



## **Predatory Lending : Predatory Lending Practices**

Taken and abbreviated from ACORN website: <http://www.acorn.org/acorn10/predatorylending/practices.htm>

The reach and effect of abusive practices by predatory lenders have increased along with the dramatic growth of the subprime industry. The following are some of the more common predatory practices.

### **Financing Excessive Fees into Loans**

Predatory lenders often finance huge fees into loans, stripping thousands of dollars in hard-earned equity and racking up additional interest in the future. Borrowers in predatory loans are routinely charged fees of just under 8% of the loan amount in fees, compared to the average 1%-2% assessed by banks to originate loans. Once the paperwork is signed and the rescission period expires, there is no way to get that equity back, and borrowers frequently lose up to \$10,000 or \$15,000 from their home while receiving little, if any, benefit from the refinancing. The damage is compounded at higher interest rates as borrowers often pay tremendous interest costs in the years it takes just to pay down the fees. Typically, the loan fees are kept below 8% in order to stay under the HOEPA fee threshold established by federal law, which would then require additional disclosures to the borrower and additional consumer protections.

### **Charging Higher Interest Rates Than A Borrower's Credit Warrants**

While the higher interest rates charged by subprime lenders are intended to compensate lenders for taking a greater credit risk, too many borrowers are unnecessarily paying higher interest rates. Borrowers with perfect credit are regularly charged interest rates 3 to 6 points higher than the market rates; with some subprime lenders, there simply is no lower rate, no matter how good the credit. According to a rate sheet used by the Associates in the spring of 2000, their lowest interest rate for a borrower with excellent credit and a low loan-to-value ratio was over 10%, and during a similar period Household borrowers with excellent credit were seeing rates above 11%. And for borrowers with imperfect credit, rates are frequently much higher than even somewhat blemished credit would reasonably warrant, as well as for what the industry describes as standard rates for B, C, or D borrowers.

### **Making Loans Without Regard to the Borrower's Ability to Pay**

Some predatory lenders make loans based solely on a homeowner's equity, even when it is obvious that the homeowner will not be able to afford their payments. For mortgage brokers, the motivation to engage in this kind of practice is a short-sighted desire for the fees generated by the loan. Loan officers at mortgage companies may have similar motivations based on earning commissions, regardless of the consequence to the lender for which they work. For some lenders, especially when there is significant equity in a home, the motivation is the ultimate foreclosure on the house which can then be resold for a profit.

### **Prepayment Penalties**

More than two-thirds of subprime loans have prepayment penalties, compared to less than 2% of conventional prime loans. The penalties come due when a borrower pays off their loan early, typically through refinancing or a sale of the house. The penalties remain in force for periods ranging from the first two to five years of the loan, and are often as much as six months interest on the loan. For a \$100,000 loan at 11% interest, this would be over \$5,000.



When a borrower with a prepayment penalty refinances, the amount of the penalty ends up being financed into the new loan. In effect, for borrowers who refinance or sell their houses during the period covered by the prepayment penalty, the penalty functions as an additional and expensive fee on the loan, further robbing them of their equity.

Lenders argue that prepayment penalties protect them against frequent turnover of loans, and that as a result of the higher rates which investors are willing to pay for loans with prepayment penalties, they are able to charge borrowers lower interest rates. The truth is, however, that very large, and apparently quite predictable, numbers of borrowers in subprime loans do refinance within the period covered by the prepayment penalty and may well end up paying more in the penalty than they “saved” even if their interest rate was reduced. It is particularly pernicious when prepayment penalties keep borrowers trapped in the all too common situation of paying interest rates higher than they should be.

Another particularly damaging instance of prepayment penalties is when they are combined with an adjustable rate loan. Borrowers are sold a loan with a starting rate which lasts for two or three years and which then rises dramatically. When, faced with the new higher interest rate, they look to refinance, they find that they will have to pay a prepayment penalty.

Borrowers are frequently unaware that their loans contain a prepayment penalty. Lenders’ agents simply fail to point it out, or they are deliberately misleading, telling borrowers that they can refinance to a lower rate later, while neglecting to inform them of the prepayment penalty which will be charged if they do so. Many borrowers are misled in this way even when they have been presented with the legally required disclosure. This and other crucial documents are easy to miss in the mounds of paperwork involved in closing a loan.

Prepayment penalties on subprime loans thus too often have the effect of keeping people tied to a lender which overcharged them, and certainly prevent people who establish and maintain improved credit from moving to a better loan. It makes no sense to penalize borrowers in subprime loans who are doing the right thing and paying their loans on time.

