TESTIMONY ON BEHALF OF
THE PENNSYLVANIA FINANCIAL SERVICES ASSOCIATION

BEFORE THE JUDICIARY COMMITTEE
OF THE
PENNSYLVANIA HOUSE OF REPRESENTATIVES

SEPTEMBER 8, 1989

IN SUPPORT OF HOUSE BILL 983

PRESENTED BY
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The subject of both House Bill 983 and House Bill 982 is the law of mortgage lien priority. This subject has been debated for a number of years, and two fundamentally opposed positions have developed.

Very briefly, I would like to state the understanding of the Pennsylvania Financial Services Association as to why the provisions of House Bill 983 are desireable, and why the alternative changes to the law of mortgage lien priority which have been proposed in House Bill 982 are not desireable.

The issue involved is whether an advance made by a mortgage lender after the mortgage is recorded will be deemed to relate back to the date the mortgage was recorded. The issue arises when another lender makes an advance and records his mortgage after the date the first mortgage was recorded, but before the additional advance made by the first lender. If the advance made by the first lender is deemed to relate back, then in the event of a foreclosure against the property the first lender will be paid before the second lender, even though the second lender made his advance, and recorded a new mortgage, BEFORE the first lender had made his advance.

The law which developed in this area held that the second lender should not prevail, despite the fact he made his advance first, IF AND ONLY IF, the first lender was OBLIGATED to make the advance which he made under the terms of his agreement with the borrower. It seemed logical and just to protect that lender if he could not refuse to make the advance under his agreement. Subsequent lenders could, and do take this into account when deciding what risks they have in making a loan to that borrower.

This rule of OBLIGATORY ADVANCES has worked well, and two general types of loans have developed under it - construction loans and open-end or revolving loans which today are most commonly called HOME EQUITY LOANS. Although the law has worked well, concerns have been expressed about certain applications of the rule in recent years.

These concerns are similar for both construction loans and for home equity loans, although the details are very different. Generally stated, they stem from a tendency in the courts to construe the OBLIGATORY ADVANCE RULE strictly, creating risks that a lender might lose his priority.

For example, on construction loans, there may be a cost overrun or an occurrence making it unwise to exactly follow the schedule of advances called for either in timing or amount. Where these deviations from the contract occur, courts sometimes hold an advance to be "voluntary" rather than "obligatory" and therefore will not permit it to relate back to the time the mortgage was recorded.

In the case of home equity loans, there is some concern that if the contract contains certain provisions a court may find it to not be an "obligatory" contract and also will not permit advances to relate back. For example, if the contract provides that the lender doesn't have to make additional advances if he has reason to believe the borrower's credit worthiness has changed, a court might hold this to negate the "obligatory" advance requirement and not permit relation back of advances for priority purposes. While we have seen no holdings to this effect in the home equity area, it is an area of concern to some creditors.

Both bills under consideration deal with the construction loan problem in the same way, and I believe there is no real controversy on that score. The language is identical in each bill and is designated Section 8144 in House Bill 982 and Section 8143 in House Bill 983.

With regard to home equity loans, House Bill 983 and House Bill 982 would change the law in drastically different ways. House Bill 983 - which we support - makes some understandable changes to the law which clarify it and make its application more certain, and which will permit the home equity loan programs which have become so popular throughout the state to continue without any major disruptions.

House Bill 982, on the other hand would change the law drastically. It eliminates the "obligatory advance" concept entirely for some lenders, and would substitute a rule providing that every mortgage which says "open-end mortgage" at the top would have an absolute priority for future advances, whenever made, whether or not that lender ever contemplates making such advances. Under House Bill 982 every mortgage can be made an open-end mortgage, with no risk to the lender at all. Nevertheless, in a confusing counterpoint the bill implies that obligatory advance loans can also exist and would have priority over loans made as provided in House Bill 982.

H.B. 982 also provides a complicated notice scheme, which prevents a borrower from obtaining a new loan without waiting at least 5 days after notifying the prior mortgage holder that he wants a new loan. We believe this violates the rights of both the borrower and the subsequent lender. The borrower is forced to deal with two lenders, and the second lender has to notify his competitor of the fact that he's making a loan and give the competitor 5 days to beat the deal. Can you imagine the situation if every auto dealer who was selling a car had to notify the dealer that the customer bought from previously before making a sale, and give the other dealer 5 days to beat the deal? At the very least, this provision simply makes no sense.

