Forward Rate Lock Agreements Help Your Bank

hedging risk management

Summary: Valued for their flexibility, forward rate lock agreements can be customized to fit the requirements of both your bank and your borrower. We explain how.

Just locking your doors can save you a lot of problems, when it comes to the risk of burglaries. Statistics show that 30% of burglars enter a home through an unlocked door or window, so locking entry points can help you avoid such an issue.

In banking, locking things can make sense too. Consider the simple forward rate lock agreement. These keys to banking success are designed to help protect your bank and borrowers from the risk and uncertainty of changing interest rates.

To do a forward rate lock, you will need to execute a simple contract known as a forward rate agreement (FRA). Any FRA is simply a commitment to engage in a future transaction at a price stated and agreed upon today, but let's go even deeper into the details and options.

An FRA is a deal between two parties which want to protect themselves from future interest rate changes. To do so, the parties agree to lock in a particular interest rate for a specific period of time. To do that, the parties need to agree on a future settlement date and the principal amount. Then, when the settlement date rolls around, the two parties simply pull out the contract and do some math, by taking the difference between the market interest rate on the settlement day and the interest rate specified in the agreement.

Valued for their flexibility, FRAs can be customized to fit the requirements of both sides of the agreement. They have other useful features, too. In addition to allowing contracts to be tailored to users' needs, FRAs protect against market volatility. They do this by serving to limit counterparty exposure to the difference between the market rate and the contract rate.

FRAs also limit administrative costs, because the only cash flow between the parties occurs on the settlement date. Both sides of the transaction avoid the headache of settling daily futures and the parties can easily reverse the transaction by creating an offsetting FRA at a new price.

FRAs are often used by banks to safely provide rate commitments to borrowers ahead of loan financing. For community banks, PCBB offers a simple solution designed to insulate both your bank and your borrower from interest rate risk. This can be done from the rate lock date to the start of financing. By design, your borrower gets a fixed rate coupon that they want, while your bank protects its margin and pricing economics too. The borrower is subject to yield maintenance, should they walk away prior to the loan's start of financing.

If there is a lien in place, no collateral is needed for the FRA transaction. If there is no existing lien, then the borrower may have to post collateral for the forward period only.

FRAs are best in situations where both borrower and lender are confident that the loan will go through for the proposed amount and terms. While it is possible to change the terms with a coupon adjustment, it occurs based on the then current market rates.

If the loan doesn't go through, then the borrower would receive a fee if rates have increased, or would need to pay a fee if rates have declined.

Now that you know about FRAs, you may still have questions, so give us a call and we will show you how easy they are to do.

HEDGING SERVICES FOR COMMUNITY BANKS

Community bankers seeing long-term fixed rate demand from business clients can transform payments into a floating rate on their books using Borrowers' Loan Protection (BLP). Contact us today for more information.