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## Interest Rate Swaps:

Avoid being exposed when the tide goes out!

June 26, 2023

10:50am – Magnolia Room Breakout Session



Bob Newman, CFA

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## Entry Poll: Derivatives Word Association



First word or emotion  
that comes to the surface  
when I hear the word:

“Interest Rate Derivative” .....

[PollEv.com/bobnewman319](https://PollEv.com/bobnewman319)

# Entry Poll: Derivatives Word Association

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“

Only when the tide goes out do you discover who's been swimming naked.

- Warren Buffett

”



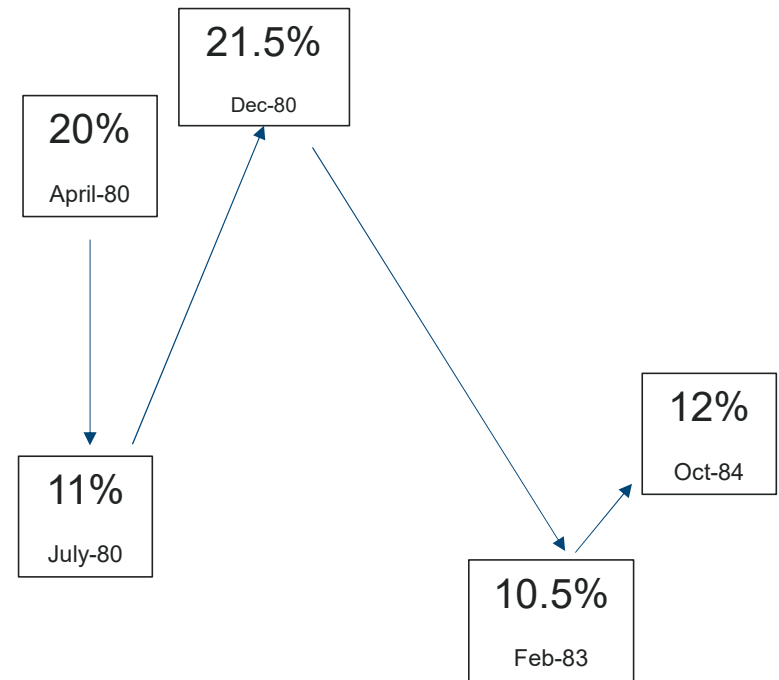
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# Why swaps?

Born in the 1980's



Prime Rate



# Why now? Made for today!



Prime Rate

8.25%  
June-2023



?  
?

