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MEMORANDUM

TO: CLIENTS AND FRIENDS OF THE FIRM

FROM: Al Alsup

DATE: October 9, 2002

SUBJECT: OTS Regulations Amended to Eliminate Authority of State Housing Creditors under the Parity Act to Override States Laws Regulating Prepayment Penalties and Late Charges; Texas Law Restricting Prepayment Penalties to be Fully Enforceable Against State Housing Creditors Effective January 1, 2003

INTRODUCTION

The Office of Thrift Supervision (OTS) has amended its regulations on alternative mortgage transactions to eliminate prepayment penalties and late charges from the list of regulations appropriate for, or applicable to, state housing creditors when making, purchasing, or enforcing adjustable rate mortgages (ARMs) or other alternative mortgage transactions in reliance on the federal Parity Act to preempt conflicting state law or regulations. This amendment means that non-federally chartered housing creditors, including state banks, credit unions, and other non-federally chartered housing creditors, such as independent mortgage companies, will again be subject to state law regulating prepayment penalties and late charges instead of OTS regulations. Federally chartered thrifts supervised by the OTS and their operating subsidiaries will continue to be subject to OTS regulations that permit them to impose prepayment penalties and late charges in disregard of any contrary state law regulating those loan terms. The OTS amendment was published as a Final Rule in the Federal Register (67 F.R. 60542) on September 26, 2002, and will be effective January 1, 2003.

BACKGROUND: THE FEDERAL PARITY ACT PREEMPTION OF STATE LAW REGULATING LATE CHARGES AND PREPAYMENT PENALTIES

The Alternative Mortgage Transaction Parity Act of 1982 (12 U.S.C. §§ 3801, *et seq.*), commonly referred to as the Parity Act, generally confers upon non-federally chartered housing creditors, including banks, credit unions, and other housing creditors, such as independent mortgage companies, the authority to make, purchase, and enforce "alternative mortgage transactions" on parity with federally chartered depository institutions so long as the transactions are in conformity with applicable regulations issued by the Comptroller of the Currency in the case of banks, the National Credit Union Administration in the case of credit unions, or the Office of Thrift Supervision in the case of all other housing creditors. Alternative mortgage transactions generally may be made by housing creditors in accordance

with the Parity Act notwithstanding the inconsistent provisions of any state constitution, law or regulation.

Under the Parity Act, the term "alternative mortgage transaction" is defined as a loan or credit sale secured by an interest in residential real property, a dwelling, stock allocated to a dwelling in a residential cooperative housing corporation, or a residential manufactured home:

- in which the interest rate or finance charge may be adjusted or renegotiated;
- involving a fixed rate, but which implicitly permits rate adjustments by having the debt mature at the end of an interval shorter than the term of the amortization schedule; or
- involving any similar type of rate, method of determining return, term, repayment or other variation not common to traditional fixed-rate, fixed-term transactions, including without limitation, transactions that involve the sharing of equity or appreciation.

Adjustable rate mortgages (ARMs) and balloon mortgages are the most common examples of alternative mortgage transactions. The term "housing creditor" is defined in pertinent part to include "any person who regularly makes loans, credit sales, or advances secured by interests in" … these properties.

This authority conferred upon housing creditors applies only to transactions made in accordance with regulations governing alternative mortgage transactions as issued by the Director of the Office of Thrift Supervision for federally chartered savings and loan associations. These OTS regulations generally are found in 12 C.F.R. Part 560 and are set forth in that agency's final rule updating, reorganizing, and "substantially streamlining" its lending regulations and policies published in the Federal Register on September 30, 1996 (61 F.R. 50951–50984). The OTS is authorized by Section 560.2 of the final rule to promulgate regulations that preempt state laws affecting the operations of federal savings associations when deemed appropriate to facilitate the "safe and sound" operation of federal savings associations or to satisfy other broad purposes therein stated, including any state statute, regulation, ruling, order or judicial decision purporting to impose requirements regarding, in pertinent part:

> (5) Loan-related fees, including without limitation, initial charges, *late charges*, *prepayment penalties* [emphasis added], servicing fees, and over limit fees;

Section 560.33 in this regard permits state housing creditors to impose late charges for any delinquent periodic payment and sets out certain limitations on the assessment of permitted late charges. Section 560.34 in turn provides the express authority for a housing creditor to charge a fee in connection with the prepayment of a loan:

> **Sec. 560.34 Prepayments**
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> Any prepayment on a real estate loan must be applied directly to reduce the principal balance on the loan unless the loan contract or the borrower specifies otherwise. Subject to the terms of the loan contract, a Federal savings association may impose a fee for any prepayment of a loan.

