Access to Capital

The availability of credit and capital is essential to a healthy economy. Changes in the national and state financial services market have significantly changed the way in which credit and capital are obtained. While market changes have given more people access to a wider variety of services, increased complexity in the lending arena has created a risk for uninformed borrowers. All too often, these borrowers enter into arrangements that provide no net financial benefit, and actually result in increased costs. In fact, many borrowers are paying higher than necessary fees and costs, or do not have access to adequate financial services, either due to a lack of local services, a limited understanding of available services, or as a result of lenders' subjective decisions.

The problems surrounding limited access to capital are particularly pressing in Texas' Border Region. With a fast growing, young population, the need for resources for quality education and access to health care is critical. Related to this, access to capital and credit are of great importance. Achieving the American dream, the dream to make a home, and gain success and stability, is intricately intertwined with having fair and open access to the tools necessary to prosper, including capital and credit.

In Texas, limited access to capital is hindering stability and growth. Of the top fifteen most populous states, Texas ranks second lowest in loan-to-deposit ratio.[1] Host state loan-to-deposit ratio is the ratio of total loans within a state to total deposits from the state for all banks with that state as their home state. Texas ranks second in population behind California and has a loan-to-deposit ratio of 68 percent, meaning that Texas' financial institutions are essentially loaning out 68 cents for every one dollar deposit. In contrast, California currently has a ratio of 105 percent and New York, the third most populous state, has a ratio of 86 percent.[2] In fact, Texas is actually ranked 45th among the 50 states for host state loan-to-deposit ratio.[3]

Mortgage Lending

Having better access to capital and credit would help Texans to move their families forward and develop a higher quality of life. Home ownership is one of the strongest indicators of quality of life in our country and building equity in one=s home is one of the largest asset building mechanisms available to the average family. In fact, a Federal Reserve Board survey found that in 1998, home ownership represented 44 percent of gross assets for families earning $50,000 or less a year.[4] Despite the importance of home ownership, many Texans, especially in the Border Region, find that accessing the necessary credit to buy a home and build equity in a home is virtually impossible.

Factors preventing increased home ownership rates in Texas, equity accumulation or access to adequate housing include: poverty, substandard housing conditions, high housing prices, and the over-use of subprime refinance loans. Additionally, the home-mortgage market has changed significantly since the 1980s when borrowers essentially went through one market for home mortgage loans. In the early 1980s, demand for mortgages exceeded supply. As more lenders were able to originate loans and sell them on the secondary market, however, the market evolved. Packages of home mortgages can be converted into securities and sold to investors.

This process, known as securitization, is now widespread. In fact, by 1993, 60 percent of home mortgage loans were securitized.[5]

As a result of securitization, non-bank lenders entered the home-mortgage market. Because mortgages could be sold, lenders did not need significant deposits and financial reserves. Therefore, mortgage bankers, finance companies and others can make and sell loans. The most promising customer base for such lenders exists where traditional banks are not currently located and where unmet demand might exist, typically among low or moderate income borrowers with some level of credit risk.

Subprime Lending

The liberalization of mortgage lending laws, coupled with a higher demand for housing capital, has led to a significant increase in subprime lending. The subprime lending market is an alternative market for accessing capital where the defining characteristics are higher rates and fees. According to the Federal National Mortgage Association (Fannie Mae), subprime mortgages are routinely three to four percentage points or more higher than a comparable prime market loan. Texas homeowners and homebuyers are receiving significant amounts of mortgage credit from subprime lenders, generally headquartered in other parts of the country.[6] As of March 2002, Texas had a total of 1,212 subprime lenders.[7] The chart below, *Subprime Loans in Texas in 2000*, outlines the amount of subprime lending occurring in this state.

