Understanding Predatory Lending: Moving Towards a Common Definition and Workable Solutions

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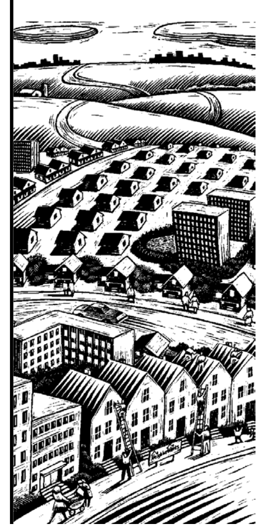

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Understanding Predatory Lending:
Moving Towards a Common Definition and Workable Solutions

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Abstract

To date, various parties have used the term "predatory lending" to describe a wide range of abuses. Regulators, industry and advocates have not agreed on a single definition, but have used the term individually to refer to different practices and loan terms. This paper describes predatory lending as a set of loan terms and practices that falls between appropriate risk-based pricing by subprime lenders and blatant fraud. Thus, all subprime lending is not predatory, but typically relies on risk-based pricing to serve borrowers who cannot obtain credit in the prime market. The higher degree of risk associated with subprime borrowers requires a higher cost for a subprime loan. At the other end of the spectrum, cases of blatant fraud are predatory, but less common and can generally be combated with current criminal statutes. The most difficult cases are those in which loan terms seem out of line with standard prices. In particular, high-cost loans coupled with unscrupulous practices that pressure a borrower into a loan are predatory. The paper sets forth three potential regulatory and legislative solutions that may address the issue of predatory lending.

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Executive Summary

To date, various parties have used the term "predatory lending" to describe a wide range of abuses. Regulators, industry and advocates have not agreed to a single definition, but have used the term individually to refer to different practices and loan terms. Predatory lending describes a set of loan terms and practices that fall between appropriate risk-based pricing by subprime lenders and blatant fraud. All subprime lending is not predatory, but typically relies on risk-based pricing to serve borrowers who cannot obtain credit in the prime market. The higher degree of risk associated with subprime borrowers requires a higher cost for a subprime loan. At the other end of the spectrum, cases of blatant fraud are predatory, but less common and can generally be combated with current criminal statutes. The most difficult cases are those in which loan terms seem out of line with standard prices. In particular, high-cost loans coupled with unscrupulous practices that pressure a borrower into a loan are predatory. The best determinates for whether a loan is predatory are:

- The form and context in which the lender provided or withheld information from prospective borrowers;
- Ability of the borrower to freely choose not to take the loan or to choose from competing products;
- Whether the lender targeted a vulnerable population or protected class;
- Intentional or systematic patterns of selling over-priced loans to populations whose mental, physical or intellectual status makes them vulnerable to the lenders' sales tactics.

Continuum of Predatory Lending

Subprime Lending ⟹ **Obscured Information & Pressure** ⟹ **Hidden Information** ⟹ **Fraud**

In order to address the problem of predatory lending, involved parties must combine a number of approaches to both prevent predatory practices and better assist consumers as they make financial choices. First, legislators can restrict the most obvious predatory practices. Because it is so challenging to agree on what specific practices are predatory, it has been difficult to devise restrictions at the federal level. Some states have passed limits on loan terms, but states' power to regulate lending is constrained by federal law. Nationally, the broader power of the Federal Trade Commission Act, which prohibits unfair and deceptive trade practices, and the Equal Credit Opportunity Act, which forbids discrimination on the basis of race or age, may be a more successful response to predatory practices.

In general, current federal legislation focuses on communicating information to borrowers, in order to help them make informed choices about financial products. Unfortunately, consumers are often not able to use the available information to their advantage. In many cases, they do not understand financial transactions, or lack confidence about financial issues. Consumers are also likely to underestimate the risks associated with mortgage loans, despite the information they receive from the lender. Legislation could be improved to provide information about loan transactions in a more clear, comprehensive and meaningful way to the consumer. In addition, consumer education should be used to teach potential borrowers about financial issues and empower them to make sound financial choices.

Finally, the subprime market needs to develop more standardized approaches and products that efficiently assess and allocate credit. As more conventional lenders provide mortgage loans to lower-quality- credit borrowers, and the government-sponsored secondary-market intermediaries provide competitively priced options, subprime borrowers will be less likely to resort to the products

promoted by predatory lenders. Borrowers often turn to high-cost loans because they have a narrow set of products from which to choose. Current financial regulations should be refined to monitor mortgage markets and highlight predatory practices. In addition, they can act to encourage investment and involvement in underserved markets that are most vulnerable to predatory lenders.

In order to accomplish these goals, advocates, regulators and industry members should build a support infrastructure that shares information and works toward helping consumers. Increased communication between local groups and state or federal regulators can help monitor predatory practices. Partnerships between industry and advocates can provide educational programs, counseling services and financial products to borrowers. Finally, each group can share resources and knowledge of the issue in order to better understand predatory lending and solutions to the needs of consumers.

Remedies for Abusive Terms and Practices

Statute	**The Depository Institutions Deregulation and Monetary Control Act**	**Alternative Mortgage Transaction Parity Act**	**Equal Credit Opportunity Act**	**Fair Trade Commission Act**	**Fair Credit Reporting Act**	**Fair Debt Collection Practices Act**
Remedy For			Targeting minorities	Upselling, collection	Collection	Collection
Weakness	Limits state regulatory power.	Limits state regulatory power.			No provision against failure to report credit history.	

Remedies for Information Gaps

Statute	**Truth in Lending Act (Fair Trade Commission Act)**	**Home Ownership and Equity Protection Act**	**Real Estate Settlement Procedures Act**
Remedy For	Failure to disclose terms: itemizing, fees, credit insurance, traps, structuring practices.	Failure to disclose terms; loan terms; loan structure for high-cost mortgages.	Failure to disclose closing costs; fees for services not provided.
Weakness	Complete disclosure not required.	Rate triggers may be too high. Does not limit cost of fees.	

Introduction

As the rate of home ownership increases at a rapid pace, reaching a record 66.7 percent of Americans in the first quarter of 1999, public awareness has grown of unscrupulous lenders seeking to profit from a thriving market. Home-equity fraud and abuse have become increasing problems that have caught the attention of government agencies, consumer advocates and housing groups. They threaten policies that encourage home ownership and have disastrous consequences for victims.

Mortgage scams and home-equity fraud have drawn increased attention in the early 1990s. Enforcement action in Massachusetts and a Congressional hearing resulted in legislation that regulated "high-cost loans" in 1994. Since 1995, additional research, a second hearing before Congress, and heightened press coverage have highlighted the problems and made them major concerns for government, community groups and the financial industry.

"Predatory lending" has become shorthand for describing a variety of practices that may be disadvantageous to the borrower. While predatory lending has come to encompass lending practices such as payday loans and check cashing, the phrase will be discussed in this paper in terms of home-equity lending. Loans become predatory when they target a particular population, take advantage of the borrower's inexperience and lack of information, manipulate a borrower into a loan the borrower cannot afford to pay, or defraud the borrower or investor. Often these tactics are directed at a particular population, most frequently the elderly and low-income minorities, that is viewed as more vulnerable to predatory practices.

It is difficult to know the extent of predatory lending for several reasons. Consumers may not be aware that they have received an unfairly priced loan or have been preyed upon in some way, or they may not report incidents to regulators. Because many nonbank lenders are not required to report data, it is also difficult for regulators to track questionable lenders themselves. In addition, because there is no single definition of predatory lending, it has been difficult to create an accurate assessment of the problem.

A recent study by Freddie Mac suggested that 10 to 35 percent of subprime loans were actually A-loans and could have been served in prime market at lower cost (Freddie Mac 1996). The California Consumers Union estimates that the 1997 cases in Los Angeles alone amounted to $300 million in losses for homeowners and investors (Garcia-Paz 1998). Legal Aid attorneys and consumer-advocacy groups have pointed to rising caseloads as an indicator that predatory lending is on the rise. Some Boston community groups see as many as 80-100 clients a year who are threatened by foreclosure. For one such group, over a third of their clients were over the age of 65 (Nathan 1999). It is unclear, however, whether these estimates capture the extent of predatory lending. Other factors, such as growth in the housing market or increased consumer awareness of how to handle lending abuses may also play a role.

Predatory Lending

Predatory lending tends to target homeowners who are equity-rich in order to offer them high-cost mortgages with their homes as security. Some predatory lenders focus on particularly vulnerable populations, such as low- and moderate- income, minority, or elderly homeowners. The loans are predatory because they prey on borrowers' inexperience and lack of information to manipulate them into loans that they cannot afford to repay or with terms that are significantly less advantageous than a loan for which the borrowers are qualified.

To date, various parties have used the term "predatory lending" to describe a wide range of abuses. Regulators, industry and advocates have not agreed to a single definition, but have used the term individually to refer to different practices and loan terms. Predatory lending seems to describe a set of activities and loans that fall along a continuum between subprime lending and fraud (Exhibit 1). At one end, all subprime lending is not predatory lending. The subprime market uses risk-based pricing to serve borrowers who cannot obtain credit in the prime market. At the other end, the most obviously predatory lenders blatantly defraud the borrower by forging their name on loan documents, having them sign blank loan papers, misrepresenting the borrower's income or debt level in loan records, or deceiving customers about the terms of the loan.

Exhibit 1: Continuum of Predatory Lending

Subprime Lending ⇨ Obscured Information & Pressure ⇨ Hidden Information ⇨ Fraud

It is difficult to establish which loans in between risk-based subprime loans and blatant fraud are predatory. Two aspects of the loan are important: the terms of the loan and the practices of the lender. Often, the lender will augment the loan with extra costs to the borrower, including excessive fees and commissions, prepayment penalties, high balloon payments, pay structures that result in negative amortization, or high-cost credit insurance. It is often hard to judge when the terms of a loan are excessive and inappropriate, given the credit-risk characteristics of the loan. The industry lacks uniform and clear risk-pricing models, though with the advent of automated underwriting, the industry is beginning to move in this direction.

