

Predatory Lending: An Overview^{*}

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Introduction

Predatory lending has become one of the most critical policy issues facing the financial services industry, particularly mortgage lending. Nearly every federal financial services regulatory agency has publicly denounced predatory lending and called for more effective regulation to address it. Legislation has been proposed in Congress and several states to combat predatory lending, and trade associations and individual financial institutions have declared their concerns. Also, the Federal Reserve Board has proposed a rule to require lenders to report annual percentage rates for all loans, a measure that could help identify predatory lenders.

Despite broad consensus to take action, efforts to end predatory lending have been modest at best. One reason for the slow response is the lack of consensus on what constitutes illegal predatory lending. While there is significant agreement on the key loan terms and lender behavior that generally constitute predatory lending, there is little political consensus at the national level within the housing finance community about how best to address the various areas of concern. Without national consensus on how most effectively to address key predatory lending practices, significant progress in this arena is not likely in the near term.

Predatory loans are characterized by excessively high interest rates or fees, and abusive or unnecessary provisions that do not benefit the borrower, including balloon payments or single-premium credit life insurance, large prepayment penalties, and underwriting that ignores a borrower's repayment ability. Yet, although high interest rates or fees are common characteristics of predatory loans, high-cost loans are not necessarily predatory. And depending on the unique characteristics of an individual loan and specific borrower, loan provisions that may be predatory in one instance, such as a prepayment penalty, may be reasonable and legitimate under others. For this reason, regulatory agencies and other institutions are cautious about instituting broad-based and sweeping regulations that could undermine legitimate sources of financing for credit-impaired households.

Further complicating efforts to stop predatory lending is the fact that there is little, if any, publicly available data regarding loan terms, such as interest rates, origination points, processing or closing fees, and special provisions such as balloon payments, credit life insurance, and

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prepayment restrictions. Without information on loan terms by borrower and neighborhood race/ethnicity and income, there is no way to effectively monitor or identify questionable lending patterns for further examination. Needless to say, a problem that cannot be identified and examined cannot be eliminated.

As suggested by Carr and Schuetz (2001) [LINK TO CARR AND SCHUETZ], predatory lending generally does not occur in a vacuum. Rather, it breeds in an environment characterized by little competition for traditional financial services. Specifically, a community flush with “fringe lenders”—check cashing outlets, pawnshops, rent-to-own stores, title lenders, and similar operations—as well as excessive subprime lending, is the environment in which predatory lending activities often flourish.

This article provides a working definition of predatory lending and highlights some of the most common characteristics of predatory loans. It distinguishes predatory lending from subprime lending, and highlights the legitimate role that subprime lending plays for households with demonstrated credit problems. The article further points out, however, that despite a clear technical distinction between legitimate subprime lending and predatory lending, there exists a huge gray area between the two, in the form of excessive subprime lending. The article concludes with a series of recommendations and considerations for further action to limit both predatory and excessive subprime lending.

Defining the Problem

A clear definition of predatory lending is difficult due to the complexity of determining the appropriate level of fees for a given level of risk. Generally speaking, three features—alone or in combination—define predatory lending practices. Those features include targeted marketing to households on the basis of their race, ethnicity, age or gender or other personal characteristics unrelated to creditworthiness; unreasonable and unjustifiable loan terms; and outright fraudulent behavior that maximizes the destructive financial impact on consumers of inappropriate marketing strategies and loan provisions. Although a loan involving any one of these tactics might legally be considered predatory, most predatory lenders use some combination of all three to extract the greatest profit and, as a consequence, cause the greatest financial harm to the borrower.

Fraudulent Target Marketing

Predatory lenders use sophisticated technology and numerous sources of publicly available data to identify potential customers. They market their products to customers they identify as financially unsophisticated or vulnerable, and therefore most likely to accept highly unfavorable loan terms. In particular, predatory lenders look for people with limited education who are not adept in financial matters and lack the financial sophistication to scrutinize loans. Such lenders often prey on households that have limited incomes but significant equity in their homes. The elderly are a primary target for predatory lenders.

Marketing techniques include placing “cold calls” to potential borrowers, direct mailings, telephone and door-to-door solicitation, and television commercials. As with many other loan features, these practices by themselves are not predatory. Target marketing is used extensively by all types of mainstream businesses to identify potential customers and customize products to meet their particular needs. Predatory lenders use target marketing not to meet the needs of their customers, but rather to identify households most vulnerable to the lenders’ aggressive or fraudulent behavior.

