Predatory Lending and Foreclosure

By Kevin Stein

The Gonzales family wanted to purchase a home, but could only afford a mortgage of $2,700 per month. Although their conversations with the mortgage broker were in Spanish, their loan documents were entirely in English, which they could not read. It turned out that their mortgage cost them $4,700 monthly and carried an interest rate that adjusted up in six months. Before long, the Gonzales family was paying $5,000 per month, twice what they could afford, and without any hope of getting out of the mortgage because of a $16,000 prepayment penalty, which they had been unaware of.

Caroline Washington, an 83-year-old African American woman living in San Francisco, was induced by her broker to refinance her home three times in three years, causing her $52,000 loan balance to balloon to $240,000. Forced to make monthly payments of over $1,600, which represented nearly all of her fixed income, Ms. Washington lost her home to foreclosure.

The Gonzales family and Ms. Washington—both early victims of the foreclosure crisis that will last years and claim millions more victims—testified at a Federal Reserve hearing on mortgage practices on June 16, 2006.

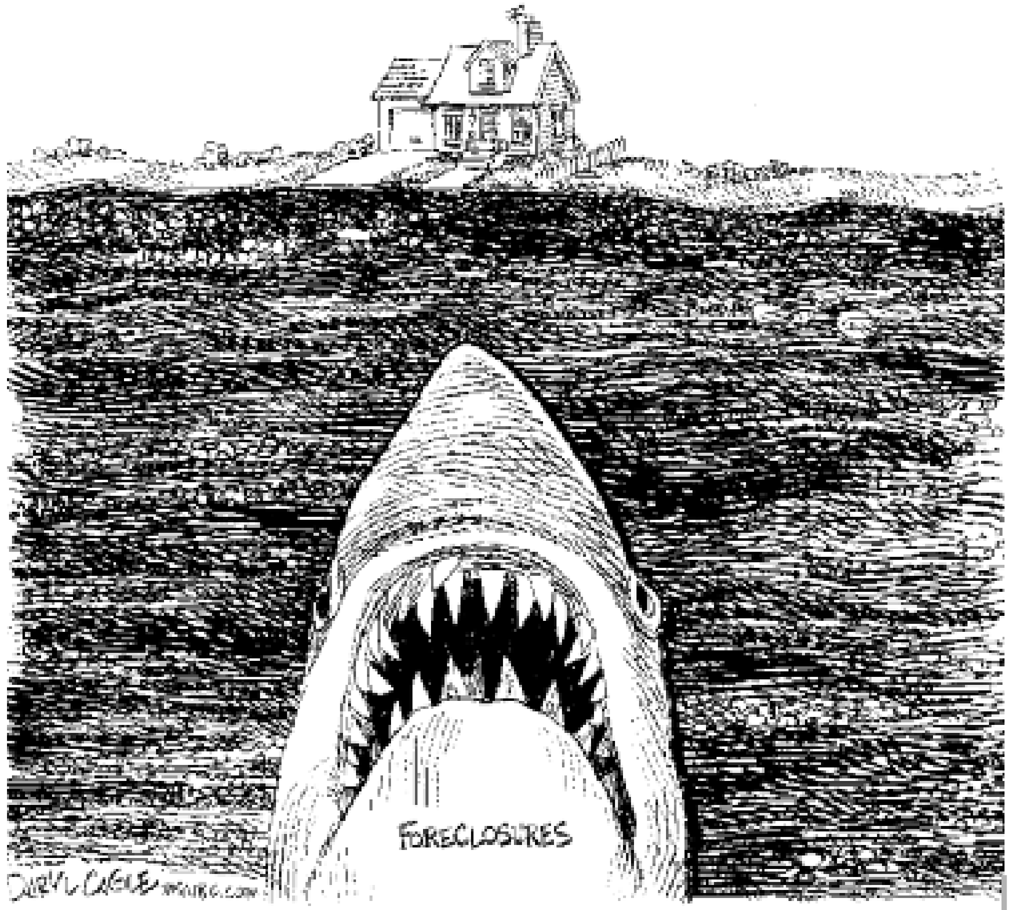
Each day, about 1,300 homes go into foreclosure in California. Many of them are occupied by working families, seniors, immigrants, and people of color who were targeted by unscrupulous mortgage lenders and brokers. The impacts of these foreclosures have been devastating: lower property values for neighboring residents, blight, increased crime, less tax revenue to local governments to fund key services, and larger numbers of displaced tenants and foreclosed homeowners competing for limited affordable housing opportunities.

