#72 1/10/73

Memorandum 73-1

Subject: Study 72 - Liquidated Damages

Background

At the November 1972 meeting, the Commission discussed the subject of liquidated damages. After considerable discussion, the Commission decided that the topic merited study by the Commission. The staff draft of a tentative recommendation appeared to be a sound approach, but the Commission decided that further information on the problem of late charges on payments on loans secured by real estate was needed and that this problem must be worked out before a recommendation of liquidated damages can be prepared.

The Commission suggested that the staff seek the cooperation of Senator Song in the effort to obtain additional information and views on the late charge problem. Senator Song sent a letter requesting a statement of views and any supporting factual information to the following organizations:

California Bankers Association

California Savings and Loan League

Department of Real Estate

California Real Estate Association

Mortgage Brokers Institute

The letters received in response to Senator Song's letter are attached as Exhibits I-III to this memorandum.

We also attach background information relevant to late charges. See "Savings and Loan's Practices" (yellow) (this is the article the repre-

sentative of CREA referred to), Assembly Finance and Insurance Committee--Final Report on Late Payment Fees (green), Results of Survey (white pages). Also attached (gold) is a copy of Civil Code Section 2954.5 which states the prerequisites to imposition of a delinquent payment charge. You should read this background material even though we do not discuss it in this memorandum.

Suggested Provision on Late Payment Charges

It is apparent from the background materials that there is no uniformity in the late payment charges actually imposed. Information as to the actual costs to the lender of a delinquency is not available, and such costs include such speculative items as the need for a savings and loan association to have a low delinquency rate for the association as a whole. (See discussion on page 2 of Exhibit II.)

The staff believes that the legislative scheme outlined by the Department of Real Estate is a sound approach to the problem. See Exhibit I. Accordingly, we recommend approval of the draft section set out as Exhibit IV of this memorandum.

Respectfully submitted,

John H. DeMoully
Executive Secretary

Memo 73-1 EXHIBIT I

STATE OF CALIFORNIA RONALD REAGAN, Governor

OFFICE OF THE COMMISSIONER
DEPARTMENT OF REAL ESTATE
714 P Street
Sacramento, CA. 95814

ROBERT W. KARPE
Commissioner

January 3, 1973

California Law Revision Commission
School of Law
Stanford, California 94305

Gentlemen:

In his letter to me of November 29, 1972, Senator Song asked me to provide the Law Revision Commission with my views as to what would constitute an appropriate formula for computing late payment charges on loans secured by real property. In addition, Senator Song asked for information concerning late payment charges currently being imposed in connection with real estate loans and data as to costs actually incurred by lenders as a result of the obligor's failure to make timely payments on these loans.

I regret that the Department of Real Estate does not have any reliable data as to the costs actually incurred by lenders on account of late payments. We have not conducted nor sponsored any surveys among the many licensees of the Department who negotiate real property loans nor are we aware of any such studies conducted by or on behalf of institutional lenders. It is, of course, possible that this information will be made available to you by the lending associations from whom you have elicited data and recommendations. As regards your request for information on late payment charges actually being imposed by licensees within the jurisdiction of this Department, our experience has shown that there is little uniformity. Until approximately two years ago, Union Home Loans, the largest mortgage loan broker in the State in volume of loans negotiated, charged a late payment fee equal to 1% of the face amount of the loan. According to Mr. Leonard Smith, attorney for Union, the company reduced its late payment charge to one-half of 1% of the face amount of the loan. Other mortgage loan brokers with whose practices we are familiar charge 10% of the delinquent installment payment as a late payment charge. I am sure that the Mortgage Brokers Institute will be able to supply you with more detailed information concerning the late payment charge practices of its members.

As my Chief Legal Officer reported to your Mr. DeMoully in recent correspondence, we have contacted the California Mortgage Bankers Association for information concerning their practices and for their recommendations to you. Enclosed is a December 28 letter of Robert E. Morgan, President of CMBA in response to our request.

The Department's recommendations with respect to statutory limitations on late payment charges on loans secured by real property in this State are summarized as follows:

1. A late payment charge of not to exceed 10% of the delinquent intallment payment comprising principal, interest and funds to be allocated to the property tax and property insurance impound account for an interest only or installment payment of $50 or more.

2. For installment or interest only payments of less than $50, a late payment charge of $5 or 20% of the installment payment, whichever is the lesser amount.

3. No statutory limit on late payment charges on those loans where the periodic payment under the terms of the loan agreement is in excess of $500.

4. A prohibition against a late payment charge being imposed more than one time for a single late installment payment.

5. A grace period to the borrower of not less than six days after the due date of the installment payment.

In arriving at this recommendation, we have endeavored to give consideration to the interests of borrower and lender -- and in the case of three-party loans -- to the broker. We believe that this recommendation is a fair compromise of the conflicting interests of these parties to real property loan transactions.

Sincerely,

Bob Karpe

Robert W. Karpe

cc Hon. Alfred H. Song
Senator
Room 3048, State Capitol
Sacramento 95814

Memo 73-1 EXHIBIT II

California Savings and Loan League

P.O. BOX R (1444 WENTWORTH AVENUE), PASADENA, CALIFORNIA 91109 • TELEPHONE: (213) 684-1010

January 2, 1973

California Law Revision Commission
School of Law
Stanford, California 94305

Gentlemen:

We have been requested by Senator Alfred H. Song to provide you with our views as to an appropriate formula for computing the late payment charge on loans secured by real property.

