Flowing Water & Funding Hedges

by Steve Brown

Water is constantly flowing all around the world, which is why we found some statistics about this very subject quite interesting. At the highest level, about 71% of the Earth's surface is water-covered vs. 29% covered in land. Also interesting, of the portion that is water, about 96% is in salt water in our oceans vs. about 4% that is fresh water. Of the fresh water portion, man uses about 70% for irrigation, 20% for industry and 10% for domestic purposes. Now that you know the flow of water around the world, we focus in today on the impact of the flow of interest rates on community banks. We then pivot from that baseline to explore how banks can protect themselves, but more importantly, increase profit and capture more customers given this environment.

First, we take a look at the flow of short maturity interest rates. Following a reduction in short rates (interest rate on excess reserves, IOER or EBA rate) to 0.25% in late 2008; the Fed switched gears starting at the end of 2015 and began raising rates (by 25bp) to 0.50%. It then repeated the process in 2016 (+25bp) and took short rates to 0.75%. Then, at its most recent meeting in Mar 2017, the Fed added another 25bp increase and took short rates to 1.00%. That is where things stand now.

Next, we look forward from there. FOMC participants at the latest meeting now project an average midpoint level of appropriate short term rates of about 1.50% for 2017 (+50bp more), 2.25% in 2018 (+75bp) and 3.00% in 2019 (+75bp). Of note, the top 25% highest projections for each year would be about 1.75% for 2017 (+75bp more), 3.00% for 2018 (+125bp) and 3.25% for 2019 (+25bp). Depending on your own view and what other things happen in the economy this is something to think about given the potential for higher rates and the speed around that.

While higher rates are generally seen as good news for banks, it depends. Yes, the NIM spread will get bigger, which allows banks to make more money. This is especially true if banks can raise deposit rates slower than lending rates (deposit beta). However, given the projections above it appears funding costs will inevitably go up. That issue and the compounding one that the advantage of increased NIM spread is only there for new variable rate loan business must be considered too. Fixed rate long-term loan structures requested by customers (or currently on your books) would cause NIM to contract. That damages the benefit of a rising interest rate. Luckily, community banks have options.

The first of these is to do a loan-for-loan swap for a customer interested in a new long-term fixed rate loan. This is where you put a hedge on your books for a floating rate, in exchange for your customer's fixed rate loan. This can be complicated and there are provisions you will need to check. It is critical in this approach to get the details right. In this instance, most banks typically engage in loan level hedging to mitigate NIM issues and remain competitive on loan rate offerings.

A twist on this occurs when you have several fixed rate, 10-15Y loans on your books already. In that case, a good option is to use a funding hedge program (also known as an umbrella hedge). This hedge is structured on a broader basis as interest rate risk protection for your balance sheet. This provides your bank with a hedge for a portfolio of loans vs. a single loan. To do this, your bank purchases a pre-paid rate protection asset in exchange for monthly payments. In this way, you cut the cost of funding (COF) on your portfolio as interest rates increase and without the complexity of derivative accounting or extra steps needed for effectiveness testing. Put another way, it helps you cut through the "noise" of interest rate variability. This sort of hedge can make sense for groups of loans and against single family residential loans because it is not loan specific (which are otherwise excluded in the previously mentioned options).

We want your team to drink in new customer and loan business, without having to swim upstream and are here to help you. We are owned by community banks and we never compete with you. Give our experts a call and we can show you how to use a funding hedge or loan level transaction to address specific circumstances. All you have to do is let us know what the customer wants and we will be happy to help you structure it in the best way for your bank.

BANK NEWS

Cyberattack

The Wall Street Journal is reporting that cyber thieves who tried to steal $170mm from an Indian bank last July used methods that strongly resemble those that successfully stole $81mm from the Bangladesh central bank. Law enforcement is warning banks around the world to take extra precautions after a rash of cyberattacks in recent months.

Clawbacks

Wells Fargo reports it has clawed back $28mm of incentive compensation paid under an equity grant to former CEO Stumpf and outstanding stock options worth about $47mm from former retail bank head Carrie Tolstedt. The clawbacks relate to fraudulent sales abuses going back to 2002 that have resulted in a $185mm fine.

Rising Pressure

The Wall Street Journal reports a group of activist investors are reportedly pushing online loan platform OnDeck Capital to cut millions in expenses and get to profitability.

Digital Leadership

Deloitte research finds only 5% of companies surveyed say they have robust digital leaders in place.