

A COMMUNITY BANK RESEARCH REPORT

# The Community Bank *Performance* Engine

How interest rate hedging drives superior ROA & ROE

## A HIDDEN TOOL FOR COMMUNITY BANKS TO REMAIN INDEPENDENT

# The Community Bank Performance Engine

How interest rate hedging drives superior ROA & ROE

A research synthesis drawn from instrument-level analysis of ten community and regional banks, more than 1,200 individual hedged commercial loans, and \$6.5 billion in principal balances. The findings make a data-driven case that commercial loan hedging is not a niche derivative — it is a structural lever for return on assets and return on equity.

## PUBLISHER

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Division

## SERIES

Commercial Lending Strategy

## EDITION

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## AUDIENCE

Community bank executive teams

## SAMPLE

10 banks · 1,200+ hedged loans · \$6.5  
Bn

## METHODOLOGY

RAROC + instrument-level profitability

## INSIDE THIS EDITION

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EXECUTIVE SUMMARY

# The data answers a question community bankers have been asking for a decade.

Hedged commercial loans deliver more than double the ROE of the average community bank — and they do it with measurably better credit, longer duration, and durable fee income.

This eBook synthesizes research from ten community and regional banks, 1,200+ hedged commercial loans, and \$6.5 billion in principal — making a data-driven case that loan hedging is a core strategic tool for improving community-bank ROA and ROE.

## Six findings, by the numbers

<p><b>24.94%</b></p> <p>Avg. RAROC of hedged loans — vs. 10.49% reported bank ROE</p>	<p><b>3.4x</b></p> <p>More profitable per loan than unhedged, on average</p>	<p><b>5.45yr</b></p> <p>Avg. life of a hedged loan — nearly 3x the unhedged average</p>
<p><b>1.04%</b></p> <p>Hedged principal that was unprofitable</p>	<p><b>18.61%</b></p> <p>Unhedged principal that was unprofitable</p>	<p><b>0.76 R<sup>2</sup></b></p> <p>Correlation of fee income to ROA vs. effectively zero (<math>R^2 = -0.117</math>) for NIM</p>

## Key Findings

- Hedged loans generated an average **RAROC of 24.94%** — more than double the 10.49% reported bank GAAP ROE.
- Across a \$34 Bn portfolio, hedged loans were <5% of loan count yet contributed **15%+ of total annual profit** — ~3.4x more profitable per loan.
- Only ~1% of hedged loan principal was unprofitable, versus almost 19% of unhedged.
- Hedged loans averaged a historical life of **5.45 years** — nearly 3x the 2.01-year average for unhedged.
- NIM has effectively zero correlation with ROA/ROE ( $R^2 = -0.117$ ); fee income correlates strongly ( $R^2 = 0.76$ ).

**“Commercial loan hedging demonstrates a broader truth about commercial banking: profitability depends less on volume and more on risk-adjusted return and long-term cross-sell and stable client relationships.”**

— RESEARCH CONCLUSION, CHAPTER 10

# 01

CHAPTER ONE

## The Community Bank Performance Crisis

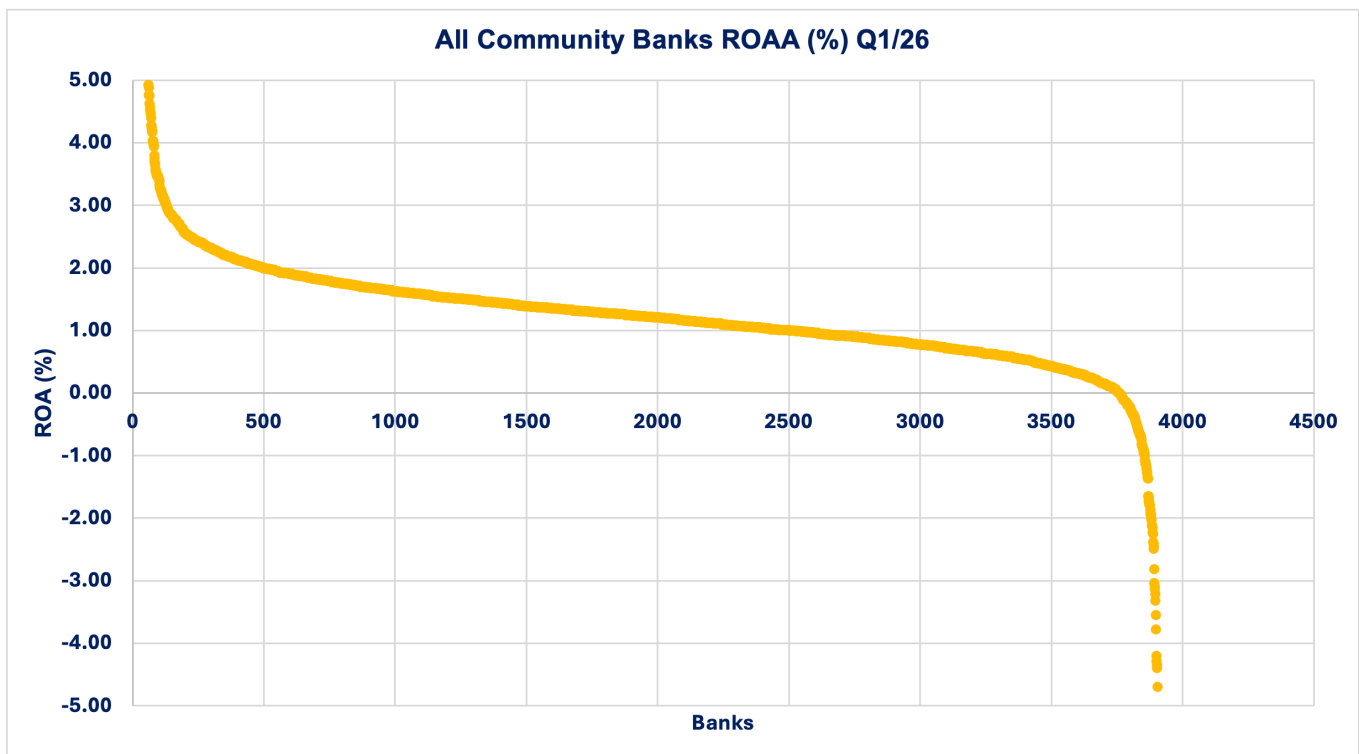
Why ROE is falling — even as NIM rises.

