Office of Thrift Supervision
Department of the Treasury
Chief Counsel
1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6251

November 27, 1996

[redacted]

Re: Fixed-Rate Mortgage Loans with a Default Rate

Dear [redacted]

This responds to your inquiry, submitted on behalf of [redacted] (the "Company"), regarding whether a fixed-rate mortgage loan secured by an interest in residential real property, the loan documents for which explicitly provide for an increase in the interest rate upon default by the borrower, is an "alternative mortgage transaction" under the federal Alternative Mortgage Transaction Parity Act of 1982 (the "Parity Act").[1] You have also asked for confirmation of your understanding that such a loan is not an "adjustable-rate mortgage loan" as defined in the Office of Thrift Supervision ("OTS") disclosure regulation for adjustable-rate mortgage loans, 12 C.F.R. § 560.210,[2] and, therefore, is not subject to the regulation's disclosure requirements.

In brief, we conclude that the type of loan described in your inquiry is an "alternative mortgage transaction" under the Parity Act, but not an "adjustable-rate mortgage loan" under OTS's disclosure regulation.

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

[2] Your inquiry references the prior version of the disclosure regulation, 12 C.F.R. § 563.99. On September 30, 1996, the OTS published a final rule, effective October 30, 1996, that redesignated the disclosure regulation as 12 C.F.R. § 560.210 and made minor modifications to the text. 61 Fed. Reg. 50,951, 50,983 (to be codified at 12 C.F.R. § 560.210). The disclosure requirements in § 560.210 remain substantially identical to those in the prior version of the regulation.

I. Background

You have indicated that the Company is a major consumer finance company, incorporated in Delaware and [redacted] The Company offers mortgage loan products on a nationwide basis through wholly-owned subsidiaries licensed under the laws of most states, including Texas.

You have also represented that the Company is a "housing creditor," as that term is defined in § 803 of the Parity Act.[3] The Company wishes to take advantage of the preemption of state law available under § 804 of the Parity Act by complying with the applicable regulations governing alternative mortgage transactions issued by the OTS.[4]

The Company proposes to offer a mortgage loan program under which fixed-rate loans will be secured by an interest in residential real property. As described in the Sample Term Sheet you submitted, the loan documents for these fixed-rate loans will expressly provide that, upon the occurrence of an "event of default," which will be defined in the loan documents, the rate of interest charged to the borrower will increase by 50 to 100 basis points to a specified fixed higher rate (the "default rate"). The default-rate will be clearly and conspicuously stated in the disclosure materials provided to prospective borrowers.

You have indicated that the loan documents will state that the specified default rate will be imposed only after the borrower becomes delinquent for more than thirty days twice in a revolving twelve-month period (the "event of default"). The applicable twelve-month period will commence 31 days after the due date of the first delinquent payment. You also have indicated that, depending on the terms of the loan documents in a particular transaction, the original interest rate may be reinstated after the borrower restores the loan to current status and keeps the loan current for a period specified in the loan documents. If the loan documents provide that the original interest rate will be reinstated if the loan remains current for a specified period, then upon a subsequent event of default, the default rate may be imposed again.[5]

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[3] 12 U.S.C.A. § 3802(2)(C) (West 1989).

[4] 12 U.S.C.A. § 3803(a)(3) (West 1989).

[5] You have indicated that while the default rate is in effect, further delinquencies by the borrower would not trigger an additional increase in the interest rate, although a separate late fee would probably be imposed to the extent permitted by applicable law. Similarly, you have indicated that if the borrower continued to be in default, the Company would foreclose on the loan as permitted by applicable law.

