

An Overview of the Predatory Mortgage Lending Process

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Abstract

This overview of the predatory lending process provides an introduction to the structure of the larger mortgage lending industry and the way predatory lending fits into it. The article begins with a description of the mortgage marketplace and its players. Next, it examines distinctions among the prime, subprime, and predatory segments of this market, particularly as they relate to risk, pricing, and borrower characteristics.

The remainder of the article describes the characteristics of predatory loans and their life cycle, from marketing and origination to securitization and servicing. The article closes with a description of the revenue source(s) for each of the actors and the effect of that revenue stream on the actor's incentives. The conclusion summarizes observations about the goals of predatory lenders and notes that by accomplishing these goals, lenders undermine the wealth-building capacity of affected homeowners.

Keywords: Financial industry; Mortgages; Subprime and predatory lending

Introduction

Ms. H. is a widowed 81 year old African-American homeowner who lives in Washington, D.C. In 1999, she was induced by a mortgage broker to refinance an existing \$118,000 mortgage loan into a new loan for \$129,000. Ms. H. testified that the broker persuaded her to take the new loan by claiming it would retire existing unsecured debt, lower her monthly payments, cover her real estate taxes and insurance, and lower her interest rate. None of these assertions was true. In fact, Ms. H.'s new loan did not pay off any unsecured debt, raised her monthly payments, did

not cover her tax and insurance obligations, and, after a two-year period, would significantly increase her interest rate. Moreover, the new loan provided Ms. H. with absolutely no other tangible benefit of any kind. Not only were no unsecured debts paid off, but she received no cash out from the loan. The mortgage broker, however, made \$3,850 as a result of the transaction. The same mortgage broker had originated Ms. H.'s prior mortgage loan, taken out in 1997. That loan contained a substantial prepayment penalty if paid off in less than three years; thus, Ms. H. paid significant sums in the form of a prepayment penalty, in addition to her closing costs, on the 1999 refinancing. The mortgage broker's combined compensation on the two loans exceeded \$12,000.

Ms. J. is 71 years old. According to Ms. J., she received a phone call from a mortgage broker, who promised her that he would refinance her two existing mortgages, provide her with \$5,000 in extra cash and lower her monthly payments. Ms. J. needed cash to repair her kitchen, so she agreed to meet. The broker visited Ms. J. at her home. Ms. J. maintains that he gained her trust by claiming that he liked her as a person and he wanted to help senior citizens because his own father had recently died of cancer. Later, the broker returned to Ms. J.'s house to have her sign the mortgage loan papers. Ms. J. said that she could not read the documents carefully because she suffers from vision problems and has a limited education. Ms. J. said she signed the mortgage loan documents based on the broker's promises and representations that the mortgage loan would provide her with cash to repair her kitchen and lower her monthly mortgage payments. Ms. J. received a \$90,100 mortgage with an APR [annual percentage rate] of 14.819%. The mortgage loan contained a 15-year balloon note that required a final payment of \$79,722.61 (due when she was 86 years old). Ms. J. paid 10% of the loan amount, or \$9,100 as a broker's fee. The monthly payment increased to approximately 80% of her monthly income. Ms. J. did not receive any money from the proceeds of this transaction.

Mr. C. purchased a home from a property owner/seller. According to Mr. C., the property owner/seller suggested that he apply for an FHA [Federal Housing Administration] mortgage to cover the \$115,000 sales price and the closing costs. The property owner/seller referred Mr. C. to a lender in a close business relationship with the property owner/seller. The lender arranged FHA financing for the purchase price and all settlement charges, including the lender's origination costs. The property was grossly over-appraised. Actual comparable properties in the area were appraised in the

\$75,000-85,000 range. Mr. C. stated he later learned that the property owner/seller had purchased the property less than a year earlier for \$32,000. The property owner/seller then made cosmetic improvements to the house and put it on sale for \$115,000. As a result of the transaction, Mr. C. now owes a mortgage of \$115,000 for a property that is worth tens of thousands less. (U.S. Department of the Treasury and U.S. Department of Housing and Urban Development [HUD] 2000, at 18–21)¹

These are just three of thousands or hundreds of thousands of stories of homeowners in this country.² The bold overreaching, outright fraud, and theft of equity described here are just some of the reasons why predatory mortgage lending has caught the spotlight—and rightly so.

Understanding how the predatory mortgage marketplace operates is essential for several reasons. First, researchers need to appreciate how these markets work so that studies can be tailored to address the most important issues and obtain the most accurate results. Second, expanding community resources to address the effects of such lending on individuals and neighborhoods requires cogent teaching and writing on the subject. Finally, the public, including legislators, judges, and the media, needs to understand the causes of this type of lending and its effects on individual homeowners and our society as a whole. Proposals to regulate mortgage loan abuses and those profiting from them will not be successful unless protections are tailored to stop the harm to homeowners without significantly affecting the flow of legitimate and fairly priced credit.

This article will also introduce the players and explain the role of the secondary market; the anatomy of the prime, subprime, and predatory mortgage marketplaces; the characteristics of predatory loans; their life cycle; and the financial incentives to make them. This background sets the stage for the articles that follow in this special issue of *Housing Policy Debate*.

¹ In April and May of 2000, HUD and the U.S. Department of the Treasury held a series of hearings in Atlanta, Baltimore, Chicago, Los Angeles, and New York in order to obtain evidence and suggestions about regulatory action. These homeowners appeared at the hearings. Their evidence was included in the agencies' report, which recommended that specific regulatory and other action be taken to ameliorate certain predatory lending practices. For additional examples, see Brennan 2000.

² There is no easily accessible public source of information on the numbers of predatory loans made in the United States each year. However, according to court decisions and government enforcement actions, the numbers are significant. See the discussion of overreaching creditor behavior in numerous court decisions in Keest and Renuart 2000, at chapter 11 and Sheldon and Carter 2001, at §§ 5.1.9–5.1.14. See also the National Consumer Law Center et al. 2003, which contains a list of over more than 20 pending and closed cases against national banks or their operating subsidiaries involving violations of law and/or predatory loans.

The players in the mortgage lending process

How the mortgage market works is a mystery to most consumers. Every mortgage transaction brings together a variety of actors. Some are directly involved with the homeowner, while others operate behind the scenes. Some appear on stage at the beginning of the process, when the loan is consummated. Others engage when the homeowner makes payments or defaults. Here are the most common players and the stages on which they operate.

Mortgage broker

According to HUD, mortgage brokers are involved in about 60 percent of all mortgage loan transactions (Office of the Federal Register 2002, at 49,140).³ Historically, brokers did not originate loans but instead acted as the intermediaries that brought home purchasers or homeowners and lenders together. These brokers often operated on behalf of borrowers and attempted to find their clients the best available loans. This type of arrangement created a special duty on the part of the broker, to act as a fiduciary for the borrower.⁴

Currently, however, brokers may work in their own interest or in the interest of the lender. To make it even more confusing, they sometimes wear two hats and act as broker and lender. Brokers function in several different ways: (1) by originating the loan using “table funding” provided by a prearranged buyer of the loan⁵; (2) by originating the loan using a line of credit from a bank, financial institution, or other entity; (3) by originating the loan using their own funds; or (4) by merely bringing the lender and borrower together in a transaction they do not originate (Eggert 2002b, at 538).

Home improvement contractors and mobile home dealers may act as

³ HUD does not break down this 60 percent into percentages of brokers in the prime, subprime, or predatory markets or purchase mortgages versus refinancings. The numbers of brokers and their frequent appearance in mortgage loans has increased dramatically since the 1970s and 1980s. See Hechinger 2003, at A1, who reports that brokers earn an average of about \$120,000 but that at least 5 percent of them earn \$1 million a year or more.

⁴ See, for example, *Barker v. Altegra Credit Co. (In re Barker)*, 251 B.R. 250 (Bankr. E.D. Pa. 2000) (a mortgage broker owes a fiduciary duty to a borrower when it promised to find a loan in the best interest of the borrower); *Arnold v. United Companies Lending Corp.*, 511 S.E. 2d 854 (W. Va. 1998) (whether a broker acted on behalf of borrowers and, therefore, owed a fiduciary duty or was merely a “middleman” is a question of fact); *Byrd v. Crosstate Mortgage & Inv., Inc.*, 1994 Va. Cir. LEXIS 38 (Va. Cir. Ct. Apr. 6, 1994) (a mortgage broker owes a fiduciary duty to the borrower).

⁵ Table funding is the process whereby a loan is closed in the name of the original lender, typically a mortgage broker, and the loan funds are provided by an investor that immediately takes assignment of the loan. HUD recognizes that the true lender in this situation is the funder, meaning the entity to which the loan is initially assigned after settlement. See Regulation X, 24 C.F.R. § 3500.2 (definition of “lender”).

brokers as well. In this capacity, they usually prearrange with a lender to funnel loans to customers who need financing.

Real estate agent

Property is often sold through real estate agents. They usually represent the seller and list the property in newspapers, circulars, and computer databases, as well as showing it.⁶ Most commonly, they are paid a percentage of the sales price and frequently recommend mortgage lenders and brokers to home buyers.

