

Quantifying the Economic Cost of Predatory Lending

A Report from the
Coalition for Responsible Lending

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I. Executive Summary

Federal Reserve Board Governor Gramlich has correctly noted that, just as with “safety and soundness” and “unfair and deceptive trade practices,” there is not and should be no final definition of the term “predatory lending.”¹ But just as capital ratios and delinquency rates tell a story about safety and soundness, certain overall indicators and loan level practices characterize predatory lending.

The Coalition for Responsible Lending, in this report, quantifies the cost of several predatory lending practices to American homeowners. **Using the best data available to us, we estimate that U.S. borrowers lose \$9.1 billion annually to predatory lending practices. For the most part, these practices are entirely legal under existing law; only changes to federal and state laws and regulations will significantly reduce this figure. Further, the magnitude of the problem, we believe, demonstrates that the most important lending issue today is no longer the denial of credit, but rather the terms of credit.**

This estimate is based on our analysis of the loan-level components of the following three predatory lending practices:

- **Equity Stripping**—charging borrowers exorbitant fees, which are routinely financed into the loan. These costs result in substantially higher payments while the loan is outstanding and are stripped directly from the equity of the home when a borrower refinances or sells his or her house. At the loan level, equity stripping occurs when borrowers are provided loans that (1) finance credit insurance, (2) require exorbitant up-front fees, or (3) include prepayment penalties on subprime loans.
- **Rate-Risk Disparities**—charging borrowers a higher rate of interest than their credit histories would indicate is justified—often either by the lender’s or its affiliate’s own underwriting criteria. In fact, one recent study used sophisticated statistical modeling to show that 100 basis points of all subprime lending (and presumably much more for predatory lenders) could not be explained by credit risk.²
- **Excessive Foreclosures**—making loans without regard to a borrower’s ability to repay. Homeowners struggling to make payments under the combined weight of excessive fees and high interest rates often pay the ultimate price—the loss of their home and all the equity they had accumulated in it. In addition, the equity held by neighboring homeowners is reduced as home values fall in areas of concentrated foreclosure. Finally, there are significant social costs to the pending wholesale loss of neighborhoods of homeowners, particularly in African-American communities. While this report discusses foreclosures, it does not attempt to quantify the costs.

¹ Remarks before Consumer Federation of America conference, Washington, DC (Dec. 1, 2000).

² Peter Zorn, “Subprime Lending: An Investigation of Economic Efficiency”, Freddie Mac (Dec. 21, 2000).

Figure 1: Estimated Cost of Predatory Lending in the U.S.

Source	Predatory Practice	Annual Cost (billions)	Number of Families Affected Annually
Equity Stripping	Financed Credit Insurance	\$2.1	500,000
	Exorbitant Up-Front Fees	\$1.8	750,000
	Subprime Prepayment Penalties	\$2.3	850,000
Rate-Risk Disparities	Excess Interest Charged	\$2.9	600,000
Excessive Foreclosures	Lack Concern for Ability to Pay	?	
	Total	\$9.1	

II. Introduction

Federal Reserve Board Governor Gramlich has correctly noted that, just as with “safety and soundness” and “unfair and deceptive trade practices,” there is not and should be no final definition of the term “predatory lending.”³ But just as capital ratios and delinquency rates tell a story about safety and soundness, certain overall indicators and loan level practices characterize predatory lending.

This paper responds to Governor Gramlich’s call for additional research to explore the significance of predatory lending by examining three common predatory lending practices: equity stripping, rate-risk disparities, and excessive foreclosures. It analyzes the loan-level traits that comprise each to estimate the economic toll imposed on American families. Based on the best data available to us, we conservatively conclude that the cost is **\$9.1 billion each year of lost homeowner equity and back-end penalties and excess interest paid.**

While Self-Help⁴ and other community development organizations around the country can be proud of the work we have done to create wealth in disadvantaged communities, the fact remains that all of us put together cannot come close to replacing \$9.1 billion each year. **Further, the lending practices that cause this loss in homeowner wealth are largely entirely legal under existing law.** Consequently, without action from federal and state lawmakers and regulators, there is no effective way to protect this home equity. The problem is particularly severe in minority communities.

³ Remarks before Consumer Federation of America conference, Washington, DC (Dec. 1, 2000).

⁴ I am vice president of Self-Help, www.self-help.org, which is a 20-year old community development financial institution that creates ownership opportunities for low-wealth families through home and small business lending. We have provided over \$1.6 billion dollars in financing to help 23,000 low-wealth borrowers buy homes, build businesses and strengthen community resources. We believe that homeownership represents the best possible opportunity for families to build wealth and economic security and take their first steps into the middle class. Accumulating equity in their homes is the primary way most families earn the wealth to send children to college, pay for emergencies and pass wealth on to future generations, as well as develop a real stake in society. Self-Help has had significant experience making home loans available to families who fall outside of conventional guidelines because of credit blemishes or other problems, and our loan loss rate is under 0.5% each year. Self-Help has assets of \$800 million.

III. Predatory Lending Practices

The threat posed by predatory subprime home lending is as severe as its growth is recent. Subprime lending, 80% of which consists of refinance loans for debt consolidation and consumer credit, has increased almost 1,000% in five years.⁵ While increased access to credit for families with impaired credit histories is to be applauded, the prevalence of subprime loans with abusive characteristics has been devastating to families and neighborhoods.⁶

A. Equity Stripping

Too many homeowners are losing the wealth they spent a lifetime building because of equity stripping. Equity stripping occurs when predatory lenders charge excessive fees. Fees include money collected in cash up-front (such as origination or broker fees), amounts financed into the loan at closing (including single premium credit insurance), and fees paid later on the back-end (through prepayment penalties).

The problem of **excessive fees** for the subprime refinancing borrower is two-fold: the fees seem painless at closing and they are forever. They are *deceptively costless* to many borrowers because when the borrower “pays” them at closing, he or she does not feel the pain of counting out thousands of dollars in cash. The borrower parts with the money only later, when the loan is paid off and the equity value remaining in his or her home is reduced by the amount of fees owed. And *fees are forever* because, even if another lender refinances a family who financed exorbitant fees or who are subject to a prepayment penalty into a better loan just one week later, the borrowers’ wealth is still permanently stripped away.

