Executive Summary

Through home equity loan abuse and fraud, homes are stolen and lives are devastated. High cost home equity loans sold to homeowners with no reasonable ability to repay them, have taken the homes and devastated the lives of California homeowners, many of whom are low-income and elderly. High pressure home improvement salespeople, foreclosure "rescue" services, and unscrupulous lenders and mortgage brokers have ensnared victims into traps that rob them of their homes. The victims are manipulated and deceived into signing for loans with interest rates as high as 30% and fees of 20 or more points.[1] Often times a home improvement project is used to tie the homeowner into an unconscionable home equity loan.

It appears the lenders or brokers are more interested in the borrower's equity than the ability to repay the loan because the lender can recoup the investment at a handsome profit or take the equity from the unsuspecting homeowner once the borrower falls behind on the payments. Some brokers steer borrowers to high cost, hard money lenders who will lend solely on the basis of the amount of equity in the home, regardless of the borrowers ability to repay the loan.

The lender or loan broker makes money even if the consumer can't repay the loan through one or more of these means:

pocketing high loan fees and points charged to make or arrange the loan;

getting paid in full when the homeowner refinances with another lender (usually at exorbitant rates),

selling the loan to a private investor, who may or may not realize that the borrower is unable to repay it, or

foreclosing on the loan, thereby acquiring the home and all the homeowner's equity at the foreclosure sale for the price of the remaining loan amount, rarely paying the fair market value of the property.

The victims are mostly elderly, minority and low-income residents who have owned their homes for many years. Although many of the victims are "cash poor" they have built tremendous equity through decades of hard-earned mortgage payments. This makes them prime targets for this "insidious form of urban economic violence."[2]

According to victims' advocates and law enforcement officials, Los Angeles (especially the South Central neighborhood), San Francisco and Oakland are the areas hardest hit in California by home equity fraud artists and unscrupulous lenders. There are several parts to the problem: legal, high cost loans made to people who can't afford to repay (combined with poor or absent disclosures of loan terms) and outright fraud in the inducement or creation of the loan. Estimated losses due to home equity fraud and overpriced and unfairly induced loans in California run at least into the tens of millions of dollars and very possibly hundreds of millions. Law enforcement officials and lawyers for victims say the cases that are discovered and brought to court are just the tip of the iceberg.

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1 A "point" is one percent of the face amount of the loan.

2 Massachusetts Attorney General L. Scott Harshbarger, Senate Banking Committee Hearings, Feb. 17, 1993.

Nationally, home equity fraud and home repair fraud have stripped the value from the homes of an estimated 100,000 people in 20 states.[3]

The evidence available from Los Angeles County alone suggests that a serious problem exists in California:

The Los Angeles County District Attorney's office in 1994 established a special real estate fraud unit to respond to an exploding caseload of home equity lending abuse cases.

The Los Angeles District Attorney's major fraud division is currently prosecuting 28 real estate fraud cases — involving 52 defendants and nearly 1,000 victims. Of these, approximately one-third involve home equity fraud where victims lost an estimated $183 million during 1993 and 1994.[4]

The Los Angeles County Recorder, under a pilot program, sends a notice to a homeowner when a deed or trust deed is recorded on his or her property. (A trust deed is the document that gives a lender rights in the debtor's home.) About 10% percent of homeowners — or 3,900 — who received a notice under this program (between March 1994 and March 1995) were unaware that deeds had been recorded. The Los Angeles County District Attorney's office estimates that approximately 400 of those cases involve criminal wrongdoing.

THE FORMS OF HOME EQUITY LOAN ABUSE

Abusive and questionable home equity loans often are initiated through door-to-door solicitations and usually involve hard-sell tactics. Borrowers are frequently told they will qualify for a loan as long as there is equity in the home. The loans usually involve high interest rates and high fees, and are made through non-bank lending sources such as small mortgage companies, consumer finance lenders, mortgage brokers and private individuals. Often these loans involve seemingly low monthly payments with exorbitant, impossible balloon payments due at the end of the loan. Unprincipled lenders see these loans as a way to offer a false ray of hope to those borrowers experiencing financial difficulties. In reality, these loans can be simply an avenue toward acquiring the home at a rock-bottom price or placing the consumer on a cycle of increasingly expensive short term loans that eventually lead to foreclosure.

Generally, home equity fraud and abuse appears in one of four forms:

Home Improvement Contracts. These are often initiated by door-to-door contractors who also arrange financing for their work through a home loan. Often there is no "improvement" at all. The work is substandard or left incomplete. The homeowner generally ends up deeply in debt and in grave danger of foreclosure after contractors (frequently unlicensed) charge very inflated prices for earthquake repairs, interior or exterior remodeling, floor coverings, siding or other similar products.

Disaster Related Home Loan Abuses. Unsuspecting homeowners are easy prey for friendly door-to-door salesmen who offer services to repair damages to a home following a natural disaster. This is a variation on the "home improvement contract" theme, although the results are usually the same.

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3 *The New York Times*, "Fraud Growing in Lending Push on Home Equity," October 13, 1991.

4 The remaining cases involved losses by investors who purchased trust deeds and institutional crimes such as appropriating funds from escrow companies.

Foreclosure Rescue. When homeowners fall behind in their mortgage payments — even one day late — lenders may file notices of default against them and start the foreclosure process. Mortgage brokers and hard money lenders scan these notices of default, which are public record, and use them to target people for refinance loans which the already strapped borrower cannot afford to pay back. The loan may be presented to the consumer as a "bailout" but often ends up draining the remaining equity out of a home while offering little more than postponing the inevitable.

Bill Consolidation/Refinancing Offers. Lenders may claim that a home equity loan will reduce monthly payments on credit cards and other debts through lower interest rates and tax deductions. The primary targets for these offers are homeowners with poor credit and an immediate need for funds. These victims may accept these loans because they are attracted by deceptively low monthly payments preceding a large final balloon payment at the end of the loan. They may also be willing to accept a higher-than-average interest rate because they would have trouble qualifying for a loan from a mainstream lender. These loans often result in higher debt — driven by high interest rates and fees — with impossible balloon payments. The result may be foreclosure *even though* the consolidated loan was for unsecured debts (such as credit card debt) that could not otherwise have resulted in the loss of the home.

CASE HISTORIES

In Part II of this report are several case histories involving egregious lending practices. These include:

A 75-year-old woman who reported she was convinced by a door-to-door solicitor to contract for painting services even though she told him she did not have the money. He told her she did not need cash, just equity in her home, as long as she could afford $140 per month. What he didn't tell her was there would be a balloon payment of more than $11,000 due in seven years. Several months later, her grandchildren found her at home with no utilities, no phone, and no electricity because she had run out of money trying to make her loan payments.

A San Francisco widow with a $1,200 per month income whose home was damaged in the Loma Prieta earthquake reported she was approached by a contractor and loan officer regarding repairs. Because she suffers from glaucoma and had broken her eyeglasses, she could not read or sign loan documents — so the loan officer convinced her to sign a blank piece of paper. Without her knowledge, the mortgage company arranged for a $150,000 loan and charged $23,000 in origination fees, tripling her monthly mortgage payment. The work was never completed by the contractor. The widow was evicted from her house when it was sold at the foreclosure sale, and was carried out of her home in a wheelchair by paramedics.

A 95-year-old mentally incompetent man and his 82-year-old wife were living on a small fixed income and according to their lawyer a mortgage broker arranged for a home equity loan to refinance their credit card debt and several home improvement projects (performed by a company owned by the cousin of the lending company's president). The mortgage broker put them in a loan for $30,000, even though their total debt was only $15,000. The broker kept $15,000 of the proceeds as broker fees. By the time the loans were refinanced, liens against the home totaled about $92,000 — almost all resulting from work on a single bathroom.

REGULATION

California's weak regulatory environment does little to discourage abusive home equity loans.

Regulation of non-bank home equity lending is not centralized in any single government agency. Jurisdiction can be either with the Department of Corporations, which regulates consumer finance lenders and industrial loan companies, or with the Department of Real Estate, which regulates real estate licensees engaged in mortgage brokering and lending.

Financial standards and annual reporting requirements vary with each agency, with the Department of Corporations imposing stricter standards. Companies holding a DOC license must meet financial standards and file annual reports showing lending activities.[5]

Many lenders avoid the DOC requirements by lending under a Department of Real Estate license, which does not require brokers to meet minimum financial standards and does not make records public regarding companies' activities.

The Department of Real Estate is widely considered to be weak and indifferent in its enforcement efforts. In fact, attorneys say they seldom report cases to DRE for investigation because the DRE does little to help their clients. That may explain why a DRE official said the department receives very few complaints about cases of home equity loan abuse.

Some relief came last year at the federal level in the form of the Home Ownership and Equity Protection Act of 1994, which places certain restrictions and requirements on "high-rate, high-fee mortgages." The new provisions will be included in the Truth in Lending Act (TILA) as of October 1, 1995.

While the expanded federal law provides some much needed reforms, it success will depend on how aggressively states enforce it. The priority California officials will give the Home Equity Protection Act remains to be seen. Also looming is the possibility that the Act may be revised or diminished in the deregulation environment of the new Congress. Proposals to remove or restrict the three day right of rescission on home loans were recently defeated. Additional proposals would change the definition of high cost mortgages to exclude first liens providing incentives for lenders to consolidate pre-existing liens into a new first mortgage to obtain immunity from the provisions of the Home Ownership and Equity Protection Act, including these provisions governing high cost mortgages.

RECOMMENDATIONS

Potential victims of home equity loan fraud and abuse must be protected through more vigorous regulatory action, new laws, and effective community education programs. Large mortgage companies and mainstream financial institutions also can contribute to the solution by offering quality home equity loan products in neighborhoods targeted by abusive lenders and by carefully scrutinizing the fairness of the loans they purchase to ensure that they are not providing funding for hard money loans.

The financial and emotional toll home equity loan abuse takes on Californians can be reduced by: 1) strengthening existing laws and regulations, 2) fully enforcing existing laws, 3) preserving existing remedies such as the Truth in Lending Act; 4) educating homeowners about the risk of these loans; and 5) providing access to affordable home equity loans on fair terms for

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5 These reports show loan activity by the companies, including the number of loans made within designated rate ranges. Unfortunately, the reports do not distinguish between unsecured loans and loans secured by property within a designated interest rate range, making it impossible to determine the number of high-interest home equity loans that a lender has made.

low-income and elderly homeowners. These actions will require concerted efforts by a combination of agencies, the legislature, and the lending industry. To effectuate these actions Consumers Union recommends these measures:

Consolidate all mortgage lending licenses under the Department of Corporations and set reporting and financial standards for all lending entities.

Prohibit balloon payments on home equity loans unless the borrower has the option to fully amortize the balloon payment on reasonable terms at the end of the initial loan term.

Prevent weakening consumers' right of rescission for refinance loans and equity loans under the Truth in Lending Act.

Reinstate reasonable usury laws with floating rate caps.

Restrict "high-rate, high-fee" loans and their sale on the secondary market.

Prohibit home improvement contractors from acting as mortgage brokers or *de facto* agents of mortgage companies, and prohibit door-to-door soliciting of home equity loans and home improvement services that are financed through home loans.

Require pre-loan counseling for high-risk borrowers, and for borrowers refinancing loans for which a notice of default has been filed.

Require notaries statewide to record a thumbprint to verify the identity of a person signing a deed, quitclaim deed or deed of trust, and expand statewide the pilot program requiring county recorders to notify homeowners of filings affecting title to or rights in their homes.

Provide law enforcement agencies with the funds and legal tools they need to fight home equity fraud and to prosecute criminals. This could be paid for by assessments on persons holding licenses to make or arrange home loans.

Regulatory agencies should act vigorously to investigate and prosecute cases of home equity lending abuses and fraud.

Centralize records of home equity-related complaints against lenders and contractors, and make these records readily available to the public.

Develop and expand training programs for law enforcement officers and education programs for potential victims.

Encourage banks to properly serve low-income areas by providing a full range of loans and services to these communities.

CONCLUSION

The victims of home equity loan abuse and fraud must not be blamed for falling under the spell of unscrupulous lenders, brokers, or contractors, any more than victims of muggings and armed robberies can be blamed for becoming targets of assaults. Home equity loan abuse and fraud will not go away by being ignored.

This report recommends steps necessary to stop an assaultive economic abuse on California's elderly and low-income population of homeowners. The magnitude of the crimes and the need to stop them from occurring are summed up in the words of one victim. Of the people who cheated her out of her home, she said to the Massachusetts Attorney General's office:

"They did to me what a man with a gun in a dark alley couldn't do: They stole my house."[6]

6 Massachusetts Attorney General L. Scott Harshbarger, quoting a Massachusetts home equity loan scam victim, Senate Banking Committee Hearings, Feb. 17, 1993.

Introduction

THE PROBLEM

The tremendous surge in real estate prices in the late 1970s and early 1980s opened the door for the creation of a new source of funds for many homeowners: home equity loans. Many homeowners found the appreciation in property values a welcome source of funds for remodeling projects and their children's college education. But the growth of home equity loans also has its dark side. An increasing number of homeowners in California have been the target of unscrupulous lenders who use fraud or confusing tactics to lead homeowners with low and moderate incomes into loans they cannot possibly afford to repay. The very loans that homeowners thought would be beneficial may instead cost them their homes and life savings.

In California, it is estimated that losses caused by home equity fraud and unscrupulous loans run into the tens of millions of dollars and possibly into the hundreds of millions.

Elderly, minority, low-income and inner city residents who owned their homes through the real estate boom of the '70s and '80s and built tremendous equity are prime targets for home equity scam artists. According to law enforcement officials, legal advocates and news reports, Los Angeles (especially the South Central neighborhood), San Francisco and Oakland are the state's centers for exorbitantly priced home equity loans, fraud and manipulation that place residents in imminent danger of losing their homes.

By the early 1990s, home equity loan scams in Boston, New York, Atlanta and Los Angeles became the focus of national news coverage. Shows such as "60 Minutes," "Prime Time Live," and nightly network news reports showed how loan documents were falsified, how lenders packed loans with costs that tripled or quadrupled the amount homeowners initially intended to finance, and how incomplete home improvement projects left trusting homeowners on the verge of foreclosure. The exposure of the problem led to U.S. Senate hearings on the issue, passage of landmark federal legislation and major legislative reforms in Massachusetts and New York.

In California, it is estimated that losses caused by home equity fraud and unscrupulous loans run into the tens of millions of dollars and possibly into the hundreds of millions. The human toll of displaced homeowners and lost life savings is also monumental.

