Lending on Borrowed Time

Melissa Krzywicki

The federal government promotes homeownership as the cornerstone of the "American Dream" because, for many Americans, the home is the only means of building equity, what the owner can use as collateral in a home-secured loan for consumer spending. That home-secured loan carries the risk of foreclosure if the borrower fails to make loan payments. By 2007, the percentage of home-secured loans that became delinquent or in foreclosure hit an all-time high. That mortgage crisis has now spread to the rest of the economy.

Before the current crisis, federal lawmakers put in place mandatory disclosure regulations to educate the consumer about the costs of a home-secured loan and the risk of foreclosure if loan payments are not met. Policymakers assume if borrowers are educated about the price of the loan and the risk of foreclosure, then the borrower will act rationally by choosing a loan carrying the best price and least risk of foreclosure.

The high foreclosure rate shows that, instead of acting in their own self-interest, many borrowers have signed loans carrying unjustifiably excessive price and risk, loans known as "predatory loans." Most often these loans were found in the subprime lending market, the market traditionally serving those deemed as high credit risks. Predatory lenders target and understand what policymakers do not: the subprime home mortgage market.

Traditionally, most mortgage lending was done in the "prime market," where traditional lenders financed their mortgage lending through their customer's deposits. This limited the amount of mortgage lending banks could do. Banks only lent or gave mortgage loans to borrowers with documented credit histories that showed them at low risk of default.

The subprime lending market serves those borrowers who might not meet the standard for receiving loans in the prime market. The borrower's limited loan options may be due to a limited income, poor credit history, or high debt. Subprime lenders compensate for the increased risk by charging the borrower higher interest rates and upfront fees. Subprime lenders target mortgage holders because mortgage holders have the ready equity to pay the upfront fees. In the past decade only a small fraction of these loans have been used to purchase homes.

In about half of all subprime loans, borrowers are not dealing with the funding source itself, but with intermediaries between the borrower and the lender, such as mortgage brokers. The job of a broker includes "counseling borrowers on suitable loan products, assisting with the borrower's application, obtaining credit and employment reports, and performing other necessary origination services."[1]

Borrowers usually pay brokers through a percentage of the total loan amount or other direct fees. Mortgage brokers are under less state and federal regulation than financial institutions, which leads to abusive tactics, such as targeting minority neighborhoods with deceptive sales practices.

The majority of subprime mortgage borrowers live in low-income and/or minority neighborhoods traditionally underserved by federally-supervised lending institutions, such as banks and thrifts. Subprime lenders may "monitor people's credit reports for debt problems, buy lists of delinquent debtors from debt collectors, and drive through neighborhoods looking for decrepit roofs and porches"[2] to target potential borrowers. Lenders use readily available census data to target this demographic.

In February 2008, a Director of the State of New York Banking Department testified at a House Hearing on the subprime mortgage crisis, "…in 2006, residents in minority neighborhoods in New York County, received subprime loans to a rate of 4 to 1, when compared to borrowers from white neighborhoods."[3]

The subprime market first came about when "it became legal"[4] in the early 1980s when the federal government decided to stimulate the economy through home ownership.

Congress passed the Depository Institutions Deregulation and Monetary Control Act (DIDMCA)[5] which deregulated the mortgage market by allowing lenders to preempt state interest rate caps and charge borrowers higher rates and fees. In 1982, the Alternative Mortgage Transaction Parity Act (AMTPA)[6] allowed lenders to use variable interest rates, balloon payments, and the option-adjustable rate mortgages (ARMs).

The explosion of subprime lending came about in the mid-1990s due to securitization of the loans on "the secondary market." Securitization is the

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[1] U.S. Department of Housing and Urban Development: the U.S. Treasury Dep't. *Curbing Predatory Home Mortgage Lending.* Washington, DC: GPO, 2000; <http:huduser.org/publications/hsgfin/curbing.html >: 39.

[2] McCoy, Patricia A. "A Behavioral Analysis of Predatory Lending," 38 *Akron Law Review* 725. 2005.

[3] Azia, Jane M. "Effects of the Subprime Mortgages Crisis in New York City." Testimony before the Subcommittee on Financial Institutions and Consumer Credit, U.S. House of Representatives. Washington, D.C. 11 Feb 2008. <http://www.banking.state.ny.us/sp080211.htm>.

[4] Chomsisengphet, Souphala and Pennington-Cross, Anthony. *The Evolution of the Subprime Mortgage Market*. Federal Reserve Bank of St. Louis *Review*, January/February 2006, 81(1): 38. <http:research.stlouisfed.org/publications/review/06/01/ChomPennCross.pdf >.

