

(717) 787-1471

June 5, 1998

Dear:

This letter responds to the request that you made on behalf of your clients, a national bank, and a federal savings bank (together, the "Banks") for the position of the Pennsylvania Department of Banking ("Department") regarding the following issue. Specifically, you inquire whether the Department concurs with the Banks' joint position that neither of two closing cost features that the Banks propose to include in their respective home equity loan programs constitute prepayment penalties prohibited under the Simplification and Availability of Bank Credit Act ("SABCA"), which is codified as section 322 ("Section 322")¹ of the Banking Code of 1965 ("Banking Code").² The closing cost features proposed by the Banks are (i) an up-front waiver feature ("waiver feature"), and (ii) a reimbursement after closing feature ("reimbursement feature"), described in greater detail below.

¹ Section 322(b) provides, in relevant part, that SABCA is available as authority for "institutions" (meaning Pennsylvania state-chartered banks and bank and trust companies according to 7 P.S. § 301) to originate direct and indirect extensions of credit for personal, family, household, business, or agricultural purposes to an individual, except for extensions of credit "(i) which are secured by a first-lien, purchase money, residential real estate mortgage, ... or (ii) which are not subject to a maximum rate of interest or finance charge, or as to which the pleading of usury as a defense is prohibited, pursuant to Federal or State law." 7 P.S. § 322(b)(i) and (iii).

² You indicated that NB relies on Section 322 under the authority of 12 U.S.C. § 85 and that FSB relies on Section 322 under the authority of 12 U.S.C. § 1463(g). This letter neither confirms, denies, nor otherwise opines on that assertion. For purposes of this letter, it is assumed that the home equity loan program the Banks seek to implement through Section 322 is authorized to be engaged in by the Banks under federal law.

Background

The Department's understanding of the Banks' proposal as stated below is based on your letter to the Department and a meeting between officials of the Banks and the Department.

The Banks propose to implement home equity loan programs³ to include the waiver feature and/or the reimbursement feature pursuant to the terms of Section 322. The closing costs involved are described in your letter as costs associated with the making of a loan, such as document preparation fees and recording fees, and in the meeting included, but were not necessarily limited to, appraisal and title fees (together hereinafter for purposes of this letter, "closing costs"). It is assumed that the closing costs proposed to be conditionally waived or reimbursed are actual closing costs that the consumer would be required to pay in the absence of the waiver feature or reimbursement feature.

Waiver Feature: Under this proposed feature, the Banks would not require a loan applicant to pay closing costs at the time of the closing of the home equity loan or at any time thereafter, unless certain subsequent conditions occurred. Specifically, if the loan applicant who becomes a borrower prepays the loan within a certain period of time before the end of the loan term, as designated in the written agreement, then the borrower would be required to pay the closing costs to the lending Bank or FSB at the termination of the loan. For example, on a five year closed-end home equity loan, if the borrower prepaid the loan in full within one year, then the borrower would be required to pay the closing costs to the lender at the time of full prepayment of the loan. But if the borrower did not prepay and instead paid the loan in full according to the five year amortization schedule, then the borrower would not be required to pay the closing costs to the lender at the end of the five year term.

You indicated that the benefit of the waiver feature to the borrower would be that the borrower would not have to pay the closing costs normally required to be paid at the loan closing, and might not have to pay the closing costs at all if the loan remains open for a certain amount of the total loan term because the Banks would recover the closing costs over time. In addition, borrowers who normally would prefer to finance the closing costs by adding the closing costs to the loan amount borrowed and paying interest on that additionally financed amount, would not incur debt and interest

³ The discussion in this letter regarding prepayment penalties could apply equally to lending programs besides home equity loans, provided such loan programs are eligible to be engaged in by the proposed lender pursuant to the terms of Section 322.

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charges related to the closing costs under the waiver feature.

