FHLB Des Moines Region Member Meetings

SESSION 2 – CREATING YOUR IDEAL FUNDING PLAN

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PDF: https://www.abrigo.com/fhlb-des-moines-webinar-series-2020/

The easiest way to listen is through your computer's speakers or headphones

Ensure your device speakers are on, or calling in is an option.

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Making Big Things Happen from Small Actions!
2020 FHLB Des Moines Regional Member Meetings

- Session 1: Managing Your Balance Sheet in Times of Crisis
- ***Session 2: Creating Your Ideal Funding Plan Structure***
- Session 3: Navigating a Flattening Yield Curve During Record Low Rates
- Session 4: Asset and Funding Strategies

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Our Unique Inventory

Proto-cuneiform tablets showing quantities of barley and malt.
2nd Century BC.

The moneychanger and his wife
Marinus van Reymerswaele - 1539

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How Do We Acquire Our Liquidity?

Where does it come from?

Market share, economic growth, expansion, acquisition, demographic trends

How do we sell (attract) it?

Safety, convenience, rates, technology, "*we're friendly*"

How do we manage the supply?

ALCO meetings, contingency funding plans, pricing

What do we do if we run out?

Wholesale funding, brokers, specials

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NOW HIRING

JOIN OUR TEAM

OUR FAST-GROWING COMPANY IS LOOKING FOR THE BEST CANDIDATE TO FILL THE FOLLOWING POSITIONS

FUNDING MANAGER

GENERAL REQUIREMENTS

Accounting skills, technology skills and awareness, market knowledge and trends, sales skills, CPA level insight when reading financial statements, complete familiarity with statistical methods, ability to woo board members and regulators.

The most highly qualified candidate will understand market rate elasticity, what it takes to attract millennials, and will possess the ability to accurately predict the future.

Anyone seen our CDO?

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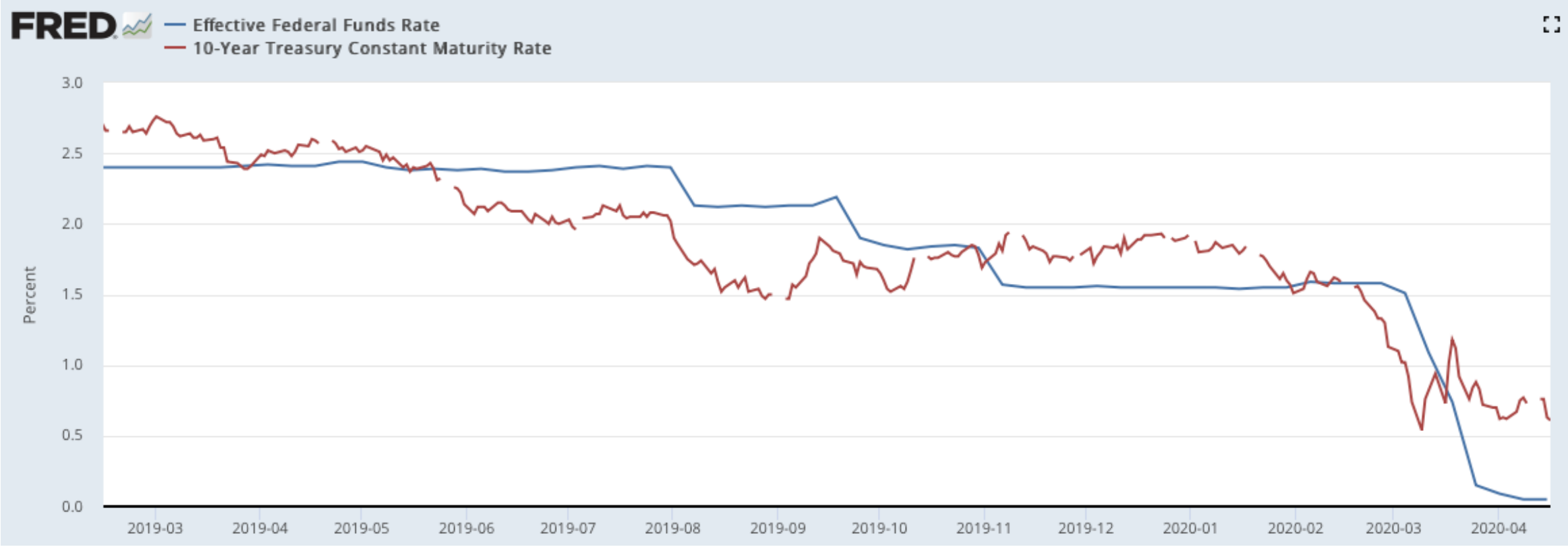
Session 2
Agenda

1. **Institution Strategy**
   Does my lending strategy fit with my funding situation?
2. **Market Awareness**
   Growth no longer comes from keeping doors open.
3. **Quality of Inventory**
   Is what we offer the same as what the consumer is looking for?
4. **What about Wholesale?**
   We have dry powder, now what? How do we fit wholesale into our plan?
5. **How Do We Track Progress?**
   What does a budget look like? How do we measure marketing success vs. pricing success?
6. **Nurturing the Plan**
   Does our staff know what we are trying to accomplish?

What Does This Mean for Funding in 2020?



