AMERICANS FOR FAIRNESS IN LENDING

Neighborhood and Individual Impact of the Subprime Mortgage Lending Crisis: A Reporter's Guide

The national and global economic impact of the subprime lending crisis has been front-page news for weeks. The following overview is designed to turn the focus of the subprime crisis closer to home, to the impact of these highly questionable and generally unregulated loans on individuals, families and communities. The effect of subprime lending on our local and national economies, though less obvious at first, represents the more devastating and longer-lasting consequences of the subprime crisis.

By 2005, 26% of mortgage loans were subprime.[1] The Federal Reserve Bank has lowered its rate to lenders and adjusted its collateral standards in a quick effort to soften the blow of the collapse on Wall Street. Individuals and institutions behind the subprime frenzy have made their billions and those still in the investment game are receiving quick relief from the government. Yet no money has been offered and no legislation has been passed to reduce the impact of this crisis on consumers, neighborhoods, and local economies.

This resource guide, prepared by Americans for Fairness in Lending (AFFIL), is based on current analysis and past research reports by AFFIL's partner organizations—national consumer groups who have consistently warned of the dangers of subprime mortgage lending. Their illuminating reports are referenced and quoted throughout the guide.

Part I covers the far-reaching impact of subprime lending on families, communities and economies, as well as recommendations for how to reduce the impact on Americans of the subprime industry's collapse. Part II provides a brief overview of the key facts that led to the origins, growth, and eventual collapse of subprime lending.

PART I: The Real Impact of the Subprime Crisis on Our Economy

Loss of Homeownership

Subprime lenders claim their products open possibilities of homeownership to a new group of consumers. Yet, while traditional homeownership stabilizes communities and builds family wealth, homeownership fueled by subprime lending does neither. According to the Center for Responsible Lending, "Subprime loans made during 1998-2006 have led or will lead to a ***net loss of homeownership*** for almost one million families." [2]

It is estimated that "since 1998, only 9% of subprime loans have gone to first-time homebuyers." [3] Yet, it is also estimated that at least "15.6% of all subprime loans originated since 1998 either have

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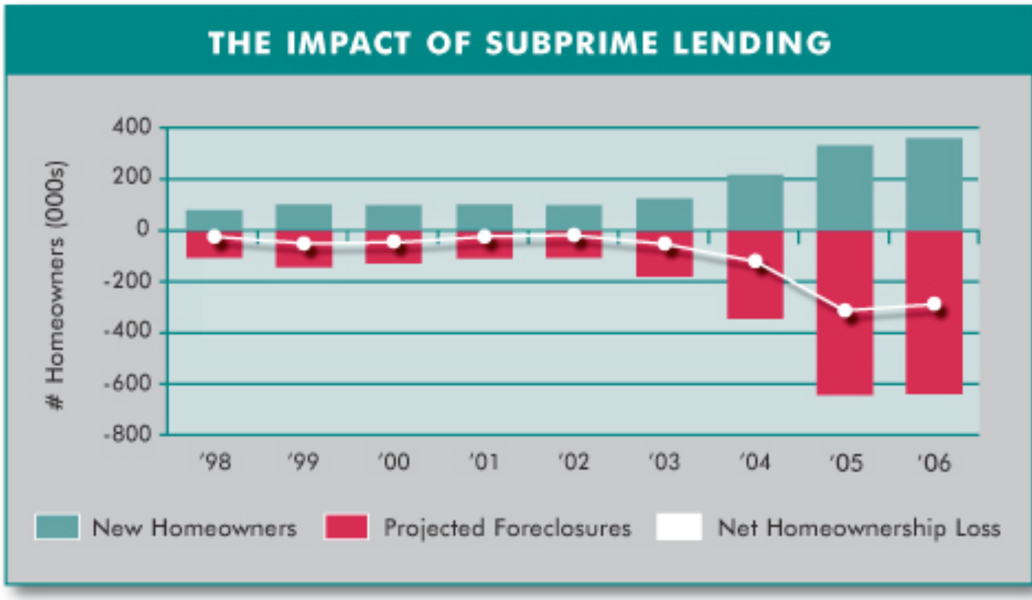
[1] Consumer Federation of America, Women are Prime Targets for Subprime Lending: Women are Disproportionately Represented in High-Cost Mortgage Markets, Allen J. Fishbein and Patrick Woodall, at 2, (December 2006) <http://www.consumerfed.org/pdfs/WomenPrimeTargetsStudy120606.pdf>.

