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Borrowing Trouble: Illinois Tries New Tack Against Predatory Loans --- Its First Effort Drew Charges of Racism; Mortgage Brokers Revolt

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The Illinois legislature this month passed a law that goes to the heart of the global subprime lending mess that is rattling the housing industry and shaking financial markets from Wall Street to Hong Kong.

The new law will require people in the Chicago area who want to take out a home loan with nontraditional terms -- such as prepayment penalties or interest-only payment options -- to spend an hour or two with a credit counselor so they won't be hoodwinked at the closing table.

President Bush has endorsed such educational efforts, noting in a recent press conference that in many cases "people aren't sure what they're signing up for." The new law, which would go into effect next July, comes as states across the country are rushing to address the rising foreclosure rates that threaten to expel hundreds of thousands of people from their homes.

Yet Illinois's experience to date shows how difficult it is to create even modest safeguards in the home-buying process. A previous pilot program similar to the new law was viciously attacked and rescinded in January, after only a few months. Instead of winning plaudits, the pilot program quickly became mired in charges that it would make it harder for minorities to buy homes. Mortgage brokers, fearing a loss of business, claimed that access to credit would tighten in the neighborhoods targeted by the law. Rumors flew that dozens of lenders had pulled out of the area.

One woman filed a lawsuit saying the program scared away buyers for her home in a working-class neighborhood in the city's so-called Bungalow Belt. A pastor called it "the most racist piece of legislation that we have ever experienced in Illinois."

Now that the new law is expanding the program, the nearly one dozen Department of Housing and Urban Development-approved counseling groups who will be responsible for the measure's success aren't sure they have enough resources to handle the thousands of mortgages they will be expected to review.

At least 30 states, including Illinois, have predatory-lending laws that outlaw or limit specific loan terms, fees and practices. Such laws target practices including "balloon mortgages," which are payable in full after a period of low monthly payments, and "steering," in which a broker profits by recommending a loan with unnecessarily tough terms. But there still are many abuses, and some lenders have adapted to skirt the laws.

The turmoil in the subprime-mortgage market may temporarily suppress the riskiest loan provisions, says Geoff Smith, research director of the Woodstock Institute, a Chicago-based research organization focused on housing and economic-development issues. But in the long term, he says, "you need strong consumer protections, because eventually the market will correct itself, and people will start to make speculative loans again and take much more risk."

Illinois aimed to shift the focus of predatory-lending laws from the lender to the borrower, addressing the problem with education rather than prohibition. State officials expected that once counselors showed borrowers the traps hidden in their mortgage terms -- and taught them to spot where their mortgage documents differed from verbal promises made by their brokers -- the borrowers would seek better loans.

The original law, known as HB 4050, was promoted by Illinois House Speaker Michael Madigan, a powerful politician who for years had been concerned about rising foreclosures and vacant homes in his district, a group of working- and middle-class neighborhoods surrounding Midway Airport on Chicago's Southwest Side.

In an interview, Mr. Madigan said his bill was modeled after a successful program in the 1970s that helped reduce foreclosures of loans insured by the Federal Housing Administration, which is part of the U.S. Department of Housing and Urban Development. "Counseling clearly works," he says. "Our goal is to stop the abuse of unsophisticated people."

Introduced at the end of the 2005 legislative session, HB 4050 was intended as a four-year pilot program covering specific ZIP Codes in Mr. Madigan's district and a few others. It required certain mortgage applicants -- the precise criteria hadn't yet been set -- to meet with a credit counselor before signing their loans. Other lawmakers, including many who are African-American, added ZIP Codes from their districts to the bill, bringing the total number to roughly 80. (The law applied to loans taken out through mortgage brokers, but not with banks or savings-and-loan associations, which are subject to federal regulation.)

