

A PRIMER ON MORTGAGE LENDING PRACTICES

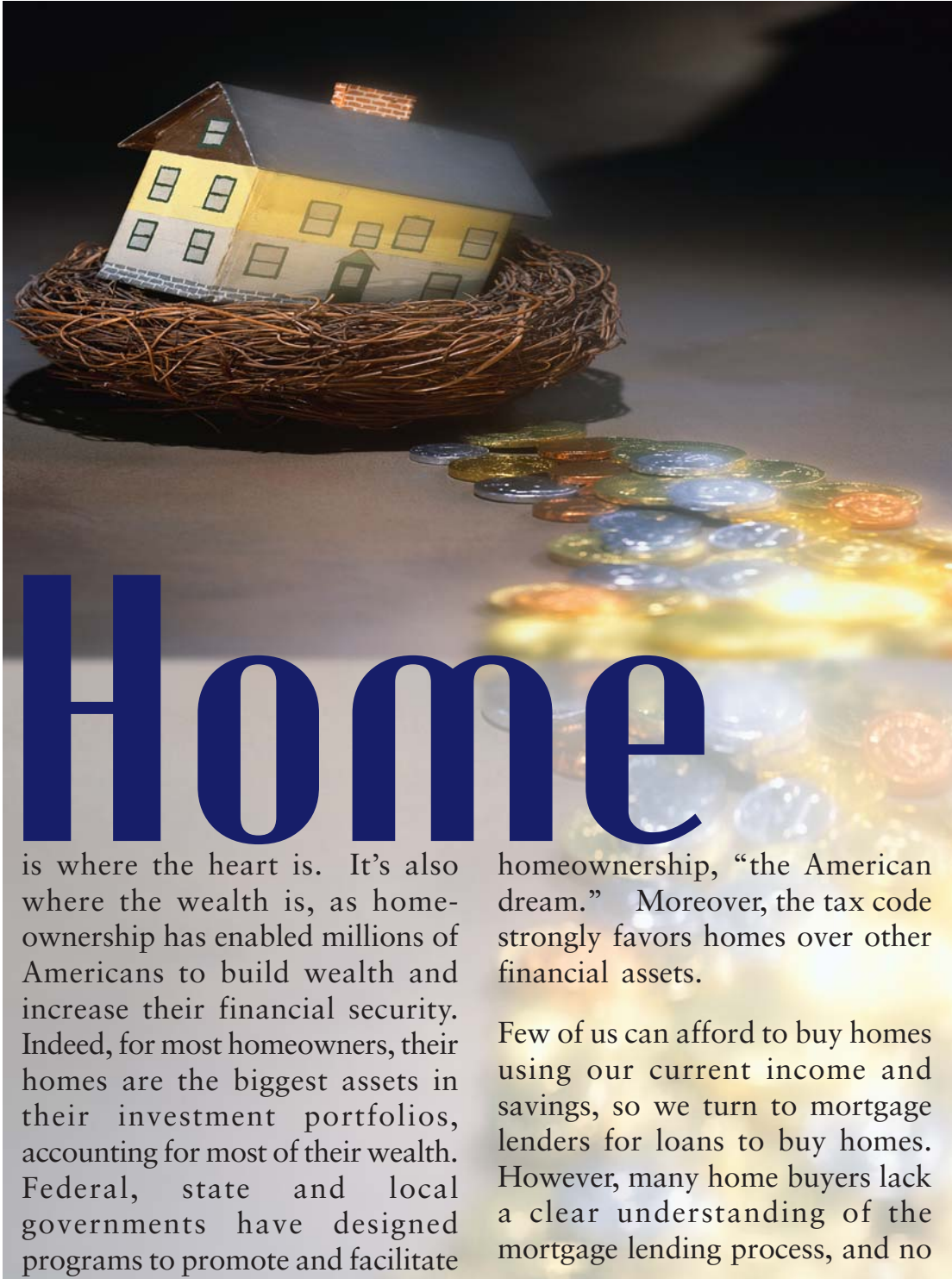
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Home

is where the heart is. It's also where the wealth is, as homeownership has enabled millions of Americans to build wealth and increase their financial security. Indeed, for most homeowners, their homes are the biggest assets in their investment portfolios, accounting for most of their wealth. Federal, state and local governments have designed programs to promote and facilitate

homeownership, “the American dream.” Moreover, the tax code strongly favors homes over other financial assets.

Few of us can afford to buy homes using our current income and savings, so we turn to mortgage lenders for loans to buy homes. However, many home buyers lack a clear understanding of the mortgage lending process, and no

wonder. It's a complex, detailed and specialized process, and it's not something you would go through as often as, say, buying a car. This can leave some consumers at a disadvantage in deciding what type of mortgage is right for them. Is the interest rate appropriate? What should I ask in return for agreeing to pay higher up-front fees? Is it a good idea to finance the points? (More about fees and points later.) What kind of prepayment penalty is appropriate? Home buyers may have difficulty answering such questions if they don't understand how the lending process works.

This primer provides an overview of the elements of this process, with a particular focus on how mortgage lenders approach it. If homeowners understand where lenders are coming from, they will have a better idea of how to obtain mortgage loans that are right for them. This primer also considers a number of mortgage practices that have been the focus of recent concern, discusses their rationale, and explains their advantages for particular segments of the home buying population as well as how they might be abused.

Key goals of this report are to facilitate informed conversation about mortgage lending issues among policy-makers, consumer advocates, and lenders and to highlight the importance of education in protecting against fraud and unscrupulous mortgage lenders.

Ultimately, however, the most important goal is to help you, as consumers, better understand the mortgage lending process, including some key lending practices, in order to find the mortgage that's right for you.

AN OVERVIEW OF THE MORTGAGE MARKET

Financial markets make it possible for lenders to provide long-term loans for consumers to buy homes. Most people do not have the savings or current income to pay cash for a home, so they put a down payment on a home, much as they would put a down payment on a car. For example, a home buyer might make a down payment equal to 10% of the purchase price of the home, and finance the rest with a mortgage from a lender. Because homes are such big investments, lenders usually give buyers a long time to repay mortgage loans, typically up to 30 years. Financial markets are particularly important for purchasing homes, cars, furniture, large appliances and other goods with high prices and extended lives.

ELEMENTS OF THE MORTGAGE

PRICE

What does it cost a buyer to obtain a mortgage loan? The price of a mortgage includes the interest rate the lender charges on the loan, plus any points and fees the lender charges at the time of origination.

INTEREST RATE

A mortgage can specify a single interest rate for the entire term of the mortgage (fixed-rate mortgage) or an interest rate that varies over the life of the mortgage (adjustable-rate mortgage, or ARM). More recently, a mortgage combining the features of fixed-rate and adjustable-rate mortgages has become a popular option among prospective homebuyers. These *hybrid mortgages* feature a fixed interest rate for a set number of years at the beginning of the mortgage, after which they become an annual adjustable-rate product. Common fixed rate periods are 3 years (known as a “3/1” mortgage), 5 years (5/1), and 7 years (7/1). Hybrid mortgages



have become popular because, relative to fixed-rate mortgages, they are more affordable and, relative to ARMs, they provide more price stability (see below).

FEES

Fees typically account for costs directly associated with the lender's processing the mortgage, such as title, appraisal, and credit report fees. Fees can also include the lender's post-closing costs, including making sure that taxes and insurance are paid by the

property owner, either directly or via escrow accounts, which are special accounts set up to hold money for taxes and insurance managed by the lender.

POINTS

A "point" is one percent of the total loan amount, for example, \$2,000 on a \$200,000 mortgage. Lenders can offer loans with no points or multiple points as part of the price. While lenders charge points to cover salaries, overhead, and service fee revenue, their primary purpose in today's market is to adjust the mortgage's yield, or return, so the lender can sell it on the secondary market without experiencing losses (see below).

Home buyers usually pay fees and points in full at the time the mortgage is originated and interest over the full life of the mortgage.

