrowers end up in the subprime market. Rather, their paper supports the alternative view that the current mortgage delivery system produces an allocational inefficiency wherein households of similar economic, demographic, and credit risk characteristics do not pay the same price for mortgage credit.

2.2.3. The Shopping Behavior of Subprime Borrowers

As envisioned in simple economic theory, the ability of consumers to shop for the best available price and terms plays a key role in preventing market discrimination. For example, in a market where people have the ability to comparison shop, a broker may lose business if he pushes costs too high. Unfortunately, given the bewildering array of mortgage products available, even the most sophisticated borrower will find it difficult to evaluate the details of a mortgage since the essence of mortgage pricing reflects decisions concerning repayment of debt over time. Indeed, there is a

[16] For example the survey gathers data on whether the borrower believes that they "have good credit," "pay bills on time," and are "in control of their finances," as well as information on search behavior and adverse life events such as loss of job.

growing body of "behavioral economics" literature that suggests that consumers have differing and often inconsistent time preferences depending on how the choices regarding payment over time are framed.[17] For example in a recent paper, Shu (2002) argued that the complexity of discounting mathematics and an inability to estimate this function in their head leads people to turn to alternative "Short Cut Methods," such as heuristics or simplified linear models. For example, one short cut method might be for the consumer to estimate the total loan payments (number of payments times the payment size) and look for a loan that minimizes this total. If the loan terms being compared were held constant, this heuristic would be equivalent to finding the loan with the lowest interest rate. Yet over loans of various terms, the loan with the lowest total payments may not be the loan with the lowest annual percentage rate (APR).[18] Aside from APR, others focused on minimizing the length of the loan term, while for others, minimizing monthly payments was given priority.

Mortgage brokers may be particularly likely to exploit the fact that borrowers rely on short cut methods to make borrowing decisions to sell borrowers on subprime loans or other unfavorable loan terms. For example, a recent AARP study (Kim-Sung and Hermanson 2003) examined subprime lending patterns using a random sample of 1,008 individuals aged 65 and older that refinanced their home between January 1999 and December 2000. Kim-Sung and Hermanson noted that broker-originated refinance loans were nearly twice as likely to be subprime as lender-originated loans (33 versus 17 percent). They also showed that nearly half (49 percent) of the surveyed borrowers obtained a retail lender-originated loan, 39 percent a broker-originated loan, while some 12 percent reported receiving their loan from a home improvement contractor or some other source. A higher share of broker-originated loans went to African American borrowers (64 percent) than white borrowers (38 percent) and broker-originated loans were also more common among borrowers who were divorced or female.

What is perhaps most striking is the way homeowners in the sample searched (or in many instances did not search) for the best loan available. The AARP study supports the notion that in many instances subprime refinance loans are "sold, not sought" in that they result from the extensive and often unsolicited outreach by brokers. Kim-Sung and Hermanson found that some 56 percent of borrowers with broker-originated loans reported that brokers initiated contact with them, compared with only 24 percent of borrowers with lender-originated loans. Since they did not initiate the search activity, it is not surprising that a larger share of borrowers with broker-originated loans (70 versus 52 percent) "counted on lenders or brokers to find them the best mortgage." Unfortunately, this confidence was often misplaced.

Many borrowers, especially elderly borrowers, and borrowers in lower-income and/or minority areas, succumb to the marketing tactics of aggressive brokers. Borrowers with broker-originated loans were more likely to pay points (25 versus 15 percent) and more likely to have a loan with a prepayment penalty (26 versus 12 percent). A greater share of borrowers with broker-originated loans also believed that they did not get a loan that was "best for them" (21 versus 9 percent), received a loan

[17] For a good summary of this strand of literature see Thaler and Sunstein, 2003.

[18] Shu (2002) presents evidence that the problems associated with deciding what is the best way to borrow money and repay over time is not limited to "unsophisticated borrowers." Using a panel of students enrolled in the MBA program at the University of Chicago, she finds that even financially sophisticated individuals have trouble determining cost minimizing alternatives for a stream of future payments.

with mortgage rates and terms that were "not fair" (23 versus 8 percent) and did not receive "accurate and honest information" (19 versus 7 percent).

These findings are echoed in a number of other studies. Survey data presented in a study by Courchane, Surette and Zorn (2004) painted a similar picture. This study suggested that subprime borrowers are less knowledgeable about the mortgage process, are less likely to search for the best mortgage rates, and are less likely to be offered a choice among alternative mortgage terms and instruments. Similarly, another AARP survey (AARP, 2003) conducted in 2003 examined consumer knowledge of the mortgage lending process. While AARP reported that most survey respondents aged 45 and older understood the basic loan application process, including Truth in Lending Act (TILA) disclosure requirements, many did not. For example, more than 10 percent of all respondents were unaware that the lender is required to disclose fees before loan closing, while more than 20 percent were unaware that the lender is required to disclose the APR of the loan prior to closing. Moreover, AARP noted that African Americans were slightly less likely than the general population to correctly answer the TILA related questions included in the survey.

The AARP survey also asked respondents about the steps they took to shop for a home equity lender. Most respondents made multiple inquiries concerning alternative home equity loan products; however, there were notable exceptions. For example, African Americans were significantly less likely than the general population (36 versus 77 percent) to shop for a home equity loan at their bank, savings and loan or credit union. AARP posited that this might be related to the fact that the African Americans surveyed were significantly less likely (72 versus 88 percent) than the general population to have a savings or checking account at one of these same institutions. Lacking access to banking services, African Americans were more likely (29 versus 10 percent) than the general population to go to a lender recommended by their contractors and more likely (21 versus 9 percent) to respond to advertisements received in the mail or over the phone.

While the studies by Courchane, Surette and Zorn and AARP showed that subprime borrowers do not shop, Guttentag (2001) went further to argue that because of the complexity of mortgage products, consumers are, in many ways, incapable of being effective shoppers. According to Guttentag, "the core reason for market failure is that effective shopping for a mortgage is extraordinarily difficult for even sophisticated borrowers (2001: 3)." To support this claim, Guttentag documented substantial variation in broker compensation, a situation that should not exist if consumers have the capacity to shop for the best available terms. He examined a sample of conventional prime loans and found that broker profits ranged from $1,077 to $2,748 and had no apparent relationship to the level of the effort required to process the loan application.[19]

Guttentag emphasized the fact that pricing variability is not a prime or subprime issue but rather a product of the way mortgage markets function. This was followed by a detailed discussion of the characteristics of the current mortgage market, such as product complexity and the tendency for loan terms to change daily, that undermine the ability of borrowers to effectively comparison shop. For example, the difference between a thirty year fixed rate mortgage with an interest rate of 6.5 percent and 3 points and one at 7.25 percent with no points, while substantial if the loan is held to term, is negligible over a five-year time horizon. Most borrowers, however, are unaware that the length of

[19] In a recent paper, Woodward (2003) came to a similar conclusion.

time the loan is actually held has a tremendous influence on the effective interest rate generated by the point and rate combination.

Shopping for the best price is made even more difficult by the fact that mortgage borrowing involves many participants including loan officers, underwriters and processors, property appraisers and insurers, title insurers, credit reporting agencies, mortgage insurers, abstract companies, pest inspectors, and flood insurers to name a few. In addition to the complexity of the product, the complexity of the process provides an opportunity for brokers to collude with some of these participants to skim extra cash from the borrower. Moreover, the sheer number of documents associated with a mortgage loan provides ample opportunity for a broker to introduce unfavorable provisions into the loan without the borrower's knowledge.

2.3. Adverse Consequences of Subprime Lending

An unintended side-effect of the ongoing efforts to extend home ownership opportunities to less credit worthy consumers – and particularly the rise in subprime lending – is a commensurate increase in foreclosure rates. While unintentional, this outcome is not surprising because many lower-income and lower-wealth borrowers have trouble making timely mortgage payments and are more likely to slip into delinquency and default. The fact that much of the recent expansion in homeownership has occurred among historically underserved borrower groups has served to concentrate homebuying in lower-income neighborhoods with relatively fragile housing markets. This pattern, coupled with the sometimes aggressive and abusive marketing and origination practices described in other sections of this report, produce concentrations of foreclosures potentially giving rise to a 'contagion' effect in which foreclosures above some threshold level can depress prices in an area and set off a further cycle of foreclosures and decline.

