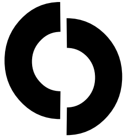

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #1015
February 2005

September 20, 2004

Subject: Indiana Law on Balloon Payment Consumer Loans

Dear [ ]:

This letter responds to your request for an opinion on whether [***NB***] and its operating subsidiaries, [ ] (***Opsub1***) and [ ] (***Opsub2***)[1] are subject to section 24-4.5-3-402 of the Indiana Code (section 3-402) when originating subordinate lien mortgages.[2] Section 3-402 places restrictions on the terms of balloon payment loans. For the reasons explained in this letter, we conclude that these restrictions do not apply to [***Bank&Subs***].

Background

[***NB***] has its main office in [***City***], Indiana. [***OpSub1***] and [***OpSub2***] are wholly owned operating subsidiaries of the bank. All three companies originate subordinate lien residential mortgage loans nationwide. In accordance with the national bank usury statute and OCC regulations,[3] [***Bank&Subs***] charges interest on its subordinate lien residential mortgage loans at the rate permitted by Indiana law.

[1] These three companies are collectively referred to in this letter as "[***Bank&Subs***]."

[2] *See* Letter from [ ], to Coreen Arnold, District Counsel for the Central District, Office of the Comptroller of the Currency (OCC) (September 11, 2003).

[3] 12 U.S.C. § 85 (authorizing national banks to charge interest at the rate allowed by the laws of the state where it is located); 12 C.F.R. § 7.4001 (OCC's regulation implementing section 85).

Section 3-402 provides that a debtor has the right to refinance, without penalty, the amount of a balloon payment on a consumer loan at the time the payment is due.[4] If the debtor elects to refinance, the bank must offer terms that are no less favorable than the terms in the original loan. Section 3-402 provides as follows:

> (1) With respect to a consumer loan, other than one pursuant to a revolving loan account or one on which only loan finance charges are payable prior to the time that the final scheduled payment is due, if any scheduled payment is more than twice as large as the average of earlier scheduled payments, the debtor has the right to refinance the amount of that payment at the time it is due without penalty. The terms of the refinancing shall be no less favorable to the debtor than the terms of the original loan. This section does not apply to the extent that the payment schedule is adjusted to the seasonal or irregular income of the debtor.
>
> (2) For the purposes of this section, "terms of the refinancing" means:
> (a) In the case of a fixed-rate consumer loan, the individual payment amounts, the charges as a result of default by the debtor, and the rate of the loan finance charge; and
> (b) In the case of a variable rate consumer loan, the method used to determine the individual payment amounts, the charges as a result of default by the debtor, the method used to determine the rate of the loan finance charge, the circumstances under which the rate of the loan finance charge may increase, and any limitations on the increase in the rate of the loan finance charge.

The effect of these provisions is to require the lender to refinance consumer loans, including home equity loans, that have a balloon payment feature and to restrict the permissible terms of the refinancing to those "no less favorable to the debtor" than the terms of the original loan. To answer your question whether these restrictions apply to **[*Bank&Subs*]**, we first review national banks' authority to engage in real estate lending, then discuss our regulation and precedents concerning the applicability of state law restrictions on the terms under which a national bank makes balloon loans.

Discussion

Federal law authorizes national banks to engage in real estate lending activities and vests in the OCC comprehensive authority to regulate and supervise those activities:

> Any national banking association may make, arrange, purchase or sell loans or extensions of credit secured by liens on interests in real estate, subject to section 1828(o) of this title and such restrictions and

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[4] For purposes of section 3-402, the term "consumer loan" includes subordinate lien residential mortgage loans. Ind. Code § 24-4.5-3-104.

> requirements as the Comptroller of the Currency may prescribe by regulation or order.[5]

The authority granted by section 371 to make loans "secured by liens on interests in real estate" includes the authority to make subordinate lien residential mortgage loans, such as home equity loans, on such terms as are permissible under Federal law and regulations.

Part 34 of the OCC's regulations implements section 371. Part 34 authorizes national banks and their operating subsidiaries to engage in real estate lending activities.[6] In addition, Part 34 contains provisions listing certain types of state laws that do not apply to a national bank's conduct of such activities. In particular, section 34.4(a)(4) of the regulation provides that a national bank may make real estate loans under 12 U.S.C. § 371 and § 34.3 of our rules without regard to state law limitations concerning:

> The terms of credit, including schedule for repayment of principal and interest, amortization of loans, balance, payments due, minimum payments, or term to maturity of the loan, including the circumstances under which a loan may be called due and payable upon the passage of time or a specified event external to the loan.[7]

The provisions of section 3-402 fall within the scope of § 34.4(a)(4) in that both provisions impose limitations on the terms of credit extended by a national bank. First, the provision entitling a borrower to refinance a loan with a balloon repayment feature in effect operates to add a term to the original loan, that is, a guarantee to the borrower that the original loan will be refinanced without penalty. It precludes the lender from offering a loan that does not, in effect, include an option to the borrower to refinance. Thus, the schedule for repayment of principal and interest is modified and the effective maturity of the loan is extended, at the option of the borrower, by operation of the Indiana law. Second, the requirement that the "terms" of the refinancing be "no less favorable" to the borrower than those of the original loan in so many words precludes the lender from extending the new credit on terms that reflect, for example, deterioration in credit quality on account of changes in the borrower's ability to repay. Accordingly, section 3-402 of the Indiana law is preempted.

