Veteran portfolio managers know that a selection of investment products and services have traditionally been offered only for large banks. More recently, efficiencies have allowed a number of these to be made available for community banks, and the list continues to grow:

- Wholesale funding;
- Trust preferred issuance;
- Capital markets; and
- Third party interest rate risk consulting.

For several very compelling reasons, another item can, and should, be added to the list—interest rate swaps. Before the reader flips to the next article in this magazine, assuming rate swaps have nothing to do with his or her balance sheet management, let’s review some rate-swap fundamentals.

Swaps Defined
In its simplest form, an interest rate swap is a contract between two parties in which they agree to periodically pay interest to each other based on a theoretical principal balance, called a notional amount. One party will pay a fixed amount of interest for the entire term, and the other will pay a floating rate, usually reset every 90 days. The payments are usually made every six months, and a “net” payment is actually wired between the parties.

If a bank is asset/liability sensitive from an asset-liability standpoint, or it anticipates that short-term rates may be falling in the future, it may choose to enter into a “pay floating” swap. The risk in that event is that short-term rates either don’t fall, or worse, rise during the term of the swap.

As table 1 indicates (excerpted from icbascapital.com), the fixed-rate portion of a swap is derived from the Treasury curve, and currently is running about 50 basis points over the curve. This spread can fluctuate, and has a bid/ask spread component as well. The floating rate portion is assumed to be LIBOR flat. Notice, therefore, that at the inception of a rate swap the “pay floating” party usually will have a positive spread.

Next, if deposit gathering is a challenge for your institution (as it is in most cases), the bank could simultaneously issue wholesale CDs equal to the notional amount. In effect, it would create rate-sensitive liabilities that can then be used for leveraging, meeting loan demand, or paying down advances or other debt. The term of the CDs can be structured to coincide with the rate swap contract.

Example Quantified
We should now convert these concepts into a live example.
Assumptions:
Notional amount: $5 million
Term: Five years, callable in two years
Pay fixed rate: 5.75 percent
Pay floating rate:
3 month LIBOR flat
Initial floating rate: 5.25 percent

Ninety days from inception, the fixed-rate payer will wire $6,250 to the floating-rate payer. The calculation is: $5,000,000 x .50 percent x 90/360 = $6,250. At that point, the new floating rate is established, and 90 days hence another net interest payment is made.

A bank may have chosen to simultaneously issue fixed rate callable CDs with a five-year term that is callable in two years. The cost of the CDs to the bank is assumed to be equal to the “fixed” rate portion of the rate swap, which in this case is 5.75 percent. Since the issuer will be on the “pay floating” side of the rate swap, the net cost of the CDs is the “pay floating” rate, initially 5.25 percent.

How this Helps
If, over the next several years we see a decline in short-term interest rates, the rate swap will produce a gradually lower “pay floating” element, which increases the net profit from the transaction. This will also likely cause both the rate swap and the CD to be called, as both the “pay fixed” party and the CD issuer (i.e., the bank) could get better deals for themselves in a lower rate environment. And, even if rate swaps do not have a defined call feature, they still have a degree of liquidity, so the contracts can be bought back by either party prior to maturity.

As far as the “those who cannot remember the past” reference goes, the year 2000 comes to mind. Liquidity was low, the yield curve was flat, and the Fed had been raising rates for over a year. Sound familiar? Those banks that in the summer of 2000 executed “pay floating” rate swaps in concert with a wholesale CD issuance were rewarded handsomely. Of course, there is no guarantee of a repeat performance, but some of the fundamentals of 2000 seem to exist today.

So, for at least the two-year lockout period, the very real possibility of enhanced liquidity (through the CD issuance) coupled with declining borrowing costs (through the rate swap) makes this strategy worth considering. Rate swaps with notional amounts as small as $5 million can now be executed, which in many cases can produce a noticeable improvement in a community bank’s net interest margin.

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If you would like more information on the structuring of an interest rate swap and its potential impact on your bank’s net interest margin and asset-liability position, contact your ICBA Securities account rep or call (800) 422-6442.

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