NCLR
NATIONAL COUNCIL OF LA RAZA

The Impact of the Home Equity Lending Market on Latino Consumers

Submitted to:

The Board of Governors of the Federal Reserve System
In conjunction with Docket No. OP-1253

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August 15, 2006

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On behalf of the National Council of La Raza (NCLR), please accept these written comments in conjunction with the Home Ownership and Equity Protection Act (HOEPA) hearings held by the Federal Reserve. As the nation's leading Hispanic organization, NCLR works to improve opportunities for more than 41 million Hispanic Americans. NCLR applauds the Federal Reserve for initiating the HOEPA hearings across the country in June 2006. Latino families are entering the mortgage market in record numbers, and their participation stands to have significant influence over the size and shape of the market. Given current market conditions and the limited experience that Latinos have in the mainstream financial services market, it is critical to consider the effectiveness of consumer protection laws on all constituencies.

NCLR has a long history in the financial services field. For more than two decades, NCLR has actively engaged in relevant public policy issues such as preserving and strengthening the Community Reinvestment Act (CRA) and HOEPA, supporting strong fair housing and fair lending laws, increasing access to financial services among low-income people, and promoting homeownership in the Latino community. In addition to its policy and research work, NCLR has been helping Latino families become homeowners for nearly ten years as a sponsor of housing counseling agencies. The NCLR Homeownership Network (NHN) works with 15,000 families annually, approximately 2,500 of which become homeowners. NCLR has sophisticated relationships with major financial institutions, which allows NHN counselors to prequalify their mortgage-ready families according to the product specifications of their partners. Our subsidiary, the Raza Development Fund (RDF), is the nation's largest Hispanic Community Development Financial Institution (CDFI). Since 1999, RDF has provided $400 million in financing for locally-based development projects across the country, building the capacity of local nonprofits and creating opportunities for Latino communities. These relationships have increased NCLR's institutional knowledge of how Latinos interact with the financial marketplace.

Through its series of public hearings in June 2006, the Federal Reserve sought the perspectives of a wide variety of mortgage industry stakeholders on the impact and effectiveness of existing HOEPA regulations. Specifically, the hearings were held on three topics: the impact of state and local predatory lending laws; the rise of nontraditional mortgage products; and the manner in which consumers choose mortgage products. As part of the hearing held June 9, 2006 in Philadelphia, Pennsylvania, NCLR had the opportunity to offer its perspective on the status of the mortgage market and its impact on how Latino consumers obtain their mortgage product. In our testimony, we concluded that a series of market forces result in the de facto channeling of Latino borrowers to high-cost, high-risk mortgage products. In these written comments, NCLR will expand on our initial testimony to address additional issues raised in the hearings which are of concern to the Latino community. First, we summarize the current status of the mortgage market and its impact on Latino consumers. Next, we examine the corresponding consumer protections and their role in providing balance to the market. Third, we discuss housing counseling as a best practice model for educating consumers. Finally, we conclude with a set of recommendations for the Federal Reserve and other policy-makers.

The Status of the Mortgage Market

NCLR's experience in partnering with financial service institutions and providing homeownership counseling to Latino borrowers reveals that there is much that mortgage industry stakeholders have yet to understand about the Latino community. Latino and immigrant families face a number of unique underwriting challenges that the mortgage market is ill-equipped to process effectively. For example, 22% of Latinos have a "thin" credit file, or no credit history, which usually results in a "0" credit score, compared to only 4% of Whites.[1] Moreover, approximately 35% of Latino families do not have basic checking or savings accounts.[2] This suggests not only inexperience with mainstream financial service providers, but also the potential presence of a largely cash-based savings that is difficult to verify. While mortgage products exist that use nontraditional credit to establish an acceptable credit history and allow for a certain amount of cash income or savings, they generally require manual underwriting, which is time- and resource-intensive for a lender. In addition, compensation systems tend to make manually underwritten loans less attractive to loan officers. NHN organizations prequalify families only for prime and FHA/VA loan products Almost nine out of ten (88%) of these families have incomes below 80% of Area Median Income (AMI), busting the myth that low-income, nontraditional credit families cannot qualify for prime products. Rather, lenders effectively limit the credit made available via such flexible products because of the increased cost of underwriting a family with such barriers. These structural factors effectively bar many Latino families from obtaining prime mortgage financing.

