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238

Via E-MAIL

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W. 20552

Attention: Docket No. 2002-17

Dear Sir/Madam:

We appreciate the opportunity to comment on the Office of Thrift Supervision's ("OTS" or the "Agency")) notice of proposed rulemaking (the "Proposed Rule") on amendments to its Alternative Mortgage Transaction Parity Act Regulations[1] (the "Parity Act Regulations")). This comment letter is submitted on behalf of certain of our clients, including those that would be considered "housing creditors" as that term is defined under the Alternative Mortgage Transactions Parity Act of 1982 (the "Parity Act"),[2] including nonfederally chartered housing creditors.

The OTS must withdraw the Proposed Rule, as it would render the Parity Act meaningless if nonfederally chartered housing creditors could not originate alternative mortgage loans under the same terms and conditions as federally chartered savings association and their mortgage company operating subsidiaries. The Proposed Rule is inconsistent with the plain language of the Parity Act and, if adopted, would undermine efforts by Congress to eliminate the adverse discriminatory impact that state laws have on nonfederally chartered housing creditors making alternative mortgage transactions. The OTS cannot take any action to amend its Parity Act Regulations in a manner that would leave nonfederally chartered housing creditors at a competitive disadvantage with federally chartered thrifts and their mortgage company operating subsidiaries when making, purchasing, or enforcing alternative mortgage loans.

Over the last twenty years, the Federal Home Loan Bank Board (the "Bank Board") and the OTS, in well reasoned rulemakings and opinions, have moved gradually to define the scope of the broad preemption language of the Parity Act. Now, after mounting criticism by consumer

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[1] 12 C.F.R. § 560.220.

[2] Pub. L. No. 97-320, title VIII, 96 Stat. 1469, codified at 12 U.S.C. §§ 3801 et seq.

advocates and state regulators over the preemption authority articulated by the OTS in its Parity Act Regulations and its preemption opinions, the OTS is poised to make a 180-degree turn and limit the preemption that it had endorsed in regulations and agency opinions for nonfederally chartered housing creditors making Parity Act loans. The Proposed Rule would remove the prepayment fee and late fee authority from the Parity Act regulations that are appropriate for nonfederally chartered housing creditors to follow in making alternative mortgage loans subject to the Parity Act. In addition, the OTS recommends that Congress revisit the Parity Act, with an eye to its repeal, to determine if alternative mortgage transactions merit special consideration.

In proposing these amendments to its Parity Act Regulations, the OTS is abandoning its responsibilities under the Parity Act. Rather than identify the rules applicable to its chartered institutions that are appropriate for nonfederally chartered housing creditors to follow in asserting the preemption authority of the Parity Act, the OTS has taken the statute, unambiguous in its terms, twisted its meaning, and now moves to dismiss its preemption authority. Adoption of the Proposed Rule would have the effect of converting the Alternative Mortgage Transactions Parity Act into the "Alternative Mortgage Transaction Non-Parity Act." If adopted, the Proposed Rule would reverse the Parity Act Regulations and longstanding opinions of the OTS on which lenders have relied. The preemption authority afforded nonfederally chartered housing creditors by the current Parity Act Regulations making alternative mortgage transactions would be stripped away, leaving those lenders who do not happen to be federally chartered thrifts or their mortgage company operating subsidiaries subject to the vagaries of state laws.

The efforts of state regulators and consumer advocates to emasculate the preemption authority of the Parity Act is seen as a means to fighting predatory lending practices. The effort is illusory. Predatory lending tactics, such as equity skimming, flipping, packing, and scams or other frauds perpetrated against the consumer exist independent of a lender's ability to contract for prepayment fees in connection with an alternative mortgage loan. The predatory lending practices that invariably harm consumers are illegal under many state laws, and can be fought in many ways other than eliminating the benefits of a federal law that has served to promote uniformity in, and increased the accessibility of, housing credit nationwide.

That state regulators and consumer advocates have enlisted the OTS in their efforts is surprising, as the OTS had taken a studied and disciplined approach to examination of the Parity Act, and consistently concluded that its preemption authority applied broadly. Moreover, the Agency's efforts to the repeal the prepayment fee authority for nonfederally chartered housing creditors for Parity Act loans is all the more alarming, as it flies in the face of the Agency's findings that prepayment fees serve a legitimate purpose and are a valuable tool for managing interest rate risk by its chartered thrifts and their mortgage company operating subsidiaries.

In proposing to delete from its Parity Act Regulations the prepayment fee and late fee authority available to its chartered institutions and their mortgage company operating subsidiaries as being appropriate for nonfederally chartered housing creditors to follow for Parity

Act loans, the OTS is taken a course of action that appears to be designed to mollify critics of preemption, rather than based on any authority of the Parity Act or administrative procedures. The Agency's actions would penalize responsible lenders who rely on prepayments fees to manage interest rate risk, as do federal thrifts and their mortgage company operating subsidiaries.

Adoption of the Proposed Rule will serve to reinstate the adverse discrimination that nonfederally housing creditors faced in making alternative mortgage transactions if not for the Parity Act, undoubtedly laying the framework for a wave of litigation and renewed enforcement action against lenders who seek to apply the Parity Act. Ultimately, consumers will be harmed, as compliance costs associated with meeting the laws of 50 states and the District of Columbia will drive up the costs of housing credit, and drive reputable lenders out of the marketplace in certain states.

Given the plain language of the Parity Act, the mandate to eliminate the adverse discriminatory impact that state laws have on nonfederally chartered creditors making alternative mortgage loans, the Agency's prior rulemakings and opinions, and the findings of the OTS that prepayment fees provide a benefit to creditors managing interest rate risk when offering alternative mortgage products, the actions of the OTS in proposing the Proposed Rule appear to be devoid of any statutory authority or factual support.

Accordingly, for the reasons discussed more fully herein, the OTS cannot adopt the Proposed Rule, as it would destroy the authority of the Parity Act to eliminate the adverse discriminatory impact that state laws have on nonfederally chartered housing creditors making alternative mortgage loans, limit the ability of nonfederally chartered housing creditors to compete in the mortgage marketplace with federally chartered thrifts and their mortgage company operating subsidiaries, and dismiss the integral part that prepayment fees play in enabling creditors to offer alternative mortgage products. We also believe that, contrary to the comments received from state regulators to the Advanced Notice of Proposed Rulemaking ("ANPR"), state restrictions on alternative mortgage transactions may be as prevalent today as when the Parity Act was enacted. Accordingly, we strongly urge the OTS to withdraw its recommendation to Congress to revisit the need for the Parity Act.

I. Congress Enacted the Parity Act to Increase the Availability of Housing Credit and Eliminate the Adverse Discriminatory Impact of State Laws on all Housing Creditors

From the perspective of nonfederally chartered housing creditors, the concerns that prompted Congress to enact the Parity Act in the early 1980s parallel the concerns that led to the efforts to ensure the viability of thrift institutions at that time. Drawing a balance between increasing the availability of competitively priced mortgage credit, while providing ways to manage interest rate risk uniformly throughout the nation, was at the core of the federal legislation in the early 1990s involving housing finance credit, whether for federally chartered thrifts or nonfederally chartered housing creditors.

Historically, savings and loan associations derived their profits from long-term, fixed-rate mortgage loans. Their liabilities, however, consisted of highly liquid demand deposits.[3] If a savings and loan were to raise the interest rates it paid on its demand deposits in an effort to retain depositors, it ran the risk of operating at a loss with respect to those long-term mortgage loans that it previously originated at lower interest rates.[4] This mismatch between assets and liabilities caused savings and loans to be especially vulnerable to interest rate risk.

In response to the challenges facing the thrift industry, Congress enacted the Interest Rate Control Act of 1966[5]. Among other things, this Act established an interest rate ceiling on deposits ("Regulation Q"). Although the Act had the beneficial effect of causing thrifts to end their self-destructive bidding war for depositors, consumers were left dissatisfied with their choices for interest-bearing depository instruments.[6] At the same time that thrifts operated under Regulation Q, the financial services industry began offering innovative and attractive investment options.[7] The result was a period of disintermediation[8] that further weakened the savings and loan system and caused a credit crunch for potential homebuyers.

