California Real Estate *magazine*

When Subprime Turns Predatory

Loans extended to at-risk buyers & vulnerable clients ultimately undermine consumers' confidence in real estate

By Judi Connor

With interest rates at all-time lows, the current market presents a prime opportunity for first-time buyers to land their dream homes, existing homeowners to refinance to lower rates, and others to tap into their homes' equity. And nine out of 10 borrowers qualify for the prime mortgage market, which typically provides many choices and the lowest rates. However, there are others who don't qualify for prime loans for any number of reasons and who turn to the subprime lending market to secure funds.
Typically, recipients of subprime loans receive home mortgage credit at higher interest rates and fees because they're considered higher risk borrowers. Unfortunately, some borrowers of subprime loans are targeted by predatory lenders who underwrite egregiously high-cost loans, the terms of which either aren't clearly understood or are misrepresented by the lender and typically don't take into account a borrower's ability to repay.

Defining the Problem

According to the Department of Housing and Urban Development (HUD), the number of subprime home refinancing loans increased tenfold between 1994 and 1999, with the industry exploding from $20 billion to $150 billion. Although increased access to credit for different levels of creditworthy consumers makes sense–particularly when there are no other alternatives for higher risk borrowers–evidence suggests that some subprime lenders and other industry practitioners have been engaging in predatory practices that leave victims in financial ruin.

Home mortgage and consumer advocate groups agree that predatory lending is a problem, but it's hard to find consensus on the definition of the practice, and what should be done to halt its existence. Some say that predatory lenders are those that seek out and target unsophisticated populations, minorities or consumers in certain age groups to trick them into paying an interest loan that's higher than what they actually qualify for. Others say while such behavior qualifies, simply overcharging people for loans also should fall into the definition of predatory lending. The lack of a clear definition underscores the problem of finding an adequate solution that protects consumers but doesn't restrict access to credit.
Predatory lenders use a variety of techniques in their repertoire, including "flipping," "packing" and "failing down." Flipping refers to repeated refinancing of debt in order to drain a borrower's equity via multiple commissions and charges. Packing is fraudulent non-disclosure, where loan terms or additional charges are financed or added to the transaction without the borrower's consent. Failing down

is the term used for steering a borrower to a loan that's worse for the borrower than other available loans, but more profitable for the lender or broker.

Who Are the Victims?

Due to a number of factors, including the complexity of home mortgage documentation and the lack of a standard definition for predatory practices, there's no definitive data about the number of victims and who they are. But many industry professionals agree that predatory lending most often derives from the subprime market, and in an effort to curb abusive practices, concerned groups have conducted studies to try to understand the market better.

In a study released by HUD in April 2000, "Unequal Burden: Income and Racial Disparities in Subprime Lending in America," key findings show that: subprime loans are three times more likely in low-income neighborhoods than in high-income neighborhoods; subprime loans are five times more likely in black neighborhoods than in white neighborhoods; and homeowners in high-income black areas are twice as likely as homeowners in low-income white areas to have subprime loans. Findings from another, more comprehensive study, "Risk or Race? Racial Disparities and the Subprime Refinance Market," conducted by the Washington, D.C.-based non-profit Center for Community Change (CCC), support the same pattern of racial disparities in subprime lending, but show disparities increasing with higher incomes. The conclusion that some have drawn is that because these groups have heavier concentrations of subprime lending, they're also more likely to be targets of predatory lenders.

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Beyond these studies, anecdotal evidence suggests that the elderly, along with minorities and low- to moderate-income groups, have been victims of abusive practices. According to statistics from the American Housing Survey conducted by the Census Bureau for HUD, as of 2001, 80 percent of the nation's senior citizens owned their own homes, and of those, about 80 percent owned them free and clear. However, the reality that many elderly homeowners are on fixed incomes and have accrued significant amounts of equity in their homes makes them attractive targets for unscrupulous lenders. Jean Davis, a senior litigation attorney for AARP in Washington, D.C., says, "The real calling card of these cases is that whatever egregious terms people have on their loans, uniformly they cannot repay them."

In an effort to tackle the issue head-on, AARP engaged in a four-year legal battle against Irvine, Calif.-based First Alliance Mortgage Company. Negotiated by the Federal Trade Commission (FTC), the case, which alleged First Alliance had charged excessive origination fees, among other things, began in 1998 and ended in a record $60 million settlement for 18,000 borrowers across the country. Davis says, "In this case, there was a script that loan officers were trained to use that was designed to pull the wool over people's eyes. Unlike the typical cases, a lot of the plaintiffs (borrowers) were more sophisticated, educated people who had even asked some of the right questions, but the loan officers were trained to derail the questions."

Searching for Solutions

While defining the problem has presented obstacles for organizations that are

working to develop solutions, a number of initiatives are popping up in the private and government sectors. For example, the California Reinvestment Committee (CRC), a coalition of over 200 non-profit and public agencies, is working toward getting banks to adopt a "referral-up" system. The system would help ensure that loan applicants get the best loan product for which they qualify.

Kevin Stein, associate director of CRC in San Francisco, says, "I think people tend to view predatory lenders as just small operators, and that's certainly part of the story, but we're also concerned with banks and their origination of subprime loans that are disproportionately impacting the elderly, minorities and the low- to moderate-income-level groups. Seven or eight of the top 10 subprime lenders nationally are owned by a bank and have the capacity to make a prime loan to qualified borrowers who come in from the subprime channel, and we think those institutions need referral-up systems in place so that consumers get the loans they deserve regardless of where they live or what they look like."

