

Know your funding sources

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The old adage states, “easy come, easy go”. Since 2008, financial institutions have easily grown and maintained stable deposit balances. Due to risk aversion among the general public, deposits across all institution sizes have witnessed significant growth with relative ease. Accessible funding has been a great benefit to financial institutions; however, it is important for these institutions to document and understand how each source will react in various stress situations. Most economists and Wall Street professionals believe the economy is in the latter stages of recovery. Understanding funding sources and how they will react to different markets will help guide financial institutions to achieve a proper liquidity balance, while ensuring stable deposit balances won’t end.

IDENTIFY AND DEFINE FUNDING SOURCES

There are a number of funding options available to financial institutions and it is important to identify which sources your bank is working with. You can identify what gaps may exist in your current funding sources, and what their role plays, by answering a few key questions:

- Are deposits in foot-print or out of foot-print?
- Are deposits operating or non-operating?
- Are deposits commercial, residential or institutional?
- Does interest rate sensitivity exist, and if so, at what level?
- What concentrations are in the deposit portfolio?

By answering these questions, a financial institution can obtain a quick snapshot of their deposit mix and begin to effectively define an operating and contingency funding plan.

WHICH FUNDING OPTIONS ARE RIGHT FOR YOUR FINANCIAL INSTITUTION

After recognizing current funding sources and any pitfalls that may exist, a financial institution should look to bridge the gaps. Once a bank has determined its most appropriate funding options, the next step is to identify the role each option will play within an operating and contingency funding plan. It is critical that diversification, credit sensitivity and concentration limits be included. A good test of these attributes can be identified through a SWOT analysis (Strengths, Weaknesses, Opportunities and Threats). For example, a SWOT analysis of a municipal depositor may resemble the following:

STRENGTHS– A municipal depositor is typically local, has a predictable deposit cycle and can be a stable funding source.

WEAKNESSES– Deposit capabilities can fluctuate and are cyclical; usually requiring some form of collateralization (per state statute or investment policy). Credit restrictions may also be present.

OPPORTUNITIES– A municipal client can become a significant, multifaceted relationship through transaction activity, long-term banking service contracts, borrowing, safekeeping, etc. Additionally, diversification among multiple municipalities may mitigate cyclicity risk.

THREATS– The general economic conditions may deteriorate, creating revenue shortfalls from a declining tax base and/or a delay in state or federal aid.

Regulators are taking a close look at financial institutions' funding policies to ensure that proper controls are in place, which should adequately address the environment in which each financial institution operates. Testing sources on a regular basis allows a financial institution to readily access funds as needed while eliminating the element of surprise.

MONITOR AND MAINTAIN YOUR FUNDING SOURCES

To avoid undue stress, it's important for financial institutions to monitor the inherent risk characteristics of its funding sources, as well as the evolving needs of those sources. Gaining a comprehensive understanding of your funding sources and the relationships to their investors and depositors provides much needed information to help understand how those deposits will respond under stress. Adverse effects to a financial institution's credit profile will increase the bank's cost of funds and may limit their ability to access funding. Different depositors have diverse investment criteria and yield expectations. A comprehensive understanding of these metrics will enhance the financial institution's ability to price and access funding sources. Furthermore, it allows for a risk-averse operating and contingency funding plan to be executed. To build a solid, ongoing understanding of its funding sources, a financial institution should continually ask these important questions:

- How does the market view my bank? Do I know the credit criteria my funding sources monitor (qualitative and quantitative)? What are the implications if the criteria are breached?
- Do I understand my funding source's (depositors) investment objectives (safety, liquidity, yield, etc.)?
- Have I identified, and do I monitor, the factors that could affect my ability to access various funding sources?
- Does my funding source have concentration limits?
- Have I documented each funding source's role and communicated it where applicable?

CONCLUSION

Developing reliable, diversified funding sources is critical to the success of a financial institution. By defining, identifying and maintaining funding sources, a financial institution will gain further insight and discover tools that help mitigate risks when issues arise. For this part of a financial institution's balance sheet, a good thing does not have to come to an end. A well-defined plan will help maintain stability, provide sound liquidity and interest rate management, and add value through increased earnings.

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

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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.

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