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After the Storm: Asymmetrical Information, Game Theory, and an Examination of the "Minnesota Model" for National Regulation of Mortgage Brokers and Tomorrow's Predatory Lenders

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AFTER THE STORM: ASYMMETRICAL INFORMATION, GAME THEORY, AND AN EXAMINATION OF THE “MINNESOTA MODEL” FOR NATIONAL REGULATION OF MORTGAGE BROKERS AND TOMORROW’S PREDATORY LENDERS

Mark Ireland†

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“There’s no question about it. Wall Street got drunk.”¹
—President George W. Bush

There is a general consensus that the root cause of the most recent turmoil in the domestic and global financial markets was the failure to properly regulate mortgage lending and consumer debt.²

² Timothy Geithner & Lawrence Summers, A New Financial Foundation, Wash. Post, June 15, 2009, at A15 (“This current financial crisis had many causes. It had its roots in the global imbalance in saving and consumption, in the
Regardless of whether the United States is now at the beginning, middle, or end of what some call the “Great Recession,” it is clear that there will be regulatory reform in response to this failure. Indeed, some reforms have already occurred. Other reforms are being debated. These initial reforms, however, have been largely structural. The government still needs specific regulation of the day-to-day conduct of mortgage brokers and lenders.

Part I of this article provides a brief history of the rise of the subprime and Alt-A mortgage industry, the economic and regulatory environment in which that rise occurred, and the disastrous consequences of failed government policies. Part II analyzes the failure to properly oversee mortgage lending and the selling of mortgage backed securities through the lens of two economic concepts: asymmetrical information and game theory. Part III outlines Minnesota’s Anti-Predatory Lending Law, one of the toughest and most comprehensive mortgage lending statutes in the country, and discusses the first case brought under this law. Part IV concludes by analyzing how the Minnesota Anti-Predatory Lending Law could serve as a model for national regulatory reform.

I. THE RISE OF SUBPRIME AND ALT-A MORTGAGES

Creating a response to the foreclosure and economic crisis requires a clear understanding of how the crisis occurred. There are some who blame the Community Reinvestment Act. The widespread use of poorly understood financial instruments, in shortsightedness and excessive leverage at financial institutions. But it was also the product of basic failures in financial supervision and regulation. Our framework for financial regulation is riddled with gaps, weaknesses and jurisdictional overlaps, and suffers from an outdated conception of financial risk.”


4. GEORGE SANTAYANA, THE LIFE OF REASON 82 (1905) (“Progress, far from consisting in change, depends on retentiveness. When change is absolute there remains no being to improve and no direction is set for possible improvement: and when experience is not retained, as among savages, infancy is perpetual. Those who cannot remember the past are condemned to repeat it. In the first stage of life the mind is frivolous and easily distracted, it misses progress by failing in consecutiveness and persistence. This is the condition of children and barbarians, in which instinct has learned nothing from experience.”).

Community Reinvestment Act, aimed at preventing red-lining and reverse red-lining, prohibited federally insured banks and thrifts from limiting loans or prohibiting loans offered in certain neighborhoods. Critics of the Community Reinvestment Act argue that the government itself was to blame for the current economic crisis by forcing innocent lenders to originate loans to high-risk black and Hispanic borrowers. For example, Ann Coulter wrote an article titled, “They Gave your Mortgage to a Less Qualified Minority.” In her article, Ms. Coulter argues that the foreclosure and economic crisis was caused by “political correctness being forced on the mortgage lending industry in the Clinton era.” She then posits that banks were forced to ignore credit scores and lend based on “nontraditional measures of credit-worthiness, such as having a good jump shot or having a missing child named Caylee.”

This theory, related to the Community Reinvestment Act, has largely, if not entirely, been de-bunked. The most high-risk lending occurred through non-bank lenders that were not even covered by the Community Reinvestment Act. Some estimates are that three-quarters of the sub-prime loans that were originated by non-bank lenders during the real estate boom were not subject to the Community Reinvestment Act. This is, of course, assuming that the Act requires lenders to give loans to people who have good jump shots, which it does not.

Sub-Part A of this section posits that the root cause of the crisis was the regulatory structure itself, or lack thereof, and three critical decisions made by the government from 1999 to 2004 to weaken oversight of the financial services industry. Sub-Part B of this section connects these three decisions to the sudden rise of sub-prime and Alt-A loan, from less than 5% of all mortgage

(summarizing and citing various commentaries blaming the Community Reinvestment Act for the foreclosure crisis).

6. Id. at 11.

7. Id.


9. Id.

10. Id.

11. See id. at 12–14.

12. Id. at 12.

13. Id. at 13–14.
originalizations in 2000 to 40% of the mortgage market at the time of
the crash.

A. The Regulatory Environment

On January 23, 1996, President Clinton famously stated “The
era of big government is over.” Then, arguably influenced by
approximately $1 billion in bi-partisan campaign contributions
from the financial services industry, Congress began systematically
dismantling the regulation of lenders and financial institutions.
First, Congress passed the Gramm-Leach-Bliley Financial Services
Modernization Act of 1999 (GLB), removing restrictions that
prevented various financial services industries from merging,
growing larger, and becoming too big to fail. Second, Congress
passed the Commodity Futures Modernization Act of 2000,
removing the prohibition on unregulated derivatives or “side-bets”
that stocks or other financial instruments are going to rise or fall.
Third, Congress allowed the Securities and Exchange Commission
to double the amount of debt that investment companies, like Bear
Stearns and Lehman Brothers, were allowed to accrue. Each of
these actions created a regulatory environment that was ill-
equipped to manage billion-dollar companies that engage in risky
behavior.

1. Gramm-Leach-Bliley Financial Services Modernization Act of
1999

On November 12, 1999, Congress passed GLB. GLB
eliminated the depression-era regulations set forth in the Glass-
Steagall Act, which limited the permissible activities of a bank. For
example, a bank could not sell insurance or have subsidiaries that
did nonbanking activities under the Glass-Steagall Act. With GLB,

14. President William Jefferson Clinton, State of the Union Address (Jan. 23,
page/5.
15. Center for Responsive Politics, Finance, Insurance, Real Estate: Long Term
insurance and real estate industries contributed over $2.2 billion from 1990 to
2009, and approximately $1 billion from 1996 to 2004).
Markham, Banking and Insurance: Before and After the Gramm-Leach-Bliley Act, 25 J.

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Markham, Banking and Insurance: Before and After the Gramm-Leach-Bliley Act, 25 J. 

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such restrictions were eliminated. The only major requirement was that the activities were done under the umbrella of a “Financial Holding Company” and “complimentary” to the bank’s other activities. 18

At its core, there were two fundamental flaws with GLB. While sanctioning large, integrated financial, insurance, and investment businesses, the drafters failed to reform or modernize the oversight of these businesses. GLB retained separate and distinct regulatory agencies across various industry segments. 19 None of these regulators had the resources, authority, or jurisdiction to handle a major economic crisis, as found in a report issued by the U.S. Government Accounting Office in 2004 (four years prior to the height of the current economic crisis). 20 That report, in part, noted that the fractured regulatory system undermined the ability of the government to identify problems in their early stages. 21

Not only did this fractured system allow predatory financial products to “fall through the cracks,” as stated by former Treasury Secretary Henry Paulson, it also created a dangerous environment wherein federal regulators competed with one another to be the regulator-of-choice for financial companies. 22 Federal regulators also deemphasized their role as consumer protection agencies and were arguably captured by the industries they regulated. 23

21. Id.
22. Moran, supra note 19, at 96; Diana McMonagle, Comment, In Pursuit of Safety and Soundness: An Analysis of the OCC’s Anti-Predatory Lending Standard, 31 FORDHAM URB. L.J. 1533, 1541–42 (2004) (summarizing the argument that federal regulators are in a “race to the bottom” often fueled by their need to obtain examination fees to fund their agencies).
In addition to the restrictions that GLB eliminated, the drafters and supporters of GLB deliberately chose not to create regulations for hedge funds or derivatives. Hedge funds are private pools of capital that are not open to the public, which means that there are few public statements about a fund’s activities and minimal transparency even to the investors who have provided the fund managers with millions of dollars. Estimates of the size of the hedge fund industry ranged from $1.2 to $2.4 trillion at its peak.

Derivatives are essentially side-bets on whether a stock, bond, or the overall market will increase or decrease in value that do not require the bettor to ever purchase or sell the security itself. For example, a derivative may be a bet related to whether the Standard & Poor’s 500 Index will rise or fall. It is used by responsible investors to hedge against losses, but can easily be abused.

The earliest derivatives were sold in businesses called “bucket shops” and were just another form of gambling. Many blame that federal regulators often do not place consumer protection as their primary goal; H.D. Vinod, Conflict of Interest Economics and Investment Analyst Biases, 70 Brook. L. Rev. 53, 57 (2004) (“Unfortunately, what followed [the passage of GLB] was predicted by economists’ ‘capture theory’ of regulation: sophisticated and powerful financial institutions with considerable political clout simply captured or co-opted the regulators.”).

24. Duff McDonald, Running of the Hedgehogs, N.Y. MAG., Apr. 9, 2007, available at http://nymag.com/news/features/2007/hedgefunds/30341 (stating that hedge funds are high risk and high reward that rely on leverage: “[T]hat means big bets with little or no downside protection. In a word, risky.”); Carrie Johnson, Scrutiny Urged for Hedge Funds, WASH. POST, June 29, 2006, at D02 (quoting Marc Kasowitz, a lawyer suing various hedge funds, who stated “no one” knows within a trillion dollars how large the hedge fund industry is and Senator Orrin Hatch who described hedge funds as the “Wild West of our financial markets”).

