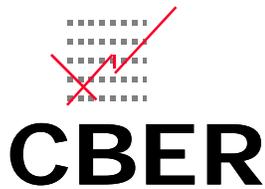


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Project #1097



**Predation in the Sub-Prime  
Lending Market:  
Montgomery County  
Executive Summary**

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## **EXECUTIVE SUMMARY**

### **Predation in the Sub-Prime Lending Market**

#### **I. INTRODUCTION**

The Center for Business and Economic Research (CBER) at the University of Dayton aided Lutheran Social Services, Miami Valley Fair Housing Center and Legal Aid Services of Dayton in their study of Predatory Lending Practices in Montgomery County.

The objectives of the study were to:

1. Characterize quantitatively the extent of the predatory lending problem in Montgomery County and trace its growth over the 1994 to 2001 period.
2. Define the detailed geographic and demographic (ethnic identity, age, gender) pattern of loans with predatory characteristics.
3. Define the set of lenders who are involved in lending that has the characteristics of predation.
4. Define the geographic patterns of mortgage lending by lenders who appear to be involved in predatory lending practices.

To accomplish these objectives, CBER utilized a combination of record searches and interviews with affected parties.

The primary data sources utilized included Montgomery County Clerk of Courts records of Mortgage Foreclosures, Montgomery County Recorder data on mortgages, Montgomery County Auditor data on property appraisals and bases and Loan Application Register data from the Home Mortgage Disclosure Act.

CBER conducted 27 interviews with a sample of homeowners whose mortgage foreclosures exhibit evidence of predatory practice and 200 interviews with a sample of people who have mortgage loans (not foreclosed) with lenders who have been identified as using predatory practices.

#### **II. FINDINGS**

##### **A. National Context**

The expanded securitization of mortgage products in the 1980s led to the realization that it was possible to offer home mortgage loans to borrowers with a higher credit risk at higher interest rates. Such sub-prime loans were a much needed source of credit to many low and moderate income homeowners and the popularity and profitability of the market brought the entry of relatively large financial corporations.

With the expansion of this sub-prime mortgage market however, several marketing practices emerged that appeared to exploit these low and moderate income households and deepen their

financial woes. The Federal Trade Commission (FTC) characterized these practices as aiming “to extract excessive fees and costs from the borrowers or to obtain outright the equity in the borrowers’ home”. The FTC identified four particular aspects of these predatory practices, 1) Equity Stripping: loans based on assets rather than the borrower’s ability to repay which have a higher probability of moving to foreclosure, 2) Packing: adding single premium credit insurance to the loan amount in a situation where the borrower could assume that the credit insurance was a necessary part of getting the loan, 3) Flipping: the practice of convincing the borrower to refinance several times in a short period, 4) Linkage of loans to home improvement projects where work is not completed or actual loans terms differ from those discussed verbally.