The options available to victims of home equity lending abuses are few, if any. Seeking redress in the courts is a slow and costly process that greatly taxes the emotional and financial resources of the victims. In the end, even success in court can still leave a victim liable for thousands of dollars in loans needed to refinance an unfair loan. Access to litigation also is limited. Many of the victims are low-income, and depend upon already strapped legal aid societies to advocate on their behalf. The prognosis for legal aid societies to handle more of these cases is bleak. Presently there is only a limited number of lawyers to handle expanding caseloads, and legal services programs are facing the threat of serious budget cutbacks. Intervention by state regulatory agencies also has been limited. The lack of complete jurisdiction

by a single regulatory agency lessens the likelihood that any future action taken at the administrative level will be effective. The new federal statute, while helpful, is not sufficient to resolve the problem, and homeowners' rights are under attack in Congress.

Potential victims of home equity loan fraud and abuse must be protected through more vigorous regulatory and law enforcement, new laws, and effective community education programs. Large mortgage companies and mainstream financial institutions also can contribute to the solution by offering quality home equity loan products in neighborhoods targeted by abusive lenders and by carefully scrutinizing the fairness of the loans they purchase.

The objective of this report is to provide the general public and public policy makers with important background about home equity loan abuse and fraud. Personal histories illustrate the scope of the problem and show the shattering effect abusive loans have on the lives of Californians. According to Ron Kaye of the Legal Aid Foundation of Los Angeles, incidences of home equity loan abuse and fraud cases have reached "epidemic" proportions. Recommendations are provided for substantive action needed by government, lenders and the public to stem this tide of abuse.

Part I

An Overview of Home Equity Loan Fraud and Abuse

HOME EQUITY LOAN DEFINED

The basis for a home equity loan or line of credit is the "equity" in a homeowner's property. Equity is measured by the difference between outstanding obligations — such as a first mortgage — and the home's market value. For example, a $250,000 home with $150,000 due on the first mortgage and any other liens has $100,000 in equity that might be borrowed against.

Home equity loans were introduced to the marketplace in the 1970s. During that decade real estate prices soared and longtime homeowners suddenly found their homes worth far more than the amount of their mortgage balances. Lenders saw home equity loans as an opportunity for a new product for the market, and homeowners found a new way to tap into a valuable asset.

In the loans described in this report, consumers paid annual percentage rates of up to 30%, and 15 or more points. By contrast, in August 1995, California's leading financial institutions were charging 8.5% to 11.5% for a fixed-rate home equity loan with no points.

A home equity loan uses the traditional loan structure of equal monthly payments covering principal and interest over a designated period. Home equity lines of credit, which now exceed home equity loans in volume, provide a revolving line of credit that homeowners can call upon as necessary, much as they would a credit card. In both products the loans may be non-amortizing. This means the loan principal is not reduced by the monthly payments and is still owed at the end of the loan term.

Home equity loans differ from standard mortgages used to purchase or refinance a home. The principal difference is that they are based on the market value minus what is owed under the existing mortgage and any other encumbrances. A home equity loan is sometimes — although not always accurately — referred to as a "second mortgage," or a mortgage taken in addition to the primary loan used to finance the purchase of the property.

BENEFITS AND DETRIMENTS OF HOME EQUITY BORROWING

Home equity loans and lines of credit can be a way for consumers to turn the investment they've made in their homes into a liquid asset. Equity built over many years often can mean substantial funds are available for home improvement, college tuition, major purchases and other purposes. But home equity loans also come with risks. Consumers must plan their finances properly and be careful they choose an affordable, competitive, fully amortizing loan from a reliable lender.

Interest rates on home equity loans and lines of credit should be lower than rates for consumer loans not secured by real estate. In 1995, the average annual percentage rate (APR)[7] for commercial bank fixed-rate credit cards was 15.23%.[8] The average annual percentage rate for a home equity loan offered by commercial banks was just 10.49%, according to HSH Associates, a California financial research group. An estimated $255 billion in home equity debt was outstanding in the U.S. in 1993.[9]

Nationally, home repair and home equity fraud have stripped the value from the homes of an estimated 100,000 people in 20 states. California, especially Los Angeles, Alameda and San Francisco counties, has been one of the biggest problem areas in the country.

In the loans described in this report, consumers paid annual percentage rates of up to 30%, and 15 or more points.[10] By contrast, in August 1995, California's leading financial institutions were charging 8.5% to 11.5% for a fixed-rate home equity loan with no points.[11]

Banks and other lenders increasingly use home equity lending as a primary feature in their marketing efforts, especially when interest rates for refinancing start to rise. Many institutions offer adjustable home equity loans or lines of credit with low introductory interest rates, often below 7% APR for a limited period, and no points or fees. One of the biggest boosts to home equity financing was the Tax Reform Act of 1986, which abolished tax deductions for interest paid on non-mortgage debt such as credit card accounts, automobile loans and student loans. Interest paid under home equity loans, in most cases, remains deductible, as long as the homeowner itemizes all deductions.

The benefits of home equity lending, however, are accompanied by serious risks. If a borrower fails to pay off unsecured debt such as credit card debt, the creditor cannot force the sale of the home to repay that debt. However, the borrower opens the door to a possible loss of his home when he pays off previously unsecured debt by obtaining an equity loan or line of credit, pledging his home as security for repayment. At that point, the previously unsecured debt is transformed into debt secured by the home which gives the lender rights to the borrower's home that the old creditor did not have. Even though the loan is based only on a portion of a home's value, if the borrower defaults on the home equity loan, the home can be sold by the lender to pay off the debt. The lender can sell the home without a court hearing as the final step of the foreclosure process.

HOME EQUITY LOAN ABUSE

While the introduction of home equity loans may have increased financial opportunities for consumers, it has certainly provided new opportunity for fraud and abuse by unscrupulous operators. Legal aid societies in California say they are handling a rapidly growing number of cases involving home equity loan abuse and fraud. The principal victims they see are elderly and low-income homeowners.

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7 The annual percentage rate (APR) is the annual cost of credit over the life of the loan. It is calculated by factoring in the interest rate, points, fees and interest-calculation methods.

8 *Consumer Action News*, "High Rates Obscured by 'Teaser' Come-ons: 1995 Credit Card Survey," March/April 1995.

9 Home Equity Lending: Evidence from Recent Surveys, Federal Reserve Bulletin, July 1994, p. 579.

10 A "point" is one percent of the loan amount charged, in addition to the loan's interest rate, as a fee for providing the loan.

11 *San Francisco Chronicle*, August 7, 1995, p. D6.

Nationally, home repair and home equity fraud have stripped the value from the homes of an estimated 100,000 people in 20 states.[12] California, especially Los Angeles, Alameda and San Francisco counties, has been one of the biggest problem areas in the country. Although it is impossible to know exactly how many people have been victimized or how many homes and millions of dollars have been lost, the evidence that a serious problem exists is overwhelming:

> The Los Angeles County District Attorney, responding to an exploding caseload, established a special real estate fraud unit in 1994. Three assistant district attorneys and three investigators are assigned *full time* to investigate and prosecute real estate fraud cases. Other members of the District Attorney's staff are often brought in to handle the overflow.
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> Twenty-eight real estate fraud cases — involving 52 defendants and nearly 1,000 victims — are currently being prosecuted by the L.A. District Attorney's major fraud division. About one-third of the cases involve home equity fraud or fake deeds. In total, victims lost an estimated $183 million during 1993 and 1994.[13]
>
> The Los Angeles County Recorder, under a pilot program, notifies homeowners whenever a deed or trust deed is recorded on their property. (A trust deed is the document that gives a lender rights in the debtor's home.) Of the 39,000 homeowners who responded to notices from the Recorder's office between March 1994 and March 1995, about 10% percent — or 3,900 — were unaware that deeds had been recorded until they received a notice from the recorder. The L.A. County District Attorney's office estimates that approximately 400 of those cases involve criminal wrongdoing by real estate fraud of some type.

There are several other compelling reasons to believe that the cases of home equity loan abuse and fraud reported to authorities and lawyers are indeed, as one advocate put it, the "tip of the iceberg":[14]

> An individual abuse or fraud report often arises out of a business practice imposed on many borrowers. Most claims include common denominators such as victim characteristics or the tactics used to take unfair advantage of homeowners.
>
> Victims often are reluctant to come forward because they are embarrassed, feel vulnerable or simply do not realize they have been defrauded.
>
> Current laws and practices make it difficult for state agencies to track home equity fraud complaints. Several different agencies are involved: licenses to make and arrange loans are under the jurisdiction of either the Department of Corporations or Department of Real Estate, while complaints against home improvement contractors usually go to the Contractors State License Board. An attorney with the California Department of Consumer Affairs, recognizing the split jurisdiction problems, says the agency plans to increase its involvement in the issue because "the ball was rolling around, and someone needed to grab it."

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12 *The New York Times*, "Fraud Growing in Lending Push on Home Equity," October 13, 1991, p. 1.

13 The remaining cases involved losses by investors who purchased trust deeds and institutional crimes, such as appropriating funds from escrow companies.

14 Manuel Duran, Bet Tzedek Legal Services, Feb. 21, 1995.

In many cases, victimized homeowners appeal to local legal aid societies and other non-regulatory agencies for assistance. It is nearly impossible, therefore, to compile statistics that accurately reflect the scope of the problem. However, *The New York Times* quoted Troy Smith of the Legal Aid Foundation of Los Angeles as saying, "For every case seen by lawyers, 100 go unchallenged because owners are too distraught, embarrassed or do not realize they have legal recourse."[15]

There also are compelling social reasons to pay attention to cases of home equity fraud and abuse. Experience with abusive lending in other parts of the United States shows the potential societal impact. The economic and social stability of a neighborhood targeted by abusive lenders is substantially threatened when enough unsuspecting homeowners lose their homes to foreclosure. In low-income neighborhoods, home equity scams can be particularly devastating because the homeowners targeted are often longtime residents who provide stability and an important economic base to the neighborhood. When a home is sold in foreclosure, previously owner occupied homes frequently become rental properties managed by absentee landlord investors.

It appears that in nearly every case, the loan is designed from its inception so that the borrower will never have any realistic hope of paying it off.

Losing a home can catapult a low-income homeowner, especially one living on a fixed income, into a cycle of poverty. Legal aid and assistance organizations for the elderly are reporting an increased number of individuals on the verge of homelessness or who have become homeless because of home equity loan scams. Many of the victims are elderly citizens who purchased their homes after World War II, well before prices skyrocketed in the 1980s. After losing their homes to unscrupulous lenders or brokers, victims cannot afford the high prices of new homes in the same communities.

Prosecutors tell stories of homeowners who end up living in their cars as a result of abusive loans and home equity fraud. The effects can be even more extreme. In one case study described in this report, a victim states that she believes the unaffordable payments on a home equity mortgage drove her husband to kill himself.[16]

WHAT DOES AN "ABUSIVE" LOAN LOOK LIKE?

Abusive loans and home equity fraud come in several different forms. It appears that in nearly every case, the loan is designed from its inception so that the borrower will never have any realistic hope of paying it off.

As the personal histories in Part II show, perpetrators of home equity abuse set up loans with payments that far exceed the incomes of the borrowers. The lender knows the borrower will not be able to repay. The lender's only way to be repaid is to either take the home through foreclosure or place the victim into a new, more expensive loan with additional points and fees. Many abusive loans have impossibly large "balloon payments" tacked on to the end of the loan. Some victims struggle to make their high payments on high interest rate loans for several years only to lose their homes when balloon payments nearly as high as the original loan balance come due at the end of the loan.[17]

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15 *The New York Times*, "Fraud Growing in Lending Push on Home Equity," October 13, 1991, p. 1.

16 "Ms. Smith" victim profile, see p. 20 of this report.

Borrowers, however, are not the only victims of lending fraud. In some cases, the loan money was provided by individual investors seeking a high return on their investment. During these transactions, the broker acting as the middleman may pocket a significant portion of the funds through "fees." The broker may also mislead the investor into thinking that the homeowner has sufficient income to make the loan payments by including several months of "advance payments" in the loan to the homeowner. These advance payments are withheld by the broker and paid to the investor during the first several months of the loan. The investor may not know that the payments are coming directly from the new loan proceeds. When the homeowner goes into default, the investor — often a retiree — also loses funds through the bad loan and becomes another victim. According to the Los Angeles County District Attorney's office, about one-third of the real estate fraud cases it is currently prosecuting involve bilked investors.

"NO JOB, BAD CREDIT OK"

High-risk lending is not an isolated phenomenon. Newspapers, radio and television all carry advertising for lenders who promise to make home equity loans despite a homeowner's unemployment or bad credit record. "Hard money" lenders, who provide some of the highest rate loans, are the real estate equivalent of a pawn broker. They will extend a loan at high interest rates, knowing that if borrowers cannot pay, the lender can either take the home through foreclosure or refer the homeowner to another, equally high-cost lender, for another expensive loan if there is unused equity remaining in the home. These practices, while harmful to consumers, are perfectly legal.

Abusive and unfair home equity loans often are initiated through door-to-door solicitations and usually involve hard-sell tactics. In many cases, borrowers are told they will qualify for the loan as long as there is equity in the home. The loans usually involve high interest rates and high fees. They are made through non-bank lending sources such as brokers, consumer finance lenders and private individuals. Victims of abusive lending often report outrageous terms such as interest rates in the mid- and upper-teens and extraordinarily high origination fees ("points") of 14% or more.

Translated into dollars and cents, the practice is unconscionable. For example, a 30-year, $100,000 loan made to one victim — 15.55% interest and 23 points — would mean monthly payments of approximately $1,310 per month plus $23,000 in fees.[18] If the points are amortized (gradually paid off at regular intervals) over the life of the loan, the payments increase by $300. In the end, the homeowner will have paid a total of more than $456,000 in interest — two and one-half times the $186,000 that would be paid on an average 8.75%, no-point loan available through major banks.

"CRIMINAL" AND "LEGAL" SCAMMERS

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17 A balloon payment mortgage is a loan that requires a large lump-sum payment at the end of the loan period. Traditional, regular mortgages are paid off in consistent monthly payments over 15, 20 or 30 years. Payments are applied to both interest and principal. With a balloon payment loan, the monthly payments go only to pay off the interest. This makes the payments unrealistically low relative to the obligation. After a few years, the full balance of the mortgage loan becomes due, including all or most of the principal.

18 When this loan was made in July 1994, the prime rate was 7.25% and major commercial banks were charging between 8.25% and 9.25% for home equity loans with no points.

Victims' advocates say they see two types of operators: what they call "criminal" and "legal" scammers.

A "criminal" scammer uses boldly fraudulent techniques including convincing homeowners to sign blank documents, forging signatures, misrepresenting income and payments, or operating without a proper license. The loan often is used to finance some type of home improvement that, once the loan is funded, involves substandard work or work that is left unfinished. For example, some homeowners have reported that contractors have ripped out interiors for remodeling work and have used poor quality construction and materials. In some cases, homeowners have been left with uninhabitable shells when the contractors failed to complete the job.

