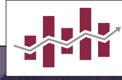

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DO SUBPRIME LOANS CREATE SUBPRIME CITIES?

Surging inequality and the rise in predatory lending

BY GREGORY D. SQUIRES

Over the last several decades, thanks largely to passage of the Community Reinvestment Act in 1977, enforcement of the federal Fair Housing Act, and compliance with a range of local, state, and national fair lending rules, many households and communities long denied conventional financial services have found access to credit. But today the rise in subprime and predatory lending has put many families and neighborhoods in financial jeopardy as default and foreclosure rates skyrocket, particularly in minority and low-income areas. Community groups, elected officials, bank regulators, and mortgage lenders themselves are debating how the nation should respond.

Reform of predatory lending practices is a necessary first step, but a comprehensive approach must take into account the connections between the evolution of financial services and rising inequality, particularly as they affect mortgage lending in the United States. Inequality and diminishing access to conventional financial services have become inextricably linked:

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- Rising inequality of income and wealth in the United States has intensified the segregation of metropolitan areas by class, with race and ethnic segregation persisting at high levels.
- For residents of these increasingly segregated low-income and minority communities, the range of opportunities, including access to financial services, is limited. But the burden is not limited to distressed households and

poor neighborhoods. Rather, uneven development is costly to all parts of many metropolitan areas and to the U.S. economy as a whole.

- A two-tiered system of financial services has emerged that reflects and reinforces these patterns of inequality. One tier serves primarily middle- and upper-income, disproportionately white suburban markets, and the other targets low-income and predominantly minority communities concentrated in central cities with higher-priced, often predatory products.

Ameliorating inequities in the provision of financial services is unlikely without addressing the structural sources of inequality. Public policies and private practices have shaped the uneven development of metropolitan areas, and alternative policies and practices can ameliorate those patterns.

Growing inequality and growing segregation

By virtually any measure, economic inequality has increased in recent decades. Between 1967 and 2005 the share of income in the United States going to the top quintile of all households increased from 43.6% to 50.4% while the share going to the bottom fifth dropped from 4.0% to 3.4%. Since the mid-1970s compensation for the 100 highest-paid chief executive officers increased from $1.3 million or 39 times the pay of the average worker to $37.5 million or more than 1,000 times a typical worker's pay (Krugman 2002, 64). In 2004 those in the top 1% enjoyed a 12.5% increase in their incomes while everyone else—the bottom 99%—saw an increase of just 1.5% (Krugman 2006).

Wealth has long been much more unequally distributed than income, and that gap has continued to widen over time as well. Between 1983 and 2001 the share of wealth going to the top 5% grew from 56.1% to 59.2%. While African Americans and Hispanics earn approximately two-thirds as much as whites, wealth holdings for the typical non-white family are approximately one-tenth that of the typical white family (Shapiro 2004; National Community Reinvestment Coalition and Woodstock Institute 2006).

City residents have been falling behind their suburban counterparts, and non-white neighborhoods have been falling behind white communities. In 1960 per capita income in cities was 105% that of the suburbs, but by 2000 the earnings of urban residents were just 84% of those of suburbanites (Cisneros 1993, 25; Logan 2002a, 4). The median census tract income for the typical black household in 1990 was $27,808 compared to $45,486 for whites, a gap of $17,679. A similar pattern holds for Hispanics (Logan 2002b).

Between 1970 and 2000 the number of high-poverty census tracts (those where 40% or more of the population is poor) grew from 1,177 to 2,510, and the number of people living in those tracts grew from 4.1 million to 7.9 million (Jargowsky 1996, 2003). The isolation of rich and poor families is also reflected in the declining number of middle-income communities. Between 1970 and 2000 the number of middle-income neighborhoods (census tracts where the median family income is between 80% and 120% of the median family income for the metropolitan area) dropped from 58% to 41% of all metropolitan area neighborhoods. And whereas more than half of lower-income families lived in middle-income neighborhoods in 1970, only 37% of such families did in 2000. The share of low-income families in low-income areas grew from 36% to 48% (Booza et al. 2006).