Section 560.220 of the OTS regulations sets out the specific authority for state housing creditors to make alternative mortgage transactions despite inconsistent state law and identifies the specific OTS regulations that are appropriate and applicable to the exercise of this authority, including expressly Sections 560.33 regarding late charges and 560.34 regarding prepayments:

Sec. 560.220 Alternative Mortgage Parity Act

> Pursuant to 12 U. S. C. 3803, housing creditors that are not commercial banks, credit unions, or Federal savings associations may make alternative mortgage transactions as defined by that section and further defined and described by applicable regulations identified in this section, notwithstanding any state constitution, law, or regulation. In accordance with section 807(b) of Public Law 97-320, 12 U.S.C. § 3801 note, Sections 560.33 [late charges], 560.34 [prepayment penalties], 560.35 [rate adjustments for home loans] and 560.210 [adjustable rate disclosures, notices and rate caps] of this part are identified as appropriate and applicable to the exercise of this authority and all regulations not so identified are deemed inappropriate and inapplicable. Housing creditors engaged in credit sales should read the term "loan" as "credit sale" wherever applicable.

Accordingly, mortgage companies and other state housing creditors are presently authorized under the preemptive provisions of the Parity Act and OTS regulations to impose a fee, premium or penalty for any prepayment of a loan in accordance with the terms of the promissory note or other loan contract when making a loan qualifying as an *alternative mortgage transaction*, despite any inconsistent state constitution, law, or regulation purporting to restrict or otherwise regulate any such charge. This authority is available to a housing creditor only if (i) its ARMS, balloons, and other alternative mortgage transactions are made in conformity with OTS regulations, including expressly the provisions of Section 560.220 of those regulations, and (ii) it is duly licensed, or exempt from licensing, under the laws of any state in which it seeks to invoke the preemptive authority of the federal act. The authority of state housing creditors to enforce contractual prepayment penalties in reliance on the preemptive provisions of the Parity Act is also subject to the following further limitations, when applicable:

- The preemptive authority of the Parity Act is inapplicable (i) to certain state laws enumerated in Section 560.2(c) of the OTS regulations, including the constitutional homestead laws specified in 12 U.S.C. § 1462(f), and (ii) to state laws in states that elected to override the Parity Act during the three-year window period ending October 15, 1982, as provided in 12 U.S.C. § 3804. [NOTE: Texas did not override the Parity Act during the window period.]
- Federal law may prohibit the imposition of a prepayment penalty when made in connection with a housing creditor's enforcement of a *due on sale* clause under 12 C.F.R. Section 591.5(b)(2) and (3) and may restrict the imposition of a prepayment penalty in connection with certain "high-rate, high-cost loans," commonly known as HOEPA or Section 32 loans, that are subject to the provisions of Regulation Z, § 226.32(d)(7).

WHY THE OTS AMENDMENT AND WHY NOW?

When first promulgating its alternative mortgage transaction regulations in 1996, the OTS identified late charges and prepayment penalties in § 560.220 as appropriate and applicable to state housing creditors under the Parity Act based on the apparent rationale contained in a contemporaneous opinion of its chief counsel that state housing creditors would be "disadvantaged vis-à-vis federal thrifts" if required to comply with various state laws restricting late charges and prepayment penalties. The purpose of the Parity Act after all was to assure an adequate national supply of housing credit by eliminating discriminatory advantages that federally chartered institutions enjoyed over state housing creditors when making alternative mortgage transactions. The OTS regulations authorized state housing creditors to make ARMs and other alternative mortgages under the same terms as federally chartered institutions, including overriding state laws prohibiting or restricting late charges and prepayment penalties.