Closing agent or attorney

The mortgage closing or settlement is usually conducted by an agent for the lender.⁷ Often this agent is an attorney. Homeowners are sometimes under the mistaken impression that the closing agent works for them. This is not surprising since the homeowner pays the agent's bill for conducting the closing and for performing other preclosing activities, such as searching the title and preparing the documents.

The mortgage originator versus the mortgage holder

The mortgage lender whose name appears on the loan note, mortgage, and HUD-1 Settlement Statement is the loan originator. The mortgage holder, however, "owns" the mortgage. If the original lender never sells the mortgage, then it is both the originator and the holder. If the original lender sells the mortgage, then the purchaser is the holder. The holder is the party that has the right to foreclose. Since many mortgages are sold by the originator to a purchaser on the secondary market, the mortgage holder will very often not be the bank or mortgage company that made the loan. Many mortgages are now pooled and sold pursuant to a trust agreement so that the holder is a trustee for a larger group of investors. This is called securitization and will be discussed at more length shortly.

Secondary mortgage market

The secondary market is not a place like Wall Street. Rather, this term describes the sale of loans, usually in bulk, by originating lenders to buyers

⁶ See, for example, *Van Deusen v. Snead*, 441 S.E.2d 207 (Va. 1994).

⁷ See, for example, *Horvath v. Adelson, Golden & Loria, P.C.*, 773 N.E.2d 478 (Mass. App. 2002) and *Garrett v. Fleet Fin., Inc.*, 556 S.E.2d 140 (Ga. App. 2001).

(often called investors). Such sales enable mortgage companies specializing in home equity lending to operate with a small capital base. They can obtain a line of credit from a major bank or firm, originate mortgage loans, and then sell them in the secondary market. The secondary market includes wholesale lenders that buy loans from smaller lenders and the securitization market, where mortgage loans are pooled and the interest in cash flows from those pools are sold to investors. Fannie Mae and Freddie Mac purchase huge numbers of loans in the secondary market.⁸

Securitization

This is a process of separating certain types of assets, in this instance, mortgage loans, from the risks associated with the original lender, and selling these assets to a third party that in turn issues securities to raise funds in the capital market at a lower cost to the original lender than obtaining a line of credit (Schwartz 2002, at § 1.1). Consequently, the financial state of the original lender becomes less relevant to investors than the investment worthiness of the mortgage loans. In other words, the loans become commodities in and of themselves. Capital is created in this way to fund the making of loans. This process brings together a variety of entities to accomplish these goals. The trail of players takes us from the originating lender to Wall Street.

The monthly payments made by the homeowners whose mortgage loans are in the pool are used to pay the servicer, the trustee, and the investors (Robinson 2003). The interest portion of the monthly payments must be high enough to cover these costs.

Subprime mortgage lending increased rapidly after 1994, and creating capital flow through securitizations followed suit (Temkin, Johnson, and Levy 2002, at 7–9). The value of the mortgage-backed securities (MBS) issued by the subprime market grew from \$11.05 billion in 1994 to \$133 billion in 2002 (2003 *Mortgage Market Statistical Annual* 2003, at 5–7). The risk of loss to senior investors can be negligible, given mortgage and pool insurance, over-collateralization, senior-subordinate structures, and recourse agreements between the trust and the lender (Eggert 2002b, at 540–41, 548–49).

⁸ Congress created these private entities to provide liquidity or capital in the housing market by purchasing mortgages. This process puts money back into the hands of the originating lender so that new loans can be made. When qualifying the borrower for a loan, the originating lender must follow certain underwriting guidelines specified by Freddie Mac and Fannie Mae.

Mortgage servicer

Mortgages that are assigned upon sale in the secondary market are generally serviced by a bank or servicing company, which collects the monthly payments and interacts with the homeowner on the holder's behalf. The servicer may be the originating lender, which retained servicing rights when it sold the loan. It holds money in escrow to pay the property taxes and homeowner's insurance. The servicer also negotiates any repayment or loss mitigation plan with a defaulting homeowner or hires a foreclosure attorney if necessary.

Mortgage insurance companies

Mortgage insurance is common in transactions involving home purchases. When the borrower's down payment is less than 20 percent of the purchase price, private mortgage insurance (PMI) is generally required.⁹ The cost of this insurance is added to the borrower's monthly payment and escrowed by the lender. If the borrower defaults, the mortgage insurer will pay the lender some of the money not recouped in the foreclosure process.¹⁰

The use of this insurance has spread to the subprime refinancing market. About 45 percent of the subprime mortgage loans that Standard & Poor's rated in the last quarter of 2000 carried mortgage insurance. ("Deep' Mortgage Insurance Pays Dividends" 2001).¹¹ In some cases, lenders are obtaining insurance that cuts the effective loan-to-value (LTV) ratio to 50 percent, providing ample protection against the risk of loss in the event of a foreclosure ("Deep' Mortgage Insurance Pays Dividends" 2001).

Government mortgage guarantors

Special federal government programs provide mortgage insurance or guarantees to lenders that make purchase money loans to home buyers who meet certain criteria. These programs are offered through the Federal Housing Administration (FHA), which is part of HUD; the Rural Housing Service, which is part of the U.S. Department of Agriculture; and the U.S. Department of Veterans Affairs. State housing finance agencies may also insure loans. Under these programs, the insurance covers close to 100 percent of losses.

⁹ See the definition of PMI in HUD 2004.

¹⁰ The insurance often allows the holder to recover 30 percent of losses, but policies can cover losses up to 50 percent.

¹¹ It is unclear how many of the subprime loans that included PMI were purchase money as opposed to refinancing loans.

The prime, subprime, and predatory markets

Many middle- and upper-class Americans are used to receiving competitive interest rates and paying little in the way of fees to buy or repair their homes, refinance their mortgages, purchase cars and other consumer goods, take vacations, and send their children to college. The prime or conventional lending market serves these homeowners. In this market, consumers qualify for the best rate offered by the lender (see ABN AMRO Mortgage 2004). Lenders in the prime market may allow borrowers to buy down the rate by paying percentage-based fees called points¹² in cash or financing them as part of the loan. Lenders may also permit the borrower to opt for a higher interest rate rather than pay points or closing costs. The prime market serves “A” borrowers whose credit scores are typically above 650¹³ (U.S. Department of the Treasury and HUD 2000, at 33). Prime borrowers can access fixed or adjustable long- and short-term mortgage loans to purchase or refinance a home, home equity lines of credit, and second mortgages for repairs. Underwriting standards are fairly uniform, thanks in large part to Fannie Mae and Freddie Mac (U.S. Department of the Treasury and HUD 2000, at 33; Temkin, Johnson, and Levy 2002, at 21).

For those whose credit is blemished to any degree and for others who are steered to unconventional lenders, the subprime mortgage market can be a very different experience. This market provides credit for “A–” to “D” borrowers with FICO scores under 650 to 670. Refinancing mortgages account for about 80 percent of the subprime market (Temkin, Johnson, and Levy 2002, at 4). “Alt-A” loans (low- or no-document loans) are considered subprime even though the FICO scores of the borrowers may be similar to those of their prime counterparts (Temkin, Johnson, and Levy 2002, at 4). Finally, the subprime market makes high-LTV loans, even where the borrower has relatively good credit (Temkin, Johnson, and Levy 2002, at 4–5). This market is characterized by a sliding scale of interest rates based, in part, on credit risk. For example, one industry newsletter reports composite par¹⁴ interest rates for A–, B, and C paper, assuming certain LTV ratios. Table 1 summa-

¹² “Points” is the umbrella term for origination and discount fees. One point equals 1 percent of the principal amount.

¹³ A credit score is a number lenders use to help them decide how likely it is that the borrower will repay the loan in a timely fashion. Lenders believe that a credit score is a snapshot of credit risk at a particular point in time. The most widely used credit scores are FICO scores, which were created by Fair, Isaac & Company. These scores are based solely on information in consumer credit reports maintained at the credit reporting agencies. Fair, Isaac & Company developed a booklet describing its scoring system, which is available online (2004).

¹⁴ The par rate is the base rate at which a lender will make a loan to a borrower on a given day. For an example, see Keest and Renuart 2000, at § 11.2.1.4.3.

rizes that information for certain dates since 2001. It is not clear what is included in a “composite” rate, however.¹⁵

By contrast, table 2 shows the conventional mortgage rates published by the Board of Governors of the Federal Reserve System for the same time periods.¹⁶

In addition, subprime lenders usually charge higher points and fees than their prime counterparts. About 80 percent of subprime loans contain prepayment penalties, compared with only 2 percent of loans in the competitive prime market (Stein 2001, at 9).¹⁷ Significantly, up to half of all subprime

Table 1. Subprime Mortgage Rates for Various Dates

Composite 30-year fixed-rate mortgage, par pricing	January 18, 2001	January 25, 2002	January 16, 2003	December 4, 2003
A– Credit (85 percent LTV)	Not reported	9.80 %	8.94 %	7.60 %
B Credit (80 percent LTV)	11.43 %	10.00 %	9.32 %	7.05 %
C Credit (75 percent LTV)	12.41 %	11.36 %	10.28 %	8.53 %

Source: Inside B&C Lending 2001, 2002, 2003a, 2003b.