Even longer standing patterns of racial segregation persist. One reliable measure is the black/white index of dissimilarity, which contrasts the racial composition of neighborhoods with the racial composition of a metropolitan area as a whole. (The index ranges from 0 to 1, with a score of 0 indicating that each neighborhood had the same racial composition of the metropolitan area and a score of 1 representing total segregation, meaning every neighborhood was either all black or all white. Scores above 0.60 are widely viewed as reflecting high levels of segregation.) While nationwide the index declined from 0.73 to 0.64 between 1980 and 2000, in the large metropolitan areas, where the black population is most concentrated, segregation persists at high levels, reaching approximately 0.80 in New York, Chicago, Detroit, Milwaukee, and many other urban communities. Lower levels exist primarily in western and southwestern communities with small black populations. For Hispanics and Asians segregation levels are

much lower, approximately 0.4 and 0.5, but they remained at that level or actually increased slightly between 1980 and 2000 (Iceland et al. 2002; Farley and Squires 2005).

Costs of uneven development

These patterns of widening economic and racial segregation have adverse consequences for metropolitan areas. For residents of low-income and minority communities, a range of opportunities, including access to financial services, is limited.

Perhaps the most immediate costs result from both a skills and spatial mismatch. Those most in need of jobs (low-income residents of central city neighborhoods) lack the skills for jobs and live the greatest distance from the areas where job growth is most highly concentrated (Kain 1968, 2004; Wilson 1996, 1999).

Health care services are particularly unevenly distributed. For example, in the affluent and predominantly white northwest corner of Washington, D.C. and the neighboring suburb of Bethesda, Md., there is one pediatrician for every 400 children; in the city's predominantly poor and black southeast corner the ratio is one to 3,700 (Dreier et al. 2004, 77-78). The predominantly black and Latino South-Central Los Angeles community has one primary care physician for every 12,993 residents, while the nearby wealthy community of Bel-Air has one for every 214 (Brown et al. 2003, 14).

The quality of public schools varies dramatically as well, in large part because funding is based primarily on local property taxes. For example, in the 2002-03 school year the city of New York (where 72% of the school population was black or Hispanic and 83% was eligible for free or subsidized lunches) spent $11,627 per pupil while the nearby suburb of Manhasset (where 9% of the school population was black or Hispanic and 5% qualified for subsidized meals) spent $22,311. Similar disparities prevail in most major metropolitan areas (Kozol 2005, 321-24).

When tragedies occur, it is usually low-income and minority communities that are particularly hard hit. Hurricane Katrina is a case in point. Damaged areas in New Orleans from Katrina were 46% black and 21% poor compared to 26% and 15% in non-damaged neighborhoods (Logan 2006). This was not the outcome of natural forces. Low-income and minority communities in New Orleans are concentrated in low-lying, flood-prone areas that are less protected by the levees. One year after the storm 23.0% of blacks compared to 13.3% of whites reported losing a job since Katrina hit (South Louisiana Recovery Survey 2006). This is consistent with the effects of previous so-called "natural disasters" (Hartman and Squires 2006; Klinenberg 2002).

But it is not just distressed households and poor neighborhoods that pay a price. Ghettos and barrios in the nation's metropolitan areas undermine the political stability, social development, and economic growth of the entire region. Cities with large poor populations and high levels of concentrated poverty pay more for a range of public services (including education, police, health care, and fire protection), thereby increasing taxes and reducing their ability to attract middle-class families and the resources they bring. Metropolitan areas with particularly high levels of income inequality grow more slowly than those where income is distributed more equally (Katz 2003, 2006; Dreier et al. 2004; Bollens 2002). In turn, the competitiveness of the nation's economy generally is undercut (Baker and Boushey 2008). Uneven development is costly to all parts of many metropolitan areas and to the United States overall in an increasingly global world.

