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WILLIAM N. LUND
SUPERINTENDENT

April 25, 2008

Joint Advisory Ruling #115

Re: Treatment of Construction to Permanent Loans

Dear:

You have sought guidance regarding the proper treatment of construction-to-permanent mortgage loans in relation to the definition of a "subprime mortgage loan" as defined in Title 9-A § 8-103 sub-§1-A(BB). Specifically, you have asked whether a construction-to-permanent mortgage loan is a subprime mortgage loan, given the terms which are summarized below.

The lender holds a single closing at which the borrower agrees to the following:

- Payment of interest only on funds disbursed during the construction phase which phase usually lasts no more than one year. Interest is only paid on the funds actually disbursed during this phase;
- At the end of the construction phase, the borrower's "balance owed" is rolled into the "permanent" loan product selected by the borrower pursuant to a loan modification agreement which is signed by the borrower at this time.

You indicate that, for some of these loans, the terms for the construction and permanent phases will all be agreed to at the outset, prior to construction. In other cases, you state that the loan will be subject to a modification agreement entered into at the end of the construction phase, pursuant to which the terms of the permanent phase of the loan will be agreed.

Specifically, your membership seeks clarification to determine if the construction phase of the loan makes it a subprime mortgage loan due to the fact that this phase requires the consumer to pay interest only, thereby deferring payment of principal. As you are aware, a subprime mortgage loan is defined, in part, as a "nontraditional" mortgage which allows the borrower to defer repayment of principal or interest.



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In your letter dated April 4th, 2008, you argue, first, that such loans should not be considered “residential mortgage loans” based on the fact that, under Federal Regulation Z, adopted in relevant part by the Bureaus as Regulation Z-2, if a dwelling will become the principal dwelling upon completion of construction, that dwelling is a “principal” dwelling, but only for specific provisions of Regulation Z.

You argue alternatively that, even though these loans may be residential mortgage loans, they do not qualify as “subprime mortgage loans” because they are not “non-traditional” loans as described in the Interagency Guidance on Nontraditional Mortgage Product Risks, issued in 2006.

In support of your argument, you cite various references in the Interagency Guidance which, you assert, support your view that construction-to-permanent mortgage loans are not contemplated as “nontraditional” loans in the Interagency Guidance, despite their interest-only attribute.

Bureaus’ Response

(a) Are such loans residential mortgage loans?

With respect to your first argument that such loans are not “residential mortgage loans” based upon your interpretation of certain provisions of Federal Regulation Z, the Bureaus disagree. The Bureaus are of the view that such loans are “residential mortgage loans.”

First, it is the Bureaus’ view that it would not be in keeping with the spirit of “An Act to Protect Maine Homeowners from Predatory Lending” to exclude such loans from the definition of “residential mortgage loans.” The Bureaus believe that the legislative intent behind the “primary dwelling” requirement for “residential mortgage loans” was to exclude vacation homes and investment properties – not to exclude primary dwellings solely because they had yet to be constructed.

Second, it is the Bureaus’ view that construction-to-permanent mortgage loans are not “construction loans” as that term is used in Title 9-A § 8-103 sub-§ 1-A(W)(4) and, therefore, may be considered “residential mortgage loans.” In determining which construction loans are properly excluded under Title 9-A § 8-103 sub-§ 1-A(W)(4), the Bureaus believe that it is appropriate to look at 24 CFR 3500.5 (federal RESPA) for guidance, firstly, given the importance of consistency among state and federal laws (24 CFR 3500.5 is relevant to determining whether temporary financing is a “federally related mortgage loan under Title 9-A § 8-103 sub-§ 1-A(W). Secondly, the Bureaus believe that it is appropriate to look at 24 CFR 3500.5 due to the fact that RESPA enforcement is specifically incorporated into Maine law; see elsewhere in 9-A M.R.S.A. § 8-103, and 9-A M.R.S.A. §§ 3-316, 9-311-A and 10-307.

Pursuant to 24 CFR 3500.5, a “construction loan” is determined to be a type of “temporary financing.”

