Bank Asset/Liability Management

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Are You Ready for *Inflaterate*?

As a lifelong New England Patriots fan, I have grown tired of hearing about Deflategate. For the past six months, Patriot fans, and most NFL fans, have become all too familiar with the pounds per square inch (PSI) of air used in a football, as well as the impact atmospheric changes can (could, may, or potentially) have on the PSI. We have also become much more conversant in vague, unclear, ambiguous, legalese phrases such as, "*it is more probable than not*" that someone was "*at least generally aware*" of something that may or may not have occurred.

Six months of silly rhetoric seems inconsequential compared to the amount of time, effort and money banks have spent planning for an increase in the Fed Funds rate. Since December 2008, there have been many vague, unclear, ambiguous comments by Fed officials on when short-term rates would rise. For the purposes of this article we will call this event *Inflaterate*. The most recent comments seem to suggest that it is "more probable than not" tightening will begin in 2015. If this occurs are you "at least generally aware" of the impact on your balance sheet?

Should you prepare for *Inflaterate*? YES! Prepare, prepare, prepare. Should your bank's management pull the trigger and execute strategies to reduce potential liquidity risks and interest rate risks in a rising rate environment? For some of you the answer is YES; for some the answer is NO and others fall somewhere in between. How's that for vague, unclear and ambiguous?

To help you assess your bank's preparedness, answer these 5 questions:

1) How much liquidity does your bank have?
2) How much liquidity does your bank need?
3) How much does your bank want to pay for increased liquidity?
4) How much exposure does your bank have to a change in interest rates?
5) Is your bank's level of profitability adequate for the risks that the bank is taking?

There are obviously many sub-questions under each of the five listed above. However, these are the high-level critical questions that should be answered, and stress-tested, of course, at every strategic ALCO meeting. If you can answer these questions quickly and are comfortable with the answers, it is *more probable than not* that you are *at least generally* prepared. If you are unsure of the answers or are uncomfortable with the answers, your bank is not sufficiently prepared for a rising interest rate environment.

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Questions 1, 2 and 3 are critical catalysts to strategic discussions and tactical development and should be first and foremost on your ALCO meeting agenda. There are many different liquidity calculations out there. However, to correctly answer the questions, your liquidity calculation needs to include a collateral-based inventory of funds available at any given time.

Given this type of approach, a good definition of liquidity is “the ability to raise cash quickly, without principal loss (collateral based borrowing capacity, not asset sales) and at a reasonable cost (i.e. wholesale market rates).” If your calculations do not match this definition, your bank cannot sufficiently answer the first three questions.

Questions 1-3 should automatically jump-start strategic discussion based on the answers. Whether your bank has too much liquidity or not enough liquidity, today and projected over the next 90-180 days, this will clearly impact investment and loan strategies, as well as retail and wholesale funding strategies.

Of course, the answers to the liquidity questions above impact both the asset and liability sides of the balance sheet. However, the remainder of this article will be directed at the funding side of the balance sheet given the heightened focus in the marketplace and the angst over the *more probable than not* upcoming Fed move as well as its potential impact on deposit balances and rates.

Let’s assume the answers to the first three questions are: 1) not enough; 2) more and 3) as little as possible. Hopefully, these answers are due to projected loan growth and not projected deposit outflow. What’s more, many banks are beginning to experience, or at least are worried about, the latter, due to deposit specials starting to appear in the marketplace. Either way, projections show a need for funding.

So what do you do? There is no *one size fits all* answer. If you are in need of funding you may consider the following alternatives:

- increase reliance on wholesale funding such as the FHLB, brokered deposits, or national deposits;
- increase rates on existing retail products (to stem outflow or to grow);
- introduce a new, presumably higher rate, retail deposit product;
- implement initiatives to expand wallet penetration of existing customers;
- purchase deposits through acquisition.

Each of the above options comes with its own set of risks and rewards.