Uneven development and financial services

The restructuring of financial services both reflects and reinforces these patterns of inequality and uneven metropolitan development. A two-tiered system of financial services has emerged, one featuring conventional products distributed by banks and savings institutions primarily for middle- and upper-income, disproportionately white suburban markets and the other featuring high-priced, often predatory products, offered by such "fringe bankers" as check-cashers, payday lenders, pawnshops, and others, targeted at low-income and predominantly minority communities concentrated in central cities (Leonhardt 1997; Caskey 1994, 2002; Hudson 1996; Karger 2005).

One of the most dramatic changes in financial services has been the expansion of mortgage products. Just one generation ago most borrowers applied for a conventional loan and were either approved or denied. Today dozens if not hundreds of products are available in the marketplace.

With the advent of risk-based pricing, lenders now offer an array of products priced in most cases according to the risk borrowers pose. So, in addition to what was formerly a conventional or traditional fixed-rate 30-year loan, today there are interest-only, payment optional, variable rate, and many other loan types (Fishbein and Woodall 2006). These so called "nontraditional" mortgages accounted for more than one-third of all mortgage loans during the first nine months of 2006 compared to 2% just six years earlier (Downey 2007, F4).

A consequence of these developments has been a significant increase in high-priced, subprime mortgage loans, i.e., loans made to borrowers who, because of their blemished credit records, cannot qualify for conventional loans. Lenders are compensated for the increased risk through higher interest rates or fees. These kinds of arrangements make economic sense, and legitimate subprime lending has increased homeownership for many families. The problem is that many borrowers who should qualify for conventional loans are steered to higher-cost predatory loans, which charge excessive fees relative to the risk involved. These loans are aggressively marketed to unsophisticated buyers and are frequently unaffordable to the borrowers. The result is often default and foreclosure.

Between 1994 and 2005 the annual dollar volume of subprime loans grew from $35 billion to more than $600 billion, and their share of home loan originations increased from 5% to 20% (Avery et al. 2006, 125). Homeownership rates have reached record levels in recent years, and many have attributed this rise to the availability of subprime loans. But the argument that subprime lending increased homeownership has been challenged by recent research documenting that most subprime loans are for refinancing rather than purchase, and the number of families losing their homes as a result of default and foreclosure on these loans, which are often predatory, far exceeds the number who became homeowners (Schloemer et al. 2007).

As a result of the current debate over predatory practices, lenders were required to publicly report pricing information on selected high-cost loans beginning with their 2004 Home Mortgage Disclosure Act (HMDA) reports. (These are loans where the annual percentage rate exceeded that for treasury securities of comparable maturities by 3 percentage points for first lien loans and 5 percentage points for second lien loans (Avery et al. 2006)). Enacted in 1975, HMDA requires most mortgage lenders to disclose the geographic location, income, race, and other information for all loan applicants as well as whether the application was approved or denied. When the Federal Reserve Board analyzed the most recent pricing data, researchers found that, in 2006, 53.7% of blacks, 46.6% of Hispanics, and 17.7% of whites received high-priced loans. In minority areas 46.6% obtained high-priced loans compared to 21.7% in white communities (Avery et al. 2007).

Has predatory lending increased? Is it targeted at low-income and minority groups? If so, what, if anything, should be done in response? While there are no data specifically on predatory loans, news reports, community advocacy, research, and enforcement activity pertaining to the rise and uneven distribution of subprime loans have all increased dramatically in recent years (Squires 2004; *Housing Policy Debate* 2004; Dodd 2007). Clearly not all subprime loans are predatory, but virtually all predatory loans are in the subprime market. While there is no official definition of a predatory loan, most observers recognize that loans with the following characteristics are likely to be problematic:

- Interest rates and fees that far exceed the risk posed by the borrower.
- Low initial "teaser" rates that adjust rapidly upward within two or three years and quickly become unaffordable for borrowers.
- High pre-payment penalties that trap borrowers in unaffordable loans.
- Loan amounts based on the value of the property with little regard for the borrower's income and, therefore, ability to repay.
- Frequent refinancings ("loan flipping") that generate fees for the lender but no financial benefit for the borrower.
- High balloon payments.
- Negative amortization whereby the loan balance increases as borrowers make payments that are sufficient to cover only a portion of the interest but none of the principal that is due.

