# Net Interest Margins And Interest Rate Swaps

hedging pandemic

**Summary:** Have you thought of using interest rate swaps to help shore up your margins? We explain how.

Babies learn to smile before they can speak, so smiling must be important. We know that these times are not exactly smiling times, but, hopefully we can give you something to smile about (or at least make you feel less stressed) in regards to your margin.

While some community financial institutions (CFIs) may already have been preparing for a possible recession before COVID-19, the speed with which the current economic crisis arrived caught everyone by surprise. The Fed's interest rate drops (combined with aggressive bond-buying) have helped backstop the economic fallout from the coronavirus, yet the interest rate squeeze on CFIs has been tough to manage, to say the least.

Interest rate swaps offer one way to hedge the margin squeeze. They can be an effective cash flow hedge for bottom lines, provide you with fee income, and can be a tool to hedge against today's low interest rates. Using swaps allows you to provide business loans at a long-term fixed rate while your institution gets a floating rate that should be more advantageous over time. Managing interest rate pressure is particularly important since CFIs get about three-fourths of their revenue from net interest income.

Swaps of all types have become more popular and trading in interest rate swaps has been very strong during the pandemic. Trading dollar volume of interest rate swaps reached $8.8T, a new record high in March.

But swaps are complex transactions that are not without risk, and CFIs, particularly those new to the game, should thoroughly understand them before jumping in. In fact, many CFIs have avoided swaps and other derivatives, largely due to the complexity. Before the pandemic, only one in 10 community banks with assets between $500K and $1B used derivatives in hedging. But among banks with $2-$5B in assets, more than half of them had used derivatives.

One thing to keep in mind is that derivatives come in many varieties and levels of risk. There are two main options to consider if you have been uncertain of hedging in the past, but still want to generate more interest income.

1. You can focus on much simpler derivatives. These are generally known as plain vanilla derivatives and interest rate swaps can fall into that category. While these are more straightforward, they may not provide you with the interest income you need.
2. You can turn to a partner for assistance with interest rate swaps. This gives you a greater opportunity to hedge according to your needs.

In a world full of risks including interest rate risk, it is nice to know that there are options. If you have questions about hedging or simply want to discuss the elements of interest rate swaps, feel free to reach out to us. We have 15Ys of hedging experience and we are happy to help.

## NEED MORE NET INTEREST INCOME?

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