

# ESTABLISHING A LINK AMONG SUBPRIME LENDING, PAYDAY LENDING, AND HOUSING COSTS

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## Abstract

*This study identified counties with high shares of payday businesses and high shares of subprime loans. Payday lending establishments, banks, and credit unions were inventoried in every county in Utah. The objective was to empirically analyze a potential link between high shares of payday lending and subprime lending, and between high shares of payday lending and housing cost burden. A statistically significant association was estimated by calculating Spearman's rho on the ranking of the variables. The study found a moderately strong correlation between payday lending and subprime lending, and between payday lending and housing cost burden. The regression model showed that 30% of variability in subprime lending was accounted for by payday store-per-household and housing cost burden. Specifically, payday store-per-household alone accounted for 20% of the variation in subprime lending. Recommendations for payday lending and subprime lending were provided.*

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## Introduction

Only a few decades ago scarcity of credit was a problem for women, low-income Americans, and borrowers in communities of color. Today, because of advances in technology and changes in the marketplace, many in these same populations are bombarded with offers from subprime mortgage lenders, check cashers, payday lenders, and other fringe bankers. The Center for Responsible Lending (CRL) (2006) estimated that the payday lending industry has grown over 100% in the last five years. At the end of 2006 there were about 25,000 payday loan outlets in the U.S., with an annual loan volume of at least \$28 billion (Center for Responsible Lending, 2006). Those 25,000 outlets accounted for almost \$5 billion in loan fees paid by consumers (Center for Responsible Lending, 2006). At the same time, subprime mortgages proliferated. Approximately 21% of all mortgage originations from 2004 through 2006 were subprime, up from 9% from 1996 through 2004. Subprime mortgages totaled \$600 billion in 2006, accounting for about one-fifth of the U.S. home loan market (Rushton, 2007).

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While there has been extensive literature on subprime lending, there has been less research to determine whether both the subprime lending and payday lending industries are associated. This article empirically establishes a potential link between subprime lending and payday lending, and between payday lending and housing cost burden.

The main assumption of this study is that payday lenders are serving credit impaired borrowers who are not using mainstream financial services. Similarly, subprime lenders serve borrowers who do not qualify for prime market interest rates because of problems with their credit history. Carr and Shuetz (2001) observed that excessive subprime lending tends to flourish in communities saturated with check cashers, pawnshops, and related financial services outlets. Therefore, one hypothesis for this research is that counties that rank high in subprime lending also rank high in the number of payday stores-per-household. The other hypothesis tested is that if a county faces unaffordable housing costs (as measured by housing cost burden), then this may induce residents to incur additional debt to pay for essential expenses. Therefore, it is expected that counties that rank high in housing cost burden also rank high in payday stores-per-household. Based on these hypotheses, the following research questions are posed:

**RQ1:** Is the rank-ordered payday store-per-household significantly correlated with the rank ordered subprime lending activity?

**RQ2:** Is the rank-ordered payday store-per-household significantly correlated with the rank-ordered housing cost burden?

**RQ3:** Do payday store-per-household and housing cost burden uniquely explain variance in subprime lending?

### **Review of Literature**

The diversity of mortgage products and credit supply observed in the mortgage market can be explained as a natural response of heterogeneous borrowers. There are lending products for the prime, near-prime, and subprime markets. By the same token, there is also a supply of consumer credit for users of mainstream financial services, and a supply of consumer credit offered by fringe financial service providers. The literature review presents research on payday lending including the geographic market shares of the payday lending stores. This is followed by research on subprime lending including the market shares of subprime lending activities. Finally, a brief report on the connection of payday lending and housing cost burden is presented.

#### ***Research on Payday Lending Activity***

Payday loans are short-term, high-interest loans backed by a personal check or access to a banking account. These loans are typically two weeks in duration, which is the average payday period for many consumers. A typical fee for a

\$100 loan ranges from \$15-\$20, which translates into a 520% annual percentage rate (APR) (Elliehausen & Lawrence, 2001).

