PREDATORY LENDING IN MIDDLE AMERICA

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Abstract

In this research the impact of predatory lending and discriminatory marketing techniques were examined through a qualitative review of selected household files. Citizens for Community Improvement in Des Moines, Iowa assembled the files from interviews with 27 concerned homeowners regarding their mortgages in response to an announcement of Fannie Mae's Anti-Predatory Lending Initiative. It was found that phone calls and mailings were the primary marketing strategies used by predatory lenders. Results of the homeowners' experiences push for legislation, education, and outreach.

Introduction

Predatory lending has become a serious problem for many homeowners and potential home buyers. Predatory lending is a combination of abusive loan terms, unscrupulous and misleading marketing, and high pressure lending tactics that limit information or choices available to a consumer (Davis, 2000). Common predatory lending practices include, but are not limited to, solicitations of targeted neighborhoods (repeated phone calls, mail solicitations, etc.), high interest rates (rates not justified by risk), balloon payments (most of the principal is still owed at the end of a loan), flipping (repeated refinancing), and asset-based lending (lending with disregard to the borrower's ability to repay).

"Predatory and abusive practices by mortgage lenders and brokers, which impose excessive and unreasonable charges on homeowners, are pervasive and cause serious harm" (Sturdevant & Brennan, 2000, p. 1). According to the Iowa Attorney General, Tom Miller, predatory lending practices threaten the American dream of homeownership (Roach & Tabor, 2001). The practices undermine the ability of the neighborhoods where the loans are made. Major effects of predatory lending include foreclosure, rapid turnover of property, and ultimately an increase in vacant housing structures. "Foreclosures drag down property values and make it harder to refinance or obtain new financing.

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Leaving a property vacant while in foreclosure often creates a negative cycle of disinvestment and decline for entire communities" (Garsson, 2007).

There remains strong concern that lending discrimination persists, even after years of scrutiny (Courchane, Nebhut, & Nickerson, 2000). Predatory lending practices raise serious issues about fair housing and fair lending concerns, largely because banks and their mortgage and/or finance company subsidiaries appear to be representing the market and targeting minority communities for higher priced, lower quality products (Housing Ohio, 2002).

Changes in the Fair Credit Reporting Act have been linked to the explosion in direct mail advertising and telemarketing by home equity lenders. In 1996 changes made under the act allowed lenders to offer pre-approved loans to lists of prospective customers obtained from credit bureaus (*The case against predatory lending, 2002*). Many organizations discussing predatory lending make statements about aggressive marketing and advertisement techniques offering pre-approved loans and other products, but no formal research was located. According to Citizens for Community Improvement (CCI) (2001), predatory lenders aggressively market their loan products through mailings, telephone sales, door-to-door, and home improvement contractors.

Abusive lending practices are of great concern nationally. In 2002 the Bush Administration launched the Credit Watch program to provide additional protection for home buyers to help curb predatory lending (U.S. Department of Housing and Urban Development, 2002). With this program HUD has the authority to bar lenders from issuing FHA-insured mortgages if their default and claim rates on average exceed the national default and claim rate. Christopher Dodd, a U.S. Senator from Connecticut, cited statistics showing Iowa had the ninth highest home foreclosure rate in the nation and said that he would back tough criminal penalties for brokers who engaged in predatory lending practices (Love, 2007).

The purpose of this study was to explore the impact of predatory lending practices in Middle America, namely, Des Moines, Iowa. The objectives were to determine the marketing techniques employed by predatory lenders and to examine the characteristics and concerns of households who believed that they were victims of predatory loans. This qualitative approach using homeowner files, which included their experiences written in their own words, allowed the practices of predatory lending to emerge through the voices of the victims.

Method

On February 22, 2002, Fannie Mae, CCI of Des Moines, local banks, and attorneys announced an innovative anti-predatory lending refinance initiative to help Des Moines area homeowners obtain responsible mortgage loans (Dinnen, 2002). Shortly after the refinance initiative was announced in the local paper, homeowners began calling and coming to CCI. CCI supplied the files of 27 homeowners seeking assistance through the refinance initiative for this study. Although CCI conducted the interviews, the files (void of names and street addresses) were available for this study under the human subject guidelines (CCI File, 2002).

The $3 million initiative was designed to provide relief to borrowers who were victims of predatory lending. Fannie Mae planned to assist lenders in refinancing homeowners out of predatory loans made under recognized predatory lending practices. CCI was responsible for identifying borrowers in need of assistance and providing one-on-one counseling and post-closing counseling, including six months of client follow-up required for all mortgages. The procedure used by CCI is outlined below.

