Good balance sheet managers have had to come to grips over the last 10 years with a necessary evil in the name of profitability: Optionality.

Stated another way, ever-increasing portions of a community bank’s assets and liabilities can be converted to either cash or a different rate, at somebody else’s whim. In still other words, more and more callability exists for banks of all sizes in the investment portfolio, loan portfolio and deposit mix. What separates well-run banks from the masses in large part depends on identifying the risks imbedded and their management.

The Regulators’ Take
It has been a consistent theme among Federal Financial Institutions Examination Council (FFIEC) members that the presence of callability in the balance sheet is not a reason per se for concern. After all, community banks increasingly rely on wholesale funding sources (see Table A). What is incumbent upon the banker is the ability to demonstrate reasonable assumptions about the impact of rate changes on his or her earnings. This has resulted in more and more community banks being required to manage their interest rate risk with third-party asset/liability models.

To prove that this is not a case of crying wolf, I would ask you to consider this: As of June 30, 2006, only about 15 percent of the bonds in bank investment portfolios were non-callable. It is more difficult to assess loan portfolios’ callability, but it’s safe to say that the vast majority has no prepayment penalty. These factors can produce a whipsaw effect: lots of cash in low and falling rate periods, and little or no cash in high or rising ones.

Deposit Options
Wholesale funding, which primarily (not exclusively) means Federal Home Loan Bank (FHLB) advances, can include structures with a fixed rate for the term of the borrowing as long as LIBOR stays below a certain rate, or “strike.” If LIBOR does exceed this designated level, the advance becomes floating rate or can be paid off.

Of course, if LIBOR is above the strike level of say, 7.00 percent, any borrowing rate, fixed or floating, is likely to be on the high end. This
could be a good call or a very bad one because these “strike” advances’ original fixed rates are lower than non-strike advances.

Even more common is the convertible advance. These are fixed rate originally, but the FHLB has the option of converting them to a floating rate on specific dates. If the FHLB exercises its option, the advance may also be paid off, similarly to the strike advance described above at its own discretion. Some borrowers refer to these as “putable” advances, and they represent a corollary to callable investments in that the bank is forced to refinance its debt in high-rate environments.

Another popular time deposit offering among community banks is the “bump” CD. This gives the depositor a one-time option to “bump” the rate higher, without extending the original term of the deposit. This creates in essence a one-way floater, which of course is in the wrong direction for a bank’s earnings.

One can see just from these three examples that fairly sophisticated modeling is required to accurately reflect the income and cash flow consequences of changing rates. The same can be said for the asset side of the balance sheet. We will next look at a couple of the newer developments in callable securities as examples of recent financial engineering.

Range Notes
Range notes have been around for years, but only recently become more visible in community banking circles. Range notes as investments can come in a variety of colors and flavors, some better than others.

Earlier this year, FHLB issued a note with a 7.00 percent coupon with a stated final maturity of 2016 (10 years). The coupon is guaranteed for only 90 days, after which the bond is callable quarterly. The coupon will continue to accrue at 7.00 percent on a daily basis as long as six-month LIBOR is between the range of zero and 7.50 percent (hence the term “range note”). If LIBOR rises above the “strike” rate of 7.50 percent, interest will accrue at zero for every day the index exceeds the strike rate.

It could be argued by an investor that this is a fairly safe route for a high yield in a government-agency issued bond. January 1991 is the last time LIBOR stayed above the strike level for any time, although it exceeded 7.00 percent briefly in both 1994 and 2000. However, while the strike level may appear to be sufficient for most rate environments, the market price of a range note will begin to suffer long before the coupon gets stopped out. Add to this baggage a wide bid/ask spread, and difficulty in getting third-party market pricing and price volatility information, and one begins to realize why this note has a 7.00 percent coupon when the 10-year note is well under 5.00 percent.

Non-inversion Notes
Non-inversion notes are
a variation of the range notes mentioned above. Typically, it will be a corporate issue, with names like Lehman Brothers or Rabobank, so your investment policy sections concerning Loans to One Borrower and minimum credit ratings will definitely come into play.

The coupon will usually be fixed and non-callable for a period of time (for example, two years) after which it’s callable semi-annually. The “range” for the coupon requires some explanation.

These non-inversion notes will pay the stated coupon as long as the interest rate curve known as the Constant Maturity Swap (CMS) stays positively sloped between two points—commonly two years and ten years. Just like the range notes mentioned above, it is quite unusual for the curve to be inverted; the average is less than one day per year over the last 14 years. The bond will also stop accruing interest for every day the curve is inverted.

Recent issues of these non-inversion notes have attractive coupons ranging from 7.00 percent to 8.25 percent. As a final comment, they have these high yields at inception for a number of reasons. Make sure you, the investor, have accounted for price volatility, liquidity, bid/ask spread, credit quality and convexity as you determine the suitability of these items in your investment portfolio.

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