"PREPAYMENT POSES A SPECIAL RISK TO A CERTAIN GROUP OF INVESTORS IN CMBS. THOSE INVESTORS ARE THE PURCHASERS OF 'INTEREST-ONLY' STRIPS."

Prepayment Disincentives in Securitized Commercial Loans

By George Lefcoe

Like bonds with call provisions, mortgages allowing prepayment at will are less valuable to investors. As a result, commercial lenders seek to reduce the risk of prepayment through various disincentives in notes. Lenders that are accustomed to retaining in their own portfolios the loans that they originated have long used prepayment disincentives, such as lockouts, capped fees and yield maintenance provisions. Investors in commercial mortgage-backed securities (CMBS) find some of these prepayment disincentives unacceptable. To accommodate CMBS investors, originating lenders have added defeasance to the traditional menu of prepayment disincentives. This article compares the various prepayment disincentives from the viewpoints of borrowers and mortgage investors and summarizes the results of legal challenges to their enforceability.

Prepayment Risks to Mortgage Investors

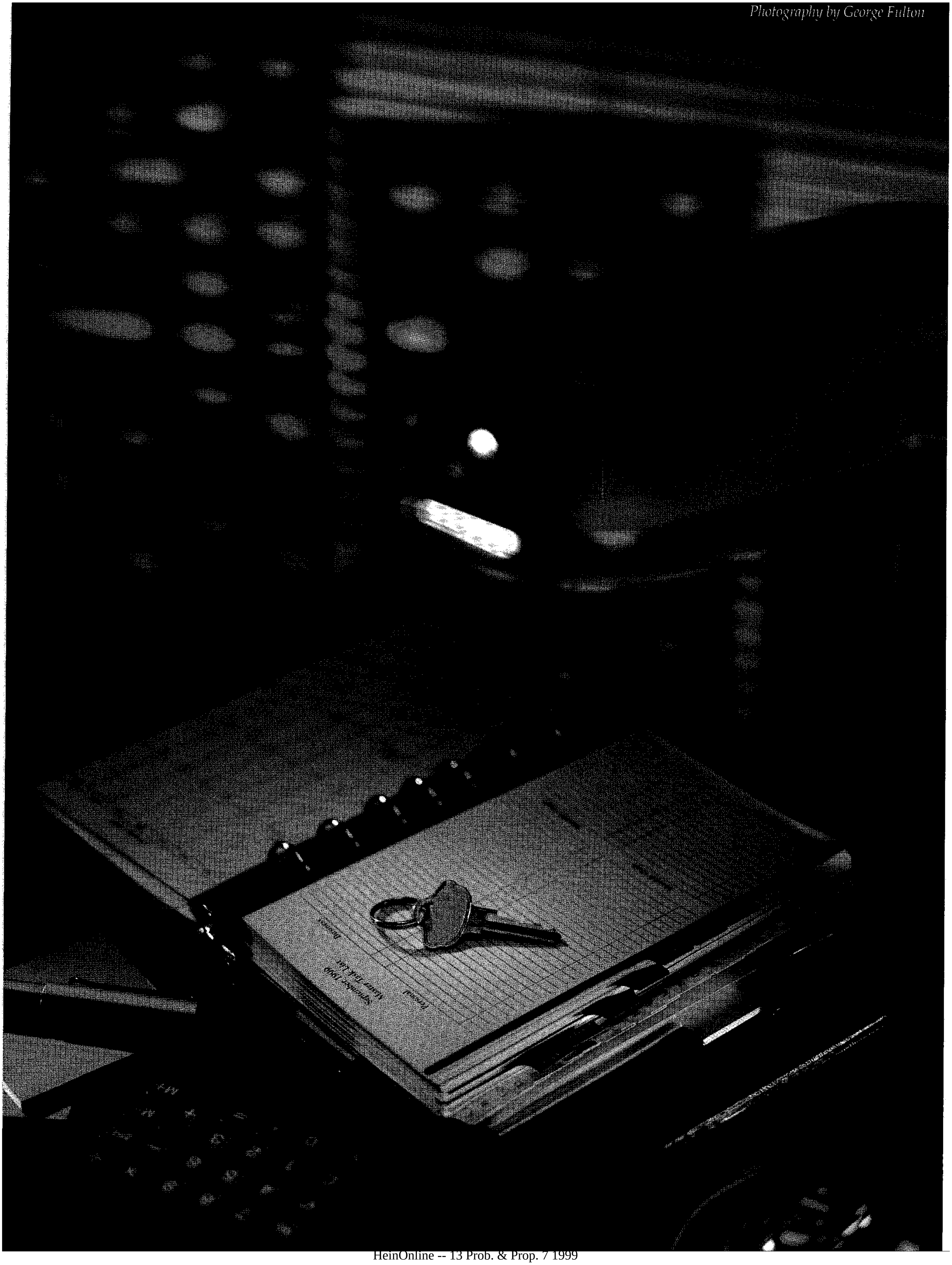
The risks of prepayment to mortgage investors are well known. Prepayments on long-term, fixed rate loans increase when rates go down and decrease when rates go up. Lenders' yields decline as untimely prepayments force them to reinvest loans at prevailing lower rates. Because the loans originated when rates were higher, the borrowers' prepayments remove appreciated assets from the lenders' portfolios. Compounding the lenders' interest rate risk, borrowers who would normally prepay loans in six or seven years keep loans longer as interest rates rise.

