DARLING CONSULTING GROUP

CHOOSING THE RIGHT FUNDING STRATEGY

Written By:
Matt Pieniazek
President, Darling Consulting Group

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D·C·G
DARLING CONSULTING GROUP

Towle Office Building
260 Merrimac Street
Newburyport, MA 01950
Tel: 978.463.0400
Fax: 978.465.6033

DarlingConsulting.com

Choosing the Right Funding Strategy

Introduction

How effectively a bank manages its cost of funds plays a big role in determining its financial performance and, ultimately, its value. Fortunately, most banks have been quite successful thus far in pulling back on the reins of funding costs as interest rates have risen, due primarily to deposit pricing discipline. However, and notwithstanding a Fed that appears to be on hold, angst is accelerating given concerns that deposit pricing and balance pressures could escalate over the coming year as competition for deposits is expected to increase. This sentiment was confirmed in a survey recently conducted by Promontory Interfinancial Network (Bank Executive Business Outlook Survey, 4th Quarter 2018, February 2019).

Regulators taking note

Prospects for elevated deposit competition have also clearly captured the attention of bank regulators, especially given the degree of current interest rate and economic environment uncertainties. This has resulted in liquidity management becoming a key area of concern with the regulatory community. Even banks with strong liquidity are under the microscope for liquidity management, with the focus frequently shifting to the efficacy and robustness of bank contingency funding plans. With that in mind, developing and defending a meaningful contingency liquidity policy and plan is an exercise in futility without a well-defined funding strategy that includes an appropriate role for wholesale funding and alternative deposits.

Similarly, banks that complement their traditional deposit strategy with a quiver of appropriate funding alternatives will undoubtedly be more successful in managing their overall funding costs, regardless of the rate environment.

Good business sense & best practices

Having a well-defined funding gameplan and supporting policies is a necessity for all banks, regardless of asset size. It makes good business sense on a number of fronts, such as:

- prudent liquidity management;
- ability to effectively manage cost of funds;
- flexibility in managing interest rate risk; and
- expanded ability to support credit and growth needs of local communities.

Best practices clearly include a delineation of the role for and prudent utilization of alternative funding sources. Regulatory guidance confirms this as well.

Funding options should include FHLB advances, brokered deposits, repurchase agreements, and reciprocal deposits from using deposit placement services such as Promontory Interfinancial Network (e.g. Insured Cash Sweep, or ICS, and CDARS), that enable financial institutions to offer FDIC insurance eligibility beyond $250,000. Of course, not all funding sources are created equally, and each can have a different impact on not only a bank's bottom line, but also its overall balance sheet risk position. In reality, some sources are more seamless than others.

Considerations When Choosing an Alternative Funding Source

A number of key business issues should be considered when selecting a particular funding source. Obviously, relative cost (or price) is always a variable. But price should not be the driver of marginal funding strategies without additional important considerations. These include:

- outlook for loan vs. deposit growth;
- available collateral levels, both securities and loans;
- level of "on balance sheet liquidity" (unencumbered marketable securities and cash equivalents—another accelerating focal point in bank exams);
- current mix of funding and levels (including concentrations) relative to policy limits; and
- interest rate risk management objectives.

When bankers consider and evaluate funding alternatives, they are typically responding to traditional deposit growth challenges or other liquidity related management variables. However, interest rate risk should also be an important consideration. When managing interest rate risk, ready access to a diversified set of funding structures/alternatives is important and thus can influence incremental funding decisions.

Interest rate risk

For example, it is very difficult for an institution to quickly effect any meaningful change in its interest rate risk position through local market deposit strategies. It comes down to one of three basic realities:

1) Banks can't drive enough volume of the particular type and/or term structures of funding they need in a reasonable time period, if at all;
2) The rate needed to be paid to attract deposits is too expensive (particularly relative to other alternatives); and/or
3) Customers are not interested in what the bank is "selling" (e.g. CD special that is either too long or too short for the customer's liking).

Accordingly, interest rate risk driven funding decisions, especially for liability sensitive banks looking to extend funding maturities, will be much more successful if executed in the wholesale-oriented markets. While brokered deposits are a viable solution, the FHLB's array of advance structures can provide broader flexibility depending upon a bank's particular balance sheet structure and related needs.

Keep in mind that the availability of callable brokered CD and FHLB structures (where bank owns the option) is an important consideration for managing prepayment risks embedded in the asset base of bank balance sheets. Also, the ability to embed derivatives such as interest rate caps into FHLB advances is another example of important tactical advantages wholesale funds can provide as a complement to traditional deposit gathering initiatives.

In terms of attracting meaningful balances into desired products, we see banks successfully targeting larger relationships using ICS and CDARS to drive deposits into bank-preferred deposit structures with rate concessions readily accepted by customers in exchange for the FDIC insurance benefit.

Since most reciprocal deposits are no longer considered brokered under federal law (subject to cap of $5B, or 20% of liabilities), we expect banks to increase their use of deposit services such as ICS and CDARS.

Collateral Management Is Key

Choosing the right funding strategy necessitates the management of an interesting dichotomy when it comes to a bank's reservoir of investment and loan collateral: using it judiciously for operating purposes, while ensuring appropriate availability for contingencies. Funding decisions, including retail-oriented deposit strategies, can have notably different impacts on this collateral reservoir.

To illustrate how alternative funding sources differ in their impact on collateral management, and to also demonstrate how existing retail-oriented strategies can be augmented favorably in the context of both liquidity and interest rate risk management, it is insightful to take a quick look at common public funds and customer repo strategies whereby security collateral is being pledged.

