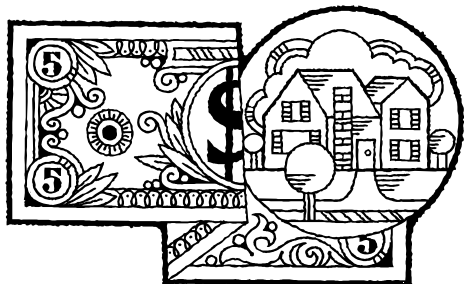




POLICY PERSPECTIVES

Volume 2, No. 2
January 2003

In 1982, South Carolina deregulated the home mortgage market. Not only was the usury law that capped interest rates repealed, first mortgages were also removed from most of the protections of our Consumer Protection Code. Consequently, South Carolinians are largely unprotected when borrowing on the largest asset most of us will ever own—our home. In 1982, no one imagined the creativity of those who would prey on low income citizens and older South Carolinians. However, twenty years later the experiment has failed. The Coalition for Responsible Lending finds that in 2000 predatory lenders siphoned \$107.1 million in assets from South Carolina communities and families.



Predatory lenders employ a variety of dishonest and manipulative techniques to pressure borrowers into signing up for high cost loans—loans which frequently provide no real benefit to the borrower or require payments beyond the borrower's means. Charm or high pressure tactics coupled with confusing financial jargon enables predatory lenders to manipulate individuals into signing off on a loan that they more than likely will not be able to pay off.

Predatory mortgage loans flourish in the “subprime” market. Subprime loans are those on which a higher (typically 1 % to 9 % higher) than standard interest rate is charged because the borrower presents a greater risk. The risk may come from lower income or past problems with credit.

Predatory Lenders Everywhere You Turn

It's not just mortgage loans. Predatory lenders have discovered numerous ways to get money from borrowers. For example, auto title lenders charge 25 % per month (That's equivalent to 300% APR) on loans over \$601 secured by car titles. Payday lenders (check cashers) charge up to 15% for two weeks (That's equivalent to 390% APR) on an advance up to \$300. Like drug dealers and video poker operators, these lenders understand that the key is getting you hooked.

Lenders knowingly allow desperate borrowers to take out loans that will not be paid back on time. If a borrower takes out a \$1,000 loan from a car title lender, in thirty days the balance owed will be the amount of the original loan plus 25% interest. Chances are that if an individual needed \$1,000 in March, s/he will not have an additional \$1,250 in April. That is the scheme of things in this business. The last thing predatory lenders want is for you to pay off your loan.

Perpetual refinancing and renewals, which generate more revenue from loan fees and interest, lie at the heart of this business model. The lender keeps raking in cash—and you never pay off the loan.

We could go on with pawn brokers, rent-to-own, small loan companies and “instant” tax refunds. A lot of folk get rich off the poor.

Why Would You Lend Money to Someone Who Can't Pay It Back?

We are frequently asked this question by legislators. It's often not the predator's money at risk. Here the abuses come from mortgage brokers or mobile home salespeople. Their money comes from fees for arranging the loan or from selling the mobile home. They get their money up front. Somebody else won't get paid back.

(www.responsible.org). It has become a very lucrative business for the unprincipled lenders looking to cash in on America's availability of credit poor, or "subprime", individuals.



The number of mortgage brokers originating subprime loans in the US today is three times the number it was five years ago, which is approximately 18,000 (www.responsiblelending.org). Adding insult to injury, even conventional, fair market mortgage lenders are adding subprime loans to their list of services. This development has also been compounded by the eagerness on the part of large national firms to acquire smaller, local home equity companies. All of this translates into aggressive competition for loan volume, which in turn creates an incentive and opportunity for abusive lending practices (www.responsiblelending.org).

Numerous studies, including two from the federal Department of Housing and Urban Development (HUD) and the Fannie Mae Foundation, indicate that the public is financially at risk as a direct result of increasing predatory lending practices. Certainly, not all subprime lenders employ dishonest practices. Many provide services fairly to individuals who are unable to obtain fair market rate loans. However, statistics demonstrate an increasing trend to target specific populations of the American public because of (1) the realization that these individuals lack information that would protect them from such exploitative measures and (2) the increasing number of credit-poor Americans in need of cash.

