Bank Asset/Liability Management

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The Deposit Conundrum

As we enter the second half of 2017, it is clear that liquidity has become of heightened concern among bank management and regulators. More specifically for bank management teams, deposits are the hot topic. Recent industry conferences, strategic engagements and press all highlight the escalation of unease around deposit rates, deposit balances and overall funding costs for financial institutions. While most have yet to observe any meaningful change in local deposit behavior (both rate paid and balance), the threat is real and could be brought to life by a variety of factors. *As such, each bank should take steps to ensure it is proactively prepared from a liquidity perspective and also understand the risk and return dynamics of potential deposit strategies.*

Be Prepared...Take Inventory

Core deposit growth is an essential strategic component for banks, but recognize that changing environments can hamper access to cost effective deposits. As such, a best practice ALCO process monitors the measurement and management of all forms of operating and contingency liquidity – not just access to deposits. The first liquidity component is typically on-balance sheet liquidity or what is often referred to as "liquid assets." This consists primarily of excess cash and government back securities (MBS, treasury and agency bonds), which are available for collateral purposes to secure funds. Recent examination feedback highlights a renewed focus on the importance and sufficiency of this number. Recognizing that most banks have a strong handle on the intricacies of interest rate risk modeling and stresses as interest rates rise, examiners are looking to ensure that banks could withstand potential deposit outflow scenarios and that they have access to the most pure form of liquidity – cash and securities. While management's ability to articulate the overall risk position and strategic direction of their bank can allow for a number lower

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or require something much higher, a minimum of 10% of total assets seems to be holding ground here.

Given the renewed focus on this item and the uninviting yields on cash and securities today, ensure that your security collateral is being effectively utilized. For example, many banks have had success in securing public deposits with forms of collateral other than government-backed securities. This in turn has freed up these liquid assets, improving liquidity ratios, or allowed the bank to redeploy securities into more attractive loans enhancing earnings. If you have excess liquid assets, recognize that this is free and available liquidity for funding cash needs should deposit behavior change.

Revisit your ability to borrow funds from the FHLB. The FHLB will accept your loans held in portfolio as collateral while allowing you to keep your bonds available for other liquidity purposes. We often encounter banks that in this cycle have strategically been holding additional residential mortgages in portfolio and/or growing commercial real estate loans. However, many have failed to "beef up" their ability to borrow at the FHLB despite their larger asset base and pool of loans that could be pledged. Ensure this outlet for funding is not only established, but that it is sufficient for any future funding needs (contingency planning as well). Considering that many banks establish policy minimums for operational and stressed liquidity that include their ability to borrow at the FHLB – this is a no-brainer.

Board re-education is vital for those that have not been utilizing wholesale funding for several years...or longer. Many banks have brought in new board talent since the 2007 financial crisis and as we all know, board members do not necessarily eat, breathe and sleep banking. Wholesale funding is a key component to the liquidity process at many high-performing banks, so ensure that your board of directors has an understanding of and comfort level with all forms of liquidity and that policy tolerances are set appropriately.

Quantify the Cost of Increasing Deposit Rates

Moving from one annual hike by the FOMC to potentially three this year has likely been the main culprit for bankers' heightened concern around deposits. *There appear to be two camps among bankers: those with a real need to grow deposits and those with a feeling that they should.* Both groups are trying to lag rates on existing balances. If the liquidity profile of your bank is strong, lagging deposit rates may be the appropriate strategy. If liquidity is or is projected to become tight, deposit retention and/or growth strategies are likely appropriate. It is critical to understand the cost/benefit associated with either strategy.

Each bank has assumptions for how rates paid on its deposit base are projected to move as market rates increase (the correlation is referred to as a beta).

Most frequently, the non-maturity deposit betas/assumed rate movements are appropriately supported by historical pricing and product strategies at the bank in prior rate cycles (not industry data). The current challenge with utilizing bank-specific data in isolation is twofold – 1) the last rising rate cycle was over a decade ago (2004 to 2006) and the banking atmosphere has changed significantly in the meantime and 2) the FOMC is currently moving at a glacial pace (0.75% per year going forward) given this very slow economic *recovery."*

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There is significant variation in betas across the industry. However, to date most banks *have not* increased "posted or rack rates" on non-maturity deposit accounts. This has resulted in additional income in the form of cost savings – for most the annualized number is quite meaningful when taking the total balance of non-maturity deposits and multiplying by the assumed beta for these deposits. Said another way, the FOMC has increased short-term rates four times beginning in December of 2015 and the strategy of lagging deposit rates has produced a benefit to earnings that interest rate risk models may not have predicted. This should be considered at each bank, regardless of its liquidity profile and determined need for deposits. Additionally, examine the cost associated with increasing rates on various deposit products with each future 25bp hike. The reality for many banks is that their balance sheets are structured such that the next several 25bp rate increases produce very little benefit to net interest income and earnings even with a strategy to hold firm on deposit rates.

This analysis above can be eye opening at ALCO meetings and helps facilitate animated strategic discussions of deposit product and pricing strategy going forward. As a result, many banks are shifting away from increasing posted rates on all product types. Instead they are refocusing deposit strategies to incorporate the total customer relationship and allowing for rate *bumps* if the depositor has a variety of relationships with the bank as opposed to a CD only depositor. They are also capitalizing on opportunities to expand the total relationship (grow balances and strengthen ties to the bank) by offering deposit products that incent more than just a one-time deposit event. Other strategies often include demographic or geographic expansion through a targeted product set or tier pricing. Having access to your bank's data has become critical to analyzing your current customer base and to be able to devise strategies to expand these relationships.

Deposit Strategies. *Deposit strategies should be based on a bank's individual risk position...not a competitor's.* Deposits may be the buzz word among bankers and there is always a desire to grow deposits, but each bank must honestly assess the need for liquidity in the form of deposits in a manner that is consistent with its overall risk profile. For example, many banks have been concerned with the increasing amount of CD specials in their market over the course of this year; these specials are frequently 3- to 5-year term CDs with a 2% or higher interest rate. This can provide a challenge at the branch level if not handled properly, since most banks do not need to lock in funding for 3 to 5 years based on their interest rate risk positions. This strategy can actually add cost today, pressuring margin, and worsen other risks down the road to a balance sheet.

Before jumping to the conclusion that your deposit rates need to increase or that you should be offering long term CD specials, review your existing access to funding, look at your earnings at risk under a variety of rate scenarios and run the cost/benefit analysis. Each bank's *realistic* forecast for *net new* loan growth should feed into determining liquidity needs, but be conscious of the yields on loans in your market when discussing deposit retention and/or growth strategies. For many, loans yields are flat to down...not just mortgage rates, but commercial as well.

The existing challenges in today's environment are powerful and so far unyielding: pressure on asset yields, a very gradual rising interest rate cycle and economic uncertainty. Add in the potential for escalating deposit costs...ugh. It is critical to break down silos and fully analyze all strategies – not just deposits strategies – relative to your overall risk position.

— Keri Crooks
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