Great Lakes Banker Magazine

February 2026 • Volume 12 • Number 2

When "Easy" Fixed-Rate Programs Stop Working

How community banks are taking back pricing and control in fixed-rate lending

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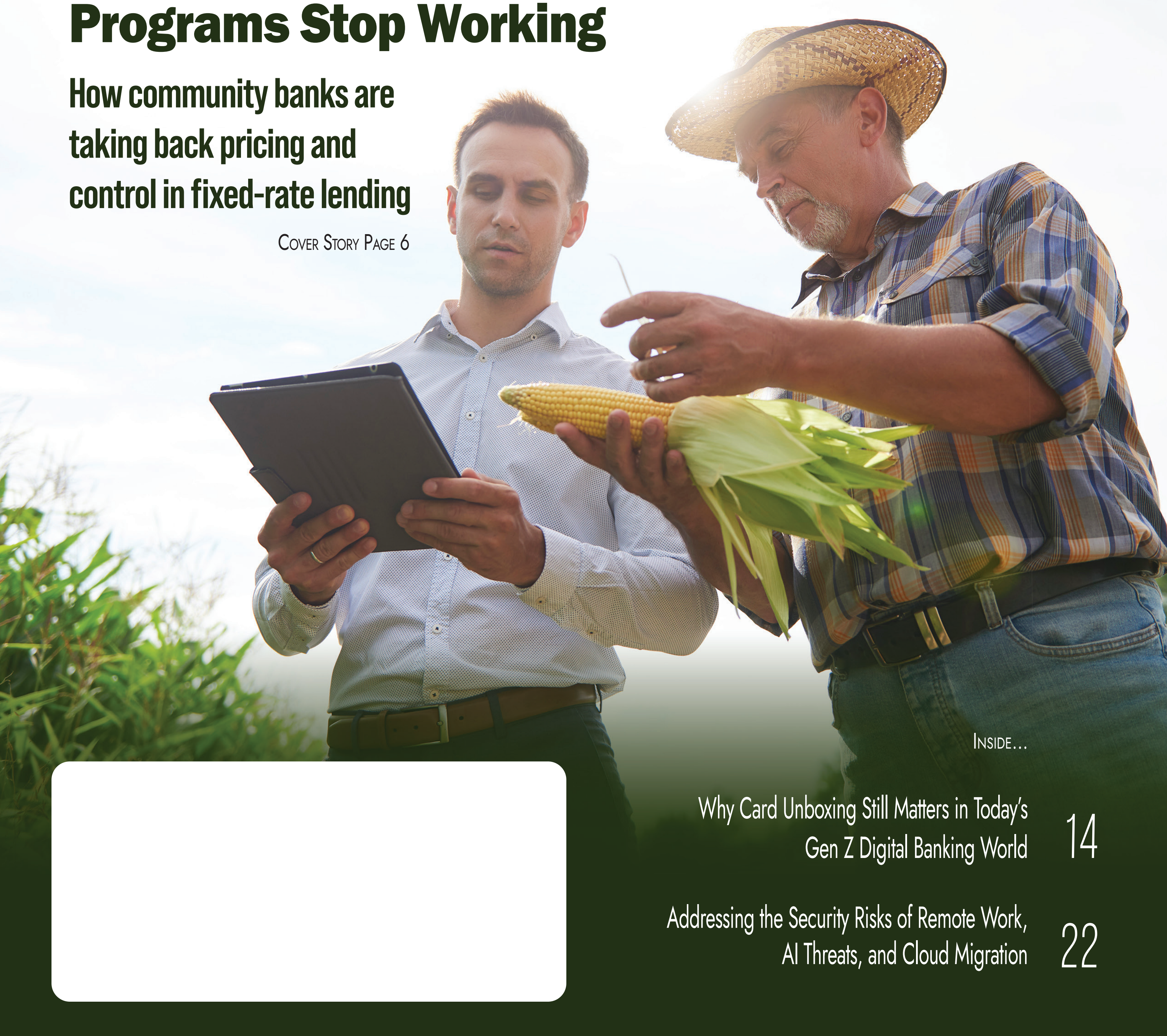

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COVER STORY

When “Easy” Fixed-Rate Programs Stop Working

How community banks are taking back pricing and control in fixed-rate lending

By Josh Cannington

When borrowers began asking – again – for seven- and ten-year payment certainty, one Great Lakes community bank found itself weighing a familiar trade-off: how to offer fixed rates without taking on more long-duration risk than the balance sheet could comfortably support.

The timing made the question harder. Rates were no longer rising quietly in the background; they were front and center in every borrower conversation. Customers wanted certainty. Bankers wanted flexibility. And the balance sheet had to hold up under both.

Like many banks, its first answer was an assumable rate conversion (ARC) program through a correspondent bank.

On paper, ARC solved several problems at once. Lenders could quote fixed rates from a daily grid. Borrowers signed a single note and made a single payment. The bank booked a floating-rate asset. And the pitch was speed and simplicity—“easier than swaps.”

“It filled a real gap for us,” one executive involved in the decision recalled. “We could finally say yes to fixed-rate requests without building a derivatives operation overnight.”

A solution becomes a habit

ARC started showing up in more and more deals. Owner-occupied expansions, ag real estate, and term loans. Anywhere payment stability mattered, ARC became the default.

