Questions & Answers About

Subprime Lending

Save Money

Get Help

Avoid Rip-Offs

A Consumer Action Publication

Contents

About this guide

Consumer Action has written this guide to help community-based organizations communicate with their clients. A free companion brochure for consumers titled "Poor credit means higher interest rates" is available free and in bulk in English, Chinese, Korean, Spanish and Vietnamese. Visit the Consumer Action web site (www.consumer-action.org) or call 800-999-7981 for a free publication order form or more information about Consumer Action's services.

Bank of America

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Poor credit means higher interest rates

Low-rate credit cards, car loans and mortgages are widely available to people with good credit. Increasingly, loans also are available to people with damaged credit, although at higher rates than people with good credit would pay. Companies that make loans to borrowers with damaged credit are referred to as subprime lenders. As the market has grown some subprime lenders and loan servicers have engaged in illegal practices to the detriment of borrowers.

What does it mean if an individual has "prime" credit?

Prime credit means that an individual has paid their outstanding credit (car loans, credit cars and mortgages) on time. Most people with prime credit also carefully manage their credit by applying only for the loans and credit cards they need. People with prime credit have excellent "credit scores," numbers that the credit industry uses to rank individuals' overall credit. Credit scores range from below 500 to above 800. Prime borrowers usually have scores of 749 or higher. It is not necessary to have prime credit to qualify for a decent interest rate—people with credit scores of 675 and above still qualify for lower rates.

Are borrowers with less than prime credit denied credit?

Not always. Many companies will extend credit to people with poor credit—so-called "subprime" customers—but they will charge them a higher interest rate than people with good credit would pay. Borrowers fall into the subprime category because they made late payments on credit cards or loans, abandoned loans or filed bankruptcy in the past seven years. Many subprime borrowers are low-income individuals, minorities, elderly and/or women. Lenders may also assign this label to people who have little or no credit history, change jobs frequently or move often.

How much credit do today's consumers have?

According to Fair Isaac, a company that provides credit scoring services to lenders, today's consumer on average has a total of 11 credit obligations on record at credit bureaus. These include credit cards (such as department store charge cards, gas cards, or bank cards) and installment loans (auto loans, mortgage loans, student loans, etc.). Of these 11 credit obligations, 7 are likely to be credit cards and 4 are likely to be installment loans.

Do most consumers pay credit obligations on time?

Most consumers pay on time. Fewer than four in 10 have been reported 30 or more days late with a payment. Only two in 10 have been 60 or more days overdue on any credit obligation. Eighty-five percent have never had a loan or account that was 90 or more days overdue and fewer than 10% have defaulted on a loan. (Source: Fair Isaac/MyFico.com)

Subprime credit

What is a subprime loan?

A subprime loan is the extension of credit to a person with a damaged credit history who is considered to be a high risk borrower. Subprime loans have higher—sometimes much higher—than average interest rates. Subprime lenders reduce their risk in making loans by charging borrowers a higher interest rate and sometimes additional fees.

How will a lender know that I have poor credit?

When you apply for a loan, the lender will check your credit history. Look at your credit report before the lender does. (See the information farther down on this page about how to do this.) Reviewing your credit report will provide you with a list of most, if not all, of your current debts, and give you a chance to make sure they are reported accurately.

Why do people with poor credit pay more for loans?

Lenders feel that people who have not handled credit well in the past are at a greater risk of failing to repay their loans. Standard-priced loans are typically made to people with good credit history because their past record proves to lenders that they are at low risk of default.

Who are subprime lenders?

Many major banks offer loans to both prime and subprime customers. Other companies specialize in lending to subprime customers by offering high-interest debt consolidation loans, "pay day" loans and car title pawn services. These services—often called predatory lending—can put people with already damaged credit deeper in debt.

How can I check my credit history?

You can get copies of your credit report from one of the big three credit reporting bureaus: Equifax (www.equifax.com, 800-685-1111), Experian (www.experian.com, 888-397-3742) and TransUnion (www.transunion.com, 800-888-4213). Each report costs about $10. In 2005, a new law will give you the right to obtain a free copy of your credit report from all three companies every year. As the 2005 deadline nears, check Consumer Action's web site (www.consumer-action.org) for more information on how to order your free report.

Where can I find a lender who makes loans or provides credit cards or loans to people with poor credit?