Section 34.4(a)(4) was adopted in its current form on January 13, 2004. It took effect on February 12, 2004. Your request was submitted during the pendency of that rulemaking and was therefore based on the OCC's rules in effect at that time and supported by prior opinion letters

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[5] 12 U.S.C. § 371(a). *See also* 12 U.S.C. § 24(Seventh) (authorizing national banks to engage in "all such incidental powers as shall be necessary to carry on the business of banking….").

[6] *See* 12 C.F.R. § 34.3 (authorizing national banks to engage in real estate lending activities); § 34.1(b) (expressly providing that Part 34 applies to national banks and their operating subsidiaries). *See also id.* at § 7.4006 (providing that state laws apply to national bank operating subsidiaries to the same extent as they apply to the parent national bank).

[7] 69 Fed. Reg. 1904, 1917 (January 13, 2004) *(codified* at 12 C.F.R. § 34.4(a)(4)).

issued by the OCC. While our conclusion that section 3-402 is preempted is based on current § 34.3(a)(4), we note that the conclusion would have been the same under our prior rules and precedents.

Before we adopted current § 34.4(a)(4), the OCC had a similar regulation, providing that a national bank was authorized to make real estate loans without regard to state law limitations concerning, among other things, "the schedule for the repayment of principal and interest," or "the term to maturity of the loan."[8] These phrases are identical to phrases that appear in current § 34.4(a)(4). We have previously construed them to preempt state law restrictions on balloon loans.

In 1983, we considered a Massachusetts law prohibiting mortgage loans containing a balloon payment or demand feature, except when such feature was at the option of the borrower.[9] We concluded that the Massachusetts restrictions constituted a limitation on the schedule for repayment of the principal and interest of the loans and, therefore, were preempted expressly by part 34. For the same reasons, we deemed preempted the balloon payment restrictions of Colorado law, which entitled consumers to refinance balloon payments in consumer loans,[10] and Pennsylvania law, which prohibited banks from making residential loans with demand or balloon payment features.[11] Most recently, in the OCC's Determination and Order concerning the Georgia Fair Lending Act (GFLA),[12] issued to National City in August 2003, we considered Georgia law, which requires that no scheduled payment on a high-cost loan be more than twice as much as the average of earlier scheduled payments, thus precluding the inclusion of a balloon

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[8] 12 C.F.R. § 34.4(a)(2) and (a)(3) (2003) (provisions in effect prior to the amendment of Part 34 in January 2004). In 2003, section 34.4(a) provided in relevant part as follows:

> A national bank may make real estate loans under section 371 and 34.3 without regard to State law limitations concerning:
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> (1) The amount of a loan in relation to the appraised value of the real estate;
> (2) The schedule for the repayment of principal and interest;
> (3) The term to maturity of the loan;
> (4) The aggregate amount of funds that may be loaned upon the security of real estate; and
> (5) The covenants and restrictions that must be contained in a lease to qualify the leasehold as acceptable security for a real estate loan.

[9] Letter from Peter Liebesman, Assistant Director, OCC, to [
] (December 8, 1983); *see also* Letter from Charles F. Byrd, Assistant Director, OCC, to [
] (August 24, 1987) (reaching same conclusion with respect to another portion of Massachusetts law that obligated a lender making first mortgage loans with balloon features to renew or extend a loan on the request of a borrower).

[10] Letter from Jonathan L. Levin, Senior Attorney, OCC, to [
] (September 27, 1984) (Levin Letter) (citing 12 C.F.R. § 34.2, which subsequently was relocated without substantive change to what is now § 34.4).

[11] Letter from William B. Glidden, Assistant Director, OCC, to [ ] (September 30, 1992).

