Subprime Lending:
Helping or Hindering America’s Low Income and Minority Residents

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Honors Senior Thesis
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Introduction

For years, subprime lending has helped financially disadvantaged individuals partake in various aspects of the American dream. Chairman of the Federal Reserve Board, Alan Greenspan has even proclaimed that the expansion in the lending market "helps families purchase homes, deal with emergencies and obtain goods and services that have become staples of our daily lives." More specifically, this form of lending has helped low income families own homes, purchase cars, and even qualify for credit cards. But recently, subprime lenders have been under the spotlight. This is because lending organizations are taking advantage of individuals, primarily minorities and people with low-incomes, and crossing the line into unethical predatory lending practices. There are a variety of unethical lending practices that plague the financial lending market. They range from placing a borrower into a higher interest rate loan then they qualified for, to "packing" the loan, or adding optional insurance coverage unbeknownst to the borrower. The interest rates, as high as twenty percent, are extremely detrimental to disadvantaged individuals who have no other means of lending options available. Not to mention, credit records are further tarnished by the hard to meet standards. They are stuck with subprime lending as their only source of funds, and when money is detrimental to survival, predatory tendencies are often ignored. Obviously then, it is important for government institutions and consumers to take a deep look into these predatory lending practices and attempt a resolution to save borrowers from unscrupulous activities. To further delve into the particulars of subprime lending, I will discuss the background and history of the

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1 Feldman, Ron and Schmidt, Jason. "Why All Concerns About Subprime Lending are not Created Equal." Federal Reserve Bank of Minneapolis 1999.
market itself, and then explain the growth of the predatory lending market in this decade. Next, the background of legislative and regulatory responses to predatory lending practices will be discussed, the theories supporting these practices will be explained, and finally my summary and conclusion on the issue. The main question is whether subprime lending is helping or hindering people who otherwise do not qualify for conventional loans.

**Background and History of Subprime Lending**

Subprime lending is a recent addition to the banking industry. It is defined as an extension of "credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers."² It began with the growth of the economy and stock market in the early nineties. It was a time of expansion for individuals who saw their standard of living increase. However, it was said to have started when banks left less wealthy communities in the nation and moved to more affluent communities. Then, banks who are historically known to issue a lower rate of interest known as the "prime" market rate of interest, started issuing fewer mortgages. Individuals who did not qualify for these conventional, normal interest rate loans because of past bankruptcy, poor credit and various financial problems, found themselves running to lenders other than banks for loan origination. These lenders took the form of loan sharks and money stores who took on the added risk these individuals had, but not without some form of compensation in return. This compensation was found in the high interest rates charged on these loans, as much as a nine percent margin, as well as excessive origination costs and expensive miscellaneous fees. It seems the hunger for big

profits has wetted the appetite of banks, who at one time saw the risk in this industry as undesirable. The typical default rate is presently as high as six to eight percent, absolutely unacceptable for the average banker. Yet many national banks like Citigroup, BankAmerica, and Chase Manhattan are purchasing subprime lending businesses as the industry becomes increasingly lucrative. After all, just like any other company, banks are in business to make money.

The Growth of Predatory Lending

Subprime lending has been a valuable tool for high-risk individuals that would not otherwise be able to find financing. Yet many lenders have taken advantage of uneducated and disadvantaged borrowers and crossed the line into predatory lending practices. Although not officially defined yet, predatory lending has been deemed as “unfair credit practices that harms the borrower or supports a credit system that promotes inequality and poverty,” or practices that are fraudulent, deceptive, unfair, coercive or otherwise illegal. People who are less financially sophisticated are usually more vulnerable to unethical practices, especially when money is critically important to their immediate survival.

It seems some lenders are mimicking the not so friendly animal kingdom. It is as if “a predatory lender ensnares—indeed, sometimes seeks out—vulnerable customers,” which then allows them to “offer loan products designed to prey on their weaknesses, bleed them financially and, in some cases, strip them of their most precious

The most common tactic used by lenders is to place borrowers into loans that have a higher interest rate than they actually qualified for. Since higher profits are generated with revenue earned from the interest rate spread, percentage rates can rise as high as twenty percent. Another tactic used is equity stripping, which has become a commonly used practice. The idea is for lenders to not bother looking into an individual’s financial background to determine how risky they are, but automatically base the loan on the equity accumulated in the borrower's home, giving them no other options for repayment if in a bind. Unscrupulous lenders have even been known to “pack” a loan or add unwanted fees and services not previously agreed on. Some examples are credit insurance, which is coverage to pay off the loan if the individual passes away before the repayment period is completed and disability and unemployment insurance. Another devastating practice used on low income and minority individuals are balloon payments, which require borrowers to pay off the loan in one huge payment, forcing them into excessive loan flipping or frequent refinancing to pay for this requirement. These practices are even used by home building contractors who have begun targeting individuals strapped for cash, by working as agents for lenders. Before beginning work on a home, the contractor and homeowner work out a loan agreement at a set interest rate and fees. After work has began, the contractor comes back with an agreement set at a higher interest rate, and afraid the work will be left uncompleted the homeowner signs anyways.

