Maine Law Review

Volume 61
Number 1 *1/1/2009*

Article 12

October 2017

Crossing the Line: Prime, Subprime, and Predatory Lending

Nathaniel R. Hull
University of Maine School of Law

CROSSING THE LINE: PRIME, SUBPRIME, AND PREDATORY LENDING

Nathaniel R. Hull

CROSSING THE LINE: PRIME, SUBPRIME, AND PREDATORY LENDING

Nathaniel R. Hull[*]

I. INTRODUCTION

The cornerstone of the "American Dream" has long been marked by the purchase of a home.[1] Most families cannot afford to purchase a home with cash and, almost universally, need financing. Financing for a home purchase begins when a person or couple applies and is preliminarily approved for a home loan by a lender. The lender's decision to approve is based on a number of different factors that are thought to predict how likely it is for the borrower to repay the loan according to its terms. The factors used to make this prediction have undergone drastic reformulations over the past century. For instance, before the 1930s, qualifying for a home loan usually meant that the borrower had to have a fifty percent down payment; that is, a borrower needed to

---

* J.D. Candidate, 2009, University of Maine School of Law. The author thanks his wife, Reid Hayton Hull, for her patience and advice. Also, thank you to my families on both coasts for your unending support. Finally, thank you to Lauren Blake, to whom I owe a great debt for being such a wonderful editor. As always, the mistakes are mine alone. The majority of this Comment was written at the end of 2007 and my concerns about freezing Maine's credit market have subsequently become a national reality. I decided to leave the Comment as written with the understanding that our situation is far too fluid for there to ever be a "right spot" to call the work complete.

1. Homeownership has been both an individual and a governmental priority since at least the 1930s. James Surowiecki, *Home Economics*, THE NEW YORKER, Mar. 10, 2008. Arguments in favor of broad homeownership center around the "tremendous" social and economic benefits that are attendant to owing a home. *Id.* Among the social benefits are that neighborhoods are stabilized, which, in turn, makes people more willing to invest in a community. *Id.* This argument proceeds from the belief that people make a social investment in the area in which they purchase a home, and that social investment pays dividends to the surrounding community. Perhaps more important to the individual homeowner is the economic benefit of owning a home. The chief economic benefit to the individual owner is that homes, oftentimes, function as "forced-savings program that allows people to leverage their income and build wealth." *Id.* The general appreciation of a home combined with the reduction in liability through mortgage payments allows the average citizen to generate wealth on a scale not commensurate with their income. For example, "[I]f you earn [$80,000] a year, no one will lend you [$400,000] to buy stocks, but plenty of people will lend you that money to buy a house." *Id.* This ability to generate wealth far beyond your salary is the economic strength of being "leveraged" and, as the example deftly points out, most of the general population would never have the opportunity to experience the financial power of leverage but for the priority we place, as a nation, on homeownership. Of course, as the nation is experiencing now, when home prices are stagnate, or even falling, the tremendous downside of being leveraged becomes apparent–people owe more on their mortgages than their homes are worth. *Id.* As the popular oxymoron goes, when people "cannot afford to sell" their homes, it works a complete reversal upon the traditional benefits of homeownership. For example, people are now forced to stay in the communities in which they currently reside, despite failing local job markets, because they do not have the money pay off the difference between what they owe on the mortgage and the price they can fetch for their home. *Id.* This calls into question the benefit of neighborhood stability, however, as not being able to move to areas where work is more readily available works an economic disservice. *Id.* In sum, it is unlikely that homeownership will ever stop being an individual or governmental priority; however, as the recent economic slowdown has shown, there are substantial downsides associated with widespread homeownership.

have at least one-half of the purchase price of the home in savings before a bank would provide funding for the other half.[2] Additionally, before the 1930s, most home loans had a variable interest rate, and the borrower and the bank commonly renegotiated the terms of the loan each year.[3] Finally, before the 1930s, the payments the borrower made on the mortgage generally were for interest only and the principal balance due was paid down using separate "balloon" payments.[4] In response to the Great Depression, during which many families were forced into foreclosure because they could not afford the balloon payments, this practice changed.[5] The change meant that home loans were made to individuals for a fixed period of time, usually twenty years, and the principal balance was paid down slowly.[6] Additionally, the new "typical" homebuyer had a twenty percent, instead of fifty percent, down payment. However, both before and after the Great Depression, and, in fact, until recently, the home mortgage generally was approved and funded by a deposit-taking bank.[7]

The practice of banks lending to borrowers who have significant down payments, (i.e., twenty percent) and good credit histories continues today, although this "prime lending" represents a smaller and smaller portion of the total mortgage market.[8] The shrinking market share of the prime mortgage loan is a result of the advent and rapid expansion of so-called "subprime lending," beginning in the mid-1990s. Simply put, the subprime lending market is populated by borrowers who would not have qualified for conventional home loans because of their lower-than-average credit scores, low net incomes, or low savings.[9] Generally, these are borrowers who would have been rejected by traditional deposit-taking banks because the risk of lending money to these borrowers would have been deemed too great. Undeniably, access to loan funds from non-traditional sources made the dream of home ownership attainable for a much larger segment of the population.[10] Yet the subprime lending arena has also spawned several ethically questionable lending practices, often loosely grouped under the heading "predatory lending practices."[11] These practices seek to exploit borrowers

---

2. *See How We Got into the Subprime Lending Mess*, KNOWLEDGE @ WHARTON (Sept. 19, 2007), http://knowledge.wharton.upenn.edu/article.cfm?articleid=1812.

3. *Id.; see also* PAUL G. CRETEAU, MAINE REAL ESTATE LAW 235-36 (1971) ("The *term* mortgage, which was common prior to the great depression of the thirties, usually called for quarterly or semi-annual payments of interest, with the principal debt payable in a lump sum at the end of the term, which was typically three to five years.").

4. *Id.; see also* PETER M. BARNETT & JOSEPH A. MCKENZIE, ALTERNATIVE MORTGAGE INSTRUMENTS 5-1 (1984) ("A nonamortizing mortgage is one in which a loan becomes, or may become, due and payable before it is fully amortized. Nonamortizing mortgages are more commonly referred to as balloon mortgages . . . .") A "balloon payment" is the common name the large payment made under the terms of the nonamortizing, or balloon, mortgages.

5. *See How We Got into the Subprime Lending Mess*, *supra* note 2.

6. *Id.*

7. *Id.*

8. *See generally The Role of the Secondary Market in Subprime Mortgage Lending Hearing Before the Subcomm. on Financial Institutions and Consumer Credit*, 110th Cong. (2007), *available at* http://frwebgate.access.gpo.gov/cgibin/getdoc.cgi?dbname=110_house_hearings&docid=f:37206.pdf.

9. Heather M. Tashman, *The Subprime Lending Industry: An Industry in Crisis*, 124 BANKING L.J. 407, 407-08 (2007).

10. *Id.* at 407.

11. *See generally* Dulce J. Foster, *Pursuing the Predators: Regulators' Response to Mortgage Fraud*,

who, because of the risk associated with lending money to them, have far fewer options for financing. The exploitation can come in the form of onerous repayment terms and large up-front fees with little or no benefit to the borrower. A number of catch phrases have become synonymous with predatory lending including "asset-based lending,"[12] "loan-flipping" and "equity stripping,"[13] "loan-packing,"[14] "steering,"[15] and "abusive broker kickbacks."[16]

Elizabeth Renuart of the National Consumer Law Center has suggested that understanding how the predatory marketplace operates is necessary for a number of reasons.[17] First, an understanding of the market will allow researchers to narrowly tailor studies to obtain the most accurate results.[18] Second, community resources aimed at addressing the effects of predatory lending need cogent teaching and writing on the subject.[19] "Finally, the public, including legislators, judges, and the media, needs to understand the causes of this type of lending and its effects on individual homeowners and our society as a whole."[20] However, Renuart also cautioned that "proposals to regulate mortgage loan abuses and those profiting from them will not be successful unless protections are tailored to stop the harm to homeowners *without significantly affecting the flow of legitimate and fairly priced credit*."[21]

These predatory lending practices and abuses were the targets of the Maine Senate when, on June 5, 2007, by a unanimous vote of 35-0, the Senate passed a broad sweeping act aimed at curbing abusive mortgage lending practices in Maine.[22] "An Act to Protect Maine Homeowners from Predatory Lending," Legislative Document 1869, ("Original Act") was signed into law by Governor Baldacci on June 11, 2007, and

---

62 BENCH & B. MINN. 18 (2007); Marvis W. Kennedy, *Don't Let Your Client be Labeled a Predatory Lender*, 89 ILL. B.J. 595 (2001); David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985 (2006); Lynne F. Riley, *The Bankruptcy Perspective: Predatory Lending in the Home Mortgage Market*, 2007 ANN. SURV. OF BANKR. LAW PART II S 13 (2007).

12. Asset-based lending is defined as "making unaffordable loans based on the borrower's home equity without regard to the borrower's ability to repay the loan obligation." Riley, *supra* note 11, at 13.

13. Loan-flipping and equity stripping occur when a borrower is induced to repeatedly refinance a loan "even though the refinance transaction is not in the borrower's best interest." *Id.*

14. Loan-packing occurs when lenders engage in "fraud or deception to conceal the true nature of the debt obligation from a naïve borrower." *Id.*

15. Steering happens when a "borrower receives a more expensive loan than he or she could qualify for accounting for legitimate risk to the lender." CARLA DICKSTEIN ET AL., PREDATORY MORTGAGES IN MAINE: RECENT TRENDS AND THE PERSISTENCE OF ABUSIVE LENDING IN THE SUBPRIME MORTGAGE MARKET 14 (2006), *available at* http://www.responsiblelending.org/pdfs/rr009-Predatory-Lending-Maine-0206.pdf.

16. These are indirect payments that lenders give to mortgage brokers for getting borrowers to finance with particular loan products that often carry a higher interest rate than the borrower should receive based on the borrower's risk. This practice is closely tied to steering. *Id.* at 14-15.

17. Elizabeth Renuart, *An Overview of the Predatory Mortgage Lending Process*, 15 HOUSING POL'Y DEBATE 15, 467, 469 (2004).

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.* (emphasis added).

22. *See* L.D. 1869 (123rd Legis. 2007)

became effective on January 1, 2008.[23] However, on January 8, 2008, just a few days after the Original Act went into effect, the Maine Legislature passed "An Act Relating to Mortgage Lending and Credit Availability" ("Emergency Amendment"),[24] which is a lengthy amendment to the Original Act. The Emergency Amendment sprung from a fear in the legislature that some of the provisions of the Original Act may ultimately have the unintended consequence of further destabilizing the mortgage market in Maine by drying up credit.[25] The legislature further amended the Original Act by passing a second amendment ("Second Amendment") later in 2008.[26]

This Comment seeks to understand the implications of the Act and the Amendments for the credit markets in Maine. In Part II, this Comment explores the background and the boundaries of the legitimate subprime lending market—a market that remains a valuable resource for borrowers unable to qualify for traditional mortgage products—versus the predatory lending practices that rightfully are the target of state action. In Part III of this Comment, the original response of the Maine Legislature, known as "An Act to Protect Maine Homeowners," is detailed and certain key provisions are compared with the Emergency Amendment, with particular attention paid to how the anti-flipping provision will now apply in light of the Emergency Amendment. Finally, in Part IV, this Comment suggests that the Maine Legislature should (1) continue narrowing the scope of the anti-flipping provision and (2) suggest other areas of the Original Act that should be narrowed or repealed in order to prevent any additional destabilization of the credit market in Maine. This Comment concludes that the Maine Legislature, and those who supported the passage of the Original Act, have crossed the line between protecting homeowners from abusive lending practices and stepped into the area of "significantly affecting the flow of legitimate and fairly priced credit."[27]

I. THE U.S. MORTGAGE MARKET AND SUBPRIME LENDING: PROBLEMS AND PERCEPTIONS

A. What is Subprime Lending?

At the most abstract level, it generally is accepted that there is a trifurcated mortgage market in the United States: a prime market, a legitimate subprime lending

---

23. *Id.*

24. *See* 2008 Me. Legis. Serv. 6-10 (West).