Operationally, it was easy to live with. There were no borrower ISDA conversations. No daily margin calls. No need to turn relationship managers into swaps specialists. For a lean institution focused on lending relationships, that simplicity matters.

But over time, as ARC became the default in more situations, subtle pressures began to surface.

Pricing was the first. Deals that should have been routine wins – strong guarantors, clean collateral, meaningful deposits – were increasingly hard to close on rate. Competing offers came back just a little lower, forcing lenders into a familiar choice: concede margin or lose the relationship.

The friction became more noticeable after deals closed. When borrowers wanted to sell early, refinance, or restructure, relationship managers found themselves relaying payoff figures tied to a third party’s calculations.

As one lender put it, “It’s hard to be the trusted advisor when you’re also the messenger, especially when the math isn’t fully yours.”

Looking more closely

There wasn’t a single deal that went wrong, and no regulatory issue forced a rethink. The shift came later, during a routine review of recent loans, when the finance team started comparing two things:

- What it would cost to hedge a fixed-rate loan directly with a swap dealer;
- And what were the all-in economics embedded in the ARC program’s fixed rate and fee structure

At first, the exercise seemed academic. But as assumptions were refined and numbers aligned, the gap became difficult to ignore.

"It wasn't just a few basis points," the executive said. "It was enough to make us ask where the value was actually going."

That's when leadership articulated what ARC marketing often downplays: ARC programs are swap programs. The swap is simply executed and controlled at the correspondent level.

Once leadership viewed it through that lens, three trade-offs became clear.

> "We thought we were avoiding swaps," the executive said. "But we were really just buying someone else's, and paying for it."

Tradeoff #1: Pricing

The bank wasn't discovering price in the swap market; it was accepting a rate passed through from a correspondent desk that was itself sourcing levels from swap dealers. In practice, that meant the bank was a few steps removed from the wholesale swap price it could have accessed directly. The fixed rate it quoted to borrowers reflected dealer execution levels plus the desk's embedded fees and optionality. The bank could compress its own spread to compete, but it couldn't truly shop the hedge component.

Tradeoff #2: The economics

Much of the revenue generated by the hedge accrued outside the institution. While the bank earned something at closing, a significant portion of the hedge's value remained with the correspondent.

Tradeoff #3: Control

Many ARC structures rely on participation or assignment mechanics to protect the hedge. The bank continued servicing the borrower, but it was no longer alone at the top of the capital stack.

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Why the move didn't happen sooner

From the vantage-point of hindsight, it was clear the delay wasn't about a lack of understanding around swaps. It was about timing and confidence.

Like many community banks, the institution had watched derivatives cautiously. Swaps carried a reputation for complexity and operational burden. ARC felt like a responsible middle ground.

"It wasn't fear," one person close to the decision said. "It was prioritization. We were solving for speed and certainty first."

The spreadsheet changed that calculus.

Keeping the loan, hedging the rate

The bank's goal wasn't to become a derivatives shop. It was to compete on rate, structure, and relationship without outsourcing control.

So leadership shifted to a more traditional approach that kept the fixed-rate loan on the bank's paper, retained the first lien on collateral, and hedged the interest-rate exposure directly with swap dealers.

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Little changed for borrowers. Most signed a plain-vanilla fixed-rate note and made one payment. The derivative lived between the bank and the dealer as a balance-sheet hedge, converting fixed-rate exposure back into floating.

What changed was where the levers sat.

Instead of starting with a correspondent grid, the bank accessed the dealer market directly. By onboarding multiple counterparties, it could compare execution and tighten pricing when competition demanded it.

The impact was immediate. Lenders were able to win deals on rate without giving up spread. And when competition wasn't the issue, the bank retained more revenue because the hedge economics stayed in-house.

Equally important, prepayment and modification conversations returned to the bank's own credit framework. When a hedge needed to be resized or unwound, decisions were made in the context of the full relationship, not a formula owned by a third party.

"The flexibility came back right away," said someone close to the transition. "The hedge became a tool, not a constraint."

> We didn't switch because we wanted something more complex. We switched because we finally understood what we were already doing, and who was getting paid for it.

Why ARC isn't the end state

ARC programs exist for a reason. They offer smaller institutions a way to meet fixed-rate demand without building full derivatives infrastructure overnight.

In practice, it often turns out not to be the final stop.

Larger banks hedge directly – either internally or through dealer relationships – because pricing and hedge execution are part of how they compete. They don't outsource those economics because they view them as core.

Community banks don't need the scale of large institutions to adopt the same principles. With clear policies, approved counterparties, independent pricing, and transparent reporting, they can retain ownership of loans, collateral, and economics while managing risk responsibly.

A checklist for banks feeling the same squeezeBanks that have used ARC for a year or two often start to recognize the signs:

- Fixed-rate deals only clear when margin is conceded
- Borrower rates feel consistently "a little high"
- Payoffs and modifications depend on third-party math
- Collateral control is diluted
- Hedge economics seem real, but don't stay in house

The takeaway here isn't that ARC is wrong. It's that for many banks, ARC ends up being a transitional step – and once they understand the mechanics, it becomes easier to see where they might be giving up pricing power, flexibility, and revenue that could otherwise support growth.

As one executive, who moved from outsourced conversion programs to a traditional swap program, put it, "We didn't switch because we wanted something more complex. We switched because we finally understood what we were already doing, and who was getting paid for it."

About the Author

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