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SCHEDULED PRINCIPAL PREPAYMENTS: THE RESIDENTIAL MORTGAGOR'S FINANCIAL RESPONSE TO FRONT-ENDED INTEREST CHARGES

In this era of double-digit inflation and high mortgage interest rates, many aspiring homeowners (as well as present homeowners) are searching for ways to mitigate the financial sting of skyrocketing housing costs. Prepayment of mortgage loan principal is a simple, little publicized, but completely legal technique which allows certain mortgagors to completely repay their mortgage loans, usually within half of the original loan period. This technique simultaneously trims thousands, and more often tens of thousands, of dollars from the interest charges the mortgagor would ordinarily pay under the terms of his mortgage note.1

I. ANALYSIS OF INVESTMENT STRATEGY

Assume, for example: (1) the selling price of a specific residential property is $50,000;2 (2) the buyer is required to make a down payment of ten percent3 of the purchase price, $5,000; (3) the buyer secures a thirty-year mortgage loan for the balance of the sales price, $45,000; and (4) the buyer must repay the principal sum of $45,000, with interest on the unpaid principal balance from the date of the mortgage note, until paid, at the rate of fourteen percent4 per annum, by making consecutive monthly

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1. A mortgage note is a written agreement to repay a loan. The agreement, usually in the form of a promissory note, serves as proof of an indebtedness and states the manner and terms of repayment. The note is secured by a mortgage, a contract which pledges specific property as security for the payment of the debt. The mortgage note also states the actual amount of the debt secured by the mortgage and renders the mortgagor personally responsible for repayment.

2. Since this article was written, the median price for single family houses has risen sharply. As of July, 1981, the median price of used, single family homes was $67,500, and the median price of new dwellings was $69,800. Money, Oct, 1981, at 41. The increase in prices and mortgage interest rates which has occurred during 1981 merely amplifies the savings to be obtained through the procedures described in this article.

3. Savings and loan associations usually require a down payment of 10-20% for an ordinary residential mortgage. However, if a house or condominium qualifies for a loan insured by the Federal Housing Administration, the down payment may be as little as 5%. Also, if the mortgagor has served in the armed forces and purchases a house that qualifies for Veterans' Administration financing, a mortgage covering the entire cost of the property can be secured. Asbury Park Press, Sept. 28, 1980, § H (Real Estate), at 1, col. 4.

installments of principal and interest in the amount of $533.20 beginning on January 1.

Referring to the amortization schedule for a $45,000, thirty-year mortgage, at fourteen percent interest set forth in the Appendix, two things are immediately apparent. First, a changing relationship exists between interest and principal. With each successive installment, the interest component slowly decreases while the amortization of principal slowly increases. Second, during the first twenty-five years of the mortgage term, the majority of each monthly installment is allocated to interest repayment, resulting in "front-ended" interest charges. In the latter stages of the mortgage period, the situation is reversed, and a greater share of the monthly installment is applied to principal repayment. It is a somewhat lopsided reversal, however. Not until the three hundred and second regular payment, which would normally fall in the beginning of the twenty-sixth year, does the principal portion of the installment payment exceed the interest portion.

5. "[M]ost home mortgages have become self-amortizing, which requires periodic interest and principal payments leading to the gradual reduction of the loan balance over the term of the loan." A. AXELROD, C. BERGER & Q. JOHNSTONE, LAND TRANSFER AND FINANCE 153 (2d ed. 1978). The level payment method of debt service requires that all mortgages self-amortize through equal installments of principal and interest. Id.


7. An amortization schedule is a computer print-out which contains the history of a particular interest bearing loan transaction. It reflects the application of each scheduled installment payment to principal and interest and shows the outstanding principal balance of the loan after each payment. See Appendix. Many banks, savings and loan associations, and other mortgage lenders furnish borrowers with an amortization schedule at real estate closings to confirm the exact amounts of principal and interest which will be paid over the life of a particular mortgage. However, a growing number of lenders are cutting their overhead costs by eliminating this once standard service. Thus, borrowers must make special requests to obtain updates from their lenders concerning the amount of principal and interest outstanding on their mortgages. One alternative is for the borrower to contact a reliable third party who specializes in providing amortization schedules. An amortization schedule can be generated for a self-amortizing, level-payment mortgage loan based on the amount of the loan, the interest rate, the term of the loan, and the amount of the monthly payment.

