COMMUNITY REINVESTMENT
cr forum

Predatory Lending Strikes at the Heart of American Neighborhoods

Are abusive lending practices undoing the progress of the Community Reinvestment Act? There is rising concern that the benefits of CRA in helping low- and moderate-income families build wealth through homeownership could be eroding. Reports from around the country indicate that widows, elderly couples, and hard-working, low-income and minority families are losing their homes in foreclosure because they have been persuaded to take on high-priced loans they cannot afford.

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SUMMER | 2000 | PUBLISHED BY THE FEDERAL RESERVE BANK OF CLEVELAND

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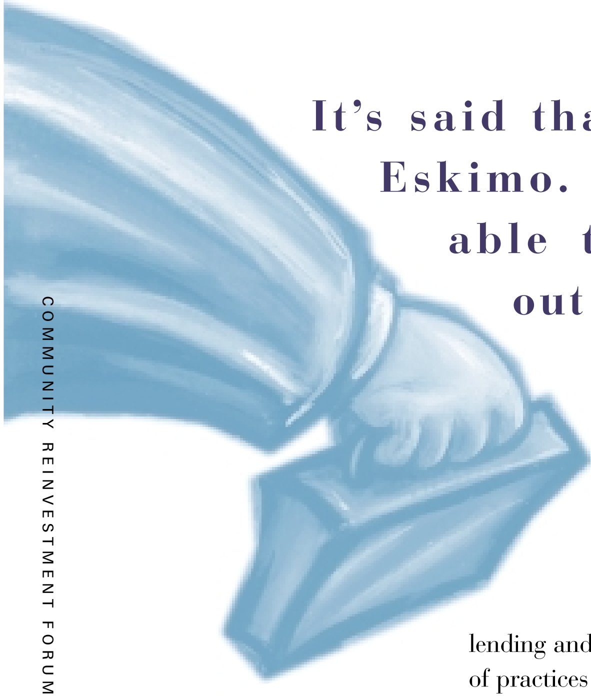

It's said that a good salesman can sell ice to an Eskimo. Likewise, predatory lenders often are able to persuade their customers to take out loans they don't need and can't afford.

These foreclosures effect not only the individual homeowners, but entire communities—frequently inner-city, minority, and low- and moderate-income neighborhoods.

Predatory lending is a national problem that is reallocating public and private dollars away from low- and moderate-income families and struggling inner-city neighborhoods to a variety of private parties. Federal and local tax dollars have been invested in such communities, adding to private donations, church contributions, bank loans made under CRA, and work done by nonprofits and community volunteer organizations such as Habitat for Humanity. All of these entities are the victims of predatory lending and have a stake in stopping this abusive practice.

The wide range of stakeholders involved in predatory lending and the national scope of practices demands a broad policy response. No single action—legislative, administrative, or judicial—can remedy the problem. Efforts to combat predatory lending must occur at the national, state, and local levels. Recent state legislation, such as that passed in North Carolina, is a positive first step that may eliminate the most common abuses, but legislation alone is not sufficient. There are calls for stronger enforcement of existing consumer protection laws, as well as stronger regulatory oversight of the entities responsible for the abuses.

A TANGLED WEB

Predatory lending is the result of a confluence of factors, making it difficult to approach from any one angle. Contributing factors are access to credit in at-risk neighborhoods, deceptive sales tactics among predatory lenders, and inadequate enforcement of existing laws, as well as consumers' lack of financial education.

Access to Credit

Access to credit from legitimate subprime lenders or regulated financial institutions is key in communities that have been targeted by predatory lenders. Often, victims of lending abuse are such easy targets because they perceive that no other forms of credit are available to them.

First and foremost, consumer education is called for: Consumers must be encouraged to shop around to find the best credit terms available. Financial literacy campaigns can raise awareness of effective money management and the importance of good credit histories, and they are one way to reduce the number of borrowers who have bad credit and are desperate for loans—prime targets for predatory lenders. However, actions designed to prevent predatory lending should not have the unintended consequence of curtailing low- and moderate-income consumers' access to legitimate credit. It is not clear how many victims of abusive lending practices could have qualified for loans from mainstream lenders.

Deceptive Sales Practices

It's said that a good salesman can sell ice to an Eskimo. Likewise, predatory lenders often are able to persuade their customers to take out loans they don't need and can't afford.

