

## **Predatory Lending Practices**

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

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

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

*A couple with limited English speaking skills was convinced to refinance their mortgage and take a cash-out of around \$9,500. To do so, they were charged \$10,368 in lender fees, plus another \$927 in third party fees, which totaled around 8% of their loan amount of \$145,259. They are now struggling to make their monthly payments, which, unlike their previous loan, do not include taxes and insurance.*

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

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

blemished credit would reasonably warrant, as well as for what the industry describes as standard rates for B, C, or D borrowers.

*A husband and wife with FICO scores of 721 and 693, respectively (they had even higher ratings from other credit bureaus), were not looking to refinance, but they were distracted by the recent death of a granddaughter and the loan officer made a strong sales pitch. Over \$14,000 in fees and a \$5,271 single premium credit insurance policy were financed into their loan, which they are locked into by a five-year prepayment penalty for over \$10,000. Despite their excellent credit record, they were given an interest rate of 13.0% on their mortgage.*

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

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

*A mortgage lender solicited a homeowner for a second mortgage to consolidate his debt. The new loan had a 13.4% interest and a monthly payment of \$612, leaving him with a total housing payment of \$1,257 a month. At the time that he received the loan, he was working at a plastic company and had gross earnings of \$1,600 a month, meaning that his housing payment was 79% of his income. As would be expected, he has fallen behind on both of his payments and is facing foreclosure.*

### **Prepayment Penalties**

More than two-thirds of subprime loans have prepayment penalties, compared to less than 2% of conventional prime loans. The penalties come due when a borrower pays off their loan early, typically through refinancing or a sale of the house. The penalties remain in force for periods ranging from the first two to

five years of the loan, and are often as much as six months interest on the loan. For a \$100,000 loan at 11% interest, this would be over \$5,000.

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

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

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

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

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

*A couple wanted to lower the monthly payment on their two mortgages and was looking to refinance. A loan officer told them he could save them \$200 to \$300 a month, and they went ahead with the refinance. They ended up with two mortgages, a first for \$133,000 at 10.5% interest and a second for \$10,000 at 21.7%. This gave them a total monthly payment of \$1,501 – \$125 more than before. Their new first mortgage also included almost \$10,000 in fees. They had very good credit and when they looked into refinancing in order to receive a better interest rate, they found out that both of their loans had prepayment penalties which required that if they refinanced within the first five years of the loan, they would have to pay a penalty of six months interest – more than \$7,000. Despite their good credit, they are now stuck in these high interest rates. Mainstream lenders will not refinance them, because between their loan amounts and the prepayment penalties, their new loan would have to be for more than their house is worth.*

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

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

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

### **Home Improvement Scams**

Some home improvement contractors deliberately target their marketing efforts to lower income neighborhoods where homes are in most need of repairs, and where the owners are unable to pay for the service. The contractor tells the homeowner that they will arrange for the financing to pay for the work and refers the homeowner to a specific broker or lender, even driving them to the lender's or broker's office. Sometimes the contractor begins the work before the loan is closed, so that even if the homeowner has second thoughts about taking the loan, they are forced into it in order to pay for the work. The lender may then make the payments directly to the contractor, which means that the homeowner has no control over the quality of the work. As a result, the work may not be done properly or even at all, but the homeowner is still stuck with a high-interest, high fee loan.

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

*A couple received a phone call from a construction company asking if they needed any work done on their house. The couple did need some home repairs, but they didn't have the money to pay for it. The man from the construction company told them that he could arrange for them to get the financing not only to pay for the repairs, but also to pay off other bills. He picked them up and drove them to fill out a loan application with a loan officer he knew at a local lender. The contractor began the work, but as soon as the check was ready from the lender, he went to pick it up and never came back to finish the work. But the couple still has to pay the loan back at 12.9% interest.*

*A homeowner was contacted by a lender about refinancing. She consolidated \$3,000 in unsecured debt with the \$28,000 that she still owed on the house, and borrowed an additional \$6,000 for a new bathroom and some other improvements on her home. She requested that she be allowed to choose her own contractor, but the lender said she had to use a specific contractor or they would not loan her the money. The lender paid the \$6,000 directly to the contractor, but no work was done to her house because the contractor filed for bankruptcy. She is now stuck paying back the loan at 13% interest. She was also charged \$3,426 in fees and closing costs which were rolled into the \$34,000 loan.*