In response to the credit crunch and the thrift industry's plight, several important legislative and regulatory actions were taken. First, in 1979, federally chartered thrifts were granted authority to originate and purchase adjustable rate mortgages ("ARMs").[9] With federally chartered thrifts being authorized to originate ARM loans under their charters, they were able to offer such products without regard to state restrictions and prohibitions, as they could assert preemption from such restrictive state laws. Today, the mortgage company operating subsidiaries of federally chartered thrifts can do so as well.

State-chartered institutions and independent mortgage lenders, however, were not able to add alternative mortgage transactions to their limited portfolio of regularly amortizing mortgage loan products, as the laws in many states prohibited them from originating such loans

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3 Alvin K. Lim, Other International Issues: The S&L Crisis Revisited: Exporting an American Model to Resolve Thailand's Banking Problems, 9 Duke J. Comp. & Intl 'L. 343, 346 (1998).

4 Id.

5 Pub. L. No. 89-597, 80 Stat. 823.

6 Lim, supra note 2.

7 Id.

8 Id. (Lim explains that disintermediation occurs when savings formerly held by financial intermediaries are diverted to financial instruments such as stocks, bonds and various derivative products).

9 Jonathon McCarthy and Richard W. Peach, FRBNY Economic Policy Review, "Monetary Policy Transmission to Residential Investments" p. 141 (May 2002).

or severely restricted the terms of such loans.[10] Consequently, state-chartered institutions and independent mortgage lenders were placed in a competitive disadvantage with federally chartered thrifts who could offer alternative housing financing mechanisms without regard to state laws that could prohibit their products.

Second, Congress enacted two important laws that benefited federally chartered thrifts, other chartered depository institutions, and nonfederally chartered housing creditors. The first, the *Depository Deregulation and Monetary Control Act of 1980* ("DIDMCA")[11] (i) repealed Regulation Q in phases, (ii) gave federal thrifts state-chartered, FDIC-insured depository institutions, and federal-and state-chartered credit unions certain interest rate exportation authority, and (iii) preempted state usury ceilings on "federally-related mortgage loans," essentially first-lien residential mortgage loans, for all creditors who qualified to make such loans under DIDMCA.[12]

In addition to DIDMCA, Congress enacted the Garn-St Germain Act.[13] The Garn-St Germain Act had a significant impact on both the thrift industry and the mortgage industry generally. Not only did it broaden investment opportunities and change the accounting rules for thrifts, it also contained the Parity Act, the purpose of which was to address:

> [I]ncreasingly volatile and dynamic changes in interest rates [that] have seriously impared [sic] the ability of housing creditors to provide consumers with fixed-term, fixed-rate credit secured by interest in real property, cooperative housing, manufactured homes and other dwellings.[14]

At the time, Congress found that alternative mortgages were essential to curing the credit crunch of the late 1970s and early 1980s, as variable rate loans did not pose the interest rate risk prevalent with 30 year, fixed-rate, regularly amortizing mortgage loans. Congress also

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[10] See 67 Fed. Reg. 20,468 (April 25, 2002). In the preamble to the Proposed Rule, the OTS references Senate hearings in 1981 in which "mortgage bankers testified that statutes in 26 states barred state-chartered mortgage bankers and lending institutions from originating alternative mortgage loans or imposed significantly higher restrictions on such loans than applied to federally chartered lenders operating under federal regulation." In 1981, as is the case today, restrictions on the origination of alternative mortgage loans existed in statutes specifically regulating different forms of alternative mortgage loans, and in statues of general applicability that apply to all loans including alternative mortgage loans.

[11] 12 U.S.C. § 1735f-7a.

[12] Id. During this period, Congress also enacted another housing credit statute that preempted state usury ceilings with respect to FHA-insured loans. See 12 U.S.C. § 1709 et seq.

[13] Pub. L. No. 97-320, 96 Stat. 1469.

[14] 12 U.S.C. § 3801.

intended for the Parity Act to eliminate any discriminatory effect that state laws had on nonfederally chartered housing creditors who could not otherwise assert preemption from the panoply of restrictive state laws.[15] Congress achieved this objective by authorizing all housing creditors to make, purchase and enforce alternative mortgage transactions, "notwithstanding any State constitution, law or regulation,[16] provided such transactions were in conformity with regulations issued by the applicable federal agency.[17] To implement the Parity Act's directive to identify, describe, and publish those portions of its regulations that were inappropriate and inapplicable for nonfederally chartered housing creditors making loans under the Parity Act,[18] the Bank Board, and now, its successor, the OTS published certain rules and issued opinions that addressed the preemption authority of the Parity Act. Through the broad preemption language of the Parity Act and the OTS Parity Act Regulations, nonfederally chartered housing creditors were placed on equal footing with federal thrifts in originating, purchasing or enforcing alternative mortgage transactions. If the OTS were to adopt its Proposed Rule, nonfederally chartered housing creditors would be left wandering through an overgrown thicket of state restrictions that could ensnare them in crippling litigation.

A. The Parity Act Preempts Any State Constitution, Law or Regulation

Fundamental to any analysis regarding the application of the Parity Act is an understanding of the scope of its preemption authority. Does the Parity Act only preempt state restrictions specific to alternative mortgage transaction; or does the Parity Act preempt state laws of general applicability, as such state provisions also may have the effect of imposing restrictions on alternative mortgage transactions? The language of the Parity Act is unequivocal. In no uncertain terms, for all housing creditors, it preempts any and all state constitutional provisions, laws, or regulations when it comes to making, purchasing, or enforcing alternative mortgage transactions.

As the Supreme Court has declared, "the meaning of the statute must, in the first instance, be sought in the language in which the Act is formed, and if that is plain, ... the sole function of the courts is to enforce it according to its terms.[19] The "plain meaning rule" should be elemental in any rulemaking effort. Where the statute is clear and unambiguous, as it is with the Parity Act, the agencies cannot alter the meaning of the statute.

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[15] 12 U.S.C. § 3801(b).

[16] 12 U.S.C. § 3803.

[17] Id.

[18] 12 U.S.C. § 3801, note.

[19] Sutherland on Statutory Construction (6th Edition), quoting U.S. v. Revis, 22 F. Supp. 2d 1242 (N.D. Okla. 1999); see also Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842– 843, L. Ed. 2d 694, 104 S. Ct. 2778 (1984).

For alternative mortgage transactions made under the authority of the Parity Act, it matters little whether a state law specifically prohibits alternative mortgage transactions or components of alternative mortgage transactions, or generally imposes restrictions applicable to all loans, as the consequence for alternative mortgage transactions is the same. The structure of alternative mortgage products and the availability of such products in a particular jurisdiction will be based on the most restrictive state law provisions, irrespective of whether such provisions are specific only to the origination of alternative mortgage products or applicable to the origination of all mortgage products. Nothing in the Parity Act limits the preemption available to housing creditors to those state provisions that exclusively apply to alternative mortgage transactions. Indeed, it would have been meaningless and shortsighted to have limited the Parity Act's preemption authority only to state laws that specifically restrict the origination of alternative mortgage products, as restrictions on the origination of alternative mortgage products can be achieved indirectly.

Despite the plain language of the Parity Act, state regulators and consumer advocates now argue that the Parity Act only preempts state laws that specifically restrict or prohibit alternative mortgage transactions. The intent of Congress to apply the preemption more broadly than merely to specific laws that prohibit alternative mortgage transactions is evident from its decision to preempt any state constitution provision, as well as law or regulation, when it comes to making alternative mortgage transactions. We are unaware of any state constitution that expressly restricts or prohibits alternative mortgage transactions. Rather, constitutional provisions that could affect residential mortgage loans apply generally to extensions of credit or real estate-secured loans.[20] Congress recognized the breadth of the preemption it had created when it subsequently amended the Parity Act to limit its application when the constitutional provision involves "homestead protections."[21] The Congressional action to amend the Parity Act in 1994 was predicated on the holding of a Texas court that had concluded that, with respect to a reverse mortgage loan, the broad preemption language of the Parity Act preempted a Texas constitutional provision precluding homestead property from being collateralized.[22]

Other courts that have looked at this issue also have applied the Parity Act preemption to state laws of general applicability.[23] The holdings of these courts are consistent with the opinions issued by the OTS over the years in which it found the Parity Act to preempt restrictive state provisions of applicable to loans generally that could impinge on a lender's ability to

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[20] Ark. Const. art. 19, § 13 (regulating usury); Cal. Const. art. XV, § 1 (regulating usury); Tex. Const. art. XVI, § 50 (regulating credit terms).