The fairer and more responsible approach for lenders to recoup costs on riskier loans is to be compensated through charging higher interest rates, not higher fees. If a lender charges too high of an interest rate, the market will respond and other lenders will compete to correct this situation by offering to refinance at a more reasonable rate. So long as there is no anti-competitive prepayment penalty or exorbitant financed fees, the borrower only loses excess interest for a period of time and closing costs, not a life-time of accumulated equity.

Despite the rationality of this pricing scenario, many predatory lenders continue to lock borrowers into equity stripping loans. The New York Times described the practices of First

⁵ See Joint HUD/Treasury “Report on Recommendations to Curb Predatory Home Mortgage Lending” at pp 28-29 (citing 104,000 subprime home loans in 1993 and 997,000 such loans in 1998, June 20, 2000).

⁶ See Joint HUD/Treasury Report, pp.12-49; Panels I to III at May 24, 2000 House Banking Committee Hearings: <http://www.house.gov/banking/52400toc.htm>; HUD, “Unequal Burden: Income and Racial Disparities in Subprime Lending in America” (April 12, 2000); National Training and Information Center, “Preying on Neighborhoods: Subprime Mortgage Lenders and Chicagoland Foreclosure” (Sep. 21, 1999); Daniel Immergluck & Marti Wiles, “Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development” (The Woodstock Institute 1999). See also Diana Henriques with Lowell Bergman, “MORTGAGED LIVES: A SPECIAL REPORT: Profiting From Fine Print With Wall Street's Help”, *New York Times* at Section 1, Page 1 (companion piece ran on ABC's 20/20 the same night, March 15, 2000).

Alliance Mortgage, for example, which regularly charged borrowers 20% of the loan balance in points on loans.⁷ This lender is an egregious, but not isolated, user of excessive fees.

Paying excessive fees once is bad enough. However, this abuse is often repeated, as many lenders “flip” borrowers through frequent fee-loaded refinancing transactions. This allows predatory lenders to strip equity through additional high fees each time without providing the borrower with a net tangible benefit. In their transactions with relatively unsophisticated borrowers, predatory lenders often disguise the fact that their mortgages have balloon payments or adjustable rates, only to inform the borrowers of this fact soon after closing to convince them to get a new and “better” loan. Other predatory lenders require borrowers to refinance in order to catch up if the loan becomes delinquent. In one case we are familiar with, a lender told a borrower she could use refinancing to “skip” her December payment to buy presents for her grandchildren – thousands of dollars in fees later, the presents turned out to be quite expensive.

In another egregious example of flipping, North Carolina research found that abusive lenders flip one in ten Habitat for Humanity borrowers from their 0% first mortgages into high interest subprime loans in order to strip the equity built up through borrower and volunteer sweat equity.⁸ ABC News reported on a Charlottesville, Virginia man who went to an Associates First Capital office to get a small loan to buy groceries. He ended up being talked into 11 refinancing transactions in less than four years that resulted in a \$50,000 mortgage at 19% interest that he could not afford. At this point, half the loan balance came from up-front fees.⁹

To analyze the cost of equity stripping, it is necessary to examine each of the following three loan level components that fuel the practice: (1) financed credit insurance, (2) exorbitant fees, and (3) prepayment penalties on subprime loans.

1. Financed Credit Insurance: \$2.1 billion

Credit insurance is a loan product paid for by the borrower that repays the lender should the borrower die or become disabled. A case can be made for the usefulness of credit insurance when paid on a monthly basis (although conventional term life or disability insurance policies can accomplish the same goal and are often a better deal for the consumer).

In the single-premium credit insurance (SPCI) case, however, the total premiums for the life of the insurance policy are added to the amount of the loan. Generally, this means that five years worth of premiums are added directly to the loan amount. The borrower then pays interest on this amount for the life of the loan and typically has not even begun reducing the loan’s principal balance by the time the five-year credit life insurance coverage period expires. Consequently, **when a borrower moves or refinances out of a subprime loan after five years, all of the**

⁷ See MORTGAGED LIVES at note 6. According to Pamela Kogut, Assistant Attorney General of Massachusetts, 73% of first Alliance borrowers paid more than 10 points and 35% paid more than 20 points (comments made at Washington, D.C. meeting between Federal Reserve Board of Governors and Consumer Advocates on April 12, 2001).

⁸ See “Overview of Habitat for Humanities Refinances” (Coalition for Responsible Lending, Dec. 9, 1999) under “Studies” at <http://www.responsiblelending.org>.

⁹ ABC News, “Prime Time Live” (April 23, 1997).

premiums for the terminated insurance are stripped directly out of the borrower's home equity.

CRL believes that SPCI is one of the most significant predatory mortgage lending abuses. Financing credit insurance is equivalent to financing five years of utility or grocery bills over 15 or 30 years. Purchasing credit insurance in this way makes no sense since it is consumed and can be paid for every month, just like other insurance policies, thereby avoiding unnecessary interest payments and equity stripping. When insurance is purchased on a monthly basis, it is known as a monthly outstanding balance (MOB) form.

Thus, when credit insurance is paid for up-front, it does little more than strip equity from homeowners, which is why Fannie Mae and Freddie Mac, U.S. Departments of Treasury and HUD, bills introduced in the Senate and House banking committees (via the bills introduced by Sen. Sarbanes and Rep. LaFalce), the Federal Home Loan Bank of Atlanta and the North Carolina and California legislatures have all condemned the practice for all home loans.¹⁰

In addition, **Bank of America, Chase, First Union, Wachovia, Ameriquest, Option One, Citigroup, Household, Suntrust, Washington Mutual and American General have all decided not to offer SPCI on their subprime loans or never have engaged in the practice.**¹¹ Conseco Finance, formerly Greentree, seems to be the last large lender continuing to defend the practice. The Federal Reserve has proposed to count SPCI in determining what loans are "high cost," which will further disfavor the practice.

