Office of Thrift Supervision
Department of the Treasury
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Chief Counsel

May 3, 1996

[redacted]

RE: Reverse Mortgage Loans That Include an Equity Share Feature

Dear [redacted]

This responds to your inquiry, submitted on behalf of the Federal National Mortgage Association ("Fannie Mae"), regarding whether federal savings associations and "housing creditors" under the federal Alternative Mortgage Transaction Parity Act of 1982 (the "Parity Act")[1] may originate the Home Keeper Mortgage, an adjustable rate reverse mortgage loan that sometimes includes an equity share feature. Under the program described by Fannie Mae, federal savings associations and others will originate these loans for prompt sale to Fannie Mae.

You have also asked for confirmation of your understanding that federal law preempts the application of state interest rate limits to mortgage loans (including reverse mortgage loans) that are secured by first liens on residential real property.

In brief, we conclude that federal savings associations and "housing creditors" who are authorized by the Parity Act to rely on regulations of the Office of Thrift Supervision ("OTS") may originate the Home Keeper Mortgage for prompt sale to Fannie Mae, subject to the conditions noted below. We also concur in your conclusion regarding the preemption of state interest rate limits on residential first mortgage loans, subject-to the qualifications noted below.

We wish to emphasize that our conclusion that federal thrifts may originate the Home Keeper Mortgage is based on the premise that these loans will be promptly sold to Fannie Mae. We do not address whether thrifts could originate these loans to hold

[1] Title VII of the Garn-St Germain Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (1982), codified at 12 U.S.C.A. § 3801 et seq. (West 1989 & West Supp. 1996).

in portfolio. Given the loans' equity share, nonrecourse, and other features, any proposal to hold them in portfolio would require a thorough safety and soundness review -- which we do not undertake here.

I. Background

Fannie Mae has begun a new program under which various lenders originate, and Fannie Mae promptly purchases, adjustable rate reverse mortgage loans called the Home Keeper Mortgage (the "Product"). The Product is offered to senior citizens 62 and older on a nationwide basis. The Product is a conventional reverse mortgage loan that permits eligible home owners to borrow against the equity in their homes and delay repayment of the loan until they no longer occupy the property as their principal residence. The Product makes three payment plans available to borrowers: (1) a tenure payment plan provides for equal monthly payments to the borrower so long as the borrower occupies the property as his or her principal residence; (2) a revolving line of credit payment plan provides for payments to the borrower upon request and in whatever amount the borrower specifies up to the borrower's credit limit; and (3) a modified tenure payment plan combines the characteristics of a tenure payment plan with those of a revolving line of credit payment plan. The modified tenure plan allows borrowers to set aside part of the principal to establish a revolving line of credit and to receive the rest of the principal in equal monthly payments until the borrower ceases to occupy the property as his or her principal residence.

The revolving line of credit (a feature of two plans) permits borrowers to repay borrowed money and borrow the same funds again. Partial payments made by the borrower increase his or her borrowing power on a dollar-for-dollar basis. The borrower selects one of the three payment plans at closing, but may change the plan at any time for a fee.

All principal payments to the borrower are added to the loan balance as they are made. Interest accrues on, and is added to, the loan balance at the end of each month. Other fees, such as the servicing fees paid to the loan servicer, the fee for changing the payment plan, and charges incurred to protect the property, are also added to the loan balance on a monthly basis.

The amount of principal payments available to the borrower under the plans is a function of the value of the property and the remaining life expectancy of the borrower. The loan becomes due and payable at the time the borrower moves or dies. Because the maturity date cannot be fixed in advance, the amount of credit that will actually be extended (i.e., principal payments and fees plus accrued interest) cannot be determined precisely in advance and may exceed the lender's original estimate if the borrower lives in the home longer than expected.

The Product carries an adjustable interest rate. Rate changes are based on the monthly average of the one-month CD ARM index value published by the Federal Reserve Board and are computed by adding a margin to that index value. Rate adjustments may be made monthly, based on changes in the index, with a maximum rate cap over the life of the loan of 12 percentage points above the initial interest rate.

The Product is non-recourse, meaning that the loan is to be repaid exclusively out of the proceeds of sale of the borrower's home, and is not a general liability of the borrower.

