

## Jeopardizing Hispanic Homeownership: Predatory Practices in the Homebuying Market

By Janis Bowdler \*

### INTRODUCTION

**I**n 2001 the U.S. Census Bureau announced that the U.S. Hispanic\*\* population had grown to 13%, making Hispanics the nation's largest minority. The Latino population has continued to grow rapidly since that time, and is projected to reach 15.5% of the population by 2010.<sup>1</sup> With this explosive growth has come

considerable demand for homes and accompanying financial services, which has banking institutions searching for ways to engage the underserved Hispanic market. Despite their efforts, the mainstream housing market has moved too slowly to develop appropriate and affordable mortgage products and outreach services that effectively meet the needs of Latino consumers. With

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\*\* The terms "Hispanic" and "Latino" are used interchangeably throughout this brief and refer collectively to Mexicans, Puerto Ricans, Cubans, Central and South Americans, Dominicans, and others of Spanish and Latin American descent. Latinos may be of any race; therefore, unless denoted as "non-Hispanic," persons of Hispanic origin may be included in both the "Black" and "White" racial categories. Data on Latinos do not include the 2.8 million residents of Puerto Rico.

mainstream institutions invisible to many Latinos, other mortgage lenders have aggressively moved to capitalize on the ownership aspirations of Hispanic workers, bombarding Latino media and neighborhoods with advertisements for mortgages and other financial products and services from these institutions and agents. In this targeted market, where regulation and oversight are poor and consumers are largely uninformed, the ground has become fertile for questionable mortgage lending practices known industry-wide as predatory lending.

For many American families, homeownership is the most important vehicle for building wealth. This is especially true for Latinos, whose wealth levels lag behind those of non-Hispanic Whites by more than ten to one, which is largely attributable to differences in homeownership and home equity.<sup>2</sup> This issue brief examines the home mortgage market as it serves, or does not serve, Latino consumers. Where deficiencies in the market exist, the environment is ripe for predatory lending – a collection of unethical lending products and practices that erode the hard-earned equity gains achieved by homeownership.

## MORTGAGE LENDING IN THE HISPANIC COMMUNITY

The powerful symbolism and imagery of American homeownership often stand in stark contrast to the anxiety-filled and grueling process of purchasing a home. Since most families do not have sufficient cash to purchase their homes, the vast majority borrow the money from lenders, usually in the form of a mortgage loan. Financial institutions that finance home mortgages protect their investment by ensuring that the borrower has the capability to repay the loan. A would-be homeowner's measured risk is evaluated in a number of ways, including income, previous credit history, and savings. There are two basic kinds of home mortgage: prime – reserved for those with the most favorable credit risk, and subprime – offered to families who pose a greater risk of nonpayment to the lender.\* In general, prime loans have a standard pricing system based on credit scores, income, and savings; subprime loans, on the other hand, use "risk-based pricing," which uses a number of

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\* The interest rate and fees offered to mortgage customers are based on the customer's proposed risk of default, known as credit risk. These terms are graded on a scale from "A" to "D," or lower, with "A" loans representing the best terms, which are offered to those who pose the least amount of credit risk. Prime mortgages are "A" and "A-" loans. Subprime loans may also include "A-," but are mostly "B" -grade loans and below. These loans are generally considered too risky for many mainstream banks. As a result, subprime loans are offered through mortgage finance companies, some of which are affiliated with banks. The Department of Housing and Urban Development (HUD) keeps a list of subprime lenders, available at <http://www.huduser.org/datasets/manu.html>.

factors to determine the likelihood of default, then uses fees and higher interest rates to compensate the lender for the riskier nature of the loan.

Most American homeowners have a mortgage or have been through the mortgage lending process. Millions of Americans apply for mortgages each year including increasing numbers of Latinos. Among all American households in 2003, 68% owned homes.<sup>3</sup> Of those homeowners, 65% held outstanding mortgages.<sup>4</sup> In 2003 approximately 17.5 million mortgages were made to homebuyers; nearly 80% of those were loans that refinanced existing mortgages.\*

While the overall homeownership figures for Latinos may be modest relative to Whites, the number of Latinos entering the mortgage market each year continues to swell. Less than half of Latino households nationwide own a home, but of the more than five million Hispanic households who owned their home in 2003, 71.6% had an outstanding mortgage. The number of Hispanic families closing purchase mortgages was 185% higher in 2002 than in 1993.<sup>5</sup> Latinos are increasingly influencing the shape and size of the U.S. mortgage lending market.

