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Another View of Predatory Lending

by
Jack Guttentag

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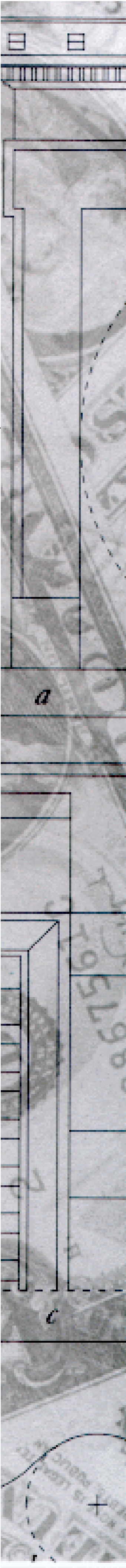

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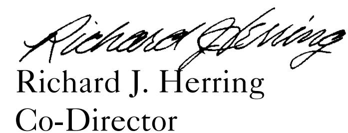

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Jack Guttentag*

ABSTRACT

Virtually all the analysis of predatory lending in the home loan market has been based on a dual-market paradigm. Sub-prime borrowers, usually less-sophisticated, lower-income, and disproportionately minority, are preyed upon. Other borrowers are not preyed upon, or if they are, it doesn't matter.

The dual-market paradigm has conditioned the remedies proposed for predatory lending. Since sub-prime borrowers can't take care of themselves in the marketplace, government needs to help them by curtailing contractual options, setting price limits, mandating counseling, and the like. These "remedies" impose heavy costs on the system and remove options from the borrowers they are supposed to help.

This paper presents a single-market paradigm of market failure. It argues that market failure is pervasive, and presents some new data that support this view.

The core reason for market failure is that effective shopping for a mortgage is extraordinarily difficult for even sophisticated borrowers. The effective remedy is to make mortgage shopping unnecessary. Eliminating the causes of market failure would eliminate predatory lending.

Mortgage shopping is a highly-skilled professional service that should be purchasable in the market. I call the professionals providing this service "Upfront Mortgage Brokers" (UMBs), to distinguish them from conventional mortgage brokers who contribute to the problem.

UMBs act as agents of the borrower in shopping for a mortgage, are paid a negotiated fee for their services, and disclose and pass through the prices they receive from lenders. In contrast, conventional mortgage brokers are

independent contractors who mark up the prices they receive from lenders, which they do not disclose.

The global remedy to predatory lending is to require by law that all mortgage brokers operate as UMBs. Then borrowers would shop for mortgage brokers, not for mortgages, and need concern themselves only with price, quality and referrals -- the same factors they look at when hiring a house painter or an electrician. Predatory lending would then disappear.

A voluntary association of UMBs, initiated by the writer, already exists. These UMBs are listed on my web site (www.mtgprofessor.com), through which they receive clients. While they comprise a tiny segment of the market, that segment works as competitive markets should. These brokers pass through the competitive wholesale prices they receive from lenders, while borrowers shop the brokers based on price and reputation.

*Professor of Finance Emeritus, Wharton. The author is indebted to Richard Herring for helpful comments.

Another View of Predatory Lending

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I Introduction

Virtually all the analysis of predatory lending in the home loan market has been based on a dual-market paradigm. Sub-prime borrowers, usually less-sophisticated, lower-income, and disproportionately minority, are preyed upon. Other borrowers are not preyed upon, or if they are, it doesn't matter.

The dual-market paradigm has conditioned the remedies proposed for predatory lending, which are directed toward practices used abusively in the sub-prime market. Fueled by horror stories and the righteous indignation of community groups, politicians, and regulators, a wave of restrictive legislation and regulations is sweeping the country at the state and municipal levels.

Litan[1] argues persuasively that these "remedies" impose heavy costs on the system and remove options from the borrowers they are supposed to help, but he and other voices of reason are on the defensive. This is partly because the opposition is supported by mortgage lenders, who are a vested interest perceived as having unclean hands. But it is also because the opposition offers no compelling alternative remedy.

This paper offers a remedy based on a single-market paradigm of market failure. It argues that market failure pervades all sectors -- every borrower is vulnerable. In the prime market the consequences just aren't as obvious and don't cause the same level of distress. And I present some new data that support this view.

The core problem with this market is that effective shopping for a mortgage is extraordinarily difficult for even sophisticated borrowers. A few things could be done to make mortgage shopping easier, but it can't be made much easier because it is inherently complex. Few borrowers want to take the time to educate themselves on the complexities. The effective remedy is to make mortgage shopping unnecessary by turning it over to professionals.

[1] See Litan, p. 1.

Mortgage shopping is a highly-skilled professional service that should be purchasable in the market. I call the professionals providing this service "Upfront Mortgage Brokers" (UMBs), to distinguish them from conventional mortgage brokers who are part of the problem.

UMBs act as agents of borrowers in shopping for mortgages, are paid a negotiated fee for their services, and disclose and pass through the prices they receive from lenders. In contrast, conventional mortgage brokers are independent contractors who mark up the prices they receive from lenders, which they do not disclose.