Prepayment poses a special risk to a certain group of investors in CMBS. Those investors are the purchasers of "interest-only" strips. The purchasers of interest-only strips contract to receive the difference between the average interest rate pledged by mortgagors and the weighted average yield investors pay for the right to receive those mortgage payments for a particular tranche. ("Tranche" is French for "slice.") According to Scott L. N. Davidson, Managing Director of CMBS for Chase Securities, Inc., these investors are especially important to issuers of securitized mortgages. A great deal of an issuer's profit comes from what the purchasers of interest-only strips are willing to pay. Purchasers of interest-only strips stand to lose their entire investment when mortgage loans are prepaid.

Consider this simple example. A mortgage securitization consists of only one underlying mortgage of $50 million with interest at 8%. The issuer creates an A tranche and a B tranche. The A tranche investor buys the right to receive the first principal and interest payments at 7% on $30 million. The B tranche investor buys the right to receive principal and interest payments on $20 million at 7.7%. Finally, the issuer sells to C an interest-only strip for the 1% premium on the A tranche—the difference between the mortgagor's interest rate and the A tranche investor's promised return.

One day following C's purchase, the mortgagor prepays. Both A and B will be fully repaid. The mortgagor's obligation to pay interest ceases with prepayment. C will get nothing, unless the borrower is obligated for a prepayment fee and the issuer has given C the right to receive it.

Each mortgage-backed securities issue designates the distribution of



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prepayment penalties. Although the odds are good that the mortgage calls for a prepayment fee, A, B and C will likely share it. C factors the chance of uncompensated prepayment into its decision about how much to pay for the interest-only strip. The greater C's share of the prepayment penalty and the greater the limitations on the mortgagor's prepayment right, the less C discounts its purchase price for prepayment risk.

Contract Limitations on the Right to Prepay

FNMA and FHLMC require that homeowners be given the right to prepay freely at any time without prepayment penalty, but lenders are unconstrained in their right to limit prepayments of commercial loans. The right to prepay is a borrower's call option, which many lenders are willing to sell for a price—an upfront fee or a higher mortgage interest rate. Otherwise, lenders on most commercial, fixed rate loans limit the borrower's right to prepay in one or more of the following ways.

• **Lockouts.** The most effective deterrent to voluntary prepayment is an absolute prohibition, called a "lockout." Lockouts are commonly found in loans with maturities of less than five years. Loans with a duration of longer than five years are sometimes written with lockouts for the first three to five years, followed by a yield maintenance or defeasance provision. Lockouts longer than five years are vigorously resisted by most commercial borrowers, which depend on being able to capture appreciating value by either selling or refinancing.

• **Capped fees.** A prepayment fee formula common to many home and commercial mortgages, enshrined in the 1971 FNMA/FHLMC single-family note, was six months' interest on the prepaid loan balance, except that the borrower could freely prepay up to 20% of the original principal amount in any 12 month period. This formula later appeared in the regulations of the Federal Home Loan Bank Board that govern allowable prepayment fees in home loans by savings and loan associations. Another popular "capped fee" formula charges a percentage of the prepaid loan balance, typically on a declining scale, such as 5% of the prepaid sum if paid in year one, 4% in year two and so forth. It is often dubbed a "5-4-3-2-1" fee. Less restrictive than a lockout, these fees discourage prepayment unless interest rates have fallen so far below the contract rate as to offset the fee plus refinancing costs. Further, these fees apply even when the prepaid contract rate is below the current market rate.

