

Predatory Mortgages in Maine

Recent Trends and
the Persistence of
Abusive Lending in
the Subprime
Mortgage Market



A joint report issued by Coastal Enterprises, Inc. and the Center for Responsible Lending, 2006



Authors
For CEI: Carla Dickstein & Hannah Thomas
For CRL: Uriah King



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CEI is one of the nation's leading community development finance institutions (CDFI) and community development corporations (CDC) primarily serving Maine. Our mission is *to help create economically and environmentally healthy communities in which all people, especially those with low incomes, can reach their full potential*. Since our founding in 1977 we have worked to provide financing and technical assistance to Maine small businesses, develop affordable housing, and provide job opportunities for low-income individuals in firms that we finance. CEI currently has \$247 million in assets under management, 85 staff, and a 15-member board. CEI is becoming a regional financial intermediary with certain finance programs covering rural New England and upstate New York, and over time we expect our other community development programs and policy work will contribute to our work in other states.

Center for Responsible Lending

The Center for Responsible Lending is a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, one of the nation's largest community development financial institutions. Self-Help has provided \$3.9 billion in financing to help nearly 45,000 low-wealth borrowers buy homes, build businesses and strengthen community resources. A major part of Self-Help is a credit union, which maintains deposit accounts for individuals, non-profit and religious organizations, and foundations. Self-Help was instrumental in helping to pass North Carolina's comprehensive state statute against predatory mortgage lending, the country's first. Subsequently, Self-Help and CRL have been leaders in legislative and regulatory efforts to address predatory lending issues nationally. More information is available on these websites:

www.responsiblelending.org

www.self-help.org

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SUMMARY

In recent years, a number of states, including Maine, have taken legislative action to protect their citizens from abusive practices in the subprime mortgage market. Even so, Maine's law provides fewer protections from predatory lending for fewer borrowers than do laws in many other states. This report arises from concerns that Maine citizens are not receiving the same protections against predatory lending practices that are available in other states such as Massachusetts, New Mexico and North Carolina.

This report is the first systematic investigation of the nature and extent of predatory lending in Maine. Based on research conducted during July and August 2005, we examine Maine's subprime mortgage market and determine the extent and impact of predatory lending in the state between 2000 and 2005. In this research we draw on a number of sources, including available empirical data on the subprime market, publicly available foreclosure records and lien histories, and interviews with various stakeholders and borrowers. In addition, we review the relevant laws and regulations in Maine's Consumer Credit Code asking the basic question: Do current laws in Maine provide an appropriate framework to regulate subprime mortgage lending given the practices we have seen in the research?

In answering this question, this paper highlights four major findings:

- **Maine is vulnerable to abusive lending practices.** Maine's high homeownership rate and aging population, combined with declining economies and escalating housing prices in many parts of the state, provide conditions for predatory lending practices to flourish and strip equity from borrowers and their communities. Furthermore, key trends in the Maine subprime market suggest vulnerability to abuse, including the high proportion of subprime cash-out refinances (typically where most abuses are seen in the market) and a large proportion of hybrid adjustable rate mortgages.
- **Maine is experiencing significant levels of predatory mortgage lending.** This research documents evidence of the following predatory mortgage lending practices in Maine: equity stripping practices, such as excessive points and fees, yield spread premiums and abusive prepayment penalties; overcharging many subprime borrowers; and mandatory arbitration.
- **The consequences of predatory lending include foreclosure and equity stripping.** Maine already has a high subprime foreclosure rate due to certain economic and demographic conditions. Predatory lending is likely exacerbating the foreclosure rate. Estimates suggest that equity losses from predatory lending in Maine exceeded \$23 million in 2000.
- **Maine's current legal framework lags behind other states and is inadequate to protect Mainers.** States such as Massachusetts, New Mexico and North Carolina demonstrate effective legislation that could protect Mainers from the practices documented in the research. As such Maine citizens could benefit substantially through legislative action to prevent predatory mortgage lending.

I. INTRODUCTION

Impetus for this Study

In 2003, 47 state Attorneys General (including Maine's) brought a predatory lending suit against two subprime mortgage lenders - Beneficial Finance Corporation and Household Finance Corporation, both subsidiaries of Household International Corporation. Under the \$484 million national settlement, 2,150 Maine borrowers qualified for a total \$1.6 million payout for loans made between January 1999 and September 2002.¹ To provide some context, this is the equivalent of almost one-third of Maine's 2003 subprime mortgage originations (6,735),² indicating that predatory lending was widespread in Maine.

In the same year, the Maine legislature passed PL49, industry-sponsored legislation ostensibly to curb predatory lending practices involving "high-cost" mortgage loans. This law essentially codified the federal Home Ownership and Protection Act (HOEPA) of 1994 into the Maine Consumer Credit Code with a few additional protections for "high-cost" loans. "High-cost" loans in Maine represent a very small segment of the subprime mortgage market. "High-cost" loans are defined as those with interest rates in excess of eight percent over U.S. Treasury Securities Yields for fixed-rate closed-end loans (in November 2005, this represents an interest rate of approximately 12.72 percent), and in excess of 10 percent above U.S. Treasury Yields (approximately 14.72 percent) for open-ended loans, and/or fees over eight percent of the total loan amount for either closed- or open-ended loans. Housing counselors, bankruptcy trustees, and legal advocates nevertheless indicated during 2004 that predatory lending practices were continuing. Further, Maine's Attorney General and Attorneys General from over 30 other states are cooperating in a joint-investigation of the largest subprime mortgage lender in the country, Ameriquest, which is accused of predatory lending practices.

Predatory lending could have a serious impact on the Maine population. Maine has the sixth highest homeownership rate (72.9 percent) in the country.³ Many Maine citizens have built considerable equity in their homes over several generations. At the same time, Maine is the oldest state in the country in terms of residents' median age⁴ and in the bottom half in terms of median income. Many Mainers are house- and land-rich, but cash poor. These facts, combined with declining economies - particularly in rural regions - and escalating housing prices in many parts of the state, provide conditions for predatory lending practices to flourish and strip equity from borrowers and their communities.

In October 2004, Coastal Enterprises, Inc. (CEI) brought together a group of stakeholders to discuss trends in the subprime mortgage market. The discussion revealed a need to better understand the subprime market and whether predatory lending practices were still occurring in Maine after the passage of new legislation in 2003. Subsequently, CEI raised funding and in-kind support from the Annie E. Casey Foundation, the Maine Attorney General, the Center

¹ See State of Maine Superior Court Civil Action Docket No. CV02-255.

² 2005 *Mortgage Market Statistical Annual. Volume 1: The Primary Market*. Inside Mortgage Finance Publications.

³ U.S. Census Bureau, 2004 American Community Survey.

⁴ Ibid.

for Responsible Lending (CRL) and AARP to study Maine's subprime mortgage market and assess whether current Maine laws provide an appropriate framework to regulate this relatively new segment of the mortgage industry.⁵

Background on the Subprime Market and Predatory Lending

During the past decade the subprime mortgage market grew at a rapid rate across the nation, expanding from \$96 billion in 1996 to \$530 billion last year, an increase of 450 percent.⁶

Subprime loans are more expensive than prime loans, ostensibly to compensate lenders for the added risks imposed by borrowers who are less likely to repay their loans. The Maine subprime mortgage market is largely dominated by non-bank lenders and mortgage brokers, many of whom lend responsibly. This market has expanded access to credit to consumers who might not qualify for prime mortgages, but it has also spawned a wide array of abusive lending or predatory practices that occur mostly among refinanced mortgages.

Predatory lending includes unfair loan terms or credit practices that harm the borrower and help create a credit system that promotes inequality by steering borrowers to unnecessarily more expensive credit. Several general practices are widely accepted as predatory, such as excessive points and fees, abusive broker kickbacks (yield spread premiums), excessive prepayment penalties (charging a large amount or lasting for a long period), mandatory arbitration clauses, and refinancing loans without a net tangible benefit to borrowers, known as "loan flipping." (See Section III below for a more detailed description of these and other terms.) It is important to recognize that not all subprime loans are predatory. However, predatory loans are concentrated in the subprime market.

Overview of Report

The report is structured as follows:

Section II presents information on the subprime mortgage market in Maine.

Section III outlines loan terms and lending practices that are characteristic of predatory mortgage lending.

Section IV examines the extent of abusive lending practices in Maine, focusing particularly on practices that have been banned in other states.

⁵ The last publicly available study of Maine's mortgage market was conducted in 1989 by the Maine State Housing Authority in response to a legislative request for information about residential mortgages and delinquencies. At the time of the study, the subprime mortgage market was not a significant lending sector in Maine. See Maine State Housing Authority. *Residential Mortgage Delinquencies and Foreclosures in Maine*. Augusta: MSHA, 1989.

⁶ 2005 *Mortgage Market Statistical Annual, Volume I: The Primary Market*. Inside Mortgage Finance Publications.

Section V reviews the impact of predatory mortgage lending. It briefly notes the need to protect homeowners by establishing assignee liability – i.e., ensuring that victims of predatory lending retain legal remedies when their loan is sold by the original lenders.

Section VI reviews Maine law as compared to states that have enacted stronger laws against predatory mortgage lending (“best practice states”).

Section VII examines the impact of laws in “best practice states,” using North Carolina as a case study. It asks, “Do stronger laws actually prevent the abuses they were intended to prevent?” and “Have state laws had unintended consequences that harm consumers?”

Section VIII offers recommendations based on our investigation and analysis. These recommendations include calls for changes to the regulatory environment and more effective laws governing the subprime mortgage market

Finally the report concludes with a series of appendices offering detailed information on the data and methods used in the report, the results of a detailed data analysis for Maine, interviews with stakeholders in connection with this study, and a letter to consumers regarding the study.

II. MAINE'S SUBPRIME MORTGAGE MARKET

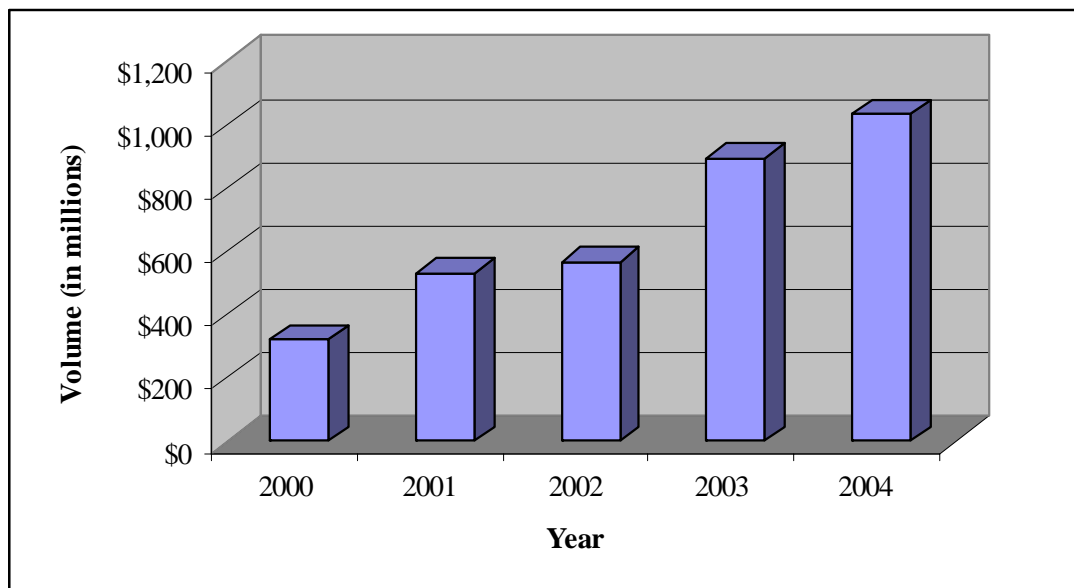
Examining a variety of data sources enabled us to identify several key characteristics of Maine's subprime mortgage market. For a fuller discussion of these data sources, see Appendix 1.

Rapid Growth

Two different sets of data indicate that Maine's subprime mortgage market is growing rapidly. First we examined federal Home Mortgage Disclosure Act (HMDA) data for 2000 and 2003, which makes use of annual lists of subprime lenders that the U.S. Department of Housing and Urban Development (HUD) prepares.⁷ The gross number of mortgage loans by subprime lenders increased from 2,328 in 2000 (9.3 percent of all mortgages in Maine that year) to 7,170 in 2003 (9.6 percent of all mortgages), an increase of 208 percent. Refinances accounted for the bulk of the increase in originations, showing growth of 263 percent from 1,645 in 2000 to 5,977 in 2003. In contrast, home purchase lending increased only 75 percent in the same period, rising from 683 to 1,193.

We then obtained subprime lender dollar origination data from the mortgage industry publication *Inside B&C Lending*, and found that the dollar volume of lending in Maine by subprime lenders grew from \$193 million in 2000 to \$1.036 billion in 2004, a dollar increase of 436 percent.

