FHLBank Boston

Using Advances to Efficiently Price Deposits

By Andrew Paolillo, CFA, *Director of Member Strategies & Solutions*

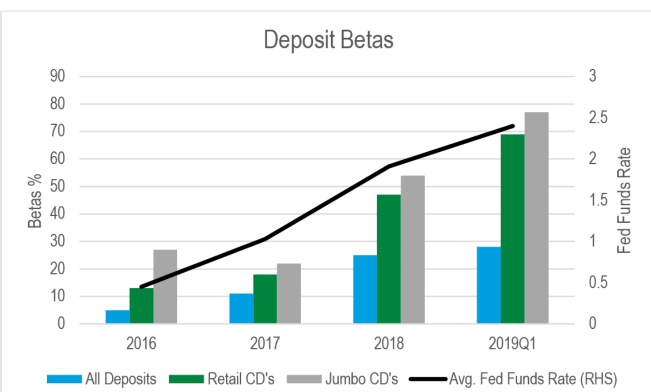
Summary

- *Competition for deposits is heating up*
- *Deposit and wholesale rates have converged*
- *Advances can help set favorable deposit pricing and control cost of funds*

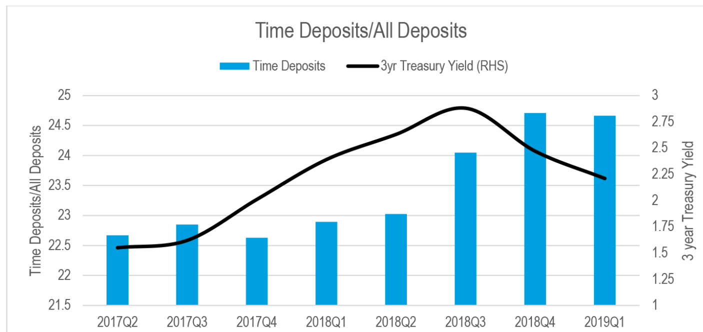
Rising Betas and Certificate of Deposit (CD) Balances

In its first quarterly profile for 2019, the FDIC highlighted increasing competition for deposits and its impact on community banks. Emphasizing the trend, FDIC Chair Jelena McWilliams pointed out the "competitive environment for deposits [has pushed] up interest rates on certificates of deposit [and] savings accounts."[1]

This is not news to balance sheet managers. As the chart below shows, the rate on Fed Funds rose by more than 200 basis points from 2016 to 2018, whereas the pricing lag that benefitted depository institutions early in the tightening cycle has waned. Pricing betas increased considerably, pushing interest costs higher.



Compounding the challenge, the relative amount of time deposits on the balance sheet has increased over the last two years, while in 2019, market interest rates have started to fall. The chart below shows the recent path of the three-year Treasury yield, as well as the percentage of time deposits vs. total deposits for FHLBank Boston depository members. Unsurprisingly, depositors sought to lock in higher rates through greater use of certificates of deposits as market yields rose. Now, even with rates reversed, interest expense continues to creep up. Margins are under pressure as asset yields drop.



Aggressive CD Pricing

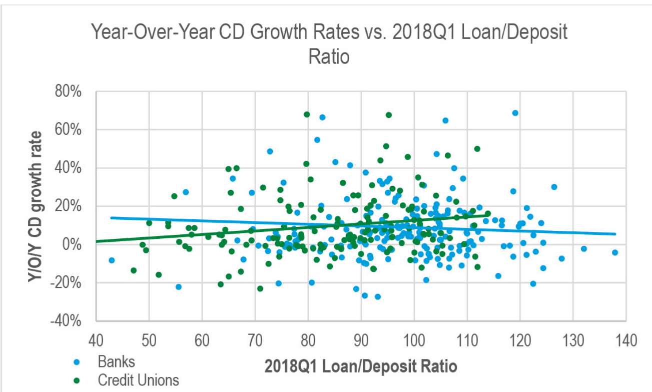
This dynamic has led to the convergence of wholesale borrowing rates and retail CD rates offered by banks and credit unions. In recent discussions with members, we found many instances where CD offerings were just a few basis points lower than advance rates for comparable terms. In some cases, CD rates even exceeded FHLBank Boston advance rates. This was before accounting for the benefit of the FHLBank Boston dividend, which currently provides approximately 21 bps of benefit to the net all-in cost of funding.

Many factors impact funding decisions, including the juggling of competing needs for earnings, liquidity, interest-rate risk, and growth. A blend of some of these drivers might suggest a rationale for a more aggressive deposit strategy. For example, offering higher CD rates might rein in a relatively higher loan-to-deposit ratio. However, our research showed mixed results when we analyzed the data.