Subprime Loans in Texas in 2000

Type of Loan	Number of Loans	Total Value of Loans
Home purchase	23,309	$2,082,169,000
Home improvement	2,795	$53,439,000
Refinancing (includes home equity loans)	25,195	$1,637,951,000

Source: Dallas Morning News, June 26, 2002, using Home Mortgage Disclosure Act data

The impact of a subprime loan on a borrower can be immense, as the chart *Economic Consequences of a Subprime Home Mortgage Loan*, on the next page demonstrates. Each additional interest point on a home mortgage means tens of thousands of dollars on the total cost of a mortgage over the life of the loan. These higher payments reduce funds families have for education and other critical living expenses. Moreover, many subprime loans are made by unregulated lenders who are not prohibited from certain practices that can cost homeowners large sums in fees and penalties. In fact, prepayment penalties alone cost homeowners $1.3 billion in lost home equity annually. Such penalties can reach $7,500 on a $150,000 house, as federal regulations do not limit these amounts. While the Texas Constitution protects persons who obtain home equity loans from such prepayment penalties, Texas does not have the same protections for non-home equity loans. The chart on the next page, *Economic Consequences of a Subprime Mortgage Loan*, describes the fiscal impact of this type of lending.

Economic Consequences of a Subprime Home Mortgage Loan

30-Year Fixed-Rate Loan
House Value: $85,000
Down Payment: $4,250 (5%)
Loan Amount: $80,750

Annual interest rate	Monthly payment	Annual payment	Annual difference from 8%	Lifetime difference from 8%
8%	$ 592.51	$ 7,110.18	N/A	N/A
9%	$ 649.73	$ 7,796.79	$ 686.61	$ 20,598.43
10%	$ 708.64	$ 8,503.67	$ 1,393.49	$ 41,804.69
11%	$ 769.00	$ 9,228.01	$ 2,117.83	$ 63,535.05
12%	$ 830.60	$ 9,967.26	$ 2,857.08	$ 85,712.32

Source: Texas Low Income Housing Information Service, July 2002, using data from Fannie Mae

There are legitimate reasons for subprime loans. For example, a higher interest loan is the market's way of providing credit to borrowers who pose a greater risk of default. Despite the legitimate need for a subprime lending market, the overall growth of that market is cause for concern. The U.S. Department of Housing and Urban Development (HUD) estimates that in any given year 30 to 50 percent of subprime borrowers nationally could have qualified for a prime loan. Using HUD's lower estimate of 30 percent, the Texas Low Income Housing Information Service (TLIHIS) estimates that in 2000 Texas homeowners overpaid $16 billion in home mortgage payments due to subprime rates, based on 20,767 subprime home purchase loans initiated that year.[8] The table *Increase in Loans Nationwide* shows that subprime lending has grown faster than prime lending in the past year, primarily due to the fact that subprime lenders continue to originate growing numbers of refinance loans.[9]

Increase in Loans Nationwide

	Number Originated in 2001	Number Originated in 2002	Percent Increase
Prime Loans	700,638	933,025	33%
Subprime Loans	6,073,987	8,062,713	25%

Source: ACORN

Subprime lending particularly plagues Texas' Border Region. A May 2002 national study provided startling data about subprime home refinance loans in the Texas Border Region. The study reports that several Texas Border cities have the highest rates of subprime home mortgage refinance loans in the nation, with El Paso ranking worst among the nation's 311 major cities.[10]

The chart on the next page, *MSA Ranking by Overall Percentage of Subprime Refinance Loans* shows that out of 331 MSAs nationwide, 11 out of the 30 MSAs with the largest percentages of subprime loans are in Texas; seven of these 11 are in the top 10, four of which are Texas Border cities. Nationally, subprime lending comprises about 25 percent of all refinance lending.

