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# **Financial Services in Distressed Communities: Issues and Answers**

**Financial Services in Distressed Communities:  
Framing the Issue, Finding Solutions**  
By James H. Carr and Jenny Schuetz

and

**Predatory Lending: An Overview**  
By James H. Carr and Lopa Kolluri

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## **Executive Summary** \*

The American financial system is arguably the most sophisticated and efficient in the world. The power of our financial services industry derives from the complexity of the nation's financial intermediaries including commercial banks, savings institutions, mortgage banks, credit unions, investment banks, securities firms, insurance companies, specialized credit intermediaries, and a variety of specialized government and government-sponsored or -regulated financial institutions.

But this sophisticated financial services infrastructure differs markedly from the world of finance in lower-income and minority communities. There, the language of finance is increasingly pawnshops, check-cashing outlets, payday lenders, and rent-to-own stores. Largely unregulated in many states, the fees charged by these alternative financial services outlets are frequently excessive and their business practices often differ greatly from the asset-building and wealth-creation services provided by mainstream financial institutions.

In addition, excessive subprime, as well as predatory, lending tend to flourish in communities saturated with check cashers, pawnshops, and related financial services outlets. The heavy concentration of these practices in lower-income and minority communities further erodes the asset-building potential of financially vulnerable households. This concentrated negative impact on households translates into increased financial distress at a community level as households already living on the margin are forced to navigate a minefield of high-cost, unscrupulous, and often fraudulent financial services providers.

The following two articles focus on the financial services infrastructure that typically serves lower-income, minority, and distressed communities. They document how the failure to ensure efficient financial services markets in those areas exposes residents to wealth-stripping financial services activities and greatly contributes to their financial marginalization. The articles offer several policy recommendations to improve the delivery of lower-cost, asset-building financial services to the nation's most financially vulnerable consumers.

The first article, titled "Financial Services in Distressed Communities: Framing the Issue, Finding Solutions," by James H. Carr and Jenny Schuetz, examines the recent explosive growth of alternative financial services outlets in distressed communities and the corresponding growth of subprime and predatory lending in those same markets. Carr and Schuetz document the high costs for households relying primarily or exclusively on those lenders. Recognizing that fringe lenders have filled an important credit gap by developing products and services to meet the unique needs of lower-income consumers, the article cautions that those services, nevertheless, often come at staggering costs. Further, the article explains that because alternative financial services providers do not offer savings products, households that rely exclusively on them to meet their financial services needs have neither the incentive nor opportunity to save.

Carr and Schuetz also highlight the substantial costs to households exploited by excessive subprime and predatory lending. The article notes that while subprime lending is a critical source

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of credit for millions of families, minority households are disproportionately steered to higher-cost subprime lending. The extreme reliance on subprime lending by minority households raises the question of whether they are steered on the basis of their race or ethnicity rather than due to legitimate creditworthiness issues. The article documents that as much as 35 to 50 percent of the borrowers in the subprime market could have qualified for lower-cost prime market loans and provides examples of the extraordinary costs to households of being unfairly steered to subprime credit. The article notes that steering of borrowers to the subprime market contributes to confusion in the policy-making community in distinguishing between legitimate subprime and predatory lending.

Carr and Schuetz conclude with three policy recommendations to improve the financial services environments of distressed communities. They are: (1) Enhance data collection on finance services transactions and increase enforcement of fair lending, equal credit opportunity, and consumer protection laws and regulations; (2) Create greater competition for financial services in distressed communities by improving the range of available financial products and services and enhancing government's role as a facilitator and supporter of financial services innovation; and (3) Enhance and expand consumer outreach and financial education and awareness.

In the area of enhancing financial innovation, the recommendations include creation of partnerships between mainstream financial services providers and alternative financial services outlets that would leverage the strengths of both sets of institutions. Such partnerships would leverage the economies of scale that could be provided by mainstream firms while leveraging the customized products and outreach techniques perfected by fringe lenders.

The second article, "Predatory Lending: An Overview," by James H. Carr and Lopa Kolluri, examines more closely the issue of predatory lending. It notes that predatory lending represents some of the most abusive lending behavior in the financial services community and highlights the fact that predatory lending is not a simple issue of high-cost lending. Rather, Carr and Kolluri note that predatory lenders structure loans to force borrowers to default for the express purpose of extracting the equity homeowners have accumulated in their properties. But the article also notes that steering households to high-cost subprime loans on the basis of race/ethnicity or other personal characteristics is also a predatory practice that should be considered in the context of debates on predatory lending. A three-part definition for predatory lending is offered to explain how lenders utilize a variety of otherwise legitimate marketing techniques and loan terms to create fraudulent and financially destructive loans. The article concludes with a series of recommendations to directly address predatory lending.

Carr and Kolluri note that because predatory lending thrives in an environment where competition for financial services is limited or lacking, effectively eliminating predatory lending requires the same three-pronged approach recommended by Carr and Schuetz to enhance the efficiency of financial services generally in distressed communities. Carr and Kolluri further point out that as few as five to seven practices constitute the bulk of the most egregious predatory lending behavior and meaningfully addressing those practices would greatly reduce the most blatant forms of predatory lending.

# Financial Services in Distressed Communities: Framing the Issue, Finding Solutions\*

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## **Introduction**

The American financial system is arguably the most sophisticated and efficient in the world. The power of the U.S. financial system comes from the complexity of financial intermediaries that include commercial banks, savings institutions, mortgage banks, investment banks, securities firms, insurance companies, specialized credit intermediaries, and a variety of specialized government and government-sponsored financial institutions.

But this sophisticated financial services infrastructure differs markedly from the world of finance in lower-income and minority communities (see figure 1, Bifurcated U.S. Financial System). There, the language of finance is increasingly pawnshops, check-cashing outlets, payday lenders, and rent-to-own stores. Largely unregulated in many states, the business practices of these financial services outlets differ greatly from the asset-building and wealth-creation services accessed by the majority of Americans.

Further, excessive subprime, as well as predatory, lending tend to flourish in communities saturated with check cashers, pawnshops, and related financial services outlets. Creating greater efficiency in, and competition for, financial services in distressed communities is the key to enabling lower-income and minority residents to maximize their asset-building capabilities and limit the negative influence of excessive high-cost and predatory financial services providers.

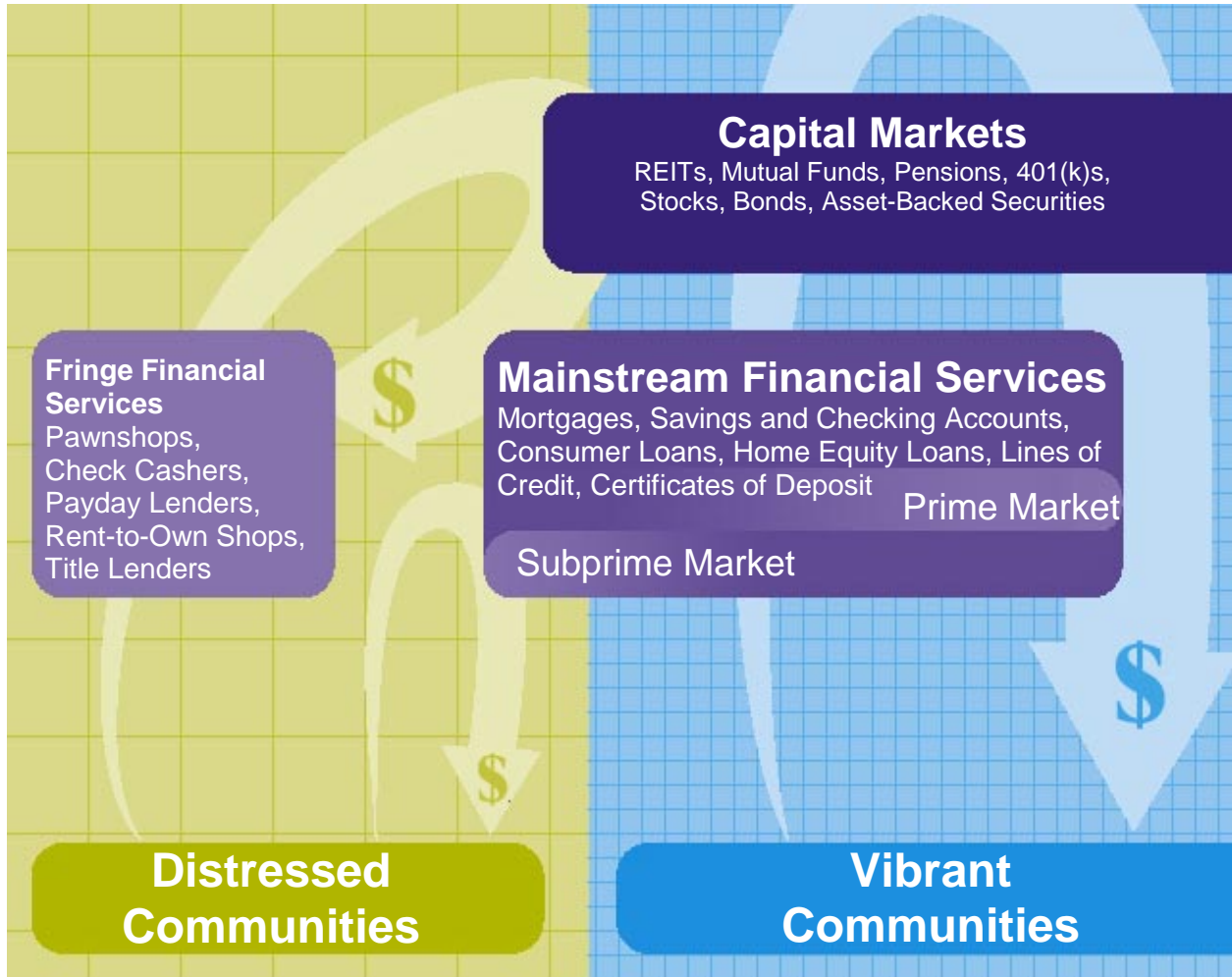
This article discusses the recent rapid growth of the alternative or fringe financial sector and highlights how its high-cost fee structure greatly undermines the ability of individual households to accumulate assets and build wealth. The article further notes that, to the extent that fringe financial services providers concentrate in, and are the primary financial services providers for, distressed lower-income and particularly minority communities, the neighborhoods in which they locate are also seriously disadvantaged. The article concludes with a series of recommendations to promote efficient financial markets in lower-income and minority

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communities. A companion article focuses explicitly on predatory lending (see “Predatory Lending: An Overview”).

*Figure 1. Bifurcated U.S. Financial System*



### **Financial Services in Distressed Communities**

As many as 12 million households in the United States either have no relationship with traditional financial institutions or depend on fringe lenders for financial services. These households are disproportionately poor and minority. Among lower-income families surveyed in a 1995 Federal Reserve Survey of Consumer Finances, 25 percent were unbanked, as well as one-third of African-American households and 29 percent of Hispanic households. Without banks, these households operate largely in a cash economy or resort to fringe banking services that routinely charge significantly higher fees for services than those assessed by mainstream financial institutions. The situation is particularly daunting for African-American households, 60

percent of which have zero or negative net financial assets, according to a report by the Corporation for Enterprise Development.

Lack of physical proximity to mainstream financial institutions is perhaps the most frequently cited reason for the disparity in financial services utilization by low-income and minority populations compared with wealthier households. A 1999 *Harvard Business Review* article, for example, cites extreme disparity in financial services options available to residents of two neighborhoods in Los Angeles—one in South Central and the other in Pacific Palisades. South Central has one depository institution for every 36,000 people, while Pacific Palisades has one for every 1,250 people.

Yet while physical proximity is important, it is not the only—and often not the most significant—barrier to the use of mainstream financial services among lower-income and minority households. There are a variety of complex reasons why many lower-income and minority households do not use traditional financial services even when they have access. Those reasons include unfamiliarity with banking and savings services, a belief by consumers that they do not write enough checks to justify an account, and lack of trust of the mainstream financial services providers. In addition, mainstream financial services can also be very expensive for households that do not have a relationship with those institutions, when customers cannot fulfill minimum balance requirements, or when poor management of an account results in bounced-check or related fees.