This practice of credit rationing has contributed to the growth of the subprime market. Not unlike the prime market, in the subprime market efficiency, automation, and accuracy are key to maximizing profit. The subprime market does not refer its "hard-to-serve" clients to another market. Rather, lenders in the subprime market rely on risk-based pricing models to price loans for any risk level. The criteria for gauging risk are discretionary, vary by lender, and are centered on making profits rather than the appropriateness of the loan to the consumer's financial situation. Lenders use credit enhancements such as increased interest rates and prepayment penalties to offset the perceived risk and increased cost of a manually underwritten client. In some cases, lenders sell Latino families Stated-Income loans rather than take the time to verify their cash income and savings. According to data collected via the Home Mortgage Disclosure Act (HMDA), 11% of Hispanic denials for conventional loans were due to unverifiable information. Thus, Latinos and other minorities find themselves channeled toward the products most profitable to the lender, but which are expensive and risky for borrowers. For example, new research shows that Latinos are 30% more likely than Whites to receive a high-cost loan (one that meets the HOEPA rate spread) when purchasing their home. Other research shows that alternative mortgage products such as Option Adjustable Rate Mortgages (ARMs) and Interest-Only mortgages are disproportionately concentrated among minority borrowers. Latinos are more than twice as likely as Whites to receive a payment option mortgage.

Furthermore, the subprime market is segmented between retail and wholesale loan providers. Since wholesale delivery is less expensive, lenders looking to cut costs and increase profits have come to rely heavily on market intermediaries, or mortgage brokers, who originate two-thirds of the nation's mortgages by most estimates. To lenders, market intermediaries promote themselves as a less expensive alternative to retail operations that also provide greater reach into

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[1] Stegman, Michael, *et al.*, "Automated Underwriting: Getting to 'Yes' for More Low-Income Applicants," Presented before the 2001 Conference on Housing Opportunity, Research Institute for Housing America Center for Community Capitalism, University of North Carolina-Chapel Hill, April 2001.

[2] Pew Hispanic Center/Kaiser Family Foundation, *2002 National Survey of Latinos*. Washington, DC: 2002.

diverse markets. Consumers, especially Latinos, also rely on the services of mortgage brokers. Bilingual and bicultural brokers market themselves as agents who can be trusted to find consumers the best "deal." Many brokers are outperforming the prime and retail institutions in their service to Latino families by diversifying their workforce, offering a wider range of products, and adopting a one-on-one style that makes Latino families feel comfortable. However, Yield Spread Premiums (YSPs) offered by lenders provide financial incentives for brokers to steer borrowers to products that are more profitable for themselves rather than those most suitable to the client's needs.

The financial risk to consumers created by the layering of subjective pricing and credit enhancements are exacerbated by the rise of nontraditional and non-amortizing mortgage products. In the current market, profit margins are narrowing and competition is increasing. Lenders have responded by promoting mortgage products originally designed for market-savvy investors as affordable alternatives for first-time homebuyers. Such products as Interest-Only loans, Option ARMs, and Stated-Income are sold to marginally-qualified borrowers while relying on credit enhancements to mitigate the lender's and investor's risk. Consumers, on the other hand, lack a comparable credit-enhancement-style tool to offset their own risk. A recent study by the Federal Reserve concluded that many low-income, lesser-educated borrowers did not understand many features of their ARM loan and could not estimate the probable increases in their interest rate. Nontraditional products are becoming increasingly popular, with double-digit sales increases in recent years. Recent projections of a rise in foreclosure rates raise legitimate concerns that these products will have long-term consequences for the affected borrowers, communities, and investors when rates reset.

The Impact of Consumer Protections

It is clear that, in the current market condition, it is the consumer who carries the brunt of the risk in the mortgage transaction. As described above, lenders protect themselves from losses by executing a business plan that compensates for a certain percentage of losses. Most securitization and risk models in the subprime market, for example, anticipate holding a loan less than three years. By that time, most loans are sold, refinanced, or liquidated, as in the case of a foreclosure. Thus, lenders use prepayment penalties and over-collateralization to make their securities pools more attractive to investors. Comparatively, consumers lack the information and experience to put them on a level playing field with industry professionals. Consumer protections are required to offset the informational asymmetry that favors brokers, lenders, and investors, and to allow consumers to share their risk burden with the other players in the mortgage market.

For most consumers, the process of purchasing a home begins with an information-gathering stage. Many buyers formulate their initial perception of the real estate market by investigating their local market through the Internet, the local newspaper, and existing bank relationships. Next, most consumers reach out to a real estate agent or broker or lender who guides them through the process. Latino and immigrant families, on the other hand, rely heavily on informal networks such as word-of-mouth and Spanish-language outreach (print and radio media) and are likely to seek out a "trusted advisor" whose credibility has been established within these informal networks. Anecdotal comparisons of Spanish-language newspapers and mainstream English-language papers demonstrate a stark contrast between the products targeted to the different communities. Spanish-language papers almost exclusively display advertisements from subprime financers and mortgage brokers. Even when mainstream institutions placed advertisements in the Spanish-language press, they mirrored those products advertised by the other lenders: Interest-Only, Payment Option ARM, and Stated-Income loans. Mainstream newspapers, however, feature convenient charts that compare the major local mortgage institutions and their competing rates for standard mortgage products. Since financers of non-prime and high-risk mortgage products have little if any incentive to up-sell their clients to less risky mortgage products, many Latinos and others less-connected to mainstream financial institutions or information sources are set on a path early on that limits the mortgage options they will be presented.