8. The term "front-ended" denotes the process whereby each installment payment is applied first to payment of interest due on the current unpaid principal balance of the loan, with any remaining portion applied to principal repayment. For example, with a $46,000, thirty-year mortgage at 14% interest, the interest due at the end of the first month of the loan period would be $525, computed according to the basic formula: Principal x Rate x Time = Interest ($45,000 x 14% x 1/12 months = $525). The difference between the monthly mortgage installment amount of $533.20 and the $525.00 of interest due at the end of the first month ($8.20) represents the amount by which the loan principal will be reduced.
By following a well planned prepayment strategy, the mortgagor in the above example can use front-ended interest charges to his advantage and, thereby, can own his house, unencumbered, by the end of the fifteenth year. This strategy is simple. In essence, the mortgagor remits the principal due for each succeeding month with the current month’s regular installment of principal and interest. Each month this procedure effectively shortens the term of the mortgage loan by an additional month, and saves the mortgagor the full amount of interest charged to the succeeding month’s regular payment. The monthly “doubling-up” of principal payments cuts the original mortgage term in half, and reduces the overall interest charges proportionately.

For example, on January 1, when the mortgagor makes his first regular payment of $533.20, he adds the following month’s principal amount of $8.30. Thus, the January 1 mortgage payment totals $541.50. Remitting the principal amount of the second regular payment in advance saves the interest of $524.90 normally charged to the second installment and shortens the maturity of the mortgage note by one month. On February 1, when the next regularly scheduled payment becomes due, the mortgagor remits the total amount of regular payment number three ($533.20), originally due on March 1, together with the principal amount of $8.49 for regular payment number four. The February 1 remittance totals $541.69. The mortgage term is reduced by an additional month and the interest savings is $524.71. On March 1, the mortgagor remits regular payment number five and the principal amount of regular payment number six, and so on. The mortgagor continues this process for 180 consecutive months, at which time the entire mortgage note is repaid.

The amount of interest that normally would have been assessed over the full term of the mortgagor’s loan is an astronomical $146,909.46. In

9. The interest savings of $524.90 results from the fact that the principal prepayment of $8.30, on January 1, prematurely reduced the outstanding loan balance from $44,991.80 (the balance after application of the $8.20 principal portion of the January 1 regular payment) to $44,983.50. Since the $44,991.80 will be outstanding one less month than originally scheduled, one month’s interest savings accrues to the mortgagor ($44,991.80 \times 14\% \times 1/12 \text{ months} = $524.90).

Calculation of the monthly interest savings can be effected in another manner. The original loan period of 360 months will be reduced to 180 months by the mortgagor’s monthly remittance of the principal due for both the current and the succeeding month. Thus, the monthly loan installment amount of $533.20 will not be paid for the last 180 months of the original mortgage term. The net savings of interest to the mortgagor in any particular month is the difference between the monthly installment of $533.20 eliminated by each prepayment and the amount of any principal prepaid (e.g., $533.20 minus $8.30 = $524.90).

10. Regular payment number two is not remitted on February 1, because prepayment of $8.30 on January 1 effectively eliminated that payment obligation.
contrast, by repaying the loan in half the required time, the mortgagor saves $73,324.18 in interest payments.

The foregoing synopsis of this systematic prepayment plan is not complete without five operational observations. First, in the example given, because the plan requires the mortgagor to pay an additional $40,032.57 of principal during the first fifteen years of the original mortgage term, his outward flow of cash will increase. However, as previously explained, most of the regular payments over the life of a mortgage loan consist of front-ended interest charges. Therefore, the extra principal payments will be relatively insignificant for several years. In reality, the extra payment of mortgage principal will not reach $100 per month until the beginning of the tenth year, by which time the mortgagor’s presumably increased income should make the financial burden quite bearable.

