Predatory Lending
The New Face of Economic Injustice

By Nikitra S. Bailey

Only a few years ago, the scarcity of credit was a problem for women, low-income Americans, and borrowers in communities of color. Today, because of advances in technology and changes in the marketplace, many in these same populations are bombarded with offers from subprime mortgage lenders, check cashers, payday lenders, and other fringe bankers. Credit in the United States is now more widely available than ever before. Yet this expansion has been accompanied by a sharp rise in predatory lending, which undermines the economic benefits of home ownership and helps perpetuate the widening wealth gap between whites and people of color.

Predatory lending occurs when lenders impose excessive or unnecessary fees or steer borrowers into expensive loans when they could qualify for more affordable credit. The costs and fees packed in predatory loans extend beyond reasonable risk-based pricing. The Center for Responsible Lending estimates that predatory lending of all kinds costs American borrowers $25 billion annually. The problem has gotten worse as the subprime lending market continues to expand.

Today, subprime mortgages represent the fastest growing segment of consumer finance. In addition, an industry of "alternative" types of consumer financing, including payday lending, car title lending, and high-cost overdraft lending, has quickly expanded. As one indicator of their proliferation, *Sixty Minutes* recently reported that payday lending shops in the United States now outnumber McDonald's restaurants.

As fringe lenders become a pervasive presence in low-wealth neighborhoods, economic justice concerns have shifted away from *access* and to the *terms* of credit. White borrowers tend to be served by banks and other conventional institutions in the prime market. In contrast, people of color, women, and the elderly are targeted by high-cost lenders. Consider the case of Ira and Hazel Cheatham. Ira Cheatham is a seventy-three-year-old retired veteran who has lived with his wife, Hazel, in a predominantly African American neighborhood of Portland, Oregon, for twenty-one years. In 2002, when they had nearly paid off their mortgage, the Cheathams received a check for roughly $1,000 in the mail from a finance company. For an older couple living on limited retirement income, the sudden appearance of this money seemed like a dream come true. They cashed the check and in the process took out a very high-interest loan.

The lender followed up by calling the Cheathams and urging them to consolidate the loan with their credit card debt into a single mortgage. The Cheathams, who apparently had good credit at the time, were promised an interest rate between 5 and 6 percent. However, when the loan papers were presented, the interest rate was 9.9 percent, with an annual percentage rate of 11.8 percent. Moreover, their loan contained ten "discount points" amounting to $15,289. The lender financed these points as part of the loan, stripping away equity the Cheathams had earned through years of mortgage payments. The loan also contained a prepayment penalty, requiring the Cheathams to pay the lender approximately $7,500 to escape their predatory loan. Cheatham noted that once he received a call from the lender when the lender "happened" to be right down the street with a neighbor. It seems clear that this African American neighborhood was being systematically targeted and stripped.

This story represents one example of thousands of similar transactions that occur each year. The results are loss of hard-earned savings for families and all too often the loss of homes. Today, subprime mortgages go into foreclosure ten times more often than prime mortgage loans, and as many as one in five borrowers in the subprime market end up losing their homes. Evidence shows that the ill effects fall hardest on the families and communities who can afford it least.

Disproportionate Economic Burdens

The full impact of predatory lending becomes even clearer in light of the widening wealth gap between whites and people of color. According to a recent report by the Pew Hispanic Center, both African Americans and Latinos experienced a significant decline in wealth from 2000 to 2002. In 2002, African Americans and Latinos had a median net worth of $5,998 and $7,932, respectively, compared to $88,651 for whites. Even more alarming, 32 percent of African Americans and 36 percent of Latinos have a zero or negative net worth.

Home ownership has proven to be an effective way to increase wealth

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and move into the middle class. Even though the Federal Fair Housing Act and the Equal Credit Opportunity Act have been helpful in combating discrimination in the extension of credit, the American dream of home ownership remains elusive for many African American and Latino families. While home ownership has been increasing for Americans across the board, African American and Latino families still remain far behind, with a home ownership rate just below 50 percent. In contrast, the rate for whites is roughly 75 percent.

To close the wealth gap, it is essential to close the home ownership gap. Home equity is the only savings account that most families of color possess. Among African Americans and Latinos who do hold wealth, at least two-thirds of it consists of home equity. However, the potential economic advances achieved through home ownership are severely undermined by predatory lending.

Predatory mortgage lending. Research indicates that race, gender, and age are often key factors in whether a borrower receives a prime loan or a subprime mortgage. According to a recent study published by the Association of Community Organizations for Reform Now, African Americans were 3.6 times as likely as whites to receive a home purchase loan from a subprime lender and 4.1 times as likely as whites to receive a refinance loan from a subprime lender in 2002. Latinos were 2.5 times as likely as whites to receive subprime home purchase and refinance loans. Further, the U.S. Department of Housing and Urban Development found that in neighborhoods where at least 80 percent of the population is African American, borrowers were 2.2 times as likely as borrowers in the nation as a whole to refinance with a subprime lender. Perhaps most revealing, upper income borrowers living in predominately African American neighborhoods are twice as likely as low-income white borrowers to have subprime loans.