Community banks — defined as those with under \$10 billion in assets — are the financial backbone of local economies across America. Yet by the most important measure of financial health, on average, they are falling short.

Community banks serve small businesses, finance startups, and provide personalized service that larger institutions cannot match. That is why we need your bank to succeed.

The total number of FDIC-insured banks shows a persistent, structural pattern of consolidation — at a rate of roughly **350 institutions per year since 1984**. The total was nearly 18,000 in 1984, versus approximately 4,400 at the beginning of 2026.

In Q1 2026, there were 4,050 FDIC-insured community banks. The average unweighted ROA and ROE were 1.46% and 11.76%, respectively — still below the estimated cost of capital of 12.5% for community banks. Within that average, 1,397 community banks reported ROA below 1.0%, 860 reported ROA below 0.75%, 487 below 0.50%, and 162 banks reported negative ROA. The distribution of community banks' ROAA is shown in the graph below.



Banks that cannot consistently generate returns above their cost of capital face inevitable pressure: sell, merge, or fail. In the last 13 years, community banks have accounted for virtually all the decline in banking charters. While 435 banks over \$10 billion in assets control 85% of all loans, the community bank market share is shrinking proportionally even faster than the raw charter count suggests.

The inability to earn shareholders' required return on capital will pressure banks to consolidate. For banks that want to remain independent, understanding what drives ROA and ROE — at the instrument level — is non-negotiable.

**What is causing this underperformance? The answer is both surprising and actionable: the majority of community banks are optimizing for the wrong metrics.**

— THE METRIC TRAP

They are managing for Net Interest Margin (NIM) rather than risk-adjusted return on capital (RAROC) — and the data shows these two objectives are not the same.

#### THE STRUCTURAL REALITY

**Sub-cost-of-capital ROE is not a temporary problem.**

Banks that cannot consistently generate returns above their cost of capital face an inevitable choice: sell, merge, or fail. The next chapter quantifies just how disconnected NIM and ROA actually are.

# 02

CHAPTER TWO

## Why NIM Does Not Drive ROA / ROE

The metric trap that costs banks millions.

For decades, bank managers have measured lender performance by loan yield and portfolio NIM. The logic seems intuitive: a higher yield on loans means more income, which should mean higher profitability. The data, however, tells a very different story.

Across the entire U.S. banking industry over various business cycles between 2004 and 2024, the correlation between NIM and ROA has been effectively zero — with an  $R^2$  of  $-0.117$ . In peer-group analyses of 16 community banks operating in the same competitive market, the NIM/ROA correlation rises only slightly, to  $R^2 = 0.125$  — still statistically insignificant.

**“This finding surprises most bankers — but it should not. Commercial loans are heterogeneous instruments. Pricing to maximize yield ignores the variables that actually determine profitability.”**

— ON THE METRIC TRAP

Credit risk, loan size, term commitment, acquisition cost, efficiency ratio, cross-sell opportunity, and fee income matter more than the headline yield. A bank that wins high-yield loans is often winning the worst credits or the shortest-duration transactions.

To be clear: if a bank earns a lower net interest margin on the same assets and liabilities, ROA will decrease. The point is that across *assets with varying yields*, other variables matter far more for driving ROA and ROE.