Second, if the mortgagor decides to discontinue scheduled prepayments of principal, either permanently or temporarily, any interest savings achieved will remain intact. Such savings are calculated by multiplying the product of the amount prepaid times the annual mortgage interest rate by the quotient of the installment period (e.g., month, calendar quarter) divided by one year. The partial prepayments made by the mortgagor are credited against the outstanding loan balance. Since the principal is reduced, a smaller portion of each installment payment is allocated to interest and a larger portion is allocated to amortization of the loan, thereby accelerating the maturity of the mortgage debt.

Third, it has been held that a mortgagor who makes voluntary partial prepayments of mortgage principal, and who subsequently misses one or more installment payments, will not be in default until the amount of the overpayments has been exhausted. This would not be the result, however, if the mortgage agreement stipulated that default would occur if an installment is missed, notwithstanding any voluntary partial prepayments of mortgage principal.11

Fourth, the investment strategy of repaying a mortgage note in half the time can be further accelerated in the case of a “cash healthy” mortgagor. For instance, a mortgagor obligated under a thirty-year mortgage note requiring equal monthly installment payments could satisfy his indebtedness in ten years by including with the current month’s installment of principal and interest the principal amount due for the following two months.

Fifth, a mortgagor may elect to double-up on his principal payments at any time during the term of his mortgage note rather than initiating the prepayment process on the due date of the first mortgage installment. The result of such “mid-stream” election is the same as outlined above for a mortgagor who discontinues principal prepayments.

II. WHY MORTGAGE PREPAYMENT?

A. Advantages v. Disadvantages

The benefits of the mortgage prepayment strategy outweigh the potential drawbacks. Prepayment not only saves the mortgagor money by reducing his interest burden, it also immediately increases the mortgagor’s equity12 in his home by the amount of principal prepaid. If the mortgagor is carrying mortgage default insurance, prepayment will both reduce the premium and shorten the time until the mortgagor can cancel the insurance coverage.

The prepayment option is attractive for persons who do not want the financial burden of monthly mortgage payments after retirement. If a forty year-old couple takes on a thirty-year mortgage, they may not be able to retire comfortably when facing several more years of mortgage payments. Homeowners facing such a retirement problem or those concerned about the stability of the country’s economic climate may want to be absolutely debt-free as soon as possible. They may prefer to use their peak income-producing years to short-cut the duration of their mortgages.

Prepayment may be viewed as a positive factor in the mortgagor’s credit rating, which may allow him to secure additional credit and better terms in other loan transactions. In addition, prepayment represents a powerful hedge against future economic deflation or depression, since the mortgagor repays his mortgage in relatively “cheap” dollars today instead of “expensive” dollars during a deflationary period.

Prepayment also enables the mortgagor who utilizes his mortgaged property as a source of rental income to realize at some future date (usu-

12. The term “equity” has been defined as:
The value of a homeowner’s unencumbered interest in real estate. Equity is computed by subtracting from the property’s fair market value the total of the unpaid mortgage balance and any outstanding liens or other debts against the property. A homeowner’s equity increases as he pays off his mortgage or as the property appreciates in value. When the mortgage and all other debts against the property are paid in full the homeowner has 100% equity in his property.

U.S. DEPT. OF HOUSING AND URBAN DEVELOPMENT, HOME BUYER’S VOCABULARY 8 (1979).
ally the date of remittance of the final installment of principal) a substantial increase in the cash flow which the rental property produces.

Although the prepayment strategy is certainly a viable option, it does have three noteworthy drawbacks. First, prepayment is highly illiquid. The financial benefits derived from the process may not be converted readily into cash. Financial benefits accrue in the form of increased equity and interest savings, but the additional cash outflow required for principal prepayment is not offset until the mortgaged property is sold or the principal is completely repaid. When the mortgagor sells his house during the period of prepayment, or thereafter (but before the original maturity date of his mortgage note), he realizes greater net proceeds from the sale due to the increased equity generated by prepayment. Similarly, when the mortgage note is repaid before maturity, the interest avoided thereby represents an actual cash savings which the mortgagor can invest or use to meet his other costs of living.

