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HELPING SUBPRIME BORROWERS: GOVERNMENT, PUBLIC INTEREST GROUPS MAKE VOICES HEARD

by **Brian Witkowski**

Because of the nation's subprime mortgage crisis, up to 500,000 homes are at risk of foreclosure in 2007, with up to two million mortgages resetting to higher rates by the end of 2008.[1]

The federal government is attempting to ease the crisis by providing financial relief to at-risk homeowners, allowing more borrowers in the future to qualify for government-backed loans at lower interest rates, and requiring lenders to fully and clearly inform borrowers of the terms of their loans.[2]

Subprime mortgages are loans with higher interest rates than prime loans and are intended for borrowers who do not qualify for the lender's prime rate.[3] Reasons for not qualifying for the prime rate include a high debt-to-income ratio, income that cannot be documented, and most frequently, a bad credit history.[4] Borrowers with these traits are often given subprime adjustable-rate mortgages (ARMs) – nontraditional loans with low initial interest rates that "reset" to significantly higher rates at the end of a defined time period.[5]

The problem with subprime ARMs, according to Todd Zywicki, a Senior Scholar at the Mercatus Center at George Mason University, is "payment shock" — borrowers are often unaware of the impending large increase in their mortgage payments at the end of the initial low-rate period or, even if they are aware, are unable to meet the suddenly higher mortgage payments.[6] The effects of payment shock include higher rates of delinquency and foreclosure.[7]

In the first half of 2007, approximately 635,000 foreclosures were initiated, which represents about one in every 196 homes in the United States.[8] More than half of all foreclosures initiated were on subprime mortgages.[9]

Recognizing the mounting problems caused by ARMs and subprime mortgages generally for homeowners and financial markets alike, the federal government is acting to protect those homeowners currently at risk of foreclosure and also those who would be vulnerable to the dangerous consequences of such loans in the future.[10]

In August 2007, President Bush announced a plan to aid struggling homeowners.[11] The main component of the plan — a new government initiative called FHASecure — would allow borrowers with a history of on-time payments, but who are currently in financial trouble due to higher variable rates, the opportunity to refinance into lower, fixed-rate mortgages insured by the federal government.[12]

According to the U.S. Department of Housing and Urban Development (HUD), FHASecure is "designed for families who are good borrowers but were steered into high-cost loans with teaser rates."[13] HUD claims FHASecure would save approximately 240,000 homeowners from foreclosure.[14]

President Bush's plan also calls on Congress to eliminate tax penalties imposed on homeowners who have a portion of their loans cancelled by their mortgage companies.[15] And the plan would allow more borrowers the opportunity to qualify for lower, fixed-rate loans insured by the federal government.[16]

Lawmakers are hearing President Bush's call for help.[17] Congress is currently discussing proposals to lower the down payment requirement and increase the maximum lending amount for federally insured mortgages.[18] A resolution proposed on October 25, 2007 by three Democratic representatives seeks to reform the mortgage industry, in part, by imposing a federal duty of care on lenders.[19]

The resolution requires lenders to "make full, complete, and timely disclosure [to each potential borrower of] the comparative costs and benefits of each residential mortgage loan product offered, discussed, or referred to."[20] Another requirement is that "no creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination. . . that the consumer has a reasonable ability to repay the loan."[21]

"When a family's home is at stake, lenders had better play by a fair set of rules," said Rep. Brad Miller (D-NC), a co-sponsor of the bill.[22] The resolution's call for requiring lenders to fully and clearly inform borrowers of their loan terms resembles similar suggestions made by the public interest community.[23]

In fact, many states are acting to protect future homeowners from predatory lending.[24] At least 30 states have laws against certain types of subprime mortgages.[25] However, the public interest community is cautioning against significant restrictions on subprime credit.[26]

Zywicki said that tightening subprime credit would lead to "reduced access to credit by borrowers who otherwise lack credit on competitive terms."[27] Indeed, subprime loans have been an important factor in the huge increase in home ownership rates, including for low-income households, in recent years – from 64 percent in 1994 to 68 percent in 2007.[28] Home ownership is the primary method of wealth accumulation for many of the low-income households that can only afford homes with the help of subprime mortgages.[29]

Also, according to the Mercatus Center, subprime mortgages have typically been prevalent in "poorer urban neighborhoods with disproportionately minority populations. . . [A] reduction in subprime lending due to tighter requirements for borrowers is likely to disproportionately reduce credit for minority borrowers."[30]

One example of these negative effects was seen recently in an attempt at increased mortgage regulation in Illinois. Illinois House Bill 4050, signed into law in 2005, required borrowers applying for subprime mortgages to attend a certification class which counseled them on the details of their loans so that they would understand exactly what their financial commitment would be throughout the duration of the loan.[31]

Illinois Governor Rod Blagojevich said that the legislation was needed because "[t]oo many working families who struggled to own their own home have been hurt by abusive mortgages they can't afford. Many end up defaulting on their loans and are forced to abandon their homes."[32]

However, critics of the legislation raised strong objections.[33] Some warned that the program would cause a large decrease in minority home ownership, as the heightened requirements would make lenders less likely to work with subprime borrowers.[34] Additionally, a study by the University of Illinois showed that home sales in the program's pilot area had fallen by 50 percent as compared to a 20 percent drop in similar areas not participating in the pilot program. Blagojevich eventually suspended the pilot program.[35]

In the end, Zywicki said that any solution to the subprime crisis must limit the "higher propensity for fraud and abuse [that comes with subprime mortgages] without the unintended consequences of drying up legitimate subprime credit, which has enabled millions of households to buy homes and to start building wealth."[36]

Notes

1 David Bach, *Making Mortgage Relief Work for You*, Yahoo! Finance (Sept. 10, 2007), *available at* http://finance.yahoo.com/expert/article/millionaire/44325.

