Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

October 7, 1997

Interpretive Letter #803
October 1997
12 U.S.C. 85

Dear [ ]:

This letter responds to your inquiry asking whether certain fees levied by [ ] (the Bank) in connection with home equity loans constitute"interest" for purposes of 12 U.S.C. § 85 (section 85) as that term is defined in 12 C.F.R. § 7.4001(a) (section 7.4001(a)). If the fees constitute "interest" and if they are permitted by the state where the national bank is located, then section 85 provides authority to the national bank to charge those fees to borrowers who reside in another state even if that other state prohibits the imposition of a particular fee in connection with home equity loans.

As more fully described below, the fees about which you inquire are (1) an account opening fee, (2) a fee for exercising a fixed rate option, (3) a fee for prepaying a fixed rate option, (4) a fee for early closure of the account, and (5) rejected item fees imposed in a variety of situations. For the reasons set forth in detail below, it is our view that the first four categories of fees constitute "interest" for purposes of section 85 and section § 7.4001(a) as upheld by the United States Supreme Court. See Smiley v. Citibank (South Dakota) N.A., 135 L.Ed.2d 25 (1996) (Smiley). Likewise, except for fees imposed on items presented following termination of a home equity account, the fees in category 5 -- rejected items fees -- also would constitute interest. The fees constituting interest may be assessed by a national bank if similar charges may be imposed by another lender in the state where the national bank is located without reference to whether these fees are denominated as "interest" under state law. See 12 U.S.C. § 85; 12 C.F.R. § 7.4001(c). These fees also may be charged without reference to whether they are permissible under the laws of another state where the borrower may reside. See Marquette National Bank of Minneapolis v. First of Omaha Service Corp., 439 U.S. 299 (1978).[1] Rejected items fees imposed based on the presentation of items

[1] You have asked us to assume in answering this question that the bank's main office state rate applies because no state other than the main office state has any connection with the

following the termination of an account are governed by 12 C.F.R. § 7.4002 which applies to noninterest charges and fees.

Background[2]

As we understand it, the Bank offers home equity secured, variable rate, open-end lines of credit (the home equity account or the line of credit). Borrowers may draw on the line of credit during a 10-year period and then have an additional 15 years to repay the outstanding balance. You have advised us that terms used by the bank include an annual fee for the first 10 years, and an account closing charge if the borrower closes the line within the first three years unless the property that secures the loan is sold.[3] One feature of the home equity account is that it permits the borrower, at his or her option, to obtain fixed rate advances that are repayable in regular monthly installments over a fixed term. If this option is exercised by the borrower, the Bank charges a fee for exercising the fixed rate option and also charges a fee for prepaying an advance received pursuant to the exercise of the fixed rate option. In addition, the Bank charges fees for rejected items, that is, items that are presented by the customer for payment from the home equity account and which are not, for a variety of reasons, paid by the Bank. You state that items might be rejected if the home equity account has been suspended or terminated (either by the borrower or the Bank[4]), if the advance would

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loans other than the fact the borrowers, and the residence that secures the loan, will be located in various states. Consequently, you have not asked us to address any issues about which state's interest rate law applies to loans made by an interstate national bank which has taken action with respect to a loan in a state, other than its main office state, in which it has branches. See, e.g., Interpretive Letter No. 686, September 11, 1995, reprinted in [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-001.

[2] The facts, as set forth in this response, are based on your letter dated August 6, 1997, and telephone conversations between you and a member of my staff.

[3] You have advised us that, while fees may vary in different loan programs, a representative annual fee would be about $65 per year which, under the terms of the home equity account agreement, could be adjusted over the 10 year period to increase by up to five percent per year. A representative prepayment penalty would be $500. No prepayment fee is imposed if the line is closed after three years or if the property securing the loan is sold during the first three years.

[4] The circumstances under which a bank may terminate or suspend a home equity line of credit are set forth in Regulation Z at 12 C.F.R. § 226.5b(f)(2) and (3). A creditor may terminate a plan and demand repayment of the outstanding balance in advance of the original term if there is fraud or material representation by the consumer in connection with the line of credit, the consumer fails to meet the repayment terms or any action or inaction by the consumer adversely affects the creditor's security or any right of the creditor in such security.

cause the outstanding balance to exceed the customer's credit line or if the attempted draw was for less than the required minimum advance.

