

# Combating Predatory Lending in California

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## A. INTRODUCTION

Predatory lending has become an insidious financial problem in recent years for thousands of Californians. In any real estate loan, the loan terms and consequences must be adequately disclosed and, more importantly, financially feasible for the borrower. Through "flipping" and "packing," predatory lenders avoid these two requirements, reaping massive benefits while causing financial ruination for the consumer.

Fortunately for consumers, the California Legislature has recognized the growing problem of predatory lending by adding Division 1.6 to the Financial Code<sup>(2)</sup>, effective July 1, 2002. This law specifies what constitutes predatory lending and expressly prohibits certain acts. In discussing predatory lending practices in California, this article will demonstrate the potential impact of the new law, and what remedies are now available to those affected by these practices. .

## B. DEFINING PREDATORY LENDING

Predatory lending encompasses a variety of practices. The most prevalent of these practices, however, is predatory lending in connection with home mortgage loans. These loans are targeted at homeowners who may be living on fixed or lower incomes, and those who have checkered credit histories.

Unlike most prime loans, subprime mortgage loans are generally based on the equity in a borrower's house instead of his or her ability to make the scheduled payments. Therefore, problems meeting scheduled payments frequently arise due to the borrower's lack of liquidity, a problem obviously foreseeable, yet ignored, by the lender. When this occurs, the predatory lender encourages the borrower to refinance the loan into another unaffordable loan, thus increasing the loan amount

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owed, primarily due to new finance fees. This "refinancing" severely decreases the borrower's equity in his or her home and is a common practice referred to as "loan flipping."

Another practice utilized by predatory lenders is "packing." This is the practice of surreptitiously placing lender-protective credit insurance or other goods and services into consumer loans. For example, a predatory lender will state a fixed monthly payment to the borrower. Upon closure, however, the loan papers will include numerous single premium payment insurance policies which need to be added to the quoted monthly payment. These insurance policies are not mentioned during the loan negotiations as an additional cost. The lender ultimately hopes the borrower will not notice the added charges at all; if, however, the borrower is lucky enough to recognize the hidden costs, predatory lenders are equipped with numerous tactics to force the loan through despite the borrower's misgivings. The most prevalent tactic is to threaten the closing of the loan by stating that deletion of the challenged costs will either cause delay, or effect the borrower's loan eligibility. Given the financial situations of most of these borrowers, the threat of not receiving the loan, or even just a delay in the closing of the loan, can be enough to make the borrower forget about the added charges

Although many borrowers become aware of these hidden charges when they receive their first statement, other hidden terms and penalties are included that become apparent only when the borrower decides to get out of the loan.

One of the most potent tools used by predatory lenders to keep borrowers defenseless is the prepayment penalty. According to Standard & Poor's, subprime loans contain prepayment penalties 80% of the time, while prime loans only 2% of the time.<sup>(3)</sup> Since it is lower income individuals who are targeted by predatory lenders, the threat of thousands of dollars in prepayment penalties obviates the lenders fear of the borrower prepaying the balance through a more affordable prime loan. The prepayment penalties trap the individual in a long-term unaffordable loan that can only be refinanced by the lender who misrepresented the loan terms in the first place.

Predatory loans can be financially devastating. A borrower owing up to three times as much as he or she has borrowed is not an uncommon occurrence with a sub-prime predatory home mortgage loan.

### **C. PREDATORY LENDING IN CALIFORNIA**

The California Reinvestment Committee (CRC) is currently conducting a study weighing the effect predatory lending has had on Californians. The preliminary findings suggest predatory lending is a very common practice in California:

- 73% of all borrowers saw key loan terms (e.g. interest rate, fixed versus adjustable mortgage, prepayment penalty) change for the worse at the closing of the loan as compared to what was

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represented to them;

- 61% of all borrowers had loans containing prepayment penalty provisions which lock borrowers into bad loans by assessing a fee of several thousand dollars if borrowers pay off their subprime loans early;
- 64% of borrowers reported refinancing their home loans from two to six times, suggesting widespread "loan flipping" and "equity stripping" by lenders;
- 39% of borrowers reported that the idea to take out a loan secured by their home came from the marketing of subprime lenders. Aggressive marketing through telephone calls, mailers and broker solicitations, was experienced by most study participants.<sup>(4)</sup>

Although the study is still in its infancy, the preliminary numbers leave no room for doubt that predatory lending has become a tremendous problem in California and is robbing Californians of millions of dollars. The discrepancies in prime loan interest rates and those offered by the subprime lenders has steadily increased.

Subprime lenders state that they serve a very important function, mainly providing credit to borrowers with imperfect credit histories. However, it is this exact premise, the supposed benevolence of subprime lending, on which predatory lenders rely to justify their practices, thereby blending financially feasible subprime lending into predatory lending. Financial Code § 4970 is California's remedy to this problem.

