

August 1, 2001

Page One Feature

Subprime Borrowers Are Haunted By Mortgage Prepayment Penalties

By JOHN HECHINGER

Staff Reporter of THE WALL STREET JOURNAL

All over the U.S., homebuyers are reaping a bonanza in one of the biggest mortgage-refinancing booms ever. Taking advantage of lower interest rates, they are slashing their monthly mortgage payments or extracting tens of thousands of dollars in equity for new cars, vacations or their children's education.

But many low-income consumers are missing the party: "subprime" borrowers with blemished credit, a spotty employment record or a lot of debt. Increasingly, these homebuyers are finding that if they want to pay off their loan early to get a better deal, they are socked with thousands of dollars in fees.

These prepayment penalties, all but gone from the mortgages taken by average homebuyers, are alive and well among those who don't qualify for conventional financing. About 80% of mortgages in the subprime market carried prepayment penalties in mid-2000, up from 50% in 1997, according to a Standard & Poor's survey.

The penalties often assess borrowers 5% of the loan amount outstanding if they pay the mortgage off within its first three to five years for any reason, whether to refinance, consolidate debts or sell the home. Lenders say they need such a provision because of the high costs they incur in making subprime loans.

Growing Criticism

But some consumer advocates and politicians contend that borrowers aren't being adequately informed of the prepayment penalties, which critics characterize as a "predatory" lending practice aimed at low-income people who

may not fully understand loan terms. "Prepayment penalties rip money out of people's pockets," says Lisa Donner, a coordinator with the Association of Community Organizations for Reform Now, or Acorn, a nonprofit and activist group that often targets housing issues. "Owning a home goes from being a source of wealth into a constant drain."

Lisa and Mark Cabral of Mount Vernon, Wash., say they didn't know they were getting locked in. Four months ago, the Cabrals took out two new home loans from **Household International Inc.**: a \$102,000 loan at a 13.99% interest rate and a \$10,000 line of credit at 21.9%. They weren't planning to stay in their manufactured home for much longer. In fact, one reason they borrowed was to fix it up so they could sell it and move to a bigger place.

Can't Afford to Move

The work is finished, but the Cabrals say they can't afford to move, having recently realized that the bigger loan carries a penalty of about \$7,000 if it is paid off within five years. "We didn't know a lot about these kinds of things," says Mrs. Cabral, 36, a medical administrator who earns \$24,000 a year.

Mrs. Cabral and her husband, a construction-company superintendent, have sued Household. Their suit, in state court in Skagit County, Wash., claims Household didn't adequately disclose the prepayment penalty and some other terms of the loan, and alleges fraud and deceptive trade practices. "They took advantage of us, and now we can't sell our home," Mrs. Cabral says.

Household denies the allegations. "We don't believe we've done anything wrong," says a spokesman, Craig Stroom, who adds that the company levies prepayment penalties on most of its loans and always discloses them.

Higher Expenses

Household incurs higher expenses than conventional lenders, Mr. Stroom says, partly because it does more creditworthiness research and partly because it has to shell out more for collections on past-due loans. Subprime lenders don't collect their origination fees upfront but wrap them into the loan amount. So if a borrower

refinances after just a few months, Mr. Stroom says, "you eat your own costs." Hence the prepayment penalties.

About 35 states have laws that ban or restrict prepayment penalties, many enacted to protect consumers during the high-interest 1970s. It was these laws, together with lending competition, that prompted lenders to drop the penalties in most conventional mortgages.

Subprime lenders have found a way to retain the penalties even in the restrictive states. The device is an obscure federal law called the Alternative Mortgage Transaction Parity Act. Passed in 1982 to help lenders avoid the hassle of varying state restrictions, the law allowed them to subject "alternative" home financing -- such as adjustable-rate mortgages -- to oversight by the federal Office of Thrift Supervision. The OTS doesn't restrict prepayment penalties. In 1999, Virginia noticed growing numbers of loans showing up with prepayment penalties larger than the state cap, which is 2% of the loan amount. The state's banking regulator warned lenders they would be cited for violations. But a trade group sued in federal court, arguing that subprime loans were alternative mortgages under the 1982 law and thus could be covered by the OTS, not the state. The group's suit has prevailed at both the district and appellate level. Virginia is seeking Supreme Court review.

At the OTS, Director Ellen Siedman has voiced concern about lenders using the federal exemption to dodge states' restrictions on lending practices. But she says states can still go after many practices by using consumer-protection laws.

Subprime home loans carry interest rates three to six percentage points higher than conventional mortgages. Household generally charges 9% to 13%, at a time when conventional 30-year mortgages are running about 7%. Household also charges fees of about five "points," or 5% of the loan amount. Conventional loans may entail no points or several. They average about one.

Offsetting the Risks

Household and other subprime lenders say they need these terms to offset the risks they take. At the end of last year, 2.73% of subprime mortgages were

delinquent by 90 days or more -- about 10 times the level for conventional loans -
- according to market researcher Mortgage Information Corp.

The fairness issue has taken on greater importance because of explosive growth in subprime lending. The volume of subprime mortgages grew fourfold from 1994 to 1999, according to the trade publication Inside Mortgage Finance, before falling about 12% last year as some lenders faced financial problems after making bad loans. About 13% of mortgages originated last year were subprime. The Senate Banking Committee held a hearing last week on subprime practices, including early-payoff penalties. The Treasury Department and the Department of Housing and Urban Development have urged restrictions, such as barring prepayment penalties when the borrower is selling the home. And a House bill introduced by Rep. John J. LaFalce, Democrat of New York, would cap prepayment penalties at 3% of loan amounts and limit them to the first two years of a mortgage.

