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PREDATORY LENDING

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About credit.org

We are a nonprofit organization founded in 1974.

We offer personal financial education and assistance with money, credit, and debt management through educational programs and confidential counseling.



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The logo for credit.org, featuring the text ".org" in white inside a blue speech bubble shape.

Credit.org is a nonprofit consumer credit management organization formed in 1974. Our mission is simple: to provide financial education to members of the general public and families and individuals in need. We are accredited by COA (the Council on Accreditation), signifying the highest standards for agency governance, fiscal integrity, counselor certification and service delivery policies.

Our services include:

Financial Education Programs – We offer seminars, workshops, and educational materials on topics such as budgeting and money management, identity theft, and understanding credit.

Credit Report Review – Our certified coaches work with you to break down your credit report, answer questions, and give guidance for improving your credit score over time.

Confidential Debt Coaching – Our certified consumer credit counselors will discuss your financial situation with you, help you understand what may cause financial stress, and help you create a personalized budget, an action plan and give you options to help manage your finances more effectively.

Debt Management Plans – If you choose this option, we can work with your creditors to reduce costs and repay debt through one monthly payment. **We do not offer debt management plans in all states; please call or check our website for state availability.*

Bankruptcy Pre-petition Credit Counseling and Budget Briefing / Pre-discharge Personal Financial Management Instructional Course – We provide budget and credit counseling (*and a certificate of completion as mandated by the bankruptcy reform law*) for those who consider bankruptcy. We also provide financial education and instruction (*and a certificate of completion as mandated by the bankruptcy reform law*) for those completing their bankruptcy discharge.

Housing Counseling – We are a HUD-approved comprehensive housing counseling agency. We provide homebuyer education seminars, mortgage coaching, counseling for foreclosure prevention assistance, landlord/tenant counseling, post homebuyer education and reverse mortgage coaching (*please call ahead for reverse mortgage appointments*).

Counseling is available by phone, internet, or in person

800.449.9818

Introduction

What is Predatory Lending?

Predatory lending can take many forms, and can be difficult to define. Abusive lenders are constantly developing new ways to take advantage of debtors, often in response to government regulation designed to curtail their abuse.

In general, predatory lending occurs when creditors, brokers, or home improvement contractors engage in deception or fraud, manipulate a borrower through aggressive and persuasive sales tactics, or take unfair advantage of a borrower's lack of understanding about loan terms.

This generally occurs in the subprime mortgage market, where borrowers have limited access to the mainstream financial sector. Predatory lending can occur in the prime market, but it is ordinarily deterred by competition amongst lenders and greater financial information among borrowers.

Further, most prime lenders are banks, credit unions, etc. which are thoroughly regulated by state and federal oversight, while most subprime lenders are not.

Credit.org is committed to helping the community through loss prevention; the losses borrowers suffer as a result of predatory lending affects all of us, just as bankruptcy affects us all. The health of our economy depends on the financial health of the individuals in our communities.



Subprime Mortgage Lending

The subprime mortgage market has grown rapidly in recent years. Subprime lenders provide an important service by providing loans to borrowers who do not meet the credit standards for the prime market, thereby enabling those borrowers to buy new homes or improve their homes.

A majority of mortgages in the subprime market are used for consumer debt rather than housing purposes.

Credit.org recommends against using mortgage and home equity loans in this manner. While a home refinance might pay off a consumer's debt, it won't address the reason that debt was incurred in the first place. There's nothing stopping a consumer fresh from refinancing, from going back out and running up new consumer debts that will further weaken their financial position.

While subprime lenders do provide a valuable service to segments of our society who won't otherwise receive those services, they also provide fertile ground for predatory lending activities. Predatory lending practices can occur at any stage of the loan process and can be undertaken by any of the participants in a particular transaction.

Subprime borrowers often have had difficulty obtaining credit in the past. This makes them more vulnerable to being misled and manipulated. Subprime borrowers will often underestimate their ability to obtain new sources of credit and therefore accept the first offer of credit they receive rather than shop for a loan with the best terms.



What specific lending practices are abusive or predatory?

The lender-borrower relationship has never been viewed as a place where all bets are off relating to disclosure, sales practices, and complications after the sale are made.

Predatory lending is particularly devastating because subprime borrowers typically seek home equity loans at a time of great financial need, when they are in the weakest bargaining position and most susceptible to practices that can strip them of substantial sums of money and, ultimately, their homes. These practices, which are described in more detail below, include the following:

- Deceptive marketing
- Lending without regard to a borrower's ability to repay the loan
- Excessive fees and insurance
- Broker yield-spread premiums
- High interest rates and "balloon" payments
- Loan "flipping" (frequent refinancing)
- Prepayment penalties

It is difficult to collect statistics concerning predatory lending practices. Most of these cases go unreported because victims are not aware they have been conned or are embarrassed to admit it. It is estimated that for every one case seen by a lawyer, another 100 go unchallenged.