Non-subprime ("conventional") loans almost never include, much less finance, credit insurance. One statewide study that found a 6% penetration rate for credit insurance on prime loans.¹² In contrast, subprime lenders such as CitiFinancial and Household had, before their recent decisions to end the practice, self-reported SPCI penetration rates of approximately 50% and the Associates' an even higher rate of 57%.¹³

Unscrupulous lenders use up-front financing as a tool for hiding the fact that borrowers are obtaining credit insurance at all, regardless of any disclosure requirements. According to an

¹⁰ See <http://www.freddiemac.com/news/archives2000/predatory.htm> and http://www.fanniemae.com/news/speeches/speech_116.html; Joint HUD/Treasury Report, page 91; H.R. 4250/S. 2415, Sec. 2(b)(3); Federal Home Loan Bank of Atlanta, *BankTalk* (Nov. 27, 2000); NC Senate Bill 1149 (1999); California: http://www.leginfo.ca.gov/pub/bill/asm/ab_0451-0500/ab_489_bill_20010912_enrolled.html.

¹¹ See "Equicredit to Stop Selling Single-Premium Credit Life", *Inside B&C Lending* at p.3 (Bank of America, April 2, 2001); Erick Bergquist, "Gloom Turns to Optimism in the Subprime Business," *American Banker* at p.10 (Chase, May 15, 2001); "First Union and Wachovia Announce Community Commitment for the New Wachovia," (May 24, 2001); statements by officers of Ameriquest, Option One, Suntrust and Ameriquest; Jonathon Sapsford, "Citigroup Will Halt Home-Loan Product Criticized by Some as Predatory Lending," *Wall Street Journal* (June 29, 2001); Anitha Reddy, "Household Alters Loan Policy," *Washington Post* (July 12, 2001); Press Release, Washington Mutual, Sept. 5, 2001; Patrick McGeehan, "Third Insurer to Stop Selling Single-Premium Credit Life Policies", *New York Times* (American General, July 21, 2001).

¹² From Eric Stein's conversation with Robert Cook, Consumer and Community Affairs, Federal Reserve Board on Dec. 1, 2000.

¹³ Statements by CitiFinancial and Household officers; Richard A. Oppel Jr. and Patrick McGeehan, "Along With a Lender, Is Citigroup Buying Trouble?" *New York Times* at Section 3, p.1 (quoting internal Associates memo, Oct. 22, 2000).

industry-funded study that considered consumer loans (which have much less paperwork to confuse borrowers than home loans), almost 40% of borrowers either did not know they had received credit insurance or thought that credit insurance was required or strongly recommended by their creditor.¹⁴

Lenders certainly have an incentive to push single premium credit insurance since they receive, on average, 30% commissions up-front on its sale.¹⁵ The product is even more profitable for companies that own both lenders and insurance companies since credit life insurance only suffers a loss rate of 40% compared to a loss rate of 90% for group life insurance.¹⁶

We estimate that prohibiting financed credit insurance would save 500,000 families **\$2.1 billion each year.** (Please see Appendix for an explanation of all cost estimates.)

2. Exorbitant Fees: \$1.8 billion

Exorbitant fees include any fees greater than 5% of the loan amount plus any lender or third-party fees charged a borrower who receives no net tangible benefit in a refinancing transaction.

Our view is that the limit on fees (as defined by HOEPA) should be 3% of the loan amount (4% for FHA/VA loans). By contrast, conventional borrowers pay, on average, a 1.1% origination fee.¹⁷ Fannie Mae, the NC General Assembly and Washington Mutual¹⁸ have all found that points and fees greater than 5% are abusive. For the purpose of estimating the economic cost of predatory lending, we will assume that 5%, rather than 3%, is the correct limit.

In addition, because no borrower should be refinanced into a loan that fails to provide a net tangible benefit, all fees associated with such flips, by definition, should be considered excessive. The NC General Assembly and WUMU have adopted this flipping standard.

We estimate that exorbitant fees cost 750,000 families **\$1.8 billion each year.**

3. Prepayment Penalties on Subprime Loans: \$2.3 billion

The subprime sector serves an important role for borrowers who encounter temporary credit problems that keep them from receiving low-rate conventional loans. Ideally, this sector should provide borrowers a bridge to conventional financing as soon as the borrower is ready to make

¹⁴ Credit Research Center, "Credit Insurance: Rhetoric and Reality", Credit Research Center, Krannert Graduate School of Management, Purdue University, pp 1-3 (1994).

¹⁵ See Joint HUD/Treasury Report, page 88, note 84 (citing Consumers Union) and Consumers Union, "Credit Insurance: The \$2 Billion A Year Rip-Off" (March 1999): http://www.consumersunion.org/finance/credit_info_page.htm

¹⁶ Consumers Union, id.

¹⁷ Peter Mahoney, Associate General Counsel of Freddie Mac, reported that total points and fees for conventional loans has decreased from 1.6% in 1993 to 1.1% in 1999 at the Fannie Mae conference, "The Role of Automated Underwriting in Expanding Minority Home Ownership," Airlie Center, Warrenton, Virginia, (June 8, 2000).

¹⁸ WAMU limits up-front fees and yield-spread premiums to 5% of the loan; see their Responsible Mortgage Lending Principles at http://www.wamunewsroom.com/images/pressreleases/Responsible_lending_principles.pdf

the transition. However, prepayment penalties are expressly designed to prevent this from happening.

Prepayment penalties for subprime borrowers are troubling because these consumers do not “choose” prepayment penalties in any meaningful sense; otherwise, 80% of subprime loans would not have such penalties, compared with only 2% of loans in the competitive, more transparent conventional market.¹⁹ The competitive conventional mortgage market provides a test for people’s true preferences for a prepayment penalty in exchange for a lower rate. Rational subprime borrowers with market power should prefer them no more often, and probably less often, than conventional borrowers so that they can refinance into a conventional loan as soon as credit improves.

