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OKLAHOMA ASSETS

AFFORDABLE CREDIT IN OKLAHOMA: Asset-Building and Financial Security

Access to credit has become a necessity for modern American living, touching virtually every aspect of our lives. Many consumers need credit to buy a house or a car, get an education, pay for medical expenses, or start a business. Credit is also increasingly necessary to make daily purchases at automated points of sale and through the Internet. 'Credit' is a generic term for an array of financial products and services that involve the borrowing of money. A borrower receives money or assets and promises to pay the lender back at an agreed upon future date, frequently with added interest.

The purpose of this brief is to explore the critical role of credit in helping Oklahomans maintain financial security and build assets for a prosperous future, especially for low- and middle-income households. What constitutes "affordable" varies from borrower to borrower, but in general we use affordable to mean terms of credit proportionate to a borrower's ability to repay. The first section explains why widespread availability of affordable credit is critical to achieving those goals. The second section reviews factors that affect borrowers' access. The final section reviews programs, products, and polices that facilitate access to affordable credit in Oklahoma.

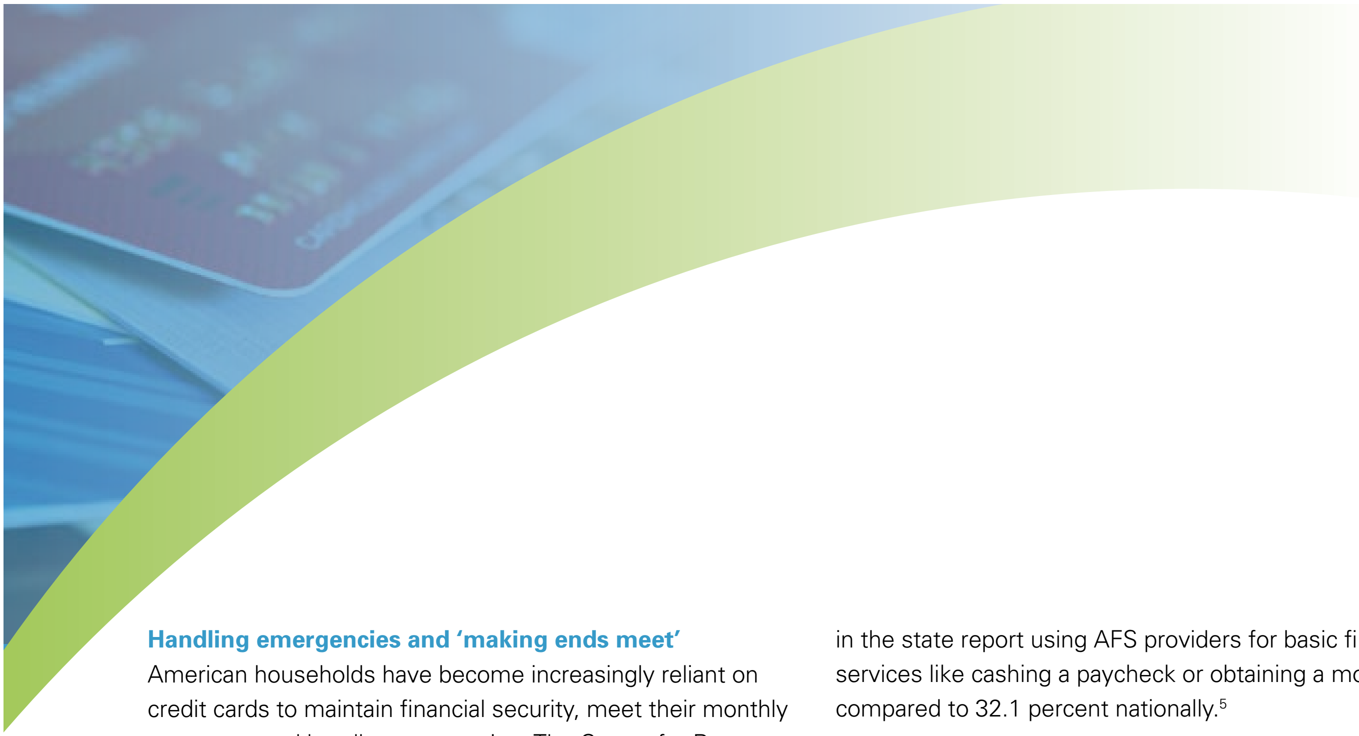
1 The Importance of Access to Affordable Credit

Affordable credit plays a pivotal role in a household's capacity to *maintain financial security* and *build assets*. Lower income earners in particular need the flexibility that credit affords to handle emergencies, make ends meet, and avoid high cost credit products that could set them back even further. In fact, obstacles to credit can create obstacles to work—creating a feedback loop that inhibits self-sufficiency. Without a car and a place to live, a job is very difficult to secure.

