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THE WINTER OF OUR DISCONTENT: MADE GLORIOUS SUMMER. . . BY DOCMAGIC STATE-BASED PREPAYMENT PENALTY REQUIREMENTS AND THE DOCMAGIC SOLUTION

*Lissa Marie Cinat, Esq.**

Now is the winter of our discontent
Made glorious summer …by Doc Magic?[1]

Indeed!!

INTRODUCTION

"Justice? You get justice in the next world … in this world you have the law."

----- William Gaddis

Justice for the mortgage lending industry or not, on July 1, 2003 "the law" – for state-chartered housing creditors -- will include state-based restrictions on prepayment penalties assessed in connection with alternative mortgage transactions. This is so because the Office of Thrift Supervision ("OTS") will no longer identify prepayment penalties as "intrinsic" to such transactions. Since October 1996 the OTS has identified such penalties as central to alternative mortgages, and the federal Alternative Mortgage Transaction Parity Act ("Parity Act") thus enabled state-chartered housing creditors to make alternative mortgage loans without regard to state-based prepayment restrictions. According to the OTS itself, the change in the law is motivated largely by an identified growth in predatory loans, and a perceived contribution of prepayment penalties thereto. Congress passed the Parity Act two decades ago in response to economic circumstances that required greater freedom for lenders to extend residential housing credit to borrowers in desperate need of the same. The OTS is now restricting this freedom, believing it to have provided a lender's license to abuse sub-prime borrowers who do not have bargaining power in the marketplace. The "winter of our discontent" – for mortgage lenders -- came to pass in late 2002 when the Office of Thrift Supervision decided that the Alternative Mortgage Transaction Parity Act would no longer override state-based prepayment penalty regulations in connection with alternative mortgage loans.[2] Despite the regulatory change -- the summer of 2003 will be made glorious by DocMagic -- the company that will ensure that all mortgage loan documents are fully compliant in the face of the OTS change.[3]

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* Lissa Marie Cinat is Associate General Counsel for Document Systems Inc. Ms. Cinat received her J.D., *cum laude*, from the University of Michigan School of Law where she was Book Review Editor and an Associate Editor of the *Michigan Law Review*. She received her B.A. *with High Distinction* from the University of Michigan at Dearborn. Ms Cinat is licensed to practice law in both California and Michigan. She has extensive experience in both general civil litigation and mortgage lending compliance issues.

[1] Paraphrase of W. Shakespeare, *Richard III*, Act I, scene I, line i.

[2] The OTS initially scheduled the change in the Parity Act regulations to become effective January 1, 2003. On December 12, 2002 the OTS stated: "upon reconsideration, OTS believes that an extension is warranted to provide state housing creditors with additional time to adapt to newly applicable state and local requirements. Specifically, OTS believes that a delay is necessary to permit state housing

This Article consists of three essential parts. First, the Article will review the history of the Alternative Mortgage Transaction Parity Act and the largely incoherent treatment that the OTS has given prepayment penalties in connection with alternative mortgages. This part of the Article will argue that the OTS' failure to articulate a comprehensive, consistent policy in connection with prepayment penalties is the result of Congress' concomitant failure to specify whether the statute's express purpose of "parity" was distinct from -- or convergent with – defining an alternative mortgage loan. Second, the Article will examine predatory lending legislation and will conclude that such legislation motivated the OTS decision to remove prepayment penalties as applicable to state-chartered housing creditors making alternative mortgage loans. Third, this Article will examine specific state-based prepayment penalty restrictions and will demonstrate that – although federal law will no longer preempt state-based prepayment penalty laws – prepayment penalties are nonetheless alive and well. In fact, in some cases, state-based predatory lending legislation arguably and ironically allows prepayment penalties that are more generous than those prescribed for lenders originating prime mortgage loans in the same jurisdiction. Star-crossed laws? In some instances – Yes! Finally, Part Four of the Article will briefly examine the laws in those states that have enacted legislation specific to alternative mortgage transactions and will compare these laws to those that govern fixed-rate loans. This section will demonstrate that only a handful of states will require adjustment to prepayment penalty rules after July 1.

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creditors to (1) determine applicable legal requirements and (2) reprogram systems and rewrite documents and (3) conduct training. The OTS further stated: Under the revised PPTS rule, state housing creditors that engage in alternative mortgage transactions under the [Parity Act] will become subject to state laws on prepayment penalties and prepayment charges.... Because state prepayment penalty and late charge restrictions for alternative mortgage transactions frequently differ substantially from restrictions on fixed-rate products, any experience that that a state housing creditor may have with applicable restrictions on fixed-rate mortgages may be irrelevant. See 67 Federal Register 76305. For additional analysis on the reasoning that underlies the OTS delay, see page 12 infra.

[3] Make no mistake: Congress has not "repealed" the Parity Act, nor is the Office of Thrift Supervision about to take action that will annul the preemptive effects of the Parity Act altogether. The effect of OTS action is simply as follows: lenders will have to apply state-based limitations on prepayment penalties and late charges to alternative mortgage loans just as states have been required to do in connection with fixed-rate mortgage loans. To the extent that a particular state contains complicated prepayment laws that treat variable rate loans and fixed rate loans differently (and there are really very few), prepayment penalty rules may become arguably more complex. To the extent that a particular state does not regulate prepayment penalties at all (and there are some) the OTS change may not make all that much difference. Whatever the future holds, DocMagic is fully and completely prepared.

<u>PART ONE</u>: ALTERNATIVE MORTGAGES AND PREPAYMENT PENALTIES UNDER THE PARITY ACT

HISTORY OF PARITY ACT

Necessity is the mother of invention, no less so with federal legislation than with any other creation. The United States Congress crafted the Alternative Mortgage Transaction Parity Act in 1982 when the residential housing market was immersed in socio-economic chaos. At that time, interest rates were volatile and unusually high. To complicate matters, many states had outright <u>prohibited</u> mortgage lenders from originating "alternative" mortgage loans – that is loans that were not fixed-term, fixed-rate, and fully amortizing transactions. State housing creditors, therefore, could not adjust long-term mortgage portfolios to high and widely fluctuating short- term deposit interest rates. Lenders that had to conform to state restrictions on alternative mortgages simply did not originate residential loans. Housing credit was consequently in short supply and unavailable to many persons who sought access to residential housing. To remedy these circumstances, Congress enacted the Alternative Mortgage Transaction Parity Act so that state-based housing creditors could originate alternative mortgage loans – like their federal counterparts -- in contravention of state laws that prohibited or impeded the same. Specifically, Congress asserted:

> It is the purpose of [the Parity Act] is to eliminate the discriminatory impact that [state] regulations have upon non-federally chartered housing creditors and provide them with parity with federally chartered institutions by authorizing all housing creditors to make, purchase and enforce alternative mortgage transactions so long as the transactions are in conformity with the regulations issued by the Federal agencies.

12 USC 3801(b).

The Parity Act further stated:

> In order to prevent discrimination against … non federally chartered housing creditors, with respect to making, purchasing and enforcing alternative mortgage transactions, housing creditors may make, purchase and enforce alternative mortgage transactions, except that this section shall apply ---
>
> With respect to housing creditors…only to transactions made in accordance with regulations governing alternative mortgage transactions as issued by the OTS… to the extent that such regulations are authorized by rulemaking authority granted to the OTS by laws other than this Section.
>
> An alternative mortgage transaction may be made by a housing creditor in accordance with this section, notwithstanding any State constitution, law or regulation

12 U.S.C. 3803

Congress also issued the following findings to support the legislation:

1. *Interest Rates*. Volatility of interest rates impaired the ability of lenders to provide consumers with fixed-rate home loans.
2. *Supply of Credit*. Alternative mortgage transactions were essential to the supply of residential mortgage credit.
3. *Federal Regulations*. The Comptroller of the Currency and the National Credit Union Administration and the Federal Home Loan Bank Board had recognized the importance of alternative mortgage transactions and had adopted regulations permitting federally chartered institutions to make such loans
4. *Purpose of Parity Act.* The purpose of the Parity Act was to eliminate the discriminatory impact that those regulations had on non-federally chartered institutions by providing them parity with federally chartered lenders. The Parity Act authorized all housing creditors to make and purchase alternative mortgages so long as the transactions were made in conformity with applicable federal regulations.

According to the legislation, the ultimate goal of the Parity Act was to enable state chartered housing creditors to originate alternative mortgage transactions on an equal footing with their federal counterparts.

HEY BROTHER CAN YOU PARADIGM? [4] DEFINING AN ALTERNATIVE MORTGAGE TRANSACTION

While the goals of the Parity Act are clear on the face of the statute, Congress apparently could not – or did not -- provide a paradigm, at least where alternative mortgages themselves were concerned. Under the Alternative Mortgage Transaction Parity Act an "alternative mortgage transaction" is broadly defined as a loan or a credit sale secured by an interest in residential real property, a dwelling, all stock allocated to a dwelling unit in a residential cooperative housing corporation or a residential manufactured home:

(A) In which the interest rate or finance charge may be adjusted or renegotiated (adjustable rate mortgages)

(B) 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 (balloon mortgages).