Increase Reliance on Wholesale Funds – Depending on current wholesale funding levels, this is likely the quickest and cheapest way to add funding. Any term needed is available to your bank at market rates and local deposit pricing will not be impacted. However, management, Board and regulatory perceptions will need to be managed. It is important to recognize that growing funding in this manner does not necessarily grow your franchise value.

Increase Rates on Existing Retail Products – Increasing rates can stem outflow and grow deposits, but the true cost of the increase is likely much more than the new stated rate. The real cost of a retail deposit rate increase is the rate plus the cost of conversion, i.e., *marginal cost of funds*.

Introduce a New Retail Deposit Product – This option is likely to have similar risk/reward dynamics as simply increasing rates. However, before raising the rates on your existing accounts and/or introducing a new special, much work needs to be done. First, you must fully understand how much of your deposit base is truly rate sensitive. Answering this question can be done by gut feel, by core deposit analysis and anything in between. However, regardless of the analytical approach, the question needs to be answered. Listed below are other critical questions that your bank’s management should be asking:

- For your liquidity and interest rate risk models, how often are the assumptions updated? Do you stress test your assumptions? When was the last time your underlying assumptions were validated by a thorough analysis? *Translation, do you truly believe your models?*
- How much growth has your bank seen in deposits in the last 5 years?
- Is your bank’s deposit growth abnormal or surging?
- Has there been a shift from CDs to non-maturity deposits?
- Have average balances increased? If so, in which accounts? Are these increasing balances retail or commercial accounts?
- Has your bank increased the number of deposit accounts?
- Can your bank afford to lose deposits in terms of liquidity, interest rate risk and earnings?

The answers to all of these questions will impact the true cost of any retail deposit strategy. Answering these critical questions as part of your strategy development process does not ensure success. However, not answering them prior to implementation could prove dangerous.

Expand Wallet Penetration of Existing Customers – This is an extremely challenging long-term strategic initiative that all banks claim to work on. What are the initiatives currently underway at your bank to achieve greater customer penetration? How effective have your efforts been? Is this strategic initiative a priority? If it is not, it should be.

When executed properly, true core customer relationships are expanded and franchise value is increased. When executed poorly, expenses can increase, employee morale can decline. For example, competition between branches can backfire. What's more, already profitable customers may become disenchanted. If nothing else, starting to track customers with multiple relationships will provide you with valuable information.

Purchase Deposits Through Acquisition – Another strategic alternative that may or may not be realistic depending on your balance sheet, earnings, capital and market locale, may be growth through acquisition. The reality is whether you purchase deposits through acquisition or through rate, you are buying deposits and you need to fully understand the deposits you are buying and the potential effects on the deposits you already have.

If you are in the position of having too much liquidity (cash), loan and investment strategies would be a recommended choice to affect change. However, an overly strong liquidity position should also give you the organizational courage to meaningfully hold or lag your deposit rates if *Inflaterate* occurs.

Regardless of your current liquidity position, ask yourself, and your ALCO, how much short-term rates would have to rise before you need to start increasing retail deposit rates. You will likely receive answers ranging from yesterday to never. You can shed light on the correct answer by running different ALM model scenarios with varying amounts of market rate increases and changing deposit betas. Discuss the model results with your management team and make sure that everyone is on the same page. Fully understand your plan and communicate it to management, the Board and customer facing employees. Without doing this, your knee-jerk reaction will likely be to increase rates too soon and by too much.

The strategic initiatives that will result from these discussions will obviously impact liquidity, interest rate risk and earnings. You can't implement effective balance sheet strategies by only answering the liquidity questions mentioned above. The interest rate risk and earnings questions will clearly be impacted by the answers to the liquidity questions and vice versa. Assessing the risk/return of any and all strategies and the effect each has on the key facets of your institution is critical to ensure success—of each individual strategy and your institution as a whole.

There should be nothing vague, unclear or ambiguous about your institution's near-term tactics or longer-term strategic vision. It appears *more probable than not* that short-term rates will increase soon. You can be *at least generally aware of* the impacts on your balance sheet of increasing short-term rates and accept the penalty associated with *Inflaterate*. Or you can be proactive and design strategies to turn potential penalties into potential windfalls.

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