A "legal" scammer is a lender who manipulates the borrower — usually an elderly person — into an expensive or unaffordable loan but creates the proper paper trails. The loan document may appear legally enforceable on its face, but the techniques used to ensnare the borrower may involve illegal fraud or misrepresentations. The legal scammer induces the borrower to sign the agreement, but does not ensure the borrower actually understands what she is signing. One approach is to give the homeowner, frequently an elderly widow, a hard sell until she finally decides to sign a "loan application" to get the salesman out of the house. Only later does she discover that the "application" was actually a loan agreement.

If the victims of these scammers are able to find legal assistance through underfunded legal services organizations or scarce volunteer attorneys, then their lawyers are usually able to find violations of law, such as misrepresenting the terms of the loan in the loan documents, which makes the loan rescindable under the federal Truth-in-Lending Act. But some disputes are barred from review by any court of law by mandatory arbitration clauses imposed by the lender. Even if the victim can go to court, during the year or more it can take to resolve the issue the loan may be "folded" or "flipped" (refinanced by an even larger loan) several times to temporarily keep the homeowner afloat. In addition, a note may be sold to a series of investors on the secondary market who assert rights of ownership. This complicates matters because the homeowner must defend against ownership claims by the investor who was not the original lender. As a result, homeowners must often quickly go to court to get a temporary restraining order to stop foreclosure, which increases their costs and anxiety.

Part II

The Four Most Common Scams and Abuses with Case Histories

There are hundreds, if not thousands, of Californians who can tell stories of how they were bilked by home improvement scams, loans to pay for repairs from natural disasters, and foreclosure "rescue" attempts. Some cases involve outright fraud and misrepresentation. The following case histories,[19] supplied by legal advocates and victims, are representative of the growing number of reported and unreported home equity loan fraud and abuse cases in California. The victims are typical of those targeted by scammers: most are elderly, many are women and many are of African-American or Latino heritage.

Generally, home equity fraud and abuse appears in one of four forms:

- Home improvements service contracts
- Disaster related home loan abuses
- Foreclosure "rescue"
- Bill consolidation/refinancing loans

HOME IMPROVEMENT SCAMS

A significant percentage of the home equity fraud cases litigated by legal aid advocates concern home improvement projects. These cases often involve elderly or disabled homeowners who are longtime residents of older, inner-city neighborhoods. In the San Francisco Bay Area, several cases have involved solicitations for repairs related to damage caused by the 1989 Loma Prieta earthquake.

Home improvement scams generally start with a friendly door-to-door salesperson offering services such as earthquake repair, interior or exterior remodeling, floor coverings, or siding. Sometimes the services offered include installing unattached property such as satellite dishes. Often, the sellers of these products are not licensed contractors. They use high-pressure sales tactics, and charge very inflated prices. To cover the cost of "repairs," the salesperson conveniently offers to arrange financing. Unfortunately, homeowners frequently are unaware that their homes are collateral for these loans because the salesperson skillfully uses deception or misrepresentation to dupe the unsuspecting homeowner. The salesperson may even arrange to lend against the home's equity for equipment such as satellite dishes, even though state law forbids loans for this product to be secured by a lien against a home.

19 All case histories have been supplied by victims or legal service providers. Pseudonyms have been used when requested by the victims and their attorneys. Most victims have requested anonymity. In some cases, litigation is continuing and defendants have not admitted wrongdoing.

Once the contract is signed, the contractor obtains the financing and arranges for his fee to be deducted from the loan proceeds. The Federal Truth in Lending Act requires the lender to provide the borrower with certain disclosures and a three-day right of rescission period.[20] Although forbidden by the Truth in Lending Act, the contractor frequently begins work before the end of the three-day rescission period. By law, work is not supposed to be performed during this period unless the homeowner signs two waivers: one agreeing that the work is of an "emergency" nature, and another waiving his or her right to rescind the loan.

In many cases, what homeowners received was a far cry from actual home improvement services. Instead, work was left uncompleted or homes were reduced to virtually uninhabitable shells.

Homeowners are generally not targeted randomly for high-cost, equity-based financing. Contractors and others seeking to sell high-cost loans usually look for older homes with visible signs of wear and tear, or, as demonstrated in some San Francisco cases, for city/county notices of structural deficiencies caused by earthquake damage. Public records show who owns the property, whether the owner occupies the house, how long the owner has resided there, whether the person owns the house outright or jointly, and what mortgages and encumbrances are on the property. A trip to a county hall of records also shows whether the owner is widowed and, if so, for how long.

Armed with this information, sales representatives have targeted the homeowners they know are likely to need money or to be the easiest target for an expensive loan. These salespeople have even approached the person by name on the initial cold call.

What makes these practices particularly egregious is, regardless of the quality of the home improvement work — or even whether it is ever completed — the homeowner remains liable for paying the loan to avoid losing the house to the lender. In many cases, what homeowners received was a far cry from actual home improvement services. Instead, work was left uncompleted or homes were reduced to virtually uninhabitable shells. Some of these victims have been forced from their homes into rental housing because their dwellings were no longer habitable. The monthly rental payments added to the economic burden these victims already faced with paying equity loans for work that was never completed to their satisfaction.

Here are how home improvement scams have affected some Californians:

MS. JONES is a 73-year-old woman who has suffered from several strokes and does not have full control of her mental faculties. In 1992, Ms. Jones' roof was leaking and needed repair. Her son had spoken to various contractors in the Los Angeles area about the roofing work, but had not yet settled on a specific contractor.

One day, a representative of a home improvement contracting company came to Ms. Jones' home and offered to have his company do roofing work for her. Ms. Jones told the representative to speak to her son. At Ms. Jones' house, the representative called the son, and the son inquired whether the representative was from the contracting company with whom the son had previously sought an estimate for the job. The representative said he worked for another company.

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20 15 U.S.C. Section 1601-1641 (Truth In Lending Act) and 12 C.F.R. Section 226.1 *et seq*. (Regulation Z) apply to credit transactions involving more than four installment payments. The creditor must deliver specific loan disclosure statements. The borrower is entitled to rescind the loan agreement for a period of three days following the delivery of the disclosures. Failure to provide the required disclosures can extend the rescission period for up to three years.

Subsequently, the son told Ms. Jones that she should allow the representative to inspect the premises. But before he began, the representative told Ms. Jones that he needed her to sign an authorization form in order to inspect the premises. But what she actually signed was a contract to do remodeling work, as well as a security agreement putting a lien on Ms. Jones' property.

Not knowing what she was entering into, Ms. Jones erroneously signed all the documents presented to her, resulting in a contract for $15,000 and a 10-year loan at 19.5% interest. The following day a crew of workers from the home improvement contracting company began ripping down the old roof and putting up plywood.

Ms. Jones eventually reached a settlement in the case.

JOSEPHINE B. is an 75-year-old widow who owns a home in Oakland. In 1991, she was approached by a salesman for a painting contractor who, according to Mrs. B., told her that it did not matter whether she had any cash to pay for the paint job because he could arrange for a loan to pay for it.

Soon thereafter, Mrs. B. was visited at her home by a loan agent from a finance company. The agent had her sign several documents, which she did not read because of the extensive wording and her limited reading ability and comprehension. According to Mrs. B., the only thing the loan officer asked her was whether she could afford to pay $140 per month. She could, she said, and the loan agent had her write a statement to that effect.

At no time, however, did the loan agent tell Ms. B. that, in addition to the monthly payments, she would be responsible for a balloon payment of $11,200, which would be due in seven years. Several months after the loan was made, Mrs. B. became ill and fell behind in her loan payments. Around Thanksgiving, 1993, Mrs. B.'s grandchildren found her at home with no utilities, no phone and no electricity. She had run out of money to pay for her utilities because she was still trying to pay her mortgage.

Mrs. B. received an injunction against the finance company when the company failed to appear in court. However, the finance company had sold the loan to an investor who had purchased several other of the finance company's notes. The investor continued to assert his right to foreclosure on the property as a holder in due course of the loan note until a settlement was reached. All interest and fees were waived and Mrs. B. is now responsible only for payment of the loan principal.

HERMAN R. is a 68-year-old retired maintenance man who has an eleventh grade education. His wife is 58 years old and is mentally incapacitated. In 1957, Herman R. purchased his home, which over the years has appreciated significantly.

His attorneys reported the following. In late November 1993, Herman R. was approached by a salesman who convinced him to undertake a home improvement project. The home improvement contractor then sent a representative from a loan company to see Herman, who signed what he thought was simply a contract for work to be done. In fact, he had signed a loan agreement.

Soon after the Northridge earthquake, Herman discovered that there were not one, but two, separate deeds of trust placed on his property for twice the amount to which he thought he

had eventually agreed. Without Herman's consent, the contractor had upped the price of the project and arranged for a second loan. When Herman complained, the salesman said earthquake safety work — for an additional fee — would be required before the lender would consolidate the loans, and if it wasn't done the lender would call the other loans, making them due immediately.

Herman's lawyers eventually discovered that a deed for a third loan — again made without Herman's permission — was about to be filed when they stepped in to block it.

In all, Herman had liens totaling $35,000 against his home for shoddy construction work. Following extended settlement negotiations with the finance company, which Herman's lawyers say have a history of abusive loans, the finance company agreed to relieve him of any obligation for the loans.

NORA B. is an 80-year-old widow who had a first mortgage on her home of just $214.00 per month. She has a ninth-grade education and is unsophisticated about financing techniques such as balloon payments.

According to Ms. B., in 1990, she was approached by a home improvement contractor who told her that he could arrange for a loan to pay for new siding and to consolidate the consumer debt of $15,000 left by her deceased husband. She was then visited at her home by a salesperson for a finance company who had her sign the loan application and several other documents. Many of the documents contained blank spaces, she said.

According to Mrs. B., the only thing the salesperson discussed with her about the loan was whether she could afford to pay $300 per month. Mrs. B. said she thought she could.

She said never, however, did the lender explain to her that a mortgage was going to be placed on her home or that a balloon payment of $32,900 would have to be paid in addition to the monthly payments. She also said she never was told the balloon payment was due in September 1995.

The lender arranged to finance the home improvements and make the loan to Mrs. B., apparently without taking into consideration her ability to pay the monthly mortgage payments or final balloon payment. In 1993, she fell behind in the mortgage payments, and the lender began foreclosure proceedings. In desperation, Mrs. B. filed for bankruptcy.

With the help of legal counsel, Mrs. B. was able to receive an injunction against the lender and delayed the foreclosure. However, the investor to whom the lender sold the note continues to assert a right to collect. Recently, the investor obtained relief to begin foreclosure proceedings again, but Nora's lawyers got another preliminary injunction to temporarily delay the proceedings. The case is set for trial in October 1995.

DORIS is 78 years old, has an 11th grade education, and suffers from a heart condition. Her husband in 95 years old, has no formal education and is mentally incompetent. They live on a small, fixed income.

In September 1991, a salesperson tricked Doris into signing a home improvement contract to install a new fuse box and electrical wiring she did not need. Doris was already holding a loan through a traditional lender; the salesperson convinced her to arrange for a larger loan to cover the repairs and to pay off her existing lien. Eventually, a lien for $33,895.20 was placed on Doris' home even though the value of the improvements was only $1,500.

Unsuspecting homeowners are easy prey for friendly door-to-door salesmen who suddenly offer the prospect of money for repairs and possibly even some extra money.

By the time Doris settled her legal action against the lender, approximately seven deeds of trust had been signed on the property and the company had tried to buy the house. The loan was found invalid due to statutory violations by the company, including the failure of the salesman to hold an appropriate license. She now owns the home, free and clear. Punitive damages were assessed against the contractor totaling $175,000, but Doris' attorneys say there is little hope of recovering the award.

DISASTER-RELATED HOME LOAN ABUSES

Many individuals whose homes were damaged by natural disasters, such as the Loma Prieta and Northridge earthquakes, are particularly vulnerable as they seek ways to make their homes — and lives — whole again. Many of the homes that were damaged, especially in low-income areas, were not insured for earthquake risks and remained unrepaired long after the quakes hit. Unsuspecting homeowners are easy prey for friendly door-to-door salesmen who suddenly offer the prospect of money for repairs and possibly even some extra money.

The Contractors State License Board has issued several bulletins warning homeowners to work exclusively with reliable, licensed contractors and to look out for "wanna-be's looking to take advantage of people's desire to get their lives back to normal."[21] Nevertheless, several homeowners have found equity in their homes threatened or lost due to unscrupulous or unlicensed contractors who arrange home equity financing.

Here are the stories of some victims of overpriced, disaster-related loans:

EVA D. of San Francisco is a 55-year-old widow and 36-year resident of her Potrero Hill home. Ms. D. said she was lured into a loan with a lender after being approached by a contractor and loan officer who offered to repair damage done to her house during the Loma Prieta Earthquake. Mrs. D. could not read or sign the loan documents because she suffers from glaucoma and had broken her eyeglasses before the meeting. Instead, the loan officer had her sign a blank piece of paper.

Her income at the time of the loan was less than $1,200 per month, but the lender arranged for a $150,000 loan, charging $23,000 (over 15 points) in loan origination fees. The loan consolidated her existing mortgage indebtedness of $58,000. The balance was for the repairs to the home which was estimated to cost $70,000.

The loan more than tripled Ms. D.'s monthly loan payments from $619 to just under $2,000 per month. The repairs to her home were never completed by the contractor, whom Ms. D. later discovered was unlicensed.

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21 CSLB press release, "Beefed-Up Quake Response Units Nab 24 in Quake Area," March 22, 1994.

While Mrs. D. was unrepresented by counsel, an arbitration decision was rendered against her. Mrs. D's home was sold at trustee's sale on April 21, 1993 after unsuccessful attempts by her present attorneys to have the arbitration decision set aside. When Mrs. D. was evicted on February 16, 1994, she was carried out of her home in a wheelchair by paramedics and taken to Mt. Zion hospital.

Since that time, Mrs. D. has been staying with different relatives and has been hospitalized for high blood pressure and diabetes. She has lost her home and continues to search for affordable housing. Her case against the lender is still pending in the courts.

WILNA A. is an 80-year-old woman with a tenth-grade education who has owned her Los Angeles home since 1971. She and her 86-year-old husband live on a small, fixed income. After the Northridge Earthquake, Mrs. A. received a telephone call from a woman who claimed she worked with the Federal Emergency Management Agency (FEMA). She asked Mrs. A. if she needed food stamps to recover the food she lost because of the power outage. She also told Ms. A. that FEMA would send an inspector to Mrs. A.'s home.

The next day, a man claiming to work with FEMA came to Mrs. A's home and convinced her to sign several documents. He told Mrs. A. that the documents were FEMA applications and promised her he would immediately take these applications to FEMA for processing. Instead, the documents turned out to be a home improvement contract with a building contractor and a financing contract through a lender — two companies which often do business with each other and are run by cousins. Work was begun before the end of the three-day right of rescission period required by federal law. Liens were placed on her home for $32,635.68 for exterior paint, roof shingles, and a garage door.

