# Home Equity Reform

As most subprime lenders will explain, risk-based pricing is not necessarily a bad thing. Subprime lending—the practice of setting a higher price on a loan to a riskier borrower—has enabled families with a history of problem credit to get homes. Homeownership brings asset growth through equity building, and the vast majority of these borrowers pay their new mortgage in full and on time.[1]

On the other hand, some people may be paying subprime rates when they actually have prime credit. Others may not have shopped for a loan, but instead took one that was marketed to them directly through mail or telephone solicitation. These consumers may be paying more in fees, paying a higher interest rate, or borrowing more than they can afford to repay. Some people with sufficient equity in their homes may represent a good risk for a lender regardless of their ability to pay because their home can be foreclosed and resold if they stop making payments. This is predatory lending.

### Texas protections

In order to prevent any lender from targeting vulnerable borrowers, Texas instituted a number of consumer protections when it opened the home equity market for the first time in 1998.

- To preserve equity, Texas capped the amount borrowed at 80 percent of the home's value and prohibited home equity lines of credit.
- To enable consumers to pay off high cost loans early if they wish, Texas prohibited prepayment penalties.
- To impede "loan flipping" (multiple refinance transactions with high fees that strip equity each time) a consumer may only refinance a home once a year.
- Texas capped closing costs at 3 percent of the amount borrowed to eliminate the fee incentives for loan flipping. But some of these rules may not be protecting borrowers as well as lawmakers hoped.
- Texas forbade lenders from forcing their customers to shift unsecured debt over to a home secured loan.
- We legislated a three day right of rescision for consumers who feel pressured at closing, but then want to back out when they have time to read their closing papers. Consumers must also wait 12 days from the time they apply until the time they close while they read through their Good Faith Estimate and other pre-closing disclosures.
- We require loans to close at a title company or attorney's office, rather than at home where door-to-door sales can capture vulnerable borrowers.
- Foreclosure can only occur by court order.[2]

Despite these protections, consumers have begun to report very high cost loans and deceptive transactions to government regulators. Consumers Union reviewed some of these complaints and surveyed borrowers to determine whether Texas consumers are paying too much or facing deceptive practices in the market for home secured refinance loans.

### Fees higher than the three percent Fee cap

Texas law appears to strictly limit the fees that can be charged to a home equity borrower to three percent of the amount borrowed. This was among the strongest and most controversial consumer protections passed by the Legislature and the voters when Texas finally approved home equity lending in 1997.

But if the fees on your home equity loan seem far higher than three percent of the amount you borrowed, it could be perfectly legal. The statute prohibits "necessary" fees greater than three percent, except for "interest." So when you add up those fees, exclude fees that are not "necessary" from the capped fee amount (like credit life insurance). And lenders want you to exclude money you paid directly to your lender as well. Lenders say fees paid directly to the lender are "interest" (not "fees") regardless of what they may be called on the loan disclosures. Even a good lawyer may have trouble sorting it all out.

The exclusion of "interest" from the three percent cap enables lenders to charge significant fees, although the courts are only starting to interpret these provisions. For example, the law appears to state that fees paid "to any person" to "originate" loans should be capped by the three percent limit.

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This consumer paid more than $10,000 to close a home equity refinance loan, even though she borrowed only $59,200. Her new loan includes $3870.76 in credit life/disability insurance, lender discount points, and a fee of $2,663.33. Credit insurance is not covered by the fee cap because it is not "required," and lender points are "interest."

Just a few months after closing her husband became too ill to work, and she tried to use her credit disability insurance. The lender said the notation on her closing statement was a mistake--they do not sell this coverage in Texas. Instead, they said, she had purchased Involuntary Unemployment. While they would not pay her claim, they would refund her premium and apply the refund to her principal balance.

