

Two Steps Back:

**The Dual Mortgage Market, Predatory Lending,
and the Undoing of Community Development**



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and the Undoing of Community Development**

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Executive Summary

In the last few years, predatory mortgage lending has become an increasingly critical issue facing those working to promote community reinvestment. Predatory lending practices include, but are not limited to, fraudulent, high-pressure, or misleading marketing and sales; the “packing” and financing of unnecessary fees; and “flipping” or overly frequent refinancing with fees being repeatedly rolled into the loan. These and similar practices are threatening years of community development progress across the country. The restructuring of financial services industries and the failure of federal and state regulators to respond to these changes have increased the ability of certain lenders and brokers to exploit homeowners, particularly in minority and modest-income communities. This report describes predatory lending, identifies some explanations for its growth in recent years, quantifies the hypersegmentation of lending by neighborhood racial composition, and calls for a set of policy changes to curb abuses.

Predatory lending often leaves homeowners with substantial debt that they cannot afford or are unwise to take on. Even when the debt is necessary, the fees and rates are excessive or the terms are detrimental to the borrower. Documented cases of abuse include fees exceeding 10 percent of the loan amount, payments structured so that they do not even cover interest (resulting in increasing principle balances), and flipping a loan numerous times in a couple of years. Predatory lending strips owner equity out of the home and reduces a household’s cash flow for other essential needs. Abusive lending strains household finances, worsens credit problems, and leads to foreclosures, abandoned homes, and blighted neighborhoods.

While there are multiple causes of predatory lending, one fundamental source lies in the nature of mortgage markets in the U.S. Home equity and refinance lending are excessively segmented, especially by race and neighborhood. Lenders active in white and upper-income communities tend to be much less active in lower-income and minority neighborhoods. Conversely, many of the dominant lenders in minority areas tend not to compete for business in white areas, in part because their products are not competitive in that segment of the market.

The Rise of the Subprime Industry and Growth of Predatory Lending

The increase in predatory lending is tied to the rise of the subprime lending industry, which includes firms specializing in lending to borrowers with subpar credit histories. It is among subprime firms that predatory lending behavior is typically found. In order to understand the growth of predatory lending, it is important to understand the subprime sector.

From 1993 to 1998, loans by subprime lenders in the U.S. rose substantially faster than those by prime lenders, with a 760 percent increase in home purchase loans and an 890 percent increase in refinance loans. Corresponding increases among prime lenders were only 38 percent

and 2.5 percent respectively. Refinance and home equity loans accounted for the bulk of the growth of subprime lending, with the increase in refinance loans exceeding that in purchase loans by almost four to one.

A variety of factors have spurred the explosion of subprime lending and the resulting increase in lending abuses. While increases in homeownership can result in significant benefits for lower-income families and neighborhoods, the large increases in minority and lower-income home buying of recent years have resulted in many homeowners with little experience in financial matters. Many of these families are in a poor position to scrutinize the wisdom of loan offers offered by high-pressure sales people.

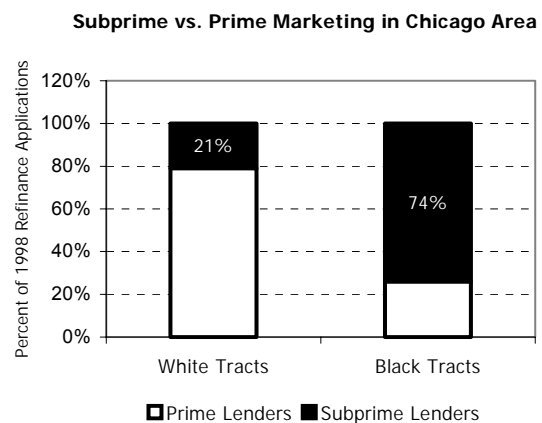
Additional reasons for the growth of subprime and predatory lending include the increasingly segmented system of consumer finance, with higher-income homeowners as the main target of more highly regulated banks, thrifts, and their affiliates who seek the ability to cross-sell account and investment products. At the same time, lending to lower-income and minority communities is often viewed as an isolated line of business, in which the focus is on the short-term transaction and associated fees. Lenders active in such communities tend to be mortgage and finance companies subject to much less regulation than banks and thrifts. The increased scale of the subprime industry itself has resulted in a larger number of abuses. Moreover, there has not been a proportionate increase in regulation or regulatory resources devoted to this new industry. Also to blame are growing debt problems, especially among lower-income households, stemming in large part from uninsured health care costs and the aggressive marketing of credit-cards to modest-income households in the last decade. The growth of the mortgage- and asset-backed securities industry that funds high-risk lending operations has also played a role. Finally, subprime lending feeds itself, as homeowners' credit is damaged by their inability to repay high-cost debt.

The Hypersegmentation of Residential Finance

In order to examine the patterns of mortgage finance across different types of communities, we have analyzed Home Mortgage Disclosure Act data from 1993 and 1998 for the six-county Chicago metropolitan area. While home purchase lending is also analyzed, the report focuses on refinance lending patterns. This product has accounted for the largest portion of subprime activity and is commonly cited as the product accounting for the greatest amount of abuse. We rely primarily on a categorization of lenders as prime or subprime developed over a number of years by the U.S. Department of Housing and Urban Development.ⁱ Key findings include:

ⁱSome "prime" lenders do make subprime loans. However, such lenders are not specialized in subprime lending and offer prime loans as their major products. It is also likely that the subprime lending done by prime lenders is less prone to abuse, given that they also offer lower-cost products, tend to work less with brokers, and are often subject to increased regulatory scrutiny.

- ◆ In 1998, 58 percent of conventional (not government guaranteed) refinance applications in predominantly African-American neighborhoods were made by subprime lenders, compared to less than 10 percent in predominantly white neighborhoods.ⁱⁱ These lenders accounted for 74 percent of applications in black census tracts, compared to 21 percent in white areas.
- ◆ The segmentation of the refinance market is considerably stronger by race than by income. In comparing African-American, middle-income neighborhoods to white, middle-income neighborhoods, the difference in the proportion of refinance loans made by subprime firms remains very high, at 41 percentage points, not much less than the 48 percentage point difference between black and white neighborhoods of all income groups. Multivariate statistics also show that segmentation by race dominates segmentation by income.
- ◆ Refinance lending by subprime firms in African-American neighborhoods grew by almost 30 times from 1993 to 1998, much faster than the 2.5 times increase in white areas. Minority tracts overall accounted for 52 percent of the increase in refinance loans by subprime lenders, despite accounting for only 8 percent of refinance loans in 1993.
- ◆ Of the 20 lenders accounting for the most conventional refinance applications in white tracts in 1998, 17 were prime lenders. Conversely, 18 of the 20 lenders reporting the most applications in African-American tracts were subprime firms. Also, 17 of the 20 leading lenders in white neighborhoods are banks, thrifts, or bank-owned mortgage companies. In black tracts, 14 of the top 20 are independent mortgage companies. Black-white disparity ratios show that the largest prime lenders focus their marketing predominantly on white areas, while the leading lenders in black tracts take few applications in white neighborhoods.
- ◆ Similar patterns exist when looking at refinance originations. Nineteen of the top 20 lenders in white neighborhoods are prime lenders, while 14 of the top lenders in black tracts are subprime firms. For each of these 14 lenders, the market share of all loans in black tracts exceeds the market share in white tracts by more than 6 to 1.
- ◆ Finally, even within the subprime industry itself, substantial segmentation exists. The leading subprime lenders in predominantly African-American tracts typically have shares of subprime applications in black tracts that considerably exceed their shares of subprime



ⁱⁱPredominantly African-American neighborhoods are those where 75 percent or more of residents are African-American. Predominantly white neighborhoods are those where 85 percent or more of residents are white.

applications in white tracts. For 14 of the top 20 firms, their shares of subprime applications in black tracts are at least 50 percent greater than their shares in white tracts.

Policy Recommendations

Substantially reducing predatory lending is likely to require a number of policy tools. Many of the recommendations to date on predatory lending policy have focused on changes to consumer protection laws. We recommend similar changes but also emphasize increased enforcement of such laws, especially for independent mortgage companies, and improved implementation of community reinvestment and fair lending laws.

➤ ***Strengthen Federal Consumer Protection Laws***

The federal Home Ownership and Equity Protection Act (HOEPA) should be strengthened. HOEPA and its regulations establish a cost threshold, which, once exceeded, triggers a set of restrictions on lending practices. First, the threshold for defining a high-cost loan should be lowered, at least to the level of recently proposed State of New York regulations. The New York proposal includes a threshold of fees exceeding 5 percent of the total loan amount or an annual percentage rate (APR) exceeding the corresponding treasury rate plus 8 percentage points. Many argue that this threshold is still too high. The restrictions on HOEPA loans should be increased, including, for example, prohibiting loan flipping, restricting financing of fees for high cost loans, prohibiting loans with high debt-to-income ratios, and expanding restrictions on prepayment penalties.

➤ ***Increase Enforcement Resources Devoted to Predatory Lending Issues***

The staffing and resources at the Federal Trade Commission (FTC), the Department of Justice, and the Department of Housing and Urban Development devoted to predatory lending issues should be dramatically increased. Currently, the FTC, with fewer than 40 staff to cover these and other consumer credit problems across the entire country, is woefully understaffed for regulating the explosion of subprime lending. Most reported abuses are linked to firms under their purview. Thus, a severely understaffed agency is responsible for regulating a major new industry. Moreover, these lenders are the ones that dominate the refinance and home equity markets in most minority and lower-income neighborhoods. By not adapting to changes in the mortgage marketplace, the federal government has allowed for the development of a race-based, two-tiered regulatory system, with lenders in white areas being held to much higher standards than those lending in minority communities.

➤ ***Promote Stronger State Regulation of Home Lending***

States should adopt regulations similar to those in North Carolina and New York. Efforts to increase the regulation of mortgage brokers are also needed, as has been proposed in North Carolina. However, state laws may be subject to preemption by national banking laws. If state regulation improves generally, thrifts and national banks may increasingly become vehicles for avoiding state rules. Thus, unless the federal government changes HOEPA to follow the North Carolina and New York models, federal preemption laws should be modified to allow states to protect their homeowners.

States must also strengthen their enforcement of existing laws and develop a proactive approach for identifying lending abuses. Most importantly, state regulators should not merely respond to consumer complaints but should conduct regular and systematic examinations to identify patterns of abuse or discrimination. They should examine lender files for unfair pricing or terms, improper disclosures, and fraudulent practices.

Finally, in order to aid their enforcement efforts and to provide federal agencies, community organizations, and others with better information on subprime lenders, states can require licensed mortgage lenders to report data on loans, including rates, fees, etc., and can make these data available to the public. Home Mortgage Disclosure Act data has proven a powerful tool in improving access to credit. But HMDA data lack key information on costs and terms, do not include many second mortgage home equity loans, and miss some lenders entirely due to exemptions in the law. Ideally, of course, such data would be collected at the federal level.

➤ ***Expand Fair Lending Regulation and Enforcement***

Despite some increased attention to fair lending aspects of the predatory lending problem, the scrutiny of refinance and home equity lending patterns -- particularly of mortgage companies -- is still very limited. This is in part due to the limited resources of the FTC and the Department of Justice. Some of the successes brought about by examining approval rates in the home purchase loan market need to be replicated in investigating subprime lenders. In the new fair lending examination procedures of the bank regulators there is more explicit attention given to loan pricing and steering, including potential steering between banks and affiliates. The FTC needs to be given the resources and direction to conduct similar examinations. HUD should use Secretary-initiated investigations to target lenders whose applications are concentrated in minority areas.

➤ ***Eliminate CRA Credit for Predatory Lending and Utilize CRA to Encourage Responsible Refinance and Home Equity/Improvement Lending***

There are six fairly modest modifications to Community Reinvestment Act (CRA) policy that would significantly reduce the predatory lending problem:

- Regulators should not allow prime lenders to establish CRA assessment areas that do not include minority and low-income areas. While current regulations ban such “gerrymandering,” these rules are not consistently enforced.
- Regulators should give more attention to patterns of refinance and home equity lending. CRA examinations often focus on home purchase loans, or do not analyze refinance or home improvement products separately.
- Much more effort should be made to evaluate the quality as well as quantity of lending. The failure to examine loan pricing and terms in CRA exams means that high-cost and even predatory loans are likely to receive as much credit as conventional lending. Because predatory lenders often concentrate in minority areas, those subject to CRA may be receiving high marks. High-cost loans should be given less credit than low-cost loans.
- If banks are allowed to continue to receive credit for buying as well as originating loans, these loans should be scrutinized carefully to avoid encouraging predatory activity.
- All lending by affiliate mortgage companies should be considered in CRA exams. Otherwise, a company’s subprime activity is unlikely to be considered.
- Any credit given to investments in mortgage-backed securities should be carefully examined. Investments in high-cost loans to LMI borrowers should be given less credit than investments in low-cost loans. Alternatively, investment test credit for mortgage-backed securities could be eliminated altogether.

➤ ***Increase Financial Literacy and Access to Legal Services***

Another complementary strategy for attacking the predatory lending problem is to increase the capacity of homeowners to discern unfair credit offers. While necessary, consumer disclosure – the primary approach of consumer lending laws – is a woefully inadequate tool. The ability of lower-income homeowners to obtain the aid of a legal assistance organization with expertise in mortgage lending could prove a cost-effective approach to reducing abusive lending. Homeownership counseling must help prepare existing and prospective homeowners for their financial dealings after buying a home. More needs to be known about how best to deliver financial literacy programs aimed at existing and prospective homeowners.

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Introduction

Over the last three decades, many community-based organizations, government agencies, and responsible financial institutions have partnered to increase investment in minority and lower-income communities. Thousands of community development corporations (CDCs), community development financial institutions (CDFIs), and other local organizations have developed innovative approaches to increasing homeownership, building wealth among lower-income families, revitalizing blighted neighborhoods. The 1998 census of community development corporations by the National Congress for Community Economic Development estimates that CDCs have produced more than a half million units of housing and almost a quarter million private-sector jobs. Additional reinvestment has occurred through the efforts of CDFIs, various levels of government, and private financial institutions. The U.S. Department of Treasury has certified more than 300 CDFIs, which do not include all of the revolving loan funds and other financial intermediaries that have focused on developing lower-income communities. Certainly, any reasonable count of the investments made in minority and lower-income neighborhoods even in the last ten years would measure in the trillions of dollars. In many ways, real progress has been made. Most notably, minority and lower-income home buying has increased substantially in the 1990s.

In the last few years, however, abusive mortgage lending has grown to a scale that threatens to reverse the impact of these achievements. There has been a dramatic increase in reported cases of what have been termed “predatory” mortgage lending practices. A set of changes in the financial services industry and the failure of federal and state regulators to respond to these changes have increased the ability of some lenders and brokers to exploit minority and modest-income homeowners.

Characteristics of predatory mortgage lending include, but are not limited to: excessive fees and interest rates (beyond those necessary to cover costs and reasonable, risk-adjusted returns); fraudulent, high-pressure, or misleading marketing; the “packing” and financing of unnecessary fees; and “flipping” or overly frequent refinancing with repeated fees being rolled into the loan, resulting in increasing debt and reduced owner’s equity.

Predatory lending often leaves homeowners with substantial debt that they cannot afford or are unwise to take on. Even if the debt is needed, the fees and rates are excessive or the terms are detrimental to the borrower. Documented cases of abuse include fees exceeding 10 percent of the loan amount, payments structured so that they do not even cover interest, the flipping of a

loan numerous times in a couple of years, and many others.¹ Predatory lending can strip equity out of the home and reduce a household's cash flow available for other essential needs. Abusive lending puts severe strains on household finances, worsens credit problems, and can lead to foreclosure, abandoned homes, and blighted neighborhoods.

