June 24, 2002

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.,
Washington, DC 20552
Email: regs.comments@ots.treas.gov

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Attn: Docket No. 2002-17

Dear Office of Thrift Supervision:

Self-Help (www.self-help.org), the organization for which we serve as President and Vice President, respectively, consists of a credit union and a nonprofit loan fund. For over 20 years, these entities, have created ownership opportunities for low-wealth families through home and small business lending. **Self-Help has provided over $1.7 billion dollars of financing to help 23,000 low-wealth borrowers buy homes, build businesses and strengthen community resources.**

Self-Help believes that homeownership represents the best possible opportunity for families to build wealth and economic security, taking their first steps into the middle class. Accumulating equity in a home is the primary way most families earn the wealth needed to send children to college, weather emergencies and pass wealth on to future generations, as well as develop a real stake in society. **Self-Help has had a significant and successful experience making home loans available to families who fall outside of conventional guidelines because of credit blemishes or other problems, reporting a loan loss rate of well under 0.5% each year.** Self-Help's assets are $700 million.

We are also spokespersons for the Coalition for Responsible Lending (CRL). CRL (www.responsiblelending.org) is an organization representing over three million people through eighty organizations, as well as the CEOs of 120 financial institutions. CRL was formed in response to the large number of abusive home loans that a number of lenders and housing groups witnessed in North Carolina. In 1999, CRL spearheaded an effort that helped pass the NC predatory lending law. The bill was supported by trade associations representing the state's large banks, community banks, mortgage bankers, credit unions, mortgage brokers, realtors, NAACP, consumer, and community development/housing groups. In 2001, CRL helped lead the successful effort to pass a bill licensing and regulating mortgage brokers, which originate an estimated 50-70% of all home loans.

Coalition for Responsible Lending responses to OTS questions

In response to OTS's four questions in its April 25, 2002 Notice of Proposed Rulemaking, Self-Help submits the following answers:

1. OTS has correctly identified the factors it must weigh in determining whether a specific rule should be designated as applicable for state housing creditors.

2. OTS has appropriately and fairly applied these factors, identifying the correct two regulations to be retained on the list of designated regulations.

3. We do not believe that the Parity Act should treat state-chartered savings associations differently from finance companies under the Parity Act; the OTS should give neither automatic parity with federally-chartered thrifts. As a matter of policy, state-chartered institutions should remain governed by state law except where federal preemption is absolutely required, including the ability to make alternative mortgages. Many states have passed laws designed to give state-chartered institutions parity with federal institutions, [1] a choice that should remain wholly within their discretion. As a matter of law, nothing in the Parity Act or its legislative history would allow the OTS to distinguish between state housing creditors that are depository institutions and those that are not. However, the premise behind this question is compelling: the OTS should be reluctant to identify additional applicable regulations under the Parity Act since, unlike the OCC and NCUA, its regulations also apply to state-chartered lenders that lack the safeguard of being regulated depository institutions.

4. That an argument can be made that prepayment penalties and late fees contribute to the safety and soundness of lenders does nothing to alter the fact that the Parity Act places depository and non-depository state-chartered creditors in exactly the same position as a matter of law. The contrary argument can also be made, stating that prepayment penalties, by depleting the home equity wealth held by borrowers, increases the risk of foreclosure, the risk of loss, and therefore the safety and soundness of lenders. Further, to the extent that one believes that safety and soundness is enhanced by such loan provisions, one furthers the argument that the decision on whether to extend additional privileges concerning them is one appropriately left to the very states who provide charters for and regulate such lenders, not the OTS.