Senator Song in his letter of November 29, 1972, also requested that we furnish you with information on late charges now made and data showing the actual costs incurred by lenders for failure to make timely loan payments. At this time we do not have the information requested and, therefore, regret that we are unable to furnish the same.

As to our views, we believe that the great bulk of cost for loan servicing is attributable to those relatively few borrowers who are chronically late in making loan payments. There is certainly no desire by savings and loan associations to place an undue charge on those smaller borrowers whose payments are occasionally not timely because of inadvertence or hardship. In these cases, therefore, we suggest that a late charge limitation of 10% of the late installment is appropriate. We would confine this limitation to loans on owner-occupied, single family residences.

Larger, more sophisticated borrowers are a more difficult problem. In times when money is tight, sophisticated borrowers frequently find it easier to withhold loan installments and pay late charges than to borrow from banks for normal business needs. Yet it is at precisely these times that mortgage lenders need their regular flow of loan repayments to meet their own lending commitments and obligations to make new mortgage loans. Accordingly, the late charge on these loans must be sufficient to encourage prompt payment as well as to compensate for the disproportionate expense of servicing chronically late borrowers.

It seems clear to us that the exclusion of late charges on non-single family home loans from legislative limitations is appropriate. Late payments on long-term real estate loans are not the normal type of breach to which liquidated damage limitations should apply. It is one thing to preclude forfeitures on single payment contracts; it is another to limit collection procedures and cost apportionment as to a long-term lender whose very existence depends upon having almost all its loans in a current status.

One of the reasons it would be virtually impossible to determine the cost to a savings and loan association resulting from delinquent loans is attributable to the necessity for having a low delinquency rate for the association as a whole. Under current federal regulations, various restrictions apply when an association's "slow loans" and "scheduled items" increase beyond a minimum amount. These items affect an association's reserve requirements, permitted lending territory, ability to sell participations in loans, and ability to make loans in other states (see for example 12 C.F.R. 561.15, 561.16, 561.22, 563.9(a)(4), 563.9-1(b)(2) and 563.13). Certainly no one can measure the loss which may be incurred by an association by the imposition of these federal restrictions or by the risk to the association and its savers and investors in having its loan portfolio on less than a current basis.

We believe that any comparison of late charges on conventional loans with similar charges on FHA insured or VA guaranteed loans is inappropriate. With FHA and VA loans, the risk of delinquency and ultimate loss from default is placed upon the federal government and it is, therefore, appropriate for the federal government to specify late charge limitations. The risk of loss on conventional loans, on the other hand, is with private lenders who must have appropriate collection remedies or bear the loss themselves.

We trust the foregoing answers Senator Song's inquiry as to our views. Should you need a further statement as to any particular aspect, we will be pleased to furnish it.

Yours sincerely,

W. Dean Cannon, Jr.
Senior Vice-President

WDC:sp
cc: Senator Alfred Song

Memo 73-1 EXHIBIT III

December 26, 1972

Mr. J. Jerome Thomas
Chief Legal Officer
Department of Real Estate
State of California
714 "P" Street
Sacramento, California 95814

Dear Mr. Thomas:

Thank you for your letter of December 12th confirming our telephone conversation of the previous day regarding late payment charges currently being imposed by various lenders on loans secured by real property in California.

You are correct in your assumption that each member firm of CMBA is free to adopt its own policy on late charges for commercial or industrial loans. In line with our conversation, our Association is prepared to recommend a 5% charge of the delinquent installment payment to be assessed one time only for each delinquency. This charge would include impounds on taxes and insurance. We would like to point out that delinquencies of commercial and industrial property are normally caused by mis-management of the property and therefore it is oftentimes necessary for the lender and/or servicer to actually manage the property during this delinquent state. However, there are no provisions under the terms of our servicing agreement that allows us a manager's fee during this period and consequently it is necessary that there be an adequate late charge in order to re-imburse us for the work performed.

We have been aware of instances during periods of declining interest rates where sophisticated commercial or industrial borrowers of substantial amounts have deliberately evaded their

obligations by reason of the lender not having imposed a loan provision calling for substantial late charges. Also to be effective, the late charge must be high enough so that a business concern does not take the position that paying the penalty is less expensive than bank borrowing, and trade on this for spendable funds.

Let me illustrate the point. A sophisticated borrower obtains a commercial loan in the sum of $1 million at an 8% rate. Pre-payment penalties are provided during the intial period of the loan. A year or two years after the loan is made, the current interest rate becomes 6%. The borrower can obtain refinancing at this rate but determines to evade his obligation for pre-payment penalties on any pay off. The borrower deliberately defaults and continues his default, forcing the lender into calling his loan which accelerates the maturity of the entire obligation. In such a case, the borrower refinances his loan and pays it off without incurring any pre-payment penalties. Obviously, this is to the detriment of the lender and a deliberate violation by the borrower of the loan agreement. Some lenders have protected themselves against such occurrences by loan provisions providing for a substantial late payment charge. When lenders are making substantial commercial or industrial loans to sophisticated borrowers, I believe they are justified in protecting themselves in such a manner. The origination of such loans are costly, giving rise for a need of the lender to protect himself against loss.

The current late charge allowed by Government agencies is 4% by the Veterans Administration and 2% by the Federal Housing Administration which includes principal, interest and impounds. We do not feel that the 2% allowed by the FHA covers the cost of collection on the part of our members, consequently, we recommend that a 4% late charge be allowed on conventional residential loans which should include the payment of principal, interest and impounds.