2.3.1. National Trends

There can be little doubt concerning the link between the increase in foreclosures and the growth of subprime lending. Employing the best available data on loan performance, researchers at Freddie Mac (Cutts and Van Order, 2003) estimated that as of mid 2002, the serious delinquency rate for conventional prime loans was 0.55 percent (serious delinquency is defined as loans that are already in foreclosure and/or with payments that are 90 days or more late).[20] In contrast, subprime loans had a serious delinquency rate of 10.44 percent, nearly 20 times higher. Further, the more risky subprime loans examined by Cutts and Van Order (labeled in the study as 'C' or 'CC' loans) had rates topping 21 percent. Subprime serious delinquency rates were more than twice those of FHA insured mortgages (4.45 percent). Though hardly in evidence a decade ago, subprime loans are now the most default-prone mortgage segment of the home loan market. Overall, the Freddie Mac data suggest that today, subprime loans account for half of all seriously delinquent loans, while conventional prime and FHA loans each account for about one quarter of all seriously delinquent loans.

The success of the subprime segment of the mortgage market in extending credit to ever more risky borrowers, in combination with the weak economy, have combined to push the national serious

[20] See especially Cutts and Van Order (2003) Table 1 that combines data on loan performance from various sources to develop estimates of serious delinquency for loans of varying credit quality.

delinquency rate to its highest level in decades. Collins, Belsky and Case (2004) present estimates of serious delinquency rates by market segment for the period 1998 to 2003 showing that the number of subprime delinquencies and foreclosures have nearly doubled from 1998 to 2001 before falling off slightly. Irrespective of the change in foreclosure rates, subprime foreclosures are a larger problem today than in 1998 because subprime's share of loan originations now exceeds 5 percent – a 50 percent increase over its mid-1998 share – and because the overall mortgage market is much larger than five years ago. As noted earlier, higher foreclosures among subprime loans are a natural outgrowth of the lower credit quality that characterizes the subprime market. This effect is reinforced by the fact that collateral value in the subprime market is generally weaker.

2.3.2. Metropolitan Area Specific Foreclosure Studies

While no study has systematically examined foreclosures at the MSA level nationally, a handful of existing studies demonstrate increasing foreclosure rates in low-income communities across the country. The roughly ten studies of foreclosure activity in particular metropolitan areas conducted to date, while differing in terms of the quality and extent of available foreclosure data, paint a remarkably consistent picture of the rising incidence of foreclosure, especially in lower-income and minority neighborhoods.

A study of Baltimore noted that the number of foreclosures increased from 1,900 in 1995 to over 5,000 in 1999 and that the growth was particularly pronounced in African American areas (Treasury-HUD 2000). The study also found that over a quarter of the subprime loans in foreclosure in the first quarter of 2000 were less than a year old and over half were less than two years old. The fact that so many loans were in foreclosure less than two years after origination suggests that many borrowers may not have had the capacity to repay the loan at the time it was made.

In Atlanta, researchers from Abt Associates examined loans entering foreclosure and found that the share of foreclosures attributable to subprime lending increased from 5 percent in 1996 to 16 percent in 1999 (Gruenstein and Herbert, 2000a). Moreover, researchers noted that almost half of the foreclosed subprime loans were 'high-cost,' that is they had interest rates more than 4 percentage points above the 30-year Treasury rate at the time of origination. As was true in Baltimore, more than half of these subprime loans went into foreclosure less than two years after being originated.

In Boston, where home values appreciated rapidly in the late 1990s, the strong market allowed many distressed owners to sell their homes thereby avoiding foreclosure. In fact, from 1995 to 1999, overall foreclosures decreased by 30 percent (Gruenstein and Herbert 2000b). However, the study also noted that subprime originations more than quadrupled from 1994 to 1998, with even stronger growth in areas with high concentrations of low-income minorities. Over the same period, subprime foreclosures grew by some 154 percent, and came to constitute 11 percent of Boston area foreclosures in 1999.

In Rochester, New York residential foreclosures almost tripled from 361 in 1990 to 1,000 in 1999 (The Housing Council, 2000). Historically, Rochester witnessed high levels of FHA foreclosures, foreclosures that were typically linked to programmatic mismanagement and abuse. Of particular concern was the fact that operating under the safety net of 100 percent government insurance, some unscrupulous lenders and mortgage brokers pushed mortgages on individual low-income families

with limited ability to repay, or otherwise abused unsuspecting low-income borrowers. While these abuses appear to have subsided, high rates of prime mortgage foreclosures continue today in Rochester as a result of the persistent economic weakness of the Upstate New York Region and the generally weak demand for homes located in central city neighborhoods. Many homeowners in inner city communities with weak real estate markets have mortgage balances that exceed the appraised value of their homes. In this instance, financial problems stemming from illness, unemployment or divorce can quickly lead to default and foreclosure.

Perhaps the most detailed examination of foreclosure trends was conducted in Chicago. Faced with a rapid rise in foreclosures for the neighborhoods in which it operates, NHS of Chicago, along with Neighborhood Reinvestment and the National Training and Information Center (NTIC) released a report in February 2003 that analyzed available Chicago area foreclosure data (Collins, 2003). According to this report, the foreclosure rate in Chicago stood at 4.7 percent in 2001 – over tens times the national average foreclosure rate for prime conventional loans. In the nine low-income neighborhoods served by NHS of Chicago, the foreclosure rate reached 7.7 percent in 2001. Overall, some 40 percent of all completed foreclosures in Chicago were in these nine-targeted neighborhoods. Yet, these communities represented only 5 percent of all mortgage originations in 2001 and accounted for just 18 percent of the city's population.

The fact that concentrated foreclosures weaken revitalization efforts and may trigger or exacerbate neighborhood decline is one of the most compelling, mortgage-related public policy issues today. Capone and Metz (2003) point out that, even as the increased focus on homeownership as a component of community development efforts throughout the 1990s stabilized and improved many neighborhoods, it also exposed them to additional risk of foreclosure-related problems by increasing the share of marginal borrowers in these places. While Capone and Metz focus their analysis on FHA's loss mitigation practices, the process of decline they associate with FHA foreclosures is equally applicable to the subprime market. Put simply, to the extent that increasing credit access among less creditworthy borrowers boosts foreclosure rates, then subprime lending may be having negative external effects in some neighborhoods.

Taking a fine-grained approach to the potential for foreclosure contagion, Collins (2003) finds evidence supporting such a claim in the nine NHS OF CHICAGO neighborhoods in Chicago. He argues that the timing of foreclosure increases is consistent with the growth of the subprime market. Between 1993 and 2001 foreclosures increased at nearly double the rate (74 percent) of the increase in mortgage lending (38 percent). Examining potential causes of the increase, Collins shows that unemployment in the Chicago was low and home prices were generally rising, indicating that two of the most common triggers of default and foreclosure were unlikely to account for the rise. Another possible explanation, an increased share and/or deteriorating performance of FHA/VA loans is also not to blame as the number of these loans originated in Chicago fell by 3 percent while foreclosures dropped 46 percent. In contrast, conventional lending rose 148 percent and conventional foreclosures were up 271. Finally, Collins (2003) shows that more than three-quarters of foreclosure proceedings initiated in 2001 were on loans with interest rates at least 300 basis points above the thirty-year Treasury rate in the year they were originated.

