Foreclosing on Mabel: A case of predatory lending

by Daniel P. Lindsey in the August 11, 2009 issue

All Mabel wanted was a roof over her head. Well, a bit more than that: she wanted the same roof that had been over her head for most of her life. Mabel and her husband, Chester, had bought the house back in the 1940s under the GI Bill. They had raised their children there, and she and Chester had grown old there together. It was a simple home, a plain, Chicago-style brick bungalow, but it was hers. Mabel had been struggling to keep her house ever since Chester died. With Social Security she could cover the mortgage that she and Chester took out ten years ago to pay off some bills, but every year taxes and insurance were going up.

Mabel knew she didn't have many years left. It was getting harder to walk up the front steps. Harder to get up every morning. Harder to finish the housekeeping she did for her neighbors John and Rachel Manor to earn a few extra dollars. And she was forgetting things more often—she knew that—but she wasn't feeble, and she didn't like it when her niece Alice used that word.

Though she didn't like the way Alice talked to her sometimes, Mabel trusted her. So when Alice introduced her to a man who said he could save her home, Mabel trusted him too. The loan man—let's call him Bill Sykes—was so nice. As they sat on the sun porch sharing a pot of tea, he admired her ficus and complimented her on the excellent condition of her home. She was pleased when he told her that she was eligible for a special senior rate.

Mabel worried about making it downtown to sign the papers, but the loan man said it would be no trouble to bring them to her. When he arrived, Mabel prepared a pot of Earl Grey while he spread out the papers on the kitchen table. There would be higher monthly payments, Mabel learned for the first time. She knew she couldn't afford them, but the man said she'd get money from the loan to make the payments for a while, and then he could get her a new loan with lower payments. Mabel wasn't entirely sure it was a good idea to sign the papers, but the man was so nice, and

Alice was there, and surely the bank wouldn't allow her to borrow the money if she couldn't afford it. So she went ahead and signed.

The day before the signing, Sykes had not been happy. Two deals had tanked already that morning when a stubborn appraiser had refused to bring him high enough home values. He wouldn't use that bozo again. And now with Mabel's loan in doubt, he'd be lucky to gross $5,000 for the week—half his usual. He'd have to call the car dealer and tell him to put the Jaguar on hold.

With Mabel, the value of the home was no problem, but her income was hopeless. The old lady's niece—his principal ally in the deal—had told him that Mabel still owed a hundred thousand, but she was off by a good 40 grand. And then Sykes found a water bill, back taxes and two judgments on the home. Mabel couldn't begin to afford to pay all this debt off, much less repay the cash outlay that would grease the deal.

A year ago Sykes would've given up. But that was before the big lunch he'd had with a representative of a subprime lender. The rep had displayed his employer's array of aggressive loan products: no doc, low doc, doc lite. All Sykes needed was a cooperative appraiser and a friendly closer, and he would be set: with these new products he'd be able to finance anybody. A year later, Sykes could see that the rep wasn't far wrong.

Mabel's case was tough, but maybe there was a solution. Sykes called up her loan application on his computer screen, found the income field and added a zero. He frowned. Even if nobody was looking closely, $5,000 a month for part-time housekeeping was a stretch. He tabbed over and made another change, then another. "Housekeeping Supervisor," he typed. "The Manors." Very official, very institutional-sounding. Sykes loved these subprime loan applications. They were liquid gold.

The story of Mabel and Sykes may seem like a colorful fiction, but Mabel (not her real name) was an actual client at the Legal Assistance Foundation of Metropolitan Chicago, and Sykes is a composite of her broker and a half-dozen others whom my colleagues and I have gotten to know well over the years.

Though the numbers in Mabel's case are extreme, her story has become a familiar one over the past decade: the vulnerable and overly trusting homeowner sitting on a ton of equity, the nice mortgage broker worming his way into her life, the greedy family member helping things along, the high up-front fees, the cash payment to cushion the deal, the risky mortgage products and the broker schooled by a lender's rep on how to push them.

The risky financial instruments were the heart of the problem. No-doc, low-doc and doc-lite loans were the building-blocks of the now-defunct subprime lending industry. Independent brokers and in-house loan officers were encouraged to make as many loans as possible, and they were told that with these sorts of loans the consumer's income did not have to be independently verified—no need for W-2s or pay stubs, just the loan application filled out by the broker. It was an invitation to fraud, an invitation that was accepted by thousands of brokers and loan officers every day. In the peak year of 2006, over half of all subprime loans were of this no-doc or low-doc variety.

These loans were doomed to fail. So why did lenders make them?

It was all about volume, which drove decisions at every level. Brokers working at the front end to close loans were paid on the basis of volume—and the greater the volume, the better the earnings for lenders and investors down the line. As long as everyone did everything necessary to pump up the volume, everyone was happy and everything worked fine.

Independent brokers like Sykes, who were paid on commission, had no stake in the viability of loans because they never owned them. Disregarding long-term sustainability, lenders rewarded productive brokers by paying them kickbacks (known as yield-spread premiums) to arrange mortgages at rates higher than borrowers qualified for. As in Mabel's case, this made the loans more expensive—and riskier—but brokers and lenders were happy because of the higher return. Yes, there were more defaults, but those took a while to accumulate, and the high rates, fees and volume more than compensated.

