# FUTURE REFINANCE RISK WITH RISING RATES

by Steve Brown

A couple of weeks ago we ran a piece on the historical percentages of CRE refinancings for 2010. Our goal was to give you a feel for what attributes (LTV, DSCR, etc.) can have the largest impact on a borrower's ability to refinance. At the time, an astute banker pointed out that while historical percentages were good, how do you ascertain the risk in the future?

To answer the question, it helps to know the following: type of property, rate on a potential new loan, the value of the property, annualized net income, net income growth rate and the projected capitalization rate on the property (which is the property's income over its valuation at loan maturity). Using these factors, a simple model can be developed that forecasts expected DSC and LTV given higher rates. Depending on the type of property, when DSC is above 1.2x and LTV below 75%, we deem the loan to have a slightly better than a 50% chance of being refinanced (either at the original bank or at another bank). The less liquid the property type, the better performance needed to refinance. Multifamily doesn't need as strong a cash flow as retail, which in turn doesn't need as strong as cash flow as industrial in order to get refinanced. The higher the cash flow coverage and/or lower the LTV, the higher the probability of the property being refinanced. While this is all well and good, what is interesting are some of the takeaways you can see when playing with such a model.

First you realize that appreciation, because of the property's leverage, has a bigger impact than net income growth. In other words, given the choice between more speculation and higher rents, banks want the former if the loan is being refinanced away and the latter if they are going to refinance it on their own. Oddly, we are in a rare period of time where appreciation in some markets is rising faster than expected net income growth portends. In other words, the speculative bubble that is being created is giving some banks a nice opportunity to get some marginal loans refinanced away.

Understanding the interplay between net income growth, appreciation and interest rates is an important one. A bank that is not on top of monitoring refinancing activity will find its best loans refinanced away, leaving it with an income hole to fill. Worse yet, a bank that isn't paying attention to refinance risk may also find inferior loans "parked" on its balance sheet, leaving the bank with a future capital hole to fill.

Smart lenders that realize this interplay are worried in this current environment because of the threat of higher rates, without a corresponding increase in property net income growth. In other words, it not only matters that a loan can be refinanced as rates rise, but also why rates went up in the first place. If rates rise by 200bp, either appreciation has to increase by 1% or net income has to grow by 2% for a fixed rate loan to maintain its current value and current probability of refinance. If it is a floating rate loan, then both appreciation and net income growth has to be greater to compensate for the higher interest rate.

Unfortunately, in many markets appreciation and net income growth are not moving. Here, if higher rates reflect the expectation for a jump in inflationary pressure alone and not income growth, then the probability of refinancing gets cut by approximately a third to a half. This means that those properties that are most at risk of not being able to be refinanced have a DSCR of 1.20x or less, a

70% LTV or higher, have no net income growth, have not been appreciating and have a balloon maturity in the next 2Ys.

By looking at all CRE loans maturing in the next 2Ys against the backdrop of rising rates and setting a refinance strategy now, banks can optimize both future earnings and capital. Working with a borrower now to come up with a suitable solution that benefits both parties just makes sense. Having this knowledge will help increase your future probability of success.

## BANK NEWS

**Debit Rewards**

Wells Fargo becomes the latest bank to drop its debit card reward plans.

**Risk Retention**

To avoid having to hold 5% of securitized loans, a new FDIC proposal (being voted on today), would reportedly set tighter standards for qualified residential mortgages (QRM) in order to be exempt from risk retention requirements. Those standards include having the borrower make a 20% down payment, a max LTV of 80%, specific debt-to-income ratios and no 60-day delinquencies on any debt within the past 24 months. Other servicing requirements, such as loss mitigation actions the originating bank would have to take, are also built into the QRM test.

**Municipal Pressure**

The municipal bond market in the 1Q will record the lowest quarterly issuance in 10Ys, as investors worried about the potential for default have pulled back sharply. So far, only $44B has been issued this year, less than half the level sold last year at this time.