[21] Reigle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, § 102(b).

[22] First Gibraltar Bank, FSB v. Morales, No. 93-8170, 42 F.3d 895, 1995 U.S. App. LEXIS 251, 31 Fed. R. Serv. 3d (Callaghan) 1078 (5th Cir., January 4, 1995); Tex. Const. art. XVI, § 50

[23] See Nat'l Home Equity Mortgage Ass'n. v. Face, 239 F.3d 633 (4th Cir., Oct. 30, 2000); Shinn v. Encore Mortgage Services, 96 F. Supp. 2nd 419 (N.J. Dist., Nov. 8, 2000).

originate alternative mortgage products.[24] Accordingly, there should be no question that the Parity Act preempts state provision specific to alternative mortgage transactions, as well as those that apply generally to all loans to the extent such provisions would restrict alternative mortgage products. In its rulemaking efforts, the OTS should not now give credence to those who would continue to deny that the Parity Act preempts all state provisions that would restrict alternative mortgage products, whether under a specific statute or one of general applicability.

B. The OTS Cannot Amend Its Parity Act Regulations to Apply Differently to Different Mortgage Lenders

The objective of the Parity Act is evident from the name of the statute. The Parity Act creates a level playing field for all housing creditors offering alternative forms of housing credit, *irrespective of whether the creditor is a federally chartered thrift*, its mortgage company subsidiary or affiliate, a national or state-chartered commercial bank, a federal or state-chartered credit union, or a nonfederally chartered housing creditor. For purposes of the Parity Act, these institutions are equal in their authority to originate, purchase, and enforce alternative mortgage transactions, subject to the Parity Act rules of their particular federal regulator. For nonfederally chartered housing creditors, the rules of the OTS are significant as Congress decided that alternative mortgage transactions of nonfederally chartered housing creditors would need to be made in accordance with regulations governing alternative mortgage transactions issued by the Bank Board, now the OTS, for federally chartered savings and loan associations, to the extent such regulations are authorized under laws other than the Parity Act.[25] The OTS cannot change by rule what the Parity Act clearly authorizes.

From the perspective of nonfederally chartered housing creditors, the broad preemption authority of the Parity Act is limited only to the extent that the preemption cannot be any greater than the preemption available to federally chartered thrifts. Equally true, the preemption authority for nonfederally chartered housing creditors cannot be any less than that available to federally chartered thrifts.

For nonfederally chartered housing creditors, the preemption authority of the Parity Act *should be simple in its application -- if federally chartered thrifts can make alternative mortgage* loans in accordance with the rules of the OTS and preempt certain state laws that would limit such ability, then nonfederally chartered housing creditors also should have such authority. *Accordingly, if federally chartered thrifts can preempt a state law of general applicability when* making alternative mortgage transactions, then nonfederally chartered housing creditors are equally entitled to preempt such a state law when making an alternative mortgage transaction. Nothing in the Parity Act argues against this basic premise.

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[24] See e.g. 1996 OTS LEXIS 19 (April 30, 1996) (preempting Wisconsin prepayment fee restrictions); 1997 OTS LEXIS 1 (Feb. 10, 1997).

[25] 12 U.S.C. § 3803(a)(3).

From our review of the Agency's rulemakings and opinions to date, the OTS has recognized without reservation that the purpose of the Parity Act was to eliminate the adverse discriminatory impact that state laws have on nonfederally chartered housing creditors originating alternative mortgage transactions without the benefit of federal preemption generally available to federally chartered thrifts and their mortgage company operating subsidiaries.[26] Before the OTS expressly identified its regulations governing prepayment fee authority as appropriate for nonfederally chartered housing creditors to follow for Parity Act loans, the OTS considered the issue of state prepayment fees restrictions and their application to alternative mortgage transactions under a Wisconsin statute governing Wisconsin-chartered savings institutions, and definitively concluded in 1996 that they were preempted.[27] Although the prepayment fee authority for its federal thrifts applied to all real estate-secured loans and not just alternative mortgage transactions, the OTS recognized that "if state housing creditors were required to follow the Wisconsin statute when making variable-rate mortgage loans, they clearly would be disadvantaged vis-à-vis federal thrifts -- the very result Congress intended to prevent" with the passage of the Parity Act.[28] Given the adverse discriminatory impact that Wisconsin chartered savings institutions would face in making alternative mortgage loans in accordance with the Wisconsin statutory restrictions on prepayment fees, the OTS determined that the Wisconsin law fell within the scope of laws preempted by the Parity Act.

In the ANPR and its Proposed Rule, the OTS now seems to be searching for ways to distinguish the nature of the adverse discriminatory impact that nonfederally chartered housing creditors may experience in originating alternative mortgage transactions in support of those commenters to the ANPR who want to limit the preemption authority of the Parity Act. The OTS appears to believe that despite the plain meaning of the Parity Act, it can pick and chose the discriminating impact that nonfederally chartered housing creditors must suffer when originating alternative mortgage transactions. Commenters attack the authority of the Parity Act when they suggest that one set of rules should apply to federally chartered thrifts and another set of rules to nonfederally chartered housing creditors. The OTS should not be aiding their efforts to undermine federal law.

The purpose of the Parity Act is to promote parity between different categories of creditors in the origination of alternative mortgage transaction by affording nonfederally chartered housing creditors preemption authority equal to that of federally chartered thrifts. Under the Parity Act, nonfederally chartered housing creditors should get no more, and certainly no less, preemption authority when it involves prepayment fees and late fess than that available to federally chartered thrifts and their mortgage company operating subsidiaries. If the OTS believes its rules governing prepayment fees and late fees provide preemption authority that is too broad for nonfederally chartered housing creditors, then in keeping with the purpose of the

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[26] 1996 OTS LEXIS 19 (April 30, 1996).

[27] Id.

[28] Id.

Parity Act to eliminate the discriminatory impact state laws have on nonfederally chartered housing creditors making alternative mortgage products, the OTS could restrict the prepayment fee and late fee authority available to its chartered thrift institutions and their mortgage company operating subsidiaries. This would achieve the Agency's objective to restrain the prepayment fee authority without reinstating the discriminatory impact that would result from the Proposed Rule. As we discuss below, we recognize that the OTS has concluded that prepayment fees provide an effective way for thrifts to manage their interest rate exposure,[29] and, therefore, we *do not believe the OTS could adopt this approach. Accordingly, given the purpose of the Parity* Act and the Agency's responsibility to implement the Act to eliminate the adverse discriminatory impact state laws have on nonfederally chartered housing creditors, and given the benefit the OTS has found in prepayment fees as a tool for managing interest rate risk for its chartered savings institutions, we fail to see how the OTS could advocate that nonfederally chartered housing creditors should be denied the ability to rely on the same prepayment fee authority to manage interest rate risk as permitted for federal thrifts and their mortgage company operating subsidiaries.

