Center for American Progress

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Lending for Success

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Introduction and summary

For generations in the United States, the availability of credit has supported economic opportunity for families. Millions of Americans became homeowners as the result of housing policies during the New Deal and after World War II that made mortgages increasingly safe and affordable.[1] For example, between 1940 and 1960, the nation's homeownership rate increased from 44 percent to 62 percent—this coming after decades during which fewer than half of all Americans owned their own homes.[2]

Additionally, credit cards and other forms of consumer credit have enabled American families to access quickly new products and technological advances—from radio and television to cars and computers—without having to save for years to make these purchases. The ready availability of credit also has provided flexibility and convenience to families in the presence of uncertainty.

Traditionally, credit markets have thrived when both the lender and the borrower benefit. As Richard Cordray, director of the Consumer Financial Protection Bureau, or CFPB, recently stated, "In a healthy credit market, both the borrower and the lender succeed when the transaction succeeds—the borrower meets his or her need and the lender gets repaid."[3]

But for decades now, a certain category of lender has profited not despite borrower failure but because of it. From subprime mortgage and credit card purveyors to payday and auto title lenders, credit models that make money off of late fees, serial loans, and repossession of collateral have proliferated. Some banks and other financial institutions deliberately make loans that borrowers will be unlikely to repay, load excessive fees onto products that appear otherwise affordable, and offer products that encourage default rather than repayment.

As a result of unsustainable and often unscrupulous mortgage lending in the run-up to the financial crisis, more than 5 million families lost their homes to foreclosure.[4] Meanwhile, the national homeownership rate fell to 63.7 percent in the first quarter of 2015, the lowest level in more than two decades.[5] As the economy slowly recovers from the Great Recession—a crisis caused by the toppling of a massively risky house of cards that Wall Street built on top of unsustainable mortgage lending to consumers—it is time to ask: What does it look like to lend for success?

This report describes the principles that characterize a system in which borrowers are primed for success rather than failure. Among other things, financial institutions and regulators should look beyond a single point in time and consider the entire life of a loan, including contingencies that may arise.

The report considers the experiences of borrowers over the life of a loan for a number of financial products, including mortgages, auto loans, credit cards, payday loans, and auto title loans.[6] While the specific risks of each product differ, as do the regulations governing each product, there are significant commonalities across these consumer lending products that deserve the attention of policymakers.

Responsible lending practices begin with a true assessment of the borrower's ability to repay the loan. Misaligned incentives in the mortgage market leading up to the foreclosure crisis encouraged financial institutions to extend credit to homebuyers without regard for the borrower's ability to repay, and credit cards were frequently marketed to college students—in some cases, without any review of their income. While regulators and policymakers have addressed many of these concerns, these harmful practices continue to be features of other consumer loan products. Originating loans with borrowers' success in mind includes the following characteristics:

- Documented income and expenses
- Reasonable interest rates
- Appropriately aligned originator incentives
- Complete, accurate, and relevant credit scoring as part of the approval process

Responsible origination practices, however, do not ensure the long-term success of a loan. The very design of a loan product also determines outcomes. If a loan will require refinancing or taking out another loan in the future—as was the case with some high-cost mortgages prior to the foreclosure crisis and as is often the case with payday loans today—the initial presumption of the borrower's ability to repay does not necessarily hold firm over time. Similarly, loan products in which the loan balance does not go down as borrowers make payments also trap consumers. The following product design principles would contribute to borrower and lender success:

- Clear, transparent loan terms
- Reasonable loan fees
- Fully amortizing loans
- No prepayment penalties

Even with a sound loan that the borrower is likely able to repay, unforeseen changes in economic or family circumstances may make it more difficult for that borrower to make payments in the future. Lenders should be prepared for contingencies and, again, ensure that their incentives are aligned so that both financial institutions and borrowers benefit from performing loans. More specifically, responsible account management practices include the following:

- Regular statements, whether printed or electronic
- Payments at the borrower's discretion
- Effective communication with the borrower
- Quick and responsive error correction
- Working with borrowers who are experiencing short-term hardship
- Fair debt collection practices

Greater adoption of these principles by regulators and financial institutions alike would contribute to a vibrant lending market in which both borrowers and lenders could benefit from the extension of credit.

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