Introduction

Homeownership not only supplies families with shelter, it also provides a means to build wealth and economic security. Unfortunately, too many American homeowners are losing their homes, as well as the wealth they spent a lifetime building, because of harmful home equity lending practices. Some lenders target elderly and poor or uneducated borrowers to strip the equity from their homes, trapping borrowers in bad loans and creating a high risk of foreclosure. The threat posed by predatory subprime

[1] See e.g., Cal. Fin. Code §753 (West 2002), Fla. Stat. Ann. § 655.061 (West Supp. 2000), Ga. Code Ann. § 7-1-61(a)(1) (1997), Haw. Rev. Stat. Ann. § 412:7-201 (Michie 1997), 205 Ill. Comp. Stat. 205/1006 (West 2000), Mich. Comp. Laws Ann. § 487.14101 (West 2002), Mo. Ann. Stat. § 369.144 (West 1997), N.J. Stat. Ann. § 17-9A-24b1 (West 2000), N.C. Gen. Stat. § 54B-195, N.C. Gen. Stat. § 54C-145, Or. Rev. Stat. § 722.204 (1989), Ohio Rev. Code Ann. § 1121.05(5) (West 2002), 7 Pa. Cons. Stat. § 6020-3(5) (1995), Tex. Fin. Code Ann. § 32.009 (West 1998), Va. Code Ann. § 6.1-194.141 (Michie 1991).

lending is as severe as it is recent. Subprime lending, 80% of which consists of refinance loans for debt consolidation and consumer credit, has increased almost 1,000% in just the last five years, and abusive lending is up commensurately.[2]

Much abusive lending activity by unregulated, non-depository finance companies has inadvertently been promoted by a regulatory interpretation adopted by the Office of Thrift Supervision (OTS) in 1996 under the Alternative Mortgage Transaction Parity Act (the "Parity Act").[3] Passed during the interest rate crisis of the early 1980's, the Parity Act enabled state depository institutions and "other housing creditors" to make adjustable rate mortgages without complying with state laws prohibiting such mortgages. Twenty years later, the Parity Act has been reinterpreted by the OTS to enable unregulated mortgage companies to ignore state consumer law protections regarding prepayment penalties and late fees.

Thirty-five states and the District of Columbia prohibit or restrict prepayment penalties on home loans to protect their citizens from abusive lending practices.[4] However, the OTS reinterpretation prevents states from enforcing these restrictions against unregulated finance companies (which make the vast majority of subprime loans) by allowing them preemption on par with regulated depository institutions. The Parity Act has fueled the use of prepayment penalties by finance companies, which are now included in 80% of all subprime loans (compared to 2% of conventional loans). **Forty-six state Attorneys General, both Republican and Democrat, have urged the OTS to reduce the scope of Parity Act finance company preemption.**[5]

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[2] See Joint HUD/Treasury Report on Recommendations to Curb Predatory Home Mortgage Lending (June 20, 2000) at pp. 28-29.

[3] 12 U.S.C. §3800 et seq., P.L. 97-320, 96 Stat. 1469 (Oct. 15, 1982).

[4] See e.g., ALA. CODE § 5-19-4 (1999), ALASKA STAT. ANN. § 45.45.010 (Lexis 1998), ARK. CODE ANN. §23-32-203 (2001), CONN. GEN. STAT. ANN. §§ 36a-265(c), 519 (West 1996 & Supp. 2000), 5 DEL. CODE ANN. §§ 945,969 (2000), D.C. CODE ANN. § 28-3301 (1996), FLA. STAT. § 697.06 (Lexis 2000), OFFIC. CODE GA. ANN. § 7-4-2 (2000), IDAHO CODE §28-42-306 (Lexis 2000), IND. CODE ANN. §§ 28-1-13-7.1, -15-11-14, -15-11-16 (Michie 1996 & Supp. 1999), IL. COMPIL. STAT. 205/4 (Lexis 2001), IOWA CODE ANN. §§ 535.9 (West 1997), § 528.4 (West 1993), KANSAS STAT. ANN. § 16-207(c) (Lexis 2000), KY. REV. STAT. ANN. §294.110 (Lexis 2001), LA. REV. STAT. ANN. § 9:3509, 32, § 9:3532, § 6:1097, § 6:1224 (West Supp. 2000), ME. REV. STAT. ANN. tit. 9-A, § 9-308 (West 1997), MASS. ANN. LAWS ch. 140, § 90A (Law. Co-op. 1995), ch. 183, § 56 (Law. Co-op. 1996), MICH STAT. ANN. §19-176-19.15(1c), MINN. STAT. ANN. § 47.20, MISS. CODE ANN. § 75-17-31, § 89-1-317 (1999), MO. ANN. STAT. § 408.036 (West Supp. 2000), N.H. REV. STAT. ANN. 398-A:2 (Lexis 2000), N.J. STAT. ANN. § 46:10B-2 (West 1989), N.M. STAT. Ann. § 56-8-30 (Michie 1996), N.Y. REAL PROP. LAW 49 § 254-a (McKinney 1989), N.C. GEN. STAT. § 24-1.1A(b), OH. REV. CODE ANN. 1343.011 (Anderson 2001), OR. REV. STAT. § 86.150 (1999), 41 PA. STAT. ANN. § 405 (1999), R.I. GEN. LAWS § 34-23-5 (Supp. 1999), TENN. CODE ANN. § 47-14-108 (Lexis 2001), TEX. FINANCIAL CODE ANN. § 302.102 (West Supp. 2000), VA. CODE ANN. § 6.1-330.83 (Michie 1999), W. VA. CODE § 47-6-5b (1999), WIS. STAT. ANN. § 138.051 (West Supp. 1999).

