POINT — COUNTERPOINT

Is There A Distinction Between "SUBPRIME" and "PREDATORY" Lending?

NO

Alan White

If there is subprime lending that is not at least potentially predatory, I haven't seen it yet. Reason #l, there is no price competition when prices are a secret. Rates are being held down by competition to some extent, but the real gouging is in the points and fees (as exemplified by FAMCO in the extreme.) When I say points and fees, I include all the other loan packing stuff, like credit insurance. There is no subprime lender I know of that accurately discloses its points and fees for home equity loans in advertising, on web pages, or anywhere other than in loan documents.

I disagree that all subprime lending involves fraud, at least as the courts define it. I have met a few subprime mortgage clients who pretty much knew they were paying 10 points, just as some rent to own customers know they are paying double or triple the retail value of appliances. So if there is a fraud, it's some sort of omission, that the credit could be had elsewhere, or is a bad idea, or is overpriced. That's not the type of fraud most judges will recognize.

Now, there are some subprime lenders charging "only" 4 or 5 points. They generally do not seem to lend in minority neighbor-hoods, at least based on the HMDA data I've studied for Philadelphia. I do not think we or anyone can prevent all mortgage lending to subprime borrowers. That is why I suggested earlier a sort of code of conduct for subprime lending, that could conceivably influence players like Freddie Mac who seem bound and determined to keep the credit tap open to borrowers with weak credit. My concept is to get lenders to take a pledge to follow

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YES

Margot Saunders

I respectfully disagree with my colleague Gary Klein's analysis regarding the distinction between subprime lending and predatory lending. I disagree for both substantive and political reasons. There is a distinction between "good" subprime lending and "bad" predatory lending.

The substantive reasons:

1) I have sat in on numerous analyses of Freddie Mac's credit scoring and risk based pricing system. While I cannot be sure from these presentations, I believe that the distinction between prime and subprime loans that Freddie is contemplating only means that subprime loans have greater interest rates of 1 to 3 percent, and not much else. In our informal conversations with Freddie Mac officials they have indicated a distaste for many of the types of provisions in predatory mortgages that we abhor — financing of high points and fees, high prepayment penalties, etc. Admittedly they have bought Money Store loans with higher costs and worse provisions, but that does not mean that Freddie does not see and agree with the distinctions.

2) I sat in on a task force meeting at the last NRC conference where there was an extensive discussion of a new Fannie Mae "subprime" loan product which the community groups would market which was in all ways identical to an A or prime loan, except for a very slightly higher interest rate.

3) I understand, again from verbal sources, rather than written, that Fannie Mae and Freddie Mac are in the process of issuing guidelines regarding their subprime lending which might prohibit the purchase of loans with certain preda-

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NO

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these rules, or be subject to condemnation as predators by consumer advocates. Here is the list, including suggestions received in replies to my original message:

1) Don't charge more than 5% (3% over say $75K) points, fees, closing costs, or whatever new names you come up with for all those junk fees. There was an interesting discussion in a workshop at the NCLC conference in Washington with an economist from Freddie Mac, where it became clear that Freddie Mac will not have any influence on points and fees charged for subprime mortgages that it buys.

2) Publish your interest rates and all other points and fees including broker compensation in all advertising and on your web page. Don't allow "upselling" of rates or points.

3) Don't sell single premium credit insurance.

4) Don't refinance someone's low rate mortgage at a higher interest rate. Like 0% Habitat for Humanity mortgages for instance.

5) Don't promise to lower payments in advertising, unless you can demonstrate that 100% of your borrowers actually got lower payments.

6) Don't write balloon loans to subprime borrowers.

7) Don't exceed FHA/VA debt to income guidelines (45% of income for all monthly installment debt, I believe, along with residual income guidelines.)

8) Make brokers produce a written fee agreement with the loan application. Cap their fees.

