



Sub-prime Lending

From the Office of Minnesota Attorney General Lori Swanson

Problems in the sub-prime mortgage lending market have led to large declines in the stock market, company bankruptcies, and a rash of consumer defaults on home loans in recent months. During the 1990s, sub-prime lending constituted a small niche market within the larger mortgage market. In recent years, however, lenders began to relax sub-prime underwriting standards, with the result being that by 2006, sub-prime lending had expanded to account for 20% of new mortgages.

What is Sub-prime Lending? A sub-prime loan is a loan given to a consumer with impaired credit. Lenders offer the best rates, referred to as “prime,” to consumers with the best credit. Consumers with less than perfect credit scores, credit history, employment history, or savings may be directed toward “sub-prime” loans.

Stock Market Declines. On Tuesday March 13, 2007, the Dow Jones Industrial dropped 242.66 points, due in part to problems in the sub-prime lending market. Some analysts express concern that mutual funds and other investors may sustain financial losses as securities backed by sub-prime mortgage accounts take hits. Even stock markets in Europe and Asia have sustained losses due to the problems in the U.S. sub-prime market.

Mortgage Company Bankruptcies. At least 20 mortgage companies have already filed for bankruptcy or gone out of business because of troubles in the sub-prime market. In some cases, financial institutions have forced mortgage companies to reclaim defaulted sub-prime accounts that they sold on the secondary market, leading to financial troubles for some of these companies.

Foreclosure Increases. Recent increases in the number of foreclosures have frequently been attributed to the substantial growth in the sub-prime lending market in recent years. Some analysts anticipate even greater foreclosure problems as many adjustable rate mortgages (“ARM’s”) reset with the changing interest rates in the spring of 2007.

Here are several tips to consider when purchasing or refinancing a home:

1) Can You Make the Payments? Just because an institution is willing to lend you money does not mean you can afford the loan. Increasingly, brokers and lenders have used “no-documentation (no-doc)” or “stated income” loans, whereby a consumer simply states their income without documentation or underwriting by the lender. In some cases, brokers and lenders have encouraged consumers to inflate their stated income to qualify for a loan. Furthermore, when you shop for loans, make sure to include the cost of homeowner’s insurance, taxes, and any escrow payments in your comparisons. In some cases, unscrupulous brokers or lenders may compare the monthly payment you make now (including escrow, insurance, taxes, etc.) with a monthly payment that only includes the payment of principal. Make sure that you compare the *entire cost* associated with the loans over the *entire life* of the loans.

2) Adjustable Rate Mortgages (“ARM’s”). ARM loans fluctuate with the interest rates set by the Federal Reserve. Since the rates will increase, be on guard against low introductory rates that may change. Under an ARM, you can wind up paying significantly more in your monthly payments than you initially paid at the beginning of the loan. In some cases, mortgage payments may *double* in a relatively short period of time. Since interest rates have been relatively low in recent years, consumers have often been able to get ARM loans with a lower initial payment than what they might find with a fixed rate mortgage. As rates increase, however, many homebuyers are faced with sticker shock as their mortgage payment quickly surpasses what they may have paid with a fixed mortgage.

3) Be on Guard Against Interest-Only Loans. Interest-only loans are structured so that for the first few years of the loan, you only pay the interest on the loan. Although you may be drawn to such loans because the

initial payments are lower than other loan products, be careful. Once the interest-only period ends and you must begin paying on the principal of the loan, the monthly payment may skyrocket. Similarly, some loans may even be structured with a negative amortization. Under a negatively-amortized loan, the principal of the loan actually grows with the life to the loan.

4) Beware of Balloon Payments. Be on guard against loans that bear an unusually large payment toward the end of the loan, also known as a “balloon payment.” Although the initial mortgage payments may make the loan appear attractive, you may not be able to pay when the balloon payment comes due, leaving you vulnerable to foreclosure or unfavorable refinancing. Make sure that you read your loan documentation very carefully to determine whether or not the loan contains a balloon payment.

5) Shop Around to Avoid High Interest Rates and Fees. Interest rates and fees vary from loan to loan and from lender to lender. Remember that *everything is negotiable*. In some cases, mortgage brokers may actually receive payment from the lender for providing you with a higher interest rate loan than you may be qualified for. The difference in these rates is called the *yield spread*. Avoid high yield spreads and fees by comparison shopping for the loan with lowest fees and the best interest rate over the life of the loan.

6) “Churning.” Some unscrupulous brokers may solicit you to refinance your home with a loan that does not benefit you. This practice is called “churning.” Be on guard against any refinance offers that sound “too good to be true.”

7) Who is Looking Out for You? Years ago, consumers brought lawyers to their closings to review their documentation and represent their interests in the transaction. Since this is no longer a common practice, consumers may be left asking the question: “who is looking out for me?” Due to the high volume of paperwork required at the closing, you may be tempted to simply listen to the broker or agent’s verbal advice regarding the documentation. Be careful what you sign. It is advisable to bring someone to the closing that you trust, who can review the documents to ensure that what

you are signing is in your best interest. Verbal guarantees may be difficult to prove in court if you need to take legal action later.

The Minnesota Department of Commerce is the State agency responsible for licensing and taking disciplinary action against mortgage brokers, realtors, appraisers, and other real estate professionals. If you believe you have been deceived or unfairly treated in connection with a real estate transaction, you should file a complaint with the Department of Commerce as follows:

Minnesota Department of Commerce
Market Assurance Division
85 7th Place East, Suite 500
St. Paul, MN 55101
(651) 296-2488 or 1-800-657-3602

For additional information, contact us as follows:

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