THE OLYMPICS, SWIMMING, AND INTEREST RATE RISK

by Steve Brown

The Olympics have their ups and downs. We remember Nadia Comaneci's perfect 10, the U.S. men's basketball dream team in 1992 and the 1980 U.S. hockey miracle win. But we also remember the Ben Johnson doping scandal, and the "soap opera drama" of figure skater Tonya Harding and Nancy Kerrigan.

Interest rates, like Olympic moments, also have ups and downs. Like the events surrounding the games, interest rates are difficult to predict. Historically, short-term rates have been directed primarily by the FRB, while long-term rates were largely market driven and only loosely associated with monetary policy. Recently, nearly all rates have been driven by market conditions outside the control of any central bank.

This creates a problem because no one can correctly predict interest rates. They are driven by market conditions and no one can predict all market conditions. In fact, even short-term rates are difficult to predict because of divergent views by key players and continuously unfolding market conditions. As the old saying goes "How can you tell when an FOMC member is unsure about his/her position on interest rates? His/her lips start moving." Over the past few months FOMC members have expressed divergent views on rates. While many members have said they are likely to leave rates unchanged for the near future, some state the exact opposite. A week ago, Philly FRB President Charles Plosser (non-voter) said the central bank should raise interest rates "sooner rather than later." At the same time, FRB Governor Kevin Warsh (voter) said in a speech that the "real economy is underperforming," which seemed to point toward an "on hold" FOMC position for now.

What's a banker to do in the meantime? The answer is to manage for the longer-term but be cognizant of the short-term. Note for instance that the Fed Funds rate has averaged 4.61% over the past 20Ys. It has been as high as 9.875% and as low as 1%. Given that the rate is currently 2%, the FRB is being very accommodative right now. Barring a disaster, if history is any guide, the next rate move should be higher.

The Fed Funds futures market (as can be seen in the grid below) also projects that. While the next shift in the Fed Funds rate is not projected until early 2009, these numbers can be quite volatile and unpredictable.

Banks are in the risk business, but predicting the future is a dicey proposition. Even the Fed Funds futures market stops posting meaningful rates beyond 6 months (i.e. contacts become very, very thin beyond 2008).

What are the practical implications for independent banks? First, consider the interest rate outlook for a given asset or liability. A 10Y loan for example, has a duration of around 7 (depending on the amortization, etc.). Next, take into account the bank's overall interest rate risk position. It is critical to understand how new assets or liabilities interact with the existing structure of the balance sheet at both the instrument and overall company level. Third, keep in mind that regulators require banks to have a comprehensive risk management process in place to identify, measure, monitor and control interest rate risk. Proper modeling and analysis are crucial to understanding the overall risk position of the organization. Finally, the board of directors is responsible for approving strategies and polices with respect to interest rate risk. Management must ensure it is taking the steps necessary to monitor and control these risks and the board should be informed regularly of risk exposures.

We'll have more to say about interest rate risk management in upcoming publications. In the meantime, we'll be keeping our eyes on Fed Funds rates and be pulling for Michael Phelps who could break the 1972 record set by Mark Spitz of 7 gold medals in one Olympic Games.

BANK NEWS

Benefits of Trust

According to a survey of 3,200 consumers, banks with the highest level of trust captured over 50% of a customer's business compared to only 34% for banks with the lowest results. Nearly 85% of local bank and credit union customers trust their primary bank completely or mostly, compared to less than 70% of customers whose banks are in the top 12 largest in terms of asset size.

Bankruptcies

According to research from Bain & Co., as many as 75 corporations may file for bankruptcy this year and more than 100 may do so next year. For comparison, there were 13 filings in 2007 and the record was hit in 2001, when 263 public companies fell into bankruptcy.

Citi

A preliminary agreement was reached between Citigroup and the NY AG that will likely result in the Bank repurchasing $8B of auction rate debt and paying a fine of $100mm. The AG felt Citigroup did not fully disclose the risks to both retail and institutional buyers of these commercial paper-liked instruments and failed to honor its liquidity obligations.

ECB

As expected the European Central Bank kept rates unchanged. While their target rate remains at a 7Y high, like the Fed, the ECB is increasingly worried over inflation and growth.