Lenders may also use pressure tactics to convince the borrower to consolidate mortgage and consumer debt, or to take out a second mortgage to lower the borrower's current mortgage costs or to undertake home improvements. Again, the difficulty here is gauging the intent of both parties and the circumstances surrounding the transaction. Many homeowners take out second mortgages to consolidate their debt for good reason, or borrow against their equity to improve their homes. Lenders may also structure the loan in a way that is disadvantageous to the borrower, often without the full knowledge and understanding of the customer. Though disadvantageous, these structures may not be predatory unless the lender pressures the client, hides information or targets a protected class. Coupled together, the abusive practices and unfair loan terms determine the predatory nature of the loan, but also make it difficult to identify and measure what exactly is predatory and what is not.

Subprime Lending

Subprime lenders offer credit to A- and-below borrowers (Exhibit 2). In the past, most subprime lenders relied on low loan-to-value (LTV) ratios and charged higher rates and fees than a lender would for an "A-credit" loan in order to compensate for risk. Subprime lenders today are more willing to make loans at high LTV ratios. In either case, the increased risk justifies lenders charging 1.5 percent to 4 percent more for providing credit (Muolo 1996).

Exhibit 2: Criteria for Loan Rankings

Grade	Payments Late 30 Days	Bankruptcy Filing
Prime (A)	None	None
A-	Less than 2	None in 5 years
B	Less than 4	None in 3 years
C	Less than 6	None in 2 years
D	Constantly late	None in 1 year

Source: Kalser and Novak 1997.

Risk and cost differ between subprime and conventional loans for a number of reasons. The willingness of subprime lenders to take these risks can be beneficial for borrowers who cannot obtain credit at prime rates. It is when the cost of credit for a borrower is not related to these costs and risks that a loan becomes predatory. A subprime lender may spend more than three times the amount a conventional lender spends to service its loans. This is due to different servicing practices, such as more frequent calls to the borrower, or invoices rather than payment coupons (Muolo 1996). Subprime lenders also assess risk differently than conventional lenders. They may not use credit scoring, or may use less-standardized risk models. Some subprime lenders make what are called "story loans," also sometimes characterized as "capacity-based lending." Rather than use credit scoring, the lender would listen to the applicant and "determine if their trouble was a one-time problem or indicative of a history of inability to pay debt." (Cocheo 1996). Finally, secondary-market investors require higher returns from the subprime loans they securitize.

All of these practices have become either less common or more standardized in the past two to three years. Subprime lenders who sell their loans tend to use some risk-assessment model, and story loans have become a smaller part of the market. Servicing practices like the invoice, on the other hand, have become common in both traditional and subprime markets. As the subprime industry becomes increasingly standardized, the risk and cost of subprime loans will decrease.

Loans with higher interest rates than those seen in the conventional market may not be predatory. They may be based on the higher risk and cost associated with subprime lending. These loans are an appropriate and necessary response to the needs of borrowers who cannot qualify for prime loans from traditional lenders. Even among nonpredatory subprime lenders, interest rates and fees may vary for the same borrower. This is because lenders have different cost structures and capacities to accurately evaluate credit risk. Thus, it is difficult to tell whether the loan fees and rates reflect predatory practices or differences in cost.

Fraud

The most extreme cases of predatory lending involve blatant fraud of the borrower or the investor. A study conducted for Freddie Mac reveals that of 44,665 cases of financial-institution fraud reported in 1996, 3.2 percent involved mortgage-loan fraud. However, mortgage-loan fraud accounted for 12.9 percent of dollar losses in the same period (Walczak 1997). Homeowners and investors are usually defrauded in one of the two following ways:

Home-Improvement Fraud: Individuals or companies may take advantage of the borrower at the beginning of a loan transaction through home-improvement offers. A home-improvement contractor may also act as a mortgage broker or lender, offering a loan to finance home repairs, but fail to make its role as a broker understood to the borrower, or offer poor loan terms. The loan will then be immediately assigned to a lender, an arrangement that has been made in advance (NCLC 1998). In some instances, the contractor may derive a fee from the bank for brokering a loan with high rates. Other contractors may pay a fee to the bank in order to complete a loan that will bring a higher sum to the contractor than the repair work is worth. Pressure tactics may be employed to convince the borrower to purchase a product, such as bringing the lender to the borrower's home the same day to complete a loan application. Some banks may be willing to transfer funds directly to the contractor, before work on the home is begun, in contrast to public programs, which do not allow loan funds to be dispersed directly to the contractor. The contractor may do shoddy work, or fail to complete the repair, but already have the payment. In some cases, the repair work has been known to lower the value of the home or make it unlivable.

Case Study 1: Home-Improvement Fraud and High-Pressure Tactics

Janet G. is a single mother who cares for a partially disabled adult son. She works as a dishwasher making $5 an hour. A thermal-window salesman telephoned her to offer replacement windows for a home she was originally gifted. During a visit to her home, when Janet said she could not afford the windows due to credit debt, the salesman called a lending company and obtained approval for a loan that would pay off all of Janet's debts. The closing was held at a McDonald's, where the lender brought two employees and their attorney to close the loan. Janet did not learn the monthly payment until the closing. She felt she had to sign the loan, because she had already agreed to purchase the windows. The loan included a 10-point origination fee, and the windows cost $8,500.

Source: Rutland West NHS.

False Information: Another common fraud tactic is to forge signatures on loan documents, lie about the borrower's income or backdate documents. The Mortgage Asset Research Institute estimates that in 1993 and 1994, 59 percent of mortgage fraud involved falsifying application information (Walczak 1997). One former loan officer of a finance company has stated that his office included a resident forger, and that forging information was a regular part of business. In many cases, forgery has been committed without the knowledge of the borrower. When the borrower later threatens to take action, some lenders have been able to convince the borrower that the borrower will go to jail for fraud if the borrower brings the loan to the attention of enforcement officials.

When Loans Become Predatory

In between legitimate subprime lending and blatant fraud are loans that have terms that appear to be unfair to the borrower, but may or may not be predatory. The practices of the lender may give a good indication of whether the loan is abusive. In particular, the following factors can help to place the loan on the continuum:

1. Did the borrower have full knowledge and understanding of the terms of the loan? Or, did the lender obscure information about the loan?
2. Did the borrower feel that the borrower could cancel the loan transaction? Or did the lender apply pressure to keep the borrower from exiting?
3. Does the lender have a pattern of targeting a vulnerable population or protected class for the purpose of making high-cost loans?
4. Did the lender know, or should the lender have known, that the borrower could not afford the loan? Or did the lender make the loan based on the value of the asset, without regard for the borrower's ability to pay?

Unfair Loan Terms.

Predatory lenders go beyond risk-based pricing, and, instead, set loan terms high above what they need to offset costs and earn a return that compensates for their risk. This is done through high interest rates, high points or origination fees and additions to the loan. While many of the loan terms listed below may not be predatory on their own, the failure of the lender to disclose to the borrower the risk or cost associated with each individual term can make the loan package more problematic, especially if the borrower is unaware that better terms are available from other lenders. Many of these terms may not be fraudulent, unethical or prohibited by law, but thrive because there is a lack of competition in the marketplace and lack of information for consumers. Predatory loan terms can include:

- High Interest Rates: Lenders take advantage of the borrower's lack of information to charge an interest rate far above market rates. Although it is necessary to charge a higher rate for higher risk, some predatory lenders charge rates that do not correlate with risk. They are able to do so because the borrower is unable to judge what the rate should be, either because the information is unavailable or other loan products are not available for comparison.

- Fees: In some cases, a mortgage broker may take fees up-front and fail to lower the interest rate, not basing the cost on risk, but, instead, taking advantage of an unknowing customer. Costs and fees may also be set in excess of market value in order to increase the annual percentage rate. Examples include $350 for document preparation or fees in excess of the legal requirement for recording documents at the local courthouse. Fees which are blatantly fraudulent may include charging the borrower for an appraisal when a drive-by was conducted, or for fees for brokers the borrower has never met (Brennan 1998).

Case Study 2: Falsifying Income

In Chicago, one lender recorded a client' income at $9,900 a month, including rental income and employment. The borrower's real income was $1,100 a month. A lender in New York City recorded one elderly woman's employment as babysitter, despite the irregularity of this work. A Portland lender wrote on one borrower's application that she sold her cats for income.

Source: Interviews.

- Credit Insurance: A growing problem is the sale of credit insurance as part of the mortgage loan, particularly when charged as a lump-sum payment or single premium. The single premium requires the borrower to finance the charge and thus pay interest, while also paying more for the insurance. Critics charge that the insurance is unnecessary and rarely pays off to the insured. Revenue from credit insurance is high, and one ex-broker for a predatory company testified before the Senate that salesmen were heavily encouraged to tack credit insurance onto loan packages. "Usually, the more naïve the customer, the more insurance I would pack on the loan before I made the initial monthly payment quote." Finance companies may maintain insurance-sales quotas and offer bonuses for employees who exceed a company's goals (Dough 1998).

- "Traps": Predatory lenders also find ways to trap borrowers in loans and force them to refinance or enter into foreclosure. In some cases, borrowers enter into mortgage loans with the assumption that when they have the money or repair their credit, they can pay off the debt and obtain a more-favorable mortgage. The borrower may be unaware of loan terms that will prevent the borrower from doing this. While these terms are legal in most cases, and can be desirable for some borrowers, the failure to disclose the characteristics of the loan or explain the cost associated with the term can harm the borrower.

Common traps include:

- ✓ Negative Amortization: Repayment structure may be set up in such a way that the monthly payment fails to pay off accrued interest and increases the principal balance.
- ✓ Balloon Payments: Balloon payments at the end of the loan often equal about 85 percent of the principal amount.
- ✓ Prepayment Penalties: Lenders may attach high prepayment penalties to prevent the borrower from refinancing or selling the home.
- ✓ High LTV Loans: Loans in excess of 100 percent of loan-to-value (LTV) may also lock the borrower into additional debt. Because a borrower in delinquency may not be able to pay off the debt through a foreclosure sale, once a borrower falls behind in payments, the borrower faces continued debt past the foreclosure or an option to refinance. High LTV loans may at times be a useful product for borrowers, and in fact, some affordable-housing programs use high LTV loans to assist clients. The intent of the lender in offering the product and the borrower's understanding of the consequences of the loan help to clarify whether a particular transaction is predatory.
- ✓ Mandatory arbitration: Loan contracts often contain mandatory, binding-arbitration clauses because lenders perceive this forum to be more favorable to them than the court system. Borrowers also are usually required to help pay for the arbitration.