Mrs. A. did eventually receive an injunction and settlement from the two companies, and the home's title was reconveyed to her, the loan was discharged, and she received punitive damages as a result of the settlement.

ADDIE C. of San Francisco is a 43-year-old licensed home health care specialist who runs a board and care facility in her home. She cares for six adults with disabilities ranging from emotional difficulties to cerebral palsy.

In November of 1989, a loan officer from a finance company appeared at Addie C.'s home and asked whether she needed any financing to help complete refurbishing of two flats in her home, which had been damaged by the Loma Prieta earthquake. She agreed, and the loan agent arranged a $33,000 loan (plus loan fees of $4,950, or 15 points).

After the initial reconstruction project was completed, she was able to obtain added income by increasing the number of adults she cared for. The loan officer suggested a debt consolidation loan that would pay off her first mortgage and the smaller previous loan the finance company had already given her. She agreed again, and they met at a K-Mart store in Redwood City to sign the papers. Upon receiving the documents, however, she noted that some of the pages were blank and that the note she signed did not include the loan amount. Her income was not verified before the loan was approved and she never saw completed loan documents until after the loan was consummated.

When she did finally see the completed documents, she learned she was carrying a loan of $286,500 (including loan fees totaling $42,975). Ms. C. immediately fell behind because the payments of over $3,300 per month exceeded her income level.

As a result of these loans, Ms. C.'s home was sold in foreclosure on February 24, 1993. (Ironically, shortly after she defaulted on this loan she received a letter from a "consultant" at the lender's subsidiary, stating that the company had "over $800,000 allocated to assist the residents of San Francisco out of foreclosure and on to a strong financial path.") After eviction proceedings were completed, Ms. C. was forced to relocate herself and her board and care patients to a new location. She reports she had great difficulty locating another affordable residence large enough to continue providing board and care to her clients, and many of them suffered trauma and disorientation as a result of the move. Her case against the lender is still pending.

FORECLOSURE "RESCUE"

Another form of home equity abuse inflicted on homeowners is so-called foreclosure "rescue." Homeowners who fall behind in their mortgage payments may have notices of default entered against them by the lender. These notices mark the beginning of the foreclosure process and are a matter of public record in the County Recorder's offices. Lenders combing the files at the recorder's office use default notices to target people for "foreclosure rescue" services, often in the form of a "refinance" loan. Although the loans are presented to consumers as a "bailout," the truth is they generally postpone the inevitable loss of the home while draining most or all of the homeowner's remaining equity. Frequently, homeowners who must resort to this type of emergency, last-ditch financing would be better off selling the home earlier than accepting a short-term "rescue" at such a high cost.

Lenders combing the files at the recorder's office use default notices to target people for "foreclosure rescue" services, often in the form of a "refinance" loan.

Typically, homeowners in default are bombarded with unsolicited visits, phone calls and mailings (such as the one Addie C. received from a company affiliated with the lender) from so-called "foreclosure rescuers." For example, one Bay Area borrower in foreclosure saved more than 50 letters she received over a three-year period from consumer finance lenders, attorneys, real estate licensees, private investors, real estate appraisers, developers and others.

The overwhelming message of these sales pitches is "help is on the way even if the situation seems hopeless." These lenders claim to offer credit without a verifiable source of income as long as there is equity in the borrower's home. Often, a "rescuer" will persuade an unsuspecting homeowner to deed the property to him by making lofty promises. In exchange for the deed to the property, the "rescuer" promises to make all mortgage payments, help the homeowner restore his credit, and allow the homeowner a lifelong right to stay in the home as a renter.

Recognizing that homeowners whose residences are in foreclosure are particularly vulnerable to illegal and unfair practices, the California Legislature in 1979 enacted Civil Code section 2945 *et seq.* to protect the public in foreclosure consulting transactions. In addition to requiring written foreclosure consulting service agreements, the statute also permits the homeowner to rescind the contract, prohibits misleading representations, and encourages fair dealing. Unfortunately, this statute has not eliminated foreclosure consultant abuses because it

exempts eight classes of potential consultants from the statutory definition of "foreclosure consultant" subject to statute's prohibitions. The exempted groups include two of the most common types of foreclosure rescuers, consumer finance lenders, and real estate licensees (making a direct loan to a homeowner from the licensee's own funds).

The promises foreclosure rescuers use to lure homeowners are rarely honored. For example, a so-called rescuer may take title to the house and agree to make the payments, then collect rent from the homeowner but fail to make the mortgage payments. In Los Angeles, for example, the FBI and U.S. Attorney's Office are investigating a man named Bernard Gross (he changed his name to David Love Paris in 1993, but uses his old name). The *Los Angeles Times* reported that papers had been filed in court alleging that Gross defrauded homeowners and mortgage holders of financially distressed properties by falsely promising to prevent foreclosure though similar white knight techniques.[22]

Gross, who maintains his innocence, allegedly "failed to make payments or otherwise negotiate with the mortgage holder" after obtaining title, according to a federal court affidavit. One couple said they paid Gross about $9,900 in rent — only to later lose their home anyway. They said they had no idea payments were not being made until a notice was mailed to their home that the house was identified as an asset in another's bankruptcy proceedings.

According to the *Los Angeles Times* report and the Los Angeles County Department of Consumer Affairs, Gross kept the original mortgage holders from obtaining transferred properties by dividing ownership into shares, and then deeding them to other individuals or businesses who had just filed, or were about to file, for bankruptcy. Records obtained by the *Times* showed a handyman for one of Gross' firms had received an interest in nearly 300 properties. As a result, the mortgage holders had to travel a seemingly endless trail of bankruptcy hearings before they could take title to a property.

22 *Los Angeles Times*, "Real Estate Whiz Target of Rent Scam Inquiry," March 5, 1995, Valley Edition, p. 1.

Other Examples of Foreclosure Rescue Cases:

GENEVA B. of San Francisco is 58 years old. In 1989, due to illness, Ms. B. fell behind in payments with a major bank. In January of 1990, the bank started foreclosure proceedings and notified her that she needed to pay $3,478.37 to cure the default. Ms. B. received a mailing from a mortgage company saying they could give her a loan to get her out of foreclosure.

Ms. B. called the mortgage company and told the loan officer she needed about $7,000 to cure the default and pay utility liens. According to Ms. B., she was persuaded to take out a larger loan and sign a note and deed of trust that were blank; only after the loan was approved and she received all the documents did she discover that the full amount of the loan was $77,000 and that she was paying $12,320 (16 points) in loan origination fees.

In addition, the mortgage company held onto $43,000 to cover 30 months of payments to the company and two years of payments on the bank loan. Ms. B. had arranged to receive $15,490 in cash from the mortgage company loan to improve her home, but it took 16 months and the help of an attorney before she received $13,565.

Ms. B. also learned after her loan was approved that it contained a “call” provision, which would allow the mortgage company to demand payment in full if she was just one day late with her payment during the first 36 months. As she struggles to make the payments, Ms. B.’s attorneys have succeeded in obtaining an injunction against the sale of her home, allowing her to stay in her home of 15 years. Nevertheless, she is still threatened with the loss of her home if she cannot keep current on the loan.

FRED W. is a 79-year-old Berkeley resident who has owned his home since 1964. After his wife’s death, Mr. W. suffered a series of strokes and deteriorated mentally and physically. His son contacted an East Bay legal services agency after Mr. W. received letters from a mortgage servicing company for another lender, threatening him with foreclosure. Mr. W. had fallen behind on two monthly payments of $982.87, not surprising since his total monthly income consisted of a Supplemental Security Income check for $602.40.

According to his attorneys, closer examination through the recorder’s office revealed that *six loans* had been taken out on the property from April, 1992 to December of 1993. (Mr. W. did not have any documents.) During that time a loan broker had appeared at Mr. W.’s home and befriended this disabled minister of questionable capacity, then proceeded to arrange a succession of small to larger loans that presently total more than $100,000.

Mr. W.’s attorneys are attempting to piece together which loans were used to pay off a former $30,000 loan and how much money Mr. W. actually saw (about $500, according to Mr. W.). This case is currently under investigation by his attorneys who will continue to examine each of the loan disclosure statements for excessive fees and to determine if Mr. W.’s brother’s income was used by the lender to pad Mr. W.’s monthly income. No resolution has been reached in the matter.

RACHAEL X. is an elderly disabled woman who lives on a fixed income. She has lived in her Los Angeles home since 1975 and presently is the guardian of five grandchildren. According to Ms. X.’s attorney, she was in default on a $10,000 loan in June, 1993 when she was approached by a man who said he represented a wealthy investor who wanted to give something back to his community by helping people in foreclosure. Ms. X. said the man made

many promises and had Ms. X. sign a typewritten contract that he said would "help save the home and keep the grandchildren from being homeless."

In August of 1993, Ms. X. said she received a notice of foreclosure from a bank she had never heard of. She investigated and discovered that someone else owned her home, and the person had taken out an $80,000 loan and defaulted. She found a deed with her signature forged on it — certified by a notary public who also certified the trust deed for $80,000.

Ms. X filed a notice of rescission and eventually reached a settlement against the mortgage company which had sold the loan on the secondary market to investors.

BETTY M. of San Francisco fell behind in the mortgage payments on her first trust deed in 1989 as a result of a disabling illness. After receiving a mailing from a mortgage company, a loan officer came to her house. Ms. M. informed the loan officer that she could not afford a loan with payments of more than $200 per month, and he assured her that he could arrange a loan meeting that requirement.

During the meeting at her home, Ms. M. was asked to sign numerous documents, including a promissory note and deed of trust — both of which were blank. When Ms. M. asked why the documents were blank, the loan officer said that it was their practice to fill out the documents back at the office and then provide them to their borrowers. Two weeks later, Ms. M. received a copy of the completed promissory note and discovered that she had been placed into a loan that required monthly payments of $695.44. She also learned for the first time that she was being charged $8,800 (or 16 points) in loan origination fees. This $8,800 in fees was for a loan with proceeds of only $46,200. Ms. M. lost her home of 25 years in 1991 through foreclosure to the lender, and she now resides in a rented San Francisco apartment.

REFINANCES AND DEBT CONSOLIDATION

Home equity loans are often promoted as a way to consolidate debts or refinance an existing loan. Lenders may claim that a home equity loan will reduce monthly payments on credit cards and other debts through lower interest rates and tax deductions. The primary targets for lenders selling debt consolidation loans are homeowners with poor credit and an immediate need for funds, but who would have trouble qualifying for a loan from a mainstream lender. Therefore, the potential victim may be willing to accept a higher-than-average interest rate.

In reality, however, what appears to be a needed source of funds may often result in a higher debt — driven by high interest rates and fees — with impossible balloon payments, all secured[23] by the home. The result may be foreclosure, even if the loan consolidated unsecured debts (such as credit card debt) that would not have resulted in loss of the home if they had remained unconsolidated.

Debt consolidation, as the following case histories show, can be a step in a cycle of unnecessary, unscrupulous or unwise loans that place the borrower in a hopeless financial situation. Unprincipled lenders see it as a way to offer a false ray of hope that is, in reality, simply an avenue toward acquiring the home at a low price. The homeowner is put on a

23 The home is pledged as collateral to guarantee repayment. If the homeowner fails to pay as agreed, the lender can order the home sold in order to obtain repayment of the loan.

treadmill of increasingly expensive loans followed by foreclosure when the loans have drained all the equity from the home.

ELLIE M. of Oakland is 67 years old and has owned her home since 1961. By June 1994, the principal balance due on her mortgage was down to approximately $19,000. After more than 30 years of mortgage payments, Ms. M. made one payment one day late, which prompted the lender to send her a letter threatening to foreclose. Not surprisingly, the letter greatly upset Ms. M.

As Ms. M. (or Ms. M.'s attorneys) reported, while Ms. M. was bedridden for two weeks following an automobile accident in which her car was destroyed, a loan officer from a mortgage company began making unsolicited phone calls urging Ms. M. to refinance her mortgage. Ms. M. repeatedly told the loan officer she was too ill to consider a refinance at that time, but finally consented to a personal visit. When the loan agent arrived, Ms. M. got up from her bed and sat at her kitchen table in her housecoat. The loan agent assured Ms. M. that he would obtain for her an 8.55% fixed rate refinance loan. She signed the loan documents he had brought with him and returned to her sickbed.

A week later, Ms. M. was well enough to read her copies of the papers she had signed, and discovered she had signed a variable rate note providing for a semi-annual adjustment and a maximum rate of 15.55% interest. She was also being charged $6,648.00 (23 points) as a loan fee.

Attorneys for an East Bay legal aid group assisted Ms. M. and persuaded the lender to reconsider the loan. Ms. M. has since refinanced with a loan from a different lender at a significantly lower rate.

JAMES D. is 95 years old, has no formal education, and is mentally incompetent. His wife, Doris, is 82, and they live on a small, fixed income in the Los Angeles area.

In March 1991, a loan broker arranged with a lender to refinance James' credit card debt and several home improvement contracts (once again on work by a contractor who often does business with the lender). The loan broker put them into a loan for $30,000, even though their total debt was only $15,000. The loan broker kept $15,000 of the proceeds as broker fees.

By the time loans were made and refinanced, liens totaled about $92,000 — almost all due to work on a single bathroom. James and Doris were unable to make payments, and foreclosure proceedings were begun.

After seeking legal aid, James and Doris were granted a permanent injunction against the foreclosure. In addition, the loans were rescinded and damages were awarded.

MS. SMITH is an 81-year-old woman who bought her house with her husband in Los Angeles in 1937. The Smiths paid off the house in 1950, raised their children in the home and were upstanding members of the community.

In May, 1990, Mr. and Ms. Smith contacted a loan broker for a loan to consolidate four loans (which they had obtained since paying off their house) into one and to secure a smaller monthly payment. At the time, the Smiths had debts totaling approximately $70,000. Their monthly income consisted of approximately $1,000 per month in Social Security payments.

Instead, the loan broker arranged a loan for $88,150 and pocketed $11,900 in commissions. The terms were interest only (no payments applied to the principal), at $1,128.32 per month payment for 35 monthly payments, culminating in one balloon payment of $86,450.17. Although the loan broker gave the Smiths the impression that all four loans would be consolidated, only two were actually refinanced. The two loans that were paid off were fully amortized loans with a payoff balance of $70,000. The Smiths paid $1,030.73 per month for these two loans.

