Why Prepayment Penalties are Abusive in Subprime Home Loans

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Introduction

Homeownership not only supplies families with shelter, it also provides a means to build wealth and economic security. For American families, 71% of their wealth is located in home equity.1 Unfortunately, too many American homeowners are losing their homes, as well as the wealth they spent a lifetime building, because of harmful home equity lending practices. Studies suggest homeowners lose $9 billion in home equity due to these practices.2

Predatory lenders target elderly, poor, and uneducated borrowers to strip the equity from their homes. Some predatory lenders trap borrowers in bad loans through the imposition of prepayment penalties that require the payment of a significant penalty to refinance into a better loan. While the borrower may be able to qualify for a lower cost loan,3 the prepayment penalty charge either prevents the refinance or creates a windfall for the lender. Furthermore, prepayment penalties facilitate kickbacks by lenders to brokers (yield-spread premiums) for placing borrowers in loans at a higher interest than the borrower could otherwise qualify for. Without prepayment penalties, lenders would be less willing to pay these kickbacks, as borrowers could refinance into a cheaper loan before the lender recouped the amount of the kickback.

1 U.S. Census Bureau, Household Net Worth and Asset Ownership: 1995, at xii tbl.E (2001), at http://www.census.gov/prod/2001pubs/p.70-71.pdf. The median net worth of households surveyed is $40,200, including home equity. Excluding home equity, the net worth is $11,773. Therefore, for American households, the median net worth attributable to home equity is 71%.


3 Fannie Mae has estimated that 30-50% of subprime borrowers could have qualified for a loan with better terms. Freddie Mac estimates that 10-35% of subprime borrowers could have qualified, and cites a poll of 50 subprime lenders who estimate that half could have qualified for prime loans. See Freddie Mac Special Report on Automated Underwriting (Sept. 1996) at http://www.freddiemac.com/corporate/reports/moseley/chap5.htm; Half of Subprime Loans Categorized as ‘A’ Quality, Inside B&C Lending (June 10, 1996).
I. Prepayment Penalties are Pervasive in Subprime Home Loans and are used Predominately by Unregulated Finance Companies.

Prepayment penalties have become increasingly prevalent in the subprime market since 1996, at a level far out of proportion to the conventional or “prime” mortgage market.\(^4\) While a competitive market and the threat of supervisory action by a federal regulator have limited prepayment penalties on conventional loans, in the context of subprime lending, prepayment penalties and late fees have become a common area of abuse. In contrast to an 80% prevalence of prepayment penalties in subprime loans,\(^5\) in the competitive, conventional conforming market, less than 2% of borrowers accept prepayment penalties.\(^6\)

Area studies and evidence from individual lenders support these aggregate statistics, and show that many subprime lenders use prepayment penalties on all or most of their loans. For example, in a study of mortgage foreclosures in Montgomery County in Ohio, out of 36 subprime lenders, 11 lenders had prepayment penalties on all of their sample loans.\(^7\)

The prevalence of prepayment penalties on subprime loans means that prepayment penalties are used predominately by unsupervised finance companies. An analysis of the top 25 subprime lenders according to Inside B&C reveals that at least twenty of the lenders are finance companies that are not depository institutions whose mortgage practices are regulated at the state level or at the federal level by the Office of the Comptroller of the Currency, the Office of Thrift Supervision, or the National Credit Union Association.\(^8\)

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\(^4\) This growth can be attributed to a change in the Office of Thrift Supervision’s (OTS) regulations regarding the application of the Alternative Mortgage Transaction Parity Act of 1982 (“AMTPA”), 12 U.S.C. § 3800 et seq. The OTS reinterpretation in 1996 prevented states from enforcing prepayment penalty restrictions against finance companies (which make the vast majority of subprime loans) by allowing finance companies preemption on par with regulated federal depository institutions. OTS now has reconsidered its interpretation and returned to its prior interpretation that state laws apply. See 67 Fed. Reg. 60542 (Sept. 26, 2002).