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A voluntary association of UMBs, initiated by the writer, already exists. These UMBs are listed on my web site (www.mtgprofessor.com), through which they receive clients. While they comprise a tiny segment of the market, that segment works as competitive markets should. These brokers pass through the competitive wholesale prices they receive from lenders, while borrowers shop the brokers based on price and reputation.

Section II of this paper distinguishes predatory lending from market failure. Section III provides some new data that support the thesis of pervasive market failure. Section IV explains market failure in terms of the great difficulty even sophisticated borrowers have in shopping the market effectively. Section V assesses various current or proposed approaches to helping borrowers shop more effectively. Section VI develops the alternative approach of shifting responsibility for shopping to trained specialists – UMBs. Section VII describes my experience with voluntary UMBs.

II Predatory Lending Versus Market Failure

A: Defining Predatory Lending

Predatory lending is a murky concept defined by examples of practices viewed as abusive. Here is a list I developed that is similar to many others.

- **Persuade a borrower to refinance for the sole purpose of generating fees ("loan flipping").**
- **Propose a loan that a borrower cannot possibly repay, that will very likely cause the loss of her home ("equity stripping").**
- **Insert a prepayment penalty or other burdensome provision into the loan contract without the borrower's knowledge, and without their receiving adequate compensation ("contract knavery").**
- **Persuade the borrower to purchase credit insurance or any other third party service of questionable value ("packing").**
- **Charge excess fees or "points" that are not adequately compensated by a reduction in the interest rate ("gouging").**
- **Propose mortgage types that carry high fees, even though they do not meet the borrower's needs as well as alternatives ("steering").**

In its reliance on a "I know it when I see it" kind of test, predatory lending is similar to obscenity. Just as two observers may differ over whether a picture is obscene, they may also differ over whether a particular practice is abusive. And just as there is no end to the sources of obscene expression, there is no end to the list of lending practices that could be used in abusive fashion.

Indeed, the analogy can be pushed further. Whether a particular mode of expression is viewed as obscene often depends on the context. Similarly, as was pointed out in the HUD/Treasury report on predatory lending (p.17), practices that may be abusive in one set of circumstances are not abusive under different circumstances.

To deal with the context problem, those concerned about predatory lending have focused on the sub-prime market – often referred to as the "high-cost" market. Implicitly, it is assumed that abusive practices don't arise in the prime market, or if they do, it doesn't matter.

This dual-market paradigm has conditioned the remedies proposed for predatory lending. Since sub-prime borrowers can't take care of themselves

in the marketplace, government needs to help them by curtailing contractual options, setting price limits, mandating counseling, and the like. These "remedies" impose heavy costs on the system and remove options from the borrowers they are supposed to help.

B. Defining Market Failure

This paper uses a concept more familiar to economists: market failure. In significant numbers of transactions, loan prices are substantially higher than those the borrowers could have obtained on identical transactions had the borrowers been knowledgeable, and able to shop alternative sources effectively.[2]

While predatory lending and market failure have obvious overlaps, there is one area in which they do not overlap. Mortgage pricing based on ability to pay is a clear indication of market failure, but few observers would view it as predatory.

Market failure is a single-market paradigm. It makes no sense that the same market structure would work for some borrowers but not for others. The borrower who pays $10,000 more on a $400,000 loan than he could have paid had he been more alert, astute and aggressive probably won't lose his house as a result, and won't find himself the subject of a news article. Yet he has been hoodwinked just as badly as the borrowers who populate the horror stories appearing in the press.

My point is not to generate sympathy for more well-heeled borrowers but to change the paradigm from which we infer remedies. The single-market paradigm implies that every borrower is vulnerable. The problem is not with the borrowers but with the market, and the remedy is to change the way the market operates. If the causes of market failure can be removed, predatory lending will be eliminated, no matter how it is defined.

III Some Evidence of Market Failure

[2] Usually, market failure is associated with significant market power or externalities, but neither condition exists in the home loan market.

The evidence I have comes from several mortgage brokers whom I cannot identify. Brokers today touch about 2/3 or more of all home loans. Wholesale Access estimated their market share at 70% in 1998, up from about 20% a decade earlier.[3] The major reason for their growth is the nichification of the market, discussed later.

Mortgage brokers are service providers. They counsel borrowers on any problems involved in qualifying for a loan, help borrowers select the loan that best meet their needs, shop for the best deal among the lenders offering that type of loan, take the application, and lock the terms with the lender at the borrower's request. Brokers also provide borrowers with required disclosures, and compile all the required documents including the credit report, property appraisal, verification of employment and assets, and so on. When the file is complete, it is handed off to the lender, who approves and funds the loan.

Mortgage brokers are paid by borrowers and in many cases, by lenders (see Section IV). The total from both sources is their gross profit from a transaction. The mortgage brokers cooperating with me provided data on gross profits and other transaction characteristics covering 774 loans they brokered in December 2000 and January 2001. The brokers operate in largely upscale areas and all the loans are prime conventional or FHA loans. There are no sub-prime loans in the data set.

If the market for broker services generated the results usually associated with competition, profit per loan would be related to workload per loan. Just as painters charge more to paint a large house than a small one, brokers would charge a higher fee to clients who used more of their time.

