



Interest Rate Collars In Today's Market

👉 hedging

Summary: Financial institutions looking to manage interest rate risk may want to consider an interest rate collar. We map it out for you.

Inc. reports some of the easiest ways to get people to like you more include: asking questions, talking more, giving your time for free, listening better and truly caring. Yet, the risk of doing something to upset people is always there and so are risks in banking.

For instance, financial institutions looking to [manage interest rate risk](#) (IRR) have to think about many different things that impact it. One way to manage IRR is with an interest rate collar. An interest rate collar manages the exposure of interest rate movements and provides you with a certainty of results, within a stated range.

Essentially, it contains both an interest rate cap and an interest rate floor. The cap and floor each consist of a series of call options on a floating interest rate index. The call dates typically coincide with the rollover dates on the floating assets and liabilities being hedged. The collar specifies a notional value to use for calculation purposes and exercise rates for the floor and the cap. This creates a collar.

For bankers thinking lower short term rates could occur as the economic cycle slows, these can help protect net interest margins (NIM) against a falling rate environment. To protect NIM, you may want a specific type of interest rate collar known as a reverse interest rate collar. This is done by simultaneously buying an interest rate floor and selling an interest rate cap (on the same index) to offset some or all of the cost of the cap. You would determine the floor rate based on your target level of protection. Your institution then receives a payment when the interest rate dips below the floor exercise rate and makes payments when the interest rates rise above it.

For an example, consider a collar on 1-month LIBOR for a \$50mm notional amount and a 5Y term. The floor exercise rate is selected along with the cap exercise rate. Let's say 1-month LIBOR is 1.80%. The cost of the floor is known when set and it is offset by the premium received from the cap sold. If 1-month LIBOR decreased to 1.55% on the rollover date, the institution would receive payments and if 1-month LIBOR increased to 2.05% on the rollover date, it would make payments.

Unless you want to apply hedge accounting, the collar would impact interest income in two ways. First, the cash flows and the resulting impact to NIM will effectively dampen the impact of rate movements on the NIM, when rates fall outside of the collar. Second, since the collar is carried at market value on the balance sheet and changes with movement in market rates, the value is positively impacted as market rates fall and negatively impacted as market rates rise. The optionality impact of the collar similarly dampens the impact of rate movements on NIM.

If you need assistance with any of this or want to see how a live example might work to protect your financial institution, give us a call. We are happy to help.

NEED MORE FEE INCOME?

Financial institutions seeing long-term, fixed-rate demand from business clients can transform payments into a floating rate on their books using [Borrowers' Loan Protection \(BLP\)](#). Contact us today for more information.

Copyright 2021 PCBB. Information contained herein is based on sources we believe to be reliable, but its accuracy is not guaranteed. Customers should rely on their own outside counsel or accounting firm to address specific circumstances. This document cannot be reproduced or redistributed outside of your institution without the written consent of PCBB.