Collins (2003) further examines the nine neighborhoods that have been targets of community development efforts by NHS of Chicago and found that they accounted for 40 percent of all

foreclosures in 2001. Whereas the citywide average rate of foreclosures per single-family mortgage was 4.7 percent, six of the ten NHS of Chicago neighborhoods had rates exceeding 10 percent, the highest of which was 30 percent. Many of these foreclosures apparently end up as vacant units as indicated by the discrepancy between the differing trends in vacancy rates in the area and the rest of the City. Between 1990 and 2000 vacant units declined 20 percent citywide but increased 8 percent in these nine neighborhoods.

The fact that the subprime market accounts for the majority of recent foreclosures need not serve as an indictment of the entire industry, but rather as a caution about the potential impact of a modest share of poorly underwritten loans, or higher-cost loans made with little regard for the borrower's ability to pay. In fact, legitimate subprime servicers and investors are vulnerable to the negative impact of the contagion dynamic as the rise of foreclosures from bad loans can negatively influence what otherwise would have been good loans made on nearby properties. Bunce et al. (2000) found that while foreclosure rates are higher in the subprime market, foreclosures per subprime loan were not higher in low-income neighborhoods than in other areas. The danger to these neighborhoods therefore comes from their high concentrations of subprime lending, rather than worse loan performance there. Finally, both Collins (2003) and Bunce et al. (2000) found that subprime loans entering foreclosure did so about twice as rapidly following origination as did other loans, a pattern consistent with lower levels of attention paid to borrower ability to repay the loan in the subprime market.

2.3.3. Predatory Lending and Predatory Servicing

The growth of subprime lending is in some respects a positive development—borrowers with impaired credit or seeking more flexible underwriting guidelines now have more mortgage finance options. Unfortunately, the growth of subprime lending has been associated with an increase in so-called "predatory" lending practices – and more recently with accusations of "predatory" loan servicing. Besides the challenge of coming to agreement about what defines predatory practices, another challenge in evaluating the prevalence of these practices is that little systematic information exists about loan terms.

Existing studies of predatory lending are largely anecdotal, collected by legal and community advocates. Case studies of predatory lending practices have appeared in the Treasury-HUD (2000) study, in a study on subprime lending and foreclosures by the National Training and Information Center (1999) in Chicago, and in a series of reports produced by ACORN. Along with expanded credit access, subprime lending has exposed many low-income and low-wealth borrowers to abusive practices commonly referred to as predatory lending. Predatory origination practices may involve mortgage bankers and brokers, realtors, appraisers, home improvement contractors, or others involved directly or indirectly in the process. Such practices include not only outright deception and fraud, but also include efforts to manipulate the borrower through aggressive sales tactics or to exploit their lack of understanding about loan terms.

Engel and McCoy (2002) note that while abusive lending practices can and do occur in all market segments, they are most prevalent in the subprime market. In fact, they subdivide the mortgage market in three distinct segments: the prime market, the "legitimate" subprime market, and the predatory market. They argue that predatory lenders target naïve clients – often low-income and low-

wealth individuals – who are most vulnerable to abusive practices. Such vulnerable borrowers are typically disconnected from other credit markets, may lack information about best available products and/or are subject to lingering mortgage market discrimination and other social and demographic forces.

Engel and McCoy document numerous predatory practices employed to strip the borrower's home equity, burden them with higher interest rates and fees, or predispose them to default and foreclosure by disregarding the borrower's ability to repay. The most egregious examples involve unscrupulous real estate agents, mortgage brokers, appraisers, and lenders duping unsuspecting borrowers into purchasing a home at inflated prices and/or with significant undisclosed repairs. These practices harm borrowers and their communities, as well as mortgage investors and insurers. By reducing true equity in the home (the true market value less the amount of the mortgage), an inflated appraisal makes it difficult for a borrower to sell the home and repay the mortgage in a time of distress. This, in turn, increases the likelihood that the mortgage will go into default and increases the magnitude of losses incurred by the investor and or mortgage insurer during the foreclosure process.

The notion of 'predatory servicing' now rivals 'predatory lending' as a concern of regulators, community advocates and mortgage industry officials. As noted in the NHS of Chicago report (2004) this new term is generally reserved for the subprime market and refers to unfair, deceptive, and illegal practices that harm borrowers' financial interests, especially in cases where their ability to remain in the home is affected. The most egregious claim is that some servicers or servicer/investors profit from foreclosures, though industry representatives unanimously decry this claim. The recent settlement between the FTC and the largest subprime servicer, Fairbanks Capital Corp, has given weight to concerns over the fact that, for actors with substantial power to determine subprime borrowers' outcomes, servicers face little regulatory oversight, a concern compounded by the fact that borrowers cannot choose who services their loan. Fairbanks was accused of violating four federal statutes: the FTC Act, the Fair Debt Collection Practices Act (FDCPA), the Fair Credit Reporting Act (FCRA), and the Real Estate Settlement Procedures Act (RESPA). In the recently announced settlement Fairbanks agreed to pay $55 million dollars to address complaints and reimburse consumers.[21]

[21] See "Fairbanks Folly Continues" in Online Disclosure, the *National Newspaper of Neighborhoods*, September/October 2003, Issue 195.

Section 3: Alternative Financial Services Providers

Just as the subprime mortgage market was experiencing rapid growth during the 1990s, there was also rapid growth among firms outside of the system of federally insured financial institutions that provide a range of financial services typically associated with banks. These firms include check cashing outlets, payday lenders, pawnshops, title lenders, tax refund anticipation lenders, small loan firms, and rent-to-own stores. Collectively, these types of firms are generally referred to as alternative financial service providers (AFSP). As with subprime lending, several aspects of the growth of these firms have raised concerns among policy makers and advocates for low-income households. First, the costs of these services can be quite high – particularly when compared to similar financial services available from mainstream firms. For example, the annual cost of using a check casher for paychecks can amount to several times the annual cost of a low-frills checking account, while the annual percentage rate associated with short-term loans from AFSPs commonly exceeds several hundred percent compared to rates in the teens for credit charges or lines of credit associated with checking accounts or credit cards. Second, the users of these services are disproportionately low-income and minority. As a result, there is a concern that firms are taking advantage of either a lack of financial literacy among these groups or a lack of competition from mainstream financial service providers in low-income and minority communities to earn excessive profits. The implication is that the ability of low-income and minority individuals and families to save and accumulate wealth has been impaired by the growing prevalence of these firms.

This chapter begins by reviewing the literature describing the rise of the AFSP industry, including the different types of AFSPs and their growth rates. The next section then summarizes findings from studies that have examined the factors associated with the use of AFSPs, including both client and market characteristics. This chapter concludes with a review of the literature that has examined the potential adverse impacts of AFSPs on their clients.

3.1. The Rise of the AFSP Industry

Ranging from pawn shops that offered short-term loans to the grocery store on the corner that would cash a pay check for a small fee, AFSP have been a common feature in low-income and low-wealth communities for decades. The rapid growth in the AFSP industry during the 1990s has its roots in a number of factors, including changes in the regulatory environment, rapid increases in immigration, and enhanced technology that enabled AFSPs to lower costs of operations and more recently to check on the credit characteristics of individual customers. Given its diverse origins, the AFSP industry is not monolithic, as different types of firms have grown at different rates over the last few decades. Even so, many diverse types of financial services providers have discovered the profitability of serving what appears to be an unmeet demand for financial services – especially by low-income, low-wealth, and credit impaired individuals. This section provides an overview of the main types of AFSPs and trends in the size of each of these AFSP sectors.

3.1.1. Check Cashing Outlets

Overview of Check Cashing Outlet Services

The primary service of check cashing firms is to cash government benefit or payroll checks. These firms generally charge a fee of between and 1 and 3 percent of the check amount for payroll and government checks, while fees for personal checks are much higher, averaging 10 percent or more. In a survey of firms in four markets, Bachelder and Ditzion (2000) found fees that ranged from 1.3 to 2.4 percent for government and payroll checks of $400 or more, while $50 checks had fees that ranged from 2 to 4 percent. There is some indication that check-cashing fees rose during the 1990s. Caskey (1994) cites a survey by the Consumer Federation of America (CFA) in 1989 that found average fees of 1.75 percent for government and payroll checks, while a CFA survey in 1997 found that the average had risen to 2.2 to 2.3 percent for these types of checks.