Since brokers can't fully anticipate workload in advance, they might elect to ignore it and let workload average out, but in this case there should be little profit dispersion. There should be no relationship between gross profit and loan size, since the number of digits on the loan amount is not related to work load.

What we find is quite different. Table 1 shows a frequency distribution of gross profits on prime conventional loans. The dispersion is very large,

[3] Wholesale Access, p. 1.

ranging from less than $1,000 to more than $10,000, and there is no relationship to broker workload as measured by processing time.[4]

The major determinant of profit per loan is loan size, as indicated in Table 2, which covers both conventional and FHA loans. For example, borrowers who took conventional loans larger than $225,000 paid almost 4 times as much as borrowers who took loans of $80,000 or less. It is clear that brokers take advantage of the inability of borrowers to shop effectively by extracting more from those who can afford to pay more.

According to the brokers, the other major determinant of profit per loan is the sophistication of the borrower relative to the sales skills of the loan officer. Table 3 illustrates the force of these factors. It covers the 17 conventional loans in the database that were for exactly $100,000. The profit per loan ranged from $1,077 to $2,748, with no relationship between profit and work load.

[4] According to the brokers, processing time is a fairly good proxy for work-load.

Table 1

Frequency Distribution of Mortgage Broker Profit Per Loan*
(Conventional Prime Loans Only)

Gross Profit Per Loan	Number of Loans	Average Processing Time
Less than $1,000	14	8.8 Days
1,000 to 1,499	56	8.1
1,500 to 1,999	99	12.7
2,000 to 2,499	99	10.3
2,500 to 2,999	84	6.6
3,000 to 3,499	86	8.5
3,500 to 3,999	59	8.9
4,000 to 4,499	51	7.8
4,500 to 4,999	41	8.4
5,000 to 5,999	37	11.4
6,000 to 6,999	20	15.8
7,000 to 7,999	12	5.7
8,000 to 10,000	5	7.6
10,000 and over	4	29.5
Total	667	
Median	$2852	
Mean	$3190	

Table 2

Mortgage Broker Profit Per Loan by Loan Size

	Conventional Prime				FHA			
Loan Size	Number of Loans	Gross Profit	Profit as % of Loan	Ave. Days to Process	Number of Loans	Gross Profit	Profit as % of Loan	Ave. Days to Process
$80,000 and below	95	$1433	2.30	11.68	27	$2188	3.25	22.44
$80,001-$110,000	93	2093	2.17	12.27	45	3234	3.42	21.22
$110,001 - $135,000	108	2420	1.98	7.49	21	3112	2.57	19.17
$135,001 - $165,000	109	2998	2.00	7.29	14	4514	3.01	20.14
$165,001 - $225,000	145	3933	2.02	10.21				
Greater than $225,000	117	5453	1.86	8.86				
Total	667				107			

Loans closed by selected mortgage brokers, December, 2000 and January 2001

Table 3

Mortgage Broker Profit on 17 Loans of $100,000
(Conventional Prime Loans Only)

Profit	Processing Time
$1,077	14 days
1,325	6
1,555	3
1,555	6
1,645	20
1,654	2
1,955	1
2,000	86
2,033	4
2,055	10
2,075	14
2,122	14
2,438	0
2,515	4
2,680	0
2,681	7
2,748	5

Loans closed by selected mortgage brokers, December, 2000 and January 2001

Some economists find it difficult to comprehend how profits per customer can vary so widely in a market with so many lenders and such easy entry. The reason is that borrowers can't shop effectively, for reasons explained below.[5]

IV Why Mortgage Shopping Is So Difficult

The home loan market has unique characteristics that, in combination, create problems for shoppers in all 3 phases of the transaction: Phase 1 when they select a loan provider; phase 2 when the terms of the loan are locked; and phase 3 after the major components of the price are set but the loan has not yet been closed. These characteristics are market nichification, price volatility, rebate pricing, price complexity, locking delays, and processing complexity. They will be discussed in turn.

A. Market Nichification and the Problem of Finding the Applicable Price

Market nichification means that mortgage prices[6] are affected by a wide variety of borrower, property, transaction, and documentation features that affect risk or cost to investors. Prices that are fully adjusted for such features are "transaction specific".

The number of factors used in calculating transaction specific prices keeps growing all the time. For example, when GHR Systems Inc., which develops software that lenders use for pricing, first began operations in the early 90s, lenders recognized up to 4 sets of documentation requirements.[7] Today they use 8. GHR today allows up to 40 million pricing combinations on any single loan program.

Nichification is the major reason for the growing importance of mortgage brokers. The more separate niches the market recognizes in setting prices and underwriting requirements, the smaller the proportion of total niches that

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[5] One consequence of the combination of easy entry with barriers to effective shopping is vast excess capacity among loan officers. Many if not most loan officers spend as much as 4/5th of their time looking for customers and only 1/5th dealing with customers.

[6] Unless indicated differently, "mortgage price" will mean a combination of interest rate and points, where points are an upfront charge expressed as a percent of the loan.

