



Risk Management for Swaps & Derivatives

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Summary: Financial institutions are turning to interest rate swaps and other derivatives to hedge against rising interest rates and to offer customers greater flexibility when structuring loans. As customers try to fix borrowing costs amid rising interest rates, swaps are something your CFI might want to consider.

There comes a point in every car's life where things start to head south and it is time to unload it before repairs become too costly. Trade-ins to dealerships have long been a popular option because it is the easiest way to get rid of a used car and get credit towards a new vehicle, but ongoing supply chain issues mean that there may not be many suitable cars to trade your old one in for.

Dealer trade-ins may not be in vogue at the moment, but hedging interest rate risk through derivatives, particularly swaps, has become extremely popular. As borrowers flock toward fixed rates amid the interest rate spike, many community financial institutions (CFIs) are turning to interest rate swaps as a way to manage rate risks.

Rising Swaps Activity

With the Federal Reserve fighting inflation with higher interest rates, borrowers — both those with existing variable-rate loans and those seeking new loans — are scrambling to stem off increases by requesting fixed rate loans. In turn, to manage this risk, CFIs are hedging with interest rate swaps where the borrower gets a fixed rate for a set period of time, while the institution gets a variable interest rate. So, both parties mitigate the risk to themselves.

With interest rates already up and the Fed telegraphing additional increases, CFIs are embracing hedging through interest rate swaps as a way of stabilizing their credit exposure, insulating themselves from net interest margin compression, and generating noninterest income, [as we discussed earlier this year](#). The appeal of interest rate swaps for CFIs lies in the ability to avoid constantly changing loan pricing and deposit accessibility; the fact that they are cheaper than other options; and their overall efficiency. One CFI using this approach is Atlanta-based Regions Bank, [which had \\$20.6B of receive-fixed floating rate swaps as of the end of 2021](#).

What to Keep in Mind

While there may be hesitancy among some CFIs to utilize swaps because of the perception that doing so is risky, the reality is that swaps are just another way to help manage interest rate risks. Swaps can also help to reduce borrower credit risk arising from higher interest expense in a rising rate environment. Debt service coverage is stabilized by effectively fixing borrowers interest rate profiles with swaps.

Since the banking industry's largest players are aggressively utilizing swaps and other derivatives (four major banks alone [account for roughly 89% of all notional amounts in the first quarter of 2022](#), according to the OCC), CFIs would be well served to take advantage of the same strategies. Doing so can:

- Enhance their lending capacity

- Increase yield
- Manage surplus liquidity
- Provide customers with the flexibility to switch even just a portion of a loan from a floating to a fixed rate

CFIs that aren't comfortable handling swaps themselves but want to benefit from the added flexibility can enlist the help of outside specialists to assist with the process. PCBB has the expertise to guide your CFI through interest rate swaps, so both you and your customers can benefit from more stability in the current market.

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: 10/13/2022 05:49AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	3.70	0.37	3.64
6M	4.16	0.24	3.97
1Y	4.41	0.40	4.02
2Y	4.46	0.18	3.73
5Y	4.28	0.19	3.02
10Y	4.01	0.18	2.50
30Y	3.96	0.18	2.05
FF Market	FF Disc	IORB	
3.08	3.25	3.15	
SOFR	Prime	QREF	
3.04	6.25	3.07	

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