[5] See OTS comments of National Association of Attorneys General at http://www.ots.treas.gov/docs/48197.pdf.

The Coalition for Responsible Lending estimates that up to 500,000 families across the country have $1.3 billion stripped from their home equity <u>each year</u> directly as a result of the OTS's interpretation of the Parity Act.[6]

<u>The Parity Act and OTS</u>

In the early 1980's, high interest rates prevailed in the economy at the same time that states remained hostile to adjustable-rate mortgages, and secondary markets had not yet developed. As a result, asset-liability mismatches devastated the savings and loan industry. In response, federal regulators developed regulations to allow the entities they regulate to make ARMs and other "alternative" mortgages notwithstanding state law.[7] With the Parity Act in 1982, Congress extended this preemption authority of state laws restricting alternative mortgages to state-chartered institutions.

Under the law, the Office of the Comptroller of the Currency promulgates regulations for providing alternative mortgage parity to state-chartered banks, the National Credit Union Administration (which has never allowed prepayment penalties) for state-chartered credit unions, and the OTS for two different classes of lenders—state-chartered thrifts and unregulated, non-depository lenders ("finance companies"). The Parity Act assigns the OTS the responsibility to determine which of its regulations governing federal thrifts apply specifically to alternative mortgages (so-called "applicable regulations") and therefore allow state thrifts and finance companies (together, "state creditors") to preempt state law.[8] State creditors then have the choice of whether to abide by state regulations or to choose the regime provided for by the OTS.

<u>Regulatory Actions Under the Parity Act: 1983-1995</u>

In May 1983, FHLBB issued a final rule regarding implementation of the Parity Act.[9] FHLBB identified three regulations applicable to housing creditors:

(1) 545.33(c), setting forth the authority to make balloon and negative amortization loans, and to adjust interest rate, payment, term;
(2) 545.33(e), setting forth limitations on loan adjustments; and
(3) 545.33(f)(4)-(11), setting forth disclosure requirements on non-fixed-rate, fully-amortized loans.[10]

All of these regulations are targeted at alternative mortgages alone, not at mortgage loans generally. The FHLBB stated, "those requirements applicable to mortgage lending generally (i.e. fixed-rate, fixed-term fully amortized loans as well as alternative mortgage transactions) are deemed inappropriate [and therefore inapplicable

[6] See footnote 31.
[7] *See e.g.*, 46 Fed Reg 24,148 (Apr 30, 1981) (authorizing federal thrifts to make adjustable-rate mortgages); 46 Fed Reg 18,932 (Mar 27, 1981) (authorizing national banks to make adjustable-rate mortgages); 46 Fed Reg 38,669 (Jul 29, 1981) (authorizing federal credit unions to make adjustable-rate mortgages).
[8] P.L. 97-320, §807(b).
[9] 48 Fed. Reg. 23032 (May 23, 1983).
[10] Id.

to state housing creditors] because they do not further 'describe or define' alternative mortgage transactions . . . ."[11] FHLBB refused to include regulations for state housing creditors that "apply generally to mortgage loans," including regulations on length of amortization term and loan to value ratios, since their reading of the Parity Act was that it provides parity only for state laws that restrict alternative mortgages in particular.[12] According to FHLBB,