## **DISPARITIES IN THE MARKET**

It appears that Latino consumers are increasingly attractive to mortgage lenders; however, significant disparities exist in the types

of loans they are getting compared to Whites. They are more likely than Whites to finance a home purchase with an expensive mortgage product and are less likely to refinance, which often can lower the cost of a mortgage. Subprime mortgages, and those insured by the Federal Housing Administration (FHA), both of which are more expensive than prime mortgages, accounted for more than 40% of Hispanic purchase mortgages and nearly a quarter of refinance mortgages in 2002. For White families these products account for 18% of purchase mortgages and less than one in ten of refinance mortgages.<sup>6</sup> Disproportionately high denial rates among Hispanic prime mortgage applicants also suggest that the prime market is not meeting the needs of Hispanic families. It is likely that some of the disparity is attributable to demographic differences such as age, income, and immigration status; however, fair lending research has demonstrated consistently that demographic factors alone do not entirely explain the inconsistent approval and denial rates discussed above.<sup>7</sup> For example, research pairing Hispanic and White testers with similar financial information found that the Hispanic buyers were less likely to receive assistance with financing and downpayment assistance and were told they qualified for lower loan amounts than their White counterparts.<sup>8</sup> Other research estimates that as many as one-third to one-half of all subprime borrowers could have qualified for prime credit.<sup>9</sup>

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\* Unless otherwise stated, estimates on the number of mortgages are based on figures publicly disclosed in accordance with the Home Mortgage Disclosure Act (HMDA). Most depository and mortgage finance institutions are required to disclose certain attributes of their mortgage business, including number of applications taken, approved, and denied, and their racial, ethnic, and geographic representation. For more reporting information go to <http://www.ffiec.gov/hmda/reporter.htm>.

## Federal Housing Administration

Mortgages insured by the Federal Housing Administration (FHA) have been a mainstay of minority mortgage capital, serving families who would not otherwise qualify for a mortgage due to insufficient cash for a 20% downpayment, poor credit, or other barriers. One in five Hispanic families with a mortgage in 2003 had an FHA-insured mortgage. FHA products, however, are expensive and financially risky. Several studies have pointed to the loose regulatory structure of FHA, overreliance on under-regulated mortgage brokers and finance companies, and high Loan-to-Value ratios (LTVs) as reasons for the high foreclosure rates of FHA mortgages.\* At the close of 2003, HUD reported that more than twice as many FHA mortgages were in foreclosure than prime mortgages. Of the top 50 FHA originators from 2003, ten were also on HUD's 2002 Subprime Lender list, accounting for more than a third of the loans originated by those lenders, and nearly three out of four loans are not subject to CRA or HMDA

**Table 1: Analysis of Top 50 FHA Lenders, 2003**

	HUD Subprime List	Institutions with CRA/HMDA Requirements
Number	10	11
Number of Loans Closed	176,737	134,744
Percent of Total Loans Closed	34.8%	26.5%

Source: [www.hud.gov](http://www.hud.gov)

\* For more information see Bradford, Calvin, *The Two Faces of FHA: A Case of Government Supported Discrimination Against Minority and Racially Changing Communities*. Chicago, IL: Chicago Fair Housing Alliance, 1998; Immergluck, Dan, *Hyper-segmentation and the Exclusion in Financial Services in the U.S.: The Effects on Low-Income and Minority Neighborhoods*. Grand Rapids, MI: Grand Valley State University, July 23, 2003. See also stories regarding "fly-by-night" mortgage brokers that take advantage of FHA's loose regulatory structure: Killingsworth, Inez, "FHA: Turning an American Dream into a Neighborhood Nightmare," *Shelterforce Online*, No. 124, July/August 2002; Harney, Kenneth, "FHA Seeks Property 'Flip' Crackdown," *RealtyTimes*, November 5, 2004; *What to Know When Buying Your First Home: Avoid 'Property Flipping' Scams*. New York, NY: South Brooklyn Legal Services, available at <http://www.sbls.org/forecfs2.htm>.

In contrast to Hispanics' growing participation in the purchase market, there has not been similar growth in the refinance market.

Refinancing a mortgage is often an opportunity for families to apply for a mortgage with a lower interest rate, or cash out equity for home repairs that lead to an increase in home value. When Hispanic families do refinance, they are more likely than their White counterparts to refinance with a subprime loan. This disparity was true when controlling for income, even increasing as incomes increased.<sup>10</sup>

## IMPACT

Inefficiencies in the mortgage lending market directly impact the ability of Latino families to build and maintain wealth. Families who finance their home with mortgage products more expensive than warranted by their credit risk pay more of their monthly payment toward interest and fees, rather than the principal balance, which is the only way to build equity. This leakage of income and assets erodes the achievements of increased homeownership. In some cases families may be exposing themselves to an increased risk of foreclosure when they opt for expensive subprime products with certain

features, such as excessive interest rates, high Loan-to-Value (LTV) ratios, and subprime loans.

A driving force behind making homeownership available to all who qualify is its ability to generate wealth. Home equity accounts for approximately two-thirds of Hispanic families' net worth, and is likely to be the only appreciating asset the family owns.<sup>11</sup> Hispanic families who pay too much for their mortgage, or do not access homeownership despite their ability to qualify, lose an opportunity to build wealth. The example to the right, *Prime vs. Subprime*, demonstrates how an interest rate even slightly higher than necessary can be a serious setback for families, especially those shopping in high-cost markets.

