CATALYST
Corporate Federal Credit Union

2023 | INTEREST RATE DERIVATIVES

INTEREST RATE DERIVATIVES:

TRENDS AND STRATEGIES

CATALYST CORPORATE FCU

Trends and Strategies for Interest Rate Derivatives

Catalyst has seen a sharp uptick in derivative trading activity through the first half of 2023, and it appears more than just Catalyst clients increasing their trading activity. Since the end of 2019, total derivatives outstanding have increased from $13.2 billion to almost $34 billion, as of March 31, 2023.

As shown in the tables below, the vast majority (> 80%) of these derivative transactions have been in interest rate swaps, while the bulk of the remaining amounts have been used to support pipeline hedging activities.

Why are we seeing this trend in the industry?

Not Just for Big Credit Unions

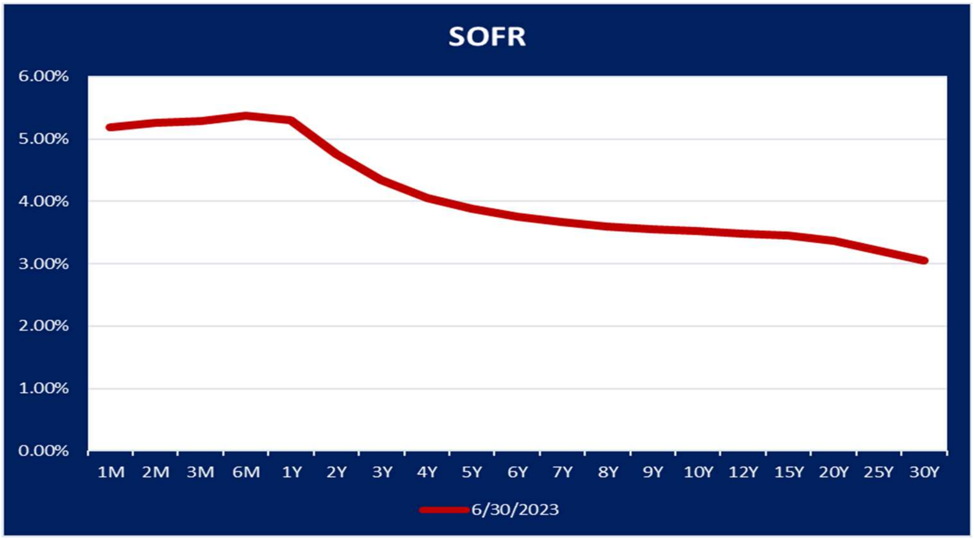
Available to all financial institutions, interest rate derivatives are an extremely effective tool to help manage interest rate risk exposures. Traditionally, these instruments were employed by the larger financial institutions, but it’s much more common now for smaller credit unions to use interest rate derivatives. At the end of 2019, the smallest credit union to have interest rate derivatives on their balance sheet was $659 million, but in 2020, that asset size declined to below $300 million. The same expansion trend is present with the largest credit unions using interest rate derivatives: average asset size increased from $5.7 billion at year-end 2019 to almost $7 billion the first quarter in 2023.

	12/31/2019	12/31/2020	12/31/2021	12/31/2022	3/31/2023
Number of Credit Unions	**5,277**	**5,207**	**5,048**	**4,863**	**4,814**
Derivatives					
Derivatives Oustanding:	13,245,734,641	30,391,568,454	25,124,422,902	31,725,539,169	33,798,899,467
# of Credit Unions Trading:	81	93	107	120	125
Smallest Asset Size:	658,588,428	283,047,330	330,402,265	342,114,644	389,096,784
Average Asset Size:	5,684,438,332	6,418,752,398	6,740,948,311	6,475,818,766	6,833,373,385
Swaps Outstanding:	8,615,300,000	9,610,700,000	13,721,650,000	27,763,690,000	28,205,143,284
# of Credit Unions using Swaps:	19	27	38	53	55
Pipeline Hedges Outstanding:				2,530,630,017	4,142,079,211
Other Derivatives Outstanding:				1,431,219,152	1,451,676,972

The takeaway from these trends is not the average asset size or even the smallest asset size of credit unions using derivatives, but, rather, that credit unions of all sizes have been turning to the derivatives market to support their risk management practices. Catalyst is seeing the same trends within its client base, as well. This is good news for the credit union industry.

What Risks Are Credit Unions Looking to Hedge?

Within the Catalyst client base, credit unions are not pursuing any single hedging strategy, but represent two main viewpoints, which coincide with the balance sheet composition of each credit union.



1 Credit unions with large and growing mortgage portfolios

These credit unions need risk capacity to continue to originate and portfolio more real estate loans, given current mortgage rates. The swap strategies pursued enable them to mitigate the interest rate risk these mortgages add to the balance sheet by synthetically converting a portion of their fixed-rate mortgage loans into adjustable-rate assets. Additional risk capacity is created for these credit unions to continue growing real estate loans.

Another benefit of this strategy now is offered by the overall shape of the yield curves. When you hedge real estate assets, you enter into a pay fixed/receive floating rate swap, which enables credit unions executing this strategy to be a net receiver of interest payments over the initial terms of the transaction. Some credit unions desire the short-term potential boost to income over the near-term.

2 Credit unions with shorter-term asset maturity structures combined with significant growth in high-rate term deposits

These credit unions have relatively short asset maturity structures (i.e., auto loans) but have seen strong growth in high-rate member term certificates (non-member deposits). They are concerned that, when the economy turns, their asset yields will fall when interest rates decline (as the autos roll over into lower yielding loans), but their term certificates will remain at elevated interest rates, materially hurting their earnings profile.

These credit unions are entering into an opposite interest rate derivative structure where they pay floating and receive fixed rates. This hedge is typically applied against the high-rate term certificates, synthetically converting these deposits into adjustable-rate deposits. The goal of this strategy is to ensure that cost of funds declines when market interest rates decline to alleviate margin compression when asset yields decline along with falling market rates.

Are You Interested in Derivatives?

Interest rate derivatives offer certain advantages over other products that also manage interest rate risk exposures. One of the most common alternatives is the use of borrowings. Interest rate derivatives tend to be more advantageous than borrowings for two primary reasons:

1 The fixed rate side of an interest rate swap is typically lower than FHLB alternatives.

2 Using interest rate swaps does not consume secondary liquidity, as the use of borrowings would.

"In our current market, we have extremely high composition for deposits, low liquidity and uncertainty in the overall economic direction. Any of these three challenges create liquidity pressures at credit unions, but the presence of all three at the same time requires great prudence in liquidity management practices."

We can help!

Catalyst guides credit unions toward a solution that offers the lowest possible cost to achieve their goals, while preserving liquidity sources. Interest rate derivatives can be that tool when it comes to interest rate risk management.

Speak with an expert about how interest rate derivatives could help your credit union manage risk. Contact us today.

Request a Consultation

CATALYST
Corporate Federal Credit Union