April 15th, 2020

Why is the quoted interest rate on my commercial mortgage higher than it was three months ago, even as the Federal Reserve continues to lower interest rates and US treasury yields are at an all-time low? Although the Fed lowered the U.S. benchmark federal funds interest rate to 0.0% in March 2020, this doesn't correlate directly to mortgage rates, particularly for life insurance company lenders.

Here's why:

Historically, life insurance companies have priced commercial mortgages to a relative spread over the yield on corporate bonds. More specifically, spreads on BBB/Baa rated bonds have served as a primary benchmark for commercial mortgage pricing. Insurance companies view mortgages as an alternative investment to BBB corporate bonds, as they have similar risk profiles. However, mortgages require a small premium to account for both the illiquid nature of a commercial mortgage, and the inherent risk of real estate. There are no concrete guidelines life insurance companies follow, and the volatility over the past few months has caused markets to vary from historical trends, however typically, they have priced commercial mortgages roughly 50 basis points wider than BBB corporate bonds yields.

The recent impacts of COVID-19 have had many ripple effects across the economy and have put stress on all types of businesses, from local businesses to large corporations. Large corporations, which typically enjoy steady and predictable cash flows, are now faced with uncertainty as supply chains and customer behaviors are disrupted by COVID-19. This has increased the risk associated with repaying their debts and caused investors to seek higher yields. As a result, in March 2020 the spread in BBB corporate bond yields widened nearly 150 bps relative to the 10-year treasury, the most rapid increase seen since 2008.

Federal Reserve Bank of St. Louis, Moody's Seasoned Baa Corporate Bond Yield Relative to Yield on 10-Year Treasury Constant Maturity [BAA10Y], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/BAA10Y, April 13, 2020.

In order to maintain its relative value and illiquidity premium compared to BBB corporate investments, commercial mortgage rates have also faced rapid upward pressure. The abruptness of change has pushed many life insurance companies to temporarily stop lending until the volatility subsides, while others are issuing quotes with a footnote that pricing could change from one day to the next.

Now for some good news: recent moves implemented by the Federal Reserve have thus far had a positive effect and have caused corporate bond yields to slowly compress. While mortgage rates will likely remain higher than they were earlier in the year, at least in the near term, continued stimulus by the Fed, coupled with a stabilization of COVID-19, should help alleviate the strain on commercial mortgage rates.