Office of Thrift Supervision
Department of the Treasury

1700 G Street, N.W., Washington, D.C. 20552 • (202) 906-6000

May 10, 1995

[redacted]

RE: Usury Preemption/Loans Secured by Timeshare Interests

Dear [redacted]

This responds to your request for reconsideration of an Office of Thrift Supervision ("OTS") opinion dated March 17, 1992 ("March 17 Op."). That opinion discusses, inter alia, the applicability of the residential real estate usury preemption provision of the Depository Institutions Deregulation and Monetary Control Act of 1980 ("DIDMCA") to loans secured by timeshare interests. See 12 U.S.C. § 1735f-7a. You ask that we review the conclusion that loans secured by timeshare interests will be deemed to qualify for usury preemption under 12 U.S.C. § 1735f-7a only when "the re-sale value of the timeshare interest at the time of purchase equals or exceeds the principal amount of the loan in question." March 17 Op., p. 7.

For the reasons explained below, we believe that the foregoing conclusion should be modified. When the sole purpose of a loan is to finance the purchase of a timeshare or other residential real estate, the loan qualifies for usury preemption regardless of the value of the real estate pledged to secure the loan. The value of collateral is relevant, however, in non-purchase money situations or in mixed purchase money and non-purchase money situations. Nevertheless, we do not believe that the value of the collateral must necessarily "equal or exceed" the principal amount of the loan. It is sufficient if the value of the collateral at the time the loan is originated is substantially equal to the principal amount of the loan. We elaborate below on what constitutes "substantially equal" value.

I. Background

Your client, [redacted] (the "Lender"), is a real estate developer/homebuilder that originates a substantial volume of loans secured by liens on fee simple interests in timeshares. A timeshare ordinarily confers upon

its owner the exclusive right to occupy a dwelling unit in a real estate development for a period of time each year.[1]

The Lender represents that the March 17 Op. is not widely known in the timeshare industry. If applied in its current form, the Lender believes the opinion would have a severe adverse impact on the industry, for several reasons. First, often there is not an active aftermarket for timeshares. Thus, in many instances it may be difficult or even impossible to reasonably estimate re-sale value.

Second, even when there is an aftermarket in timeshares, the strength and predictability of that market may vary widely depending on several factors, including the extent of the developer's participation in the re-sale market and the developer's marketing cycle. For example, the immediate re-sale value of a timeshare unit may be fairly easy to determine when the developer is still heavily engaged in the marketing effort. Under these circumstances, owners attempting to re-sell their timeshares could presumably piggy-back off the developer's marketing effort and re-sell their timeshares at or near the developer's asking price for unsold units. The re-sale value of units purchased at the end of a marketing cycle, however, may be substantially below their initial sale price due to the absence of a continuing marketing effort or a program to assist such sales. Thus, in many instances, the re-sale value of a timeshare may be significantly lower than its initial purchase price. If usury preemption is tied to re-sale value, the preemption status of a timeshare loan could end up turning on whether the timeshare is purchased at the beginning or end of a marketing cycle.

Third, you note that when timeshares are financed by the developer (as is often the case), the developer typically does not require the customer to obtain an appraisal of the timeshare, as might be the case if a third-party lender were involved. Under the March 17 Op., however, appraisals might always be necessary as a defensive measure for developers anxious to protect themselves against alleged usury violations. This would add to the cost of timeshares. Moreover, because the March 17 Op. requires re-sale value to be determined at the time a loan is originated, lenders may feel a need to delay appraisals until immediately prior to closing, thereby adding uncertainty to the closing process.

Finally, you note that the March 17 Op. could have a similar adverse impact on manufactured home lenders, since the value of manufactured homes often drops immediately upon sale.

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1. See J. Douglas, The Arnold Encyclopedia of Real Estate, 1985 Yearbook, at 492-3 (1985).

You note that the text of 12 U.S.C. § 1735f-7a nevertheless makes clear that it was intended to encompass manufactured home loans.

For these reasons, you ask that we reconsider the March 17 Op. As you recognize, the OTS, as successor to the Federal Home Loan Bank Board ("FHLBB"), is statutorily responsible for implementing and interpreting 12 C.F.R. § 1735f-7a for all lenders, not just savings associations.[2]

II. Discussion

The DIDMCA, 12 U.S.C. § 1735f-7a(a)(1), prescribes the standards governing the preemption of state usury laws in transactions involving residential real estate. The statute provides, inter alia, that such loans will be deemed to fall within its preemptive provisions only if they are made by certain types of lenders and are "secured by a first lien on residential real property." To meet this latter requirement, the property interest pledged as collateral must constitute "residential real estate" and the loan in question must be "secured by a first lien" on that property interest.

As noted in the March 17 Op., the FHLBB issued several opinions in the early 1980s that concluded that loans secured by first liens on timeshare interests in vacation residences qualify under the foregoing two-part standard, provided the timeshare interests in question constitute real property under the laws of the state in which they are located.[3] In reviewing these older decisions, the March 17 Op. expressed a concern that, in the absence of a requirement that loans be fully secured, lenders could make a loan of any amount for virtually any purpose and still qualify for usury preemption under the residential lending provisions of the DIDMCA, so long as at least a minute portion of the principal amount of the loan was secured by residential real estate. In an effort to avoid such sham transactions, the March 17 Op. concluded that loans secured by timeshare interests, as well as other types of residential real estate, should qualify for usury preemption only when, inter alia, the re-sale value of the timeshare or other real estate interest at the time of purchase equals or exceeds the

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2. The FHLBB was the OTS's predecessor agency and was given authority to issue rules, regulations and interpretations governing usury preemption for all lenders pursuant to 12 U.S.C. § 1735f-7a(f). The FHLBB's functions were transferred to the OTS pursuant to the Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183, 357 (1989), codified at 12 U.S.C. § 1462a.

