The Tricks (continued)

Trick #4: Equity Stripping

Equity stripping is where the lender is depending more upon the value of the property to repay the loan than on the borrower's actual income or ability to repay the loan. As long as the value of the home at a foreclosure sale exceeds the amount of the loan, the lender will be made whole. Meanwhile, you as the borrower will be left without a home when you default. Sometimes, borrowers are encouraged to overstate their income in order to qualify for the loan. This is illegal, and cannot change the fact that the loan payments remain beyond the borrower's ability to repay.

Trick #5: Over-Inflating the Appraisal

Appraisals are undertaken by the lender to make sure that the value of the property will likely pay off the loan in case the borrower defaults. Their purpose is to protect the lender, not necessarily you as the borrower. If the initial appraisal indicates the home does not have enough value to support the loan, the mortgage broker might suggest that another more "friendly" appraiser come in to take a second look. While it might seem like an inflated appraisal is to your benefit, it does have its downside, particularly in the subprime market. First, the greater the alleged value of the property securing the loan, the greater the ability of the broker or lender to suggest or obtain higher fees. (i.e. Five percent of $55,000 is greater than five percent of $45,000.) Similarly, if a broker can get a lender to loan $60,000 when you are only seeking $45,000, the extra cash can be used as an inducement to go forward with the loan while being a vehicle to pay additional fees, in effect splitting the "windfall." You, for example, get an additional $7,500 in money to do what you like, while $7,500 in fees is tacked on to the loan to be financed. Second, an overinflated appraisal makes it difficult to refinance the loan later through a lower-rate mortgage. Then, if your credit improves or rates drop and you wish to refinance, it may be impossible to find another lender. Thus, you become locked into a subprime loan.

Trick #6 Insurance Packing

Credit insurance is a highly profitable product for most mortgage lenders; therefore, some lenders push borrowers to buy such products. Consumers need to shop around and see if other lenders offer better terms, or determine if existing insurance coverage they may have would already accomplish the same purposes. Multiple credit insurance products may be offered to some consumers where they are unneeded or unsuitable. Credit life insurance, credit disability insurance and credit unemployment insurance are the most common forms of credit insurance. For example, it would be wholly inappropriate for a nonworking retired senior citizen who is refinancing his or her house to purchase credit unemployment insurance.

Trick #7 Trapping the Mark

For a borrower in the subprime loan market, the goal should be to re-establish one's credit and, if possible, refinance the loan at a much lower rate. Large prepayment penalties can hinder refinancing, as can borrowing based on an inflated appraisal. A subprime consolidation loan with a balloon payment can also be a credit trap if borrowers fail to change their spending habits and run up the same credit card debts they had initially paid off. The effect of these loan terms, especially when combined with unreformed spending habits on the part of the consumer, ensure the consumer will remain trapped in the subprime, high-rate/high cost mortgage market.

Predatory Lending: Tricks of the Trade & How to Recognize Them

Ohio Department of Commerce
Division of Financial Institutions

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Helping Ohioans Borrow Smart

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Predatory Lending & Its Tricks

In today's lending market, more and more people can qualify for a home loan or equity line of credit. However, some unscrupulous lenders and brokers have taken advantage of the situation to place borrowers in unnecessarily costly and inappropriate loans for their own financial gain. This is known as predatory lending. While predatory lending can be found in all type of loans, it generally happens in the subprime loan market.

Subprime lending involves loans to consumers who do not meet standard lending criteria, either because of previous late payments, bankruptcy filings or an insufficient credit history. These loans are priced according to risk, with higher interest rates or higher fees than standard credit products. This lending market allows individuals who would not otherwise be able to purchase a home to find financing. While subprime lending is not bad in and of itself, it becomes a problem when predatory lending practices or "tricks" become part of the deal.

Some of the main tricks of the trade are:

- **Selling the Monthly Payment**
- **Flipping by Repeated Refinancing**
- **Growing the Debt**
- **Equity Stripping**
- **Overinflating the Appraisal**
- **Insurance Packing**
- **Trapping the Mark**

Here's how they work...

The Tricks

Trick #1: Selling the Monthly Payment

When dealing with loans, it is a mistake to focus exclusively on the monthly payment — it's not the whole story. Of equal or greater significance are — *What is the loan's interest rate and other finance charges as shown by its annual percentage rate (APR)? How long will it last and how much will it cost in total payments? Will the regular monthly payments pay it off, or is there one large balloon payment at the end? Is there a risk of the interest rate going up, and how will that affect the monthly payment?* In addition, when comparing claims of savings over your current mortgage payments, include the cost of setting aside the property taxes and home insurance if these costs are currently part of your monthly payments. Otherwise, it's comparing apples to oranges.

Trick #2: Flipping by Repeated Financing

This trick usually targets a person who has already been overcharged by the same lender or broker. It is an offer to refinance a high cost/high rate loan at a slightly lower rate than the one they arranged for the borrower within the past year or so. Since the initial loan's interest rate is needlessly higher than the one the borrower could qualify for, the borrower is soon contacted and urged to refinance. The catch is that the borrower is again charged, or more likely overcharged, for all the loan origination fees, broker fees, points, and other closing costs. The effect is that the consumer, who initially sought to borrow, for example, $50,000, and ended up borrowing $55,000 in order to finance the $5,000 in fees associated with the first loan, is now borrowing $60,000 since the same $5,000 in loan costs are again being charged. The consumer is now carrying an additional $10,000 in debt just to get the loans.

Trick #3 Growing the Debt

Upstreaming and wrap-arounds are efforts by lenders to grow the debt. Having borrowed a small amount to purchase an appliance or another consumer good, consumers are approached by the lender about borrowing more money. This usually ends up in the lender having the consumer refinance their mortgage and add in all their consumer debt for one loan payment secured by their home. While debt consolidation can have advantages, there are often serious risks as well. First, changing regular consumer debt into a mortgage loan means non-payment can now result in foreclosure and the loss of your home. Second, the monthly "savings" from a lower payment as a result of a mortgage consolidation or equity consolidation loan will be quickly lost if you run up debt on the credit cards you paid off.

Home improvement schemes also can lead to growing the debt. High pressure door-to-door salespersons urge homeowners to make expensive home improvements, which are funded through a connected lender. But instead of financing only the cost of the home repair, they seek to refinance the whole mortgage and add in the cost of the repair. The reason is that a loan origination fee of, for example, 2%, is worth a lot more if the loan is for $55,000 than for $5,000. The problem is that this "growing the debt" can result in situations where, for example, you are paying $6,000 in points and other loan fees to refinance the whole loan in order to get the $5,000 you need to pay for the home improvement. Suddenly, a $5,000 project costs $11,000.

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