



Prepayment Options for Fixed-Rate Fannie Mae Multifamily Loans

For **fixed-rate loans**, Fannie Mae offers a variety of choices with regard to prepayment options. The low interest rates available through Fannie Mae and other lenders are to a great extent based upon the early prepayment protection created by lockouts, yield maintenance, defeasance, or graduated percentage prepayment penalties. Generally speaking, the greater the call protection, the lower the mortgage rate because the lender, or the investor behind the loan (such as the purchaser of a Mortgage Backed Security, or MBS), is protected from the borrower being able to call the investment away. From the borrower's viewpoint, part of what one is buying when taking a loan (the price for the loan being the interest rate) is optionality; the more options a borrower receives, i.e., the easier the prepayment terms, the higher the cost or interest rate. Following is a brief description of the prepayment options available under the Fannie Mae DUS® program, listed in order of popularity. In every case, the choice must be made and finalized at the time of rate lock and must be reflected in the original loan documents.

Yield Maintenance:

Loans with yield maintenance allow full prepayment of the loan at any time during the term subject to a prepayment premium equal to the greater of 1% or the amount determined by the yield maintenance formula. The formula calculates the present value over the remaining yield maintenance period of the difference between the mortgage note rate and the yield on a specific U.S. Treasury security. The Treasury security, selected at the time of rate lock and specified in the mortgage, matures shortly after the expiration of the yield maintenance period. In theory, the investor in a mortgage with yield maintenance is made whole because it can take the payoff balance plus the prepayment premium and reinvest it in the Treasury security for the same return.

Advantages:

Great Rates: Because of the prepayment protection it provides to investors, and because it has become an industry standard, yield maintenance affords borrowers great low interest rates.

Simplicity: Although the yield maintenance formula involves more complicated math than can be calculated with pencil and paper, it is simple in comparison to defeasance. Yield maintenance has only three variables to identify for input to the formula: the balance at payoff, the remaining yield maintenance period and the current yield on the Treasury (found in the Wall Street Journal). Constants that are pulled from the mortgage include the yield maintenance expiration date, the specified Treasury issue whose yield is part of the formula, and the note rate.

No Lockout: The loan can be prepaid in full at any time. Borrowers planning to prepay early should not opt for yield maintenance, but sometimes value appreciates more quickly than expected and it makes sense for a borrower to sell and take a nice profit despite the prepayment expense. (Fannie Mae does give buyers a free option besides paying off or assuming a low loan-to-price loan: they offer a supplemental loan at first mortgage prices so that buyers can assume the existing loan and leverage the property up to 80% LTV or 1.25 debt coverage ratio.)

Flexibility: Although these terms are not flexible once the choice is made, there are other options up front besides the most common yield maintenance expiration of 6 months prior to maturity. Prior to rate lock, the borrower may choose yield maintenance periods ranging from 3 years to the full loan term.

Disadvantages:

Call Protection that works: Generally speaking, yield maintenance does exactly what it is meant to do: it makes refinancing to capture a low rate unattractive because the lower the rate in the marketplace, the higher the prepayment premium.

What To Look Out For:

All things being equal, the yield maintenance cost will decline as the end of the yield maintenance period draws closer, but all things typically are not equal. When a 10-year loan is originated, the Treasury cited for a loan with yield maintenance is something close to a 10-year Treasury, but when the loan is 8-years old, the Treasury cited will be closer to a 2-year Treasury. All things are equal if the yield curve is flat, but given a yield curve with a sharply positive slope, i.e. low short-term interest rates, the yield maintenance premium can still be onerous due to the greater difference between the mortgage note rate and the short-term Treasury yield. Also, do not assume that all or part of yield maintenance can or will be waived in consideration of new business, as there are usually legal and accounting issues that prohibit the lender from making such concessions.



When Paying The Premium Makes Sense: No-cash-out refinances generally do not make sense for a borrower seeking to pay off a loan with yield maintenance in order to capture a lower fixed rate over the remaining term of the loan being paid off. However, if the refinance loan amount will be much greater than the loan being refinanced, then it can make good economic sense because the borrower will benefit from lower rates on the cash-out amount as well as the dollars that are subject to prepayment premium. Borrowers who firmly believe that rates will rise before their current loan matures might also consider paying yield maintenance in order to lock in a current low interest rate for a period of time extending well beyond the maturity of the loan being paid off.

Defeasance:

Instead of replacing the mortgage loan with a Treasury investment, as is the theory behind yield maintenance, defeased loans actually continue the same anticipated series of payments for the investor. Legally speaking, the loan is not paid off, but practically speaking for the borrower, the loan is paid off because the collateral is released and the borrower's obligation to make future payments is eliminated. In a defeasance, the real estate collateral is replaced by a Fannie Mae security, and the real estate owner (the borrower) is replaced with a new entity that owns the security and is controlled by Fannie Mae. Fannie Mae defeasance is far easier than a conduit loan defeasance because Fannie Mae creates its own security instead of requiring the borrower to pay high commission costs to buy a series of U.S. Treasury securities to replace the stream of mortgage payments. The amount needed to purchase the security is known as the defeasance deposit, and it can be greater or less than the mortgage balance depending upon interest rates at the time of defeasance.

