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Comments on Predatory Lending Behaviour

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This paper surveys the literature on predatory lending behaviour in the banking system. We define predatory lending behaviour, discuss the problems arising from this bank lending model and critically comment on the work that studies the detection of predatory lending, optimal borrowing and the social welfare implications of predatory lending behaviour. The above is further examined by reflecting on the subprime mortgage crisis and the financial regulations (pre and post crisis) framework.

Field of Research: Predatory lending, Subprime Mortgage, Financial Regulation.

1. Introduction

The rapid development of the subprime mortgage market in the late 1990s contributed towards a significant proportion of the booming of the world economies. Most developed and developing countries enjoyed this explosive growth during this period. However, this growth comes with a cost. The inherent loose monetary policy encouraged the activity of speculation and consequently over-supply of capital in the global market. Under this economical environment, the lending behaviour within the banking system also shifted from risk neutral to risk taking.

Prior to late 1990s, for an ordinary individual to obtain mortgage or to finance an existing mortgage, banks would often evaluate mortgage applications based on individuals' income, wealth and credit history to determine whether to approve a loan. However, external economic environment coinciding with the financial innovations relaxed the screening process of approving a loan. This led to banks intentionally lending excessive funds to borrowers who might not be able to repay. The incentive and potential conflict of interest behind this lending activity will be discussed in detail in chapter three.

Due to lacking of the screening and monitoring in the process of originating a loan, consumer credit grew significantly from late 90s to 2006[i]. However, the booming of credit market could not be sustained for long because the quality of loan varies significantly from one to another. The level of defaults, foreclosures and bankruptcies

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also increased substantially during the same period of time. A typical mortgage loan is originated by banks and banks usually held them until its maturity. However, financial innovation combined with technological and legal innovation allows financial institutions to create and offer a wider range of financial products within the mortgage market. Potential residential mortgage borrowers are exposed to this newly invented lending model, namely "predatory lending".

The term predatory lending first appeared in *American Banker (*1994). However, there was no clear general definition for it. Ehrenberg (2001) first provided a rough definition of predatory lending as "*a mismatch between the needs and capacity of the borrower…in essence, the loan does not fit the borrower, either because the borrower's underlying needs for the loan are not being met or the terms of the loan are so disadvantageous to that particular borrower that there is little likelihood that the borrower has the capacity to repay the loan*".(Ehrenberg, 2001, p119-120). Morgan (2007) has also defined predatory lending from an economist perspective as a welfare-reducing provision of credit. This arise the question that how market competition failed to prevent such irresponsive lending behaviour and why banks are willing to provide unaffordable credit to borrowers who might not be able to repay and hence profit from this lending model. The above arguments are critically discussed in the literature review in the following chapter.

According to a report by the U.S. General Accounting Office (GAO)[ii] that predatory lending is an umbrella term and is used to describe consumer welfare loss due to the following abusive practices and loan terms: 1) excessive fees, 2) excessive interest rate, 3) single premium credit insurance, 4) lending without regard to ability to repay, 5) loan flipping(repeated refinancing of a mortgage loan within a short period of time with little or no economic benefit for the borrower) , 6) fraud and deception, 7) prepayment penalties and 8) balloon payment(large payments of principal due at the maturity of the loan.). Most, if not all, predatory loans combine one or more of these problems. The above statements are carefully assessed in detail in chapter three.

Predatory lending behaviour did not draw much attention until mid 2000s. As mentioned earlier that low interest rate environment, property market appreciation and search for yield investment attitude contributed to the active of the subprime mortgage market. Subprime lending became a significant proportion of source of finance for some particular borrowers (the number of subprime loans increased from 452000 in 2000 to 2274000 in 2005[iii]). These borrowers are typically with lower incomes, less wealth and riskier credit history than the traditional borrowers. This extension of credit provided extra capital into the property market which reflected on the increasing value of properties. Banks enjoyed generate profit without bearing risks from this lending model while borrowers benefited from the appreciation of property value which they have purchased. These arguments are presented and explained in detail in chapter four.

