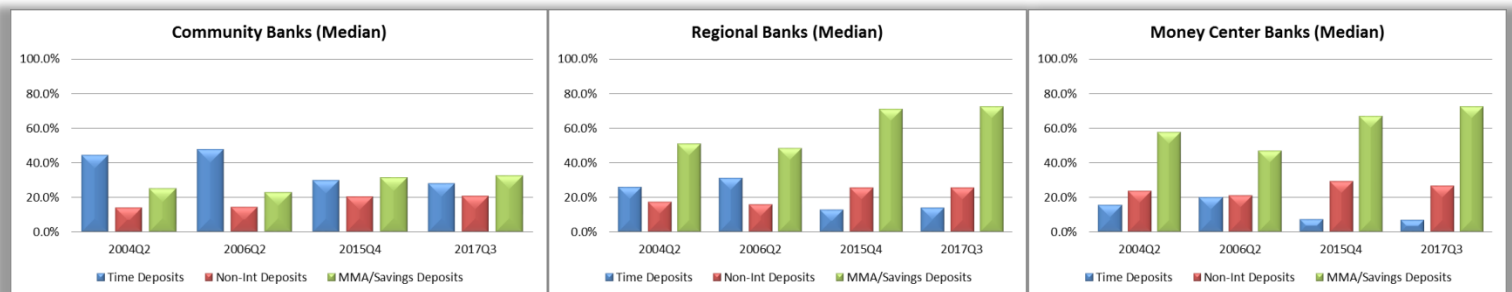


Deposit Composition and Funding Channels

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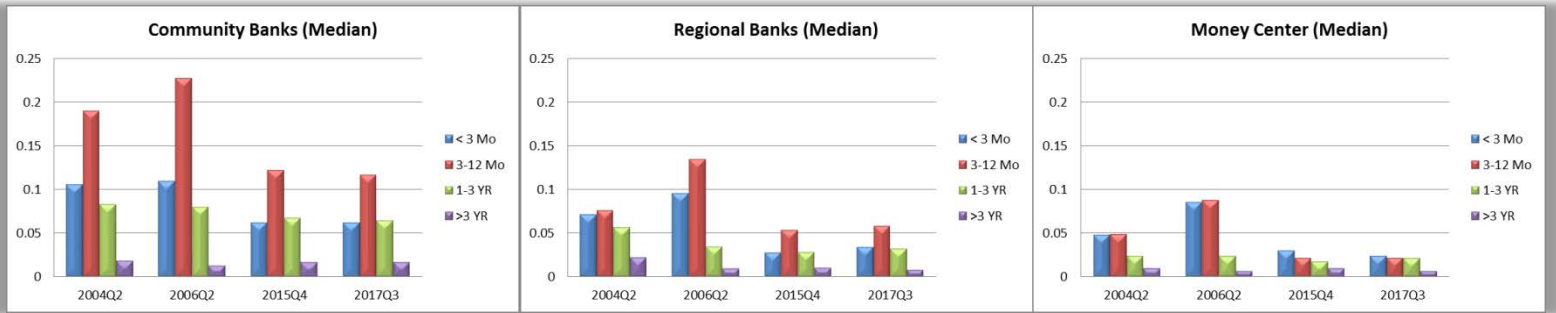
Until the recent rate hikes starting at the end of 2015, banks have had unprecedented access to cheap funding sources. Over the last decade, banks across all asset sizes witnessed extraordinary growth in core deposits due to general risk aversion among the population. This allowed banks to deleverage balance sheets and restructure liabilities to reduce interest rate sensitivity. However, as interest rates have begun to rise again, it's important for banks to reassess their current deposit composition and funding sources.



