April 8, 2008

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

Dear Ms. Johnson:

The American Financial Services Association ("AFSA")[1] welcomes the opportunity to comment on the proposed amendments to Regulation Z ("Reg Z"), which implements the Truth in Lending Act ("TILA") and the Home Ownership and Equity Protection Act ("HOEPA"). AFSA agrees with the Federal Reserve Board's ("Board") stated goals: (1) to protect consumers from unfair, abusive, or deceptive lending and servicing practices while preserving responsible lending and sustainable homeownership; (2) to ensure that advertisements for mortgage loans provide accurate and balanced information and do not contain misleading or deceptive representations; (3) and to provide consumers transaction-specific disclosures early enough to use while shopping for a mortgage. In order to meet these goals, AFSA believes that the Board must promulgate rules that continue to allow lenders the flexibility they need to exercise prudent underwriting. Additionally, AFSA notes that the Department of Housing and Urban Development ("HUD") has recently proposed amendments to the Real Estate Settlement Procedures Act ("RESPA"). AFSA believes that it is imperative that the Board and HUD coordinate their efforts to avoid duplication and the possible consumer confusion.

(AFSA will comment on the sections of the proposal in the order they are discussed in the preamble to the proposed rule.)

PROPOSED DEFINITION OF "HIGHER-PRICED MORTGAGE LOAN"

Proposed APR Trigger

AFSA appreciates the Board's recognition that its proposed rule may cover part of the alt-A market. However, AFSA believes that setting the trigger at an APR that is more than three percentage points in excess of the comparative Treasury security for first liens and five percentage points for subordinate liens will cover all of the alt-A market, and even a significant portion of the prime market. One AFSA member company has already determined that almost all the loans they make would be covered under this rule.

[1] AFSA is the national trade association for the consumer credit industry protecting access to credit and consumer choice. AFSA encourages and maintains ethical business practices and supports financial education for consumers of all ages. AFSA has provided services to its members for over ninety years. AFSA's officers, board, and staff are dedicated to continuing this legacy of commitment through the addition of new members and programs, and increasing the quality of existing services.

If the Board sets the threshold for higher-priced mortgage loans too low, many consumers with less-than-perfect credit histories will very likely not have access to credit. Because the excessive penalties that apply to violations of the proposed rules on higher-priced mortgages are very significant, the secondary market will shy away from buying higher-priced mortgage loans. As we have already seen with HOEPA loans, many lenders will not make loans if the secondary market will not buy them. The public HMDA data reflects that the number of high cost (Section 32) loans has dropped dramatically. Further restrictions, penalties and stigmatization will likely further restrict the availability of credit for consumers with less than perfect credit histories. While certain groups may advocate for a decline in higher-cost lending, the Board has stated its desire to promote and preserve homeownership and credit availability. AFSA believes that forcing a decline in high-priced lending, even where the price is appropriately risk-based, will not lead to an increase in the number of prime loans extended to subprime customers.

As noted above, tying the definition of higher-priced mortgage loans to Treasury securities is likely to capture a broader segment of the market than the Board intended. Therefore, AFSA recommends that, at a minimum, the Board set the threshold at four percentage points over the index selected by the Board for first-lien loans (and at least six percentage points for subordinate-lien loans). This would better satisfy the Board's objectives of covering the subprime market and perhaps the lower portion of the Alt-A market, while excluding the prime market. However, please note that unintended consequences may still arise for consumers in the alt-A market. In addition, requiring lenders to use securities with a maturity as short as one year for long-term variable rate loans would virtually assure that all variable rate loans currently offered to non-prime borrowers would fall under the proposed regulations.

Impact of Loan Size

AFSA also wishes to note that the proposed thresholds do not adequately account for the impact of loan size. While the fees paid by the consumer for a $100,000 loan and a $400,000 loan are substantially the same, once the fees are calculated into the APR, the APR on the smaller loan will be much higher. It is entirely possible that smaller, closed-end home equity loans ($5,000 to $30,000) will be more difficult to obtain because of a lack of profitability at the proposed 6 point margin. Smaller purchase money and refinance loans are also likely to be similarly affected. Lower income borrowers will be disproportionately affected by the proposed amendments.

Separate Fee Trigger

The Board also requested comment on whether or not to adopt a separate fee trigger. AFSA members do not believe that the Board needs to adopt a separate fee trigger. The Board expressed a concern that lenders would manipulate points, fees and rates to engineer lower APRs so as to avoid the higher-priced mortgage loan rules. Creditors would not circumvent the proposed restrictions by charging more fees and lower interest rates to reduce APRs because creditors price loans based on the requirements of the secondary market, not compliance concerns. The market determines pricing for mortgage loans based on reasonable interest rates and fees. The APR is irrelevant to the secondary market.

HMDA Reportable Mortgage Loans

AFSA believes that establishing a definition for higher-priced loans under TILA that differs from the method of calculating reportable mortgage loans under the Home Mortgage Disclosure Act or "HMDA" will significantly complicate compliance. AFSA does not see a reason for a different definition. Different methods of computing trigger rates would be burdensome. Thus, AFSA recommends that the implementation of the higher-priced mortgage loan rules be delayed until HMDA can be amended to be consistent with the new and improved methodology.

Scope of Covered Loans

AFSA believes that the Board correctly limits coverage of all or some of the proposed restrictions to certain kinds of subordinate-lien loans such as "piggy backs" to first-lien loans, or to subordinate-lien loans that are larger than the first-lien loan.

AFSA agrees with the Board's decision to exclude Home Equity Lines of Credit ("HELOCs") from the proposed protections. The Board has correctly determined that these transactions do not present a need for new regulations. Because most HELOC originators hold the loans in portfolio rather than sell them, the originators' interests in loan performance are more closely aligned with their borrowers' interests. Additionally, TILA and Reg Z already provide special protections to borrowers in HELOC transactions.

AFSA also agrees that "bridge loans" should be exempted because HOEPA covers certain bridge loans with rates or fees high enough to make them HOEPA loans. Absent an exemption, most, if not all, bridge loans (even for prime customers) would be considered higher-cost loans because of the short term nature of bridge loans and the effects of fees on the APR.

SUGGESTED AUTHORITY FOR HIGHER-PRICED MORTGAGE LOAN RULES

AFSA recommends that the Board use its authority under § 105(a) of TILA to promulgate the proposed amendments as opposed to its rulemaking authority under § 129(*l*)(2) of TILA, particularly if any ambiguity remains in the proposed higher-price mortgage loan rules. The Board has broad authority to implement the purposes of TILA under Section 105(a). Because nearly all the proposed regulations are designed to promote the informed use of credit and, correspondently, avoid the uninformed use, AFSA urges the Board to use its Section 105(a) authority. The penalties under Section 129 are disproportionately great and should be limited to practices that are truly unfair and deceptive and implemented on a wide, pervasive scale. AFSA has particular concerns about the application of Section 129 because a number of the proposed regulations concern the actions of third parties over which the lender has little or no control. The statutory penalties for a violation of a rule promulgated under § 129(*l*)(2) of TILA include up to $2,000 in an individual action ($500,000 in a class action), attorneys fees and loss of all finance charges and fees. In addition, a violation may lead to a right to rescind the transaction. Additionally, TILA is unclear as to whether the special measure of damages for a violation of § 129 of TILA – loss of all finance charges and fees – is applicable in a class action. When Congress added § 130(a)(4) to increase the damages for violations of § 129 of TILA and any rules promulgated under § 129, it failed to specify whether these increased damages are available only in individual actions. This lingering fear about penalties for even an inadvertent violation under § 129 has stopped most lenders from knowingly making a loan subject to HOEPA. Since these same penalties would apply to "higher priced mortgage loans," the Board should anticipate a similar reaction, particularly if there is any doubt about how to safely make a higher-priced mortgage loan.

Promulgating these rules under § 129 may also have a significant impact on the secondary market's willingness to purchase higher-priced mortgage loans. The secondary market will be reluctant to buy loans where the potential for penalties could exceed the total expected earnings on the loans.

If the Board promulgates the proposed amendments under § 105 of TILA, lenders would be subject to penalties under § 130 of TILA for a violation. These penalties are still significant, but do not include the loss of all finance charges and fees. AFSA members feel that penalties under § 130 strike an appropriate balance between sufficiently deterring prohibited conduct and preserving the secondary market's investment in these loans.

As to the feasibility of using § 105 as the source of the higher-priced mortgage loans, AFSA believes that the Board has sufficient authority to issue these proposed regulations under either § 105 or § 129(*l*)(2). Section 105 authorizes the Board to "prescribe regulations to carry out the purposes of this title." Thus, while § 129(*l*)(2) gives the Board independent regulatory authority to prohibit certain acts or practices, § 129 is itself part of Title I, and the Board may use its alternative regulatory authority under § 105 to issue regulations to carry out the purposes expressed in § 129(*l*)(2). The use of this alternative authority seems reasonable if the Board concludes that the draconian penalties that apply to § 129 would otherwise limit the availability of credit to a significant portion of the market.

PROPOSED RULES FOR HIGHER PRICED MORTGAGE LOANS–§ 226.35

Repayment Ability – 226.35(b)(1)

AFSA would like to reiterate that mortgage lenders intend to originate good, performing loans. Mortgage lenders want to avoid foreclosure. Nobody wins in a foreclosure, particularly mortgage lenders, who lose approximately $50,000 per foreclosure.[2] This is especially true of the majority of AFSA members that are portfolio lenders and do not sell their loans. Even for lenders that sell their loans, the secondary market now requires more rigorous underwriting to ensure the ability to repay. The market has adjusted to the mistakes of the past. In view of the previously issued Guidance on Nontraditional Mortgage Product Risks, the proposed regulation is easily viewed as overly restrictive and may well have the contrary effect of further restricting credit.

Need for a Safe Harbor

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[2] Renae Merle, "You're Invited . . . To Pay Your Mortgage," Washington Post 16 Feb 2008: D01.

AFSA notes that currently the proposed rule provides for a presumption of a violation, but not a safe harbor, in underwriting practices. AFSA recommends that the Board establish a safe harbor. A verifiable safe harbor is particularly necessary if failure to comply will trigger the penalties available for violations of § 129. AFSA suggests that there be a safe harbor if the lender can demonstrate that it considered a consumer's ability to repay pursuant to the lender's underwriting guidelines. In order to be eligible for the safe harbor, lenders must document the sources of a consumer's income, as well as the calculations that the lender used to determine the consumer's ability to repay the loan at the fully indexed rate and the fully amortizing payment. This documentation would be required on an individual loan basis, so that verification of income and expenses and calculations of ability to repay would appear in each loan file, and on a company-wide basis by the implementation of policies mandating consideration of the ability to repay.

A special rule may be necessary, however, for lenders that sell loans to government-sponsored enterprises ("GSEs") like Fannie Mae and Freddie Mac. These lenders are required to use the GSEs' automated proprietary underwriting systems. Because these systems are proprietary, lenders would not be able to document the calculations used in the underwriting process to determine ability to repay. Such lenders should not be required to document these calculations. Instead, and the lenders should only be required to show that they submitted the loan for underwriting to a proprietary third-party system and that they documented all sources of income used in that submission.

Events That Occur After Origination

The Commentary (for 226.34(a)(4)) suggests that events that occur after the mortgage is originated may be used to prove a violation of the underwriting requirements. The Commentary provides only two examples of post-closing events that would not indicate that a violation occurred: serious illness or job loss. While job loss after consummation does not, in itself, lead to a violation, the Commentary further provides that employment should be considered. The Commentary states that in some circumstances, it may be appropriate or necessary to take into account expected changes in employment, while in other circumstances a creditor may have information indicating that an employed person will become unemployed. Given this language, it is unclear whether creditors should underwrite loans differently in a locality, such as Cleveland, that is losing its industrial base or has other negative economic indicators. Based on this provision, creditors may decide to impose more stringent underwriting criteria in certain areas due to projected economic decline. Such areas are likely to be concentrated in metropolitan areas rather than an entire state, and the creditor will undoubtedly face allegations of red-lining.

Further, the Commentary discussion on post-closing events is highly subjective and will lead to second-guessing, perhaps even years after the loan has been made. Courts are quite likely to impose liability where a consumer is unable to repay his or her loan due to a subsequent event other than a serious illness or job loss. Many life events may lead to a borrower's inability to pay his or her loan, i.e., divorce, or other household disruption, children, retirement. A lender's inquiry about any of these topics is inappropriate at best and maybe even a violation of Regulation B at worst. It is not our intent to be cavalier about underwriting. AFSA believes that underwriting should be rigorous, prudent and flexible. The Commentary, while clearly intended to promote a return to more stringent underwriting practices, simply invites second-guessing with the benefit of 20/20 hindsight.

Additionally, many AFSA members use computer programs to underwrite mortgages. If the proposal goes into effect as currently drafted, programmers would have to find a way to write code to determine how the examples described above may affect the loan. In other words, computer programmers, for example, would have to write code that would be able to determine the likelihood of a subsequent event such as those mentioned above.

AFSA requests that the Commentary clarify that post-closing events cannot be used to second-guess a lender that verified the sources of the borrower's income and documented both the verification and the calculations the lender used to determine that the borrower could repay the loan at the fully indexed rate and fully amortized payment in accordance with the lender's underwriting procedures. To provide otherwise is fundamentally unfair.

Reliance on Pattern or Practice

The preamble to the proposed rule suggests that tying a violation to a "pattern or practice" of failing to comply will be sufficient to protect creditors from undue risks, and perhaps for this reason, a safe harbor was not proposed. However helpful the "pattern or practice" standard is, it is not a substitute for a verifiable safe harbor. There are two reasons for this. First, it is not clear what actually constitutes a pattern or practice. AFSA's research has uncovered just two cases interpreting this phrase as it is used in HOEPA. In one case, the court found that seven loans out of a lender's portfolio would constitute a pattern or practice. In the other, the court rejected an attempt to show a pattern or practice with one loan. There is no way to predict where a court will set the threshold for a pattern or practice. Is it 100 loans, is it one percent of a lender's production? There is no way for lenders to know and consequently there is no way for the secondary market to know. This uncertainty will make the sale of higher-priced mortgage loans problematic and thus reduce credit availability. Second, a plaintiff's lawyer may attempt to prove a pattern or practice by arguing that a lender's failure to maintain appropriate underwriting guidelines is sufficient to prove a pattern and practice. This is particularly of concern given that the regulations and Commentary will require verification and documentation. A court could reject a lender's policy based on what type of income is acceptable, whether certain expenses should have been considered or whether a particular type of documentation is adequate. Thus, while the "pattern or practice" concept is helpful and welcomed, AFSA members do not believe it is a substitute for a verifiable safe harbor.