In addition to the standard program described above, the Product also offers an equity share option that enables the borrower to borrow a larger amount of principal. The borrower may select this option at the time of loan origination in exchange for agreeing to pay an additional fee, the "equity share," at the time the loan is paid off. The equity share is equal to 10% of the property's value at maturity. If the combined value of the loan balance and the equity share is greater than the property value, then the amount repaid will be limited to the property value. Moreover, if the loan is paid off in the first 24 months of the loan term, the equity share will not be charged.

Fannie Mae has represented that it has legal authority to purchase, and does purchase, all Product loans originated by approved lenders in accordance with Fannie Mae's guidelines. Lenders may retain, contract out, or sell servicing rights to these loans. After purchase, Fannie Mae will fund disbursements and assume the risks associated with the Product (e.g., longevity of the borrower or depreciation of the property).

II. Discussion

A. Authority to Originate Reverse Mortgage Loans

In Guidance issued in 1994 ("OTS Guidance"), the OTS indicated that federal savings associations have authority to originate or purchase reverse mortgages.[2] The

[2] OTS Memorandum to Regional Directors, "Guidance on Reverse Mortgage Loans" (September 30, 1994) at 8 (copy enclosed), to be incorporated in § 212 (Mortgage Lending) of the Thrift Activities Regulatory Handbook. See also, FHLBB Op. by Smith , August 4, 1989, at 5 (concluding that line of credit conversion mortgages originated in conformity with HUD regulations are permissible investments for federal thrifts).

standard version of the Product proposed by Fannie Mae (i.e., without an equity share) comports with the type of reverse mortgages described in the OTS Guidance.

The Guidance is based on section 5(c)(1)(B) of the Home Owner's Loan Act ("HOLA"), which authorizes federal savings associations to invest in, sell and otherwise deal in loans on the security of liens upon residential real property, to the extent authorized in regulations of the OTS.[3] Although the OTS's implementing regulations do not specifically use the term "reverse mortgage loans," they do permit residential real estate loans that contain each of the terms that are characteristic of reverse mortgage loans.

The OTS's regulations governing residential real estate loans permit: (a) the loan balance to be disbursed to the borrower over time, rather than in a lump sum at origination; (b) principal and interest to be paid at maturity, rather than in periodic payments; and (c) the interest rate to be adjusted periodically.[4] In addition, there is nothing in the regulations that prohibits loan fees from being rolled into the loan, that requires the maturity date on the loan to be fixed, or that prevents thrifts from restricting recourse to the value of the home, rather than imposing a general liability on the borrower. Thus, each of the unique features of a typical reverse mortgage loan, including Fannie Mae's standard Product, comports with the OTS's lending regulations.[5]

Of course, whenever a federal thrift makes a loan, it must do so in a safe and sound manner. The fact that a loan comports with all the technical requirements of the regulations is no guarantee that it is safe and sound. Savings associations are responsible for ensuring that each loan they originate is safe and sound under all the facts and circumstances. To assist associations in this endeavor, the OTS Guidance identifies a number of key safety and soundness factors that should be considered

[3] 12 U.S.C.A. § 1464(c)(1)(B) (West Supp. 1996).

[4] 12 C.F.R. §§ 545.32(b)(3) and (b)(4), 545.33(a) and (c), and 563.99. In a Notice of Proposed Rulemaking on Lending and Investment issued on January 7, 1996, the OTS proposed to remove §§ 545.32(b)(3) (Adjustments) and (b)(4) (Amortization), and 545.33(c) (Adjustments) from its regulations; however, the OTS "does not intend any change in federal thrifts' authority to conduct these activities, but rather to enhance associations' flexibility in lending." 61 Fed. Reg. 1,162, 1,165 (1996).

[5] We note, however, that § 102 of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. Law No. 103-328, 108 Stat. 2338 (1994), codified at 12 U.S.C.A. § 1462a(f) (West Supp. 1996), and homestead restrictions under Texas law prohibit federal and state thrifts from making reverse mortgages in that state. See First Gibraltar Bank, FSB v. Morales, 19 F. 3d 1032 (5th Cir. 1994).

when originating or purchasing reverse mortgages.[6] The Guidance recognizes, however, that the safety and soundness issues unique to reverse mortgages are not presented when advance arrangements are made to sell such loans promptly into the secondary market without recourse -- as would be the case here.[7]

B. Authority to Take an Equity Share

As a general rule, federal savings associations are not permitted to make equity investments in real estate.[8] Consequently, whenever the compensation that a federal thrift receives from a loan is tied to the appreciation of the underlying real estate, consideration must be given to whether the thrift has indirectly acquired a prohibited equity interest in real estate.

