Strategic Funding Optimization: A More Proactive Balance Sheet Management Tool for ALCO

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For too long, funding has been a neglected cousin in the strategic planning process. But there are storm clouds gathering — driven by rising rates, competition and increased regulatory focus on liquidity. Going forward, banks need an enterprise-wide strategic funding optimization approach.

Banks often short-change the liability side of their balance sheets when building out their strategic plans. In the current environment, why not? Most US banks have more cheap deposits than they can deploy. This situation is rapidly waning. Wholesale market rates are on the rise and banks are likely to face more funding challenges than ever before. Competitively, the largest US national banks are capturing most organic deposit growth (in all lines of business), while direct banks are pressuring traditional pricing levers for convenient access to rate sensitive savings and CDs. Meanwhile, regulation is requiring banks to balance a wide range of liquidity, capital, and interest rate risk constraints. Banks must have better funding planning to excel in this uncharted territory.

During the sustained low-rate environment, banks could afford to be

FIGURE 1: The State of Strategic Planning

Previously neglected, funding is becoming more fundamental to long-term success.

CURRENT STATE

- Determine asset growth target, which leads to required funding growth
- Set funding targets at the business unit level, often using rough "back of the envelope" allocations
- Ask each business to minimize short-term marginal cost of funds
- Manage to other constraints (e.g., liquidity) centrally in Treasury as the loans and deposits are booked

FUTURE STATE

- Build the asset plan and the liability plan simultaneously
- Set funding targets at granular business unit and product levels, including all relevant deposit characteristics
- Minimize all-in cost of funds across multiple time horizons and scenarios
- Proactively identify and plan for implications on a range of scenarios, constraints, and goals
- Re-assess performance against strategies as the year progresses

Source: Novantas

complacent about funding. Funding plans tended to be simplistic, with funding goals allocated to businesses using ad hoc budgeting analysis and relying on minimizing short-term cost of funds within the businesses. Now, leading institutions have begun leveraging advanced deposit analytics to create more nuanced funding plans at the customer segment level (Figure 1). These plans consider the full range of balance sheet constraints and do so across longer horizons and more diverse scenarios. The result is a strategic optimization of the liability side of the balance sheet. These banks are already seeing benefits to both cost of funds and net interest margin (NIM), thanks to rebalanced liquidity profiles. These benefits will only grow as wholesale market rates rise.

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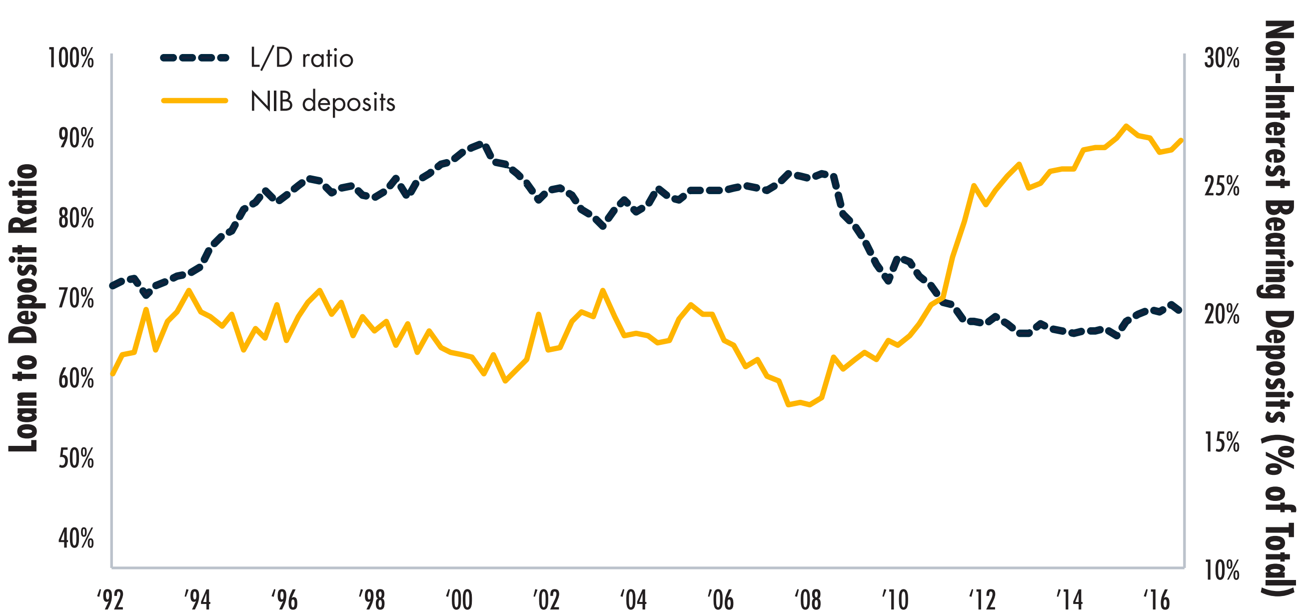
At their hearts, banks used to be asset-focused enterprises, meaning loan production was the driving force in planning. Even today, most strategic planning starts each Fall with the question "How much are we looking to grow next year?", with the implication being growth in assets. This question gets answered across the organization, the results are added together, and only then does the liability side of the balance sheet get introduced into the planning process.