While there are multiple causes of predatory lending, one fundamental source lies in the bifurcated nature of mortgage lending markets in the U.S. While the Community Reinvestment Act (CRA) and fair lending laws have resulted in some significant improvements, especially in the home purchase arena, mortgage markets are still highly segmented across race, income and neighborhood. Moreover, with advances in sophisticated data-mining technologies that allow lenders to identify vulnerable homeowners, this segmentation is likely to continue and even worsen without the increased attention of policy makers. Lenders active in white, middle- and upper-income communities tend to be much less active in lower-income and minority neighborhoods. Conversely, many of the dominant lenders in lower-income areas tend not to compete heavily for business in more affluent areas, in part because their products are not competitive in that segment of the market.

To understand better the degree and nature of the segmentation of mortgage markets, this report analyzes the geographic patterns of home lending within one large metropolitan area – Chicago. The focus is on refinance lending because it has accounted for many complaints of predatory activity and because relatively good data are available on refinance loans. First, because predatory loans and lenders are primarily found among subprime lenders – firms specializing in lending to borrowers with blemished credit -- the phenomenal growth of subprime activity since the early 1990s is described.

Then, the characteristics of predatory lending are described based on some of the more frequently documented abuses. Predatory characteristics include both specific types of loan terms as well as overly aggressive marketing and deceptive or fraudulent practices of lenders or brokers. This is followed by explanations for the growth of subprime and predatory lending.

The core of this study is a detailed analysis of intrametropolitan patterns of refinance lending, with some comparison to the home purchase loan market. First, differences in the geographic patterns of prime, subprime, and government-guaranteed home purchase and refinance loans are explored. Refinance loans are explored in greater depth, including some trend analysis for recent years. Then, leading refinance lenders are identified for different neighborhood groups.

¹For descriptions of actual predatory loans and their victims, see Senate Special Committee on Aging, "Equity Predators: Stripping, Flipping and Packing Their Way to Profits," March 16, 1998, at <http://www.senate.gov/~aging/hr14.htm>. Also see D. Goldstein, "Predatory Lending: Definitions and Solutions," Cambridge, MA: Harvard Joint Center for Housing Studies, in press, 1999; The Coalition for Responsible Lending, "The Case Against Predatory Lending," at <http://www.responsiblelending.org/Case.html>; and the National Training and Information Center, "Preying on Neighborhoods: Subprime Mortgage Lending and Chicagoland Foreclosures," Chicago, September, 1999.

Comparisons of market shares in geographic segments are used to identify the degree to which different lenders focus on various communities.

Finally, policy options for reducing predatory lending are presented. These include some key concepts that have been proposed or adopted for state and federal regulation of loan terms and lender and broker practices. Also covered are the use of fair lending laws and the Community Reinvestment Act. Particular attention is given to the use of CRA regulations. CRA provides regulators with an underutilized tool that could be employed to encourage banks and thrifts to avoid predatory practices and provide more affordable alternatives to impacted communities. Moreover, CRA as currently implemented could encourage banks to purchase predatory loans or to buy securities backed by predatory loans, thereby fueling abusive practices.

I. The Rise of the Subprime Sector and the Growth of Predatory Lending

In recent years, there has been a tremendous increase in the number of mortgage loans made by lenders specializing in lending to borrowers with subpar credit histories. Most “subprime” lenders are independent mortgage or finance companies, but they can also be thrifts or even banks. Some large banks have affiliate mortgage companies that are subprime lenders. Subprime firms typically charge borrowers higher fees and interest rates than “prime” lenders, which include most banks and thrifts as well as many mortgage companies.² It is among subprime firms that predatory lending behavior is typically found. In order to understand the growth of predatory lending, it is important to understand the growth of the subprime sector.

Figure 1 describes the national increase in home purchase lending by prime and subprime lenders in the U.S. from 1993 to 1998.³ Loans by subprime lenders rose substantially faster than loans by prime lenders, but subprime firms still comprised only 7 percent of all conventional loans by 1998. Nationally, home purchase loans originated by subprime lenders increased by 760 percent from 1993 to 1998, compared to 38 percent for prime lenders.

An even larger increase in lending by subprime firms occurred in the refinance market, where subprime lenders increased their loans by 890 percent, even though refinances by prime lenders grew by only 2.5 percent. The years 1993 and 1998 are appropriate for comparing refinance trends because both were peak refinancing periods due to declining interest rates.⁴

Refinance and home equity loans account for the most growth among subprime lenders. The 1993 to 1998 increase of more than 700,000 subprime refinance loans was almost four times the increase in subprime home purchase loans.

Figure 2 illustrates changes in refinance lending by prime and subprime lenders from 1993 to 1998. Prime refinancings peaked in 1993 and 1998 due to low interest rates. Subprime refinancings grew steadily from 1993 to 1997, to approximately 27 percent of the refinance market. While still growing significantly in 1998, subprime refinances did not keep pace with the explosion of prime refinances in 1998, so that their share of conventional refinances dropped to 15 percent in 1998.

²Some prime lenders make subprime loans. But they do not specialize in subprime lending, offering prime loans as their major products.

³Figures 1 and 2 are prepared from data contained in R. Scheessele, *1998 HMDA Highlights*, U.S. Department of Housing and Urban Development, September 1999. Scheessele has identified lenders specializing in subprime lending for the years 1993 to 1998.

⁴There may have been some substitution from subprime second mortgages to subprime refinances in the early 1990s due to the decline in interest rates. Refinances become more attractive in lower interest rate environments.

Figure 1. Increases in Home Purchase Lending by Prime and Subprime Lenders in the U.S., 1993 - 1998

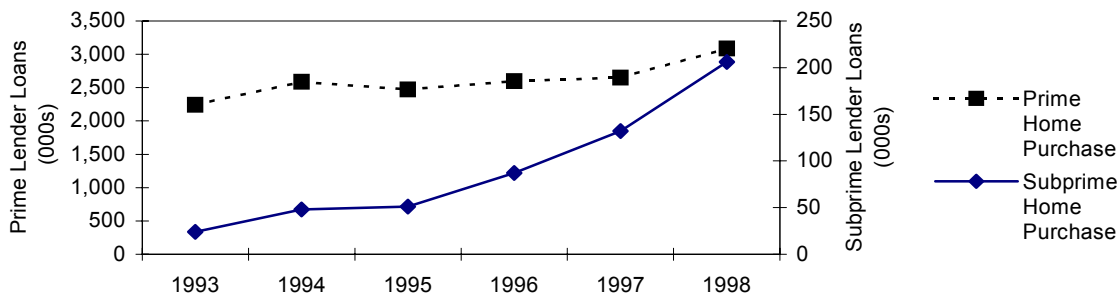
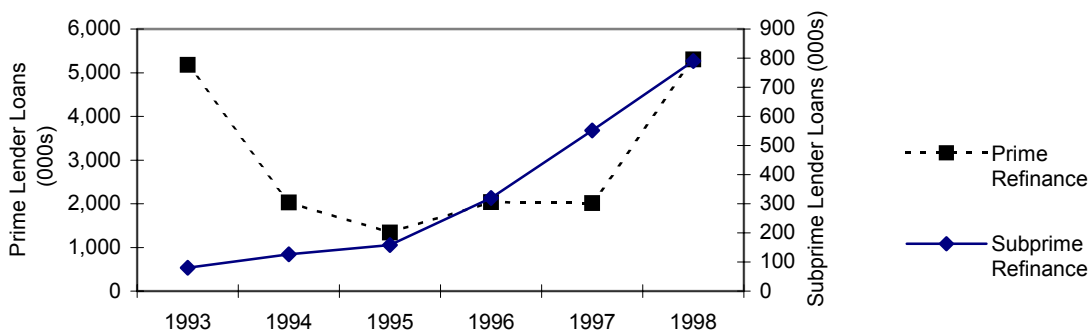


Figure 2. Increases in Refinance Lending by Prime and Subprime Lenders in the U.S., 1993 - 1998



The volatility of refinance lending by prime lenders is shown in Figure 2, with interest rates drastically affecting loan activity. Despite increasing rates in 1994, 1995, and 1997, however, subprime lenders continued to increase their refinance volumes. This suggests that subprime refinancings are not driven by homeowners refinancing to save money during times of declining rates and that subprime lenders are aggressively marketing loans regardless of the rate environment.

In 1999, interest rates have risen significantly and prime refinancing activity has dropped dramatically as a result. In response, some lenders are increasing their subprime activity due to a drop-off in prime refinance business. Recently, for example, Countrywide – one of the largest lenders in the country – reported that, although its total volume was down 34 percent from 1998, its subprime lending was up 35 percent.⁵ This could mean that some lenders considered

⁵H. Habal, "Countrywide Beefing Up Subprime Mortgage Loans," *American Banker*, October 7, 1999.

prime in 1998 will become specialized in subprime in 1999. Moreover, while subprime lending increased in 1998, some large subprime lenders had serious financial difficulties in the later part of the year and were forced to suspend or slow down activity. Thus, 1998 subprime activity was not as high as it might have been. Certainly, the expectation is that subprime lenders will constitute a larger share of home loans in 1999 than in 1998.

A Typology of Predatory Lending

More than two dozen loan terms and lending practices have been described as predatory or abusive.⁶ These practices have been documented in many case studies of predatory lending abuses.⁷ Table 1 provides a typology of these terms and practices together with several examples of each. An instance of predatory lending could involve just one of these practices. More commonly, though, a number of practices occur simultaneously. For example, high-pressure marketing may be most effectively employed when targeting homeowners in vulnerable situations, including those with high levels of health-related or credit-card debt. Those without immediate financial problems may be less susceptible to pressure tactics and are more likely to “shop around” for better alternatives.

From American Dream to Worst Nightmare

Increasing homeownership among minorities and lower-income families and neighborhoods has been a policy thrust of recent federal administrations. The current Administration has adopted a National Homeownership Strategy to increase the national homeownership rate significantly, with a focus on increasing rates among minority groups. The push for homeownership has met with significant success. The African-American homeownership rate grew from 42.1 percent in the beginning of 1994 to 45.2 percent in 1998. This 7.4 percent increase was significantly larger than the overall increase in U.S. homeownership of 3.3 percent over the same period.

One of the principal factors in increasing homeownership rates is improved access to credit for home buyers. In 1991, the Federal Reserve Bank of Boston completed a major study on lending discrimination that fueled increased attention to minorities' access to mortgage credit. In 1993, federal agencies instituted more aggressive investigations of lending discrimination, leading to some high profile cases. In the same year, bank regulators announced plans to revise Community Reinvestment Act regulations to include a new emphasis on measuring lending outcomes.

⁶Many of the examples of predatory lending listed in Table 1 were described by William J. Brennan, Jr., Director, Home Defense Program of the Atlanta Legal Aid Society, Inc., in his statement before the United States Senate Special Committee on Aging on March 16, 1998.

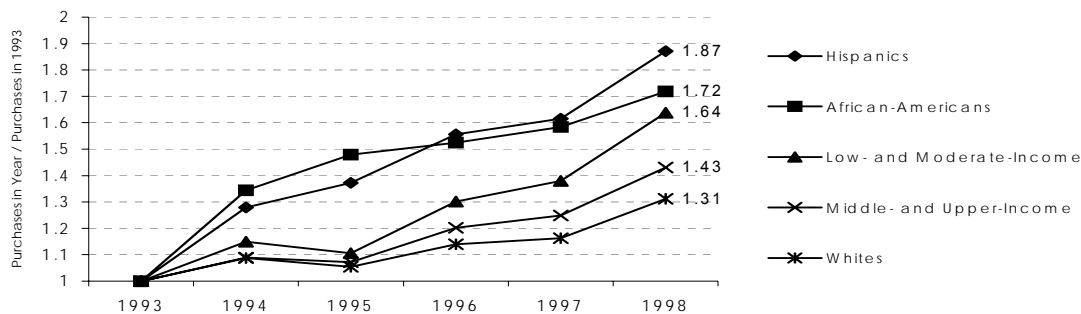
⁷For examples, see sources in footnote 1.

Table 1. A Typology of Predatory Lending Practices and Loan Terms

Type of Predatory Behavior	Examples
Sales and marketing	<ul style="list-style-type: none"> • high pressure, door-to-door sales • targeting vulnerable populations (e.g., those with health debts, elderly, less educated) • steering to higher-cost loans despite borrower qualifying for lower-cost credit • flipping – excessive refinancing • home improvement scams, in which contractors act as loan brokers
Excessive fees	<ul style="list-style-type: none"> • “packing” loans with unnecessary fees, including credit life insurance, which are often financed in the loan • padded closing costs or third party fees • excessively high points or origination fees • high broker fees, including yield spread premiums
Terms that trap borrowers into unaffordable financing	<ul style="list-style-type: none"> • balloon payments, which conceal the true cost of financing and may force repeated refinancing or foreclosure • negative amortization, in which payments are less than interest, resulting in an increasing principal balance and decreasing owner equity • prepayment penalties • “asset-based” lending, ignoring repayment ability
Other fraudulent or deceptive practices	<ul style="list-style-type: none"> • reporting inflated income figures • forgeries • insufficient or improperly timed disclosure • inflated appraisals, in part to enable secondary market sale

These policy initiatives, together with lower interest rates and an economic expansion, contributed to substantial increases in home buying and homeownership among minority and low-income families and neighborhoods in the U.S. in the 1990s. Figure 3 illustrates the large increases in home buying among minorities and low- and moderate-income households in the U.S. metropolitan areas from 1993 to 1998.

Home buying among Hispanics increased by 87 percent from 1993 to 1998 and by 72 percent for African-Americans. Low- and moderate-income households saw home buying increase by 64 percent over the same period. These increases are substantially greater than the corresponding

Figure 3. Increases in Home Buying in the U.S., 1993 - 1998

Source: Authors' calculations from FFIEC national compilations of Home Mortgage Disclosure Act data

increases among middle- and upper-income and white buyers of 43 and 31 percent, respectively.⁸

Increases in homeownership can result in significant benefits for lower-income families and neighborhoods, including the ability to build financial assets. Low levels of homeownership have been partly responsible for lower levels of wealth accumulation among minority groups.⁹ Homeownership is associated with improved property maintenance and longer neighborhood tenure, as well as positively affecting community participation and informal interaction with neighbors.¹⁰ Other studies indicate that homeownership positively affects life satisfaction and levels of neighborhood activism.¹¹

But the benefits of homeownership are not automatic. Many new low- and moderate-income homeowners have little experience in financial matters, and some are no more than a few paychecks from insolvency. Such families may be slow to resist the lure of ready financing and may be in a poor position to scrutinize the wisdom of a specific loan offer.

The rise in homeownership among lower-income families and communities -- together with the continued segmentation of credit markets by race, income and geography -- has left an unintended byproduct that must be addressed. Prior to owning real estate, most low-income

⁸These figures actually understate the gains made by minorities and lower-income homebuyers in the early 1990s. From 1992 to 1993, substantial increases also occurred in home buying among lower-income and minority groups. These increases are shown in D. Evanoff and L. Segal, "CRA and Fair Lending Regulations: Resulting Trends in Mortgage Lending." *Federal Reserve Bank of Chicago Economic Perspectives* 20, no. 6: 19-46, 1996.

⁹T. Parcel, "Wealth Accumulation of Black and White Men: The Case of Housing Equity." *Social Problems* 30: 199-211, 1982; M. Oliver and T. Shapiro, *Black Wealth, White Wealth: A New Perspective on Racial Inequality*, New York: Routledge, 1995.

¹⁰For a review of homeownership effects see W. Rohe, and L. Stewart, "Homeownership and Neighborhood Stability." *Housing Policy Debate* 7: 37-81, 1996.

¹¹See for example, W. Rohe and M. Stegman, "Public Housing Homeownership: Will It Work and For Whom?" *Journal of the American Planning Association* 58: 144-157, 1994; and K. Cox, "Housing Tenure and Neighborhood Activism." *Urban Affairs Quarterly* 18: 107-129, 1982.

families owned little property that could be used as collateral for a loan. If renting households fell prey to predatory credit card lenders, they would be harmed, but the debt would be unsecured and usually of limited scale. Homeownership leaves these new, less experienced, and often less sophisticated households more vulnerable to unscrupulous or overpriced credit.