5.50%  
July-2019

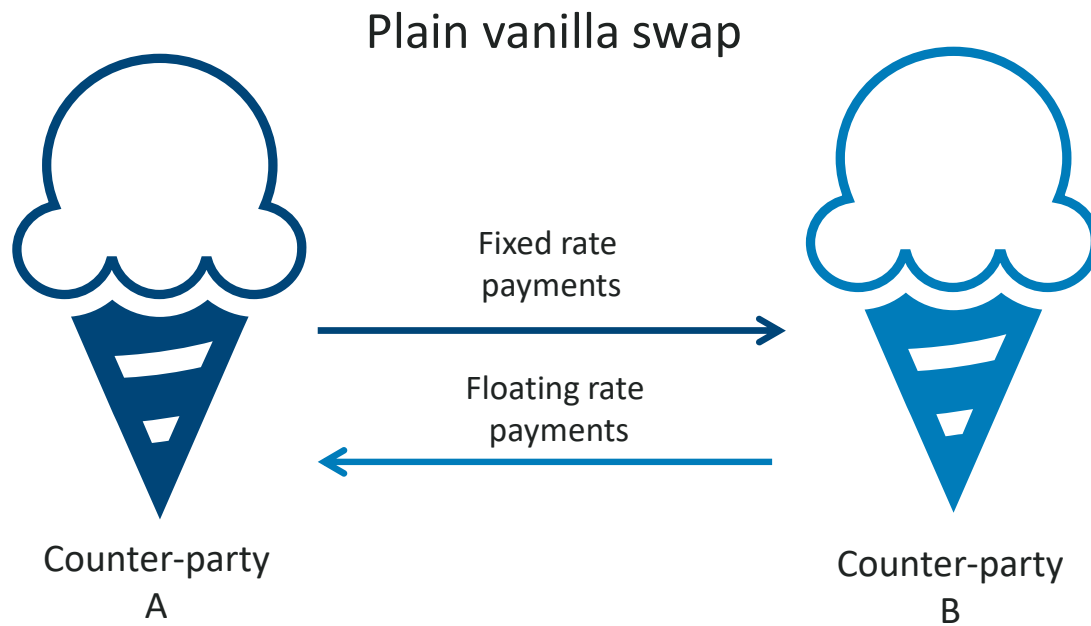


3.25%  
March-2020  
Thru  
March-2022



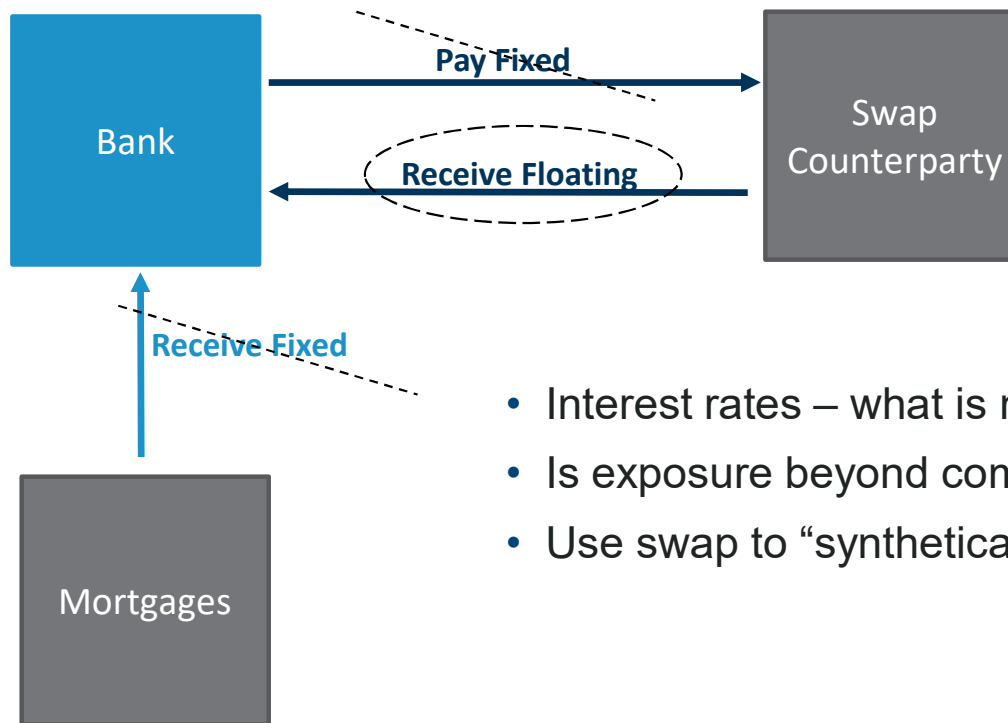
# Derivatives – The “Vanilla” Interest Rate Swap

