Multifamily Interest Rate Cap FAQs

This Job Aid provides answers to frequently asked questions related to **Interest Rate Caps** for certain Fannie Mae variable rate Mortgage Loan products.

What is an Interest Rate Cap?

The standard hedge instrument for variable rate transactions with Fannie Mae is an Interest Rate Cap. (Note: Currently, we do not permit swaps as hedges for interest rate risk on a delegated basis. A swap is only allowed in special circumstances, with Fannie Mae review and approval.) Interest rate Caps act like an insurance policy to hedge against interest rate fluctuations and protect Borrowers against paying interest above the underwritten rate. The Interest Rate Cap Agreement is a contract between the Borrower and an approved Interest Rate Cap seller ("Provider") that provides the Borrower with payments at the end of each period when the interest rate Index exceeds the **Cap Strike Rate**. The Interest Rate Cap provides a hedge on the Borrower's out-of-pocket interest payment on the Mortgage Loan, with the Provider paying the difference between the Cap Strike Rate and the interest rate Index. Due to the short term of an Interest Rate Cap Agreement, a replacement Interest Rate Cap is required when an existing Interest Rate Cap expires before the variable rate Bond conversion or Mortgage Loan Maturity Date.

Who sells Interest Rate Caps for Multifamily Transactions?

Below is a list of approved Providers from whom Borrowers may purchase a required Interest Rate Cap for a variable rate Mortgage Loan. The financial institutions listed below meet Fannie Mae's current credit ratings requirements and all other criteria as determined by Fannie Mae for sellers of Interest Rate Caps:

- The Bank of New York Mellon;
- Commonwealth Bank of Australia;
- Royal Bank of Canada;
- SMBC Derivative Products Ltd. and SMBC Capital Markets, Inc.;
- UBS;
- US Bank National Association; and
- Wells Fargo Bank, N.A.

As of this date, Fannie Mae's criteria require that the Provider must have a credit rating:

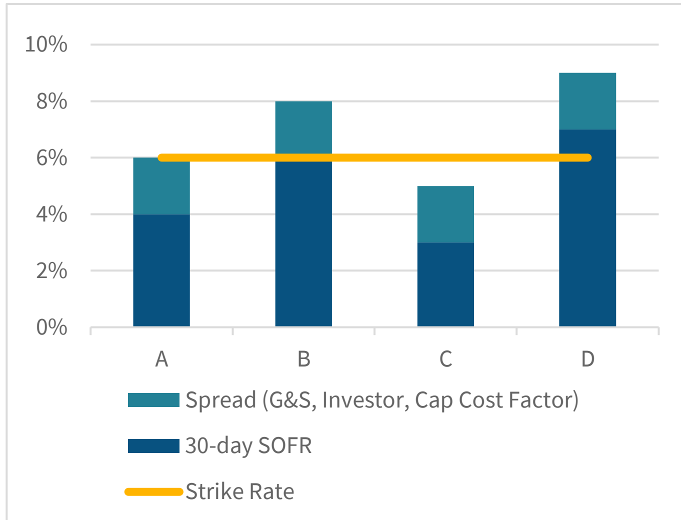
- from Standard & Poor's, of at least:
  - an A issuer or senior debt rating; or
  - an A-1 short-term rating; and
- from Moody's, of at least:
  - an A2 issuer or senior debt rating; or
  - a P-1 short-term rating.

A Borrower must use only the Providers on this list to purchase new Interest Rate Caps or replacements for expiring Interest Rate Caps. However, the exclusion of a Provider included on a previous list does not indicate that Fannie Mae believes any existing interest rate hedge sold by that Provider should be terminated and replaced prior to its expiration date. Fannie Mae will notify Lenders and Providers if Fannie Mae determines that a ratings downgrade or other adverse event for a given Provider necessitates a termination and replacement of an existing Interest Rate Cap.

How Does the Interest Rate Cap Work?

This section offers four examples describing how Interest Rate Caps function. Remember, in every Interest Rate Cap, the Borrower will pay an upfront premium to the Provider who, in turn, agrees to pay the Borrower if the Index rises above a predetermined level, called the **Cap Strike Rate**. The **Cap Strike Rate** is the specified interest rate above which payments by the Provider will be owed.

