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September 28, 2011

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Monica Jackson
Office of the Executive Secretary
Bureau of Consumer Financial Protection
1801 L Street, N.W.
Washington, D.C. 20036

Re: Proposed Rule, Regulation Z, Truth in Lending; Docket No. R-1417; RIN Number 7100-AD75, Ability to Repay and Minimum Mortgage Underwriting Standards

Dear Ms. Johnson and Ms. Jackson:

We appreciate the opportunity to submit this supplement to our comment on the proposed rulemaking ("Proposed Rule")[1] of the Board of Governors of the Federal Reserve System (the "Board") and the Bureau of Consumer Financial Protection to amend Regulation Z in implementation of amendments to the Truth in Lending Act ("TILA") made by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[2] Our original comment was filed on July 22, 2011 ("July 22 Comment Letter"). This supplemental comment briefly summarizes certain academic research that supports the point made in our July 22 Letter that prepayment penalties benefit consumers by providing greater access to credit at a lower interest rate. This supplemental letter also notes that the FDIC's new assessment adjustment guidelines recognize that non-traditional mortgages do not present higher risks when properly underwritten with strong income coverage and collateral ratios.

[1] 76 Fed. Reg. 27390 (May 11, 2011).

[2] The Consumer Financial Protection Bureau ("CFPB") will be succeeding the Board in administering TILA upon the Dodd-Frank Act's Designated Transfer Date.

As discussed in our July Comment Letter, the definition of "Qualified Mortgage" and the related provisions of the rule as proposed, as a practical matter, effectively preclude prepayment penalties on loans that are not traditional, fixed rate 30-year mortgages that fully amortize from the outset of the loan. Our suggestions are to: (1) broaden the definition of "Qualified Mortgage" to include appropriate types of loans beyond traditional 30-year fixed rate loans that fully amortize from the first payment to the last; (2) create an exemption from the prohibition on prepayment penalties for prudently underwritten loans to prime borrowers with significant equity in the home and strong payment coverage ratios and, consistent with the considerations set forth in 15 U.S.C. § 1604(f)(2); and (3) create an exemption for homeowners with documented annual net income in excess of $200,000 or net worth in excess of $1,000,000, which would qualify them as "accredited investors" under the federal securities laws, without reference to loan-to-value or income coverage ratios. If adopted without these suggested changes, the proposed rule will limit the ability of a consumer to choose the most appropriate type of loan for that consumer, increase interest costs to consumers, and reduce the availability of home financing.

Offering consumers the option of choosing prepayment penalties in order to obtain a lower interest rate is a consumer-friendly option. Borrowers who select loans with prepayment penalties are selecting a lower interest rate in exchange for committing to stay with the loan for a period of time before refinancing (or pay a prepayment fee down the road if they change their minds and can find an even lower rate within the prepayment period). In particular, we believe it would benefit borrowers to permit prepayment penalties for adjustable rate mortgages to prime borrowers where there is a low loan-to-value ratio and a high income coverage ratio. Such an exception would make credit more readily available at a lower cost for borrowers whose loans can meet these criteria, without exposing subprime customers to contractual risks associated with mortgage terms that may not be appropriate for them.

Research has documented the lower interest rates charged on loans that contain prepayment penalties (and higher prices paid for such loans in the secondary market), and the favorable impact on the availability of credit.[3] This research indicates the lower rate

[3] *See, e.g.*, Gregory Elliehausen, Michael E. Staten and Jevgenijs Steinbuks, *The Effect of Prepayment Penalties on the Pricing of Subprime Mortgages*, 60 Journal of Economics & Business 33 (2008) ("Elliehausen, Staten & Steinbuks"); Christopher Mayer, Tomasz Piskorski & Alexi Tchistyi, *The Inefficiency of Refinancing: Why Prepayment Penalties are Good for Risky Borrowers* (Nov. 28, 2010)

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associated with prepayment penalty terms in a loan approximates 0.38% per annum on fixed rate mortgage loans, 0.13% per annum on adjustable rate mortgage loans, and 0.19% per annum on hybrid mortgage loans.[4] Or, to put it another way, a borrower with a $500,000 fixed-rate loan pays $1,900 less per year in interest if the loan terms include a prepayment penalty. If the rule is adopted as proposed and bans prepayment penalties on non-amortizing loans, a prime borrower with a ten-year $500,000 non-amortizing loan who might otherwise choose to include prepayment penalty terms in exchange for the lower rate, will as a result of the rule pay an extra $19,000 in interest over the life of the loan. The rule as proposed has an anti-consumer effect.

Many mortgages are resold by the originating lender into the secondary market. Buyers of loans in the secondary market consider, among other things, the rate at which loans prepay or are likely to prepay in the future.[5] Prepayment penalties indicate that the borrowers are less likely to prepay their loans. Prepayment rates for loans without prepayment penalties are higher.[6] Buyers of loans, if they are willing to buy them at all, pay significantly less for loans without prepayment penalty clauses than for similar loans with prepayment penalties. As a consequence, loan originators of mortgages without prepayment penalties must charge borrowers a higher interest rate to allow the loans to be sold at reasonable prices.

As noted in a recent GAO Report, the impact of regulatory restrictions on mortgages affect secondary market prices and will be passed through to borrowers in the

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(available online at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1108528) ("Mayer, Piskorski & Tchistyi").

[4] Elliehausen, Staten & Steinbuks at 12. *Accord*, Morgan J. Rose, *Origination Channel, Prepayment Penalties and Default* at p 27 (June 2011 working paper), forthcoming in Real Estate Economics ("Rose/*Origination Channel*") available online at: www.umbc.edu/economics/wpapers/wp_10_124.pdf (finding inclusion of prepayment penalty clauses in mortgages decreased interest rates charged by 0.34% on fixed rate loans).