Source: Brennan 1998

- "Wrapping": Lenders structure second-mortgage and refinancing packages in ways that adversely affect borrowers. The lender may require the borrower to pay off the borrower's purchase-money mortgage and build that cost into a new mortgage with a higher interest rate and principal amount. This is advantageous to the lender, both because the loan becomes larger and also because the new mortgage will still have first-lien status. First-lien status is important because first liens are harder for states to regulate and they have priority for collection in the case of a foreclosure (Interviews).

Case Study 3: Credit Insurance

In 1997, the FTC settled a case against The Money Tree and its president involving the sale of credit-related insurance. The complaint also charged that the company induced consumers to sign statements that they voluntarily chose the required extras. The cost of the credit insurance was not included in the finance charge nor disclosed to the consumer as part of the annual percentage rate, but, instead, included in the amount financed. The final settlement required The Money Tree and its officer to allow customers to cancel the insurance packages and to obtain cash or credit refunds. It also prohibited the company from requiring consumers to sign a statement that their insurance purchase was voluntary. The Money Tree was required to tell consumers their loan applications had been approved before referring to the extras, and to disclose that credit life insurance or auto club memberships were optional.

Source: FTC v. The Money Tree, Inc. and Vance R. Martin (No. C-3735) (F.T.C. Apr. 28, 1997).

Abusive Practices.

The above loan terms alone may not be predatory. In particular, if the borrower is aware of and agrees to the terms, the lender may be providing an important service for that borrower. The degree to which the lender obscures information from the consumer or pressures the consumer into agreement increases the predatory nature of the transaction. Additionally, the aggressive targeting of vulnerable individuals or a protected class, often referred to as "reverse redlining," suggests that the lender intends to take advantage of consumers. Some of the ways lenders prey on consumers include:

- **Pressure tactics:** The lender may fail to explain the terms of the loan until closing. The borrower will think the borrower is agreeing to a certain level of monthly payment, but find a much higher payment on the actual loan documents. Often, the borrower will be made to feel it is too late to back out of the loan. Either the borrower has already agreed to purchase a home-improvement product, or is confronted with fraudulent information on the documents and threatened. In some cases, the lender will reassure the customer that the payment will be reduced or the loan will be refinanced after an initial period.

- **Obscuring information:** Brokers may bury the cost of the loan in pages of documentation, and discourage the borrower from reading the agreement. Brokers may avoid giving the borrower a copy of the documents. The broker may place his or her arms over the document in order to hide the actual terms from the borrower during a meeting. Some borrowers have said when they asked what would happen if they missed a payment, the broker laughed and said, "we'll take your house," as if the response were a joke, rather than a serious consequence.

- **"Upselling":** Predatory sales practices push customers into the most-profitable products for the lender. A company uses a small loan, such as a check voucher mailed to the customer or a retail-sales installment loan, to obtain information about the new customer. Following the first transaction, the finance company can obtain information about the customer's credit history, employment, income, home ownership status and debts. A branch employee then contacts the customer, with the goal of converting the small loan into a personal or home-equity loan (Dough 1998).

- **Loan consolidation:** The lender may pressure the borrower to consolidate the borrower's credit and mortgage debt, without disclosing the risks and costs of the consolidation. Borrowers may not realize that this could lengthen the amount of time it takes to pay off credit debt, or that previously unsecured debt is now secured by the borrower's home (Brennan 1998).

- **Collection:** Lenders may employ abusive collection tactics to prevent customers from seeking recourse. Some lenders call frequently, even at night, to request payment, and in some cases send late payment notices or call when a payment plan has already been created. Lenders may also threaten to immediately evict the borrower, with the knowledge that foreclosure and eviction will actually take longer than threatened (Brennan 1998).

- **"Flipping":** Another common practice after the loan is "flipping," where the finance company convinces the customer to refinance the customer's current loan. Some branch managers have been told to target "blue collar" workers and current customers who are delinquent on their loan payments for "flipping." Another target has been personal-loan customers, whose terms have less than six months remaining, and those who owe less than 50 percent of the original principal balance on their loans. Each loan conversion or renewal results in a charge to the consumer and profit to the finance company (Dough 1998).

Case Study 4: Flipping

Jon K., age 54, lives in Vermont and his medical bills average $1,800 a month. He is responsible for $300 a month and his only income is Social Security Disability. Jon refinanced his mortgage with two lenders, who in turn sold the loan to a third lender. This company then refinanced the loan. A loan that was $88,000 became $96,000 in eight months, and included $4,600 in points. Jon now has a housing debt of 60 percent.

Source: Rutland West NHS

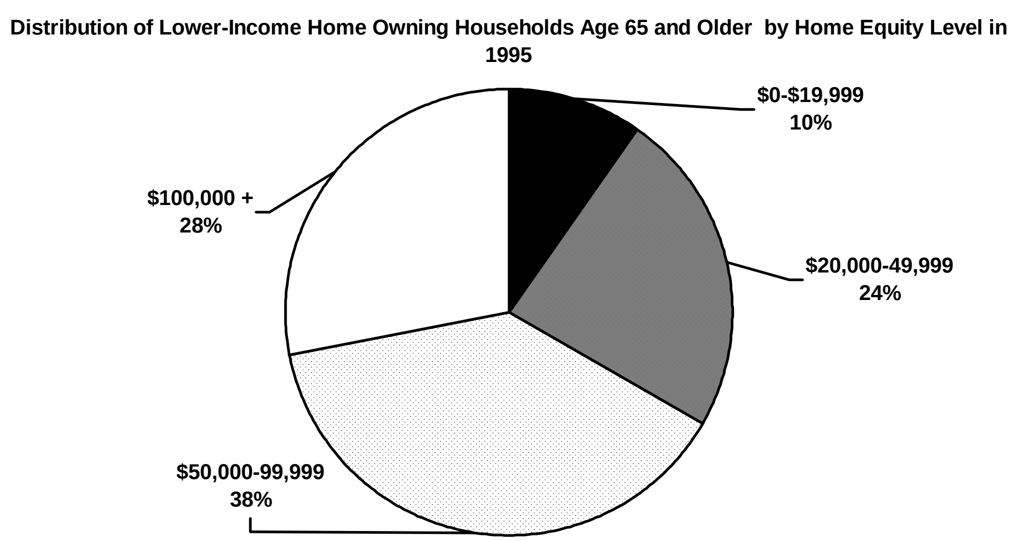
Reverse Redlining.

Many advocates are also concerned that certain lenders are targeting specific vulnerable or protected groups. This suggests that borrowers may be targeted for subprime products based on factors other than the quality of their credit. Legal advocates have found that predatory lenders target elderly homeowners who have a high level of equity in their home. Brokers may drive through a neighborhood looking for older homes or purchase lists from credit-reporting agencies of elderly homeowners who have recent debts (focus group, 1999). Recent cases have also charged lenders with targeting low-income minorities.

Older homeowners are a target for predatory lenders because they have substantial equity in their homes, significant needs for money, and are underserved by conventional sources. Increase in housing prices in the past five years and savings accumulated by paying down the mortgage give elderly homeowners, who have presumably owned their homes longer, considerable equity. Recent data provide evidence why elderly homeowners have become a key target market for home-equity lenders. Exhibit 3 shows two-thirds of elderly households that own homes had $50,000 or more in home equity in 1995. Given increases in home values in the late 1990s, it can be assumed that elderly households have even more home equity today. According to the 1995 Survey of Consumer Finances, half of those age 65 or older held 59 percent or more of their wealth in home equity (Joint Center 1997). Thirty-three percent of owner-occupied units with an elderly householder have less than $20,000 outstanding in mortgage principal on their homes (Exhibit 4). Thirty-one percent have less than eight years remaining on their mortgage (Exhibit 5).

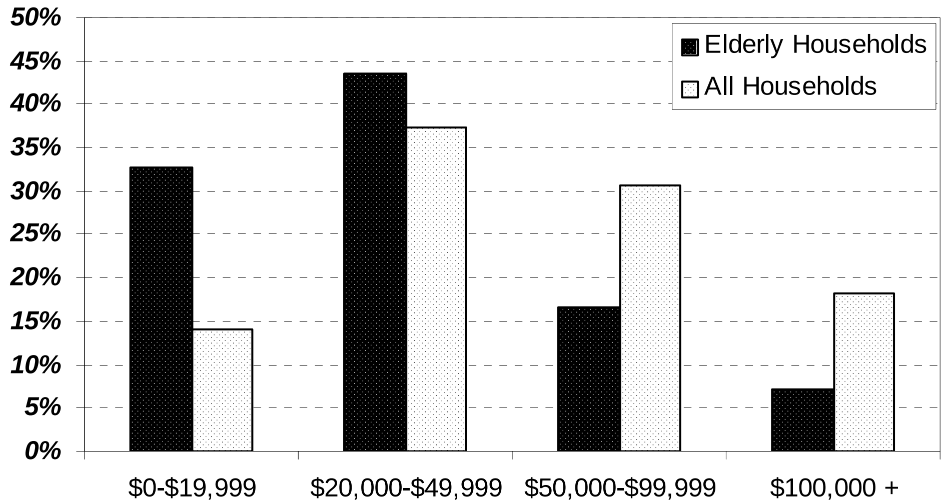
Exhibit 3: Home Equity Held By Age of Householder

Source: Tabulations of the 1995 Survey of Consumer Finances by the Joint Center for Housing Studies. Home equity is value of primary