## What it “IS”



## Derivatives – The “Vanilla” Interest Rate Swap

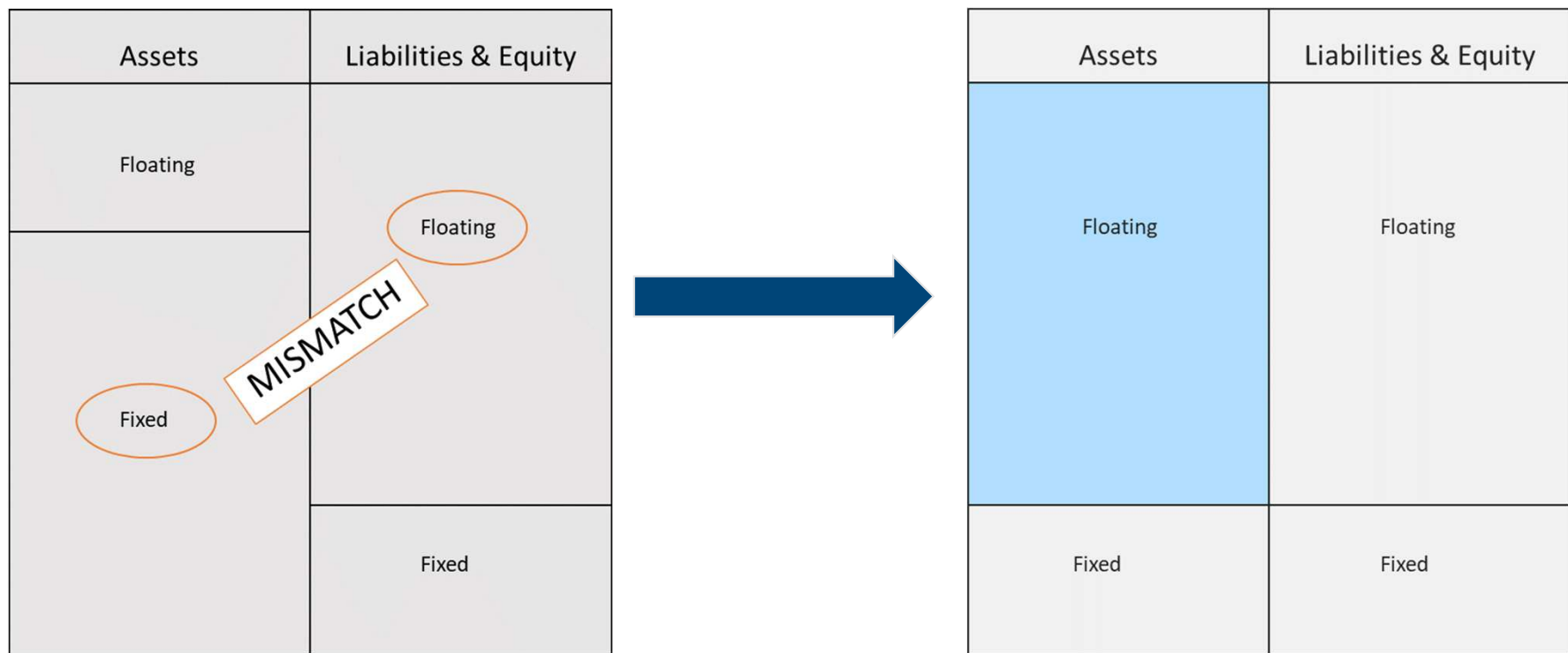
What it “DOES”



- Interest rates – what is my natural exposure?
- Is exposure beyond comfort zone (or policy limit)?
- Use swap to “synthetically” change positions

