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Burton, Marilyn K

From: Brian Dacy (Branch President) [BDacy@D1Mortgage.com]
Sent: Wednesday, June 05, 2002 12:55 PM
To: 'regs.comments@ots.treas.gov'
Subject: pre-payment penalties afford financing to borrowers who can't obtain credit through traditional sources like Fannie, Freddie and FHA

Chief Counsel's Office
Office of Thrift Supervision
1700 G. Street, NW
Washington, DC 20552

Attention: Docket 2002-17

Dear Chief Counsel:

The logic behind removing prepaids from Parity Act coverage is that people who have a high-interest mortgage will be able to refinance sooner at a lower rate without being penalized. In theory, that sounds plausible. In reality, it is merely smoke and mirrors.

We have found that if we ask someone, "Would you like to pay a prepayment penalty?" they would say "No." If we asked them if they would like to pay points or pay for title insurance, we would get the same answer. The problem here is the borrower who answered negatively is being manipulated. How can this be? Because the question lacks sufficient facts, it is designed to elicit a certain response. We could do the same with taxes, traffic tickets and tolls. However, when the question is phrased with more of the facts available to the responder, the answer is usually much different. Most people do choose taxes because we want education, a military and social programs. Borrowers often understand that it is desirable to pay points because the interest rate is significantly lowered. Points, in effect, are a form of prepayment penalty.

Lenders in the Subprime market found that many of their borrowers were unable to pay sufficient points to justify the very significant costs of originating a Subprime mortgage. Therefore, they instituted the prepayment penalty as a method of reducing the points needed in the origination process. Since prepayment penalties are somewhat less used and newer than points, they are often misunderstood.

The people hurt most by eliminating prepayment penalties as an option are those who are overwhelmingly choosing them, the consumer. A recent poll of mortgage originators found that in over 95% of the cases where a prepayment penalty was offered in lieu of several upfront points, the borrowers chose the

prepayment
penalty.

The idea that a Subprime borrower can quickly refinance is also a myth. Credit blemishes are not quickly resolved. The same reasons for those blemishes usually go unresolved indefinitely such as poor spending habits, living beyond one's comfortable means and erratic employment. There are a host of psychological reasons as well that accompany poor credit. Despite the most valiant efforts of a Subprime borrower, their credit pattern is slow to improve, if it improves at all.

Does this mean that these borrowers, who some estimate at 50% of our population, should have their ability to own a home denied because the closing costs are too great? Does it mean that they should be unable to utilize the equity in their homes to make life more bearable without paying high upfront costs? I believe the answer is an unequivocal No!

The OTS is hearing from a few severely disadvantaged borrowers, not the general public. The vast majority of borrowers do not want their freedom to choose removed by the Federal government. I do not know of a single Subprime lender who does not offer exactly what the OTS is proposing, Subprime lending without a prepayment penalty. It is being flatly rejected by the majority of Subprime borrowers.

The following list highlights just a few of the reasons why the equality given by the Parity Act should be maintained:

1. Removing prepayment penalties with their associated incentives removes choices from consumers. I know of no lender that does not offer the same loan both with and without a prepayment penalty. The consumer can choose if the term of the penalty for early payoff is beneficial to them. If they are going to

keep the loan for 2 to 5 years, they should choose the prepayment penalty.

Most borrowers who cannot qualify for a prime interest rate do not improve their credit enough in less than two years to warrant refinancing. The norm for credit healing, if it occurs, is 3 to 5 years. The prepayment penalty actually serves as a benefit since it discourages frequent refinances that accrue little benefit and can actually harm borrowers.

2. Unlike points, the prepay can act as a gift to the borrower who keeps the

loan until the prepay expires. There can be little doubt that lenders who choose to offer Subprime loans are offering the borrower the savings derived from not having to reoriginate another loan.

3. Not all loans with prepayment penalties are associated with poor credit. The property they have chosen may have certain features that make it less desirable. The loan-to-value or lien position may often dictate less than prime status.

These will not improve with time.