Predatory lenders’ advertisements claim that easy and affordable home equity loans are a quick way for consumers to pay down credit card debt, take a desired vacation, or pay off other expenses, and still have lower monthly mortgage payments. Predatory lending also often involves fraudulent home improvement scams targeted to elderly homeowners because they are more likely than younger people to live in older homes that need repair, are less likely to undertake the repairs themselves, and may not have the cash to pay for someone else to perform them. Because these homeowners have built up substantial equity in their homes, they are particularly at risk of losing a major share, if not all, of their equity. Predatory lenders also make loans to homeowners who are mentally incapacitated and do not understand the nature of the mortgage transaction or papers to be signed.

Abusive Loan Terms

The second characteristic of a predatory loan is the set of abusive terms it contains. Predatory loan terms are structured to extract the greatest possible return to the lender. For equity stripping purposes, they are also routinely designed to preclude a borrower’s ability to repay the loan. The loan itself may be unnecessarily large, even in excess of a 100 percent loan-to-value ratio. As long as the amount of the loan exceeds the fair market value of the home, it is difficult for the owner to refinance the mortgage or to sell the house to pay off the loan. Negative amortization loans are structured so that interest is not amortized over the life of the loan and the monthly payment is insufficient to pay off the accrued interest. The principal balance therefore increases each month and, at the end of the loan term, the borrower may owe more than the originally borrowed amount.

Aside from the loan itself—typically offered at very high interest rates—loan terms often include inflated and padded costs, such as excessive closing or appraisal charges, high origination and other administrative fees, and exorbitant prepayment penalties that trap lower-income borrowers into the subprime market. While prepayment fees are rarely charged in the prime market—some 2 percent of mortgages carry them—they are included in 80 percent of subprime mortgages, according to the Detroit Alliance for Fair Banking. And, unlike in the prime market, where prepayment fees are a tradeoff for lower interest rates, subprime mortgage holders rarely, if ever, get anything for the added fees, which can cost as much as a 6 percent penalty for early payoff. Consumers are locked into the subprime market even if they demonstrate improving creditworthiness, and are doubly hurt because they are not free to take advantage of lower interest rates as can prime market customers.

There may also be insertion of pre-dispute, mandatory, binding arbitration clauses in contractual documents. Such clauses are not necessarily offensive by themselves. When combined with other predatory loan provisions, however, they can greatly inhibit a borrower from receiving relief from highly unfavorable and unreasonable loan terms and conditions. Other typical predatory loan features include balloon payments that effectively force borrowers to refinance their loans at even higher rates later. Predatory loan terms also commonly feature single-premium credit life insurance that the lender requires as an up-front, lump-sum payment that the borrower must finance. Thus the borrower ends up paying additional interest—on top of the cost of overpriced and often unnecessary insurance. Maintenance provisions may increase the interest rate of a loan as a result of a 30- or 60-day late payment.

Fraudulent Lender Behavior

Fraudulent behavior is the third identifying characteristic of a predatory loan. It refers to illegal management by the lender of the loan transaction to extract the maximum value for the lender. Fraudulent behavior might include: 1) failing to explain the terms of the loan or providing obscure information, 2) using high-pressure tactics to force a prospective borrower to continue through the loan application process in cases in which the customer would prefer to discontinue the process, 3) omitting explanations of credit life insurance or balloon payments, and 4) discouraging borrowers from exploring lower-cost options.

One common tactic is to offer a short-term loan and quote a seemingly reasonable rate, without explaining that the “reasonable” rate becomes astronomical when translated into the annual percentage rate. “Flipping,” or repeated refinancing, is another powerful tool of a predatory lender. The lender might offer to refinance a loan on the justification that the borrower can obtain a lower interest rate. But upon signing the new loan documents, the borrower finds out either that the interest rate is not lower or higher processing fees more than overwhelm any offset in interest rates. Or, a balloon payment provision in the original loan might make refinancing unavoidable.

Initiating loans without considering the borrower’s ability to repay or structuring loans with payments that a borrower cannot afford can effectively strip the equity from a homeowner. And encouraging borrowers to consolidate consumer debts into a home equity loan with a higher interest rate than the underlying consumer credit debt—thereby also increasing the size of the loan—is a standard predatory lending practice. Further, predatory lenders may refuse to provide modest home equity loans and, instead, use high-pressure tactics to persuade borrowers to fully refinance their homes—again, usually at interest rates that exceed the underlying mortgage.