In fact, fringe lenders attribute their rapid growth to large, unmet consumer financial services needs among many lower-income households. According to the Financial Service Centers of America (FiSCA) (formerly the National Check Cashers Association) alternative sources of credit are filling an important credit gap for “individuals with limited financial means or who may lack the tangible assets to pledge in connection with traditional types of collateralized transactions...” FiSCA further asserts that alternative financial services providers are in higher demand than banks or credit unions in many markets because they provide a wider range of services and more flexible hours of operation tailored to meet the unique needs of their clients.

There is little debate that fringe lenders provide critical services to customers whose extremely low or unreliable incomes, limited tangible assets, or inability to manage credit make them unlikely candidates for mainstream financial services. But the explosive growth of these financial services storefronts over the past decade raises many critical policy issues. First, because fringe lenders do not provide savings accounts, households that rely exclusively on them lack both the incentive and option to save. Second, the heavy concentration of fringe lenders in minority communities means that those areas are disproportionately burdened with second-class financial services options. Finally, reliance on fringe lenders, even to the extent they provide needed financial services, routinely comes at a very high cost.

Consider these examples for check cashers, payday lenders, pawnshops, auto title lenders, and various other fringe financial activity:

- Check cashers—Although the average fee at a check cashing outlet for a government or payroll check ranges from 1.5 to 3 percent of its face value, fees can run as high as 20 percent for personal checks. At least 19 states regulate some aspects of check cashing services.
- Payday lenders—institutions that offer small consumer loans of \$100 to \$300—routinely charge 15 percent per two-week period. In addition to annualized interest rates of more than 400 percent, such loans encourage households to spend the next paycheck before it arrives, thus encouraging a dangerous cycle that can trap a household in permanent debt.
- Pawnshops offer small, short-term loans using personal items as collateral. State-imposed interest rates are capped as high as 25 percent monthly, which, annualized, can exceed 300 percent. Loopholes in some states allow “lease back” or “roll over” agreements that add fees, sometimes doubling the already high interest rate.
- The rent-to-own industry offers purchasing credit to consumers for a variety of merchandise, such as furniture and home electronics, for weekly or monthly payments that can be applied toward ownership. Leased items are typically priced at two to three times the standard retail amount. No equity builds up in the leased items until the final payment. According to a Federal Trade Commission survey, 60 to 70 percent of customers who initiate leases eventually purchase the items. The Association of Progressive Rental Organizations estimates that the percentage of customers who complete a purchase is less than 25 percent.
- Auto title lending is a variation on traditional pawnbroking. A person with clear title to a vehicle can borrow money from a lender by giving him or her power of attorney to transfer the title should the borrower default. Title loans are typically made for about 25 percent of the car’s value. Interest rates and other service charges vary between 2.5 and 25 percent per month, depending on a state’s pawnshop laws. Title loans are particularly dangerous for working families because defaults can result in the loss of the car and, consequently, the job, if there is no other way to get to work.
- Robert Manning in his book, *Credit Card Nation*, also describes direct marketing campaigns for high-interest “secured” credit cards that are marketed to customers who likely would not qualify for a standard-rate bank-issued credit card. In one example, he cites an offer for a \$400 line of credit for which, in return for applying for the credit card, an unsuspecting consumer agrees to pay a variety of fees totaling \$369. Such “offers” may be widely distributed, but the people most likely to accept the offer are the most financially vulnerable populations with the least financial sophistication and the fewest credit options.

### **Compensating for Risk**

While the fees charged by fringe lenders are justified on the basis of the perceived high risk of their borrowers, most of these financial services providers have devised creative ways to reduce or protect themselves against borrower default on top of the high fees they charge. Payday lenders, for example, not only require proof of employment, income, and a personal checking

account, but the borrower also must provide a postdated personal check. The rent-to-own industry allows no equity to be built up until the final payment, so a customer may meet all weekly payments and default near or at the end of the loan term, losing the item plus all previous cash payments. The retailer can then re-lease the item at the same weekly or monthly rate. Pawnshops provide cash loans in return for collateral left in the possession of the pawnbroker. And “cash leasing,” a cross between payday loans and pawn loans, involves small, short-term cash advances that carry monthly interest charges of up to 30 percent, backed by an active checking account and “pledged” household items, such as a stereo, computer, or television. Some states are better than others in affording consumer protections in these types of transactions.

In fact, Progressive Policy Institute analyst Anne Kim notes that the two largest check-cashing companies in the United States cashed roughly \$6.5 billion in checks last year. According to Kim, the majority of those checks were payroll or government benefit payments. The value of bad checks—that is, the checks for which the check cashers could not collect—totaled less than one-fourth of one percent of the total amount of checks cashed. The nation’s two largest check cashers thus realized healthy profits charging on average 2.2 and 3.5 percent, respectively, of the face amount of the checks they cleared.

### **The Problem Is Growing**

As table 1 illustrates, alternative financial services activity is big business. Fringe services engage in at least 280 million transactions each year for gross revenues of more than \$168 billion that extract fees of at least \$5.5 billion. According to Norman D’Amours, former chairman of the National Credit Union Administration, the number of unregulated and unlicensed financial services providers is growing nationwide, but the increase is exponential in low- and moderate-income and minority communities.

He notes that while the number of credit unions, banks, and thrifts has been steadily decreasing over the past five years in the United States, the number of check-cashing outlets has doubled. An April 2000 report by Dove Consulting for the U.S. Department of the Treasury reveals that about 11,000 check-cashing outlets in the United States cash more than 180 million checks annually, worth roughly \$60 billion. D’Amours also estimates that there are between 12,000 and 14,000 pawnshops across the country, outnumbering credit unions and banks. Further, in 1996 there were 8,000 rent-to-own stores that served 3 million customers, according to a recent Federal Trade Commission survey. And in *Savings for the Poor*, Dr. Michael Stegman of the University of North Carolina, Chapel Hill, reported that payday lending grew nationally from 300 stores seven years ago to more than 8,000 in 1999.

**Table 1. Fringe Lending Is Real Money:  
Estimated Annual Transactions**

<b>Service</b>	<b>Fee/Rate per Transaction</b>	<b>Volume of Transactions</b>	<b>Gross Revenues</b>	<b>Fee Total</b>
Check Cashing	2–3 % payroll and government checks (can exceed 15% for personal)	180 million	\$60 billion	\$1.5 billion
Payday Loans	15–17% per 2 weeks 400% APR	55–69 million	\$10–13.8 billion	\$1.6–2.2 billion
Pawnshops	1.5–25% monthly 30-300% APR	42 million	\$3.3 billion	N/A
Rent-to-Own	2–3 times retail	3 million	\$4.7 billion	\$2.35 billion
Auto Title Lenders	1.5–25% monthly 30–300% APR	N/A	N/A	N/A
<b>Total</b>	<b>N/A</b>	<b>280 million</b>	<b>\$78 billion</b>	<b>\$5.45 billion</b>

### **It Undermines Households and Communities**

Even at the most modest levels, alternative financial services fees can greatly undermine the asset-building capacity of lower-income households. According to research cited by the Federal Reserve, fringe services for cash conversion and bill paying would cost an average \$20,000-income household between \$86 and \$500 per year, while the same services at a bank would cost only \$30 to \$60 (assuming that low-cost banking services are available and the prospective customer is not disqualified for an account by lack of credit). Yet, \$500 per year saved for a period of 10 years at a modest interest rate of only 4 percent would grow to more than \$6,000. That amount would be sufficient for a down payment on a modestly priced home.

Moreover, the actual costs to many households using fringe banking would be even higher if those same households also resort to payday loans, pawnshops, rent-to-own retail, or auto title pawn loans. An example Manning offers in *Credit Card Nation* is of a \$196 Magnavox TV that costs \$9.99 a week for 78 weeks from a rent-to-own shop, for a total of \$779. Compare it to buying the same television with a credit card at 22.8 percent interest from a national discount electronics store over the same time period for a total of \$231. The difference in finance charge

would be \$548. Assuming a household relied on fringe lenders for only an additional \$300 worth of services per year, the new total of \$800 of potential savings would grow to nearly \$10,000 over a 10-year period, again assuming a modest 4 percent rate of return.

Even if these households actually were able to save some of their earnings, their failure to access mainstream financial services institutions undermines their long-term asset accumulation. To illustrate, table 2 calculates the different investment vehicles. If, in 1989, a family had \$3,000 in savings, but saved the money in a shoebox, 10 years later that \$3,000 would be still be worth \$3,000 in nominal dollars but only \$2,233 when adjusted for inflation. However, the same sum invested in a 10-year Treasury note would have grown to more than \$5,000 by 1999. Investment in an S&P index fund would have yielded \$9,180 over that 10-year period. And if the family had, by prophetic insight, invested their savings in Microsoft Corporation in 1990, their wealth could have grown to a staggering \$211,360 by 1999.

*Table 2. The Value of Saving \$3,000\**

Year	Shoebox	Treasury Note	S&P 500 Index Fund	Microsoft Stock
1989	\$3,000	\$3,000	\$3,000	\$3,000
1999	\$3,000	\$5,072	\$9,180	\$211,360

\* In nominal dollars.

### **Excessive Subprime Home Mortgage Lending**

As with fringe lending, subprime mortgage lending has also experienced tremendous growth in recent years. A recent U.S. Department of Housing and Urban Development (HUD) study indicates that between 1993 and 1998, the dollar volume of subprime loans grew sevenfold, from \$20 billion to \$150 billion, and the number of subprime refinance loans grew tenfold, from 80,000 loans to 790,000 loans. This growth in subprime lending compares to less than a 40 percent increase in prime lending for home purchases and a 2.5 percent increase in prime refinance loans.

HUD reports that subprime loans are heavily concentrated in lower-income and minority communities—the same communities that are the target for fringe financial outlets. HUD's analysis indicates that subprime loans are three times more prevalent in lower-income neighborhoods than in high-income areas, and five times more likely in black communities than in white neighborhoods. In fact, in black neighborhoods, high-cost subprime loans accounted for 51 percent of home loans in 1998, compared with 9 percent in white areas. Moreover, homeowners in high-income black communities are six times as likely to have a subprime loan

as homeowners in high-income white neighborhoods. Estimates by Fannie Mae, Freddie Mac, and others conclude that many households in the subprime market could reasonably qualify for a prime market loan (see article on Predatory Lending in this report).

### The Financial Impact of Excessive Subprime Lending

Subprime loans do not have to be predatory to seriously undermine the financial viability of households. Targeting or referring households to the subprime market in instances in which those loan applicants could reasonably have qualified for prime market loans greatly undermines the long-term asset-building potential of those households. Each additional interest point on a home mortgage totals tens of thousands of dollars on the total cost of a mortgage over the life of the loan. Subprime mortgages are routinely 3 to 4 percentage points or more higher than a comparable prime market loan. Yet, a mere 1 percentage point of additional interest can make a substantial financial impact over the life of a loan (see table 3).

*Table 3. Comparing Mortgage Payments for Different Interest Rates*

<b>30-Year Fixed-Rate Loan</b>				
<b>House Value</b>		<b>\$85,000</b>		
<b>Down Payment</b>		<b>\$4,250 (5%)</b>		
<b>Loan Amount</b>		<b>\$80,750</b>		
<b>Annual Interest Rate</b>	<b>Monthly Payment</b>	<b>Annual Payment</b>	<b>Annual Difference from 8%</b>	<b>Lifetime Difference from 8%</b>
<b>8%</b>	592.51	7,110.18	N/A	N/A
<b>9%</b>	649.73	7,796.79	686.61	20,598.43
<b>10%</b>	708.64	8,503.67	1,393.49	41,804.69
<b>11%</b>	769.00	9,228.01	2,117.83	63,535.05
<b>12%</b>	830.60	9,967.26	2,857.08	85,712.32

Take the example of a home modestly priced at \$85,000. Assuming a 5 percent down payment, the mortgage is slightly under \$81,000. With a base interest rate of 8 percent on a 30-year loan, a loan 1 percentage point higher results in \$687 more annually. Over the lifetime of this 9 percent

loan, it would be a \$21,000 difference. At 2 percentage points—a 10 percent interest rate—the difference from a prime loan of 8 percent would be \$42,000, half the original loan amount. Now, take that same \$687 a household could save each year by shaving off a percentage point on their mortgage and invest it at 6 percent. At the end of 30 years, that household would have \$57,572 instead of having to pay \$21,000 in additional interest. The 2-percentage-points savings of \$1,393 per year, invested at 6 percent, would total \$116,736 at the end of 30 years for the household. And if the subprime loan carried a 12 percent interest rate, the extra interest payment over the base 8 percent loan would be \$85,712 over the life of the loan. Invested at 6 percent for 30 years, that \$85,712 of additional payments would grow to \$239,421 in savings over a 30-year period.

