RATE ARBITRAGE AND FUNDING STRATEGIES

by Steve Brown

There are only 2 ways to make money in banking. One is to manage customer profitability so that, like a retailer, you are able to derive a risk-adjusted return above your cost of capital. The second way is to position the bank so that it can arbitrage risks such as credit, interest rate, liquidity, etc. Arbitraging is easier to execute, but much more difficult to pull off consistently over time. The good news is that there is nothing wrong with either method and most banks use a combination of the two. However, the key to successful management is to focus on the first and know exactly when you are trying to take advantage of the second. We bring this up as an interesting interest rate arbitrage has surfaced in the market that has many banks talking. Namely, with the release of the FOMC rate guidance, there is currently a 35bp difference between the forward curve and implied rates forecasted by each of the FOMC members from today until 2014. Put another way, the market is predicting something different than the Fed is predicting. If you are asking which one to believe, the answer is that the Fed, with their control over monetary supply and power in the media, has been much more accurate over the last 4Ys. This is leading many banks to ask, how do I take advantage of this? Of course, there are many different ways but until this situation corrects, it would be a mistake is to book any material amount of fixed rate assets. Booking a 5Y fixed rate loan for example would place your bank at a disadvantage if Fed member projections are accurate; to the tune of about a 9% loss in profit over the life of the loan (compared to if they would have structured the loan on a floating rate basis). Of course the reverse is also true, as banks should think about extending liability duration. This can be done through natural funding, caps, CDs or by using FHLB advances. All of these are fine (although we heavily favor the first), but one particularly popular strategy given current interest rates is the utilization of FHLB advances. Here, many banks consider taking out an advance with a low starting rate that rises in the future (this includes the popular "short fund with a strike" structure). This allows banks to garner a larger margin now, when it is needed, but upside is given up as soon as rates rise. In similar fashion, many banks are thinking about paying a penalty and terminating advances. This can be done by terminating funding and expensing the penalties or by restructuring the advance to include the previous advance penalty (thereby allowing the amortization of the penalty over the life of a new advance). Most of these strategies work best when shorter term rates pivot upwards more rapidly than longer term rates - a situation we may be facing given the latest FOMC positioning. The question becomes, should you take advantage of this? Astute bankers know that for any of these strategies to pay off they not only have to be correct as to the direction of rates, but also in the amount of movement and the shape of the yield curve. If the 10Y rate goes sky high, the banker may have the future direction of rates and the basis point movement of rates correct, but that type of steepening will do little to benefit the bank. If you are a Liability Coach customer, you can simply call us and we can bring out one of our many calculators that will look at various funding strategies against current and future rates. If you are quantitatively inclined, you can also present value the cash flows yourself of different funding strategies and take into account optionality. Once this is done, you can assign probabilities of potential rate moves (or you can call us and we will give you the implied probabilities); so you can make a decision on which strategy is best. However, if you don't have the time or the inclination to do any of the above, we might suggest holding off on any funding restructuring, as you have a high probability of compounding your current problem. Given the above, our general advice is to be cautious about extending funding terms and to be equally cautious about pricing deposits (especially shorter-term ones) to avoid contributing to interest rate sensitivity in the future. Any strategy should be run against a series of scenarios (including non-parallel interest rate shifts) and movement of more than 400bp, to ensure compliance with risk policies. Because it is difficult to see the future and execute on market arbitrage, the best defense against all types of interest rate movement is to spend your resources developing a product structure and customer base that has a long liability duration and is highly positively convexed in order to ensure that positive risk-adjusted spread that is so crucial for banks to make money.

BANK NEWS

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SunTrust Banks will buy FirstAgain LLC for an undisclosed sum, as it seeks to increase direct online lending. FirstAgain specializes in providing direct unsecured loans to super-prime borrowers via the Internet and operates proprietary technology offering clients' completely digital and paperless origination, underwriting and servicing.

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U.S. Bank will buy the Indiana trust corporate trust business from UMB Bank for an undisclosed sum.

Business Lending

The Fed indicates about 15% of U.S. banks saw higher demand for C&I loans from small businesses, the largest net percentage since 2005. Meanwhile, the same survey found fewer bank lenders expected improvement in the credit quality of C&I loans to smaller firms; most expected the quality of residential real estate to remain the same and some banks eased terms and reduced spreads on CRE lending.