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Unfairness in Life and Lending: Credit and Low-Income Americans

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Introduction

As the economic recession continues to threaten the economic security of low- and middle-income households, its effects have been heightened by the reality that even before the downturn, millions of households were experiencing difficulties making ends meet. Between 2000 and 2006, most households experienced stagnant or declining incomes.[1] At the same time, cost of living expenses increased by 32 percent[2] -- leaving households with a growing gap between their incomes and basic costs. These two factors combined with low interest rates and inflated home values, helped fuel the growth of credit card debt and cash-out refinancings. During the height of the housing bubble—2001 to 2006—homeowners cashed out $1.2 trillion in home equity (2006 dollars) and households accumulated nearly $900 billion in credit card debt.[3] As households tapped their savings and spent nearly all of their incomes, the nation's personal saving rate dropped to 0.04 percent of disposable income in 2006— its lowest level since 1934.[4]

Now, as families experience declining home values and tightened credit markets, many are falling behind on their mortgage and credit card payments. The Mortgage Bankers Association recently reported a delinquency rate of 9.64 percent on all mortgage loans, the highest since the MBA started keeping records in 1972.[5] The percentage of households more than 30 days past due on their credit card bills reached 6.58 percent at the end of 2008, an all time high.[6] Late payments can have a domino effect on a household's financial stability as penalty fees accumulate and higher interest rates are triggered.

The last decade has been one of increasing financial vulnerability for low-income households, who without savings or wealth to tap, often turned to high-cost credit to meet basic expenses. Many of these households, particularly low-income households of color, were targets of predatory lenders—selling them toxic mortgages that ultimately created more hardship when home prices fell and the terms reset. An important factor in the rapid accumulation of credit card debt and dramatic rise in sub-prime refinancing loans is the deregulation of the lending industry, which left consumers largely in the dark about the real costs of the credit they were tapping. The ongoing recession and continued credit tightening have only exacerbated the fragile economic state of these households.

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[1] Mishel, Bernstein, and Shierholz (2009).
[2] US Census, Statistical Abstract (2009).
[3] Joint Center for Housing Studies, The State of the Nation's Housing (2009).
[4] U. S. Department of Commerce: Bureau of Economic Analysis.
[5] Mortgage Bankers Association (2009).
[6] Federal Reserve Board, Federal Reserve Statistics Release, Charge-Off and Delinquency Rates on Loans and Leases (2009).

This paper examines the context under which low- and moderate-income households accumulated record levels of debt, focusing on trends in credit card and mortgage debt. The paper will first provide a brief overview of trends in household income and living costs. The paper will then discuss major trends in credit card usage and debt among low- to middle-income households followed by an analysis of the growth and impact of the sub-prime mortgage market on low-income households, particularly households of color. Finally, the paper will sketch out some initial avenues for policy development.

Trends in Household Income and Living Costs

The last decade has not been good for low-income households, who have suffered significant declines in family income. Between 2000 and 2007, average real family income dropped by 5.5 percent among the lowest fifth of households and by 1.5 percent among the second fifth of households.[7] Real wages, which account for three-quarters of most families' income, grew modestly during the same period. The average wage for all workers in the 20th percentile grew from $9.35 to $9.45 between 2000-2007; among workers in the 40th percentile from $12.63 to $12.94; and among workers in 60th percentile from $17.44 to $17.93.[8] The decline in real family income reflects a decline in hours worked, as the percentage of unemployed and under-employed workers rose over the period.

Of course, family income and wage data can only tell us so much about a household's economic security. The capacity for households to make ends meet depends on a number of variables in addition to their income, especially the cost of meeting their basic needs for housing, food, clothing, transportation and child care. Household financial security is also greatly impacted by the level of savings or assets available to the household to deal with unexpected drops in income due to job loss or illness, as well as cover any emergency expenses such as car and home repairs, or medical bills. Over the last decade, the costs of basic goods and services spent as a share of household income, especially housing and health care, have grown faster than inflation or family income. There are numerous data sources tracking the costs in each of these sectors. We focus on data that documents the cost burden, as defined as the percentage of income devoted to paying for health care and housing, of these two major and necessary household expenditures.

[7] Mishel, Bernstein, Shierholz, (2009, p.59).
[8] Mishel, Bernstein, Shierholz, (2009, p.134).

Let's start by examining health care costs. According to the Commonwealth Funds' Biennial Health Insurance Surveys, out-of-pocket medical costs have mushroomed for the both the insured and the uninsured. [9] In 2007, one-third of adults spent more than 10 percent of their income on out-of-pocket medical expenses and premiums, up from 21 percent in 2001. Among adults in families earning less than $20,000, more than half (53%) spent 10 percent or more of their income on health care costs, up from 26 percent of households in 2001. The growth in health care costs as a share of income were more stable among those with moderate incomes ($20,000-$39,999), changing only slightly from 35 percent in 2001 to 36 percent in 2007.

As we now know all too clearly, housing costs ballooned across the country over the last decade. Before values started plummeting, the combination of rising housing costs and stagnant or declining incomes drove a nearly six percentage point increase in the number of households with high housing cost burdens, defined as spending more than 30 percent of their income on housing.[10] Renters were much more likely to experience both moderate and severe cost burdens, with more than one in five (22%) of renters spending between 30-50 percent of their income in rent and nearly one-quarter (25%) devoting more than 50 percent of their income to rent. Among homeowners, 18 percent spent between 30-50 percent of their income on housing and 12 percent spending more than 50 percent of income on housing. Households with incomes in the bottom quartile were far more likely than other households to be moderate or severely burdened by housing costs, with 65 percent of owners and 77 percent of renters spending 30 percent or more on housing.