(C). 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, described and defined by applicable regulation (loans with any feature not common to fixed term fixed rate transactions).

12 U.S.C. 3802(1).[5]

[4] Kenneth W. Graham, There'll Always Be an England: The Instrumental Ideology of Evidence, 85 *Michigan Law Review* 1204 (1987)

Congress directed three federal agencies – the Office of the Comptroller of the Currency ("OCC"), the National Credit Union Administration ("NCUA") and the Federal Home Loan Bank Board (now the Office of Thrift Supervision) -- to "identify, describe and publish" those federal regulations that are "appropriate" for state-based lenders making alternative mortgage loans.[6] So long as state-based lending institutions made alternative mortgage transactions in conformity with the specified regulations, state laws were irrelevant. While the statute does define alternative mortgage by reference to variable rate loans, balloon loans, and loans with any other feature not common to fixed-term, fixed-rate transactions, it arguably allows the three federal agencies that regulate the relevant financial institutions to virtually define the part and parcel of alternative mortgage loans. To wit:

> Housing creditors may make purchase and enforce alternative mortgage transactions, except that this section shall apply …***only to transactions made in accordance with regulations governing alternative mortgage transactions as issued by the OTS*** … to the extent that such regulations are authorized by the rulemaking authority granted to the OTS by laws other than this section.

12 U.S.C. 3803(a)

Thus, the Parity Act indicates that a state-based mortgage lender can make an "alternative mortgage loan" free from state-based restrictions so long as the OTS defines the transaction an "alternative mortgage loan". The reasoning contained in the statute is completely and utterly circular. According to the OTS: "to be considered an alternative mortgage transaction within the meaning of the Parity Act, a loan must conform to regulations that the OTS specifies as … definitive of alternative mortgages." *See* Opinion of OTS Chief Counsel, February 10, 1997. In other words, a loan is an alternative mortgage transaction if it is an alternative mortgage transaction according to the OTS. As a result, prepayment penalties have gotten lost in the fray. [7] A prepayment will be definitive if an alternative

[5] In a recent rulemaking, the OTS has further stated that the following types of transactions are alternative mortgage transactions under the Parity Act. Although the OTS states that the Parity Act applies to all loans that do not conform to the traditional fully amortizing fixed-term, fixed-rate fully amortizing loan, it has further stated that the following types of transactions are alternative mortgage transactions under the Parity Act:] Interest rates that reduce if the borrower pays on time. Loans that reflect a borrowers actual payment performance can be alternative mortgage transactions under (A) or (C). Balloon Payments. A loan may be an alternative mortgage transaction if it has a fixed rate, but permits rate adjustments by having the debt mature at the end of an interval shorter than the term of the amortization schedule (e.g. balloon loan.) Shared Appreciation. Shared appreciation loans are specifically included in paragraph C and can be an alternative mortgage transaction. Negative Amortization Some mortgages are designed to negatively amortize or have the potential to negatively amortize in the absence of delinquency or default.

[6] As will be explained more fully below, the Office of the Comptroller of the Currency is responsible for regulating national banks and the regulations that it identifies under the Parity Act are therefore applicable to state-chartered banking institutions. The National Credit Union Administration governs federal credit unions, and the rules that it identifies as applicable to alternative mortgages are applicable to state-chartered credit unions. Finally, the Office of Thrift Supervision (formerly the Federal Home Loan Bank Board) regulates all other "housing creditors". A housing creditor is any person who regularly makes loans, credit sales, or advances secured by interests in properties … or any transferee of any of them." To be a housing creditor under the Parity Act, an entity must be licensed under applicable state law and be subject to applicable regulatory and enforcement mechanisms of State law. See 12 U.S.C. 3802(2).

[7] A prepayment penalty is simply a charge that a lender assesses from a borrower for the borrower's repayment of a loan before the loan is due. M. Dennis, *Residential Mortgage Lending*, p.362. The idea of such an assessment in a loan transaction is really just that simple. The prepayment charge is intended to protect a lender from a reduction in the cash flow that it expects based upon the original loan, term and rate. If a borrower pays a loan early, the lender would loose the cash flow that it expected based upon the loan term and rate and the prepayment penalty compensates for this. Under the common law, the mortgagor had no right to prepay the mortgage. The rationale for

mortgage transaction if the OCC, NCUA and OTS assert that such is the case – and conversely – a prepayment penalty will be excluded from the definition of alternative mortgage if the OCC, NCUA and OTS deem that to be so as well.

"THREE BLIND MICE":
THE OFFICE OF COMPTROLLER OF CURRENCY, NATIONAL CREDIT UNION ADMINISTRATION AND THE OFFICE OF THRIFT SUPERVISION

As indicated, Congress clearly articulated two concepts as integral to the Parity Act: defining alternative mortgages and achieving parity between state and federal lending institutions. Not only did Congress articulate circular reasoning in directing the OCC, the NCUA and the OTS in terms of defining alternative mortgages under the Parity Act, the Congress provided no guidance as to whether these concepts of parity and alternative mortgage are analytically *convergent* or analytically *distinct*. In other words, must a loan attribute define an alternative mortgage in order to preempt state law (in which case the concepts converge) or is it sufficient for a loan attribute to achieve parity regardless of whether it is definitive of an alternative mortgage loan (in which case the concepts are distinct). Because Congress was not clear in this regard the role of prepayment penalties has been the subject of regulatory confusion. A loan attribute such as a late charge or a prepayment penalty, for example, may not be "intrinsic" to or "definitive" of an alternative mortgage because fixed-rate loans possess them as well, but the ability to assess these fees may well affect a lender's ability to compete on equal footing in the marketplace. As the OTS itself has stated: Apart from references to federal regulations governing alternative mortgage transactions and regulations authorizing federally chartered lenders to engage in alternative mortgage transactions, *neither the statute nor the legislative history details how the three federal agencies are to exercise their authority under [the Parity Act]….* [the Parity Act] and the legislative history do not reference or provide examples of specific types of regulations that the agencies should identify for state housing creditors. " See Office of Thrift Supervision, Final Rulemaking.

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this rule lies is the lender's contractual right to have its money earning the stipulated rate of interest. The rule applies, furthermore, even when the borrower offers to pay all principal and interest to maturity of the debt. *See Peter Fuller Enterprises Inc. v. Manchester Savings Bank,* 102 NH 117, 152 A2d 1979 (1959)[7] Prepayment penalties are clearly not unique to alternative mortgage transactions. Many fixed rate transactions possess them as well. Nonetheless, the three agencies responsible for regulating financial institutions making alternative mortgage loans have struggled with the place such penalties play in those types of transactions. Such is especially the case with the OTS. Further, although the concept is relatively simple and straightforward, opinions on such penalties are vociferous and perspectives vary wildly in the mortgage lending industry. According the United States Department of Housing and Urban Development, for example, such penalties are disadvantageous to the borrower, and are simply not allowed for FHA or VA loan transactions. The NCUA disallows prepayment penalties altogether as well. The mortgage lending industry has a much different perspective. Lenders basically contend that prepayment penalties enable a lender to offer lower interest rates, thus providing borrowers with affordable loans. Lenders also generally contend that without prepayment penalties they would not be able to manage the risk of prepayment. Further, "loans prepay at a much faster rate in 2002 than they did in 1982, injecting more risk in the process of originating mortgage loans. In addition, the role of the secondary market and investors in establishing loan pricing and risk characteristics is much more highly developed." See Comment, America's Community Bankers, Letter Dated July 24, 2002 to OTS.

All And Nothing: The National Credit Union Administration and Prepayment Penalties

The National Credit Union Administration is the federal regulatory agency that governs and regulates federal credit union associations. The NCUA identifies all of its lending regulations as applicable to alternative mortgage transactions. Mortgage regulations that the NCUA identifies include the term of the loan, requirements governing security instruments, notes and liens, due on sale provisions, and loan assumptions. Although the NCUA identifies each and every regulation as applicable to alternative mortgages, it *bans* federal credit unions -- and thus state based credit unions -- from imposing prepayment penalties on any type of loan. Neither state-based credit unions nor their federal counterparts may impose prepayment penalties in connection with alternative mortgages. Note, however, that consistency -- and by implication parity -- between state and federal credit unions exists in connection with prepayment penalties and alternative mortgage loans. A relatively clear vision, therefore, seems to exist.

Little But Everything: The Office of the Comptroller of the Currency and Prepayment Penalties

The Office of the Comptroller of the Currency regulates federal banks. The OCC identifies a narrow set of rules as applicable to alternative mortgage transactions. The OCC authorizes certain indices, and specifically allows lenders to assess prepayment penalties in connection with alternative mortgages. Specifically, the OCC has promulgated a prepayment penalty provision that applies only to ARM lending. The OCC applies this rule to state-chartered banks under the Parity Act. Thus, state-chartered banks may make alternative mortgage loans without regard to state based prepayment penalty restrictions. Again, consistency and thus parity are the hallmark of prepayment penalties for banking institutions under the OCC.