- The total amount of the Interest Rate Cap – known as the **notional amount** – must equal or exceed the Unpaid Principal Balance of the Mortgage Loan at the time the cap is purchased.



$10 Million Cap w/ 6% Strike Rate

Cap Scenario	30-day avg SOFR	Cap Payment
A	4%	0%
B	6%	0%
C	3%	0%
D	7%	1%

In scenario A, Borrower has a $10 million, 10-year Structured ARM Loan, with an Index of 30-Day Average SOFR, and the Loan Agreement specifies a Required Cap Strike Rate of 6%. The Borrower buys a 5-year Interest Rate Cap with a notional amount of $10 million and a Cap Strike Rate of 6% indexed to 30-Day Average SOFR. When the Interest Rate Cap is purchased, 30-Day Average SOFR is 4%.

In scenarios B and C, the Index is at or below the Cap Strike Rate under the Interest Rate Cap Agreement and the Borrower will not receive payments from the Provider.

The Borrower and Provider typically settle any Interest Rate Cap payments on a monthly basis. To ensure compliance, Fannie Mae usually requires that payments from the Provider are paid by the Provider directly to the Servicer.

In Scenario D, the Interest Rate Cap Reaches the Cap Strike Rate under the Interest Rate Cap Agreement. The Index – 30-Day Average SOFR – has now risen to 7%. The Provider would pay 1% on behalf of the Borrower to the Servicer, as the Index exceeds the Cap Strike Rate specified in the Interest Rate Cap Agreement. This effectively caps the Borrower's interest rate on the Mortgage Loan at 8%.

The Borrower is always obligated to make the full payment required under the Loan Documents regardless of any Interest Rate Cap payments that may be due and owing from the Provider.

How are Cap Payments Collected?

The Interest Rate Cap is assigned to Fannie Mae at closing and all payments on the Interest Rate Cap must be made directly to the Servicer. Most Providers are not billed and Provider payments are received in arrears on a date specified in the Interest Rate Cap Agreement. The Servicer must bill the Borrower for the full amount of all required principal and accrued and unpaid interest due and owing on the Mortgage Loan (together with any required reserve or escrow payments), and the Borrower must make the full Mortgage Loan payment. When the Provider payment is received, the Servicer must check to see if the Mortgage Loan is in default. If the Mortgage Loan is not in payment default, the Servicer may return the Provider payment to the Borrower. If the Mortgage Loan is in payment default, the Servicer must retain any payment made by the Provider under the Interest Rate Cap Agreement.

Regardless of whether any payments are received from the Interest Rate Cap provider, the Borrower is required to make the full Mortgage Loan payment. The full Mortgage Loan payment includes principal, interest and all escrow payments including the Interest Rate Cap escrow payment. Fannie Mae does not accept partial Mortgage Loan payments. If the full Mortgage Loan payment is not received, the Servicer should suspense the funds and not apply any of the Mortgage Loan payment. The Mortgage

Loan is in monetary default. The Servicer should report the delinquency in DEWS and not advance the LPI date. The Servicer should also contact Fannie Mae Special Credits.

How is the size of the Replacement Interest Rate Cap Escrow calculated?

The initial Interest Rate Cap is required to have a minimum term of 5 years unless a shorter term is approved by Fannie Mae. Because Interest Rate Caps typically have shorter terms than the loans being hedged, Borrowers are required to make monthly escrow payments to fund the purchase of a **replacement Interest Rate Cap** upon expiration of the initial Interest Rate Cap. Escrow payments are based on 100 percent of estimated Interest Rate Cap replacement costs; typically escrow payments are spread over the same term as the initial Interest Rate Cap and paid on a monthly basis.

Example

Mortgage Loan Term	**Initial Interest Rate Cap Term**	**Escrow Payments for Replacement Interest Rate Cap Begin…**
10 years	5 years or less	Immediately
10 years	7 years	At the end of year 2. For Interest Rate Caps with terms greater than five years, escrow payments begin five years before the expiration of the existing Interest Rate Cap.

