FHLBNY Advantage

FEDERAL HOME LOAN BANK OF NEW YORK — DECEMBER 2013

Asset/Liability Management Considerations for the New Year

Directly following the financial crisis, lenders across the country experienced a significant influx of deposits, which many considered as "core" liquidity. Deploying this liquidity in loans and securities proved difficult considering the very competitive lending environment and less than attractive security yields, further compounded by heightened interest rate risk concerns. As time has passed, many of our members have deployed this excess liquidity and now utilize advances to fund their liquidity shortfalls. Today, as we face a different point in the interest rate cycle, concerns exist that these "core" deposits may behave differently than they would in past interest rate cycles; meaning they will not "stick" as rates rise.

Core Deposit "Flight"

Although many members would benefit from a steeper yield curve and an uptick in rates, a rise in rates could change the deposit environment rapidly, as depositors seek greater returns either at other institutions, in money market instruments or in the equity markets. In past interest rate cycles, as rates trended upward, deposit rates generally increased to a lesser degree than the return on assets, thus resulting in an improvement to net interest income. However, today's environment is unique and market sensitivities may be very different from previous cycles. As stated in an article published by the Bank Administration Institute (BAI) dated November 12, 2013, the current cycle differs from past cycles due to the following reasons:

» Increased role of Internet banking — depositors can shop around and place funds remotely

» The erosion of branch traffic and less personal interaction is not helpful in the effort to fend off depositor defection

» Pent up demand for higher-yielding deposit accounts is great

» Competition for core deposits is fierce[1]

The message in the article is to have a deposit strategy in place — a plan to compete for deposits to stay ahead of the game. Lenders may not be able to "lag" the market when increasing deposit rates as they have done in the past. The FHLBNY's message to its members is that they should ensure collateral levels are sufficient at the FHLBNY so they can meet all potential liquidity needs in the event they experience a sudden outflow of cash. Also, consideration should be given to the possibility of losing historically "long-term" core deposits; could interest rate risk positions change to the point where layering in long-term funding is needed? Consider the possibility of extending liabilities now while rates are still low.

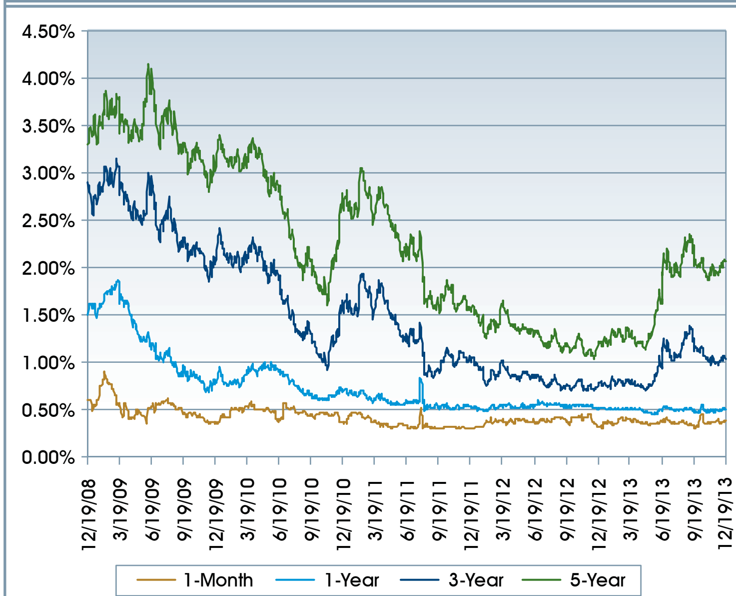
Looking at financial institutions across the Federal Home Loan Bank (FHLB) System, deposit flight (money seeking greater yield) may already be prevalent. Since the second quarter of 2013, FHLB advances have experienced an increase of $38 billion. An American Banker article dated September 9, 2013 stated, "The Federal Deposit Insurance Corporation's second-quarter industry update illustrated a significant shift as depositors finally opted to seek higher returns elsewhere. With banks looking for funding alternatives, FHLB advances held by banks enjoyed their biggest percentage increase in nearly six years."[2]

Advance Rates are Still Low — and Down from the Recent Peak

As seen in the following chart and table, although longer-term rates are up from the levels seen this past June, they are below the recent high experienced this past September. Take a look at the 5-year advance — the September 5, 2013 rate represented a 73 bp climb from June 19, 2013. As of December 18, 2013, the 5-year has come off almost 30 bps since that point in September 2013. However, when the Board of Governors of the Federal Reserve System (Federal Reserve) announced later that day that a formal "tapering" would occur, this caused the 5-year advance rate to increase 11 bps on the next day.

