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Agency Floaters: Adjusting Interest Rate Cap Escrows

SARM Features Alleviate Floaters Challenge, With Conversions in Tow

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An adjustment to the interest rate cap escrow requirements on Fannie Mae's structured adjustable-rate mortgages (SARMs) spotlights how the agencies have been addressing issues that currently challenge private-label deals, notably SASB floaters. SARMs replacement interest rate cap escrow now requires re-sizing every six months rather than previously once per year. As such, SARM servicers are reevaluating the prevailing cost of replacement cap agreements more frequently and can increase escrow amounts accordingly. This should help alleviate the risk agency borrowers (and by extension, the exposed bondholders) are facing as they need to renew cap agreements amid price spikes.

In contrast, non-agency multifamily borrowers with floating-rate loans have increasingly chosen to forgo contractual extension options, partially (or perhaps sometimes fully) driven by rising cap agreement costs. The $667.9 million Veritas Multifamily Portfolio Pool (GSMS 2021-RENT and GSMS 2021-RNT2) and the $270.3 million Manhattan Multifamily Portfolio (BX 2019-MMP) are two notable recent examples (Figure 1). In Veritas, the borrower did not exercise its last one-year extension option on the 61-property portfolio in San Francisco. The loan is now in maturity default. In a similar vein, in Manhattan Multifamily Portfolio, the borrower also chose not to exercise its third and last extension option on the 637-unit, 11-property portfolio in New York. The loan is now in special servicing with limited fresh servicer commentary on the borrower's commitment or the trust's workout approach.

Figure 1. Veritas Multifamily Portfolio Pool and Manhattan Multifamily Portfolio - Loan and Property

Asset	Veritas Multifamily Portfolio Pool	Manhattan Multifamily Portfolio
Deals	GSMS 2021-RENT ($344MM); GSMS 2021-RNT2 ($104MM); unsecuritized ($220MM)	BX 2019-MMP
Balance	$667,880,098	$270,300,000
Maturity	November 2022	August 2023 (1-year extension option to Aug 2024)
Coupon	1ML + 3.4428%	1ML + 1.5778%
Loan Status	Matured Non-Performing	Current Specially Serviced
Property Size	1,734 units	637 units
Occupancy	91.4% as of 3/31/2023	97% as of 3/31/2023
DSCR	0.89x as of 2/28/2023	0.79x as of 3/31/2023
Location	San Francisco, CA	New York, NY

Source: MCIA and Academy Securities

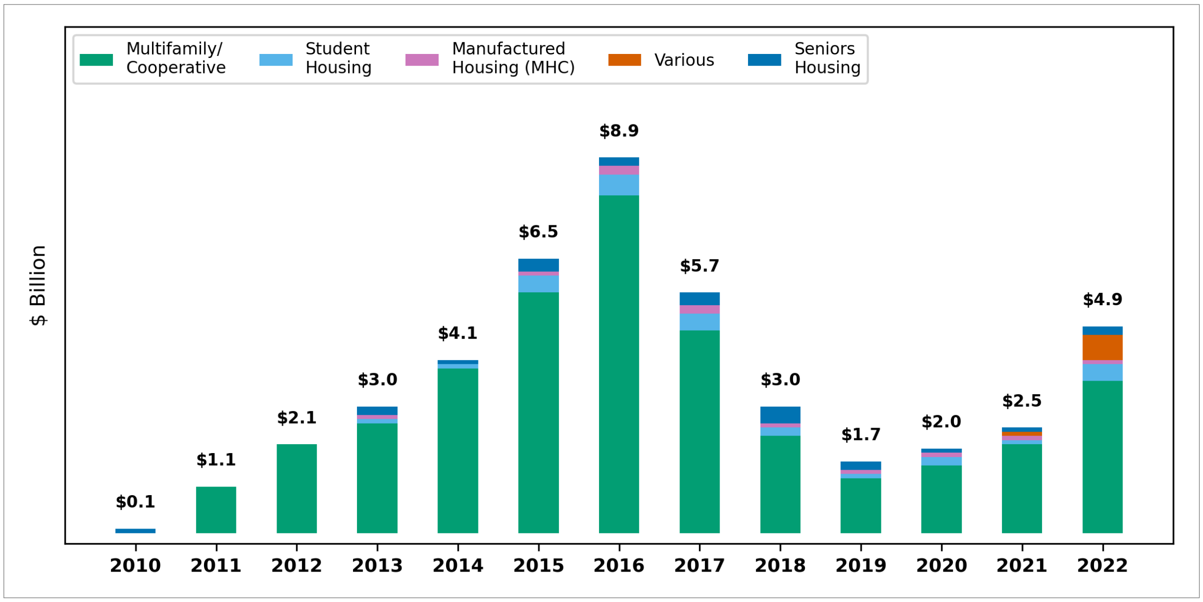
Floating-to-fixed Conversions Introduce Some Paydown Uncertainty

