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**Protecting Balance Sheets
in a Rising Interest Rate Environment**

June 7, 2014 | 11:45 a.m. – 12:45 p.m.
Charley McQueen

 www.mcul.org  www.uniteforgood.org

**Protecting Your Balance Sheet in a
Rising Interest Rate Environment**
June 2014



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Outline

- Interest Rates and the Fed
- Economic Trends & FOMC Data
- Industry Trends
- Interest Rate Risk Strategy
 - Cap
 - FHLB
 - Swap



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Interest Rates and the Federal Reserve

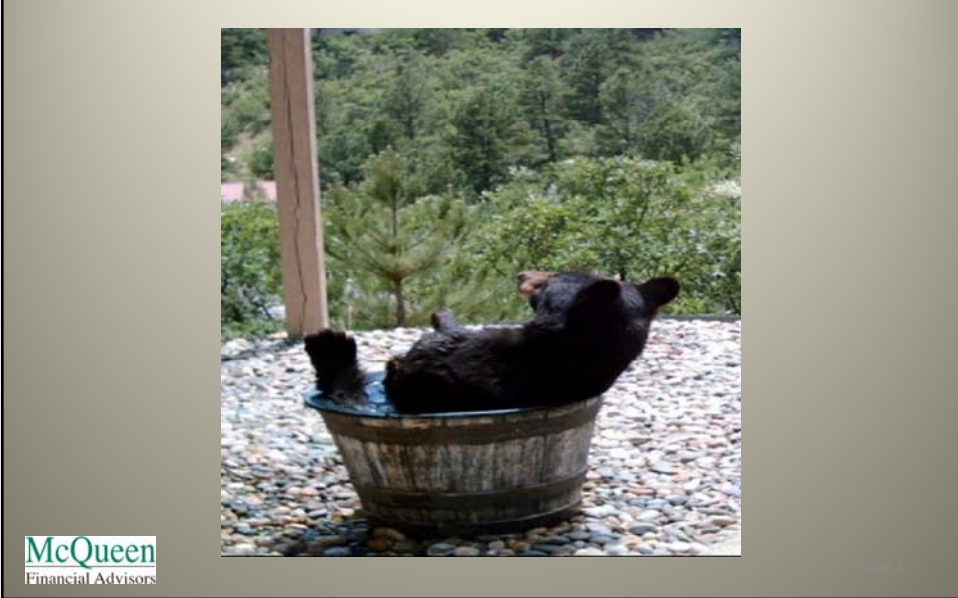
- Current Interest Rate Environment
- Fed and Bond Purchases
- Economic Data Review

