



## Rural Borrowers More Likely to be Penalized for Refinancing Subprime Home Loans

CRL Key Findings

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Contact: Keith Ernst at (919) 313-8500

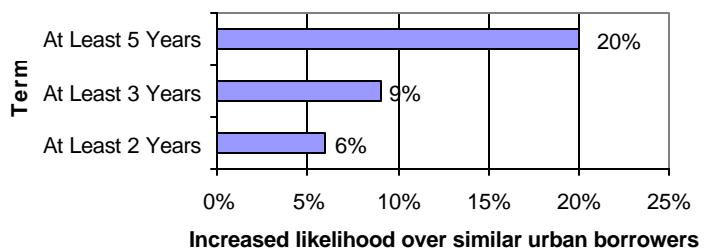
As non-traditional credit has become more widely available in the United States, policymakers and consumer advocates have observed increases in abusive lending practices in the subprime mortgage market. While much of the focus has been on metropolitan markets, predatory lending also may be a significant issue for subprime borrowers in rural areas. To test this hypothesis, the Center for Responsible Lending (CRL) investigated the use of prepayment penalties in subprime mortgage markets in different locations.<sup>1</sup>

Examining a nationwide sample of approximately two million subprime home loans, CRL researchers looked at the incidence and length of prepayment penalties in defined geographic categories. The analysis produced the following findings:

- Rural homeowners are more likely than similar urban borrowers to have subprime mortgages with prepayment penalties imposed for three years or longer.
- A majority of rural borrowers who received subprime home loans in 2002 -- nearly 63 percent -- had a prepayment penalty with a term of two years or longer.
- The disparity appears to be widening over time. In 2000, rural subprime homeowners were eight percent more likely than similar urban borrowers to receive a prepayment penalty with a term of at least five years. By 2002, the difference had climbed to 20 percent.

Given the consequences of prepayment penalties for borrowers, these findings are striking. More studies are needed to determine whether rural areas are at substantially greater risk for abusive lending, but this research clearly shows that researchers and policymakers should consider the effect of predatory lending on rural constituents as well as on borrowers in more urban areas.

Increased likelihood that rural borrowers received subprime prepayment penalties of various terms in 2002



## Background

Subprime mortgages typically are geared to borrowers with lower credit scores who might not qualify for a “prime” loan in the mainstream mortgage market. The subprime market can provide a beneficial service for those who historically have had less access to credit. On the other hand, when subprime mortgages contain predatory or abusive terms, they can cause great harm to families and communities.

### A. Prepayment Penalties

A prepayment penalty is a fee charged by a lender when a borrower pays a designated amount of mortgage debt prior to the due date. In a typical scenario, borrowers pay off the entire mortgage in order to refinance into a lower-cost loan. Prepayment penalties may harm borrowers in the subprime market in a number of ways:

1. Draining equity. Many subprime homeowners have worked hard for years to accumulate equity in their homes. A prepayment penalty, often amounting to thousands of dollars, directly drains home equity when a borrower refinances.
2. Creating a high-cost trap. Sometimes borrowers simply cannot afford the cost of the prepayment penalty. In such cases, they may be forced to keep a high-cost mortgage when they could otherwise refinance and qualify for a more affordable loan.
3. Providing an incentive for kickbacks. When brokers deliver loans at a higher interest rate than the lender requires, the lender sometimes pays the broker a kickback, known as a “yield spread premium.” Because lenders are more willing to pay yield spread premiums on loans that include prepayment penalties, the inclusion of a prepayment penalty indirectly facilitates higher interest rates for borrowers.

Prepayment penalties have become increasingly common in the subprime market in recent years, at a level far out of proportion to the prime mortgage market. While less than two percent of prime mortgages contain prepayment penalty provisions, such penalties occur in up to 80 percent of subprime mortgages. This wide disparity raises substantial questions about the extent to which consumer choice explains the prevalence of prepayment penalties in the subprime market, especially given subprime borrowers’ incentive to build a good credit history and refinance as soon as feasible.