Predatory lenders can encourage homeowners to acquire substantial debt that they may not be able to afford or are unwise to take on. Alternatively, even if a loan is needed and appropriate, the fees and rates are excessive or the terms trap the borrower into refinancing again in a short period of time. Predatory loans can strip out critical home equity by increasing the debt on the home, and can reduce the household cash flow available to maintain the property or cover regular household expenses. This can put severe strains on family finances, aggravate credit history problems, reduce investment in home maintenance and repair, and lead to foreclosure and even abandoned properties. A recent Chicago area study found that foreclosures on properties with high-cost loans (4 or more percentage points over the 30-year Treasury rate at the time of origination) grew by more than 500 percent from 1993 to 1998 while foreclosures on properties with lower-cost loans grew by only 31 percent.¹² The high-cost loans accounted for more than one-half the total increase in foreclosures. While foreclosures and abandoned properties are the gravest consequences of predatory lending, they represent only some of the effects, all of which lead to long-term losses in household and community wealth.

Homeownership represents a key wealth-building opportunity for lower-income and minority families and the communities in which they live. The stripping of wealth by predatory lenders is undermining the stabilization and revitalization of low- and moderate-income neighborhoods. Community development practitioners, funders, and policy makers must understand the magnitude and nature of the impact that this phenomenon has on minority and lower-income areas.

At the same time, there is some role for responsible and affordable subprime lending. Such lending can enable homeowners that have experienced some credit difficulties to lower monthly debt payments, finance repairs to their home, and reduce mortgage payments in times of falling interest rates without unreasonable expenses or significant reductions in their home equity. Affordable subprime lending can also provide home ownership opportunities to some families who are ready for homeownership but are unable to qualify for a prime loan. However, homeowners and homebuyers must not be pressured into subprime debt. Ideally, they would be equipped, either through education or technical assistance, to judge whether the potential advantages of a subprime loan merits the costs of the loan as well as the risk of credit problems or even foreclosure. Because it is not feasible to give such skills to all homeowners and due to the scale of the problem, it is incumbent upon public policy to reduce the opportunities for lenders and brokers to originate predatory loans.

¹²National Training and Information Center, *Preying on Neighborhoods: Subprime Mortgage Lenders and Chicagoland Foreclosures*, September 21, 1999.

One necessary but not sufficient requirement of responsible subprime lending is that any premium in rate over the rate of prime lenders is justified by increased lender risk. Some argue that risk-based pricing, such as that being implemented by the government-sponsored enterprises (GSE's), Freddie Mac and Fannie Mae, provides a tool to bring the costs of subprime lending down closer to a more responsible and affordable price.¹³ Under appropriate risk-based schemes, for example, loans with lower loan-to-value ratios, other things being equal, are made at lower rates. At the same time, even these risk-based schemes can mechanize and legitimate differentials in the cost of credit that derive from inequities and discrimination in mortgage and other markets.¹⁴ For example, families with relatively good credit before being victimized by predatory lenders may well see their credit worsen due to the inability to pay a high cost mortgage. When they then turn to a risk-based lender, they will be offered a higher than average rate. Also, lower-income and minority residents are more likely than others to have received little education in financial matters, to have suffered instability in employment, and to have incurred uninsured medical expenses, which increase their vulnerability to economic change.

Notwithstanding the inequities inherent in risk-based pricing, it may allow some lenders to offer *relatively* lower-cost financing to subprime borrowers than is currently being provided by predatory lenders. Of course, given the tactics of predatory lenders and the segmentation of home loan markets, risk-based pricing, by itself, is unlikely to provide a substantial solution to the predatory lending problem. It merely provides a tool that responsible lenders can use to provide subprime credit. However, this tool is also subject to abuse by predatory firms. If the GSE's do not develop strong guidelines for purchasing only responsible subprime loans, their risk-based products could allow predatory firms to gain liquidity and increase their scale of operations.

Understanding the Growth of Subprime and Predatory Lending

In attempting to understand the rise of predatory mortgage lending, it is important to place it in the context of the overall increase in subprime lending. It is also important to distinguish predatory lending from fair subprime activity.

The explanation for why predatory lending has grown in the 1990s involves multiple events and trends. In part, the growth of predatory activity stems directly from the development of an increasingly specialized and segmented mortgage market, especially for refinance and home equity loans. In this segregated system, higher-income homeowners are the main target of

¹³P. Mahoney, "Counseling's New Role," *The NeighborWorks Journal*, Summer 1999: 7-9.

¹⁴J. Carr, "Risk-Based Pricing: Automation's Benefits are not Automatic," *The NeighborWorks Journal*, Summer 1999: 10-12.

banks, thrifts, and many prime mortgage companies, which are frequently owned by bank holding companies. For banks, these homeowners represent the possibility to cross-sell account and investment products that are important to increasing bank earnings. At the same time, mortgage lending for less affluent homeowners is not seen as part of a larger relationship. Thus, mortgage lending to lower-income and minority communities is often viewed as an isolated line of business, in which the focus is on the short-term transaction and associated fees. This dual finance system has fed the rise of the subprime firms and has increased the "room for abuse" in the marketplace, especially for less sophisticated homeowners. Because there are many more subprime lenders, some of whom look to capitalize on less sophisticated homeowners with fewer options, the abuses have increased. The increased scale of the subprime industry itself has given rise to a larger number of abuses. At the same time, there has not been a proportionate increase in regulation or regulatory resources devoted to these problems.

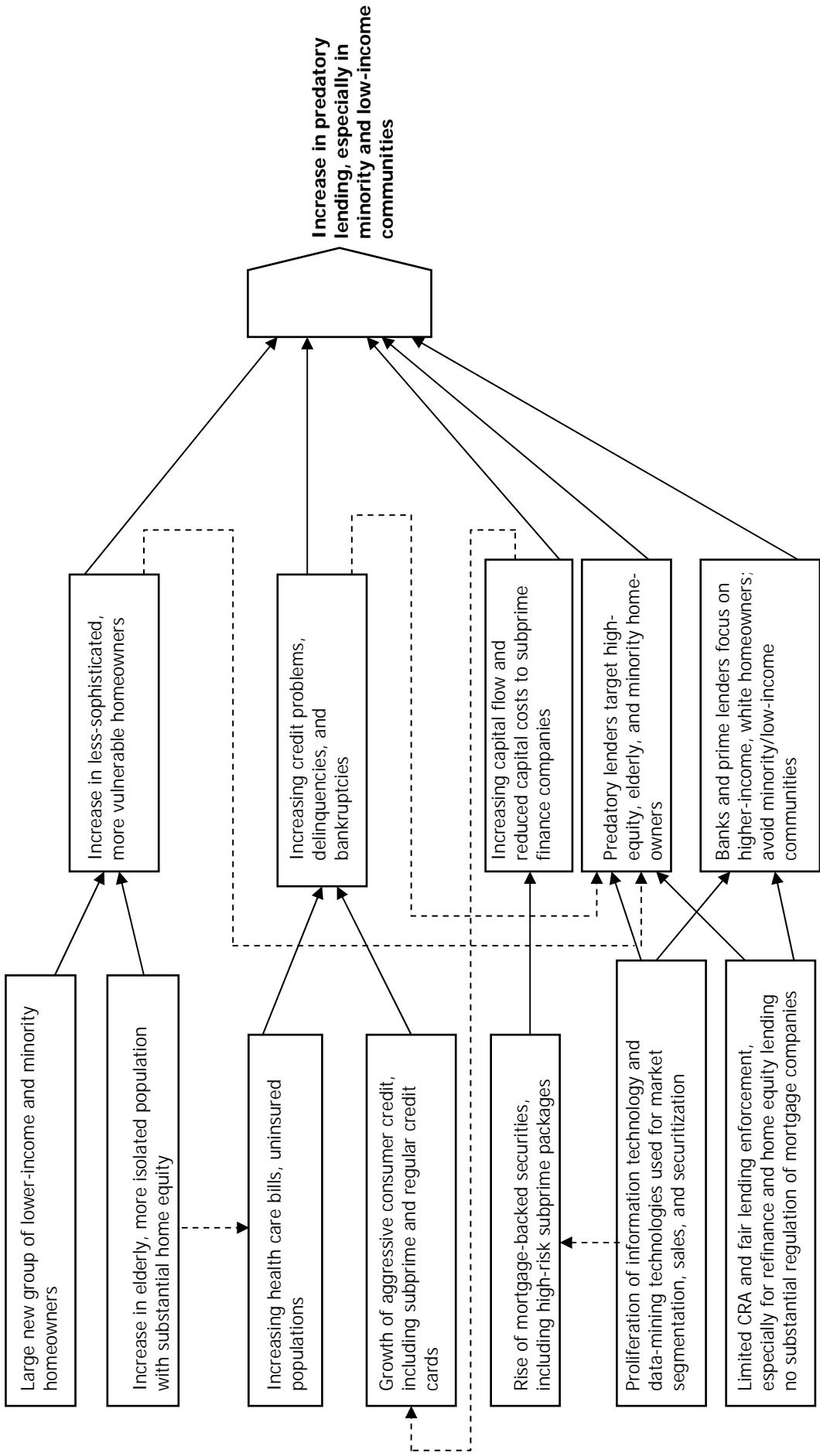
Figure 4 describes some of the key causes of the rise in predatory refinance and home equity lending, particularly as it affects minority and lower-income communities. Some of these factors have spurred both subprime lending and predatory practices within the subprime sector.

The rise in predatory lending has been made possible by a set of demand and supply factors, with some of the increases in supply factors feeding back to stimulate demand. Already mentioned is the substantial rise in the number of lower-income and minority homeowners since the early 1990s. Many of these new homeowners are relatively unsophisticated in financial matters and have never before owned an asset that can be used as collateral for a substantial loan. There has also been a growth in the elderly population, including some homeowners who are relatively isolated and unfamiliar with recent trends in residential finance. Health bills are also a major determinant of credit problems and bankruptcy, spurring demand for debt by homeowners in desperate situations. This problem has also been aggravated by high numbers of uninsured families.

But supply factors have also been important. Subprime firms have been fueled by the growth of the mortgage- and asset-backed securities industry that funds high-risk mortgage lending operations. From 1994 to 1998, the issuance of asset-backed securities (ABS) for home-equity loans increased from about \$10 billion to more than \$80 billion. By 1997, home equity ABS had replaced credit-card-backed securities as the leading type of issuance.¹⁵

¹⁵Bond Market Association, research newsletter, February, 1999. ABS's fund second-mortgage home equity loans, although large increases in securities backed by first mortgage refinancings also occurred.

Figure 4. The Causes of Increased Predatory Lending in Minority and Lower-Income Communities



Much of the lending funded by these securities is subprime in nature.¹⁶ Capital has also flowed into consumer credit operations, including credit card firms and fringe bankers like title and payday loan outfits. Credit-card-backed ABS issuance climbed rapidly from \$30 billion to almost \$50 billion from 1994 to 1995, but declined somewhat in 1997, due to troubles in the industry.

Subprime credit markets build on each other. Aggressive marketing and lax underwriting of subprime credit cards have resulted in heavy debt loads, credit history problems, and increased bankruptcies among many lower-income families. This, in turn, has helped build the demand for subprime refinance loans which are often used to pay off such debt. Federal Reserve figures show that outstanding nonmortgage consumer debt increased from \$840 billion in 1993 to \$1.3 trillion in 1998. Over the same period, personal bankruptcies rose by more than 70 percent to almost 1.4 million filings.

Research suggests that credit card debt, together with uninsured medical bills, is a primary catalyst in bankruptcies.¹⁷ The surge in credit-card debt has been particularly acute among lower-income households and preceded the mid-1990s surge in subprime mortgage debt. Research on the Federal Reserve's Survey of Consumer Finances shows that the percentage of households below 150 percent of the poverty line that had one or more credit cards increased from 44 percent in 1989 to 57 percent in 1995.¹⁸ Worse yet, the percentage of households below 150 percent of the poverty line with credit-card-debt-to-income ratios above 1.0 grew from 11.2 percent in 1989 to 23.2 percent in 1995. Lower-income borrowers also have more trouble rescuing themselves from consumer debt. Many lower-income homeowners, however, have been encouraged to use home equity financing to get out of their troubles. Because credit card debt is unsecured and mortgage debt is not, in many cases such a substitution may be unwise.

Increasing market segmentation has been facilitated by advances in information technology that have enabled banks and prime mortgage lenders to mine sophisticated databases in an effort to identify higher-income segments of the market. This plays out by race and geography, especially for banks, who continue to expand branch operations in white, affluent neighborhoods at the expense of minority, lower-income ones.¹⁹ As banks and prime mortgage firms compete more furiously for more affluent customers, they leave the minority and lower-income neighborhoods ripe for penetration by subprime and predatory lenders. And because

¹⁶G. Canner, T. Durkin, and C. Lueckert, "Recent Development in Home Equity Lending," *Federal Reserve Bulletin*, volume 84 number 4, April, 1998: 242-251.

¹⁷I. Domowitz, "Personal Bankruptcy in the United States," Northwestern University Institute for Policy Research, WP-96-24, 1996. Also see Domowitz' Senate testimony described in, "Economist Explains Why More Consumers Going Broke," *Institute for Poverty Research News*, Summer, 1997.

¹⁸E. Bird, P. Hagstrom, and R. Wild, "Credit Card Debts of the Poor: High and Rising." *Journal of Policy Analysis and Management* 18 (1999): 125-133.

¹⁹R. Avery, R. Bostic, P. Calem, and G. Canner, "Changes in the Distribution of Banking Offices," *Federal Reserve Bulletin* 83:9 (1997): 708-725.

the marketing and sales efforts of prime lenders are often tied to branch locations and mail solicitations, segmentation takes on a particularly geographic nature.

Geographic segmentation is reinforced by the fact that predatory lenders often target customers via direct mail or work with brokers who often rely on aggressive door-to-door sales or local relationships. Data mining technologies allow lenders to obtain lists of homeowners with unpaid health bills, and other signs of vulnerability.

Finally, it is important to note that the 1986 tax reform act has generally encouraged the use of home equity as a source of debt for American households.²⁰ This has generally fueled the demand for home equity and refinance lending due to favorable tax treatment of interests paid under such loans. While this benefit is greater for higher- rather than lower-income homeowners, anecdotal evidence suggests that subprime lenders frequently use purported tax benefits as part of their sales pitch even in marketing to low-income homeowners.²¹

²⁰J. Forrester, "Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing," 69 *Tulane Law Review* 373 (1994): 373-456.

²¹Conversation with Gary Klein, National Consumer Law Center, November 1, 1999.

II. The Hypersegmentation of Residential Finance

In order to examine the patterns of mortgage finance across different types of communities, we have analyzed Home Mortgage Disclosure Act data from 1993 and 1998. We begin by describing differences in 1998 home purchase lending across neighborhoods by race and income, and then delve more deeply into differences in refinance lending. This product has accounted for the largest portion of subprime activity and is commonly cited as the product responsible for the largest amount of abuse.

The U.S. Department of Housing and Urban Development has identified lenders specializing in subprime loans.²² This does not mean that lenders categorized as “prime” do not make any subprime loans. However, such lenders do not specialize in subprime lending, offering prime loans as their major product. It is also likely that the subprime lending done by prime lenders is less prone to abuse, given that they also offer lower-cost products, tend to work less with brokers, and are often subject to increased regulatory scrutiny.