Under the proposed loan program, you have asked us to assume that a borrower obtains a loan at a fixed rate from the Company in January of a given year. The borrower makes timely payments on February 1 and March 1, but is more than thirty days delinquent on the April payment. At this point, the Company would notify the borrower in writing that a second delinquency during the twelve-month period commencing on May 1 will constitute grounds for imposition of the default rate, resulting in an increase in the interest rate of the amount specified in the loan documents (not to exceed 100 basis points). The borrower then makes timely May and June payments, but is more than thirty days delinquent on the July payment. At this point, the Company would notify the borrower in writing that because he or she has been more than thirty days delinquent twice during a twelve-month period, the Company, pursuant to the terms of the loan documents, is imposing the default rate, which will increase the interest rate on the loan by up to 100 basis points for a specified period. If the loan documents provide for the reinstatement of the original interest rate, the interest rate may return to the original fixed rate if and when the borrower restores the loan to current status, maintains a perfect payment record for a period of time as stated in the loan documents, and meets any other conditions stated in the loan documents.

Finally, you have indicated that the default rate is not intended to be a "late fee," but rather a form of performance-based pricing that is designed not only to encourage borrowers to make installment payments on time, but to more accurately allocate credit costs among borrowers. Thus, you have represented that in addition to the default-rate feature, a separate late fee not in excess of 10% of the amount of the payment due, may be imposed upon the expiration of a fifteen-day grace period after the installment due date.

II. Discussion

The Parity Act authorizes lenders that meet the definition of a "housing creditor" 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.[6] The term "housing creditor" is defined to include, inter alia, state-chartered depository institutions and any other lender

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[6] 12 U.S.C.A. §§ 3801(b) and 3803 (West 1989).

"who regularly makes loans."[7] The Parity Act thus preempts state laws that prohibit or impede alternative mortgage transactions.[8] 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.[9]

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

> a loan or credit sale secured by 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;
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> (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
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> (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,

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[7] 12 U.S.C.A. § 3802(2) (West 1989). <u>See</u> OTS Op. Chief Counsel, Oct. 20, 1995 (discussing when a lender will be deemed to make loans regularly).

[8] 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). You have represented that [redacted] did not opt out of the Parity Act and we have made no independent determination in that regard. 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. <u>See</u> 12 U.S.C.A. § 1462a(f) (West Supp. 1996).

[9] 12 U.S.C.A. § 3803(a) (West 1989).

> transactions that involve the sharing of equity or appreciation;

described and defined by applicable regulation.[10]

OTS regulations adopt the foregoing definition without significant elaboration. However, 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 interest rate adjustments, late fees and prepayment penalties, and disclosure, to the extent those regulations would apply if the same loan were originated by a federal thrift.[11]

Thus, a two-step analysis is required to respond to the Company's inquiry. First, we must consider whether the default-rate loans proposed by the Company fall within the above-quoted statutory definition. Second, we must consider whether the default-rate loans conform to applicable OTS lending regulations.

A. Are the default-rate loans "alternative mortgage transactions" under the Parity Act definition?

Based on the information set forth in Part I, we are satisfied that the Company's default-rate loans fall within subparagraphs (A) and (C) 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. Second, upon an "event of default," as defined in the loan documents, the interest rate on the loans will increase to a specified default rate. Thus, the interest rate on the loans "may be adjusted" within the plain meaning of subparagraph (A). Third, the loans' default rate also constitutes a "variation" that affects the interest rate and that is "not common to traditional fixed-rate, fixed-term transactions" within the plain meaning of subparagraph (C).[12]

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[10] 12 U.S.C.A. § 3802(1) (West 1989).

[11] 61 Fed. Reg. at 50983 (to be codified at 12 C.F.R. § 560.220).

[12] We have considered whether the default rate would more appropriately be characterized as a "late fee," rather than an interest rate adjustment. For the reasons explained below in Part II.B.1., we conclude that the default rate is not a late fee. Even if it were, however, this would not remove it from the coverage of the Parity Act. Subparagraph (C) of the Parity Act definition of "alternative mortgage transactions" encompasses any variation "not common to traditional fixed-rate, fixed-term transactions" that affects the interest rate or method of determining return as "described and defined by applicable regulation." Late fees clearly affect an institution's ultimate rate of return. Moreover, OTS's

Thus, we conclude that the Company's proposed default-rate loans will constitute "alternative mortgage transactions" within the meaning of the Parity Act, provided the loans conform to applicable OTS regulations. This conclusion is consistent with the policy objectives that underlie the Parity Act. The express purpose of the Parity Act is to ensure that state-chartered lenders may originate mortgage loans with features "not common to traditional fixed-rate, fixed term transactions" to the same extent as federal lenders.[13] As the discussion below indicates, federal savings associations may originate the type of loan proposed by the Company. If state lenders were not permitted to originate these loans, they would clearly be disadvantaged vis-a-vis federal thrifts, contrary to Congressional intent.

