

Active or Passive Funding Strategy–Tug of War

CUInsight (Originally published on CUInsight.com, May 15, 2017)

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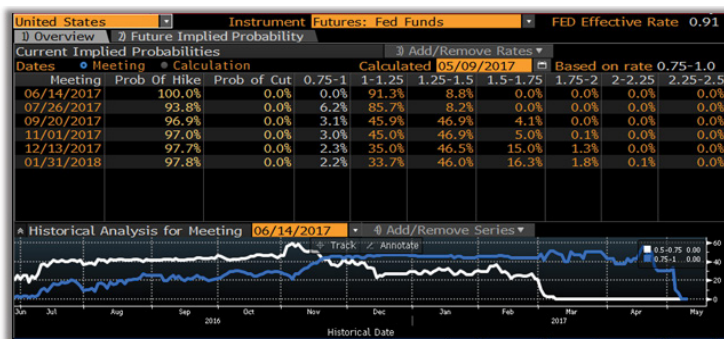
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The Fed is still on course to raise interest rates 25 basis points in June. This would be the second rate increase in 2017, despite a GDP reading of .7 percent year over year, and inflation running below their stated goal of 2 percent. Other recent data points include solid job gains and a declining unemployment rate under 5 percent.

Bottom line – the implied probability of a June 14th rate hike is now 100% (as of May 9, 2017).



Source: Bloomberg

With this in consideration, what impact will a rate change have on your institutional MMA and DDA depositors? Based on your current pricing model, do you anticipate an increase, decrease or stability amongst this group of depositors? What is the end goal; funding stability through an active model or funding volatility utilizing a passive model? These are important questions to address early on in a changing/volatile rate environment. Your pricing strategy will predicate the level of funding stability.

For example, envision pulling on a rope from both sides (tug of war). On one side, there is pricing strategy, and the other is funding stability. Depending on how hard either side is pulled, the amount of resistance will determine your stability. In a changing rate environment, if you're experiencing

decay, (whether rapid or persistent) you're out of equilibrium in your pricing.

Although the FOMC meeting is next month, market based rates have continued to ramp up in anticipation of this rate hike. The greater the probability the Fed will increase rates, the greater the impact it will have on other fixed income investments.

The below graphic illustrates the spread differential of one month LIBOR to Fed Funds. Investments such as overnight repo, FHLB advances, agencies, treasuries and commercial paper increase in yield leading up to the Fed increase.



Source: Bloomberg

What does this mean to you? Your institutional investors are actively being solicited (pulled at) by competing fixed income investments through investment advisors, broker dealers and other financial institutions. If you are deploying a passive pricing strategy where you are in a holding pattern until after the Fed movement, then you need to assume that you're not in equilibrium. You will begin to experience some decay amongst a percentage of your instructional depositor base. With each Fed modification to the overnight rate, your depositor base is continually being solicited, (pulled at) which will lead to an eventual

acceleration in the decay rate. Back to the rope example, the greater the force out of equilibrium, the greater the impact on the shift. The rope scenario is dynamic, as is your decay rate.

What is the end goal: an active or passive pricing/funding strategy? Typically, financial institutions hold between 60 to 80 percent of the liabilities and non-duration accounts. If one is looking to reduce reliance on institutional investors, a passive strategy may be acceptable. If not, the passive strategy may end up costing more with heightened volatility than an active market-based strategy.

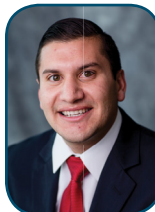
About D. James Lutter



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

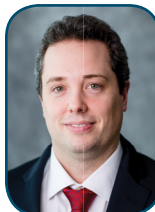
institutions with a broad array of cost effective funding alternatives. Mr. Lutter is a Registered Representative with PMA Securities, Inc. and Investment Advisor Representative with Prudent Man Advisors, Inc. Mr. Lutter has the following FINRA licenses with PMA Securities, Inc.: Series 7, 24, 50, 53, 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.

About John T. Vaci



John Vaci manages the PMA Trading team, which supports investment advisory and broker dealer services. He is responsible for all broker dealer functions for PMA Securities, and trade support for Prudent Man Advisors, Inc. His FINRA licenses include Series 7, 63 and 24. John joined PMA in 2009 after working at Lionhart Investments where he was responsible for hedge fund trade support and accounting. Prior to that, he worked as an analyst for a third party logistics company. John earned a BA in Communications and an MBA from Benedictine University.

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