The Future of Funding: *Funding Sources Going Forward*

CBInsight (Originally published on CBInsight.com, July 9, 2014)
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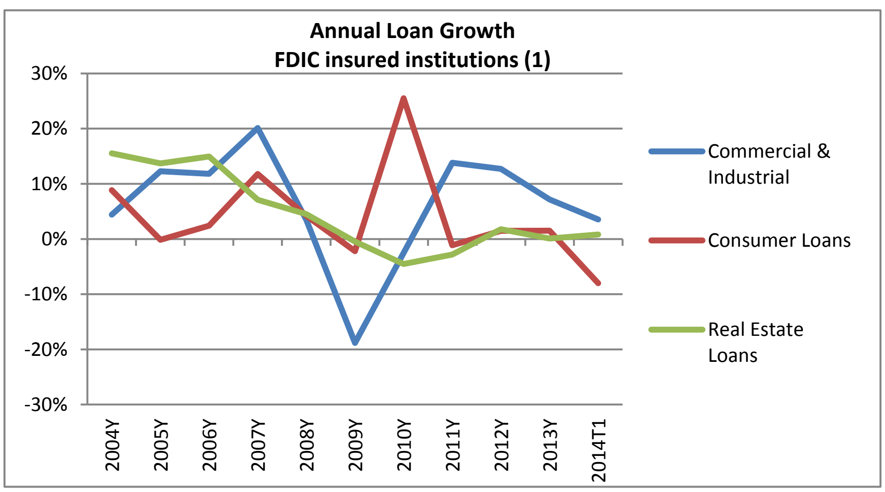
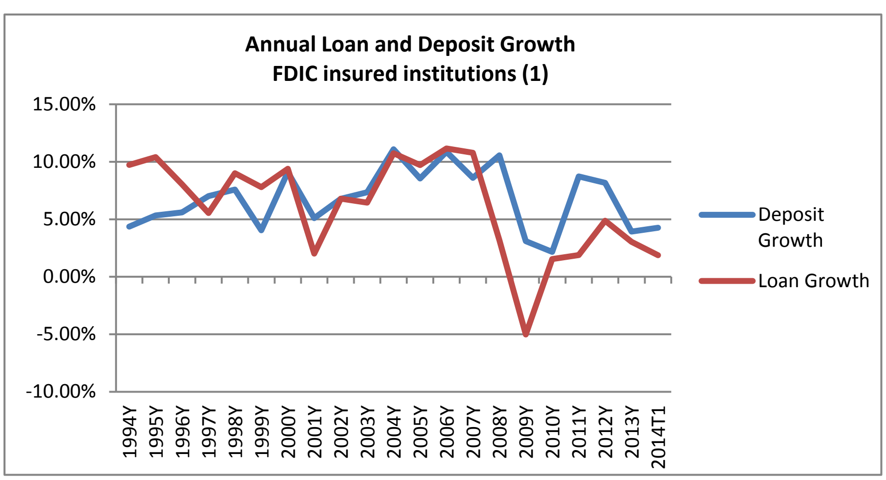
Will traditional sources of funding available for financial institutions today be viable options going forward? Primary depositors include retail, corporate and political subdivisions, while primary borrowers include the discount window, the federal funds lines, repurchase agreements and Federal Home Loan Bank (FHLB) advances. The composition of each source traditionally changes in response to the economic environment. Over the past six years, the banking industry as a whole has experienced a significant shift in the funding paradigm, both in source and in deposit vehicle. On the onset of the Great Recession, financial institutions sought to build out diversified liquidity even to the detriment of spread. The uncertainty of the crisis, both in depth and duration, forced banks to secure multiple sources of funding and borrowing that may not have been traditional pre-crisis. Although funding remains critical, it is readily available in the current economic environment through core and noncore sources at cost effective levels.

The Federal Reserve Bank's continued commitment to an accommodative monetary policy (6 years and counting), coupled with limited loan growth, has created an abundance of supply with moderate demand (see graphs below). Large depositors, primarily consisting of corporations and political subdivisions, are scrambling to find banks to participate in their investment of funds. These sources are usually limited by investment policy and/or state statute to low risk fixed income investments, and most political subdivisions require collateralization on funds in excess of Federal Deposit Insurance Corporation's (FDIC) insurance limitations.