Source: SNL Financial

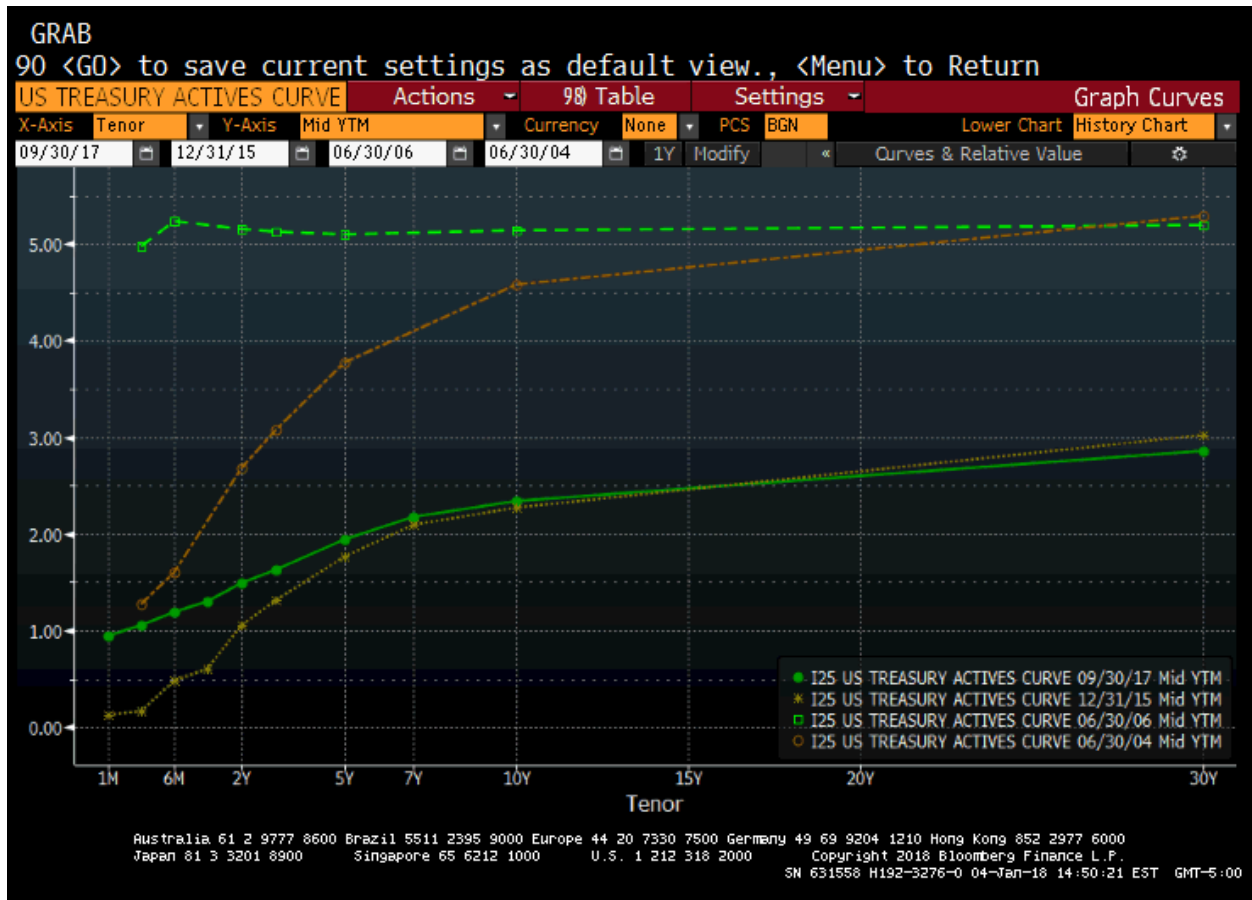
The graphs above take a look at median percentage of deposits for time deposits, non-interest bearing deposits, and money market accounts (MMA) and savings deposits across community, regional, and money center banks. The time frames assessed are Q2 2004, Q2 2006, Q4 2015 and Q3 2017 (the most recent accessible data) as these periods represent the beginnings and end of rate hike cycles (with the exclusion of Q3 2017 which is used to compare current trends). Looking at the graphs you'll notice some similarities and differences during the last rate hike cycle and today's environment. As rates rose during the last rate cycle (Q2 2004 through Q2 2006), not surprisingly time deposits grew whereas non-interest bearing deposits and MMA and savings deposits subsequently decreased, albeit marginally. Money center banks experienced the greatest variance in composition, while the delta for community banks was more muted.

Looking at today's current rate cycle the landscape has changed. Through Q3 2017, growth in time deposits is marginal across banks. However, there has been growth in MMA and savings deposits. This trend should be closely monitored as continued rising rates could lead to an exodus out of non-maturity deposits like MMA and savings deposits. In order for a bank to maintain institutional MMA balances in a rising rate environment, they need to incorporate a market-based pricing/rate for these accounts to mitigate investors' temptations to seek higher yields.



