

## ASSET-LIABILITY MANAGEMENT IN A TRANSITIONAL INTEREST RATE ENVIRONMENT: THE CHANGING COMPLEXION OF FUNDING

When the FOMC embarked on its loosening cycle in September of 2007, the Fed Funds rate was 5.25%, 30-year mortgage rates were around 6.25%, and the real estate market was past its peak. More than twelve months later, the Fed Funds rate is approaching 1%, 30-year mortgage rates are approximately 5.75% and the collapsed real estate market hopefully is approaching bottom. It is likely, according to the futures market that the Fed Funds rate will remain low for the foreseeable future or at least until the economy shows some life. Gross Domestic Product is expected to remain soft and is soon likely to confirm that the economy is, in fact, in a recession.

With the continued financial crisis, low interest rates and fears of investing in a very volatile and bearish market, what does that mean for deposit strategy? How long will short-term rates remain low, the Fed providing liquidity, and the treasury and swaps yield curves remain flat and low? Along with these questions is the fear of increased charge-offs, the low opportunities for loan growth and low investment yields. With little in the way of positive news, will banks be able to take advantage of the 'fear to invest' and expect growth in deposits. This may be the only way to improve margins in this extremely challenging environment.

### Deposits

We analyzed retail time deposit data from a sample of clients located in the mid-Atlantic region for a six month period ending September 30, 2007 and 2008 respectively. We looked only at new money and rounded promotional rates down to their nearest typical CD term and graphed the results below. These institutions range between \$500 million and \$2 billion in total assets.

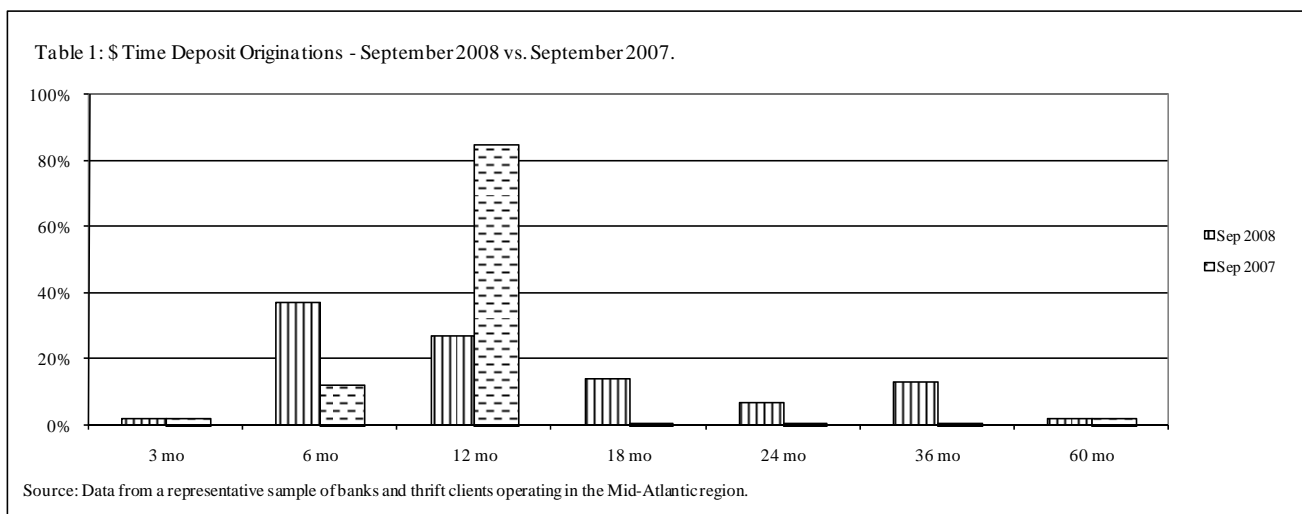


Table 1 above shows that in September 2007, new money retail CD balances one year or less made up nearly all new deposit monies. However, by the end of September 2008, that percentage fell to about 65% of total originations for the preceding six months.

During the summer, many community bankers thought interest rates would begin to rise soon and they began running longer-term Promo CDs to lock in funding at the lower levels. Many bankers reported pleasant surprise that customers were willing to lengthen the amount of time their money was tied up. Further, the weighted average rate of the CDs sampled above fell about 153 basis points from 4.87% to 3.34% from 2007 to 2008 while raising just over 45% of the new money balances that they raised in 2007. Funding got longer and cheaper.

Comparing the time periods above, it appears that Money Market Demand Account (MMDA) balances increased less than 1% from 14.1% up to 14.7% of total deposits. Other savings deposit balances remained flat at about 14% of total deposits. Noninterest-bearing deposits actually grew about 1% to just above 12.1% of total deposits. Although this balance historically drops as we enter the holiday shopping season. Finally, time deposits fell 0.8% from 45.2% to 44.4% of total deposits. Our hypothesis is that since domestic deposits remained flat at about 75% of total assets, net funding shifted from time deposits and NOW accounts to Noninterest-bearing deposits and MMDA accounts. In 2008, Overall, customers became less willing to lock up funds in CDs and were attracted promo MMDA rates offered by many community banks early in 2008. However, the data in Table 1 shows that those customers who went for CDs, could be pushed into longer than one year CDs. This is a strong example of the uncertainty depositors were feeling in 2008 as overall customer trends became more segmented. Year-over-year, banks in this category maintained a domestic deposit ratio at almost 75% of total assets. By September 2008, time deposits were just under 45% of total deposits for banks in our sample.

### Funding and Leverage

So, what have we observed regarding funding over the last two years? In our sample of banks described earlier, we saw FHLB advances as a percent of total assets decrease by over six percent. Also, the CDARS program is rapidly increasing in popularity despite the increase of FDIC insurance maximums.

## **ASSET-LIABILITY MANAGEMENT IN A TRANSITIONAL INTEREST RATE ENVIRONMENT: THE CHANGING COMPLEXION OF FUNDING**

However, since the close of third quarter 2008, FHLB funding is again becoming attractive as bankers now see longer term FHLB rates as favorable to comparable termed brokered CDs. Finally, many banks are considering the US Treasury's TARP Capital Purchase Program as a source of new and relatively inexpensive capital. At the time of this writing, it is not clear which banks will qualify and the requirement to issue warrants to the Treasury may represent a cost potentially too high for some to consider, should their stock price improve.

### **Conclusion**

Early in 2008, promotional MMDA products were heavily offered. As spring eased into summer, many felt that rates would begin rising and longer term promo CDs were pushed in hopes to lock in funding at cheaper rates. Today, we are facing a huge financial crisis. Both depositors and institutions are afraid to part with their money. FDIC insurance has been increased to cover deposits up to \$250,000 and the international equity markets have tumbled. Will depositors double down on the stock market or will they come for the safety of FDIC insured institutions?

Many of the aging baby boomers will not be able to double down in equities and wait for the markets to return. We believe, as in the tech bubble burst of 2000, funds should flow again into the community banks. It will just take some time for the skittish public to regain confidence. Once confidence is restored in the banking sector, a volume of deposit inflows should also negate to need for high promotional rates, strong medicine with lending rates currently being so slow.

We are not surprised to see institutional borrowers staying short and expect this trend to continue until things stabilize and confidence returns. These uncertain times are causing both bankers and depositors to shy away from locking up money long term. FDIC insured Money market accounts may be an attractive vehicle to depositors and a more productive place to offer a promotional rate than retail CDs.

BRIAN A. VELLIGAN  
Velligan-Blaxall Consultants, LLC