



**Office of Thrift Supervision**

Department of the Treasury

*Chief Counsel*

1700 G Street, N.W., Washington, DC 20552 • (202) 906-6251

February 10, 1997

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Dear [ ]:

This responds to your inquiry submitted on behalf of [ ](the "Company"), to the Office of Thrift Supervision ("OTS") regarding the applicability of certain state law restrictions to adjustable rate mortgage loans ("ARM loans") the Company proposes to make under the Alternative Mortgage Transaction Parity Act of 1982 (the "Parity Act").<sup>1</sup>

In brief, we conclude that the Company's proposed home equity lines of credit loans and closed-end, subordinate lien loans constitute "alternative mortgage transactions" under the Parity Act regardless of whether they are secured by first or subordinate liens, or are open- or closed-end loans. In making the proposed loans, the Company will have to comply with the OTS's lending regulations regarding late charges, prepayments, adjustments and disclosures.

**I. Background**

The Company is an FHA-approved mortgage lender, chartered and headquartered in [ ]. The Company's ultimate owner is [ ]. The Company is not an affiliate or a subsidiary of any federally-

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<sup>1</sup> Title VIII of the Garn-St Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469, 1545 (1982), codified at 12 U.S.C.A. § 3801 et seq. (West 1989 & Supp. 1996).

chartered depository institution. You have represented that the Company is a "housing creditor" as that term is defined in § 803 of the Parity Act.<sup>2</sup>

The Company proposes to offer, in various states, home equity lines of credit ("HELOCs") secured by an interest in residential real estate. The security interest in the residential real estate will most often be a subordinate lien, but occasionally may be a first-lien. The Company may also offer closed-end, subordinate lien loans secured by an interest in residential real estate, some of which may involve balloon payments. The Company intends to adjust the interest rates on the HELOCs and on the closed-end, subordinate lien loans periodically during the term of the loans. You represent that the Company will secure all necessary licenses under applicable state laws before offering these adjustable-rate HELOCs and closed-end, subordinate lien loans in a particular state.

You indicate that various state statutes, regulations, attorney general opinions, or judicial decisions impose restrictions on ARM loans, including, but not limited to, prohibiting negative amortization; prohibiting or restricting prepayment penalties, late charges, balloon payments and adjustments.<sup>3</sup>

You inquire whether the Parity Act applies to the Company's proposed loan products. You also inquire, for states that have not opted out of the Parity Act's preemption, what types of restrictions are applicable.

## II. Discussion

The Parity Act authorizes non-federally chartered "housing creditors" to engage in "alternative mortgage transactions" without regard to "any State constitution, law, or regulation," provided the transactions are in conformity with certain federal lending regulations.<sup>4</sup> The Parity Act thus preempts state

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<sup>2</sup> 12 U.S.C.A. § 3802(2) (West 1989). For the purposes hereof, we are relying on your representation and make no independent determination regarding the Company's status as a "housing creditor."

<sup>3</sup> You note that state restrictions on ARM loans also include: imposing direct limitations on variable rate transactions; requiring equal payments of principal and interest; imposing dollar limitations under which ARM transactions cannot be consummated; authorizing only add-on precomputed finance charges; creating a usury ceiling; limiting the term to maturity; imposing maximum and/or minimum loan amounts; and making continuing lien priority uncertain in the event of multiple advances.

<sup>4</sup> 12 U.S.C.A. §§ 3801(b) and 3803 (West 1989).

laws that prohibit or impede alternative mortgage transactions.<sup>5</sup> Housing creditors, other than state-chartered banks and state-chartered credit unions, lending in reliance on the Parity Act must follow regulations issued by the OTS for alternative mortgage transactions.<sup>6</sup>

Section 803(1) of the Parity Act defines an “alternative mortgage transaction” as:

a loan or 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;

(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; or

(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; . . . .<sup>7</sup>

OTS regulations adopt the foregoing definition without significant elaboration.<sup>8</sup> However, the regulations do specify that, to be considered an