### Reasons for Rapid Growth

Three trends in recent years appear to have strengthened the alternative financial services sector: 1) increasing consolidation into large, publicly held firms with standardized business outlets across the nation, 2) increasing involvement by mainstream financial institutions in fringe lending outlets, and 3) enhanced products and services and effective marketing schemes to capitalize on rising consumer debt and the disconnect between low-income households and the mainstream financial system.

#### *Industry Restructuring*

Restructuring within both the mainstream and fringe financial services industries are contributing to the growing significance of fringe financial storefronts in disenfranchised communities. Michael Stegman cites consolidation in the banking industry as one reason for the decline in the presence of traditional banks in neighborhoods of all income levels. In *Fringe Banking: Check-Cashing Outlets, Pawnshops, and the Poor*, John Caskey suggests that banking deregulation and pressure for increased profits have led banks to charge for previously free services and close unprofitable branches (often in low-income and minority areas) as well as eliminate money-losing services, such as small-balance deposit accounts.

Over the same period, several fringe financial outlets, such as pawnshops, check cashers, and payday lenders, have engaged in major consolidations. In the check-cashing industry, for example, six firms owned at least 50 outlets each in 1991. By 1999, one of the largest of these establishments had grown to more than 1,000 company-owned stores with franchises in 30 states. Further, this company has expanded its traditional in-store check-cashing business to include bill payment services as well as automated check cashing using advanced function ATMs with user-friendly touch screen menus.

Pawnshops, too, have grown into national chains. Data from *Fringe Banking* report the existence of at least five large, publicly traded nationwide pawnbroking firms. The largest of these chains went public in 1987, and by 1999 had acquired 414 stores in the United States. The rent-to-own industry has shown similar trends of consolidation. The largest firm was founded in 1986, and by 1999 owned 2,300 stores across the nation, or roughly one-fourth of all rent-to-own stores.

### *Convergence of Fringe and Mainstream Lenders*

Wall Street has also fueled the growth in fringe and subprime activity. A recent *Business Week* article notes, for example, that through securitization—that is, the practice of issuing securities based on a pool of mortgages that can be sold to investors—leading Wall Street firms resold \$60 billion of subprime mortgage loans in 1999, up from \$3 billion in 1995. Between 1995 and 1998, subprime loan note sales rose from \$10 billion to \$87 billion. Banks now control 5 of the nation's top 10 subprime lenders and 10 of the top 25 subprime lenders.

### *Effective Marketing and Customized Services*

While many low-income households exhibit reluctance to use traditional banks, fringe financial services providers have well-developed marketing strategies to draw in and retain customers by focusing on the relationship between customers and staff. Pawnshops and rent-to-own stores emphasize treating customers with personal attention and encourage small weekly payments made in person, allowing the retailer to market additional products to existing customers. These types of businesses rely heavily on repeat customers, which they cite as a means of increasing transactions while reducing risk, as Caskey reports in *Lower Income Americans, Higher Cost Financial Services*.

## **Role of Financial Markets in Community Reinvestment**

Creating efficient markets in distressed communities is essential to successful revitalization of those areas. Stated otherwise, building community wealth requires the building of individual wealth. Mainstream financial institutions are the engines of wealth creation and upward financial mobility in America. Improving access to, and utilization of, the mainstream engines of wealth creation would by itself promote significant community investment.

Each dollar that is spent on overpriced financial services by a lower-income household represents potentially important savings that could lead to wealth building. For example, the more than \$5.45 billion in fringe financial services fees that are collected from financially vulnerable consumers each year is slightly less than the entire asset base of the more than 460 community development financial institutions (CDFIs) operating in the United States. It is also moderately less than the fiscal year 2000 HUD budget for Community Development Block Grants plus all HOPE VI and Empowerment Zone/Enterprise Community funding.

Moreover, the fees represent an annual funding stream. If only a portion, perhaps 20 percent, of those dollars lost each year to fringe financial services could be captured and redirected to housing, that would represent more than \$1 billion for home-buyer assistance or housing rehabilitation in many of the most distressed communities in the nation. And, that funding stream would not require any additional taxpayer contributions. Add to that sum the hundreds of millions of dollars unnecessarily paid each year, by households unfairly and unnecessarily steered into high-cost subprime loans, and it is immediately clear how better organizing the

financial markets in distressed communities and connecting households to the engines of wealth creation can provide a major boost to the community revitalization process.

Flowing to a broader range of consumer goods and services, that money could encourage the opening of new business based on market demand for locally desired products or services. Helping to create wealth could reduce the need for complex tax-related government subsidies that encourage businesses to relocate to distressed communities that have no economic rationale for being there other than to benefit from untargeted and questionable tax subsidies. If channeled into savings, money lost to check cashers and similar high-cost services could offer financial institutions and community residents enormous wealth-generating potential.

### **Fixing the Problem**

Enhancing financial services options for lower-income and minority households and communities will require action in three areas:

1. Improving the availability of data on financial services transactions and aggressively enforcing fair lending, equal credit opportunity, and consumer protection laws and regulations.
2. Enhancing availability of products and services designed to meet the unique needs of lower-income and lower-wealth customers.
3. Offering consumer financial education and outreach programs.

### *Collecting Additional Data and Enforcing Laws*

An important missing tool to address the issue of market failure in distressed communities is a robust set of data that could more easily enable policy makers, regulatory agency personnel, researchers, nonprofit community activists, and other interested parties to pinpoint critical areas and issues for examination and possible action. Enhancing data collection is always controversial. But it is simply not possible to resolve a problem that cannot be identified and examined. When the federal government first sought to include borrower race/ethnicity information in the Home Mortgage Disclosure Act database, many argued that added information would be useless because it would answer only *who* was accepted or rejected for mortgage credit but not *why*. Yet that data exposed major and critical areas for concern throughout the mortgage lending industry related to lending to traditionally underserved borrower groups. The net result has been explosive growth in affordable lending to lower-income and minority households over the past decade.

Because alternative financial services providers are regulated at the state level, with widely varying regulatory oversight, a single national reporting requirement could greatly enhance the ability of regulators, community groups, and research institutions to examine the practices of

these firms. Data elements might include fee schedules, collateral requirements, number of customers served, and revenue and earnings statements.

The goal of greater regulation with respect to fringe lenders should not be to eliminate those sources of credit. In moderation, they provide important access to credit for a variety of consumers. Rather, enhanced regulation should ensure that to the extent those services are provided, they are offered at costs that more reasonably reflect the real risks presented by consumers. Interest rates, for example, that when annualized can exceed 300 percent or more, are hard to justify under any circumstance. Further, the targeting of high-cost financial services on the basis of personal characteristics such as race or ethnicity, rather than on the basis of income or creditworthiness, should be closely monitored and effectively addressed.

For subprime loans, additional information might include key loan terms such as the inclusion of credit life insurance, balloon payments, prepayment penalties, and related major loan characteristics. Further, interest rates, points, processing fees, and closing costs would also be critical. This data could highlight areas for further investigation and allow for a more aggressive enforcement of fair housing, equal credit opportunity, and a variety of consumer protection laws.

To the greatest extent possible, reporting requirements for similar financial transactions should be the same for the greatest number of institutions possible. Dissimilar reporting requirements across institutions that perform similar services create opportunities for abuse by institutions that are not covered. At the same time, institutions that are covered may be discouraged from attempting to enter emerging markets with new or innovative products. Further, because data collection can be very costly, care should be taken to ensure that any new reporting requirements do not overwhelm financial institutions with requests for insignificant and extraneous information.

Further, an explicit focus on how equal credit opportunity and consumer protection laws are violated in distressed communities would provide financially vulnerable households with the kind of support offered to middle-income and wealthy households in vibrant communities. Each year, millions of dollars are spent on financial system regulation through agencies such as the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision, Department of the Treasury, and Federal Reserve System, to name a few. But federal institutions can do relatively little to protect the financial interests of households operating in a cash economy or relying on fringe financial services providers whose activities are not covered by those key federal financial regulators.

### *Enhancing Products to Serve Lower-Income Households*

Efforts to promote a wider range of financial products and services for low-income and minority households can be divided into three categories: 1) efforts to connect households receiving government benefits to low-cost access to those funds through electronic transfer accounts (ETAs) and related initiatives; 2) enhanced utilization of technology, such as sophisticated ATMs and the Internet; and 3) innovative products and partnerships designed to meet the unique needs of lower-income, lower-wealth households.

*Government Initiatives.* The Debt Collection and Improvement Act of 1996 is one of several promising initiatives launched by the federal government to decrease processing costs, reduce fraud, and provide a lower-cost alternative for benefit recipients than sending them paper checks that must be cashed, usually for a fee. The law mandated that, by 1999, all federal benefit payments would be delivered electronically—a measure that is expected to save the federal government an estimated \$100 million annually on processing and delivering payments. Since the legislation went into effect, Congress has mandated that states convert food stamp programs to electronic payment by 2002, using point-of-sale (POS) terminals at participating retailers. Additionally, more than 40 states have voluntarily decided to add their emergency cash assistance programs to the plastic food stamp cards so that welfare benefits will be accessible at ATMs and POS networks.

These laws create even more opportunities to link low-income families and people living in underserved areas to banks and other savings institutions. Michael Stegman, in his forthcoming article, “Banking the Unbanked,” says the electronic delivery of government benefits “promotes financial inclusion” and recognizes that “economic opportunity cannot thrive where access is denied.” In fact, an estimated 3 million of the roughly 12 million unbanked individuals in the United States receive federal government benefits—a large market that has gone largely untapped.

*Expanding Use of Technology.* A Ford Foundation white paper, “Financial Technology and the Lower-Income Consumer” by Steve Davidson et al., notes that new types of ATM and card-based technology have the potential for “turning the unbanked to the self-banked” while lowering costs and increasing access and convenience to financial services and products. The report provides several examples: Umbrella Bank in Illinois plans to put ATM-equipped kiosks in lower-income housing developments; FirstTel is gearing up for similar services in HUD housing in Florida; and Banco Popular offers an all-electronic account to customers without a traditional bank account.

Similar to the federal government’s ETAs is a U.S. Treasury Department pilot initiative that uses ATMs to limit the reliance on fringe lenders and check cashers in traditionally underserved markets. Treasury is piloting a program to put ATMs in post offices to distribute Social Security payments, federal retirement payments, and other government benefits. Consumers use a debit card or credit card to access their benefits with no extra fees. The ATMs would provide safe and convenient access to banking services in traditionally underserved areas. The project, in partnership with the U.S. Postal Service and Key Bank of Cleveland, which owns and operates the ATMs, is testing the use of the free-of-charge ATMs at three urban locations in Baltimore and three rural locations outside Tallahassee, Florida.

Efforts to lower the cost of banking by using technological advances should be encouraged among the private sector as well, since an estimated half of the country’s private sector employees do not participate in direct deposit. Comptroller of the Currency John D. Hawke Jr. recently told the National Community Reinvestment Coalition that expanding the structure of the direct deposit account to make it more appealing to the unbanked is critical to bringing them into the mainstream banking system. Creating these connections—and adding functions such as transfer

of funds to other countries at a lower cost than wire transfer fees—can create links between banks and lower-income residents.

*Innovative Products and Services.* Mainstream financial services providers can learn from the considerable finesse demonstrated by alternative financial services providers in marketing, packaging, and bundling services. One example is bundling services such as check cashing, money orders, money wiring, utility and cable bill payment, and related services (see the summary of John Caskey’s proposed solution following this article). Mainstream financial institutions can take a lesson from and form partnerships with fringe service providers, creating efficient operating structures that lower costs and then pass along savings to clients.

Innovative programs that have recently been introduced or are being test-marketed by institutions such as community development credit unions (CDCUs) and CDFIs should be encouraged and expanded. Woodstock Institute’s *Reinvestment Alert No. 16* provides two examples of CDCUs that are offering alternative payday loan products to counter the often-excessive fees charged by fringe payday lenders. The Faith Community United Credit Union in Cleveland and the Louisiana-based ASI Federal Credit Union offer affordable alternatives to their members, and their experiences can show how other mainstream credit unions and financial services providers can establish similar consumer loan products. Both offer interest rates of 17 to 18 percent, with \$15 to \$30 processing fees and timely repayment requirements. Credit counseling is offered with the service, and a savings plan can be integrated into the loan.

