Center for American Progress


AP/DAVID GOLDMAN

Lending for Success

By Joe Valenti, Sarah Edelman, and Julia Gordon July 2015

Center for American Progress

Lending for Success

By Joe Valenti, Sarah Edelman, and Julia Gordon July 2015

Contents

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.

Responsible loan origination relies on the borrower's ability to repay

Making loans based on the borrower's ability to repay sounds like a common-sense practice. Historically, lender interests were aligned with borrower interests such that if borrowers were unable to keep up with payments, lenders would lose money. An economically rational lender would therefore be unlikely to make such a loan.

However, in the years leading to the financial crisis, this rational outcome became less and less prevalent as misaligned incentives pushed lenders to make loans that were either unaffordable from the starting gate or that would be likely to fail in the future—essentially, gambling in an environment where the house always wins.

In some cases, these types of loans are made because the lender is more interested in the collateral—such as a house, a car, or in the case of payday loans, the consumer's bank account—than in the loan itself. As Cordray noted at a recent hearing on payday loans, "many lenders make loans based not on the consumer's ability to repay but on the lender's ability to collect."[7]

Lending where the borrower's house or car is on the line may make the borrower more committed to repaying a loan, but sometimes the lender is less invested in loan quality because it can simply seize collateral instead of relying on repayment.[8] However, this type of lending is also extremely risky because if collateral values decline—as they did during the financial crisis—the collateral no longer makes lenders whole. When instead lenders truly take into account the borrower's documented income and expenses when making a loan, these determinations of risk can make it more likely for both the borrower and the lender to succeed.

In the 1990s and 2000s, mortgage lenders often combined designed-to-fail subprime loans with low or no underwriting and documentation, a toxic combination that ultimately triggered the larger financial crisis. In 2006, nearly half of all subprime loans lacked documentation of income.[9] The following year, Countrywide Financial, at one time the nation's largest mortgage lender,[10] admitted that 70 percent of its recent borrowers would be unable to keep up with payments if their loans were subjected to the standard of a fully amortizing 30-year mortgage, the traditional mortgage product for most borrowers since the Great Depression.[11] These loans were clearly unaffordable to borrowers from the outset.

Poor underwriting practices were not limited to mortgage loans. Auto dealerships that offered subprime used car loans at what are termed "buy here-pay here," or BHPH, outlets that directly finance the cars they sell based their lending decisions on an inflated value of the car, expecting to repossess and resell it later. A 2011 series by the *Los Angeles Times* identified vehicles sold at twice their Blue Book retail value to low-income borrowers with unmanageable payments.[12] And a recent *New York Times* analysis found numerous cases in which car buyers were given loans at interest rates that exceeded 23 percent on inflated prices for vehicles that, based on the buyers' incomes, they would not ordinarily be eligible to buy.[13] In some cases, the dealer had falsified borrowers' incomes.

Moreover, as a result of conflicted incentives for lenders, homebuyers and car buyers are also subject to paying higher interest rates than their financial backgrounds would suggest. Prior to the financial crisis, mortgage brokers were paid more to offer riskier, higher-rate loans than borrowers otherwise would have qualified for through a system of lender-paid "yield-spread premiums."[14] In fact, more than 60 percent of subprime mortgages that were securitized in 2006 went to borrowers who should have been eligible for lower-cost, prime loans.[15] Through similar markups, auto dealers sell car loans that pay the highest compensation to the dealer rather than offer the lowest interest rate available to the consumer. These dealer rate markups cost consumers an estimated $26 billion over the life of their auto loans.[16] With higher rates come the higher risk that borrowers will have difficulty keeping up with payments.

The failure to evaluate the borrower's ability to repay also extends to other types of consumer lending. Credit cards have at times been frequently available to consumers with little documentation required. Prior to passage of the Credit Card Accountability Responsibility and Disclosure, or CARD, Act of 2009, college students were often issued credit cards without having to provide documented independent income, projected future earnings, or even student status.[18] Despite having no basis on which to conclude that students would be able to repay the loans, lenders assumed that the loans would be repaid by parents or by future earnings.

Originate to distribute

The role of securitization in the lending process

One of the factors that led to excessive, risky mortgage lending, as well as other asset-based lending, is the so-called originate-to-distribute model. In this model, a lender sells its consumer loans into a secondary market in exchange for cash. The buyer of these loans then bundles together a large number of loans into a bond, which is then sold to investors. In some cases, the bond is sliced into different tranches, or levels, of risk. The investors receive monthly payments as consumers make their payments on the loans in the pool. This process, which is called securitization, helps repay lenders quickly, freeing up more capital to lend to other consumers. When done properly, securitization can support a robust and healthy consumer lending market where families can more easily obtain loans to buy homes, go to school, or buy a car.

However, by eliminating the original lender's stake in the borrower's success, the securitization process can instead encourage risky lending. In the years leading up to the financial crisis, mortgage brokers, lenders, and investors all obtained quick returns when homeowners bought and refinanced homes—as long as home values continued to rise.[17] The pursuit of these immediate returns reduced the desire for financial actors to take into account loan quality and sustainability in favor of selling as many loans as possible.

A similar problem plagues small-dollar loan products. Payday loans, generally two-week loans pledged against a future paycheck or government benefit check, are made based on the premise of future money in the bank, though four out of five payday loan borrowers are unable to pay back the loan without reborrowing or refinancing and incurring additional fees.[19] Similarly, auto title loans, in which a borrower hands over his or her car title and a spare set of keys in exchange for cash, are made based on a small percentage of the car's retail value—typically about one-fourth—rather than the borrower's income or ability to keep up with payments.[20] Both products can carry triple-digit annual interest rates, with 391 percent annual percentage rate, or APR, being typical for a payday loan.[21] In these cases, the lender is more interested in accessing the bank account or obtaining the car than in the borrower making payments.

