May 1, 1987

RE: Code Prohibition on pre-payment penalties (§2-509) and Federal Housing Administration Mortgages

A mortgage lender has posed a question relating to the interplay of certain Federal Housing Administration (FHA) regulations on prepayment and §2-509 of the Maine Consumer Credit Code which prohibits prepayment penalties. The thrust of the questions is whether or not Maine law has been preempted by the relevant FHA regulations.

Various Parts of FHA Regulations on the FHA-Insured Single Family Mortgage Program (Parts 203, 213, 222 and 234 of 24 CFR) prior to August 2, 1985 required mortgagors to provide at least 30 days' written notice of intent to prepay mortgages insured under that program. Because prepayment was also only permitted on installment due dates, this rule had the effect of requiring mortgagors to pay up to 60 days' worth of extra interest, depending upon when prepayment occurred. Because of growing objection to the unfairness this practice worked on consumers, the FHA amended the rule, dropping the 30-day notice requirement. After August 2, 1985 mortgagers could only require consumers to pay interest to the next installment due date (50 FR 25919, June 24, 1985).

The questions posed by the mortgage lender reduce themselves to this: a) is any interest paid after the date of prepayment, pursuant to FHA regulations (whether to the next installment due date on post-August 2, 1985 loans, or to the next installment due date plus 30 days on pre-August 2, 1985 loans), a prepayment penalty under §2-509 of the Code? b) is §2-509 of the Code preempted by the FHA Regulations? The Bureau answers both questions in the affirmative.

I. EXTRA INTEREST WHICH MAY BE RECOVERED UNDER FHA REGULATIONS IS A PREPAYMENT PENALTY PROHIBITED BY THE CODE.

Section 2-509 provides:

> Subject to the provisions on rebate upon prepayment, section 2-510 [not relevant here], the consumer May prepay in full the unpaid balance of penalty, except for minimum charges as permitted by law.

Because non-bank mortgage lenders are not exempt from the application of §2-509 to their mortgage products under §1-202(8), the prohibition on prepayment penalties would appear to apply. (It should be noted, however, that the Code only applies to real estate-secured transactions with rates in excess of 12¼% (§1-301(11), (14)) or which have the capacity to exceed 12¼% (AR # 45).)

The first question to be resolved is whether or not the extra interest under the FHA regulations is a "prepayment penalty." The Code does not define the term; however, guidance is found in the Commentary to Regulation Z and from relevant case law. The fifth update to the Commentary, effective April 1, 1986, makes it clear in §226.18(k)(1)-1, that for disclosure purposes, a prepayment penalty is any amount imposed when paying early that would not have to be paid if

the loan were paid at maturity. Relevant case law reaches the same result on a contractual analysis basis. Schmidt v. Interstate Federal S & L Ass'n, 421 F. Supp. 1016, (D.D.C. 1976); Goldman v. First Federal Savings & Loan Ass'n of Wilmette, 518 F. 2d 1247 (7th Cir. 1975). In light of these precedents, the Bureau finds that the extra interest allowed to be assessed under FHA regulations is a prepayment penalty.

II. SECTION 2-509 OF THE CODE IS PREEMPTED AS TO FHA INSURED MORTGAGES BY APPLICABLE FEDERAL LAW.

The next question is whether or not these prepayment penalties are exempt as "minimum charges...permitted by law" under §2-509, or are permissible under some other law. The only permissible minimum charges the Code appears to authorize are found in §2-201(6) and §2-401(7), which involve minimum finance charges in small credit sales and loans, obviously not applicable here. A review of the relevant provisions of federal housing law, however, discloses preemptive language which should be dispositive of the question. 12 USC §1709-la provides a general preemption of State mortgage usury law involving certain federally insured mortgages. Specifically, the statute provides, in pertinent part:

> (a) The provisions of ... any law of [a] State expressly limiting the amount of interest which may be charged, taken, received or reserved shall not apply to-
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> (1) Any loan or mortgage which is secured by one-to-four family dwelling and which is (A) insured under subchapter I or II of this chapter [the statutory authority for the FHA regulations in question]....
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> (b) The provisions of this section shall apply to such loans, mortgages or other interim financing made or executed in any State until the effective date (after June 30, 1976) of a provision of law of that State limiting the amount of interest which may be charged, taken, received or reserved on such loans, mortgages, or financings.

To the Bureau's knowledge the State of Maine has not overridden the federal preemption of its usury laws and related provisions set forth in 12 USC §1709-la. Because of the effect of the general preemption worked by that section, any impact §2-509 would have on a non-bank mortgage lender's practices in collecting interest authorized under FHA regulation, is nullified. In short, §2-509 is preempted with regard to the FHA loan products identified in this Advisory Ruling.

/s/ Robert A. Burgess
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RAB/lm