PREDATORY LENDING

As we push for increased homeownership in the United States, the incidence of unscrupulous lending practices has increased. The term “predatory lending” has crept into our vocabulary. But what is predatory lending?

Unfortunately there does not seem to be a single, succinct definition for predatory lending that would allow us to recognize it immediately. Instead, the term has come to be associated with a variety of lending practices that may target a vulnerable segment of the population, that may take advantage of a borrower’s inexperience or lack of knowledge, that may place a borrower in a loan agreement that they can not afford, or that may simply defraud the borrower. To illustrate, the website of the Community Reinvestment Association of North Carolina defines predatory lending as “…any unfair credit practice that harms the borrower or supports a credit system that promotes inequality and poverty.”

In Florida with its large and growing elderly population, the American Association of Retired Persons claims that unscrupulous lenders are targeting the most vulnerable citizens in the state. The AARP website points out that poor elderly Floridians are losing or at the risk of losing their homes.

The purpose of this newsletter is to raise awareness for predatory lending and to shed some light on what predatory lending practices comprise. For additional information or more in-depth discussion, you are encouraged to visit the website of the Joint Center for Housing Studies of Harvard University www.jchs.harvard.edu/publications/finance/goldstein_w99-11.pdf and retrieve the 41-page, 1999 publication by Deborah Goldstein titled “Understanding Predatory Lending: Moving Towards a Common Definition and Workable Solutions.” Another source of information on predatory lending is the web site of the Fannie Mae Foundation’s KnowledgePlex at www.knowledgeplex.org.

What is Predatory Lending?

The literature on predatory lending says that a loan becomes predatory when a particular population is targeted, when the loan takes advantage of the borrower’s inexperience and lack of information, when the borrower is manipulated into a loan that they cannot repay, or when the borrower is clearly defrauded. These tactics are often directed at particularly vulnerable population segments – the elderly and low-income minorities.

Deborah Goldstein points out that it is difficult to know the extent of predatory lending. The reasons cited are that consumers often are not aware that they have received a loan that is unfairly priced or that they have been preyed upon. Further, these consumers simply may not report the incident to regulators. There is also the problem that non-bank lenders are not required to report lending transactions. Even the regulators themselves find it difficult to track questionable lenders. Finally, because there is no single definition of predatory lending, it has been difficult to accurately assess the extent of the problem.

Sub-prime Lending

This discussion of predatory lending practices would be incomplete without first introducing sub-prime lending or non-conforming lending. The purpose of sub-prime lending is to provide lending programs for those borrowers whose credit history does not fit conventional underwriting requirements. These borrowers may have some unfavorable items in their credit report but still need some source for lending. It is important to recognize that unfavorable items include such routine items as a second mortgage including loans for home improvement, debt consolidation, or a home equity loan. The Brookings Institution, however, points out that it is important for policymakers and citizens not to equate sub-prime or high-cost lending with predatory lending.
A joint report published in June 2000 by the Departments of HUD and Treasury highlighted the abuses among sub-prime lenders but also showed that sub-prime mortgages are more risky than prime loans or FHA-insured mortgages. This increased risk to the lender is why these loans are defined as sub-prime. The study reported that sub-prime mortgages are five times more likely to be delinquent (13.5% versus 2.8%). Serious loan delinquency (i.e., 90 days past due and entering foreclosure) rises significantly as credit scores decline. These findings reinforce a central feature of sub-prime lending; that is, interest rates reflect the risks posed by borrowers with different financial characteristics. In 1999 federal banking regulators stated that, due to their higher risk, sub-prime loans command higher interest rates and loan fees than those offered to standard-risk borrowers.

Accordingly, sub-prime lending plays an important role in providing loans to borrowers that do not fit conventional underwriting criteria. Goldstein writes that sub-prime loans represent an appropriate and necessary response to the needs of borrowers who cannot qualify for prime loans from traditional lenders.

**Predatory Lending Practices**

According to the Fannie Mae Foundation, there are three categories of activity that, either alone or in combination, are predatory lending practices:

1. The first of these categories is aggressive and targeted marketing to financially vulnerable households, including the low-income, minorities, and the elderly. Included in this category is the act of steering borrowers to sub-prime loans on the basis of race/ethnicity, age, or gender when the borrower could actually qualify for a prime market loan. Using door-to-door sales tactics in vulnerable neighborhoods, which is a practice often associated with home improvement scams. In this situation the scammer convinces the homeowner of the need for a home repair, such as a new roof, and further persuades the homeowner to refinance their mortgage with the proceeds going to the repair. The scammer promises to arrange for the repair to be done with those funds, but the work may be overpriced, poorly done, or never completed at all. In fact, the work may not even be needed in the first place. Finally, there is the situation where homeowners are targeted on the basis of the equity in their home rather than on their ability to repay the loan.

2. The second category is the application of unreasonable and unjustifiable loan terms. The Fannie Mae Foundation reports that 35 to 50 percent of borrowers in the sub-prime market could have qualified for lower-cost prime market loans. An example of this practice is excessive fees of more than 3 to 4 percent of the loan amount, depending on the loan amount. Another form of this practice is prepayment penalties that trap borrowers in high-cost loans. There are also yield-spread premiums that prompt mortgage brokers to charge borrowers higher rates than those for which they actually qualify. Finally there are mandatory arbitration clauses that restrict the borrower’s rights.

3. The third category is outright fraudulent behavior, either before or after closing on the loan, and other actions that maximize the destructive financial impact of inappropriate marketing strategies and loan provisions on consumers. An example of this practice is repeated refinancing, which is called loan flipping and which does not benefit the borrower. Another practice is credit insurance premiums that are financed into the loan as well as being paid for upfront. Finally there is the blatant falsifying of loan documents such as appraisals or required disclosures.

**Potential Solutions**

Predatory lending practices are often found in the same low-income and minority communities where residents tend to rely on high-cost financial services. About one-quarter of lower-income families has no traditional financial relationships or is dependent on fringe financial services. Although these fringe organizations fill an important gap left by the absence of mainstream financial institutions, they can negatively impact low-income household’s ability to build assets and credit histories. This situation, in turn, makes these households more vulnerable to sub-prime and predatory loans.
In order to enhance financial services and limit predatory lenders in distressed communities, the Fannie Mae Foundation suggests that a comprehensive national strategy might include the following:

- Improved availability of data on financial services transactions including fees, rates, and other terms of the transactions.
- Improved access to financial services and products designed to meet the needs of lower-income and lower-wealth consumers in order to allow these consumers to become more experienced with the banking system and become more comfortable with shopping around for mortgages or asking questions when the lender’s terms seem unfair.
- Stricter enforcement of fair lending, equal credit opportunity, and consumer protection laws and regulations while at the same time not prohibiting or discouraging legitimate and necessary sub-prime lending.
- Broad-based consumer financial education and outreach to inform borrowers of their options and rights as consumers. This is particularly relevant in for immigrant households, which are usually less familiar with the American financial system and may hold certain biases based on their experiences with banks in their native countries.

Additional Information

Excellent sources of additional information on predatory lending include the Fannie Mae Foundation’s Internet site called KnowledgePlex, Harvard University’s Joint Center for Housing Studies, and The Brookings Institution. All three of these organizations may be found in the Internet.