High-cost lenders often justify the lack of standards for determining whether a borrower can repay a loan as a necessity to ensure access to credit for underserved consumers. Indeed, many of these lenders are concentrated heavily in communities still reeling from the effects of historical disinvestment, particularly among borrowers of color. But the abundance of these types of lenders in disadvantaged communities only demonstrates greater access to predatory loans that set up borrowers for failure. The reality is that these loans may be worse than offering no credit at all.

Meanwhile, innovative loan programs have proven that even borrowers with low credit scores or nontraditional credit histories can be served affordably. For example, thousands of borrowers with low incomes and low down payments in the Community Advantage Program, run by the nonprofit lender Center for Community Self-Help, have been able to buy and keep their homes as a result of appropriate underwriting and an affordable 30-year fixed mortgage product.[22]

In recent years, Congress has repeatedly endorsed the conclusion that demonstrating the ability to repay is a key component of lending for success. The Credit CARD Act of 2009 requires that credit card issuers consider a borrower's ability to repay before extending credit and limits the availability of credit for borrowers under age 21 without a parental co-signer or independent income.[23] A centerpiece of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 mortgage rules is an ability-to-repay standard for all lenders. Similarly, the Consumer Financial Protection Bureau is considering subjecting many small-dollar loans, such as payday loans, to an ability-to-repay standard.[24]

The following principles of loan origination can help ensure that both lenders and borrowers benefit from loans:

- **Documented income and expenses.** When originating a loan, lenders should take into account the borrower's ability to repay the loan based on both income and expenses. This analysis should ensure that the borrower has sufficient recurring income to keep up with payments over time, not just the ability to make initial payments that may increase in the future. Any debt-to-income ratio used as a threshold to measure the borrower's ability to repay should also meaningfully evaluate the borrower's total debt obligations. Even if loan payments are intended to be a small percentage of the borrower's income—such as 5 percent or 10 percent—one loan does not exist in a vacuum and could cause or exacerbate financial hardship when stacked on top of other bills. Lenders and regulators should also examine new approaches to satisfy these requirements for self-employed workers and others with irregular incomes to ensure that they have access to responsible credit.

- **Reasonable interest rates.** As the Community Advantage Program demonstrated, an affordable financial product has a high likelihood of repayment.[25] But as interest rates increase, higher costs to borrowers create their own default risk, leading to a self-fulfilling prophecy. Interest rate caps exist for a number of financial products to prevent high-cost debt traps. Fourteen states and the District of Columbia limit interest rates to 36 percent annually or less, as does the federal government on many loans made to military service members and their families.[26] And the federal Home Ownership and Equity Protection Act of 1994, or HOEPA, recognizes the dangers posed by higher interest rates by providing extra protections for consumers who receive high-cost mortgages.[27]

- **Appropriately aligned originator incentives.** Financial institutions should not use compensation mechanisms that reward loan originators for issuing borrowers loan products that are more expensive or risky than they can qualify for; they also should not offer products that are too expensive to be safe for consumers to repay reasonably.

- **Complete, accurate, and relevant credit scoring as part of the approval process.** Credit reports and scores play an important role but should not be the sole criterion in lending decisions. In some cases, lenders currently rely on outdated systems, such as mortgage score models that are more than a decade old, when better scoring mechanisms exist.[28] Because reports may miss important payment histories—such as rent and utilities—or overstate the effects of obligations, such as medical debt, their accuracy in predicting a borrower's ability to repay can be limited. Additionally, approximately 45 million consumers are considered either "credit invisible" or "unscoreable," according to a recent CFPB analysis, meaning that they lack a sufficient credit record for lenders to make a decision about a loan.[29] Meanwhile, the growth of nonfinancial correlates in underwriting—such as social media profiling—also opens the door to unfair lending practices.

Product design decisions determine future success or failure

The origination of a loan is only one step in determining whether a financial product is likely to lead to successful outcomes for both the borrower and the lender. The design of a loan product is also closely related to future loan performance. For generations, well-designed loans have helped borrowers build stronger financial foundations. On the other hand, poorly designed financial arrangements move families, particularly lower-income families, further away from financial security.

When a household reaches for a credit card to make a purchase; takes out a loan to buy a family car; or looks for a short-term, emergency infusion of cash, the structure of these products determines whether the credit helps create stability or strips wealth. For example, houses sold under predatory installment contracts result in families spending thousands of dollars in payments on homes they will never own.[30] On the other hand, the fully amortizing, long-term, fixed-rate mortgage that has been at the center of home lending since the Great Depression has enabled millions of Americans to build significant wealth.

Poorly designed mortgage products represented a significant share of the mortgage market in the years leading up to the financial crisis. These loans were often rooted in misaligned incentives that placed immediate financial returns and benefits to investors above borrower success. For example, hybrid adjustable-rate mortgages such as 2/28s or 3/27s—in which a teaser rate that lasted for two or three years was replaced by a dramatic rate hike based on a margin on top of a financial index or reference rate—essentially required borrowers to refinance, often causing them once again to lose equity to the high fees and costs of the refinancing process.[31] Often, borrowers were locked into these deals by prepayment penalties of up to 4 percent, preventing them from refinancing until the rate had reset. The terms of these loans were confusing and could change significantly throughout the life of the loan. Many borrowers were not prepared to meet their monthly payments when the interest rate increased dramatically.

Some predatory mortgages were designed with interest-only payments where the borrower was not paying down principal, and some had monthly payments that did not even cover the monthly interest costs.[32] In this scenario, known as negative amortization, even despite regular on-time payments, the loan balance became progressively larger rather than smaller.

