FEDERAL PRE-EMPTION OF PREPAYMENT PENALTIES

By

Rod Clement
Brunini, Grantham, Grower & Hewes PLLC
1400 Trustmark Building
248 E. Capitol Street
Jackson, Mississippi

ABA Section of Real Property, Probate & Trust Law
18th Annual Real Property and Estate Planning Symposia
Washington, DC

April 27, 2007

FEDERAL PRE-EMPTION OF PREPAYMENT CHARGES

Most state have enacted limits on the amount of the charge that lenders can impose when a borrower prepays a loan. The federal government has enacted legislation that pre-empts these state limits for certain types of loan. The statutes distinguish between the types of lenders, the type of collateral for the loan, and between federally chartered and state-chartered institutions.

Banks

Under the National Bank Act, federal banks are authorized to charge the same interest rates as state banks. 12 U.S.C. § 85. The Office of the Comptroller of the Currency ("OCC") has determined that this statute authorized national banks to charge the same prepayment fees as state banks. OCC Interpretive Letter #744, dated August 21, 1996, available at http://www.occ.treas.gov/interp/oct/int744.pdf *See also Northway Lanes v. Hackley Union National Bank & Trust Co.*, 334 F. Supp. 723, 732 (W.D. Mich. 1971)(national bank could charge five percent prepayment charge when state law did not prohibit such charge.)

On real estate loan secured by adjustable rate mortgages, federal law provides banks with additional rights. 12. U.S.C § 371 provides that national banking associations may make loans secured by real estate subject to regulations issued by the OCC. Pursuant to this authority, the OCC has issued regulations that permit federal or state banks to make adjustable rate loans and charge prepayment fees on such loan

notwithstanding state laws limiting prepayments. , "A national bank offering or purchasing ARM loans may impose fees for prepayments notwithstanding any State law limitations to the contrary." 12 C.F.R. § 34.23. The regulations make state that they are not limited to loans secured by residences but include loans secured by "condominiums, leaseholds, cooperatives, forest tracts, land sales contracts, and construction project loans." The validity of these regulations was affirmed, at least as to national banks, in *National City Bank v. Turnbaugh,* 367 F. Supp.2d 805, 818 (D. Md. 2005). The regulations also apply to state chartered bank and provide in relevant part as follows: "Pursuant to 12 U.S.C. § 3803(a), a State chartered commercial bank may make ARM loans in accordance with the provisions of this subpart." The quoted statute, 12 U.S.C. § 3803(a), only addresses "housing creditors" making adjustable rate loans, so this regulation arguable only addresses state banks making loans secured by residential real estate.

Savings Associations

Federal savings associations are exempt from state limitations on prepayment penalties. Regulations issued by the Office of Thrift Supervision ("OTS"), under the authority granted to the OTS in the Federal Home Owners' Loan Act, expressly provide that a federal savings association may impose a fee for any prepayment of a loan. 12 C.F.R. § 560.34. The regulations further provide that the OTS regulations regarding prepayment penalties pre-empt state laws. 12 C.F.R. § 560.2(b)(5).

In 1982 Congress enacted the Alternative Mortgage Transaction Act, 12 U.S.C. § 3801. This act, also known as the Parity Act, authorizes "housing creditors" to make residential adjustable rate loans and pre-empts state laws to the contrary. 12 U.S.C, § 3803(c). The purpose of the Parity Act was to give state-chartered institutions and private lenders the same ability to make adjustable-rate loans as federal institutions. The legislative history of the Parity Act indicates that volatile changes in interest rates had affected the ability of housing creditors to provide fixed rate loans, and that the ability to provide adjustable rate loans was essential to the availability of residential mortgage lending. In 1996 OTS issued regulations, 12 C.F.R § 560.220, stating that the Parity Act pre-empted state limitations on prepayment penalties, and thus "housing creditors" could impose prepayment penalties in excess of state law. In 2003, in response to concerns that the federal pre-emption of state prepayment penalties facilitated predatory lending, the OTS revised 12 C.F.R. § 560.220 to remove the federal pre-emption of state limitations on prepayment charges for state-chartered housing. The OTS also determined that federal pre-emption was not essential to the ability of state housing creditors to offer adjustable rate mortgages. The United States Court of Appeals for the District of Columbia Circuit upheld the validity of the revised regulations. *National Home Equity Mortgage Ass'n v. Office of Thrift Supervision*, 373 F.3d 1355 (D.C. Cir. 2004). *See generally* Jack Murray, *Federal Preemption of State Prepayment-Penalty Statutes: The OTS Reverses Itself*, http://www.firstam.com/content.cfm?id=2950. The effect of this change in the regulations is that state associations lost the pre-emption from state prepayment laws that they enjoyed by virtue of the Parity Act, while federal associations continue to have the exemption.

Loans secured by first liens on residential real estate

The federal Depository Institution Deregulation and Monetary Control Act of 1980 ("DIDMCA") pre-empts state limitations on prepayments in loans made by lenders secured by federally insured first liens on residential property, provided that state has not elected to opt out of the statute. 12 U.S.C. § 1735f-7. The definition of residential real property subject to the DIDMCA includes stock in a real estate cooperative and residential manufactured homes. 12 U.S.C. § 1735f-7a(a)(1)(A). "Lenders" are defined as "any lender approved by the Secretary of Housing and Urban Development for participation in any insurance program under the National Housing Act and any individual who finances the sale or exchange of residential real property or a residential manufactured home which such individual owns and which such individual occupies or has occupied as his principal residence." 12 U.S.C. § 1735f-7a(a)(C) (vi). States had the opportunity to opt-out of the DIDMCA by enacting a statute to the effect that the state did not want this portion of the DIDMCA to apply to the state. 12 U.S.C. § 1735f-7a(b)(2). Fifteen states have opted out. One case has suggested that the DIDMCA's pre-emption is not a complete pre-emption of state prepayment limits. *Nelson v. Associates Financial Services of Indiana, Inc.*, 79 F. Supp. 813, 817 (W.D. Mich. 2000).