1. Homeowner contacts CCI for interview
2. CCI conducts interview with homeowner regarding their mortgage situation
3. CCI reviews homeowner situation and makes a decision regarding loan; pre-purchase counseling/education
4. Legal advocate partner may negotiate down the terms of original loan
5. Loan committee reviews loan files monthly
6. Lender underwrites/originates loan
7. Fannie Mae purchases the loan
8. CCI provides post-purchase/early delinquency counseling

The information for this article was gathered from the interviews conducted by CCI with homeowners who came to the agency for assistance. A purposive sample was used to study the details of possible predatory lending practices. The participants self-selected themselves as homeowners in trouble and possibly victims of predatory loans. These homeowners brought documentation of their loans with them so a complete assessment could be made. Some homeowners submitted written accounts of their interactions with lenders.

Participants were interviewed using the "Foreclosure Intake Questionnaire and the Document Review Checklist" provided by Fannie Mae to identify predatory loans. Some of the pertinent questions for this study are as follows.

- Background Information/Household Demographics
  - Home purchase price?
  - Original mortgage amount? Monthly payments?
  - Current mortgage amounts and monthly payments?
  - Property census tract?
  - Second mortgage?
- Credit History
  - Before you refinanced your loan, did you stay current on your monthly mortgage payments?

- Mortgage History (how many times refinanced, loan amount, lender)
    - Reason for refinancing (i.e., home repairs, pay taxes, pay other bills, lower monthly payment)?
    - How did you come to contact the repair company (i.e., response to mail solicitations, door-to-door solicitation, phone call)?
    - How did you come to contact the specific lender/broker (i.e., contractor referral, referral from a friend/relative, mail solicitation, phone solicitation, door-to-door solicitation)?
    - Interaction with lender?
    - As a result of the refinancing, did your payments increase or decrease from your previous mortgage payments? By how much?

Results

Profile of Homeowners

Among the 27 homeowners studied, one-fourth were African-American. Seventeen of the households consisted of married couples, and the householders ranged in age from the early 30s to late 70s. Household incomes ranged from \$6,408 to \$76,308. The initial purchase price of the homes ranged from \$10,000 to \$170,000.

There were several types of loan terms, but three were most frequently cited: ARM 30 years, 30 years fixed, and 15 years balloon. Over one-half of the homeowners experienced an increase in their monthly payment. Their current loans ranged from \$21,700 to \$157,000, with interest rates of 6.5% to 15.4%. Nearly 12% of the homes had loans higher than the current worth value, and more than half of the homeowners reported having additional debt. Forty-four percent of the homeowners reported having filed bankruptcy previously and another 44% reported that their mortgages were not current. More than 90% of the respondents refinanced their original mortgage at least once.

The loan amounts were between \$12,662 and \$114,900, and about 60% received cash from the transaction. Eleven percent of the homeowners received financial services from the same (original and current) lender. Over one-half of the participants experienced an increase in monthly payments, and one-fourth of the households were in the process of foreclosure.

Marketing Techniques Used in Predatory Lending

A breakdown of the marketing techniques revealed that 41% of the homeowners were contacted by phone, 33% were contacted by mail, 22% were referred to the lenders, and 7% saw television advertisements. One participant found the lender in the phone book, and another homeowner's initial contact was arranged by a contractor. Three homeowners had multiple types of contact.

Victims of predatory lending frequently described being flooded with phone calls and letters from brokers and lenders, encouraging them to take out a home equity loan (*The case against predatory lending*, 2002). They also advertised through television commercials, highly visible signs in neighborhoods, door-to-door solicitations, and flyers stuffed in mailboxes. Many companies deceptively tailor their solicitations to resemble social security or other government checks to prompt homeowners to open the envelopes and otherwise deceive them about the transaction (Sturdevant & Brennan, 2000).

Common predatory lending marketing techniques involve solicitations to targeted neighborhoods, consisting primarily of elderly, minority, female, and/or low- to moderate- income homeowners. Elderly populations are typically classified as a target market (Quercia & Rohe, 1992). One elderly homeowner described her fear of not having enough money.

> *I'm 65 years old and this is my one and only house I have ever owned at age 61. Please, please, please make them eat this loan; otherwise I am going to lose my house. My mortgage payment to ______was $519.13. It had all my taxes, flood insurance, and house insurance all in one taken out automatically from checking so it's never late. The payment to ______was $597.95 so, 597.95+519.13= 1117.08 a month from 1476.24 = 359.16 left. That does not leave enough for car insurance, life insurance, gas, electric, food, clothing, phone, cable, newspapers and so on. I'm now in a financial bind.* (CCI File)

Sales techniques used in predatory lending include shifting unsecured debt into mortgages and inaccurate appraisals. Borrowing more than the worth of the house can cause problems when/if the borrower decides to move and sell the house. Three of the homeowners had loans that were higher than the current worth value of the home. One homeowner referred to the appraisal as a "drive by appraisal" (CCI File). One homeowner made over $76,000 a year and was in the process of foreclosure. He and his wife tried to refinance their loan in an attempt to save their home but found out they would not be able to do so based on the appraised value of the house.

