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FORWARD COMMITMENTS: TRANSACTING IN A RISING INTEREST RATE ENVIRONMENT

By Patrick Minea, EVP/Regional Managing Director

Real estate professionals are always curious about the direction interest rates are headed. For the last seven-plus years, experts have been predicting an increase. It appears that with recent LIBOR increases, long-term rates may finally trend up.

In the last 90 days, the 10-Year Treasury has wavered between 2.05 percent and 2.45 percent. Any borrower caught in the middle of this ebb and flow with the potential of closing a loan that is 40-basis points higher than when they signed the application is concerned. This unexpected higher rate erodes a borrower's expected cash flow and ROI and may change the "out-of-pocket" capital required to close the transaction.

The uncertainty affects both borrowers in the midst of a transaction, and those looking to refinance an asset in the next 24 months. Many scenarios play out across every asset class and in every market, requiring an investor to consider hedging against this uncertainty. For example, the asset may not be in a position for permanent financing due to low occupancy, lack of seasoned rents, or perhaps the renovation and lease-up have not been completed.

A borrower could also have a prepayment penalty or lockout that is preventing them from refinancing now. They are then faced with gambling that rates will stay low until they can refinance or sell the asset.

So how do forward commitments work?

For up to 12 months, and in some cases longer, life insurance companies will provide a firm commitment to borrowers that today's interest rate will be the interest rate when they close, barring any substantial changes to the property and its economics. This feature comes with an interest rate premium in most cases; some will provide a forward commitment up to six months without charging a premium, but the usual cost is 3-5 basis points per month when the rate is held beyond a 90-day period. Almost all life companies will lock the interest rate when the application is signed and a refundable good faith deposit is received from the borrower. They will then give a free 90-day period to complete due diligence and negotiate the loan documents.

What are the other options and how do you control your rate?

In the multifamily capital markets, Freddie Mac and Fannie Mae offer a wide variety of attractive loan options, including a 60-90-120 day lock feature with the quoted spreads being higher for the longer timeframes.

Banks can usually lock a rate for 60-90 days for fixed-rate loan products, but can create other issues for borrowers by requiring depository relationships and ongoing covenants for property performance.

CMBS lenders typically can't lock more than a few days before loan closing. This leaves borrowers vulnerable to rate movements, which can affect loan proceeds and other terms.

The best solution to hedge against rising rates is the forward commitment and life insurance companies offer the best products in this area.

What risks/downsides are associated with forward commitments?

The downside is the potential for the property to suffer an unforeseen material change that affects the underwritten investment the lender committed to fund when the rate was locked. This doesn't happen often, but it can happen, and then the deposit can be at risk as well as other potential financial damages.

The other downside is that if you guess wrong and rates stay the same or go down, you are stuck funding at a rate that is either above market or at market, but you paid extra for the forward lock. Like any insurance, there is a cost to know you are secure in the future with your rate.

It is up to the borrower to decide if they want to roll the dice and bet that rates will continue to stay low. If they would rather sleep better, they can lock early and remove the market risk. ❖