FHLBank Atlanta

Challenges Managing Interest Rate Risk at Community Banks

Symposium on Interest Rate Risk Management
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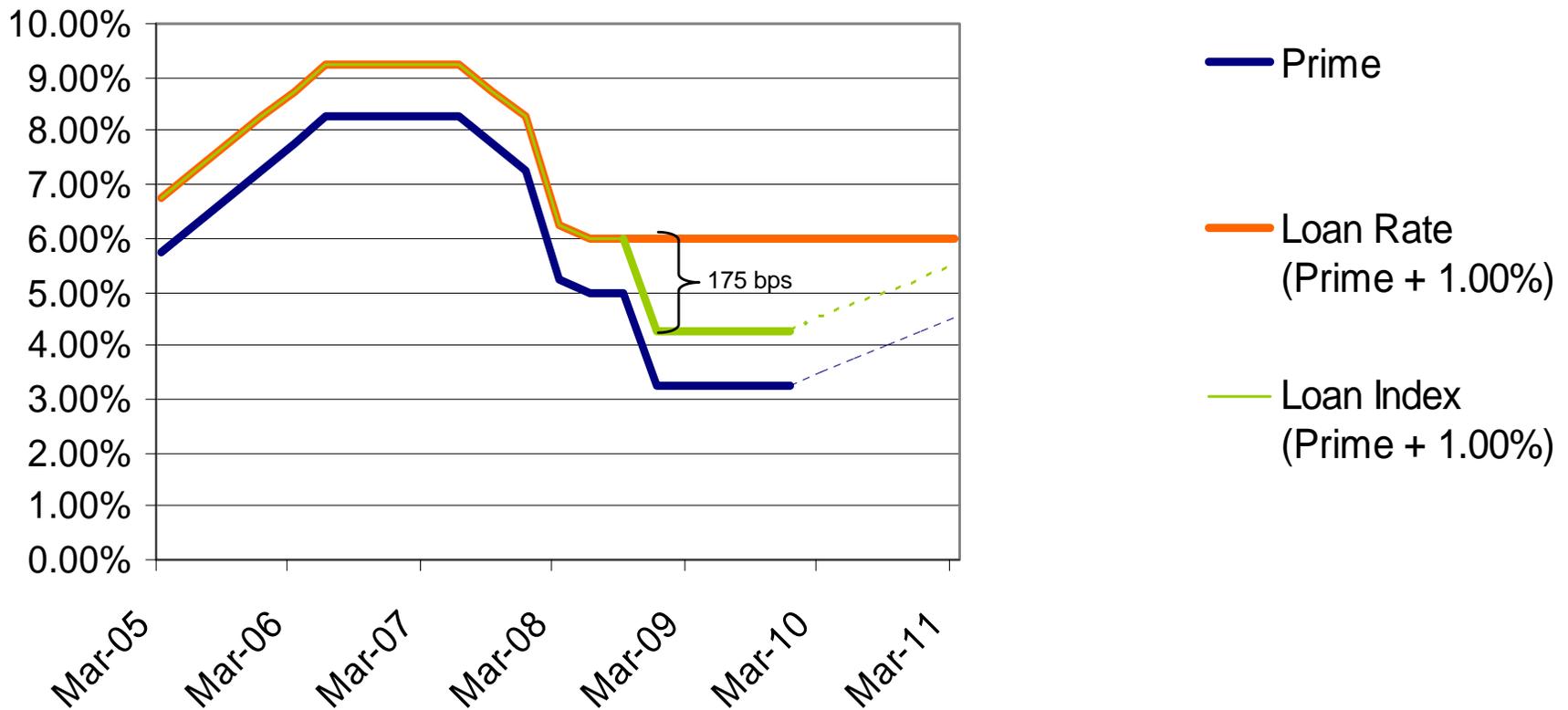
▶ Challenges

- Assets
- Liabilities
- Excess Liquidity

▶ Solutions

- Long Term Deposits
- FHLB Advances
- Off-Balance Sheet

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Assets

▶ Margin Compression in the Future ?

