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# Bank Asset/Liability Management

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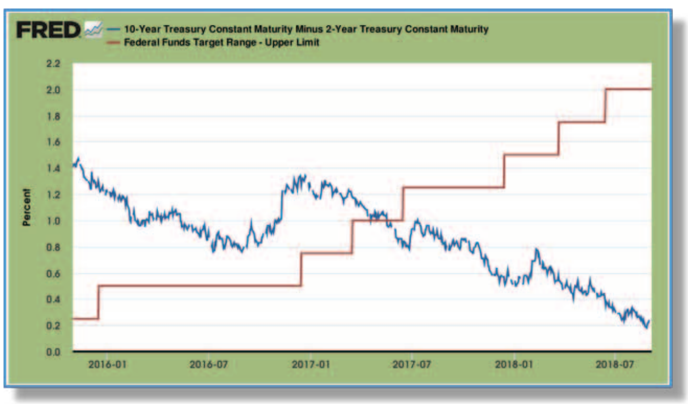
## The Flattening Yield Curve Environment

As we head into the winter of 2018, the shape and slope of the U.S. Treasury yield curve seems to have taken the limelight at most bank's ALCO meetings. As well it should. We have seen the 2-10 spreads, a fancy way of expressing the 10 year Treasury bond yield and subtracting the 2 year treasury note yield, fall from a high of roughly 150 basis points (bps) before the Federal Reserve started raising rates in September 2015 to the current low of roughly 20 basis points as of early September 2018. (See Exhibit 1). Consequently, we have seen the yield curve flatten over the last three years as the Federal Reserve continues to raise the Federal Funds Rate.

**Exhibit 1**




As a result, in ALCO meetings, posted quarterly financial results, along with bank analysts' calls with publically traded companies in the community bank space, it became abundantly clear that the banks' cost of funds and deposit *beta* has taken center stage. In this circumstance, the *beta* means the relationship between the rates paid on deposit accounts and a related wholesale rate, which in this instance is the targeted

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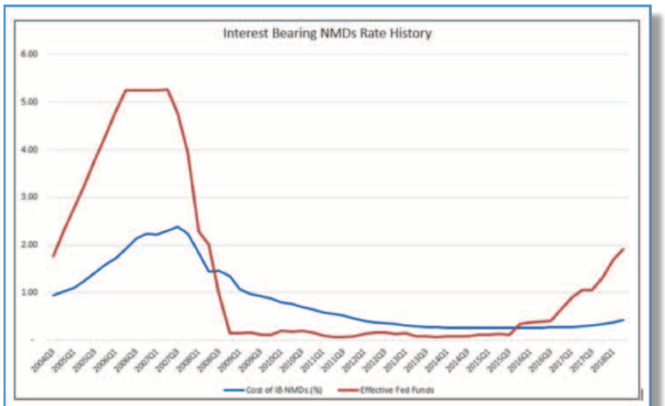
Fed Funds Rate. Looking at Exhibit 2, we see the Fed Funds Rate (red line) is becoming substantially higher than the cost of interest bearing non-maturity deposits (blue line).

**Exhibit 2**



*Data sourced by S&P Global, chart and beta regressions prepared by Darling Consulting Group

From the 3rd quarter of 2015 to the 2nd quarter of 2018, the targeted Fed Funds Rate (upper-limit) has increase by 175 bps. During that same time period, the deposit *beta* for interest bearing non-maturity deposits was 8%, or 14 bps. The industry has been able to lag their cost of funds. Interestingly, the first 125 basis points, from Q3 2015 to Q4 2017, the *beta* was only 6%, the last 50 bps of increase, Q14 2017 to Q2 2018, the *beta* had jumped to 14%. This begs the questions, a) should the Federal Reserve continue to raise rates? b) how much higher will the deposit *betas* go and, c) what will the impact be on financial institutions' balance sheets and income statements?

**Effective Cost of Funds Management**

Therefore, it's incumbent on each bank to have effective cost of funds management plans and deposit strategies. When it comes to developing an operational deposit strategy, there is no *one size fits all* solution. More importantly, asset size and the outlook for loan growth drive funding needs expectations in conjunction with the current liquidity position, interest rate risk profile, and capital. A general theme for deposit strategy discussion, with regards to growth, pricing, product design and promotion, you should be considering the following (not all encompassing):

- Develop clear offensive & defensive deposit strategies:
  - They *differ* greatly;
- Adjust tiered products to reflect realities of current account balance distribution;
- Have ready-to-go shelf products such as MMDA, CDs and Super Savings;
- Lay out very specific strategies for each of your *Largest* accounts/relationships;
- Get compliance & operations in sync with your deposit strategy needs; and,
- Identify plausible strategies for the role & use of wholesale funding (reciprocal, brokered, borrowings).

So, what's the key to a successful deposit strategy? Data is the key. The formula for success is buried in the data... data about your business strategy, risk profile, and customer base. Clearly, no two banks are the same.

Just as important, while it may be tempting to try to follow the strategy of your competition, it's not a wise choice, since their strategy may be the complete opposite of what yours should be. The most successful strategies are those that are based on thoughtful consideration of each institution's business strategy, balance sheet risk profile, and peculiarities and realities of its customer base.

**However, However, However**

Industry and regulatory concerns over liquidity, and interest rate risk associated with rising rates are real and justified. As of June 30, 2018, the rising interest rate scenarios show varying degrees of exposure for a large number of banks. However, for many of these financial institutions the worst case interest rate risk scenario is not rising rates, but rather declining rates. In other words, don't become so fixated on rising rates that you discount or ignore the possibility of rates reversing themselves and starting to decline. With the industry deposit *beta* of only 8% on the first 175 basis points increase in Federal Funds Rate, the ability to lower deposit pricing may be very difficult with any meaningful financial impact, should the Fed start cutting rates. When the vast majority of pundits predict that rates are moving up, one should start to worry about when rates are going to go back down.

Furthermore, now is the time to re-examine the quality and appropriateness of your assumptions used in your interest rate risk models (IRR), especially given the real pressure on deposit pricing and strategies. Ask yourself, have you:

- Modeled different assumptions for deposit *betas* for different rate scenarios?
- Modeled different assumptions for deposit migration or run-off in rising rate scenarios?
- Completed or updated your core deposit study / analysis?

• Stressed your prepayment assumptions?

• Stressed your EVE simulations with different average lives for non-maturity deposits?

Undoubtedly, it's a critical exercise that enables you to validate your assumptions, both quantitatively and qualitatively, that are used within your IRR model outputs and, thereby, all strategies implemented based on the model. As 2018 quickly comes to a close and 2019 looms in the foreground, banks that take the time, effort, and energy to dig deep into their data and challenge the assumptions used in their interest rate risk models to help understand the current business issues as it relates to liquidity, deposit pricing strategies, and risk profiles will likely be the banks that succeed, and outperform their peers, in this flattening yield curve environment.

These business issues can greatly influence the *rightsizing* of deposit strategies for your institution and guide clearer discussions regarding appropriate offensive vs. defensive strategies, as well as influence the prioritization of targeted customer/deposit types.

*— Patrick Ward*
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