Practical hedging strategies
Using derivatives to help with loan portfolios, deposit costs

A growing number of smaller institutions are deploying interest-rate hedges in ways that enable them to offer more competitive fixed-rate, long-term loans in today’s difficult environment, an industry hedging strategist points out.

They are also implementing derivatives-based hedges to provide longer term protection against possible rising liability or deposit costs in future years.

Such hedging strategies are certainly a practical alternative that CFOs may consider as a tool for managing assets and liabilities more effectively in today’s ultra-low rate environment.

Brian Matochik, hedging strategist in the derivatives product group at FTN Financial Capital Markets, Memphis, Tenn., says that some of the major derivatives strategies now being utilized include loan-by-loan hedges, interest rate caps, and deposit hedges with swaps.

Loan hedging
Commercial loan hedging by the pairing of derivative instruments with a commercial loan is still one of the primary ways that community banks are hedging interest rate risk, Matochik pointed out.

This strategy, utilized by many banks across the country, allows an institution to offer a more competitive fixed rate on a larger commercial loan than it otherwise would be able to do without the hedge, he said.

In addition, institutions are implementing interest-rate cap strategies, by purchasing a cap to hedge rising deposit costs. A cap can also provide some market appreciation in a rising rate environment, which some... continued on page 4

Deposit pricing
What to expect once rates begin rising

While no one can say for sure when deposit prices will begin their ascent from today’s ultra-low interest rate levels, statistical models may offer some insight into what to expect once rates finally begin to rise, an industry strategist says.

Based on an analysis of previous periods of rising interest rates, once a rate climb begins, it will take about 11 months for the average rate of term accounts to reach 1% and 30 months to reach 4%, says deposit pricing specialist Dan Geller, executive vice-president at Market Rates Insight, Inc., San Anselmo, Calif.

However, before the major upward shift occurs, it’s likely that longer term CD prices will continue to show even further declines.

The persistent decline in deposit rates, which started nearly five years ago, may be coming to an end: the national average rate of all liquid accounts has mostly stabilized, as have rates on certificates of deposit up to 24 months, Geller said.

Future increases
And once rates are fully stabilized on an average national basis, it will indicate that deposit rates are nearing their lowest point, an obvious prerequisite for any future increases, he noted.

“Even when deposit rates reach their turning point, it’s hard to tell exactly when rates will start rising, because of the many macro-economic variables that need to become favorable before this happens,” Geller explained.

“However, it is possible to project, with a reasonable level of confidence, the pace and extent of rate increases once they start rising.”

His analysis is based on three... continued on page 5
Mobile payments
FTC warns fast-growing risks must be addressed

A recent Federal Trade Commission report warns that protective new regulations are needed to address a multiplicity of increasing risks that threaten the growing mobile payments trend.

The FTC cited a survey of 1,000 financial services, technology, telecommunications, and retail executives which found that 83% of respondents believe mobile payments would “achieve widespread mainstream consumer adoption” by 2015.

Fever pitch
“For years, there has been growing anticipation about the use of mobile payments as a regular way for consumers to pay for goods and services,” the report said. “Recently, this anticipation has reached a fever pitch.”

However, despite those sentiments, only a small percentage of consumers with mobile devices are actually using them to make payments—and the primary reason is fear about security concerns.

The FTC report, “Paper, Plastic or Mobile: an FTC Workshop on Mobile Payments,” cited several key areas of concern that must be addressed by all stakeholders—including banks—that seek to benefit from growing mobile payments.

Major problems include: the mechanism for resolution of disputes involving payments; problematic factors affecting mobile carrier billing; ongoing consumer data-security issues; and threats to privacy, the FTC said.

The report recommended steps to solve these problems, but any resolution will require a combined effort since multiple players are involved in mobile payments. In addition to banks and credit unions, they include hardware manufacturers, operating system developers, application developers, data brokers, coupon and loyalty program administrators, payment care networks, advertising firms, and retail merchants.