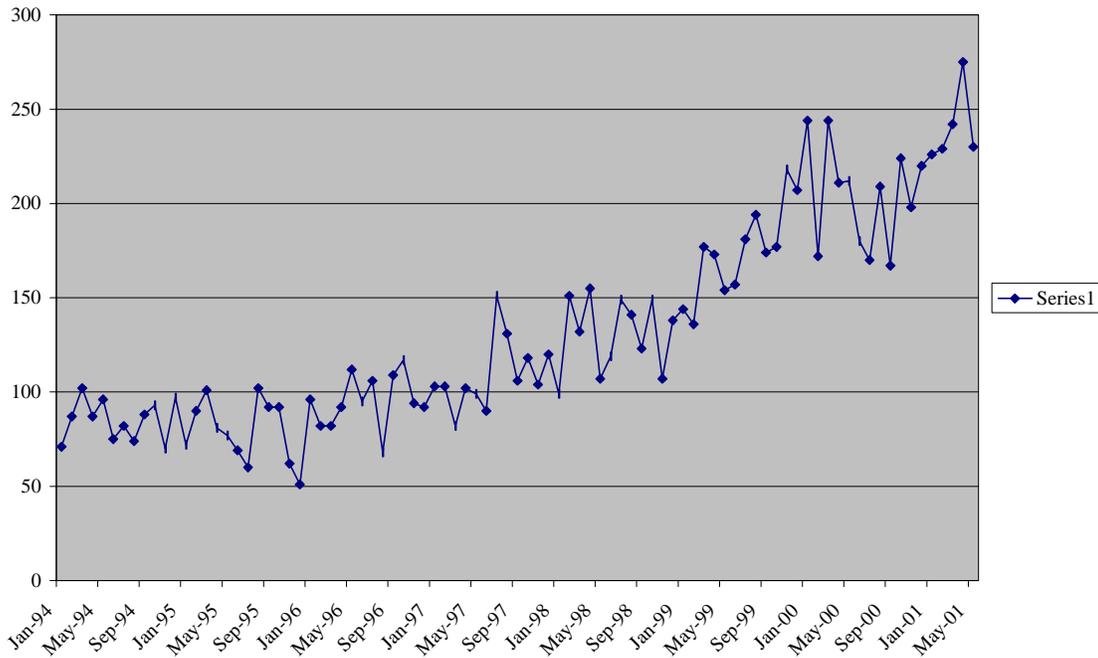
In hearings the Federal Reserve Board held for revising Regulation Z: Truth in Lending (the primary regulation that implements the Home Ownership and Equity Protection Act, HOEPA), the FTC recommended (among other things) 1) prohibiting the financing of single premium credit insurance and other loan extras because borrowers are not able to evaluate the costs and benefits of the insurance when it is included automatically with the loan, 2) banning mandatory arbitration agreements in HOEPA loans and 3) lowering the HOEPA APR trigger to 8% above comparable treasury securities and seeking authority from Congress to lower it to 6% above. The FTC felt too few consumers benefited from HOEPA legislation because the trigger was set too high. They had found a pattern of “abusive loan practices that often occur in loans that fall below the trigger” and many lenders price their loans just below the trigger. This 6% cutoff figure above a comparable U.S. treasury bond would have brought about 25% of the sub-prime loans made in the period from 1995-1999 under HOEPA Regulation.

## **B. Rise of Mortgage Foreclosures in Montgomery County**

CBER analyzed the rise and geographic spread of Mortgage Foreclosure filings in Montgomery County using Clerk of Court records.

- Over the period from 1994 to 2000, mortgage foreclosure filings in Montgomery County increased from 1,022 to 2,451. (Chart on next page and Main Report.)
- As the volume of loan foreclosure filings increased throughout the county, the relative share of suburban jurisdictions increased relative to Dayton. Dayton’s percent share decreased from 48% to 40%. Huber Height’s share for example went from 4.4% to 6.8%.

**Mortgage Foreclosure Cases Filed, Jan. 1994-May, 2001**



**Mortgage Foreclosure Cases by Geographic Area: Percent of Total, 1994 and 2000**

Area	YEAR	
	1994	2000
Dayton	47.7%	39.5%
<b>Kettering</b>	<b>7.8%</b>	<b>9.6%</b>
Trotwood	8.4%	7.9%
<b>Huber Heights</b>	<b>4.4%</b>	<b>6.8%</b>
<b>Miami Township/Miamisburg</b>	<b>4.2%</b>	<b>6.1%</b>
<b>Harrison Township</b>	<b>5.3%</b>	<b>5.9%</b>
<b>Washington Township/Centerville</b>	<b>3.4%</b>	<b>4.4%</b>
Clayton/Englewood/Union	3.8%	3.6%
<b>Jefferson Township</b>	<b>1.5%</b>	<b>2.8%</b>
Mad Riverside	4.6%	2.4%
Oakwood	2.1%	2.0%
West Carrollton	1.7%	1.7%
<b>Vandalia</b>	<b>0.8%</b>	<b>1.4%</b>
Clay Township/Phillipsburg/Brookville (Partial)	1.1%	1.2%
Moraine	1.0%	1.0%
<b>Butler Township</b>	<b>0.4%</b>	<b>0.9%</b>
<b>German Township/Germantown</b>	<b>0.2%</b>	<b>0.9%</b>
<b>Perry Township/Brookville (Partial)/New Lebanon (Partial)</b>	<b>0.6%</b>	<b>0.9%</b>
Jackson Township/Farmersville/New Lebanon (Partial)	1.0%	0.8%
<b>Total</b>	<b>100.0%</b>	<b>100.0%</b>

**Bolded**=Increase in Percent Share

Sub-prime lending and sub-prime lenders associated with sampled predatory loans did differentially contribute to the rise in mortgage foreclosures in Montgomery County.