These subprime mortgage loans are critical to homeownership in lower-income neighborhoods. While the businesses are necessary to many in order to secure loans, too many lenders in the subprime mortgage market have taken advantage of low income earners and elderly borrowers.

Unfortunately, the rate of increase in subprime lending establishments is accelerating at an alarming pace. For example, in 1998 subprime originations in the U.S. totaled \$160 billion—more than a 500% increase since 1994 (www.responsiblelending.org). Eighty percent of subprime loans are refinance loans for debt consolidation and consumer credit. Borrowers increase one debt in an effort to be free of another debt. The practice of debt refinancing has increased by almost 1,000% in the last 5 years

Are Subprime Loans Limited to Risky Borrowers?



According to Fannie Mae, up to half of all subprime borrowers could qualify for lower cost conventional financing. Freddie Mac estimates that 10% – 35% of subprime borrowers could have qualified, and cites a poll of 50 subprime lenders who estimate that half could have qualified for prime loans. Pamela Kogut, Assistant Attorney General of Massachusetts, estimated that 20% of loans from First Alliance, which declared bankruptcy after a New York Times article exposed its predatory lending practices, went to "A" borrowers.

Stein, *Quantifying the Economic Cost of Predatory Lending*,

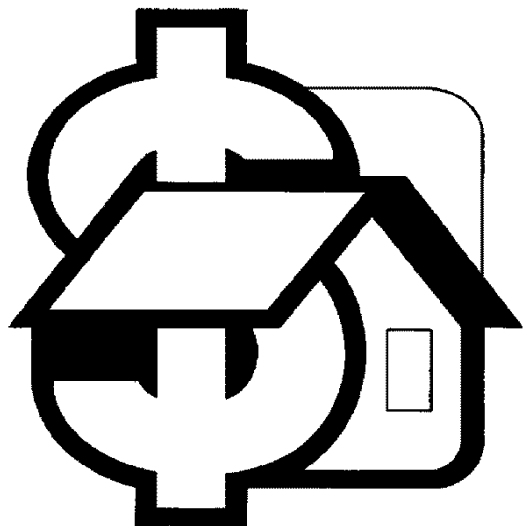
Coalition for Responsible Lending (2001), p. 10.
<http://www.responsiblelending.org/research/Quant10-01.PDF>

(references omitted)

Elderly homeowners are the main targets for predatory subprime lenders. In the US, approximately 663,000 elderly homeowners have lived in their homes for over 20 years, have debt-free ownership of the home, have incomes of less than \$30,000, and have equity of \$100,000 or more (www.responsiblelending.org).

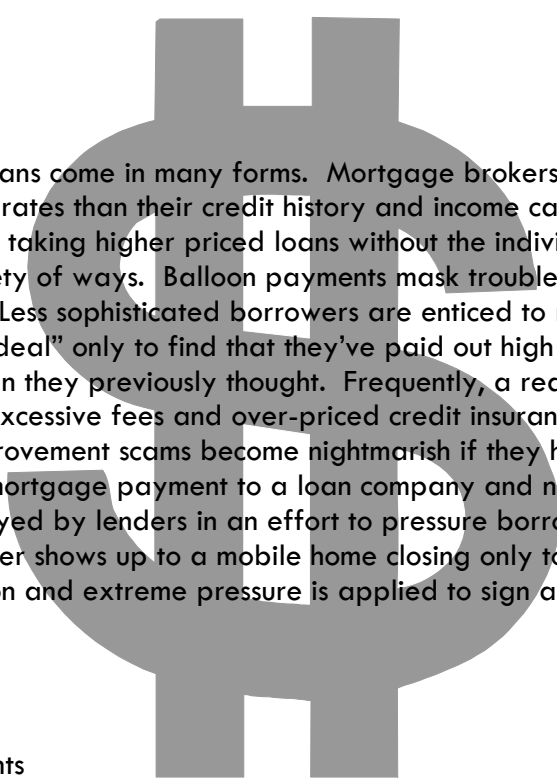
Living with limited or fixed-incomes, many of these elderly homeowners are "cash-poor" but "asset-rich". When faced with unexpected medical expenses or repairs on their older homes, the elderly have few options (www.responsiblelending.org). The decision most often made results in making financial use of the equity that has accumulated in their homes over the span of many years. It seems like a logical decision, but because of a lack of knowledge about financing or financing alternatives the elderly are placed in a vulnerable position. Predatory lenders recognize and routinely exploit this wealth of elderly homeowners.