Second, the funds which the mortgagor uses to repay his mortgage note are derived from his current assets. Since he ultimately must repay the loan, prepayment is not as much a drawback as a question of the cost or inconvenience of paying early. For those mortgagors operating on a limited budget, prepayment may prove too burdensome.

Finally, the interest savings resulting from prepayment can be reduced by future inflation. If inflation continues its upward spiral, the mortgagor who prepays his mortgage note will do so with relatively “expensive” current dollars instead of “cheap” dollars in the future. However, any inflationary dissipation of the mortgagor’s interest savings can be substantially mitigated if the mortgagor invests such savings at a rate of return greater than or equal to the difference in the inflation rate at the time of prepayment and at the time of the originally scheduled payments of principal.

B. The Fallacy of the Lost Interest Deduction

Under federal income tax provisions, any homeowner is entitled to a deduction from his adjusted gross income for interest paid (or accrued, if the homeowner is an accrual method taxpayer) under any mortgage that is a lien against the home. The majority of states which have enacted individual income tax statutes also provide a tax benefit, in some form, to homeowners making mortgage interest payments.

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14. Most states which have an individual income tax use as a basis for that tax adjusted
Recognizing the income tax advantages of paying mortgage interest, homeowners might be skeptical of a repayment strategy designed to substantially reduce interest payments. However, such skepticism seems misplaced when prepayment is viewed in terms of net cash savings.

In the example of the $45,000, thirty-year mortgage at 14% interest, it was shown that $73,324.18 of interest would be saved by repaying the mortgage in half of the original loan term. Assume the mortgagor, for federal income tax purposes, was an unmarried person in the thirty-nine percent tax bracket (i.e., that his taxable income exceeded $23,500 but did not exceed $28,800).

The mortgagor's election to pay the $73,324.18 in interest, rather than to save that amount by prepayment, would yield a federal income tax benefit of only $28,596.32. The difference between the amount of interest savings and the tax effect of the interest deduction ($44,727.75) represents actual cash outlays by the mortgagor having no federal income tax benefit. In other words, the mortgagor is faced with the rather one-sided choice between an outright savings of $73,324.18 in interest, or the payment of that amount so that he may receive a $28,596.43 reduction in his federal income tax liability. No matter how one views this situation, an actual cash savings of $73,324.18 is certainly more financially acceptable than an after-tax expenditure of $44,727.75.

For many homeowners, the question of lost tax benefits stemming from prepayment never arises. Due to the migratory habits of American households, thirty- and forty-year mortgages rarely go to term. "Most mortgages are paid off long before maturity, when the property is sold to a refinancing buyer."

With the exception of retirees, a conservative estimate of the time period during which the average homeowner occupies a particular home is ten to fifteen years. In fact, many first and second-time

gross income as calculated for federal income tax purposes, thus incorporating the federal tax deduction for mortgage interest payments. See note 13 supra.

15. I.R.C. § 63 defines "taxable income."
17. Prepayment is identical in its tax effects to an alternative investment of equal yield that is taxed as ordinary income. The act of prepayment results in the loss by the taxpayer of the interest tax deduction, increasing his taxable income by the amount of the lost deduction, and his tax liability by the amount of the lost deduction multiplied by his effective tax rate.
18. This figure was calculated by multiplying the interest paid ($73,324.18) by the taxpayer's 39% tax rate.
19. The amount of any federal tax reduction would be supplemented by any state or local income tax benefits derived from the payment of mortgage interest. Together, these reductions would yield the maximum potential tax savings to the homeowner.
20. A. Axelrod, C. Berger & Q. Johnstone, supra note 5, at 105.
21. Id.
home buyers are simply riding the real estate escalator toward the dream house they ultimately want and can afford.

