

## Creating Funding Stability During Uncertain Times

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The days of cheap funding appear to be winding down. Since 2008, financial institutions have been able to access and maintain 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, with most economists and Wall Street professionals believing the economy to be in the latter stages of a bull cycle, it is important for institutions to document and understand how each source will react in various stress situations. Understanding funding sources and how they will react to different markets can help lead to a proper liquidity balance.

### Identify and Define Funding Sources

There are a variety of funding options available to financial institutions, and it is important to incorporate those that fit within your strategic plan. In doing so, you can identify what gaps exist within your current funding sources by answering a few basis questions:

- Are deposits in-footprint or out-of-footprint?
- Are deposits operating or non-operating?
- Are deposits commercial, retail or institutional?
- What are your noncore funding sources – wholesale, reciprocal or listing service?
- What are concentrations amongst the various sources and what are their investment objectives (rate, diversification, etc.)?
- What degree of interest rate sensitivity exists and how are you hedging it?

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

### Which Funding Sources Are Right for Your Institution?

After recognizing current funding sources and any pitfalls that may exist, a financial institution should look to bridge the gaps. Once appropriate funding options have been determined, 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 analysis of the strengths, weaknesses, opportunities and threats (SWOT). 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 cyclical risk

**Threats** – General economic conditions may deteriorate, creating revenue shortfalls from a declining tax base and/or a delay in state or federal aid

Regulators expect a financial institution to have established funding policies, ensuring that proper controls are in place to adequately address the environment in which it operates. Testing sources on a regular basis allows the 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 cost of funds and may limit its 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 the institution to execute a risk-averse operating and contingency funding plan. 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 institution? 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 sources' (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, an institution can gain further insight and discover tools that help mitigate risks when issues arise. A well-defined plan will help maintain stability, provide sound liquidity and interest rate management, and add value through increased earning.

*Disclaimer: The views and opinions expressed in this article are those of the author and do not necessarily reflect the official policy or position of the Financial Managers Society.*

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