

Providing deposit stability in an uncertain rate environment

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Entering January 2016, there was a sense that the Federal Reserve (“Fed”) was beginning the process of returning interest rates to ‘normalcy’. Bankers began coordinating how to handle a rising rate environment, both from an asset and liability standpoint. Unfortunately, there are a large portion of bankers who have never experienced a rising rate environment during their professional careers. Furthermore, for seasoned bankers, a rising rate environment seemingly has become a distant memory. However, as we are now halfway through 2016, the excitement over rising rates has faded as the Fed looks to be destined to continue an ‘uncertain’ interest rate policy. The Fed’s effort to provide “transparency” has created layers of uncertainty in the market. Bankers are now tasked with trying to understand this rate environment and how it will affect deposit composition and funding strategies. If rates rise, deposit run-off could happen quicker than expected. If rates remain stagnant, they may be left overpaying for deposits.

At the end of 2015, when it looked like the Fed was likely to put rates on an upward trajectory, financial institutions dusted off their old liquidity models. However, a decade of zero interest rates, unprecedented liquidity, economic uncertainty and regulatory reforms has rendered past models outdated. To further complicate this matter, the Fed has been unable to provide sustained rate increases due to the myriad of economic headwinds.

Historically in a “traditional” rising rate environment, regional and money center financial institutions have moved in sync with rate increases because their deposit and loan structure is based off of a market index, such as LIBOR. Community financial institutions, on the other hand, tend to lag as they increase rates after the Fed moves. This typically causes a mismatch in the market, making regional and money center financial institutions more competitive in a rising rate environment and community financial institutions more competitive in a falling rate environment.

The early 2016 rate movement played out differently this time. Money centers have accumulated a vast wealth of low-cost deposits during the last decade and view their current deposit base as inelastic toward marginal rate hikes. Community financial institutions acted more traditionally and gradually phased in higher rates. The inaction of larger financial institutions benefited smaller financial institutions, making their rates the de facto market rate.

Overall, financial institutions are trying to provide stability to their balance sheets, understanding regulator policy and normalize spreads– all in the face of anemic economic growth. Banks are cautiously monitoring to see if a rising rate environment is actually sustainable or a blip in the radar. This constant state of uncertainty is rendering “traditional” models obsolete. Financial institutions will look to leverage their unprecedented amount of core deposits as long as possible to provide stability.

The Fed, along with financial institutions, continues to be inundated with a number of contrasting variables, making a clear path nonexistent. However, for financial institutions looking to maintain stability in their deposit portfolios in this uncertain rate environment, employing a market-based pricing model should be at the top of their list. By employing this strategy, financial institutions of all sizes will be well positioned should a sustained upward rate environment occur.

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, 53, 63, 65 and 99.

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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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