Subprime Lending and Foreclosure in Hennepin and Ramsey Counties

by Jeff Crump

In the first three months of 2007, there were 678 foreclosure sales in the city of Minneapolis, an increase of more than 100% since 2006. More than 50% (384) of these foreclosures were located in North Minneapolis, an area particularly hard hit by predatory lending and foreclosure. As city officials struggled to cope with what the *Minneapolis Star Tribune,* in an April 24, 2007 article, termed a "foreclosure epidemic," the Minnesota Family Housing Fund announced an $11 million loan to the city of Minneapolis to purchase foreclosed homes on the Northside and resell them.

In highly impacted locations such as North Minneapolis, scrappers remove copper pipes from foreclosed and abandoned homes, a practice that has resulted in at least four natural gas explosions. Arson fires are also on the increase in North Minneapolis. Yet, the neighborhood distress is not limited to one community or city. In fact, a 2006 study titled *Mortgage Foreclosure and Vacant Building Trends in St. Paul* conducted by the City of St. Paul found that there are more than 800 abandoned buildings in the city, the highest number since the city began keeping track in the 1980s. Foreclosures and abandonment are also on the rise in suburban locations such as Brooklyn Park, where city officials struggle to keep pace with the growing problem.

The rapid rise in foreclosures is not unique to the Twin Cities. Throughout the United States, a wave of foreclosures has swept through residential neighborhoods. Associated with subprime and predatory lending, the default rate among borrowers holding subprime mortgages soared to 12.6%. Consequently, several large subprime mortgage companies such as New Century Mortgage Corporation have gone bankrupt because they were unable to obtain the needed credit to remain solvent. Jittery investors were also jolted by a 2006 report published by the Center for Responsible Lending titled *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners,* which predicted 1.1 million new foreclosures in the United States.

