Bank Strategy Insights
FINANCIAL SERVICES GROUP | BALANCE SHEET STRATEGIES

May 28, 2020

Finding Value in Fair Value Hedges

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

As always, we open this week by saying thank you to the first responders, medical professionals, government officials, researchers, and other essential workers around the country who are on the front line facing down COVID-19. These heroes continue to move mountains and inspire us.

Some economists believe that the U.S. economy is approaching an inflection point. As of last week, all of our fifty states were back in business. Major stock market indices have rebounded sharply off their March lows. Consumer confidence is showing signs of stabilization and spending on hotels, restaurants, airlines and other industries ravaged by social distancing are rising, albeit tenuously, off historical lows.

The narrative may be shifting from shelter in place towards a therapeutic, towards a vaccine, towards economic renewal, towards a new normal, but the fact of the matter is that the range of outcomes remains disturbingly wide. These same economists will concede that a second wave of infections could undo the progress we have made.

Facing such uncertainty, it's back to basics for banks. Among other imperatives, this means knowing your exposure to different curve shapes and the on- and off-balance sheet remedies that can help address it. Here, the underlying assumption is that a neutral balance sheet is more efficient in the long run. The ferocity with which this pandemic catapulted us from economic expansion to deep recession stands as the most recent example of the danger of direct or indirect rate bets. Still, getting back to neutral cannot supersede underwriting discipline.

For example, a moderately asset sensitive bank may have capacity to add long duration fixed-rate bonds or loans just as a moderately liability sensitive institution may have capacity to add variable-rate bonds or loans. Just because these actions would nudge the balance sheets to neutral does not mean that they are prudent. By definition, prudent capital allocation requires that every earning asset exceeds its cost of capital.

We also know that a massive liquidity wave is building. Just to name a few of the forces at play, Paycheck Protection Program (PPP) loans promise to be a source of short- and long-term liquidity, deposits are flowing into the system, non-PPP loan pipelines have been depleted, and mortgage prepayment speeds are accelerating. This means that many banks will have to sop up some of this excess liquidity by purchasing bonds. Going one step further, many of these institutions will find more relative value in municipals or bank subordinated debt further out on the curve.

So how do banks thread this strategic needle – purchasing bonds with bullet cash flows without loading up their balance sheets with rate risk? We have been talking at length about how banks can use pay-fixed swaps against floating-rate liabilities to synthetically extend liability duration (i.e., cash flow hedge). Institutions that do not have wholesale funding or index-based deposits can achieve a similar balance sheet impact by converting fixed-rate assets to floating (i.e., fair value hedge). This week, we shine a bright light on single asset fair value hedging using shortcut hedge accounting. It's a mouthful, but it's actually simple. It also eliminates earnings volatility.

The Nuts and Bolts of Hedging Fixed-Rate Assets with Shortcut Hedge Accounting

There are a few moving parts, but this hedging strategy is about as straightforward as it gets. Let's use an example inspired by one of our recent bank subordinated debt deals to evaluate this strategy.

Scenario: Bank A, a large, high-quality issuer, is issuing $225 million of fixed-to-floating rate subordinated notes due 2030. The notes bear interest at a fixed-rate of 5.25% through June 1, 2025 (payable semiannually). After the initial 5-year fixed interest period, the interest rate converts to a floating-rate equal to then current 3-month SOFR plus 512 basis points (payable quarterly). Bank B, a small community bank with a moderately liability sensitive balance sheet, has an opportunity to purchase $25 million of the notes. Bank B is comfortable with Bank A's balance sheet mix, capital structure, credit quality, and liquidity, having followed its performance for many years. Bank B likes the yield and duration profile. However, Bank B's ALCO is anxious about booking a 5-year fixed-rate asset.

Bank A Subordinated Debt Terms	
Principal	$225,000,000
Maturity	6/1/2030
Coupon	Fixed-to-Floating
Fixed Detail	Fixed at 5.25% to 6/1/25
	30/360, Payable semiannually in arrears
Floating Detail	Floating at 3m SOFR + 512 bps to Maturity
	Actual/360, Payable quarterly in arrears

Pricing is purely illustrative
Source: Piper Sandler & Co.

<u>Solution:</u> Bank B can use a pay-fixed fair value hedge to address ALCO's concern. It is easiest to think of this transaction in three steps. First, Bank B identifies the critical terms of the subordinated debt (principal, coupon, fixed-rate period, day count convention, etc.). Next, Bank B enters into a pay-fixed interest rate swap with a dealer replicating the key terms of the bond. Finally, Bank B designates the swap as a fair value hedge under the shortcut method, which is only available if the hedge terms match the asset terms.

At current market rates, the 5.25% coupon could be swapped to 3-month LIBOR + 4.72%. The first period yield of 3-month LIBOR + 4.72% equals 5.07%. Therefore, Bank B cedes 18 basis points of yield today, an exceptionally low concession in historical terms given the flatness of the swap curve, for the right to benefit from higher rates in the future. Importantly, this fair value hedge also creates symmetry between the value of the swap and the hedged item, protecting tangible book value from higher rates.

Pricing is purely illustrative
Source: Piper Sandler & Co.

Notably, swapping a fixed-rate asset to floating with a pay-fixed swap or swapping a floating-rate liability to fixed with a pay-fixed swap both produce a more asset sensitive balance sheet. However, if given the choice, we tend to look first to the liability side of the balance sheet because the hedge accounting treatment provides more flexibility.