2 *See infra* notes 12-23 and accompanying text.

3 *See Subprime Mortgage Lending and Mitigating Foreclosures: Hearing Before for the H. Comm. on Fin. Serv.*, 110th Cong. (2007)[hereinafter *Hearing*] (testimony of Ben S. Bernanke, Chairman, Federal Reserve Board); U.S. Department of Housing and Urban Development, Subprime Lending, http://www.hud.gov/offices/fheo/lending/subprime.cfm (last updated Mar. 4, 2006).

4 Mercatus Center at George Mason University, *Public Interest Comment on Proposed Statement on Subprime Lending* at 2 (May 7, 2007), *available at* http://www.mercatus.org/Publications/pubID.3958/pub_detail.asp.
5 Deborah Solomon, *How FHA Could Help Homeowners*, WALL ST. J., Aug. 22, 2007, at A4.
6 E-mail Interview with Todd J. Zywicki, Senior Scholar, Mercatus Center, George Mason University (Oct. 21, 2007) [hereinafter Zywicki Interview]; *see also* Mercatus Center at George Mason University, *supra* note 4, at 1.
7 *Hearing*, *supra* note 3 (testimony of Ben S. Bernanke, Chairman, Federal Reserve Board).
8 Keisha Lamothe, *Foreclosures: Moving up*, CNN (Nov. 1, 2007), http://money.cnn.com/2007/10/30/real_estate/foreclosure_activity/index.htm?cnn=yes.
9 *Hearing*, *supra* note 3 (testimony of Ben S. Bernanke, Chairman, Federal Reserve Board).
10 *See generally Of the Wretched and Wreckless: Subprime Mortgages*, ECONOMIST, Sept. 8, 2007 (discussing implications of subprime crisis and the government's plans to help).
11 Press Release, President George W. Bush, President Discusses Homeownership Financing (Aug. 31, 2007) (available at http://www.whitehouse.gov/news/releases/2007/08/20070831-5.html).
12 Press Release, U.S. Department of Housing and Urban Development, Bush Administration to Help Nearly One-quarter of a Million Homeowners Refinance, Keep Their Jobs (Aug. 31, 2007) (available at http://www.fha.gov/press/2007-08-31release.cfm).
13 *Id.*
14 *Id.*
15 Dave Michaels, *Housing Administration Key in Home Aid Plan*, DALLAS MORNING NEWS, Sept. 1, 2007, at 1A.
16 *Id.*
17 *See generally* Charlene Carter, *Congress is Primed to Address Crisis over Mortgages*, ROLL CALL, Sept. 24, 2007 (discussing measures currently proposed in Congress).
18 Deborah Solomon, *supra* note 5, at A4.
19 The Mortgage Reform and Anti-Predatory Lending Act of 2007, H.R. Res. 3915, 110th Cong., § 102 (2007).
20 *Id.* § 102.
21 *Id.* § 201.
22 Press Release, House Comm. on Fin. Serv., Comprehensive Mortgage Reform and Anti-Predatory Lending Legislation Introduced in the House, Oct. 22, 2007, http://www.house.gov/apps/list/press/financialsvcs_dem/press102207.shtml.
23 *See, e.g.*, Alex J. Pollock, *The One-Page Mortgage Disclosure*, NARLO TODAY, May 14, 2007, *available at* http://www.aei.org/publications/pubID.26171,filter.all/pub_detail.asp (proposing a one-page form that sets out the essential terms of the loan in plain English that borrowers must sign before obtaining any mortgage).
24 Amy Merrick, *Borrowing Trouble: Illinois Tries New Tack Against Predatory Lending*, WALL ST. J., Aug. 21, 2007, at A1.
25 *Id.*
26 *E.g.*, Mercatus Center at George Mason University, *supra* note 4, at 2.
27 Zywicki Interview, *supra* note 6.
28 *Hearing*, *supra* note 7 (testimony of Ben S. Bernanke, Chairman, Federal Reserve Board).
29 Zywicki Interview, *supra* note 6.
30 Mercatus Center at George Mason University, *supra* note 4, at 6.
31 Press Release, Rod R. Blagojevich, Governor, Illinois, Gov. Blagojevich Signs Law to Protect Homebuyers in At-risk Communities from Predatory Lending (July 21, 2005) (*available at* http://www.illinois.gov/PressReleases/PressReleasesListShow.cfm?RecNum=4166).

32 *Id.*
33 *See* Merrick, *supra* note 24, at A1.
34 *Id.*
35 *Id.*
36 Zywicki Interview, *supra* note 6.