The OTS is given authority under the Parity Act to determine which of its regulations *applicable to its chartered savings associations engaged in alternative mortgage transactions* are inappropriate and, thus, inapplicable to certain other nonfederally chartered housing creditors seeking to rely on the Parity Act. This authority should not be applied arbitrarily and capriciously to limit the extent to which nonfederally chartered housing creditors can rely on the Parity Act. As the Parity Act is intended to allow nonfederally chartered housing creditors to make, purchase, and enforce alternative mortgage transactions on the same basis as federally chartered thrift institutions, the rules applicable to nonfederally chartered housing creditors originating alternative mortgage transactions cannot be any more restrictive than the rules applicable to federally chartered thrifts and their mortgage company operating subsidiaries without running afoul of Congress' purpose in enacting the Parity Act. Otherwise, as the OTS *has concluded, nonfederally chartered housing creditors seeking to engage in alternative* mortgage transactions would be at a disadvantage vis-a -vis federally chartered thrifts and their mortgage company subsidiaries.[30]

Accordingly, given the plain language of the Parity Act and the clearly articulated intent of Congress to eliminate the adverse discriminatory impact experienced by nonfederally chartered housing creditors in connection with alternative mortgage financing, we believe that the authority of the OTS to modify the applicability of its Parity Regulations is limited and cannot proceed as proposed. Under the Parity Act, the OTS cannot adopt rules that benefit its chartered institutions and their mortgage company operating subsidiaries making alternative *mortgage products, but deny such benefits to nonfederally chartered housing creditors.*

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[29] See generally 57 Fed. Reg. 40,350, 40,352 (September 3, 1992); 12 C.F.R. § 560.34; and Office of Thrift Supervision, Regulatory handbook, p. 571.4, 571.5, 576.11 (January, 1994).

[30] 1996 OTS LEXIS 19 (April 30, 1996).

II. Removing the Prepayment Fee Authority from the Parity Act Regulations of the OTS Would Undermine the Parity Act

In response to comments to the ANPR received from consumer advocates and state regulatory authorities, the Proposed Rule seeks to remove the OTS regulations governing prepayment fees and late fees from the regulations that must be followed by nonfederally chartered housing creditors when making loans subject to the Parity Act.[31] The intent of this proposed rule change is to preclude nonfederally chartered housing creditors from having regulatory authority to preempt state laws that prohibit or restrict prepayment fees and late fees in connection with loans subject to the Parity Act. In doing so the OTS leaves intact the preemption from state restrictions on prepayment fees and late fees available to its federally chartered thrifts and their mortgage company operating subsidiaries. The OTS has proposed this rule change because it now believes that the prepayment fee and late fee provisions are not "intrinsic" to the ability to offer alternative mortgage loans. Removing the prepayment fee and late fee provisions from those provisions that are appropriate to be followed by nonfederally chartered housing creditors for purposes of the Parity Act would be misguided, as the ability to offer different pricing alternatives for residential mortgage loans is intrinsic to the Parity Act, and offering loans with a prepayment fee feature is one component to pricing flexibility. Moreover, removing those provisions would distort the purpose of the Parity Act by adversely discriminating against nonfederally chartered housing creditors offering alternative mortgage products, foster a competitive imbalance between nonfederally chartered housing creditors and their chartered thrift counterparts, and undermine efforts to make housing credit widely available and accessibility

A. Prepayment Fee Features are a Key Component in Structuring Alternative Mortgage Loan Products

The prepayment fee feature of ARM loans and other alternative mortgage transactions is a key component of such mortgage products, as such features address two significant concerns that prompted the enactment of the housing credit statutes in the late 1970s and early 1980s, interest rate risk and pricing flexibility.

A major concern for creditors in offering alternative mortgage products is managing the interest rate risk. As articulated by the OTS, prepayment risk is one form of interest rate risk.[32] Whether a creditor is a thrift or a nonfederally chartered housing creditor, it is concerned with the risk of prepayments in markets when mortgage loans prepay as interest rates begin to drop. Mortgage bankers use the secondary mortgage market to reduce the interest rate risk associated with originating mortgage loans by selling the loans while retaining the servicing rights.[33] For mortgage bankers, the OTS believes that prepayment risk can significantly affect

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[31] 69 Fed. Reg. 20468, 20470 (April 25, 2002).

[32] See Office of Thrift Supervision, Regulatory Handbook, p.571.5 (January 1994).

[33] See Office of Thrift Supervision, Regulatory Handbook, p. 571.4 (January 1994).

their servicing assets. "[W]riting off those servicing assets for early prepayment [and other reasons] to reflect unexpected prepayments can produce large losses."[34] The OTS also is concerned with the prepayment risk attached to mortgage servicing held by thrifts.[35] Nevertheless, in light of the prominent role that interest rate risk plays in mortgage bankers' pricing and sale of mortgages, the use of prepayment fees to manage such risk may be more important to mortgage bankers than it is to their thrift counterparts.

Since the enactment of the Parity Act, lenders, including thrifts and other housing creditors, have become more experienced in managing risk as it relates to the origination of mortgage loans. Nevertheless, prepayment risk remains a problematic form of interest rate risk. As the OTS has found, housing creditors and thrifts manage this risk through the use of various tools, including prepayment fees.[36] By eliminating a lender's ability to offer loans with a prepayment feature, the lender will be compelled to contract for a higher interest rate or greater fees in order to mitigate its interest rate risk.

Prepayment fee features also factor into the extent to which lenders can be flexible in their pricing. As interest rates increased in the late 1970s and early 1980s, the 30-year, fixed rate, regularly amortizing loan became an unattractive product for many prospective homeowners. With homeowners being squeezed out of the housing marketplace, the need for alternative mortgage products with flexible pricing became evident. Accordingly, the lending community developed loan products that offered increased pricing flexibility including ARM loans, mortgage loans with balloon features, or shared appreciation mortgage loans. A key component to the pricing flexibility offered by such products was the prepayment fee feature of the loan product. Without the prepayment feature that would provide the creditor with some protection against the prepayment of alternative mortgage transactions originated at below market rates, creditors would not be able to provide the innovative housing financing the marketplace was demanding.

B. The OTS Has Found Prepayment Fees To Benefit Creditors In Managing Interest Rate Risk.

Over the years the OTS has come to acknowledge the utility of prepayment fees and has placed its imprimatur on the use of such fees as an effective interest risk management tool. In the ANPR and the Proposed Rule, however, the OTS seems to accept the notion that prepayment fees contracted for in connection with residential mortgage loans are predatory in nature when contracted for by nonfederally chartered housing creditors.

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[34] See Office of Thrift Supervision, Regulatory Handbook, p. 571.5 (January 1994).

[35] See Office of Thrift Supervision, Regulatory Handbook, p. 576.11 (January 1994).

[36] See Office of Thrift Supervision, Regulatory Handbook, p. 571.5 (January 1994).

The exception the OTS has taken to providing nonfederally chartered housing creditors with the authority to follow the OTS rule governing prepayment fees is surprising as it has given its chartered institutions free reign to charge prepayment fees. The OTS allows its chartered thrift institutions and their mortgage company operating subsidiaries to freely contract for prepayment fees in making residential mortgage loans, whether the loans are fixed-rate mortgage loans, ARM loans, or any other residential mortgage product.[37] Federally chartered thrifts and their operating subsidiaries are entitled to assert preemption from any state laws or regulations governing prepayment fees, irrespective of whether the state prohibits prepayment fees, limits the amount of prepayment fees, limits the term of the repayment period when prepay fees are permitted, or imposes significant disclosure obligations at time of origination or during the servicing of the loan before prepayment fee provisions can be contracted for or invoked.[38] Given the extent to which the OTS is concerned with interest rate risk faced by its chartered institutions due to prepayments, the OTS rules enable its chartered institutions and their mortgage company operating subsidiaries to fully utilize prepayment fees in structuring the pricing of their alternative mortgage products and minimizing interest rate risk.

Obviously, the OTS sees the benefit of contracting for mortgage loans with prepayment fees, or else the OTS would repeal or limit its rule allowing its chartered thrifts and their operating subsidiaries to charge prepayment fees and preempt those state law that prohibit or restrict prepayment fees. A review of the regulatory history associated with the Agency's affirmation of prepayment fees for its chartered thrifts and their operating subsidiaries is instructive, as it shows the Agency's gradual recognition of prepayment fees as a valuable tool in the management of interest rate risk for all mortgage loans, including alternative mortgage loans. In 1979, when thrifts gained the authority to originate alternative mortgage loans, thrifts were given the authority to impose prepayment fees on all loans secured by owner-occupied residential real estate (whether fixed- or adjustable-rate).[39] At the time, thrifts were entitled to impose a prepayment fee in an amount equal to "six months' advance interest on that part of the aggregate amount of all prepayments made on such a loan in any 12-month period which exceeds 20 percent of the original principal amount of the loan."[40]

Over the span of several years, the OTS made various amendments to the prepayment fee provision and eventually, in 1983, created a bifurcated policy with respect to fixed- and adjustable-rate mortgages. In the preamble to the 1983 final rule, the OTS explained that its

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[37] 12 C.F.R. § 560.34

[38] 12 C.F.R. § 560.2

[39] 44 Fed. Reg. 39,130 (July 3, 1979).

