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FACT SHEET

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SHOULD MORTGAGE PRINCIPAL BE PREPAID?

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Prepaying mortgage principal can save large interest costs incurred when purchasing property. However, alternatives to this use of funds must be carefully considered before principal prepayments are made. This fact sheet examines the advantages, an example, and the disadvantages of prepaying mortgage principal.

Advantages to Principal Prepayment

Prepaying mortgage principal saves interest costs, pays off a large debt sooner, rapidly builds equity, and frees a large sum of money for other uses after retiring the mortgage. Also, a relatively small sum of money is required to benefit from this prepayment – especially when the loan is in its early years.

This is the situation: Monthly mortgage payments include two parts – interest and principal. Interest on most mortgages accrues each month on the unpaid balance of the loan. Large monthly interest payments, typically six or seven times the monthly principal payment, occur on the large unpaid balance during the early years of the mortgage. It is then that early prepayment of principal reduces interest the most.

An Example

The actual mortgage schedule shown below for a $25,600 loan at 8¼ percent interest for 25 years requires $201.86 monthly payments. This payment reduces the principal by only $26.73 and includes $175.13 in interest, almost seven times the principal payment. Also note that 200 monthly payments (over 16 years) must be paid before the principal portion of the monthly payment is more than the interest portion.

Now, assume a prepayment of the principal portion ($26.91) of the third monthly payment is made. The $26.91 could be paid at the same time as the $201.86 for the second month. Thereafter, each monthly payment is moved up; the fourth monthly payment is paid in the third month and so on. Because the $26.91 is prepaid, the $174.95 interest charge for the third month is not incurred and the length of time to retire the loan is shortened by one month.

Note: Mortgage prepayment reduces the term of the loan and the total interest paid. The fixed monthly payments must continue and do not change.

Further, principal can be prepaid for more than just one month. For example, with the fourth payment the three principal payments for the fifth, sixth, and seventh months can be prepaid. To do this, $201.86 plus $82.41 ($27.28 + $27.47 + $27.66) would be paid at one time. By prepaying the $82.41 in principal, a savings of $523.17 ($174.58 + $174.39 + 174.20) in interest is realized and the mortgage is retired three months earlier.

Following the normal payment schedule (without prepayment of principal), in the first three years of the mortgage $1,045.78 in principal and $4,468.84 in interest will be paid. Even after these 36 monthly payments, only $33.05 of the monthly payment is applied to principal, while $168.81 is interest. Of course, the first three years' principal of $1,045.78 could be prepaid and the $5,468.84 in interest saved. This would add $1,045.78 to the equity in the property; and if the property is sold before the loan is retired, the property holder and not the lender gets this equity money.

Prepayment Penalty

The policy on principal prepayment varies among lending institutions. Before sending in money for principal prepayments, the lender should be asked what the prepayment options and requirements are for the loan. Some institutions allow borrowers to prepay any amount. Others allow specified monthly sums, and some contracts specify a penalty if prepayments are too large within a certain time period. These penalties are relatively small, however, when compared to the interest savings associated with prepayment.

To illustrate, consider the $25,600, 25-year mortgage example where the lender requires a three months' interest penalty for prepayment of more than 20% of the unpaid balance in any twelve-month period. If $6,000 (which is more than 20%

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of the unpaid balance) could be applied to the principal in the second year of the mortgage, the penalty would be approximately $515 and the interest saved would be over $22,000.

Other Prepayment Advantages

- Prepayment of mortgage principal allows the loan to be retired in less time, and the satisfaction of owning the property without indebtedness is realized sooner.
- For those who would otherwise spend their money unwisely, principal prepayment is a method of forced equity accrual.
- Prepayment allows savings on interest costs when the mortgage rate is higher than on other available investments.
- Principal prepayment offers protection against economic adversity, i.e., funds invested in a homestead are protected against attachment in case of bankruptcy or other financial collapse.
- Once the mortgage dept is retired financial detail is simplified, i.e., monthly payments and forced prepayment of taxes and insurance are no longer required.

Disadvantages of Prepayment

Before prepayment of mortgage principal is made, other important factors should be considered.

1. It should be determined if the yield on money used for prepayment would be higher if invested elsewhere. For example, interest on Certificates of Deposit, real estate second mortgages and corporate bonds is sometimes higher than interest on mortgages. If this were the case, making principal prepayments on a mortgage having a lower interest rate than could be obtained from other uses of the money would be a poor investment.
2. Once the mortgage prepayments are made these assets are frozen until the property is sold. In other words, the funds used for prepayment would not be available should a financial emergency arise, without first selling the property.
3. Principal prepayment increases the equity in the home at a faster rate and can be a disadvantage at resale time. This increased equity requires the buyer to make a larger cash down payment, and he is not able to assume as large a mortgage.
4. Mortgage loans typically have lower interest rates than operating loans of a business or shorter term personal installment loans. Therefore, if a shorter term personal or business loan is needed because funds are tied up with principal prepayments, then a relatively high interest loan has to be made while a relatively low interest loan is being liquidated.

Suggestions Before Prepayment

If prepayment of principal is considered, the following questions should be asked of the lender:

1. How can the principal be prepaid?
2. Must the lender be informed in advance of prepayment?
3. What prepayment penalty, if any, exists?
4. Request a mortgage payment schedule. Even if no prepayment is made, the schedule provides an easy way to keep track of the interest and principal portions of the monthly payments, total interest paid, and total remaining principal.

MORTGAGE $25,600		INTEREST RATE $8\frac{1}{4}$%	FIXED MONTHLY PAYMENT $201.86	LENGTH OF LOAN 25 Years
Month	Year	Interest Portion	Principal Portion	Remaining Principal
2nd	1st	$175.13	$ 26.73	$25,447.41
3rd	1st	174.95	26.91	25,420.50
4th	1st	174.77	27.09	25,393.41
5th	1st	174.58	27.28	25,366.13
6th	1st	174.39	27.47	25,338.66
7th	1st	174.20	27.66	25,311.00
8th	1st	174.01	27.85	25,283.15
9th	1st	173.82	28.04	25,255.11
9th	2nd	171.42	30.44	25,903.21
9th	3rd	168.81	33.05	24,521.17
9th	4th	165.98	35.88	24,106.39
5th	16th	100.20	101.66	14,472.60
9th	25th	.16	22.70	0.00

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