Prepayment Penalties in Subprime Loans:

When Qualifying for a Better Mortgage Doesn't Pay Off

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EACH YEAR, PREPAYMENT PENALTIES IN SUBPRIME LOANS CAUSE 850,000 FAMILIES TO LOSE $2.3 BILLION IN HOME EQUITY WEALTH.

What is a prepayment penalty?

A prepayment penalty is a fee required by the lender when borrowers pay off a mortgage loan early. In the subprime mortgage market, where borrowers tend to have less-than-perfect credit, an abusive prepayment penalty can trap them in a high-interest loan even after they improve their credit rating. When borrowers qualify for a better loan, even several years later, they are charged a large fee to pay off their old loan. This penalty is seldom imposed in the conventional mortgage market.

Who is affected by prepayment penalties?

The majority of borrowers who obtain loans in the subprime market receive prepayment penalties. In fact, many borrowers, regardless of their credit, are "steered" to such loans. Unscrupulous lenders – typically, mortgage brokers working with unsupervised finance companies – target our most vulnerable citizens: minority groups, working families of all backgrounds, and the elderly.

What is the cost of a prepayment penalty?

One common penalty costs six months' interest on the loan if the borrower prepays in the first five years (roughly 4-5% of the original loan amount). Particularly for families that struggle to make regular monthly payments on time, paying thousands of dollars to get out of a loan represents an overwhelming expense, and can prevent them from obtaining a more affordable loan as their credit improves. In 2001, based on industry assumptions on prepayment patterns, CRL estimated that 44% of borrowers pay a 4% fee in the first four years of the loan. Given $160 billion in 1999 subprime originations, CRL estimated that 850,000 homeowners per year lose $2.3 billion in equity per year.

The Penalty for Improved Credit

Consider this typical scenario: An African-American family gets a subprime mortgage loan for $150,000 with a 12% interest rate. After making timely payments for three years, they realize they can qualify for a better loan.

However, when the family tries to refinance, they discover their existing loan comes with a hefty prepayment penalty -- adding up to 5% of their loan balance, or about $7,500*. The family is forced to choose between paying the penalty out of their equity or continuing to pay 12% interest for two more years.

**Equal to the median net worth of African-American households in 2000.*

Do prepayment penalties help subprime borrowers get lower interest rates?

Some lenders say that prepayment penalties offset the cost of early payoffs, allowing them to offer lower interest rates. However, in most cases, there is no evidence that borrowers with prepayment penalties actually receive a break on their interest rates. In fact, because penalties

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often are coupled with kickbacks, just the opposite may be true. Research indicates that any interest rate savings realized by the borrower tend to be significantly outweighed by the costs of the penalty. Even a conservative estimate shows that the typical cost to the average borrower is three to four times more than the savings in interest payments.

Consumers Aren't the Only Ones Who Pay …

Prepayment penalties also have an anti-competitive effect. When a borrower could qualify for a conventional loan but finds it is too expensive to seek an alternative, conventional mortgage lenders lose the opportunity for the business. Given the rapid growth of the subprime market in recent years, this lost opportunity adds up.

Don't consumers choose prepayment penalties?

If these types of loans were freely selected, one would expect consumers to choose them at about the same rate in the subprime and prime lending markets. However, in the competitive conventional mortgage market, only 2% of mortgage loans impose prepayment penalties. In the subprime market, the figure is 80%. Borrowers, who are focused on the interest rate and monthly payment, often are unaware of the prepayment penalty – an obscure clause buried in a large stack of documents.

The Kickback Connection

When a mortgage broker originates a loan that carries a higher interest rate than the rate set by the lender, the lender sometimes pays a "yield spread premium" – a kickback for delivering a more expensive loan. Lenders are more willing to pay kickbacks on loans with prepayment penalties. As a result, loans in the subprime market are more likely to come with prepayment penalties, and brokers have a clear incentive to persuade borrowers to accept excessively high interest rates and loans with prepayment penalties.

FAST FACTS

- The negative effects of prepayment fees are widely recognized: More than 35 states have placed some limitation on prepayment penalties for home loans.
- Borrowers who live in high-minority neighborhoods face 35% greater odds of receiving a prepayment penalty than similar borrowers in low-minority neighborhoods.
- The typical cost of a prepayment penalty is three to four times more than any savings gained in interest payments.
- In the competitive conventional mortgage market, less than 2% of borrowers accept prepayment penalties, while 80% of subprime loans include a penalty for early payoff.
- Penalties do little to prevent or slow down prepayments. In fact, subprime loans that carry prepayment penalties are prepaid at about 90% of the rate of subprime loans without prepayment penalties.

About the Center for Responsible Lending

The Center for Responsible Lending is dedicated to protecting home ownership and family wealth by working to eliminate abusive financial practices. The CRL is a national nonprofit, nonpartisan research and policy organization that promotes responsible lending practices and access to fair terms of credit for low-wealth families.

For additional information, please visit our website at **www.responsiblelending.org**.

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