25. Edward D. Murphy, *Legislators Rush to Fix Lending Law*, PORTLAND PRESS HERALD, Jan. 13, 2008, at F1. According to House Speaker Glen Cummings, the Original Act's sponsor, the Emergency Amendment was needed because of "the whole issue of access to credit and stability in the lending industry."

26. *See* Sen. Amend. A to L.D. 1869, No. S-201 (123rd Legis. 2008), which provides:

> Amend[ing] the amendment in section 35 by inserting after the first paragraph the following: That portion of the section of this Part that enacts the Maine Revised Statutes, Title 9-A, section 8-206-D, subsection 1, paragraph G does not apply to the refinancing after January 1, 2008 of a loan that did not require documentation of income or required limited documentation of income and was entered into on or before January 1, 2008.

Id.

27. Renuart, *supra* note 17, at 469.

market, and a predatory lending market.[28] Despite the trifurcated mortgage market, from a lender's perspective, all residential home mortgages roughly may be categorized as either prime or subprime; the grouping is simply a function of a lender's view of the risk involved with extending credit to the particular borrower.[29] If the borrower meets certain established criteria, she qualifies for a prime mortgage, and if she does not meet these criteria, she only qualifies for a subprime loan. From the borrower's perspective, being screened for a loan based on risk-of-default suggests that oftentimes there is a clear demarcation between those borrowers who qualify for prime, or conventional, mortgage products and those who would not obtain the financing but for the relaxed standards of the subprime lending market.[30]

The demarcation between prime and subprime loans is fairly standardized throughout the United States and is reflected in the requirements of the secondary mortgage market purchasing guidelines.[31] Under these guidelines, a borrower must meet three major criteria to be eligible for a prime (or conventional) mortgage: (1) a FICO score[32] greater than 660; (2) full documentation of income; and (3) a loan amount less than the maximum size loan that Fannie Mae[33] and Freddie Mac[34] are allowed to purchase.[35]

The prime market primarily services middle- and upper-class Americans who are accustomed to receiving competitive interest rates and "paying little in the way of fees to buy or repair their homes, purchase cars and other consumer goods, take vacations, and send their children off to college."[36] In its purest form, subprime lending exists to

---

28. *See* Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1258 (2002).

29. *See generally* DICKSTEIN ET AL., *supra* note 15.

30. Tashman, *supra* note 9, at 409.

31. DICKSTEIN ET AL., *supra* note 15, at 18.

32. *Id.* A credit score created by Fair Isaac Corporation (FICO) is used to measure consumer credit worthiness. *See generally* FICO Credit Scores http://www.myfico.com.

33. President Franklin D. Roosevelt created Fannie Mae in 1938 in response to the perceived lack of consistent supply of mortgage funds across the United States. FANNIE MAE, AN INTRODUCTION TO FANNIE MAE 3 (2008), *available at* http://www.fanniemae.com/aboutfm/index.jhtml;jsessionid=HTW04BM3 CCFTHJ2FECHSFGA?p=About+Fannie+Mae. In 1968 Fannie Mae became a privately-owned company, and in 1992 its traditional mission greatly expanded. *Id.* The current role of Fannie Mae occupies three distinct business units: first, Fannie Mae purchases mortgage loans from lenders for cash to hold in their portfolio; second, Fannie Mae issues mortgage-backed securities in exchange for pools of mortgages from lenders; third, Fannie Mae continues to support its original function of providing liquidity to the lending markets by purchasing and selling mortgage loans and mortgage-related securities. *Id.* at 6. Fannie Mae has a federal charter which mandates that it "channel its efforts into increasing the availability and affordability of homeownership for low-, moderate-, and middle-income Americans." *Id.* at 3. Fannie Mae's common stock is listed on the New York Stock Exchange and traded under the symbol "FNM." *Id.*

34. Freddie Mac, much like Fannie Mae, was created by congressional charter in 1970 with the mission to "stabilize the nation's mortgage markets and expand opportunities for homeownership and affordable rental housing." FREDDIE MAC, JUST THE FACTS: HOW WE MAKE HOME POSSIBLE 4 (2008), *available at* http://www.freddiemac.com/landing/2007/mission1.html?cmpid=bac_mission_1&attr=thenote_728x90. Freddie Mac does not make loans to homebuyers and, instead, it "buys mortgages from lenders such as commercial banks, mortgage banks, savings institutions and credit unions." *Id.* at 5. According to Freddie Mac, it helps finance one in six American homes. *Id.*

35. DICKSTEIN ET AL., *supra* note 15, at 18.

36. Renuart, *supra* note 17, at 474.

service borrowers who did not qualify for a prime mortgage because the borrower lacks one of the abovementioned criteria. Despite the fact that when evaluating a borrower's credit-risk, in certain cases, there may be little practical difference between those borrowers who qualify for a prime loan and those who only qualify, or are steered into, a subprime loan; the differences in the interest a borrower will have to pay to borrow an equivalent amount of money is significant.[37] Finally, once in the realm of the subprime market, loans are further divided according to the level of risk associated with the particular borrower and assigned a "grade" ranging from "A-" to "D," with "A-" being just shy of qualifying for a conventional loan.[38]

B. Who are the Borrowers in the Subprime Market?

Instead of a borrower simply being a greater credit risk, some disturbing trends are emerging suggesting that discrimination and steering may account for a borrower being placed into the subprime arena.[39] African Americans and Hispanics are "disproportionately represented in the subprime market, even at upper-income levels."[40] Additionally, "[l]ow- and moderate-income families, women, and older homeowners may be overrepresented in the subprime and predatory markets."[41] Although not the focus of this Comment, more attention will need to be paid to disseminating vital information to communities disproportionately impacted by discrimination and steering as these patterns continue to reveal themselves.

C. A Brief History of Subprime Lending

Simply identifying the subprime lending market as a segment of the greater mortgage market servicing borrowers "who, for a variety of reasons, have lower-than-average credit scores and would otherwise be denied credit"[42] or, more nefariously, as an area of lending overrun with discrimination, does little to explain how the subprime market developed and, more recently, how the fallout from defaults in the subprime lending market has effected such a widespread economic impact.[43]

---

37. *Id.* at 475 (noting that between January 18, 2001, and December 4, 2003, the average prime loan borrower would expect to pay between 5.97 percent and 7.02 percent interest, however, during that same time, the average subprime borrower, depending on what credit "grade" they were, could expect to pay between a low of 7.05 percent and a high of 12.41 percent interest).

38. *Id.* at 474.

39. *Id.* at 477.

40. *Id.* "Lower income blacks receive 2.4 times as many subprime loans as lower-income whites; however, upper-income blacks receive 3 times as many subprime loans as whites with comparable income." *Id.* (*citing* CALVIN BRADFORD, CENTER FOR COMMUNITY CHANGE, RISK OR RACE?: RACIAL DISPARITIES AND THE SUBPRIME REFINANCE MARKET (2002)).

41. *Id.* at 478 (noting that in 1998 "about 50 percent of the subprime refinancing market consisted of loans to low- and moderate-income borrowers, whereas this percentage . . . was just 34 percent in the prime market. Women account for 29 percent of subprime refinance mortgages, compared with 19 percent of all refinancing mortgages.").

42. Tashman, *supra* note 9, at 408.

43. *See, e.g.*, Carrick Mollenkamp & Edward Taylor, *Moving the Market: Woes Know No Border*, WALL ST. J., Nov. 29, 2007, at A1 ("Banks and investors in Germany and Norway are facing new losses from exposures to U.S. subprime mortgages, highlighting how credit problems continue to seep into places far afield for the U.S.").

Within the overarching subprime mortgage arena, one can find three distinct businesses: (1) loan origination, (2) loan sales (or securitization), and (3) loan servicing.[44] A borrower who is unable to qualify for a prime loan would approach, or be solicited by, a subprime lender for the loan origination. In the first distinct business group, a typical subprime lender originates loans via two channels: wholesale and retail.[45] The wholesale channel functions through intermediaries, with mortgage brokers originating the loans that the lender, in turn, funds.[46] This route means that the borrower is dealing with a middleman, the broker, who would handle the screening process and gather the needed documentation. When it is time to actually fund the loan, the lender would write the check, with the broker taking a commission. The retail channel, on the other hand, involves the lender providing loans through their own employees directly to the borrower.[47] Notice that the only difference is the presence of an intermediary in the wholesale channel.

Mortgage lending, if successfully done, is a cash intensive business. With each loan that is made, money moves out of the accounts of the lenders. The lenders need a method to replenish their lending capital. Since subprime lenders are not usually deposit-taking entities, the manner by which subprime lenders raise capital to fund additional loans, and the second distinct business, is by selling the loans into the secondary market through a process known as securitization.[48] It is impossible to appreciate how fallout from subprime lending has touched so many different areas of the economy[49] without at least a passing acquaintance with securitization and collateralized debt obligations ("CDOs").

Although the intricacies of the mortgage-backed security market are beyond the scope of this Comment, at its most basic level, securitization involves the packaging of mortgages into debt securities that back CDOs.[50] The debt securities, in this case mortgages, generate interest.[51] Typically, the CDO is divided into different tranches, ranging from highest to lowest, and a CDO investor can decide whether to own all or part of one or more of the tranches.[52] The "highest" tranche is the most secure because

---

44. BUS. BANKR. COMM'N, SECTION OF BUS. LAW, AM. BAR ASS'N, THE SUBPRIME LENDING INDUSTRY: A LOOK AT THE RESTRUCTURING OF MARKET IN TURMOIL (Aug. 11, 2007), *available at* www.abanet.org/buslaw/newsletter/0063/materials/pp1a.pdf.

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.*

49. *See, e.g.*, Julie Creswell & Vikas Bajaj, *Jittery Stock Market Drops as Mortgage Fallout Spreads*, N.Y. TIMES, Aug. 1, 2007, at C1; Vikas Bajaj & Peter Edmonston, *E*Trade Hit By Fallout of Subprime*, N.Y. TIMES, Nov. 13, 2007, at C1; David Prosser, *Sub-prime Mortgage Fallout Could Spell Disaster for Pending Deals*, THE INDEPENDENT, Aug. 13, 2007, at A1.

50. *Hearing on Protecting Homeowners: Hearing Before the Subcomm. on Housing and Community Opportunity and Subcomm. on Financial Institutions and Consumer Credit*, 108th Cong. (2003) (statement of Cameron L. Cowan, Partner, Orrick, Herrington, and Sutcliffe, LLP on behalf of the American Securitization Forum).

51. *See, e.g.*, United States v. Cioffi, No. 08CR00415, 2008 WL 2448463 (E.D.N.Y. June 18, 2008). Ralph Cioffi and Matthew Tannin were portfolio managers for two, now collapsed, hedge funds at Bear Stearns. *Id.* at ¶¶ 7-8. The two managers were indicted on June 18, 2008, for conspiracy to commit securities fraud and wire fraud. *See generally*, *Cioffi*, 2008 WL 2448463.