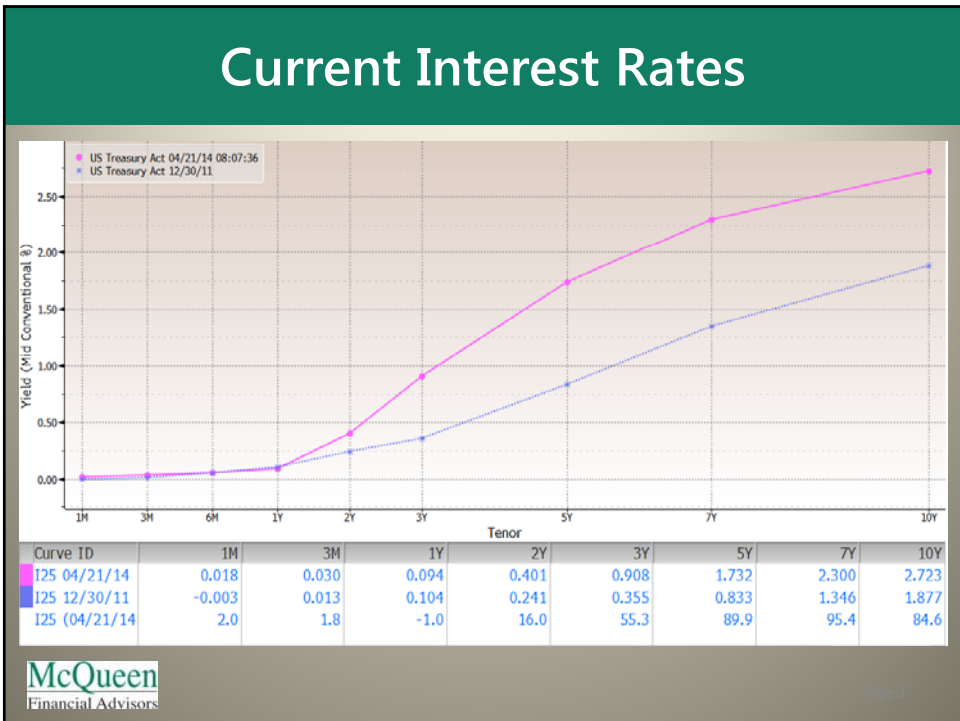
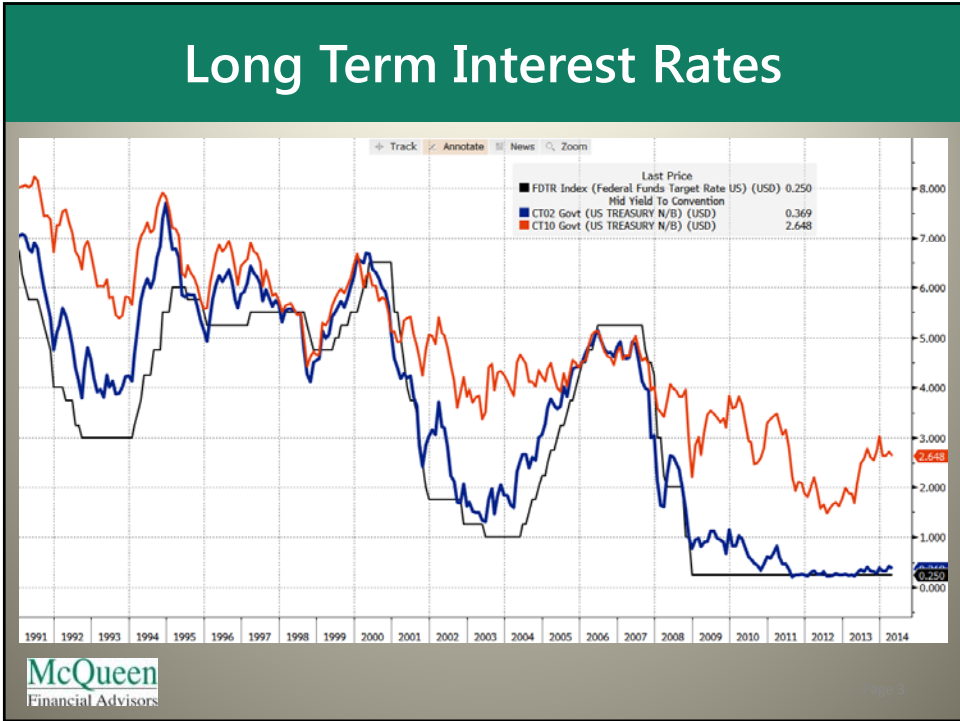


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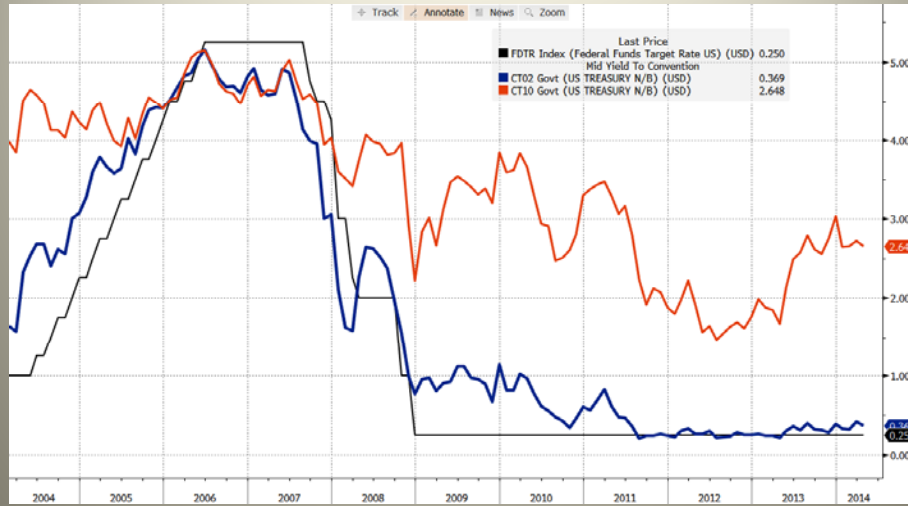