25. Johnson, supra note 24, at D02.


27. See Kim, supra note 26.

28. See id.

29. 60 Minutes: The Bet That Blew Up Wall Street (CBS television broadcast report by Steve Kroft Oct. 26, 2008) (“In the early part of the 20th century, the streets of New York and other large cities were lined with gaming establishments called ‘bucket shops,’ where people could place wagers on whether the price of stocks would go up or down without actually buying them. This unfettered speculation contributed to the panic and stock market crash of 1907, and state
these bucket shops as one of the causes of the stock market crash of 1929, and laws were passed to ban bucket shops. Despite these early laws, derivatives rose to prominence again in the 1980s. The risks, however, remained the same. Indeed, a May 1994 report to Congress by the General Accounting Office was entitled Financial Derivatives: Actions Needed To Protect the Financial System.

Both hedge funds and derivatives encourage unsustainable borrowing and leveraging that resembles a Ponzi scheme. Ultimately, it undermines the entire economy. It is what economist Hyman Minsky described over fifty years ago as his “financial instability thesis”:

When the economy was strong and interest rates were low, Minsky said, firms would borrow themselves (and the economy as a whole) into periods of acute financial fragility, hence the economy’s ‘tendency to explode.’ This tendency to explode resulted from structural biases in capitalist economies towards increasingly riskier forms of financing by firms.

Recognition of this risk was one of the primary reasons that Senator Byron Dorgan chose not to support GLB. In fact, his speech against GLB on the floor of the senate was incredibly prescient. More than any other, the speech accurately predicted the need for a massive government intervention just nine years later:

Is it part of financial modernization to say this sort of nonsense ought to stop; that banks ought not be able to trade derivatives on their own proprietary accounts because that is inherently gambling? . . . Does anybody

laws all over the country were enacted to ban them.”) available at http://www.cbsnews.com/stories/2008/10/26/60minutes/main4546199.shtml. See also Kenneth C. Kettering, Securitization and its Discontents: The Dynamics of Financial Product Development, 29 CARDOZO L. REV. 1553, 1655 (2008) (introducing the creation of “bucket shop” laws).

30. See 60 Minutes, supra note 29.
31. See Kettering, supra note 29 (describing the creation of “bucket shop” laws in “the late 1800s and early 1900s”).
32. Id. at 1654 (stating that “[t]he market in over-the-counter derivatives grew from essentially nothing to enormous size in the course of the 1980s”).
35. See id.
36. Id. at 491.
think it makes any sense to have hedge funds out there with trillions of dollars of derivatives, losing billions of dollars and then being bailed out by a Federal Reserve–led bailout because their failure would be so catastrophic to the rest of the market that we cannot allow them to fail?

And as banks get bigger, of course, we also have another doctrine. The doctrine in banking at the Federal Reserve Board is called “too big to fail.” Remember that term, “too big to fail.” It means at a certain level, banks get too big to fail. They cannot be allowed to fail because the consequence on the economy is catastrophic and therefore these banks are too big to fail. Virtually every single merger you read about in the newspapers these days means we simply have more banks that are too big to fail. That is no-fault capitalism: too big to fail. Does anybody care about that? Does the Fed? Apparently not.

We have all these folks here who know a lot more about this than I do, I must admit, who say: [e]xcept we are creating firewalls. We have subsidiaries, we have affiliates, we have firewalls. They have everything except common sense; everything, apparently, except a primer on history. I just wish, before people would vote for this bill, they would be forced to read just a bit of the financial history of this country to understand how consequential this decision is going to be. 

Despite Senator Dorgan’s speech, GLB overwhelmingly passed in the Senate and House of Representatives. In the Senate, only nine Senators voted against GLB. It passed in the House of Representatives on a 362 to 57 vote, and then was signed by President Clinton a few days later.

2. The Commodity Futures Modernization Act

Approximately a year after the passage of GLB, the absence of regulation related to derivatives, specifically credit default swaps, became the express policy of the United States. In the late 1990s, the Commodities Futures Trading Commission attempted to fill the regulatory vacuum and oversee credit default swaps, but these

efforts were challenged legally and publicly.\textsuperscript{38} One of the highest profile critics of efforts to regulate derivatives was Federal Reserve Chairman Alan Greenspan.\textsuperscript{39} Chairman Greenspan spoke out against regulation, even recanting his earlier support for regulating professional investors of derivatives.\textsuperscript{40}

Then, in the waning days of the Clinton administration, Senator Phil Gramm inserted a 262-page amendment called the Commodity Futures Modernization Act of 2000 into a much larger omnibus spending bill.\textsuperscript{41} Without debate or even a hearing in the House of Representatives, the modern unregulated derivatives market was born.\textsuperscript{42} The Commodity Futures Modernization Act of 2000 exempted most derivatives from federal oversight and regulation as well as preempted any state laws that may have prohibited the activity.\textsuperscript{43}

Although derivatives based on securities, like stocks, may be regulated, derivatives on non-securities were exempted from the Act.\textsuperscript{44} Therefore, credit default swaps based on pools of debt (like mortgages) were free from regulation because pools of debt are not technically securities.\textsuperscript{45}

3. \textit{Blessing the Over-Leveraging of Wall Street Investment Banks}

The capital that investment banks or broker-dealers must

\begin{thebibliography}{9}
\bibitem{40} \textit{Id.}
\bibitem{42} See 60 Minutes, \textit{supra} note 29.
\bibitem{43} The Commodities Futures Modernization Act, 15 U.S.C. §§ 77b-1, 78c-1 (2000) (providing that swap agreements such as credit default swaps are not securities); see also Kamman \& Hood, \textit{supra} note 38 (discussing the Gramm-Leach-Bliley Act, 15 U.S.C. § 78c-1 (2006), which defines securities-based swaps and provides the Securities and Exchange Commission only the authority to regulate securities based swaps for fraud and nothing else, as well as no authority for non-securities-based swaps).
\bibitem{44} See 15 U.S.C. §§ 77b-1, 78c-1.
\bibitem{45} \textit{Id.}
\end{thebibliography}
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maintain is governed by the Net Capital Rule, which was established in the mid-1970s. The Net Capital Rule, in essence, requires investment banks to review their balance sheets and categorize their tradable assets at market prices. A categorization of assets includes equities or stocks, as well as Treasury bills or bonds. Then, a discount or “haircut” is applied for each category, meaning an investment bank must set aside a certain amount of capital to protect itself from risk and market volatility. For example, equities had required a 15% haircut. The Net Capital Rule also required that broker dealers limit their debt-to-net capital ratio.

The catalyst for originally passing this rule was the Securities and Exchange Commission’s concern about small, fly-by-night firms destabilizing the market and causing a “race to the bottom.” But, in 2004, support for the Net Capital Rule began to wane. The SEC, concerned that the rule was too strict and would drive investment banks overseas, created a special program for the largest firms or broker-dealers. This new program was an alternative to the existing Net Capital Rule and its ratio requirements. Specifically, a broker-dealer that had capital of over $5 billion could, under the new Consolidated Supervised Entities program, use its own computer models as an alternative method of calculating ratio requirements. The program was essentially a very high-profile, high-stakes experiment in self-regulation. This, in practice, allowed for much higher amounts of debt.

Five broker-dealers immediately volunteered for the program:

47. Darcy, supra note 46, at 624; Satow, supra note 46.
48. Satow, supra note 46; see Darcy, supra note 46, at 625 n.191.
49. Satow, supra note 46.
50. Id.
51. Satow, supra note 46.
52. Id., supra note 46, at 624.
53. See id.
54. See id.
55. Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, 17 C.F.R. §§ 200, 240 (2004); Satow, supra note 46.
56. Satow, supra note 46.
Bear Stearns, Lehman Brothers, Merrill Lynch, Goldman Sachs, and Morgan Stanley. Debt-to-net capital ratios soon became imbalanced, some as high as 40-to-1. Now, only Goldman Sachs and Morgan Stanley exist, but neither are broker-dealers. Goldman Sachs and Morgan Stanley reorganized and obtained a federal charter to simply be bank-holding companies.

In March 2008, Bear Stearns collapsed following the fall of two large hedge funds and the withdrawal of millions of dollars by major investors. Soon, JPMorgan Chase & Co. swept in to buy Bear Stearns with the encouragement and blessing of the government, and Bear Stearns, as an independent entity, disappeared after eighty-five years. Lehman Brothers collapsed in mid-September 2008 and declared bankruptcy after failing to locate a buyer and the government refusing to bail out the company. And, on the brink of collapse, Bank of America purchased Merrill Lynch for $50 billion. It was a deal that was not only facilitated by the government, but also one in which Bank of America’s CEO claims the company was forced by the federal government to cooperate.

B. The “Giant Pool of Money” and the Perfect Storm

Along with a lax, if not non-existent, regulatory environment, there was also a perfect storm of other factors that radically transformed the housing sector in the United States and,

57. Id.
58. Id.
60. Id.
62. Id.
65. Andrews, supra note 64.
ultimately, created the current financial crisis. At the center of the storm, there was what a National Public Radio program described as a “giant pool of money.” The giant pool of money is all the money in the world that people are saving in case of a catastrophe, retirement, education, or just a rainy day. This giant pool of money equaled $70 trillion. It had doubled over the past few years from $36 trillion in 2000 to $70 trillion, as traditionally poorer countries became richer countries. This pool of money did not and does not just sit in a bank. Rather, people are responsible for safely investing such money to provide a nice profit for the bank as well as stability for the depositor.

