

BankDirector.

Lunch & Learn Session 6:
**Fight the Fed: Hedging
to Protect the Balance
Sheet**

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#A0BA24

Fight the Fed: Hedging to Protect the Balance Sheet

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Introduction



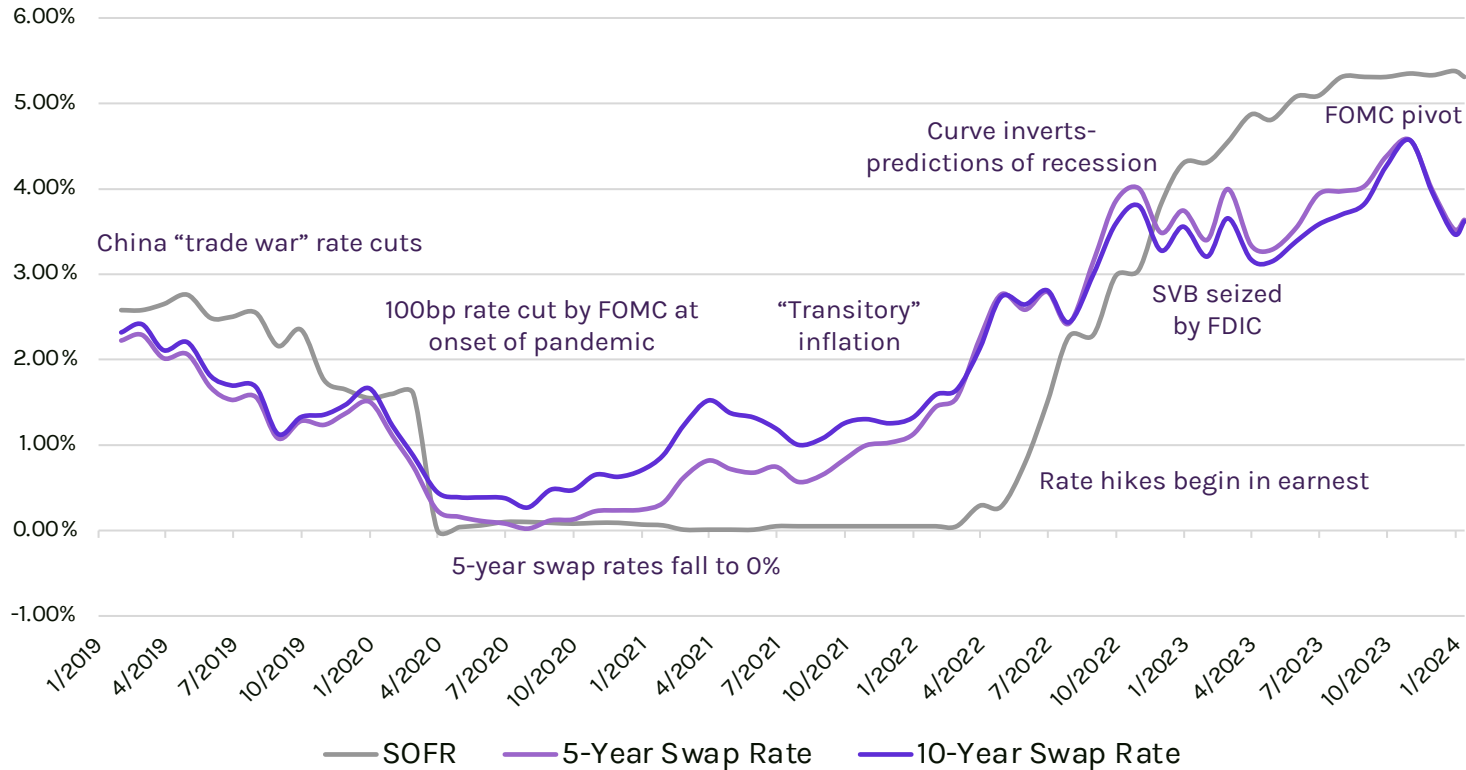
- Leading capital markets advisory and technology firm.
- Advise over 200 financial institutions in managing interest rate, foreign exchange and commodity risk.
- Global Capital's Risk Management Advisory Firm of the Year from 2020-2023.