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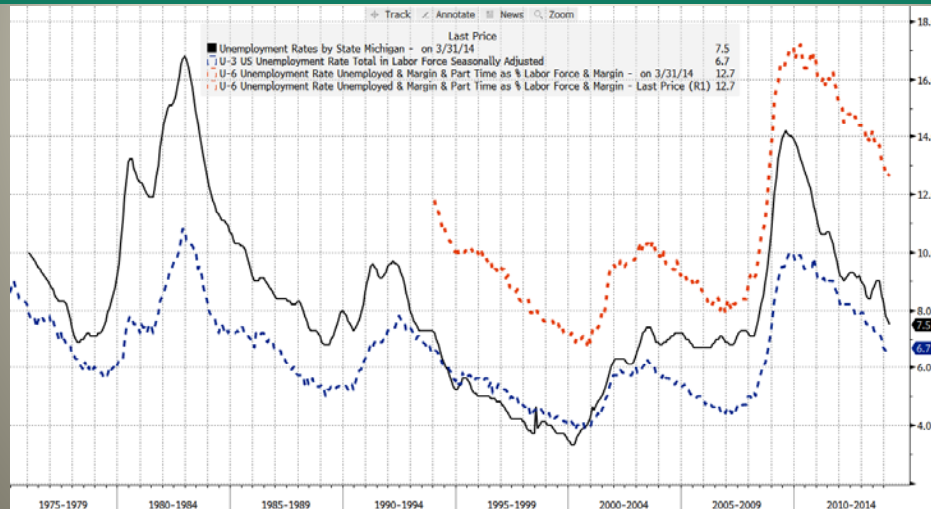


Recent Changes



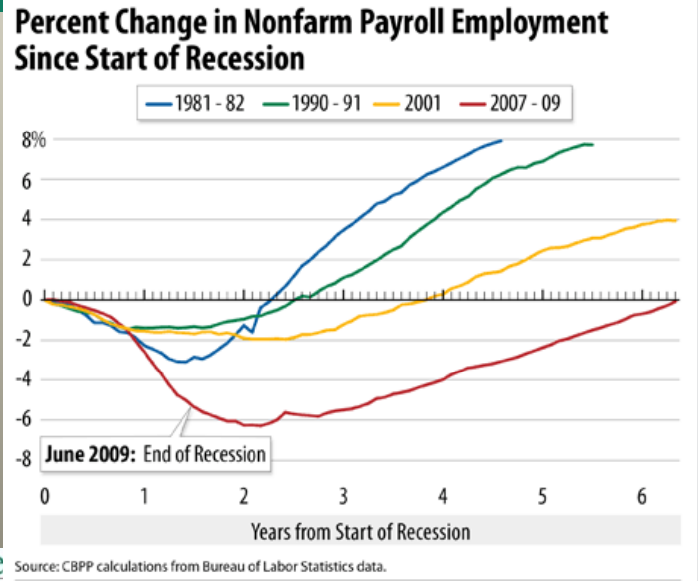
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Unemployment and U6 Unemployment