Once the target has been set, businesses get allocated a portion of the funding goal and are asked to achieve it as cheaply as possible. They are given leeway to find the deposits however they can (occasionally with some high-level directives from Treasury). This leads to a bundle of deposits with a range of attributes from flighty high-yield savings, to relationship-based checking accounts, to locked-in term deposits. A well-crafted funds transfer pricing (FTP) methodology can help direct businesses to balance sheet-friendly funds (sticky, low-beta, regulator-encouraged), but ultimately the businesses pass the baton back to Treasury to assemble a balance sheet with the desired interest rate risk and liquidity positions.

Given recent rate history, this planning process has not been especially problematic. The unprecedented "low forever" rate environment gave rise to an equally unprecedented period of deposit excess (Figure 2). In the years after 2011 — when wholesale market rates fully bottomed out — loan to deposit ratios across US banks reached a new low of 69%. And the low rate environment inspired apathy in customers' deposit decisions as well, leading non-interest bearing products to grow to 25% of all deposits. (At the bot-

FIGURE 2: Impact of Sustained Low Rates on Funding Behaviors

Rate apathy has led to stockpiles of cheap deposits.



Source: FDIC Quarterly Banking Profile

tom of the last rate cycle, this figure was 19%.) In this environment, banks have been able to survive on relatively simple and straight-forward funding plans.

But fundamental shifts in the industry, driven by the hastening rising rate environment, are making simplistic funding plans untenable. The stickiness of newly found "core" deposits will be tested and some banks will be painfully disappointed. If the non-interest bearing deposit mix returns to pre-2011 levels (19% of total deposits), banks can expect a quarter of these deposits to move into rate paying or non-deposit alternatives. The funds that remain in deposits will be subject to increased competition from direct banks, which have proven they can pull hot money and even relationships from traditional brick-and-mortar franchises as consumer sentiments trend ever more digital. On top of these funding pressures, banks bear the weight of heightened regulatory scrutiny in the post-crisis environment: new interest rate risk, liquidity, and resolution/recovery planning regulations pile additional constraints on top of existing economic and strategic considerations. Unfortunately, competing constraints often send different signals, making Treasury's job of assembling the balance sheet exceedingly complicated.

Many of the challenges of current funding plans are attributable to the singular focus on near-term cost of funds. While obviously a key component of a bank's profitability, it is too dominant in a more broadly optimized funding plan. Because banks are not actively planning around other funding constraints, Treasury must optimize on these other constraints reactively as funding arrives. This reactive position increases focus on short-term funding levers and "flavor of the day" tactics. Longer term, higher value long-term funding levers are left in the lurch as the plans rarely provide the time to allow slower moving relationship-driven funding to be built and maintained (e.g., commercial operating funds).

Say Business XYZ gathers its next billion in deposits, and does it with minimal impact to near-term interest expense. Job well done. Treasury, on the other hand, is worried about more than just the interest expense of the deposits. Depending on the deposits acquired, Treasury now must consider mitigating the new LCR outflows through the securities portfolio, rebalancing key rate durations, and hedging the interest rate risk. Each of these actions could incur additional costs, costs that were not considered when the deposits were being acquired. In our evolving environment, this ex post management can cause substantial harm to the bank's balance sheet.

"A bank cannot let the liability side of the balance sheet "happen" — it must proactively plan and be prepared for a range of potential scenarios."

Current enterprise funding plans also lack the granularity to optimize effectively across businesses. Broad targets make it difficult to capture the tradeoffs between products overall and their marginal volume. The first incremental $100 million in funding might be cheapest in retail MMDA, but what about the next $100 million? Determining where to draw these lines is challenging with blunt enterprise funding plans. These tradeoffs only become more complicated as constraints such as liquidity and interest rate risk are factored in to cross-business and cross-product decisions. It may be cheaper to acquire the next $100 million from commercial, but what knock-on effects will the higher outflow deposits have on LCR and what will it mean for investment yields if the bank has to rebalance high-quality liquid assets?

Few banks currently have the capabilities to make these decisions efficiently and effectively. As external pressures grow, enterprise funding planning will become increasingly necessary to build strong NIM and shareholder value. Banks that master these skills will realize substantial advantages in a more dynamic macroeconomic, wholesale market rate, and competitive environment.

To rise to this challenge, banks need to change the way they think about enterprise funding planning. This requires an evolution of the enterprise funding framework as well as the development of the appropriate analytic tools to perform strategic funding optimization in support of the new framework.