Mortgage brokers, concerned that there wouldn't be enough HUD-certified counselors to ensure that loans closed on time, lobbied state senators to reduce the size of the pilot area. The Senate ultimately threw out the list of ZIP Codes and gave the responsibility for choosing the pilot area to the state. The law passed on May 31, the last day of the 2005 session.

The state chose a 10 ZIP-code area on Chicago's Southwest Side that was home to many low-income residents. The area, which was 82% black or Hispanic, had a foreclosure rate of 19.2 per 1,000 homes in 2004, about double the citywide rate at the time. Predatory lending in those neighborhoods has caused blight and hardship, community activists say.

Yet even before the law went into effect on Sept. 1, the response was vitriolic. Dean Martinez, secretary of the Department of Financial and Professional Regulation, says he first began receiving angry calls and letters from people in the mortgage industry who claimed that business would dry up in the pilot area. Then, he says, he started hearing from community organizers and religious leaders who raised concerns about discrimination.

At least two lawsuits alleging discrimination and civil-rights violations were filed against the state that fall. One plaintiff was Tammy Pena, who says she put her house up for sale several months before the law took effect. She and her husband, Francisco, wanted to move to the suburbs to enroll their four children in better schools and cut down her 100-mile round-trip commute.

But they were unable to sell their house. One potential buyer who signed a contract to purchase the home couldn't qualify for a loan because he was unwilling to attend the required counseling session, Ms. Pena asserts in her lawsuit. The suit argues that the law constitutes state-approved redlining -- the refusal of lenders to work with borrowers in certain neighborhoods or ethnic groups -- because it effectively prevents minorities from getting credit on the same terms as non-minorities.

Mr. Martinez, a former prosecutor, says he would have moved to strip the license of any lender that intentionally ditched the study area because of the new rules. Ms. Pena's suit was dismissed after the pilot project was called off. Her home still hasn't sold, her lawyer said.

Charges of redlining are particularly fraught in Chicago, where housing segregation has a long history. In a 1966 march for fair housing in one of the neighborhoods covered by the HB 4050 pilot program, Martin Luther King Jr. was stoned by white residents.

That memory is still vivid for some of the hundreds of people who crowded into a basement auditorium of the glassy, cylindrical James Thompson Center in Chicago's downtown Loop for a Nov. 27 public hearing called by Mr. Martinez. The atmosphere became especially heated when Rev. Al Sampson, pastor of a South Side church and an early member of Dr. King's Southern Christian Leadership Conference, railed against the program.

According to a transcript, Rev. Sampson called HB 4050 "one of the most dangerous pieces of legislation ever done." He charged that it would drive out minorities from the pilot area and clear the way for white investors to snap up properties. "We know the history of housing in this town," he said.

Then Jim Capraro stepped to the microphone. For 30 years, he has been the executive director of Greater Southwest Development Corp., a nonprofit community-development group that advised Mr. Madigan, the Illinois House speaker, on HB 4050.

"Boy, how do you start after that?" Mr. Capraro asked. "I think I'm going to start by saying, 'Thank you, Jesus,'" he said, claiming he would "tell the truth as opposed to spitting fantasy. Just spin these wild, wild tales of land grabs."

"Mr. Martinez," Rev. Sampson interjected. "I want equal time, because I know about Jesus."

With the meeting threatening to descend into chaos, Mr. Martinez soon asked Mr. Capraro to leave the hearing for his own safety.

Adding fuel to the fire, a report from the University of Illinois released a month later said housing sales in the pilot area had dropped by nearly half. By comparison, a demographically similar area outside the pilot had a 20% decline.

Some supporters of HB 4050 say the pilot program wasn't given enough time. They also argue that the University of Illinois study doesn't show whether credit actually dried up in the pilot area's ZIP codes. In addition, the tumbling housing market in Chicago complicates efforts to assess the impact of the program. In June, sales of existing homes in the Chicago area dropped 19.8% compared with the same month a year earlier, worse than the 11.4% drop nationwide.