DIZZY!! MY HEAD IS SPINNING: The Office of Thrift Supervision and Prepayment Penalties

Consistency is certainly not the legacy of the Office of Thrift Supervision -- and its predecessor the Federal Home Loan Bank -- in connection with their treatment of prepayment penalties and alternative mortgages. These agencies have been particularly irresolute in relation to prepayment penalties and alternative mortgages. Consider the following -- largely incoherent -- regulatory history.

An Overview: The Initial 1982 Rule

When Congress enacted the Parity Act in 1982 the FHLBB published a temporary rule to implement the Parity Act directive. The temporary rule identified regulations that governed the following loan attributes:

- Adjustments to interest rate
- Adjustments to payment and loan balance
- The use of indices
- Adjustment notices and initial disclosure requirements

The initial temporary rule did <u>not</u> identify federal regulations on prepayment charges as essential to an alternative mortgage loan. The <u>final</u> rule that the FHLBB published also did not identify prepayment penalties as intrinsic to the definition of an alternative mortgage transaction. Thus, from 1982 to 1996 – a period of fourteen years – the OTS did not identify prepayment penalties as regulations that the Parity Act preempts. State-based lenders making alternative mortgages were thus subject to state prepayment penalty restrictions for a decade and a half.

<u>1996: Unexplained Modifications</u>

In January 1996, OTS proposed moving applicable Parity Act regulations to a new location in the Code of Federal Regulations, ostensibly to make the rules easier for housing creditors to locate. The OTS also proposed to "modify" the applicable regulations, without explaining the significance of the modifications it proposed. Specifically, the OTS made several additional mortgage-lending rules pertinent to state housing creditors, including the OTS regulation addressing prepayment penalties. The change in the OTS regulatory scheme and the identification of prepayment penalties contained <u>no</u> discussion of the reasons underlying the inclusion of prepayment penalties in the list of regulations suddenly identified. The new set of regulations applicable to state housing creditors, effective October 30, 1996, were as follows:

560.33 Late Charges. OTS reference to this regulation permitted state housing creditors to impose late charges for any delinquent periodic payment in disregard of state laws restricting or regulating the same so long as they complied with the federal regulation.

560.34 Rate Adjustments. OTS reference to this regulation addresses adjustments to interest rates, adjustments to payment and loan balance and the use of indices. Again, it allows state-chartered housing creditors to originate alternative transactions without adherence to state laws that regulate these loan features so long as the state housing creditor complied with the federal regulation.

560.210 Disclosures. OTS reference to this regulation permits state housing creditors to provide initial disclosures and adjustment notices for variable rate transactions in compliance with federal rules in disregard of state-based rules regulating the same.

560.35 Prepayment Penalties. OTS reference to this regulation permits state housing creditors to impose a prepayment penalty regardless of state laws restricting or limiting the same. Such is the case so long as the state housing creditor complied with federal regulations on prepayment penalties.

In all but five states[8] lenders making alternative mortgages could assess prepayment penalties free from state based restrictions so long as the penalty was in accordance with federal prepayment regulations. Federal regulations for housing creditors in connection with prepayment penalties simply provided that:

> 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.

12 C.F.R. 560.34

With a simple change of location in the Code of Federal Regulations—a change made largely in a vacuum and without explanation – the OTS literally changed the face of alternative mortgage lending for state-based housing creditors.

"PARITY" AS ANALYTICALLY DISTINCT FROM THE "ESSENTIAL NATURE" OF AN ALTERNATIVE MORTGAGE

Fifteen years after passage of the Parity Act, state-based housing creditors could make alternative mortgages free from state-based prepayment restrictions. The chaotic "back and forth" treatment that prepayment penalties have received does not end with the OTS' unexplained regulatory modifications the OTS made in 1996 for prepayment penalties. OTS legal opinions on the prepayment penalty regulation are equally as baffling. As noted, Congress provided the OTS with broad discretion to decide which regulations were – and which were not – applicable to alternative mortgages. It did so, moreover, without specifying whether the goal of the Parity Act was to accomplish "parity" regardless of whether a loan attribute is "intrinsic" to an alternative mortgage or whether a loan attribute must be "intrinsic" to an alternative mortgage in order to be considered conducive to the attainment of "parity". Consider OTS regulatory behavior apart from the 1996 rulemaking, particularly OTS legal opinions issued regarding prepayment penalties and alternative mortgages.

THERE YOU GO AGAIN![9] Opinion of OTS Chief Counsel, April 1996 and Continuing Confusion

If the regulatory history of the OTS is not confusing enough, a perusal of OTS legal opinions that buttress those regulations may well convince the reader that "reason" is not the heart OTS rulemaking any more than – in this case -- brevity is the soul of wit. The most illuminating, yet confusing, piece of authorship that has emanated from the OTS in connection with prepayment penalties is an opinion of the OTS Chief Counsel dated April 30, 1996. In the Opinion, the Chief Counsel clearly articulates the Parity Act's goal of parity is best served by allowing state-based housing creditors to disregard state prepayment penalty restrictions.

[8] Under the Parity Act, states could "opt out" of the preemptive effects of the Act for a period of three years after the statute's passage. The states that opted out are Arizona, Massachusetts, Maine, New York, South Carolina and Wisconsin. Of these five states, two – Arizona and Wisconsin – opted out of the Parity Act only "partially".

[9] A famous line of President Ronald Reagan, that captures the essence of blindly and repeatedly making the same mistakes.

> Federal thrifts are permitted to impose prepayment penalties at any time and in any amount authorized under their loan contracts. For these purposes, no distinction is drawn between variable rate and fixed rate mortgages. Thus unlike lenders operating under [the state statute at hand] federal thrifts are not required [to provide a 30 day window] after each interest rate adjustment nor are federal thrifts prohibited from imposing prepayment penalties after the fifth anniversary of the origination of the loan.
>
> If state housing creditors were required to follow the state statute [restricting prepayment penalties] when making variable rate mortgage loans, they would clearly be disadvantaged vis-à-vis federal thrifts, the very result Congress intended to prevent. The Wisconsin statute thus appears to fall within the scope of laws preempted by the Parity Act.

OTS Chief Counsel, Dated April 30, 1996.

The OTS thus recognizes in this opinion that the Parity Act preempts state-based prepayment penalty restrictions because the ability to feely assess prepayment penalties has a direct affect on the competitive position of state-based housing creditors. Such is the case even though prepayment penalties are not intrinsic to alternative mortgages. The OTS opinion, though again notable again for its brevity of analysis, does implicitly articulate the following reasoning in connection with the role of penalties for premature payment of a loan. Prepayment penalties directly affect the parity of state-based housing creditors. The presence or absence of a prepayment charge in a mortgage may directly affect the pricing of the mortgage product. If a federal savings institution was permitted to include prepayment charges in its mortgage products while a state based housing creditor was not permitted to include prepayment charges in its mortgage products – or to include them only on less favorable terms and conditions – then the state chartered housing creditor would be forced to price its mortgage products with higher rates or fees. The increased pricing would make the housing creditors products less competitive in the marketplace. The increased pricing could also decrease the supply of residential mortgage credit for many consumers. [10]

Unbelievably, the OTS issued this opinion before it recognized its regulations relating to prepayment penalties as those appropriate, intrinsic or essential to making alternative mortgage loans. At the very same time that the OTS took the position that prepayment penalties are not intrinsic to alternative mortgages or to the attainment of parity, it issued an opinion indicating that prepayments were fundamental to parity. The OTS thus took a legal position in contravention of its own prepayment penalty regulations!

[10] The Maryland Attorney General has also stated that the ability of a housing creditor to impose prepayment fees enlarges the secondary market for these loans, thereby increasing the amount of housing credit available. *See* Maryland Attorney General Opinion dated August 19, 1997.

> One area of preemption involves prepayment fees, because the ability of a housing creditor to impose prepayment fees is thought to enlarge the secondary market for these loans, thereby increasing the amount of housing credit available. …Thus it is clear that State law prohibitions against and restrictions on prepayment fees do place non-federally chartered housing creditors at a competitive disadvantage with their federally chartered counterparts, which are not subject to these prohibitions and restrictions. This “uneven playing field” presents the very situation that the Parity Act was intended to prevent.

See Opinion of Maryland Attorney General, Dated August 19, 1997. Thus, the preemption of prepayment penalties in connection with alternative mortgage loans serves the express Congressional purpose of expanding the housing credit supply.

As of April 1996 OTS chief Counsel indicated that the Parity Act preempted state-based prepayment penalty restrictions, but the formal regulatory change did not take place until October 1996.

The OTS opinion did recognize, however, that prepayment penalties were not *ipso facto* central to alternative mortgage loans. Instead, they "fell somewhere between laws that the Parity Act clearly preempts such as state laws that bar variable rate transactions and laws that the Parity Act clearly does not preempt – liens and foreclosures."

> The Parity Act provides no explicit guidance regarding the types of state laws Congress intended to preempt. On the one hand, it is clear that certain state laws, such as those governing liens and foreclosure, still apply to loans originated under the Parity Act…On the other hand, it is equally clear that a state law prohibiting the issuance of variable rate loan would be preempted by the Parity Act. The [prepayment penalty statute] falls somewhere between these two examples in its potential impact on alternative mortgage loans.