The replacement Interest Rate Cap escrow must be re-sized at least once per year or more frequently if required or permitted in the Loan Documents. (Note: The Interest Rate Cap and Security Agreement (Form 6442), effective in Q1, 2023, requires the replacement Interest Rate Cap escrow to be re-sized every 6 months.) At the end of each period specified in the Form 6442, the Servicer must reevaluate the cost of a replacement Interest Rate Cap with a strike rate not greater than the Required Strike Rate as specified in Schedule 2 to the Loan Agreement and a notional amount equal to the Unpaid Principal Balance of the Mortgage Loan at the time of the cap purchase. If the cost of the replacement Interest Rate Cap is expected to increase, the monthly escrow payments must be increased accordingly to ensure sufficient funds will be available to purchase the replacement Interest Rate Cap at the end of the escrow period. If the estimated cost of the replacement cap decreases, no adjustment need be made to the monthly escrow payments. Servicers will adjust the required payment in their systems and begin to bill the Borrower for the new amount.

Any amount left in the escrow account after the purchase of a replacement Interest Rate Cap may be refunded to the Borrower or used to fund subsequent Interest Rate Cap escrow payments only if no payment default has occurred under the Mortgage Loan.

When can an Interest Rate Cap be terminated?

If a Borrower prepays the Mortgage Loan, the Interest Rate Cap remaining for the life of the Mortgage Loan may be released to the Borrower. Waivers to the requirement that variable rate Mortgage Loan products be hedged are not available from Fannie Mae at this time. After a Mortgage Loan is paid in full, an interest rate cap can be traded or released. Release of Interest Rate Cap documentation can be forwarded to Fannie Mae Servicing along with other release of lien documents. Please contact your Provider for more information.

Other Frequently Asked Questions

FAQs Relating to Interest Rate Caps for New Loans

Q: Does the Servicer have to put the Provider's payment into the custodial account?

A: Yes, until the Guide and Loan Documents permit it to be returned to the Borrower.

Q: Is there a waiver for a shorter-term replacement Interest Rate Cap?

A: Currently, waivers for shorter terms may be considered by Fannie Mae, but are generally limited to managed Borrowers and repeat Fannie Mae Borrowers with $100 million and above in current Fannie Mae exposure. Approval of a shorter-term Interest Rate Cap is also subject to the overall Credit of the transaction, including Sponsor's experience.

Q: What is the deadline to receive monthly escrow payments for the replacement Interest Rate Cap Agreement?

A: The monthly deposit for the replacement Interest Rate Cap must be made on the full mortgage payment due date as specified in the Loan Agreement.

Q: Is there an option to get forbearance to avoid default if the replacement Interest Rate Cap is economically unavailable?

A: No.

Q: Can the Borrower's requirement to obtain the Interest Rate Cap be waived entirely?

A: Fannie Mae does not provide waivers on Interest Rate Caps at this time. Please refer to the Loan Documents, which require an Interest Rate Cap to be in place at all times during the term of the Mortgage Loan.

Q: Can I receive a waiver to obtain a 1-year Interest Rate Cap term?

A: No, Fannie Mae does not allow 1-year Interest Rate Caps at this time.

FAQs Relating to Interest Rate Caps for Existing Mortgage Loans

Q: Is there an option to get a shorter term for the replacement Interest Rate Cap?

A: As stated above, a waiver may be requested for a shorter term for the Interest Rate Cap.

Q: Is there a maximum amount the escrow can increase?

A: No

Q: Can the Servicer reset the escrow at a greater frequency than once per year?

A: Yes, if permitted in the Loan Documents.

Q: What forms of collateral are allowed for the Interest Rate Cap escrow?

A: Cash is typically the required form of collateral. Other acceptable forms of collateral are outlined in **Form 6442** – Section 4.01(a) through 4.01(k).

Q: What happens if the Borrower does not make the monthly Interest Rate Cap escrow payment?

A: The full Mortgage Loan payment includes principal, interest and all escrow payments including the Interest Rate Cap escrow payment. Fannie Mae does not accept partial Mortgage Loan payments. If the full Mortgage Loan payment is not received, the Servicer should suspense the funds and not apply any of the Mortgage Loan payment. The Mortgage Loan in in monetary default. The Servicer should report the delinquency in DEWS and not advance the LPI date. The Servicer should also contact Fannie Mae Special Credits.

Supporting Documentation

- Multifamily - Industry Partners - Interest Rate Cap Providers
- Fannie Mae Best Practices in Managing Interest-Rate Hedges
- Fannie Mae Interest Rate Cap Requirements