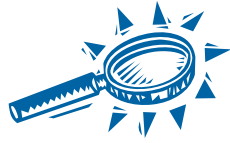




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Blueprint Brief



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**Blueprint for Opportunity:
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Blueprint Brief No. 13

Aug. 22, 2006

Predatory lending costs Colorado consumers tens of millions of dollars a year in stripped home equity and excessive interest and traps families in a cycle of debt.

Subprime borrowers have limited loan options and may turn to unscrupulous lenders, who often attach exorbitant, unnecessary fees and excessive interest onto subprime loans.

When unnecessary and excessive fees are financed into the loan, part of the monthly payment is interest on the fee. That supplants money that could instead be going to pay off the principal.

Protect Colorado consumers from predatory lending

By Daniel Spivey
Public Policy Fellow

Predatory lending costs Colorado consumers tens of millions of dollars a year in stripped home equity and excessive interest. It also traps families in a cycle of debt that can be devastating.¹ Part of the problem can be attributed to Colorado's lax standards for the payday loan industry and for loosely regulating mortgage brokers who cater to borrowers with spotty credit histories. Fortunately, the most effective solutions to predatory lending come at the state level.

During the 1980's, the federal government deregulated consumer credit practices — action that trumped many state protections. This launched a new, aggressive predatory lending industry.²

Many states responded with protections against predatory lending that are substantially stronger than federal protections. But Colorado offers only minimal protection for consumers.³ Meanwhile, Colorado led the nation in mortgage foreclosure rates from March through May 2006.⁴ To protect home owners, Colorado should strengthen its policies against predatory lending.

Predatory mortgage lending

Subprime loans are high cost, high interest loans for borrowers with imperfect credit histories. Not all sub-prime loans are predatory, but nearly all predatory lending is done within the subprime market. Subprime borrowers have limited loan options and may turn to unscrupulous lenders, who often attach exorbitant, unnecessary fees and excessive interest onto subprime loans. Unsophisticated borrowers don't understand the fees, and can't tell if they should be getting a better deal.

In the subprime mortgage market, predatory brokers prey on unsophisticated borrowers by:

- Stripping home equity. When unnecessary and excessive fees are financed into the loan, part of the monthly payment is interest on the fee. That supplants money that could instead be going to pay off the principal.

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- Basing interest rates on how sophisticated they think the borrower is, rather than on risk.
- Using lending tactics that assure a high profit without regard to the borrower's ability to pay.⁵

In 1999, North Carolina passed legislation targeting predatory lending. North Carolina now has a housing market where low- to moderate-income borrowers can still find subprime loans, but borrowers are protected from most unscrupulous tactics. In 2000, the new protections were estimated to have saved North Carolina subprime borrowers more than \$100 million.⁶

In 2002, Colorado passed House Bill 02-1259 that addressed predatory mortgage lending. The legislation, however, falls short in protecting Colorado consumers when compared to states such as North Carolina. Colorado still allows balloon payments and prepayment penalties on home loans. Both practices are most common among subprime loans. Colorado also does not require subprime borrowers to receive financial counseling.

Three new bills passed in 2006 would require mortgage brokers to be registered, prohibit deceptive practices by foreclosure consultants, provide more information to sellers, impose a stiff fine for mortgage fraud and bar plea bargains in fraud cases that don't include restitution for victims.⁷

Payday loans: an endless cycle of debt

Payday loans are short term loans that help people get by between paydays. A person will write a check to a payday lender in exchange for a loan, and the lender will wait up to 14 days to cash it. In Colorado, it costs an average of \$18.79 to borrow \$100 — an astounding annual percentage rate of 488 percent.⁸

The payday lending industry is also structured to keep borrowers in an endless cycle of debt. The transaction is made with the knowledge that the borrower does not have enough money in their account to cover the check. After 14 days, the lender can deposit the check even if the borrower still does not have the money, leading to bank charges from the bounced check and fees to the lender. If the borrower cannot pay, the payday lender often gives another loan to pay off the previous one, so the cycle repeats itself.⁹

In a 2003 report, the Center for Responsible Lending, a North Carolina based advocacy and research group that promotes fair lending, found that borrowers take out eight to 13 payday loans a year.¹⁰

In 2000, Colorado's legislature passed the Deferred Deposit Act, which was aimed at regulating the payday loan industry. A 2005 review of the law by Colorado Assistant Attorney General Paul Chessin shows it did little to protect consumers from predatory payday lending.