Credit Card Debt among Low- to Middle-Income Households

As low-income households faced rising costs amidst stagnant or declining incomes, in addition to growing unemployment, it is not unreasonable to assume that when possible, these households, similar to higher-income households, would tap any savings, assets or credit available to them to smooth their consumption. According to the Federal Reserve's triennial Survey of Consumer Finances (SCF), credit card balances among households with incomes below $10,000 grew 342% between 1989 and 2004, from $622, to $2,750.[11] It also showed that both the percentage of low- and moderate-income households who owned credit cards increased significantly as did the percentage of low- and moderate-income cardholders who carried balances.

[9] Collins, Kriss, Doty and Rustgi (2008).
[10] Joint Center for Housing Studies, State of the Nation's Housing (2009, p. 26).
[11] Demos, Borrowing to Make Ends Meet, (2007, p.19).

While the SCF data are useful for tracking trends in indebtedness over time, the survey does not capture comprehensive information about the nature and scope of household indebtedness, such as how long the average household has been in debt and what types of purchases led to their outstanding balances. To answer these questions, and many more about low-income households' credit card debt, Demos commissioned national household surveys of households in credit card in 2005 and 2008. In this section, we will detail some of the key findings of the most recent survey conducted in 2008, and where appropriate, compare those findings to the previous survey.[12]

Methodology

The survey of indebted households was conducted by Macro International between April and August 2008 with 1,205 low- and middle-income adults (18 years or older) respondents who reported having credit card debt for longer than the previous three months. "Low- to middle-income" was defined as having a total household income between 50 percent and 120 percent of the local median income. Credit card indebted households were identified based on the question "Do you or your spouse have any credit card debt; that is, money due on credit cards that you did not pay off in full at the end of last month?" To ensure that we were capturing households with credit card debt, as opposed to those households who may be temporarily carrying a balance, we chose to exclude from the survey any households who reported having credit card debt for less than three months. The screening questions also ensured that the respondent was a head of the household and that s/he was involved in making financial decisions.

Macro International developed the survey instrument in close consultation with Demos. The survey was given in either English or Spanish, based on the respondent's preference. Households were contacted by phone using nationwide random-digit dialing.

The final sample included oversamples of Hispanics and African Americans to allow for greater data analysis of these groups. For this Random Digit Dial survey, the 95% confidence interval has a margin of error of plus or minus 3.73 percentage points. The Hispanic sample has a margin of error of plus or minus 10.5 percentage points and the African American sample has a margin of error of plus or minus 9.4 percentage points. Weights have been added to account for disproportionate probabilities of selection.

[12] For a comprehensive report on the survey findings, please see Draut and Garcia, 2009.

The Basics of Credit Card Debt: Average Amount, Length and Cost

The average credit card debt of low- and middle-income credit card indebted households in 2008 was $9,827, up from $9,536 in 2005. Just over one in four (27%) households had credit card debt over $10,000; while 29 percent reported debt lower than $2,500. At the time of our survey, households reported that they had been in credit card debt for five years, on average. In addition, households reported that, on average, it would likely take them another 3.4 years to pay off their debt entirely.

The longer duration of credit card debt reported at the time of our survey does not necessarily mean households are accumulating larger balances with each passing year. When asked "is the total amount of credit card debt that you have today less than, about the same, or more than the total amount of credit card debt that you had three years ago," 48 percent said they had less debt than the year before, while 42 percent reported having more debt and 10 percent reported having the same amount. Most households reported having swings in their debt—periods of paying down balances then accumulating them due to external events.

We examined the average amount of debt among households by race/ethnicity, age and income level. As in 2005, age differences were less pronounced, although unlike in the previous survey, Americans aged 65 and older no longer had lower average credit card debt than all other age groups. In fact, older Americans' credit card debt increased 31 percent since 2005, the second highest average debt of any age group, after those aged 35-49 (See Table 1). As expected, average credit card debt was higher for households with higher incomes.

Table 1: Average Credit Card Debt by Age, Income Level and Race/Ethnicity (2008 dollars)			
	2005	**2008**	**% Change**
All	**$9,536**	**$9,827**	**3%**
By Age			
18-34	**$9,020**	**$9,111**	**1%**
35-49	**$9,853**	**$10,514**	**7%**
50-64	**$10,059**	**$9,342**	**-7%**
65 and older	**$8,138**	**$10,235**	**26%**
By Race/Ethnicity			
Non-Hispanic Caucasian	**$9,891**	**$9,775**	**-1%**
Hispanic	**$7,091**	**$12,094**	**71%**
African-American	**$8,738**	**$7,394**	**-15%**
By Income Level			
Less than $35,000	**$7,170**	**$7,598**	**6%**
Between $35,000–50,000	**$9,171**	**$10,737**	**17%**
Greater than $50,000	**$11,545**	**$11,914**	**3%**

An examination of differences by race/ethnicity revealed major changes since our 2005 survey. These changes should be interpreted with some caution since the 2008 survey included an oversample of Latinos and African Americans but the 2005 did not. Nonetheless, in 2008, Latino households reported the highest level of credit card debt compared to white and African American households. In 2008, Latino households carried $12,094 dollars in credit card debt compared to $9,775 among white households and $7,394 dollars among African American households. The higher level of credit card debt among Latino families could be driven by a variety of factors. Census data shows that more adults live in Latinos households.[13] With more consumers under one roof, a "family" credit card may be used by more than one borrower. In addition, Latino borrowers have been targeted for costlier credit cards with high fees and interest rates, increasing their probability of accruing additional debt from late fees and penalty interest rate hikes.[14]