Consumers frequently use credit to finance asset-building, i.e. to purchase a home or a car or invest in education. As one researcher writes, "Access to credit has been found to be crucial for the low-income population because the ability to invest in productive assets and the associated rise in wealth encourage investment in human capital, increase productivity, and quality of life."[1]

When households without access to affordable credit face emergency situations that threaten their ability to work—like illness or car repairs—they either take the credit they are offered, often at prohibitive rates of interest, or face unemployment and insolvency. Simply put, affordable credit enables individuals and families to create the building blocks of a happy and prosperous life.

1 Ozgur Emre Ergungor. "Bank Branch Presence and Access to Credit in Low-to Moderate-Income Neighborhoods." Journal of Money, Credit and Banking 42, no. 7 (2010): 1321–1349.



Handling emergencies and 'making ends meet'

American households have become increasingly reliant on credit cards to maintain financial security, meet their monthly expenses, and handle emergencies. The Center for Responsible Lending surveyed 15 million low- and middle-income households and found that unforeseen events, like medical expenses, car repairs, and unemployment contributed to credit card debt, "Quite simply, what distinguishes low- and middle-income households with relatively high levels of credit card debt from those with lower levels of debt is chance and misfortune."[2]

The average revolving debt per consumer in Oklahoma is $3,600.[3] We fare less well when it comes to borrower credit ratings, which affects the cost of credit available to consumers. The state ranks 44th out of 50 states, with an average credit score of 666, 17 points below the national average of 683.[4] While Oklahomans have less debt than other states, they may be paying more to finance that debt because of lower credit ratings.

Avoiding high-cost credit products

Many consumers are turning to nontraditional credit products offered through the alternative financial sector to make ends meet. The alternative financial sector (hereafter the 'AFS') offers a wide-range of services, including check cashing, bill payment, short-term loans and rent-to-own contracts for popular consumer goods. Oklahomans are frequent consumers of AFS transaction services: 38.7 percent of households in the state report using AFS providers for basic financial services like cashing a paycheck or obtaining a money order, compared to 32.1 percent nationally.[5]

Low-income households are particularly likely to use AFS services, with 47 percent of those in the state earning less than $30,000 a year reporting patronage.[6] The high cost of AFS transaction services can chip away at the disposable income of lower-earning consumers with the least to spare.[7] The real threat to the financial security of lower-income Oklahomans, however, lies not in the marginally higher cost of basic transactions like check cashing, but the drastically higher cost of credit offered by the alternative financial sector (AFS).

Oklahoma households use AFS credit services at a much higher rate (17.5 percent) than the average American household (11 percent). Oklahoma ranks 3rd – behind only Arizona and Kentucky – in overall use of alternative financial sector credit services, and the rate is even higher among low-income households. The FDIC reports that 48.9 percent of Oklahoma households making less than $30,000 a year turn to the alternative financial sector for credit.[8]

Alternative financial sector outlets offer 'payday' or 'advance-check' loans, high-cost credit products popular among consumers with acute cash-flow problems. These are short-term loans from $50-$500 dollars with upfront fees that often translate into APRs of between 200-500 percent.[9] Assuming the average fee ($51.93) and loan amount (388.12) in Oklahoma,

2 Center for Responsible Lending. The Plastic Safety Net: The Reality Behind Debt In America. Findings from a National Household Survey of Credit Card Debt Among Low- and Middle-Income Households, October 2005. http://www.responsiblelending.org/credit-cards/research-analysis/DEMOS-101205.pdf.

3 Kelly Edmiston. Consumer Credit Report, Oklahoma. Federal Reserve Bank of Kansas City, Quarter 2011. http://www.kansascityfed.org/publicat/community/ccr/oklahoma.pdf.

4 Experian®. "State by State Average Credit Scores." CreditReport.com, 2010. http://www.creditreport.com/creditscores/creditratings/average-credit-scores.aspx.

5 Addendum to the 2009 FDIC National Survey of Unbanked and Underbanked Households: Use of Alternative Financial Services, Table B1 and Table C-110. Federal Deposit Insurance Corporation, September 2010. http://www.fdic.gov/householdsurvey/AFS_Addendum.pdf.

