What community bank isn’t interested in making more profitable loans? The consensus among ICBA members is that if loan demand isn’t slack, pricing is an issue. High-quality credits that won’t leave lenders in the dust when rates begin to rise are always precious.

That’s not a prediction that interest rates are about to ascend, by the way. Just the same, prudent bank managers wisely keep their eyes on their interest-rate risk exposures to ensure a relatively stable net interest margin regardless of nominal rates. One way to accomplish this is to use the services of Vining Sparks Interest Rate Products (VSIRP).

VSIRP works with community banks to create a desirable interest-rate mix, primarily by designing and executing interest-rate swaps. These strategies can, for example, allow a bank to offer a long-term fixed-rate loan to a customer and simultaneously convert the loan to a floating-rate instrument on its own balance sheet. Thus the bank remains both competitive and compliant with its interest-rate risk policies.

Satisfied client
Roy Haga is the chief credit officer for KeySource Commercial Bank, a $200 million-asset member in Durham, N.C. The community bank opened its doors in March 2007 and has achieved impressive year-over-year growth organically. Its loan mix is typical of a community bank: primarily commercial, fixed rate, with balloon maturities ranging from three to seven years.

Just as the borrowers generally want fixed-rate loans (particularly in an interest-rate environment that is a generational low), lenders have heartburn about anything fixed beyond two years. Add to this the not-so-subtle reminders from bank examiners about their asset/liability management expectations.

Haga has used VSIRP to help manage these issues. “To be competitive in a fixed-rate market, we needed to use some of their tools,” he says. “It has allowed us to make the type of loan the customer was being offered by other banks, but at terms that we could live with.”

KeySource has used the VSIRP platform several times. It’s in essence a commercial loan hedging program that can be customized to fit a specific credit. Loan sizes can vary from $500,000 to as large as a community bank can originate.

“It’s a turnkey solution from an accounting and operations perspective,” Haga says. “The customer signs a simple addendum to their note with us, not with some third party. For us, any mark-to-market issues are completely
mirrored from the customer to VSIRP, so we get the effect of making a floating-rate loan and earn some nice fee revenue too.

**Interested?**

VSIRP is a sibling of Vining Sparks IBG, which acts as ICBA Securities’ clearing broker. VSIRP’s staff has nearly 40 years of helping banks manage their rate risk through interest-rate swaps. Over the past decade, the typical block size for swaps has shrunk as efficiencies have enabled community banks to access these products. As of the end of 2009, more than 1,000 banks with less than $5 billion in individual assets had derivative contracts on their books. And that doesn’t include bank holding companies, many hundreds of which likely are using these strategies.

The loan hedging platform is one of a number of hedging strategies that community banks can use. Another common technique is to lengthen the durations of a bank’s deposit liabilities, which is the corollary to shortening the durations of the loan portfolio. Variations on these themes can be created to “fit” a rate swap to a given community bank’s needs.

VSIRP publishes a weekly pricing matrix that is available from your ICBA Securities sales rep. A good starting point for understanding the process of using these services is to discuss the terms on the matrix with one of the VSIRP professionals, who can advise you on possible interest-rate hedge strategies.

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**Derivatives—Improvements Equal Good News for Banks**

The Dodd-Frank Wall Street Reform and Consumer Protection Act contains ICBA-advocated exemptions for banks using derivative “swaps” in connection with providing loans. In addition, commercial banks that use hedging contracts to manage interest-rate risk are not required to spin off that portion of their business into special-purpose subsidiaries. It also includes a de minimus exception for infrequent users of swaps. A mandate for higher capital and margin requirements for customized swaps was removed, and these requirements are now tied to economic risks rather than whether swaps have been cleared.