For all but the most sophisticated borrowers, a loan that requires refinancing down the road in order for the borrower to succeed creates significant risk. Furthermore, when refinancing becomes difficult—as borrowers discovered during the financial crisis—the consequences can be catastrophic. In the case of the subprime lending described above, when home prices stopped their lengthy climb, the only way out of these loans was often through foreclosure. African American and Latino households were targeted disproportionately for these loans that were set up to fail; they lost 48 percent and 44 percent of their wealth, respectively, during the financial crisis.[33]

Financial reform has effectively reined in many of these practices. Yet today, some of the loan terms that were commonplace during the predatory lending boom remain regular features of loans for manufactured housing—home structures that are transportable in one or more sections.[34] Misleading terms, excessive fees, and high interest rates often make manufactured-home loans unsustainable for borrowers, while these same terms make the loans profitable for the lenders even when the loan fails.[35]

Again, these practices are not limited to the mortgage market. Negative amortization is a common risk of auto loans because vehicles generally only go down in value, not up. As car loan terms grow increasingly long—the average car loan term is now more than five years, according to car shopping resource Edmunds[36]—borrowers have a greater risk of owing more than the vehicle is worth and being unable to sell it if financial circumstances change; they also have less chance of getting out of debt if their car is totaled in an accident. This risk is compounded for borrowers unable to make a sizable down payment or opting to trade in another car with an underwater loan to purchase their current vehicle.

Flawed product designs also existed for credit cards before the financial crisis. A 2007 National Consumer Law Center review of credit card products intended for borrowers with poor credit found a number of products with low credit limits that appeared at face value to keep card users from being trapped in debt, such as a card with a modest $250 credit limit.[37] However, these cards were actually designed to extract fees from borrowers in every conceivable way, with $178 in activation fees that included a program fee, an account set-up fee, a monthly participation fee, and an annual fee. Spending $85 pushed cardholders over their limit—which could then carry its own fee. Credit card companies also had the ability to effectively change the rules of the game once consumers started using their cards. One major national bank increased interest rates on borrowers from 15 percent or less to 28 percent or more in early 2008 without providing justification and only gave consumers less than a month to reject the change in writing.[38]

Payday loans are also deliberately designed to exploit a borrower's inability to make timely payments. As noted in the previous section, high costs and short repayment cycles lead four out of five payday borrowers to reborrow or refinance an initial loan, further extending loan repayment. The median payday borrower ends up in debt for more than half of the year in which a loan is taken out.[39]

Advocates for high-cost loan products often claim that these offerings—whether a 2/28 mortgage, in which the interest rate is fixed at a low teaser rate for the first two years and then resets to a higher, variable rate; a deeply underwater car loan; a fee-harvester credit card; or a payday loan—exist to provide consumers choices. After all, there are millions of borrowers who use these products, though many of them are ultimately worse off as a result.

However, the mere existence of a predatory financial product does not justify its practices if this product has devastating effects on families and on the broader economy. Moreover, if the most predatory products did not exist, competitive pressures would most likely drive financial institutions to improve their offerings and to fill these gaps in a more responsible way.

Once again, some responsible alternatives have a proven track record. A number of credit unions offer alternatives to payday loans that are fully amortized and incorporate reasonable payments, such as North Carolina's State Employees' Credit Union, which offers a Salary Advance Loan of up to $500 at 12 percent annual interest.[40] Even lease-purchase programs can be promising when properly designed: A Cleveland nonprofit organization offering home lease purchases converted more than 85 percent of participants to homeownership in 2008.[41] And the 30-year fixed, fully amortizing mortgage that has ensured access to homeownership for decades continues to provide families with a way to afford a home over the long term.

Just as recent public policies have recognized the importance of making loans based on a consumer's ability to repay, they also have recognized the importance of responsible product design practices. The Consumer Financial Protection Bureau's "qualified mortgage" definition also encourages fully amortizing mortgages in lieu of the many risky alternative products that existed before the crisis. The Credit CARD Act of 2009 banned several types of fees; reined in fee-harvester cards by limiting fees to one-quarter of a card's credit limit; and mandated new disclosures that inform consumers of the cost of making minimum payments, as well as the cost of paying off the debt over the course of three years.[42] A 2013 study found that these changes have saved consumers an estimated $12.6 billion annually in credit card fees, including as much as $71 million solely from providing information on the cost of paying off the card in full over three years.[43]

The following product design principles will help ensure that borrowers can repay a loan:

- **Clear, transparent loan terms.** Borrowers should understand how their loans work. They should know what they will be expected to pay in principal, interest, and fees and how long it will take them to repay the loans. If the terms of the loan will change during the life of the loan, the borrower should be aware of such changes before taking out the loan and should receive advance notice of interest rate resets. The CFPB's simplified mortgage disclosure, which goes into effect October 3, provides this transparency to the mortgage market,[44] and credit card holders already have many of these protections.[45]

- **Reasonable loan fees.** Borrowers should expect a reasonable fee for taking out a loan; fees exist partly to cover costs and protect against losses. However, fees should be priced appropriately and should not be used simply to avoid interest rate caps or other restrictions, which is how payday loan fees have been used in some states.[46] Points and fees are now capped on some mortgage products,[47] and there are limits on the issuance of credit card fees during the first year in which a card is open.[48]

- **Fully amortizing loans.** When a borrower makes a payment, the loan should get smaller, not larger. Except in times of financial hardship—when a borrower receives a forbearance or is on a payment plan with greatly reduced payments—loan payments should be structured in a way in which each payment helps repay the balance of the loan in a timely and affordable way.