6 *Ibid.* 5

7 Michael S. Barr. "Banking the Poor." Yale Journal on Regulation 21, no. 121 (2004): 123-238.

8 *Ibid.* 5

9 Veritec Solutions LLC. Oklahoma Trends in Deferred Deposit Lending. Oklahoma Department of Consumer Credit - Deferred Deposit Lenders, October 2010. http://www.ok.gov/okdocc/Deferred_Deposit_Lenders/index.html.

> American households have become increasingly reliant on credit cards to maintain financial security, meet their monthly expenses, and handle emergencies.

the average borrower paid an APR of 349 percent on a 14-day loan in 2010.[10] There are 404 payday-lending storefronts in Oklahoma, more than the number of Walmarts, McDonalds, and Quicktrips combined.[11]

Opponents of the practice maintain that these loans trap borrowers in a cycle of debt. The Center for Responsible Lending (CRL) found that out of the total volume of payday loans in 2009, 76 percent were 'churned' loans – meaning consecutive pay period transactions. As the CRL describes, "This rapid re-borrowing indicates that most payday borrowers are not able to clear a monthly billing cycle without borrowing again."[12]

Consumers in Oklahoma need access to affordable credit products – especially lower income earners who are more likely to struggle with meeting expenses. When low-income households come up short and lack access to affordable credit, they are faced with some grim realities: falling behind on bills and damaging their credit history or tapping a high-cost credit product whose debt service payments they can ill afford. Since maintaining financial security is a prerequisite for asset building, barriers to affordable credit can become life-long barriers to building the assets that provide families with a stable retirement and a prosperous future for their children. The next section of this brief explores why consumers might have difficulty accessing credit on terms they can afford to repay.