Legend:
- **Prime** (dark blue)
- **Loan Rate (Prime + 1.00%)** (orange)
- **Loan Index (Prime + 1.00%)** (green)

Chart annotation: 175 bps

Y-axis: 0.00% to 10.00%
X-axis: Mar-05, Mar-06, Mar-07, Mar-08, Mar-09, Mar-10, Mar-11

Dotted line projections for presentation purposes only

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Liabilities

Funding Costs for Community Banks

Legend:
- **Rate on Interest Bearing Liabilities** (dark blue line)
- **Average Rate of Interest Bearing Liabilities** (green line)

Banks with Total Assets less than $5 Billion, data from March 2005 – September 2009
Source: Datagy

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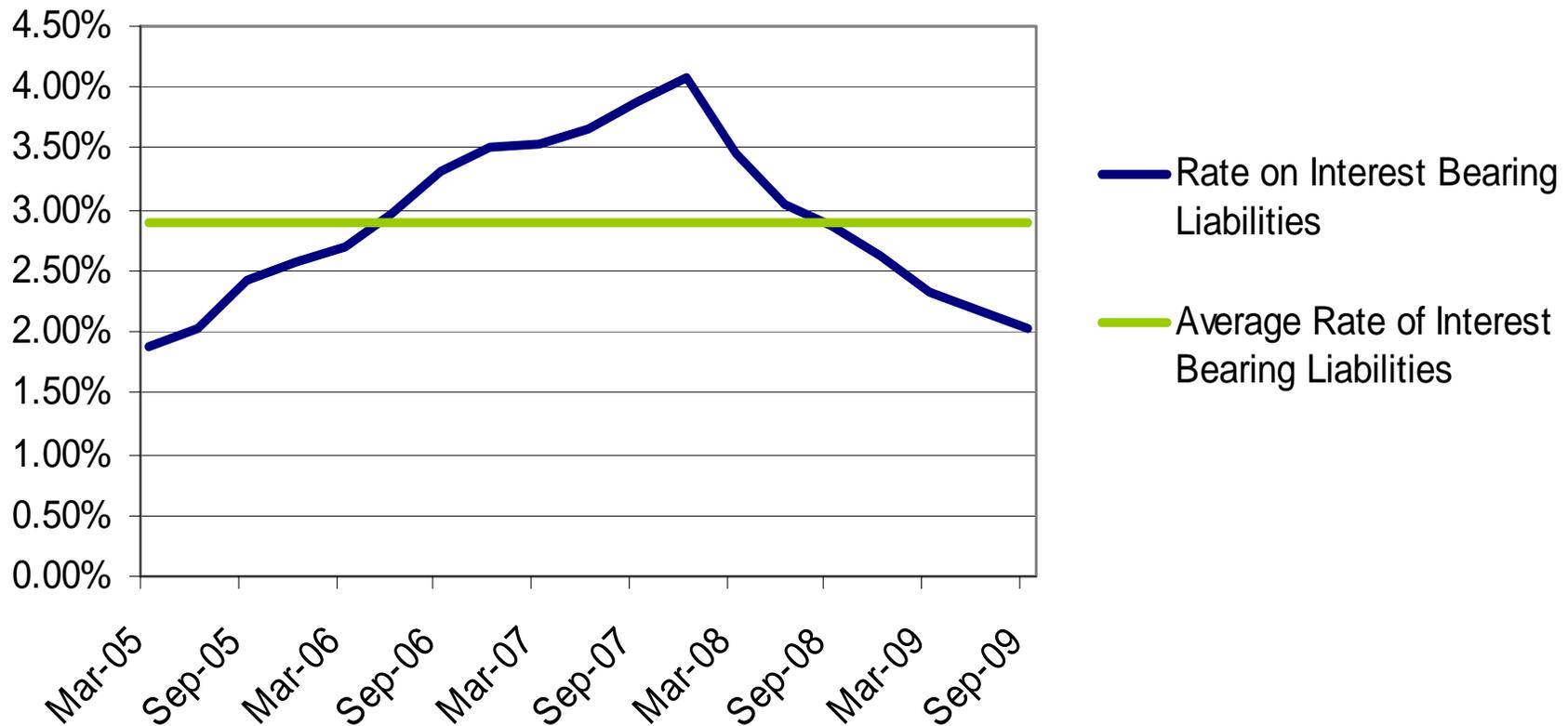
Rising Rates Add to Margin Compression

Legend:
- Loan Rate (Prime + 1% with 6% Floor)
- Rate on Interest Bearing Liabilities
- Average Spread

Dotted line projections for presentation purposes only
Source: Datagy

Advance Decision Tree

?

