

TESTIMONY OF PENNSYLVANIA BANKERS ASSOCIATION ON
OPEN-END MORTGAGE LEGISLATION

HOUSE BILL 942, PRINTER'S NO. 1060

and

HOUSE BILL 983, PRINTER'S NO. 1118

BEFORE THE HOUSE JUDICIARY COMMITTEE

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Mr. Chairman and Members of the Committee, my name is Ron Hankey and I am the President and Chief Executive Officer of the Adams County National Bank in Gettysburg. We are a community bank with \$360 million in assets. Our bank principally serves consumers and small businesses in our area.

I appreciate the opportunity to be with you today to present the views of the Pennsylvania Bankers Association. I currently represent banks similar in size to mine on the PBA Executive Committee and previously served on the Association's Government Relations Policy Committee which has analyzed this legislation in depth over the past few years.

By way of background, the issue of mortgages for future advances has been around in the Legislature for some time. The Pennsylvania Bankers Association has been intensely interested in its progress and has made enactment of House Bill 942 one of its highest legislative priorities.

In February of 1984, the Pennsylvania Bar Association introduced a bill to alleviate the technicalities arising out of court decisions that had complicated construction mortgage financing. We were interested in that issue and expanded our research and investigation and concluded that the main concern of lenders lay with the consumer credit field and home equity financing. Thus, we looked to other states for guidance which led to the development of the bill which is now House Bill 942.

The subject of "open-end mortgages" or "mortgages for future advances" is of particular concern to me and community bankers like me who extend a great deal of credit to consumers in the form of residential mortgages. I don't have to tell you about the increased demand for home financing, especially in southern Pennsylvania. In addition, all banks have experienced a sharp increase in demand for home equity loans which is a type of mortgage for future advances. This was due in part to the 1986 revision in federal tax law which generally eliminated deductions for interest payments on consumer loans except for those secured by residential mortgages. The balance of the increased demand can be explained by the sizable increase in the value of home equity in our State which presents borrowers with bankable collateral for borrowing for further home improvements, education of children, and other major endeavors while preserving the tax deductibility of the interest paid on those loans.

I should add that clarification of the lien priority of mortgages for future advances would substantially aid in

financing loans to small businesses through the use of revolving lines of credit. My bank and many others do a great deal of financing of this type and are very interested in this aspect of the legislation.

Unfortunately, lenders in Pennsylvania lack the clear ability to rely on their recorded liens as security for mortgages for future advances which permit the borrower to draw on a line of credit as he sees fit at any point in the future, and possibly repay such advances and make new draws. This uncertainty results because Pennsylvania lacks a statute clearly providing for the priority of open-end mortgages.

Pennsylvania lien priority law is built upon a principle known as the "obligatory advance doctrine" which provides that a mortgage may secure only a loan made at the time of the mortgage or at a later date pursuant to a binding commitment. Without a binding commitment which obligates the lender to make an advance, a loan made under a mortgage previously recorded is subject to any liens that have been filed between the date of the recording and the date of the advance.

Thus, we now lack a judicial interpretation which holds that advances under open-end mortgages such as home equity loans and other lines of credit are indeed entitled to priority as of the date of recording of the mortgage. This is because the long-standing interpretations of lien priority law were made under statutes which do not directly address this issue. House Bill 942 is simply an effort to update Pennsylvania statutory law to reflect the increased use of these mortgage instruments and provide direction to the courts should a dispute regarding the priority of an open-end mortgage arise.

(Note to Committee : Please see attached Addendum for a further discussion of the technical legal aspects of this issue.)

Now I'm not a lawyer, but I have discussed this gap in Pennsylvania law with our bank's attorneys who stressed to me the fact that if a future advance loan such as a home equity loan is to remain dependent on the availability of home equity as collateral, then the only safe choice I have under existing common law and statutory authority is to incur the time and expense necessary to check the records before each advance to determine if any liens have intervened since our bank last recorded its lien for the previous advance. This impediment has not stopped many banks from making home equity loans - we simply have to because of consumer demand, but it does restrict the amounts committed and heightens the credit standards substantially. We need a method which is efficient, relatively inexpensive and reliable.