Foreclosure is a dangerous potential consequence of putting families in loans that are more expensive than required by their actual credit risk. According to the Joint Center on Housing, there was a 3.6% growth in homeownership compared to a 335.6% increase in number of foreclosures per home

### Prime vs. Subprime

Table 2 demonstrates the economic impact on a family who obtains a "prime" versus a "subprime" mortgage loan. The scenario assumes the family purchases a modest \$130,000 home with a 3% downpayment, which is common among many affordable conventional and FHA products, and a standard 3% closing cost. The Federal Reserve Bank found there was a 3.8 percentage point difference between the typical mortgage rate charged on a prime loan and a subprime loan between 1998 and 2001; this example uses a conservative three percentage point difference. Finally, it also assumes the subprime borrower would have to pay higher points. Points are fees borrowers can pay at closing to "earn" certain loan features, such as not having a prepayment penalty, using a mortgage broker, or financing closing costs. In the example below, the borrower is financing part of the fees due at closing and would likely pay a point for that service.

The result of the scenario is that the subprime borrower would pay \$285 more per month – a sizeable amount for a low-income family. Perhaps more importantly, the family loses an opportunity to build wealth. The subprime borrower accumulates 50% less equity than the prime borrower. A subprime lender or mortgage broker would likely advertise the subprime loan's low closing cost (notice that the closing costs are the same, but the fees are financed into the loan in the case of the subprime loan). Such features come at a cost. A housing counselor would likely advise a family to wait and save additional funds in order to obtain the benefits of the prime loan.

**Table 2: Affordability Scenario**

SCENARIO:	PRIME	SUBPRIME
<ul style="list-style-type: none"> <li>■ Purchase Price: \$130,000</li> <li>■ Cost to close: \$3,783</li> <li>■ Downpayment: 3%</li> <li>■ Loan Type: 30-year fixed</li> </ul>		
Interest Rate	6%	9%
Points Paid	1.0	2.5
Fees Financed	\$0	\$3,000
Monthly Payment (including mortgage insurance)	\$844	\$1,129
Equity in five years	\$12,658	\$6,218

between 1980 and 2002.<sup>12</sup> On average, a family loses \$7,200 in net worth during a foreclosure, and the community stakeholders, including the lender, stand to lose approximately \$73,300 per FHA foreclosure and \$26,600 per conventional foreclosure.<sup>13</sup> Despite data limitations, several comprehensive case studies report similar findings that draw connections between subprime loans and certain loan characteristics and increased foreclosures in minority and low-income neighborhoods. These case studies found that increases in foreclosure follow increases in subprime lending, foreclosures are concentrated in minority and low-income communities, subprime loans are disproportionately represented among foreclosures, and high interest rates and Loan-to-Value (LTV) ratios are common in loans in foreclosure.<sup>14</sup>

## BARRIERS TO THE PRIME MARKET

Structural impediments inherent in the mortgage market hinder it from better serving potential Hispanic homebuyers. More than economic or cultural barriers, although these may be more prevalent in some areas than others, the manner in which the industry has structured its day-to-day business activities, such as where to locate bank branches, their manner of outreach, and underwriting tools, create barriers for Hispanic families trying to access appropriate mortgage products. As a consequence, many families find themselves in high-cost loans unwarranted by their actual risk level or are outright denied financing. Policies and practices in the prime mortgage lending market, described in more detail below, translate into ways in which Hispanic

homebuyers and owners are left open to predatory lenders. Specifically:

- **Outreach.** The financial institutions that offer prime mortgage products are being outperformed in Hispanic communities by subprime lenders and mortgage brokers, as evidenced by their gaining market share. In both the purchase and the refinance markets, the proportion of Hispanic borrowers' total applications taken by subprime lenders compared to prime lenders was nearly twice that of Whites. In some cases this is due to the physical absence of prime institutions in Hispanic communities, but often it is a result of not using effective outreach techniques that resonate with potential Hispanic homebuyers.<sup>15</sup> Subprime lenders and mortgage brokers have increased market penetration by hiring bilingual staff, translating materials, and spending individual time with the families. Families are unable to shop effectively when they do not have access to all the financing opportunities for which they qualify.
- **Commission-Based Policies.** The mortgage market is locally driven, largely dependent on the local branch managers and loan officers whose compensation is typically commission-based and dependent on the size and number of loans processed. In this context, lenders have a disincentive to serve low- to moderate-income families applying for modest-sized mortgages, and whose applications may take extra time due to downpayment assistance or other special processing needs. Similarly, affordable

products and initiatives created at the headquarters may be difficult to utilize at the branch level, without which they provide little value to families.

