

## Forward Commitments: Transacting in a Rising Interest Rate Environment

By **Patrick S. Minea**

The uncertainty surrounding where interest rates are headed can significantly affect borrowers in the commercial real estate industry. In the last 90 days, the 10-Year Treasury has wavered between 2.05 percent and 2.45 percent. Closing a loan that is 40 basis points higher than when the application was signed erodes a borrower's expected cash flow and ROI and may change the out-of-pocket capital required to close the transaction.

Whether borrowers are in the midst of a transaction or looking to refinance an asset in the next 24 months, hedging against the uncertainty has some appeal. Locking in a forward commitment from the lender is one option, but borrowers need to evaluate their risk tolerance and decide if minimizing risk is worth the cost.

### How Do Forward Commitments Work?

For up to 12 months, and in some cases longer, life insurance companies will provide a firm commitment to borrowers that today's interest rate will be the interest rate when they close, barring any substantial changes to the property and its economics. This feature comes with an interest rate premium in most cases; some will provide a forward commitment up to six months without charging a premium, but the usual cost is three to five basis points per month when the rate is held beyond a 90-day period. Almost all life companies will lock the interest rate when the application is signed and a refundable good faith deposit is received from the borrower. They will then give a free 90-day period to complete due diligence and negotiate the loan documents.

### What are the Other Options and How Do You Control Your Rate?

In the multifamily capital markets, Freddie Mac and Fannie Mae offer a wide variety of attractive loan options, including a 60-90-120 day lock feature with the quoted spreads being higher for the longer timeframes.

Banks can usually lock a rate for 60 to 90 days for fixed-rate loan products but can create other issues for borrowers by requiring depository relationships and ongoing covenants for property performance.

CMBS lenders typically can't lock more than a few days before loan closing. This leaves borrowers vulnerable to rate movements, which can affect loan proceeds and other terms.

The best solution to hedge against rising rates is the forward commitment, and life insurance companies offer the best products in this area. Life companies may also



offer more favorable terms early in the year when they have new allocations to consider and new loans are needed to fill the pipeline.

### What Risks/Downsides are Associated with Forward Commitments?

The downside is the potential for the property to suffer an unforeseen material change that affects the underwritten investment the lender committed to fund when the rate was locked. This doesn't happen often, but it can happen, and then the deposit can be at risk as well as other potential financial damages.

The other downside is that if you guess wrong and rates stay the same or go down, you are stuck funding at a rate that is either above market or at market, but you paid extra for the forward lock. Like any insurance, there is a cost to know you are secure in the future with your rate.

It is up to the borrower to decide if they want to roll the dice and bet that rates will continue to stay low. If they would rather sleep better, they can lock early and remove the market risk. ■



**Patrick S. Minea**, executive vice president-managing director of NorthMarq Capital, has been in real estate finance since 1987 and is a proven producer who is highly experienced in all areas of debt and equity finance. Over the past 10 years

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