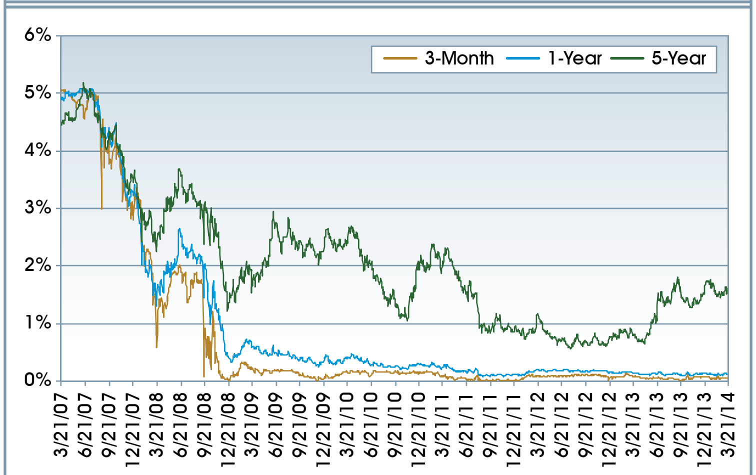
FHLBNY Advantage
FEDERAL HOME LOAN BANK OF NEW YORK
MARCH 2014

Managing Interest Rate and Liquidity Risk – Options to Consider

Current Environment

In the wake of the financial crisis of 2008, many of our member institutions experienced an influx of liquidity when consumers sought the protection of FDIC insurance on their deposits. Generally these deposits were considered "core," which have longer durations. Concern exists that these "core" deposits could rapidly dissipate when the interest rate environment changes and consumers have more opportunities to find greater yield elsewhere. A rapid outflow of long-term liabilities could negatively impact the interest rate risk positions at many of our member institutions. Long-term Treasury rates have come off of their lows since mid-year 2013 (see the following chart), and in the wake of the Federal Reserve formally announcing and implementing a tapering to their quantitative easing efforts, interest rate risk is of heightened concern.

U.S. Treasury Rates



Member Behavior and Funding Mismatches

Although there is the expectation that both long- and short-term rates will eventually rise, we are not seeing a significant number of our members position their balance sheets for rate increases. The predominant trend among our membership is to continue with a "short funding" strategy, to combat earnings pressures from declining net interest margins, elevated regulatory and compliance costs, and to offset declining fee revenue from mortgage banking businesses. As the economy continues to improve, balance sheets grow, and as the specter of rapid "core" deposit outflows loom on the horizon, members and regulators alike are concerned about interest rate risk and liquidity positions.

In a recent March 17, 2014 article by SNL entitled "Banks' asset/liability mismatch is totally 80s," significant concern was expressed that banks could face severe compression of margins (or underwater assets) should rates rise rapidly, akin to what occurred in the 1980s.[1] According to SNL data, as banks seek to deploy excess liquidity and seek additional yield, they have extended duration and grown securities as a percentage of their total assets to approximately 21% (up from 16.5% three years ago). Additionally, we are seeing a greater appetite for holding mortgages in portfolio within our own district due to the spike in long-term rates last year. The SNL article pointed out that most banks are really not prepared yet for rising rates and that careful consideration should be given to the degree of funding mismatches found on many financial institutions' balance sheets.

Although the majority of our advances remain short-term, we are seeing some members layering in longer-duration advances to preserve spread. The following are a few strategies to consider when positioning your balance sheet for rising rates.

Strategies for Rising Rates

Fixed-Rate Advance with a LIBOR Cap (Fixed-Rate with Cap)

To mitigate the impacts of rising rates, consider exploring the relatively new advance product — the Fixed-Rate with Cap. This advance combines a Fixed-Rate Advance with a cap that is tied to 3-month LIBOR. As 3-month LIBOR rises above a pre-determined threshold (strike), the advance rate would decline 1 basis point for every basis point that 3-month LIBOR is above the strike (1× multiplier), or 0.5 basis points for every basis point 3-month LIBOR is above the strike (0.5x multiplier), reset quarterly with a floor of zero.