## What actually drives ROA / ROE?

CORRELATION OF COMMON BANK METRICS TO ROA

DRIVER	CORRELATION TO ROA ( $R^2$ )	DIRECTION
Net Interest Margin (NIM)	0.125	Weak Positive
Efficiency Ratio	-0.911	<b>Strong Inverse</b>
Fee Income (% of Assets)	<b>0.760</b>	<b>Strong Positive</b>

The implication is profound: a bank that earns less in NIM but generates more fee income and operates more efficiently will dramatically outperform a high-NIM, low-fee bank.

And the single most scalable source of fee income available to community banks — one that *also* improves loan quality, increases loan size, and extends loan duration — is commercial loan hedging.

**BOTTOM LINE****NIM is a tactic. RAROC is a strategy.**

If your bank measures lender performance only on yield, you are optimizing for a number that has near-zero correlation with shareholder return. The metrics that matter — efficiency, fee income, and risk-adjusted profitability — point somewhere else entirely.

# 03

CHAPTER THREE

## The Carry Trade Is Broken

Why the old model no longer works.

For over 40 years, community banks ran a highly profitable, and seemingly risk-free, strategy: book 5-year fixed-rate commercial loans and fund them with short-term, low-cost deposits.

This "carry trade" worked as long as the yield curve was upward-sloping and overall inflation and interest rates were declining — and this was the environment, almost without interruption, from the early 1980s through 2021.

During the period ending in 2022, the spread between the 5-year Treasury and the Fed Funds rate averaged **+93 basis points**. Banks were paid to take duration risk. But yield curves change, and interest rates and inflation can also rise. In 2023, many banks learned the painful lesson of the carry trade when rates increased sharply. In today's environment, many banks are again taking duration risk and are not being properly compensated for that risk.

**"The traditional 5-year fixed-rate carry trade now generates a negative 47bps drag on performance — making fee income essential."**

— EXECUTIVE SUMMARY, KEY FINDING

The consequences are visible across the industry. Community banks still carry significantly longer loan duration than larger banks, which have shifted to more floating-rate instruments. This continued reliance on the carry trade is a structural drag on community bank performance — and it helps explain why NIM can be rising while ROE falls simultaneously.

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## Fee income: the structural solution

Larger banks have historically generated approximately 50 basis points more fee income as a percentage of earning assets than community banks. That gap represents millions of dollars in missed earnings for the typical community bank. And the primary vehicle through which community banks can close that gap — without changing their core business model or hiring new teams — is loan-level hedging.

### Six structural advantages of hedge fee income over margin income

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- 01 Recognized immediately upon booking.**  
Provides an instant boost to ROA and ROE in the period earned.

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- 02 Multiplied by the contractual loan term.**  
A 10-year hedge generates far more fee income than a 2-year loan.

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- 03 Not paid out-of-pocket by the borrower.**  
Embedded in the hedge structure — transparent, non-competitive.

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- 04 Retained even if the margin business prepays.**  
Earned income is protected from asset duration risk.

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- 05 Recurring on renewal or restructure.**  
Builds compounding long-term value across the book.

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- 06 Directly accretive to performance.**  
No additional capital is consumed to generate the fee.

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# 04

CHAPTER FOUR

## What Is Commercial Loan Hedging?

How the product works and why borrowers want it.

Commercial loan hedging — also called loan-level hedging or back-to-back swap hedging — is a product in which a community bank offers a commercial borrower a floating-rate loan while simultaneously entering into an interest rate swap to convert the borrower's interest rate exposure to a fixed rate.

The result: the borrower receives the certainty of a long-term fixed rate, while the bank retains a floating-rate exposure matched to its funding cost.

## Why borrowers seek hedged loans

Borrowers who opt for hedged loans are typically making a deliberate, strategic decision. They want:

- **Long-term fixed-rate financing** matched to the cash flow of their project, lease, or business plan.
- **Predictable debt service** throughout the life of the loan, regardless of where interest rates go.
- **A committed banking partner** for the duration of the financing — not a short-term transactional lender.
- **Sophisticated structures** like portable loans or turnkey construction-to-permanent — only available through community banks with hedging programs.

**The average hedged loan in our study was \$3.25 million — over 8× the community bank industry average of approximately \$400,000.**

— A DIFFERENT CLASS OF BORROWER

These characteristics self-select a class of borrower that is fundamentally more valuable to the bank: larger, longer-term, higher quality, and more deeply engaged.

## How the bank benefits

The bank's economics are equally compelling. In addition to the ongoing interest margin on the loan, the bank earns a hedge fee at inception — typically **1.0% to 2.5% of the loan amount** — recognized immediately in income.

The average hedge fee in our nine-bank study was 1.03% of loan principal. On a \$3.25 million loan, that represents over \$33,000 in non-interest income earned at closing, with no additional capital deployment required.