Many institutions are still funding short since the short end of the yield curve has remained relatively flat. However, those who are experiencing more robust loan growth have decided to portfolio some of their mortgage production and layer in longer-term funding to reduce interest rate risk.

Fixed-Rate Advance History



Fixed-Rate Advance Indices

	1-Month	1-Year	3-Year	5-Year
6/19/2013	0.38	0.49	0.94	1.63
6/20/2013	0.38	0.51	1.16	1.96
9/5/2013	0.34	0.53	1.39	2.36
12/18/2013	0.39	0.51	1.04	2.07
12/19/2013	0.40	0.52	1.10	2.18

continued on reverse>

[1] Richard Solomon et al., "Deposit Strategy in a Rising Rate Environment," BAI, Web. 12 Nov. 2013 <http://www.bai.org/BANKINGSTRATEGIES/Product-Management/Deposit-Products/Deposit-Strategy-in-a-Rising-Rate-Environment>

[2] Joe Adler, "Interest Rate Risk Giving Home Loan Banks a Boost," American Banker, Web. 9 Sept. 2013 <http://www.americanbanker.com/issues/178_174/interest-rate-risk-giving-home-loan-banks-a-boost-1061897-1.html>

Asset/Liability Management Considerations for the New Year *(continued)*

The opportunity to lock in term funding at low rates still exists, but could diminish should the market experience an extreme reaction to a more substantive future tapering announcement by the Federal Reserve. When conducting a stress test on the deposit base and factoring in the possible behavior of long-term "core" deposits in this unique interest rate cycle, members may conclude that a prudent asset/liability management approach would be to layer in advances to offset possible shortfalls in longer-duration liabilities if the deposit base rapidly erodes.

Term Funding Options

In addition to straight bullet advances, the Callable Advance, the Fixed-Rate Advance with a LIBOR Cap (Fixed-Rate with a Cap), and the Amortizing Advance are all funding alternatives worthy of consideration by members seeking to lock in term funding:

» **Callable Advances** give the member the option to extinguish the advance, in whole or in part, after an agreed upon call period. If the interest rate environment changes during the life of the advance, the member is not stuck with long-term "out of the market" funding — they have the option to call the advance and rebook the funding at a more advantageous rate. If prepays are higher than anticipated and the mortgage portfolio pays down, 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.

» **Fixed-Rate with a Cap Advances** lock in term funding and have an embedded cap. The cap is tied to a 3-month LIBOR strike threshold. If the 3-month LIBOR rate rises and breaches the cap, the advance, on a 1-to-1 or 0.5–to-1 basis, declines in cost for every basis point 3-month LIBOR is above the cap.

In a rising rate environment, the cost of this advance reduces as the cost of other liability categories increase. This advance is especially beneficial when performing regulatory shocks, as this advance would mitigate net interest income at risk and become "in the money" when looking at Economic Value of Equity at risk.

» **Amortizing Advances** can be a good option to match-fund mortgages, mitigate interest rate risk, and to preserve spread. Amortizing Advances can be structured to specifically match the anticipated cash flows of a single transaction or an entire mortgage pool, with a choice of amortization schedules and maturity terms out to 30 years. This can enable a member to lock in a spread for a period of time with the advance extinguishing according to the average life of the match-funded asset. See the September 2013 *FHLBNY Advantage* for more information on the Amortizing Advance.

For more information on the funding strategies discussed, contact a Calling Officer at (212) 441-6700.

The FHLBNY wishes you a wonderful holiday season and a prosperous 2014. We are looking forward to partnering with you in the coming year!

Feedback Welcome

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

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