Avoid Adopting Other Presumptive Violations

In addition to reconsidering the proposed presumption of a violation in favor of adopting a safe harbor, AFSA requests that the Board refrain from incorporating additional presumptions. In the proposal, the Board specifically requests comments on whether there should be a rebuttable presumption of a violation if the borrower's debt-to-income ("DTI") ratio exceeds 50%. DTI is neither a proven indicator of loan performance, nor a well defined concept. Lenders have successfully managed portfolios with loans that have DTIs in excess of 50% and have seen relatively low delinquency rates on these loans. If the Board establishes a safe harbor provision at 50% DTI, any lender making loans with DTIs in excess of 50% would be subject to litigation. The plaintiff will allege that the Board established a presumption that the borrower does not have the ability to pay such a loan and the defendant creditor will have an uphill battle to prove its case. The alternative safe harbor approach described above would both protect creditors and continue to offer them flexibility in approving consumers that have the ability to repay, but do not qualify under traditional "prime" underwriting standards.

Seven-Year Safe Harbor

The proposed regulation provides that a creditor would satisfy the ability to repay rule if the creditor had a reasonable basis to believe that the borrower would be able to make scheduled loan payments for at least seven years. The preamble asks if a shorter time period would be more appropriate. A shorter period of five years for purchase money loans and three years for non-purchase money loans would be more appropriate. AFSA believes that the Board might have chosen a period of seven years because that period was once, anecdotally, average length of time that a borrower held on to the same mortgage. However, that average has fallen. According to the Mortgage Bankers Association, the historical average duration in the subprime market has been thirty months, while the average duration in the prime market has been slightly greater than four years.[3] In any case, the average length of a mortgage is far shorter than the seven years required for underwriting loans under the proposed rule, and a reasonable reduction is warranted.

Considering LTV

In answer to the Board's question, lenders should be allowed to consider a borrower's loan-to-value ("LTV") ratio. Borrowers with a low LTV usually receive a better rate on their mortgage because a higher LTV is associated with higher risk. The Board could clearly state that although lenders can use a LTV ratio when deciding what rate to offer the consumer, they may not choose to extend the loan based solely on the value of the house. Such a clarification would be appropriate.

Miscellaneous Comments

AFSA would like to emphasize that a violation should not be presumed simply because a property is foreclosed upon. All borrowers experience events that cannot be foreseen, whether they are in the prime or the subprime market. AFSA respectfully requests that the Board include this sentiment in the Commentary to prevent frivolous lawsuits.

In considering any clarification of these rules and the need to create a true safe harbor, the Board should keep in mind the concerns expressed above regarding the potential penalties for violating

[3] Statement of John M. Robbins, CMB Chairman of the Mortgage Bankers Association, before the Subcommittee on Housing, Transportation, and Community Development during the U.S. Senate Hearing on "Ending Mortgage Abuse: Safeguarding Homebuyers," June 26, 2007.

any rule promulgated under § 129(*l*)(2) of TILA. If there is any ambiguity about whether a loan would violate Section 226.35, the credit will not be offered.

Verification of Income and Assets – 226.35(b)(2)

AFSA commends the Board for allowing the lender to verify the consumer's income and assets through third-party documents that provide reasonably reliable evidence such as W-2 forms, tax returns, payroll receipts, or financial institution records. However, AFSA respectfully requests that this section, or the accompanying Commentary, be amended to include a clear statement that "bank statements" are "financial institution records" which a creditor may rely on to satisfy the obligation to verify income contained in the proposed regulation. The rule is flexible and appropriately balances costs with benefits. However, AFSA also asks that the Board include comment that, in some cases, for example, a refinance of an existing mortgage, full documentation is not necessary. The Board took this position in the Statement on Subprime Mortgage Lending: "Therefore, the final Statement provides that stated income and reduced documentation should be accepted only if there are mitigating factors that clearly minimize the need for verification of repayment capacity. The Statement provides some examples of mitigating factors, and sets forth an expectation that reliance on mitigating factors should be documented."[4] The Statement also mentions that full documentation may not be necessary "where a borrower has substantial liquid reserves or assets that demonstrate repayment capacity and can be verified and documented by the lender."[5] The safe harbor as expressed in the Statement would be adequate.

Prepayment Penalties – 226.35(b)(3)

AFSA commends the Board for acknowledging that prepayment penalties can benefit the borrower. If a lender offers a borrower a written choice between a loan with or without a prepayment penalty, a consumer should be able to choose the loan with the prepayment penalty as long as there is a demonstration of a benefit to the borrower. AFSA does not object to the new standards imposed on HOEPA loans. AFSA also agrees that a five-year limit is appropriate for higher-priced loans.

AFSA understands that there has been significant criticism of prepayment penalties. However, contrary to the common misperception, prepayment penalties *do* offer a benefit to the borrower. Countrywide Financial's Senior Managing Director and Chief Legal Officer, Sandy Samuels, testified that, "Used properly, prepayment penalties offer significant benefits to borrowers. In today's market conditions, a three-year prepayment penalty on Countrywide's most popular product (a 3/27 adjustable rate 12 loan) provides the borrower with an interest rate reduction of 1 percent. This would reduce the monthly payment on a $150,000 loan by $125, a significant amount for any family trying to make ends meet."[6]

[4] Federal Register, Vol. 72, No. 131, July 10, 2007, p. 37571
[5] Federal Register, Vol. 72, No. 131, July 10, 2007, p. 37573-37574
[6] Testimony of Sandy Samuels, Senior Managing Director and Chief Legal Officer, on behalf of Countrywide Financial Corporation and the Housing Policy Council of The Financial Services Roundtable before the Subcommittees on Financial Institutions and Housing in the U.S. House of Representatives, March 30, 2004.

Mr. Samuels also gave a specific example of a Countrywide customer to illustrate his point, "Mr. C. from Clovis, California, had a 510 credit score and monthly mortgage and other debt payments that exceeded 60% of the income from the tanning salon he owned. We helped Mr. C. consolidate his fixed-rate first mortgage at 7.75% and his adjustable-rate second mortgage into one 30-year, fixed-rate first mortgage at 6.875%, with total discount points and lender fees equal to 4 percent of the $264,000 loan amount. Mr. C. also opted to take a prepayment penalty in order to reduce his rate. This loan lowered Mr. C.'s monthly payments by more than $1,550, and reduced his monthly debt ratio to a much more manageable 43% of income. Mr. C.'s low credit score precluded any rate reduction refinance or debt consolidation with a prime loan."[7]

Additionally, Gregory Elliehausen, Michael Staten and Jevgenijs Steinbuks, in their paper, *The Effect of Prepayment Penalties on the Pricing of Subprime Mortgages*, suggest that a prepayment penalty reduces risk premiums by 38 basis points for fixed-rate loans, 13 basis points for variable-rate loans, and 19 basis points for hybrid loans. The data for this study are from the Financial Service Research Program's (FSRP) subprime mortgage database.[8] (The paper is presented in its entirety as an attachment to this letter.)

Not only do prepayment penalties help individual borrowers, they also lower the aggregate cost of credit. According to Michael LaCour-Little, a Professor of Finance at California State University, "Completely eliminating prepayment penalties from the entire mortgage market (estimated market size, in terms of originations, during 2004 at $1.5 trillion) would cost approximately $21 billion; to do so in the subprime segment alone (assuming that segment is about 10% of the overall market) would cost $3.3 billion."[9] In an interview, Professor LaCour-Little explained his findings saying, "Prepayment penalties reduce the aggregate costs of credit. Admittedly, for any particular individual who hadn't planned on having to prepay a mortgage, when they encounter the contract precision for the first time, the penalty may be an unpleasant surprise. However, the point is that, in the aggregate, mortgage rates are lower when you have penalties than when you don't. So the trend to restrict that contract feature makes it more expensive for everybody."[10] Professor LaCour-Little also explained why prepayment penalties are more prevalent in the nonprime sector, "The option is more valuable in the nonprime market than in the prime market because nonprime borrowers prepay faster. Nonprime borrowers typically have a temporary problem – once they get over their temporary problem, they can improve their rates by refinancing. And the length of most prepayment penalties is about the amount of time it takes to cure a credit problem."[11]

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[7] *Id.*
[8] Gregory Elliehausen, Michael E. Staten and Jevgenijs Steinbuks, "The Effect of Prepayment Penalties on the Pricing of Subprime Mortgages," Journal of Economics and Business 60 (2008) 33–46, Aug 07.
[9] Michael LaCour-Little, "Call Protection in Mortgage Contracts," 4 Jan 2005. http://www.fma.org/Chicago/Papers/CallProtectionPaper.pdf.
[10] Equity Update (February, 2006). [Interview with Michael LaCour-Little, author of Call Protection in Mortgage Contracts]. http://www.juliefeinstein.com/downloads/Equity%20Update%2002-06-06.pdf.
[11] *Id.*

When offering prepayment penalties to borrowers, AFSA members generally show them two rates, one without the prepayment penalty and one with it. Usually, there is about a 40-60 basis point difference between the two rates. Also, prepayment penalties discourage frequent refinances, which can be very expensive for the borrower. Moreover, some borrowers only qualify for a loan with a prepayment penalty. On the other side, prepayment penalties protect the lender against the competitive nature of the market and the loss that occurs on a loan that was expensive to originate. This protection is key to maintaining liquidity in the market.

In its study of North Carolina's regulation of subprime mortgages, which included limitations on prepayment penalties, The Center for Statistical Research, Inc. concluded, "Everyone who has examined the issue recognizes that the effect of the North Carolina law has been to reduce subprime credit availability, probably in the range of 15% to 20% for refinance loans. Moreover, the weight of research suggests that higher risk borrowers feel the shrinkage in availability most."[12]

The Office of the Comptroller of the Currency also believes that, "There is a good deal of empirical evidence to suggest that anti-predatory statutes impede the flow of mortgage credit, especially to low income and higher-risk borrowers, and any reductions in predatory abuses resulting from these measures is probably achieved at the expense of many legitimate loans."[13]

Some states, such as California, Colorado, Florida and Wisconsin allow prepayment penalties, as long as the borrower has a choice. Would this rule preempt those laws?

Escrow Requirements – 226.35(b)(4)

As with many lending practices, the decision to escrow or not escrow is not inherently either "good" or "predatory," and AFSA believes that the Board should consider the costs as well as the benefits of the proposed regulation. AFSA also notes that the proposed escrow requirement represents a significant change in paradigm relating to escrow regulation, and asks that the Board carefully consider unintended consequences.

Background

As the Board indicates, prime mortgage lenders have traditionally required escrow accounts on first mortgage loans as a means of protecting the lender's interest in the property securing the loan. Finance companies, on the other hand, traditionally have not escrowed. Most finance company mortgage offerings began as second mortgage programs and have evolved over time to include first mortgage products. AFSA members that do not currently escrow have not stopped escrowing for some "competitive advantage," but rather have never required escrows to begin

[12] George Wallace, "The North Carolina Regulation of Subprime Mortgages: The Debate Over Social Benefits and Costs, A Review of Current Statistical Research," Jan 04. http://www.centerstats.org/pdf/04NCRegulationSubprimeMortgages.pdf
[13] Comptroller of the Currency, "Economic Issues in Predatory Lending, OCC Working Paper," 30 July 2003. http://www.occ.gov/workingpaper.pdf.

with, initially because they offered only second lien loans, and later because they have not had the systems capability or internal expertise needed to do so.

A lender's right to require an escrow account is established within the loan contract, which generally provides that an escrow account will be established unless the lender agrees otherwise. Most prime lenders waive escrow requirements for lower loan-to-value loans with satisfactory payment histories, and there is often a fee for this waiver. Although the proposed rule focuses on the benefits of escrow accounts to consumers, escrow requirements have often been viewed as an imposition on consumers and a practice needing control. A simple internet search reveals numerous financial columnists advising homeowners that they are better custodians of their own escrow funds than lenders. In fact, many attorneys general list escrows as one of the top consumer complaints. Escrow requirements and lenders' handling of escrow accounts have been the focus of a significant amount of litigation over the years, some of which has been originated by the same consumer advocates that now contend that the lack of an escrow account is a predatory loan marker.[14] Finally, most, if not all, of the numerous federal and state laws regulating escrow either impose requirements or place limitations on escrow accounts for the purpose of reigning in lenders' perceived mistakes or abuses in exercising their contractual right to hold escrow.[15]

The proposed amendments to Regulation Z change this paradigm and transform escrow from a negotiable loan term to a "service" that lenders are legally obligated to provide to borrowers, and borrowers are legally obligated to utilize, regardless of individual circumstances, with only one determining criteria – loan price.

The Proposed Escrow Requirements Will Result in Significant Costs to Both Lenders and Borrowers

The origination and servicing of escrow accounts is a quite complex endeavor – one mortgage servicer reports over 22,000 tax payees, each with its own payment structure, due dates, discount dates, and penalty dates, and nearly 18,000 insurance payees, with borrowers able to change insurance companies and policies at will. The calculations involved in analyzing an escrow account – both at the time it is initially established and annually thereafter, while designed to minimize the amount retained in an escrow account, are complicated.

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[14] AFSA notes that the National Consumer Law Center (NCLC), which has strongly urged the Board to unconditionally define the failure to escrow as an unfair and deceptive trade practice, http://www.federalreserve.gov/SECRS/2007/August/20070816/OP-1288/OP-1288_52_1.pdf, was also co-counsel to the plaintiff class in Curry v. Fairbanks Capital Corp., settled in 2003, which included several counts relating to mishandling of borrower escrow accounts. See http://www.nclc.org/issues/mortgage_servicing/content/settlement_summary.pdf.

[15] See Attachment A - State Escrow Regulation Chart. Even as this proposed rule is pending, a bill has been introduced in Oklahoma to require lenders to pay interest on escrow accounts. The bill's sponsor decries the "profit" lenders make on the use of borrowers' escrow funds, without any acknowledgement of the costs lenders incur to service these accounts. *See* Oklahoma House Bill 2594; *see also* http://wwwtmrcom.blogspot.com/2008/01/luttrell-wants-mortgage-escrow-account.html.

The proposed escrow requirement will, at a minimum, result in significant operational costs, as well as compliance burdens and the inevitable litigation risk, for lenders that do not currently escrow. There are currently no reliable “off-the-shelf” escrow computer systems that can be quickly and easily integrated with lender origination and servicing platforms for those lenders who do not currently have escrow systems. Putting an escrow system in place will cost millions of dollars just for medium sized companies. One AFSA member company estimated that it would cost $13 - $16 million to implement in the first year alone. Another AFSA member company said that the costs of hiring and training personnel to manage and administer escrow accounts, as well as the increased liability exposure, has the company strongly considering exiting the first mortgage lending business if this regulation becomes effective as promulgated. This single, seemingly simple requirement will require the involvement of every aspect of these companies’ operations: -- origination, servicing, compliance, training, risk, pricing, credit, systems, etc. As with any project with such a large scope, there will be opportunity costs, as these lenders devote significant resources to maintaining the status quo rather than focusing on enhancing their business and new innovations.

