

A Reprint from *Tierra Grande*

# DEALING FROM THE BOTTOM OF THE DECK

## Will Predators Force Subprime Lending to Fold?

By Jack C. Harris

Home sales have been unusually strong in recent years in part because mortgage financing has expanded to allow those in underserved markets to become homeowners in unprecedented numbers. Until recently these markets, which consist primarily of ethnic minorities, have been underserved because many of their members do not fit the profile traditionally favored by lenders. Often they are hard-pressed for cash and either have an inconsistent credit history or none at all.

For borrowers with impaired credit, a segment of the mortgage industry has ventured into subprime lending — mortgage loans for those who do not qualify for the best terms. Subprime loans carry higher interest rates and closing costs and a higher risk of default.

Subprime lending has become a major growth industry. The volume of subprime originations went from \$35 million in 1994 to \$140 million in 2000 — from 4 to 13 percent of total mortgage originations nationally. Subprime loans are an

important element of a “complete” mortgage market aimed at maximizing homeownership.

Lenders categorize mortgage borrowers by their FICO (Fair Isaac Co.) scores, which predict a person’s likelihood of defaulting on a loan based on past credit use. The highest FICO score is 850, and the median score nationally is 720. Subprime borrowers have scores below 570.

Because subprime borrowers lack the alternatives open to those with good credit, they are more vulnerable to unscrupulous lenders. Subprime borrowers also tend to have little experience with financial matters, including homebuying. They have probably been turned down for a loan, making them less likely to shop around for the best terms.

While most subprime lenders are reputable, offering terms appropriate for the risk inherent in the loan arrangement, the temptation to take advantage is too strong for some. So-called “predatory lenders” use a variety of techniques to defraud and



overcharge borrowers. In some cases, they intentionally try to overburden the borrower in the hope of obtaining the home through foreclosure.

Predatory lending has become widespread and notorious enough to have engendered legislation at the national and local levels. However, efforts to stamp out predatory lending practices threaten to limit subprime borrowers' access to financial markets.

## Predatory Lending Difficult to Spot

Distinguishing a predatory loan from a fair subprime loan is not easy. A loan is considered predatory if a borrower armed with adequate knowledge of the marketplace would not accept it. A loan with a high interest rate is predatory if the borrower could get a comparable loan elsewhere at a significantly lower rate. Loan terms are predatory if the borrower could get a loan with better terms or without these restrictions elsewhere. A number of practices are associated with predatory loans.

**Equity stripping.** This technique is employed in loan refinancing. The lender persuades the borrower to take on a loan he or she cannot afford. The lender charges excessive fees, points and other closing costs and allows them to be financed into the loan. Consequently, the loan may be close to or exceed the current value of the home. The object is to cause the borrower to default so the lender acquires the home through foreclosure.

When the borrower can no longer make the monthly payment, he or she discovers that the outstanding debt on the loan is greater than the proceeds to be gained from selling the home and has no choice but to default. Some of these loans also have punishing prepayment penalties, making repayment of the loan even more unlikely.

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**Deceptive marketing and servicing.** An aggressive loan officer might tell prospective borrowers that they need a subprime loan when, in fact, they qualify for a regular loan with much better terms. Borrowers end up paying excessive fees and points and an above-market interest rate.

Sometimes the deceptive sales pitch is part of a "bait and switch" effort. The lender draws in customers with the promise of an attractive interest rate. Once the customer shows up, the lender tells them they do not qualify for the advertised loan but do qualify for a higher-cost loan.

Deceptive servicing involves keeping inaccurate records of what the borrower owes. Errors are always in the lender's favor, inflating the loan balance.

**Loan flipping.** Mortgage brokers may pressure homeowners into refinancing their mortgages when interest rates fall.

Instead of reducing the debt burden, each refinancing raises indebtedness while generating lucrative fees for the broker.

**Loan packing.** This predatory technique involves making a new loan with unnecessary fees and cost items, including credit insurance that is of little benefit to the borrower.

**Negative amortization and balloon loans.** These techniques are not predatory per se, but can be used to trap a homeowner into refinancing or foreclosure to the advantage of the unscrupulous lender. A loan with a rising principal balance may appear more affordable than it is, pushing the borrower further into debt. A large balloon payment forces the borrower into a costly refinancing.

## Common Abuses Outlawed

The obvious solution to the problem of predatory lending would seem to be a more educated and sophisticated mortgage consumer. HUD and a number of public interest organizations are promoting awareness among borrowers and groups most susceptible to the schemes.

Federal, state and local governments have outlawed the most common abuses. At the federal level, October 2002 revisions to the 1994 Homeownership and Equity Protection Act (HOEPA) ban specific practices when lenders make "high-cost" mortgage loans.