The economical phenomenon created by the explosive growth of subprime lending conceals the true cost of predatory lending behaviour. In 2006, subprime mortgages accounted for 40 percent of newly originated securitised mortgages[iv]. However, as the

Federal Reserve gradually increased the interest rate from 2004; many borrowers found it difficult to repay their mortgages. Subprime borrowers realised that they are not able to afford their home mortgage, because not only the costs of monthly repayment increased but also the terms and conditions of mortgage contracts were intentionally created in favours of banks. .

Predatory lending practices are usually concentrated on borrowers with low or moderate income and who are financially unsophisticated. These predatory loans are mostly a subset of subprime loans, namely loans with higher interest rate and fees that are designed for borrowers who cannot meet credit criteria for loans in the conventional prime market. However, predatory loans do not necessarily only exist in the subprime market. It is possible to find such predatory loans in prime market which contains one or more of those abusive terms as defined by the U.S. General Accounting Office (GAO). Predatory loans in the subprime market will form the focus of our analysis. In brief this paper is structured as follow, section 2 critically covers the related literatures, section 3 introduce and discuss predatory lending problems in subprime market, section 4 examines and evaluates the role of predatory lending in the subprime securitisation process and its implications, section 5 surveys the resulting changes in financial regulation for predatory lending behaviour and section 6 provides the conclusion.

2. Related Theoretical and Empirical Studies

Given the wide range of papers on predatory lending, this section sets out the theoretical background and reviews the key problems raised in the introduction. A clear definition of predatory lending is difficult due to the nature of its complexity. Carr and Schuetz (2001) were first to highlight the substantial cost of households exploited by excessive subprime and predatory lending. They examined the explosive growth of subprime and predatory loans in the alternative financial services market and presented how the high-cost fee structure of predatory loans greatly undermines the ability of individual households to repay and accumulate assets. They pointed out that lack or limited market competition for financial services greatly increase the possibility of predatory lending behaviour and hence propose three policies recommendations to improve the financial services environment for some distressed communities. They are1) Enhance data collection on finance services transactions and increase enforcement of fair lending , equal credit opportunity, and consumer protection law and regulations; 2) Create greater competition for financial services in distressed communities by improving the range of available financial products and services and enhancing government’s role as a facilitator and supporter of financial services innovation; and 3) Enhance and expand consumer outreach and financial education and awareness. However, these proposed polices have limited impact on predatory lending behaviour as the problems behind this lending activity involve various frictions in the cycle of securitisation process,

Eggert (2002) adds significant contribution to this field by providing comprehensive documentary from finance and law perspectives. He describes the characteristics of a predatory loan and pays special attention to the subprime mortgage market. There were significant proportions of predatory loans involved in subprime market. Predatory lending is often viewed as the subcategory of subprime lending and plays a key role in subprime securitisation process. He addresses how the subprime lending is aimed at minority neighbourhoods and elder homeowners since they are usually financially unsophisticated. Extensive literatures on the subprime mortgage crisis are widely discussed; see Ashcraft and Schuermann 2008, Keys, Mukherjee, Seru and Vig 2008 for recent contributions.

A number of studies by policy groups and law schools have assessed the scope of predatory lending from regulation perspective. Prior to the subprime mortgage crisis, most federal legislations are heavily relying on the expectation that market will self-correct with time. Engel and McCoy (2002) and Reiss (2009), however, argued that disclosure as an effective intervention when market competition failed to correct itself. Lack of price competition among predatory lenders prohibits the market from its self-correct function.

Some academician review predatory lending problem from an economist point of view. It is understandable that economists question on how such lending behaviour can be existed as if credit is so expensive to obtain, why new lenders don't enter the market and compete rates and hence bring the rate to fair value. A recent study by Morgan (2007) first presents an economical behavioral mode in which lenders exaggerate borrowers' future income hence encourages excessive consumption at the expense of future wealth. The authors attempt to review predatory lending from a broader picture and discuss the social consequences of this lending behaviour.