Opinion of Office of Thrift Supervision, Dated April 30, 1996.

In February 1997 the OTS reiterated this position in connection with prepayment penalties. "The regulations do specify that to be considered an alternative mortgage transaction within the meaning of the Parity Act, a loan must conform to OTS regulations regarding late charges, prepayments, adjustments to interest rate, payment, balance or term to maturity and disclosures…The OTS recently concluded that prepayment penalty restrictions imposed by state law on variable rate loans were preempted by the Parity Act and that state lenders … that originate variable rate loans under the Parity Act and in conformity with all applicable OTS regulations need not comply with state restrictions [on prepayment penalties]." See Opinion of OTS Chief Counsel dated February 10, 1997.

"PARITY" AS ANALYTICALLY CONVERGENT WITH QUALITIES "INTRINSIC" TO ALTERNATIVE MORTGAGES

The OTS spent seven years attempting to justify – however ambiguously -- its identification of prepayment penalty regulations as central to alternative mortgage transactions under the Parity Act. The reasoning that OTS employed seems to have concentrated on the attainment of parity for state-based housing creditors as opposed to the "essential nature" or "quality" of alternative mortgage transactions. In its recent rulemaking this reasoning has been completely reversed.

Portions of the Parity Act do seem to indicate that it was intended only to preempt those laws that interfere with actually making alternative mortgage loans. The statute states, for example, that "housing creditors may make, purchase and enforce *alternative mortgage transactions*" and "*an alternative mortgage transaction* may be made by a housing creditor…notwithstanding any State constitution, law or regulation." Under the Parity Act, an alternative mortgage loan is an adjustable rate mortgage, a balloon mortgage, or a mortgage involving any similar type of rate, method of determining return, repayment or other variation not common to traditional fixed rate, fixed term transactions. Given this definition – one could take the position that the Parity Act was intended to preclude only those state laws that address loan features unique to alternative mortgages – features that fixed rate, fixed term transactions do not possess. Specifically:

> Section 3803 (c) was meant to preempt only those state laws that obstruct the making of Alternative Mortgage Transactions. According to Plaintiffs, prepayment penalties do not obstruct the creation the creation of [Alternative Mortgage Transactions] and therefore are not preempted by section 3803. Plaintiffs argue that such an interpretation is mandated by the plain language of Section 3803(c). [11]

In its recent rulemaking, the OTS concludes that the prepayment provisions are not essential or intrinsic to alternative mortgages. Rather, these regulations apply to real estate lending in general and are part of a broader regulatory scheme governing the lending operations of thrifts. One of the Congressional findings underlying the Parity Act was that the various federal regulators adopt regulations authorizing federal institutions to offer alternative mortgages, and that the purpose of the Parity Act was to eliminate the discriminatory impact of those regulations. Prepayment fees are not to enable thrifts to engage in alternative financing, but rather to permit them to operate safely and soundly under a uniform federal scheme. Therefore, these regulations do not offer a basis for discriminatory treatment and are not needed to provide parity with federally chartered institutions. *See* Final Rulemaking at 9-10. Without explicit recognition of the reasoning that it employs, the OTS now collapses the concepts of intrinsic to alternative mortgages with the goal of parity. It specifically states that if a loan attribute does not enable a lender technically to make an "alternative mortgage loan" that loan attribute is not essential to the attainment of "parity".

The OTS also surmises that <u>Congress</u> did not find that prepayment penalties are philosophically or esoterically "intrinsic" to alternative mortgages. While the OTS admits that neither the Parity Act nor its legislative history provides any useful guidance on the issue, it noted that Congress banned federal credit unions from imposing prepayment penalties, which suggests that at least for credit unions, Congress recognized that prepayment penalties were not essential to the ability to make purchase or enforce alternative mortgage transactions. See Final Rulemaking at 16. OCC regulations on the other hand permitted banks to impose prepayment penalties on ARMs until 30 days prior to the first scheduled interest rate adjustment. Bank Board regulations permitted savings associations to impose prepayment penalties on alternative mortgages under limited circumstances. "If Congress had viewed the regulation of prepayment penalties as essential to parity it is unlikely that Congress would have imposed a regulatory scheme that ay the time of enactment ensured different treatment among the various state creditors." *See* Rulemaking at 17.

The OTS now not only contends that prepayment penalties are not "intrinsic" to alternative mortgages, but it also argues that as an <u>empirical</u> matter they are not essential to the attainment of parity. "Contrary to commenters' [sic] speculation, historical evidence

[11] *Shinn v Encore Mortgage Services,* 96 F. Supp.2d 419 (D.N.J. 2000)

indicates that the final rule should not have significant detrimental effect on state housing creditors ability to compete against federal thrifts in the alternative mortgage market. State housing creditors functioned for 14 years (1982 – 1996) without applying OTS regulations on …prepayments…These regulations are not essential for parity. Moreover, the OTS has concluded that "state housing creditors were vigorous competitors during this time period." In 1982 commercial banks and thrifts dominated the alternative mortgage market by originating 66% of one to four family mortgages. Mortgage companies market share was significantly smaller at 28.9 percent of the market. By 1996, when OTS changed its Parity Act rules, these positions had reversed with mortgage companies originating 56.8 percent and commercial banks and thrifts originating 42.5% of all one to four family mortgages. Thus, the Parity Act – without the inclusion of prepayment preemption – enabled state based housing creditors to compete vigorously with federal housing creditors.

THE FEDERAL COURTS: A RUBBER STAMP FOR THE OTS OR "PARITY" AS AN INDEPENDENT VALUE?

Federal courts have been unwilling to read the statute narrowly to preclude only those state laws that interfere with alternative mortgage loans. Consider the following two cases which quite cogently analyze precisely the issues with which the OTS has grappled. Ultimately, the Courts decide that the Parity Act does not mandate only those regulations technically definitive of loan transactions that are "alternative." What is unclear is whether the following Courts s held because the OTS had already identified prepayment regulations as central to alternative mortgages, or whether the Courts found parity to be an independent value under the Parity Act itself. The OTS predictably concludes that these Courts found only that the Parity Act preempts prepayment penalties because the OTS identified them as central to alternative mortgage transactions.

> The Courts ruling correctly rested on whether OTS had designated its prepayment fee regulation as applicable to alternative mortgage transactions. Under 6this analysis, if OTS did not so designate the prepayment fee regulation, then that regulation would not apply to alternative mortgage transactions, and non-federally chartered housing lenders would be subjected to state laws concerning prepayment fees.

OTS Rulemaking at 21-22.

The following two cases do point up the tension that prepayment penalties pose between the ideal of parity and the concept of alternative mortgage loan. For this reason, they are included here.

Shinn v. Encore Mortgage Services

Shinn v. Encore Mortgage Services, 96 F. Supp. 2d 419 (D.N.J. 2000) crystallizes the confusion the Parity Act can engender. In that case, the plaintiffs borrowed $74,900 from the defendant Encore Mortgage Services. In addition to a variable rate note, the loan documents included a prepayment penalty addendum. The addendum provided that if the borrowers prepaid the loan within the first 36 months of the loan term, they would pay a prepayment fee calculated in accordance with a specified formula. About 45 days after the loan closing, plaintiff refinanced the mortgage, and paid the original loan in full. The prepayment penalty amounted to $4838.80. Plaintiffs subsequently filed a complaint in the New Jersey Superior Court alleging – *inter alia* – that Defendant Encore violated New Jersey's state-based prohibition on prepayment penalties.

The New Jersey law stated "prepayment of a mortgage loan may be made by or on behalf of a mortgagor at any time without penalty." The borrowers argued that the Parity Act – specifically Section 3803 – was meant to preempt only those state laws that obstruct the making of alternative mortgage loans. The plaintiffs further contended that prepayment penalties do not obstruct the creation of alternative mortgages, and that the Parity Act does not therefore preempt them. "Plaintiffs argue that such an interpretation is mandated by the plain language of the Act 'to foster the making of alternative mortgage loans by nonfederal lenders." Id.

The Court flatly disagreed, relied on the objective of federal and state parity and stated:

> *Contrary to plaintiffs' characterization of the Act, the Court finds that section 3903(c) does not limit the preemptive effect of the Act to state laws which would completely prohibit or obstruct the creation of alternative mortgage loans. Section 3803(c) states only that an alternative mortgage transaction may be made by a housing creditor within this section notwithstanding any State constitution, law or regulation." The language does not support plaintiff's' narrow interpretation of the statute's preemptive effect. Nor does the Court agree that the sole purpose of the Act is to enable state lenders to engage in alternative mortgage transactions. A paramount purpose of the Act is to create parity between state and federal lenders who engage in alternative mortgage transactions. The Court finds that the 1996 Opinion and OTS regulations governing prepayment penalties are, to the extent that they preempt state law, a permissible interpretation of congressional authority vested in OTS under the Act*

Id.

