Developing A Hedging Strategy

hedging risk management

Summary: Financial hedges are a bit like shock absorbers on a car. They can help reduce the volatility or bumps a bank may experience. But, you need a good hedging plan to ensure success.

Historically speaking, hedges have been planted and trained over time to form a barrier or mark the boundary of a property. These topiaries have been used to enclose land as far back as some 6,000 Ys ago.

In the banking world, the plant types of hedges are interesting, but the financial ones make executives even happier. Like most financial institutions, banks need a cohesive, overall hedging strategy though to do this right.

Financial hedges are a bit like shock absorbers on a car. They can help reduce the volatility or bumps a bank may experience and limit the effect of sudden changes in interest rates. Hedging won't entirely do away with risk, but it can help control it at a price that won't break the budget.

Hedging plan development can follow the same pattern as your bank's contingency funding plans. You start by describing roles, detailing responsibilities, and then setting out action plans that let your bank move quickly when conditions warrant.

Determine your goals. What economic risks are of the most concern? What negative outcomes would hurt your bank's position the most? The more you can identify a specific, quantifiable risk, the more targeted your hedge can be. Consider bifurcating portfolio and loan-level hedging needs to address exposure at different levels.

Find the right hedges. Look for those hedges that can help your bank manage the risks that concern it most. Get familiar with how the trades behind the hedges work, so you won't have to educate yourself or your staff in the midst of a volatile market.

Identify and list the types of trades you'll permit. Bank executives should be able to act when the opportunity strikes, without having to wait too long. Keep your trade definitions broad enough so that staff members have room to work.

Execution typically means paying a hedged rate. Sign up for a rate sheet distribution and keep your eyes open to current hedge rates and opportunities. Have a sense of the hedging economics and how much you're willing to spend for protection. When you've decided this in advance, you can move quickly -- and that can save you money.

Learn the details. You'll need to know how you'll execute your trades, including whom you'll call and the terminology you'll use to describe what your bank wants to do. You'll need a hedging or swap counterparty with direct access to the markets. Without one, efficiently acting on a hedging plan can be more difficult.

Understand accounting. Hedging (derivatives) are subject to various accounting rules under FAS133/ASC815 accounting standards. Understand which rules apply to your hedging circumstances to be sure reporting is done properly.

If this seems too complicated, but you still want the benefits of hedging, we are here to help. Our hedging experts have decades of experience and our loan level hedging solution in particular allows you to protect yourself without paying an up-front fee or having to deal with derivative accounting (we handle this for you). Contact us today for more information.

HEDGING SERVICES FOR COMMUNITY BANKS

Community bankers 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.