While check cashing is the main service of a CCO, it is by no means the only one. Other typical services include the sale of money orders, wire transfers, and bill payment. Other services commonly offered by CCOs include: the sale of transit passes, postage stamps, and phone cards; the issuance of licenses; the processing of parking tickets; and providing photocopying and faxing services. In addition, CCOs are increasingly offering payday loans or pawn broking services.

Trends in the Check Cashing Industry

While the check cashing industry grew rapidly beginning in the 1980s, it actually has a fairly long history in the US. Caskey (1994) describes how the check cashing industry has its roots in the Depression-era when the collapse of banks left a void for those needing to cash checks. The industry received a further boost in the years after World War II as more employers began using checks to pay their employees. But up until the 1970s check-cashing outlets (CCOs) were mostly found in a few large urban areas, in particular in Chicago and New York, and did not have much of a presence elsewhere in the country. CCOs started to become more prevalent beginning in the late 1970s. Among the key factors cited by Caskey to explain this growth are the deregulation of banks that reduced the availability of no cost bank accounts and a rise in immigration. These issues will be discussed in more detail in the following section.

Another argument for the growth in CCOs is a lax regulation of the industry. An AARP review found that as of 1998 only 28 states regulated some aspect of the check cashing industry, and of these only 20 regulated the fees that could be charged (Eskin, 1999). Of the states that did set fee limits, the most common limitation was for the maximum of $5 or a fee of 3 percent on government benefit checks, 5 percent for payroll checks, and 10 percent for personal checks. Only five states had limits that were 2 percent or less. Thus, even when fees were limited, in most cases the limits were above the range most commonly charged in the check cashing industry. While the AARP survey is now somewhat dated, it does provide an indication of the regulatory climate that existed as the check cashing industry grew during the 1990s.

There are no reliable sources of information on trends in business volumes. Numerous studies report that the CCO industry accounts for 180 million transactions a year totaling $60 billion in gross revenue including $1.5 billion in fees. The original source of this figure appears to be based on data reported in a Fortune Magazine article from 1998 that was, in turn, the basis of this estimate in a Dove Consulting report (Bachelder and Ditzion, 2000). But this same figure is still quoted by the

industry association, the Financial Service Centers of America (FSCA), on their website (www.fisca.org/about.htm).

In general, growth in the industry has mostly been documented by trends in the number of CCOs listed in business or phone listings. Caskey (2003) cites figures based on national yellow page listings showing that the number of CCOs nationally grew steadily from 1,202 in 1986 to 6,097 in 1998, for an annualized rate of 14.5 percent. After 1998, the growth in CCOs became much more rapid, increasing to 16,689 in 2003. However, Caskey believes that much of the growth after 1998 can be attributed to increases in payday lending, as yellow page listings generally do not distinguish between these types of firms.

It is difficult to document Caskey's contention that there has been a slowdown in the growth of CCOs given the overlap in CCO and payday lending services in the industry, but there are several factors that support this point of view. First, as will be discussed more below, the share of the population that is unbanked has been declining since the early 1990s. This may well reflect efforts by federal and state governments to increase the availability of low or no cost checking accounts. These efforts were spurred both by concerns about the rising share of unbanked households and the high costs of CCOs as well as by a desire to distribute federal benefits through electronic transfer rather than paper checks, which required that more low-income households have bank accounts. Over the last decade there has been increasing use of electronic transfer for government programs and of direct deposit for payroll checks (Caskey, 2003; Hogarth and O'Donnell, 1999). In addition, there is also a recent trend toward the use of payroll cards to pay wages in place of paper checks. These cards function like debit cards and can be "cashed" at ATM machines or by local merchants. A recent industry newsletter corroborated the low growth potential of CCOs and the resulting shifting emphasis on payday lending.[22]

3.1.2. Payday Lenders

Overview of Payday Loan Transactions

Payday loans consist of short-term loans that are backed by a post-dated check or, in a more recent variation, an authorization for a direct withdrawal from a checking account on a specified date (Barr, 2004a). These loans are also referred to as "deferred presentments" or "deferred deposit loans" because of the use of post-dated checks as collateral. The period of the loan is typically tied to the borrowers payday – hence the name. Most commonly, loans are repayable in two weeks, but they may be as short as a week or as long as a month. Loan amounts are typically in the range of $100 to $500, with average loan amounts reported in the literature of $166 in Indiana in 1999, $246 in Wisconsin in 2001, and $232 in North Carolina (Indiana Department of Financial Institutions, 1999; State of Wisconsin, Department of Financial Institutions, 2001; and Stegman and Faris, 2003).

In contrast to the clients of CCOs, the majority of whom are unbanked, payday-lending customers by definition have a checking account. Given the greater credit risk associated with this transaction, the process for using a payday lender is somewhat more involved than simply cashing a check. In addition to a check, first-time clients are likely to have to provide recent pay stubs, copies of recent bank statements, valid identification, and utility bills or other evidence of stable residence (see

[22] See www.paydayandpaycheckloans.com/payday-loan-newsletter.html.

Caskey (2003) and Elliehausen and Lawrence (2001) for a discussion of the underwriting process). New clients may also be limited in the amount they can borrow until their credit worthiness has been established. Up until recently, credit checks have not been an important part of the process, although the industry has begun to develop its own credit reporting system, TeleTrack, to identify clients who have reneged on other payday loans.[23] Nonetheless, the process is easier and much faster than being approved for other types of credit, with a credit decision available nearly instantaneously.

A significant part of the controversy surrounding payday loans is the high interest rates charged on an annualized basis. Fees for these loans are generally expressed as a rate for each $100 borrowed due within a standard time frame, such as two weeks. A survey by CFA in 1999 found an average fee of $18.25 for a $100 loan due in two weeks, with the most common fee being $15 for such a loan (U.S. PIRG and CFA, 2000). This rate is consistent with the report by Elliehausen and Lawrence (2001) that fees typically range from $15 to $20 per $100 borrowed. The studies cited above by state regulators in Wisconsin and Indiana found slightly higher average fees of $20 to $22 per $100 borrowed, while an Illinois study found an average of $16 per $100 (Illinois Department of Financial Institutions, 1999). Given a standard term of two weeks, the annualized percentage rate (APR) is calculated by multiplying the interest rate by 26. Thus, a fee of $15 per $100 is associated with an APR of 390 percent, while a $20 fee translates into an APR of 520 percent. The APR can be even higher if the customer pays the loan back sooner than two weeks. This can occur if customers want to repay the loan on their next payday, which may be sooner than two weeks from when they take out the loan. Since the fee is not prorated for shorter loan periods, in these cases, the APR would be higher still.

When compared to APRs for other sources of unsecured, short-term consumer credit such as overdraft protection and credit cards, the fees charged by payday lenders are excessive. On the other hand, industry representatives compare the costs of a payday loan to the fees charged for a bounced check, which is typically a bank fee of $20 to $30 in addition to whatever fees may be charged by the party to whom the check was written. By these standards the fees for payday loans do not seem as excessive.

The other aspect of payday loans that is controversial is the cost of these loans when borrowers roll over the initial loan into successive payday loans. Consider a borrower who initially borrows $200 at a rate of $20 per $100 borrowed. He would have to repay $240 in two weeks, for an APR of 520 percent. If after two weeks he renews this loan, he would receive no additional funding, but now have to repay $288 in four weeks, for an APR of 572 percent. Successive rollovers of the initial loan would continue to escalate the APR.

Stegman and Faris (2003) provide a good summary of information on how common it is for payday borrowers to roll over loans. The most common sources of information on rollovers are reviews or surveys of lenders conducted by state regulators. Wisconsin regulators found that 53 percent of payday loans were rollovers of other loans. While many loans were rolled over a single time (41 percent), 22 percent were rolled over twice, 20 percent were rolled over three or four times, and 17 percent were rolled over five or more times. Indiana found an even higher share of loans that were rollovers: 77 percent of all loans reviewed were renewals.