Smaller subprime and Alt-A lenders may not be able to afford to enhance their origination and servicing systems and hire employees with appropriate escrow experience, and thus will be forced out of business. Many local and regional banks, who often sell their Alt-A and subprime originations rather than hold them on their own books, will choose not to invest in the system upgrades and employee training that will be required even for those lenders that choose to only originate, but not service, higher-priced loans. Thus, the proposed escrow requirement will negatively impact the availability of credit to subprime and even alt-A borrowers.

By necessity, the costs incurred by these lenders will inevitably be passed on, at least in part, to the consumers. Lenders that hold escrowed loans in their own portfolios will have to increase fees or interest rates to cover the increased costs. Lenders that service loans for others will have to increase servicing fees, which will eventually result in increased origination costs for consumers.

Beyond more expensive loans, borrowers will also lose flexibility in handling their own tax and insurance payments. Seasonal workers will not be able to adjust their tax and insurance reserves to match their income flows. Borrowers will not be able to utilize alternative resources for tax and insurance payments – income tax refunds, bonuses, or other forms of credit. Last but not least is the opportunity cost for borrowers who could use the funds for a more productive purpose and still meet their tax and insurance obligations. For prime loans, borrowers that meet their lender’s criteria for an escrow waiver retain this personal flexibility and autonomy in managing their own tax and insurance obligations. The proposed escrow requirement, however, will deprive subprime borrowers of this option, regardless of their loan-to-value or the reason for their subprime status, which could have no relationship to their budgeting and payment abilities, but result from an unexpected medical or employment crisis.

Mandatory escrow accounts may also impact lenders’ ability to work with borrowers experiencing payment difficulties and in need of loss mitigation. Borrowers’ contractual obligations will include both the principal and interest payment and the escrow payment, and delinquency will result if the full payment cannot be made, even if the principal and interest is covered. Any escrow shortages allowed by the lender in resolving a delinquency will have a compounded effect following the next escrow analysis. Thus, mandating escrow accounts may have the unintended consequence of increasing delinquency, with an impact on both borrowers' credit ratings and lenders' workout options.

Disclosures Are a Better Response to the Perceived Escrow Problem

This is not to say that AFSA believes that lenders should not be able to require escrow accounts or that borrowers should not be given the opportunity to escrow. Instead, individual lenders and borrowers should be able to make their own decisions about escrowing within a free marketplace.

Many of the escrow problems outlined in the Board's commentary can be traced to an information breakdown – borrowers allegedly not being aware that their proposed loan or their existing loan did not include escrows and being "surprised" when an "unexpected" tax or insurance bill came due. AFSA notes that when considering this element of "surprise" one must also consider that, as with a borrower's obligation for other housing-related payments (such as utility expenses and condominium or homeowners association dues), the borrower's responsibility for tax and insurance payments exists independently from the loan obligation. The lender's interest in controlling payment of these two items is based solely on their ability to impact the lender's security, not on any altruistic wish to assist a borrower with budgeting. AFSA also notes that the concern that subprime borrowers are moving from loans with escrows to loans without escrows is in itself evidence that there are subprime lenders that offer/require escrows and that subprime borrowers do have a choice within the marketplace.

Thus, AFSA urges the Board to reconsider this drastic requirement and replace it with enhanced disclosure requirements that will ensure the borrower's understanding of his or her obligations with respect to tax and insurance payments. A simple disclosure regarding the lender's escrow policies, such as the one below, provided at the time of application and again at closing should place borrowers on notice if the lender does not escrow:

___ The Lender does establish escrow accounts for the payment of property taxes and insurance premiums.

___ You will be required to establish an escrow account as a condition of your loan.

___ You will not be required to establish an escrow account as a condition of your loan.

___ The Lender DOES NOT establish escrow accounts for the payment of property taxes and insurance premiums. You will be responsible for the payment of these items yourself and should budget for their payment.

This, in combination with the proposed advertising requirement (§226.24(f)(3)), requiring a disclosure when a payment quote does not include amounts for taxes and insurance premiums, should ensure consumer knowledge and understanding regarding their escrow status as well as allow borrowers to shop for the availability of escrow accounts.

AFSA notes that eliminating the mandatory escrow requirement in favor of enhanced disclosures would not mean that subprime lenders that currently do not escrow would not at some point in the future add an escrow feature to their loan programs. It would mean, however, that such lenders could do so on their own timetable and in a way that best meshes with their other system and business initiatives.

In the event that the Board moves forward with the mandatory escrow requirement, however, there are several important points that the Board should consider.

Any Escrow Requirement Should Allow An Adequate Implementation Timeframe

As previously noted, the impact of the proposed escrow requirement on non-prime creditors that currently do not escrow will be extensive. A delayed effective date is essential for those companies that do not have systems in place to escrow for mortgage loans. Lenders will need much more than the usual six-month effective date to make and test system enhancements. An AFSA member company estimated that it would take approximately 30,000 person hours (2,040 work hours in a year assuming a forty hour work week or the equivalent of fifteen people working full time for a year) in order to implement escrows from a technology standpoint. That does not include time spent by non-technology staff to train personnel and develop policies and procedures. Another AFSA company has said that they would not be able to have an escrow system in place until 2010. If this rule goes into effect as proposed, this company would not make higher-priced mortgage loans until 2010. This company estimates that this would mean that they would lose $24 million a month. AFSA requests that any mandatory escrow requirement not be effective for at least 24 months after the rule is finalized, but in no event before July 1, 2010.

Clearer and Complete Preemption of State Law is Needed

As was also previously noted, the proposed regulation is a paradigm change – from escrow being a lender's contractual right that has required federal and state governmental restriction to escrow being a federal law requirement. This creates a new tension between federal and state law that is not fully addressed by the proposed preemption provision.

AFSA is concerned that the proposed preemption provision relies solely on conflict preemption, and then only for the narrow conflict between state laws that limit when a lender can require an escrow account. However, there are numerous other types of state regulation of escrow that impose disclosure requirements, limit the amount of escrows that can be retained, regulate when and how escrow disbursements are to be made, and require lenders to pay interest on escrow accounts without considering the cost to the lender of servicing the escrow account. (See attached chart.) These state laws create operational costs, compliance burdens, and litigation risks that up to now subprime lenders have been free to avoid by not escrowing. Without a clearer and more complete preemption of state law relating to escrow accounts, the new mandatory escrow requirement will unfairly encompass these state law requirements.

At a minimum, preemption should not end after the twelve-month initial escrow requirement ends, but should apply for the life of the loan. Otherwise, lenders could be placed in the position of being in immediate violation of state law when the loan reaches 12 months plus one day.

The proposed preemption provision also fails to address the likelihood, which the Board anticipates, that lenders are likely to establish internal thresholds lower than the definition of higher-priced mortgages or even treat all loans as "higher-priced" to ensure compliance. This could lead to the odd situation in which borrowers seek to prove not that their loans are higher-priced and therefore subject to TILA/Regulation Z protections, but that their loans are not higher-priced and therefore subject to non-preempted state escrow laws. The proposed preemption provision would not protect lenders who choose to be over-inclusive in their higher-priced loan determinations, but would instead create a legal Catch-22 under which a lender would be unable to structure its policies and operations to avoid compliance risk.

The federal government already significantly regulates escrow practices through the RESPA, and the new mandatory escrow requirement considerably expands that regulation. AFSA therefore strongly urges the Board to acknowledge that the federal government now "occupies the field" of mortgage escrow requirements, and to preempt all state laws relating to mortgage escrow accounts. To the extent that affirmative regulation of escrow accounts on prime loans would be needed to support this preemption, the regulation could provide that while escrow is required on higher-priced loans, it is permitted but not required for non-higher-priced loans.

Retain Limitation to First Mortgages Only

AFSA agrees with the application of the mandatory escrow requirement only to first mortgages. A requirement to maintain escrow accounts on second mortgages could lead to conflicting escrow obligations, especially when a first mortgage without escrows is refinanced without paying off the second mortgage. Moreover, within a few years of implementation of the proposed escrow requirement there would likely be very few non-prime first mortgage loans without escrow accounts.

Exceptions to Escrow Requirement

AFSA supports exceptions to the escrow requirement for those circumstances in which the consumer protection concerns identified by the Board are not likely to be present, such as lower loan-to-value loans or situations in which the borrowers are already managing their own tax and insurance payments, such as refinances of loans without escrow accounts and loans where the borrower has no existing loans on the home. It should be clear, however, that any such exceptions are not to be construed as prohibiting escrows or allowing borrowers to refuse escrows on exempted loans. Instead, where escrow is not legally required, the loan contract and the lender's standard underwriting guidelines regarding escrow waivers should apply.

Escrow Termination Should Not Be Mandatory

AFSA supports limiting the mandatory nature of the escrow requirement, but disagrees with providing the borrower with an absolute right to terminate the escrow account with only twelve months loan seasoning. First, allowing unilateral termination of the escrow account by the borrower after only one year invalidates any contention that an escrow account is an essential consumer protection. It does not make sense for the Board to require that lenders make the tremendous technological and operational investments needed to originate and service escrow accounts if they are legally able to maintain the accounts for only one year. Further, allowing unilateral borrower opt-out would open the door to the very type of consumer behavior that the Board wishes to prevent -- consumers who opt out could spend their escrow refund rather than hold it for taxes and insurance payments, with the possibility that they would then have to refinance their loan in order to obtain funds for taxes and insurance and re-establish an escrow. Instead, AFSA believes that once the mandatory escrow period expires, the escrow account should be governed by the terms of the loan contract, and the lender should be able to apply its standard underwriting guidelines to escrow waiver requests. If the Board believes that there are situations in which the consumer protection interest swings from requiring an escrow account to prohibiting an escrow account (such as for loans with very low loan-to-values or loans that have reached low loan-to-original-balance ratios), then these exceptions should be established by rule and should apply both at origination and during servicing.

Penalties

When considering the need for these rules, the Board should again keep in mind the serious penalties that creditors might face for an alleged violation of this provision. Creditors will be reluctant to consider making any “higher-priced” mortgage loans unless the rules are absolutely clear and free from ambiguity.

Special Considerations for Insurance Escrows

With respect to insurance premiums, the escrow requirement should be expressly limited to only those premiums for coverage required by the lender as a condition of the loan and should not apply to other property-related insurance carried by the borrower or to optional credit insurance products. Further, the proposed rule is silent on the lender’s options, responsibilities, and liability in the event borrower cancels an escrowed insurance policy and does not obtain replacement coverage. Prime lenders uniformly force-place insurance coverage in this situation; however, sub-prime lenders generally avoid force-placing insurance due to significant past criticism and litigation over this practice. AFSA requests that the Board specifically address this issue in the final rule and either expressly authorize the lender to force-place insurance in this situation in the same manner that a lender subject to the flood insurance requirements is authorized to force place flood insurance, or expressly absolve the lender from any liability relating to or resulting from the borrower’s insurance cancellation.

Conclusion

In conclusion, AFSA believes that the Board's concerns can be adequately addressed through enhanced disclosure requirements without requiring the extensive and costly system and operational enhancements that mandatory escrows would require. In the event that the proposed mandatory escrow requirement is finalized, however, AFSA respectfully requests the Board to consider the concerns set forth above.

Evasion Through HELOCs – 226.35(b)(5)

AFSA appreciates the fact that the Board has excluded home equity lines of credit ("HELOCs") from the proposed rule. However, the proposed rule includes problematic language that seems to prohibit offering a HELOC program that fails to meet the definition of open-end credit as a means of evading the requirements of this new section. However, if a HELOC program does not meet the definition of open-end credit, it is by definition closed-end credit and would be subject to § 226.35 and thus, could not evade the requirements of this section. In fact, such an attempt would make the creditor subject to all the penalties that apply to any creditor that fails to provide closed-end credit disclosures and otherwise comply with the rules for "higher-priced mortgage loans."

We recognize that this proposal parallels § 226.34(b), which is similarly problematic and has led to expensive litigation over the years. Our concern is that a judge will attempt to read some meaning into this otherwise meaningless tautology. For example, a judge could determine that a HELOC, which otherwise complies with the definition of open-end credit, must meet some higher standard to be considered a legitimate HELOC, if the plan would otherwise be considered a "higher-priced mortgage loan." If this is the Board's intention, the Board should spell out what special definition of open-end credit applies to HELOCs. If not, this section should be deleted. While it is our strong preference that this meaningless provision be eliminated, at the very least a Commentary provision should be added stating that this section is not intended to transform any HELOC that meets the definition of open-end credit into closed-end credit subject to this rule.

PROPOSED RULES FOR MORTGAGE LOANS–§ 226.36

The Board promulgated this section pursuant to its authority under § 129(*l*)(2) of TILA. For the reasons discussed above, AFSA respectfully asks that the board use § 105(a) of TILA instead. The Board has broad authority to implement the purposes of TILA under Section 105(a). Because nearly all the proposed regulations are designed to promote the informed use of credit and, correspondently, avoid the uninformed use, AFSA urges the Board to use its Section 105(a) authority. The penalties under Section 129 are disproportionately great and should be limited to practices that are truly unfair and deceptive and implemented on a wide, pervasive scale. AFSA has particular concerns about the application of Section 129 because a number of the proposed regulations concern the actions of third parties over which the lender has little or no control. The penalties under § 129(*l*)(2) of TILA create extensive and unnecessary litigation risk for the lending community that will invariably leave many potential homeowners without access to affordable credit. These excessive penalties, which were originally applicable only to HOEPA loans, seem particularly inappropriate when applied to all mortgage loans, including those created in the prime market.

Creditor Payments to Mortgage Brokers – 226.36(a)

AFSA asks that the Board clearly and unambiguously remove liability from the lender for things that the broker controls. The Commentary suggests that the lender can rely on a document that meets the criteria set forth in § 226.36(a)(1)(i)-(iii) that is signed and contemporaneously dated by the consumer and the broker. However, to be an acceptable safe harbor, the agreement would apparently have to be signed before the payment of any fee, as required in § 226.36(a)(1). But the lender would not know when the document was signed. In addition, the document would have to be signed and dated contemporaneously. Again, the lender would not know when the agreement was signed or dated. The lender must be able to rely on a document handed to it by the broker without further requirements.

AFSA respectfully suggests that the Board use its authority under TILA § 105 instead of TILA § 129. TILA § 129 mandates onerous penalties for failure to comply. Since liability is extended to the lender for things that the broker does, it is necessary that an unintentional violation not carry the penalty mandated by TILA § 129.

