JO Knows Options for Interest Rate Swaps

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Real estate owners, operators, and developers operating in the commercial market encounter interest rate swaps when securing financing, as they are usually a key component of a lender's fixed-rate offerings. Interest rate swaps are derivative financial instruments that allow two parties to enter into mutually beneficial contractual arrangements, where generally, floating interest rates are exchanged for fixed rates. This allows owners, operators, and developers to "hedge their bets" and mitigate interest rate risk, reduce the overall cost of borrowing, manage long-term cash flows for a project, and strengthen their credit profile. As a result, interest rate swaps have become increasingly mandatory when trying to reign in expenditures over the life cycle of a project and attract new investors.

A typical commercial real estate loan contains a floating interest rate comprised of a benchmark rate, which fluctuates over time with the market, plus an additional fixed amount known as the spread. The Secured Overnight Financing Rate (SOFR) is a benchmark interest rate often used to set interest rates for commercial loan financing. One of the more common swap arrangements in commercial real estate lending involves a loan borrower signing a contract with a hedge provider to make monthly fixed interest rate payments. Each month, depending on where the variable rate is relative to the fixed rate, the borrower is either paying more than the stated interest rate in the initial loan agreement to get to that fixed rate or they are receiving money from the hedge provider if the variable rate is higher than the fixed rate.

However, there are hidden risks and costs to interest rate swaps that must be considered by the owner, operator, and developer when securing financing and when examining term sheet proposals from hedge providers. Since most hedge providers do not provide a breakdown of the swap rate initially, it is important to inquire about the credit charge before picking a provider and signing the term sheet. Additionally, it is important that when considering loan financing and interest rate swaps, the real estate owner, operator, and developer factors in the possibility of delays in construction, which could result in paying interest on swap agreements for amounts not yet drawn down.

Under Generally Accepted Accounting Principles (GAAP), interest rate swaps must be recorded on the balance sheet at fair value, with changes in fair value recognized in earnings unless designated as a hedge. Hedge accounting requires stringent documentation and effectiveness testing to ensure the swap remains effective in offsetting changes in fair value or cash flows. While private companies may elect certain alternatives to lessen this burden, this will nonetheless require additional work and disclosures during your financial statement preparation, not only for you, but also for the independent CPA firm that is performing the audit or review of the financial statements.

Your first step should be to discuss the process with a CPA who knows the ins and outs of interest rate swaps and has significant experience with real estate. He or she can assist you in engaging a qualified intermediary to facilitate the transaction. The real estate team at JO knows how to structure and properly account for these transactions.

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