

**American Bankers Association  
Consumer Mortgage Coalition  
Mortgage Bankers Association**

September 23, 2009

The Honorable Ben S. Bernanke  
Chairman  
Board of Governors of the Federal Reserve System  
20th St. and Constitution Avenue, NW  
Washington, DC 20551

The Honorable Shaun L.S. Donovan  
Secretary  
U.S. Department of Housing and Urban Development  
451 Seventh St., SW  
Washington, DC 20410

The Honorable David Stevens  
Assistant Secretary for Housing—Federal Housing Commissioner  
U.S. Department of Housing and Urban Development  
451 Seventh St., SW  
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Thomas R. Weakland  
Acting Executive Vice President  
Government National Mortgage Association  
U.S. Department of Housing and Urban Development  
451 Seventh St., SW  
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Re: FHA Loans And The New Regulation Z Threshold For Higher-Price  
Mortgage Loans

We wish to bring to your attention an issue regarding FHA loans under the rule for higher-priced mortgage loans (HPMLs), which rule will become effective October 1, 2009.<sup>1</sup> The form of notes commonly used on FHA loans permit what will be deemed an impermissible prepayment penalty under the new HPML rule. We describe the problem below, then suggest two remedies.

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<sup>1</sup> 12 C.F.R. § 226.35.

## Background

Notes for FHA loans commonly permit interest to be charged through the next installment due date after the loan is fully repaid on a date other than the installment due date. That is, after a loan is fully paid, the borrower may still owe interest for a number of days. Ginnie Mae requires servicers to pass through this interest to Ginnie Mae, regardless of whether the servicer collects the interest from the borrower.

Effective October 1, 2009, Regulation Z will define HPMLs to include loans with an interest rate above a specified threshold. The threshold for a first-lien loan is 1.5 percentage points above the average prime offer rate for a comparable loan, which is not an unusual interest rate.<sup>2</sup>

Prepayment penalties on HPMLs are restricted and sometimes prohibited altogether. Significant here is that “A loan may not contain a [prepayment] penalty . . . unless . . . [t]he penalty will not apply after the two year period following consummation[.]”<sup>3</sup> The fact that FHA notes *permit* borrowers to be charged interest through the installment due date that follows full prepayment, before and after two years from loan consummation, will mean that these FHA loans, if above the HPML threshold, will not be permitted to be made on or after October 1, 2009. Even if the servicer were to decline to charge the borrower the interest, and were to pay Ginnie Mae interest that the servicer did not collect, the loan would still appear to be in violation of the HPML rule.

Creditors are subject to prohibitive liability for violation of the Truth in Lending Act and Regulation Z. Creditors are also required to disclose prepayment penalties to consumers.<sup>4</sup> In addition, assignees of FHA HPML loans may be subject to the cost of rescission until delivery of all “material disclosures,” which include “disclosures and limitations referred to in section[ ] . . . 226.35(b)(2).”<sup>5</sup> This includes disclosures about prepayment penalties.

## Possible Remedies

Servicers, of course, can simply not charge borrowers for post-payoff interest on FHA loans that are HPML loans. To avoid severe liability for TILA violations, likely all or most lenders will do so. But this does not mean Ginnie Mae will not require the payments from servicers. Because lenders will not be able to collect post-payoff interest from borrowers on FHA loans that are HPMLs, we believe it would be appropriate for Ginnie Mae not require servicers to pay Ginnie Mae interest charges the servicers cannot collect.

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<sup>2</sup> 12 C.F.R. § 226.35(a)(1).

<sup>3</sup> 12 C.F.R. § 226.35(b)(2)(i)(A).

<sup>4</sup> 12 C.F.R. § 226.18(k)(1).

<sup>5</sup> 12 C.F.R. § 226.23(a)(3), including footnote 48.

This change would not resolve, however, the underlying problem that the HPML rule will make illegal a term in the note that permits interest to be charged after loan repayment. It would also not resolve the TILA liability that lenders and investors could face.