2 Factors Affecting Access to Affordable Credit

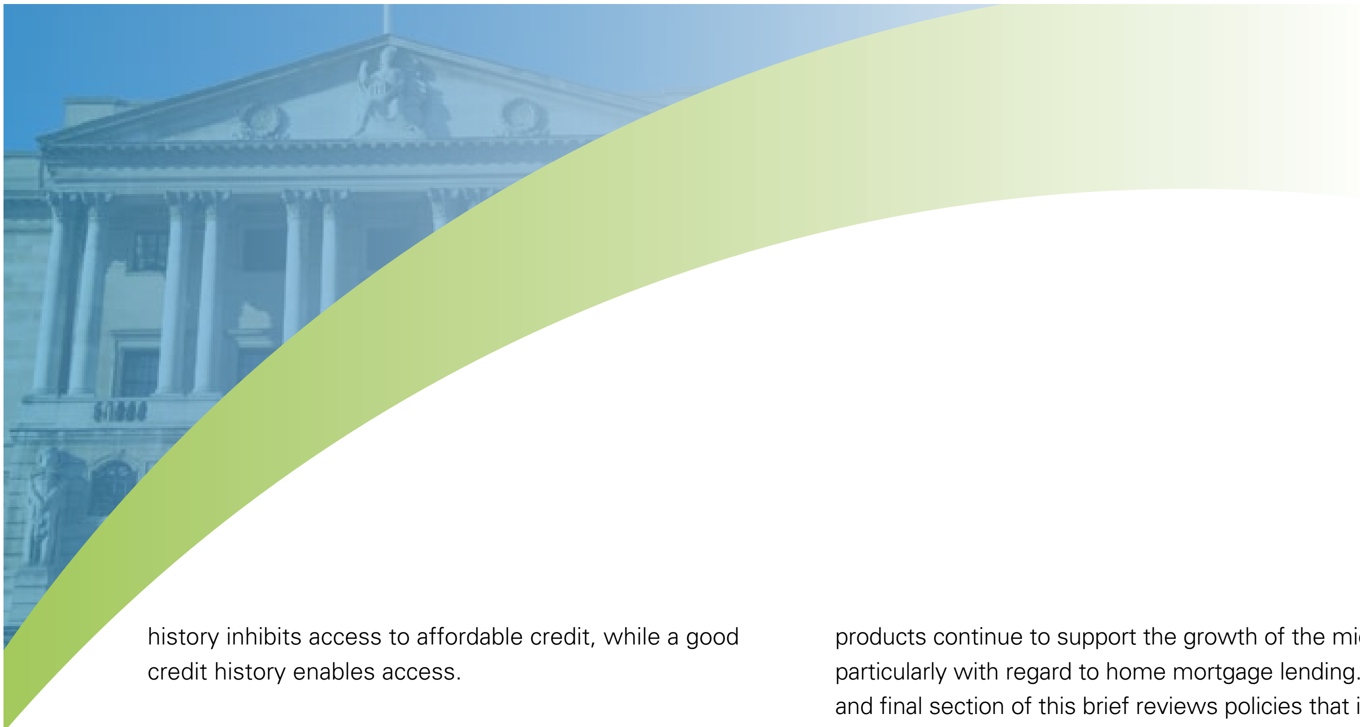
Income and assets

A variety of factors affect the cost of credit available to each consumer, chief among them being income and assets. Some borrowers have sufficiently high incomes that borrowing is unnecessary, and when it is necessary, they have access to low-cost credit options. Borrowers with higher incomes and substantial assets pose less risk to lenders and get lower priced credit as a result. This brief will focus instead on low and middle-income earners' ability to access affordably priced credit. Borrowers with lower incomes and fewer assets pose a higher risk to lenders and get higher priced credit as a result.

Personal credit history and existing debt

Personal credit history significantly affects credit-pricing options. Credit history is a financial asset in its own right, because credit scores are widely used by lenders, employers, insurers, and landlords and a good credit history positions borrowers for long-term financial stability. The Woodstock Institute explains how credit scores are calculated using data on borrowers' financial history: "Credit scores are calculated by credit bureaus from information included in an individual's credit report. Credit reports track information from an individual's financial history including credit use, late payments, and credit inquiries as well as public information related to finances, such as bankruptcies."[13] A bad credit

10 *Ibid.* 9
11 *Ibid.* 9
12 Center for Responsible Lending. Phantom Demand: Short-Term Due Date Generates Need For Repeat Payday Loans, Accounting For 76% Of Total Volume, July 2009. http://www.responsiblelending.org/payday-lending/research-analysis/phantom-demand-short-term-due-date-generates-need-for-repeat-payday-loans-accounting-for-76-of-total-volume.html.
13 Geoff Smith, and Sarah Duda. Bridging the Gap: Credit Scores and Economic Opportunity in Illinois Communities of Color. Woodstock Institute, September 2010. http://www.illinoisassetbuilding.org/wp-content/uploads/2008/07/bridging-the-gap-credit-scores.pdf.



history inhibits access to affordable credit, while a good credit history enables access.

Many lenders assess credit worthiness by calculating an applicant's debt-service ratio (DSR), a ratio of debt payments to disposable income. The DSR is a common guideline for mortgage lenders and is used in financial research of large samples of American households. Using this benchmark, 19 percent of all households in the United States were credit-constrained between 1992 and 2004.[14] Clearly, a scarcity of affordable credit is a problem facing millions of households. Credit may be "prohibitively expensive or out-right rationed" in low-income areas where credit histories are bad, tainted, or non-existent.[15]

Proximity to lender

Exacerbating the effect of low incomes, few assets, and poor personal credit history is the tendency for high cost lenders to cluster in working-poor neighborhoods. Physical proximity to alternative financial sector outlets peddling high-cost credit products makes it easier for households in these neighborhoods to turn to products that are detrimental to their financial security. Mainstream bank branches are sparse in low-income communities, but high-cost alternatives are abundant. Research suggests that physical proximity to a traditional bank increases the number of affordable mortgage originations for borrowers in low-income neighborhoods.[16]

Lastly, there are a number of structural factors affecting the availability of affordable credit options. The state and federal regulatory environment affects the products and services that are available to consumers by setting interest rates or outlawing certain types of credit agreements. Public and private initiatives aimed at promoting the availability of affordable credit products continue to support the growth of the middle class, particularly with regard to home mortgage lending. The next and final section of this brief reviews policies that improve the regulatory environment for consumer credit and programs and products that support access to affordable credit.

3 Products, Programs and Policies: Enabling Access to Affordable Credit

Oklahomans prosper under common sense policies that adequately protect consumers and control the cost of credit. An under-regulated consumer credit market encourages risky behavior on the part of lenders and borrowers and has the potential to undermine both the security of the financial system at large and individual borrowers' financial security.[17] This final section recommends products and programs that help low- and moderate-income households access affordable credit. It concludes with policy suggestions for improving the regulartory environment in Oklahoma and a review of major changes to federal law governing mortgage lending, consumer credit, and financial services.

