Tap Into The Benefits Of Hedging During A Flat Yield Curve

hedging

Summary: Community financial institutions are looking for opportunities to increase income, mitigate risk, and retain customers in this current flat to inverted yield curve environment. Look no further. Hedging can provide your institution with these opportunities. We explain how.

Many people recognize today as National Earth Day. But, did you know it is also National Jelly Bean Day? According to Jelly Belly, the gourmet jelly bean company, the origins of the jelly bean come from a combination of a Mid-Eastern soft center candy and the French process of panning invented to create the hard shell for Jordan Almonds presented to royalty. 1861 was the first mention of jelly beans in the US, by Boston confectioner William Schrafft, who promoted sending them to soldiers during the Civil War. These candies are enjoyed by all ages to this day.

As you hunt for a few leftover jelly beans in your desk, we turn your attention to the hunt for ways to benefit from a flat yield curve. The yield curve has been flat for a while. Yields on short-term notes have gone up quickly this year because investors expect the Fed will keep raising rates. Yields on longer-term bonds have not risen as fast, as uncertainty about the future state of the economy and geopolitical concerns heighten demand for longer-term bonds.

Two-year notes stood at 2.30% at the end of March, up from 0.73% at the end of 2021. That’s a 215% hike. Ten-year bond yields have gone up as well, but by a smaller percentage, moving from 1.5% to 2.35% over the same period. On March 30, the spread between yields on 2Y T-notes and 10Y T-bonds was just 5 bp. This is not only happening here in the US. A similar change is taking place in Australia, Germany, Canada, and other countries that expect higher interest rates.

Can community financial institutions (CFIs) benefit from this current interest rate environment? The answer is yes. We find many bankers hedging their loans in this type of market to retain customers, increase their income, and mitigate risk.

Hedges can help you float or fix rates

When the yield curve flattens, CFIs can take advantage of the curve “discount” to swap interest rates on liabilities from short-term floating to longer-term fixed and lock in a level of certainty at a favorable rate.

Alternatively, a CFI might use a hedge to go the other direction with its assets, from fixed to floating rates. The choice depends on what you hope to gain from the transaction and the expected timeframe.

Borrowers want fixed & CFIs want floating rates

Since business customers often prefer the security of fixed rates in an environment of rising interest rates, a hedge can provide that security. CFIs can provide customers with longer-term, fixed rates, with the fixed rates swapped back to floating for their institution. The customer gets the certainty of stabilized interest expense, while the CFI gets the benefit of rising rates and keeps valuable customers. The institution mitigates interest rate risk and credit risk.

To maximize the benefits of hedging, pay careful attention to how you price the choices you offer customers. Give clients what they want, but set your price with an eye for the current yield curve. Here are **three key benefits of hedging** in this rate environment.

1. **Lock in customer relationships with forward rate locks**. Forward rate locks can be used to extend fixed rate terms for financing anywhere from one week to 36 months in the future. These are primarily used for fixing the rate on existing loans, future commitments, and construction to permanent financing.

In a normal yield curve environment, forward rates are typically at notable premiums versus spot rates. In the current flat to inverted yield curve environment, forward premiums are lower, more competitively priced, and offer opportunities to build in additional yield (depending on the forward period).

2. **Provide other income sources.** While you wait for your net interest margin to expand, you need to consider other sources of income. Hedges provide CFIs with an opportunity to serve their customers and collect fee income. Building in a fee for a fixed rate that fits your customer's needs is a win-win situation.

3. **Use as rate insurance.** Buying caps and floors can also help CFIs and their customers insure against rate movement. With that hedge in place, floating-rate exposure is contained within a set and quantifiable range. This can be a good option, but you'll want to consider the cost of buying caps and floors, relative to the benefit of having rate protection.

No matter what direction the yield curve goes, hedging allows your institution to help its customers, mitigate its own risk, and take advantage of various opportunities. Contact us today about our hedging solutions to start reaping some of the benefits.

HOW DO INTEREST RATE SWAPS BENEFIT MY INSTITUTION?

Business clients are expecting long-term, fixed rates from their financial institutions. See how you can meet both your needs and your borrower's needs with an interest rate swap using Borrower's Loan Protection® (BLP). See how today.

ECONOMY & RATES

Rates As Of: 04/22/2022 05:44AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	0.83	0.31	0.77
6M	1.32	0.26	1.13
1Y	2.08	0.46	1.69
2Y	2.76	0.41	2.01
5Y	2.98	0.52	1.71
10Y	2.90	0.56	1.39
30Y	2.92	0.46	1.01

FF Market	FF Disc	IORB
0.33	0.50	0.40
SOFR	**Prime**	**OBFR**

0.26	3.50	0.32