

Financial Services Research Program Newsletter
Issue I, 2009

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Best Article Award

The editors of *Contemporary Economic Policy* have chosen “A Comparative Analysis of Payday Loan Customers” coauthored by Greg Elliehausen and Ed Lawrence (University of Missouri-St. Louis) to receive the journal’s 2008 Best Article Award. The award will be presented at the Western Economic Association’s Presidential Luncheon on June 30, 2009 as part of the WEA’s 84th Annual Conference in Vancouver, B.C. The article was published in the April 2008 issue of *CEP* and a description of the article can be found below.

Journal Articles

The Effect of Prepayment Penalties on the Pricing of Subprime Mortgages

Authors: Gregory Elliehausen, Michael E. Staten, and Jevgenijs Steinbuks

Published in *Journal of Economics and Business*, 60(2008): 33-46, January-February 2008.

This paper investigates the effect of prepayment penalties on the pricing of subprime residential mortgages. The paper is the first to consider that mortgage price and prepayment penalty may be chosen jointly, making single-equation estimates of the effect

of prepayment penalty on price biased. Using a model that accounts for endogeneity of price, loan to value, and prepayment penalty, the authors find that prepayment penalties are associated with lower loan prices. This finding is important because perceptions that prepayment penalties harm borrowers have led many states to restrict their use, regulation that may reverse the gains in credit availability achieved over the last decade.

A Comparative Analysis of Payday Loan Customers

Authors: Edward C. Lawrence and Gregory Elliehausen

Published in *Contemporary Economic Policy*, 26(2): 299-316, April 2008.

One of the most rapidly growing and controversial forms of consumer lending to recently emerge in the marketplace has been payday advances. This form of credit allows the borrower to obtain a small amount of cash for a short period of time. Claims of predatory lending often arise due to the high annual percentage rates that result from the fees for borrowing small amounts of money for two weeks or less. By analyzing the data collected in a national survey of payday customers, this research allows policymakers to better understand what type of consumer borrows from payday lenders, for what purpose, and what the true benefits and costs are. The results confirm a strong demand for payday loans that satisfy a real financial need within a certain segment of the population.

Monographs & Working Papers

An Analysis of Consumers' Use of Payday Loans

Author: Gregory Elliehausen

FSRP Monograph No. 41, January 2009

This monograph reviews existing evidence and presents new evidence from a 2007 survey on the economic and demographic characteristics of payday loan customers, their patterns of payday loan use, their understanding of payday loan costs and alternatives, and outcomes of payday loan use. It also seeks to assess whether payday loan customers know what they are doing when they use such credit and the extent to which payday loan credit benefits or harms consumers. The survey results presented in the monograph are consistent with the findings in other studies which indicate that access to payday loans may reduce the incidence of financial problems and provide rationed consumers with control over their financial situations that they otherwise would not have.

Note: This monograph was cited in an op-ed article by Robert DeYoung in the April 14, 2009 edition of *The Wall Street Journal*.

Hybrid Interest Rate Choice in the Subprime Mortgage Market: An Analysis of Borrower Decisions

Authors: Gregory Elliehausen, Min Hwang, and Jeehoon Park

FSRP Working Paper No. 74, May 2008

This paper examines subprime borrowers' choices of fixed-rate, hybrid, and other adjustable-rate mortgages between 1998 and Q1 2006 using the Financial Services Research Program's subprime mortgage database, a database on mortgage originations in the portfolios of eight large subprime mortgage lenders. This paper is the first to consider choice of interest rate type in the subprime market comparing hybrid mortgages to other adjustable mortgages. The authors find evidence suggesting that hybrid loan choices are distinct from fixed-rate or variable-rate choices. This study also contributes to a very limited literature assessing the rationality of subprime mortgage decisions.

Using a multinomial logit model, the authors investigate borrower choices of type of interest rate among fixed-rate, variable-rate, and hybrid subprime mortgages. From directly observable borrower information, hybrid mortgage borrowers appear to be riskier than fixed-rate mortgage borrowers, but not when compared with variable-rate mortgage borrowers.

The Impact of Systematic Bankruptcy Risk on Household Lending in Local Markets

Authors: Gregory Elliehausen, Chintal Desai, Edward C. Lawrence, and Michael E. Staten

FSRP Working Paper No. 75, January 2009

The recent collapse of the subprime mortgage market in the U.S. has clearly demonstrated that consumer and mortgage lenders need to develop better tools to manage credit risk. This research empirically investigates the contribution that county-level personal bankruptcy filing data may have on risk assessment models for consumer credit. The paper extends the previous literature of county-level bankruptcy filing rates by using a capital asset pricing framework to investigate the relationship between county bankruptcy rates and U.S. aggregate bankruptcy rates.

The findings show considerable variation in correlations across counties. The variation in correlation is not caused by differences in the level of bankruptcies or differences in the ability to predict accurately. While many of the fundamental factors that explain county-level bankruptcies have a similar effect on the correlation with aggregate bankruptcies, some factors have no effect or opposite effects. The empirical evidence indicates that estimates of local-level correlations in bankruptcy filings provide additional information for risk reduction in geographically diversified portfolios. This knowledge would be useful to consumer lenders for improving models for managing portfolio risks, setting credit policies, and targeting borrower solicitations.