[2] Center for Responsible Lending, Subprime is a Net Drain on Homeownership, CRL Issue Paper No. 14, at 1, (March 27, 2007) (emphasis added) <http://www.responsiblelending.org/page.jsp?itemID=32032031>.

[3] Ibid. at 2.

ended or will end in foreclosure and the loss of homeownership." [4] Subprime lending closes down many more opportunities than it opens up.



Center for Responsible Lending, Subprime is a Net Drain on Homeownership, CRL Issue Paper No. 14 (March 27, 2007)

Devastating Foreclosures

Subprime loans are riskier than prime loans.[5] Deceptive practices make them even riskier for borrowers. The most damaging feature in the recent wave of subprime loans is exploding interest rates in Adjustable Rate Mortgages (ARMs) that cause monthly payment increases of twenty percent or more once the fixed rate period expires. ACORN reports, "Over $1 trillion in ARMs are expected to reset to a higher interest rate in the next few years." [6]

> *"Subprime mortgages routinely include features that increase the risk of foreclosure."* [7]

Going through a foreclosure is both psychologically and financially devastating. Subprime refinances have resulted in families losing homes they have lived in a major portion of their lives. They are seeing their dream of homeownership being stripped away. Children in these families also suffer as they lose their community, have to change schools, and experience serious instability at a crucial time in their lives. When subprime loans go bad, families not only lose their homes, but also the money they have invested in them, their optimism in the economy, and their self-esteem.

Weakening Property Values

Homeowners who took subprime loans are not the only ones impacted by the crisis. It is estimated that each foreclosure lowers the property values in its neighborhood by about one percent.[8] With

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[4] Ibid.

[5] ACORN, Foreclosure Exposure: A study of racial and income disparities in home mortgage lending in 172 American cities, ACORN Fair Housing, at 2 (September 5, 2007) <http://acorn.org/fileadmin/HMDA/2007/HMDAreport2007.pdf>.

[6] Ibid.

[7] Center for Responsible Lending, Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners, Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest (December, 2006), <http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189>.

1.2 million foreclosures in 2006, and a higher number expected in 2007, the impact on communities will be grave. This impact, compounded by a general decrease in property values that is occurring as the real estate bubble bursts, translates to a loss of the wealth that neighboring homeowners not directly involved in this crisis expected to gain from their homes.

> *"Foreclosures don't just hurt individuals and families, they hurt entire neighborhoods and communities, leaving homes abandoned and vulnerable to vagrancy and crime."* [9]

Increasing Consumer Debt

A whole other, likely larger category of borrowers include those not in foreclosure but who are living on the edge, struggling to make their increasing monthly payments. More money paid out to lenders means less money for family necessities and savings, and increasing credit card and consumer debt for the average American. The impact is real and quantifiable. Demos reports on a disturbing trend: "In 2006, the financial obligations ratio—the percentage of monthly income to the amount needed to manage monthly debt payments—surpassed 19 percent, a record since data started being collected in 1980." [10] Home equity has already been depleted, the report adds, "to pay off a growing mountain of unsecured debt" [11] fueled by the desire to hold on to the American dream of homeownership.

The net impact of subprime mortgage lending has been almost entirely negative, but mortgages are not the only arena in which subprime lending has flourished. Today, auto financing, credit cards, short-term loans and other financial products utilize deceptive practices employed by subprime mortgage lending to further trap Americans in a cycle of debt. Is it just a matter of time until these lending categories also collapse with a devastating impact on families and communities?

Impact on Women, Low-income, and Minority Homeowners

As with any number of faulty or dangerous consumer products, vulnerable and less financially secure consumers have been principal targets for subprime loans. The Consumer Federation of America notes that women are more likely to receive subprime loans than men.[12] A study by New York University's Furman Center for Real Estate and Urban Policy reports that, "lower-income households in rapidly appreciating markets are much more likely to rely on subprime lending, "exotic" mortgages and ARMs to enter or preserve homeownership." [13] Maps of lending patterns in major cities clearly illustrate the impact of subprime lending on vulnerable and minority neighborhoods.[14]

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[8] Center for American Progress, From Boom to Bust: Helping Families Prepare for the Rise in Subprime Mortgage Foreclosures, Almas Sayeed, at 6, (May 12, 2004) <http://www.americanprogress.org/issues/2007/03/pdf/foreclosure_paper.pdf>.

