



Premium CD Promotion Using Interest Rate Swaps

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The Opportunity

From time to time, because of the way banks lag CD rates paid to other market rates (i.e. U.S. Treasuries, London InterBank Offered Rate (LIBOR), etc. there is an opportunity to purchase term money from CD customers and convert the rate paid from fixed rate to a below market short-term rate.

The elements of the strategy are short-term limited time only CD offerings combined with off-balance sheet interest rate swaps.

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.

Premium Term CD's Swapped to Variable

In the current market, yields on U.S. Treasuries and other money market rates have significantly increased. Bank CD rates have not risen in tandem. As a result, term rates on market instruments, including interest rate swaps are higher than CD rates.

The bank would offer a premium priced CD for 15, 18 or 24 months. Based upon a recent market rate survey, a CD rate of 6.25 to 6.50% would be high enough to attract new 15 month money to the bank. Therefore, a 15 month CD at a 6.30% yield will be used below as an example.

The CD promotion would be advertised as available for a limited time only (i.e. thirty days) or to a maximum amount of money (i.e. \$10 million), whichever occurs first. This would limit the conversion of existing accounts and, hopefully, allow the bank to attract more new money.

At the inception of the program, the bank would enter into a \$5 million swap with a strong financial counterparty, for example, Bank of America or Bear Stearns. Based upon recent quotes, the counterparty would pay the bank a fixed rate of 6.70% for 15 months and the bank would pay the counterparty the ninety day LIBOR rate (currently 6.00%).

The net funding cost to the bank for the first quarter would be 5.60%, computed as follows:

	• 15 month CD yield to customer	6.30%
<u>Swap</u>		
	• Payment received from counterparty	6.70%
	• Payment made to counterparty	6.00%
	• Net Swap Spread (1 st Quarter)	.70%
	Net Funding Cost (1 st Quarter)	5.60%

The effect of rising or falling rates on this program is shown below:

	<u>Rates Fall</u>	<u>Flat Rates</u>	<u>Rates Rise</u>
	<u>200 BP</u>		<u>200 BP</u>
Rate Paid on 15 month CD	6.30%	6.30%	6.30%
Receive 15 month fixed rate from counterparty	6.70%	6.70%	6.70%
Pay 90 day LIBOR to counterparty	<u>4.00%</u>	<u>6.00%</u>	<u>8.00%</u>
Net Funding Cost	3.60%	5.60%	7.60%

Risks of Premium CD/Swap Promotion

The risks of offering a premium CD promotion as outlined above are outlined below:

- The initial rate offered on the CD is not high enough to attract enough volume to cover the size of the interest rate swaps.
- A high conversion volume from low cost “core” deposits wherein the bank would be paying up for funds it already has on the balance sheet.
- Early withdrawal CD’s leaving the bank without the liability it has hedged. (This is why an early withdrawal penalty is important.)
- Default of the SWAP counterparty.
- How new money raised are deployed as assets or to pay down liabilities (other borrowings may or may not result in more or less interest rate risk to the bank).
- The rate received from the counterparty might be lower on the next swap if market rates fall and the promotion to raise the second half of the \$10 million is successful.

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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.

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