- **No prepayment penalties.** Borrowers should not be penalized for getting out of a loan if they have the ability to pay it off early, refinance it, or sell the collateral. Market dynamics, not lenders' desire to lock in consumers, should drive decisions about prepayments.

Account management and servicing practices determine outcomes when borrowers fall behind

In some ways, the hardest part of lending begins after the loan is originated. During the repayment period, a lender has no guarantee that the loan will be repaid, and a consumer risks incurring additional fees related to the loan, as well as the possibility that the lender could seize the collateral.

Yet strong account management practices can help minimize the risks to both parties. An effective account manager will have tools to assist borrowers as they encounter temporary financial hardships or other obstacles, providing them with forbearances, modifications, or options other than simply defaulting on the loan.

While bad origination practices set the stage for the foreclosure crisis, the lack of an appropriate response from account managers, generally referred to in the mortgage industry as loan servicers, caused the crisis to be much broader and deeper than it would have been otherwise. In short, when mortgage defaults began to spike, the major mortgage servicers did not have systems in place to ensure that mortgage-servicing account managers could provide prompt, consistent information to borrowers or offer an appropriate suite of options for borrowers who were experiencing a hardship.

In large part, this lack of response to widespread borrower distress was caused by misaligned incentives in the servicing industry. A core problem is that many accounts are managed by servicers that do not own the loans themselves. A mortgage servicer that does not own the loan can earn just as much, and possibly more, if a delinquent loan goes through to foreclosure as if a homeowner resumed making payments.[49] Yet for the owner of the loan, it is often financially more advantageous to provide the borrower with other alternatives such as a temporary payment forbearance or a permanent loan modification.

While challenges in the mortgage sector have received significant attention in recent years, account management is critically important across all consumer finance markets. Widespread abuses in the credit card industry led to rulemaking by financial regulators to define timely payments and crack down on excessive fees in advance of the passage of the Credit CARD Act of 2009, which greatly improved disclosures and gave borrowers additional tools to manage their accounts.

The subprime auto finance sector is particularly notable for servicing practices geared toward borrower failure rather than success. One strategy is to make payments logistically difficult, such as the in-person payments required by "Buy Here Pay Here" dealers.[50] Another strategy is to engage in increasingly aggressive tactics. For example, one Southern California borrower was lured back to the dealer with the false promise of better payment terms only to find employees blocking in her car—with her children still inside—when she came out.[51] And as *The New York Times* recently reported, many vehicles are now equipped with remote disabling devices, so that if the borrower is even a few days late in making a payment, the lender can make it impossible for the car to start—effectively doing a remote repossession.[52] As borrowers fall behind, dealers are able to repossess the same low-value car and sell it again to another financially strapped consumer. One in eight California used car dealerships have had at least one vehicle churn to a new borrower three or more times.[53]

Perhaps most egregious of all are payday loans, where the profit model for lenders assumes that borrowers will fail to repay the loan in the prescribed term and will therefore need to reborrow or refinance, which is the case for four out of five borrowers.[54] Because payday loan borrowers generally have authorized automatic withdrawals from a bank account as a condition of receiving the loan, payday lenders can potentially seize deposits as they are made.

Debt collection practices are under increased scrutiny

Debt collection practices are another component of account management. Availability of credit depends on lender confidence that there is an effective way to offset losses in case of default.[55] However, if the collection process involves punitive collection fees, harsh collection practices, and insufficient and inaccurate information about borrower accounts, these practices may cause harm to borrowers and communities, not to mention to the reputation of the company and the popularity of the product itself.

Currently, debt collection is among the most common types of consumer complaints received by the Consumer Financial Protection Bureau.[56] Disturbing collection strategies have escalated in recent years as debt collection companies have turned to wage garnishment and, in extreme cases, outright threats. In 2014, the Federal Trade Commission, or FTC, took action to stop a debt collection company in Texas that was falsely threatening to arrest borrowers or take their children into custody of the government.[57]

Further complicating matters, it is increasingly common for a company to sell charged-off debts—or debts that it does not expect to recover. More than $60 billion in defaulted consumer debt was sold in 2011.[58] There are more than 500 companies who buy these debts: The nine largest debt buyers bought approximately 90 million consumer accounts between 2006 and 2009.[59] Debts are sometimes sold multiple times. When a company buys a consumer account, they typically do not receive documentation for the account but rather a spreadsheet with consumer names, last recorded addresses, and alleged amounts owed. Only about 6 percent of debts sold included account documentation, according to an FTC analysis of 3.9 million purchased debts between March and August 2009.[60] This lack of documentation leads collectors, at times, to collect on the wrong amount, and in some cases, debt collectors even target the wrong consumer, according to the FTC.[61]

Poor servicing strategies destabilize families and communities. When borrowers are unable to work with lenders to deal with financial shortfalls, the cost of foreclosure is often greater for the borrower, the lender, and the community than the cost of a loan modification. When remote repossession devices freeze vehicles in place, they leave families stranded and scrambling to find more expensive and less reliable alternatives to get around—if they are able to keep the jobs they need in order to repay the loan. And when a distressed payday loan borrower must rely on charity or social services to deal with the debt, those cost burdens shift from the lender to the general public.

Both regulatory and market responses to the role of account management in the foreclosure crisis may offer helpful insight into improved servicing across consumer lending products. For example, the number and size of mortgage servicing companies that specialize in servicing troubled loans have grown substantially, with the large bank servicers often preferring to sell servicing rights to or subcontract with those companies rather than attempt to conduct that aspect of account management on their own.