- Headquartered in Dallas, TX.
- \$12B in total assets, one of the 10 largest banks headquartered in Texas.
- Founded in 2010, completed IPO in 2014 (VBTX).
- 30 bank branches, 794 employees.

Interest Rate Volatility: a New Normal?

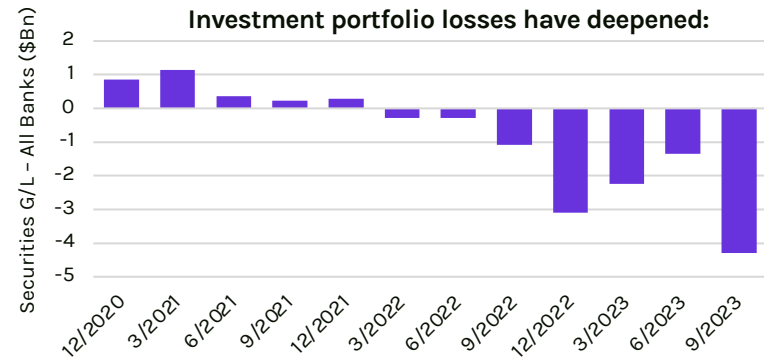
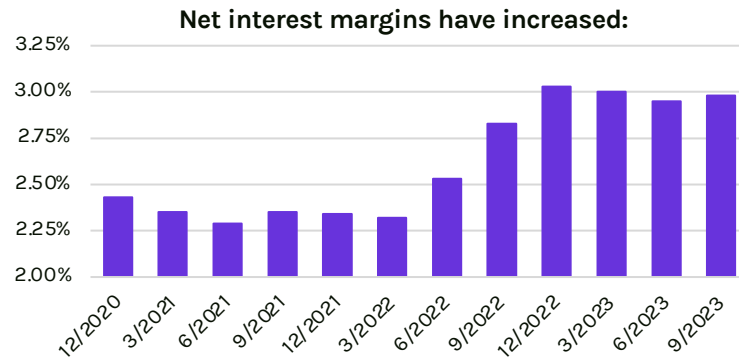
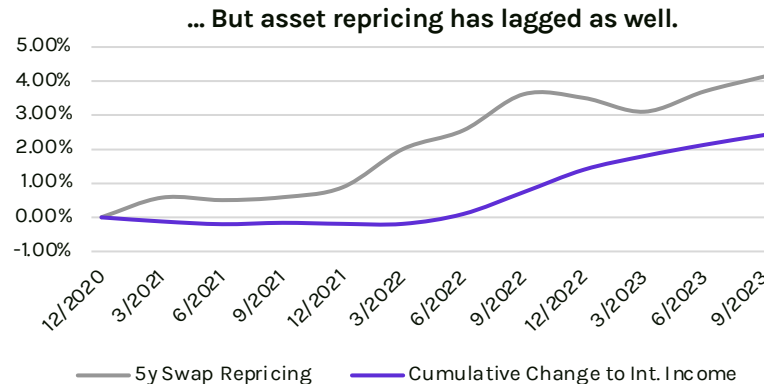
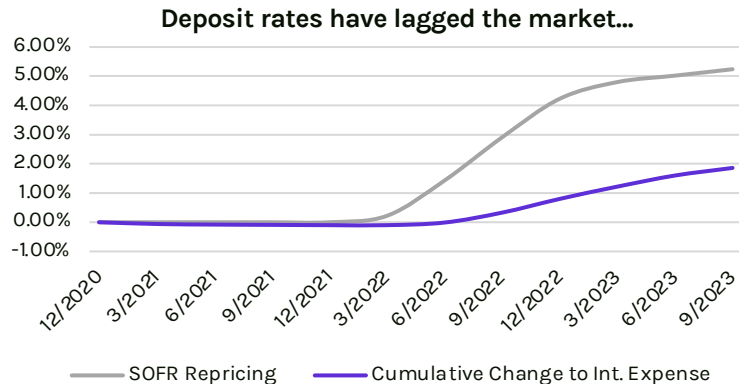
Forecasts Failed: Mapping Five Years in Rates Markets