[5] Elliehausen, Staten & Steinbuks; Mayer, Piskorski & Tchistyi.

[6] Christopher Mayer, Karen Pence, & Shane M. Sherlund, *The Rise of Mortgage Defaults*, Federal Reserve Board Discussion Series, 2008-59 at 13 (available online at www.federalreserve.gov/pubs/feds/2008/200859/200859pap.pdf) (Mayer, Pence, & Sherlund"); Morgan J. Rose, *Geographic Variation in Subprime Loan Features, Foreclosures and Prepayments* at 4 (working paper Mar. 2011, available online at: www.umbc.edu/economics/wpapers/wp_10_118.pdf) ("Rose/*Geographic Variation*").

form of higher interest rates and less availability of mortgage loans.[7] The research indicates that bank lenders generally pass through to borrowers much of the lower interest rate accepted by secondary market purchasers on loans with prepayment penalties, while nonbank lenders pass through to borrowers a smaller portion of the rate savings.[8]

Eliminating prepayment penalties may also increase the risk in bank portfolios, and reduce returns, by increasing prepayment risk on the mortgage loan portfolios of banks.[9]

Although some have suggested that prepayment penalties cause borrowers to default by limiting their refinancing options, the research indicates that poor credit quality, sloppy underwriting practices, falling real estate values, and contraction of credit, and not prepayment penalties, are the real source of an increase in mortgage defaults over the past half-decade.[10] At least one study indicates that, because higher risk borrowers (those who do not rate as high on traditional measures of ability to repay) have more difficulty in obtaining refinancing, more credit-worthy (lower risk) borrowers who are more able to refinance loans, are more likely to prepay their mortgages. Over time, this can result in a gradual migration of a lender's loan portfolio towards higher risk borrowers and greater loan portfolio default rates. This, in turn, can cause lenders to increase interest rates at the time new loans are made to address this adverse selection risk. The inclusion of prepayment penalty terms reduces the adverse selection through prepayment by high credit quality borrowers, which results in more stable portfolios,

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[7] General Accountability Office, *Mortgage Reform: Potential Impacts of Provisions in the Dodd-Frank Act on Homebuyers and the Mortgage Market* GAO-11-656 (July 2011) at 37-38.

[8] Rose/*Origination Channel* at 27.

[9] *See* Alex Fayman and Ling T. He, *Prepayment Risk and Bank Performance*, 12 Journal of Risk Finance 26 (2011).

[10] Mayer, Pence, & Sherlund at 23; O. Emre Ergungor, *Prepayment Penalties on Subprime Mortgages*, Federal Reserve Bank of Cleveland *Economic Comments* (Sept. 2007) (available online at www.clevelandfed.org/research/commentary/2007/0901.pdf); Mayer, Piskorski & Tchistyi. *See also*, Rose/*Geographic Variation* at 4 (finding that low documentation lending consistently associated with higher default rates, and prepayment penalties associated with lower prepayment rates, but prepayment penalties only sporadically associated with higher default rates among subprime loans).

lower portfolio default rates, and lower interest rates for all borrowers.[11] Moreover, the same study indicates that much of the mortgage refinancing activity over this period was not financially appropriate for the borrower because it did not result in sufficiently lower interest rates to justify the fees and costs associated with refinancing, and that this type of inappropriate serial financing is deterred by the inclusion of prepayment penalty terms.[12]

In sum, recent academic studies support the views stated in our July 22 Comment Letter that maintaining the availability of prepayment penalty clauses in mortgage contracts for prime borrowers can provide significant benefits to consumers in the form of lower interest rates, and that inclusion of a prepayment penalty clause in mortgage loans to prime borrowers is not associated with higher default rates.

In addition to the research discussed above, we note that the FDIC recently recognized in its insurance assessment adjustment guidelines that properly-underwritten non-traditional mortgages made by a bank do not involve higher risks, particularly where the borrower has a low debt-to-income ratio and there is strong collateral coverage.[13] This conclusion, which is built upon the FDIC's extensive practical experience with mortgage loan portfolios, further bolsters the conclusion that it would be appropriate and in the public interest to adopt a more carefully tailored provision permitting prepayment penalty terms in prime loans with appropriate loan-to-value and income coverage ratios, rather than restricting such provisions to traditional 30-year, fixed rate, fully-amortizing loans.

For the above reasons, as stated in our July 22 Comment Letter, we request that the Proposed Rule be revised to remove the blanket prohibition against prepayment penalty terms for mortgages where targeted loan characteristics do not exist, or when appropriate loan-to-value and income coverage ratios are met, to clarify that discounts on mortgage loan interest rates the continuation of which are conditioned upon the borrower maintaining a direct deposit account relationship or an automatic debit payment feature are not adjustable rate mortgages, and to permit adjustable rate mortgages with an initial

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[11] Mayer, Piskorski & Tchistyi.

[12] Mayer, Piskorski & Tchistyi.

[13] FDIC, *Assessment Rate Adjustment Guidelines for Large and Highly Complex Institutions* at 32-33 (Sept. 13, 2011).

fixed rate and a rate adjustment more than three years after inception of the loan. In its place, a broader definition of "Qualified Mortgage" should be adopted and a narrower restriction on prepayment penalties should be implemented that regulates the proper mortgage type, and permits prime and qualified borrowers, where appropriate loan-to-value and income coverage ratios are met, to decide whether or not an adjustable rate mortgage with prepayment penalty terms is in their best interest.

We thank the Board and the Bureau of Consumer Financial Protection for the opportunity to supplement to our July 22 Comment Letter on the Proposed Rule.

Sincerely,

David F. Freeman, Jr.