

# **Findings from the HB 4050 Predatory Lending Database Pilot Program**

## **Introduction**

This report is the result of data collected by 11 HUD-certified Counseling Agencies that participated in the HB 4050 Predatory Lending Database ('PLD') Pilot Program from September 1, 2006 through January 19, 2007 ('Pilot Phase'). These HUD-certified Counseling Agencies were: ACORN Housing, Bethel New Life, Brighton Park Neighborhood Council, Chicago Urban League, Greater Southwest Development Corporation, Institute for Consumer Credit Education, LUCHA, Neighborhood Housing Services of Chicago, The Resurrection Project, Rogers Park Community Development Corporation, and Spanish Coalition for Housing. Housing Action Illinois provided technical assistance in compiling data and writing this report.

The Counseling Agencies firmly believe that providing information and insight to borrowers so that they can make informed decisions is critically important in sustaining home ownership for families and protecting neighborhoods from the devastation of the default/foreclosure/abandoned property cycle. Providing such a service to protect homeowners and neighborhoods can only be possible when the necessary resources are available.

## **Summary of Findings and Recommendations**

During the 20 weeks of the Pilot Phase, approximately 1,200 borrowers received File Review from a participating HUD-certified Counseling Agency. The most important findings from the data collected on each loan file reviewed during the Pilot Program are as follows:

- File Review helped borrowers better understand the costs and terms of their loans, leading to better-informed decision-making. More than half of the borrowers referred for File Review could not afford the loan they were being given by their mortgage broker/loan originator. 9% of the File Reviews showed indicia of fraud. While Counselors noted the indicia of fraud in the Predatory Lending Database, to our knowledge, the Illinois Department of Financial and Professional Regulation ('IDFPR') has not initiated investigations of any of these transactions to date.
- HB 4050 provided borrowers seeking refinance loans access to services that they otherwise would not have had available to them. 75% of borrowers receiving File Review were entering into a refinance transaction. This is a population of borrowers that typically do not participate in any kind of counseling, homeowner education program, or File Review prior to applying for financing.
- Counseling agencies did not find that HB 4050 limited borrowers' access to credit within the Pilot Program Area or that the Pilot Program Area was considered unattractive to new homebuyers. More than 300 different Illinois mortgage licensees originated loans for borrowers in the Pilot Program Area during the Pilot Phase.
- More than 60% of the borrowers who received File Review were obtaining loans with adjustable rates. It was evident during the File Reviews that in the majority of cases borrowers were being approved for financing solely on the basis of the initial or 'teaser' rate, without regard to the borrower's ability to afford the loan when the rate adjusted.

In addition to the Findings from the Counseling Agencies' experience in the initial phase of the HB 4050/PLD File Reviews, this report includes Recommendations from the HUD-certified Counseling Agencies about issues and concerns that should be addressed if HB 4050 were to be reinstated and continued.

## Findings

### **1. File Review helped borrowers better understand the costs and terms of their loans, leading to better-informed decision-making.**

#### ***Background:***

During the 20 weeks of the Pilot Phase, approximately 1,200 borrowers received File Review from a participating HUD-certified Counseling Agency. These 20 weeks included the six weeks (pre-Thanksgiving to New Years) that are traditionally the least active business weeks of the real estate and mortgage lending industries.

The 11 participating HUD-certified Counseling Agencies were staffed by 41 individual counselors who were trained and available to provide the File Review. All borrowers referred for File Review were able to schedule and complete the File Review with a participating HUD-certified Counseling Agency within the 10-day statutory time frame. There were no documented delays in the closing of loans because of a lack of counselors or delays in providing the File Review. From this perspective, HB 4050 had no adverse effect on either the mortgage lending or real estate sales processes. Delays in closings were typically caused by Loan Originators entering inadequate or incorrect information into the PLD, by Loan Originators changing the terms of the loans and thus triggering a 're-counseling File Review', or by borrowers' failure to schedule and complete a File Review session.

As part of the File Review, the staff of the participating HUD-certified Counseling Agencies entered data into the PLD regarding 12 'recommendations' specified in the statute for each loan file. These recommendations were based on the counselor's judgment regarding the borrower's level of understanding of the loan transaction; the 'affordability' of the loan; whether the loan was 'market rate' or above; whether the verbal information provided to the borrower by the Loan Originator matched the documentation and disclosures provided to the borrower; and whether information about the borrower's income and expenses entered into the PLD by the Loan Originator matched the information about income and expenses that the borrower provided to the HUD-certified Counseling Agency during the File Review. The HUD-certified Counseling Agencies were required by statute to make a judgment about the borrower's level of understanding of the loan transaction and whether there was any evidence of fraudulent behavior on the part of the lender, and to enter those recommendations into the PLD as well.