Lenders can revise the notes they use for FHA loans, but this is operationally a complicated procedure. Because the note is, of course, a critically important document in a mortgage loan, its use is safeguarded by a number of operational checks, each of which has to be passed, and verified. Staff has to be trained on the change. This change cannot be implemented by the date the HPML rule becomes effective. This means that once the HPML rule is effective, lenders will be forced to consider declining to make FHA HPML loans.

A more comprehensive remedy would be for Regulation Z to exclude from the definition of prepayment penalties interest charged through the next installment due date after the loan is fully repaid on a date other than the installment due date.

### **Consistent Federal Policy That Consumers Understand is Best**

Post-payoff interest until the next scheduled due date is not a prepayment penalty. A prepayment penalty is a fee a borrower pays to compensate the lender for the abrupt end of investment payoff. The right to prepay a loan is of monetary value to borrowers, and is a cost to lenders. Most consumers understand this fact.

Interest for the few days after loan payoff before the scheduled installment date is nothing more than a simple expedient to make payments and amortization easy to calculate. It is not designed either to penalize borrowers or to compensate lenders.

The monthly interest accrual amortization method treats payments as made on the scheduled due date, even if they are made earlier or are made later but within the grace period. This has as one of its advantages making loan amortization calculations easier for consumers. This helps them understand their loan. It also helps them calculate their mortgage interest deduction correctly, and to avoid having the IRS question their deductions. It is a long-standing, accepted, common, noncontroversial practice. Moreover, it is specifically permitted under Regulation Z, as the Board explained:

According to these commenters, this so-called ‘monthly interest accrual amortization method’ provides certainty to consumers (about payments due) and to investors about expected yields. **The final rule is not intended to prohibit or alter use of this method**, so long as the servicer recognizes on its books or in its system that payments have been timely made for purposes of determining late fees or triggering negative credit reporting.<sup>6</sup>

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<sup>6</sup> 73 Fed. Reg. 44522, 44571 (July 30, 2008) (emphasis added).

In its pending Regulation Z rulemaking, the Board has proposed to clarify that post-payoff interest is a prepayment penalty.<sup>7</sup> This would be inconsistent with Regulation Z requirements governing crediting payments. Moreover, it would confuse consumers, who may have difficulty understanding why they may be charged this “prepayment penalty.”

The Department of Housing and Urban Development appears inclined to believe that post-payoff interest is not a prepayment penalty. In a version of frequently asked questions (FAQs) about the new RESPA regulations, dated August 13, 2009, HUD stated “The payment by a borrower of accrued interest upon payoff of an FHA loan is not a prepayment penalty.” That statement is gone from the most current version of HUD’s FAQs. Nevertheless, it remains our best indication of HUD’s position.

To treat post-payoff interest before the next scheduled due date as a prepayment penalty would be inconsistent with the treatment for every other payment on the loan. Every other payment is deemed made on the scheduled due date. For the treatment to change for the last payment on a loan, so that the payment must be treated as made the day received rather than on the scheduled due date to avoid a penalty to the borrower, seems without reason. It is likely to be difficult to communicate to borrowers why they must pay a “prepayment penalty” in this event.

## **Conclusion**

The undersigned organizations fear that a large segment of FHA loans will not be originated once the changes to Regulation Z are effective on October 1, 2009. This would be an unfortunate result as thousands of families will be negatively affected by a clumsy interplay of technical rules. The best approach is to eliminate the treatment of post-payoff interest as a prepayment penalty under Regulation Z. Until this matter can be resolved permanently, one option is that Ginnie Mae not require servicers to pay post-payoff interest on FHA loans that are HPML loans.

We believe that all of us share the mutual goal of assuring the continued availability of the FHA product to America’s homebuyers.

Finally, we would very much appreciate the opportunity to review this issue with you further.

Sincerely,

American Bankers Association  
Consumer Mortgage Coalition  
Mortgage Bankers Association

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<sup>7</sup> Proposed commentary to § 226.18(k)(1), 74 Fed. Reg. 43234, 43390 (August 26, 2009).