[7] The author was a founder of GHR and is currently its chairman.

any one lender covers. This strengthens the position of mortgage brokers who can cover all the niches through their multiple lender relationships.[8]

Prices quoted in the media, on most internet sites and over the telephone are generic rather than transaction specific. Unless informed otherwise, a loan provider generally assumes: [9]

- **The transaction is for a home purchase or a no-cash-out refinance. (2)**
- **The loan is below $275,000 (the current maximum for purchase by Federal secondary market agencies), and above some minimum-- usually around $50,000. (4)**
- **There will not be a second mortgage on the property when the deal closes. (2)**
- **The property is single-family, detached and constructed on site. (6)**
- **The borrower and all co-borrowers intend to occupy the house as their permanent residence. (3)**
- **The credit rating of all co-borrowers is A (good). (4)**
- **The borrower has enough cash to pay the required down payment and settlement costs. (3)**
- **The borrower's income is high enough to meet maximum ratios of housing expense to income and total expense (including monthly payments on existing debt) to income required for the loan program selected. (4)**
- **The borrower can comply with standard (full) documentation requirements. (8)**
- **The borrower is a US citizen or permanent resident alien. (2)**
- **The borrower pays a specified number of points, usually one or two. (10)**

[8] While major lenders expand their product lines to cover new niches, the process takes time and they are always behind the curve. Some niches are so small, furthermore, that it isn't worth the effort of major lenders to accommodate them.

[9] The numbers in parentheses indicate the approximate number of pricing niches that might be recognized for each item.

Nichification causes problems in shopping for a loan provider. Most shoppers don't understand the difference between generic and transaction specific quotes. Shoppers frequently select a loan provider based on generic price quotes, then find that the quotes don't apply to them. Almost all deviations from the list of generic assumptions involve a higher price.

Some shoppers select the loan provider offering the best price, but then change their mind about some feature of the loan: the loan type, down payment, term, documentation, etc. This shifts a shopper into a different pricing niche, where the loan provider already selected does not necessarily offer the best deal. There is very little consistency in pricing across market niches.[10]

If the change of mind occurs after the terms of the loan have been locked, the cost to the borrower can be even greater. The typical applicant knows even less about price differences between market niches than about price changes between two points in time. If the borrower is a home purchaser and the closing date is imminent, the loan provider can pad the price without danger of losing the loan.

B. Market Volatility and the Problem of Obtaining Comparable Price Quotes

Market volatility means that mortgage prices change frequently and without notice. In the 1950s and 60s, mortgage rates lagged changes in bond yields by 3-7 months,[11] but today there is no lag at all. This reflects the extensive development of markets in mortgage-backed securities, which trade as substitutes for bonds. Mortgage lenders reset their prices every morning, and sometime they change them during the day.

Market volatility can nullify the validity of media price quotes used by shoppers. For example, on Monday morning, lenders post their prices for the day, but the price quotes shown in Monday's newspaper were posted the previous Friday.

Because of nichification, obtaining transaction specific quotes usually requires a personal visit to a loan provider. With few exceptions, only

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[10]A few years ago, I looked at 13 lenders and 19 market niches. I found that 11 of the 13 offered the best price in at least one niche but no one lender was best in more than 3 niches. See Jack Guttentag (1996).
[11] Guttentag and Beck, p. 45.

generic quotes are obtainable over the telephone or on the internet. This forces most shoppers to spread their shopping over multiple days. But since prices are reset every day, this is usually fruitless.

C. Rebate Pricing and the Problem of Determining Mortgage Broker Compensation

Rebate pricing means that lenders offer a range of interest rate/point combinations, some of which involve negative points or rebates. (They are also called "yield spread premiums"). The two columns to the left in the table below show an actual price offer schedule for a 30-year fixed-rate mortgage. (For now, ignore the other columns).

Table 4

Rebate Pricing and APRs

Interest Rate	Points/Rebates	Other APR Fees	APR	APR at 5 Years
6.50	3.00 points	1125	6.91	7.52
6.75	1.75 points	1125	6.95	7.46
7.00	0.75 points	1125	7.19	7.46
7.25	0	1125	7.36	7.53
7.50	0.75 rebate	1125	7.54	7.59
7.75	1.50 rebate	1125	7.75	7.66
8.00	2.50 rebate	1125	8.00	7.66

Note: APRs and IRRs assume a $100,000 loan.

Some shoppers monitor the compensation of the mortgage broker. Since prices in the wholesale market are extremely competitive, this strategy makes sense. A competitive wholesale price plus a reasonable fee to the broker should equal a good deal. Most shoppers, however, can't monitor the broker's fee effectively because they don't understand rebate pricing.

The settlement statement given an applicant by a broker at or shortly after the broker has taken an application will show the broker fee to be paid by the borrower. Typically it will <u>not</u> show a rebate paid by the lender, because the rebate will not be known until the final terms are locked. In most cases, therefore, rebates can be pocketed by the broker, unless the broker commits to credit them to the borrower, which very few do.[12] Rebate pricing has been growing in importance, and one of the reasons is that it helps mortgage brokers conceal their profit on a transaction.[13]

D. Price Complexity and the Problem of Comparing Costs Across Products

To this point I have assumed that the "price" of a mortgage consisted of the interest rate plus points. In fact it is more complicated than that. Loans may have origination fees that are expressed as a percent of the loan, and also other upfront charges expressed in dollars. These other charges are usually difficult to obtain until well into the transaction process.