You have asked whether the fees described above are interest for purposes of section 85, as defined in section 7.4001(a) and, thus, can be charged by the Bank no matter where the borrower resides.

Discussion

A. The Statute

Interest rates that national banks may charge generally are governed by 12 U.S.C. § 85 which provides, in pertinent part, that "Any association may . . . charge on any loan . . . interest at the rate allowed by the laws of the State . . . where the bank is located. . . ."

You have represented that the law of the relevant state permits the fees about which you inquire. Therefore, these fees may be imposed by national banks under the authority of section 85 irrespective of the state of residence of the borrower if they are "interest" within the meaning of section 85. See Marquette National Bank of Minneapolis v. First of Omaha Service Corp., 439 U.S. 299 (1978).

B. The Regulation

OCC regulations define "interest" for purposes of section 85 and set forth a nonexclusive list of examples of fees that constitute interest. This regulation states:

> The term 'interest' as used in 12 U.S.C. § 85 includes any payment compensating a creditor or prospective creditor for an extension of, credit, making available of a line of credit, or any default or breach by a borrower of a condition upon which credit was extended. It includes, among other things, the following fees connected with credit extension or availability: numerical periodic rates, late fees, not sufficient funds (NSF) fees, overlimit fees, annual fees, cash advance fees, and membership fees. It 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.

Id. at (f)(2). Paragraph (f)(3) sets forth a variety of circumstances in which a creditor may suspend further draws against a home equity line including, among others, a period during which the value of the dwelling that secures the line declines significantly below its appraised value. Id. At (f)(3)(vi)(A). As you have described it, accounts subject to suspension remain open; if and when circumstances change additional draws may be made.

12 C.F.R. § 7.4001(a). The United States Supreme Court unanimously upheld this ruling last year in the context of a case in which plaintiffs argued that late fees were not properly considered to be interest for purposes of section 85 and, thus, not subject to exportation. See Smiley.

C. Applicability of the regulatory definition of 'interest' to the fees at issue

We note that, as recognized and upheld by the Supreme Court in Smiley, section 7.4001(a) draws a line between charges that fit within the definition of interest and "all other payments." Included in the regulation's list of non-interest charges are 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. The Supreme Court explicitly upheld this distinction stating:

> [I]t seems to us quite possible and rationale to distinguish, as the regulation does, between those charges that are *specifically assigned* to such expenses and those that are assessed for simply making the loan, or for the borrower's default. In its logic, at least, the line is not 'arbitrary [or] 'capricious' . . . .

Smiley at p. 32 (emphasis in original). The following discusses the applicability of section 7.4001(a) and the Supreme Court's decision in Smiley to the various fees about which you inquire.

1. Account opening and fixed rate option fees

It is clear that an account opening fee and a fee for exercising a fixed rate option would constitute "interest" for purposes of section 85. As you have described the account opening fee, we understand that it is imposed simply for making available a line of credit and provide compensation to the Bank in addition to periodic interest charges assessed on outstanding balances. Thus, it clearly constitutes "payment compensating a creditor . . . for an extension of credit . . ." and just as clearly *does not* constitute a charge that "is specifically assigned" to cover the cost of an activity or service, such as those listed in section 7.4001(a), pertinent to making the loan.

The history of section 7.4001(a) provides further support for this conclusion. The OCC has been explicit that the examples of fees considered to be "interest" do not constitute an exclusive list. As stated in the general rule set forth in section 7.4001(a), "interest" includes *"any payment"* to a creditor for an extension of credit or any default or breach of a condition by a borrower. Moreover, in adopting section 7.4001(a), the OCC stated in the preamble,

"the ruling is not intended to be a comprehensive treatment of the issue, and other fees or charges may also be found to be components of interest." 61 Fed. Reg. at 4859.[5]

Moreover, the preamble explaining the proposed revisions to section 7.4001 makes it clear that the OCC intended to revise the OCC's prior ruling in Part 7 pertaining to interest rates on loans to "reflect current law and OCC interpretive letters." 60 Fed. Reg. at 11,1929.[6] As the OCC stated in that preamble:

> Although the exportation principle of section 85 is well-established in case law, the application of section 85 is still the subject of court challenges, usually over whether a particular fee or charge imposed by a bank located in a given state is properly characterized as 'interest' and is thus 'exportable' to a different state . . . . [Citations omitted.]
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> The OCC has addressed, through interpretive letters, the issue of what fees or charges may be considered 'interest.' Most recently the OCC summarized its previous opinions and concluded that in addition to periodic percentage rates, charges consisting of late charges, annual fees and overlimit charges are included within the meaning of 'interest' as used in section 85. Thus, if they are permissible for lenders to impose under the laws of the state where a bank is located, they may be charged and 'exported' . . . . See Letter from Julie L. Williams to John Douglas, dated February 17, 1995 (the 1995 letter).[7]

Id. The analysis in the 1995 letter underlies the general definition of "interest" now set forth in the first sentence of section 7.4001(a); that is, "any payment compensating a creditor or prospective creditor for an extension of credit, making available a line of credit, or any default or breach by a borrower of a condition upon which credit was extended." Application of that analysis to account opening fees and fixed payment option fees provides added support that those fees fit within the newly codified definition of "interest."

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[5] The preamble to the notice of proposed rulemaking stated the same position with regard to the nonexclusivity of the list. See 60 Fed. Reg. 11,924, 11929 (March 3, 1995).

[6] A similar statement also appears in the preamble to the final regulation. See 61 Fed. Reg. 4859. The Supreme Court in Smiley acknowledged this reliance by the OCC on its precedents in formulating the regulation. Smiley at p. 32.

[7] The 1995 letter is Interpretive Letter No. 670, reprinted in [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,618. This letter reviews in detail the principles underlying section 85 including the most favored lender doctrine, the fact that the term "interest" as used in section 85 calls for a federal definition and is to be construed broadly, and provides for the exportability of interest. That analysis is incorporated into this letter.

The 1995 letter analyzed whether annual fees, late charges, and overlimit charges constituted "interest" within the meaning of section 85. The analysis emphasized that each type of charge constituted compensation to the bank for the use of its money. With respect to annual fees, the 1995 letter stated that banks apply annual fees to credit card transactions:

> as an alternative to higher monthly percentage finance charges on outstanding balances, and to compensate the bank for other costs and risks associated with establishing and maintaining the account. Annual fees fit squarely within the traditional definition of 'interest': 'compensation . . . fixed by the parties, for the use or forbearance of money, or as damages for its detention.' [Footnote and citation omitted.]

Similarly, the 1995 letter noted that late charges, imposed against borrowers who are delinquent in their payments, and overlimit fees, imposed when a customer's draws on an account exceed the amount the bank has agreed to advance, compensate the bank for risks undertaken in connection with the use of its money.

Likewise, account opening fees and fixed payment option fees are an alternative to higher monthly percentage finance charges and, like periodic interest charges, are part of the compensation that the Bank receives in connection with lending its money to a borrower. In addition, we note that the fixed payment option charge helps compensate the Bank for risks incurred in foregoing the variable rate feature and extending credit based on a fixed rate of interest.[8]

2. Fees for prepaying a fixed rate option and for early closure of the account

The OCC already has recognized that a prepayment fee assessed when a borrower prepays a home equity loan constitutes interest under section 7.4001(a). See Interpretive Letter No. 744, August 21, 1996, reprinted in [1996-1997 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-109 (the 1996 letter). Based on the analysis set forth in that letter, which is fully incorporated and relied upon in this letter, we likewise conclude that prepayment fees levied upon borrowers who make early repayments of advances obtained pursuant to the fixed rate option, as you have described, constitute "interest" under section 7.4001(a) for purposes of section 85.

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[8] In addition, we note that the fixed payment option fees, levied at the time that a borrower draws against his or her line of credit and elects the fixed rate, fixed term option, instead of the usual open end, variable rate alternative can be analogized to a cash advance fee which is specifically listed in section 7.4001(a) as a fee that is considered to be "interest" for purposes of section 85. That this fee is not levied in connection with all draws against the account is not relevant -- it is, in fact, a cash advance fee where the cash advance is made pursuant to certain terms of the line of credit agreement between the Bank and the borrower.