National Home Equity Mortgage Association v. Face

In ***National Home Equity Mortgage Association v. Face***, 239 F.3d 633 (4th Cir. 2001), the United States Court of Appeals for the Fourth Circuit held that the preemptive force of the Parity Act was not restricted to those loan features that are intrinsic to or an essential part of an alternative mortgage loan. In that case, the State of Virginia took the position that the Parity Act did not preempt the Virginia state law limiting prepayment penalties. The Virginia State Corporation Commission contended that "Congress explicitly restricted the [Office of Thrift Supervision's] authority to preemption of only such state laws as related to features … not common to traditional fixed rate-rate, fixed term transactions…The Virginia statutes applicable to prepayment penalties...govern a longstanding feature of conventional mortgage lending which Congress left to state law." In response to this position, the National Home Equity Mortgage Association sough injunctive and declaratory relief that would prohibit Virginia from enforcing state-based prepayment restrictions. The United States District Court agreed with the Mortgage Association, prohibited Virginia from enforcing prepayment penalty restrictions and the State of Virginia consequently appealed.

The state of Virginia contended that the scope of preemption effected by the Parity Act does not preclude it from regulating prepayment penalties in alternative mortgage transactions. The State argued that state laws that do not prevent or interfere with alternative mortgage transactions are not preempted. Congress defined alternative mortgage transactions as those that involve terms not common to traditional fixed rate fixed term transactions. Prepayment penalties are not included in this definition because they were and are common to traditional real estate financing. Thus, because the Virginia prepayment penalty statute does not interfere with the making of alternative mortgage transactions the Parity Act does not preempt them.

The Court understood the pertinent issue to be whether the state law stands as an obstacle to the accomplishment of the full purposes and objectives of the relevant federal law.

> In enacting the Parity Act, Congress clearly intended to preempt state law to the extent it authorized non-federally chartered housing creditors to take advantage of the federal regulations for alternative mortgage transactions that govern federally chartered lending institutions. …[The Act state that} it is the purpose of this Title to eliminate the discriminatory impact that those regulations have upon non-federally chartered housing creditors and provide them with parity with federally chartered institutions by authorizing all housing creditors to make alternative mortgage transactions so long as the transactions are in conformity with the regulations issued by federal agencies.

Id.[12]

[12] For those that would like to dispense with complicated statutory analysis, and simply "cut to the chase", the following is a summary of arguments for and against the change in the OTS identified rules.

Opponents of the change in Parity Act regulations contend that removing identification of prepayment penalties as intrinsic to making an alternative mortgage loan will have the following effects:

- It will limit the range of products that independent mortgage lenders can offer. Such lenders for instance could not longer offer loans with lower interest rates, but with prepayment penalties because some states prohibit prepayment penalties.
- It will increase independent mortgage lenders compliance costs because lenders will now have to comply with prepayment penalty provisions in more than 50 jurisdictions. Lenders also contend that the change in the regulation will increase compliance and litigation risks because lenders will gave to comply with 51 different sets of laws rather than uniform OTS regulations.
- It will reduce lenders ability to minimize prepayment risk as prepayment penalties permit lenders to protect themselves from extreme changes in their portfolios.
- It will reduce the value of loans in the secondary market because investors will incur additional due diligence costs in ensuring compliance with state laws.
- It will result in a decreased number of lenders offering alternative mortgage products in jurisdictions with restrictive laws.

Proponents of the rule change contend:

- Mortgage lenders made alternative mortgage loans successfully for more than a decade without the benefit of OTS prepayment regulations.
- Prepayment penalties are not essential to creating uniformity amongst mortgage lenders and federal creditors. If Congress viewed prepayment penalties as essential to parity between state-based and federal housing it would not have adopted a statutory scheme allowing three separate agencies to regulate – in their own discretion – three different types of lenders.
- Complete uniformity is not possible in any event given the statutory scheme under which the Parity Act was passed. At present, the OCC allows prepayment penalties in connection with alternative mortgage loans. The NCUA, on the other hand, disallows them. This indicates that the OTS possesses the authority to

At this point in time, the OTS has found the former position more cogent than the latter. Read on, for an explanation of exactly why.

<u>PART TWO</u>:

WHAT'S IT ALL ABOUT ALFIE? --PREPAYMENT PENALTIES AND PREDATORY LENDING

The proposed change in identified Parity Act regulations is largely about predatory lending. When the Wall Street Journal (yes, indeed, the Wall Street Journal) provides its readers with anecdotal evidence showing that mortgage lenders use the Parity Act to assess unconscionable prepayment penalties in the sub-prime market, a movement is most likely taking place. Consider the following story found in a recent edition of the e-wall street journal.

> Many sub-prime borrowers need to borrow so much that they have little equity when they first buy their homes. Then, selling the house while a prepayment penalty is still in force can eat up much of whatever equity they've managed to accumulate. A refinancing, either to lower the interest rate or to draw out some cash can cause a new prepayment penalty to kick in after the first one has expired. In March, Willie Irby, his left leg still stiff from a stroke walked to the front door of his … home …and ripped open a long dreaded letter from his mortgage company. "Foreclosure is imminent," read the notice demanding $6,155.24 in back payments. "If you wish to save your property, you must act now." To satisfy the debt, Mr. Irby and his wife both in their 70s made the painful decision to sell the home they had bought as newlyweds. But they soon discovered that their mortgage was blocking their escape. It carried a prepayment penalty of $13,791. The Irby's [ ] didn't have the money and the proceeds from selling the house wouldn't cover it after paying the mortgage. ..The Irby's found themselves in dire straights even though the house they bought in 1959 for $16,950 was now valued at about $350,000.

The article further states:

> These prepayment penalties, all but gone from the mortgages taken by average homebuyers, are alive and well among those who don't qualify for conventional financing. About 80% of mortgages in the subprime market carried prepayment penalties in mid-200, up from 50% in 1997, according to a Standard and Poor's survey.

Sometimes the rhetoric is even stronger:

> Proponents of prepayment penalties state that they provide consumers with a choice. A prepayment penalty makes it more likely that a borrower will stay with the particular lender for a certain number of years and will make payments on the loan to that lender. In return for t his, the lender is willing to offer a lower interest rate if the borrower accepts a prepayment penalty. …Instead of representing a consumer bargain, prepayment penalties are fueled by [the Parity Act's} preemption of state limits on prepayment penalties…By requiring borrowers to pay thousands of dollars in order to get out of their current loans and refinance with other lenders, prepayment penalties leave borrowers defenseless in the face of default and foreclosure. Everyday, predatory lenders use prepayment penalties to <u>entrap</u> Americans and <u>rob</u> them of their homes and wealth.[13]

<u>Quite</u> illuminating – from an incredibly simplistic point of view.

[13] J. Silver, Protect Homeowners as We Move Against Predators, June 2002

The OTS agrees. *The lack of direction, definition and guidance that Congress provided the OTS in connection with the Parity Act has enabled the OTS to use prepayment penalties for its own political and economic ends – whether consciously or otherwise.* While the agency clearly admits that the "OTS has found no comprehensive data available addressing state housing creditors that take advantage of the Parity Act, " it nonetheless asserts: "The data sources cited and additional data submitted by commenters suggest that unregulated prepayment penalties …may be subject to abuse." The Office of Thrift Supervision, while admitting that it has no data to support the conclusions that it draws, surmises that lenders abuse the unrestricted prepayment penalty framework.

The National Association of Attorneys General also lobbied the OTS to amend its identification of prepayment penalty and late charge regulations as central to alternative mortgage loans. The reason, again, was the contribution of these loan terms to predatory lending.

> OTS has inadvertently contributed to predatory practices by promulgating regulations and issuing opinions that tended to preempt state consumer protection laws relating to non-federally regulated lenders. …OTS preemption under its Parity Act rulemaking authority, of state law restrictions on prepayment penalties and late fees had encouraged abusive practices…Prepayment penalties are far more common in sub-prime loans than in the mainstream mortgage lending market place. Among other things, prepayment penalties serve to "lock" consumers into a loan for a period of time, often up to five years, preventing the borrower from refinancing with another lender on more beneficial terms. Borrowers can be penalized for exercising their right to get out of a high-cost loan…[We have attached] summaries that contained examples of loans cynically devised as "alternative" mortgages without any benefit to the borrower and for the apparent primary purpose of circumventing state law restrictions. In one case, the variable rate could fluctuate only between 15.9% and 16.0%…The prepayment penalty exceeded 7% of the loan amount and existed for five years and would have been prohibited by state law but for the OTS regulatory preemption.

Letter Of National Association of Attorneys General to OTS, Dated June 24, 2002

In any event, the OTS apparently concurs with this reasoning and issued the following findings in the rulemaking that deletes prepayment penalties as part of an alternative mortgage.