Other fraudulent behavior includes adding cosigners whom the lender knows have no intention of contributing to the payments, forging loan documents, and using abusive and high-pressure collection practices, such as harassing phone calls, letters, and threats. The combination of abusive loan terms and aggressive and fraudulent lender behavior that characterizes predatory lending illustrates how a loan can financially destroy an individual even in instances in which the loan’s interest rate may not be alarmingly high. Because of the many tools in the arsenal of a

predatory lender, a request for a relatively modest loan can be transformed into a major financial crisis for an unsuspecting borrower.

A real-life example is useful in understanding how predatory lenders operate: ABC television's "Prime Time Live" in April 1997 featured the story of an elderly man in poor health who could not read or write. The man initially sought a small loan to buy food. Eventually the lender converted his request into a \$50,000 home-equity loan. The loan was flipped just 17 days after signing, even before the first payment was due. Subsequently, in less than four years, the lender flipped the loan 11 times, attaching a 10 percent finance fee each time. The lender foreclosed on the house after the man could not make his loan payments. In this case, the man sued and his loans were forgiven. This was a very unusual ending to a predatory lending story—most victims are unable to obtain successful or satisfactory legal redress.

Finally, it is worth noting that some practices of other real estate professionals, such as mortgage brokers and home improvement contractors, could reinforce and further promote predatory lending. Home improvement contractors, for example, sometimes target inner-city neighborhoods where houses are older and often in need of renovation, and where households are cash-poor but have accumulated significant equity in their properties. In these instances, contractors may steer their customers to predatory lenders for loans to pay for the home improvements. Brokers are an important part of the infrastructure of predatory lenders. Checking property deeds and other public records and spending time in a community, brokers identify homeowners who have substantial equity in their properties and encourage those households to refinance with a predatory lender who, in turn, provides the broker with a substantial referral fee. Elderly, black, widowed women are frequent targets.

Predatory Lending as Subset of Subprime Lending

Predatory lending is a subset of subprime lending. The difference between the two is important. By definition, subprime lending is the provision of loans to households that have demonstrated an inability or unwillingness to properly manage credit. By definition, the subprime market is the credit source of last resort for households with poor credit histories, insufficient documentation of requisite financial resources or other important loan application information, and other loan application shortcomings that would limit a prospective borrower's ability to secure credit from the prime market.

Subprime loans carry higher interest rates than prime loans with the justification that borrowers with higher risk factors should pay more to offset their perceived greater risk to the financial institution advancing the loan. Subprime loan rates are also higher, according to Ken Temkin (2000) of the Urban Institute, because underwriting guidelines in the subprime market are not standardized across the industry. The lack of standardization causes variation in interest rates offered by different lenders and makes it difficult for borrowers to "shop" for the most favorable rates.

Despite this clear conceptual distinction between predatory lending and legitimate subprime lending, the reality of subprime and predatory lending is much murkier. A loan does not have to

be loaded with an excessive number of egregious provisions for it to unfairly undermine the financial solvency of a family. For example, steering minority households to the subprime market on the basis of race/ethnicity, rather than because of a demonstrated inability to properly manage credit, may be a violation of the Fair Housing Act and Equal Credit Opportunity Act—although it is not necessarily an act of “predatory lending.”

In fact, even one percentage point unjustifiably added to a mortgage can add substantially to a household’s financial burden and greatly undermine its asset-building capabilities. Over the 30-year life of an \$81,000 home mortgage, one additional percentage point could add nearly \$21,000 to the cost for the home buyer—not including the additional higher processing fees subprime loans typically carry. Note that the typical subprime loan is 300 to 400 basis points higher than a comparable prime market loan.

Concentration in Low-Income and Minority Neighborhoods

Just as fringe-lending activity is increasing, the subprime market has experienced exponential growth in lower-income minority communities. A recent study published by the U.S. Department of Housing and Urban Development (HUD) based on 1998 Home Mortgage Disclosure Act (HMDA) data uncovered striking racial disparities in the subprime market. The report finds that subprime loans are three times more likely in low-income neighborhoods than in high-income areas, and five times more likely in black neighborhoods than in white neighborhoods. In predominantly black communities, high-cost subprime lending accounted for 51 percent of home loans in 1998, compared with only 9 percent in predominantly white areas.

