

BANKER & TRADESMAN

THE REAL ESTATE, BANKING AND COMMERCIAL WEEKLY FOR MASSACHUSETTS

ESTABLISHED 1872

Checks on Predatory Lending Continue to Evolve

By Anna DeSimone

CONVENTIONAL HOME-PURCHASE MORTGAGE lending to low-income borrowers nearly doubled during the past seven years.



During this time, conventional mortgage lending increased by about 120 percent to black and Hispanic borrowers, compared with an increase of 48 percent to white borrowers. This is a very positive development for the mortgage lending industry. However, if we take a closer look at the loan characteristics and geographic areas of concentration, we will find some rather disturbing reports. In tandem with increased lending activity to minority and low-income borrowers are a growing number of reports of abusive and deceptive lending practices. The scope of these practices and nature of loan programs vary somewhat.

Isolated cases of abuse can involve a reverse mortgage extended to an older American that requires no monthly payment. If the loan was not offered in a responsible manner, it can be construed as predatory. An FHA mortgage may be offered at an affordable monthly payment, but the borrower may have saved up-front costs with a conventional program. These are just two examples of irresponsible lending that are not high-cost mortgages. Abusive and deceptive practices can involve other parties to the transaction, including builders and real estate brokers. For example, if a borrower is pushed into a "fast and easy" high-cost loan program and discouraged from applying for a lower rate, the real estate agent may be at fault.

On a national level, however, studies have shown that abusive and deceptive practices are more predominant in the subprime mortgage industry. A subprime mortgage is a loan that is offered to borrowers who do not otherwise qualify for an agency or conforming loan. These mortgages are made available from institutional investors and are sold through Wall Street dealers. Loan applicants

are led to subprime programs for a number of "niche" reasons. Listed are the most common:

- The borrower's debt ratio exceeds conforming limits;
- The borrower requests a "no income verification" program or a NINA (no income/no asset program) ;
- The property has an existing subordinate lien that does not meet a conforming lender's "seasoning" requirement;
- The collateral does not qualify (ineligible condo project, manufactured home, commercial/mixed use, environmental issue);
- The borrower presently has four-plus outstanding loans sold to Fannie Mae or Freddie Mac;
- The borrower does not meet citizenship or residency for the requested loan-to-value percentage; or
- The co-borrower does not intend to occupy the property.

The reasons stated above are all unrelated to credit history. Due to the niche circumstances, borrowers are willing to accept the higher interest rates and terms offered by a mortgage lender. The vast majority of subprime borrowers do not meet the minimum eligibility standard for A-credit conventional or government agency programs. In recent years, the mortgage banking industry has relied upon "risk-based pricing" to establish the borrower's rate of interest and these models have become increasingly accurate. Credit scores, such as FICO (Fair, Issac & Co.) are used to determine pricing. Nonconforming and subprime lenders provide retail institutions with a pricing matrix that delineates in fine detail the number of credit card delinquencies, mortgage history late payments, collection items, etc., which are permissible for the particular grading. The borrower's (and co-borrower's) credit scores are considered, but other factors are utilized in the decision. Most subprime loan applications are faxed to an investor for an internal underwriter to set the "risk grade" and the interest rate is out of the originator's jurisdiction.

Data reported under the Home Mortgage

Disclosure Act reveal that the number of subprime home equity loans has grown from 66,000 in 1993 to 856,000 in 1999, a 13-fold increase. Over this same period, the number of subprime loans to purchase homes increased 16-fold, from 16,000 to 263,000. In 1998, total subprime loan volumes in the United States peaked at \$150 billion. This was also the same year that all lenders in the nation originated a record \$1.55 trillion in mortgages.