The amount of credit card debt carried by an individual or household reflects not just the cost of their purchases, but also the interest rate, as well as any additional fees. The cost of debt can vary widely, and among our survey respondents, the average interest rate reported ranged from 0 percent to 40 percent, with 14.8 percent as the average interest rate paid on the card with

[13] Rodríguez, Sáenz & Menjívar, 2007.
[14] Draut, Wheary (2007); Weller, Credit (2008); National Consumer Law Center (2007).

the highest balance. But many households pay much more than the average: one in four households reported paying 20 percent interest or more on their card with the highest balance. Compared to 2005, the average interest rate was slightly higher in 2008 (14.8% versus 13.1%) and slightly more households reported paying interest rates higher than 20 percent. Households of color are much more likely to be paying interest rates greater than 20 percent. Nearly one-third of African Americans (32%) and Latinos (30%) paid interest rates higher 20 percent, compared to less than one-quarter (22%) of white households.

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Reasons Cited for Credit Card Debt

The survey asked a series of questions about the types of expenses in the last three years that had contributed to the households' current level of credit card debt (see Table 3). This series was expanded from our 2005 survey to include a fuller range of expenses for households to identify as reasons for their credit card debt, including questions about purchases most people would describe as non-essential, such as entertainment expenses Other research has explored the purchasing behavior of low-income households upon receiving lump sums of cash, typically tax refunds. For example, several studies have found that the most commonly cited intended use of tax refunds are for clothing, school supplies, car-related purchases, groceries, catching up on bills or paying down debt.[15] In a study analyzing transaction data drawn from stored value cards loaded with clients' tax refunds, Cole, Thompson and Tufano found that 37 percent of all

[15] Cole, Thompson, Tufano, (2008) p.68.

expenditures using the cards were made at grocery stores, or auto-related merchants, including gas stations.[16]

Our survey of low- and middle-income households found similar trends: the most frequently cited expenses contributing to credit card debt were for smaller purchases of non-essential goods and services (41%), followed by car repairs (41%) and home repairs (32%).

Table 2. Types of Expenses Contributing to Credit Card Debt

Smaller purchases of non-essential goods and services that can add up over time, such as meals at restaurants, movies, DVDs, clothes and other such expenses	48%
Car repairs	41%
Home repairs	32%
Major purchase of a non-essential good or service, such as a vacation, flat screen TV or other big-ticket item	29%
A major household appliance purchase such as a refrigerator, a dishwasher, or an air conditioner	25%
Layoff or loss of job	24%
Starting up a new business or running an existing business	15%
Money given to, or used to pay the debts of relatives	13%
Tuition or expenses for college for a spouse or partner, or yourself	10%
Tuition or expenses for college for a child	9%

While small non-essential purchases was the most frequently cited expense contributing to credit card debt, many households also reported relying on credit cards for necessary and often large expenses, particularly those related to car and home repairs. In addition, nearly one out of four households reported expenses related to a layoff or job loss as contributing their debt.

To understand the extent of households' reliance on credit cards to pay for essential expenses, we examined the percentage of households who cited at least one of the following expenses as contributing to their credit card debt: car repairs, home repairs, layoff or job joss, starting or running a business, money to relatives or college expenses. Three out of four low- to middle-income households reported using their credit cards as a safety net: relying on credit cards to pay for at least one of these expenses over the last three years.

In addition to asking about specific types of expenses, the survey also asked households whether they had used credit cards in the past year to pay for basic living expenses, such as rent, mortgage payments, groceries, utilities or insurance, because they did not have money in their

[16] Cole, Thompson, Tufano, (2008) p. 81.

checking or savings account. ***More than one out of three households (37%) reported using credit cards in this way—reporting that they relied on credit cards to cover basic living expenses on average five out of the last 12 months.*** Compared to the 2005 survey, slightly more households (37% in 2008; 32% in 2005) reported using credit cards to cover basic living expenses, and for one additional month.

Not surprisingly, households who needed to use credit for their basic living expenses had higher credit card balances ($13,302) than households who did not use credit cards to pay for their basic expenses ($7,795).

We also investigated whether specific reasons for credit card debt were more likely to lead to higher relative credit card debt – that is, the ratio of a family's outstanding credit card debt to their annual income. This is an important measure because it describes the "debt-stress" level of a household: for example, $5,000 in credit card debt is much harder to manage for a family earning $20,000 per year than for one earning $50,000. For the 985 respondents in our survey who provided the amount of both their credit card debt and annual income, this ratio of credit card debt to annual income averaged 24 percent.

Based on a linear regression analysis, we find that most low- and middle-income households with high debt-stress levels are using credit cards to pay for unavoidable expenses, not discretionary purchases.[17]

- The *most significant predictor* of higher "debt-stress" level was whether a household relied on credit cards to cover basic living expenses such as rent, mortgage payments, groceries, utilities or insurance.
- In addition, using credit cards to cover expenses related to job loss or layoff, car repairs or providing money to relatives, was also predictive of a higher "debt-stress" level.

Borrowing to Stay Healthy: Medical Expenses and Credit Card Debt

As noted in an earlier section, health care costs are rising sharply, placing stress on employers, individuals, and families. Rising medical expenses, and higher rates of households who are uninsured or under-insured, are a major reason why in 2007, one study found more than

[17] See Draut and Garcia (2009) for details of regression analysis.

60 percent of bankruptcies were medically related.[18] A previous study in 2005 by the same researchers found medical bills and illness contributed to about half of all bankruptcies.

To better understand whether medical expenses were contributing to household credit card debt, our 2008 survey asked a series of questions about common out-of-pocket medical charges.