A recent example of a woman who had first hand experience of these unscrupulous lending activities was Roberta Green, a laid off telephone company worker

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who had devoted 29 years of her life to the industry. Getting the opportunity through a telephone call to qualify for a small equity loan to pay off past debts, she jumped at the opportunity. She met with the loan officer and an attorney, and unknowingly refinanced the entire amount of her home at a higher interest rate. Not to mention, unknown to Roberta, the loan officer had “packed” credit insurance into the stack of papers and changed it from a fixed rate to an adjustable rate loan. Plus, if she were to find a better interest rate elsewhere and wanted to refinance the loan, it would be impossible for her to afford to move to another lender with the built in fees used to penalize her for doing so. Uneducated in the home mortgage market industry, Green became a prime example of what happens to people all across the United States. Unbelievably, this practice is completely legal in all states except for North Carolina.6 For many individuals who have no other choice but to take these loans, this has a devastating effect to their already poor financial backgrounds.

It is not only the individual who seeks out financing but the lender as well. Because of the predominantly high returns on most of the loans in this industry, lenders have reached out to members in their communities. They are reaching homes, ironically, through the use of the United States Postal Service, telemarketing, television commercials and have even been known to sell door-to-door. Many prey on individuals strapped for cash by offering lower monthly payments, yet failing to tell borrowers that the length of the loan will be extended. Once the borrower has signed her name on the dotted line, there is no turning back.

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Two main groups of individuals who are highly affected and targeted by these practices are minority and low-income groups. According to a study released by a Washington D.C. advocacy group, the Association of Community Organizations for Reform Now (ACORN), “minority and low-income borrowers are more likely to receive a costly subprime mortgage when buying or refinancing a home.”7 These activities began when banks were unable to afford the high-risk nature of this type of loan origination. These individuals tend to have lower incomes, less wealth, and poor credit histories. Many banks moved out of low-income neighborhoods in search of more profitable regions. As a result, between the years of 1993 and 1999, the growth rate of subprime refinanced loans to African Americans had risen 959%, an astronomical number. Latinos have seen a growth of 695% and Whites 569% for subprime refinanced loans.8

When excluding government loans and those needed for manufactured housing and looking only at conventional home mortgage loans, African-Americans were 4.8 times more likely, and Latinos 2.8 times more likely than white borrowers to receive subprime lending.9 African Americans in 1999 also received 13.5% of all subprime purchase

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loans, which is four times larger than the amount of prime purchase loans received. Latinos received 8.5% share of subprime loans as compared to a 4.8% share of prime loans and whites received 49.7% of subprime purchase loans compared to their 75.4% share of prime purchase loans. This disparity is not restricted to lower and moderate-income levels. ACORN found that the greatest disparities occur in upper income minority communities. Upper income African Americans are more likely to receive a subprime loan than their white counterparts. Approximately 30.5% of refinancing loans received by upper-income African Americans were through subprime markets, as opposed to 13.1% for upper-income Latinos and only 8.2% for upper-income whites. Yet upper-income minorities were 2.63 times more likely to be turned down for a loan than upper-income whites and upper-income Latinos were twice as likely to be turned down than whites. Although, ACORN's study did find that minorities are receiving a larger percentage of conventional loans now, it is still not proportional to their population numbers in the United States. It was even found that African Americans at higher income levels were turned down more often than whites at lower income levels. It has become evident that individuals are being shut out of conventional markets.

