

## **Interpretive Letter 97-4 (July 9, 1997)**

**Retroactively charging higher interest rates to borrowers who prepay their mortgage loans whose interest rate is over 8% would constitute a prohibited prepayment penalty under Section 4(2)(a) of the Interest Act. However, banks may provide incentives, such as cash bonuses and fee waivers, to induce borrowers not to prepay.**

This letter responds to your inquiry regarding the Illinois Interest Act ("Act") (815 ILCS 205/0.01 *et seq.*). Pursuant to Section 6 of the Act (815 ILCS 205/6), you have asked the Office of Banks and Real Estate to interpret whether three proposed activities would violate the Act. We find that while two of your proposals would be permissible, the third would be prohibited under the Act.

Your request regards the methods by which banks may induce borrowers to avoid prepaying their mortgage loans. In your first proposal, the bank would pay a cash bonus to any borrower who does not prepay a mortgage loan prior to a designated loan anniversary date ("Prop1"). In your second proposal, the bank would defer the borrower's payment of loan origination points or fees which would normally be paid at closing, and agree to waive those fees if the loan is not prepaid before a designated loan anniversary date ("Prop2"). In your final proposal, the bank would contract for interest to be calculated at one of two alternative rates and charge the higher rate retroactively if the loan is prepaid before a designated loan anniversary date ("Prop3").

The relevant portion of the Act states, "Whenever the rate of interest exceeds 8% per annum...on any loan secured by a mortgage on residential real estate, it shall be unlawful to provide for a prepayment penalty or other charge for prepayment." 815 ILCS 205/4(2)(a) (emphasis added). A prepayment penalty is simply "a penalty for paying all or part of the principal before the date on which the principal is due." FRB Regulation Z, ' 226.32(d)(6). A prepayment penalty "encompasses only those charges that are assessed strictly because of the prepayment in full of the obligation, as an addition to all other amounts." Truth in Lending Manual (Fifth Edition), ' 5.02[11]. These penalties are "assessed at the time of early payment of the loan, rather than at the initiation of the original loan or as an addition to the loan principal as are points. Further, points must be paid regardless of whether the loan is prepaid, in contrast to the prepayment penalties." Currie v. Diamond Mortgage, 859 F.2d 1538, 1541 (1988).

Both Prop1 and Prop2 would be permitted under the Act because they provide incentives for borrowers who do not prepay their loans, namely a cash bonus and a fee waiver. The fact that borrowers who prepay their loan are treated differently from those who do not prepay is not dispositive for analysis under the Act. The crucial issue is whether the lender would assess charges on borrowers at the time they prepay their loans. Since no charges are assessed at any time in either of these proposals, they would not be considered prepayment penalties and would not run afoul of the Act.

Prop 3, however, would be prohibited by the Act. Although retroactively charging a higher interest rate would not be a traditional penalty or charge, it is functionally equivalent to one. In order to apply this proposal, the bank would assess the borrower the difference between the two interest rates after prepayment by the borrower. This charge is a disincentive to prepay which is

described in, and forbidden by, the Act. Thus under the Act, the lender would not permitted to engage in Prop 3.