Price complexity is a particular problem on adjustable rate mortgages. The interest rate quoted is the initial rate, which may hold for up to 10 years, but it may also hold for only a month. Where the initial rate holds for a short period, the more relevant rate is the current value of the index to which the ARM rate is tied plus the margin, called the "fully-indexed rate." But that number need not be, and usually is not quoted to shoppers. Neither are borrowers aware of whether rate adjustments are rounded to the nearest 1/8% (or 1/4%), or rounded up.[14]

The Annual Percentage Rate (APR), which is supposed to provide a single measure of credit cost that captures all these components, is defective and unreliable. One problem is that it does not cover all loan fees. Some fees are excluded for no good reason.[15]

A second problem is that the APR is calculated over the term of the loan, even though over 90% of all borrowers sell their house or refinance their mortgage before term. This can lead borrowers with relatively short time horizons astray. The point is illustrated by Table 4, which shows the APRs for the various rate/point combinations, plus what the APR would be if it

[12] The significant exception is Upfront Mortgage Brokers, who do it as a matter of course.
[13] In the Wholesale Access survey referred to above, about 2/5ths of the transactions involved rebates. In my database, covering a period about 2 years later, 3/5ths carried rebates.

were calculated over 5 years. The APR makes it appear that paying 3 points will substantially reduce interest cost, but to a borrower with a time horizon of 5 years, that is not the case.

Calculating the APR over the loan term avoids having to deal with prepayment penalties, which can have a substantial affect on interest cost over shorter horizons.

A third problem is that the APR cannot be less than the interest rate. This means that on rebate loans where the rebate exceeds other APR fees, the APR is deceptively high. This is the case for the 7.75% and 8% loans in Table 4.

A fourth problem is that on refinancing transactions where the borrower withdraws cash ("cash-out"), the APR ignores the loss or gain on the extinguished loan. A borrower raising cash who compares the APR on a cash-out refinance with the APR on a home equity loan can be seriously misled.[16]

In sum, effective shopping requires the ability to compare the costs of different loans over the borrower's expected time horizon. Price complexity makes this difficult, and the APR does not help.

E. Locking Delays and the Problem of Low-Ballers, Market-Price Games, and Phony Locks

Lenders commit themselves to a price when they "lock" the loan. A lock is a written statement that guarantees the rate and points on a loan with specified characteristics to a specific borrower.[17] However, loan providers won't lock when they quote prices to shoppers. In most cases, lenders will lock only after the borrower has submitted an application.

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[14] Rounding up to the nearest 1/8% raises the average rate by up to 0625%, depending on the length of the initial rate period.

[15] For example, fees charged by the lender for property appraisal, credit report, property inspection, loan document preparation, notary, abstract or title search, and mortgage recording are not included in the APR, although none of these fees arises in an all-cash home purchase.

[16] In cash-out refinances, the APR should be calculated on the net cash withdrawn, not on the new loan.

[17] An explicit locking procedure would not be needed if the market was stable, or if lenders were willing to commit to shoppers.

Low-ballers: The combination of locking delays and market volatility provides a cloak for phony price quotes below the market. Some loan providers systematically "low-ball" to get customers in the door. Because a borrower can't shop and lock at the same point in time, the "low-ballers" cannot be held to their price quotes.

Market-Price Games: Sophisticated shoppers understand that the market changes daily, that the price will not be finalized until it locked, and that the lock price is the market price on the lock date. But what very few understand is how the "market price" on the lock date is determined.

For all practical purposes, the market price on the lock date is what the loan provider says it is![18] Loan providers are positioned to exaggerate any rise in interest rates that occurred during the period between the initial quote and the lock date, or minimize any decline. Unlike low-ballers, furthermore, who are well known to (and scorned by) other loan providers, those who play market price games keep their practices under wraps.

Those who low-ball initially to get the customer in the door <u>must</u> cheat in this next phase in order to recover what they previously gave up. Others may cheat a little or a lot, or not at all, depending on their consciences and what they believe they can get away with.[19] In general, they can get away with less in dealing with a refinancer than a home purchaser, because the refinancer can usually bail out and start the process over again with someone else.

The shoppers who are most exposed to market price games are home purchasers who elect to "float" the price until shortly before the closing, usually because they believe that interest rates are going down. A home purchase floater is completely at the mercy of the loan provider, who is restrained only by his conscience and the borrower's ability to pay.

Phony Locks: Borrowers who elect to lock their loans through mortgage brokers are vulnerable to phony locks. The broker reports that the loan is

[18] I have yet to find a loan provider (other than Upfront Mortgage Brokers) who shares with clients the procedure used for determining the market price on the lock date.

[19] Some loan providers claim that they use their market power to adjust income to workload, which is often far different than they anticipated at the outset. However, the evidence suggests that they are not very successful at this.

locked but in fact does not lock with the lender. The broker elects to arbitrage the difference between the long lock-period price and the very short lock-period price.[20] If interest rates don't change, the broker pockets the price difference.