#### Data and Methodology

Chris Richardson and John Farris, two CRL researchers, used multivariate regression models to understand how 14 variables influenced the probability of receiving a prepayment penalty and the length of the penalty.<sup>2</sup> To perform this analysis, they used a relevant subset from the Loan Performance Asset-Backed Securities database of securitized subprime loans.<sup>3</sup>

#### Database Characteristics

- Number of loans: approximately 2 million
- Origination period: 2000-02
- Refinances: 65%
- Single-family residences: 81%
- Mean loan amount: \$129,257
- Adjustable rates: 47%
- Loans with prepayment penalties: approximately 68%

#### Variables

- Geography
- Loan-level underwriting factors, e.g., loan amount, credit score, loan-to-value
- Individual loan characteristics, e.g., adjustable vs. fixed, balloon, no/reduced documentation
- Racial/ethnic concentration by zip code

## B. Characteristics of the Rural Housing Market

In general, fewer lenders operate in rural areas, resulting in less competition in rural credit markets than in urban or suburban locations. Rural areas generally have higher poverty rates, greater economic instability and less dense populations. The combined effect of these factors creates an economic environment in which borrowers have fewer choices. Consumer advocates with rural constituents have charged that predatory lenders take advantage of vulnerable rural residents, devastating families and contributing to general economic decline in more isolated communities.<sup>4</sup>

### Findings<sup>5</sup>

Controlling for a variety of factors, including creditworthiness and loan terms, the results show that two groups of borrowers are more likely to receive subprime prepayment penalties: borrowers living outside central cities and borrowers living in areas with high minority concentration.

#### Rural Borrowers

In most of the models that control for minority concentration, rural homeowners are much more likely than those in highly urban areas to have subprime mortgages with prepayment penalties.

The disparity between rural and non-rural borrowers appears to be widening over time. In 2000, rural subprime homeowners were eight percent more likely than similar urban borrowers to receive a prepayment penalty with a term of at least five years. By 2002, the difference had climbed to 20 percent.<sup>6</sup>

Table 1. Rural Borrowers' Increased Chance of Having a Prepayment Penalty (PPP)

| Length of PP Term | Increased Risk (vs. similar urban borrowers) |      |      |
|-------------------|--|------|------|
|                   | 2002   | 2001 | 2000 |
| 2+ years          | 6%   | 11%  | 6%   |
| 3+ years          | 9%   | 10%  | 3%*  |
| 5+ years          | 20%  | 6%   | 8%   |

\* Significant at a 95% confidence level. All other figures are significant at a 99% confidence level.

#### Defining Urban and Rural

Our analysis relies on the definition of metropolitan statistical areas (MSAs) published by the U.S. Office of Management and Budget. Unless otherwise noted, we define "urban borrowers" as borrowers from the central city areas of MSAs with a population of one million or more. "Rural" refers to borrowers outside any MSA.

Other findings that apply to rural borrowers with 2002 subprime loans:

- A majority—nearly 63 percent—had a prepayment penalty with a term of two years or longer.
- More than one-third (39 percent) had a prepayment penalty of three years or longer.
- After controlling for underwriting criteria and minority composition by zip code, rural borrowers had a greater likelihood of receiving a prepayment penalty. The likelihood increased with penalties that were effective longer, as shown in Table 1.

### **Borrowers in Neighborhoods with High Minority Concentration**

The probability of receiving a prepayment penalty also rises significantly when a borrower lives in a zip code area with relatively high populations of minorities. In every relevant model, minority concentration has a positive and significant correlation with prepayment penalties. However, because the loan data do not provide the race of each borrower, the study could not distinguish between neighborhood race effects and individual race effects.

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## **Conclusions and Comments**

This study provides strong evidence that rural borrowers are more likely to receive prepayment penalties of any length of time. It also finds patterns consistent with the disproportionate use of abusive five-year prepayment penalties.

For policymakers, these findings represent a disturbing indication that predatory lenders are draining hard-earned wealth from rural families. While this study does not delve into the underlying causes of a higher incidence of prepayment penalties among rural borrowers, it does suggest additional topics to explore.