Another important empirical study presents consumer credit in a rational model, in which such lending is possible. Bond, Musto and Yilmaz (2006) distinguish predatory lending in different market condition i.e. of monopoly and without monopoly. Their study suggests that predatory lending is more likely to occur in monopolistic condition; in addition, the borrowers of a predatory loan have a substantial risk of low future income. They conclude that predatory lending is associated with high collateral value, monopolistic lending and rolling over of loans regardless of ability to repay, prepayment penalties, balloon payments and poorly informed borrowers. However, the implementations of their empirical study were not fully assessed and needs to be further developed.

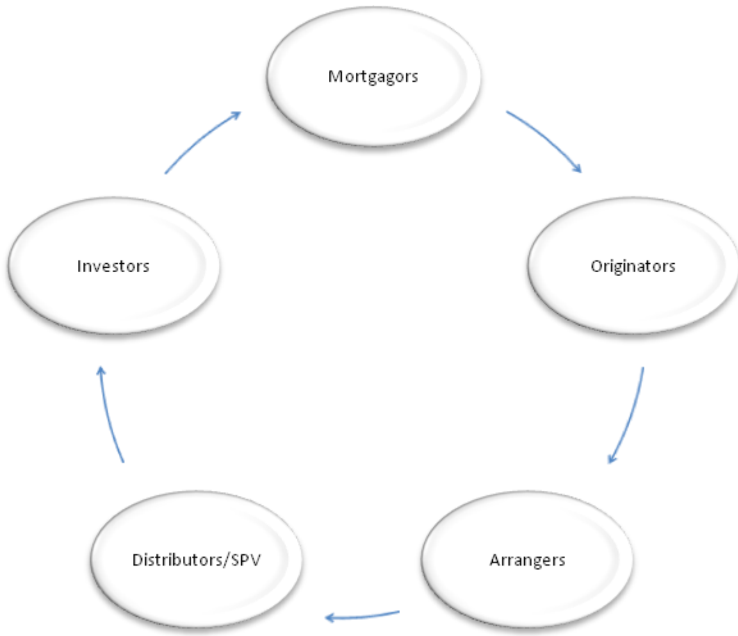
A key author to the field demonstrates the complexity of today's "securitisation mechanism" by using a simple two party mortgage market as an example. Peterson (2007) provides an overview on the evaluation of structured finance and its relationship to predatory lending from the Great Depression till 2007. His study shows that financial innovation was an important contributing factor to the creation of predatory lending behaviour. The author attempts to visualize the securitisation process in the subprime mortgage market by drawing a detailed chart on the structure of subprime mortgage process (see figure2). Furthermore, he shows the investment bank of Lehman Brother has been involved in predatory lending activity on at least five separate occasions. He concludes that the finance technology developed from innovation has outpaced the current consumer law, which is in effect deregulating the mortgage market. Another important empirical study by Peterson (2008) surveys the growing use of securtisation in other markets such as UK, Germany and Japan. He found that although UK and Germany are European countries, they have significant difference in lending attitude, for example mortgages with 80% or more loan to value ratio in UK is more often compared to Germany. Moreover, German mortgage banks are protected from declining prevailing market interest rates because consumers may not prepay their mortgage in Germany. This might eliminates one of the complex and difficult risk factor weighted by American mortgage lenders.

As this paper is related to the literatures on the subprime mortgage crisis and its securitization process, it certainly partially bears some relation to consumer protection. Our focus in this paper is to critically discuss the issues of predatory lending activity from various perspectives as well as provide a meaningful summary of existing literatures. The above is achieved by reflecting on the subprime mortgage crisis since the predatory loans is most likely to occur in the subprime market. This paper further discussed the causes and effects of the subprime mortgage crisis, in particular emphasising on the lending behavior based on the existing literatures of Crouhy, Jarrow and Turnbull(2007), Demyanyk and Hemert(2007), Miun and Sufi(2008) and Whalen(2008).