Davidson et al. also provide examples of how some mainstream financial services providers are expanding their reach to lower-income consumers by lowering the cost of those services to help “transition” these customers to mainstream markets. Union Bank of California has created a division called Cash & Save that offers check-cashing services at a lower-than-average 1.0 percent to 1.5 percent fee on payroll checks issued by area employers. Customers are permitted to open Union Bank savings accounts at Cash & Save outlets. Another company, Directo Inc., is serving lower-income customers—many of whom were denied bank accounts—with a payroll debit card, allowing employees to access their pay electronically through an ATM. Directo also has an innovative wire service/ATM feature that enables customers to wire money to foreign bank accounts that can then be accessed through an ATM. The fees are much lower than those for most wire services.

New partnerships between fringe lenders and mainstream financial services providers can also prove to be highly beneficial to residents of distressed communities and the financial institutions that serve them. By moving away from an exploitative model and toward a model that lays the foundation for a long-term, mutually beneficial relationship, mainstream financial institutions can help to build the assets of lower-income consumers that can lead to more valuable and substantial relationships over time.

In *Banking the Unbanked*, Stegman cites the Chicago Community Reinvestment Act Coalition and Bank One as an example of this type of partnership. The organizations teamed up to increase lending, service, and investments in lower-income communities in the Chicago region. They are also piloting a program to promote deposit services to unbanked customers. This pilot, the “Alternative Banking Program,” offers a safe, convenient, and inexpensive alternative to check-

cashing services and conducts financial literacy workshops to demonstrate the cost savings of using alternatives to check cashers.

The incentive to reform the financial services environment characterized by high-cost and inefficient financial services providers is compelling for policy experts interested in helping to promote the building of wealth among lower-income and minority households. The extraordinary sums of money involved in excessive fringe and subprime lending clearly demonstrate the fact that there is substantial potential for lower- and moderate-income households to build their financial assets. Further, recent research by Hogarth and O'Donnell in the *Journal of Consumer Policy* shows that when low- to moderate-income households are brought into institutions with a transaction account, there is a high probability of moving them "in and up" into other product lines.

### *Improving Financial Education and Outreach*

Even if there is improved enforcement of laws, it is very important to educate consumers about the types of institutions, products, and services they should use, and ones they should avoid. Many lower-income households have limited financial savvy and do not know the most basic aspects of household budgeting. Well-conceived, -designed, and -delivered consumer education programs can be instrumental in helping households more effectively manage their finances.

In addition, consumers need to know how to identify potentially fraudulent or otherwise questionable lenders. They need to know, for example, that when they see ads that read: "No credit, no job, no problem," they should respond with "No thanks!" Financially vulnerable households need help understanding that substantial wealth can be built from relatively small amounts of money. They need support to best understand how to properly and effectively evaluate the financial services options available to them and how to select the options that best meet their needs.

Having said that, caution needs to be exercised with respect to our expectations on the ability of financial education to aid borrowers facing predatory lenders. Households with limited education are little match for sophisticated criminals intent on defrauding a household of their wealth. Loan documents are challenging and complex even for borrowers with masters degrees in business.

Mortgage loan contracts can involve 30 or more separate documents written in the legal prose and not intended to be understood by a lay person. Expecting a poorly educated borrower to defend himself or herself in this type of situation is unrealistic. For borrower education to be most effective, it will need to include education prior to selecting a lender as well as third party review at the time of closing.

## **Conclusion**

Improving the financial services environment for lower-income and minority households is imperative to enabling them to fully benefit from the wealth-building opportunities available to

most Americans. With regard specifically to minority households, it is useful to keep in mind that discrimination has played a significant role in creating many of the distressed markets heavily populated by fringe, excessive subprime, and predatory lenders—and that for many years government policies directly supported and even enforced many of the most discriminatory actions. As a result of that history, government has an important role to play in helping eliminate the legacies of those discriminatory actions. Principal among them are the inefficient markets in distressed communities. Improving the markets can be accomplished by supporting financial institutions to reposition themselves to be more effective in meeting the financial services needs of residents of underserved communities.

Rather than acting solely as a policeman—enforcing laws and penalizing institutions that fail to perform—government should work with financial institutions to provide them with the flexibility to test programs or with the funding to pilot innovative financial services approaches that are too expensive for private financial institutions to pursue on their own.

The federal government is constantly engaged in the credit markets to ensure the efficient functioning of those markets as they pertain to middle- and upper-income households. In fact, even today, most households benefit from a substantial infrastructure of government agencies that work to perfect the operation of market mechanisms to ensure the most efficient delivery of financial services possible. But because most of the financial institutions supported or regulated by this infrastructure do not directly serve unbanked households, this elaborate infrastructure does little to promote the financial well-being of the residents of distressed communities.

Greater information and enforcement of relevant laws, combined with increased financial sophistication on the part of consumers, could go a long way toward eliminating in the near term some of the most egregious and abusive financial services practices in struggling, lower-income and minority communities. By combining the private market's innovation with publicly supported initiatives to understand and address market failure, the full range of financial services that serve the majority of Americans can be made accessible in all communities.

## Strengthening Financial Services

### Five Key Elements in Bridging the Banking Gap<sup>1</sup>

In a paper recently presented at a Federal Reserve System conference on *Changing Financial Markets and Community Development*, John P. Caskey outlined a five-point strategy to bring into the financial mainstream the “unbanked” who, without any type of deposit account, are typically customers of check-cashing outlets (CCOs). He suggests that specially bundled financial programs would help this population build savings and improve credit-risk profiles, qualifying them for lower-cost services and eliminating a common source of stress.

#### *1. Open specialized bank branch “outlets” that provide CCO services.*

Banks could provide a range of financial services to unbanked communities by creating bank “outlets” for check cashing. By locating in places convenient to large numbers of low- and moderate-income households that tend to use CCOs, these outlets could initiate banking relationships and build trust among the unbanked. Additional products and services that could be offered include money orders, stamps and envelopes, international and domestic cash wire transfers, phone cards, bus tokens and transit passes, and payment of utility and phone bills. By charging lower fees for check-cashing services than CCOs and offering discounted rates for frequent customers, bank outlets could encourage repeat business, enabling many to “graduate” to banks. The outlets could also work with customers to build savings and address credit problems.

#### *2. Offer “starter” bank accounts with low minimum-balance requirements that cannot be overdrawn, and include access to low-cost money orders for making long-distance payments.*

To encourage the unbanked to become traditional bank customers, their accounts could be tailored to their unique situations. Low-cost, low–minimum balance checking and savings accounts could be offered with nontraditional features, such as discounted money orders, stamped envelopes, convenient processing of utility bills, and electronic deposit of wages and government transfers. By blocking the account from being overdrawn, CCO customers can avoid the high costs of bouncing checks that might have dissuaded them from having traditional accounts. ATM and debit-card access could also be given, along with the service of making long-distance payments.

#### *3. Create accounts specifically designed to build savings.*

“Savings-building” accounts that allow individuals to pledge to save a fixed amount in small increments over a specified time period, usually a year, could also assist the unbanked. Contributions would coincide with receipt of regular income such as a paycheck and, if possible, would be automatically debited. Caskey suggests separating these accounts from a regular checking or savings account to keep a psychological distinction between the two. He also

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<sup>1</sup> Material in this section © John P. Caskey. Used with permission.

suggests imposing a penalty for early closure of the account and for failure to make specified deposits at regular intervals.

*4. Offer deposit-secured emergency loans to individuals whose credit histories make them ineligible for traditional mainstream credit.*

With credit-scoring and other cost-saving technologies, bank outlets could find it more feasible to make unsecured non-revolving loans of less than \$1,000 to customers with good credit records. This would allow them to compete with payday lenders and pawnbrokers to offer smaller loans often not practical at larger banks because of high risk factors and administrative costs. For customers with impaired credit histories, outlets could offer deposit-secured credit cards, or loans made against the balance of a savings-building account. In addition, outlets could partner with community-based organizations (CBOs) to establish philanthropic deposit accounts to provide collateral for loans to lower-income households without financial savings.

*5. Seek community-based partners and offer financial literacy programs.*

Banks can benefit in many ways by forming partnerships with carefully chosen nonprofit CBOs. A well-connected CBO can help overcome distrust between community residents and banks. Also, CBOs benefit from increased financial services in the neighborhood, and can initiate and promote financial literacy initiatives.

Caskey also offered two case studies of these strategies:

*“Cash & Save” Outlets of Union Bank of California*

Union Bank of California began opening “Cash & Save” outlets in 1993 in Los Angeles and San Diego offering check-cashing and banking services. By 2000, there were 12 stores, the most successful of which were stand-alone outlets in large discount stores that catered to middle- and lower-middle-income shoppers. “Check-cashing” is prominently advertised and the hours of operation include evenings and weekends. In addition to traditional banking services, the Cash & Save outlets offer a full range of commercial check-cashing services. A first-time check-cashing customer pays a \$3 fee to become a Cash & Save “member” with a digital photo, signature, and employment information on file.

To encourage repeat business, discounts are offered, including a \$10 annual “Money Order Plan” that allows six “free” money orders a month and a discounted 1 percent check-cashing fee for the year. Other services include cashing of government checks and paychecks for nondepositors, originating domestic and international wire transfers, handling the payment of utility bills, selling prepaid phone cards, faxing and photocopying, and in some locations selling bus tokens and passes. Basic checking accounts have low minimum-balance requirements. Among nontraditional accounts is a deposit account similar to an Electronic Transfer Account that receives electronic deposits of government benefits payments with a passbook interest rate. Maintenance fees are waived, but all cash withdrawals carry a 1 percent fee. Cash & Save also offers two savings plans: The “Nest Egg” account requires a commitment to deposit at least \$25 a month for one year after a \$10 initial deposit, and the “Combo” account combines the Nest Egg

account with the Money Order Plan. Cash & Save outlets formed partnerships with CBOs to offer personal financial management seminars. The CBOs host the seminars and the banks publicize them. Union Bank reports that about 40 percent of its regular check-cashing customers use at least one traditional bank product within a few years.

*“Over-the-Rhine” branch of Cincinnati Central Credit Union*

The Cincinnati Central Credit Union (CCCU), realizing the lack of depository financial institutions in the Over-the-Rhine neighborhood, formed a partnership with a local nonprofit organization based there called SmartMoney Community Services. SmartMoney raised the capital to acquire and equip a storefront credit union branch and then provided subsidized office space. The partnership is mutually beneficial: SmartMoney provides one-on-one financial counseling sessions and helps build trust between the community and the CCCU, and the credit union provides the community with convenient, professional depository and credit services. Services include low-cost, low–minimum balance checking and savings accounts, and a small-scale individual development account program.

The branch also sells low-cost money orders, postage stamps, envelopes, and bus passes. To provide small loans to residents with impaired credit histories, the “Smart Loan” program was designed. SmartMoney collected donations from churches and individuals to use as collateral for Smart Loans, with the maximum loan amount being \$3,000. SmartMoney requires that recipients enroll in its Smart Change budget counseling course to repair credit records and build savings. CCCU reports that the branch, which is largely self-supporting, has successfully met residents’ needs for convenient financial services and support.

### **Case Study on Neighborhood Trust Federal Credit Union**

Neighborhood Trust Federal Credit Union (NTFCU) in New York City is one of the fastest-growing community development credit unions in the United States. Opened in 1997, it has accumulated \$5 million in assets, about double the amount in deposits in most neighborhood credit unions, according to the *New York Times*. Based in an abandoned Chemical Bank branch in the Port Authority Terminal on Fort Washington Avenue and 178<sup>th</sup> Street, the nonprofit credit union provides services to low-income residents of the Washington Heights and West Harlem communities, where check-cashing outlets and pawnshops are on nearly every corner and predatory lenders proliferate. An estimated 70 percent of NTFCU customers have never had a bank account.

*Background/Structure*

The idea of creating a nonprofit organization to provide financial and educational services for community development was conceived in 1994 by New York City school teachers Mark Levine and Luis De Los Santos. Recognizing the disparities of service in the Washington Heights community, Levine, a graduate of the Kennedy School at Harvard, conducted a population survey that revealed a desperate need for affordable financial services. He enlisted friends to help

him conduct research to determine how to create a community-owned and -run community credit union.