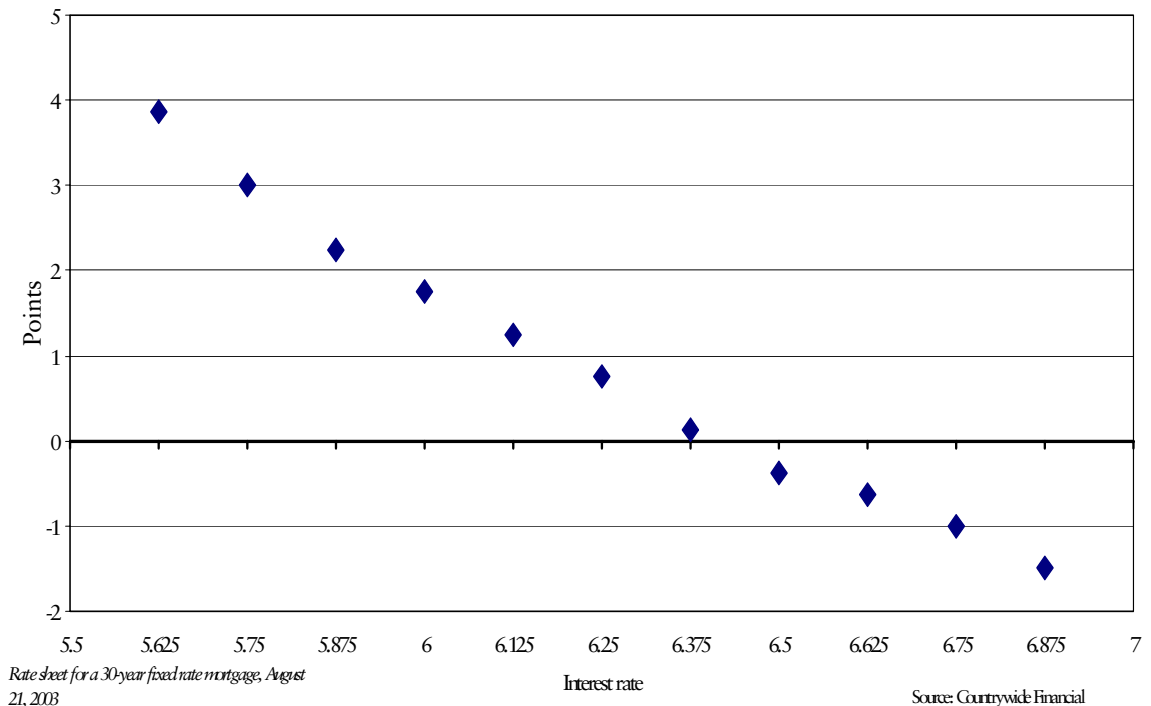
Generally speaking, lenders are willing to trade off a lower interest rate for higher points and fees or vice versa. As an example, figure 1 shows a typical trade-off between interest rates and points that one lender was willing to accept for providing a 30-year fixed rate mortgage loan on August 23,

2003. Lenders' interest rate, fee and point combinations are updated daily to reflect changes in market interest rates. The exact combinations differ from lender to lender due to competition.

This interest rate, points and fees framework for pricing mortgages offers consumers a flexibility that they often do not have when

making other large purchases. Depending on their circumstances, consumers may choose to pay more in fees and points up front in exchange for a lower interest rate during the term of the loan, or they may decide to pay a higher interest rate in exchange for lower fees or points to keep more cash to help defray other closing costs.

Figure 1. Lenders typically are willing to trade-off between interest rates and points.



PRICING A MORTGAGE – COSTS, RISKS, AND RETURN

In setting the price for a mortgage – that is, the overall revenue received through interest, points, and fees – mortgage lenders must consider several aspects of the transaction, including:

- ❖ Operating costs;
- ❖ Potential losses associated with nonpayment of the loan (credit risk);
- ❖ Interest rate risk;
- ❖ Prepayment risk; and
- ❖ The profit margin.

OPERATING COSTS

First, to insure that a lender stays in business in the long run, the price of a mortgage must cover the lender's costs to receive and process the mortgage application and originate and service the loan. Processing costs include the salaries of managers and loan officers at the branch where a prospective home buyer submits a mortgage application and any off-site application reviewers, as well

as overhead associated with maintaining branches and other offices. A lender's costs also include servicing the mortgage, i.e., maintaining and managing the escrow account, tracking borrower payments, monitoring the timeliness of repayment, and seeing that delinquent borrowers repay mortgage amounts that are in arrears. Fees to cover these costs are referred to as “servicing fees.”

CREDIT RISK

With every loan, some chance exists that the borrower will become delinquent, that is, not repay the loan in a timely fashion. In some cases, delinquency will be the result of “trigger events,” which can include job layoffs, divorce, and medical emergencies.¹ In other cases, a borrower may simply be less than reliable in making payments. Finally, lenders must be concerned about delinquencies arising from fraud on the part of the borrower. In general, the higher a borrower's credit risk, the higher the lender's costs of making a loan.

In some cases when a loan becomes delinquent, a borrower pays the

delinquent balance and associated penalties and becomes current on the mortgage, a process known as “curing.” If a mortgage cures, the main cost for lenders is identifying, tracking, and resolving the delinquency. Lenders will usually work with a borrower who has run into trouble in an effort to promote curing and avoid foreclosure proceedings. Lenders may negotiate a more lenient, temporary payment plan or help the borrower sell the home and provide relocation assistance. If those actions are not the answer, the lender may work out a solution with the borrower in which the ownership of the property is given to the lender in exchange for terminating the loan obligation. (This is called a “deed in lieu” procedure.)

However, if it appears unlikely that such actions will solve the problem, the lender will initiate a foreclosure process. The timetable for entering that process is firmly established by secondary market guarantors such as Fannie Mae, Freddie Mac, and the Federal Housing Administration (FHA) (the secondary market is discussed on page 9 of this primer). When loans are held by the originating

institution and not sold to the secondary market, the lender has more leeway in deciding when to go forward with a foreclosure action.

In a foreclosure, the lender terminates the mortgage, assumes ownership of the property, repairs any property damage, pays back taxes and insurance, and attempts to re-sell it. This process can be quite costly, in part because it often requires considerable time and effort and in part because the resale price is sometimes less than the original loan amount or may not cover all the costs of foreclosure. In addition, the lender has to cover cost of financing the property until it is sold. In setting the mortgage price, then, lenders will include some buffer to account for the expected losses that they are almost always going to face if a loan does enter into foreclosure.

INTEREST RATE RISK

When a lender commits to providing a mortgage, the funds are no longer available for alternative investments. Thus, the lender loses the chance to invest those funds in more attractive opportunities that may arise in the future. For example, if a lender commits to make a loan at 6 percent and interest rates rise to 6-1/2 percent, the lender loses the extra income associated with a loan originated at the higher rate. If the market interest rate moves above the interest rate of a particular mortgage, the lender incurs what is known as “an opportunity cost.” This results from the lender’s earning less from the mortgage than it would if the loaned dollars were available for investment at current market rates. To the extent possible, lenders seek compensation for holding this “interest rate risk.”

Because the interest rates on fixed-rate mortgages cannot be changed despite changes in current market interest rate levels, these mortgages have more interest rate risk than ARMs. Fixed-rate mortgages, therefore, typically have higher prices, usually via a

higher interest rate, than ARMs.² Hybrid mortgages pose interest rate risks during the fixed-rate portion of the mortgage but not during the subsequent ARM portion. As a consequence, hybrid mortgages are priced between fixed-rate mortgages and ARMs, with the interest rate charged falling as the fixed-rate term becomes shorter. Thus, a 5/1 mortgage is less expensive than a 7/1 mortgage, but more expensive than a 3/1 mortgage.

PREPAYMENT RISK

Another way that lenders can be hurt after they make a loan is if the borrower repays the loan sooner than its original term; this is known as *prepayment*. For example, a home buyer may have a 20-year mortgage but repay it after only 10 years. Borrowers can prepay either by paying off the remaining loan balance themselves or by obtaining another loan, a transaction known as a “refinancing.” Prepayment is attractive for borrowers because it gives them the option to adjust their financing based on current economic conditions if it is beneficial to do so. For example, if a homeowner is paying 7.5%

interest on a loan, but market interest rates have fallen to 5.5%, the owner could prepay the loan with a new loan that has the lower interest rate.

Prepayment is a cost to lenders because lenders do not receive the entire stream of interest payments they expected from the loan. Thus, the loan generates less revenue than expected and may no longer cover the costs associated with the loan. Also, when rates are lower than when the original loan was made, the lender will have to reinvest the funds at a lower rate than previously had been paid. Thus, mortgages that give the borrower the option to prepay tend to have higher overall prices, although, for reasons discussed below, some higher risk mortgages carry fees known as “prepayment penalties” to ensure that lender losses from prepayment are minimized.