52. *Id.* at ¶ 14.

it is the last tranche to lose interest—and, in the event of collapse, return of principal —if "the underlying debtors defaulted on their mortgages."[53] As with most investment decisions, the safer the investment, the lower the rate of return, and, in the world of CDOs, the owners of the highest tranche, because it is the safest, are entitled to the smallest percentage of the interest.[54] Conversely, the lowest tranche, or the so-called "equity tranche," is the first tranche to lose both interest and principal if the underlying debtors defaulted on their mortgage, but "[a]s compensation for accepting higher risks, the owners of the equity tranche holders were entitled to the highest percentage of the interest rate payments flowing to the CDO."[55]

Investors purchase these tranches because they offer a return on investment in the form of interest payments and return of principal to the holders. As noted, the money used for payments of the principal and interest due to the holder derives from the cash flow generated by the assets comprising the security.[56] In essence, this means that in order for the owners of the different tranches to be paid the interest and principal they are due, the underlying asset, in this case the mortgages, must be generating a revenue stream. For mortgages, homeowners making their monthly mortgage payments generate this revenue stream. When one or two homeowners are unable to pay according to the terms of their mortgage and move into foreclosure, their inability to pay has virtually no effect on the payment of interest and principal to tranche owners; in "normal times," CDOs, particularly the higher tranches, look to be a safe investment. However, when the foreclosure rate exceeds normal levels, and, in the aggregate, thousands of homeowners cease to pay their mortgages in favor of foreclosure, this means that there is not enough money flowing into the CDO to pay the owners. At this point, the "safe investment" becomes an albatross around the investor's neck—and on their balance sheet.

As explained above, when the average homeowner was not defaulting on the terms of their mortgage, these CDOs seemed to be an appealing investment. For lenders, like investors, the packaging of mortgages into securities was equally appealing, as it is a powerful means to generate additional lending capacity. The power of securitization for a lender is that it allows the financial institution that would normally have to wait years to realize the full benefits of the obligations owed to it (i.e., repayment of the loans that it holds) and to immediately realize the value of the obligations through the sale of the securities into the secondary market.[57] Pulling this all together, the reason that this practice touches so many areas of the economy is because these mortgage-backed CDOs offered a higher-rate of return than many other "safe investments," so many investors, including large institutions, pension plans, and even state and municipal governments, purchased these mortgage-backed bonds.

---

53. *Id.*
54. *Id.*
55. *Id.*
56. *See generally Hearing on Protecting Homeowners: Hearing Before the Subcomm. on Housing and Community Opportunity Subcomm. on Financial Institutions and Consumer Credit*, 108th Cong. (2003) (statement of Cameron L. Cowan, Partner, Orrick, Herrington, and Sutcliffe, LLP, on behalf of the American Securitization Forum).
57. *Id.*

However, in order for the purchaser of the tranche to be secure in the fact that they are going to be repaid with interest (i.e., the basic function of an investment), the asset stream that is being used to repay the bond obligation must be secure. As noted earlier, in the case of securities comprised of mortgages, this means that if the original borrowers are defaulting on their payment obligations under the mortgage, the asset stream used to pay the interest and principal on the bond will dry up. As a testament to the power of the mortgage-backed securities market, the "value of the mortgage-backed securities (MBS) issued by the subprime market grew from $11.05 billion in 1994 to $133 billion in 2002."[58]

In addition to the dominant subprime loan securitization-market, there is also a prime mortgage-securitization market. Although not nearly as large as the subprime market, this market functions in the same manner as the subprime market except that the bonds and CDOs are both theoretically, and practically, more secure because the asset underlying the bond is a mortgage to a borrower with a higher credit score. This higher credit score means that the borrower is more likely to make timely payments according to the terms of the loan. Until very recently, the prime mortgage securitization market seemingly has been unscathed by the subprime mortgage fallout. However, with the recent, very public collapse of a large prime lender, there are signs that the subprime fallout is spreading into the prime mortgage market as well.[59]

What becomes apparent is that without reliable information detailing (1) what mortgages—prime or subprime—and (2) the particular credit-risk of the individual debtors, it is virtually impossible for investors to make informed decisions regarding which CDOs and, more specifically, which tranches of the CDO to purchase. To assist in this process, the different tranches of the CDOs generally received ratings from a credit rating agency.[60] The highest tranches of the CDO generally were rated "AAA" and, supposedly, carried an "extremely limited risk of default."[61] The lowest, or equity, tranche oftentimes was unrated.[62] However, in the wake of the subprime meltdown, serious questions need to be posed to determine the criteria the ratings agencies used to rate the different tranches of the CDOs.

---

58. Renuart, *supra* note 17, at 472.

59. *See* Alex Frangos & Lingling Wei, *REIT Lender Thornburg Sees Collateral Seized*, THE WALL ST. J., March 8, 2008, at B1. Thornburg Mortgage is a real estate investment trust ("REIT"). *Id.* REITs are real estate investment companies that pay no corporate income taxes as long as they pay ninety percent of their taxable income to investors as dividends. *Id.* Several REITs that dealt in subprime loans were among the first corporate causalities of the subprime mortgage market meltdown in 2007. *Id.* What makes the Thornburg Mortgage meltdown unnerving is that Thornburg deals in "safe" mortgages, as evidenced by their borrowers having an average credit score of 744. *Id.* According to Larry Goldstone, the chief executive of Thornburg Mortgage, Thornburg's "portfolio of mortgage backed securities has exhibited exceptional credit performance and comprises loans that are among the most solid in the industry. Quite simply, the panic that has gripped the mortgage-financing market is irrational and as no basis in investment reality." *Id.*

60. *Cioffi*, 2008 WL 2448463, at ¶ 16.

61. *Id.*

62. *Id.*

Various legal changes in the 1980s enabled subprime lending to flourish.[63] Included in these changes was elimination of the interest rate ceilings imposed by state usury laws and the development of a secondary mortgage market, which permitted loan underwriters to fund subprime mortgages through the capital markets.[64] This funding of mortgages through the capital markets is what has previously been detailed as "securitization."[65] It is staggering how rapidly the markets accepted these mortgage-backed securities. However, the rapidity becomes less surprising when one considers that this method of packaging many loans together for sale on the secondary market provided the lenders with excess capital that ordinarily would not be available to make additional loans.[66] In turn, the additional subprime loans funded by this process are then packaged together as a security and the process is repeated. As previously noted, the cash intensive nature of mortgage lending means that subprime lenders were packaging loans for sale on the secondary market at an ever-increasing rate.[67]

The fallout from the packaging of subprime loans for sale on the secondary markets has impacted the United States and world economies in ways that continue to reveal themselves daily.[68] However, looking only to the movement of loans after they have been funded and sold on the secondary market is just part of the story. As with most legislation that attempts to regulate the subprime lending industry, Maine's Act to Protect Homeowners from Predatory Lending focuses on the behavior of the people originating the subprime loans: mortgage brokers or mortgage bankers. A reason for increased focus on the behavior of the brokers and bankers at the point of origin is that most subprime loans are originated through mortgage companies that are "only weakly regulated."[69] The absence of regulation is because many mortgage companies are not deposit-taking institutions and, therefore, not subject to the additional regulatory structure imposed upon deposit-taking institutions. Thus, a familiarity with the point of origination for subprime loans is necessary when analyzing Maine's new legislation.

Companies focusing exclusively on mortgage lending for their business model are the businesses most likely to be making subprime loans.[70] As noted, many of these companies are not deposit-taking institutions and are "not subject to the safety and soundness regulations that govern federal or state banks."[71] Many of the brokers

---

63. MAJORITY STAFF OF THE JOINT ECON. COMM., 110TH CONG., REPORT AND RECOMMENDATIONS ON THE SUBPRIME LENDING CRISIS: THE ECONOMIC IMPACT ON WEALTH, PROPERTY VALUES AND TAX RETURNS, AND HOW WE GOT HERE 10 (2007).

64. *Id. See also* EDWARD M. GRAMLICH, SUBPRIME MORTGAGES: AMERICA'S LATEST BOOM OR BUST, 13-18 (2007).

65. Tashman, *supra* note 9, at 410.

66. *Id.*

67. MAJORITY STAFF OF THE JOINT ECON. COMM., *supra* note 63, at 18 (noting that the "percentage of subprime mortgage securitization . . . reached a peak value of more than 81 percent in 2005").

68. *See, e.g.*, Vikas Bajaj & Louise Story, *Mortgage Crisis Spreads Beyond Subprime Loans*, N.Y. TIMES, Feb. 12, 2008, at A1; Richard A. Oppel, Jr. & Patrick McGeehan, *Lenders Try to Fend Off Laws on Subprime Lending*, N.Y. TIMES, Apr. 4, 2001, at C1.

69. MAJORITY STAFF OF THE JOINT ECON. COMM., *supra* note 63, at 17.

70. *Id.* at 19; *see also* GRAMLICH, *supra* note 64, at 7 (concluding that "30 percent of [subprime] loans are made by subsidiaries of banks and thrifts, less [*sic*] tightly supervised than their parent company, and 50 percent are made by independent mortgage companies, state-chartered but not subject to much federal supervision at all").

71. MAJORITY STAFF OF THE JOINT ECON. COMM., *supra* note 63, at 18.

working for these mortgage companies can be fairly characterized as "salesmen,"[72] and, for reasons detailed below, there may be very little financial[73] or legal[74] incentive for these brokers to originate loans that the borrowers objectively are able to afford to repay.[75]

The lack of financial incentive to loan money only to borrowers who can afford full repayment stems from the fact that when a mortgage company packages loans to sell on the secondary market, there is little direct financial risk to the lender if a particular borrower defaults on the mortgage payments.[76] In effect, with subprime lending, there is a division between the mortgage originator and the mortgage holder.[77] A mortgage originator's name appears on the loan note, mortgage, and HUD-1 Settlement Statement.[78] However, the mortgage holder actually "owns" the mortgage.[79] In a number of traditional, bank-funded loans, there exists a unity of interest between the originator and the holder because they are the same entity, the bank, for the life of the loan. However, in the subprime market, loans are often sold, and, therefore, some other entity (the new "holder") is now financially dependant on the borrower-debtor making the payments. In most cases, the entity that purchased the mortgage and the purchaser of the mortgage-backed securities are the only ones exposed to the risk of default, leaving the point-of-origin lender without consequences for making a so-called "bad loan." Generally speaking, considering the limited exposure window because of the rapid speed at which most loans are sold into the secondary market, if the borrower defaults *after* sale of her loan into the secondary market, the point-of-origination lender will not be adversely affected at all. This means that there is little, if any, financial incentive to make only so-called "good" loans.

This lack of incentive is a drastic change from the time when a deposit-taking institutions funded loans and then held the loan for the entire repayment period. In such a situation, a borrower's default directly impacted the bottom-line financial position of the lender. Additionally, should a particular loan officer make a number of ill-advised loans, the bank itself had the capacity to simply fire her. In short, direct responsibility for the consequences of a loan default created an incentive for the traditional lenders to make loans only to individuals who could objectively afford to repay the loan. This movement away from a directly-incentivized system of loan origination has suggested to many states that increased scrutiny of the practices surrounding loan origination in the subprime mortgage market, where a traditional bank is not involved, is in order.[80]

---

72. *Id.* at 20.

73. *Id.* As will be explored in Part III of this Comment, many of the indicia of a predatory loan are methods of selling loans to customers that have less favorable terms than could be provided resulting in additional fees for the company and a larger paycheck for the broker.