<p><b>1.03%</b></p> <p>Avg. hedge fee, % of loan principal</p>	<p><b>\$33k</b></p> <p>Hedge fee on a \$3.25M loan, recognized at close</p>	<p><b>5.45yr</b></p> <p>Avg. life of a hedged loan</p>
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Community banks do not need to hire new product or risk managers to offer loan hedging — it is an adjunct to an existing product. The sales team is already in place: the commercial relationship manager.

The product also creates stronger client relationships. Borrowers who commit to a hedged loan are, by definition, committing to a long-term relationship with the bank. The data confirms it: the average historical loan life for hedged loans is 5.45 years — nearly triple the 2.01-year average for unhedged loans.

### IN ONE SENTENCE

**Hedging gives the borrower a fixed rate, the bank a floating asset, and both sides a longer relationship.**

The product is the rare case where the borrower's preferred outcome (rate certainty) and the bank's preferred outcome (rate-risk-free, fee-rich, long-duration relationship) are perfectly aligned.

# 05

CHAPTER FIVE

## ROE Impact: A Nine-Bank Case Study

Measuring RAROC for hedged loan portfolios.

To quantify the ROE impact of commercial loan hedging, we conducted a study of nine community banks ranging in asset size from \$350 million to just under \$8.5 billion. Each bank shared loan-level data on their hedged commercial portfolios — 154 individual hedged loans totaling \$501 million in principal balances — analyzed through a RAROC (Risk-Adjusted Return on Capital) framework.

## Study profile

### HEDGED LOAN PORTFOLIO PROFILE VS. COMMUNITY BANK AVERAGE

METRIC	HEDGED LOAN PORTFOLIO	COMMUNITY BANK AVERAGE
Total Loans Studied	154	—
Total Principal	\$501,089,213	—
Average Loan Size	\$3,253,826	~\$400,000
Average LTV	59.6%	~70%
Average DSCR	1.92×	~1.30×
Average Commitment Term	8.31 years	~2 – 3 years
Average Hedge Fee Income	1.03%	0%
Average Credit Spread (SOFR+)	2.56%	2.69% (estimate)

The credit quality of the hedged loan portfolio was measurably superior to industry averages — lower LTV, higher DSCR, and substantially longer commitment terms. These are not randomly selected loans; they are the product of a specific type of borrower who is seeking long-term, relationship-based banking.

## The ROE comparison

### REPORTED ALL-LOAN ROE VS. HEDGED LOANS ONLY

METRIC	REPORTED (ALL LOANS)	HEDGED LOANS ONLY
Average ROA	0.94%	<b>2.22%</b>
Average ROE	10.49%	<b>24.94%</b>
Cost of Capital Threshold	12.5%	—
<b>Performance vs. Threshold</b>	<b>-2.01% below</b>	<b>+12.44% above</b>

Every single bank in the study had higher RAROC on its hedged loan portfolio than its overall reported ROE. In aggregate, the hedged loans delivered an average ROE of **24.94%** — **more than double the 10.49%** reported across all loan types.

**“Every single bank in the study had higher RAROC on its hedged loan portfolio than its overall reported ROE.”**

— CROSS-BANK CONSISTENCY

# 06

CHAPTER SIX

## Profitability: Hedged vs. Unhedged

A deep dive into a \$34 billion portfolio.

Beyond the nine-bank RAROC study, we conducted a more granular analysis of a single large community bank with approximately 100,000 commercial clients and \$34 billion in funded commercial loans — spanning both hedged and unhedged fixed-rate instruments. This analysis provides the most direct comparison of what hedging does to individual loan economics.

## Portfolio composition and profit contribution

### HEDGED VS. UNHEDGED LOANS · \$34 BN COMMERCIAL LOAN PORTFOLIO

METRIC	HEDGED LOANS	UNHEDGED LOANS
Number of Loans	1,524	32,105
% of Total Borrowers	4.53%	95.47%
Total Principal	\$5.03 Billion	\$27.83 Billion
Annual Profit Contribution	<b>\$117.6 Million</b>	\$642.6 Million
% of Total Annual Profit	<b>15.46%</b>	84.54%
Average Loan Size	\$3,478,984	\$864,716
Historical Average Life	<b>5.45 years</b>	2.01 years
Unprofitable Borrowers	16 (1.04%)	<b>4,032 (18.61%)</b>
<b>Capital in Unprofitable Loans</b>	<b>\$52.3 Million</b>	<b>\$5.18 Billion</b>

While hedged loans represent less than 5% of total loan count, they contribute more than 15% of total annual bank profit. Put another way: **hedged loans are approximately 3.4× more profitable per loan than unhedged loans on an average basis.**

The distribution of commercial loan profitability for hedged and unhedged loans is demonstrated in the graph below. Each line represents loans sorted by annual profit (highest to lowest). The asymmetry is the story.