Three years later, the NTFCU was born. A daughter organization of the nonprofit Credit Where Credit is Due organization—which provides outreach, education, and training on financial management, banking services, and homeownership—NTFCU now has a staff of 12 and 3,000 members, each of whom is a shareholder.

### *Population Served*

The two communities served by NTFCU have a total population of about 500,000 with a median household annual income of \$10,000 to \$12,000. In Washington Heights, 80 percent of the population is Dominican and in West Harlem it is 55 percent African American and Latino. A large proportion of the local businesses are home-based child care, beauty salons, grocery stores and convenience stores, and eateries. Most of the credit union's customers have never used mainstream financial institutions. Instead, they were typically served by pawnshops, check cashers, and predatory lenders.

### *Services Provided*

NTFCU provides a number of financial services, including:

- Personal and business banking: Customers can open a no–minimum balance checking account with \$100 and have no limit on the number of checks that can be written for a monthly service fee of \$5. Savings accounts require \$50 minimums. The credit union also offers ATM cards.
- Lending services in the form of personal loans, securitized credit, and mortgage lending: Personal loans (\$500 to \$10,000) are offered for personal needs or to start or build micro-businesses. Interest rates are higher on personal loans than for business development. Repayment periods vary by loan and borrower profiles, but generally do not exceed four years. At the time of this writing, the loan portfolio consisted of 700 loans totaling \$1.9 million, with a repayment rate of 97 percent. Default rates of 3 percent are consistent with commercial banks serving higher-income populations. Securitized and partially securitized credit cards are also offered. These are basically prepaid credit cards. Mortgage lending is primarily for cooperative housing purchases, normally not exceeding \$150,000. Although the majority of owner-occupied housing stock in upper Manhattan is cooperative housing, these mortgages are often viewed as risky loans for commercial banks because they are considered nontraditional.
- Education through financial literacy programs. The Credit Where Credit Is Due (CWCID) organization, the Neighborhood Trust's mother organization, conducts four different educational and outreach programs.

1. The *Personal Financial Literacy Program* focuses on developing basic accounting skills to open and use bank accounts, write checks, draft monthly budgets, save for college, and understand concepts of stock market investment. Graduates of this program can use the pro bono services of the investment company, First Investor.
2. The *Enterprise Training Program* series coaches entrepreneurs on business concepts, how to prepare business plans and budgets, access capital, handle accounting and book-keeping, and better understand the basics of business law and employee management. After completion of the eight-class series, entrepreneurs are entitled to one hour of free consultation with the CWCID education program manager, as well as free consultations with the law firm of Chadbourn and Parke.
3. The *Youth Education Program* or *School Banking* teaches local fourth and fifth graders to use banking services and to save for their futures. Participants open bank accounts and can make deposits with as little as one cent. Withdrawals require parental consent. The program operates in local schools and includes lessons in basic math as applied to banking. More than \$23,000 has been saved by the 750 participants.
4. The *Home Ownership Training Program* teaches community members how to obtain a home mortgage loan, assess one's financial capacity to repay it, calculate the terms of an affordable mortgage, and assess the value of a house. Because the majority of housing in the area is cooperative housing, the program also offers specific information about what cooperatives are and about cooperative lending.

### *Strategies for Success*

The credit union's success is attributed to its ability to fine-tune its services to community needs, and its commitment to local economic development. The survey conducted in the beginning of CWCID's project helped identify these needs. The organization is also in a constant mode of self-evaluation and regularly asks clients to fill out evaluation questionnaires. Another strength is Neighborhood Trust's sound business practices and modeling of commercial banking operations, combined with a balance between its commercial approach and nonprofit developmental agenda. Finally, successful fund raising to cover a variety of support activities has also added to the ultimate success of Neighborhood Trust.

### **Individual Development Accounts**

Individual development accounts (IDAs) are matched savings accounts designed to help low-wealth families or individuals build assets. Participants can use the money saved through these accounts to buy a house, develop a business, or increase job skills through education and training.

Similar to other defined contribution plans, such as 401(k)s, IDAs offer a monetary incentive for participation for every dollar saved. Individuals make regular savings deposits in their IDAs that

are then matched by funds from the sponsoring bank, foundation, other charitable organization, or local government.

IDA programs often include personal finance literacy counseling and training on such issues as homeownership, household budgeting, record keeping, and long-term economic planning.

Although the main goal of the program is to increase wealth, the accounts also provide opportunities for banks to attract new customers by increasing the comfort level of participants with financial institutions.

Several foundations, community organizations, elected representatives, and government officials have provided crucial support for IDA programs. Both the Corporation for Enterprise Development and the Center for Social Development at the University of Washington at St. Louis have played central roles in the implementation of a national IDA pilot demonstration, research on the effectiveness of IDAs, proliferation of federal and state IDA legislation, and the development and dissemination of program development materials. As a result, a proposed national IDA tax credit, called the Savings for Working Families Act, is expected to come before Congress for a vote this year.

The national demonstration has achieved the goal of proving that low-income and low-wealth individuals can save when given the proper incentives and educational tools. Over a three-year period, the 2,000-plus demonstration participants deposited more than \$1.3 million. The success of the national demonstration has generated tremendous interest in and support for IDA programs at the federal, state, and local levels. In considering further initiatives, however, it is important to keep in mind that these early IDA initiatives have been relatively costly to set up. Services such as outreach and consumer education can be costly.

### Community Development Financial Institutions

Definition, Structure, and Population Served	Mission	Strengths
<b>Community Development Financial Institutions (CDFIs)</b>		
<p>CDFIs are private-sector financial intermediaries with community development as their primary mission. They are bridge institutions that link unconventional borrowers and conventional financial institutions.</p> <p>There are 6 basic types of CDFIs:                      1) community development credit unions, 2) community development banks, 3) community development loan funds, 4) microenterprise funds, 5) community development corporation-based lenders and investors, and 6) community development venture funds.</p> <p>CDFIs target their efforts to distinct geographic</p>	<p>CDFIs bring private-sector capital to bear on problems that have historically required public sector solutions. They all have community development as their primary mission and carry out that mission by:</p> <p>1) financing businesses and community facilities, job creation and development, and affordable housing in low- and moderate-income communities; 2) providing technical assistance to assist “unbankable” customers; 3) demonstrating that poor urban and rural areas can be profitable markets; 4) helping banks target their</p>	<p>The strength of CDFIs is their flexibility to adapt lending guidelines to the needs of borrowers; to accept unconventional collateral for loans; and to provide education, training, and assistance to potential borrowers.</p> <p>CDFIs attract private investment, they don't substitute for it. They rely on capital-led strategies to address</p>

<p>areas that are economically distressed and/or to distinct demographic populations that are underserved. Some CDFIs, for example, target their efforts to a particular urban, rural, or reservation community. Others lend to particular groups of people (minorities, women, low-income families) or offer specific types of credit products not readily available in the conventional market.</p>	<p>community reinvestment funding; and 5) bringing innovative and trailblazing products and services to disinvested areas.</p> <p>CDFIs make possible loans and investments in community development that conventional financial institutions would consider unbankable.</p>	<p>economic and social problems, and seek to establish capital relationships within their markets that seed sustainability.</p>
<p><b>CDFI Fund</b></p>		
<p>The CDFI Fund was established by the U.S. government to facilitate the creation of and capitalize a national network of financial institutions that is dedicated to community development and is committed to serving and improving low-income and low-wealth communities. CDFI Fund supports these organizations with an aim to make the most effective use of limited federal resources. It uses relatively small amounts of federal money to leverage significant amounts of private and nonfederal dollars, promotes private entrepreneurship, and encourages self-help and self-sufficiency.</p>	<p>The Fund bolsters economic development by investing in and assisting CDFIs. By investing in institutions, not just projects, the Fund helps CDFIs better respond to their markets by increasing their ability to manage risk, enhance capacity, and be flexible in their financing. The CDFI Fund provides the following types of assistance: equity investments, credit union shares, loans, grants, and technical assistance (directly, through grants, or by contract with organizations with expertise in community development finance). The Fund supports the following uses of financial assistance: commercial facilities that promote revitalization, community stability, or job creation or retention; businesses that provide jobs for, that are owned by, or that enhance availability of products and services to low-income people; community facilities; basic financial services; housing for low-income people; other businesses and activities deemed appropriate by the Fund; and technical assistance for capacity building, training, and development of programs, investments, or loans.</p>	<p>The CDFI Fund is innovative, investment-oriented, and businesslike in approaching its funding. Recognizing that there are diverse organizational levels, the Fund has established different windows for participants. In addition to the “Core CDFI Program,” the Fund has implemented an “Intermediary Program” through which organizations in need of assistance can participate through CDFI intermediaries, and a “Technical Assistance Program” that offers financial support to CDFIs working to build their organizational capacity.</p> <p>Current Initiatives: Core Program—provides financial and technical assistance to CDFIs; Intermediary Program—provides financial assistance to CDFI intermediaries (CDFIs that finance other CDFIs); Bank Enterprise Award Program—provides financial assistance to CDFI and non-CDFI depository institutions; Certification—non-monetary classification recognizing that CDFIs meet Fund eligibility requirements; Microenterprise Awards—non-monetary award program recognizing excellence in microenterprise development; Technical Assistance Component will provide financial assistance to training and technical assistance providers that work with CDFIs; Secondary Market Initiative—financial support to enhance CDFI liquidity.</p>

*Case Study of a CDFI: First Bank of the Americas*

First Bank of the Americas (FBA) in Chicago is an FDIC-insured bank designated by the U.S. Treasury as a community development financial institution. Since its founding in 1997, FBA has served the predominately Mexican-American communities of Pilsen, Back of the Yards, and Little Village. In a speech in early 2000 to the Chicago Board of Alderman, First Bank of the Americas President and CEO David Voss described the bank’s mission of providing reasonably priced financial services to the surrounding community where high-cost fringe bankers do brisk business in “lifeline banking transactions” of check cashing, bill payment, and money transfer.

During a five-month period between September 1999 and February 2000, FBA refinanced more than 150 high-rate mortgages, home equity loans, and consumer loans at market interest rates. Voss estimated that FBA's refinancing will save community members more than \$4 million over the next five years.

To overcome neighborhood residents' distrust of traditional financial institutions, FBA, with some outside funding, has launched a community outreach and education campaign. It conducts monthly financial literacy seminars and provides information on local Hispanic TV and radio stations. FBA also has established "school banks" at two schools, Maria Saucedo Scholastic Academy and Cristo Rey High School. The banks, staffed and managed by students, offer savings accounts to students and school staff, serving a dual function of teaching children personal financial management and introducing them to the workings of a bank.

### **Microfinance for Enterprise Initiatives of Low- and Moderate-Income and Other Disadvantaged Communities**

Microfinance is the extension of small loans to small entrepreneurs and households that are too poor to qualify for traditional bank loans or lack assets for collateral. These loans are typically used for income generation, enterprise development, and, in some instances, for community needs such as health and education. Typically microfinance, also called microcredit, loans have a short repayment period and have terms and conditions suited to the local conditions of the community.

The concept of microfinance is not new. Informal systems of credit have existed in societies for centuries, long before modern, commercial banking came into the picture. Many of the current microfinance practices, made popular in developing countries, derive from community-based mutual credit transactions based on trust and peer-based non-collateral borrowing and repayment.

#### *Microcredit in the United States*

Microcredit can be an effective program to help empower financially disenfranchised populations, enabling those without access to lending institutions to start small businesses at bank interest rates. In the last five years a surge of interest has spread across the United States to broaden access to credit to lower-income Americans.

In the United States, microlending is centered in community-based banks, credit unions, community loan funds, and other local CDFIs. These institutions provide loans to businesses or households that have one or more of the following characteristics: (1) operate in low- and moderate-income and other disadvantaged communities, (2) are a start-up business or have annual revenues below a specific benchmark, (3) have owners who personally create their product or deliver the service, (4) have fewer than 25 employees, and (5) have a local customer base. The principal amounts of microcredit loans may be as little as \$300 or as much as \$25,000.

Interest rates are comparable to commercial lending rates and loan repayment rates often exceed those in the commercial sector.

