Total Bank Solutions - Insights

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Even as market dynamics impacting banks' capacity to onboard additional deposits remain a challenge and the interest rate environment has put downward pressure on pricing, the TBS Insured Deposit Program (IDP) continues to offer a competitive pricing advantage over money market mutual funds (MMFs).

On the regulatory front, the FDIC's brokered deposit ruling which went into effect on April 1 has significant implications for participants in insured cash sweep programs, as outlined below.

Market Forces Impacting TBS' Insured Deposit Program (IDP) Pricing and Capacity

Systemic Liquidity

In the current environment scarcity of bank capacity to take on additional deposits remains the single most significant challenge for broker dealers and wealth managers seeking to place balances in depository institutions at competitive rates. The pandemic-driven macroeconomic fallout and attendant low interest rate environment continue to create record-breaking excess liquidity across the banking industry. This has resulted in banks dramatically lowering their wholesale borrowings (including IDP) and the rates they are willing to pay on such funding.

According to the FDIC, loan growth in 2020 was $232 billion, versus $3.3 trillion in deposit growth. As a result, the Q4 Loans/Deposits – a primary measure of bank liquidity – was approximately 60% systemically, representing the lowest-ever level on record. This implies that approximately 40% of banks' deposits are funding very low-yielding assets, or earning only 10 bps on excess reserves. This compares to an historical average systemic Loans/Deposits ratio in excess of 80% (See chart below).

Loans and leases at the nation's 25 largest banks continue to account for less than half of their balance sheets assets. Meanwhile, cash, Treasuries and other securities effectively guaranteed by the federal government now make up more than 35% of the combined balance sheet assets of these U.S. banks, the highest level since 1985.

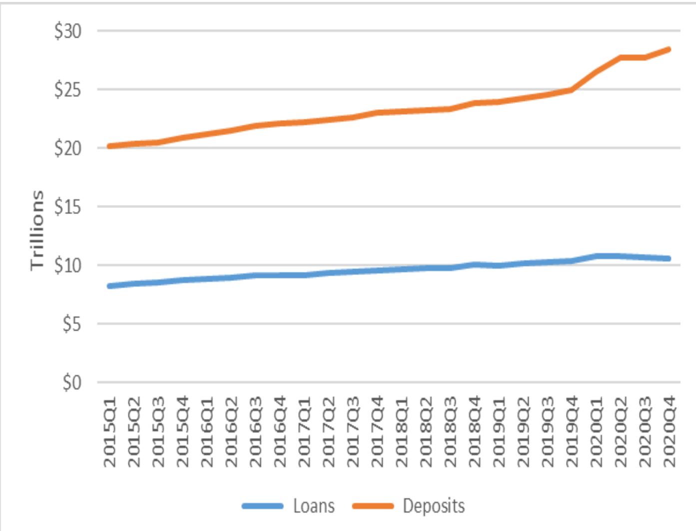
The pandemic's impact on the economy is at the heart of this issue with consumer spending and bank lending slowing to a crawl. The Federal Reserve Bank of NY reported that 35% of all pandemic-driven stimulus monies sit idly in consumers' checking accounts. This further exacerbates banks' ability to accommodate additional funding, as they seek to manage targeted total asset levels and attendant capital ratios.

When combined with the near-zero rate environment, the aforementioned issues have resulted in banks' net interest margins (NIMs) remaining at an all-time low of 2.68%. Banks have responded with aggressive liability management actions. This involves replacing higher costing sources of wholesale funding with more lower-priced alternatives and, where applicable, the de-levering of their balance sheets.

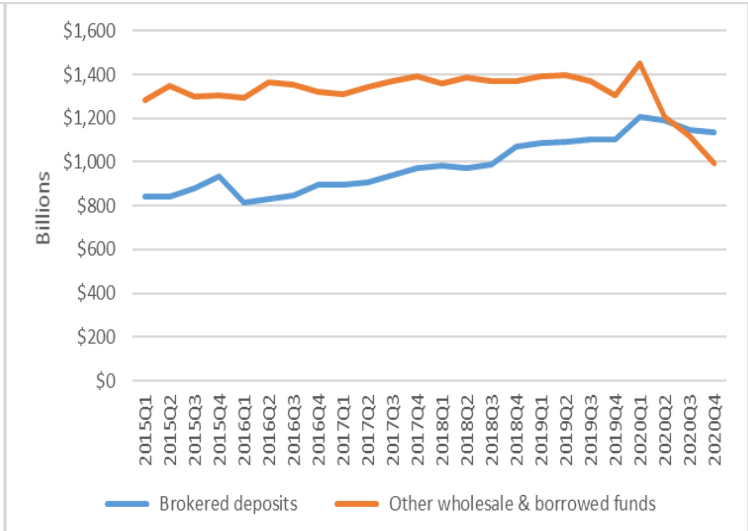
Looking forward, American Banker reports that a number of the nation's largest banks are anticipating a robust recovery in commercial lending in late Q4 or Q1. This will be instrumental towards right-sizing banks' balance sheets, setting the stage for an eventual return to pre-pandemic levels of demand for funding.