Theories Supporting the Growth of Predatory Lending

There are many different theories to the immense racial disparity. One obvious reason is the treating of an individual differently because of personal characteristics. Discrimination has plagued America since its origination. Nobel laureate Gary Becker

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developed a theory for this bigotry in what he calls “tastes for discrimination.” He explains that bigoted lenders hold minorities to higher credit standards than whites since profitability is related to creditworthiness. Yet, instead of lenders trying to maximize their profits, they maximize their utility, which results in the satisfaction received from discriminating. For example, a lender would not originate some profitable loans to minority borrowers in order to gain satisfaction or a greater sense of utility through the practice of discriminating and turning the borrowers down. This results in lower default rates for minorities compared to those of white borrowers due to the higher standards, but because of the higher standards minorities would be turned down more often than whites with identical credit backgrounds. This is assumed to be in an unregulated environment where lenders are under no public or government scrutiny or laws, and in the real world this is not true. So in effect, the opposite actually occurs. In a regulated environment, the fair lending laws cause the lender to lower the standard for minorities and in turn raise them for whites, so as not to be caught discriminating. Hence, having it appear that minority and low-income borrowers default at higher rates. Unfortunately, there is not much an individual can to do curb this problems except to have knowledge of the laws that were enacted to protect them against it.

Racial profiling also occurs in the scoring models used to speed up the lending process, which rate individuals income, credit history and job history characteristics numerically. “Credit scoring really is an objective, colorblind means of assessing the information that’s pertinent in making a lending decision,” said David Shellenberger, product manager of credit bureau products for Fair, Issac & Co., the maker of the most

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used credit scoring system around. The higher a score, the less risk imposed by the borrower. Minorities and low-income individuals score low due to lower incomes however, and lenders must step in and take extra measures to help them qualify. According to Rich Riese, project manager for compliance policy at the Treasury Department’s Office of Thrift Supervision, “discrimination can arise when human decision-makers become involved,” resulting in higher interest rates and longer origination periods on loans. Banks have even been known to pay mortgage brokers and loan originators incentive commissions when placing borrowers into higher interest rate categories than what their personal risk circumstances call for. To curb these practices, “disparate impact” lending rules were established to prevent banks from using variables that could inhibit certain minority groups from qualifying for loans as opposed to other groups, except if absolutely necessary. Yet, to become virtually undetectable of using these practices lenders simply originate more loans to minorities and less to white customers.

Legislative and Regulatory Response to Predatory Lending

Bankers have come up with ways to curb these discriminatory practices but the costs of enacting many of these programs are too expensive. For example, banks could develop programs to educate borrowers, but what if the customers decide to get financing through another bank in the end? The expenses used to enact these programs would be wasted. Alternatively then, banks could educate loan originators on how to better

13 Larson, “Everybody Needs.”
determine the unconventional backgrounds of these borrowers. Credit risks of minority
and low-income borrowers are especially difficult to determine since many of these
families have no prior credit histories, do not have savings or checking accounts, and live
simply on a cash only basis. Another simple way to stop these practices is to increase
competition in the lending market, making lenders work harder for the borrowers funds,
and allowing borrowers to comparison shop before making decisions. When bank
originators and users agree in unison with the practices used, the bad lenders will be run
out of the market. In a simple world, a sure way to end discrimination would be for
minority borrowers credit to improve so it equals that of white borrowers, developing a
market for lenders that they cannot discriminate against. Under this situation, lenders
cannot create legal rating factors that are prone to curb one group over another from
qualifying for borrowing.

Predatory lending is still legal in all states except North Carolina, which became
the first state to take a stand against these discriminatory practices starting back in 1997.
Legislation was needed, especially since state cosmetologists had tougher licensing
standards than mortgage lenders. The state wanted to pass anti-predatory legislation that
would curb high cost home loans and on July 22, 1999, with the backing of Governor Jim
Hunt, a bill was passed. Finding an agreed upon common ground between consumers
and lenders led to restrictions in the law that cap the fees accumulated in the loan
origination process to one-fourth of one percent of the mortgage principal or $150 and
upfront fees cannot exceed five percent of the loan value. Interest rates cannot fall above
10 percentage points of the yield on a comparable thirty-year United States Treasury
bond. Lenders cannot charge prepayment penalties or “flip” loans less than $150,000.
The bill also outlaws balloon payments and call provisions. The North Carolina Department of Justice has even gone as far as to run predatory lending ads in the form of public service announcements in African American newspapers and radio stations, believing they are the main target of illegal lending practices. These announcements are to warn African Americans in the area that predatory lenders find them economically disadvantaged and therefore want to take advantage of them.

