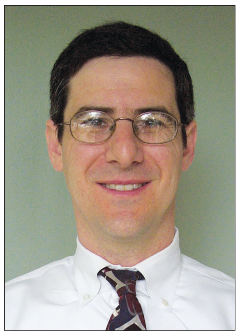


Diminishing Penalties

By Ron Kaminker

The flattening of the yield curve, the advent of defeasance and other variables have contributed to significantly reduced penalty risk with prepayment. That makes fixed-rate financing a better option for a growing number of borrowers with medium-term hold horizons.

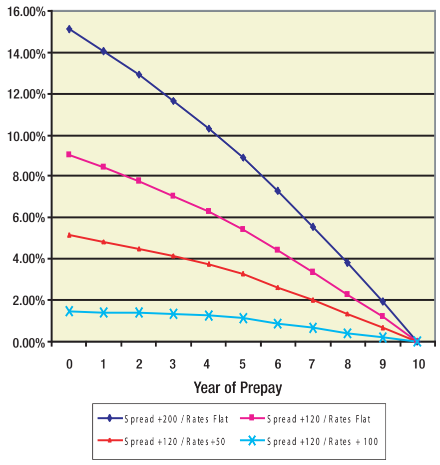
During a recent meeting with an opportunity fund investor who was attempting to purchase a stabilized property with a three- to five-year expected holding period, I inquired as to what type of mortgage financing they would seek. To my surprise, the response was, "A floating-rate bridge loan."

Borrowers with medium-term holding period horizons should seriously consider fixed-rate financing instead of floating rate. In today's environment of historically low interest rates, tight origination spreads and an expectation of increased rates in the future, the likelihood of a borrower incurring prohibitive penalties in conjunction with a relatively short-term prepayment of a loan is much less probable than in the recent past. Lower Treasury yields, reduced origination spreads, the flattening (or even inverting) of the yield curve and the advent of defeasance contributed to this.

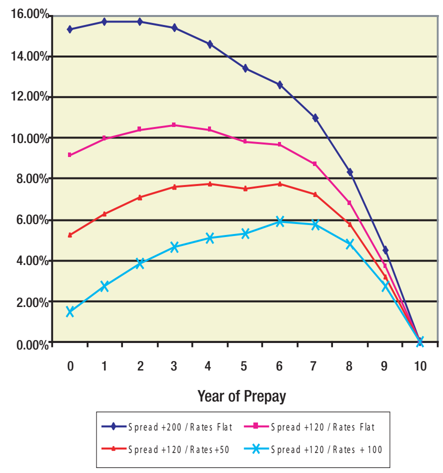
Although no one knows the timing and direction of future interest-rate movements, the current lower levels of Treasury yields leave little room for a significant decrease. The general consensus is that rates will only rise from this point on. Thus, the risk of falling rates leading to a subsequent increase in the amount of the prepayment penalty appears minimal, and the potential of rising rates leading to a decrease in the penalty appears substantial.

The dramatic narrowing of origination spreads over the past few years has resulted in diminishing the magnitude of the prepayment penalties. Lower origination spreads directly reduce the Day One prepayment penalty (i.e. the premium due if the loan were repaid at origination with no movement in rates). This penalty differential persists over the life of the loan.

Assuming interest rates as of March 1, 2006, and a 30-year loan due in 10 years, the following chart demonstrates the yield maintenance prepayment penalties throughout the remaining term, based on historical and current origination spreads and, for today's spreads, instantaneous, parallel interest-rate increases of 50 and 100 basis points:



Using interest rates as of March 1, 2004, when the yield curve was very steep, and the same loan terms as described above, a very different trend over time in the prepayment penalties is readily apparent in the chart below:



Currently, the yield curve is basically flat from six months to 30 years. This provides a strong prepayment benefit to borrowers and eliminates the advantage of short-term floating-rate debt because long-term fixed-rate debt is considerably cheaper. Assuming that this flat (or inverted) yield curve persists—granted, a large assumption—it causes a borrower's prepayment premium to decline almost in a straight line, as in the first chart. Using the earlier interest rates depicted in the second chart, the loan becomes seasoned and the Treasury off which the prepayment penalty is derived becomes a shorter-term, lower-yield security, and the borrower's prepayment penalty actually increases over time.

The total balances of commercial mortgage loans defeased in 2004 and in 2005 were approximately $5 billion and $15 billion, respectively. Among the myriad reasons for this dramatic increase in defeasance is the flattening of the yield curve, which leads to a smaller premium.

To defease a loan, cash flows must be available each month of the remaining term. Treasury securities (usually purchased in the form of Treasury strips) are generally required. In the past, the relatively large difference between the lower yields on the shorter-term Treasury securities and the mortgage coupon was a contributor to the cost of defeasance. However, with the flattening of the yield curve, the differential is not that great. Another potentially significant benefit of defeasance: Should Treasury rates rise above the coupon on the mortgage, it will be possible to prepay the loan at a discount.

There are two other factors not related to capital markets but specifically to the current mortgage market that contribute to the reduced potency of prepayment penalties. These are the increasing flexibility of portfolio lenders to offer shorter-term, fixed-rate loans and prepayment penalties at Treasuries plus a spread, as opposed to Treasuries flat.

All these elements that influence the size of the penalty should influence the types of loans borrowers choose to pursue. A borrower contemplating a short- to medium-term hold but with the possibility of a longer-term ownership may safely lock in long-term, low-rate, fixed-rate financing with the knowledge that any prepayment penalty incurred likely will be outweighed by interest savings during the holding period.

In any event, a borrower should carefully analyze the pros and cons of fixed- versus floating-rate debt from both economic and flexibility perspectives. After all, those old prepayment penalties ain't what they used to be!

Ron Kaminker is president of Condor Capital Advisors. He can be contacted at (310) 272-1390 or ron@condoradvisors.com.

Have an opinion you would like to share?
Contact Suzann D. Silverman at 646-654-4569 or ssilverman@cpngroup.com.