While the amount of money needed to be safely invested grew, the traditionally safe investment vehicles, like United States Treasury bonds, were no longer providing a sufficient return for the managers of the giant pool of money. The value of the Treasury bonds’ return was suppressed by the extremely low interest rates at the time, about 1%. Therefore, the investors started looking for other financial products that were both low risk and provided a better return on the investment.

The answer to this problem came in the form of Collateralized Debt Obligations (CDOs), Asset-Backed Securities (ABS), or Mortgage Backed Securities (MBS). These are all roughly the same things: debt that has been pooled, converted into income streams, further divided, ranked, and transformed into bonds.


67. Id.

68. Id.

69. Id.

70. Id.

71. Id.

72. Id.

73. Id.

74. Id.


76. Peterson, supra note 75, at 2203.
Through these financial products, the managers of the giant pool of money were told they could have the security of an investment in a home mortgage loan without the hassle of dealing with actual homeowners.\footnote{This American Life: The Giant Pool of Money, supra note 66.}

Due to the size of the giant pool of money and the early success of these securities, the demand was strong.\footnote{Id.} However, in order for Wall Street to sell CDOs, ABS or MBS to the managers of the giant pool of money, Wall Street needed a significant number of mortgages—far more than were historically being originated.\footnote{Id.} In response to this demand, underwriting standards deteriorated and the mortgage industry promoted new products that invited fraud and seemed pre-destined for foreclosure, such as a NINJA loan (No Income, No Job or Assets), a NINA (No Income, No Assets), stated-income, stated assets (no verification of application information, underwriting merely based on applicant’s statements), interest only mortgages, and Option Adjustable Rate Mortgages (ARMs) or Pick-A-Payment loans.\footnote{LoanBiz.com, Alternative Documentation Loans: A Mortgage Solution for the Self Employed, http://www.loanbiz.com/alternative-documentation-loans-a-mortgage-solution-for-the-self-employed.htm (last visited August 12, 2009).}

The Option ARM or Pick-A-Payment loan was particularly lucrative and dangerous.\footnote{Mara Der Hovanesian, Nightmare Mortgages, BUSINESSWEEK, Sept. 11, 2006, available at http://www.businessweek.com/magazine/content/06_37/b400000.htm; Jo Carrillo, Dangerous Loans: Consumer Challenges to Adjustable Rate Mortgages, 5 BERKELEY BUS. L. J. 1, 20–21 (2008) (describing the various types of adjustable rate mortgages, including Option ARMs).} Option ARMs are a type of mortgage that typically provides the consumer three choices each month: (1) a fully amortizing payment—meaning a part of the payment pays both the interest and part of the principal balance, which causes the principal balance to go down; (2) an interest only payment, meaning that the principal amount of the loan stays the same and the homeowner pays only the interest; and (3) a negatively amortizing payment, meaning that the homeowner’s payment neither reduces the principal balance nor does it eliminate the accrued interest—the principal amount of the loan actually goes up.\footnote{Carrillo, supra note 81.}

Option ARMs were originally created for a small niche market
of wealthy home buyers in the early 1980s. The product provided these wealthy home buyers with flexibility, as well as the ability to keep money that would ordinarily be used on a house payment available for other more lucrative investments. But, as home prices dramatically increased in certain markets from 2000 to 2007, unregulated brokers and banks pushed these products as a way to qualify more people for more expensive homes. This further inflated the housing bubble, and justified the origination of even more Option ARMs.

Now, 80% of all option ARM borrowers make only the minimum payment each month, which means that they are not even paying the interest on their loan. With the decrease in property values, many of these homeowners have no equity and are severely “underwater,” meaning they owe more on their mortgage than the home is worth. During the boom, the banks and owners of these mortgages were generally unconcerned, because the Generally Accepted Accounting Principles (GAAP) accounting rules allow them to report “phantom profits.” Specifically, GAAP allows banks and investment companies to count as revenue the highest amount of an option ARM payment, the fully amortizing amount, even when borrowers choose to make only the minimum payment. In essence, banks and investment companies pretend that homeowners are paying more than they are paying each month toward the homeowners’ mortgages, which, in turn, inflates their earnings per share.

These exotic mortgage products were a breeding ground for a variety of illegal behavior. A 2006 study on behalf of the Mortgage Bankers Association found that 90% of all applications for stated income loans contained inflated income, and over 60% were inflated by more than 50%. The authors of the report warned:

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83. Der Hovanesian, supra note 81.
84. This American Life: The Giant Pool of Money, supra note 66.
85. Id.
86. Id.
87. Der Hovanesian, supra note 81.
88. James Carlson, To Assign, Or Not To Assign: Rethinking Assignee Liability As A Solution To The Subprime Mortgage Crisis, 2008 COLUM. BUS. L. REV. 1021, 1033 (2008).
89. Der Hovanesian, supra note 81.
90. Id.
91. Id.
"[s]tated income and reduced documentation loans speed up the approval process, but they are open invitations to fraudsters."

Government regulators did not intervene and issue regulations related to stated income and low-documentation loans, so lenders continued to compete furiously with one another to acquire these loans from brokers. In an article entitled "Sex, Lies, and Subprime Mortgages," the untoward conduct included untrained, uneducated, female mortgage wholesalers who received million-dollar salaries to acquire mortgage loans from brokers and get underwriters to approve loans via sexual favors. The article further describes bribes and spiffs, fabricated documents, doctored pay stubs and bank account statements, embellished applicant job titles, and harassment of underwriters who refused to approve dubious loans.

C. Sub-Prime and Exotic Mortgages Go Mainstream and Then Go Boom

"From 2000 to 2006, there was a dramatic increase in the number of sub-prime or Alt-A mortgages" described above. In 2000, the percentage of subprime mortgages comprised about 2% of the overall mortgage market. In 2003, the percentage of subprime mortgages increased to about 8%. In 2006, the percentage more than doubled to 22%. In the meantime, the Alt-A market of exotic mortgages was created and soon occupied 18% of the total mortgage marketplace. This growth in sub-prime and Alt-A mortgages means that the overall percentage of risky, toxic mortgages went from less than 5% to 40% of the overall housing market in less than seven years.

93. Id.
94. Id.
96. Id.
98. Id.
What made these mortgages so toxic were the terms. Eighty-nine to ninety-three percent of the subprime mortgages generated during this period came with an exploding adjustable interest rate after the initial teaser interest rate expired, and subprime adjustable rate mortgages were set to adjust from 7% to 12%. As the amount of equity decreased and underwriting standards tightened, individual homeowners were no longer able to refinance their toxic mortgages and were forced to sell or go into foreclosure.

Although there are no authoritative, historic compilations of foreclosure data, there is little doubt that foreclosure rates are at high levels. It has been estimated that the nationwide foreclosure rate has more than doubled in the past eight years and is at the highest level in more than twenty-five years. The Center for Responsible Lending estimates that 15% of all subprime mortgages will result in foreclosure. These foreclosures, in the aggregate, will cause neighboring properties to lose billions of dollars in value and will thereby increase the number of blighted communities nationwide.

100. Ireland & Norton, supra note 97; Danielle DiMartino and John V. Duca, The Rise and Fall of Subprime Mortgages, ECONOMIC LETTER Vol. 2, No. 11 (Federal Reserve Bank of Dallas, Dallas, Tex.), Nov. 2007 (“Some 80 percent of outstanding U.S. mortgages are prime, while 14 percent are subprime and 6 percent fall into the near-prime category. These numbers, however, mask the explosive growth of nonprime mortgages. Subprime and near-prime loans shot up from 9 percent of newly originated securitized mortgages in 2001 to 40 percent in 2006.”), available at http://www.dallasfed.org/research/eclett/2007/el0711.html#1.
103. Id. at 691.
105. Cox, supra note 101, at 691. See also Ctr. for Responsible Lending, Subprime Spillover, Foreclosures Cost Neighbors $202 Billion; 40.6 Million Homes Lose $5,000 on Average (Jan. 18, 2008), http://www.responsiblelending.org
II. AN OVERVIEW OF ASSUMPTIONS AND REALITIES IN THE MODERN MORTGAGE LOAN MARKET USING THEORIES OF ASYMMETRICAL INFORMATION AND ECONOMIC GAME THEORY AS A GUIDE

The intellectual underpinnings for the decisions outlined in Part I were set forth in the “competitive equilibrium paradigm” articulated by Adam Smith,106 John Maynard Keynes,107 and Ayn Rand:108 free markets inherently lead to Pareto-efficient outcomes, particularly if the government gets out of the way.109 Supporters of deregulation believed that there was no need for government regulation and oversight, because the market could effectively police itself.110 Why would a company ever do something that is not in its self-interest?

Supporters of deregulation also believed that issues created by asymmetrical information in mortgage lending—meaning that borrowers know more about their ability to repay the principal than lenders111—could be overcome by the lenders themselves and that the government was no longer needed.112 Lenders can use mathematical models to discern key indicators of credit worthiness.113 With computers and other sophisticated systems to

109. Joseph E. Stiglitz, Professor, Columbia Univ., Information and the Change in the Paradigm In Economics, Nobel Prize Lecture at 472 & 503–504 (Dec. 8, 2001), available at http://nobelprize.org/nobel_prizes/economics/laureates/2001/stiglitz-lecture.pdf (arguing that the market’s failure to effectively police problems, such as pollution, illustrates how “informational imperfections” in an economy may necessitate a government intervention).
110. Id. (“[T]he most important single idea in economics is that competitive economies lead, as if by an invisible hand, to a (Pareto) efficient allocation of resources...”).
112. See id. at 505 (noting that asymmetries of information result in imperfect competition and thereby impede market efficiency).
113. Id. at 477 (“Some, like George Stigler, while recognizing the importance of information, argued that once the real costs of information were taken into account, even with imperfect information, the standard results of economics would still hold. Information was just a transactions cost.”).