Table 2. Federal Reserve Board Conventional Mortgage Rates

	Week ending January 19, 2001	Week ending January 25, 2002	Week ending January 17, 2003	Week ending December 5, 2003
Rates	7.02 %	6.96 %	5.97 %	6.02 %

Source: Board of Governors of the Federal Reserve System 2004.

¹⁵ *Inside B&C Lending* (2003a, 11) states: “IBCL composite subprime rates [are] based on rate quotes from broker Web sites.”

¹⁶ It is interesting to see that the gap in price between subprime loans and prime loans has declined over this time period.

¹⁷ See also “B&C Market in Revival” 1999 (where the vice president of Household Finance reports that 80 percent of his company’s loan purchases included prepayment penalties—longer-term penalty provisions are more desirable) and U.S. Department of the Treasury and HUD 2000, at 93 (showing a 70 percent rate for subprime loans and a 2 percent rate for prime loans). Compare Cutts and Van Order 2002, at 9 (reporting a large disparity in the incidence of prepayment penalties between the subprime first-lien mortgages and prime loans of one lender, 41 percent versus 12 percent, though this is not as great as indicated by Stein 2001).

borrowers could qualify for lower-cost conventional financing (Freddie Mac 1996; “Half of Subprime Loans Categorized” 1996).

The predatory market generally exists as a subset of the subprime market.¹⁸ In this market, price may have more to do with gouging than with risk. (See the article by White in this issue [2004].) Because there is a lack of publicly reported data on this market, other than lawsuits, news articles, and government enforcement actions,¹⁹ it is difficult to quantify the number of predatory loans or the percentage of the subprime market that they represent. One industry-commissioned study found that 12.4 percent of first-lien loans and 49.6 percent of second-lien loans made by nine lenders between July 1, 1995, and June 30, 2000, were high-cost loans as defined by the federal Home Ownership and Equity Protection Act (HOEPA) (Staten and Elliehausen 2001). These loans are extraordinarily expensive because they have annual percentage rates (APRs) of at least 10 percent above comparable Treasury securities or the points and fees exceed 8 percent of the total loan amount.²⁰ If we use HOEPA coverage as a proxy for a predatory loan, this industry survey is helpful.

In addition, two independent studies shed more light on this issue. For example, in Philadelphia, one researcher (Goldstein 2002) estimated that 21 percent of loans in certain areas of the city were predatory. Similarly, in Montgomery County, OH, a random sample of mortgage loans associated with foreclosures revealed that 21 percent were predatory (Stock 2001, at iv).²¹

¹⁸ Prime loans can be predatory, although the likelihood is much smaller in that market.

¹⁹ See note 2.

²⁰ 15 U.S.C. § 1602(aa). The Board of Governors of the Federal Reserve System lowered the APR trigger in 2002 to 8 percent above comparable Treasury securities for first-lien mortgages. The spread for subordinate-lien loans remained at 10 percent (Office of the Federal Register 2001) (effective October 1, 2002).

²¹ Note that the definitions of predatory lending varied in these two studies. In the Goldstein (2002) study, predatory lending was defined through the use of property lien data to mean the flipping of mortgage loans resulting in increasingly larger first liens placed on properties. Stock (2001) examined interest rates, fixed versus adjustable rates, balloon payments, waiver of a jury trial, prepayment penalties, excessive fees, and the inclusion of single-premium life insurance.

In another study, researchers in North Carolina found that subprime loans with features defined as predatory—prepayment penalties with terms of three years or more, balloon payments, and loans with combined LTV ratios of at least 110 percent—declined in North Carolina after the enactment of an anti-predatory mortgage lending law (Quercia, Stegman, and Davis 2003, at 19–21).

Borrower characteristics in the subprime market

Certain borrower characteristics are more prevalent in the subprime market than in the prime market. Blacks and Hispanics are disproportionately represented in the subprime market, even at upper-income levels (Calem, Gillen, and Wachter 2002, at 14²²; Goldstein 2002²³; Gruenstein and Herbert 2000, at 1²⁴; HUD 2000²⁵; Immergluck and Wiles 1999²⁶; Zimmerman, Wyly, and Botein 2002, at 5–6²⁷).

In particular, the one national study (Bradford 2002, at 6–7) found that

1. There are significant racial disparities in subprime lending. These disparities increase as income increases. Lower-income blacks receive 2.4 times as many subprime loans as lower-income whites. However, upper-income blacks receive 3 times as many subprime loans as whites with comparable income. Lower-income Hispanics receive 1.4 times as many subprime loans as lower-income whites, while upper-income Hispanics receive 2.2 times as many subprime loans as upper-income whites.
2. High concentrations of subprime lending and racial disparities in subprime lending exist in all regions throughout the United States and in metropolitan areas of all sizes.

²² These researchers found a “statistically significant relationship such that African-American borrowers, regardless of the neighborhood where they are located, have relatively high likelihood of obtaining a subprime loan compared to a prime loan” (Calem, Gillen, and Wachter 2002, at 14).

²³ This study shows that areas within the city of Philadelphia with a higher potential vulnerability to predatory lending tended to have greater concentrations of foreclosure sales; areas that are predominantly black and/or Hispanic also tended to have higher concentrations of foreclosure sales and were more vulnerable to predatory lending.

²⁴ This study reveals that the growth of subprime lending in the Boston metropolitan area was much more significant for properties in low-income and minority neighborhoods than for properties in other neighborhoods; the concentration of subprime lending in minority and low-income neighborhoods was especially striking in the refinancing market.

²⁵ This report includes data from studies conducted in five cities—Atlanta, Baltimore, Chicago, Los Angeles, and New York. Key findings show that (1) from 1993 to 1998, the number of subprime refinancing loans increased 10-fold, (2) subprime loans are over three times more likely in low-income neighborhoods than in high-income neighborhoods, (3) subprime loans are five times more likely in black neighborhoods than in white neighborhoods, and (4) homeowners in high-income black areas are twice as likely as homeowners in low-income white areas to have subprime loans.

²⁶ Data from Chicago show that mortgage refinancing by subprime lenders occurred predominantly in black neighborhoods; refinance loans by subprime lenders in black neighborhoods grew by almost 30 times during the 1993–98 period, much faster than in white neighborhoods (where it grew by only 2.5 times).

²⁷ This study finds that New Jersey blacks are 2.5 times more likely to be provided subprime loans than whites.

The consistency of these data from study to study raises the very real question of whether discrimination and steering account more for placement in the subprime market (and, hence, higher prices) than risk.

Steering by prime lenders to subprime affiliates may be prevalent. In a recent study of subprime lending in four cities in California, the authors reported that 25 percent of the surveyed homeowners took out loans from a subsidiary or affiliate of a financial institution, yet none were referred to the prime lender for lower-cost loans. It is interesting to note that 60 percent of all surveyed homeowners believed that they had good or excellent credit (Stein and Libby 2001, at 41, 47, 50).

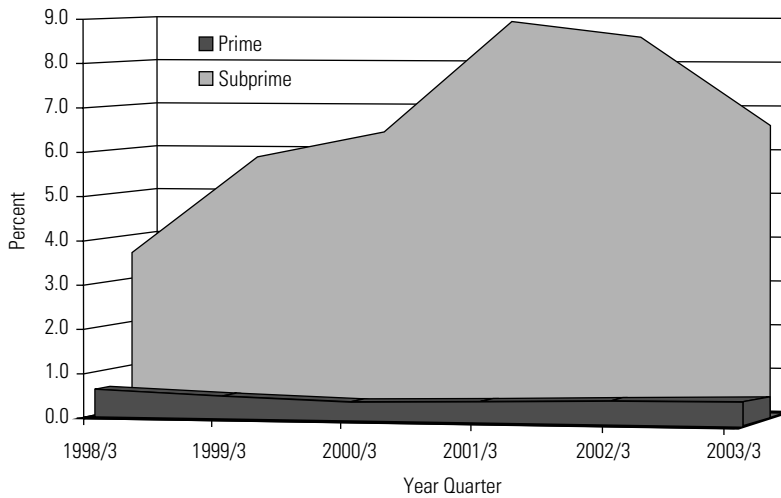
Low- and moderate-income families, women, and older homeowners may be overrepresented in the subprime and predatory markets. According to 1998 Home Mortgage Disclosure Act (HMDA) data, about 50 percent of the subprime refinancing market consisted of loans to low- and moderate-income borrowers, whereas this percentage was just about 34 percent in the prime market. Women accounted for 29 percent of subprime refinancing mortgages, compared with 19 percent of all refinancing mortgages. Those who were 45 and older represent 56 percent of all subprime refinancing borrowers, compared with 43 percent of prime borrowers. Borrowers 55 and older make up 35 percent of subprime borrowers alone (U.S. Department of the Treasury and HUD 2000, at 35–36).²⁸

Foreclosure rates

The rate at which loans go into foreclosure is significantly higher in the subprime market than in the prime market.²⁹ After controlling for certain neighborhood demographics and economic conditions, such as unemployment rates and change in unemployment, median income and changes in income, population and changes in population, and median home values and changes in those values, one study found that subprime loans in the Chicago area lead to foreclosure at 20 or more times the rate that prime loans do (Immergluck and Smith 2004, at 17, 23). In addition, figure 1 compares the percentage of prime and subprime loans in foreclosure nationally from 1998 to 2003 and

²⁸ See also Lax et al. 2000 (30 percent of borrowers getting subprime loans are 55 and older, compared with 17 percent of prime borrowers in this age category).

