Office of the Comptroller of the Currency

Interpretive Letter #744

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12 U.S.C. 85

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Dear [ ]:

This letter responds to your inquiry asking whether prepayment fees levied by a national bank with respect to home equity loans constitute "interest" for purposes of 12 U.S.C. 85. If the fees do constitute "interest" and if they are permitted by the state where the bank is located, then section 85 provides authority to the national bank to charge those fees to borrowers who reside in another state even if that other state prohibits the imposition of prepayment penalties in connection with home equity loans. For the reasons set forth in detail below, it is our view that prepayment fees constitute "interest" for the purpose of section 85. This interpretation is consistent with OCC precedent and regulations governing the definition of "interest" for purposes of section 85 as upheld by the United States Supreme Court. These fees thus may be assessed by a national bank if similar charges may be imposed by another lender in the state where the national bank is located. This is without reference to whether prepayment fees are denominated by state law to constitute "interest" and without reference to whether these prepayment fees are permissible under the laws of another state where the customer may reside.

Background

As we understand the facts, the national bank makes home equity loans on a nationwide basis. Under its program, borrowers can choose between loans that provide for prepayment fees and those which do not. If a borrower opts for a loan that does not impose a prepayment fee, the percentage rate is typically about 50 basis points higher than a loan which provides for a prepayment fee. You state that a prepayment provision used by the national bank provides that, during the first three years of the loan, the borrower may pay up to 20% of the original principal amount of the loan in any 12-month period without a prepayment fee. However, a prepayment fee is imposed if, during the first three years, the borrower prepays more than 20% of the original principal amount in any 12 month period. The amount of the prepayment fee is six months advance interest on the amount prepaid in excess of 20% of the original principal loan amount. There is no prepayment fee if the loan is prepaid in whole or in part after the three year period. <NOTE: The information on which this opinion relies is based on your letter of July 23, 1996, and other material provided by you to OCC staff both in writing and orally. >

Discussion

A. The Statute

Interest rates that national banks may charge are generally governed by 12 U.S.C. 85 which provides, in pertinent part, that "Any association may . . . charge on any loan . . . interest at the rate allowed by the laws of the State . . . where the bank is located . . . ." <**NOTE:** Under the facts that you have put forth, no issue arises as to the state "where the bank is located." The national bank is an intrastate national bank with its main office and branch offices in one state. Thus, that is the only state whose interest rate restrictions can be applied under the statutory standard upon which you rely. *See Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*, 439 U.S. 299(1978). Unlike situations where a bank has a main office and branch offices in more than one state there is no reason to analyze which state law governing interest rates may be applied to the transaction. *See*, *e.g.*, Interpretive Letter No. 686, September 11, 1995, *reprinted in* [Current Binder] Fed. Banking L. Rep. (CCH) 81,001.

Section 85 also sets forth alternative bases upon which national banks may establish interest rates. You do not, however, rely on those bases and, therefore this opinion does not analyze or consider them. Likewise, other provisions of Federal law provide alternative bases upon which national banks may rely in setting interest rates. In this regard, we note that 12 U.S.C. 1735f-7a(a) overrides state law with respect to certain charges in connection with loans secured by first liens on residential mortgages. Similarly, OCC regulations, 61 Fed. Reg. 11,294, 11,301 (March 20, 1996) (to be codified at 12 C.F.R. 34.20 through 34.25), override state restrictions on adjustable rate mortgage (ARM) loans, including restrictions on prepayment penalties, made to finance or refinance the purchase of, and secured by, a lien on a one-to-four family-dwelling. These current provisions had their origin in the OCC's initial ARM regulations adopted in 1981. The OCC, at that time, made it clear in the preamble to the proposed and final regulations that this override of state law was based on 12 U.S.C. 371 and other sources of statutory authority. *See* 46 Fed. Reg. 18,932, 18,942 (March 27, 1981) (preamble to final rule codifying ARM regulation at 12 C.F.R. Part 29); 45 Fed. Reg. 64,196, 64,198 (September 29, 1980) (preamble to proposed OCC ARM regulation). Your inquiry does not rely on these sources of statutory authority and, in fact, the loans about which you ask are not within the scope of 12 U.S.C. 1735f-7a(a) or the OCC's ARM regulation. Moreover, you do not seek to override state law with respect to prepayment penalties but to apply state law as incorporated in 12 U.S.C. 85 and export it as provided by that statute. >

You have represented that the law of that state permits the prepayment fees that the bank imposes. Therefore, these fees may be imposed by national banks under the authority of this provision, if they are "interest" within the meaning of section 85, even with respect to loans made to out-of-state residents. *See Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*, 439 U.S. 299 (1978).

B. The Regulation

The OCC has recently adopted final regulations defining "interest" for purposes of section 85 and setting forth a nonexclusive list of examples of fees that constitute interest. This ruling, adopted following a notice and comment rule-making procedure, states:

> The term 'interest' as used in 12 U.S.C. 85 includes any payment compensating a creditor or prospective creditor for an extension of credit, making available of a line of credit, or any default or breach by a borrower of a condition upon which credit was extended. It includes, among other things, the following fees connected with credit extension or availability: numerical periodic rates, late fees, not sufficient funds (NSF) fees, overlimit fees, annual fees, cash advance fees, and membership fees. It does not ordinarily include appraisal fees, premiums and commissions attributable to insurance guaranteeing repayment of any extension of credit, finders' fees, fees for document preparation or notarization, or fees incurred to obtain credit reports.

