MYSAK NEWSLETTER

RECENT INTEREST RATE NEWS

Borrowers in the apartment market have seen a substantial decline in interest rates recently. From July 22 through August 9, 2011, 5 and 10 year bond yields that are relevant to the apartment market declined by approximately 55 and 35 basis points respectively (a basis point is one one-hundredth of one percent). This is on top of a decline of about 50 and 40 basis points for 5 and 10 years, respectively, from April 1 to mid July, 2011.

This market volatility has presented a great opportunity for borrowers to lock in the lowest rates in recent memory. However, as every experienced property investor knows, rates can reverse just as quickly. Sudden changes in market sentiment among mortgage investors could result in adjustments to mortgage options available to borrowers.

This rapidly changing interest rate environment warrants close attention on the part of borrowers. As the market evolves, borrowers should clearly understand their options in the loan commitment/agreement with regard to early rate-locks, hedging costs and the "spread" over bond yields or cost of funds that determine the interest rate that will be in effect.

CMHC INSURED SECOND MORTGAGE?

Many investors are not aware that CMHC insured second mortgage loans are available for apartment buildings.

Purchase transactions often close with the purchaser assuming existing financing. Since apartment values have increased recently, there is often a large gap between existing financing in place that is to be assumed and the purchase price. VTBs are a common here.

Investors should also consider CMHC insured second mortgage financing. It isn't a solution in every case, but there are a few very general "flags" that investors should be aware of:

- the first mortgage should offer a relatively conservative Loan to Value ratio, which leads to a large second;
- the first mortgage should feature a remaining amortization period that is not less than 15 years;
- the first mortgage should have a remaining term of at least 5 years.

The CMHC insured second mortgage offers a few advantages over VTBs or private mortgages:

- a renewal is always available for CMHC insured mortgages. VTBs and privates offer no guarantee of a renewal at maturity;

- a structural advantage of the CMHC insured second mortgage is that the existing first mortgage can be re-amortized at its maturity to the longer second mortgage amortization period, which offers a significant boost to returns;
- rates in effect are usually at the same rates as insured first mortgages.

MORTGAGE FINANCING

In the current market CMHC insured mortgages are financed at such low rates that they are the default option of most apartment investors. However, many owners are not familiar with the process and often ask "what is CMHC looking for?"

There are basically 3 considerations when CMHC assesses an application for mortgage insurance:

1. **Physical Condition of the Building**: CMHC sends a technical officer to inspect the property to ensure it meets minimum housing standards with an emphasis on life and safety issues, structural integrity of the building and identifying instances of deferred maintenance. A non-CMHC insured loan will often call for an engineering report to be provided as part of the application process in order to identify the same issues.
2. **Financial Condition of the Building**: Are the rents sustainable? Have the expenses been verified by reviewing the tax, water, heat and hydro bills for the last 12 or 24 months? Are expenses for Repairs and Maintenance realistic? Is the borrower able to effectively manage the building to maximize sustainable revenues, control costs and provide quality housing to tenants?
3. **Financial Condition of the Borrower**: Borrowers have to meet a net worth requirement (25% of the loan amount) and provide evidence of liquid assets (i.e. via bank/brokerage statements), income and expense details of other income producing real estate and the capacity to cover reasonable, unforeseen expenses (i.e. boiler or roof replacement).

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