FHLBNY Advantage
FEDERAL HOME LOAN BANK OF NEW YORK
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Positioning Your Institution for Rising Rates

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The following article was prepared by Dr. Thomas J. Parliment, Chairman & CEO of Parliment Consulting Services, Inc. Dr. Parliment is an economist and has served as a commercial banker, investment banker, consultant, and educator to the financial services industry over the past four decades. He has also served as a director on several community bank boards. Currently, Dr. Parliment is serving as Interim President of a $300 million bank. He is noted throughout the business community for his colorful speeches and articles covering a wide range of financial and economic issues. His often humorous and always thought-provoking point of view is regularly enjoyed by readers.

Regulators continue to ask the same question: "What are your contingency plans for rising market interest rates?"

Macro data on the financial services industry shows historically high concentrations of deposits in shorter-term categories. At the same time, the data shows a relatively larger concentration of longer-term assets on institutional balance sheets. This obviously stresses many institutions' interest rate risk positions. Therefore, in the interest of preparing your institution for both rising rates as well as questions from regulators, here are a few tips from Dr. Tom:

Do not simply rely on simulation models that have generic duration assumptions.

As you know, your model is only as good as its assumptions. As we enter a rising rate environment and attempt to quantify the true impact of rising rates, it's imperative that you understand your deposit assumptions and are able to substantiate and properly communicate these assumptions with your regulator. The actuality of estimating the impact of rising rates results in measuring the "effective duration" of deposit balances. That is, a portfolio of one-year CDs, while theoretically all repricing in one year, actually will have an effective duration of one-to-two-plus years depending on the rate sensitivity of the depositor base. Remember, depositors all have "retail options;" however, there will always be a certain percentage of this depositor segment that will "roll" and be insensitive to a change in rates. In addition, depositors will exhibit a "cross elasticity" of demand between various deposit products offered by the institution depending on their relative preference for liquidity and rate. While not precisely calculated, these factors of "effective duration" and "cross elasticity" can be approximated by sensitivity analysis using marginal cost methodology.

By the same token, expected cash flows on loan categories should not simply be based on mortgage-backed security prepayment speeds. Commercial real estate prepayments have much to do with an investor's ability to maximize the benefit of tax depreciation, and their ability to sell their properties in five to seven years. Perform the analysis on your own loan categories in order to not overestimate the duration of commercial loans in a rising rate environment.

Develop a defensive deposit pricing strategy centered on marginal cost pricing.

That is, pay up for only rate-sensitive deposits in rising rate environments. To accomplish this, it requires the use of various segmentation strategies such as tiering and relationship pricing. Financial institutions are increasingly using more sophisticated methods to better segment their customer base, allowing them to "fine tune" their segmentation strategies. However, simply establishing tiers by performing a decile distribution of balances in today's low deposit rate environment could assist in lowering your cost of funds without having a pronounced impact to deposit balances.

Implementing tiering of all deposit categories along with a plan to use "specials pricing" in the event of rising rates ("pay the best rate…not the best rates") could sharply reduce the speed with which your cost of funds will rise when market rates shift.

Consider more aggressive marketing on transaction accounts with an eye on the costs.

Keep in mind, if the average life of a checking account is five years, then you are really comparing the duration of these checking account balances with the duration of a 5-year FHLBNY advance! Many of the marketing costs associated with the on-boarding of checking with "sticky features" such as on-line accessibility, e-statements, mobile banking and bill pay, need to be considered as if they are rate adjustments over the expected duration of these accounts. The rate adjustment to capture the current market expenditures (not to mention FDIC insurance) to "onboard transaction customers" is seldom, if ever, considered as a rate adjustment because of the accounting for direct marketing costs as an incurred expense. You may be surprised to learn that the "carrying" and "onboarding" costs associated with these accounts make them much more expensive than originally perceived.

Interest Rate Swaps

Interest Rate swaps ("swaps") can be an effective tool in managing asset/liability mismatches present in many of our balance sheets. Mismatches occur when a member funds long-term assets using shorter-term liabilities, or vice versa. For liability-sensitive members, swaps can be structured to "extend" liabilities and preserve spread in a rising rate environment — without increasing the size of their balance sheet. There are accounting considerations with off-balance sheet "hedges" and you should be cautious and consult with an accountant as a preliminary step to determine if swaps are appropriate for your institution.

Consider capitalizing on your FHLBNY membership

To mitigate the impacts of rising rates, consider exploring a new advance product called the Fixed-Rate Advance with a LIBOR Cap (Fixed-Rate with Cap). This advance is a fixed-rate bullet advance with an embedded cap which is tied to the 3-month LIBOR rate. When rates rise and 3-month LIBOR increases

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Positioning Your Institution for Rising Rates *(continued)*

above an agreed upon strike threshold, your advance rate will decline, thus offsetting the expense increase in other funding categories. This advance not only helps preserve spread, but it can also assist liability-sensitive members when conducting regulatory shock scenarios. As rates are "shocked" by instantaneous increases of 100 to 300 basis points or more, the Fixed-Rate with Cap quickly becomes "in the money," thereby offsetting market value deterioration in other segments of your liabilities. Contact your FHLBNY Calling Officer for pricing and see for yourself how the Fixed-Rate with Cap can potentially benefit your institution. If you are uncertain about mortgage prepayment speeds or perhaps lack clarity on the direction of interest rates, you may want to consider the FHLBNY's Callable Advance. This is a bullet advance with a "callable" feature which 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 quicker than anticipated, you 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, you may extinguish with no prepayment fee and rebook 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 you could potentially achieve in a declining rate environment — after all, many FHLB members across the country have experienced the pain of high-cost borrowings on their books in this prolonged low rate environment. Who wouldn't turn back the clock and pay up a little for a Callable Advance? Again, contact your FHLBNY Calling Officer for pricing and more details.

Match-funding is often part of prudent interest rate risk management, particularly as we are seemingly entering a different point in the rate cycle. Consider using intermediate term advances (three to seven years) to match-fund the duration of competitively priced fixed-rate loans that many institutions offer their "A" borrowers. I have written about "duration-based loan pricing" previously in this publication (see the June 2012 issue). It is my observation that currently, it is practical for most institutions to cover roughly 25% of their duration exposure with term funding.

It will be important for institutions to keep track of which strategies they employ and document them as part of their ALCO process. Keeping the regulators informed of your specific tactics and strategies is a key component of an effective overall interest-rate risk management strategy.

***FHLBNY Reminder*:**
Third First Home Club℠ (FHC) Enrollment Period Deadline Approaching

Members may enroll an unlimited number of qualified households for the Third Enrollment Period in 2013. The Enrollment Form must be received via e-mail to fhc@fhlbny.com by no later than **Monday, November 18, 2013, by 5:00 p.m. EST**. FHC documents and forms are available on our website.

HELOC Mortgages - Eligible Collateral

In our ongoing effort to provide additional liquidity for our members, the FHLBNY is pleased to announce that Home Equity Line of Credit (HELOC) mortgages are accepted as eligible collateral.

There are eligibility criteria for pledging HELOCs, including requirements for data submission, a combined loan-to-value ratio limitation of 80% or less, stringent delinquency provisions, etc.

The FHLBNY strives to provide maximum liquidity for our members in a sound manner consistent with the overall risk profile of the FHLBNY.

Have HELOCs on your balance sheet?

*Contact a Calling Officer at **(212) 441-6700** to further explore this collateral opportunity and how it may help expand your borrowing potential.*

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