74. *Id.*

75. *Id.*

76. *Id.*

77. Renuart, *supra* note 17, at 471.

78. *Id.*

79. *Id.*

80. According to the National Conference of State Legislatures, the following is a non-exhaustive list of states, including Maine, with some form of subprime or predatory lending legislation: Arkansas, ARK. CODE ANN. §§ 23-53-101 to -106 (West 2008); California, CAL. FIN. CODE §§ 4970, 4973 (West 2008);

Compounding the issues facing regulation of the subprime market is the existence of several completely legal alternative mortgage products that have become synonymous with the subprime lending market. Principally among these alternative mortgage products are hybrid adjustable rate mortgages ("ARMs").[81] Hybrid ARMs combine a fixed rate for an initial period, usually between two and five years, although sometimes as long as ten years, with an adjustable rate for the remainder of the life of the loan.[82] According to the Report and Recommendations of the Joint Economic Committee of Congress, "in the abstract, ARMs need not work to the disadvantage of borrowers."[83] However, in practice, most subprime ARMs are made to borrowers who are qualified for the loan on the basis of their ability to pay at the "low initial rate rather than the reset rate."[84] By simply qualifying borrowers for hybrid loans on the basis of the initial rate, these lenders make it more probable that a subprime borrower must "sell, refinance, or default" at the reset of the initial interest rate.[85] However, by the time this interest rate increases, the majority of the loans have already been sold into the secondary market and, as such, there is no financial incentive to not qualify borrowers on the basis of the low, introductory mortgage rate.

To appreciate how all these factors, as well as many others, have come together to fuel the explosive expansion of the subprime market one should note that, according to the Department of Housing and Urban Development, the subprime lending industry's value grew from "$150 billion in 2000 to $650 billion in 2007."[86] Additionally, this rapid growth in the subprime lending market combined and reinforced the

Colorado, COLO. REV. STAT. §§ 5-3.5-101 to -105, 38-40-105 (West 2008); Connecticut, CONN. GEN. STAT. §§ 36a-521, -746 to -746(q) (2008); Florida, FLA. STAT. §§ 494.0078-.0097 (2008); Georgia, GA. CODE ANN. §§ 7-6A-1 to -13 (West 2008); Illinois, 815 ILL. COMP. STAT. 137/1 to 137/135 (2008), 765 ILL. COMP. STAT. 77/70 (2008); Indiana, IND. CODE §§ 4-6-12-1 to -10 (2008); Kentucky, KY. REV. STAT. ANN. §§ 286.8-010 to -990, 360.100 (West 2008); Louisiana, LA. REV. STAT. ANN. §§ 6:1096(G), 9:3572.6(C) (2008); Maryland, MD. CODE ANN., COM. LAW §§ 12-127, 12-311, 12-409.1,12-1029 (West 2008); Massachusetts, MASS. GEN. LAWS ANN. ch. 183C, §§ 1-19 (West 2008); Michigan, MICH. COMP. LAWS §§ 445.1631-.1645 (2008); Minnesota, MINN. STAT. § 58.137 (2008); Missouri, MO. REV. STAT. § 375.937 (2008); Montana, MONT. CODE ANN. § 32-5-306 (2008); Nebraska, NEB. REV. STAT. §§ 45-702, -704, -705 (2008); Nevada, NEV. REV. STAT. §§ 598D.010-.150 (2008); New Jersey, §§ N.J. REV. STAT. 46:10B-22 to -35 (2008); New Mexico, N.M. STAT. ANN. §§ 58-21A-1 to -14 (West 2008); New York, N.Y. BANKING LAW § 6 (McKinney 2008); North Carolina, N.C. GEN. STAT. §§ 24-1.1E, 24-1.1F, 24-10.2, 53-243.01 to .18 (2008); Ohio, OHIO REV. CODE ANN. §§ 1322.062, 1322.07, 1322.08, §1345.01 to .44, 1349.25 to .51 (West 2008); Oklahoma, OKLA. STAT. tit. 14A, §§ 3-204, tit. 59, §§ 2081-2093 (2008); Pennsylvania, 63 PA. CONS. STAT. §§ 456.101 to 456.3101 (2008); Rhode Island, R.I. GEN. LAWS §§ 34-23-5, 34-25.2-1 to -15 (2008); South Carolina, S.C. CODE ANN. §§ 37-23-10 to -85 (2008); Tennessee, TENN. CODE ANN. §§ 45-20-101 to 111 (West 2008); Texas, TEX. FIN. CODE ANN. §§ 343.001-.206 (Vernon 2008), and TEX. GOV'T. CODE ANN. §§ 2306.001-.1076 (Vernon 2008); Utah, UTAH CODE ANN. §§ 61-2d-101 to 13 (West 2008); Virginia, VA. CODE ANN. §§ 6.1-422, 6.1-422.1 (West 2008); Washington, WASH. REV. CODE §§ 31.04 to .900 (West 2008); West Virginia, W. VA. CODE §§ 31-17-1 to -20 (2008); Wisconsin, WIS. STAT. ANN. §§ 428.202-.211 (West 2008). NATIONAL CONFERENCE OF STATE LEGISLATURES, PREDATORY MORTGAGE LENDING INTRODUCTION (2008), http://www.ncsl.org/programs/banking/predlend_intro.htm

81. MAJORITY STAFF OF THE JOINT ECON. COMM., *supra* note 63, at 2.
82. DICKSTEIN ET AL., *supra* note 15, at 10.
83. MAJORITY STAFF OF THE JOINT ECON. COMM., *supra* note 63, at 20.
84. *Id.*
85. *Id.*
86. Tashman, *supra* note 9, at 407.

quick appreciation in housing prices that culminated in the foreclosure crisis that the nation now is facing.[87]

D. "Subprime" Versus "Predatory"

The generally clear lines of separation between the prime mortgage market and the subprime mortgage market become much murkier when the divisions between the legitimate subprime and predatory subprime mortgage markets are explored.[88] Thus far, this Comment has mostly focused on the nature of the entire subprime market, without regard for the subprime/predatory division. Although it is safe to say that the predatory market "generally exists" as a subset of the subprime market,[89] there remains a definitional problem between the two markets; this haziness is compounded by the fact that the legitimate subprime lending market and the predatory lending market too often simply are grouped together in discussion—a natural byproduct of the latter being almost entirely a subset of the former.[90]

Additionally, as noted by Kathleen C. Engel and Patricia A. McCoy, dividing the legitimate subprime market from the predatory market by trying to define what a legitimate subprime mortgage loan *lacks* may have the consequence of framing the debate over predatory lending practices in terms of the "immorality" of the predatory lending practice.[91] On one side of this moral debate stands the fast-talking, morally-ambiguous mortgage broker and on the other, stands the hapless borrower. Or, depending on how one pictures the responsibility of the borrower, the borrower may be cast as someone who should have taken more time to understand the implications of the documents he was signing. In either case, if effective control of predatory lending practices is the goal of legislation, moving away from a conception of predatory lending as a moral failure, and its attendant rhetoric is vital.[92] In short, anecdotal evidence of abuses and overreaching does little to advance the goal of clearly defining and understanding predatory lending.

Although it is true that, in most cases, the predatory loan is a subset of the subprime loan, they remain, and should continue to remain, "analytically distinct."[93] The historic absence of a clear working definition of a predatory lending practice has not gone unnoticed.[94] The United States General Accounting Office established a working description of predatory lending as "an umbrella term that is generally used to describe cases in which a broker or originating lender takes unfair advantage of a

---

87. MAJORITY STAFF OF THE JOINT ECON. COMM., *supra* note 63, at 2-3.

88. *See generally* Engel & McCoy, *supra* note 28.

89. Renuart, *supra* note 17, at 476 n.18 ("Prime loans can be predatory, although the likelihood is smaller in that market.").

90. *Id.*

91. MAJORITY STAFF OF THE JOINT ECON. COMM., *supra* note 63, at 1.

92. Engel & McCoy, *supra* note 28, at 1260.

93. *Id.* at 1261.

94. Engel and McCoy note:

> In 2000, Senator Phil Gramm, then the chairman of the Senate Banking Committee, famously asserted that predatory lending could not be addressed until it could be defined. With that remark, Senator Gramm shrewdly seized on the difficulties in defining predatory lending, while stoking the flames that have surrounded any attempt at definition.

Id. at 1260-61.

borrower, often through deception, fraud, or manipulation, to make a loan that contains terms that are disadvantageous to the borrower."[95] Still others have suggested that predatory lending is a loan with onerous terms "targeted at naïve borrowers or otherwise vulnerable populations resulting in devastating loss including foreclosure, bankruptcy, and poverty."[96] This Comment respectfully suggests that these definitions may suffer from overly moralistic language.

Instead of looking at features that a legitimate subprime mortgage lacks, a better method to understand predatory lending may be to examine a loan for those characteristics that typical predatory loans share. This may serve to more accurately characterize any particular loan as predatory. From this starting point, one can move to a more abstract level and define a loan as predatory based on the actual terms of the loan instead of the means of selling the borrower on the loan or the particular characteristics of the borrower. Of course, at the base, the term "predatory lending" is broad enough to encompass abusive lending practices involving fraud, deception, and unfairness.[97] However, indicia of predatory lending are much broader and usually include one or more of the following characteristics:

- Asset Based Lending: making of unaffordable loans based on the borrower's home equity without regard to the borrowers ability to repay the obligation.[98]
- Loan Flipping and Equity Stripping by a broker: inducing a borrower to repeatedly refinance a loan, even though the refinance transaction is not in the borrower's best interest, and charging high points and fees for each refinance, thereby depleting the homeowner's equity.[99]Loan Packing: a loan broker engages in fraud or deception to conceal the true nature of the loan obligation from a naïve borrower by bundling credit insurance and other purported debt protections into loans without consumer's informed consent.[100]
- Steering: the borrower receives a more expensive loan than he or she could qualify for accounting for legitimate risk to the lender.[101]
- Abusive Broker Kickbacks: as mortgage brokers have no legal duty to find the loans that are best suited for borrowers,[102] brokers can be compensated in ways that create incentives to take advantage of borrowers.[103]
- Prepayment Penalties: rare in the conventional mortgage market but a "large majority" of subprime loans contain prepayment penalty terms.[104] However, not all prepayment terms are necessarily indicative of predatory lending and the

95. U.S. GEN. ACCOUNTING OFFICE, CONSUMER PROTECTION: FEDERAL AND STATE AGENCIES FACE CHALLENGES IN COMBATING PREDATORY LENDING 18 (2004), *available at* http://www.gao.gov/new.items/d04280.pdf.

96. Riley, *supra* note 11, at *1.

97. *Id.*

98. *Id.*

99. *Id.*

100. *Id.*

101. DICKSTEIN ET AL., *supra* note 15, at 14.

102. *Id.*; *see also* MAJORITY STAFF OF THE JOINT ECONOMIC COMM., *supra* note 63, at 20 (noting that brokers "lack strong legal incentives to act in the interest of borrowers . . . [because] [u]nder state law brokers are not fiduciaries, who must put the interest of their clients first").

103. DICKSTEIN ET AL., *supra* note 15, at 15.

104. *Id.*

> degree of severity of the penalty will dictate how abusive the actual effect of the penalty is.[105]

Despite the fact that subprime loans are distinct from predatory loans insofar as a legitimate subprime loan lacks any of the indicia of a predatory loan, "the extent to which the predatory lending has infiltrated the subprime market cannot be known precisely."[106] Although, "it is rare to find a case of predatory lending that does not involve a subprime lender, as opposed to a prime lender."[107]

The lack of a cohesive definition of what is a predatory loan reveals much about the fundamental assumptions that underscore the entire area of predatory lending and, to a certain extent, the greater subprime arena. What is clear is that there is an asymmetry of knowledge between the lenders and brokers, who have extensive knowledge about the credit market and products, on one side, and the typical predatory loan victim, who is generally "unsophisticated" about his options, on the other.[108] Generally, the impact of an asymmetry of knowledge need not be necessarily harmful. Many relationships are in fact necessitated by an asymmetry of knowledge with no detriment to either party.[109] However, in the predatory lending market, the asymmetry of knowledge has undoubtedly been exploited and may be responsible for the fact that nationally, predatory lending practices have been most heavily concentrated in low-income, minority neighborhoods.[110] This may be true because these neighborhoods have traditionally lacked access to both reliable information and conventional credit markets.