²⁹ The predatory market is part of the subprime market, by and large. Consequently, it is reasonable to assume that predatory mortgage loans end up in foreclosure at least as frequently as other subprime mortgage loans.

Figure 1. Prime and Subprime Loans in Foreclosure

Source: Saunders 2003; created from National Delinquency Survey data, Mortgage Bankers Association of America.

Note: This figure first appeared in Saunders 2003, at 7.

shows that the rates at which subprime mortgage loans go into foreclosure are significantly higher than those for prime loans.³⁰

Characteristics of predatory mortgage loans

Skeptics of the existence and extent of predatory lending argue that it has not been adequately defined (“House Panel Calls” 2001, at 4).³¹ Two other authors did an excellent job of defining predatory lending as “a syndrome of abusive loan terms or practices that involve one or more” of five categories of problems with loan origination. These five general categories are “(1) loans structured to result in seriously disproportionate net harm to borrowers, (2) harmful rent seeking, (3) loans involving fraud or deceptive practices, (4) other forms of lack of transparency in loans that are not actionable as fraud, and (5) loans that require borrowers to waive meaningful legal redress” (Engel and McCoy 2002, at 1260).

³⁰ See also Gruenstein and Herbert 2000, at i (found that the volume of foreclosures started by subprime lenders in the Boston area grew by 154 percent during 1995 to 1999 while the overall volume of foreclosures dropped by 30 percent).

³¹ The article noted the opposition of U.S. House Financial Services Chairman Michael B. Oxley to legislation that is designed to combat predatory lending but lacks an adequate definition of the term.

Lawyers and advocates working with homeowners flesh out these broad categories by specifying a fairly long list of abuses in the marketing and sale of loans, the application process, the loan terms themselves, the closing, the post-closing activities, and the subsequent servicing of the loan (Brennan 2000). Specific practices are highlighted next, but this list is not exhaustive. By their nature, predatory lenders are creative and, unfortunately, new predatory practices appear regularly.

The marketing and sale of mortgage loans

The predatory market is a “push” market. Targeted homeowners are generally not seeking loans. Within this market, brokers and lenders are searching for and soliciting borrowers (Iowa Attorney General 2003). The marketing practices include aggressive solicitations in targeted neighborhoods that often include older and minority homeowners, steering of borrowers to higher-rate lenders, door-to-door solicitation of business by home improvement contractors who arrange financing, and mobile home dealers acting as conduits for lenders.

Abuses occur when, for example, large fees or kickbacks promised to mortgage brokers motivate them to push loans involving unnecessary or harmful debt consolidation, the refinancing of lower-rate mortgages, and the shifting of unsecured shorter-term debt into mortgages,³² sometimes resulting in loans in excess of 100 percent of the LTV ratio (Dearborn 2003 at 20).³³ High-LTV loans may not be abusive when the borrower’s income is high and the lender relies on that fact to cover the risk of potentially high losses in the event that a foreclosure sale does not cover the indebtedness. However, in the preda-

³² Mortgage loans are marketed as a way to pay off credit cards and other unsecured debt by rolling several monthly payments into “one easy payment.” By adding this debt into the mortgage loan, the lender can charge percentage-based fees on a higher principal amount, resulting in higher fees. Interest is also charged on the higher principal over the life of the loan, allowing the lender to earn more interest. Meanwhile, the homeowner has lost equity and is left with a higher monthly payment. Finally, it is almost never a good idea to transform shorter-term, unsecured loans into long-term debt (Loonin, Williamson, and Klein 2002, at 1–7, 50–51). This places the home at greater risk of loss. If people thought carefully, who would transform credit card debt, which represents the purchase of clothes, tools, or a vacation into a mortgage loan with a life of 30 years, even a loan that has a significantly lower APR than the credit card? For example, paying off a credit card bill of \$5,000 at 18 percent APR over 60 months requires a monthly payment of about \$125. This high APR will generate \$2,500 in interest. However, if you add the \$5,000 to a \$100,000 mortgage loan for a total principal of \$105,000 at a 7 percent APR for a term of 30 years, the \$5,000 generates additional interest of \$6,617 and raises the monthly payment by about \$30.

³³ Dearborn (2003) studied the files of 434 foreclosures in St. Clair County, IL, from 1996 to 2000 and found that 221 of these files involved mortgage loans whose LTV ratio was 125 percent.

tory market, borrowers do not have high incomes and usually do not know that they are getting high-LTV loans or understand the effect of such a loan on their ability to refinance into a better loan.³⁴ Finally, the lure of first-time homeownership helps fuel “property flipping,” the purchase and quick resale of the property at inflated prices.³⁵

The application process

One of the most common practices committed by predatory mortgage brokers or lenders at the time the application is obtained is falsifying the borrower’s information, especially the income level.³⁶ Another way to qualify a homeowner for a loan is to inflate the value of the home through a partnership with an unscrupulous appraiser or to add a dummy cosigner.³⁷ At their

³⁴ Federal banking agencies define a high-LTV loan as one in which the ratio exceeds 90 percent and considers such loans to pose higher risks than traditional mortgage lending (Office of the Comptroller of the Currency et al. 1999).

³⁵ Flipping in this context means the repeated sale and resale of property, usually by investors. An investor may purchase the property cheaply at a foreclosure, tax, or other sale and then sell high after misrepresenting the condition of the house or promising to make repairs and failing to do so. The appraiser, real estate agent, and lender may be co-conspirators. The appraiser may receive a kickback from the real estate agent or the lender. The agent’s fee is a percentage of the sales price. Similarly, the lender charges points. For both the real estate agent and the lender, the higher the sales price, the higher the fees. For a good description of this practice, see *Hoffman v. Stamper*, 843 A.2d 153 (Md. Ct. Spec. App. 2004). (In this case, the jury awarded damages to nine consumers against the seller, lender, and appraiser in a property-flipping scheme: \$129,020 for economic damages, \$1.3 million for emotional distress, and \$1.8 million in punitive damages against the seller upheld. The court remanded for a new trial on punitive damages against the lender and appraiser, finding that the trial court wrongly kept a punitive damages decision from the jury. The causes of action included civil conspiracy, fraud, fraud by way of concealment, and unfair and deceptive acts and practices.) See also *Banks v. Consumer Home Mortgage, Inc.*, 2003 WL 21251584 (E.D.N.Y. March 28, 2003); *Vaughn v. Consumer Home Mortgage, Inc.*, 2003 WL 21241669 (E.D.N.Y. March 23, 2003); and *Polonetsky v. Better Homes Depot, Inc.*, 760 N.E.2d 1274 (N.Y. 2001).

³⁶ For examples of mortgage loan cases where the broker or lender’s falsifying information on the loan applications was an issue or at least mentioned as part of the facts, see *Wilson v. Toussie*, 260 F. Supp. 2d 530 (E.D.N.Y. 2003); *Cunningham v. Equicredit Corp. of Illinois*, 256 F. Supp. 2d 785 (N.D. Ill. 2003); *Matthews v. New Century Mortgage Corp.*, 185 F. Supp. 2d 874 (S.D. Ohio 2002); *Jones v. Novastar Mortgage Inc. (In re Jones)*, 298 B.R. 451 (Bankr. D. Kan. 2003); *Hoffman v. Stamper*, 843 A.2d 153 (Md. Ct. Spec. App. 2004) (a loan officer was complicit in the property seller’s creating false gift letters in order to qualify home buyers for FHA-insured loans); *Haser v. Wright*, 2003 WL 31379971 (Mass. Super. Ct. September 4, 2002); and *Opportunity Management Co. v. Frost*, 1999 WL 96001 (Wash. Ct. App. February 16, 1999).

³⁷ These cosigners often do not reside in the home or have no property interest in it and are unlikely to contribute to the monthly mortgage payment, even though their income is considered in the underwriting process.

worst, lenders or brokers sometimes forge the necessary signatures (Brennan 2000).³⁸

The loan terms

Any number of loan provisions can be perfectly acceptable if the consumer understands them and negotiates in a give-and-take process. When this occurs, the homeowner agrees to certain specified terms in exchange for something of value: For example, an informed borrower may (if given the choice) choose between a lower interest rate and no out-of-pocket closing costs. But in the predatory market, negotiation, transparency, and true understanding rarely occur. In these circumstances, the following loan terms or practices can be abusive, particularly in combination: high interest rates, high fees and closing costs,³⁹ balloon payments,⁴⁰ negative amortization,⁴¹ high appraisal costs, padded recording fees, back-dating of documents,⁴² charges for duplicative services, and mandatory credit insurance⁴³ or arbitration clauses,⁴⁴ as well as

³⁸ This testimony cites the April 23, 1997, ABC *Prime Time Live* news segment in which the ex-employee of one large subprime lender reported that each of the lender's branch offices had a "designated forger" whose job it was to forge documents.