The costs of predatory lending are severe. Families can lose their homes and the life savings that went into purchasing the home. Short of such a cataclysmic event, predatory lending still costs families a lot of money—according to one estimate $9.1 billion each year (Li and Ernst 2006, 2). And the costs are not restricted to unfortunate individual borrowers: many spill over into the neighborhood and metropolitan area. Moreover, subprime lending is concentrated in communities with high unemployment rates and declining housing values (Pennington-Cross 2002), and it reinforces those neighborhood characteristics. Econometric research has found that the recent rise in subprime lending is associated with higher foreclosure rates that in turn lead to higher crime rates, reduced property values, and, consequently, lower tax revenues. (Immergluck and Smith 2005, 2006a, 2006b). To illustrate, the 3,750 foreclosures that occurred in Chicago in 1997 and 1998 reduced property values in neighboring homes by over $598 million, an average of $159,000 per foreclosure (Immergluck and Smith 2006a, 57).

The Federal Reserve reported that 2.11% of residential mortgage loans held by banks were delinquent at the end of 2006, the highest rate since 2002 and at least twice as high as just one year earlier. In April 2007 real estate foreclosure filings were up 62% compared to 2006. There were 1.26 million filings in 2006, with many predicting that there will be 2 million in 2007 (Miller 2007). The explosive subprime mortgage market turned many mortgage bankers and brokers into millionaires seemingly overnight. But as the foreclosure rate increased, several small lenders have failed, and large investors are shying away from investments backed by subprime loans as a result of the rising foreclosure rate. The fallout has also spread to the equity markets. When the Dow Jones Industrials lost more than 400 points one day in March 2007, over 200 points a couple of weeks later, and another 1,000 points in early August, at least a portion of that loss was attributable to growing problems in the subprime mortgage industry (Bajaj 2007; Creswell and Bajaj 2007; Bajaj and Landler 2007). But even the macroeconomic effects are harshest in depressed areas, particularly the Gulf Coast and industrial Midwest. Subprime foreclosure rates in the fourth quarter of 2006 ranged from less than 3% in Washington D.C., Maryland, and Virginia to over 7% in Mississippi and over 9% in Indiana, Michigan, and Ohio (Cho and Henderson 2007).

Borrowers and their communities are taking great risks and paying substantial costs from recent developments in the mortgage market. That is less true for the industry. Originators can charge higher interest rates and fees, thus accommodating the additional risk into their business plans. Today most loans are sold in the secondary market, then packaged as securities and sold to investors. Risks, consequently, are spread across several actors, and many (though as indicated above, not all) originators and investors have been able to profit from the proliferation of mortgage loans while many households and their neighbors have suffered (Fishbein 2007). The overriding issue today is: what should be done about the emerging two-tiered financial services industry and uneven development generally?

Past, present, and future policy

Uneven development of the nation's metropolitan areas and inequities in housing and housing finance markets reflect a range of public policies and private industry practices. Among the factors that have structured the nation's housing markets, particularly the racial and economic composition of neighborhoods, are the following:

- Explicitly discriminatory policies that virtually excluded non-whites from Federal Housing Administration and other government-insured loan programs from the 1930s into the 1960s and fueled suburban development at the expense of central cities.
- Refusal of real estate and rental agents to provide similar levels of service to white and non-white clients and steering of clients to communities based on racial characteristics.
- Redlining by financial institutions (including the refusal for many years to provide financing and predatory lending more recently).
- Concentration of public housing complexes in inner city ghettos and barrios.
- Exclusionary zoning ordinances in most suburbs that limit or prohibit multi-family housing and other affordable housing units (Jackson 1985;

Massey and Denton 1993; Rusk 1999; Briggs 2005).