Most first mortgages with an annual percentage rate more than 8 percentage points above the long-term treasury security yield (for example, a rate more than 12 percent when treasuries are 4 percent) and second mortgages 10 percentage points above are subject to the law. In these cases, originators must provide the following disclosures:

- notice to the borrower that the loan application process need not be completed just because an application has been filed,
- warning that default on the loan may result in loss of the home and
- all other disclosures required by Truth in Lending and Real Estate Settlement Procedures Act (RESPA).

The law prohibits or places severe limitations on the following practices:

- balloon payments,
- negative amortization,
- raising the rate after the borrower defaults,
- prepayment penalties beyond the first three years of the loan term,
- call provisions that allow the lender to demand repayment of the loan at any time even though the borrower has not defaulted,
- granting a loan without regard for the borrower's ability to afford the loan,
- encouraging the borrower to refinance the loan with another high-cost loan at no benefit to the borrower ("loan flipping") and
- portraying a closed-end mortgage loan as an open-end line of credit.

Because of perceived shortcomings in the federal law (it is restricted to high-cost loans and imposes relatively mild penalties), several state and municipal governments have enacted their own laws. Most of these are patterned after the Model Home Loan Protection Act promoted by AARP.

The act prohibits the following practices in origination and maintenance of all mortgage loans:

- financing into the loan premiums for insurance policies that pay off the loan balance when the borrower dies or is disabled,
- loan flipping,
- lender counseling the borrower to default on the loan,
- charging excessive fees for late payments,
- call provisions and
- charging a fee to provide information on the loan balance.

AARP's model act bans another group of practices for high-cost mortgage loans. Loans subject to the act have more stringent thresholds than those for HOEPA: interest greater than 6 percentage points over the five-year treasury security yield for first mortgages or 8 points over for second mortgages and loans on manufactured homes.

An unusual number of points and fees may also cause a mortgage to be classified as high cost. For these loans, the following are prohibited:

- financing the points and origination fees into the loan balance,
- unreasonable prepayment penalties,
- balloon payments,
- negative amortization,
- rate hike upon default,
- mandatory arbitration on disputes with borrower waiving right to a court proceeding,
- origination without regard to borrower's ability to pay back the loan,
- charging the borrower to rework the loan provisions or temporary forbearance of default and
- nonjudicial foreclosure.

Because the act is a model for state and local governments, violations may be prosecuted under existing law dealing with fraudulent or misleading commercial acts. This may result in the lender's forfeiting the right to repayment of the loan or even double or triple damages.

## Controversy Remains

To most observers, HOEPA and its state and local counterparts might seem reasonable and effective in halting predatory loan abuses. However, the application of these laws has resulted in some controversy.

It is difficult, if not impossible, to design a law that applies only to clear cases of abuse. Any blanket prohibition runs the risk of outlawing arrangements that are voluntary on the parts of both lender and borrower and are necessary to extend credit to those who cannot qualify for the best terms.

Laws that apply to all high-cost loans bring all subprime loans under scrutiny. That

means subprime lenders are limited in the provisions they can place on loans and are subject to additional reporting requirements and disclosures. There is a heightened chance that subprime loans will run afoul of the law through processing mistakes or lenders' insufficient knowledge of the requirements. For these reasons, the availability of subprime loans could be constrained by stricter laws.

According to James Carr, Editor of *Housing Policy Debate* at Fannie Mae, the distinction between subprime and predatory lending is "murky," having more to do with the lender's intentions than with actual practices. There is a hard-to-define line between loan provisions meant to protect the lender from borrower irresponsibility and those that unscrupulous lenders use to commit fraud aimed at the financially unsophisticated.

Why is it important to protect subprime lending from the adverse repercussions of antipredatory lending legislation? First, not everyone has access to mainstream lending institutions. In lower-income communities, an array of "fringe lenders" serve the needs of residents who cannot afford or do not trust banks and credit unions. To those accustomed to dealing with pawnshops and payday loan companies, the terms on subprime loans do not seem so outrageous. The extension of credit to those with impaired credit histories or lack of verifiable income has been instrumental in raising homeownership rates to record levels.

Have antipredatory lending laws caused a decline in subprime loans? A study conducted by the Center for Community Capitalism at the University of North Carolina concludes that the state's antipredatory lending law has reduced loans containing abusive terms without damage to subprime credit, citing a 31 percent increase in subprime loans in the state since the law passed. Conversely, the U.S. Comptroller of the Currency said that loan originations to subprime borrowers in North Carolina declined by 30 percent in the 18 months after the law's passage.