In a decidedly more measurable example of how severe the impact of this asymmetry of knowledge can be on borrowing decisions, according to a recent Freddie Mac[111] analysis, more than twenty percent of all subprime borrowers in Freddie Mac's portfolio could have received a prime mortgage.[112] This means that despite being objectively qualified for a traditional lending product with, likely, a better rate of interest, two out of every ten borrowers received a subprime mortgage product.[113] However, it is unclear from Freddie Mac's analysis whether the objectively-qualified prime borrowers given a subprime product who defaulted would have been able to make the payments under the terms of a traditional mortgage product.

---

105. *Id.*

106. David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985, 998 (2006).

107. *Id.* (Internal citations omitted).

108. Engel & McCoy, *supra* note 28, at 1281.

109. Classic examples of relationships necessitated, at least in part, by an asymmetry of knowledge include the attorney-client relationship and doctor-patient relationship.

110. *See* TASK FORCE OF THE COMBINED DEPARTMENTS OF HUD AND TREASURY, CURBING PREDATORY HOME MORTGAGE LENDING 35 (2000), *available at* http://www.hud.gov/ utilities/intercept.cfm?/library/ bookshelf12/pressrel/treasrpt.pdf.

111. *See* FREDDIE MAC, *supra* note 34.

112. DICKSTEIN ET AL., *supra* note 15, at 14; *see also* Mike Hudson & E. Scott Reckard, *More Homeowners with Good Credit getting Stuck with Higher Rate Loans*, L.A. TIMES, Oct. 24, 2005, at A1.

113. It is unclear from Freddie Mac's analysis whether the objectively-qualified prime borrowers given a subprime product who defaulted would have been able to make the payments under the terms of a traditional mortgage product.

In addition to the asymmetry of knowledge, or perhaps because of it, the origination of predatory loans has been labeled a "push" market: a homeowner is targeted by a broker who wants to sell them on a particular mortgage instead of the traditional situation of a borrowers seeking out a loan.[114] The methods of solicitation used by brokers include targeting neighborhoods with older and minority homeowners, steering borrowers into higher-rate loans, face-to-face sales by knocking on doors, and solicitations by home improvement contractors who will attempt to steer the homeowner into getting a loan for the "needed" home repair.[115] Once the originator has solicited a homeowner, a number of common practices are employed in the predatory market. One of the most common practices is to falsify the information of the borrower, particularly the borrower's income level.[116] Another method that brokers may utilize to qualify these homeowners for the loan is to "inflate the value of the home through a partnership with an unscrupulous appraiser."[117] It has even been noted that "at their worst, lenders or brokers sometimes forge the necessary signatures."[118] These examples can serve as the outliers of the "push" market behavior insofar as the brokers are *forcing* unwilling applicants into unwanted loans. However, these anecdotes about unscrupulous behavior cannot stand as proxies for the greater subprime market. If anti-predatory lending regulation is built with this type of moral definition as the foundation, the regulation will sweep far too broadly.

Finally, it must be remembered that there is a range of loan terms that can be considered perfectly acceptable (i.e., non-predatory) with the simple qualification that the borrower understands the terms and has the capacity to negotiate for them in an arm's-length manner.[119] A knowledgeable borrower may make an informed decision to "purchase points" by paying more upfront in exchange for a lower interest rate, or decide that a nontraditional mortgage product best suits her needs. Nationally, in the predatory lending market, it is the absence of "negotiation, transparency, [or] true understanding" on the part of the borrower that leads to abusive loan terms such as "high interest rate[s], high fees and closing costs, balloon payments, negative amortization, high appraisal costs, padded recording fees, back dating of documents, charges for duplicative services, mandatory credit insurance, or arbitration clauses."[120] Most of these factors, taken in isolation, or properly negotiated for, would not warrant the "predatory" label. Unfortunately, in many instances of predatory lending, many of these factors subject the borrower to financing terms that they simply cannot afford.[121]

---

114. Renuart, *supra* note 17, at 480.

115. *Id.*

116. *Id.* at 481.

117. *Id.* This practice of inflating the value of a home in order to qualify a borrower for a loan has drawn the attention of New York Attorney General Andrew M. Cuomo, who announced that he is suing one of the nation's largest real estate appraisal management companies and its parent corporation for colluding with the largest savings and loan in the country to inflate the appraisal values of homes. *See* Press Release, Andrew M. Cuomo (*NY Attorney General Sues First American and its Subsidiary for Conspiring with Washington Mutual to Inflate Real Estate Appraisals*) (Nov. 1, 2007) (*available at* http://www.oag.state.ny.us/press/2007/nov/nov1a_07.html).

118. Renuart, *supra* note 17, at 481-82.

119. *Id.* at 482.

120. *Id.*

121. *Id.* at 483.

The predatory practices do not simply stop when the borrower has signed the documents and has begun repaying the loan. Some of the common predatory practices on the back-end of the loan include:

- Failing to post monthly payments received from borrowers so that additional fees may be collected;[122]
- Using so-called "suspense accounts" to hold the loan payments which can also result in additional fees and penalties;[123]
- Delaying credits and adjustments to the homeowner's escrow account, which results in an unnecessary increase in the homeowner's monthly escrow payment;[124]
- Conducting multiple, unnecessary "drive-by" property inspections when the homeowner is not in default and then imposing a charge for each "inspection";[125] and
- Improperly calculating interest on open-ended lines of credit or variable rate loans.[126]

In short, once a borrower becomes entangled in the web of a predatory loan, she is often left with no choice other than to go into foreclosure. When, for this limited purpose, we include predatory loans in the larger category of subprime loans, it helps explain one of the reasons why "the rate at which loans go into foreclosure is significantly higher in the subprime market than the prime market."[127]

E. Maine's Subprime Market

Keeping in mind the sharp distinction between the legitimate subprime mortgage market and the predatory mortgage market, the subprime lending market in Maine has been characterized by rapid growth and has thus trended with the rest of the nation on this front.[128] Between 2000 and 2003, the gross number of Maine's mortgage loans originated by subprime lenders increased from 2,328 to 7,170, an increase of 208 percent.[129] Additionally, mortgage refinances accounted for the bulk of the increase in originations of subprime loans, "growing from 1,645 in 2000 to 5,977 in 2003, an increase of 263 percent."[130] Within the limited category of mortgage refinances, the Maine mortgage market trended higher than the national average when it came to cash-out refinances.[131] In fact, "Mainers obtain[ed] a higher percentage of their subprime loans in the form of cash-out refinances than [did] borrowers in any other state."[132] In contrast, Maine had the lowest percentage of subprime mortgage lending used for

122. *Id.* at 484.
123. *Id.*
124. *Id.*
125. *Id.*
126. *Id.* at 485.
127. *Id.* at 478.
128. DICKSTEIN ET AL., *supra* note 15, at 9.
129. *Id.*
130. *Id.*
131. *Id.* at 10.
132. *Id.*

actual home purchases.[133] Carla Dickstein, Hannah Thomas, and Uriah King noted that the disparity between subprime lending used for cash-out refinances versus lending used to purchase a home is "consistent with Maine's high home ownership rate, rising property values in many parts of the state, rising consumer debt, pockets of economic distress, and aging population."[134]

Again, Maine is within the national average, as sixty percent of Maine's subprime loans consist of alternative mortgage products.[135] As expected from the national data, the "vast majority of these alternative mortgages are hybrid adjustable rate mortgages"[136] that have already been noted to potentially work a serious hardship on borrowers when the period of fixed-rate interest ends and the borrower is faced with the necessity of selling, refinancing, or defaulting.[137] Finally, in keeping with the national trend, the "Maine subprime market is largely dominated by non-bank lenders and mortgage brokers."[138]

As disturbing as it is, as many as fifteen percent of Maine borrowers who received a subprime loan could have qualified for a prime loan.[139] Although there was no attempt to characterize the severity of the asymmetry of knowledge exploitation in Maine compared to the national market, the fact that fifteen percent of borrowers who would otherwise qualify for conventional loans ultimately received a subprime mortgage product suggests that the asymmetry of knowledge problem that characterizes subprime lending across the United States is no less prevalent in Maine. Certainly, this asymmetry of knowledge is at least partially responsible for the fact that there is a concentration of subprime lending in the more rural portions of the state.[140] When dealing with any area of a state that lacks consistent and reliable access to information, the lesson seems to be that any asymmetry of knowledge has the potential to work a greater hardship on that population. Within more urban states, poorer pockets of neighborhoods have the most subprime-steering and predatory lending. Furthermore, in a rural state such as Maine, it is the most rural areas of the state that shoulder the burden of subprime lending.

However, the fact that fifteen percent of Mainers ended up with a subprime mortgage product despite being objectively qualified for a prime mortgage is not inexplicable when the inherent asymmetry of knowledge is coupled with the fact that, in Maine, mortgage brokers, unlike loan officers in banks, do not owe the borrower any fiduciary duty. Although the Maine Supreme Judicial Court, sitting as the Law Court, has made it clear that a fiduciary relationship may exist between a bank loan officer

---

133. *Id.*
134. *Id.*
135. *Id.*
136. *Id.*
137. *See* MAJORITY STAFF OF THE JOINT ECONOMIC COMM., *supra* note 63, at 21.
138. DICKSTEIN ET AL., *supra* note 15, at 7.
139. *Id.* at 18. This percentage was generated by determining the number of borrowers who would qualify under the secondary market purchasing guidelines yet ended up with subprime loans. *Id.* The three major criteria for qualifying for a prime mortgage under these guidelines are: (1) a FICO score greater than 660; (2) full documentation of income; and (3) a loan amount less than the maximum size loan that Fannie Mae and Freddie Mac are allowed to purchase. *Id.*
140. *Id.* at 11.

and a borrower,[141] the court has stopped short of finding a similar responsibility in the relationship between a broker and a borrower. In practice, however, it is unlikely that simply finding a fiduciary relationship between a mortgage broker and a client would solve the predatory lending problem. Perhaps the easiest way to understand why finding a fiduciary relationship between a mortgage broker and a borrower would not solve the predatory lending problem is to examine, conversely, why finding a fiduciary relationship between a loan officer at a brick-and-mortar bank and a borrower has worked to protect borrowers from abusive lending practices.

In a traditional lending situation, the loan officer working at a bank stands as an agent for the bank itself. A clear principal-agent relationship has been established by virtue of the loan officer's employment. This clear agency relationship means that if the loan officer were to breach her fiduciary duty to the potential borrower, those improper actions would be imputed onto the bank itself. Because the bank as a whole would be responsible for any remedy fashioned by a court, the borrower could be made whole again in the event of a breach.[142]

We can now contrast this clear agency relationship with the relationships in the subprime arena to see why finding a fiduciary relationship would likely not have an appreciable impact on predatory lending practices in Maine. A broker serving in his traditional role is not an agent for any one particular lender: the "purest" (and largely theoretical) function of a mortgage broker is to search for the best loan terms available for the particular borrower. As the "pure" broker is not an agent for any one lender, in the event of a predatory loan, even if the borrower can articulate and prove a theory of liability, the remedies available to make the borrower whole again are extremely limited. Most likely, the broker is not going to have the resources available to satisfy any money judgment and the particular lender will be under no obligation to re-structure the onerous loan, nor make restitution for payments already made, as they may not have an agency relationship with the particular broker.