One factor that has enabled growth of the payday lending industry is lack of regulation of small loans in a number of states. In 2002 only 19 states had provisions that significantly weakened the practice of payday lending, namely strict interest rate ceilings capping annual interest rates at 36% (Renaurt, 2002). Twenty-five states in the country have enacted laws to actually legalize payday loans. These states do not have caps on payday lender interest rates, which can be over 720% APR (Renaurt, 2002). Another reason the payday loan industry is expanding is an increase in the number of households with high debt and impaired credit who do not qualify for credit cards or for overdraft protection, or who have already maximized their borrowing from these sources (Stegman & Faris, 2003).

The lack of mainstream financial services available to low-income persons and minorities is cited as another reason for the growth of payday lending institutions (Association of Community Organizations for Reform Now, 2002; Bradford, 2002; Richter & Tan, 2002). Due in part to the banking deregulation of the 1980s, mainstream financial institutions have been moving out of low-income, minority neighborhoods. According to Graves (2003), banks are more prominent in high-income, white neighborhoods. Many payday loan advocates claim to be filling financial needs that are not being met by mainstream banks and financial institutions (Graves, 2003). According to the Consumer Credit Research Foundation, a payday industry advocacy group, the demand for small, short-term loans has grown due to the fact that many financial institutions exited the market to focus their activities on larger, more profitable loans. As financial institutions vacated the small, short-term loan market, bounced check fees, late payment penalties, and other short-term credit product costs increased substantially (Brown, Findlay, Lehman, Maloney, & Meehan, 2004).

### ***Research on Subprime Lending Activity***

Subprime lending provides loan services to those with lower credit scores at an increased cost to compensate for a higher risk (Howell, 2006). Those in the subprime market have higher rates of foreclosure and greater financial insecurity (King, Parrish, & Tanik, 2006). Extension of credit to customers with less than perfect credit has allowed more of the population access to credit and the increased consumption power that comes with the ability to use that credit. In this sense, similar to the payday lending industry, the mortgage industry has argued that the emergence of subprime lending has benefited the public as a whole (Smith, 2007). Nevertheless, this expansion of services to those with poor credit has come at a price. Subprime lending has higher associated costs than prime loans or traditional loans. These higher costs are justified to compensate for the

increased risk associated with lending to credit impaired borrowers. Engel and McCoy (2001) explained that this risk is not, however, carried by those financial institutions issuing the loan. The creation of the secondary market and the sale of bulk mortgage loans as mortgage-backed securities have offered an incentive for subprime mortgage lenders to issue loans at greater volumes. This is due in part because the risk associated with subprime loans, which is substantially higher than prime mortgage loans, is passed on to investors in the secondary market.

Much of the expansion of the subprime market has been correlated with the deregulation of the banking industry and specific reforms associated with the lending industry (Howell, 2006). Reforms such as the Tax Reform Act of 1986 and the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 not only provided incentives for lenders to enter into the subprime market but also opened the door to abusive practices, such as exorbitantly high interest rates and high fees (Howell, 2006).

Over the years, it has been argued that subprime markets have moved into areas to fill the void of services once excluded from mainstream financial institutions (Apgar & Herbert, 2006). The subprime market is now serving communities with high concentrations of minorities, particularly Latinos and African-Americans, low-income families, and persons with poor credit histories (Howell, 2006). Even when levels of income are taken into account, those living in minority communities have greater subprime lending activity as compared to predominately white neighborhoods. Subprime loans accounted for over 36% of total loans in low-income areas compared to high-income areas with only 16% of total loans being serviced by subprime loans (Scheessele, 2002).

Generally speaking, subprime loans are mortgages given to borrowers with credit scores of 620 or below. Such low scores usually result from a history of paying debts late or not paying debts at all. Because subprime borrowers are seen as higher risk, their loans carry interest rates that are at least two percentage points higher than those offered to borrowers with better credit. The CRL issue paper "Subprime lending is a net drain on homeownership" stressed that the majority of subprime loans do not go toward buying a home. Instead, these loans are used to refinance existing loans. CRL estimated that first-time homeowners made up only 25% of all subprime loans in 2006 and that 15.6% of subprime loans ended in foreclosure (Center for Responsible Lending, 2007). Michael Calhoun, director of CRL, stated that currently about 80% of all subprime loans come with an adjustable rate and/or prepayment penalty feature(s). These features significantly increase the risk of foreclosure. In fact, the CRL study showed that the risk on an ARM versus a fixed-rate mortgage is 72% higher (Calhoun, 2006).