In many such cases, salesmen use deceptive trade practices to close the deal—for instance, representing a loan as a home-improvement or home equity loan when, in reality, the customer's entire mortgage is being refinanced without their knowledge. Frequently, victims report that they noticed a discrepancy between the loan terms they had been quoted and the terms displayed at closing. In most of these cases, the predatory agent convinced the customer to sign by promising to "fix" it later.

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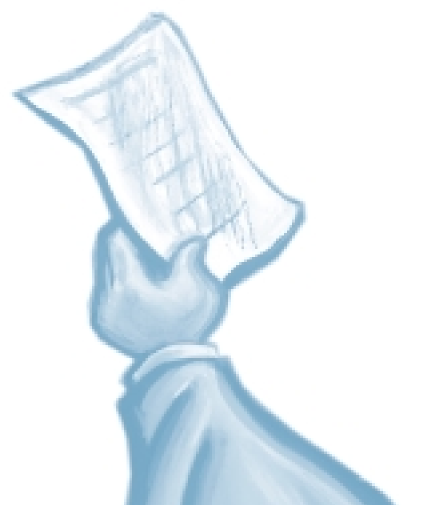

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Community Ventures Corporation's Kevin Smith: Taking Care of Business...and More

KEVIN SMITH
PRESIDENT AND CEO
COMMUNITY VENTURES CORPORATION

***Kevin Smith** is president and chief executive officer of Community Ventures Corporation, a multiservice community development financial institution that is dedicated to helping people acquire the assets and skills they need to achieve independence for themselves, their families, and their neighborhoods. Smith manages over $5 million in assets and operating funds for CVC, with the goal of rebuilding low-income communities through housing, employment, and business development. CVC is headquartered in Lexington, Kentucky, with branch offices in Danville and Campbellsville, and serves a 31-county area in central and northern Kentucky. During his 13 years as an economic development professional, Smith has created numerous programs to help the region's women, low-income, and minority residents become self-sufficient through job development and home and business ownership, and he has raised more than $15 million in capital for various Kentucky-based nonprofit social service agencies.*

Kevin Smith will tell you right away that Community Ventures Corporation's widespread success is the direct result of partnerships. In its 1999 annual report, the 18-year-old Lexington, Kentucky, agency lists 77 partners, ranging from individuals to large financial institutions. Smith, the Corporation's manager, believes nobody should go it alone when it comes to climbing out of poverty and dealing with its effects in communities.

That's true for the customers of Community Ventures and for its partners. A longtime provider of small-business assistance programs, Community Ventures has become a place where dreams are built, based on hard assets. For Smith, community development means finding the opportunities that lie between two different worlds—the haves and the have nots—and making them succeed. The work pays off only when partners and consumers come together in the effort.

Community Ventures has done just that. In the past seven years, CVC has made 324 business loans to low-income entrepreneurs—a $2.3 million investment in its service area. Products are designed to give people access to credit like they never had before, and the creative way in which Smith and CVC staff develop products is somewhat of a hallmark: They stay tuned into the market and design accordingly.

Their innovative abilities have resulted in new and different lending programs. They can now offer financing ranging from $500 microloans to small-business loans up to $750,000.

One program, for instance, will partner the U.S. Small Business Administration with the State of Kentucky to focus on farmers who have perennially raised tobacco. With the sharp decline in tobacco farming, alternative livelihoods must be found. Community Ventures will work with farmers to redevelop entrepreneurial skills and to explore alternative crops. Often, these rural business owners have credit needs of less than $20,000, but they are already highly leveraged, making them perfect candidates for the CVC microloan program. In another case, CVC, in cooperation with bank and corporate sponsors, will break ground on a small-business incubator this summer to offer very small businesses affordable space and support services.

Community Ventures' larger mission is to revitalize neighborhoods and communities by helping people acquire the assets and skills they need to achieve independence. Homeownership programs and credit and savings plans le

have been developed and specialized to meet their customers' needs. Coupled with every asset-building program is a strong educational component, so that participants are prepared to manage the assets they acquire, whether it is a home, business, or savings account. One of CVC's most unique programs is the lease–purchase plan, in which families who are unable to qualify for mortgages may lease a home from CVC for up to two years. The timeframe allows them time to resolve credit problems and to learn about responsible homeownership. "They [CVC] really work to help you become self-sufficient," said Francine Jackman, who recently acquired her home through the plan.

