

Winter 2008

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Recommended Citation

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SELLING THE PAYMENTS: PREDATORY LENDING GOES PRIMETIME

DUSTIN FISHER*

I. INTRODUCTION

The historical resentment of lenders is best captured in the popular saying that “a banker is a fellow who lends you his umbrella when the sun is shining and wants it back the minute it begins to rain.”¹ Frustration and distrust of lenders developed prior to the Great Depression, an era of almost no federal regulation.² The home lending market thrived on so-called nontraditional loans, which were not fully amortizing and generally required unique financing.³ Following the economic trauma of the Great Depression, the federal government promoted a stable lending environment based on the traditional fixed-rate thirty-year mortgage.⁴

However, the traditional mortgage was a luxury often limited to borrowers with higher credit scores. Although nontraditional loans continued to have a presence in the prime credit market, they quickly became the province of the subprime market.⁵

* J.D. Candidate, May 2008, The John Marshall Law School. I would like to thank Kimberly, Griffin and Zoe Fisher for their sacrifice, support, and daily inspiration. I would also like to thank the Fisher and Spahr families for being my foundation and always believing in my ability. Without each of you, this journey would not have been possible.

1. Many attribute this witticism to Mark Twain. Thinkexist.com, Mark Twain Quotes, http://en.thinkexist.com/quotation/a_banker_is_a_fellow_who_lends_you_his_umbrella/179029.html (last visited Feb. 17, 2008).

2. See Cathy Lesser Mansfield, *The Road to Subprime “HEL” was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473, 477-81 (2000) (identifying the Federal Home Loan Bank Act, The Home Owners’ Loan Act of 1933, and The National Housing Act of 1934 as the first attempts at regulating the lending industry since the adoption of the National Bank Act in 1864).

3. See Fred Wright, Comment, *The Effect of New Deal Real Estate Residential Finance and Foreclosure Policies Made in Response to the Real Estate Conditions of the Great Depression*, 57 ALA. L. REV. 231, 232-38 (2005) (providing an overview of the lending practices prior to the Great Depression).

4. Michael S. Knoll, *Taxation, Negative Amortization and Affordable Mortgages*, 53 OHIO ST. L.J. 1341, 1343-44 (1992).

5. Subprime borrowers are those who have “FICO” credit scores below 620. DAVID A. SCHMUDDE, A PRACTICAL GUIDE TO MORTGAGES AND LIENS 90 (ALI-

Initially, the abuses known as predatory lending focused within this lower market, causing many to associate one with the other.⁶ This Comment, in contrast, focuses on the predatory lending practices that have taken the prime credit market by surprise.

Part II begins with a background of the prime mortgage environment and its evolution from traditional to nontraditional loans. In addition, Part II discusses the definition of predatory lending and its expansion into the prime credit market. Part III follows with examples of loans that are likely to entice prime borrowers into predatory lending schemes. One of the principal distinctions between the prime and subprime market is that their loans typically serve very different purposes for each type of borrower. Therefore, Part III differentiates between prime and subprime borrowers and the ways in which their loans are being abused.

Part IV proposes a practical and simple solution to curb prime predatory lending, and reinforces the importance of stability through the use of traditional financing.

II. BACKGROUND

A. The Mortgage Process

Prior to obtaining a mortgage, a potential borrower must fill out an application allowing the lender to examine his past and present financial situation.⁷ Although credit scoring models vary,

ABA 2004). A FICO score, named after its developers, Fair, Isaac and Company, Inc. (now known as the Fair Isaac Corporation), grades borrowers on a range of creditworthiness from 300-900 with higher numbers representing a lower risk of default. *Id.* at 65.

6. Few law review articles describe the nature of predatory lending in the prime credit market. *See, e.g.*, Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1261 (2002) (noting that “[w]hile the definition of predatory loans is not restricted to the subprime market, that is where predatory loans are most prevalent[;] [a]ccordingly, predatory loans in the subprime market are the focus of our analysis”); Margot Saunders, *The Increase in Predatory Lending and Appropriate Remedial Actions*, 6 N.C. BANKING INST. 111, 112 (2002) (identifying those without access to mainstream credit as the target of abusive lending practices); Lloyd T. Wilson, Jr., *Effecting Responsibility in the Mortgage Broker-Borrower Relationship: A Role for Agency Principles in Predatory Lending Regulation*, 73 U. CIN. L. REV. 1471, 1475 (2005) (arguing that the likely targets of predatory lending efforts are those who have “significant educational, experiential, and financial disadvantage[s]”); Debra Pogrund Stark, *Unmasking the Predatory Loan in Sheep’s Clothing: A Legislative Proposal*, 21 HARV. BLACKLETTER L.J. 129, 133 (2005) (linking the rise in predatory loans with the increase in subprime mortgages over the last decade).

7. SCHMUDDE, *supra* note 5, at 64. Typically, the lender will require past tax returns, verification of present income, and a copy of the contract for the pending home sale. *Id.*

the prime borrower generally will have a FICO score equal to or greater than 620.⁸ Next, the lender will consider the property's appraisal value⁹ and weigh these factors in light of each other to assess the borrower's risk of default.

After conducting a risk assessment, the lender will devise a future monthly mortgage payment (plus property taxes) that falls within 25%-29% of the borrower's gross monthly income.¹⁰ The lender should also ensure that the borrower's total debt obligation does not exceed 41% of his monthly income.¹¹ Herein lies the

8. See *supra* note 5 and accompanying text. Fair Isaac Corporation considers the following factors in calculating FICO scores: payment history (35%), amounts owed (30%), length of credit history (15%), new credit (10%), and types of credit used (10%). What's In Your FICO Score, <http://www.myfico.com/CreditEducation/WhatsInYourScore.aspx> (last visited Jan. 19, 2008). Borrowers with a FICO score under 620 can still qualify for a prime credit loan if they have a greater amount of equity to secure the mortgage. See SCHMUDDE, *supra* note 5, at 65 (identifying the default rate of homeowners who have at least 30% equity in the home as less than one-fourth of 1%).

9. *Id.* at 64-65. The home appraisal process is underrepresented in predatory lending literature despite its significant influence on the problem. The purpose of home appraisals is to determine the fair market value of a home in order to protect the lender from any potential default by the borrower. While this appears to be a rather basic proposition, it is usually more complex. For example, how does an appraiser adequately determine the true value of a home in a rapidly appreciating real estate environment?

Appraisers traditionally use three methods of assessing a home's value: the "comparable-sales method," the "capitalization-of-income method," and the "reproduction-cost-new-less-depreciation method." Robin Paul Malloy, *Lender Liability for Negligent Real Estate Appraisals*, 1984 U. ILL. L. REV. 53, 55-57 (1984). The comparable-sales method, which determines a property's value based on the recent sale prices of similar residential properties, is by far the most prevalent method of evaluating the residential market. *Id.* However, the comparable-sales method is based on an assumption that comparable properties exist. *Id.* at 56. If home prices are appreciating or depreciating abnormally, the comparable-sales method is compromised by viewing present value through varying circumstances.

Further, appraisals are often the final step in home financing causing appraisers to frequently face significant pressure to come in at a particular number that the buyer, seller, and lender have already agreed upon. In theory, the lender wants to protect itself from future default, but the reality is that the lender knows its loans can be bundled and sold with others. See Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 550-54 (2002) (explaining how after securitization became the driving force in the lending market, underwriting became less of a concern and a significant part of the foreclosure risk shifted to the purchaser). As lenders rarely hold onto the mortgage for the life of the loan, their business model is based on volume instead. In other words, writing a large number of loans helps to cushion any risk of default.