The basic problem with House Bill 982 remains, as it has been in prior years, that it eliminates market discipline from this industry by eliminating the "obligatory advance" concept from home equity lending. House Bill 982 substitutes a complicated and confusing scheme of notices, conflicting laws (since it says present law remains in effect in some circumstances), schemes for limiting lines of credit and contemplates - and apparently would encourage - taking out third, fourth and perhaps fifth mortgages.

In contrast, House Bill 983 fixes the construction loan problem the same way that House Bill 982 does, as I pointed out earlier, and it deals with the home equity loan situation in a rational manner.

House Bill 983 spells out the type of normal credit provisions which have been included in home equity loan agreements to protect both lenders and borrowers from overexstensions of credit, where further extensions would be inappropriate, without affecting the basic nature of the lender's obligation to make advances. By clearly stating the conditions which can be placed on the obligation, borrowers are assured they are getting what they bargained for, namely the right to borrow when they need the money, and lenders are protected by knowing they can stop making advances under certain limited circumstances without losing priority for the advances they are obligated to make.

There have been amendments made by the Federal Reserve Board to Regulation Z which limit the circumstances under which home equity plans may be terminated and limit the changes which can be made in the terms of home equity accounts. These regulations became effective June 7, 1989 and must be implemented by creditors no later than November 7, 1989.

I have reviewed these regulations, and basically, the conditions under which accounts can be terminated or limited under Regulation Z are consistent, as far as I can see, with the conditions permitted under House Bill 983 which will not rendering a contract "non-obligatory". In other words, I see no inconsistency between these regulations and House Bill 983. The commentary to the new regulation in fact recognizes that the type of conditions permitted in House Bill 983 do not cause a problem where the law requires advances to be "obligatory" (see page 32 of the Federal Reserve press release on the subject dated June 5, 1989). It is not clear to me what effect the new regulations would have on House Bill 982, but in view of its additional complexities it seems likely there may be inconsistencies. I strongly suspect that with all of the various notices and changes to contracts which would be possible under the complex scheme of House Bill 982 there will be conflicts with the various prohibitions and requirements of Regulation Z.

I would like to point out, as we have in the past, that the priority issue is not a consumer issue. That is, no one is contending, as far as I have heard, that consumers are in any way suffering under the existing lien priority law.

Rather, the issue here is one of conflicting claims among creditors to the security given by the borrower. The issues would not normally arise until the borrower has defaulted and is out of the picture.

There is only one consumer issue created by this bill and that is the adverse effect on borrowers created by House Bill 982, which prevents their being able to borrow additional funds without first notifying their existing mortgagee, and waiting an unnecessary 5 days before obtaining a new loan. The problem is the same whether or not purchase money mortgages are included - a priority issue arises only between two or more lenders, and it is not significant whether they are first and second in time, or second and third, etc.

Under the present law, if the borrower wants to borrow more money at better rates, he can do so by borrowing the money and paying off the prior loan, and this happens to lenders engaged in this business here in Pennsylvania every day. When a second mortgage is paid off, the lender must release the mortgage within 10 days under Section 6614(g) of the Pennsylvania Secondary Mortgage Loan Act, and the priority question is gone. There is simply no need for the confusing schemes of House Bill 982, and they would totally confuse the situation.

To summarize:

The questions which exist as to the status of construction contracts under the obligatory advance concept can be resolved by adopting the language which is included in both House Bill 982 and 983 which relates to that problem - without adopting either version of the language relating to home equity loans.

With regard to home equity loans, the priority law does not involve the consumer directly (except for the adverse consequences of House Bill 982) but simply resolves the question of which creditor deserves to have priority over the other.

There is no reason to give one creditor priority over another unless he has taken a risk in obligating himself to make a loan, at the borrower's discretion, and there is certainly no reason to give him priority simply because he typed "open-end mortgage" on a piece of paper as House Bill 982 would do.

There is, furthermore, no reason to create an new, confusing and complicated scheme of notices and delays as House Bill 982 would do when there is no evidence of any problem with the existing law.

As I have testified before, the existing law works and if any legislation is to be adopted in this area, the existing law should be codified and improved as provided in House Bill 983, not repealed, confused and muddled as provided in House Bill 982.

Thank you for your attention. I will be happy to answer any questions.