

# Bank Asset/Liability Management

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Prepared by Mary Brookhart

## Escaping the Horns of a Dilemma

The current market environment, characterized by historically low interest rates, slack loan creates a huge challenge for bankers. Strong deposit growth provides the raw materials needed for balance sheet growth, but slack loan demand is forcing banks to put those deposits to work in the bond portfolio or let them sit idly in cash. With the yield curve flattening & rates hovering near all-time lows, it is increasingly difficult to generate spread income without taking on significant interest rate risk.

The short & intermediate part of the yield curve provides a safe place to park excess deposits. Unfortunately, you would have to extend out beyond 5 years just to pick up a 1% yield in agency securities. On the long end of the curve, municipal securities offer the greatest relative values. Beyond 10 years, the bank-qualified municipal yields beat most investment alternatives, while outside of 15 years, the municipal yields surpassed all other options. The opportunity is most evident when you observe the steepness of the municipal yield curve relative to the agency curve (see complete issue for Exhibit 1). The 10 year municipal spread over agencies is 165bps, while the 25 year municipal yields 257bps more than agencies.

The good news is that you can pick up very attractive yields by extending maturities on the municipal curve. The bad news is that doing so creates a tremendous amount of price volatility & IRR. Add to that the notion that current deposit growth trends could reverse when the economy improves, forcing banks to liquidate these bonds in a higher rate environment & we find ourselves being impaled on the horns of a dilemma.

**Interest Rate Swaps.** What if a bank could capture the attractive spreads available in the municipal market & minimize IRR & price volatility? Enter the plain vanilla interest rate swap. Interest rate swaps are designed to convert the rate basis on an underlying financial instrument from fixed to floating or vice versa. In the case of a fixed rate municipal security, a pay fixed interest rate swap can be used to convert the fixed rate on the municipal security to a floating rate. Combining pay fixed interest rate swaps & fixed rate municipal securities allows banks to create their own attractively priced

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floating rate assets & minimize the price volatility associated with long duration assets. While this transaction is very attractive from an economic standpoint, the accounting considerations can be a bit of a challenge. ASC 815 requires that interest rate swaps be carried at fair value with changes in fair value recorded in current income, & also allows for the concept of *hedge accounting* when a highly effective hedging relationship exists. Hedge accounting allows users to mark-to-market both the interest rate swap & the item being hedged. Fortunately, assets subject to ASC 320 qualify for inclusion in hedge accounting relationships if they are held in the available for sale portfolio (AFS).

**A Good Strategy.** For banks looking for income opportunities, but are concerned about taking on too much duration risk or preparing for higher interest rates, combining the relative value found in municipal securities with interest rate swaps may provide an ideal solution.

Rick Redmond, CMA  
*Vining Sparks Interest Rate Products, LLC*

To read this article in its entirety, see the January 2012 issue of  
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