### ***Housing Cost Burden and Payday Lending***

In recent years, the affordability problem has become acute in a large number of housing markets across the nation. One of the reasons for this problem may be that housing costs increased more than household incomes (Associated Press, 2007). Housing expenditures have caused many households, both renters and owner-occupants, to reduce their expenditures for food, clothing, health care, and other human capital investments (Kutty, 2005). The disparity between housing expenditures and income has led some households to incur additional debt to pay for essential housing expenses. For example, Shipler (2004) in his book *Working Poor* suggested that is not uncommon for low-income households to obtain payday loans to pay for utilities and telephone charges. Similarly, a survey of payday users conducted in Toronto and Vancouver that was sponsored by the Association of Community Organizations for Reform Now (ACORN), described that many users of payday loans are people with poor credit records that they believe bar them from getting adequate services at banks and credit unions, and/or who feel a need for quick cash to cover outstanding bills or debts. They use these services to create the liquidity for daily living so they can pay their bills and other debts (Association of Community Organizations for Reform Now, 2005).

Elliehausen and Lawrence (2001) found that the majority of payday loan users were fairly young—over 66% of the customers were under the age of 45 and 36% were under the age of 35. One hypothesis that explains the young age of payday lending customers is that consumers in the early life cycle have higher demands for the use of credit (Elliehausen & Lawrence, 2001). The study also found that the majority (58%) of payday customers were married or living with a partner and had children. About 75% had educational levels equivalent to a high school diploma and some college, and over 40% owned their homes. Unfortunately, the study did not specify whether these homeowners held prime or subprime loans.

Apgar and Herbert (2006) also found that about 40% of households obtaining payday loans were homeowners, but went on to state that at one time the majority of those using payday loans had obtained a mortgage. It was also found that over three-fourths of payday loan customers had been turned down for credit or had not received as much credit as they had applied for in the previous five years. The point to note here is that if 40% of households obtaining payday loans are homeowners, then 60% are renters. It has long been demonstrated that renters suffer a greater housing cost burden than homeowners and that the lower the income of the household, the larger the portion of income that is spent for housing (Chi & Laquatra, 1998).

Despite numerous empirical studies on the payday lending industry and subprime mortgage industry, the potential market shares of both businesses and the fact that they may be serving homogenous borrowers has not been demonstrated. The studies presented above illustrate many similarities about the type of borrower payday lenders and subprime lenders are serving and about the geographic concentrations of their market shares. For example, empirical studies and U.S. Department of Housing and Urban Development reports have pointed out that subprime loans are heavily concentrated in communities with high numbers of minorities, low-income families, and borrowers with poor credit histories. Studies on fringe financial services have identified these same communities as targets for payday stores (Graves, 2003). By the same token, having housing costs increase more than income over the past several years is making households incur other cycles of debts in order to make ends meet. Therefore, in this study it is expected that research findings will show positive correlations between subprime lending and payday lending, and between payday lending and housing cost burden.

### **Method**

An inventory of payday lending establishments, banks, and credit unions in Utah was developed in Spring 2006 using 12 different search engines (such as [www.yellowpages.com](http://www.yellowpages.com), [www.qwestdex.com](http://www.qwestdex.com), and [www.yahoo.com](http://www.yahoo.com)). Only payday lenders, banks, and credit unions with physical locations in the state were considered. Once business addresses were obtained, the appropriate county was matched using the 2006 Federal Financial Institutions Examination Council's geocoding software available at [www.ffiec.gov](http://www.ffiec.gov).

Other county level demographic and housing variables used in this study were obtained from the 2005 FDIC-Census Data CD software. The variables for this study are: number of payday lender stores, total number of households, percentage of all purchased mortgage loans made by subprime lenders, percentage of refinancing mortgage loan originations made by subprime lenders, and housing cost burden. Since it is expected that larger counties would have larger numbers of payday lenders, and to avoid a spurious relationship where size of the county is explaining the data, the number of payday lending establishments was divided by the number of households to compute the ratio of payday lending-to-households. Both subprime lending variables are given as a percentage number. Subprime lending is equal to the sum of all mortgage loans and refinance loans originated by subprime lenders. Housing cost burden is the percentage of households in each census tract that experience housing cost burden. A household has a housing cost burden if it spends at least 30% but less than 50% of its income on housing costs.