Some lenders in North Carolina have had to leave the state, unable to stay in business. The onslaught of growth in the subprime lending market is providing families who otherwise would have had limited borrowing opportunities to now have options. Although subprime lending often leads to predatory lending, not all lenders mimic these abusive practices. There are responsible lenders in the market that provide credit at rates that reflect the individual’s risks. The five percent cap on loan origination is just not enough to cover attorney and appraisal fees. A direct effect of the new legislation is that many individuals needing quick money to cover expenses are foreclosing because they cannot pay their bills.\textsuperscript{15} It is a fear of lenders that just one example of increased legislation requiring lenders to disclose quarterly call reports will “fail to distinguish between well-managed and poorly managed subprime programs.”\textsuperscript{16} Good lenders may be driven from the market, as a result of catching the bad ones.

For those citizens that do not have added regulations in their home states for protection, there is still adequate federal legislation that lenders must abide by and can be very helpful for borrowers to be knowledgeable in. In 1974, the first of these regulations was passed. The Real Estate Settlement Procedures Act (RESPA) requires home


mortgage lenders not to allow any person to profit from the settlement procedures on a loan through fees or kickbacks and the cost and charges for the settlement process must be provided up front at the loan closing. Good faith efforts must be made to approximate a cost for the making of a real estate loan in the beginning of the loan process. To protect the borrower from unknown transfers of service on the loan, the lender must provide information and give notice if it occurs. Although this seemed like adequate protection at the time, in 1975, the government wanted more information on the lending activities of banks, credit unions, savings associations and other mortgage lending institutions, resulting in the Home Mortgage Disclosure Act. The public loan data that is provided through this act helps to determine how well banks are serving the lending needs of their communities, and helps to determine where extra funds can be placed in the public sector, where added private investment is needed most. Not to mention, it helps regulators identify discriminatory patterns in the industry. These worked well for a few years, and then the government wanted to find a way to encourage depository institutions to help low and moderate income neighborhoods get credit in a safe means. The result was the Community Reinvestment Act of 1977. If the lending activities of the institutions are shown to reflect adequate lending activities for the members of the community, their positive actions are used as a reward towards more favorable treatment in considering their applications for mergers and acquisitions. Banks regulated by the CRA are held to a higher standard by the federal government and can be held accountable by community action groups if not practicing fair lending.

These acts worked well in the economy until the economic boom of the nineties. A surge in growth was evident from the west to east coast, and low-income individuals
who had once not been able to qualify for loans now could. Subprime lending became
the market of choice for people who did not qualify for prime rate loans, but with this
additional credit came bad home lending practices. To curb these deceptive acts, the
Home Ownership and Equity Protection Act of 1994 was passed. The law bars loans
with first, an annual percentage rate that exceeds the rate on a comparable United States
Treasury securities by ten percentage points or more and second, total fees that exceed
eight percent or more of the total loan amount or $451, which ever is the largest. If a
lender is originating loans with these characteristics, than the law is being violated. If a
borrower finds that their loan has one or more of these characteristics, specific written
disclosures are required to be met by the lender within three days under the law. First,
the lender must send written notice to the borrower allowing them to leave the loan
obligations. Second, a notice stating that the home is used as collateral for the loan and
can be taken if defaulted upon and finally, all annual percentage rates and payment
amounts must be disclosed.

Fortunately, borrowers do have places to turn if in need of advice or information
on unfair lending practices. Two of the main consumer advocacy groups are the United
Stated Department of Housing and Urban Development (HUD) and Association of
Community Organizations for Reform Now (ACORN). Both are a valuable tool for low
income and minority families that need information on home loans and financing.

Besides state and city proposals, the Federal Reserve Board of Governors has
once again been meeting to propose tightening legislation regulating the subprime
predatory lending practices of the banking industry. Alan Greenspan is concerned that
"abusive lending practices target specific neighborhoods or vulnerable segments of the
population and can result in unaffordable (mortgage) payments...and foreclosure.”\(^{17}\)

From 1999 on, five bills have been introduced and failed, in part due to an inability to agree on a single definition for the term predatory lending, leaving regulators to fall back on a “you know it when you see it” standard. Although, at the end of 2000, the Federal Reserve Board could agree that tightening regulation of potentially abusive loans was needed without discouraging credit availability.\(^{18}\) A proposed fed rule that will be discussed at a meeting this March will lower the 10 percent interest rate benchmark on United States Treasury securities to eight, causing five percent of loans from the current one percent to fall under the Home Ownership and Equity Protection Act. Lenders will also not be able to refinance loans within a twelve-month period unless in the best interest of the borrower to prevent excessive loan flipping that can be extremely damaging to their credit. Plus, refinancing will be prohibitive on low interest rate loans, to protect borrowers from high-interest refinancing and lastly, lenders will have to take a look at a borrowers income so they do not automatically assume the house as collateral. Unlike bankers, over 700 consumer groups are asking for tougher rules.

