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With higher rates in question, banks selectively build term funding

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While a handful of banks have built term funding in recent quarters to prepare for higher short-term rates, most institutions are shrinking the higher cost sources of funds.

The prospect of rising rates, even as the pace of increases has come into question, has prompted many institutions to consider what will happen to deposit costs when rates rise. Some bankers believe it could make sense to build term funding now through CDs or FHLB advances to lock in funding costs while they remain low.

Travis Goodman, managing director at ALM First Financial Advisors, noted at the ALM First Financial Institute in early February that CDs can be used to manage interest rate risk, but said banks usually have to pay up more for the deposit product than locking in funding costs through derivatives. He noted that CDs have the benefit of early withdrawal penalties that can discourage customers from moving funds to seek a higher rate.

Most CDs only carry early withdrawal penalties equivalent to six months of interest, Goodman said. He said the cost of most early withdrawals is not harsh enough to discourage customers from pulling their funds before the product matures.

At current rates in the market, six months of interest does not seem that punitive. The average yield on a 1-year CD stood at 39 basis points as of March 4, according to data from SNL Financial. Six months of interest on a $10,000 CD carrying that yield would equate to less than $20. Many CDs, however, carry minimum withdrawal penalties of $25 or more.

Goodman said FHLB advances are another option for institutions to build term funding and can serve as a very stable source of funding. He said FHLB advances have benefits over CDs since they do not allow for an early withdrawal. However, he noted that advances can increase leverage at an institution when they might not need it.

Some advisers have noted that banks with growth opportunities can use FHLB funding as an effective interest rate risk tool. A bank with strong organic growth opportunities could possibly utilize FHLB advances to be more competitive in their lending markets. A bank could try to originate more floating-rate commercial loans by undercutting the competition and fund those credits with relatively cheap fixed-rate FHLB funding.

Some banks have taken the opportunity to build term funding recently. For instance, seven institutions increased their CD balances by 100% or more in the fourth quarter when compared to year-ago levels. Three of those institutions, including M&T Bank Corp., completed an acquisition in the fourth quarter.

Other banks have recently launched new CD products. For instance, earlier this week, EverBank Financial Corp launched a new CD product that would allow customers to participate in upside in the commodities markets. The FDIC-insured product is a five-year commodity solutions CD called MarketSafe. The indexed and U.S. dollar-denominated CD offers 100% principal protection and the ability to earn up to a 70% upside payment at maturity if commodities — WTI crude oil, gold, silver, soybeans, corn, sugar, copper and nickel — increase in value across annual pricing dates. The product has a minimum deposit of $1,500 and no monthly account fee.

While EverBank and some other institutions are looking to build term funding, including through non-traditional approaches, CDs decreased as a portion of banks' deposit bases through year-end 2015, falling to 13.4% of total industry deposits from 14.2% at year-end 2014. The median

Q4'15 banking industry CD balances, by asset class*

	Certificate of deposits			
			Median concentration (%)[2]	
Asset class	Balance ($B)	YOY change (%)[1]	Q4'15	Q4'14
$1B & below	332.54	-8.93	30.38	32.16
$1B-$10B	290.02	3.01	22.57	24.32
$10B-$50B	186.96	-17.24	13.40	16.71
$50B-$250B	460.56	40.53	10.70	11.46
$250B & above	345.70	-24.25	6.60	18.96
Industry	**1,615.78**	**-2.47**	**29.84**	**31.74**

Data compiled March 8, 2016.
* Analysis includes commercial banks, savings banks and savings & loan associations that have filed regulatory reports for the respective period. Industrial banks, cooperative banks and nondepository trusts are excluded.
[1] Year-over-year change is based on reported CD balances and is not adjusted to exclude growth from activity related to mergers and acquisitions.
[2] Represents the median concentration of retail and jumbo time certificate of deposits as a percentage of total deposits across each asset class.
CD balances are based on regulatory filings.
CD = certificate of deposit
Source: SNL Financial, a part of S&P Global Market Intelligence

concentration across the industry also declined to 29.8% in the fourth quarter from 31.7% in the year-ago period. Those balances exclude several hundred institutions that hold bank charters but do not principally engage in banking activities, among them industrial banks, nondepository trusts and cooperative banks.

CD balances fell even with the Federal Reserve finally raising short-term rates late in 2015. That move did not come until mid-December, but LIBOR began increasing in November ahead of the Fed rate hike.

Short-term rates still have not moved that much since the Fed move and many observers are beginning to doubt how much the central bank will increase short-term rates in 2016 amid the prospect of falling commodity prices and a global slowdown. Fed futures are implying that the short-term target rate has a 25.1% probability of holding at 50 basis points through December 2016, according to CME Group. The futures market implies there is a 39.2% probability of the target rate moving up just 25 basis points from current levels, and only a 25.0% probability of the target rate climbing 50 basis points through December 2016.

SNL data shows that CD rates have not increased much at all since the Fed rate hike. Some lenders acknowledge that CDs rates will eventually increase, assuming that short-term rates move higher. They have even tested the market to try to measure how sensitive CDs will be to changes in market rates.

Matt Davidson, CFO at Wright-Patt Credit Union Inc. in Beavercreek, Ohio, said at the ALM First Financial Institute that his institution changed the rates on CD products after the Fed raised interest rates in December. Davidson said the credit union became one of the highest payers in its market, but ultimately didn't see any change in customer behavior.