In essence, the Smiths gave up two amortized loans (which steadily decreased the balance owed) for one interest-only, balloon-payment loan with *higher* monthly payments. In brokering the loan, the loan broker listed the Smiths' income as $1,770.00 per month as of May, 1990. However, approximately $450 of this income was listed as coming from "odd jobs," clearly not the type of income the Smiths could rely on, especially considering their age. By the time the loan broker had finished, the Smiths owed $1,644.24 per month — an amount they could never afford. In addition, an $86,450.17 balloon payment loomed after just three years.

During the foreclosure period, the broker promised to redo the loan several times at more favorable terms, but canceled every meeting with the Smiths just before they were to sign papers for the new loan. These evasive tactics effectively kept the Smiths from seeking other means of refinancing or selling the property, and kept them in foreclosure.

In September of 1992, Mr. Smith committed suicide at the age of 83. At that point, the Smiths were in foreclosure for their home, and according to Ms. Smith, the threat of losing the home they had lived in all their adult lives was overwhelming. Ms. Smith is convinced that the realization that the balloon payment was due in a few months, which threatened to render the Smiths homeless, significantly contributed to her husband's depression, and ultimately, his death.

Since the death of her husband, Ms. Smith's sole income is $324.00 per month from Social Security. According to the Smiths' attorneys, there was absolutely no logical reason for anyone to place the Smiths into loans that were far worse than their pre-existing obligations, and they have no doubt the Smiths were taken advantage of.

Ms. Smith fell behind on the loan, the balloon payment was due, and the loan broker representing the private investors began foreclosing on the property. Fortunately, pressure from her attorney ultimately enabled Ms. Smith to reach a confidential settlement with the loan broker which is favorable for Ms. Smith and allows her to keep the home after much personal tragedy.

FRAUD AND MISREPRESENTATION

Many of the case histories in each of the four categories of home equity loan abuse include elements of misrepresentation, and some include outright fraud. Here is another example of the harm to consumers from such practices.

EVALYN F. of San Jose is a 73-year-old widow whose sole income since 1982 has been Social Security benefits and a small amount of interest income. She reported that in an effort to obtain a reverse equity loan on her home of 27 years, she contacted a loan broker.[24] The loan broker

called in a loan agent from a mortgage company. Ms. F. was expecting a reverse equity loan that would pay her loan payments, property taxes and insurance, certain home repairs and provide a monthly income of $1,500 for life.

Instead, even though she was seeking a reverse mortgage and her monthly gross income at that time was only $600, the broker and the loan agent put her into a straight home equity loan requiring monthly loan payments of $2,405.37. During that meeting, which Ms. F. said lasted no more than 45 minutes, the broker and loan officer flipped through the loan documents. They pointed to where she should sign and place her initials, but did not explain any of the specifics of the documents. It was not until several months later that Ms. F. realized what had happened.

Ms. F.'s attorneys obtained a copy of the loan application prepared by the lender in which it was apparent the drafter had inflated her monthly gross income to more than $4,000 per month. On October 1, 1992, the lender initiated foreclosure proceedings against Ms. F.'s home. Her attorneys have succeeded in obtaining a preliminary injunction against the sale of the property on the ground that fraud was involved.

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24 A reverse equity loan is one that allows the homeowner to borrow against the equity in her home during her lifetime for living purposes and other expenses. After the borrower's death, the lender is repaid the amount of the loan from the proceeds of the sale of the borrower's home.

Part III

The Regulatory Climate

The existing regulatory structure does little to discourage abusive home equity lending. Mortgage lending in California by non-bank entities has historically been placed under the jurisdiction of two agencies: the Department of Corporations (DOC) and the Department of Real Estate (DRE). The DOC regulates consumer and commercial funding (lending) licenses, and sets financial and reporting standards for its licensees. A company applying for a DOC commercial or consumer lending license must demonstrate a net worth of $25,000 and must reveal the source of funds that supplies its capital. The company also must obtain copies of the lending laws, demonstrate familiarity with them, and file annual reports with the DOC. Those reports, which show the extent of the company's lending activities, are available for public viewing upon 24-hour notice.[25] Some DOC licensees, but not those making secured loans, must provide the names of three lenders having the same type of license with whom the broker will regularly do business.

The existing regulatory structure does little to discourage abusive home equity lending.

Possession of a DOC license is no guarantee against abusive lending practices. However, for mortgage brokers and lenders involved in abusive lending, the acquisition of a real estate broker's license presents an easier regulatory alternative to the DOC licensing requirements. An individual holding a real estate broker's license can make or arrange mortgage loans without any other license.

However, unlike the DOC, the Department of Real Estate does not require its licensees to meet any financial standards and there are no public records regarding the brokers' lending activities.[26] Some lenders involved in abusive lending elect to hold both DOC and DRE licenses. They then choose to act under one or the other license, depending on the loopholes each license offers.

Real estate licensees are free to act as lenders (making loans from their own funds) in a private capacity without any DRE jurisdictional oversight as long as they are not "in the business" of lending.[27] Once a real estate licensee is "in the business" by transacting in or servicing eight or more loans or promissory notes, his only duty is to notify the DRE of this fact.[28]

When the licensee engages in 20 or more "in the business" transactions, or transactions in an aggregate amount of two million dollars, an additional reporting requirement applies.[29] These licensees must file fiscal year reports with the DRE.[30] However, this requirement does

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25 These reports show loan activity by the companies, including the number of loans made within designated interest rate ranges. Unfortunately, these reports do not distinguish between unsecured loans and home-secured loans within a designated interest rate range. This makes it impossible to determine whether a lender is making high-interest home equity loans or near market rate unsecured loans.

26 Effective January 2, 1995, however, mortgage bankers (but not brokers) have the option of bypassing the Department of Real Estate, which currently licenses their mortgage lending activities. SB 1978, which passed the California Legislature and was signed by Governor Pete Wilson in 1994, provides for a separate license for mortgage bankers administered by the California Department of Corporations.

27 Cal. Bus. & Prof. Code Sec. 10131.1(a)(b) (West 1995), "In the business" is evidenced by "selling or exchanging with the public eight or more . . . promissory notes" or "acquiring for resale eight or more ... promissory notes during a calendar year."

28 *Id.* Sec. 10231.3.

29 *Id.* Sec. 10232.

little to benefit the public or the Department's ability to regulate its license holders. Licensees subject to the enhanced reporting requirement are exempt from filing annual fiscal reports if they have not acted as a trustee handling any trust funds in any of the 20 or more transactions.[31] The only penalty for failing to report is the possibility of an assessment by the DRE for one and one-half times the cost for making an examination and report.[32] Finally, the public does not have access to any financial reports filed by real estate licensees.[33]

The DRE also is relatively limited in its enforcement abilities against its 337,000 licensees, only some of whom arrange or broker loans. DRE action against licensees who have used illegal or unethical tactics is usually restricted to license revocation or suspension, which has little effect toward putting bad actors permanently out of business because they re-enter the business under someone else's license. Legislation enacted in 1994, however, does permit the department to levy $10,000 fines against licensed brokers who hire unlicensed loan agents. This law took effect January 1, 1995 and is scheduled to expire after five years.

Consumer advocates, victims' lawyers, and law enforcement officials interviewed for this report consistently accuse the Department of Real Estate of being weak and indifferent in its enforcement efforts concerning mortgage brokerage activities of its licensees.

Consumer advocates, victims' lawyers, and law enforcement officials interviewed for this report consistently accuse the Department of Real Estate of being weak and indifferent in its enforcement efforts concerning mortgage brokerage activities of its licensees. They say complaints to the Department about abusive loans have few results. Legal advocates, in fact, say they rarely report cases to DRE for investigation because it does little good.

In fiscal year 1993-94, the DRE had jurisdiction over 337,000 licensees. They received 8,850 complaints which resulted in only 146 license suspensions and 562 revocations. An admission by the DRE adds credence to advocates' sense of futility in dealing with the Department. In the most recent annual summary of disciplinary actions taken, the DRE admitted it has had difficulty in policing its licensees, "In fact, 1993-94 was the first time in many years that the Legal Section (primarily responsible for prosecuting violations of the Real Estate Law) was able to generally keep up with its incoming workload."[34] This may explain why a DRE official said the department receives very few complaints about home equity loan abuse.

Effective regulatory enforcement against abusive home equity lenders is possible but usually involves a slow process and is more the exception than the rule. The case of Congress Mortgage illustrates this point. In April 1993, Consumers Union filed a complaint about this Bay Area home equity lender with the California Department of Corporations and Department of Real Estate, and with the District Attorneys of San Francisco, Alameda, San Mateo and Santa Clara counties seeking an immediate investigation into its lending practices. Consumers Union took this action after a highly publicized case involving alleged abuses by Congress Mortgage prompted 23 homeowners to contact our office during a six-week period. These homeowners reported that Congress Mortgage subjected them to deceptive, unfair and illegal home

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30 *Id.* Sec. 10232.2.
31 *Id.* Sec. 10232.2(b).
32 *Id.* Sec. 10232.2(e).
33 *Id.* Sec. 10232.2(f).
34 Department of Real Estate, *Real Estate Bulletin*, Fall 1994, p. 2.

mortgage lending practices. Victims claimed they were pressured into taking out high interest rate and high fee loans they could not afford.

In one year's time, the Department of Corporations was the only agency contacted that took any significant regulatory enforcement action against Congress Mortgage.[35] In April 1994, three days before the state was to conduct a license revocation hearing against Congress Mortgage, the California Department of Corporations reached a settlement with the lender. As part of the settlement filed in the Santa Clara County Superior Court, Congress Mortgage's license was suspended for 10 days and they were ordered to refund or credit borrowers an estimated $120,000. In addition, Congress Mortgage was ordered to make and maintain records demonstrating that it has conducted a "written cash flow analysis" to determine the borrower's ability to repay the loan, exclusive of the equity in the home. An outside monitor was appointed to ensure Congress Mortgage's compliance with this provision of the settlement. Although the settlement was a victory for consumers, it came too late for many Congress Mortgage victims, some of whom were evicted from their homes during the time it took the regulatory agency to act.[36]

Enforcement of fraud statutes generally depends on actions taken by local police departments and district attorneys. Most have not taken an aggressive stance to protect homeowners. They often receive the cases through legal aid societies, such as Bet Tzedek, or through agencies, such as the Los Angeles County Department of Consumer Affairs. Advocates report, however, that the cases are often given low priority by law enforcement agencies because limited financial resources force them to focus on violent crime and on less complex cases.

The primary arena of recourse, therefore, has been the civil courts. Individuals are forced to sue unethical lenders and home improvement contractors who have few qualms about declaring bankruptcy or leaving the area. For those lucky homeowners who can get timely legal help, the overall success rate in the courts in providing some sort of settlement for the plaintiff is fairly high, according to victims' lawyers. However, victims' advocates also report that the number of cases actually reaching court reflects only a very small percentage of the total number of abusive loans made. In addition, court proceedings are usually long and can become more complicated if notes on properties have been sold and resold in the secondary market to investors. This is because investors who buy the notes on the secondary market will claim that they are holders in due course because they did not participate in or know about any abusive sales practices in the origination of the note. (They also may not have received the high loan fees and points — those are frequently pocketed by the broker acting as a middle man.) The investor asserts that as a holder in due course he or she owns the notes free from any defenses related to defects in the transactions in which the notes were originated. Often the borrower must engage in costly litigation to defeat this claim.

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35 In January 1994, Consumers Union and Consumer Action filed a lawsuit in the Santa Clara County Superior Court (Case No. CV737788) against Congress Mortgage in an effort to protect borrowers' rights while awaiting regulatory action.

36 The Department of Real Estate later took action of a more limited nature. Then Commissioner Clark Wallace ordered that all licenses and license rights of Congress Mortgage, Equity Holders Servicing Company and Robert Stephen Gaddis (the owner) be suspended for 15 days. All 15 days of the suspension were stayed for one year on the condition that they obey all laws, rules and regulations. The Commissioner's order also provided that Congress Mortgage, et al., would be subject to a chargeable follow-up audit by the Department.

While the courts play an important role in providing relief in cases of equity loan abuse, court action is on a case-by-case basis and does little to prevent the abuse from occurring in the first place. It is certainly more effective and cost-efficient to prevent abuse and to help distressed homeowners avoid the financing traps into which they can easily fall. This section suggests actions by the legislature, the regulators and the courts to protect homeowners from becoming home equity loan victims.

While the courts play an important role in providing relief in cases of equity loan abuse, court action is on a case-by-case basis and does little to prevent the abuse from occurring in the first place.

USURY LAWS

Usury laws traditionally prohibited exorbitant interest rates, but few such laws remain in place. Many states eliminated usury laws in the late 1970s and early 1980s as interest rates rose to new heights and the banking industry entered a period of deregulation. In 1982, Congress preempted state laws that limit so-called "creative financing" techniques such as balloon payments and negative amortization[37] as they applied to nationally chartered financial institutions.[38]

California does have a usury provision law in its Constitution: Article 15, Section 1 prohibits unauthorized persons from charging an exorbitant rate of interest. Over the years, however, almost all lending transactions have been exempted. Licensees of the DOC and DRE are among those lenders exempted from the constitutional usury cap.

The concept of re-instituting reasonable usury laws is supported by leading national consumer organizations. According to the National Consumer Law Center, flexible usury laws that do not constrict legitimate lenders are the single most effective way to discourage abusive home equity loans.

HOME OWNERSHIP AND EQUITY PROTECTION ACT

Finding an absence of state controls against abusive loans and laws (such as in Georgia) that allow interest rates of up to 60% per year, Congress took action in 1994 in a bipartisan effort to provide some relief. The result was the federal Home Ownership and Equity Protection Act of 1994, which places special provisions on "high-rate, high-fee mortgages." It will be included in the Truth in Lending Act (TILA) as of October 1, 1995.

High-rate, high-fee mortgages are defined in the Home Ownership and Equity Protection Act as loans with interest rates 10 percentage points above comparable terms for U.S. Treasury securities with similar maturities,[39] or a loan for which the consumer pays total points and fees exceeding the greater of $400 or eight percent of the total loan amount (including all costs and compensation for brokers).

A key provision of the Act prohibits high-rate, high-fee mortgage lenders from engaging in the pattern or practice of extending credit solely on a homeowner's equity without considering the borrower's ability to repay the loan. Lenders will be required to consider the consumer's

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37 Negative amortization is a payment schedule of regular periodic payments that does not repay the full amount of interest or does not fully amortize the outstanding principal balance.

38 12 U.S.C. Sec. 3801 *et seq*., Alternative Mortgage Transactions Parity Act of 1982 (AMPTA).

39 For example, if the 10-year Treasury security rate was at 8 percent, a 10-year home equity loan would be covered by the Act if its interest rate was 18 percent or higher.

current and expected income, any outstanding obligations, and employment status when lending against the home. These new requirements were imposed to eradicate the practice of promising loans to the unemployed or people with poor credit simply because they have equity in their homes.