In 2008, more than half of indebted low- and middle-income households (52 percent) cited medical expenses as contributing to their credit card debt. In fact, compared to all other expenses we inquired about in the survey, out-of-pocket medical expenses was the most frequently reported expense that contributed to credit card debt. On average, these households reported that $2,252 in credit card debt that was attributable to medical expenses. Older households, those 65 and over, reported the highest amount of credit card debt due to medical expenses: $3,988. In addition to credit card balances related to medical expenses, 30 percent of households also reported carrying an on average $3,174 in additional medical debt not reflected on their credit cards.

The survey asked a series of questions about the type of out-of-pocket medical expenses (not including premiums) that had contributed to the households' credit card debt over the last three years. The top three out-of-pocket charges cited were prescription drugs (27%), dental expenses (24%) and doctor visits (20%).

Previous research has found that households with medical debt often forego treatment by not filling prescriptions, delay seeking follow-up care or pursue other potentially dangerous strategies to avoid incurring more debt.[19] Our survey found that households who cited medical expenses as contributing to credit card debt also pursued similar cost-cutting strategies, with 36 percent reported not going to the doctor or clinic when they had a medical problem; 33 percent reported not filling or delaying filling a prescription, and 30 percent reported skipping a medical test, treatment or follow-up care.

Household Strategies for Reducing Credit Card Debt

Our survey found that households employ a range of strategies to pay off their debt, with the majority (59%) using their tax refund toward debt reduction and 45 percent of respondents citing working extra hours or taking on an extra job in order to get out of debt. Other common

[18] Himelstein, Thorne, Warren, Woolhandler (2009).
[19] Doty, Edwards, Holmgren (2005).

tools for paying of debt included using savings (34%), and using money from the Earned Income Tax Credit (24%).

In addition to asking about ways households tried to pay down debt in the last year, the survey asked households about their use of home equity or refinancing over the last five years. Overall, half of the homeowners in our survey had refinanced, taken out a second mortgage or accessed equity through a home equity line of credit in the last five years. Of those households, half used the proceeds to pay down their credit card debt. The average amount of credit card paid off was $14,344.

The problem of using home equity to pay down debt is that it rarely solves the underlying financial pressures that are behind rising credit card debt among low- and middle-income households. Indeed, the 24 percent of homeowners who had paid off some credit card debt with home equity in the last five years still had average credit card debt of nearly $14,000 at the time of the survey. As a result, they were carrying 20% more debt than homeowners in our survey who had refinanced a mortgage but <u>not</u> paid down credit card debt. The use of home equity, through refinancing is made even worse if the homeowner takes on a subprime mortgage at a higher interest rate—which we now know millions of homeowners did with disastrous results.

In the next section of the paper, we explore the significant and rapid growth of the subprime mortgage market, and its effect on low-income communities. The issue is directly connected to our prior discussion of credit card debt because much of the growth in the subprime mortgage market was driven by refinancing transactions, not original mortgages. This demand for refinancing, as both our study and the Federal Reserve has found, was often fueled by households' desire and need to pay down credit card debt or finance basic living expenses.

<u>The Growth of the Subprime Market</u>

Prior to the mortgage meltdown, homeowners capitalized on low interest rates and rapidly increasing home values by borrowing against their equity. Between 2000 and 2007, refinance loans exceeded purchase loans by almost four to one, with much activity concentrated in the subprime market. [20] Homeowners – from 2001 to 2006 - cashed out $1.2 trillion in home equity (2006 dollars)[21]

[20] Rushton, (2007, p.5)
[21] Federal Reserve , Z-1

Demos' study of credit card indebted households found that refinancing is often used as a tool to help pay down debt. Other studies have documented similar findings, but have also found cash from refinancing is frequently used for meeting basic living expenses. For example, Karger (2005) found that consumers, typically, spend almost all the money withdrawn during refinancing.[22] An earlier study, in 2001, by the Federal Reserve a majority of households, 51 percent, used funds from refinancing to cover living expenses and to repay other non-mortgage debt such as credit cards.[23] Twenty-five percent used funds for consumer expenditures such as vehicle purchases, education, and medical expenses.

The rapid growth and enormous of volume of the subprime mortgage market was spurred by demand from economically insecure low-income households, but also by an unfettered supply of credit in a newly deregulated lending marketplace.

From Redlining to Predatory Lending: A Brief History

The deregulation of the mortgage lending industry laid the ground work for the rise of the subprime market as interest rates were uncapped, state mortgage regulatory laws pre-empted and the lines blurred on the activities financial institutions could conduct. However, its growth spurt would not have been as remarkable without Wall Streets' rapid investment in mortgage securities. Prior to the mid-nineties, subprime mortgages accounted for a small segment of the home lending market. As the mortgage lending industry was steadily deregulated throughout the 1990s, Wall Street investment banks began to bundle their loans into securities and sell them to investors. Thanks to the high-interest rates on these loans and the belief that risk could be managed by FICO scores, mortgage securities became an attractive investment that allowed the mortgage industry to tap into a vast new pool of capital, resulting in a tremendous increase in subprime lending.[24] [25]

Driven by heavy capitalization of subprime lending, between 1994 and 2005, the annual total of subprime home loans rose from $35 billion to $665 billion.[26] The overall rate of homeownership, meanwhile, climbed to a historic high of nearly seventy percent, and though African-Americans and Latinos still lagged far behind – with homeownership rates of slightly

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[22] Karger (2005)
[23] Demos (2007)
[24] Renuart (2004, p. 489)
[25] Maloney, (2000, p. 2)
[26] Schloemer, Li, Ernst and Keest (2006,p.7)

less than fifty percent in both cases – they accounted for many of the new borrowers brought into the market by risk based pricing.[27] These specialized lenders came to make 33 percent of the loans in formerly marginalized communities between 1993 and 2000.[28] Using this hard data as support for its case for "risk-based lending" as a tool of economic opportunity, the mortgage lending industry was able to create a dual mortgage market in which higher-cost lenders target and lend to minority borrowers and low-income borrowers, while lower-cost lenders under-serve these markets.[29] As lenders experienced record profits, predatory lending practices emerged disproportionally targeting borrowers of color and lower income communities at the expense of sustainable homeownership and asset building.

