



Getting Past the “D” Word to Better Manage Balance Sheet Risk

*How to use hedging instruments
to protect yourself against volatile rates.*

by: Jeff Reynolds
Managing Director
Darling Consulting Group

When I first left the field of audit and started with Darling Consulting Group back in 1996, I was amazed at how little I really knew about managing balance sheet risk. As I grew into the job, I was fascinated by how some banks used off balance sheet contracts to manage risk and how some just couldn't get past the “D” (derivative) word and take advantage of how hedging instruments could compliment their organic business model.

Roll the clock forward 10 years. A lot has changed, including the fear of the “D” word.

See Page 2 for complete article

When I first left the field of audit and started with Darling Consulting Group back in 1996, I was amazed at how little I really knew about managing balance sheet risk. As I grew into the job, I was fascinated by how some banks used off balance sheet contracts to manage risk and how some just couldn't get past the "D" (derivative) word and take advantage of how hedging instruments could compliment their organic business model.

Roll the clock forward 10 years. A lot has changed, including the fear of the "D" word. Thanks to the good intentions of the folks at FASB to make derivatives accounting more simple (boy did they miss it on that one), SFAS 133 & 138 have turned more and more community bankers away from using hedge instruments at a time when, quite frankly, many community banks need to get some financial options working in their favor.

One such option is the power of an interest rate floor, which is nothing more than an insurance policy against falling interest rates. The remainder of this article will provide a brief overview of how interest rate floors work, why they make sense for asset-sensitive institutions, and how wholesale funding providers such as the FHLB have been working the economic power of interest rate floors into floating rate funding structures that enable some banks to avoid derivatives accounting issues and get past the "D" word.

Think of it as an insurance policy

The economics behind an interest rate floor are pretty simple. It really does behave much like an insurance policy. If your balance sheet structure exposes your earnings to falling rates (e.g. you are asset sensitive), you can insure against that risk with a floor. As such, you chose:

- The length of coverage, or term, in years
- The deductible you are willing to live with before the insurance kicks in. This is called the strike, a predetermined rate level which LIBOR (or other rate index) must push through before the insurer starts paying you.

The pricing of the insurance is determined by the market's perception of the risk. Back in June 2006, a 5-year floor on LIBOR at 5.25% would have cost a bank 185bps to buy outright (the insurance premium, keeping with the insurance analogy). That cost is amortized over the life of the insurance contract.

The benefit of a hedge with a floor is that it protects against a drop against rates down but does not disrupt the bank's potential benefit if rates rise. The most one could ever lose on a floor is the premium paid. If I am hedging, I hope that I never collect on the insurance policy. I think of it this way: I send in a check every month on a life insurance policy that I hope I (well, my wife) will never collect on. The same should be true with a hedge. Buy only the insurance you need, and don't speculate on the timing of the purchase because odds are you will not have the insurance when you need it and the cost will be outrageously high when you do.

Hedge costs have gone up, but don't sit idle

Today, given the clear pause by the Fed and evident economic slowdown, that same floor outlined above would cost 347bps. As the saying goes, the worst time to buy fire insurance is when the fire truck sits in the driveway! Conversely, if floors get cheap, that means that happy times are here again for asset sensitive banks. While the cost of the floor is a drag, the additional earnings thrown off by the rest of the balance sheet will dwarf the money being spent on the floor.

Is it too late to hedge falling rates? If that bank were to look at buying that floor today, they might find that insurance package to be cost prohibitive. That is not to say they shouldn't still look at floors. Depending on the Bank's profile, they might lessen the cost by shortening the term and / or increasing the deductible by lowering the strike to 5.00%. Regardless of cost, the risk of living with a pronounced exposure of earnings to changes in rates (up or down) is not something a community sized bank that lives off margin should do.

Floors without the headaches

Most bankers that I talk to don't sweat what a regulator might say about a prudently used hedge contract such as a floor, cap, or swap. In fact, many think their regulator will love the fact that they take earnings risk seriously and are actually hedging. The problem comes down to the uncertainty of accounting for a hedge contract.

There are some very legit accounting concerns and some very real examples to justify those concerns. In days of yore, that insurance premium paid up front would simply be amortized over the life of the insurance contract. The value of the contract would be “0” at maturity, regardless of whether it was collected on or not. Post SFAS133, that straight line amortization may not happen if the hedge is not clearly documented and accounted for properly.

Enter the FHLB. Shorter term funding is advisable for the asset sensitive Bank. By paying for the floor in the form of a spread over the floating advance rate, a Bank can get the power of a floor embedded in funding and working in their favor.

Example

The floor strategy this Bank I have referenced though this article has a pronounced exposure to falling rates and executed a floored funding strategy through the FHLB. The Bank used floating rate funding to purchase fixed rate MBS (20 year, yielding 5.90%). While this mismatch leverage position (long assets funded short) helped reduce asset sensitivity and was a positive spread, they added the 5.25% LIBOR strike / 5 year floor to the funding.

If rates fall, the advance reprices down basis point for basis point with the drop in LIBOR. If LIBOR crosses the 5.25% threshold, the cost of the funding drops two basis points for every basis drop in LIBOR.

The net effect of the transaction: They booked \$25 million of assets at 5.90%, funded with floating rate funding at LIBOR + 50bp (5.85%). I know what you are thinking: awful skinny (5bp) spread for \$25 million of leverage. But remember, this was about reducing risk to future earnings. This equated to a \$50 million reduction in the Bank’s asset sensitive profile (the power of the \$25 mismatch leverage and the power of a \$25 million floor). A graphical example of the impact on the position is provided with this article.

Conclusion

Hindsight is always 20/20. As I write this, 20 year MBS yields have slipped from 5.90% to 5.40% and the cost of the floor is through the roof. The strategy, in hindsight, looks like a home run.

If we were to do a similar transaction today (and we are), the floor might be shorter with a lower strike. We might consider aggressively priced loans in lieu of MBS. What we won't do is sit idle and not continue to look for ways to prudently reduce earnings exposure. One can never predict with certainty which way rates will move, when, and by how much. If you have risk, look for alternatives to reduce it and carefully weigh the risk/return trade-offs.

Are you exposed to falling rates? If so, funding with an embedded floor may be a good fit for your balance sheet.

Jeff Reynolds
Managing Director
Darling Consulting Group, Inc.
jreynolds@darlingconsulting.com
Tel: 978.463.0400 x137

Since joining DCG in 1996, Jeff has served the company and its clients in many capacities. His analytical and managerial skills have been recognized through the years by way of promotion within the ranks of DCG's analytics group, culminating in his current role of managing director. In this capacity, Jeff's primary responsibility is advising clients on ways to enhance earnings while more effectively managing their risk positions. Jeff is a frequent author and speaker on a variety of balance sheet management topics, and has served as a guest faculty member for the ABA's Stonier Graduate School of Banking. Prior to joining DCG, Jeff was employed as an auditor in the insurance and public accounting professions. He received a B.S. degree in Business Administration from Salem State College in Massachusetts.

*written by Jeff Reynolds, Getting Past the "D" Word to Better Manage Risk,
for the Federal Home Loan Bank of Seattle's online publication,
"What Counts: Strategies for Your Financial Success."*