Source: DerivativeEDGE

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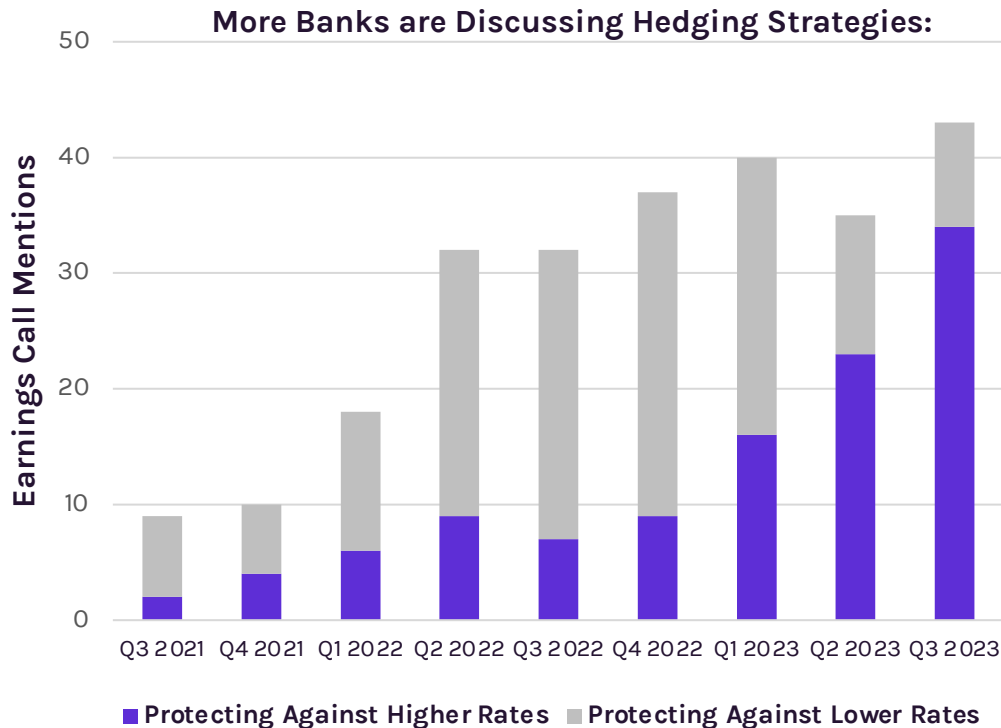
Rising Rates Boosted NIMs But Challenged Capital:



Source: bank call reports

Volatility Has Driven Greater Hedging Activity

1. Four-fold increase in hedging activity since 2021.
2. Focus on risk management across investors and management teams.
3. Shift towards hedges that protect against higher rates.



Source: bank earnings calls

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Banks are Focused on Neutralizing Rate Risk

Comerica, Q3 2023

"Successful execution of our interest rate strategy... favorably positions us with minimal negative exposure."

Flushing Financial, Q3 2023

"We added \$100 million of interest rate hedges during the quarter... These actions have significantly reduced our interest rate sensitivity position."

First Interstate BancSystem, Q4 2022

"During the quarter, we added \$850 million in notional... We are now essentially neutral to changes in short-term rates."

Old National Bancorp, Q2 2023

"We continue to make progress towards achieving our targeted neutral rate risk position."

National Bank Holdings Corporation, Q4 2022

"We selectively added some derivatives and rate floors to ensure that we can lock in as much as possible the margin that we enjoyed here."