This lack of an appropriate remedy is the first problem with finding a fiduciary relationship between a broker and a borrower. However, in practice, most mortgage brokers actually work for one particular lender as opposed to "searching" for the best possible loan terms. If a plaintiff could clear the evidentiary hurdle of establishing an agency relationship between the mortgage broker and a particular lender, the plaintiff-borrower and the court will still face the difficulty of trying to fashion an appropriate remedy, as it is likely that, because of sale into the secondary market, a completely different business entity from the named defendant (i.e., the entity that originally funded the loan) would then own the loan. This creates the paradox that the entity trying to foreclose on a home because of missed payments may not be the defendant in the litigation by the same homeowner under foreclosure. These practical difficulties in fashioning effective remedies are what stand in the way of the Law Court simply finding a fiduciary relationship between the mortgage broker and the client as a solution to the predatory lending problem.

---

141. Morris v. Resolution Trust Corp., 622 A.2d 708, 712 (Me. 1993).

142. Potential remedies include re-structuring of the terms of the loan or restitution of payments already made under the onerous loan.

F. Crossing Over the Predatory Lending Line in Maine

There are several factors that are unique to Maine's population that make Maine particularly vulnerable to predatory lending tactics.[143] One factor is that Maine has the sixth highest homeownership rate in the country.[144] Additionally, "Maine is the oldest state in the country in terms of residents' median age, and is in the bottom half of states in terms of median income."[145] This means that many Mainers are "house- and land-rich, but cash poor."[146] When a declining economy particularly impacting rural communities is combined with these factors, it can "provide conditions for predatory lending practices to flourish and strip equity from borrowers and their communities."[147]

In the past, Maine has responded to the threat from predatory lending with both legal proceedings and legislative enactments. In 2003, Maine's Attorney General, along with the Attorneys General from forty-seven other states, brought a predatory lending lawsuit against two subprime lenders, Beneficial Finance Corporation and Household Finance Corporation.[148] The settlement resolving the suit resulted in a $484 million repayment, with Maine borrowers qualifying for $1.6 million in payouts for loans made between January 1999 and September 2002.[149] Also in 2003, the Maine Legislature passed Public Law 49, "An Act To Enhance Consumer Protections in Relation to Certain Mortgages," with the purpose of curbing predatory lending.[150] The law essentially codified the federal Home Ownership and Protection Act of 1994 into the Maine Consumer Credit Code with a few additional protections for "high-cost" loans.[151] However, there were clear indications that predatory lending practices were continuing in Maine despite the introduction Public Law 49.[152] A 2005 review of the mortgage foreclosure records at the Cumberland and Lincoln County Registries of Deeds indicated multiple refinances within a short period of time with no reduction in the interest rate; this being classic evidence of loan flipping.[153]

---

143. DICKSTEIN ET AL., *supra* note 15, at 5.
144. *Id.* at 6.
145. *Id.*
146. *Id.*
147. *Id.* at 5.
148. *Id.* at 6.
149. *Id.*
150. *See* L.D. 494 (121st Legis. 2003).
151. DICKSTEIN ET AL., *supra* note 15, at 6. "High-cost" loans were defined by the Public Law 49 as those

> with interest rates in excess of eight percent over U.S. Treasury Security Yields for fixed-rate closed-end loans . . . and in excess of ten percent above U.S. Treasury Yields . . . for open-ended loans, and/or fees over eight percent of the total loan amount for either closed- or open-ended loans.

Id.
152. *Id.*
153. *Id.* at 19. There is a limitation on how probative this evidence is of "loan flipping" and a true assessment would require a review of every borrower's loan documentation and loan history. *Id.* at 19 n.29.

III. MAINE'S 2007 ANTI-PREDATORY LENDING LEGISLATION AND THE EMERGENCY AMENDMENT

A. The 2007 Act to Protect Maine's Homeowners from Predatory Lending

Although the titled purpose of this legislation is to "protect Maine's homeowners from predatory lending," the legislation goes well beyond simply attacking the indicia of predatory lending and, instead, makes significant changes to the Maine Consumer Credit Code—Truth-in-Lending Act.[154] After passage of the Original Act, the bill's primary sponsor, Senator Glenn Cummings, stated that the measure "will make Maine a national leader in the fight to protect homeowners and stop predatory lending practices that have led to climbing home foreclosures in Maine and across the country."[155] Senator Cummings, further said:

> The subprime lending crisis has revealed a large crack in the foundation of our communities. Too many Maine homeowners have found themselves at risk of predatory lenders who have turned the American dream into a nightmare. Too many families have lost their homes, their roots in the community, and their life's savings—all with nothing more than the stroke of a pen. With the signing of this new law we are putting Maine consumers and businesses on a more equal playing field.[156]

Proponents of the new legislation claimed widespread support, noting that, in addition to garnering unanimous support in both the Maine's House and Senate, Maine's new anti-predatory lending act was supported by more than thirty different groups.[157] It seems plausible that the broad-based support that the Original Act received was, at least in part, a reaction to the larger subprime meltdown in the national market. In short, popular sentiment seemed to be that *something* needed to be done. It is likely that the primary supporters of the Original Act viewed the greater subprime mortgage meltdown as a blessing when it came to ushering the Original Act through the Maine Legislature. The national subprime mortgage meltdown likely made it

---

154. *Compare* title 9-A of the Maine Revised Statutes Annotated as of January 1, 2007 *with* title 9-A of the Maine Revised Statutes Annotated as of January 1, 2008.

155. Press Release, Glenn Cummings, Maine Speaker of the House, Homeowner Protection Act Makes Maine a Leader in the Fight to Stop Predatory Lending (June 11, 2007) (*available at* http://speaker.maine.gov/HOPA/index.html).

156. *Id.*

157. Press Release, Coastal Enterprises, Inc., Maine Legislature Passes Model Anti-Predatory Lending Bill (June 11, 2007) (*available at* http://www.ceimaine.org/images/stories/pdf/predsigningpr6-07.pdf). The listed supporters of the Maine Homeowner Protection Act are: AARP Maine; Coastal Enterprises, Inc.; Common Cause/Maine; Disability Rights Center; Elder Law Section, Maine State Bar Association; Four Directors Development Corporation, Orono; Independence Living Group, Veazie; Interfaith Maine; Legal Services for the Elderly; League of Young Voters/Maine; MaineStream Finance, Bangor; Maine Association of Agencies on Aging; Maine Association of Community Action Programs; Maine Association of Community Banks; Maine Association of Interdependent Neighborhoods; Maine Association of Realtors; Maine Bankers Association; Maine Credit Union League; Maine Center for Economic Policy; Maine Christian Policy Institute; Maine Council of Churches; Maine Council of Senior Citizens; Maine Developmental Disabilities Council; Maine Equal Justice Partners; Maine Islands Coalition; Modular Home Builders Association; Maine People's Alliance; Maine Personal Assistance Services Association, Norway; Maine Rural Partners; Maine State Employees Association/SEIU Local 1989; Maine State Housing Authority; Maine Woman's Lobby; McLaughlin Financial Group, Yarmouth; National Lawyers Guild, Maine Chapter; NAACP/Portland Branch; NAACP/Bangor Branch; Roman Catholic Diocese of Portland.

easier to "sell" the Original Act. As such, it can be reasonably posited that, but for the larger subprime mortgage crisis controlling the headlines of most newspapers for the past two years, it is unlikely that the Original Act, in its engrossed form, would have garnered the unanimous support that it did. Although, through the Emergency Act, the Maine Legislature quickly amended the most obvious problems with the Original Act,[158] it is likely that a more robust debate, free from the ancillary concerns of the national subprime meltdown, would have produced a more narrowly-tailored piece of legislation in the first place.

Instead of a robust initial debate capable of producing a more tightly drafted piece of legislation, this Comment is left asking the Maine Legislature to further narrow the scope of the Original Act to mitigate any additional damage, by enacting a number of additional amendments. However, for the moment, this Comment simply will explore the scope of the Original Act and the subsequently enacted Emergency Amendment and its second amendment, and, only after, suggest ways that the Original Act should be further amended.

B. The Original Act and the Emergency Amendment

The Maine Legislature structured the Original Act to impose differing standards on lenders depending on whether they were making a "residential mortgage loan" or a "high-rate, high-fee mortgage" loan. Conceptually, the "high-rate, high-fee" mortgage is merely a subset in the broader category of residential mortgages, however, in practice, the high-rate, high-fee mortgage shares many of the indicia of a subprime, or even predatory loan, detailed earlier in this Comment. Under the Original Act, the broad category of a "residential mortgage loan," which was not defined in title 9-A of the Maine Statutes prior to the passage of the Original Act, means an extension of credit, including an open-end credit plan, in which:

> (1) The loan does not exceed the maximum original principal obligation set forth in and from time to time adjusted according to the provisions of 12 United States Code, Section 1454(a)(2);
> (2) The loan is considered a federally related mortgage loan as set forth in 24 Code of Federal Regulations, Section 3500.2;
> (3) The loan is not a reverse mortgage transaction or a loan made primarily for business, agricultural or commercial purposes; and
> (4) The loan is not a construction loan.[159]

It is significant that, under the Original Act, none of the new regulation surrounding residential mortgage lending was dependant upon there *actually being* high fees, high rates, high interest or the presence of other indicia of predatory lending. In effect, under the Original Act, the new regulations apply in blanket fashion to lending in all three areas (i.e., prime, legitimate subprime, and predatory) of the residential mortgage lending market. Although there may be *additional* regulations placed on the high-rate, high-fee loans, these blanket regulations literally rewrote the

---

158. *See infra* Part III.B.
159. ME. REV. STAT. ANN. tit. 9-A, § 8-103 (West 2008).

lending laws of Maine, despite purportedly setting out to address the predatory lending problem in Maine.

As the Original Act can be accurately seen to address many of the traditional indicia of predatory lending under the blanket regulations applicable to the making of any and all residential mortgage loans, regardless of whether the loan independently qualifies as a high-rate, high-fee loan, the Act cuts a broader swath than needed. For example, without regard to the actual terms of the loan, the Original Act prohibits a number of different acts and procedures including:

> A. A creditor may not recommend or encourage default on an existing loan . . . prior to and in connection with the closing or planned closing of a residential mortgage loan that refinances all or any portion of the existing loan or debt;[160]
>
> B. A creditor may not knowingly or intentionally engage in the act or practice of flipping a residential mortgage loan.[161] The administrator shall adopt rules defining with reasonable specificity the requirements for compliance with this paragraph. Rules adopted pursuant to this paragraph are routine technical rules pursuant to Title 5, chapter 375, subchapter 2-A;[162]
>
> C. A borrower may not be charged for a late payment unless the loan documents specifically authorize the charge, the charge is not imposed unless the payment is past due for 10 days or more and the charge does not exceed 5% of the amount of the late payment. A late payment charge may not be imposed more than once with respect to a particular late payment. If a late payment charge is deducted from a payment made on the residential mortgage loan and that deduction results in a subsequent default on a subsequent payment, a late payment charge may not be imposed for that default. A creditor or servicer may apply any payment made in the order of maturity to a prior period's payment due even if the result is late payment charges accruing on subsequent payments due;[163]
>
> D. A residential mortgage loan may not contain a provision that permits the creditor, in its sole discretion, to accelerate the indebtedness. This paragraph does not prohibit the acceleration of the loan in good faith due to the borrower's failure to abide by the material terms of the loan;[164]
>
> E. A creditor making a residential mortgage loan may not finance directly or indirectly any credit life, credit disability, credit unemployment or credit property insurance or any other life or health insurance or any payments directly or indirectly for any debt cancellation or suspension agreement or contract, except that insurance premiums or debt cancellation or suspension fees calculated and paid on a monthly basis or through regularly scheduled periodic payments may not be considered financed by the creditor;[165]

---

160. *See id.* § 8-206-D(1)(A).

161. The Maine Legislature defined "[f]lipping a residential mortgage loan" as

> the making of a residential mortgage loan to a borrower that refinances an existing residential mortgage loan when the new loan does not have reasonable, tangible net benefit to the borrower considering all of the circumstances, including, but not limited to, the terms of both the new and refinanced loans, the cost of the new loan and the borrower's circumstances.