Despite these headwinds, brokered deposit balances performed favorably versus other sources of banks' wholesale funding options. In 2020, brokered deposits declined by only $11.Billion (1.0%), versus $124 Billion (9.5%) for FHLB advances, fed funds purchased, repurchase agreements, and other borrowed money (see graph below).

This is largely attributable to brokered deposits' average cost advantage, lack of collateral requirements, zero marketing costs, and operational ease of use.



U.S. Banks: Loans vs Deposits 2015-2020



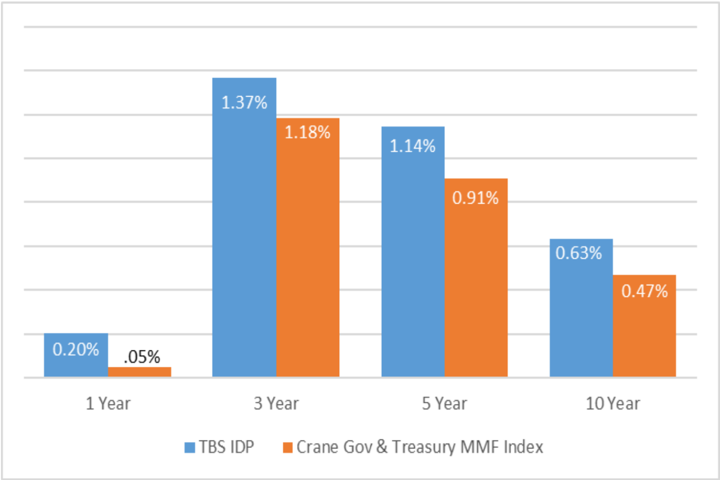
U.S. Banks: Brokered Deposits vs Other Wholesale Funds 2015-2020

Interest Rate Environment & IDP Performance

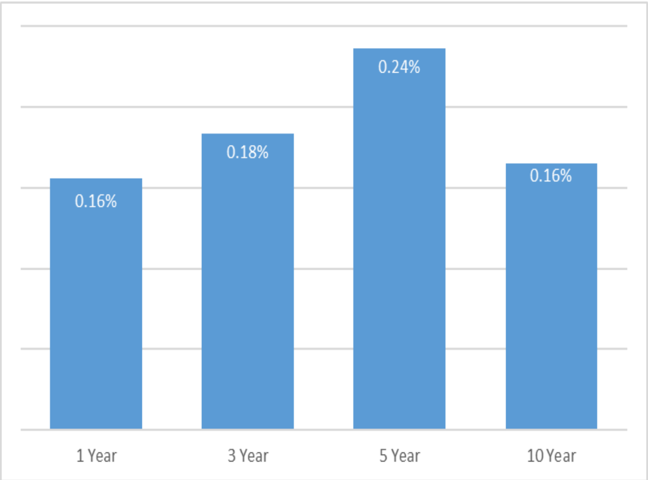
The effective fed funds rate (EFF) has dipped further, to .06%, due to excess systemic liquidity. Currently there is no firm timeline for when this will revert to higher levels. There is mounting speculation that the Fed may increase IOER and overnight repo should the EFF rate decline further. This would provide parallel support to EFF and other short-term rates that are inching closer to zero.

Despite these pressures on pricing and capacity, TBS's Insured Deposit Program (IDP) continues to maintain its strong competitive advantage over money market fund yields, with rates on new capacity that are significantly higher than MMFs (see graphs below). Spreads on legacy capacity are significantly higher, allowing IDP to offer a competitive pricing advantage of 14-16 bps higher than MMFs.

MMFs have been forced to manage down their expense ratios in an effort to provide even .01% and .02% yields. At the start of the pandemic, the expense ratio on the TBS-Tracked Gov/Trsy MMF index were .168%. As of today, that expense ratio is .08%.



TBS IDP vs Gov't & Treasury MMFs



TBS IDP spread vs MMFs

All performance data net of fees as of 4/30/21. The Crane Gov & Treasury Index is a 50%-50% blended average of the first tier Crane US Treasury and Crane US Government Institutional MMF Indices.