In response to the Board's question about payments to loan officers employed directly by the lender, AFSA believes that it would be inappropriate to apply the proposed rule, or a similar rule. Yield Spread Premiums ("YSPs") are paid to brokers at closing; whereas a loan officer's compensation, attributable to a loan, is often not determined until long after the loan has been sold in the secondary market, and may be based on numerous other factors, such as the volume of loans made over the entire month and the loan officer's adherence to all compliance guidelines. Additionally, loan officers are usually employees of lender and disclosure of their compensation is unnecessary. First, what compensation would be disclosed? Base salary? Commission structure? Internal commission structures vary by product, season, market and are highly proprietary. The loan officer's role is also not identical to that of the broker. Without discounting the inherent duty of good faith and fair dealing as an employee, the loan officer's duty is to his or her employer where the broker's duty is or should be to the customer.

If the rule is issued under § 105(c), and lenders are not held responsible for the broker's actions, then AFSA would agree with expanding this section to cover the entire market.

Appraiser Anti-Coercion Rules – 226.36(b)

AFSA respectfully requests that the Board reconsider its proposed appraiser regulations in view of the recently published agreement between Fannie Mae and Freddie Mac and the New York Attorney General. Attorney General Cuomo is to be commended for his efforts to establish appraiser independence. The proposed regulation should be carefully reviewed to insure that it is consistent with the Fannie Mae and Freddie Mac agreements. However, AFSA notes that the Agreements state that lenders may not use an appraisal prepared by the lender's employee. AFSA believes that this restriction is unwarranted. In-house, salaried appraisers have been subject to repeated regulatory examinations, and the record of accurate appraisals is excellent.

AFSA believes that these appraisers are actually more accountable to the lender, since it is the lender, not an independent appraiser, that would suffer any loss.

Additionally, the Board has the ability to work with the FFIEC Appraisal subcommittee to establish rules and to impose capital and insurance requirements on appraisers. Appraisers must bear responsibility for the opinions they give.

The Commentary associated with the proposed rule, seems to indicate that the Board is concerned about potential coercion of third-party appraisers. However, AFSA believes that the rule as proposed would have much broader scope and would apply to employees of the lender who make referrals to appraisers, employ appraisers, manage appraisers or provide an appraisal themselves.

Servicing Practices – 226.36(d)

Late Payments

The proposed rule states that a servicer must credit payments as of the day of receipt, or within five days thereafter if the consumer fails to follow written payment instructions. This new rule will have a significant impact on the industry. Lenders will need at least one year, and probably two years, to comply not only with this law, but with the various state laws. (Since servicer is defined in such a way as to include an original creditor who continues to service a mortgage secured by the consumer's principal dwelling, this rule will apply to many AFSA members.) AFSA members do their best to ensure that payments are credited in a reasonable manner. However, AFSA respectfully ask that the Board extend the time period for crediting payments from five days to eight business days. Five calendar days is a particularly short time, especially in the context of a three day weekend. Additionally, the Commentary should include a safe harbor as to what constitutes a reasonable payment requirement. A cut-off time of 5 p.m. Eastern Time is not unusual for receipt of a mailed check.

The Commentary indicates that the servicer does not violate this rule when the payment is entered on its books after the due date provided that the consumer is not charged a fee or interest as a result. However, the rule should be clarified to indicate that a payment that is received before the due date and booked on the date it is received does not impose an obligation on the creditor to reduce the consumer's responsibilities under the contract. For example, with loans that are "amortizing" loans, payments received either shortly before the due date or within a certain period after the due date are treated for the purposes of determining principal reduction as received by the due date. The same is true for real estate secured loans in some states where interest is "precomputed."

The Board should address the issue of partial payments. For loans that are amortizing (sometimes referred to as "schedule-to-schedule"), it is common for a partial payment to be held in a suspense account until a full payment is received. A late fee may be charged once on the partial payment. Reputable lenders and servicers do not pyramid late fees and the practice is already illegal in most states. Partial payments should be excluded from the regulation. After a default, the lender has a right to demand the full balance and to decline continued partial payments.

Schedule of Fees and Charges

AFSA does not agree that providing fee schedules would be particularly helpful to consumers. The schedule proposed by the Board is long, complex and likely to change frequently. Customer confusion and uncertainty seems a more likely result.

If the Board proceeds with this proposal, the scope of fees and charges covered must be limited. How will a servicer know all possible third-party fees – and their amounts? The following is a partial list of property management services that servicers often have to contract for, particularly when a home is abandoned: inspections, installation or replacement of locks or other security devices, boarding up doors and windows, winterization, sump pump replacement, exterior or interior debris removal, paint or chemical applications, lawn maintenance, shrub trimming and yard maintenance, snow removal, securing pool, vehicle removal, photographs necessary to document requirements, trip charges, and utility transfers. Additionally, many states have different laws governing fees and charges with which lenders must comply. The benefit of increasing transparency of third party charges would not necessarily outweigh the costs associated with a servicer's uncertainty as to such charges. Finally, AFSA urges the Board to finalize the rule in a manner that does not create a private right of action. Servicing fees have been fodder for class actions for many years and the complexity of the proposed rule will simply breathe new life into the claims.

Loan Payoff Statement

AFSA agrees that servicers should respond promptly to requests for payoff statements. However, AFSA respectfully requests that the Board establish a reasonable time period for response. A period of at least eight business days is recommended.

First, lenders are already required to respond to payoff requests that they receive in writing. AFSA members are concerned that this proposed amendment will create a new cottage industry that will bombard servicers with payoff requests hoping that the servicers' responses will be delayed. This is the case with credit repair mills that consistently bombard credit card servicers with inquiries under the Fair Credit Billing Act with the hope that a servicer will eventually fail to respond in a timely manner or will accede to the demand of the credit repair mill to simply avoid further harassment. Penalties for failure to respond in a timely manner should be limited to regulatory enforcement. The creation of a private right of action allowing the borrower to receive a refund of all finance charges paid is unfair and disproportionate to the issue.

State law varies as to whether and when a servicer may charge the borrower for a payoff quote. Where state law is silent, servicers generally may impose a fee. If the new rule imposes a rule requiring creditors to provide payoff quotes without addressing whether creditors may impose a fee, courts may conclude that such a fee is not permitted because the servicer is required by federal law to provide the quote. The rule should state that creditors may continue to impose fees for payoff quotes, except where prohibited by applicable law.

Proposed Section 226.36(d)(1)(iv) would prohibit a servicer from failing to provide an accurate statement of the full amount required to satisfy the obligation in full as of a specified date. AFSA respectfully asks that the Board define the term "provide." In particular, does "provide" mean the date of delivery or the date of receipt? If date of delivery, how should it be delivered? Is sending the payoff statement by regular mail acceptable or must it be sent in another manner?

Additionally, the Commentary should clarify that the payoff statement need only be accurate as to the amount of the debt as of the time the statement was prepared. Lenders must be able to account for checks that are returned after issuance of the payoff statement, corresponding NSF fees and other similar charges.

OTHER POTENTIAL CONCERNS

AFSA believes that the Board should limit the scope of these new restrictions to repayment ability and prepayment penalties. Extending the application of other HOEPA restrictions to higher-priced mortgage loans would limit the availability of many terms and conditions that consumers currently find helpful in keeping the cost of credit affordable for their particular financial needs. There is no evidence that any of these practices have caused consumers in the subprime market substantial injury. The benefits of applying the restriction to higher-priced mortgage loans would not outweigh the costs, considering that both the subprime market and the alt-A market would be covered by the proposal.

AFSA members do not make negative amortization loans and therefore have no comment on the costs and benefits for consumers of negative amortization in the part of the market that would be covered under the definition of higher-priced loans.

ADVERTISING

In general, AFSA members believe that the proposed advertising rules for open-end home-equity plans under § 226.16, and for closed-end credit under § 226.24 are fair. However, AFSA notes that these rules will increase compliance burdens, advertisement space and advertisement time.

Once again, the Board uses its authority under § 129(*l*)(2) of TILA to promulgate § 226.24(i) "Prohibited Acts or Practices in Mortgage Advertisements." AFSA respectfully asks that the board use § 105(a) of TILA instead. The penalties for violating a rule promulgated under § 129(*l*)(2) of TILA create extensive and unnecessary litigation risk for the lending community. This is a particular concern because a consumer does not have to show reliance on a potentially misleading advertisement in order to recover the draconian penalties under § 130(a)(4) of TILA, which include loss of all finance charges and fees paid by the consumer.

Among the issues on which the Board seeks comment is "whether it should amend the rules for electronic advertisements for home equity plans to require that all information about rates or payments that apply for the term of the plan be stated in close proximity to introductory rates or payments in a manner that does not require the consumer to click a link to access the information."[16]

While we support the important goal of ensuring meaningful consumer notice, AFSA believes that such a blanket requirement would be unworkable in many contexts, and would not take into account the unique issues raised by the various methods of online advertising, particularly given rapidly evolving technology and the inability of advertisers to control such factors affecting ad display as the varying screen sizes of computers and other electronic devices, as well as user controls, such as browser settings.

Advertisers do not have complete control over where their ads actually appear on an end user's computer screen or how they will look. Sites may look different when accessed through different browsers or different versions of the same browser. In addition, advertisers have no control over the settings that end users select for their browsers. These settings, which include font size, tool bar display, and other options, greatly affect the appearance of the site and disclosures or advertisements thereon. The Board's proposed requirement would impose significant legal uncertainty and substantial compliance costs that would not benefit consumers in a meaningful way. In fact, such a requirement likely would have the opposite effect of the one intended in that advertisers may have to use smaller fonts and otherwise compress information into an ad in order to provide all of the required disclosures without using hyperlinks. This would adversely affect legibility and the consumer's ability to understand the information. The concern over legibility and comprehension is further pronounced in this context given that the disclosures at issue relate to financial terms, which are often lengthy.

Moreover, such a requirement would be inconsistent with the Federal Trade Commission's ("FTC" or "Commission") guidance regarding evaluation of the "clear and conspicuous" standard in online advertisements. The Commission acknowledges the important role of hyperlinks and other technologies such as pop-ups, as well as use of visual cues such as font size, text and color, where disclosures may be too detailed to be effectively included in certain ads (as is the case with banner ads). *See Dot Com Disclosures—Information about Online Advertising*, available at http://www.ftc.gov/bcp/conline/pubs/buspubs/dotcom/index.pdf. The standards set forth in *Dot Com Disclosures* regarding the consumer's "net impression" and evaluation of the clear and conspicuous requirements from the vantage point of the reasonable consumer should apply here, rather than adopting a "one size fits all" approach that excludes the use of hyperlinks to provide additional information.

Discussing the clear and conspicuous standard, the FTC stated:

> There is no set formula for a clear and conspicuous disclosure. In all media, the best way to disclose information depends on what information must be provided and the nature of the advertisement. Some disclosures are quite short, while others are more detailed. Some ads use only text, while others use graphics, video and

[16] 73 Fed. Reg. at 1706.

audio. Advertisers have the flexibility to be creative in designing their ads, so long as necessary disclosures are communicated effectively and the overall message conveyed to consumers is not misleading.

To evaluate whether a particular disclosure is clear and conspicuous, consider:

- the **placement** of the disclosure in an advertisement and its **proximity** to the claim it is qualifying,
- the **prominence** of the disclosure,
- whether items in other parts of the advertisement **distract attention** from the disclosure,
- whether the advertisement is so lengthy that the disclosure needs to be **repeated**,
- whether disclosures in audio messages are presented in an adequate **volume and cadence** and visual disclosures appear for a sufficient **duration**, and
- whether the language of the disclosure is **understandable** to the intended audience.[17]

These criteria and the corresponding guidance reflect the FTC's important work in this area, and have benefited from public comments and a public workshop on these issues. Thus, they should form the basis for evaluating a "clear and conspicuous" standard for online advertisements in this context as well.

Dot Com Disclosures also contains important guidance regarding evaluating the prominence of disclosures and proximity to claims, including discussions regarding hyperlinking to disclosures and evaluating proximity of banner ads, and discussing the usefulness of these tools that are unique to the online advertising, particularly with respect to lengthy disclosures. For example, in discussing the use of hyperlinks, the Commission stated that "[u]nder some conditions. . . a disclosure accessible by a hyperlink may be sufficiently proximate to the relevant claim. Hyperlinked disclosures may be particularly useful if the disclosure is lengthy or if it needs to be repeated (because of multiple triggers, for example)." [18]

Similarly, with respect to banner ads, the Commission's guidance acknowledges that "[b]ecause of the space constraints of banner ads, other disclosures may be too detailed to be disclosed effectively in the banner. In some instances, these disclosures may be communicated effectively to consumers if they are made clearly and conspicuously on the Web site the banner links to and while consumers are deciding whether to buy a product or service."[19]

As these excerpts from the Commission's guidance highlight, the nature of the ad and surrounding context are important factors in evaluating prominence and proximity in the online space, and a similar approach should be adopted in connection with the advertising rules for open-end home equity plans under § 226.16 and for closed-end credit under § 226.24.

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[17] Id. at 5-6. (Emphasis in original.)
[18] Id. at 8.
[19] *Id.* at 11.

Limitations on the use of the term "Financial Advisor"

AFSA agrees that certain persons involved in mortgage loan originations should not be permitted to advertise themselves as "Financial Advisors", when in fact they are not. However, AFSA's membership does include some large stock brokerage firms, which employ truly certified and licensed Financial Advisors. These individuals are typically stock brokers licensed by the Securities and Exchange Commission or some other regulatory agency. Stock brokerage firms routinely advertise to their clients, and potential clients, the services and products available through their Financial Advisors, which may include mortgage related products. AFSA would like to see exemption language added that would exempt these institutions and/or licensed individuals from this restriction.

MORTGAGE LOAN DISCLOSURES

As we noted above, HUD has recently proposed amendments to RESPA. AFSA believes that it is imperative that the Board and HUD coordinate their efforts to avoid duplication, unnecessary expense and the possibility of adding to consumer confusion.

Many home equity lenders are not currently required to provide the early TILA disclosure required under 12 C.F.R. 226.19 as they do not make residential mortgage loans as defined by 226.19(a)(1) because all of the mortgage loans originated by such lenders are home equity loans and not purchase money loans.

Providing an early TILA disclosure can be challenging given some lender's current business process. Customers are in control of product selection and lenders frequently use automated product advisor systems to inform customers of all loans for which they are eligible. A consumer finance lender typically offers both real estate and personal loans to its customers. In some cases, the customer has not made a product decision within three days of application. Without a customer decision, a consumer finance lender has no way of knowing for what rate the customer may qualify. The lender would be forced to select a default rate that may not correspond with a customer's actual credit profile and disclosing the APR would be practically meaningless.

A meaningless disclosure based on information that is not reflective of their actual credit situation could discourage a customer from going forward with a loan.

Additionally, the proposed rule appears to make creditors liable if a broker or other third party imposes a fee prior to when the creditor gives the new disclosures. AFSA suggests that the Board change the limitation on fees to apply only to fees paid to the lender or at the lender's direction.

