



UNIT 4 – 3

Beware of Predatory Lenders

Predatory lending became a serious problem in the housing boom that started in the late 1990s. **Predatory lending** can generally be described as abusive and/or unfair lending practices. According to Freddie Mac, predatory lending practices can take many forms, including the following¹:

- Excessive cost—charging interest rates and/or fees that far exceed reasonable compensation for a lender's costs or risks
- Equity stripping—lending at a high interest rate, then repeatedly refinancing at a lower interest rate to strip the borrower's equity in order to pay new points and fees
- Failure to report borrower credit information—limiting the ability of borrowers to obtain the lowest interest rate available based on the borrower's complete credit history
- Steering to higher-cost mortgages—referring borrowers to high-cost loans when they are eligible for lower cost financing
- Credit insurance products that are financed upfront—including single premium credit insurance that is paid in a single premium or financed in the loan amount

Freddie Mac, known more formally as the Federal Home Loan Mortgage Corporation, is a federally chartered, stockholder-owned corporation set up by the U.S. Congress to increase the supply of funds to lenders of mortgage funds. Another institution is **Fannie Mae**, the Federal National Mortgage Association. Neither makes loans directly to consumers; they instead buy mortgages from commercial banks, mortgage bankers, savings institutions and credit unions so that more money can be made available to potential homeowners.

¹ From "Combating Predatory Lending," <http://www.freddiemac.com/singlefamily/anti-predatory-faq.html>



CASE STUDY: BILL AND RHONDA'S DILEMMA

Bill and Rhonda have determined that they will be eligible for a home that will require a modest \$140,000 mortgage. They have the down payment, and so their problem now is to figure out how much they will have to pay monthly, and how long they will have to make the payments.

After talking to several local lenders, Bill and Rhonda found that their best deal was a standard 8% fixed rate, 30-year mortgage that would result in a \$1,027.27 monthly payment. Another lender, proposed a different option: a 30-year 6% adjustable rate loan that would reset at 7% at the end of one year and would penalize the borrower 1% every time they were late on a monthly mortgage payment during the first 5 years of the mortgage. This penalty would be in *addition* to any other interest rate adjustments that might take place because of changes in the general level of interest rates.

Bill and Rhonda like the idea of paying 6% rather than 8% at first, but they wonder if they are in danger of predatory lending by taking the second option.

Case Study Application:

The alternative proposal in the case study is actually riskier than it seems. While we haven't specifically studied adjustable rate mortgages yet, the general idea is that every so often the interest rate on the mortgage will be adjusted to catch up with changing economic conditions. Lenders like the adjustable rate mortgage because it keeps their loan portfolio from getting out of date as interest rates change.

There is some danger to the borrower, however, because the interest rate adjustments could work against them, making the monthly payments harder to make. For example, if the interest rates in the case study were to go up, the annual interest payment could easily exceed the 8% charged on the fixed rate mortgage.

However, what makes the loan really dangerous is the 1% that can be tacked on whenever a monthly payment is late. So, if something unexpected happens to the borrower that causes a late payment, the next payment will be higher, and that much more difficult to make as well. And, if the borrower should miss any other payments in the future, the same thing could happen again, causing a series of increasingly painful rises in payments.



In fact, if the loan is structured in such a way as to make a rapidly escalating interest rate feasible if not probable, as is the second loan in the case study, it would border on predatory lending. Another factor that might make the loan a predatory one depends on the ability of the borrower to make the regular monthly payments. So if our borrowers would have had trouble making the payments in the first place, the loan would exhibit another characteristic of a predatory loan.

A major problem with a predatory loan is that the person or institution who bought the mortgage in the first place is generally long gone by the time the borrower gets into trouble and is unable to make the regular mortgage payments. The original buyer of the mortgage is happy to get a comfortable fee for getting the borrower to initiate the mortgage, but then the mortgage is quickly resold to someone else before the monthly payment problems begin.

Yet another example of predatory lending would be if an exorbitantly high origination fee were charged in return for giving the lender a temporarily low introductory rate.

What Happens to Your Mortgage

Predatory lending exists, in part, because the institution that acquires the mortgage is able to resell the mortgage to someone else before the payment problems show up. While the ability to resell a mortgage may seem odd at first, the ability to sell a financial obligation like a mortgage is a key feature of modern financial markets. When the mortgage is sold the second time, the transaction takes place in the **secondary market**, which gets its name from the fact that the seller in is not the party that originated the mortgage.

This is where Freddie Mac comes in. A potential homeowner like yourself may originate a mortgage and pledge your home as collateral to protect against default. The buyer of the mortgage—the bank, savings and loan, credit union, or other institution that supplied the money—can then resell the mortgage to Freddie Mac and get funds that can be used to buy another mortgage from another home buyer.