Enabling Access to Affordable Homeownership

Products and programs that support access to affordable mortgage financing are essential to the asset-building efforts of Oklahoma's middle class. The widespread availability of thirty-year fixed-rate financing and mortgages with low or no downpayments are the necessary fuel for homeownership to continue to serve as a vehicle for wealth accumulation. In addition, education initiatives that inform consumers of their rights under fair lending and fair housing laws empower

14 Johnson, K. W, and G. Li. "The Debt-Payment-to-Income Ratio as an Indicator of Borrowing Constraints: Evidence from Two Household Surveys." Journal of Money, Credit and Banking 42, no. 7 (2010): 1373–1390.

15 *Ibid.* 1

16 *Ibid.* 1 and 7

17 Moulton, Stephanie, and Barry Bozeman. "The Publicness of Policy Environments: An Evaluation of Subprime Mortgage Lending." Journal of Public Administration Research and Theory 21, no. 1 (January 1, 2011): 87 -115.

> Products and programs that support access to affordable mortgage financing are essential to the asset-building efforts of Oklahoma's middle class.

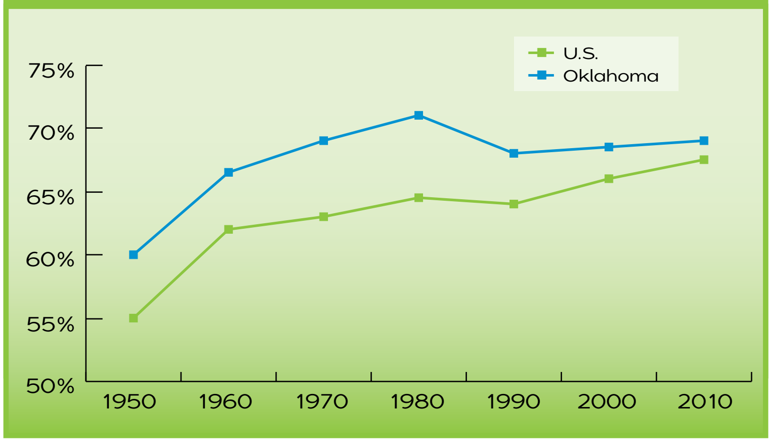
homebuyers and owners to protect their investments and guards against predatory practices that erode the stability of the mortgage market.

a. Affordable mortgage products

Thirty-year fixed-rate mortgages, a pillar of the modern housing finance system, provide the cost-certainty that households need to plan their financial futures. They stabilize the economy because longer-term mortgages are less sensitive to interest rate fluctuations and help contain "bubble-bust cycles" in the housing market. Additionally, low or no downpayment home loans provide a path to homeownership to prospective first-time buyers with enough income to support a mortgage, but not enough capital for a large downpayment. A lender can profitably issue mortgage loans in which the borrower pays little to no points, fees, or cash up front by charging a slightly higher fixed interest rate over the long term. There is ample evidence that borrowers who are unable to secure a downpayment can be reliable long-term homeowners when given access to affordable, fixed-rate financing.[18]

Government subsidies and support for long-term fixed-rate home loans are a key component of socioeconomic mobility in Oklahoma and were instrumental in growing the American middle class during the 20th century.[19] Oklahoma's homeownership rate has consistently outperformed the national average since the 1950s, but the gap has narrowed since the 1980s (see Figure 1).

