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Hedging in Today's Rate Environment: Flat Curve and Rising Rates

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What We Will Cover

- Why Hedge?
  - Key Benefits
  - Income Possibilities
  - Protect and Generate NIM
- How the Flat Curve is Effecting Hedging
- Yield Maintenance and Forward Swaps
- The Flexibility of a Hedge
- Questions?

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Key Benefits

- Reduce interest rate risk
- Reduce credit risk of borrower by stabilizing DSC
- Grow and defend your loan portfolio
- Generate fees
- Stickier and stays on balance sheet longer

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Income Possibilities

- Earn an upfront fee by increasing the swap rate
  - Traditional Fixed Rate:

Swap Rate	1.50%
Monthly Spread	2.75%
Fixed Rate	4.25%

  - Fixed Rate with Fee:

Swap Rate	1.60% (inc. 10bp fee)
Monthly Spread	2.75%
Fixed Rate	4.35%

- A 10bp upfront fee on a $1 million 10Y loan is approximately $7,000

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Effects of the Flat Curve on Hedging

- Less give up on margin at inception of loan and hedge
- Astute borrower's are going further out the curve to procure long term coupons
- Advantageous for symmetrical yield maintenance
- More utilization of forwards

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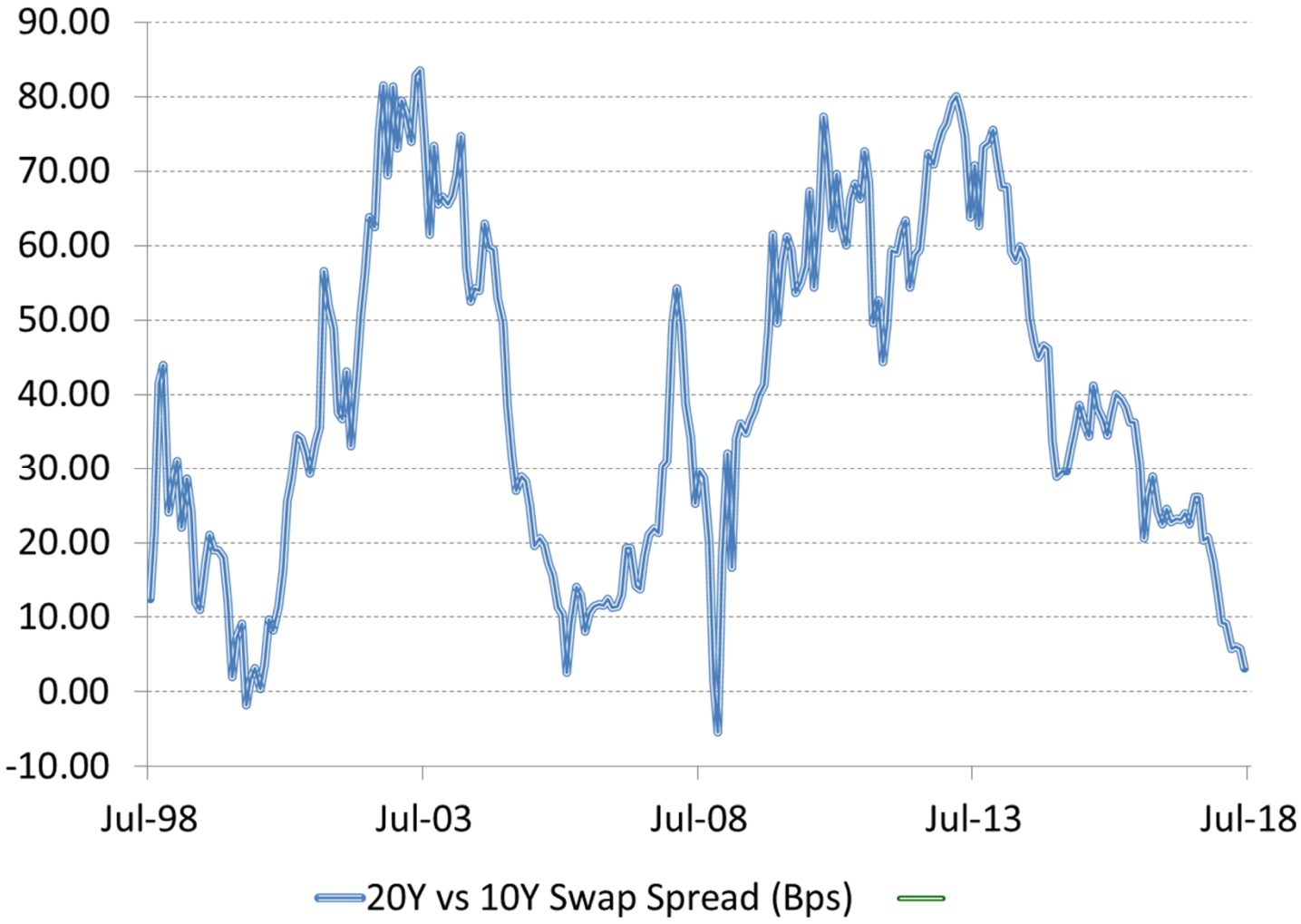
LIBOR Swap Rates: 20Y vs 10Y



