Newsweek

A Risk Worth Taking

Many ethical subprime lenders still manage to make plenty of money.

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In recent months, conservative economists and editorialists have tried to pin the blame for the unholy international financial mess on subprime lending and subprime borrowers. If bureaucrats and social activists hadn't pressured firms to lend to the working poor, the narrative goes, we'd still be partying like it was 2005 and Bear Stearns would be a going concern. The Wall Street Journal's editorial page has repeatedly heaped blame on the Community Reinvestment Act (CRA), the 1977 law aimed at preventing redlining in minority neighborhoods. Fox Business Network anchor Neil Cavuto in September proclaimed that "loaning to minorities and risky folks is a disaster."

This line of reasoning is absurd on several levels. Many of the biggest subprime lenders weren't banks, and thus weren't covered by the CRA. Nobody forced Bear Stearns to borrow $33 for every dollar of assets it had, and Fannie Mae and Freddie Mac didn't coerce highly compensated CEOs into rolling out no-money-down, exploding adjustable-rate mortgages. Banks will lose just as much money lending to really rich white guys like former Lehman Brothers CEO Richard Fuld as they will on loans to poor people of color in the South Bronx.

But the best refutation may be provided by Douglas Bystry, president and CEO of Clearinghouse CDFI (community development financial institution), based in Lake Forest, Calif. Since 2003, this for-profit firm in Orange County—home to busted subprime behemoths like Ameriquest—has made $220 million in mortgages in the Golden State's subprime killing fields. More than 90 percent of its home loans have gone to first-time buyers, about half of whom are minorities. Out of 770 single-family loans it has made, how many foreclosures have there been? "As far as we know," says Bystry, "seven." Last year Clearinghouse reported a $1.4 million pretax profit.

Community-development banks, credit unions and other CDFIs—a mixture of faith-based and secular, for-profit and not-for-profit organizations—constitute what might be called the "ethical subprime lending" industry. Even amid the worst housing crisis since the 1930s, many of these institutions sport healthy payback rates. They haven't bankrupted their customers or their shareholders. Nor have they rushed to Washington begging for bailouts. Their numbers include tiny startups and veterans like Chicago's ShoreBank, founded in 1973, which now sports $2.3 billion in assets, 418 employees and branches in Detroit and Cleveland. Cliff Rosenthal, CEO of the National Federation of Community Development Credit Unions, notes that for his organization's 200 members, which serve predominantly low-income communities, "delinquent loans are about 3.1 percent of assets." In the second quarter, by contrast, the national delinquency rate on subprime loans was 18.7 percent.

Participants in this "opportunity finance" field, as it is called, aren't a bunch of squishy social workers. In order to keep their doors open, they have to charge appropriate rates—slightly higher than those on prime, conforming loans—and manage risk properly. They judge their results on financial performance and on the impact they have on the communities they serve. "We have to be profitable, just not profit-maximizing," says Mark Pinsky, president and CEO of the Opportunity Finance Network, an umbrella group for CDFIs that in 2007 collectively lent $2.1 billion, with charge-offs of less than 0.75 percent.

What sets the "good" subprime lenders apart is that they never bought into all the perverse incentives and "innovations" of the late subprime lending system—the fees paid to mortgage brokers, fancy offices and the reliance on securitization. Like a bunch of present-day George Baileys, ethical subprime lenders evaluate applications carefully, don't pay brokers big fees to rope customers into high-interest loans and mostly hold onto the loans they make rather than reselling them. They focus less on quantity than on quality. Clearinghouse's borrowers must qualify for the fixed-rate mortgages they take out. "If one of our employees pushed someone into a house they couldn't afford, they would be fired," says CEO Bystry.

These lenders put into practice the types of bromides that financial-services companies like to use in their advertising. "We're in business to improve people's lives and do asset building," says Linda Levy, CEO of the Lower East Side Credit Union. The 7,500-member nonprofit, based on still-scruffy Avenue B, doesn't serve the gentrified part of Manhattan's Lower East Side, with its precious boutiques and million-dollar lofts. The average balance in its savings accounts is $1,400. The typical member? "A Hispanic woman from either Puerto Rico or the Dominican Republic in her late 40s or early 50s, on government assistance, with a bunch of kids," Levy says. Sure sounds like subprime. But the delinquency rate on its portfolio of mortgage and consumer loans is 2.3 percent, and it's never had a foreclosure.

Ethical subprime lenders have to look beyond credit scores and algorithms when making lending judgments. Homewise, based in Santa Fe, N.M., which lends to first-time, working-class home buyers, makes credit decisions based in part on whether borrowers have scraped together a 2 percent down payment. "If customers build a savings habit to save that money on a modest income, it says a lot about them and their financial discipline," says executive director Mike Loftin. Of the 500 loans on Homewise's books in September, only 0.6 percent were 90 days late. That compares with 2.35 percent of all prime mortgages nationwide.

Since ethical subprime lenders know they're going to live with the loans they make—rather than simply sell them—they invest in initiatives that will make it more likely the loans will be paid back. Faith Community United Credit Union, which got started in the basement of a Baptist church in Cleveland in 1952 with members saving quarters on Sundays, now has $10 million in assets. In addition to making loans, "we teach people how to manage their finances and accounts," says CEO Rita Haynes. ShoreBank, as part of its energy-conservation loan program, offers free energy audits and a free Energy Star refrigerator when upgrades are completed. The theory: reducing energy bills makes it more likely people will stay current with their mortgages. Today, only $4.83 million of ShoreBank's $1.5 billion loans are in foreclosure, or just 0.32 percent.

Ethical subprime lenders are now expanding beyond mortgages. Ed Jacob, manager and CEO of Chicago's North Side Community Federal Credit Union, was alarmed to learn that many of his 2,700 members, most of whom have less than $100 in their accounts, were relying on the "second-tier financial-service marketplace": check-cashing outlets and payday lenders, which charge exorbitant fees. So he rolled out a Payday Alternative Loan (PAL), $500 for six months at 16.5 percent. The delinquency rate on the more than 5,000 PALs extended thus far is 2.5 percent. "For payday lenders, it's a success if customers keep taking out loans. To me, it's a success if they don't have to anymore," Jacob says. He believes such loans can build a credit history and help "move people to better products for them and us—auto loans and, eventually, mortgage loans."

Lending small amounts of money, carefully and responsibly, to working-class people isn't a recipe for riches or grand executive living. At the headquarters of ShoreBank, which occupies a former movie theater built in 1923, the window in one founder's office looks out onto a brick wall. Bystry, the CEO of Clearinghouse CDFI, earns a salary of $190,000, a pittance compared with the compensation of larger lenders. (Angelo Mozilo, former CEO of Countrywide Financial, was paid $22.1 million in 2007.) For all the growth, this remains very much a niche industry.

Still, the mortgage crisis has provided an opportunity for ethical subprime lenders to expand. ShoreBank has added staffers and in August 2007 rolled out a Rescue Loan program, which aims to move borrowers out of expensive adjustable-rate mortgages into fixed-rate loans. "We really believe we can help people caught in these bad mortgages," says Jean Pogge, executive vice president of consumer and community banking at ShoreBank. And with plenty of lenders having failed or pulled back from markets, new customers are flocking to their doors. "We're getting demand for regular co-op loans for the first time," says Levy of the Lower East Side Credit Union. In California, the news on housing may be unrelentingly grim, but through the third quarter, Clearinghouse CDFI made 161 loans for $48.4 million, up about 50 percent from the total in the first three quarters of 2007. Doug Bystry says, "This may be a record year for us."

With Andrew Murr in Los Angeles and Hilary Shenfeld in Chicago

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