A few savvy borrowers turn prepayment penalties to their advantage. If they know they will be living in their homes for several years, they can choose to be subject to a penalty in exchange for a lower interest rate. The better-off customers in the "prime" market occasionally agree to them. But regulators and advocates say many uneducated borrowers don't understand the tradeoffs. And they say the penalties often are disclosed only in the fine print of loan documents.

Nonprofit groups often work with banks to funnel loans to low-income neighborhoods. Boston-based Neighborhood Assistance Corp. of America often tries to refinance borrowers out of high-interest loans. Prepayment penalties can block this strategy, says NACA's chief, Bruce Marks, though he adds that he sometimes can get a lender to drop the penalty after threatening a lawsuit or a protest.

'I Knew It Was a Bad Deal'

Jacquelyn Ali heard from a friend about a NACA program, funded by **Bank of America** Corp., that would allow her to refinance her 10.99% subprime loan with

a lower-rate mortgage. But Ms. Ali, who lives in suburban Atlanta, had to wait until a \$3,000 prepayment penalty expired this year to take the deal because she couldn't afford the penalty. The original \$73,000 loan was made in 1998 and was held by the CitiFinancial unit of **Citigroup**, one of the biggest subprime lenders. "I knew it was a bad deal," says Ms. Ali, a divorced mother of two who works as an office manager at Morehouse School of Medicine. "But I knew I had to wait to get out." Her monthly bill has dropped roughly by half with the new 6.1% mortgage.

Leah Johnson, a Citigroup spokeswoman, says the company has "heard the concerns voiced, and we're responding." Citigroup this year started offering subprime borrowers a choice of opting out of a prepayment penalty at the outset, in exchange for a higher interest rate. It also has agreed to limit prepayment penalties to three years. A week ago, Household said it, too, would limit the duration to three years.

Many subprime homeowners need to borrow so much that they have little equity when they first buy their homes. Then, selling the house while a prepayment penalty is still in force can eat up much of whatever equity they've managed to accumulate. A refinancing, either to lower the interest rate or to draw out some cash, can cause a new prepayment penalty to kick in after the first one has expired.

In March, Willie Irby, his left leg stiff from a stroke, walked to the front door of his Washington, D.C., home, collected the mail and ripped open a long-dreaded letter from his mortgage company. "Foreclosure is imminent," read the notice, demanding \$6,155.24 in back payments. "If you wish to save your property, you must act now."

A Painful Decision

To satisfy the debt, Mr. Irby and his wife, both in their 70s, made the painful decision to sell the home they had bought as newlyweds. But they soon discovered that their mortgage was blocking their escape. It carried a prepayment penalty of \$13,791. The Irbys say they didn't have the money, and



Willie Irby

the proceeds from selling the house wouldn't cover it after they paid the mortgage.

The Irbys found themselves in dire straits even though the house they bought in 1959 for \$16,950 was now valued at about \$350,000. Over the years, they had loaded it up with high-cost debt, mostly to remodel it and to pay medical expenses. The amount they owed on it also grew as lenders' fees were wrapped into the debt. Last November, the Irbys took out a new mortgage with Option One, a unit of **H&R Block Inc.**, believing they could lower their monthly payments and extract another \$45,000 for medical expenses. The mortgage climbed to \$314,000.

As his debt against the house skyrocketed, Mr. Irby had an uneasy feeling. "I thought maybe I was borrowing more than I can afford," he says. But he believed he had no choice.

The new loan's interest rate was 10.99%. According to a complaint the Irbys subsequently filed with HUD against the lender, monthly payments on the mortgage they took out in November were just under \$3,000, while their monthly income is about \$2,750. Option One executives, while declining to discuss specifics of the case, say the file shows that the Irbys had enough income to qualify for the \$314,000 mortgage.

This spring, the Irbys agreed to sell the house to pay off their loan. They moved into a cramped one-bedroom apartment and decorated it with pictures of politicians and world leaders, mementos from Mr. Irby's work in the mailroom of the Department of Energy. The couple gave away half their furniture as well as their washer and dryer when they moved.

When they learned about the penalty for prepaying their mortgage, the Irbys had to pull out of the sale. "All I wanted was enough money to sell the home and pay the people off," says Mr. Irby, 77.

The would-be buyers, Mary and Dennis Kivlighan, joined the Irbys and the National Community Reinvestment Coalition, a Washington nonprofit group, in the fair-housing complaint with HUD.

Late last week, after a reporter began looking into the case, Option One reached an agreement with the Irbys. It allowed the sale to go through, with the lender waiving about \$23,000 in fees and interest, according to Option One. Still, the lender's chief operating officer, Steve Nadon, defends prepayment penalties, saying that without them, interest rates for all subprime borrowers would have to rise and some would be shut out of the market. The Irbys' fair-housing complaint is still pending with HUD.

On a recent day, Mr. Irby, his jeans still flecked with paint from home-improvement projects, reminisced as he toured his now-empty home, walking past the paneling and wallpaper he had hung himself. "We were here for 40 years," he says. "My kids grew up here. We had good times here. Now, it's gone. Once you're behind, you can't catch up."

Write to John Hechinger at john.hechinger@wsj.com¹