61 Fed. Reg. 4849, 4869 (February 9, 1996) (to be codified at 12 C.F.R. 7.4001(a) ("section 7.4001(a)")). The United States Supreme Court unanimously upheld this ruling earlier this year in the context of a case in which plaintiffs argued that late fees were not properly considered to be interest for purposes of section 85 and, thus, not subject to exportation. *See Smiley v. Citibank (South Dakota) N.A.*, 64 U.S.L.W. 4399 (1996) (*Smiley*).

C. Applicability of the regulatory definition of 'interest' to prepayment fees

We note that, as recognized and upheld by the Supreme Court in *Smiley*, section 7.4001(a) draws a line between charges that fit within the definition of interest and "all other payments." Included in the regulation's list of non-interest charges are appraisal fees, premiums and commissions attributable to insurance guaranteeing repayment of any extension of credit, finders' fees, fees for document preparation or notarization, or fees incurred to obtain credit reports. *See* 61 Fed. Reg. at 4869. The Supreme Court explicitly upheld this distinction stating:

> [I]t seems to us quite possible and rationale to distinguish, as the regulation does, between those charges that are *specifically assigned* to such expenses and those that are assessed for simply making the loan, or for the borrower's default. In its logic, at least, the line is not 'arbitrary [or] 'capricious' . . . .

Smiley at p. 4401. It is clear on which side of the line prepayment penalties fall. While, as discussed, prepayment penalties clearly constitute "payment compensating a creditor . . . for an extension of credit . . . or any default or breach by a borrower of a condition upon which credit was extended," the definition set forth in section 7.4001(a), they just as clearly *do not* constitute a charge that "is specifically assessed" to cover the cost of an activity or service, such as those listed in section 7.4001(a), pertinent to making the loan.

The history of section 7.4001(a) provides further support for this conclusion. The OCC has been explicit that the examples of fees considered to be "interest" do not constitute an exclusive list. As stated in the general rule set forth in section 7.4001(a), "interest" includes *"any payment"* to a creditor for an extension of credit or any default or breach of a condition by a borrower. Moreover, in adopting the final rule, the OCC stated in the preamble, "the ruling is not intended to be a comprehensive treatment of the issue, and other fees or charges may also be found to be components of interest." 61 Fed. Reg. at 4859.<**NOTE:** The preamble to the notice of proposed rulemaking stated the same position with regard to the nonexclusivity of the list. *See* 60 Fed. Reg. 11,924, 11929 (March 3, 1995). >

Moreover, the preamble explaining the proposed revisions to section 7.4001 makes it clear that the OCC intended to revise the OCC's prior ruling in Part 7 pertaining to interest rates on loans to "reflect current law and OCC interpretive letters." 60 Fed. Reg. at 11,1929.<**NOTE:** A similar statement also appears in the preamble to the final regulation. *See* 61 Fed. Reg. 4859. The Supreme Court in *Smiley* acknowledged this reliance by the OCC on its precedents in formulating the regulation. *Smiley* at p. 4401.> As the OCC stated in that preamble:

> Although the exportation principle of section 85 is well-established in case law, the application of section 85 is still the subject of court challenges, usually over whether a particular fee or charge imposed by a bank located in a given state is properly characterized as 'interest' and is thus 'exportable' to a different state . . . . [Citations omitted.]
>
> The OCC has addressed, through interpretive letters, the issue of what fees or charges may be considered 'interest.' Most recently the OCC summarized its previous opinions and concluded that in addition to periodic percentage rates, charges consisting of late charges, annual fees and overlimit charges are included within the meaning of 'interest' as used in section 85. Thus, if they are permissible for lenders to impose under the laws of the state where a bank is located, they may be charged and 'exported' . . . . *See* Letter from Julie L. Williams to John Douglas, dated February 17, 1995 [the 1995 letter]. <**NOTE:** The 1995 letter is Interpretive Letter No. 670, *reprinted in* [Current Binder] Fed. Banking L. Rep. (CCH) 83,618. This letter reviews in detail the principles underlying section 85 including the most favored lender doctrine, the fact that the term "interest" as used in section 85 calls for a federal

> definition and is to be construed broadly, and provides for the exportability of interest. That analysis is incorporated into this letter. There is no need in this letter, which simply presents the question of whether prepayment fees fit within that federal definition of interest, as interpreted in the 1995 letter, codified in section 7.4001(a), and upheld by the Supreme Court in *Smiley*, to reiterate the analysis of those underlying principles.>

Id. The analysis in the 1995 letter underlies the general definition of "interest" now set forth in the first sentence of section 7.4001(a); that is, "any payment compensating a creditor or prospective creditor for an extension of credit, making available a line of credit, or any default or breach by a borrower of a condition upon which credit was extended." Application of that analysis to prepayment fees provides added support that prepayment fees fit within the newly codified definition of "interest."

