

## **No Longer Stuck Between a Rock and a Hard Place – Managing Prepayment Penalties Easier with Technology**

Everyday, the mortgage industry examines itself, trying to identify and work through the best ways to navigate a turbulent marketplace. It seems that every sector has an opinion on how to improve the situation. Lenders are calling for market forces to provide a correction. Consumer groups are yelling for the Government to step in and force changes. Homeowners just want to make sure they can stay in the homes they purchased.

Stuck in the middle of this are the broker and lender. On one side, the broker and lender rely on homebuyers purchasing new homes and existing homeowners refinancing their current loans to fill their pipeline. The broker and lender must be advocates for practices that help homebuyers purchase a home and keep a home. On the other side, the broker and lender must work with investors to provide qualified borrowers and ensure the investors are making enough profit to continue offering products they can sell.

One area of contention for consumer groups and investors is prepayment penalties. From the investors' perspective, prepayment penalties provide some protection to investors from rapid refinances and lost profit. From the borrower point of view, some prepayment penalties lock them into loans that become very costly to refinance. Additionally, the variety of rules pertaining to prepayment penalties make both preparing the correct documents and disclosing terms to borrowers difficult and time-consuming. Thankfully, there is help for the brokers and lenders.

### **What's the Prepayment Penalty For Anyway?**

Since the beginning of 2007, prepayment penalties have been one of the most scrutinized and criticized aspects of the mortgage process – especially for subprime loans. In the *Statement on Subprime Mortgage Lending*, published by the federal financial regulatory agencies in June 2007, regulators expressed concern over loans that contained five criteria, including, “substantial prepayment penalties or prepayment penalties that extend beyond the initial fixed interest-rate period.”

Part of the problem lies in confusion over what prepayment penalties are for and the variety of prepayment penalties available.

When a lender underwrites a loan, it is making a decision that a mortgage is the best revenue stream over other investments, such as bonds, stocks or commodities. The benefit of mortgages is that, even with today's historically low interest rates, it has a higher return than bonds and less risk of loss than stocks or commodities. The reason loans provide a higher return is directly tied to the higher risk. With a mortgage, the lender charges a higher interest rate to mitigate the risk of the loan's cash flow ending early – due to either a refinance or a default.

Prepayment penalties began as a way for lenders to offer qualifying borrowers a lower interest rate. With the certainty of some extra compensation if the loan is paid off within a certain time frame, usually less than three years, the lender can offer a lower interest rate. Without prepayment penalties, one of the biggest drawbacks is that if interest rates drop, the homeowner can refinance with another lender, ending the lender's cash flow.

### **Consumer Groups want Penalties Gone**

While mortgage lenders and investors defend the practice of using prepayment penalties to mitigate risk on their investments, many consumer groups charge that the penalties are no longer a protection of income loss but a predatory way to generate additional fees.

Consumer groups have focused on prepayment penalties that are in effect for more than three years or cost more than six months' interest.

A 2004 report, *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, by the University of North Carolina at Chapel Hill Center for Community Capitalism, stated, "also considered predatory are loans with lengthy and costly prepayment penalties that prevent borrowers from refinancing when interest rates fall or their credit record improves."

The use of abusive prepayment penalties reduces the refinancing options available to borrowers, making the option to default more likely.

## **A Web of Laws and Regulations**

Each lender assesses the need for prepayment penalties differently depending on the borrower, terms of the product and the local regulations. Making the decision-making process even more confusing is that the rules regulating prepayment penalties vary greatly from state to state with new rules being considered every day.

Federal regulations already place some restrictions on prepayment penalties. In high-rate, high-fee loans regulated by the Home Ownership and Equity Protection Act of 1994 (HOEPA), most prepayment penalties are prohibited except in cases meeting certain criteria.

According to the Federal Trade Commission, a lender may only apply prepayment penalties to HOEPA loans when “the lender verifies that [the] total monthly debt (including the mortgage) is 50 percent or less of monthly gross income; [the borrower] gets the money to prepay the loan from a source other than the lender or an affiliate lender; and the lender exercises the penalty clause during the first five years following execution of the mortgage.”

Individual states can also craft legislation that places additional restrictions on prepayment penalties. According to the August 24 *New York Times* article, “States Begin Action on Subprime Lending,” “legislators in more than 30 states have introduced close to 100 bills intended to stem deceptive-lending practices and foreclosure, some by stiffening criminal penalties.” Many of these bills are working to severely limit, or in some cases ban, prepayment penalties altogether.

The Federal government is considering additional regulations on the prepayment penalties. In September 2007 Senator Christopher Dodd (D-Conn.), Chairman of the Senate, Banking, Housing and Urban Affairs Committee, announced plans to introduce legislation eliminating prepayment penalties for all subprime loans.

“My bill will end prepayment penalties – which only exist in the subprime market,” Dodd said in a press release, “and which penalize homeowners for trying to do the right thing by refinancing their mortgage.”

## **Managing Prepayments with Technology**

What makes prepayment penalties tricky for brokers is that, while the penalty protects the investor, the broker is tasked with disclosing the penalty and explaining how the penalty works to borrowers.

The good news for brokers is that there are technology tools available to manage documenting prepayment penalties and the disclosures needed for borrowers. Brokers wanting to navigate the web of prepayments should look for certain features, though.

First, any prepayment tool should include automated configurations that meet all federal, state and investor requirements. Many brokers do not have the time to maintain the prepayment penalty guidelines and requirements from individual investors, state and federal government.

A rules engine can also simplify the management by only presenting applicable configurations within the loan operating system. Some systems are even updated by the vendor, removing the need to manually update the system with the constantly changing regulations.

The best systems also include tools to provide the required initial disclosures of prepayment penalties, as well as other loan stipulations, to borrowers. Today's systems can not only print the disclosure documents, but also electronically send the disclosures to the borrower, tracking receipt and required signatures. At the closing table, the prepayment penalty management tools can also populate and print the required documents.

With investors defending prepayment penalties, consumer groups fighting them, and the government considering additional regulations and legislation, the only thing brokers can count on is that prepayment penalties will continue to quickly change. No matter which side wins, successful lenders and brokers can use technology to more effectively manage prepayments, leaving more time and energy to accomplish what's truly important – providing the best service to the borrower and increasing business.

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