A primer of commercial loan hedging: Options to generate fees and reduce interest rate risk

By Brian Matochik, FTN Financial

Commercial loans are a “meat and potatoes” product for community institutions. A strong commercial borrowing base will provide solid deposits and consistent earnings. Commercial loans are typically sizeable assets and have a discernible impact on profitability. Consequently when commercial loan volume declines, bankers start to lose a key earning asset.

Lately it has been an uphill battle for bankers to maintain profitable commercial loan growth. Loan demand continues to remain a mere shadow of its 2004-2006 peak. In markets where there are loans to be made, fierce competition contributes to narrower spreads. Moreover, the current interest rate environment does not provide enough reward to compensate for the added risk of extending fixed rate loan maturities.

One often overlooked and underused tool available to overcome current lending challenges is a commercial loan hedging program. Loan hedging provides a method to offer more competitively priced loans to borrowers. Hedging eliminates long term interest rate risk for banks but still allows borrowers to obtain fixed rate funding. As an added bonus, it offers an opportunity to pick up ancillary fee income. And most importantly, it is available to any community bank. This paper will examine commercial loan hedging, how it works, and how it can be implemented to overcome market challenges and help bankers make more profitable loans.

Loan growth is stagnant

Following the 2008-2009 “credit crisis,” loan growth came to a halt. As the name suggests, credit was the main culprit. The collapse of a few major financial institutions coupled with a steady increase in mortgage defaults sent a scare across the entire market. The economy quickly faltered and companies were hesitant to expand their businesses.

However, it did not take long for credit to start flowing back into the market. Once the smoke cleared and the knee-jerk market reaction settled down, loan demand started to pick back up in mid-2009. Note that even though loan demand is on the rise, loan volume continues to decline (Chart 1).
The aftermath of the credit crisis resulted in increased regulatory scrutiny on lending standards and capital. Banks are not able to extend credit as freely as they were a few years prior. While demand may be improving, competition for good, financially sound loans is on the rise.

The glaring problem is there are currently too many banks vying for a small pool of loans. Banks are not willing to lend to just anyone looking for funding, but are focusing on doing whatever they can to retain their good relationships and prospect only to the financially sound "cream of the crop" clients in the market. Adding insult to injury, increased competition is putting pressure on loan spreads (Chart 2). Banks are being forced to eat into their profits just to win deals. Being able to stand out in the market with competitive pricing is critical to growing the loan portfolio in the current environment.

**Interest rate risk is looming**

Competition is not the only problem. Historically low interest rates coupled with rising rates on the horizon provide an even greater challenge for bankers. Interest rates have reached new historical lows at virtually every point along the curve. 10-year Treasury rates have fallen from over 5.25% in 2007 to just under 2.4% earlier this year. This means that overall loan yields are at historically low levels. Low yielding, longer maturity fixed rate loans will not reprice higher with increases in short term interest rates, potentially squeezing margins in a rising rate environment. As the economy shows signs of improvement and inflation concerns start to seep back into the market, the possibility of higher rates down...
the road is becoming an increasingly greater risk. The futures market is currently pricing in LIBOR near 4.5% by 2015.

Looking back at the market from January 2001 to June 2003, the Fed Funds rate dropped from 6.5% to 1% and stayed at 1% for a little over a year. By 2006, Fed Funds had already climbed to 5.25% in 2 years. With the Fed Funds rate at a 0.25% currently, the interest rate market is certainly poised to head much higher going forward.

In the face of rising rates, the challenge for many banks is making new loans and refinancing existing loans at competitive rates without taking on too much interest rate risk. Commercial borrowers naturally gravitate towards long-term fixed rate funding when interest rates are low. But without proper balance sheet management, banks that load up on long term fixed rate assets or even floating rate loans with embedded floors will notice margins getting squeezed as interest rates rise. This is especially true for liability sensitive institutions.

There are a couple of traditionally used methods available to banks to combat interest rate risk stemming from long-term fixed rate loans:

1) **Offer longer term deposits.** This will decrease liability sensitivity but is not easily achieved. Historically it has been difficult to get depositors to lock up cash in longer term deposits, especially when rates are low. However, attracting depositors with slightly above market rates on deposits will sometimes help ladder in some longer term structures.

2) **Match-fund long-term loans with FHLB advances.** This is a more broadly applied strategy. Most FHLBs offer products that match up to many different types of loan structures. An advance can lock in a set margin for the life of the
loan. The downside is that match-funding lowers loan spreads, reduces capital ratios, inflates the balance sheet and does not help deploy excess cash.