Employing, once again, the example of a $45,000, thirty-year mortgage at fourteen percent interest, assume the mortgagor elects a prepayment strategy, but sells the mortgaged property after occupying it for ten years. During the first ten years of the mortgage, the mortgagor will have paid $58,680.10 in interest, compared to $61,859.61 without prepayment. Such comparison yields an insignificant differential of $3,179.51 in the interest deduction recognizable for income tax purposes. Moreover, prepayment for the period will have generated additional benefits for the mortgagor. First, the mortgagor’s equity in his home will have increased by the amount of $8,545.21. Second, if the buyer can assume the mortgagor’s loan under the same terms and conditions, the prepayment strategy established by the mortgagor (provided it is adopted and followed by the buyer) will save the buyer $14,705.88 in interest payments. Such anticipated interest savings can be used to strengthen the bargaining position of the seller in negotiating the purchase price of the mortgaged property.

III. THE PRIVILEGE OF PREPAYMENT

The use of any mortgage prepayment strategy is contingent upon the borrower having the legal right to prepay. This right typically is provided through legislation or under the negotiated terms of the mortgage instrument. In the absence of statutory authority or an agreement between lender and borrower to the contrary, a mortgagor generally has no right to repay his obligation prior to its stated maturity date. The rationale for this legal posture is that the lender is entitled to the “benefit of his

22. The term “assumption of a mortgage” signifies the purchaser’s act of taking title to real property and undertaking an obligation to “be personally liable for payment of an existing mortgage.” Further:

In an assumption, the purchaser is substituted for the original mortgagor in the mortgage instrument and the original mortgagor is released from further liability under the mortgage. Since the mortgagor is to be released from further liability in the assumption, the mortgagee’s consent is usually required. The original mortgagor should always obtain a written release from further liability if he desires to be fully released under the assumption. Failure to obtain such a release renders the original mortgagor liable [as a surety] if the person assuming the mortgage fails to make the [installment] payments.


24. The counterargument from a public policy standpoint is that the mortgagee's right to refuse prepayments of loan principal by the mortgagor constitutes an undesirable restraint on alienation. In Hartford Life Ins. Co. v. Randall, 283 Or. 297, 583 P.2d 1126 (1978), an action to collect delinquent mortgage loan payments, the mortgagor admitted nonpayment, but claimed that the mortgage, which barred prepayment for the first eleven years of the term, was void since it prevented refinancing of the property upon sale. The mortgagor asserted that this bar unreasonably restrained his right to alienate the property. The Supreme Court of Oregon held the mortgage valid, however. It found that the provisions barring full prepayment did not really restrain alienation since the mortgagor could easily have sold his equity interest in the property for a form other than cash, such as a purchase money mortgage. Id. at __, 583 P.2d at 1127.

25. 3 Powell, supra note 23.

26. VA Loan Guaranty, 38 C.F.R. § 36.4310 (1979), provides:
   The debtor shall have the right to prepay at any time, without premium or fee, the entire indebtedness or any part thereof not less than the amount of one installment, or $100, whichever is less. Any prepayment in full of the indebtedness shall be credited on the date received, and no interest may be charged thereafter. Any partial prepayment made on other than an installment due date need not be credited until the next following installment due date or 30 days after such prepayment, whichever is earlier. The holder and the debtor may agree at any time that any prepayment not previously applied in satisfaction of matured installments shall be reapplied for the purpose of curing or preventing any subsequent default.

HUD Mutual Mortgage Insurance and Insured Home Improvement Loans, 24 C.F.R. § 203.22(b) (1980), provides:
   The mortgage shall contain a provision permitting the mortgagor to prepay the mortgage in whole or in part upon any interest payment date after giving to the mortgagee 30 days advance notice in writing of intention to prepay, but shall not provide for the payment of any charge on account of such prepayment.

27. Federally chartered savings and loan associations represent one major group of mortgage lenders belonging to the Federal Home Loan Bank Board System. See generally 12 C.F.R. § 500.20 (1980).
month period exceeds 20% of the original principal amount of the loan.  

As mortgage interest rates started to climb during the latter stages of the past decade, various states enacted laws giving the mortgagor the right to prepay his indebtedness without penalty. The principal assumption underlying these laws was that interest rates will eventually turn downward, and, therefore, the mortgagor should be entitled to refinance his mortgage at the lower prevailing interest rates.  