Central Pacific Financial, Q3 2023

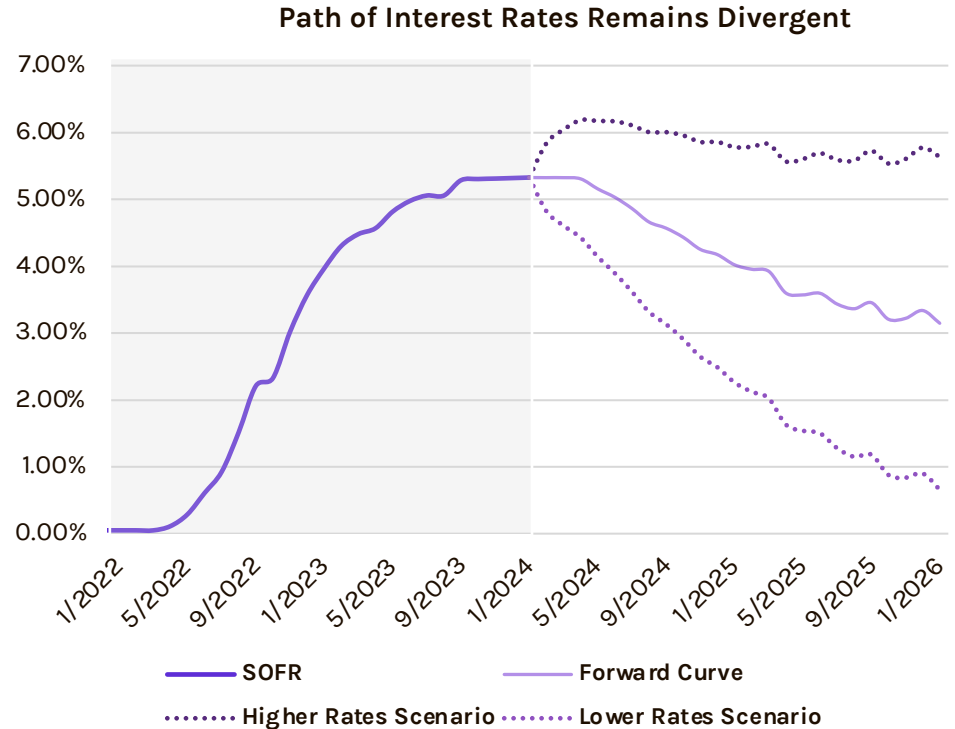
"With the current higher-for-longer interest rate forecast... A swap that we put on last year continues to increase in value and will support our future earnings."

Source: bank earnings calls

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Interest Rate Volatility is Here to Stay

- Can the Fed achieve a soft landing?
- Could inflation prove sticky?
- Will wars in Europe and the Middle East escalate?
- Will the presidential election meaningfully reshape the Fed?