HUD further notes that homeowners in high-income black neighborhoods are six times as likely as homeowners in upper-income white neighborhoods, and twice as likely as homeowners in low-income white neighborhoods, to have subprime loans. Thirty-nine percent of homeowners in upper-income black neighborhoods had subprime loans, compared with 6 percent of homeowners in upper-income white neighborhoods and 18 percent for homeowners living in low-income white neighborhoods.

Does Risk Fully Explain the Size of the Subprime Market?

As noted above, the rationale for disproportionately high levels of subprime lending to lower-income and minority households is that those borrowers represent substantially greater risk than borrowers in the prime mortgage market. Unfortunately, there is little available public data on the credit quality of households that would allow for an examination of the reasonableness of the growth of subprime lending to lower-income minority households. Data that are available, however, do not support the recent explosive growth of this segment of the mortgage market.

First, several financial institutions in the past decade have confirmed that lower-income status is not synonymous with higher credit risk. Stated otherwise, lower-income consumers who receive mainstream credit perform roughly the same as middle- and upper-income households receiving similar credit. As a result, the much greater level of subprime lending to lower-income

households relative to higher-income households is not immediately justified by available information on credit quality of these two groups. Second, although black households have been shown in studies to have greater credit problems than non-Hispanic white households, the level of subprime lending to black households and communities far exceeds the measured level of credit problems experienced by those households.

According to a 1999 Freddie Mac study, black households have roughly twice the credit problems of non-Hispanic white households. Yet HUD's data show that blacks rely on subprime refinance lending roughly four times as much for their mortgage credit. Credit quality alone therefore does not fully explain the extreme reliance of black households on the subprime market. Further research by Freddie Mac reports that as much as 35 percent of borrowers in the subprime market could qualify for prime market loans. Fannie Mae estimates that number closer to 50 percent.

If these estimates are accurate, it represents potentially hundreds of millions of dollars wasted each year by the very households that can least afford it.

Credit History Versus Creditworthiness

Although creditworthiness is the measure by which financial institutions determine the type of loan most appropriate for a particular borrower, there is substantial confusion between creditworthiness and credit history. Creditworthiness or credit risk is the measurement of the borrower's ability and willingness to repay a loan. Credit history is the financial transactions data on which a borrower's creditworthiness is determined. Stated otherwise, creditworthiness is the interpretation of an individual's credit history. An evaluation about creditworthiness of a borrower requires, among other things, judgments about the reliability and comparability of the underlying financial transactions data. There are a number of reasons why an individual's credit history may not accurately reflect his or her actual creditworthiness.

Confusion about credit history and creditworthiness inappropriately reinforces the idea that lower-income, and particularly minority, communities are largely bad credit risk environments. Several problems arise from interpreting creditworthiness from existing credit history data for minority households and comparing the data with that for non-Hispanic white households. First, low-income minorities are more likely to be financially unsophisticated, and thus may not attempt to correct poor credit histories before applying for a loan. Two borrowers may have similar credit behavior, but if one has taken steps to improve his or her credit records before applying for a loan, that borrower will be deemed more creditworthy. In fact, many households may be completely unaware of the need to maintain a good credit history, and the role that documentation plays in determining their access to credit.

A related issue is coaching of borrowers at the time of application for loans. Proper counseling at the time of loan application may enable a household to improve its credit score, but there may be substantial differences in the ways in which households receive such coaching along racial and ethnic lines. Third, comparing credit histories of households that have access to and use

mainstream financial institutions with individuals that rely primarily on fringe banking services could result in biased assessments of creditworthiness across racial and ethnic groups. Federal mortgage data, as well as the behavior of fringe and predatory lenders, suggest that minority households are more likely to have used finance companies and other fringe financial services whose terms and practices are more costly and harsh. In some cases, consumers may even have used predatory lending institutions that intentionally structure loans for default. In some instances, loan terms may be so oppressive and unreasonable that repayment is simply unrealistic. Or, some households may have used fringe lenders who might aggressively report even modest credit blemishes in an effort to hold onto their customers by ensuring they remain unattractive to mainstream lending institutions.

Finally, some households may default intentionally because they recognize, albeit after the fact, that the loan terms they have accepted are egregious and unfair if not outright fraudulent. In these instances, financially vulnerable households are penalized with additional credit blemishes for recognizing and acting to defend themselves from unscrupulous or fraudulent lenders.

