

The Importance of Funding Alternatives

An increasing number of bank funds managers will have to face the stark reality that deposit growth in their local markets no longer will be sufficient to meet their bank's ongoing funding requirements. In this article we discuss the importance of formalizing a wholesale funding game plan and suggest a sample wholesale borrowing policy for inclusion in your bank's Liquidity and Funds Management Policy Statement.

Recent Deposit Trends and Implications

Fifteen years ago banks, thrifts, and credit unions controlled approximately 90 percent of household liquid financial assets in this country.

Today that ratio is 40 percent and shrinking, as bank customers increasingly think more like investors than savers. Annualized deposit growth for Federal Deposit Insurance Corporation-insured institutions averaged approximately 2.2 percent for the three years ending in 1995; in 1996, the growth rate was closer to 4 percent, including brokered deposits. With corresponding asset growth near 6 percent, and bank borrowings growing at a rate of 15 percent over the same period, the implications are clear: Banks aren't even retaining the average interest credited on existing deposits; they can't possibly expect to finance growth entirely from their local markets.

Funding Alternatives and the Regulators

To meet their ongoing funding needs, banks must formalize a wholesale funding strategy to complement their retail/commercial deposit-generating activities. Effective funds management plans must incorporate the prudent use of wholesale funding sources, including, at a minimum:

- Federal Home Loan Bank advances;
- Repurchase agreements (borrowings using securities as collateral); and
- Brokered certificates of deposits (CDs).

Banks also should consider money-desk oriented activities, such as national CD programs and municipal deposits.

Unfortunately, many community bankers and their boards still assume that regulators don't like whole-

sale borrowing. Although war stories continue to circulate about community banks that received regulatory "spankings" for borrowing money in the wholesale markets in the past, there should be no confusion about the current regulatory position on this issue: The bank supervisors consider borrowings and brokered CDs to be acceptable funding sources if they are part of a bank's overall funding and balance-sheet management plan. Federal regulators are confirming this position with increasing frequency in the field, and senior representatives of both state and federal agencies have publicly stated this view.

Importance of Policy Statements

If banks are to participate actively and confidently in the wholesale markets, their boards must adopt (and understand) clear and meaningful policy statements governing this activity. These statements should accomplish the following:

- Describe the nature and extent of the wholesale funding activities contemplated; and
- Document how the uses of such funding sources will affect earnings, liquidity, and interest-rate risk.

Exhibit 1 on page 8 illustrates how one bank addresses wholesale funding in its funds management policy.

Wholesale borrowing policies also should reflect the use of a liquidity measurement the bank deems reliable. The measure should quantify the bank's remaining access to wholesale funding and differentiates between collateralized and uncollateralized sources. Traditional liquidity measurements do not capture the realities of the access to the capital markets that community banks of all sizes enjoy today. Banks must obtain (Continued on page 8)

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accurate liquidity measurements in order to establish appropriate minimum levels for both operating and contingency liquidity. The importance of this assessment can't be emphasized too much. Bank liquid-

ity is a critical variable in setting deposit rates and formulating investment strategy, both of which directly affect bank earnings.

Summary

If funds management policies are to be meaningful, they must reflect the realities of the environment in which banks operate. Accordingly, suc-

cessful community banks must have well-developed growth plans in which wholesale funding plays an important role — complementing, but not replacing, the deposit-generating activities that are, and will continue to be, invaluable for all banks. ■

— Matthew Pieniasek
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Exhibit 1: Wholesale Borrowing Policy

Ensuring that dependable borrowing facilities are in place provides an additional source of liquidity to the bank and as such represents an integral part of its liquidity and funds management practices. This section addresses the role and use of alternative funding sources. Because the nature and extent of wholesale funding activities will depend greatly on the bank's overall balance sheet risk position, the administration of these activities falls under the Asset/Liability Committee (ALCO).

Wholesale funding will typically be considered in the following situations:

- To supplement outflows of the deposit base;
- When there is a need to acquire funds quickly without impacting local market pricing;
- When there is an inability to fund a specific transaction from the local market with the type/term of funds desired (i.e., with funds that fit the existing balance sheet structure); or
- When the cost of such funds is below that of local market CDs.

In addition, when deemed appropriate for purposes of managing interest rate risk and/or improving the utilization of bank capital, wholesale funding may be used to purchase investment securities.

Bank management and the board recognize that the terms and repricing characteristics of such borrowing and investment activities may be intentionally mismatched to achieve specific ALCO objectives.

Federal Home Loan Bank (FHLB) Advances: The bank is authorized to borrow when necessary from the Federal Home Loan Bank. FHLB advances will tend to be the bank's primary borrowing vehicle due to both the dependability of the FHLB as a provider of funds and the availability of a broad range of maturities (overnight to 10+ years) with a variety of characteristics that can be tailored to the needs of the bank. While the FHLB lends on a collateralized basis with 1-4 family mortgages and U.S. Government and Agency securities being the collateral of choice, other loan types also qualify to varying degrees.

Repurchase Agreements (Repo): When appropriate, the bank may utilize borrowings collateralized by securities (i.e., repos) as an alternative source of funds. These funds are short-term in nature (typically overnight to 90 days) and available through the broker-dealer community. Repo lines may be solicited from and established with board-approved brokerage firms and banks.

Brokered CDs (Certificates of Deposit): When appropriate, the bank may utilize brokered CDs as an alternative source of funds. Because they do not require collateral, they have the potential for being less reliable than other forms of wholesale funding and, therefore, must be managed accordingly. The bank may solicit funds from qualified and board-approved deposit brokerage firms. Financial background analysis and due diligence must be performed to qualify a broker before deposits are accepted by the bank. Financial information on all brokers will be updated and reviewed annually.

Borrowing Limits: Given that the bank's funding preference is cost-effective local market deposits, the bank will attempt to maintain outstanding borrowings as low as is practicable. Limits on all types of borrowings including brokered CDs is set at ___ percent of Assets (Note: limit is bank-specific, reflecting issues such as balance sheet risk profile and expertise/comfort with alternative sources. Some banks prefer to establish a separate limit for brokered CDs). Board approval is required to exceed these limits.