

## A “NEW” LENDING OPPORTUNITY

*This Day in History: Today is National Irish Coffee Day. On January 25, 1915, Alexander Graham Bell made the first transcontinental telephone call by speaking to Thomas Watson in San Francisco while he was in New York. In 1937, “The Guiding Light” was first broadcast on NBC radio. It was added to CBS TV in 1952 and ran continuously until it was cancelled in September 2009.*

**Market Update: Interest rates were relatively calm last week with the range of the 10-year swap rate only about 3 basis points. The markets seemed relieved that a peaceful transfer of power in Washington occurred.**

Term	Swap Rates				Change		
	1/22/2021	1/15/2021	12/22/2020	8/4/2020	WoW	MoM	Since 8/4/2020
2y	0.20	0.20	0.20	0.18	0.00	0.00	0.02
3y	0.27	0.27	0.25	0.18	0.00	0.02	0.08
5y	0.53	0.52	0.44	0.24	0.00	0.09	0.28
7y	0.81	0.79	0.66	0.35	0.02	0.15	0.46
10y	1.11	1.09	0.92	0.51	0.03	0.19	0.61
20y	1.52	1.49	1.31	0.73	0.03	0.22	0.79
2s/10s slope	0.91	0.88	0.72	0.32	0.03	0.18	0.59

**In addition to commercial loan hedging and funding hedges, more conversations recently have centered on mortgage portfolio hedging. As banks are considering holding more mortgages on the balance sheet, they also want to make sure they don’t take on excessive interest rate risk.**

We read a recent article focused on 2021 banking risks. Some of the risks (cybersecurity, compliance, etc.) are outside our scope but other risks included tightening margins as banks fight for quality loans, interest rate risk, and uncertainties in CRE lending. We are hearing more banks say they are having difficulty generating commercial real estate loans at reasonable rates and others are sharing the desire to expand their mortgage portfolio, despite record low interest rates, to add to their earning assets.

Fortunately, banks can now portfolio these long loans without taking on the associated interest rate risk. Community banks now have a hedging option that did not exist until August 2017. At that time, FASB changed the accounting rules, establishing new standards that allow institutions to hedge prepayable assets for the first time. Community banks can now easily transform a portion of a selected portfolio (generally mortgages but it can be any amortizing fixed rate assets) from fixed to variable rate.

What are the practical implications of this significant change? Banks can now elect to make and hold assets their customers desire—for example, long term fixed rate mortgages—without incurring significant interest rate risk. At a time when most banks have excess liquidity and the

commercial real estate market is brutally competitive, holding these assets in portfolio to enhance earnings may be a possibility that would not have been considered in the past.

For example, a bank can make \$20 million of 30-year fixed rate mortgages at a 3.00% fixed rate. Without hedging, the bank is at risk of that fixed rate being well below their future funding cost and being stuck with an underwater asset. However, if they enter into an interest rate swap, they can convert the majority of those loans to floating at prime minus 80bps.

Notice we say that the majority of those loans, and not all the loans, will be converted to floating. Since mortgages are prepayable, the entire portfolio is not hedged only the portion expected to remain after prepayments. The bank can customize the hedge to offset the interest rate risk for their interest rate risk profile.

Why are banks taking advantage of this opportunity?

- Many have excess liquidity and are considering all investment options. Hedged fixed rate mortgages can be good earning loans with lower credit risk while having acceptable and controllable interest rate risk because of the new accounting rules.
- For banks that have historically kept mortgages, the current historically low rate environment has them concerned about assets that generate more interest rate risk than they desire. In addition, the traditional “hedging” tool of long-term wholesale funds are impractical when excess liquidity exists. Hedging allows them to continue to originate and efficiently hold these assets while controlling risk.
- Some banks have been selling mortgages due to rising rate concerns; hedging allows them to keep the assets, increase the total life of loan income and deploy excess cash currently earning almost nothing.