MSA Ranking by Overall Percentage of Subprime Refinance Loans

Rank	MSA Name	Population	Conventional Refinance Loans	Percent Subprime
1	**El Paso, TX**	**679,622**	**1,767**	**47.82**
2	**Corpus Christi, TX**	**380,783**	**1,061**	**46.84**
3	**Laredo, TX**	**193,117**	**342**	**45.32**
4	**Killeen-Temple, TX**	**312,952**	**683**	**44.80**
5	**Beaumont-Port Arthur, TX**	**385,090**	**1,160**	**44.48**
6	Miami, FL	2,253,362	10,701	42.67
7	Columbus, GA-AL	274,624	1,799	42.63
8	**San Antonio, TX**	**1,592,383**	**5,270**	**41.90**
9	Memphis, TN-AR-MS	1,135,614	7,577	41.86
10	**Galveston-Texas City, TX**	**250,158**	**944**	**41.63**
11	Fayetteville, NC	302,963	1,814	41.23
12	Enid, OK	57,813	427	40,75
13	Jamestown, NY	139,750	737	40.71
14	Rocky Mount, NC	143.026	872	39.68
15	Buffalo-Niagara Falls, NY	1,170,111	5,218	39.36
16	Daytona Beach, FL	493.175	3.477	38.77
17	Danville, VA	110,156	802	38.53
18	**McAllen-Edinburg-Mission, TX**	**569,463**	**1,345**	**37.62**
19	Sumter, SC	104,646	734	37.33
20	**Victoria, TX**	**84,088**	**220**	**37.27**
21	Goldsboro, NC	113,329	681	37.00
22	Lakeland-Winter Haven, FL	483,924	3,234	36.92
23	Florence, SC	125,761	963	36.55
24	Pine Bluff, AR	84,278	364	36.54
25	New York, NY	9,312,235	23,104	36.50
26	Orlando, FL	1,644,561	10,275	36.18
27	Hickory-Morganton-Lenoir, NC	341,851	3,481	36.08
28	Charlotte-Gastonia-Rock Hill, NC-SC	1,499,293	14,789	36.07
29	**Brownsville-Harlingen-San Benito, TX**	**335,227**	**795**	**35.97**
30	**Houston, TX**	**4,177,646**	**14,552**	**35.70**

Source: Texas Low Income Housing Information Service, using data from the May 2002 *Risk or Race? Racial Disparities and the Subprime Refinance Market* report by the Center for Community Change

The lending market has changed considerably over the past few decades, bringing new types of lenders into the market, expanding available avenues for accessing credit and capital. However, dangers lurk for uninformed consumers looking to access capital and credit. Paying higher fees and interest rates to own a home leaves consumers struggling to reach the American dream of homeownership.

Predatory Lending

Market changes in the financial services industry that have given more people access to a wider variety of services have also created a complex web of available services that can be confusing to even the most savvy consumer. The complexity of the emerging financial services market creates a particular danger for the uninformed or inexperienced borrower who may enter into lending arrangements that give him no net financial benefit, cause him to pay more than necessary given his credit risk, and potentially lead to foreclosure, bankruptcy, and the loss of his home. This complexity and the abuse of inexperienced borrowers have created one of the most critical policy issues facing the financial services industry and the regulatory agencies charged with monitoring that industry – predatory lending.

There is no thorough definition of what constitutes predatory lending. Instead, it is usually defined in terms of lending practices that, in combination, are said to impose substantial hardships on the borrower with little or no accompanying benefit. Developing a clear understanding of predatory lending is difficult because of the complexity of determining the appropriate level of fees and costs for a given level of risk. Generally speaking, predatory lending is characterized by excessively high interest rates or fees, harmful loan terms, including loan acceleration clauses and balloon payments, large pre-payment penalties and underwriting that ignores a borrower's ability to repay the loan, and abusive or deceptive practices. Identifying an excessively high rate or fee as opposed to one that is appropriate, given a borrower's credit rating, is very subjective, however. While traditional loans result in fees that are about one percent to two percent of the loans, excessive fees can total up to eight percent of a traditional loan. For certain types of loans, some lenders try to justify charging fees that total almost as much as the loan itself. Still, lenders argue that the risk associated with certain loans justifies the addition of high fees.