FIGURE 1: Homeownership Rates. U.S. vs Oklahoma 1950–2010 Dicenial

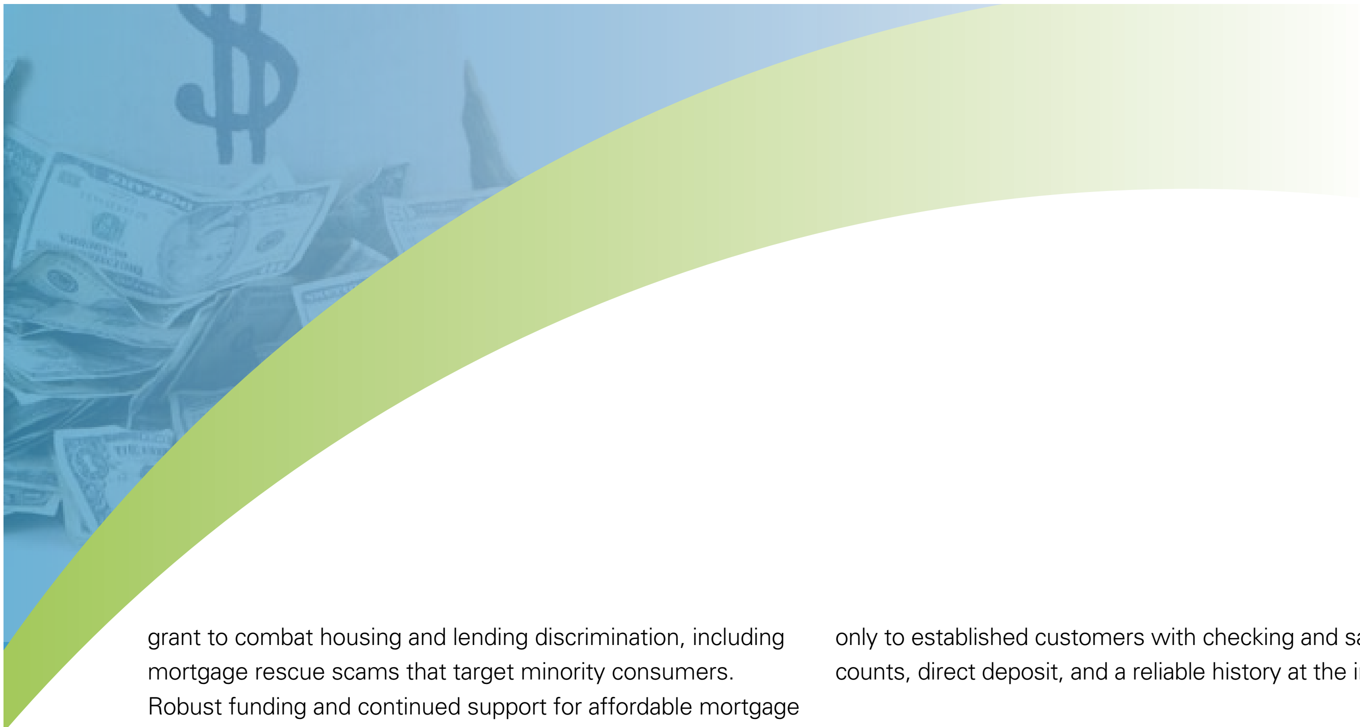


b. Education for prospective homeowners

Education initiatives further enable access to affordable mortgage financing for low- and moderate-income households. The Oklahoma Homebuyer Education Program (OHEA) trains and certifies homebuyer education professionals in the state and provides them with standardized curriculum that is specific to the laws and business practices of Oklahoma. According to OHEA, there were 219 distinct homebuyer education classes available to consumers in 2011, offering prospective homebuyers in Oklahoma the tools they need to make sound financial decisions.[20] Oklahoma Community Action Agencies offer the bulk of programs certified statewide by OHEA. The number of borrowers they reached with homebuyer education programs plummeted by nearly 70 percent, from 3,700 in 2006 to 1,121 in 2010.

Education initiatives that teach Oklahoma borrowers how to make and protect sound investments in homeownership need additional funding to reach more consumers and fulfill their mission. In addition, further support is needed for fair lending initiatives that educate the public on foreclosure modification scams and unscrupulous mortgage lenders. The U.S. Department of Housing and Urban Development awarded the Metropolitan Fair Housing Council of Oklahoma, Inc, a $324,808

18 Center for American Progress. A Responsible Market for Housing Finance, January 27, 2011. http://www.americanprogress.org/issues/2011/01/responsible_market.html.
19 *Ibid.* 18
20 Oklahoma Homebuyer Education Association. Workshop Schedule through December, 2011. http://www.homebuyereducation.info/schedule.htm.
21 Oklahoma Association of Community Action Agencies. Directories and Annual Reports. http://www.okacaa.org/.



grant to combat housing and lending discrimination, including mortgage rescue scams that target minority consumers. Robust funding and continued support for affordable mortgage products and homeowner education programs are critical components of a sustainable path to homeownership.

Enabling Access to Affordable Credit

a. Substitutes for high-cost credit products

There is an urgent need in Oklahoma for affordable short-term, small-dollar credit products for low- and moderate-income consumers. A product akin to a payday or advance-check loan, but with affordable terms and an extended repayment period, can help consumers avoid spending their already stretched incomes servicing high-cost debt. The traditional financial sector has an interest in helping their customers stay in good financial standing by avoiding overdrafts, which studies show are exacerbated by continued use of predatory lending products.[22] Offering short-term emergency advances to customers with direct deposit can be a low-risk venture for the financial institution and an excellent opportunity to educate the customer about the importance of savings and market the institution's savings products.[23]

A secure credit card with a very low-limit is another good product alternative for borrowers with bad or non-existent credit histories. A low-limit credit card with an affordable interest rate would help consumers through financial emergencies without having to turn to a high-cost credit product or subprime credit card. An affordable line of credit means that households living from paycheck to paycheck can weather minor emergencies without losing additional income to fees and interest, emptying their savings, or overdrawing their accounts. Traditional financial institutions can limit their risk by offering very low-limit cards only to established customers with checking and savings accounts, direct deposit, and a reliable history at the institution.