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The law states as follows:

§ 3500.5 Coverage of RESPA.

(a) Applicability. RESPA and this part apply to all federally related mortgage loans, except for the exemptions provided in paragraph (b) of this section.

(b) Exemptions.

...

(3) Temporary financing. Temporary financing, such as a construction loan. The exemption for temporary financing does not apply to a loan made to finance construction of 1- to 4-family residential property if the loan is used as, or may be converted to, permanent financing by the same lender or is used to finance transfer of title to the first user. If a lender issues a commitment for permanent financing, with or without conditions, the loan is covered by this part. Any construction loan for new or rehabilitated 1- to 4-family residential property, other than a loan to a bona fide builder (a person who regularly constructs 1- to 4-family residential structures for sale or lease), is subject to this part if its term is for two years or more. A "bridge loan" or "swing loan" in which a lender takes a security interest in otherwise covered 1- to 4-family residential property is not covered by RESPA and this part.

Because the loans that you describe are not a type of “temporary financing,” they would accordingly not be a “construction loan” using the guidance set forth in 24 CFR 3500.5, and may thus be a “residential mortgage loan” under Maine law. Conversely, a temporary construction loan that qualifies as “temporary financing” under 24 CFR 3500.5 is excluded from the definition of a “residential mortgage loan.” Furthermore, notwithstanding 24 CFR 3500.5, it is the Bureaus’ position that a temporary construction loan is properly excluded from the definition of a “residential mortgage loan” even if a lender issues a commitment for permanent financing, with or without conditions.

(b) Are such loans subprime mortgage loans?

With respect to your second argument, that such loans should not be treated as “subprime mortgage loans,” the Bureaus agree. The Bureaus are of the view that such loans should not be treated as “nontraditional” mortgages, and therefore should not be treated as “subprime mortgage loans” under “An Act to Protect Maine Homeowners from Predatory Lending.” In other words, the interest-only attribute of the construction phase of a construction-to-permanent loan does not cast these types of loans as nontraditional products.

In coming to this conclusion, the Bureaus note that any discussion of construction-to-permanent mortgage loans is conspicuously absent from the Interagency Guidance. In particular, the Bureaus note that,

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whenever examples of “nontraditional” loans are provided in the Interagency Guidance, construction-to-permanent mortgage loans are not mentioned. According to the Interagency Guidance, nontraditional mortgages “include such products as ‘interest-only’ mortgages where a borrower pays no loan principal for the first few years of the loan...” (Underline added.) Likewise, in the Appendix to the Interagency Guidance, an “interest-only” mortgage loan is described as “a nontraditional mortgage on which, for a specified number of years (e.g. three or five years) the borrower is required to pay only the interest due...” (Underline added.) The Bureaus are therefore of the view that the Interagency Guidance may be reasonably interpreted so as not to include construction-to-permanent mortgage loans.

The Bureaus recognize that such loans are typically not targeted at subprime borrowers. Furthermore, the Bureaus are aware that the risk of “payment shock” for such loans is significantly diminished, because a reasonably informed borrower will understand that there will be a payment adjustment once the “construction phase” of their loan is completed. Finally, the Bureaus recognize that these loans are useful lending tools for certain borrowers, play an important part in Maine’s economy and that, if the Bureaus were to classify them as “subprime mortgage loans,” certain lenders may be reluctant to offer these important loan products.

In summary, the Bureaus are of the view that construction-to-permanent mortgage loans may be residential mortgage loans but are not subprime mortgage loans. However, this conclusion applies only in those cases in which: (a) the only “subprime” attribute of the “construction phase” of such loans is the payment of interest only during this phase; and (b) there are no “subprime” attributes to the “permanent phase” of these loans.

Sincerely,

/s/Lloyd P. LaFountain, III

Lloyd P. LaFountain III, Superintendent
Bureau of Financial Institutions

Sincerely,

/s/William N. Lund

William N. Lund, Superintendent
Bureau of Consumer Credit Protection