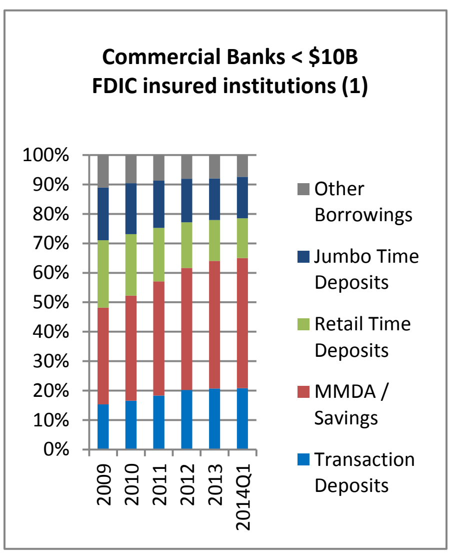


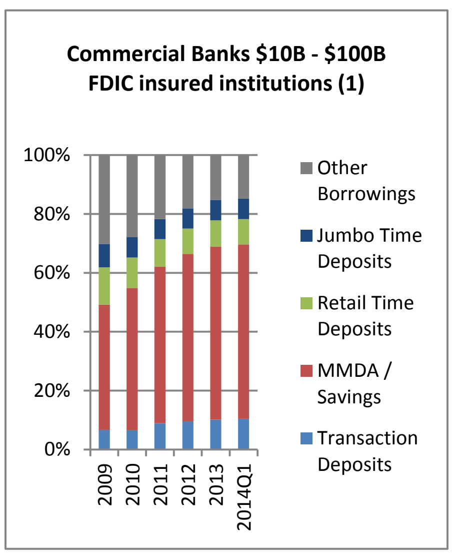


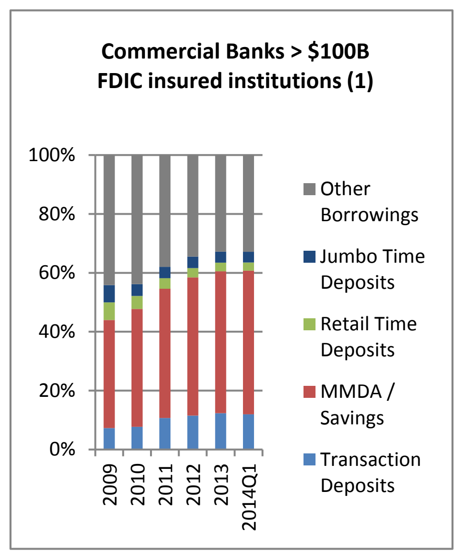
This situation is a drastic change from just a few years ago, when demand outweighed supply. In the minutes from the June 18th Federal Open Market Committee (FOMC), the consensus was to maintain a very accommodative monetary policy:

“To support continued progress toward maximum employment and price stability, the Committee today reaffirmed its view that a highly accommodative stance of monetary policy remains appropriate. In determining how long to maintain the current 0 to 1/4 percent target range for the federal funds rate, the Committee will assess progress--both realized and expected--toward its objectives of maximum employment and 2 percent inflation. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. The Committee continues to anticipate, based on its assessment of these factors, that it likely will be appropriate to maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal, and provided that longer-term inflation expectations remain well anchored.”(2)

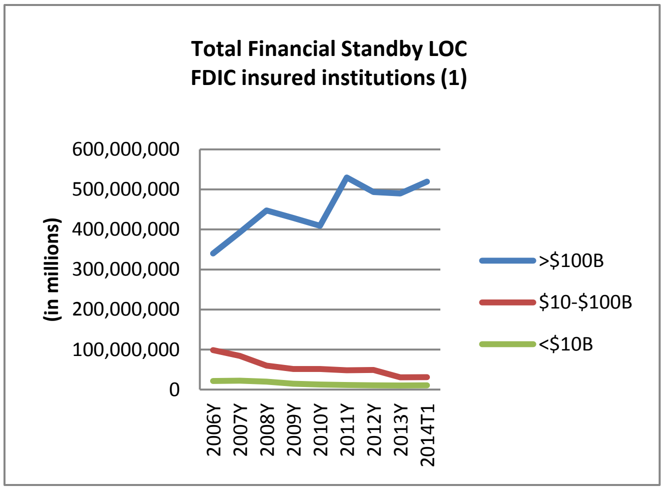
Since 2008, banks (community, regional, and money center) have seen a significant increase in Money Market Deposit Accounts, saving accounts and transactional deposits. Banks have offered a higher yield to remain short on the yield curve, which in turn, entices depositors to generate higher yields in liquid balance accounts than traditional time deposits under the 1 year term.

