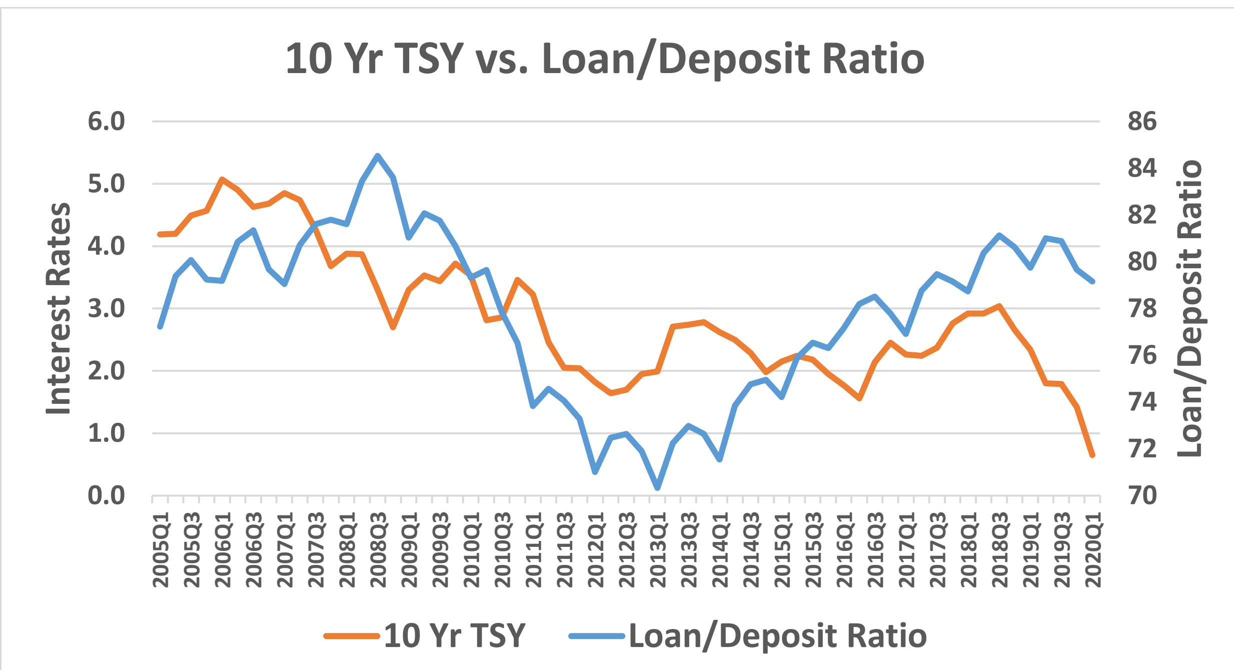
A Great Opportunity to Improve Bank Liquidity for the Long Term

A great opportunity exists for banks in the current market today. With rates at all-time lows, the cost of callable, long-term CDs has never been more attractive to raise long-term funds. While many banks are flush with liquidity today, we would encourage banks to look into the future and determine how their liquidity needs may increase when rates and the cost of liquidity increases. Then consider raising funds today at all-time lows in interest rates to stay ahead of the business cycle.

Bank liquidity trends HIGHER as rates DECREASE. This is, of course, where we are currently. Prepayments are higher. Loan demand is lower due to a weaker economy and deposits are more likely to STAY at the bank and wait for opportunities for higher returns when markets turn around.