The Perfect Customer



"... an uneducated widow who is on a fixed income—hopefully from her deceased husband's pension and social security, who has her house paid off, is living off of credit cards, but having a difficult time making payments, and who must make a car payment in addition to her credit card payments." (www.responsiblelending.org)

The Department of Housing and Urban Development, in *Unequal Burden: Income and Racial Disparities in Subprime Lending in America*, demonstrates that predatory lenders often target low-income earners. Consumers living in lower-income and minority neighborhoods—where traditional banking services continue to be in short supply—turn to subprime lenders (www.responsiblelending.org). Often living from paycheck to paycheck, these individuals borrow in an attempt to pay unforeseen medical expenses, as well as to afford their “affordable” housing or car payments so that they can have transportation to work. Subprime loans are three times more likely in low-income neighborhoods than in high-income neighborhoods and five times more likely in black neighborhoods than in white neighborhoods (HUD, April 2000).

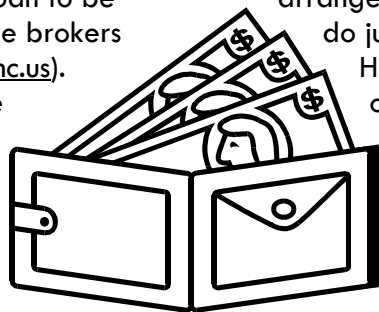


Predatory mortgage loans come in many forms. Mortgage brokers put unsuspecting borrowers into loans at higher interest rates than their credit history and income can support. Subprime lenders also deceive individuals into taking higher priced loans without the individual's knowledge. This can be accomplished in a variety of ways. Balloon payments mask trouble down the road by providing a low monthly payment. Less sophisticated borrowers are enticed to refinance an expensive loan in order to get a "better deal" only to find that they've paid out high fees during the process and are now in worse shape than they previously thought. Frequently, a reasonable interest rate becomes an unreasonable loan as excessive fees and over-priced credit insurance are packed into the agreement. Home improvement scams become nightmarish if they have been financed, leaving an elderly person with a mortgage payment to a loan company and no siding on the house. Bullish tactics are often employed by lenders in an effort to pressure borrowers into signing off on a loan. For example, a borrower shows up to a mobile home closing only to discover that terms are much worse than agreed upon and extreme pressure is applied to sign anyway.

Excessive Fees and Points

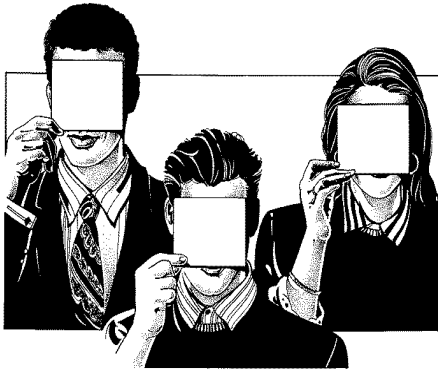
Conventional (not subprime) borrowers can expect to pay an average 1.1% of the loan amount in points and fees. These are fees such as origination fees or mortgage broker fees--not payments to third parties such as lawyers. However, predatory lenders charge substantially higher fees and charges. In South Carolina, the Consumer Advocate only looks at loans when these charges get to be 10% of the loan principle. That's \$10,000 on a \$100,000 loan. Aside from being too high, these fees are financed, or added to the loan. You pay too much and then you pay interest on the too much.

At the heart of these fees is mortgage broker compensation. Most consumers who contact a mortgage broker expect a loan to be arranged with fair terms and the lowest possible interest rates. Most mortgage brokers do just that and charge a reasonable fee for their services (www.jus.state.nc.us). However, in the subprime market, many mortgage brokers do the opposite. These brokers persuade individuals to borrow the loan with the most fees and highest rate possible so that the broker will get more compensation. If the mortgage broker gets you into a higher rate than your income and credit justify, the lender can kick back a part of that higher rate. It's called a "yield spread premium."