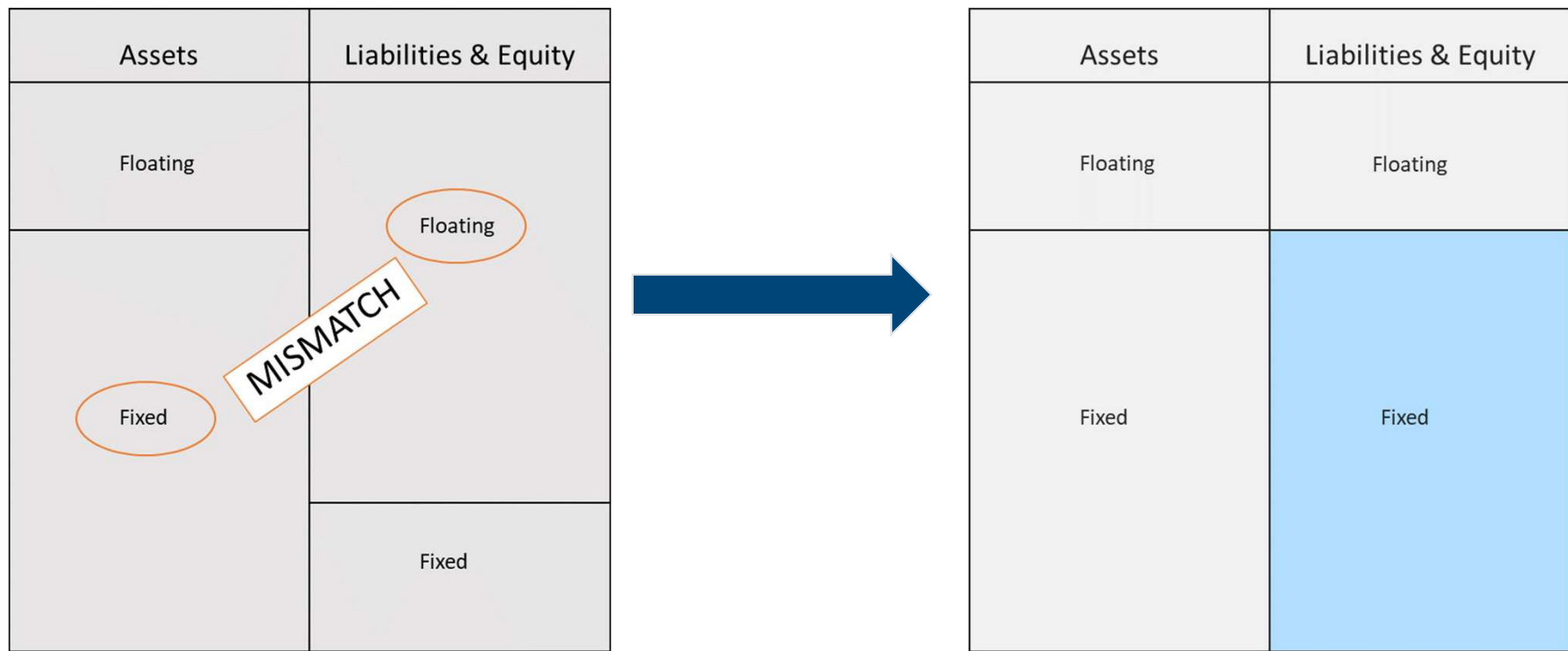
# Interest Rate Derivatives

Efficiently correcting a natural mis-match



# Interest Rate Derivatives

Efficiently correcting a natural mis-match



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How confident are you in your rate forecast?

Nobody knows for sure – not even The Fed!





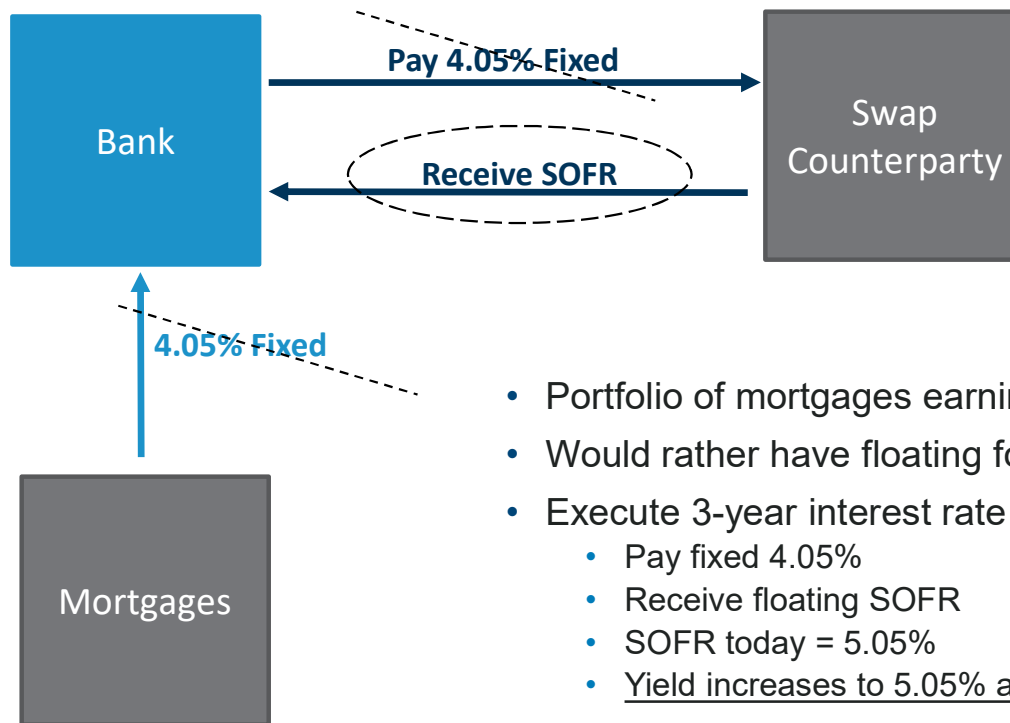
# Current market conditions: The SOFR forward curve

## Why would ANY counterparty take the other side of this deal?



## Balance sheet swap example

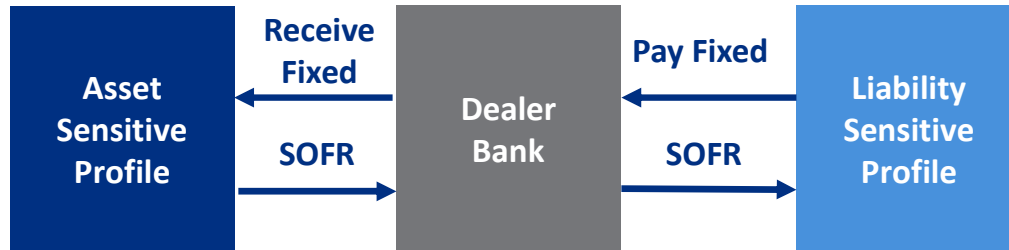
### Swap fixed-rate mortgages to floating-rate