10. SCHMUDDE, *supra* note 5, at 65.

11. *Id.* Total debt includes credit card payments, past loans, or any other debt obligations.

initial problem: if the lender chooses to disregard total debt obligation, he can use the allure of lower rates to induce the borrower into making larger principal payments to "afford" a more expensive home.¹²

The conservative nature of American borrowers combined with a relatively stable housing market has historically prevented this problem. Following the Great Depression, an overwhelming majority of prime mortgage loans had fixed-rate terms.¹³ Fixed-rate loans are widely considered to be the least risky because the borrower has cost certainty until the loan is fully amortized.¹⁴ For this reason, many people assumed that prime credit borrowers who used nontraditional loans did so based on specific need only.¹⁵

B. Stability Versus Assumption of Risk

There is no particular reason why American borrowers prefer the thirty-year fixed-rate loan; this certainly is not the case in other parts of the world.¹⁶ Indeed, confused by the conundrum, none other than Alan Greenspan openly wondered why more Americans were not using adjustable rate mortgages ("ARMs").¹⁷ Although Greenspan cautioned against using ARMs in a rising

12. A basic example clarifies the point. A \$100,000 loan amortized over thirty years at an 8% interest rate has a monthly payment of \$733.36. That same loan with a 6% interest rate has a monthly payment of \$599.95. By taking the borrower's total debt obligations out of the equation, the 8% interest rate requires a total gross monthly income of \$2933.44, while the 6% interest rate only requires \$2399.80.

13. See ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* 12-13 (2d ed., Princeton Univ. Press 2005) (2001) (noting that appreciation of homes has been a "rocket taking off," as only the post-World War II boom can rival the home appreciation of 52% between 1997-2004). Also, unlike the post-World War II boom, the more recent boom was not accompanied by a corresponding increase in income. *Id.*

14. See SCHMUDDE, *supra* note 5, at 76 (identifying one of the most beneficial aspects of the fixed-rate mortgage as allowing the borrower to know the exact dollar amount of the monthly payment for the life of the loan).

15. See Engel & McCoy, *supra* note 6, at 1284 (recognizing that although nontraditional loans are available to prime credit borrowers, such loans are discretionary alternatives to the more predictable "fixed-rate variety").

16. See Benny L. Kass, *Greenspan, ARMs and What's Best for You*, WASH. POST, Mar. 6, 2004, at F03 (quoting Alan Greenspan, "[t]his preference is in striking contrast to the situation in some other countries, where adjustable-rate mortgages are far more common and where efforts to introduce American-type fixed-rate mortgages generally have not been successful[;] [f]ixed-rate mortgages seem unduly expensive to households in other countries").

17. *Id.* "Recent research within the Federal Reserve suggests that many homeowners might have saved tens of thousands of dollars had they held adjustable-rate mortgages rather than fixed-rate mortgages during the past decade" *Id.*

interest rate environment,¹⁸ the lending industry conveniently highlighted this part of his speech:

American consumers might benefit if lenders provided greater mortgage product alternatives to the traditional fixed-rate mortgage. To the degree that households are driven by fears of payment shocks but are willing to manage their own interest rate risks, the traditional fixed-rate mortgage may be an expensive method of financing a home.¹⁹

While Greenspan did not suggest ARMs were proper for all prime borrowers, his immense credibility allowed lenders to use this statement as an endorsement for nontraditional loans.²⁰ However, Greenspan made these remarks at a time when the thirty-year fixed-rate loan approached historically low interest rates.²¹

With the market and history favoring thirty-year fixed-rate loans, common sense weighed against borrowers changing course. Unfortunately, borrowing practices changed as ARMs represented 33% of all U.S. loan applications in 2004 and 34% in 2005.²² Moreover, 43% of all first time home buyers in 2005 put “no money down” on their mortgages.²³ At least 15% of these 2005 buyers are now “upside-down” on their mortgages, meaning that they owe more than the purchase price of the home.²⁴ Perhaps even more shocking is that 12.3% of all loans written during the first five

18. See *id.* (stating that homeowners might not have saved thousands “had interest rates trended sharply upward”).

19. *Id.*

20. While there were certainly editorials and articles to the contrary, the following headlines from a variety of newspapers prove how lenders could use this statement as a selling point: Eileen Alt Powell, *Momentum Starts to Build for Adjustable Mortgages; Fed Chairman Says That Traditional, Fixed-Rate Loans Caused Some People to Pay ‘Tens of Thousands’ More During the Past Decade*, TELEGRAPH HERALD, Mar. 14, 2004, at B2; Paul Gores, *Maybe You Really Need an ARM; Adjustable-Rate Mortgages Can Offer Buyers the Muscle They Need to Land a House*, MILWAUKEE J. SENTINEL, Mar. 20, 2004, at 01D; Lew Sichelman, *ARMs Are Not Heretical, If You Can Manage Risk*, CHI. TRIB., Mar. 21, 2004, at 5B.

21. Greenspan delivered this particular speech on February 23, 2004. Kass, *supra* note 16. During that time period, the average commitment rates for thirty-year fixed-rate mortgages dropped under 6% for the first time since at least 1971. Freddie Mac, 30-Year Fixed-Rate Mortgages Since 1971, <http://www.freddiemac.com/pmms/pmms30.htm> (last visited Jan. 19, 2008).

22. Freddie Mac, Freddie Mac Releases Results of Its 22nd Annual ARM Survey, http://www.freddiemac.com/news/archives/rates/2006/20060105_05arm_survey.html [hereinafter *Freddie Mac I*] (last visited Jan. 19, 2008).

23. Lon Witter, *The No-Money-Down Disaster*, BARRON'S, Aug. 21, 2006, at 33, available at TPM Cafe, http://www.tpmcafe.com/blog/moonlore20002001/2006/aug/23/the_no_money_down_disaster (Aug. 23, 2006, 12:04 EST).

24. See *id.* (noting that “15.2% of 2005 buyers owe at least 10% more than their home is worth”).

months of 2006 were option ARMs,²⁵ in which over 80% of borrowers have failed to pay enough to cover the interest due each month.²⁶

Although this Comment does not attempt to answer the housing market's version of the chicken and the egg question (which came first, increased use of nontraditional loans or unprecedented price appreciation in the housing market?), the impact of rising home costs cannot be ignored. Robert Shiller, a Yale economist, charted home price appreciation since 1890 with staggering results. If the median home value in 1890 was \$100,000 (adjusted for inflation), the comparable home in 2003 was valued in excess of \$199,000.²⁷ Under Schiller's analysis, homes are overvalued at unprecedented levels.²⁸ This relates to the lending market in two ways. First, nontraditional financing allows buyers to qualify for homes they otherwise could not afford under traditional fixed guidelines. Second, nontraditional financing provides a windfall of equity to previous homeowners, which lenders have capitalized on through the encouragement of home equity withdrawal.

While the value of a home is usually linked to income and rental prices, neither factor has appreciated anywhere near the rate of homes.²⁹ The lending industry used to hedge against

25. Mara Der Hovanesian, *Nightmare Mortgages*, BUS. WK., Sept. 11, 2006, at 70. The number of option ARMs written in 2003 accounted for only 0.5% of all mortgages. *Id.*

26. *See id.* (identifying negative amortization as the largest problem with option ARMs, a process in which each month's unpaid interest is tacked on to the principal).