This study used descriptive statistics including frequencies to describe payday lending and subprime lending activities for the entire state by counties. To answer RQ1 and RQ2 Spearman's rho correlations were performed. Spearman's rho is a non-parametric procedure that measures how variables or rank orders are related (SPSS Version 15.0). Since it was of interest to see the magnitude of payday lending and subprime lending in each county, all counties in the state were ranked according to these two variables. Regression analysis was used to answer RQ3, with sum of subprime lending (subprime purchase loans + subprime refinances) used as the dependent variable, and payday store-per-household and housing cost burden as the independent variables. The variables entered in the regression were not ranked. A collinearity diagnosis was requested along with the regression analysis, and plots and graphics on the residuals were performed to check for any possible violation of assumptions. An alpha level of .05 was used to determine statistical significance. The statistical package SPSS version 15.0 was used to perform the analyses.

### Results

Descriptive statistics for the variables are provided in Table 1. The mean number of payday lending establishments per county in the state was 8.86 ( $SD = 20.39$ ; range = 0-96), while the mean percentage of the sum of subprime activity per county was 22.02 ( $SD = 9.07$ ; range = 6-39). The median percentage of households that experienced housing cost burden was 42.40 ( $SD = 7.05$ ; range = 30-55).

**Table 1. Descriptive Statistics for Independent and Dependent Variables (N=29)**

Variable	Mean	Median	Std. Deviation	Min.	Max.
Payday lending establishments	8.86	1.00	20.39	0	96
Payday store-per-household	.0003	.0001	.004	.0000	.0013
Subprime lending activity	22.02	21.90	9.07	6	39
Housing cost burden	42.40	41.90	7.05	30	55
Subprime purchase	13.99	12.9	7.76	.00	28
Subprime refinance	8.03	7.8	2.56	.00	13

**Table 2. Payday Store Location Analysis in Relation to Banks, Credit Unions, and Subprime Activity**

County name	Payday lenders	Banks	Credit unions	Ratio (PDL/financial institutions)	Total households	Payday lenders per household	Subprime activity
Beaver	0	3	0	-	2082	-	26.30
Box Elder	6	13	4	1 : 2.8	14486	2414.33	33.50
Cache	15	22	10	1 : 2.1	29616	1974.40	25.30
Carbon	0	7	1	-	6716	-	21.90
Daggett	0	0	0	-	375	-	6.70
Davis	6	29	10	1 : 6.5	83140	13856.67	27.50
Duchesne	6	5	4	1 : 1.5	5007	834.50	19.60
Emery	0	2	1	-	3413	-	16.70
Garfield	0	3	1	-	1478	-	12.20
Grand	0	5	1	-	3546	-	21.40
Iron	6	6	5	1 : 1.8	12989	2164.83	14.60
Juab	0	2	2	-	2736	-	18.50
Kane	1	1	1	1 : 2	2322	2322.00	9.80
Millard	2	5	2	1 : 3.5	3739	1869.50	21.40
Morgan	0	2	1	-	2363	-	29.40
Piute	0	1	0	-	483	-	11.10
Rich	0	1	0	-	673	-	23.20
Salt Lake	96	145	106	1 : 2.6	318364	3316.29	34.90
San Juan	0	5	1	-	4083	-	10.90
San Pete	1	12	6	1 : 18	7016	7016.00	26.90
Sevier	2	9	3	1 : 6	6282	3141.00	19.00
Summit	1	14	2	1 : 15	12966	12966.00	15.90
Tooele	11	4	2	1 : 0.5	16720	1520.00	38.90
Uintah	10	13	2	1 : 1.5	8954	895.40	35.20
Utah	20	75	38	1 : 5.7	134391	6719.55	29.00
Wasatch	5	7	1	1 : 1.6	6276	1255.50	23.60
Washington	9	36	10	1 : 5.1	44401	4933.44	22.00
Wayne	0	1	0	-	850	-	6.00
Weber	60	33	17	1 : 0.8	70931	1182.18	37.20
<b>Utah Totals</b>	<b>257</b>	<b>461</b>	<b>231</b>	<b>1 : 2.7</b>	<b>735467</b>	<b>68381.59</b>	<b>22.02</b>