Unfortunately for underserved households, data that might provide more accurate assessments of borrower creditworthiness are not readily available and therefore not generally used in sophisticated models of credit risk. The result is continued disparate evaluations of credit risk for lower-income, and particularly minority, households and consequently, lower homeownership rates than might be possible.

Recommendations and Solutions

Predatory lending is an outlying consequence of the inefficient financial markets that exist in many lower-income and minority communities. Predatory lending practices thrive in an environment where competition for financial services is limited or lacking, and where excessive marketing of subprime loans and fringe financial services are occurring. For this reason, effectively limiting predatory lending requires the same three-pronged approach recommended to reduce excessive fringe financial services in lower-income, minority, and distressed communities: 1) enhanced enforcement of the relevant federal and state lending and consumer protection laws, 2) increased prime market lending, and 3) improved borrower education and awareness of financial services options and opportunities (see Carr and Schuetz 2001). [LINK]

Laws that specifically relate to predatory lending and whose greater enforcement must play a key role in eliminating predatory lending include the Fair Housing and Equal Credit Opportunities Acts, the Real Estate Settlement Procedures Act, and the Homeowner's Equity Protection Act. Some predatory lending practices also might violate various federal and state consumer protection laws, such as the Truth in Lending Act. Together, these laws provide a formidable regulatory infrastructure to make important strides in removing predatory lenders from the nation's most vulnerable and distressed communities. Together, these laws cover practically every conceivable predatory lending arrangement. (For a more detailed discussion of possible legal strategies to fight predatory lending, see Engel and McCoy 2001.)

Yet, the strength of these federal laws can, nevertheless, be a weakness. Because so many different laws could pertain to various predatory lending practices, determining which law or laws may have been violated in any particular case can be complicated, time-consuming, and costly. Simplifying federal law to target predatory lending directly would greatly enhance the ability of lower-income households and their advocates to combat unfair and illegal lending behavior. Further, outlawing abusive practices would act as a preventive measure and would avoid the need for consumers to be harmed before there could be legal redress.

The North Carolina nonprofit Coalition for Responsible Lending, for example, points out that a handful of provisions account for the overwhelming majority of the most abusive predatory lending activities. The coalition recommends new legislation that focuses on seven loan terms and practices including: 1) credit insurance; 2) excessive fees charged to borrowers; 3) prepayment fees that do not benefit the borrower; 4) mortgage broker abuses including yield-spread premiums; 5) steering of borrowers to subprime loans on the basis of race/ethnicity, age, or gender; 6) mandatory arbitration clauses that restrict the rights of the borrower; and 7) loan flipping or repeated refinancings that do not benefit the borrower.

Many states have recently enacted or have begun to debate streamlining their state statutes to focus directly on predatory lending. The state of North Carolina enacted a comprehensive predatory lending law in July 1999. The North Carolina law defines two types of loans—“home loans” and “high-cost home loans.” For all home loans, the law prohibits lending abuses such as requiring credit life, disability, or unemployment insurance, and loan flipping. With regard to high-cost home loans, it imposes expanded protections against excessive balloon payments, high interest rates and fees, negative amortization, and predatory home improvement contractors. In addition, loan counseling is required and a borrower’s ability to repay must be taken into consideration.

Using the North Carolina model, the states of New York, Illinois, South Carolina, Minnesota, West Virginia, Utah, Maryland, and California are all considering predatory lending legislation. Another example of local action is Washington, DC’s, new “Predatory Lending Protections and Mortgage Foreclosure Improvements Act of 2000” that provides additional protections for District residents who might find themselves at risk of losing their homes through foreclosure as a result of corrupt lending practices. Among other features, this law attacks predatory activity by defining a subset of loans that might be predatory and providing homeowners with a quick judicial review prior to a foreclosure sale. Philadelphia is another city that has recently enacted a predatory lending law.

Perhaps the most comprehensive federal examination of predatory lending performed to date was pursued jointly by the U.S. Department of the Treasury and HUD. Their report, “Curbing Predatory Home Mortgage Lending,” included extensive discussion of predatory lending tactics and a wide range of recommendations to limit fraudulent lending behavior (see the full report at www.huduser.org/publications/hsgfin/curbing.html). The study highlighted and discussed practices ranging from loan flipping, targeting minority and low-income borrowers, and lending to borrowers based on the value of their home rather than the ability to repay a loan. Expanding borrowers’ access to the prime market by awarding banks and thrifts Community Reinvestment Act credit and amending many existing laws were among the recommended solutions.