[5] Depository Institutions Deregulation and Monetary Control Act of 1980 (P.L. 96-221, 94 STAT. 132).

[6] Alternative Mortgage Transaction Parity Act of 1982 12 U.S.C §3801.

structured finance process in which assets, receivables or financial instruments are acquired, classified into pools, and offered as collateral for third-party investment.[7] By the 1990s, securitization had "already become a major source of funding in the prime mortgage market" [8] with investor comfort leading private firms to begin securitizing mortgage loans.

In the traditional lending market, the lender kept the loan on his books, giving him a reason to make sure the loan is repaid. In the "secondary market," the brokers and lenders collect the loan fees from the borrower then sell the loan. This eliminates the credit risk to the lender. Once the loan is bundled and sold, the risk of foreclosure is passed to the market. "The secondary market has an extraordinarily difficult time, however, distinguishing predatory loans (bad) from appropriately priced subprime loans (good)."[9]

Due in part to current federal laws and the securitization of subprime loans, predatory lending became a subset of the subprime lending market. The term "predatory lending" itself has no legal definition. "Predatory lending" can be defined by "its two root harms to consumers, excessive price and excessive risk of foreclosure."[10]

While "there is little political consensus at the national level within the housing finance community about how best to address the various areas of concern,"[11] there exists *some* agreement on the practices, alone or together, that may constitute predatory lending.

The Department of Housing and Urban Development (HUD) and the Department of Treasury published a joint study, the result of a joint-sponsored nationwide forum, that found predatory lending claims tend to fall into four major groups:[12]

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[7] *Black's Law Dictionary* (7th ed).

[8] U.S. Department of Housing and Urban Development; the U.S. Treasury Department. *Curbing Predatory Home Mortgage Lending.* Washington, DC: GPO, 2000; <http:huduser.org/publications/hsgfin/
curbing.html. >:39

[9] Bagley, Nicholas. "Crashing the Subprime Party: How the feds stopped the states from averting the lending mess." *Slate.* 24 Jan 2008. <
http://www.slate.com/id/2182709/pagenum/all>.

[10] Willis, Lauren E., "Decisionmaking & the Limits of Disclosure: The Problem of Predatory Lending" (June 2005). *Loyola-LA Legal Studies Research Paper* No. 2005-14 < http://ssrn.com/abstract=748286 >.

[11] James Carr and Lopa Kolluri, "Predatory Lending: An Overview," Fannie Mae Foundation, 2001. p.6.

[12] U.S. Department of Housing and Urban Development and the U.S. Treasury Department. *Curbing
Predatory Home Mortgage Lending*. Washington, DC: GPO, 2000;<http://www.
huduser.org/publications/hsgfin/

Lending without regard for the ability to repay

A would-be-borrower's ability to repay a loan should be based on items such as existing debt, credit rating, income, and the length of the loan. With a predatory loan, lender approval may be based *solely* on the item used as collateral, the borrower's home. Monthly loan payments, which meet or exceed the borrower's pre-taxed monthly income can quickly leave a borrower with inadequate living income and/or drive a borrower into foreclosure.

In one case, a financial corporation, with "knowledge based on a borrower's past inability to meet the lower prior monthly payments,"[13] approved mortgage loans that caused the borrower's monthly debt payments to increase. This put the borrower at an increased risk for default or foreclosure.

Loan flipping

Mortgage originators refinance the loan several times in a short period to generate a fee income from "high origination fees, closing costs, points, prepayment penalties and other charges,"[14] without generating a profit or income to the borrower. The original lender charges high fees for each "flip," leaving the borrower with decreased home equity and increased monthly payments.

Excessive fees and "packing"

These are the easy-to-disguise points and fees not directly reflected in the interest rates. The points, fees, and ancillary services are "packed" into the mortgage loan (the amount financed) without the borrower's knowledge or understanding of the items. In addition to lenders, "many of these fees were charged by mortgage brokers, home improvement contractors and other third parties."[15]

The HUD/Treasury joint task force found some borrowers were sold single-premium credit life insurance. Credit insurance pays the lender should the borrower die or become disabled. With single-premium credit life insurance, "the full premium is paid all at once—by being added to the amount financed in the loan"[16] and not used in calculating the annual percentage rate—rather than on a monthly basis.

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[13] *United States v. Delta Funding Corp.*, Civ. Action No. CV 00 1872 (E.D. N.Y. 2000). <http://www.usdoj.gov/crt/housing/documents/deltacomp.htm>

[14] U.S. Department of Housing and Urban Development and the U.S. Treasury Department. *Curbing Predatory Home Mortgage Lending.* Washington, DC: GPO, 2000<http:huduser.org/publications/hsgfin/
curbing.html. > p. 5.