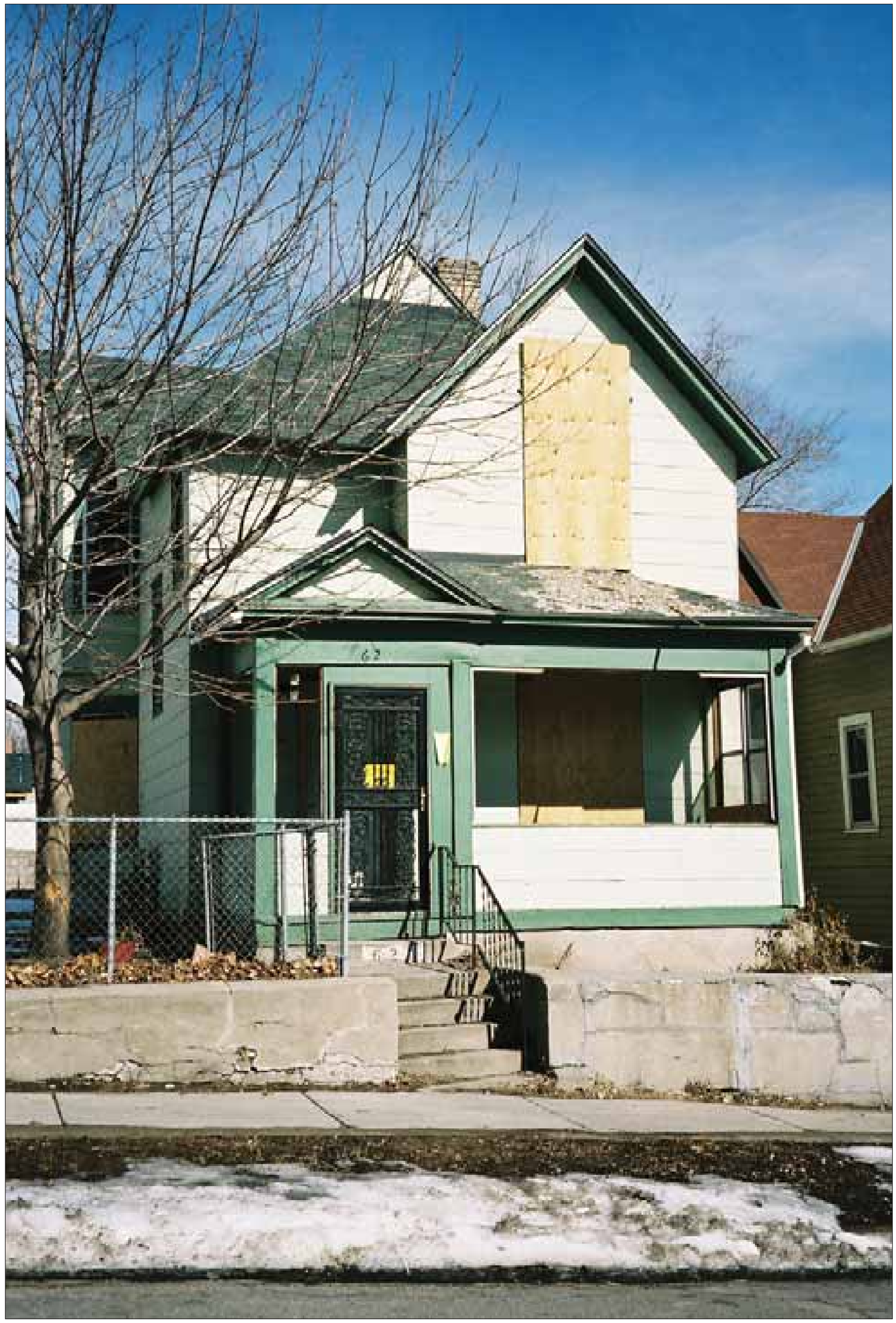


Photo by David Lyons

Abandonment, arson, and removal of copper pipes are growing problems in areas with high levels of foreclosure.

The foreclosure epidemic is part of a slow-moving crisis that is engulfing the U.S. mortgage lending industry. In recent months, the connections among Wall Street, the subprime mortgage business, and local housing markets have become increasingly evident. For example, on February 27, 2007, the U.S. stock market fell by more than 400 points for the biggest one-day loss since September 11, 2001. According to an article titled "What's an Investor to Do?" in the February 28, 2007, business section of the *Minneapolis Star Tribune*, problems in the subprime mortgage industry were the "straw that broke the camel's back" and were the single most important factor in causing the stock market decline.

In a *CURA Reporter* article published in Spring 2005, I argued that, "The high cost of subprime loans may put many families in financial jeopardy and increase the risk of foreclosure. Foreclosures in turn threaten the viability of entire neighborhoods, as the increase in vacant homes lowers property values, encourages crime, and discourages business development." Sadly, the concern I expressed with respect to subprime lending and foreclosures appears to have been entirely justified.

In this paper, I update my earlier *CURA Reporter* article, which used data from 1996 to 2002, with data on mortgages and foreclosures for 2005, the most recent year for which the Home Mortgage Disclosure Act (HMDA) data is currently available. To begin, I outline the characteristics and limitations of the mortgage and foreclosure data. Next, I analyze the subprime mortgage market in Hennepin and Ramsey Counties with particular attention to racial patterns of mortgage lending in 2005. Following that, I present a comparison of foreclosures in Hennepin and Ramsey Counties for 2002 and 2005. To conclude, I provide a legislative update on bills concerning foreclosure and subprime mortgage lending currently before the Minnesota State legislature.

Data and Methodology

The data I use to describe and analyze demographic and geographic patterns in subprime lending come from the HMDA data for 2005. There are some important limitations to the HMDA information and there are some significant differences between the 1996–2002 data set I used in my earlier analysis and the 2005 data.

The most important difference between the 1996–2002 HMDA data and the 2005 HMDA data is that, beginning in 2004, lenders were required to report the rate spread for what are termed "high-cost loans." The rate spread is the difference between adjusted annual percentage rate (APR), which includes both the fees and points in addition to the interest rate, and a treasury security of comparable maturity.

Photo by David Lyons

Abandonment and foreclosure lower the value of neighboring houses, impairing the ability of other homeowners to sell or refinance their homes.