Unfortunately, we know of no studies that have been conducted on late charges to determine actual costs incurred by lenders, either here in California or nationally, pertaining to the borrower's

failure to make timely payments We understand, however, that the State Banking Department of the State of New York may have conducted such a study fairly recently.

Sincerely,

ROBERT E. MORGAN
President

mcb

Memorandum 73-1

EXHIBIT IV

DRAFT OF STATUTORY PROVISIONS

General rule on liquidated damages

3319. A provision in a contract liquidating the damages for breach of a contractual obligation is valid unless the party seeking to invalidate the provision establishes that it was manifestly unreasonable under the circumstances existing at the time of the making of the contract.

Rules on late charges on loans secured by real property

2954.6. (a) As used in this section:

(1) "Loan" means a loan, other than a loan made pursuant to Section 22466 of the Financial Code, secured by real property.

(2) "Installment" means a periodic payment comprising any one or more of the following: principal, interest, and funds to be allocated to the property tax and property insurance impound account.

(b) Where more than one installment of not less than five hundred dollars ($500) is required on the loan, a provision of the loan contract imposing a default, delinquency, or late payment charge is valid if it satisfies the requirements of Sections 2954.5 and 3319 and all other applicable provisions of law.

(c) Except for cases covered by subdivision (b), the default, delinquency, or late payment charge referred to in Section 2954.5 is subject to the provisions of that section and the following conditions:

(1) No default, delinquency, or late payment charge may be collected on an installment which is paid in full within six days after its scheduled

due date even though an earlier maturing installment or a default, delinquency, or late payment charge on an earlier installment may not have been paid in full. For the purposes of this section, payments are applied first to current installments and then to delinquent installments. An installment shall be considered paid as of the date it is delivered if delivered in person or the date it is postmarked if delivered by mail.

(2) If the installment payment is fifty dollars ($50) or more, the amount of the default, delinquency, or late payment charge shall not exceed 10 percent of the installment.

(3) If the installment payment is less than fifty dollars ($50), the amount of the default, delinquency, or late payment charge shall not exceed five dollars ($5) or 20 percent of the installment payment, whichever is the lesser amount.

SAVINGS AND LOAN'S PRACTICES

by Reg Dupuy, Long Beach, CREA Honorary Director-for-Life

California Real Estate Magazine, September 1970

AT THE REQUEST of CREA President Melvin Mould, the author has analyzed the responses to the survey mailed in June to all California Savings and Loan Associations. Reg Dupuy has been an officer of a savings and loan association, a mortgage correspondent for a life insurance company, a mortgage broker to savings and loan associations, and is a successful operator of a real estate firm in the Bixby Knolls area of Long Beach. This article reflects his opinion after analyzing the responses, and is not necessarily the official opinion of CREA.

"THE TIME HAS COME, the walrus said, to speak of many things like ships and shoes and sealing wax and cabbages and kings." CREA President Mel Mould sent a comprehensive questionnaire to the president of each savings and loan association in the state in order to determine the procedures and policies of the responders. The savings and loan industry is the major source of lendable funds on real estate and the major source of loans is supplied by the real estate industry. It is time to discuss what has been learned about the "things" in the questionnaire.

It is true that a questionnaire tends to be cold and sterile and it is not possible to determine the reasoning behind many of the procedures and policies. Often there is misunderstanding by members of both industries, yet it is necessary for the success of the two industries to have mutual understanding and cooperation.

Realtors and their salesmen should acquaint themselves with the policies of the S&L's with which they come in contact and should therefore advise their buyers the advantages of one loan over another in a particular case. The S&L's should on the other hand become more solicitous of the Realtor for there are financially good times ahead.

The S&L's were most cooperative in replying. Only a few of the middle-sized and the small associations failed to return the questionnaire. A summary of replies follows:

I. *Do you make loan commitments?*
100% of those replying said they do.

a. 56% said they were oral.
37% said they were both oral and written.
7% said they were written.
Many said if requested, a written commitment could be obtained.

b. *For what period do you honor commitments?*
58% said for a 30-day period.
7% said the period varies.
7% said for a 15-day period.
21% said for miscellaneous periods from 3 to 60 days.

c. *Do you designate between a "firm" and "conditional" commitment?*
68% indicated yes.
32% indicated no.

II. *Prepayment Fee*

a. *How do you compute your charges for prepayment fees?*
42% charged 6 months interest on the unpaid balance after deducting 20% of the original amount of the loan.
16% charged 6 months interest on the unpaid balance.
10% charged 3 months or 90 days interest on the unpaid balance and some no fee after either 3 years or 5 years.
6% charged 2% on the unpaid balance.
5% charged 6 months interest for either 18 months or two years and then 3 months or 90 days interest after said periods.
21% had numerous other fees except for two which charged no fee. One charged only 9 days interest, another 30 days interest, another 2% on the original amount of the loan. Others charged 4 months interest and another 2% on the original amount of the loan. One charged 6 months interest on the original amount of the loan and permitted 20% of the original amount of the loan to be paid in any one quarter while other S&L's permitted the 20% either in any one month or in any one year. This same association also permitted the interest to be reduced ½ of 1% provided the 20% was paid additionally on principal.