[15] Ibid p.21

[16] U.S. General Accounting Office. *Consumer Reports: Federal and State Agencies Face Challenges in Combating Predatory Lendin*g, Washington, D.C. GPO: January 2004. GAO-04-280 Predatory Lending: 20.

Fraud and Deception

Predatory lenders "prey" on a borrower's lack of financial and legal knowledge. These lenders may use "bait and switch" tactics to mislead borrowers about the terms and amounts of their loans; some fail to disclose items to borrowers as required by law. Borrowers have also, unknowingly at the time, been the victim of fraud due to lenders' doctoring loan and settlement applications, along with inflating property appraisals.[17]

No matter the practice used, a predatory loan depends on the ability of a lender to make a loan disadvantageous to the borrower, due to borrower's inability to understand the loan terms and obligations.[18]

A predatory loan is made at the local level where the borrower signs the loan. The federal government attempts to fight predatory lending at this level through federally-mandated written disclosure laws. The enforcing federal agencies for disclosure laws are federal banking regulators, the Federal Trade Commission (FTC), and the Department of Housing and Urban Development (HUD).

The laws aim to protect the consumer by educating the borrower about the price of the loan and the risk of foreclosure if the loan payments are not met. The disclosure laws have timing requirements that must be met by the lender. The goal is for consumers to use the laws in comparison shopping.

Real Estate Settlement Procedures Act (RESPA)[19]

RESPA was passed by Congress in 1974. The Act aims to help consumers understand settlement costs. Under this law, *estimated* settlement costs must be disclosed to the borrower within three days of receipt of the application loan and again at the settlement. The estimate only needs to be a "good faith estimate" (GFE) for the consumer to use in comparison shopping. This disclosure requirement only covers federally-related mortgages.

It does prohibit "kickback payments" in exchange for referring a settlement service. RESPA "does not impose liability on a creditor for an inaccurate or incomplete estimate, or for failing to provide one."[20]

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[17] Cowen, Andy. "So We Thought, But Then Again. . ." *The New York Times* 13 Jan. 2008.
<http://www.nytimes.com/2008/01/13/business/13view.html?_r=2&scp=1&sq=Tyler+Cowen&oref=login&oref=slogin>.

[18] Ho, Giang and Pennington-Cross, Anthony. "The Varying Effects of Predatory Lending Laws on High-Cost Mortgage Applications." Federal Reserve Bank of St. Louis *Review*, January/February 2007, *89*(1),
<http://research.stlouisfed.org/publications/review/07/01/HoPennCross.pdf> p. 39-59.

[19] 12 U.S.C. §§ 2601 – 2617 (2000 & Supp 2003).

[20] U.S. Department of Housing and Urban Development and the U.S. Treasury Department. *Curbing Predatory Home Mortgage Lending.* Washington, DC: GPO, 2000; <http:huduser.org/publications/hsgfin/

Truth in Lending Act (TILA) [21]

TILA, passed in 1968 and amended in 2002, aims to help consumers understand the credit terms of a loan by requiring lenders to disclose loan costs to its borrowers on all transactions involving a mortgage on a borrower's home residence. TILA does not regulate the prices a consumer may be charged; instead, it standardizes the disclosure of costs.

For a non-purchase money home loan, the TILA disclosures must be given at closing, or the day before where the borrower so requests. TILA requires creditors to disclose to consumers for closed-end credit loans, inter alia, (1) the finance charge, (2) the Annual Percentage Rate (APR), (3) the amount financed, and (4) the total of all payments.[22]

Under TILA, borrowers can seek rescission of loans against creditors until the later of (1) three days after the consummation of the transaction, or (2) once the creditor has delivered the information, two copies of the Notice Form, and the material disclosures required by TILA.[23]

Federal agencies have success in bringing complaints and reaching settlements against subprime lenders who have violated disclosure laws. *In The Matter of Fleet Finance* Inc., a corporation[24], the FTC was able to bring charges against the finance company for TILA violations due to the lender failing to provide in writing the required disclosures about the loans costs and the right of the borrower to cancel the borrowing transaction. The company settled the case for $1.3 million.

On the flip side, predatory lenders have also been able to successfully use signed disclosure sheets against borrowers who claim to be victims of predatory lending practices. In *Williams v. First Government*, *Mortgage & Investors Corp.*[25], the plaintiff, a 61-year-old retired painter and handyman with a sixth-grade education, signed a subprime loan that included, allegedly unbeknownst to him, credit-life insurance.