Who is correct likely depends on how the numbers were selected. Nevertheless, the secondary market is showing some signs of avoiding loans from areas that have adopted stringent antipredatory lending laws. A study of Chicago and Philadelphia



**LAWS DESIGNED** to deter predatory lending practices may make it difficult for legitimate subprime lenders to offer loans to borrowers with impaired credit.

loan originations presents clear evidence that their antipredatory lending laws have significantly reduced subprime lending and impaired minority residents' access to mortgage credit.

## Broader Perspective

Focusing in on a specific problem may sacrifice perspective. Legislation aimed at curbing predatory lending assumes that subprime loan borrowers are the only ones who are taken advantage of and, therefore, the only ones who need to be protected.

University of Pennsylvania professor Jack Guttantag points out that shopping for a mortgage is a difficult job and is complicated by a mortgage market that:

- offers a wide array of loan terms with varying prices,
- changes rates and other terms frequently,
- has prices affected by rebates from the lender to the mortgage broker,
- offers unreliable interest rate locks and
- offers closing costs that are not fixed, or even predictable, at the time of loan application.

Consequently, it takes a great deal of sophistication to shop for a mortgage loan. Almost everyone is a victim to some

extent of the not-always-upfront marketing practices of loan originators.

Guttantag's suggested solution to the problem is to turn mortgage brokers into buyer's agents and let them shop for the best deal for their principals. The broker would be compensated only by a fee paid by the borrower, with no hidden rebates or speculating on interest rate swings. The broker would use skill and knowledge to get the best deal for the client, be it a subprime borrower or the richest person in town.

There are signs that the subprime lending boom has peaked. High rates of delinquency and default have cut into the sector's profitability. As interest rates rise on prime loans, the attraction of subprime lending will diminish for lenders. The Federal Housing Administration and the secondary market may be less willing to take on the higher-risk loans as federal deficits rise and investors react to the scandals at Freddie Mac and Fannie Mae.

A full legislative assault on subprime lending practices would be one more reason for lenders to pull out of this sector. How much of the entry-level housing market would be lost through contraction of credit availability remains to be seen. ♣

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# Predatory Selling

Unscrupulous lenders are not the only ones who have found ways to prey on unsuspecting homebuyers. There are “predatory sellers” too. These predators take advantage of those with limited knowledge and means.

One technique used to sell low-cost homes to buyers with no established credit is through use of a contract for deed. Exploitation of contracts for deed prompted changes to the Texas Property Code in 2001. Most of the techniques used by predatory sellers are now illegal.

Contracts for deed often are called “land contracts” because they are a relatively common method for selling undeveloped tracts. A contract for deed essentially allows the buyer to pay for the property in a series of installments. Each installment includes an interest and principal payment.

The main difference between a contract for deed and a mortgage loan used for most home purchases is that with a contract for deed the homebuyer has no legal interest in the property until the entire principal is paid. This arrangement provides the seller maximum security and, therefore, is appropriate for sales to buyers with no credit history or bad credit history.

Predatory sellers have used the contract for deed to hide high interest rates and inflated prices while avoiding the consumer disclosures and safeguards required when commercial lenders are involved. Even worse, however, is the practice of closing out these contracts after the buyer has made most, but not quite all, of the payments.

There are a number of ways the buyer may default. Someone honestly trying to sell the home might work with the buyer to resolve problems. The predatory seller will look for violations or even fabricate them in hope that the buyer has failed to keep good records. When the buyer defaults on the contract, the seller gets the home back, and the buyer is left with nothing.

Another technique predators use involves buying poor quality homes at rock bottom prices, applying cosmetic improvements and selling them to the unwitting at significantly higher prices. The sellers commonly offer seller financing and techniques such as taking the buyer’s existing house as a trade-in. These practices help disguise the fact that the buyer is overpaying for the home.

Predatory sellers are adept at setting up sales so that the buyers end up with a monthly payment at or below the level of their current rent. Ads promise a low down payment but do not mention that the earnest money deposit (usually several thousand dollars) is nonrefundable. Someone who is talked into a contract and later thinks better of it cannot get out without losing the deposit. Nevertheless, the buyer most often is satisfied until they have to sell or something happens to the home. Then they discover the property is worth much less than they owe on the loan.

Stopping such predators is not easy. The perpetrators generally are unlicensed and beyond the jurisdiction of state authorities. The practices may run afoul of the Deceptive Trade Practice Act, but enforcement requires a civil lawsuit by the buyer. People targeted by these sellers usually are not in a position to file a lawsuit.

For more information, see “New Rules Govern Contracts for Deed” at [www.recenter.tamu.edu/pdf/1547.pdf](http://www.recenter.tamu.edu/pdf/1547.pdf).



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