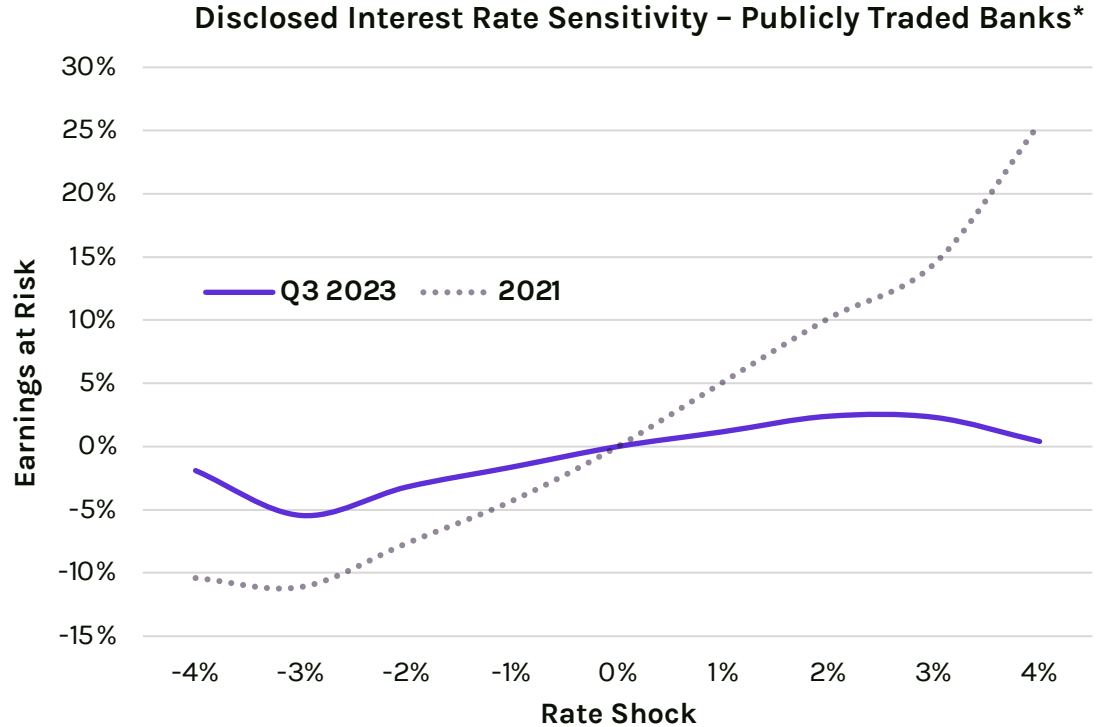


Source: DerivativeEDGE

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Bank Risk Profiles Have Changed Significantly

- Median bank benefits substantially less from higher rates today.
- Risk to lower rates remains.
- 11% of banks disclose earnings risk to both rising rates and falling rates.



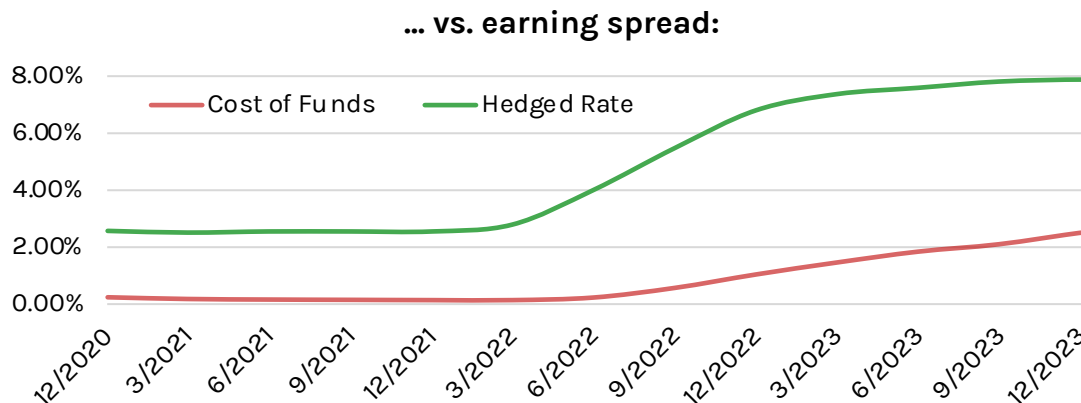
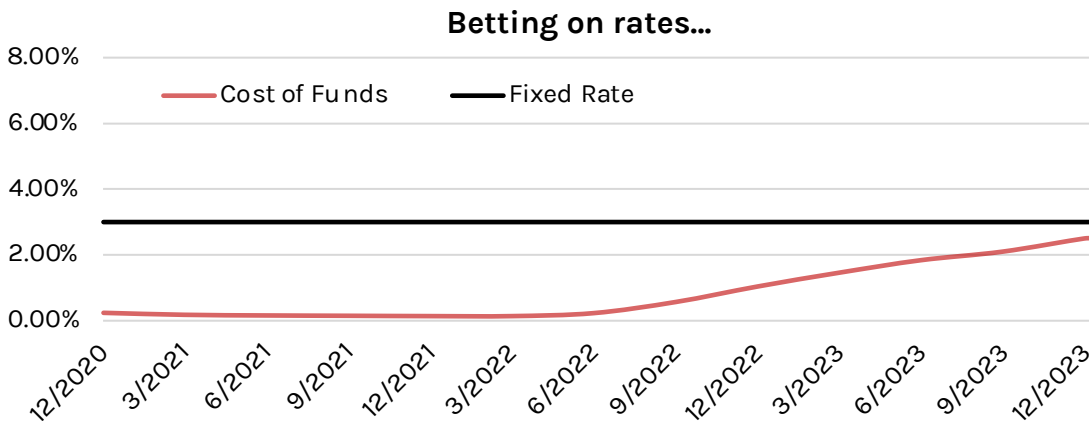
*Median disclosed NII sensitivity from constituents of S&P Regional Banking Index

