# Hedging Loan Spreads with a Corridor Advance

**August 2 , 2010**

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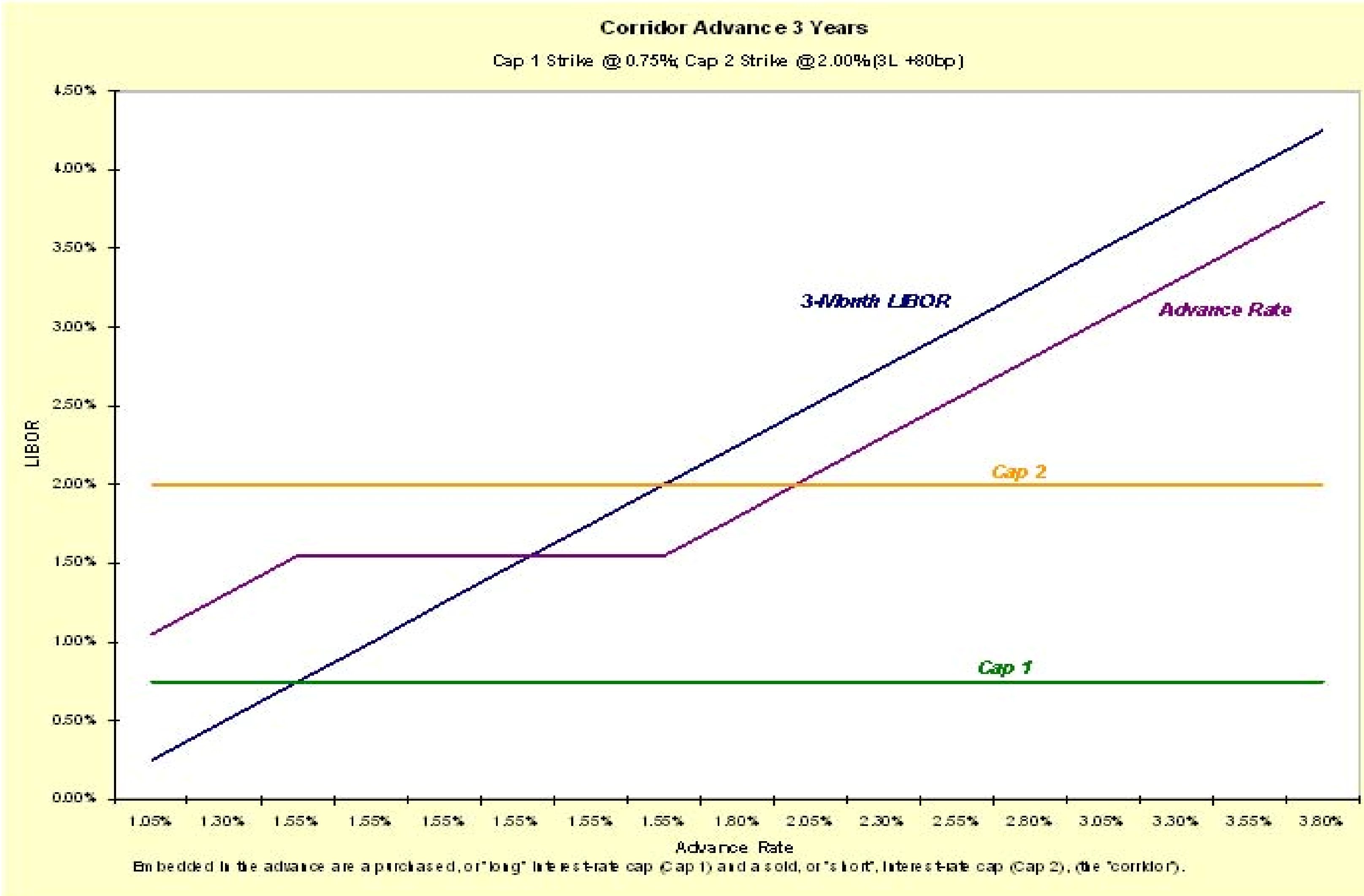
Did you stay ahead of the game by putting rate floors into some of your loan products? Right now you can enjoy watching those assets generate attractive spreads. But what happens when rates eventually start to move up again? Oops, there go the spreads!

Several members are worried about this A/L dynamic for some of their home-equity and commercial loans. As rates increase, margins on this portion of the portfolio will be squeezed. Funding costs will go up, but asset yields won't change until the floating-rate calculation exceeds the rate floor. It's a classic liability-sensitive dilemma, often for the first 100 basis points of the rate move.

What can you do? You could control deposit rates, but this is unlikely. You could borrow term funds from the Federal Home Loan Bank of Boston, but what term is best and is it worth it to pay up now? Or you could try a Corridor advance.

Introduced in April, the Corridor is a hybrid floating/fixed-rate product, similar to loans with rate floors. The advance rate floats until an index (LIBOR) exceeds a target rate cap. After the cap kicks in, the advance rate is fixed until the index reaches a second rate level and floats again. Take a look at the diagram below.




This example shows a three-year term Corridor advance priced off of three-month LIBOR with caps set at (1) 75 basis points and (2) 2.0 percent. The caps are embedded in the advance and the fees are included in the advance rate. Both caps refer to the LIBOR index rate, not the rate on the advance.

The advance is currently priced at three-month LIBOR plus 80 basis points, with LIBOR at 54 basis points. All in, the advance coupon is 1.34 percent. When LIBOR increases 21 basis points, the first cap is struck, freezing the rate on the advance until the second cap is struck when the advance rate resumes its climb. So, for example, when LIBOR moves up 100 basis points from the current level, the advance rate will be the capped rate (75) plus 80, or 1.55 percent. When LIBOR goes up 200 basis points, the new advance rate will be 75 plus (254-200) plus 80, or 2.09 percent.

Why bother with all of this? Because it locks in a spread on the asset with the floor rate. Assuming you have a home-equity line of credit (HELOC) portfolio priced at prime (3.25 percent) less 50 basis points with a 4 percent floor, you would earn 2.66 percent today over the Corridor advance rate. When LIBOR moves up 100 basis points, you would earn 2.45 percent. When LIBOR increases 200 basis points and if prime moves in tandem, you would still earn 4.75 percent less 2.09 percent, or 2.66 percent.

If you funded the HELOC portfolio with short liabilities, your current spread might be a fat 3.46 percent now, but when rates increase 100 basis points you will be down to 2.46 percent. A 125-basis-point increase will bring you to 2.21 percent—a classic squeeze. With the Corridor advance, you earn at least a comfortable 2.45 percent all the way.

In general, caps embedded in advances do not have to be marked to market as rates change, but please check with your accountants to be sure. Corridor advances are subject to a minimum of $10 million, but smaller requests may be accommodated in special offerings. You can learn more about the Corridor Advance in the credit products section of our web site.

If you are seeking margin stability, follow the Corridor!