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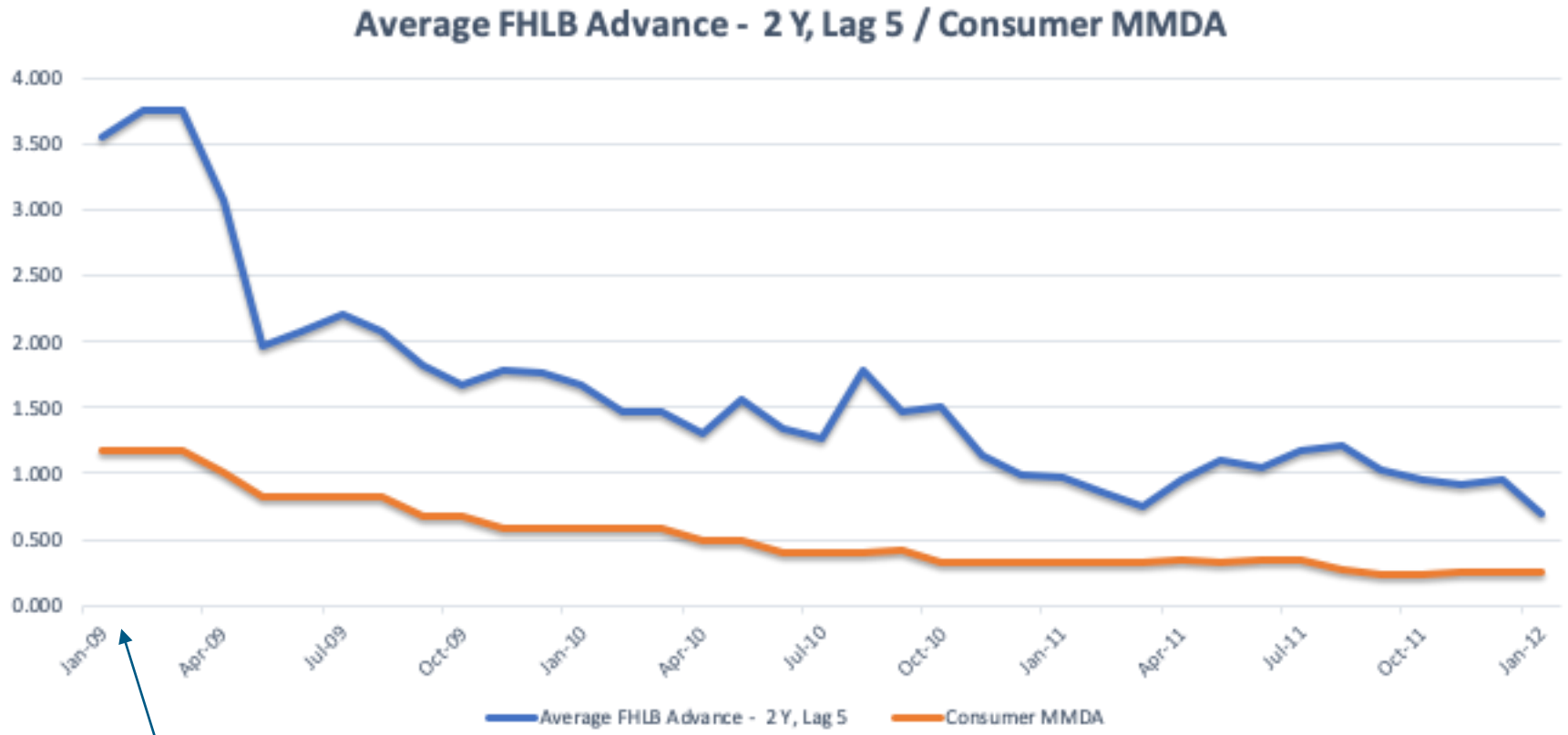
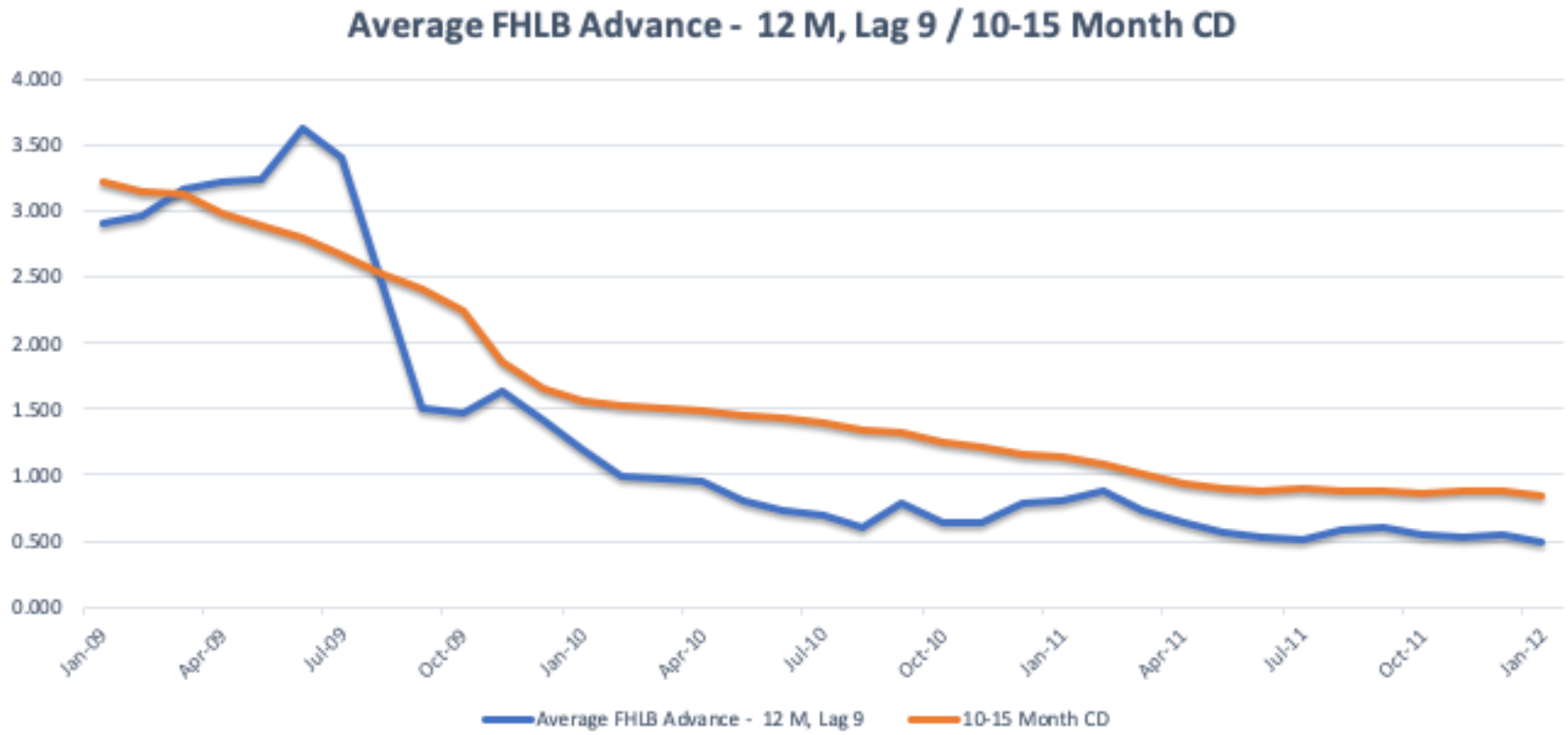
Pricing Betas – 2009 Through 2011



The Fed Funds rate went to "zero" in December 2008.

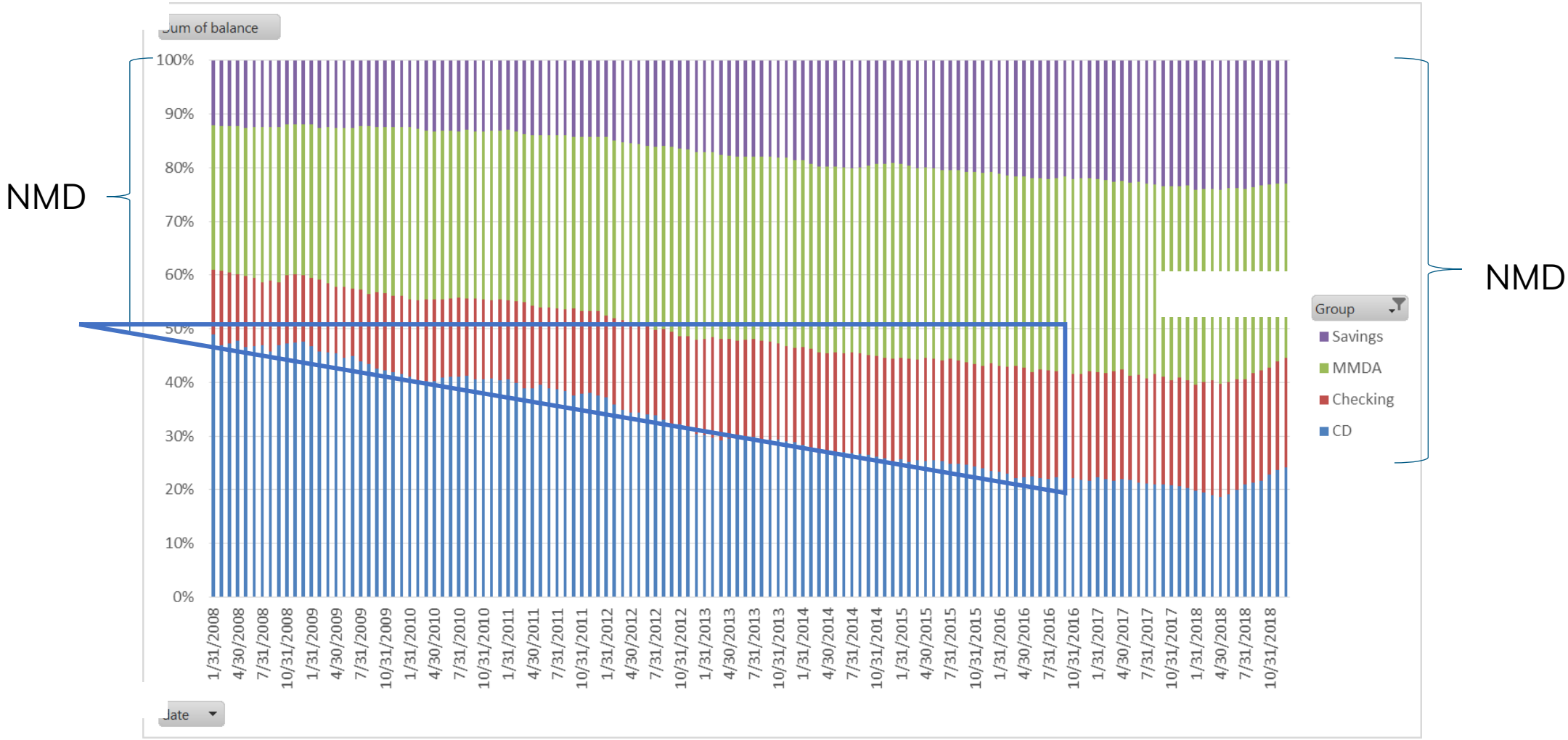
This institution reduced its weighted average rate paid on MMDA accounts by 34% of market rate changes. And it took an average of 5 months to react to wholesale rate changes.

