CURRENT FUNDING PARADIGM:
WHOLESALE FUNDING OPTIONS & THE USE OF POLITICAL SUBDIVISIONS

By: D. James Lutter

Co-author: Todd A. Terrazas

Originally published on CUInsight.com, April 1, 2019

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A decade after the great recession, the financial institution landscape has changed greatly. At the onset of the crisis, financial institutions sought to build out diversified liquidity to even the spread of detriment. The uncertainty of the crisis, both in depth and duration, forced financial institutions to secure multiple sources of funding and borrowings that may not have been traditional pre-crisis. As a result, the industry as a whole has grown; it is more profitable and better capitalized. With the economy still in growth mode and a friendly regulatory environment, funding has moved back into the forefront of issues in 2019. Supply is becoming constrained and financial institutions have to reach beyond core markets to support loan growth and stay competitive.

The traditional model of serving customers within a local footprint continues to erode because of technology and other nonfinancial services. With continued evolution of competition and technology, there is more strain for funding, both core and wholesale. For example, there are a variety of services that require balance minimums that would otherwise be deposits at financial institutions. Typical balance minimums could range from $10-$40 depending on service, such as Uber for example, which over a broad population, can be significant. In addition, many of the larger institutions are utilizing their own listing service or portal to attract retail depositors. These portals have become user friendly and offer competitive rates. Once convinced, they can begin to sell other services. In order to stay competitive, financial institutions need to be aware of other competing sources and determine ways to offset through diversification and footprint expansion. By using technology, financial institutions can expand their footprint without the addition of brick and mortar and can offset shortfalls by leveraging the wholesale market.

Having said this, not all wholesale funding sources are the same, therefore vetting should be conducted prior to engagement. The key is to determine each source's role in the deposit process and an ongoing relationship with the depositor. The more clarity provided at the onset of engagement will help eliminate unexpected surprises during times of stress. Depending on the relationship with the depositor, the source may be influenced by how the depositor reacts in various stressed situations.

Political subdivisions can be used as a stable source of funding. Comprised of municipalities, schools, libraries, water and park districts, they are typically large depositors from within the community. Political subdivisions are depositors that often utilize money managers to help in the investment process, due to the myriad of other pressing tasks they face in serving their communities. Through a money manager, political subdivisions are often viewed as wholesale funding options. They are funded through county sales, property taxes, user fees and state and federal sources and receive funding throughout the year, and then invest it to meet obligations. Funding is repeated on an annual basis, making political subdivisions reliable and consistent sources of deposits.

There are two main challenges with political subdivision deposits. Their balances are cyclical in nature and usually require some form of collateralization. In addition, political subdivisions are usually limited by investment policy and/or state statute to low risk fixed income investments, and most require collateralization on funds in excess of insurance limitations. This is one type of wholesale funding option. An overview of other options is listed below:

- REFERRAL SERVICES – Commonly referred to as a broker's broker, typically matches advisors (money managers, trusts, escrows, etc.) or depositor with banks. These services are usually limited to no direct relationship with the end depositor. Thus, they possess limited knowledge of depositor's investment policy, deposit stability and/or the impact of stressed situations on the deposits.

- BROKER-DEALER – Underwrites DTC deliverable certificates of deposit for the issuing bank. The broker-dealer then sells shares of the certificate/issue to retail and wholesale clients. The issuing bank does not have a direct relationship with the end depositor. The certificate is held in a street account through a custodian for the benefit of the depositor. Also, the certificate can continually be bought and sold throughout the life of the term. The certificate typically cannot be redeemed prior to maturity without death or adjudication. In stressed situations, the active certificates remain stable, but new/replacement issues can become expensive and even unattainable.

- MONEY MANAGERS – A direct relationship with the depositor and the bank. The money manager possesses a good understanding of the depositor's investment policy, deposit stability and the impact of stressed situations on deposit availability. The money manager may even apply additional credit standards or concentration limits beyond that of the investment policy of the depositor.

The examples above are not inclusive, but provide a broad overview to consider. Wholesale funding can be a good complement to traditional funding, but it is critical that banks understand the source behind the deposit. Prior to participating, an operating plan/template should be constructed to outline the rules of engagement, specifically covering the various sources and types of brokered funding:

- When should wholesale funding be utilized;
- Establishment of concentration limits;
- Defining the relationship of the source to the depositor.

By utilizing wholesale funding in conjunction with technology, it will help level the competitive playing field. Pressure on core funding will continue and, through technology, one can stave off competition and even mount an offensive. In addition, wholesale funding can be layered to mitigate cyclically and offer alternative solutions. The better prepared, the greater the probability of success.

About D. James Lutter

D. James (Jim) Lutter is the Senior Vice President of Trading and Operations at PMA Financial Network and PMA Securities, where he oversees PMA Funding., a service of both companies that provides over 1,000 financial institutions with a broad array of cost effective funding alternatives. Mr. Lutter is a Registered Representative with PMA Securities and Investment Advisor Representative with Prudent Man Advisors, Inc. Mr. Lutter has the following FINRA licenses with PMA Securities: Series 7, 24, 50, 53, 63, 65 and 99.

About Todd A. Terrazas

Todd joined PMA Financial Network in 2014 as a Financial Analyst for the firm's Credit Risk Management team. He now serves as Business Development & Product Manager for PMA Funding, where he is responsible for developing financial institution partner relationships and managing funding product solutions and association affiliations. Mr. Terrazas also engages in strategic planning and identifying market trends through extensive market research. Prior to joining the firm, he was a Market Research Analyst at Common Goal Systems, Inc. Mr. Terrazas earned his Bachelor of Arts in Finance from Calvin College.