Additionally, the study revealed that the Federal Housing Administration is developing tools to help borrowers who have been victimized by predatory lenders to avoid foreclosure, retain their homes with a reasonable level of debt, and, if necessary, repair their credit.

The National Community Reinvestment Coalition has outlined a multipart strategy to address predatory lending. Among its recommendations are for the Federal Reserve Board to use its existing authority to prohibit unfair and deceptive mortgage lending practices, to step up its oversight of subprime lenders, and to improve data disclosure to more effectively track subprime and predatory lending.

Conclusion

The issue of predatory lending is, for good reason, an issue of national concern. Yet, while there is strong consensus to act, there is enormous inertia in taking definitive action that might impact lending of any type. Part of the failure to aggressively address predatory lending is based on a legitimate concern that price controls and blanket prohibitions of individual loan features could negatively impact market segments in unintended ways.

Moreover, as this article and Carr and Schuetz (2001), predatory lending is merely the extreme end of a spectrum of abusive, unscrupulous, and costly financial services practices that dominate lower-income and minority communities. Placing caps on certain practices and eliminating certain other behaviors would go a long way to removing some of the most destructive wealth-stripping activities from the mortgage markets in distressed communities. But limitations, restrictions, and caps on various financial services practices are not sufficient to address the broader issue of market failure that plagues these communities. That broader challenge requires positive action and initiative. Lower-income and minority communities need high-quality, low-cost financial services tailored to their low-income and low-wealth circumstances. Further, those households need access to savings vehicles that would enable them to build their assets to the greatest extent possible.

Assisting households to better understand how to make informed choices about the financial services and providers they choose is an important aspect of a comprehensive anti-predatory lending program. At the same time, however, there are real limits on the extent to which consumer financial education can help vulnerable households who are the focus of fraudulent professionals.

Mortgage loan documents can consist of dozens of provisions written in extremely complex, confusing, and technical legal language. Predatory lenders target lower-income and minority borrowers with limited education and vulnerable elderly consumers specifically because they cannot reasonably protect themselves. To expect that financially vulnerable consumers can reasonably review, understand, and challenge specific provisions in the dozens of legal documents that are routinely involved in the mortgage lending process is a highly unreasonable expectation.

Despite the inability to achieve consensus on the perfect response to predatory lending, some immediate intervention is needed and should be forthcoming at a national level. Failure to successfully remove predatory lenders from the financial services markets could, over a relatively short time, undermine much of the success that has been achieved over the past decade in enhancing the number of historically underserved households that are now homeowners. And it could further exacerbate the tenuous financial positions of many vulnerable, lower-income, elderly homeowners, many of whom reside in older, inner-city, and distressed communities.

Principles for Responsible Lending¹

Coalition for Responsible Lending

Homeownership not only supplies families with shelter, it also provides a way to build wealth and economic security. Unfortunately, too many American homeowners are losing their homes, as well as the wealth they spent a lifetime building, because of harmful home equity lending practices. Some lenders target elderly and poor or uneducated borrowers to strip the equity from their homes, which traps borrowers in bad loans and creates a high risk of foreclosure. Subprime lending has increased 1,000% in the last five years, and abusive lending is up commensurately.

Seven principles should govern attempts to eliminate predatory lending and protect family wealth:

- Prohibit the financing of up-front credit insurance for all loans.
 - Limit fees charged borrowers, direct and indirect, to 3% of the loan amount.
 - Prohibit back-end prepayment penalties on subprime loans, since they act in an anti-competitive manner by keeping lenders from remedying abusive situations.
 - Take sufficient steps to address mortgage broker abuses on purchased loans, including prohibiting yield-spread premiums.
 - Address steering by making sure that borrowers receive the lowest-cost loan they qualify for.
 - Avoid mandatory arbitration clauses in any home loans.
 - Prohibit “flipping” of borrowers through repeated fee-loaded refinancings.
1. Credit insurance premiums should not be financed into the loan up-front in a lump-sum payment. One type of credit insurance, credit life, is paid by the borrower to repay the lender should the borrower die. The product can be useful when paid for on a monthly basis. When it is paid for up-front, however, it does nothing more than strip equity from homeowners, which is why Fannie Mae and Freddie Mac have both agreed not to purchase any loan that includes financed credit insurance. Conventional loans almost never include, much less finance, credit insurance.
 2. The borrower should not be charged fees greater than 3% of the loan amount (4% for FHA or VA loans). Points and fees (as defined by HOEPA) that exceed this amount (not including third party fees like appraisals or attorney fees) take more equity from borrowers than the cost or risk of subprime lending can justify. By contrast, conventional borrowers generally pay at most a 1% origination fee.
 3. Subprime loans (defined as interest rates above conventional) should not include prepayment penalties, for the following reasons:
 - Prepayment penalties trap borrowers in high-rate loans, which too often leads to foreclosure. The subprime sector serves an important role for borrowers who encounter temporary credit problems that keep them from receiving low-rate conventional loans. This sector should provide borrowers a bridge to conventional financing as soon as the