> "The Board adheres to the approach that those regulatory provisions that describe and define alternative mortgage transactions should be deemed applicable, but those provisions that apply generally to mortgage loans . . . should not be applied. The revised Notice, therefore, does not include a reference to the forty year amortization limit because this requirement is not one particular to alternative mortgage transactions. . . .. [Furthermore, t]he Board believes that these provisions [the ones identified as applicable] are an integral part of, and particular to, alternative mortgage transactions . . . ."[13]

Congress gave federal thrifts the ability to preempt state laws restricting prepayment penalties in 1982. The Parity Act was part of a larger revision of federal lending regulation, the Garn-St. Germain Depository Institutions Act of 1982. In implementing this law, FHLBB amended its regulations to allow thrifts to impose prepayment penalties and late charges on mortgage loans. The OTS considered prepayment penalties to be applicable to home loans generally, not just to adjustable rate mortgages, and therefore did not allow non-depository lenders to take advantage of federal thrift preemption on these points.

Thus, for the thirteen years between the passage of the Parity Act and 1996, neither Congress nor the thrift regulator ever suggested that the Parity Act should apply to state laws concerning mortgage loans generally -- including state prepayment penalty laws -- rather than to alternative mortgages specifically.[14]

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[11] 48 Fed. Reg. 23032 (in Notice to Housing Creditors discussion).
[12] Id.
[13] Id. Over the next twelve years, FHLBB made two slight technical changes to the Parity Act regulation, none of which extended the Parity Act protection to mortgage loans generally. In 1984, FHLBB modified its regulation under the Parity Act to: (a) include two provisions relating to the adjustment of interest rates for ARMs that had been overlooked in the original regulation, and (b) further explaining that "credit sales" were considered "loans" for purpose of the Parity Act. 49 Fed. Reg. 43040 (October 26, 1984). In 1988, FHLBB relocated the Parity Act provisions from an appendix to the main body of regulations and designated the newly-modified ARM adjustment and disclosure regulations as applicable to the Parity Act loans. 53 Fed. Reg. 18262 (May 23, 1988).
[14] Unlike the Bank Board, at the time of the Parity Act, OCC regulations retained specific regulations governing adjustable-rate mortgages originated by national banks. *See* 48 Fed. Reg. 9,506 (Mar 7, 1983). The OCC's stand-alone regulation on alternative mortgages contained a provision on prepayment penalties. For Parity Act preemption purposes, OCC identified this entire alternative mortgage regulation as applicable to state-chartered banks. The Bank Board took a different approach. The Bank Board's regulatory approach, promulgated just before the Parity Act's passage, consisted of provisions applicable to mortgage loans generally and a few specific provisions applicable only to adjustable-rate mortgages. *See* 47 Fed Reg. 36,612 (Aug 23, 1982). Since the Bank Board's prepayment regulation applied to both fixed-

Regulatory Actions under the Parity Act: 1996

In 1996, OTS expanded its interpretation of the Parity Act. In January of that year, OTS proposed new regulations that would have applied the entire lending and investment regulation of federal thrifts to state housing creditors for alternative mortgages.[15] In April 1996, OTS General Counsel's office opined that OTS regulations preempted Wisconsin's prepayment penalty regulation.[16] OTS found that the Congressional intent of the Parity Act was to create parity between federal and state housing creditors, and, since federal thrifts could impose prepayment penalties regardless of state restrictions, then state housing creditors could also impose prepayment penalties regardless of state restrictions.[17] This opinion letter marked the first time that OTS applied the Parity Act to preempt a state law applicable to mortgage lending generally.

In September 1996, OTS issued the final rule regarding its streamlining of lending and investment regulations.[18] This final rule clarified that OTS did not intend to either occupy the field of alternative mortgage lending or to apply federal thrift safety and soundness requirements to state housing creditors. The final rule did, for the first time, include OTS regulations applicable generally to mortgage lending (i.e. prepayment penalties and late fees) to state housing creditors on alternative mortgages transactions.