The FTC’s direct regulatory jurisdiction extends to all of these entities, except for banks and credit unions. However, the agency also enforces provisions of the Dodd-Frank Act and the Consumer Protection Act regulating interchange fees, which can impact mobile billing.

First, the FTC said that entities must develop clear policies on how consumers can resolve disputes arising from fraudulent mobile payments or unauthorized charges. Consumers may fund mobile purchases using various sources—credit cards, prepaid debit cards, or charges placed on their mobile phone bills.

But under current regulations, each of these funding methods has a different process for disputing unauthorized charges, with varying levels of consumer protection. So, depending on the payment source used, consumers may or may not have statutory protections regarding mobile billing.

Risk management
Stress testing can help defend capital adequacy

A recent FMS white paper points out that the new post-recession regulatory definition of “capital adequacy” has dramatically changed the scope and importance of the enterprise risk management function.

Among other things, capital compliance requirements have become more burdensome, as regulators have essentially imposed one-size-fits-all capital rules on smaller institutions.

But the paper, “Risk management—the new ‘dark cloud’ in bank regulation has a silver lining,” also says that there’s a potential opportunity for community banks to “defend themselves” against the imposition of such restrictive capital rules; and that option is for the institution to conduct stress testing.

Authored by Kamal Mustafa, CEO, Invictus Consulting Group LLC, the report says that apart from stress testing, there really is no practical tool or methodology that would enable a bank to defend itself from the imposition of the new macro, generic risk-asset ratios. The report is available in the Member Resources section of the FMS Website at www.fmsinc.org. 

continued on page 3
Audits committees
Are your charter and code of ethics up to date?

As the need for stronger corporate governance continues to be a major industry focus, it’s important for smaller institutions to make sure that they reassess audit-committee charters on a regular basis, a recent report by McGladrey advises.

The strength of an institution’s audit committee charter is one of the key criteria that enables auditors to be effective, thus contributing to a stronger institution.

The McGladrey report, “Audit Committee Guide for Financial Institutions,” points out that an institution’s board should review, approve and revise its charter as necessary, in order to ensure that it responds appropriately to the institution’s changing needs.

That’s no small challenge in today’s environment of rapid technological change and always evolving new threats to the institution.

The audit committee charter should be sure to fit the unique needs of each institution, the report notes. “The committee’s duties and responsibilities need to be flexible enough to allow it to operate effectively.”

The report includes a sample audit-committee charter, which includes language stipulating that the audit committee shall “review and assess annually the adequacy of this audit committee charter and recommend any changes to the board.”

Mobile payments
from page 2

Unauthorized charges.

This creates a potentially confusing landscape for consumers to decide which mobile payment system to use, and how to fund their payments. Mobile-payment users also may not recognize that their protections against fraudulent or unauthorized transactions can vary greatly.

Confusing landscape

For example, if a mobile payment is linked to a bank debit card, a consumer’s liability for unauthorized transfers is limited to $50 if reported within two business days; up to $500 for charges reported after two business days; and if not reported within 60 days, the transaction may involve unlimited liability, the FTC said.

A related problem is that the mobile carrier billing platform has been hard hit by mobile “cramming,” which occurs when third parties place unauthorized charges onto consumers’ phone bills. Such “crammed” charges are a fast growing, serious issue that threatens to undermine mobile carrier billing as a legitimate and trusted payment option, the FTC said.

It’s essential that consumers understand their rights and protections when choosing whether or not to pay using a mobile device, what payment service to use, and what funding mechanism to use, it added.

Secondly, the report encourages industry-wide adoption of strong security throughout the mobile payment process. One way to maintain security for sensitive financial information and data is end-to-end encryption, it said.

However, it also underscored that under the current payment system, financial information on a card’s magnetic stripe that is transmitted from a merchant to a bank consists of the same information sent each time a consumer makes a payment. “Thus, if this information is intercepted, it can be used repeatedly for subsequent, unauthorized transactions,” the report warned.

Third, the use of mobile payments raises many more privacy concerns, due to both the high number of companies involved in the system and the large amount of data being collected. Such privacy issues are exacerbated by the consolidation of consumers’ personal information in the mobile payment process.

