

ASSET-LIABILITY MANAGEMENT IN A TRANSITIONAL INTEREST RATE ENVIRONMENT: THE CHANGING COMPLEXION OF FUNDING

When the FOMC embarked on its tightening cycle in the middle of 2004, the Fed Funds rate was 1%, 30-year mortgage rates were around 5%, and real estate was the investment of choice. More than twenty months later, the Fed Funds rate is approaching 5%, 30-year mortgage rates are approximately 6.50% and the hot real estate market has clearly peaked. If recent Bloomberg surveys are any indication, the Fed Funds rate will be falling by the third quarter of next year. Gross Domestic Product, a widely followed measure of economic strength, is expected to soften as well. In addition, the ten-year note rate is forecast to rise to around 5.10% by the beginning of 2007.

In April of this year, the Fed made a clearer indication that the string of interest rate hikes may soon come to an end. If the Fed is about to take its foot off the brakes, what does that mean for deposit growth, loan pricing and portfolio cash flows? Anticipating that short-term rates will level off and eventually drop as the Fed's tightening cycle comes to an end, we also expect the yield curve to steepen with longer-term yields moving higher. In the meantime, higher short-term rates have hurt banks' profitability. Due to tremendous liquidity at the time, most banks didn't term out deposits or FHLB advances when the 10-year Treasury was hovering around 3.50% three years ago – and wouldn't we like to borrow in bulk at 3% today?

Deposits

In the face of rising interest rates in 2005, some banks actually shortened the maturity terms of promotional CDs targeted to customers. On the surface, this strategy seems counter-intuitive to what banks should do in a rising rate environment. To support this statement, we analyzed time deposit data from clients for the months of December 2004 and 2005 respectively. The data in Table 1 and Table 2 are comprised of several institutions operating in the Mid-Atlantic region. These institutions range between \$500 million and \$2 billion in total assets.

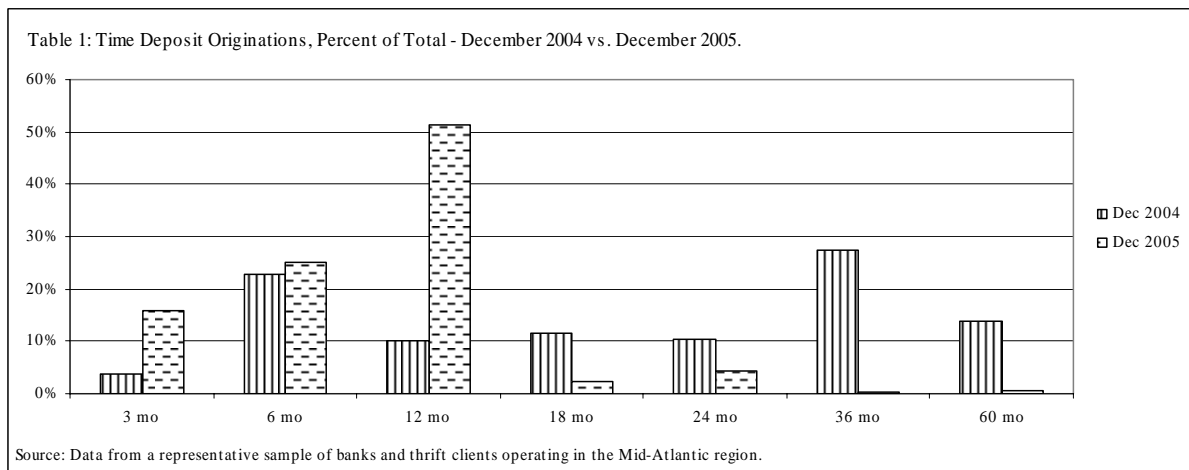


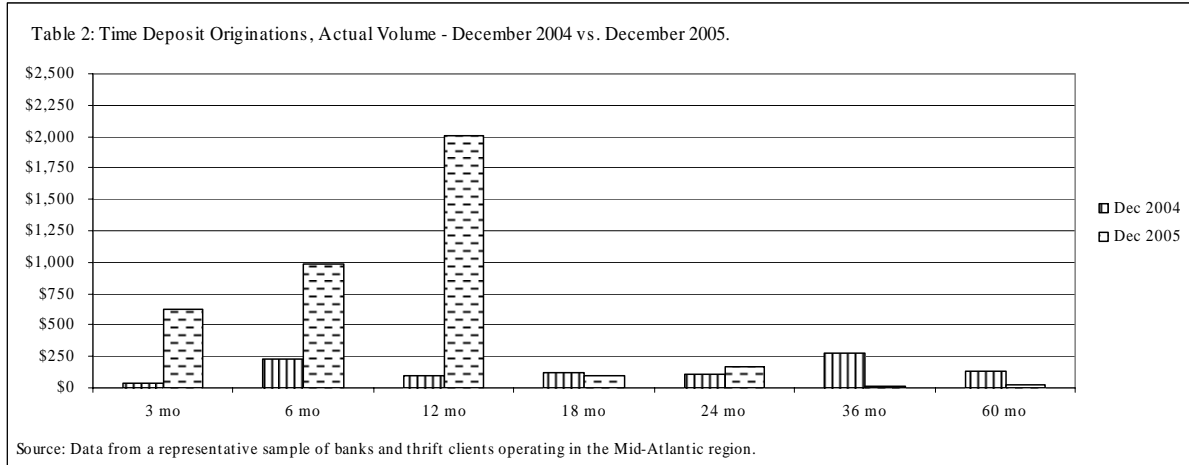
Table 1 above shows that in December 2004, CD balances one year or less made up approximately 37% of all deposits. In December 2005 however, that percentage jumped to just over 90% of total originations for the month.