Loan acceleration and balloon payment clauses are dangerous forms of predatory lending that are easily masked in the complexities of a mortgage or refinance contract. Abusive lenders often include a provision in a loan contract that allows the lender at his or her discretion to accelerate the indebtedness on the loan. In other words, with no trigger, an abusive lender will increase interest rates or demand balloon payments, single lump sum payments of the entire balance of the loan. Including the opportunity for these predatory practices in the loan contract provides lenders with legal protection against traditional consumer protection laws, as usually a signed contract controls.

Extremely high interest rates can also signal predatory lending practices. Excessive interest rates indicate that the loan is high risk, but no risk should justify an interest rate so high that paying back the loan becomes impossible. In scenarios where the rate is this exorbitant, it is more prudent for the borrower to be turned down for a loan than to take the loan, default, and then be in a less stable economic situation. However, where we see the highest interest rates are in lending situations that cater to the most vulnerable borrower.

Types of Predatory Lending

Predatory lending practices are more widespread than just high interest rates and fees, and abusive clauses in a mortgage loan. Payday loans are one of the more prominent and prolific forms of abusive lending. Sale-leaseback transactions and loan-flipping are hidden forms of predatory lending. And, targeted marketing to households for reasons other than creditworthiness constitute dangerous abusive lending practices.

Deferred presentment transactions, or payday loans, are designed to be short term, emergency loans for people who have no alternative. By catering to the most vulnerable community of borrowers, payday lenders have free reign to charge excessive interest rates without concern that their customers will reject the services. In fact, many payday loans result in triple digit percentage rates because the borrowers are identified as extremely high-risk, and lenders feel justified in charging incredibly high interest rates. The financial burden on the borrower and the damage to his credit if the check bounces create a serious pressure on the borrower to refinance loans he cannot pay back, creating an onerous cycle of increasing fees. The chart *Payday Loan Rates*, below, outlines the typical interest rates associated with these loans.

Payday Loan Rates

Loan Amount	Equivalent Rate – 7 days	Equivalent Rate – 10 days	Equivalent Rate – 14 days
$ 100	569.92%	413.55%	309.47%
$ 150	396.29%	292.00%	222.48%
$ 200	309.47%	231.23%	178.98%
$ 250	257.17%	194.62%	152.99%
$ 300	222.48%	170.33%	135.57%
$ 350	197.70%	152.99%	123.13%
$ 400	178.98%	139.89%	113.87%
$ 450	164.54%	129.78%	106.60%
$ 500	152.99%	121.69%	100.79%

Connected to payday loans are sale-leaseback transactions, where a consumer seeking a cash advance presents a serial number of an appliance to a "lender" and the lender "sells" the item back to the consumer. The consumer then makes payments to the lender with high interest rates and fees.[11] Sale-leasebacks are often entered into as solutions for short-term cash needs, but become long-term financial obligations just like payday loans.

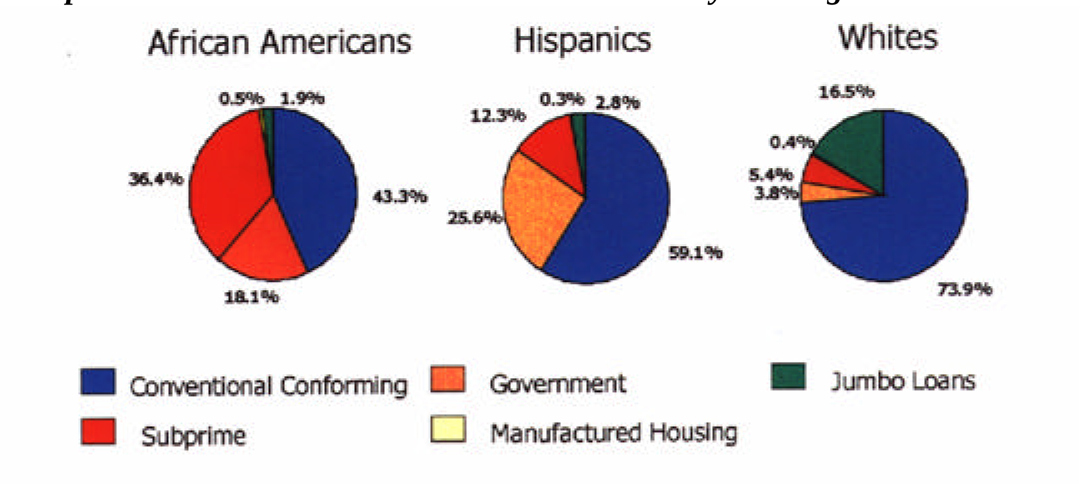
Another practice, known as loan flipping, is commonly carried out through non-traditional lenders. On *ABC News*, *Prime Time Live* a most egregious incident of loan flipping was disclosed in 1997.