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borrower is ready to make the transition, though prepayment penalties are designed to prevent this from happening. Why should any borrower be penalized for doing just what they are supposed to do—namely, pay off a debt?

- Prepayment penalties are hidden, deferred fees that strip significant equity from over half of subprime borrowers. Prepayment penalties of 5% are common. For a \$150,000 loan, this fee is \$7,500, more than the total net wealth built up over a lifetime for the median African American family. According to Lehman Brothers' prepayment assumptions, over half of subprime borrowers will be forced to prepay their loans—and pay the 4% to 5% in penalties—during the typical five-year lock-out period. And borrowers in predominantly African-American neighborhoods are five times more likely to be subject to wealth-stripping prepayment penalties than borrowers in white neighborhoods. Prepayment penalties are therefore merely deferred fees that investors fully expect to receive and borrowers never expect to pay.
 - Borrower choice cannot explain the prevalence of prepayment penalties in subprime loans. Only 2% of borrowers accept prepayment penalties in the competitive conventional market, while, according to Duff and Phelps, 80% in subprime do.
4. Lenders should take sufficient steps to address mortgage broker abuses, including prohibiting yield-spread premiums. Brokers originate over half of all mortgage loans and a relatively small number of brokers are responsible for a large percentage of predatory loans. Lenders should identify—and avoid—these brokers through comprehensive due diligence. In addition, lenders should refuse to pay “yield-spread premiums”—fees lenders rebate to brokers in exchange for placing a borrower in a higher interest rate than the borrower qualifies for. These lender kickbacks violate fair lending principles since they provide brokers with a direct economic incentive to steer black borrowers into costly loans.
 5. To address steering, lenders should make sure that borrowers get the lowest-cost loan they qualify for. As Fannie Mae and Freddie Mac have shown, subprime lenders charge prime borrowers who meet conventional underwriting standards higher rates than necessary. This is particularly troubling for lenders with prime affiliates—the very same “A” borrower who would receive the lender's lowest-rate loan from its prime affiliate pays substantially more from the subprime affiliate. HUD has shown that steering has a racial impact since borrowers in African-American neighborhoods are five times more likely to get a loan from a subprime lender—and therefore pay extra—than borrowers in white neighborhoods. A minority borrower with the same credit profile as a white borrower simply should not pay more for the same loan. Therefore, lenders should either:
 - offer “A” borrowers loans with “A” rates, or
 - refer such borrowers to an affiliated or outside lender that offers these rates.
 6. Lenders should not impose mandatory arbitration clauses in any home loans. Increasingly, lenders are placing pre-dispute, mandatory binding arbitration clauses in their loan contracts. These clauses insulate unfair and deceptive practices from effective review and relegate consumers to a forum where they cannot obtain injunctive relief against wrongful practices, proceed on behalf of a class, or obtain punitive damages. Arbitration can also involve costly

fees, be required to take place at a distant site, or designate a pro-lender arbitrator. Arbitration will always take time the consumer may not have if they are facing foreclosure. Such clauses are unfair to borrowers, who generally do not understand what rights they are giving up; if an informed consumer thinks that arbitration is a helpful step in resolving a dispute with a lender, the consumer and lender should be permitted to agree to arbitration then.

7. Lenders should prohibit “flipping” of borrowers through repeated fee-loaded refinancings. One of the worst practices is for lenders to refinance subprime loans over and over, taking out home equity wealth in the form of high fees each time, without providing the borrower with a net tangible benefit. Some lenders originate balloon or adjustable rate mortgages only to inform the borrowers of this fact soon after closing to convince them to get a new loan that will pay off the entire balance at a fixed rate. Others require borrowers to refinance in order to catch up if the loan goes delinquent.