\(^5\) The frequency of prepayment penalties on subprime loans the year before the OTS reinterpretation, 1995, was just 10% in one Salomon Smith Barney estimate. See Salomon Smith Barney, Prepayments on RFC Fixed-Rate HEL Loans, in U.S. Fixed-Income Research, at 11 (August 11, 2000). Following the OTS ruling, the frequency of such penalties steadily increased, reaching a stunning 80% in 2001. Prepayment penalties prove their merit for subprime and ‘A’ market lenders, Inside Mortgage Finance (May 21, 1999) (reporting that the percentage of the loans purchased by Household Financial Services that included prepayment penalties grew from 60% in 1998 to 80% a year later).


\(^7\) See Freddie offers a new A-, prepay-penalty program, Mortgage Marketplace, at 1-2 (May 24, 1999); see also Joshua Brockman, Fannie revamps prepayment-penalty bonds, American Banker at 16 (July 20, 1999).


Analysis based on information from Home Mortgage Disclosure Act data (see Randall M. Scheesele, Manufactured Home and Subprime Lender List, U.S. Department of Housing and Urban Development (2001); U.S. Census Bureau), the National Information Center of the Federal Reserve Board (at http://www.ffiec.gov/nic) and self-published lender websites.
II. Prepayment Penalties Drain Hard-Earned Wealth from Borrowers and Trap them in Subprime Loans.

The cost of prepayment penalties in subprime home loans is three-fold, abusing borrowers by stripping equity from their homes, trapping borrowers in bad loans with an increased risk of foreclosure, and facilitating kickbacks that encourage brokers to place borrowers in higher interest loans than the borrower qualifies for.

A. Prepayment Penalties in Subprime Loans Strip Home Equity from Borrowers.

Prepayment penalties are not only prevalent in subprime loans, but are frequently a central tool used by predatory lenders to strip equity from vulnerable borrowers. The Center for Responsible Lending (CRL) estimates that 850,000 families lose $2.3 billion each year from their home equity wealth because of prepayment penalties in subprime loans.9 Lehman Brothers data reveals that 52.7% of borrowers prepay on loans with prepayment penalties during the five-year lock-out period.10

When paid, the wealth drained from a borrower’s home due to a prepayment penalty can be significant. Notwithstanding variation across states, a recent analysis by Lehman Brothers found that the typical penalty amount in today’s market is six months’ interest on any amount prepaid over 20 percent of the loan.11 In the context of a subprime loan with an interest rate of 12%, this means that the prepayment penalty amounts to approximately 5% of the loan balance. For a $150,000 loan, this fee is $7,500, or more than the total net wealth of the median African-American family accumulated over a lifetime.12

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9 Eric Stein, Center for Responsible Lending, Quantifying the Cost of Predatory Lending, at 7 (2000), available at http://www.responsiblelending.org/pdfs/Quant10-01.PDF. While Lehman Brothers states that a 5% penalty that is outstanding for five years is standard, to be conservative, CRL assumes that the average penalty is 4% for four years. Modeling Lehman’s assumptions, 44% of borrowers actually pay this 4% fee. Total subprime originations in 1999 were $160 billion, with an average loan size of $67,000, for a total number of loans of 2.4 million. See Joint HUD/Treasury Report on Recommendations to Curb Predatory Home Mortgage Lending (June 20, 2000) at 29-31. Multiply the 4% fee times the 44% of borrowers who pay it times the 80% of subprime borrowers who have penalties by the $160 billion in total subprime originations. The net result is $2.25 billion in lost equity. Multiply the 2.4 million borrowers times 44% who pay the penalty times 80% who have prepayment penalty loans means that 850,000 families annually lose this $2.25 billion each year due to hidden prepayment penalties. Id.
10 See A. Chu & K. Kwan, Lehman Brothers, Asset-Backed Securities, MBS and ABS Weekly Outlook, at 2. (Assumptions based on Lehman’s database of 130,000 subprime loans.) Lehman assumes that the Constant Repayment Rate builds up to 17% per year for loans with prepayment penalties and builds up to 25% per year for loans without such penalties. Additional analysis shows that 52.7% of borrowers subject to the 5% prepayment penalty will prepay during the five-year period (while 67.9% of borrowers not subject to penalty will prepay, a difference of 15%).
11 See A. Chu & K. Kwan, Lehman Brothers, Asset-backed Securities, MBS and ABS Weekly Outlook (July 17th, 2000), at 8; see also Prepayment penalties prove their merit for subprime and ‘A’ market lenders, Inside Mortgage Finance (May 21, 1999).
B. Prepayment Penalties in Subprime Loans Trap Borrowers In Costly Loans.