According to the National Association of Mortgage Brokers, 60 percent of residential loans originated in the country today are through mortgage brokers. NAMB further states that half of subprime mortgages are originated by brokers. What has transpired in recent years is a proliferation of unscrupulous activities by some bad apples that became successful at organizing loopholes in the system. Industry trade groups have recognized the need for stricter controls and monitoring of third-party originators. Wholesalers have become more aggressive in the approval and monitoring of brokers and are incorporating regular checks of licenses and exclusionary lists. On the securitization side, Standard and Poors, for example, is looking for three-year loan seasoning. Task force groups formed by industry trade associations have issued guidance for reform and are experimenting with methods to "police" those who participate in predatory activities.

Foreclosure Studies

Abt Assoc. of Cambridge conducted a study of foreclosures in Atlanta. In 1993, there were 1,864 subprime refinance loans in Atlanta reported under HMDA. By 1998, this number had increased by over 500 percent to 11,408. Abt's study revealed that foreclosures of mortgages originated by subprime lenders grew by 232 percent since 1996. Foreclosures with high interest-rate spreads (more than 4 percentage points over 30-year Treasury) represented 44 percent of the subprime loans entering foreclosure, compared with only 8 percent of non-subprime loans entering foreclosure. The median age of loans entering foreclosure is only two years for sub-

continued on page 2

prime loans, compared to four years for non-subprime lenders. Abt also found that the subprime share of foreclosures is highest in lower-income and predominantly minority neighborhoods.

According to a study by U.S. Sen. Charles Schumer, blacks and Hispanics are forced to go to high-interest lenders who charge much more in interest and fees than conventional lending institutions. The study analyzed data on nearly 240,000 1998 home loans and refinancing applications in New York City. Schumer's study examined 12 neighborhoods of comparable median incomes in the Bronx, Queens and Brooklyn, half of them predominantly black and half mostly white. In the black areas, on average, 26 percent of mortgage applicants were rejected for a loan at a conventional bank, compared with 14 percent of applicants in the six white neighborhoods. Schumer's study showed that in predominantly black neighborhoods, more than half of the mortgages were issued by subprime lenders, compared with 13 percent in white neighborhoods.

ACORN, a nonprofit housing advocacy group, released a study they say shows the link between predatory loans, rising residential mortgage foreclosures and an increase in the number of abandoned houses in two census tracts in a West Philadelphia neighborhood. The ACORN study found a rapid growth of subprime lending in the area, along with an increase of vacancies and foreclosures. On a broader scale, an ACORN review of Philadelphia court records shows the number of foreclosure filings throughout the city increased from an average of 196 a month in 1995 to 441 a month on average in 1999.

According to a report by the Coalition for Responsible Lending, predatory lending practices cost borrowers \$9.1 billion annually. The North Carolina group contends that insurance packing, prepayment penalties, broker fees and other charges cost subprime borrowers \$6.2 billion annually. Another \$2.9 billion is earned by lenders through charging higher interest rates that are justified by credit histories. Coalition spokesman Martin Eakes comments, "The most important lending issue today is no longer denial of credit, but the terms of credit."

HOEPA

The Home Ownership and Equity Protection Act of 1994 is an amendment to the Truth in Lending Act. The primary purpose of HOEPA is to regulate high-cost mortgage loans. HOEPA is not a usury law. High-cost loans can still be made, but borrowers' protections are greater than for other subprime

continued on page 3

SUBPRIME MORTGAGE LENDING

Percentage of Total Residential Market 1994-2001 (\$ in billions)

YEAR	TOTAL MARKET	SUBPRIME VOLUME	% OF TOTAL
2001*	\$ 1,500	\$ 125	8.3 %
2000*	\$ 1,067	\$ 130	12.1 %
1999	\$ 1,214	\$ 135	11.1 %
1998	\$ 1,500	\$ 150	10.0 %
1997	\$ 839	\$ 112	13.3 %
1996	\$ 785	\$ 60	7.6 %
1995	\$ 639	\$ 35	5.5 %
1994	\$ 768	\$ 25	3.3 %