Reimbursement Feature: Under this proposed feature, the Banks would require loan applicants to pay closing costs at the time of the closing of the home equity loan, and would reimburse the borrower the closing costs at the end of the loan term, unless certain subsequent conditions occurred. Specifically, if the loan applicant who becomes a borrower prepays the loan within a certain period of time before the end of the loan term, as designated in the written agreement, then the borrower would not be reimbursed the amount of the closing costs. For example, on a five year closed-end home equity loan, if the borrower prepaid the loan in full within one year, then the borrower would not be reimbursed the closing costs from the lender. But if the borrower did not prepay and instead paid the loan in full according to the five year amortization schedule, then the borrower would be reimbursed the closing costs at the end of the five year term.

You indicated that the benefit of the reimbursement feature to the borrower would be that the borrower would be able to be reimbursed for the closing costs normally required to be paid at the loan closing if the loan remains open for a certain amount of the total loan term because the Banks would recover the closing costs over time. In addition, borrowers who normally would prefer financing the closing costs by adding the closing costs to the loan amount borrowed and paying interest on that additionally financed amount, would not incur debt and interest charges related to the closing costs under the reimbursement feature.

Regarding both the waiver and reimbursement features, the Banks indicated that such promotional features cannot be offered in a cost effective manner in the present highly competitive lending market unless the loan remains open for a certain period of time less than the full term of the loan. In addition, the Banks indicated that the waiver and reimbursement features constitute alternatives to higher interest rates being charged to compensate the Banks for the potential lost stream of expected income that occurs when borrowers prepay their loans.

Permissibility of Closing Costs Under Section 322

Section 322(d) of the Banking Code provides that an agreement for an extension of credit may include “charges which may be imposed in addition to interest, ... such as, but not limited to , minimum charges, check charges and [certain] maintenance charges”, delinquency charges, extension charges, “actual charges that may be incurred on default” and “additional charges...” 7 P.S. § 322(d). In addition, the Department’s statement of policy regarding SABCA indicates the Department’s position as follows.

Section 322(d) includes a nonexclusive list of the types of fees and charges which an institution may impose in addition to periodic interest. Among the types of charges which this subsection does not explicitly list are charges typically referred to as “application fees,

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commitment fees, points.” The Department finds that these charges, while not specifically enumerated, are authorized to be made by institutions under the additional fee authority provided by Section 322(d). The SABCA indicates that these charges are in addition to periodic interest charges and shall not be included in any calculation of the maximum rate of interest under Section 322(d)(iii) above.

10 Pa. Code § 13.51(b)(2)(ii). As a general matter, the Department does not object to the types of “closing costs,” as that term is defined in this letter, being imposed by eligible lenders pursuant to the terms of Section 322.

Prepayment Penalty Prohibition Under Section 322

Section 322(g)(i) of the Banking Code provides as follows.

A borrower or buyer may prepay an extension of credit in full at any time without any prepayment charge.

7 P.S. § 322(g)(ii). Restated, the issue herein is whether either the waiver feature and/or the reimbursement feature proposed by Banks to be included in their home equity loan programs to be engaged in pursuant to the terms of the SABCA would constitute an impermissible prepayment penalty under Section 322(g)(i) of the Banking Code.

The term “prepayment penalty” is not defined in Section 322 or in other Pennsylvania lender laws in which the Department has a regulatory role.⁴ For purposes of this letter, a prepayment penalty may

⁴ Examples of other Pennsylvania lender laws which discuss but do not define prepayment penalties include the following. The Loan Interest and Protection Law provides that “[r]esidential mortgage obligations contracted for on or after the effective date of this act may be prepaid without any penalty or other charge for such prepayment at any time before the end of the period of the loan.” 41 P.S. § 405. See also 10 Pa. Code § 7.8 (examples of how to calculate finance charges in event of prepayment of loan). Section 8(a)(5) of the Mortgage Bankers and Brokers Act requires that residential first mortgage lender licensees comply with all provisions of the Loan Interest and Protection Law, which would include the prepayment penalty prohibition, unless preempted by section 501 of the Depository Institutions Deregulation and Monetary Control Act of 1980. 63 P.S. § 456.08(a)(5). Section 12(a) of the Secondary Mortgage Loan Act provides that residential second mortgage lender licensees “shall permit a borrower to pay partially or wholly any contract or any installment on a contract, without penalty, prior to the due date.” 7 P.S. § 6612(a). Section 14.D of the Consumer Discount Company Act provides that consumer discount company licensees “shall permit a consumer to pay partially or wholly any contract or any installment on a contract, prior to the due date.” 7