Prepayment penalties can be abusive because they trap subprime borrowers in high-interest rate loans, forcing families to continue to pay more each month than available alternatives, and frequently leading to foreclosure. It is often argued that the subprime sector serves an important function for borrowers who encounter temporary credit problems that keep them from receiving low-rate conventional loans. Lenders emphasize that the subprime sector can provide borrowers a bridge to conventional financing as soon as the borrower is ready to make the transition. However, the economic reality of the costs of prepayment penalties often prevents this theorized transition from taking place, as the prepayment penalty means the borrower cannot make the move to conventional financing without sacrificing valuable equity. When a borrower refinances out of a subprime loan into a better-priced mortgage, a prepayment penalty allows the lender to strip the family’s hard-earned home equity wealth as punishment for obtaining a better deal.

In addition to the size of prepayment penalties, the length of time prepayment penalties apply to some loans can prevent refinancing even where a subprime borrower has cured his or her credit by making timely mortgage payments. Fannie Mae and Freddie Mac estimate that up to 50% of borrowers are steered into subprime loans even though they could have qualified for conventional financing when they entered into the subprime loan. Even for those families who legitimately received a subprime loan at the beginning, our understanding is that it typically takes a borrower with a history that includes bankruptcy or foreclosure 12 to 36 months to substantially improve their credit rating. Consequently, charging prepayment penalties for longer than this length of time is severely punitive: these borrowers have improved their credit rating but remain locked into loans with terms that are more unfavorable than those for which they now qualify or, alternatively, bear significant financial costs if they choose to refinance.

In reality, a borrower’s lock-in period can be very long since the most common prepayment period is 5 years, meaning that many borrowers spend two to four years paying interest rates that are higher than can be justified by their credit-rating. If borrowers pay the penalty and refinance during the lock-in period, it will take years to earn back the wealth that has been stripped by the payment of the penalty. Worse, if the prepayment penalty is too large, it prevents the borrower from refinancing or selling their home at all.

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14 Stein, Quantifying the Cost of Predatory Lending, at 10. Fannie Mae has estimated that 30-50% of subprime borrowers could have qualified for a loan with better terms. Freddie Mac estimates that 10–35% of subprime borrowers could have qualified, and cites a poll of 50 subprime lenders who estimate that half could have qualified for prime loans. Id. (citing Freddie Mac Special Report on Automated Underwriting (Sept. 1996) at http://www.freddiemac.com/corporate/reports/moseley/chap5.htm; see also Half of Subprime Loans Categorized as ‘A’ Quality, Inside B&C Lending (June 10, 1996)).
16 For a 30-year, fixed rate loan at 12%, it takes almost nine years to accumulate equity equal to 5% of the loan amount for a typical subprime loan. Stein, Quantifying the Cost of Predatory Lending, at 9.
17 See, e.g. John Hechinger, Home Bound: Nasty Surprise Haunts Some Folks’ Mortgage- A Prepayment Penalty, WALL STREET JOURNAL Aug. 1, 2001 (describing Jacquelyn Ali, who had to wait to refinance her 10.99% interest subprime loan with a 6.1% interest mortgage because she could not afford to pay off a $3000 prepayment penalty,
C. Prepayment Penalties Encourage Brokers to Charge a Higher Interest Rate than the Borrower’s Credit Requires.