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.



Deceptive Marketing

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 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 they 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 first loan had a 12% interest rate and a thirty year repayment term.

Lending 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.



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.

Broker 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.



High Interest Rates and 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 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.



Loan “Flipping” Frequent Refinancing

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 gain (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.



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 harmful 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 looked to refinance. A loan officer told them he could save them \$200 to \$300 a month, and they refinanced. 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.

Recommendations for Consumers

Before you begin loan shopping, visit your local non-profit housing counseling center to set up an appointment with a counselor to evaluate your financial situation and to discuss your loan needs. You can call HUD for a list of the certified counseling agencies nearest you.

You can and should also talk with a housing counselor to evaluate the loan offers you are receiving if you are already in the middle of the loan process. Many of the borrowers who receive high cost loans could have qualified for a lower cost loan from a bank.

Ignore high-pressure solicitations, including home visit offers. Before you sign anything, take the time to have an expert – such as a housing counselor or lawyer – look over any purchase agreement, offer, or any other documents.



Don't agree to or sign anything that doesn't seem right even if the seller or lender tells you that "it's the only way to get the loan through" or "that's the way it's done." Look over everything you sign to make sure all your information is correct, including your income, debts, and credit. Do not sign blank loan documents or documents with blank spaces "to be filled out later."

Before closing your loan, get a copy of your loan papers with the final loan terms and conditions so you have enough time to examine them. If anything is dramatically different at closing, don't sign it.

Don't accept a lender's statement that you have bad credit without reviewing your credit report yourself for mistakes and inaccuracies and having an independent person evaluate your credit.

Make sure you are comparing apples to apples. Know exactly what debts will and will not be paid and if your new payment will include taxes and insurance. You should also understand if the payment being quoted is sufficient to pay off the loan or only goes toward the interest.

Be wary of any lender or broker who encourages you to refinance your first mortgage if that's not what you are looking to do or if encouraged to add more and more of your other debts into the loan.

Think twice about borrowing more than the value of your house. Some lenders may make loans for more than your house is worth, up to a 125% loan to value. Owing more than your house is worth can prevent you from selling your house or refinancing to a better rate in the future.

Things To Know

Be as informed as possible when purchasing or refinancing a home. You should know the following terms of your contract:

Annual Percentage Rate (APR): The cost of getting credit; compare rates offered by various lenders.

Finance Charge: The dollar amount the credit will cost you (based on the APR). Beware of inflated fees.

Amount Financed: The dollar amount of the credit provided to you by your lenders.

“Points”: Fees you pay to a lender to obtain a real estate secured loan (not refundable).

Total Number and Exact Dollar Amount of Each Payment: Make sure the loan fits your budget.

Payment Date: The date the payment must be received by the lender.

Collateral: Property used to secure a loan. If you default on the loan, the lender may take your collateral (in a mortgage, your home is your collateral).

Total Dollar Amount of Payments: The total amount paid over the term of the loan if you have made all payments as scheduled.

Mortgage Inquiries: Remember to rate shop within a 14 day time period, so they only count as one inquiry.

Beware of Loan Terms and Conditions That May Mean Higher Costs for You:

- **High points and fees:** Bank loans usually cost 1-3% of the loan amount for points and fees to the lender. If you are being charged more, find out why. Then shop around.
- **Single premium credit life or credit disability insurance:** This kind of insurance is very expensive compared to other insurance policies, and paying it up front requires you to pay interest on it as well. Beware.
- **Prepayment Penalty:** Many subprime loans include prepayment penalties, which require you to pay thousands of dollars extra if you refinance your loan within the first several years of the loan. Make sure you know if the loan you are being offered has a prepayment penalty, how long it is in effect, and how much it will cost. If there is a chance that you will refinance during that time, you need a loan without a prepayment penalty.
- **Balloon Payments:** Balloon mortgages have the payments structured so that after making all your monthly payments for several years, you still have to make one big “balloon payment” that is almost as much as your original loan amount.
- **Adjustable Rates:** Beware of low “teaser” introductory rates on adjustable mortgages because many of these adjustable rate loans only adjust one way – up. If your loan has a fixed initial rate, make sure you know when and by how much the interest rate will increase and what your new monthly payments will be. Find out the highest rate your loan can go to and what the monthly payments would be at that rate. Don’t count on a promise that the lender will refinance the loan before your payments increase.
- **Mandatory Arbitration:** Some predatory lenders include mandatory arbitration clauses in their home loans. Signing these mean giving up your right to sue in court if the lender does something you believe is illegal.