### **D. BASIC PROVISIONS OF FINANCIAL CODE § 4970**

California Financial Code § 4970 et seq. became effective on July 1, 2002. This law recognizes the need for more stringent regulations on consumer loans secured by specified real property, defined as "covered loans."<sup>(5)</sup> The effect of the bill was best summed up by the Legislative Counsel's digest, which states:

The law prohibits various acts in making covered loans, including the following:

- Failing to consider the financial ability of a borrower to repay the loan
- Financing specified types of credit insurance into a consumer loan transaction
- Recommending or encouraging a consumer to default on an existing consumer loan in order to solicit or make a covered loan that refinances the consumer loan
- Making a covered loan without providing the consumer specified disclosure<sup>(6)</sup>

Moreover, this law expressly defines the relationship between the broker and the borrower as a fiduciary relationship, thereby placing a legal duty on the broker to act in the borrower's best interest.<sup>(7)</sup> Furthermore, the newly enacted provisions clearly lay out strong incentives for attorneys to vigorously prosecute predatory lending. Under California Financial Code § 4978, these incentives include mandatory

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attorney fees, the award of punitive damages, and the greater of either actual damages or statutorily prescribed damages when the violation is "willful and knowing."<sup>(8)</sup>

(a) A person who fails to comply with the provisions of this division is civilly liable to the consumer in an amount equal to actual damages suffered by the consumer, plus attorney's fees and costs. For a willful and knowing violation of this division, the person shall be liable to the consumer in the amount of \$15,000.00 or the consumer's actual damages, whichever is greater, plus attorneys' fees and costs.....

(b)(2). A court may, in addition to any other remedy, award punitive damages to the consumer upon a finding that such damages are warranted pursuant to Section 3294 of the Civil Code.

Accordingly, if either an express violation of this section or abuse of the fiduciary relationship between broker and borrower is established, private attorneys and their clients are now equipped with statutory power to obtain redress.

Although California Financial Code § 4970 paints with a broad stroke, with its specificity, predatory lenders will undoubtedly find loopholes in the regulations. Fortunately for California consumers, actions for predatory lending can also be brought under the very expansive state consumer protection statutes, such as Business and Professions Code §17200.<sup>(9)</sup>

### **E. WAYS TO AVOID PREDATORY LENDING**

In addition to discussing remedial measures for predatory lending, it is important to also discuss ways in which individuals can avoid receiving a predatory loan.

The first way to avoid predatory lending is to comparison shop different lenders to find the best deal. As predatory lenders would have them believe, borrowers with credit problems think that only by paying exorbitant interest rates can they qualify for a loan. However, the truth is that up to 50% of those people who receive predatory loans would actually qualify for a prime loan. The most practical way to remedy this problem is for a borrower to obtain a credit history report and have it analyzed by a disinterested third party. By doing this, the borrower will know when a predatory lender is being untruthful about the type of loan for which he or she will qualify due to credit problems.

Second, when applying for a loan, keep an eye out for common misrepresentations that are indicative of predatory loans. For example, the lender states that the loan has the flexibility of an open line of credit, or the lender requires credit insurance, claiming it is the only way the borrower will qualify for the loan. Next, the consumer should ask to see the lender's published rates on fees and points.

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Finally, the consumer should look for terms and conditions that will trap him or her into the loan. As discussed above, prepayment clauses are indicative of a predatory loan. The reasoning behind prepayment clauses is to keep borrowers from refinancing into a prime loan once they learn the financial reality of their current loan. Furthermore, when a borrower is offered a loan that is "asset based"<sup>(10)</sup>, he or she should demand to be told what affect such a loan could have on the asset's equity.

### CONCLUSION

It is important for attorneys to utilize all available tools at their discretion to curb harm resulting from predatory lending. California Finance Code § 4970 is a powerful new tool for litigators. Equipped with this new tool and California Business & Professions Code 17200, California attorneys should be eager to assist the victims of predatory lending.

In addition, it is important for the consumer to learn ways to spot predatory lending terms and conditions. By seeking the advice of counsel when applying for a loan, one may be able to avoid financial pitfalls down the road.

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### Footnotes

1. Niall P. McCarthy is a named partner with Cotchett, Pitre & McCarthy in Burlingame, California. He gratefully acknowledges the work of Brian Baker, Seattle University School of Law, Class of 2003, for this article.
2. Cal. Fin. Code § 4970 et seq.
3. Silver, Josh, *American Banker*, *Protect Homeownership As We Move Against Predators*, June 28, 2002.
4. See California Reinvestment Committee, [www.calreinvest.org/campaigns](http://www.calreinvest.org/campaigns).
5. To be a "covered loan", the loan must be secured by the equity in one's house. Also, the original principal balance of the loan cannot exceed \$250,000 in the case of a mortgage or a deed of trust. Finally, the annual percentage rate for the loan at its inception must exceed by more than eight percentage points the yield on Treasury securities bearing a comparable period of maturity or the total points and fees paid at closing exceed 6 percent of the total loan amount. For a more thorough definition, see California Financial Code § 4970(b).
6. Legislative Counsel's Digest to Assembly Bill No. 489
7. Cal. Fin. Code § 4979.5.

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8. Cal. Fin. Code § 4978.

9. California Business & Professions Code § 17200 et seq. prohibits "any unlawful, unfair or fraudulent business act or practice and unfair, deceptive, untrue or misleading advertising." Business & Professions Code § 17200 et seq not only offers restitution and disgorgement, but also injunctive relief.

10. "Asset based" loans are those that clearly cannot be repaid with the borrowers liquid cash. See Independent Banker, *Gunning For Black Hats*, October 2000.