*estimated
SOURCE: National Mortgage News

Activities that Constitute Predatory Lending

	Definition	Massachusetts Law
Asset-Based Lending	Mortgages that are made based on the amount of equity in the home rather than the borrower's income or ability to repay the loan.	Prohibited act under Mass. Section 32 unless specific requirements are met in considering the loan.
Loan Packing	Packing has the effect of concealing the true cost of credit to the borrower. Borrowers are not provided with a separate disclosure that identifies the price of service or insurance premium.	Section 32 requires oral and written disclosure provided 3 days before closing.
Loan Flipping	Churning or repeatedly refinancing loans within a short period of time, including lowered interest rate that trigger other fees or impose prepayment penalties.	Section 32 defines restrictions for high cost loans within two years.
Balloon Payments	Considered predatory if the time period is too short for the borrower to establish eligibility to the prime refinancing market.	Section 32 defines restrictions for certain loans with terms 7 years or less.
Negative Amortization	Increased borrower debt through scheduled or unscheduled additions to principal balance. Considered predatory depending on terms and structure.	Prohibited
Prepayment Penalties	A cost to the borrower if the loan is prepaid before a specific time period. Prevalent in the subprime market.	Section 32 defines restrictions regarding source of prepayment funds, borrower income and right to exercise within 3 years.
Single Premium Credit Insurance	Historically prevalent in subprime market with practices currently changing to monthly payments.	Single premium prohibited for high cost loans, including debt cancellation and suspension.
Default Interest Rate Increase	Interest rate is increased during the default (pre-foreclosure) period.	Prohibited
Advance Payments	A requirement that borrower make the first two mortgage payments at closing, generally from refinance proceeds.	Limit of two payments.
Modification or Deferral Fees	A fee charged to borrower at time of loan modification, renewals, extension or amendment.	Restrictions based on whether loan is delinquent, in default, in workout process or remains a high cost loan (APR has not decreased by 2 percentage points).
Call Provision	Any type of provision that permits the creditor to accelerate the debt unrelated to the payment schedule other than bona-fide default, due-on-sale provision.	Prohibited
Mandatory Arbitration Clause	Prevents borrower from participating in class action suit. Also called Waiver of Participation.	Must comply with standards set forth in Statement of Principles of the National Consumer Dispute Advisory Committee.
Failure to Report Credit Histories	Considered predatory when the borrower is prevented from show favorable history or limits the borrower's access to credit from other sources.	Annual reporting required if creditor regularly reports information to a credit bureau.

Note: Definitions and Regulation Summaries are provided for general guidance

mortgage loans. The law calls for a two-part test. The first test is the interest rate. If the annual percentage rate on a mortgage loan exceeds the Treasury rate on a bond of comparable maturity by more than 10 percentage points, the loan is subject to HOEPA protections. (The board has the legal authority to lower this threshold to 8 percentage points.) For the second test, loans with non-interest fees of more than 8 percent of the loan amount, or \$465, are covered by HOEPA. Although the board cannot change these amounts, it can alter the items included in the test. HOEPA restricts features such as balloon payments in the first five years, prepayment penalties, and creditors must provide a disclosure to borrowers three days before the loan is closed.

The Federal Reserve Board has proposed revisions to HOEPA that would lower the protection trigger to 8 percentage points above the Treasury security of comparable maturity. In addition, the proposal would require that single premium credit insurance be included in the fees test. Both the current and proposed HOEPA triggers apply equally to first- and second-lien mortgages.

Consumer Awareness

"Don't Borrow Trouble" is the nation's largest public service campaign aimed at combating predatory lending. The award-winning program, funded and operated by the National Home Loan Mortgage Corp. (Freddie Mac), was created in Boston by Mayor Thomas M. Menino and the Massachusetts Community Banking Council. Federal Reserve Board Gov. Edward M. Gramlich presents the most fitting comment on consumer education: "The best defense against predatory lending is in a thorough knowledge on the part of consumers of their credit options and resources. Educated borrowers who understand their rights under lending contracts and who know how to exercise those rights put up the best defense against predatory lenders. As the knowledge base of consumers grows, the market for credit-at-any-cost diminishes."