At the Appraisal

The appraisal is a particularly vulnerable time for those working to avoid predatory lending. Watch for these warning signs:

- Being told the equity in your home will be enough to cover any or all down payment provisions of a loan application.
- Being contacted by more than one appraiser to make an appointment to inspect your home.
- When an appraiser comes to your home to do an inspection and doesn't appear interested in the home and doesn't ask reasonable questions.
- Statements made by the lender before the appraisal is complete that there will be no problem getting a loan due to your home's value.
- An appraiser who does not identify him/herself or gives you no way to verify their identity or contact them.

Any of these signs may indicate you are about to receive a fraudulent appraisal.



Watch out for these 12 warning signs of high risk lending:

1. Exceedingly high interest rates and inflated fees.
2. High-pressure sales tactics requesting you sign a loan contract right away.
3. Fine print stating that your interest rate will change to require you to pay “daily interest” when your payments are late.
4. Being forced to buy credit insurance.
5. Frequent refinancing of the original loan, resulting in higher payments or more debt.
6. Unexpected closing costs.
7. Being told to leave important parts of a loan application unsigned or incomplete
8. A mortgage loan amount that is greater than the value of your home.
9. Requests to falsify a loan application.
10. Being forced to borrow to pay a large lump sum at the end of the initial payments of a balloon loan.
11. Monthly payments that turns out higher than initial disclosures.
12. Missing any of the following forms from your loan file:
 - Good Faith Estimate
 - Special Information Booklet
 - Truth In Lending Form
 - HUD Settlement Statement

Borrowers' Reminders

Know What You Can Afford

- DO manage your money wisely, as your credit history is your responsibility.
- DO carefully review your income and expenses and ALWAYS borrow within your budget!
- DO NOT inflate your earnings or provide false information to qualify for a loan, as the lender's borrower qualifications are based on what a household must earn to afford the mortgage payment.
- DO NOT bet on future income increases as there are no certainties in the future, but it is a certainty that you could face the loss of your home and all of the money you paid on the loan if you can't make the payments due to unforeseen events.

Choose a Reputable, Licensed Broker/Lender

- A good way to find a reputable broker and/or lender is to ask family members and/or friends who will not gain personally to refer you to brokers and/or lenders they have used satisfactorily.
- Be aware of salespersons that approach you with offers that sound too good to be true.
- Prior to using the services of a mortgage broker or lender, make sure they are properly licensed by checking with your state Department of Corporations and/or the Department of Real Estate.

Applying for a Loan

- There are oftentimes major differences between various lending sources, so shop around for the best loan and visit several reputable mortgage brokers and lenders.
- Compare interest rates, fees and points and examine all of the terms of the loan.
- The law requires mortgage brokers and lenders to notify you of your right to review your credit score and the key factors affecting your credit score. Obtain a copy of your credit report to verify that it accurately reflects your credit history.
- In most mortgage loan transactions, you are entitled by state and federal law to a "Good Faith Estimate" disclosure of the costs and expenses you are expected to pay in connection with obtaining the loan. Read it carefully and question any items you don't understand.
- Double-check the loan application for accuracy in the cost of the home, your income and your employment information. If false information is provided, you could lose your home if the lender decides to foreclose and/or even face criminal charges.

Before You Sign

- Ask questions about the terms of the loan and check the contract to confirm that the terms you agreed upon are clearly written in the loan documents.
- Read the entire loan contract to make sure you fully understand your obligations and all provisions of the contract before signing. NEVER sign blank forms or sign one with information that is incorrect.
- Talk with a knowledgeable and trusted advisor or professional of your choice prior to signing a loan agreement. NEVER ALLOW YOURSELF to be pressured to sign a contract that you are not comfortable with or do not understand. NEVER RELY on verbal assurances that are not in writing.
- Find out if you have cancellation rights. Some loans, but not all, give you the right to cancel the loan application within three days after signing. Carefully review your loan application to determine whether or not you have cancellation rights.

Resources

More information on predatory lending is available from:

American Association of Retired Persons (AARP)

601 E Street NW Washington, DC. 20049

www.aarp.org

http://www.aarp.org/money/wise_consumer/scams/

1-888-687-2277

Freddie Mac:

21700 Oxnard Street Suite 1900, Woodland Hills, CA. 91367-3642

www.dontborrowtrouble.com

1-818-710-3000

Federal Trade Commission Consumer Response Center

6th & Pennsylvania Ave, NW Washington, DC. 20580

www.ftc.gov/bcp/menu-lending.htm

1-877-382-4357

Federal Reserve Division of Consumer and Community Affairs

Mail Stop 801 Federal Reserve Board Washington, DC. 20551

www.federalreserve.gov/consumers.htm

1-202-452-3693

Housing and Urban Development

451 7th Street SW, Washington, DC. 20410

www.hud.gov

1-202-708-1112

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4351 Latham St. Riverside, CA. 92501 www.homeownership.org

1-800-947-3752

Notes





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