3. The Problem of Predatory Lending in Subprime Mortgage Market

Wide range of literatures and policy debates has published since the burst of the subprime mortgage crisis in 2008. While different studies assess the causes and effects of the crisis from various perspectives, most researchers suggest that information asymmetries in the subprime mortgage securtisation process (see figure 1) were a key element to the crisis. Predatory lending is one of the major frictions derived from the information asymmetries within the subprime mortgage market. It is understandable that in private property, the existence of a productive asset is frequently associated with some form of credit. However, this irresponsible lending activity deteriorates the credit market and hence impacts on broader scope of economy.

Figure 1. Securitization Process Flowchart



Predatory lending behavior is best described as lenders knowingly exaggerating borrowers' future income and persuading borrowers to enter a loan contract which they are unlikely to be able to repay due to various restrictions and high fee structure of the loan. As the subprime market is far less regulated and standardized than the prime market, it provides an opportunity for financial institutions to target some borrowers with specific needs, in particular, home mortgages.

Most predatory behaviour takes place between a mortgage broker or mortgage banks and the borrower. While the motivation of a mortgage borrower is obvious, most of borrowers may not be aware that many subprime lenders are tempted to participate in loan fraud. This is because of the nature of its pay structure. In general he more loans brokers can obtain for consumers, the more they can profit from it. It is in their best interest if their customers qualify for loans. As mentioned in the introduction, a predatory loan possesses one or more of the following abusive practices and loan terms according to the U.S. General Accounting Office (GAO):

1. *Excessive fees.* Abusive loans may include fees that greatly exceed the amounts justified by the cost of the loan. Any fees greater than 5% of the loan amount plus any lender or third party fees charged a borrower who receives no net tangible benefit in a refinancing transaction is considered as high fees charge. The limit on fees defined by HOEPA[v] should not be exceeding 3% of total loan amount.
2. *Excessive interest rate.* Mortgage lenders may charge interest rate that far exceeds what would be justified by any risk-based calculation due to the nature of its pay structure. In addition, brokers have incentive to increase the interest rate unnecessarily, since lenders often reward brokers by paying a yield spread premium.

3. *Single premium credit insurance.* Credit insurance protects lenders from receiving the repayment if borrower dies or becomes disabled. However, when credit insurance is added to a loan, the funds used to purchase the insurance are borrowed or issued as a form of credit. As such, there is an additional interest on these funds. Lenders do not often disclose this fact clearly in the beginning.
4. *Lending without regard to ability to repay.* Loans may be made regardless of borrowers' ability to repay. The loan is approved based on the high value of collateral. In the case of subprime market, the appreciation of property value enables lenders to lend amounts exceeding borrowers' monthly income. Such lending can quickly lead to foreclosure of the property.
5. *Loan flipping.* Loan flipping is another form of predatory lending when homeowners repeatedly refinancing their mortgage with no or little economic benefit from the transaction. A serious danger with loan flipping occurs when balloon payment (see note 8) is embedded into it. Under the loan flipping, homeowners might be signing a two, three or five year balloon payment. If homeowner is not able to exercise the obligation, they will have no other option but to foreclose their equity of the property.
6. *Fraud and deception.* Predatory lenders may exaggerate subprime borrowers' future income while inflating the underlying property appraisals. Because subprime borrowers are generally financial unsophisticated, predatory lenders may take advantage on the terms or conditions of their loans. In addition, predatory lenders may also intentionally fail to disclose items as required by law.
7. *Prepayment penalties.* Loans with prepayment penalties may not be necessarily predatory loans. Prime borrowers sometimes can benefit from lower interest rate if they accept prepayment penalties. Conversely, subprime borrowers will have limits to their negotiating power due to bad credit history.
8. *Balloon payments.* Loans with balloon payments are structured so that the monthly repayment is lower; however, a large sum is due at the maturity of the loan. Predatory lenders sometimes may market a low monthly payment loan without disclosure of the balloon payment. Subprime borrowers are usually not able to repay the final balloon payment, resulting foreclosure of the property, or refinancing with another higher fee or interest rate.