Moreover, consumer protection laws at the federal and state levels also have been enacted, with varying degrees of success. In 1994, federal legislation called the Homeowner Equity Protection Act (HOEPA) was passed to address deceptive and unfair practices in home-equity lending. A loan is covered by the law if it meets certain thresholds and, if so, requires certain disclosures and prohibits various actions.

Currently under HOEPA, a covered loan is one where the original mortgage on a property has an annual percentage rate (APR) exceeding more than 8 percentage points of the rates in Treasury securities of comparable maturity. For a second mortgage, a covered loan has an APR that exceeds more than 10 percentage points of the rates in Treasury securities of comparable maturity. Another provision of the law states that creditors cannot make loans based on the collateral value of a borrower's property without regard to the ability of repayment.

In addition to HOEPA, many states have passed their own anti-predatory lending statutes. In California, AB 489 is a state program that supplements HOEPA, and lenders in California must comply with the provisions in both the state and federal legislation. Pamela Foley, broker/owner of E.F. Foley & Company in Campbell and chair of C.A.R.'s Real Estate Finance Committee last year when the legislation was pending in Sacramento, says, "Our standpoint is that we believe the marketplace should dictate what rates are appropriate based on the risks of a transaction.

"Beyond that," Foley continues, "the main problem with state law is an interest rate cap. It's capped at 8 percent above a comparable term T-bill and that's an APR calculation. The current T-bill for five years is about 2.53 percent, so your APR can only equal 10.53–that's the interest rate of a loan plus the fees added into it to calculate your annual percentage rate. That's a low threshold–and it applies for both a first mortgage and a second mortgage."

Foley says she's been affected by the law directly. "I've turned down about 20 loans to subprime borrowers since AB 489 was implemented that were small second mortgages that would have violated the terms of the legislation," she shares. Although neither federal nor state laws actually prohibit high-cost lending, they do require certain disclosures and list compliance-violation actions that deter many lenders from making a loan that falls within their parameters. Stein notes, "Most lenders are not even doing HOEPA loans anymore–there's a certain stigma attached to it, and the perception of increased liability because they could be subject to a

lawsuit."
As a result of federal and state anti-predatory-lending laws, industry professionals claim that access to credit is being restricted, while consumer advocates say that there's no solid evidence that home equity loans have decreased. Some predatory lenders are getting around making HOEPA loans simply by structuring the loan in various ways. Davis explains, "HOEPA has done what it set out to do–we don't typically see loans that are above the triggers that much anymore. However, sometimes it's because the lender has buried some stuff that should have been included in the triggers, and that's usually the basis for litigation."

Pending Legislation: Hit or Miss?

One of the pieces of federal legislation related to predatory lending that is pending was introduced in February 2003 by Representative Robert Ney (R-OH). HR 833, called "Responsible Lending Act," lowers the points and fees trigger point from the current HOEPA level, but consumer groups believe it glosses over other, more significant setbacks included in the bill, such as total preemption of all state and local consumer protection provisions, elimination of liability for assignees (buyers of the loan), and limitations on damages for violations.

Roy Green, legislative representative for AARP, says, "Our position is that there should be as strong a federal law as possible, but particularly since most of the legislation we see isn't as comprehensive as we'd like, we don't support federal preemption. States are closer to the problems and are more likely to craft legislation that addresses specific problems in those states."

Other industry professionals have a different perspective, as they believe that the passing of various state laws poses a serious challenge to the free flow of capital. C.A.R. president Toby Bradley says, "We don't support federal preemption at this time–but we do support state preemption over local ordinances.

"In dealing with predatory lending," Bradley continues, "it's really important to make sure that the baby isn't thrown out with the bath water: We want to ensure that we don't make the mistake some other states have made–where if the laws are too strict it makes it impossible for lenders to lend."

John Courson, chairman of Mortgage Bankers Association of America (MBA), adds, "What's happened is that the whole system has become much more difficult and restricted by this patchwork of state laws. We need to have a national, uniform standard–whatever level is appropriate that will protect consumers but also ensure that a free flow of capital can take place."

The issue of preemption is a hot topic at both the federal and state levels. In California, the City of Oakland passed a strong predatory-lending law in October 2001 that was challenged in court by the American Financial Services Association (AFSA). The case went to the Alameda County Superior Court and the judge found that the state law did not preempt the local ordinance; that decision was subsequently appealed by the industry.
An argument was scheduled to be heard in August at the California Court of Appeals about whether the state law preempts the local law. The decision will be pivotal, as the city of Los Angeles, which passed a similar anti-predatory-lending law that is now in litigation, has agreed to be bound by the decision in the Oakland case.

Consumer groups predict that predatory lending problems will be exposed even more in the near future. Borrowers who don't understand that they have adjustable-rate loans will be surprised to see higher rates and others will discover they're locked into onerous pre-payment penalty provisions. However, Norma Garcia, senior attorney at Consumers Union in San Francisco, says professionals in the real estate industry have opportunities to discuss the issue of predatory lending and its consequences with both their clients and lawmakers to raise overall levels of awareness.

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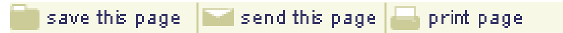

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