27. SHILLER, *supra* note 13, at 3.

28. *Id.*

29. *See, e.g.*, Press Release, U.S. Census Bureau, New Census Bureau Data Highlight Changes in Housing Values Through 2005 (Oct. 3, 2006) (on file with the U.S. Census Bureau), available at http://www.census.gov/Press-Release/www/releases/archives/american_community_survey_acs/007577.html [hereinafter *Housing Values Press Release*] (reporting increases in real median home values across the country). The Census Bureau's data shows the magnitude of the problem. Home values, in real terms, have increased nationwide by 32% since 2000. *Id.* Coastal cities have been hit the hardest, especially San Diego. *Id.* Between 2000 and 2005, the median home price in San Diego increased from \$249,000 to \$567,000 (a shocking 127.2% increase). *Id.* In addition, real median homeownership costs shot up 5% over the same five year period, with some of the highest increases in Midwestern cities such as Detroit (24.1%) and Chicago (21.7%). *Id.* The Census data further suggest that from 2000 to 2005, the cost of renting a home has increased nationally by 6.7%. *Id.* So the question arises, have economic fundamentals supported this dramatic rise in home values? The Census Bureau seems to answer in the negative. *See* Press Release, U.S. Census Bureau, Income Climbs, Poverty Stabilizes, Uninsured Rate Increases (Aug. 29, 2006) (on file with the U.S. Census Bureau), available at http://www.census.gov/Press-Release/www/releases/archives/income_wealth/007419.html [hereinafter *Income Climbs Press Release*] (noting that real median income increased 1.1% between 2004

inflation of housing prices by using independent appraisals.³⁰ However, rapid home appreciation combined with a seemingly insatiable demand for homes has created an atmosphere in which independent appraisers are asked to ignore fundamentals and “come in” at a particular number or risk losing future business.³¹

As mentioned above, predatory lending is a problem facing society’s most vulnerable borrowers.³² Those borrowers who are capable of qualifying for prime credit should be immune from predatory lending due to their perceived economic sophistication.³³ Yet, as prime borrowers continue to throw away the security blanket of fixed-rate loans and assume the inherent risks of ARMs, predatory lenders are moving into the prime credit market like never before.

C. Difficulties of Definition: What Is Predatory Lending?

Predatory lending has always been easier to identify than to define.³⁴ In the absence of outright fraud, the loans are those

and 2005, making it the “first year since 1999 in which real median household income showed an annual increase”). Also, “the nation’s official poverty rate remained statistically unchanged at 12.6 percent” and “[t]he percentage of people without health insurance coverage rose from 15.6 percent to 15.9 percent.” *Id.*

30. See Malloy, *supra* note 9, at 55-60 (describing the different appraisal methods).

31. See, e.g., Larry Finley, *Bloated Home Prices: Complaints Against Illinois Appraisers on the Rise*, CHI. SUN-TIMES, Aug. 13, 2006, at E1 (describing the growing number of complaints regarding fraudulent home appraisals). Ron De Vries, a past board member of the Appraisal Institute, stated that some lenders threaten to take their business elsewhere if the appraiser does not reach a particular estimate. See *id.* (quoting De Vries, “[t]hey get a call one day, and the lender says if you don’t raise the value on this appraisal I’m never going to give you another assignment”). Sometimes, the lender will call and say, “I want you to do an appraisal, and the property value has to be at least \$200,000. Will you do it?” *Id.*

32. See Stark, *supra* note 6, at 134 (identifying the usual victims of predatory lending as “the elderly or minorities”).

33. However, this belief is not supported by the data. See William R. Emmons, *Consumer-Finance Myths and Other Obstacles to Financial Literacy*, 24 ST. LOUIS U. PUB. L. REV. 335, 336-39 (2005) (explaining how “evidence suggests that even basic financial literacy is by no means common among U.S. households”).

34. Former Senator Phil Gramm “famously asserted that predatory lending could not be addressed until it could be defined.” Engel & McCoy, *supra* note 6, at 1259. The federal government has attempted to define predatory lending as “engaging in deception or fraud, manipulating the borrower through aggressive sales tactics, or taking unfair advantage of a borrower’s lack of understanding about loan terms. These practices are often combined with loan terms that, alone or in combination, are abusive or make the borrower more vulnerable to abusive practices.” See Eggert, *supra* note 9, at 511 (quoting U.S. DEPT OF HOUS. & URBAN DEV. & U.S. DEPT OF TREASURY, HUD-TREASURY JOINT REPORT ON PREDATORY LENDING 1 (2001), available at <http://www.hud.gov/library/bookshelf12/pressrel/treasrpt.pdf>). Others choose

which are simply inappropriate for that particular borrower, or stated differently something a reasonable borrower would avoid.³⁵ Further, the lending practices originally identified as “predatory” have evolved over time and certainly are no longer limited to a particular market.³⁶

Despite these ambiguities, a number of predatory practices have earned a name for themselves. First and foremost, there are techniques known as “equity stripping”³⁷ or “asset based lending,”³⁸ in which lenders extend loans with little expectation that the borrowers will be able to repay them.³⁹ By ignoring the borrower’s income and total amount of debt, the lender can make a quick deal and then securitize and sell the loan on the secondary market.⁴⁰

to define predatory lending by identifying a variety of its common practices. See Engel & McCoy, *supra* note 6, at 1260 (defining predatory lending as a “syndrome” involving one or more of the following five problems: “(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”).

However, some believe that the issue of defining predatory lending has received too much attention. See Christopher L. Peterson, *Federalism and Predatory Lending: Unmasking the Deregulatory Agenda*, 78 TEMP. L. REV. 1, 12-13 (2005) (arguing that the “definition of predatory lending has been the subject of more debate than it deserves” and that “at its heart [predatory lending] is nothing more than misappropriation of income or equity by financial subterfuge”); Engel & McCoy, *supra* note 6, at 1260 (remarking that activists believe “you know predatory lending when you see it”).

35. See Stark, *supra* note 6, at 134 (noting that that predatory loans are simply “bad loans”).

36. For example, the most dominant image in predatory lending literature is that of excessive fees and interest rates. See Eggert, *supra* note 9, at 514 (describing that it is common for predatory lenders to “charge fees and interest rates far greater than necessary to provide a reasonable, market-driven rate of return to the lender given the risk of lending to the particular borrower”). The prime credit market faces the opposite problem of lenders using unreasonably low rates as an inducement to enter into bad loans.

37. Eggert, *supra* note 9, at 515.

38. Engel & McCoy, *supra* note 6, at 1262.

39. Eggert, *supra* note 9, at 515.

40. *Id.* The securitization process has been credited with revolutionizing the lending industry, breaking down the process so that the lender is no longer solely responsible for all the functions of the loan. *Id.* at 552. Now the loan can be originated, funded, securitized, bought and serviced all by different entities, allowing each to deny responsibility for the others’ actions. *Id.* Mortgage brokers who originate the loan often have an incentive to push borrowers into larger and/or subprime loans in order to maximize commissions received from lenders. *Id.* at 553-54. Likewise, lenders may choose to then deceive secondary market purchasers about a borrower’s true credit risks to forego dealing with the impending default. Engel & McCoy, *supra* note 6, at 1286-87. Brokers and lenders have little incentive to act otherwise when they do not bear the risk of loss. *Id.*

ARMs with artificially low introductory rates are particularly an issue because the risk of default is low during the initial “teaser” period. Thus,

Meanwhile, the borrower is likely to face bankruptcy or foreclosure.

Another predatory practice moving into the prime credit market is “loan flipping.”⁴¹ Lenders engage in loan flipping when they persuade a struggling borrower to frequently refinance his loan while tacking on prepayment penalties, points and fees each time.⁴² Although the borrower receives temporary relief in the form of lower payments, he will eventually owe the lender a higher total principal and interest amount.⁴³ Lenders frequently use this concept as a selling point for ARMs, easing borrower anxiety with assurances that if the rates go up, “we’ll just refinance.”⁴⁴

Finally, the most notorious predatory lending practices that have found their way to prime credit borrowers are prepayment penalties and balloon payments.⁴⁵ While either practice is damaging enough independently, lenders often combine both with devastating results.⁴⁶ Surprisingly, prepayment penalties and

lenders are protected from litigation until the teaser period ends, at which point the secondary purchaser may not have a claim against the lender. Although secondary purchasers can take measures to protect themselves to some extent, none of the solutions seem to effectively deter the predatory cycle. *See id.* at 1288-89 (discussing how the lenders can declare bankruptcy, “tuck predatory loans in with bundles of good loans,” or take further measures to harm borrowers under recourse provisions).

41. *Id.* at 1263.

