Owen O. Freeman

TESTIMONY OF THE

COMMUNITY BANKERS OF PENNSYLVANIA

ON

OPEN-END MORTGAGE LEGISLATION

H.B. 942 and H.B. 983

BEFORE

THE HOUSE JUDICIARY COMMITTEE

FRIDAY, SEPTEMBER 8, 1989

ROOM 140

MAIN CAPITOL BUILDING

HARRISBURG, PENNSYLVANIA

COMMUNITY BANKERS OF PENNSYLVANIA

Thank you for this opportunity to present the views of the over 200 locally-owned and operated community banks serving thousands of depositors and borrowers across the Commonwealth. My name is Owen O. Freeman, Jr. I am a member of the Board of Directors of the Community Bankers of Pennsylvania and am Chairman of its Legislative Committee. The Community Bankers of Pennsylvania are the only statewide banking trade association that represents the independent, community banks - 100% of the time. I am Chairman of the Board of Commonwealth State Bank and its holding company Penncore Financial Services Corporation, both of which are located in Newtown Township, Bucks County, Pennsylvania. In addition, I am Chairman of the Board of First Capitol Bank which is located in Springettsbury Township, York County, Pennsylvania. This bank is located immediately to the East of the City of York, Pennsylvania. Both of these institutions are de novo charters with Commonwealth State Bank having opened for business on April 28, 1987 and First Capitol Bank on November 21, 1988. I have been involved in the banking profession for 32 years, primarily in Harrisburg, Pennsylvania and Trenton, New Jersey prior to the two new charters.

The subject of this hearing, lien priority for resolving lines of credit secured by real estate, has a material impact on a variety of lending programs offered by community banks. Those

programs include home equity lines of credit, so popular with today's consumers, construction loans and small business revolving lines of credit where the line is secured with the business real estate or the owner's personal residence. Currently, Pennsylvania's statutory law does not address lien priority in these situations. Rather, the common law as developed in the case law by judges utilizing the principle of "obligatory advances" determines the lien priority in any dispute. The common law today simply does not provide the necessary certainty for today's new lending programs as well as lacking needed flexibility for traditional construction and commercial lending. The uncertainty inherent in the common law is detrimental to both lenders and the consumer as a borrower. Now is the appropriate time to address these issues legislatively. The area of greatest concern to the community banks is the home equity loans.

Pennsylvania's community bankers are able -- because of their local commitment and autonomous nature -- to strike a balance between meeting the increasingly complex and diverse financial needs of consumers and tailoring their investment efforts and loan portfolio to benefit their local markets.

As you know, the 1986 Tax Reform Act has caused a tremendous demand for home equity loans whereby lines of credit are established based on the equity of consumer residences. These types of lending tools have precipitated a deluge of loans among

those lending institutions which are active consumer lenders, such as the community banks. Consumers seeking to consolidate their loans or open a line of credit based on their home equity may be able to enjoy a federal income tax deduction for interest paid, a provision otherwise denied with the new tax law.

So popular in fact are these types of loans, that many of the consumer-oriented lenders in Pennsylvania's smaller communities find that home equity loans constitute their second highest lending category, trailing only home mortgages.

In an effort to support their consumer customers in local communities, many of our members have developed home equity loan programs which minimize the necessity for and expenses of repeated title certifications and appraiser fees whenever a borrower draws down on a home equity loan.

Despite the mutual advantage of home equity loans to both consumer borrowers and lenders, Pennsylvania law has failed to keep pace with these new developments. Pennsylvania's statutory real property law reflects an earlier era - a simpler time where real estate secured lending involved primarily purchase money mortgages and construction loans - an era when the concept of open-end mortgages was virtually unknown. As a consequence, Pennsylvania lenders making open-end mortgage loans must cope with uncertainty as to the priority of the liens, particularly in connection with subsequent advances. Pennsylvania lenders must

rely on a hit and miss judicial interpretation of case law. This uncertainty has stifled initiative and competition and increased the legal costs and administrative expenses of making such loans to the mutual detriment of both lenders and consumers/borrowers.