Source: bank disclosures, earnings calls

Hedging Strategies

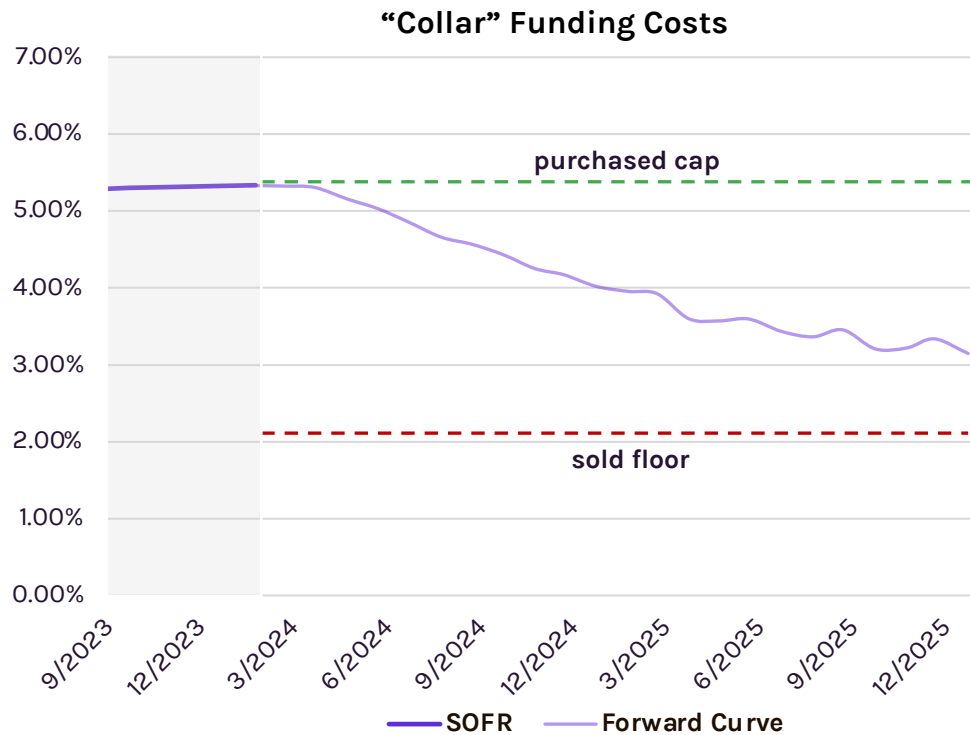
Match Asset and Liability Duration With Swaps

- Consider swaps to convert fixed-rate assets to floating.
- Swapped assets reprice with deposit costs, insulating the balance sheet from interest rate volatility.
- Earn spread for providing credit, not taking rate risk.
- Swaps can be an effective pricing tool.