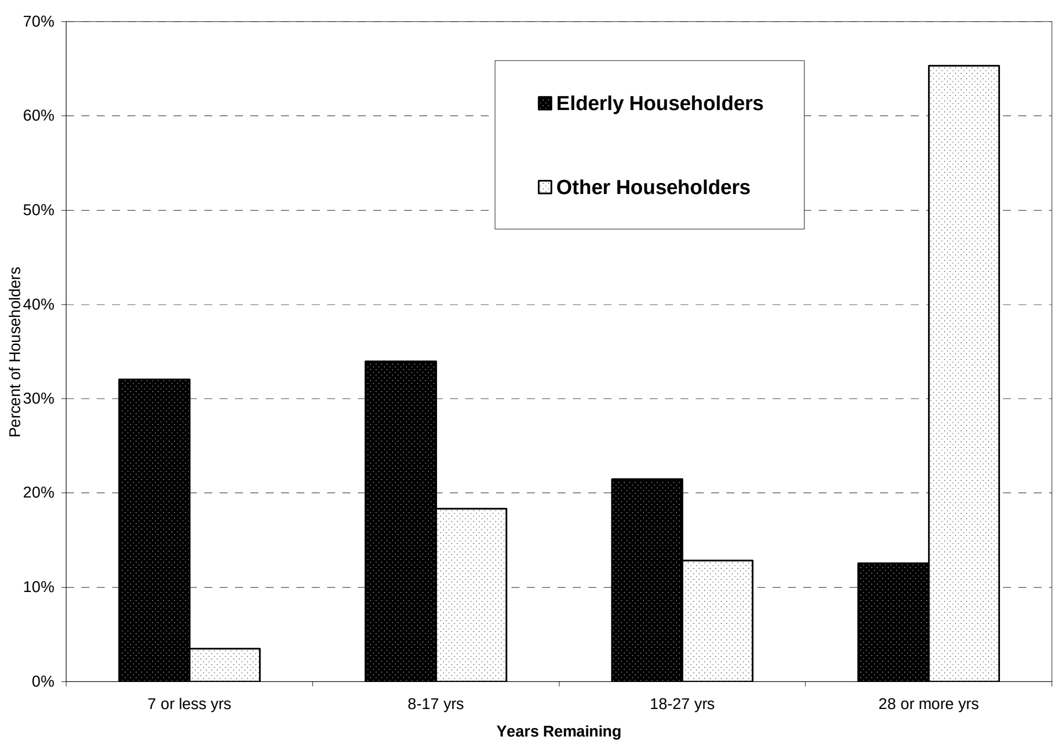
residence less mortgage debt. Income less than 80 percent of area median.

Exhibit 4: Outstanding Principal Amount by Age



Source: Tabulations of 1995 American Housing Survey

Exhibit 5: Years Remaining on Mortgage by Age



Source: Tabulations of 1995 American Housing Survey

Elderly homeowners may need to access equity in their homes for home improvements, medical expenses, or support of a family member. The 1995 American Housing Survey estimates that approximately half of all homeowners age 65 and older had repairs or maintenance work performed on their homes during a two-year period. Older homeowners are more likely to hire home-improvement contractors than younger homeowners, primarily because elderly homeowners are less likely to do necessary repairs themselves (Exhibit 6). The Joint Center for Housing Studies estimates that less than 12 percent of do-it-yourself repairs are done by homeowners age 65 and older. More than one-quarter of all homeowners is 65 or over, and almost one-third of owners who hire professional remodeling contractors are in this age group. The elderly also spend more than younger households on health care (Exhibit 7). Finally, consumer counselors have cited financial support of a family member as one major reason homeowners borrow against their home (focus group, 1999).

Exhibit 6: Percent Homeowners Hiring Professionals for Repair Work

Any maintenance or repair	**All Ages**	**Under 25**	**26 to 34**	**35 to 44**	**45 to 54**	**55 to 64**	**65 to 74**	**75 and older**
Percent reporting	94%	87%	94%	94%	94%	93%	94%	92%
Median expenditure	$ 1,270	$ 800	$ 1,400	$ 1,800	$ 1,559	$ 1,360	$ 1,000	$ 600
Professional maint/repair								
Percent reporting	39%	27%	34%	39%	40%	43%	41%	39%
Median expenditure	$ 2,240	$ 1,200	$ 2,000	$ 2,425	$ 2,500	$ 2,500	$ 2,100	$ 2,000

Source : Joint Center Tabulations of the 1997 American Housing Survey.

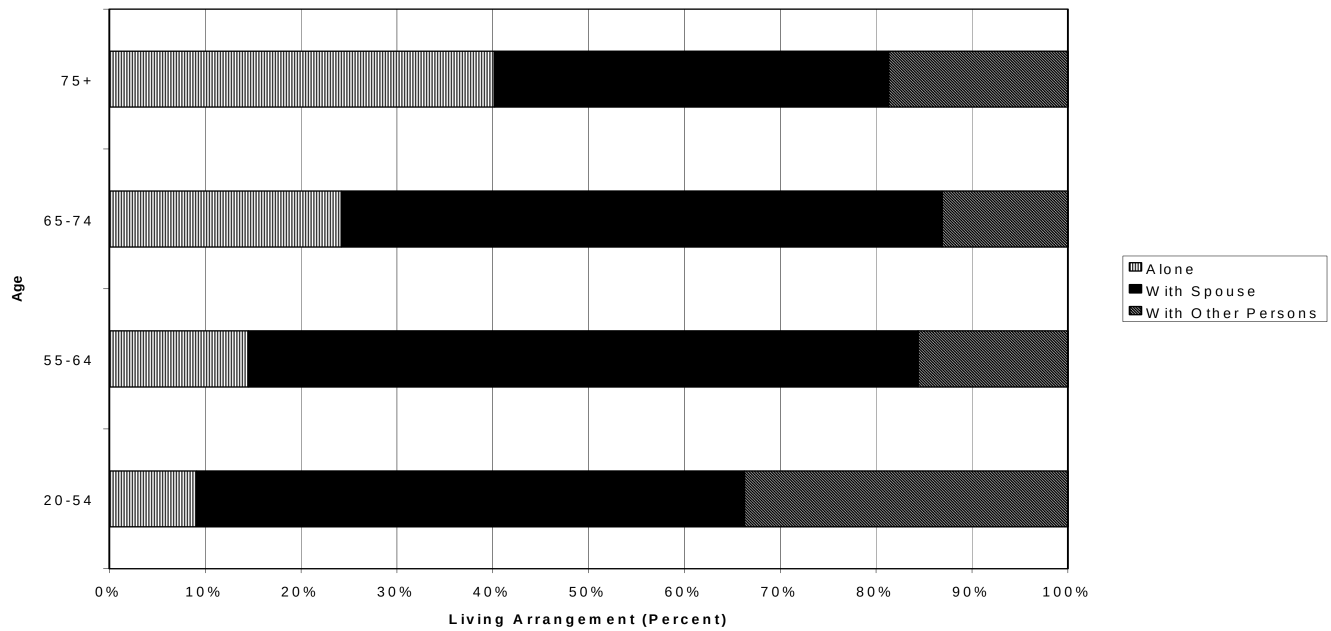
Exhibit 7: Expenditures by Age

Expenditure	**Under 25 years.**	**25 to 34 years.**	**35 to 44 years.**	**45 to 54 years.**	**55 to 64 years.**	**65 years and older.**
Mortgage interest	**$ 306**	**$ 2,211**	**$ 3,385**	**$ 3,201**	**$ 1,719**	**$ 511**
Health care	**$ 465**	**$ 1,096**	**$ 1,609**	**$ 1,850**	**$ 1,909**	**$ 2,647**

Source: U.S. Bureau of Labor Statistics, 1995 Survey of Consumer Expenditures

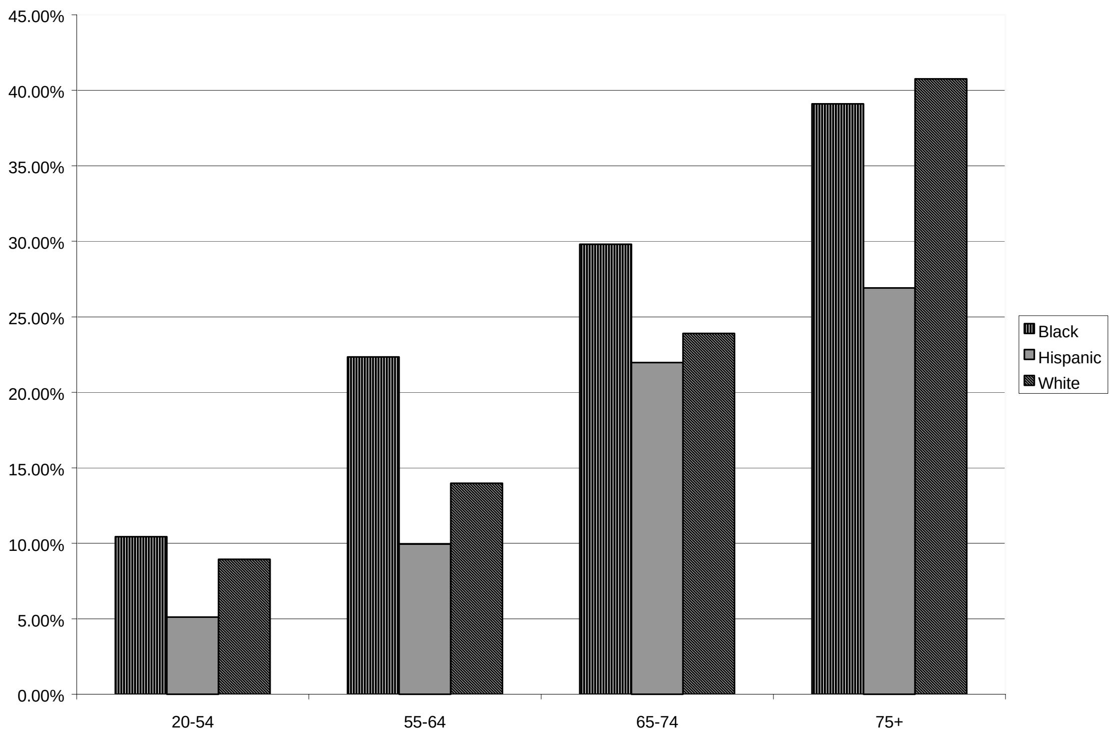
Older homeowners are more susceptible to fraud and high-pressure sales tactics for a number of reasons. First, they are likely to be home during the day when door-to-door salespeople or telemarketers call (Friedman 1992). The enormous population of elderly who live alone or only with a spouse is particularly vulnerable for this reason. This problem is exacerbated for older African Americans, who are more likely to live alone (Exhibits 8 and 9).