The Equity Protection Act has Several Other Important Provisions:

It gives state attorneys general enforcement authority for the TILA in Their States.

People who make occasional home-secured loans — less than five per year — are not usually subject to the TILA. However, the Act extends TILA requirements to all creditors who originate two or more high-rate, high-fee mortgages, or one or more of these loans through a mortgage broker.

Special disclosures alerting the consumer that a proposed loan is a high-rate, high-fee mortgage must be provided at least three business days prior to the loan's consummation. The following statement must be included in the contract:

> You are not required to complete this agreement merely because you have received these disclosures or have signed a loan application. If you obtain this loan, the lender will have a mortgage on your home. You could lose *your* home, and any money you have put into it, if you do not meet your obligations under the loan.

Penalties for early repayment are generally prohibited on high-rate, high-fee mortgages.

Money for loans made in conjunction with a home improvement contract must be disbursed directly to the consumer, or, at the consumer's choice, to both the consumer and contractor. A third-party escrow agent also may be used.

The right of private citizens to sue lenders is enhanced and claims against a lender will generally be good against the holder of a note purchased on the secondary market. This addresses some of the problems faced by homeowners trying to recover damages or get their homes back, in due course, from holders who have often prevailed against borrowers even in cases of abuse.

While the federal Home Ownership and Equity Protection Act is a step forward, in the larger picture, it is not enough to stop home equity loan abuse in California. People in need often ignore the warning disclosures designed to protect them from harm. Smooth-talking salespeople still can convince elderly and unsophisticated borrowers that the loans they offer are the best options available.

If the Equity Protection Act is to be successful, it will be up to the states to enforce it aggressively and be vigilant toward accomplishing its goals. The priority state officials will give the Equity Protection Act remains to be seen.

Also looming is the possibility that the Act, which was passed during the 1994 congressional session, may be revised or diminished in the deregulation environment of the new Congress. Proposals to remove or restrict the three-day right of rescission on home loans, a cornerstone of the Truth in Lending Act, were recently defeated. Additional proposals would change the federal definition of high cost mortgages to exclude first liens. This ignores the fact that many of the problem high cost mortgages include first liens, such as 81 year old Ms.

Smith's of Los Angeles whose case is reported on page 20 of this report. Frequently the elderly are targeted for high cost mortgages on homes that have been long paid for and have no pre-existing liens. Additionally, often individuals with some remaining balance on a first lien are persuaded to consolidate the pre-existing first mortgage into a new high cost mortgage. The new mortgage becomes the new first lien as a result of the consolidation. This gives the high cost mortgage lender priority over any subsequent liens and immunity from the provisions of the Home Equity Protection Act, including those sections governing high cost mortgages. The consolidation also generates higher fees for the lender and higher commissions for the broker by creating a new first loan in an amount greater than the amount originally contemplated by the borrower.

THE MASSACHUSETTS EXPERIENCE

One state that has worked actively to reduce home equity fraud abuse is Massachusetts. In the late 1980s and early 1990s, the Boston area experienced an explosion of reports of home equity loan abuse cases similar to those described in this report. As a result, significant changes were made to the Massachusetts General Law in 1992 to tighten controls on the parties most responsible for the abuse.

Prior to this legislation, Massachusetts had limited controls over small mortgage lenders and mortgage brokers, much like current law in California. The new law established a new lending license and new standards for mortgage brokers and for mortgage lenders (other than banks, credit unions, and similar chartered financial institutions). The new Massachusetts law also consolidated power to regulate these entities under the office of the Commissioner of Banks, a position comparable to the Commissioner of Corporations in California.

Regulations issued by the Massachusetts Commissioner of Banks' office established several new standards for mortgage lenders and brokers to obtain a license to do business in the state:

All applicants must demonstrate a net worth of at least $100,000, or at least $25,000 in assets and a bond of $75,000 or more;

The applicant must demonstrate the character and fitness to engage in the mortgage lending business "in an honest, fair, sound and efficient manner," and show that officers and employees have the necessary experience.

In order to renew, license holders must file financial statements for the previous year: individuals must submit their tax returns, while corporations must submit their corporate financial statements.

"They did to me what a man with a gun in a dark alley couldn't do: They stole my house."[41]

The new Massachusetts standards allow a licensed mortgage lender also to act as a mortgage broker. But if a lender chooses to act as a broker, it is barred from brokering a loan to its own lending arm. That eliminates a practice that increases fees for consumers and enables brokers to arrange "sweetheart" deals between affiliated companies.

41 Massachusetts Attorney General Scott Harshbarger quoting a Massachusetts home equity loan scam victim, Senate Banking Committee Hearings, Feb. 17, 1993.

In addition, the Massachusetts Attorney General helped develop legislation that prohibits home improvement contractors from acting as mortgage brokers or lenders on contracts they enter into, and sets up a guaranty fund to provide limited relief to defrauded customers unable to recover restitution. When it implemented these changes, Massachusetts placed a 120-day moratorium on foreclosures, which gave financially distressed homeowners time to thoroughly consider all their options.[42]

In testimony before the Senate Banking Committee last year, the Massachusetts Attorney General, Scott Harshbarger, reported that enforcement actions have already yielded more than $40 million in benefits to low- and middle-income consumers.

On another front, Massachusetts worked extensively with its largest financial institutions to develop lending programs for low-income communities that were prime targets for unethical lenders. It should be noted, however, that the impetus of this agreement was that several of these institutions were found to have purchased questionable high-rate loans on the secondary market. The purchase of questionable notes by mainstream financial institutions has not been proven in California. However, the potential is there: banks have closed branches in many low-income areas and consumers may have fewer choices for home equity and home improvement loans. In some cases, the trust deeds purchased by mainstream banks in Massachusetts were used to help artificially inflate the volume of their loans in inner-city communities to meet requirements of the Community Redevelopment Act.

The federal government and other states are looking closely at what Massachusetts has accomplished. California should enact protections, similar to those adopted in Massachusetts, against home equity loan abuse and fraud, a crime that the state's Attorney General, while testifying before the Senate Banking Committee, called an "insidious form of urban economic violence." In his testimony, the Attorney General also recalled poignant comments of one Massachusetts victim who put to rest any speculation about whether unconscionable lending practices are ripe for law enforcement action. Of the people who cheated her out of her home, she said to the Attorney General's office:

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42 Mass. Gen. L. ch. 93, §2(a), *et seq*. Mass. Regs. Code 8.00, 8.01 *et seq*. (1994).

Part IV

Recommendations

The problem of home equity loan fraud and abuse can no longer be ignored. If California is to successfully reduce the financial and emotional toll home equity loan fraud and abuse takes on its residents, three important areas must be addressed:

Strengthening and enforcing existing laws and regulations

Education

Accessibility to quality loans

Preventing home equity loan abuse requires action by the Legislature, state regulatory agencies, California's mainstream lenders, local law enforcement, public and private consumer agencies, and community organizations such as churches and seniors' groups. While home equity abuse and fraud may never be eliminated completely, the following recommendations can work to significantly reduce problems and save millions of dollars in home equity for those who need it most: Californians who have put years of work and savings toward owning their own homes.

California can implement many changes to make its regulation of lending practices more effective and efficient. The Department of Corporations, Department of Real Estate, Attorney General and local law enforcement agencies must pursue prosecution of cases aggressively. In the process, they must maintain a high profile to demonstrate the state's commitment toward enforcing new and existing laws and regulations that protect consumers from unscrupulous lenders. In addition to vigorous enforcement of current law, new legislation should be passed to restrict home equity abuse.

The following legislative changes would significantly reduce the extent of home equity loan abuse and fraud.

LEGISLATIVE ACTION

Recommendation: The legislature should consolidate all mortgage lending licenses under the Department of Corporations and then the Department should institute regulations mandating reporting and financial standards for lending entities.

The current dual licensing structure — some lenders licensed through the Department of Corporations, other lenders and brokers through the Department of Real Estate — is ineffective and does little to ensure that the majority of lenders are upright and financially sound. In fact, it could be argued that the greatest effect a DRE license has on an unscrupulous lender is to provide an undeserved air of credibility that misleads consumers.

The Department of Real Estate should require all its licensees who make or arrange loans to meet the standards set by the Department of Corporations for consumer and commercial finance lenders. It should go further and follow the example set by

Massachusetts, which has implemented extensive licensing and regulatory programs to thwart home equity loan fraud and abuse.

There are no financial or bonding standards for real estate licensees who engage in mortgage brokering or lending under the current Department of Real Estate license structure. Once regulatory jurisdiction is consolidated under the DOC, to receive the new Department of Corporations lending license, all mortgage lenders and brokers should first have to demonstrate that they can meet financial standards of at least $100,000 in net assets (or $25,000 in assets plus a $75,000 bond). Honest and fair business practices must be exhibited over the life of the license. Licenses should be renewed at least every three years. Failure to act properly should result in license revocation and significant civil penalties.

All mortgage lenders and brokers also should have to meet extensive reporting standards similar to those now required by the Department of Corporations for consumer and commercial finance lenders and by Massachusetts for mortgage lenders. Annual reports should include, at a minimum, the number and types of loans tendered, the interest ranges of those loans, company officers, and business locations. Complete audited financial statements also should be filed annually.

Recommendation: Prohibit balloon payments on home equity loans unless the borrower has the option to fully amortize the payment at the end of the initial loan term.

Loans based on balloon payments — a large, final payment at the termination of the loan — came into common use in the late 1970s and early 1980s, when high interest rates made home buying unaffordable for many Americans. The purpose was to give homeowners an opportunity for lower payments through what became known as "creative financing."

Although balloon payment loans may have provided an entry into the home ownership market, the payment structure of monthly payments (going towards interest only with an unusually large payment due at the end) has caused many problems for California homeowners. In the early 1980s, many Californians with balloon payments were forced to sell their homes for little or no gain as the balloon payments came due.

Balloon payment loans are often misleading and unnecessary and should be prohibited. Although current federal law undermines a state's ability to limit balloon payment loans,[43] (regardless of whether a loan is a first or a second lien), compelling reasons exist to re-examine the usefulness of such a prohibition.

Today, unscrupulous lenders use balloon payments to convince naive borrowers they will receive funds for a lower monthly payment, knowing the borrower will eventually not be able to make the balloon payment. When the balloon comes due, these lenders foreclose on the house or arrange for a new loan at even higher rates and fees.

Moreover, the protections for consumers against balloon payment loans contained in the High Cost Mortgage Act are incomplete and subject to weakening in Congress. Even

43 12 U.S.C. Sec. 3801 *et seq*., Alternative Mortgage Transactions Parity Act of 1982 (AMPTA). Each state had the opportunity to exclude itself from the provisions of this Act. California did not exercise this option.

though the High Cost Mortgage Act prohibits balloon payment loans with negative amortization, several amendments to the Act which will severely restrict this protection have been added to pending federal banking legislation. One such amendment would exempt all first mortgages, regardless of cost. If successful, the result will be that even extremely high cost first mortgages with impossible balloon payment terms will be exempt from the Act. This creates a tremendous loophole because many high cost mortgages are frequently first lien balloon payment loans. This is because the elderly with no pre-existing liens are frequent targets for high cost loans, usually related to home improvements. And borrowers with some balance on a first lien often have that debt paid off by a new lender offering a new first lien which is exempt from the Act.

Recommendation: Prevent weakening consumers' right of rescission for refinance loans and equity loans under the Truth in Lending Act.

Until recently, Congress was considering legislation that would have severely limited a consumer's right to cancel a loan during the three-day right of rescission period offered by the Truth in Lending Act. This grace period is one of the most important and effective rights consumers have to protect themselves against abusive and outrageously expensive loans. Eliminating the three-day right of rescission would have also meant that borrowers would lose the three-year right to rescission which applies when a lender fails to adequately disclose key information about the loan's terms and costs or fails to inform the borrower of his or her rights to rescind. Fortunately, Congress resisted efforts to eliminate these protections.

Although the Truth in Lending Act is federal legislation, maintaining the right of rescission is of great importance to home equity loan victims in California and nationwide. Unscrupulous lenders often violate the Truth in Lending Act, and legal advocates in California see the Truth in Lending Act and its right of rescission as effective weapons to help victims recover damages or hold onto their homes. If Congress and the President intend to help consumers, and not abusive lenders, they should reject any future efforts to weaken the right of rescission.

Recommendation: Reinstate reasonable usury laws and floating rate caps on all second mortgages and revise the Federal laws prohibiting the states from regulating interest rates on first liens.

Until the sharp rise in interest rates in the late 1970s, interest rate caps had been an integral element of consumer protection. Even as far back as 1827, the Virginia Supreme Court observed:

> *"It has been a good deal the fashion of late, to decry the policy and justice of our laws regulating the rate of interest. It may be permitted to observe, however, that if the experience of the ages, and the general opinion of mankind, deserve weight in legislation, their voice is in favor of usury laws. They have prevailed in all civilized countries, and in all time."*
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> Withworth & Yancy v. Adams, (1827) 26 VA. 333.

Usury laws — which are considered by many consumer organizations, law enforcement agencies and legal advocates to be the most effective method of controlling lending fraud and abuse — *can* be successfully integrated into today's volatile marketplace. Currently, federal law prohibits states from regulating "the rate or amount of interest, discount points, finance charges, or other charges" on loans secured by a first lien on residential real estate.[44] However, states are free to reinstate usury laws on second mortgages. And because first liens are often part of the problem in abusive home equity lending,[45] California's Congressional representatives should reintroduce legislation to remove the restrictions on states to regulate interest rates on first liens as well.

Reasonable rate caps on home equity loans can be set by using floating caps based upon the current rate for a widely accepted financial index (such as Treasury bills or the 11th District cost of funds). This would still allow room for competition and enough of a margin to allow lenders to make riskier loans. A margin such as 10 points (consistent with the federal definition of a "high-rate" mortgage) could then be added to establish a cap that would include all broker and loan fees.

As mentioned earlier, usury laws may be antithetical to the prevailing trend toward deregulation. However they are an effective way to prevent crime, which is high on the public's political agenda. Some interest rates are so high that they violate the public interest. A reasonable usury law can protect against exorbitant rates that are not offered for the convenience of parties with questionable credit, but are solely an attempt to prey on the desperation or distress of a vulnerable borrower.

Recommendation: Place additional state restrictions and requirements on "high-rate, high-fee" loans as defined by the federal Home Ownership and Equity Protection Act.

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44 12 U.S.C. Sec. 501(a)(1) Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) Pub. L. No. 96-221, 94 Stat. 161 (1980)

45 Home equity loans are often debt consolidation loans. One way a lender can avoid becoming a second lien holder is to consolidate the existing first lien into a new loan. The lender making the new loan then becomes a first lien holder exempt from many laws which regulate second mortgage abuses.