But lenders say that *lender* "origination fees" are actually "interest" under Texas case law and therefore they may charge origination fees of any size.[3] The Office of Consumer Credit Commissioner (OCCC) agrees.[4]

Mr. and Mrs. A. of Dimmit, Texas borrowed $26,800 against the family home in order to settle debts with credit card companies. In the original estimate, the Money Store indicated that it would charge a $520 origination fee, a charge that eventually climbed to $1,340 by closing. The couple felt they could not postpone the closing or look for another lender because their settlement date with their creditors was fast approaching. "We also felt that the law should protect us if they did charge more than 3% of the loan," they wrote to the Office of Consumer Credit Commissioner. The three percent fee cap would appear to limit fees to make this loan to a total of $804.

At closing they asked about the $1,340 loan origination fee, and were told it was perfectly legal. They went to several lawyers, who told them that it could be illegal but that they could not take such a small case on contingency. One attorney at least wrote a letter, and The Money Store responded:

"The $1340 fee in question was disclosed as "Loan origination fee to Lender" on line 801 of the Settlement Statement provided at the time the above referenced loan was closed. In fact, the $1340 fee is lenders points, which is properly disclosed as a loan origination fee. Whether characterized as points or loan origination fee, the $1340 is interest under Texas and federal law." The Money Store attorney cited several Texas court decisions interpreting the term "interest" broadly to include all money paid to a lender to make a loan.[5]

Long Beach Mortgage made these same arguments when Larry Thomison complained about two fees that exceeded his fee cap, a $680 loan origination fee and a $1,020 "loan discount." Thomison was able to find an attorney, and the case reached Judge Nowlin's federal court room late last year. Nowlin ruled that an "origination" fee paid to a lender was in fact a fee under the three percent rule—and further that anything called a "fee" would be a "fee" for purpose of interpreting the three percent cap. But he recognized that a distinction between a lender "fee" and "interest" was ultimately a "hair-splitting semantic debate" that could easily be gamed by the players.

"The Court fully realizes that the interpretation of 50(a)(6)(E) will lead to semantic and numerical games (assuming such games are not being played already)," wrote Nowlin. "This is due to the fact, that in instances such as this one, the stated name of the charge is dispositive, while the purported reason for the charge is irrelevant. This is a natural consequence of attempting to make a distinction between synonymous words, as "fee" and "interest" used in this context are. The semantic games will come in the form of simply changing "loan origination fee" to "prepaid loan origination interest" or some similar title. The numeric games will come in the form of shifting "fees" to "interest" and vice versa."[6]

Good Faith Estimates and settlement statements filed by consumers with the Office of Consumer Credit Commissioner illustrate the problem interpreting the three percent fee cap for most borrowers. Conseco charged three fees: a "Loan Discount," "Points" and a "Loan Origination Fee." While "points" are traditionally considered interest, would the use of the term "Origination Points" rather than "Origination fee" change the application of the statute? In a letter written after Nowlin's decision, The Office of Consumer Credit Commissioner counted the $300 Origination Fee as part of the capped three percent, but did not count the $9,600 in "Loan Discount" and "Points."[7]

Lenders can also pay fees that would ordinarily come under the three percent cap and then recoup that money through a lender charge that does not come under the cap and can be set at any level—the "numeric" games identified by Nowlin.

An East Texas man with a long history of good credit fell victim to cancer. With no insurance, the bills quickly overwhelmed the family and their credit score plummeted. "When the medical crisis passed we began looking for a "bill consolidation" loan to bring everything current as we had promised," they wrote.

But the loan from The CIT Group appeared to have added fees far in excess of the three percent cap. In fact, it was perfectly legal according to the OCCC. CIT provided a "lender credit" for exactly the amount of the title company fees and the appraisal ($1,482.40), charged the family nearly 3 percent in a single broker fee, and added more than $3,000 in a "loan discount" fee not covered by the cap. The "loan discount" fee was more than twice the "credit" and this consumer paid fees totaling 6.3 percent of the amount financed.[8]

The only limitation on such cost shifting is that all such lender fees must be disclosed as interest in the Truth in Lending box. And such behavior *might* be illegal if it can be proven that the lender intentionally shifted fees to interest to avoid application of the fee cap.