### *Effective Strategies*

According to the OCC study of microcredit practices in the United States, microlending institutions have several common strategies in small business finance. They 1) commit resources, including expert staff, and actively solicit small business customers; 2) learn about small business needs and offer tailored products and services; 3) provide small business customers with easy access; 4) establish streamlined processing for timely credit decisions; 5) offer special handling for flexible loan underwriting; 6) consider partnerships to provide options for small business finance, such as guarantees and credit enhancements, technical assistance, and gap financing; and 7) establish systems to track loan performance and profit.

### *Microfinance Challenges*

Microlending institutions in the United States, such as CDFIs and mainstream banks, face a number of challenges and barriers in providing credit to small businesses in traditionally underserved markets. These include incompatibility of traditional credit evaluation techniques adopted in the banking sector with a need for human subjective review in the decision-making process. It also requires working effectively with government and community-based partners to provide credit enhancements, technical assistance, and other resources. In addition, microcredit providers are often working with a community with information deficits. Many would-be entrepreneurs and small-business owners are unaware of the financial and technical support available to them, and they often have social and language barriers as well. Participation in government programs and with other community development organizations also requires extra time: While banks can make decisions on microcredit loans within three days, loans that involve guarantees from the U.S. Small Business Administration or funds from government agencies often may take much longer.

### **Rutgers University Research on Organizations as Leaders in Expanding Homeownership**

With support from the Fannie Mae Foundation, a team of researchers led by David Listokin and Elvin K. Wyly of Rutgers University conducted case studies of organizations recognized by their peers as leaders in expanding homeownership opportunities for historically underserved households and communities. The case studies describe the efforts of small and large lenders, nonprofit community-based organizations, and lending consortia. The researchers document strategies used by these organizations in the areas of institutional management, attracting and qualifying mortgage applicants, and retaining new homeowners.

The case studies reveal a diverse array of strategies designed to address market imperfections related to information, discrimination, and limited household financial resources. These strategies expand homeownership opportunities, and indicate that a broad spectrum of actors in

the housing finance system view historically underserved households and communities as viable markets, not regulatory burdens.

Challenges remain, however, in efforts to use housing finance to promote community development and household wealth accumulation. These challenges reflect inherent tensions between the industry trend toward standardized, efficient business practices and the customized, often expensive programs needed to address multiple obstacles to homeownership and community development faced by underserved households and communities. They also reflect a historically unequal distribution of risks and rewards associated with homeownership in America.

# Predatory Lending: An Overview\*

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### **Introduction**

Predatory lending has become one of the most critical policy issues facing the financial services industry, particularly mortgage lending. Nearly every federal financial services regulatory agency has publicly denounced predatory lending and called for more effective regulation to address it. Legislation has been proposed in Congress and several states to combat predatory lending, and trade associations and individual financial institutions have declared their concerns. Also, the Federal Reserve Board has proposed a rule to require lenders to report annual percentage rates for all loans, a measure that could help identify predatory lenders.

Despite broad consensus to take action, efforts to end predatory lending have been modest at best. One reason for the slow response is the lack of consensus on what constitutes illegal predatory lending. While there is significant agreement on the key loan terms and lender behavior that generally constitute predatory lending, there is little political consensus at the national level within the housing finance community about how best to address the various areas of concern. Without national consensus on how most effectively to address key predatory lending practices, significant progress in this arena is not likely in the near term.

Predatory loans are characterized by excessively high interest rates or fees, and abusive or unnecessary provisions that do not benefit the borrower, including balloon payments or single-premium credit life insurance, large prepayment penalties, and underwriting that ignores a borrower's repayment ability. Yet, although high interest rates or fees are common characteristics of predatory loans, high-cost loans are not necessarily predatory. And depending on the unique characteristics of an individual loan and specific borrower, loan provisions that may be predatory in one instance, such as a prepayment penalty, may be reasonable and legitimate under others. For this reason, regulatory agencies and other institutions are cautious about instituting broad-based and sweeping regulations that could undermine legitimate sources of financing for credit-impaired households.

Further complicating efforts to stop predatory lending is the fact that there is little, if any, publicly available data regarding loan terms, such as interest rates, origination points, processing or closing fees, and special provisions such as balloon payments, credit life insurance, and

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prepayment restrictions. Without information on loan terms by borrower and neighborhood race/ethnicity and income, there is no way to effectively monitor or identify questionable lending patterns for further examination. Needless to say, a problem that cannot be identified and examined cannot be eliminated.

As mentioned in the accompanying article (see “Financial Services in Distressed Communities: Framing the Issue”), predatory lending generally does not occur in a vacuum. Rather, it breeds in an environment characterized by little competition for traditional financial services. Specifically, a community flush with “fringe lenders”—check cashing outlets, pawnshops, rent-to-own stores, title lenders, and similar operations—as well as excessive subprime lending, is the environment in which predatory lending activities often flourish.

This article provides a working definition of predatory lending and highlights some of the most common characteristics of predatory loans. It distinguishes predatory lending from subprime lending, and highlights the legitimate role that subprime lending plays for households with demonstrated credit problems. The article further points out, however, that despite a clear technical distinction between legitimate subprime lending and predatory lending, there exists a huge gray area between the two, in the form of excessive subprime lending. The article concludes with a series of recommendations and considerations for further action to limit both predatory and excessive subprime lending.

## **Defining the Problem**

A clear definition of predatory lending is difficult due to the complexity of determining the appropriate level of fees for a given level of risk. Generally speaking, three features—alone or in combination—define predatory lending practices. Those features include targeted marketing to households on the basis of their race, ethnicity, age or gender or other personal characteristics unrelated to creditworthiness; unreasonable and unjustifiable loan terms; and outright fraudulent behavior that maximizes the destructive financial impact on consumers of inappropriate marketing strategies and loan provisions. Although a loan involving any one of these tactics might legally be considered predatory, most predatory lenders use some combination of all three to extract the greatest profit and, as a consequence, cause the greatest financial harm to the borrower.

### *Fraudulent Target Marketing*

Predatory lenders use sophisticated technology and numerous sources of publicly available data to identify potential customers. They market their products to customers they identify as financially unsophisticated or vulnerable, and therefore most likely to accept highly unfavorable loan terms. In particular, predatory lenders look for people with limited education who are not adept in financial matters and lack the financial sophistication to scrutinize loans. Such lenders often prey on households that have limited incomes but significant equity in their homes. The elderly are a primary target for predatory lenders.

Marketing techniques include placing “cold calls” to potential borrowers, direct mailings, telephone and door-to-door solicitation, and television commercials. As with many other loan features, these practices by themselves are not predatory. Target marketing is used extensively by all types of mainstream businesses to identify potential customers and customize products to meet their particular needs. Predatory lenders use target marketing not to meet the needs of their customers, but rather to identify households most vulnerable to the lenders’ aggressive or fraudulent behavior.

Predatory lenders’ advertisements claim that easy and affordable home equity loans are a quick way for consumers to pay down credit card debt, take a desired vacation, or pay off other expenses, and still have lower monthly mortgage payments. Predatory lending also often involves fraudulent home improvement scams targeted to elderly homeowners because they are more likely than younger people to live in older homes that need repair, are less likely to undertake the repairs themselves, and may not have the cash to pay for someone else to perform them. Because these homeowners have built up substantial equity in their homes, they are particularly at risk of losing a major share, if not all, of their equity. Predatory lenders also make loans to homeowners who are mentally incapacitated and do not understand the nature of the mortgage transaction or papers to be signed.

### *Abusive Loan Terms*

The second characteristic of a predatory loan is the set of abusive terms it contains. Predatory loan terms are structured to extract the greatest possible return to the lender. For equity stripping purposes, they are also routinely designed to preclude a borrower’s ability to repay the loan. The loan itself may be unnecessarily large, even in excess of a 100 percent loan-to-value ratio. As long as the amount of the loan exceeds the fair market value of the home, it is difficult for the owner to refinance the mortgage or to sell the house to pay off the loan. Negative amortization loans are structured so that interest is not amortized over the life of the loan and the monthly payment is insufficient to pay off the accrued interest. The principal balance therefore increases each month and, at the end of the loan term, the borrower may owe more than the originally borrowed amount.

Aside from the loan itself—typically offered at very high interest rates—loan terms often include inflated and padded costs, such as excessive closing or appraisal charges, high origination and other administrative fees, and exorbitant prepayment penalties that trap lower-income borrowers into the subprime market. While prepayment fees are rarely charged in the prime market—some 2 percent of mortgages carry them—they are included in 80 percent of subprime mortgages, according to the Detroit Alliance for Fair Banking. And, unlike in the prime market, where prepayment fees are a tradeoff for lower interest rates, subprime mortgage holders rarely, if ever, get anything for the added fees, which can cost as much as a 6 percent penalty for early payoff. Consumers are locked into the subprime market even if they demonstrate improving creditworthiness, and are doubly hurt because they are not free to take advantage of lower interest rates as can prime market customers.

There may also be insertion of pre-dispute, mandatory, binding arbitration clauses in contractual documents. Such clauses are not necessarily offensive by themselves. When combined with other predatory loan provisions, however, they can greatly inhibit a borrower from receiving relief from highly unfavorable and unreasonable loan terms and conditions. Other typical predatory loan features include balloon payments that effectively force borrowers to refinance their loans at even higher rates later. Predatory loan terms also commonly feature single-premium credit life insurance that the lender requires as an up-front, lump-sum payment that the borrower must finance. Thus the borrower ends up paying additional interest—on top of the cost of overpriced and often unnecessary insurance. Maintenance provisions may increase the interest rate of a loan as a result of a 30- or 60-day late payment.

### *Fraudulent Lender Behavior*

Fraudulent behavior is the third identifying characteristic of a predatory loan. It refers to illegal management by the lender of the loan transaction to extract the maximum value for the lender. Fraudulent behavior might include: 1) failing to explain the terms of the loan or providing obscure information, 2) using high-pressure tactics to force a prospective borrower to continue through the loan application process in cases in which the customer would prefer to discontinue the process, 3) omitting explanations of credit life insurance or balloon payments, and 4) discouraging borrowers from exploring lower-cost options.

One common tactic is to offer a short-term loan and quote a seemingly reasonable rate, without explaining that the “reasonable” rate becomes astronomical when translated into the annual percentage rate. “Flipping,” or repeated refinancing, is another powerful tool of a predatory lender. The lender might offer to refinance a loan on the justification that the borrower can obtain a lower interest rate. But upon signing the new loan documents, the borrower finds out either that the interest rate is not lower or higher processing fees more than overwhelm any offset in interest rates. Or, a balloon payment provision in the original loan might make refinancing unavoidable.

Initiating loans without considering the borrower’s ability to repay or structuring loans with payments that a borrower cannot afford can effectively strip the equity from a homeowner. And encouraging borrowers to consolidate consumer debts into a home equity loan with a higher interest rate than the underlying consumer credit debt—thereby also increasing the size of the loan—is a standard predatory lending practice. Further, predatory lenders may refuse to provide modest home equity loans and, instead, use high-pressure tactics to persuade borrowers to fully refinance their homes—again, usually at interest rates that exceed the underlying mortgage.

Other fraudulent behavior includes adding cosigners whom the lender knows have no intention of contributing to the payments, forging loan documents, and using abusive and high-pressure collection practices, such as harassing phone calls, letters, and threats. The combination of abusive loan terms and aggressive and fraudulent lender behavior that characterizes predatory lending illustrates how a loan can financially destroy an individual even in instances in which the loan’s interest rate may not be alarmingly high. Because of the many tools in the arsenal of a

predatory lender, a request for a relatively modest loan can be transformed into a major financial crisis for an unsuspecting borrower.

A real-life example is useful in understanding how predatory lenders operate: ABC television's "Prime Time Live" in April 1997 featured the story of an elderly man in poor health who could not read or write. The man initially sought a small loan to buy food. Eventually the lender converted his request into a \$50,000 home-equity loan. The loan was flipped just 17 days after signing, even before the first payment was due. Subsequently, in less than four years, the lender flipped the loan 11 times, attaching a 10 percent finance fee each time. The lender foreclosed on the house after the man could not make his loan payments. In this case, the man sued and his loans were forgiven. This was a very unusual ending to a predatory lending story—most victims are unable to obtain successful or satisfactory legal redress.

