UK banks

‘The caterpillar’: British banks’ £50bn answer to falling rates

The UK’s largest high street lenders have deployed hedging strategies to smooth volatile earnings

Ortenca Aliaj and **Louis Ashworth** in London

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Last year, Barclays chief executive CS Venkatakrishnan promised investors at least £10bn of payouts over three years as part of an ambitious overhaul of the lender.

If he succeeds, shareholders will in large part have what Barclays calls “the caterpillar” to thank.

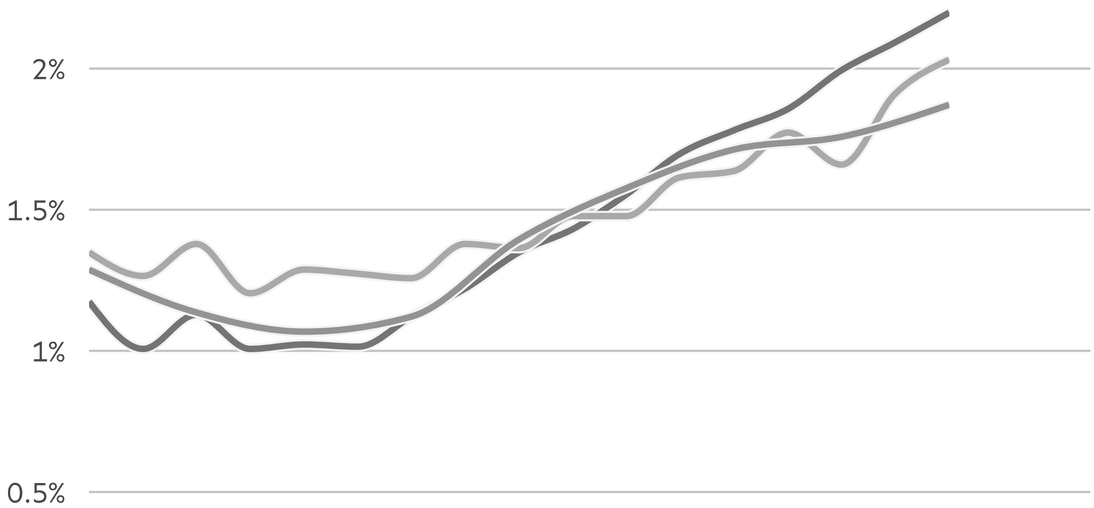
It is the term used to describe the implementation of a crucial — but, until recently, little-discussed — part of banks’ risk management toolbox: structural hedging.

Barclays, Lloyds Banking Group and NatWest, three of the UK’s largest banks, are expected to be among the biggest beneficiaries of a repricing of interest rate swaps, which analysts estimate could contribute more than £50bn in income over the next three years.

“Structural hedging is the most fascinating part of a bank from an investor’s point of view,” said Jérôme Legras, a managing partner at Axiom Alternative Investments. “It’s one of the key drivers of profit and loss and the management of risk.”

Barclays’ structural hedge yield is the highest among Britain’s big domestic lenders

Gross yield (annualised)



Structural hedging is a complex exercise that requires almost constant monitoring of a bank’s liabilities, including its customer deposits and shareholder equity. While investors are mostly focused on what it means for a bank’s profits, the main objective is to manage interest rate risk.

The “caterpillar” hedge — a style of semi-passive structural hedge management based around tranches of swaps that mature at different times — has helped banks smooth out their revenues, making it easier for investors to predict future profitability even during big movements in interest rates.

Its implementation varies from bank to bank. Analysts tend to talk about two categories, however: dynamic and mechanical.

UK banks mostly fall into the latter, replacing swaps that have matured regardless of what the forward rate is expected to be.

That makes interest income from structural hedging easier to predict for British banks than it is for some European lenders, which take a dynamic approach where they assess each swap as it matures and make a judgment on whether it should be replaced.

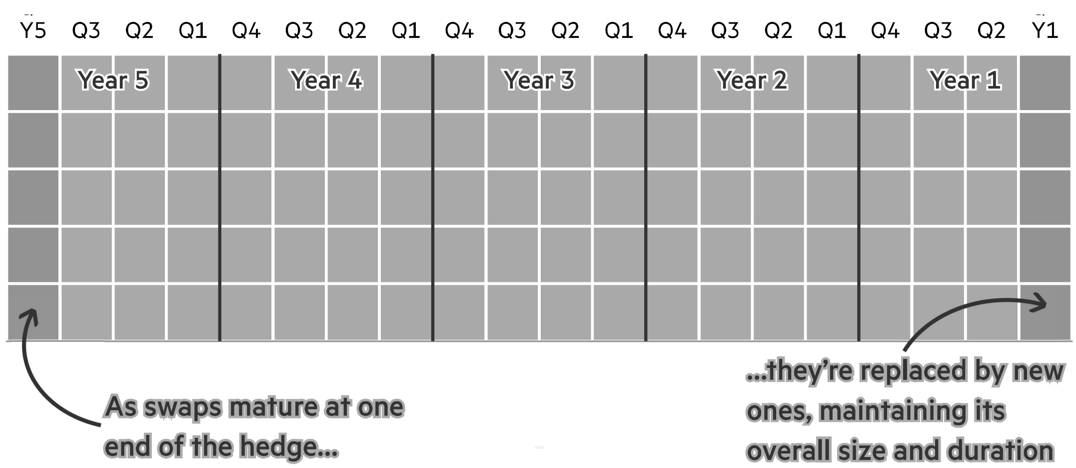
“It’s the single biggest driver of UK banks’ net interest margin,” says Andrew Coombs, an analyst at Citigroup.

