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Predatory Lending 101

An Introduction

by *Mildred Wilkins*

Indiana has been a proud leader in housing starts and minority homeownership rates during the past decade. We have received national accolades for making the dream of homeownership a reality for so many. Many new loan programs have been created, underwriting standards relaxed, creative down payment programs implemented and widespread marketing established—all have been contributing factors in helping us achieve new heights in homeownership.

Simultaneously (and not coincidentally), the foreclosure rate has skyrocketed. The state of Indiana had the highest foreclosure rate in the nation during 2001. We are on target to keep that dubious title for 2002.

Foreclosure is an equal opportunity problem. Throughout Indiana, in small towns and large communities, newer subdivisions and older ones too, many young folk and old folk of all income levels are losing their homes in record numbers. Over 600 homes were offered at the Marion County sheriff's sale in September 2002. In one county, in one month, over 600 families lost their homes and lost their dreams. While discussions about root causes for the high foreclosure rate have revealed a multiplicity of factors, a repeated and disturbing factor is the presence of a loan most would call "predatory."

There is no agreed-upon definition within the industry of what exactly constitutes predatory lending. What is an acceptable business margin and what crosses the line and should be viewed as predatory?

I believe a clear-cut definition for predatory lending is any loan which is not in the best interest of the borrower.

Broadly, such a loan might have excessive broker fees, high closing costs (including points), credit life insurance (usually charged in advance for the life of the loan), a high interest rate, a yield spread premium, an inflated appraisal, taxes held in escrow significantly less than what the taxes will actually be or not escrowed at all, or a variable rate loan product for a borrower whose income is static. Any or all of these factors and any combination thereof increases the likelihood of default.

Simply stated, a loan which the borrower does not have the ability to repay and which a prudent lender could have predicted was likely to default is highly suspect of being a predatory loan.

While predatory lending is not a new practice, it has become significantly more widespread with foreclosure as the more visible outcome during the past three to five years. The various tools being used by traditional lenders as well as sub-prime lenders and builders in order to qualify home buyers and close transactions are sometimes not

viewed from the prospective of the long-term impact on the buyer. If one looked past "making the numbers work," would this loan, this home purchase, qualify as a good decision for all parties?

I believe that in our honorable efforts to make homeownership available to everyone, we have begun to overlook some basics related to financial planning, preparation for homeownership, grasp of the long term implications of ownership versus rental housing, and the value of having a vested interest in the property (down payment saved and paid by the borrower). Coupled with these factors is the fact that the home buying transaction is fairly complex and highly emotional, with lots of subjective instead of concrete components.

There are no simple answers. Consumers who buy a home once or only a few times in their entire lives don't have the opportunity to be good at it. Instead, they get a little information and then basically trust the professionals in the business to guide them.

A reasonable person might ask, "Where are we headed? Can we slow the rate of foreclosures in our state?" My response is that we can and we must in order to preserve our home values. During the next few months as I continue this series on foreclosures and predatory lending, I will explore some underlying causes and possible strategies we can consider implementing to turn this negative trend in a positive direction. We are at the forefront of a housing crisis, but we can make inroads if we bite the bullet, get informed and take corrective action. ★



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