To permit prepayment penalties on subprime loans, then, is to protect the right of the very few sophisticated subprime borrowers who would affirmatively choose them at the expense of the 98% who would not. With such a penalty, these borrowers become trapped in higher rate loans, or refinance only to have their equity stripped away.

Prepayment penalties are no more than hidden, deferred fees that strip significant equity from roughly half of subprime borrowers. Prepayment penalties of six months of interest if the borrower prepays at any time, for any reason, during the first five years of the loan are common.²⁰

For a 10% interest rate loan, the penalty would be 5% of the loan balance. For a \$150,000 loan, this fee is \$7,500, more than the total net wealth built up over a lifetime for the median African American family.²¹ This is especially troubling because we estimate that **borrowers in predominantly African-American neighborhoods are five times more likely to be subject to wealth-stripping prepayment penalties than borrowers in white neighborhoods.**²² This

¹⁹ See *Mortgage Marketplace* (May 24, 1999); Joshua Brockman, “Fannie revamps prepayment-penalty bonds,” *American Banker* (July 20, 1999). Standard & Poor’s, “NIMS Analysis: Valuing Prepayment Penalty Fee Income” (Jan. 3, 2001); (Polly Guthrie, telephone conversation with Abner Figueroa, Duff & Phelps; for 1999 Duff and Phelps rated 37% of all private label MBS/CMO).

²⁰ Families prepay their loans to refinance because their credit improves enough to get a better loan or deteriorates so they cannot stay in their present one, or to move because their job is transferred, they want a better house or access to better schools, they get divorced or for other reasons. See Lehman Brothers’ publication, “Asset-Backed Securities” page 1 (July 17, 2000). Lehman Brothers’ example is calculated on the amount prepaid over 20% of the loan balance; for simplicity we have assumed it is calculated on the entire balance, which many prepayment penalties are, and assumed a 10% interest rate rather than a higher rate. The Mortgage Bankers Association’s Legislative Guidelines, page 3, also state that this is a common standard. It is worth noting that use of this complicated formula concerning a certain number of months of interest obscures the size of the penalty to lay people and, perversely, charges a family a higher penalty if it is trying to escape a loan with a higher interest rate.

²¹ Net worth for the median African American family in the United States was \$4,400, for the median white family, \$44,000, according to the 1990 Census. 2000 Census figures will be higher once available.

²² 51% of borrowers in predominantly African-American neighborhoods have subprime loans times 80% who have prepayment penalties (see “Unequal Burden” at note 6) equals 41% have prepayment penalties. 49% of borrowers in African American neighborhoods have prime loans times 1.5% have prepayment penalties equals 1%. 41% plus 1% equals 42% of borrowers in African American neighborhoods have prepayment penalties. 9% of borrowers in white neighborhoods have subprime loans times 80% equals 7% have prepayment penalties. 91% of borrowers in white neighborhoods have prime loans times 1.5% have prepayment penalties equals 1%. 7% plus 1% equals 8% of borrowers in white neighborhoods who have prepayment penalties. 42% is 5.25 times greater than

money is stripped directly out of the equity, or cash value, of their home. Looked at another way, by paying down the loan it takes almost nine years to accumulate equity equal to 5% of the loan amount for a typical subprime loan.²³

According to Lehman Brothers' prepayment assumptions, over half of subprime borrowers will be forced to prepay their loans – and pay the 4% to 5% in penalties – at some point during the five-year lock-out period.²⁴ Investors fully expect such prepayments, with their expectations taking tangible form as bids on a whole new class of securities (called class P securities) created by the prepayment penalty cash flows.²⁵ This stripping of subprime equity is lucrative business; as Lehman states, “the penalty cash flows themselves are substantial.”²⁶

Prepayment penalties are not even very successful in preventing prepayments. Morgan Stanley reports that subprime loans that carry prepayment penalties are prepaid at about 90% of the rate that subprime loans without prepayment penalties are prepaid.²⁷ And according to Lehman data, only 15% of additional borrowers would have paid off their mortgages before the five-year period was up if these borrowers were not subject to prepayment penalties, or 3% more per year.²⁸

The primary economic impact of prepayment penalties for subprime loans, therefore, is to benefit the holders of securities funded by prepayment penalties at the expense of over half of subprime borrowers, and not to stretch out the duration of loans. In other words, prepayment penalties are no more than deferred fees that investors fully expect to receive and borrowers never expect to pay.

We estimate that these subprime prepayment penalties cost 850,000 families **\$2.3 billion each year.**

B. Rate-Risk Disparities: \$2.9 billion

Rate-risk disparities occur when borrowers are charged more than risk can justify for a loan. Unfortunately, these disparities are commonplace in the subprime market. A recent Freddie Mac study used sophisticated statistical modeling to show that subprime loans charge an extra 1% in

8%. This calculation assumes that, within the subprime universe, loans to African Americans have prepayment penalties at the same rate that white borrowers do. While this assumption bears further research, CRL estimates that the African-American percentage would actually be higher.

²³ 30-year, fixed rate loan at 12%.

²⁴ See Asset-Backed Securities, page 2. Assumptions based on Lehman's database of 130,000 subprime loans. Lehman assumes that the Constant Repayment Rate builds up to 17% per year for loans with prepayment penalties and builds up to 25% per year for loans without such penalties. As CRL spreadsheets show, 52.7% of borrowers subject to the 5% prepayment penalty will prepay during the five-year period (while 67.9% of borrowers not subject to penalty will prepay, a difference of 15%).

²⁵ Id. at p. 3, note 2.

²⁶ Id. at p. 2.

²⁷ Morgan Stanley Dean Witter, Home Equity Loan Handbook 9 (1998 Ed.).

²⁸ See note 24.

interest (and presumably much more for predatory lenders) that could not be explained by credit risk.²⁹

Another way to consider the disparity between risk and rates has to do with the steering of borrowers to less than the most advantageous loan. Steering occurs when a borrower is placed in a loan with higher rates and or fees than another loan for which the borrower qualified.