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Employment



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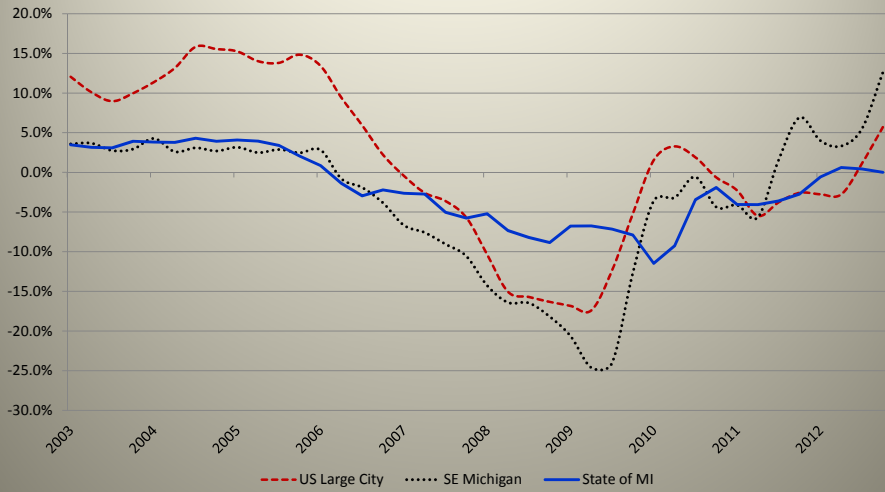
Consumer Price Index



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Source: Bloomberg

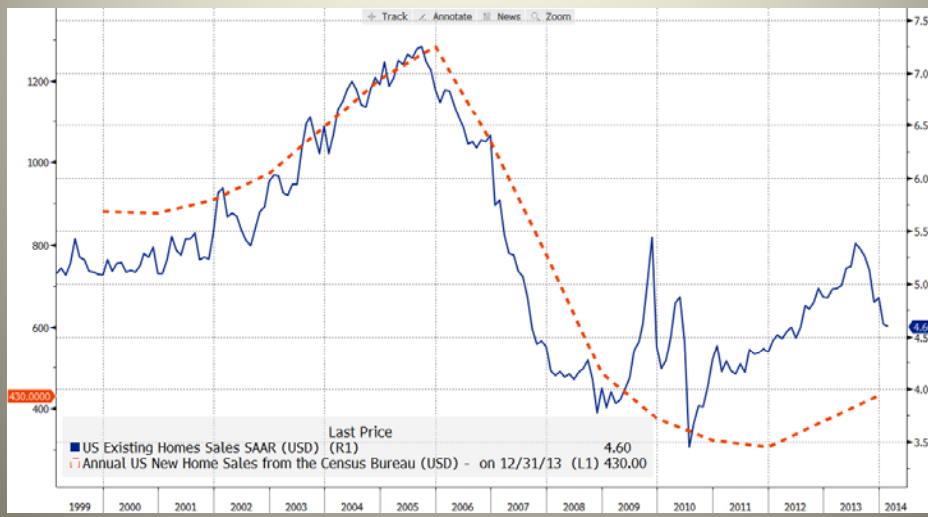
S&P Case-Shiller Composite Home Price Index Year-Over-Year: US Large City, South East MI and State of MI



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New and Existing Home Sales



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Why Are Rates Changing?

The FOMC is buying bonds:

- Buying \$45 billion a month of bonds and mortgage backed securities.
- They are buying bonds to keep long-term interest rates low, resulting in mortgage rate assistance.
- When will they stop or taper the purchases?

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When Will the FOMC Change?

The FOMC will keep buying bonds:

- Until the housing market recovers
- Economic activity returns to “normal” levels

Fed Funds Rate:

- FOMC will keep the Fed Funds rate low until **the unemployment rate declines to 6.50% and** inflation remains under control