PROFIT MARGIN

In addition to covering costs associated with originating a mortgage and accounting for credit risk and interest rate risks, the price of a mortgage also includes the lender’s profit margin. This

margin reflects the reality that the lender, as an agent of the financial market, is in the business of facilitating a purchase that the homeowner would otherwise not be able to make. This is no different than offering checking accounts, providing certificates of deposits for savers, or running a mutual fund. Moreover, this profit margin should ideally exceed the return a lender could get by investing in other assets, such as a different type of loan or a U.S. Treasury bond. Otherwise, a lender would always choose to invest in other, more profitable assets rather than provide funding for the mortgage.

PRICING A MORTGAGE - THE INFLUENCE OF THE SECONDARY MARKET

Secondary market institutions purchase mortgages originated by a mortgage lender, thus removing the loans from the lender’s books and providing the lender with fresh funds with which to extend more mortgage credit to home buyers. In this way, the secondary mortgage market adds “liquidity” to the mortgage market by making an additional source of funds

available for mortgage lending.³ Furthermore, the credit and interest rate risk as well as the mortgage interest payments are transferred from the retail lender to the secondary market institution.⁴ Usually, secondary market institutions will not conduct the on-going servicing of the mortgage account. In some cases, the lender that originated the mortgage retains the servicing; at other times, the servicing is managed by a third institution. Thus, lenders active in the secondary market garner most of their mortgage-related income from fees associated with originating and, sometimes, servicing the mortgage. This is in contrast to “portfolio lenders,” who retain the mortgages they originate and generate interest income in addition to servicing fee income from the mortgage.

Secondary market institutions can choose either to hold the mortgages they purchase in their portfolios or bundle them into what are known as *mortgage-backed securities* and sell these securities to investors such as large financial institutions, public and private pension funds, and mutual funds. Because these investors will not

purchase the mortgage-backed securities unless they offer a certain minimum yield, secondary market institutions require the mortgages they purchase to offer an adequate profit margin. This requirement drives the pricing decisions of those retail lenders that wish to be active secondary market participants.

Fannie Mae and Freddie Mac, which are known as government-sponsored enterprises (GSEs), together account for most of the secondary mortgage market purchases involving conventional mortgages.⁵ The GSEs are only permitted to purchase loans smaller than a government-established limit; loans smaller than this limit are known as “conforming” loans. In recent years, other large financial institutions including commercial banks and investment companies have become more active in the secondary market. In addition, some specialized secondary markets have emerged, such as the secondary market for loans larger than the conforming loan limit (called “jumbo” loans) and loans to lower-income borrowers and neighborhoods (called “Community Reinvestment Act (CRA) loans”). Because the market for

private label mortgage-backed securities (mortgage-backed securities not issued by Fannie Mae or Freddie Mac) is somewhat less liquid than the market for GSE mortgage-backed securities and because these private institutions are unable to raise funds as cheaply as the GSEs, jumbo loans and CRA loans usually have somewhat higher rates than conforming loans, everything else being equal.⁶

DETERMINING THE PRICE ANY INDIVIDUAL BORROWER MUST PAY

While broad market forces generally determine mortgage pricing, the lender sets the price of an individual loan, including the interest rate and other fees. The lender's pricing is based on its evaluation of the characteristics of the prospective borrower and the loan and its estimation of its operating costs, credit risk, and interest rate risk, all of which have implications for the loan's expected profit margin.

ASSESSING THE PROSPECTIVE BORROWER

In considering a loan application, a lender is most concerned about delinquency and losses associated with foreclosure. Borrowers are assessed along three dimensions:

- ❖ Income;
- ❖ Credit history; and
- ❖ Down payment (investment of assets).

Of these, consumers tend to find the credit history and down payment requirements more difficult to meet than the income requirement.⁷

A borrower must have sufficient income not only to repay the mortgage loan but also to pay any consumer loans or other debts as well as cover living expenses and other costs. If a borrower's income cannot cover all these obligations, a lender will be concerned that mortgage payments may become a secondary priority for the borrower and that, if a borrower meets a rough patch, repayment will be interrupted or stopped altogether.

Second, borrowers must demonstrate that they are likely to repay the loan and not become delinquent. They usually accomplish this by having a credit history indicating few problems in handling prior credit accounts. The standard method by which a borrower's credit quality is assessed is through a credit score that translates a borrower's credit history into a single number. Credit scores represent the past performance of loans extended to individuals with characteristics similar to those of the mortgage applicant. Applicants with a strong history of credit repayment on prior mortgage, installment, and consumer debt accounts have high credit scores; those who have been delinquent on prior debts and those with bankruptcies and other public records will have lower credit scores. Other factors that lenders consider in evaluating a borrower's credit risk include whether the borrower has several months' worth of cash reserves and has a co-borrower who is equally obligated to repay the loan.

The most common credit score is called a "FICO" score.⁸ Each credit score corresponds to a predicted probability that the

borrower will become delinquent on the loan. While different lenders use these scores in different ways, borrowers with FICO scores above 660 generally will be judged to have a low delinquency probability and clearly pass the credit quality threshold for lenders. Conversely, many lenders view borrowers with FICO scores below the 620 to 660 range as a high potential risk. This latter group of borrowers may need to be willing to pay more to obtain a mortgage or need to obtain credit enhancements, which are arrangements, such as insurance or a guarantee, that reduce a lender's exposure to the risk of delinquency.

Finally, to limit a lender's losses in the event of a delinquency and foreclosure, borrowers are usually required to invest some of their own money in the property by making a down payment, much as they would make a down payment on a car or a consumer appliance. This means a borrower must have sufficient wealth to provide a large enough down payment to meet the lender's requirements. Lenders usually base this requirement on a comparison of the loan amount to the value of the house, or the "loan-to-value ratio (LTV)."⁹

Historically, most mortgage loans were 80 percent LTV loans, meaning a borrower was expected to provide a down payment equaling at least 20 percent of the purchase price of the home. If less than 20 percent was provided, a homebuyer was required to purchase private mortgage insurance (PMI) to limit the lender's exposure. In recent years, however, industry analysts have discovered that mortgages featuring much smaller down payments have only slightly higher levels of default risk. This finding has led to a shift in industry practices and the increased prevalence of mortgages requiring down payments as low as five percent or less and a loosening of PMI requirements in some cases.¹⁰

applicant's. The lender also calculates the likely level of a loan's operating costs and assesses the appropriate service fee based on current market conditions and the competitiveness of the market. Finally, the lender calculates the loan's interest rate risk according to whether it is a fixed-rate mortgage, hybrid mortgage, or an ARM. Based on these risk estimates, the lender determines the stream of revenue and overall mortgage price needed to make the mortgage economically feasible. The lender can use a variety of interest rate, points, and fee combinations to yield the same desired overall mortgage price. Generally speaking, loans with higher points and fees will have

DETERMINING THE PRICE THE CONSUMER WILL PAY FOR THE MORTGAGE

Once a loan applicant's credit risk is determined, the lender can estimate the probability that that the borrower will become delinquent and the lender's losses if a foreclosure is necessary. These estimates are based on the lender's prior experiences with customers with a profile similar to the

lower interest rates, as lenders are willing to trade lower revenue generated in the future for more revenue earned at the time the loan is extended. To make it easier for consumers to compare loans with different combinations of interest rates, points, and fees, the federal government requires lenders to include in each loan report provided to prospective borrowers an “annual percentage rate” (APR), which translates the points and fees into an interest rate equivalent that can be incorporated into the base mortgage interest rate.¹¹

VALIDATING THE PRICE OF THE HOUSE BEING MORTGAGED

Because a home loan is a “collateralized” loan backed by the home being mortgaged, it is important for both the homebuyer and lender to verify that the home’s market price is realistic. Lenders typically require that a house undergo an *appraisal*, which is a professional estimate of the house’s market value based on the history of recent sales involving comparable homes in the vicinity of the target house. The lender factors this appraised value into

its calculation of the LTV of the requested loan. The borrower also can verify the value of the home via the *home inspection*, during which a professional contractor carefully inspects the home for defects, code violations, and other problems that could adversely affect the home’s value. In buying a new home, the borrower may demand that the seller correct issues identified through the home inspection as a condition for purchasing the home at the agreed upon price; alternatively, a borrower may ask that the seller reduce the price in lieu of making the necessary repairs.

SPECIAL LOAN TYPES – THE PRIME AND SUBPRIME MORTGAGE MARKETS

Like many other financial markets, the mortgage market is segmented. Just as companies with poor financial records or prospects must borrow in so-called “junk bond” markets, the mortgage market similarly has higher- and lower-quality components. “Prime” mortgages are high quality mortgages that are expected to pose little credit risk for

originators, secondary market purchasers, or secondary market investors. Generally speaking, conforming mortgages and other mortgages with comparable credit risk profiles fall in the prime market. There is little risk variation and price differentiation among prime borrowers; they all basically pay the same price.