### Commercial loan profitability — hedged vs. unhedged



## The unprofitability gap

The most striking finding is in the distribution of unprofitable loans. Of the unhedged commercial loans, **18.61% of total generated negative profit for the bank** — representing \$5.18 billion in capital tied up in value-destroying relationships. By contrast, only 1.04% of hedged loan principal — \$52 million — was unprofitable.

**“\$5.18 billion in unhedged principal was generating negative profit for the bank — versus just \$52 million across the hedged book.”**

— CAPITAL EFFICIENCY GAP

### Why are so many unhedged loans unprofitable?

Four key factors emerge:

#### 01 Rate Mismatch.

Fixed-rate loans booked in lower rate environments are now upside-down on funding cost due to the post-2022 rate cycle.

#### 02 Loan Size Effect.

Hedged loans attract and retain larger, more complex clients who generate more overall banking relationship value.

#### 03 Cross-Sell Depth.

Hedged borrowers are more likely to have treasury services, operating deposits, and other high-value products with the bank.

#### 04 Relationship Stickiness.

Borrowers willing to accept a hedge are signaling a long-term commitment to the bank — creating relationship-level, rather than transaction-level, economics.

# 07

CHAPTER SEVEN

## Loan Life, Cross-Sell & Relationship Economics

Why duration is the hidden driver of value.

One of the most underappreciated benefits of commercial loan hedging is its impact on average loan life — and the compounding effect that loan duration has on bank profitability. The connection is direct: a loan that stays on the books for five years generates more than twice the NIM income of a loan that prepays in two years. But the economics extend far beyond NIM.

## The compounding value of duration

### ECONOMIC COMPARISON · HEDGED VS. UNHEDGED LOAN

ECONOMIC FACTOR	HEDGED LOAN	UNHEDGED LOAN
Avg. Historical Life	5.45 years	2.01 years
Hedge Fee Income	\$33,500 (avg.)	\$0
Deposit Cross-Sell	High (relationship)	Low (transactional)
Treasury Mgmt Fees	Frequently bundled	Rarely bundled
Renewal Probability	High	Competitive rebid
Acquisition Cost	Amortized over 5+ yr	Amortized over 2 yr

The acquisition cost amortization effect is significant. Originating a commercial loan — underwriting, legal, appraisal, RM time — is largely fixed regardless of size or term. Amortizing that cost over 5.45 years versus 2.01 years dramatically improves the efficiency ratio contribution of the hedged loan.

**“The biggest drivers of ROE performance in hedged loans were increased loan size and increased loan commitment term — accounting for 66% of the performance increase. And that doesn’t even count the ongoing cross-sell opportunity.”**

— ON THE LEVERAGE OF DURATION

The cross-sell dimension — harder to measure without longitudinal tracking — is perhaps the most valuable long-term benefit. Borrowers committed to a 7–10 year hedged loan are natural candidates for operating accounts, treasury management, and executive banking relationships.

# 08

CHAPTER EIGHT

## Implementing a Loan Hedging Program

Strategy, structure & key success factors.

For community banks that have not yet launched a loan-level hedging program — or those looking to expand an existing one — the implementation process is more accessible than most bankers assume. The product does not require new hires, new technology platforms, or significant regulatory change. It is, fundamentally, an extension of the commercial mortgage product the bank already offers.

## Building the team

A successful hedging program requires cross-functional alignment, but not a new organizational layer. Key roles include:

### KEY ROLES IN A LOAN HEDGING PROGRAM

ROLE	RESPONSIBILITY
Chief Lending Officer	Product champion, setting volume goals and lender incentives.
Chief Credit Officer	Risk manager, establishing credit eligibility standards for hedged loans.
Treasury / Capital Markets	Managing the bank-side swap confirmation and counterparty relationships.
Commercial Relationship Managers	Front-line sales team; trained to identify, pitch, and close hedged loans.
Loan Operations	Handles ongoing billing, payment processing, and customer maintenance.

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## Strategic positioning options

Some community banks have successfully deployed three novel and distinct go-to-market strategies for loan hedging:

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### 01 **Turnkey Construction Lending.**

Offer single-close construction-to-permanent financing with a fixed rate locked at origination. Appeals to developers and builders seeking rate certainty across the construction and permanent periods.

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### 02 **Zero-Cost Closing.**

Use hedge fee income to cover borrower closing costs (appraisal, title, legal). The bank pays 10–25% of total hedge fee income in closing costs while retaining the balance — a compelling borrower incentive with no net cost to the bank.

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### 03 **Portable Balance Sheet Financing.**

Position the hedged loan as moveable collateral financing, allowing borrowers to transfer the loan from one project to the next. Ideal for repeat developers and investors. Creates exceptional lifetime value and differentiation.