[12] 68 Fed. Reg. 46264 (August 5, 2003).

repayment term for certain types of loans. In the Determination and Order, we stated that these restrictions on balloon lending were preempted as state laws concerning the repayment of principal and interest because they operated to limit the "inherent and inseparable elements of any repayment schedule," which are (1) the timing of the expected payments, and (2) the amount of the expected payments.[13]

For all of these reasons, we conclude that the scope of current § 34.4(a)(4) covers section 3-402 of the Indiana law. Accordingly, the provisions of Indiana's section 3-402 – requiring the refinancing of a balloon loan[14] and restricting the terms of the refinancing to terms no less favorable than those in the original loan – do not apply to **[*Bank&Subs*]**.[15]

Comments by the Indiana Department of Financial Institutions (IDFI)

Your request raises issues of Federal preemption of state law that, as we have described, are already addressed by § 34.4 of our regulations, which was issued pursuant to the notice and comment procedures prescribed by the Administrative Procedure Act.[16] These issues also are essentially identical to issues on which the OCC has previously issued opinion letters. Accordingly, the publication requirements of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 do not apply.[17]

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[13] *Id*. at 46276.

[14] We note that the Indiana statute also is inconsistent with the standards in Part 34 that are designed to ensure safety and soundness and deter predatory lending. For example, part 34 of the OCC's regulations prohibits a national bank from making a consumer loan (which includes second-lien residential mortgage loans) "based predominantly on the bank's realization of the foreclosure or liquidation value of the borrower's collateral, without regard to the borrower's ability to repay the loan according to its terms." 69 Fed. Reg. at 1917 (*to be codified at* 12 C.F.R. § 34.3(b)). *See also* 12 C.F.R. § 34.62(b)(2)(ii) (requiring that real estate lending be conducted in accordance with bank lending policies that establish "prudent underwriting standards"). The Indiana law requires that new credit be extended with no new underwriting. Thus, the Indiana law precludes the lender from making a credit decision on the refinancing of a second-lien mortgage loan based on the borrower's ability to repay or on other applicable underwriting standards and from adjusting the terms of the loan to address changes in the borrower's ability to repay.

[15] **[*Bank&Subs*]** may charge interest at the maximum rate allowed by the State of Indiana to any state-chartered or licensed lending institution. 12 C.F.R. § 7.4001(b). Given that section 3-402 is preempted under the provisions of Part 34, the bank is under no legal obligation to refinance a balloon loan. Therefore, we do not need to reach the question of whether Indiana's restrictions on the terms of refinancing that relate to the rate of that refinancing, charges as a result of default by the borrower, and, if it is a variable rate loan, requirements relating to the changing of the rate, are applicable to **[*Bank&Subs*]** under section 85. If **[*Bank&Subs*]** voluntarily chooses to refinance a balloon payment, the bank could charge the most favored lender rate and not be bound by the preempted state law that would have imposed terms no less favorable than the prior loan agreement.

[16] 5 U.S.C. § 553.

[17] *See* 12 U.S.C. § 43.

However, we provided the State of Indiana with a copy of your letter and afforded the State an opportunity to respond. The IDFI's views, [18] and our responses thereto, are as follows.

The IDFI noted its disagreement with **[*Bank&Subs*]**'s proposed position on preemption of Indiana law on balloon lending. The IDFI maintains that neither paragraph (2) nor (3) of former § 34.4(a) refers to the ability of national banks to make balloon loans, and that "[b]anks are free to structure their loans as they see fit," notwithstanding section 3-402.[19] We must disagree, since, as previously described, section 3-402 effectively adds a term to the original second mortgage loan guaranteeing the borrower the option to refinance without charge. Moreover, it precludes the use of certain terms – those that are "less favorable" to the borrower than the original loan – in the refinancing. While a bank arguably could continue to make balloon loans under section 3-402, section 3-402 limits the terms on which it can do so. Accordingly, a bank is not free to structure its loans in ways other than those permissible under the Indiana statute.

The IDFI takes the position as well that, even if the law is preempted as to banks, it is not preempted with respect to operating subsidiaries. The IDFI suggests that, because § 34.4 does not explicitly refer to operating subsidiaries, the preemption provisions set out therein apply only to national banks.[20] However, as we have pointed out, 12 C.F.R. § 34.1(b) expressly provides without qualification that "this part" – that is, the whole of Part 34 – "applies to national banks and their operating subsidiaries." In addition, § 7.4006 of our regulations says:

> Unless otherwise provided by Federal law or OCC regulation, State laws apply to national bank operating subsidiaries to the same extent that those laws apply to the parent national bank.

These regulations are based on the longstanding recognition, under Federal law, of the functional identity of operating subsidiaries and their parent banks. As a matter of Federal law, operating subsidiaries conduct only activities permissible for the parent national bank,[21] and their

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[18] Letter from Charles W. Phillips, Director, Indiana Department of Financial Institutions, to Coreen Arnold, Direct Counsel, Central District, OCC (November 7, 2003).

[19] The IDFI's letter was prepared before the OCC adopted § 34.4 in its current form. The references in the IDFI's letter are thus to the provisions of the former rule providing that Federal law preempts state law limitations concerning the schedule for the repayment of principal and interest and concerning the term to maturity of a loan. For the text of former § 34.4, *see supra* note 8.