Pricing Betas – 2009 Through 2011



The beta on this institution's CDs was 75%, and it took an average of 9 months to react to wholesale rate changes.

Deposit Mix Change – 2009 to 2018



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Have you changed your pricing or strategy as a result of the coronavirus pandemic?

- We have lowered deposit rates somewhat.
- We have made major deposit rate changes in line with overall market rate changes.
- We are still considering how and when to adjust rates.
- I’m not sure we have made any changes yet.

Institution Goals --> Funding Strategy

- 13% capital, feeling smug
- ROA above peer of 0.85%
- Loan growth of 5% expected, but worried about continuing
- Loan/Deposits at 68%

We're going to take on all loans we are comfortable underwriting that beat the investment benchmark. Not worried about funding costs.

- 11.5% capital, just above-board levels
- ROA above target of 1.05%
- Loan growth 3% (if we're lucky)
- Loan/Deposits at 94%

We're going to set ROE targets to maintain earnings and capital. This prices our funding at the margin.

- 8.2% capital, but RBC is ok
- ROA less important to us than long term ROE
- Loan growth of 10% planned.
- Loan/Deposits at 105%

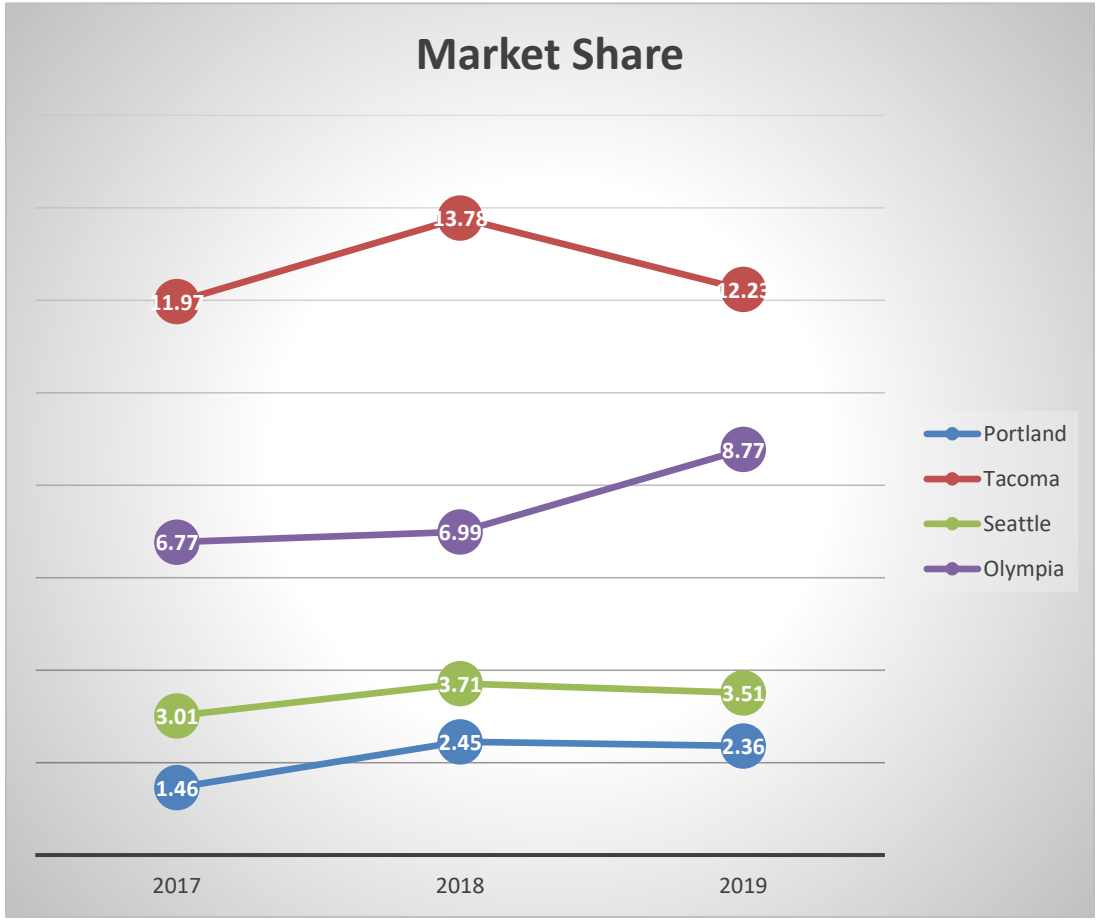
We're going to compete on price to grow loans. We'll pay whatever we need to fund it.

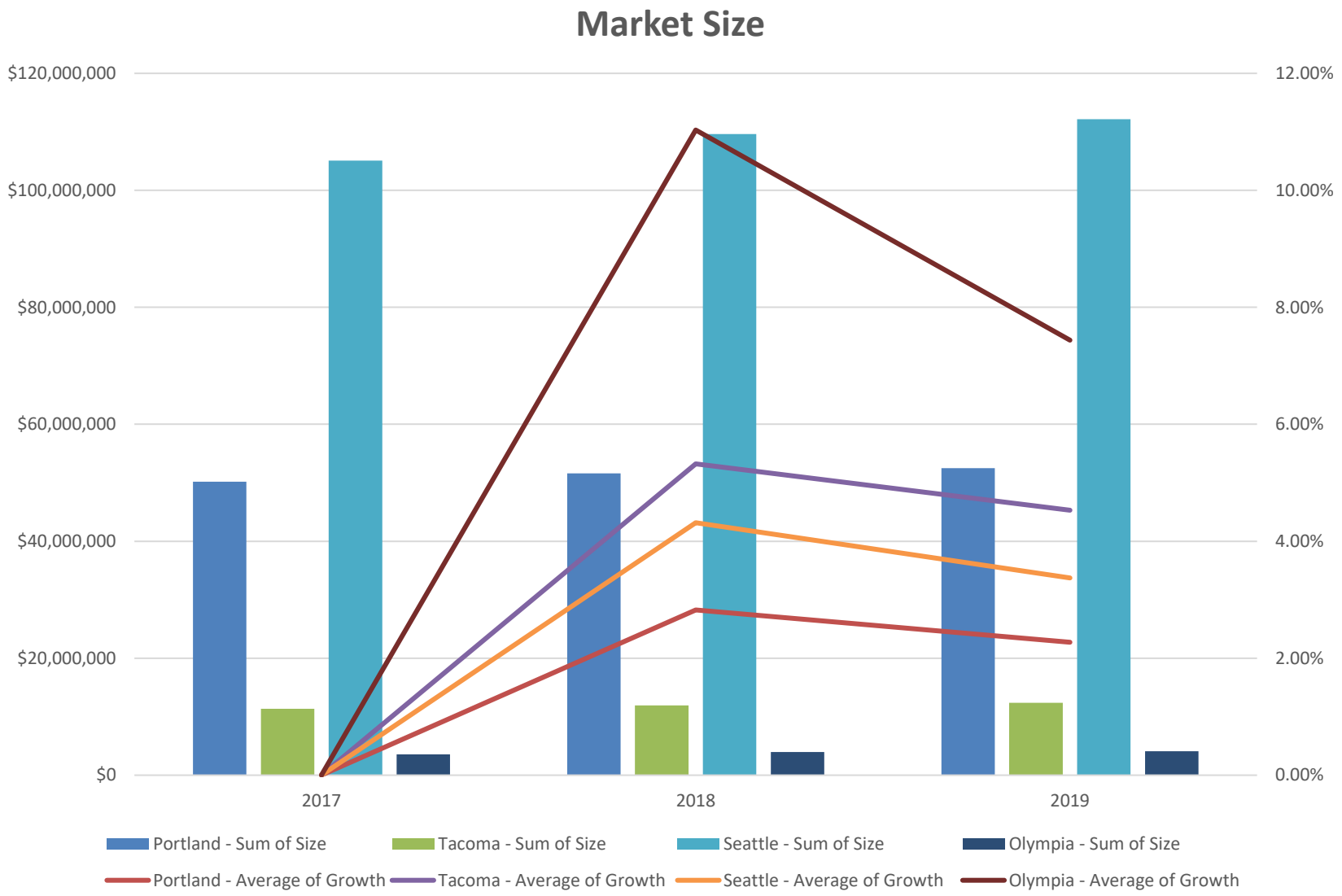
- 9.6% capital, board a little worried
- ROA of 0.75% below peer
- Loan growth of 6% planned
- Loan/Deposits at 78%

Multiple choices here – depends on priority of growth vs. capital. But earnings are a problem, therefore cost of funds is an issue.