Brokers rationalize this deceit by claiming that they will stand the loss if interest rates rise. But this ignores the small probability of a price spike so severe that the broker couldn't possibly cover the loss. Then the broker would be off to the Bahamas and the borrower would be left hanging.

F. Process/Document Complexity And the Problem of the Overwhelmed Borrower

Process complexity refers to the many steps, players, and documents that may be involved in a home mortgage loan. For example, the parties may include loan officer, processor, underwriter, appraiser, title insurer, property insurer, credit reporting agency, mortgage insurer, abstract company, pest inspector, flood insurer and many more.

Because there are so many parties involved, lenders won't guarantee total settlement costs other than points until at or near the closing date. The statement of settlement costs that the borrower receives earlier is a "good faith estimate".

This opens the door to chicanery. Some borrowers find that the settlement statements received shortly before closing contain fees that are higher than those that appeared on the Good Faith Estimate of Settlement that they had been given earlier. They are reminded that the earlier figures were estimates and the changes were due to circumstances beyond the control of the loan provider. The borrowers may suspect otherwise, but there is nothing much they can do.

The multiplicity of complex documents creates its own problem. So many documents are required that specialized firms have arisen that do nothing but provide documents. The flood of documents overloads the attention spans of many borrowers, allowing unscrupulous loan providers to take advantage.

[20] For example, lenders might quote 7% and 1 point for a 60-day lock and 7% and ¼ point for a 15-day lock.

For example, I have had dozens of borrowers tell me that they were not aware that they were subject to a prepayment penalty until they went to prepay. How can that be, given that a prepayment penalty must be noted on the Truth in Lending Disclosure Statement (TIL) that every borrower receives?

Anyone who has gone through the process will understand. The TIL is one of a flood of documents that the borrower receives, "Prepayment" is one of many items on the TIL sheet, and the penalty warning is anything but clear.[21]

V Help for the Beleaguered Shopper

I next consider some possible ways the beleaguered shopper might escape the pitfalls described above.

A. "Double-Apping"

Borrowers have one possible remedy available to them now. That is to submit applications to several lenders, and allow the price to float until all of the applications are accepted. Then, on a given day, request the lock price from all of them and select the best.

Few borrowers do this because they don't understand that they can't shop effectively in any other way, and because it is such a lot of work. When it is done, it seldom involves more than two loan providers.

Lenders and mortgage brokers view double-appers as the lowest form of animal life, because receipt of an application initiates a set of costly tasks on their part for which they will not be compensated if they lose the loan. If they discover that it is going on, they may simply terminate their relationship with the borrower.

I don't recommend double-apping to borrowers because it requires deceit, it risks retaliation when discovered, and it is wasteful – the more so the more

[21] The statement says, "If you pay off your loan early, you [may] [will not] have to pay a penalty". The choice between a definite negative and a possible affirmative has got to be confusing. To compound the problem, directly under this choice is a statement regarding whether or not, in the event of prepayment, the borrower will "be entitled to a refund of part of the finance charge". I cannot imagine why this is here, since lenders never refund finance charges.

applications that are involved. It is a sad commentary on this market that better alternatives have been lacking.

B. Development of Internet Delivery Systems

Delivery of home loans over the internet helps with two of the problems that make it so difficult for borrowers to shop the market. The first problem is the difficulty of getting transaction specific price quotes from multiple loan providers on the same day. A number of internet sites today provide price information that is partly but not wholly transaction specific. They adjust prices for some transaction features, although not for all.[22] This makes it possible for some shoppers to acquire transaction specific quotes from multiple loan providers on the same day. Multi-lender web sites make price shopping easier yet.

The second problem is the difficulty faced by borrowers who haven't yet locked their loan in monitoring the market changes used by the loan provider to adjust the price. Loan providers on the internet leave a price trail, making it difficult to cheat. A borrower who delays locking the loan until shortly before closing can't be taken advantage of by a loan provider quoting a spuriously high "market price", because the borrower can check the price against those being quoted to new borrowers. This is very difficult if not impossible to do off the net.

These advantages led to a great deal of early euphoria regarding how the web was going to transform this market, and the writer was one of those caught up in it.[23] In the event, most borrowers turned out to be too fearful of going it alone. While many browse the net for information beforehand, less than 2 out of 100 transact there. Multi-lender web sites in particular are in retreat.[24]

In time, second or third generation mortgage web sites will have figured out how to combine high-tech with high-touch, which will be the secret of success. For now, the web doesn't do it for the vast majority of borrowers.

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[22] This is due partly to limitations in their technology, and partly to a reluctance to expand the size of the questionnaire that borrowers must answer. The longer the questionnaire, the fewer the borrowers who complete it.
[23] See Guttentag, 1999.
[24] Two of the four major sites are gone. Quickenloans.com became single-lender, and iown.com folded.