From the inception of HB 4050, the Illinois Department of Financial and Professional Regulation (IDFPR), the state administrative agency tasked with implementation of HB 4050, refused the HUD-certified Counseling Agencies' repeated requests to provide guidance or definitions of the terms in the administrative rules – terms such as 'affordability', 'market rate', 'fraud' etc. In the absence of any guidance or direction from IDFPR, the participating agencies discussed and agreed upon definitions of terms that would be used in responding to the required questions, as follows:

- "Above Market Rate" – The agencies agreed that any loan that had an interest rate that was in excess of the FNMA 30-year/60-day delivery rate plus 300 Basis Points would be considered 'above market rate'. For the Pilot Phase, the 'market rate' under this definition ranged from 8.95% to 9.36%, with the average rate during the Pilot Phase being 9.186%.
- "Cannot afford the loan" – The agencies agreed that any loan that resulted in a total 'Debt to Income' ratio ('DTI') of more than 45% would be considered 'unaffordable'. DTI is calculated by dividing the total gross household income (on either an annual or a monthly basis) by the sum of the total payments due (monthly or annually) for housing expense (principal, interest, taxes, insurance, mortgage insurance, condo fees) plus other obligations (minimum payments on revolving credit, installment payments, child care expenses, tuition).

- “Precipitously close to not being able to afford the loan” – The agencies agreed that any loan that resulted in a total DTI ratio (as calculated above) of 40% to 45% would be deemed ‘precipitously close’ to being unaffordable.
- IDFPR also refused to define or provide guidance on the definition of ‘fraud’ or ‘indicia of fraud’, and the determination of either fraud or indicia of fraud was left to the judgment of the individual housing counselor that performed the File Review.

**Compilation of the Recommendations from all the File Reviews yielded the following conclusions:**

- ***More than half of the borrowers receiving File Review received the recommendation “Cannot afford the loan.” or “Precipitously close to not being able to afford the loan,”*** meaning that they were applying for a loan that put them at high risk for failure, default and foreclosure.
- ***38% of borrowers had Debt-to-Income (DTI) ratios in excess of 50% of gross income,*** meaning that these borrowers would be spending at least 62% of their ‘take home’ income on their housing expense, leaving very little monthly income for utilities, food, transportation, and other necessities.
- ***Only 12% of all the File Reviews resulted in the recommendation that there were ‘No Issues’ with the loan.*** ‘No Issues’ meant that the information entered by the Loan Originator matched the information verified by the HUD-certified Counseling Agency; there were no indicia of fraud; that the borrower appeared to understand the transaction; that the loan had a ‘market rate’; and that it was ‘affordable’.
- ***22% of all loans were determined to be “Above Market Rate.”*** During a period when interest rates were relatively low (fixed rates in the 6.1% to 6.4% range for first mortgages for home purchase or refinance), 22% of borrowers were receiving loans that had rates that exceeded the ‘market rate’ as defined by the agencies – loans with interest rates in excess of the ‘market rate’ average of 9.186%. Another 55% of borrowers were receiving loans with interest rates that were at least 1.5% higher than the conventional first mortgage rates during the Pilot Phase (*i.e.*, rates of 7.99% and above). With higher rates of interest translating into higher monthly mortgage payments, coupled with ‘unaffordable’ DTI ratios noted above, these borrowers presented a picture that had a very high potential for mortgage default/failure and foreclosure in the not-distant future.
- ***9% of the loans reviewed contained indicia of fraud.*** Despite receiving notice of the suspected fraud and having this recommendation entered into the PLD, to our knowledge IDFPR has not initiated investigations of any of these transactions to date.
- ***9% of all loans reviewed contained either discrepancies between the information entered into the database by the loan originator and the information presented verbally to the borrower or evidence that borrower “did not understand the loan.”*** Mortgage loans are complicated transactions and the proliferation of new varieties of mortgage products in the market can create confusion. Borrowers tend to trust what they are told by their loan originator and do not understand what is written in the voluminous disclosures given to them.
- ***The overwhelming majority of borrowers who were receiving adjustable-rate loans were surprised when the HUD-certified Counseling Agency informed them that they were receiving an adjustable-rate loan and not a loan with a fixed rate for the entire term of the loan.*** In every case where borrowers were surprised to be told they were receiving an

adjustable rate loan, the Loan Originator had told the borrower that the rate was ‘fixed’ but neglected to mention that the term for which the rate was ‘fixed’ was limited to 12 to 36 months. Truth in Lending Act (TILA) disclosures do not adequately disclose this to the unsophisticated borrower. Additionally, borrowers often operate under the mistaken presumption that their loan originator has an obligation to obtain the best loan and interest rate for them. Most borrowers also did not understand that they were being charged substantial fees/costs for the loan.