³⁹ These costs range from 3 percent to 25 percent of the amount borrowed, compared with the prime market, where fees and closing costs may run as high as 3 percent (Henriques and Bergman 2000, which highlights one subprime lender that made loans to consumers with relatively good credit histories and charged up to 25 points, in contrast to conventional lenders that charge no more than 2 points).

⁴⁰ Balloon payments are large payments that come due during a loan term, usually at the end. They pose a problem because consumers rarely have the means to pay the full amount. Balloon payments are often coupled with a promise to refinance. Those promises are seldom met, and foreclosure is a frequent consequence.

⁴¹ Negative amortization occurs when the payments due each period are not enough to cover the interest on the loan. The existence of a balloon payment suggests that the loan negatively amortizes when the balloon amount exceeds the original principal.

⁴² A lender may backdate (put a date on the documents that is earlier than the actual date) to undermine the borrower's right to cancel or the usefulness of other notices that must be provided before closing.

⁴³ The purchase of credit insurance must be voluntary under many state laws (Keest and Renuart 2000, at § 8.5.2.1).

⁴⁴ The use of arbitration clauses in mortgage loan notes is widespread. Most arbitration provisions eliminate or restrict the consumer's ability to arbitrate a class action, waive the consumer's right to a jury trial, negate the consumer's ability to seek punitive damages, limit discovery rights, and severely curtail the issues that can be raised on appeal. In addition, the cost of arbitration is often significantly higher than the cost of filing a lawsuit. There is some empirical evidence "suggesting that arbitrators have a tendency to favor 'repeat player' clients" (i.e., corporate clients) because arbitrators know that companies can easily take their disputes to other arbitrators if they lose too often (Bland et al. 2003, at § 1.3). Further, arbitrators may not be required to follow the law; arbitration erodes the public character of the law; and arbitration decisions are not published and do not have precedential value. See Bland et al. 2003, at § 1.3.

an unaffordable loan based on the equity in the home regardless of the homeowner's ability to repay.⁴⁵

The closing

The loan closing or settlement is the event at which the settlement agent for the lender presents the documents to the borrower for signature. In most states, subprime borrowers typically do not hire independent counsel to represent them. These consumers either do not realize that this is possible or cannot afford to do so (Engel and McCoy 2002, at 1307, 1309). Consequently, the borrower is at the mercy of a system where stacks of documents are often about an inch thick⁴⁶ and the borrower must sign or initial in 20 to 40 places. The closing is often rushed and bewildering (Engel and McCoy 2002, at 1307, 1309). The low financial literacy of many borrowers means that they are unable to make sense of the economics of the transaction, even with enough time to review all of the information presented at the closing (Renuart 2003, at 431–32; White and Mansfield 2002, at 236–39⁴⁷).

A predatory practice that homeowners are often unaware of at this stage is that they were the victims of bait-and-switch tactics. In other words, the terms at the closing differed from what the borrowers thought they would get, often to a significant degree. For example, the broker or lender promised a fixed-rate loan at 9 percent, but the loan morphed into an ARM where the interest rate only rises and never goes below the initial 11 percent.

After the closing

In the predatory market, the abuses do not stop at the closing. Sometimes, this just marks the beginning of a new phase. A new round of high-pressure solicitations commences, offering to refinance the loan.⁴⁸ Some of the most

⁴⁵ This is one of the most egregious practices of predatory lenders because it is a recipe for foreclosure (Engel and McCoy 2002, at 1262–63; U.S. Department of the Treasury and HUD 2000, at 76–77).

⁴⁶ “Many blame federal disclosure laws for the volume of paper. In fact, for fixed-rate, refinance money loans, only about 8 pages are attributable to federal law at the closing: Truth In Lending disclosure (1 page); Notice of Right to Cancel (2 copies, 1 page each); HUD-1 Settlement Statement (2 pages); Transfer of Loan Servicing Statement (1 page); Private Mortgage Insurance Statement, if applicable (1 page); Escrow Statement (1 page). The bulk of the documents are required by the lender, and some are necessary under state law” (Renuart 2003, at 431–32).

⁴⁷ These authors analyzed the findings of the National Adult Literacy Survey conducted in 1992 and applied them to credit transactions.

⁴⁸ Abusive refinancings are often called “flips.”

outrageous examples of flipping include ones by the same lender offering to fix its own loan provisions, such as balloon payments or switched loan terms! If loans are flipped frequently, the homeowner may pay excessive prepayment penalties.⁴⁹

Other serious problems can occur after the closing. When home improvements or the purchase of a mobile home is financed, the mortgage lender may be directly involved in knowingly funding transactions that involve fraud or shoddy work.⁵⁰

Loan servicing

A number of new abuses by mortgage servicers and lenders on the back end (i.e., after the loan has closed and often years later) are now common. These practices include the following:

1. Failing to post monthly payments received from consumers in a timely fashion, thus resulting in late fees and additional interest
2. Placing monthly payments in “suspense” accounts, which can result in the imposition of late fees and the collection of a larger amount of interest over the life of the loan
3. Not paying the homeowner’s hazard insurance on time from the escrow and then ordering force-placed insurance at rates higher than the original insurance
4. Delaying credits and adjustments to the homeowner’s escrow account, which results in an unnecessary increase in the homeowner’s monthly escrow payment
5. Conducting unnecessary “drive-by” property inspections when the homeowner is not in default and then imposing a charge, or conducting multiple inspections for one period of default and imposing multiple charges

⁴⁹ Some loans contain both a balloon payment and a prepayment penalty. The balloon payment drives the homeowner to refinance, but the prepayment penalty makes it expensive to the borrower (and profitable to the current lender) to do so—a double whammy, in other words.

⁵⁰ See, for example, *Williams v. Aetna Fin. Co.* (700 N.E.2d 859, Ohio 1998) and *Baker v. Harper*, No. 48 (Cir. Ct., Barbour County, Ala. July 24, 1991), reported in 57 Banking Rpt. (BNA) at 270 (August 12, 1991). See also Forrester 1996, at 1097–1102.

6. Improperly calculating interest on open-ended lines of credit or variable-rate loans⁵¹

Home purchase versus refinancing markets

Three of the practices described earlier—property flipping, falsified appraisals,⁵² and defective mobile homes—are more prevalent in the home purchase process. Servicing abuses occur with similar frequency in both markets. Many of the other abuses occur primarily in the refinancing market, although there is certainly crossover.

The most destructive practices

Four of the worst predatory practices involve the charging and financing of large amounts of points and fees, heavy prepayment penalties accompanied by higher-than-par interest rates, loan flipping, and steering homeowners to loans based on their race, age, or ethnic background (Saunders 2003, at 5–7). In combination, the first three of these practices provide the impetus for equity stripping, which results in the reduction or elimination of the value of the consumer's major asset and can lead to foreclosure. Adding the fourth practice into the mix ensures that the equity of members of protected groups is stripped more often than it is for whites. The result of equity stripping is that the wealth-building capacity of blacks and Hispanics may be permanently eliminated.

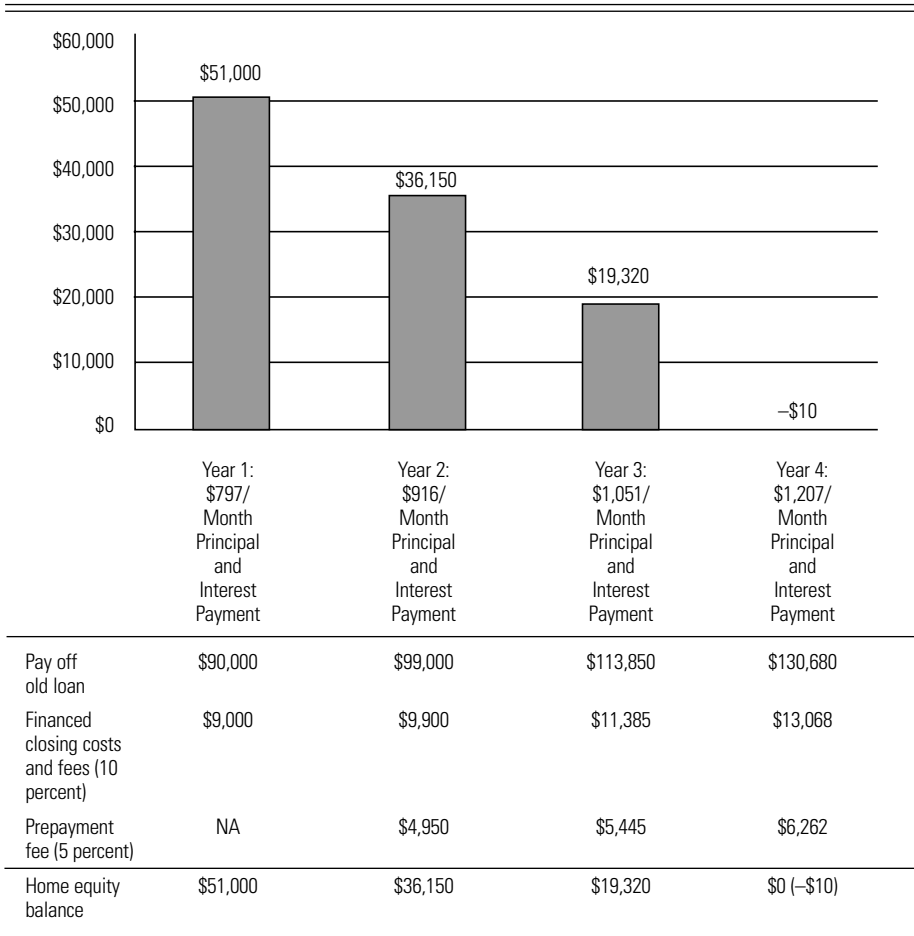
Figure 2 illustrates how equity can be stripped from a home by the repeated charging of closing costs and the collection of prepayment penalties.