3) Implement a commercial loan hedging program. Commercial loan hedging eliminates interest rate risk by allowing banks to hedge long-term fixed rate commercial loans. It also offers an opportunity to generate fee income on each transaction. The remainder of this paper will take a closer look at this particular option.

Here’s how it works

The most popular form of loan hedging is simply pairing a commercial loan with an interest rate swap. The simplicity of a swap is one of its most attractive features: an interest rate swap is merely a contract between two parties to exchange fixed rate for floating rate cash flows for a specified period of time. A swap can be structured to match up to almost any type of loan, there is no out of pocket cost and it will expire worthless on the maturity date.

In most cases the bank has two options. One is to issue a fixed rate loan to the customer and then convert the fixed rate to a floating rate through a swap with a separate counterparty. Using this method, the borrower is not involved in the swap transaction. But due to accounting reasons, generating fee income on this type of transaction is not recommended.

A second, more popular option (that will be the primary focus here) is for the bank to enter into both a floating rate loan with its customer and also a swap. There are basically three components to this type of transaction:

1) Bank enters into a floating rate loan with its customer

![Diagram of a floating rate loan](image)

This is a standard floating rate loan. The bank determines the index (usually either Prime or LIBOR) and spread that it would offer to a specific client.

2) Bank enters into an interest rate swap with its customer
The swap is structured to match up to the individual loan, i.e. index, maturity, amortization, etc. The swap pays the borrower the exact floating rate on the loan in return for a fixed rate. This converts the floating rate paid by the borrower to fixed. At this point the bank is in a net fixed position.

3) Bank enters into an offsetting interest rate swap with another counterparty

The bank passes the fixed rate received from the customer through to a counterparty in exchange for the exact floating rate on the loan. So the borrower-to-bank swap (Part 2) fixes the rate for the borrower. The bank-to-counterparty swap (Part 3) converts it back to a floating rate for the bank. The net result of the transaction is a floating rate for the bank and a fixed rate for the borrower.

Better IRR management

The primary benefit of loan hedging is to eliminate the interest rate risk on long-term fixed rate loans. In this case, a swap that is executed with the borrower is completely offset by another swap between the bank and swap counterparty. From an accounting standpoint, the mark-to-market for the swap with the borrower and the swap with the counterparty cancel each other out on the balance sheet. When one swap gains in value, the other declines by the exact same amount and vice versa. The net position of the bank is a traditional floating rate loan with its customer. The floating rate asset will reprice higher with rising rates and reduce liability sensitivity.

As an example, consider a 5-year loan priced at Prime + 0% converted to a fixed rate of 5.00% to the borrower. While the fixed rate does not change for the borrower, Chart 4 below shows how the loan for the bank would reprice over the next 5 years based on current Eurodollar futures.
With many banks reaching for yield by extending out in the bond portfolio or elsewhere on the balance sheet, swaps offer an alternative option to book floating rate assets that will outperform in a rising rate environment.

Additionally, the swap will provide pricing flexibility that is deal specific. A defining feature of the swap is that it offers the borrower a market driven rate. The $10+ trillion dollar annual volume in the swap market is brought down to an individual loan level. This allows the bank to offer a more competitive rate than neighboring institutions that may be pricing loans off of an internal cost of funds using either match funding or internally generated pricing calculations that are often not market based. The bank is left with a floating rate asset and the borrower has an attractive fixed rate – it is a “best of both worlds” scenario.

### Generating fee income

In addition to offering better interest rate risk management, there is also an opportunity for banks to generate fee income on swap transactions. Fee income on swaps is recognized in earnings and is paid by the counterparty to the bank. The amount of fees to build in is completely up to the bank. It will depend on the market and the fixed rate that a borrower is willing to accept.

The fee income offers a yield boost that banks can use to prop up current yields on floating rate loans. Consider the previous example of a 5-year floating rate loan booked at Prime + 0% to the bank with a 5.00% fixed rate to the borrower. Let’s assume that the principal balance on the loan is $2,000,000. By marking the fixed rate up 30 bps to a 5.30% borrower rate, the bank can generate $26,000 in fee income. This $26,000 can be thought of as a short-term yield boost on the Prime + 0% loan. With Prime currently at 3.25%, the yield on the
loan would move from 3.25% to roughly 4.55% (\$26,000 / \$2,000,000 + 3.25\%) in year 1 (Chart 5). The 1.30% pick up in yield will provide additional earnings to carry the loan through until interest rates rise and the loan reprices higher. (Note that for financial statement presentation purposes, fee income on swaps is reported in noninterest income, not in the margin section. It is recommended that a bank confirm the applicable accounting treatment with its external auditor prior to implementing a loan hedging program.)

