Bank Strategy Insights
FINANCIAL SERVICES GROUP | BALANCE SHEET STRATEGIES

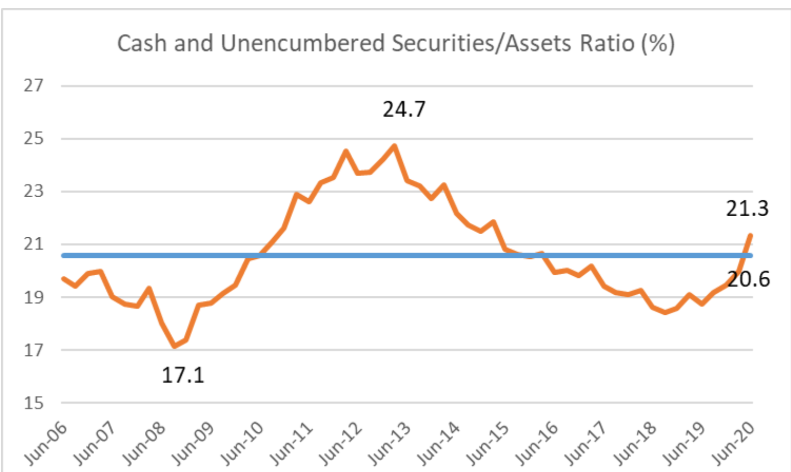
September 25, 2020

Asset-Side Hedging Supports Growth

*Please see this week's **Rate Sheet** and **Yield Curve Opportunities**.*

Last week, the FOMC held the target range for fed funds at 0.00% - 0.25%. The Fed made mention of its new inflation targeting policy, stating it will enact policy “so that inflation averages 2 percent over time and longer-term inflation expectations remain well anchored at 2 percent.” The Fed also updated their economic projections: rates appear to be bound at zero until 2023, according to their labor market and inflation projections. The Fed is broadcasting the message to get market participants comfortable with a “lower for longer” environment. The Fed’s rates outlook rattled investors, and commentary from chair Powell suggests we’ve come a long way in economic recovery, but the data continues to be nowhere near the form it was in pre-pandemic. Markets also seem to be losing frothiness as conflicting comments regarding the availability of a vaccine leave investors uncertain about how quickly the economy will recover.

Given the continued uncertainty, many community banks are considering strategies to take advantage of the historically low interest rate environment and hedge against rising rates. Two weeks ago, we discussed ways to prepare your balance sheet, quantify your risk of rising rates, and reduce the downside that threatens your Tangible Common Equity. Meanwhile, the liquidity picture has changed drastically, as the Cash and Unencumbered Securities-to-Assets Ratio has seen a significant uptick.



Source: S&P Financial

So how does a bank choose from the various hedging strategies available? The decision-making process must take into account balance sheet composition and the availability of assets or liabilities to hedge, impact to interest rate risk, earnings, capital, and liquidity from the strategy, and practical applications, such as hedge accounting.

For accounting simplicity and hedging flexibility, it’s generally recommended to first evaluate liability hedges. In fact, many institutions took advantage of both spot-starting and forward-starting cash flow hedges over the past year. With liquidity positions increased due to COVID, banks are now contemplating putting their excess cash into the bond market, but are unclear on how long the deposits and excess cash will be on the balance sheet.

Forward-starting swaps on forecasted borrowings allow the bank to purchase longer duration assets today and know they will maintain the attractive spread in the future.

But what about banks flush with liquidity with no future funding needs anticipated? In the absence of any liabilities for hedging, there are several asset-side hedging strategies available to support long-term fixed-rate loan growth.

Asset Side Hedging: What are Your Options and How Should You Evaluate?

Three popular asset-side hedging strategies include:

Implementing a back-to-back customer swap program:

- Recommended for larger loans to sophisticated borrowers
- Generates valuable fee income

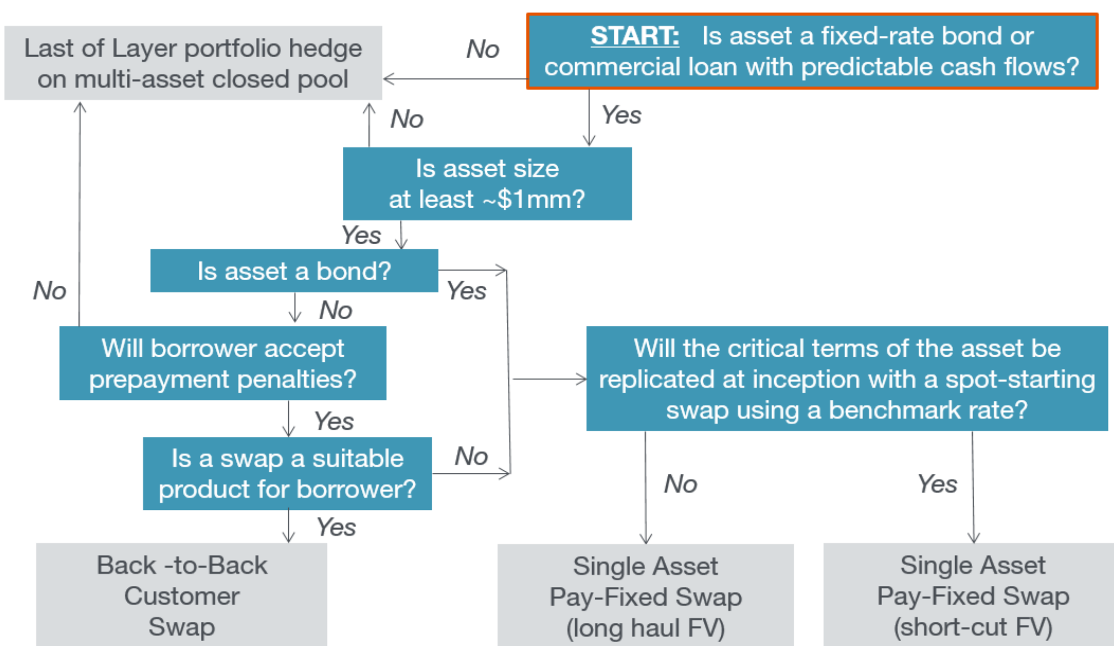
A "one-way" fixed-to-float swap on a single asset:

- The bank can originate a fixed-rate commercial loan with the intent to swap it to floating and execute the swap themselves, without involving the borrower
- The bank can also consider swapping a fixed-rate investment security with predictable cash-flows

A "last of layer" fixed to float hedge on a portfolio of assets earmarked into a closed pool:

- Used on a pool of small-balance or readily pre-payable loans or investment securities, like 1-4 family fixed-rate mortgage loans or MBS
- Beware of not stress testing these pools; some got caught in recently increased speeds

Selecting from among the options requires an understanding of the nuances of each. Despite a fear of oversimplification, we have boiled the process of hedging fixed-rate exposures on the asset side down to its main principles:



Asset Hedging Strategy Comparison

We've discussed Back-to-Back Customer swaps in the past. Some of the main benefits include the fee income a program delivers to the bank without a need for hedge accounting, and the fact that in this environment it enables the bank to deliver a fixed rate to the client while retaining a variable rate to the bank. However, the institution must consider the complexity of such a program: topics centered around client suitability & ECP, and the fact that a customer ISDA is required. Ultimately, the right partner becomes key.

Meanwhile "Last of Layer" multi-asset portfolio swaps have a different set of benefits and considerations. No client swap is needed, and it allows the institution to hedge a portfolio of small balance loans or fully pre-payable loans (e.g. 1-4 family residential). However, the hedging program does not provide fee income, some minor income volatility is possible, swap notional and tenor are limited by the closed pool balances, and the program requires additional monitoring and documentation. But most importantly: the way the rules are structured means that designing the hedge is based on rates falling scenarios, when you are attempting to hedge against rising rates, and we've seen examples where prepays can very quickly get in the way of the hedge.

Single Asset Pay-Fixed Swaps do not suffer from most of those issues: there is no income volatility with short-cut FV, forward-starting and partial-term hedges are possible with long haul FV, all without needing a client swap. The program, however, does not deliver fee income, and minor income volatility is possible.
(Note: partial term hedges are possible for short-cut if they are spot-starting, like if hedging to a call date)

Concluding Observations

Some banks may still have the opportunity to put on a new liability hedge, or to add to an existing program. For those that do not have or do not need the liabilities, asset hedges may make sense. Evaluation of the strategies available and the associated considerations takes far more than can be covered in a short piece, but understanding the high-level view of this process is an important first step in exploring and ultimately finding the appropriate solution. In the coming weeks, we will dig deeper into the mechanics of converting a fixed-rate municipal bond to a synthetic floater using a pay-fixed interest rate swap. We urge you to find a partner that can help you consider all of your options. Piper Sandler's Balance Sheet Strategy Team is here to help.

If any of these observations pique your interest, please contact your Piper Sandler representative or email us at PSbankstrategyinsights@psc.com. For derivatives, please email our affiliate, Piper Sandler Hedging Services, LLC, at FSG-Derivatives@psc.com.

Other Thoughts from Around the Firm

Technology is at the forefront of senior bank executives' minds as winning new customers, increasing efficiency and managing risk, through the implementation of new technology, is core to their strategic plans. This was highlighted in the results of Piper Sandler's 1st Fintech Survey. Senior bank executives are steadfast in their commitment to grow and evolve their business through technology, although concerns around cost, return on investment, business interruption and interoperability with current systems can slow adoption.

As we endeavor to better understand our depository clients' views on Fintech, we have prepared our 2nd Fintech Survey - please see the link below. By clicking on the link, you will be taken to Survey #2 which builds on Survey #1 by gathering additional information on tech strategy, vendor selection and core banking systems.

This 5 minute survey can be filled out by any and all members of your senior leadership team and, when completed, will meaningfully contribute to our continuing efforts to provide unparalleled thought leadership and best-in-class advice.

Thank you in advance for taking the time to respond to this survey and we look forward to sharing our insights with you.

LINK TO SURVEY:

Piper Sandler FSG Fintech Survey #2

If learning more about our recent work is of interest to you, please don't hesitate to contact FSG-Solutions at FSG-Solutions@psc.com for more information.

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