- ▶ **Workforce Diversity.** Placement of bilingual and bicultural staff throughout a financial institution is critical to serving Hispanic families well. Certainly some financial institutions have made the hiring of bilingual and bicultural staff at their retail locations a priority; however, others still rely on centralized Spanish-language services, such as online or telephone services, as a substitute for local personnel. Further, while some institutions have improved diversity at certain branches, they lack diversity throughout the rest of the organization, particularly at the upper echelons. Of the 40 commercial banks ranked among Fortune 1000 companies in 2003, only eight had Hispanic board members and four had Hispanic executive officers.<sup>16</sup> The absence of diversity among board members and executive staff almost certainly inhibits identifying, adopting, and investing in more effective Latino outreach strategies.
- ▶ **Credit Scoring.** Hispanics are more likely than Whites to have credit scores below 620 – the generally accepted cutoff line between prime and subprime. The factors used in the calculation heavily weight the borrowing activities of largely middle-class Americans, many of whom do not fit the borrowing activities of low- to moderate-income Hispanic families, creating a negative bias against otherwise

creditworthy Latinos. Hispanic families are more likely than other families to have a deficit of information on which to base a score, resulting in thin or no credit files and low credit scores. For example, credit scores do not take into account regular payments such as rent payments, utility bills, cell phone accounts, or even remittances, which are likely to reveal significant information about an Hispanic family's spending and payment habits. On the other hand, the formulas negatively score activity from payday lenders, check cashers, and subprime lenders, which are frequented by Latinos. There are still other complications, such as negative information having immediate impact while positive behaviors take much longer to make a noticeable difference on a score, institutions sometimes reporting only the negative information and not the positive, and reports often containing errors, which are not easily corrected.<sup>17</sup>

- ▶ **Automated Underwriting (AU).** AU has benefits, but it also exacerbates the problems inherent in credit scoring systems. AU removes discriminatory judgments that could negatively affect Latinos who are undeniably eligible for prime products. However, these systems tend to be rigid, and thus often relegate creditworthy Hispanics with thin credit files or minor credit blemishes to the subprime market, even though a more thorough review would demonstrate their eligibility for prime loans. Many companies seek ways to make their

processing systems more flexible, including alternative credit scoring calculations and the incorporation of nontraditional credit in their system, while maintaining its benefits (e.g., speed, efficiency, reduced bias). However, the efficacy of those efforts is unknown. For example, there are still questions as to whether products that make use of these innovations are priced at a higher risk level than products that use traditional credit scores. Industry advocates argue that this technology allows lenders to spend more time with those mortgage candidates who need human judgment, though there is evidence that loan officers spend their extra time processing additional underwriting-friendly loans instead. Consumer and industry advocates agree that automated underwriting systems must be revised on a regular basis to remain current and accurate; however, there needs to be more clarity about how often this happens, the content of the revisions, and transparency of the factors used to measure creditworthiness within these "black box" systems.

- ▶ **Information and Awareness.** Without proper information about the homebuying process, many Latino families – as many as a million in 2002<sup>18</sup> – believe that they are unable to purchase a home or are unaware of their ability to qualify for a more affordable prime product. Research shows that Hispanic families are not offered as much information on their financing options and available affordable loan

products as similarly situated White families during the homebuying process.<sup>19</sup> Other research reports that immigrant families' view of American financial institutions is influenced by the quality of their home country's financial system. Thus, a poor-quality system in a family's country of origin may leave them leery of American institutions.<sup>20</sup> Further, because many first-time Hispanic homebuyers are also first-generation homebuyers – and one in ten first-time homebuyers is foreign-born – many Latinos do not benefit from advice on the homebuying process passed through family members or neighbors as is common in other communities.<sup>21</sup>

## PREDATORY LENDING IN THE HISPANIC COMMUNITY

There is an important role for the subprime industry in delivering homeownership opportunities to those considered "too risky" for conventional mortgage loans, for example, those with credit blemishes. However, the subprime market is where predatory lenders thrive, and the growth of the subprime market along with the rise in subprime lending to Latinos raise serious concerns about the scope of predatory lending in the Hispanic community. The Federal Reserve calculated that the value of subprime mortgage originations grew 26% annually from 1994 to 2000, and the subprime share of market share expanded from 5% to 13% during the same time period.<sup>22</sup> There is also some evidence that significant numbers of individuals who qualify



for prime loans, and those who maintain a low risk of default, have subprime loans. Moreover, there is ample research documenting the concentration of this growth among minority, elderly, and low-income communities, populations that have been traditionally underserved by prime mortgage lending services.<sup>23</sup> Among Hispanic borrowers, the share of subprime purchase mortgage originations of their total purchase originations increased by 1,525%, compared to a 1,080% increase in White borrowers' share of subprime purchase mortgages, between 1993 and 2002. Advocates commonly point out that while not all subprime loans are predatory, the majority of predatory lending exists within the subprime market. Subprime lending is more easily identified and measured; predatory lending is contextual and often difficult to pinpoint.

## PREDATORY LOANS AND PRODUCTS

Predatory features are usually subtle and difficult to define because the indicators are contextual, depending on the situation of the individual borrower. Predatory loans often include the following characteristics:

- ▶ **High Interest Rates:** Interest rates higher than warranted by a borrower's credit risk.
- ▶ **Packing:** The financing of fees and second mortgages into the mortgage, often without the borrower's awareness.
- ▶ **Mandatory Arbitration Clauses:** Forcing borrowers to give up their right to litigate in the case that something is wrong with their loan.
- ▶ **Asset-based Lending:** Lending based on the value of the asset rather than on the borrower's ability to repay the terms of the loan.
- ▶ **Balloon Payments:** A short-term, fixed-rate mortgage which requires that the full balance be paid at the end of the term, often as short as five to seven years.
- ▶ **Prepayment Penalties:** A fee added to a loan as a disincentive to more rapid repayment or refinancing within a certain amount of time.