Chart 5: Projected future yield for a Prime + 0\% loan based on Eurodollar Futures w/yield pick up in Year 1

Accounting for swaps

Some bankers are deterred by seemingly complicated accounting procedures for interest rate swaps. However, the accounting for the type of loan hedging described here is actually quite simple. Many are aware of FAS Statement 133 used to outline hedge accounting for derivatives (now FASB ASC Topic 815). While hedge accounting treatment for derivatives has now been vetted out over the past several years and made easier for community banks to elect and understand, there is actually no need to elect hedge accounting in this case. There are two separate swap transactions that occur, one with the borrower and one with the swap counterparty. They will be recorded at fair value on the balance sheet. As noted earlier, because they are exact mirror-opposite contracts (e.g. the bank receives fixed from the customer and pays the exact fixed rate to the swap counterparty), their market values will completely offset each reporting period. One will be an asset and the other a liability that both run through earnings with no impact. Most swap counterparties will provide these market values for each reporting period as needed.

There is another method to hedge commercial loans that was mentioned earlier that should be noted here. When the bank enters into a fixed rate loan with a
borrower and then swaps the fixed rate loan to a floating rate with a separate counterparty, the bank would need to elect hedge accounting treatment as a Fair Value Hedge in this case. As long as the hedge accounting guidelines are met and documentation provided, these types of hedges can be efficient ways to hedge commercial loans as well. Many full support swap hedging programs will provide all of the necessary documentation and material to appropriately account for this type of hedge on the balance sheet.

**FFIEC Advisory on Interest Rate Risk Management**

In January 2010 financial regulators issued FIL-2-2010, an advisory for banks to be more focused on mitigating and managing interest rate risk. The letter points out that “funding longer-term assets with shorter-term liabilities…poses risks to an institution’s capital and earnings.” More attention is currently focused on banks having policies and procedures in place that will measure and control interest rate risk. It will be important to maintain an appropriate asset / liability mix on the balance sheet to mitigate excessive interest rate exposure. However, banks that have a large concentration of fixed rate loans, or loans with embedded floors, will notice significant pressure on earnings especially when modeling higher interest rate environments. Under these recommendations, loan hedging programs like the one outlined here have allowed community banks to maintain a healthy balance of fixed rate and floating rate loans during a period when customers predominately opt for fixed rates.

Before implementing any loan hedging program, institutions will want to have an adequate derivative policy in place in order to comply with IRR management recommendations. Because derivatives are diverse and can be broadly applied, documenting specific parameters for derivative instruments that focus on hedging and mitigating interest rate risk will be an important part of the implementation process. Some key policy items to include are:

- A prohibition on speculation
- Defining allowable hedging product types (e.g. caps, floors, swaps, etc.)
- Setting maximum term limits
- Providing a list of approved counterparties
- Determining officers approved to execute derivative transactions

Banks are encouraged to document and understand any risk management procedures being utilized. A detailed hedging policy that adequately defines the hedging program and the processes involved will be a critical component of a successfully managed program, plus the regulators will want to see it. Also, appropriate training of key personnel will help demonstrate to regulators that
management has the necessary level of expertise to undertake this type of activity.

Summary

Commercial loan hedging offers viable opportunities for banks to better manage interest rate risk and generate fee income. However, when considering a loan hedging program it is important to be partnered with a knowledgeable counterparty, preferably one that offers a full service platform. Counterparties that offer full support will include the following services:

- ALCO, Board and lender training
- Borrower education
- Presentation material for borrowers
- Pre-trade documentation
- Trade execution
- Post trade documentation and full accounting support

Partnering with the right counterparty will make implementation and execution a simpler process for the institution. Once in place, a successful commercial loan hedging program will provide banks with a tool to more effectively manage interest rate risk and grow the loan portfolio in today’s competitive lending environment.

About the Author:
Brian Matochik is a Vice President in the Derivative Products Group at FTN Financial. FTN Financial is an industry leader in fixed income sales, trading and strategies for institutional clients in the U.S. and abroad. FTN Financial also provides investment services and balance sheet management solutions. With an average daily trading volume of $7 billion, FTN transacts business with approximately 30% of all domestic depository institutions with $25MM+ in total assets.