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<sup>5</sup> 12 U.S.C.A. § 3803 (West 1989). There is, however, one exception to the Parity Act’s preemption of state law relating to alternative mortgage transactions. The Parity Act gave states three years following its enactment to override, or to “opt out” of, its federal preemption. 12 U.S.C.A. § 3804(a) (West 1989). The conclusions stated in this opinion are applicable only to loans made in states that have not opted out of the Parity Act. We also note that the Parity Act does not override the Texas homestead laws, which prohibit foreclosure on borrower-occupied homes except in connection with purchase money mortgages. See 12 U.S.C.A. § 1462a(f) (West Supp. 1996).

<sup>6</sup> 12 U.S.C.A. § 3803(a) (West 1989).

<sup>7</sup> 12 U.S.C.A. § 3802(1) (West 1989).

<sup>8</sup> 61 Fed. Reg. at 50,983 (to be codified at 12 C.F.R. § 560.220).

alternative mortgage transaction within the meaning of the Parity Act, a loan must conform to OTS regulations regarding late charges; prepayments; adjustments to the interest rate, payment, balance or term to maturity; and disclosures to the extent those regulations would apply if the same loan were originated by a federal thrift.<sup>9</sup>

Thus, we must first consider whether the Company's proposed loan products -- HELOCs and closed-end, subordinate lien loans secured by an interest in residential real estate -- fall within the above-quoted statutory definition of "alternative mortgage transaction." Then, we must determine what OTS lending regulations are applicable to the proposed HELOCs and closed-end, subordinate lien loans.

**A. Are the Company's Proposed Loan Products "Alternative Mortgage Transactions" Under the Parity Act Definition?**

Based on your description of the Company's proposed loan products, as summarized above in Part I, we conclude that the Company's proposed loan products fall within subparagraphs (A) and (B) of the Parity Act's definition of an "alternative mortgage transaction." First, the proposed loans will be "secured by an interest in residential real property," as required by the introductory clause of the definition. The security interest in the residential real estate will usually be a subordinate lien, but may be a first lien in the case of some HELOCs. The Parity Act does not require that, in order to qualify as an "alternative mortgage transaction," a loan must be secured by a first lien. The Parity Act has no limitation concerning the priority of the security interest in the residential real property. Thus, the fact that the security for the proposed ARM loans may be a subordinate lien will not remove the loan from the Parity Act's coverage.

Second, the interest rate on the HELOCs and closed-end, subordinate lien loans will be adjusted periodically during the terms of the loans. This satisfies subparagraph (A) of the definition.<sup>10</sup>

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<sup>9</sup> Id.

<sup>10</sup> Although you have not specified the precise manner in which the interest rate on each loan will be adjusted, you have represented that the Company's ARM loan products will comply with the OTS interest rate adjustment regulations (12 C.F.R. § 560.35) in that they will provide for the interest rate adjustment to be tied to an "available and independently verifiable index." Moreover, you have represented that the Company's proposed loan products meet the definition of an "adjustable-rate mortgage loan" in the OTS's regulations (12 C.F.R. § 560.210) and will be in compliance with the requirements of those regulations.

Third, to the extent that the loans involve a fixed rate, but permit rate adjustments by having the debt mature at the end of an interval shorter than the term of the amortization schedule (e.g., balloon loans), they will fall under subparagraph (B) of the definition.

In defining the term “alternative mortgage transaction,” the Parity Act does not differentiate between open- and closed-end loans. Nor does the Act contain any condition, limitation, or requirement pertaining to the open-end or closed-end nature of a loan.<sup>11</sup> Thus, we conclude that the Company’s proposed adjustable-rate HELOCs and closed-end, subordinate lien loans constitute “alternative mortgage transactions” within the meaning of the Parity Act.