4. The only reason that we do not have unilateral prepayment penalties in the mortgage industry is due to the government subsidies and guarantees of Fannie Mae, Freddie Mac, Ginnie Mae, FHA and VA. If the government begins to subsidize riskier Subprime loans, we will probably see a debacle similar to the Savings and Loan Crisis of the late 80's except on a far grander scale. Even with prepayment penalties, the thrifts that have entered the market have failed regularly. Despite the GSE's statements that they offer loans that could have been chosen instead of a true Subprime loan, I have found that very few of the loans they offer meet the needs of the typical Subprime borrower.

5. The OTS stand on allowing thrifts to retain prepayments is hypocritical. OTS is still proposing to allow thrifts to charge prepayment penalties not only on alternative mortgage products but on generic fixed-rate ones as well. If prepayment penalties are an evil to be stamped out, why then is the OTS not proposing that they be eliminated altogether? Is it that banks are so much more honest than other creditors? We need look no further than First Alliance and

other thrifts to see that some of the largest lending problems were actually

thrifts. The OTS has proven to be very poor at responding to consumer complaints. Any local regulator will verify that they stand powerless to deal with abuses by thrifts such as false and misleading advertising, promises that

are not kept, abusive loan programs and charges by insiders, to name a few.

To have the OTS suddenly reverse its interpretation of the Parity Act in favor of banks seems a bit ingenuous in itself.

6. Prepays reduce settlement costs. In exchange for a reasonable servicing life, the borrower gets approximately a two percent reduction in the origination cost of the loan. It is an undisputed fact that origination of a loan is the largest expense associated with the loan. Every time a Subprime loan is originated, the cost of origination is from three to six percent of the loan amount. Even in

prime loans it is two to 3 percent. If we remove prepays, the cost of the loan to the borrower will simply rise by two percent or the borrower will be unable to get the loan.

7. The claim that prepays strip equity is always untrue. The cost of origination would always be charged to the borrower upfront rather than having an understanding with the borrower that allows both the lender and the borrower to profit. Many loans subject to prepays are where the borrower has little or no equity. How can one say that the equity has been lost if there was little or

none to begin with? Borrowers effectively have less equity in their homes if

they will have to pay higher fees to purchase or refinance.

8. Removing prepayment penalties could cause financial disaster. If prepayment penalties are eliminated, the harm to the Subprime lending industry may be irreparable. In the late 1990's, the Subprime lending industry nearly collapsed. Wall Street investors found that it wasn't as profitable as they had thought.

Loans without prepays churned so quickly that the yield spread premiums and branch operations had not only consumed all of the profit, they were operating at a deficit. Prepays gave stability to the market as much as they ensured against origination loss. If the OTS decides to eliminate prepays, even for its member banks, it could well threaten their survival since home equity lines of credit could no longer be offered without cost. Many thrifts have now

begun
charging prepayment penalties on prime arms. Of course, thrifts have
always
been
a source of Subprime mortgage loans. We used to admire that in the movie
"It's a
wonderful life."

9. Subprime lending has greatly increased home values in underserved
areas.
People who previously could not purchase are purchasing homes. Houses
that
would
never pass muster at Fannie Mae or FHA are being purchased and
rehabilitated. It
is quite likely that if we kill Subprime lending, we will also slash the
values
in the very neighborhoods we are supposedly attempting to protect. When
property
values plummet in an area, wealth is robbed from that community. I
believe
that
is precisely what will happen if prepayment penalties are outlawed.

Removing prepayment penalties by rulemaking is a very serious step.
Unlike
legislation where the issues are fully debated, rulemaking can be
arbitrary
and
produce very disastrous results. Although the outcry has not been huge
yet,
if
this rule is implemented and sustained, the effects could be
far-reaching.
It
has wisely been opposed by every non-bank entity including the Mortgage
Bankers
Association and the National Association of Mortgage Brokers.

Finally, the intent here seems to negate the entire intent of the Parity
Act.
The Act was passed with the specific intent of putting parity between
federally-regulated entities and state-licensed and chartered lenders.
It
was
the decision of both the Federal Home Loan Bank Board and the OTS that
prepayment penalties were applicable to the Parity Act. The Act has not
been
modified. Partisan politics should not be playing a role.

Sincerely,

Brian Dacy
Branch President

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