Market Awareness

- FDIC market share data available at fdic.gov, Deposit Market Share Reports.
- Track over time to measure overall deposit market success and/or initiative success.
- 12-25% market share is a dominant position. You are likely a price/product leader.
- Does not include out of market balances that come from your depositors (online savings).



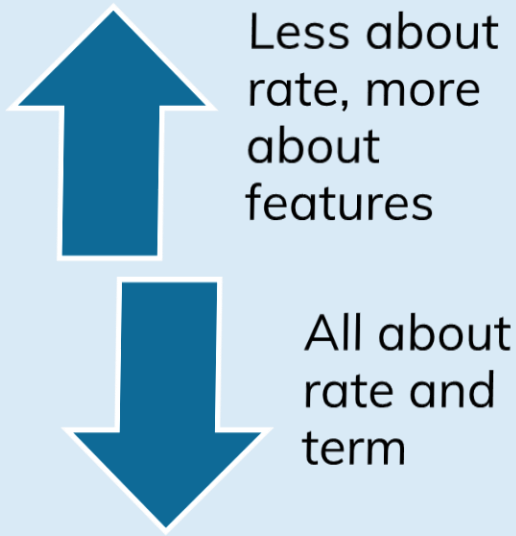


- Total market size gives us some idea what growth potential there is in deposit balances
- Here the smallest market (Olympia) has largest recent market growth rate.

What is the Ideal Funding Source?

Deposit sector continuum - the more features of a product that are important to a consumer other than rate, the less sensitive they will be to rate paid.

- Checking
  - *Transaction and access most important*
- Savings
  - *Earns interest, still accessible*
- MMDA
  - *Rate of return, higher balances with some liquidity*
- Certificates
  - *Rate and term most important*
- Wholesale
  - *Zero loyalty, fast access to liquidity*



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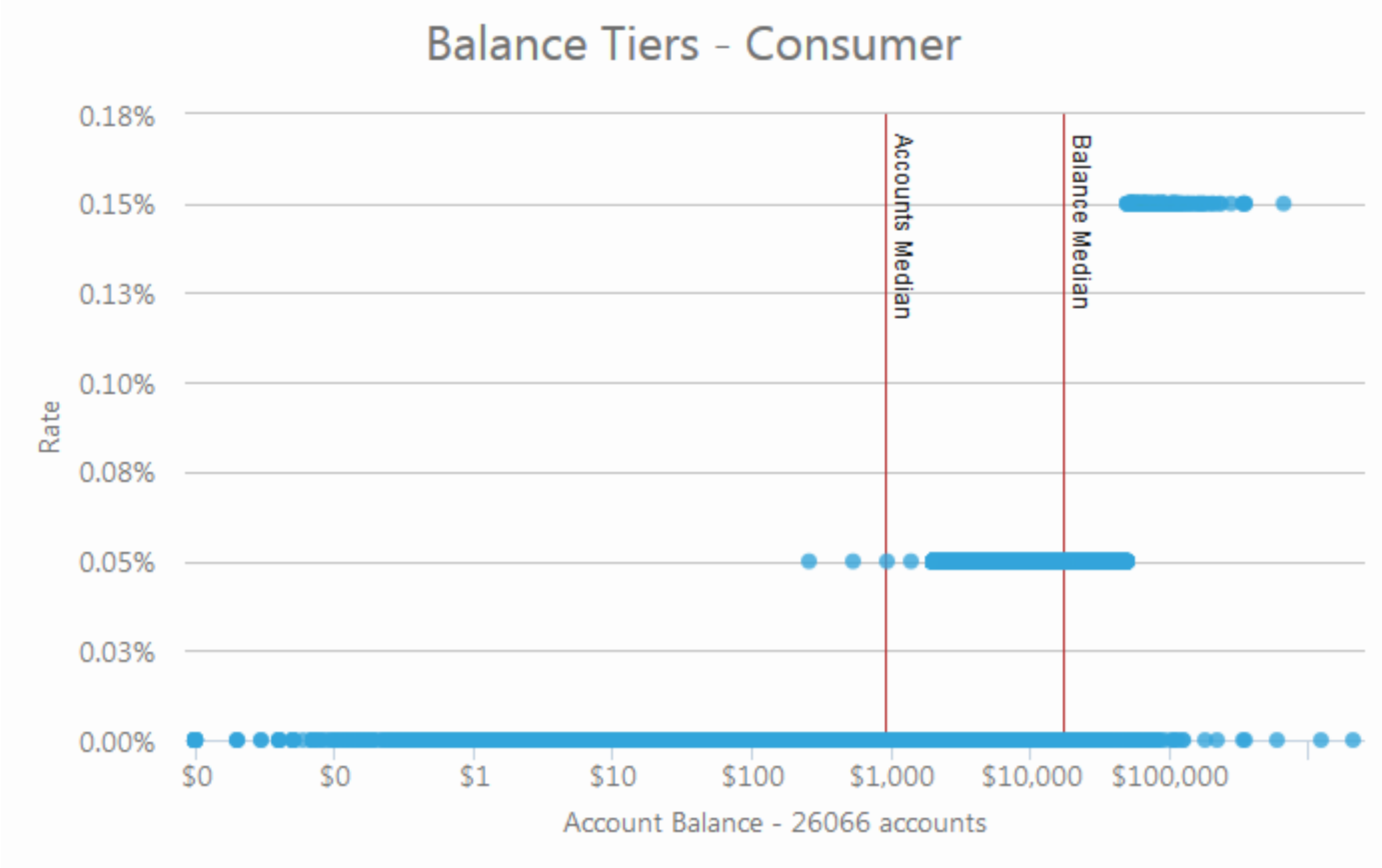
Balance vs Rate Paid



Shows us exactly how account balances are distributed and what rates we are paying based on account size.

Balance median is the point at which half of the balances are on each side of the line. In this case the balance median is at approximately $16,000, AND, at the 95th percentile – 1,303 accounts (out of 26,066) hold half of the total sector balances in this consumer checking sector.

How Do We Value Deposits?

Decay and Surge Summary

Product Category	Decay Balance	Surge %	Base Decay
Checking	15,799	27.84%	4.48%
Savings	32,139	39.83%	2.20%
MMDA	17,808	24.02%	11.54%

