Rate Caps Costs Soar Even Higher

For many, the choice is to buy a cap anyway to finance or sell off the property.

By Erik Sherman | October 17, 2022

In late May of this year, the signs were already rising with the dry hot sun of interest rate increases. With them went the **costs of interest rate caps (https://www.globest.com/2022/05/24/interest-rate-cap-fees-are-crushing-transactions/)**.

"We had somebody who had an interest rate cap, but when they signed the deal two months ago to when they could get the deal closed recently, the price tripled," Thompson Coburn partner Josh Mogin told GlobeSt.com at the time. "They had to take $1.2 million to buy a cap they were planning to spend $300,000 to $500,000."

So, between 2.4 times and 4 times as much as had been planned. Months have marched on, as have large interest rate increases the Federal Reserve has instituted since to fight inflation. Now?

"The prices have skyrocketed," David Podein, a partner at Haber Law in Miami who focuses on commercial real estate, tells GlobeSt.com. "In some instances, the price to purchase the interest rate cap is ten time more than it was a year or so ago." Others in the last month or so have said the same thing.

And yet buy they do—or must. "Despite the outrageous costs, borrowers are still purchasing them for protection against rapidly rising interest rates—and more often, because their lenders are requiring them to purchase it as part of the loan covenants," Podein adds.

Marcus Duley, chief investment officer of Walker & Dunlop Investment Partners, also sees borrowers pouring money into rate caps because lenders insist. "In some instances, lenders are requiring borrowers to purchase day-one in-the-money caps where the strike rate is less than the current index rate being hedged," he says. "In some ways, the interest rate cap premium can be looked at as prepaid interest capitalized in to deal where otherwise interest would have been paid from cash flow."

"Borrowers also do not want to take the risk of deals blowing up due to higher interest expense and hence they are buying caps," says Adil Hasan, director of real estate at Yieldstreet, and who also calls in-the-money caps "extremely expensive."

It’s all having an effect. “Development projects are being cancelled because of high construction costs and growing interest rates as developers balance the costs of carrying the land versus developing with a new cost structure, if they can get a loan,” Stephen Bittel, founder and chairman of Terranova Corporation, tells GlobeSt.com. “The over $100 million loan market is extremely tight, while property casualty insurance coverage is becoming more costly if you can get a carrier with capacity.”

In other words, increasingly borrowers have no options. “Balance sheet lenders, typically banks and life insurance companies, continue to carefully make new debt commitments to only the most experienced, best balance sheet, and best in class investor/operators,” Bittel says. “Wall Street type lenders relying on lines of credits or repurchase agreements to back up funding have been much less active.”

And so, when the lender says pay, it’s either that or don’t play.