C. Shortening Processing Time

Modern technology makes it possible today to receive a transaction specific price and lock that price on the same day.[25] And it is done, although not often. Note that processing time for 2 of the 17 loans in Table 3 was recorded as zero, which means that the applications were taken and the loans were locked on the same day. This was the case for about 10% of the loans in the database. The other 90% locked days, weeks and sometimes months after the initial contact day.[26]

The 10 borrowers who looked and locked on the same day avoided the market machinations faced by those who select a loan provider but aren't locked. However, they avoided none of the hazards involved in selecting a loan provider, nor were they immune to post-lock hazards.

D. Improved Mandatory Disclosure

In 1998, a joint Federal Reserve and HUD task force developed proposals for improving mandatory disclosures to mortgage borrowers.[27] They would expand coverage of the APR to include all loan charges, and provide more explanatory information. The purpose is to provide shoppers with a better tool for evaluating alternatives.

The report also proposes that lenders be relieved of liability for violations of the Real Estate Settlement Procedures Act (RESPA) if they offer a package of settlement services at a guaranteed total price. The purpose is to avoid situations where borrowers pay higher prices at closing than were shown on the Good Faith Estimate (GFE).

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[25] Smith visits a loan officer (LO) employed by a technologically advanced lender on Monday morning at 11 am. This is just moments after the loan officer had finished downloading new prices for the day. By 1 pm, the LO had entered the financial and property information provided by Smith into its system; had received and incorporated a credit report that Smith had authorized; had discussed with Smith the preferred type of loan, term, down payment and rate/point combination, entering Smith's preferences into the system; and had passed all of this information along to an automated underwriting system, which replied "Approve Smith". Smith completes the 1003 by 2:30, which is transmitted to a "checker" system that, among other things, makes sure that the price for Smith's market niche is correct, and that underwriting rules were applied correctly. Simultaneously, he requests a rate lock. At 3 pm, the lock is approved.

[26] 17% locked in 1-5 days, 18% in 6-19 days, 20% in 20-40 days, and 35% after more than 40 days.

[27] Joint Report (1998).

I support these proposals with a few reservations,[28] but they are essentially a side-show. Provision of an accurate interest cost measure does not help when the price components used in the calculation are vulnerable to change from factors outside of the borrower's control. The proposal for guaranteed settlement costs would shut down a minor abuse, leaving the major ones untouched.

The Joint Report, at various points, recognizes this and tries to deal with it by imposing an additional requirement on lenders: to get the RESPA exemption, they must guarantee not only settlement costs, but the rates and points as well, "subject to prescribed conditions" (P.IV). Elsewhere, they say that changes in rates and points must be "commensurate with changes in the financial markets" (P. XVIII).

But the changes that loan providers make in the rates and points on an unlocked loan are always "commensurate with changes in the financial markets". If you don't believe it, ask them! The devil is in the details of how this is actually done. The Joint Report provides no operational rules that would distinguish justifiable from unjustifiable adjustments to market changes.

E. Anti-Predatory Lending Rules

The legislation and regulations directed to stopping predatory lending that are popping up all over the country rest heavily on the dual-market paradigm.[29] Many focus wholly or largely on what are called "high cost loans", which are defined as loans priced 5-8 percentage points above Treasury securities of comparable maturity. A common provision is mandatory counseling in connection with these loans. This is a clear reflection of the mindset that only one part of the market fails, or only failure in this part matters.

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[28] The proposal to strengthen the APR deals only with the first of the two deficiencies noted earlier. The proposal to encourage lenders to offer a fixed-price bundle of settlement services includes mortgage broker fees in the package of services. Giving lenders the power to set mortgage broker fees is a blockbuster change that could substantially transform the industry, but it is not discussed at all in the Joint Report.

[29] The most comprehensive source of information on legislative and regulatory initiatives is the Predatory Lending Resource Center maintained by the Mortgage Bankers Association (http://www.mbaa.org/resources/predlend/).

A major thrust of these new rules is the elimination of types of loan options that have been used abusively. These include the financing of points, financing of credit insurance, prepayment penalties, negative amortization, and balloon payments. In addition, various abusive behaviors are prohibited, such as making loans that ignore the borrower's ability to pay, or recurring refinancing ("loan flipping").

The problem is that all of these loan options as well as the proscribed behaviors have legitimate purposes. Furthermore, as a HUD/Treasury task force on predatory lending pointed out, "Any list of predatory practices is destined to be incomplete because bad actors are constantly developing new abusive practices, sometimes to evade new government regulation."[30] Furthermore, these rules don't deal with any of the conditions described earlier that underlie the inability of borrowers – all borrowers – to shop effectively.

VI A New Approach to Predatory Lending: Professional Mortgage Shopping

Homeowners who don't have the skill or the time to paint their house hire house painters to do it for them. Mortgage borrowers who don't have the skill or the time to shop effectively, and very few do, should be able to hire an expert to shop for them.

There is a large potential supply of mortgage shopping experts available – they are called mortgage brokers.

Mortgage brokers can shop lenders much more effectively than consumers, because this is what they do. They are in the market every day. Knowledge of market niches is part of their stock in trade. They have relationships with multiple lenders, and are therefore positioned to find and shop among the lenders offering particular features. And they know the lenders who take 10 days to underwrite a loan and those who take one day.

