THE SAFETY OF PUBLIC DEPOSITS FLOATING AROUND

by [Steve Brown]

Community banks are a vital part of the business life in the communities they serve. Besides providing services to meet the banking needs of individuals and businesses, bank staff can often be found participating in civic functions and volunteering with non-profit organizations. This kind of work develops long-lasting friendships and networking opportunities for the bank. One question that often comes from this context is how best to work with public deposits. These deposits may be from a city or county and generally are of larger size. It can give prestige to the bank to be a partner with the town, but when deposits are plentiful it can also be damaging.

The question is whether these deposit relationships are profitable. Most banks are quite liquid right now, so gathering large deposits generally is less a priority than other times. But times change and banks know that it may not always be as easy to hold onto deposits as it is right now. So what should banks consider when weighing the costs vs. the opportunities and benefits of holding large public deposits?

In our opinion, one of the biggest considerations is the interest rate on that deposit. If there is bidding war over the rate, then chances are that unless your bank really needs deposits to fund loans, this will not be a profitable relationship. A competitive rate environment means even if you win, most likely the deposit will be in your bank for a limited amount of time. Banks always have a range of funding choices and the costs associated with each should be carefully analyzed. If in lieu of the public deposit, your bank is considering a CD rate special or a similar tactic that will teach your core customers to be more interest rate sensitive than they already are, then it may be best to go for the public deposit.

The best case scenario for a public deposit is when the interest rate is inexpensive and low enough that it does not raise your overall cost of funds. The deposit should be stable and basically act like a core deposit if it is to add value. The deposit should not be of a size that the bank becomes overly dependent upon it when compared to its other funding sources.

Collateral requirements are another important consideration. Securities could either be purchased outright or allocated from existing holdings to back the deposit. Many banks right now may say: oh well our securities portfolio is larger than normal anyway, so we may as well use some of those assets to win the relationship. It is a good point, but you might also consider the loss of flexibility and interest rate risk associated with holding securities right now. If the deposit goes away to a competitor, the bank will still have securities in its portfolio and these days the yields are in the 1.0% range so they don't make sense as a stand alone asset to hold (regardless of funding).

Public deposits can be good or they can be bad, depending on what you need and the impact to the bank and the perception in the community. Start by ascertaining what the bank wants to use these deposits for so there is a clear goal and be sure to price everything in before bidding occurs. When structured correctly, public deposits can add diversification and provide stability to the deposit base of the bank, so that can be good. They can also create goodwill in the bank's market which is also good. The answer isn't as easy as it seems because of the deep connections community bankers have with their community, but the best way to proceed is to do your best, as you weigh your fiduciary responsibility to your shareholders first and foremost.

BANK NEWS

Q1 Industry

The FDIC reported banks and savings institutions earned $40.3B in Q1 (a record), 90% of institutions had positive net income in Q1; loan loss provisions fell 23% from a year ago (lowest since 2007); charge-offs declined 27% from a year earlier; NIM fell 24bp from a year ago (about 7%) to 3.27% (lowest since 2006); loan balances declined 0.5%; and problem banks fell 6% from the prior quarter to 612, the 8th straight drop.

Reserves

The latest data from the FDIC finds institutions with assets <$1B had a loan loss allowance to loan ratio of about 1.78% as of Q1. How does your bank compare?

Delayed

The CFPB has delayed the effective date of the credit insurance provision of the loan originator compensation rule until Jan. 10, 2014 (originally scheduled to take effect Jun 1, 2013).

No More Liberty

Federal prosecutors have arrested the principals at Liberty Reserve, a network that charged a 1% fee for transactions to convert currency into virtual funds and then back into currency. Prosecutors say this money laundering scheme is the largest in US history at $6B, involved 1 million users and 55 million illegal transactions.

Auto Lending

Equifax reports a rebounding consumer appetite has helped push sales of new cars and trucks to a 5Y high as of Q1, increased balances on outstanding auto loans 8% YOY (a 4Y+ high) and raised the total number of loans to nearly 60mm (a 4Y high).

Changing Behavior

A study by Cisco finds 69% of US consumers want a more simplified banking experience; 63% are comfortable texting, emailing or using video when banking; 63% are willing to get expert help using virtual tools; and 48% are comfortable closing a loan virtually.