HMDA Amendments

Last November, the Federal Reserve Board solicited comments on proposed revisions to Regulation C, which implements the Home Mortgage Disclosure Act. Data now reported include the type, purpose and amount of the loan; the race or national origin, gender and income of the loan applicant; and the location of the property. The board's

proposal incorporates suggestions received in response to an earlier Advance Notice of Proposed Rulemaking. Changes in the proposal would increase the number of non-depository lenders required to submit data and clarify and expand the types of reportable transactions. The proposal includes the addition of three new loan elements: 1) the APR; 2) whether the loan is subject to HOEPA; and 3) whether the loan involves a manufactured home.

Lenders have expressed concern about reporting the APR on the HMDA Loan Application Register in fear that a higher APR may be misconstrued by examiners, particularly for zero-point/no-closing-cost programs. Closing costs are customarily rolled into cash-out refinances, and for rate/term refinances, borrowers often choose an incrementally higher rate in lieu of borrowing more than presently owed. For those with little cash, homeownership is made possible through no-closing-cost options. Buydown mortgages, which post higher APRs, are a viable choice for lowering payments. Examiners understand borrower needs and choices. As long as a lender's HMDA report shows no disparities or pricing inconsistencies for similarly situated borrowers and RESPA documents denote permissible fees, lenders should not be deterred from offering consumers pricing options that meet their wants and needs.

Legislation

Paul Sarbanes, chairman of the U.S. Senate Banking Committee, held hearings in August and is working on new legislation to curb predatory lending. Nine states filed predatory lending legislation in 2000, including Massachusetts. By September 2001, that number has grown to 32 states considering such measures.

In his testimony before the U.S. Senate Committee on Banking and Financial Services, Massachusetts Commissioner of Banks Thomas J. Curry asked for legislators and regulators at the state and federal levels to consider whether enforcement of existing laws has been adequately pursued before adding new laws or regulations to the books.

As chairman and presenting on behalf of the Conference of State Bank Supervisors, Curry stated that federal preemption, which can lead to unintended consequences, must be held to a high standard, and said that "no amount of lawmaking will protect consumers without the proper enforcement, including well-trained examiners to discover violations

and appropriate sanctions to back it up."

Curry's testimony identified some state mortgage lending laws that have been preempted through a survey conducted by CSBS. These laws include: reporting requirements for licensed lenders; prohibitions on prepayment penalties; licensing and bonding requirements for subsidiaries; limitations on up-front fees for home equity loans; limitations on late charges; prohibitions on negative amortization; disclosures for high-rate, high-point mortgage loans; limitations on appraisal fees for home mortgages; and prohibitions on balloon mortgages. Curry concluded, "The states are a laboratory for innovation and for developing the best practices in both products and services and consumer protections. We are close to our citizens ... and the first to see trends and problems and the first to develop safeguards that protect consumers and allow depository institutions to thrive."

James A. Leach, chairman of the Committee on Banking and Financial Services, suggests certain basic precepts that should be considered as part of addressing predatory practices:

- Consumers deserve meaningful and clearly understandable disclosures of loan agreements so that borrowers are informed, rather than confused, by all of the paperwork before them.
- Lenders should not extend credit to a borrower unless they have applied appropriate analysis to determine that the borrower is capable of repayment on the terms of the loan.
- Lenders should not require a borrower to finance points and fees associated with a high-cost loan. The consumer should receive a clear disclosure that the financing of points and fees is optional.
- Lenders shall not use misleading or deceptive sales and marketing practices that induce consumers to enter loan agreements that they cannot afford.
- Attempts to curb abusive practices should not be made at the expense of credit availability in under-served neighborhoods.
- Greater efforts should be undertaken to educate the public about borrowing. For example, consumers must be able to easily comprehend that a drop in their monthly payments may not translate into owing less over the long term, and may in fact increase their overall costs.
- Lenders should provide disclosures, prior to closing, which encourage consumers to seek credit counseling. ■

Reprinted with permission of Banker & Tradesman.

This document may constitute advertising under the rules of the Supreme Judicial Court of Massachusetts.