While there is no “bright line” between loan types, loans to borrowers with lower credit quality (i.e., low credit scores) generally are known as “subprime” mortgages. For regulatory and secondary market reasons, many lenders shy away from the subprime market, while other lenders specialize in serving these higher risk borrowers.

Because subprime borrowers have lower credit quality, lenders face higher credit risks and origination costs with subprime mortgages than with prime mortgages. Lenders must train experts in quantifying the special credit risks posed by applicants with poorer credit quality. Similarly, lenders may require a more detailed and thorough review of the credit records of subprime borrowers in

order to understand the true nature of the borrower’s credit risks. Moreover, subprime loans typically have higher costs associated with loan curing as they become delinquent and require workouts more frequently. Finally, because subprime loans fall outside of the set of mortgages that GSEs generally purchase, the secondary market for subprime loans is less liquid, meaning the borrower’s interest cost may be higher than with a prime loan.

In addition, subprime lenders typically demand a higher profit margin than lenders in the prime market. This is for two reasons. First, subprime lenders, like investors in other markets, will demand a higher return for the increased risk they are taking on.



Second, they are providing a service to borrowers who would otherwise not be able to obtain mortgages and buy homes. Thus, their value to subprime borrowers is quite large.

Because of these higher costs and profit margin expectations, subprime mortgages will generally have higher prices than prime mortgages. Subprime borrowers usually pay higher interest rates than prime borrowers and often also pay higher fees. However, comparisons can be tricky. Some prime borrowers may opt for mortgages with high points and fees in exchange for lower interest rates, and these borrowers may actually pay higher fees than some subprime borrowers. Ultimately, whether a pricing component is higher for a prime or subprime borrower depends on each borrower's combination of interest rates, points, and fees. However, subprime borrowers never pay a lower overall mortgage price (combination of interest rates, points, *and* fees).

In terms of pricing individual loans, the subprime market is unlike the prime market in that there is considerable variation in price

depending on the underlying riskiness of the borrower. Within the subprime market, higher risk borrowers pay higher prices for their mortgages than lower risk borrowers. This variation in pricing, which is called “risk-based pricing,” is due in part to the fact that expected loan losses increase dramatically as borrower riskiness rises. By contrast, expected loan losses are virtually the same for all prime market borrowers. Thus, in the prime market, variation in price is largely determined by differences in loan characteristics such as the down payment or other key terms of the loan.

HOME EQUITY LENDING

A household's housing-related wealth is the value of the home less the outstanding mortgage balance. For example, if the home's value is \$200,000, and the outstanding mortgage balance is \$100,000, the homeowner's housing-related wealth, or *home equity*, is \$100,000. Home equity often represents the largest asset in a homeowner's financial portfolio and thus is a powerful means for making other significant purchases. Loans in which home equity is used as collateral are known as “home



loans are attractive to those households that have seen the equity in their homes increase. However, these loans do carry some additional risk to the borrower, as non-repayment leaves consumers vulnerable to losing equity and, potentially, their homes.

equity loans” or “second mortgages.”¹² These loans are sometimes structured as open-ended lines of credit, which operate similar to consumer credit cards. Purchases can be made against this account up to a specified credit limit. Home equity loans can be used for a wide variety of purchases and transactions, including home improvements and repairs. In general, home equity

MORTGAGE LENDING: MOVING BEYOND THE BASICS

The previous section provided a broad overview of the mortgage lending market, and highlighted the key elements of a mortgage. We saw that the typical mortgage will be for the price of the house less the borrower's down payment, which lenders require to reduce the likelihood that borrowers will simply walk away from their repayment obligations. Repayment terms involve an interest rate, points, and fees, which are set by the lender to cover operating costs, credit risks, opportunity costs, and service fees associated with extending and managing the loan. Typically, a consumer pays the points and fees up-front and the interest over the life of the mortgage. Because many combinations of interest rate, points, and fees can yield the same revenue, consumers often have some discretion in deciding on the exact combination that works best for them.

Many mortgages, however, feature variations on this standard theme.

For example, some mortgages require that borrowers use some of the loan funds only for specific repairs or improvements to their homes. Other mortgages include funds that are tied to purchases of goods other than the home. In recent years, concerns have been raised about some of these variations. In particular, some have argued that, rather than improving a borrower's financial position, certain mortgage characteristics actually leave borrowers in a position where they find it difficult or impossible to repay their loans and at risk of losing their homes, a key source of financial and personal stability.

This section reviews a number of the more controversial mortgage characteristics and practices, grouped according to how they fit into the mortgage process (Table 1). The relationship between each practice and lender costs, borrower characteristics, and borrower preferences that underpin the overall mortgage process are outlined. The discussion also highlights how each practice might work to a consumer's advantage, as well as those situations in which a practice is likely to lead to problems.

Table 1. Mortgage characteristics and practices that have raised concerns in recent years

Loan pricing and loan terms

Charging interest rates above credit risk levels and high fees, especially for subprime lenders

Loan (debt) consolidation fees

Financing the points and fees into the loan balance

Prepayment penalties ñ their level and use in subprime markets

Underwriting practices

Originating loans for more than the value of the house

Originating loans based on equity rather than ability to pay

Allowing the lender to icalli a loan

Loan types and other issues

Balloon payment, interest-only, and negative amortization loans

Requiring credit life insurance, often under single premium policies, for lower quality loans

Loan flipping (multiple refinancing)



Overall, the discussion shows that assessing whether a particular mortgage arrangement is beneficial or harmful depends almost entirely on the context. For borrowers with a particular profile, certain mortgage characteristics or practices might make sense; for others with very different profiles, they can lead to a lot of trouble. Ultimately, borrowers must use care in assessing whether the terms and characteristics of a potential mortgage make sense. This requires borrowers to have a certain degree of understanding of

the mortgage lending process and to shop around and compare mortgages, much as they might shop around for a car. Some borrowers may need to consult with mortgage counselors and others who can provide objective sound advice.

In many cases, the real issue is whether the prices or fees are set at a reasonable level rather than whether or not a given practice itself is ethical. The issue of price setting underlies much of the controversy surrounding these practices. It is often difficult to reach consensus as to the appropriate definition of “excessive” or “reasonable” pricing, two terms often used by those discussing the ethics of lending.

LOAN PRICING AND LOAN TERMS

CHARGING INTEREST RATES ABOVE CREDIT RISK LEVELS AND HIGH FEES, ESPECIALLY FOR SUBPRIME LENDERS

The first job for consumers is to make sure they select loan terms that best meet their needs. Because many different combinations of interest rates, points, and fees can yield the same revenues for the lender, borrowers have options regarding the exact combination they take on. A typical mortgage pricing arrangement is to pay points and fees up front to account for a significant fraction of the revenues, and to make interest payments over the life of the loan to cover the rest. However, this might not be attractive to a borrower with limited available money but higher expected future income. For these wealth-constrained homebuyers, a lender might offer concessions on the points and fees in return for a higher interest rate over the life of the mortgage. Moreover, given the relatively low cost of refinancing compared with new loan financing, borrowers might be willing to accept a somewhat higher interest rate if they expect rates interest

rates to fall and they can quickly refinance the mortgage. Thus, high interest rates that appear to be above market are not an indication, in and of themselves, that the borrower has been overcharged.

Similarly, rather than accepting a higher interest rate in return for lower fees, a borrower might prefer to pay more up front in terms of points and fees in return for a lower interest rate. This might make sense if the borrower had sufficient wealth and was planning to hold the mortgage for a particularly long time; the lower interest rate would significantly reduce the borrower's interest payments over the life of the loan.

As we have seen, subprime loans warrant a higher overall mortgage cost to the borrower because of the elevated credit risks and operating costs. Thus, we would expect higher interest rates, points, and fees for these loans. The issue a borrower must face is, how high is too high? Absent these higher costs, consumers would ideally expect a loan with points and fees significantly above industry norms to feature an interest rate below the industry standard given risks and costs. Alternatively, they could

expect concessions on points and fees for loans with very high interest rates. Borrowers may have cause for concern if lenders do not offset high levels of some components of the mortgage price with corresponding concessions in other components, although it is possible for all the pricing components to be elevated if the borrower's risk profile is sufficiently high.

In this context, the second job that consumers face is to make sure their creditworthiness is evaluated in its best light so that they avoid the higher costs of the subprime market. This may mean that they act to clean up their credit records in order to get a better credit rating; they may also make sure their records as reported by credit bureaus are accurate, as inaccuracies can potentially adversely affect a consumer's perceived credit risk.