Table 2 illustrates the actual number of payday loan stores, and the presence of subprime lending activity in each of the counties. The payday lending industry's growing presence is hard to overlook as one finds that in some counties there were more payday loan stores than financial institutions such as banks and credit unions combined. Table 2 also illustrates this fact as a ratio of the number of payday stores (PDL) to mainstream financial institutions in each county. One example of this is Weber County, where there were 60 payday stores and only 50 banks or credit unions. The state as a whole had 257 physical payday lending stores, which translates into a ratio of one payday lending store for less than three banks and credit unions. In terms of the number of payday store-per-household, the state had on average of one payday lending store for every 2,760 households. Each county had a mean of 8.86 payday lenders. Some counties had none and one county had as many as 96. Utah has one of the highest rates of subprime activity in the country. About one-fifth (22%) of all loans originated in this state are subprime loans. Note from Table 2 that counties with a high number of payday stores also had a high percentage of subprime lending activity.

RQ1 and RQ2 were answered using Spearman's rho correlation analysis. The rank-ordered payday store-per-household lending was positively associated with the rank-ordered subprime loan purchase loans and subprime refinances (*Spearman's rho* = .438,  $p < .05$ ). The association was also positive for the rank-ordered housing cost burden and subprime lending (*Spearman's rho* = .426,  $p < .05$ ) and payday lending (*Spearman's rho* = .385,  $p < .385$ ). This indicates that the rank of a county on payday store-per-household increases with the rank of each of the independent variables (Table 3).

**Table 3. Non-parametric Correlations Using Spearman's Rho**

Variable	Sum of subprime lending	Payday lending
Sum of subprime lending	1.00	438*
Payday lending	.438*	1.00
Housing cost burden	.426*	.385*

\*  $p < .05$

One goal of this study was to explain variance in subprime lending by using payday store-per-household, and housing cost burden as the independent variables (RQ3). The regression analysis was run using the Enter procedure (Table 4). The procedure yielded an *R-squared* of .308. The *R-squared* value indicates that about 30% of the variance in subprime lending is associated with payday lending stores and housing cost burden. The standardized coefficient for the payday lending variable (*Beta* = .384) indicates that an increase of four new payday lending stores in a 10,000 household area will have a 1.5% increase in subprime lending in that

area, holding housing costs constant. The variable payday store-per-household accounts for about 20% of the variability in subprime lending.

**Table 4. Regression Analysis with Subprime Lending as Dependent Variable**

Model	Unstandardized		Standardized		
	Coefficient	Std. Error	Beta	<i>t</i>	<i>p</i>
Constant	.731	9.038	-	.081	.936
Payday lending	8628.678	3729.23	.384	2.314	.029
Housing cost burden	.436	.214	.339	2.043	.051

$R = .555$ ;  $R^2 = .308$

### Conclusions and Recommendations

Although this study was not designed to demonstrate a causal relationship between subprime lending and payday lending activities, several important associations can be made based on these findings. The data in this study indicate that there is an association between subprime lending activities and payday lending. Counties that rank high in percentage of subprime lending also tend to rank high in the ratio of payday lending to households. Such an association may be explained by a possible overlap of the market shares of both industries and/or by the possibility that both industries are serving homogenous credit impaired borrowers.

The other major finding in this study is that there is a statistical association between payday lending and housing cost burden. The evidence seems to indicate that in spite of low homeownership rates for payday users, this is still an important issue because it demonstrates that households may be turning to quick cash loans to meet their needs. One reason this may be important, and deserves to be investigated, is whether subprime mortgage users are borrowing from payday lending companies in order to make mortgage payments or pay other housing-related costs such as utility or phone bills. If this is the case, this new evidence would provide strong support for regulation to determine ability to pay back a loan, either in the subprime lending or payday lending industry. Several recommendations to enhance consumer and housing protection are presented next.

#### **Housing and Consumer Protection Recommendations**

**Both payday lending and subprime industries should improve their current disclosure practices.** Many industry stakeholders point to the borrower's responsibility to be a savvy consumer, to shop around for the best deal, and to

enter into mortgage transactions with adequate information. While many consumer educators believe that comparison shopping is an important part of a mortgage transaction, or of any credit transaction, enhanced shopping alone will not correct market failures. Most consumers do not have the tools to effectively shop. It is recommended that state level regulatory agencies of payday loans and state level regulatory agencies of non-depository mortgage brokers (from which the majority of subprime loans are originated) provide consumers with adequate disclosures before a loan application is filled out and, in addition, provide disclosures at loan application and at closing.

