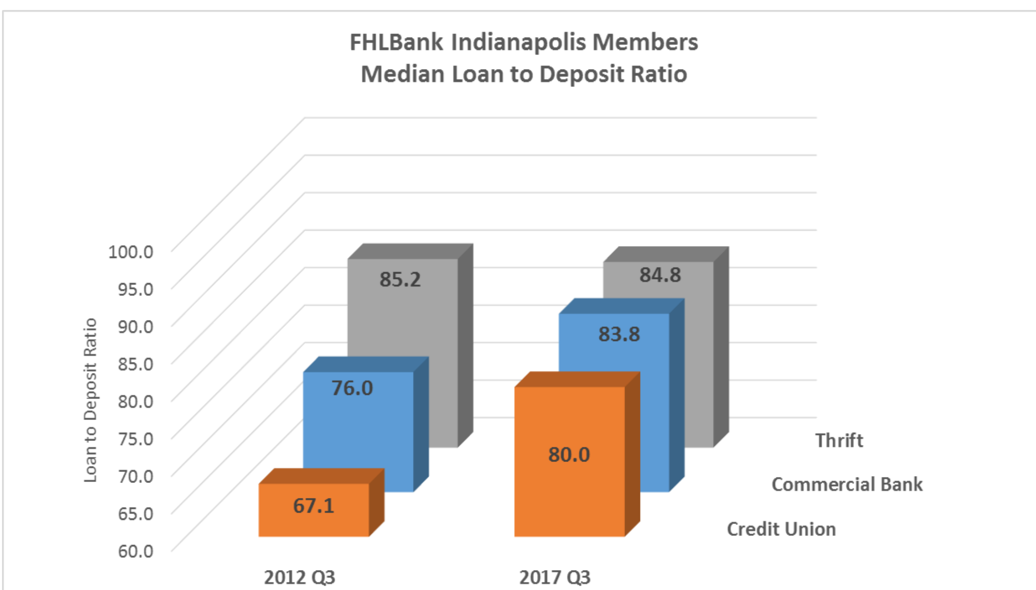
Liquidity Planning

Is the perfect storm coming?

Living in the Midwest, weathermen often warn viewers about converging cold fronts that will collide with high precipitation in a stalled low-pressure area resulting in multiple inches of snow. The banking industry is showing signs of several factors coming together, and many of the regulators are taking notice and sending a warning message. These warning signs point towards conditions that could create unexpected lack of liquidity. Are you monitoring the signs and planning for a potential storm? What are these warning signs?

1.   Increased Loan to Deposit Ratio

Many depository institutions have enjoyed increasing loan activity which has resulted in increased loans to deposit ratio. For the depository institutions who are members of FHLBank Indianapolis, we are seeing that total loans & leases grew by 67% from 5 years ago (3Q 2012 compared to 3Q 2017). Total deposits grew for this same group by 47% from 5 years ago. This has resulted in an increase in the overall loans to deposit ratio across depository member segments. An increase in earning assets is a good thing, but the regulators such as the FDIC[1], are monitoring this rise to see if liquidity planning is in place to support future growth.



[1] "Community Bank Liquidity Risk: Trends and Observations from Recent Examinations", FDIC Supervisory Insights, Summer 2017

2. Less liquid assets and compounded effect of rising rates

To help with liquidity gaps, liquid assets have been a quick source of funds. In the hunt for higher yields, the levels of liquid assets, such as U.S. Treasury and U.S. Agency securities, have been declining. Since rising interest rates decrease the market value of fixed-rate securities, liquid assets could provide less help in meeting projected liquidity needs.

3. Reliance on Brokered Deposits

A brokered deposit is generally a deposit obtained directly or indirectly from or through a deposit broker[2]. Brokered deposits can be more rate sensitive than other funding sources and have substantial run-off risk after maturity if rates are not kept competitive. If your institution has brokered deposits, they may not be a stable source when liquidity planning, especially during rising rates.

4. Funding concentrations

The FDIC notes that examiners have identified increases in funding concentrations, most commonly in uninsured large deposits, high-rate deposits, brokered deposits, internet listing services, and even FHLB borrowings[3]. In 2015, examiners identified funding concentrations at 21% of institutions surveyed; in 2017 that figure jumped to 40%. The concern of examiners is elevated if volatile funding concentrations are coupled with credit concentrations in such areas as CRE and agriculture lending.

5. Potential movement and pricing of deposits

For many years, there have been discussions on "surge deposits," and whether a depository could experience a large movement of deposits to higher yielding alternatives elsewhere, once market interest rates rise. During periods of excess liquidity and flat rates this was an interesting conversation topic. Now that liquidity may be needed due to increased loan volume, and numerous short-term rate increases have been made by the Fed with more expected in 2018, attention and planning is needed.

What could happen to your unique deposit base and how will you price your deposits to avoid paying excess marginal cost to keep them? As noted in the formula below, a 2% deposit rate promotion does not cost just 2% - it could cost 3% for each new deposit! Assuming 50% of the deposits come over from your current deposit base in which you are paying just 1%, you will have a marginal cost of 3.0%! The more deposits that come from current lower paying accounts, the higher the marginal cost. Will you be attracting new money when you raise your deposit rates, or will you just be paying a higher and higher marginal cost?

Marginal Cost = (Promo Rate – (% cannibalized x current cost of deposits))/ (1-% cannibalized)

3.0% = (2.0% - (50% x 1.0%)) / (1 – 50%)

[2] Section 29 of the FDI Act defines the term "deposit broker"

[3] "Underwriting Trends and Other Highlights from the FDIC's Credit and Consumer Product/Services Survey", FDIC Supervisory Insights, Winter 2017

How FHLBank Indianapolis Can Help

As a member of FHLBank Indianapolis, you have a reliable liquidity source that provides the following benefits when planning for liquidity:

- By growing your loan and asset portfolio, you are naturally expanding the base of eligible collateral that can be used for future funding needs.
- An expansive listing of eligible collateral includes many non-liquid assets such as mortgages, multi-family loans, and commercial real estate loans.
- The FHLBank System is a reliable source that has been in place since 1932 and provided liquidity even during times of recent market disruption such as Hurricane Sandy (October 2012), 9/11, and the financial crisis.
- As an alternative to rate-sensitive brokered deposits, FHLBank advances, such as the bullet fixed term advance, can be structured without the risk of early withdrawal and has the advantages of speed and ease of execution.
- FHLBank Indianapolis advances allow an institution to evaluate funding needs and determine the best economical cost when comparing advance rates to the marginal cost of maintaining or increasing deposits.

As depositories plan for the upcoming year, there are many dynamics stirring up concern over the liquidity environment. To prepare for potential adverse conditions, take stock of your institution's current situation, put in place sound funding strategies and prudent risk management practices, which can include the reliability of FHLBank Indianapolis advances.

For additional assistance in analyzing funding strategies, contact FHLBank Indianapolis Member Services 800.442.2568 or memberservices@fhlbi.com

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