Most important, consumers should shop around for the best deal. Because the lender's managers and shareholders expect an acceptable return for their investments, a lender's primary incentive is to maximize profits by obtaining the most advantageous spreads (between the loan's price and the

lender's costs) on each loan made. Recognizing this, a borrower should speak to a number of different potential lenders to find the best deal. Such comparison shopping will help the borrowers to identify lenders quoting prices above market and industry norms. Lenders whose mortgage price quotes are rejected repeatedly by prospective borrowers will see their loan volume shrink and should respond by lowering prices.¹³

To summarize, the concern about high interest rates and high fees is more complicated than simply looking at the interest rate or points or fees that a borrower pays. Rather, one must consider the entire package, including points and fees, in order to determine whether a loan is more expensive than the borrower's credit quality warrants. A sound assessment of whether the package of interest rate, points, and fees is unreasonably high requires knowledge of the borrower's risk profile and the mortgage market, including the pricing terms offered by competitors. This is true for both the prime and subprime markets.

LOAN (DEBT) CONSOLIDATION FEES

In some cases, a borrower will consolidate loans associated with purchases of other goods into a single mortgage-related loan, usually a home equity line of credit, by using the line to pay in full the outstanding balances on the other loans. These payments can either be made by the borrower or be paid directly by the lender through the disbursement of funds directly to other creditors. As already discussed, such loan consolidations can work to the advantage of the borrower. Unlike other consumer loans, interest on these loans can be tax deductible for many borrowers.¹⁴ In addition, interest rates on home equity lines of credit are often lower than interest rates for other consumer loans. Moreover, loan consolidation offers convenience, as the borrower needs to manage only one account rather than multiple accounts. Finally, and importantly, a loan consolidation allows a borrower to roll typically short-term debt into a loan instrument featuring a longer pay back period. While such a rollover helps to minimize a borrower's monthly debt burden, it raises other

issues. For example, borrowers opting to consolidate a car loan into a home equity loan will effectively take as much as 30 years to pay for the car, meaning they may continue to make loan payments long after they have sold or otherwise disposed of the car. One can credibly question the economic sense of such a decision. That said, there are many borrowers who have effectively made the same decision by choosing to make the minimum payment on revolving accounts like credit cards. These borrowers likewise will take many years to pay off loans for cars or other consumer products whose useful lives are much shorter than the time required for loan repayment.

As with regular mortgages, lenders will price loan consolidations to cover operating costs, the risks associated with the loan, and a service fee. Operating costs for such loans will include the costs of processing the application and setting up the account. Credit risks will essentially involve the same considerations as for standard mortgages, and the service fees will also be similar.

Borrowers considering loan consolidations need to recognize these costs in addition to the benefits loan consolidations can provide, such as an interest rate that usually is lower than with credit cards or other types of consumer financing. If they have sufficient income and wealth to either pay for or finance these expenses, loan consolidations can be a good strategy. If, however, the fees associated with a consolidation would impose a significant burden on the borrower, it might not be the best approach to take.

A HOLISTIC VIEW OF PRICING

It is difficult to talk about specific pricing practices and characteristics in isolation because, as we have noted, tradeoffs can take place which render an abnormally high interest rate or fee benign. Rather, it is the overall combined price, embodied in an APR or similar comprehensive measure, that is relevant for assessing whether a loan is “expensive” or inappropriately priced.

Given this, the key issue is how one should determine what constitutes an expensive or

inappropriately priced loan. For both the prime and subprime markets, one must know current market conditions, including the pricing terms being offered by competitors. A comparison of terms will provide an indication of whether the lender’s operations – in terms of operating costs, expected credit losses, opportunity costs, and the service fee – are in line with industry norms. If they are not, borrowers should be very hesitant to agree to the offered mortgage contract and should either seek further information as to the reasons behind the elevated costs or seek another lender.

One exception to this general approach to evaluating pricing is in the case where the lender affords the borrower no flexibility in negotiating the precise terms of the mortgage. In this case, the appropriateness of particular components of the mortgage price will have to be evaluated independently. Industry norms should be a measuring stick here as well.

FINANCING POINTS AND FEES

For many households, adequate wealth is the most difficult of all the mortgage acquisition requirements to meet.¹⁵ Many households with good credit and solid income profiles lack the wealth to cover the down payment as well as the points and fees associated with the mortgage. For them, lenders can make available a mortgage that includes points and fees as part of the loan balance, a practice known as “financing the points and fees.” In this way, the lender receives their desired revenue from the mortgage

and the borrower is able to purchase the home. This alternate mortgage will require slightly higher monthly payments than a loan that does not include the points and fees in the principal loan balance (table 2).

For consumers with incomes that can support the larger mortgage, the choice is usually clear – buy the house. For others, however, a slightly larger mortgage could push the loan to the limits of, or even beyond, affordability, and their choice should be not to purchase the home. If they did go ahead and buy, they would risk delinquency and potentially

Table 2. Financing the points and fees leads to relatively small increases in the monthly payment

	INTEREST RATE:			
<u>Monthly payment if:</u>	<u>6 percent</u>	<u>8 percent</u>	<u>10 percent</u>	<u>12 percent</u>
<i>No financing</i>	\$539.60	\$660.39	\$789.81	\$925.75
<i>Financing of fees of:</i>				
2 percent	\$550.39	\$673.60	\$805.61	\$944.27
4 percent	\$561.18	\$686.80	\$821.41	\$962.78
6 percent	\$571.97	\$700.01	\$837.20	\$981.30
8 percent	\$582.76	\$713.22	\$853.00	\$999.81

Payment based on a \$90,000 loan and a 30-year fixed-rate mortgage.

foreclosure if their incomes took a hit because a layoff, divorce, medical emergency or other circumstances.

The financing of loan fees can be attractive even to households that have sufficient wealth to cover them. If these households are able to obtain returns on other investments that exceed the interest rate on the mortgage, then they will benefit by investing in these opportunities and financing the loan fees. For example, if a borrower's interest rate on the



mortgage is 6%, and the borrower can realize average returns of 7% from investments in stocks, bonds or other investments, then the

borrower might finance the mortgage points and fees. But, as noted, this practice is riskier for potential borrowers who are on the “margin” of affordability.

PREPAYMENT PENALTIES – THEIR LEVEL AND USE IN SUBPRIME MARKETS

Because subprime loans are relatively expensive, borrowers with subprime loans have an incentive to get into a much cheaper prime mortgage as soon as possible. This poses a number of business challenges for subprime lenders. First, simply by making on-time payments on their subprime loan over a period of time, subprime borrowers improve their credit quality and more easily qualify for prime loans. This increases the ability of borrowers to prepay by refinancing with a loan from the prime mortgage market. As discussed earlier, prepayments impose a financial cost on lenders, who in this case consequently might not fully recover the up front costs of originating the loan.

However, even more damaging, if the best subprime borrowers would move to the prime market as soon as possible, subprime lenders

would be left with only the riskiest mortgages in their portfolio. Economists call this an *adverse selection* problem—one that is common in many types of markets. In the face of adverse selection, a market will operate smoothly only if there is some mechanism that prevents those with the lowest risk from leaving the market too quickly. For example, adverse selection in the auto insurance market is dealt with through legislation requiring all drivers to be insured.

In the subprime market, the corresponding mechanism is the “prepayment penalty,” which is a fee charged to those borrowers who prepay their subprime mortgages before a predetermined time, usually a few years, has elapsed. Prepayment penalties are thus a necessity for the functioning of subprime mortgage markets. Without prepayment penalties, lenders would have to charge higher prices to deal with these elevated risks. However, this would only induce more prepayments by higher quality borrowers, which in turn would lead lenders to charge higher prices, and so on. This cycle would only end when the lender decided

to offer no subprime mortgages.

From a subprime lender’s perspective, the costs associated with prepayment and adverse selection are exacerbated in a falling interest rate environment. Here, in addition to the possibility that the lender’s operating costs are not covered and its risks are higher than originally expected, a subprime lender also is hit with interest rate risk, as the reinvestment rate return is lower than the return expected from the original loan.

In short, preventing, or at least limiting, prepayment is the one practical method for reducing the effects of adverse selection. It, in turn, allows subprime lenders to maintain the necessary rate of return on loans in these higher-risk markets and allows the markets to function smoothly. As for subprime consumers, they should shop around for the most favorable prepayment terms. Alternatively, savvy consumers will consider improving their credit status prior to applying for a loan in order to access loans without prepayment penalties.