Individuals and families make choices, but often in a context not of their own choosing. It is unlikely that any progress will be made in addressing the inequitable access to financial services or exploitative practices generally if the structural sources of inequality are not addressed as well. If public policies and private practices have shaped the uneven development of metropolitan areas, including uneven access to financial services, then alternative policies and practices can ameliorate those patterns.

Several politically feasible tools are available to respond to the overall surge in inequality, primarily by boosting the incomes of the low-wage workforce. For example, the federal minimum wage should be indexed to take into consideration the cost of living so that the increase that was approved in May 2007 does not continue to lose buying power, as it has since the moment it went into effect in July 2007. (Atlas and Dreier 2006; Peirce 2007). Living wage ordinances, which mandate even higher wages than the minimum wage, generally $8 to $10 per hour, frequently with fringe benefits, have been enacted in more than 100 jurisdictions, benefiting primarily the employees of government contractors and recipients of economic development subsidies. More jurisdictions should follow this lead (Dreier 2007). The earned income tax credit could be expanded to lift more working families out of poverty (Mishel et al. 2005). Enacting the Employee Free Choice Act, to allow workers to form a union when more than 50% of workers sign a card indicating their desire to do so, in lieu of secret elections, would strengthen the role of unions in the United States and their positive impact on wage inequality (Kochan and Shulman 2007). Another option is the Income Equity Act, offered by former Minnesota Rep. Martin Sabo, which would deny corporations tax deductions on any executive compensation exceeding 25 times the pay of the firm's lowest-paid workers (Peirce 2007).

Expansion of several housing and land use policies would also reduce inequality. Inclusionary zoning laws that require developers to set aside a specific share of housing units to meet affordable housing objectives have been implemented in dozens of cities (Rusk 1999). Tax-based revenue sharing, whereby a portion of the increasing property tax revenues in prosperous neighborhoods is used to invest in housing and other community development initiatives in distressed areas, has been implemented in Minnesota (Orfield 2002). Mobility programs have enabled thousands of families to leave ghettos and barrios for more prosperous outlying urban and suburban communities, where they find safer neighborhoods, better schools, and better job prospects (Rubinowitz and Rosenbaum 2000; Goering and Feins 2003; Polikoff 2006).

Policies directed specifically at financial service providers are also required. Electronic banking makes it more cost-effective for mainstream institutions to serve the unbanked and out-compete the fringe bankers. Carefully targeted financial incentives, including tax breaks or Community Reinvestment Act (CRA) credits (discussed below), would encourage more banks to do so (Barr 2004). In fact, community development finance institutions, which receive incentives to serve traditionally underserved markets, appear to be doing just that. Such initiatives should be expanded (Karger 2005).

While financial literacy programs for consumers are helpful (Karger 2005; Duncan 2006), more aggressive efforts to redirect the activities of mainstream financial institutions are essential. The CRA's ban on redlining, which requires mortgage lenders to ascertain and be responsive to the credit needs of their entire service areas, including low- and moderate-income communities, should be strengthened by providing sanctions for those that engage in predatory practices and credits for those that pursue equitable lending in their communities. CRA records are taken into consideration when lenders seek approval from regulators for mergers, acquisitions, or any other significant changes in their business operations. Evaluation of CRA performance and its impact on such applications should reflect efforts to provide fair, equitable credit and to combat predatory lending. Currently the CRA applies only to federally chartered depositories (e.g., banks and thrifts) (Marsico 2005, 2006), but the statute should be expanded to cover credit unions, independent mortgage bankers, insurers, and other entities that now account for well over half of all mortgage loans. The Community Reinvestment Modernization Act of 2007, introduced by Reps. Eddie Bernice Johnson (D-Texas) and Luis Gutierrrz

(D-Ill.) would accomplish this objective. In addition, the Home Mortgage Disclosure Act, which facilitates enforcement of the CRA, should be expanded to include pricing information on all loans (Taylor 2006).