Prepayment penalties are costly to subprime borrowers because the penalties enable and encourage brokers to charge higher interest rates on loans than the borrower’s credit requires, earning the broker a kickback, or “yield-spread premium,” for the increased interest rate. The yield-spread premium is a cash payment from the lender in exchange for the lender receiving the higher than par value interest rate over time.18 Because approximately one-half to two-thirds of mortgage loans are broker or correspondent originated, yield-spread premiums lead to extensive abuse.19

Groundbreaking research by Professor Howell Jackson on the use of yield spread premiums reveals that “consumers get only twenty-five cents of value for every dollar of yield spread premiums. Seventy-five percent of yield spread premiums serve only to increase payments to mortgage brokers.”20 Looking at the variation in pricing between loans where yield spread premiums are used and where other forms of compensation are present, Jackson concludes:

This price dispersion strongly suggests that yield spread premiums are not simply another form of mortgage broker compensation, but rather that the payments constitute a deceptive device that the mortgage broker industry employs to extract unnecessary and excessive payments from unsuspecting borrowers.21

Lenders ensure that borrowers ultimately pay these premiums by either recovering the cost through interest payments or through a prepayment penalty when the borrower refinances or pays off the loan. For example, one rate sheet from ContiMortgage Corporation offers a maximum of 2.5% yield spread premium for loans without a prepayment penalty and a 4.25% premium for loans with a prepayment penalty.22 Without prepayment penalties, lenders would be less willing to pay these kickbacks, as borrowers could easily refinance into a cheaper loan. In this way, prepayment penalties serve to increase rates, rather than decrease them on brokered loans, and facilitate abuse where the borrower could have qualified for a better-priced loan.

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19 See Kellie K. Kim-Sung & Sharon Hermanson, Experiences of Older Refinance Mortgage Loan Borrowers: Broker- and Lender-Originated Loans (January 2003), at http://research.aarp.org/consume/dd83_loans.html#pdf; see also Wholesale Access, Mortgage Broker Study Just Released (July 5, 2001) at http://www.wholesaleaccess.com/prs.7.5.01.shtml (finding that broker market share had fluctuated from 70% in 1998 to between 55% and a projected 60% in 2001).


21 Id. at 9.

22 See, e.g., ContiMortgage and EquiFirst Rate Sheets (requiring prepayment penalties for “increased yield spread caps” or prohibiting “broker loan payment” without accompanying prepayment penalty). (On file with the Center for Responsible Lending.)
III. The Costs of Prepayment Penalties on Subprime Loans Far Outweigh Any Alleged Savings for Borrowers and Any Legitimate Needs of Lenders.

Some lenders argue that prepayment penalties are chosen by borrowers and are an important component of subprime lending, both for the borrower and the lender. The benefit to borrowers, some lenders argue, comes through a lower interest rate offered in return for the prepayment penalty. For subprime lenders, prepayment penalties are necessary to reduce the uncertainty and market instability created by the risk of early payment and refinancing. A close analysis of these arguments shows that borrowers are not in any meaningful way choosing a prepayment penalty in exchange for a lower interest rate, and this tradeoff does not justify the high cost of the penalty. Additionally, market analysis shows that prepayment penalties are not an effective way to prevent or slow down prepayment of subprime loans.


While some subprime lenders claim that borrowers actually choose prepayment penalties in order to lower the costs of their loan, borrower choice cannot explain the 80% penetration rate of prepayment penalties in subprime loans in comparison to the 2% penetration rate in the competitive, more transparent, conventional market. The wide disparity between the prime and subprime market penetration rates shows that subprime consumers do not “choose” prepayment penalties in any meaningful sense. Rational subprime borrowers with market power should prefer them no more often, and probably less often, than conventional borrowers so that they can refinance into a conventional loan at a significantly lower rate as soon as credit improves.

Similarly, the incredible increase in subprime loans with prepayment penalties after the 1996 change in OTS policy on AMTPA also suggests that borrower choice cannot explain the pervasiveness of prepayment penalties. The frequency of prepayment penalties on subprime loans the year before the OTS reinterpretation, 1995, was just 10% in one Salomon Smith

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Barney estimate. Following the OTS ruling, the frequency of such penalties steadily increased, reaching a stunning 80% in 2001. It seems unlikely that borrower preferences could have changed so drastically in so short a time frame.

