



FHLBI Insider

Optimize your borrowing capacity

Anemic deposit growth has led to a growing importance of wholesale funding sources.

According to FDIC statistics, total domestic deposits held by banks and savings institutions grew at an annualized rate of 1.6% during the 1990s. This was sufficient to fund only about one fourth of asset growth (26%). Wholesale funding has played a critical role of filling the gap. As of Sept. 30, 2000, the usage of wholesale funding had increased to the point of funding nearly \$1 out of every \$5 of assets (19%) at FDIC institutions.

For most institutions, the wholesale funding of choice has been FHLBank advances. At the FHLBI, credit extended to Indiana and Michigan members increased from \$6 billion to \$24 billion over the last decade. While concentration levels vary widely, the average FHLBI member was funding 7.5% of assets with advances by year-end 2000.

With increasing FHLBI usage comes the inevitable question of how best to collateralize current and pro-

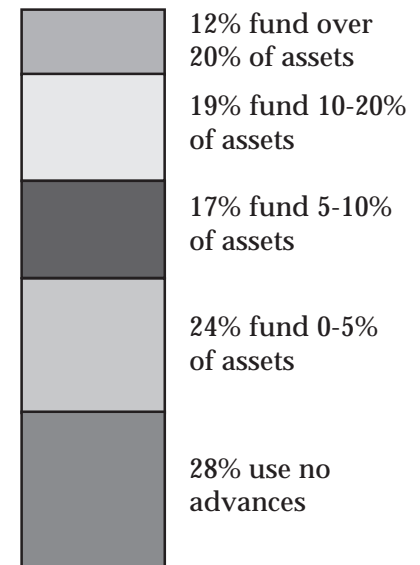
jected borrowing needs. A variety of options are available to optimize borrowing capacity. Each institution should implement the collateral strategy that provides adequate borrowing capacity with the greatest simplicity and economy. Not surprisingly, both the complexity and costs of FHLBI collateral strategies tend to increase with increasing borrowing needs. Listed below are current FHLBI collateral options from simplest and least expensive to the most complex.

Pledging securities

If an institution has sufficient agencies, treasuries or mortgage-backed securities to cover projected borrowing needs, then pledging securities is the optimal collateral strategy. It is the simplest and least expensive way to access FHLBI borrowings. Securities have the most favorable coverage ratio of any collateral type (105%-115% of market value). Also, no special reporting is required. The only catch is that securities must be either safekept at the FHLBI or with a third-party custodian.

Few institutions have enough security collateral to cover their borrowing needs. Usually, institutions that exclusively pledge security collateral eventually opt for an arrange-

Institutions classed by advances to assets %
as of Dec. 31, 2000



ment providing greater borrowing capacity, such as the blanket collateral arrangement.

Blanket collateral

The blanket collateral arrangement is by far the most popular collateral strategy. The standard blanket collateral arrangement enables a member to pledge 1-4 family mortgages and multifamily loans. Under the blanket collateral arrangement, the FHLBI will lend approximately

This *Insider* was written by James B. Eibel, CFA, vice president and marketing representative. Back issues of the *Insider* are available on the Bank's website.



\$0.69 for every dollar of book value collateral (145% coverage requirement). For many institutions, the standard blanket collateral arrangement provides sufficient borrowing capacity to meet liquidity and growth needs.

The blanket collateral arrangement is not without its costs. A single page, quarterly collateral report must be filed with the FHLBI credit department. Also, an annual verification of collateral is required from each borrowing member's independent auditors. Most audit firms charge approximately \$3,000 to perform this service, but costs differ based on auditing firms and complexity.

Specific and physical collateral

For a variety of reasons, not all members are eligible for blanket collateral status. These institutions often pledge their 1-4 family mortgages via either the specific listing or physical possession collateral pledge arrangements. In both cases, eligible mortgages receive a more favorable coverage requirement (125% of market value) than in the standard blanket arrangement.

Specific and physical mortgage pledges require more administration than the blanket arrangement. Both arrangements require institutions to select and assign specific

loans to the FHLBI as collateral. Both arrangements require monthly updates of information, such as outstanding balances. As with the blanket arrangement, the specific pledge arrangement requires the submission of an annual collateral verification. Since the physical pledge arrangement requires the FHLBI to hold the original mortgage notes, the annual collateral verification is unnecessary.

Combining collateral arrangements

The various collateral arrangements can be combined to produce additional borrowing capacity. For example, a combination of a blanket pledge of mortgages and a pledge of securities will produce greater borrowing capacity than either arrangement alone. A combination of securities and a specific mortgage pledge often produces the maximum possible FHLBI borrowing capacity. That is, unless other real estate related collateral types are considered as well.

Other real estate related collateral

Not all institutions have sufficient securities and residential mortgage collateral to cover their borrowing needs. The recent passage of the Federal Home Loan Bank Modernization Act authorizes the FHLBI to accept "other real estate related collateral" for borrowings. At the present time, the FHLBI has been approved to accept commercial real estate and home equity loans. These new collateral options allow institutions to increase their borrowing capacity up to *an additional* 1.5 times core capital, collateral permitting.

While pledging commercial real estate and home equity loans will increase borrowing capacity, it is the most labor intensive and costly of all

collateral options. First, institutions must apply to the credit department and submit a copy of lending policies. Prior to pledging either commercial real estate or home equity loans, analysis must be conducted to ensure that minimum collateral criteria are met. In the case of commercial real estate, information must be submitted *for each pledged loan*. Finally, the annual collateral verification letter will be required to cover all pledged collateral. Since pledging commercial real estate and home equity loans will add to audit complexity, the cost of the annual collateral verification may increase as well.

As exciting as they are, the new collateral options tend to produce less borrowing capacity for a given level of effort and cost. For this reason, these types of collateral should be pledged only after careful consideration. If your institution would like to pledge commercial real estate or home equity loans please contact the credit department at (800) 442-2568.

Implications of the new policy

As institutions increase their usage of the FHLBI, it becomes apparent that not all loan growth is equal from a liquidity perspective. Institutions should consider the impact of asset growth plans on their FHLBI borrowing capacity. For example, increasing mortgage loans will increase borrowing capacity more than commercial real estate lending. However, commercial real estate lending will increase borrowing capacity more than indirect auto lending. If an institution's projected borrowing needs are large, lending that meets FHLBI collateral guidelines should receive special consideration. Ultimately, these considerations should be reflected in areas such as loan pricing and policies.

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