To keep the money flowing, brokers needed allies. Every Sykes needed an appraiser who would certify high home values. Brokers would reject appraisals they considered too low. (This practice destroyed the businesses of some honest appraisers who refused to inflate home values. Dick Gordon of American Public Media's *The Story* interviewed one such business owner in a segment titled Appraised Out of Business.) Brokers sometimes needed a complicit title agent too if a suspect loan—or a borrower with suspect mental capacity—wouldn't pass muster with a legitimate closing agent.

These industry-wide practices were made possible—indeed, they came to be virtually required—as a process known as securitization expanded in the mortgage industry. At one time banks had a natural incentive to make good loans because they would lose money if borrowers defaulted. By the early 2000s those days were long gone. In the brave new world of securitization, mortgage loans were immediately sold and then resold and packaged into loan pools of 5,000 or 10,000. Then those pools were sliced and diced into securities sold on Wall Street to investment bankers, mutual funds and pension funds. There was no longer any connection between the borrower who signed the mortgage and the countless owners of the bits and pieces of the mortgage that were scattered among multiple investment funds.

This model was phenomenally successful in terms of pumping capital into the financial system. In the mid-1990s, when securitization had just begun to discover subprime loans, lenders issued $35 billion worth of these products annually, and they represented only a small percentage of all home loans. By 2006, subprime mortgages totaled almost $700 billion and had captured nearly a quarter of the market. It’s no wonder that brokers like Sykes were falling all over each other making loans to anyone whose threshold they could cross.

The cycle fed on itself. As long as brokers were eager to arrange subprime loans and as long as the lenders were willing to make them, home values continued to rise, eventually past the point of objective reality and finally to the breaking point.

Attorneys representing victims of predatory lending practices were testifying before Federal Reserve officials and other regulators years before the crash, but no one in power wanted to hear about putting on the brakes back then. They simply turned a blind eye. Now the brakes are finally being applied—but it is years too late for homeowners like Mabel.

A few days after Mabel signed the paperwork for her loan, Alice went to pick up the money—$50,000 borrowed against Mabel’s home equity. This money was supposed to help Mabel pay off her debts and make the new, higher monthly payments until Sykes could arrange for a lower-rate loan.

Alice’s equity-stripping scheme succeeded: Mabel never saw her niece again.

Without the money, Mabel defaulted on her first payment, and the lender filed for foreclosure soon after. Mabel tried to reach Sykes, but he was never in his office, and he never called her back. The last time she called him, his number had been disconnected. So Mabel called the phone number listed on the foreclosure summons. She was told that if she couldn't afford a lawyer, she could seek free legal assistance. This is how Mabel happened to come to us at the Legal Assistance Foundation.

We met with Mabel, reviewed her documents and quickly determined that we had claims against both the lender and the broker (a new company that had bought out Sykes's firm). Fortunately, the lawsuit was assigned to a sympathetic judge, who helped us to forge a settlement with the lender and broker. Then we helped Mabel refinance her new, lower debt with a reverse mortgage—a loan product for senior citizens that is paid for by the equity in the home and requires no monthly payments. The loan comes due when the borrower dies or moves out—to, say, a nursing home—at which time the home can be sold to cover the remaining debt.

Mabel got to keep a roof—her roof—over her head. But many thousands of subprime borrowers have not been so lucky. They didn't get to a lawyer in time, or the fraud or systemic unfairness in their case was not amenable to a legal solution. Their stories may not be as extreme as Mabel's, but they too are victims of a lending juggernaut built on fraud, wishful thinking and greed—whose implosion is a primary contributor to the current economic crisis.

Many have asked who is to blame. Some would blame the homeowners themselves. It is true that some borrowers bought homes they couldn't afford, but this happened mostly at the end of the lending spree and especially in certain highly publicized markets. The majority of borrowers sucked into bad subprime loans were long-term homeowners like Mabel who had equity that could be stripped and were on the receiving end of relentless marketing.

Some also point a finger at the Community Reinvestment Act, arguing that it forced banks to extend overly risky loans to unworthy borrowers. But the CRA was passed way back in 1977, some 25 years before the boom in subprime lending, and the biggest subprime lenders—such as Mabel's real-life lender, Countrywide Financial—were nonbank entities not regulated by the CRA.

The chief culprits in the subprime lending crisis are the brokers, lenders, ratings agencies and investment banks that set up the system and pushed it beyond its breaking point, together with the policy makers and regulators who ignored warning signs and failed to apply the brakes.

As for Sykes, he’s doing well these days. The meltdown has been good for the many entrepreneurs in the business who are now engaged in the mortgage-rescue industry that sprang up overnight. Just as before, Sykes sends out mailers by the thousands to homeowners in foreclosure. But now, instead of offering refinancing, he presents himself as an expert in foreclosure prevention and loan modification. He says he knows how to help homeowners get good results with their lender. He says he can gain a sympathetic hearing if he discovers that the homeowners were duped when they got their loan. He should know.