Chart 1: Maine Subprime Mortgage Growth (2000 – 2004)



Source: Inside Mortgage Finance, *2005 Mortgage Market Statistical Annual*

⁷ For more information on these data sources, please see: <http://www.ffiec.gov/hmda> ; <http://www.huduser.org/datasets/manu.html>

Predominantly Cash-Out Refinance Loans

Mainers obtain a higher percentage of their subprime loans in the form of cash-out refinances than do borrowers in any other state. Between January 2004 and May 2005, 65 percent of the state's subprime mortgage market represented cash-out refinances.⁸ During the same period, only 28 percent of subprime mortgage loans in Maine were used for home purchases, the lowest percentage in the nation. This 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.

In many cases, "cash-out" refinances reduce consumer wealth by drawing on home equity. While cash-out transactions can be helpful to borrowers under some circumstances, they frequently deplete the borrower's only significant source of savings and make it harder to attain long-term economic security.

Predominantly Alternative Mortgages⁹

Sixty percent of subprime mortgages in Maine today are alternative mortgage products, a pattern seen at the national level. The vast majority of these alternative mortgages are hybrid adjustable rate mortgages (ARMs), accounting for 56 percent of all subprime mortgages in the state. Forty percent of all subprime mortgages in Maine during the January 2004 – May 2005 period were traditional fixed-rate mortgages.

Hybrid ARMs combine a fixed rate for an initial period (usually between two and five years) with an adjustable rate for the remainder of the life of the loan. After the initial period, the rate adjusts upwards or downwards every six or twelve months in response to changes in the current level of interest rates as measured by a specified index. Such loans can offer initial monthly payments that are lower than those required on comparable fixed-rate loans, thus sometimes making it easier for borrowers to qualify for the loans. However, such alternative mortgages pose the risk of "payment shock" for borrowers since monthly payments can rise sharply when the initial period ends, especially if the lender attracted borrowers by offering an artificially low "teaser" rate for the initial period. Traditional ARMs, which make up only 0.01 percent of the Maine subprime market, differ from hybrid mortgages in that the initial period is for only six months or one year and the initial period does not exceed the subsequent reset period.

The remaining three percent of Maine's subprime mortgages were interest-only loans – that is, mortgages that are structured so that borrowers pay only interest for the first five years. Most of the interest-only loans in Maine had adjustable rather than fixed interest rates. Although interest-only loans represent a relatively small percentage of Maine's subprime

⁸ From Loan Performance database analysis. See Appendix 2.

⁹ Alternative mortgage products include ARMs, balloons, negative amortization, hybrid adjustable rate mortgages, and interest only mortgages. While these products are appropriate in some situations for some borrowers, there is concern among lenders, regulators and consumer advocates when these mortgages are made inappropriately.

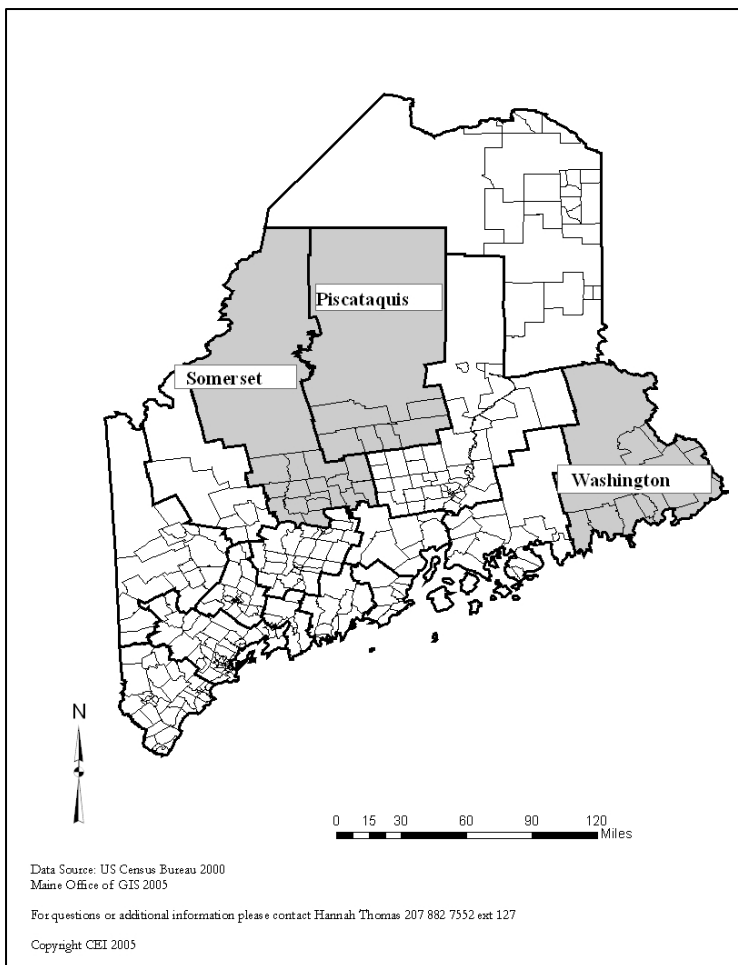
market, it is a high-growth segment that is now five times greater than it was during the 1995-2003 period.

Rural Concentration

The majority of Maine subprime mortgage originations are in rural areas. Between January 2004 and May 2005, 52 percent of Maine's subprime originations were in rural parts of the state while only 42 percent of Maine's population is rural.¹⁰ In fact, Maine ranked fourth in the nation for the percentage of subprime loan originations in rural areas.¹¹

Nearly 10 percent of all loans originated in 2003 in Maine were subprime. In contrast, there were particular concentrations of subprime loans in Maine's rural "rim" counties, as illustrated in Map 1. In Somerset and Washington counties, over 20 percent of all loans in 2003 were subprime, and in Piscataquis County 15 percent were subprime. Washington County had both the highest subprime refinance rate at 21 percent and the highest subprime home purchase rate at 17 percent.¹²

Among the state's Metropolitan Statistical Areas (MSAs) in 2003, Lewiston Auburn had the highest percentage of subprime loans at 10.9 percent.



Map 1: Location of Somerset, Piscataquis and Washington Counties

Minorities Disproportionately Represented

Although American Indians, African Americans and Latinos receive only a small percentage of subprime loans in Maine due to their small population in the state, an analysis of HMDA

¹⁰ USDA 2004 from <http://www.ers.usda.gov/statefacts/ME.htm>

¹¹ From Loan Performance database analysis. See Appendix 2. The methodology of our rural definition is described in detail in Farris, J, and Richardson, C. 2004. "The Geography of Subprime Mortgage Prepayment Penalty Patterns." *Housing Policy Debate* 15 (3) Fannie Mae Foundation 695-696. We condensed their subcategories into three overarching categories of city, non-central city and rural zip codes.

¹² HMDA data analysis 2003.

data for 2003 shows that borrowers from these minority groups disproportionately got their mortgage loans from subprime lenders.

African-Americans got 31.3 percent of their home purchase loans from subprime lenders, compared to just 6.9 percent for whites, for a disparity ratio of 4.5 (31.3/6.9). In other words, African-Americans were 4.5 times more likely to receive a home purchase loan from subprime lenders than white borrowers. Also of concern, the disparity ratio for Maine Native-Americans was 2.8. The disparity ratio for Latinos was lower, but still notable at 1.8. For refinance loans, the disparity ratios were similar, though not as marked. In 2003, both African Americans and American Indians were 2.7 times more likely to receive a subprime refinance loan than a white borrower. Many other national and local studies have also found that minority borrowers receive disproportionately large shares of their mortgage loans from subprime lenders.¹³

Elderly Disproportionately Represented

Nationally, borrowers 65 and older have five times greater odds of receiving a subprime loan than borrowers younger than 35.¹⁴ While we do not have data that identify Maine subprime borrowers by age, we expect that the national figures would apply to Maine as well.

Out-of-State, Non-Bank Lenders Dominate Market

The extent to which out-of-state lenders dominate Maine's subprime market is revealed in an analysis of HMDA data for 2003 and 2004. In 2003, over 30 percent of all subprime loans made in Maine by lenders on HUD's subprime lender list were from two lenders, Option One Mortgage Corporation and Ameriquest Mortgage Company, both out-of-state, non-bank lenders.¹⁵ Over 80 percent of their loans were for refinance mortgages.¹⁶ Twenty-one of the top 25 and 89 percent of known subprime lenders in Maine are fully subject to Maine law.¹⁷ The remaining subprime lenders are largely exempt from state law as a result of rulings by two of the federal bank regulators: the Office of the Comptroller of the Currency and the Office of Thrift Supervision.

¹³ For an excellent national study, see: Calvin Bradford, *Risk or Race? Racial Disparities and the Subprime Refinance Market*, Center for Community Change, May 2002.

[www.communitychange.org/shared/publications/downloads/Risk_or_Race_5-02.pdf]. For a study of the Greater Boston area, see: Jim Campen, *Borrowing Trouble? V: Subprime Mortgage Lending in Greater Boston, 2000-2003*, Massachusetts Community and Banking Council, 2005
www.masscommunityandbanking.org/PDFs/BorrowingTrouble5.pdf

¹⁴ Lax, H., Manti, M., Roca, P. and Zorn, P. 2004. *Subprime Lending: An Investigation of Economic Efficiency*. Housing Policy Debate 15(3) p. 564. "Subprime Mortgage Lending and Older Borrowers," citing "Subprime Lending: An Investigation of Economic Efficiency," AARP – Feb. 2000.

¹⁵ 2003 HMDA data and 2003 HUD Subprime and Manufactured Home Lender List.

¹⁶ Ibid.

¹⁷ Ibid; Internal CRL analysis based upon current federal pre-emption law, and status of lender type per the Federal Financial Institutions Examination Council at <http://www.ffiec.gov/>

Table 1: Top Ten Maine Subprime Mortgage Lenders in 2004¹⁸

Lender Name	Fully Subject to State Law	Number of Originations	Total Loaned Amount
Option One Mortgage Corporation.	Yes	2,243	\$277,998,000
Ameriquest Mortgage Company	Yes	1,672	\$232,567,000
New Century Mortgage Corporation	Yes	993	\$141,750,000
Aegis Lending Corporation	Yes	598	\$66,415,000
Mortgage Lenders Network USA	Yes	590	\$93,119,000
Argent Mortgage Company	Yes	511	\$74,118,000
Beneficial	Yes	486	\$49,588,000
Citifinancial, Inc.	Yes	430	\$28,553,000
AIG FSB	No	410	\$59,104,000
Accredited Home Lenders, Inc.	Yes	308	\$36,890,000

Source: Inside B&C Lending

¹⁸ Note that the total market size of the top ten lenders exceeds that of the estimated 2004 market size. According to researchers at Inside Mortgage Finance this is due to recent changes in HMDA data and changes in how Inside Mortgage Finance aggregates total market data in light of the HMDA changes.

III. KEY CHARACTERISTICS OF PREDATORY LENDING

Both the National Community Reinvestment Coalition¹⁹ and the Center for Responsible Lending²⁰ recognize several features of subprime loan terms and lending practices as characteristic of predatory mortgage lending. The following section reviews these core loan terms and lending practices, which informed our research as we looked for indications of predatory mortgage lending in Maine. These characteristics include the following:

Excessive Points and Fees

Points and fees are costs to borrowers that aren't directly reflected in interest rates. Excessive points and fees are frequently the hallmark of predatory loans, and can disguise the real cost of credit when they are financed rather than paid outright at a loan closing. Excessive fees strip equity from the borrower's home. Such fees are frequently financed into the loan amount and repaid from the homeowners' equity, so the borrower does not even realize they have been paid until it is too late. Furthermore, in the subprime market fees are not advertised in a consistent way, and homeowners may not learn the total fees they're being charged on a loan until the day of closing, if at all. Thus, even for the sophisticated borrower, comparing both lenders' fees and rates is more difficult than simply comparing interest rates.

Steering

Steering is a lending practice that may take a number of different forms, but the end result is the same: a borrower receives a more expensive loan than he or she could qualify for accounting for legitimate risk to the lender. For example, many prime borrowers end up in the more expensive subprime market. Whether lenders are intentionally making subprime loans when a borrower qualifies for a prime loan, or the borrower is only seeking loans from subprime lenders without comparison shopping, borrowers are not getting the best loan they can qualify for. The lender, by participating in the loan, has actively or passively "steered them" to a higher cost loan. In other instances, borrowers may be "upsold," receiving a loan with a higher interest rate or more fees than required in order for them to qualify for a loan. Indeed Freddie Mac, the government-sponsored mortgage finance entity, estimates that more than 20 percent of people who get subprime loans could have qualified for more conventional prime loans.²¹

Abusive Broker Kickbacks

In general, mortgage brokers have no legal duty to find the loans that are best suited for borrowers, and brokers are compensated in ways that create incentives to take advantage of borrowers. In addition to receiving direct fees for their services at settlement, brokers frequently receive indirect payments from the lender/investor through a "yield spread premium" based on the profit or "yield" of the mortgage. This premium reflects a cash bonus that a broker receives from a lender for placing borrowers in a loan with a higher

¹⁹ National Community Reinvestment Coalition. 2001. *Anti-predatory lending* Toolkit.