A subprime borrower is defined by the 2001 *Interagency Expanded Guidance for Subprime Lending Programme* as one who generally posses one or more of the following credit risk characteristics[vi]:

1. Bankruptcy in the last 5 years.
2. Judgements, repossession, foreclosure, or charge off in the prior 24 months.
3. Credit bureau risk score (FICO) of 660 or lower.
4. Two or more 30 days delinquencies in the last 12 months.

It is clear that borrowers who posses any one of the credit risk characteristic above will have difficulty in obtaining a loan. However, these borrowers are being targeted by subprime lenders as they are unsophisticated homeowners compared to borrowers in the prime market. The implication of predatory practices is reflected on the increasing number of foreclosures. The foreclosures rate in U.S. has increased from 0.9% in 2000 to 5.9% in 2007[vii]. Unlike the prime market, which is entered by borrowers seeking either to purchase a home or to refinance an existing mortgage at a more favourable rate, the subprime market is often used by borrowers seeking loan either to consolidate existing debts or to purchase home improvements (or consumers goods).

Subprime lender charge higher rates and fees to compensate the high credit risk characteristics of the subprime borrowers. This leads to an unhealthy lending cycle as subprime borrowers generally have impaired credit history or financial difficulties, higher interest rates and fees will only accelerate the possibility of foreclosure and hence bankruptcy. This is confirmed by a Senate hearing testimony of an anonymous employee of a predatory lenders that: "*perfect customer for a predatory finance company would be an uneducated widow who is on a fixed income - hopefully from her deceased husband's pension and Social Security, who has her house paid off, is living of credit cards, but having a difficult time keeping up her repayments and now must take car payment in addition to her credit card payment*"[viii]. It is clear that predatory lender intentionally targets minority group of customers, thus taking advantage of information asymmetries hence profit from it. The problem of predatory lending is laid in the centre of securitisation process. It is essential to understand how predatory loans are securitised in order to combat predatory lending behaviours.

4. The Role of Predatory Lending in Subprime Securitisation Process

The concept of predatory lending seems foreign from economic perspective. It is difficult to understand why a lender is willing to involve in such lending activity without knowing the flow of securitisation process behind it. In general, to determine whether a loan is approved or not, lenders will assess borrowers' credit worthiness and their ability to meet debt obligation based on income, age, collateral and wealth. It is in the lenders' best interest to avoid borrowers who are not able to meet such criteria. However, in the subprime market, those borrowers seem to be the primary target for predatory lenders (as explained in Chapter 3).

Securitisation evolved from financial innovations and constraints. In the mortgage market for example, by pooling mortgages together with similar characteristics, predatory lenders are able to repackage these assets and sell it to investors in secondary market as a debt security. The pooled mortgages assets are divided into different pieces according to their maturity, rates and so forth. Finally, as majority of funds are limited to invest in investment grade securities, the credit rating agencies (CRAs) will work closely with the originators of these structured products in order to provide acceptable credit rating. This model error in the securitisation process coupled with the loose monetary policy and appreciation of property market have both encouraged investors' attitude to shift from risk averse to risk taking. This search for yield investment attitude greatly increased the demand on debt securities in secondary market. Consequently, the popularity of predatory lending activities also grew significantly during the same period of time.

