Balance Sheet Insights

PIPER SANDLER FINANCIAL STRATEGIES

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Receive-Fixed Swaps: Enhance Earnings While Reducing Interest Rate Risk

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

With short term rates at historic lows, many commercially-oriented institutions have been struggling with earnings on their portfolio of floating rate loans. Some of these institutions had used receive-fixed swaps as an effective hedging tool in past rate cycles, and with the curve steepening year-to-date, asset sensitive institutions have been very active in returning to this strategy. The strategy works particularly well for institutions with active back to back customer swap programs who have a large pool of unfloored, floating rate loans. So, while historically low interest rates make it an attractive time for liability sensitive institutions to buy upside rate protection, asset sensitive institutions can take advantage of the curve to add income today by receiving fixed against floating loans.

What is the Strategy?

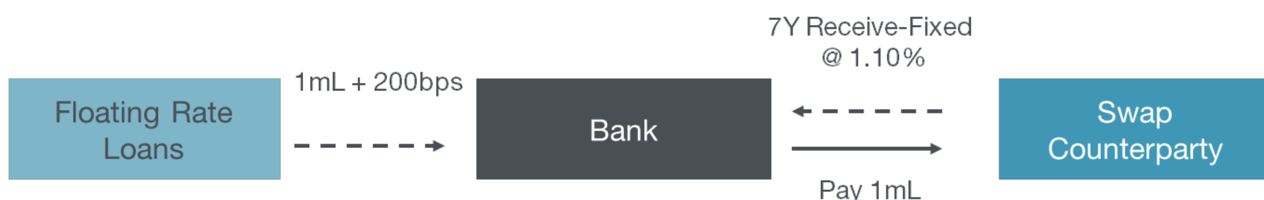
As we have often preached in the past, it is most important to ignore the urge to *bet* on rates and instead manage the interest rate risk specific to the institution. A receive fixed swap can act as a cash flow hedge of floating rate commercial loans for an asset-sensitive institution. It would be a positive carry hedge that adds 0.50%-0.75% to earnings today with a 5-year swap and 0.75%-1.10% to earnings with a 7-year swap. Essentially, the institution "spends" some asset sensitivity to position the institution to be more neutral. The hedge adds to earnings if rates stay unchanged or fall, at the cost of removing some of the upside of rates rising. If rates do rise, the institution should do better overall, due to its asset sensitive profile.

With the continued rate sell-off and curve steepening, the pick-up in 5-year swap rates vs. PRIME stands at ~60bps currently. The positive carry between what is earned on the receive fixed side of the swap versus the floating pay leg will immediately improve NIM and the swap will move the client's interest rate positioning to be more neutral. This strategy will continue to help earnings if short-term rates remain unchanged, decrease, or rise less than 60bps.

It is important to note that unlike a last of layer FV hedge, this is a "macro" hedge of the floating loan book where individual loans don't need to be specifically designated in a pool. With cash flow hedge accounting, we are hedging the floating cash flows "first received" so the institution needs to have enough of this floating risk on the books. The hedge remains intact as long as the institution continues to originate new floating loans with a similar pricing construct as the floating loans prepay/mature, maintaining the cash flow balance.

How Does it Work?

Let's say an institution owns a portfolio of unfloored commercial floating-rate loans weighing on earnings. They are looking to synthetically extend asset duration and increase NIM today with receive-fixed swaps.



By entering into the receive-fixed swap shown above, they pick up 102bps in yield (Pay 1mL of 0.08% and receive 1.10%). This strategy essentially converts a 2.08% floating loan yield (1mL + 200bps) into a 3.10% synthetic fixed yield.

The table below shows some sample pricing scenarios for a variety of tenors:

Structure	Loan Pricing	Loan Yield	Rec-Fixed Swap Rate	Synthetic Loan Yield	Current Yield Increase
3Y Swap	1mL+200 bps	2.08%	0.31%	2.31%	0.23%
5Y Swap	1mL+200 bps	2.08%	0.74%	2.74%	0.66%
7Y Swap	1mL+200 bps	2.08%	1.10%	3.10%	1.02%
10Y Swap	1mL+200 bps	2.08%	1.41%	3.41%	1.33%

Swap Assumes: Receive Fixed Rate, Pay: 1 month LIBOR, Day Count: Actual/360, Payments: Monthly, LIBOR Resets: Monthly

Considerations and Scenarios:

Institutions can benefit from working with a trusted advisor to ensure an effective hedge. The institution must designate the swap as a Cash Flow Hedge of floating loans with unrealized gains/losses flowing to Accumulated Other Comprehensive Income (“AOCI”). PSHS can help analyze a loan tape to target an appropriate population of floating rate loans, For simplicity, it is best practice to first target unfloored loans linked to a swap market rate (1mL or PRIME). If the loans contain floors, the institution can pair a receive fixed swap with a floor sale to mirror the terms of the loan rate. The institution must also consider 1mL floating loans: do the loan docs contain LIBOR transition language? If an institution has floating loans indexed to both PRIME and 1mL, they may choose to start with a PRIME based swap to avoid the complexities of the LIBOR transition. They can then review the transition language in their 1mL book of loans and do a mix of both 1mL and PRIME based swaps going forward.

One additional benefit of the strategy is that interest rate swaps have a symmetric pay-off profile, so if term rates fall and the receive-fixed swap is “in the money” the institution can unwind at a gain. If the curve remains unchanged or flattens led by a drop in term rates, the institution earns incremental income from the receive-fixed swap and will also have an unrealized MTM gain. If the curve steepens led by a sell-off of term rates, the institution will still have earned more income synthetically with the swap than if they had not hedged, but will have an unrealized MTM loss. If both short-term and long term rates rise, the institution would not realize any benefit from the hedge.

Receiving fixed on a swap can be an effective way for an asset sensitive institution to efficiently move its interest rate risk profile more toward neutral, while enhancing current earnings. The rest of the considerations must be reviewed carefully, but can be done with the help of an advisor. Piper Sandler is here to help.

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

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