Why the Parity Act should be limited to alternative mortgages

Since the provisions relating to prepayment penalties and late fees apply to all mortgage loans generally, rather than to alternative loans specifically, these provisions should be removed from the list of regulations finance companies can use to preempt state laws. Therefore, the OTS's Parity Act regulation should be revised as follows (deleting the struck citations):

12 CFR §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, §§ ~~560.33 [late fees], 560.34 [prepayment penalties],~~ 560.35[ARM adjustments]~~,~~ and 560.210 [ARM disclosures] 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.

rate and adjustable-rate mortgages (it still does), the Bank Board appropriately did not designate it as applicable to state-chartered housing creditors under the Parity Act.

[15] 61 Fed. Reg. 1,162, 1,181 ("In accordance with 12 U.S.C. 3807(b), this part 560 and 12 CFR 563.99 are identified as appropriate and applicable to the exercise of this authority [...].")

[16] OTS Gen. Couns. Ltr., April 30, 1996.

[17] Gen. Couns. Ltr, at p. 4-5.

[18] 61 Fed.Reg. 50,951 (September 30, 1996).

There are two classes of lenders that benefit from the OTS's expanded interpretation, state thrifts and finance companies, and neither should. Except for being allowed to originate alternative mortgages by the Parity Act, state thrifts are creatures of state law and should therefore abide by state law. If a state decides that it wants to grant preemption of its own consumer protection laws to state thrifts, it is free to do so. In fact, numerous states, including North Carolina, have passed state parity acts that provide for this option. On this point, it is interesting to note that unregulated finance companies are the biggest beneficiaries of the 1996 OTS revision precisely because states are unlikely to grant them such preemption; finance company lending practices are, after all, one of the primary reasons many states passed their consumer protection laws in the first place.

Allowing Parity Act preemption for finance companies overlooks the fundamental difference between regulated federal thrifts and substantially-unregulated state housing creditors. Federal thrifts are subject to stringent safety and soundness regulations and other regulation designed to ensure community benefit. On the other hand, many states protect their residents by limiting the availability of potentiallyabusive products, as opposed to engaging in strict licensing standards and time-consuming (not to mention expensive) audits of non-depository lenders. Thus, the current interpretation of the Parity Act preempts the only effective regulation states have of many non-depository lenders. **This does not create parity; instead, it creates a significant competitive advantage to unregulated lenders engaging in predatory practices.**

As federal banking regulators often correctly assert, regulated institutions are not by in large the perpetrators of predatory lending in this country; unregulated finance companies. Congress passed the Parity Act as a result of an economic crisis that, when combined with particular state laws, led to the evaporation of mortgage credit. In passing the Parity Act, Congress wanted all lenders to have the opportunity to use adjustable rate mortgages, so that mortgage credit would be available immediately.

Today, mortgage credit of all types is widely available. In addition, time has demonstrated that allowing unregulated, non-depository institutions to piggyback on federal thrift preemption has inadvertently facilitated predatory lending practices. **The distortion of the Parity Act has helped create a public environment that is skeptical of subprime lenders of all types, therefore giving responsible, regulated depository lenders an undeserved bad name.**

The Parity Act encourages subprime finance company prepayment penalties

The frequency of prepayment penalties on subprime loans the year before the OTS reinterpretation, 1995, was just 10% in one Salomon Smith Barney estimate, increasing to a "minority of loans" one year later, to 80% today, a stunning increase following the OTS ruling.[19] Today, while less than 2% of borrowers accept prepayment

[19] "Prepayments on RFC Fixed-Rate HEL Loans," Salomon Smith Barney, U.S. Fixed-Income Research, August 11, 2000, p. 11. At the close of 1997, use of prepayment penalties was not standard subprime lending industry practice. According to an analyst at Wholesale Access, "Prepayment penalties . . . tend to be the exception rather than the rule." "No end to prepayments hurting B&C lenders," Inside B&C Lending, December 22, 1997. For information on amount of Freddie Mac and Fannie Mae loans with

penalties in the competitive conventional market, according to both Standard & Poor's and Duff & Phelps, 80% in subprime do.