Given the complexity of structured products, it is not surprising that a typical investor, operating in the secondary market of such securities is an institutional investor. These include asset management, insurance companies, hedge funds and pension funds. A variety of financial institutions have participated in this securitisation process with different degree of involvement. This process of securitisation allows a firm with low or bad credit rating to spin off some of its receivables, such as mortgages, into an instrument that is capable of having a higher rating than the firm itself. It also enables firms to manage various form of risks derived from the underlying mortgages. These asset back securities (ABS) became a popular investment. The main attraction of investing in ABS is that it allows an investor to diversify interest rate, credit and sector-concentration risks while maintaining an attractive yield. In addition, as ABS is secured by underlying assets, they offer significant protection against credit event such as credit downgrades.

Another key player in the securitisation process is the credit rating agencies. The big three credit rating agencies are Standard & Poor, Moodys and Fitch. Due to the nature of structured products, it is difficult to fully assess and evaluate the risk associated with it. Even sophisticate investors such as asset management or insurance companies are not able to fully determine the risks associate with the underlying assets. The three dominant rating agencies have the privilege power in influencing the price of the underlying products as almost every mortgage backed securities (MBS) is rated by one, and often two of the three dominant rating agencies. The credit assessments of the underlying assets provided by the rating agencies represent an overall creditworthiness of that particular security regardless of the issuers' status of credit..

In the simplest case, rating agencies will need to estimate the default probability and the loss distribution of the underlying assets. This is achieved by conducting four key characteristics, 1) frequency of default, 2) severity of loss given default, 3) pool characteristics and 4) credit enhancement and the structure of the security. The privileged power of rating agencies is granted by various government bodies in exchange for quasi-public responsibilities. However, because of the nature of the fee structure, rating agencies are not able to issue independent credit opinions. The credit rating agencies are being paid by the originators of the securities for their opinions on their products. This creates potential conflict of interest between investors and originators. Since it is difficult to assess the creditworthiness of a structured product, investors are heavily relying on the credit opinion of the underlying assets issued by rating agencies. However, since the originators are paying rating agencies for their credit opinions, the rating agencies might not issue unfavourable rating to the originators because they may be afraid to lose business.

Rating agencies received criticism for not serving its original function as providing fair and independent credit opinion. They are blamed to be one of the most key factors of the subprime mortgage crisis. This is a classic example of how not to privatise a regulatory function as what rating agencies were doing is literally selling regulatory licence. It is obvious that self-regulating approach by the rating agencies has significantly failed. The position of the rating agencies is unclear in the global financial market. If the rating agencies are regarded as normal financial institutions, they should be performance driven and profit orientated, thus regulated by the financial authorities. On the other hand, if the rating agencies are served as regulatory bodies, they should be providing smoothly functioning, reputable system and issuing unbiased credit reports.

The "big three" rating agencies dominated the market with an estimated of around 95% of market share. This lack of competition in the market may have resulted in a lack of rating innovation and lower quality rating. In addition, the financial crisis led financial regulators to conclude that there was lack of appropriate regulations to assess and monitor all relevant activities in secondary market and hence called for financial regulation reforms.

5. Reform of Financial Regulations

The collapse of financial market in 2008 led to a series of review on current financial regulations. The United States has a dual banking system, the state banking system and the federal banking system. The federal government has the power to preempt state lending regulations. In the US, credit rating agencies are registered as a national recognised statistical rating organisation (NRSROs) and are regulated by the Securitises and Exchange Commission (SEC). The standard of credit rating agencies have significantly increased under the Credit Rating Agencies Reform Act since 2008. The level of disclosure required from rating agencies and the liabilities that the rating agencies imposed by the SEC have increased significantly at the same time. Rating agencies are now complying with their own standard, which they file with the SEC. Areas covered include the misuse of confidential information, the management of conflict of interest, a ban on certain practice, the appointment of a compliance officer and the disclosure of the agencies' financial department. In terms of rating agencies, the US regulations are largely based on the Code of IOSO, however, in the post-crisis reform of regulation, the SEC has extended its power to reinforce new and existing rules.