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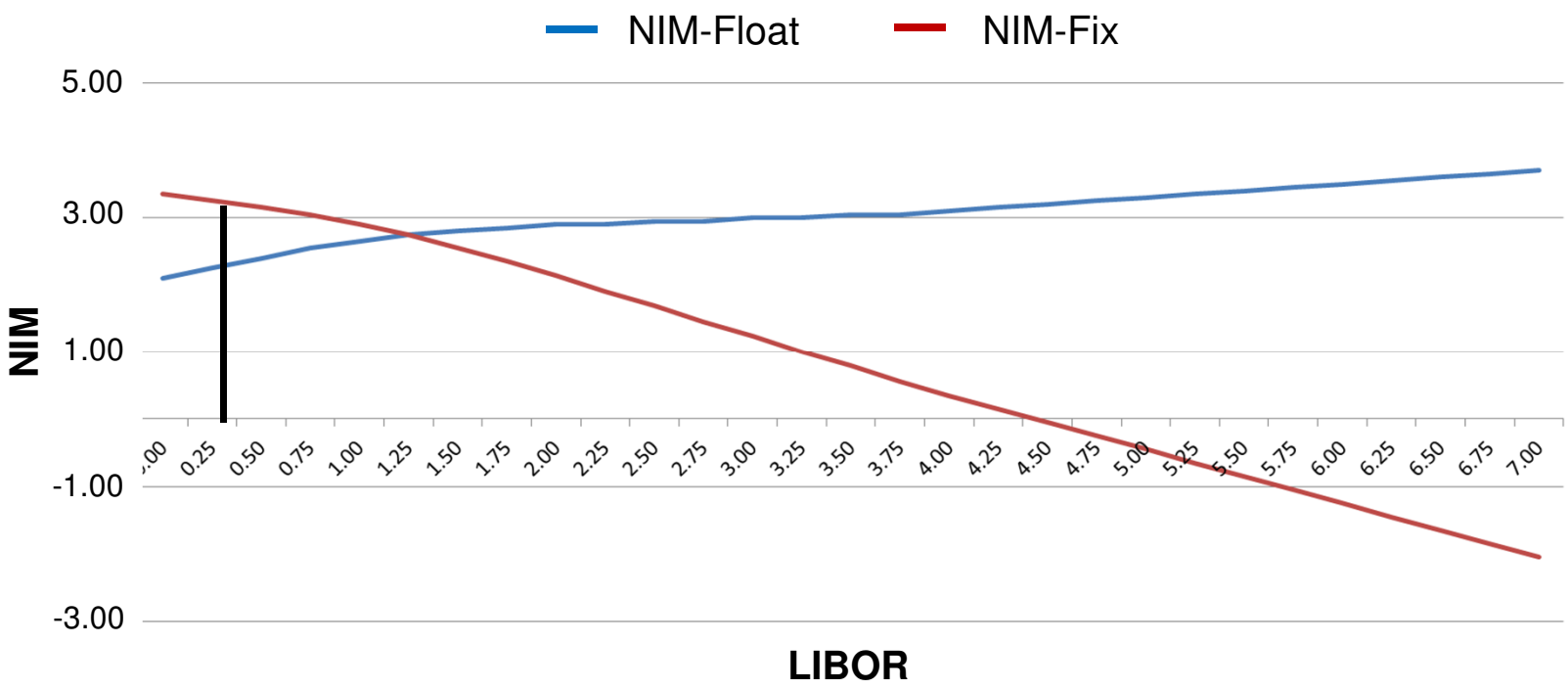
Protect and Generate NIM