According to Fannie Mae, up to half of all subprime borrowers could qualify for lower cost conventional financing.³⁰ 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.³¹ 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.³²

It is particularly troubling when subprime lenders with conventional affiliates charge borrowers who meet conventional underwriting standards higher rates than justified. The very same "A" borrower who would receive the lender's lowest-rate loan from its prime affiliate pays extra when he gets a loan from the subprime affiliate. Washington Mutual, by contrast, has pledged that it will offer the same loan to borrowers at the same office no matter whether they enter through their conventional or supprime affiliate.³³

Borrowers are also charged too much when brokers convince them to accept a higher-than-justified rate ("broker originations"). Brokers originate over half of all mortgage loans, both prime and subprime.³⁴ Brokers receive as compensation up-front fees and back-end kickbacks ("yield-spread premiums" or "YSPs") -- fees lenders rebate to brokers in exchange for placing a borrower in a higher interest rate than for which the borrower qualifies.

Kickbacks (distinguished from bona fide servicing release premiums, which are unrelated to the terms of the loan) **are inherently abusive since they give the broker an incentive to make the interest rate to the borrower as high as possible without regard to the borrower's creditworthiness.** The higher the interest rate, the higher the premium and therefore the higher the broker's compensation becomes. In this way, kickbacks provide brokers an economic incentive to steer minority and other borrowers into costly loans.

²⁹ Peter Zorn, Subprime Lending: An Investigation of Economic Efficiency (Freddie Mac, Dec. 21, 2000).

³⁰ See Fannie Mae March 2, 2000 press release at page four:

<http://www.fanniemae.com/news/pressreleases/0667.html>

³¹ See Freddie Mac Special Report on Automated Underwriting (Sep. 1996) at

<http://www.freddiemac.com/corporate/reports/moseley/chap5.htm> and "Half of Subprime Loans Categorized as 'A' Quality," *Inside B&C Lending* (June 10, 1996).

³² Comments made at meeting between consumer advocates and the Federal Reserve Board of Governors (April 12, 2001).

³³ See footnote 17.

³⁴ See Joint HUD/Treasury Report, page 39, notes 43 and 44. See also Wholesale Access press release (7/5/2001) (<http://www.wholesaleaccess.com/prs.7.5.01.shtml>) (In 2000, brokers originated 55% of total residential loans, 70% in 1998, and, since brokers tend to specialize in refinances, a projected 60% in 2001).

Kickbacks are also inherently deceptive to the borrower. No one who understands their situation would knowingly accept a higher interest rate than they otherwise qualified for without receiving a benefit,³⁵ yet this is what borrowers pay when lenders split their above-par bounty with the broker after closing.

Rate-risk disparities appear to be especially frequent for minority borrowers. Recent studies have shown that black borrowers are commonly steered into high-rate and high-fee subprime loans when they in fact qualify for lower cost loans.³⁶ A 2000 HUD study found that **higher-cost subprime loans are five times more common in black neighborhoods than in white neighborhoods**, accounting for 51% of home loans in predominantly black neighborhoods in 1998 compared with 9% in white areas. According to the study, borrowers in *upper-income black* neighborhoods were twice as likely as homeowners in *low-income white* neighborhoods to receive subprime refinance loans.³⁷

We estimate that total excess interest costs 600,000 families **\$2.9 billion each year**.

C. Excessive Foreclosures

The ultimate and tragic consequence of the wealth-stripping and steering associated with predatory lending is the loss of families' homes, and the destruction of entire communities, through high rates of foreclosure. Subprime loans with predatory terms are far more likely to end in foreclosure than conventional loans. While higher than average rates of foreclosure should be expected in subprime lending where borrowers frequently pose higher credit risks, the studies to date have suggested that subprime foreclosures are disproportionate even taking this assumption into account.

One likely explanation is that subprime loans with abusive characteristics are dramatically raising the sector's average foreclosure rates. The Joint HUD/Treasury study cites data showing that, for one recent 20-month period, subprime foreclosure rates averaged 2.6% compared to 0.62% for prime mortgages.³⁸ It also mentions a number of reports that demonstrate the disproportionate rise in foreclosures resulting from subprime loans. For example, HUD found that 45% of all foreclosure petitions in Baltimore City were from subprime loans, while the subprime share of originations was just 21%.³⁹ In another study of one subprime lender, one out

³⁵ Brokers claim that YSP's are used to pay closing costs in no- or low-closing cost mortgages to the benefit of cash-poor borrowers. While this is true occasionally for conventional purchase-money mortgages, the Coalition for Responsible Lending has seen no evidence for it in the subprime arena. In fact, loans in which we have seen YSP's labeled on the HUD-1A have uniformly contained high fees as well.

³⁶ Immergluck & Wiles; see note 6; Fred Faust, "Acorn blasts Number of Sub-Par Loans Made in St. Louis Area", *St. Louis Post-Dispatch* at C8 (Oct. 22, 1999); National Training and Information Center, "Preying on Neighborhoods: Subprime Mortgage Lenders and Chicagoland Foreclosure" (September 21, 1999); Bruce Lambert, "Analysis Shows Racial Bias In Lending, Schumer Says", *New York Times* at Section 1, p.35 (April 9, 2000).

³⁷ HUD, *Unequal Burden*; see note 6.

³⁸ See Joint HUD/Treasury Report, pages 34-35.