III. *Assumption Fees*

a. *What is your fee for transfer?*
46% replied that their fee was 1% of the unpaid balance.
11% replied that their fee was ½ of 1% of the unpaid balance.
5% said their fee was 1½% of the unpaid balance.
4% said their fee varied from 1% to 1½% of the unpaid balance.
34% varied greatly, such as 1½% plus $100.00, 1% plus $50.00, $75.00, $80.00 or $100.00. And then there was a group that had a flat fee of $100.00, $95.00, $50.00, $25.00 and as low as only $10.00. On the other end of the scale were those who said 2% of the unpaid balance or from 1½% to 2½%, or ¾% of 1%, and then one S&L said from 1% to 5% of the unpaid balance. Two others simply said they would negotiate! The great majority were at either 1% or 1% plus a processing fee of a flat dollar amount, mostly $50.00.

b. *Do you charge a fee for transfer in the case of a divorce or death of one of the trustors?*
All of the S&L's except seven said no. Two charged $25.00 in either case, another charged $50.00 in either case, another $25.00 on only the divorce, while another charged $15.00 on a divorce. Another said

they charged for "out-of-pocket costs" and the seventh charged $25.00 for the divorce and $25.00 in case of death if children or others were involved but not to a surviving spouse.

c. *If you modify your deed of trust and note when an assumption is involved, do you increase the monthly payment and the interest rate?*

73% answered that they generally not only increase the monthly payment but the interest rate to the current market rate.

11% indicated they sometimes do.

8% say they modify the payment but use a rate less than the market rate and generally at ½ of 1% less.

5% said they do not modify the payments or increase the interest rates on an assumption.

3% said they would negotiate!

IV. *Acceleration*

Do you accelerate your loans for the following reasons and what are your modified terms?

a. Divorce. Not one S&L accelerated their loans.

b. Foreclosure of a junior lien. Only 1½% said they would.

c. Further encumbrance. Only 5% said they would with one stating it increased its interest rate to the going market rate. All others said no.

d. Lease of property. 2% replied yes, while one said its written consent was required. All others no.

e. Sale by contract. 43% said yes, 53% said no, while 4% required written consent.

f. Lease with option. 12% said yes, 2% said yes on a case basis, 79% replied no, and 7% indicated they would accelerate when the option was exercised. In talking with some S&L's who had replied no, they too said they would accelerate when the option was exercised and had not thought of the answer this way.

V. *Late Charges*

a. *What is your formula for a late charge?*

38% replied that they charged 10% of the monthly payment after 10 days delinquency and many said there was a minimum of $10.00.

10% charged 1/10th of 1% of the unpaid balance of the loan.

8% charged 2% of the loan balance if not paid in 30 days and most divided the 2% amount by 360 on a prorated daily basis.

5% charged 5% of the monthly payment with some saying there was a $10.00 minimum.

6% charged 4% of the monthly payment.

4% charged 1/12th of 1% of the unpaid balance of the loan.

29% had various other charges. Some increased ½ of 1%, or 1% or 2% higher annual interest per month on the loan until the delinquency was paid. There were numerous others. The two most interesting ones replied that their formula was .000833 times the loan balance and the other was .16666 times the unpaid balance.

b. *Do you give a late charge notice?*

30% said they did 10 days after the due date.

25% replied that they did 5 days after the due date.

19% said they did 15 days after the due date.

13% stated that the borrowers were informed when the loan was made and no further notice was made. Several indicated that if the loan payment record had been good, they sent the first notice with no charge but advised the borrower a charge would be made on each delinquency thereafter.

4% said they gave the notice either 6, 7 or 8 days after the due date.

9% varied anywhere from 3 days to as long as 30 days.

And there you have it. It can be readily ascertained that in general the S&L's do not have a standardized policy or procedure. Yet the industry in California has gross assets of over $30 billion, which is approximately 20% of the national total. Our two industries are similar in that Realtors in California make up approximately 20% of the National Association of Real Estate Boards.

CALIFORNIA REAL ESTATE LICENSES ISSUED

	1970	1969 July
LICENSES ISSUED		
Real Estate	5,304	3,501
REAL ESTATE LICENSES		
Original		
Broker	379	290
Salesman	1,461	1,225
Renewal		
Broker	1,492	903
Salesman	1,972	1,083
Total	5,304	3,501

Mergers today are becoming commonplace and Preston Martin, chairman of the Federal Home Loan Bank Board, has indicated that the agency will encourage even more mergers of savings and loan institutions. At present the 26 largest with assets of over $250 million hold about 70% of the total gross assets in California while the next 21 in size hold 13% or a total of 83%. We can anticipate more mergers.

Therefore, it is even more important for a Realtor to detetermine the procedures and policies of the associations. It would appear to me that it would be preferable for a written commitment to be issued for the mutual benefit of both the S&L's and the Realtor. Generally it would be conditioned subject to the financial and credit background of a buyer or a borrower. The down payment would be likewise considered. Although some S&L's have limited funds today, the commitment should be good for 30 days, which could be extended for cause.

The prepayment fees should be standardized at 6 months interest on the unpaid balance after deducting 20% of the original amount of the loan. Assumption fees should be set at either ½ of 1% but not more than 1% of the loan in order to encourage home ownership and multiple family ownership.

There should be no fees for a transfer in case of a divorce or death of one of the trustors unless third parties are involved when credit reports should be secured and analyzed.

The writer can see no reason to accelerate a loan due to a further encumbrance being placed on the property and particularly to increase the interest rate. The association may be justified in requiring the approval of such a junior lien, but to increase interest or to charge points is to take advantage of one who is usually unfortunate in having to obtain the loan at a 10% interest rate plus the high brokerage and escrow costs.

Often a borrower must lease his home and this should be of little concern to an association.

