Restoring Integrity to the Financial System

Predatory Lending and the Economic Crisis

As the United States grapples with the most severe economic crisis of this generation, American workers face the highest level of unemployment since 1983, billions in earnings and retirement savings have been lost, and millions of households have fallen into foreclosure.

While government leaders begin to craft financial reforms equal to the scope of the crisis, the voice of faith communities will be critical. It is perhaps predictable that many policy reforms will be viewed through political prisms. However any real and sustainable reform must answer the moral questions of fairness and integrity.

Many religious traditions recognize both the necessity of lending in our society and the danger and temptation for lenders to take advantage of those in need of credit. So central is this issue that several faith traditions expressly warn against usury – the practice of charging excessive or unjust interest.

This guide covers several of the key issues at stake for people of faith in the financial crisis and reform:

1. The scope of the foreclosure crisis.

2. The role of predatory and usurious lending in triggering foreclosures and the economic crisis.

3. The need for restored integrity in our financial system.

The foreclosure crisis

The economic crisis originated in the housing sector and will have significant impact on households through foreclosures and declining home values. Here's a brief snapshot[i]:

> An economy is more than just a secure credit market. An economy is also people: people who suffer foreclosures, people who wonder about losing their jobs and live paycheck to paycheck, people who go to bed hungry.
>
> *Rev. David Beckmann, President, Bread for the World*

The foreclosure crisis will affect vast numbers of households

- 1 in 8 home loans is currently either delinquent or in foreclosure.
- Nearly 1 in 3 homes is underwater, that is, owners owe more on the home than it is worth.[ii]
- 2.4 million homes are projected to go into foreclosure in 2009.
- 13 million homes are projected to start foreclosure in the next five years (4th quarter 2008 – 2014)[iii]

Many households who are current on their mortgage will experience declining property values.

- In 2009 alone, foreclosures will cause 69.5 million neighboring homes to lose $502 billion in overall property value.
- Over the next four years, foreclosures will affect 91.5 million nearby homes, reducing property values $1.86 trillion in total or $20,300 per household.

African American and Latino households will experience a disproportionate share of lost wealth.

- During the next four years, more than 1.1 million and 1.4 million foreclosures are expected to hit African American and Latino communities, respectively.

These figures are particularly troubling because homes are, for many families, their most significant investment and source of household wealth.

Meanwhile, voluntary efforts and incentives to save homes have proceeded slowly. In the first quarter of 2009, nearly 500,000 loan modifications were completed, but foreclosure starts and serious delinquencies edged up to nearly 3.5 million. A recent report by the Treasury Department showed that voluntary efforts by loan companies to modify mortgages under and the Administration's program have only reached about 9% of the homeowners who may be eligible to participate.[iv]

Predatory lending at the core of the crisis

Economists trace the origin of the economic crisis to the failure of millions of subprime and non-prime mortgages. When borrowers began to default in large numbers, the institutions that had invested in them suffered serious losses.

At the core of this chain of events were lending practices that placed many homebuyers in expensive and unsustainable loans. Looking closely at lending practices that were common in the years preceding the crisis reveals that the current wave of foreclosures has a lot to do with the design of the loans themselves and the conditions under which they were sold, a concern that Ben Bernanke noted in a 2008 speech.

> "Unfortunately, in the past few years, many mortgages were extended that were poorly underwritten or whose terms were inadequately disclosed, particularly in the subprime market… Those poor lending practices have contributed to a sharp increase in mortgage delinquencies and foreclosures."[v]

Common subprime and non prime lending practices

ARM (adjustable rate mortgage)
A loan with a low initial interest rate that adjusts within the first two or three years to a rate that is often unaffordable for the borrower

Prepayment penalty
A fee owed by the borrower for paying off the loan in the first two to five years that can result in borrowers locked in costly loans

Yield spread premium
A kickback paid by a lender to a broker for placing borrowers in loan with higher interest rate than what the borrower qualified for

Borrowers with ARM loans and prepayment penalties are more likely to default than borrowers *with comparable credit histories* in traditional fixed-rate loans.[vi] Yet these terms were heavily marketed to the most vulnerable borrowers and those who could least afford the risk – low or moderate-income borrowers, older borrowers, and households of color.

Sadly, most of the borrowers who received ARM loans with steep penalties for refinancing before the rate reset, actually qualified for less expensive, more sustainable 30 year fixed rate loan that would have spared many from the foreclosures they now face.

One reason for these high cost loans may have been the broker and lender incentives lined up in their favor. In the vast majority of subprime loans, for example, the broker received a kickback known as a yield spread premium, a cash bonus paid by a lender to a broker for placing borrowers in a loan with a higher interest rate.

