MIDFIRST BANK

July 22, 2011

Ken R. Clark
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Via E-mail: ***regs.comments@federalreserve.gov***
Jennifer J. Johnson
Secretary, Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, DC 20511

Re: Docket No. R-1417 and RIN No. 7100-AD75

Dear Ms. Johnson:

MidFirst Bank, on behalf of itself and Midland Mortgage, a division of MidFirst Bank (collectively "MidFirst"), appreciates the opportunity to provide the Board of Governors of the Federal Reserve System (the "Board") with comments to its Proposed Rule to amend Regulation Z, Truth in Lending. The Proposed Rule was published in the May 11, 2011 *Federal Register*, Volume 76, number 91, page 27390 and asks that comments be submitted by July 22, 2011. Among other things, the Proposed Rule purports to establish standards for complying with the ability-to-repay requirement of the Dodd-Frank Act by clarifying the characteristics of a "qualified mortgage," and purports to implement the Dodd-Frank Act's limits on prepayment penalties. MidFirst understands that the Board will not finalize the Proposed Rule before general rulemaking authority transfers to the Consumer Financial Protection Bureau ("CFPB").

Although the Proposed Rule is extensive and covers a broad array of issues, with this letter MidFirst focuses on the Board's treatment of interest accrual amortization as a prepayment penalty. More specifically, MidFirst urges the Board and the CFPB to consider the significant effect this will have on the borrowing cost of FHA loans if there is not an exclusion for FHA loans in the Proposed Rule. The proposed characterization of interest accrual amortization as a prepayment penalty, if adopted without an exclusion for FHA loans, will create inefficiency in the FHA mortgage market and will increase the cost of credit available to FHA borrowers, for whom FHA loans are the only source of credit available for home purchases with small down payments. Furthermore, the Proposed Rule will provide no real benefit to FHA borrowers other than increased flexibility on deciding what day of the month to pay their loan off. We do not believe that this result is what Congress intended when it adopted the Dodd-Frank Act and urge the Board and CFPB to take steps to avert this result.

Comments to the Proposed Rules

1. **FHA loans should be expressly excluded from any prepayment penalty limitations established under the Proposed Rule because the restriction would create a conflict with HUD's rules regarding interest accrual and would fundamentally undermine the objectives of FHA loans.**

   The Proposed Rule purports to define as a "prepayment penalty", and exclude from the eligibility criteria of a "qualified mortgage", any mortgage that follows the practice of "treating

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the loan balance as outstanding for a period of time after prepayment in full and applying the interest rate to such 'balance,' *even if the charge results from the interest accrual amortization method used for other payments in the transaction.*" See Proposed § 226.43(b)(10) (emphasis added).

While the Proposed Rule specifically excepts FHA loans out of the "points and fees" definition, it does not exclude government programs from this definition of "prepayment penalties." See Proposed § 226.43(b)(10). MidFirst urges that a similar exclusion of FHA loans from the definition of "prepayment penalties" is consistent with facilitating compliance with TILA and is necessary to provide low to moderate income consumers with continued access to the most affordable credit. As described below, an exception for FHA loans would preserve efficiencies that are built in to the GNMA MBS system, and facilitate the continued efficiency of the secondary market for FHA mortgage loans, while also serving the purpose of protecting borrowers' interests with respect to excessive fees.

A. The Proposed Rule is in direct conflict with the Board's prior interpretation, which excluded how FHA interest is charged from the definition of "prepayment penalties."

The Board has addressed the issue of prepayment penalties and FHA programs on an earlier occasion, finding that it did not apply to such programs. Specifically, on September 29, 2009, the Board responded to concerns raised by the Department of Housing and Urban Development ("HUD") as to whether FHA loans are covered by certain commentary to Regulation Z about prepayment penalties including interest charges for periods after prepayment in full is made.

The Board's 2009 correspondence specifically recognized that FHA employs the monthly interest accrual amortization and acknowledged that "for federally-insured loans ... HUD has not considered the payment of interest after the prepayment date as a prepayment penalty and has advised lenders that they need not disclose this practice as a prepayment penalty for these loans."

The Board went on to expressly confirm that HUD's practice could continue and assured lenders who had engaged in this practice that they "would not be required to treat the interest charged from the date of prepayment until the next installment due date as a prepayment penalty for any purpose under Regulation" and that "lenders who have followed this practice in the past *have acted reasonably and have complied in good faith* with the prepayment penalty provisions of Regulation Z ..." (emphasis added).

By including reference to "the interest accrual amortization method" in § 226.43(b)(10) and the comment thereto, without expressly excluding FHA programs, the Proposed Rule is in direct conflict with this Board's prior reasoned position. Importantly, the Proposed Rule offers no justification for a departure that will so negatively impact FHA servicers and, ultimately, borrowers in these programs.

B. FHA's monthly interest accrual amortization does not constitute a prepayment penalty.

True prepayment penalties are designed to compensate investors and discourage borrowers from paying off their mortgage debt prior to a specified term. The FHA loan program is not at all designed with this purpose. Rather, the FHA loan program is designed to maximize the availability of affordable funds for FHA borrowers through the pooling of FHA loans in GNMA securities. The FHA structure synchronizes the amount of interest due from FHA borrowers with the interest due to the investors for the actual month of payoff. Under the current system, borrowers can pay off on the first day of the month, and incur no interest accrued beyond the date of payoff.