Table 2 describes the distribution by neighborhood income of conventional (not government-guaranteed) and Federal Housing Administration and Veteran's Administration (FHA/VA) home purchase loans across the almost 1,800 census tracts in the six-county Chicago area.²³ The conventional loans are further broken down between those made by prime or subprime lenders. Due to significant changes in many neighborhoods over the eight years since the 1990 census, commercial estimates were obtained for classifying tracts by demographic characteristics.²⁴

²²For a detailed explanation of HUD's methodology and its complete list of subprime lenders, see Scheessele, *1998 HMDA Highlights*. Also, based on HUD's notes in the report, we looked at several specialized lenders highlighted by HUD but not included by them in their subprime or manufactured home lists. Following HUD's methodology, we identified whether these lenders had high denial rates and heavy refinance activity in the Chicago area market. If so, we classified some of these lenders as subprime or manufactured home lenders. These include Indymac, Inc., Indymac Mortgage Holdings, Residential Funding Corp., and Chase Manhattan Mortgage Corporation (all classified as subprime). We also classified Chase Manhattan Bank as a manufactured home lender per HUD's methodology. Also Headlands Mortgage Company was reclassified as prime based on advice from HUD.

²³In all cases in this study, conventional home loans and applications of manufactured home lenders are excluded. Their product is unique and their denial and marketing experiences are not consistent with other lenders. In the Chicago six-county area in 1998, the 22 home manufactured home lenders identified by HUD accounted for less than 0.5 percent of the conventional home purchase loans in the region and less than 0.3 percent of conventional refinance loans. Also excluded are applications without census tract identification, which amount to fewer than one or two percent of all applications, depending on product.

²⁴Claritas, Inc.'s 1998 estimates are used rather than actual 1990 census data. Estimates for individual tracts are suspected to suffer from some error. However, tests by Claritas of 1990 estimates against 1990 census data suggest that using estimates is more accurate than using the old, 1980 data. Moreover, the large aggregations used in this report are expected to reduce random error substantially.

**Table 2. Geographic Distribution of Home Purchase Loans
by Income of Neighborhood in Chicago Area, 1998**

Income of Neighborhood	Loan and Lender Type			
	Conventional Prime	Conventional Subprime	Conventional Subprime/Share	FHA-VA All
Low (Less than 50% of MSA median)	3,396 61.36%	784 14.16%	18.76%	1,355 24.48%
Moderate (50-79% median)	8,777 55.65%	1,401 8.88%	13.76%	5,594 35.47%
Middle (80-119% median)	38,084 69.03%	4,329 7.85%	10.21%	12,760 23.13%
Upper (120% or above median)	47,605 85.11%	3,931 7.03%	7.63%	4,397 7.86%
All Loans	97,870 73.91%	10,445 7.89%	9.64%	24,110 18.21%

**Table 3. Geographic Distribution of Home Purchase Loans
by Race of Neighborhood in Chicago Area, 1998**

Race/Ethnicity of Neighborhood	Loan and Lender Type			
	Conventional Prime	Conventional Subprime	Conventional Subprime/Share	FHA-VA All
Predominantly African-American	2,672 45.07%	1,060 17.88%	28.40%	2,196 37.04%
Mixed-minority	8,659 61.30%	1,221 8.64%	12.36%	4,246 30.06%
Mixed-Majority	31,368 69.82%	3,307 7.36%	9.54%	10,250 22.82%
Predominantly White	55,163 81.80%	4,857 7.20%	8.09%	7,414 10.99%
All Loans	97,870 73.91%	10,445 7.89%	9.64%	24,110 18.21%

Table 3 provides a similar analysis of home purchase loans, by race of neighborhood rather than income.²⁵ Census tracts are categorized into four categories, including predominantly white (85 percent or greater nonhispanic white); mixed-majority (50 percent to 84 percent nonhispanic white); mixed-minority (greater than 50 percent minority but less than 75 percent African-American); and predominantly African-American (75 percent or greater African-American). The patterns by race of neighborhood are stronger than those by income, with subprime purchase loans in predominantly African-American communities equaling more than 28 percent of conventional home purchase loans. Mixed-minority neighborhoods also have somewhat higher levels of subprime purchase lending.

Patterns of Prime and Subprime Refinance Loans

The bulk of the increase in subprime lending has been in the area of home equity and refinance loans. Many abuses have been associated with subprime refinance loans. Because predatory lenders and brokers tend to make their revenue mostly on points and fees, they have an incentive to refinance all outstanding debt even if the rate of the new loan is higher than the existing mortgage. Also, refinance loans, unlike many second-mortgage home equity loans, are reported under HMDA.²⁶

Table 4 indicates the patterns of refinance lending in the six-county Chicago area by income of neighborhood.²⁷ Subprime lenders' share of conventional refinancing increases from 9 percent in upper-income neighborhoods to 46 percent in low-income tracts. Comparing Table 4 to Table 2 shows that the segmentation of lower versus upper-income neighborhoods by lender type is much stronger in the refinance market than in the home purchase market, where subprime lenders account for less than 19 percent of the low-income segment.

When breaking out neighborhoods by racial composition the segmentation is even stronger. Table 5 shows that, in predominantly African-American neighborhoods, subprime lenders account for 58 percent of conventional refinance loans, as compared to less than 10 percent in predominantly white tracts. Mixed-minority, and to a lesser degree, mixed-majority tracts also have substantially higher ratios of subprime to total refinance lending than white neighborhoods. The segmentation here is considerably stronger than in the home purchase

²⁵While the focus here is on neighborhoods, analysis by race of loan applicant is conceptually feasible with HMDA data. However, 37 percent of conventional subprime refinance loans had no racial information reported, compared to only 10 percent for prime lenders. Some large subprime lenders do not report race on most loans. Thus, in heavily segregated areas such as Chicago, the analysis by race of neighborhood may provide a better indicator of race of applicant (at least for African-American vs. white) than the racial data in HMDA.

²⁶Original junior mortgages not used for home improvement are not reported under HMDA. In addition, lenders for whom home purchase and refinance of home purchase loans amount to less than 10 percent of all loans do not have to report to HMDA.

²⁷More than 630 prime and 100 subprime lenders made conventional refinance loans in the six-county Chicago area in 1998. More than 240 prime lenders made more than 50 loans, and more than 70 subprime firms made more than 50 loans in the region.

**Table 4. Geographic Distribution of Refinancing Loans
by Income of Neighborhood in Chicago Area, 1998**

Income of Neighborhood	Loan and Lender Type			
	Conventional Prime	Conventional Subprime	Suprime/ Conventional	FHA-VA All
Low (Less than 50% of MSA median)	5,427 49.62%	4,647 42.49%	46.13%	863 7.89%
Moderate (50-79% median)	17,576 61.29%	7,657 26.70%	30.35%	3,444 12.01%
Middle (80-119% median)	76,590 76.34%	13,924 13.88%	15.38%	9,819 9.79%
Upper (120% or above median)	97,172 87.30%	9,576 8.60%	8.97%	4,563 4.10%
All Loans	196,773 78.31%	35,805 14.25%	15.39%	18,689 7.44%

**Table 5. Geographic Distribution of Refinancing Loans
by Race of Neighborhood in Chicago Area, 1998**

Race/Ethnicity of Neighborhood	Loan and Lender Type			
	Conventional Prime	Conventional Subprime	Suprime/ Conventional	FHA-VA All
Predominantly African-American	6,596 37.88%	9,220 52.96%	58.30%	1,595 9.16%
Mixed-minority	15,465 65.68%	5,250 22.30%	25.34%	2,832 12.03%
Mixed-Majority	58,356 78.40%	8,578 11.52%	12.82%	7,498 10.07%
Predominantly White	116,348 85.63%	12,756 9.39%	9.88%	6,764 4.98%
All Loans	196,773 78.31%	35,805 14.25%	15.39%	18,689 7.44%

market. Comparing Table 3 to Table 5 shows that the subprime lenders' share of the conventional purchase market increases from 8 to 28 percent for home purchase loans when going from white to black neighborhoods, much less than the increase from 10 to 58 percent in refinance.

Mortgage lending patterns are driven in large part by the marketing and application patterns of different lenders. Table 6 shows that subprime lenders account for 74 percent of conventional refinance applications in African-American neighborhoods, compared to only 20 percent in predominantly white areas. They also comprise almost one-half of applications in mixed-majority neighborhoods. Thus, subprime lenders dominate in marketing (at least *effective* marketing) to minority neighborhoods.

Figures 5 and 6 illustrate the marketing patterns of prime and subprime lenders, respectively, by plotting the refinance applications of each set of lenders. Figure 5 shows that prime lenders take very few applications in predominantly African-American neighborhoods on the West or South Sides of the city or in the southern suburbs, east of Interstate 57. At the same time, these lenders market heavily on the city's north side and in most suburbs with substantial population densities.

Figure 6 shows almost precisely the opposite pattern, with subprime lenders marketing concentrated in predominantly African-American neighborhoods in the city, the southern suburbs, and the Maywood area in western Cook County. These lenders take relatively few applications on the city's North and Northwest Sides or in most suburbs.

Figure 7 illustrates the segmentation of the refinance market by neighborhood racial composition. Almost all of the tracts with 60 percent or more loans made by subprime lenders are predominantly African-American. Similarly, the bulk of the predominantly African-American tracts experience subprime shares of refinance loans of 40 percent or greater. High subprime shares are present on the city's South and West Sides, as well as in the southern suburbs of Cook County, a cluster of western Cook suburbs, Joliet, and the Waukegan/North Chicago area.

Is Segmentation Stronger by Race or Income?

Because low-incomes and high minority populations are correlated, Tables 4 through 6 do not provide a clear answer to the question of whether subprime lenders are more concentrated by neighborhood income or by neighborhood race. To partly control for differences in income, we can compare middle-income neighborhoods that are predominantly white to those that are predominantly African-American.

Figure 5. 1998 Conventional Refinance Applications of Prime Lenders with Racial Composition of Tract

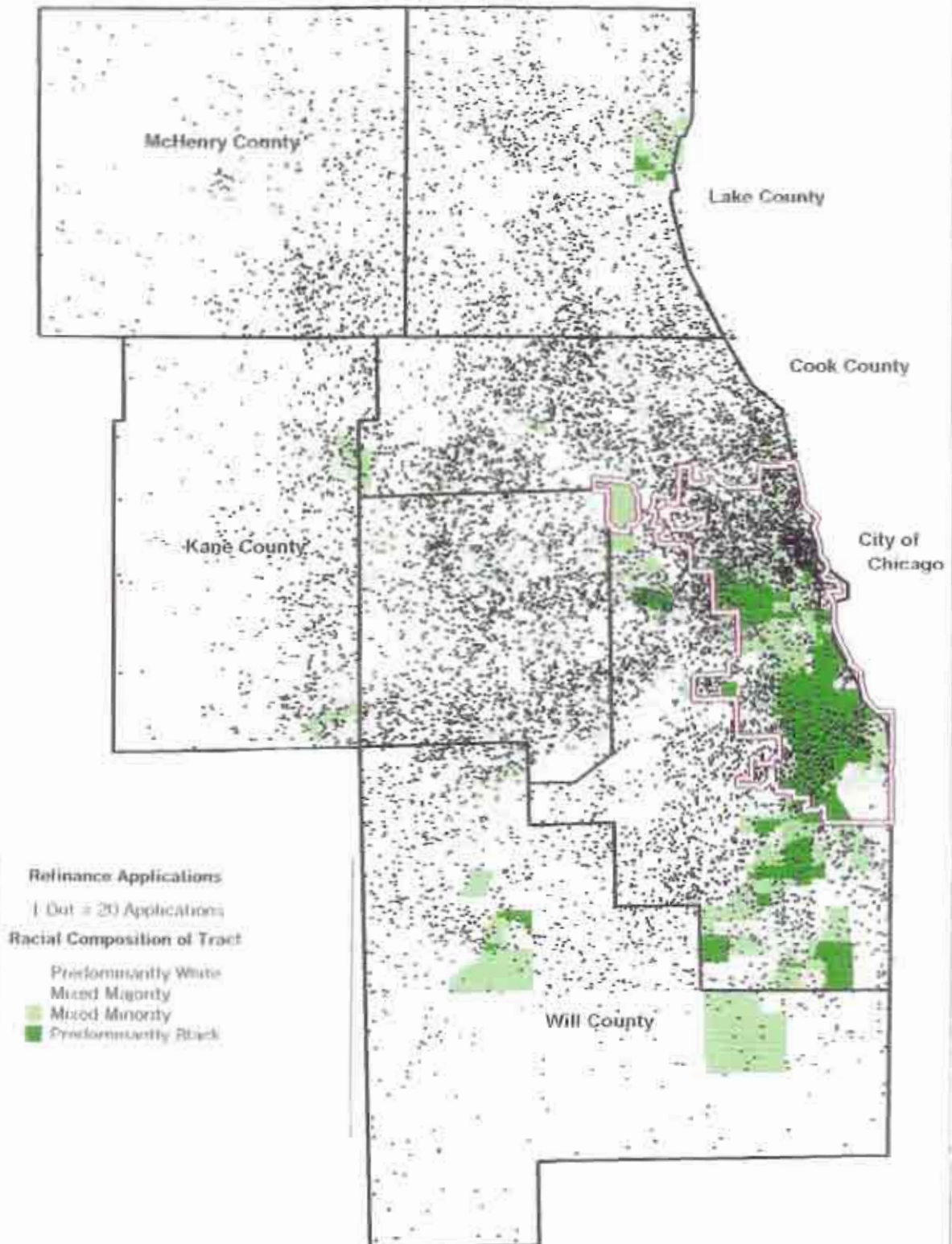
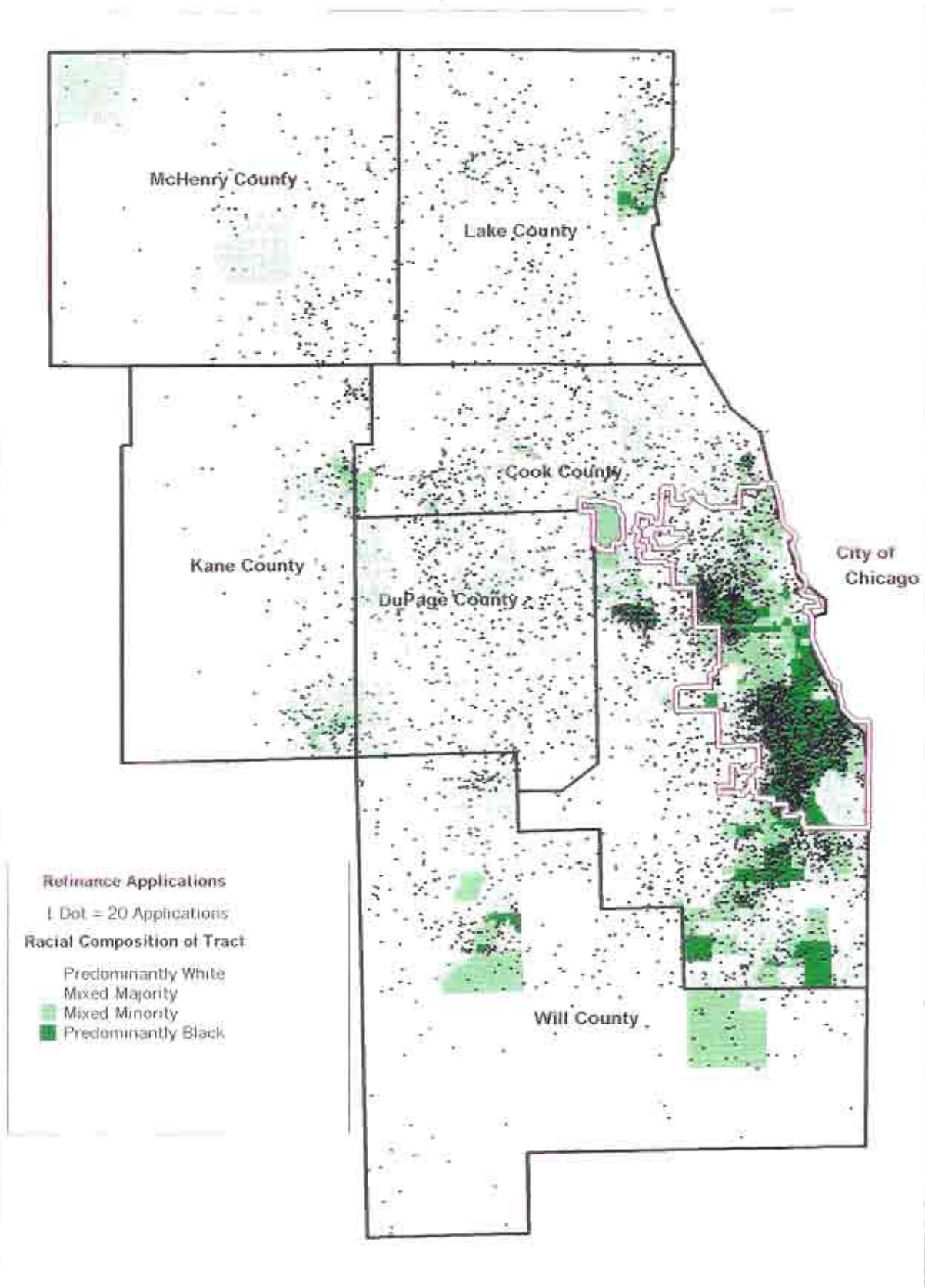
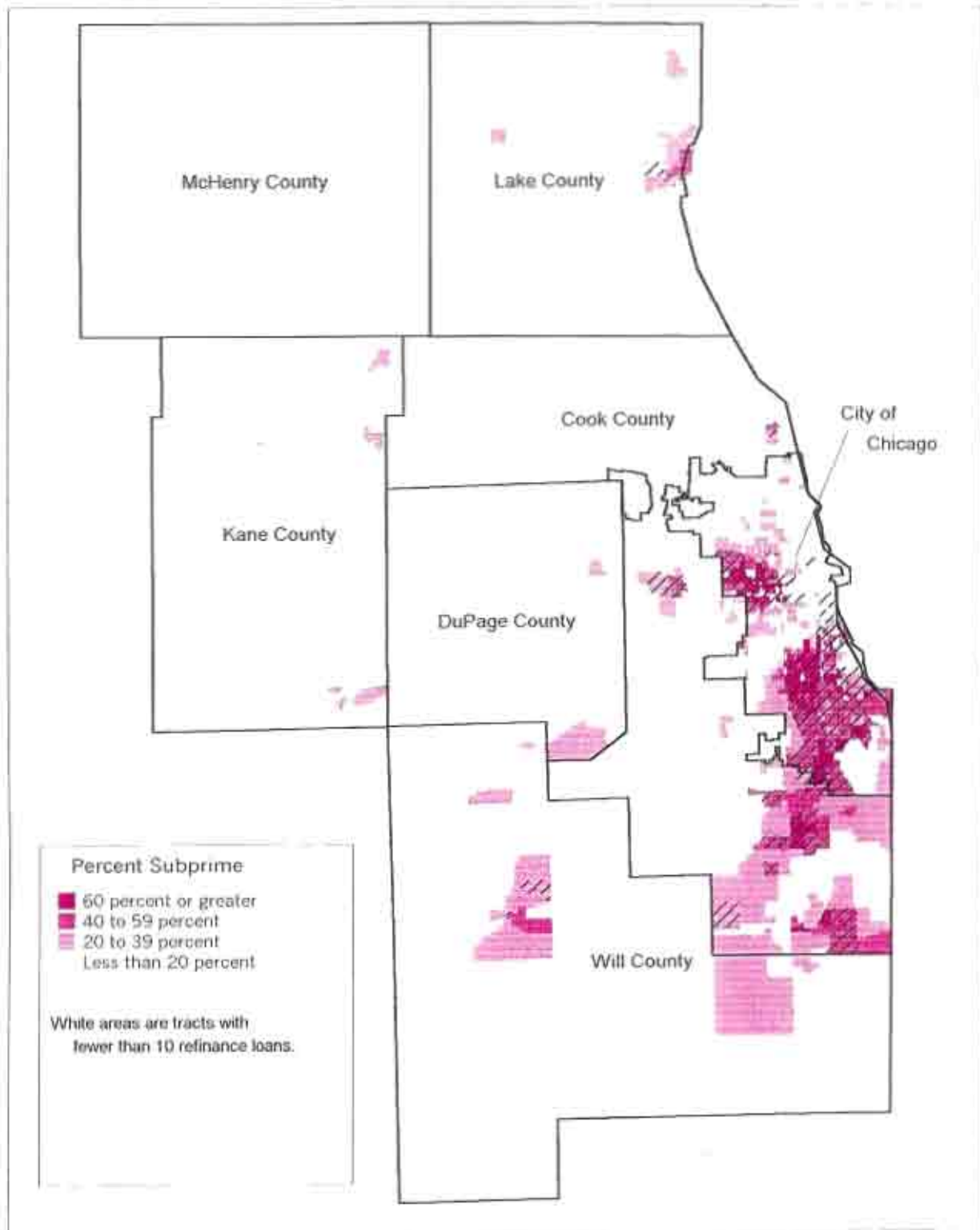