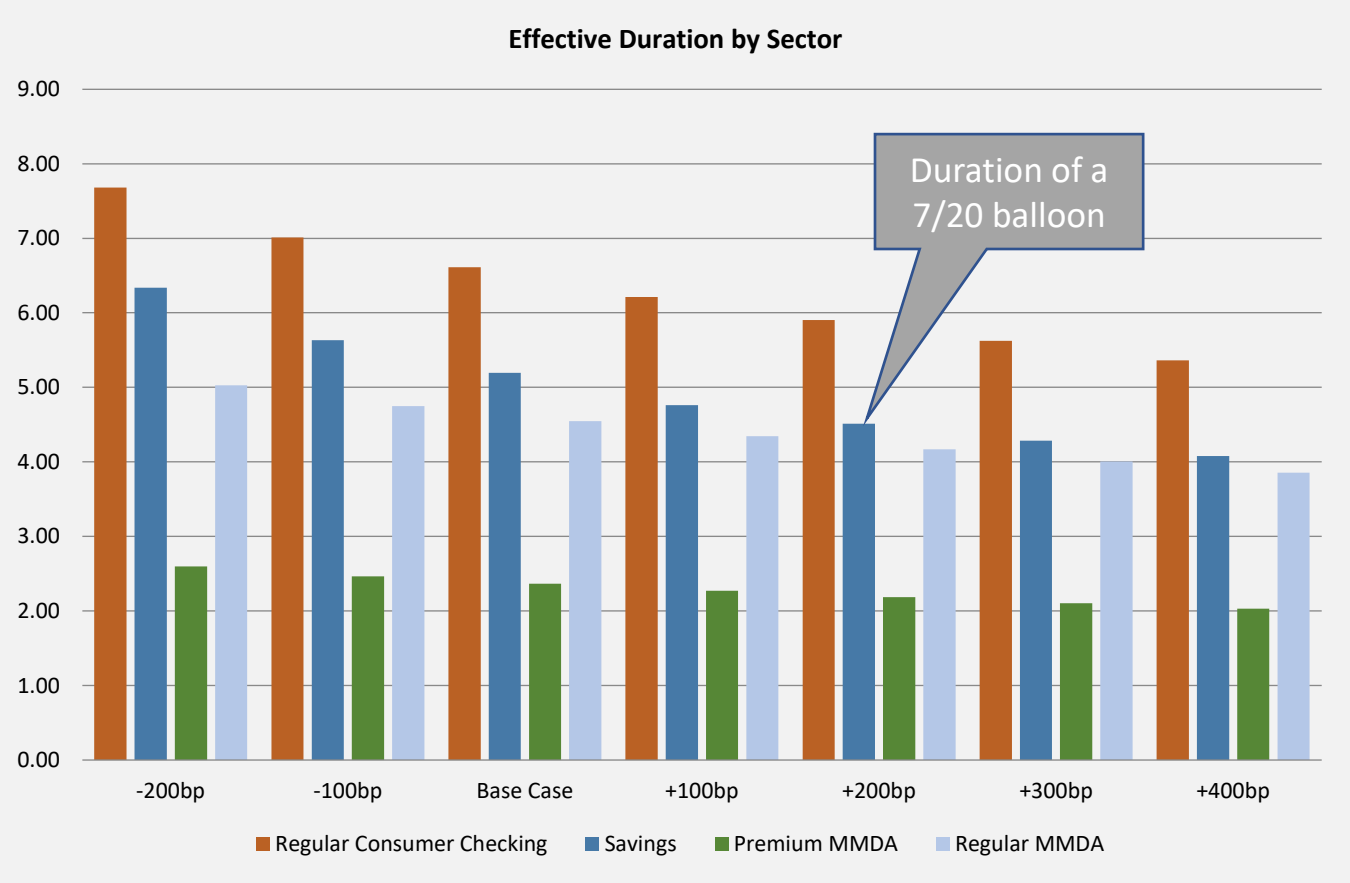
Beta Results

Product Category	Index	Lag (mo)	Pos.	Corr	Beta	Beta Balance	Curr. Rate
Premium Savings	Average FHLB Advance - 3 Y	12	1	0.863	0.294	4,592	0.51%
Regular Savings	Average FHLB Advance - 12 M	12	1	0.927	0.053	27,547	0.05%
MMDA	6 Month US Treasury	12	1	0.963	0.441	17,630	0.22%
Checking	Average FHLB Advance – 2 Y	6	1	0.000	0.095	13,505	0.20%

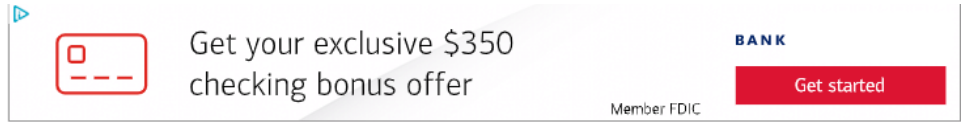
A core deposit study tells us how non maturity balances have been behaving.

The combination of base decay, surge decay, and price response to market rates allows us to calculate the relative duration of our deposits

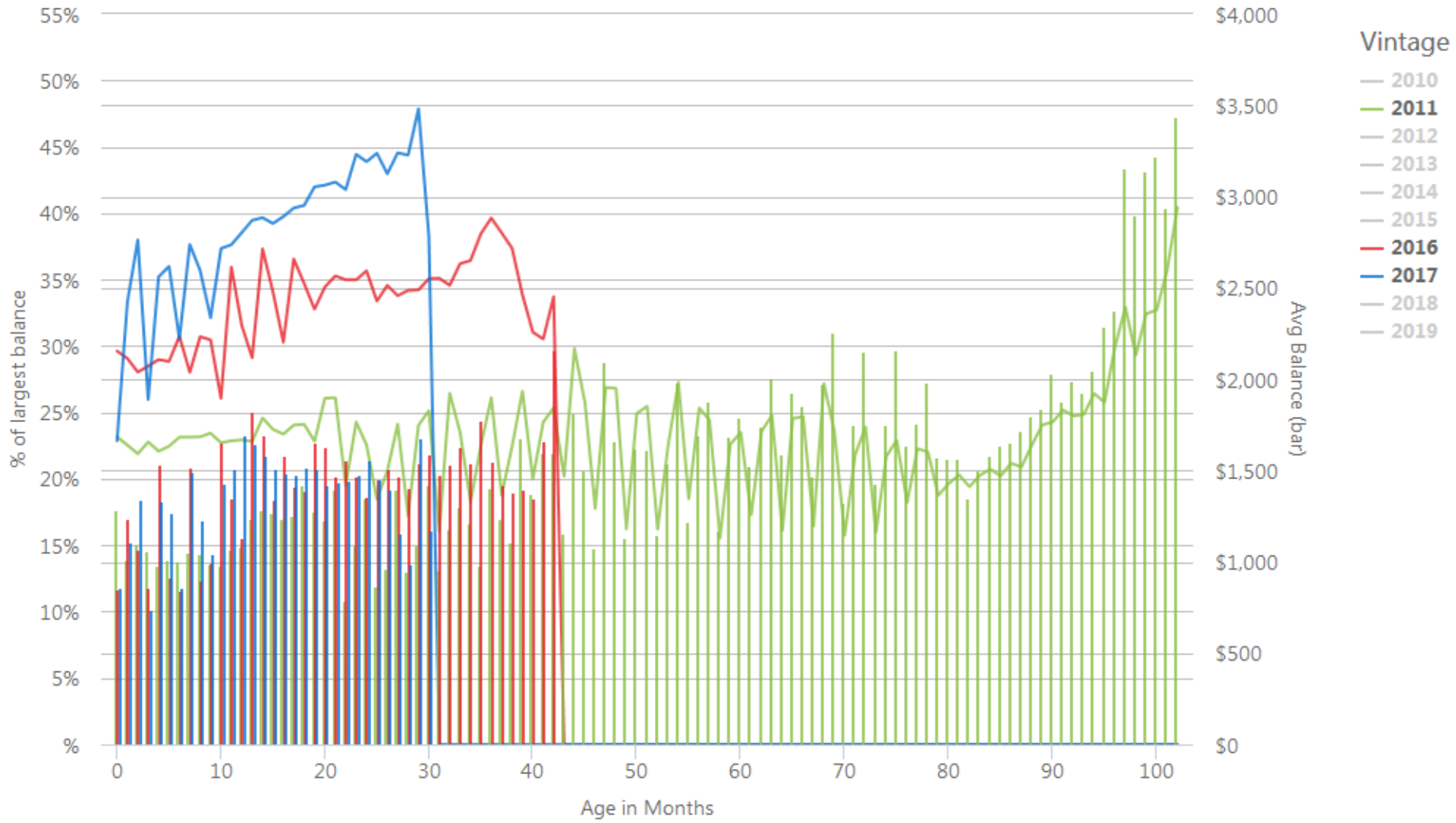
Deposit Value – Cost and Duration



- We measure the value of non-maturity deposits by marking them to market using an FTP curve. This is what is reflected in your institution economic value of equity measure (EVE).
- Using core study data (decay rates and beta values), we calculate the effective duration of various deposit categories. Higher is better – meaning it is a better hedge against interest rate risk.
- **But, it is time consuming and expensive to attract these long duration deposits!**



Gathering Deposits – It Can Take Time



Gathering Deposits – It Can Take Time

- The line chart represents the average of all account's percentage of maximum balance found for that age.

- We look at how old the account is, and after filtering out dormant and very large accounts, we calculate the percentage of that month's balance relative to the largest balance we found for that account in its lifetime (so far).

- We then average all those percentage numbers for each account in the vintage – regardless of the actual dollars in each account.

- **To keep in mind:**
  - New accounts grow or fund their balances with different patterns.
  - CDs fund immediately.
  - Non maturity accounts can vary depending on demographic factors, product design, and length of relationship.

What Drives Consumers?

- 6%-12% of consumer checking accounts turn over on their own each year.
- You can easily figure out how many checking accounts you are opening per month/per branch.
- Do you know why you are opening accounts?

Possible Factors

- Location
- Product Features (fees, rates)
- Brand
- Convenience
- Value

Polling Slide

Which of these factors ranks as most important for why consumers choose a checking account?