[40] Interesting, many housing creditors retain this formula as their "multi-state formula" for the imposition of prepayment fees. Thus, in all states (other than those that have a more restrictive prepayment fee provision) lenders use a formula not unlike the one used in 1979 (a variant of which is the law in California today). Lenders may use this formula even in those states that <u>do not regulate</u> the imposition of prepayment fees (<u>i.e.</u>, South Dakota).

adoption of an expanded disclosure requirement with respect to late charges and prepayment fees "obviate[d] the need for most of the substantive limitations in the prior regulations."[41] Nevertheless, the Agency retained a restricition on thrifts' ability to impose prepayment fees in connection with adjustable rate mortgages. Specifically, at that time, Section 545.34(c) prohibited thrifts from imposing a prepayment fee on any prepayment made within 90 days of a notice of adjustment.[42]

By 1992, the OTS was ready to repeal the rule that authorized the inconsistent requirements under which federally chartered thrifts could offer fixed-rate or alternative mortgage products with prepayment fee features. On January 28, 1992, then-President George Bush announced a Regualtory Review Program for all federal government agencies, in which federal agencies were asked to "weed out unnecessary and burdensome government regulations, which impede economic growth."[43]

In keeping with the goals of the President's Program, on September 2, 1992, the OTS published in the Federal Register a list of proposed amendments, articulating the following reasoning as the basis for liberalizing the prepayment fee authority for its chartered thrifts making ARM loans:

> OTS regulations generally permit a Federal association to impose a prepayment penalty on a loan secured by a borrower-occupied property, if the loan contract provides for the penalty and if that provision is properly disclosed to the borrower. Under current regulations, however, a federal association may not impose a prepayment penalty on an ARM loan for the 90-day period that follows a notice to the borrower that the mortgage payment will adjust. This requirement is inconsistent with safety and soundness because it discourages institutions from taking steps to prudently manage interest rate risk exposure.[44]

Clearly, the OTS eliminated the prepayment fee limit applicable to adjustable-rate mortgage loans in an effort to promote the safe and sound operation of its regulated entities and to help them control interest rate risk exposure. Such concerns surely existed in 1996, when the OTS expressly provided that the prepayment fee authority available to thrifts in managing the risk associated with prepayments of ARM loans was deemed appropriate for nonfederally chartered housing creditors to follow when making Parity Act loans. Now the OTS is prepared to do an "about-face" and deny nonfederally chartered housing creditors the ability to manage

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41 48 Fed. Reg. 23,041 (May 23, 1983).

42 Id. at 23,063 (May 23, 1983).

43 57 Fed. Reg. 40,350 (September 3, 1992).

44 Id. at 40,352 (emphasis added).

prepayment risk for alternative mortgage transactions by offering such products with prepayment features. By proposing to delete the prepayment fee authority from the list of regulations applicable to nonfederally chartered housing creditors making loans under the Parity Act, the OTS would be capriciously imposing on nonfederally chartered housing creditors, a position contrary to its findings that prepayment fees are a useful tool in managing interest rate risk for ARM loans.[45] There is no legal basis by which thrifts and their operating subsidiaries should be allowed to utilize prepayment fees to manage prepayment risk for loans subject to the Parity Act, but nonfederally chartered housing creditors should be denied such an option.

Changing the Parity Act rules so that nonfederally chartered housing creditors would not be permitted to follow the OTS rules governing prepayment fees applicable to its chartered thrifts and their operating subsidiaries would have the effect of skewing the pricing of residential mortgage loans in favor of federally chartered thrifts and their operating subsidiaries. When deciding on mortgage financing alternatives, consumers look principally at the interest rate and points offered in the loan and the periodic payment amount. Retaining the authority to charge prepayment fees on their loans enables federally chartered thrifts and their operating subsidiaries to offer ARM loans and other alternative mortgage products with lower introductory interest rates and fewer front-end points than those that could be offered by nonfederally chartered housing creditors who would not have the freedom to contract for prepayment fees as they would be subject to the vagaries of state law. Elimination of the prepayment fee authority for nonfederally chartered housing creditors when making ARM loans and other alternative mortgage transactions would make it impossible for them to compete with federally chartered thrifts and their operating subsidiaries in offering ARM loans and other alternative mortgage transactions. The pricing for their loans would be higher, and the flexibility in structuring alternative mortgage loan programs to meet each consumer's unique circumstances would be diminished.

C. Promulgation of the OTS Proposed Rule Is Inconsistent with Established Administrative Procedures

The law is well settled in the area of administrative procedure that, although agencies enjoy great deference with respect to interpreting and applying statutes with respect to their regulated entities, an agency must provide a reasoned explanation for altering or reversing a position that it previously has taken.[46] Through its rulemakings and opinions over the years, the OTS has unmistakenly and consistently adopted the position that state prepayment fee

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[45] Moreover, before September 30, 1996 when the prepayment fee authority was included in Section 560.220 identifying those regulations appropriate for nonfederally chartered housing creditors to follow when making alternative mortgage transactions, the OTS issued on April 30, 1996 its opinion that Wisconsin's restrictions on prepayment fees were preempted under the Parity Act. See 1996 OTS LEXIS 19 (April 30, 1996).

[46] Citizen Committee Against Interstate Route 675 v. Lewis, 542 F. Supp. 496, 1982 U.S. Dist. LEXIS 17522 (June 10, 1982) (distinguished on other grounds) (citing Environmental Defense Fund, Inc. v. Costle, 211 U.S. App. D.C. 313, 657 F.2d 275, 289 (D.C. Cir. 1981)).

restrictions, whether they are found in a state under a specific statute regulating alternative mortgage transactions or under a law of general applicability, are preempted for alternative mortgage products made by nonfederally chartered housing creditors in accordance with the OTS Parity Regulations.[47] Nonfederally chartered housing creditors have come to rely on rules and opinions of the OTS providing prepayment fee authority under the Parity Act.

In addition, the Agency consistently has articulated its support of a market-driven approach to the rulemaking process.

> Details on prudent operating practices should be relegated to guidance. Otherwise regulated entities can find themselves unable to respond to market innovations because they are trapped in a rigid regulatory framework developed in accordance with conditions prevailing at an earlier time.[48]

In the ANPR, the OTS echoed its market-driven approach, proclaiming that the "market should drive the products offered and terms and conditions in loan contracts should be the result of negotiation between well informed borrowers and lenders."[49] Removing the prepayment and late fee authority from the Parity Act Regulations would be inconsistent with the market-drive rulemaking policy of the OTS.

If the OTS were to adopt its Proposed Rule, the OTS would be adopting a rule that reverses its Parity Act Regulations and prepayment fee opinions on which lenders have come to rely, and also departs from the general market-driven principals to which the OTS adheres in its rulemaking efforts. The mere possibility that some lenders who engage in predatory lending practices may rely on the Parity Act to impose prepayment fees with their products, is not a sufficient basis on which the Agency can propose changes to its Parity Act Regulations for all nonfederally chartered housing creditors. Given the benefit that the OTS has found prepayment fees to have for its chartered institutions and their mortgage company operating subsidiaries in managing interest rate risk, denying the same benefits to nonfederally chartered housing creditors making Parity Act loans would appear to be arbitrary and capricious. Accordingly, we believe the OTS must withdraw the Proposed Rule as it (i) completely deviates from its existing Parity Act rule and long-standing OTS opinions governing prepayment fees for Parity Act loans, (ii) departs from its market-driven approach to rulemaking, and (iii) institutionalizes adverse discrimination against nonfederally chartered housing creditors in contravention of the Parity Act. Any Parity Act Regulations adopted by the OTS must comply with the Parity Act and eliminate adverse discrimination against nonfederally chartered housing creditors making alternative mortgage transactions.

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[47] 12 C.F.R. § 560.220, 1996 OTS LEXIS 19 (April 30, 1996); 1997 OTS LEXIS 1 (February 10, 1997).