Anatomy of a caterpillar

An illustration of a structural hedge with a £100bn notional amount and 2.5yr average duration

← Approaching maturity ←

(Each represents a £100bn swap)



Structural hedging is not new but there is little consensus on when banks started doing it. The first reference one analyst could remember was in Barclays’ 1993 annual report, which has a paragraph on structural interest rate exposure.

“There are substantial liabilities represented by interest-free deposits as well as other interest-free or fixed-rate liabilities,” the report stated. “The structural position arising from these balances is managed by the maintenance of a portfolio of assets with interest rates fixed for several years.”

A decade of near-zero interest rates pushed structural hedging to the sidelines because there was no discernible benefit banks could point to.

The practice has gained greater prominence since the collapse of Silicon Valley Bank in early 2023, which "blew up because it didn't know what an interest rate hedge was", as Legras puts it.

The bank's management had invested its rapidly growing deposit book in long dated securities without hedging, a vulnerability that was exposed when the Federal Reserve raised interest rates to fight inflation.

Now UK lenders are expected to be best positioned for a downward shift in interest rates.

"European banks had much smaller structural hedging programmes than UK banks historically," said John Cronin, founder of SeaPoint Insights. "UK banks were ahead of the curve."

The hedges by UK banks' treasury departments are usually composed of interest rate swaps in which banks receive interest at a fixed rate while paying a floating rate, typically over a period of five years. European banks, in contrast, typically hedge with so-called ALCO portfolios, named for the assets and liabilities committee tasked with managing balance sheet risk and composed of sovereign bonds.

It is a careful balancing act that mollifies the interest rate risk created by liabilities on a bank's balance sheet.

There are two key components to a UK-style hedge: its notional size, which is roughly equal to the bank's shareholder equity and current accounts; and the average length of a swap, which determines the period of time over which the bank will benefit from its hedge.

"The bigger the hedge programme going into the rate rise cycle, the more the rate rise benefit is delayed," analysts at Bank of America explained to clients in a research note last month. "The UK banks all had substantial structural hedge programmes, which meant that a significant proportion of the rate rise benefit was delayed into the future."

Structural hedging has become a hotter topic

Quarterly mentions on earnings calls and at external meetings for Barclays, HSBC, Lloyds and NatWest

The hedge depresses income when interest rates increase beyond the fixed rate — as occurred during the post-pandemic inflation spike — but when rates fall and the fixed rate exceeds the floating rate, it provides a boost.

Some banks have tried to avoid the drag on income by unwinding the structural hedge entirely as Virgin Money did in 2020, when rates hovered just above zero and central banks were openly discussing negative rates to deal with the economic shock of the pandemic.

It reversed course in the second quarter of 2021 as inflation started to pick up and it became clear central banks would raise interest rates in response.

Virgin, which was bought by Nationwide for £2.9bn last year, started rebuilding its hedge as rates moved higher, meaning it would get less of a benefit than others who had kept it in place.

“Are you back to purely mechanical or can we expect you flipping it around again if the yield curve changes sufficiently?,” asked Rob Noble, an analyst at Deutsche Bank, in a May 2021 call on Virgin’s financial results.

“I don’t foresee us changing our strategy again, it’s not a trading position,” responded Clifford Abrahams, then the bank’s newly appointed chief financial officer.

A caterpillar hedge is purposefully designed to be passive, so that banks are not taking a view as to where rates will go — but there is some wriggle room.

Lloyds is frequently singled out as an outlier, deploying a so-called “dynamic” variant of the caterpillar. While Barclays and NatWest will almost always just replace one five-year swap with another, Lloyds uses different maturity profiles.

When interest rates are close to zero, as they were before the Covid-19 pandemic, Lloyds’ treasurers might choose not to replace a maturing swap because it offers little benefit down the line. But as interest rates go up they may opt to add one-year swaps to lock in a higher rate.

RBC’s Benjamin Toms has described the dynamic approach as a “higher-risk strategy” because the duration and timing of swaps are “determined by the bank’s view on the rate curve and its future potential movements”.

Analysts differ on which approach is best. Jonathan Pierce at Jefferies has named Lloyds his favourite of the three because he predicts it will benefit from its hedge for longer. Barclays’ Aman Rakkar has labelled NatWest’s as “probably the best hedge in the world”, while Toms thinks Barclays is in prime position.

It may be some years before a verdict on which analyst was right but, notwithstanding another shock change to the economy, all three lenders stand to benefit.

“[The] magnitude and duration of the tailwind from UK bank structural hedges is under-appreciated by the market,” said Toms.

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