The basis of strategic funding optimization is an expansion of the scope of the business-specific funding optimization problem. A top-tier enterprise funding framework considers:

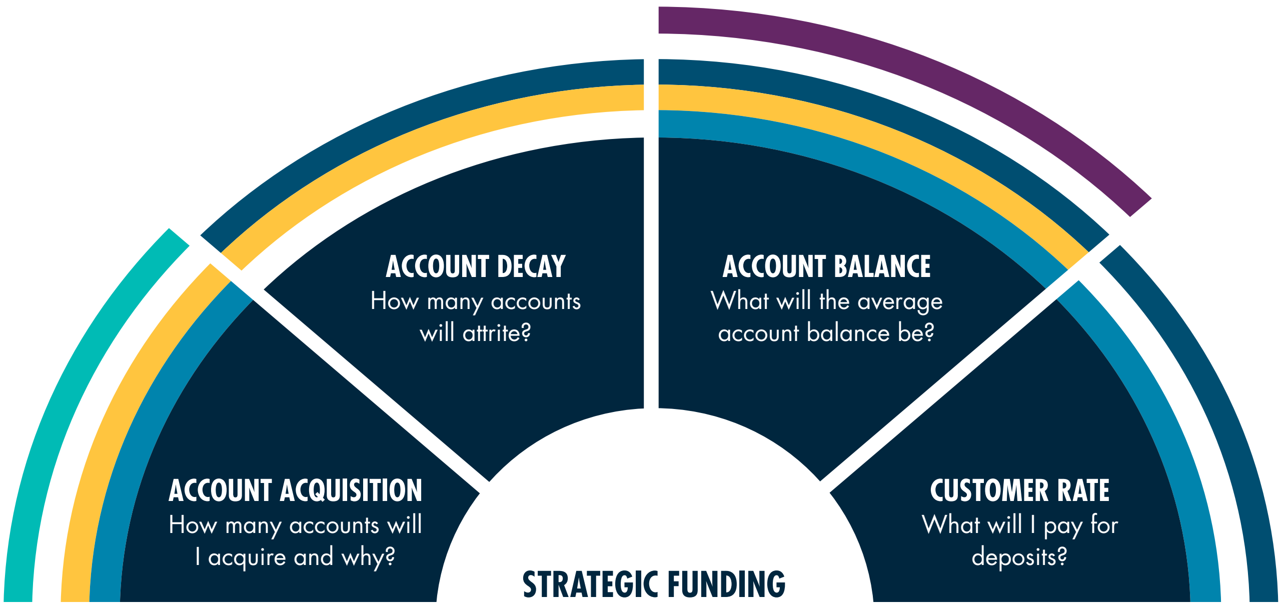
- The various constraints the bank faces, not just marginal cost of funds. This includes management targets (core funding ratios and segment concentration limits), economic constraints (interest rate and basis risk), and regulatory requirements (LCR and NSFR)
- The evolution of the bank's position relative to these constraints over both a short term (≤1 year) and long term horizon (3–5 years)
- A range of different potential scenarios including macroeconomics, wholesale market rates, and competitive dynamics.

These new dimensions of planning allow the bank to see the true impact of enterprise funding decisions. The bank is no longer just answering the question "How much will it cost me to grow funding by $X billion over the next 12 months?" It will also address how that funding will impact the bank's rate sensitivity, what position it will leave the bank in 2 years' time, and what impact that strategy will have if rates stay low for another 6 months. This requires shifting ALCO's mindset and harnessing deposit analytics to support it.

The key analytic underpinning of this effort is the ability to estimate the impact of strategic, competitive, and macroeconomic changes on deposit

FIGURE 3: Key Analytics for Strategic Funding Optimization

Understanding deposit behavior in different environments unlocks deeper strategic planning insights and options.



Typical Sources

Pricing Model | Stress Testing (CCAR/DFAST) | ALM Model | Marketing Analysis | Strategic Planning

Source: Novantas

balances and rates. Many of these analytics are in place throughout the bank; unfortunately, they are rarely leveraged for enterprise funding planning. The first step is to inventory what exists already at the bank. Novantas sees four primary components to estimating deposit behaviors (Figure 3).

Ideally, these analytics would be integrated through an existing system. However, existing software rarely has the flexibility to quickly and intuitively run strategic scenarios. In working closely with banks, Novantas has helped banks deploy a top-level tool that can aggregate these analytics and provide real-time results in various scenarios for an array of strategic decisions and initiatives.

These tools reside at the front end of the funding planning process to provide early directional input to ALCO. While the results are less precise and granular than what is provided by full instrument-level ALM cash flow projection software, they are streamlined and flexible to allow for rapid iteration of strategic options, which is difficult to achieve in ALM software. Products are aggregated for simplicity, while maintaining sufficient granularity to compare the differences across major product groupings and customer segments to optimize across meaningful dimensions. The tool accepts assumptions on the characteristics of deposit categories (e.g., LCR outflows, interest rate sensitivity) to provide a simple means of comparing across a myriad of constraints and scenarios.

As banks look forward to the rising rate environment and the projected return of stronger yields, it bears reminding that NIM often gets worse before it gets better. Typically, loan books have been slower to adjust to new rates, while liabilities reprice more rapidly. Industry-wide betas for the first rate rises have been low, but historically these catch up in the second 100 bps of a rising rate environment. Purportedly, this cycle will be different, with rates having been lower for longer and banks starved for improved NIM. But different banks will require different disciplines on deposit rates. Banks that are still funding myopically will be forced to accept higher cost deposits and liquidity positions. Perhaps for the first time, the winners of the next cycle will be determined by excellence in liability management rather than asset gathering. ■

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