3. E.g., FHLBB Op. by Laird, dated July 22, 1981; and FHLBB Op. by Doyle, dated June 3, 1982. See also, FHLBB Op. by Smith, dated March 28, 1988.

principal amount of the loan. The March 17 Op. reasoned that the full collateralization requirement was implicit in the statutory mandate that qualifying loans must be "secured by a first lien on residential real property."

We believe the general thrust of the March 17 Op. was correct. If nominal collateralization were permitted, the statutory requirement that a loan must be "secured by a first lien on residential real property" would be emptied of any real meaning. However, as you point out, the specific standard articulated in the March 17 Op. may sweep too broadly, potentially excluding a variety of bona fide residential real estate loans, including loans whose sole purpose is to finance the purchase of a residential real estate interest, and non-purchase money or mixed purpose loans secured by residential real estate whose value may sometimes be slightly less than the principal amount of the loan. Given the statements in the case law about the importance of interpreting § 1735f-7a broadly, we believe a more flexible standard is appropriate.[4]

In our view, any loan that is made for the sole purpose of financing the purchase of a residential real estate interest and that otherwise meets the requirements of § 1735f-7a qualifies for the preemption provided by § 1735f-7a, regardless of the value of the real estate interest. Where to draw the line for non-purchase money loans or mixed purpose loans is more difficult to determine. Clearly, transactions where little or no practical reliance is placed on real estate collateral would not meet the spirit or intent of § 1735f-7a. When the value of the collateral is substantially equal to the principal amount of the loan, however, and barring other unusual circumstances, we see no reason to question classification of the loan as a residential real estate loan within the meaning of the statute.[5]

This approach is consistent with how the OTS defines a real estate loan in other contexts. Thus, for example, 12 C.F.R. § 545.31(a) provides that a loan will qualify as "a real estate loan" only if the lender "rel[ies] substantially upon the real estate as the primary security for the loan." Similarly, 12 C.F.R. § 545.32(c), (d) (1994), provides that a loan will be

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4. See Grunbeck v. Dime Savings Bank of New York, FSB, 848 F. Supp. 294, 300 (D. N.H. 1994); Shelton v. Mutual Savings & Loan Association, 738 F. Supp. 1050, 1057 (E.D. Mich. 1990).

5. Several courts have held that non-purchase money loans secured by first liens on residential real estate qualify under § 1735f-7a. See Smith v. Fidelity Consumer Discount Co., 898 F.2d 907 (3rd Cir. 1990); cf., Bank of New York v. Hoyt, 617 F. Supp 1304 (D.R.I. 1985). However, the question of whether a loan may be partially, rather than fully, secured by residential real estate was not at issue in these cases.

deemed to be "made on the security of real estate" if, inter alia, the value of the security property is sufficient to produce an appropriate loan-to-value ("LTV") ratio. Under certain limited circumstances, real estate loans with LTV ratios in excess of 100% are permissible under applicable OTS guidance. See e.g., 12 C.F.R. §§ 545.32(b)(4), 545.33(b); OTS Thrift Activities Handbook, Section 212, pp. 212.8-212.9, regarding negative amortization loans; see also 12 C.F.R. §§ 563.100-.101, OTS real estate lending standards and interagency guidelines for real estate lending policies, which do not specifically prohibit LTV ratios in excess of 100% (although, for reasons of safety and soundness, such loans are extremely rare).

Accordingly, we conclude that a non-purchase money loan or mixed purpose loan that is secured by residential real estate with a value substantially equal to the loan, and that otherwise meets the requirements of § 1735f-7a, qualifies for usury preemption.

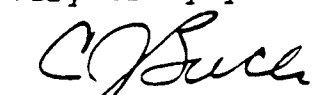
The term "substantial" cannot be defined with precision. Clearly, however, a loan that is secured by residential real estate with a value equal to 90% or more of the loan amount and that otherwise meets the requirements of § 1735f-7a will qualify for the preemption provided by § 1735f-7a. Whether a lower LTV ratio might suffice will depend on the particular facts and circumstances of each case.

In reaching the foregoing conclusions, we have relied on the factual representations contained in the materials you submitted to us, as summarized herein. Our conclusions depend upon the accuracy and completeness of those representations. Any material change in circumstances from those described herein could result in different conclusions.

It is also important to emphasize that this letter addresses the narrow question of the meaning of 12 U.S.C. § 1735f-7a, which the OTS interprets and implements for all lenders. Nothing herein should be construed as an endorsement by OTS for savings associations to originate real estate loans with LTV ratios at or even near 100%. As noted above, the circumstances under which high LTV loans can be classified as residential real estate loans by savings associations are extremely limited. Savings associations that orginate time share loans with LTV ratios at or near 100% may be required to underwrite and classify those loans as consumer or commercial loans, as appropriate, to more accurately reflect the true credit risk presented by such loans.

If you have any further questions regarding this matter, you may contact Ellen Sazzman, Counsel (Banking and Finance), at (202) 906-7133.

Very truly yours,



Carolyn J. Buck
Chief Counsel

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