Contact several companies to compare rates and other terms. Ask at your bank or credit union as well as other banks and credit unions where you live. You can also search Bankrate.com or E-Loan.com on the Internet to find loan information. Be cautious about offers that do not come from these sources. When shopping around, it's okay to admit you have credit problems, but don't agree to having your credit record reviewed until you have narrowed your choice to three good offers. Otherwise, the credit inquiries will go on your credit record and might further damage your credit history.

Credit scoring

How many U.S. residents with credit histories are considered subprime consumers?

According to Fair Isaac, the designer of the FICO credit scoring software, 11% of the American public has the highest credit scores of 800 and above. The rest of the population breaks down like this:

- 1% have credit scores of 499 or lower.
- 5%, 500-549.
- 7%, 550-599.
- 11%, 600-649.
- 16%, 650-699
- 20%, 700-749.
- 29%, 749-799.

How much more do people with poor credit scores pay for loans?

In early 2004, a person with a score below 559 would pay an interest rate of about 3.8% more (9.29% versus 5.46%) than someone with a score of 800 or above for a 30-year mortgage. On a 36-month new auto loan, the rate would vary by almost 13% (17.64% versus 4.83%).

What factors affect my credit score?

The FICO score used by many banks and other lenders uses your payment history to determine 35% of your credit score, including:

- Account payment information for your credit cards, store credit accounts, installment loans, finance company accounts, mortgage, etc.
- Public records such as bankruptcy, judgments, lawsuits, liens and wage garnishment orders.
- Collection accounts.

The amount of your overall debt accounts for about 30% of your score. The length of your credit history, recently opened accounts and applications for new credit and the credit "mix," such as credit cards, retail accounts, mortgages, account for the remaining percentage of your score.

Even if you have an excellent record of on-time payments, your score may be lowered by a short credit history or the fact that you have many retail credit cards. If you have applied for credit recently, your score will drop because new applications mean you might increase your overall debt.

How can I find out what my credit score is?

You can purchase your score online at MyFico (myfico.com) for $12.95. You can also order your credit score along with your credit report, a listing of all your creditors with your payment history, for about the same price from any or all of the three major national credit reporting bureaus. (See page 3.)

Predatory lending

Are subprime lenders the ones who make "predatory" loans?

Not necessarily. Any lender can engage in "predatory lending." Predatory lenders exploit people with very high interest rates, excessive fees, no verification of the borrower's ability to repay, repeated refinancing of the loan and hidden loan terms such as very large lump-sum (or "balloon") payments that the borrower can't pay. Predatory lenders often target desperate people, unsophisticated consumers and homeowners who own their homes outright but who have small incomes. These lenders make loans to people who often don't have a chance of repaying them.

What is a balloon payment?

A balloon payment is a very large one-time payment that is due at the end of the loan. Borrowers often agree to a balloon payment because it lowers their monthly payments, but face a rude awakening when the large lump sum is due and they can't pay it. It is illegal to require a balloon payment in a high-interest home refinancing loan.

How can I avoid taking out a predatory loan?

To avoid becoming the victim of a predatory loan, shop around among lenders and ask lots of questions. Don't take the first loan you are offered. A low monthly payment is not always a great deal. Instead, ask the lender about the total cost of the loan. Don't buy promises to refinance the loan at a better rate in the future if your credit improves. If you don't understand the loan terms, talk to someone you trust and ask them to review the documents. Never sign blank documents or allow the lender to fill in the blanks later. Avoid lenders or ads that promise "No Credit? No Problem!" Never give in to high-pressure sales tactics. When you decide to sign a contract, make sure all the terms you were promised are included. After the company's representative signs and dates the contract, make sure you get a signed copy. If you are refinancing your home mortgage, you have the legal right to change your mind for up to three days after you sign the loan.

What are the warning signs of a bad loan?

In general, avoid any loan with the following:

- High closing costs. The law requires that borrowers be given a "good faith estimate" of all fees and costs for a loan. Compare estimates from at least three lenders.
- Lenders who require a balloon payment.
- Upfront fees as a requirement for receiving a loan.
- Telephone solicitations, door-to-door sales or high-pressure sales tactics.
- Credit life or disability insurance policies. Predatory lenders often include this insurance in the loan without the borrower's knowledge. You have the right to decline such coverage. (An exception is title insurance when you buy property—get an owner's title policy.)
- Penalties for prepayment. This could cost you if you improve your credit history and want to refinance the loan at a lower rate.
- Unlicensed lenders. Always check licenses with your state banking regulator.
- Documents with missing dates or blank spaces. Make sure the signature lines are part of the entire contract, not loose pages that could be added to a loan with different terms.
- Brokers who ask you to lie on a loan application so that you will qualify. It is a crime to lie on a credit application.
- A broker who recommends that you repeatedly refinance your loan. This is a scam that results in more profit for the lender.