Homeowners attempting to refinance their mortgage face different challenges. Increasingly, homeowners are the focus of push marketing tactics of mortgage brokers, real estate agents, and wholesale lenders that are under increased pressure to produce volume in a shrinking market and tight profit margins. A survey completed for NCLR in 2005 revealed that 76% of Latino homeowners had been solicited by a financial institution recently. Reports from across the country confirm that the most egregious of these predatory lending cases occur when a mortgage broker partners with another industry representative (real estate agent, appraiser), solicits the family, and convinces them to refinance. In most cases, borrowers are solicited for the highest-cost and riskiest mortgage products without regard to their financial suitability to the situation of the borrower.

There are few protections available for consumers steered in this manner. Generally speaking, consumers are not protected from targeted marketing efforts designed to shortcut a borrower's path to the most expensive products. A handful of cases around the country have applied Unfair and Deceptive Acts and Practices (UDAP) or false advertisement laws to prosecute the worst offenders. However, application of such protection is far from consistent, leaving many borrowers unprotected. Claims of mortgage fraud are difficult to prove, and often pit the word of the professional broker against the uninformed consumer. Despite consumers' perception to the contrary, mortgage brokers do not have any professional or legal responsibility to provide borrowers a product that is suitable to their needs. Moreover, weak underwriting standards allow originators to process loans that appear affordable for the borrower in the short-term, but which they will be unable to pay as interest rates rise or the terms of their loan reset.

Consumers are at a further disadvantage because the tools necessary to shop effectively are not available. Mortgage packages vary considerably from lender to lender and change often, sometimes daily, making it difficult to compare multiple loan opportunities. Moreover, the consumer protections available via the Real Estate Settlement Procedure Act (RESPA), Truth in Lending Act (TILA), and HOEPA are generally limited in scope or applicable too late in the mortgage application process to prevent the borrower from receiving an unsuitable product. For example, Good Faith Estimates (GFEs) are required to be sent to the borrower within three days of a loan application. However, many lending institutions prequalify or preapprove their clients during an initial meeting, which clients use to shop for their home. Once they have found a home, they return to their lender to complete the full loan application and close their mortgage at the same time. Thus, borrowers may not receive a GFE in a timeframe that is conducive to shopping. Moreover, they may not receive their disclosures until they are at the closing table when they are unlikely to fully take in the information or stop the closing process. Many Latino consumers report feeling obligated to complete the loan process with a given agent once they have begun, especially at the late hour of closing. In another example, HOEPA protections do not apply to purchase mortgages. Since many instances of financial abuse in the Latino community occur during the purchase transaction, this is especially problematic.

In absence of other reliable shopping methods, many consumers turn to intermediaries to shop on their behalf. Internet search platforms are a new kind of intermediary whose full capabilities are just being explored. Although these services are relatively new, their presence suggests a desire by consumers for tools that allow them to shop for products and services. Most consumers, however, rely on mortgage brokers, whom they see as professional, trusted sources of credible information; borrowers often assume that their broker is obligated to work on their behalf. Others in the industry believe that competition forces mortgage brokers to maintain low prices and fair deals. However, brokers do not have a duty of fair dealing to their borrowers, and most consumers are unlikely to receive price quotes from more than one mortgage broker. As mentioned above, the consumer protections that govern borrower-broker relationships fall woefully short of the demands of the market.

Other Latino consumers are left out of federal protections completely. For example, approximately 12% of Latino families with a mortgage have a Contract for Deed – a rent-to-own type arrangement between the seller and buyer.[3] The contract is usually initiated with a downpayment and stipulates the minimum number of monthly payments required, among other obligations, before the borrower is eligible to assume the property. During this time, borrowers have little control over the property; they do not own the asset, receive no tax benefits, and are excluded from typical homebuyer protections. Many contracts include harsh penalties such as loss of downpayment or eviction for payments as late as three days. Similarly, one in 15 Latino homeowners lives in mobile and manufactured homes.[4] Many mainstream lending institutions will not finance a mortgage for a mobile or manufactured home, and many such homes are still sold as personal property rather than real property. In lieu of traditional financing, most families must go through home dealers, similar to an auto loan. Though TILA is applicable, investigations into reported abuses by mobile home dealers found interest rates between 9% and 13% higher than normal rates, miscellaneous fees (many of which were financed), prepayment penalties, and unnecessary insurance add-ons. Borrowers also complained of bait-and-switch scams; they were delivered a mobile home different from what they ordered, with few viable options for legal recourse. Several Texas-based industry whistleblowers verify that Hispanics, who constitute almost half of Texas' manufactured housing population, are specifically targeted by dealers who often make verbal promises in Spanish that are different than the terms contained in the contract, which is in English.[5]

Consumer Education Best Practices

Many efforts exist to increase the awareness of borrowers regarding the variety of mortgage products available. Many financial institutions and government agencies have created financial

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[3] U.S. Census Bureau, *American Housing Survey*, 2005.

