

FISCAL FOCUS

Budget and Tax Policy in  Perspective

PREDATORY LENDING

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Predatory lending practices are on the rise in Kansas - and the nation - with harmful consequences for borrowers and their communities. Unfortunately, many of the practices most harmful to consumers are currently legal in Kansas.



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INTRODUCTION

The economic prosperity of individual Kansas families is the foundation of prosperity for the state. Predatory lending practices threaten the prosperity of Kansas families by diverting family resources away from basic necessities such as food, clothing and shelter. Just as state and local agencies protect the public by ensuring food quality standards, environmental controls, consumer fraud protections, and workplace and product safety standards, public institutions must provide consumer protections in the area of predatory lending.

This publication suggests a number of policies to protect Kansas consumers with a focus on three areas of predatory lending: payday loans, car title loans and subprime mortgages.



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PAYDAY LOANS

Payday lending is a rapidly growing industry in Kansas and in the United States. Although fees for a single payday loan seem reasonable at first glance, the profits in this industry are based on repeated borrowing much to the detriment of the borrower.

HOW DOES PAYDAY LENDING WORK?

Payday loans are high-interest, short-term loans backed by a personal check dated on the borrower's payday, which often results in an ongoing cycle of debt. The requirements to qualify for a payday loan are minimal and do not take into account the borrower's ability to repay the loan in the short timeframe. Often the requirements are as basic as having personal identification, a checking account and an income from a job or government benefits, like Social Security or disability payments.

WHY IS PAYDAY LENDING HARMFUL?

National data suggests that the average payday borrower will be refinanced, or "flipped" eight times by a single lender and the average payday borrower will pay \$800 to borrow \$325. Payday lending is estimated to cost Americans \$3.4 billion per year.



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This diversion of funds from the family income means that less funds are available to pay for basic necessities such as food, clothing and shelter. It also creates a cycle of debt that is very difficult for families to escape.

WHAT IS HAPPENING WITH PAYDAY LENDING IN KANSAS?

The number of payday lending facilities in Kansas has been growing at an alarming rate. In 1993, 53 payday lender locations were licensed. By 2006, that number had grown to 436 locations. The increase was facilitated, in part, by a statutory fee increase for payday lenders that was passed in 2004.

Although legislation implementing payday loan protections has been unsuccessful in Kansas at the state level, local communities have limited the expansion of the payday loan industry. Most recently, the city of Shawnee in Johnson County passed an ordinance requiring payday lending establishments to be licensed by the city. In order to obtain a license, new payday lending establishments cannot be located within one mile of another payday lender or within 200 feet of residential property.



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CAR TITLE LOANS

Car title loans are the newest trend in predatory lending. Though similar to payday loans in many ways, car title loans increase the risk to the borrower by putting their means of transportation on the line.

HOW DOES CAR TITLE LENDING WORK?

Car title loans are high-interest, short-term loans backed by a car title. An individual may generally borrow up to 25 percent of the value of their vehicle, but in the event of a default, ownership of the vehicle transfers to the lender.

WHY IS CAR TITLE LENDING HARMFUL?

Car title lending is harmful for a number of reasons. Like payday loans, car title loans are short-term. This means a borrower experiencing a financial crisis that necessitates a car title loan has as little as a month to recover from that crisis and pay the loan back. In reality, this is seldom enough time to recover. The borrower is forced to take out another loan to pay off the first loan, and the debt spiral begins.

Another obvious problem with car title lending is that if a borrower is forced to default on the loan, they lose their vehicle which is often their only means of transportation.



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WHAT IS HAPPENING WITH CAR TITLE LENDING IN KANSAS?

The car title lending industry did not arrive in Kansas until 2004. As a result, very little exists in the form of consumer protections against abuses by the car title loan industry in Kansas. In fact, under current law it is even difficult to ensure that a car title loan company that repossesses a car returns the amount in excess of what is owed to the borrower. According to the Office of the State Bank Commissioner, more than 30,000 car title loans were made in the past two years.

In order to avoid interest rate caps that are applied to other types of loans, car title loans are structured as open-ended loans in Kansas. It is common under this structure for consumer payments to go toward fees and monthly interest while no reduction of principal is required. A number of fees are associated with car title loans including membership fees, title lien fees and even a variety of repossession fees.



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SUBPRIME MORTGAGES

Abuses within the subprime mortgage industry have been magnified recently as foreclosures have dramatically increased and a crisis has developed within the secondary subprime mortgage market. In their publication, “Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners,” the Center for Responsible Lending estimates that 19.4 percent, or one in five, subprime loans issued from 2005 to 2006 will go into foreclosure.

HOW DO SUBPRIME MORTGAGES WORK?

Subprime mortgages are more expensive loans intended for people with impaired or limited credit histories. Many recent subprime loans have been adjustable rate mortgages (ARMs). Monthly payments for ARMs fluctuate with interest rates. This makes them especially risky for borrowers when interest rates rise as they have in the past year. Meanwhile, it is apparent that many subprime mortgage lenders have relaxed their standards for loan approval.

WHY IS SUBPRIME MORTGAGE LENDING HARMFUL?

