FHLBNY Advantage

FEDERAL HOME LOAN BANK OF NEW YORK
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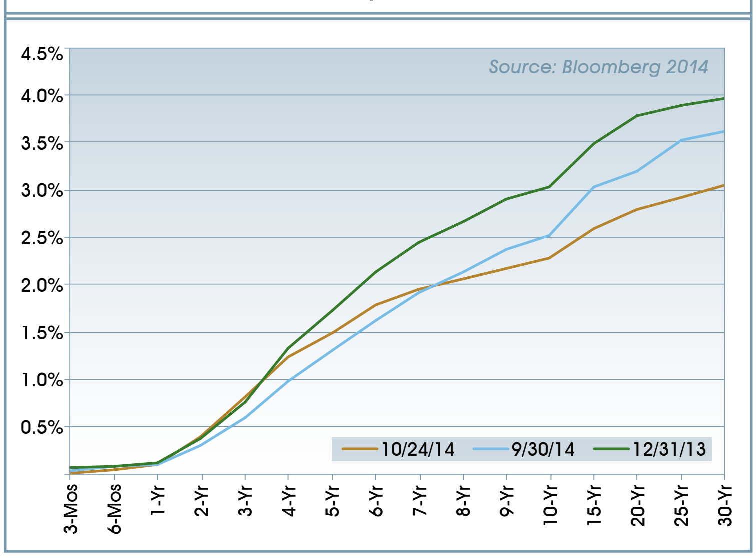
Interest Rate Risk Management — Converging Factors in a Tricky Environment

Heading into the fourth quarter of 2014, we unfortunately remain in a prolonged low-rate environment marked by economic weakness. Although periodic indications hint that a more robust economic environment is emerging, short-term rates remain at or close to zero, while longer-term rates are still historically very low. Furthermore, global economic and geopolitical events have applied significant downward pressure on longer-term rates recently, even amidst the Federal Reserve's tapering of quantitative easing — you can see the impact by looking at the U.S. Treasury Yield Curve over the past ten months depicted in the chart below. The 10-year Treasury bond has declined by 51 basis points since year-end 2013 and by 25 basis points since the third quarter of 2014.

U.S. Treasury Yield Curve



Net interest margins remain under significant pressure, and many members are also suffering from declining fee revenues coupled with increased operating expenses. Mortgage demand remains relatively weak and intense competition persists, which also challenges our members' ability to grow their balance sheets.

In addition to concerns about earnings growth and capital preservation, some asset liability management (ALM) officers believe that there are converging factors that will add further complexity in a rising rate environment, which could also compromise modeling assumptions, alter interest rate risk positions, and ultimately threaten bottom-line earnings. These factors include:

Core Deposit Outflow

"Surge deposits" that have accumulated post-crisis are an area of concern. Many members experienced an unprecedented influx of liquidity since the financial crisis, with deposit growth rates significantly outpacing historic trends. Much of this deposit inflow made its way into checking and savings accounts, which are traditionally categorized as "core" and have a long average life. Although some felt the newly-acquired, post-crisis liquidity would erode quickly, these deposits have proven to be "sticky" and have indeed behaved as "core," providing a stable source of funding for our members for many years.

Consumers have been extremely complacent in recent years as well; with rates being so low, alternative investments are not attractive enough to compel them to move their money out of their checking and savings accounts. However, if rates do rise and other fixed-income investments become more attractive, the possibility exists that post-crisis "surge deposits" could rapidly outflow to other alternative investments (i.e., money market mutual funds, high-rate deposits accounts at competitors, equity markets, etc). If this materializes, members could be put in a positon where their interest-rate risk positions are altered and their ALM tolerance levels are breached.

Reliance on CDs

With core deposits experiencing a sharp upswing post-crisis, and pressure on margins due to the low rate environment, overall CD balances have dropped in banks and credit unions nationwide, as there simply was no need to hold higher-cost term deposits on the balance sheet. Additionally, demand for long-term CDs has waned due to consumers not wishing to lock up their money long-term for such modest returns.

However, with the economy showing indications of recovery and with concern about rate risk intensifying, some members turn toward building customer CD balances to manage the risk of rising rates.

