Beat the Spread
A sound strategy for securing low-cost funding

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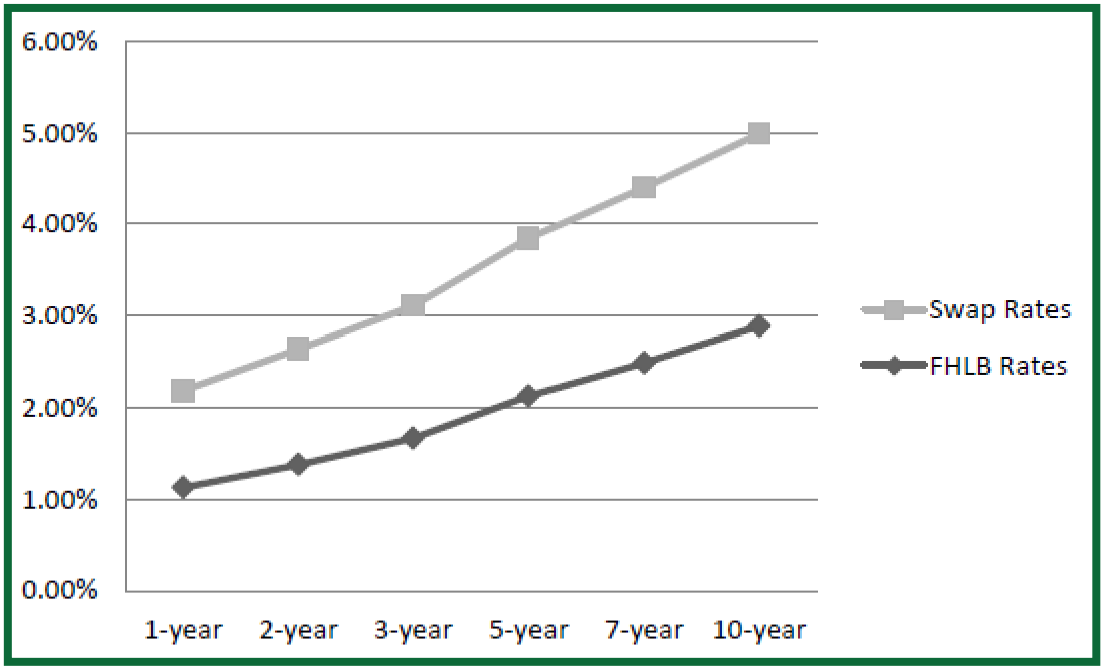
If your institution is in the market to lock in long-term funding, can handle the accounting implications of using derivatives, and is looking to find the absolute lowest funding cost possible, the "Beat the Spread" strategy might be for you. By combining a long-term plain vanilla fixed rate swap with rolling short-term FHLB Des Moines advances, your institution can lock in funding well below typical advance rates.

This pay fixed, borrow short strategy can be achieved when the long end of the swap curve is well below that of the advance curve. As illustrated in the example below, the spread between the two proxy curves can provide an opportunity for those members who desire long term fixed rate funding. See Figure 1 below.

Figure 1: FHLB Advance Rates versus the Swaps Curve



Source: Advance Rates – FHLB of Des Moines, Swap Rates – Bloomberg.
Rates as of 11/16/2016, for illustrative purposes only.

In addition to the relationship between our term FHLB Des Moines advances and swaps, short term advance rates need to be at or near the floating rate that will be received from the interest rate swap. In most cases, the execution of this strategy will have the member receive 3-month LIBOR in return for paying fixed in the swap arrangement. Table 1 below illustrates what this might look like with, 3-month LIBOR and 3-month advances pricing on top of one another.

Table 1: Short-term FHLB Advances and the LIBOR Curve

Term	Advance Rate	LIBOR
1-Month	0.84%	0.70%
3-Month	0.90%	0.96%
6-Month	1.01%	1.30%

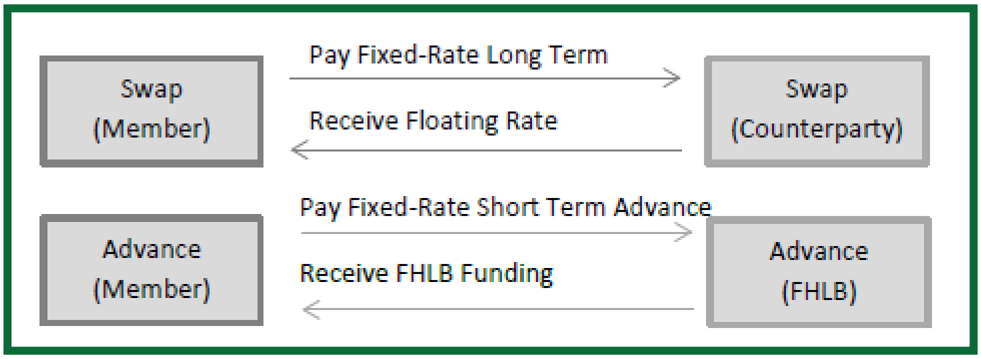
Sources: Advance Rates – FHLB of Des Moines, Swap Rates – Bloomberg.
Rates as of 12/14/2016, for illustrative purposes only.