- Portfolio of mortgages earning 4.05% today
- Would rather have floating for next three years
- Execute 3-year interest rate swap:
  - Pay fixed 4.05%
  - Receive floating SOFR
  - SOFR today = 5.05%
  - Yield increases to 5.05% and reprices monthly for next 3 years

*Wholesale Swap Rate includes fees and transaction costs  
Pricing indicative as of June 14, 2023*

## Swap pricing: Expectations create a trade-off



- Bank looking to hedge against falling rates PAYS “negative carry” on swap at inception

**T H I S  
I S N O T  
N O R M A L**

- Bank looking to hedge against rising rates EARNs “positive carry” on swap at inception

**SOFR Swap Rates as of 6/14/2022**

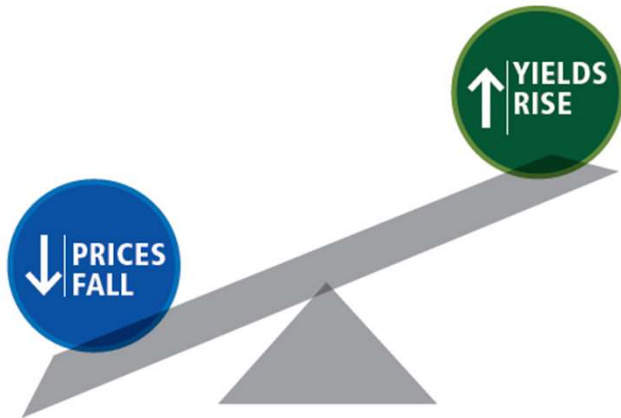
Term (yrs)	Rate	Carry
2	4.50%	55 bps
3	4.05%	100 bps
5	3.68%	137 bps
7	3.53%	152 bps
10	3.44%	161 bps
<b>SOFR</b>	<b>5.05%</b>	

Wholesale Swap Rate includes fees and transaction costs  
Pricing indicative as of June 14, 2023

# Mitigating price volatility in the bond portfolio

## Forward-starting pay-fixed swap hedging fixed-rate bond

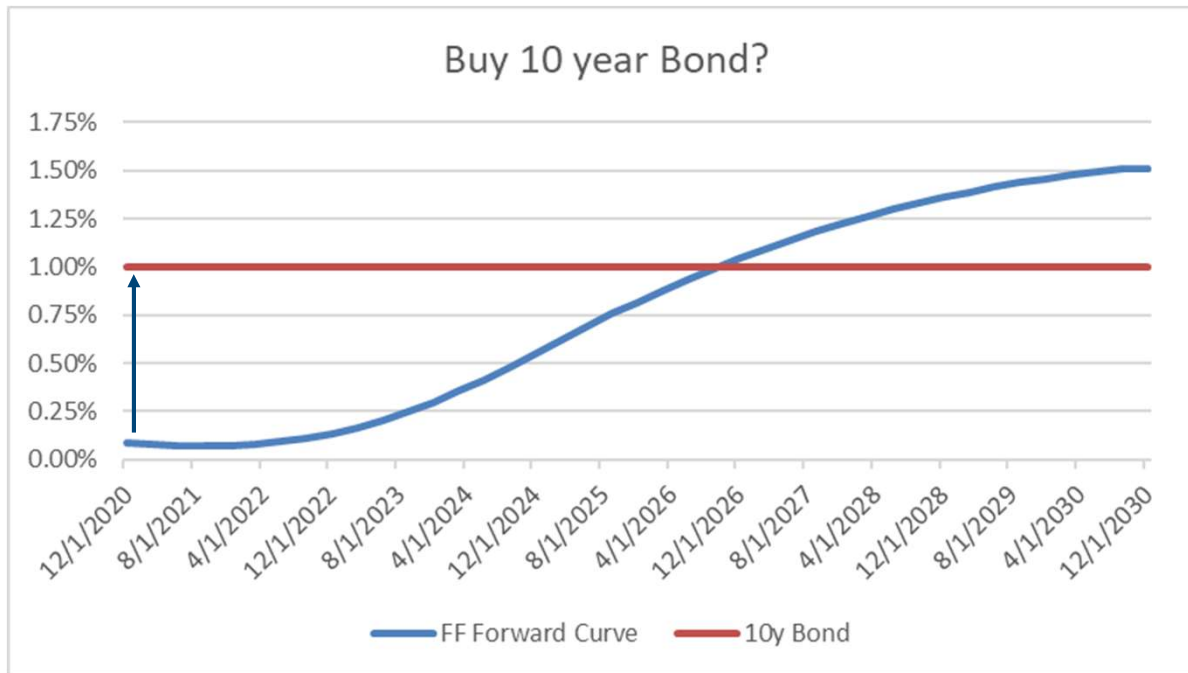
IF INTEREST RATES RISE:



IF INTEREST RATES FALL:



## Flashback to late 2020...



### 10 yr Bond Purchase:

- Pick up ~90 bps in yield today...
- Will I hate myself 2 years from now?
- Can I handle the price volatility in OCI?