In 2005, a loan was considered high cost if the APR of a first-lien mortgage was more than 3 percentage points above a treasury security. For second-lien mortgages, the threshold was set at 5 percentage points. According to the Federal Reserve Bank, these thresholds were chosen, "in the belief that they would exclude the vast majority of prime-rate loans and include the vast majority of subprime-rate loans."[1] Although complex, the inclusion of the rate spread data does greatly improve our ability to analyze the subprime mortgage market. However, the very different method used to identify subprime loans precludes easy comparison of the 1996–2002 HMDA data and the 2005 data.

An additional and ongoing problem with the HMDA data set concerns missing racial and lender information. In particular, data on the race/ethnicity of mortgage applicants is not reported for applications taken through the mail, over the phone, or via the Internet. In terms of loan applications in Hennepin and Ramsey Counties, 13.2% of the racial data was missing in 2005 because the application was taken by mail, telephone, or over the Internet; and on an additional 9.1% of the applications, the racial variable was marked "not applicable." Therefore, a total of 22.3% of all applications were lacking important information on racial patterns of mortgage lending. With so much missing racial data, the estimates presented here very likely underestimate the prevalence of subprime lending in Hennepin and Ramsey Counties.

Subprime and High-Cost Mortgage Lending in Hennepin and Ramsey Counties, 2005

In 2005, there were more than 200,000 mortgage loan applications, and high-cost subprime loans comprised 11.2% (22,690) of them. In terms of mortgage loan originations, 25.1% of the 2005 loan originations were high-cost loans (Table 1). In Hennepin and Ramsey Counties (like the rest of the United States), high-cost subprime loans comprise a very significant share of the mortgage market. This finding is not terribly surprising given the fact that according to the Federal Deposit Insurance Corporation, 33% of all home loans in the United States were considered subprime in 2005.

High-cost Subprime Lending and Race. Virtually all studies of high-cost lending find that minority borrowers receive higher proportions of such loans than Whites. In 2005, African Americans received 3.9% of all mortgages, but they obtained 17.4% of all the high-cost mortgages (Table 1). Nearly 60% of all the mortgages received by African Americans were high-cost loans. Although credit availability has increased among African Americans, the prevalence of high-cost loans raises important concerns about the cost of the credit extended.

Among Hispanics, nearly half (48.0%) of all mortgages obtained were high-cost loans and 8.4% of all high-cost loans went to Hispanics in 2005. High-cost loans were also prevalent in the Asian community where 35.9% of all mortgage originations were considered high cost, accounting for 7.9% of all high-cost loans.

By comparison, even though 60.7% of all high-cost subprime loans went to Whites in 2005, only 20.1% of all loan originations to Whites were in the high-cost subprime category.

To summarize, it is clear that high-cost lenders play an important role in providing expensive credit to the growing minority communities of Hennepin and Ramsey Counties. Communities (such as African Americans) that were formerly unable to obtain home loans due to discrimination, now can get loans. However, the cost burdens associated with high-cost subprime lending fall heavily on minority communities and neighborhoods.

[1] Federal Reserve Bank, "Frequently Asked Questions About the New HMDA Data" (2006).

Table 1. Mortgage Loan Originations by Race/Ethnicity, Ramsey and Hennepin Counties, 2005

Race/Ethnicity	Percentage of all prime loans originated	Percentage of all high-cost subprime loans originated	Percentage of all loans originated	Percentage of loans that are high-cost subprime	Likelihood of receiving a high-cost loan*
American Indian	0.4% (268)	0.9% (207)	0.5% (475)	43.6%	39%
Asian	4.8% (3,226)	7.9% (1,803)	5.6% (5,029)	35.9%	48%
African American	3.9% (2,657)	17.4% (3,941)	7.3% (6,598)	59.7%	64%
Hispanic	3.1% (2,068)	8.4% (1,910)	4.4% (3,978)	48.0%	49%
White	80.8% (54,777)	60.7% (13,766)	75.8% (68,543)	20.1%	25%
Hawaiian/Pacific Islander	0.4% (185)	0.3% (99)	0.3% (284)	34.9%	32%
Information not provided	8.9% (6,064)	12.5% (2,827)	9.8% (8,891)	31.8%	—
Not applicable	0.2% (609)	0.9% (47)	0.7% (656)	7.2%	—
Total †	**74.9% (67,786)**	**25.1% (22,690)**	**(90,476)**		—

Source: Author's calculations from Home Mortgage Disclosure Act data set, 2005.