Let's look at considerations your institution should take for funding options. Posted rates are never the all-in cost of borrowing from the FHLB. It's important to factor in the quarterly activity stock dividend, which was 3.5% in 2016 and consistently above that since then. For this example we will use the 3.5%, which would result in roughly an additional 10 basis point discount to the rate of an FHLB advance that is often overlooked.

Beat the Spread in Action

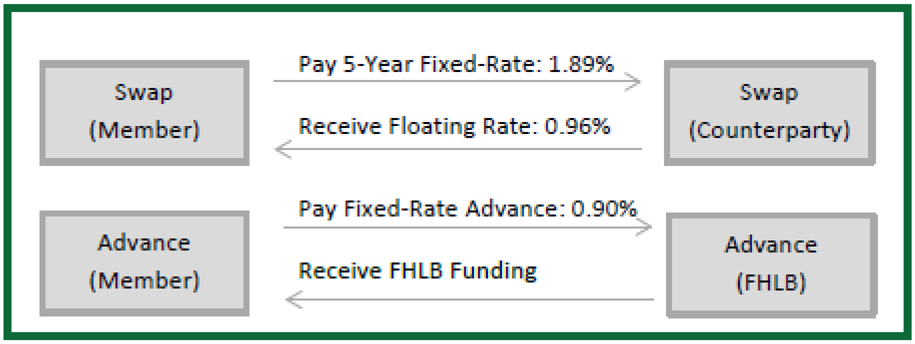
The "Beat the Spread" strategy may allow you to combine both derivatives and FHLB advances to achieve a lower all-in borrowing cost for term funds. By entering into a swap in which you pay a fixed rate and receive a floating rate in return, generally 3-month LIBOR, you can match the floating rate to an FHLB Des Moines advance. In this case, to match up 3-month LIBOR, you can borrow a 3-month advance from FHLB Des Moines with the intent of rolling the advance for the duration of the swap. The reason this trade can be so effective is the correlation that exists between a 3-month FHLB advance and 3-month LIBOR. Figure 2 demonstrates the pieces of the strategy.

Figure 2: Member Utilizes Both Counterparty and FHLB to Achieve Lower All-In Cost



As seen in Figure 2, the member can lower the all-in cost by simultaneously entering into a swap with a counterparty and an advance with the FHLB. Figure 3 will reprise the same diagram using rates from 2016 to get a better idea of the savings that can be realized.

Figure 3: Beat the Spread Example



Rates as of 12/14/2016, for illustrative purposes only.

Figure 3 demonstrates the cost of engaging in the strategy. Going through the process flow, the swap the member will enter into with the counterparty will result in the member paying a fixed 1.89% for five years, while receiving a 3-month LIBOR floating rate, priced at 0.96%. Simultaneously, the member will enter into a short-term advance agreement with the FHLB. The term of the advance will be the same as the reset period for the floating rate piece of the swap. In this case, the member would execute a 3-month FHLB advance to match the 3-month LIBOR floating rate, with the purpose being that the rate reset for both pieces occurring on the same day. The advance rate for a 3-month advance in this example was 0.90%.

Considering all Angles

Pulling the math together, the cost of entering into this arrangement for your funding needs would be 1.83% for the first period of the advance. Alternatively, the rate of a 5-year FHLB advance on this same date was 2.29%, so executing the "Beat the Spread" strategy would result in an initial savings of 47 basis points. For comparisons sake, to further highlight the savings involved using this strategy, the rate on a 5-year U.S. Treasury at this time was also 1.88%. Going forward, your institution would roll the 3-month advance at each rate reset data of the floating rate swap. Additionally, it is important to have a full understanding of the accounting implications of entering this strategy. Initial designation of this strategy could result in certain criteria that must be met during the duration of the strategy. The FHLB does not provide accounting advice, please consult with accounting professionals for further accounting guidance.

As with any opportunity, there are some risks to consider before entering into this swap long, borrow short agreement. The effectiveness hinges on the rate of a 3-month FHLB advance remaining highly correlated with 3-month LIBOR. To clarify, if rates increase, it will not necessarily negatively impact your institution as long as the two pieces remain relatively in lock step. The risk that exists is if the rate of a 3-month FHLB advance moves drastically from 3-month LIBOR, resulting in either a less effective strategy or higher cost of funds.

Take Advantage

That being said, if you are looking to lock in term funding you should consider the "Beat the Spread" strategy. Although there are complexities to be considered when entering trade involving swaps, if your institution can manage the risk associated the "Beat the Spread" strategy is an excellent option to consider for lowering your funding costs and improve net interest margins.