[23] See www.TeleTrack.com for information on the credit reporting services offered by this firm.

A unique source of information on payday customers is a national telephone survey conducted by Elliehausen and Lawrence (2001). Respondents were selected for this survey from the records of 19 of the 60 firms belonging to the trade organization, the Community Financial Services Association of America (CFSA). The selected respondents were those who had taken out a payday loan in a six-month period in 2000. There was a very high non-response rate among the sample.[24] Elliehausen and Lawrence do not comment on the potential bias of such a high degree of refusal, but it does raise questions about whether their sample is representative of the universe of payday loan customers. Their survey found that 74.9 percent of customers had rolled over a loan at least once in the last year, including 39.8 percent who had taken out 5 or more renewals.

Because of the concern about escalating loan fees due to rollovers, these transactions are barred in a number of states. But this restriction can be difficult to enforce as borrowers may use loans from one lender to pay off a loan from another lender. While not technically a rollover, the transaction amounts to the same thing. Even if customers do not rollover loans, frequent use of payday loans indicates these borrowers are paying high annual costs for routine credit as opposed to rare transactions to meet a crisis. Studies by regulators in California, Indiana, Illinois, and Wisconsin found an average number of loans per customer per year of between 10 and 12 (see Stegman and Faris, 2003, for a summary). North Carolina found a lower average number of loans (7), but this may reflect the state's prohibition on rollovers during the period studied and the fact that this is the average number of loans taken out by borrowers from a single lender. Elliehausen and Lawrence's survey results also suggest an average number of loans per customer below 10.[25] This may reflect the fact that their survey covers states with and without rollover provisions, or it may reflect the selection bias in who agreed to participate in their survey.

In any event, it seems clear that payday loan customers who use these services frequently account for a large share of lenders' business. The North Carolina survey found that only 18 percent of customers took out 12 or more loans a year, but they accounted for 40 percent of gross revenues. Similarly, Elliehausen and Lawrence's study suggests that 22.5 percent of customers take out 14 or more loans a year, but they account for nearly half of all loans. In states where repeat borrowers are more common than found by these two sources of information, these customers are likely to account for a much larger share of customers and revenue.

Trends in the Payday Loan Industry

As reported in Elliehausen and Lawrence (2001), the small, short-term consumer loan is not a new phenomenon. Similar types of loans were developed in the latter part of the nineteenth century using chattel mortgages or wage assignments. The interest rates charged (20 to 300 percent) were well in

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[24] Of 5,364 customers sampled, only 2,196 (40.9 percent) were successfully contacted for an interview. Of these, only 427 completed the interview (19 percent), while 726 (33 percent) refused to acknowledge that they had taken out a payday loan and 1,043 (47 percent) refused to be interviewed.

[25] Elliehausen and Lawrence do not report an average number of loans per customer, but they do report a distribution of customers by categories of number of loans taken out in the last year. Applying this distribution to the mid point of the categories yields an average number of loans of between 8 and 9 depending upon assumptions about the average number of loans among customers taking out "14 or more" loans.

excess of legal limits (6 percent), although laws were not strongly enforced. Efforts by progressive reformers in the early part of the 20th century led to the adoption by a number of states of small loan laws that generally permitted interest rates of up to 36 percent for small loans. This legislation enabled the development of the consumer finance industry.

However, payday loans in their present form were essentially unheard of prior to the 1990s. Payday loans appear to have developed in the early 1990s as a product offering by CCOs in states where such lending was not regulated. At the time of Caskey's seminal book on the fringe banking industry in 1994, payday lenders and loan products were not even mentioned. But in a 2003 article on the fringe banking industry a decade later, Caskey identified payday lenders as the most rapidly growing segment of the fringe banking industry. Caskey (2003) notes that it is difficult to document trends in the payday industry prior to 1995 as almost no state regulatory agencies collected data on these firms. He reports that one indicator of the growth of the industry is that prior to 1996 a Lexis-Nexis search did not find any articles published with the phrase "payday loan" in the title or first paragraph prior to 1996. In 1996, there were two articles, while by 1999 there were 111.

There is no consistent source of information on the size of the industry. By far the most commonly cited source of information is Stephens Inc., an investment-banking firm in Arkansas that specializes in analysis of the industry. Most estimates provided in the literature can ultimately be traced back to this firm, although it is not clear what their methodology is for deriving these estimates. The website for the national association for payday lenders (CFSA) reports that there are currently 15,000 payday lending locations nationwide handling $25 billion in loans annually.[26] However, no source of this estimate is provided. These figures seem higher than other measures reported in the literature, although that may reflect the rapid growth of the industry in recent years. For example, a report by CFA and the U.S. PIRG (2001), citing statistics from Stephens, Inc. from October 2001, reports that at that time the industry had 12,000 to 14,000 outlets, of which a little more than half were monoline lenders and the rest were outlets also offering checking cashing or other financial services. CFA further cites Stephens Inc. as estimating that on an annual basis there were 65 million transactions to 8-10 million households generating about $2.4 billion in fees. Assuming an average loan amount of $200 and an average fee of $20 per $100 borrowed, this would suggest a total lending volume of $12-14 billion. This is consistent with figures cited in Barr (2004a), citing a Stephens, Inc. report from 1999, indicating there were 12,000 payday-lending locations in 2000 with a total loan volume of $8 to $14 billion. Carr and Schuetz (2001) cite a similar estimate for the size of the industry ($10-13.8 billion), with 55-69 million transactions a year generating fees of $1.6 to $2.2 billion, but they do not provide a source for this information. Finally, a recent industry newsletter from October 2003 also cites Stephens Inc. as the source for an estimate that the industry accounts for $12 to $14 billion in loans each year and is experiencing an annual growth rate of 15 to 20 percent.[27]

One factor that has enabled growth of the payday lending industry is a lack of regulation of small loans in a number of states. A review by AARP as of October 2000 (Renuart, 2000) found that state regulation fell into three general categories:

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[26] See CFSA website at www.cfsa.net and their description of the industry in section labeled "General Information."

[27] See www.paydayandpaycheckloans.com/payday-loan-newsletter.html.

1. States with small loan regulations that set annual interest rate limits that made payday lending unprofitable, with a typical interest rate limit of 36 percent per year (19 states);
2. States with regulations designed specifically for the payday lending industry that generally include maximums for interest rates and fees (24 states and the District of Columbia); and
3. States where small loan regulations do not limit the interest rates that can be charged (7 states).

States in the first category have experienced much less growth in payday lending given the limits on interest rates allowed. In the other two categories of states payday lending has grown rapidly. However, payday lending has managed to grow even in places where state law would seem to prohibit this product by virtue of arrangements between payday lenders and banks that are able to preempt state laws through their federal charter that allows them to make loans across state lines under terms allowable in the state where they are located (CFA and U.S. PIRG, 2001; Caskey, 2003). Under these arrangements, payday lenders make the loan in the name of the bank, but either purchase the loan from the bank or share in the proceeds with the bank. By early 2003, the OCC and OTS had forced all banks and thrifts under their regulatory authority to exit this business, but the FDIC had yet to act similarly (Caskey, 2003).[28]

While state regulation has been an important factor in enabling the development of the payday loan industry, this does not explain why there is such strong growth in demand for these loans. The most commonly cited explanation is an increase in the number of households with high debt and impaired credit who either do not qualify for credit cards or overdraft protection or who have already maximized their borrowing from these sources (Robinson and Lewis, 1999; Stegman and Faris, 2003). It may also be that the availability of this new product has spurred demand. Caskey (1994) argued that one of the factors behind the growth in pawnshops might be a growing consumer preference for instant services. Stephens, Inc. analysts similarly note that demand is fueled by consumers desire for immediate access to cash and the ease of the transaction (Caskey, 1994; Robinson and Lewis, 1999).

