
ALCO Beat: Preparing for inevitable rate rise

Now's time to consider tomorrow's tools

Learning how to handle a road hazard is best done in advance of having to face it. So too should banks' boards and asset-liability management committees be reviewing rate-risk strategies.

By Justin Bakst, manager, Financial Analytics, Darling Consulting Group. To learn more about him, see the author's note at the end of this article.

Downward-trending net interest income is a common theme in boardrooms across the community banking sector.

Assets continue to cycle into today's low-rate environment, while funding costs have little ability to move lower. In order to help offset margin compression, many bankers are extending asset duration in both the loan and the investment portfolios. This dynamic is leading to more banks with exposure to a rising rate environment. (They are "liability sensitive.")

Compounding this issue is the buildup of parked non-maturity deposits on bank balance sheets. These funds are destined to leave as the economy stabilizes and investors move out of cash into other asset classes. The timing, magnitude, and potential causes of a rising rate environment can be debated. But rates will eventually rise.

The bond market has discounted the probability of rising rates over the next several years due to myriad factors. These include the

Fed's commitment to keep rates low until mid-2015, low inflation expectations, European uncertainty, and gridlock in Washington. The cost of hedging against rising rates (perceived as a low probability event) is available at historically steep discounts. It's analogous to lower premiums on auto insurance, where better drivers have fewer claims.

Banks that are exposed to a rising rate environment have several options to guard against this scenario. For those not yet exposed to rising rates, now is the time to prepare. Regardless of your risk position, bankers and board members alike should be familiar with the following five strategies as potential insurance policies:

1. Extend wholesale funding

Many consider long-term fixed-rate wholesale funding in the form of Federal Home Loan Bank advances or brokered CDs to be the simplest form of protection against rising rates. Wholesale funding is a guaranteed source of liquidity (assuming the bank is well capitalized) and can be managed in bulk, unlike long-term CD specials. Most bankers are comfortable with the strategic use of wholesale funding, and the product is easy for board members to understand.

Today the drawback is the inability to utilize these funds, plus the difficulty in maintaining or increasing margin at today's unattractive asset yields. The opportunity cost of keeping funding short (even with five-year funding hovering around 1%) to offset asset yield pressure is tough to overcome.

2. Callable brokered CDs

These instruments have a set maturity, similar to fixed-term funding, but the bank has the option to "call," or give back the funding in the event rates move lower or the funding is no longer needed.

This option allows a bank to lock in long-term funding but also allows for flexibility as needs change. The pricing is similar to fixed-rate funding, but 5-10 basis points higher (today) than traditional fixed-rate brokered CDs, a meager premium based on the benefit of having the call option.

3. Interest rate swap

In many community banking circles, the mere mention of a derivative instrument creates fear and uncertainty. Luckily, an interest rate swap is easy to understand, and can be invaluable in managing interest rate risk.

A swap is an agreement between a bank and a counter-party (usually a large financial institution) to exchange interest rate cashflows. In its simplest form, a bank is converting a floating-rate payment to a fixed-rate payment (or vice versa). For example, a bank with exposure to rising rates would exchange a floating interest payment for a fixed-rate payment on a previously determined dollar amount. (That is called the "notional amount.")

The advantages of interest rate swaps are numerous, including the flexibility to hedge on either side of the balance sheet and/or to hedge large positions, without increasing the balance sheet size, thus protecting capital ratios. The pricing can also be favorable. For example, five-year fixed wholesale funding is roughly 1% today, while a five-year swap is priced at 0.75%. The accounting can become complex, so hedge accounting education must be part of the due diligence process.

4. Forward interest rate swap

A forward interest rate swap is just like an interest rate swap described above, with the start date delayed (for a predetermined period of time). This tool allows you to lock in rates today at a future predetermined date at a premium. For example, a bank concerned about rates rising in one year could exchange a five year floating interest payment for a fix rate payment starting in one year for the price of the swap plus an additional 40 basis points (based on today's pricing). The bank can determine both the start date as well as the length of the fixed rate maturity. The advantages of a forward swap are similar to a traditional swap, without the negative impact to current earnings.

5. Interest rate cap

Interest rate caps are simply an insurance policy in which a bank pays a counter-party a premium (which is back loaded) to protect against a particular market index rising.

For example, if three-month LIBOR, or other market indices, move above a predetermined rate (called the "strike rate") within a predetermined window of time, the insurance policy "pays off." Similar to swaps, banks do not have to grow the balance sheet in order to buy the protection.

In addition, the bank can reduce the cost of the premium by dictating a higher strike rate, which is particularly helpful for banks which do not demonstrate exposure until rates rise 200-400 basis points. The accounting challenges are similar to swaps.

A note about using derivatives strategies: Derivative strategies cannot be implemented overnight. The asset-liability management committee and the board must be educated far in advance on types of derivatives, pricing, risks, and accounting in order to execute when needed.

Eventually all may need to hedge

Any case for rising rates in the near term is dubious at best. Experts and economists alike believe we are in this low-rate environment for the foreseeable future. The Federal Reserve recently announced its commitment to purchase \$40 million/month of mortgage-backed securities and to keep rates low until at least mid-2015. According to the Fed, rates will remain low until the unemployment rate falls back to normalized levels.

Given this outlook, it's difficult to project a scenario which causes major positive trends in employment in the near term.

The obvious question to ask is, "Why, then, hedge against rising rates? The simple answer is--it depends on your risk position. Hedge if your position warrants it. If not, at least be armed with the knowledge that it's an option as your balance sheet begins to change.

Balance sheets will change

In the past, banks were able to offset an environment like today's by growing, changing asset mix, or by taking incremental credit risk.

In this regulatory environment, all are arduous endeavors. To be sure, banks will be forced to add long-term fixed-rate assets to their portfolios out of necessity. This will inevitably create more sensitivity to rising rates throughout the industry.

Bankers need to understand and assess all options available to hedge against rising rates. The key is to educate decision makers today

(ALCO, Board, etc) in order to effectively execute when needed.

Benjamin Franklin said it best:

"An investment
in knowledge pays the best interest."

About the author

Justin Bakst is manager of Financial Analytics at Darling Consulting Group. DCG's services include consulting, education, core deposit studies, process reviews, model audits, and ALM/budgeting software. Justin has over eight years of experience assisting community banks with their risk management process. His team supports over 150 clients building ALM models and providing model assumption guidance, regulatory support, and balance sheet management education.

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