Source: SNL Financial

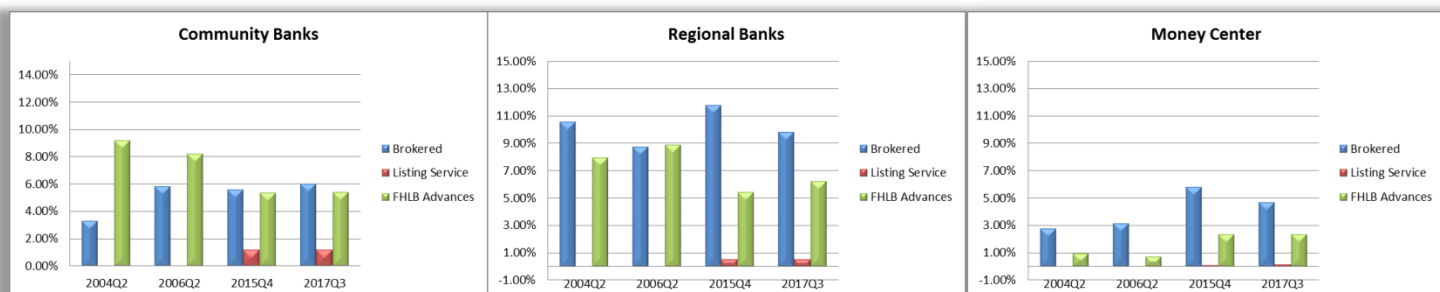
The next set of graphs looks at time deposits (both retail and jumbo) and breaks them into differing maturity buckets. During the last rate hike cycle community and regional banks held the majority of their time deposits in the 3 month to 1 year range, which is still true for our current rate cycle. Money center banks have held about equal levels of deposits in less than 3 months and 3 months to 1 year range.



Source: Bloomberg

Combining the treasury yield curves from our time periods with the above graphs we can gain insight into a few trends. During the 2004 rate hike cycle, the yield curve was much steeper, which incentivized depositors to move from non-interest bearing accounts into time deposits.

However, as the financial crisis reared its head, deposits flooded into non-interest and MMA/savings accounts mainly due to risk aversion and limited alternative investment options. Leading into the most recent rate hike cycle, the yield curve was not as steep as in 2004 and is beginning to flatten. This has reduced the incentive to move into time deposits. Furthermore, competitively priced MMA accounts have satisfied depositors yield appetite while providing flexibility.



Source: SNL Financial

Taking a look at community, regional and money center banks we see how the utilization in funding channels changes over the course of a rate cycle. The graph above looks at the aggregate totals of brokered, listing service deposits and FHLB advances as a percent of the total deposits. During the last tightening cycle for community banks, we see their reliance on brokered deposits increase substantially from beginning to end. Conversely, in our current rate cycle we are seeing community banks growing brokered deposits at a much more modest pace. This is not surprising due to the effects of the financial crisis, and the subsequent negative perception by regulators on brokered deposits.

Alternatively, for regional banks we see their reliance on brokered deposits actually decreasing from beginning to end of the rate cycle, while increasing their reliance on FHLB advances. One new component in the funding mix we didn't have last tightening cycle is the introduction of listing services being broken out on the call report. By nature of the product this makes up a relatively small percentage of total deposits across the industry, but is growing in capacity as more and more banks look to utilize those services because of their preferential regulatory treatment. Another funding source of consideration moving into 2018 could be the designation of reciprocal deposits as non-brokered. However, the principals remain the same, it's important to understand the underlying depositors, not just the source.

Conclusion

As we move further through this rate cycle, banks will be presented with challenges as deposits grow and funding compositions continue to change. Trend analyses of past results are powerful tools to understand possible outcomes when returning to a similar environment. However, the financial industry is returning from an unprecedented period of remarkably low interest rates, a slew of regulatory reforms, and anemic economic growth. Management has done a good job navigating through this environment. Looking forward, it will be important to understand the unique characteristics of the bank's depositor base and funding channels in order to continue fostering sustainable growth.

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.

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