Subprime mortgage lending threatens homeownership for low- and moderate-income families because it can result in unrealistic loan terms that a borrower has little to no hope of fulfilling. The resulting defaults and foreclosures leave Kansas families without a home and with diminished assets.



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Subprime mortgage lending is also harmful to communities because increased default rates lead to vacant properties and corresponding decreases in tax revenue. In neighborhoods hit especially hard, these foreclosures and vacated properties can lead to an increase in crime.

WHAT IS HAPPENING WITH SUBPRIME MORTGAGES IN KANSAS?

Overall, Kansas has not experienced the increase in mortgage foreclosures that has occurred in some states. However, key communities across the state have seen huge increases in foreclosures. Data from the Office of the State Bank Commissioner, which compares the number of foreclosures in August 2006 to the number of foreclosures in August 2007, indicates that foreclosures increased in several counties across the state including Sedgwick, Johnson, Douglas, Crawford and Ford. In Sedgwick County, there was a 10 percent increase in foreclosures during that one-year period, rising from 183 foreclosures in August 2006 to 202 foreclosures in August 2007.

It is important to note that mortgages go into foreclosure for a number of reasons. It is impossible to isolate predatory mortgage practices as the specific cause for the increase in defaults in Kansas communities. However, anecdotal evidence suggests that predatory mortgage practices indeed are a part of the recent foreclosure spike.



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POLICY RECOMMENDATIONS

As policymakers and communities look for solutions to protect against predatory lending practices, some general principles of good policy should be considered.

PAYDAY LOANS

Limit the duration of indebtedness. The FDIC recommends that a borrower be limited to no more than three months of payday loan debt in a year. After the three months, a payday lender would need to refer the borrower to a longer-term loan product.

Extend the length of loans. If a borrower is experiencing a financial crisis, it is unrealistic to assume that the typical two-week repayment period of a payday loan is long enough to recover.

Consider the borrower's ability to repay the loan. Borrowers should not receive loans in excess of what they are able to repay. This is a primary cause of cyclical indebtedness.

CAR TITLE LOANS

Extend the length of loans. As is the case with payday loans, if a borrower is experiencing a financial crisis, it is unrealistic to assume that the two- to four-week repayment period of a typical car title loan is long enough to recover.



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CAR TITLE LOANS *Continued*

Limit interest rates. Because car title loans are structured as “open-ended” loans in Kansas, there is no cap on the interest rate that can be charged.

Implement standards for repossession. Reasonable standards should be set for repossession of a vehicle in the event of a default. These standards should include the amount of time before a car is reposed, notice of repossession and how quickly the car must be sold after repossession.

Return of surplus after sale. The law should clarify that proceeds of the sale of a repossessed vehicle in excess of the amount of the borrower’s debt must be returned to the borrower.

SUBPRIME MORTGAGES

Prohibit pre-payment penalties. Pre-payment penalties are a barrier to responsible asset development and refinancing.

Require that lenders document income. Verification of income is a basic principle of good lending. This protects the borrower as well as the lender. However, this requirement should include flexibility to address the needs of self-employed borrowers and those with unique circumstances.

Require that loan amounts are based on the borrower’s ability to repay the loan. Borrowers should not receive loans in excess of what they are capable of repaying. This is a significant cause of mortgage loan default.



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CONCLUSIONS

Predatory lending practices undermine the ability of families to provide for themselves and their children. The business model for these industries is based on luring consumers into a cycle of ongoing debt. Just as state and local agencies protect the public by ensuring food quality standards, environmental controls, consumer fraud protections, and workplace and product safety standards, there is a compelling need for public institutions to provide consumer protections for Kansans in the area of predatory lending.



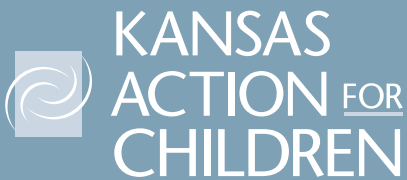
MISSION STATEMENT OF FISCAL FOCUS

Kansas Action for Children works to improve the economic success of Kansas children and their families through the policy and advocacy efforts of Fiscal Focus. The goal of Fiscal Focus is to ensure a balanced and fair tax system and budget process that protects the well-being of children and families and provides for a stable system of state revenues.

Families must have the opportunity to meet their children's economic and developmental needs through the provision of food, clothing, transportation, health care, education, and affordable housing. Ensuring this opportunity requires that essential supports for families are a priority in the state budget process, that state finances are managed in a fiscally-sound manner, and that the tax system fairly distributes the tax burden among income levels.

More specifically, Fiscal Focus:

- Analyzes the impact of state budgets and taxes on children and families.
- Publishes short papers and in-depth reports on important fiscal matters.
- Presents written analyses and oral testimony to the state legislature and other public bodies.
- Provides media organizations and constituency groups with accurate and timely information.
- Works with statewide and local organizations in Kansas to improve public understanding of fiscal issues.



KANSAS
ACTION FOR
CHILDREN

720 SW Jackson, Suite 201 | Topeka, KS 66603

785.232.0550 | kac@kac.org | www.kac.org

Kansas Action for Children is a nonpartisan, nonprofit organization dedicated to shaping health, education and economic policy that improves the lives of children and their families.