Additionally, the CFPB has issued a comprehensive set of regulations to govern account management, as have other agencies responsible for large portfolios of loans, such as the Federal Housing Finance Agency and the Federal Housing Administration.[62] The U.S. Department of the Treasury has also provided servicers with a road map for offering more consumer-friendly loan modifications through its Making Home Affordable program that created a template for investor- and consumer-friendly loan modifications and other foreclosure alternatives.[63]

The following common-sense account management principles can help lenders improve borrower success across sectors:

- **Regular statements, whether printed or electronic.** All borrowers should receive timely and sufficient notice of the balance owed and applicable repayment options. The Credit CARD Act, for example, set minimum standards for processing payments, noting that borrowers must have a minimum of 21 days after receiving a statement to make an on-time payment, as well as valuable disclosures on statements, including the consequences of making a minimum payment and the contact information for a credit counselor.

- **Payments at the borrower's discretion.** Automatic, electronic payments can be a convenient way for borrowers to pay off a loan, and they also reduce the cost to the lender of processing payments. But when a borrower faces financial hardship, automatic payments can do more harm than good, as they may lead to overdraft or insufficient-funds fees being charged to the borrower's bank account or even result in the closure of an account. Automatic payments should be a method of convenience, not coercion. Borrowers should be notified of upcoming automatic payments and provided with clear options to stop the transaction. Also, lender access to accounts should be carefully limited, particularly after a transaction has been declined. Recent CFPB proposals would reaffirm this principle.[64]

- **Effective communication with the borrower.** All borrowers, whether they are making on-time payments or are distressed, should be able to reach an account manager quickly and easily to discuss their account. The CFPB now requires mortgage servicers over a certain size to provide a single point of contact to facilitate this communication and to avoid scenarios in which customers are shuffled between various employees who provide them with different and sometimes conflicting information. With strong communication lines in place, it is more likely that borrowers will reach out to a lender in the case of hardship to request a payment arrangement before they simply stop making payments.

- **Quick and responsive error correction.** All businesses will inevitably make mistakes. A strong account manager will promptly investigate and correct any errors in a borrower's file upon request. Quick and responsive action builds trust with consumers and avoids unwarranted fees that can add up or compound and make it harder for a borrower to repay the lender.

- **Working with borrowers who are experiencing short-term hardship.** A well-underwritten loan with fair loan terms is much less likely to become delinquent, but extenuating circumstances such as job loss, illness, disability, divorce, and death that make repayment difficult can occur regardless of income or loan type. Account managers should move quickly to work out an affordable payment arrangement to help the borrower avoid default while experiencing a short-term hardship. Lenders are more likely to get repaid, and will spend less money collecting on the debt, if they provide sensible options instead of simply anticipating default.

- **Fair debt collection practices.** When repayment is not possible, a lender will need to recover any outstanding loan amount by seizing collateral. Without the ability to do so, lenders would have a difficult time staying in business to lend to other borrowers. At the same time, seizing collateral should be a last resort rather than a primary source of revenue for a lender, and it should not take place without sufficient advance warning to the consumer. Finally, when lenders write off a debt and sell it, they should provide the borrower with all of the necessary details about the account, including the correct amount owed, the original contract with all terms of the loan, and correct information about the borrower.

Conclusion

In the years leading up to the financial crisis, lenders found that instead of developing functional loan products that consumers could afford, they could sell outrageously expensive or exotic financial products in which their interest in profit was disconnected from the borrower's interest in repayment. These practices have harmed families, communities, and the larger economy.

It is time to restore the core principle of lending for success. Recent legislation, such as the Dodd-Frank Act and the Credit CARD Act, has made a significant difference by establishing substantive rules of the road for lenders. Importantly, the Dodd-Frank Act created the Consumer Financial Protection Bureau to oversee consumer products across all origination channels. As Congress and financial regulators continue to examine lending practices and access to credit, they should continue to encourage practices in which borrower and lender success are well aligned throughout the life of the loan.

About the authors

Joe Valenti is the Director of Consumer Finance at the Center for American Progress. His work focuses on improving the ability of low- and moderate-income consumers to participate in the financial sector and to make the most of their resources. Prior to joining the Center, he was a Hamilton Fellow at the U.S. Treasury Department and previously served in research and policy roles at the New York City Office of Financial Empowerment, the Aspen Institute, and as an intern for the U.S. Senate Committee on Banking, Housing, and Urban Affairs under Chairman Christopher J. Dodd (D-CT).

Valenti holds a master's degree in public policy from Georgetown University and a bachelor's degree in political science from Columbia University, where he was a John Jay Scholar. He also attended the Institute of Political Studies, Paris.

Sarah Edelman is a Senior Policy Analyst on the Housing and Consumer Finance team at the Center. Her work focuses on foreclosure prevention, single-family rental, and promoting access to affordable housing. Prior to joining the Center, Edelman worked in the areas of community development, community organizing, and consumer protection at Public Citizen; Community Legal Services; the office of Sen. Sherrod Brown (D-OH); and the Federal Deposit Insurance Corporation, or FDIC, Division of Consumer Protection.

Edelman holds a master's degree from the University of Maryland School of Public Policy and a bachelor's degree from The George Washington University.

Julia Gordon is the Senior Director of Housing and Consumer Finance at the Center. Her work focuses on shaping the future of housing finance, ensuring access to sustainable and affordable homeownership and rental, and providing all individuals with safe and appropriate financial products and services. Gordon has written extensively about the secondary mortgage market, foreclosure prevention, the Dodd-Frank Act, and both the Federal Housing Finance Agency and the Federal Housing Administration.

Prior to joining the Center, Gordon managed the single-family policy team at the Federal Housing Finance Agency and served as senior policy counsel at the Center for Responsible Lending.

Gordon received her bachelor's degree in government from Harvard College and her J.D. from Harvard Law School.