Advantages:

Great Rates: Because of the call protection it provides and broad market acceptance, loans subject to defeasance offer excellent low mortgage rates. Typically, the rates are at least as good as those with comparable yield maintenance periods, and at times are 5 to 10 basis points lower.

Potential Payoff at a Discount: Unlike yield maintenance, which has a minimum 1% prepayment premium, if interest rates are higher at the time of defeasance than they were when the mortgage was originated, it is actually possible for the loan to be "paid off" at a discount to the principal balance.

Low Cost Compared to Conduits: Conduit loan defeasance can be very costly and difficult because of the many moving parts. Fannie Mae defeasance involves no brokerage commissions and very low legal fees because Fannie Mae provides the security and controls the process.

Disadvantages:

Three-year lockout: Loans subject to defeasance may not be paid off during the first three years.

Hard to Calculate: Because the defeasance deposit is based upon the yields of many different Treasury securities, there are far more variables involved effectively making it impossible for a borrower to accurately estimate defeasance costs on its own. Fannie Mae will provide a close approximation of the size of the defeasance deposit within a few days of the borrower's request to Red Mortgage Capital, however.

Additional 1% Fee: In addition to the defeasance deposit, the borrower must pay a 1% fee to Fannie Mae at the time of defeasance. Fannie Mae will waive this fee if it is refinancing the loan; if it is not waived, it can make the difference between whether defeasance provides a lower-cost prepayment than yield maintenance. If rates are high enough that the defeasance deposit is, say, 98% of the loan balance, then it is still possible to pay off the loan for less than par (i.e., 99% of par) even with the additional 1%.

What To Look Out For:

Defeasance costs are highly volatile due both to general interest rate movements and to changes in the shape of the yield curve. If the curve is fairly flat and rates are higher at the time of defeasance than when the loan was originated, defeasance will often be cheaper than yield maintenance, but this might not be true if the yield curve steepens or if the additional 1% must be paid to Fannie Mae. Also, the borrower must put up a good faith deposit for the purchase of the security and commit to the defeasance in advance of the payoff. In the instance of the defeasance of a property being sold, the borrower/seller subjects itself to the risk of an additional sunk cost (the good faith deposit) should the buyer fail to close, unless this risk is passed through to the buyer under the terms of a contract with non-refundable earnest money.

When Paying The Premium Makes Sense:

Like yield maintenance, defeasance makes refinancing for better rate on the same loan balance unattractive but it can make sense to pay a defeasance deposit in excess of the loan balance if the refinance loan is greater in size than the old loan or if the borrower's goal is to lock in current rates for a term well beyond the remaining term of the loan being refinanced. Also, although one wouldn't typically be refinancing a loan if interest rates had gone up, there might be other reasons to pay off a loan, such as a sale to a non-leveraged buyer or a condo converter, that would enable a borrower to take advantage of being able to pay off a defeasance loan at less than par.



Graduated Prepayment Loans:

Although not very popular because of their higher interest rates, due to lesser call protection, Fixed Rate Graduated Prepayment Loans are also offered by Fannie Mae. These loans are available for 5-, 7-, and 10-year terms only and have penalties that gradually decline from 5% to 1% over the loan term.

Advantages:

Simplicity: Anyone can calculate these prepayment premiums with pencil and paper.

Predictability: Borrowers can plan in advance because the prepayment premium does not fluctuate with changes in interest rates.

Optionality: Whereas borrowers electing yield maintenance or defeasance are generally eliminating the option to refinance for the sole purpose of lowering rate, borrowers with this structure leave a great many more options open. Not only can they economically refinance if rates go down by a quantifiable level, but they also have more options in terms of being able to sell the property free and clear allowing a purchaser to convert to condo or to put on fresh market-rate financing instead of requiring an assumption to avoid a perhaps onerous prepayment charge that is hard to calculate.

Disadvantages:

Interest rates are higher, but are worth considering given the benefit of options retained.

What To Look Out For:

Seven year loans are locked out for the first two years, followed by a 5,4,3,2,1 percent prepayment penalty in each of the following years. Also, while the prepayment premium will not increase if rates go down in the market, it also will not decrease if rates go up.

When Paying The Premium Makes Sense:

This is very easy to calculate if one just compares the payments at current refinance rates on the outstanding loan balance plus closing and prepayment premium to the payments on the old loan. As a very general rule, if rates at 100 basis points below the old loan rate are available, it will make sense to refinance. Often the prepayment penalty can be rolled into the new mortgage amount, which makes the savings even more easily measured by comparing the new and old mortgage payments.

Conclusion:

The foregoing is a brief description of various prepayment premium options that can be elected prior to rate locking a Fannie Mae loan for conventional market-rate apartments. Advantages and disadvantages pointed out are the observations of experienced Red Capital bankers and do not constitute guarantees or representations of any kind. The executed Fannie Mae loan documents represent the entire agreement of the parties regarding the terms of any loan. Circumstances may arise which present advantages or disadvantages which are not outlined above. Borrowers are encouraged to make their own determinations as to when or whether prepaying with a penalty makes sense, pursuant to each borrower's own investment plans and thoughts about interest rate trends. Fannie Mae loan documents evolve over time and in all cases borrowers should review their own loan documents and make their own calculations as to the impact of any particular agreement regarding prepayment provisions.

We hope this description of the various options provides some assistance, and our bankers will provide additional assistance if you call with any questions.

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