²⁰ <http://www.responsiblelending.org/abuses/abusive.cfm>

²¹ Hudson, M. and Reckard E.S., "More Homeowners with Good Credit getting Stuck with Higher Rate Loans." *Los Angeles Times*. October 24, 2005.

interest rate than the borrower might normally accept.²² Because borrowers are typically unaware of the best available interest rate for which they qualify, yield spread premiums function as kickbacks that encourage mortgage brokers to steer consumers into more costly loans.

Prepayment Penalties

Prepayment penalties are penalty fees imposed on borrowers who repay all or the majority of a loan before a set time period. While prepayment penalties are rare in the conventional market, a large majority of subprime loans contain these terms. Prepayment penalties on subprime loans can trap borrowers in high-rate loans, often leading to foreclosure and bankruptcy. Even in less severe cases, penalties may prevent borrowers from using the subprime market as a bridge to conventional financing as their credit improves.

Prepayment penalties may vary with respect to their size (usually calculated in terms of a number of months' interest or a percentage of the loan amount) and how long they remain in effect. Some of the most pernicious penalties remain in effect for five full years with a penalty of six months' interest on any prepaid amount that exceeds 20 percent of the loan. In the context of a subprime loan with an interest rate of 12 percent, this means that the prepayment penalty amounts to approximately five percent of the loan balance. For a \$150,000 loan, this fee is \$7,500.

While an ideal market would have no prepayment penalties, our analysis later in this report reviews subprime mortgages with prepayment penalties for periods over 24 months, which we consider to be the most abusive. We have also reviewed the foreclosure data for penalties of six months' interest or five percent of the remaining loan amount.

Flipping Borrowers through Fee-Loaded Refinances

Loan flipping is the practice of refinancing a mortgage loan without conveying any tangible net benefit to the borrower, usually in order to extract additional fees and charges. Abusive lenders often refinance subprime loans multiple times within a short period, each time charging fees that reduce home equity and leave the borrower worse off than when he or she started. For abusive lenders, loan flipping can be an alternative to making loans that would trigger protections for high-cost loans. In Maine, for most loans, the high-cost trigger is eight percentage points above U.S. Treasury Yield, and/or eight points in origination or broker fees. Instead of packing fees into loans all at once, fees accumulate over the course of multiple refinances with origination fees possibly as much as six or seven percent of the loan amount each time. By flipping loans, unscrupulous lenders can avoid making loans defined as "high-cost" while still racking up exorbitant fees.

²² For example, if the borrower should receive a 7 percent loan and instead receives a 7.75 percent loan with a prepayment penalty, the lender might pay the broker \$103,000 (rather than the typical \$100,000) for a \$100,000 loan.

Mandatory Arbitration

A mandatory arbitration clause in a loan agreement forces the borrower, as a condition of receiving the loan, to resolve any dispute arising through private arbitration, as opposed to resolving the dispute through the court system. Arbitration can also involve costly fees, require participants to travel to a distant site at their own expense, or designate a biased arbitrator. When a grievance arises, mandatory arbitration reduces or eliminates the protections otherwise legally available to borrowers and may force them to waive meaningful legal redress.²³

Single Premium Credit Insurance

Single premium credit insurance is insurance designed to pay off a borrower's mortgage debt if the borrower dies or is otherwise incapable of meeting the loan obligation. "Single premium" refers to the practice of financing the insurance with a lump-sum payment folded into the mortgage loan. This insurance can be useful when paid for on a monthly basis. When it is financed up front, it does nothing more than strip equity from homeowners. Often it provides only five years of coverage, while the borrower continues to pay interest on the lump-sum cost of the insurance that has been financed into the 30-year mortgage.

²³ Engel and McCoy, 2002. "Predatory Lending: What does Wall Street have to do with it?" Housing Policy Debate 15 (3) 715 – 751.

IV. PREDATORY LENDING IN MAINE

In section II of this report we described subprime mortgage lending in Maine, and in section III we identified some of the specific loan characteristics of predatory mortgage lending. In this section we address one of the key questions of this study: how much predatory mortgage lending is happening in Maine?

Because few individual data sources are easily available to provide an answer to this question, our research relied on several different sources. First, we analyzed the Loan Performance database (see the next section, Appendix 1, and the table of results in Appendix 2) for quantitative evidence of predatory lending in Maine loans. We also examined foreclosure records in four district courthouses to document the extent of predatory features on subprime loans that had gone into foreclosure. As part of this analysis, for a sample of the subprime foreclosure records, we reviewed lien history through the courthouse registry of deeds. And then we interviewed a variety of stakeholders and borrowers around the state. More information on how we conducted each of these efforts is provided in the three subsections that follow and Appendix 1.

There are inherent data limitations to this research, and we have been careful to highlight these within the findings. It nevertheless represents a major advance over what was previously known, and provides ample evidence to conclude that predatory lending is pervasive in Maine.

Loan Performance Database Findings

The Loan Performance Subprime Asset-Based Securities database (LP database) is the most comprehensive source of data available on the subprime mortgage market and its loan characteristics.²⁴ It allows us to track changes in some characteristics of predatory lending since Maine's 2003 anti-predatory law was enacted including prepayment penalties and balloon payments, as well as several borrower characteristics to assess loan suitability.

Key findings are described below.

Prepayment penalties beyond 24 months increased marginally after the 2003 law.

The number of prepayment penalties (PPP) in Maine loans was analyzed both before and after the 2003 law, using data from the LP database. The percentage of loans with PPPs increased, albeit only marginally, after the 2003 law was passed. Additionally the frequency of penalties in excess of two years increased during the same time period. Before the law passed, 12 percent of subprime mortgages included prepayment penalties, with the vast majority lasting longer than two years. Since the 2003 law, prepayment penalties have increased to 15 percent of subprime originations.

²⁴ See Appendix 1. See also John Farris and Christopher A. Richardson, "The Geography of Subprime Mortgage Prepayment Penalty Patterns" in *Housing Policy Debate* (Fannie Mae Foundation), vol. 15, issue 3 (2004).

Fifteen percent of subprime borrowers could have received a prime mortgage.

According to a recent Freddie Mac analysis, over 20 percent of all subprime borrowers in Freddie Mac's portfolio could have received a prime mortgage.²⁵ Unlike Freddie Mac, we do not have all the necessary information to conclusively determine the proportion of Maine borrowers who could have received a prime mortgage, but we were able to derive an estimate by examining the LP database for loans that included the major criteria for qualifying for a prime mortgage. According to secondary market purchasing guidelines, the three major criteria are: (1) a FICO (Fair Isaacs Company)²⁶ 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.²⁷ Since Maine's 2003 law became effective, 15.3 percent of subprime borrowers in Maine (1,687 borrowers) obtained subprime loans with all of these characteristics, suggesting that a substantial share of Maine's subprime market between 2004 and 2005 could have received a prime loan.

Foreclosure Records Findings

To examine predatory characteristics in foreclosed loans, we looked at 339 subprime foreclosure records in four counties. Most records did not document loan characteristics, so our findings below only summarize the data we could access and very likely substantially under-report the extent of predatory lending characteristics.

Abusive practices (e.g., prepayment penalties, mandatory arbitration clauses, and high origination fees) were pervasive in subprime loans.

High interest rates alone are not necessarily problematic, but when combined with abusive practices there is cause for concern. Ninety of the 339 subprime mortgage foreclosure records we examined, or 26.6 percent, contained at least one of the following terms: prepayment penalty, mandatory arbitration or high origination fees.

Mandatory arbitration occurred in 58 loans (17 percent) and prepayment penalties in 37 loans (11 percent).

Both characteristics in the same loan were found in 13 records. Twenty-one, or over half of the prepayment penalties, had a penalty of six months' interest or five percent of the remaining loan balance.

Points and fees above five percent were seen in all district courts.

²⁵ Hudson, M. and Reckard E.S., "More Homeowners with Good Credit getting Stuck with Higher Rate Loans." *Los Angeles Times*. October 24, 2005.

²⁶A measure of credit worthiness, often called a credit score.

²⁷Fannie Mae and Freddie Mac's maximum loan size that they are able to purchase. For additional information please see <http://www.fanniemae.com/aboutfm/pdf/historicalloanlimits.pdf;jsessionid=QZL2HUHXL> http://www.freddiemac.com/news/archives/singlefamily/2005/20051129_loanlimits.html

We only rarely obtained information on points and fees in the foreclosure records, but we did find evidence of points and fees charged right up to the fee threshold that would trigger high-cost loan protections in all district courts sampled. We found 17 loans that included information on points and fees. Nine loans had points and fees between five and eight percent of the loan amount.

Only one incidence of single credit premium insurance was found.

We did not expect to see many incidences of this product since the document recording purchase of this product is usually not included in the foreclosure file. In addition, this practice is less prevalent in the subprime industry today than it was prior to the Federal Reserve Board's explicit inclusion of single premium credit insurance in the points and fees trigger.²⁸

Potential evidence of flipping was observed in all district courts sampled.

Evidence of multiple refinances within a very short time period with no reduction in the interest rate provides potential evidence of flipping and appears in mortgage foreclosure records and registry of deed records in Portland and Lincoln County. Additionally, evidence of multiple refinancing in short time periods was seen in all district courts.²⁹ The following table shows potential evidence of flipping in the registries of deeds.

Table 2: Summary of Multiple Refinances seen in Portland, South Paris, Newport and Lincoln County District Courts Registries of Deeds Sample

District Court	Number of lien histories reviewed for subprime foreclosures	Refinances where interest rate increased between subprime loans	Multiple refinances by subprime lender	Total potential flips	Percentage of possible flips for sample
Portland	30	3	7	10	33
Lincoln	11	3	1	4	36
South Paris	20	0	5	5	20
Newport	15	0	2	2	13

Source: Foreclosure Records and Registry of Deeds, Portland, Newport, South Paris and Lincoln County District Courts

²⁸ Stein, 2001, *Quantifying the Economic Cost of Predatory Lending*. Center for Responsible Lending. p.6

²⁹ In order to fully assess flipping we would have to review every borrower's loan documents and loan history.

Corroboration of Predatory Lending Practices from Stakeholder Interviews

We have supplemented our quantitative analysis with qualitative data from 26 interviews with a variety of stakeholders and borrowers. (See Appendix 4 for a list of interviews.) Our interviewees included housing counselors, credit counselors, bankruptcy lawyers, bankruptcy trustees, mortgage brokers, community bank mortgage lenders and credit union officials. Only four of the fourteen mortgage brokers that we contacted would answer our requests for an interview. When possible, we supplemented interviews with individual loan documents and credit histories that document the information we gathered orally.

“When I first came to Maine, I was surprised at how much people charge for [mortgage] loans.”

Gloria Bryant, owner of
Gloria Bryant
Mortgages

Our interviews overwhelmingly supported the empirical data outlined above. Stakeholders in Maine report many practices that are indicative of predatory mortgage lending. Experts in the field paint a picture of an increasing number of families seeking debt consolidation, or “cash out refinances,” from an industry that routinely employs aggressive sales tactics and equity-stripping practices. Often loans are beyond the borrowers’ means. Many stakeholders we interviewed could recall specific cases, though, for reasons of confidentiality, they were not always willing to provide detailed information of individual clients. The following is a report of these findings according to each type of stakeholder.

Table 3: Summary of Interviews – Stakeholders and Borrowers

Term	Stakeholders noting as a problem in ME	Borrowers with loan terms
Points and Fees	11	5
Flipping	5	3
Steering	4	1
Debt-income ratios too high	4	
Prepayment Penalties	3	4
Balloon Payments	3	0
Single Premium Credit Insurance	1	1
Mandatory Arbitration	0	4

Housing Counselors/Bankruptcy Trustees

Most stakeholders, such as housing counselors and bankruptcy trustees directly involved with bankruptcies and foreclosures, were confident that predatory mortgage lending was a significant factor among their clientele.

One person mentioned “fly-by-night” brokers as a major source of the problem. Others felt the driving issues were credit card debt and pervasive marketing of debt consolidation, even

if consolidation makes no long-term economic sense for the borrower. One bankruptcy trustee estimated that as many as 80 percent of the cases he sees filing for Chapter 7 bankruptcy are related to credit card debt. Counselors also noted that loans are often made to families who have insufficient income to support the loan payments. Thirty to 40 percent of the bankruptcy cases are single women with children.