When it comes to selling a home on contract, the S&L's have the same owner remaining responsible and often the sale differs very little from a lease of the same home. The owner has to collect the payment and thus gives it his personal attention. The use of the acceleration clause in such a case is merely taking advantage of the clause, which, when it was adopted originally by institutional lenders was for the purpose of a credit check and to make sure that a subsequent buyer would satisfy the minimum credit requirements.

Lenders never dreamed that interest rates would soar as they have. As this was the original purpose, the acceleration clause should be used in the way it was intended. At such time as the contract is to be satisfied and the existing loan assumed, then an S&L may change its interest rate if it believes it necessary. It seems strange that such large institutions as life insurance companies do not believe in increasing interest rates on assumptions. They have had their financial problems too.

Certainly the late charges should be standardized. The most popular one is where the borrower is charged 10% of the monthly payment after a 10-day delinquency. However, the median appears to be 15 days, as a greater majority give notice 10 days after the due date. Therefore the 10% of the monthly payment after a 15-day delinquency would appear to be the best solution and with a notice given to the borrower at 10 days after the due date.

When an assumption is involved, the writer believes that nearly all associations are missing the boat. Each is anxious to improve its average interest rate on its portfolio. Yet the S&L's actually are impeding progress toward this desirable end.

A survey was made in June 1970 by the Long Beach District Board of Realtors. It asked the brokers to indicate the number of sales lost since November 1968 that could have been closed if the interest rates had been increased to only 7½%, 8% or 8½%. The rates were lower in the fall of 1968 and winter of 1969. Yet with only 6% of the Realtors replying (many were large offices) they reported 140 sales lost had the interest rate been increased to only 7½%, 90 sales lost if at only 8% and 23 sales lost if at only 8½%.

One medium sized association reported in the questionnaire that it had adopted a policy of adding 1½% to the existing interest rate to a maximum of 8% on 1 to 4 units and 1½% on multiple families to a maximum of 8½%. If a loan was at 6% then the new rate would be 7½%. If it was at 7% the new rate would only be increased to 8% on the 1 to 4 unit property.

Others reported they used a rate of ½ of 1% less than the going market rate. One large association will refinance a home up to 80% of appraised value and provided there is no resale intended, and the loan has been seasoned 30 months or more, it increases its rate by only 1¼% but not more than the maximum rate of 8¼%. It has been reported that this S&L is making many such loans and bettering its yield. Why they don't do the same on sales is hard to understand.

The point is that many would-be buyers are putting off the day to buy a home as there has been much publicity in the press that interest rates will be less later. They don't know when "later" is but they are waiting. The Long Beach survey points up the fact.

A large title company went on a campaign not too long ago with advertisements and placards such as "Buy Your Home Now" and so on. The S&L's could jointly go on such a program through, perhaps, the California Savings and Loan League. These placards could be in every Realtors window. The big S&Ls' ads in the newspapers could include similar messages. And the S&L's could easily use the lower interest rates on assumptions such as indicated above for they would boost their average yield rather quickly and collect an assumption fee too.

What would be the result of a well planned campaign of this sort? It would create more money circulating from all these extra sales, for each dollar generally would circulate 10 times. Merchants, furniture and carpet dealers, painters, carpenters and many others would benefit. These sales would create more sales, creating more assumptions and in addition to increasing the portfolio yield, it would help to provide more savings deposits for the associations. The Realtors would assist in the campaign. "Buy Now" should be the slogan for the immediate future.

In short, to reduce the interest rates on assumptions would not only help the savings and loan associations in their net yield and increased saving accounts but it would help the whole economy of the state. They could be heroes and their public image would make them leaders.

ASSEMBLY FINANCE AND INSURANCE COMMITTEE

FINAL REPORT

on

Late Payment Fees

Late payment charges was the subject of several bills introduced at the 1969 session of the Legislature and which was the subject of interim study by the Finance and Insurance Committee.

A late payment charge is that amount of additional money which may be imposed by a lender on the borrower for the late payment of any installment on a loan after the due date of such payment. Under present law, late charges on loans secured by real property are not regulated by statute and the amount of late charges assessed a borrower will vary depending upon the lending institution. There is also no requirement in the present law that specified the borrower be notified at the time a payment is late that a charge will be assessed on the loan or that such a charge has been assessed.

An additional problem involved with late payment charges is that there is no standard method of determining what the late charge will be based upon. Each lender is free to decide what late charge provision will be included in his promissory note form and whether the late charge shall be a percentage

of the late installment, a percentage of the unpaid loan balance, a percentage of the original loan balance or a flat fee. A survey of late charges for California state licensed savings and loan associations was conducted by the State Savings and Loan Commissioner in August of 1966. That survey indicated that a majority (113) of the 200 associations chartered at that time charged between 1% and 10% of the monthly payment as a late charge. Twenty-one associations in that same survey charged 1/10th of 1% of the unpaid loan balance while only 11 associations charged a flat fee, usually $5.00.

This survey indicated that the greatest number of savings and loan associations (73) in California charged 10% of the monthly payment as a late charge. The next highest category was a charge of 4% to 5% of the monthly payment by 27 associations. The third highest category was 21 associations charging 1/10 of 1% of the unpaid loan balance.

The California Savings and Loan League conducted a separate survey of delinquent penalties assessed by all California savings and loan associations in June of 1968. This survey determined that 72 associations (31%) charged 10% of the monthly payment as a delinquent penalty. 13% charged 1/6th of 1% of the unpaid principal balance. The next highest category was 11½% which charged 1/10th of 1% of the unpaid principal balance. 49% of all associations charged between 2 and 10% of the installment as a late charge.