The proposed disclosure rules would create a significant compliance burden. New disclosures typically take several months, six to eight at a *minimum*, to develop and implement. New disclosures require systems resources as well as staff training on how to use the new disclosure.

EFFECTIVE DATE

Six months is an appropriate implementation period for many of the proposed rules. However, there are a few sections in the proposed rule that require a much longer implementation period. It would take at least 24 months, or until July 1, 2010, whichever is longer, for companies who do not currently escrow to develop compliant escrow systems. Additionally, the proposed mortgage loan disclosures would also require more than six months for implementation. Lastly, if the Board adopts a new method of calculating the APR trigger for higher-priced mortgage loans, AFSA members would need more than six months to implement that change.

AFSA appreciates the opportunity to comment on these proposed rules. Please feel free to contact me with any questions at 202-296-5544, ext. 616 or bhimpler@afsamail.org.

Respectfully submitted,

Bill Himpler
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American Financial Services Association

STATE REGULATION OF MORTGAGE ESCROW ACCOUNTS

State	Origination Requirements	Interest on Escrow	Servicing Requirements
Alabama	None	No	None
Alaska (Mortgage Lending Regulation Act)	*Written agreement *Allowed on subordinate lien only if not on superior lien	No	*Segregated account *Notify insurer of any servicer address change
Arizona (Banks & Fin. Inst. Title; Mortgage Brokers and Mortgage Bankers Provisions)	*Collect only amt needed to pay when due *2 month cushion limit *Comply with RESPA	No	*Pay charges promptly *2 month cushion limit
Arkansas (Fair Mortgage Lending Act)	None	No	*Segregated account in federally insured financial institution
California (All Lenders)	*Collect only amt allowed under RESPA *Only allowed in certain situations, including where required by a state or federal regulatory authority and where LTVs exceed certain parameters	Yes; 2% annually credited annually or at termination (may not apply if legally required to hold escrow in non-interest bearing account)	*Annual itemization requirements *No increase without written analysis *Pay charges promptly; *Maintain only amount reasonably necessary to pay items as become due * No fees that would reduce interest paid below 2% * If funds held out-of-state, must be in FDIC-insured acct
Colorado (Property tax law)	None	No	*Excess funds escrowed for payment of ad valorem taxes must be refunded each May *Tax escrow amts may be increased only on basis of notice of tax increase
Connecticut (First Mortgage & Second Mortgage Lender)	None	Yes; Net rate of interest established annually by Dept of Banking; Credit annually on 12/31 or at termination	First mortgages: *No charge for escrow analysis *Shortages due to lender underestimates must be paid by lender, and borrower must be given at least 12 months to repay interest free
Delaware (Licensed Lender)	*Customary and reasonable escrow reserves allowed under Itemized Schedule of Charges if provided for in loan agreement	No	None
Dist. of Columbia (Interest & Usury Statute)	*If LTV < 80%, escrow may not be required and borrower must be given notice of right to pay directly	No	*Segregated account
Florida (Dept of Revenue regulations; Mortgage Banker and Mortgage Broker Licensing Law)	None	No	*Promptly pay to obtain maximum tax discount and avoid ins. lapse *Dept of Revenue procedures for written tax Notices and for computerized mass payment of real estate taxes must be followed *Must Notify borrower of escrow acct deficiency w/in 15

State	Origination Requirements	Interest on Escrow	Servicing Requirements
			days of receipt of Notice of tax or insurance due *Specific requirements in event of ins. Nonpayment; *Annual escrow stmt * Lender liable for damages due to Nonpayment if sufficient escrow funds to make pmt
Georgia	None	No	None
Hawaii	None	No	None
Idaho (Mortgage Company Act)	*Contractual provisions relating to escrow must be disclosed * Max 120% of amts necessary to make expected pmts	No	* Max 120% of amts necessary to make expected pmts *Annual statement, with specified information, must be provided each January *Lender may charge for additional stmts requested by borrower but must provide w/in 30 days
Illinois (Various Illinois Acts)	*Notice of Mortgage Escrow Act requirements (or explanation of why not applicable) must be provided *Written escrow account disclosure agreement must be signed at closing *Must accept pledged deposit account as alternative *Can impose escrow waiver fee if disclosed.	No	*Separate account in federally insured depository institution or other specified institution *Tax bills to be pd prior to discount/penalty dates and ins. bills to be pd prior to due date as long as notice rec'd 30 days prior *Annual analysis required at least 30 days prior to effective date of pmt change *Must provide borrower copies of tax bills & assessment notices *Must provide notice of tax pmt within 45 business days of payment * After 1st year of mortgage, tax escrow cannot be based on amount greater than 150% of previous year's assessed real property tax *Must permit borrower to terminate escrow account when loan balance reduced to 65% of original amt
Indiana	None	No	None
Iowa (Mortgage Bankers and Brokers Act including exempt entities; Industrial Loan Company)	None	Mortgage bankers: *No pmt of interest required, but holding of escrow cannot increase lender's yield on loan and borrower entitled to any interest received by lender Industrial loan companies: *Must pay interest at lowest rate paid to holders	Mortgage bankers: *Must disburse funds by final due date or pay penalties *For 1st mortgage loans, annual analysis with specified information must be mailed at least 20 days prior to effective date of payment change Industrial loan companies: *Must provide annual summary with specified information about transactions for calendar year or other agreed upon fiscal year reporting period within 30 days of close of year.

State	Origination Requirements	Interest on Escrow	Servicing Requirements
		of thrift certificates issued by ILC	
Kansas (Mortgages of Real Property Law)	None	No	*Persons acquiring mortgage servicing rights must provide annual summary of escrow account transactions, with specified information, on or before February 15 of each year
Kentucky (Mortgage Loan Companies and Broker Act)	None	No; however, any interest earned is property of borrower and must be applied to expenses to be paid from the escrow account	*Separate, FDIC-insured account *Must account for escrowed funds upon reasonable notice from borrower or regulator *Payments to escrow account must be promptly and properly credited *All escrowed items must be paid in timely fashion and no later than applicable deadline
Louisiana	None	No	None
Maine (Consumer Credit Code)	*If escrow account required, requirement to pay interest must be disclosed in the mortgage *May not impose tax service fee (see Interest on Escrow column)	Yes, on loans secured by owner-occupied property; Rate of not less than 50% of 1-year Treasury Note rate as of first business day of year; Must be computed on daily balances and paid at least quarterly on last business day of quarter; Must provide statement showing interest credited at least once per year; May not be reduced by any charge for service or maintenance of escrow account.	First mortgages: *If servicer fails to make timely payments, liable for actual damages and must rectify results including correcting credit report and causing discharge of liens
Maryland (Interest and Usury law; Credit Grantor – Closed End Credit Provisions; Real Property law; Consumer Protection Act)	*Note: Prohibition against escrow servicing charge does not prohibit charging tax service fee*	Financial institutions doing business in Maryland must pay interest at greater of 3% per annum simple interest or rate paid on passbook savings accounts, computed on average monthly balance	*Except in foreclosure, release, or upon borrower's election, escrow account funds may not be used to reduce principal or pay interest or other loan charges *With respect to escrow overages, borrower shall be given option annually of receiving refund, applying overage to principal and interest, or leaving overage in escrow account. Refunds must be made within 60 days of request. If borrower does not elect, lender must

State	Origination Requirements	Interest on Escrow	Servicing Requirements
		and credit to escrow account annually; borrower's right to interest on escrow survives assignment of the loan with certain exceptions for purchases of loans through Fannie Mae, Freddie Mac, or Ginnie Mae by out-of-state lenders	refund within 60 days of sending overage notice. *Separate account *May not impose escrow servicing charge on first mortgage loans. *Tax payments must be paid by of 45 days after later of first due date, receipt of tax bill by lender, or collection of sufficient escrow funds to pay taxes and interest due *If tax payment conditions are met and lender fails to timely pay, lender responsible for any resulting increase in taxes, interest, and/or penalty
Massachusetts (Alienation of Land provisions)	None	Yes, on first mortgage loans secured by owner-occupied property; Interest to be paid at least once per year at rate and in manner determined by mortgagee; Lenders with net loss on escrow accounts may request exemption from interest on escrow requirement	*Full amount of taxes to be paid on or before due date if borrower has paid proper amount to lender; otherwise, lender required to pay only amounts received from borrower
Michigan (Conveyances of Real Property; Interest Act; Mortgage Brokers, Lenders, and Servicers Licensing Act; Secondary Mortgage Loan Act)	*Lenders may condition making of residential mortgage loans on maintenance of escrow account or pledged deposit account	Escrow accounts: No Pledged deposit accounts: Must be interest bearing	*Annual escrow account statement, showing specified information, must be provided within 60 days of close of calendar year; not required if monthly statement includes required escrow account information *Escrow account information must also be provided on annual statements and ledger histories required on first mortgage loans *Servicer liable for penalties or fees resulting from failure to pay taxes if mortgagor has paid sufficient funds into escrow account
Minnesota (Financial corporation provisions; Residential Mortgage Originator and Servicer Licensing Act)	*No restriction on requiring escrow account, however, unless escrow is required by federal law or regulation, conventional loans with LTV of 80% or less have right to discontinue escrow after five years *Where applicable, disclosure of right to discontinue escrow must be provided at closing **Note: Restriction against escrow administration fee*	No for new originations; Interest on escrow required for certain loans made prior to July 1, 1996	*No direct fee may be charged for administration of escrow account or to discontinue escrow account *Unless escrow is required by federal law or regulation, conventional loans with original LTV of 80% or less have right to discontinue escrow after five years unless borrower has been more than 30 days delinquent within previous 12 months

State	Origination Requirements	Interest on Escrow	Servicing Requirements
	does not prohibit charging tax service fee.		*Borrowers eligible for escrow account discontinuance must be notified within 60 days after fifth anniversary of date of mortgage *Lender may require escrow deficit/shortage to be repaid before discontinuing escrow account *Escrow account refund to be made within 60 days of receipt of borrower's written election to discontinue escrow account. *Escrow account payments to be made in timely manner as obligations become due provided that mortgagor has paid sufficient funds or servicer is liable for actual damages and potential penalties *Servicer is permitted to advance funds on behalf of mortgagor *Servicer must promptly notify borrower of escrow shortage *For mortgage originators and servicers, escrow amounts are "trust funds" and must be maintained in separate account and deposited into escrow account within 3 business days of receipt
Mississippi (Mortgage Consumer Protection Law)		No	*Must be maintained in separate account insured by FDIC or NCUA *Must account for escrow funds upon reasonable notice from borrower or regulator
Missouri (Mortgages, Deeds of Trust and Mortgage Broker provisions; Residential Mortgage Brokers License Act; Mortgage Broker Rules)	*Escrow account agreement may allow or disallow the payment of property taxes more frequently than annually *A written escrow account disclosure must be executed at closing; this requirement is satisfied by compliance with applicable federal law	No	*Financial institutions must pay property taxes in one annual payment by January 1 of year after year in which tax is levied *Funds must be placed in federally insured depository institution *Funds may be removed from escrow account only for authorized payments, refunds to borrower, transfer to another institution, forwarding on servicing transfer, or compliance with regulatory or court order.
Montana (Mortgage provisions; Residential Mortgage Lender Licensing Act; Regulation of Escrow	*Escrow account may not exceed 110% of projected amount needed to pay escrow expenses unless borrower and lender contract in writing for higher reserves. *May be subject to Escrow Business licensing	If subject to "Escrow Business" requirements, must credit account with any interest received on escrow funds; parties may	*Itemized record of payments and disbursements must be kept *Statement of total escrow account receipts and disbursements to be mailed to each borrower annually *Escrow funds must be immediately placed and

State	Origination Requirements	Interest on Escrow	Servicing Requirements
Business Act)		contract re interest received on deposits	maintained in separate accounts in a federally insured financial institution with an office in Montana *Funds may be removed from escrow account only for payments authorized by the borrower, loan contract, or applicable federal or state law, refunds to borrower, transfer to another financial institution with an office in Montana, forwarding on servicing transfer, or compliance with regulatory or court order. *If subject to "Escrow Business" requirements, may not disburse funds from escrow account until amounts sufficient to funds disbursements have been received and deposited
Nebraska (Mortgage Bankers Registration and Licensing Act)	*Initial deposit to cover time from when item would have been paid under lender's prudent practices to first payment *Two month cushion limit	No	*Insurance to be paid by due date *Taxes to be paid prior to becoming delinquent *Servicer to pay any penalties unless failure to make timely payment was due solely to borrower failure to remit amount due after written notice of amount due sent more than 15 days prior to due date *Annual escrow analysis, including specified information, required *Must provide at least 20 days notice prior to effective date of escrow payment change *Two month cushion limit *Shortage/deficiency may be recovered pro rata for number of months from determination of shortage/deficiency to date of payment under lender's prudent practices
Nevada (Mortgage Broker Act; Mortgage Banker Act; Impound Trust Account Provisions)	*Must require contribution in an amount reasonably necessary to pay obligations as they become due (no cushion)	Yes, on escrow overages; unless interest rate otherwise contracted for, at prime rate + 2% as specified by regulator on January 1 and July 1 of each year.	*Must require contribution in an amount reasonably necessary to pay obligations as they become due (no cushion) *Separate, insured account *Fiduciary duty with respect to escrow funds *Must provide accounting to borrower or regulator upon reasonable notice *May not allow insurance to be cancelled or taxes to become delinquent *Annual analysis stmt to be provided at least 30 days prior to effective date of any escrow payment increase *If pmt delinquency exists at time of analysis, any

State	Origination Requirements	Interest on Escrow	Servicing Requirements
			overage to be applied toward payment of delinquency *Notify borrower of overages within 30 days after annual review and allow borrower 20 days to specify disposition (refund, apply to principal, retain in account); if not specified, retain in account *May require additional amounts to be paid to recover deficiency *Borrower to be provided with option to make up deficiency in lump sum or in increased monthly payments; may not declare default based on inability to make lump sum payment
New Hampshire (Regulation of Mortgage Loan Services Act; Banking Department Regulations)		Yes; at rate set by Bank Commissioner on February 1 and August 1 of each year; interest to be credited upon assignment, transfer, or discharge of mortgage	*Must pay taxes and insurance when due provide bills received at least 15 days prior to due date and borrower has paid amounts required to be paid into escrow account *Servicer must determine at own expense amount needed to be paid into escrow account to assure availability of sufficient funds for pmt when due *If borrower makes escrow pmts as required, servicer must make up any deficiency with own funds, and give mortgagor option of paying deficiency over at least 12 months and may not charge or collect interest on deficiency for 12 months
New Jersey (Mortgage loan statute/escrow account law)	*Borrower must give written authorization for tax collector to sent tax bills to lender	No	*FDIC-insured account *Disbursements to be paid before amount due becomes delinquent provided sufficient funds paid into escrow account *Borrower must be promptly notified of any shortage; servicer is permitted but not required to cover shortage *Penalties or interest for late payments may not be charged to borrower unless can be shown that penalty direct result of borrower's error or omission; borrower must be given written notice within 30 days of charging escrow account with penalty for late payment *Servicer may not charge borrower for cost of duplicate copy of tax bill unless original sent to borrower and borrower did not forward to lender *Borrower must give written authorization for tax collector to send tax bills to lender