• **Yield maintenance.** Yield maintenance provisions are intended to insure that the lender suffers no reinvestment loss when borrowers prepay to take advantage of declining interest rates. The lender assesses a borrower who is voluntarily prepaying a fee sufficient to enable the investor, reinvesting at current rates, to earn what it would have earned had the borrower not prepaid. The fee equals the difference, usually discounted to present value, between the original contract rate and the current market rate multiplied by the amount prepaid.

Each yield maintenance clause specifies its own definitions of "original yield" and "current yield," with substantial impact on the cost of prepayment. The FHLMC multi-family note defines "current yield" (labeled the "assumed reinvestment rate") as the rate on Treasury obligations of comparable maturity to the loan being prepaid and "original yield" as the note contract rate. Because mortgage rates are always greater than the rate on U.S. Treasuries of comparable maturities, rates must rise by the amount of the "spread" before the borrower can prepay for free under this formula. When the "current yield" exceeds the "original yield," borrowers prepay for free.

Lowering the bar to free prepayment, some formulas compare "original yield" and "current yield" on rates for investments of identical quality, either by subtracting current mortgage interest rates from the investor's original contract rate or current Treasury rates from a Treasury rate based "original yield."

Prepayment of Below Market Rate Loans

According to Mr. Davidson, mortgage investment analysts have faulted yield maintenance clauses for undervaluing the risk that commercial borrowers will prepay even when current yields exceed the original yield. Although homeowners try to avoid prepaying below market loans, commercial borrowers are less likely to be similarly deterred.

Consider this example. A real estate developer needs $5 million to finance an apartment development. It can borrow $4 million on an acquisition, development and construction loan. To obtain the $1 million shortfall, it will refinance an older project, presently subject to a $3 million mortgage at 7%, despite the fact that current mortgage rates are 9%. Trading a 7% loan for a 9% loan on $3 million may increase its interest cost by up to $60,000 a year. In this case, however, the developer believes that it will earn a $250,000 construction fee on the apartment project and an annual $40,000 management fee and that, on completion, its equity in the new development will be worth $2 million. As this example illustrates, commercial borrowers are motivated by calculations much more complex than mere interest rate sensitivity—calculations that are far more difficult to model than homeowners' decisions to prepay.

There is a second reason that mortgage investment analysts caution against allowing free prepayment when current rates exceed the contract rate. Prepayment is a blessing for the portfolio lender and mortgage investor receiving the prepayment because they will be able to reinvest at current rates. But the holder of the interest-only strip loses everything, as interest payments cease on the prepaid sum.

Defeasance

Corporations use an arrangement called "in substance defeasance" to remove bonds from their books. The corporation buys matching Treasury obligations and places them in trust to make the remaining payments on the debt. The bonds are not immediately retired when the corporation acquires the Treasury obligations. Because the debt has not been legally retired, the corporation has no right to terminate its bond obligations unilaterally. For accounting purposes, though, the bond obligation is removed from the corporation's books. When interest rates have risen enough that the corporation can purchase Treasuries for less than the face value of the bonds, the savings are reported as corporate earnings in the year of purchase. Executives whose compensation depends on earnings are benefited, as are bondholders whose corporate bonds have been funded by much safer Treasury obligations. No diminution in stock prices seems to accompany these transactions, apparently because they form a small part of the typical corporation's operations. See James M. Johnson, Robert A. Pari & Leonard Rosenthal, *The Impact of In-Substance Defeasance on Bondholder and Shareholder Wealth*, 44 J. Fin. 1049 (1989).

Commercial mortgages, modeled after the corporate arrangement, may provide for a "defeasance," which requires the borrower to purchase U.S. government obligations for the mortgagee's benefit that precisely match the interest and principal payments on the scheduled mortgage. The mortgagee accepts the Treasury obligations as substitute security and releases its lien on the mortgaged property. All investors in the securitized pool continue receiving their payments on schedule, including purchasers of interest-only strips. The cash keeps flowing but from U.S. Treasury obligations, not a mortgage, increasing the value of the investment by the amount by which investors prefer government bonds to mortgages.