Exhibit 8: Living Arrangements by Age



Source: Tabulations of Current Population Survey, March Supplement, 1997

Exhibit 9: Living Alone by Race and



Age

Source: Tabulations of Current Population Survey, March Supplement 1998

Predatory lenders may also target minority populations. The initial impetus for a New York State case against Delta Funding Corporation was the discovery that Delta's business was concentrated in Census tracts where 80 percent were minority residents. In June 1999, New York Attorney General Eliot Spitzer reached an agreement with Delta Funding of Long Island to stop predatory practices. The Attorney General's office originally brought the action under the Equal Credit Opportunity Act (ECOA), 12 U.S.C. §1691, discussed below, charging that the company had made over 1,000 high-interest illegal home loans to low-income, minority residents in Brooklyn and Queens over a three-year period. The Attorney General intended to bring charges that Delta provided loans to people based on the equity in their homes rather than their ability to pay, and that Delta repeatedly refinanced its defaulting borrowers for high fees. Investigators had decided to pursue a civil rights inquiry when maps showing Delta's loan patterns in Brooklyn and Queens matched the largest amount of Delta's business to Census tracts with 80 percent or more minority residents. ECOA does not require the state to show that Delta intentionally concentrated on those neighborhoods, only that its loans disproportionately harmed a minority group (Kennedy 1999).

Available Remedies

Three approaches have generally been proposed to combat predatory lending:

1. Restricting the terms and practices of lenders;
2. Increasing the amount of information available to borrowers; and
3. Encouraging traditional lenders and government-sponsored enterprises to enter the subprime market.

No one approach suffices to solve the problem. The first, restricting the terms and practices of lenders, is challenging because of the difficulty of agreeing on what is predatory. While some blatantly predatory practices can be limited, other tactics are necessary to address those practices that may be problematic. The second approach, increasing the amount of information available to borrowers, can partially help to address this gap. However, some lenders or brokers may find ways to obfuscate information or get around disclosure requirements. In addition, this approach assumes that borrowers respond rationally to information about their loans. A third approach would be to encourage traditional lenders and government-sponsored enterprises to enter the subprime market. Underserved populations often turn to predatory loans because of the absence of other options. Increased competition would offer consumers both better choices and better information about available loan products. Finally, any approach requires better communication and shared information among regulators, advocates, industry and consumers. Each group should be empowered to respond to new information and thus encourage appropriate mortgage products, while discouraging unethical practices.

Solution 1: Regulate Terms and Practices of Predatory Lenders

Some states have attempted to regulate specific loan terms at the state level, with the most prominent legislative changes taking place in North Carolina and New York. Federal rules, however, limit the ability of states to take this approach. Because it has been difficult for legislators and their constituents to agree on exactly what terms and practices are predatory, this approach may have limited success in other states or at the federal level. Further, regulators and some consumer groups may fear that once they designate ceilings on loan terms, those ceilings become the norm for all lenders. An alternative approach might target a broader set of abusive practices, and respond in particular to civil rights violations by predatory lenders.

Exhibit 10: Remedies for Abusive Terms and Practices

Statute	The Depository Institutions Deregulation and Monetary Control Act	Alternative Mortgage Transaction Parity Act	Equal Credit Opportunity Act	Fair Trade Commission Act	Fair Credit Reporting Act	Fair Debt Collection Practices Act
Remedy For			Targeting minorities	Upselling, Collection	Collection	Collection
Weakness	Limits state regulatory power.	Limits state regulatory power.			No provision against failure to re-port credit history.	

State Legislation.

In North Carolina, recent state legislation limits terms associated with "high-cost" loans. "High-cost" loans are defined as loans that either charge an interest rate more than 10 percent above Treasury bill rates, or where points and fees exceed 5 percent of the loan amount (legitimate fees to third parties, such as for appraisals or title insurance, are not included). Such loans cannot include balloon payments, negative amortization, prepayment fees or the financing of fees. The financing of upfront, single-premium credit insurance is also prohibited, while monthly-payment credit insurance is permitted. In addition to the limits on terms, borrowers who take out high-cost mortgages must also receive home-ownership counseling. Lenders are also prohibited from making a "high-cost" mortgage loan if the borrower's debt-to-income ratio exceeds 50 percent (Collins 1999).

New York legislators recently proposed a bill that would limit broker fees paid by borrowers or lenders to 3 percent of the loan amount (Timmons 1999). Governor George Pataki proposed a regulation similar to that recently passed in North Carolina (Fraser 1999). This bill, however, does not include a ban on single-premium credit insurance and allows financing 50 percent of eligible fees (while 100 percent of fee-financing is prohibited in North Carolina).

Restrictions on State Legislative Solutions.

Although North Carolina has passed recent regulations on loan terms and New York is considering similar action, deregulation of the mortgage market in the 1980s has limited the ability of states to regulate unfair loan terms. The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980, 12 U.S.C. §1735 (1994), preempts state usury ceilings on any "federally related mortgage loan" secured by a first lien on residential real estate. The statute allowed states to opt out of the usury preemption within a certain period of time, and 16 states did so.[1] Congress passed the legislation out of concern that, at the time, interest rates were so high that state usury ceilings prevented mortgage transactions at market rates in some states (Forrester 1994).

Critics believe, however, that the provisions were too broad and thus invited unscrupulous practices. According to a ruling by the U.S. Court of Appeals for the Third Circuit, federal pre-emption on loans secured by a first lien is not limited to loans made for the purchase of a home, but refers to any first lien. This allows some home-equity lenders to turn their loans into first liens, by requiring the homeowner to pay off existing mortgages with the new high-rate home-equity loan (Forrester 1994). In addition, many states followed federal deregulation of first liens by removing rate caps and other restrictions on other types of home lending (NCLC 1998).

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[1] For a list of states that opted out, see Frank S. Alexander. 1993. Federal Intervention in Real Estate Finance: Preemption and Federal Common Law. *71 N.C. L. REV. 293, 315.*

In 1983, a second law, the Alternative Mortgage Transaction Parity Act (AMTPA), 12 U.S.C. §3800, similarly pre-empted state laws that restrict alternative mortgage financing arrangements, including balloon payments, negative amortizing loans, and variable- rate loans. AMTPA is also not restricted to purchase-money loans, but applies to any "loan or credit sale secured by an interest in residential real estate property." Thus, it goes beyond the scope of DIDMCA, which only applies to first liens. Critics have suggested either amending AMTPA to limit it to first and second liens primarily for the acquisition or construction of a residence, or with a refinance structure that offers a more favorable rate to the borrower, or repealing the pre-emption laws altogether.

Alternative Legislative Remedies.

This approach raises another fear that legislators will only be able to address the most extreme predatory practices, or fail to reach agreement at all in other state forums or at the national level. The Fair Trade Commission has been one of many regulatory organizations that has recently reacted to a broader scope of abusive practices in the subprime market by addressing the acts of specific lenders (Baer 1998). Its enabling legislation, the Federal Trade Commission Act, 15 U.S.C. §45, allows the FTC to file a complaint against a company that engages in unfair and deceptive trade practices. The FTC considers violations of the Truth in Lending Act (TILA), discussed below, to be unfair and deceptive trade practices.

An FTC suit against Capital City Mortgage[2] in January 1998 included several counts of unfair and deceptive trade practices. The complaint alleged six violations of the FTC Act, including misrepresentation of loan terms and collection of money for false purposes. For example, Capital City allegedly represented to borrowers that there would be only a slight difference between a loan payment on an existing loan and a new loan that consolidated the old loan and new funds, when the new payment, in fact, was both much higher and exceeded the borrower's monthly income. Violations of the Truth in Lending Act included failing to identify the creditor, failing to disclose the annual percentage rate, failing to disclose the payment schedule (including the balloon payment), and overstating the amount financed.

[2] FTC v. Capital City Mortgage Corp., et al. Civ. No. 98-237 (D.D.C.)

Two additional pieces of legislation can help to counteract abusive collection practices. The Fair Credit Reporting Act (FCRA), 15 U.S.C. §1681, requires credit-reporting agencies to report accurate and complete information to creditors. It also requires creditors to inform the consumer if his or her application for credit has been denied. One major weakness of FCRA is that it does not require creditors to report when a customer does pay their debts on time, which may prevent subprime borrowers from improving their credit history. The Fair Debt Collection Practices Act (FDCPA), 15 U.S.C. §1692, prohibits certain abusive, deceptive and unfair debt-collection practices for personal, family and household debts. It limits the hours during which debt collectors may contact debtors, requires debt collectors to identify themselves when they contact the borrower, and prohibits any harassment or abusive contact.

Responses to Reverse Redlining.

Regulators have responded to charges of reverse redlining at both the federal and state levels. The Equal Credit Opportunity Act (ECOA), 12 U.S.C. §1691, has been the basis of the Federal Trade Commission (FTC) suit against Capital City Mortgage and the New York state suit against the Delta Funding Corporation for targeting vulnerable or protected populations in the sale of high-cost loans. ECOA prohibits discrimination against an applicant for any credit transaction. It includes a prohibition against discrimination on the basis of age. The act also requires that within 30 days of adverse action on a credit application, the creditor must inform the applicant of the action and provide a statement of reason. The creditor must also supply a copy of the appraisal report used, upon request of the applicant.

The FTC complaint filed in January 1998 against Capital City Mortgage charged several violations of ECOA. Allegations included failure to take a written application for credit, failure to record information about the applicants' race, sex, marital status and age, and failure to provide applicants with either written notification of adverse action (the principal reasons for the action taken), or the name of the federal agency that administers compliance with ECOA. During the same year, the Fair Housing Council of Greater Washington filed racketeering charges under the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C 1962(c), 1962(d), and 1964(c), against Capital City, and included ECOA allegations in the complaint.[3] The complaint charges that Capital City specifically targeted its advertising towards African Americans in Washington, DC, and concentrated its business in predominately African-American Census tracts. Capital City allegedly sent flyers through brokers with contacts in the African-American community and promised commissions in return for new loans.

Solution 2: Increase Information Available to Consumers

To date, most federal regulations seek to increase the information available to consumers. In this way, consumers can shop for the most advantageous loan products, forcing more-costly lenders out of the market. Because information is often provided to consumers in a confusing format, consumers either do not understand the information or do not respond rationally to the information they have. Increased education coupled with improvements on the presentation of information to consumers might be one answer to this problem.

Exhibit 11: Remedies for Information Gaps

Statute	**Truth in Lending Act (Fair Trade Commission Act)**	**Home Ownership and Equity Protection Act**	**Real Estate Settlement Procedures Act**
Remedy For	Failure to disclose terms: itemizing, fees, credit insurance, traps, structuring practices.	Failure to disclose terms; loan terms; loan structure for high-cost mortgages.	Failure to disclose closing costs; fees for services not provided.
Weakness	Complete disclosure not required.	Rate triggers may be too high. Does not limit cost of fees.	