State	Origination Requirements	Interest on Escrow	Servicing Requirements
			*Tax collector must be notified of sale or transfer of mortgage loan *If servicer fails to timely pay taxes: borrower may pay directly and suspend escrow payments until amount paid is equaled; if property listed in published tax sale notice, borrower can sue servicer and cancel escrow account
New Mexico (Mortgage Act)	*May be subject to Escrow Company Licensing	On overages not properly credited to principal at rate of 6% per annum	*2 month cushion limit *Borrower may demand no more than once per year that any escrow overage be credited to principal; servicer to comply with demand within 60 days *Servicer must reconcile deposit accounts within 10 business days after receipt of statements *Escrow company deposits must be maintained in separate account in financial institution located in New Mexico
New York (Various laws and regulations)	*Closing disclosure regarding tax and insurance escrows required *No charge for maintaining or waiving escrow account permitted *Lender and borrower must give written notice on prescribed form of escrow account and authorization for tax collector to sent tax bills to lender *Borrower must designate in writing that servicer receive insurance premium notices *Note:* Prohibition against escrow service charge does not prohibit tax service fee	Yes; at minimum rate of 2% (or other rate established by the Banking Board) to be credited quarterly in accordance with General Banking Regulations	*Federally-insured account *No charge for maintaining or waiving escrow account permitted *Make tax and insurance payments on timely basis *Escrow disbursements must be paid within 21 days of debit of escrow account *Annual disclosure regarding tax and insurance escrows required *Warning notice re borrower obligations required at termination of escrow account *Lender and borrower must give written notice on prescribed form of escrow account and authorization for tax collector to sent tax bills to lender; lender to provide tax collecting officer with list of borrowers for whom lender is to receive bills; monthly report of new, transferred escrow accounts required *Borrower must designate in writing that servicer receive insurance premium notices *Servicer must notify insurer to send bills to borrower within 15 days after termination of escrow account *Annual escrow analysis required, with mandatory disclosure language regarding tax escrows *Borrower can request escrow analysis upon receiving

State	Origination Requirements	Interest on Escrow	Servicing Requirements
			school tax relief *Certain requirements upon transfer of servicing
North Carolina (Mortgage Lending Act; Mortgage Debt Collection and Servicing Act)	*Comply with RESPA	No	*Comply with RESPA *Segregated federally-insured account *Collect and make all payments from the escrow account to ensure no late penalties or other negative consequences, regardless of delinquency or default, unless loan more than 90 days in default or servicer has reasonable basis to believe recovery of funds not possible (effective 2/1/08)
North Dakota (Property law)	*Excess escrow funds = funds needed to pay assessments during calendar year + $300 (no cushion)	No	*Annual statement required *If loan owned by an out-of-state investor, servicer must notify borrower of excess escrow funds on or before March 1 of each year; borrower may request refund within 30 days and servicer must comply within 30 days of request *Excess escrow funds = funds needed to pay assessments during calendar year + $300 (no cushion) *Borrowers that are current and have sufficient escrow funds may direct servicer as to time of tax payments to qualify for discounts
Ohio	None	No	None
Oklahoma	None	No	*Real estate taxes to be paid in one annual payment due January 1 of each year.
Oregon (Mortgages and Liens; Mortgage Lender Law)	*Two month cushion limit *Compliance with RESPA *If an escrow account is not a loan condition, written statement of terms is needed	Yes for mortgages of $100,000 or less; as established by the regulator on 5/15 (effective 7/1) and 11/15 (effective 1/1), to be computed on the average monthly balance and credited at least quarterly	*No service charge permitted if interest is required *Two month cushion limit *Compliance with RESPA *Taxes, to extent money is in account, must be paid in time for any discount, otherwise servicer liable for amount of discount *Other charges, to extent money is in account, must be paid before due dates *Violation of escrow provisions renders escrow account voidable by borrower
Pennsylvania (Mortgage Bankers and Brokers and Consumer Equity Protection Act	None	No	*Escrow account balance to be refunded within 30 days of satisfaction of mortgage *Annual accounting required
Rhode Island	*Note:* Prohibition against annual tax service fee does	Yes; at the rate of 4%	*Post-closing annual tax service fee not permitted

STATE REGULATION OF MORTGAGE ESCROW ACCOUNTS

State	Origination Requirements	Interest on Escrow	Servicing Requirements
(Community Obligations and Banking provisions; Interest on Escrow Accounts regulation)	not prohibit at-closing tax service fee.	computed on the average daily balance and credited annually on 12/31 (or payoff if earlier), except for FHA, VA, or certain privately insured loans	*Notice of interest credit required; IRS 1099 sufficient *Return excess escrow funds within 30 days of payoff *Insurance disbursements, to extent sufficient funds, by later of 10 days after receipt of premium bill or seven days before effective date of policy *Monthly statements must show allocation of escrow portion of payment
South Carolina	None	No	None
South Dakota	None	No	None
Tennessee (Residential Lending, Brokerage and Servicing Act)	*Two month cushion limit *Compliance with RESPA is compliance with state law	No	*Two month cushion limit *Taxes to be paid by delinquency date *Insurance to be paid by expiration date *Compliance with RESPA is compliance with state law
Texas	No	No	*Second lien loans: no fee for managing escrow trust account *Manufactured housing loans: escrow for insurance no allowed in first year of loan; state- or federally-insured account; annual accounting required
Utah (Interest on Mortgage Loan Reserve Accounts Act; Mortgage Lending and Servicing Act)	*No service charge *Two month cushion limit	Yes; at rate of 5.5% (or one of two alternative rates), calculated on average daily balance and credited annually as of 12/31. Exceptions: FHA & VA loans; loans with LTV remaining above 80%	*No service charge *Itemized escrow account statement required within 60 days after the end of each calendar year *Timely payments required if sufficient funds available *Two month cushion limit *Deficiencies may be billed, added to principal, or recovered through additional deposits for up to 12 months; failure to pay billed deficiency after 30 days is default and relieves interest on escrow obligation
Vermont (Various statutes and regulations)	*One month cushion limit	Yes; at prevailing market rate for regular savings accounts, calculated on average monthly balance and credited on the first day of each quarter. Does not apply if escrow required because borrower failed to make timely tax and/or insurance payments in last year	*One month cushion limit *Federally-insured account *Timely payments *If borrower complies with escrow requirements, lender is primarily obligated for payment of escrowed items and any penalties attributable to late payments *Accounting on form approved by regulator annually or on request of borrower without charge

STATE REGULATION OF MORTGAGE ESCROW ACCOUNTS

State	Origination Requirements	Interest on Escrow	Servicing Requirements
Virginia (Banking and Finance title; Mortgage Lender and Broker Act)	*Not permitted on second mortgages unless not being maintained on first	No	*Segregated accounts *Servicer liable for penalties, late charges, uninsured risk if untimely payment despite notice and sufficient funds at least five days prior to due date *Servicer to give written notice to borrower of payment of penalty or late charge with in five days of payment *Notify insurer in writing of change in billing address by later of 30 days of change or 60 days prior to policy renewal date
Washington	None	No	None
West Virginia	None	No	None
Wisconsin (Various statutes and regulations)	*Comply with RESPA *Disclosure of borrower's right to direct manner of tax payments	Yes; at rate established by Division of Banking on 1/1 each year unless funds held by third party in noninterest-bearing account	*Segregated account in Wisconsin financial institution or federally-insured account *Deposit receipts within 24 hours *Comply with RESPA *Subject to certain notice and timing requirements, borrower may direct manner of tax payments, including requiring check to be sent to borrower *Trust account funds must be released within 10 calendar days of loan payoff
Wyoming	None	No	None


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The effect of prepayment penalties on the pricing of subprime mortgages

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Abstract

This paper investigates the effect of prepayment penalties on the pricing of subprime residential mortgages. The paper is the first to consider that mortgage price and prepayment penalty may be chosen jointly, making single-equation estimates of the effect of prepayment penalty on price biased. Using a model that accounts for endogeneity of price, loan to value, and prepayment penalty, we find that prepayment penalties are associated with lower loan prices. This finding is important because perceptions that prepayment penalties harm borrowers have led many states to restrict their use, regulation that may reverse the gains in credit availability achieved over the last decade.

Keywords: Subprime mortgages; Financial regulation; Prepayment penalties

1. Introduction

A prepayment penalty is a fee that borrowers pay if they repay a mortgage within a specified period after origination, usually within the first 2 or 3 years. Borrowers may choose to prepay for several reasons including to purchase another home, to refinance the original loan to take advantage of a decline in interest rates, or to refinance to obtain additional cash, or restructure existing debts. Subprime borrowers may have an additional reason for prepayment: if their

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financial circumstances improve they may qualify for a lower interest rate.[1] A significantly higher proportion of subprime borrowers prepay, relative to prime borrowers (Phillips-Patrick, Hirschhorn, Jones, & LaRocca, 2000).

From the lender's standpoint, prepayment reduces the profitability of originating loans and the predictability of returns to investing in loans. A prepayment penalty offsets some of the lender's prepayment risk by encouraging borrowers to select loans based on their private information about expected holding period and by compensating lenders in the event of prepayment. As a result, subprime mortgages with a prepayment penalty sell for higher prices in the secondary market than do mortgages without a penalty.[2] The higher cost of lending to subprime borrowers without a prepayment penalty is reflected in wholesale price sheets for subprime loans, which often contain discreet adjustments (e.g., 50 basis points) in loan rates that effectively raise the discount rate that a lender will use when purchasing loans without a prepayment penalty or with relatively short prepayment penalty periods.[3]

Whether consumer prices for subprime mortgages actually include such adjustments is subject to controversy. Advocacy groups generally view prepayment penalties as inherently abusive and question whether borrowers receive a lower loan price in exchange for accepting a prepayment penalty (e.g., Goldstein & Son, 2003). One advocacy group has produced an empirical analysis that concludes that prepayment penalties are not associated with lower interest rates in securitized subprime loans (Ernst, 2005). However, DeMong and Burroughs (2005) found that, controlling for a limited number of borrower and loan characteristics, loans with prepayment penalties have lower interest rates than loans without prepayment penalties. This result suggests a tradeoff confronting borrowers who shop for mortgages in markets that allow such penalties. Nevertheless, as of early 2007, at least 28 states restricted prepayment penalties on residential mortgages (Lacour-Little, 2007).

Reconciling these studies is difficult. The differences in the studies' estimated effects of prepayment penalties do not appear to be solely a consequence of analyzing different databases. The studies examined different subprime mortgage products using different sets of explanatory variables. Both studies use only a portion of the factors that lenders consider in pricing loans. Neither study accounted for effects of laws in many states that regulate prepayment penalties in various ways. And, in both studies, the estimated effect of prepayment penalties may be biased because of the failure to address possible endogeneity in choice of price and prepayment penalty.

Available evidence simply does not resolve the question of whether subprime mortgage prices reflect the presence of prepayment penalties. This paper improves on previous investigations in several ways: the improvements include (1) consideration of additional explanatory variables; (2) disaggregation in mortgage products to more closely reflect product definitions found in the market; (3) accounting for state regulation of prepayment penalties, and (4) consideration of endogeneity in interest rate, loan to value, and prepayment penalty choices.

[1] "The effect [in terms of qualifying for a lower interest rate] of even a small improvement in the credit history score is much larger for borrowers in the higher-priced segment of the home loan market than for those in the prime segment." Avery, Canner, and Cook (2005), p. 369.

[2] Through simulations using commercial loan valuation software on pools of subprime mortgages, Lacour-Little (2007) shows that "the economic value of prepayment penalties is substantial to lenders and investors, increasing asset values by over 2 percentage points in the case of subprime loans" p. 27.

[3] Price sheets are tables of interest rates and points that lenders are willing to accept for different loan products. Price sheets are issued on a daily basis or more frequently.

Table 1
Selected characteristics of closed-end first mortgages, 2004: by type of interest rate

Characteristic	All loans	Type of interest rate		
		Fixed	Variable	Hybrid
Average loan amount (dollars)	130,000	94,500	156,000	142,100
Loan purpose (%)				
Home purchase	23	14	34	29
Cash out refinancing	51	66	13	62
Other refinancing	25	19	53	9
Average appraised value of property (dollars)	162,300	132,000	190,000	188,300
Average annual percentage rate	10.07	10.71	8.43	9.78
Average loan to value (%)	76	73	80	78
Average borrower income (dollars)	54,000	44,100	64,300	60,200
Average FICO score	613	624	608	599

2. Methodology

The data for this study are from the Financial Service Research Program's (FSRP) subprime mortgage database.[4] The database contains loan-level data on all originations of the subprime subsidiaries of eight large financial institutions between the third quarter 1995 and the fourth quarter of 2004. The Federal Reserve estimated that the FSRP subprime mortgage database covered nearly a quarter of higher priced home purchase and refinance mortgages originated on owner occupied homes in 2004 (Avery, Canner, & Cook, 2005). Estimates of higher priced loan coverage for earlier years are not available, because the Home Mortgage Disclosure Act (HMDA) did not require reporting of risk premiums for higher priced mortgages prior to 2004. Nevertheless, it seems reasonable to believe that the FSRP's subprime mortgage database captures a considerable share of all subprime mortgage lending.[5]

Lenders that contribute loan data to the subprime database service loans that they originate directly, as well as acquire through brokers and via purchase from other lenders. Nearly a quarter of the loans originated in 2004 were purchased from other lenders, and 58% of all loans were originated through brokers. These percentages are typical of the lenders' loan acquisitions over the time period of the database.

Nearly all of the loans, 94% in 2004, in the database are closed-end.[6] Forty percent of these closed-end loans were first liens. Table 1 describes selected characteristics of closed-end first mortgages, the type of loan analyzed in this study. The average loan size of closed-end first mortgages in 2004 was $130,000. Fixed-rate mortgages were, on average, smaller than variable-rate and hybrid (initial fixed rate for an introductory period, followed by variable rate thereafter) mortgages. Overall, 23% of closed-end first mortgages were used for home purchases, but loan

[4] The Financial Services Research Program was formerly named the Credit Research Center. The center changed its name when it moved to George Washington University in August 2006.

[5] For further discussion of market coverage of various subprime databases, see Wallace, Elliehausen, and Staten (2004).

