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DATE: October 1, 2001

SUBJECT: Does the Federal Parity Act, which Permits Creditors to Impose a Fee for any Prepayment of an ARM or Other Alternative Mortgage Transaction, Override Contrary Texas Law Prohibiting Prepayment Penalties in Connection with Certain "High Cost" Home Loans and Home Equity Loans?

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I. BACKGROUND: TEXAS LAW LIMITING PREPAYMENT PENALTIES

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

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

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

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

Although these provisions at first appear duplicative, a mortgage loan with an interest rate greater than 12% would not necessarily meet the definitional test of a "high-cost home loan" and the prohibitions on prepayment penalties of § 302.102 would appear to apply to all loans secured on a residential homestead regardless of the loan size or other definition limitations of § 343.205. Furthermore, the

prohibitions of prepayment penalties under new § 343.205 apply only when the annual percentage rate or total points and fees charged with respect to a home loan exceed certain Section 32 thresholds, while prohibitions under § 302.102 apply when the interest rate alone exceeds 12% a year.

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

II. ANALYSIS: FEDERAL PARITY ACT PREEMPTION OF STATE LAW

Mortgage lenders and mortgage brokers understandably need to know whether federal law preempts these contrary Texas laws prohibiting prepayment penalties and whether mortgage lenders accordingly may lawfully charge prepayment penalties in connection with its ARM and Balloon loans made in Texas under the authority granted "housing creditors" by the Alternative Mortgage Transaction Parity Act of 1982 (12 U.S.C. §§ 3801, *et seq*.), commonly referred to as the Parity Act.

The Parity Act, generally confers upon non-federally chartered housing creditors, including banks, credit unions, and other housing creditors such as independent mortgage companies, the authority to make, purchase, and enforce "alternative mortgage transactions" on parity with federally chartered depository institutions so long as the transactions are in conformity with applicable regulations issued by the Comptroller of the Currency in the case of banks, the National Credit Union Administration in the case of credit unions, or the Office of Thrift Supervision ("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.

This 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 of the final rule to promulgate regulations that preempt state laws affecting the operations of federal savings associations when deemed appropriate to facilitate the "safe and sound" operation of federal savings associations or to satisfy other broad purposes therein stated, including any state statute, regulation, ruling, order or judicial decision purporting to impose requirements regarding, in pertinent part:

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

Section 560.34 in this regard provides the express authority for a housing creditor 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.

Section 560.220 of these 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.

However, 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 specified under 12 U.S.C. § 3804. Although not independently verified, 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.

Texas did not override these provisions and, therefore, generally is subject to the preemptive provisions of the Parity Act. However, an amendment to the Home Owners Loan Act in 1994, codified as 12 U.S.C. § 1462a.(f), and sometimes referred to as the "Gonzales Amendment" for its sponsor, Texas Congressman Henry B. Gonzales, effectively carved out an exception to the preemptive provisions of the Parity Act for homestead provisions contained in the Texas Constitution:

> (f) STATE HOMESTEAD PROVISIONS
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> *No provision of this chapter or any other provision of law administered by the Director [of the Office of Thrift Supervision] shall be construed as superceding any homestead provision of any State constitution, including any implementing State statute, in effect on September 29, 1994, or any subsequent amendment to such a State constitutional or statutory provision in effect on September 29, 1994, that exempts the homestead of any person from foreclosure, or forced sale, for the payment of all debts, other than a purchase money obligation relating to the homestead, taxes due on the homestead, or an obligation arising from work and material used in constructing improvements on the homestead.*
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> [**NOTE:** The Fifth Circuit Court of Appeals in *First Gibraltar Bank, FSB v. Morales*, 42 F. 3d 895 (5th Cir. 1995) when vacating its earlier decision in the case holding that the Parity Act preempted certain homestead provisions of the Texas Constitution following passage of the Gonzales Amendment found that the Gonzales Amendment was a Constitutionally valid limitation on the scope of authority delegated by Congress to the OTS and that it effectively eliminated any authority on the part of the OTS to construe any provision of law administered by the Director of the OTS as superceding Texas constitutional homestead law under the Parity Act.]

Provisions of Section 50(a), Article XVI, of the Texas Constitution in effect on September 29, 1994, conformed precisely to this narrow state homestead exception set out in § 1462a.(f) by providing that the homestead of a family, or of a single adult person, was thereby protected from foreclosure or forced sale for the payment of all debts except for the purchase money thereof [§ 50(a)(1)], the taxes due thereon [§ 50(a)(2)], or work and materials used in constructing improvements on the homestead [§ 50(a)(3)].

Section 50(a) has since been amended in 1997 and 1999 to include additional exemptions of the homestead from foreclosure or forced sale and to revise others. These amendments include, among others, an exemption from forced sale for the payment of debts for an extension of credit commonly referred to as a home equity loan. A home equity loan made under the authority of Section 50(a)(6), Article XVI, of the Texas Constitution is defined in part as an extension of credit that … "is payable in advance without penalty or charge."