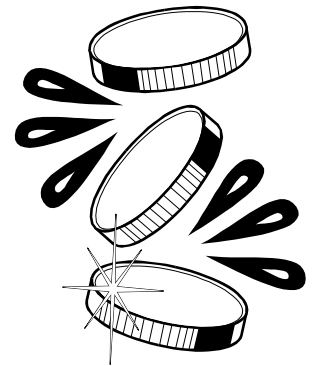
Insurance Packing

The most common product added to a loan is insurance. The high cost insurance premium is into the loan in one lump sum (single premium) financed over the life of the loan. Credit prices are set by law in South Carolina at a level. Most consumers who need life can buy cheaper term life insurance. Thus individuals pay additionally for interest on priced insurance. By packing single premium insurance into the loan, the lender earns more the loan as well as the commission from the the insurance (www.jus.state.nc.us).



Loan Flipping/Refinancing

“Flipping” is the repeated refinancing of a borrower’s loan with no benefit to the borrower. After the balance on a loan has been paid down slightly, a predatory lender may encourage the borrower to refinance the loan and get a little more cash out of the available equity in the home (www.jus.state.nc.us). However, every time a loan is flipped, loan fees strip hard-earned equity from the home. Frequently the broker does not fully explain the fees, points, and single premium insurance that were originally financed into the loan. When the borrower is made aware that this loan is unaffordable, the lender will then offer to refinance it so that the payments are more manageable. Naturally, the borrower becomes even further in debt, remaining so for much longer than was initially expected. Meanwhile the lending company benefits financially by squeezing out every last dime possible.



When interest rates go down, it may make sense to refinance a loan to take advantage of lower rates. But the rates have to be low enough that you can recover your points and fees fairly quickly. The usual rule of thumb is that you should recover your points and fees within two years. If not, the benefit from refinancing is going to the mortgage broker or lender—not to the borrower. Many borrowers get pushed into refinancing loans solely to benefit the broker or lender.

Clean Hearts—Empty Heads

South Carolina law prohibits making a loan which the borrower cannot reasonably repay on time. . However, lenders repeatedly evade this law because it depends upon “the belief” of the lender. Lenders who don’t do credit checks or use appropriate underwriting criteria use the “clean heart—empty head” defense to escape court prosecution. *“We didn’t know that this 75 year old man living only on Social Security couldn’t make \$800 per month payments. We believed that he must have had other income.”*

Increasing numbers of lenders have stopped single premium credit insurance. These include Household and Citigroup, two large players in this market, who agreed to stop the sale of this product in the face of charges of predatory lending.

credit added and insurance very high insurance borrowing over-credit interest on sale of

Balloon Payments

Predatory lenders deceive borrowers by providing low monthly payments through balloon payments. With this arrangement the borrower pays off mainly the interest on the loan each month. This low monthly payment is really of no benefit to the borrower because it only leads to a large sum of money that is owed at the end of the payment period and another loan. This comes as quite a shock to borrowers who are under the impression that the loan is almost paid in full. To their horror, they discover that the amount owed due to the balloon is almost as much as the amount that was originally borrowed. If the borrower is elderly, it will be very difficult to refinance the loan and foreclosure may become inevitable.

Arbitration

Almost every abusive loan contract now provides for mandatory arbitration—the location and the arbitrator are of the lender's choosing. As a result, low-income consumers seeking redress from a predatory loan may discover that they have to pay \$5,000 to hire an arbitrator to hear the case in Dallas. Touted as a way to avoid "costly litigation," mandatory arbitration makes it impossible for borrowers to get out of an unfair loan.

One Lender Promises to Do Better

Household Finance and its related companies are major players in the subprime market. In 2002, Household Finance was an active player at the South Carolina General Assembly, pushing a piece of cosmetic legislation that purported to address predatory lending.

In October 2002, Household reached a \$484 million settlement of predatory lending charges with the attorneys general of nineteen states and the District of Columbia. In South Carolina, Household has reportedly made about 3,800 loans since 1999, and will repay as much as \$5 million to its borrowers.

Under the settlement, Household agrees to:

- Pay up to \$484 million in restitution to consumers nationwide.
- Limit prepayment penalties on current and future home loans to only the first two years of a loan.
- Ensure that new home loans provide a benefit to consumers prior to making the loans.
- Limit up-front points and origination fees to 5 percent.
- Reform and improve disclosures to consumers.
- Reimburse states to cover the costs of the investigations into Household's practices.
- Eliminate "piggyback" second mortgages.