[48] 61 Fed. Reg. 1, 164 (January 17, 1996).

[49] 66 Fed. Reg. 17,812 (April 5, 2000).

III. The Parity Act Should Not Be Repealed

A. State Laws Continue to Restrict or Prohibit Alternative Mortgage Transactions

In the preamble to the Proposed Rule, the OTS recommends that Congress revisit the Parity Act to determine if a need for the Act still exists, or allow states to opt out of the preemption provided by the Parity Act. The OTS appears to have made these recommendations based on comments received from state regulators that nearly "all states" now allow alternative mortgage loans.

The comments of state regulators that all states but one currently allow alternative mortgage transactions rings hollow, as restrictions on alternative mortgage financing are evident in countless laws of the states throughout the country. The Agency's reliance on these comments is misplaced. Generally, laws that imposed restrictions on alternative mortgage finance products in the early 1980's have not necessarily been repealed, but lie fallow as the Parity Act precludes their application. Restrictions vary widely by state. They may apply directly to alternative mortgage products or indirectly infringe on a lender's ability to structure the alternative mortgage product. With respect to ARM loans, state laws continue to impose limits on adjustments affecting the yearly and lifetime caps of interest rate, the payment amount, or the term of the loan. Restrictions exist as to the structure of ARM loans, or the type of loan products that can be offered with adjustable features.

For some forms of alternative mortgage products, state laws specifically regulate their origination. For example, reverse mortgage loans are highly regulated in such states as California, Florida, Hawaii, Minnesota, Missouri, North Carolina and South Carolina.[50]

Today, more states may prohibit, restrict, or impose requirements on mortgage loans with balloon features that existed in 1981. In 2000, when we last looked at the permissibility of making a closed-end, first- and/or subordinate-lien residential mortgage loan with a balloon payment feature, 22 states prohibited, restricted, or imposed requirements specific to balloon mortgage loans. Of these states, five states, Arizona, Massachusetts, New York, North Carolina, and Vermont,[51] restricted or prohibited a balloon payment under a law of general lender applicability, but may have limited the types of real estate-secured loans to which the restriction applied. The restrictions imposed by these state laws varied, as some provided that a balloon mortgage loan must be amortized over the term of the loan, and others indicated that payments must be substantially equal in amount.

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[50] Cal. Civ. Code § 1923; Fla. Stat. Ann. §§ 697.20 et seq.; Haw. Rev. Stat. § 506-10; Minn. Stat. § 47.58; Miss. Rev. Stat. § 443.901; N.C. Gen. Stat. §§ 53-256 et seq.; S.C. Code Ann. § 37-3-402, respectively.

[51] Ariz. Rev. Stat. §§ 6-114(A)-(C) and 6-903(Q) ; Mass. Gen. Laws ch. 183, § 6D and Reg. Bull. 1.3-101 ; N.Y. Comp. Codes R. and Regs. tit. 3, §§ 80.2, 82.1 and 82.2 ; N.C. Gen. Stat. §§ 24-12 and 24.1.1E(b) ; and Vt. Stat. Ann. tit. 8, §2216(5).

Eight of the 22 states prohibited or significantly restricted balloon payments under a state's mortgage lending law and, therefore, the restriction or prohibition applied only to licensees, or those otherwise subject to the state law. These states were Alaska, California, Florida, Kansas, Kentucky, Maine, Pennsylvania, and West Virginia.[52] As these restrictions fell under laws of limited lender application, the states discriminated against classes of lenders in restricting mortgage loans with balloon payment features. States in this group typically provided that loan contracts made subject to these laws had to provide for substantial equal payments and, therefore, balloon payments were restricted on such loans.

Although state law did not necessarily prohibit balloon payments in the remaining states in this group of 22, the states required that, in instances where a mortgage loan contained a balloon payment feature, the borrower had to be permitted to (i) refinance the balloon payment (Alabama, Colorado, Indiana, Iowa, Oklahoma, South Carolina, Utah, and Wyoming); or (ii) postpone the balloon payment (Maryland).[53] Generally, in states that regulated housing credit under a version of the Uniform Consumer Credit Code, borrowers had the right to refinance a loan with a balloon payment, except where the borrower's repayment schedule was adjusted to conform with the seasonal or irregular income of the debtor.

Our 2000 research also found that 13 states had a disclosure obligation in connection with the origination of a mortgage loan with a balloon payment feature. Although we have not had occasion to retrace our 2000 research for all of the states, the same restrictions were found in the states we re-examined for purposes of submitting comments to the Proposed Rule. In addition, since 2000, a number of states have enacted anti-predatory lending measures, which routinely restrict loans with balloon payment features, with some of the restrictions applying to loans other than those covered by the anti-predatory lending statute

Moreover, the absence of any state prohibition or restriction in alternative mortgage lending transactions today is meaningless, as states, and as we are seeing today even local governments, may enact laws that restrict alternative mortgage loan products. In examining the laws of the four states that overrode the Parity Act within the three year window period for all loan transactions, Maine, Massachusetts, New York and South Carolina,[54] the OTS would find a

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[52] *Cal. Fin. Code §§ 22307(b) and 22250(a) [Finance Lenders Law]*; *Fla. Stat. Ann. § 516.36 [Consumer* Finance Act]; Kan. Stat. Ann. §§ 16a-2-308 and 16a-3-308 [Consumer Credit Code]; Ky. Rev. Stat. § 288.580(2) [Consumer Loan Act]; Me. Rev. Stat. Ann. tit. 9-A, § 8-206-A(11) [Consumer Credit Code]; Pa. Stat. Ann. tit. 7, § 6613 [Secondary Mortgage Loan Act]; and W. Va. Code Ann. § 31-17-8 [Secondary Mortgage Loan Act].

[53] Ala. Code § 5-19-7 [Consumer Credit Act]; Col. Rev. Stat. § 5-3-402 [Consumer Credit Code]; Ind. Code § 24-4.5-3-402 [Consumer Credit Code]; Iowa Code § 537.3308 [Consumer Credit Code]; Okla. Stat. Tit. 14A, §3-402 [Consumer Credit Code]; S.C. Code Ann. § 37-3-402 [Consumer Protection Code]; Utah Code Ann. § 70C-3-102 [Consumer Credit Code]; Wyo. Stat. § 40-14-333 [Consumer Credit Code]; and Md. Comm. Law Code Ann. § 12-1003(c)(2) *[Consumer Grantor Provisions]*.

[54] Arizona overrode the Parity Act for loans made under Sections 6-114 and 6-637 of the Arizona Revised Statutes. Section 6-114 prohibits balloon payments only on subordinate-lien loans of $10,000 or less, and contains

variety of significant restrictions that are imposed on different forms of alternative mortgage products. Attached to this comment as Appendix A is a brief summary of some of the restrictions in these four states. Just as these states have enacted laws that prohibit or restrict alternative mortgage products, other states would enact such restrictive laws or prohibit alternative mortgage transactions if the Parity Act was repealed or if Congress accepted the Agency's suggestion that states be permitted to again opt out of Parity Act.

In addition, the majority of states, including, California,[55] Connecticut,[56] Hawaii,[57] Iowa,[58] and Wisconsin[59] continue to place restrictions on the ability of lenders to impose prepayment fees in connection with loans, including ARM loans. The laws in these states run the gamut from prohibiting prepayment fees entirely with respect to alternative mortgages transactions, to limiting a lender's ability to impose such fees within a certain period after a change in the interest rate.[60] To suggest that the Parity Act should be repealed because "all states but one currently allow alternative mortgage transactions," flies in the face of reality as the countless state laws that restrict, limit, or prohibit provisions of alternative mortgage transactions would effectively bar nonfederally chartered housing creditors from making such products.

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other exemptions. Section 6-637 of the Consumer Loan Act requires consumer loans, which could include a closed-end real estate-secured loan in a principal amount of $10,000 or less, to be repaid in "approximately equal periodic installments." Wisconsin overrode the Parity Act essentially for loans made under its Consumer Act, which could include subordinate-lien mortgage loans of $25,000 or less.