In Iowa, Minnesota, New Jersey and Pennsylvania, residential mortgage loans, which are not federally regulated, may be partially or fully prepaid at any time without premium or penalty. California, Michigan, New York and Wisconsin have enacted similar laws, but these jurisdictions permit the assessment of a modest prepayment penalty under certain narrowly defined conditions.  

In California, the borrower is obligated to pay a prepayment penalty only if (1) he agrees in writing to do so, (2) the prepayment is made within five years of the date the mortgage or deed of trust was executed, and (3) the amount prepaid in any twelve month period exceeds twenty percent of the original principal amount of the loan.  

Under Michigan law, the borrower may be assessed a penalty only for prepayments of mortgage principal made within three years of the date of the loan, at a rate not to exceed one percent of the amount of the prepayment. In New York, a prepayment penalty is permitted only when prepayment is made within one year from the original date of the mortgage loan and provision for a penalty is expressly stated in the loan instrument.  

Wisconsin law allows only savings and loan associations to exact penalties for prepayment by the borrower of any portion of his residential mortgage loan. However, such penalties can be charged only if the mortgage note makes express provision therefore and the borrower has made aggregate principal payments during any twelve month period which ex-

31. CAL. CIV. CODE § 2954.9 (West Supp. 1980).
32. MICH. COMP. LAWS ANN. § 438.31c (West Supp. 1980).
33. N.Y. GEN. OBLIG. LAW § 5-501(3)(b) (McKinney 1978). Under this statute, a mortgage lender doing business in New York has an affirmative duty to expressly provide within the loan instrument for the mortgagor's right of prepayment.
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ceeded twenty percent of the original amount of the loan. The penalty equals ninety days' interest on that part of the prepayment exceeding twenty percent of such original amount.

Other jurisdictions have enacted legislation that forbids the assessment of a penalty when the mortgagor either prepays his indebtedness in full or prepays, in whole or in part, specific types of mortgage obligations. Such laws are limited, however, in that they do not confer upon mortgagors the absolute right to prepay mortgage principal at any time, in any amount, without penalty.

Mortgage prepayment has become increasingly regulated by statute. State legislatures have taken notice of rising mortgage interest rates and the effect of inflation on the soaring cost of housing. Following the federal government's lead, these legislatures continue to enact laws designed to aid the homeowner by limiting or prohibiting the penalties upon prepayment. Thus, the trend appears to be toward greater protection of the mortgagor and the expansion of his prepayment rights.

B. Prepayment Premiums or Penalties

In modern real estate practice, long-term mortgages usually contain provisions authorizing prepayment of part or all of the debt, but, as noted above, often require the mortgagor to pay a "premium" or "penalty"

35. Id.
36. Id.
37. See, e.g., Fla. Stat. Ann. § 697.06 (West Supp. 1980), which states: "Any note which is silent as to the right of the obligor to prepay the note in advance of the stated maturity date may be prepaid in full by the obligor or his successor in interest without penalty." Accord, Mo. Ann. Stat. § 408.036 (Vernon Supp. 1980) which provides:

No prepayment penalty shall be charged or exacted by a lender on any promissory note or other evidence of debt secured by residential real estate when the full principal balance thereof is paid after five years from the origination date and prior to maturity; in no event shall any prepayment penalty exceed two percent of the balance at the time of prepayment.