Equity stripping rewards the originator through an increase in the principal that is paid immediately to the originator when the loan is sold in the secondary market. Subsequent holders reap the higher amount of interest generated by the inflated principal. The more the borrower is charged up-front, the greater the financial gain for the lender and holder. Prepayment

⁵¹ These practices and others are being challenged under a number of legal theories. (See Keest and Renuart 2000, at § 11.2.1.5.) An example of servicing abuses can be found in *Maxwell v. Fairbanks Capital Corp.* (*In re Maxwell*), 281 B.R. 101, 117 (Bankr. D. Mass. 2002) (which stated that “Fairbanks, in a shocking display of corporate irresponsibility, repeatedly fabricated the amount of the Debtor’s obligation to it out of thin air. There is no other explanation for the wildly divergent figures it concocted in correspondence with the Debtor and her agents and in pleadings and documents filed with the bankruptcy court.”). See also *Choi v. Chase Manhattan Mortgage Co.*, 63 F. Supp. 2d 874 (N.D. Ill. 1999). Fairbanks recently settled a major enforcement action brought against it by HUD and the Federal Trade Commission because of its allegedly abusive and illegal servicing behavior. (See HUD and Federal Trade Commission 2003.)

⁵² See Bankrate.com 2002 for a discussion of falsified appraisals.

Figure 2. How to Eliminate Home Equity in Four Easy Steps



Source: This chart first appeared in Renuart 2002. Permission to reprint this chart is granted by the National Consumer Law Center.

Notes: This chart assumes that the value of the home will not rise over the four years. The fair market value of the home is \$150,000. The loans are 30-year at nine percent interest rate. After one year, a negligible amount of principal has been repaid by the borrower. Refinancing this home loan four times in four years depletes \$51,000 in equity because of fees.

NA = not applicable.

penalties provide additional profit to the holder when the loan is paid off and provide an incentive to entice the customer to refinance to trigger this income stream (loan flipping).

If the homeowner cannot continue paying a loan, the lender or holder often refinances to make the loan “performing.” The result is more profit for the lender since a new round of points and fees is added to the principal. A prepayment penalty may be collected as well. As long as there is enough equity in the home, this lender benefits every time the borrower defaults. A default provides the lender with reason to make a new loan and charge more points

and fees. This creates another immediate opportunity to turn a quick profit. Even if the borrower does not default, predatory lenders convince borrowers to refinance their loans and receive a small amount of additional cash, thus taking advantage of the large prepayment penalty typically included in these loans.

The cost of predatory mortgage lending to homeowners is enormous. The Center for Responsible Lending estimates that just four predatory practices costs homeowners more than \$9 billion per year. Table 3 summarizes the center's findings.⁵³

Table 3. Cost of Predatory Practices to Homeowners

Practice	Number of Families Affected Annually	Cost to Homeowners (in Billions of Dollars)
Equity stripping	500,000	\$2.1
Exorbitant up-front fees	750,000	\$1.8
Prepayment penalties	850,000	\$2.3
Rate-risk disparities	600,000	\$2.9

Source: Stein 2001.

Life cycle of a predatory loan

How the predatory mortgage market works for consumers is best told through real experiences. So to set the stage for a description of the typical life cycle of a predatory loan, we should first remember that each one represents real people trying to keep or improve the family home and build wealth. Instead of assisting them, the mortgage loan they get creates new harm and havoc. Themes from the homeowners' stories described at the beginning of this article will resonate in the life cycle description that follows.

Predatory refinancing loans have a fairly typical life cycle, although the length of their life span varies. Conception includes the solicitation of the homeowner and the application process. Birth occurs at the closing. The loan then travels from the originator through various hands to a trustee's custodian, where it resides until its death, from natural causes (payment over the full term), prepayment (refinancing, the sale of the home, divorce, death, or other reasons), or foreclosure.

⁵³ This does not take into account the direct and indirect effects on families, neighborhoods, and communities from foreclosure, loss of shelter, and boarded-up buildings.

The conception of the predatory loan generally begins well before the homeowner is approached. One or more of the following events has already occurred:

1. A broker agreed with one or more lenders to bring in business.
2. A mobile home dealer or home improvement contractor created a relationship with a lender to refer customers.
3. A wholesale lender signed a contract with a correspondent to immediately buy the loans originated under certain conditions.
4. A financial institution contracted to provide a line of credit to the lender.
5. A pooling and servicing agreement obligated certain entities to originate and securitize loans with specific characteristics.⁵⁴

The first actor to enter the stage is typically the mortgage broker, the mobile home dealer, or a home improvement company. These “bird dogs” (hereinafter referred to as “brokers”) sniff out the potential borrowers, bait them, sometimes fatten them up by inflating income on loan applications, and then present them to lenders.

The sniffing occurs through mail, telephone, and door-to-door solicitations.⁵⁵ If a homeowner bites, then the broker often makes promises that do not get fulfilled. For example, the broker might promise to lower monthly payments, consolidate all debt into a much better loan, fix up the home in a quality manner, find the best loan, fix the homeowner’s credit, qualify the homeowner for a loan regardless of credit history, or sell the homeowner a brand-new mobile home and get good financing. Sometimes the homeowner thinks that the broker is the lender and finds out only later that this is not the case.

The broker gets the homeowner to commit to a loan as early as possible and expeditiously moves the process to the closing. The whole point is to get the homeowner to feel committed. To that end, the broker has the borrower sign a form agreeing to pay the broker even if the loan falls through. The broker immediately draws out some of the requisite information in order to

⁵⁴One could argue that the driving force behind many subprime mortgages is not the need of the borrower to refinance a mortgage, but the need of the originator and the secondary market to fill a securitization.

⁵⁵Brokers can purchase lists of homeowners with their address, telephone number, sex, income, and ZIP code, as well as information on whether they live alone. Public land records also tell brokers the approximate value of the home, the size of the current mortgage, the name of current mortgage holder, and the number of refinancings, as well as whether the house is in foreclosure or near a sale date.

draw up a handwritten loan application that the homeowner rarely sees. Consequently, since the broker knows the underwriting guidelines of the lenders with which it does business, the temptation to qualify the borrower for the loan by inflating income or the value of the home is great. The only application that the homeowner is allowed to review is a nicely typed version that may be provided at the closing. The closing agent asks the homeowner to sign this application along with all of the other closing papers.

The broker usually passes on any necessary information to the lender, and the broker or the lender orders an appraisal. The terms of a predatory loan are generally those that make the loan “work” for the lender. The loan terms work for the lender when the principal is reduced to meet LTV criteria; when the principal is inflated by refinancing a more favorable first mortgage, taking on other debt, or selling and financing credit insurance or other products to increase the value of points and interest over the life of the loan; when the loan characteristics are massaged to meet those of loans to be securitized (for example, switching a variable-rate term loan for a fixed-rate term loan); or when the interest rate is raised to pay a yield spread premium (YSP) to the broker. A YSP is a fee advanced by a lender to a mortgage broker for bringing the lender a loan with an interest rate inflated to an amount higher than the par rate to cover the cost of the fee.