The OTS has recognized that equity share loans do not necessarily give rise to prohibited equity interests in real estate. Section 545.32(b)(3) of OTS's regulations provides that a federal savings association:

> may receive a portion of the consideration for making a real estate loan in the form of a percentage of the amount by which the current market value of the property, during the loan term or at maturity, exceeds the original appraisal value, or as provided in § 556.13 of this subchapter.[9]

The equity payment described in the foregoing regulatory language differs slightly from the equity payment that Fannie Mae utilizes for the Product. The Product's equity payment is computed as a percentage of the property's total value at the time of sale, whereas the equity payment described in the regulation is computed as a percentage of the appreciation of the property between origination and maturity.

However, the regulation indicates that an equity share payment may also be computed as provided in the OTS policy statement codified at § 556.13. Paragraph (b) of that statement reads as follows:

[6] OTS Guidance at 2-11.

[7] Id. at 11.

[8] Exceptions are made for investments in office premises, investments made through service corporations, certain community development investments, and real estate acquired in foreclosure or in lieu of foreclosure. See 12 U.S.C.A. § 1464(c)(3)(B) (West Supp. 1996) and 12 C.F.R. §§ 545.74(c)(3) and 545.77.

[9] 12 C.F.R. § 545.32(b)(3).

> The {OTS] has determined that the receipt of [a share of the income generated by a security property] or the right to receive [such] income should not be considered an equity interest [in the security property] if it in substance constitutes no more than a part of the compensation received for use of the Federal savings association's funds. Accordingly, if the borrower has an unconditional obligation to repay the loan principal, and if a Federal savings association receives a substantial payment of interest calculated periodically as a percentage of the outstanding principal loan balance, it may receive additional interest calculated on the basis of the income from or the appreciation of the security property, the income of a corporate borrower, or some other measure of a venture's success. The means by which a Federal savings association calculates its share of the income is not a material consideration in determining whether the share constitutes an equity interest in the property.[10]

The Product meets the standard established in the first sentence of § 556.13(b). The equity payment called for by the Product will "constitute no more than a part of the compensation received for use of the [lender's] funds." However, the Product does not conform to the second sentence. Although a substantial portion of the compensation paid on each loan is to be computed as a percentage of the loan balance, the borrower does not have an unconditional obligation to repay the loan. As noted above, the Product is non-recourse, meaning that it is repaid exclusively out of proceeds of the sale of the underlying property.

In our view, however, the second sentence of § 556.13(b) is not intended to establish a binding norm. Read in context, the function of the second sentence appears to be to provide an example of a loan instrument that would meet the basic standard articulated both in § 545.32(b)(3) and in the first sentence of § 556.13(b), i.e., the equity payment constitutes no more than a portion of the compensation the lender will receive. There is no indication that the second sentence was intended to define the only circumstances under which an equity feature will be deemed permissible. This reading is consistent with the nature of § 556.13 as a policy statement. Policy statements generally do not establish binding norms.[11] This reading is also consistent with § 545.32(b)(3), which does not impose a general liability requirement on loans originated under it. Thus, we do not believe that the second sentence of § 556.13(b) should be read as an absolute bar on equity share features in nonrecourse loans.

[10] 12 C.F.R. § 556.13(b).

[11] Seidman v. OTS, 37 F.3d 911, 930-932 (3rd Cir. 1994).

The regulatory objective of both §§ 545.32(b)(3) and 556.13 is clear. The goal is to separate bona fide lending transactions from equity investments disguised as loans. This is necessarily a fact driven inquiry. Both the regulation and the policy statement indicate that the most important factor is the relative significance of the equity payment compared to the amount of interest computed as a percentage of the loan balance. Both the regulation and the policy statement emphasize that the equity payment should be no more than "a portion of the consideration" that the lender will receive.[12] The policy statement also indicates that other factors may be relevant, such as the nature of the borrower's liability. All relevant facts must be reviewed in context.