- Product features
- Location
- Convenience
- Fees
- Brand recognition
- Friendliness

J.D. Power 2019 U.S. Retail Banking Satisfaction Study

- 4% of consumers shifted primary accounts to a new institution, lowest level since measurement began 10 years ago.
- 10 largest banks increased share of deposits from 39% to 48% since 2009.
- Customers are staying because it's become so convenient at the large banks to transact business.
- The Big 6 banks have benefitted from improved customer satisfaction among customers under age 40 in recent years and, in 2019, attain higher satisfaction scores than regional and midsize banks.
- Across all age groups included in the study, overall satisfaction increases more notably among digital-centric customers of midsize and regional banks than among customers of Big 6 banks.

Convenience may be more critical than reputation

"Customer satisfaction and convenience have improved, but far too many customers have not re-established the trust and developed the deeper levels of connection required to improve the industry's reputation. Looking 10 years into the future, when digital banking will be the norm for nearly all customers, retail banks will be required to be unique by scale or unique by strategy. Personalization of important customer journeys—transactional, advisory and solving problems—will emerge as the ways to elevate customer trust."

Challenge to community FIs – Finding a message while offering top tier convenience and offerings!

Online Competitors

Chime

- A free transaction account.
- You get a debit card and an app.
- It includes an innovative NSF solution.
- They ignore a bad ChexSystem report.
- *It is not called a checking account.*

American Express Bank

- Online savings rate of 1.60%
- 18 Month CD at 1.50% (April 15).
- Possibly the best online account opening experience.
- It still feels like an old-money bank.
- Do you still think they are just a card company?

The Good News

- Incomes and savings rates are up, highest since 2013 and well above pre-crisis levels. You have access to more liquidity.
- Non-maturity savings are likely to grow as long as we have economic uncertainty.
- Majority of consumers who use electronic banking still prefer to open an account in person.
  - 2018 survey of electronic banking trends.
- Large bank market share growth is not universal.
- Fintech startups are at an all time high.
- Many of these firms want to partner with you in order to compete with large bank market share.

Our Sample Bank – Wholesale Options

- We are at 90% loans to deposits.
- MMDA rates are near top of market.
- We increased brokered CDs in the past year.
- We have been using FHLB overnight for cash needs.

Deposit Mix	Balance	% of Deposits	Current Cost	Current Offer Rate
DDA	$ 99.00	15.00%	0.00%	0.00%
NOW	$ 115.50	17.50%	0.15%	0.15%
Savings	$ 132.00	20.00%	0.10%	0.10%
MMDA	$ 165.00	25.00%	1.00%	1.00%
Time - Retail	$ 115.50	17.50%	1.85%	1.30%
Time - Brokered	$ 33.00	5.00%	2.01%	1.60%
Total Deposits	**$ 660.00**	**100.00%**	**0.72%**	**0.60%**

Traditional Wholesale Strategies

- They are used as liquidity sources, not funding sources.
- You may even designate specified values in a liquidity action plan. (Bottled water)
- You don’t consider the marginal cost and IRR implications of bottled water sources. You just look at the volumes.
- We avoid using available FHLB capacity in order to keep our powder dry.
- Other than brokered or rate board CDs, we keep the balances short term.

Sample Bank – Wholesale Funding Plan

- Avoid paying rate board CD rates (no loyalty).
- Reprice standard CD rates at the median of the market.
- Plan CD specials priced to maintain budgeted growth rate for sector. Price at marginal cost under FHLB advance rates.
- If CD pricing is not working, replace funding with duration matched advances.
- Use best short-term funding option as part of the liquidity action plan.
- Segment MMDA balances to reduce current funding costs.
- Price MMDA accounts to achieve sector growth budget.
- You are willing to pay more for MMDA growth because of effective duration, especially in this rate environment.

The Cost of Paying Up?

Marginal Cost Analysis

Name: Top of Market Special
Date: 7/31/2019
Rate Env (bp): 0

Summary

	Balance	Expense	Cost	BnchMk	Spread
Strategy 1	9,900	79	0.800%	2.300%	1.500%
Strategy 2	11,500	134	1.169%	2.300%	1.131%
Marginal Cost	1,600	55	3.450%	2.300%	-1.150%

Current					*Strategy 1* Notes: Continue to lose 10% of balances					*Strategy 2* Notes: Price special at top of market				
Accounts	**Term**	**Current Rate**	**Maturities**	**Decay %**	**New Rate**	**Beta**	**Retention %**	**Retention $**	**Expense**	**New Rate**	**Beta**	**Retention %**	**Retention $**	**Expense**
		0.800%	**11,000**	**0.0%**	**0.800%**			**9,900**	**79**	**1.169%**			**11,500**	**134**
12 Mo CD - 1K	12	0.400%	1,000		0.400%	0.00	90.0%	900	**4**	0.400%	0.00	80.0%	800	**3**
12 Mo CD - 25k	12	0.600%	2,000		0.600%	0.00	90.0%	1,800	**11**	0.600%	0.00	80.0%	1,600	**10**
12 Mo CD - 100K	12	0.900%	8,000		0.900%	0.00	90.0%	7,200	**65**	0.900%	0.00	80.0%	6,400	**58**
13 Mo Special - 25K	13				0.000%	1.00	0.0%	0		2.000%	4.00	100.0%	700	**14**
13 Mo Special - 150K	13				0.000%	1.00	0.0%	0		2.500%	5.00	100.0%	2,000	**50**

The real cost of pricing a CD special at top of market. Balance growth of 5% that includes cannibalizing 1/5th of existing balances results in actual cost of **3.45%.**

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Segmentation

- How can we grow balances without paying up on “old” balances?
- How do we compete with other institutions paying more than the FHLB advance curve for funding?
- How long do you wait to assess success of a strategy or product?
- What about “fairness”?

Fairness Issues - Consumer

- Institutions struggle with the concept and execution of offering different rates for what seem to be the same product.
  - Is this fair?
  - Won't we get complaints?
  - How do we actually pull this off?
- Virtually every institution offers rate discounts for:
  - Volume discount (balance tiers, fees waived on minimum)
  - Relationships (discount on loan with direct deposit)
  - Credit mitigation (discount on loan with auto pay, better rate for higher FICO)
  - Short term promotion (limited time offer, short term CD special)
  - Channel (discount on on-line only product, special at the new location)
- In other words, we use segmentation to determine which characteristics are more important to the consumer – just like every other consumer industry.

Solutions

- Fairness is a bigger problem if I have not segmented, or do not have products with different characteristics.
  - Do not assume that all consumers have the same preferences for all characteristics (rate, fees, minimums, locations, features like paper statements or no fee ATMs).
  - A retailer rarely offers a special without forcing consumer to take an action advantageous to both.
  - If a retailer has a “flat fee” mentality, it is part of a marketing campaign.
- Does your product line have choices for a consumer who perceives an unfair or uncompetitive rate?
  - We do have a better rate for you. You simply need to choose this…
  - Yes, there are better rates out there, but they don’t come with …, or they require to you …
- DO NOT assume that all consumers will elect to spend the effort to switch, even if they know about the choices!
  - Let the consumer select the product, not the CSR.

Funding Plan

Funding Goal	$44,258
Projected Funding	$37,816
	$6,442 <-- needed to meet goal

1 Breakout retail balances by sector.

	Cons MMDA	Bus MMDA	Inst CD	ST CD	LT CD	Cons Savings	Bus Savings	PF Savings	Cons Checking	Bus Checking	PF Checking
Current balance	$128,552	$39,650	$0	$46,973	$45,957	$87,552	$0	$0	$176,829	$298,144	$61,509
Organic growth	2%	5%	0%	8%	3%	5%	0%	0%	5%	5%	0%
New growth	0%	0%	0%	0%	0%	0%	0%	0%	0%	3%	0%
Net Accounts						4,374			6,552	1,855	6
New Accounts Goal (annual)*						694			1,582	355	2
Net Accounts Goal						4,723			7,569	2,100	8

Organic growth	$2,571	$1,983	$0	$3,758	$1,379	$4,378	$0	$0	$8,841	$14,907	$0
New growth	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0	$0
Totals	$2,571	$1,983	$0	$3,758	$1,379	$4,378	$0	$0	$8,841	$14,907	$0

Assets	$1,105,643
Loans	$796,225
Loan Growth %	5%
Net Loan Growth	$39,811
Curr Loan/Deposit Ratio	90%
Target Loan/Deposit Ratio	88%
Ann Funding Goal (maintain L/D ratio)	$44,258
Ann Funding Goal (target ratio)	$64,875
Deposits	$885,166 (net of borrowings)

2 Make a loan growth assumption.

3 Project growth in number of accounts.

Funding Plan – The Whole Balance Sheet

- The concept of effective duration can be extended to the entire balance sheet produced by an EVE/NEV report.
- Once the report is produced it can be used to identify potential strategies aimed at managing interest rate risk.
- Forecast EVE reports can be used to measure the effectiveness of these strategies.