"I don't think the redlining accusations were at all fair," says Mr. Smith of the Woodstock Institute. "I think they were more just the lending industry and mortgage-broker industry trying to play off a very sensitive topic in the African-American community."

Nevertheless, in January, Gov. Rod Blagojevich suspended the law.

Frustrated that his plan was blocked, Mr. Madigan this spring pushed an expanded counseling program as part of a broad new bill to combat predatory lending. The bill was held up for months in a budget battle between Mr. Madigan and Gov. Blagojevich. It passed the state legislature Aug. 7.

The bill extends the counseling program to all of Cook County, an area of 5.3 million residents that encompasses Chicago and surrounding suburbs, removing concerns that the original pilot boundaries created an extra hardship for minorities trying to buy or refinance a house. Among other measures, the bill requires all first-time homebuyers and borrowers refinancing their homes to attend a counseling session if the mortgage contains certain provisions, such as a rate that adjusts within three years or a penalty for borrowers who want to pay down their loan principal ahead of schedule.

Mortgage counselors are worried they won't be able to handle the expanded program's caseload. Petra Villazana, a 42-year-old counselor with Greater Southwest Development Corp., says she and two other counselors were swamped while the original law was in place. "Oh, my God," she says. "We were really, really busy."

On top of her normal caseload, she usually had four HB 4050 counseling sessions a day, each lasting an hour to an hour and a half. She often bumped meetings with other clients and stayed late at work two nights a week. She did one session at the hospital with an elderly woman who wanted to refinance her home so she could pay for desperately needed repairs.

Ms. Villazana says many of her clients appeared to have been misled about the terms of their loans. In one case, a father who had agreed to co-sign a refinancing of his daughter's home in the Gage Park neighborhood didn't realize that he was actually agreeing to buy the house from his daughter, making him responsible for two mortgages if she didn't meet her payments. The man told Ms. Villazana he wasn't going to close on the loan.

"I'm not against any mortgage broker or finance company," Ms. Villazana says. "The only thing I'm not in favor of is for them to take advantage of someone."

One early estimate indicates that the new program would cover 19,000 loans each year. The counseling agencies believe a minimum of 25 new housing counselors would have to be hired and trained -- an increase of 60% over the current number of 41 counselors at 11 HUD-certified agencies. The state hasn't said where the agencies would get the money to hire and train new counselors.

However, the subprime mortgage market has changed so drastically in recent weeks that it's difficult to gauge how big the counseling program might be next year. Mortgage lenders are currently tightening their standards and eliminating certain types of loans, as fewer investors are willing to hold the riskiest loans in their portfolios.

Whether the pilot program actually reduced credit availability in the area remains contested. During the program, the agencies completed 1,200 counseling sessions over a 20-week period. In a report, they said they found no evidence that access to mortgage loans dried up in the pilot area.

Some people who received counseling are now believers in the program. Alvaro Cortez, a 38-year-old who works in sales for an automotive paint shop, found his dream home in December for $190,000 in a neighborhood near Midway Airport. Because the house was in the pilot area and he had a low credit score, his mortgage broker told him he had to go to a counseling session. The broker seemed angry, says Mr. Cortez, who is Hispanic.

"They were trying to tell me it was racist," says Mr. Cortez, sitting in the cramped offices of the Resurrection Project, one of the groups providing the counseling. "When I came here, I saw it wasn't that."

Mr. Cortez pored over his loan documents with a counselor, who showed him how to verify his mortgage's terms. He says the session helped him stand up for himself when he went to his closing. There, he says, the paperwork showed that he had an adjustable-rate loan, instead of the fixed-rate one he had been promised. The interest rate also was higher than he had agreed to pay. Mr. Cortez refused to sign.

On his second closing date, the documents still were wrong. Mr. Cortez exploded. Finally, on the third try, he signed for the loan he had been promised and moved into his brick, two-story row house the next day.

Alvaro Cortez

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