Credit Regulation and the Availability of Subprime Mortgage Credit

Authors: Gregory Elliehausen, Michael E. Staten, and Jevgenijs Steinbuks

FSRP Working Paper No. 76, May 2008

This study investigates the effects of state predatory mortgage lending laws on the availability of subprime mortgage credit. Using the Rothschild-Stiglitz approach to model credit markets under asymmetric information, restrictions on prepayment penalties are shown to reduce the use and attractiveness of mortgage credit. Consistent with model predictions, empirical results indicate that originations of high-cost mortgages subject to tighter restrictions were generally significantly less than predicted in states with more restrictive laws but that this difference of predicted and actual was not significant in states with less restrictive laws. These differences were not found for originations of non-high-cost loans. Thus credit regulation was differentially associated with reduction in originations of high-cost mortgages and non-high-cost lending did not expand in areas where high-cost mortgages were restricted.

Credit Regulation and Termination of Subprime Mortgages

Author: Jevgenijs Steinbuks

FSRP Working Paper No. 77, October 2008

This study examines the effects of state predatory lending laws on prepayments and defaults of subprime mortgages. The results from competing risks models of mortgage termination on 30-year fixed subprime mortgage data suggest that, controlling for other factors, the estimated probabilities of prepayment are higher in the states that have introduced predatory lending laws. Though no definite conclusions could be drawn regarding the effect of state laws on subprime defaults, there is some evidence that early defaults have decreased as regulation scope expanded. Consistent with predictions of a theoretical model these results indicate that predatory lending laws lowered defaults and raised prepayments in the subprime market.

Presentations

Washington Area Finance Association's Fourteenth Annual Meeting

April 18, 2008 at The George Washington University School of Business

Greg Elliehausen was the discussant for a paper entitled "Banks and the Bankruptcy Reform Act of 1978: A Study of Moral Hazard Behavior" during the session "Consumer Finance, Law and Microstructure."

Federalist Society's 2008 Consumer Credit Protection Conference

May 20, 2008 at the National Press Club

Tom Durkin was a panelist for the session "Credit Card Regulation" that discussed the potential impact of amendments to Reg Z.

American Real Estate & Urban Economics Association Mid-Year Meeting

May 27, 2008 in Washington, D.C.

Greg Elliehausen presented "Hybrid Interest Rate Choice in the Subprime Mortgage Market: An Analysis of Borrower Decisions" during the session "Exotic Mortgages."

Financial Management Association's 2008 European Conference

June 4 & 5, 2008 in Prague, Czech Republic

Greg Elliehausen presented "Hybrid Interest Rate Choice in the Subprime Mortgage Market: An Analysis of Borrower Decisions" during the session "Consumer Debt Issues." He co-authored the paper with Min Hwang and Jeehoon Park.

Tom Durkin presented "Long-Run Growth in Mortgage and Consumer Credit: New Perspectives" during the session "Consumer Debt Issues." The paper was coauthored by David Walker.

Greg Elliehausen was the discussant for a paper entitled "US and European Household Debt and Credit Constraints: Comparative Micro Evidence from the last 15 Years" during the session "Consumer Debt Issues."

Greg Elliehausen was the chairperson for the session "Behavioral Finance." During the session, he was the discussant for the paper "Self-Control and Debt: Evidence from Data on Credit Counseling."

Federal Reserve Board Consumer Advisory Council Meeting

June 18, 2008 in Washington, D.C.

Greg Elliehausen presented “Consumers’ Use of High-Price Credit Products: Do They Know What They Are Doing?”

Financial Management Association’s 2008 Annual Meeting

October 11, 2008 in Dallas, TX

Greg Elliehausen presented “Hybrid Interest Rate Choice in the Subprime Mortgage Market: An Analysis of Borrower Decisions” during the session “Mortgage and Subprime Markets.”

Greg Elliehausen chaired the session “European Banking” and served as the discussant for the paper “Securitizations as Financings or Sales? Financial Evidence for Accounting and Regulatory Balance Sheet Treatment in a World of Structured Finance.”

CRA & Fair Lending Colloquium 2008

October 27, 2008 in Orlando, FL

Greg Elliehausen was a panelist for the session “Payday Lending: A Financial Option or Predatory Product” during which he assessed whether payday loan customers fully comprehend the ramifications of using this type of credit.

Research in Progress

Effects of Changes in State Payday Laws on Household Credit Delinquency

Most payday loan customers also use other types of consumer credit. This paper examines the effects of changes in state payday loan laws on the delinquency rates for different consumer credit products. Results may provide insight on how changes in the availability of payday loans affect consumers’ payment performance for consumer credit—that is, overall, whether payday loans help consumers manage their credit better or trap consumers in ever increasing indebtedness.

Determinants of Search and Choice in Payday Loan Decisions

This project extends evidence from the recently completed FSRP Monograph No. 41 (January 2009) on payday loan decisions. Using a cognitive model of the decision process and buyer behavior as a framework for analysis, payday loan customers’ understanding and consideration of alternatives are related to payday loan choices and outcomes.

The Pricing of Subprime Mortgages by Mortgage Brokers and Lenders

This paper reexamines pricing of subprime mortgages by mortgage brokers and lenders using a less restrictive model than the one used for the original analysis (FSRP Working Paper No. 70). Preliminary results are consistent with earlier findings that subprime mortgage borrowers on average pay slightly lower prices when they obtain the loan through a broker than they would had they obtained the loan directly from a lender.

Effects of Bankruptcy Exemptions on Foreclosures of Prime and Subprime Mortgages

The extent to which bankruptcy exemptions affect markets for secured credit is unresolved. This paper extends previous studies examining the effects of bankruptcy restrictions in mortgage lending.

Please direct questions and comments to:

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