[9] ACORN website, "Neighborhoods torn apart by predatory lending." <http://acorn.org/index.php?id=12067>.

[10] Demos, A House of Cards Update: *Refinancing the American Dream*, at 2, (November 14, 2006) <http://www.demos.org/pub1124.cfm>.

[11] Ibid.

[12] Consumer Federation of America, Women are Prime Targets for Subprime Lending: Women are Disproportionately Represented in High-Cost Mortgage Markets, Allen J. Fishbein and Patrick Woodall, at 1, (December 2006) <http://www.consumerfed.org/pdfs/WomenPrimeTargetsStudy120606.pdf>.

[13] NYU's Furman Center fro Real Estate & Urban Policy: Draft paper on NYC mortgage foreclosures, Mortgage Foreclosures in New York City, Jenny Schuetz, at 6, presented at New York State Banking Department's Campaign to Halt Abusive Lending Transaction & Mortgage Fraud, (April 11, 2007) <http://furmancenter.nyu.edu/documents/FurmanCenterPresentationNYSBD041107.pdf.>.

[14] See A Joint Report By: California Reinvestment Coalition, Community Reinvestment Association of North Carolina, Empire Justice Center, Massachusetts Affordable Housing Alliance, Neighborhood Economic Development Advocacy Project, Woodstock Institute, Paying More for the American Dream: A Multi-State Analysis of Higher Cost Home Purchase Lending, (March 2007) <http://www.nedap.org/pressroom/documents/2007_Report-2005_HMDA.pdf>; NYU's Furman Center fro Real Estate & Urban Policy: Draft paper on NYC mortgage foreclosures, Mortgage Foreclosures in New York City, Jenny Schuetz, presented at New

Damaging Neighborhood and National Economies
Far from being the ticket to the American dream, subprime lending has an impoverishing effect on neighborhoods. More money going to mortgage lenders and investors means Americans have less to spend in their communities. The Center for American Progress notes that foreclosure is more than an individual tragedy: "A spike in foreclosures can also create a domino effect in a single area, leading to a sharp depreciation in property values, decreased business investments, and lower tax revenues, which in turn affect the quality of schools and decrease nearby property values."[15] Stores such as Home Depot and Wal-Mart are reporting reduced consumer spending in the wake of the meltdown, resulting in a loss of tax revenue. Counties are reporting losses in revenue from filing and tax fees. Property values are decreasing, yielding even greater losses for local communities in tax revenue.

The national economic impact of the subprime crisis is just beginning. As credit dries up and interest rates rise, other domestic industries are beginning to suffer. The only question now is how great the toll will be of years of unregulated, predatory lending on the larger American economy.

Fixing the Problem

Mortgage borrowing is a complicated process, and consumers need and deserve to be protected. Just as supermarkets are prohibited from selling poisonous food, borrowers should be protected from toxic mortgages that have a one-in-five chance of choking them. Borrowers should be able to trust that lenders will not sell them loans they cannot afford, and that our government will protect them against deceptive and unfair lending practices. Neither assumption is currently accurate. This lack of lender responsibility and government oversight needs to change.

Federal, state and local governments must act to help homeowners who are stuck in troubled loans. While the federal government has focused on an economic bail out for Wall Street, nothing is being done to help consumers who can't afford their mortgages. Recent proposals, such as a few state-sponsored refinancing programs and President Bush's FHA-Secure Program to help 60,000 homeowners, are inadequate and may not target those who need it most. The number of Americans affected by the subprime lending crisis and its fallout is being likened to the Depression, when foreclosure moratoriums were instituted. Default percentages are climbing, but even higher numbers of consumers are scraping by to make their home loan payments. Housing counselors can attest that homeowners will do anything to avoid defaulting on a mortgage payment. This means depending more heavily on credit cards or failing to provide even for family necessities.

> "Local foreclosure prevention and loan restructuring programs today can help only a limited number of borrowers due to budgetary and size restrictions, but there is no reason they couldn't be expanded to serve a greater number of borrowers. . . . The federal government has a role to play in helping families facing foreclosure by increasing funding and support." [16]

Laws are needed to protect borrowers and stop predatory lending practices. The lending market has demonstrated that it will not right itself. Greater disclosure of predatory practices is not an answer. The time has come for regulations that prohibit unfair consumer lending practices.