Endnotes

1 It has been well documented that these gains were not widely available to communities of color—communities in which access to affordable, responsible credit was often unavailable or limited, while predatory credit was more prevalent; the effects of an unequal credit market continue to be seen today. One recent discussion is found in Ta-Nehisi Coates, "The Case for Reparations," *The Atlantic*, June 2014, available at http://www.theatlantic.com/features/archive/2014/05/the-case-for-reparations/361631/.

2 Bureau of the Census, "Historical Census of Housing Tables: Homeownership," available at http://www.census.gov/hhes/www/housing/census/historic/owner.html (last accessed July 2015).

3 Richard Cordray, "Prepared Remarks of CFPB Director Richard Cordray at the Field Hearing on Payday Lending," Consumer Financial Protection Bureau, March 26, 2015, available at http://www.consumerfinance.gov/newsroom/prepared-remarks-of-cfpb-director-richard-cordray-at-the-field-hearing-on-payday-lending/.

4 From September 2008 to March 2014, approximately 5 million homes were lost to foreclosure. This does not count numerous additional foreclosures in the early stages of the crisis prior to September 2008. See CoreLogic, "National Foreclosure Report: March 2014" (2014), available at http://www.corelogic.com/research/foreclosure-report/national-foreclosure-report-march-2014.pdf.

5 Bureau of the Census, *Table 14: Homeownership Rates for the US and Regions: 1965 to Present* (U.S. Department of Commerce, 2015), available at http://www.census.gov/housing/hvs/data/histtab14.xls.

6 Future efforts by the Center for American Progress will separately address concerns across the growing student loan market.

7 Cordray, "Prepared Remarks of CFPB Director Richard Cordray at the Field Hearing on Payday Lending."

8 Yaron Leitner, "Using Collateral to Secure Loans," *Business Review* (Q2) (2006): 9–16, available at https://www.philadelphiafed.org/research-and-data/publications/business-review/2006/q2/br_q2-2006-2_using-collateral.pdf.

9 Eric Stein, "Turmoil in the U.S. Credit Markets: The Genesis of the Current Economic Crisis," Testimony before the Senate Committee on Banking, Housing, and Urban Affairs, October 16, 2008, available at http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/senate-testimony-10-16-08-hearing-stein-final.pdf.

10 Center for Responsible Lending, "Unfair and Unsafe: How Countrywide's irresponsible practices have harmed borrowers and shareholders" (2008), available at http://www.responsiblelending.org/mortgage-lending/research-analysis/unfair-and-unsafe-countrywide-white-paper.pdf.

11 Ibid.

12 Ken Bensinger, "A vicious cycle in the used-car business," *Los Angeles Times*, October 30, 2011, available at http://articles.latimes.com/2011/oct/30/business/la-fi-buy-here-pay-here-part1-storyb.

13 Jessica Silver-Greenberg and Michael Corkery, "In a Subprime Bubble for Used Cars, Borrowers Pay Sky-High Rates," DealBook, July 19, 2014, available at http://dealbook.nytimes.com/2014/07/19/in-a-subprime-bubble-for-used-cars-unfit-borrowers-pay-sky-high-rates/.

14 Center for Responsible Lending, Consumer Federation of America, and National Consumer Law Center, "Comments of the Center for Responsible Lending, Consumer Federation of America, and National Consumer Law Center on Proposed Rules Regarding Regulation Z" (2009), available at http://www.responsiblelending.org/mortgage-lending/policy-legislation/regulators/CRL-et-al-Comment-YSP-Steering.pdf.

15 Rick Brooks and Ruth Simon, "Subprime Debacle Traps Even Very Credit-Worthy," *The Wall Street Journal*, December 3, 2007, available at http://www.wsj.com/articles/SB119662974358911035.

16 Delvin Davis and Joshua M. Frank, "Under the Hood: Auto Loan Interest Rate Hikes Inflate Consumer Costs and Loan Losses" (Washington: Center for Responsible Lending, 2011), available at http://www.responsiblelending.org/other-consumer-loans/auto-financing/research-analysis/Under-the-Hood-Auto-Dealer-Rate-Markups.pdf.

17 Julia Gordon, "Regulatory Obstacles to Mortgage Credit," Testimony before the Senate Committee on Banking, Housing, and Urban Affairs, April 16, 2015, available at http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=9be04e24-63a0-42b6-a180-30a3e36ccd80.

18 Edmund Mierzwinski and Christine Lindstrom, "The Campus Credit Card Trap: A Survey of College Students and Credit Card Marketing" (Washington: U.S. Public Interest Research Group Education Fund, 2008), available at http://www.uspirg.org/sites/pirg/files/reports/Campus_Credit_Card_Trap_2008_USPIRG.pdf.

19 Consumer Financial Protection Bureau, "Payday Loans and Deposit Advance Products: A White Paper of Initial Data Findings" (2013), available at http://files.consumerfinance.gov/f/201304_cfpb_payday-dap-whitepaper.pdf.

20 Susanna Montezemolo, "The State of Lending in America & its Impact on U.S. Households: Car Title Lending" (Washington: Center for Responsible Lending, 2013), available at http://www.responsiblelending.org/state-of-lending/reports/7-Car-Title-Loans.pdf.

21 Joe Valenti, "Encouraging Responsible Credit for Financially Vulnerable Consumers" (Washington: Center for American Progress, 2014), available at https://www.americanprogress.org/issues/economy/report/2014/07/10/93459/encouraging-responsible-credit-for-financially-vulnerable-consumers/.

22 University of North Carolina Center for Community Capital, "Regaining the Dream: Case Studies in Sustainable Low-Income Mortgage Lending" (2014), available at http://ccc.unc.edu/files/2015/01/RTD-Case-Studies-Nov-2014.pdf.