By the 1990s thanks to a robust economy, deregulation and innovations in mortgage lending products, communities that had historically been mortgage deprived received an over abundance of attention from subprime lenders. While borrowers of color represent less than one-fifth of all homeowners they accounted for more than one-third of the increase in home purchase lending between 1990 and 2001 and for nearly 40 percent of the increase in the number of homeowners.[30] Between 1993 and 2001, home purchasing lending to Hispanic borrowers increased by 159 percent and to African American borrowers by 93 percent, while lending to whites grew by just 29 percent.[31] Despite the dramatic expansion of subprime home purchase lending, the bulk of subprime loans - representing nearly 13 percent of the nation's outstanding home mortgage in 2006 – were for refinancing (64 percent), with a substantial percentage (55 percent of 64 percent) being taken for "cash-out" purposes, that is, for converting the value of their home into cash.[32]

The explosion in alternative mortgage products on the lending market certainly improved the borrowing prospects of African Americans, Latinos and low-income borrowers. Indeed, their chances of getting a mortgage had gone up dramatically; in both cases, within just a few years, the rejection rate had been cut in half - from nearly sixty percent to 26.8 percent for blacks; from 42 percent to 21 percent for Latinos.[33] But Blacks and Latinos were also conspicuously overrepresented among those who received subprime mortgages, even when credit ratings should

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[27] Mishel, Bernstein, Allegretto, (2007).
[28] Nesiba and Diaz (2005, p. 181).
[29] Apgar & Calder (2005, p. 2)
[30] Apgar & Calder (2005, p. 2)
[31] Apgar & Calder (2005, p. 2)
[32] Rushton, (2007, p.5)
[33] Fox(2007, p.1)

have entitled them to lower-interest loans.[34] Studies have found that the greater the number of African Americans households in a neighborhood, the higher the rate of subprime mortgages.[35]

Minority borrowers were disproportionately targeted by subprime lenders because their access to traditional loans and other financial services has been historically limited. The dearth of mortgages in communities of color and lower income communities prior to the mid-1990s - when subprime lending was virtually non-existent- provided few opportunities for financial education and literacy. Subprime mortgages tend to be complicated in nature which can often hide their true cost. As a result many borrowers were unable to discern the unfair credit offers that bombarded their neighborhoods.

The credit vacuum created by redlining formed a market niche of credit starved neighborhoods where subprime lenders found a captive market with poor financial literacy and no access to reasonably-priced credit. A HUD-Treasury 2000 report found that the lack of competition from prime lenders enabled subprime lenders to gain a growing share of mortgage lending activity in lower-income and minority communities.[36] Known as reverse redlining, the predatory practices, which often went hand in hand with subprime lending, such as high pressure sales and marketing, excessive fees, unfair terms resulting in unaffordable financing came to characterize the type of loans that were offered to borrowers of color and low income borrowers particularly in areas that decades before had been redlined due to the continued concentration of people of color residing in them.

The preponderance of subprime borrowing occurred in communities of color and lower income communities. From 1993 to 2000 home purchase loans increased 61.8 percent; but loans to black applicants increased, from 5,482 to 12,889 (135% increase), and loans to residents in minority census tracts grew from over 19,656 to 39,586 (a 101% increase).[37] Much of the increased lending was attributable to increased activity by specialized lenders, and particularly to minority borrowers or areas – subprime lenders made 33% of the additional loans to minority tracts and 43.5 percent of the loans to blacks.[38] Lower income African Americans and Hispanics were 2.4 and 1.4 times, respectively, more likely to receive subprime loans than lower

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[34] Bradford, Calvin, (2002, p.6-7).
[35] Mayer & Pence (2008, p.3)
[36] HUD-Treasury (2000, p. 105)
[37] Williams, Nesiba and Diaz (2005, p.194).
[38] Williams, Nesiba and Diaz (2005, p 194)

income whites. [39] The boom in refinancing spurred by subprime lending accounted for 78 percent of increased lending in minority neighborhoods during 1993-2000, while refinancing by traditional lenders saw declines especially in minority tracts.[40] A recent study conducted the US Department of Treasury compared similar African American and White neighborhoods but found that while subprime refinancing mortgages accounted for only nine percent of refinancing loans in White neighborhoods, they made up 51 percent of the refinancing loans in the African American neighborhoods.[41] As such, the concentration of subprime loans could be found in geographical areas with a higher concentration of minority residents. Between January 2000 and July 2004, 1.8 million subprime loans originated were given to borrowers living in zip codes identified as "medium-low" minority (10-24% of residents in the zip code are minority), "medium-high" minority (25-49%), and high minority (50% or greater).[42]

Minorities Disproportionately Pay Higher Costs for Mortgages

Minorities and lower income borrowers are far more likely to receive a high-cost home loan than whites –and while some of the disparity can be tied to economic factors – risk alone can not account for the higher cost of credit. In 2004, Black and Latino borrowers were over 30 percent more likely than white borrowers to receive high-rate subprime loans, controlling for risk factors such as risk.[43] Even when adjusting for income, the difference between lending to minority areas/borrowers and nonminority areas/borrowers were very significant, both for refinance and home purchase: 29.8 percent of black borrowers at less than 60 percent of MSA Median Income received a loan from a specialized lender, while only 9.5 percent of nonblack borrowers in that income category did – a 300 percent difference.[44]