In addition to these often predatory features of loans, there is an array of dubious products on the mortgage lending market that are often used in a predatory manner. Abuses of these products often slip beneath the regulatory radar because they are made by locally-driven, highly-unregulated entities whose sole purpose is to target vulnerable and unsophisticated borrowers who are unlikely or unable to complain. Like other loan products and characteristics abused by predatory actors, these products are created for a specific clientele, but are often misused to scam unsuspecting borrowers. Product scams that are prevalent in Latino communities include:

- ▶ **Contract for Deed.** Also called "Land Contract," this product allows a buyer to pay the seller directly, or through an escrow account, based on a written contract that stipulates that after a certain number of payments the buyer is eligible to purchase the property. Theoretically, the buyer provides a downpayment and makes payments, typically for several years, at which time a balloon payment is due. In

theory, the buyer then pays the balloon via a standard mortgage and thereby assumes the property. This product may be useful during informal selling situations such as family member to family member. However, buyers have little control over the property while making payments to sellers, they do not own the asset, receive no tax benefits, and are excluded from typical homebuyer protections. Many find themselves vulnerable to eviction and unable to recoup their downpayment and rent investment for even a late or missed payment. This is especially common among limited-English-speaking communities, in the U.S.-Mexico border region known as the *Colonias*, and among undocumented families trying to purchase a home. Approximately 456,000, or 12.5%, Hispanic owners have a Contract for Deed mortgage.<sup>24</sup>

- ▶ **Interest-only Loans.** This is not a product, *per se*, but an option on a mortgage in which a buyer makes payments only on interest as a way to reduce monthly expenses, and is intended for borrowers who expect their income or home value, or both, to increase dramatically in a very short period of time. Few buyers, however, realize that they are not paying off the loan principal. This option is often attached to an Adjustable Rate Mortgage (ARM), a mortgage in which the interest rate changes according to the marketplace or other factors, with a low interest rate in the first few months of the loan, which is attractive to families trying purchase a

home quickly. However, changes in the interest rate could increase the payment two percentage points every six months up to a cap of 9.875% after the introductory period.<sup>25</sup> Depending on how quickly the home value does or does not appreciate, buyers may find themselves owing more on their property than the home is worth, called an "upside down mortgage," and without any equity. A recent survey of ARMs revealed that of those customers who had interest-only loans, the majority were less educated, young adults, and Latinos.<sup>26</sup>

- ▶ **Mobile and Manufactured Housing.** Though a common affordable home choice of families in rural and immigrant communities, most mainstream lending institutions will not finance a mortgage for a mobile or manufactured home. In lieu of traditional financing, most families must go through dealer financing similar to that of an auto loan. A report by the Consumers Union Southwest Regional Office investigated charges of fraud and deception surrounding mobile and manufactured housing purchases in Texas and found interest rates between 9% and 13% higher than normal rates, miscellaneous fees (many of which were financed), prepayment penalties, and unnecessary insurance add-ons. Borrowers also complained of bait-and-switch scams; they were delivered a mobile home different from what they ordered, with few viable options for legal recourse. Several industry whistleblowers verify that Hispanics, who

constitute almost half of Texas' manufactured housing population, are specifically targeted by dealers who often make verbal promises in Spanish that are different than the terms contained in the contract, which is in English.<sup>27</sup> Nearly one in ten (9.7%) Hispanic homeowners lives in manufactured housing or mobile homes.<sup>28</sup>

Although not discussed here, there are other products that are easily abused, such as "gift" downpayment programs, Adjustable Rate Mortgages (ARMs), and Home Equity Loans. In the absence of legitimate mortgage products for Individual Tax Identification Number (ITIN) holders, priced according to actual risk similar to legitimate conventional and subprime products, families with ITINs are especially vulnerable to being steered toward a dubious product.\*

Since most predatory lending tactics and loan features are legal, it is difficult for homebuyers and owners to find legal recourse. Investigation and prosecution of predatory loans is time-consuming and expensive, and requires close analysis of loan documents, interviews with affected parties to investigate lenders' disclosures, or evidence of widespread and systemic discrimination by an institution.