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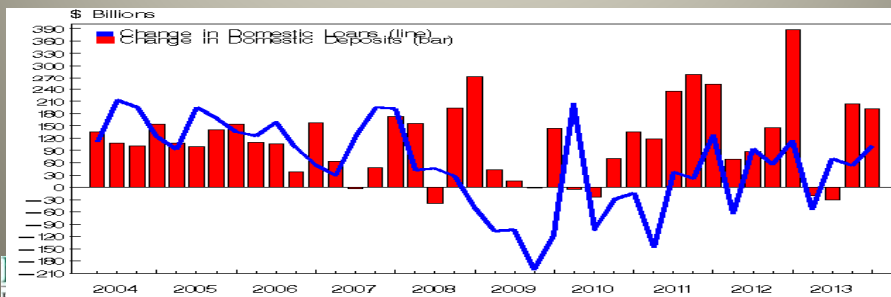
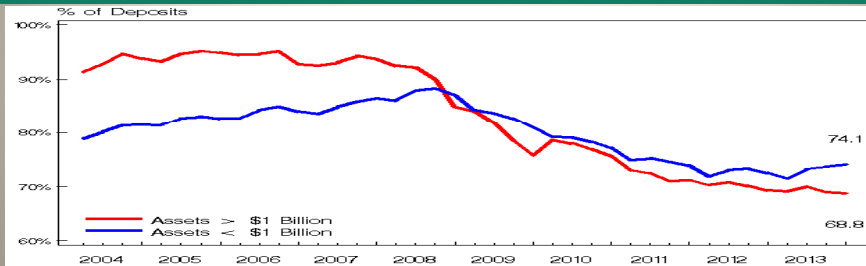
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What is going on in the industry?

- Asset Duration
- Loan to Deposit Ratio

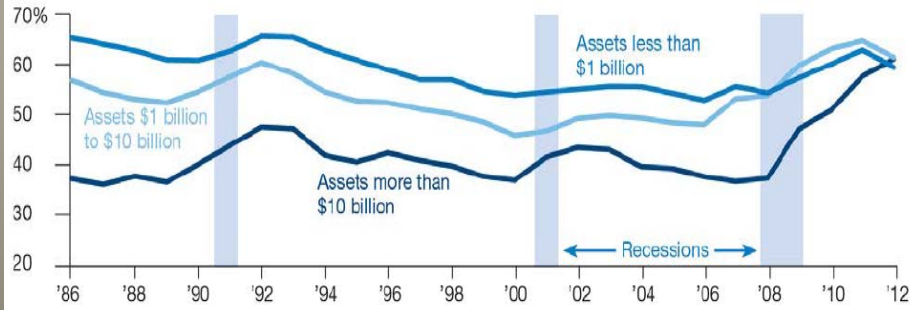


Loan to Deposit Ratio



Core Deposit Growth

Core deposits, excluding small CDs share of liabilities



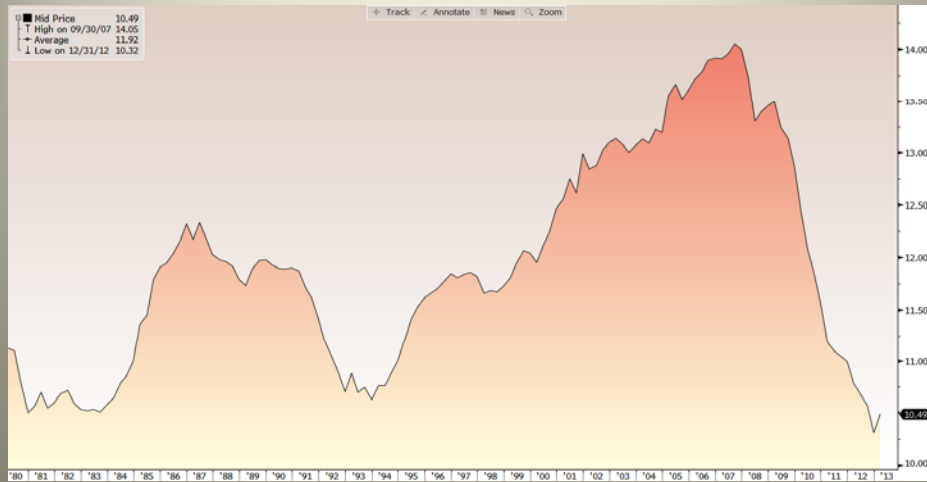
Source: OCC Integrated Banking Information System.

Note: All data as of year-end. Core deposits defined as domestic deposits less time deposits of \$100,000 or more. Ratio also excludes small CDs.