[20] The IDFI supports its position by referring to the Conference Report on the Riegle-Neal Interstate Branching and Bank Efficiency Act of 1994 (Riegle-Neal), in which the conferees discussed the interest of the states in the activities and operations of banks. While we disagree with the IDFI's construction of Riegle-Neal and its legislative history (*e.g.,* as the conferees indicated, Riegle-Neal did not alter established standards for preemption, *see* H.R. Conf. Rep. No. 103-651 at 53 (1994)), we need not reach Riegle-Neal, given that the it concerns application of state laws to interstate branches. In the case at hand, Indiana is the home state of **[*Bank&Subs*]** .

[21] 12 C.F.R. § 5.34(e)(1). The rule specifies the licensing process through which national banks seek OCC permission to conduct business by means of an operating subsidiary. 12 C.F.R. § 5.34(b).

activities are subject to the same terms and conditions as apply to the parent bank.[22] Operating subsidiaries are consolidated with – that is, their assets and liabilities are indistinguishable from – the parent bank for accounting purposes, regulatory reporting purposes, and for purposes of applying many Federal statutory or regulatory limits.[23] Courts have treated operating subsidiaries as equivalent to national banks in determining their powers and status under Federal law,[24] except where Federal law requires otherwise. When established in accordance with OCC regulations and approved by the OCC, an operating subsidiary is a federally authorized and federally licensed means by which a national bank may conduct federally authorized activities. Consistent with these authorities, the provisions of § 34.4 apply to real estate lending conducted by national banks either directly in the bank or indirectly through an operating subsidiary. For the reasons set forth in this letter, **[*Bank&Subs*]** may originate subordinate lien mortgages with balloon features without regard to the restrictions of section 3-402 of the Indiana law.

I trust that this letter responds to your inquiry.

Sincerely,

/s/ *Julie L. Williams*

Julie L. Williams
First Senior Deputy Comptroller and Chief Counsel

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[22] In conducting permissible activities on behalf of its parent bank, the operating subsidiary is acting "pursuant to the same authorization, terms and conditions that apply to the conduct of such activities by its parent national bank." 12 C.F.R. § 5.34(e)(3). This text echoes a Congressional characterization in recent legislation, where Congress made reference to national bank operating subsidiaries as engaged "solely in activities that national banks are permitted to engage in directly and are conducted subject to the same terms and conditions that govern the conduct of such activities by national banks." Section 121 of the Gramm-Leach-Bliley Act (GLBA), Pub. L. 106-102, section 121, 113 Stat. 1338, 1373 (1999), *codified at* 12 U.S.C. 24a(g)(3)(A). *See Wachovia Bank v. Burke*, 319 F. Supp.2d 275, 280 (D. Conn. 2004) (ability of national bank to conduct activities through operating subsidiary implicitly recognized by Congress); *see also Wachovia Bank v. Watters,* 2004 WL 1948655, at *5 (W.D. Mich. Aug. 30, 2004) (upholding OCC rule providing that state laws apply to operating subsidiaries to the same extent that those laws apply to the parent national bank in context of assertion of visitorial powers by the State of Michigan); *Wells Fargo Bank v. Boutris,* 265 F. Supp. 2d 1162, 1167-1170 (E.D. Cal. 2003) (same in case concerning assertion of visitorial powers by the State of California); *National City Bank of Indiana v. Boutris,* 2003 WL 21536818 at *3 (E.D. Cal. July 2, 2003) (same).

[23] *See, e.g.,* 12 C.F.R. § 5.34(e)(4) (requiring application of, *e.g.,* statutory lending limit and limit on investment in bank premises to a national bank and its operating subsidiaries on a consolidated basis); 12 U.S.C. §371c(b)(2)(A); 12 C.F.R. § 223.3(w) (exclusion of operating subsidiaries from restrictions on transactions with affiliate).

[24] *NationsBank of North Carolina, N.A. v. Variable Annuity Life Ins. Co.,* 513 U.S. 251 (1995) (sale of annuities by operating subsidiary); *Clarke v. Securities Industry Ass'n*, 479 U.S. 388 (1987) (securities brokerage operating subsidiary); *American Ins. Ass'n v. Clarke*, 865 F.2d 278 (D.C. Cir. 1988) (bond insurance subsidiary); *M & M Leasing Corp. v. Seattle First Nat'l Bank,* 563 F.2d 1377 (9th Cir. 1977), *cert. denied,* 436 U.S. 956 (1978)(auto leasing subsidiary); and *Valley Nat'l Bank v. Lavecchia*, 59 F. Supp. 2d 432 (D. N.J. 1999) (title insurance subsidiary); *Budnik v. Bank of America Mortgage,* 2003 U.S. Dist. LEXIS 22542 (N.D. IL 2003) (mortgage subsidiary).