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The End of Prepayment Penalties?

The subprime mortgage market continues to face widespread trouble, with foreclosure filings on the rise. The current woes are a product of loose underwriting standards for subprime or poor credit home loans over the past several years. Many people who previously would not have qualified for mortgage funding because of their credit or income were welcomed into the market during the now-past housing boom. They entered the home-owning scene with all sorts of exotic adjustable rate mortgages (ARMs) including interest-only loans and pay option ARMs. Now that many of these loans are resetting with higher interest rates and monthly payments and the market is providing less easy equity to tap into, many borrowers are finding themselves faced with foreclosure.

Many in government and the financial sector are starting to worry that tightening of credit in the subprime industry and a large rise in foreclosures will lead to greater troubles for the big economy picture. Many proposals have been made in an attempt to prevent a tidal wave of foreclosures. Some like House Financial Services Committee Chairman Barney Frank feel that many poor credit borrowers could prevent foreclosure by refinancing into new loans, if only the prepayment penalties on their loans could be dropped.

“A lot of [borrowers] are people who can make reasonable payments; they just can't deal with this jump” in interest rates, said Frank, D-Mass. “If we can get them out of prepayment penalties, many of them can refinance.”

A prepayment penalty is a clause in a mortgage contract that imposes a large fee on a borrower who decides to completely pay off the home loan within a certain amount of time. That time period may be five or more years. If the borrower tries to refinance before that time, he will have to first pay a penalty of several hundred or thousands of dollars.

In the prime or good credit market, the terms of a prepayment penalty may include a drop in the interest rate in exchange for agreeing to the clause. Yet in the subprime market prepayment penalties are almost always required. In 2006, for example of all the subprime loans bundled and sold on Wall Street, roughly 70 percent had attached prepayment penalties. (Among prime mortgages, only 2 percent had associated penalties.) They are so popular with subprime lenders because they take larger risks on these poor credit borrowers and they want ways to guarantee good returns for their risk.

Prepayment penalties have not been a matter of governmental concern until now as 14 percent of subprime borrowers are in default on their home loans. Many like Representative Frank believe if borrowers could be released from their penalty clauses, they could refinance and save their homes. Such suggestions obviously meet with resistance from lenders however as they would miss out on the expected profits of early refinances.

Nevertheless, things may change soon. The Federal Reserve Board plans to meet this week to decide whether or not to ban several lending practices including the requirement of prepayment penalties.

“Our main purpose is to gather information on how we might craft rules to stop fraud and abusive practices, but that are also sharply and clearly drawn to avoid the unintended consequence of restricting consumers' access to responsible subprime credit,” said Fed Governor Randall Kroszner in statements before a House panel. “We must be careful,



however, not to curtail responsible subprime lending or beneficial financing options for consumers.”

Time will tell whether the lenders or the borrowers win out on the prepayment penalty issue.