Figure 6. 1998 Conventional Refinance Applications of Subprime Lenders with Racial Composition of Tract



**Figure 7. Percentage of Refinance Loans Made by Subprime Lenders in 1998
(Predominantly black tracts are crosshatched)**



**Table 6. Geographic Distribution of Refinancing Applications
by Race of Neighborhood in Chicago Area, 1998**

Race/Ethnicity of Neighborhood	Loan and Lender Type			
	Conventional Prime	Conventional Subprime	Suprime/ Conventional	FHA-VA All
Predominantly African- American	12,223 24.64%	34,820 70.19%	74.02%	2,568 5.18%
Mixed-minority	22,145 48.03%	19,952 43.28%	47.40%	4,005 8.69%
Mixed-Majority	72,745 63.89%	31,380 27.56%	30.14%	9,741 8.55%
Predominantly White	136,851 74.93%	37,255 20.40%	21.40%	8,536 4.67%
All Loans	243,983 62.20%	123,413 31.46%	33.59%	24,850 6.34%

Table 7 compares refinance activity among middle-income neighborhoods only, thus partly controlling for the effect of neighborhood income on refinancing patterns. Even in the 40 middle-income African-American neighborhoods, subprime lenders still make more conventional refinancing loans than prime lenders. The subprime lenders' share of conventional loans increases from 12 percent in predominantly white, middle-income tracts to 53 percent in the predominantly black tracts, for a differential of 41 percentage points, not much less than the 48 point differential when comparing black and white neighborhoods of all income levels.

Another way to examine whether neighborhood race or income drives the patterns of subprime lenders is to use multivariate regression. This allows for measuring the independent effect of a number of neighborhood characteristics on the share of refinance loans made by subprime lenders.

Table 8 presents the results of a regression estimating the relationships between some key neighborhood variables and the proportion of refinance loans originated by subprime lenders. Because the subprime share of refinancing fluctuates widely in tracts with very few refinance loans, tracts with fewer than 20 loans were excluded from the regression. The independent variables include the number of owner-occupied housing units, median home value, the average real estate debt for households with such debt, the age of housing stock (measured by the percentage built after 1984), median household income, resident educational attainment

Table 7. Geographic Distribution of Refinancing Loans by Race Among Middle-Income Neighborhoods in Chicago Area, 1998

Race/Ethnicity of Middle-Income Tract	Number of Tracts	Loan and Lender Type			
		Conventional Prime	Conventional Subprime	Subprime/Conventional	FHA-VA All
Predominantly African-American	40	1,833 41.59%	2,090 47.42%	53.28%	484 10.98%
Mixed-minority	64	3,947 62.84%	1,448 23.05%	26.84%	886 14.11%
Mixed-Majority	236	30,325 75.93%	4,849 12.14%	13.79%	4,762 11.92%
Predominantly White	227	40,485 81.44%	5,537 11.14%	12.03%	3,687 7.42%
All Middle-Income Neighborhoods	567	76,590 76.34%	13,924 13.88%	15.38%	9,819 9.79%

(measured by the percentage of adults with a high school education), and whether the tract is located in the city of Chicago.²⁸ Also, three dummy variables (each equal to 0 or 1) are included that indicate whether the neighborhood is mixed-majority, mixed-minority, or predominantly African-American.²⁹

Of the variables in the regression, all are statistically significant except for the number of owner-occupied housing units and average real estate debt. The magnitudes of the standardized coefficients in the third column indicate which of these variables explain more of the variation in the share of loans made by subprime lenders. Thus, whether a neighborhood is predominantly African-American explains the greatest amount of variation in subprime lending, followed by educational attainment, median home value, and whether a neighborhood is mixed-minority. Holding median home value, income and other variables constant, going from an all-white to an all-black neighborhood increases the share of refinance loans made by subprime firms by 40 percentage points. Higher education levels, as might be expected, do have a negative effect on subprime lending, but the effect is not very large, especially compared to the race variable. A 20 percentage point increase in the proportion of residents finishing high school

²⁸All data are 1998 estimates produced by Claritas, Inc. See footnote 24. The household debt estimate is based on Claritas proprietary survey data.

²⁹Predominantly white is the omitted dummy variable. Note, the intent here is not to identify the specific mechanisms of racial segmentation, just to indicate that market is segmented by race much more than by income or home value.

Table 8. Ordinary Least Squares Regression of Subprime Lenders' Market ShareDependent Variable: Share of Refinancing Loans in Census Tract Made by Subprime Lenders³⁰

Variable	Coefficient	Standard Error	Standardized Coefficient	Significance Level
Constant	0.301	0.023		0.000
Owner-Occupied Units	5.91E-06	0.000	0.027	0.094
Median Home Value	-2.79E-07	0.000	-0.158	0.000
Average Real Estate Debt	-4.40E-07	0.000	-0.037	0.180
Percent of Housing Units Built After 1984 (0.0 to 1.0)	-8.56E-02	0.016	-0.076	0.000
Median Household Income	6.41E-07	0.000	0.103	0.000
Percent of Adults with High School Education (0.0 to 1.0)	-0.188	0.025	-0.166	0.000
Predominantly Black (0 or 1)	0.395	0.009	0.782	0.000
Mixed-Minority (0 or 1)	6.75E-02	0.008	0.149	0.000
Mixed-Majority (0 or 1)	1.56E-02	0.006	0.040	0.005
City (0 or 1)	-1.13E-02	0.006	-0.031	0.047

R² = 0.802

N = 1,478 (only tracts with 20 or more refinance loans are included)

All data are 1998 estimates

Bold variables are significant at the 0.05 level or below

-- a sizable increase -- results in less than a four percentage point decrease in the subprime share. The next most important determinant of subprime lending is median home value. A negative effect of higher home values on subprime activity is expected because prime lenders may compete more heavily in segments of the market with larger home values where their interest and fee returns are higher even at competitive rates. Holding race, income and other variables constant, a \$100,000 increase in median home value decreases the portion of refinance loans made by subprime lenders by only 2.8 percentage points. Thus, while lower home values explain some of the increased presence of subprime firms, race again has a much stronger independent impact.

³⁰To control for the problem of nonconstant variance, or heteroscedasticity, weighted least squares regressions with optimized weighting schemes were also run but are not shown here. Effects on the results were negligible.

Perhaps surprisingly, once race and home value are controlled, higher neighborhood incomes are actually associated with somewhat higher subprime lending shares, but the magnitude of the effect is almost negligible. It is important to be careful in interpreting this analysis. Since property values usually rise and minority populations fall as incomes increase, it is not accurate to say that higher-income neighborhoods are expected to have higher subprime lending shares. As Table 4 shows, this is not the case. However, after holding race and property values constant, lower incomes will not increase the level of subprime lending, suggesting that race, and not income is the stronger determinant of subprime patterns.

Race could, in part, be serving as a proxy for some missing variable, such as credit history. However, the very large magnitude of the race effect and the inclusion of other variables likely to be related to credit history makes it difficult to dismiss the bulk of the race effect with such an explanation. Moreover, the point remains that the hypersegmentation of the refinance market is more related to race than income.

The Growth of Subprime Activity by Neighborhood Group

As shown in Figure 2, refinance lending by subprime firms dramatically increased from 1993 to 1998 in the U.S. Table 9 details increases in the Chicago area by race of neighborhood. Overall, the percentage increase in subprime lending was lower in the Chicago area than for the nation as a whole due in large part to the fact that Household Bank, FSB, one of the earliest large subprime mortgage lenders, already had a major foothold in the local market in 1993. In fact, Household accounted for 58 percent of all refinance loans by subprime lenders in the Chicago area during 1993. Only 14 subprime lenders made conventional refinance loans in the Chicago area that year.

Table 9 also shows that subprime refinance lending was not nearly as segmented by race in 1993 as it was by 1998. Subprime lenders accounted for just over 8 percent of refinance loans in predominantly African-American neighborhoods in 1993, less than double the 4.3 percent share in predominantly white neighborhoods. (The figures for 1998, shown in Table 5, were 58.3 percent in black neighborhoods and 9.9 percent in white neighborhoods.)

Refinance loans by subprime lenders increased almost 30 times in African-American neighborhoods, while increasing by less than 2.5 times in white tracts. While accounting for less than 2 percent of all conventional refinance loans in 1993, predominantly African-American neighborhoods accounted for 34 percent of the increase in subprime refinance loans between 1993 and 1998. When adding in mixed-minority tracts, neighborhoods with greater than 50 percent minority populations accounted for 52 percent of the increase in subprime refinance loans, despite accounting for only 8 percent of all refinance loans in 1993.

Table 9. Increases in Prime and Subprime Refinance Loans by Race of Neighborhood in Chicago Area, 1993 -1998

Race/Ethnicity of Neighborhood	Loan and Lender Type				
	1993 Conventional Prime	1993 Conventional Subprime	1993 Suprime/ Conventional	1993-1998 Increase in Subprime	1993-1998 Percent Increase
Predominantly African-American	3,473	310	8.19%	8,910	2,874%
Mixed-Minority	12,862	683	5.04%	4,567	669%
Mixed-Majority	60,796	3,307	5.16%	5,271	159%
Predominantly White	121,556	5,414	4.26%	7,342	136%
All Loans	198,717	9,714	4.66%	26,091	269%

Lender Analysis

To get a better handle on the differences in refinance lending between white and African-American neighborhoods, it is helpful to examine the specific lenders active in the different communities. In order to understand where different lenders market, we first look at loan applications in predominantly white and predominantly African-American neighborhoods, and then consider origination activity.

Table 10 lists the 20 refinance lenders that took the most applications in predominantly white neighborhoods in the Chicago metropolitan area in 1998. It also indicates the share of all refinance applications that each lender took in predominantly white tracts as well as in predominantly African-American tracts. Finally, a black-to-white neighborhood disparity ratio is calculated. This ratio is equal to the lender's share of refinance applications in predominantly African-American tracts divided by its share of refinance applications in all predominantly white census tracts.

If a lender is focusing equally on both white and African-American neighborhoods, then the black-white disparity ratio is expected to equal 1.0. A disparity ratio above one means that a lender is more focused on marketing to African-American neighborhoods than to white areas. A ratio below one means that a lender markets more heavily in white neighborhoods. Table 11 provides similar information for African-American neighborhoods, giving the same information for lenders taking the most applications in predominantly black census tracts.

