



Interest Rate Swaps Help Retain Customers



hedging business customers credit risk

Summary: Some community financial institutions may not know the benefits of interest rate swaps. Not only do they help you manage interest rate risk, but they also help you retain customers. Your customers want fixed rates, especially as rates rise. You can help them with interest rate swaps — and you gain noninterest income too. We explain how.

For the fifth year in a row, [Finland was voted the happiest country in the world](#), according to the World Happiness Report. The report asked questions about wellbeing, trust in government, and quality of life and included 146 countries. Denmark was the second happiest country, followed by Iceland, Switzerland, and the Netherlands. The US came in 16th, which is its best ranking in the past 5Ys.

While this is important, bankers find it even more important to make sure their customers are happy. When interest rates hovered at historically low levels, many community financial institution (CFI) customers were happy to have floating-rate loans. Borrowers often started at an attractive interest rate. As long as benchmark rates stayed more or less the same, their interest expense did not go up significantly. But, things have changed since then.

Business customers want fixed rates as benchmarks rise

Now benchmark interest rates have risen, and the Fed has indicated that the markets should expect additional rate hikes this year. Borrowers are interested in locking fixed rates as a protection against both inflation and projected higher rates, whether for existing loans or new funding.

As Aleksandar Tomic, economist and assistant dean at Boston College's Woods College of Advancing Studies tells businesses in a recent MarketWatch article, *"Get it [funding] quickly and at a fixed rate [so] you can plan your expenses. Even if [rates] are a little bit higher, you are protected against future increases."*

An interest rate swap offers borrowers a fixed rate with benefits for CFIs

CFIs need to attract and retain customers by providing fixed-rate funding. Hedging through an interest rate swap can benefit your customers, stabilize credit exposure, generate noninterest income, and insulate against net interest margin compression, all at the same time.

How it works

The CFI underwrites a floating rate loan and the borrower signs the required loan documents. The loan is pegged to a standard interest rate benchmark plus a credit spread. The borrower then executes a swap agreement where they pay a fixed rate and receive a floating rate to offset the loan rate. Although there are two financial contracts (the loan and the swap), the net result is that the borrower achieves an effective fixed rate on their loan for the desired term.

More flexibility for borrowers

An interest rate swap offers borrowers flexibility around term and loan restructuring as well. If the borrower wants to pay a fixed rate for part of the loan tenor and a floating rate for the remainder, that is possible. An interest rate swap also lets the customer move just part of a loan to a fixed interest rate or refinance from a floating to fixed rate.

Important considerations with interest rate swaps

There are many benefits of interest rate swaps. Yet, CFIs must understand the technical details in order to make sure they are offering the appropriate solution and staying in compliance. Here are three important considerations.

1. Match the interest rate swap payment dates to those of the original debt, so the two instruments pay at the same frequency and on the same date. If the payment dates on the original loan occur monthly, so should the interest rate swap payment dates.
2. Match the original loan's variable rate index to the interest rate swap's benchmark rate, to eliminate any index differential. Currently, SOFR and fed funds are the two indexes to utilize.
3. Ensure that the arrangement meets hedge accounting and regulatory standards.

If you are looking for a partner to do the heavy lifting and not just to facilitate the interest rate swap, look no further. PCBB has been providing a hedging solution for over 18Ys. Our experts provide full coverage throughout the process, from lender support on the front end to operations support on the back end. In addition, we carry the derivative on our balance sheet, so you do not have to.

Interest rate swaps are important tools to retain customers and manage interest rate risk, regardless of the rate environment. We are here to work with you and guide you through the process. Contact us today for more information.

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: 05/31/2022 05:38AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	1.08	0.23	1.02
6M	1.54	0.13	1.35
1Y	2.06	-0.04	1.67
2Y	2.57	-0.15	1.83
5Y	2.84	-0.12	1.58
10Y	2.87	-0.06	1.36
30Y	3.07	0.07	1.17
FF Market	FF Disc	IORR	
0.83	1.00	0.90	
SOFR	Prime	OBER	

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