Theoretically, consumers should actually shop for the best loan deal based on the final interest rate expressed in the Truth in Lending disclosure. Unfortunately, consumers do not see this disclosure until closing, when many feel under a great deal of pressure to complete the deal. The Good Faith Estimate sometimes does not disclose key information like broker fees, and the fee allocation can completely change between the Good Faith Estimate and the final closing statement.

A Conroe consumer faxed her Good Faith Estimate to the OCCC. It showed fees of $2,390. At closing, her settlement charges had jumped to $5,654.89, including previously undisclosed "Discount" points and a $1,505 broker fee. "We were charged a broker fee after I had clearly ask the broker who paid his fee and was told the mortgage company paid him. Not us," she said. In addition, the final interest rate was 12 percent APR, up significantly from the 10 percent written on the Good Faith Estimate.[9]

### Flipping

The Texas Constitution prohibits more than one equity loan per year. While this may inhibit flipping, it has not ended it. D. Bowers of San Antonio reported to Consumers Union a series of home equity loans from 1998 to the present, staring with Green Tree and ending with Associates (see "Women in the Subprime Market, p. 1). Each time she sacrificed thousands in equity to closing costs and lender fees.

### Settling unsecured debt

Texas law currently states that a lender may not require a borrower to "apply the proceeds of the extension of credit to repay another debt except debt secured by the homestead or debt to another lender." An Austin couple reported that their lender required them to pay off unsecured debt, but the OCCC took the position that a lender "could require direct payment to creditors, especially if that action is needed to attain the desired income to debt ratio." In this case, the family had planned to use the new loan to pay off those unsecured debts anyway, but they wondered why the lender could require it when the law appears to say they cannot.[10]

### Backdating and the right of rescission

Fortunately, when consumers do see their final closing documents, some consumers take advantage of another protection in the Constitution—the three day right of rescission. Consumers report using their three day right of rescission to get out of bad loans. Because settlement disclosures are complex, and the final numbers may not be identical to the Good Faith Estimate, many people need time to digest the information, ask questions, and cancel if they don't like the answers. But some consumers report that companies ask them to sign documents dated days earlier, eating up their rescission period.

A state employee wrote to the Office of Consumer Credit Commissioner when Bank of America offered him a refinance loan on the internet. The entire transaction occurred by mail and via the internet, even though Texas law requires closing to occur in the office of an attorney, lender or title company. "We received the loan papers in the mail and were instructed to sign documents that had been predated as of 3/22/00. As I was out of town on business until 3/24/00, my wife and I signed the papers on 3/26/00." The Right to Cancel notice, also pre-dated 3/22/00, stated they needed to exercise their right to cancel by March 25. When the couple got their copies in the mail, they noticed unwanted credit insurance added to the loan. They wrote to Bank of America, providing proof that he was out of town on the date he supposedly closed his loan, and the company offered to settle their potential lawsuit by rescinding the loan.[11]

An elderly Waco couple, Mr. and Mrs. R., refinanced their home in April, 2000 with Beneficial. With only $18,350 left on their existing mortgage, they borrowed $27,259 to pay off two credit cards, a small Beneficial loan, and take some cash out.

But the new home loan bore an interest rate of 15.98 percent APR, nearly 6 percent higher than their existing home loan. Settlement fees, totaling 11.5 percent of the amount borrowed, included more than $2,500 in "points" and credit life insurance (neither fee counts towards the fee cap). Furthermore, the couple reported that they believed Beneficial intended to back date the loan documents. Mr. R told the Office of Consumer Credit Commissioner that the broker told them to "come by Saturday morning, 4/29/00, and pick up the check and sign the other check for pay-off and we will back date this so we are closed." They wanted to cancel the transaction within their three day recission period.

