SVN
BLUESTONE & HOCKLEY

SVN | Bluestone & Hockley
9320 SW Barbur Blvd., Suite 300
Portland, OR 97219

quick
FACTS

CREATING AMAZING VALUE

with our clients, colleagues, and communities

QUICKLINKS

Blog

LinkedIn

Facebook

Beware the Prepayment Penalty

By: Clifford A. Hockley, President Bluestone and Hockley Real Estate Services, Executive Director, SVN | Bluestone and Hockley

I have been counseling clients for a long time to be careful of prepayment penalties that lurk everywhere in today's mortgage environment. I don't like prepayment penalties because they limit your flexibility as an investor (as both Buyer and Seller) in real estate, but they are hard to avoid, and my clients have had many run-ins with prepayment penalties.

Three years ago, I had a client (a Buyer) that was about to close on a transaction when the Seller refused to close. The Seller had not checked on his prepayment penalty, and at the last minute found out it was going to be $250,000. In the end, the Buyer assumed the existing CMBS financing with the Seller paying all assumption costs and agreeing to a price reduction, but it added tension to the deal, and it involved attorneys to sort it out. The Buyer was in a 1031 and had a huge amount of tax penalty at risk.

In a similar situation, another client was recently bitten by the prepayment penalty snake. She refinanced a property, assuming that she was going to hold it for an additional five years. She intended to use the refinance funds to buy another property. Then, out of the blue - just six months after her refinance, another investment opportunity surfaced that needed her to come up with more cash. Her prepayment penalty cost for that small project was $ 45,000 - that's $45,000 that is no longer available to invest in another project. Using a 6 CAP she lost $750,000 in upside – a significant loss - but she had a better opportunity that needed the balance of the cash.

When does a prepayment penalty occur?

Some prepayment penalties (or inability to pay off a loan) typically occur in the following cases:

- For some loans - no prepayments are permitted, either partially or in full. This is often the case with large or securitized loans.

- It is not unusual with new financing or refinancing to be faced with prepayments for the first five or 10 years of a loan, or to be prohibited from paying off more than 20% of a loan in any one year.

- In other cases, the loan can be prepaid - but only if the new borrower either assumes the existing loan or pays a 1% prepayment penalty to assume the existing loan.

- Wrapping your loan around an existing loan is typically discouraged with major penalties, by the lender that is in first place.

- Most banks will not charge a penalty if the prepayment is less than 10% of the original principal. This obviously does not apply if you sell your property.

- The loan can be prepaid, but a penalty and is charged, especially if the loan is being fully prepaid prior to maturity.

- Finally, some loans have no pre-payment penalties at all. An Adjustable Rate Mortgage (ARM) might be free of any prepayment penalties.

Prepayment penalties come in many flavors. For example:

- A financial institution might charge a set fee like $2,000, this is assessed no matter what the remaining size or term of the loan. In most cases this is minor and primarily reimburses the bank for expenses related to the release of collateral on the loan and terminates the borrower's obligation.

- A bank might also charge a set percentage like 1% of the loan amount, depending on the size of the loan.

- It is not unusual to see a stepped percentage formula for commercial loans that varies with time. For example, with a 10-year loan, you might see descending percentage penalties for each year of the loan. Such as: 10,9,8,7,6,5,4,3,2,1 or 5,4,3,2,1- 5,4,3,2,1 or on shorter term loans include 5-4-3-2-1 or 3-3-3-2-2-1, where in the first example 5% of the remaining balance is the penalty if the loan is prepaid during the first year of its life, 4% in the second year, 3% in the third year, etc. This recognizes that the longer the remaining term of the loan the more value it likely has to the bank.

- Commercial Mortgage Backed Securities – (CMBS) loans typically have yield maintenance clauses, these are very expensive and very hard to offset, though they can be assumed at a substantial cost and with huge attorney fees. Since these loans are sold in tranches on the stock market (hence mortgage backed security) and a yield has been promised to the investors the yield must be maintained when a loan is assumed or replaced. Usually they offer two options to deal with an existing loan:

1. **Defeasance** involves the substitution of government securities for the mortgage collateral. A borrower wishing to obtain a release of his/her property from the trust may purchase and pledge to the trust a collection of government securities that are specifically selected to generate sufficient cash to make all monthly payments due on the loan through and including any balloon payment due at maturity.

2. **Prepayment penalties** consist of the payment of a sum of money designed to compensate investors for the loss of yield (often referred to as 'yield maintenance.') Yield maintenance is a present value calculation that enables investors to reinvest the loan payoff proceeds at then current treasury yields through the original loan maturity and maintain the same yield as if the loan had not paid off early. https://precisionlender.com/blog/general/yield-maintenance-on-commercial-loans/

Conclusion

As you choose your loan, and balance between the decisions of loan cost, cash flow, and interest rate - consider the importance of the prepayment penalty in your decision making. For the financial institutions the most important issue is the yield on the loan.

Some banks will hold the loan in their own portfolio, or alternately sell the loan, but - if they sell the loan they have less flexibility to negotiate. A mortgage broker can help you compare your options carefully. In my experience, financial institutions may be willing to change the prepayment penalties if you agree to pay an extra eighth of a percentage point in interest rate. All you have to do is ask.

Bottom line, do what you can to keep your prepayments small and keep your investment strategies flexible as you build your investment portfolio.

BLUESTONE & HOCKLEY

SVN | Bluestone & Hockley
9320 SW Barbur Blvd., Suite 300
Portland, OR 97219
503.222.3800
www.svnbluestone.com

Cliff Hockley
Executive Director
503.222.3800
cliff.hockley@svn.com

Full Bio