42. Eggert, *supra* note 9, at 515-16.

43. *See* Engel & McCoy, *supra* note 6, at 1263 (noting that loan flipping often results in “equity stripping” because the borrower’s home equity declines with each refinance).

44. Predatory lenders used this disingenuous sales pitch for variable rate mortgages at a time of historically low fixed rates. Informed borrowers recognized the inevitable truth that the possibility of rising interest rates was a matter of “when” and not “if.” Less educated borrowers, however, were easier to exploit through the belief that a new paradigm existed in the real estate market.

45. Prepayment penalties are imposed on a borrower when she repays the entire loan balance prior to reaching its full-term. *See generally* Eggert, *supra* note 9, at 518-19 (explaining that such penalties were originally designed to prevent prepayment, which results in the lender receiving less interest than he bargained for; however, predatory lenders use prepayment penalties to “trap the borrower . . . or to reward the lender with an unreasonable payoff”). For the purposes of this Comment, prepayment penalties are typically found in teaser loans, such as the 2/28 loan, that initially have artificially low interest rates and then readjust after a certain time period to reflect the lost interest rate income. *See infra* Part III.A (analyzing the way in which “teaser” loans attract borrowers).

Conversely, balloon payments force borrowers to repay the entire remaining balance of the loan after a certain number of years, rather than continue to pay monthly payments for the duration of the loan. Eggert, *supra* note 9, at 519-20. Balloon payments are common in negative amortization loans and are particularly an issue in option ARMs. *See supra* Part III.C.

46. *See generally* Hovanesian, *supra* note 25, at 70 (describing how the use of these and other predatory lending tactics are breaking homeowners across

balloon payments continue to gain in popularity.⁴⁷ Overall, as home prices continue to appreciate to unprecedented levels, prime borrowers have proven to be less sophisticated and equally susceptible to these and other predatory lending practices.

III. ANALYSIS

Those debating over predatory lending in the subprime market have always struggled with the fundamental issues involved. For example, why do people take out such unfavorable loans? Will regulation have the counterproductive effect of making all loans less available to the subprime market?⁴⁸

To a certain extent, the answers are straightforward. Subprime borrowers take out unfavorable loans because they are available when more favorable loans are not.⁴⁹ Without nontraditional loans, subprime borrowers are often denied the popular American dream of owning their own home.⁵⁰ Thus,

the country). An anecdotal story describes the situation:

Jennifer and Eric Hinz of Somerset, Wis., are feeling the squeeze. They refinanced out of a 5.25% fixed-rate, 30-year loan in June, 2005, and into an option ARM with a 1% teaser rate from Indymac Bank. The \$1,483 payment for their original mortgage dropped to as low as \$747 with the new option ARM. They say they had no idea when they signed up, however, that the low payment adds \$600 in deferred interest to their balance every month. Worse, they thought the 1% would last three years, but they're already paying 7.68%. "What reasonable human being would ever knowingly give up a 5.25% fixed-rate for what we're getting now?" says Eric, 36, who works in commercial construction. Refinancing is out because they can't afford the \$15,000 or so in fees.

Id.

47. See generally *id.* (noting that "despite the housing slump, option ARMs totaling \$77.2 billion were written in the second quarter of [2006]"). Further, such predatory loans are not limited to the coastal areas facing astronomical appreciation. In 2006, option ARMs comprised 51% of all loans in West Virginia and 26% in Wyoming. *Id.* Further, LoanPerformance LLC, a San Francisco real estate information service, found that interest-only mortgages made up 45.5% of all loans written in Atlanta and 43.4% of loans in Denver during 2004. Peter Coy, *The Home Loans Vexing Greenspan*, BUS. WK., June 10, 2005, available at http://www.businessweek.com/bwdaily/dnflash/jun2005/nf20050610_5662_db016.htm.

48. See Mary Wisniewski, *Loan Shock: Mortgage Pros Fear New State Regs Will Hurt Business*, CHI. SUN-TIMES, Sept. 11, 2006, at 53 (discussing the debate over HB 4050, Illinois' new anti-predatory lending law that requires borrowers under a certain credit score to obtain financial counseling before entering into a loan with a broker; opponents worry that the law "might make credit unavailable [to certain] areas"); see also Engel & McCoy, *supra* note 6, at 1257-58 (providing a brief summary of the "fierce debate" over how to resolve the predatory lending problem).

49. See *id.* at 1279 (identifying the subprime market as a place where those with "elevated risk levels" can "take advantage of the influx of mortgage capital and flexible . . . loan products").

50. See *id.* at 1261 (noting that lenders have eased numerous underwriting standards in the subprime market to enable those borrowers to purchase a

predatory lending literature and regulation must grapple with criticizing the only parties extending credit to the subprime community.

This Comment is not attempting to combat the problem of predatory lending in the subprime market. Indeed, the problems highlighted above are happening in both the prime and subprime market. However, the evolution of predatory lending in the prime credit market is unique. Instead of “tightening” credit, where borrowers are faced with unfavorable loan terms or not getting a home, lenders combine the perfect storm of rising home costs and “loosening” credit to induce prime credit borrowers into equally unfavorable loans.

In theory, prime credit borrowers should have greater flexibility in obtaining financing.⁵¹ Additionally, the ability to qualify at historically low fixed interest rates should have protected prime borrowers from predatory lending practices. As home prices began to appreciate faster than income,⁵² however, prime borrowers became more willing to assume risk to purchase homes.⁵³ This opens the door to predatory lenders and allows them to do what the car industry has done for decades: sell the payments, not the price.⁵⁴

A. *The Allure of Low Payments: The “Teaser Loan”*

There is perhaps no better demonstration of “selling the payments” than the teaser loans advertised on the television, radio, newspaper, and the Internet. The concept behind teaser loans is quite simple. For a temporary period of time, the borrower has an extremely low monthly payment through either an artificially low interest rate or by neglecting to pay any

home).

51. See *id.* at 1284 (describing lending conditions in the prime market where borrowers can obtain easy to understand fixed-rate loans, or choose to use a nontraditional loan alternative).

52. *Housing Values Press Release*, *supra* note 29.

53. *Freddie Mac 1*, *supra* note 22.

54. “Sell the payments, not the price” is a phrase most commonly associated with car sales. See generally Automotive.com, Car Buying Basics, <http://www.automotive.com/new-cars/36/car-buying-tips/car-buying-tip-basics.html> (last visited Feb. 17, 2008) (describing car dealer tactics and how to avoid paying too much for a car); SUPERNOVA SELLING SYSTEMS, SHOW ME THE MONEY! (2003), <http://www.serviceroundtable.com/freebies/viewfreebie.asp?PCID=296> (last visited Mar. 11, 2008) (explaining how salespeople achieve success through financing plans). In essence, a salesperson determines how much a buyer can pay per month on a vehicle and then uses that price point to sell a more attractive, and more expensive, vehicle. By playing with interest rates and loan terms, the salesperson can achieve a greater commission for herself and send larger profits to the dealership and manufacturer.

principal.⁵⁵ After the initial “teaser” period, the payments readjust to reflect a higher interest rate⁵⁶ or a shorter term to pay off the remaining principal.⁵⁷

Two notorious teaser loans are the “2/28” loan and the “interest-only” loan. With respect to 2/28 loans, the number “2” reflects the period of under-market interest and the number “28” refers to the years remaining on the loan term. For example, a borrower takes out a \$200,000 2/28 loan with an initial teaser rate of 4.5%. For the first two years of the loan, the borrower’s monthly payment will be \$1,013. At the end of the two-year period, the interest rate readjusts to the contracted market rate, which can increase payments by as much as 25%.⁵⁸

Originally, subprime borrowers agreed to 2/28 loans as instruments to “rebuild” credit. Lenders convinced borrowers that they could establish better credit by making prompt payments at a low rate⁵⁹ and then refinancing at a “prime” rate after the two-year

55. The teaser loan term varies from a few months to the most popular two-year term. See generally *Calculated Risk: Assessing Non-Traditional Mortgage Products: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs, Subcomm. on Housing and Transportation, and Subcomm. on Economic Policy*, 109th Cong. 5-7 (2006) [hereinafter *Calculated Risk*] (statement of Michael D. Calhoun, President, Center for Responsible Lending), available at http://www.responsiblelending.org/pdfs/Testimony-Calhoun_092006.pdf (referring to two-year teaser loans as “exploding ARMs”). While the focus of Calhoun’s testimony is directed on the subprime market, he notes that one out of five recent subprime borrowers could have qualified for a traditional prime market loan. *Id.* at 3 (citing Mark Hudson & E. Scott Reckard, *The Nation; More Homeowners With Good Credit Getting Stuck With Higher-Rate Loans*, L.A. TIMES, Oct. 24, 2005, at A1).