Encouraging traditional financial institutions to offer substitutes for the high-cost services of the alternative financial sector (AFS) – check-cashing outlets, payday lenders, pawnshops – would reduce Oklahomans heavy reliance on these sources for basic financial services. During the latter part of the 1990s, public and private financial institutions began to focus more on expanding access to financial services for low-income and middle-income earners. Community development banks have experimented with new products to reach the unbanked. Some banks and credit unions are successfully experimenting with new products, but they are small in scale and not widely available.[24] Credit unions, not-for-profit lending institutions with an established record of service to low- and middle-income customers, are well suited to offer alternatives to high-cost products.

b. Controlling the cost of credit

There are several ways Oklahoma regulators can mitigate the harm of high-cost credit products. Advocates of payday loans insist that their products serve an important need — providing emergency cash to consumers who would not otherwise have access to credit. However, data collected through the state payday loan database show that only 5.4 percent of the total loan volume went to borrowers who took out between 1 and 3 loans over the course of a year. The bulk of the loans, 61.3 percent, went to customers who took out between 12 and 40 loans in one year (see Figure 2).[25]

A researcher at Northwestern University analyzed data from over 40,000 households over several years and found no

22 Center for Responsible Lending. Payday Loans Put Families in the Red, February 2009. http://www.responsiblelending.org/payday-lending/research-analysis/payday-loans-put-families-in-the-red.html.
23 Sheila Bair. Low-Cost Payday Loans: Opportunities and Obstacles. The Annie E. Casey Foundation, 2005. http://www.aecf.org/knowledgecenter/publications.aspx?pubguid=%7Be9ca9157-7e15-4a95-902d-f26132c36aa6%7D.
24 *Ibid.* 7

> There is an urgent need in Oklahoma for affordable short-term, small-dollar credit products for low- and moderate-income consumers.

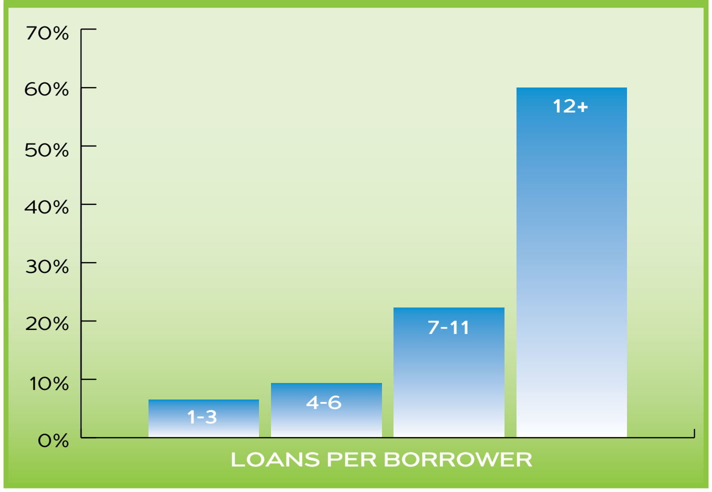
evidence that payday loans helped alleviate economic hardship over the long term. Rather, payday loan access was correlated with increased difficulty paying mortgage, rent and utilities. The analysis concludes that, "Contrary to the view that improving credit access facilitates important expenditures, the empirical results suggest that, for some low-income households, the debt service burden imposed by borrowing inhibits their ability to pay important bills."[26]

State regulators can strengthen statutory transaction limits to prevent loan 'churning' and ensure consumers are not vulnerable to a paycheck-to-paycheck debt trap. Oklahoma law already prohibits direct rollovers. However, since consumers are permitted two open transactions at once, there is nothing preventing a borrower from using funds from a second payday loan to pay off an outstanding loan.

To protect consumers from the financially draining implications of a series of high-interest loan rollovers, the state should permit only one open transaction per borrower, which is the only way to effectively enforce a no-rollover policy. Additionally, it should limit the allowed number of transactions per borrower per year to curb chronic borrowing. This will help ensure that consumers do not become regularly dependent on a source of credit that drains their disposable income.