It is interesting to note from this survey what other types of delinquent penalties are assessed the borrower. One association charges a maximum of 20 percent of the monthly payment, another charges one percent per day of the monthly payment while two associations charge one percent of the original principal balance. Two other associations charge 1/8 percent of the unpaid balance and 1/9 percent of the unpaid balance. Two additional associations would increase the rate of the note to a set percentage per annum due to the delinquent payment.

This committee has received numerous complaints from borrowers regarding the amount of penalties assessed for late payment of installments. One was a late charge of $41.92 assessed by a savings and loan association on a monthly payment of $196.00, which would be calculated to 21.38% of that delinquent payment. Another example of late charges was that one borrower was charged $139.20 on a loan payment of $560.00 for being in default for seven payments, or 24.85%

The work sheet on one loan indicates that the borrower took out an original loan of $1400.00 payable in monthly installments of $20.00 each. From November 10, 1964, to July 24, 1969, the borrower paid a total amount of $1170.00. Of that figure only $78.18 was applied to the principal amount and $664.82 was applied to the interest. There were 28 late

payments during this period which were assessed at $14.00 each for a total amount (including six telegrams that were sent) of $427.00 for penalty assessments on late payments. It is interesting to note that after paying on the original amount of $1400.00 for five years the unpaid principal balance due was $1321.82.

One legislative proposal introduced during the 1969 session to correct the problem of late payment charges was AB 517 which was referred to interim study by this committee. This bill would have limited the maximum charge that may be imposed on late installment payments of a loan which is secured by real property to 10 percent of the amount of the installment or a $5.00 minimum, whichever is greater.

Proponents of AB 517 point out that the Unruh Retail Installment Sales Act limits the maximum delinquency charge to five percent of the installment or $5.00 whichever is less with a minimum charge of $1.00. Further, proponents maintain that the borrower usually is not informed of the size of the late charges or often that such charges are even being assessed.

Opponents of this legislation contend that the charge must be sufficiently stiff to encourage prompt payment and to prevent frequent delinquencies on loans.

Another bill relating to this subject was AB 1909, also introduced during the 1969 session. This bill makes two changes in the statutes covering real property mortgage loan brokers.

Section 1 of the bill would require that the terms of any late payment fee or default charge be disclosed in the broker's statement furnished the borrower at the time the loan is made.

Section 2 of the bill would limit any late payment charge on a loan arranged by a mortgage loan broker to 10 percent of the late installment or $3.50, whichever is greater. Such charge could only be collected once and if deducted from the next payment could not then be assessed against that payment because it is less than the amount owed.

It should be noted that these late payment provisions only apply to loans negotiated by mortgage loan brokers and do not apply to loans made by licensed lenders.

The position of the Attorney General is that there have been substantial abuses of the late payment privilege on loans placed through these brokers, abuses which do not occur to the same extent with licensed lending institutions.

Opponents argue that there is no reason for singling out this part of the industry and that late payment fees should be high enough so that borrowers are sufficiently encouraged to make their payments on time.

A subsidiary problem of the late payment charges is that of notification to the borrower that such fees are being

assessed against him for his delinquency in paying the installments.

Referring once again to the survey by the California Savings and Loan League, the method of informing the borrowers of delinquency notices varies among the savings and loan associations. A majority of 51 percent of the associations inform the borrower by printed form or letter. Fifteen-and-a-half percent indicate this information by a copy of the note or other documents, 11 percent verbally and one percent give this information on request. It is interesting to note that 4½ percent of the associations (11 in number) have no system of notifying the borrower of his delinquency.

AB 1924 (1969 General Session) would require that with respect to any loan secured by real property, the borrower must be notified in writing that a late payment charge will be applied to the loan and the amount thereof, and be afforded five days from the mailing of the delinquency notice to cure the delinquency.

This procedure would apply to the first default. With respect to subsequent defaults, the borrower need only be advised in writing of the imposition of the late charge within five days after the late charge has been imposed.

From the lenders point of view, the imposition of a substantial late payment charge serves the purpose of reducing the institution of foreclosure proceedings when a borrower is

tempted to use his funds to meet obligations other than his mortgage payment. Without such delinquency charges at relatively high levels, a borrower may let his mortgage payment slide while making other pressing debt payments. However, generally, a mortgagee or trustee will only allow no more than 60 days to elapse from the date of payment before filing notice of a delinquency and instituting foreclosure proceedings. It is important that borrowers be made to feel the impact of potential late payment charges. If foreclosure proceedings start, it will be much more expensive to cure than would the cost of any reasonable late charge.

Most lenders would agree that late fees should not be a source of extra profit to the lender. The fee should be adequate, however, to defray any additional expense involved in processing a late payment as well as compensating for lost interest which could have been earned if the payment were made on time. In addition, there should be a "motivation factor" included. This would be a sum reasonably designed to encourage prompt payment of the installment without amounting to an exorbitant or unconscionable charge.

At the time a promissory note is executed by a borrower, he will usually pay little attention to late payment provisions or various penalty provisions. His main interest on real property loan transactions is the interest rate, the term of

the loan and his monthly payments. Since most debtors, at the time of borrowing, do not intend to make payments late, they are not inclined to actively negotiate over delinquency payment clauses. Nor are they likely to compute out the actual amount which would be due if a penalty of 1% of the original balance of a loan were assessed.

