

FYI: The Subprime Market: Wealth Building or Wealth Stripping for Older Persons

The American mortgage market has been the most efficient in the world, and has offered unparalleled financing opportunities. The “democratization of credit” has led to record numbers of Americans reaching the American dream of homeownership. Today, more than 2 of 3 households own their homes and equity in these homes represents approximately one-half of American households. For persons 65 or older, this represents more than \$2 trillion in home equity¹ – wealth transferable to future generations.

Today there is growing evidence that many borrowers are being sold products that strip, not build, home equity and household wealth. Innovative products with complicated and variable terms, once marketed to the “sophisticated borrower,” are now marketed to a less affluent borrower for their “affordability.” “Push-marketing” to borrowers who many times are not even shopping for a loan, often through telemarketing, as well as cross-marketing to mortgage shoppers (by acquiring lists from credit bureaus of recent mortgage “inquirers,” including a substantial amount of information on their financial activities), is common.

Many borrowers, especially the less affluent, are not able to absorb monthly “payment shocks” when variable terms reset, such as expiration of teaser rates and/or interest rate increases. Some borrowers discover that their mortgage cannot be paid off with the sale of the home, for example due to negative amortized loans or the current slump in housing prices.

Securitization has changed the mortgage market dramatically since the mid-1970s when most banks (the primary source of mortgage lending) held loans, and thus the risks, to maturity. Today, brokers account for over one-half of mortgage loans, and nearly all loans are quickly sold, bundled, and securitized. Many borrowers continue to believe that the person lending them the money is at financial risk if the loan fails, and would never offer an unsuitable loan. In fact, fee structures of loans are not based on the performance of the loan. Compensation often includes immediate payment to the broker, without any regard to the loan’s appropriateness or ultimate performance. In fact, broker fee structures often include more revenue from the lender for selling higher rate loans to borrowers who qualified for lower rate loans (yield spread premiums.)

When equity is stripped from first generation homeowners, disproportionately minorities in today’s market, it is stripped from future generations, and places at risk the recent success in decreasing minority homeownership gaps. When equity is stripped from older persons, it is stripped from children and grandchildren. In both instances, the clock cannot be turned backward to “catch back up.”

¹ U.S. Census data.

Why AARP is Concerned About Abuses in the Subprime Market

- ✓ **Older Persons, Persons of Color² are More Likely to Hold a Subprime Loan.** Borrowers 65 years of age or older were found to be 3 times more likely to hold a subprime mortgage than borrowers less than 35 years of age.³ In addition, numerous studies have shown that persons of color are much more likely than whites to have a subprime loan, even when similar in income levels.

- ✓ **Increasing Foreclosures in the Subprime Market Harm Individuals and Communities.** A recent study found that 2.2 million subprime home loans made in recent years have or will end in foreclosure, costing homeowners as much as \$164 billion.⁴ The same study estimates that one out of every five subprime mortgages originated during the past two years will end in foreclosure. For an older person, a foreclosure can mean losing a retirement nest egg as well as a lifetime of family memories without the ability to ever recover.

- ✓ **Lack of Clarity in the Responsibility of Broker Regarding Affordability.** Fannie Mae's 2003 National Housing Survey found that 41 percent of adults [mistakenly] believe "housing lenders are required by law to give you the best possible rates on loans."⁵ Borrowers should not be led to believe that brokers have responsibility for getting them the "best loan." Revenue for the mortgage broker is not related to the performance of the loan, but to the sale alone – often with a payment structure (yield spread premiums) that benefits the broker the interest rate on the loan.

- ✓ **Increasing Complexity of Products Make Disclosures Inadequate to Protect Consumers.** The complexity, terminology, and variability of these products are enormous, and choosing the right loan becomes difficult.⁶ Disclosures simply cannot compensate for the sophistication it takes to shift through all the information and assess the possible risk, given the vast array of possible outcomes – the professional in the transaction must be responsible for making appropriate loan offers.

