

Prepayment Penalties



-Debbie Yost

I imagine buying a property, owning it for a few years and then you decide to sell or refinance it, and the lender charges you a penalty for paying off the loan early! In recent weeks, I've seen more and more prepayment penalties, and in almost every case the property owner did not remember signing loan documents that included such a penalty.

Prepayment penalties, or prepayment "premiums" as some lenders are choosing to call them, are being used to discourage homeowners from refinancing their loans at a lower interest rate. Many people have found it advantageous to refinance their home loan multiple times as interest rates dropped lower and lower. The lenders counter that they have invested their money and expect a financial return based on the money earning that rate of interest for a specified time.

Many loan documents include prepayment penalties if the loan is refinanced within the first two years. After two years the loan may be refinanced without paying a penalty, or if the property is sold to another buyer the prepayment penalty will be waived. Sometimes lenders will insist on charging the prepayment penalty, and will only refund the amount of the penalty after receiving proof that the property was sold to a new buyer and the new deed recorded. Of course, the homeowner or their representative will need to remind the lender of the exact terms as stated in the original loan documents, or the prepayment penalty will be collected at closing.

The amount of these prepayment penalties can vary. Typically I've seen penalties as low as 1% of the unpaid principle balance or six months of interest on the unpaid balance. On a loan amount of \$100,000 these fees will range from \$1000 to \$3000. However, the most obscene abuse of a prepayment penalty is with a client we are working with now who has given me permission to write about her situation, without names, of course. The prepayment penalty charged by her lender is \$40,000 on a \$212,000 loan balance!!! YIKES!!! Yes, this client has retained an attorney to try to reduce this penalty, but the bottom line is that this prepayment penalty was disclosed in the loan documents. Even though this penalty was written in such confusing language that only a mathematician could understand and calculate it, the penalty was disclosed in the loan documents.

Why do so many people sign loan documents with prepayment penalties? In some cases, particularly if the property is an investment property, the investor decides they prefer the lower interest rate and will hold the property past the time when a prepayment penalty can be charged. However, in most cases, the client signed their documents without thoroughly reading and understanding them. Unfortunately, for every hardworking loan officer with integrity, there is another willing to tell the homebuyer anything they want to hear, counting on the fact that most buyers are so anxious and rushed at the close of escrow, they won't thoroughly read the loan documents, and if they do read them and are unhappy with the loan terms they won't have time to switch lenders and find

another loan at the last minute.

I've talked to so many smart people who make poor decisions when they borrow money or sign legal documents. In the case of the client with the ridiculously large prepayment penalty, she told me the loan documents were delivered at the last minute and they didn't have the time to thoroughly read them, so they signed them as is.

I have another client who decided to apply for a home equity loan on the internet after seeing a promising TV ad offering fast internet loan application and approval. When it came time to sign her loan documents, not only were they not even close to the original loan amount and terms they applied for, but since they had already made commitments to spend the money from the loan, they just signed the documents and closed the loan.

These clients are smart people. Why were they so easily deceived? I think it boils down to a few basic policies we all need to remember as consumers: 1. If someone's sales pitch sounds too good to be true, it probably is. 2. Don't sign legal documents if you haven't read them and thoroughly understand them. 3. Don't let the excitement of the moment (closing on the new house) convince you to accept less than what you expected or were promised. 4. You get what you pay for. Buying or selling a home is frequently your largest financial asset. Don't take the cheapest route when looking for advice. Frequently you'll be making an expensive mistake.

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