First, rural populations are characterized by lower average incomes, yet homeownership is relatively high. Although most of the poorest counties in the United States are rural, non-metro residents are much more likely to be homeowners than people who live in central cities.<sup>7</sup> In essence, this situation creates a large pool of rural citizens who have home equity but very little cash, making them attractive targets for unscrupulous lenders.

Another key point is that rural residents have fewer options for prime loans. The secondary market plays a critical role in facilitating the availability of reasonably priced loans by providing a reliable source of liquidity to lenders. However, because many rural loans do not meet standard underwriting guidelines, the secondary market is less accessible in rural areas, driving up costs for rural borrowers.<sup>8</sup> Another factor is industry consolidation in recent years, which has resulted in decreasing the conventional community lenders that serve rural areas. According to a 2001 study by the National Rural Housing Coalition, less competition means that rural consumers must “accept the lenders’ requirements or go without a loan.”<sup>9</sup> Such a market environment seems to represent an ideal breeding ground for lenders who use abusive terms.

The results of this study also highlight the need to further investigate how predatory lending affects minorities in rural areas. Because this study of various racial and ethnic groups was not designed to assess the impact on individuals, we

### **About the Center for Responsible Lending**

The Center for Responsible Lending is dedicated to protecting home ownership and family wealth by working to eliminate abusive financial practices. CRL is a national nonprofit, nonpartisan research and policy organization that promotes responsible lending practices and access to fair terms of credit for low-wealth families.

For additional information, please visit our website at [www.responsiblelending.org](http://www.responsiblelending.org).

## Key Findings: Rural Borrowers More Likely to Face Prepayment Penalties

cannot draw any definite conclusions with respect to race or ethnicity. However, the findings strongly suggest a disproportionate incidence of prepayment penalty provisions among minority communities and neighborhoods. Further research should address this issue explicitly.

While more research is needed, the narrow results of this study – the high incidence of prepayment penalties in rural areas – and the negative implications for rural borrowers are clear. The use of prepayment penalties in subprime home loans is one of the most prevalent and costly predatory practices, especially penalties with longer terms. Given the economic challenges rural residents face, policymakers should consider the benefits of encouraging the retention of home equity and allowing qualified homeowners to seek more affordable loans without paying penalties.

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### Notes

<sup>1</sup> For more information on the role of prepayment penalties in predatory lending practices, see “Why Prepayment Penalties are Abusive in Subprime Home Loans,” CRL Policy Paper No. 4 by Debbie Goldstein and Stacy Strohauser Son (April 2, 2003).

<sup>2</sup> For a fuller treatment of the research, see “The Geography of Subprime Mortgage Prepayment Patterns” by John Farris and Christopher A. Richardson in the Fannie Mae Foundation’s *Housing Policy Debate*, scheduled for publication in October 2004.

<sup>3</sup> For more information on this database, see “North Carolina’s Anti-Predatory Lending Law: Doing What It’s Supposed to Do: A Reply,” Stegman, Quercia and Davis. AEI-Brookings Joint Center for Regulatory Studies, November 2003.

<sup>4</sup> See, e.g., the Housing Assistance Council’s *Rural Voices*, Spring 2002, vol. 7, no. 2 (entire issue devoted to predatory lending).

<sup>5</sup> In this discussion, we highlight findings focused on geographic location. For more information, see “The Geography of Subprime Mortgage Prepayment Patterns” cited in footnote 2.

<sup>6</sup> Prepayment penalties of five years or longer are of particular interest because they often have been cited as inflicting the greatest harm on borrowers. See, e.g., the Goldstein-Son paper cited in footnote 1.

<sup>7</sup> “Recommendations to the Millennial Housing Commission,” National Rural Housing Coalition – June 30, 2001.

<sup>8</sup> “Rural Housing Options for Optimizing the Federal Role in Rural Housing Development,” General Accounting Office, GAO/RCED-00-241, Report to the Chairman, Subcommittee on Housing and Community Opportunity, Committee on Banking and Financial Services, House of Representatives – September 2000.

<sup>9</sup> “Recommendations to the Millennial Housing Commission” National Rural Housing Coalition, June 30, 2001, page 3.