The Current Debate

“The existing federal and state law is totally inadequate,” says Lisa Donner, who works for the Association of Community Organizations for Reform Now, resulting in over thirty states like Illinois, Missouri, New York, Texas, Oklahoma, Virginia, Connecticut, Colorado, Massachusetts, Utah, West Virginia and Nebraska following suit


by proposing the start of new regulatory measures along the same lines. And just recently, New York has been added to the list of states passing legislation specifically addressing abusive lending practices. Cities have jumped on the bandwagon too. Chicago became the first city in the United States to pass a predatory lending ordinance that requires any institution in the state that wants to do business with the city to sign an agreement stating that they themselves and no one they do business with practices predatory lending. Washington D.C. has joined in the fight by passing legislation that curb these practices, but more specifically requires more than one foreclosure notice on a home. With states and cities following suit, a hodgepodge of various bills have been popping up around the country. Peter Skillern, executive director of the Community Reinvestment Association of North Carolina believes that “a patchwork of state regulations on lending is not ideal, but in the absence of strong consumer protection from the federal government, that’s the next best alternative.” Subprime lenders have a different viewpoint. They explain the new laws make it impossible to operate and make money. Businesses across North Carolina have begun to leave and they believe this new bill will reduce available credit to consumers with tainted credit histories. Especially since the current market is seeing an increase in subprime loans to minorities and low-income individuals, while at the same time seeing a decrease in prime lending.

Summary and Conclusion

The chairman of the House and Senate Banking Committees, Representative James Leach and Senator Phil Gramm believe, "the failure of federal agencies and legislators to define predatory lending practices, as well as their 'failure' to enforce existing provisions addressing such issues made federal legislations impractical." So, the first step for change is for the Federal Reserve Board to decide on a definition for the term predatory lending so data can start to be collected. This will enable the good lending to be easily distinguished from the bad lending. With this in place, officers can easily regulate the lending industry without affecting the legitimate businesses in the economy. It is an especially important issue since the need for racial equality has plagued the United States for centuries and predatory loans are notorious for discriminating against minority groups. With a definition allowing for regulation, the curbing of these abusive practices can begin.

The next step will be for all lenders who carry subprime loans to be regulated on a regular basis. Currently, part of the market is unregulated and it is these businesses that have no need to strictly abide by federal regulations. Currently, Bank of America is the largest subprime lender in the nation, but its subsidiaries are not required to be regulated. The same goes for private finance companies. Reports by each lending institution should be required, so a running tab of the everyday lending practices of the business are kept and can be referred to later if a complaint or question arises. For this

reason, both the federal and state governments need to work together and create a joint program to help track down faulty lenders.

As shown, subprime lending has both positive and negative characteristics. The positive aspects are borrowers who were once unable to find lending now have a variety of options available. Unfortunately for the sake of low income and minority borrowers, the negative effects of the lending market become prevalent when predatory lending is evident. Excessive interest rates, loan packing and equity stripping become detrimental to the financial success of disadvantaged borrowers, leaving them even more financially tarnished than when they began. Alan Greenspan has even criticized "mortgage and home equity loan companies of going after low income borrowers and charging them unfairly high fees and interest rates."24 The growth of predatory lending shows these groups are explicitly targeted based on disadvantaged circumstances and an urgent need for liquid resources. As a result, instead of helping individuals to succeed, they are purposely being hindered knowingly. Legislation is a definite must for every state in this nation. Reputable lenders will find the legislation a slight nuisance, but not enough of a burden to push them out of the lending market if they began on ethical ground in the first place. The debate over the proper regulation for predatory lending needs to be clearly defined by the federal government as soon as possible. Without current uniform legislation, states will have a mix of different laws, making it impossible for lenders to distinguish amongst them reasonably if lending across a variety of state borders. A definitive set of regulations will have to be established so lenders have no way to make mistakes and blame it on a hodgepodge of rules. No one said it better than Stella Adams,

executive director of the award winning North Carolina Fair Housing center, "The economic future of the community must be built upon wealth accumulation and the transfer of that wealth to the next generation. Without wealth, our communities will die and our children will continue to be denied the economic fruits of their labor. We must fight to protect the economic future of minority communities." Legislation alone is not expected to fix these problems, but it is a huge first step to the enforcement against such deceptive practices.

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