³⁹ See Joint HUD/Treasury Report, page 50, notes 67-68.

of four loans were in foreclosure or well on their way *in the first two years* after origination, compared with just one-half of one percent of FHA loans during the same time period.⁴⁰

Compounding the problem of high foreclosure rates in subprime lending is the growing body of evidence indicating that subprime foreclosures are disproportionately affecting inner city and African-American communities. One study by the National Training and Information Center suggests that subprime foreclosures were more likely than conventional foreclosures to be linked with the abandonment of buildings in an urban section of Chicago.⁴¹ A HUD paper suggests that subprime foreclosures may have a more significant impact in low-income and African-American neighborhoods where subprime loans account for a substantial portion of home lending in such cities as Baltimore, Chicago, and Atlanta.⁴²

In addition to the obvious cost to the homeowners who are foreclosed on, stakeholders such as government and private mortgage insurers, loan servicing entities, and others face significant costs associated with foreclosure. A 1995 study by the Family Housing Fund of Minnesota offered two scenarios representing “average losses experienced by typical homeowners” they served with foreclosure prevention counseling. The losses for homeowners and other stakeholders ranged from \$26,600-\$73,300 per foreclosed property.⁴³

In addition to these direct costs associated with a single foreclosure, foreclosures cause externalities that neighborhoods, and the other families that live there, must bear, since boarded-up homes in low-income neighborhoods carry a social cost far beyond the cost of the foreclosures themselves. The value of surrounding homes, and therefore the equity held by neighboring homeowners, drops as a result of high rates of foreclosure. Crime increases in high-vacancy areas, imposing economic costs. Communities with excessive foreclosure rates face a host of other costs, including lost revenues associated with difficulty attracting investments.⁴⁴

Theoretically, one could estimate the economic loss in homeowner equity that results from foreclosures due to unsound subprime lending practices by calculating direct losses to homeowners and then determining a multiplier that would capture consequential direct and indirect external economic losses. These additional costs from resulting social externalities may

⁴⁰ Testimony of Drake Law Professor Cathy Lesser Mansfield on a pool of mortgages by WMC, before the Committee on Banking and Financial Services, U.S. House of Representatives (May 24, 2000). This category included all loans that were more than 90 days or more delinquent, in foreclosure, in bankruptcy, or already foreclosed upon. By comparison, well under one-half of one percent of FHA loans had defaulted in their first two years throughout the 1990s. See Price Waterhouse Coopers’ Actuarial Review of FY 1998 of FHA’s Mutual Mortgage Insurance Fund (March 1, 1999).

⁴¹ National Training and Information Center, “Preying on Neighborhoods” (Sep. 21, 1999).

⁴² Harold L. Bruce, *et al*, “Subprime Foreclosures: The Smoking Gun of Predatory Lending?” (U.S. Department of Housing and Urban Development); see <http://www.huduser.org/publications/polleg/hpcproceedings.html>)

⁴³ Family Housing Fund, “Cost Effectiveness of Mortgage Foreclosure Prevention” (1995, republished in 1998). The cost estimates were broken out as follows: FHA mortgage: \$7,200 from homeowner, \$1,500 from lender, \$26,500 from FHA-HUD, \$1,100 from servicer, \$27,000 from city, \$10,000 from neighbors; Conventional mortgage: \$7,200 from homeowner, \$2,300 from lender, \$1,100 from servicer, and \$16,000 from private mortgage insurer. Note that Minnesota has a longer than average redemption period, which might cause these cost estimates to be higher than would occur in other states.

⁴⁴ See Joint HUD/Treasury Report, page 25.

well dwarf other estimates made in this report. However, because these costs are exceedingly difficult to specify, this study makes no attempt to quantify them.

Conclusion

The calculations offered in this paper are clearly rough, though conservative, estimates. We believe, however, that they provide an order of magnitude of the amount of equity stripped, each year, from those least able to afford it. They also attest to the notion that the most important lending issue today is no longer denial of credit but the terms of credit.

APPENDIX A

Explanation of Estimated Costs

1. Financed Credit Insurance. Nationally, providers wrote \$4.98 billion in credit life and credit accident and health insurance in 1999.⁴⁵ One provider, CUNA Mutual, writes virtually no single-premium credit insurance. Subtracting CUNA mutual's share of \$0.51 billion from 1999 totals leaves \$4.47 billion.⁴⁶ Based on conversations with regulators,⁴⁷ we conclude that half of this total amount written provides coverage on home loans, with 95% written on a single-premium basis. Accordingly, this calculation yields a total cost to consumers of \$2.1 billion.

We looked at the amount of SPCI for North Carolina alone and then expanded the amount pro rata to the rest of the country as a check to our calculations. A prohibition on financed credit insurance will, for North Carolina alone, each year save at least 10,000 to 20,000 homeowners almost \$100 million of needlessly lost equity.⁴⁸ Extrapolating nationwide, that would be roughly \$3.3 billion of equity for 500,000 families at a cost of \$6,600 each per year saved by a general prohibition for all home loans.⁴⁹ However, we use the more conservative figure to arrive at a final estimate of \$2.1 billion for 500,000 families nationwide.

2. High Fees. Although there are few data sources available on fees, we have learned enough to estimate them. ACORN reports that, based on their review of many Household Finance

⁴⁵ National Association of Insurance Commissioners, "Credit Life and Accident and Health Insurance Loss Rations for 1997-1999" (March 2001).

⁴⁶ Id.

⁴⁷ According to William F. Burfeind, Executive Vice President Consumer Credit Insurance Association, 95% of credit insurance is financed single-premium credit insurance. According to state insurance regulators, half of this amount is typically for mortgages, while the other half is written in connection with consumer debt.

⁴⁸ In North Carolina for calendar year 1997, according to the National Association of Insurance Commissioners, \$204,814,627 in credit insurance policies for credit life and credit disability/accident and health insurance were written. Because of data limitations, this amount does not include credit property or credit unemployment insurance, which are both significant credit insurance products sold in the state. Using the assumptions in footnote 47 yields a total of \$97 million in single-premium credit insurance policies written in connection with mortgages each year in the state. Since 99% of the original balance of single premiums remains after its average life of five years on a standard amortizing loan, 99% of \$97 million, or \$96 million, is stripped out of the home equity of North Carolina families. The 10,000 to 20,000 figure comes from an average single premium ranging from \$5,000 to \$10,000 that we have observed, and is consistent with information found in footnote 13 that half of retail subprime home loans originated by three large lenders had financed single premium credit insurance (total subprime loans in NC in 1999 was 40,000).