1. *Inhibition of Refinancing*. A joint report issued by the Department of Housing and Urban Development and the Department of Treasury found that prepayment penalties in high cost loans can inhibit borrowers from refinancing at lower rates when their credit improves.
2. *Prepayment Penalties Are Common in Sub-prime Loans*. Prepayment penalties are becoming more common in sub-prime loans. One commenter estimated that the frequency of prepayment penalties in subprime loans was 10 percent in 1995. Yet the HUD/Treasury report indicates that four years later approximately 70 to 76 percent pf subprime mortgage originations carried prepayment penalties. ….By contrast, between 1 and 2 percent of prime borrowers currently are subject to such penalties.
3. *Prepayment Penalties and Predatory Loans.* OTS also concludes that prepayment penalties are almost universally included in predatory loans. One commenter found that the vast majority of loans that it sampled were high cost loans with

> burdensome monthly payments that consumed unreasonable portions of borrower income and included prepayment penalties. The commenter suggested that high delinquency rates showed a failure to adequately document borrower income levels and pricing inefficiencies. The OTS also points out that one fair housing center indicated that it had 417 predatory lending cases in 2001 and that all loans in these cases included a prepayment penalty for a period of at least five years. Ninety seven percent of these cases involved ARMs.

Thus, the OTS concludes:

> The above information leads to the reasonable conclusion that sub-prime lenders often include prepayment penalties in sub-prime loans. OTS recognizes that there is some disagreement as to the extent that prepayment penalties may affect a borrower's ability or willingness to refinance. It is reported that one unidentified study found that sub-prime loans with prepayment penalties are prepaid at about 90 percent of the rate of sub-prime loans without prepayment penalties. Nevertheless, common sense dictates that the existence of a prepayment penalty may well inhibit a borrower from refinancing his or her loan, which can be problematic where a good payment history may allow the borrower to graduate to a lower cost loan. …In short, OTS can properly conclude that the widespread use of prepayment penalties not only may deter consumers from seeking to refinance high cost loans that have burdensome provisions, but also may have other adverse consequences for sub-prime borrowers, such as increasing the overall cost for a consumer who refinances to avoid default. ***OTS believes that laws on prepayment penalties …are a key component in states' regulation of predatory lending. Because these laws reflect each state legislature's judgment, after due consideration, about appropriate consumer protections applicable to OTS will not construe its authority under AMPTA to frustrate these state efforts where another less intrusive construction of AMPTA is permissible.***

See Rulemaking at 27. [14]

[14] Some segments of the mortgage lending industry do not dispute that prepayment penalties may contribute to predatory lending in the sub-prime market. However, the position of most mortgage lenders is that resolution resides not in state-based prepayment penalty restrictions, but in the enforcement of existing consumer protection laws and disclosure requirements.

> We are aware that prepayment penalties are frequently on the list of loan terms that may be abusive, and in fact the housing government sponsored enterprises do not purchase loans that have certain types of prepayment penalties. However, both loan features serve a useful purpose for the entity originating the loan as well as the consumer. If a loan has a prepayment penalty, the interest rate may be lower, thus enabling the borrower to afford a loan that he she may not otherwise be able to afford. As is the case with all loan terms, the key to his loan term is borrower education and disclosure. …We believe that additional enforcement of the laws and regulations governing the operations of state housing creditors and borrower education are more effective in combating abuses than restricting loan terms for which a federal preemption will apply for certain lenders.

Comment of America's Community Bankers to OTS dated June 24, 2002.

PART THREE:

A WALKING SHADOW[15] : PREPAYMENT PENALTIES AND PREDATORY LENDING

The OTS will no longer identify prepayment penalties as central to alternative mortgage transactions largely because it does not want lenders to use the Parity Act to circumvent state-based prepayment penalty restrictions, especially in connection with predatory lending legislation. Ironically, the predatory lending legislation enacted in most states does not dramatically alter nature of the prepayment penalties that most lenders can assess. Thus, the motivation for the OTS rulemaking is largely illusory—a "walking shadow." Although state chartered housing creditors will have to comply with state prepayment penalty restrictions, prepayment penalties are nonetheless almost universally allowed. In some instances, the predatory lending prepayment rules are less restrictive than the rules that apply to loan transactions that are not "high cost" or "predatory." The regulatory quagmire aside, a lender's ability to assess a prepayment penalty has not disappeared. The following nineteen states have enacted "predatory lending" legislation. Of the nineteen, only one—Texas -- prohibits prepayment penalties in connection with a high-cost or predatory loan. In the remainder of the states, prepayment penalties are allowed on terms that are unchanged, allowed on slightly different terms or unbelievably – allowed on terms more generous than those allowed in connection with conventional mortgages. [16]

Think – Lest Ye Be Mistaken[17]

Note as well that although the following analysis compares high-cost loans to loans that are not so classified (as opposed a comparison of predatory lending legislation to a complete lack of regulation under the Parity Act) the reasoning is nonetheless relevant. First, the OTS itself admits that it has no "hard" evidence to indicate that lenders use the Parity Act to assess unreasonable prepayment penalties. This implies that the penalties that lenders do assess in connection with alternative transactions are reasonable and thus within purview of the rules outlined below. Second, in the experience of the author, lenders simply have not imposed shocking or unconscionable prepayment penalties in the heretofore unregulated alternative mortgage market. Sound business sense would seem to dictate otherwise. With these tenants in mind, consider the following.

Arkansas: Prepayment Penalties Are Alive and Well

In Arkansas, both fixed-rate and alternative mortgage transactions are unregulated unless the loan at issue is a high-cost home loan under the Arkansas Home Loan Protection Act. The Arkansas Home Loan Protection Act specifically addresses prepayment penalties, but does

[15] W. Shakespeare, *MacBeth,* Act V, scene v.
[16] Unless otherwise indicated, the analysis of predatory lending legislation that follows – and the comparison to prepayment penalty rules that apply to loans that are not so classified – is limited to first-lien transactions.
[17] Oliver Cromwell, before the Battle of Dunbar– and it is certainly what the author is attempting to do.

not place a hard and fast limitation on them. The Arkansas statute states that if a lender assesses a prepayment penalty in excess of the stated penalty described in the high-cost statute, the lender must include the maximum prepayment penalty that may be collected under the loan documents. The state's limit is 3% of the principal amount remaining on the date of prepayment if the prepayment is made within the first 12-month period immediately following the date of the loan, 2% of the principal amount of the loan remaining on the date of prepayment if the prepayment is made within the second 12-month period immediately following the date the loan was made and 1% of the principal loan amount remaining on the date of prepayment if the prepayment is made within the third 12-month period following the date the loan was made. The statute also states that a lender may not finance prepayment fees or penalties in a refinancing transaction if the lender or an affiliate of the lender is the note holder of the note that is being refinanced.

California –Change Only in the Prepayment Penalty Term

In California, the most widely used prepayment charge is six months advance interest on the amount prepaid in any 12-month period in excess of 20 percent of the original principal amount. The lender may generally assess the penalty for a period of 5 years. Under California's covered loan provisions, the lender may assess the prepayment penalty for a period of 36 months, the lender must provide a disclosure in writing and must provide the borrower a choice of mortgage products. Thus, the difference is primarily the period of time during which the penalty may be assessed.[18]

Colorado-New Regulation of Prepayment Penalties, But Narrowly Defined Changes

Colorado's predatory lending legislation addresses prepayment penalties on covered loans that are made to refinance first-lien purchase money loans. In these narrowly defined circumstances, a lender may assess a prepayment penalty only on a refinance to a different lender other than pursuant to a sale. The lender may assess a prepayment charge only for the first 36 months after the date of the execution of the loan and no penalty is allowed if the prepayment is partial. The lender must also offer the obligor the option of choosing a loan product without a prepayment penalty. Prepayment penalties are not otherwise regulated in Colorado in connection with purchase money transactions or in connection with the refinance of first-lien purchase money transactions. Colorado also does not regulate mortgage transactions in which the interest rate is 12% or less unless the loan is a covered loan under the predatory lending legislation.

[18] In broker-to-broker transactions, the permissible prepayment penalty in California is six months' advance interest on the amount prepaid in any 12-month period in excess of 20 percent of the unpaid balance. The lender may assess the penalty for a period of seven years.

Connecticut –New Regulation of Prepayment Penalties, But Prepayment Penalties Survive

Connecticut does not regulate prepayment penalties in connection with most first-lien transactions. Connecticut predatory lending legislation does place new restrictions on prepayment penalties if a loan is defined as a high-cost home loan. For high cost home loans, a lender may not assess a prepayment penalty that exceeds 3% of the principal balance prepaid if the borrower prepays before the first anniversary of the loan closing, the penalty cannot exceed 2% of the principal balance prepaid if the borrower prepays on or after the first anniversary of the loan closing but before the second anniversary of the loan closing, and 1% of the principal balance prepaid if the borrower prepays on or after the second anniversary of the loan closing but not later than the third anniversary of the loan closing.

District of Columbia –No Change in Prepayment Penalty Regulations

The District of Columbia Home Loan Protection Act of 2002 specifically addresses prepayment penalties, but interestingly, does not alter the rule applicable to mortgages that are not defined as high cost or predatory. Thus, lenders may assess two months interest on the amount of all prepayments made a 12-month period in excess of one third of the amount of the original loan. The lender may assess the prepayment penalty for three years from the date of the execution of the loan.

