Need Fee Income? Try Hedging

hedging business customers

Summary: While the yield curve is flat to inverted, community financial institutions are looking for fee income. Hedging loans for your customers provides you with upfront fee income, immediately recognized as earnings. Is this a good time to consider hedging for your institution and gain extra income? While some may feel hedging could be cumbersome, it can be easier than you think. Join us as we explore how it works.

Not many people know that today is National Zipper Day. According to the Sew Guide, there are 15 types of zippers. But, don't worry, we won't go into detail on the 15 types. Suffice to say, the zipper is a handy little invention that has come a long way from 1917, when it was invented by Swedish American, Gideon Sundback. Its first uses included rubber boots and tobacco pouches. Today, we can all come up with hundreds of uses, from clothing, outdoor equipment, shoes, bags, suitcases to pillowcases, and more.

Unzipping the details of extra fee income through a hedge may feel cumbersome to many bankers. But, it can be easier than you think. Most financial institutions are looking for ways to generate fee income, especially where loan yields are still compressed. Executing hedges for customers with outstanding commercial loans can create substantial noninterest income for a community financial institution (CFI), while also serving their customers' needs. Many customers want to swap a floating-rate loan for the certainty of a fixed rate in an environment of rising rates, which is where we find ourselves now.

Hedging offers multiple benefits

Hedging loans provides multiple benefits for CFIs. A hedge can reduce interest rate risk, stabilize debt service coverage, and reduce borrower credit risk associated with rising rates. The latter, which in turn, reduces expected losses over the life of a loan and subsequently, decreases the necessary reserves a CFI must retain.

A hedge can also help a financial institution grow and defend its portfolio, creating loans that stay on the balance sheet longer. This advantage helps maintain "stickier" customer relationships. Hedges can also make smaller CFIs more competitive with larger financial institutions, by enabling them to offer favorable rates and expanded term structures to customers.

How hedge fee income works

Hedge fee income is an established practice in the marketplace and is economically attractive as CFIs get the full earnings benefit, regardless of related loans paying off before their maturity.

A hedge can produce up-front, noninterest income for a CFI, that is paid in cash to the CFI at closing. The institution can recognize the full amount immediately, as earnings, without amortizing it over the life of the loan.

This fee represents the present value of corresponding income for the monetized basis points, applied over the hedged-term, notional schedule. The longer the term, the larger the monetized value of the upfront fee income. The basis points are monetized and added to the swap rate, which increases the total fixed rate that a borrower pays. The swap rate plus the credit spread over the benchmark pricing index, plus the monetized basis points, equals the total fixed rate. Or, to put the same equation in another way:

Credit spread = predetermined fixed rate - swap rate - upfront fee income

Examples of hedge fee income

To understand how a hedge might work, it's helpful to see a couple of real-life examples.

1. Modification of an existing loan of $17.3MM with a 25Y amortization, 20Y term, and 25 bp of monetization. That hedge brought in **fee income of $503K** (approximately 3% of the loan amount).
2. Multiple banks were involved in a loan of $8.7MM with a 25Y amortization and 5Y term. With 10 bp in monetization, the hedge brought in **$39K in fee income**, which the originating bank retained.

A hedge program that is robust, yet simple for CFIs and their borrowers

Some bankers may think of hedging as an inaccessible tool that requires managing complex derivatives. That does not have to be the case. PCBB's hedging solution is robust, yet simple. Allow our hedging experts to work with you and share how this might be incorporated into your lending activities. Contact us today to have a chat.

NEED MORE FEE INCOME?

ECONOMY & RATES

Rates As Of: 04/29/2022 05:48AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	0.82	0.30	0.76
6M	1.38	0.32	1.19
1Y	2.06	0.44	1.68
2Y	2.73	0.39	1.99
5Y	2.93	0.47	1.67
10Y	2.88	0.54	1.37
30Y	2.93	0.48	1.02

FF Market	FF Disc	IORB
0.33	0.50	0.40
SOFR	**Prime**	**OBFR**
0.28	3.50	0.32