Bank Asset/Liability Management

Vol. 35, No. 12 December 2019

Prepared by Peter Mihaltian

In This Issue:

• LIBOR Transition Picking Up Momentum...........1

• Making the Most of Interest Rate Derivatives.......3

• Components of a Solid ALM Program……..…...4

• What A/L Managers Need to Know About Intangible Assets…………………………………......6

• 2019 Bank Asset/Liability Management Index….8

Editorial Board:

Michael Arnold, Ph.D., *ALCO Partners, LLC*
Jerry Clark , *ZM Financial Systems*
David Easton, Ph.D., *Bank of America*
Michael Jamesson, Jamesson Associates
Ira G. Kawaller, Ph.D., *Derivatives Litigation Services,*
Deedee Myers, Ph.D., *DDJ Myers Ltd.*
Rick Redmond, *Vining-Sparks IBG*
Neil Stanley, *The CorePointarling Consulting Group*
Matthew Pieniazek, *Darling Consulting Group*
Brian Velligan—*DVelligan-Blaxall, LLC*

Making the Most of Interest Rate Derivatives

The idea behind hedging interest rates is that by maintaining an appropriately sized derivatives position, the gain or loss on the derivative can be expected to offset a preexisting or anticipated interest rate risk. This article highlights seven different applications for bank asset/ liability managers where derivatives can increase flexibility, enhance performance, or reduce the uncertainties associated with shifting interest rate levels.

Improving Performance Without Altering Maturity

When used in combination with cash market fixed-income securities, the combined cash-plus-derivatives can replicate a different cash market position. Such a substitution would be attractive when the new combined cash/ derivatives position offers a more attractive yield than would be available otherwise.

For example, consider the case of an asset manager who is holding six-month Treasury bills. By selling these bills today and simultaneously buying three-month Treasury bills and hedging a subsequent three-month investment in Treasury bills, the portfolio manager might be able to earn a higher rate of return and still preserve the six-month maturity coverage.

On the liability side, a manager desiring to secure funds for, say, six months can issue a six-month deposit directly; or he can issue a three-month deposit and hedge a subsequent issue of another three-month deposit in order to lock in a liability cost.

Extending the Maturity Structure

Asset managers can extend the maturity structure of their portfolios using interest rate swaps. This hedge would serve as an alternative to actually restructuring the portfolio by liquidating and replacing existing cash market assets or liabilities. Derivatives would likely be attractive when physical restructuring is not possible (e.g., term deposits cannot be bought back prior to their maturity dates). It may also be cheaper to use derivatives when liquidity is stressed in cash markets, resulting in substantial market penalties.

Shortening the Maturity Structure

This idea would be appropriate for the asset manager expecting a rise in interest rates or the liability manager anticipating a decline in rates. As with the previous application, a cash market restructuring can sometimes accomplish these goals, but derivatives may offer improved

LexisNexis®
An A.S. Pratt™ Publication

yield outcomes and greater flexibility.

Establishing Yields on Forthcoming Asset Acquisitions or Liability Issuances

The asset manager, knowing that funds will be available for investment beginning on some forward date, may use derivatives to establish rates of return for planned investments. Similarly, liability managers may have an analogous exposure relating to planned debt or deposit issuances. Hedging of this type is most effective when the cash markets in question are identical to the instruments underlying the intended derivatives. When the cash market instruments are *not* the same as those underlying futures, a *cross hedge* can still be constructed. For example, hedging non-LIBO R money market deposit accounts with LIBOR-based derivatives would be an example of a cross hedge. In such cases, the hedge manager must allow for some slippage, or less-than-perfect hedge performance.

Protecting Present Value of Fixed Income Assets from Effects of Changing Interest Rates

In this instance, derivatives can be used to stabilize the values of the asset position, enabling the portfolio manager to earn the accrual of interest from, say, coupon distributions. This hedge practice can insulate a portfolio from erratic changes in the principal due to volatile interest rates.

Creating Customer Products

Banks that currently don't make markets in derivative instruments can often introduce these products to their clients, acting as intermediaries between their customer and larger, better established derivatives dealers. Effectively, the bank would pair two, back-to-back derivatives – one between the bank and its customer, and the other between the bank and an external derivatives dealer. Pricing to the customer would reflect a small mark-up from the price charged by the derivative dealer, thereby allowing the bank to realize some incremental income. Perhaps more importantly, providing this product to the customer would likely serve to keep the customer close and protect the client/bank relationship.

Trading

While the focus of the article has been on hedging or risk management, derivatives also serve as cheap and easy trading tools to speculate on outright changes in interest rates or changes in credit spreads. These activities are a natural extension for institutions currently operating cash market trading desks. Given any targeted duration, the sharp-penciled trader can, and should, compare the cost (yield) of the prospective cash market instrument with that of a competing derivative. If the derivative is more expensive, or cheaper, than the cash instrument, it could very well be a smarter sell, or buy.

Conclusion

The above examples demonstrate opportunities for using derivatives both in *conjunction with* and as an *alternative to* cash market instruments. Thus, in some sense, one might argue derivatives are not essential, and bank managers could get along quite well without them. This attitude is shortsighted, however, in that it ignores the *value-added* benefit that derivatives can offer.

Derivatives are best used when they provide an incremental advantage relative to the action taken *without* using derivatives. This advantage can't be realized, however, unless portfolio managers understand how these tools work and take the necessary steps to achieve a comfortable level using them. Banks that fail to take these steps will categorically limit their opportunities in the marketplace, and they will necessarily operate at a competitive disadvantage. On the other hand, banks that develop this expertise will approach their financial risks with an expanded set of remedies that will invariably offer opportunities to enhance overall performance.

— Ira G. Kawaller, Ph.D.
Derivatives Litigation Services, LLC

Bank Asset/Liability Management

Editor
Peter A. Mihaltian, President
Southeast Consulting, Inc.
212 S. Tryon Street, Suite 925
P.O.Box 470886
Charlotte, NC 28247-0886
(704) 338-9160
E-mail: info@southeastconsulting.com
Website:www.southeastconsulting.com

Publisher's Staff

Manuscript Editor
Jennifer Brooke

Editorial Inquiries
Peter A. Mihaltian

BANK ASSET/LIABILITY MANAGEMENT (ISBN 978-0-76987-756-3) is published monthly by Matthew Bender & Company, Inc. Copyright 2014 Reed Elsevier Properties SA., used under license by Matthew Bender & Company, Inc. All rights reserved. No part of this newsletter may be reproduced in any form by microfilm, xerography, or otherwise incorporated into any information retrieval system without the written permission of the copyright owner. Requests to reproduce material contained in the publications should be addressed to Copyright Clearance Center, 222 Rosewood Drive, Danvers MA 01923, (978) 750-8400, fax (978) 750-4470. For customer support, please contact LexisNexis Matthew Bender, 1275 Broadway, Albany, NY 12204 or e-mail Customer.Support@lexisnexis.com.

POSTMASTER: Send address changes to BANK ASSET/LIABILITY MANAGEMENT, LexisNexis Matthew Bender, 121 Chanlon Road, North Building, New Providence, NJ 07974.