York State Banking Department's Campaign to Halt Abusive Lending Transaction & Mortgage Fraud, (April 11, 2007) <http://furmancenter.nyu.edu/documents/FurmanCenterPresentationNYSBD041107.pdf.>.

[15] Center for American Progress, From Boom to Bust: Helping Families Prepare for the Rise in Subprime Mortgage Foreclosures, Almas Sayeed, at 6 (May 12, 2004) <http://www.americanprogress.org/issues/2007/03/pdf/foreclosure_paper.pdf>.

[16] Ibid. at 11.

Congress has the authority to stop lenders from making bad loans. At the very least, we need laws that regulate:

- Lender *responsibility*, to require loans be underwritten to ensure borrowers can afford them not just today but into the future
- Lender *discrimination*, to prevent targeting predatory loans to minorities and other special communities
- Lending practices, to *prohibit* unfair practices
- Meaningful *disclosure*, to realistically enable borrowers to understand loan terms
- Assignee liability, so borrowers have meaningful *recourse* for predatory lending practices
- Greater *accountability,* by all parties involved in the lending process.

A number of solutions have been suggested to help consumers caught in this crisis -- including refinancing programs, increased funding for default counseling and a moratorium on foreclosures. No single solution will be enough. Government leaders must think outside the box to create new solutions to mitigate the impact of the foreclosure crisis.

Lenders and investors must come to the table. Incentives must be created by the federal government to make Wall Street become part of the solution. Investors now own these bad loans. In order to reap the benefits the federal government proposes to alleviate the impact on Wall Street, investors should be compelled to help borrowers. Whether it is through their agreement to modify loans to make them affordable, to donate the monumental profits they have made to programs to allow homeowners to refinance, or other means, the government must compel the investors to come to the table.

Lending industry "self-oversight" does not work. It's a nice idea, but it's abundantly clear that industry self-regulation does not work. Today's lending industry is so strongly driven by profits that the best interests of borrowers have disappeared from the equation. Self-regulation and letting the market correct itself will only be feasible once a base level of protections are guaranteed for borrowers, as well as the investors.

PART II: How Did We Get Here?

The subprime mortgage lending boom started in the mid-1990s. Subprime lending flourished with the introduction of a practice called "securitization," in which loans were pooled and sold to investors as securities. Securitization minimized risk for lenders making questionable loans and generated more money for more lending. Mutual funds, hedge funds and private investors fueled the fire of the subprime mortgage lending industry through the purchase of these mortgage-backed securities (also referred to as asset-backed securities, tranches, and Collateralized Debt Obligations "CDOs" in different forms).

Securitization and the subprime boom also are related to a wave of government deregulation of the credit and lending industry that started in the 1980s, when the government started eliminating laws that capped interest rates and overrode state consumer protections.[17] Current lending laws mandate disclosures of credit terms, but prohibit or limit next to nothing, including fees, interest rates, and making loans to people who cannot afford them.

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[17] See <u>The Road to Subprime Hell Was Paved With Good Intentions: Usury Deregulation and the Subprime Home Equity Market</u>, Cathy Lesser Mansfield, 51 S.C.L. REV. 473 (2000).

Federal regulatory agencies have also largely abandoned their role of providing oversight of lending practices. In 2003, the federal government, through the Office of the Comptroller of the Currency (OCC), stripped states of their ability to regulate state chartered operating subsidiaries of national banks. The result has been what experts term "the wild, wild west of lending," in which lenders flood the market with products that yield extraordinary profits for them, with no regard for traditional lending guidelines and what is good for borrowers.

The subprime boom

The original subprime product, introduced in the late 1990's, was a high-cost, high-interest refinance loan that usually targeted older, lower-income and minority consumers with a substantial equity in their homes. While lenders of these types of loans had new names, many were actually subsidiaries of the country's largest banks, including:

- Bank of America (EquiCredit)
- Citibank (Associates and Citifinancial)
- Chase (Advanta)
- HSBC (Household Finance Corporation)

Other lenders included independent companies such as:

- First Alliance Mortgage Corporation (FAMCO)
- Delta Funding
- United Companies Lending

While some of the biggest lenders have closed their subprime subsidiaries in hopes of shedding a predatory image, they have not gotten out of the business. These major banks continue to be among the greatest investors in the pools of subprime loans. (Interestingly, foreign investors have also profited from the United States' lack of lending regulations. China has been highlighted as having billions of dollars in investments in the United States' subprime industry.)