Organizing a defeasance can be a challenge, complicated by the fact that mortgage payments usually call for monthly amortization and Treasury obligations do not. Mortgagors refinancing substantial sums with loans from major commercial banks may be able to persuade the bank to organize the defeasance. Other mortgagors may require the assistance of a paid intermediary.

Comparing Defeasance to Yield Maintenance

Compared to yield maintenance clauses, a defeasance only marginally disadvantages a mortgagor that prepays when rates have fallen. Instead of paying a yield maintenance fee plus the balance due on the debt, the mortgagor purchases government securities in an equivalent sum. If the loan documents require a defeasance and rates are significantly above the contract rate, a borrower that would have been entitled to prepay without charge under a yield maintenance clause will be shopping for Treasuries. As a consolation, if interest rates have risen enough to offset the spread between the borrower's interest rate and current Treasury yields, the borrower will be able to defease with Treasuries presently worth less than the loan balance. A defeasance burdened borrower is penalized by having to finance the spread between Treasury and mortgage rates.

Why the spread? The spread could be eliminated if the mortgagor were allowed to substitute a mortgage of comparable quality in place of the one being prepaid, as several commentators have proposed. Cf. Restatement (Third) of Property (Mortgages) § 6.2(b) (1996) (providing for substitute security). Among portfolio lenders, there is no agreed system for rating the quality of mortgage loans. Prepaying mortgagors might find themselves in disputes familiar to tenants trying to

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assign a lease that requires the lessor's consent. No similar contest over mortgage quality is necessary in CMBS transactions because rating agencies evaluate the quality of mortgage loans, monitor portfolios continuously and are well positioned to determine the comparability of a substitute mortgage.

Another significant impediment exists, however, to the acceptance of a substitute mortgage in a CMBS transaction. To avoid taxation of earnings at the entity level, almost all CMBS are organized as real estate mortgage investment conduits (REMICs). A substituted mortgage would not qualify for REMIC tax status. Unwelcome tax consequences are avoided only if government securities are substituted as collateral, and then only two years after startup. 26 C.F.R. pt. 1, § 1.860G-2(a)(8). An alternative pass-through entity, or financial asset securitization investment trust (FASIT), allows substitution of secured debts. But FASITs are rare in the CMBS market. See generally William A. Wurch, *The FASITnating Facets of FASITs*, 11 Prob. & Prop. 21 (Nov./Dec. 1997). Because of the tax consequences, REMIC securitized mortgages with defeasance provisions usually come with a lockout in the first two years.

Enforceability of Prepayment Disincentives: Lockouts

Except in bankruptcy, courts almost always enforce lockout prohibitions. See Dale A. Whitman, *Mortgage Prepayment Clauses: An Economic and Legal Analysis*, 40 UCLA L. Rev. 851, 866 (1992)(Whitman). Lockout provisions are enforced even though an award of money damages, not specific performance, is the preferred remedy for a contract breach concerning the payment of money. The primacy of money damages is rationalized by reference to the theory of efficient breach. As long as the nonbreaching party receives a sum sufficient to purchase equivalent performance, there is no reason to deny the breaching party the right to exit the contract. Money damages would seldom suffice, however, to compensate the issuers of securitized debt. The issuers would lose the confidence of investors if cash flows diminished or ceased due to prepayments made during the lockout period. See *Continental Secs. Corp. v. Shenandoah Nursing Home Partnership*, 188 B.R. 205 (W.D. Va. 1995).

Bankruptcy judges normally disregard lockouts when prepayment is necessary to fulfill a confirmed reorganization plan. A bankruptcy court's "equitable power to fashion an appropriate reorganization plan almost certainly trumps a contract provision." *Continental Securities*, 188 B.R. at 215. Exacerbating the secured creditor's loss, a bankruptcy court that overrides a lockout may deny the lender compensatory damage unless the lender specifically reserved in the note the right to a "backup" fee.