56. See *Calculated Risk*, *supra* note 55, at 6 (indicating that a 2% increase in the market index at the end of a teaser period would be a “conservative assumption[]”).

57. See BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, INTEREST-ONLY MORTGAGE PAYMENTS AND PAYMENT-OPTION ARMS 2 (2006), available at http://www.federalreserve.gov/pubs/mortgage_interestonly/mortgage_interestonly.pdf [hereinafter *Board of Governors*] (remarking that the “[interest-only] payment period is typically between 3 and 10 years”). The Federal Reserve further stated:

After that, your monthly payment will increase - even if interest rates stay the same - because you must pay back the principal as well as the interest. For example, if you take out a 30-year mortgage loan with a 5-year I-O payment period, you can pay only interest for 5 years and then both principal and interest over the next 25 years. Because you begin to pay back the principal, your payments increase after year 5.

Id.

58. Notably, this figure was reached by applying Mr. Calhoun’s “conservative” market rate increase of 2%. *Calculated Risk*, *supra* note 55, at 6. For example, after the ARM adjusts, a 4.5% interest rate payment of \$1013 per month would increase to a 6.5% interest rate payment of \$1254 per month for the lifetime of the loan. Vikas Bajaj & Ron Nixon, *Variable Loans Help to Put Off Mortgage Pain*, N.Y. TIMES, July 23, 2006, at A1.

59. See Mortgage-X, http://mortgage-x.com/library/2_28_loan.asp (last

term. Borrowers could thereby reestablish their credit rating and achieve a prime credit loan with more favorable terms.

However, 2/28 loans have not been limited to the subprime market.⁶⁰ Instead, prime borrowers have used the 2/28 loan to qualify for homes they could not afford under traditional financing.⁶¹ As described above, qualification for a mortgage depends on the mortgage payment versus income and debt, not on the total cost of a home.⁶² Therefore, if a prime borrower is willing to assume the risks of a 2/28 loan, she too can qualify for a home based on an artificially low payment.

Interest-only loans take the desire for low monthly payments to the next level. With this type of loan, the borrower initially is required to pay only the interest that accrues each month.⁶³ For example, a \$200,000 loan with a 6.5% interest rate would yield a monthly payment of \$1,083 during the interest-only period. However, at the conclusion of the interest-only period, the borrower's monthly payment will include interest plus principal payments that fully amortize the loan.⁶⁴ This will, almost

visited Jan. 19, 2008) (stating that 2/28 loans "allow [borrowers] two years to rebuild [their] credit, at which point [they] may refinance at a better rate"); Loan Programs, http://www.bancasa.net/loan_programs.HTM (last visited Jan. 19, 2008) (describing that the 2/28's "purpose is to offer temporary financing to these applicants until they can qualify for [prime] financing"); Advantix Lending, 2/28 ARM Mortgage Loan, http://www.advantixlending.com/eliminate_debt_arm_loan.asp?loantype=3 (last visited Jan. 19, 2008) (advertising the 2/28 as an instrument that allows the borrower two years to "rebuild [her] credit, at which point [she] may refinance at a better rate").

60. *Calculated Risk*, *supra* note 55, at 3 (noting that 20% of the subprime mortgages in 2006 were actually borrowed by people who could have qualified for a prime credit loan).

61. See FDIC, Breaking New Ground in U.S. Mortgage Lending, http://www.fdic.gov/bank/analytical/regional/ro20062q/na/2006_summer04.html [hereinafter *FDIC*] (last visited Jan. 30, 2008) (noting that borrowers have used nontraditional mortgage products "to stretch home-buying power").

62. See SCHMUDDE, *supra* note 5, at 65 (stating that lenders usually qualify borrowers for mortgages that have monthly payments no greater than 25-29% of the borrowers' gross monthly income, and that will not cause the borrowers' total monthly debt to exceed 41% of their total monthly income). For example, a \$200,000 loan with a 4.5% teaser rate would require an income of approximately \$43,000 to qualify. By contrast, a borrower must have a yearly income of approximately \$54,000 to qualify for a 6.5% interest rate on the same loan. In other words, teaser loans allow a borrower with approximately 25% less income to qualify for a similar home. Further, the larger the loan, the larger the spread in real dollars.

63. See BOARD OF GOVERNORS, *supra* note 57, at 2-3 (stating that interest-only mortgage payments, unlike traditional mortgage payments, do not decrease the principal balance).

64. The monthly payment on the fully amortized loan will be approximately \$1264. Thus, the interest-only loan functions very much like a teaser rate loan in that it allows a borrower to defer principal payments during the interest-only period (typically 3-10 years) in exchange for a lower monthly payment. See BOARD OF GOVERNORS, *supra* note 57, at 2-4 (comparing

certainly,⁶⁵ increase monthly payments.⁶⁶

Interest-only loans often attract prime borrowers who are willing to “gamble” that they will have a substantial increase in income or equity during the teaser period.⁶⁷ Borrowers who fear they will be “priced out” agree to a loan with hopes that their future gain will justify the overall expense of the home.⁶⁸ This rationale is particularly interesting because it is similar to the sales pitch given to subprime borrowers.⁶⁹ While subprime borrowers are sold on the hope that they can repair credit and qualify for a lower fixed interest rate loan, prime borrowers are sold on the suggestion that their income (or rapid home appreciation) will grow and allow them to comfortably make payments down the road.

B. No Income Documentation, No Problem

Borrowers, lenders, and investors have always relied on a borrower's income to act as a protective shield in the lending industry.⁷⁰ A borrower who qualifies for a prime credit loan is deemed to be a relatively safe investment in a properly appraised home,⁷¹ as job loss is the only major risk.⁷² Due to this sense of

interest-only loans with payment-option ARMs).

65. The major exception to this outcome is the few borrowers capable of making principal payments on top of the initial interest-only charges. Indeed, interest-only loans were originally designed for wealthier borrowers who received their earnings in irregular lumps, allowing them to pay principal during the months in which they received a greater amount of income. See Holden Lewis, *Who Should Get an Interest-Only Mortgage?*, BANKRATE, <http://www.bankrate.com/bnm/news/mtg/20020620b.asp> (last visited Jan. 30, 2008) (identifying the typical candidate for an interest-only mortgage as “an executive who earns a moderate salary and whose main income is from bonuses once or twice a year,” but advising that such loans are not recommended for “regular wage earners”).

66. The amount of the payment increase is determined by the length of the interest-only term. Using the \$200,000 loan example, a five-year interest-only period would result in a monthly payment of \$1350 after five years.

67. See BOARD OF GOVERNORS, *supra* note 57, at 7 (listing one reason for taking out an interest-only loan as being “reasonably certain” that income will increase in the future). Home appreciation is another common gamble with interest-only loans. The borrower gambles that the home's appreciation over the interest-only term will outpace the outstanding principal, allowing the borrower to easily refinance or sell at a profit.