Finally, it is worth noting that some practices of other real estate professionals, such as mortgage brokers and home improvement contractors, could reinforce and further promote predatory lending. Home improvement contractors, for example, sometimes target inner-city neighborhoods where houses are older and often in need of renovation, and where households are cash-poor but have accumulated significant equity in their properties. In these instances, contractors may steer their customers to predatory lenders for loans to pay for the home improvements. Brokers are an important part of the infrastructure of predatory lenders. Checking property deeds and other public records and spending time in a community, brokers identify homeowners who have substantial equity in their properties and encourage those households to refinance with a predatory lender who, in turn, provides the broker with a substantial referral fee. Elderly, black, widowed women are frequent targets.

### **Predatory Lending as Subset of Subprime Lending**

Predatory lending is a subset of subprime lending. The difference between the two is important. By definition, subprime lending is the provision of loans to households that have demonstrated an inability or unwillingness to properly manage credit. By definition, the subprime market is the credit source of last resort for households with poor credit histories, insufficient documentation of requisite financial resources or other important loan application information, and other loan application shortcomings that would limit a prospective borrower's ability to secure credit from the prime market.

Subprime loans carry higher interest rates than prime loans with the justification that borrowers with higher risk factors should pay more to offset their perceived greater risk to the financial institution advancing the loan. Subprime loan rates are also higher, according to Ken Temkin of the Urban Institute, because underwriting guidelines in the subprime market are not standardized across the industry. The lack of standardization causes variation in interest rates offered by different lenders and makes it difficult for borrowers to "shop" for the most favorable rates.

Despite this clear conceptual distinction between predatory lending and legitimate subprime lending, the reality of subprime and predatory lending is much murkier. A loan does not have to be loaded with an excessive number of egregious provisions for it to unfairly undermine the

financial solvency of a family. For example, steering minority households to the subprime market on the basis of race/ethnicity, rather than because of a demonstrated inability to properly manage credit, may be a violation of the Fair Housing Act and Equal Credit Opportunity Act—although it is not necessarily an act of “predatory lending.”

In fact, even one percentage point unjustifiably added to a mortgage can add substantially to a household’s financial burden and greatly undermine its asset-building capabilities. Over the 30-year life of an \$81,000 home mortgage, one additional percentage point could add nearly \$21,000 to the cost for the home buyer—not including the additional higher processing fees subprime loans typically carry. Note that the typical subprime loan is 300 to 400 basis points higher than a comparable prime market loan.

### **Concentration in Low-Income and Minority Neighborhoods**

Just as fringe-lending activity is increasing, the subprime market has experienced exponential growth in lower-income minority communities. A recent study published by the U.S. Department of Housing and Urban Development (HUD) based on 1998 Home Mortgage Disclosure Act (HMDA) data uncovered striking racial disparities in the subprime market. The report finds that subprime loans are three times more likely in low-income neighborhoods than in high-income areas, and five times more likely in black neighborhoods than in white neighborhoods. In predominantly black communities, high-cost subprime lending accounted for 51 percent of home loans in 1998, compared with only 9 percent in predominantly white areas.

HUD further notes that homeowners in high-income black neighborhoods are six times as likely as homeowners in upper-income white neighborhoods, and twice as likely as homeowners in low-income white neighborhoods, to have subprime loans. Thirty-nine percent of homeowners in upper-income black neighborhoods had subprime loans, compared with 6 percent of homeowners in upper-income white neighborhoods and 18 percent for homeowners living in low-income white neighborhoods.

### **Does Risk Fully Explain the Size of the Subprime Market?**

As noted above, the rationale for disproportionately high levels of subprime lending to lower-income and minority households is that those borrowers represent substantially greater risk than borrowers in the prime mortgage market. Unfortunately, there is little available public data on the credit quality of households that would allow for an examination of the reasonableness of the growth of subprime lending to lower-income minority households. Data that are available, however, do not support the recent explosive growth of this segment of the mortgage market.

First, several financial institutions in the past decade have confirmed that lower-income status is not synonymous with higher credit risk. Stated otherwise, lower-income consumers who receive mainstream credit perform roughly the same as middle- and upper-income households receiving similar credit. As a result, the much greater level of subprime lending to lower-income households relative to higher-income households is not immediately justified by available

information on credit quality of these two groups. Second, although black households have been shown in studies to have greater credit problems than non-Hispanic white households, the level of subprime lending to black households and communities far exceeds the measured level of credit problems experienced by those households.

According to a 1999 Freddie Mac study, black households have roughly twice the credit problems of non-Hispanic white households. Yet HUD's data show that blacks rely on subprime refinance lending roughly four times as much for their mortgage credit. Credit quality alone therefore does not fully explain the extreme reliance of black households on the subprime market. Further research by Freddie Mac reports that as much as 35 percent of borrowers in the subprime market could qualify for prime market loans. Fannie Mae estimates that number closer to 50 percent.

If these estimates are accurate, it represents potentially hundreds of millions of dollars wasted each year by the very households that can least afford it.

### **Credit History Versus Creditworthiness**

Although creditworthiness is the measure by which financial institutions determine the type of loan most appropriate for a particular borrower, there is substantial confusion between creditworthiness and credit history. Creditworthiness or credit risk is the measurement of the borrower's ability and willingness to repay a loan. Credit history is the financial transactions data on which a borrower's creditworthiness is determined. Stated otherwise, creditworthiness is the interpretation of an individual's credit history. An evaluation about creditworthiness of a borrower requires, among other things, judgments about the reliability and comparability of the underlying financial transactions data. There are a number of reasons why an individual's credit history may not accurately reflect his or her actual creditworthiness.

Confusion about credit history and creditworthiness inappropriately reinforces the idea that lower-income, and particularly minority, communities are largely bad credit risk environments. Several problems arise from interpreting creditworthiness from existing credit history data for minority households and comparing the data with that for non-Hispanic white households. First, low-income minorities are more likely to be financially unsophisticated, and thus may not attempt to correct poor credit histories before applying for a loan. Two borrowers may have similar credit behavior, but if one has taken steps to improve his or her credit records before applying for a loan, that borrower will be deemed more creditworthy. In fact, many households may be completely unaware of the need to maintain a good credit history, and the role that documentation plays in determining their access to credit.

A related issue is coaching of borrowers at the time of application for loans. Proper counseling at the time of loan application may enable a household to improve its credit score, but there may be substantial differences in the ways in which households receive such coaching along racial and ethnic lines. Third, comparing credit histories of households that have access to and use mainstream financial institutions with individuals that rely primarily on fringe banking services could result in biased assessments of creditworthiness across racial and ethnic groups.

Federal mortgage data, as well as the behavior of fringe and predatory lenders, suggest that minority households are more likely to have used finance companies and other fringe financial services whose terms and practices are more costly and harsh. In some cases, consumers may even have used predatory lending institutions that intentionally structure loans for default. In some instances, loan terms may be so oppressive and unreasonable that repayment is simply unrealistic. Or, some households may have used fringe lenders who might aggressively report even modest credit blemishes in an effort to hold onto their customers by ensuring they remain unattractive to mainstream lending institutions.

Finally, some households may default intentionally because they recognize, albeit after the fact, that the loan terms they have accepted are egregious and unfair if not outright fraudulent. In these instances, financially vulnerable households are penalized with additional credit blemishes for recognizing and acting to defend themselves from unscrupulous or fraudulent lenders.

Unfortunately for underserved households, data that might provide more accurate assessments of borrower creditworthiness are not readily available and therefore not generally used in sophisticated models of credit risk. The result is continued disparate evaluations of credit risk for lower-income, and particularly minority, households and consequently, lower homeownership rates than might be possible.

## **Recommendations and Solutions**

Predatory lending is an outlying consequence of the inefficient financial markets that exist in many lower-income and minority communities. Predatory lending practices thrive in an environment where competition for financial services is limited or lacking, and where excessive marketing of subprime loans and fringe financial services are occurring. For this reason, effectively limiting predatory lending requires the same three-pronged approach recommended to reduce excessive fringe financial services in lower-income, minority, and distressed communities: 1) enhanced enforcement of the relevant federal and state lending and consumer protection laws, 2) increased prime market lending, and 3) improved borrower education and awareness of financial services options and opportunities (see “Financial Services in Distressed Communities”).

Laws that specifically relate to predatory lending and whose greater enforcement must play a key role in eliminating predatory lending include the Fair Housing and Equal Credit Opportunities Acts, the Real Estate Settlement Procedures Act, and the Homeowner’s Equity Protection Act. Some predatory lending practices also might violate various federal and state consumer protection laws, such as the Truth in Lending Act. Together, these laws provide a formidable regulatory infrastructure to make important strides in removing predatory lenders from the nation’s most vulnerable and distressed communities. Together, these laws cover practically every conceivable predatory lending arrangement. (For a more detailed discussion of possible legal strategies to fight predatory lending, see Engel and McCoy 2001.)

Yet, the strength of these federal laws can, nevertheless, be a weakness. Because so many different laws could pertain to various predatory lending practices, determining which law or

laws may have been violated in any particular case can be complicated, time-consuming, and costly. Simplifying federal law to target predatory lending directly would greatly enhance the ability of lower-income households and their advocates to combat unfair and illegal lending behavior. Further, outlawing abusive practices would act as a preventive measure and would avoid the need for consumers to be harmed before there could be legal redress.

The North Carolina nonprofit Coalition for Responsible Lending, for example, points out that a handful of provisions account for the overwhelming majority of the most abusive predatory lending activities. The coalition recommends new legislation that focuses on seven loan terms and practices including: 1) credit insurance; 2) excessive fees charged to borrowers; 3) prepayment fees that do not benefit the borrower; 4) mortgage broker abuses including yield-spread premiums; 5) steering of borrowers to subprime loans on the basis of race/ethnicity, age, or gender; 6) mandatory arbitration clauses that restrict the rights of the borrower; and 7) loan flipping or repeated refinancings that do not benefit the borrower.

Many states have recently enacted or have begun to debate streamlining their state statutes to focus directly on predatory lending. The state of North Carolina enacted a comprehensive predatory lending law in July 1999. The North Carolina law defines two types of loans—“home loans” and “high-cost home loans.” For all home loans, the law prohibits lending abuses such as requiring credit life, disability, or unemployment insurance, and loan flipping. With regard to high-cost home loans, it imposes expanded protections against excessive balloon payments, high interest rates and fees, negative amortization, and predatory home improvement contractors. In addition, loan counseling is required and a borrower’s ability to repay must be taken into consideration.

Using the North Carolina model, the states of New York, Illinois, South Carolina, Minnesota, West Virginia, Utah, Maryland, and California are all considering predatory lending legislation. Another example of local action is Washington, DC’s, new “Predatory Lending Protections and Mortgage Foreclosure Improvements Act of 2000” that provides additional protections for District residents who might find themselves at risk of losing their homes through foreclosure as a result of corrupt lending practices. Among other features, this law attacks predatory activity by defining a subset of loans that might be predatory and providing homeowners with a quick judicial review prior to a foreclosure sale. Philadelphia is another city that has recently enacted a predatory lending law.

Perhaps the most comprehensive federal examination of predatory lending performed to date was pursued jointly by the U.S. Department of the Treasury and HUD. Their report, “Curbing Predatory Home Mortgage Lending,” included extensive discussion of predatory lending tactics and a wide range of recommendations to limit fraudulent lending behavior (see the full report at [www.huduser.org/publications/hsgfin/curbing.html](http://www.huduser.org/publications/hsgfin/curbing.html)). The study highlighted and discussed practices ranging from loan flipping, targeting minority and low-income borrowers, and lending to borrowers based on the value of their home rather than the ability to repay a loan. Expanding borrowers’ access to the prime market by awarding banks and thrifts Community Reinvestment Act credit and amending many existing laws were among the recommended solutions. Additionally, the study revealed that the Federal Housing Administration is developing tools to

help borrowers who have been victimized by predatory lenders to avoid foreclosure, retain their homes with a reasonable level of debt, and, if necessary, repair their credit.

The National Community Reinvestment Coalition has outlined a multipart strategy to address predatory lending. Among its recommendations are for the Federal Reserve Board to use its existing authority to prohibit unfair and deceptive mortgage lending practices, to step up its oversight of subprime lenders, and to improve data disclosure to more effectively track subprime and predatory lending.