As discussed in Part III, the federal Home Ownership and Equity Protection Act of 1994 modifies the federal Truth in Lending Act to define and restrict “high-rate, high-fee” loans. California should go a step further.

Using the definitions in the Act (points exceeding the greater of $400 or 8% of the loan, or an interest rate greater than 10 points over comparable Treasury Bill rates), high-rate, high-fee mortgage loans should be subject to the following conditions in California:

Borrowers should be provided with a mandatory waiting period of seven days in which to read the loan documents and seek advice before signing.

Borrowers should be required to provide their initials next to the interest rate and fees to acknowledge they have seen the extraordinary terms of the loan;

High-rate, high-fee mortgages may not be consummated if payments on all existing debt exceed 40% of the borrower’s total income, and should be void if miscalculations or misstatements are made by the loan officer so the contract can appear to meet this condition;

Loan documents should include a statement, in bold face type, which clearly states that the borrower is entering into a contract with terms that exceed general market rates. The statement should be more direct and clear than what is required by federal law and written in the language in which the loan negotiations were conducted. For example, such a notice could say:

Important Notice of High Fees and Interest Rate

The fees or interest rate this lender wants to charge you are *much* higher than normal. They are so high that they greatly increase the risk that you will end up *losing your home*.
They also greatly increase the risk that you will end up *losing your equity in the home*.

Before you sign this contract, you should look for a cheaper source of credit. You should also talk to (appropriate agency).

In addition to requiring written disclosure, lenders should be required to provide borrowers with oral disclosure of the contents of the “Important Notice” paragraph cited above.

Recommendation: Prohibit door-to-door soliciting of loan services and home improvement services that are financed through a home equity loan.

A common denominator in many home equity scams, especially those involving home improvement, is that the initial contact is made through a door-to-door solicitation. Prohibiting door-to-door soliciting of home equity loans and any home improvement services that are financed by loans against the property should have a substantial impact against scam artists. Even though they may still be able to target neighborhoods and potential victims by mail, the impact of a letter is far less powerful than having a friendly stranger offer money at the front door.

Recommendation: Prohibit home improvement contractors from acting as mortgage brokers or *de facto* agents of mortgage companies.

One of the greatest single sources of home equity loan abuse has been home improvement projects in which the contractor arranges for a loan to pay for the work. Unfortunately, the work isn't always completed or fails to meet local building code standards.

By arranging for financing and acting as the link between the customer and a lender, a contractor is actually acting in the same capacity as a mortgage broker. Unethical contractors often work with unethical lenders. The result can be tremendous loan fees and "sweetheart" high-commission loans.

California should follow the lead of Massachusetts by requiring the following:

All loan documents must be presented by a loan officer representing the lender, not by the contractor

Lenders must personally inspect and sign off on completed home improvements before full payment is tendered

Payments on home improvement loans may not exceed 40% of the borrower's gross income;

Lenders who finance home improvement projects should be subject to consumer claims and defenses so homeowners cannot be left with a half-finished remodeling job and a loan for the project that is still due. Consumers' rights should be preserved even if the lender breaks the law by omitting from the contract the clause required by the Federal Trade Commission to preserve consumer claims and defenses against buyers of the note

Checks for the entire loan amount, less loan fees, must be presented to the borrower, not the contractor. If both parties agree, the loan proceeds instead may be held by an independent licensed escrow company for proper disbursement when the work is completed.

Recommendation: Require pre-loan counseling for all homeowners applying for loans that will result in debt payments exceeding 40% of income.

Conversations with dozens of victims of home loan scams reveal that many of them did not understand the impact of interest rates and points on the cost of a loan. Many also did not understand the relationship between their monthly income and new monthly payments since they were told they could qualify for loans simply because they had equity in their homes.

Clearly, many abusive loans could have been averted if the borrowers had received pre-loan counseling from an independent consumer agency. Victims could have been made aware of lower-cost financing programs. Counseling can help the borrower determine how much money he needs to borrow — rather than simply taking what the lender offers — and help to ensure that the loan documents are completed fully and accurately.

Mandatory counseling for borrowers whose total monthly debt payments (including non-mortgage payments) exceeds 40% of monthly income would create a disincentive for scammers to prey on the elderly and naive, and would allow counselors to alert law enforcement officials about lenders exhibiting illegal or abusive practices. Counselors could include HUD-approved counseling agencies, nonprofit community counseling services and community housing or consumer affairs organizations.

While counseling would be mandatory, the borrower would still be free to choose to enter into a loan transaction against the counselor's advice. Some borrowers may make this choice, but conversations with home equity loan scam victims indicate that they would have looked for other alternatives if they had been given adequate information about the risks and nature of unfavorable loan terms.

Educated borrowers are safer borrowers, and smarter borrowers are better credit risks. Pre-loan counseling has been recognized as beneficial to both borrowers and creditors by consumer advocates and mortgage banking industry leaders. Angelo R. Mozilo, president and CEO of Countrywide Funding Corporation, summed up the benefits of counseling when he said, referring to home purchase loan customers, "marginal borrowers become superior performers once they have been enlightened about their financial responsibilities."[46]

Recommendation: Require counseling for borrowers seeking to refinance an existing loan which has gone into default.

Homeowners on the verge of losing their homes are desperate for relief. They are among the most vulnerable of potential victims. Unfortunately, in many cases, it is often better to sell the home at the outset of the foreclosure process than to try rescue measures that may lead to a total loss of equity.

Homeowners who have had notices of default filed against them often are bombarded with rescue offers from lenders, mortgage brokers, attorneys and others. These often lead to desperate, expensive and ultimately worthless activities — such as high-rate

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46 "*Unlocking the Door to Home Ownership: Mortgage Banking's Role in Affordable Housing,*" remarks by Angelo R. Mozilo, president and chief executive officer of Countrywide Funding Corporation. The remarks were delivered at the St. Mary's College Executive Symposium, Moraga, California, March 11, 1994.

loans that the homeowner has no chance of repaying. These pitfalls could be avoided through post-default financial and homeowner counseling by independent, nonprofit agencies.

To make assistance accessible, realtors and title insurers should help fund free or low-cost counseling and education programs administered by nonprofit groups or governmental agencies. Mainstream banks and lending agencies also should be encouraged to set up cooperative ventures with these entities to provide financial and pre-loan counseling to residents of inner-city and low-income neighborhoods. Some major banks now provide homeownership preparation programs for low- and moderate-income people who hope to be future homebuyers. Existing homeowners need similar consumer education directed to home improvement loans and second mortgages.

Recommendation: Require notaries statewide to record a thumbprint to verify the identity of a person signing a deed, quitclaim or deed of trust.

Los Angeles County requires that a thumbprint be recorded in a notary's journal to verify the identity of the person signing a deed, quitclaim deed, or deed of trust. This three-year pilot program is set to expire in December 1995. It was enacted by the Legislature in response to many cases in which grant deeds and loan documents were found to be forged and notarized with a stolen stamp or by a notary acting as an accomplice to forgery.

Almost immediately after the program began, the number of real estate fraud and forgery complaints in the county dropped significantly. Detective Paul Harvey of the Inglewood Police Department said the 10 to 15 calls a month he formerly received about real estate scam artists have been considerably reduced thanks to the thumbprint requirement.

"If you're a crook and you're going to forge a grant deed or a quitclaim deed, you will be deterred unless you're just plain stupid," Harvey said.[47]

The program should be continued (as proposed in legislation by state Sen. Diane Watson)[48] and expanded throughout the state. Requiring a thumbprint is a simple, but effective, deterrent to forgery of deeds.

Recommendation: Maintain and increase the vital funding law enforcement agencies need to fight home equity fraud and prosecute criminals. Supplement these funds through assessments on licenses or voluntary contributions from industry.

Law enforcement agencies and prosecutors with tightening budgets are constantly called on to do more to stop crime. As the money dwindles, violent crime is given a higher priority and complex, non-violent crimes such as home equity loan fraud get less attention. Funding must be available to dedicate the time and personnel needed to fight the crimes that are indeed "economic violence."

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47 *San Francisco Examiner*, "Thumbprints Squash Real Estate Fraud in L.A. County," May 7, 1995.

48 SB 963 (Watson) would have extended indefinitely the Los Angeles pilot program. Unfortunately, the bill did not pass. It was opposed by the California Association of Realtors.

"There might be a point at which we won't do any real estate fraud cases," said Don Tamura, the Los Angeles County deputy district attorney who heads the real estate fraud unit, "because 'Three Strikes' has created such a backlog of cases and violent crime has taken priority over white collar crime."

SB 537 (Hughes), introduced in the California legislature in 1995, would provide vital funding to district attorneys and local law enforcement agencies for the purpose of determining, investigating and prosecuting real estate fraud crimes. The funding would come from imposing a nominal fee for recording real estate related documents. As of this writing, SB 537 has passed both houses of the California legislature and awaits Governor Pete Wilson's signature.

Title companies, which have a financial interest in preventing home equity fraud, provided $500,000 to Los Angeles law enforcement officials in 1994 to fight fraud. Unfortunately, a downturn in the real estate market makes a similar contribution unlikely this year, and fraud prevention programs in other areas of the state still are severely underfunded. Other industries with a financial or public relations stake in preventing home equity loan abuse — such as reputable realtors, lenders and mortgage brokers — should help underwrite some of the costs of enforcement programs. Additional money or matching funds could be made available through a small assessment charged on real estate and lending license applications and renewals.

REGULATORY ACTIONS

Although we recommend many legislative changes, there are also steps the regulators can take today to protect homeowners from lenders engaging in abusive and illegal practices.

Recommendation: Regulators should take vigorous regulatory action to investigate and prosecute cases of home equity lending abuses and fraud.

The public has largely given up on any regulatory enforcement of existing laws meant to protect homeowners from home equity lending abuses. With few exceptions, aggressive, swift regulatory action has not been forthcoming in even the most high-profile cases.

Regulatory agencies must identify and treat home equity abuse cases as high priority. This means these cases must be assigned for immediate, timely and thorough investigation with appropriate follow-through. Regulatory agencies must vigorously prosecute the offenders, including avoiding settlements which are against the public interest. They must be true advocates for the public interest at administrative hearings involving the offenders.

Regulatory agencies must ensure that offenders comply with the terms of any settlement reached or disciplinary action imposed. It should be the responsibility of the regulatory agency prosecuting the offender to ensure that the offender does not re-enter the profession by opening up business under another name or under someone else's license.

Recommendation: Collect and centralize detailed information about the interest rate ranges and fees charged by home loan lenders and brokers.

One of the difficulties in determining the extent of home equity loan abuse is no centralized, clear records exist that delineate what lenders are charging their home mortgage customers. Although the Department of Corporations requires annual reports from consumer and commercial finance lenders showing the range of interest rates on loans charged during the year, lenders are not required to break out which of these loans were against real estate and which were unsecured.

It is difficult to interpret interest rate data when the types of loans in various interest rate categories are not defined. For example, a report showing a large number of loans with interest rates in the 18%-22% range could be evidence of home loans resulting from abusive practices, or it could be the result of unsecured loans at somewhat competitive rates.

Department of Corporations reports, including those that would be required under a new mortgage lending license, should clearly show the interest rates and points charged for home loans. These reports would help regulators determine which companies are practicing abusive lending practices. An obligation to make the reports public also may help to deter lenders from making outrageous loans.

Recommendation: Make home improvement contractor and mortgage lender complaint records readily available by region.

The public often does not know where to look to determine whether a contractor or lender has an existing record of abusive practices. The Contractors State License Board, Department of Real Estate and the Department of Corporations should issue and make available regular reports that could help consumers avoid unscrupulous lenders and contractors by showing the number and nature of complaints against companies.

Consumers also should have access to information about pending complaints against companies, information that is not currently released. Privacy and due process rights could be protected by revealing the number and general nature of the complaints against a particular entity plus the fact that the allegations are not conclusive and are still under investigation.

Ideally, information on home improvement contractors and lenders would be available through a single toll-free number and in a periodic report published by the state. This service should be provided by the California Department of Consumer Affairs.

Recommendation: Develop identification programs which inhibit criminals' ability to set up new lending and brokerage businesses by changing names.

Civil and criminal cases involving home equity loan fraud often involve defendants who have been associated with a string of companies whose names have changed or "reformed" after legal action or bankruptcy. It is not unusual for disreputable lenders or even known criminals to set up shop under a new company name after the old company has been the target of a license action or a civil suit.

Preventing convicted criminals and disreputable lenders from simply operating under new names or holding a key position at a different company should help reduce the number of repeat offenders. One way to accomplish this goal would be to require all companies holding the proposed Department of Corporations mortgage lending license to provide a current list of all key officers. Those officers should then be held to the same standards of honest business practices and character that would be required of the corporate licensee.

If the officers do not meet the Department's character standards or are known to have a history of abusive lending or disreputable practices, the company's license application should be denied. Existing licenses should be subject to revocation and their holders liable for criminal and civil penalties. This would give the company owner more incentive to hire quality people and would increase the state's ability to hold entire companies to higher standards of practice.

EDUCATION

Educating potential victims is essential to prevent fraud and abuse. Victims of home equity loan abuse say they would never have become involved with the contractors, brokers, lenders and others who took advantage of them if only they had known what they were getting into. Another critical component is to educate law enforcement officials on how to recognize and protect the public from fraud.

Education efforts should begin where the victims often meet these abusers. Appropriate sites for outreach include churches, women's clubs, seniors' groups, service clubs and other community organizations in neighborhoods where elderly homeowners have built significant equity in their homes. Loan salesmen often build confidence in neighborhoods by attending churches where they meet elderly widows for whom they can later "help" finance home improvements or debt consolidation. In one Los Angeles case, fraud charges were brought against a lender who met several of his victims through church organizations.[49]

The Los Angeles County Department of Consumer Affairs has instituted an education program, which includes presentations to neighborhood organizations and easy-to-understand literature. The program has been successful in the areas it has been introduced, but it has had an unfortunate side effect. The department's limited financial and staff resources allow it to concentrate only on small segments of the county at any one time, and the effect is like squeezing a balloon. As unscrupulous lenders are forced out of one neighborhood, such as South Central Los Angeles, they simply re-establish themselves in another area which the

49 *People of the State of California v. Tim Barnett*, Los Angeles County Superior Court, Case No. BA105786.

department cannot afford to serve simultaneously. As a result, home equity loan abuse is now reportedly a growing problem in areas of the San Fernando Valley such as Panorama City and Pacoima.

The Legal Aid Foundation of Los Angeles, Bet Tzedek Legal Services, Legal Assistance for Seniors in Oakland and other advocates also provide community outreach, but much of their efforts go to helping victimized homeowners seek redress in the courts. Unfortunately, they lack sufficient staff and budgets to perform intensive community education. In short, many people are working hard to spread the message that unscrupulous lenders are preying on unsophisticated homeowners. Unfortunately, their efforts will be effective only if their programs receive more financial support to provide more comprehensive services.