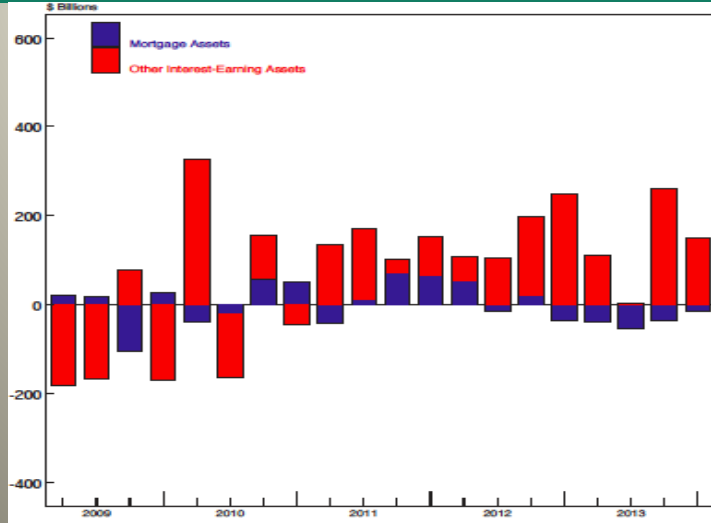
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Household Debt to Disposable



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Asset Duration



Strategies



Interest Rate Strategies

How to protect your income in a rising interest rate environment:

1. Purchase a cap on interest rates.
2. Acquire Federal Home Loan Bank (FHLB) advances.
3. Enter into an interest rate swap.

Cap

Purchase a Cap on Interest Rates:

When purchasing a cap, you buy a notional amount of protection for a stated term. If interest rates rise above a certain rate (strike price) the cap pays you. Payment is based on the interest rate above your strike price based on the notional amount. To acquire this protection, you need to pay a one-time fee.

Cap Example

- Notional Amount: \$5 million
- Strike Price (yield) _____%
- Index: 1 Month LIBOR
- Term: 7 years
- One time cost \$_____

If LIBOR was to rise from _____% today to _____%, the cap would pay out. The payment would be _____% (_____% - _____%) multiplied by the notional amount of \$5 million or \$_____. Therefore, the first quarterly payment would be one fourth of the annual amount or \$_____.

FHLB Advances

Acquire FHLB Advances:



A well tested method to improve interest rate risk is borrowing fixed rate advances from the FHLB.




When creating a borrowing strategy, it is important to remember to ladder your borrowings, just like your investment portfolio.

Interest Rate Risk Strategies

<u>Amount</u>	<u>Term</u>	<u>Rate</u>
\$1mm	7 years	____%
\$1mm	8 years	____%
\$1mm	9 years	____%
<u>\$2mm</u>	<u>10 years</u>	____%
\$5mm	8.80 years	____%


This strategy provides us with \$5 million in borrowings at an average rate of ____%.


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Interest Rate Swap

GOAL: Protect the value of the balance sheet and provide stable earnings

What is a Swap:
A Swap is the action of changing (Swapping) from one payment type to another. A fixed to floating swap is when you give a counterparty a fixed interest rate and they pay you a floating rate.





Sample Swap

Swap from a fixed payment to a floating payment

- Step 1** – Identify a partner to help you to determine if this is action will fit your needs.
- Step 2** – Identify a notional amount you would like to swap.
- Step 3** – Identify assets that you can utilize to provide the fixed payment to the counterparty
- Step 4** – Obtain market pricing to understand the fixed rate you will need to pay, and the floating rate you will receive

Sample Swap

Swap from a fixed payment to a floating payment

- Step 5** – Identify potential counterparties.
- Step 6** – Work with your accountant to understand the accounting and financial impact of a swap.
- Step 7** – Review the effect to your ALM position and ensure the outcome is worth the effort.

Sample Swap

Current Market Price

Notional Amount \$5 million
Fixed rate you will pay ____%
Floating rate you will receive LIBOR + ____% or ____%

Sample Swap


Questions to Ask

What is the effect to current income?

How much do interest rates need to rise to break even?

Summation

- Interest Rates may trend higher
- Interest rate risk protection:
 - Cap
 - FHLB Advance
 - Swap
- What is the correct cost and return that best fit your needs?



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Summation

_____	Cost	Protection
Cap		
FHLB Advance		
Swap		

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Questions

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