A better explanation for why so many borrowers accept subprime loans with prepayment penalties is the highly asymmetric position of borrowers versus lenders in understanding, first, that the loan actually includes a prepayment penalty, and second, the likelihood that, through hardship or flipping, they will be forced to pay the penalties. In general, borrowers do not have access to the lenders’ prepayment rates and statistical tables to understand their significant odds of paying the penalty. Lehman Brothers data reveals that 52.7% of borrowers prepay on loans with prepayment penalties during the five-year lock-out period.

Borrowers in predominantly African-American neighborhoods are five times more likely to be subject to wealth-stripping prepayment penalties than borrowers in white neighborhoods. There is no reason to believe that African American borrowers are five times more likely to desire a penalty that would cost them more than their median net worth. Additionally, where a particular lender targets a neighborhood, borrower choice is constrained by a lack of competing offers, especially in the case of low-income borrowers who lack mobility and spare time to shop around for alternative borrowing options. Given that some subprime lenders use prepayment penalties.

24 See supra note 5.
25 Id.
26 Given that the 20% of subprime loans without prepayment penalties also include fixed rate loans in one of the 30 states that substantively limit prepayment penalties and loans made in the six states that opted out of AMTPA, and not just alternative mortgages without penalties, choice becomes an even weaker explanation.
27 See A. Chu & K. Kwan, Lehman Brothers, Asset-Backed Securities, MBS and ABS Weekly Outlook, at 2. (Assumptions based on Lehman’s database of 130,000 subprime loans.) Lehman assumes that the Constant Repayment Rate builds up to 17% per year for loans with prepayment penalties and builds up to 25% per year for loans without such penalties. Additional analysis shows that 52.7% of borrowers subject to the 5% prepayment penalty will prepay during the five-year period (while 67.9% of borrowers not subject to penalty will prepay, a difference of 15%).
28 Eric Stein, Coalition for Responsible Lending, Quantifying the Cost of Predatory Lending, at 8 n.22 (2001) available at http://www.responsiblelending.org/pdfs/Quant10-01.PDF. 51% of borrowers in predominantly African-American neighborhoods have subprime loans times 80% who have prepayment penalties (see “Unequal Burden” at note 6) equals 41% have prepayment penalties. 49% of borrowers in African American neighborhoods have prime loans times 1.5% have prepayment penalties equals 1%. 41% plus 1% equals 42% of borrowers in African American neighborhoods have prepayment penalties. 9% of borrowers in white neighborhoods have subprime loans times 80% equals 7% have prepayment penalties. 91% of borrowers in white neighborhoods have prime loans times 1.5% have prepayment penalties equals 1%. 7% plus 1% equals 8% of borrowers in white neighborhoods who have prepayment penalties. 42% is 5.25 times greater than 8%. This calculation assumes that, within the subprime universe, loans to African Americans have prepayment penalties at the same rate that white borrowers do. While this assumption bears further research, CRL estimates that the African-American percentage would actually be higher.
penalties on all of their available products, push marketing and limited competition severely limit the opportunity for borrowers to “choose” loans without the costly penalties.30

There is considerable evidence that subprime lenders take advantage of vulnerable borrowers’ weak bargaining position and lack of information to push them to accept loans with terms that are more costly than a borrower’s credit quality requires, including a prepayment penalty.31 Borrowers, especially unsophisticated ones, are hounded by lenders and subjected to an onslaught of solicitation and push-marketing enticing them to refinance until they eventually capitulate, refinance, and have to pay the prepayment penalty. Data from a survey conducted by Freddie Mac shows that between 10% and 30% of current subprime borrowers refinanced their mortgages as a result of responding to the persistent advertising and calls of lenders.32

Additional evidence suggests that most subprime borrowers not only do not choose prepayment penalties, they are unaware that their loans include such problematic terms. Thirty-one percent of borrowers in a subprime market study claimed that they were not given accurate information about the mortgage by their lenders.33 The FTC has pointed out that a loan with an initial high interest rate is often sold to borrowers with reassurances that they will be able to refinance at lower interest rates in a short period of time, without explaining that the prepayment penalties will make that difficult.34

30The practices and effects of “push marketing” were explained in this way by Thomas Miller, Iowa’s Attorney General:

“Push marketing:” The notion of consumers shopping for a refinance loan or a home improvement loan, comparing prices and terms, is out of place in a sizeable portion of this market. Frequently, these are loans in search of a borrower, not the other way around . . . . Consumers who buy household goods with a relatively small installment sales contract are moved up the ”food chain” to a mortgage loan by the lender to whom the retailer assigned the contract; door-to-door contractors come by unsolicited with offers to arrange manageable financing for home improvements; telemarketers offer to ”lower monthly payments” and direct mail solicitations make false representations about savings on consolidation loans. Another aspect of push marketing is ”upselling.” (”Upselling” a loan is to loan more money than the borrower needs, wants, or asked for.)