When the plaintiff brought suit claiming TILA violation, the defendant brought with him the signed disclosure forms. The Court affirmed the lower

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curbing.html. >: 55.

[21] Truth in Lending Act, 15 U.S.C. §§ 1601 – 1667f (2000 & Supp 2003).

[22] U.S. Department of Housing and Urban Development and the U.S. Treasury *Department. Curbing Predatory Home Mortgage Lending*. Washington, DC: GPO, 2000<http:huduser.org/publications/hsgfin/
curbing.html. > p. 54.

[23] 15 U.S.C. §§ 1635, 1639(j).

[24] *In Fleet Finance, Inc.; Home Equity U.S.A., Inc. (Rhode Island); and Home Equity U.S.A., Inc. (Delaware),* File No. 932 3074, Docket No. C-3899. <www.ftc.gov/os/caselist/c3899.shtm>.

[25] *Williams v. First Government Mortgage. & Investors Corp.,* 225 F.3d 738, 750-51 (D.C. Cir. 2000).
http://www.ll.georgetown.edu/federal/judicial/dc/opinions/97opinions/97-7195b.html>.

court's ruling stating, "Credit related life insurance is not required to obtain credit and will not be provided unless you sign and agree to pay the additional cost."

The Home Ownership and Equity Act (HOEPA)

HOEPA, passed in 1994 as an amendment to TILA, addressed the concern lawmakers had about predatory brokers and lenders targeting residents of low-income areas for credit on unfair terms through "reverse redlining." HOEPA includes restrictions on such acts as balloon payments and prepayment penalties on loans that exceed certain rate or fee triggers; it requires lenders to verify the borrower's ability to repay the loan.

HOEPA only places these restrictions and requirements on high-cost closed-end refinancing loans and home equity loans, so it's unclear how many subprime mortgages fall under this act. Predatory lenders only need to keep the loan and fee amounts below the HOEPA threshold to avoid this law.

The law requires lenders to tell high cost loan borrowers in writing at least three days before closing that they could lose their homes if their loans are not paid.

The increase in predatory lending leads one to believe that disclosure laws alone do not work because they do not take into account those most targeted by predatory lenders, the subprime mortgage borrower. Predatory lenders target those borrowers who do not have the ability to understand the disclosures due to limited contact with banks and thrifts, and despite having been through the mortgage process. The disclosure laws relate to the implementation phase, not the borrowing phase, leaving borrowers with little time to get advice on the loan.

The House and Senate have introduced a myriad of bills to stem the current mortgage crisis. In November 2007, the House passed the Mortgage Reform and Anti-Predatory Lending Act of 2007 (H.R. 3915) as an amendment to TILA, which uses remedy and enforcement provisions by addressing specific abusive lending practices "including reckless underwriting practices, subprime prepayment penalties, and yield-spread premiums."[26] The law calls for establishing licensing and registration requirements for residential mortgage originators.

In July 2008, the American Housing Rescue & Foreclosure Prevention Act (H.R. 3221) became law. The main intention of the Act is to stem the current foreclosure crisis. To prevent future foreclosures, the bill provides $150 million to expand counseling for borrowers and establishes "stricter disclosure rules to require lenders to make plain the maximum monthly payment for a borrower with an adjustable rate loan."[27]

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[26] Center for Responsible Lending. "Analysis of H.R. 3915 Mortgage Reform and Anti-Predatory Lending Act of 2007" *CRL Policy Brief*. 24 October 2007. < http://www.responsiblelending.org/pdfs/analysis-of-hr-3915.pdf>.

[27] Herszenhorn, David M. "Approval is Near for Bill to Help U.S.Homeowners" The New York Times 25 June 2008. < http://www.nytimes.com/2008/06/25/washington/25housing.html>.

In both of the above acts, the consumer is not supplied with information on what the disclosures mean. H.R. 3221 provides pre-foreclosure prevention counseling when the borrower is about to lose their home. However, there is no concerted outreach effort by the federal government to identify and educate those communities targeted by predatory lenders. The consumer needs to understand the laws for disclosure laws to be effective. Predatory lenders use federal and local data to target borrowers; there is no reason why the federal government cannot use its own data for community outreach. If consumers are educated, they will realize that they too have a responsibility, to sign only those loans that they can afford. As Benjamin Franklin has said, "An ounce of prevention is worth a pound of cure."

Nominating faculty: Professor Jeannette Espinoza, Law 1202, Department of Law and Paralegal Studies, School of Professional Studies, New York City College of Technology, CUNY.

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