



Don't Pay to Hedge Interest Rate Risk You Don't Have

The single most important set of assumptions you load into your asset-liability model is the decay rate and pricing beta assumptions for your core deposits. For over 30 years, the industry has relied on the Office of Thrift Supervision as the primary source of industry assumptions for core deposits. OTS assumptions are the default set of assumptions for most asset-liability model vendors and most outsource services. This is true whether you are a bank, savings institution, or credit union.

That is about to change. The OTS Net Portfolio Value model, which has provided reporting on value at risk (NPV) to OTS regulated shops, will be run for the last time based on 12/31/2011 data. When the model goes away, so will the primary industry source of core deposit assumptions. We have it on good authority that none of the regulatory agencies plan to continue to provide industry core deposit assumptions. They feel, and rightly so, that these assumptions need to be institution specific. I can hear some of you groaning, "Not another compliance cost!"

But the value of core deposit studies goes beyond merely complying with regulatory initiatives. It also has real potential to deliver a high ROI, enhancing your bottom line. "Why, you ask?" Because the OTS assumptions tend to understate the duration of non-maturity deposits and overstate the pricing betas. The combination of the two diminishes the apparent value of non-maturity deposits as a hedging tool. As a result, we offset this understated core deposit hedge by paying up for longer term funding, and keeping our assets shorter than we need to. Every day, we spend real net interest margin dollars to hedge interest rate risk we may not have.

During this webinar Tom Farin will review the analytical foundation behind decay rate and pricing beta studies. He will illustrate how relatively small changes in these indices from the OTS standard assumptions can have a significant impact on both income and economic value (EVE, NEV). In addition, he will show you how to use the most cost-effective interest rate risk hedging tool at your disposal, the use of effective deposit segmentation strategies in rising rate environments.

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