With this in mind, the Community Bankers of Pennsylvania believe it is not only appropriate but necessary to restate in clear, concise, non-ambiguous statutory language, the priority of loans secured by mortgages, including home equity loans.

Typically, a real estate mortgage has priority of lien according to the amount secured by it when it was recorded at the county recorder's office. There currently is no clear statutory language that provides a clear designation of lien priority for home equity loans. Without such a provision, both the lender is unnecessarily at risk and the consumer/borrower's credit record is jeopardized.

To begin with, we support the exclusion in House Bill 942 of purchase money mortgages, which, we believe, is an important consumer provision, as it forces purchase money lenders to focus on providing funds for the acquisition of the real property by the consumer without tying them to such lender or providing that lender with any undue access or power over the consumer in the future when the mortgagor/borrower seeks additional funds after building up equity in his or her home. House Bill 942 will require such purchase money lenders to compete with other lenders

in providing a different kind of loan product to meet some very different consumer needs (such as college tuition) and to force such purchase money lenders to focus on marketing strategies and products to meet the needs of an aging public with most of their wealth tied up in their homes.

Our chief concern with both bills is the current lack of certainty with respect to the lien priority of future advances made under open-end, nonpurchase money mortgages. Current case law provides that a lender must be obligated to make its future advances to the consumer in order to claim priority dating back to the date of filing the mortgage. Succinctly put, there are no clear standards as to what is meant by the term "obligated", as opposed to future advances deemed to be "discretionary". Every lender has certain preconditions for making future advances, such as the borrower not being in default or insolvent. We do not believe that House Bill 942 or House Bill 983 sufficiently define the term "obligated". The proposed definition does expand and clarify to some degree what is meant by the term "obligated" but it does not create a "safe harbor" for a lender - a statutorily defined assurance for the lender that his open-end mortgage loan will be interpreted as providing for obligatory advances and therefore be assured of priority for future advances.

The recent federal Home Equity Loan Consumer Protection Act of 1988 amends the federal Truth-in-Lending Act and creates substantive requirements concerning a lender's obligations to

make advances under home equity loans governed by the Act. This federal law's new regulations will be mandatory on November 7, 1989 and will limit and prescribe when and how a lender may accelerate or foreclose upon a consumer home equity loan as well as limit the discretion of a lender to withhold an advance. In the interest of consistency and certainty, we suggest that House Bill 942 and House Bill 983 be amended to provide that all advances made pursuant to a home equity loans subject to the Federal Truth-in-Lending Act are deemed as a safe harbor as "obligated" advances. This safe harbor may be in addition to any other general statutory definition of "obligated advance". Because of the federal Truth-in-Lending Act provisions, the consumer will be protected and the lender would share in that protection by having the assurance that all of its advances under a home equity loan program subject to the federal Truth-in-Lending Act will have the priority dating to the date the mortgage is left for recording.

We believe that in addition to providing this particular safe harbor, that the three year limitation proposed in House Bill 942 (§8143(f)) not be applicable to home equity loans that are subject to the federal Truth-in-Lending Act so as to alleviate the need for consumers to refinance their home equity loans every three years and to avoid the needless waste of expenditures to redocument and refile the home equity mortgage. We know of no CBP member bank that limits a home equity line of credit to a three year term.

House Bill 942 provides two specific mechanisms under which a consumer will have an opportunity to secure other financing with a more junior lender without having to prepay the outstanding balance on the existing line of credit. These two methods are in addition to the traditional way a borrower obtains new financing in which the new lender simply refinances any outstanding balance, thereby terminating the lender/borrower relationship with the first lender. To the extent House Bill 942 needs to be clarified that it does not alter this traditional method of substituting lenders, CBP would support such a clarifying amendment.

The first method provides simply that a junior lender would notify the more senior mortgage lender of its lien. If the senior mortgage lender is not obligated to make a future advance at the time the notice is received, then the junior mortgage lender will take priority as to advances made on or after five days after the notice is provided.