Subprime mortgages among borrowers of color were much more likely to include pre-payment penalties and interest-only terms than among white borrowers. Black borrowers were 6 percent to 34 percent more likely than whites have loans with pre-payment penalties. [45] Most subprime loans included heavy prepayment penalties, whether borrowers realized it or not. About 80 percent of the subprime mortgages issued in 2005 contained such penalties; only about

[39] Bradford(2002, p.6)
[40] Williams, Nasiba and Diaz (2005, p.194)
[41] Allen Fishbein and Harold Bunce(2005, p.275).
[42] Gruenstein Bocian and Zhai, (2005, 3)
[43] Gruenstein Bocian, Ernst and Li, (2006, p.3).
[44] Williams, Nesiba and Diaz McConnell (2005, 198)
[45] Gruenstein Bocian, Ernst and Li, (2006, p.2).

2 percent of that year's prime mortgages did.[46] Pre-payment penalties make it harder for a homeowner to refinance since they would be required to pay a fee for repaying a loan early. For example, a homeowner prepaying a typical $200,000 first-lien subprime loan would have to pay $6,000.[47] This makes subprime loans costlier as nearly 70 percent of subprime borrowers, by the fifth year into the loan, have prepaid their mortgage at least once. A study found that when considering the category of prepayment penalty period, those living in "high minority" zip codes were 35 percent more likely to receive prepayment penalties with terms of 24 months; 35 percent more likely to receive penalties with terms of 36 months; and 33% more likely to receive penalties with terms of 60 months or more, than those living in "low minority" areas. This is after controlling for risk factors that included borrower, property and loan characteristics (including credit scores).[48]

Latinos borrowers were 29 percent to 142 percent more likely to have received higher interest loans than whites.[49] Avery et al (2008) found that Latinos were overrepresented among borrowers receiving interest-only and negatively amortizing products.[50]Among the higher risk home purchase loans was the interest-only loan. By design, a borrower only pays the interest, as opposed to the principal, for a fixed period time so that initial payments tend to be 20 percent lower than a traditional loan. Once the interest-only period has ended, the borrower must begin paying both the interest and the principal – which can be 50 to 80 percent higher than their initial monthly payments[51]. Nationwide, interest-only loans gained popularity during the recession and assisted the ballooning and popping of the housing market. Loan Performance has reported that interest-only mortgages made up nearly one third of mortgage originations in 2004 and 2005.[52] At the height of the subprime market, in 2007, the proportion of interest-only loans increased from 11 percent in 2003 to 26 percent in 2007.[53]

The mortgage industry attributes the high cost of subprime loans as necessary because of the financial risks of lending to borrowers with low credit scores but studies that have controlled for similar economic characteristics, credit risk and other demographics find that minorities, on whole, pay more

[46] Lardner(2007, p. 24)
[47] Lardner (2007, p.24)
[48] Gruenstein, Bocian and Zhai, (2005. p.5)
[49] Gruenstein Bocian, Ernst and Li, (2006, p.6)
[50] Avery et al (2008)
[51] Erate, Interest Only Loans have risk. Retrieved January 28, 2007 http://www.erate.com/interest_only_loans.htm
[52] Fishbein and Woodall, (2006 p. 21).
[53] Financial Adviser, (2007),

for a mortgage.[54] For refinance, the discrepancies are starkest: 37.8 percent of high-income black borrowers received subprime loans, compared with 14.0 percent of nonblack borrowers.[55]

Among higher income borrowers, the difference between subprime lending to Whites and subprime lending to minorities is more pronounced. Many upper income Blacks and Latinos ended up with subprime mortgages (more than twice as often as upper-income whites did).[56] Williams and Diaz-McConnell (2005) found that slightly more than 21 percent of African American borrowers in the top income category, over 120 percent of median income, received a specialized lender purchase loan, versus 7.1 percent of non-black borrowers.[57]

The Aftermath of Alternative Mortgage Products

When interest rates climbed in early 2007, many subprime borrowers began to default as their mortgages were reset to higher monthly payments. More than half of the homeowners who went into default in the fourth quarter of 2007 had a subprime mortgage (54%). National home prices fell, leaving 10 percent of the nation's homeowners with negative equity – a mortgage debt higher than the value of their home.[58] With borrowers unable to meet their payments or refinance due to prepayment penalties, foreclosures reached 20,000 a week by early 2008.[59] At that rate, more than two million families stood to lose their home by the end of 2009.

A study found that after controlling for neighborhood demographics and economic conditions, subprime loans lead to foreclosure at far greater rates than do prime loans. Furthermore, the authors found that subprime lending accounts for a substantial percentage of foreclosure activity in high-foreclosure neighborhoods.[60]

Millions of borrowers who accepted subprime loans between 1998 and 2006 already have or will lose their homes to foreclosure, resulting in a net loss in homeownership for nearly one million families. Minorities and low-income borrowers are disproportionately represented among the subprime victims. As a result, these borrowers—who for decades had little or no access to credit—are once again being shut-out.