B. Do the proposed default-rate loans comply with all applicable OTS regulations?

1. Late Fee Regulation.

Section 560.33 of OTS's lending regulations authorizes federal thrifts to include late fee provisions in their residential mortgage loan contracts, provided certain conditions are met.[14] 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. The apparent purpose of this latter requirement is to ensure that borrowers are not overwhelmed by a rapid accumulation of late fees that leaves them unable to catch up and avoid foreclosure.

Assume, for example, that the monthly installments on a mortgage loan are $1000, and the mortgage loan provides for late fees equal to 10% of the installment due. Assume further that the borrower falls five months behind in making payments. Under the OTS regulation, the maximum late fees the borrower could accumulate would be 10% x $1000 x 5 months, or $500. If a late fee could be reassessed each time an installment remained unpaid for an

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implementing regulations specify that late fees fall within the scope of the Parity Act. 61 Fed. Reg. at 50983 (to be codified as 12 C.F.R. § 560.220); see also Op. Chief Counsel, April 30, 1996) (concluding that prepayment fee provisions fall within the scope of the Parity Act).

[13] 12 U.S.C.A. §§ 3801(b), 3802(1), and 3803(a) (West 1989).

[14] 61 Fed. Reg. at 50974.

additional thirty days beyond the date the first late fee was assessed, costs could multiply rapidly. In this example, late fees would balloon to $1500.

As Part I indicates, the Company's loan contracts will contain a conventional late fee of up to 10% for any installment that becomes overdue by more than fifteen days, plus a default-rate adjustment of up to 100 basis points if any two installments become overdue by more than thirty days in any twelve month period. This presents the question of whether the default-rate adjustment should be classified as a late fee, in which case it would constitute an impermissible additional fee charged against the same installment.

We conclude that the default rate adjustment is not a late fee, for several reasons. First, the default-rate adjustment is not structured as a traditional late fee. Traditionally, late fees are in the form of flat fees calculated as a percentage of the late installment, rather than as interest rate adjustments. Second, creditors routinely fix their interest rates at levels that take account of credit risk, i.e., the risk that a borrower will make payments late or not at all. Clearly, when lenders originate loans with higher rates for customers that present greater risk, they are not thereby deemed to have imposed a late fee. Pricing credit at rates that reflect credit risk is a common practice. There is little, if any, substantive distinction between this common practice (i.e., rate adjustments at origination to reflect a borrower's anticipated payment performance) and what the Company proposes (i.e., rate adjustments during the life of a loan to reflect a borrower's actual payment performance).

Third, the default-rate adjustment proposed by the Company does not raise the same policy concerns as motivated OTS's prohibition against multiple late fees. The Company's default-rate adjustments apply to future payments, rather than to payments already past due and do not take effect until at least two payments in the same twelve month period have each become more than thirty days overdue. Moreover, the default-rate adjustment occurs only once with respect to the same sequence of late payments. The adjustment does not escalate over time in response to continued failure to resolve late payments. Thus, as structured, the default-rate adjustment will not result in rapid multiplication of late fees, which is the focus of § 560.33. For example, in the five-month illustration given above, if a loan balance of $100,000 is assumed, the default-rate adjustment would increase the borrower's net costs during the five month period from $500 to about $800, rather than the three-fold increase that could result from layering traditional late fees.

Accordingly, the default-rate adjustment proposed by the Company will not, on the facts presented, be classified as a late fee within the meaning of § 560.33.[15]

2. Interest Rate Adjustment Regulation.

Section 560.35 of OTS's lending regulations imposes various restrictions on interest-rate adjustments for residential mortgage loans secured by borrower-occupied property.[16] The regulation requires that the interest rate adjustments either be tied: (a) to a readily available and independently verifiable index; or (b) to "a formula or schedule that specifies the amount of the increase, the time at which it may be made, and which is set forth in the contract." On the facts presented, the Company's default-rate adjustments will qualify under the latter requirement. The Company represents that the precise amount of the default-rate rate adjustment and the precise circumstances under which the adjustment will be made will be specified in each mortgage loan contract.