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## Overcoming adoption barriers

### COMMON BARRIERS TO LOAN HEDGING ADOPTION — AND HOW TO OVERCOME THEM

BARRIER	SOLUTION
Lender discomfort explaining prepayment provisions	Standardize borrower-friendly language; provide RM scripts and training
Misconception that hedging complicates deals	Streamline documentation; position as a premium product, not a complex one
Lack of internal alignment (credit / treasury / lending)	CLO-led steering committee; unified incentive structure
Short-term focus on deal closing over long-term ROE	RAROC-based lender compensation that rewards lifetime relationship value
Borrower discomfort with derivative accounting	Structure as bank-side-only hedge; borrower books a fixed-rate loan only

Community banks that promote loan hedging report a consistent finding: hedged clients are larger accounts, more profitable, more stable, and more deeply engaged with the bank. **The opportunity cost of not promoting loan hedging is substantial.**

#### IN PRACTICE

**The product does not require new hires, new technology platforms, or significant regulatory change.**

It is, fundamentally, an extension of the commercial mortgage product the bank already offers — surfaced through the relationship managers already on staff.

# 09

CHAPTER NINE

## Client Profitability Analysis

Instrument-level data reveals the true value of hedging.

The preceding chapters have presented instrument-level data demonstrating that hedged loans outperform unhedged loans across every key performance metric. This chapter takes the analysis one step further — from the instrument level to the client level — to show how instrument-level profitability measurement, when applied systematically, becomes a strategic management tool in its own right.

Our data and analysis strongly suggest that banks capable of measuring instrument- and relationship-level performance for ROA and ROE can improve simply by reallocating capital and resources to more profitable relationships and by pursuing strategic, data-driven cross-selling. We measured how hedged commercial loans — where interest rate risk is removed, credit margin is properly determined at inception, and maintained through the life of the loan — compared to the same bank's non-hedged commercial loans.

Our results are highly instructive for community banks considering a commercial loan hedging program, or those questioning the merit of continuing one. When examining client profitability data, one conclusion emerges with clarity: **a meaningful portion of negative-profit accounts are not the result of bad credits — they are the result of unmanaged interest rate risk and pricing erosion.**

In our case study examining a regional bank, we reviewed each instrument for each client and measured 12-month profit after funding costs, adjusted for fund transfer pricing (contribution to overhead). This bank has booked fixed-rate loans both as hedged loans and as fixed-rate on-balance-sheet instruments, providing a direct apples-to-apples comparison. A full portfolio comparison appears on the following page.

## Portfolio comparison · full detail

### HEDGED VS. UNHEDGED LOANS — FULL CLIENT-LEVEL BREAKDOWN

METRIC	HEDGED LOANS	UNHEDGED LOANS	ALL LOANS
Number of Borrowers	1,524	32,105	33,629
Percent of Borrowers	4.53%	95.47%	100%
Sum of Loans	\$5,027,132,096	\$27,830,027,891	\$32,857,159,987
Sum of Annual Profit	<b>\$117,556,223</b>	\$642,610,153	\$760,166,376
Percent of Profit	<b>15.46%</b>	84.54%	100%
Historical Avg Life (yrs)	<b>5.45</b>	2.01	2.54
Average Loan Size	\$3,478,984	\$864,716	\$977,048
# of Unprofitable Borrowers	16	<b>4,032</b>	4,048
Sum of Negative Profitability	(\$252,076)	<b>(\$23,476,371)</b>	(\$23,728,447)
Sum of Unprofitable Loans	\$52,255,567	<b>\$5,179,644,151</b>	\$5,231,899,718
<b>% Principal Unprofitable</b>	<b>1.04%</b>	<b>18.61%</b>	<b>15.92%</b>

## Four takeaways from the data

The client-level analysis surfaces four critical findings for bank management:

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### 01 Hedged Loans Punch Far Above Their Weight.

While hedged loans represent a small minority of total relationships, they contribute a disproportionate share of total profit. Hedged loans are significantly larger, more profitable per dollar of capital deployed, and consistently more resilient to earnings erosion over time.

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### 02 Hedged Loans Are Structurally Protected Against Profit Erosion.

Because the interest rate risk is removed at origination through the swap structure, hedged loans maintain their profitability profile even as market rates shift. Unhedged fixed-rate loans, by contrast, become increasingly unprofitable when funding costs rise — as they did sharply after 2022. This rate mismatch is the single largest driver of the 18.61% unprofitable unhedged principal figure.

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### 03 Hedged Loans Drive Stickier, Higher-Value Relationships.

With a historical average life of 5.45 years versus 2.01 years for unhedged loans, hedged loans are nearly three times more durable. This duration advantage compounds across cross-sell, deposit gathering, treasury management fees, and renewal probability. Clients willing to commit to a hedged loan are self-selecting as long-term partners — not transactional borrowers shopping for the best one-time rate.

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### 04 The Capital Efficiency Gap Is Enormous.