55 Cal. Civ. Code § 1916.5 (prohibiting the imposition of prepayment fees within 90 days of providing notice of an increase on a borrower's loan).

56 Conn. Gen. Stat. § 36a-265 (prepayment fees are prohibited on reverse mortgage loans and graduated payment loans secured by a lien on one-to-four family owner-occupied residential real property).

57 Haw. Rev. Stat. § 412:9-304 (prepayment fees may not be assessed on variable-rate loans).

58 Iowa Code §§ 528.2, 528.4 (lenders prohibited from imposing prepayment fees on reverse annuity and graduated payment mortgage loans secured by owner-occupied one-to-four family dwellings).

59 Wis. Stat. § 138.056 (a variable rate loan using an approved index may be prepaid at any time in or whole or in part without penalty. Other variable rate loans may be prepaid in whole or in part without penalty within 30 days after notice of an increase in the interest rate if prepayment is made before or after the 30-day period).

60 If it would aid the OTS in understanding the full scope and variety of prepayment fee restrictions adopted by the states, we would be pleased to submit a survey of state prepayment fee restrictions for the Agency's consideration if this survey can be kept privileged and confidential.

B. The Parity Act Promotes the Uniformity of Laws Governing Mortgage Finance

The single biggest advantage to lending under the Parity Act for nonfederally chartered housing creditors is the same one that benefits federally chartered thrifts and their mortgage company subsidiaries – uniformity and consistency in offering alternative mortgage products across state lines. The vagaries of state regulation that could apply to alternative mortgage loans make it virtually impossible for a nonfederally chartered housing creditor to offer competitively priced alternative mortgage loans if not for the Parity Act.

If the Parity Act is repealed, rather than being able to offer one product that complies with one set of nationwide rules, nonfederally chartered housing creditors would need to have 51 variations of the product to ensure compliance with the laws of each state and the District of Columbia. The costs to comply with 51 jurisdictions and the limitations on alternative mortgage products in different jurisdictions would ensure that nonfederally chartered housing creditors are economically disadvantaged when competing with federally chartered lenders. This could lead many nonfederally chartered housing creditors to abandon alternative mortgage products, tightening the availability of credit, restricting accessibility to creditors, and ultimately increasing the cost of the credit to the consumer. These are precisely the types of problems that Congress sought to avoid when enacting the Parity Act.

Over the last 20 years, the Parity Act and other federal housing credit measures have been successful in promoting competition and expanding sources of available housing credit. In the 21st century, with the opportunity for one creditor to deliver housing credit to all consumers across state lines made easier and more direct through the Internet, satellite and other electronic means of communication, barriers to offering housing credit on a uniform, nationwide basis should not be reconstructed.

Those state regulators who seek repeal of the Parity Act would have the country revert back to the pre-1980s when lenders were subject to separate rules in each jurisdiction in which they did business. Once the Parity Act falls by the wayside, it would not be long before the same advocates petitioned Congress to (i) repeal the federal preemption of state first-lien interest rate limits found in DIDMCA, and (ii) deny the preemption that the OTS has established for mortgage company operating subsidiaries of federal savings association.

Ultimately repeal of the Parity Act, or limitations on its broad preemption authority, will harm the interests of consumers. Increased costs for nonfederally chartered housing creditors to comply with inconsistent state laws will drive up the cost of housing credit and drive competition away from the marketplace.

C. The Secondary Mortgage Markets will be Harmed by the Adoption of the Proposed Rule

Although the secondary mortgage marketplace has grown significantly since the enactment of the Parity Act, we fear that the efficient workings of the marketplace will be undermined if the OTS adopts the amendments to the Parity Act Regulations as proposed.

Not only does the Parity Act authorize nonfederally chartered housing creditors to make alternative mortgage transactions on an equal footing with their federally chartered thrift counterparts, it also provides authority for such creditors to purchase and enforce such transactions on the same basis as federal chartered thrifts. The effect of this provision has been to facilitate a steady stream of capital to finance diverse mortgage products. Congress, in its wisdom, determined that the best way to ensure the availability and accessibility of mortgage credit throughout the country, and to ensure the free and unrestrained flow of mortgage credit from the secondary markets, was to have one system with one set of rules for making, purchasing, and enforcing alternative mortgage loans applicable to all creditors. Any amendment to the OTS Parity Act Regulations that creates different rules depending on the creditor undermines the purpose of the Parity Act, and defeats Congressional efforts to ensure the free flow of housing credit from, despite the cliché, Wall Street to Main Street.

If nonfederally chartered housing creditors are subject to one set of rules for purposes of the Parity Act, and federally chartered housing creditors are subject to another set of rules when making, purchasing and enforcing alternative mortgage products, then the secondary mortgage markets would be disrupted as questions about the enforceability of alternative mortgage products would arise. Will nonfederally chartered housing creditors that purchase ARM loans made by a federally chartered thrift or its mortgage company operating subsidiary be unable to enforce a prepayment fee in a Parity Act loan in a state that prohibits prepayment fees, as the nonfederally chartered housing creditor does not have the same prepayment fee authority for ARM loans as its federally chartered counterparts? Will the value of ARM loans with a prepayment fee made by a federally chartered thrift or its mortgage company operating subsidiary be diminished if there is any litigation brought against a secondary mortgage market entity that seeks to enforce the prepayment fee feature on an ARM loan or other alternative mortgage product originated by the thrift or its subsidiary? Will the secondary markets be less willing to purchase ARM loans from nonfederally chartered housing creditors who were unable to offset the early-term refinance risk by contracting for a prepayment fee? If the Proposed Rule is adopted, uncertainty about the enforceability of alternative mortgage products could lead to a tightening of housing credit.

IV. Being Licensed Under State Law Is Not a Condition to Being a Housing Creditor Under the Parity Act

With this letter, we also want the OTS to correct an oversimplification it made in the preamble to the Proposed Rule that could lead to confusion by housing creditors who seek to rely on the Parity Act.

Contrary to the statements in the preamble that (i) the Parity Act "allows state licensed and regulated housing creditors to engage in alternative mortgage transactions," and (ii) "to qualify as a housing creditor to take advantage of preemption, the Parity Act specifically provides that the creditor must be licensed under applicable State law and [remain or become] subject to the applicable regulatory requirements and enforcement mechanisms provided by State law," the Parity Act does not unconditionally require housing creditors to be licensed under State law.

Rather the Parity Act conditions the licensing obligation only if a license is needed to enter into the alternative mortgage transaction. Specifically the Parity Act provides that "[a] person is not a 'housing creditor' with respect to a specific alternative mortgage transaction if, except for this title, in order to enter into that transaction, the person would be required to comply with licensing requirements imposed under State law, unless such person is licensed under applicable State law...." The distinction between the language of the Parity Act and the OTS characterization in the preamble is significant. With the exception of a few states, a statutory licensing obligation generally exists to make first-lien residential mortgage loans and/or subordinate-lien residential mortgage loans, with the typical licensing statute providing certain exemptions from the licensing obligation or the entire licensing statute. The exemptions may be limited or may be extensive, and may include federally chartered savings banks, national banks, state chartered banks or savings banks, or bank or savings and loan holding companies, or the subsidiaries or affiliates thereof. Some states provide an exemption for (i) insurance companies, (ii) FHA, VA, FNMA, FHLMC or GNMA-approved entities, (iii) mortgage companies licensed by other states, or (iv) real estate broker licensees. Other states may provide an exemption from licensing if the lender does not have an office in the state, or if the lender only does "wholesale business" and no retail business. Even in states where there is no express statutory exemption from licensing for a subsidiary of a federally chartered savings association, operating subsidiaries of federal thrifts could assert a preemption from licensing.

The language of the OTS in the preamble to the Proposed Rule leaves the impression that entities exempt from a statute's licensing obligation as a matter of state law, or entities asserting a preemption from licensing, would not be able to rely on the Parity Act to make alternative mortgage transactions as they would not be holding a license in the state. Rather, as such entities would not be required to hold a license under a state's law in order to enter into an alternative mortgage transaction, such entities still would be considered housing creditors under the Parity Act and be entitled to make loans in reliance on the Parity Act preemption. These exempt entities would be in compliance with the applicable licensing requirements of a state's law, as the requirements would exempt them from the need to hold a license. Essentially, these exempt entities would be lending pursuant to their exemption authority. We urge the OTS to correct this oversimplification if it adopts a Final Rule.