Usually, the predatory loan is not presented to the homeowner until the closing. Other than a good faith estimate and a booklet on closing costs, an affiliated business arrangement disclosure (where applicable), a notice that the servicing of the loan may be transferred, and an advance-warning HOEPA notice if the loan is high-cost, federal law does not require that any other loan-related documents be given to the homeowner before the closing.⁵⁶ The good faith estimate, in particular, is valuable because it gives an estimate of each settlement fee to be charged by third parties and each fee to be imposed by the lender. It does not typically recite any of the anticipated loan terms, such as the interest rate or APR, the loan term, the character of the loan (whether the interest is fixed or variable), and the monthly payment. However, in the experience of many legal advocates, homeowners rarely receive any of these notices in a timely way. Instead, this good faith estimate appears at the closing, well after its usefulness has expired, if at all. Educated shopping for a subprime

⁵⁶ See Regulation X, 24 C.F.R. §§ 3500.6, 3500.7 (good faith estimate and booklet), 12 U.S.C. § 2607(c) (affiliated business arrangement disclosure), 12 U.S.C. § 2605(a) (servicing transfer information), and 15 U.S.C. §§ 1639 (a) and (b) (advance warning notice for high-cost mortgage loans).

loan by comparing terms and costs in advance of the closing rarely occurs because of the complete lack of information provided at the gestation stage of the loan.

From the lender's perspective, the two most important documents are the loan note and the mortgage (a deed of trust is used in some states). First, the loan note represents the obligation to repay. It is drafted and later handled in such a way so as to become a negotiable instrument that will allow subsequent purchasers to buy it without buying legal trouble. In other words, holders will not be subject to most of the claims and defenses that the homeowner can raise against the original lender (Eggert 2002a, at 374–77; Eggert 2002b, at 566–70). This characteristic of the loan transforms the note into a commodity that has value and can be bought and sold with little fear of liability due to the wrongdoing of the predatory instigator.

Second, the mortgage represents the homeowner's agreement that the note holder may repossess (foreclose upon) the home in the event that homeowner defaults on the obligations specified in the note and mortgage. Together, these documents represent the predatory loan as it leaves the closing and moves on to the secondary market.

At the closing, the loan note and mortgage are buried in a stack of documents about an inch thick for the homeowner to either sign or initial. The pages of the stack are in no particular order, for example, from most to least important. The closing is usually rushed, sometimes with little explanation from the closing agent. So from the homeowner's perspective, these two documents get lost in the shuffle. However, after the closing, the loan note and mortgage acquire incredible importance because they become the commodity that fuels the MBS investment market in the United States.

After the closing, the mortgage is recorded in the local land records office and the original is returned to the lender. The note and the mortgage are then signed over and sold to a purchaser for value. These documents may be physically transferred or may remain in the possession of the original lender, which may serve as custodian. Ultimately, for those loans that are securitized, the notes and mortgages are owned by a trust that is represented by a trustee, usually a bank. This bank oversees the loan servicer, accepts the monthly mortgage payments, pays the investors, and decides when to foreclose on a delinquent loan.

The life of a predatory loan ends when it is paid off over its term; when it is paid off early through refinancing, the sale of the home, divorce, death, or other reasons; or when the holder forecloses, the property is sold, and the amount owed is paid from the proceeds. The higher rates at which predatory

loans go into foreclosure result in their being terminated more quickly, on average, than prime loans. Of more importance is that each foreclosure results in the loss of the home for the family that struggled to pay the predatory loan. The consequences of this loss are tremendous, rippling through the family itself, then outward to the neighborhood and the city or town whose tax base may be undermined if property values decline as a result of vacant and vandalized homes.

Financial incentives encourage predatory lending

Three major types of financial incentives significantly help fuel predatory mortgage lending. The first relates to payments made by lenders to brokers. The second involves padded fees and the financing of points and fees. The third is the ready access to capital that permits even marginal lenders to enter this line of business.

YSPs and other broker compensation

In both the prime and subprime markets, lenders often pay brokers to bring them loans. These lender payments are usually paid in one of two ways: by a YSP or by volume-based compensation (based on the number of loans brokers steer their way).

What generally distinguishes the payment of YSPs in the prime market from those paid in the subprime and predatory markets is that prime borrowers often pay the broker his or her total fee through the interest rate spread. In addition, prime borrowers usually negotiate knowingly to structure the payment in this fashion.⁵⁷ By contrast, homeowners who receive subprime or predatory loans normally pay a separate fee or fees to the broker in cash or from the proceeds of the loan. In this circumstance, the YSP is paid on top of the borrower's direct compensation.⁵⁸ When this occurs, the YSP may be a

⁵⁷ However, prime borrowers have allegedly experienced abuses in connection with YSPs. Numerous lawsuits include prime borrowers who challenge the legality of YSPs under the Real Estate Settlement Procedures Act. See generally Keest and Renuart 2000, at § 11.3.1.5.

⁵⁸ Noting that the borrower ultimately pays the YSP is important because it is roughly equivalent to the present value of the interest earned over the life of the loan as a result of the higher-than-par interest rate. For example, in one case, the consumers applied for a \$70,200 mortgage loan, 30-year term, at the allegedly par rate of 8.75 percent. They received a loan with a 9.5 percent interest rate. The YSP to the broker was \$2,457. The higher interest rate would generate an additional \$13,680, a much higher amount than the premium itself. The homeowners also paid the broker \$1,128 directly. See *Barbosa v. Target Mortgage Co.*, 968 F. Supp. 1548 (S.D. Fla. 1997). The total broker compensation (\$3,585) is 5.11 percent of the principal (\$70,200). Broker fees should average only about 1 percent to 1.5 percent of the loan amount (Hechinger 2003).

kickback under the Real Estate Settlement Procedures Act if it is not paid for services actually rendered.⁵⁹

These payments to brokers can drive up the cost of mortgage loans and create reverse competition where brokers have incentives to steer borrowers to lenders that pay them the most rather than to lenders who give borrowers the most favorable terms (Jackson 2002⁶⁰; Jackson and Berry 2002; Woodward 2003, at 2, 7–8⁶¹). This problem is exacerbated for low-income borrowers because unscrupulous elements of the mortgage industry perceive them as vulnerable targets.

Direct supranormal profits to lenders

Predatory lenders can generate supranormal profits from making mortgage loans in a variety of ways.

1. A predatory lender that succeeds in locking in homeowners can use the resulting market power to charge them higher-than-competitive interest rates on loans, extracting rents in the process. One way lenders can mask this practice is by unbundling the cost of lending into exorbitant points and other closing fees, in addition to charging a higher interest rate.⁶²
2. Following origination, unjustified prepayment penalties will generate a stream of income for securitized loans. When loans are sold on the secondary market, those with higher interest rates and prepayment penalties command a higher price (“B&C Market in Revival” 1999).⁶³ In the securitization process, the prepayment penalty cash flow takes the tangible form of a separate class of securities, called Class P securities (Stein 2001, at 9).
3. If the lender made the loan at an above-par interest rate, the purchaser of the loan may pay a “premium” in cash for it.
4. If the lender flips its own loans and then sells them on the secondary

⁵⁹ 12 U.S.C. § 2607. See also the discussion in Keest and Renuart 2000, at § 11.3.1.5.

⁶⁰ Howell E. Jackson, in his written statement to the U.S. Senate Banking Committee (2002), concludes that YSPs benefit only mortgage brokers, not consumers, and impose interest rates that are “absolutely outrageous.”

⁶¹ This study reviews the role of YSPs and concludes that borrowers pay a higher total broker fee when they pay such fees directly *and* through a YSP.

⁶² These fees are often labeled as origination, application, processing, document preparation, inspection, courier, and other fees.

⁶³ The article quotes a Household Finance vice president who stated, “We price based on return on investment.” (“B&C Market in Revival” 1999, 4–5)

market, it immediately receives any points and fees the borrower financed if the loan is sold for its full price (the principal).

Unbundling the costs of making the loan when these costs are financed is one of the most lucrative ways to profit from high-cost mortgages. When these fees are padded, the profits multiply. For example, lenders offering mortgage loans 30 years ago typically charged an interest rate to cover the cost of funds plus the cost of making the loan without tacking on added points and fees. Shopping for mortgage loans was easier because homeowners generally compared the rates, terms, and monthly payments.

More recently, however, mortgage lenders unbundle loan charges from the interest rate. These costs appear as line items on the HUD-1 Settlement Statement that must accompany the loan documents at closing.⁶⁴ Up to 15 different fees could be imposed. These can include some or all of the following: loan origination, loan discount, appraisal, credit report, lender's inspection, YSP, underwriting, processing, warehousing, mailing, wire, signing, credit insurance premium, settlement/closing, abstract title search, title examination, title insurance binder, title insurance premium, document preparation, notary, recording, courier, and fax fees. Because the borrower frequently finances these costs as part of the principal, this drives up the amount on which both the percentage-based fees (points) and the interest are computed.

For example, let us assume a mortgage loan where the homeowner needs \$100,000 as cash out. The unbundled closing costs exclusive of the origination fees (points) total \$3,000 and the lender charges 5 points, all of which is financed. Typically, the points are computed on the principal of \$103,000 and equal \$5,150.⁶⁵ So the principal amount of the loan is \$108,150, not \$100,000. Assume an interest rate of 10 percent and a term of 30 years. Given these terms, a principal of \$108,150 produces a monthly payment of \$941.25 and interest of \$230,700 over the life of the loan. By contrast, a principal of \$100,000 generates a monthly payment of \$870.32—\$70.93 less per month. The interest projected to be earned over the life of the \$100,000 loan is about \$213,314, a difference of \$17,386. Put another way, the extra \$8,150 in principal will cost the consumer \$17,386 plus the \$8,150 for a total of \$25,536, assuming that the loan is paid over 30 years.⁶⁶

⁶⁴ This is required by 12 U.S.C. § 2603.