The vast majority of subprime loans are currently being originated by non-depository lenders.[20] **These lenders are originating loans with prepayment penalties notwithstanding the fact that thirty-five states place some limitation on prepayment penalties for home loans.**[21] Finance company lenders often structure their loans -- to the disadvantage of borrowers -- as "alternative" mortgages to be able to take advantage of Parity Act preemption, such as requiring a balloon payment at the end of the term or making interest rates adjust regularly or upon default. Altering the terms of credit that would otherwise have been available to the detriment of borrowers was never the Congressional intent for the Parity Act. As one example, the North Carolina Attorney General's Office received a complaint from a Household Finance borrower who received a loan with a prepayment penalty that violated state law. The lender asserted that it was a "Alternative Mortgage" under the Parity Act because the interest rate adjusted, therefore preempting state law, though the adjustment was conspicuously small—altering the loan from 15.9% to 16% interest![22]

Finance companies have sued to preempt these state laws based on the current interpretation of the Parity Act and have won.[23] Standard & Poor's study of prepayment penalties on subprime loans repeatedly cites the Parity Act for providing non-depository lenders the ability to preempt state laws. The second largest subprime lender in the country, Household Finance, has publicly stated the importance of Parity Act preemption in originating loans with prepayment penalties.[24] Associates First Capital, which before its acquisition by Citigroup was the third largest subprime lender in the country, has had a standard provision in its note referencing Parity Act preemption. And in an opinion letter to a lender, the North Carolina Attorney General's office stated that "although NC law normally prohibits prepayment penalties under $100,000 [now $150,000] this prohibition does not apply when a loan contains a balloon payment" because the loan is an alternative mortgage under the Parity Act.[25]

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prepayment penalties, see *Mortgage Marketplace*, May 24, 1999 and Joshua Brockman, "Fannie revamps prepayment-penalty bonds," *American Banker*, July 20, 1999. For 80% cite, see Standard & Poor's, "NIMS Analysis: Valuing Prepayment Penalty Fee Income," January 3, 2001 and (Polly Guthrie, telephone conversation with Abner Figueroa, Duff and Phelps; for 1999 Duff and Phelps rated 37% of all private label MBS/CMO). Household Financial Services also reported that the percentage of the loans they purchase that include prepayment penalties grew from 60% in 1998 to 80% a year later. "Prepayment penalties prove their merit for subprime and 'A' market lenders," Inside Mortgage Finance, May 21, 1999.

[20] See Top 25 B&C Lenders in 2000, Inside B&C Lending, November 20, 2000, at 4.

[21] See note 4 above.

[22] See letter from M. Lynne Weaver, Assistant Attorney General, North Carolina, to Robin Adcock, Vice President of Operations Support, Household Finance Corporation, April 19, 2000.

[23] National Home Equity Mortgage Association vs. Face, 64 F. Supp. 2d 584 (E.D.Va. 1999) (preempting Virginia's state law against prepayment penalties as it applied to state housing creditors), aff'd, http://laws.findlaw.com/4th/992331p.html (4th Cir. Feb. 7, 2001) and Shinn v. Encore Mortgage Services, 2000 WL 55863 (D.N.J.).

[24] "Prepayment Penalties Prove Their Merit for Subprime and 'A' Market Lenders," *Inside Mortgage Finance*, May 21, 1999 (quoting Michael Forester).

[25] For Associates' note and NCAG opinion letter, see links to attachments to Coalition for Responsible Lending's July 5, 2000 comment to OTS, available at http://www.responsiblelending.org/AMt_ots.htm.

Why states should be allowed to limit prepayment penalties imposed by finance companies

States should be allowed to make their own judgement about the desirability of prepayment penalties offered by unregulated lenders. Adopting one of our proposed solutions will enable individual states to better regulate state-chartered housing creditors. As the Conference of State Bank Supervisors, the national organization of state officials who regulate state-chartered thrifts, states:

> "State authorities can present a much more compelling case to thwart predatory lending abuses by demonstrating that lenders have violated specific state laws such as charging unlawful and unreasonable prepayment penalties. Through a history of aggressive preemption, the OTS has removed such legal tools from the state authorities' arsenal."[26]