31 Stein, Quantifying the Cost of Predatory Lending, at 10. Fannie Mae has estimated that 30-50% of subprime borrowers could have qualified for a loan with better terms. Freddie Mac estimates that 10–35% of subprime borrowers could have qualified, and cites a poll of 50 subprime lenders who estimate that half could have qualified for prime loans. Id. (citing Freddie Mac Special Report on Automated Underwriting (Sept. 1996) at http://www.freddiemac.com/corporate/reports/moseley/chap5.htm; see also Half of Subprime Loans Categorized as ’A’ Quality, Inside B&C Lending (June 10, 1996)). A Freddie Mac study in 2000 showed that subprime loans charge an extra 1% interest (and presumably much more for predatory lenders) that could not be explained by credit risk. Stein, Quantifying the Cost of Predatory Lending, at 9-10 (citing Peter Zorn, Subprime Lending: An Investigation of Economic Efficiency, Freddie Mac (Dec. 21, 2000)).


33 Id. at 11.

34 Id. at 11.
Prepayment penalty abuses, such as misleading borrowers regarding prepayment penalties in their loan, have consistently been a part of predatory lending cases brought in recent years. Such penalties were a significant point of focus for the investigation and settlement of predatory lending charges against Household International that led to a $484 million settlement with all 50 states, the largest in a string of settlements of predatory lending cases against finance companies. Prior to the state settlement, one state banking supervisor, the Washington Department of Financial Institutions, produced a report summarizing its investigation and examination of loans and business conducted by Washington-based branches of Household and its affiliates. In an examination of loan documents relative to specific complaints filed by Washington consumers between May 2000 and January 2002, the Department found evidence of a pattern of consumer abuse in Household’s origination practices, including the deceptive use of prepayment penalties. Abusive practices related to prepayment penalties included the failure to disclose the existence of a prepayment penalty in the borrower’s loan, intentionally misleading the borrower that a prepayment penalty was not included in the loan, and steering the borrower’s attention away from the penalty by physically covering parts of certain disclosures while pointing to other information. The Washington Department’s own testing of Household’s origination practices confirmed the use of these deceptive tactics, and the Department concluded that “[p]ractices of this type are not uncommon in the mortgage industry and are used to effectively steer the borrower’s attention away from certain sections that would alert them to unwanted terms and conditions.”

Pursuant to the October 9, 2002 preliminary Settlement Agreement entered into by Household and the 50 states, the company is prohibited from including prepayment penalties on real estate secured loans with terms greater than 24 months from the date of loan origination. In the future, Household must provide borrowers loan products both with and without prepayment penalties. Additionally, Household must amend all real estate secured loan agreements outstanding as of the effective date of the settlement to provide that prepayment penalties are not payable after 24 months from the date of origination.

