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Baby steps against mortgage defaults

By David G. Harding

A basic principle of politics holds that anyone, present company included, can point out a problem, but that solutions are somewhat scarcer. The escalating crisis in residential mortgage defaults is a classic example. We see the results, and those of us who do not profit by them are disgusted, but the details of how mortgages come into existence, are regulated and operate until paid off are compartmentalized, so it is difficult to offer more than blame. *Mea culpa*.

The limitations imposed by federal law are both counterintuitive and stringent, so we find the inability of our leaders to meet this crisis with a sweeping gesture frustrating. The forces that work to promote competition and economy in a free market are equally ineffective because information does not flow. A partial fix may lie in forcing needed information to flow as it should in a market economy, and a few suggestions may inspire others to offer refinement, correction or something altogether superior.

Distilling a hundred or so pages of federal regulations, the states cannot generally regulate the terms of residential real estate loans or the disclosures lenders must make to borrowers. Fees and charges paid by the borrower in a residential mortgage transaction must be disclosed to the buyer/owner, added into the loan amount, backed out as an increase to the note's face interest rate, and shown on a federal form as the annual percentage rate.

Mortgage brokers and their sales staffs are licensed by the state and very much subject to state regulation. They take in money from two sources. A smidgen comes from fees, listed on page 2 of the HUD-1 or RESPA Settlement form — a portion of credit report, tax service or appraisal fees, perhaps, plus what have come to be called "junk fees." Federal regulations do not require that amounts paid to brokers be stated separately from amounts paid to lenders, but they also do not prevent separation.

Back when mortgage brokering was new, a broker's fee for origination was stated as "points" and paid to the broker from the borrower's funds at closing. Points morphed into a tool used to buy down interest rates. The bulk of broker compensation is now paid by lenders, outside of closing — a portion of the present cash value of the difference between the minimum rate a lender will accept and the rate a broker can sell, called the yield-spread, with the lender's cash outlay often protected by prepayment penalty.

No reasonable person would suggest for a moment that lenders and mortgage brokers do not provide a valuable service. Can we make a phone call and start the process of getting a mortgage? Enough said. But the information a mortgage shopper would want to use for comparison is either not disclosed at all, or to the extent disclosed, sits, in bulk, in a subterranean vault in Washington, possibly down the aisle and around the corner from the Ark of the Covenant.

Real estate attorneys' fees are disclosed at the time of hire, often to the accompaniment of sustained howling. The cost of sales brokerage is disclosed before a buyer is even found. The charge for title insurance is shown with the title commitment. What is the difference between the interest rate a lender advertises and the apples-to-apples APR on the federal form? There is no way to guess until closing. How much does it cost to use a mortgage broker? Currently, this remains a mystery.

There are answers to these questions, but the answers need to be gleaned, organized and sent where they will do some good. The state could, without violating any federal regulation, distribute information on the average APR charged by each lender and the dangerous features (early rate adjustment, prepayment penalty, negative amortization, etc.) each employs. Borrowers would then have more to go on than the stripped-down, advertised rates.

Useful comparisons on the Illinois Department of Financial and Professional Regulation Web site (www.idfpr.com), monthly newspaper listings or the rankings booklet at the nearest community center, library or grocery store would open up competition. Those with the least income pay the highest rates, and it takes more a thousand dollars in annual gross income to support a one percent increase in interest on a hundred thousand dollar loan. Default is less likely where the monthly payment is lower. Informed competition might even spell the death of the all-too-common 13 percent loan.

The savings and resulting insulation from foreclosure could be even greater if we required mortgage brokers to project, at the time of application, and disclose, at closing, all compensation from all sources for originating a loan, under pain of loss of license. Compile that information from closings and distribute it along with lender information, and borrowers could see, not only the average cost of brokerage services as a percentage of amounts borrowed, but each broker's ranking as against other brokers.

Finally, there is an opportunity for relief in the mortgage after-market. Payments sometime fail to come in, an inevitable part of business. Unpaid debt eventually becomes, as a practical matter, worthless. Allow 4 percent in bad receivables in the business model, and with \$5 billion in loans outstanding, if the bad debt rate goes to 4.1 percent, \$5 million in profit vanishes. At 4.2 percent, payroll is met with borrowed money. At a sustained 4.3 percent, people wonder how a company with all that money went belly-up.

No one should have to sit on bad debt or foreclose and hold title in a slack market. The road back to liquidity is to accept the reality of nonpayment and factor out some debt, so extending the example, \$50 million in bad loans go on the block for 30 cents on the dollar, and cash flow turns from disaster to positive. When it is over, an investor, with very little invested, can leverage a small investment into foreclosure, title, and ultimately, a windfall profit.

Denying enforcement to assignees, unless a lender first offers a homeowner a window, say 90 days, to pay off at the assignment price, or treating the obligation of a residential mortgagor as equitably limited to the investment of the assignee plus after-accruing interest and charges would offer defaulting homeowners a last chance. Write-off regulations would need to change, but this may not be a hurdle. The IRS knows that homeowners earn more consistent income and pay more tax than do the dispossessed.

[David G. Harding](#) is a Chicago lawyer.

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