## PREDATORY BEHAVIOR

Beyond the features of the loan or product, predatory lending also manifests itself in the Latino community through a variety of abusive tactics by lenders and brokers. For example:

- **"Push" Tactics.** Push tactics are aggressive marketing techniques whereby consumers do not seek but are affirmatively offered credit or loan products by a loan officer, broker, or finance company, often sold via door-to-door sales, mail, or phone solicitation. Such solicitations are often accompanied by attractive characteristics that disappear within months of closing, such as low or no interest in the case of credit offers or deferred payments in the case of home improvement deals. In the purchase market, predatory advertisers seek out underserved and less sophisticated borrowers, promising to qualify them for a home loan, regardless of their circumstances (bad credit, no cash, previous foreclosure). In the refinance market, solicitors target vulnerable homeowners, such as the elderly or those who appear financially troubled, and who have accumulated equity in their home. Subprime loan products are even more confusing in this context – fees charged on

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\* As the immigrant population continues to grow, so does the demand for ITIN mortgage products. Mainstream lenders are slowly realizing the market potential. However, in the meantime, ITIN borrowers are at the mercy of those lenders that are willing to make the loans, which are perceived as high-risk because of uncertainty surrounding immigration status. Pilot projects experimenting with reasonably-priced ITIN products have been successful. The quality of lending to ITIN consumers will continue to be inconsistent until more standardization is introduced via mainstream lenders, mortgage insurance providers, and the secondary market.

a loan are easily hidden, and information about the financial institution and loan terms are not publicly displayed for comparison purposes as they are for prime loans.<sup>29</sup> These examples are particularly problematic in immigrant communities where families have little experience with the market.

- ▶ **Independent Third-Party Brokers.** Many Hispanic families who might otherwise be intimidated by the homebuying process rely on independent third parties, such as real estate agents, mortgage brokers, appraisers, and translators, to help them overcome the barriers to prime services discussed in the previous section. Many of these agents provide valuable services that connect families to mainstream financial services. Unfortunately, others prey upon vulnerable consumers who are trying to navigate the homebuying process, especially those who are limited-English-speaking.<sup>30</sup> In some cases these unscrupulous agents steer families to dubious products and high-cost loans, or push them to unnecessarily refinance their home or automobile. The family unknowingly and blindly trusts the agent because of their cultural connection.
- ▶ **Mortgage Brokers.** Mortgage brokers are independent third-party agents who sell

mortgages from a variety of sources including depository institutions, mortgage companies, and wholesale lenders. The advantage of mortgage brokers is the wide variety of loan products to which they have access. The disadvantage is that they have an economic interest in pushing the cost of a loan higher to produce a higher fee for themselves, called a Yield Spread Premium (YSP). In 2002, mortgage brokers originated approximately two-thirds of the nation's mortgages and between 65% and 80% of the nation's non-conforming mortgages\* (this market share is higher in minority communities);<sup>31</sup> approximately 45% of Hispanic purchase mortgages, and 25% of Hispanic refinance mortgages, are non-conforming. Many finance companies, most of which are not subject to Home Mortgage Disclosure Act (HMDA) data reporting requirements or Community Reinvestment Act (CRA) exams, prefer to market their mortgage products through brokers to avoid the expense of maintaining retail branches.<sup>32</sup> In addition, the one-on-one approach adopted by many brokers who visit the homes of their clients, often conducting the closing process there, is attractive to many Hispanic families who may be intimidated by the formal, mainstream mortgage system or who appreciate the personal attention.

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\* Mortgages that are typically not bought by Freddie Mac or Fannie Mae are called "non-conforming mortgages." This category includes FHA, subprime, "A-," and "Alt-A" mortgages. "Alt-A" mortgages are "A" level risk, but with nontypical borrower characteristics such as nontraditional credit or stated income.

## Federal Oversight

Federal oversight of financial institutions and mortgage lenders is complex and confusing. For those who wish to file a complaint against a financial institution, the process is unclear. In many cases, consumers are unsure of what actions to take, if any, and what happens to their complaint once filed. That said, there are a number of federal laws and regulations that are designed to protect consumers and shape practices in the marketplace. The principal law used by advocates and government agencies to combat abusive practices is the Home Ownership and Equity Protection Act (HOEPA). This legislation, passed in 1994 as an amendment to the Truth in Lending Act (TILA), was recently expanded by the Federal Reserve and includes thresholds that define high-cost loans for which additional disclosures, restrictions, and consumer protections apply.\*

These laws notwithstanding, enforcement has been limited. Except for one formal enforcement action taken by OCC, there has been no other formal action against predatory lenders by federal regulators. The FTC, which is charged with enforcing consumer protection regulations among non-depository institutions that are not regulated by the other regulatory agencies,\*\* has filed only 17 cases since 1998.\*\*\* HUD instituted Credit Watch and Appraiser Watch to crack down on abuses made by FHA-approved lenders through FHA purchase and refinance originations, but the overall impact of the programs is unclear as the number of FHA foreclosures continues to increase.\*\*\*\* DOJ filed only nine cases involving discrimination by lenders between 2000 and January 2004.\*\*\*\*\* Section 8 of the Real Estate Settlement Procedures Act (RESPA), which prohibits "kickbacks" for referrals and only allows fees for *bona fide* services performed, is the main law that regulates mortgage brokers at the federal level. Violations of this law are not as likely to be caught when mortgages are closed through less-regulated mortgage finance companies and the absence of HMDA and other data requirements make it difficult to demonstrate unlawful patterns of discrimination. Further, the purpose of the regulatory agencies is to monitor certain lending activities; they are not designed to conduct routine investigations that would uncover suspicious patterns and practices.