Consistent with our review of foreclosure records, housing counselors, trustees and attorneys cited the following examples of abusive lending practices:

- Excessive points and fees
- Flipping
- Balloon payments
- Steering
- Bait and switch (i.e., initially offering a broker fee that becomes much more expensive at the loan closing)
- Lending without regard for the borrower’s ability to repay
- Appraisal inflation, where mortgage debt exceeds market value of the home, effectively trapping a borrower in the mortgage, regardless of whether the borrower rebuilds his or her credit score
- “Bottom-feeders” who offer to get individuals out of Chapter 13 bankruptcy by refinancing their loan at outrageous terms³⁰

Industry

Interviews with individuals in Maine’s lending community noted several issues that are leading to abuses in the subprime mortgage market. Three lenders noted excessive points and fees as a problem, as well as a general imbalance of knowledge between lenders and borrowers in the Maine subprime market.

“By placing folks into ARMs, they [lenders] may be assuming that once the client’s rate increases at the trigger date ... [the client] may feel they need to refinance.”

Dan Daggett, CEO of Bowdoinham Federal Credit Union

One industry professional also noted that steering was occurring and was driven by wholesale lenders’ compensation to the broker. The relationship between flipping and hybrid mortgages was cited. So-called “2/28s” (hybrid mortgages that are fixed for a two-year period and adjust for the remaining 28 years of the term) are used to flip a borrower from one artificially low-rate mortgage to the next. These

generate fee income for the broker or lender but leave borrowers in ever more debt and unlikely to build equity in their home.

³⁰ Homeowners will often agree to any terms in a last-ditch effort to save their house. In almost every case, the most that such a loan might do is allow the person to stay in their house for one more year, while their equity has been stripped away through excessive fees, points, and interest rates and with a balloon payment at the end of one year. Ultimately, that person would end up in the courts in foreclosure or filing bankruptcy at a cost to the judicial system and Maine communities.

The lenders we interviewed did not think that mandatory arbitration and prepayment penalties were occurring to any significant degree. However, we were only able to speak with lenders who did not typically use such features in their loans.

Borrowers

We completed interviews with nine borrowers, all of whom had experienced some features of predatory mortgage lending. For five of these borrowers, we obtained full documentation of their loans. For an additional three we obtained partial loan documentation. One of the borrowers did not wish to provide loan documentation. An additional five borrowers were identified as victims of predatory lending, but were unwilling to complete the interview with us. We did obtain some initial information from these borrowers that indicated they had been subject to some predatory practices.

In summary the practices that we saw for borrowers included the following:

- Four cases of prepayment penalties, two of which extended to five years after the start of the loan
- Four cases of mandatory arbitration clauses
- Five cases of excessive points and fees
- One case of single-premium disability insurance that the borrower was unable to use when diagnosed with multiple sclerosis
- Two cases of yield spread premiums in addition to fees and points
- Three cases of flipping, and one of attempted flipping
- Five cases ended in foreclosure, one of which fully liquidated
- Aggressive and intimidating sales techniques, fee packing, lack of disclosures, high loan-to-value ratios and outright fraudulent activity

Debt Consolidation: At Risk of Abuse?

Mrs. P from central Maine consolidated \$31,000 in credit card debt into a mortgage with Homecomings Financial for \$47,775. The origination fee was 4.2 percent of the loan, which included a five-year prepayment penalty of six months interest, an interest rate of 11.25 percent, and a mandatory arbitration agreement.

Not too long after Mrs. P took out the mortgage, she ended up in foreclosure. She approached a local broker who tried many different approaches to make the refinance work. According to Mrs. P, on one occasion the broker offered to put the house in his own name so Mrs. P could stay in the house while improving her credit. Fortunately Mrs. P did not take out this mortgage.

In our interviews with borrowers victimized by predatory lending practices, they indicated two reasons for taking out their loans: debt consolidation plus aggressive marketing and deceptive practices that disguised the actual costs of the mortgage. Virtually all of the borrowers interviewed felt vulnerable, with no other choice regardless of whether this was actually the case, and that they relied on the honesty of the broker or lender. Many of the interviewees had consolidated credit card debt by refinancing their home mortgage. Most of them did not understand the long-term implications of increasing the debt secured by their

homes: specifically, that increasing their mortgage puts them at greater risk of losing their house, whereas if they are forced into bankruptcy because of unsecured credit card debt, there are some protections against losing their house.

Frequently, mortgage companies had initiated contact with interviewees by telephone or postal service and in these cases typically the interviewees, being economically insecure, were susceptible to the suggested refinancing. Once trapped in these expensive loans, borrowers described a vicious downward spiral, often ending up close to foreclosure and becoming prime candidates for a broker to continually refinance.

Summary

We've demonstrated that predatory characteristics are present in Maine's subprime mortgage market, but it is very difficult to quantify the full extent of predatory lending practices in Maine from existing data sources. However, the LP database gives us an objective, if limited, view of loan characteristics likely to be predatory, with the widest coverage of subprime loans in Maine. The strong indications of predatory lending provided by the data were supported by information gathered from stakeholders and borrowers.

V. THE COST AND CONSEQUENCES OF PREDATORY PRACTICES

For homeowners, the two major consequences of predatory practices are foreclosure and lost equity. In this section we examine these economic consequences in Maine by reviewing relevant state data focused primarily on foreclosures, plus strong evidence linking foreclosures to predatory mortgage lending. We also briefly review the need for assignee liability that provides legal recourse for borrowers harmed by predatory lending.

Foreclosures

One of the most important and devastating consequences of predatory loans is that people often lose their homes through foreclosure, sale of the house, or by giving a lender their deed in lieu of foreclosure.

Not all foreclosures are due to predatory lending practices. We expect that subprime loans will have higher foreclosure rates than prime loans, given the higher risk inherent in subprime lending. However, studies point to a foreclosure rate among subprime loans that may well indicate irresponsible underwriting, and these studies specifically show that certain loan terms characteristic of predatory lending (balloon payments and prepayment penalties) substantially increase the likelihood of foreclosure.³¹ Borrowers with subprime loans are far more likely to default than those holding prime loans, even when controlling for additional credit risk.³²

Although we do not have Maine-specific data indicating the portion of Maine's subprime foreclosures that can be explained by higher credit risk, we can draw on research elsewhere in the country. Some of the foreclosure trends that are of concern are as follows:

\$800 Compensation for a \$100,000 Loss

In 1999, looking for business financing, Mr. T from a town near Bangor, was referred to a broker who made loans for WMC Mortgage in California. He got an adjustable rate mortgage for \$59,000 with a two-year fixed rate of 9 percent, about 1.5 percent more than the initial rate quoted. The lender put a lien on the entire property, although Mr. T had asked for a lien only on the one acre that included the house. When he noticed the problem two years later, WMC wouldn't change the deed.

So in 2001 Mr. T refinanced with Beneficial to sort out the lien problem. Beneficial offered an initial interest rate of 7.5 percent over the telephone, but the final rate at loan closing turned out to be 11.9 percent. The initially-offered \$1,000 in broker fees increased to over \$6,000 by closing, or 7.2 percent of the loan amount.

At closing, Beneficial presented Mr. T. with two loans, including a second loan with a 19 percent interest rate. The first loan included a mandatory arbitration clause that he didn't know about until after closing. In spite of the 2003 Maine anti-predatory lending law, all the terms and conditions of these loans were legal.

Mr. T is now in foreclosure and likely to lose his house. He and his family lost about \$100,000 in equity and only got \$800 back from the Beneficial settlement in 2003.

³¹ Quercia et al. 2005. *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*. Center for Community Capitalism.

³² Squires, G. 2004. *Why the Poor Pay More: How to Stop Predatory Lending*. Praeger Press.

For subprime mortgage loans originated in 1999, Maine has the highest cumulative foreclosure in New England.

More than one in five (20.9 percent) Maine subprime mortgages originated in 1999 have entered foreclosure, the highest rate in New England.

Table 4: Percentage of Cumulative Foreclosure Filings for New England States in 2005 for Subprime Mortgages Originated in 1999

State	Foreclosure Filings %
Connecticut	16.2
Massachusetts	11.2
Maine	20.9
New Hampshire	11.0
Rhode Island	13.6
Vermont	13.1

Source: Loan Performance database

*Maine subprime loans serviced by the Mortgage Bankers Association between 2003 and 2005 were on average 11.5 times more likely to be in foreclosure than prime loans during that period.*³³

The subprime foreclosure rate and the subprime/prime ratio have declined since mid-2003, but subprime loans are still nearly nine times more likely to be in foreclosure than prime loans. In the first quarter of 2005, subprime loans in Maine accounted for 14.7% of the total mortgage market and 60.4 percent of all foreclosures.

Table 5 shows foreclosure rates for both prime and subprime loan and the ratios of subprime to prime foreclosures. The foreclosure rate in Maine peaked during 2003 and has decreased in subsequent quarters, consistent with national trends.

³³ This is an average of nine quarters of data from the Mortgage Bankers Association during 2003-through the first quarter of 2005.

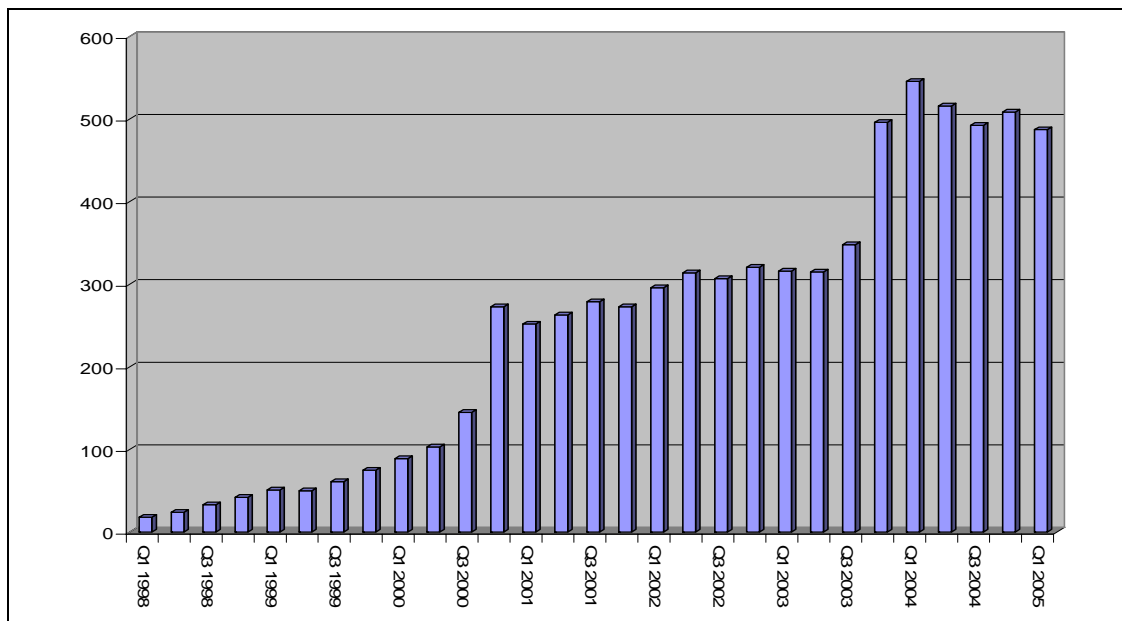
Table 5: Maine Prime and Subprime Foreclosure Rates 2003 - First Quarter 2005

	Quarter	Prime foreclosure rate percent	Subprime foreclosure rate percent	Ratio of Subprime/Prime
2005	1	0.4	3.2	8.9
2004	4	0.4	3.6	10.4
	3	0.4	3.8	10.7
	2	0.4	4.3	11.8
	1	0.4	4.8	11.8
2003	4	0.5	5.8	12.3
	3	0.5	6.3	13.4
	2	0.5	6.2	12.8
	1	0.6	6.7	11.9

Source: MBA National Delinquency Survey.

Chart 2 shows the growth in foreclosures since 1998. The number of subprime mortgage loans that have gone into foreclosure for the most part steadily increased between 1998 and 2003, stabilizing in 2004 and the first quarter of 2005.

Chart 2: Growth in Numbers of Subprime Mortgages Serviced by the Mortgage Bankers Association Survey Respondents that Entered into the Foreclosure Process in Maine by Quarter (1998 – 2005)



Source: Mortgage Bankers Association Delinquency Survey

National trends suggest that foreclosure rates in Maine will likely increase again in the next few years. Low interest rates and a refinancing boom have possibly delayed foreclosures in Maine and the rest of the country. Appreciating property values have allowed borrowers to extract increasing amounts of equity from their homes. As interest rates continue to increase and demand for housing is reduced, property values may stabilize and cause an upsurge in the foreclosure rate, particularly among borrowers with hybrid adjustable rate mortgages (ARMs) who are often betting on the value of their property appreciating.