Disclosures would be particularly helpful for consumers who are shopping for loans and comparing costs and benefits before they apply for a mortgage or credit transaction. For example, many state laws currently require payday lenders posting fee schedules to show both the APR and the dollar amount of the fees. However, in many instances APRs are not posted in a clear and conspicuous manner. Empirical evidence from newspapers shows that payday loan borrowers do not take the APR into consideration when deciding to acquire a loan; rather, the finance charge is of greater importance. Because it is important for consumers to have complete and accurate information about the cost of payday loans, posting fees is not enough to help them understand the actual cost of the loan. It is strongly recommended that along with posting fees, a mandatory disclosure of a possible cycle of debt should be given in writing and explained to the consumer before the transaction takes place.

Likewise, while subprime mortgages have brought an increased availability of mortgage credit to a segment of the population who otherwise would not have access to credit, there is concern that consumers may enter into these transactions without fully understanding subprime lending products' terms and risks. In addition to apprising consumers of the benefits of subprime loans, institutions and mortgage brokers should take appropriate steps to alert consumers to the risks of these products, including the higher cost associated with them, prepayment penalties, and the borrower's obligations for taxes and insurance. This information should be provided in a timely manner—before the actual loan application—to assist consumers in the product selection process.

Federal banking regulators are currently improving disclosure requirements to ensure that lenders provide homeowners with complete, accurate, and understandable information about their mortgages, including the possibility that their monthly payments could dramatically increase. In other words, it is believed that if the consumer is better informed, problems are less likely to arise in the first place. Banking regulators are also strengthening lending standards to help ensure that borrowers are not approved for mortgages larger than they can handle. Examples of these efforts are a joint release by federal regulators and a recent statement by institutions to work with mortgage borrowers who are unable to

make their mortgage payments (FDIC, 2007). Government agencies have provided incentives to bank and thrift programs that transition low- or moderate-income homeowners from higher-cost loans to lower-cost loans by receiving favorable consideration under the Community Reinvestment Act (CRA), provided the loans are made in a safe and sound manner. Federal credit unions are exempt from CRA requirements (U.S. Department of the Treasury, 2007).

**Support regulation that determines ability to pay back a loan in the payday lending and subprime lending industries.** The results of this study show a positive correlation between payday lenders and subprime lending. If subprime borrowers are borrowing from payday lending companies in order to make mortgage payments, this would provide stronger support for regulations to determine ability to pay. Borrowers should be qualified based on the ability to pay back a loan at maturity. One way to do this in a payday transaction is by limiting rollovers to *two*, and by enacting a three-day cooling off period before a consumer can take out another loan. It has been pointed out that the payday loan industry thrives on repeat customers. A study by CRL revealed that only 1% of payday loans are to borrowers who use payday loans once per year. The majority of borrowers (91%) who use payday loans average five or more transactions a year. The study also found that the average payday loan consumer averaged nine rollovers/extensions a year (King, Parrish, & Tanik, 2006). Payday borrowers are not using this product as an occasional emergency loan, but rather are trapped in the loan and routinely pay more in fees than they originally borrowed. States should limit the number of rollovers a consumer can make on a loan to two, thus enabling a person six weeks to pay off a loan but also limiting the amount of fees they would have to pay.

A cooling off period between loans is needed. A cooling off period of three days, similar to the right of rescission in mortgage refinances, will ensure that consumers are not just flipping the loan over to another loan the same day. Payday loan flipping refers to the practice of once consumers have reached the limit on the number of rollovers they can have on a loan, closing out one payday loan and immediately opening another one. This practice continues the cycle of debt and enables more fees to be stripped from consumers. In the mortgage industry, the Home Ownership and Equity Protection Act (HOEPA) provides a variety of measures designed to limit the ability of a lender to repeatedly refinance its loans. Unfortunately, HOEPA only provides protection to high-cost loans, which are defined as loans with an APR of 8% above the rate for Treasury securities with a comparable maturity.