Similarly, we conclude that the fee for early closure of the home equity account constitutes interest. As discussed in the 1996 letter, "prepayment fees constitute compensation to the bank, in the form of an alternative to higher finance charges, for the risk that an extension of credit will be repaid prior to the maturity date on which the interest rate was predicated."[9] We conclude that a similar principal applies to the early closure fee that you describe. As discussed, when the Bank extends the line of credit under the terms that you have described, it anticipates, at a minimum, that it will receive interest in the form of annual fees for at least a 10 year period. The early closure fee, like the prepayment penalty fee, compensates the Bank for the risk that the borrower may choose to close the account prior to the expiration of the ten year period and the Bank will not receive the income it anticipated in extending the line of credit.

3. Rejected items fees

You also have asked whether a $10 fee imposed by the Bank when it rejects an attempted draw by the borrower constitutes interest for purposes of section 85. The reasons that you cite for rejecting a draw are that the account has been suspended or terminated as described previously, the draw would cause the outstanding balance to exceed the borrower's credit line or the attempted draw is less than the minimum draw that can be made by the borrower under the terms of the credit agreement. As stated, the definition of "interest" in section 7.4001(a) includes "any payment compensating a creditor or prospective creditor for an extension of credit, making available a line of credit, or any default or breach by a borrower of a condition upon which credit was extended."

When developing a particular loan product and setting its terms, it is reasonable for a bank to expect that the borrower, entering into that loan agreement, will comply with those terms and for the bank to base its interest charges on the expectation of compliance with those terms by the borrower. Thus, as was recognized in the 1996 letter concerning prepayment fees, a lender may base its charges on the expectation that the loan will be repaid over the term of the loan stipulated by the contract. However, as that letter determined, if earlier repayment is

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[9] As at least one court has noted:

> By accepting prepayment, the bank relinquished its right to receive anticipated earnings on the money loaned, and was faced prematurely with the reinvestment of a large sum of money, with the additional expenses thereof and the vagaries of the money market at the time.

See Northway Lanes v. Hackley Union National Bank and Trust Company, 334 F. Supp. 723, 732 (W.D. Mich. 1971), aff'd, 464 F.2d 855 (6th Cir. 1972). Because plaintiff's in this case altered their argument on appeal regarding the permissibility of prepayment fees, the appellate court did not have to, and did not, opine on the district court's analysis of this issue.

made, the prepayment fee levied by the lender is considered to be "interest" for purposes of section 85 and section 7.4001(a). Likewise, the OCC has recognized in section 7.4001(a) that other fees, such as late fees, overlimit fees, and nonsufficient fund fees, are considered interest for purposes of section 85. See also the 1995 letter. Similarly, though no money is advanced in connection with rejected items,[10] these fees compensate the lender for a borrower's actions in connection with an extension of credit which are contrary to the terms of the credit agreement and which are not otherwise taken into account by the lender in establishing the other components of the interest applicable to the extension of credit. Consequently, we conclude that where a borrower presents for payment against the home equity account an item that is rejected because the advance would cause the balance to exceed the outstanding credit line, or the attempted draw was for less than the amount permitted under the terms of the agreement between the lender and the borrower or the account has been suspended, as described above, the rejected item fee constitutes interest under section 7.4001(a) and section 85.[11] Where, however, an item is presented against an account that has been terminated, either

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[10] In this regard, we note that the rejected items fees are similar to the nonsufficient funds charges levied by lending banks for the return of dishonored checks presented in payment of a loan. These fees were recognized as "interest" by the OCC in Interpretive Letter No. 85,676, August 11, 1988, reprinted in [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,676 and this determination was codified in section 7.4001(a).

[11] Our determination that rejected items fees constitute interest within the meaning of section 7.4001 also is consistent with the holding of the one court that considered the question of what constitutes a "breach" of a condition under which credit was granted. See Doe v. Norwest, 107 F.3d 1297 (8th Cir. 1997). That case involved a failure by the borrower to maintain insurance on the collateral for a loan which, under the terms of the loan agreement, permitted the lending bank to purchase insurance to protect its interest in the collateral and pass the premiums along to the borrower. Though section 7.4001(a) specifically excludes from the definition of interest "premiums . . . attributable to insurance guaranteeing repayment of any extension of credit," the borrower argued that, under these circumstances, the premiums were "interest" because they compensated the creditor for a breach by the borrower. Id. at p. 1302-1303. In upholding the OCC's exclusion of these premiums from interest, the court stated:

> It is true that Norwest charges a borrower for insurance only after the borrower breaches the covenant to maintain insurance. But there is a notable difference between a late fee, which compensates the creditor *solely for the effects of the debtor's default*, and an insurance charge, which compensates the creditor for the cost of protecting its security, a cost the debtor is supposed to bear anyway.