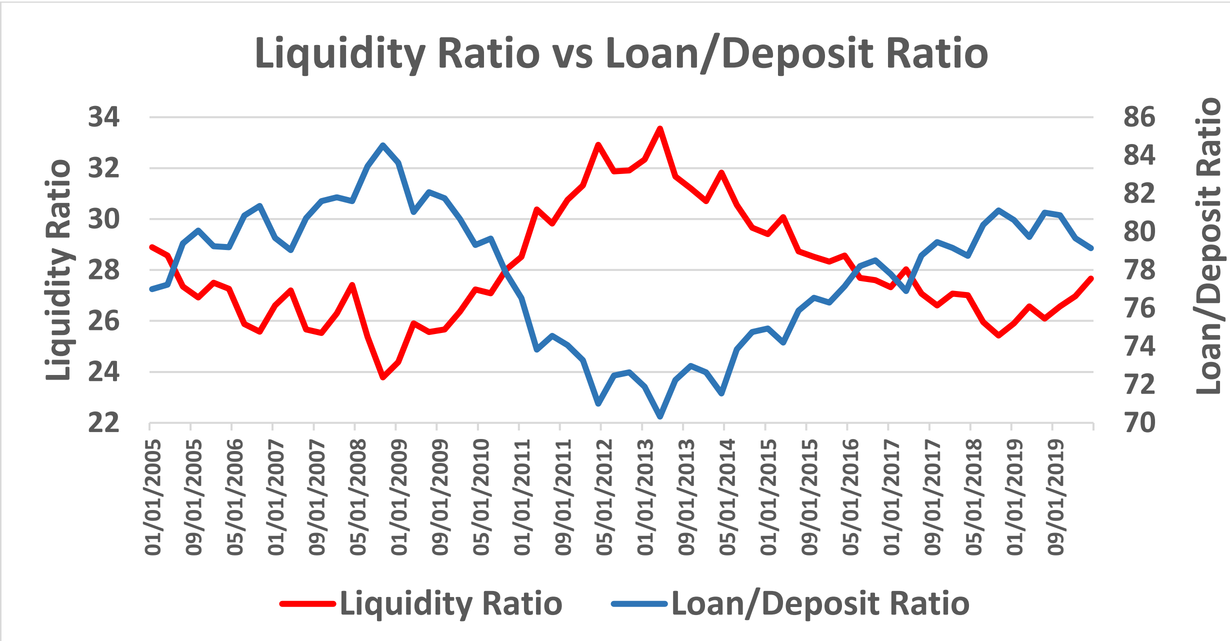
Conversely, bank liquidity trends LOWER as rates INCREASE. This is due to prepayments on loans and investments slowing. Loan demand increases as rates increase which is due to an expanding business cycle. There is also pressure on deposits to LEAVE the bank due to depositors 1) withdrawing more money to put into their businesses, 2) searching for higher yields on fixed income securities, and 3) allocating money to the stock market that is most likely increasing in an economic expansion. This is the scenario in the future that banks should be preparing for today.

The graph below shows how loan to deposit ratios change as interest rates change. As rates increase, loan to deposit ratios increase. As rates decrease, loan to deposit ratios decrease. In looking at the data, there is also a 9-12 month lag from when rates change to when L/D ratios begin to react. This lag says that once loan demand begins to increase, the cost of funds will have already increased and the opportunity to raise cheap funding will have been missed.



Interest Rates Source: Board of Governors of the Federal Reserve System (US)/Freddie Mac/FRED
Loan to Deposit Ratio Source: S&P Global
Loan to Deposit Ratio shown represents average of all banks <$10B in assets.

The graph below shows the inverse relationship between bank liquidity and loan/deposit ratios. When liquidity is lower, loan to deposit ratios are higher and when liquidity is higher, loan to deposit ratios are lower.



Ratio Source: S&P Global
Ratios shown represent average of all banks <$10B in assets.

In addition to the usual effects from the business cycle, most banks have been flooded with additional deposits during these uncertain times. This has been due to clients 1) depositing PPP loan proceeds into their bank accounts, 2) drawing down credit facilities and depositing those funds in the bank, 3) moving deposits to more primary banking relationships, and 4) holding on to cash that might otherwise be invested in their business. The economic distress caused by the pandemic has triggered this flood of deposits into banks, which has made it even more difficult to consider raising additional liquidity now. Keep in mind though, that this economic distress is also the main reason this opportunity is available in the first place (low rates) and when these circumstances begin their correction, this opportunity will begin to disappear (higher rates), along with some of the flood of deposits heading back out the door.