Florida - Change Only in Prepayment Penalty Term

In Florida a lender may contract for a prepayment penalty so long as the note provides therefore. If the note is silent as to the right of the obligor to prepay the note in advance of the stated maturity date, the borrower may be prepaying the loan in full without penalty. Under Florida's predatory lending legislation, a lender may assess a prepayment penalty for up to 36 months if the borrower is offered a choice of a mortgage product without a prepayment penalty and if the lender provides the borrower with a written disclosure of the terms of the prepayment penalty at least three business days prior to loan consummation.

Georgia - New Prepayment Regulation of Prepayment Penalties, But Prepayment Penalties Survive

In Georgia, relevant law specifies only that the lender and borrower must agree to the prepayment penalty in writing. Thus, prepayment penalties in this state are essentially unregulated. If the loan at issue is a high-cost home loan, a prepayment penalty is limited to the first twenty-four months of the loan term. The penalty itself cannot exceed 2% of the amount prepaid in the first twelve months of the loan and 1% of the amount prepaid in the second 12 months of the loan.

Illinois – More Generous Prepayment Penalties?

Illinois is truly an oddly regulated state and arguably allows more generous prepayment penalties in connection with high-risk home loans than in connection with loans that are not so classified. In Illinois, if a loan has an interest rate of 8% or less, the general prepayment rule is 6 months' advance interest on that part of the aggregate amount of all prepayments on a loan in one year that exceeds 20% of the original principal amount of the loan.[19] In connection with high-risk home loans, a lender may assess a prepayment penalty for a period of 36 months. During the first 12-month period after the date the loan was made, a lender may not assess a charge of more than 3% of the total loan amount, during the second 12-month period after the date the loan was made, a lender may not assess a charge of more than 2% of the total loan amount, and if the prepayment is made during the third 12-month period after the loan was made a lender may not assess a charge in excess of 1% of the total loan amount.

Kentucky – Changes in Prepayment Penalties, But Prepayment Penalties Survive.

In Kentucky -- if the loan at issue is not a high-cost loan -- a lender may assess a prepayment charge of 5% of the outstanding balance of the loan. The lender may not assess this charge after the fifth year from the date of the loan. Recent predatory lending legislation provides that a lender may not charge prepayment penalties exceeding 3% of the amount prepaid during the first year after loan closing, 2% of the amount prepaid during the second year after loan closing, 1% of the amount prepaid during the third year after loan closing.

Maine- Only The Circumstances Under Which the Prepayment Penalty May Be Imposed.

The Maine High Rate High Fee Mortgage Law does not define the type or term of the prepayment penalty that a lender may impose, but rather specifies the circumstances under which a lender may assess the penalty. Specifically, a lender may collect a prepayment fee in connection with a high rate, high fee mortgage if 1) the consumer is not liable for an amount of monthly indebtedness payments-including that extended under the mortgage transaction- that is greater than 50% of the monthly gross income of the consumer and 2) the income and expenses of the consumer are verified by a financial statement signed by the consumer, by a credit report, by payment records, or with verification from the employer of the consumer 3) the penalty does not apply at the end of the 5-year period beginning on the date that the mortgage is executed and 4) the penalty applies only to a prepayment made with amounts obtained by the consumer by means other than a refinancing by the creditor or an affiliate of the creditor. Maine does not otherwise restrict prepayment penalties unless the loan at issue is a first-lien alternative mortgage loan. In such a case, prepayment penalties are prohibited.

[19] Some authorities indicates that if the interest rate on a loan is 8% or less, prepayment penalties are unregulated altogether. The statutory framework is less than crystal clear.

Maryland – No Change in Prepayment Penalty Regulation

The Maryland Predatory Lending Legislation does not affect prepayment penalties. Thus – as is the case with conventional loans – a lender may assess a prepayment penalty on payments made within three years from the date that the loan is made and the penalty may not exceed an amount equal to two months advance interest on the aggregate amount of all prepayments made in any 12-month period in excess of one third of the amount of the original loan.

Massachusetts – Only The Circumstances of the Prepayment Penalty, Not the Penalty Itself

In Massachusetts, High-Cost mortgage loan provisions provide that a mortgage transaction may provide for a prepayment penalty if 1) the penalty can be exercised only for the first 3 years following consummation of the loan 2) the source of the prepayment finds in not a refinancing by the creditor or an affiliate of the creditor and 3) at loan consummation the total monthly debts do not exceed 50% of the consumer's monthly gross income. Generally in Massachusetts, a lender may assess a penalty upon a borrower's prepayment equal to the balance of the first year's interest or three months' interest – whichever amount is less. There is some authority for the position that prepayment must be made in full. Further, if prepayment is made within the first 36 months from the date of the note for the purpose of refinancing the loan with another financial institution, the lender may assess an additional payment not in excess of three months' interest.

Michigan –No Change In the Prepayment Penalty

The Michigan Consumer Mortgage Protection Act requires persons to make and service mortgage loans in accordance with all state and federal laws – including the Home Ownership Equity Protection Act – and it prohibits numerous deceptive practices and requires various disclosures. The law does not directly address prepayment penalties. Thus, lenders can assess 1% of the amount of any prepayment made within 3 years of the date of the loan.

Minnesota – No Change In the Prepayment Penalty

New Minnesota legislation (though not technically "predatory") requires lenders to provide a required prepayment penalty disclosure to the borrower, both orally and in writing. Otherwise, prepayment penalty restrictions remain unchanged. A residential mortgage originator may assess a prepayment penalty as follows: the aggregate amount of the prepayment penalty together with all other fees charges and premiums may not exceed the lesser of an amount equal to 2% of the unpaid principal balance at the time of the prepayment or an amount equal to 60 days interest on the unpaid principal balance at the time of the prepayment. If the penalty exceeds this amount, the lender must provide the oral and written disclosure specified.

New York – No Change in the Prepayment Penalty

The New York High Cost Home Loan Law does not specifically address prepayment penalties. Thus prepayment penalty specifications effective for loans that are not defined as high cost loans are applicable to high cost loans as well. In New York, no person may assess a prepayment penalty during the first year from the date of the loan unless the loan contract specifically provides therefore. Further, no prepayment penalty is allowed for alternative mortgage loans in amounts of less than $250,000 during the first year of the loan unless the interest rate of the loan is fixed for a period of five years. Prepayment penalties are also prohibited in connection with reverse mortgages.

North Carolina- Prepayment Penalties Define a Predatory Loan

Under North Carolina High Cost Home Loan provisions, a loan is predatory or high cost if the lender can – among other things – collect a prepayment penalty more than 30 months after the loan closing or if the penalty exceeds more than 2% of the amount prepaid. A lender may not finance prepayment penalties on a refinancing transaction. Generally in North Carolina, a lender may not assess a prepayment penalty on a first-lien loan of $150,000 or less. *Otherwise, there are no restrictions*. In connection with subordinate-lien loans, a lender may not assess a prepayment penalty in connection with loans of $25,000 or less. If the subordinate-lien loan is in the amount of $100,000 or less, the borrower may prepay the loan after 30 days notice to the lender and the lender may assess a penalty of 2% of the outstanding balance of the loan within three years of the first payment of the principal.

Pennsylvania – More Generous Predatory Prepayment Penalties?

In Pennsylvania, relevant law prohibits a lender from assessing a prepayment penalty on first-lien transactions if the loan is in the amount of $50,000 or less. Under the state's predatory lending legislation, a lender may assess a prepayment penalty for the first 60 months after the date of the execution of the loan. The lender must also make available a loan product without a prepayment penalty and may not assess a prepayment penalty on a refinance of a loan if the lender owns the loan that is the subject of the transaction. Note that a loan is subject to Pennsylvania's Consumer Equity Protection Act only if the transaction is considered a mortgage under the federal Home Ownership Equity Protection Act and the original principal balance is less than $100,000. Because the high-cost rule applicable to loans of less than $100,000 obviously swallows the rule applicable to non high-cost loans of $50,000 or less, lenders may arguably assess more generous prepayment penalties in connection with predatory loans than with loans that are not so classified.

Texas – No Prepayment Penalties Allowed

In Texas a lender may not collect a prepayment penalty on a high-cost home loan. Other than high-cost home loans, Texas prohibits prepayment penalties in connection with loans that carry an interest rate of greater than 12% or if a borrower fully or partially prepays a home equity loan. A lockout provision that prohibits a borrower from paying a loan early is considered to be a prepayment penalty in Texas.