* The likelihood of receiving a high-cost subprime loan was calculated with income held constant.

† Columns do not add up to the figures shown under Total because "Hispanic" is an ethnic category and was not included in the calculated totals. People of Hispanic origin can be of any race.

The penetration of the minority market by high-cost subprime mortgage loans is further illustrated via the use of logistic regression analysis. Using a statistical equation identical to the one I used in my previous article, I found that, irrespective of income, the likelihood of receiving a high-cost subprime loan is significantly higher among minority borrowers (Table 1). African Americans (regardless of income) had a 64% likelihood of receiving a high-cost loan, Asians a 48% likelihood, and Hispanics a 49% likelihood. The chance of Whites getting a high-cost loan was 25%. These findings lead to the conclusion that high-cost lending is targeted toward the minority communities of the Twin Cities.

The Geography of High-Cost Lending. In my previous article, the spatial analysis of the geographic distribution of high-cost subprime loans indicated that such loans were concentrated in minority neighborhoods. In particular, neighborhoods that were predominantly African American were especially hard hit by high-cost subprime lending. Although direct comparisons are problematic, analysis of the 2005 data shows a very similar spatial pattern (Figure 1). In 2005, high-cost loans were more than 20% of all mortgages in many census tracts in North Minneapolis; several census tracts in St. Paul have similar proportions. High-cost subprime loans remain concentrated in minority neighborhoods and the proportion of loans has achieved startling proportions. Not surprisingly, the areas with the highest percentage of high-cost loans are also those where foreclosure rates are the greatest (Figure 1).

High-Cost Lending and Foreclosure in Hennepin and Ramsey Counties, 2002 and 2005

It is no exaggeration to say that foreclosures in Hennepin and Ramsey Counties increased at a frightening pace between 2002 and 2005. In 2002, there were 907 foreclosures in Hennepin County; by 2005 there were 1,681, an increase of 85%. In 2006, there were more than 3,000 foreclosures in Hennepin County, an astounding increase of 235% since 2002. Similar increases are evident for Ramsey County. In 2002 there were 353 foreclosures, by 2005 there were 626, and in 2006 foreclosures had increased to 1,407. In percentage terms, Ramsey County foreclosures increased by 77% between 2002 and 2005 and by an astonishing 299% between 2002 and 2006.

When the 2005 foreclosures are mapped, two facts stand out. First, the spatial pattern of foreclosure is very similar to that of 2002. Second, the intensity of the patterns has been greatly accentuated. Foreclosures in North and South Minneapolis are especially striking. The pattern in St. Paul is somewhat less concentrated, but it is clear that many St. Paul neighborhoods are experiencing a very high number of foreclosures. Of particular note is the spread of foreclosures to suburban locations. In particular, Brooklyn Park and other suburbs northwest of Minneapolis are experiencing high numbers of foreclosures. The growth in foreclosures is an alarming trend and indicates that financial distress and neighborhood decline are serious and growing problems.