### **Loans for Over 100% Loan to Value**

Some lenders regularly make loans for considerably more than a borrower’s home is worth with the specific intents of maximizing their debt and thus their payments, and trapping them as customers for an extended period. Even borrowers with excellent credit have no way to escape from a high rate loan if they are ‘upside down’ and owe more than their home is worth. Borrowers are frequently unaware that they owe much more than their homes are worth, and even more frequently unaware of the consequences.

A single mother bought a house for her three kids and soon started receiving solicitations to refinance her debts from a lender. When she eventually agreed to do so, her loan amount was inflated to \$156,000 – compared to the house’s value of \$145,000 – by well over \$12,000 in financed fees and a financed single premium credit life insurance policy for \$3,491. Her interest rate jumped to 12.2%, and she was locked into the high rate with a five-year prepayment penalty of nearly \$10,000, which she was never told about. Now she is prevented from refinancing out of her high interest rate of 12.2% – compared to the variable interest rate of around 7% on her previous first mortgage – because her loan is for more than her house is worth, plus she has a five year prepayment penalty for nearly \$10,000.

### **Home Improvement Scams**

Some home improvement contractors deliberately target their marketing efforts to lower income neighborhoods where homes are in most need of repairs, and where the owners are unable to pay for the service. The contractor tells the homeowner that they will arrange for the financing to pay for the work



and refers the homeowner to a specific broker or lender, even driving them to the lender's or broker's office. Sometimes the contractor begins the work before the loan is closed, so that even if the homeowner has second thoughts about taking the loan, they are forced into it in order to pay for the work. The lender may then make the payments directly to the contractor, which means that the homeowner has no control over the quality of the work. As a result, the work may not be done properly or even at all, but the homeowner is still stuck with a high-interest, high fee loan.

Allowing for the loan proceeds to go directly to the contractor for work that has not been completed often also leads to problems for those homeowners who seek out contractors rather than being solicited by them.

### **Single Premium Credit Insurance**

Credit insurance is insurance linked to a specific debt or loan which will pay off that particular debt if the borrower loses the ability to pay either because of sickness (credit health insurance), death (credit life insurance), or losing their job (credit unemployment insurance). It is rarely promoted in the 'A' lending world, but it has been aggressively and deceptively sold in 'single premium' form in connection with higher cost loans, and then financed into the home loans, costing borrowers equity in their homes, and forcing them to pay interest on the insurance premium for 30 years.

With 'single premium' policies, instead of making regular monthly, quarterly, or annual payments as people do with other insurance policies, the credit insurance is paid in one lump sum payment, which may be as high or even higher than \$10,000, especially if borrowers are sold multiple forms of credit insurance, as is frequently the case. This premium is then financed into the loan, increasing the loan amount (and since the loan amount is higher, the lender's origination fees also increase), and the borrower must then pay monthly interest on the amount of the insurance premium. While the coverage on a single premium policy usually lasts for only 5 years, the borrower pays for it, and pays interest on it, over the 30 years of the home loan. Typically, single premium credit insurance policies cost four to five times as much as monthly-paid credit insurance and over ten times as much as term life insurance policies, and of course the cost of these alternative products are not staked against the borrowers home.

There is widespread agreement that financing single premium credit insurance into mortgage loans is abusive and illegitimate. Fannie Mae and Freddie Mac both refuse to purchase loans that include financed credit insurance. Last year's HUD/Treasury report on predatory lending recommended that the financing of single premium credit insurance policies be banned on all home loans. The Federal Reserve Board has issued a proposed regulation that would count single premium credit insurance premiums as 'points and fees' for the purposes of the federal Home Ownership Equity Protection Act (HOEPA). The Consumer Federation of America calls financed single premium credit insurance "the worst insurance rip-off in the country."

In recognition of the widespread opposition to this predatory product, and in response to massive pressure from community organizations and advocates, many large lenders, including Citigroup and Household Finance, have agreed to stop selling financed single premium credit insurance policies.

### **Balloon Payments**

Mortgages with balloon payments are arranged so that after making a certain number of regular payments (often five or seven years worth, sometimes 15), the borrower must pay off the remaining loan balance in its entirety, in one "balloon payment." About ten percent of subprime loans have balloon payments.

There are specific circumstances where balloon payments make sense for some borrowers in loans at "A" rates, but for most borrowers in subprime loans they are extremely harmful. Balloon mortgages,



especially when combined with high interest rates, make it more difficult for borrowers to build equity in their home. After paying for some number of years on the loan, with the bulk of the payments going, as they do in the early years of a loan, to the interest, homeowners with balloon mortgages are forced to refinance in order to make the balloon payment. They incur the additional costs of points and fees on a new loan, and they must start all over again paying mostly interest on a new loan, with another extended period, usually thirty years, until their home is paid for.