V. Conclusion

In adopting the Parity Act, Congress stated that "alternative mortgage transactions are essential to the provision of an adequate supply of credit secured by residential property."[61] This goal has not changed with the passage of time. Limiting interest rate risk, providing pricing flexibility, and encouraging home ownership were the driving forces in the 1980s behind adoption of such credit laws as the Parity Act and DIDMCA. With nationwide homeownership reaching 67 percent in the 1990s, it would appear that borrowers have been the ultimate beneficiaries of these legislative efforts that provide pricing flexibility for consumers and ways to manage interest rate risk for creditors. Despite today's low interest rate environment, these objectives are applicable today as they were 20 years ago. Surely given the fallout from poor interest rate risk management experienced by chartered institutions in the early 1990s, the OTS recognizes the heightened concerns nonfederally chartered housing creditors have to restricting their ability to manage interest rate risk and remain competitive in the marketplace. As the OTS has concluded, prepayment fees are a useful tool in managing such risk. In keeping with the unambiguous language and clear purpose of the Parity Act, nonfederally chartered creditors should be permitted to use prepayment fees in structuring their alternative mortgage products, notwithstanding any state constitution, law or regulation that would restrict their ability to contract for prepayment fees, just as federally chartered thrifts and their mortgage company operating subsidiaries can rely on prepayment fees to manage such interest rate risk.

For the reasons set forth herein, we respectfully request that the OTS withdraw the Proposed Rule as it does not have authority under the Parity Act to adopt a regulatory structure that would apply one set of preemption rules to its chartered thrifts and their mortgage company operating subsidiaries making alternative mortgage products while denying such preemption authority to nonfederally chartered housing creditors making the same type of alternative mortgage products. We also urge the OTS withdraw its recommendation to Congress to repeal the Parity Act, or to allow states to again opt out of the Parity Act, as such actions would make it impossible for nonfederally chartered housing creditors to make, purchase, or enforce alternative mortgage loans nationwide without being subject to the adverse discriminating impact of countless state laws.

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Sincerely,

Costas A. Avrakotos, Esq.

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[61] 12 U.S.C. § 3801(a)(2).

Kirkpatrick & Lockhart LLP

Appendix A

The four states that overrode the Parity Act for all loans made in their jurisdiction, Maine, Massachusetts, New York and South Carolina, extensively regulate alternative mortgage instruments.

In Maine alternative mortgage transactions are subject to the Office of the Consumer Credit Regulations Chapter 250 ("Rule 250") and Bureau of Banking Chapter 119 (Regulation 19), referred to collectively as Joint Rule 250. Joint Rule 250 applies to an alternative mortgage transaction which includes a first-lien, closed-end loan made primarily for personal, family or household purposes with a term greater than one year: (i) which is subject to Article IX of the Maine Consumer Credit Code or made to finance or refinance the purchase or initial construction of a one to four family dwelling; and (ii) in which the interest rate may be adjusted or renegotiated, involving fixed rates but which implicitly permits rate adjustments by having the loan mature at the end of an interval shorter than the term of the amortization schedule or involving any similar type of rate, method of determining return, term, repayment or other variation not common to fixed rate, fixed term transactions, including, but not limited to, shared appreciation mortgages, partially amortized mortgages and renegotiable rate mortgages.

As a shared appreciation mortgage is defined as an alternative mortgage transaction in Maine, all the conditions, requirements, and limitations that generally apply to alternative mortgage transactions would apply equally to shared appreciation mortgages, irrespective of whether such conditions, requirements, or limitations are typically found in a shared appreciation mortgage loan. For loans and lenders subject to Joint Rule 250, limitations exist on (i) the term, rate and payment, including frequency of payment change; (ii) increases and decreases to the interest rate; (iii) the applicable index and use of discounted rate; (iv) graduated payment and payment cap loan. In addition, Joint Rule 250 requires notification to borrowers of changes in the interest rate, loan balances, required payments or pending maturity. For partially amortizing loans, the creditor must offer to qualify the borrower for a fully-amortizing loan currently being offered by the creditor to the general public.

Massachusetts also extensively regulates alternative mortgage instruments. The Office of the Commissioner of Banks has issued Regulatory Bulletin 1.3-101 (the "Bulletin") that applies to all banks, savings institutions, credit unions, licensees, mortgagees and their representatives. The conditions and restrictions set forth in the Bulletin apply to ARM loans secured by a first-lien on one-to-four family properties occupied or to be occupied in whole or in part by the borrowers. Moreover, any sale of mortgage loans or the servicing of such loans must be subject to the continued applicability of the Bulletin. The Bulletin specifically regulates the (i) ARM loan price structure (i.e. index, margin, amortization, introductory discounts, maximum term, interest rate caps); (ii) ARM loan options (i.e. buydown, periodic adjustment, interest rate caps, payment caps, convertibility); (iii) interest rate adjustments (i.e. calculation, notification); (iv) payment adjustments (i.e. calculation and notification); (v) product design and application processing; and (vi) disclosure requirements. Reverse mortgage loan products are subject to the Bulletin and also are regulated under Massachusetts General Laws chapter 183, section 67 and chapter 167E, section 2(14A).

New York has promulgated a regulation that constitutes the exclusive authority for banks, trust companies, savings banks, savings and loan associations, credit unions, person and entities engaging in the mortgage banking business other than certain federally chartered entities to make, sell, purchase, or participate in mortgage loans in a principal amount of less

than $250,000 other than fixed-rate, equal payment, self-amortizing loans. See N.Y. Comp. Code R. and Regs. tit. 3, §§ 82.1 et seq. This regulation applies to loans secured by a first mortgage on real property improved by a one-to-four family residence occupied by the owner. Such loans are subject to, among others, restrictions on (i) loan-to-value ratios; (ii) adjustments to the rate, payment, balance or term of the loan; (iii) negative amortization; and (iv) prepayment fees. The New York regulations impose notification requirements and disclosure obligations. A loan that contains a demand feature, or a mortgage loan structured as a price level adjusted mortgage, are prohibited. This regulation also prohibits a balloon mortgage loan, a pledged account mortgage loan and a growing equity mortgage loan to provide for negative amortization. Shared appreciation mortgages are prohibited under the New York Regulation on (i) first-lien mortgage loans with a principal balance of less than $250,000; and (ii) junior liens which, when combined with the outstanding unpaid principal balance on existing loans secured by the real property are less than $250,000. See N.Y. Comp. Codes & Regs. tit 3, § 82-1. Reverse mortgage loans are regulated separately pursuant to Sections 280 and 280a of New York's Real Property Law, as well as regulations promulgated thereunder. See N.Y. Comp. Codes R. and Regs. tit. 3, § 79.1 et seq.

South Carolina extensively regulates mortgage loans, including variable interest rate loans. Such loans are subject to the South Carolina Consumer Protection Code (S.C. Code Ann. §§ 37-3-100 et seq.) that regulates interest rates, fees, and disclosures, and imposes other substantive practice requirements including rebating the unearned portion of the prepaid finance charge upon prepayment. See id. §§ 37-3-209 and 37-3-210. With respect to a consumer loan, secured in whole or in part by a lien on real estate, in which the aggregate of all sums advanced or contemplated by the parties will not exceed $100,000, the rate of the loan finance charge must be a fixed nonvariable rate unless (i) the borrower agrees otherwise; and either (ii) the loan is primarily for a business or agricultural purpose or is used for the construction of any improvements on the real estate which provides the security for the loan; or (iii) the creditor makes the loan in accordance with any regulations governing alternative mortgage loans promulgated by the State Board of Financial Institutions or a federal regulatory agency. See id. § 37-3-412 and 37-10-103. The state's Board of Financial Institutions adopted Regulation 15-39Q which allows variable rates if the variable rate index is beyond the control of the financial institution making the loan and is readily available to and verifiable by the borrower and disclosures complying with the Federal Truth-in-Lending Act variable rate disclosure obligations are timely given to the debtor.