\* In December 2001, the Board issued new rules expanding the reach of HOEPA. Under the new rule, the threshold for a "high-cost" mortgage is eight percentage points above Treasury rates or with total points and fees over 8% of the loan amount; these loans require additional disclosure, prohibit lending without regard for borrower's ability to make payments, limit prepayment penalties, and prohibit balloon payments (for loans made for five years or less) and negative amortization.

\*\* Several federal agencies that play some role in enforcing predatory lending legislation or regulations are: Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), National Credit Union Administration (NCUA), Board of Governors of the Federal Reserve System (the Board), Federal Trade Commission (FTC), Department of Justice (DOJ), and the Department of Housing and Urban Development (HUD). Five of these agencies are financial regulators (FDIC, OCC, OTS, the Board, and NCUA) that are responsible for monitoring the lending activities of their respective institutions.

\*\*\* General Accounting Office, *Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending*. Washington, DC: Special Committee on Aging, U.S. Senate, 2004.

\*\*\*\* "Bush Administration Announces Additional Protections For Homebuyers To Curb Predatory Lending," Press Release, U.S. Department of Housing and Urban Development, Washington, DC, August 9, 2002; "Bush Administration Announces 'Appraiser Watch' - New Protections For Homeowners," Press Release, U.S. Department of Housing and Urban Development, Washington, DC, July 18, 2002.

\*\*\*\*\* See specifically: *United States v. Associates National Bank*; *United States v. First National Bank of Dona Ana County*; *United States v. Northern Trust Company*; *United States v. Shawmut Mortgage Company*; *United States v. Fidelity Federal Bank*; *United States v. Fleet Mortgage Company*; *United States v. Security State Bank*; *United States v. Long Beach Mortgage Company*; and *United States v. Mid America Bank, fsb*.

However, unlike lenders, brokers have no vested interest in the viability of a loan and have nothing to lose if a borrower goes into default. Inconsistent state licensing requirements and limited federal oversight leave brokers highly unregulated and unaccountable to consumers.

- ▶ **Product Steering.** Several studies have determined that between 35% and 50% of subprime borrowers could qualify for A or A- loans, such as those sold by prime banking institutions.<sup>33</sup> Other research highlights the increase in prime-subprime lending disparities among high-income neighborhoods as compared to low-income neighborhoods. The evidence demonstrates that Latinos are more likely than their White counterparts to finance through a subprime lender and, somewhat counterintuitively, that this disparity increases as income increases.<sup>34</sup> Thus, it is reasonable to assume that a significant number of Latino families have financed their mortgage using products priced higher than their risk level warrants.\*

## FEDERAL PREDATORY LENDING POLICY DEBATE

Curbing predatory mortgage lending has increasingly become a national priority. The

policy debate centers around three critical issues: the extent to which federal law should preempt existing state lending laws; the thresholds and definitions that trigger added consumer protections; and who in the mortgage process can be held liable. Many industry representatives maintain that existing laws are adequate and need only to be more vigorously enforced, and that the mortgage market will be more efficient and cost-effective with a uniform federal standard. Most consumer advocates point out that many predatory tactics currently are not illegal under federal law, thus improved standards must be passed, and that states should be free to enact stronger legislation if they choose. Individual states have found federal law to be insufficient and have enacted stronger laws to augment borrowers' protections.

There are number of points upon which both mainstream industry representatives and consumer advocates agree. For example, most agree that the "bad actors" must be driven out of the mortgage system and that improved enforcement of existing laws would be a step in that direction. In some cases there is even agreement on the need for stronger consumer protections. Opinions among stakeholders diverge, however, on how these objectives should be accomplished. For instance, industry officials argue that a patchwork of state laws with varying restrictions, liabilities, and definitions drives up the cost of credit or limits

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\* There is also significant cause for concern over industry practices of referring "up" or "down." For example, if a Latino family's first encounter with a financial institution is with its subprime lending arm, it is reasonable to assume that even if they would qualify, the family would not be referred "up" to the prime lending arm. Similarly, a low-income family may approach an institution's prime arm, only to be referred "down" to the subprime arm despite qualifying for prime products because they are difficult to serve (due to downpayment assistance requirements, or use of nontraditional credit, for example).

its availability to consumers who could benefit from such loans. Consumer advocates point to the inactivity of federal regulators and the limited scope of federal law as evidence of an inefficient federal enforcement system.\*

Moreover, stakeholders disagree over who should be held liable for a predatory loan. Advocates argue for "assignee liability." This means that the party who purchases a predatory loan on the secondary market, thereby providing the funds for a loan to be made, should be held liable. While views vary among industry representatives, most feel that assignee liability will put undue pressure on the secondary market, causing funders to disengage from the mortgage market, thereby drying up credit. Finally, there is disagreement concerning what loan characteristics trigger additional federal protections. The Home Ownership and Equity Protection Act (HOEPA),<sup>35</sup> the main federal law regarding predatory lending, sets a series of criteria, or triggers, based on the interest rates and fees that when met invoke a set of additional protections, such as disclosures and bans on certain features (e.g., prepayment penalties and mandatory arbitration clauses).<sup>36</sup> However, HOEPA covers only a fraction of subprime loans; the Federal Reserve estimates as little as 5%, though industry advocates suggest it may be as high as 26% to 38%.<sup>37</sup> Industry representatives maintain that lowering the triggers will result in the reduction of

mortgages available to credit-impaired borrowers. (See Federal Oversight on page 13).