Table 10. Lenders with the Most Refinance Applications in Predominantly White Neighborhoods in the Chicago Area, 1998
(Subprime lenders shown in bold italics)

Lender	Number of Appl's in White Tracts	Share of Appl's in White Tracts	Share of Appl's in Black Tracts	Black-White Tract Disparity
First Chicago NBD Mortgage Co.	7,602	4.37%	1.13%	0.26
Norwest Mortgage	7,225	4.15%	0.34%	0.08
Countrywide Home Loans	5,833	3.35%	1.88%	0.56
<i>Chase Manhattan Mortgage Corp³¹</i>	5,504	3.16%	0.74%	0.23
Harris Trust And Savings Bank	4,776	2.74%	0.24%	0.09
Washington Mutual Bank	4,118	2.37%	0.45%	0.19
LaSalle Bank FSB	3,694	2.12%	0.97%	0.46
<i>Ameriquest Mortgage Company</i>	3,622	2.08%	5.68%	2.73
Mid America FSB	3,505	2.01%	0.05%	0.02
Citibank	2,917	1.68%	1.15%	0.69
<i>The Money Store</i>	2,790	1.60%	7.94%	4.95
Standard Federal Bank	2,765	1.59%	0.16%	0.10
Old Kent Mortgage Company	2,667	1.53%	0.40%	0.26
Bank Of America	2,504	1.44%	0.17%	0.12
North American Mortgage Company	2,407	1.38%	0.46%	0.33
Fleet Mortgage Corporation	2,292	1.32%	0.22%	0.17
Ohio Savings Bank	2,229	1.28%	0.12%	0.09
Fidelity Mortgage Inc.	2,177	1.25%	0.91%	0.73
Firststar Home Mortgage Corp.	1,986	1.14%	0.07%	0.06
Bank One	1,985	1.14%	1.42%	1.24

Immediately apparent is the fact that, of the 20 lenders receiving the most applications in predominantly white tracts, 17 are prime lenders, including banks and thrifts, bank-owned mortgage companies, and a few independent mortgage companies. The composition of the lenders receiving the most applications in predominantly African-American tracts is almost precisely the opposite, with 18 of the top 20 being subprime. Also, 14 of the 20 are independent mortgage companies, while 17 of the top 20 marketing lenders in predominantly white neighborhoods are banks or bank-owned mortgage companies.

³¹See footnote 22. HUD did not include Chase Manhattan Mortgage Corporation on its 1998 list of subprime lenders in *1998 HMDA Highlights*, but did include it in the appendix as one of a few "prime" lenders that do substantial amounts of subprime lending and have resulting high denial rates. Based on conversations with HUD staff and after examining the firm's denial rates and volume of refinancing in the Chicago market, the company was included as a subprime lender. However, some trade publications do not describe the company as a subprime lender. Inclusion of Chase Mortgage as subprime does not materially affect any of the results in this study and, in fact, biases the analysis toward showing less segmentation by race and income when looking at prime versus subprime lenders. Thus, the classification as subprime may result in an understatement of the problem.

Table 11. Lenders with the Most Refinance Applications in Predominantly African-American Neighborhoods in the Chicago Area, 1998
(Subprime lenders shown in bold italics)

Lender	Number of Appl's in Black Tracts	Share of Appl's in Black Tracts	Share of Appl's in White Tracts	Black-White Tract Disparity
<i>The Money Store</i>	3,733	7.94%	1.60%	4.96
<i>Ameriquest Mortgage Company</i>	2,674	5.68%	2.08%	2.73
<i>Equicredit Corp Of America</i>	1,501	3.19%	0.25%	12.76
<i>Advanta National Bank</i>	1,462	3.11%	0.70%	4.44
<i>New Century Mortgage Corp.</i>	1,196	2.54%	0.85%	2.99
<i>WMC Mortgage Corp.</i>	1,132	2.41%	0.54%	4.46
<i>Option One Mortgage Corporation</i>	1,075	2.29%	0.39%	5.86
<i>IMC Mortgage Company</i>	952	2.02%	0.31%	6.53
<i>Parkway Mortgage</i>	935	1.99%	0.21%	9.46
Countrywide Home Loans	885	1.88%	3.35%	0.56
<i>Pan American Financial Service</i>	881	1.87%	0.04%	46.82
<i>Superior Bank</i>	857	1.82%	0.29%	6.28
<i>BNC Mortgage</i>	840	1.79%	0.33%	5.41
<i>Pinnfund</i>	834	1.77%	0.10%	17.73
<i>First Franklin Financial Corp.</i>	832	1.77%	0.86%	2.06
<i>Banc One Financial Services</i>	814	1.73%	1.08%	1.60
<i>Delta Funding Corporation</i>	753	1.60%	0.08%	20.01
<i>Mortgage Lenders Network USA</i>	741	1.58%	0.20%	7.88
<i>Corewest Banc</i>	674	1.43%	0.28%	5.12
Bank One	666	1.42%	1.14%	1.24

Of the 17 lenders marketing most heavily in white neighborhoods, only two – Countrywide Home Loans and Bank One -- were among the top 20 marketers to African-American neighborhoods. Fourteen of these 17 prime lenders have a share of applications in African-American neighborhoods that is less than one-half their share in white neighborhoods. Ten of the 17 have a share of refinance applications in black tracts less than one-fourth their share in white tracts. One prime lender – Mid America FSB -- took more than 5,300 refinance applications in the six-county area but took only 25 in African-American tracts.³²

Of the top 20 refinance marketers in African-American neighborhoods, all but one have a substantially higher share of refinance applications in black tracts than in white tracts. All 18 of the subprime lenders in this list have a higher share of refinance applications in African-American neighborhoods than in white neighborhoods, with 14 having black-to-white tract disparity ratios exceeding 4 to 1. For four of the lenders, their marketing presence to African-American neighborhoods is more than ten times their presence in white neighborhoods. One

³²Despite these figures, Mid America FSB received an Outstanding CRA rating in 1999. This is due in part to being allowed to define an assessment area excluding almost 80 percent of the tracts in the metropolitan area even though it is the 8th largest refinance lender in a market with more than 700 refinance lenders.

lender, Pan American Financial Services, took 881 refinance applications in African-American neighborhoods but only 67 in white tracts.

Figures 8 through 10 provide illustrated examples of the marketing patterns of three major subprime lenders, Equicredit, Pan American Financial Services, and Pinnfund. The refinance applications of each of these lenders, as well as those of many others, are heavily concentrated in African-American communities.

Table 12 and 13 show the leading lenders in predominantly white and black neighborhoods by number of loans rather than applications. These rankings vary from Tables 10 and 11 due to differences in loan denial and acceptance rates. Because many subprime firms have high denial rates, some of those ranking in the top 20 among marketers to African-American neighborhoods do not end up among the top 20 by number of loans. Subprime firms generally end up ranked lower by number of loans in predominantly white neighborhoods as well.

However, Tables 12 and 13 confirm the findings of Tables 10 and 11 by showing that prime lenders are heavily concentrated in white neighborhoods. Moreover, 19 or 20 of the top 20 lenders in white neighborhoods are prime lenders, depending on the categorization of Chase Manhattan Mortgage Corp. Fifteen of the top 20 lenders in white neighborhoods have black-to-white disparity ratios for lending of 0.50 or less.

Similarly, subprime lenders dominate actual refinance lending, as well as marketing, in predominantly African-American neighborhoods. In black neighborhoods, 14 of the top 20 refinance lenders are subprime firms. Moreover, all 14 of these lenders have black-to-white disparity ratios for loans of greater than 6 to 1.

The segmentation of lending by race and neighborhood goes beyond differences between subprime and prime lenders. Even within the subprime lender category, there is significant segmentation by race, with some lenders clearly focused on black neighborhoods. Table 14 lists the 20 subprime lenders with the most refinance applications in black tracts. It indicates each lender's share of only the refinance applications *made by subprime lenders* in these neighborhoods. It also indicates each lender's rank among subprime lenders in white neighborhoods and its share of such applications.

Figure 8. Conventional Refinance Applications of Equicredit Corp. of America in 1998 with Racial Composition of Tract

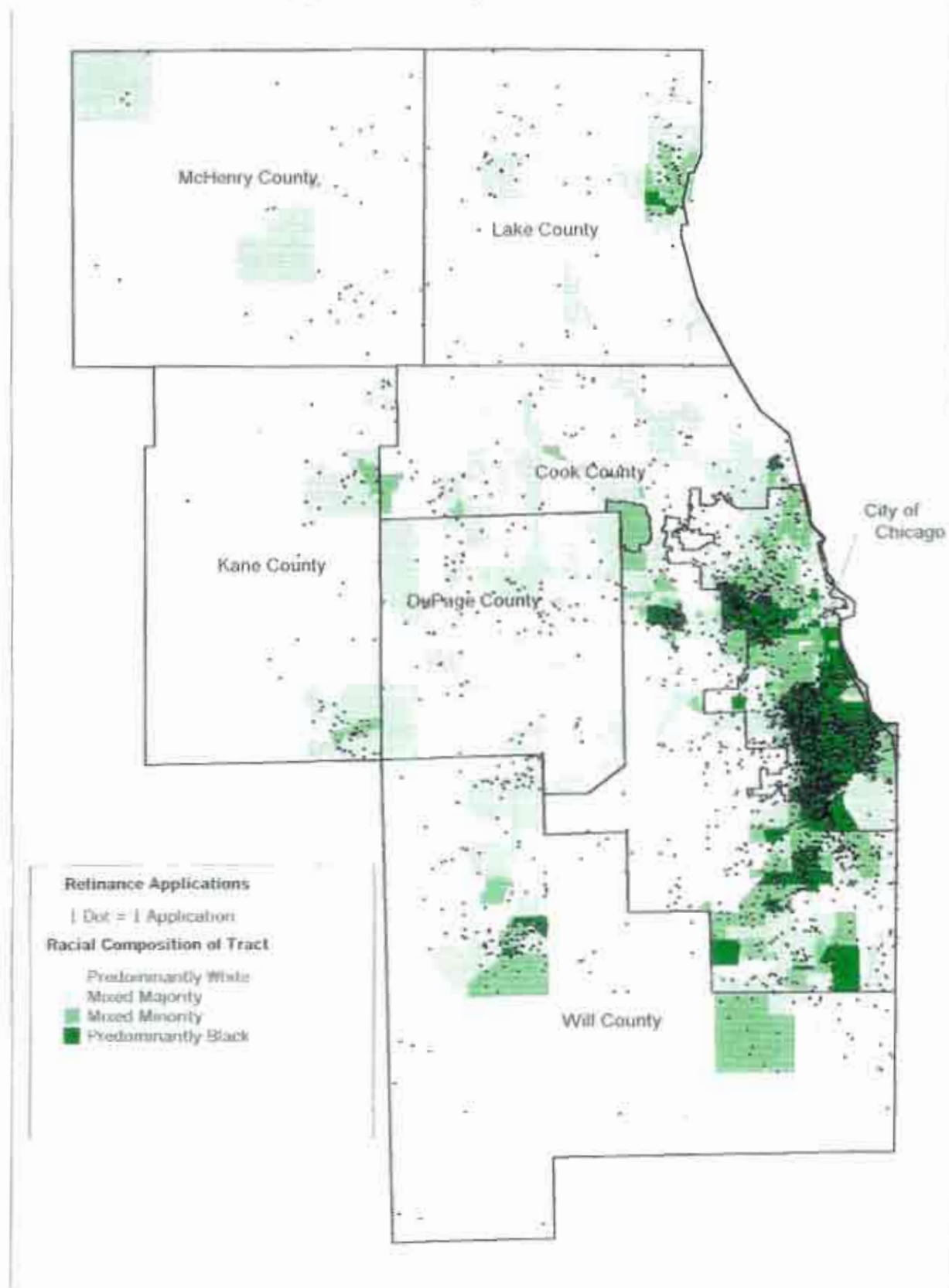
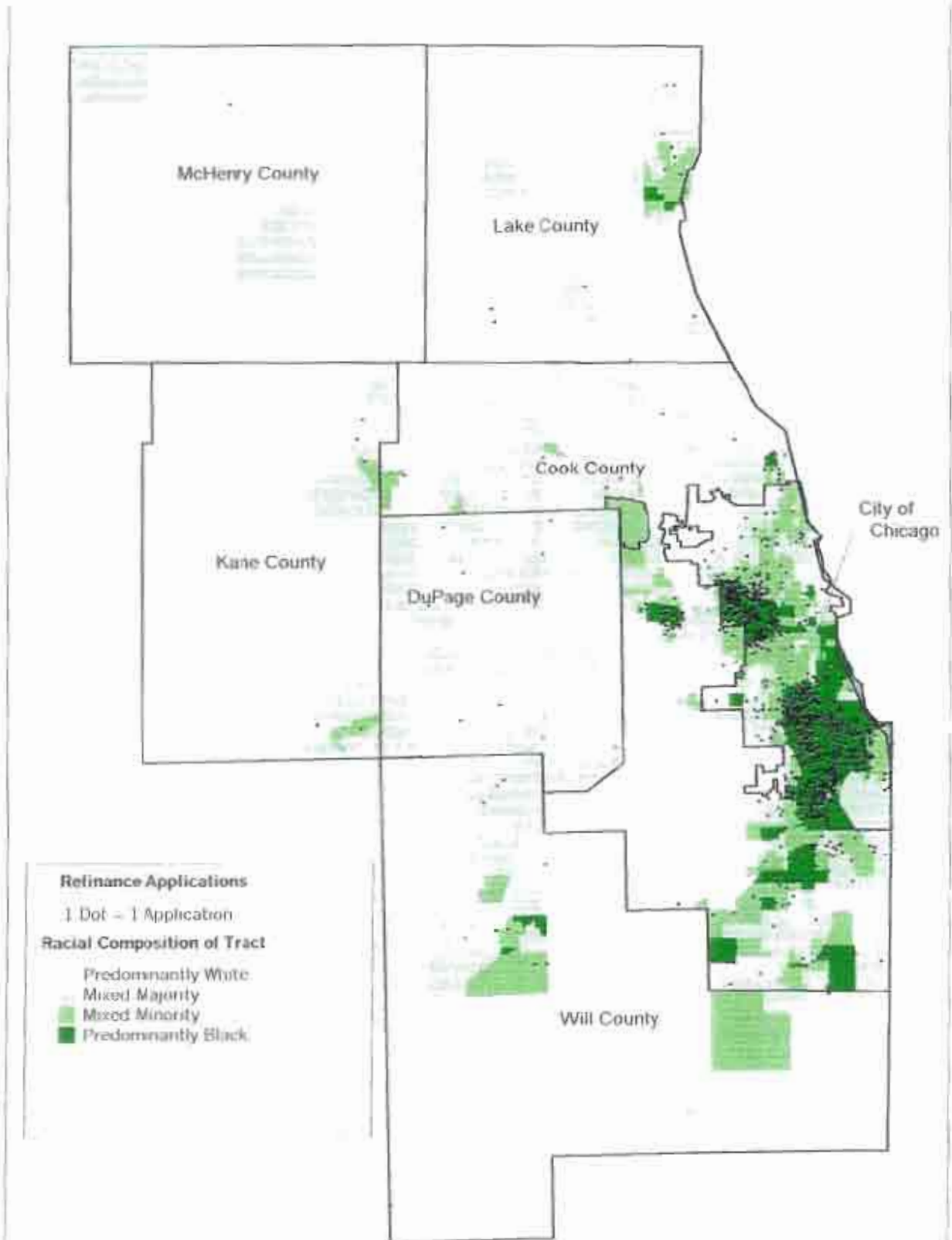


Figure 9. Conventional Refinance Applications of Pan American Financial Services in 1998 with Racial Composition of Tract