For example, at the height of the mortgage boom, Chairman Alan Greenspan touted the deregulation and consolidation resulting from the passage of GLB as a boon to consumers.\footnote{115. Id.} He stated that “technological advancements” and complex algorithms could now accurately predict risk:

With these advances in technology, lenders have taken advantage of credit-scoring models and other techniques for efficiently extending credit to a broader spectrum of consumers. . . . Where once more-marginal applicants would simply have been denied credit, lenders are now able to quite efficiently judge the risk posed by individual applicants and to price that risk appropriately.\footnote{116. Id.}

In addition to technology, lenders were also relying heavily on three tools that many economists believed could mitigate the risks of asymmetrical information: signaling, screening and separating, and guarantees. But all of these tools failed.

Sub-Part A of this Section provides a brief definition of the tools used by the mortgage lending industry, and then Sub-Part B of this article uses economic game theory to explain why the tools of signaling, screening, and guarantees did not work. Sub-Part A and Sub-Part B are included in this article because it is important to consider how these tools could have been effective when complemented by effective government regulation. In essence, effective and targeted government regulation can ensure that bad actions have consequences that the free market cannot provide.

\textbf{A. Asymmetrical Information in Mortgage Lending and the Common Tools Used to Mitigate Risk}

One of the most important modern developments in economic theory is the recognition that information plays a critical role in a functioning economy, and that asymmetrical information can have a negative impact on proper pricing and efficiency of the

Stiglitz, Spence, and Akerlof were pioneers in asking questions about why consumers and sellers often act irrationally or not in their best interests; ultimately having adverse affects on the market. Their conclusion was that in such situations there is an asymmetry of information.

A mortgage transaction is one example of a market with asymmetrical information. In these transactions, it has traditionally been assumed that the lender is in the weaker bargaining position because the homeowner obviously has more information about his or her own ability to pay. In response, the lending industry developed tools to evaluate borrowers. Three of the most common tools are signaling, screening and separating, and guarantees.

1. Signaling Through Credit Scores

The theory behind signaling and signaling models is that there is necessary information that one party does not have and cannot readily obtain, which requires that party to look at other attributes to “signal” the information that is actually sought.

For example, an employer wants to know about the productivity of a job applicant. Yet, the best person with the most accurate knowledge of a job applicant’s productivity is the actual applicant. Therefore, the employer often uses education as a signal of the applicant’s potential productivity. If the applicant’s education is low, it is assumed that the productivity is low. If the applicant’s education is high, it is assumed, based upon the

117. The Royal Swedish Acad. of Scis., supra note 111.
118. Id.
119. The Royal Swedish Acad. of Scis., supra note 111.
120. Id.
121. Joseph E. Stiglitz, Information and the Change in the Paradigm In Economics, 92 AM. ECON. REV. 460, 470 (2002) (“[T]he borrower knows more about the riskiness of his project than the lender does . . .”).
122. Id.
124. Id. at 436–37.
125. Id.
126. Id.
127. Id.
attributes necessary to obtain such an education, that the applicant’s productivity is high.\textsuperscript{128}

In mortgage lending, the credit score was one signal that was often relied upon above all other signals by lenders as well as by the underwriters, Wall Street investment firms, and credit rating agencies.\textsuperscript{129} This was illustrated by the prevalence and popularity of the stated-income and stated-asset loans.\textsuperscript{130} Even after the loans acquired the nickname “liar’s loans” and it was well known that the stated information was very likely to be false, such loans continued to be originated based upon an applicant’s high credit score.\textsuperscript{131}

2. Screening and Separating Through Actions

The theory of both screening and separating is that, faced with a situation wherein a person has limited knowledge, that person can construct barriers or options that force the other party to screen and separate him or herself.\textsuperscript{132} In doing so, the more knowledgeable person conveys the necessary information to the other party.\textsuperscript{133} For example, an insurance company that only wants healthy insureds could locate itself on the fifth floor of a building with no elevator. The willingness of an applicant to walk up the five flights of stairs, or a potential applicant’s decision not to walk up the five flights of stairs conveys information.\textsuperscript{134} The less informed party is forcing the other party to select or reject him or herself.\textsuperscript{135}

Similarly, for example, an insurance company can offer a variety of insurance products, some with high co-payments and high deductibles with low monthly premiums, and others with low

\textsuperscript{128} Id. \\
\textsuperscript{129} Mark Gimein, Inside the Liar’s Loan, SLATE (Apr. 24, 2008), http://www.slate.com/id/2189576/ (“These were not ‘subprime’ loans. The borrowers’ average credit score was 705, well within prime territory.”); E. Scott Reckard, Defaults Exposing Truth of “Liar’s Loans”, L.A. TIMES, Jan. 15, 2008, http://seattletimes.nwsource.com/html/business/technology/2004125368_liarloans15.html (“Numbers from industry trackers suggest that these borrowers — most of whom boast respectable, often top-tier credit scores and appear to have substantial incomes and home equity—are starting to create a second tide of defaults in addition to the subprime-loan meltdown.”). \\
\textsuperscript{130} Reckard, supra note 129. \\
\textsuperscript{131} Id. \\
\textsuperscript{132} Stiglitz, supra note 121, at 463, 472. \\
\textsuperscript{133} Id. at 472. \\
\textsuperscript{134} Id. \\
\textsuperscript{135} Id.
co-payments and low-deductibles with high monthly premiums.\textsuperscript{136} The various products theoretically force potential insureds to separate themselves.\textsuperscript{137} The applicants disclose their own perceptions of their health, based upon the types of plans that they choose.\textsuperscript{138} A healthy individual would likely choose the high co-payment and high-deductible with low monthly premium, because that individual believes they are healthy and wants the lower monthly payment.\textsuperscript{139}

In mortgage lending, the originators of mortgage loans offer a variety of products and interest rates. The belief is that individuals that are the lowest credit risk and the most likely to repay the mortgage loan will not choose a sub-prime or high interest rate loan, because they know that they pay their bills and qualify for a better loan product. Likewise, a sub-prime borrower knows that they are likely to default and have limited credit options. Therefore, they accept the higher interest rate. The credit market, in theory, sorts itself.

In separating, the lender relies heavily upon a mortgage broker to act in a manner that guides the homeowner to the appropriate mortgage product. In practice, it has been found that such efficient and accurate separating did not occur.\textsuperscript{140} Many subprime borrowers could have qualified for prime loans.\textsuperscript{141}

3. Guarantees

In order for a more informed seller to assuage the fears of less informed “buyers,” sellers began offering guarantees to the buyers related to the quality of the goods or services.\textsuperscript{142} A good guarantee conveys needed and otherwise indiscernible information about the product to the buyer.\textsuperscript{143} The better the guarantee, the buyer is intended to assume and believe that the product is better. In that

\textsuperscript{136} Id. at 479. See also Joseph E. Stiglitz, Monopoly, Non-Linear Pricing and Imperfect Information: The Insurance Market, 44 REV. ECON. STUD. 407, 414 (1977).
\textsuperscript{137} Stiglitz, supra note 136 at 414–21.
\textsuperscript{138} Id.
\textsuperscript{139} Id. at 419.
\textsuperscript{141} Id.
\textsuperscript{142} Stiglitz, supra note 121, at 468.
\textsuperscript{143} Id.
sense, a guarantee is a type of signal.\textsuperscript{144} It is, however, more direct than employment history, education, or credit scores in determining the likelihood of paying back a loan.

In the mortgage lending industry, the use of guarantees was common at virtually every stage. Borrowers signed a guarantee in connection with their mortgage loan application.\textsuperscript{145} The standard, boilerplate 1003 mortgage loan application contains a lengthy “Acknowledgement and Agreement” that states that the borrower understands that the lender is relying on all of the information in the application.\textsuperscript{146} The borrower then acknowledges that false statements may result in civil penalties as well as criminal punishment, fines or imprisonment.\textsuperscript{147}

Mortgage brokers sign an agreement with the lenders or originators of a mortgage loan, stating that they will not submit a loan application that contains false or misleading information. Most lenders further require that the brokers agree to “buy back” mortgage loans, if it is discovered that there was fraud in the application and origination of the loan.

