

Borrowing Trouble: Is Illinois Taking Mortgage Oversight Too Far?

by *Blanche Evans*

Predatory lending. It's an ugly-sounding practice, but lenders say including sub-prime lending into the predatory category is unfair. First, there's no real definition of where high interest rates for poor borrowing risks cross the line. That's because for most lenders, loaning money is a judgment call, based on as much science as numbers can possibly deliver.

While it's true that some lenders take advantage of consumers' ignorance or those with poor English-speaking skills, sub-prime lending puts more people into homes who otherwise couldn't afford to own, and has contributed significantly to raising national homeownership rates.

But higher cost loans suggest higher risk to borrowers because they cost more, and a certain percentage of borrowers default. The problem is no one knows if these people would have defaulted anyway, or if they defaulted because they were defrauded.

That's what the Illinois state legislature is seeking to find out. Noting a higher foreclosure rate in certain zip codes, Senator and Speaker of the House Michael Madigan (Dem) has pushed through [legislation](#) (HB4050) that will require borrowers in 10 Chicago-area zip codes to obtain HUD-approved credit counseling if their credit score is below 620. If their scores are between 621 and 650, and they're seeking "exotic loans" like an interest-only or option-ARMs, they must also see a counselor.

The borrowers don't have to follow the counselors' advice, but the requirement is hoped to protect them from so-called predatory lenders. This is all part of a program that will be implemented by the Department of Financial and Professional Regulation.

The down side is that the list of possible consequences is so long that lenders, title company officials and others in the real estate industry are still stunned the legislation passed:

1. There are the considerable risks to borrowers. In a rising interest rate environment, any delay in getting a loan through processing -- especially to get the borrower in to see a counselor, could result in higher interest rates as time passes.
2. Whole neighborhoods could possibly be stigmatized as difficult to buy, threatening property values for existing homeowners.
3. There are only about 100 HUD-approved counselors in the state of Illinois qualified to participate in the program. There are approximately 200,000 households or nearly 800,000 people who could potentially be impacted by the new law if they buy a new home or refinance their mortgages. If only 25 percent need counseling in the next three years, which is a conservative guess, that means that 200,000 people will have to be processed by about 25 counselors, or 2,666 cases per year, per counselor. What happens when these four-person households begin to conform to national numbers closer to 2.65 persons per household? The counselors' workload doubles.
4. Will the program work? Not without considerable liability to others on the HUD-1. The pilot program largely depends on participants such as title companies, which are being asked to do things for which there may be too much liability attached. They are expected to input information to the pilot program database that they normally wouldn't touch with a 10-foot pole, such as the borrowers' FICO score.

How would they obtain that without interviewing the borrower or relying on the lender? If they input the wrong number by mistake, there could be hell to pay.

"Any violation of this law is also a violation of the Consumer Fraud and Deceptive Practices Act," explains Jim Weston, vice president and counsel for Chicago Title Company. "That doesn't require intent, any error is sufficient to pay attorney's fees and that can evolve into a class action suit."

5. Lenders must pay the \$200 to \$300 to hire the credit counselors for their borrowers regardless of whether or not they actually get the loan. The credit counselor could conceivably advise the borrower to seek another program. In any case, the fees to comply with the program will surely be passed along to consumers in the form of higher interest rates or loan management fees.
6. Lenders can't avoid lending in certain zip codes, or they will be accused of "redlining," and consumer groups have already threatened action if lenders attempt to discourage sub-prime borrowers. If the lenders are sued for redlining, the awards can be as high as 100 times the damages, as well as go into class-action status. Some lenders may decide it's simply not worth the risk to do business in Illinois at all, which could bring transactions to a halt, potentially putting even more homeowners at risk of foreclosure. Pulling out the state could send a strong message to other states not to follow Illinois' example.

Credit scores are important to mortgage lenders, but having them doesn't necessarily make lending decisions easier, because lenders don't base their lending decisions on scores alone -- they weigh such factors as how much down payment the borrower has and how much the borrower wants to borrow relative to his/her income and debts. Low scores don't always mean the buyer will receive a high interest rate.

Explains Bill McNamee, president of Pinnacle Home Mortgage, "The borrower can have below 620 (credit score) and get market rates, if they have a large downpayment and low income to debt ratios, but if they have a score of 600 and high consumer debt, then that throws them into a sub-prime category. That's a higher cost loan because of the risk to the lender."

Just as wrong as making a credit decision on credit scores alone is making the assumption that foreclosures are rising because of mortgage fraud, suggests McNamee.

"When you have more people who used to have lower credit scores, they would sit on the sidelines because they thought they couldn't get loans," he explains, "but now we have programs to accommodate those people. When you have more people who fall into that category, you'll have higher foreclosure rates because you have a bigger pool of risk. But now there are more people in homes who would never had gotten that chance otherwise, and there's a desire among lenders to take that risk, and we have programs to accommodate those people, but it's simple math that if you are going to have more people buying, you're going to have more foreclosures."

Interestingly, the number one cause of foreclosures is not predatory lending -- it's loss of jobs, followed by health issues, and unforeseen expenses.

Published: July 11, 2006