9) Technical TILA compliance does not make a loan ethical. Would you sell this loan to your mother? Would you be happy if one of your competitors made this type of loan to your elderly par-

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YES

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tory characteristics, such prepayment fees, the financing of single premium credit insurance, and the like. Also both Fannie and Freddie have indicated that they are refusing to purchase subprime loans made to borrowers who qualify for prime loans — essentially turning them back to the makers and requiring that the proper loan be made. (I find this one a bit hard to believe, but that is what they are saying.)

4) Lastly, and most importantly, HUD is engaged in a rulemaking on the lending requirements of the GSEs, which is likely to include specific requirements for GSE purchase of subprime lending, especially if the consumer community pushes HUD hard to do just this.

The political reasons: We can argue among ourselves all we want whether there is a distinction between subprime lending and predatory lending. But the fact is that the community folks and the rest of world insist that there is a distinction, and that subprime lending is good and necessary, and that predatory lending is bad. The hard part — in everyone's mind — is determining what that distinction is. I think that is where we have our work cut out for us defining what is a predatory loan. It is especially important to include in this definition practices which are legal, but predatory. (I frankly think it is a waste of ink to include already illegal practices in the list, because there is little that can be done about these practices from a regulatory point of view.)

The short list of PREDATORY and LEGAL practices (and there is a much better, longer list compiled in the past) includes, in my opinion: the lethal combination of the following:

a) the financing of a high number of points, fees and credit insurance premiums;

b) high prepayment penalties;

c) high interest rate.

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NO

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ents or your favorite aunt? (i.e. loan should benefit borrower).

10) Don't require (or encourage) payment of unsecured debts.

11) Make special inquiries regarding loans to older individuals, especially when such loans are referred by independent brokers.

12) Provide clear explanations for all items listed on the HUD1.

13) Don't require borrowers to sign mandatory arbitration agreements.

14) Acknowledge responsibility for violations of these principles as to/any loan you purchase, regardless of whether the conduct was the broker's, the originator's, or some other participant's (closing attorneys, title companies, appraisers, etc.).

Gary Klein —

The mainstream lending community seems to be stepping up its effort to create a distinction between "sub-prime" and "predatory" lending. In their view, responsible sub-prime lending is necessary to make credit available to consumers with credit problems on fairer terms. By contrast, predatory lending, in their view, involves active, unfair practices designed to mislead.

Two recent examples of the effort to create this distinction are D. Goldstein, "Predatory Lending: Definitions and Solutions," Harvard Joint Center for Housing Studies (1999) and the recent predatory lending seminar sponsored by Fannie Mae, Freddie Mac, and Deutsche Bank (parent of Bankers Trust) at the Neighborhood Reinvestment Institute in Atlanta.

Goldstein attempted to create a continuum between legitimate sub-prime lending (good and

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YES

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This combination serves to bleed the consumer of the home equity while not allowing him/her to seek lower cost financing elsewhere — because of the prepayment penalties. It also allows the lender to ignore the consumer's ability to repay the loan since the lender makes so much money by selling the loan immediately after it is made.

Thanks

Rebuttal from: Gary Klein

Margot:

I concede that the jury is still out, but, respectfully, you haven't addressed the heart of my argument.

To summarize the earlier post:

1) In the interest of promoting its own products, mainstream lenders including Freddie and Fannie are creating a big tent labeled legitimate "sub-prime" lending, and every dog in the country is going to assert its right to be in that tent. (I know its a mixed metaphor - but you should know that I rejected the potential image inherent in saying that the FAMCO's of the world will hide beneath Fannie's skirt. I had an Aunt Fannie - may she rest in peace.)

2) There is no evidence that it will be our clients who get the most legitimate of these subprime loans. Experience indicates otherwise, but we shall see.

3) There is a big discrepancy between articulated policy and practice among mainstream lenders. They can claim till they are blue in the face that they oppose predatory lending, but the Citicorp's and Bank of America's of the world have to stop buying up predatory portfolios.

I think too that until, as a society, we are very sure that our process for identifying risk is accurate and race-neutral, we should, all of us, share

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NO

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to be encouraged) and predatory lending (bad and to be discouraged). On the road from one to the other she finds practices including hiding loan terms and active misrepresentation. (The distinction between them is fairly muddy in the paper.) Fannie Mae and Freddie Mac used the NRC institute as an opportunity to market their new sub-prime products.