Similarly, the lenders or originators of mortgage loans made further guarantees related to the absence of fraud when that loan is securitized.\textsuperscript{148} Lenders and originators also agreed to buy back loans that defaulted within a certain period of time; underwriters often provided further guarantees to investors related to the overall performance of the pool of mortgage loans.\textsuperscript{149} These were internal and external enhancements that included buy-back provisions and insurance in the event that fraud was discovered or performance failed to meet certain expectations.\textsuperscript{150} The credit rating agencies, like Moody’s, Fitch, and Standard & Poor’s, relied heavily on these guarantees in rating the bond certificates.\textsuperscript{151} Absent these guarantees, the bonds would not have been investment-grade and

\begin{flushleft}
\textsuperscript{144} Id.  \\
\textsuperscript{145} Uniform Residential Loan Application Form 1003, available at \url{https://www.efanniemae.com/sf/forms/docs/forms/pdf/sellingtrans/1003.pdf}. All mortgage loans contain some sort of signing statement; the most prevalent is the signing statement contained in the 1003 Form produced and distributed by Fannie Mae.  \\
\textsuperscript{146} Id.  \\
\textsuperscript{147} Id.  \\
\textsuperscript{148} Engel & McCoy, supra note 75, at 2070.  \\
\textsuperscript{149} Id. at 2062.  \\
\textsuperscript{150} Id.  \\
\textsuperscript{151} Id. at 2046.
\end{flushleft}
would likely have not been sold.\textsuperscript{152}

B. The Housing Bubble and Foreclosure Crisis Viewed Through the Lens of Economic Game Theory

As stated above, there was a working assumption that computer models, complex algorithms, and mitigation tools effectively managed risk without government regulation.\textsuperscript{153} It was an assumption premised on the idea that an efficient equilibrium in a market not only exists, but that it can also be reached by the market actors themselves.\textsuperscript{154} Specifically, each individual actor within an economic market is so small that his interactions do not and cannot affect the entire market.\textsuperscript{155}

Game theory, including the behavioral and emotional branches of economic game theory, recognizes that such perfect competition is unrealistic.\textsuperscript{156} The assumption of “small” actors—whose fraud, strategies and misdeeds don’t have an effect—is not universally true and arguably not even that common.\textsuperscript{157} Going back to the seminal book \textit{Theory of Games and Economic Behavior}, published in 1944, game theory recognizes that there can be very large actors whose actions can interfere with the holy grail of perfect competition and Pareto equilibrium.\textsuperscript{158}

The mortgage lending industry and post-GLB financial services industry is just such an economic market where the actions of relatively few actors have a profound effect upon the market as a whole. For example, there are very few major credit rating agencies for mortgage-backed securities. The decision by any one of these credit rating agencies to downgrade the investment quality of such mortgage-backed securities or deny a triple-A bond rating

\textsuperscript{152} Id.
\textsuperscript{153} See supra note 116 and accompanying text.
\textsuperscript{154} Id.
\textsuperscript{156} Id.
\textsuperscript{157} Id. at 136 (“[F]or most parts of the economic system, perfect competition would now be an unrealistic assumption. Most industries are now dominated by a small number of large firms, and labor is often organized in large labor unions. Moreover, the central government and many other government agencies are major players in many markets as buyers and sometimes also as sellers, as regulators, and as taxing and subsidizing agents.”).
\textsuperscript{158} Id.
to sub-prime or Alt-A (e.g., low doc, no doc, or option ARMs) securities could have had a substantial impact in preventing the current foreclosure and economic crisis. If the credit rating agencies had scrutinized pools of mortgage loans more carefully, lenders would have been forced to provide and adhere to stricter underwriting standards, and the credit rating agencies would have likely demanded further internal and external enhancements for top-rated, triple-A bonds.

The larger vertically and horizontally integrated financial services companies, as well as the role of Fannie Mae and Freddie Mac, further undermine the concept of a small, single actor whose decisions have no impact on the overall market. Therefore, the decision to deregulate, as outlined in Part I, and rely on the traditional mitigation tools outlined in Part II, Sub-Part A, fail to consider how the unfettered ability of this relatively small number of actors to generate or approve trillions of dollars of mortgage loans could destabilize not just the housing market but the global economy. The housing bubble and the economic collapse can be traced to just a handful of financial services companies that generated, underwrote, or securitized billions of dollars of mortgage loans and related securities.

The mortgage lending industry or housing market may be fairly categorized as an I-Game, meaning that there is incomplete information among the actors, as compared to a C-Game, meaning that there is complete information among the actors. The failure of signaling, screening and separating, and guarantees is most easily traced to the fact that the market actors were participating in an on-going or continuous I-Game. While such tools may be effective in self-regulating a single transaction, the entire mortgage lending industry (from the broker to the investor) was not participating in a single transaction. There were multiple transactions over the course of many years with enormous pressure for the companies to reap large returns or profits. This had an impact on the actor’s strategies, incentives, and priorities. Each actor was gathering information and analyzing short-term and long-term risks of violating contractual terms, bargaining in bad faith, or even behaving illegally.

C. What Will the Punishment Be?

The broker is evaluating what punishment, if any, will truly occur for fraudulently inflating an applicant’s income in a stated-
income or low documentation loan. The lender is evaluating whether the underwriter or bondholders will actually exercise their buy-back rights. The credit reporting agencies are evaluating whether they will lose business if they toughen their rating requirements. In an isolated transaction, the market actors’ analyses would be different. Indeed, the misplaced market incentives of this continuous I-Game was illustrated during a Congressional hearing related to credit rating agencies and the financial crisis, showing that competition for business among the credit rating agencies skewed their business model.\(^\text{159}\)

For example, one confidential presentation to the Board of Directors of Moody’s stated the following under the header “CONFLICT OF INTEREST”:

Ideally, competition [among credit rating agencies] would be primarily on the basis of ratings quality, with a second component of price and a third component of service. . . . The real problem is not that the market does underweights [sic] ratings quality but rather that, in some sectors, it actually penalizes quality by awarding rating mandates based on the lowest credit enhancement needed for the highest rating. Unchecked, competition on this basis can place the entire financial system at risk. It turns out that ratings quality has surprisingly few friends: issuers want high ratings; investors don’t want rating downgrades; short-sighted bankers labor short-sightedly to game the rating agencies for a few extra basis points on execution.

This memorandum clearly describes how there were and are cross and competing motives.\(^\text{160}\) Credit rating agencies had pressure to maintain market share, while trying to keep perspective and ethics in the midst of an onslaught of investment bankers and lenders pitching them deals and tempting them to “drink the Kool-


\(^{161}\) Id.
The market actors ultimately determined that there was little risk to originating more mortgage loans, while there could be serious consequences for originating fewer. That is why signaling, screening and separating and guarantees failed. The traditional reliance upon a borrower’s credit score as a “signal” failed because the other information used to underwrite a loan (income, debt, assets) was often false. There was seemingly no penalty for providing such false information, and an immediate financial reward for originating the mortgage loan. The reliance on a broker to help sort and separate homeowners into the appropriate financial product failed because brokers were financially rewarded by lenders to steer borrowers into high-cost loans. The reliance on guarantees similarly failed because all of the actors perceived little risk of punishment for breaching their guarantees and many of the brokers and lenders were under-capitalized. Once pervasive fraud or illegal business practices were identified, the mortgage brokers and lenders simply disappeared or declared bankruptcy. Thus, mortgage brokers and lenders avoided any pecuniary punishment. Their guarantees were of no value.

162. Id.
163. Der Hovanesian, supra note 95.
164. Id.
166. This phenomenon is aptly described, along with other issues surrounding securitization by Professor Eggert, in a 2002 law review article that was incredibly forward-thinking, published six years before the complete economic melt-down. Although Professor Eggert describes the consequences to consumers, the undercapitalization has an effect both up and down the vertical economic stream:

[B]ecause securitization allows individuals with little or no capital of their own to originate or broker loans, it dramatically reduces the likelihood that the borrower can obtain any sort of repayment for her damages from the broker or originator, who can easily avoid paying any sizeable damages judgment by declaring bankruptcy or merely disappearing.

Kurt Eggert, Held up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine, 35 CREIGHTON L. REV. 503, 556 (2002).
167. Id.
168. Id.
169. An apt illustration of the worthless guarantee is featured in the movie Tommy Boy staring the now-deceased comedian Chris Farley. In the movie, the
III. MINNESOTA’S ANTI-PREDATORY LENDING LAW

Although the ability for states to regulate lending is limited by federal preemption, many states have passed or updated laws that regulate the conduct of mortgage brokers and certain lending practices. For example, some states prohibit churning, meaning that a homeowner is refinanced repeatedly with little to no benefit,

Chris Farley character (Tommy) is attempting to save his father’s auto-parts factory by going on a major sales trip with the actor David Spade (Richard Hayden). In closing his first major sale, Tommy must overcome the fact that his primary competition guarantees their product:

*Tommy:* Let’s think about this for a sec, Ted, why would somebody put a guarantee on a box? Hmmmm, very interesting.

*Ted Nelson, Customer:* Go on, I’m listening.

*Tommy:* Here’s the way I see it, Ted. Guy puts a fancy guarantee on a box ‘cause he wants you to feel all warm and toasty inside.

*Ted Nelson, Customer:* Yeah, makes a man feel good.

*Tommy:* ‘Course it does. Why shouldn’t it? Ya figure you put that little box under your pillow at night, the Guarantee Fairy might come by and leave a quarter, am I right, Ted?

[chuckles until he sees that Ted is not laughing too]

*Ted Nelson, Customer:* [impatiently] What’s your point?

*Tommy:* The point is, how do you know the fairy isn’t a crazy glue sniffer? “Building model airplanes” says the little fairy; well, we’re not buying it. He sneaks into your house once, that’s all it takes. The next thing you know, there’s money missing off the dresser, and your daughter’s knocked up. I seen it a hundred times.

*Ted Nelson, Customer:* But why do they put a guarantee on the box?

*Tommy:* Because they know all they sold ya was a guaranteed piece of s***. That’s all it is, isn’t it? Hey, if you want me to take a dump in a box and mark it guaranteed, I will. I got spare time. But for now, for your customer’s sake, for your daughter’s sake, ya might wanna think about buying a quality product from me.


as well as negative amortization loans.\footnote{171} Other states license mortgage brokers and require that the mortgage brokers post a surety bond.\footnote{172}

But Minnesota has the most comprehensive Anti-Predatory Lending Law in the country.\footnote{173} Indeed, a New York Times editorial called the law “farsighted” and “excellent.”\footnote{174} The tools provided by and the scope of Minnesota’s Anti-Predatory Lending Law are described in Sub-Part A. Sub-Part B describes the first case brought under the statute.