Fixed or Floating

→ **Structure**

- **Purchased (Long) Options** → **+**
- **Purchased (Long) Options** → **-**
- **Sold (Short) Options** → **+**
- **Sold (Short) Options** → **-**

Higher Initial Cost
Higher Protection

↕

Lower Initial Cost
Higher Risk
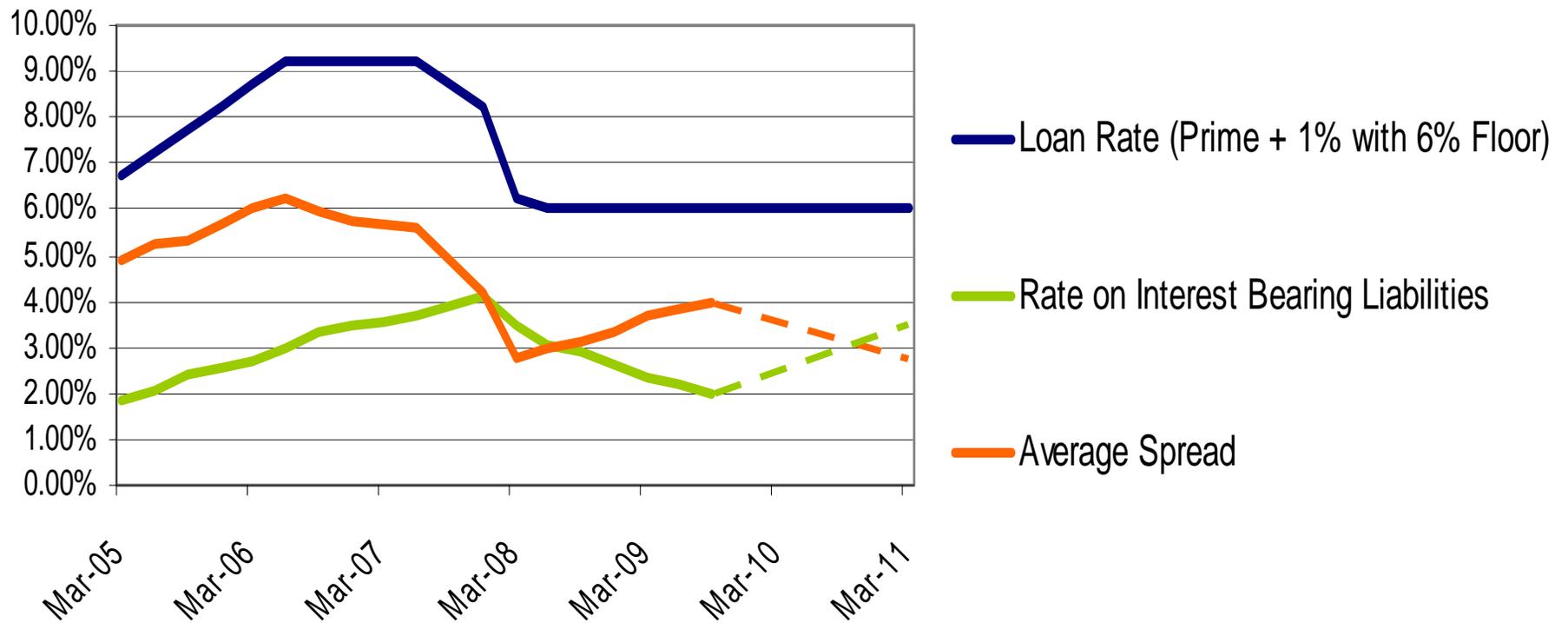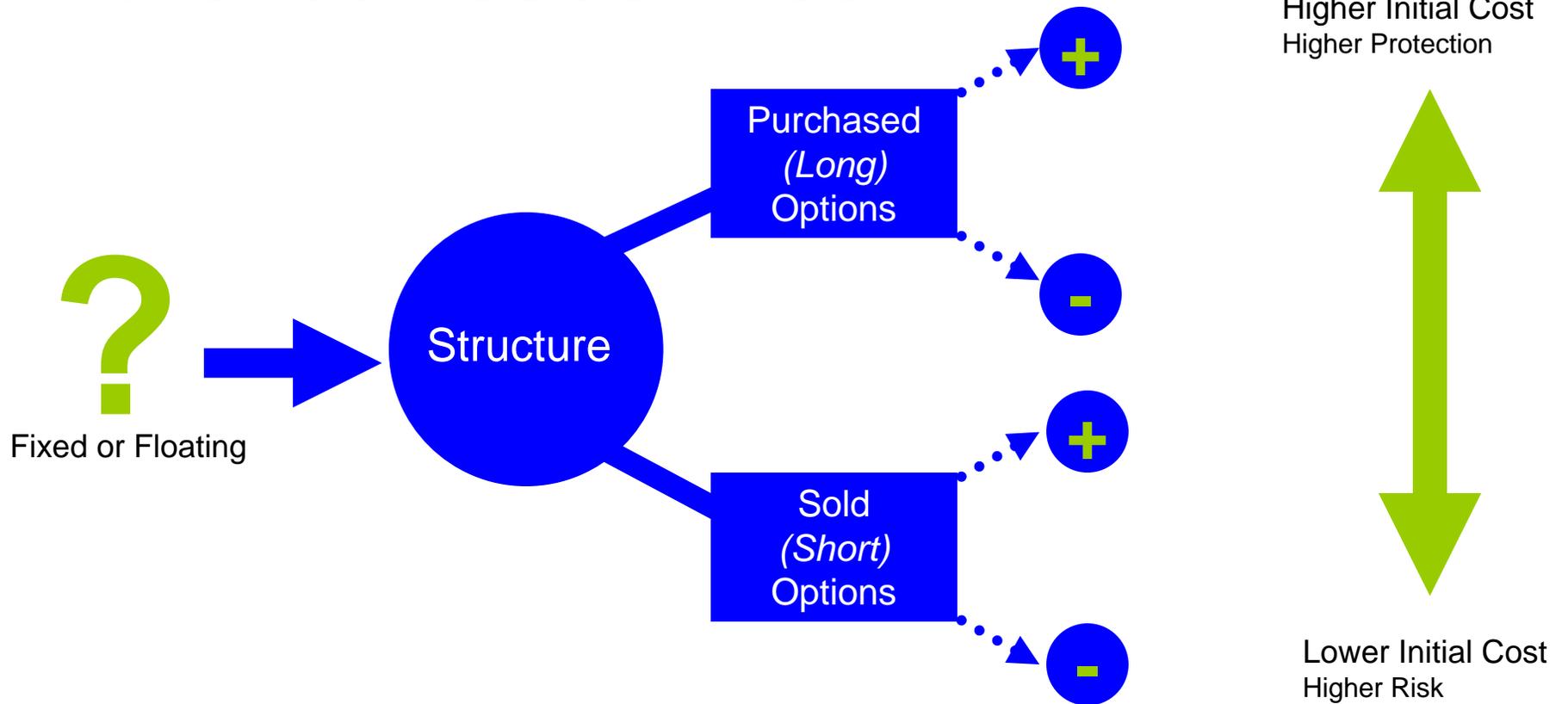
Due to accounting requirements, advance rates cannot be negative and realized unwind gains cannot exceed 10 percent of principal.