- ***Some Loan Originators or Mortgage Brokers required borrowers to bring a \$300 fee to the Broker or Originator prior to scheduling the File Review, in violation of the statute.*** The statute specifically requires the Broker or Originator to pay for the File Review. In numerous cases, the Broker/Originator required the borrower to pay the File Review fee to the Broker/Originator who would then in turn issue a check to the Counseling Agency from their business account creating the appearance that the Broker/Originator was paying the fee. This was a direct violation of the statute. When the Counseling Agencies brought this to the attention of IDFP, they refused to investigate the complaint or to pursue disciplinary action against the licensee.

**2. HB 4050 provided borrowers seeking refinance loans access to services that they otherwise would not have had available to them.**

- ***75% of borrowers receiving File Review were entering into a refinance transaction.*** This is a population of borrowers that typically do not participate in any kind of counseling, homeowner education program, or File Review prior to applying for financing. In many cases, these same borrowers did not have the benefit of pre-purchase education before purchasing their homes, and did not understand the complexity of mortgage refinancing – specifically the nature of the loan products and fees involved.
- ***Borrowers tend to trust what they are told by their Loan Originator or Mortgage Broker rather than reading and understanding what is written in the Disclosures given to them.*** Based on the borrower interviews during File Review, there appeared to be relatively little concern by Loan Originators or Mortgage Brokers about the borrower’s ability to afford and sustain the loan, or for whether the borrower understood the terms of the transaction. Based on the independent verification made by the housing counselors, nearly 90% of ‘stated income’ loans reviewed during the Pilot Program over-stated the borrower’s income and thus put borrowers in jeopardy of default. In one case, when the housing counselor contacted the Broker about the overstated income in a file, the Broker proudly responded, “that is the purpose of a stated income loan – to overstate income.” As noted elsewhere, the overwhelming majority of borrowers receiving adjustable-rate loans had been told that they were receiving a fixed-rate loan.

**3. There is no conclusive evidence that HB 4050 significantly limited borrowers’ access to credit within the Pilot Program Area or that the Pilot Program Area was considered unattractive to new homebuyers.**

- ***More than 300 different Illinois mortgage licensees originated loans for borrowers in the Pilot Program Area during the Pilot Phase.*** The diversity of licensees that originated loans in the Pilot Program Area during the Pilot Phase belies the fear and claims that the requirements of HB 4050 would end lending in the Pilot Program Area and deny borrowers access to credit.

- **25% of borrowers receiving File Review were purchasing homes in the Pilot Program Area.** Of the 25% of borrowers who were obtaining financing for the purchase of a home, more than 31% of these buyers were buying into the Pilot Program Area from ZIP codes and neighborhoods outside the Pilot Program Area. This indicates that the requirements of HB 4050 did not halt home purchases in the Pilot Program Area, nor did it prevent new homebuyers from choosing to purchase and move into the Pilot Area.
- **HB 4050 had no adverse effect on the real estate market.** The Pilot Phase included what is considered the slowest time of the year in the real estate industry – Thanksgiving through New Years – a period during which traditionally there is a significant decline in both home sales and mortgage originations. Also during this Pilot Phase, the mortgage and real estate industries experienced both increases in mortgage loan rates and a general ‘softening’ of the real estate market throughout the entire Chicago metropolitan area.

**4. The loan products offered are typically at the discretion of the Loan Originator or Mortgage Broker, and loan underwriting does not generally take into account the borrower’s ability to afford and sustain the loan.**

- **More than half of the borrowers who received File Review were obtaining loans with adjustable rates.** Based on the verification of household incomes and debts, it was evident that in the majority of cases borrowers were being approved for financing solely on the basis of the initial or ‘teaser’ rate, without regard to the loan’s affordability when the rate adjusted. Since household income from all sources (wages, pensions, Social Security) does not rise in proportion to interest rate adjustments, nor are income sources as responsive to market forces as interest rates, it is highly unlikely that household income would sufficiently increase to cover the increased mortgage payments.
- **69% percent of File Reviews were completed for borrowers with credit scores of 620 and below,** which was one of the statutory ‘triggers’ for File Review. Recent years have seen a proliferation of conventionally-priced mortgage products for borrowers with credit scores below 620, but those borrowers who received File Review generally believed that a sub-prime loan was their only alternative, often because they had been told so by the Loan Originator. Many of the affordable loan products offered to first-time homebuyers and low/moderate income borrowers now use a credit score of 580 as the threshold for qualifying for a conventional rate loan; so many of these borrowers could have qualified for a more affordable loan had they been better informed about what was available to them.
- **30% of borrowers had credit scores in excess of 620,** but received File Review because their loans contained features that met other statutory ‘triggers’ such as: prior financing of the property within the previous 12 months; interest-only loan payments; adjustable rate loans with less than a 3-year initial rate period; ‘stated income’ loans (where the lender does not require independent verification of a borrowers’ income); loans with prepayment penalties; loans that resulted in negative amortization and total points & fees in excess of 5% of the loan amount.
- **Borrowers with credit scores in excess of 620 would generally have been acceptable borrowers for a more conventional and prime-rate product,** rather than the higher cost/improvident characteristic loans for which they were applying. 10% of borrowers had credit scores of 650 or above, which would generally qualify them for a conventional loan product.