UNDERWRITING PRACTICES

ORIGINATING LOANS FOR MORE THAN THE VALUE OF THE HOUSE

In any financial transaction, a good rule for a borrower or investor is to avoid high risk situations unless they are on firm financial footing. Taking on large mortgage loan balances is such a high-risk situation. Borrowers have incentives to fold as many debts as possible into their mortgages. They may gain tax relief, as interest paid on housing-related debts is generally tax deductible while interest paid on other debts is not. In addition, as noted, interest rates for mortgages are often lower than those for other consumer loans, and borrowers generally like to incorporate car, appliance, and recreation loans into their mortgage loan. In some cases, however, loan consolidation can push the LTV ratio on a mortgage loan to 100 percent or more. For borrowers with enough savings, incorporation of these other debts will not adversely affect their ability to meet lender down payment requirements and reduce the LTV ratio to generally accepted levels. For others, however, these

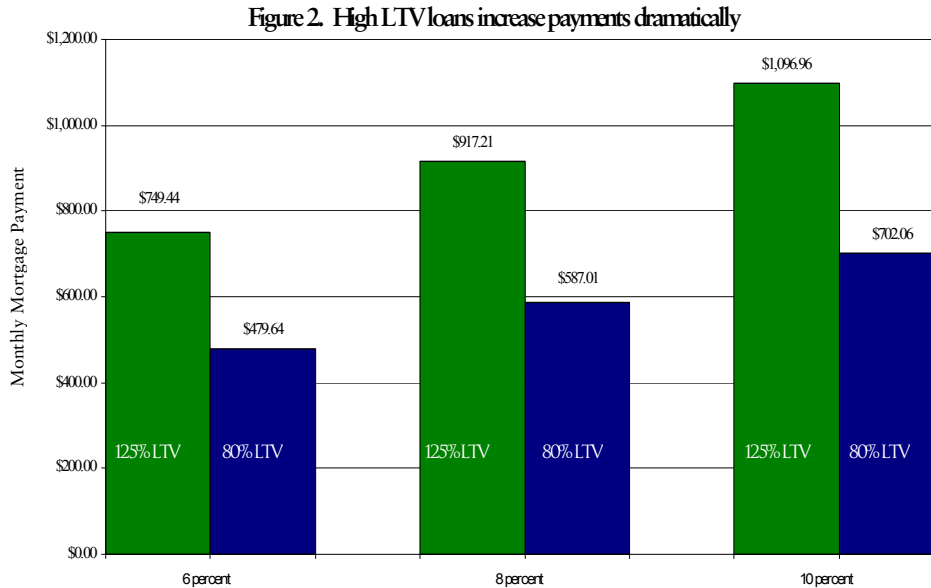
additional debts will exceed accumulated savings and wealth and leave the final loan amount higher than the value of the home, sometimes by a significant amount.

Despite their standard down payment requirements, lenders might opt to underwrite a loan where the loan amount exceeds the value of the home in certain circumstances. If housing markets are rapidly appreciating or are likely to in the near future, then a loan with a high initial LTV will be expected to move into conformity with standard requirements in a short time. A second, perhaps more significant consideration is bankruptcy. The debts typically folded into these high LTV loans would otherwise be unsecured, leaving lenders with little hope of recouping loan proceeds in the event that the borrower declared bankruptcy. By folding these debts into a mortgage, which is secured, there is an increased likelihood that a borrower will try to repay some of the outstanding debt rather than simply walk away and leave the lender with a complete loss.

For high LTV loans, lenders closely assess a borrower's credit quality and income. In most cases, loans with an LTV ratio exceeding 100 percent are limited to those borrowers with the best credit quality. This is because a foreclosure would expose the lender to extra loan losses tied to the non-housing expenses folded into the loan. Compared to the standard mortgage, these high LTV loans require monthly payments that are larger, sometimes by substantial amounts (figure 2). Thus, borrowers who take out mortgages with LTV ratios

exceeding 100 percent will need to have higher incomes.

This final point – a borrower should have a high enough income to manage a mortgage with an LTV above 100 percent – is important and should be kept in mind when considering such arrangements. A borrower who does not have sufficient income to comfortably repay the higher monthly payments associated with such loans should not agree to this type of loan, as it exposes them to significant risk of delinquency and foreclosure.



Monthly mortgage payment for a 30-year fixed rate loan on a \$100,000 house at 125 percent LTV and 80 percent LTV, assuming 6 percent, 8 percent, and 10 percent interest rates.

Source: Author calculations

ORIGINATING LOANS BASED ON EQUITY RATHER THAN ABILITY TO PAY

The important question of whether the consumer can really afford the loan also arises when lenders originate loans, usually for refinancing purposes, primarily based on the homeowner's equity position. Typically, lenders require a down payment to discourage borrowers from simply walking away from the mortgage. However, if a borrower already has a significant equity stake in a property, a lender might not require the borrower to provide additional funds as a separate down payment. The potential loss of this equity can be incentive enough for borrowers to repay the loan. In this sense, borrowers with significant home equity satisfy the wealth criteria mandated by lenders.

In most cases, though, having sizeable home equity is not sufficient to justify extending a loan. A potential borrower will need to surpass credit quality and especially income thresholds to be deemed creditworthy. There are exceptions to this rule, though. One case might be a borrower who

is facing a short-term or temporary hardship, such as an illness or sudden work layoff, and needs an infusion of capital to make ends meet. In such a case, a lender might agree to extend a loan with the expectation that the borrower's situation, and by extension his income and wealth position, will improve such that repayment of the loan is no longer an issue. Here the borrower is able to use his housing wealth to obtain "bridge financing" to weather the difficulty and clearly benefits from the transaction.

On the other hand, if the resolution of the immediate crisis is not likely to lead to an improvement in the borrower's income or wealth, then this sort of arrangement will be far riskier and expose borrowers to a heightened likelihood of losing equity and potentially their homes. Borrowers and lenders both need to face the possibility of such risks when considering entering into such a mortgage contract.

In many cases, borrowers might decide that such a mortgage is not in their interest and should not be pursued. For example, in most cases senior citizens on fixed incomes planning to remain in their

homes indefinitely generally should not enter into loan agreements where they have enough equity but not enough income to cover required monthly payments on the loan. Delinquency and foreclosure are likely to be the result of such loans. However, even here, this is not a general rule. Reverse mortgages, which are a special type of loan available to older Americans to convert home equity into cash, have proven to be attractive for many seniors on fixed incomes.¹⁶ Ultimately, borrowers must assess their financial position and their future plans to determine whether such loans make sense.

LENDER CALL PROVISIONS

For some loans, particularly the more risky ones, lenders may opt to include a “payable on demand” clause, which gives them the right to require a borrower to repay the entire loan at any time during the term of the loan. Lenders that exercise this right are said to “call” the loan. Typically, lenders will “call” a loan when they have experienced some elevated risk of loss and are concerned that more significant losses are imminent. (This is a feature often found in business loans too.) For example,



if a borrower with a somewhat checkered credit history has missed payments on a mortgage for several months in a row, this might be viewed as a precursor to default. Rather than waiting several more months to determine whether the mortgage is clearly in default, the lender might call the loan to minimize its opportunity costs and credit risk exposure. Lenders might also call loans if the borrower has taken actions that affect the lender’s risk position, such as converting the property from an owner-occupied home to a rental property.

Concerns have been raised about lenders exercising calls absent evidence suggesting that losses are imminent. Such a practice could be beneficial to lenders if they can reinvest the funds at more attractive market rates of return. However, it can impose a financial burden on borrowers, who, to satisfy the call, will often need to refinance the loan and, if interest rates are increasing, at a new, higher interest rate.

The concern regarding the effects of calls not associated with imminent losses has led regulators to impose restrictions on a lender's

ability to exercise calls for higher priced loans.¹⁷ For loans defined as "high priced" under the Homeownership and Equity Protection Act (HOEPA), lenders are prohibited from exercising call provisions unless the mortgage is in default. High-priced loans have been the main focus of regulatory action for two reasons. First, call provisions are most prevalent for subprime loans, many of which would qualify as high priced under HOEPA. Second, subprime borrowers are often income-constrained; the higher payments associated with a refinanced loan could leave them vulnerable to delinquency and default.