Current Information for Consumers.

Enacted in 1968 and 1974, respectively, the Truth in Lending Act (TILA), 15 U.S.C. §1601, and Real Estate Settlement Procedures Act (RESPA), 12 U.S.C. §2601, are designed to provide information to consumers about the cost of credit during the transaction process. The goal of both laws is to help consumers shop for mortgage loans by comparing various disclosures and estimates. TILA requires disclosures about the cost and terms of consumer credit, including both closed- and open-end credit for personal, family or household purposes. Under the act, the lender must provide the finance charge, the annual percentage rate (A.P.R.) , the amount financed, and the total of payments. Under RESPA, any transaction involving a "federally related mortgage loan" must include a disclosure of the costs of settlement services based on estimates after a consumer applies for credit and again through a settlement statement at closing. RESPA also

[3] Complaint for Plaintiff. Fair Housing Council of Greater Washington Inc. v. Capital City Mortgage Corp., (D.D.C.).

requires disclosure of aspects of the mortgage-servicing process, including initial and annual escrow account statements and notices of the transfer of servicing.

In addition, each law contains consumer protections regarding the transactions and their costs. RESPA prohibits certain practices that add to settlement costs, such as, for example, adding fees for services not provided or requiring the borrower to obtain title insurance from a particular title company. TILA offers a three-day right of rescission for loans secured by the consumer's primary home from when the consumer becomes obligated on the loan. This does not apply to home-purchase loans.

The FTC complaint against The Money Tree in 1997 alleged that, in violation of the Truth in Lending Act, the company had required consumers to purchase some combination of credit insurance, accident insurance or automobile club membership. The cost of these extras was not included in the finance charge nor disclosed to the consumer as part of the annual percentage rate, but, instead, was included in the amount financed. The second count of the complaint charged that the company induced consumers to sign statements that they voluntarily chose the required extras. The FTC also considered this practice an unfair and deceptive trade practice.

There has been a great deal of debate in recent years over reform of both TILA and RESPA. In 1996, the Federal Reserve Board and Department of Housing and Urban Development were asked to promulgate regulations that simplified and improved the disclosure requirements under each law. By the following year, the agencies concluded that such changes required legislation. Consequently, they issued a joint report of their recommendations and Congressional hearings were held in September 1998. Key recommendations include expanding the A.P.R. to include all of the costs the consumer must pay for credit and adding the interest rate as a new disclosure. HUD also recommended that consumers be provided guarantees about credit costs earlier in the application process. While consumer groups endorse HUD's proposal, industry has proposed a guaranteed "closing-costs package" instead of guarantees of the rates. Both agencies also propose tightening limits on good-faith estimates of closing costs.

Increased Disclosure for High-Cost Loans.

Federal legislation currently requires stricter disclosure for very-high-cost loans, but critics have charged that many predatory loans fall outside federal parameters, and that federal rules do not restrict the terms of the loan. The Home Ownership and Equity Protection Act (HOEPA), 15 U.S.C. §1602, a 1994 amendment to the Truth in Lending Act (TILA), 15 U.S.C. §1601, provides restrictions on the terms of "high-cost mortgages" and requires special disclosure for such loans. "High-cost mortgages" are defined in the legislation as closed-end loans that are not used for acquisition or construction, and that have an annual percentage rate (A.P.R.) exceeding 10 percentage points above the rate on comparable-maturity Treasury securities. "High-cost loans" also include those with upfront fees and points exceeding the greater of $400 or 8 percent of the total loan amount.

HOEPA requires a disclosure form to accompany high-cost loans that says the borrower does not need to complete the transaction and warns that the borrower could lose his or her home through failure to comply with loan terms. The form must state the A.P.R. and monthly payment for fixed-rate loans, or that the rate can increase and cite the maximum monthly payment for a variable-rate loan. Disclosure must be provided three days before consummation of the loan. Loans are prohibited from containing certain prepayment penalties, points on loan amounts refinanced, default interest rates above the rate prior to default, balloon payments, negative amortization, or consolidated prepayment of more than two of the regular payments. In addition, assignees of "high-cost mortgages" were made subject to all claims and defenses that could be raised against the original lender. Discretionary regulatory authority went to the Federal Reserve, while attorneys general have authority to enforce the regulation (S. Rep. No. 103-169)

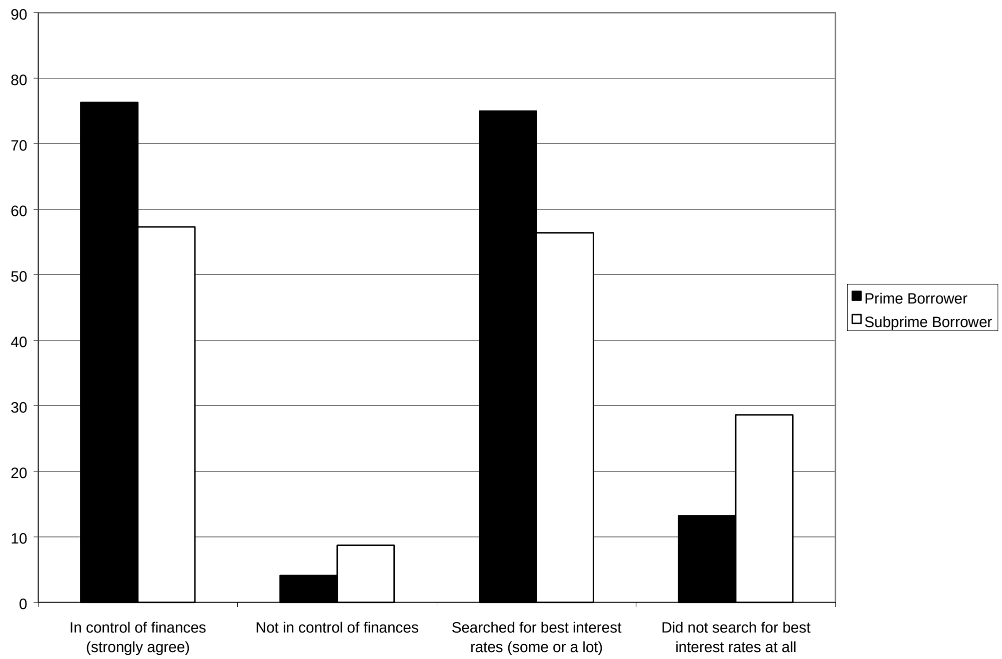
Critics have charged that the HOEPA interest-rate trigger is set too high and allows abusive lenders to use the rate as a ceiling, setting their high-cost loans just below HOEPA limits. In addition, HOEPA fails to limit the amount lenders can charge in fees and other upfront costs as part of a high-cost loan. Advocates suggest two approaches to fill the gaps in HOEPA. The National Consumer Law Center proposes a graduated set of triggers that would reach "very-high-cost loans" and "high-cost loans" through similarly graduated regulations (NCLC 1998). The North Carolina bill, discussed above, applies the HOEPA interest-rate trigger, but adopts a tighter fee trigger and limits terms of high-cost loans.

Consumer Knowledge and Confidence.

Providing information about the cost of credit does not assist consumers who are typically uninformed about credit options and unfamiliar with the complications of financial transactions. For example, a study by the Consumer Federation of America found that while over 70 percent of those surveyed knew what the letters APR stood for, only half understood their significance as an indicator of the cost of credit (NCLC 1993)

A recent survey by Freddie Mac compared prime and subprime borrowers' knowledge of and confidence on financial issues. While 76.3 percent of prime borrowers strongly agreed that they were in control of their finances, only 57.3 percent of subprime borrowers felt the same. 8.7 percent of subprime borrowers felt they were not in control of their finances, compared to 4.1 percent of prime borrowers. 75 percent of prime borrowers said they searched for the best interest rates either some or a lot, while only 56.4 percent of subprime borrowers did. 28.6 percent of subprime borrowers said they did not search at all, compared to 13.2 percent of prime borrowers (Exhibit 12) (Freddie Mac 1997).

Exhibit 12: Consumer Knowledge and Confidence



Source: Freddie Mac 1997.

Biases Influence the Decisions of Consumers

Even if consumers are well informed, they may not respond to credit options by making rational choices. Recent scholars have argued that cognitive biases influence the decisions of consumers, and that manufacturers reinforce these biases in the sales of their products (Hanson and Kysar 1999.). Julia Forrester has pointed out how cognitive biases influence consumer decisions in the home-mortgage market. For example, behavioral studies have shown that people underestimate the occurrence of some low-probability, high-loss events. The loss of a home to foreclosure is one such event. Forrester suggests that people may underestimate foreclosure risk due to the "availability" heuristic. People will view an event as probable if the event is easy to imagine or remember. Because foreclosure is rare and not very public, homeowners are unfamiliar with the event and underestimate its likelihood. People also tend to make judgments in reference to a starting point, a heuristic called "anchoring." Thus, even when new information is available, people are biased towards their original view. Thus, says Forrester, if the homeowner made payments on time in the past, they may underestimate the risk of foreclosure by a new loan, even if they are taking on new financial burdens or facing growing financial needs. Researchers have also found that people believe that negative events happen to others, not themselves, calling this tendency "unrealistic optimism." Finally, researchers have found that the more control an individual feels they have in avoiding a risk, the more optimistic she or he is about the risk of harm (Forrester 1999).

All of these heuristics are recognized by lenders and explain the draw of loan products. A recent study by the television news program *20/20* showed car-sales tactics, where the borrower was told of an initial payment plan and then offered a higher interest rate when the documents were ready to be signed. Advocates have pointed out the same tactic among predatory lenders, who might first offer one loan package, but attach extras or use a higher interest rate later in the process. This tactic takes advantage of the "anchoring tendency," because the borrower has already concluded the debt is affordable. The borrower may be more willing to overlook indicators that the loan is more expensive than it first appeared, and the borrower’s reluctance to restart the application process elsewhere only encourages this view. A broker who jokes with his clients about the risks of a mortgage may intentionally encourage the borrower's belief that foreclosure is unrealistic, almost ridiculous, when a high-cost mortgage really poses a serious risk to the borrower. Finally, predatory lenders often sell their products as a way for consumers to gain control over their debts. This plays on the tendency to be overly optimistic about events over which one has control. Borrowers may believe that because they are paying off debts over which they have lost control, by making what appear to be small payments than can pay over time, they are better off. But the risk attached to unsecured debt actually may have less-serious consequences than the risk they take on with a mortgage, that they may lose the home to foreclosure.