See id. § 8-103(1-A)-(P).

162. *See id.* § 8-206-D(1)(B).

163. *See id.* § 8-206-D(1)(C).

164. *See id.* § 8-206-D(1)(D).

165. *See id.* § 8-206-D(1)(E).

> F. A borrower may not be charged a fee in addition to the actual public discharge fee to provide a release upon prepayment. Payoff balances must be provided in accordance with section 9-305-B.[166]

It is precisely the broad-based application of these additional regulations to *all types* of residential lending in Maine that is most concerning. If the Maine Legislature wanted a complete overhaul of Maine's lending laws, the case should have been made for a rewrite at the onset instead of casting the issue in terms of regulating predatory lending only to produce a piece of legislation that literally rewrote the entire book.

Thankfully, the legislature realized the most obvious of their mistakes and rushed to enact an Emergency Amendment in a belated attempt to narrow the scope of the legislation.[167] Of particular concern to the Maine Legislature when enacting the Emergency Amendment was the broad application of the above-quoted anti-flipping provision.[168] Under the Maine rules pursuant to the Original Act, this provision would have required the so-called "tangible net benefit" paperwork to be included in the loan packages of even the safest (i.e., prime) loans.[169] The problem created by requiring the tangible net benefit paperwork for a prime loan is that failure to do this paperwork has dramatic legal implications.

In effect, the tangible net benefit paperwork is an "analysis of the transaction—comparing the new and old loans' monthly payments, interest rates and other factors—to determine that the borrower will get some financial benefit from the loan" that the lender will review with the borrower prior to making the loan.[170] From a stance that purely seeks to protect borrowers, this type of requirement may make some sense and, at the very least, it would force borrowers and lenders to engage in a frank discussion over the impact of the loan on the borrowers.

Unfortunately, in practice, the legal impact of this requirement is far too broad as a failure to prepare or review the tangible net benefit paperwork with the borrower can lead to both primary liability for the original lender and secondary liability for any

---

166. *See id.* § 8-206-D(1)(F).

167. *See* L.D. 2125 (123rd Legis. 2008), which provided

> Whereas some of the provisions of Public Law 2007, chapter 273, which enacted restrictions on predatory lending practices took effect on January 1, 2008; . . . [and] there are a number of questions regarding the intent of that Act that need to be clarified as quickly as possible to avoid future problems in lending practices; . . . in the judgment of the Legislature, these facts create an emergency within the meaning of the Constitution of Maine and require the following legislation as immediately necessary for the preservation of the public peace, health and safety.

Id.

168. P.L. 2007, ch. 471, § 11 (effective Jan. 1, 2008).

169. *See* Me. Dep't. of Prof. and Fin. Reg., 02-029 CMR 144-1, which provides

A creditor may not knowingly or intentionally make a residential mortgage loan to a borrower who refinances an existing residential mortgage loan when the new residential mortgage loan does not have reasonable, tangible net benefit to the borrower, considering all of the circumstances, including, but not limited to, the terms of both the new and refinanced loans, the cost of the new loan and the borrower's circumstances.

Id.

170. Edward D. Murphy, *Legislators rush to fix lending law*, PORTLAND PRESS HERALD, Jan. 13, 2008, at F1.

entity that may purchase that loan on the secondary market.[171] This means that if a broker in Maine fails to prepare or review the tangible net benefit paperwork with a prime borrower, and then that loan is sold into the secondary markets, any entity that purchases the loan to package into a security will be exposed to liability should the original borrower sue. The secondary market for home loans (i.e., the market dealing in securitization) is understandably hesitant to accept any additional risk in an already tumultuous market. Because of this risk aversion, the mortgages from Maine requiring the tangible net benefit paperwork would likely have been shunned by investors. This is especially so in the prime mortgage securitization market because it exposed buyers to legal liability for purchasing even the safest of mortgages.[172] This aversion to purchasing "tangible net benefit" loans on the secondary market could in turn mean that Maine lenders would have a hard time generating additional funds to make new loans. This aversion could have dried up the Maine mortgage market entirely. However, even the less dramatic scenario of this requirement—drying up funding for prime mortgages alone—should signal to the reader that the legislature drastically overstepped its stated goal of curbing predatory lending when it enacted the Original Act: prime mortgage lending stands, by definition, in direct opposition to predatory lending. Where predatory lending is marked by onerous loan terms and overreaching, prime lending is marked by fair credit terms and arms-length negotiation. Where predatory lending is marked by foreclosures, prime lending is marked by timely payments. As such, warning bells about the scope of a piece of legislation meant to curb predatory lending should sound when that same piece of legislation could have a dramatic impact on prime lending. In fact, this Comment suggests that alarm bells should sound when legislation has the potential to impact prime lending in Maine *at all* and not simply when people start speaking in terms of a drastic impact.

It was with these concerns in mind that the Maine Legislature enacted the Emergency Amendment in an attempt to exempt prime mortgages from the ambit of the tangible net benefit paperwork requirement. The Emergency Act amended section 8-106-D, subsection 1, paragraph B, such that it now reads:

> A creditor may not knowingly or intentionally engage in the act or practice of flipping a residential mortgage loan *when making a subprime mortgage loan*. The administration shall adopt rules defining with reasonable specificity the requirements for compliance with this paragraph. Rules adopted pursuant to this paragraph are routine technical rules pursuant to Title 5, chapter 375, subchapter 2-A.[173]

Through the Emergency Amendment, the Maine Legislature excluded the requirement of a tangible net benefit from prime mortgage arena by narrowing the application to instances of "making a subprime loan." "Subprime mortgage loan" is separately defined by the Original Act, as amended by the Emergency Amendment, to include "a residential mortgage loan that is either a nontraditional mortgage as defined by paragraph T or a rate spread home loan as defined in paragraph V."[174]

---

171. *Id.* ("The so-called 'tangible net benefit' paperwork could transfer some legal liability to the buyers on the secondary market, said Chris Pinkham, who heads the Community Bankers Association.").

172. Under the terms of the Original Act, this paperwork would have been required even for prime loans.

173. *See* P.L. 2007, ch. 471, § 11 (effective Jan. 1, 2008) (emphasis added).

174. *See* ME. REV. STAT. ANN. tit. 9-A, § 8-103(1-A) (West 2008). Paragraph T provides:

By exempting prime loans from the tangible net benefit paperwork requirement, the Maine Legislature displayed a refreshing willingness to re-examine past assumptions in an effort to craft a better piece of legislation. As noted earlier, even though the size of the securitization market of prime loans is dwarfed by the size of the securitization market for subprime loans, the prime securitization market still serves an important function in the greater economy. If the prime mortgage lenders in Maine were to lose access to the prime mortgage funding advantages that prime-mortgage securitization provides because the national markets were too risk-adverse to accept prime mortgages from Maine, it would work a genuine hardship on the borrowers considered the most credit-worthy.

Moreover, there existed no discernable reason why the Maine Legislature should have injected this additional risk into the prime mortgage arena. This fact alone adds more weight to the suggestion that, but for the national subprime mortgage crisis making headlines, it is unlikely that the Maine Legislature would have enacted such a drastic overhaul. Thankfully, the legislature reacted quickly enough that, in all likelihood, there will not be any appreciable economic fallout from this overstep.

However, even as amended, the "tangible net benefit" still casts a wide net over many types of loans, some of which are surely members of the legitimate subprime market. While the legislature should be commended for exempting prime loans, they should be prodded to be faithful to their original goal of curbing predatory lending. As explored earlier in this Comment, there is a real difference between the legitimate subprime market and the predatory market, and this difference should be respected by the legislature.

Notably, the State of Maine Office of Consumer Credit Regulation (the Office) was skeptical about this drastic reformulation of lending laws in Maine before the passage of the Original Act. The Office specifically raised concerns about the value of including a "net tangible benefit" provision into the 2007 Original Act.[175] This skepticism was not based solely on the wide net that the anti-flipping provision cast, but also to the practical difficulties associated with applying the test. According to the Office, "[I]n the abstract a net tangible benefit test seems simple to determine and easily enforced. . . . However, this type of test would add a level of subjectivity to the lending process, and both lenders and loan brokers are united in strong opposition to

---

> "Nontraditional mortgage" has the same meaning as those mortgages described in the "Interagency Guidance on Nontraditional Mortgage Product Risks" issued September 29, 2006 and published in 71 Federal Register, 58609 on October 4, 2006 and as updated from time to time except that "nontraditional mortgage" does not include a mortgage that does not allow a borrower to defer repayment of principal or interest.

ME. REV. STAT. ANN. tit. 9-A, § 8-103(1-A)(T) (West 2008).

Paragraph V states:

> "Rate spread home loan" means any loan for which the rate spread must be reported under the Home Mortgage Disclosure Act of 1975, Regulation C, 12 Code of Federal Regulations, Section 203.4(a)(12); and any loan *that meets the criteria of a high-rate, high-fee mortgage*.

ME. REV. STAT. ANN. tit. 9-A, § 8-103(1-A)(V) (West 2008) (emphasis added).

175. STATE OF MAINE OFFICE OF CONSUMER CREDIT REGULATION, LEGISLATIVE PROPOSALS TO ADDRESS PREDATORY LENDING PRACTICES IN MAINE 13 (Dec. 8, 2006), *available at* http://www.maine.gov/tools/whatsnew/attach.php?id=26818&an=1.

the measure."[176] It seems clear that the Office believed a more effective way to approach the predatory lending problem in Maine was to design a piece of legislation narrowly tailored to the predatory loan problem. By crafting rules that could be applied objectively, the legislature could have attacked the predatory lending problem—the stated objective of the legislation—while minimizing the disruption to the larger lending market. Instead, the legislature saw fit to craft subjective standards, such as the tangible net benefit paperwork, that, in fact, increase the likelihood of disruption.

Finally, the Office also noted that "it is important to remember that tools already exist [prior to passage of the Original Act] to address the patterns of unconscionable lending behavior" because the Maine statutes allow for investigation into any lenders making "unfair," "deceptive" or "abusive" loans.[177]

In conclusion, the Maine Legislature was on notice that using the tools in place prior to the adoption of the Original Act "tailored to the specific instances or trends discovered in this State, may prove both more flexible and more effective than statutory changes . . . ."[178] It is hoped that the legislature will now heed the warning and scale back the impact of the Original Act.

IV. SUGGESTIONS FOR THE FURTHER NARROWING THE SCOPE OF THE ORIGINAL ACT

A. Apply the Tangible Net Benefit Provision Exclusively to High-Rate, High-Fee Loans

As noted, the Maine Legislature may be commended for narrowing the application of the tangible net benefit paperwork to exclude prime loans from its reach. However, the legislation, even after the amendment, still applies the requirement of a tangible net benefit to both the legitimate subprime and illegitimate predatory markets. The problem associated with drying up the credit markets in Maine previously discussed in reference to the prime lending market applies with equal force to the legitimate subprime lending market. As such, the same logic dictates removing *legitimate* subprime loans from the tangible net benefit requirements. Foremost among these concerns is that, at least arguably, the subprime secondary market cannot absorb an increased level of risk. The same secondary market liability that was shunned in the prime arena will likely also be shunned in the subprime secondary market.

It is possible to accept the premise that, the Maine Legislature should remove *legitimate* subprime loans from the tangible net benefit requirement, yet be left with the question of how to separate the legitimate subprime market from the illegitimate

---

176. *Id.*

177. *Id.* at 14. Lenders and brokers may retain their licenses only so long as they operate their businesses "fairly." *See* ME. REV. STAT. ANN. tit. 9-A, §§ 2-302(2), 10-201 (West 2008). Furthermore, the administrator,

> by regulation or order, shall prohibit acts or practices in connection with: A. Mortgage loans that the administrator finds unfair [or] deceptive . . . ; and B. Refinancing of mortgage loans that the administrator finds are associated with abusive lending practices or that are otherwise not in the interest of the borrowing public.