A number of articles also argue that the growth of payday lending was fueled by the withdrawal of traditional lenders, including banks and consumer finance companies, from the small loan market (Caskey, 1994; Elliehausen and Lawrence, 2001). Caskey (1994) attributes the decline of small consumer loans to changes in bankruptcy laws in 1979 that increased the risk of small, unsecured loans. The rise of computers greatly lowered the cost of providing revolving credit through credit cards, but this technology did not bring cost savings to the provision of one-time loans. Given these changes, banks shifted toward credit cards, while consumer finance firms shifted to home equity lending. Payday lending arose to fill the void left by the lack of short-term, small loans from consumer finance companies.

[28] For a summary of recent federal regulatory action see www.consumersunion.org/consumeronline/latestissue/topstories/payday/html

3.1.3. Tax Refund Anticipation Loans

Overview of the Tax Refund Transaction

Refund anticipation loans (RALs) are quite similar to payday loans in that they provide a loan against an expected payment to the borrower in a short period of time. However, the amounts of these loans are much larger than the typical payday loan, averaging $1,900 in 2000. A large share of the users of RALs is comprised of recipients of the earned income tax credit (EITC). Of the roughly 12 million RAL borrowers in 2000, 4.3 million were EITC recipients (Wu, Fox, and Renuart, 2002). The attraction of these loans for the customer is that they can get access to their tax refund within two days of electronically filing their return, or about seven to ten days sooner than if they had requested direct deposit to a personal bank account (although clients may not be aware of the direct deposit option and mistakenly believe that absent the RAL it would take four to six weeks to get their refund in the mail). These transactions also appeal to unbanked households who do not have an account to take advantage of the more rapid refunds that come with direct deposit. Finally, customers who do not have funds available to pay for the tax preparation and filing fees up front can use these loans to pay for these services.

RALs are made through a partnership between the tax preparer and a bank that provides the loan. In cases where the client does not have a bank account, the tax preparer will file the client's tax return electronically and direct that the refund be deposited into a temporary account set up by the bank to receive the refund. This is referred to as a refund transfer or accelerated check request. The borrower signs documents instructing the IRS to direct funds into this account and the contract allows the lender to be repaid from these funds.

There are a handful of banks that engage in this type of lending. The largest participant in the market has been Household Bank, who has a partnership with H&R Block, the single largest preparer of electronic returns in the country. Household also has arrangements to offer RALs through other tax preparers. Wu, Fox and Renuart report that in 2000 Household Bank had an 80 percent share of the RAL business. The next largest lender in the market is Santa Barbara Bank & Trust, which has a partnership with Jackson Hewitt, the second largest commercial tax preparer in the country. Other RAL providers include Bank One Corp, Republic Bank & Trust, Republic First Bancorp and River City Bank. Arrangements between banks and the tax preparer may be structured so that the preparer earns a fee for each RAL originated or the lender may take a flat fee for processing the loan before selling the loan back to the tax preparer. Wu, Fox, and Renuart report that H&R Block's arrangement with Household Bank calls for it to earn a fee on half of the loans it originates and to repurchase the other half.

RALs are associated with three sets of fees: tax preparation fees, electronic filing fees, and the fees for the loan. Berube et al. (2002) report that an informal survey of tax preparers in Washington DC found most tax preparation fees for a return claiming the EITC were between $75 and $100, compared to an average of $85 cited by Wu, Fox, and Renuart. The cost of electronic filing was found to average about $30 by Berube et al. (2002) compared with a $40 average cited by Wu, Fox, and Renuart. The cost of the loan itself is often on a sliding scale basis. The fees for these loans rise with the amount of the loan, but the highest APRs are associated with the smallest loans. Wu, Fox, and Renuart report that in 2002 the loan fees offered through Household Bank ranged from $34.95 for loans of between $200 and $500 to $89.95 for loans between $2,001 and $5,000. Assuming a ten-day

loan term (the amount of time the IRS claims it will pay most refunds electronically), the associated APR for a $200 loan would be 638 percent, 111 percent for a $2,001 loan and 19 percent for a $5,000 loan.

Thus, for all but the smallest loan amounts, the interest rates charged for the loans are generally not as high as typical payday loans. Nonetheless, for typical loan amounts, the interest rates are 100 percent or higher. Advocates argue that the loans are extremely low risk given the nature of the collateral, although Berube et al. (2002) report that the default rate on these loans is somewhat higher than on other types of consumer credit. Lenders have several ways of mitigating these risks. First, the IRS notifies RAL lenders if the applicant owes any outstanding federal debts, which the tax refund might be used to offset. Second, RAL lenders share information about their clients so that if a borrower defaulted on an RAL in the past, the current lender will deduct the amount past due from the refund before providing the borrower with the remaining proceeds.

Another cost of RALs is from check cashing fees. Since many RAL customers are unbanked, they also need a means of cashing checks. In fact, tax preparation and RALs are among the services that some CCOs have come to provide. Wu, Fox, and Renuart report that ACE Cash Express had entered into a partnership with H&R Block to place check cashing machines in their offices to cash RALs. Check cashers may also increase their fees for cashing these checks. Although state laws limit the fees on cashing recurring government benefit checks, these laws do not apply to one-time payments such as tax refunds. ACE is reported to have charged up to 4 percent for cashing RALs, as well as a $3 membership fee. While there is also a trend toward issuing RAL proceeds in debit cards, there are also fees associated with using these cards up to $2 per transaction (Wu, Fox, and Renuart, 2002).

Trends in the Refund Anticipation Loan Industry

The RAL business appears to have grown rapidly in the late 1990s. Berube et al. (2002) report that the three largest participants in the market – Household Bank, H&R Block and Pacific Capital (Santa Barbara Bank & Trust's parent) – combined saw earnings from RALs grow from $138 million in 1998 to $357 million in 2001. It is not clear how much of this growth is due to an increase in the number of transactions as opposed to an increase in fees, but both factors appear to have contributed. The number of RALs issued by H&R Block increased from 2.8 million in 1999 to 4.5 million in 2001. But the firm also reported a 44 percent increase in average fees between 2000 and 2001. Figures from the IRS cited by Wu, Fox, and Renuart indicate that the total number of RALs only increased from 9.5 million in 1994 to 12 million in 2000. But it may be that growth has been concentrated in recent years along with other segments of the AFSP industry.

3.1.4. Pawnshops

Overview of the Pawn Transaction

Pawnbrokers operate by providing small loans against collateral left with the pawnbroker. The amount of the loan is limited to the pawnbroker's estimate of the quick resale value of the item left. Caskey (1994) reports that as a rule of thumb this is about 50 percent of the current value of the item. If the loan is not repaid, the broker sells the collateral to cover the loan. Loans are typically for fairly small amounts – a 1997 survey by the National Association of Pawnbrokers found an average

transaction of $70 (Johnson and Johnson, 1998).[29] The term is typically for two months, but may be as short as a month or as long as three months. The most typical items pawned are jewelry, household electronics, guns, and tools. The 1997 survey found that about two-thirds of pawned items are eventually redeemed.

Given the long history of the industry, most states have regulations governing these transactions, including the rates allowed and the rules governing redemption of items that are not claimed by the end of the loan term. The annual interest rates allowed by states very widely, from 36 percent to over 300 percent, with a typical cap around 167 percent. Johnson and Johnson (1998), summarizing the literature examining variations across states in the number of pawnshops per capita, report that the maximum interest rate allowed is an important factor in explaining differences in the prevalence of pawnshops across states.

Pawn transactions are similar to payday loans in that borrowers obtain a small amount of cash and are required to repay the loan with a single payment in a short amount of time. However, one important difference between a payday loan and a pawnshop transaction is that pawnshop clients do not need a checking account to obtain a loan from a pawnshop. Surveys of pawnshop customers have found that about two-thirds have a bank account, although only about half have a checking account (Caskey, 1997; Johnson and Johnson, 1998).