The delinquency rate is a good indicator of future foreclosure rates, since it indicates borrower hardship in making monthly mortgage payments. The nationwide delinquency rate for both prime and subprime mortgages originated in 2004 alone is as high as the overall delinquency rate for the entire Mortgage Bankers Association portfolio of outstanding loans.³⁴ This high delinquency rate on loans so young suggests that the overall foreclosure rate for outstanding loans will increase substantially over the next few years, since subprime foreclosure rates typically peak when loans are two-to-three years old.

We cannot specify precisely what percentage of Maine's foreclosure rate is due to predatory mortgage lending. It's likely that manufacturing job losses since 1999 have played a major role in raising foreclosures, especially since the performance of subprime loans might be more sensitive to economic variations. However, in light of our current analysis as well as previous national research on this topic,³⁵ it is probable that predatory mortgage lending has contributed significantly to the high cumulative foreclosure rate in Maine. Given the high current rate presented here, Maine's actions to prevent predatory mortgage lending will be a key factor affecting the state's foreclosure rates in the future.

Equity stripping

Many people who do not lose their homes still lose considerable wealth because of the equity stripped from their home or from excessive fees and interest rates imposed by predatory practices. In 2001, the North Carolina Coalition for Responsible Lending estimated that U.S. borrowers lost \$9.1 billion annually to predatory equity-stripping from excessive fees, financed credit insurance, prepayment penalties and interest rate-risk disparities.³⁶ This figure includes \$23.4 million annually for Mainers based on 2000 loan volume. Given the growth of the subprime market since 2000, these figures are almost certainly higher today. The evidence gathered here from foreclosure records and interviews consistently reveals that equity-stripping through excessive points and fees continues to be a significant problem in Maine.

³⁴ August 1, 2005, *Mortgage Servicing News* Vol. 9, No. 7.

³⁵ Quercia *et. al*, *The Impact of Predatory Loan Terms on Subprime Foreclosures*; The Reinvestment Fund. 2005. *Mortgage Foreclosure Filings in Pennsylvania: A Study by the Reinvestment Fund for the Pennsylvania Department of Banking.*; National Training and Information Center, 1999. *Preying on Neighborhoods: Subprime Mortgage Lending and Chicagoland Foreclosures.* National Training and Information Center. Chicago.

³⁶ Stein, *Quantifying the Economic Costs of Predatory Lending.*

Assignee Liability

Only a relatively small portion of mortgage loans is held by the lender who originated them; most mortgages are sold into the secondary market for investment purposes. Assignee liability means that legal liability can be assigned to loan purchasers, thereby giving purchasers accountability and greater incentive to take reasonable measures to avoid buying predatory loans. With assignee liability, when loans go into foreclosure as a result of abusive or illegal practices, borrowers have an opportunity to pursue legal action that might save their home. In Maine, as discussed further below, there is limited consumer recourse if a property goes into foreclosure.

VI. HOW DOES MAINE MEASURE UP?

Before considering how Maine might address current lending practices and loan terms to help prevent predatory lending, it is useful to compare Maine's current law with policies in "best practice" states, such as Massachusetts, North Carolina and New Mexico. It is also instructive to compare Maine's law with provisions of the Household Finance settlement with states' Attorneys General – a remedial action that was framed to set a standard for subsequent state laws. Based on these comparisons and in light of Maine's continuing problems with predatory lending, in the final section of the report we'll offer recommendations for improving Maine's law to provide stronger protections for homeowners while preserving access to responsible mortgage credit.

"Best Practice State" Laws

The Home Ownership and Equity Protection Act (HOEPA) of 1994 established a framework for providing special protections governing loans identified as "high-cost." The federal HOEPA applies to all lenders in all states, while preserving the authority of individual states to enact laws that provide additional protections as the need arises. The state laws that we review here have largely maintained the HOEPA model but closed loopholes in the HOEPA approach, covering a broader scope of abusive loans and prohibiting certain abusive practices for all loans. These states are considered to be among the "best practice" states because they have carefully crafted laws designed to remove abusive practices, providing a comprehensive set of protections to homeowners without reducing access to credit.³⁷ Here we briefly discuss these state laws.

"High-Cost" Loans

- **Comprehensive definition of "high-cost" loan.** The definition of a "high-cost" loan is critical because it determines which loans qualify for special scrutiny under the law.³⁸ Meaningful points and fees triggers for additional protection should include prepayment penalties, yield spread premiums and single premium credit insurance in addition to the baseline HOEPA definition of points and fees.³⁹ New Mexico, Massachusetts, and North

³⁷ In spite of fears that state laws might stifle the growth of subprime lending and diminish access to credit, this has not proven to be the case. In fact, states that have enacted some form of predatory mortgage lending legislation, the growth of the subprime mortgage market has been unambiguously robust. The 24 states that had a predatory lending law in effect during 2003 had a **45 percent increase** in subprime origination volume since 2001, whereas states without a predatory lending law experienced only a **20 percent increase** in volume. Prepared Testimony of Martin Eakes, CEO of Self-Help and the Center for Responsible Lending. May 24, 2005. Joint U.S. House Subcommittee Hearing entitled "Legislative Solutions to Abusive Mortgage Lending Practices." Appendix A ("Significant Increases in Subprime Lending"), based on data published in *Inside B&C Lending*, 2001 – 2004. <http://www.responsiblelending.org/pdfs/Testimony-Eakes052405.pdf>

³⁸ High cost loans are defined under Maine law using the same standard as HOEPA. These federally defined HOEPA-covered loans comprised only 0.9 percent of the total *subprime* mortgage market in 2004. See *Inside B&C Lending*. September 23, 2005. pg. 5 for the total HOEPA covered originations. The total subprime mortgage origination count was derived from the LP database.

³⁹ See 15 USC § 1602 (aa)(1)(B) The baseline HOEPA definition includes all compensation paid to mortgage brokers such as discount points, service charge, loan fee, credit report fee, borrower-paid mortgage broker fees, but excludes fees paid directly to the broker by the lender.

Carolina have adopted such comprehensive measurements of fees.⁴⁰ Maine on the other hand relies on an incomplete definition of “high-cost” that does not include yield spread premiums, prepayment penalties, and does not directly include single premium insurance products. The loopholes in the Maine law allow unscrupulous lenders to recharacterize fees under a different name and continue to make abusive loans that are not covered by the state law.

- **“High-cost” loan trigger set at five percent of the loan amount.** Other states have set the points and fees threshold used to determine which loans are considered “high-cost” at five percent of the loan amount. At least nine states, including Massachusetts, define “high-cost” loans as those with points and fees of five percent of the loan amount or greater.⁴¹ Five percent has also been adopted as an appropriate standard in the secondary market.⁴² Similarly, subprime lenders have, under a variety of regulatory regimes with different definitions, adopted policies that prohibit home loans with points and fees of more than five percent.⁴³ In contrast, Maine borrowers currently rely on a federal fee threshold of eight percent⁴⁴ that is widely viewed as too high to offer meaningful protections.
- **Open-ended loans covered under “high-cost.”** As a companion to a broad definition of points and fees, it is important to include open-ended loans⁴⁵ in the definition of “high-cost” loans thereby removing any option for lenders to subvert “high-cost” loan protections by re-characterizing loans. North Carolina amended its state law in 2003 to cover open-ended loans after discovering that lenders were using spurious open-ended loans to avoid coverage under the law. Numerous states, including Arkansas, Georgia, Illinois, Massachusetts, New Jersey, New Mexico, and New York also cover open-ended loans in their state anti-predatory lending laws. Currently these loans are not included under the definition of “high-cost” loans in Maine law.
- **“High-cost” loan protections.** There are several provisions found in other state laws that might be helpful for Maine, including a ban on financing fees, mandatory credit counseling and no prepayment penalties.
- **No financed fees:** North Carolina bans financing fees on all “high-cost” loans thereby deterring lenders from making fee-laden loans and encouraging them to put the cost of

⁴¹ States with five percent triggers include Arkansas, Georgia, Illinois, New Mexico, New York, Massachusetts, South Carolina and North Carolina. New Jersey amended its law and now has a 4.5% trigger.

⁴² Freddie Mac and Fannie Mae, the two largest purchasers of home loans in the nation, will not purchase home loans with points and fees in excess of five percent. <http://www.freddiemac.com/sell/selbultn/1228indltr.html>; http://www.efanniemae.com/singlefamily/forms_guidelines/lender_letters/db_lender_letters.jhtml?role=ou#03-00

⁴³ Household now caps origination fees at three percent, CitiFinancial branches will not originate loans with more than three percent, and Washington Mutual will not originate loans with points and fees exceeding five percent, including broker compensation paid from any source.

⁴⁴ See 15 USC § 1602 (aa)(1)(B).

⁴⁵ Open-ended loans include a revolving line of credit that may be used over and over again, including credit cards, overdraft credit accounts, and home equity lines. For the purposes of this policy recommendation we are referring to revolving debt secured by a borrower’s residence.

the loan into the interest rate, rather than into fees. New Mexico limits financing more than two percent of the loan amount on a “high-cost” loan.

- Mandatory credit counseling: Massachusetts, New Mexico, and North Carolina all require borrowers to seek mandatory credit counseling before entering into “high-cost” loans.⁴⁶ Mandatory credit counseling helps give borrowers time and resources to consider whether a loan is in their interest and quite possibly deters unscrupulous lenders from push marketing since they know that a credit counselor will closely scrutinize the loan terms. Such counseling provides a disincentive to lenders and brokers who might otherwise steer unsophisticated consumers into loans that are more expensive than warranted by the credit risk. Counseling also helps homeowners understand the loan’s real costs and consider more affordable alternatives.
- No prepayment penalties: Since many subprime loans are refinanced within the first three years, banning penalties on “high-cost” loans will help curb the loss of equity that occurs through high penalty costs and make it easier for borrowers to refinance if they qualify for a more affordable home loan.

The table below provides a comparison of Maine’s “high-cost” loan features with three best-practice states.

⁴⁶ New Jersey requires counseling if any points and fees are financed.

Table 6: Comparison of “High-Cost” Loan Features in Best Practice States and Maine⁴⁷

Feature	NM Law	MA Law	NC Law	Current Maine Law
“HIGH-COST” TRIGGERS				
Points and fees trigger				
Threshold for “high-cost” (above which certain protections go into effect)	5%	5%	5%	8%
Prepayment penalties included in points and fees calculation	Yes.	Yes.	Yes	No.
Yield spread premiums included in points and fees calculation	Yes	Yes	No, but abusive kickbacks are addressed by North Carolina’s mortgage broker licensing law.	No
Upfront insurance premiums included in points and fees	Yes.	Yes, also prohibited for all home loans.	Yes, also prohibited on all home loans.	Via HOEPA definition. Restrictions apply to “high-cost” only. If offer choice of monthly premium, no restrictions. ⁴⁸
APR trigger				
“High-cost” APR trigger	8% first lien, 10% junior lien	8% first lien, 10% junior lien	8% first lien, 10% junior lien	8% first lien, 10% junior lien

⁴⁷ For the general anti-predatory laws of these best practice states see: New Mexico (NM 58-21A-1 et seq; NMAC 12.15.3 et. seq.); North Carolina (Session Law 1999-332); Massachusetts (Chapter 268 of the Acts of 2004) Chapter 183 C

⁴⁸ Additionally, due to the statutory language, the 2003 law may have implicitly legalized single premium credit insurance, contrary to Maine insurance law.

Feature	NM Law	MA Law	NC Law	Current Maine Law
SCOPE OF ACT/COVERAGE				
Includes open-ended loans ⁴⁹ and purchase-money mortgages ⁵⁰	Yes	Yes	Yes	No
“HIGH-COST” LOAN PROTECTIONS				
Counseling required	Yes	Yes	Yes	No
Limits or prohibits financing points and fees	Yes, limited to 2% of the loan amount	Yes, limited to 5% of the loan amount	Prohibited	Neither
Prohibits prepayment penalties	Yes	Yes	Yes	No ⁵¹

Sources: Internal CEI/CRL review⁵²

General Provisions

- **Limits on prepayment penalties.** Many states strictly limit prepayment penalties on all home loans, including loans well below “high-cost” thresholds. Nine states completely ban all penalties. New Mexico and North Carolina (prohibited on loans below \$150,000), prohibit prepayment penalties, and Massachusetts ensures that prepayment penalties expire before three years. By comparison, in 1987 Maine prohibited prepayment penalties on alternative mortgage transactions. However in 2003, PL 49 created some ambiguity regarding legislative intent on prepayment penalties as it overrode previous law, thus establishing a more permissive environment in Maine for prepayment penalty use. As such, a predatory lender could argue that on refinance mortgages – the type most susceptible to abusive practices – lenders can charge as much as they want. The amendment also permits penalties to be effective for up to five years further confusing the Maine law.
- **Prohibitions against loan flipping.** North Carolina and New Mexico offer a good example of strong legislation against loan flipping. North Carolina forbids “knowingly or intentionally” refinancing a home loan that does not provide the borrower with a

⁴⁹ Open-ended loans are mortgages that are secured by a borrower's home and allow the borrower to repeatedly draw upon and pay down funds, similar to a credit card or revolving line of credit.