23 *Credit Card Accountability Responsibility and Disclosure Act of 2009*, Public Law 24, 111th Cong., 1 sess. (May 22, 2009), available at http://www.gpo.gov/fdsys/pkg/PLAW-111publ24/pdf/PLAW-111publ24.pdf.

24 Consumer Financial Protection Bureau, "Fact Sheet: The CFPB Considers Proposal to End Payday Debt Traps" (2015), available at http://files.consumerfinance.gov/f/201503_cfpb-proposal-under-consideration.pdf.

25 Ibid.

26 Valenti, "Encouraging Responsible Credit for Financially Vulnerable Consumers."

27 *Home Ownership and Equity Protection Act*. In *Riegle Community Development and Regulatory Improvement Act of 1994*, Public Law 325, 103rd Cong., 2d sess. (September 23, 1994).

28 VantageScore, "VantageScore 3.0: Better predictive ability among sought-after borrowers" (2013), available at http://www.vantagescore.com/images/resources/VantageScore3-0_WhitePaper.pdf.

29 Consumer Financial Protection Bureau Office of Research, "Data Point: Credit Invisibles" (2015), available at http://files.consumerfinance.gov/f/201505_cfpb_data-point-credit-invisibles.pdf.

30 Sarah Edelman, Michela Zonta, and Julia Gordon, "Lease Purchase Failed Before—Can It Work Now?" (Washington: Center for American Progress, 2015), available at https://www.americanprogress.org/issues/housing/report/2015/04/29/112014/lease-purchase-failed-before-can-it-work-now/.

31 Gordon, "Regulatory Obstacles to Mortgage Credit."

32 Ibid.

33 Signe-Mary McKernan and others, "Impact of the Great Recession and Beyond: Disparities in Wealth Building by Generation and Race" (Washington: Urban Institute, 2014), available at http://www.urban.org/sites/default/files/alfresco/publication-pdfs/413102-Impact-of-the-Great-Recession-and-Beyond.PDF.

34 U.S. Department of Housing and Urban Development, "HUD- Manufactured Housing and Standards: General Program Information," available at http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/ramh/mhs/faq (last accessed June 2015).

35 Daniel Wagner and Mike Baker, "Warren Buffett's mobile home empire preys on the poor," Center for Public Integrity, April 3, 2015, available at http://www.publicintegrity.org/2015/04/03/17024/warren-buffetts-mobile-home-empire-preys-poor.

36 Ann Carrns, "More Expensive Cars Are Leading to Longer-Term Loans," *The New York Times*, November 5, 2014, available at http://www.nytimes.com/2014/11/06/your-money/more-expensive-cars-are-leading-to-longer-term-loans.html.

37 Rick Jurgens and Chi Chi Wu, "Fee-Harvesters: Low-Credit, High-Cost Cards Bleed Consumers" (Boston: National Consumer Law Center, 2007), available at www.nclc.org/images/pdf/credit_cards/fee-harvesters-report.pdf.

38 Robert Berner, "A Credit Card You Want to Toss," Bloomberg Business, February 7, 2008, available at http://www.businessweek.com/stories/2008-02-07/a-credit-card-you-want-to-tossbusinessweek-business-news-stock-market-and-financial-advice.

39 Kathleen Burke and others, "CFPB Data Point: Payday Lending" (Washington: Consumer Financial Protection Bureau Office of Research, 2014), available at http://files.consumerfinance.gov/f/201403_cfpb_report_payday-lending.pdf.

40 State Employees' Credit Union, "Salary Advance Loans," available at https://www.ncsecu.org/PersonalLoans/SalaryAdvance.html (last accessed June 2015).

41 Cleveland Housing Network, "LIHTC Lease Purchase Program Fact Sheet" (2014).

42 *Credit Card Accountability, Responsibility, and Disclosure Act of 2009*.

43 Sumit Agarwal and others, "Regulating Consumer Financial Products: Evidence from Credit Cards." Working Paper 19484 (National Bureau of Economic Research, 2013), available at http://www.nber.org/papers/w19484.

44 Consumer Financial Protection Bureau, "What the new simplified mortgage disclosures mean for consumers" (2013), available at http://files.consumerfinance.gov/f/201311_cfpb_tila-respa_what-it-means-for-consumers.pdf.

45 Valenti, "Protecting Consumers Five Years After Credit Card Reform."

46 In Virginia, while the statutory annual interest rate cap is 36 percent, two additional fees lead to a triple-digit APR of 289 percent, on average. See Joe Valenti and Lawrence J. Korb, "Strengthening the Military Lending Act to Protect Troops From Predatory Practices" (Washington: Center for American Progress, 2015), available at https://www.americanprogress.org/issues/economy/news/2015/01/15/104597/strengthening-the-military-lending-act-to-protect-troops-from-predatory-practices/.

47 For qualified mortgages for loan amounts of $100,000 or more, points and fees may not exceed 3 percent of the loan amount. See Consumer Financial Protection Bureau, "Basic guide for lenders: What is a Qualified Mortgage?" (2013), available at http://files.consumerfinance.gov/f/201310_cfpb_qm-guide-for-lenders.pdf.

48 *Credit Card Accountability, Responsibility, and Disclosure Act of 2009*.

49 Once loans are delinquent, servicers can start to charge late fees, and even after the loan goes through to foreclosure, the servicer gets paid out of the proceeds before the owner of the loan is paid. For more details about misaligned mortgage servicing incentives, see Tara Twomey and Adam Levitin, "Mortgage Servicing," *Yale Journal on Regulation* 28 (1) (2011): 1–90.

50 Delvin Davis, "The State of Lending in America & its Impact on U.S. Households: Auto Loans" (Washington: Center for Responsible Lending, 2012), available at http://www.responsiblelending.org/state-of-lending/reports/4-Auto-Loans.pdf.