The SARM rate cap escrow revision joins other features of the GSEs adjustable-rate mortgage products that we see coming into focus, such as conversion features. Borrowers can convert SARM loans to fixed-rate mortgages after a lockout period, typically one year. Conversions could accelerate paydowns on SARM DUS pools if the agency purchases the converting mortgage from the pool. Conversions do not require prepayment premiums. All told, the conversion option may introduce different cashflow dynamics compared to prepayment-driven activity. Voluntary prepayments could be a concern for DUS investors that may have purchased bonds at higher premiums in recent years, as we suggested in a previous report.[1]

SARM Originations Show Peaks and Valleys

DUS SARM originations fluctuated in recent years, likely reflecting changing borrower interest. Total originations peaked in 2016, at $8.9 billion, according to Fannie's Data Dynamics (Figure 2). Following more muted origination levels in recent years, 2022 vintage picked up again at $4.7 billion. Recent DUS SARM issuance includes a $21.9 million pool backed by Clearwater at Sonoma Hills, a 90-unit senior housing property in Santa Rosa, CA (BS8502).

Figure 2. SARM Issuance by Year and Property Type

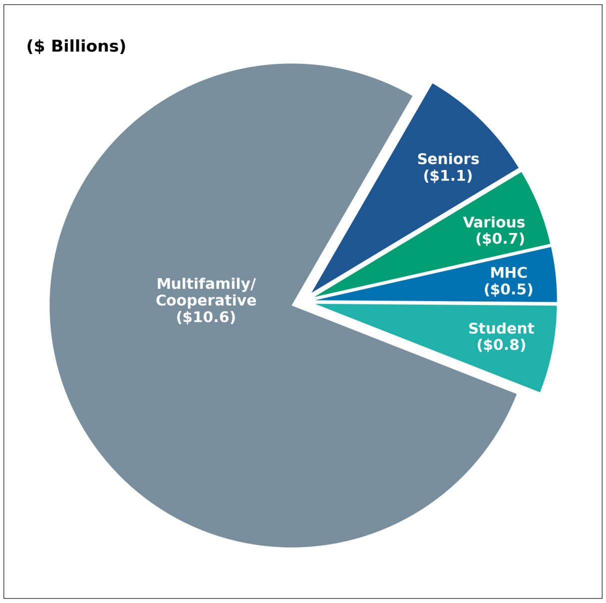


Source: Fannie Mae and Academy Securities

1 "Manufactured Housing: Resilient Segment Amid Potential Multifamily Softness," Securitized Products Special Topics, Academy Securities, July 27, 2022

The 2022-vintage SARM originations included a significant chunk of non-conventional multifamily segments, such as student and senior housing, as well as a "various" component, as Figure 1 showed. This echoes the growing diversity across the broader DUS segment, as we highlighted in a report on manufactured housing we cited above. Nearly 23% of the active DUS SARM are backed by non-conventional multifamily (Figure 3).

Figure 3. SARM Outstanding by Property Type



Source: Fannie Mae and Academy Securities

No Embedded Periodic or Lifetime Caps

The SARM rate cap escrow adjustment we flagged at outset is notable as SARM loans do not have built-in periodic or lifetime caps. Instead, the borrower needs to purchase an interest rate cap from one of the cap providers that Fannie approves. The term of the initial cap agreement may be shorter than the mortgage term, hence the need for a replacement cap and an escrow. The SARM escrow requirement contrasts with the situation on private-label floaters. Servicers confirmed on panels at the recent CREFC conference that non-agency rate cap reporting is spotty, and investors may find it hard to consistently track agreements' terms and provisions. CREFC Investor Reporting Package Committee is working on this aspect, and plans to finalize revisions to CREFC's IRP.

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