- Mortgage foreclosures associated with plaintiffs who are identified sub-prime lenders increased at an annual rate (43%) that was more than double the annual rate of increase (18%) associated with plaintiffs who are not identified sub-prime lenders, (see Table 2a in the main report).
- The percent of foreclosures associated with sub-prime lenders rises steadily in the 1994-1999 period (from 19% to 48%) and then abruptly falls in 2000 (to 41%). The decline in share is due to stagnation in sub-prime plaintiff foreclosures while prime foreclosures continue to increase.
- Those sub-prime lenders with sampled mortgages which exhibit predatory characteristics (see section 3. below) account for 65% of the sub-prime associated foreclosures in 2000, (see Table 2b in the main report).
- The average annualized rate of growth for the subset of sub-prime lenders identified with predatory sampled mortgages is somewhat lower than for other sub-prime plaintiffs (41% vs. 47%).

### **C. The Role of Predatory Practices in Mortgage Foreclosures**

To determine whether predatory lending played a role in the rise in mortgage foreclosures in Montgomery County a random sample of mortgages associated with foreclosures by sub-prime lenders was examined to determine whether they exhibited predatory characteristics. For each declared sub-prime plaintiff, CBER took a random sample of 20 of their mortgage foreclosure cases. If a declared sub-prime plaintiff had fewer than 20 foreclosures, the entire group of cases was examined. Each mortgage in the sample was examined for mortgage amount and terms (interest rate, fixed vs. adjustable, balloon payment, waiver of jury trial, pre-payment penalties, excessive fees, single premium life insurance).

- A total of 1,198 individual mortgage instruments were examined out of the 3,054 mortgage (8,885 mortgage foreclosure cases in all) foreclosure cases filed in the 1994 to 2001 period by self identified sub-prime lenders.
- Of the 1,198 sampled mortgage instruments, 255 mortgages exceeded the FTC's recommended cutoff point for HOEPA status (6% above a U.S. Treasury bond of comparable maturity). This interest rate trigger is the cutoff for designation of predatory status in this report. At interest rates this high, many of the FTC's concerns for asset based lending and equity stripping become extremely important.
- In addition, these 255 mortgages were differentially associated with several other characteristics associated with predatory loans:
  - 75% had pre-payment penalty clauses (only 54% below did)
  - 24% had balloon payments (only 11% below did)
  - 4% had payable on demand features (only 2% below did)

- The recorded interest rates understate the number of loans that would qualify for HOEPA status. HOEPA APRs take into account the fee structure of the loan and most mortgage instruments do not record these fees. In a few cases where such fees were recorded there was evidence of excessive upfront fees.

In summary, examination of a random sample of mortgages associated with foreclosure filings suggest that a significant minority of sub-prime loans involved with foreclosures exhibit interest rates or other features that are predatory in nature.

#### **D. Survey Findings**

CBER conducted telephone interviews with two groups of respondents 1) 31 respondents who were associated with one of the sample mortgage foreclosure mortgages determined to be predatory in nature (**hereafter mortgage foreclosure respondents**) and 2) 200 respondents who had closed a mortgage loan with one of the companies responsible for the sampled predatory loans (**hereafter mortgage respondents**) within the last two years.

- Approximately 30-40% of initial contacts were initiated by the lender by phone or by mail, (39% for mortgage foreclosure respondents, 33% for mortgage respondents).
- Slightly less than half of mortgage foreclosure respondent loans (45%) and mortgage respondent loans (49%) were for refinancing.
- For 45% of mortgage foreclosure respondents and 24% of mortgage respondents the terms at closing were different than had been discussed during the process.
- Changes in the terms were often associated with higher fees although in some cases the interest rate was also higher. Other respondents mention a balloon payment or hidden insurance fees.
- Reinforcing the FTC's point that the closing meeting is a situation where the borrower feels vulnerable, 12 of the 14 mortgage foreclosure respondents and 68% of the mortgage respondents who noted differences in terms at foreclosing accepted the differences.
- Nineteen percent of mortgage respondents and forty-two percent of mortgage foreclosure respondents were encouraged to borrow more than they intended.
- In 93% of the mortgage foreclosure cases, a home improvement loan was involved (30% of mortgage respondents). A couple of the mortgage foreclosure respondents noted that either the work cost more than they were told it would or that it did not get completed. In general, mortgage respondents did not report difficulties with home improvement project completion.