### **B. What OTS Lending Restrictions Are Applicable to the Company’s Proposed Loans?**

Section 560.220 (Alternative Mortgage Parity Act) of the OTS regulations, set forth in the OTS’s Final Rule on Lending and Investment,<sup>12</sup> identifies the following OTS regulations as being appropriate and applicable to state housing creditors (other than state banks and credit unions) originating alternative mortgage transactions under the authority of the Parity Act: § 560.33<sup>13</sup> (late charges); § 560.34<sup>14</sup> (prepayments); § 560.35<sup>15</sup> (adjustments to home loans); and § 560.210<sup>16</sup> (disclosures for ARMs, adjustment notices and interest rate caps). Each of these regulations imposes some requirement, limitation, or restriction that federal savings associations must comply with in conducting their lending activities. The OTS has determined that state housing creditors must also comply with these regulations when engaging in alternative mortgage transactions under the authority of the Parity Act. As long as the Company complies with the requirements of these OTS regulations in making

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<sup>11</sup> The OTS has determined, for example, that a reverse adjustable-rate mortgage loan that provides for disbursements over time, as well as principal and interest payments at maturity, and that may include an equity share feature, is an alternative mortgage transaction under the Parity Act. OTS Op. Chief Counsel (May 3, 1996).

<sup>12</sup> 61 Fed. Reg. 50,951, 59,953 (1996).

<sup>13</sup> 61 Fed. Reg. at 50,974.

<sup>14</sup> Id.

<sup>15</sup> Id.

<sup>16</sup> 61 Fed. Reg. at 50,983.

and enforcing its ARM loans, the Company need not comply with conflicting or inconsistent state restrictions.

### 1. Late Charges Regulation

Section 560.33 of the OTS regulations authorizes federal thrifts to include late fee provisions in their residential mortgage loan contracts, provided certain conditions are met.<sup>17</sup> Among other things, the regulation specifies that late fees may not be assessed until a payment is more than fifteen days overdue, that all billing coupons must disclose the potential late fee, and that only one late fee may be assessed for each late installment.

### 2. Prepayments Regulation

Section 560.34<sup>18</sup> of the OTS regulations requires that any prepayment on a real estate loan must be applied directly to reduce the balance on the loan, unless the loan contract specifies otherwise. This section also authorizes federal thrifts to impose a fee for any prepayment of a loan, subject to the terms of the loan contract. The OTS recently concluded that prepayment penalty restrictions imposed by a state law on variable rate loans were preempted by the Parity Act and that state lenders (other than state banks and credit unions) that originate variable rate loans under the Parity Act and in conformity with all applicable OTS regulations need not comply with the state restrictions.<sup>19</sup>

### 3. Adjustments Regulation

Section 560.35<sup>20</sup> of the OTS regulations imposes various restrictions and requirements on interest rates adjustments and other adjustments relating to residential mortgage loans secured by borrower occupied property. These restrictions include the requirement that adjustments to the interest rate, payment amount or loan balance correspond to, or be in accordance with, an approved index, or a formula or schedule set forth in the loan contract. This section also requires compliance with certain notice and disclosure requirements.

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<sup>17</sup> 61 fed. Reg. at 50,974.

<sup>18</sup> Id.

<sup>19</sup> OTS Op. Chief Counsel (April 30, 1996).

<sup>20</sup> Id.

#### 4. ARM Disclosures, Adjustment Notice and Interest-Rate Caps

Section 560.210<sup>21</sup> of the OTS regulations imposes certain requirements on “adjustable-rate mortgage loans” as the phrase is defined therein. The regulation, among other things, specifies the type and timing of disclosures and requires compliance with certain maximum interest rate caps.

In reaching the foregoing conclusions, we have relied upon the representations made in the materials you submitted and in conversations with staff. Our conclusions depend upon the accuracy and completeness of those representations. Any material difference in facts or circumstances from those described herein could result in different conclusions.

If you have any questions regarding this matter, please feel free to contact Evelyne Bonhomme, Counsel (Banking and Finance), (202) 906-7052.

Very truly yours,

/s/

Carolyn J. Buck  
Chief Counsel

cc: All Regional Directors  
All Regional Counsel

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<sup>21</sup> 61 Fed. Reg. at 50,983