51 Bensinger, "A vicious cycle in the used-car business."

52 Michael Corkery and Jessica Silver-Greenberg, "Miss a Payment? Good Luck Moving That Car," DealBook, September 24, 2014, available at http://dealbook.nytimes.com//2014/09/24/miss-a-payment-good-luck-moving-that-car/.

53 Davis, "The State of Lending in America & its Impact on U.S. Households: Auto Loans."

54 Burke and others, "CFPB Data Point: Payday Lending."

55 Robert M. Hunt, "Collecting Consumer Debt in America," *Business Review* (Q2) (2007): 11–24, available at https://www.philadelphiafed.org/research-and-data/publications/business-review/2007/q2/hunt_collecting-consumer-debt.pdf.

56 Consumer Financial Protection Bureau, "Debt Collection (Regulation F)," *Federal Register* 78 (218) (2013), available at http://files.consumerfinance.gov/f/201311_cfpb_anpr_debtcollection.pdf.

57 *Federal Trade Commission v. Goldman Schwartz Inc.*, No. 4:13-cv-00106 (Tex. 2014), available at https://www.ftc.gov/system/files/documents/cases/140519goldmanstip.pdf; Federal Trade Commission, "FTC Puts Texas-based Operation Permanently Out of the Debt Collection Business After It Allegedly Used Deception, Insults, and False Threats against Consumers," Press release, May 19, 2014, available at http://www.ftc.gov/news-events/press-releases/2014/05/ftc-puts-texas-based-operation-permanently-out-debt-collection.

58 Robert M. Hunt, "Understanding the Model: The Life Cycle of a Debt," Presentation to the FTC and CFPB, June 6, 2013, available at https://www.ftc.gov/sites/default/files/documents/public_events/life-debt-data-integrity-debt-collection/understandingthemodel.pdf.

59 Lisa Stifler and Leslie Parrish, "Debt Collection & Debt Buying: The State of Lending in America & its Impact on U.S. Households" (Washington: Center for Responsible Lending, 2014), available at http://www.responsiblelending.org/state-of-lending/reports/11-Debt-Collection.pdf.

60 Ibid.

61 Federal Trade Commission, "Collecting Consumer Debts: The Challenges of Change" (2009), available at https://www.ftc.gov/sites/default/files/documents/reports/collecting-consumer-debts-challenges-change-federal-trade-commission-workshop-report/dcwr.pdf.

62 Consumer Financial Protection Bureau, "2013 Real Estate Settlement Procedures Act (Regulation X) and Truth in Lending Act (Regulation Z) Mortgage Servicing Final Rules," available at http://www.consumerfinance.gov/regulations/2013-real-estate-settlement-procedures-act-regulation-x-and-truth-in-lending-act-regulation-z-mortgage-servicing-final-rules/ (last accessed July 2015). See the Federal Housing Finance Agency's Servicing Alignment Initiative in Freddie Mac, "Servicing Alignment Initiative," http://www.freddiemac.com/singlefamily/service/servicing_alignment.html (last accessed July 2015); Federal Housing Administration, *Single Family Policy Handbook* (U.S. Department of Housing and Urban Development, 2015), available at http://portal.hud.gov/hudportal/documents/huddoc?id=40001HSGH.pdf.

63 Making Home Affordable, "Home Affordable Modification Program," available at http://www.makinghomeaffordable.gov/programs/lower-payments/Pages/hamp.aspx (last accessed July 2015).

64 The CFPB's proposed prepaid card rule would require that any credit linked to a prepaid card would need to follow credit card regulations, with the borrower deciding when to make payments instead of having them automatically deducted. See Consumer Financial Protection Bureau, "CFPB Proposes Strong Federal Protections for Prepaid Products," Press release, November 13, 2014, available at http://www.consumerfinance.gov/newsroom/cfpb-proposes-strong-federal-protections-for-prepaid-products/. Similarly, the CFPB's outline of proposed payday loan regulations would require borrowers to be notified three days before an automatic withdrawal for repayment of the loan and would limit lenders to two unsuccessful attempts to pull funds from a consumer's bank account to reduce the likelihood of borrowers incurring bank fees. For additional detail, see Consumer Financial Protection Bureau, "Small Business Advisory Review Panel for Potential Rulemakings for Payday, Vehicle Title, and Similar Loans: Outline of Proposals Under Consideration and Alternatives Considered" (2015), available at http://files.consumerfinance.gov/f/201503_cfpb_outline-of-the-proposals-from-small-business-review-panel.pdf.

Our Mission

The Center for American Progress is an independent, nonpartisan policy institute that is dedicated to improving the lives of all Americans, through bold, progressive ideas, as well as strong leadership and concerted action. Our aim is not just to change the conversation, but to change the country.

Our Values

As progressives, we believe America should be a land of boundless opportunity, where people can climb the ladder of economic mobility. We believe we owe it to future generations to protect the planet and promote peace and shared global prosperity.

And we believe an effective government can earn the trust of the American people, champion the common good over narrow self-interest, and harness the strength of our diversity.

Our Approach

We develop new policy ideas, challenge the media to cover the issues that truly matter, and shape the national debate. With policy teams in major issue areas, American Progress can think creatively at the cross-section of traditional boundaries to develop ideas for policymakers that lead to real change. By employing an extensive communications and outreach effort that we adapt to a rapidly changing media landscape, we move our ideas aggressively in the national policy debate.

Center for American Progress

1333 H STREET, NW, 10TH FLOOR, WASHINGTON, DC 20005 • TEL: 202-682-1611 • FAX: 202-682-1867 • WWW.AMERICANPROGRESS.ORG