The absence of notice to the borrower at the time a late payment fee is imposed creates additional problems. Often the lender will deduct the late fee from a subsequent payment leaving that payment inadequate to meet the current installment. In that case, the inadequate payment will be returned to the borrower. In other cases, the fact a late charge has been imposed will not be told to the borrower until the end of the loan at which time all such charges are payable before the promissory note is cancelled.

The purpose of a late fee is to insure prompt payment. This purpose cannot be served if the late charge is too low. The size of the fee can aid in insuring prompt payment. But such a result cannot be expected if the borrower is without notice of the imposition of the fee. For that reason, the committee favors a requirement that with respect to the first late installment the borrower be given five days after notice of the delinquency to cure it without penalty. For subsequent delinquencies the borrower should be notified of the imposition of the late charge within five days of its imposition.

The committee, however, does not recommend statutory maximum late payment fees at this time. Such maximums when set by statute invariably become minimum or standard charges to which all lenders adhere. Competition over these terms is virtually eliminated and those institutions that would assess a smaller penalty raise their fees to the maximum permitted by the statute. We believe that the notice provisions that we have recommended will alert borrowers to their potential liability when making payments after the due date without the inflexibility of maximum and minimum charges set by statute.

Moreover the committee's studies indicate that the grace period allowed by lenders before the late charge is assessed will be shorter where the charge is smaller with a longer grace period given when the charge is higher. If no grace period were permitted in a statutory late charge provision, the public could end up paying more if all institutions adopted as standard the maximum late fee permitted by statute. For the Legislature to enact a mandatory grace period would be improper since it amounts to telling persons that they do not have to pay their bills on time but by law may pay late without penalty. Such conduct should not be legislatively encouraged.

SURVEY OF FEES AND CHARGES FOR CALIFORNIA STATE-LICENSED ASSOCIATIONS - AUGUST 1966

All California Associations

Late Payment Charges

Assets Million Dollars	No. of Assoc.	No Chrg.	Less than 1%	Percent of Monthly Payment						Percent of Unpaid Loan Balance								Flat Fee				
				1-2	4-5	6-8	10	15	20	1/12	1/10	1/6	1/5	1/4	1/2	1	2	$2	$2.5	$5	$7.5	$10
0-5	8		1	1			2		1		1	1						1				
5-15	47	1		2	5		22			1	3	1	1		1	2	4			4		
15-25	33	1		2	4	1	10			2	3	1				3	2		1	2		1
25-50	44			3	8	1	16	1		1	3	1	1	1	2	1	3			1	1	
50-100	24			1	7		6	1	1		4					1	3					
100-300	34				3	1	12			1	5		5		1	1	5					
Over 300	10						5				2	1					2					
Total	200	2	1	9	27	3	73	2	2	5	21	5	7	1	4	8	19	1	1	7	1	1

SURVEY OF FEES AND CHARGES FOR CALIFORNIA STATE-LICENSED ASSOCIATIONS - AUGUST 1966

Southern California Associations

Late Payment Charges

Assets Million Dollars	No. of Assoc.	No Chrg.	Less than 1%	Percent of Monthly Payment						Percent of Unpaid Loan Balance								Flat Fee				
				1-2	4-5	6-8	10	15	20	1/12	1/10	1/6	1/5	1/4	1/2	1	2	$2	$2.5	$5	$7.5	$10
0-5	2			1			1															
5-15	23				2		15				1	1	1		1		1			1		
15-25	18	1				1	8				3	1					1		1	1		1
25-50	26			1	4		8				3	1	1	1	2		3			1	1	
50-100	14				3		4		1		4						2					
100-300	24				2		9				4		4		1	1	3					
Over 300	8						3				2	1					2					
Total	115	1		2	11	1	48		1		17	4	6	1	4	1	12		1	3	1	1

SURVEY OF FEES AND CHARGES FOR CALIFORNIA STATE-

LICENSED ASSOCIATIONS - AUGUST 1966

Northern California Associations

Late Payment Charges

Assets Million Dollars	No. of Assoc.	No Chrg.	Less than 1%	Percent of Monthly Payment						Percent of Unpaid Loan Balance								Flat Fee				
				1-2	4-5	6-8	10	15	20	1/12	1/10	1/6	1/5	1/4	1/2	1	2	$2	$2.5	$5	$7.5	$10
0-5	6		1				1		1		1	1						1				
5-15	24	1		2	3		7			1	2					2	3			3		
15-25	15			2	4		2			2						3	1			1		
25-50	18			2	4	1	8	1		1						1						
50-100	10			1	4		2	1								1	1					
100-300	10				1	1	3			1	1		1				2					
Over 300	2						2															
Total	85	1	1	7	16	2	25	2	1	5	4	1	1			7	7	1		4		

EXHIBIT B

SURVEY OF DELINQUENT PENALTIES - CALIFORNIA SAVINGS AND LOAN ASSOCIATIONS

DELINQUENT PENALTIES

	Percent of Monthly Payment						Percent of Unpaid Principal Balance						Miscellaneous		
	2%	4%	5%	6%	10%	Other	1/12%	1/10%	1/6%	1/5%	1/4%	1/2%	Flat Fee	None	Other
No. Assns.	6	16	15	5	72	10*	20	27	31	6	1	10	3 ($5) 2 ($2)	2	6**
% of Total Responding	2.5%	7%	6.5%	2%	31%	4%	8.5%	11.5%	13%	2.5%	.5%	4%	2%	1%	2.5%