Because of the size and breadth of their programs (they are growing about 150 percent each year), serving 31 counties in northern and central Kentucky, Community Ventures has captured the attention of banking and corporate partners. In a particularly innovative move, CVC recently developed an equity pool in which several banks have invested for the long haul; the money is reinvested in the agency for mortgages or small-business loans. Banks have also contributed to CVC lending pools through participation in the U.S. Treasury's Community Development Financial Institution Bank Enterprise Award program.

Community Ventures now finds that banks are coming to them with deals and further partnership ideas. While CRA may be an impetus for some, Smith believes the competitive climate is ripe for banks to do as much as they feasibly can with community development organizations. Banker and board member Allison Arnett feels that partnerships with organizations like CVC help banks to manage risk and develop customers.

CVC is also dabbling in consumer loans, and it is deeply concerned about the implications of predatory lending. Smith believes the pervasiveness of these practices indicates that alternative financial mechanisms are needed. CVC's task, then, is to develop products to address the needs of low- and moderate-income families before predatory lending is stamped out, leaving a potential credit gap in its wake.

Smith knows the value of partnerships and small-business ownership personally: He comes from a family of entrepreneurs and operates a small business with his wife. Acting as Community Ventures' leader is ideal for him, because he can apply a business mind to the complex human and community development issues that challenge the nonprofit world.

What's next for CVC? A business plan that includes controlled growth, with an emphasis on more quality services and penetration into the region it serves—and the cultivation, of course, of more partnerships!

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survey

CR Forum Chalks Up Positive Response

In the last issue of *CR Forum*, we asked for your feedback about the newsletter's content, format, and features, and immediate results indicate that readers like what they see. A gratifying 96 percent of you wish to continue to receive the newsletter, and most prefer to read it the old-fashioned way—on paper—and then share it with colleagues. A good-sized minority, however, recommended making the periodical available on the Internet. Over 60 percent of readers stated that they find the newsletter easy to read, and more than half noted its professional appearance, particularly the photographs and artwork.

As for content, readers clearly rated the cover story or special feature as the item they like best in *CR Forum*, followed by "Of Interest" and "Fourth District Profile." The newsletter's contents were rated "very good," with readers citing the publication's conciseness, reliability as a source of information, and trustworthiness as source of analysis.

results

Readers offered several reasons why reading *CR Forum* makes a difference to them professionally. Respondents stated that they use *CR Forum* most often for reference material and for keeping up-to-date on trends in community development. Readers feel the contents are appropriate to their business and they provide fodder for collegial exchange.

Future issues will feature successful community/economic development models and current community development resources, as well as news from the Federal Reserve (such as economic trends, CRA regulations, or consumer issues) and special topics. Survey respondents expressed a particular interest in seeing predatory lending covered in a separate in-depth publication. (See this issue's cover story and the enclosed *CR Report*.)

The organizational backgrounds of readers responding to the survey ran the gamut: Bankers, nonprofit directors, and government workers represented the largest segment, followed by the for-profit, educational, and other diverse sectors. Most respondents are aged 35–64 and hold a college education or higher, and approximately half work in companies with 100 or more employees. On the opposite end of the range, 39 percent represented organizations with 25 or fewer employees.

The Community Affairs staff thanks all of you for replying to our reader survey, and we pledge our continued efforts to making it a publication that answers your needs.

IN MY opi

Predatory Brokers: Licensed to Steal?

BY NOEL MORGAN
STAFF ATTORNEY
LEGAL AID SOCIETY OF GREATER CINCINNATI

Complete a four-page application, post a $25,000 surety bond, and pay the state $350. That's roughly all it takes to become a mortgage broker in Ohio. Although applicants must not have criminal records, once they get a registration certificate, too many of Ohio's 1,500 registered brokers treat it as a license to steal.

Crooked mortgage brokers are an important part of the predatory lending picture, yet their role is often overlooked—perhaps because their damage is done by the time the loan closes. Predatory brokering has caused serious harm to countless consumers and occurs in the absence of any meaningful regulation.