Options Are Assets Too

- Options are most valuable when rates are volatile.
- Don't give away optionality to customers (prepayment, rate locks, caps).
- Buy back options to protect the balance sheet.
- Collars protect against rising rates without adding to exposure to the first 300bps in rate cuts.

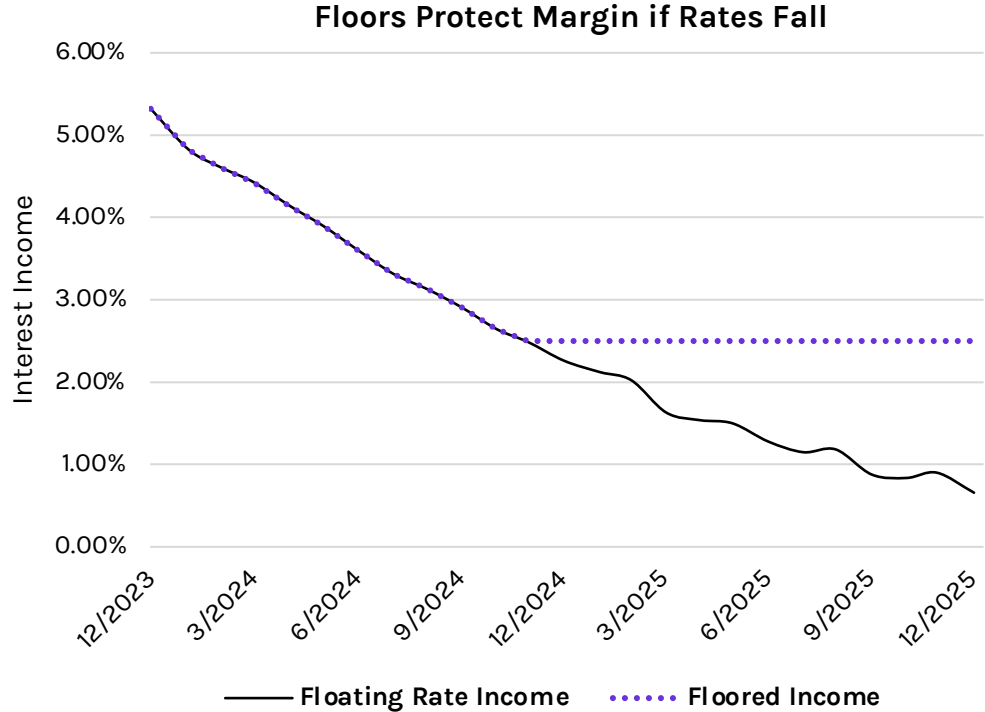


Source: DerivativeEDGE

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Floors Protect Margin in Declining Rate Environments

- Floors protect against lower rates without reducing earnings if rates rise.
- Floors help sustain margin in declining rate environments.
- Purchased floors from dealers provide most value- customers can refinance or renegotiate.



Manage Risk Through Customer Hedging Programs

Swaps provide **borrowers** with...

Interest rate certainty

Market-based rates

Potential for longer term financing

Two-way, market-based termination

Swaps help **banks**...

Reduce long-term rate risk

Floating rate loans with customer swaps create assets with consistent yields over cost of funds with no long-term rate risk to earnings.

Increase fee income

Customer swap programs can boost earnings through non-interest fee income.

Deepen customer relationships

Swap discussions provide an opportunity to educate clients on products and financial markets, learn more about their risk appetite, and create “stickier” relationships.

Compete on more than price

Swaps allow banks to create custom rate solutions that match each client’s unique needs and compare competing rate offers with equivalent terms.

Takeaways

1. **Foresight over hindsight:** anticipate risks and prepare proactively for volatility.
2. **Earn spread, don't bet on rates:** use swaps convert fixed assets to floating.
3. **Preserve optionality:** don't forfeit options to customers, buy them back in hedges.
4. **Practice pricing discipline:** hedging can reveal miscalibrated loan pricing.

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