



WHITE PAPER

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GETTING TO KNOW YOUR FUNDING SOURCES

Mitigating your bank's liquidity risk through a proper understanding of funding sources.

Increased competition, market uncertainty and regulatory scrutiny have left many banks scrambling to redefine their funding plan for mitigating liquidity risk. In a recent speech to the Florida Bankers Association, FDIC Chairman Sheila Bair emphasized the need for a strong liquidity plan stating, "Liquidity problems can often hit an institution fast and hard, which is why it's so important to have ample liquidity on hand and readily available."

Below are three easily executable steps that can aid in the development of an effective comprehensive funding plan for your bank.

Step 1: Identify and Plan for Risk

Determine your bank's risk profile (defined here as the volatility, sensitivity and character of your bank's deposit structure), and evaluate internal and external factors that may negatively affect liquidity and increase the cost of funds.

Key indicators include:

1. A decline in asset quality
2. A decline in earnings
3. Concentrations on both sides of the balance sheet
4. Increased risk in any area or product line
5. A decline in earnings performance or projections
6. Rapid asset growth through wholesale funding
7. Credit line deterioration
8. Shifts in depositor preference
9. Negative publicity

Step 2: Develop Reliable Funding Sources

There are numerous funding options available to banks, including funds from financial institutions, corporations, public funds, negotiable certificates of deposits, Federal Funds, FHLB advances, bank notes, brokered deposits and Federal Reserve Advances, to name a few. Once your bank has identified the possible funding options available to it, the next step is to determine what role each option will play in your bank's operating and contingency funding plan. It is critical that diversification, credit sensitivity and concentration limits be included as part of your bank's funding plan and that each funding source is activated and tested on a regular basis.

Testing sources regularly allows your bank to readily access funds as needed while eliminating surprises. Regulators look closely at bank funding policies to ensure proper controls are in place that adequately address your bank's operating environment.

Step 3: Maintain and Monitor Your Funding Sources

Two often overlooked factors that may put a bank under undue stress are the inherent risk characteristics of its funding sources and the evolving needs of those sources' underlying investors and depositors.

Gaining a comprehensive understanding of your funding sources and their relationships to their investors and depositors provides you with much needed information to understand how those deposits will respond under stress. Adverse effects to a bank's credit profile will increase the cost of funds and may limit their ability to access funding. Different depositors have different investment criteria and yield expectations.

A comprehensive understanding of these metrics will enhance the bank's ability to price and access these funding sources as well as allow a bank to develop a risk-averse operating and contingency funding plan. Below are five questions that can help your bank build a solid understanding of its funding sources.

1. Do I understand the credit sensitivity of my funding sources? (e.g., investment objectives, investment policy, credit criteria, etc.)
2. How well have my funding sources defined the credit sensitivity of potential depositors?
3. Have I identified, and do I monitor the factors that could affect my ability to access various funding sources?

4. Do I know the credit criteria my funding sources monitor as well as the implications of those criteria?
5. Do my funding sources invest based on a purely quantitative model, or are qualitative factors taken into consideration?

Developing reliable, diversified funding sources is critical to the success of your funding plan. By executing the three aforementioned steps (identify, develop and maintain), you will gain an understanding of the issues surrounding funding planning and increase your knowledge of the deposit marketplace. A well-defined plan will ultimately add value through increased earnings while providing liquidity and interest rate management.

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