\section*{A. Summary of Minnesota’s Anti-Predatory Lending Law}

Individual provisions within Minnesota’s Anti-Predatory Lending Law are important, but what makes the law a model is its comprehensive approach to the problem. The amendments passed in 2007 did not just add new standards of conduct, but also created powerful enforcement tools and meaningful remedies as well as making existing laws more effective. Finally, and most importantly, the new law creates a duty of agency between the borrower and the


\footnote{172. The following is a sample of requirements by some state statutes: Arizona ($10,000 to $15,000 bond, three years experience and pass written exam); Arkansas (net worth of $25,000 and surety bond of $35,000); Connecticut (surety bond of $40,000); Kentucky (surety bond for $50,000 and training course); Nebraska (surety bond for $50,000); Texas (net worth of $25,000 or surety bond of $50,000).

\footnote{173. Minn. Stat. § 58.13 (2008).}

mortgage broker. This duty creates a general and flexible tool to combat the new schemes of tomorrow's predatory lenders.

1. Enforcement and Remedies

Until the passage of Minnesota's Anti-Predatory Lending Law, no express private right of action existed for consumers that specifically targeted illicit lending practices. The new law did not just give homeowners the private right to enforce new standards of conduct in Minnesota, but it also provided an expansive private right of action for "any violation of state or federal law regulating residential mortgage loans," and misconduct by appraisers.\(^{175}\) The remedies for violations are cumulative but include (1) actual, incidental, and consequential damages; (2) statutory damages equal to the amount of all lender fees included in the amount of the principal of the residential mortgage loan as defined in section 58.137; (3) punitive damages if appropriate, and as provided in sections 549.191 and 549.20; and (4) court costs and reasonable attorneys’ fees.\(^{176}\)

The new law, however, only applies to non-bank lenders and mortgage brokers, including brokers who help originate mortgages for state and federally chartered banks.\(^{177}\) It exempts state and federally chartered banks from liability under the Act.\(^{178}\) This limitation is due to federal pre-emption, and does not and should not be replicated in a federal statute that uses the Minnesota Anti-Predatory Lending Law as a model.

The new Anti-Predatory Lending Law also created a new crime of "Residential Mortgage Fraud." The law makes it illegal whenever a person:


\(^{176}\) Minn. Stat. § 58.18, subdiv. 1, 3 (2008); Minn. Stat. § 82B.24, subdiv. 1, 3 (2008).

\(^{177}\) See id. §§ 58.04, subdiv. 4, 58.13, subdiv. 1 (b).

\(^{178}\) See id. §§ 58.04, subdiv. 4, 58.13, subdiv. 1 (b). It should be noted that mortgage brokers who help originate a mortgage loan on behalf of a state or federally chartered bank are covered by Minnesota’s Anti-Predatory Lending Law and can be liable for damages under the Act. The federal pre-emption of state laws does not extend to mortgage brokers, and one of the main purposes for enacting the law were the predatory lending practices that were facilitated by mortgage brokers regardless of whether they were helping to originate a non-bank lender’s mortgage loan or a state or federally chartered bank.
(1) knowingly makes or causes to be made any deliberate and material misstatement, misrepresentation, or omission during the mortgage lending process with the intention that it be relied on by a mortgage lender, borrower, or any other party to the mortgage lending process;

(2) knowingly uses or facilitates the use of any deliberate and material misstatement, misrepresentation, or omission, knowing the same to contain a material misstatement, misrepresentation, or omission, during the mortgage lending process with the intention that it be relied on by a mortgage lender, borrower, or any other party to the mortgage lending process; or

(3) conspires to violate clause (1) or (2).

2. Mortgage Broker and Non-Bank Lender Standards of Conduct

There are twenty-seven separate standards of conduct for “mortgage originators,” with five of those standards having been enacted as part of the 2007 Minnesota Anti-Predatory Lending Law. The existing standards of conduct, however, are also important. Because the legislature gave a private right of action for violations of any of the twenty-seven standards, each should be reviewed for applicability in any action. The following are some of the most important standards of conduct set forth in the statute.

a. Prohibiting a Mortgage Originator From Setting a Homeowner up for Failure

There are four standards that prohibit a mortgage broker or mortgage loan originator from not acting in the borrower or homeowner’s best interest. These standards include making or

179. Id. § 609.822.

‘Residential mortgage originator’ means a person who, directly or indirectly, for compensation or gain or in expectation of compensation or gain, solicits or offers to solicit, or accepts or offers to accept an application for a residential mortgage loan through any medium or mode of communication from a borrower, or makes a residential mortgage loan. ‘Residential mortgage originator’ includes a lender as defined in subdivision 11 and a broker as defined in subdivision 13.; Minn. Stat. § 58.13, subdiv.1 (b)(2008). Subdivision (a)(23) to (27) were part of the 2007 Minnesota Anti-Predatory Lending law.
assisting with the origination of a loan “with the intent that the loan will not be repaid” and that title will transfer to the originator through foreclosure;\(^{181}\) making or assisting with the origination of a loan that is “of a lower investment grade” than the homeowner or borrower would otherwise qualify for based on his or her credit score;\(^{182}\) making or assisting with the origination of a loan without verifying the borrower’s ability to pay the fully amortizing rate;\(^{185}\) and engaging in “churning,” meaning that the new loan does not provide a reasonable, tangible net benefit to the borrower.\(^{184}\)

With regard to verifying an individual’s ability to pay, it is important to note that the “ability” of the borrower cannot be based upon the initial teaser rate.\(^{185}\) Previously, it was common for predatory lenders to underwrite to the initial teaser rate and not consider the ability to pay once the teaser rate expired.\(^{186}\) Under this provision, the borrower must have sufficient income or other assets to pay the loan when the rate adjusts to its true interest rate.

\(b.\) Inflating Appraisals

Mortgage loan originators, including mortgage brokers, are prohibited from compensating, directly or indirectly, coercing or intimidating an appraiser for the purpose of influencing the judgment of the appraiser related to the value of the borrower’s home.\(^{187}\)

\(c.\) Banning Toxic or Exploitative Mortgages

Mortgage loan originators are prohibited from making, providing, or arranging for a loan that allows for negative amortization during any six-month period.\(^{188}\) The law further prohibits the origination of a loan that refinances or pays-off a “special mortgage,” unless the borrower has received counseling from an authorized, independent loan counselor.\(^{189}\) For example,

\(^{182}\) Id. § 58.13, subdiv. 1 (a)(18).
\(^{183}\) Id. § 58.13, subdiv. 1 (a)(24).
\(^{184}\) Id. § 58.13, subdiv. 1 (a)(25).
\(^{185}\) See id.
\(^{186}\) Prentiss Cox, Consumer Fraud and Deceptive Trade Practice Regulation in Minnesota 8–3(A) (1) (2d ed. 2009).
\(^{188}\) Id. § 58.13, subdiv. 1(27).
\(^{189}\) Id. § 58.13, subdiv. 1(23).
a homeowner who has a zero interest or total forgiveness loan through a charity, like Habitat for Humanity, needs to receive housing counseling prior to refinancing out of such a special mortgage. This provides extra protection to vulnerable homeowners who may otherwise be convinced by an unscrupulous mortgage broker to give up a zero interest loan to pay-off unsecured credit card debt.

d. Truthful Marketing: Apples to Apples

In addition to general prohibitions of false and misleading advertising, the law was further amended to specifically prohibit a common tactic used by mortgage brokers: comparing apples to oranges. Often a homeowner will be told that refinancing will result in significantly lower monthly payment. After closing, the homeowner discovers that the quoted, new monthly payment does not include taxes and insurance.

The amendment creates a new standard of conduct that requires that a homeowner be informed about the total monthly payment, including “the amount of the anticipated or actual periodic payments for property taxes and hazard insurance.” However, disclosure must also indicate if the refinanced loan does not have an escrow account.

e. Handling Client Funds

Three of the standards of conduct relate to the handling of client funds. Minnesota Statute section 58.13, subdivision 1(1) prohibits a mortgage loan originator, which includes a broker, from failing to “maintain a trust account to hold trust funds received in connection with a residential mortgage loan,” and subdivision 1(2) prohibits a mortgage loan originator from failing to “deposit all trust funds into a trust account within three business days of receipt; commingle trust funds with funds belonging to the licensee or exempt person; or use trust account funds for any purpose other than that for which they are received.”

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190. Id. § 58.13, subdiv. 1(9), (19).
191. Id. § 58.13, subdiv. 1(26).
192. Id.
193. See id. § 58.13, subdiv. 1(1)–(2), (4).
194. Id. § 58.13, subdiv. 1(1).
195. Id. § 58.13, subdiv. 1(2).
Subdivision 1(4) prohibits a mortgage loan originator from failing to “disburse funds according to its contractual or statutory obligations.”\textsuperscript{196}

\textit{f. Catchall}

In addition to the specific prohibitions, the code of conduct also includes a catchall.\textsuperscript{197} The catchall provision makes a violation of any state or federal law “regulating residential mortgage loans” a basis for a cause of action.\textsuperscript{198}

3. A 5\% Limit on Financed Charges

In 2001, the Minnesota State Legislature amended chapter 58 to limit “lender fees” that are financed as part of the principal loan amount.\textsuperscript{199} The limit is five percent.\textsuperscript{200} In 2007, the definition of lender fee broadened to not just include the charges “payable by the borrower.”\textsuperscript{201} Lender fee now includes all charges paid “by the lender to a mortgage broker.”\textsuperscript{202} Therefore, a “yield spread premium” paid outside of closing by a lender to a mortgage broker counts toward the 5\% cap on financed charges.

This is an important change because yield spread premiums have been an on-going concern to consumer advocates for many years.