Prepayment Fees

A strict application of familiar liquidated damage principles would prohibit lenders from assessing prepayment charges of any kind, because actual damages are readily calculated by comparing contract with actual interest rates at the prepay date. A more relaxed application of the principles would dictate only that the estimate of damages reasonably account for the lender's likely damage in the event of breach. Applying this standard, portfolio lenders would have no right to charge for the prepayment of below-market loans. They could more than offset any actual damage by reinvesting at current rates.

Most courts reject the application of liquidated damage rules to prepayment provisions. They decline to characterize prepayment as a breach. Instead, they accept the mortgage investment communities' explanation of it as an option, like call provisions in a bond, a risk properly allocated between the parties when the contract is formed and not to be undone in court after the fact. State courts have routinely enforced prepayment fee provisions, rejecting arguments that they are usurious or unconscionable, constitute restraints on alienation or are invalid liquidated damage provisions. See Whitman at 859.

Some bankruptcy courts, however, regularly construe prepayment as a breach of the borrower's obligation to pay exactly on time and have rigorously applied liquidated damage rules in assessing the reasonableness of prepayment provisions. Other bankruptcy courts have simply declared prepayment fees exceeding the lender's actual loss to be unreasonable and, hence, disallowed, under Bankruptcy Code § 506(b). An academic critic contended that refusal to enforce prepayment fee provisions would raise interest rates. Frank S. Alexander, *Mortgage Prepayment: The Trial of Common Sense*, 72 Cornell L. Rev. 288, 328-43 (1987). In response, a bankruptcy court explained that:

> uncertainty about the validity of prepayment charges does not make the maturity date of such investments less predictable . . . prepayment will still occur. . . . Application of the liquidated damages rule to prepayment charges affects only the validity of the charges themselves, not the likelihood that a stream of periodic payments from a pool of mortgage notes will or will not continue.

In re A.J. Lane & Co., 113 B.R. 821, 829-30 (Bankr. D. Mass. 1990). The court's response disregards the demonstrated impact that prepayment disincentives have on the incidence of prepayment. Jesse M. Abraham & H. Scott Theobald, *Commercial Mortgage Prepayments*, The Handbook of Commercial Mortgage-Backed Securities (Fabiozzi and Jacob eds., 1977) 55, 68.

Bankruptcy courts have stricken the "5-4-3-2-1" and "six months' interest" formulas as bearing no reasonable relationship to the lenders' actual or probable loss in the event of prepayment. See *In re Imperial Coronado Partners, Ltd.*, 96 B.R. 997, 1001 (Bankr. 9th Cir. 1988). Yield maintenance clauses that subtract the current rate on a U.S. Treasury obligation from the contract rate on a mortgage, or that fail to discount the lost interest yield to present value, overcompensate lenders. On that basis, courts have refused to enforce them. See, e.g., *In re A.J. Lane & Co.*, 113 B.R. 821; *In re Skyler Ridge*, 80 B.R. 500 (Bankr. C.D. Cal. 1987). But see *In re Financial Ctr. Assocs. of East Meadow v. TNE Funding Corp.*, 140 B.R. 829 (Bankr. E.D.N.Y. 1992) (upholding use of Treasury bond rate to measure "current yield").

Although no reported bankruptcy cases have applied liquidated damage rules to mortgage defeasance provisions, they are just as vulnerable because defeasance calls for prepaying borrowers to substitute Treasury obligations for mortgages, instead of providing a substitute property of equivalent risk. Defeasance is also objectionable because it applies even to borrowers prepaying below-market notes.

There is no evidence that mortgage investors reformulate prepayment provisions to make them more acceptable to bankruptcy courts. The investors' emphasis seems to have been on making mortgagors bankruptcy-remote, given that mortgage investors stand to lose a great deal more in bankruptcy than their prepayment fees.

Conclusion

For CMBS investors, lockouts and defeasance top the other prepayment disincentives by keeping the cash flowing. For borrowers, anything beats a lockout. In bankruptcy, the only prepayment disincentive likely to survive unscathed is a yield maintenance formula measuring the actual damages of a prepaid portfolio lender. That will often prove to be the commercial borrower's best bet as well, except when interest rates plummet. Then, a fixed cap formula like "six months' interest" or "5-4-3-2-1" could be better for the borrower.

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With due apology to Hans Holbein the Younger
(1497-1543)