Conclusion

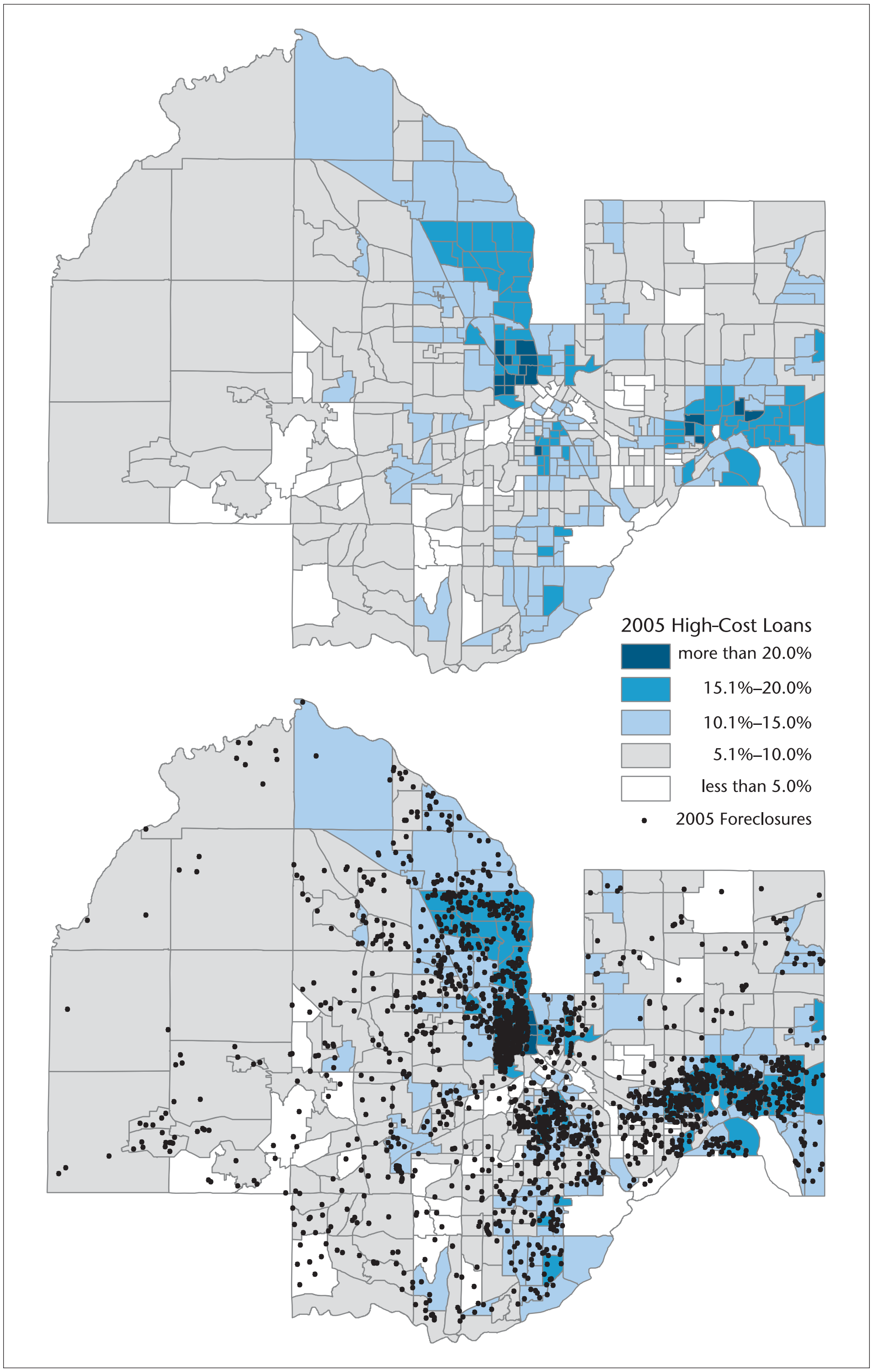
The results reported in this article indicate that the number of high-cost mortgages is concentrated in minority communities, and is especially prevalent among African Americans. In tandem with the growth of high-cost subprime loans, the number of foreclosures increased at a very high rate. Especially hard hit were minority neighborhoods where high-cost subprime loans are common. However, it is important to note that significant numbers of the foreclosures are related to investors using subprime loans to purchase rental properties.

These patterns indicate a state of crisis in many neighborhoods. As I see it, many high-cost subprime lenders, although they claim to be providing increased opportunity for homeownership, have systematically stripped the wealth of vulnerable communities, leaving in their wake a trail of financial distress that will likely take years to recover from.

Through interviews with housing market professionals, I have gained some insight into the process of wealth removal from homeowners. It began with an increase in home prices that led to increased equity among minority homeowners. Responding to home equity accrual, subprime or predatory lenders gained access to this equity by extending high-cost credit to borrowers who had few other alternatives. In most instances, homeowners were encouraged to refinance their homes multiple times ("loan churning"), each time netting profitable origination and other fees for lenders. And every time a mortgage refinance occurred, the homeowner lost some of the equity he or she had built up in the home. After three or four mortgage refinances, the homeowner was left with little or no equity. It is at this point that many go into foreclosure. Their financial and emotional resources exhausted, foreclosed homeowners are forced to seek rental housing in the same neighborhoods where they once were homeowners.