The 1995 letter analyzed whether annual fees, late charges, and overlimit charges constituted "interest" within the meaning of section 85. The analysis emphasized that each type of charge constituted compensation to the bank for risks undertaken in connection with the use of its money. With respect to annual fees, the 1995 letter stated that banks apply annual fees to credit card transactions:

> as an alternative to higher monthly percentage finance charges on outstanding balances, and to compensate the bank for other costs and risks associated with establishing and maintaining the account. Annual fees fit squarely within the traditional definition of 'interest': 'compensation . . . fixed by the parties, for the use or forbearance of money, or as damages for its detention.' [Footnote and citation omitted.]

Similarly, late charges, imposed against borrowers who are delinquent in their payments, and overlimit fees, imposed when a customer's draws on an account exceed the amount the bank has agreed to advance, compensate the bank for risks undertaken in connection with the use of its money.

Likewise, prepayment fees compensate the bank for risks incurred in connection with the lending of its money to a borrower. As at least one court has noted:

> By accepting prepayment, the bank relinquished its right to receive anticipated earnings on the money loaned, and was faced prematurely with the reinvestment of a large sum of money, with the additional expenses thereof and the vagaries of the money market at the time.

Northway Lanes v. Hackley Union National Bank and Trust Company, 334 F. Supp. 723, 732 (W.D.Mich. 1971), *aff'd*, 464 F.2d 855 (6th Cir. 1972) (*Northway Lanes*). <**NOTE:** Because plaintiffs in this case altered their argument on appeal regarding the permissibility of prepayment penalties, the appellate court did not have to, and did not, opine on the district court's analysis on this issue. > As the program you describe is structured, it is plainly evident that the prepayment fees constitute compensation to the bank, in the form of an alternative to higher finance charges, <**NOTE:** In this regard, we emphasize that while the program you describe clearly illustrates the point, it is not necessary for a bank to offer a borrower the alternative of accepting a prepayment fee in exchange for a lower rate of interest. Just as annual fees on credit cards, as described in the 1995 letter, may be levied across the board to help a bank reduce its finance charges, so might prepayment fees on home equity loans be levied by a bank across the board to reduce its finance charges.> for the risk that an extension of credit will be repaid prior to the maturity date on which the interest rate was predicated. The bank can cover that risk by charging a higher finance charge without provision for imposition of a prepayment penalty, or by reducing the finance charge in cases where the borrower agrees to pay a prepayment penalty. Needless to say, where the bank can offer a borrower a choice, both parties benefit. A borrower who, at the time of receiving a loan does not anticipate prepaying the loan, can reap the benefits of the lower interest rate while the bank remains protected against the losses incurred as a result of an unanticipated need by the borrower to prepay. As a result, prepayment penalties fit within the section 7.4001(a) definition of "interest" as including any payment compensating the creditor for an extension of credit. <**NOTE:** In analyzing annual fees, the 1995 letter also addressed in detail the issue of whether "interest" in section 85 had to be expressed on a

percentage basis. The Supreme Court has since made it abundantly clear that interest does not have to be expressed on a percentage basis or as functions of time and amount owing. *Smiley* at p. 4402. Moreover, the list of fees, set forth in section 7.4001(a), demonstrates that when the fee is due -- prior to the extension of funds, after the extension of funds or otherwise -- is irrelevant in determining whether a given fee constitutes interest within the meaning of section 85.

In connection with its analysis of late charges, the 1995 letter also rejected the argument that these charges did not constitute "interest" within the meaning of section 85 because they were "contingent." Prepayment fees, like late charges, also can be said to be "contingent." As the 1995 letter stated, however:

That argument simply does not make any sense. Many charges, including the monthly percentage finance charges on a credit card account, are 'contingent' on whether the customer draws on the account or on the amount or duration of the draw, but they are still recognized as 'interest.'

Apparently, this argument was not made before the Supreme Court in *Smiley* and the Court did not address it, but as the 1995 letter noted, the Supreme Court had previously noted that *Citizens' National Bank of Kansas City v. Donnell*, 195 U.S. 369 (1904), clearly established that a contingent charge imposed by a national bank (based on a borrower's failure to pay on time) is governed by section 85.

The 1995 letter also rejected the argument that late charges were not "interest" because they are "penalties." The Supreme Court in *Smiley* explicitly addressed this argument and flatly rejected it. As the Court stated: "In 85, the term 'interest' is not used in contradistinction to 'penalty' and there is no reason why it cannot include interest charges imposed for that purpose." *Smiley* at p. 4402.>

Conclusion

Based on the foregoing, we conclude that the described prepayment fees on home equity loans constitute "interest" within the meaning of 12 U.S.C. 85, as codified in section 7.4001(a) and upheld by the Supreme Court, and that a national bank located in a state where another lender is permitted to assess these fees may assess the fees to customers within that state and in other states without reference to whether these fees are considered by the state in which the national bank is located to constitute "interest" or whether these fees are permissible under the laws of the other state where the customer may reside. I hope that this has been responsive to your inquiry.

Sincerely,
/s/
Julie L. Williams
Chief Counsel