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Why Should Depositories Consider Hedging in the Current Market?

Year-end industry analysis has shown that 2018 was a standout year for financial depository performance. Both banks and credit unions recorded the highest ROA and ROE metrics observed post-crisis, and industry net worth finished at one of the strongest levels in years. With short-term rates having increased 2% in three years' time, the influence of increasing asset yields on performance cannot be understated; but another key factor has contributed to healthier bottom lines – a low, sticky cost of funds. However, given current upward trend in industry cost of funds, this advantage might be nearing an end.

	Credit Unions (source: NCUA)			Banks (source: FDIC)		
	2017	**2018**	**Change**	**2017**	**2018**	**Change**
Yield on Assets	3.75%	4.02%	0.27%	3.73%	4.16%	0.43%
Cost of Funds	0.57%	0.69%	0.12%	0.48%	0.75%	0.27%
Net Interest Margin (NIM)	2.99%	3.13%	0.14%	3.25%	3.40%	0.15%
Return on Assets (ROA)	0.78%	0.92%	0.14%	0.97%	1.35%	0.38%
Return on Equity (ROE)	7.10%	8.26%	1.16%	8.61%	11.98%	3.37%

Financial institutions have seen a steady increase in net interest margins throughout the FOMC's tightening activities, but market concern is shifting focus to when the earnings benefit might come to a halt. Can the trend persist given the current level of rates and the sustained pressure of solid economic growth? Can financial institutions continue to fund asset growth with the low, stable costs of yesterday?

The Business Cycle and The Balance Sheet

In times of economic expansion, the demand for credit heats up resulting in steady loan growth. Deposits generally increase due to expansion-related benefits to households, but market alternatives can create competition for those dollars resulting in mismatched growth and funding gaps. This often leaves financial institutions with a difficult decision: fill the funding gap or temper asset activity.

Depositories that regularly and systematically analyze profitability and relative value understand the attractiveness of lending and its importance to sustainable, strong financial performance. As such, most institutions gravitate toward solving funding problems rather than halting loan production or selling assets. As loan books fill up, marginal reinvestment is even more critical to the overall profitability of the institution. Generating maximum risk-adjusted spread over funding is key to maintaining healthy net interest margins. In order to stay nimble and allow for utmost adaptability to changing markets and balance sheets, many institutions turn to hedging programs to give them flexibility while enhancing financial performance.

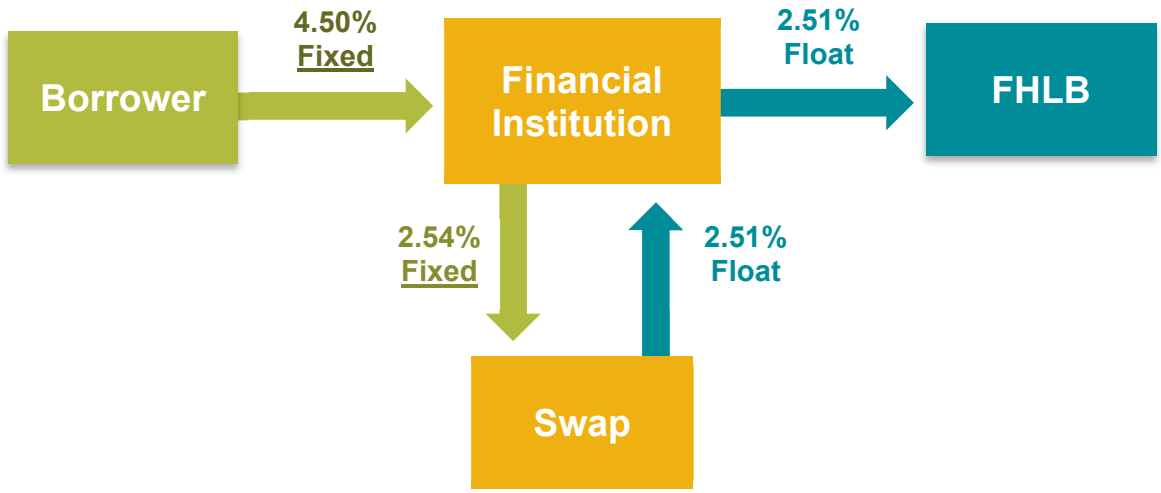
Why Derivatives Should Be in Your Toolbox

Financial depositories have long managed margins and risk exposure by pairing lending activities with low-cost deposit gathering. Post-crisis, balance sheets became flooded with cash deposits parked there by wary depositors with limited investment alternatives. These deposits not only helped lower funding costs but also provided a natural hedge for risk inherent to the loan book. For institutions that have not felt pressure to establish a derivatives program given strong deposit funding and corresponding low NEV/EVE volatility, the growing concern over changes in funding composition and increasing exposure to interest rate sensitivity is reason enough to explore hedging applications.

Balance Sheet Hedging in Practice

Consider an institution characterized by strong, steady mortgage origination. Mortgages generate high relative value driven by stable spreads to market rates, low credit costs and servicing expenses, and low capital requirements. Additionally, today's flatter yield curve and lower cost of duration extension augments risk-adjusted compensation. Historically, the institution relied on stable deposits to fund loan demand and naturally offset most interest-rate risk exposure at a relatively low interest expense. However, slowing deposit growth has resulted in the need to fund via other sources such as promotional term deposits, brokered deposits, or FHLB advances. FHLB advances and brokered deposits tend to carry high term premiums on longer positions making them a relatively expensive risk mitigation tool. Mismatched funding may generate more spread, but at the cost of adding greater interest-rate risk exposure and volatility of earnings.

Figure 1: Interest Rate Swap Mechanics



An alternative option is to fund the mortgage assets with a short-term borrowing position and hedge the funding using a fixed-to-floating interest rate swap (Figure 1). By entering into this swap contract, the institution pays a fixed rate interest payment on a notional amount over the contractual period while receiving a floating interest rate payment from its counterparty. The floating payment is used to offset the floating cost of rolling the short borrowing position, while locking in a fixed expense on the borrowing cost equal to the fixed leg rate and stabilizing the spread to the mortgages being funded. The swap synthetically extends the borrowing to the term of the swap contract, offsetting interest-rate risk at a much lower cost than a duration-matched term borrowing.

Opening the Door to Profitability

In today's rate environment, a well-designed hedging program in conjunction with strong funds management can increase opportunities for institutions to add more profitable assets on the margin while managing risk exposure. Without access to derivatives, depositories could be faced with the expensive decision to alter their lending programs or funding strategies to manage risk and earnings volatility, all while passing that cost to the shareholders over time through tighter margins and lower returns on capital. Hedging programs can create greater flexibility and adaptability for an institution, allowing management to develop strategies based on risk-adjusted compensation and profitability, rather than being forced to limit their playing field.

If your institution is anticipating similar funding pressures, it's time to consider hedging applications.