A strong national anti-predatory lending law should also be enacted. Currently 36 states, the District of Columbia, and 17 local jurisdictions have such laws (Mortgage Bankers Association 2007, 11; Antonakes 2007, 12). At a minimum, the national standard should require lenders to verify all applicants' income and recommend loan products borrowers are likely to be able to repay, prohibit prepayment penalties that currently trap many borrowers in predatory loans, and provide financial penalties for investors who purchase securities backed by predatory loans.

More aggressive enforcement of fair housing and fair lending laws would also increase access to credit and banking services (Ross and Yinger 2002). A provocative proposal by sociologist James Loewen would withhold federal subsidies for homeownership (e.g., income tax deductions for mortgage interest and property taxes paid) in segregated communities until their racial composition more closely approximated the region of which they were a part, thus making the fact of segregation rather than the presence of non-whites the problem to be solved (Loewen 2005, 442-6).

A more fundamental change would be to place a duty of suitability on lenders that would require them to recommend loan products that are most appropriate for borrowers given their financial situation (thereby reducing the likelihood of default and foreclosure). This obligation would be similar to rules that currently apply to securities brokers and financial planners and would, in essence, shift at least some of the burden from individual consumers to lenders themselves to assure compliance with fair lending and anti-predatory lending rules. Some states are already moving in this direction by prohibiting those loan products and services that do not provide a net tangible benefit to the borrowers (Covington 2005; McCoy 2005; Engel and McCoy 2002).

In recent years several community groups and national membership organizations and networks have effectively challenged and changed the behavior of the financial services industry. Groups like the Association of Community Organizations for Reform Now (ACORN), the National Community Reinvestment Coalition (NCRC), the National Training and Information Center (NTIC), and the National Fair Housing Alliance (NFHA) have secured access to financial services for markets that have long been underserved or exploited by the industry (Squires 2005). For example, ACORN estimated that between 1995 and 2004 it generated more than $6 billion for low-income communities through its CRA organizing efforts and another $6 billion from its anti-predatory lending campaigns. Combined with its work to encourage enactment of living wage ordinances, develop affordable housing, and reform various public services, ACORN pegs its return to low-income communities at more than $15 billion (Ranghelli 2006). NCRC estimates that more than $4.7 trillion in new loans have been secured for low-income and minority markets, largely in response to community organizing efforts, since the CRA was enacted in 1977 (National Community Reinvestment Coalition 2007). The National Fair Housing Alliance estimates that nonprofit advocacy groups, under authority provided by the federal Fair Housing Act, have generated $225 million for plaintiffs since 1990 (National Fair Housing Alliance 2006).

But future advances will likely require even stronger coalitions, and a number of logical partners are already working with these community organizations. Organized labor, church groups, members of the local media, some elected officials (e.g., mayors whose cities are losing tax revenue from predatory lending), foundations, and many others have begun to collaborate in effective efforts to extend recent successes in democratizing access to financial services (Dreier 2003).

In what may be a sign of things to come, in January 2008 the city of Baltimore sued Wells Fargo Bank for targeting minority neighborhoods for predatory loans leading to high forceclosure rates costing the city millions of dollars in lost tax revenues, added fire and police costs, court administrative costs, and social programs to maintain healthy neighborhoods, thus constituting the first lawsuit filed by a municipality seeking to recover costs of foreclosure caused by racially discriminatory lending practices (Mayor and City Council of Baltimore v. Wells Fargo Bank N.A., U.S. District Court for the District

of Maryland). Cleveland followed by suing 21 financial institutions for flooding the local housing market with subprime loans to people who could never repay, leading to a foreclosure crisis costing the city millions of dollars to maintain boarded-up homes and respond to increases in arson and other violent crimes. Whereas Baltimore is suing loan originators, Cleveland is suing financial institutions involved in mortgage-related investment activity (Maag 2008).

The financial crises that many poor, working-class, and even middle-income families face are inextricably linked to broader forces of uneven development. The public policies and private practices that have generated these outcomes are no secret. Neither are at least some of the remedies.

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