## Recommendations

IDFPR released proposed rules for a redesigned HB 4050 Predatory Lending Database Pilot Program on March 21, 2007. IDFPR has proposed these Rules without any direct consultation with the HUD-certified Counseling Agencies that provided the File Review in the initial Pilot Phase. Pending formal comment on the rules, the HUD-certified Counseling Agencies offer the following recommendations:

**1. *IDFPR should not move forward with an expanded program without analyzing or understanding what was learned from the initial Pilot Phase program.*** During the Pilot Program, the counseling agencies entered information about individual borrowers into the Predatory Lending Database. This database was then and is now under the sole control of IDFPR. To date, there has been neither any public disclosure from either IDFPR or the State legislature regarding what was learned during the initial Pilot Program; nor any published analysis of the data collected to determine the impact of the Pilot Program on borrowers, lenders, the loan products provided, or the market.

**2. *There is a significant lack of qualified staff among HUD-certified Counseling Agencies to implement a Pilot Program on a county-wide basis;*** and there are very few HUD-certified Counseling Agencies staffed and available to provide File Review in the majority of the suburban areas of Cook County. There are currently only two HUD-certified Counseling Agencies servicing the north suburban portion of Cook County, and these agencies have a total of only 2 housing counselors.

The Woodstock Institute has estimated that implementing HB 4050 under the proposed rules would impact in excess of 19,000 loans annually. Taking into consideration the capacity of the HUD-certified Counseling Agencies in Cook County to provide File Review under the proposed rules, we estimate that a minimum of 25 new Housing Counselors will need to be hired and trained in order to provide the volume of File Review contemplated under the proposed rules – a 60% increase in counseling staff among the HUD-certified Counseling Agencies. Without sufficient staff in place to provide the File Review, the proposed program is guaranteed to fail.

**3. *The involvement of HUD-certified Counseling Agencies in an expanded Pilot Program will depend on a demonstrated willingness on the part of IDFPR to work collaboratively in partnership with the HUD-certified Counseling Agencies.*** The HUD-certified Counseling Agencies provided recommendations for program improvements to IDFPR on several occasions during the Pilot Phase. To date, IDFPR has refused to respond to or address any of those recommendations.

**3. *IDFPR must provide more training to its Licensees before implementing an expanded renewed program.*** In the initial Pilot Program, there was a lack of training for mortgage licensees. The lack of training and technical support to licensees by IDFPR resulted in mortgage licensees calling HUD-certified Counseling Agencies for advice on how to implement the requirements of HB 4050 and how to use the PLD software. In addition, the HUD-certified Counseling Agencies must be part of the training program offered to licensees, to address the misinformation and misunderstanding about the File Review process before an expanded program is implemented.

**4. *IDFPR must create and implement a complaint process and a defined schedule of disciplinary actions to respond to issues identified during the File Review.*** The HUD-certified agencies identified the lack of response from IDFPR regarding complaints of fraud and the reluctance/refusal of IDFPR to implement a standard complaint process as serious failings during the Pilot Phase. If the PLD program is to have any impact on preventing foreclosures, there must be a measure of accountability imposed on both IDFPR and its licensees. Effective enforcement action by IDFPR is a necessary component of the program if the Pilot Program is to have any meaningful impact on the predatory lending crisis.

**5. IDFPR should adopt the definitions of terms in the statute as developed by the HUD-certified Counseling Agencies.** The statute does not establish a protocol for the File Review, nor does it define terms such as “affordability”, “market rate”, etc. as noted above. To ensure that the intent and spirit of the statute are served and to ensure consistency and transparency in the File Review process, IDFPR should adopt the definitions that have been developed and, by working collaboratively with the HUD-certified Counseling Agencies, agree to a process/protocol for File Review.

**6. IDFPR should establish a centralized system for collection of File Review fees and disbursement to the HUD-certified Counseling Agencies as File Review is completed.** IDFPR regulates and licenses mortgage lenders, mortgage brokers and Loan Originators that are required by statute to pay the cost for the File Review. The proposed Rules recognize that the \$300 fee charged for File Review in the Pilot Phase meets the ‘reasonable and customary cost’ test of the statute. Insofar as the HUD-certified Counseling Agencies have no authority to enforce the collection of the fee and IDFPR is charged to implement the statute, IDFPR should take responsibility for ensuring that their licensees pay for the File Review.