House Bill 942 provides just such a method. It would add to Pennsylvania lien priority law the necessary provisions to cover optional future advances and permit a lender to give a borrower a line of credit for a stated amount that could be on a revolving credit basis and require only a single check of the real estate records to determine if the lien priority for all subsequent advances under the line. It includes a definition of "obligated" which clearly provides that the holder of a mortgage is "obligated" if he has made a contractual commitment to advance money even if advances may be made up to three years following the time the mortgage is recorded. With enactment of House Bill 942, lenders could prudently make more credit available to borrowers at lower costs, and I don't expect any possible objections to that.

House Bill 942 is drafted the way it is for particular reasons. It is modelled on an Ohio statute in place there for over twenty years and is similar to statutes on this subject in a number of other states as well. The Pennsylvania Bankers Association has contacted the bankers associations in those states to determine the effectiveness of their statutes on mortgages for future advances and has found them to be heartily endorsed as useful and efficient.

By its nature, an open-end mortgage establishes a continuing relationship between the borrower and the lender so that all credit extended at any time can be covered by the lien of the mortgage as of the date of the recording. The question arises as to how a borrower may terminate that relationship if he wishes to do so. Ordinarily, a mortgage simply remains on the record until the amount secured is paid in full, as in the case of the ordinary purchase money first mortgage. That procedure, however, would be very disadvantageous to a borrower on an open-end mortgage. If the borrower has no balance outstanding or if the amount of the outstanding balance is much less than the amount that could be borrowed against the value of the property, the borrower is effectively prevented from taking advantage of more favorable loan terms that might be offered by another lender until that mortgage is satisfied of record or the maximum amount which the mortgage can cover is reduced to the current balance.

House Bill 942 includes a very important consumer protection to preclude that problem from occurring. This provision enables a borrower to give notice to terminate an existing open-end mortgage on record if there is no outstanding debt or to limit the lien of that mortgage to the outstanding balance if there is one by filing a notice to the current lender. This method is also employed by the Ohio and other state statutes and we strongly support it as a workable procedure for Pennsylvania as well.

Without such a consumer protection, a borrower with an earlier open-end mortgage on record would face obvious difficulty in going to another lender for a better rate or terms due to the delay in having to obtain a recorded satisfaction of the first open-end mortgage before the new lender could obtain effective security in the same real estate. It is our experience that the normal procedure for satisfying recorded mortgages has the consequence of giving the first lender a near monopoly on the mortgagor's future business. House Bill 942 includes the consumer protection provision necessary to relieve consumers of this monopoly.

House Bill 942 is sharply different from another version of legislation on this subject introduced in the House as House Bill 983 which does not include such a consumer protection. In fact, House Bill 983 includes what would constitute a statutory "laundry list" of conditions which would permit the lender to decline to advance money to the borrower and still retain its right to lien priority. House Bill 942, on the other hand, while permitting future advances to be conditioned on certain events would provide that such conditions be included in the agreement to be negotiated by the lender and the borrower rather than limiting the parties to the overly broad conditions in House Bill 983 which would even include the right of the lender to discontinue the business of making loans secured by real estate which require future advances. The Pennsylvania Bankers Association cannot support House Bill 983 for this reason and because it lacks the important consumer notice provision I previously discussed.

Thank you for the opportunity to present the views of the banking industry on the issue of mortgages for future advances. I certainly hope your Committee will make every effort to take favorable action House Bill 942 as soon as possible.

I will be happy to entertain any questions you may have about my testimony.

ADDENDUM TO TESTIMONY OF PA BANKERS ASSOCIATION

There is no unanimity among lawyers with regard to interpretation of a "binding commitment" or "obligation" under the obligatory advance doctrine. Most experienced real estate lawyers, however, hold the view that the "binding" requirement does not leave very much space for any "ifs", "ands" or "buts" as to whether a loan will in fact be made in accordance with a commitment. For example, there is a Pennsylvania Supreme Court decision that, in the common situation in a construction loan in which advances are on a schedule based on the state of completion of the project, an advance made by the lender prior to the scheduled date will be deemed an optional rather than an obligatory advance so that it will not be covered by the lien of the mortgage from the date of recording but only from the date of the advance. [Housing Mortgage Corp. v. Allied Construction, Inc., 374 Pa 312 (1953)]

Such strict law does not permit much latitude in making a future advance commitment subject to continuing review of the amount of the commitment and other qualifications.