Ohio defines a mortgage broker as a person who collects money for "assist[ing] a buyer in obtaining a mortgage." Predatory brokers turn that definition on its head: Consumers unlucky enough to be "assisted" by one of these outfits pay obscene fees to be steered toward equally obscene loans.

Two years ago, the Legal Aid Society of Greater Cincinnati assigned several attorneys to focus on consumer fraud. The fraud squad's caseload has ballooned, and now most of our cases involve predatory lending. In case after case, we've traced the predatory deal back to the mortgage broker. The pattern we've identified includes brokers who provide no written service agreement, falsified mortgage applications, loans with outrageous terms, no advance disclosure of terms, and broker fees that are grossly disproportionate to the services provided.

Cincinnati's Yellow Pages are littered with ads for mortgage brokers, though you'd never know it. The word "broker" is conspicuous in its absence, giving the unwary consumer no clues to distinguish brokers from lenders. Often, consumers believe they are dealing directly with a lender, not a third party masquerading as a lender to collect a fat broker fee. Many consumers end up paying thousands of dollars to brokers they didn't even know they had employed.

Predatory brokering is an aggressive enterprise, and the salespeople don't wait for their customers to call. They peddle their services over the phone and make house calls to close the deal. That's how the Smiths* met the broker who put them on the road to foreclosure.

***Noel Morgan** is a staff attorney with the Legal Aid Society of Greater Cincinnati (LASGC). At present, LASGC is representing consumers in numerous lawsuits that involve predatory lending issues.*

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Both retired and in their seventies, the Smiths made the mistake of listening to a phone pitch that promised to pay their bills, provide cash, and lower their monthly payments.

The couple recall the salesman painted the same rosy picture when he came to their house to fill out their loan application. The paperwork was simple enough—they had no savings or assets other than the house (which they had already mortgaged three times in the past two years), and their monthly Social Security income totaled only $770. The Smiths didn't learn until closing that the monthly payment would be more than half their income, and they did not understand that a 1/2 percent increase in the interest rate included a $40,000 balloon payment, due after 15 years. The broker overcame their objections to the terms, badgering them into signing with empty promises of refinancing the new loan with better terms. In addition to $900 in settlement costs, the broker received $2,100 for arranging the loan, and the Smiths now struggle to make the payment.

Time and again, such brokers don't let the facts stand in the way of "assisting" their customers. If the facts don't fit, they invent ones that do. Mrs. Wilbur,* for instance, had recently become unemployed and was looking for a new apartment; she decided instead to buy when she met a man who promised to sell her a house with "100 percent financing." To disguise her destitute circumstances, the broker's salesman concocted phony employers, a car, insurance, and savings. Without understanding, in short order Mrs. Wilbur had signed a stack of documents, taken on an overwhelming debt including three mortgages, and became the disillusioned owner of a "money pit"—at the bottom of which were defective sewer lines and inevitable foreclosure. The broker's fee for this "assistance" was $3,000.

Consumer Protections and Remedies

It's easy to spot the fraud in these examples, and the claims in our court actions against brokers (and others) include fraud, deceptive and unfair sales practices, breach of fiduciary duty, and even violations of the state home solicitation sales law. If we prevail, our clients may survive their predatory encounters. But individual lawsuits are not an efficient way to address such pervasive abuses.

Los Angeles County's fraud-fighting coalition (see the accompanying *CR Report*) is an impressive model, but it is not easily duplicated. Fraud cases are complex and require resources that prosecutors typically assign to other cases.

There is, of course, no substitute for pre-purchase counseling from agencies like Cincinnati's Better Housing League (BHL) and Mortgage Counseling Service, which provides excellent services to those who take advantage of them. In a perfect world, counseling would be a prerequisite to signing a mortgage; one recent court settlement required a Cincinnati seller and broker to send their customers to BHL before proceeding on the loan.

Ohio consumer advocates—including legal services offices and fair housing agencies—have begun working together to increase public awareness of predatory lending practices and to improve legal protections against abusive lending. One product will be proposals for tougher state regulations, building on those already enacted in other states. But meaningful reform must address brokers as well as lenders.

