March 2001 / Number 28

Active planning and monitoring of funding strategies not only provide profit and risk management opportunities; they also help ensure the safety and soundness of your bank.

Regulators are looking much harder at advance usage by Federal Home Loan Bank members. Usually, additional regulatory scrutiny focuses on activities that could increase a bank's risk profile. With advances, the attention stems from a solution to a problem: funding asset growth during periods of low deposit growth.

Growth issues

Any asset growth can create legitimate regulatory concerns such as lower capital ratios, riskier loans, and declining ROAs. These issues are a concern in any strategic decision to grow. But once the decision to grow is made, the funding manager must locate the best available funding options consistent with internal policy guidelines. Normally, the choice is among advances, brokered CDs, reverse repurchase agreements, and aggressive deposit specials.

A bank's reliance on advances increases through funding growth or replacing existing deposits. Advances improve net income when their cost is less than the full cost of deposit specials. That full cost equals the rate paid for new deposits (including retention of deposits that would have been lost without the special rate) plus the additional cost of existing deposits shifting into the special rate category. The marginal cost model on Member Link helps estimate and document the full cost of deposit specials. Of course, directors should be actively involved in overseeing a shift in funding strategy.

Funding growth with advances may actually curtail an institution's ability to invest in higher risk assets due to collateral requirements. Borrowing capacity varies inversely with the risk level of the assets serving as collateral. Specifically, if a member shifts its loan mix toward higher risk products, its available collateral, and thus its capacity for advances, should decline.

Liquidity concerns

Bankers are increasing portfolio yields by replacing liquid investments with loans. When liquidity declines, borrowing capacity must be part of ongoing liquidity assessment. For liquidity, there is no difference between selling securities and wholesale borrowing, provided the capacity to borrow can be readily accessed. Taking this opportunity to construct a higher yielding asset portfolio should be supported by clear policy guidelines and sound cash management procedures.

However, when growing advance balances deplete the borrowing capacity, action is needed so that funds will be available to prevent an unanticipated funding crisis. A contingency funding plan can address the issue by quantifying what internal (asset sales) and external funding sources would be available during a crunch. Active monitoring of potential cash flows is another important step in minimizing the likelihood of a liquidity shortfall.

Regulators are very focused on how reliable advance funding would be if a bank's financial condition be-

This *Insider* was written by Jeff Sanders, assistant vice president and senior financial strategist. Back issues of the *Insider* are available on the Bank's website.

gan to deteriorate, fearing the loss of liquidity just when it is needed most. But since members borrow on a secured basis, the FHLBI can lend to troubled institutions with liquidity needs as long as they have adequate collateral. However, these members would face more stringent collateral requirements and additional monitoring, and only certain advance types would be available.

Interest rate risk

Advances can be an integral part of an interest rate risk management program. Terms ranging from one day to twelve years (20 years for CIP) are useful in structuring the risk profile. The greatest benefit occurs when a full balance sheet risk perspective drives the selection of advance terms. The FHLBI routinely assists members in determining desirable advance term strategies, using full balance sheet analysis.

The conversion option in putable advances creates a separate issue. The FHLBI retains the ability to convert a putable advance from a fixed to an adjustable rate after a predetermined lock-out period. There is no liquidity risk at conversion since the member may choose to retain the funds until maturity as an adjustable-rate advance. However, there is interest rate risk, which the member is compensated for through a lower rate on the advance.

The FHLBI shares the regulatory view that putable advances require oversight. So, we 1) require a pre-purchase disclosure that the risk has been reviewed, 2) offer analytic support via customized modeling and on-line valuation reports, and 3) monitor usage as a proportion of advances. The potential use of putables should be reflected in the appropriate policies. Management should be able to demonstrate that putable risks are consistent with the desired balance sheet risk profile.

Members may use putables to improve their risk profile and lower their funding costs, provided they understand and measure the risks of the product. A lock-out period of five years provides the same protection against rising interest rates as a five-year fixed-rate advance or CD. Should rates decline, the advance rate may remain unchanged until the final maturity, making the total cost less attractive than a series of shorter-term advances.

Bottom line

The following statement from RD Memo 00-046 issued by the FDIC on August 22, 2000, offers one regulator's perspective. "The FDIC does not discourage the use of FHLBI advances as part of a well-managed funding program. However, management of institutions that use advances should fully understand the risks that may be associated with their use." Essentially, regulators want management to show an understanding of the role of advances in conducting their business. To that end, members should do the following things.

- Cover advance usage in the proper policies and in the business plan.
- Address advance usage only in policies pertaining to funding instruments.
- Make sure the board monitors advance activity.
- Monitor liquidity in terms of both assets and available borrowing capacity.
- Maintain a liquidity contingency plan.
- Document the rationale for funding strategies involving advances.
- Complete pre-transaction analysis for the use of putable advances.
- Contact the FHLBI to discuss concerns or emerging issues.

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Send comments to Financial Communications, Federal Home Loan Bank, PO Box 60, Indianapolis, IN 46206.

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