- Contractually exchange fixed income stream to floating using swap market
- 5 Year Fixed NIM vs. any Floating Rate Term NIM Priced at LIBOR + 2.50%



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Fixed Rate Pricing: LIBOR + 2.50%

Indicative Fixed Rate to Achieve Required Margin

AMORTIZATION \ TERM	3	4	5	6	7	8	9	10	12	15	20
3	5.29										
5	5.35	5.37	5.38								
7	5.37	5.40	5.41	5.42	5.42						
10	5.38	5.41	5.43	5.44	5.45	5.46	5.47	5.47			
12	5.37	5.41	5.43	5.44	5.46	5.46	5.48	5.48	5.49		
15	5.38	5.41	5.43	5.44	5.46	5.47	5.47	5.49	5.50	5.51	
20	5.38	5.41	5.43	5.45	5.46	5.47	5.49	5.50	5.52	5.53	5.53
25	5.38	5.41	5.43	5.45	5.46	5.48	5.49	5.50	5.52	5.54	5.54
30	5.38	5.42	5.44	5.45	5.46	5.48	5.49	5.51	5.53	5.54	5.54

1-Month LIBOR: 2.08%

Source: Bloomberg

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Yield Maintenance

- If the borrower decides to prepay partially or in full, the hedge has to be lifted at the then existing swap replacement rate
- At time of prepayment, if the replacement swap rate is:

  ↑ hedge gain

  ↓ hedge loss

- Documentation will require the borrower to reimburse the hedge provider for a hedge loss or alternatively, if there is a hedge gain, the hedge provider pays the gain to the borrower

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Yield Maintenance: $1MM, 20Y due 10Y

Remaining Term	Swap Rate at Prepayment vs. Initial Swap Rate				
	+0.50%	+0.25%	0%	-0.25%	-0.50%
	3.50%	3.25%	3.00%	2.75%	2.50%
10yrs	$36,152	$18,275		($18,684)	($37,788)
9yrs	$32,348	$16,337		($16,669)	($33,677)
8yrs	$28,558	$14,408		($14,672)	($29,612)
7yrs	$24,792	$12,495		($12,697)	($25,600)
6yrs	$21,058	$10,602		($10,751)	($21,653)
5yrs	$17,367	**$8,735**		**($8,838)**	($17,782)
4yrs	$13,731	$6,899		($6,965)	($13,997)
3yrs	$10,163	$5,100		($5,138)	($10,313)
2yrs	$6,675	$3,346		($3,363)	($6,742)
1yrs	$3,282	$1,643		($1,647)	($3,299)
	Borrower Receives Fee			Borrower Pays Fee	

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Alternative to Yield Maintenance

For those borrowers that are not interested in yield maintenance, there is an alternative structure more typically used in CRE financings.

Borrower

- No Yield Maintenance
- Traditional Prepayment Penalty
- Simpler Documentation
- Slightly higher fixed rate *

Bank

- Easier for lenders to market
- Potential for more loan originations, both C&I and CRE
- "Soft Exposure" easier to quantify

Prepayment Penalty:*
5 yr- 5,4,3
7 yr- 5,4,3,2
10 yr- 5,4,3,2,1
12 *yr – 5,5,4,3,2.1*

*** Incremental cost will vary depending on prepayment period and penalty, which are flexible to suit the needs of the borrower.**

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Hedging through Forwards

- Lock in fixed rate for borrower and floating spread for financial institution before closing permanent financing
- Typically used for construction loans or extended closing periods from a few weeks to 24 months
- Borrower signs Forward Rate Lock Agreement and is responsible for symmetrical yield maintenance from time of lock
- Borrower secures the forward rate lock with the underlying DoT/Mortgage
- Lock in financing at a competing bank prior to the note maturing
- Primarily used when a borrower and lender are certain of consummating the term loan
- Forward missed the mark. How handle?

Examples of Hedging Flexibility

- Accommodates any structure out to 25Ys and a 30Y amortization
  - Includes: mortgage style, straight line, stair step, accreting schedule, and IO
- Can be placed on any amount (up to full amount)
  - And on any term (up to the full term)
- Assignable/assumable to a new property and/or new borrower
- Simple modification process allows for use on existing note(s)
- Amend/Extend a currently hedged loan blending prepay into new principal to avoid out of pocket expense for borrower
- Re-coupon a currently hedged loan to retain borrower

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Who
When
What
Which
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Why What Who Where
Concepts

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