Does this mean that these banks do not understand how to manage interest rate risk? Not at all! Many institutions raised short-term time deposit rates disproportionately to longer-term rates, not to shorten time deposit durations, *but to retain non-maturity deposit accounts*, which traditionally run-off when interest rates rise. An in-depth study of this phenomenon was published in the August 2004 issue (Vol. 20, No. 8) of this publication.

Comparing the 2004 and 2005 year-end balances from call reports, it appears that Money Market Demand Account (MMDA) balances declined 1% from 18.2% down to 17.2% of total assets. Other savings deposit balances remained flat at about 14% of total assets. Noninterest-bearing deposits actually grew about one-half percent to about 8.5% of total assets. Finally, time deposits increased two percent from 28% to 30% of total assets. Our hypothesis is that since domestic deposits remained flat at about 71% of total assets, net funding shifted from MMDA to time deposits. Furthermore, the MMDA funding moved largely into the 12-month term time deposit bucket. This shift came at a cost to our sample of banks. For the month of December 2005, the sample's weighted average, 12-month CD rate was about 4.42% whereas the MMDA rate was about 2.47% -- an increase of almost 200 basis points.

Table 1 looked at 2004 and 2005 data independently. Each month's balances were analyzed as a percentage of that month's total volume to determine which Gap bucket contained the greatest balance of originations. Table 2 shows the actual dollars of CDs issued during the month of December 2004 versus the month of December 2005. For illustrative purposes, we factored down the 2004 originations to \$1,000 in total and adjusted December 2005's originations proportionately.

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We should note that the data in Table 2 suggests that overall, time deposit originations quadrupled in the month of December 2005 versus the same month in 2004. This trend may not have occurred in any other month.

The key point is that year-over-year, banks in this category maintained a domestic deposit ratio at almost 71% of total assets. Within the domestic deposit ratio however, was a shift from non-maturity (specifically MMDA) balances into time deposits. At the conclusion of 2004, time deposits were about 28% of total assets. By the end of 2005, time deposits had increased to about 30% of total assets for banks in this category. So the banks were not shortening liability duration in the face of rising interest rates, but trying to retain funding traditionally found in non-maturity deposits during periods of lower market interest rates.

Funding and Leverage

Balance sheet deleveraging was popular in the last half of 2005 and may still be an option for some -- either organically, or by actively selling "underwater" securities and using the proceeds to reduce borrowings. In fact, as earnings reports start coming in from some of the bigger financial institutions, we are hearing reports of deliberate shrinkage of the balance sheet (Washington Mutual's quarterly report comes to mind). Several institutions fail to see any benefit in growing in a flat yield curve environment.

So, what have we observed regarding borrowings over the last two years? In our sample of banks described earlier, we saw FHLB advances as a percent of total assets fall slightly from 13% to 12.5%. The shift was largely into Fed Funds Purchased and Repo. Initially, we were surprised by this finding. Talking with our clients, we saw an increase in borrowing activities. We believe one reason is that the rising rate environment has triggered conversions in certain types of FHLB advances. Since institutions have the option to pay off the (now) floating-rate funding without penalty, they are replacing that funding. Banks are using short-term, fixed-rate FHLB bullets or bullet repo -- which is usually cheaper than FHLB funding, but requires collateral. Or, as the data suggests, banks are simply drawing on Fed Funds purchased and not rushing into term borrowings.

Conclusion

As rates were rising, asset extension and sharply higher funding costs hurt leverage trades that were put on during the lower rate period. Callable bonds that were purchased with the thought that they would be called are now extending, as are mortgage-backed issues whose prepaids have slowed. In the meantime, floating-rate loans have been a boon to many institutions. If rates stabilize or fall, however, floating-rate loans will reset lower. Remember, if there are floors embedded in these loans, they will be ineffective unless there are prepay penalties specified in the loan documents. One way to remedy this situation is to make a stand-alone purchase of an interest rate floor. A floor will pay you cash when the reference rate (commonly either three-month LIBOR or PRIME) is below your predetermined strike rate.

Lower cost, short-term funding came due and has been replaced with much higher cost, generally shorter-term, borrowings. These newer liabilities may turn out to be a net positive as, if the cycle plays out as we expect, short rates start to fall and the yield curve steepens. Banks may finally be able to renew funding at ever-lower short-term rates and make loans or purchase investments at higher long-term rates. The spread game could finally be back on!

We are not surprised to see institutional borrowers staying short. As we mentioned earlier, April's Bloomberg survey respondents have suggested that we are near the end of the tightening cycle. These institutions are hoping that short-term borrowing costs will be falling in the not-too-distant future. Shortening liabilities will allow companies to reprice their funding costs lower as rates fall. One could also enter into a receive-fixed swap (pay-floating) which allows rates to adjust downward as the Fed Funds rate falls.

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A recent article from the FDIC noted: “Regardless of the slope of the existing yield curve – positive, flat, or negative – bankers will benefit from strategies designed to cope with the uncertainty of changing interest rates.” (from “What the Yield Curve Does (and Doesn’t) Tell Us”, [FYI: An Update on Emerging Issues in Banking](#), by Nathan Powell, FDIC Division of Insurance and Research, February 22, 2006) Once again, the time-honored strategy of spreading your “bets” among various funding sources and terms is likely to produce more stable and predictable (if boring) liability costs over time.

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