"People are insensitive to rate changes. It's going to have to change a lot to change behavior," Davidson said at the event. "A 50 basis point change in short-term rates, I don't think will do it. If we're talking 2%, yeah that will do it."

Average $10,000 CD rates at US banks & thrifts, by asset class*

	Certificates of deposits-$10K^									
	3-month		6-month		1-year		3-year		5-year	
Asset class	**12/11/15**	**03/04/16**	**12/11/15**	**03/04/16**	**12/11/15**	**03/04/16**	**12/11/15**	**03/04/16**	**12/11/15**	**03/04/16**
$1B-$10B	0.13	0.13	0.20	0.21	0.34	0.35	0.75	0.76	1.19	1.18
$10B-$50B	0.12	0.12	0.18	0.20	0.32	0.36	0.74	0.74	1.13	1.11
$50B-$250B	0.10	0.09	0.22	0.19	0.36	0.33	0.68	0.65	1.04	0.98
$250B & above	0.04	0.04	0.05	0.05	0.10	0.10	0.25	0.25	0.48	0.48
Industry average*	**0.15**	**0.15**	**0.23**	**0.24**	**0.38**	**0.39**	**0.81**	**0.81**	**1.22**	**1.23**

Data compiled March 8, 2016.
* Analysis includes commercial banks, savings banks and savings & loan associations that have filed regulatory reports for Dec. 31, 2015. Industrial banks, cooperative banks and nondepository trusts are excluded.
^ Represents average U.S. interest rates for different $10,000 certificate of deposit products. Interest rate data may not reflect all pricing regions for each company and is based on current S&P Global Market Intelligence coverage.
CD = certificate of deposit
Source: SNL Financial, a part of S&P Global Market Intelligence

US holding companies with the highest YOY change in CD balances (%)*

Company (top-level ticker)	Q4'15 balance ($M)	Change (%)[1] QOQ	Change (%)[1] YOY	Average $10K CD rates, by maturity (%)[2] 3-month	1-year	3-year
M&T Bank Corp. (MTB)	13,110.4	369.68	327.89	0.05	0.10	0.17
Your Community Bankshares Inc. (YCB)	317.2	-4.13	137.03	0.07	0.20	0.39
SmartFinancial Inc. (SMBK)	340.7	-2.07	136.14	0.20	0.45	1.00
NexBank Capital Inc.	512.7	69.32	136.08	0.15	1.25	0.45
Franklin Financial Network Inc. (FSB)	751.5	-0.82	133.96	0.29	0.57	0.89
Green Bancorp Inc. (GNBC)	1,352.8	108.41	112.59	0.15	0.60	1.00
Bridge Bancorp Inc. (BDGE)	292.9	-5.47	107.17	0.05	0.20	0.40
LegacyTexas Financial Group Inc. (LTXB)	1,027.4	14.09	99.89	0.05	0.25	0.45
Pinnacle Financial Partners Inc. (PNFP)	824.7	11.55	91.28	0.35	0.50	0.84
Sterling Bancorp Inc.	430.5	2.26	90.53	0.20	0.65	1.25
First Foundation Inc. (FFWM)	470.2	30.30	85.59	0.10	0.25	NA
CIT Group Inc. (CIT)	18,221.6	1.72	84.48	NA	1.22	1.50
Univest Corp. of Pennsylvania (UVSP)	454.4	-7.21	80.14	0.05	0.45	1.10
Bank of the Ozarks Inc. (OZRK)	2,438.5	11.71	78.17	0.05	0.18	0.55
Banner Corp. (BANR)	1,353.9	85.29	75.71	0.10	0.20	0.60
American Express Co. (AXP)	14,137.0	24.63	72.99	NA	0.55	1.25
FCB Financial Holdings Inc. (FCB)	1,858.2	21.87	72.56	0.05	0.65	0.35
Penn Community Mutual Holdings Inc.	492.1	-1.43	70.41	0.15	0.35	0.80
Merchants Bancorp	403.4	19.12	69.63	0.35	0.35	0.80
Silver Queen Financial Services Inc.	229.0	21.78	65.24	NA	1.25	1.60
Industry median[3]		**-0.68**	**-2.02**	**0.14**	**0.35**	**0.80**

Data compiled March 8, 2016.
* Analysis is limited to 20 top-tier U.S. holding companies with the highest year-over-year change in certificates of deposits, as of Dec. 31, 2015. Only institutions with assets greater than $1 billion, CD balances of more than $100 million and loan-to-deposit ratios of greater than 50% were considered.
Morgan Stanley, Deutsche Bank Trust Corp. and Atlantic Capital Bancshares Inc. were excluded from the analysis due to unavailable CD rates.
[1] Quarter-over-quarter and year-over-year changes are based on reported CD balances and are not adjusted to exclude growth from activity related to mergers and acquisitions.
[2] Represents average U.S. interest rates for different $10,000 certificate of deposit products. Interest rate data may not reflect all pricing regions for each company and is based on current S&P Global Market Intelligence coverage. Rates are as of March 4, 2016.
[3] Represents the median figures across all commercial banks, savings banks and savings & loan associations that filed regulatory reports for Dec. 31, 2015. Industrial banks, cooperative banks and nondepository trusts are excluded.
CD balances are based on regulatory filings.
CD = certificate of deposit; NA = not available; QOQ = quarter-over-quarter; YOY = year over year
Top-level ticker is based on the home country of the highest traded entity within the corporate structure.
Source: SNL Financial, a part of S&P Global Market Intelligence

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