In the mature phases of a rate hike cycle, several conditions for banks tend to consistently appear. Those conditions include narrow margins (compliments of the flat yield curve) and low liquidity, the latter of which has historically been blamed on a number of unrelated factors, such as:

- **Disintermediation.** An expanding economy will usually create improved corporate profits, which translate into high share prices, which lure small investors into the stock market just as overall indices are peaking. These small investors typically have a balance sheet that includes financial institution deposits, some of which can be converted to cash and used to dabble in stocks.

- **Increased lending.** If Americans’ comfort level with record household debt weren’t enough, corporate America also seems to have gotten the message. The terms “leverage” and “return on equity” have become common terms in describing business models and corporate strategy. The engine powering these models is, of course, debt. As economies expand during a rate hike cycle, so does borrowing, most of which is supplied by banks.

- **Less cash flow from investments.** From the perspective of bank portfolio managers and the broker/dealer community, the most visible cause of liquidity shrinkage is the near stoppage of cash flow from a bank’s bond portfolio. The two root causes: Callables don’t get called, and bonds with “imbedded options” like mortgage-backed securities have a slowdown in prepayment activity.

  Fact: Fannie Mae alone averaged calling nearly $16 billion in bonds per month in 2003. In 2005, only about $3 billion per month was called. Some of the bonds not called were callable one time only (a European option), so they are now certain to remain on the books until maturity. Similarly, using data supplied by the Mortgage Bankers Association, about one-fourth the number of mortgage refi applications was received in the first quarter of 2006 compared with a similar period in 2004.

**Sector Shifts**

Regulators have a keen interest in satisfying themselves that banks are adequately managing the mix of deposits. After all, a liquidity policy run amok can have serious negative consequences for profits (and thereby capital) as well as asset/liability exposure. Chart I on page 87 highlights funding trends over the last several years, namely...
fewer dollars in “traditional” deposits, and greater reliance on brokered deposits and Federal Home Loan Bank advances. Regulators by and large have become more comfortable with these trends as bankers have become better at documenting their management.

One product that has seen a consistent weighting drop is certificates of deposit. This may be a temporary decline, as some dollars may have shifted into more liquid products (for example MMDAs) at the bottom of the rate cycle in 2003 and 2004. Other arguments for this drop have usually centered on the notion that most CD owners are individuals above median age. As they die or turn their financial affairs over to others, the CDs are not rolled over, but instead are placed in some type of money market account, or more likely, another vehicle that is non-bank related entirely.

Interestingly, jumbo CDs have seen a noticeable jump in the last four years. The most logical factor accounting for this shift is inflation, coupled with a general aging of the population. It had been argued for years that the $100,000 limit for FDIC insurance, which had been in effect since 1980, was no longer adequate inasmuch as core Personal Consumption Expenditures had risen 212 percent in the last 25 years. A new act signed into law Feb. 8, 2006, may help return a bank’s funding strategy to a more traditional approach.

**New Era for IRAs?**

Here is a synopsis of the new FDIC insurance coverage rules:

- Many retirement accounts, including traditional and Roth IRAs, have a $250,000 limit, effective April 1, 2006.
- Employee-sponsored plans

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### Chart I

**Core versus Non-Core Funding Sources**

**FDIC-Supervised Banks with < $1B Assets**

(Monetary figures in millions)