Hedging risk using CDs is tricky, because in many cases CD "breakage" penalties are inefficient and do not always serve as an adequate deterrent to customers wishing to extinguish their CD contracts. If rates experience significant increases and fixed income investments become more attractive, customer behavior may be uncharacteristic where they may choose to move their money out of existing CDs despite a prepayment penalty. If CDs behave differently from your ALM model assumptions, you may face a situation where you breach your tolerance levels — a potential problem that could negatively impact earnings and capital.

Extension Risk

Historically low mortgage rates over the past several years have caused many homeowners to refinance their properties multiple times as rates steadily declined. As you already know, the possibility exists that these homeowners could stay in their homes with a very low mortgage payment for a very long time, especially in a rising rate environment. More "normalized" rate patterns could dramatically alter the traditional average life assumptions of your long-term, fixed-rate mortgage and mortgage-backed security portfolios, creating the potential of "underwater" mortgages as their average lives extend and funding costs rise.

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FHLBNY Products to Help Address Potential Threats

As we emerge from this unprecedented economic environment, there is the possibility that balance sheets may experience uncharacteristic behavior, which may threaten earnings and capital. The FHLBNY is here to help you combat challenging operational environments and maintain profitability. As part of prudent balance sheet management, you may want to consider the use of term FHLBNY advances or Interest Rate Swaps ("Swaps") to help guard against unforeseen converging factors that can exacerbate the complexity of managing your balance sheet in a rising rate environment.

Fixed-Rate and Amortizing Advances

Guard against the impact of a rapid outflow of long-term core deposits by layering in term borrowings, which will lengthen your liabilities and preserve your risk position.

You may want to consider a "laddering" strategy, using regular Fixed-Rate Advances, or possibly take advantage of an Amortizing Advance that can be structured to match the cash flows of a mortgage pool. From a marginal cost perspective, adding FHLBNY advance funding is often less expensive than a campaign to attract and onboard customer CDs.

Callable Advances

Callable Advances are long-term funding with an option to extinguish in whole or in part, after an agreed upon call period — without a prepayment penalty. Callable Advances provide term funding that can match the average life of an underlying asset. If the interest rate environment changes during the life of the advance, the member can extinguish and not be stuck with long-term "out of the market" funding. If mortgage prepayments are greater than expected, members are not locked into retaining excess funding — the advance can be partially extinguished.

The Callable Advance helps protect against both interest rate risk and prepayment risk. You may opt to use a long-term Callable Advance to fund the "tail" of a mortgage. If mortgages prepay according to your assumptions, you may extinguish the Callable Advance, and conversely, it can remain in place as mortgages exceed their expected average life. The cost of the Callable Advance is slightly higher than a regular Fixed-Rate Advance and volume minimums and term restrictions apply.

Interest Rate Swaps ("Swaps")

Swaps can be an effective tool in managing asset/liability mismatches present in the balance sheet. Mismatches occur when a member funds long-term assets using shorter-term liabilities, or vice versa. Members may structure a Swap to "extend" or add duration to liabilities and preserve spread in a rising rate environment — without inflating the size of the balance sheet. Swaps can potentially be a useful tool to preserve your risk position should you be concerned about the possibility of a rapid outflow of post crisis "surge deposits."

There are accounting considerations associated with off-balance sheet transactions and you should be cautious and consult with an accountant as a preliminary step to determine if Swaps are appropriate for your institution.

All strategies discussed in this article should be carefully considered. If you have any questions, please consult your Calling Officer at **(212) 441-6700**. As always, the FHLBNY is here to assist with all of your funding and hedging needs.

Do you have HELOCs on the Balance Sheet? HELOCs are Accepted as Eligible Collateral.

In an effort to provide maximum liquidity for our members and expand their borrowing potential, the FHLBNY accepts Home Equity Line of Credit (HELOC) mortgages as eligible collateral. Eligibility criteria does exist for pledging HELOCs, including requirements for data submission, a combined loan-to-value ratio limitation of 80% or less, stringent delinquency provisions, etc. Contact a Calling Officer at **(212) 441-6700** to explore this collateral opportunity.

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