The State of South Carolina
Department of Consumer Affairs
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ADMINISTRATOR
AND
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Administrative Interpretation No. 3.104-8014

WRAPAROUND MORTGAGE LOAN IS CONSUMER LOAN SUBJECT TO CONSUMER PROTECTION CODE

You have asked several questions concerning the applicability of the Consumer Protection Code to loans you describe as wraparound mortgage loans which a company anticipates making in South Carolina. These transactions would involve homes upon which Federal Housing Administration, Veterans Administration or assumable conventional first mortgage loans already exist. In short, there would be no limitation upon sale or transfer of the home under the existing first mortgage loan.

The face amount of the wraparound mortgage loan would include the amount of the existing first mortgage loan and the "new money" advanced. For example, if the price of the home were $52,500 with the buyer's having paid $2,500 down, the face amount of the wraparound mortgage loan would be $50,000. Of that amount $40,000 is the principal balance remaining on the first mortgage loan which was made at a 9% rate. However, the first mortgage loan is not paid off at closing but instead the homebuyer-borrower obtains the wraparound mortgage loan subject to the original first mortgage loan. The homebuyer-borrower and the wraparound lender agree that the wraparound lender will make the payments on the first mortgage loan as those payments become due out of payments made by the homebuyer-borrower to the wraparound lender. Neither the wraparound lender nor the homebuyer-borrower assumes the first mortgage loan.

The homebuyer-borrower would agree with the wraparound lender to an overall rate on the total wraparound mortgage loan of, for example, 10¼%. This rate would be higher than the rate on the outstanding first mortgage loan (9%) but lower than the going rate for new first mortgage loans. Because the wraparound lender would not be advancing the entire amount of the loan ($50,000) at the overall rate (10¼%) but instead would be advancing the difference between the full amount of the transaction and the outstanding principal balance of the first mortgage loan ($40,000) for a total of $10,000, his actual yield (e.g., 15%) would be higher than the rate paid by the homebuyer-borrower on the entire $50,000. The term of payment of the wraparound mortgage loan would be equal to the term remaining on the first mortgage loan. If the consumer defaults in payments on the wraparound mortgage loan, the wraparound lender would have the option but not the obligation to continue paying on the first mortgage loan.

The first question is whether the wraparound mortgage loan is a consumer loan as defined in the Consumer Protection Code. In our opinion it is. The transaction is analogous to the one outlined in Administrative Interpretation No. 2.605-8002 of March 20, 1980. The major difference is that in the earlier interpretation the wraparound mortgage transaction was a sale by the homeowner instead of a wraparound mortgage loan by a third party. While the homeowner-seller in the earlier transaction was not regularly engaged in credit transactions of the same kind, the lender in your question is or will be regularly engaged in credit transactions which otherwise meet the

TELEPHONES (AREA CODE 803)
ADMINISTRATION 758-3017
CONSUMER COMPLAINTS 758-2040 WATS 1-800-922-1594
PUBLIC INFORMATION 758-7546
NOTIFICATION 758-8587
CONSUMER ADVOCACY 758-8996

definition of "consumer loan" in Consumer Protection Code Section 37-3-104: the debtor is an individual; the debt is incurred primarily for a personal, family or household purpose; the debt is both payable in instalments and a loan finance charge is made; and the principal, regardless of amount, is secured by an interest in land. These loans do not come within the exclusion from the Consumer Protection Code contained in subsection (11) of Section 37-1-202 (Cum. Supp. 1979) which provides:

> This title does not apply to ...
> First mortgage loans made to enable the debtor to build or purchase a residence, when made by a lender whose loans are subject to supervision by an agency of this State or of the United States or made by a Federal Housing Administration approved mortgagee .... (Emphasis added)

In our opinion, the wraparound mortgage loan does not qualify as a first mortgage loan because a first mortgage loan on the home is still outstanding. The wraparound mortgage transaction therefore is a second mortgage consumer loan (assuming there are no intervening mortgages).

Your next question was what maximum rate of finance charge may be charged on such a wraparound mortgage transaction. Consumer Protection Code Section 37-3-201 (Cum. Supp. 1979 as amended by §2 of Act No. 433 of 1980) provides a ceiling of 18% annual percentage rate for consumer loans (and higher for supervised lenders making loans falling within the graduated rate scale). You asked whether this limitation applies to the total amount of the wraparound mortgage transaction ($50,000) or only the amount of the new money advanced ($10,000). In our opinion, the maximum rate applies to the money actually advanced by the wraparound lender in the transaction.

Section 37-3-201 provides that a lender "may contract for and receive a finance charge, calculated according to the actuarial method" (emphasis added), not exceeding 18% per year or, if a supervised lender, the graduated rate scale or 18%. Although the rate of finance charge computed on the total obligation does not exceed 18%, a determination of the rate received by the wraparound lender must be made for purposes of maximum permissible charges under the Consumer Protection Code. In this type of wraparound mortgage transaction a distinction can be made between the rate paid by the consumer on the overall transaction and the rate received by the wraparound lender. The wraparound lender is in a position similar to that of a lender making a separate second mortgage loan to a consumer who assumes the first mortgage loan. The wraparound mortgage "loan" in the described transaction falls within subsection (1) of Section 37-3-106 (1976):

> The creation of debt by the lender's payment of or agreement to pay money to the debtor or to a third party for the account of the debtor.

