SELF-LIQUIDATING LOANS

By Patrick Niland

The image of taking a match to a paid-off mortgage is woven into the American psyche, and this notion drives many co-op boards to seek self-liquidating loans. However, for most co-ops, a self-liquidating loan...that is, a loan that pays itself off over its life...is financially feasible only if the loan has a 25- or 30-year term. Shorter-term self-liquidating loans have much higher monthly payments that few co-ops can afford.

But, what's wrong with a 25- or 30-year fixed-rate loan? I see four disadvantages:

First, no one can predict, with any degree of certainty, what will happen over the next 25 or 30 years. Therefore, why would anyone want to lock their building into a capital structure for such a long period when changes in their building's financial and physical needs are virtually guaranteed? Remember, most co-op buildings in the greater New York area are old enough to require major repairs every 7 to 12 years. If a building has a long-term loan, where will the board get the money for those repairs without paying a huge prepayment penalty? Higher maintenance and assessments are not always possible.

The second reason I don't recommend long-term loans is cost. In today's financial market, the interest rate on a 30-year self-liquidating loan is almost 2% higher than the rate on a more typical 10-year loan with 30-year amortization. That extra interest really adds up over 25 or 30 years.

The third reason I discourage long-term loans is the prevailing wisdom of cooperators themselves. In more than 30 years of helping boards arrange new financing, I have closed just two of these loans...and each of those was due to very special circumstances. Every other board felt that a long-term loan was not in the best financial interest of their shareholders. That's a lot of smart people who independently came to the same conclusion.

The fourth reason is experience. Every year, I work with several boards who desperately need funding for emergency repairs but are stymied by the terms of their existing long-term loan. In many cases, their only option is a very onerous prepayment penalty and an expensive premature refinancing...most of which could have been avoided had an earlier board made a better financing decision.

So, unless your building has a very special circumstance, there are much better options than a 25- or 30-year self-liquidating loan.