[6] Closed-end loans are loans in which the borrower receives the proceeds of the loan at closing with full repayment of interest and principal required on a predetermined date. Closed-end loans often have scheduled periodic payments of principal and interest during the term of the loan. In contrast, an open-end loan has a predetermined maximum loan amount that can be used repeatedly in any amount up to the maximum at the borrower's discretion.

purpose varied substantially by type of interest rate. Variable-rate and hybrid loans were more than twice as likely to be used for home purchases as fixed-rate loans. Average annual percentage rates were 10.71% for fixed-rate mortgages, 8.43% for variable-rate mortgages, and 9.78% for hybrid mortgages. Borrowers obtaining fixed-rate loans had lower incomes and higher FICO scores than borrowers obtaining variable rate or hybrid loans. Loan sizes, property values, and borrower incomes were lower in earlier years, while loan purpose distributions, annual percentage rates, and FICO scores varied during the entire 1995–2004 period. Nevertheless, the 2004 statistics illustrate the differences in loan products and borrower characteristics that prevailed during this period.

2.1. Model

We specify loan price as a function of loan terms, distribution channel, and borrower risk characteristics. Price is measured by the risk premium, which is defined as the annual percentage rate of interest minus the rate for a Treasury security of comparable maturity. The annual percentage rate includes both the contract interest rate and any initial points or fees. The risk premium is used instead of the annual percentage rate to remove the effects of movements in the market interest rates.

Lenders typically have different pricing schedules for different mortgage products. We therefore estimate separate models for (1) fixed-rate first mortgages, (2) variable-rate first mortgages, and (3) hybrid first mortgages that have a 30-year term to maturity. These products accounted for nearly all first mortgage loans originated by the eight subprime subsidiaries in the database. We excluded loans with loan amounts greater than 90% of home value because such high loan-to-value loans are not generally available to most subprime borrowers.

Loan terms include loan amount, home value, the ratio of loan to value, and whether the loan is a reduced documentation loan.[7] Distribution channel is indicated by a dummy variable that equals one when the loan was originated by a mortgage broker and zero otherwise. Borrower risk characteristics include borrower income, FICO risk score, and whether the home is owner occupied.[8]

The loan term that is of particular interest for this paper is the presence of a prepayment penalty. Loans having a prepayment penalty are identified by a dummy variable, which equals one if the loan has a prepayment penalty and zero otherwise. If lenders charge higher prices on loans without prepayment penalties, then the presence of a prepayment penalty should be inversely related to the risk premium. Because loan price and presence of a prepayment penalty may be determined simultaneously, we first estimated a probit model predicting the presence of a prepayment penalty. The predicted probability that the loan has a prepayment penalty is used in place of the dummy variable in the simultaneous equation model.

Many states restrict prepayment penalties. Restrictions may limit the time period allowed for prepayment penalties, limit the size of the prepayment penalty, or prohibit prepayment penalties. Generally, restrictions on prepayment penalties should increase risk premiums since such regulation would increase the prepayment risk to lenders. Federal preemption allows certain lenders to offer loans with prepayment penalty terms that other types of lenders are prohibited from offering under state laws. This regulatory structure may influence competition and the range of loan

[7] A reduced documentation loan is a loan in which income, assets, or employment are not fully verified by the lender or documented by bank statements or tax documents.

[8] A FICO risk score is the widely used risk-scoring product developed by Fair, Isaac Corp.

Table 2
Descriptive statistics of regression variables

Variable	Mean	Standard deviation
Risk premium (%)	5.06	1.96
Loan to value	0.75	0.18
Prepayment penalty (dummy variable)	0.60	0.49
Monthly income (dollars)	4,252	3,481
FICO score	605	62
Loan purpose (dummy variables)[a]		
Home purchase loan	0.19	0.40
Refinance loan, no cash out	0.25	0.43
Owner occupied (dummy variable)	0.90	0.30
Broker origination (dummy variable)	0.59	0.49
Documentation (dummy variables)[a]		
Full documentation	0.05	0.21
Low documentation	0.07	0.26
Borrower age (dummy variables)[a]		
Age 20–44 years	0.39	0.49
Age 45–59 years	0.40	0.49
Age 60 or older	0.20	0.40
Value of homes in ZIP-code area (proportion)[a]		
$100,000–199,999	0.37	0.19
$200,000–299,999	0.10	0.10
$300,000–499,999	0.04	0.07
$500,000 or more	0.02	0.04
Homeowner mobility in ZIP-code area (proportion)[a]		
Moved within last year	0.10	0.04
Moved 1–4 years ago	0.24	0.06
Moved 5–10 years ago	0.18	0.04
Prepayment penalties restricted (dummy variable)	0.15	0.36

[a] Excluded categories: loan purpose, cash out refinancings; documentiation, unknown; borrower age, less than 20; value of homes, less than $100,000; homeowner mobility, moved more than 10 years ago.

offerings in regulated states and weaken the observed effect of state law on mortgage prices. We specify state regulation of prepayment penalties as a dummy variable that equals one if state law restricts or prohibits prepayment penalties.[9] Descriptive statistics for the variables are reported in Table 2.

2.2. *Estimation*

Previous papers examining the effect of prepayment penalties on mortgage prices (DeMong & Burroughs, 2005; Ernst, 2005) estimate a regression model predicting price as a function of the presence of a prepayment penalty, the ratio of loan to value, and other variables such as income and FICO risk score. A potential confounding factor is that the price may be chosen simultaneously with other loan terms such as loan amount (and therefore loan to value),

[9] See Ho and Pennington-Cross (2005) for a summary of state restrictions on prepayment penalties.

and the presence of a prepayment penalty. Lenders typically offer a number of different equity and prepayment options, with each option entailing a different interest rate. The borrower chooses from among these options. Consequently, interest rate, loan to value, and the prepayment penalty option are all endogenous, a condition that causes single-equation coefficients to be biased and inconsistent. A biased parameter estimate will tend either to overestimate or underestimate the true parameter. An inconsistent estimate will not provide a smaller error as the number of observations increases. Ernst (2005) does consider loan to value as endogenous but treats prepayment penalty as exogenous. DeMong and Burroughs (2005) treat both terms as exogenous.

Failure to account for endogeneity in loan decisions can have serious consequences. In their assessment of models of mortgage rejection and default decisions, Yezer, Phillips, and Trost (1994) investigated bias by conducting Monte Carlo experiments and found that single-equation models did not provide reliable evidence on the structural parameters describing the behavior of borrowers or lenders. Depending on the experiment, single-equation estimates were sometimes significant when the structural parameter was zero or insignificant when the parameter was not zero, or the magnitude of the estimated coefficient was considerably different from that of the structural parameter. Simultaneity is a factor in modeling loan choices that may cause single-equation estimates of parameters to be biased in an unknown direction and sensitive to differences in model specifications.[10] Although we are interested in different choices than Yezer, Phillips, and Trost, simultaneity clearly is a consideration.

An analysis of mortgage loan performance by Rose (2007) also supports consideration of simultaneity in mortgage decisions. Rose examined the effects of long prepayment penalty periods (more than 3 years), balloon payments, and reduced documentation on foreclosures. He found that long foreclosure periods did not have a uniform effect on the probability across different loan products, defined by loan purpose and type of interest rate. Long prepayment penalty periods had no significant effects on foreclosures for purchase fixed and adjustable rate mortgages, a significant positive effect for refinance adjustable rate mortgages, and a significant negative effect for fixed-rate purchase mortgages. Rose hypothesized that the different findings might be explained by borrowers choosing a long prepayment penalty period to signal that they may be better credit risks. Thus, choice of prepayment penalty would be endogenous in the loan decision.

To address the endogeneity issue, we develop the following simultaneous equations model:

$$
\begin{aligned}
y_i &= ltv_i'\alpha_0 + d_i'\gamma_0 + X_i'\beta_0 + Z_{y,i}'\phi_0 + u_i \\
ltv_i &= y_i'\lambda_1 + X_i'\beta_1 + Z_{ltv,i}'\phi_1 + v_i \\
d_i &= y_i'\lambda_2 + X_i'\beta_2 + Z_{d,i}'\phi_2 + \xi_i
\end{aligned}
\tag{1}
$$

This system of simultaneous equations (1) comprises three endogenous variables—the interest rate, y_i; loan to value, ltv_i; and the presence of a prepayment penalty, d_i. Vector d_i is the dummy variable indicating the presence of a prepayment penalty. As mentioned, borrowers typically choose from a menu of interest rate and loan-to-value options, and choice of a prepayment penalty triggers an adjustment to the interest rate. Thus, ltv_i and d_i are endogenous variables in the interest rate equation. We have no reason to believe that loan to value and prepayment penalty are simultaneously determined. Therefore, d_i does not appear in the loan to value equation, and

[10] See also Brueckner (1994) and LaCour-Little (2001).

ltv_i does not appear in the prepayment penalty equation. Matrix X_i comprises exogenous explanatory variables: loan characteristics (owner occupied, loan purpose, documentation requirements); borrower characteristics (income and FICO score); and distribution channel (broker origination). The last matrix in each equation $Z_{y,i}$, $Z_{ltv,i}$, or $Z_{d,i}$ comprises the instruments excluded from either of equations to identify our system of equations. This model is, of course, a simplification. Other terms such as type of interest rate, the term to maturity, and distribution channel may be endogenous as well. Nevertheless, by consideration of simultaneity in the choice of interest rate and prepayment penalty, we are able to address the issue of possible bias in estimates of the effect of prepayment penalties on loan prices.

For the first equation explaining the risk premium, we use the prime rate as an instrument. This variable is primarily used to price business loans and reflects an opportunity cost of production of the mortgage loans. The prime rate is not widely used as an index rate for variable-rate or hybrid closed-end subprime mortgages.[11] The prime rate is an administered rate that changes relatively infrequently and is influenced by many considerations other than the cost of funds (see Nabar, Park, & Saunders, 1993). As such, the prime rate is not very responsive to changes in market rates and is largely uncorrelated with borrowers' decisions to choose a loan with or without a prepayment penalty.

For the second equation explaining loan to value, we use the age of the borrower and the average property value in borrower's zip-code area as instruments. Use of these variables as instruments is motivated by observations that older households tend to have higher wealth than younger households, which may make them less likely to seek a large loan amount relative to home value, and that wealthier borrowers tend to choose higher value properties than less wealthy borrowers (Bucks, Kennickell, & Moore, 2006). These values would not be expected to be correlated with borrower choices for risk premium or prepayment penalty.

For the last equation explaining choice of prepayment penalty, we use the share of home-owners that recently moved in the borrower's metropolitan area and a dummy variable indicating whether the borrower's state passed a law restricting prepayment penalties. A high share of homeowners that recently moved is an indication of high turnover in the local real estate market, which may lessen demand for mortgages with prepayment penalties. This indicator would be uncorrelated with the loan's interest rate or loan to value ratio. State laws restricting prepayment penalties directly affect the supply of loans with prepayment penalties. State laws would be uncorrelated with choice of loan to value.

Simultaneous equations systems can be estimated using a full information systems method such as full information likelihood or generalized method of moments or a limited, equation-by-equation method such as two-stage least squares. System procedures are asymptotically more efficient than equation-by-equation procedures if all equations in a system are specified correctly. However, any misspecification in a system of equations will be transmitted to the entire system of equations, and systems method estimates of parameters will be generally inconsistent (see Woolridge, 2002, pp. 221–224). Equation-by-equation methods limit a misspecification problem to the equation in which it appears, making equation-by-equation methods more robust than systems methods. Because our dataset does not contain all of the information used in pricing loans, and other loan characteristics are also potentially endogenous, we opt for the more robust, equation-by-equation approach for estimation.

[11] By far most variable-rate and hybrid mortgages in the subprime mortgage database use LIBOR or a constant maturities Treasury rate as an index. The prime rate is widely used in pricing open-end mortgages, but open-end mortgages are only a very small percentage of these lenders' originations.

To identify first two equations in (1), we first fit a probit model for the third equation using exogenous variables and instruments on the right-hand side to obtain a predictor of d_i:

$$\hat{d}_i(\theta_0) = \frac{\phi(\tilde{Z}\theta_0)\tilde{Z}'\varepsilon_i}{\Phi(\tilde{Z}\theta_0)[1-\Phi(\tilde{Z}\theta_0)]} \tag{2}$$

where $\tilde{Z} = [Z : X]$, $\varepsilon_i = d_i - \Phi(\tilde{Z}\theta_0)$, and θ_0 is a unique solution to maximization of probit log-likelihood function.

Then we estimate the first two equations in (1) by two stage least squares (2SLS)

$$\{\hat{\alpha}_i, \hat{\lambda}_i\} = [\tilde{X}_i'Z_i(Z_i'Z_i)^{-1}Z_i'\tilde{X}_i]^{-1}\tilde{X}_i'\tilde{X}_i(Z_i'Z_i)^{-1}Z_i'Y_i,\ Y_i = \{y_i, ltv_i\},\ \tilde{X}_i = [X_i : \hat{d}_i] \tag{3}$$

To identify the last equation in (1), we implement Amemiya (1978) Generalized Least Squares (AGLS) estimator for probit with endogenous regressors.[12]

3. Findings

Two-stage least squares (2SLS) and single-equation estimates of our equations are presented in Table 3 . F-ratios indicate that each of the models estimated for risk premium and loan to value are statistically significant (panels A and B, respectively). Chi-square statistics indicate that the probit models for prepayment penalty are statistically significant (panel C). Statistical tests support the concern about endogenity of loan to value and presence of a prepayment penalty. In each equation, a Hausman test rejects the hypothesis that the coefficients of the single-equation and instrumental variable models are equal (Table 4). This result suggests that the single-equation model is inconsistent (Hausman, 1978) and supports use of 2SLS.

3.1. Risk premiums

The estimated equations for risk premium generally explain a large percentage of the variation in risk premiums. In the two-stage least squares models, the effects of loan to value on risk premiums are uniformly positive, consistent with expectations, and larger in absolute value. In the single-equation ordinary least squares (OLS) models, the effect of loan to value on risk premiums is quite small and positive for fixed-rate and hybrid loans but small and negative for variable-rate loans. Thus, OLS estimates of loan to value coefficients appear to be biased toward zero.

The predicted probability of a prepayment penalty in the 2SLS models and the prepayment dummy variable in the single-equation models are statistically significant and negatively related to risk premiums.[13] 2SLS and single-equation results for prepayment penalties are not directly

[12] See also Newey (1987) for discussion.