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35 See Press Release, Office of Consumer Credit Commissioner, Commissioner Signs on to $7.5 Million Household Settlement (Dec. 17, 2002), at http://www.occc.state.tx.us/pages/publications/press/Household.html; see also http://www.state.me.us/pfr/ccp/releases/Household%20Settlement%20FAQs.htm (setting out the Settlement Agreement in full).
36 See, e.g. Washington Department of Financial Institutions, Expanded Report of Examination for Household Finance Corporation III as of April 30, 2002, Complaint #2356 at 26 (describing borrowers who were told they would not have a prepayment penalty, but were assessed one when attempted to refinance), #2550 at 28 (finding Household refinanced non-English speaking borrowers from loan with 7% interest rate and no prepayment penalty into loan with 12.5% rate and a significant prepayment penalty without providing sufficient disclosures), #2751 at 33-34 (finding that when borrowers questioned prepayment penalty on their loan, representative of Household said that they “normally don’t enforce it” and noting that “the prepayment penalty information [in the note] is not carried on the same page as the signature blank and therefore it is highly likely it was not seen by the borrower when signing”), #2797 at 36-37 (finding that borrowers believed there would be no prepayment penalty on their loan but one was included).
37 Id. at 42.
Numerous other examples of predatory lending cases have also included abuses around prepayment penalties. In 1999, seven subprime lenders settled Federal Trade Commission charges against the lenders for serious violations of the federal Home Ownership and Equity Protection Act, including four cases where the lenders illegally included prepayment penalties in violation of federal law. In 2002, a subprime lender settled charges by the Federal Trade Commission, the U.S. Department of Housing and Urban Development, and the State of Illinois, that it misrepresented key terms of its loans, including the inclusion of prepayment penalties.

B. Modest Interest Rate Savings Do Not Justify the High Cost of Prepayment Penalties.

Some lenders argue that the costs of prepayment penalties are not as onerous as they first appear because many loans theoretically include prepayment penalties in order to offer a lower interest rate than similar loans without prepayment penalties. However, this assumption is not borne out by the facts. A simple calculation suggests that for subprime loans, interest rate savings are generally significantly outweighed by the increased costs of the prepayment penalty. Even assuming a prepayment penalty of 4 percent (low for the typical subprime loan), a generous estimate of an interest rate reduction of 55 basis points (0.55%), and an average subprime loan life of 2 to 3 years, the average borrower therefore saves between 100 and 150 basis points in interest costs, but has paid out 400 basis points in prepayment penalty costs. Thus, the cost to the average borrower is 3 to 4 times the savings in interest payments. Further, as we have shown in the discussion on yield-spread premiums, it is much more likely that even if an interest rate reduction does occur, the rate is actually reduced from an inflated rate that is higher than what the borrower would qualify for because the lender paid a kickback, or yield spread premium for the above-par value interest rate.

C. Prepayment Penalties In The Subprime Market Are Not A Necessary Component Of Loans To Subprime Borrowers, But Function As Another Fee That Lenders Fully Expect To Collect.

The argument is often made that prepayment penalties are needed in the subprime market to deal with the need for more certainty with respect to prepayment speeds to ensure that lenders make a profit. However, evidence from the markets suggests that prepayment penalties are not in fact very successful at preventing or slowing down prepayments, and most prepayment penalties are in effect for a longer duration than is necessary for subprime market viability.

In fact, prepayment penalties on subprime loans are simply another fee that lenders and investors expect to collect; a fee that borrowers generally do not know is included in their loan or that they

41 See A. Chu & K. Kwan, Lehman Brothers, Asset-backed Securities, MBS and ABS Weekly Outlook (July 17th, 2000), at 6. This figure is for fixed rate loans. The difference between interest rates on penalty and non-penalty 2/28 ARM loans is 31 bp, according to the same authors.
42 See supra notes 15-18 and accompanying text
are likely to pay. Moreover, by collecting the fee through a prepayment penalty, rather than through points and fees charged at the time of origination, lenders evade federal and state protections for borrowers of high-cost loans.\textsuperscript{43}

Assumptions about borrower prepayment speeds play a very important role in how securities are priced and the return that investors receive. Investors often want some assurance that borrowers will not refinance too quickly. The penalties are supposed to reduce this risk for investors, thus stabilizing the market, and indeed stimulating the market in subprime loans.\textsuperscript{44} Analysis of the market suggests that this argument does not justify the frequency or size of prepayment penalties on subprime loans.

Morgan Stanley reports that subprime loans that carry prepayment penalties are prepaid at about 90\% of the rate of subprime loans without prepayment penalties.\textsuperscript{45} Lehman Brothers data reveals that 52.7\% of borrowers prepay on loans with prepayment penalties as opposed to 67.9\% who prepay when there are no prepayment penalties.\textsuperscript{46} This suggests that only an additional 3\% of borrowers per year would have paid off their mortgages if their loans had not been subject to prepayment penalties, or 15\% over a five-year period. Thus, the number of prepayments that are prevented as a result of prepayment penalties is very small, especially relative to the large number of borrowers who are either trapped paying a loan with a higher interest rate for which they qualify or are forced to pay the penalty and, in the process, are stripped of hard-earned home equity.