To accomplish this, the committee may consider retaining counsel, the independent auditor, or other consultants, for the purpose of reviewing its performance.

Not surprisingly, another closely related issue is the importance of ensuring that an institution’s code of ethics is updated. “While the audit committee is not directly responsible for establishing, monitoring or enforcing the company’s code of ethics, many companies have delegated oversight responsibilities to the audit committee,” the report says.

Interested FMS members may review the McGladrey report by accessing it in the News Archive on the FMS web site at www.fmsinc.org.

For example, in a traditional credit card transaction, a merchant has sensitive financial information about consumers, but will generally not have their contact information and a record of their location. However, mobile-payment providers potentially have access to a much larger cache of personal information stored on the consumer’s mobile device, the report said.

“Mobile payments can allow multiple players within the mobile payments ecosystem to gather and consolidate personal and purchase data in a way that was not possible under the traditional payments regime,” it said.

Privacy concerns

The report highlights the need for companies in the mobile payment sphere to practice “privacy by design,” incorporating strong privacy practices, consumer choice, and transparency into their products from the outset. Doing so, the report noted, increases the likelihood of consumer trust in the mobile payment process.

You may review the FTC report by accessing the payments section of the News Archive on the FMS Web site at www.fmsinc.org.
institutions view as an ancillary benefit for hedging against market-value losses.

Since the beginning of the year, another strategy that has been rapidly growing in popularity involves the use of pay-fixed, interest-rate swaps to hedge short-term, re-pricing deposits.

**Hedge accounting**

This strategy effectively locks in a spread, versus a pool of fixed-rate assets, and in many cases, a smaller institution can elect hedge accounting, Matochik said. “In contrast to (the strategy of) converting a pool of fixed-rate assets to a floating rate—which in a lot of cases can be tricky from an accounting standpoint—what we see institutions doing is hedging liabilities and locking in a fixed rate on the liability side of the balance sheet.”

“Competition remains fierce in most markets for loans, and borrowers continue to seek long-term fixed rates,” Matochik said. Thus, if institutions want to be competitive with their loan offerings, especially for high quality credits, offering long-term fixed rates is “almost inevitable.”

So, many institutions have been utilizing hedging programs to offer fixed rates to commercial borrowers, which eliminate interest rate risk on a loan-by-loan basis. “However, for other types of loans, and for loans that may not be a good fit for individual loan hedging, a deposit hedge presents an opportunity to hedge this risk on a macro basis,” he added.

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**The deposit-hedge strategy effectively locks in a spread, versus a pool of fixed-rate assets, and in many cases, a smaller institution can elect hedge accounting.**


The deposit-hedge strategy is typically applied to “high-tier” money market accounts, which usually have larger balances, and converts them to a fixed rate. “This effectively creates a fixed margin when paired with fixed-rate assets and eliminates interest rate risk for the hedged amount,” he said.

In many cases, such high-tier, re-pricing accounts are similar to investor accounts in that they historically track a rate index, such as one-month LIBOR. And if there is a high correlation to that index over time, it’s possible to establish a pretty strong hedge relationship, he explained.

Such a hedge converts the deposit rate, which is usually pretty close to what one-month LIBOR is today, and locks it in long term. Many institutions have been implementing this type of hedge, going out about five to 10 years, he noted.

“For example, let’s say you had $25 million in a high-tier money market account—you can essentially carve out $10 million of that balance and convert it to a fixed rate,” Matochik said. Thus, an institution can lock in the hedge’s fixed rate starting today, or lock in now for a fixed rate beginning at some point in the future—say, in 12 or 18 months.

“You are essentially protecting those deposit costs from rising over the long term,” he said. “And it gives the institution the ability to keep in step with LIBOR with the knowledge that they are hedged and they are protected from interest rates rising, because they have locked in a fixed rate on those deposits.”

**Expected runoff**

As part of the strategy, the other $15 million could remain in the MMA.

