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Preventative Maintenance

Fixing your deposits can protect your capital and make you money

By Jim Reber

It's time to assess your community bank's fiscal health. Although it's not uniform by any means, the community banking industry has continued to improve most elements of its performance, as measured by any number of yardsticks. Earnings, though modest, are better than at any time in the last five years. Bank failures are also far lower than in the recent past. Capital levels are much higher than those before 2008.

The lowly deposit base has been oft-neglected during this time frame. From my perspective there are three reasons for this. First, they don't represent any credit risk to a bank. That, in fact, was ICBA's chief argument for successfully reconfiguring the FDIC deposit assessment math several years back, to the everlasting benefit of 98 percent of community banks. Secondly, banks have been tidal-waved with deposits recently, because thirdly loan demand has been weak.

And since demand for the safe haven of FDIC-insured deposits outstripped the need, rates paid have fallen to all-time lows. Average all-in cost of funds for banks of $1 billion assets and under were only 55 basis points as of June 30. So with this as a backdrop, let's consider longer-term wholesale borrowings.

Move out on the curve

Ironic, it may seem, for an investment column to suggest that a community banker consider extending the maturities on deposits. After all, the steepness of the yield curve, which seems likely to persist for maybe two more years, would appear to guarantee a higher cost of funds for longer durations. But that doesn't mean it's not a good idea.

Currently, Federal Home Loan Bank advances can be accessed with a floating rate feature and a six-year maturity at a rate of about one-month LIBOR plus 20 basis points, or about 38 basis points (0.38 percent). One can execute an interest rate swap to fix the rate at about 2.00 percent for the term. This will be around 15 basis points less expensive that taking down fixed-rate advances directly. This itself is good, but there's more.

Asset/liability sync

A reasonable match to a longer-term deposit is a 20-year, 3.00 percent mortgage-backed security (MBS). Purchasing roughly equal amounts of this fixed-rate funding can produce a number of benefits. The most obvious is a well-structured leverage that produces a spread of around 100 basis points. The average life of the MBS will likely be within one year of the term of the advance, so an asset/liability match, while not perfect, will essentially be achieved.

Just as important, but perhaps under the radar, is that fact that a rise in rates will create a gain on the interest rate swap. If a borrower has a "pay fixed" posture, as it does in this example, the funding will gain value if interest rates increase. While economically the same would occur if the advance had been originally a fixed-rate FHLBank advance, the pay-fixed swap gives the borrower (your bank) the ability to actually realize and monetize the gain if desired by collapsing the leverage early. And there's still more!

Capital insulation

Unrealized gains and losses on Available For Sale securities are an element of accounting capital or

M&A Leader

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tangible common equity. I believe that much has been well-digested by community bankers by now. It's able to be excluded from regulatory capital per the recent Basel III rulings, but still affects GAAP capital.

If the strategy above is employed, and the interest rate swap achieves hedge accounting qualification, the market value of the swap is likewise run through GAAP capital. Since the duration of the asset (the MBS) and the liability (the advance) are roughly similar, the effect on tangible common equity from rate movements has effectively been removed.

To review

» Borrowing wholesale from the FHLBank on a long-term floating-rate basis, and swapping to fixed, can achieve a low-cost, desirable deposit.

» By pairing that deposit with a similar-duration asset, like a 15- or 20-year MBS, one can lock in a decent spread with a tolerable asset/liability match.

» The interest rate swap can be terminated early, if the capture of a gain (or a loss for that matter) has benefits for the community bank.

» GAAP capital can be insulated against wide swings by the pairing of a swapped advance and similar-duration assets.

Transactions such as these have helped hundreds of community banks stay up-to-date on their income statement and capital maintenance. IB

Rate Swap Advice

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