Although Ohio registers brokers and prohibits deceptive and unfair sales practices, there is little affirmative regulation beyond the broad proscription of fraudulent practices. I'm convinced that an important part of the solution should be to add teeth to broker regulation and to directly address some of the blatant abuses. At a minimum, this should include:

- Requiring brokers to provide customers with a written agreement before performing any services. The agreement should affirm the broker's duty to locate a loan that is in the customer's best interest, disclose the amount of the fee, and include a three-day cancellation clause.
- Capping broker fees (for example, no more than 2 percent of the total loan).
- Prohibiting brokers from receiving a "bonus" or "upsell" from the lender for steering borrowers to loans at higher interest rates.
- Explicitly requiring brokers to comply with federal lending laws.
- Requiring brokers to disclose that they are brokers—and not lenders—in advertisements and direct solicitations.

Brokers are, to be sure, only one piece of the predatory lending picture. There are plenty of good brokers, but there are too many bad ones. Lending predators can bypass brokers altogether by using their own aggressive sales forces. That said, enactment of just these minimal protections would force a significant change in the way today's predators do business and increase consumers' chances for fair treatment. That would be progress!

*The names have been changed on each of the examples used.

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We welcome your comments and suggestions.

Although it is difficult to protect consumers from their own poor decisions, it is possible to ensure that borrowers have clear, accurate information to make informed decisions. Efforts are under way to press for stronger consumer protection laws to address unfair and deceptive trade practices, pressure tactics, and fiduciary responsibility.

Inadequate Law Enforcement

Many predatory loans involve blatant fraud, both civil and criminal. However, real estate fraud has received little attention from state and local authorities, and as a result, few cases are investigated and almost none are prosecuted. The appropriate response to fraud should be better enforcement of existing laws, with more education for both consumers and law enforcers in recognizing and preventing home equity fraud.

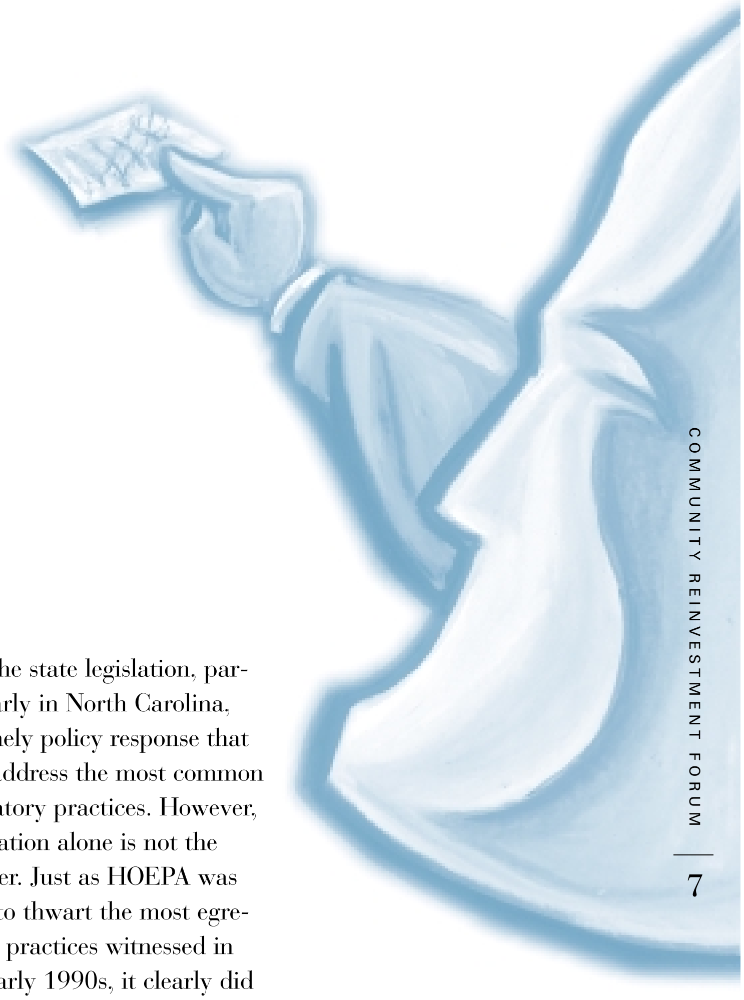
POLICY RESPONSES

Predatory lending is not a new phenomenon. In 1994, Congress passed the Home Ownership Equity Protection Act (HOEPA), responding to reports of fraudulent and abusive lending practices in the high-cost loan market. The act defined high-cost loans, set additional disclosure requirements, and restricted some loan practices.