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Flashback to late 2020...

“How it started...How it’s going” for an ICU nurse

## How it started



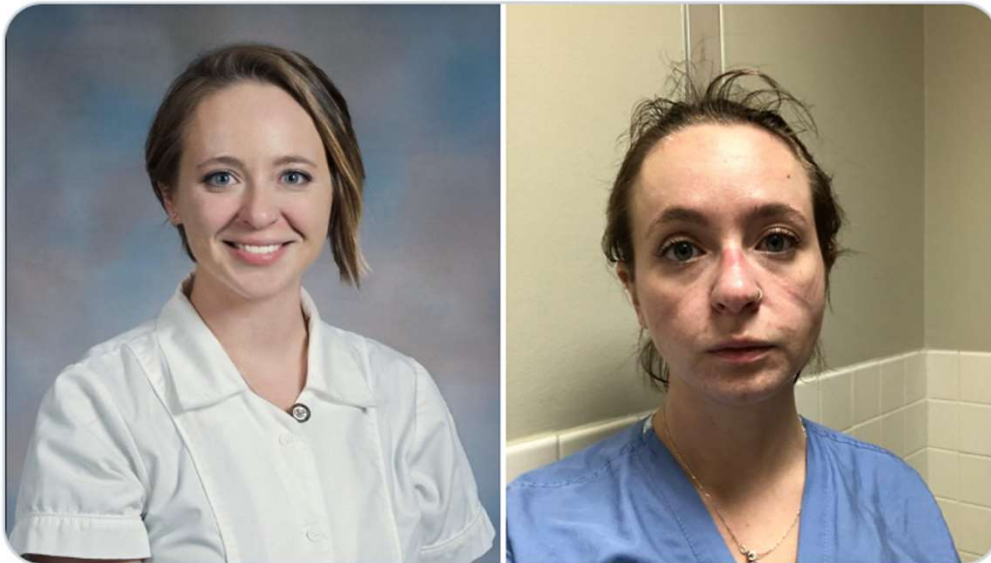
12:23 PM · Nov 22, 2020

Flashback to late 2020...

“How it started...How it’s going” for an ICU nurse

How it started

How it's going



12:23 PM · Nov 22, 2020



## Buy 10-year Treasury in late 2020

“How it started...”

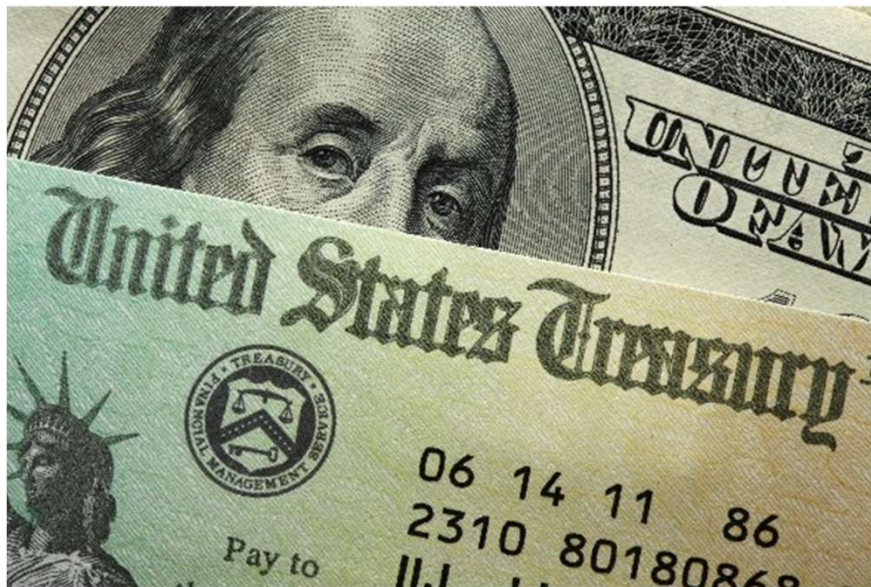


- Yield = 1.00% for next ten years
- Price = Par \$100



## Price of 10-year Treasury in late 2022

“How it’s going...”