Moreover, evidence exists that in the subprime market in particular, prepayment speeds are actually faster on lower credit grade loans with prepayment penalties. For example, the Mortgage Information Corporation\textsuperscript{47} found that for C and D paper (subprime) loans, loans with prepayment penalties actually prepay faster (CPR of 32\% and 34\% respectively) than their counterparts without prepayment penalties (CPR of 30\% and 31\% respectively).\textsuperscript{48} This may be because in the subprime loan market, and particularly with lower credit grade loans, interest rates are so high that the cost of paying the penalty and refinancing into a better interest rate loan, although substantial, makes more economic sense than continuing to repay the original loan. Another explanation may lie in brokers’ incentive to “flip” these borrowers, because they earn fees every time a borrower refinance and already have a relationship with the borrower. Whatever the reason, prepayment penalties do not seem to be succeeding in substantially slowing down prepayment speeds for the borrowers who are strapped with the highest interest rate loans.

\textsuperscript{43} HOEPA does not include prepayment penalties in calculating the points and fees or rate threshold for a high-cost loan. See 15 U.S.C. § 1602(aa)(4). Some state laws now include prepayment penalties in the calculation of thresholds. See, e.g., N.C. GEN. STAT. § 24-1.1E(a)(5)(d) (2001); GA. CODE ANN. § 7-6A-2(13)(D) (2002).
\textsuperscript{44} See, e.g., Joshua Brockman, Fannie revamps prepayment-penalty bonds, American Banker (1999).
\textsuperscript{45} See supra note 28.
\textsuperscript{46} Morgan Stanley Dean Witter, Home Equity Loan Handbook 9 (1998 Ed.).
\textsuperscript{47} Mortgage Information Corporation recently changed its name to Loan Performance.
\textsuperscript{48} Prepayment penalties work on some subprime loans, Inside B&C Lending, July 6, 1998. CRP, or Conditional Prepayment Rate, indicates, for any given year, the fraction of mortgages principal that had not prepaid at the beginning of the year that does repay during the year.
Most prepayment penalties are in effect longer than needed to recoup lenders’ costs. Subprime lenders have been quoted in the press as saying that a prepayment penalty period of two years is sufficient to make subprime lending a financially viable activity.\textsuperscript{49} Despite such statements by lenders, most prepayment penalties currently in effect are still for a period of five years.\textsuperscript{50}

\textbf{IV. Conclusion}

Homeownership is a primary means by which American families build wealth and economic security. The subprime lending market serves an important role for borrowers who encounter temporary credit problems that keep them from receiving low-rate conventional loans. Ideally, the subprime market should provide borrowers a bridge to conventional financing as soon as the borrower is ready to make the transition. However, prepayment penalties are expressly designed to prevent this from happening.

The use of prepayment penalties in subprime home loans is one of the most prevalent and costly predatory practices, costing homeowners an estimated $2.3 billion each year. Through the imposition of prepayment penalties that require the payment of a significant penalty to refinance into a better loan, subprime borrowers become trapped in bad loans, increasing the risk of foreclosure, or must pay the penalty of having the lender to strip the family's hard-earned home equity wealth, which is taken as punishment for obtaining a better loan. This is not a choice that borrowers should face.

\textsuperscript{49} See, e.g., Prepayment Penalties Prove Their Merit for Subprime and ‘A’ Market Lenders, Inside Mortgage Finance, May 21, 1999 (stating that Household Financial Services would be content with prepayment penalties that are in effect for “two or three years” and Washington Mutual has managed to restrict its prepayment penalty period to 3 years).

\textsuperscript{50} A. Chu & K. Kwan, Lehman Brothers, Asset-backed Securities, MBS and ABS Weekly Outlook (July 17\textsuperscript{th}, 2000), at 8.