FINANCIAL INTELLIGENCE from FHLBank Topeka

Beta Preparation

A sound deposit strategy yields results

Two things have remained consistent since the start of the pandemic – uncertainty and speed. As the Federal Open Market Committee (FOMC) combats inflation by rapid tightening with the historic rate increases and pace garnering greater publicity, deposit customers are beginning to seek more attractive yields.

Despite many members currently holding ample deposits/shares at a low cost and historically lagging the Federal Funds rate, the speed and amount of the rate increases is a game changer making it harder to lag rates.

If you haven't started, now is the time to prepare and develop sound deposit strategies to combat further margin compression. Based on prior rising rate environments, overall deposit betas range from 40 to 60 percent of the change in the Federal Funds rate as illustrated in the graph below.

As many members recall from the last cycle, the increased cost of deposits often lags when rates fall as it takes time to lower the

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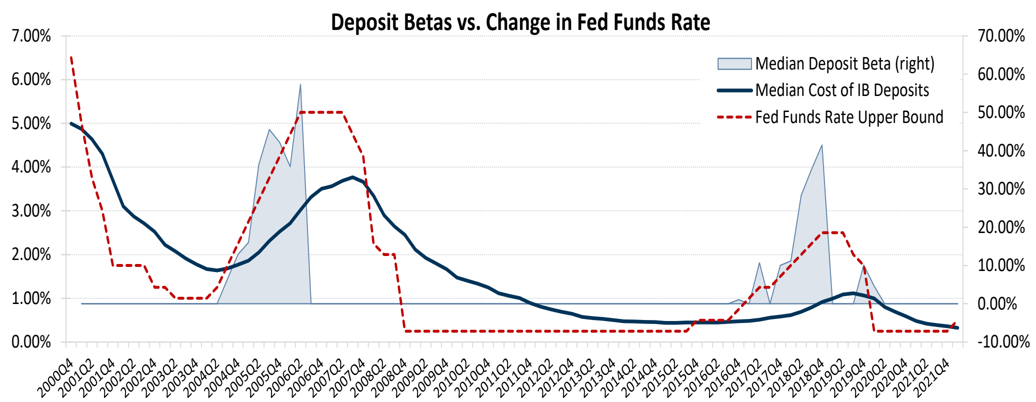

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cost of higher rate certificates of deposit added to the balance sheet, which can cause margin pressure for member institutions.

To help better manage deposit pricing, a marginal cost of funds concept can be considered as a way of focusing on the cost of adding additional funding to the balance sheet.

As inflation and other variables drain the flood of deposits from the pandemic-induced liquidity, what deposits and amounts do you want to retain? How and at what cost will you accomplish retaining or raising deposits? If your institution is lacking loan demand, will these deposits be deployed to net positive earning assets until loan demand picks up?

These are all important questions that are complicated by market differences and competitive pressures, with the financial institution down the street no longer being the only competition for deposit funding. Online financial institutions and money market funds are likely to drive your deposit pricing, especially with the increased digital adoption rate and the number of individual investors at an all-time high.

Successful strategies that have been employed by members to better manage their deposits and related funding costs include:

- Develop an understanding of the elasticity of different deposit products with an emphasis on identifying core deposits.
- Identify the most stable deposits and account types and be realistic about the amount of deposits you will attract or retain and the true costs and risks of achieving the desired result.
- Avoid overpaying for deposits and price based on the value of the overall relationship with your customers.
- Work to differentiate your institution based on your staff, products and services in a way that allows for managed, incremental increases to your deposit rates.
- When making pricing decisions, consider a blended funding strategy that includes deposits and FHLBank advance funding while also taking into account the advance funding curve.
- Consider new premium products and non-standard maturity CD offerings with entry barriers that help minimize lower rate deposits moving into higher rate products.

While FHLBank advances are likely already in your liquidity plans, backfilling deposit runoff with advances is a prudent cost savings strategy. The marginal cost of funds (MCOF) is an all-in measure to determine the impact of changing deposit rates, including promotional pricing.

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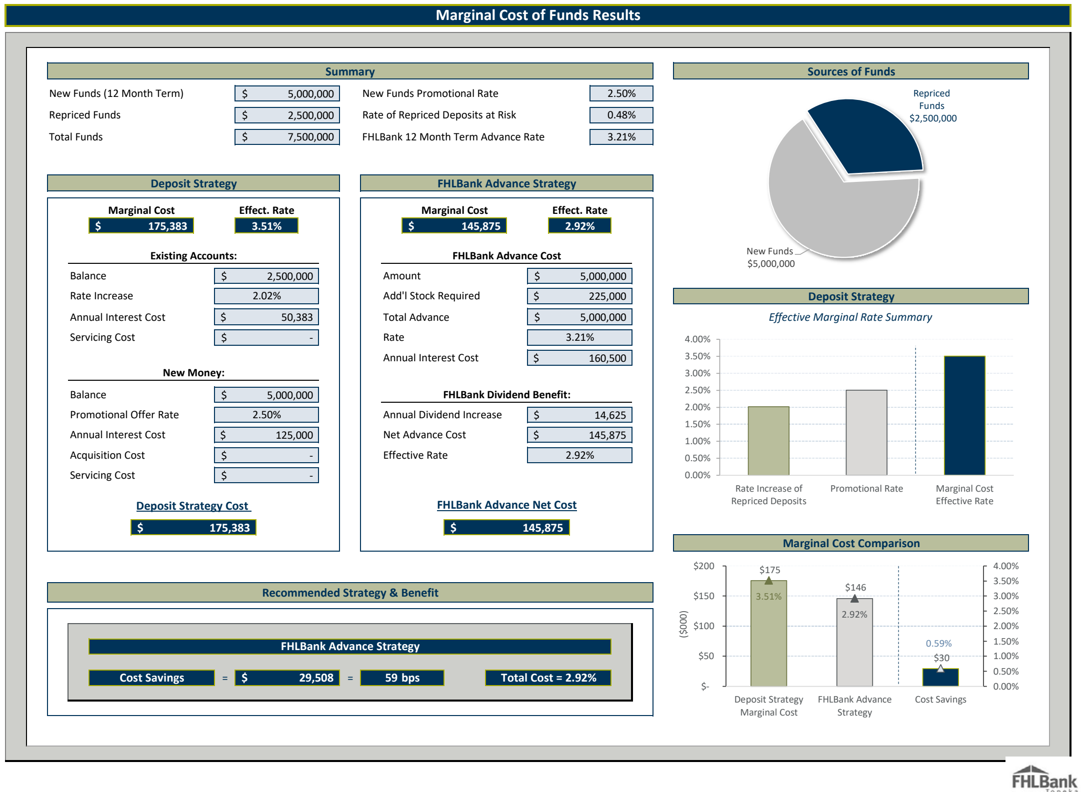

CONTACT US

Get in touch with your regional account manager to discuss deposit pricing strategies or to request a presentation of our MCOF tool to evaluate different scenarios tailored to your particular situation.

800.933.2988

The example above was generated using an FHLBank-developed tool to help you evaluate your funding options.

The illustration shows the impact of cannibalizing existing deposits into higher yielding offerings and how the cannibalized amounts increased the costs of the additional funding.

In this illustration, a member would have reduced their marginal funding cost by 59 bps by taking an advance instead of offering the CD special.

WANT TO LEARN MORE?

Visit our website for a whitepaper entitled *More 'Core' than Core Deposits,* which contains several comparisons between deposit and advance funding to guide you as you prepare for what your balance sheet will look like over the next several quarters.