

Home Equity Loans and the Foreclosure Crisis:

Avoiding Foreclosure for Victims of Predatory Lending

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Introduction

- A “perfect storm” for foreclosures looms on the horizon.

Causes include:

- Resetting of Adjustable Rate Mortgages (ARMs)
- Weak housing market and falling property values
- Severe restriction on credit to refinance mortgages

(intro cont'd)

- **The factors are interdependent:**

- Resetting ARMs cause more defaults and foreclosures
- Foreclosures lower property values and cause borrowers to be “upside-down” in their mortgages
- Insolvency of sub-prime lenders causes a severe tightening of credit
- Tightening of credit prohibits distressed borrowers from being able to refinance

(intro cont'd)

- **Emerging federal, state and local responses to the crisis include:**

- Lenders encouraged to restructure mortgages
- Appropriations made for housing counseling and legal representation
- Loan trusts or pools established for refinancing predatory or sub-prime loans

Identifying Solutions

Legal Representation vs. Housing Counseling

- Critical difference? Identifying sub-prime vs. predatory loans
 - Good housing counseling candidates: borrowers who made informed decisions to get high-risk ARMs, "80-20", or interest-only loans
 - Predatory lending victims need legal representation to get all relief to which they are entitled
 - There is demonstrated need for both options

- **Two cautions to consider:**
 - Incidence of predatory lending *within* the sub-prime market is underestimated
 - Non-lawyer housing counselors often fail to identify potential violations of the law

The Ideal Model

Offers legal representation *and* housing counseling

1. Trained lawyers will:
 - Interview distressed borrowers
 - Review loan documents
 - Identify potential causes of action
2. If no legal remedy, client is referred to housing counselor for loss mitigation assistance; *or*
3. If dual-service model not possible, housing counselors need intensive training in identifying legal issues for referral to a lawyer.

MALS' Project Second Chance

- A prototype for the delivery of assistance to borrowers facing foreclosure
 - Potential funding for similar projects

Legal Representation:
Identifying Predatory Lending Practices

- Telemarketing, Door-to-door solicitation
- Home improvement scams
- Reverse redlining, steering, targeting
- Loans made without regard to the borrower's ability to repay
- Lending to an incapacitated homeowner
- Falsifying loan applications, incorrect credit scoring
- Failure to provide disclosure documents
- Bait and switch, loan padding
- Multiple refinancing or "flipping"
- Converting unsecured (credit-end) debt into secured debt
- Payment of yield spread premiums

Legal Representation:
Characteristics of Predatory Loans

- High interest rates, high points, unearned fees
- Unaffordable monthly payments
- Prepayment penalties
- Loan padding
- Balloon payment
- Yield spread premiums
- Flipping
- Falsified loan applications, inflated appraisals, forgeries
- Mandatory arbitrations
- Negatively or non-amortizing loan
- "Ghost" second mortgage
- Making loans in excess of 100% of loan-to-value (LTV)

Legal Representation:
Potential Legal Theories

- Truth in Lending Act (TILA)
- Homeownership and Equity Protection Act (HOEPA)
- Racketeer Influenced and Corrupt Organizations (RICO)
- Equal Credit Opportunity Act
- Tennessee Consumer Protection Act
- Real Estate Settlement Procedures Act (RESPA)
- Fair Housing Act
- Tennessee Home Loan Protection Act
- Home Mortgage Disclosure Act
- Office of the Comptroller Guidelines on Predatory Lending

Effective Litigation Results

- The RICO Cases:
 - Cash settlements of \$1.3 million
 - Loan modifications worth \$1.7 million
 - Cash to plaintiffs of \$76 thousand
 - Total benefit to plaintiffs of \$99 thousand
 - Repayment over \$86 thousand in costs
 - \$125 thousand in funding for Project Second Chance

TOTAL VALUE: \$3 million

Effective Results without Litigation

Often depends on history of effective litigation

Case study #1

- Reduced principle balance by over \$6,000
- Reduced interest from 17.98% to 6%
- Reduced monthly payment from \$513 to \$232

Case study #2

- Reduced principle balance by over \$10,000
- Reduced interest from 12.5% to 8.5%
- Reduced monthly payment from \$630 to \$473

Loan Refinance Programs

- **These programs have limited usefulness for the following reasons:**
 - Only scratch surface of need
 - Extremely strict credit criteria
 - Many borrowers cannot meet loan-to-value ratios
 - Many borrowers cannot meet loan-to-income ratios

Combining Legal Representation with Loan Refinance Programs

- **Addition of legal representation can greatly enhance effectiveness:**
 - Lessens demand on special loan funds by effectively restructuring existing loans
 - Negotiation of reduction in principle may allow refinance applicants to meet loan-to-value ratios
 - Negotiation of reduction in principle may allow refinance applicants to meet loan-to-income ratios

Combining Legal Representation & Loan Refinance Programs Cont'd

- **Example 1:**
 - There is pay-off of \$50,000 on an existing mortgage
 - The mortgaged house is only worth \$40,000
 - If the attorney can negotiate a pay off of \$35,000, the loan may work.
- **Example 2:**
 - Borrower owes \$50,000 in principle balance on mortgage
 - Income is too low to qualify for a \$50,000 loan because income was falsified on the application for current loan
 - If attorney can negotiate a pay off of \$35,000, borrower may qualify under loan-to-income ratios.

Housing Counseling

- **Best used when no violation of law can be identified or statutes of limitations have run on a viable claim**
- **Several factors make loan restructuring through housing counseling more promising than before**
 - Regulatory pressures
 - Financial penalties
 - Lender bankruptcies

Regulatory Pressures:

- **OCC directive to federally chartered banks to restructure ARMS when re-setting is likely to cause foreclosure**
- **Prudent lenders will retain a performing mortgage rather than try to reap increased interest value**

Financial Penalties:

- **Financial penalties in loan purchase agreements between lenders and hedge funds give lenders incentive to take back and restructure defaulted loans to avoid penalties tied to default rates**
- **Ongoing litigation over whether lenders have right to reclaim these mortgages**

Lender Bankruptcies:

- **Several of largest sub-prime lenders have or will soon go into bankruptcy**
- **Bankruptcy trustees are selling servicing component to new companies at great discount**
- **New companies have incentive to restructure loans to allow as many of them to perform as possible**

Conclusion

- **Communities must take proactive steps to ameliorate consequences of the impending foreclosure crisis**
- **Legal service field programs and non-profit housing counseling agencies should be at the center of the efforts**

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