**Figure 10. Conventional Refinance Applications of Pinnfund, USA in 1998
with Racial Composition of Tract**

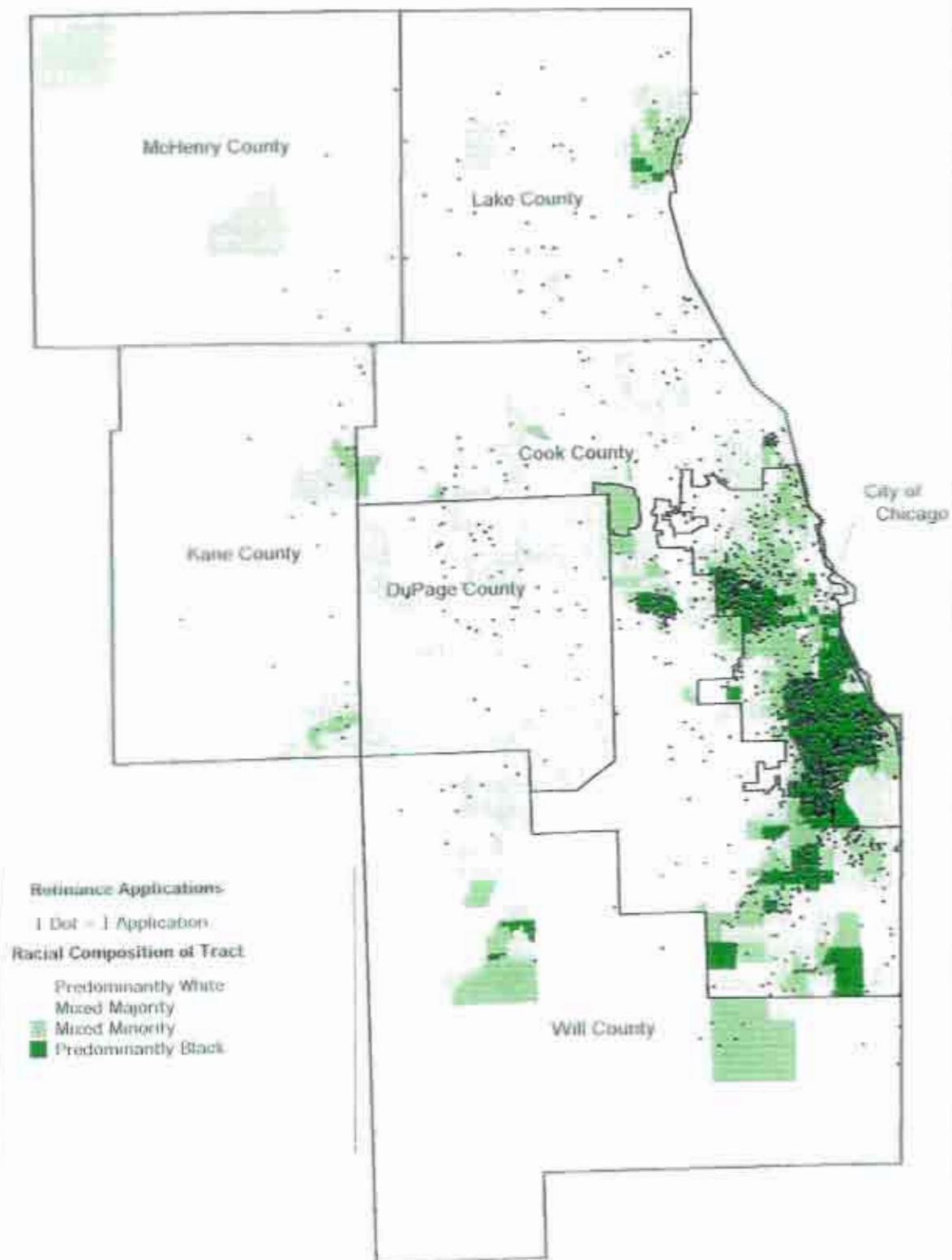


Table 12. Lenders with the Most Refinance Loans in Predominantly White Neighborhoods in the Chicago Area, 1998
(Subprime lenders shown in bold italics)

Lender	Number of Loans in White Tracts	Share of Loans in White Tracts	Share of Loans in Black Tracts	Black-White Tract Disparity
First Chicago NBD Mortgage Co.	7,068	5.47%	2.73%	0.50
Norwest Mortgage	6,539	5.06%	0.67%	0.13
<i>Chase Manhattan Mortgage Corp.</i> ³³	4,940	3.83%	1.19%	0.31
Countrywide Home Loans	4,488	3.48%	2.81%	0.81
Harris Trust And Savings Bank	4,335	3.36%	0.55%	0.16
Washington Mutual Bank	3,547	2.75%	0.95%	0.35
Mid America Bank FSB	3,299	2.56%	0.10%	0.04
LaSalle Bank FSB	3,283	2.54%	2.13%	0.84
Standard Federal Bank	2,490	1.93%	0.36%	0.19
Citibank	2,308	1.79%	1.95%	1.09
Old Kent Mortgage Company	2,235	1.73%	0.59%	0.34
Bank Of America	2,150	1.67%	0.33%	0.20
Ohio Savings Bank	1,965	1.52%	0.27%	0.18
North American Mortgage Company	1,944	1.51%	0.77%	0.51
Fleet Mortgage Corporation	1,923	1.49%	0.42%	0.28
Firststar Home Mortgage Corp.	1,809	1.40%	0.13%	0.09
Standard Financial Mortgage Co	1,695	1.31%	0.17%	0.13
Preferred Mortgage Assocs.	1,566	1.21%	0.13%	0.11
Crestar Mortgage Corporation	1,565	1.21%	0.09%	0.07
G.N. Mortgage	1,523	1.18%	0.94%	0.80

By looking only at the applications of subprime lenders, Table 14 shows another layer of segmentation by race and neighborhood – that within the subprime segment itself. Sixteen of the 20 lenders have disparity ratios greater than 1, with 13 having shares of subprime applications in black neighborhoods at least 50 percent greater than their shares of subprime applications in white neighborhoods. For 7 lenders, the disparity is greater than 2 to 1, suggesting large amounts of segmentation.

Equicredit, for example, ranks third in applications among subprime lenders in black tracts, but only 23rd among subprime lenders in white tracts. Pan American ranks tenth in black tracts but only 79th in white tracts. There are more examples of extreme segmentation, including Delta Funding, Pinnfund, and Parkway.

³³See footnote 24. Chase Manhattan Mortgage is not considered subprime by some industry sources.

Table 13. Lenders with the Most Refinance Loans in Predominantly African-American Neighborhoods in the Chicago Area, 1998
(Subprime lenders shown in bold italics)

Lender	Number of Loans in Black Tracts	Share of Loans in Black Tracts	Share of Loans in White Tracts	Black-White Tract Disparity
<i>Equicredit Corp of America</i>	696	4.40%	0.12%	36.67
<i>The Money Store</i>	672	4.25%	0.33%	12.88
<i>New Century Mortgage Corp.</i>	467	2.95%	0.40%	7.38
Countrywide Home Loans	445	2.81%	3.48%	0.81
First Chicago NBD Mortgage Co.	432	2.73%	5.47%	0.50
<i>Advanta National Bank</i>	394	2.49%	0.14%	17.79
<i>Mortgage Lenders Network USA</i>	366	2.31%	0.13%	17.80
<i>WMC Mortgage Corp.</i>	365	2.31%	0.35%	6.59
<i>Option One Mortgage Corporation</i>	356	2.25%	0.22%	10.23
LaSalle Bank FSB	337	2.13%	2.54%	0.84
<i>Ameriquest Mortgage Company</i>	320	2.02%	0.32%	6.32
Citibank	309	1.95%	1.79%	1.09
<i>Parkway Mortgage</i>	285	1.80%	0.09%	20.02
<i>Fieldstone Mortgage Company</i>	270	1.71%	0.12%	14.23
<i>BNC Mortgage</i>	261	1.65%	0.20%	8.25
<i>Contimortgage Corporation</i>	261	1.65%	0.09%	18.34
Bank One	256	1.62%	0.81%	2.00
<i>IMC Mortgage Company</i>	234	1.48%	0.09%	16.44
<i>Pinnfund</i>	218	1.38%	0.04%	34.46
TCF National Bank Illinois	207	1.31%	0.33%	3.97

Table 14. Subprime Lenders with the Most Refinance Applications in Predominantly Black Neighborhoods -- Share of Subprime Applications in Predominantly Black and Predominantly White Neighborhoods, Chicago Area, 1998

Lender	Black Tracts		White Tracts		Black-White Tract Subprime Disparity
	Subprime Rank	Share of Subprime Appl's	Subprime Rank	Share of Subprime Appl's	
The Money Store	1	10.72%	3	7.49%	1.43
Ameriquet Mortgage Comp.	2	7.68%	2	9.72%	0.79
Equicredit Corp Of America	3	4.31%	23	1.15%	3.75
Advanta National Bank	4	4.20%	8	3.27%	1.28
New Century Mortgage Corp.	5	3.43%	7	3.98%	0.86
WMC Mortgage Corp.	6	3.25%	9	2.51%	1.29
Option One Mortgage Corp.	7	3.09%	11	1.82%	1.69
IMC Mortgage Company	8	2.73%	14	1.44%	1.89
Parkway Mortgage	9	2.69%	27	1.00%	2.69
Pan American Financial Serv.	10	2.53%	79	0.08%	30.41
Superior Bank	11	2.46%	16	1.34%	1.83
BNC Mortgage	12	2.41%	13	1.54%	1.57
Pinnfund	13	2.40%	42	0.48%	4.99
First Franklin Financial Corp	14	2.39%	6	4.00%	0.60
Banc One Financial Services	15	2.34%	5	5.03%	0.46
Delta Funding Corporation	16	2.16%	44	0.39%	5.48
Mortgage Lenders Network	17	2.13%	30	0.93%	2.28
Corewest Banc	18	1.94%	18	1.29%	1.51
United Companies Lending	19	1.87%	37	0.58%	3.23
Key Bank USA	20	1.64%	20	1.19%	1.37

III. Predatory Lending and Public Policy

Consumer advocates, public interest attorneys, and even many lenders have become increasingly concerned about the predatory lending problem. Increasingly, community development practitioners, including those at community development corporations and community development financial institutions, have witnessed the toll that predatory lending takes on neighborhoods. Some residents become so entangled in debt that they are no longer eligible even for specialized community development finance programs. Families see their disposable income swallowed by excessive loan payments and fees. And perhaps worst of all, blocks are devastated by the scourge of foreclosure and neglected and abandoned properties. These problems quickly spill over into a worsened climate for investment in home buying, repair and upkeep, creating a cycle of disinvestment.

Predatory lending has reached a scale where it has now been recognized as a major community development problem. It threatens decades of effort in promoting homeownership as a means of wealth creation and neighborhood stabilization.

A number of policy responses have been suggested to curb predatory lending.³⁴ Most of these have been fairly direct attempts to regulate the fees, rates, terms, and conditions of mortgage loans. Some have also recommended removing federal preemptions of state consumer lending laws.³⁵ These approaches hold substantial promise. At the same time, the growth of specialized subprime lenders and predatory lending is symptomatic of the fundamental segmentation that persists in financial markets. A comprehensive strategy to reduce predatory lending should include efforts to increase the presence of conventional, prime lenders who serve a broad spectrum of homeowners and who are subject to a larger set of consumer and community reinvestment regulations. Thus, Community Reinvestment Act and Fair Lending policies can be key tools in the fight against predatory lending, especially if implementation and enforcement are improved.

Restricting Lender Practices and Loan Terms

At the federal level, the Truth-In-Lending-Act was amended by the Home Ownership and Equity Protection Act (HOEPA), which went into effect in 1995. HOEPA and its regulations establish a cost threshold, which, once exceeded, triggers a set of restrictions on lending practices. These

³⁴See for example, M. Saunders, National Consumer Law Center, testimony before the Senate Banking Committee on the changes in the Truth in Lending, July 9, 1997; and The Coalition for Responsible Lending, "The Case Against Predatory Lending."

³⁵The two federal laws of particular impact here include the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Alternative Mortgage Transactions Parity Act of 1983. The former preempts most state laws on regulating interest rates on first mortgages. Sixteen states opted out of this preemption during an expired opt-out period. The later law preempts many types of state laws restricting loan terms such as balloon payments and negative amortizations. For more details see K. Keest, *The Cost of Credit: Regulation and Legal Challenges*, National Consumer Law Center, Boston, 1996.

restrictions include prohibitions against balloon payments for loans of less than five years, prepayment penalties, payments that are less than interest and so result in increasing principal balances (known as negative amortization), and asset-based lending. The HOEPA regulations currently define a high-cost loan as one with an APR (annual percentage rate) that exceeds the yield on comparable-term Treasury securities by more than 10 percentage points or one where points and fees exceed 8 percent of the loan amount (or \$441, whichever is greater). The HOEPA interest rate “trigger” can be lowered somewhat by Federal Reserve regulation.

HOEPA has been severely criticized both for having a trigger that is too high and for having restrictions that are too weak. Some have argued that the law's high triggers act as a price-setting tool for the industry, so that many subprime lenders price their loans just below the trigger, but still at very high rates. Others point out that some of the restrictions are insignificant because they apply to few loans (e.g., restrictions on balloon payments only for loans with terms of less than five years).

Two states have recently taken steps to go further than HOEPA in direct restrictions on high-cost loans. North Carolina recently enacted legislation that follows the HOEPA approach, but with a lower threshold and stronger restrictions. New York State is, at the time of this publication, considering a proposal similar to North Carolina's through a regulatory process. Key to such efforts is a prohibition against financing fees in a high-cost loan. Other prohibited practices for high-cost loans include: refinancing a high-cost loan with another high-cost loan, balloon payments, negative amortization, and the selling or financing of unnecessary insurance products. The law also prohibits the financing of lump-sum credit insurance in any home-secured loan. Other states are beginning to consider comparable approaches. For example, Illinois has recently held legislative hearings to consider legislation similar to the North Carolina law.

While state efforts against predatory lending are likely to reduce predatory lending, at least in the near term, lenders shifting institutional structure may be able to avoid state regulations in the long run. National banks and thrifts benefit from broad preemption of state banking and lending regulations. Thus, efforts to strengthen HOEPA should be part of a mixed state-federal strategy.

Reversing De Facto Deregulation

The shift of mortgage lending from depository institutions to mortgage companies has drastically reduced the proportion of home lending being examined by bank and thrift regulators. These agencies are much better staffed than the Federal Trade Commission (FTC) in enforcing Truth in Lending (including HOEPA) regulations and fair lending rules. Moreover, the mortgage companies are not regulated for CRA. For mortgage companies, especially

independent ones, the FTC has principal enforcement powers over HOEPA and the Equal Credit Opportunity Act (ECOA), which prohibits lending discrimination. Independent mortgage companies, as shown above, are the dominant subprime lenders in minority and lower-income communities, yet they are largely unregulated. The FTC has fewer than 40 staff in its consumer credit division, which is responsible for the entire country. Moreover, the division's responsibility covers much more than home lending regulations.

The combination of changes in mortgage lending markets and the inability of federal regulators to adapt to these changes has resulted in the *de facto* deregulation of lenders that focus on minority communities. As a consequence, a two-tiered regulatory system has evolved, with institutions lending to white and more affluent communities subject to significant regulation, while those targeting minority communities receive much less effective oversight. This *de facto* deregulation is layered on top of the *de jure* deregulation provided by the federal preemption of state consumer lending laws described above.

Without a fundamental reorganization of priorities in regulating home lending, it will be difficult to achieve substantial success, even with better state or federal consumer compliance laws. Absent a new commitment to increased enforcement, particularly in impacted communities, any body of regulation will be routinely skirted or ignored by many lenders and brokers.

Federal Fair Lending As A Tool Against Predatory Lending

Federal fair lending policies prohibit home lending practices that involve disparate treatment of, and some disparate impacts on, protected classes (e.g., minority groups, the disabled, etc.). The four bank regulatory agencies have recently issued new procedures for fair lending examinations of banks and thrifts and their affiliate mortgage companies.