Although the Product is nonrecourse, we are satisfied that it constitutes a bona fide loan. Here the equity share feature applies only if the borrower wishes to increase the principal amount of the loan beyond the standard loan-to-value ratio specified by Fannie Mae. The equity payment, which will not exceed 10% of the value of the property, is intended to compensate the lender for the extra measure of risk created by the higher loan-to-value ratio. Interest computed as a percentage of the loan balance will be paid on the entire loan balance (including the additional balance made possible by the equity share election) at the same rate as would have applied absent the election. Under these circumstances, we are satisfied that the equity share feature is merely supplementary and does not defeat the characterization of the transaction as a loan, even when coupled with the nonrecourse feature.[13] Accordingly, federal savings associations may originate the Product with the equity share feature.

C. Authority of Non-Federally Chartered Housing Creditors

You also inquire whether "housing creditors" under the Parity Act may originate the Product and take an equity share in the security property. The term

[12] The Preamble of the final FHLBB regulation states that the Board "intends that interest received under this section should be considered as an addition or supplement to the periodic interest and should constitute no more than a small part of the total interest." 48 Fed. Reg. 23,032, 23,042 (1983).

[13] We recognize that under unusual circumstances, such as premature death of the borrower or extraordinary property appreciation, the amount of the equity share payment could exceed the amount of interest otherwise due on the loan. This does not alter our conclusion. We are satisfied that, as designed, the equity payment will in the vast majority of cases merely constitute a supplementary payment.

"housing creditor" is defined to include, inter alia, state-chartered depository institutions and any other state lender "who regularly makes loans."[14]

The Parity Act permits lenders that meet the definition of a "housing creditor" to engage in "alternative mortgage transactions" without regard to any state constitution, law, or regulation, provided the transactions are in conformity with certain federal regulations.[15] State banks and state credit unions lending in reliance on the Parity Act must follow alternative mortgage transactions regulations issued by, respectively, the Comptroller of the Currency and the National Credit Union Administration. All other "housing creditors" must follow regulations issued by the OTS for alternative mortgage transactions.[16]

An "alternative mortgage transaction" is:

> a loan or credit sale secured by residential real property, a dwelling, the stock of a residential cooperative housing corporation or a residential manufactured home (i) in which the interest rate or finance charge may be adjusted or renegotiated, (ii) which involves a fixed-rate, but which implicitly permits rate adjustments, or (iii) involving any similar type of rate, method of determining return, term, repayment, or other variation not common to traditional fixed-rate, fixed-term transactions, defined by applicable regulation.[17]

The OTS regulation implementing the Parity Act specifically cross references and incorporates the OTS regulations authorizing reverse mortgages for federal thrifts, as described in Subparts A and B above.[18] Thus, reverse mortgages, including the Product, clearly constitute alternative mortgage transactions within the meaning of the Parity Act for housing creditors authorized to rely on the OTS regulations. The Parity Act thus preempts any state law that would prevent such housing creditors from

[14] 12 U.S.C.A. § 3802(2) (West 1989). See OTS Op. Chief Counsel, Oct. 20, 1995 (discussing when a lender will be deemed to regularly make loans).

[15] 12 U.S.C.A. §§ 3801(b) and 3803 (West 1989).

[16] 12 U.S.C.A. § 3803(a) (West 1989). The Parity Act "does not place non-federally chartered housing creditors under the supervision of the federal agencies, but instead merely enables them to follow a federal program as an alternative to state law." S. Rep. No. 97-463, 97th Cong., 2d Sess. 55 and 48 Fed. Reg. 23,032, 23,053 (May 23, 1983); see also 49 Fed. Reg. 43,040, 43,043 (October 26, 1984).

[17] 12 U.S.C.A. § 3802(1) (West 1989).

[18] 12 C.F.R. § 545.33(f).

originating the Product (including the equity share feature). There is one exception, however. The Parity Act gave states three years following its enactment to override, or to "opt out" of, its federal preemption.[19] Our conclusion would not apply to loans made in any "opt out" state.

D. Interest Rate Limitations

Finally, you have also asked us to confirm your view that federal law preempts the application of state interest rate limits to the Product.