At the national level, there are a few policies designed to protect consumers from unscrupulous lending practices. The Truth in Lending Act (TILA), the Home Ownership and Equity Protection Act (HOEPA), and the Real Estate Settlement Procedures Act (RESPA) are steps in the right direction. However they often do not provide adequate protection of consumer's rights at the state level. They are largely focused on disclosures rather than prohibitions on predatory practices.

For this reason, several states have either enacted legislation or have legislation pending that restricts predatory lending practices. Georgia and North Carolina have emerged as leaders in protecting borrowers. In 1999, North Carolina passed predatory lending legislation that saved over \$100 million in the first year for borrowers without decreasing the availability of credit options for subprime borrowers in need of loans (www.responsiblelending.org).

Both North Carolina and Georgia predatory lending legislation provide special protections for so-called "high cost" loans—those with either a high interest rate or high fees. (The attached summaries are just that.) They both prohibit credit insurance packing. Georgia's Fair Lending Act also places emphasis on providing information needed by the public in order to make a competent decision based on the evaluation of all financial options.

North Carolina's 1999 Anti-Predatory Lending Law

1. Prohibits for all loans:

- § Prepayment penalties for home loans of \$150,000 or less;
- § "Flipping," where a lender repeatedly refinances an existing home loan with upfront fees;
- § Financing of upfront, single premium insurance.

2. On **high cost home loans** (residential home loans of \$300,000 or less where the borrower is charged more than 5% of the loan amount in upfront points, fees, or other charges, an interest rate that is 8% more than the comparable Treasury bond rate, or prepayment penalty longer than 30 months or more than 2% of amount prepaid):

- § Prohibits financing of upfront fees and insurance premiums;
- § Requires counseling for high cost home loan borrowers prior to loan closing;
- § Prohibits balloon payments;
- § Prohibits loans where the loan amount increases because the monthly payments do not cover the loan costs; and
- § Prohibits lending without consideration of consumer's ability to repay.

Coalition for Responsible Lending, *Summary of NC Predatory Lending Law*

http://www.responsiblelending.org/nc_law/shortsumm.pdf

Georgia's 2002 Fair Lending Act

1. Prohibits for **all mortgage loans**:
 - § Financing single premium credit insurance;
 - § Encouraging default on a debt;
 - § Mandatory arbitration clauses.
2. On **high cost loans**:
 - § Limits prepayment penalties;
 - § Prohibits balloon payments;
 - § Prohibits loans where the loan amount increases because the monthly payments do not cover the loan costs;
 - § Prohibits loans where interest rates go up after default;
 - § Requires counseling from a third-party nonprofit counseling service;
 - § Prohibits loans where a reasonable person would not expect the borrower to be able to make the payments;
 - § On home improvement loan, requires contractor affidavit that all work done and all subcontractors are paid before creditor can disburse funds;
3. On **covered loans**:
 - § Prohibits "flipping".

Scott H. Michalove, Esq., "Analysis of The Georgia Fair Lending Act"
<http://www.woodandmeredith.com/articles/analysispredatorylending2002.html>

In 2002, Senator David Thomas (with co-sponsoring Senators Glenn McConnell, J.V. Smith, John Matthews, Kay Patterson, Wes Hayes, Darrell Jackson, Linda Short, Arthur Ravenel, Glenn Reese, John Drummond, Warren Giese and Luke Rankin) introduced strong anti-predatory lending legislation. Similar legislation was introduced in the House in 2002. That bill (S 994) would have:

1. Prohibited making a loan when you should know the borrower can't make scheduled payments or won't derive substantial benefit from the loan;
2. Applied law on which loans can't be made (see no. 1) to first mortgages which are not covered by our Consumer Protection Code;
3. Limited loans for term of less than 120 days to Restricted Lender rates (about 60 – 100 %, instead of 300 % charged by Title Lenders) and caps interest on payoff balance at maturity to 36 % ;
4. Required disclosures before mobile home sales to be comparable to those for stick-built home sales with penalties;
5. Prohibited flipping;
6. Required checks for home improvement loans secured by a mortgage to be signed by the homeowner as well as the contractor;
7. Limited points and fees charged for a mortgage to 4 % of the loan;
8. Required application of South Carolina law to any mortgage for a first residence located in South Carolina (South Carolina dirt-South Carolina law);
9. Prohibited financing of credit insurance; and
10. Increased loan amount below which prepayment penalties may not be assessed from \$100,000 to \$150,000 and indexes amount to inflation.