⁵⁰ Purchase money mortgages are mortgages used to buy a home, as opposed to mortgages used to refinance an existing mortgage.

⁵¹ Maine’s “high-cost” mortgage provisions have a broad five-part exception to the “high-cost” prepayment penalty prohibition, effectively rendering it meaningless within the realities of the subprime mortgage market. However, the Office of Consumer Credit Regulation has aggressively prohibited by regulation all prepayment penalties on “high-cost” mortgages, that is somewhat contradictory to the plain face of the statute.

⁵² Title 9A: Maine Consumer Credit Code §8-206-A. See <http://janus.state.me.us/legis/statutes/9-A/title9-Asec8-206-A.html>

“reasonable, net tangible benefit,” considering “all of the circumstances.”⁵³ The North Carolina standard is a compromise that favors both homeowners and lenders by providing: (1) incentives for lenders to reduce the incidence of flipping by monitoring the underwriting and origination of refinances more closely; (2) specific language that discourages potential litigants from bringing frivolous claims; and (3) specific language that makes it impossible for a claim to be asserted as a class action.

Maine limits its flipping prohibitions to current “high-cost” mortgages, meaning that predatory lenders can repeatedly refinance mortgages without providing a benefit to the borrower and while charging total points and fees up to 7.9 percent (and that is without even considering prepayment penalties and yield spread premiums). In this way Maine’s law essentially creates a state safe harbor for predatory lenders.⁵⁴

- **Ban on mandatory arbitration.** Both Freddie Mac and Fannie Mae refuse to purchase loans that include mandatory arbitration clauses, and banning mandatory arbitration has become a best practice among several leading lenders in the industry. New Mexico and Massachusetts ban mandatory arbitration clauses for high cost loans. Maine law is currently silent on this issue.
- **Adopt assignee liability provisions that will allow borrowers who have received a predatory loan to defend against losing their home in foreclosure.** New Mexico and Massachusetts have adopted language that strikes the appropriate balance between preserving homeowners’ ability to defend their homes against illegal predatory loans and providing the secondary market with the ability to continue to purchase subprime loans without the fear of overbroad liability. North Carolina already had a similar approach in place under its existing case law.

The assignee liability provisions in New Mexico and Massachusetts work in two steps. First, a company that fails to exercise due diligence in preventing the purchase of “high-cost” home loans is subject to all the liability of the original creditor. This preserves the claims of homeowners who otherwise would be left defenseless when the original creditor has gone out of business having sold the borrower’s loan. Second, for companies that accidentally purchase a “high-cost” home loan after engaging in due diligence, homeowners have the right to defend their home against foreclosure for a limited time, subject to caps on damages equal to amounts paid and owed. Borrowers also cannot assert those rights in a class action lawsuit, only as an individual claim.

⁵³ North Carolina’s statute says “No lender may knowingly or intentionally engage in the unfair act or practice of ‘flipping’ a consumer home loan. ‘Flipping’ a consumer loan is the making of a consumer home loan to a borrower which refinances an existing consumer home loan when the new loan does not have reasonable, tangible net benefit to the borrower considering all of the circumstances, including the terms of both the new and refinanced loans, the cost of the new loan, and the borrower’s circumstances. . . .” N.C. Gen. Stat. § 24-10.2(c) (1999).

⁵⁴ MRS 9-A, part 2 § 8-206-A, 12(A).

Table 7 compares general provisions in Maine’s law with the laws of “best practice states.”

Table 7: Comparison of General Provisions under Maine, New Mexico, Massachusetts, North Carolina Laws

Feature	NM Law	MA Law	NC Law	Current Maine Law
<u>OTHER GENERAL PROVISIONS</u>				
Prepayment Penalties (PPP)				
Broad ban or restrictions for all loans on PPP?	Broad Ban	Limits that can be paid on prepayment, banned outright on junior mortgages	Broad Ban	No prepayment penalty for alternative mortgage transactions
Flipping				
Requires that refinance loan provides borrower with a reasonable, tangible net benefit	Yes, on all loans.	Yes, applies to all loans, but adopts a standard that refinance must be in the “best interest of borrower” and has some potential loopholes in the determination of best interest.	Yes on all loans, and forbids “knowingly or intentionally” refinancing where it is not in best interest of borrower.	“High-cost” loans only.
Mandatory Arbitration				
Prohibition of mandatory arbitration	Yes, “high-cost” only	Yes, “high-cost” only	Silent	Silent
Remedies for Consumer				
Assignee liability	Yes	Yes	Yes, by long-standing case law.	Unclear

Sources: CEI/CRL internal Review

While there are no specific provisions relating to steering in any of the “best-practice” state laws, as we shall discuss later in Section VII, these laws do discourage steering borrowers into higher cost loans.

Household Settlement

Table 8 outlines the high-impact components of the Household settlement, which demonstrates that there are several key areas where Maine’s law could be strengthened.⁵⁵ The settlement was the basis for establishing best practices within Household and Beneficial and in some states provided a basis for improvements to anti-predatory lending laws.

But the settlement has not spurred improvements in Maine. For Maine’s law to be as strong as the Household settlement, Maine would need to prohibit balloon payments on “high-cost” loans, limit prepayment penalties to 24 months, limit points and fees to five percent, adopt language to ensure a net tangible benefit in refinancing, prohibit single premium credit insurance on all mortgages, and require lenders to provide non-English language documentation.

Table 8: Maine Law Compared to the Provisions of the Household Settlement Focusing on Specific Loan Terms

Specific Characteristic from State Action against Household	Maine Law in 2003	Household Settlement Relief Terms	Maine Law: Weaker or Stronger?
Balloon Payments	No provision	Prohibited	Weaker
Prepayment Penalties	Prohibited on alternative mortgages	No prepayment penalties beyond 24 months after loan closing on any Household loan	Mixed
Points and Fees	8 percent	5 percent	Weaker
Net Tangible Benefit in Refinancing	Silent – restrictions of new fees on high-cost mortgages only	Included	Weaker
Single Premium Credit Insurance	Included in points and fees trigger via HOEPA definition	Prohibits single premium credit insurance on all mortgages.	Weaker
Open-Ended Loans	Exempt under the definition of high cost loans meaning	Addressed spurious open-ended credit	Weaker
Non-English Language Documentation	Silent	Required	Weaker

Source: CEI/CRL review

⁵⁵ There are some parts of the Maine action against Household that relate to unfair and deceptive trade practices. They are not included in the chart as they are beyond the scope of this comparison of the regulation of loan terms.

VII. WHAT ARE THE EFFECTS OF “BEST PRACTICE” LAWS? A CASE STUDY FROM NORTH CAROLINA

The benefits of “best practice state” laws are on display in the experience of states at the forefront in responsible lending policies, such as North Carolina. Approximately 30 states enacted some type of anti-predatory lending legislation following passage of North Carolina’s law in 1999. Among those states, about 10 to 12 adopted statutes that closely follow the North Carolina model, including Massachusetts and New Mexico.

Evidence from North Carolina, the first state to pass comprehensive reform, strongly suggests that the law has been successful in purging the market of abusive practices while preserving access to credit. Consequently, North Carolina, and other forerunner states provide a tested model for Maine. In this section we will review the evidence from these states showing that predatory lending has been reduced even as the subprime mortgage market remains strong.

North Carolina’s law has reduced predatory lending.

Because North Carolina’s law has been in place the longest, there is a significant body of evidence regarding its impact. The state’s reform is having its intended effect. CRL’s own estimates show that in its first year, the new law saved consumers at least \$100 million—by eliminating predatory loan terms that would have been expected in the law’s absence.⁵⁶

A 2003 study by the University of North Carolina concluded that the law has had a particularly significant impact on abusive home mortgage refinances, suggesting a reduction in loan flipping – loans that are refinanced for the purpose of generating fees without providing any net tangible benefit to the homeowner.⁵⁷ The UNC study also noted a decline in the incidence of subprime home refinance loans containing prepayment penalty terms beyond the loan’s first three years. In fact, while the number of loans with extended prepayment penalties increased by 30 percent nationwide, such loans *declined* in North Carolina by 75 percent.⁵⁸

Without question, North Carolina has reduced predatory lending. At the same time, borrowers in North Carolina continue to have access to a wide variety of competitively priced loans from a wide variety of lenders. As UNC Professor Michael Stegman reported, “[t]he North Carolina predatory lending law is doing what it was intended to do: purge the market of abusive loans without restricting the supply of subprime mortgage capital accessible to North Carolina borrowers with blemished credit records.”⁵⁹

⁵⁶ Ernst, Keith, John Farris, and Eric Stein, 2002, *North Carolina’s Subprime Home Loan Market After Predatory Lending Reform*, Center for Responsible Lending, available at www.responsiblelending.org.

⁵⁷ Roberto G. Quercia, Michael A. Stegman, and Walter R. Davis, 2004, “Assessing the Impact of North Carolina’s Predatory Lending Law” *Housing Policy Debate*, 15 (3), Fannie Mae Foundation. See Press Release 2003, “*STUDY: NC Predatory Lending Law Cuts Abuses, Does Not Dry Up Credit for Borrowers*,” Center for Community Capitalism (available at <http://www.kenan-flagler.unc.edu/News/DetailsNewsPage.cfm?id=466&menu=ki>).

⁵⁸ The authors also found a decline in subprime balloon payments and loan-to-value ratios of 110 percent or more.

⁵⁹ See Quercia et. al., “Assessing the Impact” in *Housing Policy Debate*, pp. 573+.

The subprime market continues to thrive in North Carolina.

If Maine moves to strengthen its anti-predatory lending legislation as we recommend below, some of those opposed are likely to assert that anti-predatory lending laws limit access to credit.⁶⁰ This has not been the experience of North Carolina and many other states with stronger anti-predatory lending laws, where the subprime market has continued to thrive.

For example, the 2003 UNC study⁶¹ found that home purchase loans to borrowers with credit scores below 580, those whose only option is subprime, more than doubled after the law was fully implemented, compared with an increase of 62 percent nationally.

This study also found that, after the law was fully implemented, North Carolina's mean origination interest rates were consistent with corresponding national rates and actually increased slightly less than the national average increase. One might have expected that rates would rise more than elsewhere since the intention of the law was to clamp down on fees and shift lender compensation to rates. This result suggests that the fees being charged before the law's implementation were not genuinely priced to account for the risk of default, but rather functioned as a vulnerability tax on North Carolina families.

While it is the most rigorous examination of North Carolina's subprime market, the UNC study does not stand alone. A leading industry trade journal, *Inside B & C Lending*, reported that top North Carolina subprime lenders “continue to offer a full array of products for borrowers in North Carolina—with little or no variation in rate” compared to other states.⁶² Similarly, a Morgan Stanley & Co. survey of 280 subprime branch managers and brokers found that tougher state laws, including North Carolina's, have not reduced subprime residential lending volumes.⁶³ In fact, 84 percent of the managers thought changed practices were having neutral to positive impacts on volume because they make customers feel more comfortable and “lower points and less onerous prepayment penalties make the economic terms more attractive.”

⁶⁰ Although an industry-sponsored Credit Research Center (CRC) study claimed that the North Carolina law led to a decrease in access to credit for low-income borrowers, that conclusion should be viewed with significant suspicion. It relies upon a limited data set from nine anonymous lenders that has not been made available for independent verification. The study examines data from a period ending June 30, 2000, the day before most of the North Carolina law's provisions took effect. Moreover, the data omits all open-ended home loans from those lenders. Finally, it ignores the problem of “flipping” (refinancing loans with no benefit to the borrowers) and “steering” (providing subprime loans to prime-eligible borrowers) and consequently assumes that any reduction in subprime originations is evidence of harm.

⁶¹ See Quercia et. al., *Assessing the Impact* pp. 573

⁶² “Lenders Will Try to Pin Down Effects of NC Mortgage Law,” *Inside B&C Lending*, March 5, 2001.

⁶³ Morgan Stanley. “Channel Check: Surprisingly Strong Subprime Growth,” *Diversified Financials*, August 1, 2002.

These indicators simply confirm the experience of lenders who operate in states with strong laws such as North Carolina -- there is no shortage of credit available to borrowers across the state. In 2003, Joseph Smith, North Carolina's Commissioner of Banks, commented that "[d]uring the last twelve months, over seventy-five percent of formal complaints to [his office] ... have involved mortgage lending activities [but] [n]ot one of these complaints has involved the inability of a North Carolina citizen to obtain residential mortgage credit."⁶⁴

⁶⁴ North Carolina Office of the Commissioner of Banks, Joseph A. Smith, Jr. letter to Comptroller John D. Hawke, Jr., October 2, 2003, available at <http://www.banking.state.nc.us/reports/Hawke.pdf>.