⁶⁵ $\$103,000 \times 0.05$. If the closing costs are not financed, the points would total only \$5,000. Some lenders compute the points on the principal plus the points. This increases the yield to the lender by a greater amount.

⁶⁶ Of course, shopping for loans when a consumer must compare both interest rates and closing costs and points is very confusing. It is impossible for most consumers to understand whether a 10 percent loan with 5 points financed is a better or worse deal than a 10.5 percent

Loading the loan with points is lucrative for the lender for several reasons. When financed, points increase the yield from the note rate because of compounding, as shown in the example in the previous paragraph. Points also enable the lender or broker to lowball the rate in marketing and sales pitches because the points disappear into the principal and do not affect the interest rate.⁶⁷ Finally, points are considered “earned” at consummation so they increase the lender’s effective yield on prepayment of the principal and protect the yield against early payoff or refinancing by other lenders. If the lender refinances its own loan, the extra yield becomes implanted in the new principal. For this reason, the points from the previous loan escape disclosure in the APR of the new loan (Keest 2001).

Charging consumers origination fees plus a variety of other fees, such as underwriting fees, credit report fees, processing fees, and so on, may be mere gouging. Further, charging discount points without reducing the interest rate is an unfair and deceptive practice or outright fraud. This practice appears to be fairly widespread in the predatory market.⁶⁸

The padding of closing costs occurs with some regularity. Take credit report fees, for example. The predominant type of credit report used by lenders, an electronic “infile” from one of the three major credit reporting agencies for two joint borrowers, costs about \$5. A merged infile from all three agencies costs \$15 (Harney 2001, at H1). However, consumers routinely see charges of \$50 or more on their HUD–1 Settlement Statement when they arrive at closing.⁶⁹ While this overcharge may not mean much to one home-

loan with no points because they need an amortization program or financial calculator to do the math and understand how these calculations work. Which is the better deal? Here is the comparison: If cash to the consumer is \$100,000 and assuming no other closing costs, loan #1 has a principal balance of \$105,000 (points are financed) at 10 percent for 30 years, and the monthly payment is \$914. However, \$100,000 (no points) at 10.5 percent for 30 years generates a monthly payment of \$907. So the 10.5 percent loan is a slightly better deal in terms of the monthly payment. Also, less equity is stripped from the home because the principal starts at \$100,000 rather than \$105,000. It will take the borrower with the 10 percent loan about 76 months (over 6 years) to pay off just the \$5,000 in points. This example first appeared in Renuart 2003, at 432 (note 52).

⁶⁷ Points are reflected in the Truth in Lending disclosure of the APR, which is one reason why the APR is higher in mortgage loans than the note rate. However, lenders and brokers frequently emphasize the interest rate to homeowners. See the discussion of the sales tactics of loan officers at First Alliance Mortgage Company in *In re First Alliance Mortgage Co.*, 298 B.R. 652 (C.D. Cal. 2003) and in Henriques and Bergman 2000.

⁶⁸ For example, the largest subprime finance company was called on the carpet for this practice by the State of Washington, Department of Financial Institutions (2002).

⁶⁹ In his article, Harney (2001) quoted one mortgage industry official as saying that marking up credit report charges to \$60 would not trigger a challenge from a consumer. He also reported that one major mortgage company gave an award to the loan officer who originated the largest number of \$60 charges to consumers for credit reports.

owner, the profit to the lender from imposing this inflated fee on a large pool of loans can be enormous. If the lender collected \$50 when its actual cost was \$15, the profit on 10,000 loans is \$350,000; on 100,000 loans, it is \$3.5 million.⁷⁰

Ready cash to make predatory loans

Securitization is the primary fuel for subprime lending. As noted earlier, the volume of MBS issued by the subprime market has grown dramatically since 1994. This is a huge amount of capital available to originate mortgage loans. Many of the most notorious predatory lenders used the securitization process to generate funds to continue their lending practices.⁷¹

Each entity involved in securitization gets a cut of the income pie. First, when the original lender sells the loan, it normally receives the principal, including all costs and points charged at closing. If the lender retains servicing rights, contracts usually pay 25 to 50 basis points per annum (or $\frac{1}{4}$ or $\frac{1}{2}$ of 1 percent) of the total of the principal balances remaining on a certain date (Lax et al. 2000, at 18). The agreement usually allows the servicer to retain late fees and other charges imposed for certain actions it takes to collect on the loan, foreclose, and preserve the quality of the property.⁷² Retention of these fees provides the servicer with an incentive to collect junk or duplicative charges. If the servicer retains the homeowner's escrow money in an interest-bearing bank account, there is an incentive to increase the amount of the escrow in order to increase income.

The trustee may be paid "reasonable compensation" for expenses, losses, and liabilities incurred in performing its duties. This may be defined to equal a fixed percentage per annum on the sum of the principal balance of the mortgage loans plus the earnings on certain investment accounts.⁷³ The cash to pay these expenses generally comes from the mortgage income stream that is passed through to the trustee by the servicer.⁷⁴

⁷⁰ HUD had been serious about cracking down on such practices. In November 2001, the agency announced the settlement of enforcement actions it had taken against 38 lenders for violations related to illegal referral fees and unearned fees (HUD 2001).

⁷¹ See the list of most notorious predatory lenders and the national banks acting as the trustee in the securitization in National Consumer Law Center et al. 2003. See also Robinson 2003, at 7.

⁷² See, for example, First Alliance Mortgage Loan Trust 1999, at 79.

⁷³ See, for example, Option One Mortgage Acceptance Corporation 2003, at S-55-56.

⁷⁴ Option One Mortgage Acceptance Corporation 2003 at S-54, 55-56 (a servicer establishes a "collection account" into which are deposited the monthly mortgage payments less fees due the servicer, and the trustee opens a "distribution account" into which will be deposited amounts withdrawn from the collection account for distribution to the investors. The trustee's fee is based in part on the investment earnings from the distribution account.)

The entity that issues the securities pays the rating agency fee (McDaniel 2002). These fees are “market-driven and var[y] according to the size and complexity of the transaction being rated” (Schwarcz 2002, at 12).

All of this is possible because investors provide the income stream that flows back to the lender and allows it to originate a whole new round of loans. The income stream from the monthly mortgage payments covers the investors’ return on investment and many of the costs of the securitization. Cash washes forward to the investors and back to the lender, all through various conduits, to fuel predatory lending. Ending this process will require removing the current inducements for each of the participating actors. However, most important, it will require eliminating the incentives, or increasing the disincentives, for the investors that ultimately drive the process.

Conclusion

The purpose of this article is to provide an overview of predatory lending and to set the stage for the more focused articles that follow in this special issue.

First, I describe the many actors performing various roles in the mortgage lending process. These range from the real estate and mortgage brokers, to the lenders, to the loan guarantors, to the purchasers of and investors in mortgage loans. These players appear in all three parts of the mortgage market: the prime, subprime, and predatory segments.

Next, I discuss the similarities and differences among the three mortgage markets. The prime, subprime, and predatory markets each provide loan products to borrowers with a variety of characteristics, some of which overlap and some of which differ. The predatory market is generally understood as a subset of the subprime market. Research consistently shows that when compared with their white counterparts, minority homeowners are disproportionately represented in the subprime market. Further, subprime mortgage loans go into default and foreclosure at significantly higher rates than prime mortgage loans do.

I then examine the predatory market in some detail. Predatory practices begin with the push-marketing and solicitation phase of the lending process, continue in various forms through the application process, appear in the loan terms, occur during and after the closing, and dog homeowners throughout the servicing. The most destructive practices, however, include charging and financing high points and fees, levying heavy prepayment penalties accompanied by higher-than-par interest rates, engaging in loan and property flipping, and steering homeowners to loans based on their race, age, or ethnic background.

Finally, I review how the actors in the predatory market benefit financially through the lending process. The financial incentives come in various forms, primarily through the direct payment of YSPs by lenders to brokers and the supranormal profits to be netted by padding and financing points and fees. The funding for a large portion of the predatory market occurs through securitization, which itself generates income for each of the players in this process.

Predatory lenders are in the business of selling debt. To grow and profit, these lenders have “to get more people in debt, get them deeper in debt, keep them there longer, get other lender’s customers, or a combination of those” (Keest 2001, at 1141). The endgame results in a mammoth transfer of wealth from middle- and lower-income families to the purveyors of debt. This part of the market deserves the intense scrutiny of the media, researchers, legislators, judges, and society as a whole. Otherwise, the loss of home and the wealth these loans represent will continue to grow.

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The author thanks Patricia McCoy and Elvin Wyly for their insightful comments and suggestions regarding this article. This article expresses the views of the author and does not represent the official position of the National Consumer Law Center.

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