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**How to set up or fine-tune your hedging program**

If an institution is looking to launch, or fine-tune, a hedging program, industry strategists suggest the following steps:

- Isolate the objectives for hedging, based on the institution’s overall situation and balance sheet position.
- Put in place a policy on hedging that is approved by the institution’s board of directors.
- Determine the appropriate hedging strategy and items to be hedged. This derives from the institution’s overall asset-and-liability strategy and risk management objectives.
- Review plans and hedging policy with auditors and banking regulators—it’s important to ensure that they are on board.
- Set up dealer counter-party documentation. An International Swaps and Derivatives Association (ISDA) agreement is essential.
- Manage periodic valuations and FASB ASC Topic 815 accounting on an ongoing basis. There are services that do this, or it can be done in house.
cycles of historical interest rate increases that took place within the last 20 years—between April 1993 and December 1994, between January 1999 and November 2000, and between August 2003 and July 2007. While the rate increases during each of these three time periods varied, the pace of annual percentage-yield increases exhibited exceptionally high and very significant correlations, despite different economic conditions during each of the periods, he explained.

Using an average of the increases during the three periods to smooth out variances, Geller constructed a time-series model. His analysis included a projection for the average of certificate-of-deposit accounts for all terms from three to 60 months, and the average of liquid accounts, which includes checking, savings and money market accounts.

Expected trends

Given the results of his model’s analysis, Geller has concluded that the average rate of liquid accounts will be much lower for liquid accounts, because traditionally such as checking, savings and money market accounts, because usually their rates are lower,” Geller said.

He underscored that knowing the projected velocity of rate increases can be helpful to smaller institutions in anticipating potential pricing changes that competitors will make for their deposit products.

“I would say that by the end of this year, we will pretty much see the stabilization of rates across all deposit products on the national level.”

Dan Geller, Executive Vice-president
Market Rates Insight, Inc.
San Anselmo, Calif.

In addition, an understanding of the expected pace and extent of rate increases can also be beneficial for institutions that are working to develop budgets and analyze risks related to interest expense, based on anticipated liquidity needs.

However, he cautioned that it may take a while for deposit prices overall to begin rising. While much deposit-price stability has taken place, the cost of funds for institutions will gradually decrease even more starting this fall, as five-year certificates of deposit issued during the latest rate peak in September 2008 mature.

Geller explained that the yield on the five-year certificate of deposit reached its latest peak of 3.39% after fluctuating throughout 2008. From that point on, yields of the five-year CDs declined all the way to their current average rate of 0.79%.

“Starting in September of this year, the cost of funds on the five-year CD portion of deposit balances will gradually decline as certificates of deposit with relatively higher interest rates will start maturing,” Geller said.

He explained that the five-year certificates of deposit are the last of the highest-yielding deposits issued in 2008 when interest rates were still relatively high. CDs of lesser terms, such as the four, three, and one-year CDs issued during 2008 have already matured. And all new or rollover certificates of deposit were issued at lower interest rates.

The exact amount of bank balances to be impacted by the lower cost of funds is unavailable, since the FDIC does not release separate balances of five-year certificates of deposit. However, FDIC data shows that as of December 2012, there were about $180 billion in CD balances of three- to five-year terms, which means that part of that balance will gradually carry a lower cost of funds staring this fall.

“The maturation of the five-year certificates of deposit from 2008 is a mixed bag,” Geller said. “It will adversely impact those who depend on higher interest rates as income, but it might make loan rates more attractive due to declining cost of funds.”

Rate stabilization

“I would say that by the end of this year, we will pretty much see the stabilization of rates across all deposit products on the national level,” he said.

Geller advised that once rates start rising, institutions would be wise to lock in as much long-term money as possible, because they will only get more expensive over time.

In addition, they should perform a risk analysis to determine the level of liquidity that they will need going forward. “Rising rates on deposits are an indication of increased demand for loans—they always go together,” he added.

“But this is not the case of chicken and egg—loans come first,” he said. “You have to have demand for loans, which will trigger higher interest rates on loans.”