Now, some six years later, the OTS on its own initiative has reexamined the proper scope of regulations that should be available to state housing creditors to assure parity and concluded that late charges and prepayment penalties are not terms *intrinsic* to state housing creditors' ability to provide alternative mortgage transactions and not essential to achieve parity with federally chartered institutions in the making of the loans. Rather, on further reflection, the OTS now reasons that prepayment and late fee charges apply in general to all real estate loans and do not bear directly on the unique features of alternative mortgage transactions. There is no basis in its estimation to any longer distinguish prepayment penalties and late charges from other real estate loan terms that are not given preemptive authority under the Parity Act. The OTS rationalizes its decision to eliminate prepayment penalties and late charges in part by observing that market conditions have dramatically changed since 1982 when the Parity Act was enacted to stimulate housing credit in what was then an unusually high interest rate environment by encouraging adjustable rate mortgages and other creative financing. Today there is a constant flow of capital into the home mortgage business because of the development of an efficient secondary market, and thinly capitalized creditors can originate loans for sale in the secondary market. As a result, the OTS comments further, mortgage credit of all types is widely available and should not be significantly affected by the OTS Amendment, which effectively strips state housing creditors of parity in the ability to impose late charges and prepayment penalties. In that rationale the OTS seems to ignore or marginalize the importance to state housing creditors that prepayment penalties provide in the management of interest rate risk – a significant influence on the cost and general availability of housing credit – while nevertheless reserving to federally chartered thrifts the same ability to impose late charges and prepayment penalties so as to assure the "safety and soundness" of those institutions. Federal thrifts and operating subsidiaries of federal thrifts may impose prepayment penalties at any time and in any amount authorized in the loan contract for both adjustable- and fixed-rate mortgage loans under OTS regulations.

But beneath this gloss of plausible rationale, the OTS Amendment should be seen simply as another *predatory lending* regulation — in this case one yielding to political pressure to curb real and supposed abusive lending practices of some unscrupulous mortgage lenders and brokers who are believed to misuse the Parity Act preemptions to circumvent state laws and regulations. In the current Washington political clamor over so-called *predatory lending*, unregulated late charges and prepayment penalties are perceived to be the very indicia of abusive lending practices. This is particularly the case in the so-called *sub-prime* market where 70%, or more, of all such loans are said to carry prepayment penalties and late charges are often excessive at 10% of the overdue payment. Over one-half of all such loans are thought to be paid off with prepayment penalties ranging from 5–7% of the loan amount and the prepayment penalties simply function as deferred fees that borrowers are forced to pay to benefit from improved rates or as a condition to recasting a loan after default. In the worst cases, high prepayment penalties are said to be used by some unscrupulous lenders to strip equity from the homes of disadvantaged homeowners under so-called *loan flipping* practices in which the prepayment penalties are rolled into the principal loan amounts of successive refinancings over a short period of time in multiple transactions that generate excessive fees and charges for the lenders but produce no apparent benefit to the borrowers. The OTS concludes that laws on prepayment penalties and late charges are a key component in states' regulation of such predatory lending practices and expressly declines to construe its authority under the Parity Act to frustrate these state efforts "where another less intrusive construction of [the Parity Act] is permissible."

Despite criticisms from the mortgage lending industry that the OTS Amendment in effect has "thrown the baby out with the bathwater," the OTS apparently thinks it has not gone far enough. The OTS, in its newly found activism, advocates that the Parity Act itself should be revisited by Congress in the context of broader mortgage reform legislation concerning the Real Estate Settlement Procedures Act, the Truth in Lending Act, and predatory lending law. If not repealed, the OTS urges Congress to once again give states an opportunity to "opt out" of the Parity Act so that housing creditors would be bound by the

state's regulations on alternative mortgage transactions, and, when making loans under the Parity Act in states that do not "opt out," to require that state housing creditors identify themselves to state regulators through registration or other means to enhance enforcement and monitoring activities of state regulatory agencies.

CONCLUSION: THE EFFECT OF THE NEW OTS AMENDMENT ON TEXAS LAW

Effective January 1, 2003, the OTS Amendment deletes references in the OTS regulations to Sections 560.33 [late charges] and 560.34 [prepayment penalties] and amends Section 560.220 to read as follows:

> **Sec. 560.220 Alternative Mortgage Parity Act**
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> (a) *Applicable housing creditors.* A housing creditor that is not a commercial bank, a credit union, or a federal savings association, may make an alternative mortgage transaction as defined at 12 U.S.C. § 3802(1) by following the regulations identified in paragraph (b) of this section, notwithstanding any state constitution, law, or regulation. See 12 U.S.C. § 3803.
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> (b) *Applicable regulations.* OTS identifies §§ 560.35 and 560.210 as appropriate and applicable for state housing creditors. All other OTS regulations are not identified, and are inappropriate and inapplicable for state housing creditors. State housing creditors engaged in credits sales should read the term "loan" as "credit sale" wherever applicable in applying these regulations.

