

Those Pesky Prepayment Penalties...

One of the most difficult issues commonly faced by Borrowers seeking to refinance commercial mortgages involves the decision as to when it does, or does not make sense to pay a sometimes substantial prepayment penalty in order to refinance at: 1) a much lower rate, 2) much higher dollars, or 3) both.

Clearly, it's tantalizing to find yourself in a historically low interest rate environment only to feel shut out of the party because your current loan has a 3% or 4% flat penalty, or, potentially even worse, a yield-maintenance or defeasance prepayment penalty. Yield maintenance or defeasance makes the lender indifferent to an early repayment of a loan with a higher-than-current-market interest rate. Briefly, a yield-maintenance or defeasance penalty results in a lender receiving every penny of interest that they would have received holding a loan until maturity. The worst possible scenario, of course is an absolute "lock out" for a certain period of time, which would prevent an early repayment of the current mortgage for any reason whatsoever.

It's an interesting analysis because, in many cases, there IS no "right" or "wrong" answer...the borrower's decision is not based solely on mathematics as much as on a Borrower's immediate need for cash (for repairs, capital improvements, or to pursue other business opportunities), and on a Borrower's purely subjective assumptions about, and prediction of, the future direction of interest rates.

Still, there are certain situations that are easier than others to grapple with; for example, you've got a yield maintenance penalty on a \$10,000,000 balloon mortgage, with only three years left to run until maturity. You have no intention of selling the asset, and you fully intend to refinance the debt rather than write a \$10,000,000 check to the lender at maturity. You cringe at the prospect of paying a \$900,000 prepayment penalty, yet you know that the odds are pretty good that in 3 years, you will find yourself in a higher interest rate environment. So what course of action is better – taking advantage of today's terrific interest rates, swallowing hard, and at least controlling your own destiny? Or, riding out the current loan, eliminating the penalty and gambling that you won't get killed by the interest rates that will be available in three years?

I would say that most of the Borrowers that we've represented, facing the above dilemma, would pull the trigger and choose the Devil they know over the Devil they don't know. I certainly would.

The answer will often be more a function of the Borrower's personality than of the mathematics. Those who prefer to control events will strike while the iron's hot and the rates are low, while those who simply can't bear the idea of a huge prepayment penalty will freeze like deer in the headlights and let outside events, rather than their own actions, dictate the outcome. The concept of the "time value of money" also, of course, works into this decision-making process. Part of the algebra must contain an analysis of how much money you feel you can make by gaining access NOW, rather than 3 years from now, to this once-trapped equity.

I have seen procrastination turn out to be both a huge mistake, as well as the best move that a Borrower could have possibly made. I have seen forward commitments (early rate locks) seem visionary in retrospect, or abysmally misguided.

As a mortgage broker, it's interesting to bring the facts to the table, offer a carefully considered, professional opinion, and then see what course of action a client decides to take. There are many other aspects of advising our clients which are quite black and white, and are driven by our experience, yet this is a gray area that is quite interesting, and it always reveals a lot about a client's worldview. As technical as commercial real estate financing can be, this is the territory that must be navigated with a leap of faith and good gut instincts.