## POLICY RECOMMENDATIONS

Hispanic families want what other homebuyers expect – a fair and equal opportunity to get the "best deal" possible on their home mortgage. The prime mortgage market must perform better, work to more effectively assess risk, and deliver their products directly to qualified Latino families. Those Latinos who find themselves in the subprime market for whatever reasons need adequate legal protection from predators who seek to strip them of assets, equity, and wealth. No minority homeownership policy agenda can be complete or fully effective without addressing the incidence of predatory lending in minority communities. For Latino homebuyers, the priority is not whether these protections exist at the federal or the state level, but that the protections are meaningful and the market is serving them adequately. Currently, many predatory practices are legal, either because fee thresholds are not inclusive enough or because legitimate mortgage products and features are being abused. As Congress grapples with these challenging issues, lawmakers should do the following:

- **Increase consumer protections that target abusive practices.** Congress

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\* Approximately 26 states have enacted anti-predatory lending laws, presenting logistical challenges to lenders; however, it was a coalition of the 50 state attorney generals which prosecuted the groundbreaking predatory lending lawsuit against Household, Inc.

must increase protections that accurately target abusive practices in both the purchase and refinance markets. Remedies include: limiting excessive fees by incorporating all fees in the definition of a high-cost loan under HOEPA; prohibiting unnecessary add-ons that provide no added home value such as single premium credit insurance, especially in high-cost loans; and holding brokers and financial institutions accountable for their role in structuring a deceptive or abusive loan at various points in the purchase process. Further, federal legislation should only improve, not weaken, available consumer protections. Currently, states' laws are the only meaningful safeguards available to families, and reducing them without meaningful federal legislation in place would be a step backward in all Americans' right to fair lending and equal access to credit.

- ▶ **Stop "referral down" practices.** As part of financial institutions' regular CRA and fair lending exams, financial institutions should be required to submit their policies and procedures for referring creditworthy customers "up" to their prime lending business. If such a policy is not in place, it should count against their final exam score. Moreover, for those organizations not subject to CRA or regular fair lending exams, the FTC must regularly investigate referral patterns by requiring institutions to submit their policies and procedures at their request to ensure that families are getting the best terms for which they qualify.
- ▶ **Federal regulation and monitoring of mortgage brokers.** Congress has an obligation to create a regulatory body, or amend an existing agency's charter, to monitor mortgage brokers. As the main party interfacing with customers, explaining loan terms, providing disclosures, and securing the loan closing, more oversight is warranted to ensure sound and equitable activities and performance. Congress can decrease the incentive to brokers to push families into higher-cost loans by accounting for YSPs in the calculation of a high-cost loan. Finally, mortgage brokers should be subject to HMDA data reporting requirements, including the type of institution for which their loans are packaged. Such transparency will allow the public to better understand the impact of mortgage brokers on the homebuying market.
- ▶ **Increase access to the mainstream mortgage market.** There are a number of steps Congress can take to improve access to the mainstream mortgage market. First, standardization of the subprime mortgage market is critical to ensuring that consumers can find and compare the real costs of a mortgage from lender to lender. Congress must empower and require agencies to incorporate mortgage finance companies into the regulatory oversight systems and enforce existing legislation. Subprime lenders can make their business more transparent by providing a public listing of terms and fees, as is done for prime products. Second, Congress must support housing counseling agencies that



prepare low- and moderate-income families for homeownership by increasing appropriations and reducing agencies' regulatory barriers to self-sustaining revenue. Finally, vigorous, routine, and independent investigations of all mortgage lenders are necessary to regulate their lending, as well as to better understand the predatory lending market. Further, it should be clear to consumers which agency is responsible for receiving and investigating their complaints, and regulators should be encouraged to coordinate efforts if complaints are submitted to the wrong agency.

access the mortgage products that best meet their needs. To combat it effectively, policy-makers, advocates, and financial services industry representatives will have to work in concert to implement new legislation backed by tough enforcement that will achieve effective best practices and the development of new lending models. While the above recommendations focus on national policy solutions, industry can also take steps to curb abusive lending in Hispanic communities by improving outreach to the community, diversifying their workforce, reevaluating automated underwriting systems, and creating flexible prime products that meet the needs of "mortgage-ready" families. Latinos are the nation's largest minority and, as such, can no longer be considered a niche market. Rather, those involved in the homebuying market must incorporate the needs of the Latino community into their core business plan, delivering the quality financial services that Latinos deserve.

## CONCLUSION

Predatory lending is an indicator of market failure in the mortgage lending industry; too many consumers, including a disproportionate number of minority families, are unable to

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