A YSP [Yield Spread Premium] is a cash bonus that a broker receives from a lender for placing borrowers in a loan with a higher interest rate than the lender would accept. The higher the interest rate, the higher the premium received by the broker. These kickbacks provide brokers a strong incentive to charge borrowers a higher interest rate when they could qualify for a less expensive loan. The effect of YSPs is to steal equity from struggling families.\textsuperscript{203}

\textsuperscript{196} Id. § 58.13, subdiv. 1(4).
\textsuperscript{197} See id. § 58.13, subdiv. 1(8).
\textsuperscript{198} Id.
\textsuperscript{199} COX, supra note 186, at 8–8(C).
\textsuperscript{200} MINN. STAT. § 58.137, subdiv. 1 (2008). It should also be noted that federal statute does not preempt Minnesota’s limits on financed charges proscribed in this statute. See COX, supra note 186. Minnesota opted-out of the preemption. Id. (citing MINN. STAT. §§ 47.203–204 (1999)).
\textsuperscript{201} See MINN. STAT. § 58.137, subdiv. 1 (2008).
\textsuperscript{202} Id.
\textsuperscript{203} Center for Responsible Lending, supra note 165
For example, a single mother who was assisted by the Center for Responsible Lending paid a broker over $9,000 in settlement charges on just a $43,750 mortgage loan.\footnote{Id.} The interest rate was 13.74%.\footnote{Id.} The YSP was $2,680, approximately six points, meaning that the borrower qualified for a significantly lower interest rate and monthly payment.\footnote{Id.} Why did the broker not provide her with the lower cost loan? Including the Yield Spread Premium, the broker’s total compensation was nearly $6,000, more than 13% of the loan amount.\footnote{Id.} Under Minnesota’s Anti-Predatory Lending Law, this transaction would be illegal.\footnote{Id.}

4. The Creation of Agency and Agency Relationship Between Borrowers and Mortgage Brokers.

The new Anti-Predatory Lending Law also creates an agency relationship between borrowers and their mortgage brokers.\footnote{Id.} Minnesota Statute section 58.161, subdivision 1 then sets forth five specific duties.\footnote{Id.} First, mortgage brokers must “act in the borrower’s best interest and in the utmost good faith toward borrowers.”\footnote{Id.} The broker also is prohibited from acting, giving, or charging “any undisclosed compensation or realize any undisclosed remuneration, either through direct or indirect means, that inures to the benefit of the mortgage broker on an expenditure made for the borrower.”\footnote{Id.} Second, brokers are required to carry out all “lawful instructions” given to them from the borrowers.\footnote{Id.} Third, mortgage brokers must disclose to borrowers all material facts that might reasonably affect the borrower’s rights, interests, or ability to receive an intended benefit from the residential mortgage loan.\footnote{Id.} Fourth, mortgage brokers are required to use “reasonable care in performing duties,”\footnote{Id.} and, fifth, mortgage brokers must account to
the borrower all of the money and property received as agent.  

5. Licensing and Bond

The “Minnesota Residential Mortgage Originator and Servicer Licensing Act” provides further protection for homeowners and borrowers. Although not technically part of the 2007 Anti-Predatory Lending Law, the Minnesota Residential Mortgage Originator and Servicer Licensing Act was also amended in 2007 to compliment the provisions and rights outlined above. Specifically, the Act now requires mortgage brokers to submit a surety bond or irrevocable letter of credit in the amount of at least $50,000 to pay for, among other things, expenses, fines, and fees levied by the commissioner under this chapter and for losses incurred by borrowers. This bond is important, because often the mortgage broker either goes out of business prior to bringing a lawsuit or declares bankruptcy after a judgment is entered by the court.

B. The First Case: Hilleshiem v. Source Lending

Although the 2007 Minnesota Anti-Predatory Lending Law originally passed in the spring of 2007, the new provisions did not come into effect until August 1, 2007. On April 3, 2008, approximately eight months after the law took effect, the first lawsuit claiming a violation of the new laws was filed by the Housing Preservation Project, a non-profit law firm in Saint Paul, Minnesota. The plaintiffs were an elderly couple, William Hilleshiem and Judy Hilleshiem, who had lived on their small farm for forty-one years. The following section summarizes the

216. Id. § 58.161, subdiv. 1(5).
217. MINN. STAT. § 58.01 (2008).
218. Id.; See also discussion of Anti-Predatory Lending Law infra pt. III, subsec. A.
219. MINN. STAT. § 58.06, subdiv. 2(b)(2) (2008).
222. First Am. Compl. 1, Hillesheim v. Source Lending Corp., Civil File No. 27-
allegations made in the Plaintiffs’ Complaint.

1. Background

In spring 2007, Mr. and Mrs. Hilleshiem received a phone call from the defendant, Source Lending.223 Source Lending stated that it was interested in helping them refinance their home.224 At the time, Mr. and Mrs. Hilleshiem were living on a very tight budget.225 They had to pay approximately $898 per month for their existing mortgage, and then pay other bills for food, transportation, health care, and utilities using primarily Social Security benefits.226 Their existing mortgage had an adjustable interest rate, and they wanted to refinance and have a fixed interest rate.227

Source Lending promised that it could arrange for a fixed interest rate with a monthly payment of approximately $500 per month, and they arranged for a mortgage broker to come to their home to provide more details.228 About a week later, a mortgage broker named David Kuntz came to their home and told them about Source Lending’s plan.229

Specifically, Kuntz said that Mr. and Mrs. Hilleshiem would not immediately qualify for the fixed interest rate mortgage with a monthly payment of approximately $500 per month.230 Source Lending, however, could obtain the fixed interest rate mortgage with a monthly payment of approximately $500 per month, if they agreed to refinance twice.231

Kuntz explained that Mr. and Mrs. Hilleshiem would have to refinance twice because of their poor credit.232 Source Lending would help them improve their credit score by first obtaining an ARM.233 After making two or three payments, Mr. and Mrs. Hilleshiem’s credit score would be improved enough to refinance,
again, into a fixed-rate mortgage.\(^{234}\) Source Lending further told the plaintiffs that they would pay no closing costs for refinancing the second time.\(^{235}\)

In reliance on Source Lending’s representations, Mr. and Mrs. Hilleshiem decided to refinance their existing mortgage.\(^{236}\) On June 11, 2007, Source Lending’s Dave Kuntz and another person came to the plaintiffs’ home to sign the various mortgage documents.\(^{237}\) The June 11, 2007 mortgage loan refinanced the plaintiffs’ existing mortgage loan, paying-off their balance of $127,590.78 and replaced it with a new mortgage with a principal balance of $153,750.\(^{238}\) According to the U.S. Department of Housing & Urban Development Settlement Statement Form (HUD-1), the settlement charges were over $7,000.\(^{239}\)

Specifically, the defendant charged the plaintiffs $400 for an appraisal, even though Mr. and Mrs. Hilleshiem have no memory of any appraiser entering their home or coming to their property to conduct an appraisal.\(^{240}\) They directly paid Source Lending nearly $4,000 in fees for origination, processing, underwriting, application, and administration.\(^{241}\) Source Lending was also paid a $2,882.81 yield spread premium from the lender, meaning that the interest rate was nearly two points higher than the interest rate that they had actually qualified for.\(^{242}\) The plaintiffs also paid $175 for a notary, and whopping $1,175 for title insurance, which is approximately three to four times higher than the reasonable market-rate for title insurance.\(^{243}\)

As instructed, Mr. and Mrs. Hilleshiem made two monthly payments of approximately $1,320 for the June 11, 2007 mortgage and waited to hear from Source Lending about the second refinance.\(^{244}\) On October 26, 2007, Source Lending arranged for a closing company to come to Mr. and Mrs. Hilleshiem’s house to

\(^{234}\) Id.
\(^{235}\) Id. at 17.
\(^{236}\) Id. at 18.
\(^{237}\) Id. at 19.
\(^{238}\) Id. at 20.
\(^{239}\) Id.
\(^{240}\) Id. at 21.
\(^{241}\) Id.
\(^{242}\) Id.
\(^{243}\) Id.
\(^{244}\) Id. at 22.
sign the various mortgage documents for their second loan.\(^{245}\) The second loan paid-off the June mortgage loan of $156,781.41, and then created a new mortgage loan with the principal balance of $167,250.\(^ {246}\) Contrary to Source Lending’s statements, the monthly payment for the new mortgage loan would not be $500 per month.\(^ {247}\) Instead, the monthly payment would be $1,300 (only about $20 less than the June 11, 2007 mortgage loan).\(^ {248}\) Thus, the amount owed on Mr. and Mrs. Hilleshiem’s home went up approximately $40,000 in six months and their payments increased 30%.\(^ {249}\)

Much to Mr. and Mrs. Hilleshiem’s surprise, there were also thousands of dollars of closing costs for the October 26, 2007 mortgage loan.\(^ {250}\) Mr. and Mrs. Hilleshiem were charged another $200 for an appraisal—even though they had purportedly just had an appraisal four months ago—and, they were charged an “external” appraisal review fee of $140 and an “internal” appraisal review fee of $95.\(^ {251}\) Source Lending also charged Mr. and Mrs. Hilleshiem over $5,000 in additional fees.\(^ {252}\) Source Lending also received another yield spread premium from the lender in the amount of $3,972.19, meaning that Mr. and Mrs. Hilleshiem received an interest rate approximately two points higher than the interest rate that they had qualified to receive.\(^ {253}\) They were also charged $1,175 for title insurance, again.\(^ {254}\)

2. Legal Claims Asserted by Mr. and Mrs. Hilleshiem Against Source Lending

The lawsuit had a total of seven counts, three of which were against Source Lending and asserted violations of the 2007 Anti-Predatory Lending Law.\(^ {255}\) Count I alleged a violation of Minnesota Statutes section 58.137, subdivision 1, originating a mortgage loan with points and fees in excess of 5% of the loan, which includes the

