Excess Deposit Bonds- Flexible Form of Collateral

By: D. James Lutter
Co-author: Todd A. Terrazas

Originally published on CUInsight.com, May 23, 2018
Reprinted and posted with permission by CUInsight.com

As the economy continues to expand, financial institutions are again in the mode of seeking funding sources to support loan growth. Instead of cannibalizing their local market, they look to institutional/wholesale depositors for the additional funding. Institutional deposits allow financial institutions the flexibility to expand or contract deposit levels without disrupting their core market. Institutional depositors are more structured in nature and are often times bound by investment policies or state statutes requiring a rating on the financial institution and/or collateralization on investments; both of which create a barrier of entry and limitations on available funding. There are multiple forms of collateralization, but each has benefits and limitations depending on the type of depositor and the financial institution's ability to collateralize.

With the pledging of collateral, a financial institution encumbers their highly liquid investments, which has a negative impact on their Liquidity Coverage Ratio. In addition, there is usually a haircut associated with pledging, and ongoing operational maintenance. When issuing a Federal Home Loan Letter of Credit, a financial institution reduces their ability to access the Federal Home Loan Banks ("FHLB") directly for advances. Operationally, FHLB letters of credit are straightforward. The Letter of Credit is a direct obligation of the FHLB and does not fluctuate in market value. Reciprocal deposits also do not require the encumbering of securities or fluctuate in market value, but have rigid terms in settlement.

Excess Deposit Bonds ("EDB") have resurfaced as a feasible source of collateralization. An EDB is a guarantee from an insurance provider that a financial institution will perform its obligation to the depositor. Should the financial institution default in its obligation to the depositor, the EDB can be "drawn" upon and the

insurance provider will make the depositor whole in principal and interest through default.

The reappearance of EDBs will provide bankers with an additional securitization option when participating in deposits that require collateral. Furthermore, this type of securitization can be utilized with any type of depositor, unlike Letters of Credit or pledged securities which are limited to specific types of depositors. However, just like current securitization options, it is important to be cognizant of all tangible and intangible costs. Insurance providers issuing EDBs will charge a premium on the deposit being placed. The cost may vary depending on a number of factors which include program size, credit quality, duration, etc. It is important to ask your insurance broker or the underwriter about the cost associated with your bond and various factors that may influence it. Due to the impacts of the financial crisis, EDB providers are mitigating risk through shorter durations and smaller program sizes.

EDBs are a welcome re-addition to the options of securitization. This tool provides financial institutions with an opportunity to attract deposits that they typically wouldn't due to securitization requirements. Furthermore, if used effectively, EDBs can provide regulatory relief. On the surface, EDBs seem more expensive than other forms of securitization, but when factoring in operational cost, functionality and regulatory diversification, they become a competitive alternative.

About D. James Lutter

D. James (Jim) Lutter is the Senior Vice President of Trading and Operations at PMA Financial Network, Inc. and PMA Securities, Inc. where he oversees PMA Funding., a service of both companies that provides over 1,000 financial institutions with a broad array of cost effective funding alternatives. Mr. Lutter is a Registered Representative with PMA Securities, Inc. and Investment Advisor Representative with Prudent Man Advisors, Inc. Mr. Lutter has the following FINRA licenses with PMA Securities, Inc.: Series 7, 24, 50, 53, 63, 65 and 99.

About Todd A. Terrazas

Todd joined PMA Financial Network, Inc. in 2014 as a Financial Analyst for the firm's Credit Risk Management team. He now serves as Business Development & Product Manager for PMA Funding, where he is responsible for developing financial institution partner relationships and managing funding product solutions and association affiliations. Mr. Terrazas also engages in strategic planning and identifying market trends through extensive market research. Prior to joining the firm, he was a Market Research Analyst at Common Goal Systems, Inc. Mr. Terrazas earned his Bachelor of Arts in Finance from Calvin College.