The problems that banks face with the general business cycle is that when rates are LOWER, there is MORE money to allocate to investments because loan demand is **lower** and liquidity is **higher** but there is the reluctance to extend out the curve with your investments because you want to avoid future mark to market losses in your investment portfolio. Conversely, when rates are HIGHER, there is LESS money to allocate to investments because loan demand is **higher** and liquidity is **lower**, even though that is when you want to allocate more money to longer duration investments. To add to the difficulty, if rates have been trending higher, like they were in 2018, the feeling may be that rates will CONTINUE to go **even higher**, so even though rates are higher, the trend still makes it hard to pull the trigger on longer duration investments in a rising rate scenario.

The KEY is to try and stay ahead of these cycles. One good tool to use to monitor interest rate cycles is the historical regression. The graph below shows that the 10yr treasury is between two and three standard deviations below the mean. This indicates that the next move is likely to be a move back towards the mean at some point, which would be a move back to higher interest rates. Back in late 2018, the 10yr treasury was actually at +2 standard deviations when it was in the 3.20% area, which was a sign that it was time to extend asset duration, even though many felt the 10yr was on its way to 5.00%. Today this regression tells us it is time to extend liabilities.

Source: Bloomberg, LLC.

We believe that issuing long-term, brokered callable CDs is the best and most efficient way to extend liabilities in this market. Some of the advantages of issuing brokered callable CDs are as follows:

1. Allows the issuer to take advantage of historical low rates today with the ability to call the funding and reissue if rates go even lower, creating cheap, long-term options for the portfolio.
2. The CALL is controlled by the issuing bank. One of the few options on your balance sheet you actually control.
3. Lockout period is typically 6 months but can be structured to fit the bank's needs. For the longer issues, a lockout of 1-3 years provides better execution in the market today.
4. No IRR in the down rate scenarios such as with bullet funding or interest rate swaps.
5. No provision for early withdrawal (except for death put) which is an absolute must at this level of rates. The funds cannot be called away.
6. There is no posting of collateral or stock purchase required.
7. Keeps current borrowing lines open for when you need them down the road.
8. No ongoing fees.

9. Only one CUSIP.
10. Target specific maturities or call schedules. A bank could lock in a spread on a basket of loans that might prepay in the future.
11. Does not cannibalize retail funding markets. There is less pressure to go out and run CD specials to attract funds at these low rates. Banks can focus their deposit strategy on growing and retaining core retail deposits rather than raising "hot money" CDs.

Below is the latest rate sheet that shows the all-in cost of the longer term brokered CDs for bullet and callable debt as compared to treasury securities and FHLB Advances. With rates at these levels, we would recommend that banks consider maturities from 5 years out to 15 years.

Maturity	TREASURY	Brokered CD Fixed	Brokered CD Callable	FHLB TOPEKA	FHLB DMOINES
5YR	0.32%	0.75%	0.80%	0.89%	0.82%
7YR	0.52%	0.90%	1.05%	1.10%	1.09%
10YR	0.68%	1.20%	1.35%	1.41%	1.40%
12YR	0.64%		1.45%		1.60%
15YR	N/A		1.65%	1.97%	1.87%

Indicative rates only, subject to change and availability. For illustration purposes only as of June 22, 2020

Another thing to consider is that when rates begin to go back up, deposit rates will, of course, eventually have to be repriced up as well. However, if you have long term fixed rate funding already in place when this happens, that could provide you with more flexibility in deciding how much and when to raise deposit rates. In other words, the pressure to keep liquidity in the bank by raising deposit rates will have been eased somewhat. You've already got the money in the bank!

And finally, interest rates are at historic lows. Deciding whether or not to issue CDs is actually an easier call because interest rates are so close to zero. When rates are higher and you are trying to decide where the top is, rates can always go higher, but in today's environment, we are so close to zero that they can't go much lower, assuming the Fed is telling us the truth about negative interest rates. And even if rates do go lower, call the CD and reissue it!

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