Funding Plan – The Whole Balance Sheet

- Here is a typical EVE summary. Effective duration comes from the relative price (value) difference when we shock our institution with rate scenarios.

EVE Report	Book	-100bp	Flat	+100 bp	+200bp	+300 bp	+400bp
Assets							
Investments	49,246	48,589	46,216	44,404	42,172	40,366	38,570
R/E Loans	152,290	152,165	147,415	142,295	137,316	132,178	127,648
Commercial	19,993	19,920	19,575	19,227	18,891	18,557	18,238
Consumer	2,486	2,475	2,449	2,423	2,398	2,373	2,349
Non-Earning	11,547	11,547	11,547	11,547	11,547	11,547	11,547
Total Assets	235,562	234,696	227,202	219,896	212,324	205,021	198,352
Liab & Equity							
NIB DDA	18,856	16,495	15,618	14,752	13,900	13,188	12,538
IB DDA	60,797	53,410	51,282	49,204	47,034	45,319	43,751
Savings & MM	51,460	43,033	43,119	42,464	41,892	41,410	40,960
CDs	63,868	63,887	63,109	62,349	61,605	60,887	60,164
Borrowings	18,707	18,702	18,604	18,508	18,413	18,319	18,225
NIB Liab	767	767	767	767	767	767	767
Total Liab	214,455	196,294	192,499	188,044	183,611	179,890	176,405
Equity	21,107	38,402	34,703	31,852	28,713	25,131	21,947
Total Liab & Equity	235,562	234,696	227,202	219,896	212,324	205,021	198,352

Funding Plan – The Whole Balance Sheet

- Concept: Based on core study information, and EVE/NEV report, allocate the sources based on "duration" of cash flows, like you would an investment "ladder".

Duration Map (+200)	0-1	1-2	2-3	3-4	4-5	5-6	6-7	7-8	8-9	9-10
Assets										
Investments					49,246					
R/E Loans				152,290						
Commercial		19,993								
Consumer		2,486								
Non-Earning	11,547									
Total Assets	11,547	22,479	-	152,290	49,246	-	-	-	-	-
Liab & Equity										
NIB DDA						18,856				
IB DDA					60,797					
Savings & MM		51,460								
CDs		63,868								
Borrowings	18,707									
NIB Liab	767									
Total Liab	19,474	115,328	-	-	60,797	18,856	-	-	-	-
Equity										21,107
Total Liab & Equity	19,474	115,328	-	-	60,797	18,856	-	-	-	21,107
Mismatch	(7,927)	(92,849)	-	152,290	(11,551)	(18,856)	-	-	-	(21,107)
Cum Mismatch	(7,927)	(100,776)	(100,776)	51,514	39,963	21,107	21,107	21,107	21,107	-

Polling Slide

Do you have a 2020 funding plan that more than just projecting a deposit growth and average cost of funds?

- Yes, we project balances at the major deposit sector level.
- Yes, we project costs at the major deposit level.
- Yes, we use an IRR approach to plan funding to match earning assets.
- No, we use a simple budget.

Measuring Success

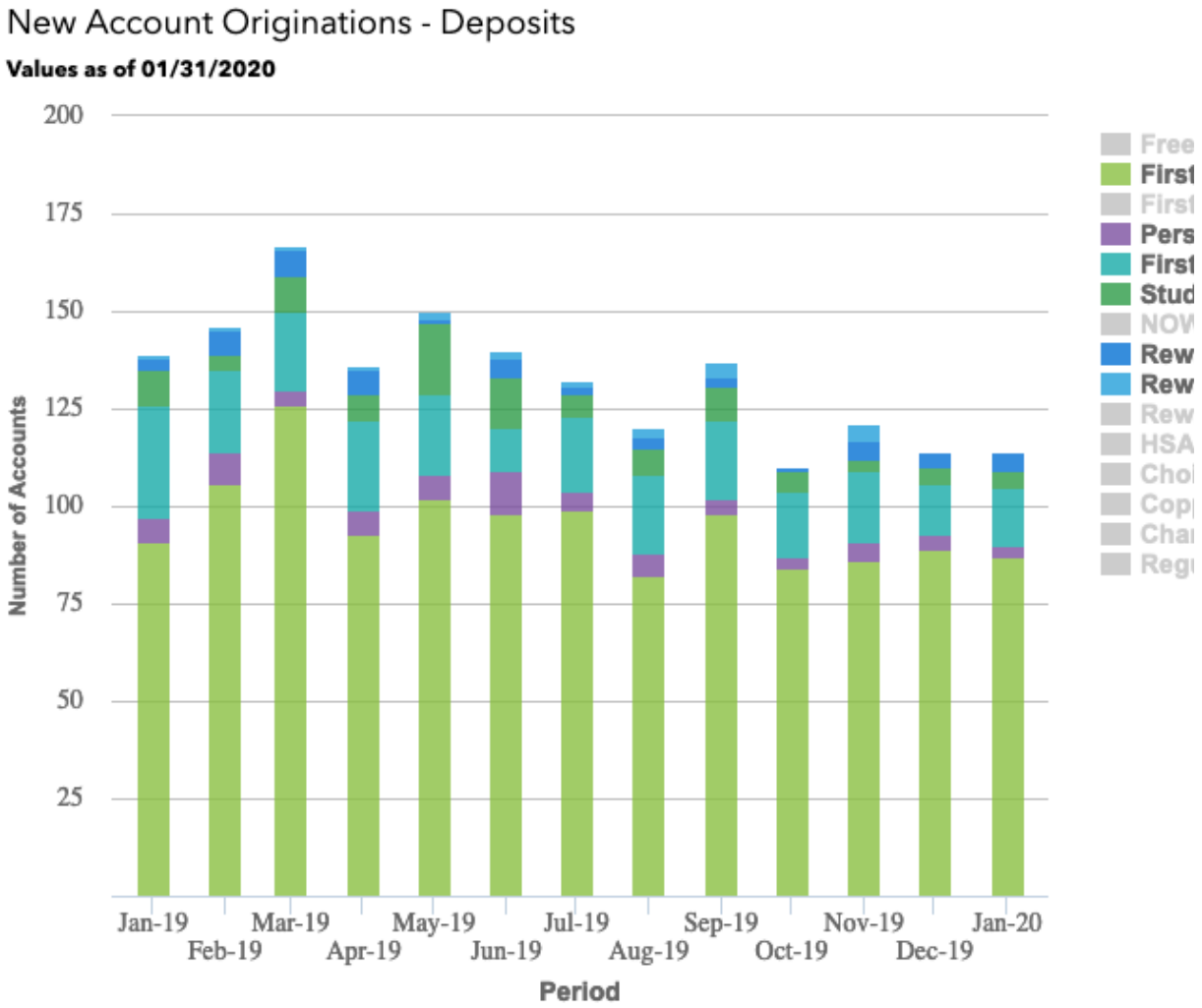
Is my strategy working?

- What is my market share trend?
- Are average balances growing?
- What share of customer balances do we have?
- Are active accounts growing?

Are my assumptions correct?