After thinking about these issues for some time, I believe that we need to resist the effort to distinguish between "sub-prime" and "predatory" loans for at least three reasons. While acknowledging the premise that our clients would do better, on average, if they had more options in the marketplace for credit, I think the industry muck-a-mucks touting "fair" sub-prime lending are missing at least three crucial points:

1) Neither predatory nor sub-prime mortgage lending (as currently constituted) is genuinely justified by real risk of loss if the loans are fully secured. I would have more tolerance for "sub-prime", but fair, unsecured lending than for "sub-prime" secured lending that puts family's homes at risk.

2) The "sub-prime" justifications are so broad that just about every abusive practice we have ever pursued (short of forgery) is arguably legitimate and not predatory. Historically, mainstream lenders themselves have shown no ability to understand the kind of distinctions they are now attempting to press on the marketplace. Bankers Trust works with Delta. Nationsbank purchased Chrysler First. Fleet Bank ran Fleet Finance, and on and on. I have no confidence that these same players can draw meaningful lines that our clients can live with.

3) The jury is still out on the question of just which borrowers will be targeted by the so-called legitimate sub-prime products. I think it is likely that Fannie Mae and Freddie Mac type products

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YES

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the risk of loss associated with asset-backed lending.

A borrower that is asked to pay 1-3 percent more for credit because the plant she worked at closed down or because her husband walked out - leading to credit card defaults and a lower credit score - is going to be placed in a pool with a lot of borrowers whose unexamined profiles have similar indicators of risk. The borrower here and all of her cohorts are nevertheless 97% likely to pay their mortgages. Is it fair to ask this borrower to pay 1-3% more for credit because she lost her job (or husband), or should we all (including you and me) pay .25% (1/4%) more for credit to spread the risk more evenly? In my view, spreading the risk more evenly is appropriate because it functions like insurance for all of us, if we have credit problems in our future.

Moreover, it reduces the potential that the 1-3% additional carrying costs for credit is causing defaults which then, ironically, justify the claim that the loans were risky.

Well that's as close to philosophy as I get these days. I'm done for now.

NO

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will be foisted on people with some credit blemishes that are now getting A-paper non-purchase money mortgage credit. These folks would do worse than they are doing now. Unless there is meaningful re-regulation that forces the worst lenders out of business, our clients, the "C" and "D" market, will be left, like chum, to be swarmed by the sharks.

Manuel Duran —

What is Predatory Lending? I have heard many definitions for this monstrous sounding business practice from our east coast advocates. Many of these definitions include high rates, junk fees, subprime... The definitions seem to focus on objective indicators that never grab my interest.

Every once in a while I get calls from east coast reporters and they ask me if I see much predatory lending in California. I always say that that is an east coast phenomenon. What I see in California is plain old FRAUD. It is not predatory or subprime. It is just plain and simple FRAUD.

The reason FAMCO gets homeowners to sign documents with 25% loan origination fees is fraud. The reason Bank of America buys over inflated debt instruments is because fraud is profitable. The reason arbitrary credit risk (which many of the lenders create themselves in order to charge a higher rate) is fraud. Any way you package it - it still smells like FRAUD.

We can debate all day and all night on the distinction between predatory lenders vs. subprime lenders. What we basically are doing is classifying an industry, and as has been pointed out, the industry is redefining the term "predatory lending" and will make themselves not predatory lenders by definition. What I believe the policy should be is to attack the acts and punish the actors. Let us define what is fraudulent and deceptive and advocate for strong remedies (civil and criminal) which will punish and deter, as well as hold those who profit from the fraud liable.

If we draw the lines at a definition of who is a predatory lender, the industry will easily distinguish themselves as many have, when HOEPA came into effect. The structure changes but the fraud continues. We should focus on the fraud and the scammer, and not the label.

Well, that is my 2 cents.