THE DEADLY DOZEN – Part I

By Patrick Niland

Don't fall victim to these mistakes when refinancing your co-op's underlying mortgage.

Anyone who closed a new underlying mortgage loan around October 1998 has every reason to smile. That's when interest rates dropped to a 31-year low, fueling a refinancing boom that only now is tapering off. Many boards took advantage of this historic opportunity to lock in rock-bottom rates for long terms. Some co-ops were able to borrow significant additional funds to pay for major capital improvements without any increase in shareholder maintenance, just because their old monthly payment covered their new debt service at the lower interest rate.

Unfortunately, some boards squandered this wonderful opportunity, either by rushing blindly after what they thought was the lowest rate (at the expense of other crucial terms) or by waiting so long for rates to fall even lower that they "missed the boat" entirely. Other unlucky boards have discovered (too late) that their new loan does not quite meet their needs. They now realize that they should have spent more time planning their refinancing and should have involved all of their professional advisors much earlier in the process. This certainly is an important lesson for the future. Unfortunately, they now are stuck with their mistake for many years.

So, don't jeopardize your shareholders' future by failing to involve your full professional team in your refinancing effort right from the start. If you don't, you might make one (or more) of the following mistakes:

(1) *Starting too early.*

Often, boards start "shopping" for a new loan long before they actually need it. In the classic case, several shareholders are appointed to a "finance committee" which is expected to "research the market" and report back to the full board on what loans are available for their building. These energetic committee members call every lender they can find in the yellow pages, newspaper ads, and late-night TV commercials. Over the next several months, they collect quotes from most of these lenders. In addition, at least one committee member has heard of a mortgage broker from whom a few more quotes are collected.

Then, the most computer-literate member of the committee arranges all of the quotes on a massive spreadsheet for review by the full board at the following month's meeting. After much discussion, board members start treating the spreadsheet like the menu at a Chinese restaurant, selecting desirable terms from column A to combine with the most favorable terms in column B, and so on. The board president then asks the finance committee to recontact all lenders for revised quotes based on this new set of reconfigured parameters.

This cycle may be repeated several times before the board settles on what it wants. Unfortunately, by that time, the various quotes solicited over the previous several months are invalid because the market has changed. More problematic, however, is the fact that all of this "shopping" by members of the "finance committee" has contaminated the market for their building. Loan officers, contacted repeatedly by committee members or wild-card brokers, concluded long ago that this co-op was " just shopping" and not really serious about a new loan. To be labeled a "shopper" is the kiss of death from a loan officer. Don't ever let it happen to *your* building.

(2) *Waiting too long.*

At the other end of the timeline are those co-op boards who don't start looking for a new mortgage until the very last months of their existing loan. In some cases, the existing loan has a very attractive interest rate that the board would like to enjoy for as long as possible. As understandable as that might be, these boards are forfeiting much of their negotiating power with lenders by waiting to the last minute. If a loan officer thinks that board members are desperate for a new loan, he will have little incentive to be competitive in his pricing. Therefore, boards should have their refinancing process well under way *at least* six to nine months before the maturity of their existing loan. And this is true even if you plan to "roll-over" with your *existing* lender.

(3) *Not borrowing enough.*

This is by far the most costly mistake that a board can make when refinancing. Many boards are extremely short-sighted when planning their new loan. They focus only on the money they need *immediately*, forgetting (or ignoring) the fact that capital repairs might be necessary later on during the life of their new loan. After a new loan closes, it is very difficult (and, sometimes, impossible) to get more money – even from the new lender. Then, when the future need inevitably arises, the board could be forced too assess its shareholders for the full amount needed or pay a hefty prepayment penalty (plus new closing costs) to raise the extra money by refinancing their entire loan once again.

(4) *Borrowing too much*.

Of course, there are those board members who get carried away by the smell of money and borrow much more than they need – just for the sake of having a fat reserve fund. The problem with big reserves is that boards almost always find a way to spend them, either for things the co-op doesn't really need or to avoid raising maintenance. Many troubled cooperatives got that way because they borrowed too much in past refinancings. As other costs increased, their debt load became too much for shareholders to carry. One shareholder default led to another and, before long, the whole building was in trouble. In today's tough economic climate, it is essential that board members carefully assess their building's true needs and not borrow extra money for frivolous expenditures – no matter how low today's rates may seem.

(5) *Interest rate myopia*.

Too many board members still think that "rate" is the most important part of their new loan. Some obsessive souls will jump from one lender to another just to save a few basis points (remember, a basis point is just one *one-hundredth* of 1.00%). This obsession with interest rate blinds them to other important aspects whose costs easily could dwarf whatever savings they might achieve from a lower rate. Moreover, the particular circumstances of individual cooperatives can make other loan terms much more significant.

For example: If you lower the interest rate on a $1 million loan by an eighth of a point (i.e., by 12.5 basis points), you will save your co-op about $1,250 per year in interest. While certainly worthwhile, that amount pales beside the $30,000 to $40,000 cost of refinancing a poorly-structured loan – or the $40,000 to $50,000 (or more) penalty associated with prepaying your existing loan before its due date as part of that restructuring. Par ("no point") loans, loans without escrows, those with longer amortization schedules or better prepayment provisions, and those providing credit lines or allowing subordinate financing, all can be "better deals" despite their higher interest rates. Don't forget: It's the total *package* of terms that counts, not just the rate.