How ARC Helps Banks and Borrowers With Anticipated Fed Cuts

At the December 12-13th FOMC meeting, the Fed left its target range of 5.25%-5.50% in place. The committee and Chair Powell did acknowledge that the current rate hiking cycle has likely ended. The committee forecasted three rate cuts in 2024 based on its summary of economic projections. However, currently, the Fed Funds futures are pricing six rate cuts in 2024, and only time will show if rates follow the committee's or the market's path.

How does the ARC program help banks and borrowers in the face of anticipated interest rate cuts in 2024?

For Banks

The current inverted yield curve permits banks to gain additional net interest and fee income for terms between 3 and 20 years fixed. This benefit applies to new or existing loans refinanced through a hedging program. Currently, for a 5-year fixed rate, a bank will generate an immediate adjustable yield that is 1.54% higher than what the borrower will pay fixed - the additional income for the bank over the borrower's payment is shown in the table below for various fixed terms.

Amort.	Maturity										
	3yr	4yr	5yr	6yr	7yr	8yr	9yr	10yr	12yr	15yr	20yr
25yr	1.29%	1.44%	1.54%	1.57%	1.60%	1.63%	1.63%	1.63%	1.63%	1.61%	1.61%

Banks may question why loan hedging makes sense despite possible short-term rate cuts. There are multiple good reasons why national and regional banks continue to offer fixed-rate loans to borrowers only via a loan hedging program, regardless of the interest rate cycle. Community banks should also consider those same reasons, which include the following:

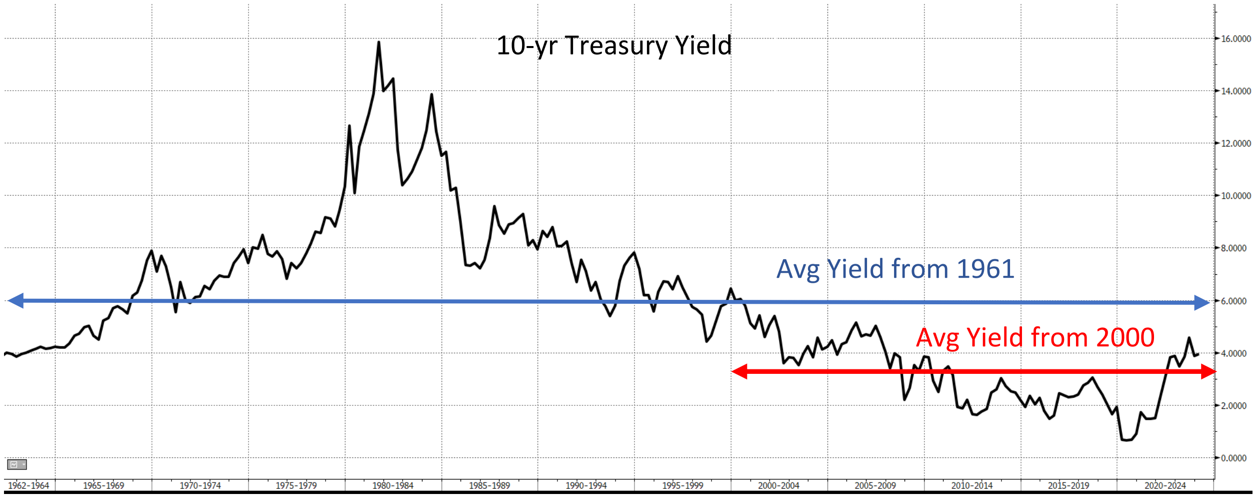
1) Economists', the FOMC's, and the market's forecasts are often incorrect, and the precision of forecasts falls dramatically beyond one quarter. However, the ability to recognize fee income and higher yield upfront is often a major win for banks.
2) The bank can also earn a substantial hedge fee of 1.0% to 2.5% of the loan amount. This income can dramatically boost current ROE/ROA and is retained by the bank even if the borrower prepays or refinances the loan before the contractual term. In fact, refinancing and prepays may boost the bank's return for loans hedged in an inverted yield curve because the bank generates NIM during a higher rate environment, and the retained hedge fee can be applied economically over a shorter time. Consider that a 5-year hedged loan has an average expected life of about 4 years.

3) Banks should consider the time horizon for the credit and match loan revenue and deposit costs over that time horizon. While the FOMC is broadcasting the possibility of three rate cuts in 2024, a 5 or 10-year loan will be subject to many more FOMC pivots and rate increases and decreases, which are impossible to predict today. Eliminating this future risk for the bank (and the borrower) is an essential objective of a loan hedging program. The average community bank's COF is highly correlated to SOFR and Fed Funds rate.
4) A fixed-rate loan without a hedge does not result in a yield most banks expect when rates decrease. For on-balance sheet fixed-rate loans, most banks will either not include a prepayment provision, have a soft prepayment provision, or waive that provision when pushed by an important client. Therefore, these on-balance sheet fixed-rate loans tend to prepay if interest rates drop and extend if interest rates rise.

For Borrowers

Why should borrowers lock in fixed-rate financing today, given the forecast of lower short-term rates in the future? If a borrower desires a fixed-rate loan, waiting for short-term rates to fall is not a defensible strategy for achieving an optimal financing outcome for the following reasons:

1) Short-term rates are not necessarily correlated with long-term rates. Therefore, while Fed Funds are expected to decrease in 2024, long-term rates (rates beyond 3 years) are not.
2) Because of the divergence of forecasts between the FOMC and the market, long-term fixed rates are likely to rise and not fall in 2024 and beyond if short-term rates follow the Fed's projected path.
3) No one can predict with certainty where interest rates will be in the future. However, the borrower knows what credit structure is available today and at what cost. This certainty eliminates many risks for borrowers.
4) If interest rates fall in the future, it may be because of a recession. Refinancing in a downturn is risky, with unknown project cash flows, uncertain credit availability from banks, and wider credit spreads from most creditors.
5) Long-term interest rates are not above historical levels. The graph below shows 10-year Treasury rates and average rates for two periods (from 1961 to the present and from 2000 to the present). By longer-term historical averages, current 10-year rates are low. From 2000 to the present (which includes depressed rates during the pandemic and great financial crises), long-term rates are at average levels. It may be unwise for borrowers to wait for a more suitable time to secure long-term financing.



For Lenders

Lenders can be heroes to borrowers by offering fixed-rate debt through a loan hedging program. A hedged loan offers the following benefits: 1) a lower borrower's interest rate and periodic payment, 2) increased yield to the bank, 3) substantial fee income for the bank, and 4) future certainty of payments to the borrower. ARC can be easily applied to new loans or existing bank loans where the borrower would like to lock rates today to be effective after the expiration of the existing term.

Action Item

Contact us to obtain a presentation showing the benefits of ARC for your specific borrower using various structures and terms.