The disparities also show up in specific mortgage lending practices. For example, in the subprime mortgage market, mortgage brokers often receive cash kickbacks, known as "yield spread premiums," for delivering loans at higher interest rates than required by the lender. According to research conducted in 2001 by Professor Howell Jackson of Harvard Law School, African American and Latino borrowers usually pay more than similar white borrowers when yield spread premiums are used to compensate mortgage brokers. For a family already stretched thin between paychecks, these additional costs represent a significant burden.

A settlement with the Delta Funding Corporation and the Department of Justice, U.S. Attorney General for the Eastern District of New York, the Department of Housing and Urban Development, and the Federal Trade Commission shows that the disparities posited by Jackson are more than academic. In 2000, Delta Funding Corporation, a subprime mortgage lender, agreed to pay remediation of more than $7 million in response to accusations that brokers working for Delta charged higher fees to African American women than to similarly situated white males. The disparate charges were clearly based on the race of the borrowers rather than any difference in risk of repayment.

More recently, the Center for Responsible Lending found that borrowers living in predominately African American neighborhoods are more likely than other borrowers to receive loans that contain a prepayment penalty, an expensive fee charged for paying off the loan before its due date. This study controlled for other key variables, such as creditworthiness, that might affect whether a lender imposes a penalty. It leads to one unmistakable conclusion: borrowers from white neighborhoods have the best chance of getting a mortgage without a prepayment penalty.

Auto lending and payday lending. Auto loan markups are lender kickbacks to dealers for quoting consumers higher finance rates when they could qualify for a lower rate. The car dealer and the lender often split the markup, and consumers typically never know they paid too much. A study by Consumer Federation of America found that the subjectivity of the markups results in discriminatory treatment of African Americans and Latinos and that the markups cost consumers $1 billion annually. As in the case of yield spread premiums, the difference in creditworthiness does not fully explain the disparate pricing. Several prominent cases have been litigated under the Equal Credit

Stats: Predatory Financial Practices

- Amount that borrowers lose annually to predatory mortgages: $9.1 billion; to payday loans: $3.4 billion; to other lending abuses, such as overdraft loans, excessive credit card debt, and tax refund loans: $3.5 billion
- Average loan rate for payday loans: roughly 400 percent
- Average profit rate on payday loans: 34 percent
- Percent of payday loans that go to one-time emergency borrowers who pay their loan within two weeks and do not borrow again within a year: 1

Source: Center for Responsible Lending, available at www.responsiblelending.org/index.cfm

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Opportunity Act, resulting in large settlements from companies such as Nissan and General Motors.

Payday lending is another form of predatory lending that contributes to economic decline in low-wealth communities. Payday lenders offer small, short-term loans (often two weeks or less) using a check dated in the future as collateral. Most borrowers cannot repay the full loan by their next payday, so they are forced to renew the loan repeatedly for additional two-week terms, paying new fees with each renewal. Ninety-nine percent of payday loans go to repeat borrowers. Over 5 million American families are caught in a cycle of payday debt each year, paying $3.4 billion in excess fees.

As with subprime mortgage lending, communities of color are bearing a disproportionate share of payday costs. A recent study conducted by the Center for Responsible Lending showed that African American neighborhoods have three times as many payday stores per capita as white neighborhoods. This disparity remains even after controlling for nine relevant variables. It becomes even more pronounced as the proportion of African Americans in a neighborhood increases.

State Laws Against Predatory Practices

A number of states have enacted antipredatory mortgage lending laws in response to unscrupulous mortgage lenders who engage in practices that fall just below the thresholds set in 1994 by the Federal Home Ownership and Equity Protection Act. North Carolina was the first state to do so, and its 1999 legislation became a model for many other states. The North Carolina law, which reflects a consensus built among bankers, consumer advocates, and civil rights leaders, provides meaningful protections for high-cost loans while preserving access to credit.

Today, such state laws are in danger of being preempted by weaker national legislation. Several proposals were introduced in Congress during 2005, including a bill sponsored by Rep. Robert Ney (R-Ohio) and Rep. Paul Kanjorski (D-Pennsylvania) that seeks to override existing state laws and, on balance, weaken existing protections for borrowers.

Currently, payday lending is illegal in fourteen states, but in many of them national payday chains circumvent the law by forming partnerships with out-of-state banks, a practice known as "rent-a-bank." For example, payday lending is illegal in Texas, but the state has the highest number of rent-a-bank shops in the country, collecting fees in excess of the triple-digit interest rate limit set by state law.

Communities of color bear a disproportionate share of payday loan costs. African American neighborhoods have three times as many payday stores as similar white communities.

Conclusion

To protect citizens from predatory lending, the states—with their greater flexibility and speed—must maintain their power to enact and enforce laws as necessary. Unscrupulous lenders inevitably will find loopholes in federal laws. If consumers are to receive meaningful protections, the optimal solution is a partnership between the federal government and the states, wherein the federal government sets reasonable minimum standards and the states maintain their authority to address local issues. During the next year, Congress and federal regulators are likely to make key decisions that will either facilitate a productive partnership or effectively hamstring state lawmakers. For borrowers who have little economic or political power, the stakes are high, and the outcomes will determine the economic future for millions of families.

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