Illegal practices

A lender tried to sell me up-front credit insurance, saying I wouldn't notice the premium because it would be financed in my loan. Is this a good deal?

No. Walk away from this lender because loans that include credit insurance (especially when it's financed up front) are a rip-off. Credit insurance is a plan that minimizes the risk of non-payment caused by financial or economic difficulties. Avoid lenders who attempt to sell you life, accident and health, disability or unemployment insurance products in connection with a high cost loan. The fees for these optional products may exceed the loan amount.

A contractor showed up at my elderly parent's door offering to do some work and find financing to pay for it. Is this a good idea?

Do not trust contractors who show up unasked and suggest that you need home repairs or other work done, especially if they recommend a lender to finance the work. Sometimes dishonest lenders work with building contractors to deceive home owners and steal their home equity.

What is a prepayment penalty?

Prepayment penalties require that you pay a fee if you refinance a loan or pay it off before the term is up. These penalties lock consumers into bad loans and penalize them for paying off the loan early. Prepayment penalties of up to 5% are common. (For a $100,000 mortgage loan, this would be $5,000.) Prepayment penalties are hidden fees that rob homeowners of the equity in their homes. (Equity is the portion of your home's value that you own outright.)

How likely is it that a subprime borrower will encounter a loan with a prepayment penalty?

Very likely. According to a study by Duff & Phelps only 2% of prime borrowers in the competitive mortgage market accept prepayment penalties while 80% of subprime borrowers agree to prepayment fees.

How can I tell a bad loan when I see it?

If a loan sounds to good to be true, it's probably a bad deal and chances are it has illegal elements to it. Predatory lenders make money and even foreclose on property through unfair means. They will tell you whatever you want to hear, just so they can close the loan. Some try to get upfront money from you before the loan is made. Predatory lenders often encourage borrowers to repeatedly refinance ("flip") existing loans or to take out additional home loans to pay for a contractor's services. Watch out for high fees and optional insurance or credit services which can quickly eat up the equity in your home.

What information must lenders provide me with?

The federal Truth-in-Lending Act requires the lender to inform you of all the terms and costs of the loan when you receive an application, including the annual percentage rate (APR). Additional costs include "points" (each point equals one percent of the loan amount), appraisal fees (for inspecting the property), and closing costs and loan initiation fees (commission for the lender). If you do not receive this information, your loan contract may be unenforceable.

What is a "high-cost" loan?

A high-cost loan is a home equity loan with high rates, points or fees that can put you in jeopardy of losing your home if you can't make the monthly payments. You have special legal protections when you take out a high-cost loan secured by your home (such as a home equity loan, refinancing loan, or second mortgage). The Home Ownership and Equity Protection Act (HOEPA) provides extra protections if the interest rate on the loan is eight or more percentage points higher than the rate on a Treasury bill with the same term. HOEPA loans cannot require a large final ("balloon") payment due in fewer than five years. If the lender violates HOEPA or federal Truth-in-Lending laws, you have the right to cancel the loan. But act quickly—you may lose some rights if you don't act within three business days. Visit the Federal Trade Commission online (www.ftc.gov) for more information on restrictions on HOEPA loans.

What should I do if a lender offers me a loan I can't hope to repay?

Unscrupulous lenders have very loose or unrealistic underwriting standards. This means that they will close on loans they know that the applicants can't repay. Even if a lender says you qualify, do the math to see if you can manage the monthly payments. Compare your monthly income to your monthly expenses, including the new loan payment, to make sure you can afford the loan. Don't ever agree to inflate your earnings or give any other false information in order to qualify for a loan.

How can I check if a lender is reputable?

Contact your state banking regulator and consumer affairs agency and local Better Business Bureau (www.bbb.org) to see if any consumer complaints have been filed.

What is counseling disclosure?

