



Nov 10, 2023

Categories:

[Multifamily Matters](#)

[Publications](#)

[The Carveout](#)

Authors:

[Sandra M. Eismann–](#)

[Harpen](#)

[Elizabeth L. Black](#)

Considerations for Commercial Borrowers: Mitigating Uncertainty and Risk with Interest Rate Swaps

Commercial borrowers often use interest rate swaps to manage interest rate risk in loan transactions. An interest rate swap does not change the terms of the underlying loan transaction. Rather, it is a separate transaction that helps to reduce interest rate risk. Because most commercial loans bear interest at a variable rate based on an index such as the Secured Overnight Financing Rate (SOFR), borrowers are often concerned about the effect that future changes in a variable rate benchmark will have on their borrowing costs. A rise in interest rates increases the cost of interest payment obligations for borrowers, which results in reduced liquidity that can be used for other purposes. An interest rate swap can provide greater cash-flow predictability and protection from rising rates.

With the U.S. Federal Reserve continuing to battle inflation, the interest rate environment [remains uncertain](#) in the United States. Given this uncertainty, commercial borrowers may want to adopt strategies, including entering into interest rate swaps, to manage their risk exposure.

What Is an Interest Rate Swap?

In an interest rate swap, two counterparties agree to exchange interest rate cash flows for a specified period of time. When a borrower enters into an interest rate swap, the counterparty is often the bank (or its affiliate) where the borrower obtained the underlying loan. In a typical interest rate swap, one party hedges against a rise in interest rates and another party hedges against a decrease in interest rates. The two parties then enter into an interest rate swap where there is an exchange of a fixed interest rate for a floating rate over a stated period of time.

For example, Party A pays Party B, usually on a quarterly basis, a fixed payment equal to the product of (i) a fixed interest rate, and (ii) a notional amount (typically the principal amount of the loan).

Party B pays a floating payment to Party A equal to the product of: (i) a floating interest rate based on a spread over a benchmark rate (typically SOFR), and (ii) the same notional amount. These periodic payments are then netted, with the party owing the greater amount making the quarterly payment to its counterparty.

Typically, if either party wishes to terminate the interest rate swap then the terminating party must pay a termination payment to the other party. The termination payment is often based upon the agreed upon fixed interest rate and the variable rate in effect on the termination date. Whenever the variable rate materially changes from the variable rate at the time the interest rate swap was entered into, a large termination payment may be required, which may make it costly for a party to terminate an interest rate swap. Because there is potential for a termination payment upon early termination, interest rate swaps have an inherent prepayment risk.

Standardization of Swaps and Derivatives

The International Swaps and Derivatives Association, Inc. (ISDA) is the primary global trade association for the swaps and derivatives industry. ISDA promotes safe and efficient derivatives markets by publishing standard documents, definitions, and other resources for all users of derivative products. ISDA's standard forms to document derivatives transactions include:

- ISDA Master Agreement
- Schedule to the ISDA Master Agreement
- Transaction Confirmations
- ISDA Credit Support Annexes

ISDA's standardized documentation serves to reduce the risk and cost of transacting in the over-the-counter (OTC) derivatives markets.

Understanding the ISDA Master Agreement and Schedule

The ISDA Master Agreement (“ISDA Master”) is a standard umbrella agreement between the two contracting parties. Any revisions or negotiated changes to the ISDA Master occur in the Schedule to the ISDA Master Agreement (“ISDA Schedule”). The ISDA Schedule allows the parties to modify the standard terms of the ISDA Master, tailor the terms to the specific needs of the parties, and add provisions not included in the ISDA Master.

Increased Use of Interest Rate Swaps in 2023

The U.S. Federal Reserve’s recent [interest rate hikes](#) have contributed to a significant growth in trading activity for interest rate derivatives, which include interest rate swaps. On October 2, 2023, ISDA [reported](#) that the total notional amount of interest rate derivatives traded in the first half of 2023 has risen by 16.8% to \$181.6 trillion compared with \$155.5 trillion in the first half of 2022. ISDA theorized that this increase is likely driven by the need for parties to manage risk, safeguard against rate increases, and adjust borrowing or investment strategies.

Key Takeaways

With the ongoing uncertainty in the interest rate environment, interest rate swaps can help commercial borrowers manage risk and increase cash-flow predictability. When entering into an interest rate swap, commercial borrowers should carefully review the terms in the ISDA documents to ensure that they align as closely as possible with the underlying loan transaction that is being hedged, quantify prepayment risk, conduct a cost-benefit analysis, and seek experienced counsel to evaluate the different components of the proposed swap rate.

Frost Brown Todd routinely counsels multifamily investors, developers, sponsors, lenders, and other key stakeholders on their developments, assets, and rentals across the country. We stay at the forefront of all industry trends, developments, and legislative and executive efforts affecting the industry, and we are ready to assist and guide our clients throughout the life of their projects. For more information, please contact the authors of this article or any attorney with Frost Brown Todd’s [Multifamily Housing](#) industry team.

Multifamily Matters Blog

Providing relevant legal perspectives to keep developers, investors, and lenders at the forefront of the multifamily industry in our footprint.

[Subscribe for Updates](#)

© 2026 FBT Gibbons LLP. May be considered attorney advertising in some jurisdictions.