



## Callable Brokered CDs

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The following is an explanation of the way a bank can issue callable CDs through a broker and convert them to a one month or three month LIBOR based rate. This strategy has the advantage of:

- Raising cash to fund the balance sheet without cannibalization of local deposits;
- Improving term liquidity; and,
- Being able to fund at a short term rate.

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### **Structure**

The Bank would issue callable CDs through a broker. The structure would usually be 7 year non-call 1 year, 10 year non-call 1 year or 15 year non-call 1 year. The Bank would simultaneously enter into an interest rate swap that would exactly mirror the CDs issued. The swap would convert the funding cost from a fixed rate to a variable rate (see example below).

### **Interest Rate Swaps – Definition**

An interest rate swap is an exchange of payment streams without an exchange of principal:

- One party pays a fixed rate for a specified time period.
- The other party pays a variable (short-term) rate for the same time period.
- No cash is raised; no asset is funded.

Interest rate swaps can be very effective at converting fixed rate assets or liabilities to a variable rate or variable rate assets or liabilities to a fixed rate.

The primary risk of an interest rate swap is a default risk of the counterparty or, if used as a hedge, the correlation to the asset or liability hedged.

### **Example**

For illustrative purposes, assume the Bank would issue a seven year NC1 (non-call 1 year) CD at 7.75%. This CD is callable in twelve months, at the Bank's option and every interest crediting date thereafter. Simultaneously, the Bank enters into an interest rate swap that is a 7 year NC 1 year. This swap pays the Bank 7.75% fixed for seven years, but is callable at the option of the counterparty. In exchange

for the fixed rate payment, the Bank agrees to pay the counterparty one month LIBOR (currently 5.88%). The end result is the Bank acquires twelve month money that floats with LIBOR as follows:

Bank pays customer	7.75% (APY)
Bank receives a swap	7.75%
Bank pays LIBOR (1 month)	5.88%

**Potential Outcomes**

Flat Rates - If rates remain the same over the next twelve months after issue, the Bank’s cost of funds is 5.88%. At call date, if the swap is called, the Bank has the option of calling the existing CD and reissuing another CD of similar structure, finding another funding source or leaving the 7.75% CD on the balance sheet. If the swap is not called, the Bank continues funding at the one month LIBOR rate.

Falling Rates - If rates fall over the next twelve months, the swap will most probably be called and the Bank will call the CD. At that time the Bank has the option of reissuing another CD or finding another funding source.

Rising Rates - If rates rise over the next twelve months, the swap will probably not be called and the Bank will not call the CD. In this case, the Bank continues to fund its balance sheet at a one month LIBOR rate.

See Table Below

	<u>Rate Changes</u>		
	<u>-200BP</u>	<u>0</u>	<u>+200BP</u>
Swap	Called	?	Not called
CD	Called	?	Not called
Funding cost	3.88%	5.88%	7.88%

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George Darling is the Chief Executive Officer of the Darling Consulting Group (DCG), a firm that provides comprehensive business solutions to financial institutions, primarily in the areas of Balance Sheet Management and Strategic Planning.

Mr. Darling's professional experience includes: thirty years with his own company, two years as a senior executive with a \$2 billion financial institution; two years with a Big Five Accounting firm and ten years with IBM. He is a nationally recognized resource for assisting financial institutions in the areas of interest rate risk management, liquidity management and capital planning.

Mr. Darling is a contributing editor to the monthly Bank Asset/Liability Management newsletter, and a co-author of The Business of Banking for Bank Directors published by Robert Morris Associates. Mr. Darling is a graduate of the University of Massachusetts, Amherst, Massachusetts.

*This article was written in February 2000.*