And obviously, it makes sense to keep a very close eye on the competition, because when rates start rising, the competitors “might up you a few basis points.”

Interested FMS members may review further developments on deposit pricing strategies in the asset-liability management category of the News Archive on the FMS website at www.fmsinc.org.
# Regulatory and Accounting Checklist

These proposals may be accessed through the FMS Web site at [www.fmsinc.org](http://www.fmsinc.org). Go to the Members Only section and follow the Regulations/Proposals link for direct access to the following documents.

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<th>Topic</th>
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<td><strong>Accounting for Credit Losses on Financial Instruments</strong></td>
<td>FASB: The FASB proposed changes aimed at improving the accounting for credit losses on loans and other financial assets, and to provide more timely recognition of credit losses. Comments Due: April 30, 2013</td>
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<td><strong>Financial Market Utilities</strong></td>
<td>Fed: The Fed proposed rules to set requirements for a Federal Reserve Bank to maintain accounts and provide services to financial market utilities designated as systemically important. Comments Due: May 3, 2013</td>
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<td><strong>Annual Stress Test Reporting</strong></td>
<td>OCC: The OCC proposed a notice of information collection for the reporting of annual stress tests for covered institutions with consolidated assets of $10 billion to $50 billion. Comments Due: May 10, 2013</td>
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<td><strong>Financial Instruments Recognition and Measurement</strong></td>
<td>FASB: The FASB issued a proposal to improve financial reporting by providing a comprehensive framework for recognition and measurement of financial assets and liabilities. Comments Due: May 15, 2013</td>
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<td><strong>Credit Union Ownership of Fixed Assets</strong></td>
<td>NCUA: The NCUA proposed changes in the rules on credit union ownership of fixed assets, in order to help CUs understand and comply with its requirements. Comments Due: May 20, 2013</td>
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<td><strong>Community Reinvestment Q&amp;A</strong></td>
<td>Fed/FDIC/OCC: The agencies proposed changes to interagency questions and answers regarding community reinvestment. The Q&amp;A provide guidance to institutions on CRA regulations. Comments Due: 60 days after publication in <em>Federal Register</em></td>
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<tr>
<td><strong>Non-bank Student Loan Servicers</strong></td>
<td>CFPB: The CFPB proposed a rule that would allow it to supervise certain non-bank student loan servicers for the first time. The rule would bring new oversight to a rapidly growing market that has seen rising borrower delinquencies. Comments Due: 60 days after publication in <em>Federal Register</em></td>
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<td><strong>Call Reports</strong></td>
<td>Fed/FDIC/OCC: The Fed, FDIC and OCC proposed revisions to the Call Report that would take effect in June 2013 and are intended to provide data needed for safety-and-soundness purposes. Comments Closed: April 22, 2013</td>
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<td><strong>Derivatives and Hedging</strong></td>
<td>FASB: The FASB issued a derivatives-and-hedging exposure draft on the inclusion of the Fed funds effective swap rate or overnight index swap rate as a benchmark for hedge accounting purposes. Comments Closed: April 22, 2013</td>
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<td><strong>Income Taxes (Topic 740)</strong></td>
<td>FASB: The FASB issued an income-tax exposure draft on the presentation of an unrecognized tax benefit when a net operating loss carry-forward or tax credit carry-forward exists. Comments Closed: April 22, 2013</td>
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<td><strong>Deposit Insurance Regulations</strong></td>
<td>FDIC: The FDIC is proposing rule changes that would clarify that deposits in the foreign branches of U.S. banks are not FDIC-insured deposits. Comments Closed: April 22, 2013</td>
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account, to be managed in the normal fashion. That’s because as rates rise, some runoff is likely to take place, with dollars leaving the account to move elsewhere as customers seek out other sectors in the market for higher returns.

“You want to target an account where you can hedge just a portion of that account—maybe up to as much as 75%; but you also want to prepare for some of that balance to be run off over the next several years,” Matochik advised. “So at any given time you don’t want to be in an over-hedged position, because then you would essentially be paying a fixed rate for funds that aren’t even there.”