<table>
<thead>
<tr>
<th></th>
<th>12/31/99</th>
<th>12/31/01</th>
<th>12/31/01 Sector Weighings</th>
<th>9/30/03</th>
<th>9/30/05</th>
<th>9/30/05 Sector Weighings</th>
</tr>
</thead>
<tbody>
<tr>
<td>DDAs</td>
<td>$68,857</td>
<td>$72,477</td>
<td>10.97%</td>
<td>$77,382</td>
<td>$84,749</td>
<td>10.76%</td>
</tr>
<tr>
<td>NOW Accounts</td>
<td>57,269</td>
<td>61,301</td>
<td>9.28</td>
<td>65,184</td>
<td>63,878</td>
<td>8.11</td>
</tr>
<tr>
<td>Savings Accounts</td>
<td>63,494</td>
<td>68,560</td>
<td>10.38</td>
<td>86,324</td>
<td>93,458</td>
<td>11.87</td>
</tr>
<tr>
<td>MMDAs</td>
<td>75,202</td>
<td>90,270</td>
<td>13.67</td>
<td>108,155</td>
<td>109,886</td>
<td>13.96</td>
</tr>
<tr>
<td>CDs&lt;$100M</td>
<td>184,608</td>
<td>187,453</td>
<td>28.38</td>
<td>175,983</td>
<td>174,521</td>
<td>22.17</td>
</tr>
<tr>
<td><strong>Core Funding Total</strong></td>
<td>$449,430</td>
<td>$480,061</td>
<td>72.69%</td>
<td>$513,028</td>
<td>$526,492</td>
<td>66.87%</td>
</tr>
<tr>
<td>CDs &gt;$100M</td>
<td>$74,044</td>
<td>$88,148</td>
<td>13.35%</td>
<td>$94,248</td>
<td>$121,625</td>
<td>15.45%</td>
</tr>
<tr>
<td>Brokers Deposits</td>
<td>6,314</td>
<td>8,937</td>
<td>1.35</td>
<td>14,129</td>
<td>28,620</td>
<td>3.62</td>
</tr>
<tr>
<td>Foreign Deposits</td>
<td>898</td>
<td>1,066</td>
<td>0.16</td>
<td>951</td>
<td>1,426</td>
<td>0.18</td>
</tr>
<tr>
<td>FHLB Advances</td>
<td>31,565</td>
<td>33,302</td>
<td>5.04</td>
<td>39,432</td>
<td>46,318</td>
<td>5.88</td>
</tr>
<tr>
<td>Other Borrowings</td>
<td>45,906</td>
<td>48,891</td>
<td>7.40</td>
<td>53,951</td>
<td>62,906</td>
<td>7.99</td>
</tr>
<tr>
<td><strong>Non-core Funding Total</strong></td>
<td>$158,727</td>
<td>$180,344</td>
<td>27.31%</td>
<td>$202,711</td>
<td>$260,795</td>
<td>33.13%</td>
</tr>
<tr>
<td><strong>Total Funding</strong></td>
<td>$608,157</td>
<td>$660,405</td>
<td>100.00%</td>
<td>$715,739</td>
<td>$787,287</td>
<td>100.00%</td>
</tr>
</tbody>
</table>

*Source: FDIC Call Report Data*
Regulators have a keen interest in satisfying themselves that banks are adequately managing their mix of deposits.

and 401(k) plans also have the $250,000 limit.

• Other non-retirement accounts still have a $100,000 limit per depositor.

• Insurance limits can be adjusted upwards every five years starting in 2011, based on set of factors including inflation.

The upshot from the new law remains to be seen, but it is at least plausible to consider an increase in some other deposit products, unrelated to retirement balances. The $100,000 insured limit will apply to all other accounts in aggregate, in addition to the $250,000 for retirement accounts.

Portfolio Implications

This is potentially good news for insured depositors and deposit-gatherers. If the supply of CDs is able to grow even marginally (thanks to the new rules) balance sheets will see more stability in their liability profile than they have in a long while. Since CDs have historically been a cheaper source of borrowing than have FHLB advances, this could spell enhanced profit margins.

Also, if the advance needs are somewhat curtailed, so too will be the gymnastics of finding pledgeable collateral. Taking this one step further, if collateral needs are diminished securities that aren’t currently pledgeable but are otherwise attractive may find a larger role in the portfolio. Examples of these are municipal securities, corporates or private-label mortgage-backed securities.

Managing the Mix

If, and when, the liability make-up begins to evolve, portfolio managers need to be mindful of the interest rate risk implications. ICBA Securities has several tools that can help quantify a bank’s exposure to changing rates, including:

• A Liquidity Kit, which includes a liquidity policy template in Word format, as well as directors’ training and an FDIC PowerPoint presentation regarding funding issues;

• An asset/liability policy template in Word format available by registering on icbasecurities.com;

• A complimentary calculation of your earnings at risk, using ICBA Securities’ proprietary Earnings Change Ratio model included in the popular Performance Profile;

• Full-service asset/liability management available through the Risk Manager program. This is appropriate for banks with assets roughly between $200 million to $1 billion.

Contact your ICBA Securities sales representative or call (800) 422-6442 to inquire about any of these services.

Jim Reber is president and CEO of ICBA Securities, a broker-dealer in Memphis and a member of NASD and SIPC. Reach him at jreber@icbasecurities.com.