Virginia – No Change in Prepayment Penalties

Virginia's predatory lending statute lists several prohibited practices for licensed mortgage lenders and brokers, but it does not specifically address prepayment penalties. Virginia's general prepayment penalty rules thus apply. Specifically, if a loan is secured with property that is or will be borrower-occupied, the prepayment penalty may not exceed 2% of the amount of the prepayment. If the loan is secured with property that is not to be occupied by the borrower and the principal of the loan is in the amount of less than $75,000, a lender may assess a prepayment penalty of 1% of the unpaid principal amount. If the property is not to be occupied by the borrower and the principal is $75,000 or more, prepayment penalties are unregulated.[20]

PART FOUR:
ALTERNATIVE MORTGAGE LOANS: *A TALE TOLD BY THE...OTS FULL OF SOUND AND FURY … SIGNIFYING NOTHING*[21]

Apart from predatory lending legislation, the change in identified Parity Act regulations will have little effect on the prepayment penalties that lenders can assess in connection with loans that do not meet the criteria of "high-cost" or "predatory" transactions. This is so because few states treat fixed-rate and alternative mortgage transactions differently and -- of the states that do – even fewer require prepayment penalty restrictions. The OTS – yet again – seems to have missed the mark. Indeed, to the extent that the purpose of OTS rulemaking is to protect and promote parity between state and federal housing creditors, the December OTS decision to delay the effective date of the prepayment penalty regulation from January 2003 to July 2003 is enlightening. It demonstrates that clarity of thought and purpose is not the motivating factor behind OTS regulatory action. Specifically, the Rulemaking states that the OTS will delay the effective date of the of the regulatory change because state-based based regulations in connection with fixed and variable rate loans are so different.

[20] New Jersey and New Mexico have also passed predatory lending legislation, but these laws will not become effective until May 6, 2003 and January 1, 2004 respectively.
[21] W. Shakespeare, *Macbeth*, Act V, scene v.

Upon reconsideration, OTS believes that an extension is warranted to provide state housing creditors with additional time to adapt to newly applicable state and local requirements. Specifically, OTS believes that a delay is necessary to permit state housing creditors to (1) determine applicable legal requirements and (2) reprogram systems and rewrite documents and (3) conduct training. The OTS further stated: Under the revised PPTS rule, state housing creditors that engage in alternative mortgage transactions under the [Parity Act] will become subject to state laws on prepayment penalties and prepayment charges.... ***Because state prepayment penalty and late charge restrictions for alternative mortgage transactions frequently differ substantially from restrictions on fixed-rate products, any experience that that a state housing creditor may have with applicable restrictions on fixed-rate mortgages may be irrelevant.***

See 67 CFR 76305.

Pardon me? In the Rulemaking that removes prepayment penalties from the list of identifies regulations, the OTS -- and other advocates of the rulemaking change -- indicate that one reason for eliminating preemption for prepayment penalties in connection with alternative mortgage loans is that state-based limitations specific to alternative mortgages have all but disappeared! Specifically: "Now [almost twenty years after the Parity Act was passed] state law restrictions on lenders' ability to make ARMs have been almost entirely eliminated. The Parity Act therefore serves little useful purpose."[22] If limitations have been "eliminated" it is difficult to see how more time would be needed to adjust to the complexities of state-specific alternative mortgage lending laws. The OTS states that it is delaying the effective date of the prepayment penalty regulation because experience with state-based fixed-rate regulations is irrelevant to state-specific laws passed in connection with alternative mortgage lending. Of the fifty-one jurisdictions in which mortgage lending occurs, approximately eleven treat variable rate prepayment penalties differently than prepayment penalties in connection with fixed-rate transactions. Of these eleven, only two possesses rules that will have a significantly different impact on prepayment penalty assessment. Three jurisdictions possess rules for variable rate prepayment penalties that affect marginally relevant variable-rate mortgage loans.

Arizona – No Prepayment Penalty Changes

Arizona opted out of the Parity Act only in connection with non-purchase money junior-lien balloon loans in the amount of $10,000 or less. These loans must have a term of less than three years. Applicable Arizona law does not address prepayment penalties.

[22] Letter from National Association of Attorneys General to Office of Thrift Supervision, Chief Counsel, Dated June 24, 2002.

California - Minimal Prepayment Penalty Changes

Provisions of the California Civil Code prohibit the imposition of prepayment charges within 90 days after notice of an increase adjustment in connection with an adjustable rate mortgage loan. This prohibition applies to all lenders in California except those lenders that are licensed as Consumer Finance Lenders under the Financial Code.[23]

Connecticut-Minimal Prepayment Penalty Changes

In Connecticut, the first-lien mortgage banker provisions of the banking law provide that if a loan is an alternative mortgage loan made by a bank or a credit union, a penalty for prepayment is prohibited. The law defines an "alternative mortgage" incredibly narrowly as a reverse annuity mortgage or as a graduated payment mortgage. Until now, the Parity Act has preempted these provisions. However, to the extent that the Connecticut law defines alternative mortgage narrowly, the change come July 1 will be minimal.

Hawaii

Hawaii precludes prepayment penalties only in connection with variable rate loans of $25,000 or less. The effect of this prohibition will be minimal.

Kansas - No Prepayment Penalty Changes

The only provision specific to alternative mortgages that Kansas has enacted are specific to balloon loans and loans that negatively amortize. In Kansas if a loan possesses a combined loan to value in excess of 100% at the time the loan is made or an annual percentage rate that exceeds the Kansas Consumer Code Rate (which at present is 12%) relevant law prohibits those transactions. However, because the change in Parity Act regulations affects only prepayment penalties and late charges, Kansas will experience no effect by the change in the law.

Maine – No Prepayment Penalty Changes

Maine overrode the preemptive effects of the Alternative Mortgages Parity Act, thus state-based restrictions in connection with prepayment penalties have been -- and will continue to be applicable to alternative mortgages -- made in that state. In Maine, an alternative mortgage

[23] These lenders are exempt from the variable rate provisions as "supervised financial organizations." As an alternative to the 90-day prohibition on prepayment penalties, a lender making a variable rate loan in California can choose to comply with the requirements of Civil Code section 1916.7. Section 1916.7 sets forth several requirements for variable rate loans, one of which is that the lender may not assess a prepayment penalty at all. There is really no choice for a lender that desires to assess a prepayment penalty: Section 1916.5 allows a prepayment penalty after a window period of 90 days. Section 1916.7 does not allow a prepayment penalty at all. Note as well that the Parity Act will still preempt only those state laws that address prepayment penalties.

means a loan or a credit sale secured by an interest in residential real property 1) in which the interest or finance charge may be adjusted or renegotiated 2) 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 3) involving any similar type of rate, method of determining return, term repayment or other variation not common to traditional fixed-rate fixed term transactions. Maine disallows prepayment penalties in connection with first-lien alternative mortgage transactions.

Massachusetts - No Prepayment Penalty Changes

Massachusetts opted out of the Alternative Mortgages Parity Act, however variable rate loans in Massachusetts are nonetheless allowed. Variable rate legislation addresses rate charge caps and disclosures and are not specific to prepayment penalties. Thus prepayment rules applicable to fixed-rate mortgages in Massachusetts will be applicable to alternative mortgages as well.

Missouri –No Prepayment Penalty in Connection With Variable Rate Loans

Missouri law provides that a borrower may prepay a variable rate loan without penalty. This is rule does differ from those that apply to fixed-rate loans.

New York – No Prepayment Penalty Changes

In New York, no prepayment penalty is allowed for alternative mortgages made in amounts of less than $250,000 during the first five years of the loan term unless the interest rate on the loan is fixed for the first five years of the loan. Such is the case for both first and subordinate lien loans. New York also overrode the preemptive effects of the Parity Act so the OTS change in identified regulations will have no practical effect.

South Carolina No Change in Prepayment Penalty Rules

South Carolina opted out of the Alternative Mortgages Parity Act, and its state-based rules have always applied to alternative mortgages. Interestingly, South Carolina's laws on variable rate loans, allow lenders to make such loans on precisely the terms that the Parity Act allows. Specifically, South Carolina law states that "a creditor may make a loan in accordance with any regulation governing alternative mortgage loans promulgated by … a federal regulatory agency."

Wisconsin - Specific Variable Rate Prepayment Penalties

Wisconsin does possess a set of different set of rules for variable-rate and fixed-rate loans. Wisconsin also opted out of the Parity Act, but only in connection with consumer credit transactions – that is transactions of $25,000 or less secured by a second lien on real estate. Thus, the Parity Act enabled lenders to make loans free from the following state restrictions: On variable rate loans under which changes in the interest rate are based on an approved index, prepayment may be made at any time without penalty. If interest rate changes are not based on an approved index, a variable rate loan may be prepaid without penalty during the first five years if prepaid within 30 days of a notice of an increase in the interest rate. In these circumstances, the prepayment penalty permitted is the same as that permitted for fixed rate loans. Specifically, the parties may agree that if a prepayment is made within five years of the date of the loan, the lender may receive an amount not exceeding 60 days interest at the contract rate on the amount by which the aggregate principal prepayments for a 12-month period exceeds 20% of the original principal amount of the loan.

CONCLUSION

This article has attempted to outline and analyze the tortured history of prepayment penalties under the Parity Act. It has also attempted to demonstrate that for all of the brouhaha surrounding the change in OTS' identification of prepayment penalties as applicable to alternative mortgage transactions, the mortgage lending sky will not fall. Whether in connection with state-based predatory lending legislation – or in connection with state-based alternative mortgage laws – prepayment penalties are for the most part alive and well. Stay tuned for further developments.