38. See, e.g., Conn. Gen. Stat. Ann. § 36-9g(6) (West Supp. 1980) (financial institutions issuing a reverse annuity or graduated payment mortgage loan cannot impose a penalty for repayment of such a loan); La. Rev. Stat. Ann. §§ 9:5321-5324 (West Supp. 1980) (conventional mortgage on rural property can be partially prepaid, without penalty, in multiples of $100 not exceeding 20% of the initial principal debt, after the first anniversary date of the loan, or prepaid in full, at any time, and without penalty, if prepayment occurs more than five years from date of mortgage instrument); W. Va. Code § 47-6-5c (Supp. 1980) (non-precomputed loan, i.e., a debt not expressed as a sum comprising the principal and the amount of the loan finance charge computed in advance, secured by a mortgage or deed of trust on real property, can be prepaid, in whole or in part, without penalty, where the parties contract in writing for the payment of interest on such loan at a rate not exceeding the effective maximum rate prescribed by the state banking commissioner).
upon the exercise of his prepayment privilege. Such provisions give the mortgagor an option to “call” the mortgage loan on the terms specified. Since the lender’s net yield will be curtailed if the mortgagor exercises the prepayment privilege, the lender charges the mortgagor a premium for exercising his “call.” The amount of this premium is set by agreement between the parties and usually is stated either as so many days additional interest on the amount prepaid, or as a flat dollar amount. Several states, such as Massachusetts and Virginia, have limited by statute the amount that may be assessed as a prepayment premium or penalty in certain mortgage loan transactions.

For federal income tax purposes, the premium or penalty paid by a mortgagor in connection with any prepayment of mortgage principal is characterized as “interest expense” and is deductible, whether the mortgaged property is business or investment property or a personal residence. However, such characterization is not controlling in determining whether the imposition of a prepayment premium or penalty is a usurious exaction. The standard response embodied in existing case law is that “the sum exacted is not interest but an agreed upon payment for exercising a privilege.” The premium or penalty generally is viewed as a charge which compensates the lender both for his expenses in making the mortgage loan and for his loss of the interest that would have been earned on the loan if it had been permitted to mature.

Any mortgage note secured by a first lien on a dwelling house of three or less separate households occupied or to be occupied in whole or in part by the mortgagor shall be subject to the condition that if said note is paid before the date fixed for payment, any additional amount required to be paid in such event shall be an amount which shall be the balance of the first year’s interest or three months’ interest whichever is less; except, that if anticipatory payment is made within thirty-six months from the date of the note for the purpose of refinancing such loan in another financial institution, an additional payment not in excess of three months’ interest may be required

40. In Virginia, the unpaid principal of a loan (other than a loan made under an installment sales contract) secured by a first deed of trust or first mortgage, where the amount loaned is less than $75,000, can be prepaid at any time at a penalty not exceeding 1% of the unpaid principal balance. Va. Code Ann. § 6.1-330.27:1 (Repl. Vol. 1979). Va. Code Ann. § 6.1-330.29 (Repl. Vol. 1979) states: “The prepayment penalty for a loan secured by a home which is occupied or to be occupied in whole or in part by a borrower shall not be in excess of a sum equal to two per centum of the amount of such prepayment.”

41. See notes 31, 32, and 36 supra and accompanying text.
43. A. Axelrod, C. Berger & Q. Johnstone, supra note 5, at 110 n.4.
Some courts have taken an alternative view of mortgage prepayment charges. It has been held that such charges are not usurious when a mortgagor voluntarily repays principal before maturity, pursuant to a mortgage contract exacting a fee or interest penalty for such prepayment; and the total interest received by the mortgagee does not exceed interest computed at the maximum lawful rate from the effective date of the mortgage to the absolute maturity date specified in the contract.\textsuperscript{45}

In addition to the payment of a premium or penalty, a lender may further condition mortgage loan prepayment on (1) the loan continuing for a specified period of time before advance payment is permitted, (2) the borrower not prepaying more than a stated percentage of the original mortgage loan each year, and (3) the borrower giving the lender sufficient notice of his intention to prepay the loan.\textsuperscript{46} The primary purpose of the first condition is to afford the lender some assurance that the mortgage loan will continue long enough to produce interest income sufficient to cover a portion of the lender's loan expenses. The latter two conditions provide the lender with some investment stability in the maintenance of his mortgage portfolio. The lender can usually run a more efficient and profitable lending operation when he does not have outstanding mortgage loans that can be prepaid at any time.\textsuperscript{47}


A lender may charge, take, reserve or receive points or a premium on any loan secured by real property provided the points or premium together with the interest or discount charged, taken, reserved or received do not exceed the maximum interest or discount permitted by law. The lender shall not be required to refund this charge in the event of prepayment even if the prepayment would result in a higher charge to the borrower than permitted by law.