TBS IDP & Bank Capacity Management

CAPACITY. TBS manages inflows and outflows by requiring that all banks set contractual target and maximum balance levels. This allows for the accommodation of unexpected surges and/or withdrawals. In addition, TBS seeks to maintain a capacity pipeline and will accelerate the onboarding of these banks as needed. TBS can also accommodate waterfall allocation and hybrid waterfall/distance to target allocation methodologies.

PRICING. Given the aforementioned challenges faced by the excess liquidity across the banking system, pricing on new capacity remains well below the pre-pandemic spreads of 25-35 bps over the effective fed funds. Such pricing and placement is evaluated on a bank-by-bank basis, taking into consideration the accretive or dilutive impact on a given program's weighted average gross bank rate. While a number of program banks have priced their balances lower, there remains a significant level of legacy balances at competitive rates that continue to provide competitive returns overall.

TBS effectively utilizes its anchor bank strategy, whereby large depository institutions paying higher rates will take sizeable tranches that serve to maintain competitive program rates.

Using our proprietary Bank Monitor© risk assessment platform, TBS monitors the safety and soundness of all banks on an ongoing basis and will make the necessary recommendations should a bank begin to display heightened levels of counterparty risk. Bank Monitor's© robust early warning indicators have resulted in TBS never experiencing a failure of a program bank.

Market Projections

The distribution and efficacy of the COVID vaccines is expected to play a major role in determining when the economic recovery will gain steam and the magnitude by which the attendant growth will occur. Banks are currently forecasting the beginnings of a reversion to normative lending activity by late Q4 2021 or early 2022, depending on how quickly “herd immunity” will be realized.

While it is anticipated that demand for funding will begin to increase as the aforementioned economic rebound and lending growth occur, the rates banks will be willing to pay for wholesale funding will not likely return to pre-pandemic levels until 2-3 quarters thereafter.

The FOMC continues to project rates remaining unchanged through 2022, with an eye towards inflation creeping above 2.0% before they will consider an increase. As of May 20, the CME futures were pricing in a 90% probability of rates remaining unchanged by December. This change from the 100% probability that existed through much of 2020 reflects growing sentiment that the economic recovery will be far more pronounced than previously anticipated. During the April 11 airing of 60 Minutes, Federal Reserve Chairman Jerome Powell echoed this sentiment, noting that he wants to see inflation at an average of 2.0%, implying that he is comfortable letting it drift above that level for a period towards reaching that average.

Once lending heats up – particularly in the commercial and industrial sectors (C&I) – banks’ balance sheets will begin rightsizing, resulting in a resumption of appetites for wholesale funding. Meanwhile, TBS expects to maintain its competitive advantage via IDP’s spread advantage over money market funds throughout the economic recovery period.

Regulatory Environment

The FDIC’s brokered deposit ruling went into effect on April 1, with the amendment to the regulation seeking to more clearly define what constitutes a “deposit broker” and, by extension, the classification of the deposits administered by such parties. *See TBS’s Resource Center on this web site for additional assistance with navigating this rule.*

While certain aspects of the rule require additional clarification from the FDIC, the outcome provides, under the appropriate circumstances, the opportunity for banks to classify these insured sweep balances as non-brokered deposits. Companies providing these funds would have to first qualify under the Primary Purpose Exception, which states that the agent or nominee’s primary purpose is not the placement of funds with depository institutions. Companies meeting this qualification would be permitted to place up to 25% of the client assets under administration (AUA) with depository institutions. This requires notification to the FDIC starting April 1st of this year. Amounts greater than 25% would require submission of a formal application to the FDIC.

Allowing banks to classify these deposits as non-brokered has a number of advantages including, but not limited to, improved balance sheet optics; lower deposit runoff assumptions; and the potential for lower FDIC assessment costs.

For the 30+ large banks required to be compliant with the Basel III Liquidity Coverage Ratio (LCR), the advantage is significant: 30-day deposit runoff rates would decrease from 25% to 10%, and perhaps as low as 3% should the deposits qualify as retail only. These LCR banks currently hold approximately 75% ($800 billion) of the $1.1 trillion of total reported brokered deposits.

The aforementioned advantages should result in a measurable increase in demand for these balances and, by extension, the rate banks are willing to pay. Of course, the excess systemic liquidity discussed above will need to dissipate before such benefits can be realized.

About TBS

TBS is a leading financial technology firm founded in 2005, with its Insured Deposit Programs (IDP) as its core business. TBS's IDP is a cash sweep service providing broker-dealers and wealth management firms with extended FDIC insurance, daily liquidity, and highly competitive yields on behalf of their clients. Participating banks are able to enjoy a stable, diversified, and cost-effective source of deposit funding. TBS currently has $82 billion in assets under administration (AUA), with 90+ institutions sweeping balances to 135 FDIC-registered banks.