



BOARD OF GOVERNORS  
OF THE  
**FEDERAL RESERVE SYSTEM**  
WASHINGTON, D. C. 20551

SANDRA F. BRAUNSTEIN  
DIRECTOR  
DIVISION OF CONSUMER  
AND COMMUNITY AFFAIRS

September 29, 2009

Shaun Donovan  
Secretary, U.S. Department of Housing  
And Urban Development  
451 Seventh Street, SW  
Washington, DC 20410

Dear Secretary Donovan:

In July 2008, the Federal Reserve Board (“Board”) issued final rules amending Regulation Z, which implements the Truth in Lending Act (TILA). The July 2008 final rules adopted new protections for consumer mortgage loans, including several provisions that address recent problems in the subprime mortgage market. (73 FR 44522, July 30, 2008). Among other things, the July 2008 final rules define a class of higher-priced mortgage loans that are subject to certain protections. One protection involves prepayment penalties. Higher-priced mortgage loans may not have a prepayment penalty for longer than two years and, for some higher-priced loans, prepayment penalties of any duration are prohibited. The provisions concerning prepayment penalties are applicable to higher-priced loans for which a creditor receives an application on or after October 1, 2009.

You have asked whether the provisions limiting prepayment penalties would apply to certain FHA loans beginning on the October 1, 2009 effective date. In particular, you have asked whether FHA loans are covered by the Board’s staff commentary to Regulation Z that provides that prepayment penalties include any “interest charges for any period after prepayment in full is made.” See 12 CFR part 226, comment 226.18(k)(1)-1. You note that under FHA programs, for purposes of allocating a consumer’s payment to accrued interest and principal, all loan payments are treated as being made on the scheduled due date so long as the payment is made prior to the expiration of the payment grace period (“monthly interest accrual amortization”). For example, if the consumer’s installment payment of principal and accrued interest is due on the first day of each month, the portion of the payment that will be allocated to accrued interest is the same, whether the creditor receives the payment on the due date, an earlier date (such as the 20<sup>th</sup> of the previous month), or shortly after the due date. Under this arrangement, we understand that consumers would not be penalized for making payments during the grace period because all timely payments are considered to be received on the payment due date for purposes of calculating the accrual and payment of interest. At the same time, we understand that consumers that make early payments are treated as having paid on the payment due date and do not receive any reduction in interest due.

Shaun Donovan  
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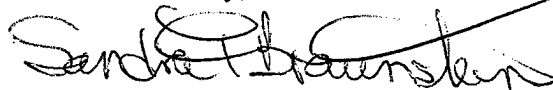
We understand that the same monthly interest accrual amortization method is also used when the consumer prepays the loan in full. Thus, if the consumer's prepayment occurs 10 days before the payment due date, the consumer owes the same amount of interest as if the prepayment occurs on the payment due date. You have advised the Board that, for federally-insured loans, due to the monthly interest accrual amortization method, HUD has not considered the payment of interest after the prepayment date as a prepayment penalty and has advised lenders that they need not disclose this practice as a prepayment penalty for these loans.

The Board's staff commentary noted above provides guidance about prepayment penalties but does not address the specific situation involving loans that generally use the monthly interest accrual amortization method. In light of the guidance given by HUD regarding the payment of interest after the prepayment date, and the fact that the Board staff commentary on this issue does not expressly address this issue in the context of monthly interest accrual amortization, Board staff believes that lenders that use such an interest accrual method discussed above may continue to follow that practice. Lenders that engage in this practice would not be required to treat the interest charged from the date of prepayment until the next installment due date as a prepayment penalty for any purpose under Regulation Z. Staff also believes that lenders who have followed this practice in the past have acted reasonably and have complied in good faith with the prepayment penalty provisions of Regulation Z in this circumstance, whether or not the additional interest was treated or disclosed as a prepayment penalty under Regulation Z.

We understand that HUD is considering revising this portion of its rules and FHA loan agreements. In addition, over the coming months, staff expects to review the staff commentary and consider whether the commentary should be changed to address specifically this aspect of FHA and other lending programs, including whether the commentary should be changed to treat this feature as a prepayment penalty.

Creditors may rely on this letter as an official interpretation of Regulation Z and, under TILA, liability will not apply to actions taken in good faith reliance on the guidance set forth in this letter, to the same extent as if this guidance were set forth in the commentary to Regulation Z.

Sincerely,



cc: David Stevens, Assistant Secretary & Commissioner  
Federal Housing Administration

Thomas R. Weakland, Acting Vice President  
Government National Mortgage Association