There are actually several audiences that should be reached, including current homeowners, potential victims, politicians, law enforcement, real estate industry professionals, and future homeowners. The following recommendations are offered to help improve education efforts, make consumers more sophisticated and aware, and facilitate law enforcement's involvement in preventing abuses and prosecuting scammers.

Recommendation: Properly fund programs to reach and inform potential victims about how they can prevent home equity loan abuse.

Education about home equity loan abuse will be effective only if advocates can reach all segments of the at-risk homeowner population. Adequate funding is essential to:

Communicate to the target audience of potential victims in a way they can understand and relate to their own lives; and

Develop an effective outreach program to increase the media's awareness of home equity loan abuse and how it affects its readers and viewers.

Preventing crime saves money, and educating potential victims about home equity loan abuse through the media and community presentations is one of the most effective ways to stop a crime or fraud before it starts. More money is needed to educate homeowners about loans offered by cities, counties and the U.S. Department of Housing and Urban Development. Adequate funding is needed to help representatives of legal aid societies and consumer affairs organizations expand their programs to serve more Californians.

"Education is the key," says Betty Stark of the Los Angeles County Department of Consumer Affairs. She says a "massive educational attack" is needed to stamp out home equity loan fraud and abuse throughout that county.

California should consider community education about home equity loan abuse and fraud a high-priority crime prevention measure and fund it accordingly. If money from the state general fund is not available, money can be generated by assessments on licensed lenders, slight increases in recording and notary fees, and through severe fines against companies and individuals convicted of fraud. In addition, title insurers, lenders, realtors and other segments of the lending industry can promote their financial and public relations interests by voluntarily funding education programs run by legal services type organizations and government consumer affairs offices.

Recommendation: Develop and fund programs that train more law enforcement officials about home equity loan fraud and abuse.

Groups fighting home equity loan abuse often comment that law enforcement agencies are unwilling or unable to address the problem because they don't understand the complexities involved and don't have the time and staff to investigate these cases. Police departments agree that the complexity and time-consuming nature of home equity loan abuse and fraud make it difficult to adequately respond to the problem.

Local law enforcement officials should make an effort to learn about the extent of home equity fraud and abuse, how to spot patterns of abuse, who the bad actors appear to be, and techniques to help prevent and stop abuse. These officials should work closely with the legal advocates and community groups that are often the front line of defense against home equity fraud and abuse.

With the proper training, community law enforcement officials can recognize crimes faster, report violators to their regulators, and also help educate the public and coordinate home equity abuse prevention with other programs. For example, Neighborhood Watch programs could include information about the warning signs of home loan fraud.

Home equity loan abuse is a growing, and sometimes criminal, activity. It can only be stopped if law enforcement agencies catch the wrongdoers and punish them accordingly. If law enforcement officials understand the extent of the problem and who it affects, and have adequate staff, they will undoubtedly have more incentive to work towards eliminating home equity loan fraud and abuse. The relatively small expenditure of crime prevention funds that would be needed to train officials — with the help of nonprofit victims' advocates services — could help significantly reduce these crimes that total tens of millions of dollars in losses annually.

Recommendation: Continue to fund and expand statewide the pilot program requiring county recorders to notify homeowners of notices of default.

The pilot program in Los Angeles requiring the county recorder to notify homeowners when a change in title takes place or a notice of default or foreclosure action is being taken against their property should be continued and expanded. Between March 1994 and March 1995 more than 39,000 property owners returned postcards to the Los Angeles County Recorder acknowledging receipt of notice that deeds had been recorded on their properties. Approximately 10% responded that they were unaware of the deeds. According to the L.A. County District Attorney's office, an estimated 400 of those cases may have involved criminal wrongdoing.

Surprisingly, many homeowners who are victims of home equity fraud or foreclosure "rescue" agents do not know their homes are in peril until the sheriff nails a foreclosure notice to their doors. By that time, it is often too late to prevent expensive legal action or even loss of the homes. Notices from the recorder's office are an effective way to reach homeowners early in the process, and the cost of mailing a notice is minimal.

Recommendation: Local utilities and banks should include in their customer mailings warnings about questionable home improvement contractor

practices and equity loan abuse. County recorders should include similar notices in county property tax bills.

Including a flyer in utility and cable billings is a relatively inexpensive and thorough method of reaching almost all homeowners (and future homeowners who currently rent) in a geographic area. Homeowners also can be reached effectively by including similar notices with county property tax bills and with their bank statements.

For greatest efficiency, a master design for the flyer should be developed — possibly by the state Department of Consumer Affairs — and then localized for each county with the help of local legal aid services, law enforcement agencies, and other appropriate organizations.

Recommendation: Include basic instruction in high school curricula about home ownership, loans and managing finances.

The word that is often used to describe potential victims of home equity loan abuse is "unsophisticated." One way to increase the savvy of the next generation of homeowners is by teaching the basics about home ownership, loans, and financial management in the state's high schools.

There are programs available to students that touch on these areas — for example, the Department of Education's home economics curriculum includes a "Consumer and Family Services" cluster. However, the classes are electives and do not necessarily enter the more complex area of home ownership. The benefits of reaching the general student population with these subjects include:

Students would have more realistic expectations regarding what it takes to qualify for a loan, buy a home and maintain ownership; and

Informed students would be less likely to be targets of fraud and financial abuse in the future, and could help keep their parents and grandparents from becoming victims today.

ACCESSIBILITY TO QUALITY LOANS

Unscrupulous lenders feed on the desperation caused by the actual and perceived lack of credit offered by mainstream financial organizations in minority and low-income neighborhoods. Many of the victims who could not find financing at competitive market rates because they were considered unacceptable credit risks go to extraordinary ends to keep current on their outrageous payments made through hard money home equity lenders.

Several studies — from sources including the Federal Reserve Bank of Boston, the Medger Evers College Center for Law and Social Justice, the *Atlanta Constitution*, and others — have documented a higher rejection rate by mainstream lenders for African-Americans' mortgage applications than for those of other ethnic groups. Not surprisingly, African-Americans are the ethnic group most often targeted by unscrupulous lenders.

Here are three ways banks and savings and loan associations can reverse this trend and demonstrate a greater commitment to local communities and their citizens:

Recommendation: Banks should develop home equity loan products with sound but flexible underwriting standards and market them to low-income and minority neighborhoods.

One way to take the market away from irresponsible lenders is to make financial services and credit fully accessible in low-income and minority areas. Many financial institutions are already working to make first mortgages more available in these areas, but similar efforts are needed in the neglected home equity loan market. Banks should develop and aggressively market these loan products to these populations. Banks offering improved opportunities for competitive home equity loans in low-income and minority neighborhoods would demonstrate a commitment to the local community that would likely lead to profitable long-term customer relationships.

Recommendation: Banks should recognize their responsibility to serve minority and low-income customers, and that banks can reap benefits over the long-term.

Banking is a basic service as necessary to communities as a post office or utility. Banking drives the availability of funds for new businesses, mortgage lending and home improvement. All of these activities offer employment opportunities and a better quality of life.

Banks also must recognize that California is becoming a state with a "majority of minorities."[50] Within the next decade, minorities will constitute more than half the state's population. While some banks are doing more ethnic marketing, growing minority communities are still a largely untapped market for home equity loans from mainstream bank lenders. Banks that involve themselves in these communities now can establish customer loyalty that will lead to a larger share of the marketplace in the future.

50 Walters, Dan, *California Journal Press: Sacramento,* "New California: Facing the 21st Century," 1992, p. 12.

Recommendation: Require any chartered financial institution or its subsidiary purchasing a high-rate, high-fee loan on the secondary market to offer a competitive-rate loan to the borrower.

When a major financial institution such as a bank or savings and loan association purchases the note for a questionable or outrageously expensive loan on the secondary market, it tacitly condones abusive lending practices and perpetuates unfair treatment of consumers.

If a mainstream financial institution buys a trust deed meeting the high-rate, high-fee definition and truly believes the borrower will be able to meet the prescribed payments, there is no reason for the institution to doubt the borrower's ability to meet lower payments. Requiring "mainstream" institutions to offer lower-interest loans — at possibly slightly above market rates to allow for an increased credit risk — will limit backing for disreputable mortgage companies and brokers. This requirement would be a preemptive step that would help limit future problems and offer more options for consumers.

Recommendation: Banks should commit to serving neglected low-income areas. Furthermore, banks should aggressively recruit, train and promote loan agents of color and recruit minority representatives to their boards of directors.

Banks and other financial institutions should open and maintain branches in low-income areas. The Community Reinvestment Act places a legal responsibility on banks to serve low- and moderate-income consumers in the communities in which they are located. Unfortunately, many banks lack a significant branch presence in low-income areas, so credit and other services appear to be less available to residents. Local governments should work with banks to encourage them to open branches and serve low-income communities to benefit the community.

Financial institutions earn more credibility and acceptance, and maintain stronger bonds with the community, when they hire local residents. Local loan agents who are familiar with a neighborhood and its residents can provide additional input in loan decisions that can help provide funds to upgrade homes, improve neighborhoods and increase property values.

Conclusion

Home equity loan abuse and fraud will not go away by being ignored. Nor can the victims be blamed for falling under the spell of unscrupulous lenders any more than victims of muggings and armed robberies can be blamed for becoming targets of assaults.

In fact, home equity loan abuse and fraud often causes far deeper wounds than street crimes. Instead of a few dollars and credit cards, victims are robbed of their homes and life savings. Losing one's home can lead to a cycle of despair and homelessness for victims.

It is important to treat home equity loan abuse and fraud for what it frequently is: a crime, directed mostly against the elderly and residents of low-income neighborhoods. Perpetrators need to be held responsible and punished, just as they would be for theft or assault. Potential victims need to be taught how to protect themselves in the same way that police and community programs teach women how to protect themselves from harm. Just as street lights are erected to brighten dangerous corners, preventive measures — new laws and regulations — must be taken.

Home equity loan fraud and abuse has cost Californians tens of millions of dollars and maybe even more. Ineffective tracking methods and unreported cases make it impossible to know the true extent of the problem.

The recommendations in this report are necessary to stop an economic form of elder abuse and an assault on low-income communities. The problem must be addressed swiftly and effectively, with the same zeal that is applied to other crimes. Home equity loan abuse and fraud is an insidious crime that leaves victims feeling confused, betrayed and hopeless. Loopholes in current laws and lax enforcement make it too easy to take advantage of elderly and low-income Californians and to destroy lives.

Homeowner Checklist

HOW TO AVOID BECOMING A VICTIM

Protect your most valuable asset — your home. Carefully investigate all the possibilities before you decide to obtain a second mortgage or home equity loan. Call several savings and loan institutions, banks and mortgage lenders to obtain information about current interest rates, fees and points for second mortgages/home equity loans; reputable institutions will gladly give you this information.

Beware of entering into second mortgage/home equity loan transactions with anyone who comes to your door or which you did not initiate or solicit! Consider the following tips:

Beware of anyone who tries to convince you to take out a second mortgage/home equity loan with the following characteristics:

A contractor or broker offers the loan in connection with an unsolicited home improvement contract.

The loan is made solely on the equity value of your home, not on your ability to repay the loan. This means a "guaranteed foreclosure" because it will be impossible for you to pay the loan according to the terms of the loan agreement.

The interest rates are very high, greatly exceeding current market rates. Take care to look at the annual percentage rate of interest (APR). This is the real cost of the loan, including both the simple interest rate and certain fees, commissions, costs and expenses. Use the APR to compare loans which have different simple interest rates, points and other loan charges. The loan with the higher APR usually will cost you more over the term of the loan. You can check your local newspaper's real estate section to get an idea of prevailing market interest rates for home loans.

The loan is set up as an "interest only, non-amortizing or partially amortizing loan" with a large balloon payment that is impossible to meet. This could cause default and foreclosure. Ask if you will still owe any money at the end of the loan. In an effort to make a loan look more "affordable" some broker/lenders arrange for balloon payment loans. The payments are low for the first several years because they are applied to pay off the interest and little or none of the loan principal. After several years of low payments, you are required to pay off the loan principal in one large balloon payment. If you cannot pay the balloon payment when it comes due, the loan will go into default and you may lose your home through foreclosure.

The lender or broker requires you to pay high and non-refundable application fees.

The broker/lender engages in unfair and deceptive practices such as:

asking you to sign blank forms;
using high pressure sales tactics;
asking you to sign forms written in a language which you do not understand;
making loans regardless of the borrower's physical or mental capacity to understand the legal and financial implications of entering into the loan;
misrepresenting the nature of the document signed by the borrower (a "contract for home improvement services" is really a "deed of trust" giving the broker/lender an interest in the borrowers home should the borrower default).

Protect yourself. Never sign any documents which you don't understand or which put your home on the line without first consulting with an attorney.

Never sign blank documents or documents with any blank spaces.

Do not give in to high pressure tactics. If the salesperson or loan agent will not leave you a copy of the loan papers to read over before you sign — look for another lender.

As of this writing, the Federal Truth in Lending Act requires a lender to inform you of your right to rescind (get out of) a loan contract within three days of signing whenever your home is used as security for a home equity loan. Even if you have already signed a contract, if you act promptly to get competent advice, you may still protect yourself from an unscrupulous lender. If the lender failed to provide you with all of the required disclosures regarding the terms and cost of your loan and your rights, you may have up to three years to rescind the contract. Contact an attorney if you have any questions about whether your lender violated the law.

Beware of scams which attempt to take advantage of individuals with similar interests or affinities. Investigate offers for home equity loans with equal care and caution even if the loan agent is someone you know.

Above all, spread the word in your community about this type of fraud. The scam artists' greatest enemy is a well-informed public. Do what you can to keep scam artists out of your neighborhood.

IF YOU HAVE ALREADY BEEN VICTIMIZED

Contact an attorney immediately to find out about what rights and remedies you may have under state and federal law. You must act quickly, particularly if foreclosure is imminent. Prompt legal action can make the difference between losing and saving your home. Contact your local bar association for a referral to a qualified lawyer in your area. Try to get a lawyer as soon as possible even if you feel you cannot afford one. Losing your home will be even more expensive than paying a lawyer. Contact your local bar association and ask about seeing an attorney for a fixed or reduced fee.

Open all and any mail that may have to do with your house. Do not ignore any mail about your loan. This mail could include notices of default or foreclosure. If you don't understand what the notices mean, ask a trusted family member or friend to read and explain them to you and see an attorney immediately.

File a complaint with the appropriate regulatory and law enforcement agencies in your state. Call and write the places where you filed your complaint every month to see if they are investigating it.

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In California, the Department of Real Estate regulates the conduct of all mortgage brokers who, by law, are required to be licensed real estate agents. The Department of Corporations regulates non-institutional consumer finance lenders and mortgage bankers.