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Fixed Rate Credit

Pros

- Fixed rate funding with stated maturity
- Think CD
- Hedge for fixed rate assets or loans
- Maturities of one month to 10 years
- Provides longer term funding not typically available in the retail market

Cons

- Community banks do not need additional liquidity

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Purchased Optionality

Managing Risk
- Interest rate risk
- Asset sensitivity
- Liability sensitivity
- Rising rates
- Falling rates
- Prepayment risk
- Member controls the exercise of the option

Base Advance
-Fixed
-Floating

Plus

Cost of option
- Caps
- Floors
- Prepayment
- Expansion

FRC Hybrid with cap

FRC Hybrid with floor

Expander

Callable

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Fixed Rate Credit with Cap

Pros
- Fixed rate funding with stated maturity
- Cost of Cap is embedded into the rate on the advance
- Caps can be leveraged for additional protection (need the protection and not the funding)

Cons
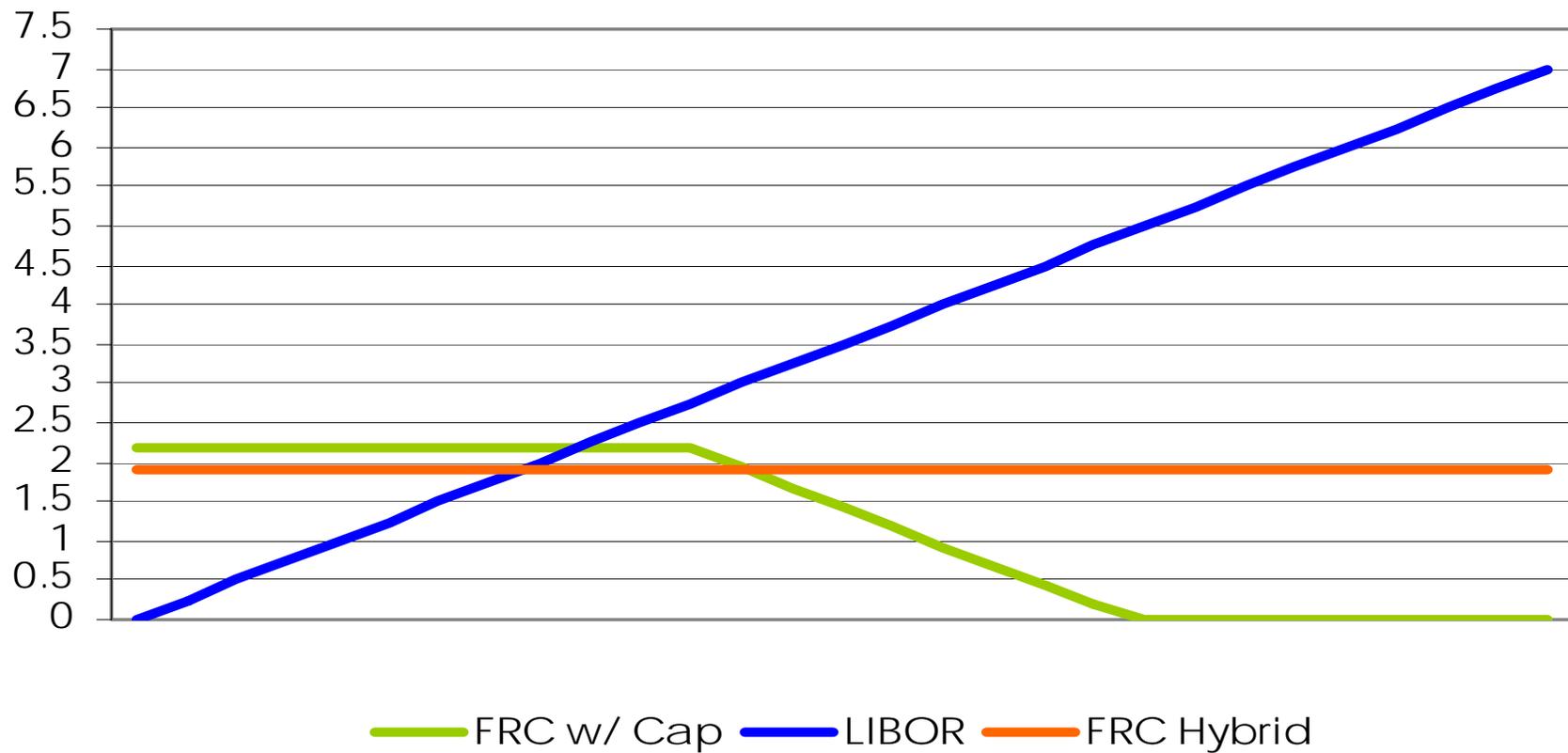- Market value
- Community banks do not need additional liquidity

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Fixed Rate Credit With Cap

Example: 3 year FRC Hybrid Advance 1.90%

Cap

Term	3 Years
Strike Index	3-Month LIBOR
Strike Rate	2.75%
Annual Cost 1X	28 BPS

Rate Indication as of January 13, 2010

Fixed Rate Credit Hybrid With Cap

Callable Advance

Pros

- Fixed rate
- Borrower may repay on specific dates with no penalty
- Prepayment option may be European or Bermuda
- Allows borrower to lower funding costs if rates decline and prepayment on loans or securities increase

Cons

- Expensive
- Borrower is responsible for exercising the option to pay back the advance without a fee

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5/1 Callable Advance Example

- 5 year Fixed rate advance 2.95%
- 5 year Callable advance and the member owns the option to pay back the advance at 1 year or any six month period there after

5 year Fixed rate advance   2.95%

5/1 year Callable advance 3.23%

Cost of Option   .28%

Rate Indication as of January 13, 2010

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Final Thoughts

- Balance Sheet structure and interest rate view are critical in this environment

- ALCO process should be refined and proactive

- Liability pricing and liquidity are key drivers for the future

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