

BALANCE SHEET STRUCTURE IN A RISING RATE ENVIRONMENT: WHAT TO EXPECT REGARDING LIABILITY SENSITIVITY

These days, most of us are routinely preparing a formal business plan. Most of us simply allocate more resources to the business lines that have been the most profitable. After all, targeted growth in certain business lines is purely management's decision—or is it?

External factors impact the balance sheet more than most of us would like to admit. For example, you can't grow your historically profitable commercial lending line of business if there are no new commercial borrowers, or if current economic factors are reducing your available funding. The major determinant is that customers on both sides of the balance sheet behave differently at various points on the rate cycle. Therefore, the primary external factor that impacts the balance sheet structure is the customer's response to the movement of market interest rates.

Over the last 18 months, we have all been anticipating the upward turn in the interest rate cycle. This year, while short term rates remain stubbornly still, we see longer term rates rise, only to see them slip back down to 2003 levels. Now, all indicators are pointing to the anticipated rise in short term interest rates occurring as early as next month.

During the last FOMC meeting, the Fed left the Fed Funds target rate at 1%, where it has been since June 25, 2003. The Fed, however, shifted from a "patient" stance, suggesting that a rate hike may come as early as June. Economists were already predicting rising inflation in the current rate environment – a feared result of keeping short term rates too low, too long. And now, the Fed Funds Futures market is now predicting a rate hike in June.

It is unlikely that we are headed back to the summer of 1981 when crowded theaters premiered "Raiders of the Lost Ark" and when the Fed Funds rate hit 20%. But now, everyone is bracing for the FOMC's Federal Funds Rate increase. In anticipation, you should be aiming to both mitigate risk and maximize return.

Customer reaction to higher interest rates has historically led to asset extension. After all, who wants to refinance their mortgage into a new, high rate? The question remains, how much of this asset extension will be offset by customer shifts into longer (CD) liabilities? How will the margin be impacted by this shift?

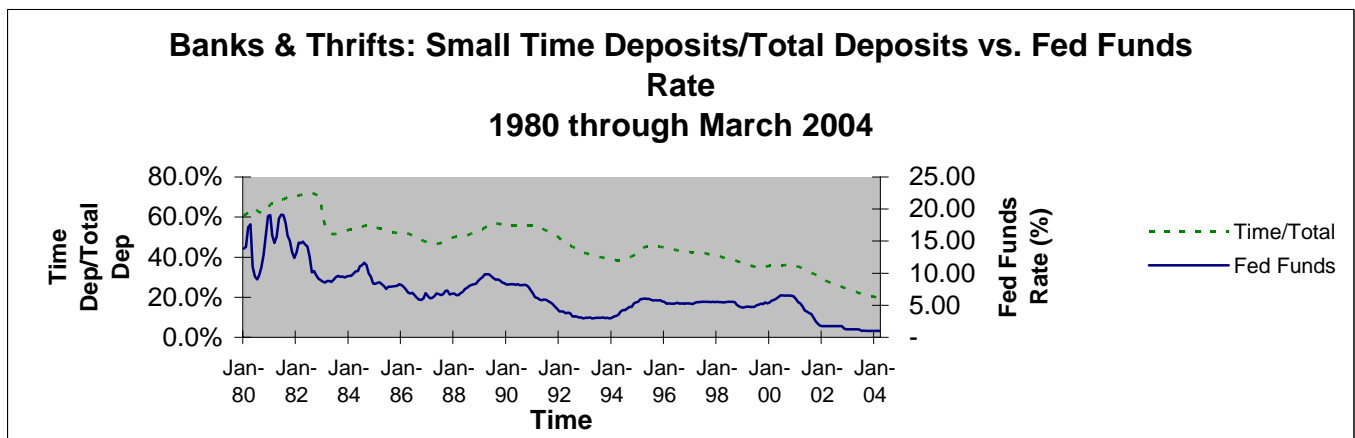
Do nothing and your margin could compress. In your business plan and A/L modeling, do you project your existing mix of time to savings and MMDA balances? Or, do you adjust that ratio to shift balances toward more costly time deposits? Or, do you pay rates high enough to incent customers to stay where they are?

Consider the following. If your current mix of small time to savings and MMDA is 50/50, what happens if the Fed Funds rate moves up? History tells us that your customers will move money from liquid accounts into higher paying CDs. Are you projecting this trend? If not, you may be understating your risk to rising rates.