The impact of foreclosure is not only devastating to the homeowner. It also has significant negative neighborhood impacts as well. As homes are foreclosed, they may remain vacant or become rentals. Vacant homes lead to further declines in home values in the community. The ability of homeowners in the neighborhood to refinance their homes is thus further restricted, reinforcing the downward spiral and leading to even more foreclosures.

Figure 1. High-Cost Mortgage Originations and Foreclosures, 2005



Source: Home Mortgage Disclosure Act 2006; Hennepin County 2006; foreclosures.com 2006; City of St. Paul 2006

I would argue that just such a cumulative downward process is occurring throughout our metropolitan region.

It is important to note that although some media accounts of subprime and predatory lending emphasize the poor credit histories of subprime borrowers, research by Eric Stein in 2001 *(Quantifying the Economic Cost of Predatory Lending)* indicates that up to 50% of those who have expensive subprime products could have qualified for a prime loan with its lower costs. Due to the marketing practices of the subprime industry, however, such borrowers are never offered the prime loan products they are qualified for. Instead they are steered toward the costly (and profitable) products offered by subprime or predatory lenders.

Minnesota Legislative Action on Subprime Lending

During the 2007 legislative session, the Minnesota State Legislature passed two significant bills addressing predatory lending. Below is a brief summary of these important bills.

HF1004/SF0809: Predatory mortgage lending practices prohibited. This bill passed the Minnesota House and Senate and was signed by Governor Pawlenty on April 20, 2007. The main provisions of the bill are as follows:

- Requires that lenders verify the borrower's ability to repay the loan, including real estate taxes and property insurance. This provision addresses concerns around loans that use stated income or no documentation of income (so-called "liar's loans").
- Prohibits "churning" of mortgage loans. The churning provision requires that mortgage refinancing only be done when there is a "reasonable and tangible" benefit to the borrower.
- Prohibits loans that will result in negative amortization. Here, the intent is to ban no interest or other loans where, although the borrower makes payments, the loan balance continues to increase.
- Places a 5% limit on closing costs, other fees, and fees paid by the lender to a mortgage broker. This provision places a cap on the fees that can be included in the mortgage amount.
- Establishes a duty of agency for mortgage brokers. Requires that mortgage brokers act in the borrower's best interest, account for all funds, and disclose materials facts that may affect borrower's rights.

SF0988/HF0931: Predatory mortgage lending practices prohibited, criminal penalties prescribed and remedies provided. This bill passed the Minnesota House and Senate and was signed by Governor Pawlenty on May 14, 2007. The main provisions of the bill are as follows:

- Prohibits lenders from making misleading or false statements.
- Prohibits selling a borrower a subprime loan if that borrower qualifies for a prime mortgage.
- Prohibits the refinancing of special mortgages (e.g., loans obtained via Habitat for Humanity) without written certification from a qualified loan counselor.
- Prohibits prepayment penalties.
- Provides for a right to private action for borrowers.
- Defines and prohibits mortgage fraud.

Policy makers are now beginning to address the issues surrounding high-cost subprime lending and foreclosure (see sidebar). Two bills, one that outlaws predatory lending and another that adds civil penalties and enforcement provisions, have passed the Minnesota legislature and been signed by Governor Pawlenty. These are important first steps to address the problems associated with subprime lending and foreclosure.

Additional measures will be needed. For example, people who still hold mortgages that put them in financial jeopardy need assistance to refinance or otherwise address their financial distress. Unfortunately, because of the losses associated with the subprime mortgage industry debacle, tightening credit standards will make it difficult to refinance many of the costly subprime loans.

Foreclosure, family distress, and widespread neighborhood deterioration are just some of the lasting consequences of the profitable and heretofore unregulated subprime mortgage industry. It is sad to note that those who profited from subprime lending will not bear the consequences. Instead, the people who bought into the American Dream of homeownership via subprime and predatory mortgages will deal with its lasting nightmares.

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