In a rising rate environment, the interest expense on this advance could decline, while the rest of the floating-rate liabilities become more expensive. This advance extends liabilities and preserves spread, and also can help assist liability-sensitive members with their regulatory shock scenarios, as the value of the cap becomes "in the money," and serves to offset market value deterioration of other liability categories. Lastly, the Fixed-Rate with Cap would become "richer" during times of global economic crisis, as 3-month LIBOR tends to become more volatile and rise during times of uncertainty (as demonstrated at the height of the financial crisis in September/October 2008 when 3-month LIBOR rose by approximately 200 basis points). This advance has the benefits of an interest rate cap and may potentially be accounted for without the issues associated with stand-alone derivatives. Members are advised to consult with their accountants in order to confirm the appropriate accounting treatment.

Adjustable Rate Credit Advance (ARC) with an Embedded Cap

An ARC (floating rate advance tied to either 1- or 3-month LIBOR) with an embedded cap is a potentially useful way to have long-term floating rate liquidity with built in protection

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[1] Stovall, Nathan. "Banks' asset/liability mismatch is totally 80s." SNL Financial LC (www.snl.com), 17 Mar. 2014. <http://www.snl.com/interactivex/article.aspx?id=27307840&KPLT=6>.

Managing Interest Rate and Liquidity Risk – Options to Consider/Strategies for Rising Rates *(continued)*

against rising rates. For example, a 5-year ARC (tied to 3-month LIBOR) with an "all in" embedded cap of 2.75% was recently quoted at 3-month LIBOR plus 86 basis points (the regular 5-year ARC without cap was 3-month LIBOR plus 39 basis points). If 3-month LIBOR rises to the point where the advance reaches the 2.75% rate, the advance would stay fixed at that level until 3-month LIBOR declined and caused the advance rate to fall below 2.75%.

Why would some elect to do this transaction today? Members may want to utilize this trade to address interest rate risk now and to help protect future spread on their assets. In the event of a rise in interest rates, the advance turns to a fixed structure at a given point; if rates remain low or experience a decline, the member could potentially benefit from long-term, lower-costing liquidity. For liability sensitive members, an ARC with an embedded cap could potentially mitigate Net Interest Income at Risk and also could benefit Economic Value of Equity at Risk, as the benefit of the embedded cap would have value in regulatory shock scenarios.

Extending Liabilities with Term Advances

Layering in long-term, fixed-rate advances may be a prudent strategy to preserve spread and guard against extension risk in mortgage and mortgage-backed security portfolios. Long-term advances can be utilized to extend liabilities and "lock in spread" to help preserve your interest rate risk position should the environment change. In the event that a respective mortgage portfolio extends past its expected average life, term advances could be utilized to reduce this extension risk and could serve to protect the spread on the remaining balance of the mortgage pool. Amortizing Advances also may be used to match-fund according to the specific attributes of a given mortgage pool.

Callable Advances

If you are uncertain about mortgage prepayment speeds or are unclear as to the direction of interest rates, you may want to consider the Callable Advance. This is a Fixed-Rate Advance with a "callable" feature that gives members the option to extinguish the advance (in whole or in part) at no cost after a predetermined period of time. If prepayment speeds are faster than anticipated, a member may extinguish part of, or the entire advance with no prepayment fee. If the rate environment changes causing the advance to become "out of the money" and above market, the member may extinguish with no prepayment fee and borrow at a lower rate.

If rates increase, you have the protection of long-term funding to "extend" liabilities and preserve spread. There is a cost to the option embedded in the Callable Advance; however, consider the savings that could potentially be achieved in a declining rate environment or if the funding is no longer needed at a future date.

If you would like to learn more about these strategies or any other FHLBNY advance option, contact your Calling Officer at **(212) 441-6700**.

Have You Considered the Economic Impact of Your Dividend?

On February 18, 2014, the FHLBNY distributed a total dividend of 4.75% to members for the fourth quarter of 2013 (annualized). It is important for members to factor in the economic benefit of the FHLBNY's dividend rate, which, depending on the advance term, can substantially lower the "all-in" borrowing cost of the advance. For a detailed analysis, contact your Calling Officer at **(212) 441-6700** or refer to the July 2013 edition of the *FHLBNY Advantage* for an example of the "all-in" cost.

Note: There is no guarantee that the level of future dividends will match or be comparable to the level of previous dividend payouts.

Feedback Welcome

Have a suggested topic for the *FHLBNY Advantage*? E-mail us at fhlbny@fhlbny.com.

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