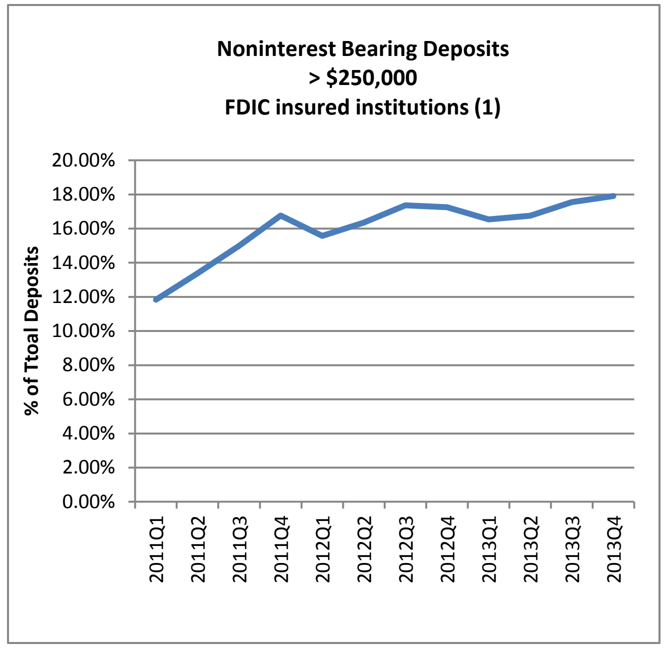


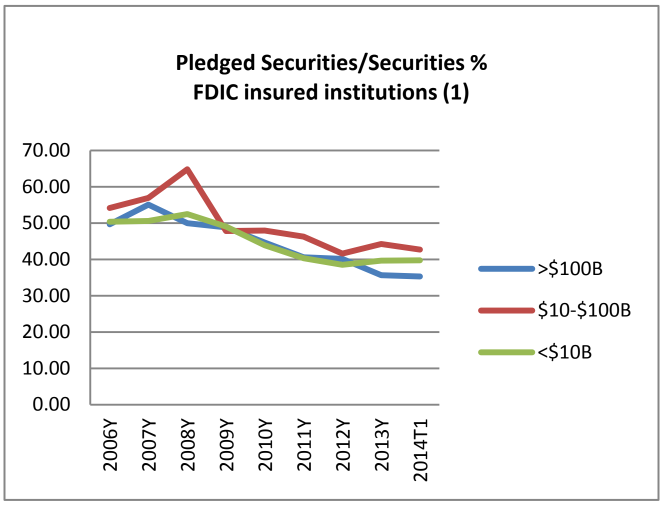




During this same time period, non-interest bearing accounts as a percentage of overall deposits increased through 2013 to 17.9%. Throughout this time, political subdivision deposits have increased, yet the landscape of securitization has changed dramatically. Pledged securities as a percentage of overall securities have decreased across community, regional, and money center institutions. Utilization of Letters of Credit has decreased across community and regional banks, and increased among money center banks. In place of pledged securities, listing services and reciprocal deposits have offset the balances.







The current market consensus according to Bloomberg is that short term rates will not begin to increase until the second half of 2015(3). In addition, to accommodate for Federal Reserve policy, banks have prepared for the implementation of the Dodd-Frank Act, and BASEL III, which includes the Liquidity Coverage Ratio (LCR), Leverage Ratio, and Net Stable Funding Ratio (NSFR) (4). The combination of low rates and increased regulation are forcing banks to rethink how they will fund activity going forward.

These regulations will mean that banks must analyze each depositor, not only by rate, amount, duration and type, but also by the effects they may have on the LCR and NSFR. The effects to the LCR and NSFR will determine the viability of the customer as a depositor and what product will be most appropriate. Depending on how the deposit is originated and if there is collateralization requirements, a bank will need to then determine the overall viability of the depositor. Political sub-divisions provide a good example of how these changes are affecting the depository landscape. From an investment policy standpoint, political subdivisions usually have limits on the amount they can deposit with a single depository, and in instances, utilize financial advisors in the facilitation of deposit placement. Factors such as how the deposit is originated, the extent of the relationship with the depositor, duration of the deposit and collateralization all may have varying effects on the LCR and NSFR. Going forward, banks will have a growing regulatory burden to consider in determining the makeup of their depository relationships.

(1) Data drawn from SNL Financial, 2014
(2) FOMC: http://www.federalreserve.gov/monetarypolicy/fomccalendars.htm
(3) Bloomberg, 2014
(4) Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools: January 2013, Basel Committee on Banking Supervision

About D. James Lutter

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