LOAN TYPES AND OTHER ISSUES

BALLOON PAYMENT, INTEREST-ONLY, AND NEGATIVE AMORTIZATION LOANS

Borrowers often seek ways to reduce the monthly payments in the early years of a mortgage, when their incomes are lower than they will be in later years. One method for accomplishing this is by agreeing to pay off the entire loan in less than the 30 years common to fixed-rate mortgages. Instead, after making regular monthly payments for a short period, a borrower would pledge to repay the loan in a lump sum, known as a balloon payment. When the balloon becomes due, a borrower would either pay the remaining amount or secure a replacement loan for the outstanding amount. If the borrower takes no actions to refinance with another lender, the original lender will typically refinance the outstanding amount. This reduces the lender's opportunity costs and exposure to credit risk. Thus, lenders will often offer a lower interest rate for such loans.

An alternative approach for minimizing the monthly payment is for the borrower to make only a partial payment. The monthly payment could just cover the interest (often called “interest-only” loans) or the monthly payment could be less than the interest (negative amortization loans). In both of these cases, the reduced payments typically run for a set term, usually around five years, after which the loan converts to a 30-year mortgage unless the borrower refinances the loan. The borrower's equity in the home does not increase during the reduced-payment period under either of these programs; furthermore, the borrower's repayment burdens in the later years of the loan term are elevated. In fact, under a negative amortization loan, the borrower *loses* equity, as the difference between the interest and the monthly payment is added to the original loan principal. While interest-only and negative amortization loans can reduce monthly payments, borrowers should remember that these loans defeat one of the wealth creating aspects of homeownership—the “forced” savings of retiring the mortgage debt.



Balloon payment, interest-only, and negative amortization loans can make sense for borrowers expecting to live in a house for only a short time and for borrowers seeking houses in markets with strong housing appreciation. Borrowers that sell their homes during the first few years after ownership gain relatively little equity, so foregone equity is less of a concern. Moreover, in markets with strong appreciation, the equity accrual from appreciation in the home's value is likely to dwarf the equity accrued through repayment. In these "hot markets," a borrower with an interest-only or negative amortization loan can still realize a sizable equity gain upon the sale of the home, and thus speculators often find this mortgage instrument attractive.¹⁸

Outside of these cases, these types of loans can make sense for borrowers expecting their incomes to increase dramatically in future years. They can increase their repayments to cover not only the interest but also the loan principal. However, such dramatic income increases are not common.

**REQUIRING CREDIT LIFE INSURANCE,
OFTEN UNDER SINGLE PREMIUM POLICIES,
FOR LOWER QUALITY LOANS**

Credit life insurance is a tool that ensures repayment of particular credit-related debts if the policyholder dies, becomes disabled, or has a sudden loss of income. It can make sense for people who would like to free surviving relatives and friends from having to deal with these obligations. Moreover, it can be an attractive option for a person in poor health or with a family history of certain illnesses. This product also minimizes lenders' risk of not getting repaid if a policyholder is unable to repay the loan.

However, credit life insurance, as offered by some lenders, to some prime and many subprime mortgage borrowers does raise

issues. First, if the lender bundles credit life insurance with the mortgage loan, the borrower cannot consider whether to apply for such insurance independent of the mortgage transaction. Second, while most insurance policies require the premium to be paid in installments over the life of the policy, many of these credit life insurance policies require the entire premium to be paid in a lump sum up front. This places additional financial burden on borrowers that are often already income- and wealth-constrained. Third, borrowers who cannot afford to pay the single lump sum premium are often encouraged to finance it via the mortgage. Here, the borrower pays for the insurance over 30 years even though most policies are effective for less than 10 years. Thus, unlike nearly all other financing arrangements, repayment extends well beyond the period that the policy offers benefits.

These features, and the outcry that has resulted, have caused many lenders to discontinue offering single premium credit life insurance in the context of mortgage lending. In 2001, the largest subprime lenders, including Citigroup,

Household International, and First Union, announced that they would no longer offer the single premium version of credit life insurance and would instead offer only a more conventional monthly fixed-premium policy.¹⁹

LOAN FLIPPING

If interest rates fall enough, borrowers may find it beneficial to refinance their mortgages at terms that translate into lower monthly payments. Importantly, refinancing requires the borrower to pay fees to cover the lender's operating costs in underwriting the new loan. Thus, refinancing is economical only if the decline in interest rates is sufficiently large that the reduction in monthly payments outweighs the fees to be paid.

Given the fees associated with refinancing, it will be relatively uncommon for a borrower to refinance multiple times over a short period of time (one year, for example). For example, if refinancing fees were 1 percent of a loan, a borrower would need an interest rate decline of about three-eighths of a percentage point for the cost savings over the entire life

of a \$100,000 30-year loan to exceed the fees. Two refinancings would require an interest rate decline of roughly a full percentage point for savings to exceed fee expenses.²⁰

Historically, mortgage market interest rates have not fallen such that the savings in monthly payments consistently exceeds the costs of frequent refinancings. Since the early 1970s, interest rates for 30-year fixed-rate mortgages have declined by 1 percentage point from a year earlier in only 83 out of 375 months (22 percent). The situation is even starker for subprime loans, which often feature higher refinancing fees. If fees were 2 percent, two refinancings in a year would require a year-over-year decline in the interest rate of approximately 2 percentage points. This has occurred only 28 times since 1971.²¹

Historical trends notwithstanding, repeated refinancing can be in a borrower's interest under certain circumstances. First, interest rates have seen periods of sustained decline. The post-2000 period is one example. Second, borrower needs may dictate multiple



refinancings, even when interest rates have not changed. For example, a borrower who has recently refinanced a mortgage might face large unexpected expenses that can only be paid for by drawing on home equity through an additional mortgage refinancing. Today's relatively low cost of refinancing makes this more feasible.

In some cases, though, borrowers frequently refinance in the absence of changes in their needs. This pattern of multiple refinancings is sometimes referred to as “loan

flipping” and can be detrimental to a borrower’s financial condition. That is because it strips home equity from borrowers via fee charges without providing the borrower with tangible benefits, such as reduced payments or more rapid equity accrual. Consumer advocates have raised concerns about loan flipping because of the increased prevalence of fee-based incentives for brokers to originate loans. These inducements are designed so that brokers have little or no down-side risk if the loan is subsequently refinanced. Thus, brokers are motivated to originate as many mortgages as possible, regardless of whether this might be in the borrower’s best interests. Borrowers therefore need to carefully consider whether a refinancing makes sense.

ADDITIONAL THOUGHTS

The foundation of a well-functioning market for any product is informed buyers and sellers. In such markets, consumers and businesses interact on level ground – neither has an information advantage that they can use to the detriment of the other. Markets with informed buyers and sellers will generally be less likely to have abusive or deceptive participants who can operate for long periods of time.

Unfortunately, many prospective homebuyers are not well-informed about the mortgage market. The mortgage transaction is quite complex. Homebuyers must authorize and pay for title searches, appraisals, and credit reviews, as well as sign a host of forms covering good faith estimates of costs, truth in lending disclosures, anti-discrimination laws, transfer of servicing, and other state- and federally-mandated items. Few go through the process frequently enough to gain a comprehensive grasp of all its nuances.

This leaves consumers vulnerable to fraudulent or illegal practices that can be quite costly in terms of money, time, future opportunities, and financial security. Lenders could fail to provide complete, accurate, timely, and clear information to consumers, with serious results for a borrower. For example, a borrower could be locked into a high cost mortgage if a lender did not provide clear and accurate information regarding the opportunity to prepay the loan subject to any prepayment penalty. Similarly, borrowers could be quite surprised, and potentially financially threatened, if they did not recognize that a very low interest rate was only a “teaser” that would increase at some point in the near future. Finally, uninformed borrowers are more likely than more knowledgeable consumers to succumb to high pressure tactics that could result in their agreeing to a loan that does not best serve their interests.

This vulnerability is the motivation for the regulatory framework that has been established for the mortgage process. It has also been at the heart of many of the concerns regarding particular

mortgage practices and policies, and it highlights the importance of enforcement by the banking regulatory agencies, the U.S. Department of Housing and Urban Development, the Federal Trade Commission, and state regulatory agencies.

However, it is unlikely that enforcement alone will be sufficient to stamp out all illegal and fraudulent activity. The number of small, independent mortgage brokers and agents is large and growing rapidly, and there are millions of transactions annually. Given that there are limited resources devoted to consumer protection at all levels of government, the regulatory agencies responsible for investigation and enforcement are fighting a daunting, uphill battle. While a few unscrupulous lenders might be punished for illegal and fraudulent activity, many others like them will probably be able to avoid prosecution and continue their practices.

Thus, in addition to enforcement, consumers need to be better informed regarding the mortgage process. There are now many resources that prospective

homebuyers can use to learn about mortgage-related practices, mortgage features, and current market conditions. For example, the Internet offers consumers quick and inexpensive opportunities to research the mortgage market. In addition, information is also available through libraries, local bookstores, and clinics offered by commercial banks and other mortgage lenders.