"…an elderly gentleman who had never learned to read or write wanted to purchase meat on credit. A home equity lender loaned him the money…The gentleman did not understand he was mortgaging his home and pledging 50 percent of his monthly income. Seventeen days later, the lender contacted the gentleman again and convinced him to take out a larger loan, at a higher rate of 19 percent, to pay off all his debts. The gentleman was 'flipped' again in 42 days and again 26 days later. Each time he was charged a 10 percent financing fee… He was flipped 11 times in less than four years. By the time he was interviewed…he had a $50,000 mortgage on his home, which he had owned free and clear, and $25,000 of this amount was financing fees."[12]

This is an unfortunate example of the industry preying on the elderly, who often are not given complete information. Targeted marketing to households on the basis of race, ethnicity, age, gender or other personal characteristics unrelated to creditworthiness, unreasonable or unjustified loan terms, and outright fraudulent behavior often indicate predatory lending.[13] In Texas, there are indications that targeting minorities for higher interest rate loans is a regular practice. African-Americans and Hispanics still have homeownership rates that are significantly lower than rates for the general population--about 48 percent compared to the national rate of 68 percent.

A recent study, *Risk or Race? Disparities and the Subprime Refinance Market*, substantiates that minority borrowers, specifically Hispanics and African Americans, historically suffer from the highest percentages of subprime home refinance loans. The chart below, *Subprime and Government Loans Dominate Minority Lending Across the Nation*, demonstrates the high levels of subprime lending to minorities, with 12.3 percent of Hispanics receiving loans from subprime lenders, compared to only 5.4 percent of Whites. Due to the particularly large population of Hispanics in the Border Region and Texas as a whole, high rates of subprime lending to minorities have profound implications for these areas.

Subprime and Government Loans Dominate Minority Lending Across the Nation



Source: Michael T. Hernandez, March 14 2002, Report to the Subcommittee on Interim Charge 4, of the Senate Business and Commerce Committee

Though some representatives of non-traditional lenders argue that they offer much needed services in distressed areas where traditional lenders are inaccessible, many community members and traditional financial service providers assert that fringe lenders do nothing to help build wealth in their communities. The irony of the decry of the traditional lender rests in the fact that it is the inaccessible nature of the mainstream lending market that has led to the proliferation of fringe lenders and the growth of predatory lending. As James Carr in a report for the Fannie Mae Foundation said, "Predatory lending is an outlying consequence of the ineffectual financial markets that exist in many lower-income and minority communities. Predatory lending practices thrive in an environment where competition for financial services is limited or lacking, and where excessive marketing of subprime loans and fringe financial services are occurring."[14] Mainstream financial service companies may denounce predatory lending and nontraditional lenders, but the mainstream market is, in essence, reason for its proliferation.

Increasing access to capital and credit is important for most Texans, but particularly for Texans and Texas communities struggling to improve their economic stability and success. The State faces significant challenges in ensuring that all areas of Texas have access to capital and credit. Given the changing demographics in the state, and historical patterns of lending, it behooves the state's economy for leaders to explore all available avenues for achieving a healthy lending environment. Steps should be taken to ensure that all Texans are knowledgeable consumers capable of generating positive credit histories, and that lenders offer fair and reasonable credit terms. If borrowers have sufficient access to capital, more Texans will prosper and achieve the American dream.

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