The Costs of Subprime Prepayment Penalties:

A Response to "Call Protection in Mortgage Contracts"

In a new working paper "Call Protection in Mortgage Contracts" Michael LaCour-Little concludes that prepayment penalties reduce the cost of credit to borrowers.[1] However, there are several shortcomings in his analysis:

1. ***Inadequate Data:*** LaCour-Little analysis relies on only one year's worth of data from one lender to arrive at the claim that prepayment penalties reduce the cost of credit to borrowers. Such a limited data source is inadequate for estimating the impact of prepayment penalties on the cost of credit for the entire subprime mortgage market since there is no evidence that this particular lender's loan portfolio, underwriting criteria, customer base or pricing system is representative of the market as a whole.

2. ***Inconsistent Results:*** LaCour-Little's model results in findings that contradict common intuition about lending practices and other research on prepayment penalties. Specifically,

   - ***Inconsistent with risk-based pricing.*** His model estimates that borrowers with low levels of income documentation have lower interest rates than those with full documentation and that loans for investor properties have lower interest rates than those for owner-occupied properties. These findings are not consistent with a theory of risk-based pricing and throw doubt on the validity of his model and/or data.

   - ***Inconsistent with other research.*** LaCour-Little's conclusions directly contradict those of CRL's more comprehensive study of prepayment penalties in the subprime market. Specifically, our 2005 analysis of more than 200,000 subprime loans originated by multiple lenders over three years found that prepayment penalties on refinance loans conveyed no interest rate benefits to borrowers and were actually associated with higher interest rates on purchase loans.[2] LaCour-Little makes no mention of this study or why his results are incompatible with it.

3. ***Neglects Negative Effects of Prepayment Penalites:*** Finally, the paper fails to account for the significant negative effects of prepayment penalties. Specifically,

   - ***Prepayment penalties cost borrowers billions of dollars[3]:*** Borrowers with prepayment penalties have two choices when faced with the opportunity to refinance into a lower-rate loan. They can pay the prepayment penalty, which is often as much as six months worth of interest and is directly stripped from the home equity they have built, or they can remain in the higher-cost loan. LaCour-Little's analysis does not attempt to quantify these costs. Therefore, even if there are initial rate benefits to prepayment penalties, there is no evidence that such benefits outweigh the actual and opportunity costs to borrowers over the longer term.

- ***Prepayment penalties facilitate kickbacks.*** Prepayment penalties facilitate kickbacks (in the form of yield-spread premiums) by lenders to brokers for placing borrowers in loans with higher interest rates than those for which they otherwise qualify. In the absence of prepayment penalties, lenders would be less likely to pay these kickbacks, since borrowers could refinance into a lower-rate loan before the lenders could recoup the amount of the kickback.

- ***Loans with prepayment penalties are significantly more likely to foreclose than those without prepayment penalties.*** A 2005 study by researchers at the University of North Carolina showed that, controlling for other risk factors, the odds of foreclosure for loans with prepayment penalties were 16-20 percent higher than for loans without prepayment penalties.[4]

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[1] LaCour-Little. "Call Protection in Mortgage Contracts." http://www.fma.org/Chicago/Papers/CallProtectionPaper.pdf
[2] Ernst. "Prepayment Penalties Convey No Interest Rate Benefits on Subprime Mortgages." http://www.responsiblelending.org/pdfs/rr005-PPP_Interest_Rate-0105.pdf
[3] In "Quantifying the Economic Cost of Predatory Lending", the authors estimate that the payment of prepayment penalties cost borrowers $2.3 billion annually.
[4] Quercia, Stegman and Davis. "The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments." http://www.kenan-flagler.unc.edu/assets/documents/foreclosurerelease.pdf

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