Because lenders did not typically hold onto mortgages, but sold them immediately to investors, they had no incentive to determine that loans were sustainable.

For a closer look at these practices see the appendix to this guide.

Predatory lending as usurious lending

Religious teaching on lending and debt offers an important perspective on the current crisis. Many faith traditions share these core convictions:

- Honesty and ethical dealing should be practiced in all economic transactions;
- Loans should strengthen the borrower; they should not be designed to produce cycles of debt; and
- Loans that exploit borrowers' vulnerability offend a deep religious commitment to defend the well-being of those who are poor or marginalized.

Moreover, many religious texts that counsel against abusive lending are adamant that usurious lending should not be used to deprive a person of their basic necessities or home. Indeed, it was the seizure of land and home that Biblical leaders and prophets denounced among the oppressions of the poor (Nehemiah 5:11, Micah 2:1-2).

Because of their historic concern for fair lending and protection of the vulnerable, religious leaders and investors were among the first to sound the alarm about the rising number of unscrupulous mortgage loans. In 2002, for example, Cardinal Theodore McCarrick, Catholic Archbishop of Washington, warned Congress,

> "Efforts to revitalize neighborhoods and to expand homeownership among low income families are being threatened by abusive lending practices. These practices termed, predatory lending, trap far too many unsophisticated and vulnerable people often the elderly into high cost loans that frequently lead to foreclosure after stripping any equity from the home. The Catechism of the Catholic Church condemns this sort of speculation, this usury, as "morally illicit."[vii]

The Presbyterian Church, Jewish Council on Public Affairs and the Commission on Social Action of the Union for Reform Judaism have all issued formal resolutions of concern regarding predatory lending. Starting in the early 1990s, religious investors began calling for improved supervision of subprime lending and the monetization of irresponsible risk.[viii]

If you lend money to one of my people among you who is needy, do not be as a creditor, charge him no interest. If you take your neighbor's cloak as a pledge, return it to him by sunset.

Exodus 22:25-26

If you sell something to your neighbor or buy something from your neighbor's hand, you shall not wrong one another.

Leviticus 25:14

Do not rob the impoverished because he is impoverished.

Proverbs 22:22

Let the exacting of usury stop! Give back to (your countrymen) …. their fields, vineyards, olive groves and houses, and also the usury you are charging them.

Nehemiah 5:11

Restoring the integrity of the financial system

The subprime market's woes and economic crisis can also be understood as a crisis in integrity. Integrity suffered when financial institutions sold consumers needlessly costly loans rather than loans that they could reasonably pay back. Integrity suffered when brokers had greater incentives to obscure the cost of credit than to help customers navigate increasingly complex financial products. Integrity suffered when investors profited handsomely from shares in subprime mortgage loans that took unfair advantage of homeowners, without caring about the terms on which their profits were made.

That some businesses and individuals would push the boundaries of fair dealing should come as no surprise to many people of faith who understand the temptation of greed and overreaching. Soon after the economic crisis reached its peak in the fall of

2008, Al Mohler, President of the Southern Baptist Theological Seminary wrote,

> "Given the nature of this fallen world and the reality of human sinfulness, we should expect that greed will be a constant temptation. Greed will entice the rich to oppress the poor, partners in transactions to lie to one another, and investors to take irrational risks. All of these are evident in this current crisis."[ix]

In the years preceding the financial crisis, a lack of effective oversight allowed greed and unethical dealing to proceed unchecked. Many of the institutions that supervise banking and lending are funded by the very companies they are supposed to police. Some predatory mortgages were made by companies that weren't supervised at all. And no supervisory entity placed the protection of consumers from unscrupulous practices at the core of their mission.

In response to massive gaps in oversight, many members of Congress and the President are calling for creation of a Consumer Financial Protection Agency (CFPA) to supervise the financial services that are marketed and sold to consumers – home loans, credit cards, banking services, and other consumer loans.

It would be this agency's task to ensure that the cost of a loan or other financial service is straightforward and that credit is extended on terms which the borrower can repay. This entity could ban unfair practices such as yield spread premiums and pre-payment penalties and require much clearer comparisons of the cost of adjustable and fixed rate mortgages. An entity dedicated to consumer financial protection would improve the quality of credit offered to consumers and help restore trust between borrowers and lenders.

Next Steps

Historically, access to credit has almost always been a good thing for American families. Financial services – from savings banks to credit cards to home loans – have enabled millions of households to respond to emergencies, save money and build family wealth over time.

Without internal forms of mutual trust, the market cannot fulfill its proper economic function. And today it is this trust which has ceased to exist.

The economic sphere…is part and parcel of human activity and precisely because it is human, it must be structured and governed in an ethical manner.