68. See Blanche Evans, *Dark Housing Data Clouds Have Silver Linings*, REALTY TIMES, Aug. 16, 2006, http://realtymtimes.com/rtapages/20060816_silverlinings.htm (stating that “many who bought homes in recent years purchased them sooner than they otherwise would have because of very low interest rates and a great sense of urgency, given the fear of being priced out forever or missing out on a great investment”).

69. See *supra* note 61 and accompanying text for various examples.

70. See SCHMUDE, *supra* note 5, at 64-65 (indicating that lending standards were put in place to protect all parties from the risk of default).

71. *Id.*

security, lenders started providing “low documentation” or “stated income” loan products to certain prime borrowers.⁷³

Lenders originally developed these loans for prime credit borrowers who have difficulty documenting their income due to the nature of their employment or a particular family situation.⁷⁴ Traditionally, lenders required proof of monthly and yearly income for the past two years through W-2 forms and tax returns.⁷⁵ However, because the government never required this documentation, lenders shifted to a greater use of lower documentation loans, especially in the subprime market.⁷⁶

Lower documentation loans range from low documentation⁷⁷ to, most alarmingly, no documentation at all.⁷⁸ For example, “stated income” loans allow borrowers to write in their income, no proof required.⁷⁹ The borrower only needs to provide a signed IRS Form 4506 that allows the lender to verify the borrower’s income history and source, that potentially allows the lender to verify the

72. *Id.* at 65-66.

73. *See, e.g.,* Freddie Mac, Alternative Stated Income Mortgage, http://www.freddiemac.com/sell/factsheets/alt_stated_income.htm [hereinafter *Freddie Mac 2*] (last visited Jan. 30, 2008) (noting that its stated income program is designed to eliminate “the need for the large amount of income documentation and complexities inherent in self-employment”).

74. Families commonly use stated income loans when one family member has a subprime credit rating but another member’s credit could qualify for a prime loan. Stating the family’s income as a whole, along with one person’s prime credit rating, allows the family to purchase a home on more favorable loan terms.

75. *See supra* note 7 and accompanying text.

76. *See* Lingling Wei, *Stated-Income Loans Can Pose Risks*, DOW JONES NEWSWIRES, Aug. 20, 2006, available at http://boston.com/business/articles/2006/08/20/stated_income_loans_can_pose_risks/ (noting that “greater competition and the desire to simplify and quicken the . . . process has led more lenders to extend stated-income loans to [subprime] borrowers”); *see also* FDIC, *supra* note 61 (noting a minimum increase of 15% in stated income loans since 2001).

77. A “low documentation” loan is very similar to a “stated income” loan, except that the lender will at least attempt to verify loan qualification in the former. Marilyn Kennedy Melia, *More Keeping Their Pay Secret*, CHI. TRIBUNE, Dec. 11, 2005, at Real Estate. For example, if the borrower alleges that she is an attorney, the lender may check for the appropriate license. Likewise, if the borrower is a business owner, the lender may check with the Secretary of State to confirm that the business is in good standing.

78. *See id.* (remarking that “on a no-doc loan, the borrower doesn’t reveal his profession, income or assets”).

79. Due to the near total reliance on borrower honesty, stated income loans have been dubbed the “liar’s loan.” *See “Liar Loans” Contribute to Mortgage Problems*, NPR, Mar. 17, 2007, <http://www.npr.org/templates/story/story.php?storyId=8972571> (stating that the “liar loan” has allowed borrowers to take out larger loans than they can afford); *see also* Melia, *supra* note 77 (recognizing the apparent confusion that “stated” income means the borrower can state any number).

borrower's income history but not amount.⁸⁰ While stated income loans presented the risk of mortgage fraud, adverse effects were expected to be minimal. After all, how many borrowers would go through the trouble of obtaining financing for a home they could not afford?⁸¹

The answer is that an increasing number of borrowers use low documentation and stated income loans to purchase homes they could not qualify for under traditional guidelines.⁸² Indeed, as home prices continue to climb, so has the use of these types of loans.⁸³

C. Freedom of Choice? The Payment Option Loan

Perhaps no other instrument in lending demonstrates the desire for Americans to own their own home than the payment option loan. Under this type of loan, the borrower has the option to pay her mortgage in the fashion she desires.⁸⁴ Such options usually include the fifteen-year amortizing payment,⁸⁵ the conventional thirty-year amortizing payment,⁸⁶ the interest-only

80. *Freddie Mac 2*, *supra* note 73. An IRS Form 4506 authorizes the IRS to release a person's tax returns to a third party. Henry Savage, *What is the Form 4506 and Why Do Lenders Want You to Sign It?*, REALTY TIMES, Oct. 2, 2002, http://realtymtimes.com/rtpages/20021002_form4506.htm. Therefore, by signing the 4506, the borrower supports his statement of income by authorizing the loan originator to check his tax returns. However, the lender is not required to actually check and compare each borrower's income versus tax returns. *See generally id.* (positing that a signed 4506 serves little purpose in stated income loans other than to increase the loans' value in the secondary market).

81. *See generally* Wei, *supra* note 76 (quoting Countrywide Financial Corporation, "we have not found a significant enough difference in performance between fully documented loans and stated-income loans to cause us concern").

82. *See id.* (disclosing a report that out of a sample of 100 stated-income loans, almost 60% had stated incomes that were inflated by over 50%). One example is a seventy year-old Illinois borrower with a monthly income of \$1400, including \$800 from Social Security, who received a \$149,000 stated income loan with a monthly payment of \$1029. *Id.* The mortgage broker, who prepared the loan application, stated the borrower's monthly income as \$7225. *Id.*

83. *See* FDIC, *supra* note 61 (noting that stated income and other nontraditional loan products are more popular in states with strong housing appreciation).

84. *See generally* Hovanesian, *supra* note 25 (stating that lenders started marketing payment option ARMs in 1981 to "well-heeled home buyers" who desired maximum flexibility in making their payments).

85. *See* Hovanesian, *supra* note 25, for an example of a thirty-year \$500,000 payment option loan that will be applied in the following endnotes. The fifteen-year fully amortizing option would cost \$4601.03 per month. *Id.*

86. The fully amortizing thirty-year option would charge \$3455.08 per month. *Id.*

payment,⁸⁷ and a minimum monthly payment that fails to meet the full interest burden on the loan.⁸⁸ Payment option loans accounted for approximately 12.3% of all mortgages written through the first half of 2006.⁸⁹

The fifteen and thirty-year options are considered traditional variable rate loans⁹⁰ because they will amortize the loan on schedule. The interest-only payment option refers to a particular type of “teaser” loan.⁹¹ Overall, the minimum payment option is the most dangerous in the lending market.⁹² The minimum payment option allows the borrower to pay an amount less than the interest due on the loan and still remain in good standing.⁹³ However, the lender will subsequently tack the unpaid interest onto the principal balance and readjust the payment structure once the balance increases by 10-15%.⁹⁴ The borrower also faces a *de facto* prepayment penalty and must settle the deferred interest payment before refinancing can take place.⁹⁵

The number of homeowners falling into this negative amortization trap is staggering. Research studies estimate that up to 80% of payment option mortgage holders only make the minimum payment on their loans.⁹⁶ This is a recipe for disaster when the loan readjusts to reflect the added principal, forcing the borrower to either pay an amount greater than she was capable of paying during the unadjusted period or fall into default.

87. The interest-only option would cost \$3073.26 per month. *Id.*

88. The minimum payment on this \$500,000 property would be \$1608.20 per month, with the remaining interest tacked onto the principal balance. *Id.*

89. *Id.*

90. Even these alleged “safe” options can create an extensive amount of risk. See BOARD OF GOVERNORS, *supra* note 57, at 3-4 (discussing how monthly payments may “go up a lot” depending on the market interest rate).

91. See *supra* Part III.A (analyzing “teaser loans”).

92. See Hovanesian, *supra* note 25 (quoting housing economist George McCarthy that an option ARM is “like the neutron bomb . . . kill[ing] all the people but leav[ing] the houses standing”).