Combating Predatory Lending Practices

Federal Banking Regulatory Agencies Call for Greater Oversight

The Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision in January issued a directive that strengthens the examination and supervision of institutions with significant subprime lending programs.

The “expanded guidance” decree specifies borrower characteristics that indicate an institution is targeting the subprime lending market, clarifies the standards to use when evaluating loss allowances, and identifies potentially predatory lending practices that safety and soundness examiners will criticize, among other features.

The expanded guidance is expected to help banks and thrifts engaging in subprime lending activities be more aware of the banking agencies’ expectations regarding risk management processes.

Responses to Predatory Lending by the U.S. Department of Housing and Urban Development (HUD) and U.S. Treasury Department

A joint U.S. Department of Housing and Urban Development and U.S. Treasury Department Task Force on Predatory Lending has conducted five field forums around the country and, based on its findings, proposed a four-point plan to address predatory lending practices. The plan is detailed in the report, “Curbing Predatory Home Mortgage Lending,” summarized below. The full report is available at: www.huduser.org/publications/hsgfin/curbing.html.

1. Provide improved disclosures to borrowers and enhance consumer literacy. Require creditors to recommend that high-cost loan applicants seek home mortgage counseling, disclose credit scores on request, and provide better information on loan costs and terms.
2. Prohibit damaging or unfair lending practices. Loan flipping and lending to borrowers without regard to their ability to repay should be prohibited, and brokers and lenders should be required to provide greater documentation of loan and payment history.
3. Restrict abusive terms and conditions on high-cost loans, including balloon payments, prepayment penalties, and the financing of points and fees; prohibit mandatory arbitration agreements on high-cost loans; and ban single-premium credit life insurance.
4. Use Community Reinvestment Act (CRA) credit to create a positive incentive structure for banks and thrifts. Grant CRA credit to institutions that promote borrowers from the subprime to prime mortgage market, and deny CRA credit to institutions that originate or purchase loans that violate applicable lending laws.

Proposals by the Federal Reserve Board to Strengthen Predatory Lending Prohibitions

The Federal Reserve Board has proposed amending two of its regulations to crack down on predatory lending:

The first proposal is to require additional disclosure of mortgage applications and loans under the Home Mortgage Disclosure Act (HMDA). The revision, which would mandate reporting of requests for mortgage preapprovals and home-equity lines of credit, is designed to track the level, trend, and underwriting characteristics of high-cost mortgage loans. It would help identify institutions engaged in subprime lending, make high-volume nondepository lenders subject to HMDA reporting requirements, and simplify the definition for “refinance” and “home improvement loan” to ensure more complete and consistent data. [See <http://www.federalreserve.gov/boarddocs/press/boardacts/2000/20001214/>].

The second proposed amendment broadens the scope of loans subject to the Home Ownership and Equity Protection Act (HOEPA) of 1994 by adjusting price triggers that determine coverage under the act. Interest rate triggers would be lowered by two percentage points (from 10 points to 8 points above current Treasury bill rates), and the fee-based triggers would include optional insurance premiums and similar credit protection products paid at closing. [See <http://www.federalreserve.gov/boarddocs/press/boardacts/2000/20001219/>].

The proposed amendment also prohibits certain practices, such as repeated refinancing of HOEPA-regulated loans over a short time when transactions are not in the borrower’s interest, and making loans without verification of a consumer’s repayment ability.

It is important to note that HOEPA still does not cover all home equity lenders and all home equity loans, and there are loopholes that allow room for abuse.

Calls for Additional Federal Action

The National Community Reinvestment Coalition (NCRC) has made several recommendations for additional federal anti-predatory lending action.

It recommends calling for federal banking regulations to increase their oversight of subprime lenders during CRA exams and accompanying fair-lending reviews. The NCRC suggests that regulatory agencies issue an interagency advisory letter saying that predatory lending will not receive credit under CRA exams and will be penalized through lower CRA ratings and fair lending referrals to the Department of Justice. It calls for the Federal Reserve Board to use its authority to conduct regular fair lending reviews of subprime affiliates of bank holding companies, as recommended by the General Accounting Office.

Secondly, the NCRC has called for Congress to pass more comprehensive anti-predatory lending legislation.

The NCRC is a national community reinvestment and fair lending trade association of more than 700 community-based organizations and local public agencies dedicated to increasing access to credit and capital for traditionally underserved urban and rural areas.

References

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