For the 2003 Legislative Session, Senator David Thomas has also introduced strong anti-predatory lending legislation. The bill takes most of its mortgage lending features from North Carolina's law. It is not as broad as legislation introduced by Senator Thomas and others in the 2002 session in that it focuses on high cost loans. For high cost loans, 2003 Senate Bill 11(S.11):

1. Defines a "high cost" loan as one with total points and fees exceeding 5 percent of the loan (on loans above \$20,000) or has an interest rate which meets or exceeds the federal Home Ownership and Equity Protection Act (HOEPA);
2. Provides that high cost home loans cannot (among other things):
 - a. be accelerated at the lender's discretion;
 - b. contain balloon payments; or
 - c. have negative amortization that causes the principal to go up; or
 - d. increase the interest rate after default;
3. Requires counseling for borrowers of high cost loans;
4. Prohibits financing of points and fees; or
5. Prohibits charging points and fees on a refinance with the same lender.

For all mortgage loans, S.11:

1. Prohibits financing of single premium credit insurance;
2. Prohibits making a loan when you should know the borrower can't make scheduled payments;
3. Prohibits refinancing without tangible benefit to the borrower
4. Prohibits a lender from encouraging default on an existing loan in connection with a new loan.

In addition, S. 11:

1. Limits loans for term of less than 120 days to Restricted Lender rates (about 60 – 100 %, instead of 300 % charged by Title Lenders) and caps interest on payoff balance at maturity to 36 % ;
2. Requires disclosures before mobile home sales to be comparable to those for stick-built home sales;
3. Prohibits flipping;
4. Requires checks for home improvement loans secured by a mortgage to be signed by the homeowner as well as the contractor or held by an escrow agent.

South Carolina Fair Share would also like to see mortgage brokers given a fiduciary obligation to their customers so that they are required to look out for the customer—not just their own bottom line. Persons who buy loans which were made under predatory circumstances should also be held liable.

Of course, the lending industry will once again argue that all we have to do is tell folks not to utilize predatory loans. But disclosures don't work where there is an imbalance in power and information. Nowhere is that clearer than in the mortgage loan market. Here, we have to pass laws that stop abusive behaviors. And we have to pass them soon—before hundreds of millions of dollars are stripped out of the life savings of older South Carolinians and vulnerable low income citizens. It is past time.

References

1. Coalition for Responsible Lending. (2001). Stein. *Quantifying the Economic Cost of Predatory Lending*, p. 10 www.responsiblelending.org.
2. Coalition for Responsible Lending. *Summary of North Carolina Predatory Lending Law*. www.responsiblelending.org.
3. Dept. of Housing and Urban Development. *Unequal Burden: Income and Racial Disparities in Subprime Lending in America*. (April 2000).
4. Michalaye, Scott, Esq. *Analysis of the Georgia Fair Lending Act*. (2002). www.woodandmeredith.com.
5. North Carolina Dept. of Justice Consumer Protection Section. www.jus.state.nc.us

SOUTH CAROLINA FAIR SHARE POLICY PERSPECTIVES

This is the first *South Carolina Fair Share Policy Perspectives* for 2003. If the Lord is willing and the creek don't rise, we will publish quarterly. The *Policy Perspectives* are an addition to our regular *Legislative Update* and *Margins of Health* which go to SCFS members.

Our intention is to explore more fully than the *Legislative Update* format allows important issues facing everyday South Carolinians. We hope to provide a better explanation of the roots of problems and creative approaches to solving them.

South Carolina Fair Share's interests and concerns are broad. This month's subject is Predatory Mortgage Lending Practices. Future Perspectives will cover the variety of consumer and family issues that occupy our advocacy work.

We look to our community to assist us in preparing *Policy Perspectives*. We invite other organizations and persons working to better South Carolina to join us in producing future *Policy Perspectives*. If you have an issue that you think should be a subject of a *Policy Perspective*, please give us call.



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