Beneficial denied any effort to backdate the loan documents. The couple signed a request to rescind their loan contract two days after closing and Beneficial cancelled the transaction. The OCCC sent a followup letter to the company advising them to "again advise your branch employees of the impropriety of backdating loan documents."[12]

### Evaluation of ability to pay

Texas did not pass, among its home equity protections, a requirement that lenders evaluate a person's ability to repay the note. Without such a protection, some

## Lenders shift closing costs from "fees" to uncapped "discount" charges

| Charge or Fee | Amount | In or Out of cap |
|---|---|---|
| Loan Discount of 3.5% to CIT | $3,012.87 | Out |
| Appraisal Fee | $300.00 | In |
| Mortgage Broker Fee | $2,419.00 | In |
| Broker Fee by CIT (POC) | $806.00 | Out |
| Title Insurance | $997.40 | In + |
| Escrow Fee | $75.00 | In + |
| Tax Certificate | $35.00 | In + |
| Messenger Service | $10.00 | In + |
| Express Mail | $25.00 | In + |
| Recording Fees | $12.00 | In + |
| Delivery Fee | $28.00 | In + |
| | | =$1,482.40 |
| 3% of principal amount (Cap) | $2,582.46 | |
| Subtotal of Fees | $3,901.40 | |
| Lender Credit--from CIT | $1,482.40 | |
| Total Included in 3% Cap | $2,419.00 | |

In this actual example, the sum of these fees equals exactly $1,482.40, the amount of the CIT "lender credit." This lender could shift settlement charges to an unregulated lender "Discount" charge because the fee cap does not apply to "interest." The consumer paid settlement charges totaling more than 7% including the lender fees.

lenders might make loans based largely on the available equity in the home. Since the home can be repossessed in the event of default, the lender is protected...but the consumer is ruined.

Mrs. T. of Lubbock, Texas was 79 years old and still working when she applied for a home equity loan with Conseco. Conseco based its loan offer on her credit (she was an A-2 borrower) and her current earned income. But at $463 per month, the new loan cost more than she would be able to pay once she finally retired.

"I am making the payment now because I am still working," she wrote to the Office of Consumer Credit Commission. "But at 79, I may have to stop working any day. $463 a month for 20 years is too much, even if I could pay that long. I will not live to 99."

In May 2001, Conseco offered her a cash-out refinance, initially promising $6,000 that she could use to install central air conditioning. But by the time the prepaid points and fees were paid, her cash amounted to only $2,848—not enough to pay for the central air. And her new loan bears an interest rate of nearly 14%.

Although her settlement charges amounted to more than 8 percent of the new loan amount, her loan did not violate any existing constitutional protections because most of the fees (an origination fee to the lender and "points") do not count towards the 3 percent fee cap. They are incorporated into the APR.

"I realize I should not have signed a contract like this. But I did not realize my mistake until my children told me I had been fleeced by Conseco," she wrote. "It should be against the law for someone to take advantage of naive seniors."[13]

## Recommendations

Current protections in Texas law are good and should be retained, including the loan to value cap and the waiting periods.

In addition, some protections, like the three percent fee cap, need to be fixed. A recent Model Act, developed by AARP and others, offers a solution to the semantic tangle created by a cap on "fees." For "high cost" loans, the AARP model prohibits *the financing* of fees. Lenders who cannot finance high fees will find them far more difficult to charge to consumers.