That is, since swapping a floating-rate liability to fixed qualifies as a cash flow hedge, changes in the mark-to-market of the swap flow through OCI, not income. The beauty of hedging a single fixed-rate asset with shortcut fair value hedge accounting is that changes in the fair value of the swap are exactly offset by changes in the value of the fixed-rate bond due to interest rate risk, which eliminates earnings volatility. Conversely, swapping a fixed-rate asset to floating with long haul fair value hedge accounting or a pool of fixed rate assets with a "Last of Layer" fair value hedge create some earnings volatility with additional operational complexity.

(Author's note: this strategy can be tailored to fixed-rate securities or fixed-rate commercial loans hedging the full or partial term of these assets, though certain partial term structures may not qualify for shortcut treatment).

A Word on Back-to-Back Loans Swaps and One-Way Loan Hedges

The only thing worse than a lull in loan demand is not taking advantage of it to strengthen the bank's foundation. Knowing this, we have been helping several clients implement or strengthen their back-to-back loan swap programs.

A back-to-back swap program allows a bank to meet a client's request for long-term fixed-rate financing without sacrificing underwriting discipline or incurring excessive interest rate risk within the loan portfolio.

Let's think about this strategy in three steps from the perspective of our friends at Bank B. First, Bank B originates a floating-rate loan to the client. Second, Bank B and the borrower enter into a swap agreement to allow the borrower to synthetically convert the variable-rate to fixed (Bank B pays floating, receives the equivalent fixed-rate which includes a swap credit mark-up). Third and finally, Bank B enters into a mirror swap with a swap dealer to offset the customer swap's rate risk (Bank B pays fixed, receives floating). The dealer pays the present value of the mark-up to Bank B, which typically flows through noninterest income at settlement. Since the swaps offset, both transactions are mark-to-market and therefore there is no need for a hedge accounting election.

Bottomline, back-to-back loan swaps benefit the bank and the customer. Bank B receives a floating-rate based on its own underwriting criteria and swap income. The borrower benefits from fixed-rate certainty.

So, the key question facing bank managers is whether they should be hedging interest rate risk *proactively* with back-to-back loan swaps or one-way loan hedges swapped to floating with fair value shortcut hedge accounting or *reflexively* by swapping a portfolio of prepayable fixed-rate assets to floating with the "Last of Layer" approach.

There is no one-sized fits all solution, but we have long questioned the efficacy of "Last of Layer" due to convexity risk. Think about it: if interest rates rise, the prepayable assets extend and if rates fall, they shorten. Thus, the hedge underperforms in the rate environment the bank is trying to hedge.

The objective of any loan hedging strategy is to empower lenders to lend while treasury manages the rate risk. Plus, we want to achieve specialization with as little complexity and operational risk as possible.

All things considered, we are inclined to consider back-to-back loan swaps or one-way loan hedges first. If these are not viable, we would then explore "Last of Layer" portfolio hedging.

(Author's note: please see our note dated January 16th "Don't Turn Your Back on Back-to-Back Swaps" for a comprehensive look at this strategy).

Find a Partner Who Understands Your Balance Sheet and Story

We have just scratched the surface on several asset side hedging strategies. Recent hedge accounting simplifications have made these strategies easier to execute and monitor on an ongoing basis. But there is still plenty of nuance and risk on the road to optimal performance. The key is to find a partner you trust to examine your options and customize solutions to your balance sheet, risk tolerance, and story. As always, we are 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.

Please see "Other Thoughts from Around the Firm" on the next page of this report.

Other Thoughts from Around the Firm

- **FSG Solutions**: The financial services industry is increasingly looking to financial technology to advance their businesses and address current and prospective challenges. At Piper Sandler, we are spending more time with financial technology companies that may be able to provide solutions to these challenges. Please email FSG-Solutions@psc.com to discuss your FinTech needs and the ways in which Piper Sandler can be of assistance in providing solutions.

- **Technology Solutions**: In addition to our recent note regarding banks looking for off-the-shelf technology solutions to assist in the onboarding, processing, tracking and servicing of PPP loans, we have also had a growing number of conversations regarding solutions that can bring scale and efficiency to the loan modification and forbearance process.

  If learning more about solutions to the aforementioned challenges is something that is of interest to you or if you would like to discuss some of our recent success in pairing banks with financial technology providers please reach out to FSG-Solutions@psc.com for more information.

- **10 Question FinTech Survey**: Thank you to the many banks that have responded, we sincerely appreciate your feedback and insight. To those that have yet to do so, please see below for a short, 10 question FinTech survey that is designed to gather our clients' perspective on the opportunities and challenges associated with financial technology. Your response is greatly appreciated and will help us to continue to provide our clients with best-in-class advice and solutions. Please click here to take the survey.

CONTACTS

Scott Hildenbrand
Managing Director
Head of Balance Sheet Analysis and Strategy
Head of Piper Sandler Hedging Services
212 466-7865

Matthew Forgotson*
Director
212 466-8064

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

Evan Lozier
Associate
212 466-7837

Hayes Bynum
Analyst
212 466-7913

Sarah De Vries
Analyst
612 303-0616

Matt Earley
Analyst
212 466-7816

Hill Fleet
Analyst
212 466-7825

*Primary Author

Meet our team