We can help you analyze the impact of hedging an existing portfolio or implementing strategies to meet customer demand for long term fixed rate mortgages while controlling rate risk. Give us a call and let us help you control some of the risks of 2021.

Have a great week!

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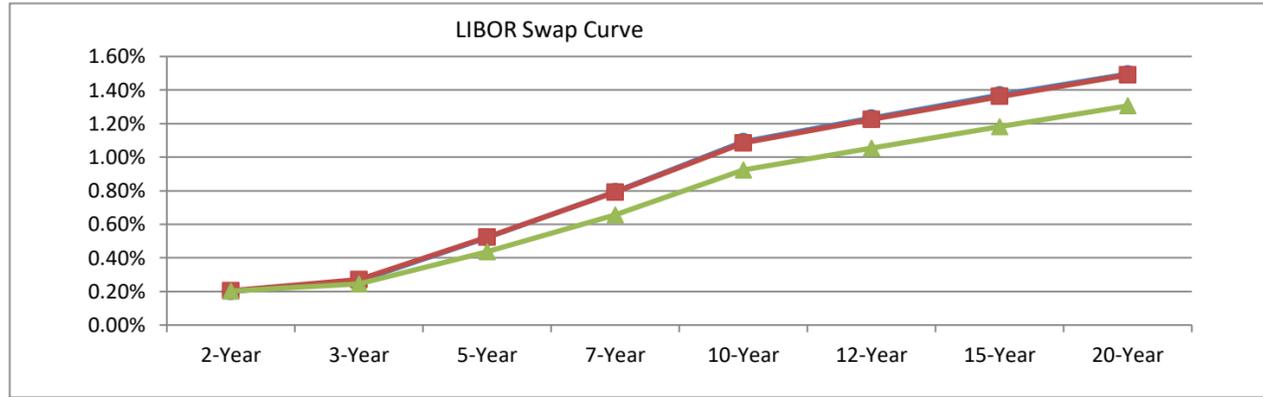
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### Interest Rate Swap Curves

LIBOR Swap Curve			
	Current	Last Week	Last Month
2-Year	0.199%	0.205%	0.202%
3-Year	0.264%	0.270%	0.246%
5-Year	0.520%	0.523%	0.437%
7-Year	0.793%	0.790%	0.657%
10-Year	1.093%	1.086%	0.925%
12-Year	1.233%	1.224%	1.054%
15-Year	1.370%	1.361%	1.182%
20-Year	1.496%	1.490%	1.306%

\*Bloomberg mid-market quotations



Money Market Rates		3M LIBOR Forward Rates	
1M LIBOR	0.12750%	Mar-21	0.18500%
3M LIBOR	0.21288%	Jun-21	0.17000%
6M LIBOR	0.23300%	Sep-21	0.18000%
12M LIBOR	0.31225%	Dec-21	0.21000%
Prime	3.25000%	Mar-22	0.18500%
FFTR	0.2500%		
Eff FF	0.0800%		
SOFR	0.0500%		

### Spot Start Loan Hedging

Rate Term (Years)	Floating Rate	Amortization Term (Years)							
		3-Year	5-Year	7-Year	10-Year	15-Year	20-Year	25-Year	Bullet
2-Year	LIBOR + 2.00%	2.24%	2.24%	2.24%	2.24%	2.24%	2.24%	2.24%	2.24%
3-Year	LIBOR + 2.00%	2.25%	2.28%	2.29%	2.29%	2.30%	2.30%	2.30%	2.30%
4-Year	LIBOR + 2.00%		2.34%	2.37%	2.40%	2.41%	2.42%	2.42%	2.43%
5-Year	LIBOR + 2.00%		2.37%	2.46%	2.51%	2.52%	2.53%	2.53%	2.54%
6-Year	LIBOR + 2.00%			2.52%	2.60%	2.63%	2.64%	2.65%	2.67%
7-Year	LIBOR + 2.00%			2.55%	2.67%	2.73%	2.75%	2.77%	2.80%
8-Year	LIBOR + 2.00%				2.72%	2.81%	2.85%	2.87%	2.90%
9-Year	LIBOR + 2.00%				2.76%	2.89%	2.93%	2.95%	3.00%
10-Year	LIBOR + 2.00%				2.77%	2.94%	3.00%	3.02%	3.09%
12-Year	LIBOR + 2.00%	Customer Pays Fixed, Monthly, Act/360				3.02%	3.10%	3.15%	3.22%
15-Year	LIBOR + 2.00%	Customer Receives 1-Month LIBOR + 2.00%				3.05%	3.19%	3.25%	3.35%