In addition, many borrowers are unaware that their loan has a balloon payment, that their monthly payments are essentially only paying interest and not reducing their principal, and that the balloon will ultimately force them to refinance.

### **Negative Amortization**

In a negatively amortized loan, the borrower's payment does not cover all of the interest due, much less any principal. The result is that despite regularly making the required monthly payment, the borrower's loan balance increases every month and they lose, rather than build, equity. Many borrowers are not aware that they have a negative amortization loan and don't find out until they call the lender to inquire why their loan balance keeps going up. Predatory lenders use negative amortization to sell the borrower on the low payment, without making it clear that this payment will cause the principal to rise rather than fall.

### **Loan Flipping**

Flipping is a practice in which a lender, often through high-pressure or deceptive sales tactics, encourages repeated refinancing by existing customers and tacks on thousands of dollars in additional fees or other charges each time. Some lenders will intentionally start borrowers with a loan at a higher interest rate, so that the lender can then refinance the loan to a slightly lower rate and charge additional fees to the borrower. This kind of multiple refinancing is never beneficial to the borrower and results in the further loss of equity. Flipping can also take place when competing lenders refinance the same borrowers repeatedly, promising benefits each time which are not delivered or which are outweighed by the additional costs of the loan.

### **Property Flipping**

Property flipping is an elaborate scam in which unsuspecting first-time homebuyers are sold houses in serious states of disrepair for prices far above what the houses are actually worth.

The typical "property flip" begins with an investor or real estate company purchasing a distressed property for as little as a couple of thousand dollars. After doing minimal cosmetic or even no work to the property, the owner finds a buyer, frequently targeting low-income, minority families. The buyers have no agent representation of their own and no real estate knowledge, putting them at the mercy of the seller/owner. The seller/owner abuses this position by lying about the condition of the house, promising to make visibly-needed repairs, setting the sales price at far above the property's actual value, and referring the buyer to a subprime lender or broker.

Many subprime lenders will only make a purchase loan if the loan is for 80% or less of the value of the property. In these instances, the property seller uses a number of schemes in order for it to appear that the buyer has the required down payment of 20% or more. The seller first sets the sales price far above what the property is actually worth, then the seller falsifies the buyer's deposit and will often create a second mortgage, which exists on paper only. The key to the scam is having a lender or broker that will utilize appraisers who will support the property's inflated sales price. In exchange for their participation, the



lender or broker is compensated by the fees and additional charges on the loan, which are often excessive.

Buying one's first house is often a major milestone in life and an important step towards achieving economic self-sufficiency, but the swindlers involved in property flipping have made the experience one of the worst things to ever happen to their victims. While there are no hard numbers about how many families have been victimized by property flipping, the problem reached epidemic proportions in many cities before the authorities were even aware that a problem existed.

### **Aggressive and Deceptive Marketing – The Use of Live Checks in the Mail**

Much of the competition between lenders in the subprime industry is not based on the rates or terms offered by the different lenders, but on which lender can reach and “hook” the borrower first. Predatory lenders employ a sophisticated combination of “high tech” and “high touch” methods, using of multiple lists and detailed research to identify particularly susceptible borrowers (minority, low-income, and elderly homeowner) and then mailing, phoning, and even visiting the potential borrowers in their homes to encourage them to take out a loan.

One of the methods used routinely and successfully by predatory lenders such as Household is the practice of sending “live checks” in the mail to target homeowners. The checks are usually for several thousand dollars and the cashing or depositing of the check means the borrower is entering into a loan agreement with the lender. The appeal of the checks is that are a fast and easy way for a homeowner to obtain cash.

This initial loan is just an entry point into the financial life of the homeowner. The loan has an artificially high interest rate and monthly payment, in order for the predatory lender to be able to offer the homeowner an opportunity to refinance it, along with other debts, into another loan. The predatory lender's ultimate goal is to get the homeowner to refinance their first mortgage with them.

### **Yield Spread Premiums**

A yield spread premium is compensation from a lender to a mortgage broker for the broker's success in getting the borrower to accept a higher interest rate or more fees than the lender would have given the borrower at their standard or “par” rate. Yield spread premiums create an obvious incentive for brokers to make loans with the highest interest rates and fees possible, regardless of whether the borrower could qualify for better terms.