The Subprime American Dream Unravels

Much of the current foreclosure crisis is rooted in the subprime home loan market, where lenders make expensive loans to "credit-impaired" borrowers who are, or believe they are, otherwise unable to qualify for a conventional or prime loan. In 2006, subprime lending was a $600 billion industry that made its money by trapping borrowers, often people of color, in bad loans.

At the height of the subprime loan market, brokers pushed loans that in many cases were fraudulent, and lenders responded to growing competition by lowering underwriting standards and creating incentives to sell problematic option Adjustable Rate Mortgage (ARM) and stated income loans. These flawed products were then packaged and fed to Wall Street securitizers and investors who chose not to screen out the problematic products and were not compelled to do so by the so-called regulators. As more and more borrowers like the Gonzales family and Ms. Washington began to default on their unaffordable loan payments, subprime lenders started to go out of business by the hundreds. But the very risky loans they made remained in our neighborhoods and exploded into foreclosures that continue to harm communities.

An analysis by the California Reinvestment Coalition (CRC) and allies showed that neighborhoods of color in seven metropolitan areas throughout the country were much more likely to be saturated with loans made by subprime lenders who went out of business for making too many bad loans. In Los Angeles, the market share of these high-risk lenders was 9.5 times higher in neighborhoods of color than white neighborhoods.



Subprime Loans = Repackaged Redlining

In some ways, subprime lending changed the traditional lending paradigm for neighborhoods of color from one of redlining (where lenders avoided entire neighborhoods) to reverse redlining (where lenders targeted these neighborhoods for more costly and risky home loans).

Study after study has shown that people of color are far more likely to get stuck with higher priced subprime home loans than whites. In 2006, over 45 percent of loans to African Americans and over 43 percent of loans to Latinos in California were higher-priced subprime loans, compared with only 19 percent to whites. Overall, neighborhoods of color in California were 2.7 times as likely to be stuck with subprime loans as white neighborhoods.

The CRC estimates that borrowers of color in California (many of whom could have qualified for prime loans) have lost billions of dollars of equity in their homes because of subprime loans.

Containing the Crisis: A Modest Proposal

Shockingly, there are virtually no rules, reporting obligations, or regulatory oversight which obligate loan servicers to work with borrowers seeking to avoid foreclosure. As such, it is not surprising that in four CRC surveys of home loan counseling agencies serving over 10,000 borrowers per month, the most common outcome for homeowners cited was foreclosure.

There are ways to alleviate the devastating impacts of foreclosures, and policymakers must act quickly to pursue solutions that match the magnitude of the problem, including:

- Imposing a 180-day moratorium on all foreclosures to allow time for workouts to take place.
- Requiring loan servicers to offer long term, affordable loan modifications to borrowers trying to stay in their homes, including reform of the Bankruptcy Code.
- Imposing checks on loan servicers to ensure that they are truly working to keep borrowers in their homes for the long term, including requiring them to report data that show whether they are helping people or not.
- Enforcing consumer protection, the Community Reinvestment Act, and fair lending laws to ensure that low-income and neighborhoods of color are neither targeted for abusive products, nor ignored by mainstream financial institutions.
- Prohibiting predatory lending practices.

At their testimony, the Gonzales family and Ms. Washington hoped that the laws would change soon enough to help homeowners struggling to keep their homes. Two years and millions of foreclosures later, so do we. ■

Illustration: Foreclosures.

Kevin Stein is the associate director of the California Reinvestment Coalition. To view a short documentary about the foreclosure crisis, and for more information, visit www.calreinvest.org

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