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## Call Protection in Mortgage Contracts

41 Pages

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## Abstract

Call protection in debt contracts is ubiquitous in the bond market, customary in the commercial mortgage market, yet reviled and highly restricted in the residential mortgage market. We examine the reasons for these differences and use Monte Carlo techniques to calculate the economic value of call protection (prepayment penalties) in residential mortgage contracts. Results explain why prepayment penalties are more prevalent in the subprime, compared to the prime, market segment. From the simulation results we also compute the reduction in equilibrium contract rates call protection allows and then verify those predictions using empirical using data on actual contracts, extending the existing literature. Results strongly suggest that call protection has significant economic value to both borrowers and lenders and that, hence, the trend toward greater restrictions on this contract feature is bad public policy.

Keywords: mortgage, callable debt, prepayment, prepayment penalty

JEL Classification: G21, G28

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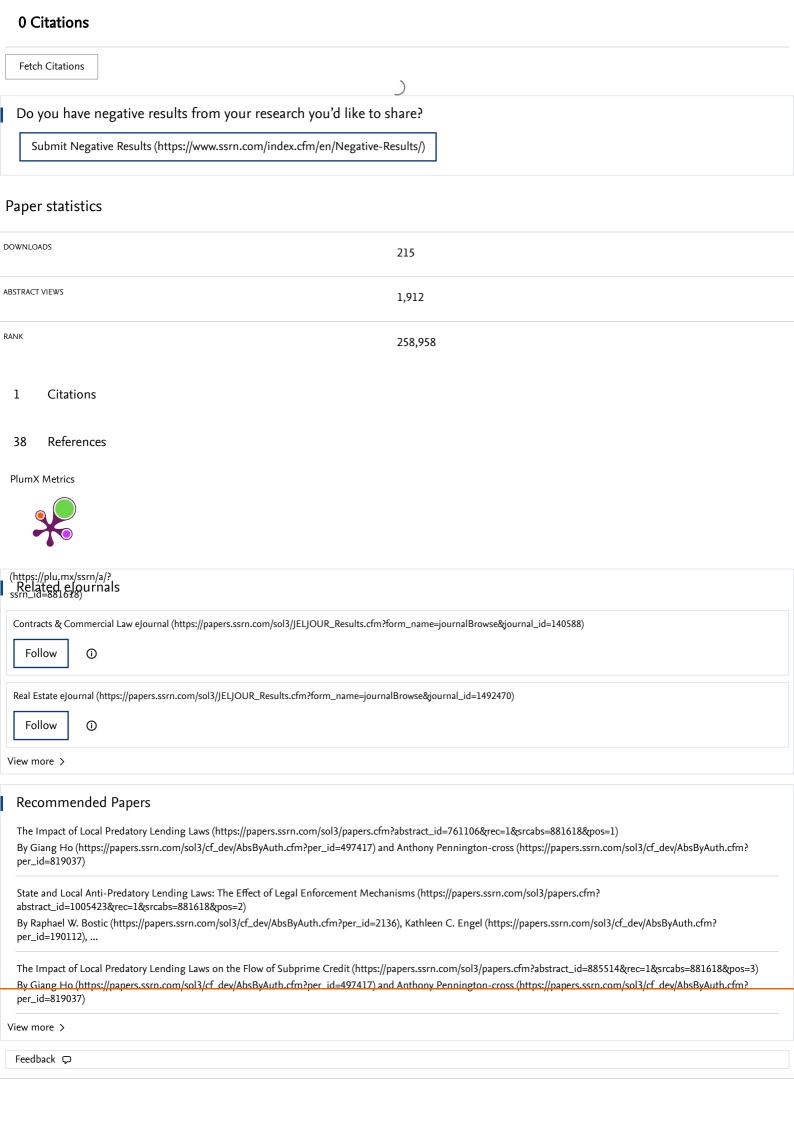
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