## **Balloon Payments**

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

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

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

*A couple refinanced in 1998 and received an \$89,250 loan at 9.95% interest from a lender. After fifteen years of paying \$780 a month for a total of \$138,400, they will owe a balloon payment of \$73,564. In addition, the loan had a prepayment penalty if they try to refinance out of the loan during the first three years.*

### **Negative Amortization**

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

*A homeowner with good credit received a \$64,000 loan through a mortgage broker. The broker told her the loan would have an interest rate of 5.5% and a monthly payment of \$363. However, she was not told that this was only a “teaser rate” and that the interest rate would increase and soon rise to 8.4%. Her monthly payment of \$363, which was based on the “teaser” interest rate, remained the same even after the interest rate increased, and so did not cover all of the interest due. Thus, even when she makes her full payment, her principal amount increases. The homeowner was unaware that her loan contained these terms.*

### **Loan Flipping**

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

*A lender convinced an elderly couple to refinance their mortgage to a new loan amount of around \$93,000, which included over \$10,000 in financed fees and a single premium credit life insurance policy for close to \$6,000. Two years later, the same lender convinced the couple to refinance again (without paying off any other debts) a fixed interest rate of 11.5%, financing into their loan what looks like over \$2,200 in fees plus a credit insurance policy for over \$10,000. Another year later, the same lender refinanced them again at an 11.5% interest rate without any discernible benefit while they were charged another nearly \$900 in additional fees.*

### **Property Flipping**

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

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

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

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

*A first-time homebuyer was sold a house for \$75,000. The seller referred the buyer to a mortgage broker which arranged for the buyer to receive a \$60,000 loan (80% of the purchase price) from a lender at 10.65% interest. In order for the buyer to show a 20% down payment, the seller made it seem as if the buyer had put down a \$7,500 deposit and that the seller was providing a \$7,500 second mortgage. The seller paid all of the buyer’s closing costs, \$3,900, to the broker and lender. In addition, the broker received an \$1,800 yield spread premium from the lender. The seller walked away with a profit of \$54,799.*

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

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

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

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

*A couple received a check in the mail for \$4,000. It came at a time when they needed money and so they decided to deposit it. The check was a loan with a 21% interest rate and a 5 year repayment term. Almost immediately after depositing the check, the lender called the homeowner and offered to refinance that loan at a lower rate and give them additional money. The new, larger loan was at 19% interest rate with a ten year repayment term which lowered the monthly payments. Shortly after this, the lender again contacted the homeowner and encouraged them to refinance again and to consolidate other debts. This loan was at 17% interest rate and had a repayment term of twenty years. The lender went back to the homeowner and encouraged them to refinance this loan along with their first mortgage which was with another lender. Their loan had a 12% interest rate and a thirty year repayment term.*

## Yield Spread Premiums

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

*A homeowner with good credit received a \$57,600 loan through a mortgage broker. On the loan, which had a fixed interest rate of 9.75% for two years and then became adjustable, the broker charged the borrower a 6% origination fee, and then the lender charged the borrower another \$850 for processing fees. In addition, the lender paid the broker a yield spread premium of \$1,152 – 2% of the loan amount – for getting the homeowner to accept this loan.*

## Conclusion

"Predatory Lending" comes in many shapes and sizes. Most often it is a result of a lender obtaining a loan for a borrower, while hiding some of the specifics or details of the loan in order to extract a higher payment or commission as a result of that loan. Obviously, not all lenders, mortgage brokers, and loan officers are guilty of this. Most times, our industry is given a black eye because of the unethical approach by a small number of financial professionals. It is my goal to not allow the dishonest 10 percent to affect the honest 90 percent of loan officers and lending individuals here in Idaho.

If you should decide to use me for the purposes of helping you find the loan you need, understand this. I promise to always disclose everything about the loan to you, especially the items that result in a fee or a commission. My goal is to see you back at my desk, when it comes time to buy that cottage on the lake, your parent's retirement home, or that new building for your business. I strive for your long term business, not just one loan.

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