The most alarming finding for bank management is the scale of capital trapped in unprofitable unhedged loans: \$5.18 billion in unhedged principal was generating negative profit for the bank at the time of measurement. The annual cost of that capital misallocation was \$23.5 million in foregone earnings. By contrast, just \$52 million in hedged principal was unprofitable — generating a loss of only \$252,000. The disparity is not marginal; it is structural.

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## Why unhedged loans underperform · root causes

Four root causes explain the chronic underperformance of unhedged fixed-rate commercial loans at this bank and across the industry:

### 01 Rate Mismatch at Origination.

Many unprofitable unhedged loans were priced in a lower interest rate environment and are now underwater on funding cost due to the post-2022 upward rate cycle. This is a problem that cannot be solved after the fact — only avoided through hedging at origination.

### 02 Loan Size Effect.

Hedged loans attract structurally larger clients. Larger clients generate more total relationship economics, making each loan more profitable on a fully-loaded basis even before considering the hedge fee income.

### 03 Cross-Sell and Treasury Engagement.

Hedged borrowers are measurably more correlated with treasury services, operating account deposits, and other high-margin bank products. These ancillary products disproportionately improve the total profitability of the hedged relationship.

### 04 Relationship vs. Transaction Economics.

Clients who accept a hedge are making a long-term commitment. That commitment transforms the account from a transactional loan into a strategic relationship — one that is renewed, deepened, and retained over time rather than repriced or lost at the next rate cycle.

**“A meaningful portion of negative-profit accounts are not the result of bad credits — they are the result of unmanaged interest rate risk and pricing erosion.”**

— CLIENT PROFITABILITY CONCLUSION

# 10

CHAPTER TEN

## Conclusion & Action Plan

The path to superior bank performance.

The evidence is clear: commercial loan hedging is a structural lever community banks can pull — today, with their existing teams — to improve ROA, increase ROE, reduce earnings volatility, and build deeper, more profitable client relationships. The performance crisis has a solution that requires no acquisitions, technology overhauls, or headcount additions — just repricing long-duration risk through RAROC and offering its most natural hedge.

## Summary of key data points

### THE FINDINGS, AT A GLANCE

FINDING	DATA
Hedged Loan Average ROE (9-bank study)	<b>24.94%</b>
Average Reported Bank ROE	10.49%
Hedged loans outperform by (ROE)	<b>+14.45 percentage points</b>
Hedged loan % of portfolio (profit study)	4.53% of loans
Hedged loans % of total annual profit	<b>15.46%</b>
Unprofitable principal — hedged	1.04%
Unprofitable principal — unhedged	<b>18.61%</b>
Average hedged loan life	<b>5.45 years</b>
Average unhedged loan life	2.01 years
NIM / ROA correlation (R <sup>2</sup> )	-0.117 (none)
Fee income / ROA correlation (R <sup>2</sup> )	<b>0.76 (strong)</b>
<b>Average hedge fee income</b>	<b>1.03% of loan value</b>

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## Recommended action items

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- 01 Conduct an instrument-level RAROC analysis**  
of your current commercial loan portfolio to identify unprofitable loan segments.

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  - 02 Benchmark your bank's fee income**  
as a percentage of earning assets against peer banks; if under 1.0%, treat fee income growth as a strategic priority.

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  - 03 Assess the feasibility of a loan-level hedging program:**  
identify your CLO as product champion, engage a qualified swap advisor hedge provider, and establish credit eligibility standards.

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  - 04 Train your commercial relationship managers**  
on the borrower value proposition of fixed-rate hedged loans — not just the mechanics.

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  - 05 Set RAROC-based lender incentives**  
to reward lifetime relationship value, not just current-period loan yield.

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  - 06 Target your largest, longest-duration commercial borrowers first**  
— these are the clients most likely to benefit from and respond to a hedged loan offering.
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For community banks that want to remain independent, competitive, and financially strong — commercial loan hedging may be the single most impactful tool available. **The data has spoken. The question is whether your bank will act on it.**

### NEED HELP GETTING STARTED?

**If the above action items are overwhelming, contact us for a free analysis of your bank's loan hedging opportunity.**

Our ARC Team will assess your portfolio at no cost — see the next page for details.

## Conclusion: profitability is a choice

The client-level profitability analysis reinforces what the portfolio-level data already showed: commercial loan hedging is not a niche product or a marginal enhancement. It is a structural mechanism that removes the single largest source of profit erosion in community bank commercial lending — interest rate risk mismatch — while simultaneously attracting higher-quality clients, generating upfront fee income, and building long-term relationship economics.

The data presented in this eBook should prompt community bank management teams to ask a fundamental question: **how much capital are we currently allocating to unprofitable unhedged loans — and what would our ROA and ROE look like if we could systematically convert even a fraction of those relationships into hedged, relationship-based accounts?**

**“Commercial loan hedging demonstrates a broader truth about commercial banking: profitability depends less on volume and more on risk-adjusted return and relationship stability.”**

— RESEARCH CONCLUSION

By protecting margins, improving pricing discipline, and reducing negative-profit exposure, hedging plays a pivotal role in sustainable community bank performance — not as a niche or defensive product, but as a core structural tool that reduces earnings volatility, improves client-level returns, and builds healthier, longer-lasting relationships.