⁴⁹ In 1999, North Carolina's population was 7.7 million, while the United State population was 274 million, according to U.S. Census Bureau. NC's population is therefore 3% of the total. If \$100 million of lost equity due to financed credit insurance is also 3% of the country's total, then the national total is 33 times this amount, or \$3.3 billion. There were 2.4 million subprime loans in 1999 (\$160 billion in originations [Inside Mortgage Finance, Mortgage Market Statistical Annual 2000, Volume II, p. 1-2 and Joint HUD/Treasury Report, pp. 29-31] divided by \$67,000 average loan size [see Joint HUD/Treasury Report, pp. 29-31] equals 2.4 million loans). \$3.3 billion is looked at another way, assume conservatively that 20% of subprime loans have financed credit insurance attached (500,000 borrowers each year); \$3.3 billion divided by 500,000 is an average premium amount of \$6,600. This figure is consistent with loan documents and other evidence we have reviewed. It is also consistent with loans examined by the Iowa Attorney General's office, see May 1, 2001 HOEPA comment letter from Kathleen Keest to the Federal Reserve System.

loans, Household's standard charge on first mortgages is 7.25% of the loan.⁵⁰ First Alliance Mortgage routinely charged over 20 points and we regularly see loans charging over 10 points. Also, a study of high loan-to-value mortgage loans found that average fees were 7% of the loan amount.⁵¹ Finally, CRL has reviewed the loan documents on several thousand loans originated by a multitude of lenders in North Carolina.

Based on all this information, we conservatively assume that 25% of subprime mortgage loans charge an average of 7% in upfront fees. That amounts to an unnecessary 2% in fees on \$40 billion of the \$160 billion total for subprime mortgages. An extra 2% of a quarter of \$160 billion in 1999 subprime originations totals \$800 million in excess up-front fees paid by 600,000 borrowers each year. Again, the dearth of reported information on fees further points to the need for additional data reporting. The Federal Reserve's recent proposal requiring lenders to disclose the APR of all home loans would be a helpful step. However, without a corresponding disclosure of points and fees, as defined by HOEPA, the information would be incomplete.⁵²

Through deed research at the county courthouses and experience viewing the loan documents of several thousand subprime borrowers, we very conservatively estimate that 15% of all subprime refinances do not benefit the borrower in economic terms. Thus, they should be deemed flipped and any charges, either fees to the lender or third parties, constitute money unnecessarily paid by the borrower. Closing costs -- third party fees -- average \$1,500, or 2.2% of a subprime loan.⁵³ Assume very conservatively that the average amount of lender fees charged in these flipping transactions is 2.8%, the total amount of lender and third party fees unnecessarily paid is 5%. 80% of all \$160 billion in subprime loans are refinances, multiplied by an estimated 15% flipped, by 5% in fees totals \$960 million in excess fees paid (rounded to \$1 billion) by 150,000 flipped borrowers each year.

Accordingly, fees charged over 5% and fees paid on flipped loans total approximately \$1.8 billion in excess fees paid each year.

- 3. Prepayment Penalties.** While Lehman states that a prepayment penalty of 5% that remains in effect for five years is standard, we conservatively assume that the average penalty is 4% for four years. CRL modeled Lehman's assumptions on a spreadsheet available on request and found that 44% of borrowers actually pay this 4% fee. Multiply this amount times the 80% of subprime borrowers who have penalties, by \$160 billion in originations and it amounts to \$2.3 billion in lost equity annually to 850,000 homeowners per year due to prepayment penalties.

⁵⁰ August 1, 2001 email from Lisa Donner, Director of Legislative and Strategic Campaigns, ACORN.

⁵¹ Charles W. Calomiris & Joseph R. Mason, "High Loan-to-Value Mortgage Lending: Problem or Cure?" at 12 (citing unpublished reports that HLTV loans average fees of 7 percent of the loan value, American Enterprise Institute 1999).

⁵² See CRL comments on the Fed's HMDA proposal at: <http://www.responsiblelending.org/hmda.htm>.

⁵³ See Lew Sichelman, "Closing Costs Will Drop By Half, Predicts Freddie Mac", Realty Times (5/16/2000); http://realtytimes.com/rtnews/rtcpages/20000516_closingcosts.htm; \$1,500 divided by average subprime loan balance of \$67,000 (see footnote 49) is 2.2%.

While some lenders argue that borrowers choose prepayment penalties in exchange for lower rates, we have found little evidence to support this claim in the subprime market. In fact, we have found repeated cases where borrowers receive *higher* rate loans than the borrower actually qualified for because the lender paid a kickback, or yield spread premium, to a broker as a result of the loan containing a prepayment penalty. This makes sense because lenders would have little incentive to pay brokers a premium for high interest rate originations unless those loans were protected from flipping by the same or another broker. The link between prepayment penalties and higher rates than borrowers qualify for, not a reduction in rate, is demonstrated by lender rate sheets. For example, one rate sheet from ContiMortgage Corporation dated 12/8/98 offers a maximum of 2.5% yield spread premium for loans without a prepayment penalty and a 4.25% premium for loans with a prepayment penalty.

- 4. Rate-Risk Disparities.** Fannie Mae and Freddie Mac estimate that somewhere between 10% to 50% of subprime borrowers would qualify for conventional financing. Assume conservatively the correct number is 20%. On December 1, 2000, conventional loan interest rates averaged 7.75%, while “A-“ rates averaged 10%, “B” loans averaged 11.8% and “C” loans averaged 12.7%.⁵⁴ Based on the percentage distribution of A-, B and C credit loans in the subprime market,⁵⁵ the weighted average interest rate of subprime loans over the interest rate on conventional loans is 3%. Other analyses would place this number even higher.⁵⁶ Converting 3% to net present value, one should use a multiple of roughly three,⁵⁷ for a total of 9% in fee-equivalent extra net present value that borrowers pay for loans due to rate-risk disparities. Multiplying this amount times the 20% of borrowers that would qualify for conventional mortgages, times \$160 billion in originations, we find that there is \$2.9 billion in needlessly lost equity by 600,000 families each year due to excess interest alone.

