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Understanding Hard and Soft Prepayment Penalties

In the mortgage world, you will often come across loan clauses called prepayment penalties. A prepayment penalty is inserted into a mortgage loan in order to deter a borrower from selling or refinancing within a short period of time. If the borrower does decide to pay back the loan earlier than the original terms called for, a prepayment penalty clause will require him to pay the lender an additional fee. This charge may vary from lender to lender, but a good average estimate is about six months worth of interest.

Why do these clauses even exist? Isn’t it in the best interest of both lender and borrower if the loan gets repaid quickly? Actually, no. The lender suffers if the borrower pays of the loan early, as he will lose money from the anticipated interest fees. While this might sound like the result of pure greed on the part of the lender, in many cases it is more about simply recovering enough money to cover the services rendered. Lenders put a lot of time and money into creating a loan with the hopes that they will make a good return on the investment. If the borrower repays the loan too quickly, he may not have made enough interest payments to cover the expenses incurred by the lender. Therefore, penalty periods are generally one, two, or three years long.

There are two types of prepayment penalties, hard and soft. A hard prepayment penalty is the stricter of the two and requires a penalty fee if the borrower sells or refinances his home before the set time has lapsed. A soft prepayment penalty restricts the borrower only from refinancing the property before the time period is up; otherwise he is liable to pay the fee. With this type of penalty, the home could be sold at any time after the close of the first loan without incurring the extra fees.

Even so, with most home loans prepayment penalties are only optional. Generally, borrowers and lenders can decide on a penalty term of one, two, or three years. The reason a prepayment penalty clause might be favorable for a borrower is that lenders generally will offer a lower interest rate. This is because they are securing themselves against losses from early repayment. So you will get the best rate by choosing a hard prepayment penalty with the longest term, three years. Your rate would be incrementally higher for shorter terms or with a soft prepayment penalty, but choosing to go with any form of prepayment clause will typically produce a better rate then opting out of the penalty.

A hard prepayment penalty might be a wise choice for you, if you plan to stay in the home you are buying for several years. It may also be advisable if interest rates seem to be going up consistently; this would make it less appealing to refinance soon anyway.

If you are planning to move a few years after you buy the home, you will probably do better by choosing either the soft prepayment penalty or no penalty clause at all. You will have to pay a higher rate during the time you live there, but since you will not be there long, you will not feel the effects of it as much. If you still have questions, your trusted mortgage professional or financial advisor can help you figure out which choice is in your best interest.