The question is no longer whether loan hedging improves bank profitability. The data answers that conclusively. **The question is how quickly your institution will move to capture that opportunity.**

FREE ANALYSIS · NO OBLIGATION

# Get in touch with SouthState's ARC Team.

We will analyze your bank's loan portfolio and identify the specific RAROC and ROE lift available from a hedging program — at no cost, with no obligation to engage.

## REQUEST YOUR FREE ANALYSIS

[arc@southstatebank.com](mailto:arc@southstatebank.com)

[southstatecorrespondent.com/arc](https://southstatecorrespondent.com/arc)

## WHAT THE ANALYSIS INCLUDES

- Hedge-eligible loan inventory across your commercial book
- Modeled RAROC, ROE and yield lift — at the loan and portfolio level
- Fee-income forecast for a 12-month hedging program
- ALCO-ready summary deck for your board or risk committee

## HOW IT WORKS

- 01 Send us your portfolio data.**  
Securely share commercial loan-level data — rate, structure, balance, maturity. No client identifying information required.
- 02 We model the ROE and RAROC lift.**  
Our team identifies the hedge-eligible portion of your portfolio and quantifies the specific yield, fee, and capital impact.
- 03 Review results in a 30-min call.**  
Walk through the analysis with our credit and derivatives team. No obligation, no follow-up unless you ask.

[START MY FREE ANALYSIS →](#)

CONFIDENTIAL · NO COST · NO OBLIGATION

## THE ARC ADVANTAGE

# Interest rate swap programs shouldn't give you headaches.

Traditional swap programs were built to let banks offer fixed-rate financing — but they came with a tax. Derivative accounting. ISDA paperwork. Capital allocation. Two bills a borrower has to reconcile. Loan officers who can't explain what they're selling.

## Sound familiar?

### 01 Headaches for your Finance Team.

Derivative accounting, collateral posting, capital allocation, Dodd-Frank reporting, and substantial overhead costs.

### 02 Headaches for your Clients.

Derivative accounting on their books and two separate billing statements each month — it isn't really a true fixed-rate loan.

### 03 Headaches for your Lenders.

Hard to explain and hard to sell to most borrowers, so they avoid pitching it.

**We understand these frustrations. That's why we built ARC.**

— SOUTHSTATE CORRESPONDENT DIVISION

ARC — Assumable Rate Conversion — is SouthState's loan-level hedging program. The borrower gets a true fixed-rate loan. The bank earns floating. No swap on the bank's books, no ISDA between bank and borrower, no separate monthly settlements. The next page shows the side-by-side.

## Traditional swap programs vs. The ARC Program.

	ARC	SWAPS
<b>GENERAL</b>		
Fee generation	✓	✓
Swap / hedge portability	✓	✓
Hedge for unique structures	✓	✓
Hedges for forward-starting structures	✓	✓
<b>ACCOUNTING</b>		
No hedge-effectiveness accounting	✓	✗
No Call Report derivative disclosure	✓	✗
No derivative capital allocation	✓	✗
No Dodd-Frank reporting	✓	✗
<b>DOCUMENTATION</b>		
No ISDA documentation for the bank	✓	✗
No ISDA documentation for the borrower	✓	✗

**GET STARTED WITH ARC**

### See how ARC can work for your bank.

If you're ready to win more loans, boost fee income, and beat the local and national banks, then an ARC demo is the next step.

**TALK TO AN ARC SPECIALIST →**

ABOUT SOUTHSTATE

# A regional partner for community banks.

SouthState is a \$68 billion regional bank headquartered in Winter Haven, Florida — serving 1.8 million customers across nine states. The Correspondent Division partners with 1,200+ community banks on loan hedging, fixed-income solutions, and balance-sheet advisory.

<p><b>\$68<sup>B</sup></b> Total assets</p>	<p><b>48</b> States with correspondent clients</p>	<p><b>1,200+</b> Community-bank clients</p>
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## What the Correspondent Division does

CORE SERVICE LINES

SERVICE	USE CASE
ARC Loan Hedging	Offer customers a fixed rate while the bank earns floating — no swap on the borrower side
Loan Pricing Model	Price loans that are both competitive and profitable, with the guesswork removed
Debt Capital Markets	A full suite of balance-sheet management services, designed by bankers for bankers
International Services	Equip the bank with full-service international capabilities
Clearing & Cash Management	Converge — online banking custom-built for community banks

OUR PROMISE

### We help community banks remain independent.

Our Correspondent Division exists because community banks are essential to local economies — and the right tools, properly implemented, are what separate banks that endure from those that consolidate.