Rapidly Rising Rates Complicate Existing Floating Rate Loans

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The rapid rise in interest rates over the past year has had a dramatic impact on commercial real estate lending activity. The rate increases have slowed both fixed and floating rate originations, though perhaps not equally. Many borrowers who do not need to transact, such as those with fixed interest rates and without a looming loan maturity date, are choosing to ride out the current interest rate environment, hoping that things will improve.

A significant portion of real estate loans, however, accrue interest on a floating rate. Debt service payments on floating rate loans rise and fall with a particular index, such as the Secured Overnight Financing Rate (SOFR). A crucial component of making these loans work from an underwriting perspective is an interest rate protection agreement, often referred to as an interest rate cap.

This is the second in a series of articles exploring how interest rates impact commercial real estate lending. This piece focuses on interest rate caps used to mitigate the risks of floating rate loans and the related loan document analysis. The first article, *Interest rate woes: A snapshot of the lending landscape in commercial real estate*, evaluated the effect of rising rates on the lending market as whole. A forthcoming third piece will analyze the legal implications of the rising rates on existing loans – including loans in, or approaching, maturity defaults.

The Economics and Components of an Interest Rate Cap

An interest rate cap agreement can be thought of as an insurance policy against rising rates. Borrowers can purchase the cap at loan origination or some later date upon the occurrence of a specified event, such as a relevant index rising above a predetermined threshold. Upon a purchase of the cap, the borrower makes a one-

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time payment to a counterparty in the rate cap transaction. If the index rises above the agreed-upon threshold, called a "strike rate" or "strike price," the counterparty must make payments to the extent the index is above the strike rate, effectively capping the interest rate for the borrower.

The primary economic components of an interest rate cap are: (1) the notional amount (i.e., the size of the cap), which is typically the loan amount, (2) the strike rate, and (3) the term of the cap, which is often, but not always, coterminous with the loan maturity. These three factors drive the cost of the cap, and can be the subject of negotiations to balance the cost of the cap with the interests of both borrower and lender in limiting exposure to rising interest rates.

The interest rate on many floating rate commercial real estate loans, particularly capital markets loans, is calculated based on the applicable index (called a benchmark). The benchmark is usually based on SOFR, and the lender adds a credit spread to equal the total interest rate. The interest rate then resets at predetermined times under the related loan documents, typically monthly, based on where the benchmark has moved. The interest rate cap agreement should reflect the same benchmark and correspond to the same reset dates as the loan documents.

A service provider fluent in the interest rate caps will often facilitate the purchase and help the borrower with onboarding documentation required by the counterparty. The rate cap provider may also help negotiate the economic and legal terms required by the lender to be incorporated into the rate cap agreement. The basics of these terms are memorialized in a bid package, which the rate cap provider then uses to identify a counterparty through a process called an auction.

Once the counterparty is identified and the terms are finalized, the trade parties enter into the rate cap agreement. The cap provider facilitates finalizing the diligence and documentation required to be delivered by the counterparty pursuant to the bid package. This typically involves a long-form confirmation, which outlines the economic and legal terms of the cap and supplements the International Swaps and Derivatives Association (ISDA) Master

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Agreement — together forming what is referred to as the rate cap agreement.

The post-trade diligence and documentation includes an assignment of the rate cap agreement in favor of the lender, including the right to payments under the cap. It also includes legal opinions regarding the cap, and, depending on the credit rating of the counterparty, a guaranty of the counterparty's cap obligations from an affiliate of the counterparty.

Loan Document Requirements

The loan documents will set forth the borrower's obligations to obtain and maintain the rate cap. The requirements will include the economic terms required for the rate cap and a minimum credit rating for the counterparty to ensure the counterparty will be able to perform its obligations.

Bridge loans on transitional properties account for a significant portion of outstanding floating rate debt. These loans often have short initial loan terms of two or three years, with one or more one-year extension options for the borrower, provided that certain conditions are met — including an interest rate cap for the extended term.

Borrowers must maintain the rate cap during the loan term, but the borrower's ongoing obligations under the loan documents are generally minimal, since the borrower's obligations under the cap are mostly satisfied upon its purchase. Borrowers are typically required to replace the counterparty if its credit ratings are downgraded below a predetermined threshold. Otherwise, for an in-place cap, the borrower's only other significant obligations are not to amend or modify the cap without lender's consent, and to ensure a qualifying cap is in place when required under the loan documents.

Given the importance of the rate cap to the underwriting of these loans, the consequences of a breach of the rate cap requirements are usually severe, including an event of default, and, if the loan is non-recourse, triggering recourse to the guarantor.

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Emerging Borrower Pressure

One emerging issue stems from loans that were underwritten before, or during the onset of, the rapid rise in interest rates. The price of a rate cap accounts for the forward curve of the benchmark (i.e., the projected level of the benchmark during the relevant term) and benchmark volatility. So, the cost of rate caps skyrocketed in response to the rise in rates, and the effects of the cost of rate caps on existing loans that were originated during that period are now coming into focus.

If a borrower needs to exercise an extension option under its loan, a rate cap for the extension term will be required as a condition. If the strike rate was determined in a low rate environment, the cap for the extension term likely requires a strike rate similar to what was in effect during the initial loan term, which could make the cap prohibitively expensive in today's rate environment.

Similarly, some lenders allowed borrowers to obtain caps for less than the entire initial loan term during this period. The lenders balanced the cost of the rate caps with the expectation that the borrower's business plan to reposition the property would be completed quickly, rates would come back down or stabilize, or both. In these circumstances, some lenders required a reserve to ensure funds would be available to pay for the cap for the remainder of the loan term, but many did not.

With some property values stagnating or declining, the borrowers are left selecting from several difficult options. Some could be forced to sell the underlying asset to repay the loan at maturity, while others may attempt to refinance — possibly with an equity infusion — or to make a capital call to purchase the rate cap. Borrowers that are unable to sell, refinance or raise capital would be forced to attempt to negotiate a workout with the lender or consider handing the property back to the lender.

Conclusion

Commercial real estate market participants are continuing to adjust to the new interest rate environment, with many predicting interest rates will remain high compared to what was available just a year or

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so ago. For borrowers with floating rate bridge loans obtained during a low rate environment and looming rate cap purchase obligations, few good options are available and difficult decisions may lie ahead.

For more information, contact the author or any attorney with our Financial Services industry team.

The Carveout

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