Id. at p. 1303 (emphasis added). Unlike the insurance premiums at issue in Norwest, the OCC has not excluded rejected items fees from the definition of interest, and in the language of the

by the borrower or the lender, no debtor/creditor relationship exists at that point and the fee cannot be considered to be interest for purposes of section 85. As discussed, under these circumstances, the rejected item fee is governed by the principles set forth in 12 U.S.C. § 7.4002.

Consequently, we conclude that each of the rejected items fees that you list, except for the fee imposed where a draw is attempted on a terminated account, constitutes interest within the meaning section 85 as defined by 12 U.S.C. § 7.4001(a).[12]

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court, these fees do, in fact, compensate the creditor for the effect of the debtor's action in contravention of the loan agreement, that is, the expenses that the creditor incurs as a result of the breach of the loan contract by the borrower.

[12] In analyzing annual fees, the 1995 letter also addressed in detail the issue of whether "interest" in section 85 had to be expressed on a percentage basis. The Supreme Court has since made it abundantly clear that interest does not have to be expressed on a percentage basis or as functions of time and amount owing. Smiley at pp. 34-35. Moreover, the list of fees, set forth in section 7.4001(a), demonstrates that when the fee is due -- prior to the extension of funds, after the extension of funds or otherwise -- is irrelevant in determining whether a given fee constitutes interest within the meaning of section 85.

In connection with its analysis of late charges, the 1995 letter also rejected the argument that these charges did not constitute "interest" within the meaning of section 85 because they were "contingent." Fees for exercise of the prepayment option, prepayment fees, early closure fees and rejected items fees, like late charges, also can be said to be "contingent." As the 1995 letter stated, however:

> That argument simply does not make any sense. Many charges, including the monthly percentage finance charges on a credit card account, are 'contingent' on whether the customer draws on the account or on the amount or duration of the draw, but they are still recognized as 'interest.'

Apparently, this argument was not made before the Supreme Court in Smiley and the Court did not address it, but as the 1995 letter noted, the Supreme Court had previously noted that Citizens' National Bank of Kansas City v. Donnell, 195 U.S. 369 (1904), clearly established that a contingent charge imposed by a national bank (based on a borrower's failure to pay on time) is governed by section 85.

The 1995 letter also rejected the argument that late charges were not "interest" because they are "penalties." The Supreme Court in Smiley explicitly addressed this argument and flatly rejected it. As the Court stated: "In § 85, the term 'interest' is not used in contradistinction to 'penalty' and there is no reason why it cannot include interest charges imposed for that

Conclusion

Based on the foregoing, we conclude that the described account opening, fixed rate option, prepayment and early closure fees on the home equity accounts that you have described compensate a creditor or prospective creditor for an extension of credit or making available a line of credit and, thus, constitute "interest" within the meaning of 12 U.S.C. § 85, as that term is defined in section 7.4001(a) and as upheld by the Supreme Court in Smiley. We also conclude that, except in the situation where a draw is attempted on a terminated account, the rejected items fee constitutes a fee for a default or breach by a borrower of a condition upon which credit was granted and, therefore, also constitutes interest within the meaning of section 7.4001(a) and section 85. Thus, a national bank located in a state where another lender is permitted to assess these fees may assess these fees to customers within that state and in other states without reference to whether these fees are considered by the state in which the national bank is located to constitute "interest" or whether these fees are permissible under the laws of the other state where the customer resides. I hope that this has been responsive to your inquiry.

Sincerely,

/s/

Julie L. Williams
Chief Counsel

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purpose." Smiley at p. 4402. Consequently, this argument does not preclude prepayment, early closure and rejected items fees from being considered interest.

Moreover, as stated in the 1996 letter at n. 7 and the related text, while fees may be imposed as an alternative to higher periodic interest rates, it is not necessary for a bank to offer the alternative of accepting certain fees in exchange for a lower rate of interest. As the 1996 letter noted, just as annual fees may be levied across the board to help a bank reduce its finance charges, so might prepayment fees. The same can be said of account opening fees, fixed rate option fees, early closure fees, and rejected items fees levied by a bank across the board to reduce its finance charges.