Pope Benedict XVI, Caritas in Veritate, June 2009

More Than Mortgages

Predatory practices extend beyond home loans

Payday Loans
Payday loans are short-term loans that use a paycheck as collateral. With charges of 400% APR, payday loans trap millions of borrowers in cycles of debt.

Bank Overdraft Fees
Each year, households pay over $17.5 billion in overdraft fees. Typically, banks provide customers no warning or opportunity to avoid overdraft.

Car Title Loans
Car title loans are short-term loans in which one's car serves as collateral. A typical car title loan has a triple-digit APR, requires repayment within one month, and is made for much less than the value of the car.

Unfortunately, the present financial crisis reveals the dangers of credit and the degree to which the credit market has been filled with products that drain assets and trap families in debt rather than build household wealth.

As communities and the country seek to recover from economic downturn, avoid future crises, and restore integrity to the market, three steps are critical.

1 End usurious financial practices.

Predatory lending – from unexpected mortgage hikes to triple digit payday loans – only increases families' financial insecurity. The concentration of unfair lending practices in low-income communities and communities of color undermines steps to end poverty and narrow the racial wealth gap. Eliminating predatory lending would put hard-earned resources back in the hands of working people.

2 Employ sound regulation to protect the integrity of financial services marketed to consumers.

Markets require a basic level of trust and transparency in order to function. The cost of a loan should be straightforward and credit should be extended on terms which the borrower can repay. Trust is strengthened when there are clear rules, consequences for overstepping those rules, and an entity dedicated to making and enforcing the rules.

3 Keep families in their homes and prevent needless foreclosures.

Families are too important to fail. Yet, over 4.4 million households have lost their homes to foreclosure already, with 13 million homes predicted to start foreclosure by 2014. Efforts to keep families in their homes will restore and sustain the stability of whole communities.

Reflection and action resources

Faith communities, grounded in a tradition of concern about the use and abuse of lending, have an important role in bringing about needed change. These resources may provide a start for religious reflection on the current economic crisis.

- "Faith and Finances: Christians and the Economic Crisis." A four part discussion guide from the editors of Sojourners Magazine. www.sojo.net
- "10% is Enough." An interfaith anti-usury campaign that cites teaching on lending from Jewish, Muslim, and Christian traditions. www.10percentisenough.org
- "A Reformed Understanding of Usury for the 21st Century." A historical review of lending and Protestant teaching with contemporary application. Available through the Presbyterian Church USA http://www.pcusa.org/oga/publications.htm
- The Faith Based Program at the Center for Responsible Lending offers action alerts, resources, and news related to faith and lending. www.responsiblelending.org

Also recommended

- Americans for Financial Reform. A coalition of national and state organizations working for an accountable, fair and secure financial system. www.ourfinancialsecurity.org
- "Foreclosed: State of the Dream 2008" An examination of the racial dimension of the subprime mortgage lending crisis, and the resulting huge wealth loss to people of color that has resulted. www.faireconomy.org
- Interfaith Center on Corporate Responsibility. A consortium of religious investors, many of whom called attention to subprime lending abuses years ago. www.iccr.org
- The Center for Responsible Lending. Research and advocacy regarding a wide range predatory lending practices. www.responsiblelending.org

Appendix

Predatory lending in the subprime and nonprime markets

Looking closely at common lending practices – exploding ARM terms, prepayment penalties, and yield spread premiums - reveals that the current wave of foreclosures has a lot to do with the kinds of loans sold to households.

'Exploding' ARMs

During the height of the subprime lending boom, the most common type of subprime mortgage was an "exploding ARM"—a home loan with a low, initial interest rate that adjusts within the first two or three years (ARM stands for adjustable rate mortgage).

ARM loans were heavily marketed to subprime borrowers, trapping many in un-payable loans. By 2007, 81% of subprime loans were ARMs. Many borrowers reported that their broker had not disclosed or explained the adjustable rate. A related product, payment option ARM loans allow the loan principal to increase over time, resulting high payments over the long-run.

Prepayment penalties

Many subprime loans also carried a prepayment penalty – a steep fee owed by borrowers for paying stripped thousands of dollars in home equity. For

off the loan in the first two to five years. For homeowners who refinanced, prepayment penalties stripped thousands of dollars in home equity. For others, prepayment penalties were a barrier to refinancing and trapped them in higher priced mortgages. Over 70 percent of subprime loans carried a prepayment penalty compared to only 2 percent of prime loans.

The negative impact of prepayment penalties falls hardest on African American communities. A 2005 study showed that borrowers in heavily minority areas face 35% higher odds of having a prepayment penalty on their subprime mortgage.[x]

Why did borrowers accept such costly terms?