Of course, in the event that a balance becomes lower than the hedged amount, the institution could unwind a certain portion of that hedge at any time.

**Loan pools**

In targeting the various accounts to hedge, many institutions will target a pool on the asset side that otherwise could not be targeted on a one-to-one basis. For example, the accounts might be a pool of consumer loans or residential mortgages—typically items that would be difficult to hedge on a loan-by-loan basis.

And after institutions target a relatively homogeneous pool of assets on that side of the balance sheet, they can then use the pool of deposits to hedge the interest rate risk. “One of the primary benefits here is that you do not have to inflate the balance sheet,” Matochik noted. “This hedge will go on your balance sheet and hedge liabilities that already exist.”

As a hypothetical deposit-hedge example, he explained that an institution might target a loan portfolio with an average life of seven years and an average yield of 3.50%. Locking in a fixed-rate hedge against a deposit account with rates at or near one-month LIBOR would generate a current spread of around 195 basis points for the next seven years, he said.

“You want to target an account where you can hedge just a portion of that account—maybe up to as much as 75%; but you also want to prepare for some of that balance to be run off over the next several years. So at any given time you don’t want to be in an over-hedged position, because then you would essentially be paying a fixed rate for funds that aren’t even there.”

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**Brian Matochik, Hedging Strategist, Derivatives Product Group**  
FTN Financial Capital Markets  
Memphis, Tenn.

Thus, the institution would be locking in a spread between the 3.5% yield on the loans, versus the fixed rate on the swap. “So the pay-fixed swap rate is 195 basis points lower than the 3.5% yield that you are earning on the assets,” he added.

By using the hedge strategy, an institution can lock in a lower rate, enabling it to generate some additional spread, and be more competitive in offering fixed-rate loans. “You may be able to price them a little lower, due to the efficiency that you’re gaining on the hedge,” he added.

For smaller institutions, he added, it’s important to remember that the larger banks are frequent lenders, and thus, to continue to compete effectively, community institutions will likely need to adjust their asset-liability management programs in order to stay competitive.

It’s also important to remember that many competitors are already using such strategies. “Most of the larger institutions are using some form of hedge in the current environment to protect themselves from rising rates,” he said.

**Accounting issues**

As for accounting issues, Matochik said that smaller institutions have found it a little easier to establish hedge accounting with deposit hedges, as compared to doing so for the hedge strategies involving fixed-rate loans on the asset side of the balance sheet.

“I would emphasize for community banks in particular that it will be important to look at the accounting for these types of hedges, and to obtain hedge accounting whenever it’s possible—especially if you start to do larger size swaps,” he said. In addition, it makes sense for institutions to consider partnering with a counter-party that can offer assistance with the hedge accounting.

Finally, Matochik pointed out that with the recent impact of the Dodd-Frank Act, there are some new regulations that affect swaps, even at the community-bank level. Thus, it’s important to be knowledgeable about the new rules, especially as they relate to swap reporting—another area where a counter-party can provide assistance.

Countering a commonly held perception, and fear, Matochik also advised that the hedging process doesn’t have to be overly complicated—and it’s a very beneficial tool that community institutions can and should utilize, especially in preparing for a rising-rate environment.

You may review further perspective and insights by searching for “hedging” in the Industry News Archive on the FMS web site at www.fmsinc.org.
FMS Education Calendar 2013

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Seminars
Chicago, Illinois
May 7-8       Enhancing Your ALM Modeling Process
May 9-10      Best Practices in ALM
Baltimore, Maryland
May 14-15     Internal Audit of Credit and Lending Operations

Webinars
May 6, 13 & 20 Deposit Management: Advanced Topics
May 7 & 14    Enterprise Risk: Integration with the Asset Liability Process
May 16 & 23   Two-part Series – ALM for Board and ALCO Members
May 23        Credit Risk: Management & Integration with ALM

(Calendar is subject to revision when program changes occur.)
For details, visit http://bit.ly/FMSCalendar
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Please note that as of April 19, 2013 the Financial Managers Society has relocated to a new office.

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