> *There were no problems until July/August of 1999 when we found out they had no intention of refinancing us because we owed more than the house was worth. Evidently it was appraised for more than it was worth when we bought it.* (CCI File)

Loan Conditions and Procedures Used in Predatory Lending

Predatory lenders charge interest rates well above prime rate and not justified by risk. Predatory lenders are able to charge these interest rates (frequently 14% to 18%) because subprime borrowers with limited financial resources or knowledge may be relegated to finding credit at any price (*The case against predatory lending*, 2002). One couple under study told about their interest rate.

> *The broker said he had tried every bank in town and could not get us financing. After a day or so he called back to tell us that he was able to come up with something but the interest rate would be high for a year. After we had made all of our payments for a year on time we would be refinanced at a lower and more reasonable rate. Our credit was being destroyed, so we decided to sell our home in August 2000 when the interest rate went from 11.3% to 13.1%.* (CCI File)

Another common practice associated with the actual loan in a predatory lending transaction is the balloon payment. This practice involves setting up a loan so that at the end of the loan period the borrower still owes most of the principal amount borrowed. It is often hidden and structured to force foreclosure or refinance.

Many loans are made without regard to the ability to repay. This type of lending is known as asset-based lending. Individuals who are equity rich and cash poor are prime targets for this tactic. Following is one homeowner's experience with asset-based lending.

> *After showing the house to us and then telling us the selling price, I told him it was just outside of our budget. He said he would show me a way to adjust my withholding exemptions to make better use of our finances.* (CCI File)

Loan flipping is a very common practice that occurs after the loan has been closed and involves the successive repeated refinancing by rolling the balance of an existing loan into an unnecessary new loan. There is usually no benefit to the borrower. Prepayment penalties are used to lock borrowers into high interest rates. Borrowers are charged large fees when or if there is a decision to pay off a loan early (or possibly refinance into another one). Prepayment penalties are often unknown to the borrower. One homeowner gave a description of how he and his wife discovered they had a prepayment penalty.

> *By December Realtor X had sold our home. We knew we could sell it for what we owed so we were willing to take out an unsecured loan for $15,000. Everything concerning the sale seemed to be going fine until the lender called and told us we would have to pay a penalty of $18,000 for paying off our loan early.* (CCI File)

Abusive collection practices are utilized to make sure that the payments are received. Lenders continuously call homeowners at all hours. Some borrowers are contacted prior to the grace period. These tactics often involve threats to evict the homeowner immediately, even though the lenders know they must first foreclose and follow eviction procedures (Sturdevant & Brennan, 2000). One homeowner illustrated an episode that took place as they attempted to make their mortgage payment.

> *... we made our house payment by mailing them a check each month for $1247.30 and $330.31 to _____. Several times during August 1999-September 2000 _____ would accuse us of not sending in our payment when we had. Once they called and said if we did not overnight them the check it would be counted as bad credit, so we overnighted it to them only to have them cash both checks the next day.* (CCI File)

Foreclosure is a very realistic possibility for homeowners with predatory loans. They are costly to the holder of the mortgage, financially and emotionally. Family displacement is a direct result of foreclosure. The following couple described foreclosure as their only alternative.

> *This was their final solution to our problem. We were told that we had to sell the home or face foreclosure. When it became clear that we had no other choice we sought legal counsel and were advised to file for bankruptcy and let the lender foreclose on the home.* (CCI File)

While many of the loan terms previously mentioned may not be predatory on their own, the failure of the lender to fully disclose to the borrower the risk or cost associated with each individual term can make the loan package problematic. This is especially true if the borrower is unaware that better terms may be available (Housing Ohio, 2002).

Conclusions

The Fair Credit Reporting Act and Fair Housing Act were established to deter discrimination, but as the rules are enforced the act of discrimination reinvents itself. Predatory lending is readily practiced in Middle America. "Subprime loans now constitute about 20% of home loans in Des Moines, said Tyler Uetz, who estimated that about 10% of these mortgages could be classified as predatory" (Dinnen, 2002, p. D1). Homeowners are not only paying excessive fees, but they are paying for houses that are overvalued. A recurring theme from the homeowner files suggests that loans were made with disregard to the households' ability to repay. Based on the files, phone calls and mailings were identified as the primary predatory lending marketing tools.

Generalizations cannot be made from this study due to the size of the sample and the use of purposive sampling. This, by no means, implies that the research is unimportant. This qualitative study illustrates the kind of treatment that homeowners experience when seeking assistance from predatory lenders. Results of the homeowners' experiences push for legislation, education, and outreach. Sorenson (2002) suggested that the best way to fight against abusive lending practices is through consumer education: "This is clearly an area where the lending community and community-based organizations can partner to help Iowans make better financial decisions" (p. 40P). Although this study provides limited information, it does give a voice to victims of predatory lending and permits us to learn how predatory lenders operate.

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