Wall Street further fuels the fire

Beginning around 2001, as the Internet bubble burst, Wall Street significantly increased its investments in subprime lending which in turn encouraged lenders to turn to the middle-income market and to develop new products to not only refinance existing mortgages, but for home purchase as well. These new products were usually packaged in the form of adjustable rate mortgages (ARMs). They offered a low, fixed interest rate for one to three years, which then jumped, often to five or six percentage points above the current index, causing monthly payments to increase twenty percent or more. In a fundamental shift of how financial institutions lend money, ARMs were underwritten based only on the borrower's ability to afford the initial payment, without regard to whether they would be able to afford the loan when the rate jumped. The current crisis in subprime lending developed as rates have begun to adjust and borrowers are unable to keep up payments.

A number of additional loan products were also created to push people into homes they could not afford. In one common scenario, loan amounts were split to create "piggyback" second loans for which the homeowner was only required to pay interest in the short-term. In another, called "option ARMs", borrowers were allowed to make less than the required payment, which meant that the underlying principal owed actually *increased* with each payment, often beyond the value of the property mortgaged. These new "easy money" products drove housing prices up and helped create the housing market bubble of rapidly appreciating prices that has existed since 2001.

Who made the money from subprime lending?

One frequently asked question is, "How could the subprime market flourish making loans to people who can't repay?" To understand how banks and other lenders made billions while consumers lost their homes and savings, it helps to understand the roles of a few of the most important players in the subprime mortgage game.

Brokers and loan officers—the beginning of the problem: Subprime loans are generally made through brokers and with some lenders, loan officers who, despite popular perception, are under no obligation to find the borrower the best rate…or even a loan they can afford. On the contrary, the commissions of brokers and loan officers increase based on loan size and the interest rate charged. Lenders and regulators provide very little oversight of brokers, resulting in the pervasive problem of brokers inflating appraisals, falsifying incomes of borrowers, and misleading borrowers in order to sell bad loans.

Lenders—only here for the short-haul: Subprime lenders immediately dispose of the loans they write by packaging them for quick sale to Wall Street investors. Lenders make their profits up front, from the sales of those loans and the fees they pack into each mortgage. Today's lender has little reason to be concerned if a loan defaults down the road…a far cry from the traditional lending model in which banks had a stake in whether borrowers had the capacity to repay their loans.

Wall Street—investors are protected, borrowers aren't so lucky: Until very recently, when the loan volume grew so large and default rate skyrocketed, Wall Street investors were generally insulated from the impact of bad subprime loans. The loan portfolios pooled risky subprime loans, reducing the chances that a small percentage of defaulting loans would hurt the bottom line. Investors also have little liability for bad loans because of a lack of assignee liability, which protects Wall Street from liability for unethical or illegal lending practices.

Mortgage lending in America has undergone a fundamental change. Once a responsible financial vehicle to promote homeownership, many of today's mortgage loans are just a means for investors and lenders to make huge profits. Despite the strident claims of lenders that subprime loans make homeownership possible for a new class of borrowers, the truth is that more Americans are losing their homes because of subprime loans, and that subprime lending has resulted in a net loss of homeownership.[18] Fundamental changes, including the reinstatement of some of the basic oversight and regulation that guided the lending market for years, are required to right the mortgage market and restore some security and sense of fair play to home lending in America.

Americans for Fairness in Lending (AFFIL), is a non-profit organization working to end predatory lending practices, provide information to help consumers, educate policymakers about the need for reform, and demand action to assist debt-burdened Americans. AFFIL was created through a partnership of national consumer, civil rights, faith-based, non-partisan and grassroots organizations, including ACORN, Center for American Progress, Consumer Federation of America, Consumers Union, NAACP, National Consumer Law Center, National Council of La Raza, UAW, and U.S. PIRG, among others. AFFIL's goal is to establish fair lending principles and practices that will build and preserve individual and community assets. *http://www.affil.org*

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[18] See Center for Responsible Lending, Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners, Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest (December, 2006), <http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189>.