Trends in the Pawn Broking Industry

One of the principal contributions of Caskey's 1994 book was to highlight the rapid growth of the pawn broking industry that had occurred during the 1980s and early 1990s. Caskey (2003) reports that pawnshops experienced rapid growth from the 1980s through the late 1990s. Based on business listings from American Business Information, Caskey found that the number of pawnshops grew at an 8.2 percent annual rate, from 4,849 shops to 11,537. After 1997, however, growth in the number of pawnshops ceased, so that by 2003, the number of shops was nearly unchanged at 11,683. Carr and Schuetz (2001) estimate that there were 42 million transactions per year with gross revenue of $3.3 billion, although they do not provide a source for this estimate.

Several factors are cited in explaining the growth of the industry during the 1980s and early 1990s. Johnson and Johnson (1998) cite liberalization in state laws governing the industry during this period as in important factor, although they do not provide any information to support this contention. These authors also argue that the development of national chains during the 1980s fueled industry growth by achieving economies of scale and by improving the industry's image by making stores more attractive and in better locations. On the demand side, similar factors are cited as those fueling growth in CCOs and payday lenders – less availability of small loans from the consumer finance industry and growing numbers of unbanked households with no formal credit alternatives.

However, as noted above, by the late 1990s growth in the pawn broking industry appears to have stalled. Caskey (2003) argues that the slowdown in the pawn broking industry is related to the rise of payday lending. Caskey cites several instances where large, national pawnshop chains have had to introduce payday loans in order to compete with this industry. Payday loans represent an obvious

[29] Robert W. Johnson and Dixie P. Johnson, *Pawn broking in the U.S.: A Profile of Customers*, Washington, DC: Georgetown University, The Credit Research Center, July 1998.

alternative to pawnbrokers. In many states, the interest rates charged are similar. Payday lenders can also accommodate the small loan amounts that are typical of pawnbrokers. There are also several advantages of payday lenders. First, borrowers do not have to leave collateral, which makes the transaction easier, less disruptive for the borrower, and less stigmatizing. Second, borrowers do not have to haggle over the value of the pawned item to determine the loan amount and payday loans are not limited to the value of the item. However, as noted above, pawn transactions do not require a checking account and so may continue to be an important source of small, short-term credit for unbanked households.

3.1.5. Rent-to-own Stores

Overview of the Rent-to-own Transaction

Rent-to-own stores are often included in reviews as one of the segments of the AFSP industry (see, for example: Hermanson and Gaberlavage, 2001; Carr and Schuetz, 2001). Caskey (1997) provides a good overview of this industry. Rent-to-own transactions are most common with household furnishings, appliances, and consumer electronics. The term of these deals ranges from one to three years, with 18 months the most typical length. Most agreements call for weekly payments of about $20. Payments are usually made at the store in cash or by money order. In addition to the payment for the item purchase, clients are often encouraged to purchase theft and damage insurance. Since the buyers are liable for the goods in these events, the insurance is generally purchased. Caskey reports that the total payments usually add up to two to three times the value of the item, with associated APRs of 100 to 250 percent. Hermanson and Gaberlavage report that the total costs are two to five times as much as the initial purchase price. The industry reports that only 20 to 30 percent of customers successfully complete these transactions and purchase the item (Caskey, 1997).

There is little information on the nature of clients of rent-to-own stores. One of the only sources is a survey conducted by Caskey (1997) of low-income households in Atlanta, Oklahoma City, and Eastern Pennsylvania. This survey found that 5 percent of respondents had engaged in a rent-to-own transaction in the previous 2 to 3 years, which was the same as the share who had used a pawnshop in the last year. Customers of rent-to-own stores were somewhat more likely to be unbanked than low-income households generally (65 percent versus 77 percent of those surveyed). While many households may have had alternative means of financing these transactions, many did not as only one-third of rent-to-own customers had a major credit card. Thus, the unbanked and those with constrained credit appear to represent an important segment of the rent-to-own clientele.

Trends in the Rent-to-own Industry

There is little information about trends in the size of this segment of the industry. Carr and Schuetz (2001) report an estimate, without identifying any source, that the industry accounts for 3 million transactions annually, totaling $4.7 billion, including $2.35 billion in fees. According to the estimate cited by Carr and Schuetz, the rent-to-own industry is larger than the pawn industry and generates fees that are larger than the check cashing or payday lending industry. Hermanson and Gaberlavage (2001) present a graphic showing the trend in the number of CCOs, pawnbrokers, and rent-to-own shops between 1995 and 1999 based on data from InfoUSA. While they do not report specific figures for the rent-to-own shops, the graphic indicates that the number of businesses grew from about 5,000 in 1995 to about 12,000 in 1999. Thus, this segment of the industry appears to have grown quite rapidly.

The growth of the rent-to-own industry appears to be fueled by the same factors as other consumer lending products – rising demand for instant credit among credit constrained households. However, one factor favoring the growth of this industry is that it is subject to less regulation than other sectors. As Caskey (1997) reports, since the deals are structured as short-term rental contracts, these transactions are not governed by state usury laws, although some states do explicitly regulate the terms of these types of agreements.

3.1.6. Auto Title Lenders

Overview of the Auto Title Loan Transaction

Hermanson and Gaberlavage (2001), Caskey (1997) and a report by the Illinois Department of Financial Institutions (1999) provide a profile of this segment of the industry. Caskey reports that this type of lending is legal in only a handful of states. The loans are similar to pawnshop transactions in that the borrower pledges their collateral against a short-term loan. However, the loans are for larger amounts than the typical pawnshop transaction and the borrower continues to possess and use the collateral during the loan term. The borrower must own a vehicle without any liens so that the vehicle's title can be held as collateral. In some states the borrower actually sells the vehicle to the lender and then executes a rent-to-own contract with the lender to regain ownership when the loan is paid off. In other states the lender will require a power of attorney to transfer the title of the car if the borrower fails to make the agreed upon payments. Lenders may also require that the borrower leave a set of keys to expedite the lender taking possession of the car. But, in general, the underwriting process is fairly simple. There is no credit check required, although lenders will likely verify places of employment and residence as well as obtain a few personal references to help locate the borrower should they default.

Loan amounts are typically between a quarter and a third of the market value of the vehicle. Caskey reports that a typical loan amount in Georgia in 1997 was $275. Loans are typically for a single month (30 days), with payments either weekly or biweekly. In terms of the rates charged, the one example cited by Caskey is for Georgia where lenders can charge 5 percent interest and a 20 percent monthly service charge, which together equate to a 300 percent APR. This is similar to the Illinois study, which found an average APR among title lenders of 290 percent. However, both Caskey and the Illinois Department of Financial Institutions report that loans are rarely paid off within the initial loan term. Rollovers of these loans are common, which will raise the APR.

One of the complaints about this industry is that lenders are often motivated by the potential for making a profit on reselling the car once it is repossessed as many of the lenders operate used car lots. Caskey (1997) reports that one title loan lender in Georgia estimated that between 70 and 85 percent of borrowers redeem their titles in that state. Nonetheless, this same lender noted that there were two types of title lenders – those motivated by the profits from the finance charges and those motivated to obtain cars for resale at bargain prices.

Trends in the Title Lending Industry

The literature reviewed for this study did not provide any information on this size of this segment of the AFSP industry or trends over time.

3.1.7. Small Loan Companies

Overview of the Small Consumer Loan Transaction

Caskey (1997) includes a profile of small consumer loan companies, although his study is one of the few to include this type of firm in a typology of AFSPs. These firms are similar to payday lenders in that they make small consumer loans with a fairly streamlined underwriting process providing loans to borrowers almost immediately. He distinguishes these firms from multi-product consumer finance companies, such as Household Finance, that provide home equity loans, auto loans, and credit cards. These firms specialize in loans less than $1,500 – a category that is below the minimum amount lent by the multi-product firms. They exist in only about one-quarter of states, mostly in the South. An example of this type of firm is World Acceptance Corporation, a publicly traded company specializing in this type of loan. As of 1996, they had 300 offices in six Southern states. The company's average loan amount ranged from $321 in Oklahoma to $420 in South Carolina, with an average term of eight months.

