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Hedging Prepayment Penalties

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There is a way to hedge against falling rates – swaptions. Simply put, a swaption is a call option on swap rates.

Generally, swaptions are used to hedge against rising rates. For example, you're locking in a CMBS deal in 45 days but are worried rates will move up between now and then. The 10 year swap rate is 2.10%, and you don't want anything above 2.25%. Buy a call option on 10 year swap rates that hedges for any rate movements above 2.25%.

But swaptions can also hedge against falling rates to protect against a prepayment penalty from spiking.

Let's assume you have a $25mm loan with 3 years remaining and a signed agreement to sell the property. For each basis point drop in 3 year rates, your prepayment penalty increases by approximately $7,500. If the 3 year swap rate today is 1.85%, and it falls to 1.45% before closing, your prepayment penalty would rise almost $300,000. That's a problem.

Here's a solution. Buy a swaption today that will hedge against any further drop in 3 year swap rates between now and August 1 (your projected closing). You pay an upfront $110k for this option.

On August 1, here's what the settlement looks like.

- If 3 year swap rates are above 1.85%, the option expires worthless and you are just out the $110k you paid upfront
    - You would simply lock in your prepayment using the higher rate
- If 3 year swap rates are below 1.85%, you exercise the option and the hedge provider pays you the pv difference between the strike and swap rate
    - You would still have a higher prepayment on the actual payoff, but would use the payment from the hedge provider to offset the penalty

In both scenarios, what you pay on the actual prepayment penalty fluctuates with the market movements. But if rates fall, you receive an offsetting payment from the hedge provider, helping to wash out that decline in rates. The upfront cost is driven by the strike (the lower the strike, the cheaper it costs) as well as the tenor (the shorter the remaining term on your loan, the cheaper the cost).

This is obviously a very simplistic explanation and we would need to spend more time to walk through the risks and considerations, but that is the basic gist. And while swaptions hedge swap rates, they also are highly effective (but not perfect) hedge against Treasury yields, so they work well with defeasance and yield maintenance.

Here's our white paper on the topic if you want to dig in further.

https://www.pensford.com/resources/swaptions-101

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