Over the years, we have demonstrated to numerous banks how their liability sensitive interest rate risk profile is driven largely by their public deposit and/or repo strategy. It emanates from the need to buy securities to meet the collateral requirements for that funding, and the simultaneous quest for a reasonable yield in excess of the related funding costs. Unfortunately, this has resulted in no liquidity benefit and the creation of interest rate risk that is unnecessary and readily avoidable. In effect, the bank becomes locked into a series of security leveraging activities that, instead of being funded by borrowings, are funded by public funds and/or deposit surrogates (repo).

Role of reciprocal deposits

One way to mitigate this, or any collateral challenge, is with a reciprocal cash sweep product. For example, utilizing the ICS program we have helped numerous banks completely change their interest rate risk position and materially improve their liquidity flexibility by freeing up collateral that enables investment portfolio management to be driven by overall balance sheet management needs, rather than collateral needs. Incorporating an ICS-type service into public funds and customer repo funding strategies can be a game changer.

Role of FHLB

FHLB Letters of Credit (LOCs) should also be included in a bank's funding quiver. We have also influenced many banks to successfully utilize FHLB LOCs (MULOC, or municipal letters of credit) in lieu of pledging securities for public funds. LOCs have a common benefit with reciprocal deposits in that they don't require security collateral.

Reciprocal vs. FHLB

The primary disadvantage of FHLB LOCs vs. insured cash sweeps is that they are liquidity neutral (exchange loan collateral for security collateral), while the sweep product produces a net liquidity benefit (no collateral required). In general, related costs are comparable; however, the all-in cost advantage can sway between LOCs and ICS-type products depending on circumstances. While not collateral related, an important consideration when comparing FHLB credit products with other alternatives is the dividend received on the stock purchase required to support such activities, which lowers the effective cost of FHLB credit.

Importantly, as insured cash sweeps and LOCs free up security collateral, they also result in higher levels of on balance sheet liquidity, which is an accelerating area of regulatory focus. It should be noted that banks can create an off balance sheet liquidity reserve (and earn fee income) by using one-way programs such as the ICS One-Way Sell service to temporarily shift excess deposits to banks that are in search of funding.

Another relative benefit of products like ICS and CDARS vs. repos or other borrowings is that the customer monies are classified as deposits, which not only helps lower the loan/deposit ratio, but can also positively impact franchise valuation metrics for public banks.

Customer repos

Notwithstanding its collateral requirements, customer repurchase agreements are an important funding alternative and continue to be used quite effectively at many banks to capture rate sensitive deposits. One drawback is that repurchase agreements come with some administrative downsides for both the bank and the customer. Repos require daily remittances, which customers dislike, even though this is intended to protect them. They also necessitate collateral market value tracking and can result in other collateral management activities. That is why we are seeing many banks substitute insured cash sweeps for repurchase agreements. Another consideration is that customer repurchase agreements are typically reserved for larger balance relationships, while cash sweep products are more conducive to a broader array of balance sizes.

Contingency liquidity management & stress testing

When it comes to contingency liquidity management and stress testing, total security and loan collateral availability is key. Reciprocal deposit programs do not impact either security or loan collateral levels and thus can increase stress-testing resiliency vs. collateralized borrowings (repos and FHLB) and letters of credit. FHLB products have the advantage of being able to shift between loan and security collateral, and the FHLB System has a history of being a reliable source of funding for banks even in stressful banking industry environments.

However, regardless of funding source, banks must understand the circumstances that could curtail access to funding or even require repayment, either because of regulatory restrictions (e.g. falling below well capitalized and assuming no FDIC waiver) or because of the funding provider backing away due to its own policy. This is a much bigger issue for brokered deposits (entails immediate curtailment and required non-renewals of existing) than it is for FHLB advances (rarely involves non-renewal of outstanding advances, but has potential for curtailment of new). Reciprocal deposits fall in-between these two. Clearly, banks must document their understanding of these realities and incorporate that knowledge into their liquidity stress testing and related management processes.

Conclusion

Prudence and best practices necessitate that all banks have an appropriately developed funding strategy incorporating a role for wholesale funding and alternative deposit products such as reciprocals. Every funding source, including "local market" deposits, has its advantages and disadvantages that can ebb and flow in terms of relative importance or value at any given time. It is situational, and that is why it is important to have all of them readily available at all times. Banks that complement their core deposit strategy with a prudent and well-defined role for borrowings (e.g. FHLB advances), brokered deposits, letters of credit, and reciprocal deposits (e.g. ICS and CDARS) will greatly enhance their ability to successfully manage their overall funding costs throughout a myriad of economic and interest rate cycles.

Liquidity management in general and stress testing in particular have become key areas of regulatory focus. Accordingly, managing the levels of both unencumbered security and loan collateral is essential. Collateral management, along with a funding strategy that incorporates a variety of approved funding alternatives, truly forms the foundation for managing operating liquidity and establishing a resilient contingency liquidity plan and strategy.

Funding choices are important and matter greatly. Flexibility is key. Educate management and the Board, and revisit the appropriateness of your funding philosophies and related polices. Time is not your friend.

About the Author

Matt Pieniazek is the President of Darling Consulting Group. Along with a team of highly experienced colleagues, DCG partners with hundreds of banks nationwide to ensure that their asset/liability management process becomes a sustainable profit center through accurate risk assessment and the development of tailored solutions for earnings enhancement and risk mitigation. He and his colleagues are frequent speakers and authors on balance sheet management topics. Matt can be reached at mpieniazek@darlingconsulting.com or 978-463-0400.