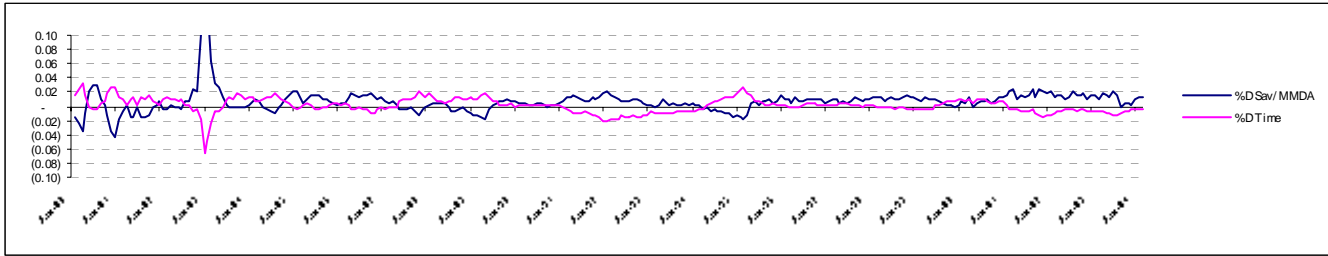
To illustrate this trend, let's look at the historical relationship between the Fed Funds rate and the proportion of small time deposits to total deposits (small time deposits, savings and MMDA) outlined in the first graph below.

We see below that there has been a strong relationship between the directional move of the Fed Funds rate and the proportion of bank and thrift small time to total time and savings/MMDA balances.

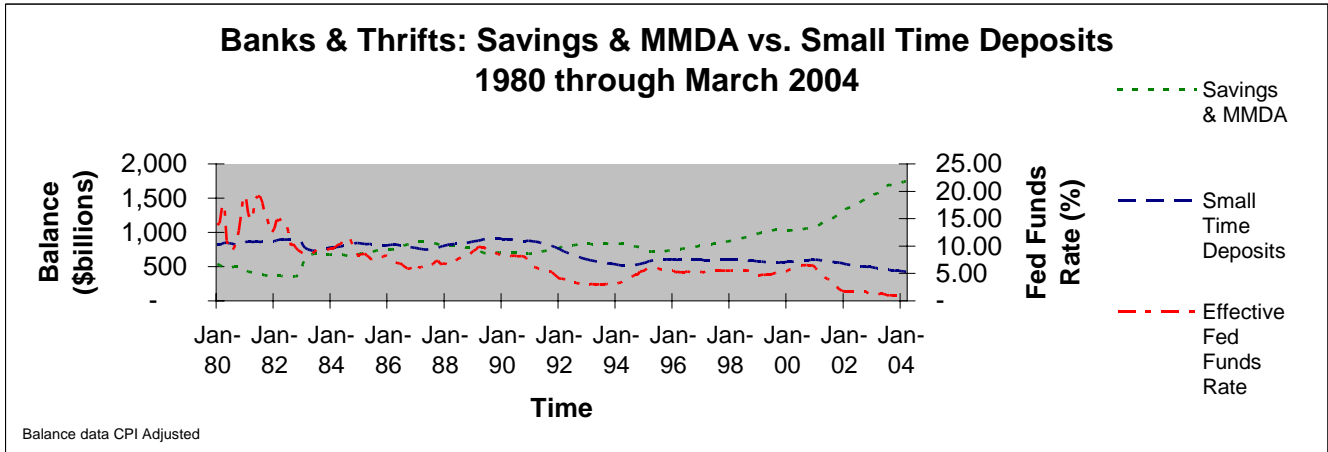
It is intuitive, therefore, that when short term interest rates rise, CD balances grow and savings & MMDA balances decline. Consider this relationship going forward as you plan your funding needs.



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The second graph above shows the percentage month-to-month change in non-maturity savings and MMDA vs. small time deposits. The virtual mirror image confirms that the balances do move in opposite directions.



In our third and final graph (above), the values (\$billions) for savings and CDs have been inflation adjusted, using the CPI and graphed with the Fed Funds rate. This picture shows that there is a strong relationship between all three variables.

For those who like numbers, the correlation coefficients shown to the right are a statistical confirmation of all three graphs above. Fed Funds is 76% positively correlated with CDs and 78% negatively correlated with Savings.

	Savings	CDs	FF
Savings	1.00		
CDs	(0.76)	1.00	
FF	(0.78)	0.76	1.00

The data presented illustrates the historical relationship between short term interest rates (Fed Funds rate) and where customers deposit their funds. Customers are more willing to give up liquidity by locking up their funds in longer term deposits when they are paid appropriately. Now, ask yourself “Do our Deposit and CD rates drive our customers behavior, or is it the other way around?” This is something to consider as we revise our business plans. It is prudent to begin preparing for this before short term rates begin rising.

Is there action to mitigate potential duration mismatch that can be taken now? Targeting specific maturities with term CD specials or introducing indexed Money Market accounts are viable ways to retain deposits and/or target your growth in term or core accounts. By methodically shortening new asset and lengthening liabilities, both risk and return can be managed to mitigate any ill effects of an upward rate cycle.

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