Excerpt from the Knowledge@Wharton article: "Victimizing the Borrowers: Predatory Lending's Role in the Subprime Mortgage Crisis."

To many people, loans with extraordinarily high interest rates constitute predatory lending. Critics often cite payday loans, which charge the annual equivalent of more than 100% for loans in advance of a worker's next paycheck. Loans putting borrowers at high risk of default also are often called predatory. This would include "negative amortization" mortgages that allow borrowers to make very low monthly payments, causing the outstanding balance to grow over time rather than get smaller.

But loans that are bad for some borrowers can be appropriate for others. The payday loan might be a sensible choice for a worker in a short-term cash crunch who will pay the debt off quickly and prefers a high interest rate for a short time over the paperwork and delay of a more conventional loan from a bank or credit union. The negative amortization mortgage might make sense for a knowledgeable, disciplined borrower whose income is irregular, such as someone who lives on commissions or relies on a year-end bonus for a big part of his pay.

Subprime mortgages come in various types but tend to share several features. They start with a "teaser rate" -- a low interest rate which keeps initial payments small and makes it easier for applicants to qualify. After one, two or three years, the interest rate resets to a new rate calculated by adding a "margin" of 6 or more percentage points to some established floating rate, like the yield on one-year U.S. Treasury bills. Typically, the reset involves a drastic increase in monthly payments, in some cases a near doubling. Finally, many subprime loans carry pre-payment penalties that make it prohibitively expensive for borrowers to refinance during the first two or three years.

Subprime borrowers are typically described as people with poor credit who cannot get conventional loans -- people with spotty credit histories or low incomes. But not all subprime borrowers fit the mold. Some loans -- no one knows how many -- were made to people who could have qualified for conventional mortgages but were steered to subprime products by brokers seeking the higher-than-normal commissions these loans often paid. Other borrowers with good credit might have been drawn to subprime loans' low teaser rates. Some apparently used subprime loans to buy second homes or investment properties.

Therefore, it is not clear how many subprime borrowers were truly victimized by predatory lenders and how many simply had bad luck with risky loans they took on with open eyes. After short-term interest rates rose dramatically, starting in the summer of 2004, subprime loans reset with much larger payments. Meanwhile, the housing bubble burst and home prices began to fall, making it hard for subprime borrowers to refinance to better loans or sell their properties. Foreclosures have spiked.