[1] David Hood, "FDIC chair: Some banks 'reaching for yield' as nonbank competition heats up," S&P Global, May 29, 2019 https://www.spglobal.com/marketintelligence/en/news-insights/trending/MQptBeNTyA9JHTXuMU35_w2

Loan-to-Deposit Ratio Research

To test if a higher loan-to-deposit ratio typically led members to seek out higher levels of CD growth, we looked at the loan-to-deposit ratio for all FHLBank Boston depository members from the first quarter of 2018, as well as year-over-year growth rate in CD balances (2019Q1 vs. 2018Q1). We expected to see a reasonably strong positive relationship — one could argue that members with higher loan-to-deposit ratios could justify more aggressive pricing on CDs to push deposit growth beyond that of loans and produce more growth in CDs, improving the liquidity profile. However, that was not the case. As shown below, banks showed a negative relationship, and credit unions were only mildly positive, with the net result of the two combined being largely negligible.



Leveraging the Efficiency of FHLBank Boston

Our depository institution members can take advantage of their ready access to advances and ease of use to combat these challenging conditions. The cost of advances, as the benchmark wholesale funding alternative, can serve as the foundation for deposit pricing. By starting with the advance price, factoring in the benefit of the dividend, and then making institution-specific spread adjustments (room for negotiation with depositors, FHLBank Boston special pricing, Advance Renewal Discount Program savings, collateral or loan/deposit issues that would influence liability structure, cushion vs. market volatility, etc.), an institution can efficiently price their deposits to control interest expense.

FHLBank Boston Advance Rate – **FHLBank Boston Dividend Benefit** – **Spread Adjustments** = **Retail CD Price**

FHLBank Boston two-year rate	2.27%*
FHLBank Boston dividend benefit	0.21%
Spread adjustments	0.15%
Retail CD price	**1.91%**

** Rate on 07/11/19*

In the table below, using the FHLBank Boston two-year rate at 2.27 percent, factoring in the dividend benefit of 21 bps, and applying 15 bps for the combination of hypothetical institution-specific spread factors, results in an optimal offering rate of 1.91 percent for retail CDs. If money flows into CDs, it comes in at a favorable cost to the member. If it doesn't, then the on-demand liquidity from FHLBank Boston can quickly and efficiently plug the funding gap, with a variety of maturities and structures providing more customization than retail time deposits.

For example, the asset/liability positioning may call for three-year funding, but if there is little customer demand beyond 18 months, the member can take the three-year wholesale borrowing that best fits the balance sheet needs, even as they remain competitively priced inside of the in-demand 18-month term for retail CDs.

The factors impacting your competitors' pricing decisions (liquidity needs, capital structure, asset mix, etc.) may not be relevant to your institution. The wholesale components of the balance sheet (investments and borrowings) can be complementary and reactive tools that balance out those times when unfavorable conditions occur in the core loan and deposit portfolios.

By using FHLBank Boston advance rates as the benchmark reliable source of funding to set pricing levels, your organization can leverage its partnership with FHLBank Boston, instead of incurring unnecessary deposit costs to support your balance sheet's structure and health.

Our strategy group has a suite of deposit strategy analysis tools, including Marginal Cost of Funds (MCOF) Analysis, Special Rate Sensitivity Analysis, and Deposit Defense Analysis reports. We can identify breakeven cannibalization rates and pricing levels, test sensitivity to various inputs, and conduct scenario analysis surrounding deposit migration and runoff. See the sample analysis and new money chart below to see how we can help.

Let us tailor a unique program based on your institution's circumstances. For more information, contact your relationship manager or me at andrew.paolillo@fhlbboston.com or 617-292-9644.

Marginal Cost of Funds (MCOF) Analysis

Sample Inputs		
Existing Deposit Cost	1.50%	
Money Raised	$10,000,000	
Special Rate	2.00%	
FHLBank Boston Advance Rate	2.27%	2yr
FHLBank Boston Dividend Adj. Rate	2.06%	

New Money %	Incremental Cost	MCOF	MCOF vs. FHLBank Boston
10%	$65,000	6.50%	4.44%
20%	$80,000	4.00%	1.94%
30%	$95,000	3.17%	1.11%
40%	$110,000	2.75%	0.69%
50%	$125,000	2.50%	0.44%
60%	$140,000	2.33%	0.27%
70%	$155,000	2.21%	0.15%
80%	$170,000	2.13%	0.06%
90%	$185,000	2.06%	-0.01%
100%	$200,000	2.00%	-0.06%

New Money Breakeven Percentage	89%