Another approach to controlling the cost of payday lending for low-income borrowers involves capping the interest rate on a standard loan. Since 2007, federal law has prohibited creditors from charging more than an annual percentage rate of 36 percent to members of the military and their dependents.[27] State legislators can enact the same interest rate cap for civilian households that military leadership felt was

FIGURE 2: PayDay Loans Per Borrower as a Percentage of Total Loan Volume, July 2009–June 2010



necessary to protect active duty households – 36 percent. A two-digit interest rate cap in 15 other states has already saved consumers $1.8 billion in predatory fees.[28]

State regulators in Oklahoma can also do more to enforce the Federal Reserve Board's 2000 decision to formally clarify that the Truth in Lending Act's (TILA) APR disclosure requirement applies to payday loans.[29] Even though the law requires APR disclosure, payday lenders often advertise the flat rate fee of their product instead of the standard Annual Percentage Rate of Interest (APR), which more effectively communicates to the consumer the cost of the payday loan compared to other products and over time. Payday loan APR disclosure helps alert consumers and policymakers that the product being offered is very high-cost.

25 *Ibid.*
26 Melzer, Brian. "The Real Costs of Credit Access: Evidence from the Payday Lending Market." The Quarterly Journal of Economics 126, no. 1 (2011): 517.
27 Michelle Singletary. "Financial readiness for service personnel." The Boston Globe, February 17, 2008. http://www.boston.com/business/personalfinance/articles/2008/02/17/financial_readiness_for_service_personnel/.
28 *Ibid.* 23

Recent federal reforms and the regulatory environment

Recent reforms at the federal level have improved the regulatory environment for consumer credit. The Credit Cardholders' Bill of Rights was passed in 2009 as part of The Credit Card Accountability Responsibility and Disclosure Act (CARD) aimed at protecting consumers and improving transparency. The CARD Act requires credit card companies to notify cardholders 45-days in advance of an interest rate hike and give them the option to pay off their existing balance at the current interest rate. It also makes high-cost subprime (with annual fees exceeding 25 percent of the credit limit) credit card offers more transparent by requiring all fees are paid up front and before the card is issued.

Lastly, it requires card companies to apply consumer payments to the portions of their balance with the highest interest rate first, and then the next highest, and so on until their balance is paid in full. CARD reforms go a long way toward protecting consumers from misleading terms and abusive industry practices, but there is more that can be done to level the playing field for low-to moderate-income consumers. Regulators could further mitigate harm of sub-prime credit products by prohibiting card companies from offering cards with total fixed fees over 25 percent of the card's limit.[30]

The Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law in July of 2010. The bill consolidated regulatory agencies, enacted new and comprehensive regulations of financial markets, and strengthened consumer protections.[31] It created a new consumer protection agency and set uniform standards for "plain vanilla" financial products with terms simple enough for the average consumer to comprehend. The Dodd-Frank Act also established new federal mortgage lending standards which, among other things, eliminates the practice of lenders incentivizing brokers and originators with bonuses for steering borrowers into more costly loans, prohibits pre-payment penalties, and lowers the interest rate and points/fee triggers that define high cost loans.[32]

Dodd-Frank was an important step, but the mortgage market is still far from recovery. As of January 2011, the federal government guarantees around 90 percent of all new mortgages, an obviously unsustainable share of the market, but necessitated by a vacuum of private sector actors following the catastrophic collapse of the housing market in the late 2000s.[33] The priority for policymakers moving forward should be putting in place a robust regulatory framework that ensures the continued availability of non-discriminatory, affordable, fixed-rate financing.

Conclusion

Access to affordable credit is critical to the financial security of hundreds of thousands of low and middle income families and individuals in Oklahoma. It enables not just financial security, but provides households with opportunities to build assets for long-term stability and prosperity. While some of the factors affecting access to affordable credit result from each individual households' choices and credit history, there are also structural barriers to affordable credit that households alone cannot change. To ensure that all Oklahomans have a chance at prosperity, policymakers and private sector leaders should explore the products, programs and policies detailed in this brief.

Acknowledgments

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Visit www.oklahomaassets.org to access the first policy brief in this series, *Taking It To the Bank: Promoting Savings in Oklahoma*.

29 Center for Responsible Lending. 2009. APR Matters on Payday Loans: Interest rate disclosures allow apple-to-apple comparisons, protect free market competition. June.
30 *Ibid.* 2
31 House of Representatives. docs.house.gov/rules/finserv/111_hr4173_finsrvcr.pdf
32 House of Representatives. docs.house.gov/rules/finserv/111_hr4173_finsrvcr.pdf
33 *Ibid.* 18