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be defined as follows: a charge that would be assessed by a lender against a borrower only if the borrower pays all of a remaining loan amount to the lender in advance of the amortized amount due during the loan term and prior to passage of the full loan term. For example, a lender assessing a prepayment penalty might do so when holding a loan with a five year term that is prepaid in full by the borrower in two years, meaning three years in advance of the due date. The prepayment penalty charge by the lender against the borrower in such a circumstance presumably would be to compensate the lender for the loss of three years of interest earnings from loan payments that the lender had expected to receive.

Discussion

You indicated in your letter that the Banks believe that there should be no distinction drawn between the waiver feature and the reimbursement feature because, in either case, the nature of the transaction is the same, namely, that the customer receives a conditional benefit as part of a promotional effort by the Banks.

You cited the Office of the Comptroller of the Currency (“OCC”) interpretive letter #744 dated October 21, 1996, to support the Banks’ assertion that the waiver and reimbursement features do not constitute prepayment penalties because prepayment penalties, but not closing costs, constitute part of the “interest” that may be exported by national banks pursuant to 12 U.S.C. § 85. Pursuant to the same OCC interpretive letter citing to 12 CFR § 7.4001(a), interest as used in 12 U.S.C. § 85 does not include at least some of the items defined in this letter to you as “closing costs.” *Id.*, 12 CFR § 7.4001(a). More specifically “interest” pursuant to 12 U.S.C. § 85 does not ordinarily include “appraisal fees, premiums and commissions attributable to insurance guaranteeing repayment of any extension of credit, finders’ fees, fees for document preparation or notarization, or fees incurred to obtain credit reports.” By distinguishing between prepayment penalties that qualify as a component of “interest” pursuant to 12 U.S.C. § 85, versus closing costs (document preparation, recording, appraisal, and title fees) as defined in this letter to you, the Banks seek to demonstrate to the

P.S. § 6214.D. Section 22 of the Motor Vehicle Sales Finance Act provides that the buyer of a motor vehicle, financed by a licensed installment seller, “notwithstanding the provisions of any installment sale contract, shall have the privilege of prepaying at any time all or any part of the unpaid time balance under an installment sale contract.” 69 P.S. § 622

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Department that Section 322(g)(i) of the Banking Code's prohibition on prepayment penalties is not meant to prohibit the conditional waiver or reimbursement of "closing costs" as that term is defined in this letter.

You also indicated that the National Credit Union Administration ("NCUA") has opined that home equity and first mortgage loan program features such as the waiver feature and reimbursement feature described herein do not constitute prepayment penalties under the Federal Credit Union Act at 12 U.S.C. § 1757(a)(viii)⁵, based on NCUA interpretive letters.⁶

⁵ 12 U.S.C. § 1757(a)(viii) provides that loans to members of a federal credit union shall be made in conformity with criteria established by the board of directors, provided that "a borrower may repay, prior to maturity in whole or in part on any business day without penalty, except that on a first or second mortgage loan a Federal credit union may require that any partial prepayments (I) be made on the date monthly installments are due, and (II) be in the amount of that part of one or more monthly installments which would be applicable to principal[.]"

⁶ See NCUA Interpretive letter dated March 9, 1993 from Hattie M. Ulan, Associate

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The overall rationale expressed by the NCUA in the cited interpretive letters was that the conditional waiver of fees or closing costs conferred a benefit on the borrower, and that the borrower would only lose the contracted benefit of waived fees or closing costs upon prepaying the loan ahead of schedule. It is also noted that the NCUA letters cited address affirmatively only the loan features apparently similar to the waiver feature described and defined in this letter.