A number of states require that loan applicants receive a counseling disclosure notice when they apply for a home loan with a high interest rate, such as 12% or greater. Contacting a counselor before closing on a loan is a smart thing to do, and it might save you hundreds or thousands of dollars

Can I ever improve my credit?

Yes. It is never too late to clean up your credit or build a credit history. It won't happen overnight, but you can improve your credit by paying bills on time and not over-using or abusing credit. If you have a slightly damaged credit history, with only a few late payments, you may be able to bring your accounts up-to-date and improve your credit in just a few months. For information on how to improve your credit, visit the Consumer Action web site (www.consumer-action.org) and click on "Credit."

How can I get help if a lender takes advantage of me?

If you have been taken advantage of by a lender, immediately contact your state lending or banking commissioner, your state attorney general and the federal Office of the Comptroller of the Currency or the Federal Deposit Insurance Corporation for advice on filing a complaint. Also file a complaint with the Federal Trade Commission and with advocacy groups. (See "Complaint-handling agencies.") By contacting the proper authorities, you will establish a paper trail for your complaint and help regulatory agencies identify abusive lenders.

Do I need a lawyer to help with my complaint?

In most cases, victims of unfair or deceptive loans have to hire an attorney to sue the lender. The National Association of Consumer Advocates' web site (www.naca.net) lists member attorneys organized by region and area of expertise, as well as tips on finding an attorney.

Complaint-handling agencies

State attorneys general

Check the state government section of your phone directory or visit the National Association of Attorneys General web site (www.naag.org) for a directory of state attorneys general.

State banking regulators

Check the state government section of your phone directory under "Banks" or "Financial Institutions." The Mortgage Bankers Association (http://www.mortgagebankers.org/state_update) has an online list of state agencies that regulate banking and lending.

Comptroller of the Currency

For violations of federal lending laws and the Real Estate Settlement Practices Act (RESPA).

Customer Assistance Group, 800-613-6743, www.occ.treas.gov

Department of Housing and Urban Development (HUD)

Office of Consumer and Regulatory Affairs - Interstate Land Sales/RESPA Division

202-708-4560, www.hud.gov/complaints/landsales.cfm

Federal Deposit Insurance Corporation (FDIC)

Consumer Affairs Division, 877-ASK-FDIC (925-4618), www.fdic.gov

Federal Trade Commission

(For federal lending violations involving mortgage and consumer finance companies.)

877-FTC-HELP (382-4357); TTY 202-326-2502, www.ftc.gov

Federal Reserve Board of Governors of the Federal Reserve System

Division of Consumer Affairs, 202-452-3693, www.federalreserve.gov/pubs/complaints

Further information

• ACORN, the Association of Community Organizations for Reform Now, is an advocacy group active in protecting consumers from predatory lending. To find the chapter nearest you, visit the ACORN web site (www.acorn.org) or call 202-547-2500.

• The Center for Responsible Lending (www.responsiblelending.org) works to stop the finance industry from stripping wealth from minority and poor communities. Click on For Consumers, then Getting Help, to find referrals to complaint-handling agencies at the state level.

• Consumer Action (www.consumer-action.org) provides consumer advice, suggests appropriate complaint-handling agencies and offers free consumer education publications. Leave a message and a counselor will call you back. Chinese, English and Spanish spoken. 415-777-9635 and 213-624-8327, TTY: 415-777-9456; e-mail: hotline@consumer-action.org.

• Consumers Union (www.consumersunion.org) offers free consumer tips on financial services on its web site. Consumers Union, the publisher of Consumer Reports magazine, is active in lobbying for laws to protect borrowers from predatory lenders.

• The Federal Trade Commission accepts complaints from consumers for use in investigating violations and offers a wide range of publications on loans, home improvement and consumer rights. (It does not resolve individual complaints.) 877-FTC-HELP (382-4357), www.ftc.gov.

• National Association of Consumer Advocates (www.naca.net) allows you to search its membership listings to find a consumer lawyer who practices in your area.

• The National Community Reinvestment Coalition offers "America's Best and Worst Lenders: A Consumers' Guide," which ranks lenders in 25 metropolitan areas. 202-628-8866, www.ncrc.org

• Stop Mortgage Fraud (www.stopmortgagefraud.com) is a web site developed by the Mortgage Bankers Association. It has information on how to tell if you are the victim of a predatory mortgage loan and provides suggestions on where to complain.