

The Devastating Impacts of Predatory Lending on Individual and State Economies

Posted on March 21, 2018

Predatory lending is a practice, used by financial institutions, which imposes illegal and unfair terms and conditions on the borrowers. Financial institutions involved in predatory lending try to convince people to accept the institution's prejudiced terms and conditions through misleading means, often using unethical measures to force people to take loans, even if they don't need a loan ("Predatory Lending: Oregon | HUD.gov / U.S. Department of Housing and Urban Development (HUD)," n.d.).

Lenders involved in predatory lending usually target the poor, senior citizens, and uneducated people. They also approach people who need cash immediately for medical bills, car payments, or college fees. Among their potential customers, those with credit problems and those who are jobless, are their most prized customers. These customers might not be able to attract a conventional loan because of their economic condition, but they are attractive customers for predatory lenders.

The predatory lending practice has been widespread in the home mortgage field. The home loans are sponsored by the customer's actual property, and the lender can make a lot of profit from the loan terms that go in his favor, as well as from the sale of the foreclosed home, in case the borrower defaults. This practice may or may not be illegal, but it has and can leave victims homeless and with an enormous debt. Many States in the [United States have laws](#) that ban predatory lending; however, they still operate freely in the rest of the country (Staff, 2003).

Subprime Loans

Subprime loans are the actual form of predatory lending because they are offered to borrowers with poor credit histories and are usually turned away by conventional lenders. In subprime loans; like mortgages, the additional interest rate often means thousands of dollars worth of investment payable, during the loan. It can make paying back subprime loans difficult for low-income borrowers (Staff, 2009). Subprime mortgages were popular in the 2000s and peaked in 2005, with around \$625 billion worth of loans released. It led to the economic collapse of 2007 - 2008.

Economic Collapse Of 2008

The financial crisis of 2008 can be considered the worst after the Great Depression. It was caused by the bursting of the subprime mortgage bubble in 2007, which later turned into a global banking crisis after the downfall of the Lehman Brothers in September 2008. Some other global financial crises followed the crisis: the Great Recession, the debt crisis in Europe, and the collapse of the euro

following the collapse of the European banking system(Carney, n.d.).

The crisis directly resulted from the high default rate in the U.S. [subprime mortgage loans](#). Apparently, high approval rates for the subprime mortgage led to the lenders creating a large pool of house owners, raising house prices. It caused many people to seek loans against their homes, creating a bubble. The bubble burst when many single-family households failed to repay their loan payments. The rise in delinquency rates resulted in a rapid devaluation of the mortgage-backed securities, causing the securities' buyers to diminish and banks that had invested in the subprime mortgage quite heavily faced a liquidity crisis.

With the subprime bubble burst, the securities related to the U.S real estate; most definitely the subprime mortgage were exposed and damaged the financial institutions, impacting the whole world("Financial regulation in New Jersey - Ballotpedia," n.d.).

What Led To The Subprime Bubble Becoming A Reality?

In 1977, Congress passed the Community Reinvestment Act. The aim was to motivate banks to give loans to low-income and poor people so they could buy houses for themselves and live a better life. The evidence overwhelmingly supports the idea that the CRA played an essential role in creating a situation, which led to the housing bubble. Apparently, the regulators allowed banks to increase the number of CRA loans and relax lending standards.

During the nineties, as banks lowered the lending standards, mortgage rates remained high. The incentives that allowed borrowers to re-finance continued to be low. Back then new buyers were not as much interested in real estate investment. However, as time went on, these things changed. The Fed decreased the interest rates, making refinancing a lucrative deal and creating a demand for it. A shrinking consumer asset base, because of the dot-com bust resulted in high demand for home equity loans. Hence, investors have learned that they can buy bigger homes without spending significant money.

If data is to be studied, it becomes clear that it wasn't the CRA that resulted in the crisis but everything else. However, the CRA led to all other factors, which played a crucial role in the bubble("FRB: FEDS Notes: Assessing the Community Reinvestment Act's Role in the Financial Crisis," n.d.).