Loan flipping in the mortgage industry can be harmful to borrowers because typically each time a loan is refinanced, or flipped, new points and fees are charged, often without regard to the borrower's ability to repay the additional amount. As the Federal Reserve Board noted, victims of flipping are typically borrowers who are

already having difficulty repaying their original loan. The issue gets complicated because deceptive sales techniques may successfully confuse borrowers about the significant costs of successive refinancing (Clark, 2001). In May 2007 the U.S. Department of the Treasury, along with the Board of Governors of the Federal Reserve System and the National Credit Union Administration, was requesting comments on a new proposed statement on subprime mortgage lending which will discuss criteria and factors, including payment shock, that an institution should assess in determining a borrower's ability to repay a subprime loan (Federal Reserve Board, 2007). Like the Nontraditional Mortgage Guidance enacted in November 2006, the proposed subprime lending mortgage statement specifies that an institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate assuming a fully amortizing repayment schedule.

**More mainstream financial institutions should be involved in meeting the financial needs of payday lending users by providing short-term emergency loan products.** Affordable small-dollar loans are in demand. Many consumers turn to payday or other lenders because they are accessible and can quickly provide loans. Yet, the inability to repay these short-term, high-cost credit products often exacerbates a customer's ability to meet cash flow needs. Some financial institutions are providing the same service provided by payday loans with more appropriate loan terms and at a lower cost (Blair, 2005). Banks that are interested in gaining a foothold in the market for remittances are looking to offer low-cost checking accounts with overdraft insurance. In December 2006 the FDIC released guidelines to encourage institutions to consider opportunities for offering innovative, reasonably priced products that meet this need. Furthermore, such products offered in a responsible, safe, and sound manner will warrant favorable CRA consideration.

**The Federal Housing Administration (FHA) has the potential to serve as a bridge to bring subprime borrowers into the prime market.** Just recently, in August 2007, President Bush announced that his administration plans to use FHA's residential mortgage insurance program to help thousands of troubled subprime borrowers avoid foreclosure. The president is calling for a broader modernization of FHA which has at least two goals: to reduce or eliminate the downpayment requirement and to allow FHA to insure larger loans, especially in expensive housing markets. In September 2007 FHA launched a new temporary program called FHA-Secure. This program will allow American homeowners who have good credit history but cannot afford their current payments to refinance into FHA-insured mortgages. The mortgage being refinanced must be a non-FHA ARM that has reset (Mortgagee Letter, 2007).

In addition to the FHA-Secure program, the House Committee on Ways and Means unanimously approved H.R. 3648, the Mortgage Forgiveness Debt Relief

Act of 2007 in September 2007 in response to some of the tax issues that have arisen as a result of problems in the subprime mortgage market. Under current law, debt forgiven following mortgage foreclosure or renegotiation is considered income for tax purposes, resulting in tax liability for individuals and families. For example, let us say the value of your house declines by \$20,000 and your ARM payments have grown to a level you cannot afford. If the bank modifies your mortgage and forgives \$20,000 of your loan, the tax code treats that \$20,000 as taxable income. The legislation advanced by the Committee would provide relief to those families by permanently excluding debt forgiven under these circumstances from tax liability. The bill would also help would-be homeowners secure their investments through a long-term extension (through the end of 2014) of the tax deduction for private mortgage insurance, and would ease restrictions for qualifying as housing cooperative corporations. Finally, the bipartisan bill would tighten requirements taxpayers must meet to exclude gain from the sale of certain homes that have been used as a vacation home or rental property (Bush 2007; House Committee on Ways and Means, 2007).

The current administration is also launching a new foreclosure avoidance initiative to help struggling homeowners find a way to refinance. Secretary Jackson and Secretary Paulson are going to reach out to a wide variety of groups that offer foreclosure counseling and refinancing for American homeowners. These groups include community organizations like NeighborWorks, mortgage lenders and loan services, FHA, as well as government-sponsored enterprises like Fannie Mae and Freddie Mac (Bush, 2007).

These proposals would put the government into the subprime lending business now that the private sector version has failed. But even though the proposals would allow FHA to compete with subprime lenders by slashing downpayment requirements, working with defaulted clients and involving several partners in a foreclosure avoidance initiative, the proposals would not allow FHA to adopt the most suspect and dangerous practices of that troubled industry, such as no-doc lending. If prudently designed and administered, FHA modernization would permit the agency to play a useful role in the post-subprime housing market.

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