- Fifty-nine percent of mortgage respondents and fifty-eight percent of mortgage foreclosure respondents indicated their credit had been fine at the time they took out the loan. This suggests that at least some respondents were inappropriately placed in sub-prime loans.
- Forty-three percent of mortgage foreclosure respondents and twenty-one percent of mortgage respondents indicated the appraisal of their property was higher than a fair estimate of the property's value. Some mortgage foreclosure respondents reported brokers indicated they should over-report their income to help the loan be approved.
- Mortgage respondents in general had positive comments about their treatment by the broker or lender. In contrast, about half of the mortgage foreclosure respondents had negative statements about their broker or lender.

The survey results suggest many of the tactics associated with predatory lending practices at a national level (phone solicitation, new fees and other charges at closing, encouragement to increase borrowing, steering people with good credit histories into sub-prime loans, inappropriately high appraisals) are occurring in the sub-prime market in Montgomery County.

#### **E. Examination of Loan Application Register Data**

Loan Application Register Data for 1998 and 1999 is available for many of the sub-prime lenders associated with the sample mortgages with predatory aspects. This data allows an analysis of the ethnic and income makeup of the average borrower of these firms relative to the overall market.

- Most of the sub-prime lenders examined are doing three to four times as many loans with African American borrowers in comparison to the overall market. Associated with that is a geographic concentration in census tracts that are heavily minority.
- Most of the sub-prime lenders examined are doing two to five times as many loans with borrowers whose household income is 50% or less of median household income in comparison to the overall market. Associated with that heavier concentration on low income borrowers is a heavier concentration in low income census tracts.

#### **F. Evidence on Sub-Prime Mortgage Patterns from Recorder Office Data**

An electronic file of mortgages associated with sub-prime lenders whose sampled loans contained predatory characteristics was obtained from the Montgomery County Recorder's Office for the years 1994 through August 2001. While limitations in this data source do not allow the accurate tracking of all companies, it does provide suggestive data on the penetration by some firms.

- The Citigroup subsidiaries (Household Realty, Associates, Citifinancial, Ford Consumer Finance) have dominated the market over the period with 37% of the mortgages made by

the group of sub-prime lenders associated with sampled mortgages with predatory characteristics, (see Appendix Table 3).

- Household International (Beneficial Mortgage, Decision One) is a distant second (13.1%) and City Loan Financial is a distant third (12.3%).
- There was a significant increase in activity by this group of lenders starting in 1997. This group was responsible for about 2,900 mortgages annually from 1994 to 1996. In 1997 that increased to 3,946 and increased again in 1998 to 4,316.
- The group's activity level declines slightly in 1999 and 2000.

For jurisdictions for which legal descriptions allowed a match (this was not possible for Kettering and Huber Heights) there was some change in geographic market shares associated with these sub-prime lenders. For the group of lenders associated with sampled predatory loans the high water mark of sub-prime lending in Dayton occurred in 1998 with declines in absolute numbers in 1999 and 2000, (see Appendix Table 4).

- Dayton's market share of these mortgages remained relatively constant at 47%-48% over the period from 1994 to 1999. In 2000 and 2001 its market share declined to 45% and then 41.6% respectively (see Appendix Table 5).

Clayton, Harrison Twp., Miami (which includes Miamisburg and Miami Township), Riverside and Washington Twp. had substantial increases in the number of mortgages associated with this group of lenders over the 1994 to 1998 period. In the 1998-2000 period, the absolute number of mortgages remained relatively constant so did their market share increases relative to Dayton.

### III. CONCLUSIONS

The unprecedented rise in mortgage foreclosure filings in Montgomery County in the late 1990s is associated with the dramatic increase in sub-prime lending. As an examination of the geographic distribution of foreclosures indicates, the problem is increasing faster in suburban communities than in Dayton. There is an element of the sub-prime market that operates using tactics that are predatory in nature. These tactics, in the words of the FTC, lead to excessive costs for borrowers and strip equity from their homes. The consequences are not, however, just felt by the homeowner who falls prey to these tactics. Equity wealth flows out of the community. The increase in foreclosures in low and moderate income neighborhoods destabilize the life of the community and impose external costs in all the areas where foreclosures have increased.

The rapid increase in foreclosures in the late 1990s occurred in the context of a booming economy. The current economic weakness will undoubtedly accelerate the increase in mortgage foreclosures the county is experiencing. Actions this year to ensure that creditworthy borrowers receive appropriate loans with interest rates that reflect the true costs of borrowing could have a substantial impact on foreclosure rates in Montgomery County over the next five years.