And as a National Association of Attorneys General letter signed by forty-six state Attorneys General says:

> "The OTS' regulations can, therefore, serve to encourage predatory practices by allowing state housing creditors to charge unlimited prepayment penalties and late fees on high-cost mortgage loans. . . . As the chief law enforcement officers of our states, we tend to look with disfavor on attempts to preempt state laws designed to protect our citizens, particularly when the federal regulator scheme offers no similar protections. . . . We strongly urge the OTS to take appropriate action to revise its regulations and opinion letters that preempt state consumer protection laws and allow unregulated lenders to impose unlimited prepayment and late payment penalties."[27]

In fact, there are strong policy reasons supporting states' desires to control finance company prepayment penalties. Prepayment penalties too often lead to foreclosure since they trap subprime borrowers in high-rate loans, forcing them to continue to pay more each month than available alternatives. Additionally, the price a borrower pays to escape such a penalty is for the lender to strip the family's hard-earned home equity wealth, which is taken as punishment for obtaining a better deal. Subprime borrowers do not "choose" prepayment penalties in any meaningful sense; otherwise, 80% of subprime loans (according to Duff & Phelps and Standard & Poors) would not have such penalties, compared with only 2% of borrowers in the competitive, more transparent conventional market. Further, borrowers in predominantly African-American neighborhoods are **five times** more likely to be subject to wealth-stripping prepayment penalties than borrowers in white neighborhoods.[28]

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[26] See January 5, 2000 comment to OTS at http://www.ots.treas.gov/docs/48201.pdf.
[27] See July 7, 2000 letter at http://www.ots.treas.gov/docs/48197.pdf.
[28] *For neighborhood frequency calculation, see Coalition for Responsible Lending's suggestions to Federal* Reserve Board, footnote 23, at http://www.responsiblelending.org/FEDsug.htm.

Prepayment penalties in subprime loans function as deferred fees that lenders fully expect to receive and borrowers never expect to pay. Prepayment penalties are commonly 5% of the loan balance. For a $150,000 loan, this fee is $7,500, more than the total net wealth built up over a lifetime for the median African American family. According to Lehman Brothers' prepayment assumptions, **over half of subprime borrowers will be forced to prepay their home loans – and pay the penalties** – during the typical five-year lock-out period.[29] Borrowers do not have access to the lenders' prepayment rates and statistical tables to understand their significant odds of paying the penalty. Borrowers' highly asymmetric position versus lenders in understanding the likelihood that, through hardship or flipping, they will be forced to pay the penalties explains why so many accept subprime loans with prepayment penalties attached. In addition, unregulated lenders use obfuscation to press prepayment penalties on borrowers who are often unaware of the provision until it is triggered.

The Coalition for Responsible Lending (CRL) estimates that 850,000 families lose over $2 billion each year directly from their home equity wealth because of prepayment penalties in subprime loans.[30] Of this amount, **CRL estimates that up to 500,000 families across the country have $1.3 billion stripped from their home equity <u>each year</u> directly as a result of OTS's discretionary interpretation of the Parity Act.**[31]

CRL does not believe that the late fee provision is abused to the same extent as the prepayment penalty provision; however CRL believes OTS should remove it from the list of applicable regulations under the Parity Act because it is a regulation that applies generally to mortgage loans, not just to alternative loans, and because of its potential for abuse. While many states, such as North Carolina, have limitations on the amount of late fees,[32] usually in the range of 4-5% of the payment amount, the federal thrift regulation on late fees does not cap the amount of the late fee.[33] Finance companies take advantage