International Organisation of Securities Committee (IOSO) concludes that the provision of IOSO codes were inadequate as a result of the financial crisis. The code is revised in 2008 in response to the lack of supervisions and to address issues arising from the activities of rating agencies in the market for structured finance products such as asset-backed securities, residential mortgage back securities and collateral debt obligation. The major changes in the revised Code are as following.

To protect the quality and integrity of the rating process, CRAs should:[ix]

1) Prohibit CRA analysts from making proposals or recommendations regarding the design of structured finance products that the CRA rates
2) Ensure the quality of the information needed for ratings and inform users about the limitations of the rating
3) Periodically review the methodologies and models they use

4) Ensure that the decision-making process for rating action is conducted in an objective manner

5) Ensure that rating analysts have appropriate knowledge and experience

6) Establish procedures to review the feasibility of providing ratings for new structures

7) Ensure that methodologies and models for determining credit rating of structured products are appropriate when the risk characteristics of the assets underlying a structured product change materially

8) Ensure that adequate resources are allocated to monitoring and updating their ratings.

To ensure CRA independence and avoidance of conflicts of interests, CRAs should:

1) State whether issuers will publicly disclose all relevant information about the products being rated
2) Disclose whether any client accounts for more than 10% of the CRA's annual revenue
3) Review the past work of analysts that leave the CRA
4) Review remuneration policies to ensure the objectivity of the CRA's rating process
5) Define what they do and do not consider to be an ancillary business and why

There were further significant changes in global financial regulation after the subprime mortgage crisis. Compare to the pre-crisis period, the regulatory setup in Europe was mainly based on self-regulated with certain supervisory regulation from the IOSCO Code. The rating agencies in Europe are also being regulation by the Capital Requirement Directive, which implements Basel II in the EU. Under the Basel II framework, an agencies' rating method must satisfy criteria set by supervisors concerning independence, objectivity, transparency and continues monitoring. The rating methodology has to meet the following requirements in order to be recognised by the supervisors:

1) Rating must be objective; the methodology used must, in particular, by systematic and subject to some form of validation
2) The process should be free from political influence and economic pressure
3) Rating should be reviewed at least once a year
4) General information about the methodology should be documented and publicly available.

The G20 summit in 2008 was the example of financial regulation integration in a broader scope. Various national and international regulation bodies rose a number of proposals reflecting different perspective of banking regulation. For instance, the G20 London summit further emphasised on that

1) Internationally active rating agencies should be registered with an institution entrusted with capital market oversight, e.g., the international Monetary Fund (IMF) or Bank for International Settlements (BIS)

2) On a regular basis, agencies should deposit their rating assessments with the entrusted institution, which should undertake a thorough statistical analysis of this data and publish regular rating default and rating migration tables
3) These assessments should be disclosed to markets and investor
4) A high level, open annual event should discuss the status of the rating industry and its performance.

The proposed consultations on regulating rating agencies in European Commission were swiftly discussed by European Parliament and European Council in 2008. The Regulation on Credit Rating Agencies was adopted and approved by both the Parliament and the Council in 2009; it has now put into practice and has the direct impact on regulating the rating agencies. The new financial regulation imposed extensive disclosure requirements with special attention on various aspects such as internal auditing, corporate governance, transparency and structured finance.

6. Conclusion

Predatory lending is one of many issues derived from information asymmetries in the securitisation process. There will be certain level of information lose during the transition of moving from one party to next party in the securitisation process. It is regulators as well as investors' responsibility to track this information in order to prevent the previous party taking advantage on superior information regarding on the underlying assets. While a various ongoing financial regulation reforms take place, policy makers and regulators should be aware that the public concerns on the crisis diminish over time, however, such predatory lending activity might return in other form of financial products as financial innovation continues. From consumer protection perspective, it is essential to further educate borrowers to better understand the financial products that they are purchasing as well as improve the transparency of mortgage origination so that predatory lending behaviour can be reduced or minimised.

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