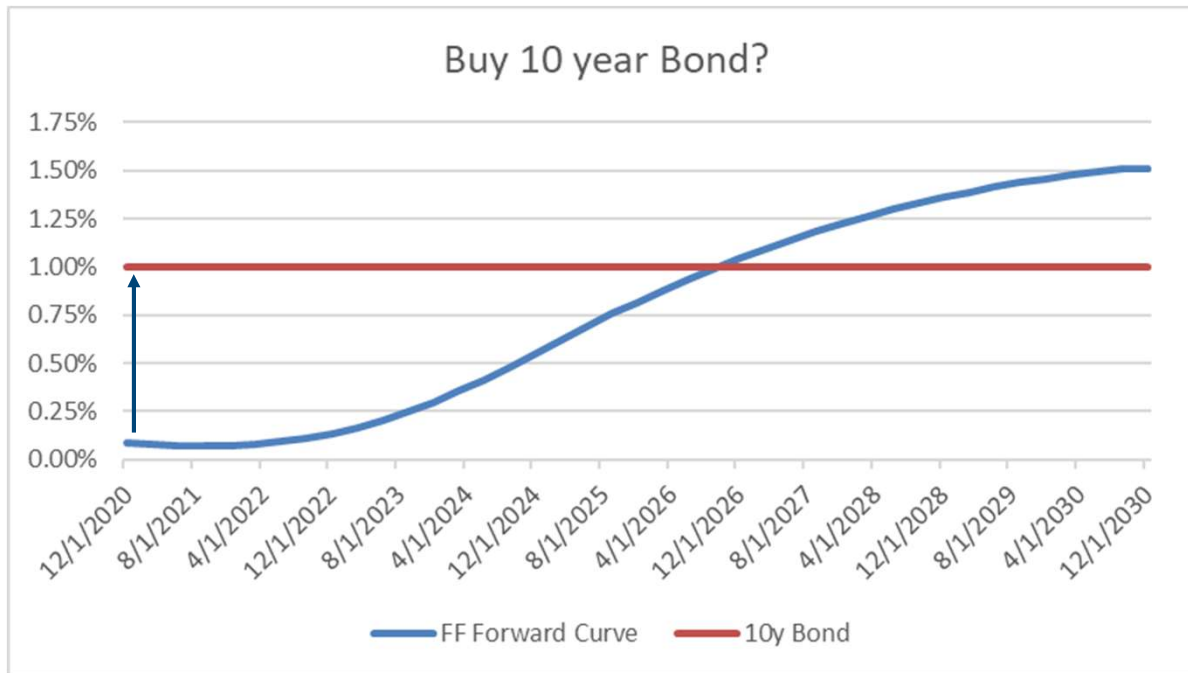


- Yield = 1.00% (still)
- Price = 80% par (\$80)





## Flashback to late 2020...alternate ending!



### 10 yr Bond Purchase:

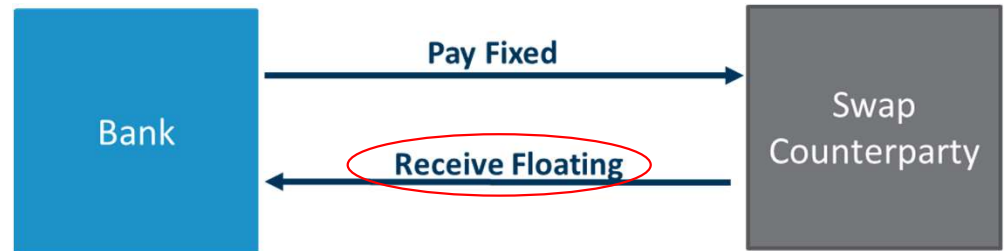
- Pick up ~90 bps in yield today...
- Enter 8-year swap starting two years in the future
- Keep the 1.00% fixed yield for first two years
- Flip to Fed Funds floating for the final eight years



## Impact on NIM

When swap takes effect in late 2022:

- Earn floating for final eight years:

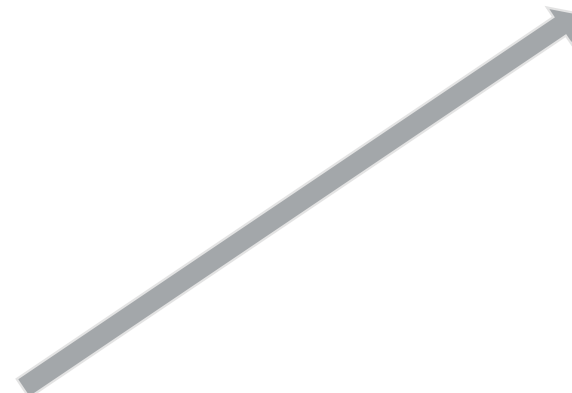


- Earn fixed for first two years:



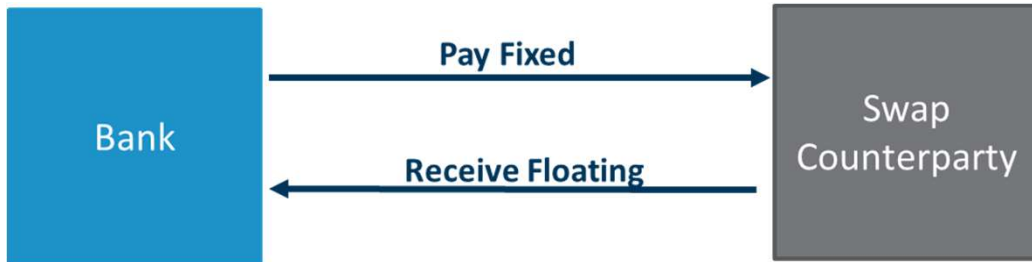
- Yield = Fed Funds floating = 4.00%+

- Yield = 1.00% fixed until late 2022



# Impact on EVE

From inception of swap:



- Swap value + \$18
- Price = 80% par (\$80)



**Total value \$98!**

# Why do banks use interest rate swaps?

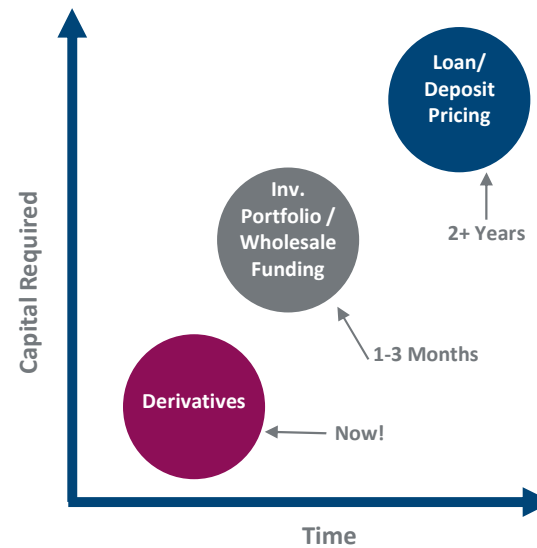
## Two primary reasons and applications

### 1. Manage balance sheet interest rate risk

- Allows banks to synthetically alter asset-liability sensitivity
- Avoids need to turn on/off “spigots”
- Impact/protect NIM and EVE
- Enables banks to more nimbly steer the ship

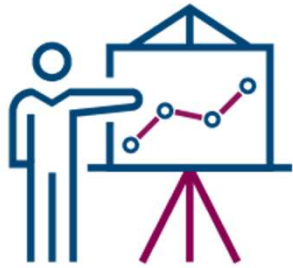
### 2. Meet borrower demand for long-term fixed rates

- Borrower can lock in long-term fixed-rate financing options
- Bank can lend variable to more closely align loan to funding costs

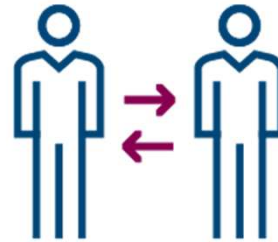


# Swaps in the risk management toolkit?

Laying the foundation for native hedging capabilities



Education



Counterparty



Policy



Regulatory

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Questions?

Q&A





## Bio and Contact Info



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Bob is a Managing Director in Chatham's financial institutions business which specializes in interest rate risk management for regional and community banks. He is a frequent speaker at industry events and serves on the faculty of the ABA Stonier Graduate School of Banking. Prior to joining Chatham in 2003, most of Bob's 20 years in commercial banking were focused on bringing "swaps to Main Street", helping to start the derivatives operation at Maryland National Bank and expand the derivatives effort at SunTrust Bank. He graduated from the College of William and Mary with a BA in Economics and has earned the Chartered Financial Analyst (CFA) designation.



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Access advantage

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