The legal effect of this amendment to § 560.220 is to again subject non-federally chartered housing creditors to state law regulating prepayment penalties and late charges instead of OTS regulations. Texas law in that regard prohibits prepayment penalties in connection with home mortgage loans in two instances set forth in §§ 343.205 and 302.13, respectively, of the Texas Finance Code and in connection with home equity loans as set forth in Section 50(a)(6)(G), Article XVI, of the Texas Constitution.

New Chapter 343 to the Texas Finance Code, which was effective September 1, 2001, imposes restrictions on mortgage lenders when making high-cost home loans, including limitations on balloon payments, negative amortization features, and prepayment penalties. "High-cost home loans" under this act generally refers to traditional closed-end home mortgage loans that (i) are secured by real property improved by a one-to-four family dwelling (including a manufactured home) that is used or is to be used as the borrower's principal residence and that (ii) are credit transactions subject to the enhanced notice, restricted terms, and other requirements for certain high-rate, high-cost loans under the federal Truth in Lending Act, sometimes referred to as "Section 32" or "HOEPA" loans. However, "high-cost home loans" under the Texas act are limited to those loans that do not exceed in principal amount one-half of the maximum Fannie Mae conventional loan amount, which today would be $137,500, and, unlike Section 32 loans, include residential mortgage loans used to purchase or to construct the borrower's principal residence, if the total loan amount is at least $20,000. New Section 343.205 in that regard provides:

> PREPAYMENT PENALTIES PROHIBITED. A lender may not make a high-cost home loan containing a provision for a prepayment penalty.

Prepayment penalties also are prohibited under Texas law in connection with the repayment of residential mortgage loans secured by the *residential homestead* of the borrower if the interest rate on the loan is greater than 12% per annum. The Texas Finance Code § 302.102 in this regard provides:

PROHIBITION ON PREPAYMENT PENALTY. If the interest rate on a loan for property that is or is to be the residential homestead of the borrower is greater than 12 percent a year, a prepayment penalty may not be collected on the loan unless the penalty is required by an agency created by federal law.

Although these provisions at first appear duplicative, a mortgage loan with an interest rate greater than 12% would not necessarily meet the definitional test of a "high-cost home loan" and the prohibitions on prepayment penalties of § 302.102 would appear to apply to all loans secured on a residential homestead regardless of the loan size or other definition limitations of § 343.205. Furthermore, the prohibitions of prepayment penalties under new § 343.205 apply only when the annual percentage rate or total points and fees charged with respect to a home loan exceed certain Section 32 thresholds, while prohibitions under § 302.102 apply when the interest rate alone exceeds 12% a year.

In that regard, however, the nominal note rate may not be controlling. Under Texas law, charges other than the contract rate of interest may constitute interest and, therefore, should be taken into account in determining whether interest in any case exceeds 12% a year for purposes of this statutory prohibition. Any finance charge imposed by a lender "for the use or forbearance or detention" of money, however denominated, would constitute interest as defined in the Texas Finance Code. That includes origination fees, discount points and similar lender charges, and such other charges as commitment fees when paid at or near the time of loan closing, and thus not regarded as valid compensation for the lender's commitment to make a loan at some future time, "compensating balances" when the borrower is required by the lender to maintain a depository balance as a condition of the loan, and charges imposed by the lender on any delinquent installment, all of which Texas courts have found to constitute interest.

Finally, it should be noted that Texas home equity loans made under the authority of Section 50(a)(6), Article XVI, Texas Constitution, must be payable in advance at any time without penalty or other charge, and this constitutional requirement has never been subject to preemption under the Parity Act (because of exclusion under the so-called Henry B. Gonzales amendment of constitutional homestead laws specified in 12 U.S.C. § 1462(f)). Moreover, Texas law is more restrictive than even federal law regulating high-cost home loans. Texas law imposes an absolute prohibition of a prepayment penalty in connection with these loans (or any loan secured on a homestead property in which the rate of interest is greater than 12%), whereas federal law merely restricts the imposition of a prepayment penalty in connection with certain "high-rate, high-cost loans" subject to the provisions of Regulation Z, § 226.32(d)(7). Federal law permits a prepayment penalty in connection with these loan only if (i) the penalty may be exercised solely within the first five years of the loan term, (ii) the source of the prepayment funds is not a refinancing by the creditor or its affiliate, and (iii) at the time loan was made the borrower's total monthly debts, including the mortgage debt, does not exceed 50% of the borrower's monthly gross income. Under the effects of the OTS Amendment, the more restrictive Texas law will apply and govern the imposition of prepayment penalties in Texas as of January 1, 2003.