* 1 assn. - 7%
3 assns. - 8%
2 assns. - 15%
1 assn. - 20% max.
1 assn. - 1% per day
2 assns. - pmt. x int. rate of note

**1 assn. - 1/8% of unpaid prin. bal.
1 assn. - 1/9% of unpaid prin. bal.
2 assns. - 1/10% of original prin. bal.
1 assn. - incr. rate of note to 8% per annum
1 assn. - incr. rate of note to 9% per annum

GRACE PERIODS

	None or None Stated	10 days	15 days	Other	Grand Totals	% of Total Responding
Contractual	1	69	61	4	135	58%
Non-Contractual	51	20	20	6	97	42%
Total	52	89	81	10*	232	100%
% of Total Responding	22%	38%	35%	4%		

*1 assn. - 5 days, non-contr.
1 assn. - 7 days, non-contr.
1 assn. - 20 days, non-contr.

6 assns. - within mo. pymt. due
(4 contractual - 2 non-contr.)
1 assn. - determined on individual basis

METHOD OF INFORMING BORROWERS OF ASSOCIATION POLICIES

	Printed Form or Letter	Copy of Note or Other Documents	Verbal	Information on Request	None	Did Not Indicate
No. Assns.	118	36	25	2	11	40
% of Total Responding	51%	15.5%	11%	1%	4.5%	17%

Prepared by the California Savings and Loan League - June 1968

Civil Code Section 2954.5

§ 2954.5 Delinquent payment charge; prerequisites to imposition

(a) Before the first default, delinquency, or late payment charge may be assessed by any lender on a delinquent payment of a loan, other than a loan made pursuant to Section 22466 of the Financial Code, secured by real property, and before the borrower becomes obligated to pay such a charge, the borrower shall either (1) be notified in writing and given at least six days from mailing of such notice in which to cure the delinquency, or (2) be informed, by a billing or notice sent for each payment due on the loan, of the date after which such a charge will be assessed.

The notice provided in either paragraph (1) or (2) shall contain the amount of such charge or the method by which it is calculated.

(b) If a subsequent payment becomes delinquent the borrower shall be notified in writing, before the late charge is to be imposed, that the charge will be imposed if payment is not received, or the borrower shall be notified, at lease semiannually of the total amount of late charges imposed during the period covered by the notice.

(c) Notice provided by this section shall be sent to the address specified by the borrower, or, if no address is specified, to the borrower's address as shown in the lender's records.

(d) In case of multiple borrowers obligated on the same loan, a notice mailed to one shall be deemed to comply with the provisions of this section.

(e) The failure of the lender to comply with the requirements of this section does not excuse or defer the borrower's performance of any obligation incurred in the loan transaction, other than his obligation to pay a late payment charge, nor does it impair or defer the right of the lender to enforce any other obligation including the costs and expenses incurred in any enforcement authorized by law.

The provisions of this section shall only affect loans made on and after January 1, 1971.

(Added by Stats.1970, c. 1430, p. 2773, § 1. Amended by Stats.1971, c. 813, p. ——, § 1.)

LAW OFFICES OF

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January 12, 1973

California Law Revision Commission
School of Law
Stanford University
Stanford, California 94305

Re: Liquidated Damages Study

Gentlemen:

Senator Alfred H. Song, on your behalf, has requested a statement of the views of the California Bankers Association as to what would constitute an appropriate formula for computing the late payment charge on a loan secured by real property and for supporting information stating the actual late payment charges now made, including data showing the actual costs incurred by the lender as a result of the failure to make a timely payment on such a loan.

As you may be aware, the Association has sponsored legislation to limit the charges for late payments on loans secured by real property containing single-family, owner-occupied dwellings to 10% of the installment due. In 1972, Assemblyman Pierson carried A.B. 1516 which would have imposed such a limitation. While this measure was unsuccessful, we are in hopes that other types of lending institutions will be able to support some limitation in the future.

With respect to the actual charges now made by members of the Association for late payments on loans secured by real property, I am advised that the majority

of the major banks impose a charge of 4% of the delinquent installment on conventional loans. There are, of course, variations from this figure as each bank sets its own policy based upon the character of its loan portfolio. As to cost data, I am unable to furnish you with that information because I am advised that the primary purpose of such a charge is to encourage installment payments be made in a timely manner.

I note that the Commission will be considering a staff recommendation that, with respect to loans with installments of not less than $500, the late payment charge, whatever the amount, would be subject to invalidation on the grounds it was manifestly unreasonable. It is not uncommon for sophisticated commercial borrowers to deliberately default on installments when conditions in the money market make it advantageous to do so. I would suggest that the Commission consider limiting the likelihood of litigation to situations where the late payment charge is in excess of 10% of the delinquent installment. While the Commission has found it desirable to permit the parties more freedom in negotiating late payment charges on large loans, it would appear inconsistent, as well as undesirable, to permit litigation as to the reasonableness of the charge if it does not exceed 10%. I am also concerned that such a distinction would raise the issue of whether it is a reasonable classification. The comments on the foregoing recommendation are my personal views in that the members of the Association have not had an opportunity to consider this particular recommendation.

The California Bankers Association appreciates this opportunity to make its views known to the Commission. In order that this letter be available to the members of the Commission prior to the January 19th meeting, I am sending copies to each of you individually.

Very truly yours,

LANDELS, RIPLEY & DIAMOND

John E. Ballouff

Counsel
California Bankers Association

JEB:rm

cc: Honorable Alfred H. Song