The New Value of Public Funds

Over the last year, a confluence of regulatory changes and market factors has substantially altered the dynamic of bank funding, which has, in turn, increased the attractiveness of public funds for community banks.

It’s likely that, over the next few years, deposits from governmental entities may become an increasingly essential and accessible source of funding for community banks.

Here’s why:

The Basel III Liquidity Coverage Ratio is Pushing Public Funds out of Bigger Banks

The 36 largest banks in the country, those with more than $50 billion in assets, currently hold the majority of the public fund deposits in the U.S.—more than $265 billion as of the end of the fourth quarter of 2014, according to the FDIC.

In September 2014, U.S. bank regulators implemented a final rule that established a baseline liquidity requirement called the Liquidity Coverage Ratio (LCR). The new rule applies to banks

Bank Deposits from U.S. Governmental Entities by Bank Asset Size

Source: FDIC Statistics on Depository Institutions, 12/31/2015

<table>
<thead>
<tr>
<th>Bank Asset Size</th>
<th>Percentage</th>
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</thead>
<tbody>
<tr>
<td>Less than $100M</td>
<td>1.7%</td>
</tr>
<tr>
<td>$100M-$1B</td>
<td>16.5%</td>
</tr>
<tr>
<td>$1B-$10B</td>
<td>18.7%</td>
</tr>
<tr>
<td>$10B-$50B</td>
<td>51.8%</td>
</tr>
<tr>
<td>Greater than $50B</td>
<td>11.3%</td>
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with over $50 billion in assets and, in simple terms, requires these banks to hold an amount of High Quality Liquid Assets (HQLA) equal to or greater than the outflow of deposits that may occur during a 30-day period of stress. To calculate this deposit run-off, regulators determined run-off rates for different types of deposits. The run-off rate for retail deposits can be as low as 3%, financial institution money is 100%, and public funds are generally 40%.

This new rule has forced large banks to reconsider how they value different customer segments. Regarding public funds, when banks consider the 40% run-off rate with the requirement in almost every state to collateralize these deposits, it is not surprising that many large banks are lowering the returns they offer on public funds or, in some instances, informing public entities that they are not interested in their deposits. Simply put, public deposits have become far less attractive for large banks, and could become less expensive for community banks not affected by LCR.

But that’s just one factor changing the value of public funds for community banks.

Changes to Money Market Fund Rules Are Limiting Deposit Options for Public Funds

As public fund deposits start to move from the largest banks, there are limited places for them to go, and options are becoming more limited with recent changes in rules governing money market mutual funds (MMFs), which were adopted by the SEC in July of last year.

According to the new rules, by the middle of 2016, prime MMFs will have to change how they calculate their net asset value (NAV), so the NAV will float rather than stay fixed at $1/share. This change will add a new level of risk to an investment channel that has typically been seen as stable and liquid.

The general consensus is that the new rules will also apply to local government investment pools (LGIPs), which act essentially as MMFs for public fund depositors. Many of these LGIPs have historically paid competitive yields, and banks have often been forced to match the LGIP rate in their state if they want to win public deposits.

To remain a viable channel for public funds, it is likely that many of these LGIPs will move away from being characterized as prime funds with a floating NAV to operating as government funds that invest only in government securities but have a stable NAV. This change has already started to occur with many LGIPs, and the continued trend may force LGIP yields down even lower.

These changes, taken together with a likely decrease in public funds at large banks, could make a substantial amount of public funds deposit balances available to community banks, with less emphasis on rates.

The Timing May Be Right for Community Banks

Community banks have traditionally met the majority of their funding needs through retail and corporate deposits, but those deposits are becoming more competitive. This increase in competition is partially caused by growing loan demand, but it is also the result of regulation changes. Another effect of new LCR rules is that even as they make public funds less desirable to large banks, they substantially increase the value of retail deposits, pushing big banks to value the latter more highly.
In Promontory’s Bank Executive Business Outlook Survey for the first quarter of 2015, more than 65% of community banks expect competition for deposits to increase over the next 12 months, with the largest source of competition coming from larger banks.

At the same time, survey respondents indicated that they are still relying on their existing retail and corporate deposits to be the chief source of meeting their institution’s funding goals over the next year.

And while many of the largest banks are still liquid and unlikely to raise the rates they pay for retail deposits at this time, as rates begin to rise and loan demand continues to grow, community banks may have to start competing more aggressively to retain their own customers or risk losing them to bigger banks.

The availability of and reduced competition for public funds may provide some relief to community banks.

A Potential Win-Win

The new value of public funds could benefit communities, as well as community banks. Community banks have typically been the leading source of small business lending in the U.S., and, as more deposits from federal, city, state, and local governments are funneled into community banks, the rise in liquidity at community banks could increase the funds available for local lending.

To grab hold of this potential opportunity, community banks may want to revise their vision of public deposits. What has often been looked at as a mixed blessing may be the key to community banks thriving.

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