[13] In order to assess whether our findings are unique to the companies contributing data to the FSRP's subprime mortgage database, we used the database to attempt to replicate the DeMong and Burroughs (2005) and Ernst (2005) studies that investigated the relationship between prepayment penalties and mortgage prices. Neither of those studies allowed for endogeneity in the choice of loan price and prepayment penalty. We found that model specifications similar to those in previous studies produced similar results in the FSRP subprime mortgage database, including the key Ernst result of no relationship between loan price and prepayment penalty. However, the FSRP subprime mortgage database contains additional risk-related variables (borrower income, whether the home was owner-occupied, and whether the loan was originated by a broker) which are not available in the Ernst database. With these variables added to the Ernst model, the

Table 3
Regression Results

Variable	Two-stage least squares			Ordinary least squares		
	Fixed rate	Variable rate	Hybrid	Fixed rate	Variable rate	Hybrid
(A) Risk premium equation						
Loan to value	0.027**	0.051**	0.167**	0.008**	−0.006**	0.008**
	26.39	77.14	79.56	39.56	36.95	46.75
Prepayment penalty	−5.328**	−6.442**	−2.252**	−0.462**	−0.299**	−0.037**
	108.7	141.99	51.98	70.78	75.82	7.68
Monthly income	−0.008**	−0.021**	−0.045**	−0.010**	−0.014**	−0.021**
	13.01	56.25	49.41	17.22	44.13	43.69
FICO score	−0.008**	−0.009**	−0.013**	−0.010**	−0.007**	−0.010**
	154.75	232.81	173.42	232.93	252.87	280.02
Home purchase loan	0.184**	−0.01	−0.147**	0.162**	−0.013*	0.283**
	16.32	1.56	13.85	17.02	2.37	58.25
Refinance, no cash out	−0.951**	−0.082**	−0.051**	−1.037**	−0.108**	0.214**
	143.19	14.16	3.77	156.77	21.99	29.27
Owner occupied	−0.460**	0.467**	−1.381**	−0.556**	0.467**	−0.850**
	47.59	65.31	85.21	56.99	77.93	102.76
Broker origination	0.903**	−0.078**	0.650**	0.156**	−0.293**	0.274**
	103.04	13.58	50.11	24.07	61.79	42.38
Full documentation	−1.509**	−0.890**	n.a.	−1.747**	−0.599**	n.a.
	136.06	154.43		165.52	129.75	
Low documentation	−0.991**	−0.488**	n.a.	−1.261**	−0.158**	n.a.
	65.8	75.58		84.04	31.12	
Prime rate	0.172**	0.602**	0.170**	0.184**	0.588**	0.131**
	104.02	503.48	82.05	110.73	593.14	115.34
Constant	10.643**	7.059**	2.647**	10.594**	5.900**	10.871**
	115.39	149.14	21.82	305.71	273.17	390.97
Observations	263,775	327,566	351,646	263,775	327,564	351,645
R-squared	0.44	0.55	0.05	0.43	0.66	0.24
F-statistic	20,314**	45,188**	4,538**	17,981**	58,896**	12,259**
(B) Loan to value equation						
Risk premium	−1.215**	−0.974**	−5.425**	0.240**	−1.114**	0.418**
	13.68	50.98	18.75	13.1	79.88	24.77
Monthly income	0.250**	0.142**	0.075**	0.263**	0.143**	0.163**
	45.5	39.27	11.26	47.10	39.74	36.86
FICO score	−0.005**	0.023**	−0.027**	0.009**	0.022**	0.024**
	5.69	63.25	10.49	19.59	62.73	68.73
Home purchase loan	4.106**	0.522**	4.736**	3.911**	0.497**	3.064**
	44.96	8.15	48.72	43.66	7.77	69.23
Refinance, no cash out	−1.747**	−2.227**	3.095**	−0.245**	−2.269**	1.891**
	15.28	39.81	31.68	3.5	40.69	28.3
Owner occupied	−2.002**	−3.282**	−0.563*	−1.171**	−3.268**	3.943**
	19.04	47.2	2.39	12.78	47.12	51.05
Broker origination	−1.254**	−0.053	−0.820**	−1.253**	−0.118*	−0.597**
	19.52	0.97	11.25	19.73	2.17	9.6
Full documentation	−1.587**	−0.948**	n.a.	1.438**	−1.153**	n.a.
	7.63	16.49		13.92	21.36	
Low documentation	−2.166**	−1.716**	n.a.	0.025	−1.872**	n.a.
	11.1	29.17		0.18	32.71	
Age 20–44 years	0.318**	−0.108	−5.649**	0.590**	−0.028	0.915**
	3.22	0.17	17.08	6.12	0.04	16.42
Age 45–59 years	−2.199**	−3.432**	−7.442**	−1.899**	−3.398**	−1.020**
	22.31	3.59	22.75	19.84	3.56	15.24
Age 60 or older	−6.332**	−0.244	−12.049**	−5.806**	−0.176	−4.348**
	46.49	0.11	29.44	44.23	0.08	33.55
% of housing units	21.125**	14.305**	12.024**	20.988**	14.434**	−7.777**
$100,000–199,999	24.41	30.31	5.74	24.55	30.60	4.87

Table 3 (*Continued*)

	Two-stage least squares			Ordinary least squares		
Variable	Fixed rate	Variable rate	Hybrid	Fixed rate	Variable rate	Hybrid
% of housing units	15.615**	12.302**	5.601**	17.723**	12.297**	−8.127**
$200,000–299,999	17.54	25.75	2.81	20.36	25.74	5.02
% of housing units	8.192**	9.095**	−11.493**	10.426**	9.048**	−25.124**
$300,00–499,999	9.38	19.37	6.46	12.22	19.27	17.67
% of housing units	−1.786	0.708	−4.905	0.44	0.794	−16.521**
$500,000 or more	1.29	0.97	1.45	0.32	1.09	5.72
Constant	69.385**	61.009**	120.171**	51.007**	62.168**	64.805**
	48.07	113.5	36.27	55.07	118.14	40.02
Observations	263,775	327,566	351,646	263,774	327,570	351,643
R-squared	0.06	0.10	0.01	0.08	0.10	0.07
F-ratio	1,355**	2,007**	1,245**	1,387**	2,243**	1,680**

	Instrumental variable probit			Probit		
Variable	Fixed rate	Variable rate	Hybrid	Fixed rate	Variable rate	Hybrid
(C) Prepayment penalty equation						
Risk premium	−0.022*	−0.023**	0.382**	−0.120**	−0.107**	0.008**
	2.57	8.56	36.67	66.16	56.11	3.96
Monthly income	0.001*	−0.005**	−0.003**	−0.001	−0.008**	−0.012**
	2.22	12.07	4.69	0.97	19.64	24.31
FICO score	0.001**	−0.000**	0.003**	0.000**	−0.001**	−0.001**
	13.31	5.59	26.51	6.36	18.04	15.7
Home purchase loan	0.094**	0	0.110**	0.123**	−0.012	0.248**
	9.54	0.02	15.24	13.03	1.32	42.44
Refinance, no cash out	0.017	−0.066**	0.037**	−0.075**	−0.096**	0.141**
	1.65	8.25	3.89	11.48	12.23	16.16
Owner occupied	0.039**	−0.021*	0.256**	−0.01	0.041**	−0.054**
	3.73	2.24	19.38	0.99	4.37	5.45
Broker origination	0.443**	0.115**	0.144**	0.438**	0.072**	0.272**
	74.11	15.24	17.15	74.14	9.73	37.69
Full documentation	0.235**	−0.193**	n.a.	0.037**	−0.312**	n.a.
	11.59	24.07		3.30	41.54	
Low documentation	0.279**	−0.236**	n.a.	0.130**	−0.317**	n.a.
	13.44	29.15		7.98	40.43	
% moved within last year	0.008**	0.027**	0.040**	0.005**	0.026**	0.015**
	6.92	30.64	17.96	4.43	28.67	7.5
% moved 1–4 years ago	−0.006**	−0.002**	0.058**	−0.005**	−0.002**	0.070**
	7.52	4.12	40.2	6.44	3.82	53.2
% moved 5–10 years ago	0.023**	0.021**	0.019**	0.021**	0.020**	0.023**
	23.43	28.57	10.83	22.03	27.29	13.75
Prepayment penalty restricted	−0.318**	−0.079**	−0.641**	−0.318**	−0.108**	−0.521**
	44.43	10.33	77.05	44.74	14.36	72.73
Constant	−0.739**	0.551**	−5.701**	0.506**	1.302**	−1.333**
	6.55	13.84	44.78	12.84	36.66	30.76
Observations	263,775	327,564	351,645	263,774	327,568	351,642
Chi-squared	12,946**	5,253**	26,186**	17,797**	8,531**	3,0106**

Note: *t*-ratios or chi-squared statistics are below coefficients. n.a. Not available.

** Significant at 1% level.

* Significant at 5% level.

Table 4
Hausman Test

Loan type	Chi-squared
(A) Mortgage price equation	
Fixed rate	599.87**
Variable rate	10,300**
Hybrid	19,300**
(B) Loan to value equation	
Fixed rate	288.40**
Variable rate	114.40**
Hybrid	550.20**
(C) Prepayment penalty equation	
Fixed rate	140.10**
Variable rate	1,886.55**
Hybrid	1,474.73**

** Significant at 1% level.

comparable because the prepayment variables are different. Multiplying the 2SLS parameter estimates by the difference in the mean predicted probabilities for loans with and without prepayment penalties suggests that presence of a prepayment penalty reduces risk premiums by 38 basis points for fixed-rate loans, 13 basis points for variable-rate loans, and 19 basis points for hybrid loans (numbers not in table). The magnitude of the bias is notable, even if the sign of the coefficients is the same. These estimated reductions are 21% and 131% smaller than the single-equation estimates for fixed-rate and variable-rate mortgages, respectively and 3 3/4 times larger than the single-equation estimate for hybrid mortgages.

Our estimated effects for prepayment penalties are within the range of interest rate adjustments for prepayment penalties commonly found in lenders' loan pricing sheets. Risk price adjustments for factors such as loan purpose, owner occupancy, type of property, loan amount, and loan term are often of comparable magnitudes in price sheets. In contrast, risk price adjustments for relatively low FICO scores or high loan to value percentages often exceed 100 basis points.

Parameter estimates for the exogenous variables are generally statistically significant. Borrower income and FICO risk score are both negatively related to risk premiums in all models, consistent with expectations. Higher income is generally associated with higher disposable income after providing for necessities. Higher FICO risk score indicates a lower probability of serious delinquency, bankruptcy or other derogatory event. Signs of the other exogenous variables sometimes had different signs across products. The changes in sign across products may reflect correlations with explanatory variables that are not available in the dataset or possible endgogenity.

3.2. Loan to value

The effect of risk premium on loan to value is negative (i.e., higher risk premiums are observed on loans with more borrower equity) in the 2SLS equations (and in one of the OLS equations). These results may reflect self-selection. Age, a proxy for wealth, has the expected negative effect

estimated effect of a prepayment penalty on loan price is negative. For more details see Elliehausen, Staten, and Steinbucks (2007).

on loan to value. Mortgages in areas with large proportions of moderately valued homes have larger loan to value ratios, especially in the $100,000–199,999 range but to lesser extents in the $200,000–299,999 and $300,000–499,999 ranges. A larger proportion of homes valued $500,000 or more is not significantly related to loan to value, however. Income is positively related to loan to value. It may be the case that some borrowers with higher incomes and wealth use mortgage debt to allocate a greater share of their wealth toward financial assets or to reduce the share of non-mortgage debt. Indeed, many of the high loan to value mortgages that we observe are owed by borrowers with relatively high incomes and FICO scores. Calomiris and Mason (1999) made a similar observation, that high loan to value borrowers tend to be low credit risks, unlike other segments of the subprime market. The presence of such borrowers may confound results despite the exclusion of the highest loan to value loans.

3.3. Prepayment penalties

Risk premium is inversely related to presence of a prepayment penalty for fixed-rate and variable-rate mortgages and directly related to prepayment penalty for hybrid mortgages in both instrumental variable and single-equation probit models. Estimated effects of income, FICO score, and loan purpose vary by type of interest rate. That the estimated coefficients for these explanatory variables differ should not be particularly surprising since differing circumstances may influence both choice of prepayment penalty and type of interest rate. A worthwhile area for further research is how borrower circumstances affect choices of prepayment penalty and interest rate.

Loans originated through brokers are more likely to have prepayment penalties than loans originated directly by the lender. As evidence suggests that loans originated through brokers prepay faster than loans originated directly through lenders (LaCour-Little & Chun, 1999), lenders may give brokers incentives to originate loans with prepayment penalties.[14] This result may be influenced by selection bias, however. Choice of distribution channel may itself be endogenous with choice of prepayment penalty.

Finally and not surprisingly, state regulation of prepayment penalties influences the likelihood of a prepayment penalty for loans in the sample.[15] Loans in states with restrictions on prepayment penalties are significantly less likely to include prepayment penalties than loans in states with no restrictions. This estimated relationship influences the predicted probability of a prepayment penalty, which is used in place of the prepayment penalty dummy for the 2SLS risk-premium model.

4. Conclusions

Mortgage choices are complex decisions involving simultaneous consideration of numerous loan terms. This paper is the first to consider that mortgage price and prepayment penalty may be chosen jointly, making single-equation estimates of the effect of prepayment penalty on price biased. Our estimates from two-stage least squares models – which address endogeneity of price,

[14] LaCour-Little and Chun hypothesized that lenders encounter an agency problem when third parties, such as brokers or correspondents, originate mortgages because third-party originators receive revenue from originations, not from the stream of mortgage payments. Since completing transactions with previous customers is often easier than finding new customers, third-party originators have an incentive to contact previous customers about refinancing existing loans. Third-party originators would also have little incentive to discourage refinancing if contacted by previous customers.

[15] Recall some loans in the sample may be exempt from state-level regulations that restrict prepayment penalties.

loan to value, and presence of a prepayment penalty – suggest that a prepayment penalty reduces risk premiums by 38 basis points for fixed-rate loans, 13 basis points for variable-rate loans, and 19 basis points for hybrid loans. These estimated reductions for prepayment penalties are within the range of interest rate adjustments for prepayment penalties commonly found in lenders' wholesale loan pricing sheets and are comparable in magnitude to the risk pricing adjustments for other loan features such as loan purpose, owner occupancy, type of property, loan amount, and term to maturity.

These findings contradict the negative perceptions regarding prepayment penalties that have led to restrictive regulation in many states. Risk-based pricing has enabled lenders to make credit available to many borrowers who would have difficulty obtaining such credit in the prime market. Where allowed, prepayment penalties offer borrowers a lower price in exchange for assuming some of the risk (and associated costs) of prepayment. Our results suggest that limits on the tools lenders use to offset higher risk – such as prepayment penalties – effectively raise prices to borrowers.

It is doubtful that our results are unique to our particular database of subprime mortgages. Using our database, we re-estimated the models used in two previous studies of the pricing of prepayment penalties, and found results similar to those of the original authors. However, consideration of additional variables in one model reversed the previous author's finding on the effect of prepayment penalties on price. Clearly, results are sensitive to model specification and cautious interpretation of findings is warranted. We share Yezer et al.'s (1994) skepticism of the ability of simple single-equation models to provide reliable estimates of many of the structural parameters of complex mortgage choices that are of interest for public policy and economic modeling.

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