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[54] Apgar, & Herbert (2006, p.186)
[55] Williams and Diaz , 2005, p. 198)
[56] Bradford,(2002, p.6-7).
[57] Williams, and Diaz (2005, p.198).
[58] Lardner, (2007)
[59] Lardner, (2007)
[60] Immergluck and Smith (2005, p.853)

Foreclosures

New foreclosures have increased rapidly since 2006 and subprime lenders have come to represent a disproportionate percentage of these residential foreclosures. According to the Center for Responsible Lending, subprime borrowers have the highest foreclosure rate in the housing industry. In fact, in 2006, it was projected that 2.2 million homeowners lost their homes due to foreclosure.[61] About 3.6 million subprime mortgages were outstanding at the end of 2007; more than one in five of the borrowers were at least three months behind on their payments.[62]

Foreclosures have a tendency to cluster in low-income and minority neighborhoods with a large share of sub prime lending. In 2009 a study analyzed the incidence of foreclosures in Ohio where one third of the foreclosures originated from subprime lenders. Comparing the interest rates of foreclosed properties with the prevailing rate at the time of the loan origination, the study found that most of the rates for foreclosed properties were much higher than the going rate, both for prime and subprime lenders.[63] Nearly half were 3 points above the going rate. An estimated 83 percent of foreclosures occurred within 5 years after origination, 36 percent within 2 years, indicating that faulty loans likely contributed significantly to the foreclosures.[64] Moreover, while subprime loans accounted for less than 10 percent of loans in the county, in some Akron neighborhoods subprime loans represented over 20 percent of the total loans.[65] Those were in lower-income, high-minority proportion, and higher-poverty neighborhoods. The authors noted that the subprime lending activity was concentrated in areas where prime loans had a limited presence. [66]

The high incidence of foreclosures has greater costs for African Americans and Latinos beyond losing their home. For these homeowners, their home is a significant source of wealth accumulation. Although property values are typically lower in nonwhite neighborhoods, home equity still constitutes the majority of wealth for nonwhite homeowners. Housing equity accounts for an estimated two-thirds of the wealth of African-American homeowners, while representing only about one-third of white homeowner wealth. Estimates place the total loss of wealth among households of color at between $164 billion and $213 billion for subprime loans

61 Center for Responsible Lending (2006, p.2)
62 Lardner, (2007, p. 14)
63 David H. Kaplan; Gail G. Sommers (2009, p. 110)
64 David H. Kaplan; Gail G. Sommers (2009, p. 110)
65 David H. Kaplan; Gail G. Sommers (2009, p. 110)
66 David H. Kaplan; Gail G. Sommers (2009, p. 110)

taken during the past eight years.[67] That would be the greatest loss of wealth to people of color since Reconstruction.

Communities have experienced the downside of concentrated numbers of subprime loans as the number of foreclosures adds up. Financially, the foreclosure crisis has negatively impacted state and local governments by creating new needs and depleting resources at the same time. Largely as a result of the mortgage crisis, tax revenues are falling precipitously. Spending trends are destined to move in the same direction.

The surrender of so many homes—and the movement of so much housing into absentee ownership—will impact all homeowners as neighborhoods fall into decay, bringing down housing prices. Immergluck and Smith (2006) reviewed the relationship between foreclosures in Chicago and the incidence of crime, testing its hypothesis that foreclosures affect neighborhood crime - both property and violent crime - in lower-income neighborhoods through long-term vacancy and abandonment of homes unsold, or what social scientists term "physical disorder". Their study found that for 1 foreclosure out of 100 properties, the level of violent crime is expected to increase 2.33% and that given the concentration and volume of foreclosures, driven in the late 1990's and early 2000's by increased subprime lending activity, with greater presence in low-income and minority neighborhoods, the potential costs of crime to those neighborhoods are magnified.[68]

A study of the economic effect of foreclosure activity on residential property found that as homeowners in foreclosure decreased their upkeep of their home, the value of surrounding homes decreased. The authors noted that an average house ($200,000 price) within 250 feet of a foreclosed property lost $1,666 in value. The authors concluded that foreclosures did have a negative and significant effect on neighborhood quality.[69]

Tightened Credit

As more and more households defaulted on their subprime mortgages, the lenders and investors that had fueled the alternative mortgage market began experiencing record losses. With shrinking capital, lenders reduced the availability of home lending lines, and decreased amounts available to borrowers.

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67 Lardner (2009, p.16)
68 Immergluck and Smith, (2006, p.862).
69 "Murdoch, (2009, p 322).

In anticipation of escalating write-downs from further mortgage resets, lenders began introducing stringent lending practices. The write-offs spurred lenders to adjust their business practices and tighten the requirements for obtaining a mortgage. Precarious products like the no document mortgage have been pulled from the market. Lenders, such as J.P. Morgan Chase, now require at least a ten percent down payment with areas hit hardest by foreclosure like Reno, Nevada require borrowers to put down 25 percent.[70]

The Furman Center for Real Estate & Urban Policy analyzed loan approval rates, by loan purpose and by racial group at the national and NYC level using HMDA data for 2007 to ascertain if mortgage loans were harder to obtain following the wave of foreclosures in the mid 2000s. The report showed that, while both the U.S. and New York City experienced declines in home mortgage lending activity during 2006 and 2007, black and Hispanic borrowers suffered more substantial declines than white or Asian borrowers, both at the local and national levels. While the decreases were attributable across the board to a combined decline in applications by borrowers as well as an increase in denials by lending institutions, the activity in denials for black and Hispanic borrowers was greater proportionately.[71] African-Americans and Latinos remain more likely than whites to be turned down for mortgages, with 26.1 percent of applications from Hispanics rejected in 2007, 30.4 percent of applications from blacks and 12.1 percent of applications from whites.[72]