Note that all we are doing is calculating the percentage of borrowers paying subprime rates when they would have qualified for conventional rates. We have not attempted to estimate the percentage of borrowers who legitimately qualify for a subprime loan but are placed in a credit risk class that is lower than that for which they actually qualify -- such as an A-borrower who receives a C loan and thereby pays an extra 2.7% interest (see footnote 54). Lisa Donner at ACORN reports that Household Finance, for example, charges lower risk subprime borrowers the same high interest rates they charge higher risk borrowers, and CRL has seen numerous examples of lower-risk subprime borrowers being overcharged. In addition, this type of steering occurs virtually every time a subprime loan is originated by a mortgage broker who charges a yield-spread premium in exchange for placing the borrower in a higher-rate loan than the borrower qualifies for, and brokers originate 50% to 70% of all

⁵⁴ See Inside B&C Lending (showing A- averages 150 – 200 bp less than B credits, Dec. 4, 2000 at page 12).

⁵⁵ According to National Home Equity Mortgage Association, A- loans are 60% of total subprime market, B loans are 30%, and C loans are 9% (cited in Joint HUD/Treasury Report, page 34).

⁵⁶ An unpublished analysis of Mortgage Information Company data actually suggests this figure is 4.2%, while the Wall Street Journal reports it to be between 3% and 6%. See John Hechinger, “Subprime Borrowers are Haunted by Prepayment Penalties,” August 1, 2001, p. 1.

⁵⁷ Inside B&C gave the 12-month prepay speed of 23%, which translates into an average life, and thus yield-fee multiple, of just under three years, so I have used a multiple of three in calculating NPV.

home loans.⁵⁸ Since this type of steering within and between subprime classes is difficult to estimate, we have ignored it in our calculations.

As a check to our rate-risk disparity estimate, assume that Freddie Mac's calculation that subprime loans charge 1% more interest than creditworthiness would indicate is accurate.⁵⁹ Converting this excess yield to a net present value fee would be 3%. Multiply \$160 billion in subprime originations by 3% equals \$4.8 billion of interest paid that is not justified by the borrower's creditworthiness, a higher figure than our calculated estimate. Again, we have used the more conservative estimate in our calculations.

⁵⁸ See footnote 34.

⁵⁹ Peter Zorn, "Subprime Lending: An Investigation of Economic Efficiency", Freddie Mac (Dec. 21, 2000).

APPENDIX B
Estimated Costs by State

Estimated Cost of Predatory Lending*

(dollars in millions)

State	Loan Volume	Percent of Total Volume	Estimated Cost of Predatory Lending
AL	\$ 11,076.6	0.9	\$ 84.1
AK	\$ 1,953.7	0.2	\$ 14.8
AZ	\$ 29,364.4	2.5	\$ 223.0
AR	\$ 5,617.2	0.5	\$ 42.7
CA	\$ 245,403.1	20.5	\$ 1,863.5
CO	\$ 40,234.9	3.4	\$ 305.5
CT	\$ 17,366.0	1.4	\$ 131.9
DE	\$ 3,155.8	0.3	\$ 24.0
DC	\$ 3,280.2	0.3	\$ 24.9
FL	\$ 69,328.9	5.8	\$ 526.5
GA	\$ 39,277.5	3.3	\$ 298.3
HI	\$ 4,884.2	0.4	\$ 37.1
ID	\$ 4,549.6	0.4	\$ 34.5
IL	\$ 58,011.2	4.8	\$ 440.5
IN	\$ 19,547.4	1.6	\$ 148.4
IA	\$ 6,252.6	0.5	\$ 47.5
KS	\$ 7,303.6	0.6	\$ 55.5
KY	\$ 10,489.1	0.9	\$ 79.7
LA	\$ 9,331.1	0.8	\$ 70.9
ME	\$ 3,086.4	0.3	\$ 23.4
MD	\$ 27,468.2	2.3	\$ 208.6
MA	\$ 34,248.8	2.9	\$ 260.1
MI	\$ 43,303.7	3.6	\$ 328.8
MN	\$ 21,786.9	1.8	\$ 165.4
MS	\$ 5,370.4	0.4	\$ 40.8
MO	\$ 18,108.8	1.5	\$ 137.5
MT	\$ 2,254.2	0.2	\$ 17.1
NE	\$ 4,454.9	0.4	\$ 33.8
NV	\$ 13,173.9	1.1	\$ 100.0
NH	\$ 5,306.1	0.4	\$ 40.3
NJ	\$ 38,867.3	3.2	\$ 295.1
NM	\$ 5,523.3	0.5	\$ 41.9
NY	\$ 57,358.1	4.8	\$ 435.6
NC	\$ 30,574.7	2.6	\$ 232.2
ND	\$ 839.8	0.1	\$ 6.4

OH	\$ 39,994.8	3.3	\$ 303.7
OK	\$ 7,347.0	0.6	\$ 55.8
OR	\$ 15,611.6	1.3	\$ 118.5
PA	\$ 31,611.0	2.6	\$ 240.0
RI	\$ 3,810.3	0.3	\$ 28.9
SC	\$ 14,107.7	1.2	\$ 107.1
SD	\$ 1,465.8	0.1	\$ 11.1
TN	\$ 18,785.5	1.6	\$ 142.7
TX	\$ 65,564.9	5.5	\$ 497.9
UT	\$ 11,977.3	1.0	\$ 91.0
VT	\$ 1,535.3	0.1	\$ 11.7
VA	\$ 34,854.7	2.9	\$ 264.7
WA	\$ 32,518.1	2.7	\$ 246.9
WV	\$ 2,513.0	0.2	\$ 19.1
WI	\$ 17,233.1	1.4	\$ 130.9
WY	\$ 1,290.3	0.1	\$ 9.8
Total	\$1,198,373.0	100.0	\$ 9,100.0

* State estimates produced by multiplying the \$9.1 billion national estimate by each state's percentage share of total 2000 U.S. loan volume. Loan volume was calculated as the total amount of all year 2000 Home Mortgage Disclosure Act data loans reported as originated or purchased in one of the fifty states or the District of Columbia.