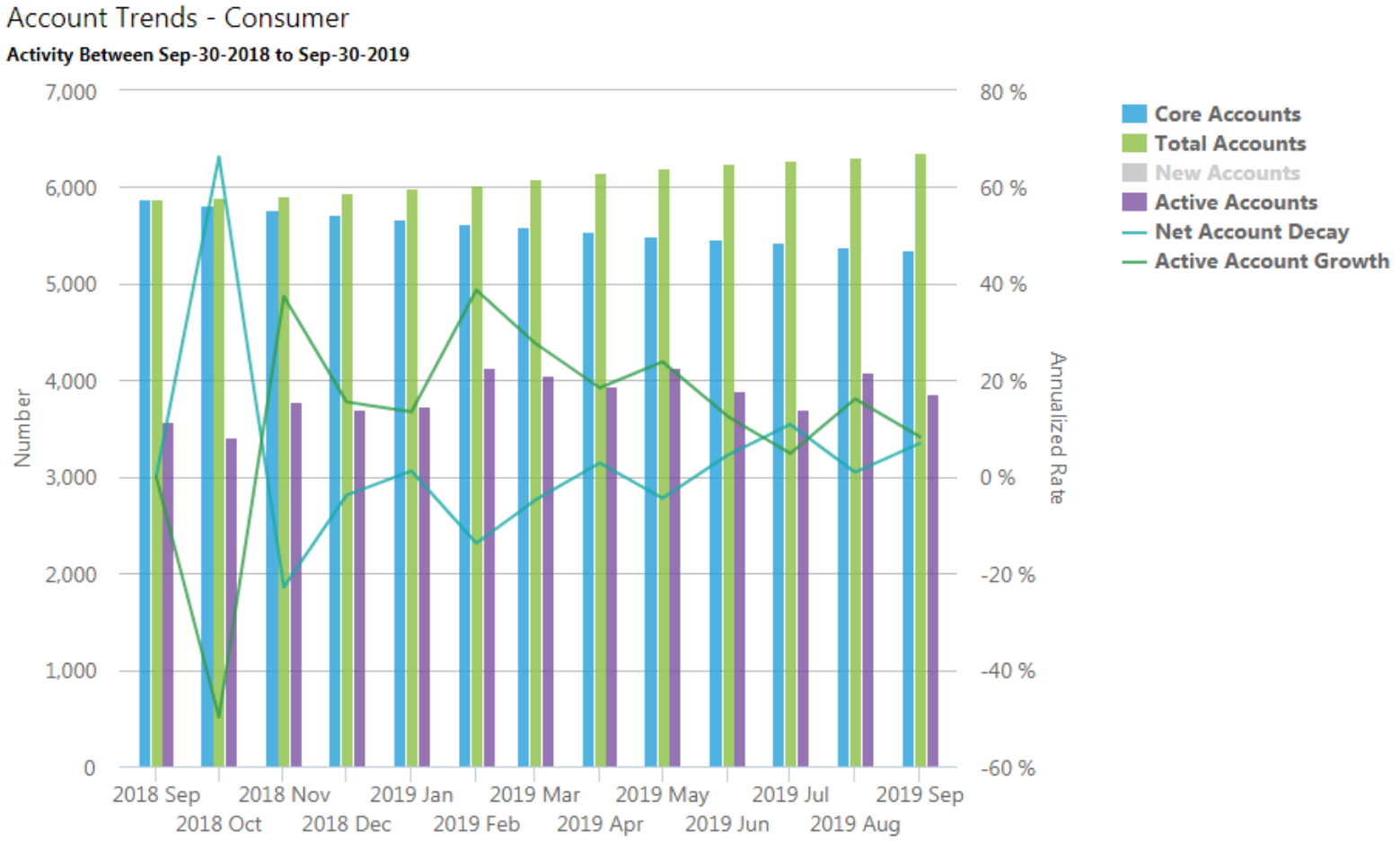
- Back test your core assumptions
- Track the response to promotions and balance migration.

Measuring Success – What Are We Opening?



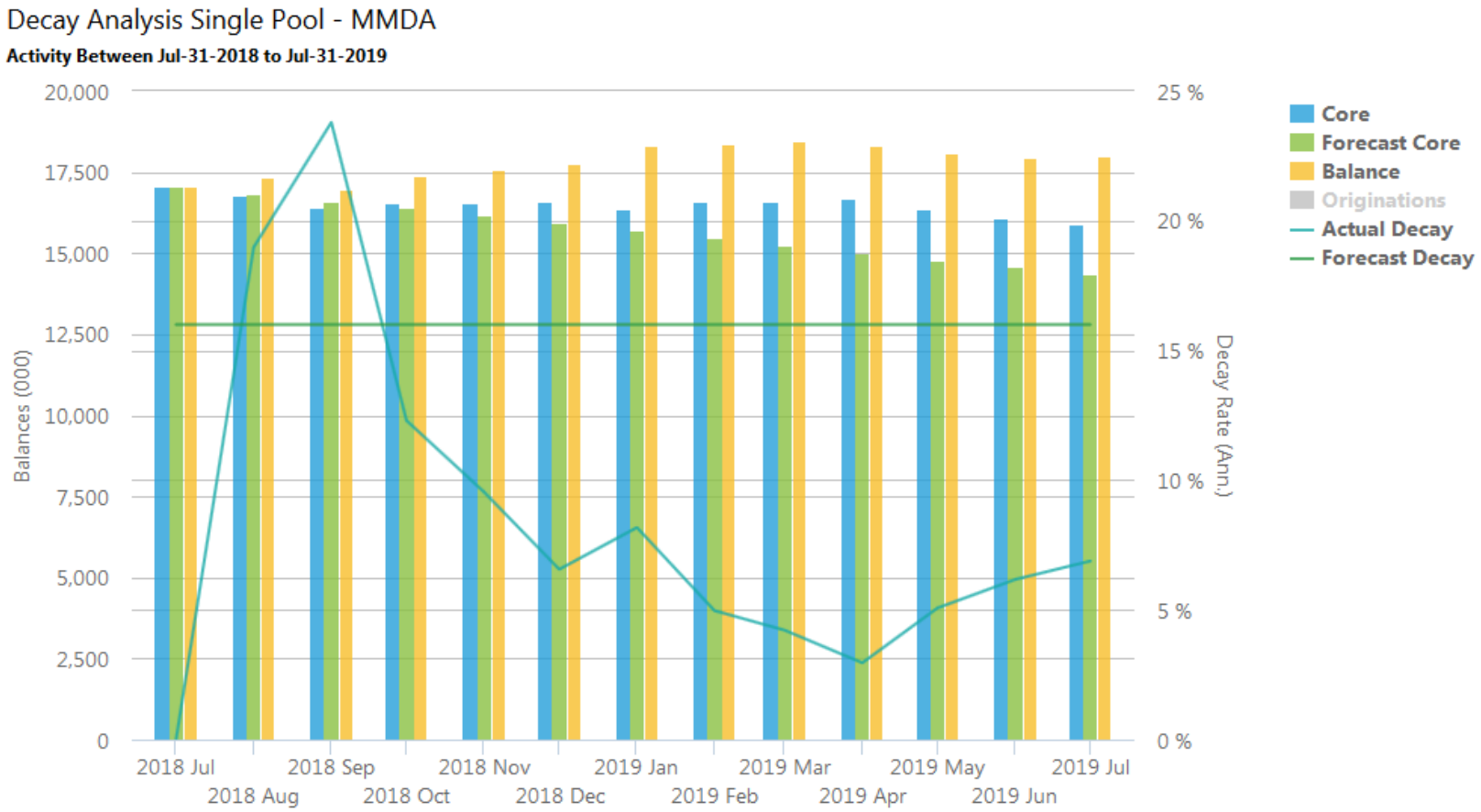
- This looks at number of new accounts per month, not balances.
- What accounts do you want to open?
- Accounts take some period to “fund” or reach a typical balance.
- Specific promotions, lobby strategies, consumer preferences, staff turnover, competitor positioning all will affect these numbers and trends.

Measuring Success – Active Accounts



- Active accounts – the number of accounts in a sector that are above either a dormant threshold (e.g. $50 savings), or have income generating activity (e.g. more than 10 transactions/month).
- The active account growth rate is the net growth in this number.
- It is affected by new account originations, closed accounts and accounts going inactive.

Measuring Success – Recent Decay



- The core study predicted about 16% annual decay in MMDA accounts in this rate environment.
- This institution's actual experience was lower. Why?
- In this case it was due to the behavior of a small number of large depositors.

How Do We Nurture

- Education and training
  - Retail errors can sabotage a well thought out plan.
  - Scenarios, what happens when someone walks in and…
- Consumer empathy and fairness
  - Sorry, we don’t carry that model vs. I think we have something that meets your needs.
- Pricing strategies
  - Avoid a wild west mentality on rates and terms.
  - Pricing rules, generic and specific, can help here.

Thank You

Program Resource Page

https://www.abrigo.com/fhlb-des-moines-webinar-series-2020/