Banking on Stability: Hedging Strategies for CFIs

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Summary: Economic indicators suggest that the Fed is likely to ease monetary policy by lowering the Federal Funds Rate at some point this year. We discuss what factors could influence the Fed's decisions and how hedging strategies could benefit your CFI in this changing market.

The quokka — a marsupial that hails from a remote region of southwestern Australia — is often thought to be the happiest animal on earth, thanks to a facial structure that makes it look as if it is permanently smiling. With interest rates finally starting to fall, borrowers across the US might perhaps also begin displaying a smile like the quokka's.

A Healthy Economic Environment, but Caution Prevails

Current economic data indicates a relatively strong economy. Unemployment has remained at, or below, 4% for the last 26 months; inflation continues to abate — the three-month annualized Core PCE (the Fed's preferred inflation measure) has averaged 2.1% since August 2023. As of February 15, according to GDPNow, the economy is projected to grow by 2.9% during Q1. With this economic backdrop, the Fed remains cautious about cutting interest rates too soon or too fast and does not anticipate more than two or three cuts this year, starting sometime this summer.

The market, on the other hand, has had a more bullish view, and was pricing accordingly. At the beginning of the year, the market was projecting as many as six cuts by the end of 2024, but as stronger-than-expected economic data continues to come in, market expectations for rate cuts continue to evolve. Although market expectations and Fed projections have differed over the last few months, they are more aligned now — with yearend targets of 4.4% and 4.6% respectively.

Helping Borrowers Make Sound Financial Decisions

It's important that "borrowers focus on longer-term rate projections when thinking about their financing needs," says Chad Hunter, SVP of Hedging Solutions at PCBB. However, many borrowers are opting for shorter loans, hoping to refinance at lower rates in the future. That said, looking at the swap curve — a good proxy for borrowing rates — shows that longer-term rates have already dropped significantly since their October highs.

While Fed Funds and other short-term rates are expected to drop, the market is not anticipating much of a change in longer-term rates. Forward swap curves for the end of 2024, 2026, and 2028 show that expected 5Y and 10Y rates are near current levels. "This suggests that borrowers choosing a strategy of a shorter loan now with hopes for a lower rate in the future, might be disappointed," concludes Hunter.

Example Scenarios

Working through some scenarios could help community financial institutions (CFIs) understand how they can support their customers with their borrowing decisions.

1. **Long-term swap vs. shorter-term loan and refinancing.** Let's compare two options based on a $2MM loan with a 10Y holding period and 25Y amortization. The first option is a 10Y swap, the second a 5Y loan

that reprices in 5Ys. A quantitative analysis shows that at the time the second loan reprices in 5Ys, the 5Y Treasury yield would need to be more than 100bp below current projected levels for that option to be better for the borrower than the 10Y swap. The borrower should evaluate the likelihood of such a drop when making their financing decision. If they conclude that an unexpected drop of 100bp in 5Ys is unlikely, then a 10Y swap is a better option for them.

2. **Swapped loans with embedded floors.** Consider two structures for a $1MM loan with a holding period of 5Ys and amortization of 30Y — one with a 2% floor and the other without a floor — we see that the fixed rate on the loan with the floor is about 35bp higher. While loans with embedded floors, or a specified minimum rate, sound attractive to lenders in a falling rate environment, they can be expensive and often make the all-in fixed rates uncompetitive. However, if the borrower is willing to pay a higher fixed rate, financial institutions should consider whether they would be better off with the floor, or increasing the credit spread and/or fee income. In this example, the floating index would have to fall by approximately 375bp immediately for the financial institution to be better off with the embedded floor vs a 35bp wider loan margin.
3. **Hedging reset risk.** Reset risk arises from longer-term, fixed-rate, on-balance-sheet loans that have periodic repricing events, potentially exposing borrowers to dramatically higher rates. One solution to mitigate this risk, provide rate certainty to the borrower, and generate non-interest fee income is to pair a change in terms agreement with a forward-starting swap. The loan's current rate remains the same until the reset date, at which point the loan converts to a floating rate. The floating rate is then hedged to maturity with a swap. This helps borrowers eliminate their reset risk now, while also having time to prepare for the new payment amount. Negative forward premiums from the market's rate cut optimism make this an attractive solution. Lenders also benefit by managing credit risk and creating non-interest fee income opportunities.

Many CFIs have to contend with the fact that their customers, and sometimes their lenders, are not always derivative savvy, making them hesitant to consider derivative solutions. PCBB designed its Borrower's Loan Protection® (BLP) program with simplicity and transparency in mind. Our hedging team works seamlessly with your lenders to educate borrowers so that they understand the derivative-based solutions and are comfortable using them. Best of all, with BLP, there are no derivatives on the CFI's balance sheet. "With a quantitative analysis like I used for these scenarios, lenders and borrowers can evaluate financing alternatives and make more informed decisions," says Hunter. "Our hedging team would be happy to help evaluate your specific opportunities."

**Data used in this article was collected as of Feb. 15.*

ECONOMY & RATES

Rates As Of: 02/20/2024 05:36AM (GMT-0800)

Treasury	Yields	MTD Chg	YTD Chg
3M	5.44	0.02	0.04
6M	5.31	0.13	0.05
1Y	4.92	0.22	0.16
2Y	4.58	0.37	0.33

5Y	4.25	0.41	0.40
10Y	4.27	0.35	0.39
30Y	4.44	0.28	0.41

FF Market	FF Disc	IORB
5.33	5.50	5.40
SOFR	**Prime**	**OBFR**
5.30	8.50	5.32