Likewise the "principal" of the wraparound mortgage loan is:

> The net amount paid to, receivable by, or paid or payable for the account of the debtor [CPC §37-3-107(3)(a) (Cum. Supp. 1979)]

plus additional charges to the extent payment is deferred.

The wraparound lender "pays" only the new money ($10,000) for the account of the debtor. The wraparound lender does not "pay" the first mortgage loan amount. He only acts as a vehicle for passing payments as they are received from the consumer to the first mortgage lender rather than advancing funds on the consumer's behalf. See, e.g., Galowitz, "How to Use Wraparound Financing," 5 Real Est. L.J. 107 (1976); Schrader, "Wrap-Around Mortgage: A Critical Inquiry," 21 UCLA L. Rev. 1529 (1974); Note, "Wrap-Around Financing: A Technique for Skirting the Usury Laws?" 1972 Duke L.J. 785.

Your third question was whether the wraparound mortgage transaction would be considered a first or second mortgage with regard to any limitation on interest. Your question arises due to the recent passage of Public Law 96-221 as amended by Public Law 96-399, the Depository Institutions Deregulation and Monetary Control Act of 1980. Section 501(a)(1) of that act preempts state laws restricting the rate or amount of finance charges that may be made on loans secured by a first lien on residential real property in certain circumstances. With your request, you enclosed a letter dated May 20, 1980 from the General Counsel of the Federal Home Loan Bank Board concluding that a loan described as a wraparound mortgage loan qualifies as a loan secured by a first lien if funds are immediately available for the liquidation of the first lien. The letter further stated that "the technical second lien status of the loan was not considered controlling as long as the lender has the ability to either cure defaults or convert its lien to a first lien in the event of default" (emphasis added). Whether or not the wraparound lender qualifies for preemption with respect to his wraparound mortgage loans is a question to be determined under federal law. However, even assuming the wraparound mortgage loans described in your request do qualify as "first liens" for purposes of the federal law, they still qualify as second mortgage loans for purposes of the Consumer Protection Code with the result that only the 18% annual percentage rate ceiling would be preempted if indeed preemption occurs at all. Other applicable provisions of the Consumer Protection Code would still apply to the transaction notwithstanding a preemption of the rate ceiling.

Your fourth question was whether the amount paid for the mortgage insurance protecting the wraparound lender against loss in the event of default would be considered a finance charge. Consumer Protection Code Section 37-3-109 (Cum. Supp. 1979) defines "loan finance charge" as:

> ... the sum of ... all charges payable directly or indirectly by the debtor and imposed directly or indirectly by the lender as an incident to the extension of credit, including ... premium or other charge for any guarantee or insurance protecting the lender against the debtor's default or other credit loss ... . (Emphasis added)

A charge for such mortgage insurance imposed by the lender is clearly within the definition of loan finance charge when paid by the consumer and therefore would be reflected in the 18% annual percentage rate maximum applicable to the transaction.

Your final question concerned disclosure. Consumer Protection Code Section 37-3-301 (1976) requires a person to comply with the federal Truth in Lending Act. Therefore, the terms of the wraparound mortgage transaction should be disclosed in accordance with requirements of the Truth in Lending Act [15 U.S.C. §§1601 to 1687e] as implemented by Federal Reserve Board Regulation Z [12 C.F.R. 226]. Official Staff Interpretation FC-0146 of the Federal Reserve Board (effective February 28, 1978) says that a wraparound mortgage loan in a given fact situtation should be disclosed as a traditional refinancing. The facts involved a borrower already obligated on the outstanding first mortgage loan who obtained a subsequent wraparound mortgage home improvement loan. 5 Cons. Cred. Guide (CCH) ¶31,763. Another Federal Reserve Board interpretation (this one unofficial) concerns the sale of a house subject to an existing first mortgage loan. Although not a wraparound mortgage transaction, the situation is similar to one. The Board said that the balance on the existing first mortgage loan should not be deducted from the cash price in arriving at the unpaid balance of the cash price and that the annual percentage rate should not reflect the interest earned by the seller on the existing mortgage. FRB Letter No. 1235 of September 2, 1977 [1974-1977 Transfer Binder] Cons. Cred. Guide (CCH) ¶31,674.

In both instances the Board decided that disclosure of the annual percentage rate of finance charge as it relates to the total obligation of the consumer would be more meaningful for shopping purposes. Because we do not know whether the Board would come to the same conclusion in your fact situation we are requesting an interpretation. However, the question of disclosure of the finance charge and annual percentage rate paid by the consumer is separate from the question of the rate of finance charge received by the lender and the Board's answer would not be determinative of the rate received by the lender for maximum charge purposes under the Consumer Protection Code.

A word of caution is in order to those anticipating making loans similar to the wraparound mortgage loans described in this interpretation. Because of the novelty of these transactions, it is especially important that consumers be made aware of their nature and terms. Additionally, as we stressed in Administrative Interpretation No. 2.605-8002, we encourage providing adequate protection to the consumer in the event the wraparound lender defaults in making payments to the first mortgage lender.

In summary, it is the opinion of the Department that the loan you described as a wraparound mortgage loan is a second mortgage consumer loan whose amount is the money actually advanced by the wraparound lender for Consumer Protection Code maximum rate purposes.

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