\(^{245}\) Id. at 28.
\(^{246}\) Id. at 29.
\(^{247}\) Id. at 30.
\(^{248}\) Id.
\(^{249}\) Id.
\(^{250}\) Id. at 31.
\(^{251}\) Id. at 32.
\(^{252}\) Id. at 33.
\(^{253}\) Id.
\(^{254}\) Id. at 34.
\(^{255}\) See Id.
yield spread premium received by Source Lending.\textsuperscript{256} Count II alleged that Source Lending failed to verify Mr. and Mrs. Hilleshiem’s ability to pay the mortgage loan.\textsuperscript{257} Mr. and Mrs. Hilleshiem’s monthly mortgage payment was approximately 80\% of their monthly income, consisting of a Social Security check and a small pension. Count III alleged that Source Lending was liable for violating the Anti-Predatory Lending Law for “churning” Mr. and Mrs. Hilleshiem.\textsuperscript{258} Specifically, given Mr. and Mrs. Hilleshiem’s age, income, liabilities, and the mere $20 to $30 difference between the monthly payments of the new and refinanced mortgage, the new mortgage did not provide a tangible net benefit to them.\textsuperscript{259}

3. The Pressure Increases on Source Lending

Later, the Minnesota Attorney General filed a four-count complaint against Source Lending alleging a pattern of illegal conduct similar to the allegations made in Mr. and Mrs. Hilleshiem’s complaint.\textsuperscript{260} Specifically, the Minnesota Attorney General stated that:

Source Lending sold risky and complex loans to Minnesota consumers, including “Hybrid ARMs” and “Pay Option ARMs,” by employing a multitude of false, misleading, and deceptive acts and practices. These unlawful acts and practices include misleading consumers about the terms of the loans; using the classic “bait-and-switch” technique; and making false promises of serial refinancing.\textsuperscript{261}

The Attorney General’s Complaint alleges that Source Lending routinely represented in direct mail and on its website that people can save $200 or more on their monthly mortgage payment by refinancing through one of its brokers.\textsuperscript{262} This is consistent with Mr. and Mrs. Hilleshiem’s claim that Source Lending represented to her that her monthly mortgage payment

\begin{align*}
\textsuperscript{256} & \text{Id. at 37–42.} \\
\textsuperscript{257} & \text{Id. at 45–46.} \\
\textsuperscript{258} & \text{Id. at 47–50.} \\
\textsuperscript{259} & \text{Id. at 50.} \\
\textsuperscript{260} & \text{Compare Complaint, Minnesota v. Source Lending Corp., No. 27-CV-08-19803 (Minn. Dist. Ct. filed August 14, 2008), with First Amended Complaint, supra note 222.} \\
\textsuperscript{261} & \text{Id. at 1.} \\
\textsuperscript{262} & \text{Id. at 15.}
\end{align*}
would drop from approximately $800 to $500.

The Attorney General’s Complaint also states that Source Lending routinely baited consumers into refinancing, and then switched to another loan on “the eve of closing or at the closing.” This is also what Mr. and Mrs. Hilleshiem allege happened to them.

4. Toward Resolution

On July 11, 2008, Source Lending offered a “Confession of Judgment” in the amount of $11,187 related to Count I of Mr. and Mrs. Hilleshiem’s Complaint. The Confession of Judgment was offered pursuant to Minnesota Rule of Civil Procedure 68.01(c), and did not include attorneys’ fees and costs. Within the applicable time period, Mr. and Mrs. Hilleshiem accepted the Confession of Judgment, and then moved the court to immediately award attorney’s fees and order that the $11,187 either be paid or placed in escrow for the benefit of Mr. and Mrs. Hilleshiem. Because of the Attorney General’s lawsuit and the failure of Source Lending to pay its newspaper advertising bills, Mr. and Mrs. Hilleshiem were concerned that Source Lending was going out of business.

That suspicion was confirmed when Source Lending’s counsel withdrew, and the company defaulted on the remainder of Mr. and Mrs. Hilleshiem’s claims. Luckily, due to the new Minnesota Anti-Predatory Lending Law, there was a bond in place to protect Mr. and Mrs. Hilleshiem. Judgment was entered against Source Lending for well over the $50,000 bond amount, and Mr. and Mrs. Hilleshiem proceeded to collect this judgment against the bond.

IV. THE MINNESOTA ANTI-PREDATORY LENDING LAW AS A NATIONAL MODEL

The strength of Minnesota’s Anti-Predatory Lending Law is the balance it strikes between specific prohibitions, such as a clear cap

263. Id. at 45.
264. Rule 68.01 Offer of Judgment as to Count 1 of Plaintiff’s First Amended Complaint, Hilleshiem, No. 27-CV-08-7612.
265. See Id.
266. Acceptance of Rule 68.01 Offer of Judgment, Hilleshiem, No. 27-CV-08-7612.
267. See Order Granting Summary Judgment and the Award of Reasonable Attorney Fees and Costs, Hilleshiem, No. 27-CV-08-7612.
on financed charges, and general provisions that will apply to the new predatory lending schemes in the future. It is similar to the structure and approach of the federal Fair Debt Collection Practices Act (FDCPA).\textsuperscript{268} The FDCPA has specific prohibitions, such as prohibiting communication once a written request is made or “depositing or threatening to deposit any postdated check or other postdated payment instrument prior to the date on such check or instrument.”\textsuperscript{269} The FDCPA also has general prohibitions on actions that harass, oppress, or abuse debtors.\textsuperscript{270} The general and specific aspects of the Minnesota Anti-Predatory Lending Law are the approach that should be adopted as a model at the federal level. General and specific provisions complement one another, and they often, in practice, hasten a resolution to the larger action by creating clear liability related to one part.

Specific provisions allow the consumer to obtain immediate relief through litigation. In \textit{Hilleshiem}, the homeowner received a Confession of Judgment just six months after filing the lawsuit. But the broader, more general duties of agency created an opportunity to recover far more damages. A duty of agency between a Minnesota borrower and the mortgage broker is also flexible, and has the ability to adapt to emerging schemes that are not presently known. A duty of agency is also consistent with how ordinary borrowers already view their relationship with their mortgage broker. It should be a uniform, national policy.

Some of these concepts are part of the Mortgage Reform and Anti-Predatory Lending Act that passed the United States House of Representatives on May 7, 2009.\textsuperscript{271} For example, it requires that the loan have a tangible net benefit for the borrower and that the borrower have the ability to pay.\textsuperscript{272} It also prohibits yield spread premiums paid outside of closing from a lender to a mortgage broker as a reward for facilitating a loan with a higher interest rate than the borrower otherwise qualified for.\textsuperscript{273}

The bill, however, does not create a legally enforceable agency relationship between a mortgage broker and the borrower. That is

\textsuperscript{270} 15 U.S.C. § 1692d.
\textsuperscript{271} See Mortgage Reform and Anti-Predatory Lending Act, H.R. 1728, 111th Cong. (2009).
\textsuperscript{272} Id.
\textsuperscript{273} Id.
short-sighted, and it is a mistake. This agency relationship would help ensure that the signaling, sorting, and guarantees discussed in Part II are effective and have a positive effect on the transaction and the overall market. Additionally, a national law that creates this legally enforceable relationship can uniformly apply to all entities, because pre-emption is obviously not an issue with federal statutes. If regulation is simply focused or limited to “independent” mortgage brokers, lenders will just use brokers or loan officers that are actually bank employees to avoid the regulations and continue predatory practices.

The other lesson learned from the Hilleshiem litigation is that predatory lending and damages from predatory lending are significant. Although Mr. and Mrs. Hilleshiem were able to recover damages from Source Lending’s bond, they did not collect their full judgment and the bond is now gone. For the second, third, or fourth victim of Source Lending’s predatory practices, there is no bond and there will likely be no recovery. The only thing that these victims will collect is an empty and uncollectable judgment against a defunct corporation.

As evidenced by the numerous individuals cited in the Attorney General’s Complaint, Source Lending’s illegal practices were pervasive and widespread. Assuming that there are merely fifty more victims (which is an unreasonably low estimate) that each had just $15,000 in damages (which is also an unreasonably low estimate), the total amount of claims would be $750,000. This illustrates that the statutorily proscribed $50,000 bond is insufficient to compensate the victims of predatory mortgage brokers. Either the bond requirement needs to be increased or there needs to be an alternative system, or both.

Similarly, at a federal level, enactment of any new rights for borrowers or homeowners must recognize that this is a billion dollar industry and also that many of the actors appear and disappear. It is estimated that there will be approximately three hundred bank failures as a result of the current economic crisis. The number of mortgage brokers that have shut down is even more striking. For example, in Massachusetts there has been an 80% decrease in the number of mortgage brokers.

275. Eric Convey, Mortgage Misery: After Months of Decline, Broker Ranks Seen Falling by 80 Percent from Peak, BOSTON BUS. J., June 6, 2008, available at...
Congress uses the Minnesota Anti-Predatory Lending Law as a model, Congress must ensure that homeowners are financially protected from under-capitalized and bankrupt companies.

In conclusion, reform of the day-to-day regulation of lending must take into account the irrationality, emotion, and, sometimes, exploitation that occurs in a continuing or on-going business relationships. The foreclosure and economic crisis highlights what happens when such issues are not taken into account and the community assumes that markets behave rationally and there is no need for government regulation. The Minnesota Model provides a framework for national regulation of predatory lending practices. It sets clear standards of conduct to eliminate the most egregious behavior, but also includes broader more flexible standards to address the predatory lending schemes of tomorrow.