Section 501 of the Depository Institutions Deregulation and Monetary Control Act of 1980 ("DIDMCA")[20] provides that:

> [t]he provisions of the constitution or laws of any State expressly limiting the rate or amount of interest, discount points, finance charges, or other charges which may be charged, taken, received, or reserved shall not apply to any loan, mortgage, credit sale, or advance, which is (a) secured by a first lien on residential real property; (b) made after March 31, 1980; and (c) described in section 527(b) of the National Housing Act (12 U.S.C. 1735f-5(b)) . . . .

However, states were permitted to "opt out" of this preemption provision within the three-year period beginning on April 1, 1980, and ending on March 31, 1983.[21]

[19] 12 U.S.C.A. § 3804(a) (West 1989).

[20] Pub. L. No. 96-221, 94 Stat. 132 (1980), codified at 12 U.S.C.A. § 1735f-7a(a)(1) (West 1989). See also 12 C.F.R. §590.3.

[21] 12 U.S.C.A. § 1735f-7a(b)(2)(West 1989). A savings association making a loan in any state that opted out of the preemption of 12 U.S.C.A. § 1735f-7a would be able to charge the highest rate permitted under (a) that state's usury laws or (b) the Most Favored Lender provision of 12 U.S.C.A. § 1463(g) (West Supp. 1996), provided the state has not opted out of the Most Favored Lender provision. See OTS Guidance at 9. The Most Favored Lender provision authorizes savings associations to charge interest on loans at the maximum rate authorized for any class of lender under the laws of the state where the association is located or at the rate of 1% above the Federal Reserve discount rate on 90-day commercial paper, thereby preempting any state law that might attempt to limit thrifts to lower interest rates. Should a loan meet the standards for interest rate preemption under both DIDMCA § 501 and the Most Favored Lender Doctrine, § 528 of DIDMCA provides that such loan may be made at the highest applicable rate, which under § 501 would be an unlimited rate. 12 U.S.C.A. § 1735f-7 and note (West 1989).

Thus, the Product will qualify for preemption under § 501, regardless of whether it is originated by a state- or federally-chartered lender, provided it meets the following four standards:

1. The loan must be made in a state that did not opt out of § 501;

2. The loan must be secured by a first lien on residential property;

3. The loan must be made after March 31, 1980; and

4. The loan must be a "federally related mortgage loan," which is defined for these purposes to include any loan that is (a) secured by residential real property,[22] and (b) is eligible for purchase by Fannie Mae.[23]

In reaching the foregoing conclusions, we have relied on the factual representations contained in the materials you submitted to us. Our conclusions depend upon the accuracy and completeness of those representations. Any material change in circumstances from those described herein could result in different conclusions.

[22] 12 U.S.C.A. § 1735f-7a(a)(1)(C)(i)(West 1989).

[23] Grunbeck v. Dime Savings Bank of New York, FSB, 74 F. 3d 331 (1st Cir. 1996), held that a state "simple interest" statute (i.e., a statute prohibiting the compounding of interest) was not preempted by DIDMCA § 501. The court indicated, however, that state simple interest statutes may be preempted by other federal laws. Thus, the court noted that state simple interest statutes would not apply to a state lender originating loans in conformity with the Parity Act. Id. at 343. OTS regulations also specifically authorize federal thrifts to capitalize interest on real estate loans. 12 C.F.R. § 545.32(b)(4). It is well established that OTS lending regulations have preemptive force. E.g., Conference of Federal Savings and Loan Associations v. Stein, 604 F.2d 1256, 1260 (9th Cir. 1979), aff'd mem., 445 U.S. 921 (1980); see also FHLBB Op. by Quillian, April 28, 1987. Thus, even in jurisdictions that follow Grunbeck, federal thrifts, as well as state lenders originating loans in conformity with the Parity Act, are not subject to state simple interest statutes. The lender in Grunbeck was a service corporation of a federal thrift that may or may not have complied with the Parity Act (this issue was not decided). Service corporations are not entitled to the same scope of preemption as federal thrifts, but may lend in reliance on the Parity Act. OTS Op. Chief Counsel (Oct. 17, 1994); FHLBB Op. by Williams, Nov. 21, 1988.

If you have any further questions regarding this matter, you may contact Evelyne Bonhomme, Counsel (Banking & Finance), at (202) 906-7052.

Very truly yours

Carolyn J. Buck
Chief Counsel

cc: All Regional Directors
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