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The Demise of Prepayment Penalties?

Prepayment penalties, once the rage of mortgage originators, will soon face their near demise. Used ostensibly to offer better terms to the borrower, and not coincidentally also providing increased income to the originator, **these penalties tended to lock borrowers into their loans when they wanted to refinance, making it financially infeasible for many borrowers to refinance without loss of equity.** Yet there was rarely any discipline, let alone motivation, on the part of the originators to implement policies to curtail the use of prepayment penalties.

The government, belatedly but finally, has said “Enough!”

On October 1, 2009, new restrictions will reduce the incentive to use prepayment penalties in residential mortgage loans. On that date, the new and final revisions to [Regulation Z](#), the implementing regulation of the Truth in Lending Act, will take effect. Although the common sense features of these new restrictions have long since been apparent to many compliance and industry professionals, it has taken some time (and a mortgage meltdown) for these needed changes to become the law of the land. Especially in the current economic environment, when millions of borrowers are seeking to refinance their mortgages, the debilitating aspects of prepayment penalties needed to be reduced, if not eviscerated.

High Cost and Higher Priced Mortgages

Prepayment penalty restrictions will soon apply to **not only “high cost” but also “higher priced” mortgages.** The former refers to [“Section 32,” so-called “HOEPA” loans](#) (referencing Section 32 of Regulation Z, and HOEPA

referencing the Home Ownership and Equity Protection Act of 1994, the high cost mortgage legislation).

A **high cost** mortgage loan is determined by a “test” of its rate as well as its points and fees: if a rate exceeds the rate on certain [comparable term Treasury securities](#) or if points and fees exceed the higher of 8% of the total loan amount or \$583 for 2009, the loan is considered high cost.

- Exclusions: purchase money mortgages, reverse mortgages, and Open-End Credit.

The **higher priced** mortgage loan, a new category created under Regulation Z, tests for rate, but not fees. If the Annual Percentage Rate (APR) exceeds a **new index**, called the “**average prime offer rate**” by a specific amount, the loan is considered “higher priced.”

- Exclusions: construction loans, “bridge” loans with a term of 12 months or less, reverse mortgages, and Home Equity Line of Credit loans (HELOCs).

This index is not the same one used to calculate the high cost loans. Instead, this is a **new index**, based on [Freddie Mac’s Weekly Primary Mortgage Market Survey](#), and will be published by the Federal Reserve Board. We have written somewhat extensively on the revisions to Regulation Z and the new index in our [Advisory Bulletins, which can be found in our Archive](#), as it pertains to various Regulations.

([Visit our Archive](#) for: “FRB Finalizes Revision to Regulation Z – Truth in Lending,” dated July 28, 2008; “FRB Proposes Revision to Regulation C (HMDA),” dated July 30, 2008; “FRB Issues Final Rule to Regulation C (HMDA),” dated October 20, 2008.)

Before and After

Take a look at the following schematic, which provides a [Before and After](#) analysis of certain restrictions of the Prepayment Penalty:

HIGH COST LOANS

Prepayment Penalties **PROHIBITED UNLESS ALL Restrictions Apply**

RESTRICTIONS	BEFORE 10-01-09	AFTER 10-01-09
1) State or Federal Prohibitions	Unless otherwise permitted by law.	Unless otherwise permitted by law.
2) Term	After first 5 years, no penalty.	After first 2 years, no penalty.
3) Refinance Originator	Creditor affiliate refinance does not trigger the penalty.	or Credit or affiliate refinance does not trigger the penalty.
4) DTI Ratio (including mortgage PITI) *	May not exceed 50.	May not exceed 50.

* DTI = Debt to Income; PITI = Payment, Interest, Taxes, and Insurance

HIGHER PRICED LOANS

Prepayment Penalties **PROHIBITED UNLESS ALL Restrictions Apply**

RESTRICTIONS	AFTER 10-01-09
1) State or Federal Prohibitions	Unless otherwise permitted by law: <u>must meet BOTH high cost AND higher priced conditions.</u>
2) Term	After first 2 years , no penalty.
3) Refinance Originator	Creditor or affiliate refinance does not trigger the penalty.
4) Periodic Payment	Periodic payment of principal and/or interest DOES NOT change for first 4 years.

Disciplining the Prepayment Penalty

Clearly, the revisions to Regulation Z contemplate reining in the kind of loan origination initiatives that utilize prepayment penalties, especially in loan products that require periodic increases to the mortgage payment. **The effect of having the prepayment penalty restrictions apply to both the high cost and higher priced loan categories will be that all subprime and most Alt-A loan products will be affected.**

Creditors will only be able to impose a prepayment penalty for the first 2 years after consummation, thus jettisoning the previous 5 year period imposition, and the lender's pricing incentive in relation to the per loan revenue will be significantly lowered.

The lender must qualify the borrower's DTI **before consummation** by utilizing all appropriate verifications of income and documenting them. Therefore, the borrower's ability to repay must be verified **prior to relying on it to impose prepayment penalties.**

Currently Regulation Z prohibits a "pattern or practice" of lending without regard to the borrower's ability to repay, thereby providing a presumption of a violation only if a **pattern or practice** can be established in which income verification is not processed or documented adequately.

This language has been removed in the final rule, further exposing lenders to heightened diligence in reviewing a borrower's ability to repay. Consequently, **it will soon be a violation of TILA for any high cost or**

higher priced loan (excluding a high cost bridge loan of 12 months or less) to be originated without regard to a borrower's ability to repay from income and the collateralized assets.

Given that **prepayment penalty restrictions will apply to both high cost and higher priced mortgages**, many more loan products as well as borrower income, credit, and asset profiles will be included than ever before.

Although the new rules do not put an end to the use of prepayment penalties, they will have lost much of their attraction for most lenders when the final revisions of Regulation Z take effect on October 1, 2009.

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Lenders Compliance Group is a risk management firm, providing professional guidance to financial institutions in all areas of mortgage compliance, including the following areas: CORE Compliance Matrix and Rating • Federal and State Mortgage Compliance • Loan Level Analytics • Risk Assessments • Legal and Regulatory Reviews • Licensing - State, Federal, and FHA • Mortgage Quality Control • HMDA / CRA • Due Diligence Audits • RESPA / TILA / All Regulatory Compliance Reviews • Loss Mitigation • Banking, HUD, and Regulatory Examinations. Website: www.lenderscompliancegroup.com
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