## Conclusion

The issue of predatory lending is, for good reason, an issue of national concern. Yet, while there is strong consensus to act, there is enormous inertia in taking definitive action that might impact lending of any type. Part of the failure to aggressively address predatory lending is based on a legitimate concern that price controls and blanket prohibitions of individual loan features could negatively impact market segments in unintended ways.

Moreover, as this article and the previous one on *Financial Markets in Distressed Communities* highlights, predatory lending is merely the extreme end of a spectrum of abusive, unscrupulous, and costly financial services practices that dominate lower-income and minority communities. Placing caps on certain practices and eliminating certain other behaviors would go a long way to removing some of the most destructive wealth-stripping activities from the mortgage markets in distressed communities. But limitations, restrictions, and caps on various financial services practices are not sufficient to address the broader issue of market failure that plagues these communities. That broader challenge requires positive action and initiative. Lower-income and minority communities need high-quality, low-cost financial services tailored to their low-income and low-wealth circumstances. Further, those households need access to savings vehicles that would enable them to build their assets to the greatest extent possible.

Assisting households to better understand how to make informed choices about the financial services and providers they choose is an important aspect of a comprehensive anti-predatory lending program. At the same time, however, there are real limits on the extent to which consumer financial education can help vulnerable households who are the focus of fraudulent professionals.

Mortgage loan documents can consist of dozens of provisions written in extremely complex, confusing, and technical legal language. Predatory lenders target lower-income and minority borrowers with limited education and vulnerable elderly consumers specifically because they cannot reasonably protect themselves. To expect that financially vulnerable consumers can reasonably review, understand, and challenge specific provisions in the dozens of legal documents that are routinely involved in the mortgage lending process is a highly unreasonable expectation.

Despite the inability to achieve consensus on the perfect response to predatory lending, some immediate intervention is needed and should be forthcoming at a national level. Failure to

successfully remove predatory lenders from the financial services markets could, over a relatively short time, undermine much of the success that has been achieved over the past decade in enhancing the number of historically underserved households that are now homeowners. And it could further exacerbate the tenuous financial positions of many vulnerable, lower-income, elderly homeowners, many of whom reside in older, inner-city, and distressed communities.

## Principles for Responsible Lending<sup>1</sup>

Coalition for Responsible Lending

Homeownership not only supplies families with shelter, it also provides a way to build wealth and economic security. Unfortunately, too many American homeowners are losing their homes, as well as the wealth they spent a lifetime building, because of harmful home equity lending practices. Some lenders target elderly and poor or uneducated borrowers to strip the equity from their homes, which traps borrowers in bad loans and creates a high risk of foreclosure. Subprime lending has increased 1,000% in the last five years, and abusive lending is up commensurately.

Seven principles should govern attempts to eliminate predatory lending and protect family wealth:

- Prohibit the financing of up-front credit insurance for all loans.
  - Limit fees charged borrowers, direct and indirect, to 3% of the loan amount.
  - Prohibit back-end prepayment penalties on subprime loans, since they act in an anti-competitive manner by keeping lenders from remedying abusive situations.
  - Take sufficient steps to address mortgage broker abuses on purchased loans, including prohibiting yield-spread premiums.
  - Address steering by making sure that borrowers receive the lowest-cost loan they qualify for.
  - Avoid mandatory arbitration clauses in any home loans.
  - Prohibit “flipping” of borrowers through repeated fee-loaded refinancings.
1. Credit insurance premiums should not be financed into the loan up-front in a lump-sum payment. One type of credit insurance, credit life, is paid by the borrower to repay the lender should the borrower die. The product can be useful when paid for on a monthly basis. When it is paid for up-front, however, it does nothing more than strip equity from homeowners, which is why Fannie Mae and Freddie Mac have both agreed not to purchase any loan that includes financed credit insurance. Conventional loans almost never include, much less finance, credit insurance.
  2. The borrower should not be charged fees greater than 3% of the loan amount (4% for FHA or VA loans). Points and fees (as defined by HOEPA) that exceed this amount (not including third party fees like appraisals or attorney fees) take more equity from borrowers than the cost or risk of subprime lending can justify. By contrast, conventional borrowers generally pay at most a 1% origination fee.
  3. Subprime loans (defined as interest rates above conventional) should not include prepayment penalties, for the following reasons:
    - Prepayment penalties trap borrowers in high-rate loans, which too often leads to foreclosure. The subprime sector serves an important role for borrowers who encounter temporary credit problems that keep them from receiving low-rate conventional loans. This sector should provide borrowers a bridge to conventional financing as soon as the

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<sup>1</sup> “Principles for Responsible Lending” are from the Coalition for Responsible Lending and are used with permission. For more information, see [www.responsiblelending.org](http://www.responsiblelending.org).

borrower is ready to make the transition, though prepayment penalties are designed to prevent this from happening. Why should any borrower be penalized for doing just what they are supposed to do—namely, pay off a debt?

- Prepayment penalties are hidden, deferred fees that strip significant equity from over half of subprime borrowers. Prepayment penalties of 5% are common. For a \$150,000 loan, this fee is \$7,500, more than the total net wealth built up over a lifetime for the median African American family. According to Lehman Brothers' prepayment assumptions, over half of subprime borrowers will be forced to prepay their loans—and pay the 4% to 5% in penalties—during the typical five-year lock-out period. And borrowers in predominantly African-American neighborhoods are five times more likely to be subject to wealth-stripping prepayment penalties than borrowers in white neighborhoods. Prepayment penalties are therefore merely deferred fees that investors fully expect to receive and borrowers never expect to pay.
  - Borrower choice cannot explain the prevalence of prepayment penalties in subprime loans. Only 2% of borrowers accept prepayment penalties in the competitive conventional market, while, according to Duff and Phelps, 80% in subprime do.
4. Lenders should take sufficient steps to address mortgage broker abuses, including prohibiting yield-spread premiums. Brokers originate over half of all mortgage loans and a relatively small number of brokers are responsible for a large percentage of predatory loans. Lenders should identify—and avoid—these brokers through comprehensive due diligence. In addition, lenders should refuse to pay “yield-spread premiums”—fees lenders rebate to brokers in exchange for placing a borrower in a higher interest rate than the borrower qualifies for. These lender kickbacks violate fair lending principles since they provide brokers with a direct economic incentive to steer black borrowers into costly loans.
  5. To address steering, lenders should make sure that borrowers get the lowest-cost loan they qualify for. As Fannie Mae and Freddie Mac have shown, subprime lenders charge prime borrowers who meet conventional underwriting standards higher rates than necessary. This is particularly troubling for lenders with prime affiliates—the very same “A” borrower who would receive the lender’s lowest-rate loan from its prime affiliate pays substantially more from the subprime affiliate. HUD has shown that steering has a racial impact since borrowers in African-American neighborhoods are five times more likely to get a loan from a subprime lender—and therefore pay extra—than borrowers in white neighborhoods. A minority borrower with the same credit profile as a white borrower simply should not pay more for the same loan. Therefore, lenders should either:
    - offer “A” borrowers loans with “A” rates, or
    - refer such borrowers to an affiliated or outside lender that offers these rates.
  6. Lenders should not impose mandatory arbitration clauses in any home loans. Increasingly, lenders are placing pre-dispute, mandatory binding arbitration clauses in their loan contracts. These clauses insulate unfair and deceptive practices from effective review and relegate consumers to a forum where they cannot obtain injunctive relief against wrongful practices, proceed on behalf of a class, or obtain punitive damages. Arbitration can also involve costly

fees, be required to take place at a distant site, or designate a pro-lender arbitrator. Arbitration will always take time the consumer may not have if they are facing foreclosure. Such clauses are unfair to borrowers, who generally do not understand what rights they are giving up; if an informed consumer thinks that arbitration is a helpful step in resolving a dispute with a lender, the consumer and lender should be permitted to agree to arbitration then.

7. Lenders should prohibit “flipping” of borrowers through repeated fee-loaded refinancings. One of the worst practices is for lenders to refinance subprime loans over and over, taking out home equity wealth in the form of high fees each time, without providing the borrower with a net tangible benefit. Some lenders originate balloon or adjustable rate mortgages only to inform the borrowers of this fact soon after closing to convince them to get a new loan that will pay off the entire balance at a fixed rate. Others require borrowers to refinance in order to catch up if the loan goes delinquent.

## Combating Predatory Lending Practices

### Federal Banking Regulatory Agencies Call for Greater Oversight

The Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision in January issued a directive that strengthens the examination and supervision of institutions with significant subprime lending programs.

The “expanded guidance” decree specifies borrower characteristics that indicate an institution is targeting the subprime lending market, clarifies the standards to use when evaluating loss allowances, and identifies potentially predatory lending practices that safety and soundness examiners will criticize, among other features.

The expanded guidance is expected to help banks and thrifts engaging in subprime lending activities be more aware of the banking agencies’ expectations regarding risk management processes.

### Responses to Predatory Lending by the U.S. Department of Housing and Urban Development (HUD) and U.S. Treasury Department

A joint U.S. Department of Housing and Urban Development and U.S. Treasury Department Task Force on Predatory Lending has conducted five field forums around the country and, based on its findings, proposed a four-point plan to address predatory lending practices. The plan is detailed in the report, “Curbing Predatory Home Mortgage Lending,” summarized below. The full report is available at: [www.huduser.org/publications/hsgfin/curbing.html](http://www.huduser.org/publications/hsgfin/curbing.html).

1. Provide improved disclosures to borrowers and enhance consumer literacy. Require creditors to recommend that high-cost loan applicants seek home mortgage counseling, disclose credit scores on request, and provide better information on loan costs and terms.
2. Prohibit damaging or unfair lending practices. Loan flipping and lending to borrowers without regard to their ability to repay should be prohibited, and brokers and lenders should be required to provide greater documentation of loan and payment history.
3. Restrict abusive terms and conditions on high-cost loans, including balloon payments, prepayment penalties, and the financing of points and fees; prohibit mandatory arbitration agreements on high-cost loans; and ban single-premium credit life insurance.
4. Use Community Reinvestment Act (CRA) credit to create a positive incentive structure for banks and thrifts. Grant CRA credit to institutions that promote borrowers from the subprime to prime mortgage market, and deny CRA credit to institutions that originate or purchase loans that violate applicable lending laws.

## **Proposals by the Federal Reserve Board to Strengthen Predatory Lending Prohibitions**

The Federal Reserve Board has proposed amending two of its regulations to crack down on predatory lending:

The first proposal is to require additional disclosure of mortgage applications and loans under the Home Mortgage Disclosure Act (HMDA). The revision, which would mandate reporting of requests for mortgage preapprovals and home-equity lines of credit, is designed to track the level, trend, and underwriting characteristics of high-cost mortgage loans. It would help identify institutions engaged in subprime lending, make high-volume nondepository lenders subject to HMDA reporting requirements, and simplify the definition for “refinance” and “home improvement loan” to ensure more complete and consistent data.

The second proposed amendment broadens the scope of loans subject to the Home Ownership and Equity Protection Act (HOEPA) of 1994 by adjusting price triggers that determine coverage under the act. Interest rate triggers would be lowered by two percentage points (from 10 points to 8 points above current Treasury bill rates), and the fee-based triggers would include optional insurance premiums and similar credit protection products paid at closing.

The proposed amendment also prohibits certain practices, such as repeated refinancing of HOEPA-regulated loans over a short time when transactions are not in the borrower’s interest, and making loans without verification of a consumer’s repayment ability.

It is important to note that HOEPA still does not cover all home equity lenders and all home equity loans, and there are loopholes that allow room for abuse.

## **Calls for Additional Federal Action**

The National Community Reinvestment Coalition (NCRC) has made several recommendations for additional federal anti-predatory lending action.

It recommends calling for federal banking regulations to increase their oversight of subprime lenders during CRA exams and accompanying fair-lending reviews. The NCRC suggests that regulatory agencies issue an interagency advisory letter saying that predatory lending will not receive credit under CRA exams and will be penalized through lower CRA ratings and fair lending referrals to the Department of Justice. It calls for the Federal Reserve Board to use its authority to conduct regular fair lending reviews of subprime affiliates of bank holding companies, as recommended by the General Accounting Office.

Secondly, the NCRC has called for Congress to pass more comprehensive anti-predatory lending legislation.

The NCRC is a national community reinvestment and fair lending trade association of more than 700 community-based organizations and local public agencies dedicated to increasing access to credit and capital for traditionally underserved urban and rural areas.

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