ME. REV. STAT. ANN. tit. 9-A, § 8-206-A(16) West (2008).

178. STATE OF MAINE OFFICE OF CONSUMER CREDIT REGULATION, *supra* note 175, at 14.

predatory market. In essence the question becomes: "How can we, in a principled manner, ferret out predatory loans and subject them to restrictions without simply casting a net over the entire subprime arena?" Fortunately, the Maine Legislature has already begun the process by legislating thresholds that, when exceeded, turn a common residential loan into a "high-rate, high-fee mortgage."[179] Under the Original Act, a high-rate, high-fee mortgage exceeds the following points and fees threshold:

> (2) The total points and fees threshold, which is:
>
> (a) For loans in which the total loan amount is $40,000 or more, the point at which the total points and fees payable in connection with the residential mortgage loan less any excluded points and fees exceed 5% of the total loan amount; and
>
> (b) For loans in which the total loan amount is less than $40,000, the point at which the total points and fees payable in connection with the residential mortgage loan less any excluded points and fees exceed 6% of the total loan amount.[180]

In effect, by legislating these thresholds, the Maine Legislature has already made a policy decision that loans exceeding the above-quoted limits should be subject to additional scrutiny.[181] This Comment suggests that the reason that the Legislature saw

---

179. *See* ME. REV. STAT. ANN. tit. 9-A, § 8-103(1-A)(FF) (West 2008).

180. *Id.*

181. There are a range of additional requirements placed on lenders making high-rate, high-fee mortgages. ME. REV. STAT. ANN. tit. 9-A, § 8-206-C West (2008). The following is a non-exhaustive list of some of the additional requirements, above and beyond the generally applicable requirements now in effect under the Original Act, that apply when making a high-rate, high-fee loan:

> 1. The making of a high-rate, high-fee mortgage is subject to the following prohibitions . . .
>
> A. In connection with a high-rate, high-fee mortgage, a creditor may not directly or indirectly finance any points or fees.
>
> B. A prepayment fee or penalty may not be included in the loan documents or charged under the terms of a high-rate, high-fee mortgage.
>
> C. A high-rate, high-fee mortgage may not contain a scheduled payment that is more than twice as large as the average of earlier scheduled payments. . . .
>
> E. A high-rate, high-fee mortgage may not contain a provision that increases the interest rate after default. . . .
>
> G. A creditor may not make a high-rate, high-fee mortgage without first receiving certification from a counselor with a 3rd-party, nonprofit organization approved by the United States Department of Housing and Urban Development, a housing financing agency of this State or the Bureau of Consumer Credit Protection that the borrower has received counseling on the advisability of the loan transaction. . . .
>
> I. All high-rate, high-fee mortgage documents that create a debt or pledge property as collateral must contain the following notice on the first page in a conspicuous manner: "Notice: This is a high-rate, high-fee mortgage subject to special rules under state law. Purchasers or assignees of this high-rate, high-fee mortgage may be liable for all claims and defenses by the borrower with respect to the high-rate, high-fee mortgage."

Id. The litany of additional requirements includes a notice provision (I), a creditor counseling provision (G), a restriction on pre-payment fees (B), and a ban on the lender financing any of the points or fees (A). *Id.* Taken as a whole, these additional requirements make it unattractive for lenders to write high-rate, high-fee mortgages as well as serving to educate any potential borrower about the dangers of these types of loans.

fit to impose additional requirements (i.e., the notice provision, the creditor counseling provision, a restriction on pre-payment fees, and a ban on the lender financing any of the points or fees) is because it is when entering the realm of high-rate, high-fee mortgages that the dangers of predatory lending become evident. By identifying a class of loan terms with the potential to be so onerous to the borrower that the lender and borrower must take additional steps to close the loan, the Legislature has, in effect, identified a principled means to separate predatory loans from legitimate subprime loans.

When taken as a whole, the additional restrictions placed on a high-rate, high-fee loan serve to force the type of dialogue between a lender and a borrower (that we would hope is happening even without the legislation) while also independently ensuring that the borrower is provided access to reliable information about the loan by requiring that they take a credit education class. This education for the borrower may serve to reduce some of the asymmetry of knowledge that has formed the basis for some of the abuses in the predatory lending arena.

The Maine Legislature should engage in a more focused debate on objective means to identify loans with terms so burdensome that they should be subject to additional requirements. Perhaps the current thresholds strike the appropriate balance and no adjustment is needed. However, the next step is to further amend the Original Act to have the "tangible net benefit" apply *only* to those loans that exceed the high-rate, high-fee threshold and then engage in a debate to set those thresholds.

There are at least three advantages to amending the Original Act in this fashion. First, and by far the most important, is that amending the Original Act to have the tangible net benefit only apply to high-rate, high-fee loans would actually be focused on accomplishing the stated goal of the Original Act—protecting homeowners from predatory lending—without impacting either prime or legitimate subprime lending. This is of paramount importance because, as noted, if the legislature feels that a complete overhaul of mortgage lending in Maine is needed, it should allow the debate to be broad enough to touch on all the issues before passing the measure. By framing the debate in terms of predatory lending, the legislature silenced legitimate concerns that would have been raised had it been clear that such a radical overhaul of the entire lending industry in Maine was impending.

Quite simply, no one supports predatory lending; unanimous support in opposition to predatory lending is unremarkable. However, the Original Act went much further than simply trying to attack predatory lending and the Legislature should correct this overstep.

The second and third advantages in narrowing the Original Act involve the prevention the secondary mortgage market shunning Maine-based legitimate subprime mortgages. This one principle has two equally important, but conceptually distinct, advantages: (1) having Maine mortgages accepted into the secondary market prevents Maine credit markets from drying-up, which allows lenders to make additional legitimate subprime loans to deserving borrowers; and (2) by identifying those loans that are truly risky (those loans carrying the notice provision required for a high-rate, high-fee mortgage), the Maine Legislature will allow the secondary markets to filter out those loans from any securitization portfolio. The better able the secondary market is to filter out the truly risky loans, the more confidence investors will have returning to buying mortgage-backed securities, which in turn will allow for more lending. The information relied upon by rating agencies needs to be more reliable in order to have consumers return to the CDO market.

B. The Second Amendment: Correcting an Unfairness in the Burden of Refinancing a Stated-Income Loan

The stated-income loan allows for potential homeowners who had difficulty producing documentation supporting their income to simply "state" what they made each year for the purpose of obtaining a home loan. Although these stated-income loans are oftentimes referred to as "liar's loans" or "ninja loans" (no income, no job, and [no] assets), there are a number of reasons why an individual may have a difficult time providing full documentation of income. Those in the service industry who rely on tips for a large portion of their take-home income are classic examples. Of course, stated-income loans are considered riskier than loans in which the borrowers can produce full documentation in support of their income, so these loans carry a higher interest rate. Under the Original Act, it is virtually impossible to write or receive a stated-income loan because of the depth of the statutorily-imposed factors that must be considered made before making a subprime loan.

As written, in addition to the "tangible net benefit" requirement, a subprime mortgage loan may not be extended to a borrower unless a reasonable creditor would believe at the time the loan is closed that the borrower will be able to make the scheduled payments associated with the loan. According to the Original Act,

> (1) The determination of a borrower's reasonable ability to repay a subprime mortgage loan *must include*, but may not be limited to, consideration of the borrower's income, including statements submitted by or on behalf of the borrower in the loan application, except that a creditor may not disregard facts and circumstances that indicate that the income statements submitted by or on behalf of the borrower are inaccurate or incomplete, credit history, current obligations and employment status; the debt-to-income ratio of the borrower's monthly gross income, including the costs of property taxes and insurance; and other available financial resources other than the borrower's equity in the principal dwelling that secures or would secure the subprime mortgage loan.[182]

This "checklist" seems to still allow room for a stated-income loan, although, it is unclear under what factual scenario the lender could satisfy the inquiry without full documentation of income. Importantly, these requirements apply to both the legitimate subprime and illegitimate predatory lending market with equal vigor. Hence, this analysis must be preformed without independent consideration as to whether the terms of the loan are high-rate, high-fee.

The State of Nevada recently enacted a similar provision regarding stated-income loans.[183] The new legislation, which places a burden on the lender to investigate a borrower's income and ability to repay, garnered more media attention in Nevada than the similar provision in Maine. This is unsurprising when one considers that many more people in Nevada are dependent on tips for a large portion of their income due

---

182. ME. REV. STAT. ANN. tit. 9-A, § 8-206-D(1) (West 2008) (emphasis added).

183. *See* Assemb. 440, 74th Gen. Assemb., Reg. Sess. (Nev. 2007) amending NEV. REV. STAT. Ann. § 598D.100 (West 2008).

to Nevada's robust gaming entertainment industry. However, it is no defense of the Maine legislation to say that it impacts a smaller portion of the community; the fairness of the legislation should be evaluated independently of the size of the impact.

The concerns voiced about the Nevada legislation are similar to those voiced throughout this Comment. After passage of the legislation in Nevada, several large banks stated that they will no longer purchase stated-income loans from Nevada.[184] Additionally, under Maine's Original Act, there was no provision allowing borrowers who received a stated-income loan prior to the passage of the Original Act with no paperwork burden to refinance into a mortgage that offers a better rate unless, somehow, they could produce documentation of income. This is indicative of the absence of debate before passing this legislation. It apparently did not occur to the legislature that a borrower faced with this situation would not be able to meet the new documentation requirements and the legislature would have, in effect, locked a borrower into a loan that could not be refinanced. Thankfully, the legislature has subsequently exempted the paperwork burden from borrowers who received a stated-income loan prior to passage of the Original Act.[185]

V. CONCLUSION

The Maine Legislature undertook an ambitious plan to rewrite the lending laws in Maine. Unfortunately, the legislature should have focused on the narrower problem of stopping predatory lending instead of drafting an overhaul of the state's lending laws. This Comment suggests that the legislature has already provided a disciplined and orderly process to refocus the Original Act to solve the problem of predatory lending while working within its current draft.

By focusing more closely on those loans with the most onerous terms, the most potential for abuse, and the highest-risk of default (i.e., the so-called "high-rate, high-fee loans"), the legislature could offer Maine homeowners the protection they deserve without running the risk of drying up the credit markets in Maine. Although, this Comment does not deny that the Original Act may accomplish its stated goal of alleviating some of the problems with predatory lending in Maine, the Original Act goes far beyond simply attacking predatory lending. This overreaching by the legislature has too great a price to justify the successes in the battle against predatory lending. If the legislature wants to overhaul the lending laws of Maine, there should be an open debate touching on all types of lending: prime, subprime, and predatory. However, until the legislature is prepared to engage in that debate, they should continue to amend the Original Act to narrow its application solely to high-rate, high-fee loans.

---

184. In the aftermath of the passage of the Nevada legislation on stated-income loans, "Wells Fargo & Co. and M&T Bank, a $57 billion-asset bank in western New York State, said that they will stop buying stated-income loans from Nevada. The sources also indicated Credit Suisse has stopped buying any home mortgage loans from Nevada." John G. Edwards, *Mortgage Meltdown: New Law Tightens Lending*, LAS VEGAS REV.-J., Sept. 29, 2007, at A1. Brock Davis, president of the Southern Nevada Chapter of the Mortgage Bankers Association, notes that the virtual ban on stated-income lending in Nevada "could make it even more difficult for many [homeowners who have adjustable rate mortgages] to refinance their mortgages because they won't be able to offer proof of income." *Id.*

185. *See supra* note 26.