- ✓ **Predatory Practices Strip Equity from Borrowers.** It is estimated that borrowers lose billions of dollars annually in predatory lending practices.⁸ In addition, there is evidence that anti-predatory lending laws are working such that lending continues to occur⁹ only without

² National Community Reinvestment Corporation, Fannie Mae Foundation, and the Woodstock Institute are among numerous groups with research findings showing disparate lending to minorities.

³ PPI Data Digest Number 57.

⁴ Center for Responsible Lending. Losing Ground.

⁵ Understanding America's Homeownership Gaps: 2003 Fannie Mae National Housing Survey.

⁶ Lacko, J and Pappalardo, J. (2004). The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment. The Federal Trade Commission.

⁷ The RESPA Report 2003.(2003). AARP's Public Policy Institute.

⁸\$9.1 billion in 2001. Stein, E. (2001). Quantifying the Economic Cost of Predatory Lending. Center for Responsible Lending.

⁹ Quercia, R. (2003). Anti-Predatory Lending Law: Doing What It's Supposed To Do. Center for Community Capitalism.

inappropriate and predatory terms, including prepayment penalties.¹⁰ In fact, a recent study offers that such laws may be precipitating an additional favorable outcome – they serve as a vital source of confidence for borrowers who might otherwise be afraid to participate in the mortgage market¹¹ with all the advertising, telemarketing, and volatility in the stock market.

AARP's Policy Position on Subprime Lending

- ✓ **Ability to Repay. Establish that every borrower has the ability to repay, without selling his/her home or refinancing into other loan.** The complexity of the market today, and the risk at stake (i.e., losing one's home) requires that the professional making the loan offer assess the borrower's situation, including income, as to the appropriateness of the loan, and not based solely on the value of the home. When underwriting variable products, future income must be considered with respect to potential increases at payments resets throughout the life of the loan.
- ✓ **Responsibility. Ensure that all parties, not just the borrower, have a stake in a successful loan outcome.** When Congress passed the HOEPA, it recognized that the secondary mortgage market could control the actions of the primary mortgage market. This is even more true today when the secondary market entities buying subprime and predatory mortgages not only provide wrongdoers access to the capital markets but actively shape, price, and underwrite many of the alternative mortgage products to their own specifications. Any new federal law must incentivize assignees to provide mortgage products with terms and costs that encourage responsible lending and that deter inappropriate lending. In addition, brokers, lenders, appraisers, and servicers must have appropriate responsibility – it cannot simply be left upon the shoulders of the borrower.
- ✓ **Regulators must increase vigilance in oversight.** Regulators must clearly and forcefully address the wide array of products and terms, and the breadth of professionals offering loans. Borrowers must be assured¹² that they can be confident in the banking system and the quality of loan products in the market. As early as 1998, HUD and the Fed recommended increased regulatory enhancements (via the Home Ownership Equity Protection Act, or HOEPA) to protect against predatory lending abuses. In 2000, these two agencies held joint hearings and issued a report recommending the expansion of consumer protections for homeowners targeted by predatory lenders. Yet, little action has been taken.

¹⁰ Wei, L. and Ernst, K. The Best Value in the Subprime Market: State Predatory Lending Reforms, Center for Responsible Lending (February 23, 2006).

¹¹ Bostic, Engel, et. al. State and Local Anti-Predatory Lending Laws: The Effects of Assignee Liability and Legal Remedies. Presented at the Federal Reserve Board's Conference, Financing Community Development. (March 2007).

- ✓ **Federal Legislation must serve as the floor, not the ceiling, and allow state laws to continue to protect borrowers.** Federal legislation is important to protect consumers in key areas in which states have been ruled to be preempted (Alternative Mortgage Transaction Parity Act), for example. However, federal preemption must be carefully crafted to ensure that it only preempts state law to the extent that federal law adequately addresses the issue. Broad federal preemption extinguishes states abilities, as “laboratories of democracy” to be responsive to the problems in their state. Economic indicators like housing markets and job losses will have disparate geographic impacts and states must be in a position to respond. Currently, states, Ohio and California to name two, have already begun to respond to recent economic trends and their impact upon housing markets and foreclosure issues.

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