Regulatory Changes Made By The U.S Government

In 2010, then-President Obama signed the Dodd-Frank Act, giving the U.S. government more authority to monitor financial institutions. It changes the regulatory structure and creates several

agencies to smoothen the regulatory process, promoting transparency. Also, the government made several Housing Acts, which allowed the Federal Housing Administration more authority to reduce mortgages on homes.

Impacts On New Jersey And The State's Actions To Reduce The Impacts

While the State of New Jersey was not affected as much as the other States, because of New Jersey's strong overall economy, hundreds of thousands of residents faced foreclosure, bankruptcy, and homelessness due to the bursting of the housing bubble. Almost 1.2 million loans in New Jersey, by the end of 2007, were in foreclosure. According to the records, residential foreclosure filings summed up to 34, 457 in 2007. Among all, borrowers who received adjustable-rate mortgages suffered the most.

However, the New Jersey Department of Banking and Insurance has worked hard to solve the problem. They have established the New Jersey Home Ownership Preservation Effort, the main aim of which is to monitor and reduce the impacts of the crisis on the residents of the State. They plan to safeguard home ownership by creating awareness of the financial products.

Impact On The Rest Of The World

The effects of the subprime mortgage were felt all over the world. The crisis became a full-blown financial meltdown, later called the Great Recession. It led to the European Financial Crisis and the collapse of the Euro. Several European countries; including Greece, Spain, and France, witnessed severe economic collapse and had to be bailed out by the European Union. It was predicted that collapse might also lead to the collapse of the European Union. In the rest of the world, China and India witnessed a drastic decline in sales. The United Arab Emirates, which relies heavily on tourism, also witnessed the effects of the crisis.

Standpoints Between The Republicans And Democrats

While the crisis happened during the time of the Republican President Bush, Republicans claim that it was a direct result of Democratic policies. They claim that it was Franklin D. Roosevelt who launched the New Deal reform which affected the mortgage market. Then, President Johnson's Great Society allowed Fannie Mae to bring home loans to the masses. And it was Carter who passed the Community Reinvestment Act. Hence, the Republicans use the historical evidence against the Democrats for bringing the crisis. Rep. Arthur Davis, admits that the Democrats made a mistake.

Conclusion

Subprime mortgages or predatory lending have caused America to suffer financially. It might have resulted from various laws and regulatory policies that led to it. However, the after-effects were severe. Many people lost their jobs, and homes and suffered financially, not to mention its impact on the country's economy. Though the government now has new laws that ensure such a mistake is not made again, we need to be careful with it in the future.

References

Carney, J. (n.d.). Here's How The Community Reinvestment Act Led To The Housing Bubble's Lax Lending. Retrieved November 22, 2017, from <https://www.businessinsider.com/the-cra-debate-a-users-guide-2009-6>

Financial regulation in New Jersey – Ballotpedia. (n.d.). Retrieved November 22, 2017, from https://ballotpedia.org/Financial_regulation_in_New_Jersey

FRB: FEDS Notes: Assessing the Community Reinvestment Act's Role in the Financial Crisis. (n.d.). Retrieved November 22, 2017, from <https://www.federalreserve.gov/econresdata/notes/feds-notes/2015/assessing-the-community-reinvestment-acts-role-in-the-financial-crisis-20150526.html>

Predatory Lending: Oregon | HUD.gov / U.S. Department of Housing and Urban Development (HUD). (n.d.). Retrieved November 22, 2017, from <https://www.hud.gov/states/oregon/homeownership/predatorylending>

Staff, I. (2003, November 26). Subprime Loan. Retrieved November 22, 2017, from <https://www.investopedia.com/terms/s/subprimeloan.asp>

Staff, I. (2009, July 8). Delinquency Rate. Retrieved November 22, 2017, from <https://www.investopedia.com/terms/d/delinquency-rate.asp>