For borrowers of color able to secure lending, the study found that they still continue to receive high-cost loans. During 2007, in NYC, 32 percent of black borrowers received a high-cost home purchase loan, while 18 percent of Hispanic borrowers received them, and only 5 percent of home purchase loans issued to white borrowers were high-cost. [73]During 2007, at the national level, 34 percent of black borrowers received a high-cost home purchase loan, while 28 percent of Hispanic borrowers received them, and 11% of home purchase loans issued to white borrowers were high-cost.[74]

Low-income and minority home ownership has suffered as a result of the massive foreclosures associated with subprime lending. In 2008, the homeownership rate in the United States decreased to 67.5percent after reaching a peak of 69.2 percent in 2004. Among African

[70] Lardner, (2007, p. 14)
[71] Furman Center for Real Estate & Urban Policy (2008, p. 1)
[72] Furman Center for Real Estate & Urban Policy (2008, p. 5)
[73] Furman Center for Real Estate & Urban Policy (2008, p. 6)
[74] Furman Center for Real Estate & Urban Policy (2008, p.6).

Americans, homeownership fell 2.1 percent between 2004 and 2008. Latinos continued to experience growth until 2006 before falling to 49.8 percent in 2008.[75]

The High Costs of Market-Segmented Credit

The segmentation of the mortgage lending market highlights a general trend in lending in which low-income and consumers of color pay more for accessing credit. In credit-starved minority communities across the country, the deregulated market brought a proliferation of high-cost lending, including securitized subprime and predatory loans, payday lending and check cashing stores. One study using the Survey of Consumer Finances found that gaps in credit access and costs of credit have widened by race and remained high by income.[76] With greater numbers of families struggling with ever growing debt that far outstrips their income and savings, many low-income and minority households must turn to costly lending products for immediate but expensive solutions to pressing needs. Minorities and low-income consumers resort more frequently to credit card debt and other forms of high cost debt in the absence of assets. Demos' analysis of Survey of Consumer Finance data in 2004 found that 84 percent of African American cardholders carried balances, compared to 79 percent of Latino cardholders and just 54 percent of white cardholders.[77] On average, minority and low-income borrowers are more likely to carry high interest and fee-laden credit cards. Another study commissioned by Demos found that found that four groups—low-income individuals, African Americans, Latinos and single women—are much more likely to pay interest rates above 20 percent on their credit cards.[78]

The rise in high-cost credit card debt is further compounded by the lack of banks and other mainstream financial institutions in communities of color and lower income communities, creating a vacuum into which fringe services have stepped in to profit from their economic needs. In 2005, wealthy cities had, on average, just three check cashing outlets and 55 bank branches while lower income cities had 7 banks and 24 check cashing outlets.[79] In the last few decades, the alternative financial service industry has grown into a business that handles nearly 280 million transactions a year with gross revenue of more than $16 billion. Close to $5.5

[75] Leland, (2009)
[76] Weller (2008, p.1)
[77] Garcia, (2007, p. 18)
[78] Wheary & Draut, (2007, p.1)
[79] Fisher, Allan (2005)

billion of these profits are garnered from fees alone[80]. In the end, consumers who must turn to these services end up paying much more than they would have had they gone to a "mainstream" provider. In general, all of these services use fees, interest and different types of collateral to assure that their money will be paid back by the borrower. However, these charges are often so high that they can even exceed the cost of the loan or drain most of the funds borrowed in order to pay it back.

The segmentation of the lending markets has exacerbated disparities in wealth and asset accumulation. Studies show that property values in predominantly African-American neighborhoods are lower than those in similarly situated white communities. Today, less than half of African-American and Hispanic households own their own home compared to three quarters of white households who enjoy homeownership. In times of economic distress, where the use of home equity could weather the gap between income and expenses, housing wealth remains elusive for a majority of African-American and Hispanic households.[81] This diminished asset building potential has a range of implications: families have no "nest egg" for emergencies, higher education or retirement; what we find is a viscous cycle of declining opportunity take hold.

The high costs of a segmented lending market in which low-income and minority borrowers pay more to access credit raises pressing policy concerns during the current debate over financial regulation. Fair lending encompasses more than foreclosure recovery, it is about better access to fairer terms of lending where consumers have equal access to those choices. In light of the subprime meltdown, a comprehensive approach toward efficiently regulating the all lending markets is necessary for creating a fair lending arena. Furthermore, the Federal government needs to proactively ensure fair lending innovation is afforded to low-income and communities of color.

Conclusion

American households are facing a devastating recession with little home equity and high levels of credit card debt. With few assets to turn to, low- and middle-income Americans will have a harder time recuperating from the economic downturn under mounting debt. Much of this debt has been accumulated to pay for basic costs or essential expenses—such as health care, car repairs, and home repairs—as more low- and middle-income households are confronting rising

[80] Carr and Kolluri, (2001, p. 32)
[81] Rusk(2001, p.1)

costs amidst stagnant or falling incomes. After two decades of deregulation, once credit-starved communities have been aggressively targeted with high-cost, wealth-depleting forms of credit. The sweeping reforms achieved what many championed as the "democratization of credit." But the new widely available credit accessible to lower-income and households of color was far from the quality credit that had long been extended to white and middle-income households. Instead, deregulation created a two-tiered system defined by high-cost, deceptive and often predatory loans for lower-income borrowers, and honest, safe, lower-cost loans for those who had always enjoyed access to credit. This two-tiered system flourished because at the same time that deregulation and technological innovation made new forms of financial services possible, low- to middle-income households were becoming more economically vulnerable as their incomes stopped growing – the democratization of credit provided a much-needed safety net

Addressing the rising burden of debt, and the structural imbalances facing households, will require a multi-pronged approach focused on 1) increasing household savings; 2) strengthening the safety net and reducing cost pressures facing households; and 3) ensuring fair lending practices.

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