C. Monthly interest accrual amortization provides consistency with GNMA guidelines.

Securitization in GNMA mortgage pools is the primary vehicle for transferring investment dollars to FHA borrowers. The interaction between the FHA and GNMA MBS programs eliminates inefficiency, and should be the model for all MBS programs. FHA loan terms agree with the structure of the MBS documents: GNMA securities guarantee the remittance of a full month of interest to investors for any given month in which the loan balance was outstanding; likewise, FHA mortgage contracts require borrowers to remit a full month of interest for each month that the loan balance remains unpaid. In the case of the FHA loan documents and the GNMA securitization agreement, if the borrower pays off on the first day of the month, no interest is accrued beyond the date of payoff. Therefore, the FHA borrower always pays the amount that is due to the GNMA investor, and the borrower controls the timing of the payoff and the amount of interest incurred.

The current FHA/GNMA structure gives borrowers the flexibility to limit the amount of interest paid by choosing the timing of their payoff. Under this system the borrower can pay off on the 1st of the month and incur no interest beyond the date of payoff. If the borrower chooses to payoff on another day, the cost associated with the borrower's choice is known to the borrower and is borne by the borrower. Thus, in the current system, there is an avoidable cost that is borne by the only party with the ability to eliminate that cost.

The Proposed Rule would require servicers to bear the cost associated with the borrower's choice. Under the Proposed Rule, if a borrower with a $150,000 loan in a 5% GNMA security were to payoff on the 15th of the month, they would pay 15 days of pass-through interest, or $312.50 (20 basis points), while the servicer would be required to remit 30 days of pass-through interest, or $625 (40 basis points) to GNMA, resulting in a loss of $312.50 (20 basis points) each time a loan pays off. The Proposed Rule would create a situation where the party incurring the avoidable cost cannot prevent it. Therefore, these currently avoidable costs will dramatically increase in the FHA system.

The Proposed Rule would leave FHA lender/servicers vulnerable to large uncontrollable expenses if borrowers' obligations related to interest accrual are not consistent with GNMA requirements for interest remittances to investors. The additional costs that would be borne by lender/servicers would be magnified when home refinances are their highest, increasing the negative convexity of the mortgage servicing asset even more than is currently the case. This would degrade the value of the mortgage servicing asset, create additional complications with hedging the servicing asset, and increase borrowing costs to FHA borrowers while providing no real benefit to those borrowers.

2. **MidFirst supports the exclusion of FHA loans from the proposed definition of "points and fees."**

   The Proposed Rule excludes government insurance premiums and guaranty fees from the definition of "points and fees." See Proposed § 226.32(b)(1)(i)(B)(1). As the Board noted, this exclusion is authorized under the provisions of the TILA that empower the Board to facilitate compliance with and effectuate the purpose of the TILA. The Board further noted that the proposed exclusion "is necessary to ensure consumer's access to credit" through FHA programs. The Board requested comment on the proposal to exclude from "points and fees" upfront premiums and charges for any insurance or guaranty under a Federal or state government program. MidFirst wholly supports this explicit exclusion as facilitating consumer access to credit and encourages the Board to make a similar exclusion for FHA loans with respect to "prepayment penalties."

3. **If the Proposed Rule is implemented as drafted, it should explicitly apply only to mortgages originated after the date of implementation.**

   The Proposed Rule makes no mention of whether it intends to apply retroactively to affect mortgages currently in place or will apply only to mortgages originated after the date of implementation. MidFirst Bank strongly urges that if the Proposed Rule is implemented as drafted, it should only apply to future originations and not to existing mortgages. As described above, the monthly interest accrual amortization method is an important component of the GNMA system and the Proposed Rule will adversely affect it. Those who have previously decided to participate in the FHA program and service FHA loans have done so based on the current practices, the contractual provisions of the FHA note and mortgage, and in reliance on the Board having expressly articulated in September 2009 that applying interest to FHA loans in the final month based on the accrual amortization method would not be considered a prepayment penalty. Retroactive implementation will significantly impact MidFirst Bank. MidFirst should not be required to bear the burden of the cost of the GNMA interest loss as a result of a retroactive application of a Proposed Rule that is in direct contradiction to the Board's prior practices and the terms of the existing contracts with borrowers.

Recommendation

Without an explicit exclusion relating to monthly interest accrual amortization for FHA loans, the Proposed Rule would create a financial inefficiency in the FHA and GNMA programs by introducing new levels of currently avoidable costs into the FHA and GNMA financial systems. This inefficiency will decrease the value of FHA loans and increase the cost of financing to FHA borrowers, while providing no additional benefit to the borrowers affected, other than convenience. Some estimates of the increased cost to borrowers could exceed 20 basis points of price. We are confident that, given the option, borrowers would not choose to have the cost of their loans increase, even by a much smaller amount, in exchange for the flexibility afforded by the Proposed Rule with respect to the timing of loan payoff. As drafted, however, the Proposed Rule would effectively make that choice for them. We urge the Board and CFPB to avoid this result, which will disproportionately affect FHA borrowers, who are most in need of affordable credit.

MidFirst appreciates the opportunity to participate in this rule-making process and to provide input on these important changes to the Truth in Lending Act regulation. We urge the Board and the CFPB to consider the changes suggested herein as necessary to accomplishing the goal of the Truth in Lending Act and making affordable credit available for low to moderate income borrowers.

Respectfully,

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