

Bank Strategy Insights

FINANCIAL SERVICES GROUP | BALANCE SHEET STRATEGIES

October 9, 2020

Asset-Swapping Municipal Bonds

Please see this week's [Rate Sheet](#) and [Yield Curve Opportunities](#).

Over the past weeks, we've discussed strategies to take advantage of the historically low interest rate environment and hedge against rising rates. For accounting simplicity and hedging flexibility, it's generally recommended to first evaluate liability hedges. But for banks flush with liquidity with no future funding needs anticipated, we explored several asset-side hedging strategies available to support long-term fixed-rate loan growth. One such possibility is a "one-way" fixed-to-float swap on a single asset, like a fixed rate commercial loan or on certain types of fixed rate bonds. Today we'll dig deeper into the mechanics of converting a fixed-rate municipal bond to a synthetic floater using a pay-fixed interest rate swap.

The Case for Municipals

Banks have various options available to them when deciding what asset to use in this strategy. First and foremost, the bond should be an asset that is appropriate to put on the balance sheet, from the perspective of both risk profile and relative value. The swap will mitigate the interest rate risk, so that portion becomes less of a consideration. For accounting purposes, the bond should have predictable cash flows. Municipal bonds often nicely fit the criteria for consideration. Seasonal dynamics, such as a growing visible supply heading into the end of the year, currently make the municipal market an attractive value relative to the other high grade fixed income sectors. While the ratio of municipal yields as a percentage of U.S. Treasury yields has compressed by more than 50% (Source: Piper Sandler) since its highs in March, the recent selloff in treasuries has caused the curve to steepen, creating more attractive yield pickup as you move further out the curve. For example, one year ago the spread between the 10-year and 15-year part of the AAA MMD curve was 21 bps, and as of publishing date it is 35 bps (Source: Piper Sandler). This means that some General Obligation municipal bonds with 2% coupons, 20-year maturities, and 10-year calls have yields in the mid-to-upper 2% range, on a tax-equivalent basis. Even as demand has compressed yields for 3% and higher coupons (demand skyrocketed as the yield "kick" to maturity that they offer became more valuable to banks concerned with extension risk of assets), bonds with this structure still have tax-equivalent yields in the low 2% range. That makes municipals prime candidates for this strategy.

The Strategy

Knowing that municipal bonds remain one of the few pockets of value in the fixed income world, swapping them to floating allows banks to obtain that attractive yield without worrying about the duration risk. By offsetting the negative bond mark-to-market, which would flow through OCI if unhedged, the swap allows the bank to protect TCE when rates rise. That makes this a particularly attractive path for liability-sensitive banks, or any other institution grappling with how to shield their TCE in a rising rate environment.

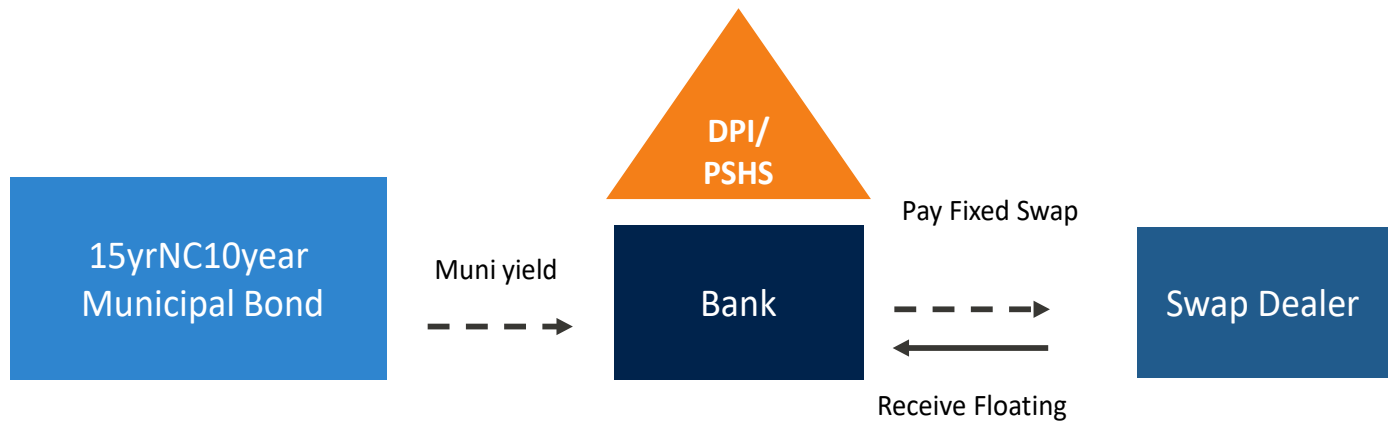
Let's dig into the mechanics:

The bank purchases a callable fixed-rate municipal bond, such as a 15NC10-year position. The bank then enters into a 5-year pay-fixed interest rate swap, replicating the critical terms of the bond. The fixed rate bond is converted to a synthetic floater over the next 5 years, which reduces duration risk and protects bank TCE.

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When compared to leaving the long-duration bond unhedged, the bank gives up ~20bps in current yield (as of publication date) by swapping out the duration risk for the next 5 years.

Considerations

The hedge accounting on fixed-to-floating rate bond hedges was greatly simplified by FASB with ASC 815. The swap generally will be designated as a Fair Value hedge for accounting purposes. If the swap is structured properly with critical terms matching, the short-cut fair value method may be applied to eliminate effectiveness testing requirements and earnings volatility. Spot-starting partial-term hedges can qualify for short-cut hedge accounting, which means there will be no income volatility. Forward-starting and partial-term hedges are possible with long haul Fair Value. Either way, the AFS bond mark-to-market due to benchmark interest rate changes is reclassified from OCI to income, which offsets the swap mark-to-market, eliminating the negative OCI/TCE impact of rising rates.

The strategy does not hedge credit risk or reduce potential spread widening of owning the municipal bond, only the interest rate risk component of the bond. The structure also adds some complexity to the liquidity of the position: if thinking about selling the bond, the bank will have to unwind the swap and recognize the gain/loss on the position, or amend it to hedge another similar bond (hedge would be long-haul, not short cut).

Concluding Observations

There are a variety of options available to banks concerned with rising rate risk. Very simply, the bank could do nothing, and rely on their capital position to withstand the interest rate shock. They can move additional securities to HTM, which provides accounting relief, but does not address the economic risk of rising rates. A “last of layer” fixed-to-float hedge on a portfolio of pre-payable assets like residential mortgages is an option, albeit with some income volatility under fair value long-haul hedge accounting and additional accounting complexity. An attractive long-term plan is to combine some of these strategies with a back-to-back customer swap program.

Even within the confines of hedging the interest rate risk of a bond, there are a few other ways to implement the strategy. The bank can enter into a partial-term fixed rate hedge against callable and non-callable securities, such as Agencies or corporate bonds, or can hedge bullets to their maturity date. On the derivative side, the bank could pay an upfront cash premium to purchase rising rate protection in the form of a cap or swaption, and could qualify for hedge accounting if structured properly. There are many possibilities, each with corresponding

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benefits and tradeoffs. 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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CONTACTS

Scott Hildenbrand

Managing Director

Head of Balance Sheet Analysis and Strategy

Head of Piper Sandler Hedging Services

212 466-7865

Jim Armstrong

Managing Director

212 466-7978

Jean Bonatucci

Managing Director

212 466-7793

Matt C. Brunner

Managing Director

913 345-3371

Mary Marshall

Managing Director

212 466-7890

Jorge Puente

Managing Director

212 466-7835

Ryan Smith

Managing Director

212 466-7966

Leah J. Viault, CFA

Director

212 466-7769

Kris E. Johnson, CFA

Vice President

612 303-0608

Kelly Hughes

Assistant Vice President

212 466-7856

Kevin Wanke

Assistant Vice President

212 466-7988

Sarah De Vries

Analyst

612 303-0616

Matt Earley

Analyst

212 466-7816

Hill Fleet

Analyst

212 466-7825

Meet our Team

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