The second method by which the consumer can, without completely paying the senior lender, limit the lien on the real estate created by the senior lender's lien, is for the consumer himself to notify both the senior lender and the Recorder of Deeds that he or she is limiting his or her lien priority to the senior lender to the outstanding balance in existence at the time of the delivery of the written notice. This provision does require the consumer to send the requisite written, notarized

notice to the Recorder of Deeds. Frankly, we believe that only more sophisticated borrowers or those represented by legal counsel will on their own initiative exercise the rights under this particular provision. In the event the borrower wishes to obtain a new line of credit from a new lender, but not completely pay the outstanding balance on the existing line of credit, we assume that the junior lender will draft the notice for the consumer and file it on his or her behalf, thereby avoiding the five day waiting period.

Both House Bill 942 and House Bill 983 include identical provisions to safeguard the rights of a mortgage lender. Those provisions specify that the priority of the lien of the mortgage applies to advances made by lenders to protect their investment i.e., for the payment of taxes, assessments, maintenance charges, insurance premiums. Such a provision encourages a secured lender to put up money to maintain the property. This benefits, not only the lender, but the consumer and the community at large.

CBP believes there is merit and public policy reasons for providing the consumer with methods for obtaining financing from other sources without having to refinance an existing loan. These provisions now found in House Bill 942 are the subject of an intense dispute between the Pennsylvania Bankers Association and the Pennsylvania Financial Services Association. As you are aware, these two associations have supported two separate bills over the past several years dealing with lien priority issues.

In large part this dispute has prevented the forming of the political consensus necessary to pass lien priority legislation.

CBP supports the two notice provisions in House Bill 942 as they provide certainty in the event a borrower wishes to obtain an additional line of credit without paying the outstanding balance and thereby terminating the relationship with the first line of credit lender. These provisions in our opinion do not effect the traditional manner of substituting lenders that occurs in a refinancing of the existing line of credit. Much has been said about the competitive impact of such notice provisions. Let me address that issue. Absent a junior lender being willing to be completely behind the senior lender as evidenced by the entire amount stated on the recorded mortgage, some contact must be made with the senior lender to ascertain the outstanding balance. Whether the contact is made by an abstract company or lawyer representing the junior lender and doing the title search or through a notice provision mandated by statute, the first lender will know that its borrower is in the process of obtaining new financing from a new lender. Knowing its customer is negotiating with a second lender, we assume may lead to the senior lender contacting the borrower. But this contact could occur whether or not the notice provisions are statutorily mandated. If a borrower has taken the time and incurred the expense to complete an application with a second lender or has, except for disbursement, actually closed the second loan, which includes recording a new mortgage, we assume the borrower has valid

reasons for not dealing with the senior lender. Either the senior lender has already refused the borrower's new request or the junior lender is offering better terms than the borrower believes the senior lender could ever offer. As such, CBP does not believe the notice provisions included in House Bill 942 will have a competitive impact between lenders in a manner greater than now occurring under the current common law. All the provisions will do is add certainty as to lien priority in the event the borrower wishes to obtain an additional line of credit but not pay the outstanding balance on the first line of credit.

CBP calls on both associations to meet to reach a consensus that will address the most pressing public policy issue: assuring lien priority for home equity lines of credit. This is in the consumers' ultimate interest because it is the assumed priority of lien that justifies the lower interest rates associated with secured versus unsecured lending. If a Pennsylvania court declares "the Emperor has no Clothes" and home equity lines of credit do not meet the common law standards for "obligatory advances", the consumer will lose as interest rates for home equity lines of credit will increase. This is too great a risk for both the lender and the borrower to assume.

We appreciate this opportunity to address the comments and concerns of the Community Bankers of Pennsylvania regarding open-end mortgages and would be pleased to address your questions now or at any other time you feel I may be of assistance. I

would equally encourage you to rely on the staff of the Community Bankers of Pennsylvania for any information you may require.

COMMUNITY BANKERS OF PENNSYLVANIA

PROPOSED AMENDMENTS TO H.B. 942

Section 8143

(f) Definitions

"Obligated" . . .

. . . , but the three-year limitation does not apply to any mortgage given to secure, in whole or in part, loan advances made to pay the cost of any erection, construction, alteration or repair of any part of the mortgaged premises[.] or given to secure in whole or in part loan advances made pursuant to a loan agreement subject to the "Home Equity Loan Consumer Protection Act of 1988" Public Law 100-709.