

SUBJECT: Understanding Federal Preemption of State Laws Restricting Prepayment Penalties Under the Parity Act

Mortgage lenders and brokers these days increasingly seek to impose prepayment penalties in connection with their residential mortgage loans even in those states that have laws prohibiting or restricting a lender's charging of such a penalty. They want to know when, and under what conditions, a mortgage company may impose a prepayment penalty in these states under the authority of the Alternative Mortgage Transaction Parity Act of 1982 (12 U. S. C. §§ 3801 *et seq.*), commonly referred to as the Parity Act. This brief article examines the authority conferred upon "housing creditors" by the Parity Act to make so-called "alternative mortgage transactions" and analyzes when the preemptive provisions of the Parity Act may be relied upon by housing creditors to impose prepayment penalties despite contrary state laws prohibiting or restricting a lender's charging of a fee, premium, or penalty in connection with a borrower's election to prepay the principal balance of the loan, in whole or in part.

AUTHORITY GRANTED "HOUSING CREDITORS"

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*, as therein defined, 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 ("OTS") 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, and as defined the term includes independent mortgage companies.

COMPLIANCE WITH OTS REGULATIONS

The authority conferred upon housing creditors other than banks and credit unions, such as independent mortgage companies, to make, purchase, and enforce alternative mortgage transactions "notwithstanding any state constitution, laws, or regulations" 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 thereof 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, servicing fees, and overlimit fees; [emphasis added]

Section 560.34 in this regard provides the express authority for a federal savings association to charge a fee in connection with the prepayment of a loan:

Sec. 560.34 Prepayments

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.

PREEMPTIVE PROVISIONS

Section 560.220 of the OTS regulations sets out the specific authority for housing creditors, other than banks, credit unions, or federal savings associations 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 Section 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, Secs. 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.

The preemptive provisions of the Parity Act do not apply to alternative mortgage transactions made in any state of the United States that explicitly exercised an option to override these federal provisions during a three-year window period ending October 15, 1982, as provided under 12 U.S.C. §3804, however. The following six states are believed to have overridden or "opted out" of the controlling provisions of the

Parity Act during this window period: Arizona, Maine, Massachusetts, New York, South Carolina, and Wisconsin.

CONCLUSION

Mortgage companies, as *housing creditors*, are authorized under applicable provisions of the Parity Act and OTS regulations to make, purchase and enforce ARM and Balloon loans in any state in conformity with applicable OTS regulations, notwithstanding any inconsistent state constitution, law, or regulation. The mortgage companies therefore are 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, *subject to* and in accordance with the terms of the promissory note or other written loan contract, despite any inconsistent state constitution, law, or regulation purporting to restrict or otherwise regulate any such charge.

However, certain exceptions and qualifications to this general authority apply:

- 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 applicable law in states that elected to override the Parity Act during the three-year window period ending October 15, 1992; and mortgage companies must conform to applicable state law with respect to enforcement of prepayment penalties in these states;
- The preemptive authority of the Parity Act to make, purchase, and enforce alternative mortgage transactions is available to mortgage companies only if (i) their ARMS and Balloons are made in conformity with OTS regulations, including expressly the provisions of Section 560.220 of those regulations, and (ii) they are duly licensed, or exempt from licensing, under the laws of any state in which they seek to invoke the preemptive authority of the federal act; and
- Federal law may prohibit the imposition of a prepayment penalty when made in connection with the mortgage company's enforcement of a *due on sale* clause. The Office of Thrift Supervision (OTS) issued a final rule [published November 13, 1985 in 50 F.R. 46744 and codified in 12 C.F.R. Section 591.5(b)(2) and (3)], specifically prohibiting lenders from imposing any prepayment penalties or equivalent fees for, or in connection with, the acceleration of loans secured by borrower-occupied homes under a due-on-sale clause. This regulation prohibits prepayment penalties on loans in cases in which a lender: (i) exercises a due-on-sale clause by written notice, (ii) commences a foreclosure proceeding to enforce a due-on-sale clause or to seek payment in full as a result on invoking such a clause, or (iii) fails to approve within 30 days the completed credit application of a qualified transferee to assume the loan in accordance with its terms, or when, within 120 days after the lender's receipt of such an application, the borrower transfers the home to that transferee and prepays the loan in full. This regulation is understood to affect all mortgage lenders because the OTS (as successor to the Federal Home Loan Bank Board) is the agency delegated authority by Congress under the Garn-St.Germain Depository Institutions Act of 1982 (P.L. 97-320) to implement and regulate enforcement of the federal preemption of state laws restricting enforcement of due-on-sale provisions.

This brief article is not intended as specific legal advice, of course, and mortgage companies relying on the preemptive provisions of the Parity Act should consult counsel regarding the application of the laws and regulations on any state to their specific case or circumstances.🏠

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