Because the § 1462a.(f) exception expressly includes " any *subsequent amendment* to such a State constitutional or statutory provision in effect on September 29, 1994", the preemptive provisions of the Parity Act would not preempt or supercede any inconsistent provision of Section 50(a), Article XVI, of the Texas Constitution as amended by the 1997 and 1999 amendments to the constitution or of any statute implementing such a constitutional provision. Therefore, the prohibition against any prepayment penalty or charge with respect to Texas home equity loans made under the authority of Section 50(a)(6) that have a variable rate feature (or that otherwise may qualify as an alternative mortgage transaction under the Parity Act) would not be preempted by the Parity Act and, if challenged, would be fully enforceable under Texas and federal law.

While this prohibition against prepayment penalties or charges with respect to Section 50(a)(6) home equity loans is clearly grounded in the Texas Constitution, there is no similar constitutional restriction against prepayment penalties for other types of loans secured by a lien on a homestead that are made under the authority of Section 50(a)(1) – (5) or (7), respectively — the only provisions of the Texas Constitution currently that exempt the homestead from foreclosure, or forced sale, for the payment of debts. Thus, the prohibitions against prepayment penalties under §§ 343.205 and 302.102, Tex. Fin. Code, regarding "high cost" home loans and residential homestead loans when the interest rate is greater than 12%, respectively, are neither found in nor derived from any homestead provision of the Texas Constitution that "exempts the homestead of any person from foreclosure or forced sale for the payment of debts" or a statute that implements such a constitutional provision. Although no Texas statute or court appears to have expressly defined the meaning of "implementing statute", the term in the context of a constitutional provision such as Section 50(a) is commonly understood to mean, and the numerous cases examined in which courts use the term consistently leads me to conclude it means, either a statute that is explicitly authorized or mandated by the constitutional provision to implement and put into effect the constitutional provisions or one in which such authority is clearly implicit in, and derived from, the constitutional provision. Because the restrictions on prepayment penalties under §§ 343.205 and 302.102 are not contained in any constitutional provision or in a statute implementing or putting into effect such a constitutional provision, neither of these provisions of the Finance Code constitutes an "implementing State statute" within the meaning of § 1462a.(f) that would be excepted from the preemptive provisions of the Parity Act.

III. CONCLUSIONS:

A mortgage company, as a *housing creditor*, generally is authorized under the preemptive provisions of the Parity Act and OTS regulations to impose a fee, premium or penalty for any prepayment of a loan, in accordance with the terms of the promissory note or other loan contract, when making a loan qualifying as an *alternative mortgage transaction*, despite any inconsistent state constitution, law, or regulation purporting to restrict or otherwise regulate any such charge. Specifically, the Parity Act may be relied upon to override the prohibitions against prepayment penalties for "high cost" loans and for residential homestead loans when the rate of interest is greater than 12% per year under Sections 343.205 and 302.102, respectively, of the Texas Finance Code. Mortgage companies in these circumstances may rely on the preemptive authority of the Parity Act to enforce prepayment penalties in accordance with contract terms for ARMs or other alternative mortgage transactions made in Texas. Because of the state constitution carve out of the Gonzales Amendment, however, the Parity Act does not override the prohibition against prepayment penalties or charges for home equity loans made under the authority of Section 50(a)(6), Article XVI, Texas Constitution.

The authority of housing creditors to enforce contractual prepayment penalties in reliance on the preemptive provisions of the Parity Act is also subject to the following further limitations:

1. 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. § 1462a.(f), and (ii) to applicable law in states that elected to override the Parity Act during the three-year window period provided in 12 U.S.C. § 3804, and housing creditors must comply with applicable state law regarding prepayment penalties in those states;

2. The preemptive authority of the Parity Act to make, purchase, and enforce alternative mortgage transactions is available to the housing creditor only if (i) its ARMS, balloons, and other alternative

mortgage transactions are made in conformity with OTS regulations, including expressly the provisions of Section 560.220 of those regulations, and (ii) it is duly licensed, or exempt from licensing, under the laws of any state in which it seeks to invoke the preemptive authority of the federal act;

3. Federal law may prohibit the imposition of a prepayment penalty when made in connection with the housing creditor'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;

4. An alternative mortgage transaction that also meets the definition of a so-called Section 32 loan in any case would be subject to applicable federal prepayment limitations of Regulation Z, § 226.32(d)(7) to the Truth in Lending Act, which permits a prepayment penalty only if (i) the penalty can be exercised just within the first five years of the loan term, (ii) the source of the prepayment funds is not a refinancing by the creditor or its affiliate, and (iii) at the time the loan is made the borrower's total monthly debts, including the mortgage debt, do not exceed 50% of the borrower's monthly gross income.