Outcomes suggest failure-by-design

Loans with **ARM** and **prepayment penalty** features have been far more likely to result in foreclosure than traditional, fixed-rate loans made to borrowers with similar credit profiles.

- For mortgages originated in the early 2000s, ARM loans were 72% to 117% more likely to fail than fixed-rate loans.
- Loans with prepayment penalties are 52% more likely to fail than those without such penalties.

Source*: Losing Ground: Foreclosures in the Subprime Market and their Cost to Homeowners.* Center for Responsible Lending (Dec 2006)

According to a Wall Street Journal article, 61% of those who received subprime loans in 2006 could likely have qualified for a less costly, more sustainable loan.[xi] For many individuals, heavy marketing, the complexity of contracts offered to unsophisticated borrowers and misplaced trust in their broker contributed to the decision to purchase a costly and risky loan.

Push Marketing: "loans in search of a borrower"

Throughout the 1990s and 2000s, homeowners were targeted with invitations to refinance. Telemarketers, direct mail solicitations and even door-to-door contractors made unsolicited offers of a new loan that would "lower their monthly payments" or provide money for home repair. Initially, many older people were targeted because they were trusting and had substantial equity in their homes.

In 2001, Thomas Miller, Iowa Attorney General testified to Congress,

> "The notion of consumers shopping for a refinance loan or a home improvement loan, comparing prices and terms, is out of place in a sizeable portion of this market. Frequently, these are loans in search of a borrower, not the other way around." [xii]

Also targeted were African American households who, for many years, received little attention from mortgage lenders (and relatively few loans). With the growth of the subprime market, lenders began to aggressively court their business. Because these borrowers had previously been outside of the mainstream of finance, many did not realize that they could have qualified for better loans or that approval for a loan was not related to ability to pay.

Complicated contracts

Most terms on a standard mortgage are buried in pre-printed documents and are dictated by the lender, not negotiated by consumers. By the time buyers see all the terms and disclosures, they are in the final stages of completing the loan and don't feel that they have any choice but to proceed.

Misplaced trust

When navigating the complex terrain of home financing, many people rely on the judgment of home lending professionals: mortgage brokers.

Unfortunately, the trust of many borrowers in their broker was misplaced. In a majority of subprime loans, the broker received a kickback known as a yield spread premium (YSP). A YSP is a cash bonus that a broker receives from a lender for placing borrowers in a loan with a higher interest rate than the lender would accept.

For additional research on predatory practices in mortgage and consumer lending, visit www.responsiblelending.org

[i] For current foreclosure data and projections, see "Soaring Spillover: Accelerating Foreclosures Cost Neghbors $502 Billion in 2009 Alone," Center for Responsible Lending (May 2009)

[ii] Data reported from First American CoreLogic, (Aug 13, 2009)

[iii] Goldman Sachs Global ECS Research, Home Prices and Credit Losses: Projections and Policy Options, p16. (Jan 13, 2009) p16. see also Credit Suisse Fixed Income Research, Foreclosure Update: Over 8 Million Foreclosures Expected, p 1 (Dec 4, 2008)

[iv] Andrea Fuller, U.S. Effort Aids only 9% of Borrowers, N.Y. Times (Aug 5, 2009)

[v] Ben S. Bernanke, Speech at the FDIC Forum on Mortgage Lending for Low and Moderate Income Households (July 8, 2008)

[vi] Lei Ding, Roberto G. Quercia, Janneke Ratcliff, and Wei Li, "Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models" Center for Community Capital, University of North Carolina Chapel Hill (Sept 13, 2008)

[vii] "Predatory Mortgage Lending," U.S. Conference of Catholic Bishops (February 2005)

[viii] "Faith-Based Early Warning System for Investors: Prophetic Religious Groups Sounded Subprime Loan Alarm 15 Years Ago," Interfaith Center on Corporate Responsibility (Sept 10, 2008)

[ix] Al Mohler, "A Christian View of the Economic Crisis" Christianity Today (Sept 29, 2008)

[x] "Borrowers in Higher Minority Areas More Likely to Receive Prepayment Penalty on Subprime Loan," Center for Responsible Lending (Jan 2005)

[xi] Rick Brooks and Ruth Simon, "Subprime Debacle Traps Even Very Credit Worthy: As Housing Boomed Industry Pushed Loans to a Broader Market." Wall Street Journal at A1 (Dec 3, 2007)

[xii] *Hearing before U.S. Sen. Committee On Banking, Housing, and Urban Affairs*, 107th Cong. (July 26, 2001) (testimony of Thomas Miller, Iowa Attorney General)

About the Center for Responsible Lending

The Center for Responsible Lending is a national nonprofit, nonpartisan research and policy organization dedicated to protecting home ownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, one of the nation's largest community development financial institutions.

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