Lenders know that brokers are careful and knowledgeable shoppers while most consumers are not. That's why price differences between lenders are smaller in the wholesale market than in the retail market.

[30] Joint Report, p. 17.

But mortgage brokers now shop for themselves. Acting as independent contractors, they have been a major part of the problem.

The key to effective reform of the home loan market is to mandate that mortgage brokers act as agents of borrowers,[31] and that the fees for their services be explicit. More precisely:

- **Brokers should be required to set their total fee in writing prior to submitting an application to a lender, with acknowledgement by the borrower.**
- **Any compensation received from lenders must be credited against the fee.**
- **Wholesale prices must be passed through to the borrower without markup.**
- **Borrowers must be given written confirmation of price locks from the lender.**

Under these rules, every borrower is a potential monitoring agent, since any disparity between the fee quoted to the borrower at the outset, and the broker compensation revealed in the HUD1 report at closing, would be a prima facie violation of the law.

These rules would protect sophisticated and non-sophisticated borrowers alike, sub-prime as well as prime. Borrowers could still be exploited directly by lenders, of course, but expect that segment of the market to shrink further as borrowers become aware of the new option.

VII My Experience With Upfront Mortgage Brokers (UMBs)

In 1998, I began to write a weekly newspaper column about mortgages, and developed a web site (www.mtgprofessor.com) to contain them. This resulted in extensive contacts with mortgage brokers, from whom I learned the "tricks of the trade" described in this paper. I also learned that most brokers used these tricks within limits. The few involved in predatory practices, however, recognized no limits.

[31] In a few states including California, it is already the case that mortgage brokers are agents of the borrower de jure. The agency law is without force, however, because it contains no operational criteria for identifying behavior that is consistent and behavior that is inconsistent with an agency relationship. Private litigation hasn't filled this void because mortgage brokers are unattractive targets. Hence, mortgage brokers are independent contractors de facto, regardless of what the law says

I also discovered that there were a few brokers who played no tricks at all; they were completely upfront with their clients. Operating in a market riddled with deception, it cost them clients who couldn't tell the difference, and it cost them fees they could have earned with little effort, but that was the way they wanted to do business. None of them knew each other, and they were delighted to learn, through me, that they were not alone. This was the genesis of UMB.

With the help of several of these brokers, I developed the UMB commitment shown below.[32] For the most part, this commitment merely formalizes and makes explicit what these brokers had been doing all along. UMB is a "best practices" movement.

THE UMB COMMITMENT

"1. The broker will be the customer's representative or agent, and will endeavor to act in the best interests of the customer.

2. The broker will establish a price for services upfront, in writing, based on information provided by the customer.

> ***The price may be a fixed dollar amount, a percent of the loan, an hourly charge for the broker's time, or a combination of these.**
>
> ***The price or prices will cover all the services provided by the broker. This includes loan processing, for which customers always pay a broker or lender.**
>
> ***On third party services, such as an appraisal, ordered by the broker but paid for by the customer, the broker will provide the invoice from the third party service provider at the customer's request. Alternatively, the broker may have the payment made directly by the customer to the third party service provider.**

3. Any payments the broker receives from third parties involved in the transaction will be credited to the customer, unless such payments are included in the broker's fee.

> ***If the broker's fee is 1 point, for example, and the broker collects 1 point from the lender as a " yield spread premium", the broker either charges the customer 1 point and credits the customer with the yield**

[32] I am particularly indebted to Catherine Coy, who works in the Los Angeles area, who has contributed countless hours to my education.

spread premium, or charges the customer nothing and retains the yield spread premium.

4. The broker will use his best efforts to determine the loan type, features, and lender services that best meet the customer's needs, and to find the best wholesale price for that loan.

5. The wholesale prices from which the broker's selection is made will be disclosed at the customer's request.

6. **When directed by the customer, the broker will lock the terms (rate, points, and other major features) of the loan, and will provide a copy of the written confirmation of the rate lock as soon as it has been received from the lender.**

7. If a customer elects to float the rate/points, the broker will provide the customer the best wholesale float price available to that customer on the day the loan is finally locked.

8. The broker will maintain a web site on which its commitment to its customers is prominently displayed, along with any other information the broker wishes to convey."

To be recognized as a UMB, the broker must have a web site that displays this commitment prominently. The broker's site must also display the UMB logo, and a link to my web site. UMBs are listed on my site by name, URL and the states in which they operate. Thus, potential clients go from my site to their sites, where the client sees the commitment and thus knows what to expect.

While they comprise a tiny segment of the market, that segment works as competitive markets should. These brokers pass through the competitive wholesale prices they receive from lenders, while borrowers shop the brokers based on price and reputation. Indeed, the major complaint of UMBs is that they are subject to price competition where other mortgage brokers are not.

VIII Concluding Comment

At this writing, there are 28 UMBs with 43 loan counselors. The movement will shortly be institutionalized by the formation of a non-profit 501(c)3 corporation, with initial support from the Ford Foundation. Support is expected from wholesale lenders, who have a financial stake in the integrity of mortgage brokers. I also expect to see an array of new players enter the market as UMBs.

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