While these loans have some features that are similar to payday loans, there are also some key differences. First, the loans are for a longer period of time—up to a year, but more typically for six months. Second, the loans require periodic payments rather than a simple one-time payment as with a payday loans, although loan payments are often structured to coincide with the borrowers payday. Loan amounts can be higher than payday loans, but are usually less than $1,000 and are typically closer to $300.[30] Finally, these loans may require that borrowers pledge collateral, such as cars, household furnishings, or electronic equipment. However, lenders do not usually inspect the goods or perfect their lien, so the pledging of collateral is primarily a motivational factor.

One advantage over payday loans is that the APRs tend to be somewhat lower, although still high by the standard of credit cards or bank overdraft protection. Caskey reports that the loans generally include a series of fees in addition to interest payments, including an origination fee, monthly maintenance fees, and fees for insurance covering disability, life, unemployment, and loss of collateral. Recall that for payday loans typical APRs are between 390 and 520 percent. Even with these fees included, APRs for $500 loans were about 100 percent. Since many of the fees are fixed, APRs are higher for small loans. But even for loans of $150 the APRs were less than 300 percent.

Caskey's survey found that small loan borrowers did not differ from other low-income households in their tendency to be banked. In fact, he found that a slightly higher share of small loan customers had transaction accounts than all low-income households surveyed (83 percent versus 77 percent). Thus, clients of small loan firms may be similar to payday borrowers who are by definition banked.

Trends in the Small Consumer Loan Industry

It is not clear how prevalent these firms are or whether they have experienced growth along with other segments of the AFSP industry. Aside from Caskey (1997), these firms have not received much attention in the literature as no other review of the AFSP industry has included these firms (see for example: Barr, 2004a; Hermanson and Gaberlavage, 2001; and Carr and Schuetz, 2001).

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[30] The maximum allowed varies with state law. Caskey's study focused on area in Georgia, Oklahoma, and Pennsylvania. Across these areas, the maximum allowed was 620 in Oklahoma and $3,000 in Georgia. This type of loan was not available in Pennsylvania as limits on small loan rates made them unprofitable.

3.2. Patterns of Use of AFSPs

Many assessments of the users of alternative financial services focus on whether individuals are "banked" or not, that is whether individuals have access to checking, savings, or other transaction accounts at a bank, savings and loan, credit union or other federal or state regulated banking organizations. These studies examine how those consumers without a checking, savings, or other transaction account go about obtaining basic financial services including cashing checks, paying bills, sending wire transfers to family and friends. Though many of the "unbanked" utilize the services of check cashing operations (CCOs) and other alternative financial services providers, somewhat surprisingly, several of these studies note that significant shares of "banked" individuals also frequent these AFSPs.

Another strand of the existing literature focuses on consumer access to cash advances and smaller short-term loan services. Of course, many banks provide these types of loans in the form of over draft protection, or short-term loans or revolving debt instruments. Yet having a checking account appears to be no guarantee that consumers – especially low-income, low-wealth, credit-impaired individuals – are able to obtain short-term advances or small loans from their banking institution. Increasingly consumers are turning to payday lenders, pawnbrokers, and refund advance lenders to obtain cash advances and/or short-term loans. By definition, consumers using the services of payday lenders are "banked" in that they must leave a post-dated check as collateral for the cash advance. Having a checking account is not a requirement for obtaining a short-term loan from a pawnbroker or refund anticipation lenders but like payday lenders these AFSPs providers fill the void left by the fact that many consumers are unable or unwilling to obtain these loans from a mainstream bank.

This section begins with a review of the existing literature on the "unbanked," especially in relation to the use of check cashing operations. The section then examines the use of payday lending. Next comes a review of the relatively few studies that examine the spatial distribution of check cashing operations and other AFSPs. Finally, the section concludes with an examination of the factors that influence the growing use of CCOs, payday lending, and other AFSPs.

3.2.1. Consumer Demand for Alternative Financial Services

As previously noted, there is a growing literature on the characteristics of households and individuals who are "unbanked", especially in relation to the utilization of check cashing operations and other AFSPs. For example, as part of their periodic assessment of family finances, the Federal Reserve estimated that in 2001 some 12.7 percent of all American households do not have a checking account, while 9.1 percent have not have any type of transaction account whatsoever (Aizcorbe, et. al., 2003).[31] Among families without a checking account in 2001, 50.4 percent reported having had such

[31] This study draws on data from the Federal Reserve Board's Survey of Consumer Finances (SCF) for 1998 and 2001, as well as previous years to place the 1998-2001 changes in a broader context. Some 4,309 families were interviewed for the 1998 survey, while 4,440 were interviewed for the 2001 survey. Since among other things the survey focuses on household wealth, the survey over samples high wealth families and develops a weighting system to make estimates of the full population. Transaction accounts include checking, savings, and money market deposit accounts, money market mutual funds, and call accounts at broker houses.

an account in the past.[32] Though still high, these most recent figures present a slight decline from figures recorded in 1998 and a more substantial decline since 1992 when fully 16.6 percent of families lacked a checking account, and nearly 13 percent had no transaction account. Families that did not have a checking account or other transaction account tended to be disproportionately low income and low wealth, to be less than 35, to be nonwhite or Hispanic, to be a renter, and to be someone who was not working or retired. Somewhat surprisingly, homeowners nevertheless account for approximately one third of all households who do not have a transaction account of any type.

Several studies have used survey results to further examine the characteristics of "unbanked" households and their use of check cashers and other alternative financial services. Using data drawn from a special survey of households living in low-income neighborhoods in New York and Los Angeles, Dunham (2001) presents an assessment of the behavior of "banked" and "unbanked" individuals, where banked individuals are defined as having one or more deposit accounts.[33] Dunham notes that not all unbanked individuals use only the services of nonbanks, nor do all banked individuals use only the services of banks. Dunham estimated that 37 percent of the population living in low-income census tracks was unbanked, while additional 11 percent had a bank account, but typically use bill payment or check cashing services in carrying out many of their routine financial activities. Alternatively, many unbanked individuals use the services of banks, particularly those who cash a paycheck drawn on the bank in question.

Relative to the banked population, Dunham's study presents data suggesting that unbanked individuals tended to be much less educated, younger, more likely to be foreign born, and more likely to have low household incomes and much more likely to receive government income support such as welfare, SSI and/or food stamps. Counter to claims of some, Dunham found that, in general, the unbanked spend very little on check cashing services. This results from the fact that unbanked individuals either had no income, were paid in cash, cashed their check for free at the supermarket or at the bank that issued the check or had a friend or relative cash their checks. Overall, some 52 percent of all unbanked did not incur any costs to convert paychecks or other sources of income into cash and another 18 percent paid less than $50 per year. In contrast, some 16 percent paid more than $100 per year and only 6 percent paid more than $150. Compared to unbanked individuals who pay under $50 per year, the unbanked who pay at least $150 tend to have higher incomes, be better educated, younger, less likely to be foreign born, Hispanic or female and receive government benefits.

Using the same database, Vermilyea and Wilcox (2002) extend Dunham's analysis and examine the relationship between the socio-economic status and residential location characteristics of individuals and their use of bank accounts. The specific questions addressed in this study include: controlling for

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[32] See example Kennickell et al. 2000 for a similar analysis using the 1998 Survey of Consumer Finances. Other studies have noted that a majority of the "unbanked" individuals were minorities, while as many as one-third of all minority households were "unbanked" (Good, 1999).

[33] The study uses a survey conducted by the Office of Comptroller of the Currency between October 1998 and March 1999 of 2,000 individuals in low-income areas of New York and Los Angeles. This survey was specifically designed to examine factors associated with bank account use and so targeted a population with a high chance of being unbanked. Low-income census tracts have a median household income less than 80 percent of the median household income of the metropolitan area.