When Freddie Mac gets the mortgages, it “bundles” them together and then uses the bundle of mortgages as collateral for a new bond issue. After the bond is issued, it will pay interest to the bondholders using the funds received from homeowners who are making their monthly payments. This process of turning a bundle of mortgages into an income-generating asset is called **securitizing mortgages**. While the process is complex, all is well as long as the homeowners keep making the payments. If some homeowners start to default on their monthly payments, then the interest on the bonds cannot be paid and the bonds lose their value, causing problems for the bondholders. In a nutshell, this is what happened during the recent sub-prime mortgage crisis. Too many mortgages were made to those who could ultimately not afford them, and the subsequent mortgage defaults



adversely affected the bond markets and the holders of mortgage-backed securities.

- Visit Freddie Mac on the web to see the full range of services they offer.
- Do you think that the mortgage market would have been more stable if the middlemen who helped arranged the loans were required to keep them longer?

Preventing Predatory Lending

One thing that institutions like Freddie Mac and Fannie Mae can do to protect the homeowner and the investor is to set more uniform standards for the mortgage obligations they buy. For example, in February of 2007 Freddie Mac announced that it would buy mortgages only if the borrower qualified for the maximum rate that a mortgage could charge, not the unrealistically low “teaser rate” that is often used to entice new and potentially unqualified borrowers. There are other restrictions on the desired size of down payments and prepayment clauses as well, but overall the agencies are trying to discourage the creation of mortgages that would get the homeowner in trouble.

When institutions like Freddie Mac and Fannie Mae take steps to prevent predatory lending, they benefit a number of parties. First, of course, are the homeowners who may have been duped into buying a home (and issuing a mortgage) they really couldn't afford. Other homeowners may have had a better credit standing, but they may have been talked into paying too many front-end costs in the transaction, thereby benefiting the middleman who arranged the transaction in the first place, rather than the lender or the home buyer. Finally, the prevention of predatory lending is ultimately going to help the bond markets where the mortgages are bundled and securitized, thereby assuring a smooth flow of funds from investors to home buyers.

The main problem with predatory lending is that it is sometimes hard to identify. For example, what may seem like a logical mortgage agreement in one situation may appear to be predatory when compared to competing mortgage agreements. Remember that the middleman between the homeowner and the lender is the one making profit whenever a mortgage is issued, and the middleman is not likely to be around when the homeowner has trouble with the terms of the mortgage.

In the end, however, the issue is one of education to get enough financial literacy to avoid the pitfalls. The old adage “if a deal seems too good to be true it probably is” still holds, and it applies to mortgages as well as to anything else. Accordingly, Freddie Mac has issued the following ten points of advice for avoiding borrowing pitfalls:



1. **Shop around.** Borrowers should talk to several lenders to find the best loan for which they qualify. A loan product or lending practice may not seem predatory until compared with a similar loan product offered by other lenders.
2. **Understand the loan terms.** Borrowers should compare loan terms from different lenders. Understand the best loan terms available in the marketplace and compare the APR (annual percentage rate) of loans from different lenders. The APR takes into account both the interest rate and the points and fees of the loan. A nonprofit housing counselor or a lawyer can review the information with a borrower.
3. **Find out about prepayment penalties.** Borrowers should know if the loan offered to them has a prepayment penalty. Prepayment penalty should be a choice, not a requirement.
4. **Make sure documents are correct.** Be cautious of someone who offers to falsify a borrower's income information to qualify for a loan. Borrowers should never falsify information or sign documents that they know to be false.
5. **Make sure documents are complete.** A borrower should not sign documents that have incorrect dates or blank fields. Be wary of promises that a lender will "fix it later" or "fill it in later."
6. **Ask about additional fees.** Borrowers should question any items they didn't ask for. Borrowers should also beware if they are told that single premium credit insurance is required get a loan, or that purchasing it will help loan approval. Review every fee and compare different lenders' fees to ensure the most competitive loan terms.
7. **Understand the total package.** Ask for written estimates that include all points and fees. The situation may not seem abusive until when everyone gets to the closing table. If any fees or charges differ from what was previously disclosed, delay the closing until all terms of the loan are clearly understood.
8. **Work with credit counselors.** A borrower should get all the facts before deciding to combine credit card or other debts into a home loan. Beware of scam credit counseling/ credit consolidation agencies—unfortunately, not all credit counseling agencies are acting in your best interests. Talk to a community based consumer credit counseling agency or housing counselor before signing the loan documents.
9. **Protect home equity.** If borrowers are taking equity out of their property, they should take out the minimum amount needed. The equity in a home is a source of wealth, which builds up slowly over time.



10. **If you're not sure, don't sign! Get advice first!** Talk to a community based consumer credit counseling agency or housing counselor."²

All of the above is excellent advice, of course, but it also covers a lot of ground. So, as you get ready to make the biggest investment of your life, prepare to put in enough time to understand all of the complexities and subtleties that an investment of this size requires.

- Which of the ten points of advice do you think is most important for homeowners today?
- Can you add anything to the list from your personal experience?

² www.FreddieMac.com