Traditionally, fair lending enforcement has concerned differences in approval practices between white and minority homebuyers. However, there has been increasing attention to pricing and steering issues by fair lending examiners. New examination procedures for bank and thrift regulators include as one "focal point" an analysis of steering of applicants of a protected class (e.g., minority or disabled) to inferior products or higher-cost affiliates. In the fair lending context, steering refers to directing applicants of a protected class to high-cost credit while directing others to lower-cost credit. In the case of banks with subprime affiliates, this includes steering of minority applicants to the subprime organization. The procedures also call for examining whether pricing, terms, and conditions vary for protected classes. Because subprime lenders are sometimes affiliated with banks or bank holding companies, these procedures can enable bank examiners to identify the steering of minority groups away from a prime lender (often a bank) and towards an affiliated subprime lender.

Another aspect of federal fair lending law that has particular relevance to predatory lending problems is Regulation B of the Equal Credit Opportunity Act. This regulation contains a section that can be used to hold those purchasing loans, such as banks, accountable for the discriminatory practices of the originators of the loans.³⁶ It also can be used to hold lenders accountable for the discriminatory actions of brokers. Depending on how the law is interpreted and enforced, this may prove a powerful deterrent to the purchasing of loans made by lenders suspected of discriminatory steering or related predatory practices. In addition to fair lending laws running to secondary market participants, HOEPA has a provision in which purchasers as well as originators³⁷ of high-cost loans violating HOEPA bear liability for violations. These extensions to the secondary market, if enforced, could reduce the capital available to such lenders, making their operations more difficult.

Again, the primary regulator of ECOA for many subprime lenders is the FTC, which currently has very limited resources available for identifying and pursuing fair lending violations. While the Justice Department and HUD could also play a role in identifying or prosecuting lending discrimination, their resources are also quite limited.

The Community Reinvestment Act and Predatory Lending

A primary method for encouraging prime financial institutions to serve the full spectrum of financing needs in minority- and lower-income communities is to improve the implementation and enforcement of the Community Reinvestment Act. Strengthening CRA could serve two fundamental purposes. First, it would encourage more prime lenders to serve lower-income and minority communities, thereby leaving less market opportunity for subprime firms. Second, the law could be used to encourage better lending by mortgage and finance companies. Ideally, all mortgage and finance companies should be subject to CRA regulation. The simplest extension of CRA would be to lenders affiliated with banks, usually through bank holding companies.

Banks and thrifts, which are directly covered under CRA, are routinely examined under three component tests: 1) the lending test; 2) the investment test; and 3) the service test. Performance under these tests is considered when banks apply to regulators for permission to merge. Also, the ratings have implications for the public relations image of larger banks and, in some cases, are used by governments and nonprofits in choosing where to bank.

³⁶At this writing, Regulation B is subject to proposed modifications. The current Federal Reserve proposal includes the following language: "The Board believes that, depending on the circumstances, the 'reasonable notice' (of discrimination by a contracted party) standard may carry with it the need for a creditor to exercise some degree of diligence with respect to third parties' involvement in credit transactions, such as brokers or the originators of loans." The definition of a creditor can include the purchaser of loans.

³⁷National Consumer Law Center, *Truth in Lending*, from the Consumer Credit and Sale Legal Practice Series, 1995 with 1998 Supplement.

CRA is broadly acknowledged to be a powerful tool in pushing banks and thrifts to lend and invest more in lower-income communities. At the same time, the details of CRA implementation can have significant impacts on how well the regulation promotes sound community reinvestment. A fundamental problem with CRA regulation that contributes to the racial segmentation of lending markets is the fact that financial institutions are allowed, with very limited oversight, to choose the geographic area – or assessment area -- for which they are evaluated. They are allowed to circumscribe their assessment area around their branch locations. Thus, banks that have few branches in or near minority neighborhoods are able to exclude such areas from their assessment areas. Requiring banks and thrifts, especially larger ones, to include entire metropolitan areas in their assessment areas is critical to reducing the hypersegmentation of the mortgage marketplace.

There are at least five additional features of current CRA evaluation that, depending on their implementation, can work to encourage or discourage predatory lending. First, under the lending test, there has traditionally been a heavy focus on home purchase lending. While activity in this area is important, the relatively small amount of attention given to refinance and second mortgage lending has meant that banks tend not to view serving the needs of minority- and lower-income communities in these product lines as a priority. Many banks have made significant progress in home purchase lending in underserved communities, but have little presence in the refinance markets in the same areas.

Second, under the lending test, little effort is being made to gauge the quality of a bank or thrift's lending. Therefore, lending is evaluated primarily for the proportion and quantity of lending to lower-income borrowers and neighborhoods. Because the pricing and terms of the lending are rarely examined in the CRA context, high-cost and even predatory loans are likely to receive as much credit as conventional lending. And because predatory lenders may concentrate in lower-income communities, they may be receiving high marks under the lending test.

Third, under current rules, banks receive credit for the loans that they purchase as well as the ones they originate, and there is no formal discounting of the former. (Many community-based groups and advocates have argued against these rules, commenting that originations should receive substantially more weight than purchases). Combined with the failure to consider the quality as well as quantity of loans, this creates an incentive for banks to buy predatory loans, since many are located in lower-income areas or go to lower-income borrowers.

Fourth, CRA examiners include loans made by an affiliate mortgage company in the evaluation of a bank or thrift's lending at the *institution's* option. Even if examiners consider the nature of the lending, if a bank chooses it can avoid CRA scrutiny of these loans. Alternatively, under the current practice of not considering the quality of loans, the lender may be rewarded for the predatory lending of an affiliate mortgage company.

Finally, investments by banks and thrifts in mortgage-backed securities that are “targeted” to lower-income communities or families are eligible for CRA credit under the investment test. If such securities are backed by predatory loans, then, again, the current CRA rules may be allowing CRA credit for such investments, thereby encouraging the flow of capital to predatory lenders.

Policy Recommendations

A large body of state and federal law is involved in the home lending process, including consumer protection, community reinvestment, and fair lending statutes and regulations. Therefore, there are number of vehicles available for addressing different parts of the predatory lending problem. As a result there have been a wide variety of suggested policies to reduce the problem. Including all of the possible remedies is beyond the scope of this report.

Reducing predatory lending substantially is likely to require a number of policy tools. To date, many of the recommendations on predatory lending policy have focused on changes to consumer protection law. While these measures, particularly changes in HOEPA, are recommended, we also emphasize improved policy changes in community reinvestment and fair lending laws and increased enforcement of consumer lending, fair lending and CRA in this arena. This is both because others have already developed detailed proposals for reforming consumer protection laws and because the focus here is on the geographic, racial, and community development impacts of predatory lending.

➤ *Strengthen Federal Consumer Protection Laws*

Federal regulations under HOEPA and other relevant consumer protection statutes should be strengthened. First, the threshold for defining a high-cost loan should be lowered, at least to the level of the New York proposed regulations, which include a threshold of fees equaling 5 percent of the total loan amount or an APR of the corresponding treasury rate plus 8 percentage points. Many argue that this threshold is still too high. The restrictions on HOEPA loans should be increased. In recommendations made in July of 1998, the U.S. Department of Housing and Urban Development and the Federal Reserve Board recommended prohibiting balloon payments for all HOEPA loans and prohibiting advance collection of lump-sum credit insurance as well as some improved consumer disclosures.³⁸ HUD went on to make a number of additional recommendations, some of which include:

³⁸Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development, *Joint Report to the Congress Concerning Reform of the Truth in Lending Act and the Real Estate Settlement Procedures Act*, Washington, D.C. July, 1998.

- Lowering HOEPA thresholds
- Prohibiting loan flipping
- Requiring lenders to account for the consumer's ability to pay
- Expanding the class of prohibited prepayment penalties
- Requiring education and pre-transaction counseling for certain consumers

While HUD's recommendations appear to be the minimum necessary to provide some reduction of predatory lending, the 1999 North Carolina law and the New York proposed regulation described above offer even stronger models. Some features of that have been suggested in model legislation by the Coalition for Responsible Lending in North Carolina include:

- Prohibiting the financing of fees in high-cost loans
- Prohibiting balloon payments in high-cost loans
- Restricting the refinancing of one high-cost loan with another high-cost loan
- Not permitting loans to contain yield spread premiums and prepayment penalties. The yield spread premium gives brokers an incentive to charge very high interest rates. The prepayment penalty then locks homeowners into the high rate loan.
- Including all financing fees, excluding third party fees such as title insurance and recording fees, in the calculation of the fee threshold defining a high-cost loan.

➤ ***Increase Enforcement Resources Devoted to Predatory Lending Issues***

The staffing and resources at the Federal Trade Commission and the Department of Justice devoted to predatory lending issues and discrimination in loan pricing should be drastically increased. Private enforcement of consumer protection and fair lending laws is inadequate for controlling the problem. Victimized homeowners are generally not in a position to obtain legal assistance and few attorneys can fund these cases in the hope of obtaining fees in the event of a successful suit or settlement.

Currently, the FTC, with fewer than 40 staff to cover these problems across the entire country, is woefully understaffed for regulating the explosion of subprime lending and the abuses that have accompanied it. Most reported abuses are linked to mortgage companies under their purview. Thus, a severely understaffed agency is responsible for regulating a major new industry. Moreover, these lenders are the ones that dominate the refinance and home equity markets in most minority and lower-income neighborhoods. By not adapting to changes in the mortgage marketplace, the federal government has allowed for the development of a race-

based, two-tiered regulatory system, with lenders in white areas being held to much higher standards than those in minority communities.

➤ ***Promote Stronger State Regulation of Home Lending***

The North Carolina and New York laws provide promising models for improved federal regulation.³⁹ However, in the short run at least, state action may be more feasible. In the absence of strong federal changes in home lending rules, state reforms should be advanced. The North Carolina/New York laws should reduce the magnitude of the predatory lending problem. Efforts to increase the regulation of mortgage brokers are also needed, as has been proposed in North Carolina.

Currently, however, some state laws may be subject to preemption by national banking laws. State regulation improves generally, thrifts and national banks may become increasingly important vehicles for avoiding state rules. If the federal government chooses not to provide meaningful regulation in this area, it should, at a minimum, allow states to step in to protect their homeowners. Thus, federal preemption laws should be changed to allow for states to provide for higher levels of consumer protection than those provided by HOEPA.

In addition to establishing regulations on loan terms and practices, states generally need to strengthen their enforcement of existing laws and develop a proactive approach for identifying lending abuses. States tend to devote meager resources to regulating consumer finance issues, and many operate in a complaint response mode. Where state licensing exists it is often a rubber-stamp process with no real examination of lender practices. States should follow the federal models of fair lending and community reinvestment examination of banks and thrifts. State regulators should examine lender files for unfair pricing or terms, improper disclosures, and fraudulent practices. Most importantly, state regulators should not merely respond to consumer complaints but conduct regular, proactive and systematic examinations to identify patterns of abuse or discrimination.

Finally, in order to aid their enforcement efforts and to provide federal agencies, community organizations, and others with better information on subprime lenders, states can require licensed mortgage lenders to report data on loans, including rates, fees, etc., and can make these data available to the public. Home Mortgage Disclosure Act data has proven a powerful tool in improving access to credit. But HMDA data lack key information on costs and terms, do not include many second mortgage home equity loans, and miss some lenders entirely due to some exemptions in the law. Ideally, of course, such data would be collected at the federal level.

³⁹The North Carolina legislation is available at www.responsiblelending.org. The New York proposal can be found at www.banking.state.ny.us/41amd.htm.

➤ ***Expand Fair Lending Regulation and Enforcement***

Despite some increased attention to fair lending aspects of the predatory lending problem, the scrutiny of refinance and home equity lending patterns -- particularly by mortgage companies -- is still very limited in part due to the limited resources of the FTC and the Department of Justice. The FTC must be given the resources and direction to conduct regular fair lending exams of major subprime lenders. HUD should utilize Secretary-initiated investigations against major subprime firms that appear to be targeting minority homeowners and neighborhoods.

Even in bank regulators' fair lending examinations, much more can be done. For example, Mathew Lee, a community activist in New York City, has argued that a subprime lender with a prime affiliate should be required to "refer up" a customer whom it knows can qualify for a loan through the affiliate.⁴⁰ Currently, fair lending regulators do not require such practice. Lee contends that, given the disproportionate number of minority subprime borrowers, the lack of such referrals constitutes disparate impact discrimination.

➤ ***Eliminate CRA Credit for Predatory Lending and Utilize CRA to Encourage Responsible Refinance and Home Equity/Improvement Lending***

There are six fairly modest modifications to CRA policy that could work to significantly reduce the predatory lending problem.

- Regulators must not allow prime lenders to establish CRA assessment areas that do not include minority and low-income areas. While such a prohibition is contained in CRA regulations, it is not effectively enforced in many cases. Large lenders, in particular, should not have assessment areas that exclude any significant part of a metropolitan area that contains substantial low-income or minority populations. This does not mean that a lender is required to make similar numbers of loans in every part of a metropolitan area. Rather, it establishes an equitable basis on which to judge a lender's CRA performance.
- Regulators should give more attention to patterns of refinance and home equity lending. CRA examinations often focus on home purchase loans or do not break out specific products at all. Also, strengthening CRA enforcement overall, including reducing the exceedingly high percentages of institutions receiving Satisfactory or Outstanding ratings, would make CRA a stronger incentive for responsible lending.

⁴⁰M. Lee, *Inner City Press' Community Reinvestment Reporter*, New York, August 30, 1999, <http://www.Innercitypress.org/crereport.html>.

- Much more effort should be made to evaluate the quality as well as quantity of lending. The failure to examine loan pricing and terms in CRA exams means that high-cost and even predatory loans are likely to receive as much credit as conventional loans. Because predatory lenders often concentrate in minority areas, they may be receiving high marks under the lending test. Examiners should follow sampling and testing methods similar to those in fair lending exams and determine whether loans are low- or high-cost. In the process, examiners should look for violations of consumer compliance laws. High-cost loans should be given less credit than low-cost loans.
- If banks are allowed to continue to receive credit for buying as well as originating loans, these loans should be scrutinized carefully to avoid encouraging predatory activity.
- All the lending of affiliate mortgage companies should be considered when CRA exams are conducted. Otherwise, the subprime activity is unlikely to be considered. The current policy of allowing the bank discretion over whether the affiliate activity is included should be dropped.
- Any credit given to investments in mortgage-backed securities should be carefully examined. At a minimum, the loans underlying the securities should be examined to test for violations in consumer compliance laws as well as fair lending problems. More proactively, examiners could identify the pricing and terms of the loans to determine how costly the loans are. Investments in high-cost loans to LMI borrowers should be given less credit than investments in low-cost loans. Alternatively, investment test credit for mortgage-backed securities could be eliminated altogether. There are additional arguments for such a policy that are beyond the scope of this report.

➤ ***Increase Financial Literacy and Access to Legal Services***

Another complementary strategy for reducing the debt problems of lower-income and minority households and neighborhoods is to increase the capacity of homeowners to discern unfair credit offers, either by themselves or with assistance. While necessary, consumer disclosure – the primary approach of federal consumer lending laws – is a woefully inadequate tool for improving homeowner discretion. Homeowners must be made more skeptical of those offering credit cards, refinance, and home equity loans. The ability of lower-income homeowners to obtain the aid of a legal assistance organization with expertise in mortgage lending could prove a cost-effective approach to reducing abusive lending.

Financial literacy programs can also serve to increase the sophistication of homeowners in financial matters. Homeownership counseling must help prepare existing and prospective homeowners for their financial dealings after buying a home. For example, the National

Consumer Law Center conducts workshops around the country for housing counselors on how to advise homeowners to avoid mortgage difficulties. More needs to be known about how best to deliver financial literacy programs aimed at homeowners or prospective homeowners.

Woodstock Institute

Woodstock Institute, a Chicago nonprofit incorporated in 1973, works locally and nationally to promote community reinvestment and economic development in lower-income and minority communities. It collaborates with community organizations, financial institutions, foundations, government agencies, and others to promote its goals.

The Institute engages in applied research, policy analysis, technical assistance, public education, and program design and evaluation. Its areas of expertise include: CRA and Fair Lending policies, financial and insurance services, small business lending, community development financial institutions, and economic development strategies.

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