Fighting Back Against Predatory Lending in the Home Loan Market

Published : July 18, 2001 in Knowledge@Wharton

In the 1990s, mortgage lenders discovered ways to lend profitably to consumers who previously could not qualify because of poor credit, or insufficient cash or income. This came to be called "sub-prime" lending. While the development of sub-prime lending stimulated a marked increase in the home ownership rate among lower-income and especially minority households, it had a serious downside. Some borrowers began to be victimized by abusive lending practices, which have become known as "predatory lending".

Predatory lending can take various forms. In some cases, lenders may encourage refinancing to generate fees but with no benefit to the borrower; in others, they may propose loans that a borrower cannot possibly repay, thus causing loss of the home. Unscrupulous lenders may also insert an undisclosed prepayment penalty or similar provision into the loan, charge excess fees or "points" and steer borrowers to mortgage types that carry high fees.

In response to the emergence of predatory lending, many states and municipalities have enacted or are actively considering legislation that outlaws practices employed by predators. In a paper titled, "Another View of Predatory Lending," Jack Guttentag, a finance emeritus professor at Wharton, points out that these practices have legitimate uses, and prohibiting them to curb predatory lending reduces credit availability to the people the legislation is designed to help. Guttentag proposes an alternative remedy that does not reduce credit and that would benefit the entire market – not just the sub-prime segment.

The major reason for predatory lending is the substantial barriers to effective shopping by even sophisticated borrowers. One barrier is niche pricing. Few borrowers understand that mortgage prices are affected by many variables involving the borrower, the property, the transaction and the documentation. Prices that are fully adjusted for all the specifics of a deal are "transaction specific". The prices quoted in the press or over the telephone are "generic," meaning that they are based on a set of standard assumptions that may or may not apply to a particular shopper.

In addition, the price is multi-dimensional, including the interest rate, upfront charges expressed as a percentage of the loan ("points") and upfront charges expressed in dollars. Furthermore, lenders typically offer a range of interest rate/point combinations from which borrowers can choose, including combinations with high interest rates and negative points or "rebates". Rebates are often used to conceal from shoppers how much mortgage brokers make on transactions.

The mortgage market is also volatile, with prices changing frequently and without notice. Most mortgage lenders reset prices every morning and sometimes change them during the day. This means that shoppers must make all their comparisons on the same day for comparability, and even this may not work if prices change within the day.

In addition, process delays can invalidate a shopper’s efforts. A borrower may correctly identify the best deal on a given day, but the selected lender will not lock in the price until the borrower has submitted an application. That can be many days later, at which point the selected lender may no longer be offering the best deal. In a similar vein, lenders will not guarantee settlement costs until right before the closing date, at which point the borrower has little leverage if the lender discovers a new cost.

Borrowers have tried several strategies for overcoming some of the pitfalls in shopping for a home loan. One is to submit applications to two (or more) lenders, allowing the price to float until all have been accepted and then selecting from the best lock price. However, few borrowers go this route because it is time consuming and risky. If the lenders find out about it, the borrower may lose both deals.

The Internet provides transaction-specific price quotes from multiple loan providers on the same day, which is a major help in shopping. Most borrowers, however, want a human to help guide them through the process. While many potential borrowers browse the net for information, less than 2% transact there.

To solve the problem of predatory lending in the home loan market, Guttentag advocates turning mortgage shopping over to mortgage brokers acting as the agents of borrowers.

Mortgage brokers can shop lenders much more effectively than consumers because brokers are in the market every day and know the market niches. Their relationships with multiple lenders position them to locate those supplying particular features. They are aware of which lenders can execute quickly and which take more time but may offer compensating benefits. And because lenders know that brokers are knowledgeable shoppers, price differences between lenders are smaller in the wholesale market than in the retail market.

Guttentag proposes that mortgage brokers be required to establish their fee in writing before submitting an application to a lender; to credit against the fee any compensation received from lenders; to pass through to the borrowers wholesale prices of lenders; and to communicate to the borrowers written confirmation of price locks received from the lender.

Guttentag has organized a voluntary association of mortgage brokers, which he calls "Upfront Mortgage Brokers," or UMBs, who have adopted these principles. While conventional mortgage brokers mark up the undisclosed prices they receive from lenders, UMBs pass through the wholesale prices quoted by lenders and charge borrowers a negotiated fee for their services that is stipulated upfront. Any fees paid to the broker by third parties involved in the transaction are credited to the borrower. The broker acts as the borrower’s agent in selecting the loan type and features that best meet the customer’s needs and in finding the lowest wholesale price.

Guttentag points out that brokers who agree to do business in accordance with UMB principles and who display these principles prominently on their web sites are listed on www.mtgprofessor.com. He expects this "best practices" association to grow as it becomes institutionalized as a nonprofit corporation with an initial grant from the Ford Foundation. Guttentag also believes that wholesale lenders that have a financial stake in the integrity of mortgage brokers will back this initiative. After all, they can only benefit from the reduction of predatory lending and the growth of healthy lending practices.