Is It Time To Hedge Interest Rate Risk With a Forward Rate Lock?

hedging BLP

Summary: In the current interest rate environment, forward rate locks offer both CFIs and borrowers an opportunity to mitigate interest rate risk. Femi Audifferen, SVP of Hedging Solutions at PCBB, explains why now might be an opportune time to hedge with a forward rate lock.

Unlike the fanciful hedges of traditional English gardens, the Great Hedge of India was designed to divide. It was built in 1868 by the British along a customs line extending 2.3K miles and guarded by 12K soldiers. The hedge, which at its peak measured at least 800 miles, was made up of thorny native shrubs, ideal for preventing smugglers from sneaking salt into British-controlled areas without paying a hefty tax.

In the current interest rate environment, a very different kind of hedge is proving to be a particularly useful tool to secure the interests of both financial institutions and borrowers: the forward rate lock (FRL) hedge. PCBB's SVP of Hedging Solutions, Femi Audifferen, explains why now might be a good time for community financial institutions (CFIs) to get started with this lending solution for new and existing loans.

What is a forward rate lock hedge?

A forward rate lock is an agreement between a borrower and a financial institution to set a fixed rate for future financing. While the FRL eliminates the risk of the borrower's rate changing before financing begins, the hedge component (a forward rate swap) also ensures the institution's loan pricing spread is preserved. FRLs are most often used to fix rates on permanent financing following construction and to fix future rates on existing resettable loans.

These strategies are particularly useful when the yield curve is inverted or when rates have risen — both of these conditions currently exist. The forward swap rate for an FRL is calculated the same way a standard swap rate would be — averaging the projected rates of a specific pricing index (usually SOFR or the fed funds rate) over a specified term. The fundamental difference is that an FRL rate is calculated based on projected rates from a future date, which could be up to several years in the future.

Why now?

The Federal Reserve has expressed a commitment to continue its tight monetary policy until inflation is brought down to its 2% target and has stated that rates will likely be higher for longer. Bond market activity currently suggests the situation will play out differently. The alternative view is that economic weakness from tight monetary policy will force the Fed to deviate from its current policy path sooner rather than later, meaning the Fed will cut rates by the end of this year or early in 2024.

According to Audifferen, while the Federal Reserve continues to emphasize rates will be higher for longer, the currently divergent market expectations bring about an opportunity for borrowers seeking the security of a fixed-rate loan. Since the bond market is projecting rates to fall, forward starting swaps are currently at a discount to standard spot rates. *"In a normal upward-sloping yield curve environment, rates are higher the* *longer the term of the loan and the further out the start date of the loan,"* Audifferen explains. This current disconnect between market and Fed projections is reflected in an inverted yield curve, where variable-rate loans (based on short-term indices) pay more than longer-term fixed-rate loans. The market is ripe for borrowers to take advantage of this irregular trend.

Of course, the inverted yield curve opportunity isn't the only upside of entering an FRL agreement. Here are **three primary benefits** to both FRL borrowers and the issuing financial institution:

1. **Eliminating future rate uncertainty for borrowers and CFIs.** CFIs typically mitigate their interest rate risk from longer-term loans by adjusting the fixed rate every 5Ys, but with rates higher by 450bp in the last 16 months, these resets are creating significant credit risk for CFIs and market risk for their borrowers. Using an FRL, the borrower sets their rate today, but it's not effective until the loan's repricing date. This solution gives the borrower time to prepare (cut costs, increase rents, etc.) for the higher debt service. Regulators will like the fact that CFIs have a strategy in place to manage their reset risk.
2. **Protecting institutions and borrowers from credit stress due to higher reset rates.** Although most institutions conduct stress testing on their loan portfolios, the magnitude of rate hikes we have witnessed over the last year is such that some loans may be approaching debt service covenant limits or at least create credit stress for both the institution and the borrower. *"By fixing the rate with a forward rate lock before rates go up further, the institution is able to reduce credit stress for its customer and itself. Regardless of what happens to rates in the next 12-24 months, the borrower is guaranteed a fixed rate they can budget around,"* says Audifferen. Keeping credit stress in check is critical for the lender to maintain a healthy portfolio, so offering an FRL to your borrowers can help you reach your goal on this front.
3. **Protecting your institution from Net Interest Margin (NIM) compression.** In recent years, when interest rates were low, cost of funding wasn't a significant issue for CFIs. As rates have risen rapidly and more than expected, financial institutions have needed to increase the rate on their deposits to avoid losing customers to more competitive offers. As such, the substantially higher cost of funds has compressed NIM. Without hedging, institutions have to wait for the reset period (e.g. 5Y reset on a 10Y term loan) to reprice their loans, while paying higher rates on their deposits in the meantime. This is where the FRL comes in to help reduce that risk. *"With forward rate locks, financial institutions can essentially convert from conventional 5Y repricing loans, at their next reset, to one that resets every month,"* explains Audifferen. *"So as rates go up, deposit costs increase, but they are matched by rising interest income on the loan, with the borrower still benefiting from the fixed rate."* CFIs also generate additional fee income from the swap with the refinancing.

Your institution may be hesitant to offer hedging solutions primarily due to complexities related to derivatives, but there are options to outsource the hedging function when working with a correspondent bank. PCBB's Borrower's Loan Protection® uniquely eliminates the need for a CFI to handle the derivatives associated with an FRL. *"So, from the institution's perspective, they handle the loan, while PCBB handles every other aspect associated with the swap,"* Audifferen explains. *"We carry the swap on our books and handle all of the operational, collateral, and regulatory requirements. Essentially, the financial institution is able to provide its customer with the fixed-rate term they want, while carrying a floating rate on their books, without engaging directly with a derivative."*

With its many benefits, from helping ease credit stress to protection against NIM compression, an FRL is a unique solution that's a great option for your borrowers as well. Thanks to their ability to protect the borrower against future rate uncertainty without exposing the bank to interest rate risk, an FRL agreement can be a win-win for everyone.

NEED MORE FEE INCOME?

Financial institutions can earn additional fee income by adding monetization to a hedged loan. Learn more about how Borrower's Loan Protection® (BLP) can help you earn higher fee income today.

ECONOMY & RATES

Rates As Of: 05/02/2023 05:34AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	5.27	0.17	0.85
6M	5.14	0.08	0.38
1Y	4.84	0.10	0.13
2Y	4.13	0.13	-0.30
5Y	3.60	0.12	-0.40
10Y	3.54	0.11	-0.34
30Y	3.79	0.11	-0.18

FF Market	FF Disc	IORB
4.83	5.00	4.90
SOFR	**Prime**	**OBFR**
4.81	8.00	4.81