Consumer Education.

Because of the difficulty of understanding mortgage issues and the tendency of consumers to underestimate risk, education must accompany the information provided by lenders. Lenders must be made aware of the necessity of educating consumers about the real cost of a loan, because it is the lender who has the most-immediate contact with the borrower. Even if a borrower is in need of capital immediately, the lender should make the cost of the loan clear enough that the borrower can compare options and make sound choices. More generally, consumers should be empowered to make financial choices and recognize the risks of any credit transaction. Learning to say no to credit solicitations or to back out of a loan during the three-day, right-of-rescission period must be part of any consumer-education program. In addition, consumers should be made aware of common scams and where consumers can turn for assistance if they think they have been defrauded.

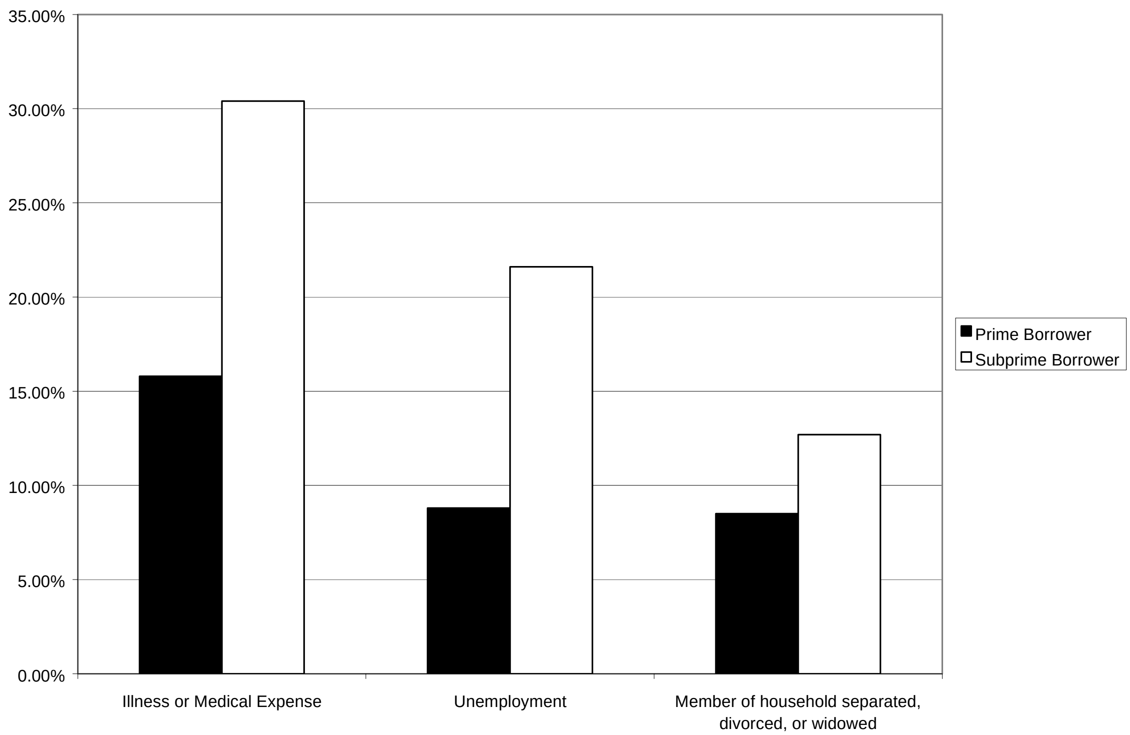
Solution 3: Increase the Involvement of Traditional Lenders and Government-Sponsored Enterprises (GSEs) in Subprime Markets

Curbing home-equity abuse requires that borrowers have better options available than the predatory loans they encounter. Homeowners may recognize the high cost of their mortgage, but agree to the terms because they are unaware of other options. This problem is exacerbated because subprime borrowers are more likely to need capital quickly, as a response to a sudden life change. It is important to recognize that predatory lenders have been successful in part because they offer loans to traditionally underserved communities.

One way to achieve this goal would be to better use mortgage data to monitor the industry, highlight discriminatory practices, and encourage more standardized and advantageous lending. Currently, regulators do not always receive the right kind of information to be able to evaluate the loan products or lending patterns of questionable lenders.

A recent survey by Freddie Mac suggests that borrowers in the subprime market are more likely to have experienced a recent major life disruption. Borrowers facing an emergency or a drastic change may be forced to turn to costly loans to meet their needs quickly, or may develop a blemished credit history as a result of borrowing associated with the disruption. According to the study, subprime borrowers were more likely than prime borrowers to have had a member of the household suffer a major illness, have a large medical expense, go through a spell of unemployment, and have a change in family structure (Exhibit 13). While the data do not reveal which borrowers might have received predatory loans, they show the effect sudden life changes can have on a borrower's credit status.

Exhibit 13: Life Disruptions of Prime and Subprime Borrowers

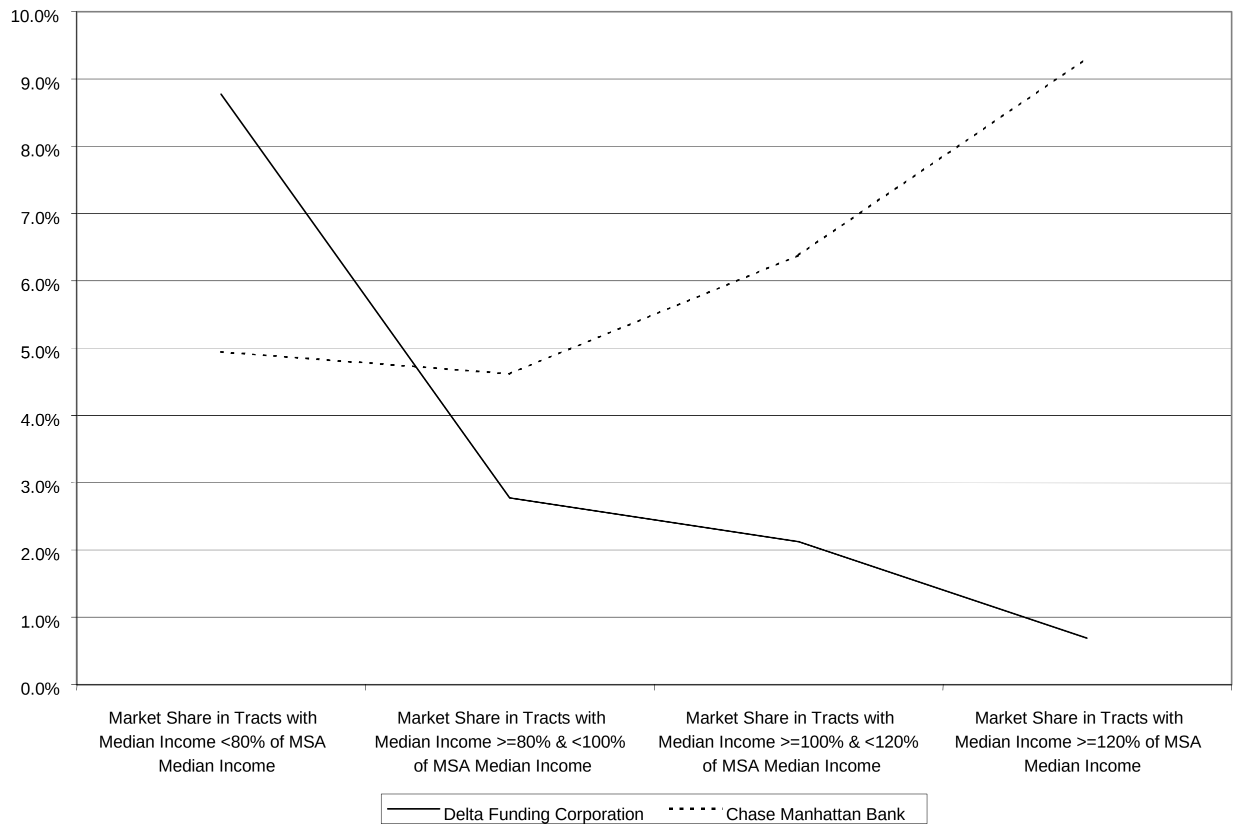


Source: Freddie Mac 1997.

The consumers who need funds the most and are most vulnerable to predatory tactics may be the same consumers who cannot obtain loans from the conventional market. A comparison of refinancing loan patterns of major lenders in the New York metropolitan area (MSA) reveals that predatory lenders may thrive where consumers have limited options. New York was chosen because of the state's recent settlement with the Delta Funding Corporation over predatory practices. The top 25 lenders in the MSA were listed by market share, and then sorted by market share in aggregated Census tracts where the median income was below 80 percent of the MSA median income, between 80 percent and 100 percent of the MSA median income, between 100 percent and 120 percent of the MSA median income, or above 120 percent of the MSA median income (A full table of the results is included in the Appendix).

Exhibit 14 compares the market share of Delta Funding to that of Chase Manhattan Bank, which has the largest market share overall in the MSA. While Delta Funding has the largest market share in low- and moderate-income tracts by far, it is virtually absent in higher-income census tracts, where Chase Manhattan dominates. In addition, Chase Manhattan possesses a much smaller market share in lower-income tracts than in higher-income tracts. These patterns hold when additional lenders are included in the analysis. It shows that Delta thrived where there were a lack of alternatives for consumers.

Exhibit 14: Market Share in New York Metropolitan Area (MSA) by Census Tract and Median Income



Source: Tabulations of FFEIC Data

Information Available to Advocates and Regulators.

The Home Mortgage Disclosure Act (HMDA) of 1975, 12 U.S.C. §2801, requires most federally regulated banks, savings and loans and credit unions to report annually the number and dollar amount of mortgage loans they make by Census tract in all metropolitan areas. Depository institutions with more than $29 million in assets or non-depository lenders with assets over $10 million in assets must report. Other for-profit institutions, such as mortgage companies, must report if their loan originations equal or exceed 10 percent of their total loan originations and they conduct business in an MSA. Reporting institutions must also collect information about the race, gender, income and final disposition of each mortgage loan application (FFIEC 1998).