The discussion around policy responses to predatory lending has centered on amending HOEPA. State legislation adopted in North Carolina follows the act's logic: It defines high-cost loans with lower criteria for fees than HOEPA's definition and, for loans meeting the criteria, requires borrower counseling and prohibits balloon payments, negative amortization, lending without consideration of the ability to pay, and financing of up-front fees or insurance premiums. In addition, the law prohibits prepayment penalties, loan flipping, and single-premium credit life insurance on most loans.

Other states (Illinois, Kansas, Maryland, Minnesota, Missouri, South Carolina, Utah, and West Virginia) have followed suit and have proposed legislation modeled after the North Carolina bill.

There is also discussion of further legislation at the federal level, focusing on broadening the definition of high-cost loans and tightening rules on prepayment penalties and preventing single-premium life insurance.



The state legislation, particularly in North Carolina, is timely policy response that will address the most common predatory practices. However, legislation alone is not the answer. Just as HOEPA was able to thwart the most egregious practices witnessed in the early 1990s, it clearly did not solve the problem of fraudulent and abusive lending practices.

New legislation is certainly the most direct policy response to prevent the most abusive practices currently seen in bankruptcy courts. To protect the nation's most vulnerable communities, legislation must work with other measures.

WHERE DO WE GO FROM HERE?

Predatory lending is a difficult and slippery problem, presenting unique challenges to borrowers, to law enforcement, and to regulators such as the Federal Reserve. In response to readers' feedback, this and future issues of *CR Forum* will address the scope and impact of abusive lending practices in a series of articles, opinion pieces, and reports. By doing so, the Community Affairs Office of the Federal Reserve Bank of Cleveland hopes to explore the problem from many angles and to highlight practical solutions.

In this issue, we lay the groundwork for research to come: In the *"In My Opinion"* column, Noel Morgan of the Greater Cincinnati Legal Aid Society argues for stricter regulation of mortgage brokers, often key players in the predatory lending game. The accompanying *CR Report*—the first of several reports to come—describes Los Angeles County's Real Estate Fraud Task Force, a comprehensive approach to fighting abusive lending practices and a model of an integrated solution.

# of interest

Fed Offers New Microenterprise Training Tools

"I Love Being Self-employed," Three Stories of Microenterprise Partnership, produced by the Cleveland Fed's Community Affairs Office, is a concise and simple microenterprise training kit designed for trainers and technical assistance providers to use during business orientation and instruction sessions. The package includes a 12-minute videotape, instructor's guide, and student workbook. It's also an excellent tool for educating bankers or funders about microenterprise. Training kits may be purchased for $25. To order, contact Jacqueline King at 216/579-2903 or Karen Mocker at 513/455-4281.

Microenterprise Video Preview

The Federal Reserve Bank of Cleveland and its Cincinnati and Pittsburgh offices will present informal preview sessions of the *"I Love Being Self-employed"* video in early fall. For information, contact Laura Kyzour at 216/579-2846.

events

September 28

New Directions in Community Reinvestment

The Federal Reserve Bank of Cleveland, with participation from the Office of the Comptroller of the Currency, the FDIC, and the Office of Thrift Supervision, will convene a half-day conference program highlighting the latest information on a variety of CRA-related topics. Agenda items will include discussion of the Sunshine provisions of the Gramm-Leach-Bliley Act and the Federal Reserve's CRA study. Watch your mail for registration materials, or check our Web site at www.clev.frb.org/CommAffairs/Conf2000/NDCR.

October 19

Pittsburgh Community Reinvestment Group Awards Luncheon

Federal Reserve Board Vice Chairman Roger W. Ferguson, Jr., is the guest speaker. (Location to be announced.)

October 24

An Appalachian Awakening

One-day conference on "Winning Strategies for Workforce Development in Rural Appalachia," sponsored by the Community Affairs offices of the Federal Reserve Banks of Atlanta, Cleveland, and Richmond. David H. Ciscel, Fogelman Professsor of Economics, College of Business and Economics at the University of Memphis, is the keynote speaker. The MeadowView Conference Resort and Convention Center in Kingsport, Tennessee, will host the conference. For registration information, call Bonnie Falls, Federal Reserve Bank of Richmond, at 804/697-8114.