Chessin found rates on payday loans to be as high as 521 percent for loans up to \$300, and recommended a cap on the allowable annual percentage rate. He did not specify a cap amount, but CoPIRG, a consumer advocacy group, called for classifying payday loans as small loans under Colorado law, which would limit annual interest rates to 36 percent.¹¹

Chessin also noted the state law has no provisions to limit the number of times a lender could offer a new loan after one had been paid off. To prevent borrowers from using one payday lender to pay off another, Chessin recommends creating a statewide database to track payday loans.

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Resources:

Center for Responsible Lending
<http://www.responsiblelending.org/>

ACORN – Association of Community Organizations for Reform Now
<http://www.acorn.org/>

COPIRG – Colorado Public Interest Research Group
<http://www.copirg.org/>

In 1996, payday loans totaled \$34 million in Colorado. By 2004, they totaled \$368 million. In 2004, the average payday loan in Colorado was \$308 with a finance charge of \$54, an annual percentage rate of 381 percent.¹² The payday lending industry is expanding rapidly in Colorado and legislators should work to better regulate this often exploitative industry.

✓ Crack down on predatory lending.

The Legislature should review Colorado's current laws that regulate the payday lending industry and limit predatory mortgage lending, with the goal of strengthening both statutes.

We should adopt stricter standards for payday lenders, including capping finance charges, prohibiting borrowing from one payday lender to pay off another, and eliminating special protections for payday lenders.

Colorado also should adopt provisions from the North Carolina law to protect families that buy or refinance their homes. These provisions ban prepayment penalties on loans of less than \$150,000, ban financing fees through high-cost loans, and require borrowers to use financial counseling.

End Notes

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- ² The Center for the Study of Social Policy. (2006). *Policy Matters: Twenty State Policies to Enhance States' Prosperity and Create Bright Futures for America's Children, Families, and Communities*.
<http://www.policymatters.us/fullreport.html>
- ³ ACORN (2002), End Note No. 1 and Wei Li and Keith S. Ernst. The Center for Responsible Lending. (2006). *The Best Value in the Subprime Market: State Predatory Lending Reforms*.
<http://www.responsiblelending.org/report/stateeffects.cfm>
- ⁴ Also Svaldi, "Foreclosures still surging," *The Denver Post*, Tuesday, July 11, 2006.
- ⁵ Keith Ernst, The Center for Responsible Lending. (2005). *Borrowers Gain No Interest Rate Benefits from Prepayment Penalties on Subprime Mortgages*.
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- ⁶ Keith Ernst, John Farris, and Eric Stein. Center for Responsible Lending. (2002). *North Carolina's Subprime Home Loan Market After Predatory Lending Reform*.
http://www.responsiblelending.org/pdfs/HMDA_Study_on_NC_Market.pdf
- ⁷ HB06-1161, SB06-071 and HB06-1323.
- ⁸ Emily Hoopes, Colorado Public Interest Research Group. (2001). *Small Loans – Big Money: A Survey of Payday Lenders in Colorado and Review of the Colorado Deferred Deposit Act of 2000*.
http://www.copirg.org/report/report4_18_01.pdf#search='Small%20Loans%20Big%20Money'
- ⁹ Ibid.
- ¹⁰ Keith Ernst, John Farris and Uriah King. Center for Responsible Lending. (2003). *Quantifying the Economic Cost of Predatory Payday Lending*.
<http://www.responsiblelending.org/pdfs/CLLPaydayLendingStudy121803.pdf>
- ¹¹ Emily Hoopes, Colorado Public Interest Research Group. (2001). End Note No.8.
- ¹² Paul Chessin, *Borrowing from Peter to Pay Paul: A Statistical Analysis of Colorado's Deferred Deposit Loan Act*. University of Denver *Law Review*, Nov. 16, 2005.
http://www.law.du.edu/lawreview/issues/83_2/Chessin_83_2.pdf