Conclusions

Reimbursement Feature: The Department concludes that the reimbursement feature does not

General Counsel, to California Credit Union League (conditional up-front waiver of appraisal and title fees on home equity lines of credit by federal credit union with requirement that such fees be paid by borrower if the borrower prepays and closes the loan within its first year is not a prepayment penalty); NCUA Interpretive Letter dated April 29, 1996 from Richard S. Schulman, Associate General Counsel, to Irvin Works Federal Credit Union (conditional up-front waiver of fees associated with a home equity loan by federal credit union with requirement that such fees be paid by borrower if borrower prepays entire loan within six months of origination is permissible when the borrower agrees to only make the scheduled monthly payments for a specified period in return for the federal credit union waiving the fees); NCUA Interpretive Letter dated June 13, 1996 from Richard S. Schulman, Associate General Counsel, to Hartford Telephone Federal Credit Union (conditional up-front waiver of closing costs associated with a first mortgage loans by federal credit union with requirement that such closing costs be paid by borrower if borrower prepays entire loan within two years is permissible.

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constitute a prepayment penalty and therefore is not prohibited by Section 322(g)(i) of the Banking Code. The reasons for this conclusion include that, in the absence of the reimbursement feature which would be used by the lender to promote the loan product, the borrower would otherwise be required to pay the closing costs. It is recognized by the Department that the borrower could lose the ability to collect a potential monetary reimbursement under the reimbursement feature, but the loss of that potential reimbursement is not a prepayment penalty because the reimbursement is directly related to the recovery of closing costs. A Department condition of the Banks using the reimbursement feature is that there is stated in the written agreement, consistent with Section 322(d), a specific time limit within the full term of the loan that the conditional reimbursement feature applies. In other words, the written agreement must state that the borrower will not be reimbursed the closing costs if the borrower prepays within a specifically stated period prior to the full term of the loan.

Waiver Feature: The Department concludes that the waiver feature does not constitute a prepayment penalty and therefore is not prohibited by Section 322(g)(i) of the Banking Code. The reasons for this conclusion include that, in the absence of the waiver feature which would be used by the lender to promote the loan product, the borrower would otherwise be required to pay the closing costs. It is recognized by the Department that the borrower could become required to pay closing costs to the lender under the waiver feature, but such a required payment is not a prepayment penalty because such payment is directly related to the recovery of closing costs. A Department condition of the Banks using the waiver feature is that there is stated in the written agreement, consistent with Section 322(d), a specific time limit within the full term of the loan that the conditional waiver feature applies. In other words, the written agreement must state that the borrower will not be required to pay the closing costs that were conditionally waived at the time of the closing unless the borrower prepays within a specifically stated period prior to the full term of the loan.

Regarding both the reimbursement feature and the waiver feature, the Department finds that such features involve closing costs that may not have to be paid by the consumer and therefore are of benefit to the consumer. In addition, both the reimbursement and waiver features are not properly categorized as part of "interest," consistent with OCC interpretive letter #744. Finally, the reimbursement and waiver features are not prepayment penalties, especially when the conditional waiver or reimbursement of closing costs constitutes a benefit, not a detriment, to the borrower. Therefore, for reasons including but not necessarily limited to those stated in this letter, the waiver and reimbursement features are deemed by the Department as not constituting prepayment penalties that would be prohibited by Section 322(g)(i) of the Banking Code.

Amendment of SABCA Statement of Policy: As a general matter, the Department does not amend statements of policy each time an interpretive letter is issued. Therefore, please be advised that at the present time, the Department does not intend to amend the SABCA Statement of Policy to state that the reimbursement feature and waiver feature do not constitute prepayment penalties.

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However, the Department reserves the right to amend the SABCA Statement of Policy in the future as deemed necessary and appropriate. In the present circumstance, the Department finds that the SABCA is adequate in its present form, and that this interpretive letter adequately confirms that the waiver and reimbursement features discussed herein do not constitute prepayment penalties prohibited by Section 322(g)(i) of the Banking Code.

The Department's analysis is based upon the facts and conditions as stated in this letter. Any change in the facts could result in a reversal of the Department's position. This letter states the Department's position regarding the issues discussed herein and may not be relied upon or construed as constituting legal advice.

Please contact me if you have any further questions regarding this matter.

Sincerely,

Reginald S. Evans
Chief Counsel

cc: The Honorable Richard C. Rishel
Patricia DeZelar
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