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[29] Net worth information from 1990 Census data. 5% of loan balance and 50% frequency number calculated from data in Lehman Brothers' publication, Asset-Backed Securities (July 17, 2000), pages 1- 2.
[30] While Lehman states that a 5% penalty that is outstanding for five years is standard, to be conservative, assume that the average penalty is 4% for four years. Modeling Lehman's assumptions, 44% of borrowers actually pay this 4% fee. Total subprime originations are $160 billion, with an average loan size of $67,000, for a total number of loans of 2.4 million. See Joint HUD/Treasury Report on Recommendations to Curb Predatory Home Mortgage Lending (June 20, 2000) at pp. 29-31. Multiply the 4% fee times the 44% of borrowers who pay it times the 80% of subprime borrowers who have penalties by the $160 billion in total subprime originations. The net result is $2.25 billion in lost equity. Multiply the 2.4 million borrowers times 44% who pay the penalty times 80% who have prepayment penalty loans means that 850,000 families annually lose this $2.25 billion each year due to hidden prepayment penalties.
[31] Thirty-five states and the District of Columbia prohibit or place restrictions on prepayment penalties; of these, five are merely procedural (require contractual agreement or disclosure). Thus, thirty states and D.C. impose substantive restrictions; without Parity Act preemption, these states could prevent the vast majority of instances in which lenders charge prepayment penalties. Because of this preemption, up to 500,000 families each year have $1.3 billion in equity stripped (30/51 multiplied by $2.25 billion and 850,000 families).
[32] *See, for example, North Carolina Statutes § 24-10.1.*
[33] 12 CFR 560.33.

of this provision; for example, Household Finance charges a 10% late fee for borrowers 15 days past due, more than double what North Carolina law allows.[34]

OTS has the authority to remove prepayment penalties and late fees as applicable regulations

The OTS proposal in its April 25, 2002 Notice of Proposed Rulemaking to take prepayment penalties and late fees off the list of applicable regulations for finance company preemption is by far the most important thing that it could do to address predatory lending abuses.

Clearly, OTS has the authority to make these changes. Under the legal standard set forth in Chevron, a federal court will defer to an agency's interpretation of a statute unless the plain language of the statute addresses the precise issue or the agency's interpretation is not a permissible construction of the statute.[35] Since the Parity Act vests the OTS with authority to designate applicable regulations,[36] reverting to its pre-1996 interpretation that survived unchallenged for 13 years would neither be contrary to the plain language nor an impermissible construction of the statute. Further, this interpretation would be owed judicial deference even though OTS would be changing its 1996 interpretation to return to its 1983 view. The Supreme Court, in Smiley v. Citibank (South Dakota), N.A., held that it would even defer to an agency's interpretation that changed 100 years after passage of a statute.[37] In fact, Congress specifically authorized the OTS to alter its Parity Act interpretation as conditions changed, as they have significantly since 1996. As the district court stated in the Virginia case deferring to the OTS's 1996 interpretation, "Congress noted its expectation that 'any future amendments that the agencies make to regulations that are within the scope of this title will conform to the objectives of this title.'"[38]

Conclusion

The Parity Act was passed to address a particular problem with mortgage credit in the high interest rate environment of the early 1980's. Because of the changed circumstances of the explosion of subprime lending by finance companies, and concomitant abuses, over the last six years, a significant amount of which is inadvertently due to a recent reinterpretation of the Parity Act, OTS should remove the preemption authority for other housing creditors.

[34] See letter from M. Lynne Weaver, Assistant Attorney General, North Carolina, to Beneficial Mortgage Company of North Carolina, March 30, 2000 (Beneficial characterized loans as "Alternative" through providing very minor rate reductions of 0.25% at the end of the third, fourth and fifth years of the loan, only if the borrower made all payments on time.

[35] Chevron U.S.A., Inc. v. Natural Resources Defense Counsel, Inc., 467 U.S. 837, 842-843 (1984).

[36] 12 U.S.C. 3803(a)(3).

[37] 517 U.S. 735, 740 (1996) (cited in National Home Equity Mortgage Association vs. Face, 64 F. Supp. 2d 584 (E.D.Va. 1999)).

[38] National Home Equity Mortgage Association vs. Face, 64 F. Supp. 2d 584 (E.D.Va. 1999) (quoting S. Rep. No. 97-463, at 55 (1982)).

Such an action would be no panacea, since it would not immediately affect states that do not limit prepayment penalties or address other types of abusive practices. It would, however, be a strong and significant move that would permit states to enforce their own laws against finance company abuses and protect the hard-earned home equity wealth that is held by millions of families across the country.

Thank you for considering our views.

Sincerely,

Martin D. Eakes
Eric Stein
Coalition for Responsible Lending