93. See *id.* (using an example where the minimum payment in year one is less than 50% of the thirty-year fully amortizing payment).

94. *Id.* Following the same example used above, paying the minimum amount would tack on \$20,214.81 in interest to the principal balance after the first year. *Id.* After approximately 2.5 years of making minimum payments, the loan readjusts once the principal balance reaches 10% of the original loan (\$50,000). *Id.* The monthly payment after reset immediately shifts to \$4107.86. *Id.*

95. *Id.* At a very minimum, the borrower would have to pay off the deferred interest prior to paying off a loan. *Id.* However, most payment option loans carry a substantial prepayment penalty. See, e.g., *id.* (reporting one borrower’s plight in having to “pay more than \$10,000 in prepayment penalties to refinance out of the loan”).

96. *Id.* (referencing Fitch Ratings).

As prime borrowers left behind the conventional wisdom of prior generations⁹⁷ and became willing to assume more risk through nontraditional loans, they opened themselves up to the same harsh lending practices plaguing the subprime market. However, these practices are distinguishable because instead of using points or above market interest charges, lenders aggressively sold low monthly payments and the American dream to expose prime borrowers to the traditionally subprime risks of default, equity stripping and loan flipping.

IV. PROPOSAL

A. *New Problems, Dated Solutions*

The ramifications of “selling the payments” are making their way through the housing and lending markets.⁹⁸ Borrowers are unable to count on rapid home appreciation, forcing them to refinance,⁹⁹ sell¹⁰⁰ or ultimately face foreclosure.¹⁰¹ In other words, borrowers of all credit ratings are beginning to feel the pressures of the predatory lending environment.

Evidence of gathering trepidation is not solely through anecdotal borrower accounts. Countrywide Home Loans, the nation’s largest mortgage originator, recently sent letters out to “thousands of borrowers” who used the payment option mortgage.¹⁰² The letter informs borrowers that, “this is an early message to alert you that, based on your current payment trends

97. See generally Wright, *supra* note 3, at 242-60 (describing the development of real estate finance regulation beginning with the New Deal).

98. See Martin Crutsinger, *New Home Prices Fall By the Largest Amount in More Than 35 Years*, AP WORLDSTREAM, Oct. 26, 2006 (identifying various symptoms of the housing slowdown, including a previous boom powered by the “lowest mortgage rates” in forty years that was followed by “the sharpest year-over-year decline” in home values since December 1970).

99. See Damon Darlin, *Mortgage Lesson No. 1: Home is Not a Piggy Bank*, N.Y. TIMES, Nov. 4, 2006, at C1 (identifying the third quarter of 2006 as having the highest refinancing rate in over fifteen years, and tying that to borrowers “scrambling to get out of interest-only mortgages that will soon reset at a higher interest rate”).

100. See Walt Molony, *Existing-Home Sales Holding at a Sustainable Pace*, Realtor.org, Sept. 25, 2006, available at http://www.realtor.org/press_room/news_releases/2006/ehs_aug06_existing_home_sales_holding.html (noting that “housing inventory levels rose . . . to 3.92 million existing homes available for sale [at the end of August] . . . the highest supply since April 1993”).

101. See Press Release, RealtyTrac Inc., National Foreclosures Remain Elevated in September (Oct. 11, 2006) (on file with RealtyTrac Staff), available at <http://www.realtytrac.com/ContentManagement/PressRelease.aspx?ItemID=1240> (identifying 112,210 properties in foreclosure during September 2006, a 63% increase in one year).

102. Kenneth Harney, *Interest-Only Loans May Start Cheap, ‘Reset’ Scary*, BALT. SUN, Aug. 18, 2006, at 1E.

and potential future interest rate changes, the monthly payment you will be required to pay may increase significantly.”¹⁰³ Lenders argue that the nontraditional loans have been “reserved . . . for borrowers with solid credit scores, large down payments and excellent employment histories.”¹⁰⁴ Yet, John G. Walsh, a senior official at the Comptroller of the Currency, still believes there is a problem with “understand[ing] the basic bargain: [t]he price of a low payment now is a much higher payment later.”¹⁰⁵

This basic premise is as misunderstood in the prime market, as are the hidden fees and interest charges used by lenders in the subprime predatory market. The belief that prime credit borrowers are more sophisticated is a fiction.¹⁰⁶ As stated by William Emmons, a Senior Economist at the Federal Reserve Bank of St. Louis, “U.S. households do not consistently demonstrate the basic skills of financial literacy.”¹⁰⁷ Prior to the aggressive marketing and use of nontraditional loans, the thirty-year fixed-rate mortgage protected these financially unsophisticated borrowers from predatory loans¹⁰⁸ and had relatively few pitfalls for qualified borrowers.

Federally mandated disclosures included in the Truth in Lending Act (hereinafter TILA),¹⁰⁹ Real Estate Settlement Procedures Act (hereinafter RESPA),¹¹⁰ and the Home Ownership and Equity Protection Act (hereinafter HOEPA)¹¹¹ attempted to quell predatory lending by making interest rates as transparent as possible.¹¹² Congress intended these disclosures to be a significant

103. *Id.* One letter addressed a borrower with a \$402,000 loan who was only making minimum monthly payments of \$1348.47. *Id.* The letter explained that after reset, the borrower’s monthly payment would increase to \$2887.50. *Id.*

104. *Id.*

105. *Id.* Walsh continues, “I think it goes without saying that someone, at some point, should have explained this” to poorly informed borrowers. *Id.*

106. See *supra* note 6 and accompanying text (listing articles that focus on predatory lending in the subprime market due to a perceived economic or educational disadvantage).

107. William R. Emmons, *Consumer-Finance Myths and Other Obstacles to Financial Literacy*, 24 ST. LOUIS U. PUB. L. REV. 335, 337 (2005). “To be sure, some households are very savvy financially, but the overall picture is of a mediocre level of financial literacy.” *Id.*

108. The standards implemented to protect lenders also act to protect the borrower from defaulting. SCHMUDDE, *supra* note 5, at 76. The terms of a fixed-rate loan are relatively simple and the borrower knows the exact payment amount over the life of the loan. See Engel & McCoy, *supra* note 6, at 1284 (stating that prime market borrowers have easy-to-analyze loans, with future income being the only possible impediment to making payments).

109. 15 U.S.C. §§ 1601-1693(c) (2000).

110. 12 U.S.C. §§ 2601-2617 (2000).

111. 15 U.S.C. §§ 1601, 1602(aa), 1639(a)-(b) (2000).

112. However, none of the three acts was completely successful in this endeavor. TILA, which requires the disclosure of finance charges and annual

barrier to predatory practices given borrowers' overwhelming preference for fixed-rate terms. Unfortunately, the disclosures are ineffective in the nontraditional loan market as borrowers who fall victim to such loans repeatedly complain that they did not understand the terms.¹¹³

Alan Greenspan openly wondered if borrowers would benefit from assuming greater risk on their mortgages.¹¹⁴ While this contention may be accurate in some cases, and certainly sparked debate among the financial press, one cannot safely assume a risk without fully understanding the nature of that risk.¹¹⁵ By concentrating on interest rates and payments, borrowers are not fully informed of the traditional lending framework. Specifically, few understand the basic formulas used for approval of the loan terms involved.¹¹⁶ Thus, TILA, RESPA and HOEPA are insufficient because their disclosures do not address how much a borrower can actually afford when buying a house.¹¹⁷

In order to avoid being taken advantage of, buyers must be placed on a level playing field with lenders. Federal disclosures

percentage rates (APRs), has significant deficiencies in the number of back door charges that are excluded, particularly closing costs and insurance packing. Engel & McCoy, *supra* note 6, at 1306-07. Congress enacted RESPA to remedy these deficiencies by forcing the lender to disclose a good faith estimation of closing costs. *Id.* at 1269. Usually, however, the estimation of closing costs bears no relation to the actual number due at the closing. *Id.* HOEPA was designed to further increase transparency, but has been ineffective because it is considerably easy to avoid. *See id.* at 1312 (stating that "HOEPA has been so easy to evade that its practical effect has been negligible").