VIII. CONCLUSIONS AND RECOMMENDATIONS

Maine's subprime mortgage market is growing rapidly in a state that has one of the highest home ownership rates in the country. Maine also has the nation's largest percentage of cash-out refinances, indicating that borrowers are drawing significant equity out of their homes. This is consistent with current economic conditions and nationwide trends. Credit card debt and economic hardships, along with escalating property prices and property taxes, are forcing Mainers to dip into their home equity as they would savings accounts.

While enjoying a high rate of home ownership, Maine has the highest rates in New England of foreclosure filings for 1999 subprime originations plus for the same year the highest rate of homes lost through the foreclosure process. Projections indicate a trend of increased foreclosures during the coming years as new loans ripen, interest rates rise, and housing values decline.

Predatory lending is alive and well in Maine. Our research has documented predatory lending characteristics including excessive points and fees, increases in the number of prepayment penalties beyond 24 months, mandatory arbitration clauses, and evidence of steering. Both mortgage data and interviews described in this report point to predatory lending as a significant cause of foreclosures and lost wealth among Maine families.

Some of the most compelling points we covered include these:

- Maine families are estimated to lose at least \$23.4 million annually due to equity stripping from predatory mortgage lending, not including the costs of foreclosure.
- Mainers are vulnerable to abuses in the subprime mortgage market.
- Maine's law is ineffective in preventing many abuses seen in this research, not least excessive points and fees above five percent.
- Maine has the ability to regulate the lenders and brokers where the worst abuses are occurring.

The losses to Maine communities go beyond the flow of fees out of state. As has been documented in the literature, a disproportionate number of loans end up in foreclosure as a result of this steady outflow of equity combined with an unaffordable loan. For each house that forecloses, the family loses tens if not hundreds of thousands of dollars in equity. The subprime market, by definition, has more risk and will result in more foreclosures than the prime market. But without stronger laws protecting consumers from abusive lending practices, foreclosures above and beyond what is predicted by risk will occur, with greater loss to both consumers and their communities. And not all of the losses are reflected directly in foreclosures, since many families will sell the property before they get to the point of being foreclosed.

Maine regulates 89 percent of its recognized subprime lenders. In addition, Maine regulates all mortgage brokers. As such, Maine can draw on the experience of a number of "best practice states" with strong anti-predatory lending laws to improve its legislation and ensure

that more Maine families hold on to their homes and their hard-earned home equity wealth. As shown by North Carolina's experience, strong laws that protect homeowners can co-exist with a growing subprime market that continues to provide abundant credit.

North Carolina and other states have been successful in preventing predatory lending by implementing strong but reasonable protections, including: lowering the "high-cost" loan points and fees trigger to five percent of the total loan amount while also creating a more comprehensive definition of points and fees; increasing protections for "high-cost" loans; ensuring a net tangible benefit for the borrower in a refinance; and providing effective consumer remedies. We believe Maine's homeowners would benefit from similar steps. Here's a more detailed description of the key provisions we recommend changing in Maine law.

1. Expand the current definition of "high-cost" loans and provide additional protections for this category.

Define "high-cost" for points and fees as five percent or more of the loan amount.

This threshold, three points below the currently-allowed level, will not prevent high cost loans from being made. But it will ensure additional protections for these more expensive loans.

Include yield spread premiums, prepayment penalties and single premium credit insurance in the points and fees calculation.

Maine should include other forms of mortgage broker and lender compensation in the calculation of the points and fees, since these forms of compensation are costs that are, practically speaking, borne by the borrower. By reviewing all forms of compensation the borrower will get a fairer picture of the true costs of the loan, and for those more expensive loans falling into the "high-cost" category, additional protections will be triggered.

Include open-ended loans in the definition of a "high-cost" loan.

This recommendation will ensure that there is not a loophole in Maine law allowing high-cost loans to be made without appropriate protections.

Require mandatory credit counseling for borrowers taking "high-cost" loans.

Taken before the loan is granted, this helps ensure that the borrower is fully informed of the loan's consequences. It is similar to the federally required counseling for reverse mortgages.

Prohibit the financing of fees for "high-cost" loans.

This prohibition deters lenders from making fee-laden "high-cost" loans and again, encourages lenders to put the cost of the loan in the interest rate instead of the fees. Limiting the financing of fees also has the simple impact of making the borrower more aware of the actual loan costs - financed fees are often invisible to the borrower, who does not actually see cash paid out for these costs.

Prohibit prepayment penalties for “high-cost” loans.

Maine should follow the lead of other states and prohibit prepayment penalties entirely on “high-cost” loans. Given the high rate and fees on a “high-cost” loan, it is simply not reasonable to permit a prepayment penalty on such loans in addition to other fees. Maine should make it easier for borrowers to refinance if they can later obtain a more affordable home loan.

2. Provide consumer remedies for all loans.

Prohibit mandatory arbitration.

Maine should add language to its Consumer Credit Code that prohibits mandatory arbitration clauses in all home loans. This is a best practice in the industry and is a key step in preserving the legal rights of borrowers.

Include a provision for assignee liability.

The Maine Consumer Credit Code should address assignee liability. We recommend a provision based on the language of Massachusetts law. This language ensures that the secondary market is still able to purchase and rate loans, while providing appropriate recourse for a borrower in the case of foreclosure from a predatory loan.

3. Require a net tangible benefit in any refinance loan.

We recommend language to prohibit refinancing home loans in the absence of a net tangible benefit to the borrower. As discussed above, the North Carolina language has proven an effective deterrent to abusive loan flipping.

4. Clarify the Maine Consumer Credit Code language addressing prepayment penalties.

We recommend striking existing language relating to prepayment penalties and replacing it with language that would limit prepayment penalties for all residential loans, with the exception of alternative mortgage transactions which already have strong restrictions, to two percent of the loan amount and prohibit prepayment penalties on all “high-cost” loans.

5. Further study the implications of a high number of subprime hybrid adjustable rate mortgages in the Maine marketplace.

The data from Maine show hybrid adjustable rate mortgages are a large part of the state’s subprime mortgage pool. Interviews suggest this may adversely impact Maine’s foreclosure rate. However, we feel that to further understand this issue we need to review elements of loan affordability, data we do not currently have. We anticipate looking for funding to further study this topic and consider the policy implications.

While strong legislation is essential, solving the problem of predatory lending requires complementary efforts. We also support increased consumer/financial education and better outreach by responsible lenders to borrowers who might otherwise fall into the hands of predatory lenders. However, such actions will have little impact unless they are supported by effective policies to ensure that responsible lenders can compete in Maine.

APPENDIX 1: METHODOLOGY

The study used various empirical and qualitative data to examine trends in the subprime mortgage market and, particularly, characteristics of loans that have commonly been defined as predatory. Given the diversity of these data sources we have had to use different time periods for analysis. These data sources are described below. We also compared our findings with existing literature on the subprime mortgage market and predatory mortgage lending.

Housing and Urban Development (HUD) Subprime Lender List

Most studies classify loans as subprime according to whether the lenders appear on the HUD subprime lenders list. Several parts of our analysis draw on the HUD subprime lender list. HUD describes the data collection for the list as follows:

A list of potential subprime or manufactured home lenders was primarily compiled from industry trade publications and HMDA data analyses. We used a number of HMDA analyses to screen potential subprime and manufactured home lenders. First, subprime and manufactured home lenders typically have higher denial rates and lower origination rates than prime lenders. Second, home refinance loans generally account for higher shares of subprime lenders' total originations than prime lenders' originations.

We called the lenders identified on the potential list or reviewed their web pages to determine if they specialized in either subprime or manufactured home lending. A large number of lenders told us that they offer subprime or manufactured home loans, but these loans do not constitute a large percentage of their overall conventional mortgage originations or applications. Most lenders identified themselves as primarily a subprime, manufactured home, or prime lender. In cases where lenders offered both prime and subprime or manufactured home loans, we identified lenders as subprime or manufactured home lenders if they reported that subprime or manufactured home loans accounted for at least 50 percent of their conventional business.⁶⁵

It is widely recognized that the list both over- and under-counts the number of subprime loans. A lender is classified as subprime if more than 50 percent of their originations are subprime. This means that some **prime** loans made by lenders on the HUD subprime list will be counted while some **subprime** loans made by lenders not on this list would not be counted

⁶⁵ HUD website <http://www.huduser.org/datasets/manu.html>

Data sources

We used the following data sources for our analysis:

Home Mortgage Disclosure Act Data

As part of the Home Mortgage Disclosure Act of 1975 (as amended), lenders are required to provide information on loans made by geographic location and ethnicity. Information on originations, applications and denials is available. HMDA data are available in various forms from the Federal Financial Institutions Examination Council (www.ffiec.gov/hmda.) We classified loans reported in HMDA data as subprime if they were made by a lender who is classified as subprime on HUD's annual list of subprime lender and manufactured home lenders (www.huduser.org/databases/manu.html).

Mortgage Bankers Association Data

The Mortgage Bankers Association provides a delinquency and foreclosure report on both the prime and subprime markets, nationally and for all states from a survey they administer every quarter. The list of subprime survey recipients is based on HUD's annual list of subprime lenders. For 2004 and 2005 data, they classified lenders on the basis of HUD's 2003 subprime lender list.⁶⁶ We purchased data up to the first quarter of 2005.

Inside Mortgage Finance Publications, Inc

Inside Mortgage Finance Publications, Inc (Inside Mortgage Finance), publishes nine mortgage newsletters, including *Inside B&C Lending*, generally considered the most widely read journal in the subprime mortgage industry. Their emphasis is on business-to-business news and information geared specifically for mortgage industry executives. Inside Mortgage Finance also publishes the *Mortgage Market Statistics Annual*, which is the most comprehensive collection of statistics on the mortgage market and the mortgage and asset securities market. The most recent data available is for 2004.

Loan Performance Database

The Loan Performance (LP) database represents the most comprehensive data available on the subprime mortgage market. According to Quercia et al. "this database is widely recognized and used by the segment of the financial services industry that originates and securitizes large numbers of subprime loans."⁶⁷ The Maine segment of the LP database represents 43 percent (2,164) of all subprime mortgages in 2001, 66 percent (3,393) in 2002 and 80 percent (5,708) in 2003.⁶⁸ LP data are particularly valuable because they contain detailed information on individual loans, including borrowers' credit scores, loan-to-value ratios (LTVs), and information on the type of mortgages. Although it does not cover all characteristics of predatory lending, it provides the widest coverage available.⁶⁹

⁶⁶ E-mail correspondence with Mickey Kalavsky, Survey Specialist, Research and Economics, Mortgage Bankers Association, December 13, 2005.

⁶⁷ Quercia et al. "Assessing the Impact," p.580.

⁶⁸ Coverage was calculated by CRL using *Inside B&C Lending* data as the overall subprime mortgage market figures.

⁶⁹ For more information see Farris and Richardson, 2004, "The Geography of Subprime Mortgage Prepayment Penalty Patterns." *Housing Policy Debate* 15 (3) 687 – 714.

Individual loan data are self-reported by financial institutions with the lender characterizing a loan as prime or subprime and reporting other loan characteristics. The database is primarily available to regulated financial institutions, and as such Self-Help Credit Union, the parent organization of the Center for Responsible Lending, and a regulated financial entity, negotiated access to the database.

We include various data points from the LP database throughout the paper (e.g., cumulative foreclosure rates) and a summary of the Maine subprime mortgage market based on LP data, as well as specific predatory lending characteristics. Appendix 2 provides detailed statistics from this database that describe the Maine subprime market pre-PL49 (1995 – 2003) and post-PL49 (2004). We also reviewed the cumulative foreclosure and liquidation rate for loans made in 1999 for all New England states (see Table 4.)

Review of District Court Foreclosure Records and Registries of Deeds

We looked at loan documents in 855 foreclosure records in four District Courts and Registries of Deeds in Lincoln County, Newport, Portland and South Paris. We determined that 339 of these loans were subprime based on the lender's inclusion in the HUD Subprime Lender List. We then supplemented this list with the top 25 list from *Inside B&C Lending* to ensure more complete coverage of subprime lenders, though all lenders in *Inside B&C Lending's* top ten list were included in the HUD subprime lenders list. We reviewed 84 subprime records in Lincoln, 157 in Newport, 498 in Portland, and 116 in South Paris.

For our purposes, the foreclosure records did not have complete information. Such records generally have information about interest rates, lenders, dates, properties, and interested parties, and occasionally information on loan characteristics. These records provide insufficient documentation to assess the impact of specific lending practices since there is no guarantee that the records will include information related to predatory lending characteristics.

A typical foreclosure file includes a mortgage note and details of the parties in interest. Since information on the interest rate is required to verify the amount owed, the files usually do contain interest rate information, the date of the note, and the original lender. From the mortgage note we were sometimes able to see information about prepayment penalties or mandatory arbitration, though this type of information was not routinely included in the note. Mortgage notes usually did include some indication on whether a loan required a balloon payment.