[4] *Ibid.*

[5] *In Over Our Heads: Predatory Lending and Fraud in Manufactured Housing.* Texas: Consumers Union, February 2002.

literacy and homebuyer education materials. However, without a proven delivery method, such as through community-based organizations, such materials are not likely to have a significant impact on the level of awareness of borrowers. In general, group education, Web-based courses, and telephone counseling are considered to have only a marginal impact, and usually target consumers who are likely to seek out the information regardless. Of all methods, housing counseling has proven the most effective way to measurably improve borrowers' understanding of their individual loan opportunities and empower them to make the best decision for their family. Housing counselors are without a financial interest in the terms of the borrower's loan and can provide objective, individual advice.

In the early 1990s, NCLR partnered with Fannie Mae and First InterState Bank to design and implement one of the earliest pilot projects to test the feasibility of new approaches to homeownership. The pilot combined flexible underwriting guidelines, pre-purchase housing counseling, and downpayment assistance to provide mortgages to nearly 500 families, all of whom earned below 80% of Area Median Income (AMI), with half going to families below 60% of AMI. An independent evaluation conducted by the Morrison Institute for Public Policy found that the three most important factors that facilitated participants' successful transition to homeownership were: (1) in-depth, one-on-one housing counseling; (2) the provision of services by trusted community-based agencies; and (3) a more flexible, more affordable mortgage product. Somewhat surprisingly, the evaluation found that downpayment assistance had a negligible effect on successful participants' capacity to purchase their home. Subsequently, Fannie Mae and First InterState reported the delinquency and foreclosure rate for the pilot portfolio to be well below industry averages.

With this experience, NCLR created the NCLR Homeownership Network (NHN). NHN organizations provide bilingual homeownership counseling to Latinos. Approximately 80% of NHN clients are not ready to purchase a home in the short-term. NHN counselors review credit reports, create family budgets, and prepare goal-oriented work plans, giving them the tools they need to achieve homeownership. Once mortgage-ready, counselors provide families with at least three comparable, competitive mortgage products and package the required documents for the lender. Counselors provide financial institutions a valuable service as well, by documenting alternative forms of credit and income.

Unfortunately, not every vulnerable borrower has access to a certified housing counselor. Housing counseling is expensive to administer and relies heavily on grant funding to operate. Counselors often compete against subprime financers who use risk-based pricing to immediately qualify a client for an expensive mortgage rather than provide them guidance as to how they could qualify for a safer, more affordable product. Moreover, their hard work is lost without the reinforcement of strong consumer protections and accountability standards for the other market intermediaries and lenders.

Recommendations
Intermediaries are clearly the new mechanism for delivering mortgages to most homebuyers and homeowners. However, regulations and consumer protections are not keeping pace with the changing dynamics of the mortgage market. Regulators and law-makers must ensure that

consumers and lenders receive accurate and timely information regarding the transaction. NCLR makes the following recommendations:

- **Improve accountability standards.** The Federal Reserve should take the lead in crafting a suitability standard that will provide an incentive for mortgage brokers and lenders to place families in products amenable to their financial situations and long-term financial goals. Such a standard should also expressly prohibit steering consumers to a high-cost product or an entity that exclusively offers high-cost products. NCLR has supported the concept of creating a duty of fair dealing for mortgage brokers analogous to that in the securities industry. Such a standard not only would hold brokers more accountable for their representation to the borrower, but would create a level of transparency that is currently absent in the process.

- **Invest in housing counseling.** While many industry stakeholders have held increased education as a potential remedy for the lack of information in the marketplace, few are doing enough to support and strengthen the counseling industry. NCLR urges the Federal Reserve to establish an incentive for investing in housing counseling. In addition, the Board can bolster the efforts of industry leaders, advocates, and government agencies to increase federal funding for housing counseling.

- **Strengthen enforcement and consumer remedies.** The existing HOEPA regulation was intended to solve predatory practices common in the mid-'90s, which primarily consisted of abuses in the refinance market. Now, much of the abusive activity takes place during the initial home purchase stage, often setting a family up to refinance a few years later. HOEPA should be amended to handle home purchase abuses such as targeted and push marketing, steering to high-cost products and lenders, and the use of teaser interest rates. With the new interagency guidance soon to be released, the Federal Reserve should set a high standard for compliance by holding unethical lenders accountable and ensuring that victims have access to meaningful remedies.