HMDA has not proven effective in tracking information about predatory lending for three reasons. First, many institutions guilty of predatory practices are not required to report. Home-equity lenders may not collect deposits, and their volume of loans may be too small to require reporting. In addition, depository institutions with no first-lien, home-purchase loans on one-to-four family dwellings or non-depository institutions whose home-purchase loans account for less than 10 percent of their loan originations are exempt from HMDA (FFIEC 1998). Second, some mortgage companies and banks fail to report the racial data on home loans. In particular, racial data are often not collected for home-improvement loans because transactions are often conducted over the telephone. If the application is not made in person, but over the telephone or Internet, the lender only has to report race if the applicant chooses to supply that information. The Woodstock Institute recently estimated that the percentage of denied loans reported without racial data in Chicago had climbed from 10 percent in 1991 to 42 percent in 1997 (Woodstock 1999). Third, HMDA data do not differentiate between subprime and prime loans. This is because HMDA does not require information about the terms of the loan, including the interest rate. Consequently, the data offer little information about the cost of credit or which loans may have been predatory.

The Community Reinvestment Act (CRA) of 1977, 12 U.S.C. §2901, requires federal banking agencies to evaluate whether federally regulated financial institutions have met the credit needs of the communities in which they are chartered when those institutions apply for depository facilities, such as a new charter or a merger with another regulated financial institution. The CRA performance evaluation conducted by the appropriate federal banking agency is public, and institutions must maintain a file for public comments and other relevant materials. In some cases, CRA may not apply to predatory lenders because the lender is not federally regulated, or the wrongful actor is not the lender but another player in the mortgage process or an affiliate of the bank.

One way CRA can be used is to affect the activities of banks affiliated with predatory lenders. First, advocates argue that some banks are receiving CRA credit for loans by their affiliates or loans they have securitized that may be predatory. For example, in recent testimony before the Senate, Deborah Goldberg of the Center for Community Change, suggested that Bankers Trust, a wholesale bank, may have received CRA credit for loans by Delta Funding, because Bankers Trust acts as a trustee for some of Delta's securitizations (Goldberg 1999). Many other banks may own subsidiary subprime lending institutions that have been accused of predatory practices. Regulators have not yet developed a measure for how to assess the quality of loans by bank affiliates, and only give CRA credit for non-predatory loans.

CRA should be used to encourage traditional lenders to provide good-quality loan products that serve the needs of the elderly and low- and moderate-income borrowers. First, they should provide traditional home-equity loans and refinancing options to those who qualify. They might also pursue alternative products for emergency events, individual savings accounts, and reverse mortgages for the elderly. Where these products are available, lenders should partner with community groups in order to publicize these products and make them accessible for those who are unfamiliar with banking practices and mortgage products.

"Best-practices" agreements between traditional lenders and community groups can be another way for industry to be involved in fighting predatory lending. An excellent example is the recent agreement between the Office of Thrift Supervision and Lehman Brother Holdings Inc. In connection with its acquisition of Delaware Savings Bank, Lehman Brothers agreed to guard against predatory pricing practices. To that end, the company committed to adopting policies and procedures to identify predatory pricing practices by its clients and to continuing due-diligence procedures that might identify such practices (OTS 1999).

Finally, traditional lenders and government-sponsored enterprises (GSEs) can create opportunities for lower-quality-credit borrowers to obtain mortgage loans at competitive prices. Their participation would help standardize the subprime market, reducing risk for lenders and isolating predatory loan products that did not conform to industry norms. Department of Justice special-litigation counsel Alexander Ross recently suggested this approach at a conference of mortgage regulators, saying, "Fannie and Freddie will drive the bad guys out and make it safe for the good guys to come in and make that loan." (National Mortgage News 1999).

Additional Needs: Information and Support Infrastructure

Industry, state and federal regulators and community advocates should share information about their knowledge of the predatory lending problem. Each group has depended on its own resources to build up a knowledge base and has limited sources for new information. Local groups need to improve connections with other organizations that interact with the financial industry. Listserves, conferences, and printed materials can each serve to share information with a broad audience and encourage dialogue among widespread groups. Federal agencies and state attorneys general should establish contacts with local groups to better regulate predatory practices, so advocates with their "ears to the ground" can report predatory lenders in a more-expedient manner. This could be accomplished with local hotlines, informational meetings or staff liaisons.

National support organizations can also assist in creating better dialogue between local groups, which can learn from model programs and legislative action in other states. Local groups might partner with state consumer affairs agencies and state banking regulators to share information, develop education programs and collaborate on ideas for regulatory reform.

It is also essential that housing counselors develop relationships with local legal aid societies and bar associations. Staff from each organization might build a “consumer-protection team,” or each organization might partner to offer comprehensive services to clients. Sharing resources and skills will enable each group to resolve individual cases much more quickly and will equip each group with more information. Tracking the contents and results of each organization's casework would help to track the extent of predatory lending and identify patterns over time.

Conclusion

In order to work together on a comprehensive response to predatory lending, concerned groups must agree on a common definition of the problem. Predatory lending may best be characterized as the combination of unfair loan terms and pressure tactics that limit the information or choices available to the borrower, or target a consumer because of the consumer’s perceived vulnerability. Subprime lending is not predatory, but provides an important service to borrowers who cannot obtain loans at prime rates. On the other hand, blatant fraud is an extreme version of predatory lending that is already prohibited by law.

Current regulations already help to contend with some predatory practices. At the state level, some legislatures have passed limits on some of the most blatant predatory lending tactics. These efforts are restricted, however, by federal legislation that pre-empts state regulation of mortgage markets. Nationally, laws that focus on offering information to consumers can help borrowers recognize the costs of various loan products, and may also help combat predatory lending. These laws could be improved by making that information more clear and providing better education to consumers to help them understand financial transactions and choices. It is important, however, to also encourage traditional lenders to become more involved in the subprime market, in order to create more financial choices for subprime borrowers, who are the most vulnerable to predatory practices.

Finally, advocates, regulators and industry members should work together to create solutions that help consumers. By sharing knowledge of the problem and partnering to create programs that draw on a variety of skills, these groups can be successful in improving financial services for vulnerable borrowers.

Appendix Table

1996 HMDA Data Market Share by Census Tract in New York Metropolitan Area (MSA)						
	Total Number of Loans in MSA	Overall Market Share for All Tracts in New York City MSA	Market Share in Tracts with Median Income <80% of MSA Median Income	Market Share in Tracts with Median Income >=80% & <100% of MSA Median Income	Market Share in Tracts with Median Income >=100% & <120% of MSA Median Income	Market Share in Tracts with Median Income >=120% of MSA Median Income
Number of Originated Single-Family, Renovation or Refinancing Loans to Owner-Occupants	78,001	100.0%	7,749	8,297	11,742	50,213
Department of Housing and Urban Development (HUD)	22,188	28.4%	48.7%	37.3%	37.4%	21.8%
Office of Thrift Supervision (OTS)	15,788	20.2%	11.9%	20.2%	18.9%	21.8%
Federal Reserve (FRB)	15,138	19.4%	13.6%	12.7%	15.3%	22.3%
Federal Deposit Insurance Corporation (FDIC)	12,092	15.5%	9.5%	12.3%	13.1%	17.5%
Office of the Comptroller of the Currency (OCC)	11,746	15.1%	15.6%	15.8%	14.1%	15.1%
National Credit Union Administration (NCUA)	1,049	1.3%	0.7%	1.7%	1.3%	1.4%
Total		**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**
Top 25 Lenders in New York-MSA in 1996						
THE CHASE MANHATTAN BANK	6,193	7.9%	4.9%	4.6%	6.4%	9.3%
CITIBANK N.A.	3,838	4.9%	2.7%	3.5%	3.8%	5.8%
DIME SAVINGS BANK OF NY	3,404	4.4%	1.5%	2.7%	2.5%	5.5%
GREEN POINT BANK	2,636	3.4%	4.6%	5.7%	5.1%	2.4%
REPUBLIC CONSUMER LENDING GRP	1,866	2.4%	2.7%	4.8%	2.8%	1.9%
NORWEST MORTGAGE	1,649	2.1%	0.7%	0.9%	1.2%	2.8%
COUNTRYWIDE HOME LOANS	1,502	1.9%	1.5%	2.9%	3.7%	1.4%
DELTA FUNDING CORPORATION	1,505	1.9%	8.8%	2.8%	2.1%	0.7%
MICHAEL STRAUSS	1,327	1.7%	1.0%	0.9%	1.0%	2.1%
ASTORIA FEDERAL SAVINGS	1,318	1.7%	0.7%	1.6%	1.4%	1.9%
MARINE MIDLAND MORTGAGE CORP.	1,262	1.6%	0.9%	1.2%	1.2%	1.9%
BANK OF AMERICA	1,174	1.5%	1.2%	1.8%	1.8%	1.4%
STATEN ISLAND SAVINGS BANK	1,117	1.4%	0.1%	0.4%	1.0%	1.9%
BNY MORTGAGE COMPANY	1,108	1.4%	1.2%	0.9%	1.2%	1.6%
THE MONEY STORE	1,088	1.4%	3.5%	2.3%	2.0%	0.8%
FLEET MORTGAGE CORP.	1,060	1.4%	3.8%	1.1%	1.2%	1.1%
CHAMPION MORTGAGE CO.	1,049	1.3%	1.5%	1.4%	1.5%	1.3%
FIRST FEDERAL SAVINGS AND LOAN	915	1.2%	0.3%	0.5%	0.9%	1.5%
EMIGRANT MORTGAGE COMPANY	889	1.1%	0.5%	0.7%	0.7%	1.4%
HOME SAVINGS OF AMERICA	893	1.1%	0.5%	0.8%	0.6%	1.4%
CHASE MORTGAGE SERVICES INC	885	1.1%	0.7%	0.9%	1.0%	1.3%
INDEPENDENCE SAVINGS BANK	851	1.1%	0.4%	0.6%	0.5%	1.4%
CROSSLAND MORTGAGE CORPORATION	798	1.0%	1.8%	1.9%	1.5%	0.7%
ROOSEVELT SAVINGS BANK	791	1.0%	0.3%	0.3%	0.3%	1.4%
THE LONG ISLAND SAVINGS BANK	773	1.0%	0.6%	1.3%	1.3%	0.9%

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