If the loan is an adjustable rate mortgage (ARM), the ARM rider is included. This is also true for hybrid loans in which interest for the first year or two is fixed, and then adjustable for the remainder of the loan term. These riders are very useful since they provide information on the index and margins used to calculate the interest rate, as well as the initial interest rate. They also include information on the interest rate ceilings and caps set for the term of the loan.

Some files contain additional information such as HUD settlement statements or correspondence from the borrower to the lender or the courts. These can provide rich additional information for analysis. However, these are the exception as opposed to the rule.

We sampled between 8 and 17 percent of the subprime foreclosures from each courthouse and then reviewed the borrowers' lien histories through the registry of deeds. Where possible, information on interest rate, lender and date of the loan were noted for analysis.

Household and Beneficial Finance Corporation Loan Characteristics

A Freedom of Access letter was submitted to the Maine Attorney General's Consumer Protection Division and the Maine Office of Consumer Credit Regulation requesting information on the loan characteristics of borrowers who qualified for the Household state action settlement. Unfortunately, this request was denied by Household and the Maine Attorney General, pursuant to arrangements made under the settlement agreement. However we were provided with the State of Maine Superior Court Civil Action Docket No. CV02-255.

The loan characteristics that qualified plaintiffs for the Household settlement were obtained from this document and complaints were associated with the following: (1) two real estate secured loans made at or near the same date to the same Borrower (i.e. split loans); (2) excessive loan points and origination fees; (3) excessive interest rates; (4) monthly payment amounts; (5) single premium credit and other insurance products; (6) prepayment penalties; (7) live checks; (8) home equity lines of credit; (9) loan billing practices relating to simple interest calculations; (10) balloon payments; (11) payoff information; (12) non-English language documentation; and (13) net tangible benefit in loan refinancing. However, we do not know the specific characteristics of Maine settlement loans, except in several cases where we located Household and Beneficial mortgage documents in the District Courts that allowed us to look at the fees.

Stakeholder Interviews

We supplemented empirical data with qualitative data from interviews with a variety of stakeholders. A list of stakeholders interviewed is in Appendix 3.

We contacted 47 stakeholders. We were able to interview 28; the remaining 21 referred us to other individuals. Seven of the stakeholders were lenders: four were subprime mortgage brokers; one was a credit union CEO, and two were bank lenders, with one of these a former subprime mortgage lender. We also interviewed all bankruptcy trustees in the state, housing counselors, two bankruptcy attorneys, two representatives from Maine's Native American tribes, one title company lawyer, and members of non-profit organizations throughout Maine.

The interviews consisted of both face-to-face and telephone conversations based on an interview guide. For all stakeholders we asked whether they saw any of the characteristics outlined as predatory in Section III: excessive points and fees; flipping; steering; balloon payments; prepayment penalties and single premium credit insurance. We then probed for further details and noted additional information provided. In addition we asked lenders questions about their lending practices, such as the types of customers they serve and the products they sell. We also asked for any details of specific predatory cases they knew of,

and attempted to do a full interview with the borrowers involved as detailed below. Stakeholders asked their clients for permission to give contact information to us.

Borrower Interviews

In addition to referrals from stakeholders, we mailed letters to 55 of CEI's housing counseling clients and to the 339 subprime borrowers from the foreclosure records we looked at, asking them to contact us if they thought they were subject to the various practices associated with predatory lending. A short description of these practices was provided in the letter. (See Appendix 4) As a result of the mailing and stakeholder interviews, we completed nine full interviews with borrowers. When possible, we collected individual loan documents and credit histories that document whether predatory lending characteristics were present. As with all interviews there is an element of hearsay involved, and certainly some information is simply not documented, for example a telephone conversation with a lender or broker. Five of these borrowers had full loan documentation and three of the borrowers had partial loan documentation. One borrower did not wish to provide documentation. We obtained initial information from an additional six borrowers who did not wish to be interviewed. We used a survey instrument developed by the Massachusetts Affordable Housing Association to interview mortgagees. Only three individuals were willing to have their information released publicly.

Limitations of Methodology

We can determine characteristics of the subprime mortgage market, but it is very difficult to determine the full extent of predatory lending practices in Maine from existing data sources. The Loan Performance Data Base gives us the best information on loan characteristics, with the widest coverage. Research has shown that certain loan characteristics predict higher foreclosure rates above and beyond what would be expected from a high-risk subprime loan, indicating the likelihood of predatory practices. Given the limitations of the data sources, we believe we are offering the best information available for establishing the extent of predatory mortgage lending in Maine.

APPENDIX 2: ANALYSIS OF LOAN PERFORMANCE DATA FOR MAINE

The following table includes data from the LP Performance database for subprime loans. Since many of these points are used throughout this report, we include this table for convenient reference. The table is intended to be purely descriptive - relevant analysis is included in the body of the paper. The rank is in descending order across 51 U.S. States.

Variables	Pre-ME Law 1995 - 2003		Post-ME Law 2004 – May 2005	
	Actual	Rank	Actual	Rank
Number of loans	15,794	43	11,078	40
Origination (in millions of dollars)	\$1,632	41	\$1,570	39
Potential Steering (FICO \geq 660 and Full documentation and below jumbo)	18.05%	34	15.23%	43
Prepayment Penalties (PPP)	12.07%	51	14.79%	44
PPP exceeding 24 months	10.99%	49	12.82%	38
Balloon Payments	1.29%	51	0.53%	50
Loan To Value exceeding 100%	8.36%	39	7.19%	44
Mean Origination Amount (in dollars)	104,000	23	142,000	23
Mean Initial Interest Rate	9.47%	29	7.42%	23
Fixed Interest Rates	52.72%	33	40.36%	18
Adjustable Rate Mortgages (ARM)	1.23%	27	0.01%	50
Hybrid ARMs	44.04%	7	55.8%	13
Fixed rate interest-only	0.01%	44	0.31%	44
ARM Interest-only	0.66%	28	3.00%	44
Mortgages used for Home Purchase	25.15%	41	27.69%	51
Mortgages used for cash-out refinances	59.60%	7	64.69%	1
Refinance mortgages with no cash-out	12.91%	36	7.55%	45
Mortgage size exceeding Fannie and Freddie limits	3.35%	26	3.27%	28
Mortgages in first lien positions	87.38%	7	94.69%	7
Mortgages with full documentation	64.96%	38	62.92%	30
Mortgages on properties in rural areas	48.13%	5	52.46%	4
Mortgages on properties in non-central city	30.26%	37	31.93%	38
Mortgages on properties in central cities	12.19%	48	13.46%	45
Mortgages on Single Family Residences	86.47%	22	83.85%	21
Mortgages on owner-occupied properties	87.78%	27	88.41%	14

APPENDIX 3: LIST OF STAKEHOLDERS INTERVIEWED

Contact	Organization	Interview type and Date
Aaron Greenlaw	Houlton Maliseet	Telephone – June 8, 2005
Alex Cuprak	Pine Tree Legal Services	Telephone – June 3, 2005
Anthony Armstrong	Maine Home Mortgage	Personal – October 13, 2005
Berry Schklair	Bankruptcy Attorney in Portland	Telephone – August 3, 2005
Betsy Harrington	Mortgage Lender, Bath Savings Institution	Telephone – October 14, 2005
Chet Randall	Pine Tree Legal Services	Telephone - August 4, 2005
Chris LaRouche	York County CAP	Telephone – June 7, 2005
Cindy McDougall	Mortgage Lender, Maine Bank and Trust	Telephone – October 2005
Dan Daggett	Bowdoinham Federal Credit Union	Telephone August 2, 2005 and subsequent clarification by email
Debbie-King-Johnson	Maine State Housing Authority	Telephone – June 3, 2005
Debbie Trenoweth	Community Concepts	Telephone – July 21, 2005
Gail Phoenix	Auburn City	Telephone – June 8, 2005
Gary Growe	Chapter 7 Bankruptcy Trustee, Bangor	Telephone – August 9, 2005
Gary LaGrange	Western Maine Community Action	Telephone – June 3, 2005
Gloria Bryant	Gloria Bryant Mortgage, Brunswick	Telephone – November 30, 2005
John Connors	Independent Mortgage Broker	Personal – August 17, 2005
John MacVane	Independent Mortgage Broker	E-mail – multiple throughout Summer 2005
John Turner	Chapter 7 Bankruptcy Trustee, Auburn	Telephone – August 9, 2005
Kathy McElway	Penquis CAP	Telephone – July 21, 2005
Kevin Washburn	Coastal CAP	Telephone – June 22, 2005
Kim Moulton	Kennebec Valley CAP	
Mary Boylan	Washington-Hancock CAP	Telephone – June 3, 2005
Mary Elwell	Rural Community Action Ministries	Telephone – July 25, 2005
Matthew McDonald	Land America Title Company	Telephone – August 8, 2005
Maurice Jeffries	Portland Regional Opportunities Program	Telephone – June 3, 2005
Neil Shankman	Attorney dealing with Bankruptcies in Southern/Midcoast Maine	Personal – July 27, 2005
Peter Fessenden	Chapter 13 Bankruptcy Trustee	Personal – August 1, 2005 and ongoing contact
Tami Connolly	Four Directions Development Corporation	Telephone – July 21, 2005

In addition, we interviewed the following individuals who did not report experience with predatory lending. We expected that this would be the case with many interviewees, since some of the people listed here do not work directly in housing or housing counseling, but we wanted to cast our nets widely in search of potentially useful information.

Contact	Organization
Al Smith	Bath Community Economic Development
Ardis Copeland	Western Maine Community Action
Bruce D. McLean	MAGIC, Millinocket
Carmella Clement	Consumer Credit Counseling, ME
Carol Thomas	Coastal Economic Development
Charles Sias	Penobscot TRIAD
Dale Holmes	Rural Development
Eliose Vetelli	Women, Work, Community
Eugene Coulgue	Millinocket Town Manager
Florence Young	Casey Family Services, Portland
Gale Kelley	Senator Snowe's Office (Former Mayor of Brewer, Member of Penobscot and Washington County Transition Teams)
Gary La Grange	Western Maine CAP
Jane Searles	Women, Work, Community
Jeff Heron	Aroostook CAP
Judson Esty-Kendell	Pine Tree Legal Services, Bangor
Ken Feller	Coastal Economic Development
Maurice Jeffries	Portland Regional Opportunities Program
Rhoda Butler	York CAP
Vickey Doughty	Portland Regional Opportunities Program
Vicki York	Waldo CAP
Yvette Bouttenot	Lewiston Housing

APPENDIX 4: LETTER TO SUBPRIME BORROWERS FROM FORECLOSURE RECORDS & CEI HOUSING COUNSELING CLIENTS

Dear “Consumer”:

In the past you received housing counseling from Coastal Enterprises, Inc. We are writing to let you know about an important study that we are currently undertaking. We are conducting research on subprime mortgage lending in our state.

As part of this research, CEI is seeking to interview mortgage borrowers who feel that they may have been subject to unfair or abusive lending practices. The goal of the study is to document whether any abusive practices are taking place in the Maine subprime mortgage market. **Subprime loans are made to borrowers who have less than perfect credit** (usually below 620). **These loans tend to charge more in interest rates and fees.** CEI intends to use the research for educational and advocacy purposes so that consumers are protected in the future.

How you can help:

If you are a subprime borrower and feel that you have been victim to unfair, deceptive or misleading lending practices then **CEI wants to hear from you!**

CEI is particularly concerned with the following practices:

- (1) Lenders providing **false or misleading information** about loan terms, or using **“high pressure” sales tactics**;
- (2) Loan-terms such as:
 - a. **early payment penalties** (known as prepayment penalties),
 - b. **very high interest rates** (at the moment the interest rate for someone with good credit over 620 would be in the range of 4.5 - 6 %)
 - c. **points and fees paid to the mortgage broker in excess of 3%** (\$3,000 on a \$100,000 loan),
 - d. **mandatory arbitration** clauses (you are unable to take the lender to court)
 - e. **balloon payments** (large final payments at the end of the mortgage term)
 - f. **single-premium credit insurance** (credit insurance will pay your mortgage in the event that you can't pay, for example if you were incapacitated and unable to work. It is problematic when paid for in one payment at the start of the loan).

If you are a subprime borrower and have experienced any of these practices, or other practices that you feel are questionable while purchasing or refinancing your home, please contact CEI's toll free number: 1-877-340-2649 and ask to speak with Hannah Thomas, Research Associate ext. 127 or email her at hlt@ceimaine.org.

Participation in this study is entirely voluntary. Your eligibility for future financial counseling or participation in other home-ownership/financial assistance programs will not be affected by your decision to participate or not participate in the study. **We will keep your information confidential if you do not want to be publicly identified.**

Through this study, and subsequent efforts, we hope to help protect consumers from abusive lending practices.

Thank you for your assistance.

Sincerely,

Jill Lorom
Housing Counselor

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