3. Interest Rate Disclosure Regulation.

Section 560.210 of OTS's lending regulations imposes certain disclosure requirements on "adjustable-rate mortgage loans." An adjustable-rate mortgage loan is defined as:

> a mortgage loan, secured by property occupied or to be occupied by the borrower, providing for adjustments to the interest rate which cause a change in balance, term to maturity, or payment levels <u>other than those established by a fixed, predetermined schedule at the time of contracting for the loan</u> (emphasis added).[17]

As noted above, the circumstances constituting an event of default and the amount of the default rate will be set forth in the Company's loan documents. Thus, the default rate constitutes an adjustment that is "established by a fixed,

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[15] We note that loans originated by the Company under the Parity Act are also subject to OTS's prepayment penalty regulation, 61 Fed. Reg. at 50974 (to be codified as 12 C.F.R. § 560.34). We do not separately discuss the prepayment penalty regulation here because, on the facts presented, no interpretive questions are presented.

[16] 61 Fed. Reg. at 50,974.

[17] 61 Fed. Reg. at 50,983.

predetermined schedule at the time of contracting," within the meaning of § 560.210.

This result is consistent with the provisions of Regulations Z[18] and the interpretation of these provisions by the Federal Reserve Board (the "FRB"). Regulation Z, which implements the Truth-in-Lending Act ("TILA"),[19] prescribes disclosure requirements applicable to closed-end "variable-rate transactions," including variable rate home loans.[20] The FRB's Official Staff Commentary provides an exclusion for transactions in which an increase in the interest rate results from a delinquency or default.[21] The OTS has previously indicated that the requirements of its disclosure regulation and Regulation Z are "substantially similar" and should be interpreted consistently.[22]

Although the Company is not subject to the disclosure regulation, we note that the Company nevertheless represents that borrowers will receive prominent disclosure of the default-rate in disclosure documents provided to borrowers prior to origination and that, whenever a borrower becomes more than thirty days delinquent, a letter will be sent to the borrower warning him or her that a default-rate adjustment will be made if a second installment becomes more than thirty days late within a twelve month period. Moreover, the Company represents that a second notice will be sent if a default-rate adjustment is actually triggered.

In reaching the foregoing conclusions, we have relied on the factual representations contained in the materials you submitted to us and in subsequent

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[18] 12 C.F.R. Part 226 (1996).

[19] 15 U.S.C.A. § 1601 et seq. (West 1989 and Supp. 1996).

[20] 12 C.F.R. § 226.18(f) (1996). For Regulation Z purposes, "closed-end credit" means "consumer credit other than open-end credit." 12 C.F.R. § 226.2(a)(10). "Open-end credit" is consumer credit involving repeated transactions, finance charges on the outstanding balance, and an amount of credit available to the extent any outstanding balance is repaid. 12 C.F.R. § 226.2(a)(20). Closed-end variable rate transactions include certain closed-end home mortgages defined as consumer credit transactions secured by a consumer's principal dwelling, subject to certain conditions. See 12 C.F.R. § 226.32(a)(1).

[21] FRB Comment 18(f)-1 provides: "The requirements of [12 C.F.R.] § 226.18(f) apply to all transactions in which the terms of the legal obligation allow the creditor to increase the rate originally disclosed to the consumer. . . . The provisions, however, do not apply to increases resulting from delinquency (including late payment), default, assumption, acceleration or transfer of the collateral." 12 C.F.R. Part 226, Supp. I (1996).

[22] 61 Fed. Reg. at 50,962-63.

discussions, as summarized herein. Our conclusions depend on the accuracy and completeness of these representations. Any material change in facts from those set forth herein could result in different conclusions.

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

Very truly yours,

Carolyn J. Buck
Chief Counsel

cc: All Regional Directors
All Regional Counsel