\textsuperscript{46} [1980] 2 REAL ESTATE INVESTMENT PLANNING - CHECKLISTS AND FORMS (INST. BUS. PLAN.) ¶ 50,830.

\textsuperscript{47} The following is an example of a prepayment clause used by many institutional lenders which conditions and regulates prepayment of a mortgage loan:

The undersigned shall have the right to prepay the whole or any part of the principal sum hereof on any date for the payment of interest hereunder during the sixth loan year (as hereinafter defined) and thereafter provided that (a) at the time specified for any prepayment there shall be no default hereunder nor under any instru-
The assessment of a premium or penalty upon the exercise of a mortgage prepayment privilege does not in itself foreclose the mortgagor's election of the systematic prepayment strategy discussed previously. Only in those situations where the amount of the premium or penalty exacted exceeds both the interest savings generated by prepayment and the income tax benefit of paying a prepayment charge will the strategy not be economically beneficial to the mortgagor. The borrower whose mortgage loan agreement provides for a prepayment charge must simply make a mathematical determination of the net financial effect of principal prepayment.

IV. CONCLUSION

In negotiating the terms of a residential mortgage loan, the borrower should recognize that he may someday want to prepay the mortgage, in whole or in part. If the loan is guaranteed by the Veterans' Administration or the Federal Housing Administration, extended by a lender who is regulated by the Federal Home Loan Bank Board, or made in a jurisdiction which provides by statute for mortgage prepayment without penalty, the mortgagor's right to prepay is automatic and absolute. Absent any of these conditions, however, the mortgagor must negotiate the prepayment provision in the mortgage instrument with the lender. Where the lender is not obligated by law to extend the privilege of prepayment, the borrower must give the lender some form of consideration for this privilege, such as an agreed-upon prepayment premium or penalty. The amount of such charge will depend on market conditions and the strength of the parties' respective bargaining positions.

Once the mortgagor's right to prepay has been legally established by

ment held as security for this note, (b) any prepayment of any amount exceeding $100,000 in any one loan year shall be accompanied by a charge, calculated upon such excess prepayment of 4% if paid during the sixth loan year and diminishing ¼ % for each succeeding full loan year to 1%, and thereafter without further decrease, (c) the holder hereof shall have received at least 30 days' prior written notice of any part prepayment and 60 days' prior written notice of full prepayment, and (d) no part prepayment shall affect the obligation to continue to pay the regular installments required hereunder until the entire indebtedness has been paid. The term "loan year" is defined as any period of one year commencing on the first date for the payment of interest hereunder or on any anniversary of such date. Notwithstanding the foregoing, the undersigned shall have no right to prepay the whole of the principal sum hereof during the sixth through the tenth loan years from funds obtained by refinancing with another lending institution unless the holder hereof refuses to meet the terms of a bona fide written commitment of a reputable lending institution within 60 days after the receipt thereof.

Id.
statute or contractual agreement, he can adopt the viable financing strategy. Systematic prepayment of mortgage principal provides the mortgagor with a shortcut to unencumbered home ownership, and saves him thousands of dollars of interest in the process.

Once a mortgagor decides to make regular prepayments of principal, he should discuss his plan with the mortgage lender and enlist his assistance. The lender's knowledge of the mortgagor's intent to prepay his principal should, in turn, promote cooperation in the handling of specific administrative matters and on an overall basis as well.

Counsel engaged in negotiating or drafting a mortgage agreement should be particularly alert to legislation which may affect the rights of the parties with respect to prepayment. In addition, an attorney who represents a buyer-mortgagor should understand how the imposition of front-ended interest charges in mortgage loans can facilitate prepayment of the mortgage obligation in a financially tolerable and economically rewarding manner, and should advise his client accordingly.

James E. Anderson
## Amortization Schedule for $45,000 Level Payment ($533.20/Month) Loan With Thirty-Year Term and Fourteen Percent Annual Interest Rate

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