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Effort to Advise on Risky Loans Runs Into Snag

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CHICAGO, June 7 — With a growing number of homeowners running into problems paying their mortgages, [Illinois](#) came up with an idea to protect people like Cassandra McKinney from lenders — and themselves.

A single mother and a homeowner on the city's south side, Ms. McKinney briefly entertained the idea of taking \$50,000 of equity out of her home to pay off debts, at an initial interest rate of 9.5 percent, sharply higher than her existing mortgage. But after attending a new mandatory state program to counsel borrowers on their mortgages, she realized the loan was too expensive and unnecessary.

“The counseling helped me understand that this was on the excessive side,” said Ms. McKinney, a project manager for a telecommunications company.

It sounds like a success story. But in January, with the program in place a little more than three months, Gov. [Rod R. Blagojevich](#) suspended it after critics complained that the government was wading too deeply into the personal financial lives of its citizens.

Mortgage brokers, real estate agents and minority community leaders said that the effort, while well intentioned, put a damper on real estate transactions in the largely black and Hispanic neighborhoods in southwestern Chicago where the program operated. This amounted, they further argued, to redlining.

Now the state is considering expanding the counseling to all of Chicago and its suburbs to avoid charges of racial discrimination. But that too has been challenged by industry officials as unnecessary meddling that will severely slow real estate transactions.

Illinois' approach raises questions about how far lawmakers and regulators can go in trying to safeguard consumers from risky and expensive home loans before they are seen as overly intrusive.

So far, discussions in Washington and elsewhere have focused mostly on what should be done to help homeowners in foreclosure and how to rein in aggressive mortgage lenders. Illinois has been largely alone in focusing on trying to make sure borrowers fully understand the debts they are taking on.

Housing counselors, who supported the initial phase of the program, say it saved people like Ms. McKinney from taking on large debts on onerous terms. But they added that many financially pressured borrowers went ahead with loans even after excessive fees and interest rates had been clearly explained to them.

Critics, however, asserted that the counseling was yet another hurdle borrowers had to surmount. Brokers also said that the program was at best a half-measure because it did not cover loans made by federally chartered banks that the state could not regulate.

The plan's first iteration applied only to borrowers in 10 ZIP codes that had experienced the most significant increases in foreclosures. Borrowers with low credit scores or people who were taking out certain exotic mortgages were required to talk with a federally certified housing group. About 1,200 loans were vetted before the program was suspended.

Now, the state is retooling the program to include all of Cook County, which encompasses Chicago and many of its suburbs. Under the proposal, first-time home buyers and borrowers who are refinancing would be referred to counseling only if they selected certain loans like adjustable-rate mortgages that reset in five years or less, or loans that initially require only interest payments. A state agency is drafting the rules, which must be approved by a committee of lawmakers.

Even as that process plays out, the Illinois General Assembly is considering legislation that would enshrine the new counseling rules in law. In addition, the bill would require mortgage brokers to act in their clients' best interest and bar state-regulated lenders from making loans without verifying borrowers' income with tax returns, paycheck stubs or other documents.

The counseling sessions provide a rare and revealing window into lending to people with weak, or subprime, credit. Borrowers in this world are often in a financial bind, and loan brokers and officers who deal in these mortgages

typically earn hefty commissions and know much more about the loans than their clients.

A report compiled by an advocacy group, Housing Action Illinois, shows that the majority of borrowers who were about to take on adjustable-rate mortgages believed that they had fixed-rate loans. More than two-thirds of the borrowers were spending more than 60 percent of their take-home pay on housing expenses. And 75 percent of the borrowers were refinancing existing debts; the rest were buying a home.

“We really feel like that the counseling was a great benefit to everyone who got it,” said Bob Palmer, policy director for Housing Action. But real estate officials “really got all the momentum in terms of controlling the public debate and very effectively and misleadingly made it an issue about race and ethnicity.”

While the counseling sessions persuaded some like Ms. McKinney to back out, counselors said that other borrowers went ahead with dubious loans, because they felt trapped by credit card balances, medical bills and other debt.

“Some of them realized that even though their monthly mortgage payment was going to increase, they had to do this,” said Alfred Guyton, executive director for the Institute for Consumer Credit Education.

It is unclear how many borrowers who were counseled closed on their mortgages, since the state has not provided an analysis of a database it maintains on the loans. The Greater Southwest Development Corporation, one of the counseling agencies, estimates that up to 60 percent of the people it talked to closed on a loan, based on a survey of public filings. But it does not know how many renegotiated the terms of their loans.

The president of the Illinois Association of Mortgage Brokers, Bill McNamee, said the nonprofit agencies' analysis could not be trusted because they have an incentive to play up problems — they receive \$300 for each counseling session, which is paid for by brokers and lenders. “They are going to want to justify their existence so they can continue to collect their fees,” he said.

Brokers and real estate agents said that home sales fell by more than 45 percent in the neighborhoods where the counseling requirement was introduced, which was much more than the decline in unaffected areas nearby. Brokers assert that a countywide requirement could severely slow the housing market in Chicago.

John West, a mortgage broker, said the government should emphasize first-time home buyer classes and a more rigorous financial education curriculum in public schools. “People want government to safeguard them,” Mr. West said. “But I don’t want to be turning my head and seeing the government saying, ‘We think you should make another decision.’ ”

Some borrowers share that view.

Jasmika Cook, who oversees vocational programs in the city college system, said that she was unimpressed by a counseling session in November when she was considering buying a house in one of the 10 ZIP codes. (She ultimately bought a house in another area.) She said the counselor merely verified that the terms of the loan a broker entered into a state database matched information on her loan application.

“I don’t see how \$300 worth of service was provided,” she said.

Ms. Cook said the state should respond to aggressive lending, noting that a friend’s monthly house payments recently jumped 45 percent when the fixed-rate period on her loan ended. She said that the proposed rules were an improvement because they screened for risky loans, not for troubled borrowers in low-income neighborhoods.

Though many may object to the idea of mandatory counseling, the mortgage industry has found it beneficial in the past.

Until last year, [Fannie Mae](#) and [Freddie Mac](#), which buy mortgages, required lenders to send borrowers who were taking out certain affordable housing loans to counseling. A Freddie Mac study from 2001 showed that homeowners who were counseled under its Affordable Gold program were 19 percent less likely to fall behind on payments for three months or more at any time during the life of the loan than borrowers in comparable circumstances who were not counseled.

Fannie Mae and Freddie Mac, which were created by Congress, eliminated those requirements because the mortgage companies they bought loans from, the agencies said, were losing customers to lenders that did not require counseling and were generally more lenient.

“We made the determination that it would be better to drop the counseling requirement to encourage customers to get into a better product,” said Thomas A. Lund, executive vice president of Fannie Mae.

Illinois officials have received more than 300 comments on its proposed rules, and lobbyists for industry groups have stepped up their campaigns to sway lawmakers.

Dean Martinez, secretary of the state’s Department of Financial and Professional Regulation, says that the uproar is missing the point and suggests that the term “counseling” may be the problem. He views the sessions as akin to state driving tests. They are there to make sure borrowers fully comprehend what they are doing, not to watch over their every action.

“Mario Andretti has to take a driver’s license test,” Mr. Martinez said, “even though he is one of the best drivers in the world. No one disputes that.”