113. *See* Hovanesian, *supra* note 25, at 76 (quoting a borrower who used a payment option ARM to refinance and withdraw equity, "[w]e didn't really understand what was taking place"); *see also*, Aldo Svaldi, *Option Arms: A Ticking Bomb?*, DENVER POST, Oct. 1, 2006, at K1 (quoting another borrower, "negative amortization was never explained to me," and a vice president of a Colorado mortgage brokerage, "who reads all the disclosures?").

114. *See supra* note 17 and accompanying text.

115. A basic concept of tort law is that, in order to assume a risk, one must have "actual and conscious knowledge of the particular risk." JOHN L. DIAMOND, LAWRENCE C. LEVINE, & M. STUART MADDEN, UNDERSTANDING TORTS § 15.04 (2d ed. 2000).

116. Examples of confusing loan terms may include "debt to income ratio," "loan to value ratio," and other traditional notions of affordability.

117. *See* Engel & McCoy, *supra* note 6, at 1305-09 (discussing the failures of the three statutes). TILA, RESPA and HOEPA generally have been attacked for the various loopholes available to sharp lenders trying to avoid enforcement. *See generally* Peterson, *supra* note 34, at 57-61 (explaining how lenders can manipulate the regulations to avoid serving their true purpose). For example, TILA provides certain exceptions that allow lenders to exclude many settlement costs, such as "finance charge fees for title examination, abstract of title, title insurance, property survey, document preparation, notary services, credit reports, appraisals, pest inspections, flood hazard determinations, security interest filing, and non-filing insurance." *Id.* at 58.

regarding financing fees, closing costs, and annual percentage rates are simply not enough to make the borrower fully aware of the risks he is assuming, especially when the loan contains exotic terms.¹¹⁸ Borrowers should focus more on the basic affordability of the home, as determined by their income.

Several commentators attempted to tackle the problem of informed purchasing. Their solutions support some type of counseling, either through a mandatory buyer representative¹¹⁹ or a disinterested third party. Such remedies faced criticism over the alleged inefficiency of the process, as well as the potential procedural hurdles.¹²⁰ These remedies are focused on problems such as financing issues, excessive fees, and unnecessarily high interest rates.¹²¹

This Comment's proposal differs in that its primary focus is on borrower self-awareness.¹²² Placing the emphasis on interest rates and closing fees, while important, diminishes the importance of paying the principal. The borrower is sold on a particular payment and its temporal affordability, rather than the soundness of the financial transaction as a whole. In order for the borrower to fully understand the transaction, lenders must include a point of reference for which the borrower is intimately familiar: income.

118. The following seeks to explain why borrowers must be financially savvy to identify and understand the terms on a variable interest rate loan. First, the TILA disclosure only identifies the temporary interest rate. Depending on the loan term, the interest rate can adjust anywhere from one month to ten years after consummation of the loan. How much the interest rate adjusts depends on a particular "index" that is tied to the one-year Treasury bill or the London Interbank Offered Rate. Next, the lender typically adds a 1-2% margin in order to arrive at the monthly adjusted rate. Other details of the loan, including ongoing adjustment periods and the overall rate cap, are often buried or minimized in their placement. *See generally*, BRIAN BUCKS & KAREN PENCE, FED. RESERVE BD. OF GOVERNORS, DO HOMEOWNERS KNOW THEIR HOUSE VALUES AND MORTGAGE TERMS? 19 (2006), available at <http://www.federalreserve.gov/pubs/feds/2006/200603/200603pap.pdf> (noting that only 25% of those surveyed could identify what index their ARM was tied to, 41% did not know the lifetime cap, and 44% did not know at least one of the variables involved in calculating adjustment caps).

119. *See Stark, supra* note 6, at 140-45 (suggesting "mortgage counseling intervention").

120. *See Peterson, supra* note 34, at 56-61 (identifying both the practical difficulties of mortgage counseling as well as the procedural barriers).

121. *See Stark, supra* note 6, at 137-42 (stating that the counselor could review the borrower's loan papers and finances, and that the counseling would cover "high-cost home loans" as determined by the APR and closing costs).

122. Stark's proposal does not require the counselor to give advice on home affordability because it would be overly time-consuming and invasive to the borrower. *Id.* at 142. However, this can be accomplished by simply requiring an income disclosure.

B. New Disclosures for New Problems

Lenders thrived for generations on the notion that a borrower should spend no more than 25-28% of her gross income on a mortgage.¹²³ Staying within these percentages helps protect lenders from most defaults outside of job loss.¹²⁴ To better inform borrowers of this concept, lenders should be required to provide a comparison disclosure of appropriate income based on a thirty-year fixed-rate amortizing schedule when using nontraditional financing.

For example, if the borrower is attempting to secure a \$300,000 mortgage, the lender should disclose that, under traditional guidelines of affordability, the borrower's household income should be no less than \$100,000.¹²⁵ Borrowers would then have an immediate baseline for making a sound financial decision as to what kind of home they can afford.¹²⁶ The disclosure should also focus the borrower's attention on the principal balance, as opposed to the monthly payment.¹²⁷

A second step, perhaps more controversial, would be to remove any doubt by clearly listing the borrower's yearly income underneath the income disclosure.¹²⁸ This would immediately allow the borrower to weigh any risks she assumes in taking the mortgage. While income disclosure may not sound particularly controversial, it would necessitate an accurate depiction of the borrower's income. Thus, lenders would have a duty to take reasonable steps to verify the borrower's yearly earnings and could not rely on the no-documentation program.

123. SCHMUDDE, *supra* note 5, at 65.

124. *Id.*

125. The rule of thumb is that the purchase price of a home should be between 2.5 to three times of the buyer's annual gross income. See, e.g., Freddie Mac, How Much Can You Afford to Spend on a Home?, http://www.freddiemac.com/corporate/buyown/english/preparing/right_for_you/afford.html (last visited Jan. 30, 2008) (using a more conservative approach of multiplying annual gross income by 2.5).

126. If a borrower knows that his household income is less than \$100,000, he would have notice directly in front of him that the mortgage is unaffordable by traditional means.

127. Lenders vastly prefer to use the debt to monthly income ratio in order to approve a borrower for a loan amount. SCHMUDDE, *supra* note 5, at 65. However, relying on this formula alone allows the "gaming" of the monthly mortgage payment through the use of teaser rates, interest-only loans and payment option loans. See *supra* Part III.A. (analyzing lender abuse of loans).

128. This could be easily integrated into the TILA disclosure form. The form would not only disclose the APR and total estimated costs of financing, but also the borrower's household income and traditional affordability guidelines.

V. CONCLUSION

The thirty-year fixed-rate loan has been the foundation of the American housing market following the Great Depression.¹²⁹ Modern borrowers should be free to choose nontraditional financing, but they must be able to assess the risks of that alternate path. A disclosure model based solely on financing rates and closing costs fails to capture the nature of this risk, allowing aggressive lenders to market exotic financing plans and qualify borrowers to purchase homes based on artificially low monthly payments. Naïve borrowers, of both prime and subprime credit ratings, are then exposed to predatory lending practices, including equity stripping through multiple refinancing and an increased risk of borrower default.¹³⁰

Disclosing traditional lending standards places the borrower in a more comparable negotiating position with the lender. Moreover, this type of disclosure is equally efficient and easy to understand. Lenders should provide a simple statement identifying the amount of the loan and the income needed to qualify under traditional guidelines, followed by a statement of the borrower's income. If the borrower chooses to take on exotic financing and assume its risks, the borrower will at least do so after being fully informed.

129. Wright, *supra* note 3, at 232.

130. See *supra* Part II.C.