### Forward Starting Swap Quotes

Rate Term (Years)	Floating Rate	20-Year Amortization		
		3-Month	6-Month	12-Month
2-Year	LIBOR + 2.00%	2.25%	2.27%	2.33%
3-Year	LIBOR + 2.00%	2.33%	2.38%	2.47%
4-Year	LIBOR + 2.00%	2.46%	2.51%	2.62%
5-Year	LIBOR + 2.00%	2.58%	2.64%	2.75%
6-Year	LIBOR + 2.00%	2.69%	2.75%	2.87%
7-Year	LIBOR + 2.00%	2.80%	2.85%	2.96%
8-Year	LIBOR + 2.00%	2.90%	2.95%	3.05%
9-Year	LIBOR + 2.00%	2.97%	3.02%	3.12%
10-Year	LIBOR + 2.00%	3.04%	3.08%	3.17%
12-Year	LIBOR + 2.00%	3.14%	3.18%	3.26%
15-Year	LIBOR + 2.00%	3.23%	3.26%	3.33%

### Profitability Analysis

Rate Term (Years)	Profit Per Basis Point of Mark-up, Per \$1,000,000 of Notional							
	3-Year	5-Year	7-Year	10-Year	15-Year	20-Year	25-Year	Bullet
2-Year	\$141	\$167	\$178	\$186	\$193	\$196	\$198	\$203
3-Year	\$160	\$221	\$247	\$266	\$281	\$289	\$293	\$304
4-Year		\$254	\$302	\$337	\$364	\$378	\$386	\$405
5-Year		\$266	\$341	\$397	\$440	\$462	\$474	\$505
6-Year			\$365	\$447	\$510	\$541	\$559	\$604
7-Year			\$374	\$486	\$573	\$615	\$640	\$702
8-Year				\$515	\$629	\$685	\$717	\$799
9-Year				\$532	\$677	\$749	\$790	\$894
10-Year				\$538	\$718	\$807	\$858	\$987
12-Year	Fee Income Generation Only Possible With				\$778	\$907	\$982	\$1,169
15-Year	Back-to-Back Swaps and SMART Loan Products				\$813	\$1,016	\$1,135	\$1,430

### Macro-Hedging

Protection Against Rising Rates							
3mL Pay Fixed Swap		Pay Fix, quarterly, act/360 both sides	3-Month LIBOR Caps - Premium in Basis Points				
Rate Term	Rate		Strike	2-Year	3-Year	4-Year	5-Year
2-Year	0.30%		0.30%	0.33%	0.56%	1.30%	2.27%
3-Year	0.37%		0.50%	0.32%	0.43%	1.01%	1.82%
4-Year	0.50%		0.75%	0.31%	0.38%	0.80%	1.44%
5-Year	0.63%						

Protection Against Falling Rates							
Prime Rcv Fixed Swap		Receive fixed, monthly, act/365 both sides	3-Month LIBOR Floors - Premium in Basis Points				
Rate Term	Rate		Strike	2-Year	3-Year	4-Year	5-Year
2-Year	3.13%		0.25%	0.48%	0.72%	0.90%	1.09%
3-Year	3.18%		0.15%	0.41%	0.64%	0.80%	0.98%
4-Year	3.30%		0.10%	0.40%	0.62%	0.77%	0.94%
5-Year	3.40%						

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