A resource that can be particularly valuable is consumer counseling and education offered by government, non-profit and other institutions. These groups specialize in providing information about mortgage markets and the mortgage process to consumers in targeted markets, some of which have seen their vulnerability exploited. Considerable resources are now being devoted to these activities. For example, the U.S. Department of the Treasury, notably through the Community Development Financial Institutions Fund, has taken steps to promote financial literacy and reduce the incidence of predatory lending. In addition, the Mortgage Bankers Association has announced best practices to curb predatory lending practices and implemented

the “Stop Mortgage Fraud” program, an educational effort aimed at stopping predatory lending through better consumer education. Another example is Freddie Mac’s “Don’t Borrow Trouble” campaign. Similarly, Fannie Mae, through its American Dream Commitment, is promoting a “mortgage consumer rights agenda”. That program includes an eight-point agenda designed to eliminate predatory lending practices. Investments such as these represent important steps toward eliminating abusive and predatory lending practices.

While much of this discussion has focused on decisions that borrowers must make in obtaining mortgage credit, lenders also have some responsibilities. Perhaps most important among these are transparency and openness. Lenders must honestly and clearly disclose all the relevant costs that borrowers will incur in advance so that borrowers can make informed decisions. There is already a regulatory structure in place that makes such a demand on lenders, created via the Real Estate Settlement Procedures Act (RESPA), but the current design of

these disclosures can be difficult for prospective borrowers to understand. This complexity has led to a push to reform RESPA and simplify the procedures; such actions could potentially represent a significant step in promoting greater transparency. RESPA reform notwithstanding, though, lenders need to make a continuous effort to improve the clarity of their disclosures, including each component of the mortgage price.

Competition can also help reduce the ability of lenders to charge mortgage prices that are out of line with market conditions. If there is adequate competition, borrowers will have little difficulty finding cheaper mortgages; high cost lenders would either have to reduce their prices or face significant loss of business. Currently, some communities do not have the same degree of competition for their mortgage business as others. Moving forward, lenders and regulators both need to make efforts to rectify such disparities, so that residents of all communities can enjoy the benefits of the mortgage market and homeownership

REFERENCES

¹ In addition, economic theory suggests that a borrower will choose to not repay the loan if the underlying value of the house is less than the value of the mortgage plus associated transactions costs. In economic options theory parlance, this is called a put option that is “in the money.”

² Interest rate risk also applies in the opposite direction, as lenders gain when market interest rates fall. However, lenders are unlikely to realize this gain, as a borrower is likely to refinance the mortgage if rates fall enough. Therefore, risks are not symmetric.

³ The secondary mortgage market was established during the Great Depression in response to a housing market crisis that arose due to high unemployment and cash-strapped banks that refused to refinance mortgages that had reached the end of their terms. For more information on the history of the secondary mortgage market, see Terence M. Clauretie and G. Stacy Sirmans (2003), *Real Estate Finance: Theory and Practice*, Thomson South-Western: Mason, Ohio. Also, by breaking the link between lending and deposits, the secondary mortgage market facilitated the rise of mortgage bankers and the mortgage banking industry. See Jay Cochran III and Catherine England (2001), “Neither fish nor fowl: An overview of the big-three government-sponsored enterprises in the U.S. housing finance markets,” Working Papers in Regulatory Studies series, Mercatus Center.

⁴ This assumes the mortgage is not insured and that there are no provisions allowing the secondary market institution to return responsibility for the mortgages to the originating lender. In practice, loans purchased by many secondary market institutions have both insurance and return provisions. See, for example, Glenn B. Canner, Wayne Passmore, and Brian J. Surette (1996), “Distribution of credit risk among providers of mortgages to lower-income and minority borrowers,” *Federal Reserve Bulletin*, 82, 1077-1102.

⁵ Conventional mortgages are mortgages that are not insured or guaranteed by a government entity, such as the Federal Housing Administration or the Veterans Administration.

⁶ CRA loans also often feature borrowers with higher credit risks.

⁷ See, for example, Stuart S. Rosenthal (2002), “Eliminating credit barriers to increase homeownership: How far can we go?” Research Institute for Housing America working paper 01-01; and Irina Barakova, Raphael W. Bostic, Paul S. Calem, and Susan Wachter (2003), “Does credit quality matter for homeownership?” *Journal of Housing Economics* 12 (4), pp. 318-336.

⁸ The FICO score, which is produced by Fair, Isaac, and Company, is one of many credit scoring systems currently being used by the industry. Each scoring system has its own scale and credit quality thresholds. For more on credit scores, see Robert B. Avery, Raphael W. Bostic, Paul S. Calem, and Glenn B. Canner (1996), “Credit risk, credit scoring, and the performance of home mortgages,” *Federal Reserve Bulletin*, 82, 621-648.

⁹ A house's value is validated by an appraiser. This is discussed more fully below.

¹⁰ Avery, Bostic, Calem, and Canner (1996).

¹¹ The APR is required under the Truth in Lending Act, which is implemented by the Board of Governors of the Federal Reserve System through Regulation Z. The exact formula for calculating the APR is laid out in Regulation Z.

¹² Although not for purchasing a home, home equity loans generally enjoy the same protections as first mortgages under Federal and state bankruptcy laws.

¹³ When comparing rates among potential lenders, the key for the consumers is finding the lowest overall rate possible. As indicated elsewhere, the consumer must make sure they are comparing apples to apples, as the interest rate may include fees that are financed over the life of the loan. For instance, in a large number of transactions, it is mortgage *brokers*, rather than lenders, that originate the mortgage loan. Generally, mortgage brokers do not have funds to lend, but commonly work with a number of lending sources to find loans for applicants. A broker will therefore serve as the point of contact with consumers, guide and advise potential borrowers with regards to options and products, and perform different levels of work to prepare the documentation and paperwork required for a mortgage loan. For the services that they render, mortgage brokers will charge upfront fees, collect yield spread premiums, or receive some combination of the two. A yield spread premium is a financing option that allows borrowers to finance some or all of the mortgage broker costs (or other loan-related costs, if they so choose) over the life of the loan. Under this option, the lender in the transaction would pay the borrower's obligation to the broker in exchange for the borrower's paying a higher interest rate. While useful in many circumstances, yield spread premiums can raise issues similar to those raised in the context of prepayment penalties (see below).

¹⁴ Though not discussed in detail in this report, mortgages receive beneficial treatment via several provisions in the tax code. Three benefits stand out. First, unlike interest associated with other debts, mortgage interest is deductible in calculating taxable income. Second, points paid as part of the mortgage transaction are also deductible. If the mortgage is a purchase mortgage, points are fully deductible in the year paid. Points are deductible over several years in the case of refinancings. Finally, the first \$250,000 in capital gains associated with the sale of a primary residence is exempt from taxation. This can be claimed once every two years. For married couples, the capital gain limit is \$500,000.

¹⁵ Wealth has been the largest barrier to homeownership for quite some time, although its importance has declined in recent years. See Barakova, Bostic, Calem, and Wachter (2003).

¹⁶ Relative to other mortgages, lenders will be relatively less hesitant to enter into these loans because LTV ratios and the likelihood of credit-related losses will be low. Thus, borrowers with significant home equity must be particularly mindful of income considerations when evaluating such loans.

¹⁷ The high-priced loans subject to this provision are laid out in the Homeownership and Equity Protection Act (HOEPA).

¹⁸ Speculators are active in nearly all investment markets, and the housing market is no different. However, unlike other investment markets, most housing market participants have a strong desire to consume the investment good, in this case the house. Thus, compared to other markets, speculation is a relatively minor consideration in housing markets.

¹⁹ See “Update on U.S. consumer lending initiatives – Single premium credit insurance on mortgage loans,” June 28, 2001, Citifinancial internal memorandum; “Household International to discontinue sale of single premium credit insurance on all real estate secured loans,” July 11, 2001, press release; and “First Union and Wachovia Announce Community Commitment for the new Wachovia,” May 24, 2001, press release.

²⁰ These scenarios hold true for a broad range of interest rates and assumes a discount rate of 10 percent. That is, we assume that money saved one year from now is valued in today’s dollars at 90 percent of its face value. The required decline in interest rates falls if a lower discount rate is assumed. For example, the required interest rate decline to cover two refinancings where the fees are 1 percent is about $\frac{3}{4}$ of a point if the discount rate is assumed to be 5 percent.

²¹ Source: Freddie Mac and author calculations.

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