The National Consumer Law Center and the Self-Help Credit Union have defined loans as "high cost" if they have an interest rate that equals or exceeds six percentage points over the weekly average yield on five year treasury bills (currently about 3.5 percent but more typically ranging from 4 to 6.5 percent over the period of this study). These groups also define "high cost" as loans that contain fees in excess of three percent of the loan amount (or six percent of the loan amount for small loans--under $30,000).[14]

The Texas Legislature should set standards for "high cost" loans:

- Prohibit the financing of fees, closing costs, or other lender charges (including "prepaid" points and optional credit insurance) that rise above three percent of the loan amount. Current Texas law limits fees to three percent of the loan amount, but lender origination fees and points are not counted in that cap. Therefore, fees quickly rise to eight or ten percent of the loan and are usually financed by increasing the amount borrowed to cover the higher costs.
- Require loan counseling for any borrower getting a high cost loan during the existing 12 day waiting period before the loan closes.

Even borrowers getting subprime loans where the rate does not exceed six percent above the treasury rate deserve additional protections to preserve their home as an asset. Along with AARP and the National Consumer Law Center, we recommend:

- limiting "discount points" to legitimate charges that actually provide a substantial benefit to consumers. The AARP, the Self Help Credit Union, and the National Consumer Law Center,have created standards for "Bona Fide Discount Points" that would eliminate many of the problem fees consumers face at closing.
- Prohibit the financing of credit insurance or debt cancellation agreements.
- Prohibit lending without due regard to repayment ability.
- Prohibit "flipping," or the refinance of a home loan if the new loan does not have reasonable, tangible net benefit to the borrower considering all of the circumstances. This will include new loans at a lower interest rate if it will take the borrower more than four years to recoup the additional closing costs in savings through the lower interest rate.
- Other reforms relate to lender error, binding arbitration and more.

## Notes

[1] Mortgage delinquency rates in the first quarter of 2000, the final year of this study period, averaged about 3.75 percent, according to *Mortgage Banking*, while 5.5 percent of subprime borrowers were seriously delinquent. Today, the subprime delinquency rate has risen, and many housing advocates believe this reflects aggressive, equity skimming practices of some subprime lenders. Quinn, Lawrence, "The Delinquency Story," *Mortgage Banking*, February 1, 2002. Paul, Neol, Homeownership can be short-lived in inner cities," *Christian Science Monitor*, May 1, 2001.

[2] Article 16, Texas Constitution, Chapter 50.

[3] Consumer Complaint, 9/25/2000, Letter from Household Finance to Mr. William Purce, Office of the Consumer Credit Commissioner, November 22, 2000.

[4] Consumer Complaint, 9/25/2000, Letter to consumer from Mr. William Purce, Office of the Consumer Credit Commissioner, 1/22/2001. "Historically, the Texas courts have held that fees and charges paid to cover the overhead expenditures of the lender are interest; therefore origination fees (application fees) and points are considered interest under Texas law." See also Consumer Complaint, 12/18/2001; Consumer Complaint, 2/22/1999; Consumer Complaint, 1/25/1999. "This Office has issued an opinion that an origination fee paid to the lender (not a broker) is actually prepaid interest and is not subject to the three percent limitation."

[5] Consumer Complaint, 2/22/1999.

[6] *Thomison et. Al. V. Long Beach Mortgage Company*, 176 F. Supp. 2d 714, 717, U. S. District Court for the Western District of Texas, Austin Division, 12/ 27/01.

[7] Consumer Complaint, Office of the Consumer Credit Commissioner, 12/18/2001.

[8] Consumer Complaint, Office of the Consumer Credit Commissioner, 10/17/2001.

[9] Consumer Complaint, Office of the Consumer Credit Commissioner, 5/24/2000. See also Consumer Complaint, Office of the Consumer Credit Commissioner, 4/18/2001.

[10] Consumers Complaint, Office of the Consumer Credit Commissioner, 1/25/99.

[11] Consumer Complaint, Office of the Consumer Credit Commissioner, 7/12/2001.

[12] Consumer Complaint, Office of the Consumer Credit Commissioner, 4/26/2000.

[13] Consumer Complaint, Office of the Consumer Credit Commissioner, 12/27/2001.

[14] American Association of Retired Persons Public Policy Institute, "Home Loan Protection Act," November 2001.