SLATT CAPITAL

# FORWARD RATE LOCK

*Overview*

When it comes to securing a mortgage, one of the most critical factors to influence the total amount of your monthly payment is the loan's interest rate. Throughout the process of securing a loan, interest rates might fluctuate dramatically based on treasury yields and other indexes. As such, what might seem like a quality investment up front can quickly become less than profitable when interest rates spike.

For this reason, many investors consider utilizing a forward rate lock, which can help protect against market fluctuations. However, forward rate locks come at a price. Understanding what a forward rate lock is, how long you can lock in a rate, and the pros and cons of a rate lock can help you decide whether or not this is the right approach for your borrowing needs.

## What Is a Forward Rate Lock?

A standard rate lock is an agreement that a mortgage lender will honor a specified interest rate. This interest rate is determined before closing and added to the loan documents. A standard rate lock usually locks in an interest rate around 30-90 days ahead of closing. To lock in a rate, a borrower will agree to pay a specific fee or deposit that is sometimes refundable, to guarantee that the current rate is honored at closing.

For example, a borrower can lock in a rate at 3.5% for 60 days. If the interest rate were to jump to 4.25% during those 60 days, the lender would still honor the original rate of 3.5%.

However, there are contingencies to rate locks. Changes to your loan application, credit score, or income can negate the rate lock. Once you lock in your rate, you want to be careful not to impact any of these variables in order to ensure your rate remains the same.

Similar to a rate lock, a forward rate lock is also an agreement that locks in a specific interest rate well before closing. The difference between a standard rate lock and a forward rate lock is that a forward rate lock extends beyond the typical 30-90 days. These rate lock agreements can be set for 12 months or more.

Forward rate locks benefit borrowers who refinance an existing loan with a prepay penalty that will burn down closer to maturity. Regardless of the type of rate lock utilized, the goal is to protect against market uncertainties by locking in the desired rate.

## The Pros and Cons of Forward Rate Locks

A forward rate lock can be a beneficial method for managing interest rate risks. However, it does have its limitations. Forward rate locks are based on estimates, so the further you estimate into the future, the less reliable your estimate will become. Extending your rate lock past a year can result in a highly inaccurate estimate of future markets.

Additionally, rate locks are not free. In many cases, your lender will add the cost of your rate lock into the interest rate that you are offered. If you need to extend the terms of your rate lock period, you will often be charged an additional fee.

While rate locks come at a cost, they can be extremely helpful for guarding against spikes in interest rates. They can also assist you in managing investment budgets, as there are fewer variables with which to deal. Ultimately, you will want to run the numbers to see what your total cost for a rate lock is against the total cost a projected interest rate increase would cost. This can help you measure the risk of waiting it out versus paying for a rate lock.

## When Can I Lock in My Rate?

When you can lock in a mortgage rate will depend on the lender with which you are working. In some cases, a lender will allow you to lock in your rate as early as the pre-approval stage. Other lenders may require the seller to accept your offer before they lock in your rate.

The key is to be strategic about when you opt for a rate lock. If you lock your rate too quickly, you could wind up going past the expiration date for your rate lock. This will result in losing that rate or requiring you to pay an extension fee to carry the rate forward.

Additionally, you'll want to pay attention to key market indicators. Locking in at the wrong time could result in you paying a higher rate than if you had waited.

## How Long Can You Lock Your Rate?

How long you can lock in an interest rate depends on your lender. While 30-90 days is a general norm, you can find lenders who are willing to work with you to extend this much further, up to 12 months or more.

Generally, the longer you lock your rate in, the higher fee you will pay for the rate lock. While this might cost you more upfront, it can save you substantially in the long run if you believe rates will continue to rise throughout the process of closing on your loan.

## What Happens if Rates Lower?

Locking in a rate is a way to protect yourself against rate increases based on a belief that further down the road, rates will increase. However, what happens if rates lower prior to closing? In most cases, a lender will allow you to pay a fee to relock at the new, lower rate.

## Determining Whether or Not to Use a Forward Rate Lock

At the end of the day, whether or not you should implement a forward rate lock will have a lot to do with your unique lending situation and current market conditions. While there are no guarantees when it comes to predicting interest rates in the future, key indicators can help you understand what the market will do in the year ahead. To understand when a rate lock is ideal, you first need to understand why rates change.

## Why Do Rates Change?

Rate locks exist because interest rates are continually fluctuating. This fluctuation is caused by a few key factors:

**Economic Fluctuations:**
During a booming economy, interest rates tend to increase. During economic slowdowns, interest rates will often lower, which can help to spur economic growth. A good example of this was seen during the early stages of COVID-19. As economic uncertainty hit, mortgage rates hit all-time lows.

**Federal Funds Rate:**
When banks and financial institutions borrow money, the rate they pay is the federal funds rate, which is controlled by the Federal Reserve. This has a direct impact on mortgage interest rates. The Federal Reserve often manipulates the federal funds rate to deal with inflation increases, as seen in recent actions taken due to record inflation that led to mortgage rate increases.

**Demand:**
When demand for mortgages is high, interest rates tend to increase. As the demand for mortgages wanes, lenders often lower rates to help encourage more demand.

Working with a lender commercial mortgage broker that can help you understand all of these factors will be critical in determining whether or not a forward rate lock is an ideal solution for your needs.