Reflecting on Current Challenges and Opportunities

The Current Environment

Today's banking environment is one of the most challenging that we have seen in quite some time in what we hope is the 7th or 8th inning of a 9-inning pandemic. I say this because vaccines are now widely available to anyone who wants them, therapeutic treatments have improved dramatically, increasing the probability of survival of those who get the virus, and finally we are entering a period of warmer weather when we will spend more time outdoors instead of as much time indoors.

The economy seems to be gaining strength which is evident in various economic numbers. Employment is improving, economic growth is accelerating, with a favorable outlook for the remainder of the year. Many households and businesses have pent up demand and liquid funds to deploy, which have the potential to give a significant boost to economic activity over the next several quarters. Within the banking sector, early indications are that profitability is going to be strong for many organizations that have been able to reduce loss reserves due to better than anticipated loss experience, expense control, mortgage activity, and loan growth.

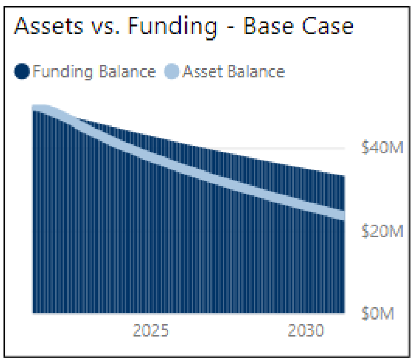
The Biggest Challenge and Some Potential Solutions

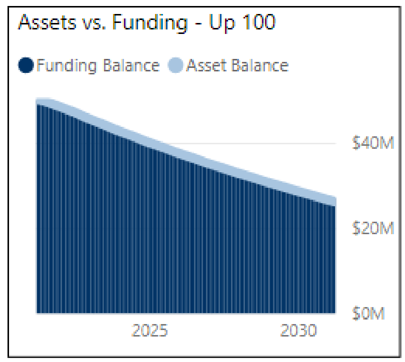
With the improving pandemic and economic backgrounds, what are some of the key **significant challenges facing our depository members**? Probably the most significant challenge will be to deploy the excess liquid funds that most of our depository members have accumulated over the past 12 months. The primary contributors to the increase in deposits are a result of the various fiscal and monetary stimulus programs with the greatest magnitude, and the most rapid deployment in the history of our country.

One consideration should be to evaluate opportunities to **deploy excess cash**. Of course, each member needs to be aware of its own risk appetite when making these types of decisions. With an improving economy, high quality loans are an option as the opportunities improve within your respective operating markets. For those members that have a significant amount of funds sitting at the Fed earning .10% as of 05/03/21, the significant marginal increases in spread over cost of funds are significant and can help in supporting the organizations Net Interest Margin and profitability. One loan type available is fixed rate mortgages. Have you evaluated the impact of retaining some of your mortgage loan production? If excess funds, above what is needed for liquidity are parked at the Fed, the pickup in yield can be significant. Of course, consideration for your overall interest rate risk position and estimated duration of your funding options should be evaluated as part of the decision. To mitigate some of the interest rate risk, some intermediate or longer term FHLB**I** advances could be part of the funding decision.

Considering Non-Maturity Deposit Sensitivity

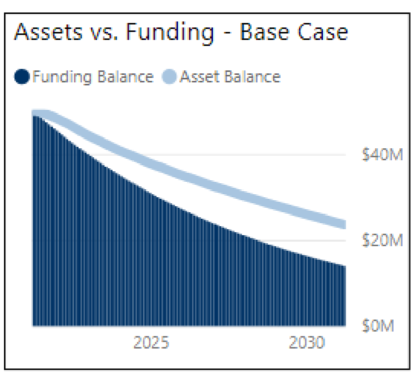
One approach for evaluating some of the funding decisions related to different types of loans, and funding a significant amount with deposits, is to consider “sensitivity” analysis with the deposit funding. In other words, you would evaluate the impact to the NII of the leverage strategy applying differing deposit decay rates to the analysis. The following is a simple example of the projected cash flows of a pool of current coupon 30-year mortgages in both the base case and in an up 100bp scenario fully funded with non-maturity deposits over a 10-year time horizon. The balances of the mortgages are indicated by the light blue line and the funding (in this case non-maturity deposits) is illustrated by the blue bars. The other primary assumption is that deposits are assumed to decay at 4% annually in the base case and 6% annually in the up 100bp scenario. As rates rise, the incentive for depositors to earn interest will increase. With these assumptions, you will note a somewhat close match between the cashflows of the mortgages and the deposits, especially in the up 100bp scenario.

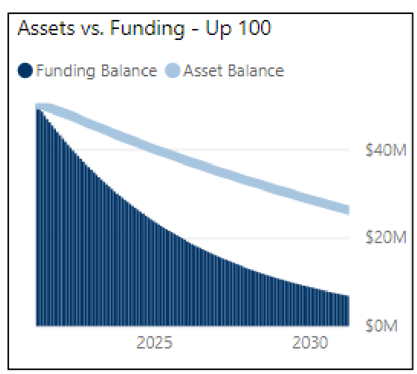




*Source FHLBI Member Funding Analytics, powered by ZM Desk – assumes 30-year mortgages @ current coupons funded by non-maturity core deposits with 4% annual decay in base case and 6% in up 100bps.

Since it is unknown how permanent that these recently acquired deposits will be, to evaluate, we increase the rates of deposit decay to 3x the original example to see the impact on projected cashflows of the non-maturity deposits. In this sensitivity scenario, the duration of the funding is significantly reduced, especially in the up 100bp scenario.





*Source FHLBI Member Funding Analytics, powered by ZM Desk – assumes 30-year mortgages @ current coupons funded by non-maturity core deposits with 12% annual decay in base case and 18% in up 100bps.

If you would like some assistance in evaluating your funding decisions related to loan growth, please reach out to your account manager and our Member Research and Strategies Team can assist. Other ways to portfolio some mortgages would be to portfolio loans of 15 or 20-year terms if the risk of 30-year term loans is outside risk tolerance or use term FHLBI advances to diversify the funding mix used.

Other Lending Options

With the appreciation in home prices and low interest rates, another loan that might warrant some consideration would be **5,7, or, 10-year term fixed rate home equity loans**. These loans may be appealing to homeowners who want cash outs but do not want to go through the process of a refinance. Again, our Member Research and Strategies Team can help you evaluate funding options, including use of your non-maturity deposits.

One other loan that might find some appeal to those lenders who make commercial loans would be making **term commercial loans beyond a 5-year term**, which is a typical maximum at many of our members. Of course, credit risk considerations and overall risk appetite should be considered but you may find that you have some businesses that would find locking into a favorable longer term loan appealing. One option for your organization might be to create a pool of funds with a maximum amount that you are comfortable with on your balance sheet and perhaps only offer it to your most pristine credits.

It is important that opportunities for prudent lending be considered to defend and improve Net Interest Margins in the coming quarters. If there are opportunities for loans and funding that you would like our Member Research and Strategies Team to help you evaluate, please reach out to your account manager to schedule a discussion. This analysis is included as a benefit of your FHLBank Indianapolis membership.

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

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